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 competiveness 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 measaures 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 staff's 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 uniformily applicable to the whole membership.

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