opinion piece

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IMF-EU Conditionality in Greece: Learning from mistakes?

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Abstract

The IMF Stand-by arrangement with Greece, agreed jointly with the EU in 2010, was one of largest IMF operations ever. However, it had to be cancelled in early 2012 as it clearly went off track. A new and much larger joint IMF-EU program was approved in March 2012. This paper analyzes why the original program did not succeed and what are the chances of the new one. The conclusion is that both programs underestimated the importance of structural reforms in achieving an exceptionally large internal devaluation that is necessary in Greece.

[1] Croatian National Bank (CNB), Senior Advisor in Governor's office, also a former IMF staff member. The expressed views are the author's and should not be seen as necessarily reflecting positions of the Board and management of the CNB, or SEESOX. The paper was finished in April 2012.

Introduction

Less than two years ago, in May 2010, the Board of the International Monetary Fund (IMF) approved a 3 year Stand-by arrangement (SBA) for Greece. The program aimed at achieving fiscal consolidation, improving competitiveness, preserving stability of the financial system and restoring access of Greece to capital markets by end-2012. Already in 2012 the economy was expected to grow again at 1%. In the same year, the primary budget balance would reach a surplus of 1% of GDP, and it would continue improving to a surplus of 6 percent by 2015. The primary balance would stay at this high level in subsequent years to facilitate fast reduction in the public debt to GDP ratio, after its peak at 140% in 2013. The total official assistance provided by the IMF and the EU over the program period 2010-2013 would amount to 110 billion euro, of which the IMF would contribute 1/3, and the EU 2/3. Private sector debt reduction (a haircut) was not envisaged.

In March 2012, the IMF cancelled the SBA and approved a new 4-year Extended Financing Facility (EFF).[2] To allow that the new program can cover 4 years the IMF had to amend its rules, which until that time envisaged three years as the maximum length of the program at the time of the approval.

The objectives of the new EFF are fundamentally the same as those of the SBA albeit less ambitious while a haircut is now imposed on private creditors. The recovery is now expected to start in 2013, with a positive annual GDP growth rate to be achieved only in 2014. The access to capital markets is expected to be partially restored by 2016, but the official assistance would remain required in 2016 and later. The target for the primary budget balance in 2012 is now by 2 percentage points lower than in the original plan (a deficit of 1% instead of a 1% surplus).

Once the fiscal adjustment is completed in 2016, the primary balance target is set to be maintained at 4.5% of GDP, which is 1.5% less than targeted under the SBA. In the EFF this is explained as being more in line with the past performance of Greece. Most of the adjustment in the primary balance would be achieved in 2013 and 2014 (5.5 percentage points relative to GDP). The public debt ratio, after reaching some 167% of GDP in 2013, would fall to 117% of GDP by 2020. However, this now required a restructuring of debt to private creditors with a haircut equal to 53% in nominal terms and about 70% in net present value terms, which was accomplished in March 2012.

Official assistance is now projected to reach 185 billion euro in 2012-2016. Together with already disbursed 73 billion euro in 2010-11, the cumulative assistance will reach 260 billion euro or 120% of Greece's GDP in 2011. This is more than double the amount

[2] Stand-by is the workhorse of IMF lending facilities, usually approved for a period of 1-2 years. The EFF is a facility that is expected to have a stronger structural component, and it used to be approved for a 3 year period.

envisaged under the SBA, and comes after the private sector haircut. However, the IMF's share in total financing will be sharply reduced relative to the SBA, to only 12% during 2012-14. Some 10 billion euros of required assistance in 2015 and 2016 remain uncovered by the current IMF-EU program, which means that the need for another program is already indicated.

Why did the first programme not succeed?

No IMF program has ever been revised to such an extent. In principle, such revisions might reflect the following reasons: 1. Unexpected external shocks. 2. Weak implementation. 3. Inappropriate design.

We can discount the unexpected external shocks. Growth in the euro zone eventually came out stronger than projected at the time of the SBA negotiations, by 0.8 percent in 2010 and by 0.1 percent in 2011 (Figure 1). Greece's spreads deteriorated, but this did not particularly affect domestic financing, given the huge liquidity support provided by the ECB. This is clearly demonstrated modest decline in the current account deficit between 2009 and 2011 declined of only 1.2 percentage point of GDP, from 11.1% to 9.8% of GDP, despite substantial fiscal consolidation. (The original program projected a decline of 4 percentage points.) In fact, the private sector S-I balance worsened in 2010. This indicates that financing constraints were absent, which the EFF staff report also admits. In any case, the deterioration in the spreads was not an external shock, given that it was also market reaction to the agreed program.

The scale of fiscal consolidation achieved in 2010 and 2011 was in line with the target (Figure 2). The fiscal consolidation was the main objective of the program and therefore its implementation matters most for assessing whether the failure of the program was caused by weak implementation or not. The cumulative adjustment 6.4% of GDP in 2010 and 2011 was even higher than the originally targeted 6% of GDP, most of it achieved in 2010. The picture is somewhat obscured by the fact that the starting point, the deficit in 2009, was revised up from 13.6% in the original program to 15.7% of GDP in the later documents.

This revision seems to reflect some one-time factors, including the widening in the scope of the general government sector. As a result, it is not clear whether reliable time-consistent series of data is even now available. Nevertheless, the substantial cut in the budget deficit was achieved. Unfortunately, some 3 percentage points came from increased tax revenue-to-GDP ratio (compared to the original target of 2 percentage points), despite the sharp contraction in output. This obviously did not help in strengthening the supply response. On the expenditure side, the best achievement was a pension reform that will have long-term effects. This, however, turned a prospectively catastrophic pension system into a mere problematic one: Pension spending is still expected to grow relative to GDP and further reform is now required under the EFF.

In respect to structural measures, the original program was extremely thin. It included only a general description of the need to reform the wage bargaining and wage arbitration frameworks, reduce the minimum rage for younger workers, establish one-stop shop for investors, and reform the so-called closed professions, including transportation by trucks. It is not clear why the program took such a soft stance on structural reforms. One explanation might be that at time the IMF was trying to create impression that its conditionality was no longer intrusive, and that countries should not be reluctant to seek assistance, all this with idea that expansive IMF lending could ameliorate the global crisis. Along this line, the IMF Board abolished the so-called structural performance criteria from various lending facilities.

The delivery of structural reforms was even thinner. The reduction of minimum wage for young employees was turned into a subsidy scheme, which put additional burden on the budget and lost potential effect on the wage decompression. Other issues of labor law reform were mainly postponed. Some legislative reforms to open closed professions and sectors were enacted in a watered-down form, but then necessary by-laws were not approved and the measures remained ineffective. Given however how un-ambitious the original program was in respect to the structural reforms, the large deviation of the macroeconomic outcome from the original projections cannot be attributed to the weak delivery of structural reforms. There should, however, be no doubt that the government did not demonstrate much reform-oriented enthusiasm. This is demonstrated by the fact that problems with misreporting data have continued. As a result, the IMF staff in report for the 5th review of the SBA had to request waivers not only for performance criteria but also for non-complaint first, second and third purchases under the SBA.[3]

The SBA documents referred frequently to the need for improving competitiveness, but only in general terms. It was reported that the overvaluation of the real effective exchange rate (REER) at the start of the program was in a range of 20-30%.[4] This suggested that Greece needed a massive internal devaluation. Against this background, measures to improve competitiveness were clearly insufficient. The staff report pointed out that the government could consider eliminating law the 13th and 14th salaries in the private sector by an act of law, but it did not press the authorities on this issue. On the other hand, the government took position against nominal reduction of wages outside the government sector, expecting the adjustment to come from increased productivity. Given the scale of the problem, this was hardly a realistic position.

Having excluded the unexpected shocks and the weakness in implementation, we are left with the conclusion that the main cause of failure was the design of the program itself. Sufficient measures for improving competitiveness were clearly missing. The excessive reliance of fiscal consolidation on increased taxation and this when tax rates in Greece were already on the high side was clearly counterproductive for improving competitiveness. Moreover, given the size of REER misalignment, the macroeconomic framework envisaging return to growth in 2012 was clearly unrealistic.

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[3] See paragraph 66 in the Staff Report for the 5th Review.

[4] Staff report on the request for the SBA, IMF, 2010. In 2009, Article IV staff report estimated that the REER of Greece was above the equilibrium value between 22.5% and 33.8%, depending on the methodology,

Soon it became clear that the macroeconomic framework of the program was unraveling. The SBA projected a total decline of GDP between 2010 and the lowest point (in 2011) of only 6.5%. The new EFF now realizes that the cumulative output drop between 2010 and 2012 will be much higher, some 14.5%, which is still very optimistic (Figures 3-4). Once the output path has been revised, it became obvious that Greece does not have chance to reduce its public debt ratio to 120% of GDP in any foreseeable future even if it succeeds in running primary surpluses of 4.5% of GDP (Figure 5)..

The old program therefore had to be scrapped. With the public debt ratio becoming obviously explosive, there was no other solution than to impose a large haircut on private creditors and increase the IMF-EU assistance. The haircut for the remaining private creditors now had to be larger, given that the official creditors insisted on their seniority status and in the meantime some private creditors managed to get out. This however brought bad reputation to the IMF-EU lending operations that now adversely affect possible programs with other countries. Furthermore, the fact that the IMF and the EU signed off on the ex-post introduction of collective action clauses in existing sovereign debt instruments is not going to help sovereign bond markets either.

Why is the EFF not promising either?

On the positive side, the new EFF discusses the competitiveness issue more in detail. It points out that so far the large current account deficit (9.8% of GDP in 2011) continues, despite the deep recession. It reports on the absence of real effective depreciation as measured by CPI, and only a limited improvement if measured by unit labor costs (ULCs,) by 9.6 percent (Figure 6-8). Most importantly, the authorities now explicitly accept that the additional adjustment of 15-20% in ULCs is needed to restore competitiveness.

However, although the need for reducing labor costs is now acknowledged, the envisaged measures are insufficient. First, the minimum statutory wage would be immediately cut by 22%, but this would come from the current exceptionally high level of some 800 euros per month, which is about 5-7 times higher than in Bulgaria and Romania, and 50% higher than in Portugal.[5] Moreover, the authorities insisted that this reduction remain in force only during the duration of the IMF program, which does not bode well for their commitment to the program. The reduction in the minimum wage is expected to reduce over time the average wage in the economy by some 4.5%. This is somewhat on the optimistic side given that only 15% of employees currently work for the minimum wage and there does not seem to be a link from the statutory minimum wage to the wage scales in collective contracts.

Second, laws have been amended with the effect that the collective contracts would no longer be automatically extended to non-participating firms if they are replaced by firm-level contracts. Third, a new legislation will change the provision according to which the collective contracts remain in force until changed by a new agreement. However, it appears that most of the existing contracts would still continue to be in force for another 1.5 years at least. Interestingly enough, the IMF staff expressed doubts that the envisaged measures would be sufficient, suggesting again that at some later stage the authorities consider legislative action to eliminate 13th and 14th salary in the private sector, which are mandated by the existing collective contracts.

Further sharp fiscal adjustment is envisaged for 2013 and 2014, but measures have not been agreed. The primary balance, which will improve by only 1.2 percentage points relative to GDP in 2012, should be increased by massive 5.5 percentage points of GDP in 2013 and 2014 combined. Owing to the decline in output and the automatic increase in some expenditure, this will require nothing less than 9.4% of GDP in new measures. *However, these measures have not yet been agreed.* They are supposed to be identified and possibly implemented by the time of the first review, which is scheduled for May 2012, despite the parliamentary elections also to be held in May. Moreover, the IMF staff already signaled that less ambitious fiscal adjustment would be desirable, disassociating

[5] The IMF staff report on request for EFF for Greece.

itself from the EU position on this issue. This means that the targeted fiscal consolidation is far from assured.

The program aims at further increasing the tax burden. The tax to GDP ratio is expected to increase by another 1.2 percentage point relative GDP in 2012, despite the fact that at 41% it is already high for a country at this level of GDP per capita and for the quality of institutions. The IMF staff is suggesting that cutting social security contribution rates by 5 percentage points would be useful for improving competitiveness, should compensatory spending cuts be agreed. However, such large additional expenditure cuts are not agreed or even identified in the program documents. (The same measure was envisaged in Portugal, but it failed in absence of offsetting measures.) Greece's social security contributions are otherwise the highest in Europe (except for Bosnia and Herzegovina), increasing the wage costs by 52.5%. (Employers contribution is 28.1% and employees' is 16%, resulting in properly calculated tax wedge of 52.5%, not 44% as reported in the IMF staff report.)[6]

Against this background, the macroeconomic framework is again overoptimistic. The GDP decline in 2012 is projected to slow to some 4.8%, relative to 6.9% in 2011. However, GDP in Q4 of 2011 was already down 7.5% year-on-year. Moreover, output in partner countries is projected flat in 2012, while it decently grew in 2011. All high-frequency indicators (new orders, composite economic sentiment, manufacturing PMI, export expectations) in late 2011 and early 2012 point to worsening prospects in 2012 (Figures 9-10). The adjustment in overall fiscal balance is going to be larger in 2012, although somewhat smaller when measured as primary balance. On balance, the output projection is therefore again overoptimistic.[7]

The revised output trajectory also raises questions if one takes into account the starting level of imbalances. For example, Greece is expected to experience a smaller cumulative decline in GDP from the peak to through of 17%, compared to 22% in Latvia, which at the onset of the crisis had the REER misaligned to a similar extent. Lower output contraction in Greece appears particularly questionable given that Latvia has much more flexible labor markets and a substantially larger export sector than Greece.

The prospects for restoring access of Greece to private markets by 2016 are unrealistic. Even in 2020 the targeted public debt ratio of 117% would still be quite high and therefore does not guarantee that Greece could return to capital markets, particularly after the recent default.

On the structural side, the program assumes commitment of the authorities to privatize some 50 billion euro of assets, but it does not push for sale of restructured banks. The bank

[6] The correct formula is wedge = (1+employers' rate)/(1-employees' rate).

[7] The National Bank of Greece has already slashed down output projection to -5%.

restructuring will require IMF/EU resources of about 50 billion euros. However, the current private owners will be offered to keep control over banks if they contribute 10% of the required additional capital. They will also be given option to repurchase government shares, whereas the government will refrain from selling its stakes over an extended period. Despite efforts to strengthen the monetary union, the concept of nationally owned banks seems to be prevailing.

The EFF now has long list of structural measures, but the focus is missing. Most of the agreed measures are of procedural and institution-building type. Moreover, their sheer number points to the fact that they lack focus.

Conclusion and looking ahead

The SBA program did not deliver its objectives because it substantially underestimated required structural reforms that could deliver the necessary internal devaluation. Admittedly, the scale of the adjustment in Greece for a country operating without exchange rate flexibility is without precedent. Designing adjustment program was therefore certainly challenging. At the end, the envisaged measures were obviously insufficient and the output projections grossly overoptimistic. It is possible that this reflected political expedience more than analytical weakness, as early in the crisis it was politically convenient to underestimate the costs of the program. However, the result was loss of credibility.

Analytical background in the EFF is now better than in the SBA, but the agreed measures are again short of what is needed. Labor market reforms are only half-hearted steps in the right direction. Many of them still remain to be implemented and will take long time to produce results. Other measures for improving competitiveness, including cuts in tax rates, prices of public monopolies, and red tape are missing. The envisaged path for fiscal adjustment is ambitious, but measures for achieving it have yet to be agreed. Expectations about the macroeconomic developments are again overoptimistic, albeit less than in SBA.

The decline in output will therefore be larger than assumed in the program, the budget deficit in the coming years will be higher, and the goal of setting the public debt on a sustainable path will again become unachievable, as well as the early re-entry of Greece to capital markets. A third program will therefore become unavoidable, either formally, or as substantial renegotiation of the current EFF. To avoid protracted recession, structural reforms will have to be substantially strengthened. Particularly important will be measures in the areas of labor laws, given the fact that unit labor costs have to be immediately reduced. It is difficult to see how the government could eliminate the 13th and 14th wage in the private sector by decree. It might be better to change labor law with the effect that all existing collective contracts immediately expire, while new ones have to be negotiated in a decentralized way. Other measures to improve competitiveness, including by controlling parafiscal costs of services provided by public monopolies should also be addressed. Cuts in tax rates, combined with broadening the base should be integrated in the program, at least over the medium term. Official donors will have to provide additional assistance, not only in cash but also by agreeing to explicit or implicit restructuring of their loans, possibly conditioned on progress in reforms. Sooner the third program is agreed, better will be chances for success.

Finally, the EU will have to reconsider its policy of insisting on senior creditor status in similar arrangements. Insistence on this status was instrumental in getting parliamentary approvals in member states. However, the implication is that once the EU-IMF provides a large lending program to a country, the scale of prospective haircut for the private sector creditors goes up. This could have been avoided had the debt restructuring of Greece been done at the start and not in the middle of the program and had the original macroeconomic framework been more realistic. Now, if the EU wants to avoid that its program becomes a signal for private sector creditors to get out, the EU will have to accept burden sharing in case of subsequent restructuring. This would be more effective measure than assurances that no other country would never ever require debt restructuring.

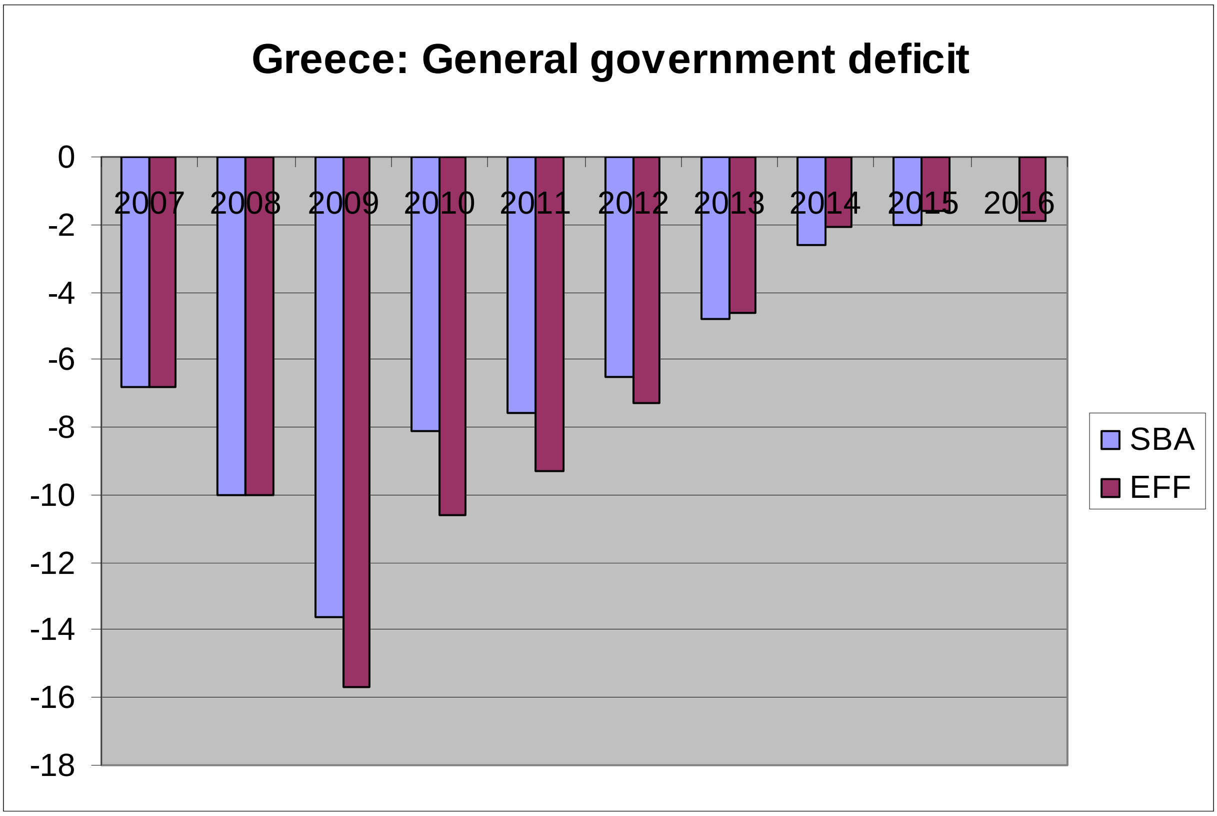
Figure 1. World Economic Outlook (WEO) projections at the time of negotiations and the outcome

GDP growth (in %)	2010	2011
Euro area_WEO April 2010	1,0	1,5
Euro area_WEO September 2011	1,8	1,6
Middle East and North Africa_WEO April 2010	4,5	4,8
Middle East and North Africa_WEO September 2011	4,4	4,0

Sources: WEO database April 2010 and September 2011

Note: There were no unexpected external trade shocks.

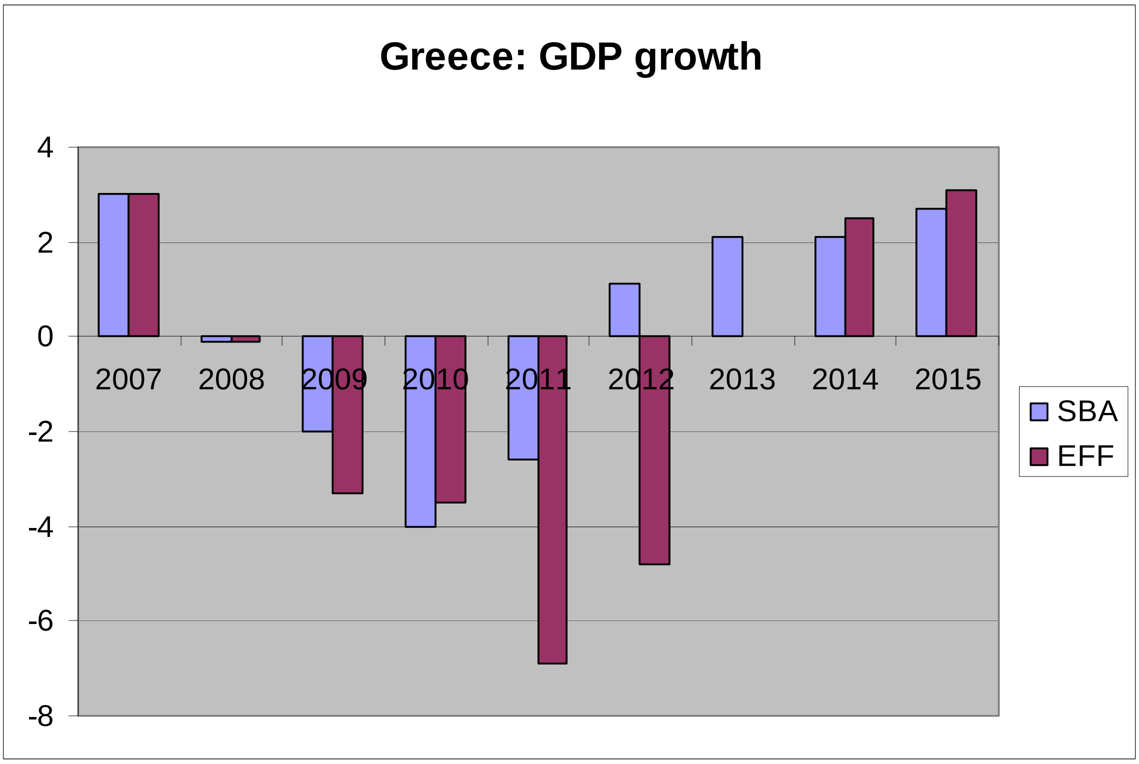
Figure 2. Greece: Fiscal adjustment 2009-2016



Source: EFF IMF Staff Report 12/57.

Note: The cumulative fiscal adjustment 2010-2011 was as envisaged under the SBA.

Figure 3. Greece: GDP growth projection under the SBA and the EFF



Source: ibidem.

Note: The revised drop in projected output relative to the SBA program projection is massive.

Figure4. GDP level 2006-2016

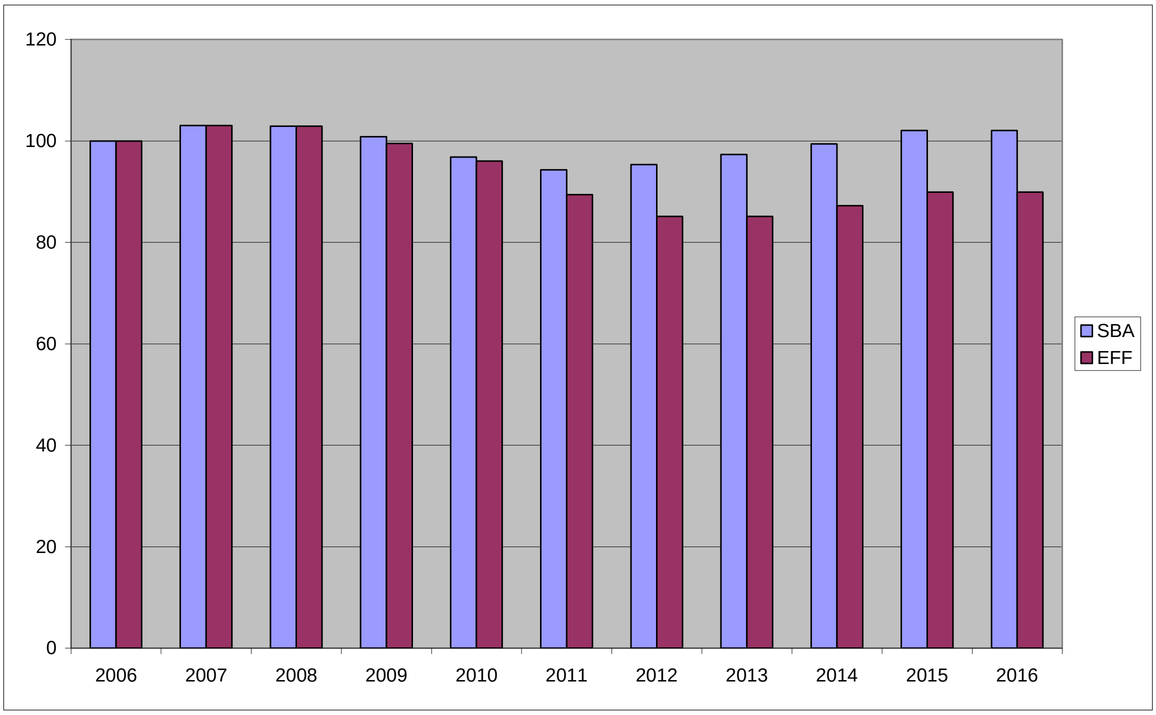
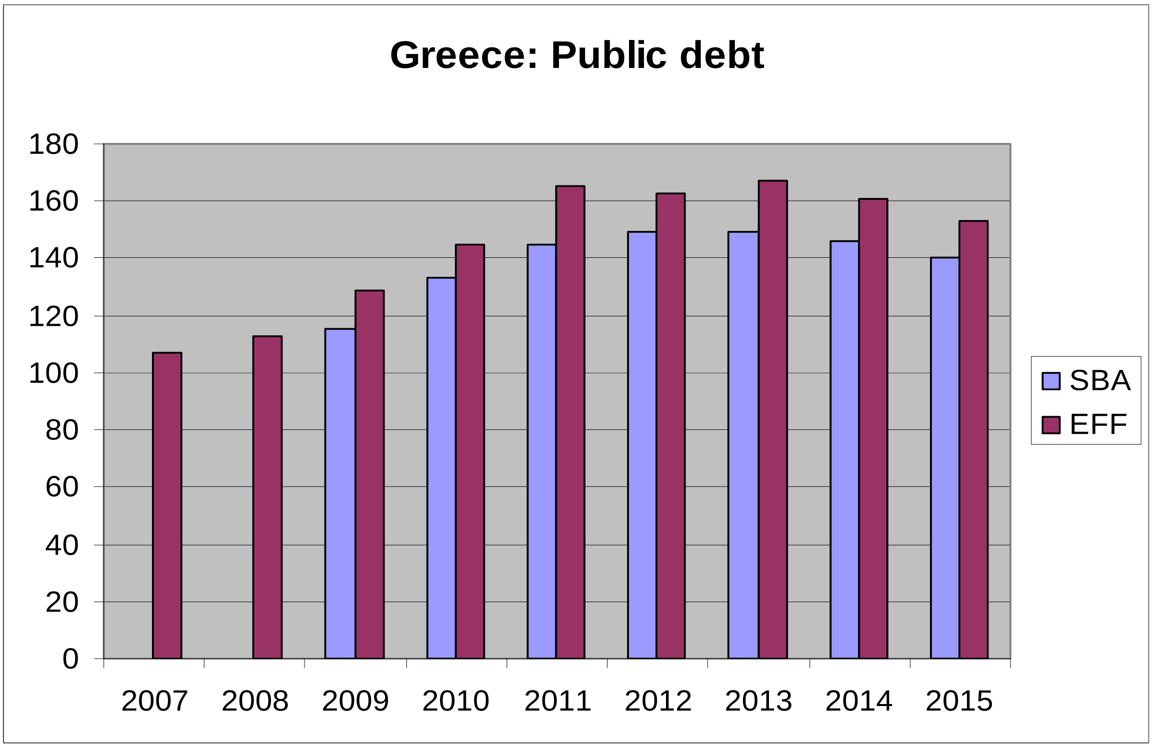


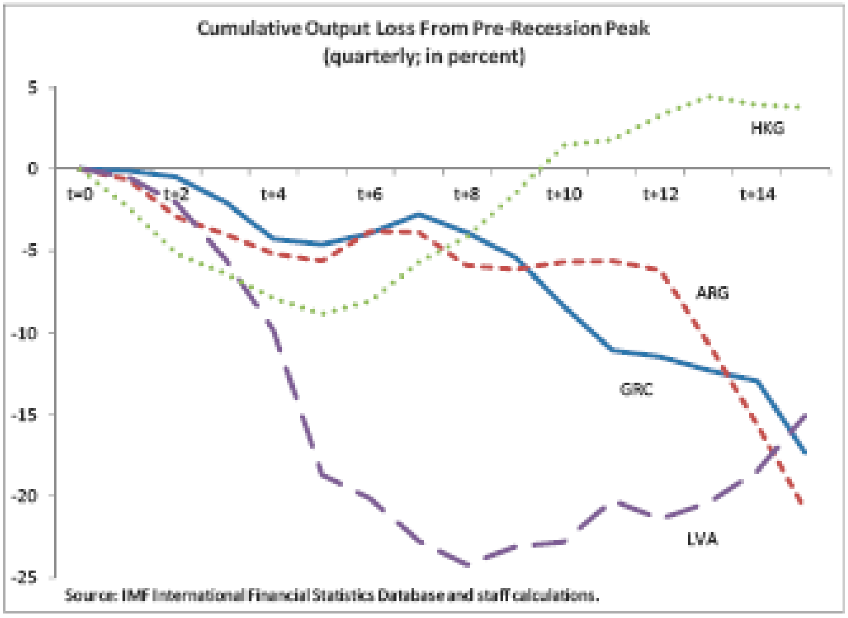
Figure 5. Public debt ratio to GDP



Source: ibidem

Note: Projected public debt path is now much worse despite the private sector haircut.

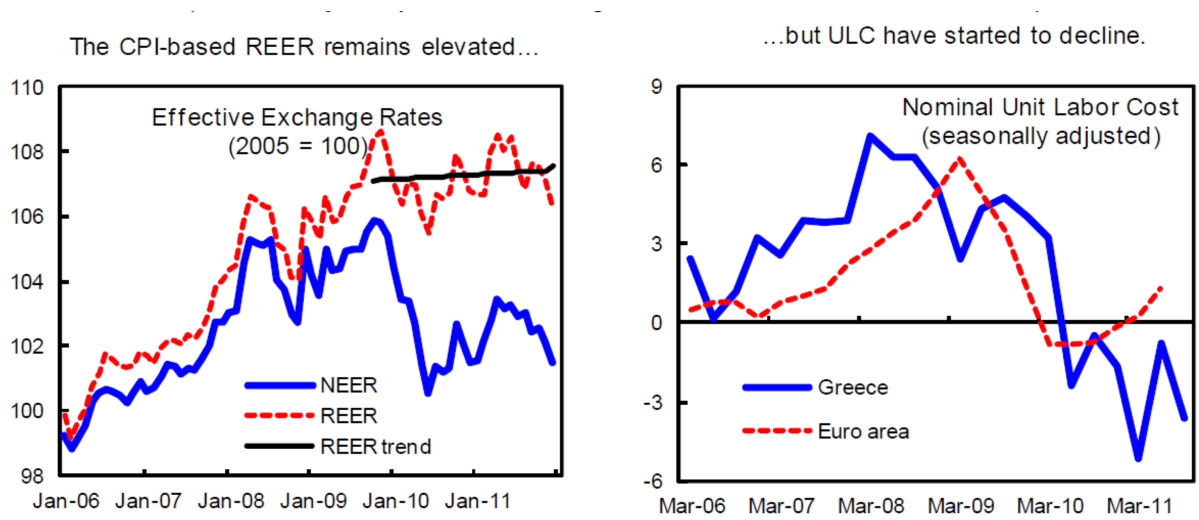
Figure 6. Output decline in countries experiencing internal devaluation



Source: IMF Staff Report 12/57.

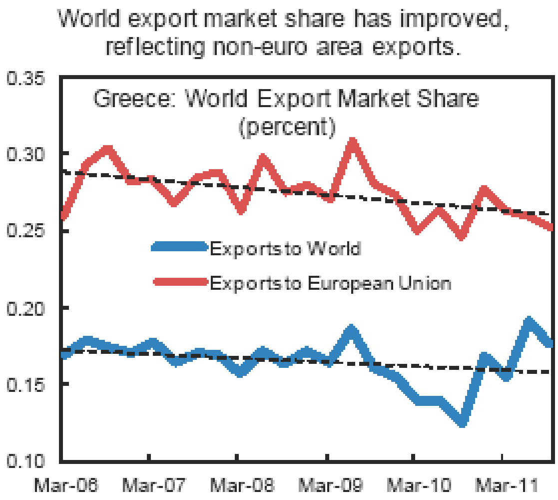
Note: The total contraction in Greece is optimistically projected to be lower than in Latvia or Argentina. The above comparison in the staff report unfortunately does not provide information on the starting level of imbalances.

Figure 6. Competitiveness indicators



Source: IMF Staff Report 12/57.

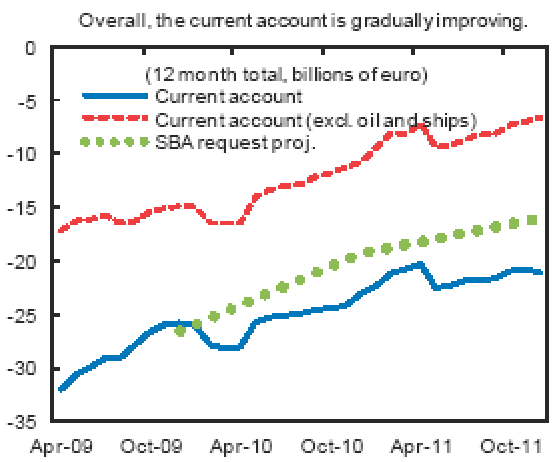
Figure 7. Greece market share



Source: IMF Staff Report 12/57.

Note: CPI based REER is not improving, while the ULC based one is adjusting slowly. Market share continues to deteriorate.

Figure 8. The current account balance



Source: IMF Staff Report 12/57.

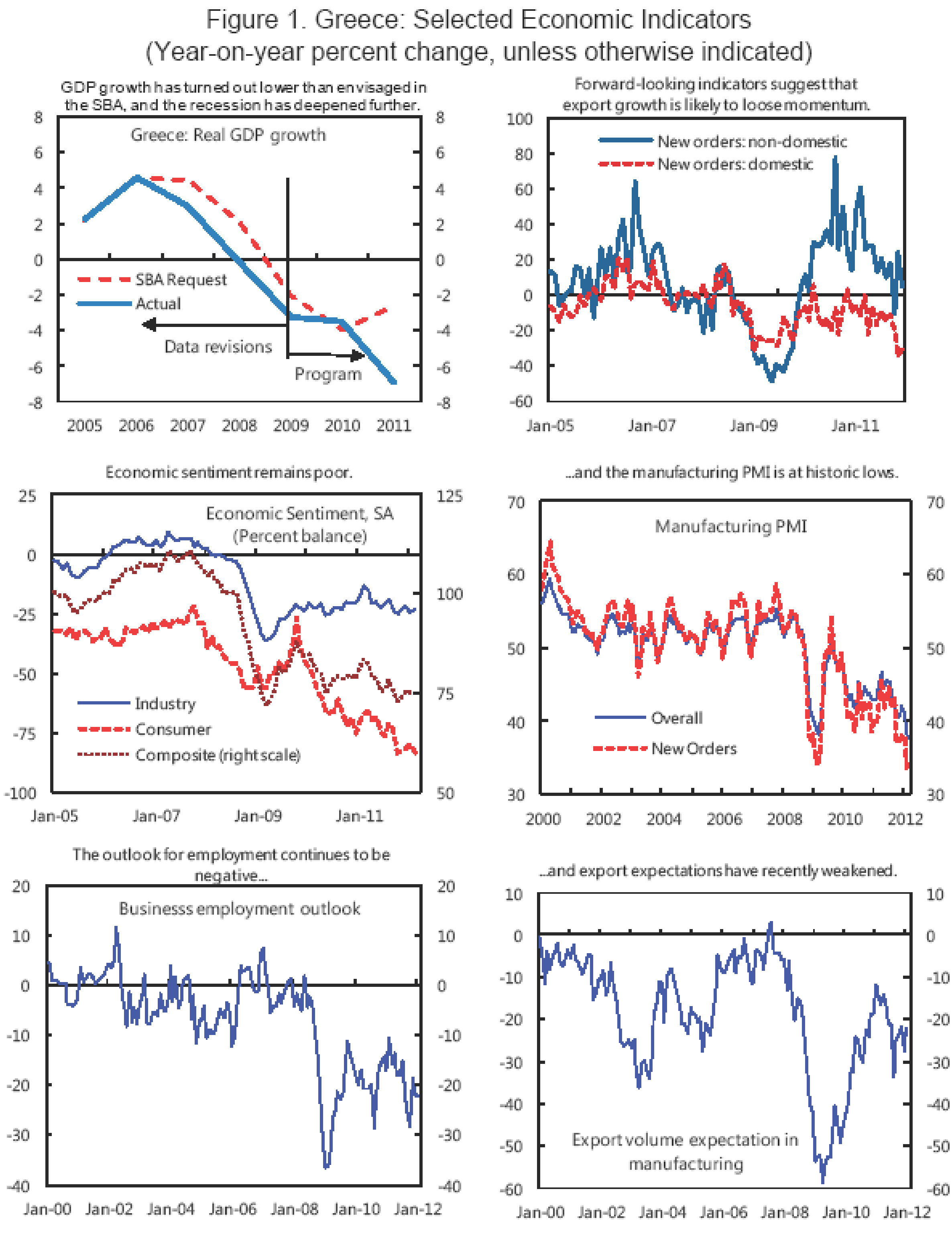
Note: The current account deficit remains large and is improving only slowly.

Figure 9. Trading partner growth

Source: IMF Staff Report 12/57.

Note: Decline in output should slow in 2012 despite weaker foreign demand and larger fiscal contraction than in 2011

Figure 10. High-frequency indicators point toward accelerated output decline



Sources: National Statistical Service; Eurostat; and IMF staff calculations and estimates.

Source: IMF Staff Report 12/57.

ABOUT SEESOX

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South East European Studies at Oxford (SEESOX) is part of the European Studies Centre at the University of Oxford. It focuses on the interdisciplinary study of the Balkans, Greece, Turkey and Cyprus. Drawing on the academic excellence of the University and an international network of associates, it conducts policy relevant research on the multifaceted transformations of the region in the 21st century. It follows closely conflict and post-conflict situations and analyses the historical and intellectual influences which have shaped perceptions and actions in the region. In Oxford's best tradition, the SEESOX team is committed to understanding the present through the *longue durée* and reflecting on the future through high quality scholarship.

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