DOC. N.º 40

The Baseline Scenario

What happened to the global economy and what we can do about it

Greece And The Fatal Flaw In An IMF Rescue

Posted on April 6, 2010 by Simon Johnson | 126 Comments

By Peter Boone and Simon Johnson. This is a long post, about 3,500 words.

In 2003 the International Monetary Fund published yet another internal review with an impressively dull title "The IMF and Argentina, 1991-2001". But hidden in that text is explosive language and great clarity of thought – in essence, the IMF staff belatedly recognized that their decision to repeatedly bailout Argentina from the mid-1990s through 2002 was wrong:

> *"The IMF should refrain from entering or maintaining a program relationship with a member country when there is no immediate balance of payments need and there are serious political obstacles to needed policy adjustment or structural reform" (p.7, recommendation 4).*

If Mr. Trichet (head of the European Central Bank), Ms. Merkel (German Chancellor), and Mr. Sarkozy (French President) have not reviewed this document yet, they should skim it immediately. Because one day soon Greece will be calling on the IMF for a loan, and it seems mostly likely that the mistakes made in Argentina will be repeated.

There are disconcerting parallels between Argentina's catastrophic decade, 1991-2001, which ended in massive default, and Greece's recent and impending difficulties. The main difference being that Greece is far more indebted, is much less competitive in global markets, and needs a commensurately greater fiscal and wage adjustment.

At the end of 2001, Argentina's public debt GDP ratio was 62%, while at end 2009 Greece's was 114%. Argentina's public deficit reached 6.4% GDP in 2001, while Greece's was 12.7% GDP (or 16% on a cash basis) in 2009. Both countries locked themselves into currency regimes which made it extremely painful to exit: Greece has the euro, while Argentina created a variant of a currency board system tied to the US dollar. And both countries had seen their competitiveness, as measured by the "real exchange rate" (which reflects differential inflation relative to competitors) worsen by 20% over the previous decade, helping price themselves out of export markets – and boosting their consumption of imports. In 2009 Greece had a current account deficit equal to 11.2% of GDP, while Argentina's 2002 current account deficit was a much smaller 1.7% GDP.

The solution to such crises is rarely gradual. Once financial market confidence is lost, yields on government debt soar, private capital flees, and sharp recessions occur. The IMF ended up drawing tough conclusions from its Argentine experience – the Fund should have walked away from weak government policy programs earlier in the 1990s. Most importantly, IMF experts argued that from the start the IMF should have prepared a Plan B, which included restructuring of debts and termination of the currency board regime, since they needed a backstop in case the whole program failed. By providing more funds, the IMF just kicked the can a short distance down the road, and likely made Argentina's final collapse even more traumatic than it would otherwise have been.

Sadly, the Greeks are today in a similar situation: the government's macroeconomic program is not nearly enough to calm markets, or put Greece's debt on a sustainable path. By 2012 we estimate Greece's debt/GDP ratio will rise from 114% of GDP to over 150%. The interest payments alone on this would amount to 9% of Greek's incomes at current rates, and almost all those funds are transferred to the German, French, and Swiss debt holders.

Greece's 2010 "austerity" program is striking only for its lack of credibility. Under that program Greece, even in 2010, does not pay the interest on its debt – instead the government plans to raise 52bn euros in credit markets to refinance all its interest while at the same time it borrows 4% of GDP more. A country's "primary budget" position measures the budget without interest expenses — at the very least, the Greeks need to move from a 4% of GDP primary budget deficit to a 9% of GDP primary surplus – totalling 13% of GDP further fiscal adjustment, in the midst of what will be a massive recession, just to have enough funds to pay annual interest on their 2012 debt. This is under the rather conservative assumption that interest rates would settle near 6% per year, where they stand today. The message from these calculations is simple: Greece needs to be far more bold if its austerity program is to have a serious chance of success.

How did Greece manage to get into such a terrible situation? Local politics that lead to profligate spending is one answer. But remember that someone needs to supply the money that allows such profligacy. In this case it was the European Central Bank that handed Greece the keys to the safe.

The reason Mr. Trichet wants Europe to stand tough against Greece

This may not be obvious, but, creating money in a currency union is no simple task. In any single country, central banks usually restrict themselves to buying government bonds, and making loans to regulated commercial banks. Net purchases of these securities by central banks creates what is called "high-powered money"; this feeds into the financial system and results in the creation of what we all use to make payments and store value, i.e., money, plain and simple.

However in the European Monetary Union there are now 17 nations and a plethora of banks. So, to put it crudely, there is sure to be a fight to decide who gets the newly printed funds. The ECB resolved this by what seemed like a fair rule: All commercial banks can borrow from the ECB if they provide collateral, in the form of highly rated government and other securities, to the ECB. So, for example, a Greek bank can gain liquidity by depositing Greek government bonds with the ECB – as long as those bonds are "investment grade", i.e., highly rated.

This simple and seemingly reasonable rule created great dangers for the eurozone, which have come back to haunt Mr. Trichet. The commercial banks in the zone are able to buy government bonds, which "paid" 3-6% long term interest rates (for all the sovereign bonds of members) over the last decade, and then deposit them at the ECB. They could then borrow from the ECB at the ECB financing rate, which today is 1%, against this collateral so pocketing a profit — and then buy more sovereign bonds with the funds. Mr. Trichet recognized this system had inherent dangers of turning into a new Ponzi game: if nations spent too much, and built up too much debt, eventually the system would collapse. So at the foundation of the eurozone, Mr. Trichet led a contingent within the EU that demanded all nations live by a "Growth and Stability Pact", whereby each nation could only run deficits of 3% of GDP, and they had to keep their debt/GDP ratio below 60% of GDP.

Of course, politics trumped Mr. Trichet – as it always must – and the Greeks, along with the Portuguese, used their new found cheap lending system to run large deficits and build up debt. The cheap access to money also helped feed the real estate booms in Ireland and Spain.

Today, Mr. Trichet and Ms. Merkel are desperate for harsh changes to ECB lending rules that will stop this ponzi game. They want to penalize profligate spenders. They also want profligate nations to pay more interest. Soon, due to its poor credit rating, Greek debt will be treated like poor collateral, so banks will no longer be able to borrow as much with Greek debt as collateral. When these changes at the ECB come into effect in 2011, the days of Greece being able to borrow easily at low interest rates in the euro zone will close once and for all.

As protector of the euro zone, the ECB does not want to see large bailouts to nations that abused the system. Marco Kranjec, an ECB council member, recently made the ECB view clear: "Membership in the Euro region dictates a special discipline....only non-euro region EU members, such as Hungary, Latvia and Romania, are eligible for financial aid". The non-euro members get aid because they do not have access to the ECB lending window, but, if you abuse that window, you will not get extra help.

If Greece needs to pay more for its debt, the debt dynamics become ever more unsustainable. What interest rate should markets charge for a nation that has 120-150% public debt/GDP ratio, a large budget deficit, a recessionary uncompetitive economy, and a bloated public sector that stages frequent and often violent strikes? The answer is probably around what Argentina paid in the late nineties: 10% per year. But as Greece's Prime Minister is fully aware when he calls for lower interest rates, Greece cannot afford these rates – their budget would simply collapse.

If they are permitted to be candid, what choices would the IMF staff present to Greece?

So when the Greeks soon turn up at the IMF, what will the IMF say? If politics did not circumvent rational economics, the choices are clear:

Choice 1: True Fiscal Austerity – 10% of GDP, with further measures soon

To gain confidence in markets, the Greeks need to demonstrate that they are prepared to actually stop the rapid rise of their debt relative to income. This means running a primary surplus in short order.

For Greece to achieve this, the numbers required are, simply put, staggering. Lower public spending and higher taxes will lead to a sharp contraction in demand, and it will have repercussions as businesses in Greece see less follow on spending. Ultimately, every $1 of fiscal tightening may generate $1.50-2.00 in lost domestic demand. Fiscal tightening only works if the new unemployment leads to wages and prices falling, so making a nation more competitive. The jury is out whether Greek unions would permit such large wage reductions, but the whole process will surely take several years. So, in the first year or two, we could expect Greek GDP to fall sharply with a strong austerity program.

This is where the problems set in – and the risk of a viscious downward cycle. Lower GDP means lower tax revenues, and higher unemployment benefits, and all these things worsen the budget.

Under reasonable assumptions, if the Greeks took an initial 10% of GDP in further fiscal measures, they would still run a budget deficit in 2011 of approximately 5% of GDP. This deficit would fall as the economy recovered later, and if unemployment fell, but that could take a long time.

We doubt such an austere program could work, and even if it did, someone needs to finance Greece's budget deficit, and roll over their debt, for 3 or more years. Markets would undoubtedly be concerned by sharp output declines and ongoing strikes. The only solution would be for the EU and IMF to step up, and effectively guarantee three years of financing needs, or $150bn in total. That is seven times the whisper numbers that the European Union is currently considering providing to Greece.

Choice 2: Sovereign default but keep the euro

The second choice means admitting that the fiscal situation is just too painful to solve: Greece would default on its debt and call a stop to all interest and principal for, say, two years.

The default on debt would have major ramifications. The government would need to take actions to avoid a run on all the Greek banks – this would need to be coordinated with the ECB to ensure there was liquidity support. Private creditors would pull loans wherever possible from Greek entities. In short: Greece would suffer a large financial and economic collapse, and GDP would decline substantially.

This financial collapse would mean Greek debt would need to be written down substantially. We would guess that a 65% write down of face value, bringing total Greek debt to around 50-60% of a lower new GDP, would be reasonable. Such write downs roughly match the terms that Argentina received after its debt restructuring.

This draconian cut to government debt would not solve Greece's problems. It would still need to cut budget spending in order to lower the deficit – and in the aftermath of defaults, there are generally few sympathizers. Greece could save on interest (which to data it never paid in any case), but it would not be a panacea for the budget or economy.

Choice 3: The IMF's Plan B – Debt default and exit the eurozone

Faced with a collapsing banking system that comes with default on sovereign debt, there is good reason to call for Greece to, at least temporarily, give up the euro. The advantage of moving to a different currency would be that Greece could generate a rapid increase in competitiveness, and so speed up its transition. The government could offer to restructure debt into this new currency, or into Euros at a much larger haircut. The bloated costs of the public sector could be eroded through inflation in the new currency. This should make it possible to quickly move to a budget surplus and an external surplus.

In Argentina, the government partially indexed deposits at banks, but they forced the deposits to be converted to pesos from dollars. They similarly required all domestic debt be converted, and they negotiated a sharp reduction in external debt while offering those debt holders the ability to convert debt into pesos.

Argentina's economic collapse ended roughly six months after they defaulted and ended their peg. While it was painful, the economic recovery started rapidly; nine months after default and devaluation, GDP began growing rapidly. This is a trend that continues even today. The same lesson, that large devaluations and default can result in rapid recoveries, was observed in Russia in 1999, and in the aftermath of the asian crises.

Greece's recovery would take longer, because they have not yet had many of the adjustments that are needed, but they could probably expect a recovery to decent growth starting H2 2011.

The IMF leadership will want to muddle through, but will Merkel and Trichet play ball?

Will the IMF prepare a program with drastic fiscal cuts, sticking to the lesson it learned from Argentina, in order to bring the nation back into solvency? Will they turn to the EU and be blunt: either you need to be prepared to provide Greece 150bn euros of loans over three years as credit lines, at low interest rates so they can afford it, or the program will be underfunded. Will they walk away from any program if the EU does not promise large enough funding, and the Greeks do not promise drastic enough cuts? And, would they dare to discuss a "Plan B" for Greece, as their own internal review suggested would have been best for Argentina back in the nineties?

The answer to all this seems very clear. The IMF will agree to another program that is very likely to fail, just like they did in Argentina. There are some obvious reasons why this is likely. One reason is that it is easy to hide behind a veil of probabilities. Of course there is some chance that Greece might make it out with little change, so why not wait and see if it works? The trouble is the odds, for Greece, are slim. It is impossible to say exactly what the odds are, but suffice it to say, Greece's external debt and current fiscal difficulties, while tied into a fixed exchange rate regime, mean that nation needs far harsher adjustments than any of the sovereign major defaulters of the last 50 years. We cannot think of one comparable example of success. The social and political divisions in Greece, along with the penchant for debilitating strikes, also reduce the odds for success.

(Some people suggest Ireland is an example – however Ireland started with much lower debt levels, and despite large fiscal cuts they are still running a deficit over 10% of GDP that requires annual financing and a rapid build-up of sovereign debt. Greece could not get these funds in markets, and they will have trouble repaying that new debt just like the old.)

Meanwhile, the longer we wait for real fiscal adjustments, the more Greece builds up debts and so needs an ever larger adjustment later. Such an end could be enormously disruptive: imagine nationwide strikes, violence, and chaotic default. Consider the burden on others: while Greece marches on building up debt and sinking ever deeper into problems, how can we expect creditors to feel comfortable lending to Portugal, Ireland or Spain? The whole euro zone will suffer if Greece defaults, and, they will suffer if Greece does not default. The IMF concluded that Argentina had a window, in the late nineties when they could possibly have escaped their burdensome debt and currency peg in a planned move – but they missed it. The euro zone arguably has a chance now to deal resolutely, one way or another, with this problem before the chronic pain impacts others.

There are also powerful personal interests that will guide these decisions. Dominique Strauss-Kahn, current head of the IMF, is primarily focused on becoming the next President of France. It will not look good – to the French electorate – if the IMF is seen forcing a Greek default, nor if it demands that the Europeans provide over a hundred billion euros of long term financing. So, he surely wants to offer a lax short term program, which is backed up by promises for "greater austerity in the future if needed". Greece will march on, mired in recession, with its debt stock growing as the IMF and EU fund them. The private sector, as in the case of Argentina, will simply not want to touch their debt. Dominique Strauss-Kahn can then declare his candidacy in early 2011, resign from the Fund, and let his successor force the true austerity – at which time Greece will suffer ever more under any solution.

It is also in the interests of most other members of the euro zone to just "kick the can down the road". The other debt laden periphery nations are naturally terrified of a Greek collapse that will spill over to their nations. They will now lobby hard for the IMF to be generous, and they will be satisfied with partial steps. Perhaps this will give them time to prepare, but more likely, they will just kick the can down the road themselves – as the Portuguese seem to be doing with their lax fiscal budget announced for 2010. These nations surely underestimate how much worse this may get, and they continue to suckle on the cheap credit window which the ECB has, until now, kept open to them.

The fight begins: Will Europe's "euro visionaries" and the austere Germans force hard decisions today?

However, there are two groups in the euro zone who may still not play this game. Ms. Merkel knows German taxpayers would loathe any kind of Greek bailout, and Germans inherently care more about the long term stability of the euro than any other nation.

It is, undoubtedly, in the ECB's and Germany's long term interest to force Greece to take tough medicine now, or, to default on their sovereign debts and leave the euro zone. Having one member be forced out of the eurozone will send a clear message to others.

There are many nations now waiting on the sidelines: How can Mr. Trichet and the Germans feel comfortable that new entrants will not copy the Greek Ponzi game once they gain access to ECB's funding windows if the new entrants see Greece get a new large loan package at subsidized interest rates? The ECB should be rightly concerned that such actions would only make fiscal probity, and therefore monetary policy, far harder to control in the euro zone.

Where next for Greece?

Mr. Trichet understands that Greece's problems reflect a dangerous flaw in the euro zone system, and the solution will set the tone for behaviour of other members for years to come. He'll want his pound of flesh before this is done. The IMF staff surely understands that Greece's economic problems are critical, and require drastic actions, but the IMF's managing director just wants to survive to be elected a new President of France in 2012.

The German population detests providing bailouts to periphery nations, while the debtors of the Euro zone would like the same game to continue a little bit longer. Meanwhile, the Greeks continue to drag their feet on serious reform while claiming to be "courageous"– presumably they are hoping, magically, that markets will start to want to lend to them again at very low rates in the midst of a fiscal program with little hope for long term success. It all seems horribly reminiscent to those early days when Argentina slid towards a cruel collapse.

SHARE THIS:

More

RELATED

Greece Should Approach The IMF
In "Commentary"

Metternich With A Blackberry
In "Commentary"

Why Are the French So Determined To Run The IMF – And What Will It Cost You?
In "Commentary"

This entry was posted in Commentary and tagged European Central Bank, Greece crisis. Bookmark the permalink.

126 RESPONSES TO "GREECE AND THE FATAL FLAW IN AN IMF RESCUE"

Ted K | April 6, 2010 at 12:06 pm |

I sympathize with Greece in some aspects. I don't want to see anybody in any country suffer. But the bottom line gets down to this: They're going down either way, so why should other nations get sucked down with them??? I think Germany has to tell them in essence "Sorry, but there's nothing we can do to change the situation." It's a hard hard pill to swallow, but what are the other choices??? Nothing better available.

geckonomist | April 6, 2010 at 12:10 pm |

the new debt is taken up by greek banks. so the (low) intrest payments stay in Greece and the french & germans get their money back.

the ECB will continue to accept greek bonds as collateral from greek banks, even if it is not investment grade (just like the FED accepts asset backed CDO's with unclear value).

What happens next. Nobody knows. Higher inflation I guess.

Rickk | April 6, 2010 at 12:31 pm |

Greece Rescue = Smoke and Mirrors

Yves Smith Mar 29, 2010 – excerpts

"I must admit that the late-night meetings, the dramatic announcement of an agreement, and the press conferences by European leaders are highly effective tools to impress the outside world. Ms Merkel in particular is a very persuasive politician. But the politics of smoke and mirrors cannot fool all the people all of the time. This will not end well....

Since there is hardly any way to force costs down in these countries, expulsion from Eurozone would be in their interests as well. I would book the holidays in greece in a heartbeat, if they would be for example at 50% of the current prices – but now I am going to Cuba.

I visited greece four times. It was getting more and more expensive each year, and I am not surprised that basically as a country they have almost nothing to export at competitive price. This is the direct consequence of cheating to join EMU.

bc123a | April 26, 2010 at 10:52 am |

Indeed, this is ridiculous. Greeks should take care that they increase their competitiveness, not protesting essentially that German workforce tolerates austerity measures – and by that somehow "profiting" from the fact that Greeks don't want similar course. WTF?

Feliks | April 27, 2010 at 8:04 am |

What is happenning in Greece will never stop happenning again...Greece structural reform has not taken place . Human Rights are at beloww minimun level, if not the same with Iran. De facto Greek politics is run by its Orthodox Church that is oppresing all others. Greece is not not in peace with the definition of what e Greek should be...Greece is living with Middle Age mentality. This will bring it again in failure regardless the fact that how much money they will get from the outside World. Greece needs CHANGE or let go...

Drachma Dude | April 28, 2010 at 5:45 am |

Greeks- Let's get the F out of the euro now, before we're literally starving in another IMF famine! It's Bono's cause!

Per Kurowski | April 28, 2010 at 6:03 am |

Europe! Call out for Bono!... that's a good one.
