THE G-20, THE IMF AND THE EUROPEAN DEBT CRISIS

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Framing the Issue

The early and tentative signs of a stabilization of the European crisis have been reversed following the inconclusive outcome of the Greek elections in May and the escalating pressures on the Spanish financial sector. While Germany is now issuing medium-term bonds at almost zero interest rates, spreads on Italian government bonds have widened again despite the stabilization policies implemented in the country.

Meanwhile, the recent G-8 Summit at Camp David has unequivocally underscored the unprecedented political isolation of the German chancellor, Angela Merkel, and her narrowly-conceived approach of strict and rigid austerity in order to address the crisis in the eurozone. While governments throughout the euro area are implementing fiscal consolidation irrespective of their economic conditions, the debt-to-GDP ratio for the single currency area is projected to increase by 3 percentage points in the 2011-13 period due to faltering economic growth—this according to the latest forecasts by the International Monetary Fund. In fact, Italy and Spain will undergo contractions well above 2 percent of their real GDPs this year. And it is likely that next year won't be much different despite optimistic projections by the IMF.

Policy Considerations

Against this backdrop, the upcoming G-20 Summit in Los Cabos will provide an opportunity to finalize an agreement on the additional resources that the IMF will need in order provide a backstop to the crisis unraveling in Europe. At the April spring meetings of the IMF and World Bank, a number of members committed to stepping up the IMF's financial firepower by over $430 billion. Some countries have already indicated the scope of their efforts, with Japan leading the pack with a $60 billion pledge. Other countries, including the BRICs, have broadly indicated their willingness to participate but will be finalizing the extent of their commitment by the summit in Mexico. Unfortunately, the fact that the United States has decided not to participate in this effort, despite being the IMF's largest shareholder, may have exerted a reverse catalytic effect, delaying the decisions of other members to contribute to the pool and reducing the latter's overall size.

As of mid-May, the IMF's forward commitment capacity stands at approximately $380 billion. Once the agreement on additional resources for the IMF is finalized, the fund's overall capacity will increase to slightly more than $800 billion. Although $800 billion seems like a significant amount, it will not be enough to make the IMF a systemic

lender to the euro area although the institution will be in a better position to (re)finance the peripheral economies in Europe as well as other member countries that may be hit by contagion should the crisis deepen.

While agreement on topping up the IMF's finances is widely expected to be finalized soon, it would be a missed opportunity if the upcoming G-20 Summit were to be reduced to an accounting exercise for who should give what. Rather, leaders should assess what strategic role, if any at all, the IMF can play in a systemic crisis, which this time happens to be in Europe. Overarching questions that should draw the leaders' attention include: to what extent should the IMF's lending capacity be commensurate to such a role? And, are the fund's current instruments for addressing systemic crises adequate?

Since the breakdown of the Bretton Woods system of fixed exchange rates in the 1970s, the International Monetary Fund has played a relatively marginal role compared to the mission that its founding fathers had envisioned; the fund has for the most part helped smaller developing countries in times of financial crisis by providing them with stabilization programs. However, the European debt crisis has changed all this but not the resource constraints that the fund's major shareholders have imposed on the institution. Discussing strategic rather than accounting issues is the very purpose of having the leaders of the major economies come together and the G-20 is now the forum for political leaders to discuss critical IMF-related issues.

Action Items for the G-20

As leaders gather in Los Cabos, they should escalate pressure on Germany toward a mutually-coordinated response to the unprecedented threat to the very existence of Europe's single common currency. There are some early signs that coordinated pressure led by the axis between Paris and Rome may be softening the German position toward Eurobonds. Clearly, G-20 leaders have a stake in the European crisis, as the unraveling of the euro could have long-ranging consequences for the global economy. There are several policy items on which the European position is still unclear: they range from the establishment of a EU-wide insurance deposit scheme to the need to reconcile fiscal consolidation with growth-enhancing measures. If the G-20 still regards itself as the premier forum for international economic consultations, this is the moment to rise to the occasion and exert the utmost pressure on their European counterparts, especially Germany.

Despite the best possible planning, there is a very real possibility that this summit may once again become hijacked by the crisis in Greece given that G-20 leaders will be convening the day following a new round of elections in that country. If the outcome of these elections is such that a pro-European cabinet is again unable to be formed, the summit will inevitably turn into a crisis committee that will have to quickly draw together a plan of action for how the global economy deals with a disorderly Greek exit from the euro and the potentially catastrophic consequences that would ensue. Yet, however unstable and uncertain the situation in Greece may look, the scenario of a Greek exit is one that can still be averted. The cost of keeping Greece in the euro area is much smaller compared to what a disorderly exit would trigger; and euro-area policymakers are well aware of that. Many of their recent statements to that effect are more tactical rather than a reflection of their deliberate intent of triggering a Greek exit from the single currency area.