

Leaked: The annotated Lagarde letter on Greece

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Monday was supposed to be the day when eurozone finance ministers flew to Brussels for an emergency eurogroup meeting (just their first of 2016!) to agree a way forward on Greece's star-crossed €86n third bailout. But despite weeks of intensive talks, negotiators are no closer to a deal than they were when they were [sent back to Athens two months ago](#).

Last night, Christine Lagarde, the International Monetary Fund chief, sent a letter to all 19 finance ministers ahead of the Monday meeting with her demands: drop all the talk about new austerity measures and quickly agree a plan for debt relief so that a deal can be met before a possible Greek default in July. We got a hold of the letter, and have [posted a news story on its contents here](#). But as is our practice at the Brussels Blog, we thought we'd offer up an annotated version of the full text, sent to national capitals last night:

Dear minister:

*Program discussions between Greece and the institutions have made progress in recent weeks, but significant gaps remain to be bridged before an agreement can be reached that would include the IMF under one of our program facilities. I think it is time for me to clarify our position, and to explain the reasons why we believe that specific measures, debt restructuring, and financing **must now be discussed simultaneously**.*

This is the main news in the letter: until now, negotiators have been trying to sequence three different sets of agreements in order. First, they wanted to agree a core set of reforms that were originally part of the new bailout programme. Second, and this was a relatively new idea, they were to agree a set of “contingency measures” that would kick in if the Greek programme veered off course. Third would come debt relief. Lagarde is essentially saying here that trying to do this sequentially makes no sense. She also is clearly signalling the “contingency measures” talks – which have been holding up progress for a month – are becoming fruitless.

*In particular, a clarification is needed to clear **unfounded allegations** that the IMF is being inflexible, calling for unnecessary new fiscal measures and – as a result – causing a delay in the negotiations and the disbursement of urgently needed funds.*

Here Lagarde is getting a bit more political. Alexis Tsipras, the Greek prime minister, has been using the IMF as a punching bag for much of the last year – and tensions became even worse when his government [seized on a transcript](#) of a private IMF teleconference [published by Wikileaks](#) to argue the IMF was negotiating in bad faith. Lagarde came close to [accusing the Greek government of recording](#) and leaking the conversation itself last month. But what has really frustrated her is that the IMF's recipe for the way forward – less austerity, more debt relief – is exactly what Tsipras had been arguing for. So why is the IMF being portrayed as the bad guys? Here, she is attempting to spell out that position more clearly.

First, together with the other institutions we have negotiated in good faith with our Greek partners on a package of fiscal measures yielding 2.5 per cent of GDP – close to being agreed – that will in our view be sufficient to reach a primary surplus of 1.5 per cent of GDP by 2018. Our assessment is based on realistic assumptions informed by Greece's track record, the international environment, and the latest data released by Eurostat.

This paragraph addresses “basket one” of the three-stage order of agreements. A deal is close on the core reforms, and all sides agree that they will bring about a 2.5 per cent of GDP cut in the Greek budget by 2018. Where the difference lies, however, is where this leaves Greece. Athens and the European Commission believe these core reforms will hit the programme target of a 3.5 per cent primary surplus in 2018; here, [Lagarde reiterates](#) that she thinks it will only get to 1.5 per cent. A primary surplus, by the way, is a budget surplus when debt payments aren’t counted.

*Second, this target **falls short of what Greece promised its European partners in July last year** – namely that it would achieve a primary surplus of 3.5 per cent of GDP in 2018. If the Eurogroup decided to hold Greece to this target, we could support an additional effort to temporarily reach this level, although it is higher than what we consider economically and socially sustainable in the long-run (see below).*

This goes to “basket two”, the contingency measures, and the heart of the dispute right now. Lagarde is arguing that the EU and Athens lower the surplus target in 2018 from 3.5 per cent to 1.5 per cent. But the EU and Athens are refusing. Here, Lagarde is saying: If you continue to insist on the higher target, we can go along...but only if there are some credible additional cuts to get there. Oh, and by the way, she doesn’t think additional cuts would be so good for Greece right now.

*However, let there be no doubt that meeting this higher target would not only be very difficult to reach, **but possibly counterproductive**. Greece’s fiscal adjustment has in the past fallen short of what was needed because of the lack of structural reforms underlying the adjustment effort. We do not believe that it will be possible to reach a 3.5 per cent of GDP primary surplus by relying on hiking already high taxes levied on a narrow base, cutting excessively discretionary spending, and counting on one-off measures as has been proposed in recent weeks. The additional adjustment effort of 2 per cent of GDP would only be credible based on long overdue public sector reforms, notably of the pension and tax system.*

Here’s where Lagarde gets into detail on why she thinks the “contingency measures” talks are going in the wrong direction. Thus far, the Greek government has tried to cut its way to surpluses by raising taxes on a very small number of taxpayers and cutting discretionary spending. Lagarde thinks that can’t continue before it starts damaging the Greek economy irreparably. If Athens and the EU really want to come up with another €3bn in savings (which amounts to 2 per cent of GDP), then she wants something that she feels is more sustainable: cuts in public sector pensions and a broadening of the tax base.

*Unfortunately, the contingency mechanism that Greece is proposing does not include such reforms. Instead, the authorities have offered to make short-term across-the-board cuts in discretionary spending – which has already been compressed to the point where the provision of public service is severely compromised – or transitory cuts in pension and wages not supported by fundamental parametric reforms. Based on past performance, **such ad-hoc measures are not very credible, but they are also undesirable** as they add to uncertainty and fail to resolve the underlying imbalances. I should also add that Greece has legislated a dozen contingency-type mechanisms in the past that have largely not worked.*

During the negotiations on the contingency measures, the Greek government – which believes it can’t politically go back to parliament for another €3bn in cuts – has offered a counter-proposal that would trigger across-the-board cuts if certain surplus targets aren’t met. Here, Lagarde makes clear the IMF rejects that proposal. Not only would across-the-board cuts fail to achieve the kind of reforms the IMF is looking for, but such things have

been tried in the past with little effect.

*Third, going forward, we do not expect Greece to be able to sustain a primary surplus of 3.5 per cent of GDP for decades to come. Only a few European countries have managed to do so, carried by a strong social consensus that is not in evidence in Athens. It would be **unrealistic to expect future governments to resist pressure to relax fiscal policy** over political cycles stretching far into the future. The recent experience – when first a center-right and then a center-left government quickly succumbed to easing pressures once a small primary surplus was achieved – should inform us against making such exceptional assumptions in the case of Greece. In our view, **maintaining a primary surplus of 1.5 per cent of GDP** over the foreseeable future may be achievable in the context of a successful program and strong European budget surveillance for many years to come thereafter.*

Although Lagarde doesn't overtly state it, this is essentially her argument for "basket three" – debt relief. The reason Greece has been forced into such large budget surpluses is to raise cash to pay off its ever-growing debt pile. Lagarde just thinks there's no way that can be sustained in the long-run. Better to restructure the debt and have more modest surplus targets instead. Germany has resisted this plan, however. Debt relief for Greece is radioactive in the Bundestag, since Germany is Athens' largest lender and would therefore be the one to see repayments cut the most. Also worth noting that Lagarde refers to Tsipras' Syriza party as "center-left" here. Not sure Tsipras would agree with that characterisation. Syriza actually stands for "Coalition of the **Radical Left**".

*I understand the urgency of the situation in the case of Greece and Europe as a whole, and our common objective is to quickly agree on a way forward. This requires compromises from all sides, and we have contributed our part by focusing conditionality on what we see as the absolute minimum, leaving important structural reforms to a later stage. However, **for us to support Greece with a new IMF arrangement**, it is essential that the financing and debt relief from Greece's European partners are based on fiscal targets that are realistic because they are supported by credible measures to reach them. We insist on such assurances in all our programs, and **we cannot deviate from this basic principle in the case of Greece**. The IMF must apply the same standard to Greece as to other members of our institution.*

Sincerely,

Christine Lagarde

This last paragraph essentially puts the gun on the table: if you don't want to play by our rules, we'll just walk away. This might be cheered in Athens, but would mean trouble for Berlin, where members of the Bundestag have said they will refuse to participate in the new Greek bailout without the IMF on board.