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Did euro leaders say goodbye to the IMF?

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The Eurozone agreement in Brussels in late June has been hailed as a critical step by the group's embattled leaders to solve the crisis. Even if there are uncertainties about the details of the agreement – some would say that the agreement has already unravelled – leaders seem to have opened up for using the European Stability Mechanism (or the EFSF) in what the summit statement calls "a flexible and efficient manner"[2]. Such use involves direct recapitalisation of banks (bypassing governments) and purchasing government bonds without establishing full bailout programmes with conditions such as those attached to the financial support received by Greece, Ireland and Portugal. The agreement by euro area finance ministers on a rescue package to Spanish banks appear to confirm this new direction of the Eurozone's crisis policy, at least as far as direct support to banks is concerned.

Notwithstanding the importance of breaking the link between fragile banks and fragile sovereigns, this brief throws some doubt on the virtues of a "flexible use" of the Eurozone's bailout funds. More specifically, it argues against using the ESM to purchase government bonds in order to drive down yields. There are several arguments supporting this view, but this paper especially takes stock of the incompatibility of this approach with standard operating procedures of the International Monetary Fund. The key problem for the Eurozone remains that its

SUMMARY

This policy brief takes stock of the agreement by Eurozone countries in late June at the European summit. If this agreement survives (which is by no means certain) and is utilised, Eurozone governments will have opened the door to a flexible use of its bailout funds. In contrast to previous packages, such flexible use could involve direct recapitalisation of banks (bypassing sovereigns) or purchasing of government bonds in order to assist governments teetering on the edge of sovereign default. The primary concern of this paper, however, is that such use would be likely to close the door to cooperation between the Eurozone and the IMF in new rescue packages.

The IMF can only lend directly to members of the Fund. And its policy on conditionality does not fit with the easing of conditionality – or the ex ante conditionality – suggested in the Eurozone agreement from late June. Given the size of the Italian and Spanish economies, any involvement by the IMF in support to their governments would likely be subject to strict conditions on policy reform and economic performance.

This presents a problem for the Eurozone. The chief problem for the strategy it has chosen to address sovereign defaults and sovereign default risks is that the funds it has constructed to support this strategy are inadequate. Even if the recent attempts by the IMF to shore up the Fund's resources and build a bigger firewall have not been a complete success, the money it has raised would be critical in the event of both Italy and Spain needing support to fund their governments. Consequently, if the cost to the Eurozone for moving towards a flexible use of its bailout funds is that the IMF no longer can team up with it, then the June summit was a Pyrrhic victory.

chosen strategy to deal with sovereign default risks and sovereign defaults is not backed up by the necessary resources. The bailout structure has grossly inadequate funds to deal with an escalation of the crisis. The problem with the new flexible approach is that it effectively cuts out the IMF leg of the Eurozone firewall. As long as Eurozone leaders fudge on the size of its bailout capacity, improvements under the new flexible approach run the risk of eroding the total bailout capacity of the IMF and the Eurozone together.

A STRATEGY FOR ITALY AND SPAIN

The June summit deal is a strategy to deal with Spain and Italy, both teetering on the edge of sovereign defaults. Spain has already been promised up to 100 billion euro to recapitalise its fragile banking system – and assuming the June deal will stand, the Spanish government does not have to get weighed down by adding that amount to the public debt.[3]

However, serious doubts remain about Spain's fiscal muscles, with several economists, including this author, believing that the Spanish government, too, will need external assistance to avoid default. Similarly, Italy – under the pressures of a ballooned public debt and a contracting economy – will not be able to refinance itself for many more months at current yields. If ESM bond purchasing can help to drive down bond yields, so goes the argument, then Spain and Italy would get more time to achieve the fiscal and economic adjustments necessary to regain credibility on financial markets. Few external observers, however, seem to believe in the virtues of supporting governments via the bond market when the funds available are limited.[4]

The advancement at the summit may be a Pyrrhic victory. The central problem for the credibility of the Eurozone's crisis policy remains the grossly inadequate resources made available in the bailout structure.[5] There is now a lending cap at 500 billion euro. It could theoretically be increased, but there are both fiscal and political limits to how much more resources countries can become liable for in the ESM. Consequently, other sources of money are necessary in the event larger economies need to be assisted.

One of them is the International Monetary Fund (IMF), which has just completed a new round of fundraising, expanding its "firewall" up to approximately 450 billion US dollars. However, if the Eurozone's bailout mechanism is actually flexibly used, those other sources of money will find it harder to cooperate with the Eurozone. This is especially true for the IMF. In fact, if the Eurozone moves toward flexible use, it is unlikely that the IMF can team up with the EU or Eurozone governments in preventing governments from default.

INCOMPATIBLE APPROACHES

There are three factors that will separate the IMF from the new Eurozone approach. The first one can be called constitutional. The IMF cannot take a direct part in an operation that eases conditions for government borrowing by intervening on the bond markets. Nor can it bypass governments by lending capital directly to banks, or to a pan-European bailout fund. Only members of the IMF can borrow from the IMF, and the debtor country's borrowing relation should be based on the treasury, the central bank or equivalent institution. For the IMF to join forces with the Eurozone – as it has done in the packages to Greece, Ireland and Portugal – there has to be a joint programme with money disbursed directly to the debtor government.

The second factor concerns conditionality. A subject of controversy and reform, IMF conditionality remains based on the simple and understandable desire of wanting its loans to be repaid. Conditionality programmes are consequently designed to ensure that a country will exit a period of IMF assistance with a better policy environment than when the

loan was requested. Obviously, this is also a central part of the Eurozone's thinking about conditionality. But that thinking is now about to change in the Eurozone's flexible use of its bailout mechanism.

It remains unclear exactly what conditions will be attached to possible assistance to Spain and Italy under the new "flexible" paradigm; the summit statement from the euro area group suggests an ex ante structure of conditions, based on compliance with e.g. the Stability and Growth Pact, and the Country Specific Recommendations. Yet the atmosphere of the suggestions is that countries like Spain and Italy can be eligible for assistance without full programmes and standard conditions because they have qualified ex ante.

It is not difficult to understand why conditionality would be weakened. The Eurozone is approaching a point of alarming distress and actions then will not be so much about aiding countries under specific conditions but avoiding a Eurozone breakup or breakdown. Assisting countries by purchasing their bonds would be tantamount to an act of desperation for the Eurozone. But the envisioned ex ante conditionality is principally not compatible with IMF views on conditionality. True, the IMF also runs programmes based on ex ante conditionality, but neither Spain nor Italy would qualify under those programmes' ex ante conditions on fiscal policy and stability. The finger would point to a lending operation based on a full programme of traditional ex post conditionality. Both countries still suffer from structural deficiencies in fiscal policy and the current account. For the IMF to ensure it will get paid back, these countries will have to change.

Italy's fractured political system would also be difficult to square with the strong emphasis on ownership of reforms in the IMF philosophy on conditionality. Understandably, the IMF does not want to get into a position where it effectively has to run the country to ensure that it still can disburse funding. Italy has a technocratic government because the parliamentary system could not produce a government with a responsible fiscal policy supported by a majority of the parliament. In other words, ownership of reforms is a concept which is distant from current political realities in Italy. The ECB as well as Eurozone leaders have tried time and again but failed to use sticks to get Italy to behave more responsibly. The outcome of the next election looks unlikely to change the texture of Italian politics to the degree that there will be a responsible majority government who would own the reform agenda. Arguably, this suggests that the IMF would not be prepared to engage in sizeable lending to Italy without balancing weak ownership by stronger conditionality.

A final point on conditionality concerns the size of the Spanish and Italian economies – and the risk that the IMF would have to take by lending them money. Failed assistance to smaller economies will not break the IMF bank, but if lending to Spain and Italy fails, the IMF's own financial credibility will be in the danger zone. Consequently, the IMF would likely have to take greater precautions to ensure that any resources it lends are part of a programme with appropriate conditionality.

The IMF is currently participating in the bailout programmes with Greece, Ireland and Portugal. There are also several other examples in recent history of resources from the IMF being combined with non-IMF resources. Usually the IMF takes the central role in hybrid programmes, but in the Eurozone bailouts it has played a junior role in terms of resources. There are "constitutional" and political limits to how junior the IMF can be in relation to other creditors. In the case of Greece, those limits have been stretched to the maximum, with the IMF obviously massaging their own reviews of the programme to avoid a conclusion that would be politically unpleasant for the Eurozone: Greece is not complying with programme conditions and should therefore not receive new tranches of money from the programme.

The IMF would find itself in even more awkward positions if it lends money to big Eurozone governments. It is often said that beggars cannot be choosers; debtors do not have the liberty to make a choice between whether they should comply with credit conditions or not. Consequently, it should not be difficult for the IMF to exert enough influence to get Spanish and Italian governments to comply with programme conditionality. But the political economy of credit is not that simplistic. Once the IMF, or another creditor, has started to lend, the beggar also gets an influence over the

chooser. And the more money that is being lent, the more the power relation shifts in favour of the debtor. This is moral hazard for creditors – and it points to the conclusion that an IMF engagement with bigger economies will have to be much more on the IMF's terms than previous IMF-Eurozone cooperation during this crisis.

The third factor concerns likely IMF resistance to engaging fully with big Eurozone economies if the Eurozone bailout funds are spent supporting governments via the bond market. A possible way around the two other factors is that the bailout funds support countries via lending to banks and interventions on the bond markets, while the IMF sets up their own programmes with countries. That strategy, however, does not look appealing from the IMF viewpoint.

The IMF would not start lending money without a clear and credible plan for how a country is going to finance itself in at least the next 12 months, possibly longer. And for a programme to ensure full financing of Spain and Italy, there must be more resources available to governments than what the IMF has to offer. The assumption behind the drive for new IMF resources has been that it would add resources that in combination with the Eurozone's own bailout funds would be a credible firewall. It has been clear for some time that the sums that the two parts could raise would not add up to the 2 trillion euro seen by many as the necessary size of the firewall. But the sum of the two parts has been assumed to be bigger that the numerical value of the money raised. But if the duo is split up, that value looks likely to shrink.

CONCLUDING COMMENTS

Two conclusions can be drawn. First, the June summit deal may be a Pyrrhic victory if an unintended consequence of that deal is that the IMF cannot be fully engaged in the event that Spain and Italy need support to avoid sovereign defaults.

Second, the Euro group must soon come up with a credible answer about funding to cover a scenario in which both Spain and Italy will need support. If it continues to fudge that issue, the piecemeal improvements it makes (like bypassing the Spanish government in a package to Spanish banks) will never buy the Eurozone the time and space it needs to rebuild credibility through fiscal, financial and current account improvements.

ENDNOTES

1. This paper is an amended version of a presentation for officials in the German Ministry of Finance, July 6, 2012.
2. Euro area summit statement, June 29, 2012, accessed at http://consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131359.pdf
3. The details of the support package to Spanish banks remain unclear, but the agreement by euro area finance ministers on July seems to confirm that the Spanish government will not be liable for the support to Spanish banks.
4. See Paul De Grauwe, Why the EU summit decisions may destabilise government bond market. Vox EU, July 2, 2012, accessed at http://www.voxeu.org/article/why-eu-summit-decisions-may-destabilise-government-bond-markets
5. See Fredrik Erixon, (2012). The Eurozone Arrested Adolescence: Sketching a Way out of the Crisis. ECIPE Policy Brief No. 06/2012. Accessed at http://www.ecipe.org/media/publication_pdfs/Policy_Brief_06.2012.pdf

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