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OPINION / COMMENTARY

The Lesson Greece's Lenders Forgot

To avoid bailouts and foster stability, the IMF used to refuse loans to countries with unsustainable public debt. It worked, until Greece got an exemption.

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Now that Greeks have said "no" to their creditors' offers and demands, the lessons for international financial institutions—the International Monetary Fund, the European Central Bank, the Eurogroup made up of national finance ministers—should be clear. Don't lend to a country with an unsustainable public debt. If you do, you'll end up bailing out the creditors and leaving the people you say you are trying to help, and many others, worse off.

The IMF first learned this lesson more than a decade ago. After years of crises in emerging markets it adopted an "exceptional access" framework in 2003, under which it would not lend to a country unless "a rigorous and systematic analysis" showed that there was "a high probability that debt will remain sustainable." The aim of these lending rules was to foster economic stability—by reducing bailouts and the recipient country's debt burden, containing moral hazard, lowering uncertainty, and encouraging responsible policy by the recipient country.

It seems to have worked. After 2003 there were fewer crises in emerging-market countries compared with the 1980s and '90s. Moreover, these countries as a whole weathered the global financial crisis remarkably well. From Mexico to Poland, economic policies generally improved. Monetary policy focused more on price stability, and fiscal policy relied less on foreign borrowing or debt linked to foreign currencies.

But the lesson was forgotten when Greece's sovereign-debt crisis arose in 2010, and the IMF could not establish that the Greek debt was sustainable with high probability. Rather than follow its "exceptional access" rule—no loans to a country with unsustainable debt—the IMF wrote in an open-ended exemption. New loans, it said, could be made in unsustainable situations so long as there was a "high risk of international systemic spillover." The IMF claimed, with very little evidence, that this was true in Greece's case and approved an exceptionally large loan of €30 billion. But it did not require any restructuring of the debt, which was held largely by European banks.

Following the loan, most private creditors started getting out of Greek debt, leaving the IMF, European governments and the European Central Bank holding the bag. The Greek economy continued to deteriorate, and by early 2012 the inevitable debt-restructuring began. But with no serious pro-growth reforms, the economy continued to sink, the debt problem grew, and Greece finally defaulted on its IMF loan on June 30.

The IMF reported on July 2, before the Greeks voted, that creditors should not expect full repayment—"maturities of existing European loans will need to be extended significantly" and, with a weakening of reforms, "haircuts on debt will become necessary."
Though the IMF's loan to Greece in 2010 was presumably made under political pressure from the banks and other private holders of Greek debt, the purported reason was a high risk of international spillover. But systemic risk is often in the eye of the beholder. If that standard holds, IMF loan decisions will continue to be largely discretionary. More bailouts and instability remain likely.

It is time to restore and strengthen the IMF's 2003 "exceptional access" framework. A starting place would be to repeal the 2010 exemption for systemic risk.

I have found much support for such a reform in the international community, including among IMF management and staff. But the U.S. Treasury Department has been resisting. Evidently some U.S. officials worry about the loss of discretion that eliminating the systemic-risk exemption implies.

But the Greek crisis shows that discretion causes uncertainty, and uncertainty *increases* the risk of spillovers. The IMF exemption is the problem, not the solution.
Moreover, the International Capital Market Association recently published revised collective-action clauses for sovereign debt that permit more orderly workouts and lower the chance of spillovers. These clauses, which establish that a supermajority of creditors can vote to change the financial terms of a loan, now allow for aggregation across many different debt issues, avoiding the need to vote on each loan one by one.

Congress is in a position to help bring about needed reform. The Treasury Department, on behalf of the Obama administration, is asking Congress to increase the U.S. contribution to the IMF and reallocate voting rights toward emerging-market countries. Given Greece's default on its IMF debt, congressional support for the idea is less likely than when the request was first made. But if the Treasury demonstrated its enthusiastic support for restoring the IMF's 2003 exceptional access framework, Congress would have reason to expect that the mistakes made with Greece will not be repeated.

The change would also improve the global monetary system and put the U.S. back in the forefront of international reform.

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