Testimony to the Joint Hearing of the Subcommittee on International Monetary Policy and Trade and the Subcommittee on Domestic Monetary Policy and Technology

"The Role of the International Monetary Fund and Federal Reserve in Stabilizing Europe"

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There is broad based consensus that the roots of the Greek crisis lie in large accumulated internal and external imbalances and weak and deteriorating competitiveness. While the public and private sectors were both to blame, large fiscal deficits masked with the assistance of international banks was the primary culprit. The underlying vulnerabilities were exacerbated by the global financial crisis and the resulting economic downturn and increased risk aversion reinforced by sovereign risk vulnerabilities elsewhere in the region, ultimately leading to a full fledged crisis.

The buildup of these vulnerabilities reflects not only a failure of governance on the part of Greek authorities but inadequate surveillance on the part of European institutions and the IMF. The IMF's Article IV consultations in 2007 had highlighted many of these vulnerabilities (although not to their full extent) but the lack of subsequent action is indicative of the asymmetry and lack of traction of IMF surveillance in advanced countries.

There can also be no doubt that the delay in coming to the IMF and in the announcement of a comprehensive program was costly. This delay has clearly contributed to the deterioration of market sentiment, led to global contagion and spillover effects and made the pace and design of adjustment measures more difficult.

Given the depth of the challenge, and the systemic implications not only for Europe but for the world economy, it is appropriate for the IMF to play a key role and to extend support to Greece. The scale of the standby that was recently approved by the IMF Board was unprecedented relative to quota (3200 percent) although comparable to some others relative to GDP. This "exceptional access" was based on the scale of financing needed even with the European support and the systemic risks involved. In principle this is fully consistent with the IMF's role as a guardian of international financial stability and ability to meet the needs of all members.

But there are some specific constraints in the case of the Greek situation that make the program more difficult and risky. In particular, the restriction of being part of the Eurozone, which curtails the ability to use monetary policy or address competitiveness through the exchange rate, and the decision not to pursue voluntary or involuntary debt restructuring make the design of the program more difficult. Exit from the euro or debt restructuring entail their own risks with potential spillover effects, but the constraints imposed by the present approach require the program to be much more draconian.

In particular, the program calls for a very large and upfront fiscal adjustment based on expenditure and wage cuts, structural reforms to boost competitiveness and measures designed to protect the financial health of the banking sector. The program also includes specific measures to protect the vulnerable. But there is an inherent tension given the immediate impact of the fiscal measures on growth and employment and the longer-term payoff from structural reforms.

The downside risks of the program are considerable. Social unrest could undermine the government's ability or resolve to implement the austerity measures. Growth could be much more adversely affected leading to a vicious rather than virtuous path to debt sustainability. Market confidence may not be restored keeping risk premia and financing costs high. The lessons from Latvia, where growth plummeted, or from Argentina, where the elusive quest for market confidence led to a downward spiral and crisis, are sobering.

It will be important therefore for the IMF to carefully monitor the situation, develop contingency plans, maintain its independence as a multilateral institution and protect its preferred creditor status. All of these are well recognized by IMF Management and its Executive Board. Nevertheless the challenges of implementing the program will be immense.

The Greek crisis has heightened concerns of contagion elsewhere in the region. The IMF may therefore be called upon to provide support to other countries in conjunction with the new European Stabilization Mechanism. Such contributions would need to be assessed on a country-by-country basis but would be consistent with the IMF's mandate. These interventions must also be carried out in a way that safeguards the IMF's resources and protects against future moral hazard through conditionality and private sector involvement.

As a result of the tripling of the IMF's resources agreed to by G20 Leaders and the Governors of the IMF, including through the enhanced New Arrangments to

Borrow, the IMF has sufficient resources to respond to these potential needs while preserving the capacity to support other regions in the developing world. But the IMF must remain a quota-based organization with adequate long-term resources to fulfill its mandate. There is a need therefore for a very substantial increase in IMF quotas in the next general review to be completed by January 2011, with appropriate balance between quota and NAB resources.

The enhanced oversight and financing role of the IMF in the wake of the crisis underlines the importance of governance and voice reform if it is to be an effective and legitimate multilateral institution. A key aspect of the change needed is to address the over-representation of Europe and the under-representation of emerging markets and developing countries. Europe occupies 8 to 9 of the 24 seats at the IMF Board and accounts for around 32 percent of voting power compared with Europe's share of 7.5 percent of the world population and 23 percent of the world economy. [1] An ambitious realignment of quota shares as called for G20 leaders and other reforms to increase the voice of emerging markets and developing countries will be crucial for the IMF to effectively assume this larger role.

[1] "Europe's Governance Stalemate Causes Gridlock for Global Governance Reform", Amar Bhattacharya, Colin I. Bradford and Johannes Linn, The Brookings Institution, April 23, 2010