CHAPTER 6

The IMF and the Euro Area Crisis: The Fiscal Dimension

GEORGE KOPITS

Introduction

At the end of the last century, a number of sovereign European IMF member states joined voluntarily in a monetary union known as the euro area within the broader European Union (EU), while maintaining essentially a decentralized fiscal policy regime. Each sovereign euro area government retained all membership obligations and rights in the IMF. Thus, from its inception through the recent crisis, euro area members have been subject to IMF surveillance both at the collective area level and at the country level. Equally, they continued to be eligible for IMF financial and technical assistance, as warranted.

This chapter evaluates the IMF's role with regard to fiscal policy in the euro area, both at the area level and in selected member countries facing vulnerabilities in their public finances, prior to and during the crisis. The evaluation draws on a review of a large number of IMF staff reports and other documents. In addition, a series of interviews was conducted with more than 50 persons, including current and former members of the IMF staff and Executive Board, staff members of the European Commission (including Eurostat), members of the European Central Bank (ECB) staff and Governing Council, and current and former government officials from France, Germany, Greece, Ireland, and Portugal.

The chapter is organized as follows. The second section provides the background for the rest of the chapter. It highlights the key fiscal issues in a common currency area, the fiscal framework that was adopted by the euro area, and fiscal developments that contributed to the crisis. The third section examines IMF surveillance of fiscal policymaking over a broad range of issues: advice on the fiscal framework and policy stance; macro-fiscal projections; and assessments of transparency, public debt sustainability, and fiscal risks. The fourth section evaluates the design and implementation of fiscal policy in IMF-supported stabilization programs in Greece, Ireland, and Portugal. The evaluation covers financial support, qualitative and quantitative elements of the fiscal adjustment, including structural conditionality, as well as public communication of the fiscal component of the programs. The fifth section covers the modalities and outcomes of the technical assistance that the IMF provided, mainly for developing or strengthening sound practices in public financial management, expenditure policies, and tax policy and administration. The final section concludes and distils tentative lessons.

Fiscal Framework and Trends

Fiscal discipline is a necessary condition for a well-functioning common currency area, especially in the absence of labor market flexibility.[1] The basis for this view is that fiscal space, labor mobility, and real-wage flexibility, viewed as shock absorbers, should be able to help offset asymmetric shocks among member countries, unless their economic structure is very similar and they are fully constituted as an optimum currency area. Within a currency union, given inexorably fixed exchange rates—through a single common currency—among participating countries, adjustments among member economies must take place through fiscal and real-wage changes.

From the perspective of a federal system, subnational governments retain a greater or lesser degree of fiscal autonomy depending on, among other things, intergovernmental relations that may include various tax-transfer arrangements. To prevent free-rider behavior, subnational governments are typically subject to fiscal rules that limit budget deficits and indebtedness. In addition, subnational fiscal behavior may be constrained by a statutory or implicit no-bailout provision[2]—where the term "bailout" denotes financial assistance without conditionality. Under the no-bailout provision, subnational governments are exposed directly to market pressures, which are reflected in a risk premium on their bonds relative to bonds issued by the national government (as, for example, in Canada, Switzerland, or the United States). By contrast, if subnational governments are shielded by an explicit or implicit nationally guaranteed bailout, the risk premium charged by the markets vanishes and the interest yield on subnational bonds moves perfectly in tandem with the yield on the corresponding national bonds (as happened, for example, in Germany and Spain). In either case, fiscal discipline is usually bolstered with centrally- or self-imposed fiscal rules. Mutatis mutandis, a rules-based fiscal framework is similarly relevant for national governments within a monetary union.

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[1] As illustrated by recent developments in the euro area, the fiscal condition becomes imperative especially in the absence of effective banking supervision and uniform deposit insurance across member countries, or of an area-wide banking union. In such situations, impaired banks may have to be recapitalized directly or indirectly by the host government, compounding the latter's debt burden.

[2] This point is often overlooked by those who argue that a full-fledged fiscal union is a necessary condition for approaching an optimum currency area. For instance, in a review of the conditions for an optimum currency area and the evidence on whether the euro area meets these conditions, Pasimeni (2014) omits any mention of the no-bailout provision.

In a monetary union of sovereign countries, the need for fiscal discipline is further underscored by nearly full fiscal autonomy and limited wage flexibility. This is the case for the euro area, which is comprised of a diverse group of economies, some of them with a history of fiscal profligacy and burdened by high public indebtedness. In this regard, the crisis of the early 1990s which led to the near-collapse of the exchange rate mechanism (ERM) of the European Monetary System (EMS) could be viewed as a dress rehearsal of the dynamics that would play out if such a crisis were to occur in the euro area. The ERM, initially with a narrow band around a central rate, was to serve as the anchor for macroeconomic policies in participating member states. However, because differences in fiscal and wage behavior and divergent cyclical positions were inconsistent with the constraints of a single monetary policy, the ERM became untenable and the narrow band was abandoned. In the face of the crisis, for EMS member countries with an unsustainable external deficit, the bulk of the correction took place through exchange rate depreciation, rather than through adjustment in nominal wages or fiscal policy. A major lesson from the EMS crisis was that without exchange rate adjustment, and given the downward stickiness of nominal wages for regaining external competitiveness, the adjustment burden would have to fall largely on fiscal policy.

In view of the critical role of fiscal discipline in a monetary union consisting of divergent economies, the Economic and Monetary Union (EMU), established by the Treaty of Maastricht, envisaged a fiscal framework requiring member countries to abide by a relatively stringent set of fiscal rules while subject to an explicit no-bailout clause (Article 104)—much as in a federal system, as outlined above. Presumably, this clause was intended, on the one hand, to gain support for the monetary union from large hard-currency member countries, and on the other, to ensure that member countries would be exposed to market discipline as an additional safeguard.

Under the EMU, details of the fiscal framework were spelled out in the Stability and Growth Pact (SGP), which took effect from 1997 and was revised in 2005, 2011, and 2013 following episodes which revealed its principal shortcoming: namely, weak enforcement (Box 6.1). In principle, the original design of the fiscal rules enshrined in the Pact was deemed to meet seven out of the eight criteria for good practice endorsed by the IMF: definition, transparency, adequacy, consistency, simplicity, flexibility, and efficiency.[3] The enforceability criterion, however, eventually proved to be the Achilles' heel of the Pact. Indeed, the Pact was undermined by certain practices of the ECB as well as the Economic and Financial Affairs Council (ECOFIN) and its subset of euro area members, the Eurogroup, which was the ultimate arbiter in charge of enforcement through peer pressure.

[3] See, for example, Buti and Giudice (2002) for an application of the criteria formulated in Kopits and Symansky (1998) for assessing the EU fiscal rules. These criteria, discussed and endorsed by the IMF Executive Board in 1997, became widely regarded as the guide to good practice for fiscal rules.

Box 6.1 Highlights of the EU Stability and Growth Pact

The original 1997 statute sets for the general government: (i) a budgetary objective of close-to-balance or surplus, under the preventive arm; (ii) limits for the deficit and gross debt of 3 percent and 60 percent of GDP, respectively, and (iii) an excessive deficit procedure with financial sanctions (0.2 percent of GDP deposit) for noncompliance, under the corrective arm.

The 2005 amendment specifies additionally: a country-specific medium-term objective in structural terms; allowance for possible temporary deviation for structural reforms; and allowance for a possible deadline extension in case of unexpected economic events beyond government control with unfavorable consequences for government finances.

The 2011 amendments (the “Six Pack”) provide additionally: a benchmark for budget expenditure to grow in line with potential GDP growth; an annual adjustment of at least 0.5 percent of GDP if debt exceeds the limit or if there is a pronounced risk to debt sustainability; a benchmark for debt reduction if debt exceeds the limit, equivalent to an annual average reduction of 5 percent of the excess over the limit over the economic cycle; further allowance for possible temporary deviations and deadline extensions in case of a severe economic downturn in the euro area or the EU as a whole; and early and gradual activation of sanctions in cases of repeated noncompliance with the excessive deficit procedure.

The 2013 revisions (the “Two Pack” and Fiscal Compact) establish additionally: enhanced European Commission coordination and surveillance of draft budgetary plans of euro area governments, subject to a common timeline, to assess compliance with medium-term objective commitments and with EC recommendations for governments under the excessive deficit procedure; incorporation of key features of the SGP, notably the medium-term objectives, into national legislation; preparation of independent national macroeconomic projections; and independent national fiscal monitoring bodies.

Source: European Commission (2013a, 2013b).

From the outset, the ECB treated all euro area members’ sovereign obligations uniformly as riskless collateral in its open market operations, regardless of significant differences, for example, between Germany and Greece in their public debt-GDP ratios or their ability to generate primary budget surpluses.[4] (Eventually, a slight discount on lower credit-rated obligations was introduced.) This practice was in stark, albeit implicit, contradiction of the Maastricht Treaty’s no-bailout clause. Interviewees for this evaluation broadly agreed that there was what could be characterized as circular behavior among

[4] See the analysis by Buiter and Sibert (2006).

the ECB, credit rating agencies, and financial markets in assessing all euro area sovereign bonds as prime paper.

An additional practice was the accumulation of residual current account imbalances to be offset through the ECB's TARGET settlement system—an integral and necessary component of a common currency area. These imbalances, which were significant and rising sharply from 2007 onward, could, however, turn into an off-budget subsidy in the event of a default. At an extreme, this practice could also be interpreted as a backdoor bailout, without conditionality, in an environment where each state retained fiscal sovereignty.[5]

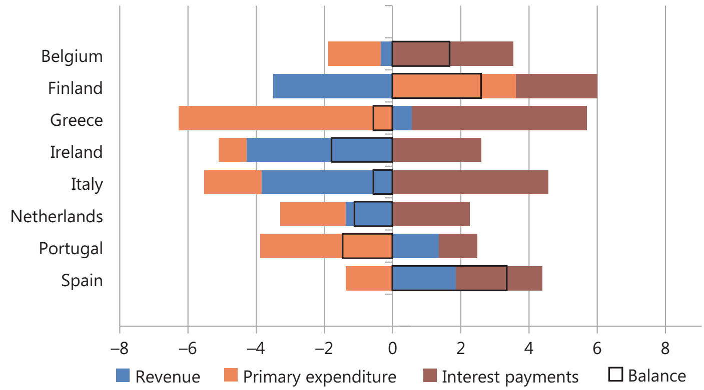
The upshot was that because of the ECB's uniform rating of euro area government bonds, banks and investors seem to have ignored the no-bailout clause and bid up the price of sovereign bonds issued by high-debt member governments to be used as collateral, thus profiting from a small interest yield on those bonds. Largely owing to this ECB practice—compounded by the disappearance of exchange rate risk—the risk premium on sovereign bonds vanished and lost any link to economic and fiscal fundamentals in each member country.

Similarly, the unavoidable buildup of TARGET claims through mid-2012 may have also eased the pressure on sovereign risk premiums. This effect was compounded by the extension of ECB credits under the emergency liquidity assistance (ELA) program, and by the August 2012 announcement of the Outright Monetary Transactions (OMT) program, which signaled a renewed softening of the no-bailout clause. Not surprisingly, the spreads on vulnerable euro area member government bonds have narrowed markedly since the end of 2012.

Over time, governments and markets were lulled into complacency and felt relatively immune to the need to abide by the fiscal rules. As a consequence of the decline in the interest cost, highly-indebted euro area member governments benefited from a windfall gain in their budgets and a corresponding sizable increase in fiscal space. But only a few of them allocated this gain to a reduction in public debt; most others squandered it by increasing primary expenditure (especially on public sector wages) or by cutting taxes. This is illustrated for governments whose interest bill has contracted by more than 1 percent of GDP following the establishment of the EMU (Figure 6.1). Between 1998 and 2005, Greece, Ireland, Italy, the Netherlands, and Portugal allocated their interest savings to finance additional outlays or tax cuts. By contrast, in Belgium, Finland, and Spain, the interest saving was fully reflected in a reduced budget deficit.

[5] See Sinn (2014) for an extensive documentation of this practice. From a monetary history perspective, Bordo (2014) argues that the euro area would have collapsed in the absence of TARGET.

Figure 6.1. Euro Area Countries: Net Contribution to General Government Balance, 1998–2005
(Cyclically adjusted, as percent of GDP)



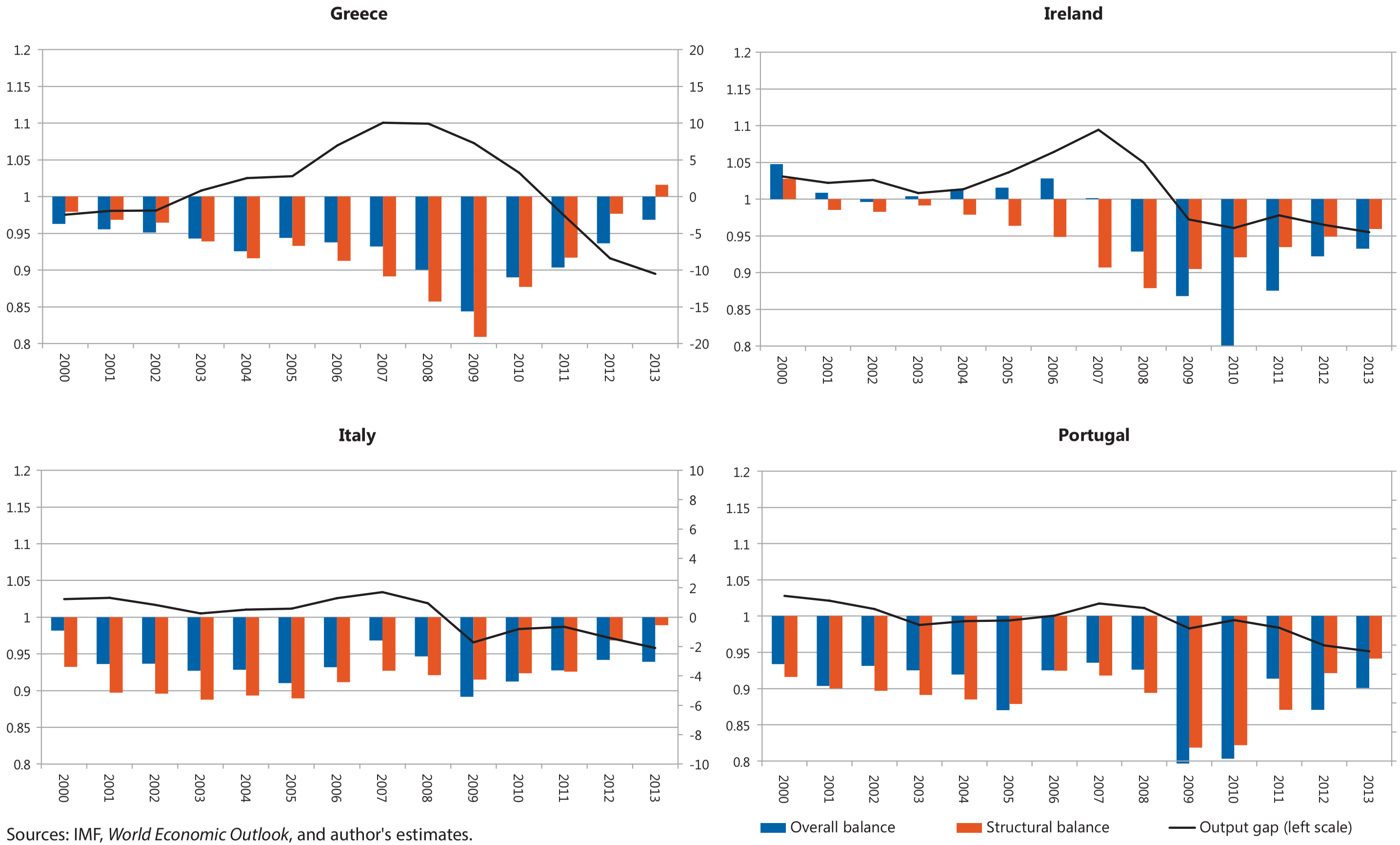
Source: Banque Nationale de Belgique (2006).

Unlike the nominal stringency of the deficit rule, the Pact did not stipulate sanctions for insufficient surpluses during an upswing in economic activity. At most, the Commission applied moral suasion in member countries to adopt a countercyclical contractionary fiscal stance to help offset the upswing, as in the case of Ireland in the early 2000s. This apparent asymmetry of the Pact failed to prevent some euro area members from pursuing a procyclical fiscal expansion during the so-called Great Moderation. The fiscal expansion was reflected by structural deficits, in excess of headline deficits (or a surplus in the case of Ireland), when the output gap was mostly in positive territory or zero (Figure 6.2). Thus measured, admittedly in hindsight, the expansionary stance is evident in Greece, Ireland, Italy, and Portugal over much of the past decade.

The deficit and procyclical biases were reinforced in 2004 by the demonstration effect of the failure of the Council and the Eurogroup to enforce sanctions against France and Germany, the largest member countries, under the EDP for violating the deficit ceiling—effectively ignoring the Commission's November 2003 recommendation to place these countries under enhanced surveillance. This event remained a testament to an essential defect of the peer review mechanism as practiced in the Council. Arguably, it caused irreparable damage to the credibility of the Pact, encouraging frequent breaches of the fiscal criteria by euro area member governments. Frequently, member governments failed to observe the deficit ceiling and the mandatory decline in the debt ratio to the prescribed ceiling, as well as the ensuing EDP, and were not sanctioned.

In a further manifestation of deficit bias, some countries tried to avert a breach of the deficit ceiling with stopgap policy measures (the first example was Italy's introduction of a refundable income-tax surcharge, to qualify for entry to the euro area) and accumulation of contingent liabilities (for instance, in the form of public-private partnership projects in Portugal) that

Figure 6.2. Euro Area Countries: General Government Balance and Output Gap, 2000–13
(In percent of actual or potential GDP)



Sources: IMF, *World Economic Outlook*, and author's estimates.

showed up in future deficits. In some cases, creative accounting practices and misreporting by governments[6] occurred with tacit consent by the EU authorities. For the most part, this behavior can be explained by pressure on governments to meet the fiscal reference values, including through various forms of repressed deficits, as predicted by Goodhart's law.[7]

Failure to enforce the EDP was accompanied by an optimistic bias in medium-term macro-fiscal projections[8] of a number of euro area member governments in yearly stability programs submitted to the EC. These programs were seen by some governments as fulfilling a reporting obligation that could soon be forgotten—a symptom of time inconsistency—rather than as a binding commitment to undertake budgetary measures that would lead to realization of the projected outcome. In some instances, notably in France and Germany in 2004, promises made by governments to exit the EDP became an elusive policy goal that was not subject to accountability and enforcement through prescribed sanctions.

In sum, several deficiencies in the enforcement of the fiscal framework have led to continued fiscal profligacy in a number of euro area countries that can be traced to before the introduction of the euro. These deficiencies reflect a significant deficit bias, procyclical expansionary bias, optimistic bias, and time inconsistency, particularly in the fiscally most vulnerable countries, namely, Greece, Italy, and Portugal.

Revisions of the Stability and Growth Pact in 2005, 2011, and 2013, intended to correct these deficiencies, have been subject to criticism by policy analysts. In principle, the allowance for structural reform measures in determining compliance with the rules, the emphasis on the structural balance or surplus, instead of the balance or surplus over the cycle; the introduction of benchmarks for expenditure growth; and the adoption of a numerical yearly reduction in the debt ratio are steps intended to strengthen the fiscal rules. In practice, the difficulty of measuring these metrics in real time can render them ineffectual.[9] More generally, the increased complexity of the rules[10] poses a major challenge for policymaking and for monitoring and enforcing compliance with the revised fiscal framework.[11]

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[6] Creative accounting included cash-based recording of expenditure, off-budget transactions, and non-reporting of losses of certain state-owned enterprises. Alt, Lassen, and Wehner (2014) provide documentation and analysis of such practices.

[7] According to Charles Goodhart, a numerical indicator (such as a monetary aggregate target or a budget deficit ceiling) ceases to be reliable once it is declared an official policy target or rule. Along similar lines, Summers (2013) observed that a budget deficit that is repressed artificially has perverse consequences—much as does inflation repressed through price controls.

[8] See Frankel and Schreger (2013).

[9] See real-time estimates of the structural balance for a large number of countries in Ley and Misch (2013).

[10] Recent publications of the European Commission (2013a, 2013b) are intended to help navigate through the maze of rules, regulations, and practices, which currently underlie the SGP.

[11] For a critical evaluation, see Barnes, Davidsson, and Rawdanowicz (2012); and Koester, Mohl, and van Riet (2012).

Surveillance

Responsibility for monitoring compliance with the EU fiscal framework rests primarily with the EC as regards member country policies and with Eurostat as regards public finance accounts and statistics. The Council (and the Eurogroup within it), however, is the sole authority for enforcing the framework, pursuant to the Treaty and the Pact.

The surveillance function of the IMF overlaps with, but in no way substitutes for, the mandate of the Commission. IMF surveillance over public finances focuses principally on their consequences for each member's external balance and, ultimately, for the stability of the international monetary system. Thus, in the case of the euro area, whereas IMF surveillance is supposed to oversee and promote fiscal discipline and public debt sustainability in each member country, EC surveillance is limited to observance of the fiscal framework per se, which is seen as paramount to preserving the integrity of the common currency area. To this effect, the IMF has held yearly consultations under Article IV not only with each euro area member government but also, since 1999, with the EC and the ECB.

On the basis of the discussion in the section "Fiscal Framework and Trends," above, the track record of some euro area member countries points to a number of deficiencies that would have merited close attention in IMF surveillance: a pronounced deficit bias, expansionary procyclicality, optimistic bias, and time-inconsistency. The combination of these deficiencies could have been expected to lead not only to a problem of unsustainable public debt, but also to widening fiscal and external imbalances (if the fiscal dissaving was not offset with private saving), exposing these countries to a fat-tail sovereign risk that would be captured by financial markets only with a considerable recognition lag.

This leads to a number of basic questions in evaluating the IMF's surveillance of euro area fiscal policies. Did the IMF take a backseat to (or rely excessively on) the Commission and Eurostat in monitoring fiscal policies in the euro area? Did the Fund deploy adequate staff resources to conduct oversight of fiscal policymaking in the euro area? In light of the heightened importance of fiscal policy as an adjustment tool under a fixed exchange rate regime, did IMF advice identify and focus on the fiscally vulnerable economies in the euro area and, more generally, on the underlying inconsistencies and weaknesses in the enforcement of the EU-wide framework? Was IMF advice supported by in-depth analysis, as well as by sufficiently forceful, timely, and well-communicated warnings? More specifically, was the IMF sufficiently thorough and candid in evaluating the transparency and veracity of public accounts, projections, and reporting practices; in assessing public debt sustainability; and in monitoring fiscal risks?

As a preface to addressing these questions, it should be noted that from the inception of the euro area, the prevailing groupthink in academic circles[12]

[12] Perhaps the best known theoretical analysis of this hypothesis can be found in Blanchard and Giavazzi (2002).

and among public officials[13] was that current account deficits—and as a corollary, government budget deficits—do not matter within a currency union. As confirmed in interviews with current and former senior euro area officials, not only the EC and ECB but the IMF as well subscribed to the view that a sudden stop of capital inflows to countries experiencing increasing external deficits was practically inconceivable within the euro area. The Fund's attitude,[14] remarkable insofar as the Fund was the institution with the most experience in dealing with balance of payments crises, was summed up in an external report on IMF surveillance: "Rather than fully exploiting its comparative advantage, based on its international experience, the IMF fell victim to a 'Europe is different' mindset" (Pisani-Ferry, Sapir, and Wolff, 2011).

By and large, in the fiscal area, the IMF and EU institutions operated in tandem as regards diagnostic and policy recommendations, with very few exceptions concerning specific euro area member countries. Following the onset of the crisis, however, the three institutions established cooperation under the so-called troika arrangement with the objective of jointly designing, overseeing, and supporting adjustment programs launched in member countries.

Surveillance of the Euro Area

Broadly speaking, the quality of IMF surveillance of fiscal policy for the euro area as a whole, conducted mainly through Article IV consultations, was on balance appropriate. While treating the euro area common currency area—the outcome of a collective political action by participating governments—as a given, IMF staff did on several occasions weigh the advantages and disadvantages of the euro area and flag challenges in the enforcement of the fiscal framework.[15]

Although there was no formal arrangement between the IMF and the ECB and EC, it seems to have been implicitly understood that IMF surveillance would support the EU institutions in their oversight responsibilities insofar as the EC and ECB staffs had limited operational experience in monitoring macro-fiscal policymaking—both institutions' analytical capacity in the fiscal

[13] In 2000, the then-Governor of the Bank of Portugal expressed succinctly the prevalent view: "Without a currency of our own, we shall never again face the balance of payments problems of the past. There is no macroeconomic monetary problem and no restrictive measures need to be taken for balance of payments reasons. No one analyses the macro size of the external account of the [state of] Mississippi or of any other region belonging to a large monetary union" (Constancio, 2000).

[14] As an exception, prior to the adoption of the euro, the Fund's Executive Board discussed the modality and conditions of a hypothetical use of Fund resources by a euro area member country in case of balance of payments need; see IMF (1998).

[15] For example, the Fund staff observed that "crux of the SGP problem was not so much designing 'optimal' but rather 'enforceable' fiscal rules. The SGP's basic design . . . remains broadly appropriate" IMF (2004: 29).

area notwithstanding. Accordingly, Fund staff appeared at times to have felt that the primary responsibility for oversight was with EU institutions not only concerning compliance with the SGP, but also regarding overall fiscal performance. This was particularly the case with regard to monitoring the accuracy of national and public sector accounts of EU member countries, which was deemed to be under the tutelage of Eurostat.

According to IMF staff members interviewed, bilateral Fund surveillance of the euro area in the pre-crisis and crisis periods, particularly in the fiscal area, was limited in two aspects. First, partly as a result of staff downsizing, the European Department (EUR) experienced considerable turnover, especially at senior staff level, including the position of EUR director. This contributed to some loss in operational continuity and in institutional memory. Second, surveillance and program work was carried out for the most part by EUR and the Strategy, Policy, and Review Department (SPR), with only occasional input from the other departments.[16] This was especially the case when it came to application of up-to-date analytical tools for measuring the structural balance and for assessing fiscal risk—the latter being an area where the Fiscal Affairs (FAD), Monetary and Capital Markets (MCM), and Research (RES) Departments had developed substantial expertise. In all, FAD input was rather limited: reviews and comments on fiscal issues in draft Board papers on advanced economies in general and euro area members in particular were sporadic, and FAD staff participation in area department missions was rare.[17]

A review of IMF Article IV staff reports since 1999 suggests that, while supportive of the initial design features of the SGP, the Fund was critical of the lack of sufficient national ownership and lax enforcement of the Pact and of the reforms to it that were introduced in 2005 and 2012.[18] However, the IMF could have been far more forceful in highlighting some of the deep-seated inconsistencies in the application of Treaty obligations, which began at the outset and damaged the credibility of both the Treaty and the Council, and created moral hazard for member governments and financial markets.

A major inconsistency was the failure by the Council to levy sanctions on governments that ignored the EDP, especially France and Germany in 2003. This negligence had a lasting demonstration effect on other member governments' fiscal behavior. Fund staff simply observed that "France and Germany—traditional bastions of fiscal discipline in the euro area—showed

[16] This seems to have been symptomatic of the silo behavior and mentality prevailing in the Fund, observed in IEO (2011).

[17] Routine FAD review of draft staff reports on advanced economies tapered off over the past decade and was formally discontinued—resumed only after the crisis—through an interdepartmental accord in 2010 in the interest of saving staff resources.

[18] On several occasions, the Fund explored ways to improve the architecture and implementation of the SGP. Most recently, the staff proposed establishing a closer fiscal union for the euro area to prevent crises; see Allard and others (2013).

little inclination to live up to their commitments to achieve underlying balance" and that "the Council decided to hold the EDP against France and Germany in abeyance" IMF (2004: 27–28).

Another inconsistency was the ECB's uniform treatment of euro area sovereign bonds as collateral, which could be viewed as de facto disregard for the no-bailout clause. The only, rather belated and oblique, reference to such practice this evaluation could find was in the staff report for the 2011 Article IV consultation on euro area policies, which noted that, "The crisis has changed a basic paradigm of the euro area, namely, that all sovereign debt of euro area member countries is equal" (IMF, 2011a: 12). In the event, it would have been useful if the IMF had raised a critical voice on this practice publicly and in a timely fashion.

On the positive side, the IMF did reiterate repeatedly the importance of complying with, and converging to, the euro area reference values on public deficits and debt. From 2002 through 2008, it consistently recommended an annual fiscal adjustment of 0.5 percent of GDP (net of temporary measures and allowance for automatic stabilizers) for euro area governments that had exceeded the reference values.[19] Also appropriate was the Fund's recommendation for improving fiscal governance by translating key features of the fiscal framework to the national level and adapting them to local needs. Equally, calls for reforming public pensions and health-care schemes to ensure fiscal sustainability were timely in view of rapid population aging in most European countries.

A selection of the IMF's major policy recommendations in the fiscal area reveals that their quality and relevance seem rather uneven (Box 6.2). For example, despite their possible conceptual appeal, the suggested introduction of a financial activities tax and a limited form of common eurobonds or bills would have benefited from elaboration of specifics and trade-offs. Somewhat controversial was the IMF's advocacy of a discretionary fiscal stimulus to counter the adverse impact of the financial crisis on the real economy. Although this recommendation was carefully nuanced in terms of composition and timing, fiscal stimulus as a cure for what was seen as a recession—a novel initiative from the Fund—was questionable for fiscally vulnerable countries that faced mounting public indebtedness and were reluctant to undertake structural reforms.[20]

Overall, the intensity of surveillance and exhortations by the Fund (and the EU) appeared to be driven to a large extent by market pressures. On the fiscal front, the Fund seemed complacent in the initial years of the

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[19] In 2002, the recommendation was directed to the three largest euro area member countries (France, Germany, and Italy), but from 2003 onward it was extended to all euro area members that did not meet the "close-to-balance or surplus" requirement.

[20] For example, Tanzi (2013) compared this advice to prescribing steroids, for symptomatic relief, to a patient suffering from a serious illness. IEO (2014) observed that the IMF did not sufficiently tailor its macroeconomic advice to fit individual country circumstances.

Box 6.2. Euro Area: IMF Advice on Fiscal Measures

"The staff continues to subscribe to the standard that countries with weak underlying positions take ex ante discretionary fiscal policy actions to achieve a ½ percent of GDP a year of structural consolidation measures. . . . Budgets in 2004 need to look hard at achieving longer-term goals, eschewing tax increases or one-off measures in favor of multiyear actions to curb current spending, especially on transfers and public sector employment, thereby fostering sustainability and creating room for necessary tax cuts over time" (IMF, 2003: 32).

"In the staff's view, popular dissatisfaction pointed to the need . . . for strengthening or establishing independent, non-partisan fiscal councils [to] assess policies, provide more forward-looking perspectives, help rally popular support for adjustment, better identify policy failures, and mark up reputation costs" (IMF, 2005: 25).

". . . tax policy should not be used to hamper adjustment to rising energy and food prices. Looking further ahead, stronger national fiscal rules and domestic governance mechanisms could help achieve more predictable and efficient fiscal policies in countries that struggle with relatively high public deficits and debt" (IMF, 2008: 22).

"While fiscal policy will need to continue to support economic activity in 2010, it is essential to embed short-term actions in credible medium-term consolidation programs to address solvency concerns. . . . The composition of the fiscal stimulus is seen to be as critical as its size, and coordination is essential. The key is to ensure that fiscal incentives boost activity over the relevant time frame, while seeking lasting benefits to productive capacity. The length and severity of the downturn justify greater weight on investment projects that typically have long lags but bring substantial longer-term benefits. Tax cuts, on the contrary, could be implemented quickly, but are likely to have more modest impact" (IMF, 2009b: 5, 21).

". . . fiscal adjustment plans need to be strengthened considerably. They should focus structural expenditure cuts on distortive and ineffective programs, such as the elimination of certain price and production subsidies, and a shift from universal to targeted social transfers which would preserve spending by low income earners, while boosting confidence in the return to sustainable spending patterns. Ambitious entitlement reforms—such as measures aimed at increasing the effective retirement age—are essential to deliver large credibility gains at a lesser cost in terms of short-term growth [sic]. In contrast, across-the-board cuts in investment programs should be avoided. In some countries, comprehensive tax reforms should aim at broadening the tax base, reducing distortions and improving compliance. In this respect, the coordinated introduction of a Financial Activities Tax would be helpful" (IMF, 2010b: 13).

"The directive on national fiscal frameworks will encourage prudent national fiscal behavior. . . . The directive could be made more effective by requiring systematic disclosure of information on state-owned corporations and public-private partnerships, spelling out good practices for fiscal rules, escape clauses and budget controls, and extending the list of fiscal risks beyond contingent liabilities. Other critical elements of budgetary frameworks such as budgetary unity and the need for a top-down sequence in budget preparation would be most welcome" (IMF, 2011a: 18).

"Introduction of a limited form of common debt with appropriate governance safeguards can provide an intermediate step towards fiscal integration and risk sharing. Such debt securities [sic] could, at first, be restricted to shorter maturities and small size and be conditional on more centralized control. . . . Common bonds/bills financing could, for instance, be used to provide the backstops for the common frameworks within the banking union" (IMF, 2012a: 26).

"Over the medium term, ideas to simplify and strengthen fiscal governance framework should be explored. Consideration should be given to a more parsimonious framework with a single objective and an economically operational lever. The credibility of the rules would be enhanced by much stronger enforcement mechanisms. Boosting the ability of the center to fund public infrastructure projects—such as cross-border investments in transportation, communications and energy networks—would help lay the foundations for sustained growth" (IMF, 2014b: 25).

euro area as sovereign risk premiums narrowed and then vanished, but this attitude turned into alarm when financial markets experienced turbulence, reflected in the gyrations of the sovereign risk premium. Instead, the Fund's surveillance should have addressed the fundamentals of fiscal policy long before market sentiment deteriorated, with a view to preventing a possible shift from an apparently good equilibrium to a bad one—as viewed from a multiple-equilibrium perspective.[21]

Surveillance of Vulnerable Member Countries

Although staff reports on euro area policies made occasional references to member country policies, for the most part they tended to downplay individual country vulnerabilities via aggregation for the euro area as a whole. Surveillance of individual member countries, mainly through Article IV consultations held yearly with the national authorities, was rather superficial. In particular, the Fund could have exercised much more intense monitoring of highly indebted governments that had a trail of fiscal problems and exhibited a deficit bias almost continuously up to the financial crisis. On this basis, countries that entered the euro area with public debt barely meeting the EMU reference values, such as Greece, Italy, and Portugal, deserved special attention from the very start of euro membership.[22]

[21] An explanation and test of this shift in the euro area can be found in De Grauwe and Ji (2013).

[22] In Italy, the deficit reference value was met with recourse to various creative accounting maneuvers, including introduction of a tax surcharge that was reimbursed following euro area accession. See Spaventa and Chiorazzo (2000) and Reviglio (2001). In the case of Greece, it was discovered several years later that the deficit reference value was reached through gross misrepresentation of fiscal data—discussed below.

For starters, the Fund could have questioned the suitability of some fiscally vulnerable countries for euro membership.[23] Its failure to do so seems to have been largely prompted by political sensitivities. In particular, there was sufficient evidence to argue that Greece was not ready to join the euro area—not only on the grounds of insufficient real economic convergence (given its markedly lower income level and different economic structure relative to the other euro area members), but also because of foreseeable difficulties in complying with the requirements of the fiscal framework given its past record of fiscal profligacy.

In addition, in the early years of the euro area, the Fund missed the opportunity to critically assess member countries that failed to allocate a significant portion of their windfall gains from lower interest costs to a reduction in public debt and concomitantly create fiscal space for countercyclical action in the event of an economic downturn.

Although the surge in economic activity over the past decade may have been difficult to detect while it was happening, in the wake of a brief downturn at the outset, the Fund could have paid more attention to the procyclical fiscal expansion that fiscally vulnerable euro area countries were pursuing. In general, however, despite occasional references to the structural budget balance, discussions with the authorities focused mostly on the headline balance. In retrospect, the expansionary stance was evident not only in Greece, Italy, and Portugal, but also in Ireland—which eventually also became fiscally vulnerable. In all these countries, the structural deficit increasingly exceeded the headline deficit against the backdrop of a rising output gap—evidence of a procyclical fiscal expansion and a positive fiscal impulse, which was most pronounced in Greece and Ireland (Figure 6.2 above).

Ireland and Spain stand apart from the other countries in the sense that the root cause of their sizable macroeconomic imbalances was a financial bubble, manifest mainly in a jump in real estate asset prices. The bubble fed a seemingly favorable revenue performance that masked a significant structural deficit that was not readily observable. The boom in tax revenue encouraged these countries to embark on a procyclical increase in expenditure on wages and pension benefits, as well as tax subsidies.[24]

This problem was particularly pronounced in Ireland, where, contrary to ECOFIN's concern about the expansionary stance, the Fund staff downplayed the issue in view of a headline budget surplus in 2001.[25] Since the beginning

[23] This view, especially with regard to Greece, was shared by IMF staff and Board members alike who were interviewed for this evaluation.

[24] This policy stance was best summarized in a quote from former Irish Finance Minister McCreevy (2002): "When I have it I'll spend it. When I don't I won't."

[25] In a rare display of difference in views in EU and IMF surveillance, Fund staff stated that ". . . the rising budget surplus fed public desires for additional tax cuts and spending increases. Shaped by these circumstances, the 2002 Budget gave rise to an opinion by the European Council in February critical of the procyclical fiscal stance. Subsequent indicators point to a welcome slowing of the economy, however, reducing the potential risks from the fiscal stimulus" (IMF, 2001a).

of the past decade the staff had expressed misgivings about the evolving real estate boom underlying the strong economic growth but, based on standard EC estimates of the output gap and structural balance, as well as the low recorded public debt ratio, considered that the fiscal accounts were broadly in equilibrium. It was only in 2009 that the staff reversed its view—based on a methodological shift, already available a number of years earlier, which revealed a change in the 2006 structural balance from a small surplus to a deficit of 7 percent of GDP[26]—and alerted the authorities about the need for a drastic fiscal consolidation.

In the case of Spain, the effect of the financial bubble on fiscal performance was more difficult to detect, for it was reflected primarily in a rise in subnational government revenue from fees charged on construction and development permits, and only to a lesser extent in capital gains from the surge of real estate prices and a resulting rise in income tax revenue. In all, the damage to the financial system and to the public sector accounts was milder, more gradual, and better managed than in Ireland.

As noted above, the conduct of macro-fiscal policies in euro area countries was further beset by a strong optimistic bias in the budgetary projections that were incorporated in these countries' annual medium-term stability programs submitted to the EC. However, the projections prepared by the IMF and reported in the *World Economic Outlook* since 1999 for Greece, Ireland, Italy, and Portugal exceeded the actual balance by a significant margin. By contrast, the projections for the euro area as a whole tracked consistently the actual balance (Figure 6.3). These projections can be interpreted as representing official IMF endorsement of the optimistic bias of several fiscally vulnerable euro area members.

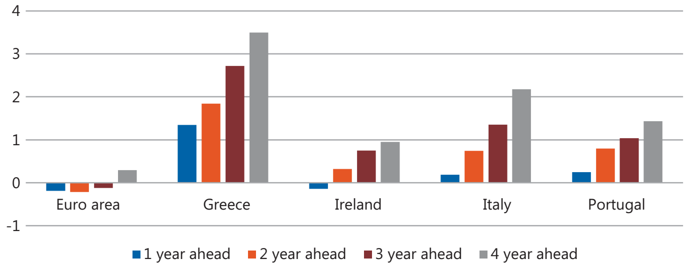
There are several explanations for the optimistic bias. One of them is simply optimistic projections of key underlying macroeconomic variables (especially output and interest rates). Another consists of optimistic assumptions on spending control or effective tax elasticities. The third is time-inconsistency in the implementation of the policy measures promised by these member governments to achieve the medium-term objective in compliance with the statutory limit on the budget deficit under the Pact.

In Greece, weak fiscal performance was further aggravated by gross misreporting of national and public sector accounts.[27] The main sources of

[26] IMF (2009a) adopted the approach reported in Kanda (2010), along the lines developed much earlier by Jaeger and Schuknecht (2004). In essence, the revised estimate of the structural balance sought to incorporate the ongoing asset price boom in the calculation of the underlying output gap.

[27] According to IMF staff members interviewed, the Greek authorities were usually evasive when asked about the gaps and inconsistencies in fiscal statistics, claiming that they had provided all the required information to Eurostat. (After the disclosure of the first misreporting, EUR staff had contacts with Eurostat at the desk level.) However, according to a senior Eurostat official,

Figure 6.3. Euro Area Countries: General Government Balance Forecast Errors, 2000–08
(In percent of GDP)



Note: Forecast errors are calculated as the difference between forecast values for each year and actual values for that same year, measured in the following year, so as to avoid the effect of subsequent revisions of actual data.

Sources: IMF, *World Economic OutLook* and author's estimates.

understatement of deficits were incomplete coverage of the losses of hundreds of public pension funds and state-owned enterprises, and unreported military outlays. This was largely attributable to data manipulation under political influence—exacerbated by a culture of opacity and promoted by certain legal constraints[28]—to meet the budget deficit reference value, first, to qualify for entry in the euro area and then, to demonstrate compliance with the Pact. On two occasions, following elections in 2004 and late 2009, the Greek authorities revealed that general government deficits and debt had been understated by a sizable margin. On the first occasion, the understatement facilitated Greece's entry into the euro area. On the second, the revelation spooked financial markets and caused a jump in the sovereign risk premium, which in turn—together with the authorities' failure to take corrective action—resulted in a sudden stop in capital inflows the following year.

During much of the past decade, Fund staff expressed far less concern about the reliability of Greece's fiscal accounts than was warranted. The IMF's fiscal transparency report for Greece went as far as to declare that the country "in recent years has made progress in meeting requirements of the fiscal transparency code. . . . At the central government level, Greek budget

the data that the agency received from Greece were not in a form that could be used for verification. Moreover, neither the Council nor the Eurogroup had granted authority to Eurostat to investigate primary data sources to verify the information provided by the Greek government, even after the misreporting in 2004.

[28] In Greece, revelation of data or information by a public official is prosecutable under legal restrictions that inhibit transparency in the public sector. A case in point is the prosecution of the former head of the Greek statistical authority ELSTAT for disclosing government data to official international institutions.

processes give assurances of integrity about fiscal data through independent audit and recently strengthened statistical reporting" (IMF, 2006). Within the Fund, senior staff and management paid scant attention to repeated warnings by staff teams about the dismal condition of Greece's public sector accounts, according to staff members who were interviewed for this evaluation. It was only in 2009 that the Fund (and the EC) openly criticized the quality of Greek fiscal statistics for the first time; and in 2010 that the IMF found Greece in breach of members' reporting obligations under Article VIII, Section 5, of the Articles of Agreement—a decision that could have been made several years earlier.

The IMF, with the support of EU institutions, could have stepped up the monitoring of public finances in the vulnerable economies by shortening the Article IV consultation cycle before the onset of the crisis. Indeed, there was a strong case for applying enhanced surveillance to some of the fiscally vulnerable euro area members, particularly Greece, given the unreliability of its fiscal data. Enhanced surveillance was only considered briefly with regard to Italy in late 2011,[29] in response to market pressure and the ECB's threat of suspending transfers under emergency liquidity assistance. Support for higher-frequency and more in-depth surveillance by the Fund would have been most helpful coming from EU institutions, especially Eurostat, which operated with considerable lags in rendering an opinion on government statistics and overlooked well-known loopholes in the measurement of general government balance and debt.[30]

At the onset of the recession in 2009, the Fund recommended that euro area member governments, among others, undertake a discretionary fiscal stimulus of some 2 percent of GDP as a countercyclical move. This advice—though qualified for certain vulnerable economies with scant or no fiscal space—was welcomed by political leaders in some of these countries. In Portugal and Spain, the recommended stimulus, adopted in the run-up to elections, was deemed ill-timed and ill-advised, given the already sizable fiscal imbalance.[31] In both countries, the resulting overall deficit reached 10 percent of GDP, equivalent to an impulse of about 5 percentage points from the preceding year in structural terms.

As part of its surveillance of macro-fiscal policies, far more positive were the IMF's frequently voiced recommendations of specific structural reform

[29] According to Leipold (2011), in the wake of the G20 meeting in Cannes, the Fund was instructed to conduct quarterly staff visits to monitor the implementation of measures promised by the Italian government. The proposed enhanced surveillance was abandoned three months after the public announcement, following the succession of the Berlusconi government by the Monti government.

[30] A notable example is the exclusion from government deficit- and debt- data of losses incurred by state-owned enterprises where more than one half of revenue originates outside the public sector—unless recapitalized with an equity transfer by the government.

[31] See, for example, Dhar (2014).

measures intended to regain or strengthen medium- to long-term debt sustainability in vulnerable euro area members. The following areas were most often singled out for reform or improvement: fiscal governance; tax policy and administration; public financial management, including expenditure control; public pensions; and state-owned enterprises. In some cases, the Fund formulated recommendations on the basis of technical assistance provided by FAD staff—as discussed in the section "Stabilization Programs" below.

Assessment of Fiscal Sustainability and Risk

In order to evaluate the Fund's role in trying to avert a crisis, it is necessary to examine its efforts in assessing the sustainability of, and risks facing, the member country's public finances.[32] A critical component of surveillance consists of helping anticipate and communicate in a timely manner the probable impact of shocks on public finances, and to advise the government on steps to mitigate or neutralize the impact of such shocks. Ultimately, insofar as feasible, the objective should be to alert the authorities as to the country's vulnerability to a so-called fat-tail risk of outright default.

Since the early 2000s, for the most part, Fund staff reports have included a debt sustainability analysis consisting of a quantitative scenario of the public debt-to-GDP ratio over a medium-term horizon, in which the underlying drivers and macroeconomic assumptions are not always fully stated. In addition to a baseline scenario, the reports provide an illustrative chart showing deviations from the baseline under an assumed change in the growth rate, interest rate, exchange rate, and realization of contingent liabilities. This basic template has been applied in most Article IV consultations with member countries, and its coverage was recently expanded to include an assessment of debt structure and liquidity issues.[33] (Obviously, for euro area members, no exchange rate change was simulated.) It is noteworthy, however, that from 2005 through 2008, Article IV staff reports for Greece did not include a public debt sustainability analysis.

Given the arbitrary character and methodological limitations of the template, efforts have been under way for more than a decade in the Fund to develop more realistic and objective methods of sustainability-cum-risk assessment, drawing on macroeconomic and financial analysis.[34] In some variants, these initiatives sought to incorporate stochastic methods in the intertemporal public sector balance sheet, incorporating the government's exposure to contingent liabilities. Such methods were available for application to vulnerable euro area countries but they were ignored in the ongoing policy

[32] This task is an integral part of Fund surveillance, as noted by the IEO, insofar as it "consists of monitoring the global economy and that of member countries to help head off risks to international monetary and financial stability, alert member countries to potential risks and vulnerabilities, and advise them of needed policy adjustments" (IEO, 2011).
[33] For the initial template and its modification, see IMF (2002, 2011b, respectively).
[34] Kopits (2014b) provides a review of the literature, as well as the results of a recent OECD survey of country practices as regards specific, general, and systemic fiscal risks.

dialogue between the Fund and the national authorities in assessing fiscal risk. Instead of applying improved debt sustainability analysis, Fund staff continued to rely on the template, even during the crisis.

An exception to the substandard approach to risk assessment was the staff's estimate of the intertemporal balance sheet of Greece's public sector in 2009, which was calculated in terms of the present value of the future stream of major assets and liabilities, including contingent liabilities, in addition to a comprehensive accounting balance sheet (IMF, 2009c). This exercise, without apparent traction in the Article IV consultation discussion and subsequently abandoned—reportedly at the request of the authorities—served to illustrate Greece's sizable fiscal insolvency about half a year before the loss of access to financial markets. Ideally, such an exercise could have been supplemented with a value-at-risk analysis, developed much earlier by Fund staff.[35]

The debt sustainability analysis template was supplemented effective 2013 with a so-called risk assessment matrix (RAM) summarizing the staff's subjective view of the likelihood of specified shocks and their impact on the economic and financial performance of the euro area. Against the RAM's advantage of communicating results in non-technical terms, however, are its obvious shortcomings as a numerical indicator of fiscal risk.[36] Equally, fiscal risk narratives in the IMF's multilateral surveillance vehicles, including the *Fiscal Monitor*, cannot compensate for the absence of regular and comprehensive risk assessments in the context of annual Article IV consultations with specific countries or groups of countries. In addition, an internal "vulnerability exercise" for advanced economies, undertaken by the staff at regular intervals since 2012, is of limited value insofar as the resulting assessments are not disclosed to the national authorities or to the general public.[37] In recent pilot assessments of fiscal transparency, however, the potential loss from specific fiscal risks involving tax measures, expenditure programs, and contingent liabilities was estimated for Ireland and Portugal.[38]

Stabilization Programs

The IMF-supported programs under scrutiny in this evaluation are: the initial three-year Stand-By Arrangement (SBA) for Greece (cancelled after two years); a three-year arrangement under the Extended Fund Facility (EFF)

[35] The estimate of negative net worth of the public sector for Greece (totaling nearly 400 percent of GDP even before correcting the data for misreporting!), however, was so large that it obviated the application of a formal value-at-risk analysis, developed by Barnhill and Kopits (2003), to calculate fat-tail risks.

[36] Staff views on the likelihood of specified shocks were classified as "low" for less than 10 percent probability, "medium" for 10–30 percent probability, and "high" for greater than 30 percent probability. For a critical discussion of the RAM, see Robinson (2014).

[37] Such confidential treatment is questionable, for example, in the case of bank stress tests conducted by major central banks.

[38] See IMF (2013c, 2014c).

for Ireland; and a three-year Extended Arrangement for Portugal. The subsequent three-year Extended Arrangement for Greece falls outside the scope of the evaluation.

Typically, when a country suffers a sudden stop in market financing of sovereign paper—as experienced by Greece, Ireland, and Portugal in 2010–11—the loss of liquidity must be offset by financing from various (mostly external) official and private sources. If the country is concurrently in default (or near default) of its obligations, the insolvency is remedied with public debt restructuring, usually in the form of a rescheduling of existing liabilities and in some cases accompanied by debt relief (so-called haircut) on those liabilities. An orderly process had been developed over the years prior to 2010 in which financing, including debt restructuring, became an integral part of the negotiation and design of any IMF-supported SBA or Extended Arrangement.

More generally, financing is one of three pillars of a fiscal stabilization program; the other two pillars are macro-fiscal adjustment and structural fiscal measures. The relative weight of each pillar depends on a number of factors, including the supply of funding, public debt sustainability, the size of the gross financing need, the extent of tax and budget distortions (with a direct or indirect bearing on the external position), and the availability of non-fiscal instruments, notably the exchange rate. These pillars are examined in turn in the following sections.

Financial Support

In the early phase of the crisis, as financial markets were spooked by developments in the vulnerable euro area member countries and by the initial resistance of supranational institutions to provide stop-gap financing, sovereign risk premiums jumped and kept rising in these countries. However, the upward pressure on spreads began to abate under the effect of multiple ECB facilities that provided indirect financing to governments mainly through the banking system.[39] In addition to the steady buildup of TARGET claims, the ECB (or the Eurosystem) began to extend refinancing credit through Long-Term Refinancing Operations (LTROs), credits under emergency liquidity assistance (ELA), and purchases of government bonds through the Securities Markets Program (SMP). But it was not until 2012, with the announcement of the Outright Monetary Transactions (OMT) program by the ECB, accompanied by a Greek debt restructuring, that spreads on vulnerable euro area member government bonds narrowed markedly, as the markets interpreted these steps as a renewed relaxation of the no-bailout clause.[40]

[39] Sinn (2014) offers a thorough analysis of excessive reliance on these facilities and their implications.
[40] Arguably, these and other forms of EU financial assistance can be justified if a member state faces "difficulties or is seriously threatened with severe difficulties caused by exceptional occurrences beyond its control," under Article 103a of the Treaty, in effect overriding the no-bailout clause in Article 104.

Thus, in an approach that was rather unusual in a sovereign financial rescue operation, the ECB became the principal channel of financing for vulnerable EU member countries during much of the euro crisis.

In comparison to past crisis episodes in other countries, the adjustment programs introduced in Greece, Ireland, and Portugal can be characterized as among the most complex; they belong to a category of their own in a number of aspects, including the financing pillar. Following loss of access to financial markets in the first half of 2010, Greece became the first case where it was incumbent on the EU institutions and the IMF, possibly with the cooperation of private creditors and in negotiation with the national authorities, to consider various forms and magnitudes of financing. Unlike in previous crises, a major challenge emerged for the various parties—occasionally operating with conflicting interests—to put together a financing package without recourse to debt restructuring.

Many outside observers in the academic and banking communities, as well as within the Fund (including some members of the Executive Board), expressed serious skepticism about the exclusion of debt restructuring for Greece,[41] and to a lesser extent for Ireland and Portugal. They pointed to a convincing prima facie case based on the sharp jump in the public debt ratio—by nearly one half in Greece and Portugal and a quadrupling in Ireland, between 2007 and 2009—which had resulted mainly from the erosion in the effective tax base (due to the significant contraction of output), and to a much lesser degree, from recapitalization of the banking system (due to the surge in impaired banking assets).[42] The general case for debt restructuring was further strengthened by fresh evidence on the growth-depressing effect of public debt ratios approaching 100 percent.[43]

Nevertheless, from the outset and well into the program period, the EC and ECB resisted any form of debt restructuring, as did the crisis-hit euro area governments. The EU institutions and their major member governments were opposed to debt restructuring, apparently in order to enforce the no-bailout provision and to protect their banks' balance sheets.[44] The IMF, partly because of fear of contagion to its members, went along with this position.[45]

The programs that were approved for Greece, Ireland, and Portugal were constrained by the availability of official balance of payments support to euro area member governments on the scale required in each case. Thus the IMF

[41] See the list of critical commentators in IMF (2013b).

[42] Even in Ireland, bank recapitalization was estimated to have totaled less than one-fourth of the increase in public debt according to Donovan and Murphy (2013) and about two-fifths according to Fund staff.

[43] See Reinhart and Rogoff (2009). Their results were subsequently corroborated by Cecchetti, Mohanty, and Zampoli (2011).

[44] This was corroborated in interviews with former Fund Executive Directors.

[45] See Kincaid (2017) and Schadler (2017).

was persuaded to lend amounts far in excess of country limits expressed in terms of membership quota—in fact, without precedent in its history—by invoking the exceptional access criteria. Initially, EC financing could be provided only by diverting some funds from earmarked windows and by drawing on the newly created European Financial Stability Facility and European Financial Stabilization Mechanism, which was succeeded in 2012 by the European Stability Mechanism as a permanent firewall for euro area members facing financial difficulties. But as sovereign risk premiums continued to spike for the vulnerable countries in the course of 2011, a relatively generous debt-restructuring agreement with private sector involvement—defined as voluntary, to avoid declaring a formal default by a euro area economy—was approved for Greece the following year. These steps, along with significant backdoor ECB financing, helped bring about a temporary decline in sovereign bond spreads.

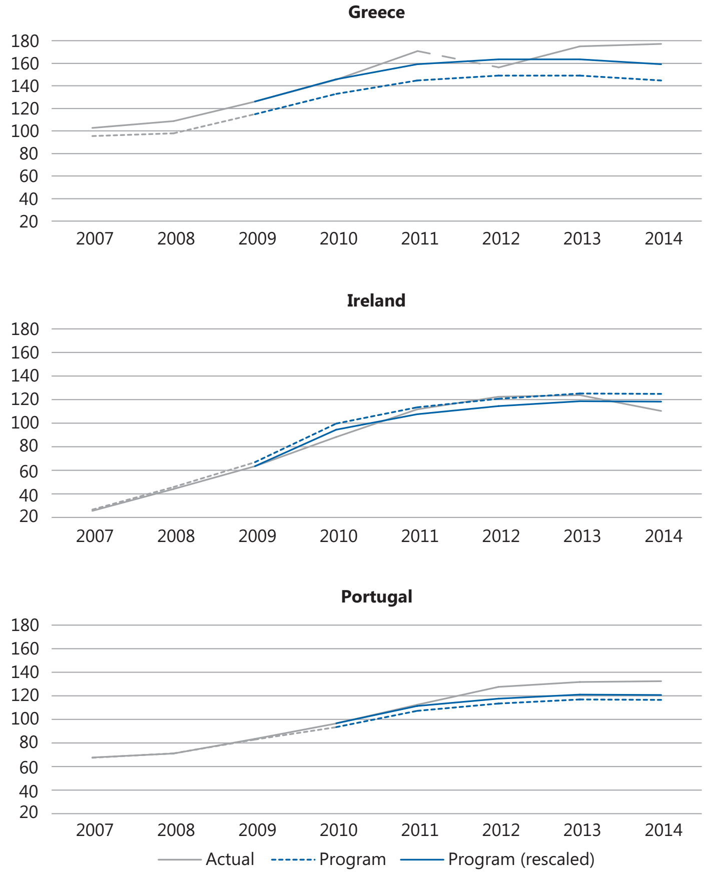
In part to justify granting Greece exceptional access to IMF resources, the Fund had to satisfy itself on several criteria, including a high probability that public debt was sustainable over the medium term. Given prevailing uncertainties regarding debt sustainability, the IMF sought to bolster the case for exceptional access by invoking the newly devised criterion of a "high risk of international spillover effects."[46] In an attempt to show that over time Greece's public debt would be sustainable, the Fund prepared a medium-term baseline debt scenario on the basis of what its own ex post evaluation would later acknowledge were excessively optimistic macro-fiscal assumptions.[47] A similar exercise was repeated at the beginning of each of the other two programs as well, though underpinned by relatively more realistic assumptions.

In both Greece and Portugal, the actual trajectory of the public debt ratio was significantly higher than projected—rescaled to incorporate data revisions—under the initial programs (Figure 6.4). Even with the 2012 debt restructuring, Greece's public debt exceeded the projected stock by a wide margin by 2013. By contrast, by the end of the adjustment program, Ireland's debt ratio had actually been contained below the projected ratio on an apparently sustainable path.

[46] On the Fund's Greek rescue operation, including insights into the inter-institutional and interpersonal dynamics, see a comprehensive discussion by Schadler (2013).

[47] Specifically, the underlying assumptions included a relatively rapid resumption of growth and a turnaround in the primary balance from deficit to surplus over the scenario period, all on the strength of structural reform measures assumed to be launched during the program; see IMF (2010a, 2013b).

Figure 6.4. Greece, Ireland, and Portugal: Actual and Projected Public Debt Ratios, 2007–14
(In percent of GDP)



Note: Projections have been rescaled to fit revised actual base-year data. The original actual data and projections at the beginning of the program are shown by broken lines.

Sources: IMF, *World Economic Outlook* and author's estimates.

Scale and Composition of the Adjustment

The IMF-supported stabilization programs that were launched in May 2010 in Greece, in December 2010 in Ireland, and in May 2011 in Portugal were unique in several respects. First, these programs were constrained by a common currency, limited nominal wage flexibility (though with some slowdown in wage growth during the programs), and low inflation. As noted above, these constraints imposed an extraordinary adjustment burden on fiscal policy. Second, the programs were undertaken in the face of stagnant external demand and financial fragmentation, which acted as impediments to export performance and capital inflows, respectively. And third, the program required unprecedented support and tutelage—both in scale and coordination—from the IMF, the EC, and ECB, which became known as the troika. This posed a singular operational challenge for all three institutions.[48]

Internally, the three programs differed in two important respects: the degree of local ownership and institutional constraints. These factors had important implications for the design and implementation of the fiscal components of the adjustment, for the credibility of the authorities' policy commitments, and ultimately, for the outcome of the adjustment effort.

In Ireland, from the outset of the crisis, there was strong and widespread local ownership of the adjustment effort, which the government had launched before the arrival of the troika. Indeed, the authorities reacted with conviction in the face of an extraordinary rise in the budget deficit to more than 30 percent of GDP and in the public debt ratio by nearly 100 percent—two-thirds stemming from the fall in tax revenue due to the collapse of asset values and one third from the recapitalization of the banking sector.

In Portugal, by the beginning of 2011, the government's initial denial of the crisis gave way to negotiation of an Extended Arrangement that was honored by the succeeding coalition government—though without completing the final review, whereby the program lapsed without the final disbursement. The resulting implicit consensus among political parties as well as other stakeholders lasted until the fall of 2012, when the government made a failed attempt to shift a portion of the social security payroll tax obligation from employers to employees—as part of an internal "fiscal devaluation" and to offset the budgetary cost of a Constitutional Court decision to annul a proposed expenditure-saving measure—without consulting social partners. Following an equally failed attempt (in line with an initial commitment under the program) to shift part of the employers' payroll tax to an increase in the value-added tax (VAT),[49] the government opted for a significant hike in the personal income tax. Subsequently, opposition parties withdrew support for the program and pledged to reverse some fiscal measures if elected.

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[48] According to several current and former staff interviewees, communication was sporadic not only among the troika participants, but also within the Fund.

[49] The government expected that the shift in the payroll tax burden to employees would have an equivalent positive budgetary effect because of the saving in the government's own gross wage bill (which would be transferred to public sector employees). This was the type of fiscal devaluation initially envisioned in the IMF-supported program. This idea was inspired by Blanchard (2007) and had been implemented with mixed success several decades earlier in Italy ("*fiscalizazzione degli oneri sociali*"); see the analysis in Kopits (1982). Internal simulations by EC staff with the QUEST model indicated that neither proposal would have any effect on Portugal's competitiveness; instead, the tax saving would be absorbed mainly as a windfall in Portugal's nontradable sector. In the end, despite its conceptual attractiveness to improve external competitiveness and its hoped-for beneficial fiscal impact, the proposed partial shift of the employers' payroll tax was opposed even by employers because of its potential adverse consequences for labor relations.

In Greece, following a period of denial that lasted well into 2010, the political leadership never really identified itself with the policy requirements of the program. As reported by various interviewees, successive governments blamed the outside world, to a greater or lesser degree, for the hardships imposed by the fiscal measures under the program. Lack of ownership throughout the program was a serious handicap to successful implementation.

Whereas in Ireland institutional constraints were minimal, in Greece, and to a lesser degree in Portugal, they posed a major stumbling block in the design and delivery of the fiscal adjustment. Despite being classified as an advanced economy by virtue of its euro area membership, by all accounts Greece's institutional capacity in the judicial process, tax administration, expenditure control, and statistical services was below that in practically any other European economy. In Portugal, apart from some weaknesses in public financial management, the program was affected by several decisions by the Constitutional Court—some of them unforeseen at the time of legislation—which struck down certain fiscal measures that the Court interpreted as being contrary to the acquired rights of citizens, especially public employees, that were enshrined in the Constitution.

Given the extent of their fiscal imbalances and accumulated public debt, in the context of the common currency and real wage rigidity, all three countries faced a major fiscal adjustment need. Therefore, inevitably, each program entailed a large-scale front-loaded budgetary consolidation, which was rendered onerous by the lack of access to market financing and by the stagnant economic environment in major trading partner countries. While the EU institutions, particularly the ECB, insisted on compliance with the statutory deficit ceiling of 3 percent of GDP by the end of the program period, the Fund's objective was to restore public debt sustainability. The resulting fiscal targets were seen by staff as a compromise between the two positions.

In both size and speed, the envisaged adjustments ranked among the largest in recent decades[50]—with the possible exception of the recent adjustment in Latvia, also undertaken under a hard exchange rate peg. Most outside observers and some inside the Fund expressed the view that the fiscal adjustment was probably excessive, but for the most part unavoidable not only because of the regional economic contraction but also because of the limits on financing available from private and official sources.[51] Nonetheless, some observers, including within the Fund, questioned whether the extent of the fiscal adjustment should have been as procyclical—apparently designed using

[50] See Tsibouris and others (2006).

[51] The external financing constraint, including the initial reluctance to undertake large-scale debt restructuring, was the reason given by some interviewees for the over-optimism of the macro-fiscal forecasts and long-term debt projections for Greece by IMF management and senior staff to justify the SBA for Greece at the Executive Board.

low underlying fiscal multipliers.[52] The debate over the size of the multipliers, though of interest from an analytical point of view, was regarded as of limited practical relevance, given the need to meet a very large financing requirement under each program because early debt restructuring was ruled out.

With far less justification, however, for both Greece and Portugal, the nominal deficit ceiling was frequently revised in the course of the program, often in tandem with GDP, which contracted more than anticipated. The latter was tantamount to disallowing the operation of automatic stabilizers, thus aggravating the procyclicality of the fiscal stance, which in turn widened the nominal deficit and exacerbated the contraction—a self-defeating approach, much like the case of a dog chasing its own tail. By contrast, in the case of Ireland, no such revisions were undertaken during the program and the stabilizers were permitted to operate, possibly contributing to the fiscal correction and an earlier recovery.

All told, the actual primary fiscal adjustment ranged from 9 percent of GDP in Greece to 10½ percent of GDP in Ireland, with Portugal recording 9½ percentage points. However, the annual retrenchment was comparatively much larger in Greece insofar as the Greek program lasted two years, while in the other two countries the retrenchment took place over a three-year period. Remarkably, in each case, the actual adjustment deviated by less than 1 percentage point from the initially programmed adjustment (Table 6.1).[53]

The composition of the fiscal consolidation varied significantly across the three programs. Whereas in Portugal the adjustment in the primary budget deficit was split evenly between revenue hikes and spending cuts (contrary to the initially programmed reliance on mostly across-the-board expenditure cuts), in Greece two-thirds of the consolidation took place in the form of increased revenue. By contrast, in Ireland almost the entire adjustment consisted of

Table 6.1. Greece, Ireland, and Portugal: Fiscal Adjustment During the Program
(In percent of GDP)

	Greece	Ireland	Portugal
Primary balance, projection	9.6	10.9	8.9
Primary balance	8.9	10.5	9.5
Revenue (excluding interest)	5.8	1.1	4.7
Expenditure (excluding interest)	–3.1	–9.4	–4.8

Sources: IMF staff reports and *World Economic Outlook*.

[52] Blanchard and Leigh (2013) found evidence that fiscal multipliers were underestimated and growth forecasts were optimistic in the adjustment programs. In fact, the multiplier of 0.5, assumed uniformly for all three programs on the basis of OECD estimates, ignored the wide range of multiplier values across countries under different conditions. The assumed value was particularly low for Greece, given its relatively closed economy.

[53] It should be noted that Table 6.1 is based on calendar year data (2010–12 for Greece, 2009–13 for Ireland, and 2011–14 for Portugal), which do not coincide with the program period. In the case of Ireland, 2009 was used as the base year for the calculation, rather than 2010 when primary expenditures included the one-off capitalization of the banking sector.

expenditure reductions. Thus, except in Ireland, the composition of the adjustment is likely to have had an unfavorable impact on output.[54]

A closer look at composition reveals additional doubts regarding the quality of the adjustment in terms of longer-run effects on economic growth and public debt sustainability. It is well known that increments in property taxes and indirect taxes on goods and services are less distortionary than hikes in income and payroll taxes; also, in general, tax-base broadening is far preferable to statutory tax rate increases.[55] On the expenditure side, cuts in wages, pensions, and subsidies are preferable to cuts in productive investment; furthermore, rationalization of the public sector work force to retain productive employees, and targeting of social benefits, can actually be favorable to growth.

From this perspective, program implementation was in some instances harmful to growth and, as a corollary, inimical to debt sustainability. For example, the reliance in Greece and Portugal on tax rate increases (and less on tax-base broadening), investment spending cuts, and across-the-board wage freezes or reductions (rather than trimming the workforce) seems to have been a strategy favored on political grounds by the authorities and endorsed at least tacitly by the Fund.[56] In Portugal the Fund backed the merger of certain defined-contribution private pension funds with the defined-benefit public pension system—thus compounding the future public debt burden with additional contingent liabilities for the sake of a short-run reduction in the budget deficit. Also, to ensure compliance with the deficit ceiling, the Portuguese authorities imposed a heavy income-tax surcharge, apparently endorsed by the Fund.

Admittedly, when confronted with solvency and liquidity problems, "policymakers may not be in a position to select an optimal tradeoff between quality and speed of adjustment" (Tsibouris and others, 2006). Yet, as indicated above, repressed deficits—through recourse to contrived short-run measures rather than sound policies—just like repressed inflation, are usually distortionary and self-defeating for restoring public debt sustainability.

Structural Conditionality

Structural fiscal measures comprised an integral component of the adjustment programs in Greece and Portugal, and to a much lesser extent in Ireland, reflecting mainly differences in institution-building needs among the three countries. From the Fund's perspective, structural conditionality in the three programs, which was mainly in the fiscal and financial areas, was

[54] According to Alesina and Ardagna (forthcoming), the higher the proportion of a fiscal adjustment achieved by expenditure cuts, the more likely its favorable impact on activity. Similarly, Perotti, Strauch, and von Hagen (1998) found that at least 70 percent of a successful adjustment is comprised of expenditure cuts.

[55] See the evidence for OECD member countries in Kneller, Bleany, and Gemmel (1999).

[56] Across-the-board wage freezes or cuts were perhaps justified given the very generous wage awards in the previous decade.

to be determined by its likely contribution to medium- to long-run fiscal sustainability and economic growth, as well as by the objective of introducing internationally accepted standards of good practice. By contrast, for the EU institutions, which were responsible for other areas, structural conditionality was formulated primarily to comply with EU single-market regulations. Accordingly, whereas in the Fund programs most structural measures were macro-critical, in the EU programs they were not.

Along these lines, while the Irish EFF-supported program contained only eight prior actions and structural benchmarks in the fiscal area, the Portuguese EFF-supported program prescribed 30 structural conditions (more than one-half of them in the form of prior actions) and the Greek SBA 27 structural conditions (fewer than one-fourth in the form of prior actions) in this area (Annex Tables 6.A1, 6.A2, and 6.A3). Unlike in Ireland and Portugal where the conditions were set over a three-year period, the structural conditions in Greece had to be met within two years. Actually, the number of measures required of Greece appears considerably higher when taking into account that each condition includes multiple measures in considerable detail.

In Ireland, the two key fiscal structural measures were (i) the adoption of a sound rules-based fiscal framework and an independent fiscal council, enacted in the Fiscal Responsibility Law, and (ii) the development of an effective medium-term budgetary strategy, with binding multiyear expenditure ceilings. Both conditions were met in a timely fashion.

By contrast, the SBA-supported program for Greece and the EFF-supported program for Portugal each included an extraordinary number of structural fiscal measures—even though these were not binding performance criteria[57]—when compared to other Fund-supported programs. According to IMF staff members and country officials interviewed for this evaluation,[58] the proliferation of measures in successive quarterly reviews of these two programs was in response not only to administrative weaknesses but also to mistrust in the authorities' commitment to reform.[59] The multiplicity of measures to be undertaken almost simultaneously, at times without adequate prioritization, imposed a considerable implementation burden on the government personnel.[60] Many structural measures were supported by recommendations from Fund technical assistance, as discussed in the next section.

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[57] In 2009, Fund conditionality was streamlined so that structural measures could no longer be specified as performance criteria (with which compliance by a specified target date is necessary for disbursements). Prior actions of course had to be met at the time of Board approval or review of a program, whereas deviation from structural benchmarks could be permitted through waivers granted on a discretionary basis.

[58] No authorities from Greece were interviewed for this chapter.

[59] According to Fund staff members involved in negotiations with the authorities in Greece, the structural reform measures that were incorporated in laws passed by Parliament were so riddled with loopholes that it was necessary subsequently to specify additional prior actions to close the loopholes.

[60] This view was stressed by a senior Portuguese official in charge of implementing budgetary reforms.

In Portugal, most measures involved improvements in public financial management and an expenditure review, whose implementation was much slower and less comprehensive than initially envisaged. Major legislative actions encompassed the amendment of the budgetary framework, local government finances, and public pensions. In addition, tax and customs administration were streamlined in some operational and structural aspects. For the most part, these steps were completed as programmed, though in some cases with considerable delay. Several measures, especially those intended to prune social entitlements and to reverse the generous increases in government wages and pensions granted in previous years, were shelved and replaced by a significant increase in the income-tax burden, including a surcharge plus a solidarity levy.[61] The government explained the Constitutional Court's decisions as a reason for substituting tax hikes for expenditure cuts. Others who were interviewed for this evaluation argued, on the other hand, that the government could have anticipated some of the Court's decisions on the basis of past precedents and prepared backup spending cuts in the event of a possible adverse ruling.[62] The fiscal devaluation, consisting of a reduction of the employers' share of the payroll tax for social security, to be offset by an increase in the value-added tax (VAT) rate or some other equal-revenue measure, was the only benchmark that did not materialize under the program—as discussed above.

In Greece, structural conditionality covered the entire gamut of public finances, including public financial management, taxation, subnational governments, state-owned enterprises, and public pensions. On the whole, progress was fitful and subject to reversals for various reasons, most of which were beyond the control of Fund staff. A major factor was the high turnover of senior officials. Indeed, lack of local managerial continuity, coupled with frequent political interference, prevented the completion of many tasks envisaged in the program, despite the appreciation of the IMF staff's work voiced by the technical personnel at government ministries and agencies. For example, tax administration was without a head for more than a year; more recently, a highly competent head (so described by IMF and EC staff) was removed after a year in office for unexplained reasons.

Perhaps the most successful fiscal reform during the Greek program was achieved in public pensions, with technical assistance from the Fund and the EC. Specific steps envisaged toward restoring the solvency of the pension

[61] In 2013, the average effective tax rate is estimated to have increased by more than 6 percentage points to over 16 percent (in addition to the 11 percent social security tax) on gross personal income. The corresponding increase in the top income bracket was 12 points to nearly 52 percent.

[62] In Ireland, the government consulted with the court before introducing potentially contentious measures to ensure judicial validation.

regime included: an increase in the standard and early retirement ages, a reduction in the statutory wage-to-pension replacement rate, cuts in marginal accrual rates, an extension in the calculation of the pension base to lifetime earnings, and indexation of pensions to inflation. Some of these measures await full implementation; in addition, a large number of pension schemes have yet to be unified under the central system. Another area of some progress has been the creation of a fiscal council, which in its initial phase was highly political, but has more recently been replaced by an independent institution attached to Parliament.

A measure that stands out in the Greek case was the government's apparent commitment to privatize state-owned enterprises and other state-owned property—at the behest of the Fund staff—with proceeds valued at 50 billion euros in the fourth review. Although intended primarily to help close the immediate financing gap, the privatization would have conferred lasting benefits in terms of increased efficiency in the corporate sector. In retrospect, the targeted amount proved unrealistic. Lack of broader support and adequate technical preparation blocked this initiative during the program period.[63]

Overall, structural conditionality in Greece's adjustment program was widely viewed as a means to build much-needed institutions that would pave the way for public debt sustainability. In essence, the goal—elusive at best—seems to have been a regime shift toward improved governance in the public finances, characterized by institutions that ensured transparency and predictability in fiscal policymaking.

Public Outreach

The success of a large-scale fiscal adjustment hinges to a large extent on public support, which in turn depends on timely availability of information on the design and implementation of its components, and—even more important—on their underlying rationale and anticipated socioeconomic impact.[64] The need for transparency and communication becomes crucial

[63] According to internal government calculations at the time, the state owned about 100 properties with a book value that was estimated at 300 billion euros and with a market value of some 70 billion euros. On this basis, the objective of selling assets worth 50 billion euros was deemed feasible by some Fund staff members interviewed. In the opinion of EC staff, the targeted proceeds from privatization were highly unrealistic. Privatization, in any event, encountered strong opposition from various interest groups, according to interviews with IMF staff.

[64] According to the Executive Board, "The primary responsibility for communicating policy intentions and program content to the public rests with the authorities themselves, but the IMF can play an important supporting role. Many staff missions are already engaged in communication with the public, and this activity has often proved to be helpful. Generalizing that type of activity could reap dividends, but it would need to be a genuine two-way exchange that respects a country's circumstances; is carried out in coordination with the authorities, and avoids perceptions of the Fund as overly intrusive" (IMF, 2001b).

where public support and/or government ownership are scant or altogether absent. This is particularly the case with regard to structural and stop-gap measures in the fiscal area, as taxes and subsidies are typically among the most visible measures and touch directly the welfare of households and enterprises. On this score, the track record of the national authorities and the troika was uneven across the three countries.

Ironically, the program's objective, rationale, and fairness were most transparent and most effectively communicated by the authorities and IMF representatives in Ireland, where the extent of local ownership was the highest. Openness and frequent media contacts may have contributed significantly to the success of the program. In anticipation of, and during, the program, government leaders regularly explained the fiscal strategy and policy measures and their likely impact, as well as the steps to alleviate adverse repercussions. With encouragement by the authorities, Fund staff held press conferences at regular intervals, after most program reviews, to brief the public on progress under the program.

In Portugal, contacts between the IMF staff and the public were less frequent but intensified at a later phase in the program, as a new IMF mission head met with various media representatives almost after every visit. In one instance, the head of a technical assistance mission on public financial management participated in a televised parliamentary budget committee meeting, which was well received by the legislators and the media.

Lack of transparency and public outreach was most pronounced in Greece on several counts. For one, the flow of information from the government to the general public and to the IMF and the EC on fiscal developments was rather infrequent and incomplete.[65] For another, this was paralleled by the lack of communication from the IMF and EU institutions to the public. Following a press conference held in February 2011 in Athens, the troika had no more contacts with the local media.[66] In addition, a culture of opacity prevailed around the Greek program both within the Fund and toward the general public.[67] These developments not only failed to generate local ownership for the program, but rather contributed to weaken it further.

[65] The problem was compounded by the risk faced by government employees in being charged for treason for having provided information to foreigners. Under a recently enacted law, any government official who served in the period 2009–14 may be summoned to appear in front of a special investigative committee to testify about releasing information to foreigners.

[66] The press conference by the troika team was widely regarded as counterproductive, attributed mainly to the surprise announcement of the privatization of state-owned assets, without prior negotiation or preparation—as indicated above. From then on, the only contacts with the media consisted of background press interviews with senior IMF staff.

[67] Several interviewees observed that the limited flow of information within members of the mission for Greece might have prevented fuller exploration of alternative approaches. Some recalled tensions within the troika and between the IMF and the national authorities.

A related area was the apparent lack of sufficient concern expressed publicly by the IMF and EU institutions in addressing the social costs of the programs, possibly as compared to a counterfactual no-adjustment scenario. Although in the design of fiscal measures under the program, Fund staff paid attention to protecting the more vulnerable segments of the population, this concern was not adequately communicated. Focusing publicly on the distribution of the adjustment burden (say, by income level or sectors), along with suggested targeted fiscal measures to alleviate hardship for those seriously affected, can help create greater support for an adjustment. In general, national authorities in the program countries did little to quantify or communicate the social and economic effects of the programs. As an exception, the Irish authorities published an initial appraisal of the impact of the pre-troika fiscal adjustment on low-income households and of a package of measures intended to alleviate it. In Greece after the evaluation period, the new Parliamentary Budget Office published estimates of the distributional consequences of the fiscal adjustment (Greece, Parliamentary Budget Office, 2014). The Fund could have done more to discuss and circulate publicly estimates of the distributional effects of the adjustment in Greece and Portugal, possibly during the program.[68]

Technical Assistance

From the beginning of the crisis, FAD staff were called upon to provide specialized technical assistance (TA) with utmost urgency over practically the entire range of public finances, on a scale comparable only to the task faced during the post-socialist transition of the 1990s. The bulk of the assistance was concentrated in Greece, followed by Portugal, while the need for TA in Ireland was minimal—as illustrated by a tally of missions for each country by major area of fiscal policy and administration (Table 6.2).

In Greece, the dearth of institutional capacity in the public finances compared to that in other EU members (including most post-socialist members that joined since 2004) first became apparent in 2005 when, at the authorities' request, the FAD fielded TA missions in social security, public financial management, and taxation. By the onset of the crisis in early 2010, FAD staff members who headed TA missions to Greece rated the country's institutional capacity in public finances as comparable to that of a low-income developing economy. Parenthetically, the staff's surprise at the low level of administrative, professional, and statistical capacity in the fiscal area attests

[68] For Greece, measurement of the distributional impact was admittedly complex. According to the ex post evaluation of the SBA by the IMF (2013b), the impact on job losses was rather uneven between public and private sectors. On the other hand, micro simulations by Avram and others (2013) on the basis of a tax-benefit model suggest that the net direct impact of the fiscal consolidation on household disposable income, as measured by changes in the Gini coefficient, was favorable. These results are briefly summarized in IMF (2014a, Box 1).

Table 6.2. Greece, Ireland and Portugal: IMF Technical Assistance, 2005–14
(Number of missions)

	Greece	Ireland	Portugal	Total
Macro-fiscal framework	1		1	2
Public finance management	21	1	8	30
Treasury operations	2			2
Expenditure policy (including review)	11	2	2	15
Tax policy	15		2	17
Tax (including social security) administration	63		8	71
Fiscal transparency, ROSCs	2	1	2	5
Total	**115**	**4**	**23**	**142**

Note: ROSCs = Reports on the Observance of Standards and Codes.
Source: IMF Fiscal Affairs Department, technical assistance reports.

to the weakness of pre-crisis surveillance (including in fiscal transparency) and the insufficient transmission of country-specific information between consecutive missions.

Besides the obvious need for structural reform encompassing practically all aspects of public spending and taxation, as well as extra-budgetary operations (including social security, subnational governments, and state-owned enterprises), Greece's fiscal adjustment hinged on speedy progress in institution building across a wide spectrum. In particular, fiscal consolidation could not be undertaken without some elementary steps toward establishing effective tax collection and budgetary control. In addition to TA missions, this effort entailed continuous hands-on assistance by a large team of resident experts and multiple follow-up staff visits. In principle, the Fund staff provides TA at the request of a member government, quite separately from any program conditionality. But, given the magnitude of the institution-building task in Greece, it was necessary to rely on TA recommendations to formulate structural fiscal measures for purposes of prior action and structural benchmarks. FAD and EUR staff reported that they worked closely and productively in this endeavor but, given the magnitude of the task and the limited window of opportunity for lasting progress, TA in the fiscal area should have been better prioritized during the program.

FAD's technical assistance advice to Greece, as reflected in its mission reports, was on the whole sound, candid, and timely.[69] But the delivery of TA was handicapped by insufficient prioritization; ad hoc decision making,

[69] The only exception was in the area of fiscal transparency, on which—as staff members themselves admitted—missions were conducted on a superficial and legalistic level. Reports on the Observance of Standards and Codes (ROSCs) were ridden with euphemistic characterizations, presumably to avoid embarrassing the authorities in public, especially as evidenced by the pre-crisis report (IMF, 2006). A more candid analytical approach was adopted only during the crisis (IMF, 2012b).

with moving targets in multiple initiatives that occasionally had a tenuous bearing on macro-fiscal adjustment; and severe limits on Greece's capacity to absorb TA due to the lack of adequate institutional and political support. By and large, at a technical level, the Greek counterparts had a receptive attitude toward TA. However, according to FAD staff members, the willingness of Greek officials to cooperate was undermined by lack of support from the political authorities—which was due to a large extent to frequent leadership changes at ministries and administrative agencies, and to a general atmosphere of distrust.[70]

The task at hand was further complicated by difficulties in coordinating with the Task Force for Greece (TFGR), which was established in 2011 under the umbrella of the EC to identify and coordinate the technical assistance that Greece needed in order to meet the terms of the EU/IMF program. The Task Force relied heavily on consultants from EU member countries to provide TA, some of which FAD staff found to be unhelpful to Greece's immediate needs. In the area of tax administration, for example, a national TA provider underplayed the need for autonomy of tax administration, whereas FAD staff considered autonomy essential for generating much-needed government revenues and for withstanding the extraordinary pressures exerted continuously by interest groups and political parties on the tax authorities. TFGR coordinators, on their part, argued that IMF TA experts did not sufficiently appreciate the continental European approach to public finances and that they focused mainly on organizational and managerial issues and elucidating good practices rather than on providing hands-on training for staff at various levels. In the views of several IMF staff members, the need to coordinate with the TFGR added an extra hurdle to the efficient delivery of TA.[71] Results have been uneven at best. By the second year of the program, some progress had been achieved in tax administration and in the reform of public pensions, but these achievements in part unraveled after the program period.

In Ireland and Portugal, both management and delivery of TA were much easier in both substantive and operational aspects. In fact, FAD TA to Ireland was peripheral insofar as the fiscal adjustment could be implemented with

[70] The reluctance of government officials to provide data was widely ascribed to a fear that they would be taken to task, and possibly accused of treason, for revealing information that could be detrimental to the national interest—as evidenced by the felony charges brought against the head of the statistical office in 2013.

[71] Perhaps the only comparable exercise was the large-scale TA that the IMF provided in 1990 to the former Soviet Union, involving cooperation among four international financial institutions. In that case, there was a clear division of labor among clearly demarcated areas, with the Fund taking responsibility for TA in the public finances (headed by the author), monetary policy, and the foreign exchange and payments system. See IMF, IBRD, OECD, and EBRD (1991).

practically no need for institution building. In both countries, the IMF was the sole provider of TA in public finances, with relatively limited input from EU institutions. Moreover, the authorities welcomed Fund assistance and were cooperative at all levels. For these and perhaps other reasons, TA was far more successful in Ireland and Portugal than in Greece. In Portugal, advice in tax administration was implemented and headway was made in improving public financial management.

Summary and Major Lessons

This assessment of the Fund's role in the fiscal aspects of the euro crisis reveals a mixed track record. Overall, whereas pre-crisis fiscal surveillance was for the most part not effective, the fiscal components of the stabilization programs, as well as the related TA provided by the Fund, may be regarded on balance as positive under the prevailing circumstances in the euro area. The evaluation of the experience before and during the euro area crisis offers a number of lessons, some of which corroborate those derived from an earlier evaluation of IMF performance in the run-up to the crisis.[72] A number of weaknesses, and concomitant lessons, noted herein have been remedied or are in the process of being corrected.

Fund surveillance of public finances in euro area member countries during the decade up to the beginning of the crisis was characterized by complacency as well as by a "Europe is different" mindset. While IMF fiscal advice for the euro area as a whole was broadly appropriate, assessments of the fiscal stance, transparency, sustainability and risks in fiscally vulnerable countries were rather superficial and mechanistic. Undue reliance was placed on vigilance by EU institutions in monitoring and enforcing the rules-based fiscal framework enshrined in the Stability and Growth Pact. The Fund adopted the prevailing conventional wisdom that external imbalances did not matter within the euro area. Although IMF staff stressed the need for fiscal discipline in euro area members, it did not highlight the possibility that fiscal imprudence could lead to a debt crisis in a currency area. Arguably, light surveillance of euro area member countries contributed directly or indirectly to the metastasis of the financial crisis into a full-fledged public debt crisis in at least three euro area members.

Lessons for the Fund from the pre-crisis surveillance experience are rather straightforward. First, fiscal surveillance needs to be applied with uniform

[72] The concluding observations of the IEO evaluation of Fund performance prior to the global financial crisis were summarized in IEO (2011) under four headings: analytical weaknesses, organizational impediments, internal governance problems, and political constraints. Along similar lines, it can be argued that such features in Fund fiscal surveillance contributed to its failure to help prevent the euro crisis.

rigor and candor across advanced, emerging market, and developing economies, with full awareness that, under certain conditions, current account deficits driven by persistent government budget deficits or private sector overborrowing, or both, may well result in a sudden stop in financing from abroad. This lesson cannot be overemphasized for members of a currency union, insofar as any remedial action, following a crisis, must be borne largely by an extraordinary fiscal adjustment. Second, surveillance should probe the fiscal fundamentals and identify critically any deficit or expansionary procyclical bias in the conduct of fiscal policy and excessive optimism in fiscal forecasts, rather than be guided by market perceptions reflected in sovereign risk premiums. Third, countries that are deemed fiscally vulnerable over a prolonged period should be subject to enhanced surveillance, which could help detect weaknesses in fiscal institutions. Furthermore, if a government is found to have repeatedly misreported or suppressed basic public finance statistics, it should be declared in breach of Article VIII. Fourth, Fund staff should employ state-of-the-art techniques for estimating the structural budget balance (e.g., with the underlying output gap augmented by asset prices) and assessing fiscal sustainability (e.g., complementing the standard template with estimates of an intertemporal public sector balance sheet) and risk (e.g., complementing the risk-assessment matrix with stochastic methods such as the value-at-risk approach). The decision of the Fund to respond to the euro crisis without a candid and realistic assessment of fiscal sustainability and financing need (to determine the case for exceptional access and debt restructuring) created a considerable burden on Fund resources and, arguably, a large fiscal adjustment for the crisis-hit euro area countries, especially Greece.

The Fund-supported euro area stabilization programs were constrained in several important respects: membership in a common currency area, stagnant external demand, and financial fragmentation within the euro area. In addition, the programs in Greece and Portugal were subject to institutional impediments and weak or eroding ownership. These conditions placed an extraordinary burden on fiscal adjustment, institution building, and public communication, particularly in Greece and Portugal. But the ensuing size of the adjustment may have been excessive in these countries, where the assumed underlying fiscal multipliers were too small and the automatic stabilizers were prevented from operating during the course of the program. Also, the composition of the adjustment in some programs was biased in favor of tax-rate increases rather than pruning expenditures. The attempt to correct for the latter with growth-supporting structural fiscal conditionality was less than successful, partly because of the apparent lack of prioritization in the face of institutional impediments. Fund technical assistance, which was mainly intended to support the structural fiscal reform measures, could have been delivered at a pace and in a manner that were more commensurate with the local resources and environment, especially in Greece. All along, the Fund did not use communication channels effectively, except in Ireland.

The Fund's experience with the fiscal aspects of the euro crisis provides a number of lessons as regards financial assistance, program design and implementation, structural conditionality, communication, and technical assistance. First, financial support should be predicated on a realistic analysis of the sustainability of public debt and, if necessary, on a debt restructuring adequate to bring about fiscal sustainability within a reasonable time horizon; in turn, such analysis and prerequisites can help tailor and phase a realistic fiscal adjustment. Second, in the design of the scale and time-path of the fiscal adjustment it is necessary to avoid insofar as possible an excessively procyclical stance; in any event, automatic stabilizers should be permitted to operate in the course of a given program year. Third, in general, the adjustment should have a heavier expenditure component than tax component, while productive investment outlays and broadening the effective tax base should be favored. Fourth, structural fiscal conditionality, as well as any supporting technical assistance, should be adequately paced and well prioritized, taking into account local implementation capacity as well as institutional and cultural impediments, and spelling out ex ante adequate fallback options in the event that such impediments materialize. Finally, managing an effective and frequent public outreach and promoting transparency are essential ingredients for the success of an adjustment, especially in countries where the authorities' credibility and public support are limited.

Annex Table 6.A1. Greece: Structural Fiscal Conditionality Under the SBA, May 2010–March 2012

Prior Actions	Test Date	Status
Reduce public wage bill by cutting bonuses/allowances; and pension bonuses (except minimum pensions).	Start	Met
Increase standard VAT rate from 21 percent to 23 percent and reduced rate from 10 percent to 11 percent and excise tax rates on alcohol, tobacco, and fuel with a yield of at least €1.25 billion in the remainder of 2010.	Start	Met
Appoint staff team and leader in GAO responsible for general government in-year cash reporting.	Start	Met
Parliament to approve medium-term budget strategy (MTFS).	4th review	Met
Government to legislate key fiscal-structural reforms in an MTFS Implementation Bill.	4th review	Met
Government to complete key actions to implement the various measures approved in the context of the first MTFS reform bill and anticipated in the second set of reform bills, including the reform of the public sector wage grid and the closure and/or merger of extra-budgetary funds.	5th review	Not applicable
Government to enact spending reductions (including pensions and earmarked spending and advanced removal of the heating fuel subsidy); revenue measures (including reducing PIT thresholds and reductions).	5th review	Not applicable

Structural Benchmarks	Test Date	Status
Adopt and start to implement a reorganization of sub-central government with the aim to reduce the number of local administrations and elected/appointed officials (*Kalikrates*).	June 10	Met
Submit to Parliament amendments to Law 2362/1995 to (i) require the Ministry of Finance to present a three-year fiscal and budget strategy, (ii) introduce top-down budgeting with expenditure ceilings for the state budget and multi-year contingency margins, (iv) require a supplementary budget for any overspending above the contingency, and (v) introduce commitment controls. The amended law should be immediately effective, including in the context of the 2011 budget.	June 10	Met
The National Actuarial Authority to produce a report to assess whether the parameters of the new system significantly strengthen long-term actuarial balance.	June 10	Met with delay
Adopt a comprehensive pension reform that reduces the projected increase in public spending on pensions over the period 2010–60 to 2½ percent of GDP.	September 10	Met
Establish a commitment register in all line ministries and public law entities. Begin publishing monthly data on general government in-year fiscal developments (including arrears).	September 10	Met
Publish 2009 financial statements of the ten largest loss-making public enterprises, audited by chartered accountants, on the official website of the Ministry of Finance.	September 10	Met
Put in place an effective project management arrangement (including tight Ministry of Finance oversight and five specialist taskforces) to implement the anti-evasion plan to restore tax discipline through: strengthened collection funds—of the largest debtors; a reorganized large taxpayer unit focused on the compliance of the largest revenue contributors; a strong audit enforcement and recovery of tax arrears—coordinated with the social security program to defeat pervasive evasion by high-wealth individuals and high-income self-employed, including prosecution of the worst offenders; and a strengthened filing and payment control program.	September 10	Met
Publish a detailed report by the Ministry of Finance in cooperation with the single payment authority on the structure and levels of compensation and the volume and dynamics of employment in the general government.	December 10	Met with delay
Adopt new Regulation of Statistical Obligations for the agencies participating in the Greek Statistical System.	December 10	Met with delay
Pass legislation to: (i) streamline the administrative tax dispute and judicial appeal processes; (ii) remove impediments to the exercise of core tax administration functions (e.g., centralized filing enforcement and debt collection, indirect audit methods, and tax returns processing); and (iii) introduce a more flexible human resource management system (including the acceleration of procedures for dismissals and of prosecution of cases of breach of duty).	February 11	Met with delay
Appointment of financial accounting officers in all line ministries and major general government entities (with the responsibility to ensure sound financial controls).	March 11	Met with delay
Publish the medium-term budget strategy paper, laying out time-bound plans to address: (i) restructuring plans for large and/or lossmaking state enterprises; (ii) the closure of unnecessary public entities; (iii) tax reform; (iv) reforms of public administration; (v) the public wage bill; and (vi) military spending.	April 11	Met with delay

(*Continued*)

Annex Table 6.A1. (Continued)

Structural Benchmarks	Test Date	Status
Articulate a strategic plan of medium-term revenue administration reforms to fight tax evasion.	June 11	Met with delay
Publish three consecutive months of consistent arrears and consolidated general government fiscal reports (excluding small local governments).	June 11	Met with delay
Adopt the necessary changes to enact the plan to reform the general government personnel system.	June 11	Met with delay
Government to enact legislation in the context of MTFS implementation (phase II) to: (i) introduce pension adjustment bill stipulating freezes through 2015, introducing individual social security numbers, caps, means testing, and rationalizing benefits of pension funds; (ii) introduce single public pay scale bill, temporarily freeze automatic progression, and halve productivity allowance; and (iii) close 40 small public entities, merge 25 more small entities, and close an additional 10 large entities under line ministries and in the social security sector.	August 11	Met with delay
Government to achieve quantitative targets set under its anti-tax evasion plan.	December 11	Not applicable
Parliament to approve a tax reform package, including (i) a simplification of the code of books and records, (ii) the elimination of several tax exemptions and preferential regimes under the corporate income tax and the VAT; (iii) simplification of the VAT and property tax rate structures; and (iv) a more uniform treatment of individual capital income.	March 12	Not applicable
Government to undertake a thorough review of public expenditure programs to identify 3 percent of GDP in additional measures (including a 1 percent of GDP buffer of potential additional measures).	June 12	Not applicable
Government to meet newly introduced and more ambitious targets for audits and debt collection and the resolution of administrative appeals.	December 12	Not applicable

Annex Table 6.A2. Ireland: Structural Fiscal Conditionality Under EFF, December 2010–December 2013

Prior Actions	Test Date	Status
Submit the 2011 budget to Dáil Éireann	Start	Met
Ensure strict budget neutrality of the jobs initiative in 2011 and over the period to 2014 by specifying fully costed offsetting measures	2nd review	Met
Submit the 2012 budget to the Oireachtas	4th review	Met
Submit the 2013 budget to the Oireachtas	8th review	Met
Structural Benchmarks	**Test Date**	**Status**
Establish a Budget Advisory Council	June 11	Met
Introduce a medium-term expenditure framework with binding multi-annual expenditure ceilings with broad coverage and consistent with the fiscal consolidation	July 11	Met
Submit to Parliament, as part of the Fiscal Responsibility Bill, a legal framework for the Fiscal Advisory Council ensuring its independence	December 11	Met
Publish 2014 budget	October 13	Met

Annex Table 6.A3. Portugal: Structural Fiscal Conditionality Under EFF, June 2011–June 2014

Prior Actions	Test Date	Status
Prepare a comprehensive inventory of the existing tax expenditures (including all types of exemptions, deductions, and reduced rates), by type of tax, along with their costing estimates.	Start	Met
Establish temporary task force of judges to clear tax cases worth above euro 1 million.	Start	Met
Approve a standard definition of arrears and commitments.	Start	Met
Prepare a comprehensive report on 10 state-owned enterprises (SOEs) posing the largest potential fiscal risks to the state. The report would cover (i) concrete plans, per enterprise, for reducing its operational costs, consistent with an average cut of at least 15 percent in the sector over 2009 levels; (ii) a planned revision of the tariffs.	Start	Met
Issue an instruction to general government units requiring that from January 1, 2012, (i) commitments must be controlled against available funds recorded in the accounting system and evidenced by authorized commitment documents ("cabimento") bearing valid commitment numbers; (ii) all other commitments would be considered illegal and not eligible for payment; and (iii) any public official incurring such illegal commitment or expenditure will be subject to specified penalties in accordance with the budget framework law.	1st review	Met
Issue an instruction to general government units to ensure that systems and procedures will comply, by end-December 2011, with the revised budget execution rule, as set out in the above instruction.	1st review	Met
Parliamentary approval of a 2012 budget consistent with the program.	2nd review	Met
Pass a resolution of the Council of Ministers on a strategy document to clear the stock of domestic arrears of the general government and SOE hospitals, establishing the governance arrangements for prioritization and payment decisions.	3rd review	Met
Submit to Parliament the 2013 budget consistent with the program.	5th review	Met
Adopt by the Council of Ministers and publish the medium-term fiscal framework that includes fully specified measures to meet the 2014 deficit target.	7th review	Met
Submit to Parliament the supplementary budget that includes measures needed to meet the 2013 fiscal objective.	7th review	Met
Submit to Parliament a draft 2014 budget consistent with the general government deficit target of 4 percent of GDP.	9th review	Met
Submit to Parliament a draft law or a budget provision to implement the single wage-scale PER measure.	9th review	Met
Submit to Parliament a supplementary budget to enact the necessary changes to the existing extraordinary solidarity contribution on pensions (CES), consistent with the general government deficit target of 4 percent of GDP.	10th review	Met
Approve the decree law on the increase in the beneficiaries' contributions to the special health insurance schemes (ADSE, SAD, and ADM).	10th review	Met
Specify fiscal measures consistent with achieving the general government deficit target of 2.5 percent of GDP in 2015.	11th review	Met

(*Continued*)

Annex Table 6.A3 (*continued*)

Structural Benchmarks	Test Date	Status
Finalize calibration of fiscal reform to reduce unit labor costs via deficit-neutral reduction in employers' share of social security contributions.	July 11	Not met
Publish a fiscal strategy document for the general government which will specify four-year medium-term economic and fiscal forecasts, supporting analysis and underlying assumptions, and four-year costings of new policy decisions.	August 11	Met
Conduct and publish the results of a survey of arrears of general government entities and SOEs for all categories of expenditure as of end-June 2011.	August 11	Met
Based on assessment from EU/IMF technical assistance on the budgetary implications of main public-private partnership programs, recruit a top tier international accounting firm to complete a more detailed study of public-private partnerships and identify areas for deeper analysis by an international consulting firm.	December 11	Met with delay
Prepare a report on SOEs based on forecast financial statements assessing their financial prospects, potential government exposure, and scope for orderly privatization.	February 12	Met with delay
Revise and submit to Parliament the draft regional public finance law.	March 12; reset to December 12	Met with delay
Develop a specific program for unwinding Parpublica.	April 12	Met
Develop a public financial management strategy covering the next three years, to be attached to the 2013 budget.	September 12	Met
Implement a full-fledged Large Taxpayer Office to cover audit, taxpayer services, and legal functions concerning all large taxpayers, including the adoption of account managers.	December 12	Met
Update projections of the medium-term energy tariff debt path and identify policy options to eliminate the tariff debt by 2020.	June 13	Met
Submit to Parliament a draft law on the redesigned mobility pool.	June 13	Met
Submit to Parliament a new draft public administration labor law that will aim at aligning current public employment regime to the private sector rules, including for working hours and holiday time, and termination of tenure.	July 13	Partially met
Submit to Parliament a legislative proposal that increases the statutory retirement age to 66 years.	July 13	Met with delay
Submit to Parliament a legislative proposal that aligns the rules and benefits of the public sector pension fund (CGA) to the general pension regime.	July 13	Met with delay

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