Two Cheers *for* Christine Lagarde

BY DESMOND LACHMAN

Bringing an era of IMF bumbling to an end.

It would be a gross understatement to observe that the International Monetary Fund has not covered itself in glory in its handling of the European sovereign debt crisis. However, this should not detract from the refreshingly bold, imaginative, and courageous leadership that Christine Lagarde, the former French finance minister, has brought to that institution since she replaced the disgraced Dominique Strauss-Kahn as IMF managing director some eighteen months ago.

Under Lagarde's leadership, the IMF is at last providing an effective voice of reason as a counterbalance to the European Central Bank and the European Commission, the IMF's "troika" partners, in efforts to find a solution to the European sovereign debt crisis. And under her leadership, there is now reason to hope that the European periphery will finally extricate itself from its austerity-induced downward economic and political spiral that still constitutes the major risk to the global economic recovery.

Prior to Lagarde's assumption of the IMF's helm in July 2011, the IMF failed miserably in its task of multilateral surveillance over the economic policies of its most important member countries. After spectacularly having failed to anticipate the U.S. housing and credit market bust in 2008, which spawned the worst global economic recession in the post-war period, the IMF did no better in anticipating the European sovereign debt crisis. In the long run-up to that crisis, which began in earnest in early 2010, the IMF was conspicuously silent in warning of the dangers of large European pay-

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IMF Managing Director **Christine Lagarde:** *Can she grasp the contradictions in Europe's present economic policy path?*

ment imbalances. This was all the more inexcusable since balance-of-payments problems were supposed to be the IMF's main area of expertise and external economic surveillance was supposed to be its basic *raison d'être.*

Rather than sounding the alarm about the large cumulative losses in international competitiveness and about the build-up of outsized external current account deficits in the European periphery, the IMF bought into the now demonstrably mistaken view of Jean-Claude Trichet, the former president of the European Central Bank. In Trichet's view, the adoption of the euro had rendered payments imbalances between countries within the European monetary union of as little relevance as payment imbalances between the individual states of the United States. Buying into that view, and failing to recognize that, unlike the United States, Europe was very far from being a political union, the IMF was blinded to the real risk of a payment and debt crisis of epic proportions.

The IMF failed miserably in its task of multilateral surveillance.

If the IMF's failure to anticipate the European crisis is to be lamented, its handling of that crisis revealed how little the IMF had learned from previous economic and financial crises. For, rather than address the crises in Greece, Ireland, Portugal, and Spain as the solvency crises that they were, the IMF chose to consider those crises as ones of liquidity. More disturbingly yet, rather than indicate the folly of trying to correct large external and public finance imbalances with severe budget austerity, within a euro straitjacket and within the context of a domestic credit crunch, the IMF threw its full weight behind a macro-economic policy mix that had little chance of success.

Since taking over from Dominique Strauss-Kahn, Lagarde has distinguished herself by her courageous truth-telling to a European economic policymaking establishment that has remained largely in denial about the severity of the crisis. In August 2011 at Jackson Hole, in her first major policy speech as IMF managing director, Lagarde broke the news to her European peers that the European banking system was grossly undercapitalized and that it was urgently in need of repair.

Following her Jackson Hole speech, the IMF staff let it be known that the degree of undercapitalization in the European banks was of the order of €200 billion, or around double the amount to which the Europeans were then prepared to own up. After taking much heat on this issue, subsequent events would prove that, if anything, the IMF's estimates were themselves underestimates of the true extent of the European banks' capital problem that has caused those banks to continuously tighten credit. A recent OECD study has suggested that the European banks are likely still undercapitalized to the tune of €400 billion.

In September 2012, in an even more fundamental and brutally honest round of truth-telling, Lagarde raised the

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basic question as to whether Europe's strategy of severe budget austerity was working or whether it was undermining the very goal of stabilizing the European periphery's public finances. She did so by allowing the IMF's research department to publish estimates that showed that the fiscal multipliers, on which the IMF's financial support programs to Greece, Ireland, and Portugal had been based, had likely been excessively low.

According to the IMF's latest estimates, those fiscal multipliers, which are a measure of the degree to which budget tightening impacts the economy, were of the order of between 0.9 and 1.7, or a multiple of the 0.5 that had been previously assumed in its European lending programs. In other words, the IMF was now owning up to the fact that it had underestimated the impact of budget tightening on the European economy by a factor of between two and three times. Armed with those estimates, Lagarde has been advocating that should economic growth falter in Ireland, Portugal, and Spain, those countries should not respond to any consequent budget slippage by another round of belt-tightening. Rather, they should be mindful of the damage that further budget tightening might do to those economies and they should postpone the date by which they intend to meet their final budget deficit targets.

To her credit, Lagarde has also shown courage in challenging the prevailing German view that fiscal consolidation is the right policy response for all European countries and for all occasions. Indeed, she has pointed out the absurdity of having all European countries tighten their budgets simultaneously in the midst of a Europe-wide recession. And much to German Chancellor Angela Merkel's displeasure, Lagarde has kept insisting that those countries such as Germany that do have the room for fiscal policy maneuver should engage in fiscal stimulus with a view to easing the economic adjustment burden of the European periphery.

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If one had any doubt as to Lagarde's mettle, that should have been laid to rest by her recent standing up to European finance ministers over the conclusion of yet another bailout program for Greece. In December 2012, Lagarde simply refused to go along with the European charade that Greece's public finances were sustainable without a large write-down in its official debt obligations. Despite considerable pressure, Lagarde was not to be budged until European finance ministers committed themselves to a round of official debt reduction for Greece after 2014, as might be needed, to put Greece back on track to reduce its public debt-to-GDP ratio to 110 percent by 2022.

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More recently, Lagarde has again been showing her resolve with respect to the ongoing IMF-EU bailout negotiations with Cyprus. She is rightly concerned that the large bailout needed for Cyprus's oversized banking system will in and of itself bloat that country's public debt-to-GDP ratio to over 150 percent. Chastened by the IMF's unfortunate Greek experience, where delayed debt reduction seriously compounded Greece's economic and financial problems, Lagarde is insisting that the IMF recognizes upfront a solvency crisis for what it is rather than pretend that the crisis is one of liquidity. This is causing the IMF to call for the early restructuring of Cyprus's debt despite Merkel's strong resistance to such a proposal ahead of the all-important September 2013 German presidential elections.

Lagarde's impressive performance over the last eighteen months can leave little doubt that she fully grasps the contradictions in the present economic policy path upon which Europe is embarked. One has to hope that this understanding, coupled with her true political courage and determination, will enable her to persuade her counterparts at the ECB and at the European Commission about the need for a fundamental change of policy course that might prevent Europe from sinking ever deeper into recession. ◆