

By Jean Pisani-Ferry and André Sapir

The best course for Greece is to call in the Fund

The past few days have been dramatic for the Greek economy. Fuelled by doubts about the government's capacity to put its fiscal house in order and by uncertainty about whether and how eurozone countries and European Union authorities would assist the country, Greek bond yields rose by more than a percentage point last week to a staggering 7.25 per cent.

If Greece was not in the eurozone it would have turned already to the International Monetary Fund and negotiated a stand-by agreement, getting financial assistance in exchange for credible fiscal adjustment measures, as Hungary, Latvia and Romania have done. Along with IMF aid, Greece would have been eligible for EU balance-of-payments assistance.

But being part of the eurozone has had two effects: first, Greece (and financial markets) had a false sense of immunity against debt problems. Second, it became ineligible for EU balance-of-payments assistance. For a long time, the first effect dominated: in spite of the "no bail-out" provision introduced in the Maastricht treaty, the risk of Greek default was barely priced by bond markets. Recently, rising concerns were masked as banks could pledge unlimited amounts of Greek bonds as collateral for loans at the European Central Bank.

One reason why things have sharply worsened is that the ECB has said that by the end of 2010 it will tighten quality requirements for bonds pledged as collateral – which risks excluding Greek bonds from repurchase agreement operations. This, and Greece's inability so far to present a credible fiscal plan, explains the alarm in financial markets.

The crisis in Greece calls for standard remedies. The best solution would be to bring in the IMF. A stand-by agreement involving conditional lending would provide financial assistance and fiscal adjustment measures which should restore confidence. However, eurozone and EU authorities appear to be against this – for two reasons.

First it would be felt as an admission that the eurozone is incapable of dealing with its internal problems and that it needs help from "Washington". Second, it would be seen as a blow to EU surveillance and in particular to the stability and growth pact.

If the IMF is disqualified, what would a stand-alone European solution look like? Since EU funding is excluded, money, if any, would have to come from other eurozone countries. Assuming Greece requires between 5 and 10 per cent of its gross domestic product, these countries would, together, have to supply €12bn-€24bn (\$16.6bn-\$33.3bn) or 0.13-0.26 per cent of their GDP. Although far from trivial such amounts could probably be obtained.

The other element of an IMF package, the standard conditionality and the credible monitoring of progress, would be more difficult to achieve. Presumably the plan would be designed by the European Commission with the eurozone countries that foot the bill. Would it be credible for the Commission to monitor progress, which may imply stopping aid payment until corrective action by Greece? The Commission has the technical competence, but it may find it difficult to balance external financing and stability pact requirements against one another. But at core the matter is really political. How would the EU react to anger in the streets of Athens? Would all eurozone countries stay on the same line? Or should some be excluded from the rescue because they may be candidates for future operations? Furthermore, would the budgetary cost be bearable if similar

operations were needed in other, larger eurozone countries, a risk that would probably increase with the stand-alone solution? There is a real danger that an EU package may not be renegotiation-proof.

Calling in the IMF would involve a political cost, but it should not be overestimated, and should be assessed against alternatives. First, although located in Washington, both the IMF and its European department, which would be in charge of negotiating the stand-by agreement, are headed by former EU finance ministers. Second, an IMF programme would not necessarily weaken EU surveillance, as nothing would preclude the IMF from agreeing to work with the Commission in designing and implementing the Greek package, even in the absence of EU funding. Third, the political cost would be far greater if the attempt to solve the problem “within the family” failed and the IMF was then called in extremis.

The EU’s Greek dilemma is of high significance. It will greatly influence both future adjustment by Greece and future crisis management in eurozone countries. Rather than embarking on a risky course, EU heads of state and government should urge Greece to call the Fund now.

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