

# Standing Up To Europe

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*By Kenneth Rogoff*

As the Eurozone crisis continues to deepen, the International Monetary Fund (IMF) may finally be acknowledging the need to reassess its approach. New managing director Christine Lagarde's recent call for forced recapitalization of Europe's bankrupt banking system is a good start. European official's incensed reaction – the banks are fine, they insist, and need only liquidity support – should serve to buttress IMF's determination to be sensible about Europe.

The IMF has so far sycophantically supported each new European initiative to rescue the over-indebted Eurozone periphery, committing more than \$100 billion to Greece, Portugal and Ireland so far. Unfortunately, the IMF is risking not only its members' money but its own institutional credibility.

Only a year ago, at the IMF's annual meeting in Washington DC, senior staff were telling anyone who would listen that the whole European Sovereign-debt panic was tempest in a teapot. Even for Greece, the IMF argued, debt dynamics were not a serious concern, thanks to anticipated growth and reforms. Never mind the obvious flaw in IMF's logic, namely that countries such as Greece and Portugal face policy and implementation risks far more akin to emerging markets than to truly advanced economies such as Germany and US.

As the situation deteriorated, one might have guessed that the IMF would mark its beliefs to market and adopt a more cautious tone. Instead, at its April 2011 interim meeting, a senior official declared that the IMF now considers troubled Spain to be a core Eurozone country like Germany, rather than a peripheral country like Greece, etc.

Simply put, Europe and US control too much power in the IMF, and their thinking is too dominant. What European leaders may want from the IMF are easy loans and strong rhetorical support. But what Europe really needs is the kind of honest assessment and tough love that IMF has traditionally offered to its other, less politically influential, clients.

The IMF's blind spot in dealing with Europe until now is only partly due to European voting power. It also stems from an "us" and "them" mentality that similarly permeates research at the top Wall Street investment houses. Analysts who have worked their entire lives only on advanced economies have learnt to bet on things going well, because for the couple of decades prior to the crisis, things mostly did go well – very well.



*The IMF has so far sycophantically supported Europe; it should now stand up to the defaulting*

That is why, for example, so many keep assuming that a normal rapid recovery is just around the corner. But the financial crisis should have reminded everyone that the distinction between advanced economies and emerging markets is not a bright red line.

In his recent speech in Jackson Hole, Wyoming, US Federal Reserve chairman Ben Bernanke forcefully complained that political paralysis has possibly become the principal impediment to recovery. But analysts accustomed to working on emerging markets understand that such paralysis is very difficult to avoid after a financial crisis. Rather than slavishly believing policymaker's assurances, emerging-market researchers have learnt to be cynical about official promises. All too often, everything that can be done wrong will be done wrong.

The IMF need to bring much more of this brand of skepticism to its assessment of Eurozone debt dynamics, instead of constantly seeking strained assumptions that would make the debt appear sustainable. Anyone looking closely at Europe's complex options for extricating itself from its debt straight-jacket should realize that political constraints will be a huge obstacle no matter which route Europe takes.

Even outside Europe, the IMF has long given too much credence to sitting governments, rather than focusing on the long term interests of the country and its people. It is doing Europe's people no favour by failing to push aggressively for a more realistic solution, including dramatic debt write-downs for peripheral Euro zone countries and reallocating core-country guarantees elsewhere.

Now that the IMF has squarely acknowledged the huge capital holes in many European banks, it should start pressing forcefully for a comprehensive and credible solution to the Euro zone debt crisis, a solution that will involve either partial breakup of the Euro zone or fundamental constitutional reform. Europe's future, not to mention the future of the IMF, depends on it.

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