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

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Chairmen Meeks and Watt, ranking members Miller and Paul, and the other honorable members of your subcommittees, I appreciate the opportunity to appear before you to discuss the role of the International Monetary Fund and the Federal Reserve in stabilizing Europe. I will focus primarily on the first aspect of this topic.

The Greek tragedy, which is now on center stage, was largely of the Greek authorities' own crafting. However, it also emerged as an aftershock of the global economic and financial crisis of 2007-09 and has set off a European crisis. The challenge is to manage the European crisis so as to minimize the negative fallout on the fragile global economy and financial system and to reduce the severity of other aftershocks, which inevitably will occur over the next several years. How successfully the Europeans, the United States, and other systemically important economies deal with that challenge will determine the strength of our own and the global economic recovery now underway.

The risk is that the European situation will spiral out of control, spread within Europe beyond Greece and push Europe back into recession, and further damage the US and global economy and financial system. Twenty percent of US exports of goods go to the European

Union. As of the end of 2009, US bank exposure to the European Union was $1.5 trillion, half the total foreign exposure of US banks.[1]

The world economy will not recover without a reasonably healthy European recovery. The US economy will not enjoy the sustained recovery without global recovery. That was the key lesson of the global crisis of 2007-09. Crises that initially affect large parts of the global economy and financial system have adverse impacts in all parts of the globe.

The major policy instrument available to the United States to contain the European crisis aftermath is the International Monetary Fund (IMF). The United States should continue to provide maximum, constructive support for the IMF in carrying out its responsibilities for the promotion of global growth and financial stability.

I will summarize my testimony this afternoon with eight points.

First, the program of Greek economic and financial stabilization and reform program approved by the IMF Executive Board on Sunday, May 10 is ambitious and demanding. It may fail, but it is in the collective interest of the United States and the international community to give the people and authorities of Greece time to implement at least the first phase of their program.

Second, the European Union (EU) authorities delayed too long in providing a framework to support economic reform and to provide the necessary financial support for Greece. Consequently, the financial contagion has spread to other countries in the euro area, and perhaps beyond. For possible future use, the EU authorities are now putting in place a European Stabilization Mechanism (ESM) and have taken other steps to contain the crisis, including

[1] US bank exposure to the Euro Area was almost $1 trillion. These data are from the Federal Financial Institutions Examination Council's Country Exposure Lending Survey released on March 26, 2010.

unconventional actions by the European Central Bank (ECB). The IMF may be called upon to cooperate with the ESM, using the Greek program as a template. A positive response by the IMF to such a request, on appropriate terms, is fully consistent with the Fund's core mission. Meanwhile, the Federal Reserve System has reactivated some of the swap arrangements that were deployed to contain the recent financial crisis and its impacts on financial markets – in my view appropriately.

Third, the IMF is not, and should not be viewed as, an institution that lends only to emerging market and developing countries. Each IMF member may call upon its financial resources. Since the IMF's founding in 1944, the vast majority of members have done so, including the United States as recently as 1978. The role of the IMF is to provide prompt and persuasive policy advice and to help design and finance economic reform programs.

Fourth, beyond its traditional role with respect to macroeconomic policies, which is much needed to restore and maintain economic growth in Europe, a key area of needed IMF policy advice for Europe is on strengthening their banks that now face the high probability of another round of substantially impaired assets and the risk of sovereign defaults.

Fifth, all IMF-supported reform programs involve a balance between painful policy adjustments that adversely affect economic growth in the short run and necessary, temporary financial support. The correct balance between adjustment and financing is a matter of intense disagreement, but both are required. Striking the right balance is a matter of judgment. The correct judgment depends on the economic and financial circumstances of the country requesting support as well as in the global economy and financial system at the time.

Sixth, the contribution of IMF lending to perpetuation of moral hazard is greatly exaggerated under current, and most, circumstances. For the potential borrowing country, the greater problem is the stigma of borrowing from the IMF, which causes crisis-stricken countries to delay requests to borrow and creates incentives to self-insure by amassing huge stocks of foreign reserves, which is expensive for the country and distorts the global economy and financial system. On the creditor side, in most cases, investors take substantial hits to their reputations and to their balance sheets even though that does not deter others from repeating their mistakes.

Seventh, I am not greatly concerned that the IMF will be called upon to lend more to European countries, will run out of resources to lend, or will leave non-European members of the IMF in the financial lurch.

Eighth, citizens of the United States have a great deal to gain from successfully containing the European crisis. However, if the US and global economy are to recover decisively and enter a period sustained expansion, more needs to be done beyond simply containment. US policy should be oriented toward further substantive and financial support for the IMF in order to provide more confidence in the global economic outlook and in the restoration of financial stability.

In the remainder of my prepared testimony, I expand on these eight points, grouped together as three related topics: Greece and the European crisis, the role of the IMF in Europe and beyond, and the implications for the United States and US policy.

Greece and the European Crisis

The Greek economic and financial stabilization program requires a huge, but not unprecedented, amount of fiscal adjustment along with other needed policy measures to restore Greece’s external competitiveness. On top of the country’s general government debt estimated at 115 percent of GDP at the end of 2009, its gross external debt was 168 percent of GDP, and it had a negative international investment position of 83 percent of GDP.

The IMF-EU-supported economic and financial reform program may not be successful, in particular because it will unfold against the backdrop of a very weak European economy and only a moderate recovery of the global economy. But Greece should be given the chance to implement its program.

Greece's government debt is estimated to have reached 115 percent of GDP in 2009, boosted by a public sector deficit estimated at 13.6 percent of GDP and accompanied by a 2 percent decline in real GDP and almost a percentage point decline in nominal GDP. The Greek program calls for a reduction of its budget deficit by 8.8 percent of GDP by 2013 in order to stabilize its government debt at 149 percent of GDP in that year before its debt ratio starts to decline. Before the projected pick-up in Greece's economy in 2012, it will have contracted 9.2 percent in real terms and 6.7 percent in nominal terms, which are probably optimistic projections.[2]

Some observers advocate an immediate adoption of an alternative approach that would involve a restructuring in which the stock of Greek government debt would be written down. A restructuring may ultimately be necessary, but it is not a cheap or easy way out. The broader negative ramifications for the world economy and financial system could be severe right now when the recovery is still fragile. Moreover, if there is to be a restructuring of Greek debt, it should be a one-time event, and its appropriate dimensions are obscure right now.

[2] The data and projections in this and the following paragraphs are from *Greece: Staff Report on Request for Stand-By Arrangement*, IMF Country Report No. 10/100, May 2010.

Under either approach, the citizens of Greece would still have to undergo a massive fiscal contraction to produce a primary budget surplus; that is the fiscal balance excluding all debt servicing costs. The deficit in Greece's primary balance was an estimated 8.6 percent of GDP in 2009 and is not expected to reach positive territory until 2012.

Greece and its political leaders are in hazardous territory, but the financial assistance from Greece's European partners and from the IMF is not creating additional moral hazard. The bad incentives were established long ago by the flawed architecture of the Economic and Monetary Union in Europe.

As long as one assumes that Greece will repay the extraordinary financial assistance it is receiving from official sources, foreign taxpayers will be subsidizing Greek taxpayers, but they will not be bailing them out. Nevertheless, it is doubtful that other countries will willingly elect to follow Greece down the road it has taken. Some creditors will benefit from the IMF-EU support of Greece's economic and financial reform program. That is the inevitable consequence of such efforts: some undeserving creditors escape from the consequences of their actions. However, even without a write-down of Greek government debt, many investors in that debt already have sustained substantial paper losses and creditors to the Greek private sector already have absorbed losses that will mount further. Greece's creditors may have thought they would be bailed out, but to a substantial degree they were mistaken. This will not stop other investors from making similar mistakes in the future, but it will also not encourage them to do so. Finally on this set of concerns, the risk to US taxpayers of non-repayment of funds advanced to Greece or other borrowers through the IMF is essentially zero. The IMF is a preferred creditor, and no country lending to or through the Fund has ever recorded a loss.

Cold-turkey fiscal adjustment by Greece that is accompanied by a debt moratorium, a suspension of payments, or a debt restructuring is also not a cheap or easy way out for the rest of Europe or the global economic and financial system. The adverse effects on other markets and economies would be substantial. The potential effects are already being felt as risk aversion returns to equity markets, credit markets again are freezing up, commodity markets discount the prospects of a strong global recovery, and the euro has fallen to its lowest level in real effective terms in eight years.[3] The weaker euro may be good news to exporters and producers competing with imports from abroad, but that stimulus is unwelcome elsewhere, and it is likely to be swamped by the weakness in domestic demand within the Euro Area.

Because the European Union did not have mechanisms in place either to force responsible fiscal management or to support fiscal adjustment and because EU leaders delayed for months before cobbling together a mechanism to provide some measure of financial assistance, Europe is now undergoing a massive process of fiscal retrenchment.

Economic crises in Europe spread from Hungary, Latvia, and Romania, which represent a combined 2 percent of estimated European Union (EU) GDP and were already operating under IMF-supported economic adjustment programs, to Greece, another 2 percent of EU GDP. Now, crisis-related fiscal adjustment is underway in countries representing more than 40 percent of EU GDP.[4] These adjustments have been forced on the citizens of the countries involved and, at this point, they cannot be avoided. However, it is difficult to imagine how Europe will avoid a double-dip recession.

[3] My statement is based on the broad real effective exchange foreign exchange value of the euro calculated by the Bank for International Settlements (BIS) as of April 2010 adjusted by the euro's further decline against the US dollar since the end of April to 1.24 US dollars per euro.
[4] In addition to the four countries mentioned in the text, this calculation includes Ireland, which embarked on its fiscal adjustment program earlier than other countries, Italy, Portugal, Spain, and the United Kingdom.

Against this background, it is appropriate that the leaders of the European Union, the ECB, the central banks of other countries, and the IMF have acted to try to mitigate the extent of the European economic and financial crisis and its inevitable negative effects on the rest of the world.

The Role of the IMF in Europe and Beyond

Is the role of the IMF in the Greek crisis and elsewhere in Europe consistent with the IMF's mission? My answer is yes for four reasons.

First, the IMF is a cooperative international organization with near-universal membership. Its mission is to promote sustainable global growth and financial stability.

Second, all members of the Fund should be eligible to borrow from the institution under appropriate conditions. The availability of IMF financial assistance along with advice on reform or adjustment programs is in the interests of all countries because all countries benefit from sustained, balanced growth and global financial stability.

Third, the Fund carries out its mission through its surveillance, policy advice, and lending programs. Those three mechanisms are, and should be, available to all members even if the wealthiest IMF members for a long time had not availed themselves of IMF lending facilities since the 1970s.

Fourth, IMF lending operations have not been limited to developing countries in recent years. In November 2008, Iceland embarked on an IMF-supported economic reform program. Its estimated per capita GDP on a purchasing-power-parity basis in 2010 is estimated still to be 25 percent more than Korea's, which borrowed from the IMF in 1997 and was the world's 11th

largest economy at that time.[5] Moreover, the IMF, in cooperation with the European Union, already is supporting economic reform programs in Hungary, Latvia, and Romania. The wealthiest of those countries, Hungary, has an estimated GDP per capita that is less than half the GDP per capita of Korea. True, these countries are members of the European Union but are not part of the Euro Area. In retrospect, the Euro Area versus non-Euro Area distinction diverted the Europeans from acting promptly in Greece. The distinction primarily reflects the pride of the political elite in the countries using the euro as their currency. For reference, within the Euro Area, Greece's per capita GDP is approximately the same as Korea's as is Spain's, but Portugal's is 25 percent lower.

Since the late 1970s, the practice has been to use EU mechanisms to address the economic and financial problems of members of the European Union. The results were economic and financial programs that tilted the balance between adjustment and financing too far toward financing with insufficient adjustment. It was no surprise that, prior to the present crisis, the authorities in EU countries went to Brussels for help rather than to Washington. During those decades, policymakers in Washington were generally content that EU countries were not borrowing from the IMF because the IMF could then concentrate its limited resources elsewhere. However, in retrospect US policymakers should have promoted European adjustment assertively, including through the IMF. As a former Federal Reserve official, I hold myself partly to blame for this failure. The pattern of limited adjustment in Europe became part of the problem and contributed to the present crisis in Europe that now is threatening all of us. European official

[5] These 2010 estimates of GDP per capita on a purchasing-power-parity basis are from the IMF's *World Economic Outlook* database.

now apparently grudgingly recognize that the credibility of IMF policy conditionality is greater than that of their own conditionality.

Is the IMF likely to exhaust its financial resources in lending to European countries and become unable to lend appropriate amounts to other members of the IMF? My answer is no.

The Economic and Financial Council (Ecofin) of the European Union on May 9 decided to establish a European Financial Stabilization Mechanism, often referred to without the word "financial" as the European Stabilization Mechanism (ESM), with potential financial resources of up to EUR 500 billion, or about $650 billion at an exchange rate of $1.30 per euro. In their decision the Ecofin stated, "The IMF will participate in financing arrangements and is expected to provide at least half as much as the EU contribution through its usual facilities in line with recent European programmes." That expectation implies as much as $325 billion in financing could come from the IMF. This may be the European expectation as part of their contingency planning, but it does not reflect an understanding of the way the IMF does its business. The IMF operates on a case-by-case basis.

References also have been made to using the "template" of the Greek program as a model. Templates are flexible. In fact, for the Greek program, potential IMF financing amounts to three-elevenths, or 27.3 percent, of the total of EUR 110 billion. Applying the inversion of this percentage to $650 billion produces a figure of $244 billion. However, the important point is that the IMF has not committed to lend to EU members beyond the current Greek program, even though it should stand ready to do so on appropriate terms.

How large are the IMF's available resources to make commitments to lend?

My estimate is that the IMF now has at least $250 billion in resources from usable quota subscriptions, the existing General Arrangements to Borrow (GAB) and New Arrangements to

Borrow (NAB), and ad hoc bilateral lending arrangements that have been put in place starting in late 2008. This estimate takes account of existing IMF lending commitments over the next several years, which were $120 billion as of the end of January 2010, not all of which is likely to be needed. I estimate that another $250 billion, on a net basis, should be available once the expanded NAB and 2008 adjustments in IMF quotas are in place. The IMF also follows a conservative policy in estimating its so-called "one-year forward commitment capacity," and with the consent of the IMF Executive Board that policy could be temporarily relaxed, as has happened in the past. More importantly, if history is any guide, the general membership of the Fund will not allow the IMF to run out of financial resources. I return to this point at the end of my prepared testimony.

It is useful to review the procedure the IMF uses to draw upon members' quota subscriptions to finance its lending operations. Every three months, the IMF draws up a "financial transactions plan," which it releases after the end of the period. The quotas of IMF members included in the financial transactions plan are drawn upon proportionately to finance IMF lending operations.

As of the end of January 2010, the latest information that is available to the general public, the IMF had $213 billion in available resources from the quota subscriptions of 52 members, about 80 percent of those members' quotas, which in turn amounted to slightly more than 80 percent of total IMF quotas. The list included 21 members of the European Union, the United States and ten other members of the Group of 20 (G-20), and 20 other members of the Fund. My assumption is that Greece and, maybe, four other members of the European Union are not now included in the financial transactions plan right now. Excluding those countries, but assuming the plan is otherwise the same, about one third of all IMF lending comes from EU members (23 percent from members of the Euro Area), 56 percent comes from other G-20 members (22 percent from the United States), and 11 percent comes from other members of the Fund. Thus, a large chunk of any IMF financing of programs of countries in the European Union comes from other EU members, and the remainder is spread around broadly. The IMF was designed a financial cooperative available to all members.

Finally, it is relevant in this context that IMF financial support of lowest-income, developing-country members does not draw upon the general financial resources of the IMF that would be used for lending to European members. The financial assistance to the lowest-income members for facilities such as the Extended Credit Facility and the Exogenous Shocks Facility relies upon mechanisms that fund the Poverty and Growth Trust in the form of repayments of previous loans or direct borrowing from other IMF members.

Returning to IMF responsibilities with respect to Europe, it is crucial in the period ahead that the IMF's policy advice is tailored to the maximum possible degree to the restoration and maintenance of domestic demand growth in Europe as a whole. This will require that in those countries with the fiscal scope to adopt policies that are calibrated to maintain support for their own, their partners', and the global economy. Many countries, including our own, must repair their fiscal positions and reduce the scale of government debt. However, in the global context, where some countries have no choice but to take drastic actions to repair fiscal weaknesses and restore debt sustainability in the face of market pressures, other countries should be more patient and deliberate if no less decisive.

Monetary policy will also be a challenge for the Europeans going forward, in particular, for the ECB and the Euro Area. Some countries using the euro will have to experience deflation – absolute declines in their price and wage levels – in order to restore their competitive positions within Europe and globally. From February 2002 to April of this year, the real effective exchange rate for Greece had appreciated by 15 percent relative to that for Germany.[6] For Spain, the figure is 10 percent. Thus, relative price levels must change substantially within Europe. To accomplish this adjustment, the ECB needs to achieve, if not exceed, its objective for inflation of less-than-but-close-to 2 percent for the Euro Area. This is necessary if countries such as Greece and Spain are not to experience absolutely crippling deflation. The IMF's April 2010 World Economic Outlook projection was that inflation in the Euro Area would be 1.1 percent this year, a number that now looks high, and will only reach 1.9 percent in 2015. This path for inflation will not do the trick.

Meanwhile, the ECB must keep an eye on the weakness in the euro. If the euro's decline continues substantially further, it would undermine the process of global rebalancing that should be underway. All members of the IMF have an interest in the ECB's success in meeting these challenges, and the IMF has the institutional responsibility to help to channel that interest constructively.

In the face of the inevitable further deterioration of balance sheets of financial institutions in Europe, resulting from the present phase of the crisis, the IMF also should encourage the Europeans to conduct another round of stress tests of their major financial institutions and, this time, to publish their methodology and the results of the tests. If the results reveal that most EU banks have adequate capital cushions, European and global financial stability would be boosted. If the results reveal the need for additional capital and the institutions are unable to raise it in the markets, governments should provide the capital support under appropriate terms and conditions.

[6] I am using the BIS broad indexes for real effective exchange rates.

Meanwhile, the ECB should continue to be imaginative in its support of financial institutions and markets.

Implications for the United States and US Policy

I will not dwell on our own, well-known economic policy challenges for which the IMF can offer dispassionate advice that we would be well advised to absorb. Suffice it to say that in the future, US growth must be driven by a balanced expansion in domestic production of goods and services and in domestic demand for goods and services. If the growth of US demand outstrips the growth of US production, our trade and current account deficits will widen further, and the risk of a disruptive correction increases. Thus, we need a healthy and expanding global economy to keep the proper balance between our imports and exports. In the first quarter of this year, US exports of goods to the European Union increased a meager 2 percent while our total exports rose by 20 percent. We also need a foreign exchange value of the US dollar that is not artificially boosted because of economic and financial weaknesses elsewhere. The IMF has an important role to play in each of these areas, and the United States should strongly support an enhanced role for the Fund in economic and financial surveillance.

The IMF is in the process of completing its assessment of the US financial sector under the IMF's financial sector assessment program (FSAP), which in 2006 the US authorities finally agreed to undergo. The resulting financial system stability assessment (FSSA) will be released later this summer once it has been reviewed by the IMF Executive Board. The US authorities are to be commended for agreeing to release the FSSA and for agreeing to the release last week of seven detailed assessments and four technical notes. I doubt if an earlier review of the US financial sector would have revealed the depth of the problems exposed by the 2007-09 crisis, but it would not have hurt us. Nevertheless, the standing of the United States in the world was adversely impacted by the perception that the US authorities thought they had nothing to gain from an FSAP.

The global economic and financial crisis and European crisis aftermath have important implications for other aspects of US policy toward the IMF and its membership. Given that the US Congress led the way in approving the expanded NAB and an increase in our IMF quota about one year ago, the United States is well positioned to press other countries to accelerate their own approval processes.

With respect to the need for additional financial resources for the IMF, one lesson of the European crisis is that the IMF's regular resources need to be further expanded. I have long advocated establishing a framework for the IMF to borrow limited amounts in the private markets. But that is not enough. Crises and the need for coordinated financial responses to them are not going away. As much as possible, the IMF should not rely on *ad hoc* borrowing arrangements.

Negotiations are now underway and should be completed by the end of the year to augment the IMF's regular quota resources. I favor a doubling of the IMF quotas, which would add about another $250 billion to the Fund's lending capacity. This will require Congressional approval unless the United States opts out of an increase in its quota, which, I expect, will not be the case. Obtaining Congressional approval for increases in the US quota in the IMF is never easy. I bear some scars from previous efforts. However, in the end, I hope it will again be recognized that the citizens of the United States have a great deal to gain from a financially strong and effective IMF.

The current negotiations on the total size of IMF quotas also will result in a further realignment of IMF quota shares as well as, I hope, address other IMF governance matters. The

European crisis underlines the importance of shifting away from relying as much as in the past on IMF financial resources provided by European members of the Fund and toward greater reliance on other countries that may not have an immediate need to borrow from the Fund. That shift in relative financial contributions will foster a much needed shift in voting power and influence in the IMF from its European members as a group toward other members, which is long overdue.

Thank you.