# Office Memorandum

May 10, 2010

**STRICLY CONFIDENTIAL**

Subject: **Board meeting on Greece's request for an SBA - May 9, 2010**

The Board unanimously approved Greece's request for a three-year Stand-By Arrangement (SBA) amounting to €30 billion (SDR 26.4 billion) or 32 times the Greek quota, the largest program approved by the Fund to date. Bilateral financial support of €80 billion will be available from euro area partners. The total amount of €110 billion will cover the expected public financing gap during the program's period. Greece has undertaken to draw on the IMF and European Commission (EC) resources in a constant ratio of 3 to 8 in each disbursement throughout the program's period.

The main objectives of the program are: (i) reducing the fiscal deficit to below 3 percent of GDP by 2014, with the debt-to-GDP ratio beginning to stabilize by 2013 and then declining gradually; (ii) safeguarding the stability of the financial system through the establishment of a fully independent Financial Stability Fund (FSF) that will support banks, if necessary; and (iii) restoring the competitiveness of the Greek economy through comprehensive structural reforms.

In addition to the fiscal measures already taken by the authorities in early 2010 (amounting to 5 percent of GDP), the program envisages a front loaded fiscal adjustment of 11 percent of GDP in 2010-13 . All the measures have been identified, the main ones being : (i) an increase of tax revenues by 4 percent of GDP, primarily through higher VAT rates; (ii) a significant reduction of expenditures by 5.2 percent of GDP, primarily through abolishing the 13th and 14th salaries of civil servants and the 13th and 14th pensions both in the public and private sectors, except for those with low salaries or pensions; and (iii) structural fiscal measures of 1.8 percent of GDP, which will.

While supporting the program, several non-European Executive Directors raised numerous criticisms.

1. Delay in requesting Fund assistance

According to some chairs (Australia, Canada, China, Russia, Switzerland), this delay highlighted shortcomings in the Euro Area architecture, including its .(rather confusing) communication strategy, which looked "piecemeal" according to the U.S. chair. The German ED clarified that, absent a provision in the Maastricht Treaty, the European Union had to rapidly devise a mechanism for financial assistance, which is now fully operational. It was most noticeable that six European EDs (Germany, Belgium, Spain, France, the Netherlands and Denmark) issued a joint statement in supporting the SBA for Greece.

2. Optimistic growth assumptions

The Chinese and Swiss chairs emphasized that growth will eventually determine the ability of Greece to manage its debt burden. Even a small departure from the program's baseline scenario may derail the objective of fiscal consolidation, putting debt sustainability at risk. Staff replied that there can also be upside risks, possible related to the uncertain size of the informal economy.

3. Risks of the program.

Because of the double-digit fiscal adjustment faced by Greece, some EDs (Argentina, Australia, Canada, Brazil, and Russia) pointed to the "*immense*" risks of the program (and the ensuing reputational risk for the Fund). Some compared the Greek situation to that of Argentina before the end-2001 crisis. On the other side, the Russian ED noted that in the past other Fund programs (e.g., Brazil and Turkey) deemed particularly risky proved successful instead.

*The exceptionally high risks of the program were recognized by staff itself, in particular in its assessment of debt sustainability, by stating that "on balance, staff considers debt to be sustainable over the medium term, but. the significant uncertainties around this make it difficult to state categorically that this is the case with a high probability".*

Staff stressed that the credibility of the program relies in part on the fact that it allows Greece not to not tap markets for a long period of time (1-2 years). Effective implementation of the program would lead to substantial fiscal primary surpluses that are expected to reassure markets despite the high level of public debt.

Staff admits that the program will not work if structural reforms are not implemented. In this regard, the biggest challenge for the authorities will be overcoming the fierce opposition of vested interests. The Australian ED emphasized the risk of repeating the mistakes made during the Asian crisis, in terms of imposing too much structural conditionality. While Fund's structural conditionality is "macro-critical", the conditionality imposed by European Commission seems a *"shopping list"*.

Staff acknowledges that the program will certainly test the Greek society. Staff met with the main opposition parties, nongovernmental organizations, and trade unions. In staffs view, the "*striking thing*" is that the private sector is fully behind the program, as it is seen as the tool to bring to an end several privileges in the public sector.

4. Debt restructuring

Several chairs (Argentina, Brazil, India, Russia, and Switzerland) lamented that the program has a missing element: it should have included debt restructuring and Private Sector Involvement (PSI), to avoid, according to the Brazilian ED. "*a bailout of Greece 's private sector bondholders, mainly European financial institutions*". The Argentine ED was very critical at the program, as it seems to replicate the mistakes (i.e., unsustainable fiscal tightening) made in the run up to the Argentina's crisis of 2001. Much to the "surprise" of other European EDs, the Swiss ED forcefully echoed the above concerns about lack of the debt restructuring in the program, and pointed to the need for resuming the discussions on a Sovereign Debt Restructuring Mechanism.

Staff pointed out that debt restructuring has been ruled out by the Greek authorities themselves. Although there were discussions on PSI, replicating the experience of the Bank Coordination ("Vienna") Initiative was not possible, because Greek sovereign bonds are dispersed among an unspecified number of holders. Besides, Mr. Lipsky pointed out that 90 percent of these, bonds do not include Collective Actions Clauses, which would complicate a restructuring even further.

The Dutch, French, and German chairs conveyed to the Board the commitments of their commercial banks to support Greece and broadly maintain their exposures.

5. Modalities on the joint IMF/EC/ECB reviews of the program.

Some Chairs (China, Egypt, and Switzerland) stressed the risk that joint reviews may reveals differences of judgments among the three involved institutions (IMF/EC/ECB). Staff specified that representatives of the three institutions will be "*sitting at the same table at the same time*". The Fund is an independent institution and will carry out the reviews accordingly. In principle, if the EC does not agree on disbursing its share of financing, because of unmet conditionality by the Greek authorities, the Fund might retain its financing because of lack of financial assurances. But this appears to be only a theoretical possibility. In fact, the mission chief for Greece (Mr. Thomsen) emphasized that "*cooperation is off to a good start*", as during the discussions in Athens the ECB took the lead on financial sector issues, the European Commission on structural issues, and the Fund on fiscal issues. Cooperation is a strength of the program, and there are checks and balances.

6. IMF's "*preferred creditor*" status

The U.S. chair (supported by Brazil and Switzerland) emphasized that, because of the preferred creditor status, the Fund's loan will be senior to the bilateral loans from E.U. countries pooled by the European Commission. Staff confirmed that this is the case, because of the public good nature of Fund financing, and in accordance with Paris Club's rules.

7. Criterion No. 2 for Exceptional Access to Fund resources

The Swiss ED (supported by Australia, Brazil, Iran) noted that staff had "silently" changed in the paper (i.e., without a prior approval by the Board) the criterion No, 2 of the exceptional access policy, by extending it to cases where there is *a high risk of international systemic spillover effects*. The General Counsel clarified that this was justified by the need to proceed expeditiously, on the assumption that the Board approval would take place through the Summing Up. The change in the access policy was necessary because Greece could not constitute an exception, as Fund policies have to be uniformity applicable to the whole membership.

Contributor: F. Spadafora

**–DRAFT–**

**The Acting Chair's Summing Up**
**Greece—Request for Stand-by Arrangement**

1. Executive Directors observed that Greece entered the crisis with a dual problem of unsustainable public finances and deep-rooted structural weaknesses that had eroded competitiveness. Initial efforts in response to the rapidly unfolding risks failed to restore market confidence, setting off a chain of events that culminated in a full-blown crisis and spilled over into the banking system, risking imminent systemic contagion. It is against this background that the international community has come together to lend unprecedented financial assistance to Greece in support of its extraordinary adjustment program. Directors urged the Greek authorities to spare no efforts to ensure the successful implementation of the program, delivering fully on their commitment. Strengthened social safety nets for the most vulnerable and broad-based public support will be extremely important in this difficult undertaking.

2. Directors strongly supported the authorities' decisive multi-year strategy aimed at restoring fiscal sustainability and competitiveness, as well as preserving financial stability. They welcomed the extensive support and deep engagement of Greece's eurozone partners. Directors underscored the importance of continued close cooperation between the Fund, the European Commission, and the European Central Bank (ECB), including with respect to communication and the provision of technical assistance.

3. Directors supported in particular· the front-loading of fiscal adjustment and the identification of measures through 2013, which should help enhance program credibility. The approval of the cuts to wages and pensions and increases in taxes represents an essential first step. The authorities' efforts to ensure a fair burden sharing, particularly by protecting low wage and pension earners, are critical to program success. Directors urged the authorities to proceed quickly with pension reform to underpin the long-run sustainability of public finances.

4. Directors stressed that strict adherence to the ambitious structural reform agenda is key to building the foundation for a sustainable growth model. Reforms of the labor and product markets to boost productivity, based on concrete, time-bound measures and complemented with further private sector wage restraint, would help Greece regain its competitiveness within the confines of the euro. Directors urged the authorities to advance the reform of loss-making state enterprises and called for bolder privatization plans.

5. Directors welcomed the ECB's recent decision to extend Greek bond eligibility for repurchase transactions, which should ease bank liquidity pressures. The creation of a Financial Stability Fund provides an additional safety mechanism to ensure that banks remain adequately capitalized during the economic downturn, preserving financial stability. Directors stressed the need for continued close cooperation within the EU framework for cross-border bank supervision.

6. Directors considered that tire program is subject to unusually high risks. This reflects the uncertain growth prospects, price rigidities, the unprecedented size of the adjustment, and potential spillovers from the financial and public enterprise sectors. The front-loading of measures will help reduce implementation risks. Nevertheless, it will be important that the government stand ready to take forceful additional actions, as needed to keep the program on track.

7. While Directors considered public debt to be sustainable over the medium term, they - recognized that there are, significant. Uncertainties that make it difficult to state categorically that there is a high probability that the:, debt. is sustainable over this period as required under the exceptional access policy. Even so, on balance, Directors considered Fund exceptional access as justified given the high risk of international systemic spillovers. Going forward, to ensure the principle of uniformity of treatment, Directors recognized that the Fund would follow this approach regarding this criterion in similar cases with a high risk of systemic spillover.

8. Directors considered that Greece’s capacity to repay the Fund is adequate and that risks to the Fund are mitigated by the Fund’s established preferred creditor status in relation to private and official bilateral creditors. This status has been widely recognized by the international community. Directors looked forward to the forthcoming safeguards assessment.

9. Directors regretted the misreporting of Greece’s 20Q8 fiscal and public debt data, which led to a finding of a breach of obligations under Article VIII, Section 5. They noted that, in consultation with EU partners and Eurostat, the authorities had instituted remedial measures to address data deficiencies, and had committed to undertaking additional corrective actions, hr view of these measures, Directors agreed that no further action is required at this point by the Fund under its procedures for the breach of obligations. They called for strict compliance with reporting requirements to the Fund going forward.

# *Office Memorandum*

MEMORANDUM FOR FILES May 02, 2010

STRICTLY CONFIDENTIAL

Subject: **Informal Restricted Briefing on Greece**

*On Sunday 2 May, the Board held an informal restricted meeting on Greece in parallel with the Eurogroup meeting in Brussels. Mr. Thomsen (Deputy Director, EUR) announced a staff level agreement with Greece for a three-year program amounting to EUR 110 bn. (EUR 80 from Euro Area countries and EUR 30 bn. from the Fund). The Fund financial contribution is the largest ever proposed in relation to the member 's quota (32 times the quota, the previous largest program was with Korea, 19 times the quota). Some Directors asked clarifications but there was no discussion on the program.*

Mr. Thomsen presented the key points of the agreed program, which was defined "tough, difficult and painful". He underscored the strong commitment and ownership by the Greek authorities as well as the fruitful collaboration with the ECB and the European Commission.

The program is centered on the resolution of the three key problems of the Greek economy: week competitiveness, unsound public finances and financial sector stress, which determined the loss in market access for the Greek sovereign debt.

The fiscal adjustment required (16 percent of GDP cumulative in the three-year period) is unprecedented. While measures amounting to 5 percent of GDP have been already taken, supplementary measures (2.5 percent of GDP) will be shortly brought to the Parliament for approval. The measures for the following years, fully specified in the program, will amount to 4.1% in 2011, 2.4 percent in 2012, and 2.0 percent in 2013. The fiscal package will include a balanced mix of revenue and expenditure measures, including the increase of the VAT rate by 2 percentage points (from 21 to 23 percent) and public wage and pension cuts. The most vulnerables will be socially protected through compensation mechanisms. Despite those measures, the debt to GDP ratio will increase to 150 percent by 2013, while the fiscal deficit s expected to be reduced below the 3 percent threshold by 2014. GDP will contract in 2010 and 2011 and is expected to grow slightly in 2012. Nominal GDP is expected to recover its 2009 level only in 2014.

Stress tests of the financial sectors confirmed that, while banks are well capitalized and Greek/ECB facilities remain adequate, distress -risks cannot be ruled out Accordingly the Greek's Financial Stabilization Fund will be financed by adding EUR10 bn.

The program will also cover a wide range of structural reforms, including a pension reform aimed at containing aging-related costs. The European Commission will take the lead in  dealing with structural reforms, while the IMF program will include just few structural benchmarks, with the Commission's "structural reform matrix" added to the program as an appendix.

The first disbursement, amounting to EUR 20bn. (of which 7 bn. from the Fund), is expected before the 19$^{th}$ of. May. The total disbursement by the end of the year will amount to about EUR 38 bn.

The Board will receive the relevant documents by next Wednesday/Thursday. In the mean time the Greek Parliament has to approve the remaining measures for this year (prior action). The Board is expected to decide on the program in the course of the week starting the 10$^{th}$ of May.

Contributor: N. Giammarioli

**SECRET**

**Greece – Key Issues**

**[March 25, 2010]**

***Greece needs a multiyear adjustment program with large financial backstopping.*** *It needs more time than provided under present SGP limits to adjust the fiscal balance, get the debt under control, and implement structural reforms to restore competitiveness. During this transition period, the financing needs will be large, the economy will be very sensitive to negative shocks and the stress for Greek society will be high as well. Capital markets need strong confidence that funding assurances are in place for the long duration of these efforts, otherwise interest rates for Greek bonds will not come down and make the debt dynamics quickly unsustainable. The challenge goes much beyond overcoming the short-term problems resulting from a bunching of amortization payments in April-May of this year.*

- **The economy is uncompetitive.** Few reforms have been implemented, the economy remains relatively closed, and competitiveness has dropped by some 25 percent since euro adoption as domestic prices have continuously exceeded the euro average. The current account balance, even in the recession, still stands at 11 percent of GDP.

- **Fiscal policy has been poor.** Reflecting higher spending on wages and entitlements, and tax cuts, non-interest spending jumped by 8 percent of GDP between 2000-09 and revenue fell by 3 percentage points, thus worsening the primary fiscal balance by 11 percent of GDP since 2000. Public debt increased to 115 percent of GDP.

- **Deflation and low growth will make this debt burden difficult to manage.** With no recourse to exchange rate changes, Greece faces the dual challenge of restoring competitiveness through internal devaluation—always a long and arduous process— while undertaking a large fiscal adjustment. This will compel Greece to go through a period of nominal wage and benefit cuts—a disinflation scenario under which it will likely see several years of declining *nominal* GDP. Domestic spending, the base for fiscal revenues, is bound to be weak. Thus, deficits and debt relative to GDP will be under upward pressure even with significant fiscal adjustment: despite ambitious measures yielding 4 percent of GDP this year, the deficit is set to rise to 11½% percent of GDP next year. Strong and prolonged fiscal adjustment is needed to break and reverse the upward trend in the debt ratio under the conditions facing Greece.

- **But the fiscal adjustment also needs to be realistic.** Even with additional fiscal measures of 2-214 percent of GDP each year for some 5 years, debt to GDP would rise to about 150 percent of GDP by 2013, before stabilizing and beginning to slowly decline. Much faster adjustment—as implied by the SGP deficit target of 3 percent of GDP by 2012—will be very risky: Greece is a relatively closed economy, and the fiscal contraction implied by this adjustment path will cause a sharp contraction in domestic demand and an attendant deep recession, severely stretching the social fabric. This is also unlikely to be technically feasible as durable spending cuts require reforms and changes in entitlement program that will take time to implement and yield results.

• **The banking system poses an important further risk**. With the downgrading of the sovereign, banks have come under funding pressures, been cut off from interbank credit lines and wholesale funding, and—recently-—lost deposits. Banks are using recourse to the ECB to tie themselves over, but this is not a durable solution. Moreover, the long downturn that lies ahead will significantly increase nonperforming loans, and it is possible, even likely, that the government will have to provide capital injections to stabilize the banking system and safeguard deposits. This would add further to the Government's already large financing requirements.

• **Financing needs to remain big**. Because deficit reduction takes time while amortizations on the growing stock of debt roll in, the public sector gross borrowing need will average about €50 billion in 2010-12, even with fiscal measures of 2-2½ percent of GDP every year, as discussed above. And this does not make allowance for the potential need for public support of the banking system,

• **Therefore, capital markets are scared**. Financial markets look ahead and perceive the difficult period that is beginning to unfold. The continuous rise in the debt ratio threatens sovereign ratings and pushes up spreads on Greek bonds. Markets need to be assured that a default is off the table before committing more funds.