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Prof. Dr. Franz Seitz
Prof. Dr. Thomas Jost

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Thomas Jost* and Franz Seitz[#]

*) University of Applied Sciences
Aschaffenburg
Würzburger Str. 45
D-63743 Aschaffenburg
Germany
thomas.jost@h-ab.de

#) University of Applied Sciences
Weiden, WSB Poznan
Hetzenrichter Weg 15
D-92637 Weiden
Germany
f.seitz@haw-aw.de

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Abstract
This paper gives an overview of the role of the IMF in the European debt crisis. It describes the rescue packages and the involvement of the IMF. The main part discusses the pros and cons of the participation of the IMF in elaborating and monitoring the economic adjustment programs for the countries in crisis. A last section concludes and tries to answer the question whether the "Troika" model might be suited to solve future international crises.

Keywords: IMF, Europe, debt, euro

JEL: F02, F53, F59

1. Introduction

Right from the beginning, the International Monetary Fund (IMF) was involved in the rescue actions of the European Union (EU) to fight the sovereign debt crisis that emerged end of 2009 in several European Monetary Union (EMU) countries. The IMF participated in the financial assistance and economic adjustment programs for Greece, Ireland and Portugal by contributing around one third to the emergency funds. In a "Troika", together with the European Commission (EC) and the European Central Bank (ECB), the IMF elaborated the economic adjustment programs for these economies and closely monitored their progress through quarterly reviews based on economic missions.

The active role of the IMF raises a series of questions: (1) Why did the IMF participate in the rescue programs? Was it a sign of weakness of the European institutions to solve their problems alone and/or did the Europeans want to use the outstanding expertise of the IMF in elaborating and monitoring economic adjustment programs with conditionality? (2) What are the pros and cons of taking the IMF on board? (3) How did the Troika act and was the cooperation successful? (4) Were there major differences in views within the Troika to solve the crisis? (4) Is the "Troika" - born in an emergency situation on an ad-hoc basis - a sustainable solution or a viable new institution in the long-run to fight a sovereign debt crisis? and (5) Is there a danger for the IMF to loose reputation by "getting into the mill" of diverging political interests in Europe? Or has the IMF even worsened the Euro-crisis? These questions are discussed in the following article whereby the analysis concentrates on the involvement of the IMF in the adjustment programs as well as on the IMF's role in the monitoring of the countries in crisis.

The IMF and prominent representatives of the IMF have also made a lot of proposals and were involved in many discussions on other measures to fight the sovereign debt crisis and prevent future crisis. This discussion is excluded and shall be left for future research.

The paper is organized as follows. After a description of the involvement of the IMF in the various financial assistance programs (chapter 2), the pros and cons of the participation of the IMF in the programs are analyzed (chapter 3). Chapter 4 discusses if the Troika is the best institution to deal with future crises in the Euro area and other regions of the world. Chapter 5 concludes.

2. Participation of the IMF in financial assistance and economic adjustment programs for EU countries in crisis

In October 2008, shortly after the culmination of the worldwide financial market crisis, Hungary requested a Stand-By Arrangement (SBA) from the IMF after it had consulted the EU.[1] The EU agreed and joined the IMF in providing Hungary additional financial support by using its Balance-of-Payments (BoP) Assistance Facility. The total front-loaded financing package amounted to € 20 billion (IMF: € 12.3 billion, EU: € 6.5 billion, Worldbank: € 1.0 billion).[2] The Hungarian program set a milestone as it was the first joint EU/IMF-program, a precedent for programs that followed. The United Kingdom in 1976 was the last EU (then European Economic Community, EEC) member that had got IMF assistance.[3] In collaboration with the IMF the EU developed internal guidelines for the implementation of future joint programs with the IMF based on the lessons of the Hungarian program.[4] Such programs should use the comparative expertise of both organizations, whereby the IMF draws on its extensive cross-country and financial crisis expertise and the EU helps to embed the financial assistance programs in a broader policy context set by the different institutional framework in the EU compared to other regions of the world.[5]

Already in December 2008, the IMF approved another SBA with Latvia, in connection with an adjustment program that was jointly elaborated with the EU and representatives from the ECB, Sweden and other Nordic countries.[6] In March 2009, the IMF granted a € 13 billion loan under the SBA to Romania (in addition to financial assistance through the EU, the Worldbank, the European Bank for Reconstruction and Development (EBRD) and other international institutions).[7] Romania was therefore the third EU (but non-EMU member) country under a joint IMF/EU program in spring 2009.

In October 2009, the newly elected Greek government raised its projections for the 2009 budget deficit from 3.7 % to 12.5% of GDP.[8] The dramatic worsening of the Greek

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[1] IMF, "Hungary: Ex post evaluation of exceptional access under the 2008 Stand-by Arrangement," *IMF Country Report* No. 11/145, June 2011, p. 4.
[2] IMF, "IMF Executive Board approves € 12.3 billion Stand-By Arrangement for Hungary," *Press Release* No. 08/275, November 6, 2008.
[3] IMF, "Hungary: Ex post evaluation," op. cit., p. 4.
[4] IMF, "Background information on participating RFAs," Seminar on regional financial safety nets, October 8, 2010, available at: imf.org.
[5] IMF, "Hungary: Ex post evaluation," op. cit., p. 35.
[6] IMF, "IMF Executive Board approves € 1.68 billion (US$ 2.35 Billion) Stand-By Arrangement for Latvia," *Press Release* No. 08/345, December 23, 2008.
[7] IMF, "IMF announces staff-level agreement with Romania on € 12.95 billion loan as part of coordinated financial support," *Press Release* No. 09/86, March 25, 2009.
[8] EEAG, "The EEAG Report on the European Economy, Governing Europe," Munich, 2011, p. 111. Finally, the deficit happened to be 15.4 % of GDP.

public deficit end of 2009 marked the beginning of the EMU sovereign debt crisis.[9] In the following months Greek's budget problems grew further – despite national reform measures and EU reactions in form of a closer monitoring.[10] Financial markets reacted heavily fearing a Greek default. Rating agencies cut Greek's rating from (A-) in early December 2009 to junk bond status end of April 2010 and Greek bond rate spreads widened dramatically in spring 2010.[11] Several other EMU countries (Portugal, Ireland, Spain and Italy) also got in trouble as their fiscal deficits grew and sovereign debt refinancing costs rose dramatically. On April 11, 2010, the EU joined by the IMF announced financial support for Greece and an economic adjustment program.[12] The increasing interest rate burden of several Euro area economies and the fear of a collapse of European banks that had not fully recovered from the 2008/2009 financial markets and economic crises prompted a collective reaction of the EU and the IMF.

In May 2010, the first financial assistance program for Greece was adopted by the European Council. The three-year economic adjustment program was supported by financial assistance of € 110 billion in the form of bilateral loans from EU economies (€ 80 billion) and an IMF contribution of € 30 billion in the form of a SBA, the standard lending instrument of the IMF (see table 1 for an overview of some program details).[13] The program was elaborated jointly by the Greek government together with the European Commission (EC), the European Central Bank (ECB) and the IMF, thenceforth called the "Troika". The program focuses on the high public debt of Greece and the lack of competitiveness of the Greek economy. The disbursement of the loan tranches is conditional on reform progress controlled by a close monitoring of the program through quarterly reviews of the IMF and the EU institutions.[14]

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[9] Hellwig differentiates between a sovereign debt crisis of Greece and Portugal and a real-estate and banking crisis in Ireland and Spain and bank vulnerabilities in Germany and France. We don't follow this classification here as all difficulties that countries face in the end lead to fiscal problems that are reflected in a strong rise in bond yields. See Hellwig, Martin, "Quo vadis, Euroland? European Monetary Union between crisis and reform," Max Planck Institute for Research on Collective Goods, Bonn 2011/2012, available at: www.coll.mpg.de/?q=node/2683.

[10] Council of the European Union, "Council gives notice to Greece to correct its government deficit by 2012, setting out a timetable for corrective measures," Press notice, Brussels, February 16, 2010.

[11] EEAG, "The EEAG Report," op. cit., p. 111. End of April 2010, 10-year Greek bond spreads over German bonds reached 755 basis points.

[12] IMF, "Statement by IMF Managing Director Dominique Strauss-Kahn on Greece," *Press Release* No. 10/143, April 11, 2010.

[13] IMF, "IMF Approves € 30 billion loan for Greece on fast track," *IMF Survey Online*, May 9, 2010.

[14] IMF, Ibid.

Table 1: Financial rescue packages for Greece, Ireland and Portugal

	Program and Financial Aid	EU contribution	IMF contribution
Greece May 2010 (first program)	3-year financial assistance program € 110 billion	€ 80 billion: via bilateral EU loans	€ 30 billion Stand-by Arrangement (SBA)
July/October 2011 (second program)	(€ 130 billion announced)	Program details and contributions of EU and IMF not concluded in January 2012	
Ireland November 2010	3-year financial assistance program € 85 billion	€ 62.5 billion: EFSM loan (€ 22.5 bn) EFSF loan (€ 17.7 bn) bilateral loans from UK (3.8), Sweden (0.6), Denmark (0.4) Irish contribution € 17.5 bn	€ 22.5 billion Extended Fund Facility (EFF) arrangement
Portugal May 2011	3-year financial assistance program € 78 billion	€ 52 billion: EFSM loan (€ 26 bn) EFSF loan (€ 26 bn)	€ 26 billion Extended Fund Facility (EFF) arrangement

Sources: Websites of IMF, ECB and EU commission.

Early in May 2010, as the crisis further spread to other EMU economies, the EU countries agreed to establish two funds with a total of € 500 billion, the European Financial Stability Facility (EFSF) and the European Financial Stabilization Mechanism (EFSM) that should lend up to € 440 billion and € 60 billion respectively to euro-area Member States in times of trouble.[15] The IMF should contribute another € 250 billion so that € 750 billion should have been available for financial rescue arrangements within EMU.[16] In March 2011, the EU decided to create a new permanent rescue fund that should replace the EFSF in 2013, the European Stability Mechanism (ESM), as it realized that the countries in trouble would

[15] EFSF Framework Agreement, 7 June 2010, available at: www.bundesfinanzministerium.de; Council of the European Union, "Council Regulation (EU) No. 407/2010 of 11 May 2010 establishing a European financial stabilization mechanism," available at: http://ec.europa.eu/economy_finance/eu_borrower/efsm/index_en.htm.

[16] In fact, the EFSF could not lend the full amount as several EMU member countries did not have an AAA rating. Therefore the EU decided in October 2011 to leverage the EFSF to an amount of up to € 1 trillion. See Deutsche Bundesbank, "Decisions of the European Council and the Euro Summit of 26 and 27 October 2011," *Monthly Report*, November 2011, pp. 64-65. Ahearn et al. point out that "The IMF, however, cannot pre-commit funds for a group of countries. Any IMF contributions to loan packages for Eurozone members will be on a country-by-country basis. Any such loan would also be subject to the approval of the IMF Executive Board in the same manner as all IMF lending arrangements." See Ahearn, Raymond, J.; Jackson, James K; Nelson, Rebecca M.; Weiss, Martin A., "The future of the Eurozone and U.S. interests," in: Farkas, Hannah J.; Murphy, Daniel C. (eds.), *The Eurozone: Testing the Monetary Union*, New York 2011, p. 18.

need much more time to return to capital markets and fund themselves.[17] Financial assistance for all the funds would be dependent on conditionality programs elaborated and monitored by the Troika.[18]

In November 2010, Ireland had to call the European Union and the IMF to help overcoming its crisis. Ireland's problems were mainly caused by state guarantees for the Irish banking system after the collapse of the Irish real estate sector in the wake of the financial market crisis in 2008/09 that increased Ireland's public deficit to 32.4 % of its GDP in 2010. A joint financing package of € 85 billion was concluded in November 2010, consisting of loans of the newly created EFSM and EFSF and bilateral loans from the United Kingdom, Sweden and Denmark. The IMF contributed € 22.5 billion via its Extended Fund Facility (EFF), the IMFs fast-track Emergency Financing Mechanism. Like in the case of Greece, the Troika elaborated a 3-year-program with the national authorities to address the main economic and financial problems of Ireland, the vulnerabilities of its banking system and the weak economic growth (table 1).[19]

In May 2011, Portugal, the third Euro area country, had to adopt a three-year economic adjustment program supported by a € 78 billion financial rescue package. It consisted of two loans from the EFSM and the EFSF (worth € 26 billion each). The IMF contributed € 26 billion under its EFF. Low economic growth, weak international competitiveness and high fiscal deficits of close to 10 % in relation to GDP in 2009 and 2010 led to an unbearable rise in government funding costs in Portugal.[20]

In July 2011, the EU announced a new program for Greece aiming to fill a prospective financing gap of € 109 billion. The lion's share of the financial help should result from reduced lending rates and extended debt maturities up to 30 years to improve the sustainability and refinancing profile of the Greek government debt. The remaining sum should come from a "voluntary" private sector involvement in the form of a haircut of outstanding Greek government bonds held by the financial sector, equivalent to an estimated

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[17] European Commission, "Treaty establishing the European Stability Mechanism (ESM) signed, 11 July, 2011, available at: http://ec.europa.en/economy_finance/articles/financial_operations/2011-07-11_esm_treaty_en.htm; EEAG, "The EEAG Report, op. cit., p. 83. In January 2012, it was decided to start the ESM already in mid-2012.
[18] EEAG, "The EEAG Report, op. cit., p. 84.
[19] IMF, "IMF Executive Board approves € 22.5 billion extended arrangement for Ireland," *Press Release* No. 10/496, December 16, 2010.
[20] IMF, "Executive Board approves an € 26 billion extended arrangement for Portugal," *Press Release* No. 11/190, May 20, 2011.

amount of €37 billion. The IMF announced continued support but no new financial resources.[21]

The European debt crisis entered a new stage as Italy and Spain got severe problems in late summer 2011. Despite continued ECB open market outright purchases of Italian and Spanish sovereign bonds their bond yields increased substantially. Markets more and more doubted the reform will, especially of the Italian government of Berlusconi. Under the pressure of several other EMU members during the G-20 meeting in Cannes early in November 2011, Italy officially asked the IMF to monitor its progress on improving its fiscal stance.[22]

The huge financial resources that would be needed to finance Italy's and Spain's sovereign debt if these economies had to leave capital markets triggered a reaction of G-20 and European politicians. In November 2011, the G-20 agreed to further strengthen global financial safety nets of national central banks, governments, regional arrangements and supported the IMF to create a new Precautionary and Liquidity Line (PLL).[23] In December 2011, the EU Council proposed to raise € 200 billion of additional funds for the IMF via loans of EU national central banks and expected "parallel contributions from the international community".[24] In January 2012, the IMF declared further financial needs of US-$ 500 billion.[25]

3. The pros and cons of IMF involvement

In what follows, we will discuss potential advantages and disadvantages as well as motivations of an IMF involvement in the intended resolution of the debt problems in the EMU. This discussion has to be assessed against the background of the official tasks of the IMF, laid down in the Bretton Woods Articles of Agreement, which are in addition to its

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[21] Council of the European Union, "Statement by the Heads of State or Government of the Euro Area and EU Institutions," Brussels, 21 July 2011; IMF, "IMF welcomes agreement to tackle Eurozone crisis," *IMF survey online*, July 22, 2011, available at: imf.org. In January 2012, the exact modus of the private sector involvement and the financial amount were not clear as the negotiations between the Institute of International Finance (IIF) which represents the bond holders and the Greek government were still not concluded. The successful conclusion of the negotiations is a prerequisite for the negotiations about the second Greek economic adjustment program.

[22] The New York Times, "Italy agrees to allow IMF to monitor its progress on debt," November 4, 2011, and IMF, "Statement by IMF Managing Director Christine Lagarde on the G-20 Cannes Summit," *Press Release* 11/395, November 4, 2011.

[23] G20, "Cannes Summit Final Declaration – Building our common future: renewed collective action for the benefit of all," November 4, 2011, available at: g20.org.

[24] European Council, "Statement by the Euro Heads of State or Government, December," Brussels, 9 December 2011.

[25] IMF, "Lagarde calls for urgent action so 2012 can be "year of healing", *IMF Survey Online*, January 23, 2012, available at: http://www.imf.org/external/pubs/ft/survey/so/2012/NEW012312A.htm.

important consultative and surveillance functions, especially providing resources to member countries experiencing temporary balance of payments problems under strict conditionality.[26]

IMF lending programs, though varying in objectives and duration, are often associated with a sharp and sustained redirection of the course of economic policy. An IMF supported program is typically initiated when a country faces the need for *external* adjustment. The IMF provides (co-)financing and the country puts in place a program of policies to redress actual or potential external imbalances. Continued lending depends on progress in implementing the program, which in turn is assessed on the basis of preset conditions (performance criteria) to be met by specified dates in the context of periodic reviews.[27] This raises the need to adapt program design to changing global and country economic conditions while preserving uniformity of treatment.

For a recent summary evaluation of IMF supported programs see the collection of papers in Mody and Rebucci (2006).[28] These papers provide a comprehensive overview on the evaluation of IMF programs. Such an evaluation is necessary to assess the IMF's role in the sovereign debt crisis in EMU. Their results related to our research question may be summarized as follows:

1. There is no significant *bias* in short-run growth projections. Beyond a horizon of about one year, however, the over-prediction of growth increases as the horizon lengthens. Reform programs tend to over-predict external adjustment, leading to a greater-than-projected buildup of external debt. Inaccuracies in the preliminary *statistical information* base are the most serious source of projection errors. In contrast, the forecasts of budget surpluses and economic growth by EU countries and the EU Commission are marked by cautionary or optimistic biases. Moreover, governments do not seem to use available information efficiently to minimise the forecast errors of their budgetary projections. There is only a partial correlation between the biases of economic growth and budgetary balances. The cyclical position and the form of fiscal governance are important determinants of biases in budgetary and GDP growth forecasts. There is also evidence that the failure to achieve the projected reductions in the general government deficit primarily reflects difficulties to adhere to expenditure plans in nominal terms. This does not seem to be due to particularly

[26] See Bordo, Michael D.; James, Harold, "The past and future of IMF reform – a proposal," in: Charles Wyplosz (ed.), *The new international monetary system*, London et al., Routledge, pp. 9f..
[27] Jeanne, Olivier; Ostry, Jonathan D.; Zettelmeyer, Jeromin, "A theory of international crisis lending and IMF conditionality," *IMF Working Paper* 08/236, Washington D.C.
[28] Mody, Ashoka; Rebucci, Alessandro, "IMF-Supported Programs: Recent Staff Research," Washington D.C., 2006.

unfavorable macroeconomic developments, but rather to the difficulties of EU countries to implement the reforms.[29]

2. More ambitious *fiscal contractions* are associated with better growth performance in the short-run and in the long-run. The quality of fiscal adjustment is better under IMF programs (than in countries without an IMF program) in the sense that it is directed more toward expenditure cuts than increases in taxes. For EMU countries, van den Noord and Cournède (2006) have shown that the short-run budgetary costs of structural reforms are small compared to the longer-term benefits for budgetary balances.[30]

3. A stronger *political and institutional environment* is conducive to better program implementation. The latter, in turn, is weakened by strong special interests in parliament, lack of political cohesion, political instability and inefficient bureaucracies. Program interruptions cause higher inflation, higher budget deficits, and lower growth even in comparison to periods without a program.

4. The IMF’s signaling role (i.e. the IMF’s “seal of approval” on a country’s reform policies) is not crucial to generate a catalytic process. Instead, it is the IMF’s *monitoring role* that allows countries on the reform path to signal commitment to reach its goals.

To qualify the outstanding role of the IMF in the European debt crisis the mere size of the financial contributions of the IMF have to be taken into account, too (see Table 1). In the past, the typical loan to quota ratio averaged 300 %, reaching an exceptional high of about 2,000 % for South Korea in the late 1990s during the Asian crisis. In comparison, the first IMF loan to Greece was equivalent to 3,200 % of Greece's quota.[31] At the end of 2011, the biggest debtors to the IMF were Greece, Ireland and Portugal. A worsening of the fiscal problems in Italy and Spain and emergency lending to these countries would clearly overburden the IMF.

Total IMF quotas amount to US-$ 383 billion. The usable resources of the IMF sum up to US-$ 628 billion, of which the one-year forward commitment capacity (fcc) is US-$ 389

[29] See Strauch, Rolf; Hallerberg, Mark; von Hagen, Jürgen, “Budgetary forecasts in Europe - The track record of stability and convergence programmes,” *ECB Working Paper* No. 307, February 2004; Moulin, Laurent; Wierts, Pieter, “How credible are multiannual budgetary plans in the EU?,” in: Banca d'Italia (ed.), *Fiscal Indicators*, Papers presented at the Banca d'Italia workshop held in Perugia, 30 March/1 April, 2006, pp. 983-1005.

[30] See van den Noord, Paul; Cournède, Boris, “Short-term pain for long-term gain: The impact of structural reform on fiscal outcomes in EMU,” in: Banca d'Italia (ed.), Fiscal Indicators, Papers presented at the Banca d'Italia workshop held in Perugia, 30 March/1 April, 2006, pp. 925-938.

[31] IMF, “IMF reaches staff-level agreement with Greece on € 30 billion Stand-By Arrangement,” *Press Release* No. 10/176, May 2, 2010. Ireland's and Portugal's loans from the IMF amounted to 2,400 % and 2,300 % of their quotas, respectively.

billion.[32] The first and second Greek programs together have a volume of more than US-$ 290 billion, nearly half of IMF's usable resources. Quota and voting reforms agreed in 2008 came into effect in March 2011, while reforms agreed in late 2010 are undergoing ratification by member governments. When completed, both reforms will have increased total quotas to about US-$ 934 billion.[33]

And finally, it has to be borne in mind that we have to find solutions for a *sovereign debt crisis* in the E(M)U. In this respect, Reinhart and Sbrancia (2011) have convincingly shown that historically - after WWII - financial repression (often disguised as prudential regulation) in combination with inflation have played an important role in reducing debt levels.[34] In many cases, this was accompanied by markets for government bonds increasingly dominated by non-market players, especially the central bank. All these considerations also have to be assessed against the fact that debt crises produce significant and long-lasting output losses with negative external effects, especially in a monetary union as Furceri and Zdzienicka argued.[35] Their research results also suggest that debt crises tend to be more detrimental than banking and currency crises.

3.1 The pros

(1) Independence, credibility and reputation

At the onset of the Greek crisis, the official EU opinion was to try to solve the problem within the EU or even within the euro area, but without external help. Asking for external help was seen as a sign of weakness of EU institutions. In effect, especially IMF intervention was opposed by the ECB. Early in March 2010, Trichet, the then President of the ECB, denied the need for IMF help and referred to the balance of payments financing mechanisms and the deficit rules of the Stability and Growth Pact.[36] At last, IMF involvement was a

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[32] Usable resources consist of holdings of currencies of IMF member states considered by the Executive Board to have a sufficiently strong balance of payments and reserve position for their currencies to be used in the financing of IMF transactions, holdings of SDRs and unused amounts, if any, under credit lines already activated. The fcc is a measure of the resources available for new financial commitments in the coming year. IMF, "IMF's financial resources and liquidity position, 2009 - November 2011," available at: http://www.imf.org/external/np/tre/liquid/2011/1111.htm.

[33] Deutsche Bundesbank, "Financing and representation in the International Monetary Fund," Monthly Report, March 2010, p. 58.

[34] Reinhart, Carmen M.; Sbrancia, M. Belen, "The liquidation of government debt," *NBER working paper series* 16893, Cambridge, Mass.

[35] See Furceri, Davide; Zdzienicka, Aleksandra, "How costly are debt crises?," *IMF Working Paper* 11/280, December 2010.

[36] Confronted with a question if Greece should knock on the IMFs door he answered: "I do not want to enter into some kind of fantasy scenario. Let me just say that belonging to the euro area is something which helps you considerably. When you are in the euro area, you have a kind of automatic financing of your current account. And when you have a current account deficit, as has been the case for Greece for a long period of time, you get the financing of your current account deficit, because the other economies of the euro area take care of that."

precondition for German chancellor Merkel to agree to financial assistance for Greece.[37] It was interpreted as the last exit option as all other opportunities had been exhausted. The principal problem that prevented a “European solution” was that the prescriptions of the EU Treaty were insufficient or not followed and that the EU Commission had no credibility and experience in handling severe national fiscal problems.

The joint EU and IMF rescue actions during the EMU debt crisis were political decisions under enormous pressure from financial markets. The IMF stood ready to participate in the rescue actions, but the EU leaders alone announced financial help and economic adjustment programs with IMF participation, starting with the first Greek program in May 2010. The IMF Executive Board that ultimately has to decide about financial assistance programs and conditionality could only follow and approve the general decisions that were made by the heads of governments of the EU.

The US government also urged the IMF to fight against the crisis mainly by pumping additional funds into the endangered countries as they feared that the crisis could spread to the US.[38] Political reasons could also have played a role. The US has an interest to stabilize Greece, a NATO member in an important geopolitical region that hosts US military bases. In the past, the US never denied help to a country with a US military base.[39] The strong political will of the EU and the United States to bail-out Greece, Ireland and Portugal put the IMF under pressure. In the IMF Executive Board the EU countries (around 32 %) and the US (16.75 %) together have the majority of voting power and dominate IMF decisions. Together with the regional identity of the managing directors this facilitated EU-IMF cooperation.[40]

But there was also an economic rationale behind the decision to take the IMF in the boat. The IMF is an international organization with now (beginning of 2012) 187 member countries. It has experience for more than 60 years of lending money and encouraging reforms to help countries with balance-of-payments problems and in financial crises. In this respect,

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ECB, “Introductory Remarks and Questions and Answers,” Press Conference, 4 March 2010, available at: www.ecb.int/press/pressconf/2010/html/is100304.en.html.

[37] Spiegel Online, “Top Banker attackiert Merkel,” 23. March 2010, available at: http://www.spiegel.de/wirtschaft/soziales/0,1518,685443,00.html.

[38] See several statements by President Obama on this issue, e.g. US News, "Obama directs EU to act on debt," November 29, 2011.

[39] Hale, “A mutual satisfactory solution for Iceland and Obama,” Financial Times, February 2010; Gros, Daniel; Mayer, Thomas, “How to deal with the threat of sovereign default in Europe – Towards a Euro(pean) Monetary Fund,” *CEPS Policy Brief* No. 202, February 2010, p. 1.

[40] Henning, C. Randall, “Coordinating regional and multilateral financial institutions,” *Peterson Institute for International Economics, Working Paper Series* WP 11-9, March 2011, available at: http://www.iie.com/publications/wp/wp11-9.pdf, p. 12.

the IMF has built up reputation and expertise.[41] The EU only has limited experience with its Balance of Payments Facility which offers medium-term financial assistance for *non*-euro-area countries.[42] It is also evident that the IMF functions as a kind of external scapegoat for the countries under reform pressure.[43] The actual realized historical default rate of IMF lending is nearly nil.[44] IMF lending to emerging market countries has always been repaid.[45] As an international organization, the IMF enjoys a preferred creditor status in that IMF loans to Greece, Ireland and Portugal will be repaid prior to all other creditors. Whereas it seems that in the first place the IMF was driven and marginalized to a certain extent by political decisions in Europe to grant financial assistance, it had a leading role in elaborating and negotiating the details of the economic adjustment programs. The programs bear the signature of the IMF as the countries have to undergo strict fiscal adjustment processes and to improve their international competitiveness.

European institutions like the European Commission are always close to European politicians. They have lost reputation and credibility to solve effectively problems like the sovereign debt crisis mainly due to their inability to enforce EU member countries to reduce their budget deficits and to their failure to force EMU members to comply with the rules of the European Stability and Growth Pact.[46] As we have seen during the crisis since mid-2010, even the independence of the ECB, which is independent by law, is in doubt. In this direction the advantage of having the IMF on board is that the IMF can stronger resist partial political influence than regional institutions and is therefore able to enforce tougher programs.[47] Cooperation with and involvement of the IMF should give additional impetus for the necessary reform process in the countries under concern. As the negotiations on the rescue packages used to be hard and time-consuming, IMF participation also helped to agree more easily and quicker on the terms and conditions of the programs.

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[41] However, expertise and experience mainly stem from developing and emerging countries.

[42] This facility is currently endowed with € 50 billion and has loans outstanding to Latvia, Hungary and Romania (Henning, C. Randall, “Coordinating,”op. cit. p. 13).

[43] Nelson, Rebecca M.; Nanto, Dick K.; Sanford, Jonathan E.; Weiss, Martin A, “Frequently asked questions about IMF involvement in the Eurozone,” in: Farkas, Hannah J.; Murphy, Daniel C. (eds.), *The Eurozone: Testing the monetary union*, New York, NY: Nova Science Publishers (Global economic studies), pp., 43ff.

[44] Rogoff, Kenneth, “Moral hazard in IMF loans – how big a concern?,” Finance and Development, Vol. 39, No. 3, September 2002.

[45] Jeanne, Olivier; Ostry, Jonathan D.; Zettelmeyer, Jeromin, “A Theory”, op. cit., p. 4. IMF lending for poor countries involved debt relief.

[46] Against this background, the proposal to create a new European Monetary Fund (see chapter 4 below) and the agreement of a vast majority of EU countries on a fiscal pact in December 2011 has to be assessed very critically.

[47] Henning, C. Randall, “Coordinating,” op. cit., p. 26

In a globalized and integrated world with spillover effects and contagion risks, the involvement of a multilateral organization like the IMF seems also to be necessary to agree and stipulate macroeconomic policies that are not only in the interest of a single country, but also in global interest. It is not likely that an ad hoc coordination between debtor and donor countries will lead to an agreement on a common set of policy rules, nor is it probable that peer pressure alone will convince countries to cooperate.[48]

(2) Moral hazard, conditionality and insurance

Financial support for countries in crisis always raises moral hazard problems. In the EMU debt crisis moral hazard is even stronger than in all crises in emerging markets of the last two decades. The heads of Governments of France and Germany, the politically and economically strongest EMU members, have endlessly repeated that a default and an exit of a country from the Eurozone must and will be prevented. The German chancellor Merkel permanently declared - to a sceptical public at home - that “Europe will fail if the Euro fails”.[49] The necessary financial resources to finance the sovereign debt of the member countries that were not able to finance themselves on the market or only to interest rates that were felt too high were provided by the European Union and its member states added by a potentially unlimited support by the ECB through outright purchases of sovereign bonds. Even as unlimited financial support of France and Germany got into doubt after the then Greek Prime Minister Papandreou (in October 2011) announced a referendum in Greece and the leverage of the EFSF did not work as it was originally planned, the countries in crisis could be confident that their European partners would do everything to save them.

Such a situation is especially prone to serious moral hazard. The only way to reduce it in the case of a massive bail-out is strong and credible conditionality as the IMF programs are intended to be. The disbursement of each tranche of the IMF loans and EU financial packages depends on the fulfilment of agreed reform steps approved by the Troika of IMF, European Commission (EC) and ECB officials. Additionally, there is also a high stigma attached to asking the IMF for financial support. In the EMU debt crisis it is hard to imagine that the EC alone had been able to combine financial help with convincing conditionality. The IMF has a long experience in negotiating and monitoring economic adjustment programs and has gained reputation in this direction over the last 60 years. In the past, many countries that were in a

[48] Rajan, Raghuram, “Can soft power help the IMF make the world more stable?,” *Review of World Economics*, Vol. 147, 2011, p. 1.
[49] See Deutscher Bundestag, “Entschließung zum EU- und Euro-Gipfel verabschiedet,“ 26.10.2011, available at: www.bundestag.de/dokumente/textarchiv/2011/36282875_kw43_de_regierungserklaerung/index.html.

program as well as the public often accused the IMF for tough measures and strong conditionality. But, the macroeconomic, financial and budgetary conditionality of the programs makes sense.[50] Often, the IMF was successful with its programs because they were targeted to fight the causes of the crisis and enforced necessary economic reforms.[51]

On the other hand, Gros and Mayer (2010), critics of an IMF involvement in the EMU debt crisis, argue that the IMF cannot enforce a program as it cannot punish a country except by withholding the next tranche of the financial rescue package.[52] In their opinion, the EU could urge more pressure as it could stop funding from various other EU transfer mechanisms, like the structural funds, and as the ECB could stop to accept sovereign bonds of the respective country in their monetary policy operations.

Finally, IMF involvement in trying to solve national fiscal crises acts as an insurance mechanism supplementing the EFSF, EFSM and other funds. Any risks will be shared by all IMF member countries and not the EU alone. This suggests the interpretation of a global dimension of the crisis. It also acts as a signalling device how comparable future crises will be dealt with.

3.2 The cons

(1) The tasks of the IMF

The IMF's main goal is to ensure the stability of the international monetary and financial system. It helps resolve crises and works with its member countries to achieve its goal. It has three main tools at its disposal to carry out its mandate: surveillance, technical assistance and training, and lending. Bilateral surveillance on a regular basis consists of conducting in depth appraisals of each member country's economic situation. The main focus is whether there are risks to the country's domestic and external stability that would argue for adjustments in policies. IMF's technical assistance helps member countries strengthen their capacity to design and implement effective policies. It is offered in several areas, including fiscal policy, monetary and exchange rate policies, banking and financial system supervision and regulation. In the event that member countries experience difficulties in financing their *balance of payments*, the IMF is also a fund that can be tapped to facilitate recovery. A policy

[50] Bordo/James, "The past," op. cit., p. 10. Conditionality and tough policy prescriptions were often criticized. Stiglitz was one of the most prominent critics of the IMF's role in the Indonesian crisis. See Beaufort Wijnholds, Onno de, "Fighting financial fires - An IMF insider account," Basingstoke, Hampshire: Palgrave Macmillan, 2011, pp. 45 ff.
[51] However, it has to be borne in mind that in the last years the IMF has introduced and used facilities with no or only negligible ex-post conditionality (e.g. the Flexible Credit Line).
[52] Gros, Daniel; Mayer, Thomas, "How to deal," op. cit.

program supported by financing is designed by the national authorities in close cooperation with the IMF. Continued financial support is *conditional* on the effective implementation of this program. The IMF also provides low-income countries with loans at a concessional interest rate.

A decisive factor is the design of the Fund as a "monetary fund", which defines its unique character as a cooperative and monetary institution and sets it apart from other global institutions.[53] Although Greece, Portugal and Ireland had large current account deficits before the outbreak of the crisis, the source of their problems was not a balance of payments disequilibrium which could not be financed due to a lack of foreign currency reserves.[54] Greece and Portugal have deep structural problems together with weak governance and unsound fiscal balances. In the case of Ireland fiscal rescue packages that in the course of the financial and economic crises were necessary to stabilize the domestic banking system led to the large public deficits. It may be argued that it is not the task of the IMF to finance national public debt in domestic currency. Moreover, the IMF does not have strong experience of how to solve such debt crises. To cite Deutsche Bundesbank: "In line with its mandate, it may use the provided foreign reserves only to help overcome short-term balance of payments difficulties and thus cover a temporary need for foreign currency. By contrast, any financial contribution by the Fund to solve structural problems that do not imply a need for foreign currency – such as the direct financing of budget deficits or financing of a bank recapitalisation – would be incompatible with its monetary mandate."[55]

(2) Incentives and moral hazard

To reduce moral hazard, IMF programs are combined with strict conditionality. The conditions are evaluated by regular visits of the Troika in which the IMF cooperates with the EC and the ECB. This monitoring role has been proven essential for the success of IMF programs in the past. The link IMF-EU might weaken this role and increase political influence and pressure. There seems to be evidence that the programs were softened during the crisis. The first Greek program of 2010, for example, was mainly worked out by the IMF staff and approved by the IMF Executive Board in June 2010. Later, when IMF Managing Director

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[53] Deutsche Bundesbank, "Financing and representation in the International Monetary Fund," *Monthly Bulletin*, March 2010, p. 60.

[54] Buiter and Rahbari argue that Greece clearly has a balance-of-payments problem interpreted in a broader sense. Its low private and public sector saving rates have resulted in persistent external current account deficits, which have cumulated into a large negative net external investment position. And the IMF is ideally set up to address precisely these kinds of difficult conditions. Buiter, Willem; Rahbari, Ebrahim, "Greece and the fiscal crisis in the EMU,"Centre for Economic Policy Research, *Policy Insight* No. 51, October 2010.

[55] Deutsche Bundesbank, „Financing,", op. cit., p. 61.

Strauss-Kahn (in spring 2011) became a prospective candidate for the French elections in 2012, he and his office reportedly got more involved into the program and exerted influence to soften it.[56] The same picture emerges when a comparison is made between the first program for Greece and the program for Portugal.

Thus, the borrowing countries face the following situation: There is another (multinational) institution which is ready to supply funds. EU officials have an interest in the proper functioning and safeguarding of the current euro area. Therefore, they will strongly disapprove any idea of a country leaving (voluntarily or involuntarily) the Euro zone. Consequently, these and prospective other countries can blackmail the others, trying to re-negotiate the conditions and reducing their reform efforts. As the Greek finance minister stated on 6 May 2010: "As we speak today the country can't borrow it from foreign markets and the *only* way to avoid bankruptcy and a halt on payments is to get this money from our European partners and the IMF".[57] Further evidence on this are repeated threats and warnings of Greek officials that Greek could default. And, at his visit to Berlin in January 2012, Italian Prime Minister Mario Monti advocated a more flexible approach to the crisis. In an interview with "*Die Welt*" on 11 January, 2012, he said: "I am demanding heavy sacrifices from Italians. I can only do this if concrete advantages become visible. If not, a protest against Europe will develop in Italy, including against Germany, which is seen as the ringleader of EU intolerance, and against the European Central Bank."[58]

(3) Decision making and availability of funds

Greece's, Portugal's and Ireland's programs with the IMF are unusual for their relative magnitudes. The IMF has general limits on the amount it will lend to a country which may be relaxed in "exceptional" circumstances. The 27 EU members together have a voting power in the Executive Board of the IMF of more than 32 %. In combination with the fact that the managing director of the IMF has always been a European, this explains why IMF involvement has been approved so quickly. Thus, EU-IMF cooperation was facilitated by the numerical dominance of EU countries in the Executive Board as well as the regional identity of the managing director.[59] If no additional and adequate funds can be raised by the IMF in the future, there will be less funds available to other countries, especially in Asia, Africa and

[56] Reuters, "Analysis: IMF may be tougher on Europe after Strauss-Kahn, May 15, 2011, available at: http://www.reuters.com/article/2011/05/15/us-strausskahn-imf-eurozone-idUSTRE74E1OT20110515.
[57] Cited after Featherstone, Kevin, "The Greek sovereign debt crisis and EMU - A failing state in a skewed regime," *Journal of common market studies* 49 (2), 2011, p. 203.
[58] Die Welt, "Mario Monti wehrt sich gegen Italien-Misstrauen, 11 January, 2012, available at: http://www.welt.de/politik/ausland/article13810405/Mario-Monti-wehrt-sich-gegen-Italien-Misstrauen.html.
[59] Henning, C. Randall, "Coordinating,", op. cit., p. 12.

the countries of the former CIS. But these are especially the countries for which the tasks of the IMF are more suited for. If bigger countries like Italy and Spain will get into trouble, this will overburden the IMF. In any case, the funds currently available to the IMF will not be enough.

(4) Financing national budget deficits

After EU countries and institutions could not agree on own rescue packages (either via EU institutions or the ECB), the cooperation with the IMF was established. Together with the EFSF and EFSM this twin-track approach[60] created parallel (shadow) budgets and further liquidity to finance country-specific public deficits and overturned the no-bail-out clause of the EU Treaty. In this respect, the involvement of the IMF seems to be an attempt to circumvent the prohibition of direct financing of national budget deficits via central banks. This view was corroborated by the decision at the EU summit in December 2011 of providing additional resources to the IMF of up to € 200 billion via bilateral loans from EU and other central banks. All this has to be assessed against the earlier decision of the IMF to nearly triple its quotas to US-$ 934 billion and the intention to further increase Special Drawing Rights (SDRs).

Thus, the European sovereign debt crisis seems to be the push to allow the IMF to become the ultimate lender of last resort through the issuance of SDRs and granting of credit. It is a back door attempt to solve the current fiscal problems through inflation (as it has been done in the past) and justified by global financial stability considerations and contagion effects. Surely, SDR creation and new IMF loans do not necessarily lead to inflation.[61] Under existing arrangements SDRs and loans are issued by the IMF to its members in proportion to each country's quota. The allocation has a potential monetary effect as it either provides IMF members with an additional contingent claim on the IMF or gives them additional funds.[62] The monetary effect will materialize if (i) the domestic money supply increases, if (ii) private agents' money demand structurally decreases and if (iii) the central banks follow an accommodating monetary policy. In the current exceptional situation, conditions (i) and (iii) are probable scenarios. In this assessment, the mere size of actual and prospective IMF funds has to be taken into account.

[60] Nelson et al., « Frequently asked," op. cit. p. 80.
[61] Cooper, Richard, "Is SDR Creation Inflationary?, Supplement of: International Monetary Stability - A Role for the SDR?," *IMF Policy Paper*, February 2011.
[62] In the euro area, a country uses its SDRs by exchanging them with another holder for euros.

If the IMF more and more develops as a lender of last resort and for that purpose demands and gets more and more funds, one may ask whether the deposits at the IMF are still safe. And if the answer is no, it is questionable whether SDRs can still function as international reserves. As already mentioned the scale of commitments by the IMF during the EMU debt crisis until the end of 2011 has already been unprecedented.

(5) Political economy arguments

During the EMU debt crisis there was a strong axis of political decision makers from France and Germany driving the rescue process. The influence of the French government also spread into the IMF as the former IMF managing director Strauss-Kahn as well as his successor Lagarde represented French positions. Such a political pressure could undermine the independence of the IMF as the IMF could be seen as a vicarious agent of European politicians in their crisis management.

The unprecedented large financial rescue packages did not raise serious opposition of emerging and developing countries. These countries also had an interest in stabilizing EMU but it could cause trouble in the future if the joint mission will fail and IMF resources will get lost. In this case, the IMF would loose credibility like in the past when its policy failed in Argentina and Russia.[63] A similar problem would arise if European interests diverge. Then the IMF would come into the midst of diverging political interests in Europe. However, despite different and conflicting views on how to manage the crisis, the EU countries - except the United Kingdom - always agreed on a common policy on their various EU summits.

Within the IMF there were different views about how to deal with the EMU debt crisis. In November 2011, Antonio Borges, the former Portuguese central banker and head of the IMF's European department which is responsible for the economic adjustment programs, resigned "for personal reasons". Before, Borges proposed that the IMF could directly buy sovereign bonds of Italy and Spain to take pressure from the market which promptly raised criticism as the IMF can only grant loans but not intervene directly in the markets.[64]

Until the outbreak of the financial market crisis in 2007, a need for the IMF was more and more questioned. The IMF was labelled of having become an obsolete institution against the background of huge foreign exchange reserves of Asian countries, especially China, and

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[63] Beaufort Wijnholds, Onno de, "Fighting financial fires," op. cit.
[64] FAZ, „IWF wechselt Europa-Direktor aus", 17.11.2011

increasing current account surpluses.[65] Moreover, the Chiang Mai Initiative of bilateral swaps and credits fostered a re-orientation towards regional arrangements. As of spring 2007, IMF credit outstanding to emerging market borrowers was less than SDR 12 billion, down from SDR 65 billion as recently as 2003, with a single country, Turkey, accounting for half of the total.[66] Since then, the Fund has enjoyed a spectacular comeback and silenced the critics. The two last big crises - the global financial crisis which started in 2007 and the sovereign debt crisis in Europe since 2010 - have also enhanced the IMF’s role in crisis management and given it a key place in current efforts to reform the world financial system. The IMF has regained and augmented its power (both politically and financially) as well as widened its tasks. This opportunity was welcomed by the IMF (officials) with great enthusiasm to increase its influence and power.

The first new task is a multinational supervisory function, especially with respect to macroprudence and contagion effects. Within this function the IMF should exercise surveillance of financial sector policies and financial markets. The second task seems to be helping countries, together with regional institutions, in case of fiscal distress. And at the G20 meeting in Cannes in October 2011, Italy formally accepted a regular IMF monitoring of its reform process on a quarterly basis. It is worth highlighting that, as part of its activities, the IMF can provide policy advice upon request by its member countries, beyond regular bilateral surveillance (Article IV). Therefore, technically speaking there is nothing exceptional about Italy having requested advice. Still, the fact that it is not the European Commission alone which is in charge of monitoring the reform process, but that it pursues this task together with the IMF is a surprising result. All this entails the danger that in the future it is the IMF (perhaps together with the US) who dominates the ways problems in the EU will be tackled.

4. The Troika of IMF/ECB/EC: a model for the future?

In March 2010, as Greek’s problems worsened dramatically and European attempts to solve the crisis solely did not work, the IMF announced to participate in the rescue actions.[67] This decision by the IMF was voluntarily as it was in the clear interest of the IMF to do so (see point (5) of the cons arguments above). Together with the EC and the ECB it formed the IMF/ECB/EC-Troika responsible for negotiating and monitoring the economic adjustment programs for Greece, Ireland and Portugal. The Troika can be seen as a new institutional body

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[65] Eichengreen, Barry, “A blueprint for IMF reform: More than just a lender,” *International Finance*, Vol. 10, 2007, pp. 153-175.
[66] Eichengreen, Barry, “A blueprint,” op.cit., p. 155.
[67] Henning, C. Randall, “Coordinating,” p. 5.

that was formed on an ad hoc basis as the EU was not able to manage its problems alone and as politicians of the donor countries (above all the German Chancellor Merkel) did not trust the European institutions and tried to reduce the moral hazard problem that was connected with the bail-outs.[68]

One might ask the following questions: (1) is the Troika a model for the future to deal with sovereign debt crises in Europe? (2) If the Troika would be successful in Europe could this model be exported to other regions in the world? (3) Is there a key problem inherent in such a model as it could delay a necessary sovereign default? (4) And finally, how should the cooperating partners better communicate their policy to the public and financial markets?

(1) The future of the Troika model in Europe

Despite the danger of loosing independence and credibility and despite the moral hazard problems the cooperation of the IMF with European institutions makes sense for the IMF as the IMF needs regional institutions to make effective lending. Before the start of the worldwide financial market crisis in 2007/2008, IMF lending was on a low and the future role and importance of the IMF was in doubt for some observers.[69] Therefore, the IMF could save its role by cooperating with EU institutions.

In the EMU debt crisis the financial aid reached dimensions that are not possible for the IMF to fund alone. During the EMU debt crisis an enlargement of existing IMF facilities and new funds were proposed. But, even with an additional US-$ 400 billion the IMF would not be able to save a large developed country like Italy. The strong willingness of the IMF to participate in the rescue actions could therefore be interpreted as an action to save its outstanding role as a global fire-brigade.

In Europe, there were different views about the involvement of the IMF. Several economists and politicians favoured a non-cooperative, European solution and proposed a European Monetary Fund to deal independently with the crisis. It was argued that an EMF should make an orderly default of member countries like Greece possible which could reduce moral hazard as a country cannot hope to receive endless help without the necessary reform measures at home.[70] But, in our opinion the political pressure on a European Monetary Fund

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[68] Financial Times, ”IMF financing role embarrasing for ECB,“ March 26, 2010, available at: www.ft.com/intl/cms/s/0/bab67356-3905-11df-8970-00144feabdc0.html#axzz1jiC7GRBY.

[69] See e.g. Truman, Edwin M., “The IMF and the global crisis – role and reform,” Remarks delivered to the Tulsa Committee on Foreign Relations, January 22, 2009, p. 3.

[70] Gros, Daniel; Mayer, Thomas, “How to deal,”, p. 2.

would be much higher than on the IMF.[71] One could also ask what sense it would make to create an additional European institution as there are already the EC and the ECB, which are both involved in the crisis management. Another often proposed solution of the debt crisis via unlimited outright sovereign bond purchases of countries in crises (“the Bazooka-solution”) would raise the most serious moral hazard problems. Fortunately, the ECB is still able to resist these proposals.

It seems now that as long as the EC does not have the expertise to elaborate and effectively monitor economic adjustment programs, the Troika is the best model to fight against the sovereign debt crisis, at least unless the sustainability of the budgetary and economic conditions in the peripheral countries are restored and a credible European surveillance mechanism for national fiscal policies will be installed. All this is currently not in sight.

(2) Cooperation of the IMF with regional institutions

The EMU debt crisis and the expansion of international financial safety nets have raised the importance of cooperation between regional institutions and the IMF. While the case for cooperation in crisis situations is often accepted, the need to organize it on an ex ante basis and worldwide is not fully appreciated. The cooperation among the Troika on the European debt crisis is not likely to be easily replicated in joint programs for countries in other regions.[72]

Like in Europe, governments and central banks as well as the public are often not very enthusiastic about an IMF involvement in the management of debt and financial crises. But, like in Europe, regional institutions in other parts of the world need the expertise of the IMF to manage a crisis and to enforce a reform program. In Asia, after the crisis of 1997/1998, the IMF was often criticized for its crisis management and tough economic adjustment programs.[73] This led to a proposal, e.g. by the Japanese Ministry of Finance, of an Asian Monetary Fund which could have displaced the IMF from the region.[74] The IMF and the US government strictly rejected such proposals as they feared that their influence in Asia could

[71] See also Fuest, Clemens, “Will the reform of the institutional framework restore fiscal stability in the Eurozone?,” Europe in crisis (Focus), *CESifo forum* 12 (2), p. 37.
[72] Henning, C. Randall, “Coordinating,” op. cit., p. 1.
[73] Park, Yung Chul; Wyplosz, Charles, “The future of the IMF and of regional cooperation in East Asia,” in: Charles Wyplosz (ed.), *The new international monetary system*, London et al., Routledge, 2010, pp. 36f.
[74] Henning, C. Randall, “Coordinating,” op. cit., p. 4.

decline.[75] The IMF argued that crises like the Asian crisis have a global impact and that regional institutions are less well equipped to deal with such crisis.

It is less a lack of financial resources than a lack of expertise which makes cooperation necessary. The Asian economies have accumulated a very large stock of foreign exchange reserves over the past two decades that could be used for financial stabilization programs. An example is the Chiang Mai Initiative Multilateralisation (CMIM) that in 2000 led to a system of bilateral swap arrangements (BSAs) between the ASEAN countries and China, Korea and Japan. With this agreement Asian countries envisaged to be less dependent on the IMF. But, they didn't left the IMF aside as the IMF has got a major role in the surveillance and monitoring of the countries in need of help.[76] Beyond 20% of a country's allotment, CMIM lending is linked to an IMF program.[77] The reason for cooperation is the comparative advantage that the IMF has over regional organizations in linking financial help with program conditionality.

(3) Does a cooperative approach prevent a necessary default?

A weakness of IMF's policy is that it tries to avoid a sovereign default and that it has no procedure to initiate and deal with a default if the fiscal position of a country is unsustainable. It seems that IMF staff at the beginning of the EMU debt crisis has systematically underestimated the problem of the sustainability of fiscal debt and the risk of a default or debt restructuring, especially in the case of Greece.[78] At the end of the 1980s, Sachs proposed that the IMF should work out models for a sovereign debt default and a supervision of an orderly reduction of public debt.[79] During her time as a chief economist at the IMF, Anne Krueger stipulated a Sovereign Debt Reduction Mechanism (SDRM). She proposed an international legal framework to allow a qualified majority of the sovereign's creditors to approve a restructuring agreement and to make that decision binding on a minority. Such a framework could facilitate an early restructuring of unsustainable debt. It would prevent destructive measures in the case of an endless delay of a default and a new start of an

[75] Bordo, Michael D.; James, Harold, "The past," op. cit., p. 13.
[76] Park, Yung Chul;Wyplosz, Charles, "The future," op. cit., pp. 36 f.
[77] Henning, C. Randall, "Coordinating," op.cit., p. 35, gives an overview of selected regional financial arrangements and their relationship to the IMF.
[78] Cottarelli, Carlo; Forni, Lorenzo; Gottschalk, Jan; Mauro, Paolo, "Default in today's advanced economies: unnecessary, undesirable, and unlikely," International Monetary Fund, *Staff Position Note*, SPN 10-12, September 1, 2010, available at: http://www.imf.org/external/pubs/ft/spn/2010/spn1012.pdf.
[79] Sachs, Jeffrey, "Efficient debt reduction," in: Ishrat Hussain and Ishac Diwan (eds.), *Dealing with the debt crisis*, Washington D.C.: A World Bank Symposium, 1989.

insolvent country. [80] A stop of help and a necessary default would also safeguard IMF's and other resources. However, financial markets and the US government resisted successfully to these plans of a SDRM.[81]

It is obvious that a sovereign default raises serious problems that were extensively discussed elsewhere (loss of market access for a long time, higher future borrowing costs, trade sanctions by creditor countries, sharp output losses, capital flight, etc).[82] But, ultimately, one should not exclude a default. Unlimited financial support in the case of an unsustainable fiscal position does not make sense and puts IMFs credibility at risk. In the case of Greece, European heads of government stipulated a "voluntary" private sector involvement (PSI) and a haircut for private bond holders. In January 2012 it became also clear that a haircut for the ECB holdings of Greek government bonds is expected. The negotiations about a restructuring of Greek debt between the Greek government and the private sector lasted more than half a year and were still not concluded in January 2012. The uncertainty about the modalities of the restructuring of Greek sovereign debt contributed to substantial nervousness and risk on international capital markets and to possible contagion effects within EMU.

(4) External communication of the Troika

If the Troika succeeds in helping to improve the economic conditions in single EMU countries like Ireland or Portugal with its economic adjustment programs so that the countries can return to capital markets in coming years, the Troika could be a model for the future. Although there were different views of the three institutions during the elaboration and the reviews of the economic adjustment programs, for example with regard to the question of private sector involvement in the second Greek program or the reform progress of Greece, the staff teams reportedly worked together efficiently and each of the three Troika members contributed its special expertise during the staff missions and the surveillance process. But, evidently, there's room for an improvement in the external communication of the Troika. Several problems arose that contributed to uncertainty on financial markets:

a) The Troika members published joint and separate declarations, speeches and reports during various stages of the elaboration and surveillance process of the programs. For the financial markets it was not always easy to interpret the common policy and the status of

[80] Krueger, Anne, "A new approach to debt restructuring," International Monetary Fund, Washington D.C., April 2002, p.
[81] Bordo, Michael; James, Harold, "The past," op.cit., p. 11.
[82] See e.g. Borensztein, Eduardo; Ugo Panizza, "The costs of sovereign default," *IMF Working Paper* 08/238, International Monetary Fund, Washington, DC 2008.

the reform progress in the countries under consideration, and sometimes the institutions had contradictory views. The EC and the IMF published staff reports after every mission. One might ask if it would perhaps be better to publish a joint staff report of the Troika to avoid the impression of controversies within the Troika. One joint program and one joint report!

b) The communication was further complicated by countless statements of the representatives of the three institutions. The extreme variety and multiplicity of proposals of EU representatives and national governments again contributed to nervousness on financial markets and in the public. During the EMU debt crisis one got the impression that the heads of governments, especially the French president Sarkozy and the German chancellor Merkel, were the main actors disturbed by many other politicians and EU officials. As in several other policy fields the European Union had the problem to speak with one voice. For the IMF this was a rather unusual and complicated situation as in past crises the IMF normally negotiated and cooperated only with the government of the respective country.

5. Summary and conclusions

The IMF has regained strong influence in the world economy and on international financial markets by its central role in the rescue actions for EMU countries in crisis. It has contributed to emergency lending and has elaborated and monitored the economic adjustments programs for Greece, Ireland and Portugal in close cooperation with the EC and the ECB. The cooperation with the other Troika-members has been essential as the IMF alone would not have been able to raise the emergency funds due to the sheer size of the rescue packages. By contributing around 33% to the rescue funds the IMF got a maximum 100% influence in the program design and surveillance procedure as the programs are IMF-style and the disbursement of each tranche of the funds ultimately depends on the decisions of the IMF executive board – indeed a good leverage!

As the European Union and EU politicians lacked the necessary credibility, the involvement of the IMF in the EMU debt crisis makes sense as it can mitigate the moral hazard problems that are connected with the bailouts - at least as long as the IMF is able to closely monitor the economic adjustment programs and enforce reform progress. Strict conditionality is crucial for the success of the programs and the credibility of the whole process. There are two risks that could endanger the success of the Troika-model: (1) The IMF must resist strong demands of politicians in the Euro area and elsewhere to save every country at every price; and (2) it must resist internal pressures to soften conditionality of the programs. A softening of the programs could destroy the credibility and reputation of the IMF and could put the future of the Troika-model at risk.

The risks of an IMF involvement in the EMU debt crisis are straightforward, but there seems to be no workable and convincing alternative. The EU countries have resisted in accepting the German economic model and its "stability culture". The Stability and Growth Pact didn't work and even if the EU countries can ratify the planned fiscal pact it will take a long time to install it and to re-gain credibility on financial markets. Another often proposed solution to the sovereign debt crisis by guaranteeing unlimited ECB support is facing tough German opposition and could pave the way for an inflationary process in the EMU. Financial support and the enforcement of reform steps by the Troika to solve the structural, budgetary and international competitiveness problems of the program countries seem to be the only solution for the near future.

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für den ifo-Geschäftserwartungsindex
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