Testimony before the Committee on Financial Services

of

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Thank you, Chairmen Meeks and Watt and the other members of the Subcommittees, for the opportunity to comment on the International Monetary Fund's (IMF) role in helping Europe deal with its economic crisis. I was also asked to remark on whether the external support for Greece and other EU member nations exacerbates moral hazard and on the adequacy of the proposed fiscal austerity measures.

I am currently a professor in the Department of Economics at the University of Maryland. I suspect that I was invited today because, for more than a decade, my research has focused on various types of financial crises. Also, I was Deputy Director of the IMF's Research Department during 2001-2003.

IMF Mission. It is not surprising that questions have arisen about the legitimacy of IMF involvement in a program aimed at aborting sovereign default in Greece and, possibly, other high-income countries. The last of the peacetime sovereign defaults among high-income economies took place during the Great Depression of the 1930s, well before the founding of the IMF in 1944.

Item V of the purposes of the IMF in its Articles of Agreement reads: "*To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or* *international prosperity."* Whatever the concerns about the solvency of Greece and other EU nations may be, these countries also face classic *maladjustments in their balance of payments* that arise from a substantial loss of international competitiveness. They are IMF member countries and, as such a part of the IMF's original mandate.

As my recent work documents, the wealthy economies are no strangers to IMF programs. The US had two IMF programs in the 1960s while the UK holds the record with 11 IMF programs. Portugal had a program as late as 1986. These programs, however, did not attempt to deal with solvency issues and were of modest size, as was customary in the pre-1995-Mexican peso crisis bailout model.

Fiscal austerity. The need for Greece and other European economies to slash government spending is not some artificial imposition by the IMF or the European Union. Once investors decide that a country living beyond its means will have a hard time meeting its debt obligations, spending cuts become a reality of arithmetic.

But fiscal austerity usually does not pay off quickly. A large and sudden contraction in government spending is almost sure to shrink economic activity as well. This means tax collections fall and unemployment and welfare benefits rise, undermining efforts to reduce the deficit. Even if new borrowing is reduced or eliminated, it takes time to whittle down a large debt, and international investors are notoriously impatient.

In recent years, several countries facing market pressures opted for austerity measures and eventually recovered, such as Mexico in 1995, South Korea in 1998, Turkey in 2001 and Brazil in 2002. But they all started with debt burdens significantly lower than Greece's.

. A restructuring of Greek sovereign debt may not be inevitable but it certainly seems probable. A country such as Greece could seek to negotiate with its creditors to reduce its debt, but that path--essentially a partial default--is no panacea. Argentina's economy contracted about 15 percent after its default in 2001, as it was shut out of international markets for a time. When debt dynamics turn as adverse as those in Greece appear to be, authorities have no good options. Other EU countries facing debt difficulties may not require a restructuring of public debts. However, there is a pressing need to facilitate a restructuring of private debts, notably those of financial institutions.

Moral hazard. As in other situations, questions now arise about the tradeoff between exacerbating moral hazard and limiting contagion. I think it is safe to conclude that the combination of bailouts and forbearance are well entrenched in the expectations of financial market participants for the foreseeable future.

On contagion, it is relevant to recall that Thailand has an even smaller gross domestic product than Greece. But in 1997, Thai financial problems ignited the Asian crisis. Indonesia ultimately defaulted while Korea and Thailand only avoided the same fate through adjustments and international support. Asian economies posted output losses of 10 to 20 percent in that episode.

There are three main mechanisms for this contagion. First, many governments have common lenders, including international banks and hedge funds. If these institutions suffer large losses in one national market, they often pull back their lending to others. Second, trouble in one country acts as a wake-up call to investors, who scour their global holdings for similar risks elsewhere. When they look hard enough, they usually find something to worry about, triggering even more funding withdrawals. Greece, Ireland, Portugal and Spain may be miles apart, but to a worried portfolio manager, they look similar: They all have ongoing budget deficits and large private and public debts. Third, Greece casts a long shadow on the European continent because fifteen other countries share a common currency with it. Greece's debt problems called into question whether the euro will survive.

The large EU/IMF package was intended to send a strong signal that the EU is committed to go to great lengths to avoid a breakdown of the euro. It is intended to provide broad-based coverage beyond Greece, as in the spirit of the TARP legislation in the fall of 2009. Like the US bailout package, an important feature of the plan of action is to have the ECB continue to treat Greek bonds as if the rating agency downgrades had never taken place. This is the kind of "forbearance" shown to toxic assets in the US over the past two years. The moral hazard issue of this approach cannot be understated.

At best, the EU/IMF initiative can buy some time for policymakers in other countries that have come under duress to implement difficult austerity measures and to move to restructure private debts. It does not change Greece's (nor anyone else's) levels of outstanding debts and their even more worrisome profile in the period ahead.