The IMF to the rescue: Did the euro-area benefit from the fund’s experience in crisis fighting?

By Barbara Fritz, Sebastian Dullien and Laurissa Mühlich


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Abstract

The paper asks whether the IMF’s inclusion in the troika bail-out programmes during the euro-crisis has helped the Europeans to benefit from the funds decade-long experiences with sovereign debt and balance-of-payment crisis in emerging markets. While many dimensions of the fund’s experience could be analysed in this context, the paper concentrates on the basic macroeconomic design issues of assistance programmes, especially the basic issue of when to apply debt restructuring, when to provide liquidity assistance and how much austerity to ask for as a conditionality. In a comparison with its experience in the Argentinian crisis in 2001/2 and the Brazilian crisis in 2002, it is shown that while the Fund had greatly improved its approach for emerging markets, the basic lessons got lost when it was involved in the troika programmes. Hence, we argue that the inclusion of the IMF in Europe’s crisis fighting approach did not completely deliver what had been hoped for.

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1 Introduction

The Euro crisis is an enormous challenge, not only for our understanding of the mechanisms of a currency union, but also for the complexity of the crisis and of the actors involved. One of them, the International Monetary Fund (IMF), has gained a new role in this context. Founded in the post war Bretton Woods system as a key institution to support member countries with temporary balance of payment problems, it had turned a key actor to tackle developing, transition and emerging market countries’ balance-of-payment (BOP) crises during decades. In the euro crisis, for the first time since 1977, the Fund has been called in to support the rescue of advanced economies in Europe.

Its inclusion in the bail-out packages in Greece, Portugal and Ireland were also peculiar as the primary reason for Europeans to include the IMF in their troika set-up (including also the European Commission and the European Central Bank ECB) was not the need for funds, but rather the idea to draw upon the IMF’s wide experience in designing and implementing rescue packages and adjustment programmes in times of crisis. As the former ECB director Jörg Asmussen put it: “It proved right to bring in the IMF. The Fund has unique experience in the design of such programs. It additionally is a kind of external policeman in Europe who may be able to act with less consideration” (Asmussen 2012).

In this paper, we ask if the IMF was indeed capable to bring in such unique experience from assisting non-advanced economies. To face this question, we analyse three aspects: First, given the theoretical knowledge about crisis such as the one experienced in the euro-area, what would have been the ideal design of rescue packages? Second, in how far has the IMF incorporated this design in past crises it was involved in and what lessons did it draw from its emerging market programs in the late 1990s and early 2000s? Third, in how far did the IMF manage to transfer this experience to the euro crisis?

The paper is organized as follows: In the second section, we first briefly review the development of theoretical models on emerging market crises and summarize what the ideal policy conclusions from these models are with regards to rescue loans and adjustment packages. In a third section, we contrast this result with the IMF’s policy stance in the most prominent emerging market crises of the past two decades, namely the Argentinian crisis of 2001/2 and the Brazilian crisis of 2002 and look at the lessons the IMF has explicitly drawn from its experiences in these crises. In a fourth section we then contrast these proclaimed learnings with the approach taken by the troika during the Eurozone countries.

While the IMF has experience on multiple levels of crisis management (from designing over implementing to monitoring programmes and enforcing conditionality) and Europeans had originally hoped to benefit from all of this knowledge, we focus on the question of the basic macroeconomic design of rescue packages, especially the question when to apply debt restructuring, under which conditions to provide liquidity and how much austerity to apply. Due to space restraints, the also important and interesting question of microeconomic implementation of structural reforms will not be covered in our contribution.

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2 Liquidity vs. solvency problems and three generations of theorizing financial crises

The increased turmoil in financial markets since the break-down of the Bretton-Woods system has stimulated interest in theorizing financial crisis events, resulting in the development several generations of balance-of-payment crisis over the 1980s and 1990s. While it is still debated which types of crises have interacted in the euro area (Shambaugh 2012; Fratzscher 2013) and also the classification of past emerging market crisis is far from trivial (Kaminsky/Reinhart 1999 or Laeven/Valencia 2012), some lessons of these models can be applied no matter which crisis elements are actually present. Central to these models is the idea that there is a limited stock of an asset (in case of balance-of-payment crisis foreign reserves, in case of sovereign debt crises government revenue) which is depleted either by policy errors or by investors’ flight.

The first generation of models still explains attacks on a currency with a fixed exchange rate by rational expectations, due to inconsistent government policies, or flight out of public bonds which will make public debt unsustainable. When for example a fiscal deficit raises domestic inflation above the international level, capital outflows will force the monetary authority to give up a fixed exchange rate (Krugman 1979). Translated to the question of sovereign debt, this model can explain that a fiscal policy which has put a country into a position where it will not be able to service its debt in the future would lead investors to stop financing budget deficits, hence forcing a government to default. Since in this situation, the cause of the default has been an unsustainable fiscal stance and excessive debt, an adjustment program would require a debt restructuring and a change of existing policies through what is generally known as austerity – expenditure cuts and revenue increases. Liquidity loans can be given after that to limit the fallout to the real economy.

The mechanism is different in second-generation models (i.e., Obstfeld 1996) which do not assume such a clear cut policy failure as the starting point. Self-fulfilling debt or fiscal crisis is a possible outcome when there are multiple equilibria due to the interaction of markets and governments (Cole & Kehoe 1996). “[T]he main point of second-generation models may be stated this way: the real cause of currency crises is not so much what you are actually doing, as what the financial markets suspect you might want to do” (Krugman 1999, p. 439). The logic here is simple: for an entity with a moderate, yet not extremely high, level of debt whether it is able to service its debt or not depends on the expectations of market participants. If investors believe that a country in debt is able to service their claims, they accept lower interest rates and the debt may therefore be sustainable. If in the case of a sovereign debtor, investors believe that the state in question might not be able to service the debt, they demand higher interest rates and the debt becomes unbearable – leading to a default. In fact, the lines between first- and second generation crisis types are blurred. Multiple equilibria occur whenever there is a possibility that market expectations about weak economic fundamentals may indeed be true. Hence, most of the time, it is difficult to point out one specific reason for a crisis to occur according to one of the model’s rationale. It may rather be a combination of both (Krugman 1999).

The catch in these models is that if a third party can guarantee continued access to loans at sensible interest rates, expectations will permanently stabilize in the ‘good’ equilibrium and a self-fulfilling fiscal crisis is thus no longer possible. The action of this third party would help in the avoidance of huge costs for the economy, in case of successful crisis prevention.
Third-generation models of currency crises (Chang/Velasco 2000; Corsetti et al. 1998; Krugman 1997 and 2003) have then explored how problems in the banking and financial system interact with public debt and currency crises and how they mutually reinforce themselves, signalling the relevance of smooth and decisive action to stop these crises from spilling over to the real sector and to other countries.

There are two main concerns about the above mentioned liquidity provision by a third, external actor to stop a self-fulfilling crisis to realize: First this third party has to be available and able to provide liquidity at a sufficient amount to turn market expectations, and second, it has to make a clear distinction between a situation of illiquidity and insolvency.

With regard to the first point of liquidity provision, in the case of a domestic banking system with financial contracts denominated in domestic currency exists usually a central bank that is able to act as LLR, as it can emit liquidity in domestic currency without limits. The relevance of a LLR for ensuring monetary and financial stability at the domestic level is known since the seminal work of Bagehot on the emergence of the Bank of England as the first central bank in the modern world (Bagehot 1873).

Yet, both in the case of debt denominated in foreign currency, and for public debt, and particular for the euro area, liquidity provision is less simple. First, for the case of foreign currency denominated external debt, the domestic central back is not able to serve as LLR, as it cannot emit foreign currency. The major non-market access to financing is liquidity provision by the IMF since there is no LLR at the global level (Eichengreen/Hausmann 2005). Second, for the case of a public debtor under stress, there is disagreement on the question if a central bank should act as LLR, or if this would undermine the main task of a central bank to maintain price stability and create moral hazard on the side of governments to overspend and expect a central bank bailout. Overall, the guiding principles of central banking are shifting away from a narrow orientation towards price stability towards achieving the overall goal of financial stability (Blanchard et al. 2010; Eichengreen et al. 2011). However, if this includes clearly defined efforts to maintain the liquidity of national governments to restore the 'good equilibrium' even though dominant market expectations may indicate otherwise then it is an issue of great debate (Eichengreen et al. 2011, p. 24; see also Blanchard 2012). Finally, for the euro area, liquidity provision to national governments through the ECB is constrained by the EU treaties’ rules which prohibit the direct purchase of government bonds as well as the provision of overdraft facilities. In this respect, the euro areas’ national governments’ outstanding debt has features of foreign-currency denominated debt.

Second, in a context of multiple equilibria, it is key for the third actor to distinguish between problems of liquidity and solvency. Insolvent entities are defined as being unable to serve their obligations in the medium- and long term, even if provided with additional short-term liquidity. Providing liquidity for an insolvent entity thus means that the postponement of the insolvency leads to increased costs.

For countries with liquidity crises, it further needs to be analysed further whether the investors’ panic has been caused by policies which have moved the country closer to an unsustainable fiscal path or whether the panic has been triggered by an event rather unrelated to fiscal policies. Only the in the former case, a strong adjustment of fiscal policy is advisable and necessary.
3 How the IMF learnt to distinguish between liquidity and solvency crisis

3.1 The IMF’s own assessment

The series of financial crises in emerging markets during the 1990s represented a threefold theoretical, managerial and financial challenge to the IMF. First, most of these currency crises occurred in a context of market-friendly reforms, especially regarding trade and financial liberalization. It was rather clear that these could not easily be explained as the consequence of mere and crude policy failures, as in the above mentioned first-generation currency crisis models, and as debt and currency crises in developing countries during the 1980 in the context of import substitution strategies had been treated. On this background, IMF economists quickly started to reflect the relevance of multiple equilibria models for this new type of crisis. Flood and Marion (1996) for instance, in an IMF working paper directly linked these models to the Mexican Peso crisis in 1994 (see also Masson 1999). These reflections regarded not only exchange rate issues, but also the question under what conditions the IMF should act as a third actor injecting liquidity to re-establish the ‘good equilibrium’ within market expectations.

After almost one decade of crisis intervention which caused immense critique to the IMF from various sides (e.g. Stiglitz 2002), the Fund developed a clear-cut framework to distinguish, for the intervention in capital-account and currency crises, between illiquid and insolvent entities, taking on board the above-discussed theoretical insights. While in situations of illiquidity, rapid and sufficient injection of liquidity, eventually together with targeted policy shifts such as fiscal austerity or structural reforms, would bring back market confidence at the ‘good equilibrium’, the injection of further liquidity in a situation of insolvency would bring only temporary respite, with an augmented and more costly problem of insolvency due to increased debt coming back rather sooner than later, as the case of Argentina clearly demonstrated.

In a programmatic paper, based on the “Prague Framework” (Köhler 2000) the IMF came out with a new guide line in which the IMF should systematically differentiate: Liquidity crises should be solved by the rapid and sufficient provision of liquidity, while solvency problems should be tackled by debt restructuring, which may involve not only the lengthening of maturities, but also a haircut in terms of a reduction of the face value of debt. To enable this distinction, the institution delivered a definition of the concepts of liquidity and solvency:

“An entity is solvent if the present discounted value (PDV) of its current and future primary expenditure is no greater than the PDV of its current and future path of income, net of any initial indebtedness. [...] An entity is illiquid if, regardless of whether it satisfies the solvency condition, its liquid assets and available financing are insufficient to meet or roll over its maturing liabilities.” (IMF 2002, p. 5)

In the very same document the IMF recognized that the distinction between liquidity and solvency crisis is rather vague. First, these concepts in fact are blurring. A liquidity crisis will, if not solved immediately, lead to rising financing costs and thus to an increase in the present value of debt. Therefore the IMF started applying the concept of debt sustainability which means compliance with both liquidity and solvency criteria: “Sustainability thus incorporates the concepts of solvency and liquidity, without making a sharp demarcation between them” (IMF 2002: 4.). Second, it was acknowledged that this concept was all but easy to empirically assess. The present value of debt and debt service are mainly determined by macroeconomic parameters such as the interest rate and the
growth rate, and in the case of emerging markets, the exchange rate, which by definition are endogenous to market expectations on the liquidity and solvency status of the debtor. The IMF concluded that “assessments of sustainability are thus inherently probabilistic and no framework can dispense with their need for making judgements” (IMF 2002: 6).

However, ever higher funds have been necessary since the 1990s to tackle international liquidity crises. Since the above mentioned wave of market friendly reforms in financial markets in the 1990s, the volume of international capital flows to emerging markets and developing economies could play a greater role and grow rapidly in booms, as in bust periods the volume of outflows also increased. Therefore, a financial crisis and the volume of liquidity to be provided significantly went up. Hitherto applied IMF quota based on a country’s share in the IMF that determines the volume of liquidity that a country may draw from the institution have showed to be insufficient by far. In the end of 2002, the IMF hence established the „Exceptional Access Policy” (EAP), to be applied to: “any lending in which access is above 100 percent of quota on an annual basis or above 300 percent of quota cumulative irrespective of the facility used” (IMF 2003, p. 5). This access to large funds was linked to exceptionally strict rules (IMF 2003, p. 3f.): First, it should be applied only to exceptional balance of payments pressures; second, and most important, “[a] rigorous and systematic analysis [should indicate] that there is a high probability that debt will remain sustainable” (IMF 2003, p. 4; highlight by the authors); third, the country should have good prospects of regaining access to private capital markets, and fourth, liquidity provision should be backed by a strong program design and implementation in terms of adjustment policies.

The EAP became fully operational in February 2003. Yet, the rather successful credit package to Brazil in 2002, the by then biggest IMF liquidity support ever provided to a member country, certainly justified such an approach (see also section 3.3). During a 2006 seminar titled "Who Needs the IMF?", Kenneth Rogoff assessed the IMF’s assistance to Brazil in 2002 as a major turning point in this period:

"Consider, for example, the Fund’s risky and creative lending package to Brazil in August 2002 (...). With market access suddenly freezing up and the country on the brink of default, the Fund stepped in with $30 billion. The Fund’s loan arguably helped avert a meltdown that would have slammed global markets from Manila to Istanbul, and forestalled the benign period that emerging market economies have enjoyed the past few years" (Rogoff 2006).

Hence, it can be clearly seen that the IMF has refined its approach for crisis management over the 1990s and as a consequence has managed to fight the Brazilian capital flight of the early 2000s much more successful and with much less criticism than crisis episodes in the 1990s.

3.2 Argentina

The IMF’s crisis response in Argentina can be considered rather as one of a fire accelerator than a fire fighter, which led to intensive reflection and posterior redefinition of its policies. The IMF’s series of liquidity provisions in the years before the default and debt restructuring where assigned based on the assumption that the country was running an unstable fiscal policy which could in principle still be remedied by budget cuts, and were inconsistent with its previous assessment of the country’s unsustainable debt levels recognized at least behind closed doors.
Flemming Larsen, then IMF Director Offices in Europe, found in 2003: “the IMF should have insisted on the conclusion we reached by 1998 that the fixed exchange rate regime was unsustainable and that the authorities seemed either unwilling or unable to adjust their policies sufficiently to avoid the eventual meltdown” (Larsen, 2003).

The country was experiencing periods of substantial capital outflows since 1997, in the aftermath of the Asian crisis. From 1999 onwards, the Argentinean economy shrank continuously to a negative GDP growth of -10.9 percent in 2002 (see table 1) and lost about a quarter of its economic capacity in this period. This was then the most severe economic crisis a non-transition country had suffered in peace times since the Great Depression. In the beginning of 2002, the country declared default on its external debt. Debt restructuring discussions with private creditors only were brought to an end in 2005, where a majority of bond holders accepted longer maturities and haircuts of nominal debt values.3 Between 1996 and 2001, the IMF had three financing arrangements with Argentina, one under the Extended Fund Facility (EFF) (1998, which was classified precautionary, and of which no drawings were made) and two Special Borrowing Arrangements (SBA, 1996 and 2000). In early 2000, the IMF aimed at addressing the deterioration of the economic situation in Argentina and the country’s missing access to international financial markets with a SBA of about 7.2 billion USD. The SBA was raised by 13.7 billion USD in early 2001. In addition, the IMF steered an international financing package by public and private creditors: the so called *blindaje* (shield) amounted to 39 billion USD (IMF 2004: 9). At the same time, in a last and desperate attempt, the Argentinean government conducted a broad restructuring of domestic public bonds that prolonged bond maturities and should have reduced public refinancing costs. However, interest rates rose in parallel and hence refinancing costs did not decrease. To the contrary, expectations of a possible default were fuelled further and capital flight continued. In the autumn of 2001, the above mentioned SBA was augmented again to about 22 billion USD of which 3 billion USD were supposed to support a possible debt-restructuring intervention.

However, the rescue package could not bring Argentina back to international financial markets. Capital inflows did not return. The country’s payment obligations were enormous, fuelled by increasing risk premium on international credits that increased within the year 2001 from an already high level of 1000 to about 5000 basis points. Finally, by the end of 2001, the IMF cut off its support to Argentina due to missing fulfillment of the agreed fiscal program and lack of market confidence (IMF 2004a: 9).

Some voices within the IMF continued arguing that the main problem had been Argentina’s unsustainable fiscal policy, most prominently Michael Mussa, head of the IMF’s research department until 2001 (Mussa 2002: 10ff). But a look to the composition of tax income and spending during the crisis period shows that the sharp increase of public debt to GDP ratios (see table XXX) was mainly due to increasing public debt service and a shrinking GDP, while the primary balance, i.e. the fiscal balance before debt service, on average showed a slight surplus of 0.45 percent during this period. Public debt service increased from 10.9 percent in 1997 to 23.4 percent in 2001 (Damill/Frenkel/Rapetti 2012b: 9). “Despite the strong adjustment in the primary balance of the public sector the virtuous circle was never attained. Even worse, the increases in taxes and the cuts

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3 A minority of institutional debt holders refused this agreement and appealed to US courts, which in 2014 decided Argentina had to fulfil its obligations, hindering the country to serve its debt with other bond holders which had accepted the restructuring deal. In reaction to the court decision, international rating agencies again declared Argentina as bankrupt, mirrored in non-investment grades.
in public expenditures reinforced the recessionary trend, thus feeding the negative expectations that prevented realizing the highly anticipated fall in the country-risk premium. Fiscal policy alone was impotent to compensate for the strong macroeconomic imbalances, which laid somewhere else, i.e., in the external sector of the economy” (Damill/Frenkel/Rapetti (2012a: 4)

The costs of delay of debt restructuring thus were severe. The above cited then IMF Director Larsen argues it was not the Fund’s fault: “Those concerns [of an eventual financial meltdown] were expressed repeatedly but the authorities refused to consider an exit from the currency board arrangement until the change was forced by markets” (Larsen 2003). A major problem can certainly be found in the rigidity of the currency board arrangement which provided no orderly exit. The IMF in fact had not been responsible for introducing this regime in Argentina in the beginning of the 1990s, but later strongly advocated in favour of this rigid version of a fixed exchange rate, in order to stabilize market expectations within multiple equilibria (i.e. Flood/Marion 1996).

This rigid exchange rate peg had, among others, produced substantial appreciation of the real exchange rate, sustained by major capital inflows in the pre-crisis period. As a consequence, the country had accumulated increasing current account deficits and external debt in foreign currency. The government feared that a give-up of the fixed exchange rate regime was hardly possible without a massive loss of confidence; in the highly dollarized economy a devaluation would cause severe balance sheet effects in the private financial and non-financial as much as in the public sector, launching a major meltdown of the economy (Fritz 2002: 147). In fact, after the long austerity period the devaluation caused a final implosion of the financial sector, but together with the moratorium and debt restructuring, brought Argentina a period of strong growth from 2003 onwards (see table 1).

<table>
<thead>
<tr>
<th>Table 1. Argentina: Selected Economic Indicators</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP growth (annual %) (1)</td>
<td>3,85</td>
<td>-3,39</td>
<td>-0,79</td>
<td>-4,41</td>
<td>-10,89</td>
<td>8,84</td>
<td>9,03</td>
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<td>48,06</td>
<td>54,34</td>
<td>53,15</td>
<td>57,37</td>
<td>153,84</td>
<td>132,46</td>
<td>114,36</td>
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<td>General government net debt (% of GDP) (2)</td>
<td>n/a</td>
<td>n/a</td>
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<tr>
<td>General government gross debt (% of GDP) (2)</td>
<td>38,18</td>
<td>43,49</td>
<td>45,62</td>
<td>53,62</td>
<td>164,99</td>
<td>139,45</td>
<td>127,03</td>
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<td>General government structural balance (% of potential GDP) (2)</td>
<td>-3,57</td>
<td>-4,85</td>
<td>-4,93</td>
<td>-6,13</td>
<td>-11,85</td>
<td>-2,94</td>
<td>-2,42</td>
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<tr>
<td>Official exchange rate (LCU per US$, period average) (1)</td>
<td>1,00</td>
<td>1,00</td>
<td>1,00</td>
<td>1,00</td>
<td>3,06</td>
<td>2,90</td>
<td>2,92</td>
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<td>Real interest rate (%) (1)</td>
<td>12,55</td>
<td>13,12</td>
<td>9,95</td>
<td>29,12</td>
<td>16,18</td>
<td>7,83</td>
<td>-1,06</td>
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<tr>
<td>Inflation, average consumer prices (% change) (2)</td>
<td>0,93</td>
<td>-1,17</td>
<td>-0,94</td>
<td>-1,07</td>
<td>25,87</td>
<td>13,44</td>
<td>4,42</td>
</tr>
<tr>
<td>Current account balance (% of GDP) (2)</td>
<td>-4,84</td>
<td>-4,20</td>
<td>-3,15</td>
<td>-1,41</td>
<td>9,00</td>
<td>6,38</td>
<td>1,75</td>
</tr>
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</table>

Source: (1) World Development Indicators, 2013; (2) World Economic Outlook, April 2014.

3.3 Brazil

The IMF’s crisis resolution mechanism applied in Brazil in 2002 can be seen as a rather successful intervention to stop a situation of illiquidity to transform into insolvency. IMF’s liquidity provision as such can be considered timely and sufficiently high to have bridged the temporary Brazilian balance of payment problem. As would be in line with the theoretical arguments above and the diagnosis of a mainly expectations-driven crisis, the IMF did not force overly harsh austerity measures on Brazil as part of the package.
In the run up to the presidential elections in October 2002, international investor’s fears about economic policy changes in case the leftist candidate Lula would win the elections provoked enormous flight out of the Brazilian currency. Behind this was a deterioration of the stock of public debt despite substantial austerity policies over the last years.

At that time, Brazil’s economic situation was ambiguous. At the one side, since the last financial crisis in 1999 and the subsequent abandonment of the pegged exchange rate regime together with a maxi devaluation, GDP growth had recovered in 2000, and the stock of both total external debt (private and public) and public debt (domestic and international) was moderate in relative terms. External debt stocks ranged around 40 percent of GNI, and government net debt was below 50 percent of GDP in 2001 (see table XXX). At the same time, public debt demonstrated high vulnerability due to exchange rate indexation and because a large part was denominated in foreign currency. Also, the debt level was increasing relative to GDP despite fiscal austerity. “The depreciation of the exchange rate as a result of a confidence shock in the run up to the presidential election in October led to an increase in the debt-to-GDP ratio as a consequence of the revaluation of outstanding exchange rate-indexed and foreign currency-denominated liabilities. Owing to this, and the concomitant monetary tightening, outlays on interest payments increased substantially, leading to a deterioration of the headline budget balance in 2002-03, despite the maintenance of a robust primary surplus” (DeMello/Moccero 2006: 13). Hence, the issuance of dollar-linked securities resulted in an exposure to exchange rate risk that deteriorated the fiscal position of the country which in turn reduced foreign investor’s confidence in the Brazilian economy and increased the risk premium of loans or cut off sources of financing to the country. The country’s vulnerability of public finances was amplified by the pro-cyclical austerity measures. Additionally, the current account deficit – though decreasing since the devaluation in 1999 - exposed the country to external shocks. Additionally, at the time of the presidential elections, the neighboring country Argentina, a major trade partner of Brazil, had just defaulted on its debt and undergone a maxi-devaluation. These events caused contagious capital outflows and a worsening of Brazil’s current account. In this sense, the uncertainty of election outcomes in October 2002 was just the tick on the brink of a general picture of high macroeconomic uncertainty. Within a few weeks, Brazil lost access to international capital markets. The Brazilian real lost about 50 per cent against the US-dollar.

The IMF classified the situation not as a case of insolvency but rather as one of temporary illiquidity – with an associated risk of it quickly turning into one of insolvency in case of ongoing market mistrust. In July 2002, the IMF stepped in with its – by that time in SDR terms largest ever – loan as a stand-by arrangement of 30.4 billion USD (22.8 billion SDR) over a period of 15 months (see also IMF 2004b). As this amount exceeded Brazil’s regular quota of 3.04 billion SDR at the IMF by far, de facto, it was a test of the Exceptional Access Policy (EAP) that was introduced at the IMF in September 2002 and fully operationalized in February 2003 (IMF 2003: 3).

The case of Brazil demonstrates the difficulties of a proper assessment of a situation of illiquidity with high probability of debt sustainability. Barry Eichengreen, who had served as a key policy advisor to the IMF the years before, publicly argued in defense of the highly criticized institution: “Brazil in 2002 is a better gamble for the IMF than was Argentina in 2001. It provides the Fund an opportunity to demonstrate that it helps well-managed economies like Brazil while offering only tough love to delinquents like Argentina” (Eichengreen, 2002: 3). He argued that the risk of this new credit was high, but that the risk of leaving Brazil’s financial needs unattended was even higher to end in a situation of insolvency and that due to geopolitical reasons this was not feasible: “To be
sure, if the gamble is lost, the fallout will be severe. But sometimes it makes more sense to gamble, despite the risk of losing, than not to gamble at all.”

The major part of the standby arrangement (24 billion USD) was disbursed only after the presidential elections, linked to a primary budget surplus target of 3.75 per cent that should be maintained from 2003 onwards. At the same time, the leftist candidate Lula had committed himself, as an informal pre-condition for the stand-by agreement, in a ‘Letter to the Brazilian people’ to “respect all contracts and obligations of the country” (Silva 2003: 3), despite his plans to change the economic model of the country. As a result, within only two months and even before presidential elections, capital flows went back and the Brazilian exchange rate had almost recovered to its original level.

However, the decision to restrain from a moratorium and debt restructuring had its price for Brazil. The new Lula government, when in power in 2003, not only did hold to its compromise to serve its obligations, but opted for a highly orthodox economic policy to maintain capital inflows. The new government continued the previous pro-cyclical policies and increased the primary budget surplus even above the IMF target to 4.25 per cent (Ministério da Fazenda do Brasil 2003: 9), to hold this for the next years, and kept real interest rates well above the 10 per cent level. As a result, the Brazilian economy entered into recession in 2003, to restart growth only slowly from 2004, with the global commodity price boom. Given high interest rates, public debt service accounted for 20.7 per cent of the public budget on average between 2003 and 2007 (Central Bank of Brazil, Historical data basis, own calculations), public domestic debt even increased in this period, from 37.5 per cent of GDP in 2003 to 51.8 per cent in 2007 (see also Fritz, 2010). The gains in terms of reducing poverty and income inequality, for which the Lula government gained fame in the end, started to materialize only during the second mandate of the government from 2007 onwards.

### Table 2

<table>
<thead>
<tr>
<th>Brazil: Selected Economic Indicators</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
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<td>GDP growth (annual %) (1)</td>
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<td>4.31</td>
<td>1.31</td>
<td>2.66</td>
<td>1.15</td>
<td>5.71</td>
<td>3.16</td>
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<tr>
<td>External debt stocks (% of GNI) (1)</td>
<td>43.15</td>
<td>38.68</td>
<td>43.04</td>
<td>47.68</td>
<td>44.13</td>
<td>34.28</td>
<td>21.98</td>
</tr>
<tr>
<td>Internal public net debt (2)</td>
<td>35.16</td>
<td>36.54</td>
<td>38.85</td>
<td>37.48</td>
<td>41.66</td>
<td>40.18</td>
<td>44.13</td>
</tr>
<tr>
<td>External public net debt (3)</td>
<td>9.38</td>
<td>9.00</td>
<td>9.59</td>
<td>12.99</td>
<td>10.69</td>
<td>6.82</td>
<td>2.33</td>
</tr>
<tr>
<td>General government net debt (4)</td>
<td>41.76</td>
<td>42.83</td>
<td>47.54</td>
<td>49.24</td>
<td>51.67</td>
<td>47.21</td>
<td>46.83</td>
</tr>
<tr>
<td>General government gross debt (3)</td>
<td>53.54</td>
<td>60.31</td>
<td>64.93</td>
<td>64.89</td>
<td>70.44</td>
<td>65.41</td>
<td>67.38</td>
</tr>
<tr>
<td>General government net debt (4)</td>
<td>n/a</td>
<td>47.75</td>
<td>52.03</td>
<td>60.38</td>
<td>54.83</td>
<td>50.61</td>
<td>48.44</td>
</tr>
<tr>
<td>General government gross debt (4)</td>
<td>n/a</td>
<td>66.65</td>
<td>70.79</td>
<td>79.38</td>
<td>74.61</td>
<td>70.66</td>
<td>69.33</td>
</tr>
<tr>
<td>Official exchange rate (LCU per US$, period average) (1)</td>
<td>1.81</td>
<td>1.83</td>
<td>2.35</td>
<td>2.92</td>
<td>3.08</td>
<td>2.93</td>
<td>2.43</td>
</tr>
<tr>
<td>SELIC rate (% p.y., end of year) (3)</td>
<td>19.04</td>
<td>15.84</td>
<td>19.05</td>
<td>24.90</td>
<td>16.33</td>
<td>17.75</td>
<td>18.04</td>
</tr>
<tr>
<td>Inflation, average consumer prices (% change) (2)</td>
<td>4.86</td>
<td>7.04</td>
<td>6.84</td>
<td>8.45</td>
<td>14.71</td>
<td>6.60</td>
<td>6.87</td>
</tr>
<tr>
<td>Current account balance (% of GDP) (2)</td>
<td>4.317</td>
<td>3.757</td>
<td>4.189</td>
<td>1.509</td>
<td>0.756</td>
<td>1.76</td>
<td>1.585</td>
</tr>
</tbody>
</table>

Source: (1) World Development Indicators, 2013; (2) Ipea Data, 2014; (3) Banco Central do Brasil, 2014; (4) World Economic Outlook, April 2014.

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4 “Premissa dessa transição será naturalmente o respeito aos contratos e obrigações do país” (Silva 2002: 3).
5 Includes Petrobras and Eletrobras
4 How the Troika handled the euro crisis

Yet, not all of these lessons were taken on board when it came to the euro crisis. Instead, the euro crisis can be seen as an example where first Greece was given liquidity provision without debt restructuring even though it was clearly insolvent and then harsh austerity was applied to countries which had first and foremost liquidity problems triggered by investors’ panic and market uncertainty.

4.1 A short narrative

At the onset of the euro crisis, government finances in many euro-zone countries were strained because of the negative effects from the global economy and global financial crisis of 2008/9. On average, the euro area in 2009 had a government budget deficit of 6.3 percent, with basically all countries having broken the Maastricht treaty’s 3-percent-of-GDP threshold. Yet, the public finance situation at that time still did not look overly concerning for most of the member states. Especially the later crisis countries Ireland and Spain, but also Portugal did not show an excessively high public debt-to-GDP level.

Table 3

<table>
<thead>
<tr>
<th>Country</th>
<th>Public sector deficit in % of GDP</th>
<th>Public debt in % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2008</td>
<td>2009</td>
</tr>
<tr>
<td>Euro area (12 countries)</td>
<td>-2,1</td>
<td>-6,3</td>
</tr>
<tr>
<td>Belgium</td>
<td>-1,1</td>
<td>-5,6</td>
</tr>
<tr>
<td>Germany</td>
<td>-0,1</td>
<td>-3,1</td>
</tr>
<tr>
<td>Ireland</td>
<td>-7,4</td>
<td>-13,7</td>
</tr>
<tr>
<td>Greece</td>
<td>-9,9</td>
<td>-15,6</td>
</tr>
<tr>
<td>Spain</td>
<td>-4,5</td>
<td>-11,1</td>
</tr>
<tr>
<td>France</td>
<td>-3,3</td>
<td>-7,5</td>
</tr>
<tr>
<td>Italy</td>
<td>-2,7</td>
<td>-5,4</td>
</tr>
<tr>
<td>Cyprus</td>
<td>0,9</td>
<td>-6,1</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>3,2</td>
<td>-0,7</td>
</tr>
<tr>
<td>Malta</td>
<td>-4,6</td>
<td>-3,7</td>
</tr>
<tr>
<td>Netherlands</td>
<td>0,5</td>
<td>-5,6</td>
</tr>
<tr>
<td>Austria</td>
<td>-1,0</td>
<td>-4,1</td>
</tr>
<tr>
<td>Portugal</td>
<td>-3,7</td>
<td>-10,2</td>
</tr>
<tr>
<td>Finland</td>
<td>4,3</td>
<td>-2,7</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>-5,0</td>
<td>-11,3</td>
</tr>
<tr>
<td>United States</td>
<td>-7,0</td>
<td>-12,7</td>
</tr>
<tr>
<td>Japan</td>
<td>-1,9</td>
<td>-8,8</td>
</tr>
</tbody>
</table>

Source: Ameco database (2014)

The euro crisis begun in earnest in early 2010, when the newly elected Greek government saw itself forced to revise upwards deficit and debt figures. According to updated figures, the 2009 deficit
finally came in at more than 10 percent of GDP. Given the already high level of Greek public debt of more than 120 percent of GDP, market participants started to doubt Greece’s debt sustainability and yields on Greek bonds started to increase. At the beginning, European leaders were opposed to any rescue package for Greece, but this view started to change when it became clear that market concerns started to spread to other countries such as Portugal, Spain, Ireland and Italy.

As recommended by the European Commission, Greece started implementing harsh austerity packages in March 2010, to the magnitude of 2 percent of GDP (Pisani-Ferry et al. 2013, p. 139). However, it quickly became clear that Greece would still miss its deficit target by a wide margin and in late April 2010, Greece requested assistance from the euro-area member states and the IMF which put together a €110 billion rescue package in early May 2010, despite warnings that Greece might have serious solvency problems which could not be resolved by the associated structural adjustment programmes (Wall Street Journal 2013). In order to make these payments, the European partners set up the „European Financial Stability Facility“(EFSF) and the „European Financial Stabilisation Mechanism“(EFSM). As a conditionality for Greece, harsh budget cuts were agreed and subsequently put into place. The Greek economy started to contract sharply from the second half of 2010 onwards and public debt levels continued to climb.

Immediately after the first Greek rescue package, spreads for other euro periphery countries fell, but started to increase almost immediately again. In order to calm financial markets, the Portuguese government announced severe austerity measures in May 2010. With the impact of these measures, the Portuguese economy slid back into recession and GDP started contracting in the fourth quarter of 2010. As a consequence, public finances deteriorated further and Portugal saw itself forced to pass new austerity measures, but did not manage to calm financial markets where spreads on Portuguese bonds continued to increase.

Meanwhile, concerns about the Irish banking system grew. Together with a sharp contraction in economic activity, this further rattled markets and spreads went up, reaching more than 360 basis points by August 2010. After the announcement of restructuring costs for the government of up to €50 billion in September 2010, the government saw itself forced to propose a harsh austerity in package in October 2010 and finally applied for financial assistance from the IMF and European partners in December 2010. With deteriorating economic data and public finances, Portugal followed in April 2011.
At the same time, it became clear that the first Greek rescue package would not be sufficient. Hence, in 2011, discussions began about a second Greek bail-out package. Yet, at this point, the feeling was that rescue loans alone would not be sufficient for Greece as government debt was now projected to soon approach 200 percent of GDP. Thus, the EU leaders agreed in October 2011 that there would be a haircut on Greek private-sector creditors, which was implemented in 2012, roughly two years after the first provision of liquidity loans from the troika.

Over the following months, the default of Greek on its privately held debt contributed to a new upward movement in spreads of the euro periphery countries. As a measure to regain markets’ confidence, the EU passed a tightening of budgetary rules through the so-called „six pack“ which legislated structurally balanced budgets and a path for debt reduction for countries with public debt levels above 60 percent. The measures came into effect in early December 2011, yet financial markets remained rather unimpressed. As a reaction, EU heads of state and government immediately passed another new multilateral treaty, the so-called fiscal compact under which the signing parties not only committed themselves to basically balanced public budgets in structural terms, but also to writing these rules into national laws and preferably national constitutions. They also agreed to replace the temporary EFSF by a permanent European Stability Mechanism (ESM) which had a lending capacity of €500bn and was properly integrated into the European Treaties. Yet, even these steps failed to bring down spreads of European periphery bonds decisively.

One of the fears was that the ESM’s lending capacity might be too low should Italy or Spain require assistance. As Giovannini and Gros (2012) pointed out in March 2012, the programmes for the (small) countries Greece, Ireland and Portugal already amounted to commitments of €490 billion, while the (re-)financing requirements for Spain and Italy over the period of 2012 to 2016 amounted to almost
\€1800 billion. Consequently, the spreads on periphery bonds continuously climbed upwards again during the spring of 2012, reaching again more than 500 basis points for Italy and Spain in the summer.

At this point, the ECB’s president, Mario Draghi, gave a widely quoted speech in London, saying the ECB would do „whatever it takes“ to save the euro. Shortly after, the central bank clarified what it meant as a first step: Under the term „outright monetary transactions“, it would be willing to buy government bonds of countries which were under an ESM programme and in danger of losing access to financial markets without predetermined limits. This event is now widely regarded as a decisive turning point in the euro crisis, as after this point in time, periphery bond spreads started to fall and have not gone up again strongly so far (Schmieding 2014).

4.2 The IMF’s ex post evaluation and its shifting positions
Against the above described theoretical background, the chain of events is rather straightforward to interpret: In Greece, there seem to have been a problem of unsustainable debt levels at the onset of the crisis which, according to the lessons from the first generation of balance-of-payment crisis models would have required an immediate debt restructuring and some corrective fiscal measures. The liquidity provisions by the troika only have delayed the debt restructuring. In the rest of the euro-area, an important element seem to have been liquidity, not solvency problems, as evidenced by the fact that the panic subsided when unlimited liquidity provision through the ECB and the ESM was announced.

According to the lessons the IMF had drawn from the Latin American crises, Greece should never have received support without a debt restructuring and the other countries in the euro-area should not have burdened with the harsh austerity they were asked for.

However, the IMF loosened its stance during the euro crisis. Rather early in the negotiations on the Greek debt crisis, the IMF correctly identified this as a case of insolvency (see also section 2) already in 2010. The country’s debt already in 2010 was classified as “not to be sustainable with high probability” (see IMF 2013, p. 18).

“The Fund approved an exceptionally large loan to Greece under an SBA in May 2010 despite having considerable misgivings about Greece’s debt sustainability (...). The decision required the Fund to depart from its established rules on exceptional access. (...) The euro partners had ruled out debt restructuring and were unwilling to provide additional financing assurances” (IMF 2013a, 32).

Despite this, the IMF agreed with its European troika partners to provide liquidity to Greece. Consequently, the Fund changed the EAP in 2010. “The chosen course was therefore to amend the policy to create an exception to the requirement of ‘high probability’ in circumstances where ‘there is a high risk of international systemic spill overs. Eventually, the planned adjustment proved unfeasible and, despite additional official sector financing on supportive terms, private debt restructuring became unavoidable and was launched in February 2012” (IMF 2013b, p. 20).

With this exception for the lending for Greece despite serious doubts of its fiscal solvency, the IMF clearly went behind its own lessons achieved in emerging market crises and translated in rather clear-cut frameworks. The IMF itself explains its behaviour with a multiple set of interests in borrower and creditor countries to delay a restructuring of unsustainable debt.
“Authorities are also concerned about a restructuring’s impact on market reaccess and spillover effects on the private sector.17 In addition, official creditors have sometimes contributed to delays, out of concern that a restructuring would reduce incentives for the debtor country to adjust, force banks located in official lenders’ countries to recognize losses, and trigger market turmoil affecting similarly-situated countries, or to preserve flexibility for the future. Private creditors will also naturally wish to avoid a debt restructuring if at all possible, and will therefore press for a bailout by the official sector” (IMF 2013b, p. 21).

At the same time, the IMF clearly acknowledges that liquidity provision in a case of insolvency is much more costly than a direct debt restructuring effort: “[…] when a debt restructuring is the only option to deal with a liquidity shock or to restore solvency, e.g., in situations where available financing and policy adjustment have been exhausted, delays end up amplifying the ultimate costs. Also, if authorities come very late to the Fund for financial assistance and have run out of funding, it may not be feasible to execute a preemptive debt restructuring ahead of a Fund arrangement (though a restructuring could be envisioned for completing a subsequent program review)” (IMF 2013b, p. 20f).

It is just now that the IMF discussed a new framework (IMF 2013b, and 2014) to address cases of illiquidity and insolvency. The IMF has recently redeemed the exceptions made in 2010 for the case of Greece. Further to this, a third option besides the classification of liquidity and insolvency crises is introduced for cases that cannot be clearly classified as the one or the other. In those cases, a country shall be offered a prolongation of maturities instead of liquidity or debt restructuring. In case of a successful so called reprofiling, the creditor’s loss is less than in the case of a restructuring. In case the crisis worsens, a restructuring is conducted. Both, the concept of multiple equilibria as well as the IMF’s own experience in Argentina and Greece show that such workaround is associated with much higher costs and a prolonged crisis if a prolongation of maturities does not do the trick. The subsequent restructuring is much more costly for both sides and possibly enables creditors to delay the restructuring altogether.

5 Conclusion
In conclusion, one can say that the Europeans’ hopes that they could benefit from several decades of IMF crisis management experience has not been completely fulfilled. Especially, fundamental insights in the design of assistance packages have been neglected even though there has been evidence that the IMF staff was well aware that the design of the euro-zone troika programmes was against better institutional knowledge. As the policy choices against the IMF’s learned lessons have arguably contributed to the depth and duration of the euro-crisis, this failure is a serious shortcoming of the troika set-up.

This offers a number of questions for future research: One important question would be why the IMF did not push more for its learned principles to be applied in the euro-crisis. Was it because it was only a “junior partner” in the troika programmes with the larger share of the funds disbursed coming from European sources? Or was it because of the political economy of the IMF’s governance structures and the fact that EU countries are among the most important shareholders of the Fund?

Depending on the answers to these questions, important policy conclusion could be drawn about the future set-up of assistance programmes and the IMF. If it was the Europeans’ influence in the fund which led to these sub-optimal policy designs, this would call for reforms in the IMF’s governance
structure. If it was undue influence of the senior partners in the troika, then the IMF should think about refraining of such joint assistance programmes.

**Literature**


Asmussen, Jörg (2012): Griechenland ist keine Bedrohung für die Welt”. Interview, Financial Times Deutschland, 20 Feb., p. 17.


