The IMF and the European Debt Crisis

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[This is not a conventional paper, but rather the conclusion of a volume examining – on the basis of IMF and other documentation – the IMF’s response to the Euro crisis.]

The IMF’s euro-area programs were about much more than just the problems of the euro-area. They raised the fundamental issue of how global governance should be arranged in a world in which the tectonic plates of fundamental economic geography were shifting.

Many Europeans immediately thought of the Global Financial Crisis of 2008 as—in the words of German Finance Minister Peer Steinbrück—“above all an American problem.”¹ However, in a globalized world, problems usually don’t stay in one country. In 1971 the U.S. Treasury Secretary John Connally famously told Europeans that the dollar was “our currency but your problem.” In the twenty-first century, an American financial crisis that was widely thought to originate in the peculiarities of housing finance in the United States became Europe’s problem, and then the crisis morphed into a European debt crisis. Forty years after Connally’s confrontational pronouncement, his successor, Tim Geithner, explained to European leaders at an “Informal ECOFIN” meeting in Wroclaw, Poland, that “This is your crisis. You have to decide how to fix it.”² By early 2010, it had become apparent that several euro-area countries were in deep financial trouble. But it was not just a financial mess: there was a fundamental political and institutional problem that was producing the mess. Key European leaders believed that the responsible European institution—the European Commission—lacked both the expertise and the credibility to oversee the needed adjustment programs on its own. Geithner was right, but there was no obvious way for Europe to “fix it” on its own. And perhaps Geithner, and President Obama, who also intervened repeatedly in the micro-management of the Euro crisis felt that, after all, there may have originally been an American cause, in the dramatic crisis of 2007–8 that came to a head with the collapse of Lehman Brothers in September 2008.

Europe after 2010 looked like a source of contagion and crisis that might infect the whole world. A special vulnerability stemmed from the prominence of banks in the European financial structure. Banks played a much larger role in industrial finance than they did in the United States, and a banking crisis might thus be expected to have much deeper or more severe effects. In addition, banks held a substantial amount of government debt, and governments bailing out banks made themselves more fiscally vulnerable and their yields surged—leading to even more bank


vulnerability as the value of government bonds as bank assets fell. This linkage became notorious as a “doom loop.” The existence of a global threat from Europe called for an institution such as the IMF, with its global mandate, to find an appropriate policy response.

The IMF had a long-standing love-hate relationship with Europe. Europe and its institutions were pillars of postwar multilateralism, and European countries were over-represented in terms of Fund quotas, and on the Fund Executive Board. Multilateralism in its European form was complicated, dysfunctional, and clearly in need of reform. The members of the IMF were nation-states, and the Fund’s core experience lay in dealing with countries; but, in the European case, it was very clear that the problems could not be solved simply by a dialogue with national authorities.

The relationship between the Fund and its European members was additionally complicated because in the course of the crisis, there was a break-down of trust and credibility in the governments of the European crisis countries. The waning of political trust within countries made it harder for them to make commitments backed by a wide political support. The programs concluded in these conditions lacked “ownership,” and populations, voters, but also markets were correspondingly not convinced. The beliefs of markets translated immediately into the cost of debt finance and calculations about debt sustainability, and thus created a vicious circle or doom loop of negative expectations: of the population, of markets, of governments, and of international institutions. The most obvious doom loop was between governments and banks: banks held government bonds, whose loss of value eroded the banks’ balance sheets, so that they required support which added to fiscal liabilities. Government debt was also linked to long-term demographic development and fiscal capacity: high debt levels meant the necessity of higher future taxes, and acted as an incentive to younger, skilled or higher-earning workers to emigrate to other countries, thus eroding the future tax base. In the scenario of multiple doom loops, there was a credibility trap: there was a temptation to talk up expectations, in the belief that higher hopes might break the doom loop and set up a new and better equilibrium (in a world in which expectations could lead to a flipping between multiple equilibria). But unrealistic forecasts when juxtaposed with subsequently revealed outcomes would lead to a further loss of credibility and trust.

It is striking, however, that the breakdown of trust is not simply confined to Eurozone debt crisis countries, but also characterizes more generally countries hit severely by banking shocks and the financial crisis, which then implemented controversial contractionary fiscal programs: in particular the U.K. in this respect resembles peripheral Europe.
Europe had a high priority for the Fund, in part because it was an obvious source of instability and global contagion. Even before the IMF’s engagement with Greece, and thus with the Eurozone, some critics complained of the institution’s Euro-centricism. The first engagements were with Baltic and Central Europe. In the Baltics, the question of an alteration of the currency regime had been a key part of the discussion, and the IMF had abandoned its initial preference for devaluation as a key component of adjustment. Devesh Kapur and Arvind Subramanian interpreted the IMF’s Latvian program as evidence of a “double standard” because of the absence of devaluation. They concluded that: “Emerging market countries in Latin America, and in particular Asia, see it as an Atlantic-centered, especially Europe-dominated, institution; that is, they see it as a Euro-Atlantic Monetary Fund.”

The accusation of a European bias became more pronounced after 2010. Treasury Secretary Tim Geithner made the complaint when he spoke to Congress, and cited as an instance the unbalanced governance structure of the Fund. The first Chinese national to be appointed to the management of the Fund, as Deputy Managing Director, the economist Min Zhu, arrived only in July 2011 after an appointment process for the new Managing Director which was widely pilloried as being just yet another case of IMF euro-centrism. Programs with large financing in relation to quota ("exceptional access") in the Eurozone but also outside the Eurozone were criticized as violations of the principle of even-handedness towards member countries.

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The IMF looked too committed to Europe. However, measured in financial terms, it may not have been committed enough to ensure that it was the critical voice in program design. Its financial support was smaller than that of the European mechanisms, the EFSF and the ESM, and it thus became a minority stakeholder in the European problem. The amounts were also inevitably substantially lower than the large imbalances built up within the European payments system: the TARGET2 balances, where a surplus in creditor countries corresponded to a financing of deficits in peripheral Europe. Some critical commentators, especially in Germany, viewed TARGET2 as the fundamental instrument of a blackmail to keep permanent north European support, as a Euro breakup would bring immense losses for the creditors. In consequence, the European rescue mechanisms and the ECB pushed the IMF into a position of being a junior partner in the rescue of Europe. The outcome could only push Europe to build its own IMF-like bodies, in particular through the development of the European Stability Mechanism. Was the IMF therefore a subservient partner, or was it acting as the midwife for a new institutional order in which regions might be better equipped to deal with financial crises arising out of their own malfunctioning?

Table 1: Financial Assistance for Eurozone Crisis Countries

<table>
<thead>
<tr>
<th>EU member</th>
<th>Time span</th>
<th>IMF (% of GDP)</th>
<th>Bilateral (% of GDP)</th>
<th>European Union Support (EFSM, EFSF, ESM) (% of GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cyprus I²</td>
<td>Dec.2011-Dec.2012</td>
<td>–</td>
<td>12.8</td>
<td>–</td>
</tr>
<tr>
<td>Cyprus II²</td>
<td>May 2013-Mar.2016</td>
<td>5.1</td>
<td>–</td>
<td>16.8</td>
</tr>
<tr>
<td>Greece I-II³</td>
<td>May 2010-Jun.2015</td>
<td>3.4</td>
<td>–</td>
<td>14.0</td>
</tr>
<tr>
<td>Greece III⁴</td>
<td>Aug.2015-Aug.2018</td>
<td>–</td>
<td>–</td>
<td>12.4</td>
</tr>
<tr>
<td>Ireland⁵</td>
<td>Nov.2010-Dec.2013</td>
<td>4.3</td>
<td>0.9</td>
<td>7.8</td>
</tr>
<tr>
<td>Portugal⁶</td>
<td>May 2011-Jun.2014</td>
<td>5.4</td>
<td>–</td>
<td>9.8</td>
</tr>
<tr>
<td>Spain⁷</td>
<td>July 2012-Dec.2013</td>
<td>–</td>
<td>–</td>
<td>2.7</td>
</tr>
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</table>

The criticism of Eurocentrism was supported by the outcome of the Fund’s own evaluation procedures. The IMF Independent Evaluation Office (IEO) report of July 2016 concluded that: “The IMF’s handling of the euro area crisis raised issues of accountability and transparency, which helped create the perception that the IMF treated Europe differently.” That nuanced critique was promptly

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⁶ IEO, The IMF and the Crises in Greece, Ireland, and Portugal, July 2016.
amplified and distorted, especially by Anglo-American economists, journalists, but also politicians critical of the whole Euro project.  

It was undoubtedly true that Europe occupied the attention of the IMF and of the international community for a time, and that especially between 2010 and 2012 it represented the epicenter of a shock to the world economy and to the idea of global governance. The Fund’s actions in Europe occurred in a fierce glare of publicity, criticism, and self-criticism. It was inevitable that the Fund looked for success stories that it might tell—as in the cases of Ireland and Portugal—and also inevitable that a lingering bitterness settled in over those cases that could not possibly appear as successes: in particular Greece.

In contemplating the European challenge, the IMF necessarily brought its own baggage. Its lending experience was framed in terms of assistance, originally conceived as balance of payments support, to member countries, and not to developing programs for whole areas or regions. Legally, the justification for Fund action necessarily still lay in a balance of payments difficulty, even though the task of managing payments in a currency union fell entirely in the responsibility of the ECB. The European crisis was a general crisis, with contagion effects, but it was also an accumulation of specific and diverse country problems. Tolstoy’s famous dictum about unhappy families applies to crisis countries: each is unhappy in its own way. They all had particular and peculiar legacies of policy mistakes and hostile circumstances. For some, the problem was primarily fiscal; for others, the issues derived from the banking sector. Banking was no longer national, and cross-border exposures figured prominently; but Europeans had regulated and supervised their banks nationally.

Moreover, the standard time frame for Fund programs was more suited to dealing with short term shocks than with longer term issues of structural adjustment and transformation. The fiscal side was at the center of the traditional program design. The IMF’s fiscal experience went much deeper than its capacity for financial sector analysis. An old chestnut had the initials of the IMF as being “It’s Mostly Fiscal.” A key issue in the IMF’s European involvement would be the interactions of fiscal and banking issues. The institution realized at a very early stage the dangerous interaction between vulnerable cross-border banking systems and national fiscal regimes. Bank recapitalizations through governments amounted to a fiscal charge, and the consequent rise in public debt might raise borrowing costs and drive down the prices of government bonds held on banks’ balance sheets, creating further banking problems in a doom loop. A second doom loop went from fiscal contraction to reduced economic activity, to higher NPLs, more damage to banks, and more need for fiscal expense in bank recapitalization. The fiscal engagement became a center of controversy about the European programs: was the IMF pushing austerity? And then: was the Fund learning and rethinking its approach?

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Finally, the European experience raised the question of what the Fund’s ultimate function should be, how it was governed and controlled, and how it might be accountable to society: to national communities, and to the international order as a whole. These questions will be examined in turn.

In the aftermath of the Global Financial Crisis, policies were formulated that necessarily had not been articulated, prepared, or discussed in advance. In 2019, European Council President Donald Tusk explained that there was “a special place in hell” for “those who promoted Brexit without even a sketch of a plan of how to carry it safely.”

Yanis Varoufakis shot back that that place would be “probably very similar to the place reserved for those who designed a monetary union without a proper banking union.” There was an inevitable absence of preparation—that required a making of policy on the hoof.

**Could the IMF keep a holistic view of European issues, or did it concentrate excessively on individual cases?**

The IMF had a substantial expertise in global monitoring and surveillance. The IMF’s 2007 Bilateral Surveillance Decision and the 2012 Integrated Surveillance Decision explicitly stated that members of currency unions “remain subject to all of their obligations under Article IV section 1, and accordingly, each member is accountable for those policies that are conducted by union level institutions on its behalf” (ISD, paragraph 8). The precise meaning of the accountability remained unclear. The ECB formally become an EU “institution” in December 2009, with the entry into force of the 2007 Lisbon Treaty, but had an independence that was anchored into the treaty. There was no country that might legally be held accountable for its actions or inactions. Politically, but not legally, it was tempting to think that Germany might exercise a leverage over the ECB, since to many the ECB seemed like an institutionalized continuation of the thinking of the German Bundesbank. But Germans persistently complained of their under-representation at the ECB. It was however the ECB that decisively averted imminent crisis and collapse in December 2011 and July 2012. Whatever it takes was done by the ECB: the ECB was the final decider

The IMF conducted Article IV surveillance exercises for the Eurozone from the beginning. The eve of crisis reports were in retrospect over-optimistic and even complacent: for July 2007, the conclusion was that “The outlook is the best in years. The economy is poised for a sustained upswing, partly because of cyclical considerations, but also because of policies, which have up to now had a forward-looking cast.” Even one year later, the verdict was not dissimilar: “The euro area has clearly become more resilient, but it is not immune to the common global shocks.” The July 2009 report rightly recognized the centrality of financial sector reform: “A broad arsenal of financial sector, monetary, and fiscal policy tools have been deployed to address the crisis. It is now urgent to

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9 @yanisvaroufakis tweet: 1:58 AM, February 7, 2019


complete the task by implementing a proactive strategy to deal with remaining stresses in the financial system.”

Annual Spillover Reports, from 2011, and External Sector Reports, from 2012, included a focus on the euro area as well as on key euro area countries. It was however difficult to connect the dots between overall thinking about the Eurozone and the evolution of particular country programs. The establishment of programs in individual cases of crisis countries is an inevitable part of the Fund’s standard practice, its way of doing business. It also corresponds to the logic inherent in the problems that generated the crises in the first place, in which a vulnerability to internationally transmitted shocks increased as a consequence of domestic institutional fragility and weakness.

In the case of a national program following a sudden stop of the capital markets, the arithmetic had to add up, in the sense that the provision of financial resources and the application of a reform program, with fiscal and structural measures, would allow a country to return to normalcy, and access financial markets. The Fund was also fundamentally and constitutionally committed to the principle of uniformity of treatment (what it termed even-handedness). That principle obviously applies to monitoring or surveillance. The 2012 Guidance Note for Surveillance under Article IV Consultations states that surveillance “must be even handed, whether economies are large or small, advanced or developing and should pay due regard to countries’ specific circumstances.” But evenhandedness also applies to the design of programs: The Fund cannot arbitrarily select which countries to support (in a marked contrast to the way in which the U.S. Federal Reserve System provided swap lines to a few emerging market economies in September and October 2008). On the other hand, in a generalized financial crisis, it may lack the resources to provide the same level of support in every program. The 2010 Greece program amounted to 3,200 percent of quota, and the 2012 EFF 2,059 percent. The Ireland program was 2,322 percent of quota, and that of Portugal, 2,306 percent. Similar sized programs for larger Eurozone countries, as suggested in the crisis moment of November and December 2011, would have stretched the IMF’s resources to the breaking point, and might not even have been enough (in 2011, a 3,200 percent of quota program for Italy would have amounted to “only” € 276 billion, and would not have covered Italy’s funding needs for a two-year period).

At the beginning of her term as Managing Director, Christine Lagarde promised an “even-handed” approach to all 187 member countries of the IMF; but also promised “an IMF that would pay more attention to ‘inter-connectedness’ between national economies rather than focusing on a more national and limited approach, as was seen to be the case in the past.” Both were theoretically desirable objectives, but they necessarily pushed the Fund in different directions. The beginning of the Fund’s engagement in the Eurozone, in Greece in May 2010, could only be justified in terms of its

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systemic importance and the risk of a general meltdown; considered on its own, Greece clearly represented too great a risk in terms of the sustainability of debt.

An additional feature made the Eurozone programs very peculiar: in general, monetary policy plays an important part in program design. But in the Eurozone, the European Central Bank was “on the other side of the table,” setting conditions and in particular through its collateral and lending policies determining a large part of the financial development. So, a major part of the discussion was outside the frame of the IMF’s stance.

An early journalistic comment picked up the problem accurately: “in eastern Europe in 2008–09, the fund had in effect operated as the senior partner or had almost complete unity of purpose with the other lenders. [By contrast, the junior role in the Eurozone] may not have mattered too much as long as the fund acted as a credibility gatekeeper, taking a leading role in negotiating and enforcing loan conditionality with the borrower, Greece. But it turns out that what it really needed was to enforce conditionality on its dysfunctional co-lender, the eurozone.”15 From 2010 to 2011, the ECB used conditionality very directly in order to enforce its vision of how the crisis should be resolved—above all through avoiding debt restructuring—and the IMF was dragged into clashes with the central bank. After that, especially from the summer of 2012, ECB liquidity provision made the bank effectively the Eurozone’s LLR, but the clashes with the Fund became even more acute, and the Fund’s leverage less as the ECB turned on its multiple liquidity taps.

Henry Kissinger famously complained that he did not know who to call when he needed to speak to Europe. By the time of the financial crisis, the answer to his question had become quite clear: Berlin and Chancellor Angela Merkel had become Europe’s decider. But telling Merkel what to do in the interests of Europe or the Eurozone as a whole was not at all easy.

In the first phase of the crisis, the IMF thought more in terms of persuading Berlin of the need for overall architectural reform of the Eurozone, and not of changing particular German policies. A particular or focused critique of Germany would actually damage to the chances of an overall political settlement in the Eurozone. In 2010, the IMF’s Article IV report card for Germany forecast a fall or moderation in the current account surplus, to 5.5 percent of GDP in 2010, and noted that this would bring the figure “broadly in line with the equilibrium level suggested by the Macrobalances approach.” It did not express much concern about what it termed “the enduring tradition of German current account surpluses.”16 The 2011 Article IV noted that “the authorities felt that the periphery’s weak competitiveness will require solutions in the periphery.” It also looked again at the issue of the current account surpluses. “In popular discourse, raising German wages to reduce German competitiveness is often recommended, as is reducing the household savings rate. But these approaches are neither analytically nor pragmatically sound. […] The most sustainable approach to reducing the German current account surplus is likely through policy efforts to raise domestic

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16 2010 Article IV Report, p. 8 and 7.
investment rates, which are low among advanced economies.”\textsuperscript{17} Sometimes the Fund message referred to the problem of an absence of rebalancing. But generally, the IMF at this stage avoided being very explicit about a call for a radical rethinking of German policy.

A 2012 IMF Working Paper, authored by Fabian Bornhorst and Ashoka Mody provided the analytical underpinning for the case that the deterioration of southern European competitiveness was mainly caused by developments outside Europe, in particular by the dynamism of emerging Asia. “Aside from the fact that there are no direct ways in which policy can cause wage increases, the analysis focusing on German policies as the reason for intra-European imbalances does not take into account competitiveness gains realized by countries outside of Europe.”\textsuperscript{18} Thus, “Germany’s ability to act as either a global or even a European locomotive is limited.” The chief contribution that Germany made to general European stability was through the financial system: “While support to European growth, either through general economic activity or through fiscal policy, is likely to be limited, as part of the Eurosystem, Germany has somewhat unwittingly played an important role in providing financial stability and hence preventing a more serious growth collapse. This has occurred through the so-called Target2 system.\textsuperscript{19} The German imbalances could not be attributed to particular policy choices.\textsuperscript{20}

In 2014, the IMF was optimistic that the current account issue would be solved in the near future. “For the last two years, wages have been growing more in line with productivity, as reflected in lower profitability and lower net corporate savings in the NFC in the years after the crisis. If this trend continues, then the current account surplus might decline in the future.”\textsuperscript{21}

The U.S. Treasury from a relatively early stage in the crisis was more concerned and more critical than the IMF about the surpluses. A turning point was the October 2013 Treasury Report on Economic and Exchange Rate Policies, which elevated the critique of German current account surpluses to a “key finding:” “Within the euro area, countries with large and persistent surpluses need to take action to boost domestic demand growth and shrink their surpluses. Germany has maintained a large current account surplus throughout the euro area financial crisis, and in 2012, Germany’s nominal current account surplus was larger than that of China. Germany’s anemic pace of domestic demand growth and dependence on exports have hampered rebalancing at a time when many other euro-area countries have been under severe pressure to curb demand and compress imports in order to promote adjustment. The net result has been a deflationary bias for the euro area, as well as for the world economy.”\textsuperscript{22} Germany vigorously rejected the criticism, claiming that no

\begin{comment}
\begin{itemize}
    \item 17 2011 Article IV, p. 19-21.
    \item 19 2013 Ibid, pp. 20, 21.
    \item 22 2016 U.S. Department of the Treasury, Office of International Affairs, Economic and Exchange Rate Policies, October 30, 2013, p. 3.
\end{itemize}
\end{comment}

imbalances needed correcting and that the current account surplus was “no cause for concern” for Germany, the eurozone or the global economy. In January 2014, U.S. Treasury Secretary Jack Lew went on a European tour, the highpoint of which was a confrontation with Wolfgang Schäuble in Berlin, where at the press conference Lew explained that the U.S. had made “very clear” that more German domestic demand and investment was central: “We have raised concerns about positive balances in surplus economies generally.” In response, the German Finance Minister argued that the source of German growth was domestic demand, not exports, and that the two ministers were not meeting to “give each other lessons.”

At the same time, the Commission in Brussels also stepped up its critique of the German position. Commission President José Manuel Barroso announced an “in depth” review of whether the German current account damaged Europe: “Our problem could never be German competitiveness but whether Germany, the EU’s economic powerhouse, could do more to help the rebalancing of the EU economy.” Again, almost every German politician pushed back on the criticism.

In fact, the current account surpluses continued to mount, and eventually became a major theme for U.S. policy debate as well as for Fund encouragement of a different policy orientation. By 2018, the Fund organized a conference in Frankfurt with the Bundesbank to press the case, and the IMF’s chief economist, Maurice Obstfeld, consequently analyzed the German (and Japanese) surpluses as posing a “mid-term risk of global financial stability.” It took even longer for the debate to figure prominently in domestic political discussions in Germany, and the issue became salient only in 2019. A holistic debate over Europe would have required an early focus on imbalances in the Eurozone, and on the asymmetry created by the surplus position of Germany and other countries.

**What Difference Did Being in the Eurozone Make?**

The phenomenon of a sudden stop in capital flows in the aftermath of the Global Financial Crisis was not confined to the Eurozone. But the Eurozone (or the hope of being in the Eurozone: the same logic applied to pegged exchange rate regimes in the Baltic states) ruled out the possibility of an exchange rate adjustment. Moreover, being in the Eurozone meant the engagement of a different LLR, the ECB, with a different set of calculations than either a domestic or national central bank, or an international institution. The absence of the exchange rate tool might thus be thought to create a problem that then required a very powerful international mechanism to respond to that problem.

For many critics, the Euro area was in consequence simply a terrible mousetrap. The criticism came symmetrically from a perspective that saw the imbalances as a consequence of a malevolent German export strategy, and those who worried about the high implicit fiscal liabilities of the surplus

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The Euro promised low interest government borrowing, but consequently created a debt problem. It makes adjustment more difficult, since there is no possibility of nominal depreciation: all the real exchange rate depreciation needs to be done through “internal devaluation,” which is economically and politically costly.

That put great pressure on fiscal policy, and led to an “austerity” mindset that may have made the crisis worse. It is significant though that the same mindset, justified by the same argument about possibly losing market access was made in the U.K., and produced a similar policy outcome. In the 2010s, in the U.K. as well as in Greece and Spain total government spending went down by over 7 percent of GDP (and in Portugal by almost 6 percent). In the U.K., indeed, the fiscal consolidation provoked a popular and populist backlash that was in its outcome more radical than in any Eurozone crisis, in that it pushed the country to vote (narrowly) in June 2016 for leaving the EU altogether (“Brexit”).

Eurozone members were also linked together by a chain of arguments about contagion and examples. In consequence, one country in particular became a whipping boy. Greece considered on its own was a small economy, and its problems should not have affected the rest of Europe (many commentators made comparisons with the unsustainable debt of Puerto Rico, which produced no spillovers for the United States). In 2010 and 2011 a major argument against debt restructuring—which would have been cheaper and more effective the sooner it occurred—concerned the effect on Italian debt, which also stood at a very high level. A debt write-down for Italy was simply too big to handle, and there were no European and international institutions in place to manage it. Later in the crisis in 2014–15, the treatment of Greece by the northern European creditors, especially Germany, was designed also to produce a demonstration effect to other countries, including large states, Spain and France, not to imitate the Greek path. The misfortunes of Syriza in the summer of 2015 eroded support for the equivalent Podemos movement in Spain.

Sometimes it is argued that the non-Eurozone EU countries faced a better political economy set of incentives to undertake adjustment and radical reform, because they could not expect the ECB to use a quasi-fiscal monetary policy to rescue them. In the derogatory terminology that prevailed for some North Europeans at the time of the crisis, the peripheral crisis countries were PIGS (Portugal, Ireland, Greece, Spain) or sometimes PIIGS (with Italy as well). By contrast, there was a virtuous group of non-Euro BELL (Bulgaria, Estonia, Latvia, Lithuania). The great Polish economist and reformer Leszek Balcerowicz concluded that “the BELL belonged to the growth leaders in the EU in terms of cumulative growth in GDP per capita, while the PIIGS were at the bottom of this league. […] Both groups finally achieved a similar extent of external adjustment, but in the PIIGS it had

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been accompanied by a much deeper cumulative decline in GDP per capita. The BELL also achieved faster reduction in unit labor costs and inflation than the PIIGS.”

Looking simply at the evolution of either GDP or per capita real GDP over the decade of the crisis, it is hard in the longer term to see that being or not being in the Eurozone made any difference at all to economic outcomes. The Euro area and the EU 28 perform almost precisely in the same way.


Before the crisis there had been a substantial convergence of incomes, as peripheral Europe grew and caught up with the richer northern and western countries. It is also striking that while convergence on the higher income group continued for many east central European non-Euro members, it also proceeded rapidly for Slovakia and Malta (both of which joined the single currency). On the other hand, for Spain and Portugal convergence slowed dramatically, and for Italy, Cyprus and Greece it reversed.

Two countries, Italy and Greece, had a significantly poorer performance than that of other Eurozone countries, or that of crisis-hit non-Eurozone EU countries, or that of the non-EU periphery. In both Italy and Greece, much of the weakness is due to previous governance problems; Cyprus is a case of linkage and spillover from the Greek crisis, as well as of the perils of over-financialization. In both Greece and Italy, there was a severe double dip recession, with major political ramifications (the effective destruction of the old political parties).

The economic downturns required policy responses, with major coordination problems between the international institutions involved. Arguably, Greece had too many programs—it nearly made it back to the markets at the end of the second program but failed because of political turmoil leading to a new clash with European institutions and the IMF. And equally arguably, Italy had not enough programs: some sort of program—perhaps on the lines of the agreement for a partial financial sector program with Spain—would have allowed Italy to resolve its substantial banking problem earlier rather than gambling on resurrection.

Peripheral Europe was divided from the core by demography. Thinking about the demographic development became a central part of the calculation about potential growth, and hence about debt sustainability issues. After the outbreak of the crisis, an exodus from peripheral Europe increased in pace, both within and outside the Eurozone (and indeed the European Union). The result was a stunning demographic collapse. Bulgaria, the country in the world currently experiencing the fastest depopulation, had a fall from 8.77 million in 1990 to 7.08 million in 2017, and neighboring Romania fell at an almost parallel rate, from 23.23 million to 19.68 million Latvia’s decline was even more stunning, from 2.67 million to 1.95 million. Around two thirds of the demographic decline of eastern and south-eastern Europe was due to emigration. The United Nations estimated in 2017 that Bulgaria, Latvia, Moldova, Ukraine, Croatia, Lithuania, Romania, Serbia, Poland, Hungary, will experience population decline of 15 percent or more by 2050. Greece and Portugal are also experiencing population declines, and there is a substantial emigration from Italy. The gerontocratic politics of southern and eastern Europe protect vested (middle aged) interests and have been counterproductive and endanger long term.

The redistributive effects were augmented by the debt crisis, which had an important intergenerational dimension. Public debt represents a commitment by taxpayers in the future to make payments for goods and services that have been supplied in the present. As a consequence, an argument is often made that debt financed activity should be confined to investments—for instance in infrastructure—that will produce substantial returns for future citizens. Debt-financed growth can pay down debt; but in the absence of that growth, a vicious cycle sets in. If debt produces a promise of larger future burdens, it will prompt those who are bound to shoulder those burdens to try to escape. But that choice will make the predicament worse. When productive and innovative (young) people abandon their country, they leave behind a highly indebted country. Now the debt has to be paid off by smaller, less productive, aging population. In a sense, individual citizens have an option to “walk away” from their government debt obligation by leaving the country. Emigration can be seen as an individual’s “private default option” on government debt.

Emigrants also walk away from infrastructure financed by previous generations. If that infrastructure is extensive and well-designed, would-be emigrants have incentives not to move and to stay with a free gift from the past. Where however mistaken investments in inadequate infrastructure in uneconomic areas predominate, the incentives are with movement. The extensive debt-financed infrastructure investments for Greece’s Olympic Games in 2004, crumbling stadia and

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swimming pools, do not constitute a strong argument for young people to stay in Greece. Individualized education and the accretion of human capital—another important investment by the welfare state—however are movable. Some European countries with education systems that are generally recognized as superior—such as Finland—suffer from the problem that highly educated young people take the exit option and withdraw their accumulated human capital, without contributing in taxes to financing the education of the next generation.

Emigration has strained welfare provision within national states. Germany’s eastern Länder and the Italian Mezzogiorno are also predominantly area where the young move and the old remain. Medical resources for the remainers became strained and inadequate. In the case of nation-states, social and medical services are provided by budget transfers, so that taxpayers in the more prosperous and dynamic areas shoulder the financial burden. This burden sharing currently does not take place in the case of cross-border or international migration.

The ability to exit debt in an economic area constituted by high labor mobility provides one of the clearest arguments for the partial mutualization of debt in Europe. The alternative would be to move to a contributions based insurance system of old age pensions on a cross-national or European basis. The demographic consideration suggests that the division between Euro and non-Euro countries is irrelevant to Europe’s most central and durable policy challenge. Currency pegging is a less relevant constraint: a conclusion that is buttressed by academic work suggesting that in a globalized world connected by capital movements there is no longer the classic trilemma and that exchange rate flexibility in practice gives little policy autonomy.31

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How did the IMF deal with financial sector issues?

The Fund had an interest in financial stability, but the major locus of international financial sector engagement and policy debate at the beginning of the crisis was a very incomplete Financial Stability Forum, instituted in 1999 as a response to the Asian crisis, but involving initially the finance ministries and central banks only of G-7 countries. After the shocks of 2007–08, the Forum was expanded to include the large emerging markets in the G-20 and renamed as the Financial Stability Board. The IMF has also built up its own International Capital Markets Department in the aftermath of the Asia crisis, but it coexisted uneasily with other Fund departments and the relationship between its reports and the older and well-established World Economic Outlook reports was never clear. Its work was not integrated in the core bilateral surveillance functions of the Fund, the Article IV consultations and reports, and outsiders viewed it as having “little traction” within the Fund. After its first director left, in 2006, the Department was renamed as the Money and Capital Markets Department. In 1999, also in response to the Asia crisis, the Fund and the Bank had instituted a joint Financial Sector Assessment Program (FSAP) that aimed to provide “a comprehensive and in-depth analysis of a country’s financial sector,” a Financial System Stability Assessment (FSSA). The framework was extended in 2009 to provide “a clear definition of the components of stability assessments (vulnerabilities and resilience of the financial system, regulatory and supervisory framework, and financial safety nets), the introduction of Risk Assessment Matrices (RAMs), and the possibility of modular FSAPs conducted separately by the IMF or the World Bank, focusing on each institution’s chief responsibility.”

The most obvious case of the need for a holistic approach was the question of the institutional regulation and supervision of the European banking system. In the 1990s, at the onset of the Asian crisis, the Fund had researched the impact of systemic banking crises. There was a powerful case that the severity of the Greek problem as it emerged in 2009–10 was a consequence of the threat Greek debt posed to the German and French banking systems, and to the German and French governments who were not disposed to think that a second program of bank rescues would sit well with their voters. So, from the beginning, an effective program to tackle Europe’s debt issues might have involved a head-on confrontation of the need to recapitalize weak creditor banks and build resiliency. But this was an issue that Europe’s policy-makers only really began to address two years into the crisis, in the summer of 2012, the moment when the continued existence of the currency union was really seriously threatened. By contrast, the Fund had already highlighted the need for a pan-European banking supervisory authority—disguised at first in “Fund-speak” as “joint responsibility and accountability” in 2007, before the crisis, and by early 2010 staff from the

32 Interview with Sir Jon Cunliffe, April 3, 2017.
33 Financial Sector Assessment Program (FSAP) Factsheet, 2016, https://www.imf.org/en/About/Factsheets/Sheets/2016/08/01/16/14/Financial-Sector-Assessment-Program
European, Legal and MCM departments were suggesting a blueprint for a European Resolution Authority.35

One of the surprises of 2011 for European policy-makers was the rapidity with which Christine Lagarde took up this issue, which was political dynamite for the European creditors (as she must have known from her experience at the French Finance Ministry). Her first Jackson Hole speech of August 2011 received a great deal of attention, in particular the call for “urgent and decisive action to remove the cloud of uncertainty hanging over banks and sovereigns.” “Financial exposures across the continent are transmitting weakness and spreading fear from market to market, country to country, periphery to core.” The European banks were a particular problem: they required rapid recapitalization.36 In Berlin in January 2012, she made the same point in a different way: “Adding substantial real resources to what is currently available by folding the EFSF into the ESM, increasing the size of the ESM, and identifying a clear and credible timetable for making it operational would help greatly. Action by the ECB to provide the necessary liquidity support to stabilize bank funding and sovereign debt markets would also be essential.”37 But this course looked too much like a Europeanization of debt, and was consequently unpopular, especially in Germany. There was an additional problem, in that bank support might conflict with competition law limiting the extent of state aid.

The first IMF EU-wide FSAP, published on February 22, 2013, followed a mission of November 27–December 13, 2012. The critical driver of the exercise was the formulation that “Moving banks and sovereigns jointly to safety is essential.”38 It built on the 2011 European Financial Stability Exercise (EFFE), as well as on individual country FSAPs—but there was a striking omission in that there had been no FSAP for Italy. That omission might have been justified in the first place in that Italian banks were not heavily involved with U.S. funding or securitization, and because their lending to governments almost exclusively involved the Italian government. But as a double recession hit Italy, the problem of Italy’s fragile banking system and its entanglement with government debt became increasingly critical.

Italy’s banking sector became especially problematic as its version of the general financial crisis developed only very slowly, and later than elsewhere in Europe, and successive governments responded even more slowly. The result was that by the time the problem became acute, new European rules were in force about bank support: operations which had been part of the repertory of north European governments in the early stages of the financial crisis were thus ruled out.


36 Remarks at Jackson Hole, By Christine Lagarde, Managing Director, Global Risks Are Rising, But There Is a Path to Recovery, IMF, August 27, 2011.


Were the Fund’s interventions in fiscal policy misplaced?

Sentiment about fiscal policy has shifted radically in the aftermath of the financial crisis. At the beginning of the GFC, the IMF had pushed very powerfully for a coordinated fiscal stimulus. It decisively helped to generate a new consensus about the use of fiscal policy as an anti-crisis measure that marked the April 2009 G-20 London Summit. The Euro-crisis coincided with but also drove a new dynamic and the prevalent argumentation flipped completely: there was now a fear than unmarketable and hence unsustainable fiscal positions could lead to new Lehman-style contagions. The result was widely described “austerity,” advocated above all by policy makers in countries that considered themselves to be at—or over—the abyss: Provopoulos in Greece, Monti in Italy, or Osborne in the U.K. In a third stage, the longevity of the low interest rate regime and the perception that central banks had run out of monetary tools prompted policy makers to think again enthusiastically about fiscal tools and stimulus, especially since with negative rates capital expenditure seemed like a free lunch.

The discussion of fiscal policy became increasingly fraught, as it no longer looked as if the link between fiscal policy and a particular macroeconomic outcome was stable or predictable. In 2013, Blanchard and Leigh concluded their assessment of the appropriate pace of fiscal consolidation with the observation that: “Since it is nearly impossible to know what will make investors shift their beliefs, the situation policymakers face here is one of ‘Knightian uncertainty’.”

There was also a question of how detailed the policy prescriptions should be. After the Asia crisis, the IMF responded to the widely expressed critique of intrusive and over-complex conditionality by simplifying or streamlining conditions. Strauss-Kahn made a point of keeping conditionality simple in discussing the Eurozone programs. The principle was also reasserted in a new review of conditionality in 2011, in which the IMF promised to keep its policy conditions “parsimonious and focused on macro-critical issues.” “Parsimony is a key principle of streamlined conditionality, implying a focus of program conditions on achievable goals and key macroeconomic objectives. Under streamlining, structural conditionality should be both parsimonious and macro-critical (i.e. conditions should be of critical importance for achieving the goals of the member’s program or for monitoring program implementation, and should be limited to the minimum necessary). Streamlining does not preclude individual programs from having substantial conditionality when needed for the success of the program.”

Strauss-Kahn insisted that the IMF should not impose complex conditionality on Greece. At the press conference after the May 9, 2010 meeting, the First Deputy Managing Director John Lipsky was asked by reporters if the agreement marked a return by the IMF to earlier times of a “laundry list” of conditions attached to loans, and replied that “these were well targeted conditions that would help correct the imbalances in the Greek economy.”

Compared to the Asian programs of the 1990s, the initial Great Financial Crisis programs were certainly somewhat lighter. In fact, however, there was a considerable amount of conditionality: in the first, 2010, Greek program, perhaps more than Strauss-Kahn might have wanted. But an indication that it was not enough was provided in the run-up to the 2012 program, when it was clear that the first program had failed because of the issue of debt sustainability, but also because of the incapacity of Greece to tackle underlying structural problems. Critics now rightly concluded that the conditionality was really becoming more complex and that the number of conditions was increasing. Thus a paper prepared by the NGO group Eurodad claimed that the IMF attached nearly 20 conditions, on average, to each loan it has approved in the past two years, substantially more than the Eurodad had calculated in two prior reports. This perception was correct: the number of quantitative conditions did indeed increase over time:

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42 https://www.imf.org/en/News/Articles/2015/09/28/04/53/sonew050910a

The structural conditions of the IMF were substantially less detailed and numerous than those contained in the European Commission’s MOUs: for Ireland and Portugal there were some 400 conditions. That level of detail was widely criticized, by academic, think tanks, and the European Court of Auditors.

Initial reluctance to impose intrusive conditionality meant that national authorities were left to take many central fiscal decisions. Some areas of expenditure—pensions in Greece—were highly protected, whereas infrastructure investment was an obvious easy target for an economy campaign—but the collapse of investment left economies struggling and diminished the long-term growth potential. Pension reform had certainly been a central part of the first program, but not enough was done to protect public sector investment from the effects of fiscal contraction. The fiscal contraction also increasingly looked misjudged because of the extent of the economic collapse, with targets set in terms of GDP then requiring further contractionary measures.

There was also no mechanism for adding up the national fiscal recommendations so as to produce a recommendation that was consistent with the IMF’s recommendation for the Eurozone fiscal stance as a whole. There were in consequence complaints that the IMF did not do more to push surplus countries such as Germany and the Netherlands to do more fiscal stimulus.

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Why were IMF projections for the Eurozone so error-prone?

IMF projections were significantly more out of line with subsequent developments in the Eurozone than in emerging market program countries. In the early stages of the crisis, the IMF systematically misjudged the extent of the European economic collapse, and consequently the vulnerability of the crisis countries. GDP projections were over-stated, and the eventual outcome meant that deficits and debt measured in relation to GDP ballooned. In late 2015, the IMF reviewed this performance and gave a striking visual account of what it euphemistically labeled “growth surprises”: see Figure 41.

Source: Crisis Program Review, November 9, 2015, p. 15.
If at the beginning, the IMF systematically under-estimated the European economic collapse, after 2012-13 the errors went in the other direction: the extent of the potential GDP recovery was under-estimated, and consequently debt sustainability calculations looked bleaker than they might have been. The unanticipated continued low interest rate period augmented this effect.

**Was the focus on debt sustainability appropriate?**

The question of debt sustainability lay at the center of the expertise that the Fund had been accumulating since the 1980s. The problem was that in the European case this perception clashed with a very different set of assumptions: that there was not an overall debt problem, as the overall level of government debt in the Eurozone in relation to output was less than in the U.K., the U.S., or Japan. Even speaking of such an issue might set off a self-imposed panic. Better to extend and pretend.

Once some part of government debt was not repaid, there was an inevitable question of differences in treatment between creditors: debt maturities varied, and determining relative seniority was complex and fraught. Debt crises thus regularly set off tussles about repayment that can become the objects of political influence as well as of legal rights. The situation of large Eurozone debtors raised the issue of whether foreign public creditors (in effect tax payers and voters in other countries) should be treated differently to private creditors. A simple approach to the problem might suggest that the motivation of the lending should be taken into account: that private creditors had been driven by private gain, and that risk should have been a part of the calculation, while the public sector lending originated in a rescue mission to treat an already existing problem.

The fissure over the centrality of debt sustainability and the danger posed by a large debt overhang existed right at the beginning of the IMF’s involvement in the first Eurozone case, the Greek program. Senior figures in the Legal and SPR Departments were strongly convinced that the absence of an early restructuring would make subsequent policy harder, more expensive, and less effective. By contrast, the heads of the European and Fiscal Affairs Departments were strongly opposed, and utterly convinced by the confidence argument. Those who were opposed had an additional argument: that there was a chance that the program might work, and that it was politically expedient, in thinking of relations with the European policy-makers, to take that chance. In the Greek case, the influential Fund staff members who had warned that the May 2010 program contained an excessive risk were clearly vindicated. Government debt held by the private sector was cut in 2012, largely at the German insistence, but the delays brought by the political and institutional complexity from the point in May 2011 when the operation was first suggested by European creditors meant that the volume of debt restructured was substantially less than it would have been had the initiative been taken earlier. Banks fled from Greek debt, and the problem of hold-outs who would attempt to stymie the debt reduction operation increased as speculative hedge funds (vulture funds) moved in. Thus, even while the PSI was being finalized, attention turned to the possibility of OSI: indeed from the beginning of the Greece discussion, IMF staff believed that official debt might and indeed properly should be included in reprofiling and rescheduling. The official sector debt from a variety of EU sources looked too big, and the logic of debt reduction was now applied by the
Fund. The EU governments were recalcitrant because they thought in terms of the law, and the logic, of the Maastricht Treaty: no monetary financing, and no debt assumption. In the end, the pretense of not having a formal debt reduction could be maintained by rescheduling terms.

This left the IMF in a peculiar position. The “preferred creditor status” was as much built into common assumptions about the legal foundation of the IMF as the limits on debt mutualization were intrinsic to the Maastricht Treaty. In both cases, the prevailing assumptions were wrong: the Articles of Agreement of the IMF do not provide for a preferred creditor status. But that status was commonly assumed: for instance, on April 4 1989, the Interim Committee had stated that the Fund’s preferred creditor status had been reaffirmed by the Interim Committee meeting in Berlin (West), and “must permanently enjoy the full support of the entire membership.” At the beginning of the European engagement, the IMF staff contemplated whether European institutions should not formally recognize the PCS, but then refrained from pushing the issue. The no-bailout provisions of Maastricht seemed to be undermined as the essence of European crisis diplomacy after May 2010 lay in the working out behind the scenes instruments for debt mutualization, including the new vehicles, the EFSM and then the ESM, but also through the balance sheet of the ECB. The world was being stood on its head.

A former IMF official from the European Department, Susan Schadler, reflected on the problematical role of the preferred creditor status in the aftermath of the 2010 Greek engagement: “This option of waiving the criterion on debt sustainability while maintaining PCS raises several questions. By facilitating IMF financing of a pre-restructuring bailout of some private creditors, does PCS in fact have the opposite effect to the intended catalytic role of the IMF? By lowering the Fund’s stakes if a program fails to return a distressed country to sustainability, does PCS reduce the Fund’s accountability?”

In 2010 and 2011, the public debts of Ireland and Portugal also looked unsustainable as doubts about the costs of the Irish bank bailout and about Portuguese fiscal stability increased. Increased spreads reflected market concern about the risk. Fund documentation underlined that point, and Fund missions made corresponding suggestions to the national authorities. In Portugal, there was no enthusiasm for PSI; in Ireland, where there was, both the government and the public sphere looked at the IMF as a rescue agent in the face of the cruel tyranny of Brussels and Frankfurt. In Portugal domestic politics, and in Ireland the ECB largely blocked the Fund’s new approach. The liquidity exercise managed by the ECB after 2012 in fact brought borrowing costs down dramatically, so that debt levels that were previously unsustainable became tolerable. In fact, the shadow of restructuring faded in the glare of unconventional monetary policy. In earlier episodes, most notably Brazil in 2002, the IMF had taken a gamble that liquidity provision might set the economy on a better track.

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trajectory, and the gamble paid off: the Portuguese and Irish cases resemble that earlier episode, except that the Fund in the European instance would have preferred to avoid the gamble. 49

In Cyprus, where the full crisis came later, after the operationalization of the banking union plans that provided some European protection against contagion to other countries, the bail-in of creditors and bank depositors occurred without a major geographic widening of the debt crisis. Having effective firewalls was thus a precondition for any ability to conduct debt restructuring in the face of excessive debt burdens. But such instruments were not in place at the beginning of the crisis, raising the contagions risk of debt restructuring to the extent that it appeared impossible to European policy-makers and many in the IMF.

The question of the IMF engagement in Europe became a red rag that was vigorously shaken in U.S. political debates about the quota increase agreed at the G-20 in London and that was needed—in the eyes of much of the international community—to give an effective response not just to the aftermath of the Global Financial Crisis, but also to potential emerging market crises that might, for instance, be triggered by an exit of advanced industrial country central banking monetary policies from the accommodative stances taken during the crisis. The Fund and its processes became embroiled in a domestic U.S. political clash, but also in geopolitical controversies.

From 2009, Republicans in Congress had been suspicious of the process used by the Obama administration to increase the IMF’s resources. In June 2009 the initial measure to institute the New Arrangements to Borrow and increase the U.S. quota had been bundled into a bill that included military spending and preparations for an influenza pandemic. In November 2010, the Republicans captured control of the House, and a long stalemate ensued. On some occasions, Republicans suggested that they might agree to the finding increase if the Obama administration made concessions over taxes. In this fraught political stalemate, accusations that the IMF had exposed the U.S. taxpayer to European liabilities became a standard claim. Thus Desmond Lachman, a former IMF official at the American Enterprise Institute wrote in 2011: “the administration now appears to be acquiescing to substantially bolstering the IMF’s available resources with large-scale bilateral European loans. It is doing so for potential massive IMF lending to Italy and Spain that would dwarf anything that the IMF has previously done and that would put U.S. taxpayers seriously at risk.” 50

The criticism increased after the Wall Street Journal in October 2013 reported the details of the May 2010 Board meeting and the controversial discussion about the systemic exemption from the exceptional access framework.51 The distinguished Stanford economist and former Treasury official John Taylor told the House Financial Services Committee that: “For the IMF to achieve goals […] such as economic stability, it really has to have a clear and predictable framework or strategy for carrying out its goal. Otherwise, decisions become highly uncertain. They lead to excessive risk-


taking and international spillovers. I think a framework like that also provides for transparency and accountability. […] Unfortunately, this exceptional access framework is no longer in place. It was abandoned in 2010 when the Greek sovereign debt crisis emerged and the IMF staff could not establish that the Greek debt was sustainable with high probability. So the IMF simply changed the rule. […] As is well-known, events in Greece following the 2010 decision, have not been pleasant. And it is time in my view to reform and strengthen that exceptional access framework. A starting place with simply be to repeal the exemption for systemic risk. That exemption is the problem, not the solution. I have found support for this kind of reform in the international community, including at the IMF.”

The issue generated great animosities. By 2013 and 2014, some large emerging economies, including Russia, started to suggest that the IMF should be reformed so as to remove the effective veto of the United States. President Putin explained that it was “most important to revise the existing IMF quota and voting system, to enhance the role of developing countries, including our BRICS partners. It is true that negotiations on these tracks are not going smoothly.”

The issue could only be solved by a two-pronged approach. The IMF’s management embarked on a charm offensive towards the Republicans in Congress. But part of the background to that was geopolitical: after the Russian annexation of Crimea in February 2014 and Russian-backed groups started fighting in eastern Ukraine, there was a substantial Congressional push for support for Ukraine, including loan guarantees but also IMF funding.

At the same time, a series of staff papers laid out a plan for a new reform that would remove the Special Exemption. The intellectual work on these papers might be thought of as a learning process: a recognition by the Fund of a more generalized problem of delayed or inadequate treatment of unsustainable debt situations in IMF programs (the “too little, too late” phenomenon). They provided a detailed analytical and empirical analysis of what drives market contagion in debt crises, and how best it might be managed. Amendments to the exceptional access policy that would eliminate the systemic exemption would also have to provide for more graduated debt treatments, depending on the severity of the country’s debt problem and market access conditions. The fundamental idea was to “eliminate the systemic exemption in light of both the flexibility being introduced in the framework and concerns that the exemption compromises the distressed member’s prospects for returning to external viability and hence does not actually achieve its objective of mitigating international systemic spillovers. The exemption also aggravates moral hazard.”

The new approach emphasized the continuity in the Fund’s handling of high debt levels,

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54 RIA Novosti News Agency June 14, 2013.


and sought to avoid any automatic requirement of a restructuring. At the conclusion, the 2015 paper stated: “Completion of a debt operation has not always been a pre-requisite for the Fund to begin disbursing. For example, under appropriate circumstances, flexibility was exercised in pre-default cases when there were urgent financing needs that could not be postponed until the completion of the reprofiling. In such cases, conditionality has been set on intermediate steps towards the completion of the debt operation.”

These papers, when debated on the Executive Board, were initially controversial, in that many voices – including the U.S. representatives, emphasized the need for flexibility in responding to future crises. There were substantial voices in the U.S. Treasury that still held to the Geithner doctrine (see above) that providing a mechanism for haircuts risked financial stability. In overcoming that objection the Republican position in Congress proved useful to the IMF reformers. Once it was clear that the reform would pass, Taylor started to persuade Republicans in Congress that they should support an institution that was returning to a rules-based approach. In this way, Congress accepted the quota increases in December 2015, and the special exemption was ended in January 2016.

The reform was possible because a substantial series of regional firewalls had been created. The 2015 IMF staff paper noted that “the establishment of the European Stability Mechanism (ESM), together with the demonstrated commitment of the European Central Bank (ECB) to provide large-scale liquidity support when needed, have created credible firewalls to help member states preserve financial stability and manage spillovers in times of severe stress.” But it drew also a more general conclusion about regionalism. The development of other regional financial arrangements and networks of bilateral swap lines – notably in Asia and Latin America, and most recently by Brazil, Russia, India, China and South Africa (BRICS) – had likewise intensified since the crisis.

**Was the Fund too technocratic?**

The Global Financial Crisis prompted a growth of populism in many rich industrial countries, fueled by distrust of “experts” and “globalists.” New political figures emerged claiming to speak to the immediate concerns of the people. According to them, the interests of a global elite were at odds with a people who were less mobile. The IMF became a major target of attacks in the two European countries where populism took over the government, with right-wing populists in Hungary, and left-wing populists in a coalition with right-wing populists in Greece. Both countries had been involved in substantial IMF programs that had to deal with the legacy of irresponsible politics before the populist government. A platform of populists across the continent involved a demand for economic measures that would produce an immediate benefit, and populists generally defined themselves as being in opposition to “austerity.” They also pushed back against the IMF’s approach to economic data as a guide to policy formulation, taking highly politicized judicial measures against national officials who might follow that approach.

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57 April 9, 2015 paper, paragraph 54.
The IMF saw itself as offering advice on the basis of empirically testable economic theories. There was a great deal of historical evidence on the damage done by populism in its Latin American variant, which had roots going back at least to the 1930s, but which had been additionally fired up by the international response to the 1980s debt crisis. An influential survey of the Latin American experience defined economic populism as an “approach to economics that emphasizes growth and income redistribution and deemphasizes the risks of inflation and deficit finance, external constraints, and the reaction of economic agents to aggressive nonmarket policies.” The government of populists produced an economic collapse, which eventually delegitimated the movement: “Pervasive shortages, extreme acceleration of inflation, and an obvious foreign exchange gap lead to capital flight and demonetization of the economy. The budget deficit deteriorates violently because of a steep decline in tax collection and increasing subsidy costs.”

The IMF on occasion used the term populism to describe government approaches that it did not like before the term became a central part of European political discourse.

Economic expertise insistently suggested the importance of time-consistent policies so as to avoid the cycle of populism and heterodox economics followed by economic collapse and often a lurch to the authoritarian right. There was a great deal of confidence that the underlying economic model was correct. Even critics of austerity signed up to that point. Paul Krugman wrote about the “MIT gang” that included Ben Bernanke, Mario Draghi, Stanley Fischer, and Olivier Blanchard, and which had a better policy understanding: “the economic analysis some of us learned at M.I.T. way back when has worked very, very well for the past seven years.”

In addition, there was a particular problem in both the EU and the Eurozone. The incomplete institutional framework, the lack of a fiscal authority and at the beginning the absence of a banking union, and the absence of a discussion of how such institutions (when they might be created) might be accountable, means that technocracy looked like the only European solution. A prominent EU Commission official note as a retrospective lesson that: “EU-level decisions should be insulated as much as possible from domestic political economy considerations.” Such a process of distancing involved transferring the responsibility for decisions to “technocrats” in Europe, but also to global technocrats.

One of the persistent themes of commentary during the financial crisis was in consequence that the technocrats in international finance—in central banks but also in the IMF—were providing the only effective response, when politicians had failed to deliver on fiscal issues. Monetary policy rather than fiscal policy became the central crisis-fighting tool. “Many central bankers are proving to be the adults in the room as global markets zig and zag, and politicians fiddle,” was an early comment.

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from 2007 in the British Sunday Independent. In 2013, Market News International recorded that: “Market players held fast to the notion that G-3 central banks were the only "grown-ups in the room," with governments, both in the U.S. and in Europe, less successful in taking action that would benefit their economies.” At the end of 2013, the Financial Times’s Gillian Tett called Federal Reserve Chairman Ben Bernanke the “grown-up in the room.” In a review of Bernanke’s crisis memoirs, Zachary Karabell wrote that “Bernanke and the Fed were the grown-ups in the room during a period of crises unprecedented since the Great Depression.” Sometimes, IMF representatives slipped into the attractions of juxtaposing irrational politics with rational economics. At a press briefing in the middle of the contentious negotiations with Greece in June 2015, and perhaps responding to Alexis Tsipras’s claim that the IMF had “criminal responsibility,” Lagarde explained that: “For the moment we are short of a dialogue, the key emergency is to restore the dialogue with adults in the room.”

The problem with the view that experts had the right solutions was that they also were often unclear about how their solutions should be translated into political practice. Jean-Claude Juncker stated that “Politicians are vote maximisers… for the politician, the Euro can render vote-maximising more difficult, as a smooth and frictionless participation in the monetary union sometimes entails that difficult decisions have to be undertaken or that unpopular reforms have to be initiated.” Even more memorably: “We all know what to do, we just don’t know how to get re-elected after we’ve done it.” There was never any effective advice on how to deal with the arguments of the populists.

The art of cutting a particular deal, relaxing fiscal constraints at one moment because an otherwise reasonable government looked as if it was in political difficulties, looked too much like the bad old European ways that had largely drawn Europe into the crisis. It would also look as if the Fund was taking sides, and was not applying a principle of equal treatment to member countries. The IMF was thus profoundly skeptical of what it simply interpreted as back-sliding. Sometimes critics suggested that the IMF should employ more political scientists as an addition to its economics expertise, but it is actually hard to see what particular wisdom might have been brought from a different academic tradition.

However, policies that were deemed to be populist appeared to bring results that ranged from reasonable recovery in Portugal to quite strong growth in Romania or Hungary. The link between structural reform and growth capacity was weakened because of the international anti-crisis policies that kept interest rates low, and prompted a search for higher yield and higher risk. The

61 Philippa Brown, Central Bankers Prove to be in Their Prime as Markets Zigzag and Politicians Fiddle, Sunday Independent, August 12, 2007.
64 https://www.politico.com/magazine/story/2015/10/ben-bernanke-the-grown-up-in-the-room-213249
international risk factors increased as the brutality of international crisis receded, and the costs of populism appeared to be lowered. In this environment, there was less room for “technocratic” solutions.

**Can the IMF learn?**

After 2008 there was inevitably a great deal of rethinking of conventional economic wisdom. The debate about the revision of the 2010 special exemption to the exceptional access conditions is only one instance of a generalized learning process. Olivier Blanchard noted how “the economic crisis has put into question many of our beliefs.”

A great deal of the literature on the IMF stresses the extent to which its views changed—and how Fund officials began to present criticisms of “neo-liberalism.” According to the political scientist Cornel Ban, a “defining moment” of the Fund’s intellectual evolution was the publication on December 29, 2008 of a joint RED—FAD staff position paper (Spilimbergo, Symansky, Blanchard, and Cottarelli 2008). The paper laid down the groundwork for macroeconomic policy during recessions: “[a] timely, large, lasting, diversified, and sustainable fiscal stimulus that is coordinated across countries with a commitment to do more if the crisis deepens.”

The paper set out the view that also was often repeatedly subsequently, and was well supported by academic research in and outside the Fund: spending increases, and targeted tax cuts and transfers, would be likely to have the highest multipliers, while general tax cuts or subsidies, either for consumers or for firms, are likely to have lower multipliers.

Even before that paper, at a very early stage in the financial crisis, in January 2008, Managing Director Dominique Strauss-Kahn announced at Davos that “I don’t think we would get rid of the crisis with just monetary tools: a new fiscal policy is probably today an accurate way to answer the crisis,” and Larry Summers responded that, “This is the first time in 25 years that the IMF managing director has called for an increase in fiscal deficits and I regard this as a recognition of the gravity of the situation that we face.” Strauss-Kahn consciously saw himself as breaking with old IMF traditions. At the inaugural conference of the Institute for New Economic Thinking (INET) in Keynes’s old Cambridge college, King’s, in April 2010, he talked about the way that policy-makers found it hard to import new analysis. The IMF was “thinking out of the box.” In a response to student demonstrators who accused the IMF of “killing millions around the world,” he replied that “That’s the old IMF you’re talking about. You should read the press.”

In 2012, the Oxford Keynesian economist Simon Wren-Lewis concluded: “Right now, the IMF appears to some to be on

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69 [https://www.ft.com/content/0407c8da-097d-11e2-a5a9-00144feabdc0](https://www.ft.com/content/0407c8da-097d-11e2-a5a9-00144feabdc0); [https://www.ft.com/content/8a3d8122-d5da-11dd-a9cc-000077b07658](https://www.ft.com/content/8a3d8122-d5da-11dd-a9cc-000077b07658).

70 [https://www.youtube.com/watch?v=qVIODU4nQZA&t=0s&index=5&list=PLF7E274BC4F2B247D](https://www.youtube.com/watch?v=qVIODU4nQZA&t=0s&index=5&list=PLF7E274BC4F2B247D)
the side of the angels. Their self-criticism about the impact of austerity is both unusual and commendable in equal measure.”

There was then a quite persistent pressure for no austerity. In the aftermath of the April 2009 London G-20 summit, the IMF fully supported the idea of a general coordinated fiscal stimulus. There may have been a little hesitation in 2010, as political conditions turned round in the two countries, the U.S. and the U.K., that had been the major advocates of fiscal Keynesianism, but also as nervousness about government bond markets became generalized. A debate now started about expansionary fiscal contractions, the idea that fiscal stabilization reduced government debt and hence the need for future taxation, and that private sector actors would respond by investment that would bring higher rewards in the absence of higher taxes. The idea had been developed in the early 1990s, primarily around the examples of some small European countries, and then on a wider sample base, where in particular fiscal consolidations implemented through reductions in government expenditure rather than by tax increases sometimes led to rapid output growth. Now IMF work pushed back against that interpretation: research first presented in the October 2010 WEO and then as a separate paper argued that the methodology of identifying fiscal contractions was flawed in the older literature, and led to a misidentification that missed episodes of fiscal contraction followed by recessionary shocks. By distinguishing actions aimed at fiscal retrenchment from outcomes, the IMF reached a much bleaker view of the likelihood of a successfully expansionary fiscal contraction.

By 2012, it was clear that the IMF was intellectually on the side of those who thought that greater fiscal activism could take some of the strain off monetary policy in accommodating the response to the Global Financial Crisis. A box in the October 2012 WEO caused a great deal of debate, and of rethinking within the IMF and elsewhere. The box, with the title “Are We Underestimating Short-Term Fiscal Multipliers?” became the basis of an article by Olivier Blanchard and Daniel Leigh in the American Economic Review in 2013. The box and the paper used data from Europe in 2010 to explore the correlation between growth forecasts and forecasts of fiscal consolidation to show that the assumption of a fiscal multiplier of 0.5 was mistaken, and that in reality the multiplier should have been calculated at around 1.0 (the WEO box suggested in the 0.9 to 1.7 range). Under rational

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expectations, fiscal consolidation forecasts should be unrelated to subsequent growth forecast errors. If, on the other hand, forecasters underestimated fiscal multipliers, there should be a negative relation between fiscal consolidation forecasts and subsequent growth forecast errors. The paper noted, however, that for 2011 and 2012 the negative correlation was less.

The data showed particular severe forecast errors in countries that had undertaken a great deal of fiscal contraction: Greece was a dramatic outlier, but the effect was also visible for Ireland, Romania, and Great Britain.

Subsequent research using this methodology on later data for the period 2011–15 however showed no statistically significant coefficient in the panel analysis. That result also echoed OECD research which showed that the convincing important explanation for the forecast errors picked up in the October 2012 WEO was the assumption of the 2010 that the Eurozone Crisis would dissipate and sovereign bond yields would narrow. Some critics in the IMF had made a similar point: that what the Blanchard/Leigh result reflected was the presence of a massive confidence shock, rather than an inherent property of the economic response to fiscal stimulus. In practice, many operational economists thinking about specific European crisis countries continued to see the argument that high risk altered the calculation.

Source: WEO October 2012, p. 43.

![Chart 11: Fiscal Consolidation Plans and Growth Forecast Errors](chart.png)

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The preference for fiscal measures against the crisis remained a large part of the Fund’s intellectual armor. An article by the Deputy Director of the Research Division Jonathan Ostry started with a concession that “there is much to cheer in the neoliberal agenda” (particularly in regard to trade expansion). But the good news did not extend to two central planks in neoliberalism: “removing restrictions on the movement of capital across a country’s borders (so-called capital account liberalization); and fiscal consolidation, sometimes called “austerity,” which is shorthand for policies to reduce fiscal deficits and debt levels.” “Austerity policies not only generate substantial welfare costs due to supply-side channels, they also hurt demand—and thus worsen employment and unemployment.” The article explicitly attacked the notion of expansionary fiscal contraction—the idea that in some cases a shrinking of the state would boost private sector development. And it named as the culprits the academic Alberto Alesina and the policy-maker Jean-Claude Trichet.

78 The Financial Times commented on the piece, and interviewed Ostry. He noted that his article did not reflect “mainstream culture” at the IMF and would not have made it into a Fund publication as recently as five years ago. “But cultures are slow moving things.”

Christine Lagarde congratulated Ostry and his co-authors. She gave a lavish endorsement to a book entitled “The Failure of Globalism” by Ian Bremmer, which argued that globalization was principally to blame for the turmoils of the world.

In 2012-13 a fundamental intellectual reorientation occurred with regard to the appropriate fiscal stance, not just at the Fund though certainly part of the push to reshape the consensus came from the Fund. There are other explanations. Some of the academic research associated with austerity recommendations may have been discredited by the high profile attack on Carmen Reinhart and Ken Rogoff’s suggestion that there was an ascertainable limit at which the risks to debt sustainability increased. Political pragmatism might be another explanation. At the beginning of 2012, Barry Eichengreen pointed out: “Tax increases and cuts in public spending are still needed; there is no avoiding this reality. But these demand-reducing measures also reduce economic growth, causing deficit-reduction targets to be missed. Getting fiscal consolidation back on track then requires more spending cuts, which depress growth still further, causing budget performance to worsen even more. At some point, recession and unemployment will provoke a political reaction. Angry electorates will boot out austerity-minded governments. A final explanation, perhaps the most powerful one was that the general turn of central banks to unconventional monetary policy aimed at driving down interest rates changed the arithmetic of debt sustainability calculations.


Apart from the stance on fiscal responses to demand shocks, the most obvious turning point, or attack on “neo-liberalism,” concerned the Fund’s position on capital controls. The new document of 2012 defining the new “institutional view” concluded that “Rapid capital inflow surges or disruptive outflows can create policy challenges. Appropriate policy responses comprise a range of measures, and involve both countries that are recipients of capital flows and those from which flows originate. For countries that have to manage the macroeconomic and financial stability risks associated with inflow surges or disruptive outflows, a key role needs to be played by macroeconomic policies, including monetary, fiscal, and exchange rate management, as well as by sound financial supervision and regulation and strong institutions. In certain circumstances, capital flow management measures can be useful. They should not, however, substitute for warranted macroeconomic adjustment.”

Capital controls played a part in temporary European response to the Eurozone crises, in particular in Cyprus in 2013 and Greece in 2015, but their longer-term use ran counter to the underlying idea of the European Union, whose four freedoms included capital mobility (the other “freedoms” concerned goods, services, and labor). Capital flows, and the problems they brought, would thus necessarily remain part of the European model, and the harmful effects could only be counteracted by increased depth of financial and capital markets integration: what became known as the banking union and the capital union.

The change in opinion in central parts of the IMF attracted bemused commentary. Dani Rodrik asked “What the hell is going on?”; but also pointed out that there was a gap between the Research Department and the operational divisions of the Fund. Other critical commentators went further and used terms like “organized hypocrisy”, “escalating hypocrisy” and “institutional schizophrenia” and “strategic ambiguity”. Stephen Nelson concluded that: “The top decision makers of the Fund have not dislodged the institutionally embedded, neoliberal-oriented mode of understanding the proper solutions to the adjustment problems of countries and replaced it with something else.” Some analysts saw the outcome as the reflection of a complex bureaucratic institution, which had its own momentum, and steamed on with those ideas that prevailed when technical staff were recruited; the efforts of a new intellectual leadership to change the course were thus necessarily frustrated. “Research by the institution’s staff and public statements by key officials remained largely orthogonal to the institution’s practice with client states.” This outcome resulted from a “silo-like” bureaucratic structure. But Ilene Grabel nevertheless concludes that “Though it is certainly not the IMF’s intent to do so, the new rhetoric is empowering external actors to fold the institution accountable to IMF-sanctioned normative criteria and concerns that had been largely

missing from the IMF platform.” 88 The problem remained that equality of treatment made the more flexible approach underlying the new intellectual consensus difficult to apply in the concrete situations of program design. There is a weight of established practice that makes adjustment of the fundamental process intrinsically difficult.

**Was the IMF too American?**

The intellectual orientation of the IMF reflected the concerns of U.S. economists, who were skeptical about the Eurozone as an unstable construction that lacked resilience because of the absence of a fiscal union. The Nobel prize winner Thomas Sargent devoted his acceptance speech in December 2011 to the theme, “United States Then, Europe Now,” an exposition of how Alexander Hamilton had made the mutualization of state debt from the revolutionary war into the “strong cement of our union.” President Obama presented European policy-makers with copies of Ron Chernow’s fluent biography of Hamilton.

But did the IMF also reflect the policy preferences of the U.S. government as well as of U.S. academia? The accusation that the IMF had been coordinating its response to the Asia crisis with U.S. government and commercial interests was one of the gravest criticisms of the Fund’s response to the Asia crisis, and was made by influential economists such as the Nobel prize winner Joseph Stiglitz. In the sense that an overwhelming policy priority at least before 2012 was to avoid the GFC becoming another Great Depression, and that Europe looked the most likely source of a potentially contagious crisis, the interests of the United States were aligned with a global public good. U.S. policy makers referred to Europe as the next Lehman just as much as European policy-makers did. Especially in the crisis summer of 2012, the U.S. government wanted Europe to do more to build resilience against crisis. At the same time, tensions between the administration and Congress held up the extension of IMF facilities through the new quota revision suggested in 2009 until 2015.

The swing of opinion that characterized the Fund also took place elsewhere in Washington. In the intense phase, between September 2008 and the April 2009 G-20 meeting, the U.S. was looking to build a more robust international financial architecture, increasing the size of the Fund, but also coordinating a marge fiscal stimulus. Then a concern about destabilization coming from weak fiscal regimes emerged. In the spring of 2010, it was President Obama who placed a telephone call to the Spanish Prime Minister, urging a fiscal consolidation. In 2012, and after, the U.S., like the Fund, pressed the surplus countries to do more expansion in order to correct the current account surpluses that were one of the causes of the European malaise.

One of the consequences of any severe international financial crisis is the rise of zero-sum thinking. That had been a damaging response to the Great Depression. The Euro crisis was often read both within and outside Europe as a battle of interests, with creditors or North Europeans arrayed against debtors and South Europeans. Pressure on the creditors was welcome in the debtor countries, and different governments in Greece and Ireland consistently hoped that the U.S. would be an ally.

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Sometimes American policy-makers sounded as if they thought German policy-makers were stupid—ignorant of Keynes—and sometimes they accused them of a narrow self-interest. They would ridicule Angela Merkel for her reference to the prudent saving of a Swabian housewife. They would complain about a German obsession with export surpluses. Tensions which escalated immeasurably after the election of Donald Trump as President already existed, not always below the surface. But bringing an outside perspective into European debates was exactly the sort of work that the Fund, in its capacity as a purveyor of advice, was obliged to perform.

Who runs the IMF?

The question of learning directly raises the issue of how the IMF actually makes policy. There are many voices, some closely involved with the Fund, who claim that the complicated mechanism of oversight of staff and management through a board politically appointed by the shareholders (member countries) is too indirect to be effective. Peter Costello, Australia’s longest serving finance minister, for instance, recalled: “One of the things you learn when you spend time at the IMF (I was a part-time governor for nearly 12 years) is that it is largely isolated from public accountability. While it notionally accounts to governments and ministers, in practice they are a long way away and distracted by domestic issues, leaving the organisation largely to itself.”\(^{89}\) The criticism has become a staple of the academic literature, which adds a series of principal-agent problems. The agents have an incentive to maximize their own utility—conclude programs that bring income and perhaps even more importantly prestige. These incentives are hard to coordinate with a general utility of a global community that needs a crisis-fighting and crisis-prevention mechanism, but wants to limit the operational hazards of such engagement.

The IMF staff certainly became more assertive and easily identifiable. In Greece, the IMF was Poul Thomsen, in Ireland Ashoka Mody and Ajai Chopra. The personification of the Fund through its agents raised problems. In Ireland excessive public sympathy for the public position of the IMF mission led to a worsening of the relations with the other troika institutions. In Greece, by contrast, Poul Thomsen appeared increasingly as a universal villain. Greek policy-makers looking back today often start their reminiscences with a reflection on the “cold blue eyes” of the Danish economist. A newspaper profile from the left wing \textit{To Vima} described him as “a diplomat in a spy movie”, but “as a shark when it comes to negotiations. It added disingenuously: “When he relaxes he is charming with women and has created a myth regarding his meetings in the restaurant of Hilton hotel in Athens which led to some articles being published on Greek tabloids regarding his alleged involvement with an Athenian socialite.”\(^{90}\) The IMF’s resident representative in Athens, the rather genial Dutch economist Bob Traa, was occasionally portrayed as a proconsul and a vindictive Calvinist.\(^{91}\)

Many analyses presented a gap between the thinking of the IMF management and the implementation by staff. Outside analysis by political scientists echoed this theme. The view of Ilene Grabel and others that hardened mid-level bureaucrats stymie the bold visions of the lofty academics in the Research Department, and the practical theologians at the top of Strategy and Policy Review, and the enlightened vision of two French Managing Directors, may be superficial. When SPR was aligned with the European Department, it had no problem it convincing the Fund’s management of its approach; the problems arose when the Fund was internally divided. The missions are indeed bureaucratically controlled, but they also come into reality in the shape of interactions with politicians, journalists, critics etc. Many of them had been in their client countries long enough to see the complexities of daily life—obvious corruption or tax avoidance, when doctors and dentists charge lower fees if paid in cash without a receipt.

The two Managing Directors in the crisis period had very different personalities, but both were highly effective players of a high political game. At the same time, both in different ways inevitably increased the perception of a European bias in the Fund. Dominique Strauss-Kahn, a former French Finance Minister, had increasingly obvious ambitions to run as the candidate of the left in the French presidential election of 2012. The socialist party was due to make its choice in the summer of 2011, and Strauss-Kahn was burnishing a reputation as the rescuer of Europe. Christine Lagarde had also been French Minister of Finance, but more recently—in the early stages of the Euro crisis. To some extent she was handicapped by the firm anti-debt reduction stance taken by Sarkozy and Trichet in 2010 and 2011, that corresponded to a French intellectual proclivity for the sanctity of sovereign debt that went back to debates during the French Revolution. Strauss-Kahn was an intellectually and personally charming visionary, who thought that he was effectively remaking the Fund and bringing a new type of Keynesian, fiscal-centered advice. He surrounded himself with, and depended on, a small group of like-minded thinkers. Lagarde brought a new level of suave sophistication, and was less inclined to define a new economic doctrine. But she very quickly grasped the financial sector problem at the heart of the European difficulty.

Both Managing Directors knew how to work with the U.S administration; and both apparently found the multiplicity of actors in the European discussions confusing and counter-productive, but were both also aware that they had unique qualifications for dealing with that institutional complexity. In 2018 Lagarde explained to a Financial Times interviewer: “No, no, no no, no no . . . I am not interested in any of the European—ECB, commission, da da da da da—jobs, no.”^92^ The German news magazine Spiegel wrote that “only her fellow Frenchman, Strauss-Kahn, equaled her charisma in running this agency.”^93^ In July 2019, she was nominated to succeed Mario Draghi as ECB President, in large part because she understood uniquely how Europe’s politics and economics could fit together. She told the New York Times’s Maureen Dowd that leadership skills mattered

^92^ James Politi, Sam Fleming and Alex Barker, Christine Lagarde Rules Herself out of Race for top jobs in EU, Financial Times, September 12, 2018, https://www.ft.com/content/1252e064-b606-11e8-bbc3-ccd7de085ffe

more than “super-duper training and degrees in economics.” She explained a new operating principle at the IMF: “with an institution with so many different people with different backgrounds, there’s a need for respect and tolerance. I know what it’s like to walk into a room where you are just by yourself, and everybody else is wearing dark suits, and you feel for a few seconds slightly intimidated and not always welcome.” Under Lagarde, the clique character of the top Fund leadership was dismantled, but that may have made for greater incoherence (or the perpetuation of the silos). It effectively furthered the emancipation of the Fund staff from political control, i.e. the influence of the Board.

The Board inserted itself into the debate particularly at one critical moment, in May 2010. The voices of critics raised the debt sustainability issue from the obscurity in which it had been left by the staff (on page ?? of the report). The turbulent Board discussion could not alter the fundamental fact that this was a moment of extraordinary threat to a fragile world economy, that called for actions outside the conventional legal and intellectual framework. The details of the May 2010 clash were leaked to the press in October 2013, and the subsequent discussion played a prominent part in driving the reform of exceptional access criteria and the ending of the special exemption.

**Lessons from Europe**

After May 2010, the Fund was caught in a credibility trap. Europe after 2010 represented the single largest source of systemic vulnerability in the world, and consequently the largest threat to a global recovery from the financial crisis. The IMF needed the European programs to work, in order not only to demonstrate its successful management of operations, but also to deal with the criticism (already quite prominent in the May 9, 2010, board discussion) that the Fund was being high jacked by European governments. The very large-scale programs were unprecedented measured as a share of quota. The consequence was that the Fund could really not easily walk away, without facing the charge of betraying the Europeans and itself. It was imprisoned as a result of its initial engagement. There was in consequence a proclivity to look for success stories in a context in which politics were complex and dysfunctional. That situation set the scene for a particularly dangerous game of chicken. Intellectually, in public discussion and in the formulation of new approaches to fiscal issues and to capital flows, the IMF went far in rethinking economic strategy in the face of an unprecedented challenge. However, operationally at the same time it needed to maintain the appearance of even-handedness and normalcy in its approach to the very diverse membership. The two pressures, on the one hand to rethink, on the other to apply generally consistent principles, were in constant tension, especially since the IMF’s resources were limited, and it had to rely on resources that came from elsewhere, from newly created EU institutions such as the ESM, or from the ECB. In consequence, the Fund was trapped in a conceptual pincer. There was an unsatisfactory division of labor between the ECB and the IMF, each of which might be seen as a LLR, but with one lacking the appropriate governance structure and the other lacking the financial resources to play the essential

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role of stabilizer in a great financial crisis. The ESM was gradually revised so as to constitute a sort of European mirror to the IMF, with a more appropriate governance structure.

In the aftermath of the experience of the Euro debt crisis, the IMF could learn two lessons. The first was that it needed to rethink the overall framework of its interactions with currency or monetary unions. The August 2017 Staff Report on Program Design in Currency Unions dealt not just with Europe but with four regional monetary unions: the Central African Economic and Monetary Community, the Eastern Caribbean Currency Union, the European Monetary Union, and the West African Economic and Monetary Union. EMU was very obviously an outlier in this group, as a monetary union with a floating currency and no peg arrangements. But the document consistently framed its reference by the need for even-handedness. The paper began by noting the necessary legal basis for the Fund’s interventions: “Under the Articles of Agreement, the Fund’s general resources may only be used to resolve a member’s balance-of-payments problem.” For the European case, there was indeed a balance of payments problem (deficits that could not be financed by the market), but they looked different to “normal” Fund cases because those imbalances might conceivably be financed by central bank credit: the deeper problem looked as if it was connected to a fiscal issue, since it was governments that could not finance themselves. The critical step for the future was to investigate new ways of integrating the supranational regional institutions in future policy formulation.95

The 2017 Staff Report set out ways of binding union-level institutions—either through formal conditionality requirements or through assurances—in order to ensure the success of programs and the correct mix of domestic or national and union-wide policy engagement. Program documentation would make this balance between levels of policy transparent: “Staff is expected to discuss clearly in the staff report why resolution of the member’s balance of payments problems cannot be achieved solely with domestic policies and which union-level measures are critical to program success.” The approach was clearly of particular importance since the ECB had moved into financial sector regulation with the Single Supervisory Mechanism and the Single Resolution Mechanism. The recommendations were taken up in recommendations on regional financing arrangements.

The second lesson related to the particular institutional origins of the crisis in the different European countries. Government and governance had malfunctioned in some European cases. Corruption had rarely been addressed as a specific issue at the outset of the programs, but its shadow fell over much of the question of both program design and implementation. By 2019, corruption had become the major focus of the IMF’s Fiscal Monitor. That report documented how “A complex and opaque tax system enables corruption by requiring more discretion in its administration and by facilitating hidden corrupt dealings.”96 Even that document, however, which gave a powerful statement of how corruption undermined government effectiveness, found it hard to give specifics about particular cases of inadequate reform (it gave case studies of successful anti-corruption initiatives from

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Georgia, Rwanda, and Estonia). In this instance, however, as in much of any reform discussion, the devil is in the details.

The Euro crisis was a profound shock to European self-understanding. Europe could not work out its own rescue mechanism, and the European leaders brought in the IMF less as a source of financial resources than as a provider of professionalism and an outside vision of how to accomplish economic reform. Jean Tirole (2002) some time ago described the IMF and other international institutions as “delegated monitors”. But the monitors were often used as part of a mechanism of blame transference, and their political capital began to erode. And then, perhaps unsurprisingly, Europeans became frustrated with the outcome.

The course of the crisis destroyed a good deal of the participants’ credibility. But a learning process set in. The most positive part of the experience was the demonstration that Europe needed a better governance structure, and that a more elaborate financial architecture, including single banking supervision, a resolution mechanism, and a rescue fund organized along IMF lines: the ESM began to evolve into a European Monetary Fund. So, on the institutional side, there was a significant learning process. But there had been a substantial political damage.

The Euro is divisive because it looks like a straitjacket. And the problem with the imposition of external constraints is that it establishes a psychological mechanism of blame transference. When the policy that results from those external constraints does not produce growth, then the Euro is reinterpreted as a trap. What was once a dream has become a nightmare of entrapment. When wage growth occurred despite the external constraint, and growth faltered, there was no way out. The Euro thus is responsible for trapping southern Europe into a low competitiveness scenario. France is suffering from the story that the French elite told when they wanted to join the single currency, namely that a strong franc, which was nicely labeled as the “franc fort” which evoked obviously Germany’s financial center.

The financial crisis produced in many (but not all) European countries a greater suspicion of other countries. Sometimes Germany is portrayed as the major beneficiary of the Euro—especially in southern Europe. But Germans do not see the trade gains—especially when southern Europe is buying less German exports, fewer automobiles and machine tools as consumption and investment have both collapsed. They see instead the financial claims building up in the payments system, the TARGET2 balances that result from the counterpart to money transfers to the southern banking system.

In Germany and many northern and eastern European countries, journalists, politicians and voters blamed southern European profligacy; in Greece and Italy, but also in Ireland, many turned against what they saw as a new bid for German hegemony, imposed through a cruel fiscal diktat designed to undermine and destroy Germany’s rivals. In the French presidential campaign of 2017, both the radical right candidate, Marine Le Pen, and the radical left candidate Jean-Luc Melenchon, ran on a heavily anti-German program. Le Pen explained that Chancellor Merkel was bringing refugees into Europe to work as slave labor for the German economy. Jean-Luc Melenchon, the far left candidate in the 2017 French presidential election, who won 19.6 percent of the votes in the first round (Le Pen
had 21.3), had written a book entitled, *The Bismarck Herring, or The German Poison*, in which he argued that the way Germany was treating Greece was just an anticipation of the way Angela Merkel would deal with France.

There was a clear polarization and a rejection of conventional politics that followed from the Global Financial Crisis, and affected almost every European country (only in Switzerland, outside the EU, did the voting share of the populist right wing party SVP fall – slightly – between 2007 and 2011, but then it increased again in 2015). The pattern actually seems less dramatic in many of the crisis countries than in the non-crisis countries, where a powerful driver of populism on the right was complaint about the fiscal costs of the Euro rescue. In Greece, Syriza increased its vote form 4.6 percent in 2009 to 26.9 percent in the second 2012 election and 36.3 in the January 2015, when it swept into power. But over the next six months it morphed away from populism and towards becoming a standard center-left party (a successor to the discredited PASOK). The populist right wing party ANEL declined dramatically from 2012 to 2015, while the much more radical neo-fascist Golden Dawn was stable. In Ireland, the populist left wing party Sinn Fein, the heir to the most dramatic version of Irish nationalism, increased its vote, but came nowhere near a share large enough to push it into government (2007: 6.9 percent; 2011 9.9 percent; 2016 13.8 percent) until it achieved the largest share of the vote, with 24.5 percent in the 2020 election. Podemos (left wing populist) in Spain emerged suddenly in the 2014 European elections, and gained 20.7 percent of the vote in the 2015 Spanish parliamentary election. The most devastating outcome of the populist momentum occurred outside the Euro area, when the U.K. voted from “Brexit” in June 2016. There is a substantial irony in the way that frustration about the Eurozone drove for a harder populism outside than within the Eurozone: and in those cases, in the U.K. and in Hungary and Poland, the disruption to civil society and to the rule of law was substantial (and much more significant than any purely economic disruption).

A much more powerful driver of northern European populism — apparent also in the success of the right wing Lega in Italy — is concern about immigration, especially Islamic immigration, which flared up after the refugee crisis. Some German commentators — including rather oddly Finance Minister Wolfgang Schäuble — claimed that a significant part (Schäuble said half, but offered no evidence to underpin the statistic) of the vote for the radical right AfD was a protest of German savers against the low interest rate regime of the ECB.

The classical cycle diagnosed above all by Dornbusch and Edwards (1990 and 1991) for the phenomenon of populism in Latin America in the late twentieth century does not apply to most of the European cases of populism. The Latin American pattern saw a new heterodox program formulated as a rejection of a previous stabilization, often involving the IMF. That produces some short-lived successes, but then inflation rises, scarcities appear, protectionist and wage and price control measures are required. In a further phase, inflation rises dramatically, real wages collapse, there is large-scale capital flight and the economic collapses. Then a new IMF led stabilization plan is needed.

One of the striking features of the European debt crisis is that populist parties in power did indeed erode and evade previous fiscal limits, but the policies were successful for longer than just the short
time frame of the Dornbusch-Edwards cycle. There is no sense in which markets are punishing right wing populists in central Europe (Hungary and Poland); and Portugal, with a left wing populist government and a substantial recovery, is often (and in an exaggerated fashion) hailed as a miracle case.

The increased longevity of fiscal populism is a reflection of the consequences of a low interest rate regime throughout the world: monetary conditions are closely correlated, and U.S. policy has a considerable influence. Cheap borrowing makes greater fiscal deficits into an effective free lunch. There is clearly a threat of renewed instability when and if monetary conditions turn.

More generally, a great deal of political capital was invested in the Euro rescue, as leaders insisted over and over again that rescuing the Euro was vital for the survival of the European Union. As a financial maneuver, the strategy worked. Market bets that the area would collapse were effectively countered. But over time the political capital was substantially eroded. Ten years after the outbreak of the European debt crisis, the European Union looks more vulnerable.