The Unthinkable *as the* New Normal

By Klaus C. Engelen

The international economic organizations established after World War II have destroyed their credibility.

On June 28, 2015, the oldest international financial institution, the Basel-based eighty-five-year-old Bank for International Settlements, asked in its annual report a most pertinent question: "Is the unthinkable becoming routine?"

The report pointed out that low interest rates "are the most remarkable symptom of a broader malaise in the global economy: the economic expansion is unbalanced, debt burdens and financial risks are still too high, productivity growth too low, and the room for maneuver in macroeconomic policy too limited. The unthinkable risks becoming routine and being perceived as the new normal."

Watching the malaise of major multinational and supranational institutions that were established after the ravages of World War II and in the post-war era in Europe as part of a historic process of ever broader and deeper economic and political integration, one could ask the same question in the shadow of never-ending financial turbulences: Is the unthinkable becoming the new normal?

Established in 1930, the BIS is the world's oldest international financial organization, with sixty member central banks representing countries from around the world that together make up 95 percent of the world GDP. Contrary to other major financial institutions, the "central banks bank," located in Basel, Switzerland, has preserved over decades a high level of

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THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
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credibility in its governing standards and with respect to the professional integrity and independence of its economic research.

When Europe's politicians embarked on establishing a monetary union, the BIS drew attention to the economic realities of irreconcilable differences between the potential member states. The BIS was right. When the French assaulted its independence by requiring the BIS managing director to supply a draft copy of its annual report to the member central banks, they were rebuffed on the ground that some national central banks had not achieved an adequate level of independency from political pressures. That was a reference to the Banque de France. Thanks to its outstanding economists, the BIS warnings on the banking crisis before 2007–2008 were legendary. And when a previous BIS general manager, long before the end of his term, announced that he would join a major commercial bank, but for the time being stay in his position, he was forced by the BIS board to clear his desk and leave the bank immediately.

The malaise the BIS is talking about in its recent annual report can be defined in much broader terms in

As the largest and controlling shareholder of the IMF, the United States has been practicing "malign neglect" for many years.

today's financial world: Undermining the institutions' governance structures. Using political pressure to take away an institution's independence and neutrality. Breaking an institution's statutes and rules for reasons of political expediency. Letting mass conflict of interest erode objective decision making. Losing reputation and credibility among the public. Letting institutions be dominated by major constituencies and blocking agreed reforms. Putting blame on the institutions for failings that national politicians and corrupt elites have been responsible for, as in the case of Greece that descended into a financial maelstrom in the spring of 2010.

There we are talking especially about the two Bretton Woods institutions, the International Monetary Fund and the World Bank Group, with a global reach of 188 member countries. We are also talking about the twenty-eight-member European Union institutions including the European Commission. Nineteen countries

The BIS was right.

form the European monetary union with the euro as their single currency and the European Central Bank as their common central bank under the 1992 Maastricht Treaty.

WORRISOME DEVELOPMENTS DAMAGE CREDIBILITY

Some worrisome developments show how political leaders and governments are severely damaging major institutions:

■ In the European crisis, the IMF was brought under enormous pressure to provide exceptional financing (especially in the case of Greece) in circumstances where the ability and willingness of the borrower to repay and the strategy for recovery were highly questionable. During five years struggling as the junior partner of the troika, the IMF experienced an unmitigated disaster with no end in sight.

■ Since the spring of 2010, when the euro sovereign debt crisis threatened the continuation of monetary union with Greece defaulting on its debt, euro leaders have opted for a euro rescue scheme that puts aside EU laws and governance standards, thus damaging the integrity and credibility of the euro area's main institutions.

■ When it comes to damage to the major international institutions, the United States turns up in the role of villain in another worrisome development. As the largest and controlling shareholder of the IMF, the United States has been practicing "malign neglect" for many years against the most important global financial institution by blocking a governance reform package that was agreed in November 2010 at the G-20 meeting in Seoul.

HOW THE IMF WAS DAMAGED IN GREECE

For decades, the IMF was seen as a useful provider of conditional balance-of-payment financing for developing countries—more or less operating in the interests of the leading industrial member countries. In the debt

German Chancellor Angela Merkel: *unofficial eurozone leader.*

crises in Latin America, Asia, and Russia, the IMF broadened its role in financial crisis management and economic stabilization. Since the IMF got more global mandates to include checkups on its major stakeholders such as the United States, the major European countries, and Japan, it has faced more political tensions. The protracted disputes about whether—as was done with the other major economies—to require periodic Financial Sector Assessment Programs from the United States is one example. The politically charged controversies about China manipulating its exchange rate to the disadvantage of American workers is another. The IMF found itself in the middle of this politically charged dispute between its largest and controlling shareholder and the newly dominant China. The IMF's critical views on Germany's persistent large current account surpluses and its bank-based financial sector have also caused tension.

In the spring of 2010, important parts of the IMF staff had serious objections to mobilizing for a Greek and euro area rescue expedition. They were right in arguing that the complex Greek and eurozone rescue effort might well go beyond the IMF's political, economic, and financial capabilities.

As the bad guy of the hated troika, the IMF was confronted not only by revolting Greeks, but also by a European anti-austerity movement.

In 2010, at the outset of the Greek tragedy, Ted Truman, the former U.S. Treasury and Federal Reserve official now at the Peterson Institute for International Economics, testified before the U.S. House Financial Services Committee that "the major policy instrument available to the United States to contain the European crisis aftermath is the International Monetary Fund." He

The Price of Five Years of Cowardice

In an editorial at the height of the Brussels high-noon negotiation drama, the German newsmagazine *Der Spiegel* took on the euro area's leaders.

"For the past five years, politicians within the eurozone, under German Chancellor Angela Merkel's unofficial leadership, have shirked painful decisions that might have helped to solve the debt crisis in Greece. The consequence has been that the problems have been protracted rather than solved.

"This trend began with the first Greek bailout program in 2010. In order to prevent a Greek default, the eurozone states provided their first credit guarantees to Athens at the time. To do so, they used tricks to circumvent clauses in European law that prohibited precisely this kind of shared liability within the currency union. Even then, the more courageous act would have been to force Greece's private creditors to absorb their losses. Under that scenario, even if banks had fallen into financial difficulties, one could have still used tax money to either partly nationalize these banks or to refinance them with fresh capital. …

"The cowardice continued with the 2012 debt haircut for Greece. At the time, eurozone officials lacked the courage to force Greece's private creditors to accept the total loss of their capital. They only had to accept losses of half. And it was already clear back then that Greece's debt load would remain unsustainable despite the 50 percent cuts. But the politicians ignored the uncomfortable figures and instead prescribed unrealistic savings and reform targets for Athens. They also entertained the comfortable illusion that a handful of troika officials could somehow rid Greece of its inefficiencies."

—*Christian Rickens,* Der Spiegel, *June 29, 2015* urged that the United States "should continue to provide maximum, constructive support for the IMF in carrying out its responsibilities for the promotion of global growth and financial stability." Truman reminded the U.S. legislators that 20 percent of U.S. exports of goods go to Europe and, as of the end of 2009, U.S. bank exposure to the European Union was $1.5 trillion, half the total of foreign exposure of U.S. banks.

Greek Tragedy in Numbers

As IFO President Hans-Werner Sinn noted in a special report, at the end of March 2010, "French banks had a €53 billion exposure to private and public instances in Greece, the German ones a €33 billion exposure, the U.S. €10 billion, and the UK €9 billion."

The IFO analysis objects to the assertion—used by the radical Syriza party and its friends all over Europe—that "90 percent of the Brussels bailout billions never reached Greece but was recycled to foreign banks and investors." According to the IFO researchers, only one-third of the rescue billions wound up with banks and other financial investors. Another third was used to finance Greece's sizable current account deficit and thus public expenditures and private consumption. The last third was used to finance Greek capital exports. As IFO calculates, Greece was able to receive foreign loans to public and private debtors of 182 percent of Greek GDP for the year 2014, which stood, according to IFO, at €179 billion.

—Hans-Werner Sinn, "The Greek Tragedy, June 2015

WHY THE IMF WANTS TO STAY OUT OF A THIRD GREEK BAIL-OUT

In the aftershock of the mid-July 2015 high-noon third Greek rescue agreement, the old objections from the IMF staff and in its Board to the Greek and euro rescue have become much stronger, as was leaked to the *Financial Times* at the end of July. The IMF Board has been told by the staff that high debt levels and its poor record of implementing reforms disqualify Greece from a third IMF bailout of the country. The recently reaffirmed access criteria for the Fund that would not be met in a third rescue operation include the failure of Greece to demonstrate ability to implement reforms, and the failure by the creditors to accept debt relief. Since the IMF indicated that the conditions are not likely to be fulfilled until the autumn, which implies that the Fund will not be able to join a third Greek bail-out until later in the year or next year, enormous pressure now rests on Greece and Germany. The fact that IMF representatives did partipate in the deliberations on the third Greek bailout can be taken by the euro governments as comforting sign that the Fund at least is staying on the side lines.

How German Chancellor Angela Merkel will get a third bailout of Greece through the German Bundestag without the IMF on board in a financing role remains to be seen.

Behind the hardening of the IMF position against the eurozone leaders—and especially against Germany—is the Fund's deep disappointment with the euro leaders' "malign neglect" in dealing with the Bretton Woods institutions' core rules and standards. Especially unsettling for the IMF was that the euro leaders allowed a euro area member country to default under a lending agreement that was part of the euro leaders' rescue for Greece and for keeping the whole eurozone together.

Some in the IMF argue that the euro leaders—including Merkel and German Finance Minister Wolfgang Schäuble—did not live up to October 15, 2011, "G-20 Principles for Cooperation between the IMF and Regional Financing Arrangements" agreement on their "financing assurances."

Paragraph 6 of this agreement states the now-broken commitment that "RFAs [the eurozone] must respect the preferred creditor status of the IMF." This unsettling breach alone, argue IMF staff members, "would be justification enough for the Fund to stay out of a third bailout for Greece."

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IMF Managing Director **Christine Lagarde:** *"Greece's debt can now only be made sustainable through debt relief measures that go far beyond what Europe has been willing to consider so far."*

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HOW THE RESCUE TURNED INTO A DISASTER

No one could have imagined what would happen to the IMF as major lender and economic advisor to Greece and as junior partner in the eurozone troika during five years of struggle to get a country of eleven million representing barely 2 percent of the eurozone's GDP back on its feet. For the IMF, being pushed by powerful governments on both sides of the Atlantic into the rescue of a regional monetary union as junior lender and advisor in two extended Greek lending programs turned into an unmitigated disaster. The IMF suffered severe reputational damage.

More than other partners of the troika, the IMF became the target of broad-based ideologically driven vilification. This came not only from Greeks, but also from the radical left and right all over Europe based on the false argument that at the advice of the IMF the poor get austerity and the capitalist banks get most of the rescue billions. How much the IMF's effectiveness in the crisis was undermined by the inability of both the euro leaders and the eurozone institutions is illuminated a *Der Spiegel* editorial, "The Price of Five Years of Cowardice" (see box).

After the left-wing Syriza party and its charismatic leader Alexis Tsipras took over the Greek government in January 2015 in a landslide election victory with the promise "to end the vicious cycle of five years of austerity," the IMF was demonized as the heartless architect of the Greek people's misery.

As the bad guy of the hated troika, the IMF was confronted not only by revolting Greeks, led by the hard left and the fascist right, but also by a European anti-austerity movement.

This added insult to injury. As Greece's elites sent their money abroad and protected their fortunes from paying taxes, the IMF's Greek team—together with the Eurogroup finance ministers who represent the main creditors in a unique and historic act of European solidarity—were called "terrorists" by a minister of finance of the program country.

After wasting almost half a year doing nothing in terms of adhering to prior commitments and making credible steps towards structural reforms, the new Greek leader let his first finance minister, Yanis Varoufakis, bring to the negotiating table in Brussels never-ending confrontation and anti-austerity polemics.

When Tsipras eventually held a national referendum under which 62 percent of voters rejected the terms of a harsh bail-out package, the prospect of defaulting into a Grexit loomed just around the corner.

An IMF Veteran: "I Told You So"

IMF veteran Ashoka Mody, now working at the Brussels think tank Bruegel, last April deplored the damage "the IMF's big Greek mistake" inflicted on his former institution. He warned that the present Greek government's mounting financial woes would lead it to contemplate the previously unthinkable: Defaulting on a loan from the IMF. The advice to his former colleagues hints of deep frustration: "Instead of demanding repayment and further austerity, the IMF should recognize its responsibility for the country's predicament and forgive much of the debt."

Greece's huge commitments to the IMF, the ECB and European governments can be traced to the April 2010 rescue by Europe's leaders, he said. "They made a fateful mistake," argues Mody, who had played a key role in Eastern Europe rescue operations. "Instead of allowing Greece to default on its insurmountable debts to private creditors, they chose to lend it the money to pay in full. At the time, many called for immediate 'restructuring' of privately held debt, thus imposing losses on the banks and investors who had lent money to Greece." The IMF and European authorities responded that "Restructuring would cause global financial mayhem." As Karl Otto Pöhl, a former president of the Bundesbank and key architect of the euro, candidly noted, "That was merely a cover for bailing out German and French banks which had been among the largest enablers of Greek profligacy."

"Ultimately, the [European] authorities' approach merely replaced one problem with another: IMF and official European loans were used to repay private creditors. Thus, despite a belated restructuring [of private creditor debt] in 2012, Greece's obligations remain unbearable—only now they are owed almost entirely to official creditors," says Mody.

"Five years after the crisis started, government debt has jumped from 130 percent of gross domestic product to nearly 180 percent. Meanwhile, a deep economic slump and deflation have severely impaired the government's ability to repay."

—Ashoka Mody, "The IMF's big Greek mistake,"
Bruegel, April 21, 2015

On Sunday, July 12, 2015, the finance ministers and leaders of the eurozone gathered at the emergency summit in Brussels, and something was very different: At the beginning of the marathon take-it-or-leave-it negotiations, German Finance Minister Schäuble landed a bombshell by proposing a five-year "time-out" for Greece from the eurozone.

Under Schäuble's plan, such a temporary Grexit would make it possible to give Greece large-scale debt relief, something that would not be legal under EU law. His "time-out" Grexit proposal—not officially introduced by the Berlin government and contested also within Germany—put enormous pressure on Greece and the eurozone leaders to come to an agreement on a third rescue financing package. Only in this way could the beginning of an unraveling of monetary union on the fringes could be avoided.

As the new Greek government now has requested a new IMF loan agreement—despite defaulting on €1.55 billion on June 30—the IMF's ordeal goes on.

The bad news is that after a hard-won third conditional financing agreement by euro leaders estimated at €82 to €86 billion to be disbursed over three years and financed largely through the European Stabilization Mechanism, the IMF is supposed to stay boxed in a futile bail-out financing of Greece.

From the IMF's top, Managing Director Christine Lagarde, to the authors of the IMF's new debt sustainability study, comes the warning: "Greece's debt can now only be made sustainable through debt relief measures that go far beyond what Europe has been willing to consider so far." According to the IMF report, Greece's debt is set to reach 200 percent of GDP in the next two years, compared to the current level of 177 percent. European countries would have to either dramatically extend the grace period on Greece's debt, or concede to "deep upfront haircuts." The IMF also indicated that Europe might be forced to hand Greece some cash, suggesting "explicit annual transfers to the Greek budget."

As the bad guy of the hated troika, the IMF was confronted not only by revolting Greeks, but also by a European anti-austerity movement.

The Bottom Line

So we get to the bottom line of "How institutions are damaged." After the worst banking crash since the Great Depression of the 1930s, Western leaders and the people they govern have now to pay the consequences of a failure to act in a timely and resolute manner.

Policymakers failed to act resolutely. The IMF was dragged into the Greek and euro rescue under political pressure and under conditions that amounted to a mission impossible. Euro area leaders let the ECB do the main euro rescue job by ignoring EU laws and governance requirements. The U.S. government and the U.S. Congress failed to live up to their reform commitments for the IMF, thereby encouraging China and other geopolitical rivals to begin gnawing away at the Bretton Woods institutions' multilateral global franchise. The unthinkable is indeed becoming routine.

—K. Engelen

Another big question mark that not only the IMF is putting behind the new third bail-out package is the expected privatization receipts. Greece has to transfer assets to an independent fund controlled by the creditors supposed to generate €50 billion by selling state assets off. Considering that over the past five years, Greece's governments managed to raise just €3 billion from asset sales, this part of the recent agreement does not seem realistic. "Europe has cooked up the same old recipe of austerity and implausible assumptions," says *The Economist.* "The IMF is supposed to be financing part of the bail-out. Even it thinks the deal makes no sense."

In Greece, the IMF had to learn the hard way what it means when a member country's politicians and parties outright reject any ownership of an economic stabilization program and any conditionality on the billions in loans they got from the IMF.

WHY THE IMF STAFF HAD MANY OBJECTIONS

When debating the IMF's highly controversial involvement in the Greek and eurozone rescue, research by Susan Schadler and Paul Blustein sheds light into the dramatic circumstances and power plays in the spring of 2010 when the IMF was under enormous political pressure to

Is AIIB a Multilateral Bank?

Günther G. Schulz, a former ADB vice president for finance, who represented Germany in several other multilateral development banks, sees in the launch of the AIIB "a system change which would establish a new competitive framework making life hard for the 'old' lending institutions unless they adapt to the new environment."

Schulz warns that the AIIB with headquarters in Beijing would be "nothing more and nothing less than an Asian Development Bank—or World Bank—without policy dialogue and conditionality."

In addition to China, many other borrowing countries would certainly regard it "as a welcome chance to get rid of present time-consuming and burdensome loan negotiations and policy discussions."

The AIIB with headquarters in Beijing would be "nothing more and nothing less than an Asian Development Bank—or World Bank—without policy dialogue and conditionality."

And he continues, "The role which China will be playing in this new Bank is still unclear as long as details on the precise voting procedures are still unknown. However, what we know is that China is to have a majority share in the capital of the Bank and presumably a majority of the voting power. Quite apart from voting and voting rules, such a majority all by itself gives China a position of power which will allow China to make justified claims, for instance, on the use of Bank resources, on personnel structure of the staff, and in other areas which may not necessarily be subject to voting.

"Moreover, to my knowledge, a majority shareholder in a development financial institution is unique in the sense that no DFI up to the present has a majority shareholder. Even if the United States played a dominant role in the Bretton Woods institutions, they never had a majority of the capital and the voting power. This meant they normally needed allies within the organization who were willing to join forces with them in order to win a vote.

"China always emphasizes its position that interference in domestic affairs should not be tolerated and that the principle of sovereignty of nations should be upheld. We could see an entirely new institution based on non-interference and the sovereignty of nations, a true innovation compared to the practice of traditional multilateral organizations!

"One could even speculate that the establishment of such an innovative policy framework is the main motivation behind the wish to establish a new AIIB."

—K. Engelen

be part of the European rescue effort. As deputy director of the IMF's European department from 1999 to 2007, Schadler was an insider. In her paper "Sovereign Debtors in Distress: Are Our Institutions Up to the Challenge?" (CIGI, No. 6, August 2012), she documents the valid IMF staff objections to the conditions under which the IMF embarked on the eurozone rescue mission.

Blustein is an award-winning journalist who has worked for the *Washington Post* and the *Wall Street Journal* and is author of *The Chastening* (2001) and other financial crisis books. In his April 2015 CIGI paper "Laid Low: The IMF, the Euro Zone and the First Rescue of Greece," Blustein also documents that the IMF's staff opposed getting into the euro rescue business. Because a restructuring of Greek debt held by private banks and investors in the spring of 2010 was blocked by eurozone leaders for fear of contagion spreading to other highly indebted euro sovereigns, the IMF—as part of the troika with the European Commission and the European Central Bank— "attempted to resolve the crisis by giving Athens bailout loans of unprecedented magnitude, piling debt on top of debt."

Schadler and Blustein point to the failings within the IMF in the Greek rescue involvement. Strong staff objections within the IMF and within the Board to the Greek loan agreement were pushed aside by the IMF's top management. High on the list was ignoring the "No more Argentinas rule" that limits lending to countries whose debt is deemed sustainable. The IMF was pushed into committing €30 billion in exceptional financing for Greece. This loan was bigger than any the IMF had given any other country, representing 3,200 percent of the Greek quota.

Another bone of contention was that the IMF—with regard to the staff's debt sustainability calculations—did not insist on making a substantial restructuring of Greek private debt with adequate haircuts a condition of joining the euro area rescue. Although Schadler and Blustein seem reluctant to draw such conclusions, the question could be raised: Was then-IMF Managing Director Dominique Strauss-Kahn, who was alleged to have ambitions for the French presidency (and who later had to leave the IMF under scandalous circumstances), not resolute enough at the time to secure from the Europeans firm commitments that its rules and standards would be strictly observed in the Greek and eurozone rescue?

"Ultimately, the decision came down to one person—Merkel."

In this connection, Schadler and Blustein explore the controversial issue within the institution: Could the IMF accept a junior role in the Greek rescue with the European Commission in the lead role and the ECB and the IMF in junior positions?

Until then, the IMF had only accepted a subordinate role to the EU Commission in the 2008 Latvia rescue when the IMF extended a €1.7 billion loan at twelve times the country's quota as part of a €7.5 billion European Union-led assistance package to which also other EU member countries, including Poland, contributed.

Blustein sheds light on another controversial aspect of the IMF's partly disastrous journey into the euro area rescue: Should the IMF play a rescue role at all in cases where a euro area country loses market access because of high debt and bad economic management? Some in the IMF argued that a rescue role in the eurozone should only be accepted if it had "been able to set terms and conditions for the entire eurozone. It should have been on the opposite side of the negotiating table from the ECB, rather than the same side, and it should have had the power to require action from all of the member countries, not just the ones urgently in need of international assistance." It should have been clear that "the Fund was coming to the rescue not just of Greece, but of the euro; even the rich countries that never needed IMF money were, in many respects, supplicants, using the Fund to help save their terribly flawed system of monetary union."

In this respect Blustein quotes Peterson's Ted Truman, Washington's highly respected veteran of financial diplomacy, who didn't mince his words. "The IMF should have insisted as part of the first program for Greece that the other members of the euro area adopt a complementary strategy as a condition for its approval of the Greek program," but the Fund was "too timid, paralyzed, or conflicted to require such steps."

Truman's message to European leaders: "The members of the euro area wanted to preserve the euro, but they were not prepared to accept conditionality applied to the euro area as a single entity. The rest of the world, to its regret, allowed the Europeans have it both ways—to save the euro but by imposing all the policy conditions only on the countries in crisis."

MERKEL DID NOT TRUST THE EUROCRATS

What Blustein recorded on the basis of many interviews with those who were part of the dramatic euro crisis management in its early stages is revealing because it documents the key role of German Chancellor Angela Merkel and the low opinion in the Berlin government of the capabilities of the EU Commission.

After a long power struggle between those who wanted to keep the IMF out of the eurozone, led by ECB President Jean-Claude Trichet, and those who wanted the IMF as part of the rescue operation, Blustein recalls: "Ultimately, the decision came down to one person—Merkel. The German chancellor, although famously cautious and deliberative, tends to be immovable once she feels she has mastered a subject. … [A]s she weighed both economic and domestic political considerations regarding the IMF, her position hardened to the point she deemed it imperative to overrule her fellow European leaders."

There are insightful elaborations of Merkel's motives by the veteran journalist:

> *"Ideal as it might be for Europe to be able to handle the crisis on its own, its institutions—specifically, the European Commission—were nowhere near up to the challenge, Merkel believed. For all the professionalism of the eurocrats who toiled in Brussels' high-rise offices, the commission lacked the program-designing skills of the IMF; more importantly, the commission had shown itself to be too cozy with European politicians and too timid about offending them. The German public, which was overwhelmingly negative toward rescuing a country that had clearly gotten itself into a mess, would never accept an emergency loan unless it came with severe conditions, enforced by arbiters with recognized neutrality and competence—and the IMF was the only institution that came close to that description. All in all, involving the Fund in the rescue of Greece was not only desirable from Merkel's perspective, it was essential if Berlin was to provide support."*

This explains why Merkel, against opposition from the new Greek leader and others, made her approval for the third rescue package—funded from the European

Stability Mechanism—dependent on the IMF continuing its advisory and financing role.

STRAUSS-KAHN: IMF MUST HELP RESCUE THE EURO

Getting the IMF on board in the spring of 2010 happened under IMF Managing Director Dominque Strauss-Kahn, who as former French minister of finance was eager to involve the IMF. There was massive political pressure as well from European governments and also from the United States.

On both sides of the Atlantic, governments were still haunted by the contagion damage that the Lehman Brothers bankruptcy in 2008 caused globally. A Greek default on its euro bonds had huge systemic financial market risks considering the high bank exposure of European and American banks and other investors in the eurozone.

What *Der Spiegel* branded as the euro leaders' "cowardice" ended up saving bankers and investor's fortunes, but shifted much of the bond bail-out burden to generations of taxpayers.

AND TRICHET DEMANDED FULL BAILOUT

As scary sell-offs indicated that Greece's ills were infecting other highly indebted and weak sovereign euro members such as Portugal, Ireland, and—because of its banking problems—Spain, Europe's policymakers, including ECB President Jean-Claude Trichet, went for a comprehensive bailout solution. They ignored the Maastricht Treaty's no-bailout clause, which states that neither the European Union nor its member states shall "be liable for or assume the commitments of other governments."

After European leaders had decided to take the bailout route and shy away from any timely Greek sovereign bond restructuring, Trichet went public with the ECB Council decision of May 10, 2010, to launch a Securities Markets Programme, under which central banks in the eurosystem were authorized to buy sovereign bonds of euro area member states to reduce steeply rising bond yields.

Those urging the need to address the risk of Greece losing its debt sustainability and move toward restructuring of Greek debt through the framework of private sector involvement—as was done two years later under mounting market pressure—lost their case for the time being. Christine Lagarde, then French finance minister, conceded during the hectic Greek rescue negotiations: "We violated all the rules because we wanted to close ranks and really rescue the eurozone."

Under unprecedented pressure, the eurozone's institutional, organizational, regulatory, and legal defenses to save the euro against powerful market forces were put in place. New rescue funds and instruments were established and funded, including the European Financial Stability Facility, followed by the permanent European Stability Mechanism, capitalized with €80 billion to support a financing volume of €750 billion.

HOW EURO LEADERS FAILED THEIR INSTITUTIONS

The extent of damage to the institutions of the eurozone after years of rescue struggles is visible in the Greek tragedy. German Finance Minister Wolfgang Schäuble may want to preserve EU law—where debt forgiveness is not possible—but instead he proposed a five-year "time-out" for Greece, since a debt reduction could be possible outside monetary union. This reflects the bad conscience of Germany's political class for having undermined the whole legal and governance foundations of monetary union.

On July 28, 2015, in reaction to the barely avoided Grexit, Germany's Council of Economic Experts, an independent body that advises the government in Berlin, came out with a Special Report proposing a "sovereign insolvency mechanism" and other urgent reforms to make the euro area more stable.

"The recent conflict between the government of Greece and its partners has shaken the very foundations of European Monetary Union," argue the economic "wise men." Under the heading "Maastricht 2.0," they present proposals for strengthening the architecture of monetary union with concepts for a long-term framework, whose guiding principles should be "the unity of responsibility and liability at national and European levels." Above all, the euro area's crisis mechanism "should be complemented by a mechanism for orderly sovereign insolvencies and should stand firm against any uncooperative, debt-stricken government. Strict adherence to euro area fiscal rules remains the only way for governments to deal with high sovereign debt," argues the Council.

> *As it turned out, for the Obama administration, failure had a geopolitical price.*

Marcel Fratzscher, a former ECB economist who now heads the Berlin think tank DIW, in a recent *Financial*

Times editorial shows how much even the unwavering defenders of the euro rescue operations have been unsettled by the Greek ordeal. "The Greek crisis has put Europe in a trap. The conflict over how to solve it has eroded trust and accelerated the renationalization of policymaking all over Europe. … Meanwhile, Germany has started disengaging from the European project. Many Germans feel victimized by international criticism. European reforms will fail if they do not address Berlin's deepest fears. The rest of the EU must take such concerns much more seriously—starting now."

In Fratzscher's view, Germany's biggest fear is that the eurozone is becoming a transfer union with Berlin as the paymaster. Germany's second-biggest fear is that common European rules are circumvented all too often. Germany's third-biggest fear is that national sovereignty is being eroded without Europe delivering more stability and prosperity.

Instead of showing resolute leadership when Greece was about to lose access to the markets and default on its creditors in the spring of 2010, euro policymakers opted to ignore the no-bailout clause of the Maastricht Treaty and allow the ECB to overstep its mandate.

This way, the ECB under Presidents Jean-Claude Trichet and Mario Draghi was able to come to the rescue by opening the monetary flood gates and by using various programs and instruments of indirect and covert state financing through the purchase of securities.

In the case of Cyprus and Greece, the ECB and the European System of Central Banks even allowed the misuse of Emergency Liquidity Assistance loans to keep insolvent banks above water. The ECB's policy of near-zero interest rates is causing political upheaval in northern, high-saving member countries where a large part of the population that is saving for additional retirement income feel their nest eggs are getting expropriated by the Club Med-dominated monetary union.

Since the debt-laden Club Med euro member states and France succeeded in getting Germany to accept that the ECB could also assume bank supervision under the Single Supervisory Mechanism beginning in November 2014, the ECB is on its way to becoming the eurozone's economic and financial power center, acting as a mixture of a modern European "Gosplan" authority and a eurozone "wealth of nations redistribution mechanism" to speed up the transformation of monetary union into the politically explosive transfer union that northern member countries such as Germany are fighting against.

As to the question of how much the European Commission and the European Council, along with the Eurogroup of euro area finance ministers, failed in handling the Greek economic and financial meltdown, the unforgettable circumstances under which a third rescue program was negotiated speak for themselves.

Washington's belated campaign to deter America's allies from supporting Beijing's ambitious multilateral project was not successful.

HOW THE UNITED STATES PROVOKED CHINA TO RETALIATE

Another worrisome development is how the U.S. government and the U.S. Congress have been damaging the most important global financial institution—the IMF—by blocking an agreed governance reform.

The United States as largest shareholder has been practicing malign neglect towards the IMF and its member states. In November 2010, at the G-20 meeting in Seoul, the U.S. government agreed to an IMF governance reform package that asked for—among other things—a commitment to doubling quota subscription so that major emerging economies such as giant China would be better represented.

As it turned out, for the Obama administration, failure had a geopolitical price.

Not overcoming the U.S. Congress's block on these IMF governance reforms may have provoked the Chinese to go their own way. Faster than anyone thought possible, Beijing launched a new multilateral development institution, the $100 billion Asian Infrastructure Investment Bank, in competition with the U.S.-dominated World Bank Group and the U.S.-Japanese-dominated Asian Development Bank.

As on other fronts of international financial diplomacy, Ted Truman of the Peterson Institute saw what was at stake. "Congressional balking on this issue did substantial, actual damage to the U.S. reputation around the world, as the leaders of many countries called into question Washington's ability to deliver on promises made in international economic agreements," he warned in his March 2014 paper, "IMF Reform Is Waiting on the United States." The vital role played by the IMF in stabilizing the world economy and financial system is in serious jeopardy, he warned.

Richard Koo, chief economist of Nomura Research Institute, explored the issue in a paper arguing, "The Greek experience with the IMF shows how the institution sometimes fails to deliver and by extension, how important it is for the countries in need to have more than one option when it comes to securing crucial aid." And

The ECB is on its way to becoming the eurozone's economic and financial power center, acting as a mixture of a modern European "Gosplan" authority and a eurozone "wealth of nations redistribution mechanism."

he continued, "In light of U.S. and European opposition to IMF and World Bank reforms, few should have been surprised that China decided it made more sense to create a new institution than to stand around waiting for the quota change."

The new China-dominated AIIB's significance, the Nomura economist argues, "lies in the degree to which it represents a shift away from the multilateral institutions that have dominated the post-war world economic order." China's ambitious new initiative in the area of broadening the options for financing Asian infrastructure projects has to be seen also in conjunction with the establishment of the New Development Bank, formerly referred to as the BRICS Development Bank, a $100 billion multilateral development bank operated by the BRICS states (Brazil, Russia, India, China, and South Africa), headquartered in Shanghai, China.

When the United Kingdom threw its support behind the AIIB venture in March of this year, alarm bells in the U.S. State Department started ringing. The move marked a diplomatic break with Washington. Fear that the new development lender could erode some of the traditional U.S. dominance over the World Bank Group is not farfetched. Washington's belated campaign to deter America's allies from supporting Beijing's ambitious multilateral project—arguing the AIIB would not adhere to international standards for governance and environmental protection—was not successful.

With its $4.5 billion contribution, Germany tops the non-regional AIIB membership list of twenty-five countries—ahead of France, Brazil, the United Kingdom, Italy, Spain, Netherlands, Poland, Switzerland, Egypt, and others—highlighting China's growing influence in financial diplomacy and actual financial firepower. With $29.9 billion, China will be the largest contributor of the $75 billion total the Asian regional members have pledged.

On June 29 of this year, at a ceremony in the Great Hall of the People, China's President Xi Jinping was able to host representatives from fifty-six member countries for the founding of the AIIB. As the *New York Times* noted, "Conspicuously absent from the gathering were the United States and Japan, the leaders of the World Bank and the Asian Development Bank, the institutions that were created after World War II to build a Western-designed global financial architecture. Washington fears those institutions will be undermined by the new body."

The article further noted the fact that "the new bank is the first large international body established by China that like the World Bank and the ADB meets the standards of the Vienna Convention on the Law of Treaties." This could be seen, legal experts argue, as an effort by China to play by the international rules in development finance. Who dares not to be cooperative with the world's largest creditor, even in the world of multilateral development finance?

So it was not surprising that Jim Yong Kim, the president of the World Bank, said in a statement that he welcomed the newcomer. Similar sounds came from the

Germany's biggest fear is that the eurozone is becoming a transfer union with Berlin as the paymaster.

immediate competitor, the Asian Development Bank in Manila. Its general council, Christopher H. Stephens, indicated that his bank "would be pleased to cooperate with AIIB in co-financing projects that meet our common objectives and looks forward to the opportunity to do so."

In the view of some experts, one should not downplay the larger implications of these new Chinese initiatives. David Marsh from the London think tank OMFIF warned in a recent editorial in the German daily *Handelsblatt* about China's "Attack on Bretton Woods."

Marsh sees "not only a grand strategy of China as the largest global creditor to establish alternative institutional structures and governance standards for global development financing in competition to the World Bank Group, but also a chance for a greater role for its currency, the renminbi, in the world's monetary system."

Marsh assumes that China will use its huge creditor position and growing political power to get the renminbi accepted in the Special Drawing Rights basket of currency, consisting of the U.S. dollar, the euro, the Japanese yen, and the pound sterling.

THE BOTTOM LINE

So we get to the bottom line of "how institutions are damaged." After the worst banking crash since the Great Depression of the 1930s, Western leaders and the people they govern have now to pay the consequences of a failure to act in a timely and resolute manner.

Policymakers failed to act resolutely. The IMF was dragged into the Greek and euro rescue under political pressure and under conditions that amounted to a mission impossible. Euro area leaders let the ECB do the main euro rescue job by ignoring EU laws and governance requirements. The U.S. government and the U.S. Congress failed to live up to their reform commitments for the IMF, thereby encouraging China and other geopolitical rivals to begin gnawing away at the Bretton Woods institutions' multilateral global franchise. The unthinkable is indeed becoming routine. ◆