DSK's Arrest: Implications for the IMF Succession and PIIGS' Bailouts

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DSK's Arrest

The arrest of IMF Managing Director Dominique Strauss-Kahn (widely known as DSK) on allegations of attempted rape has important implications for the IMF, for the succession of its leadership, for the EU-IMF bailouts of the distressed PIIGS and for the French presidential election.

Before this weekend's arrest, DSK was highly likely planning to step down as the IMF's MD to prepare to run for the French presidency in 2012. In most polls, DSK was ahead of incumbent Nicolas Sarkozy and was the leading candidate to win.

While the allegations of rape are for now only allegations, this weekend's event will surely have effectively destroyed DSK's chances of running for the French presidency: In the court of public opinion he is now damaged goods, even if legally he is innocent until proven guilty. There is a small chance that his political ambitions will be resurrected if the allegations against him are found to be false in very short order: Indeed, some have put forward the hypothesis that DSK may have been set-up in a trap to destroy his candidacy. The French press close to Sarkozy had recently started a smear campaign against DSK and some intelligence sources suggest that "dark forces" in France may have been determined to destroy the IMF chief. But unless these allegations of "conspiracy" and "trap" are found to be true in the very short term (the next few days or weeks), his career at the IMF will be over (although he was planning to leave the Fund to run against Sarkozy anyway) and his chances of running for the French presidency will be destroyed into the bargain, regardless of whether he is eventually found guilty or innocent in a court of law.

Implications for PIIGS' Bailouts and Greece

DSK was supposed to meet with German Chancellor Angela Merkel on Sunday and with the EU Finance Ministers on Monday to discuss the approach to take with Greece: Stick to a "Plan A+" by augmenting (by a large amount) the official IMF-EU-EFSF program, allowing Greece to fill its financing gap of €25 billion-30 billion for 2012 (as the country will obviously not return to market access in 2012); or to move to a "Plan B" and force an orderly debt restructuring while continuing with a modified program of austerity and reforms. (In terms of RGE's matrix of options for Greece, these are Options 3 and 6; see "A How-to Manual for Plan B: Options for Greece's Debt Restructuring".)

While others at the IMF can take up the baton of negotiating the Fund's role in an additional bailout of Greece or in a bail-in of its private creditors, DSK had the necessary experience and gravitas to lead the IMF through these difficult trade-offs. Also, the planned departure in August of John Lipsky, the IMF's number 2, adds to the leadership void (even if Lipsky is now the Acting MD and was supposed to stay until November as a consultant). Yes, the organization is large and functional even without DSK, but only he had the experience and gravitas to impose the IMF's views on the rest of Europe. Indeed, the IMF program for Greece is seriously off track. Not only does the country have a huge financing gap for 2012, but also the tranche of official loans that was supposed to be disbursed after the June review is now at risk as Greece has overshot its deficit targets, with the worsening of the recession this year. And it is too easy for the IMF and the EU to argue that the June tranche would be paid if the program gets on track: Greece doesn't just need to be on track; it now needs another €25 billion-30 billion of additional official money (since it will not regain market access in 2012). So Greece would have to do more than the original program—whose targets it is already failing to hit—to come even remotely close to being able to request and receive additional bailout resources for 2012 and beyond as the chances are it will not regain market access for many years.

DSK's personal views *did* matter in terms of whether the IMF-EU program for Greece would be augmented or whether an orderly debt restructuring would take place: While IMF staff views carry some weight, the Greek program did not pass the Fund's strict debt sustainability analysis criteria initially; it was a case of a political decision to "lend and pray," given the EU's decision to take the bailout route. Thus, while DSK knew perfectly well that Plan A had failed and that moving to Plan B (an orderly debt restructuring) was necessary, he is also a political man who had to take into account political factors: 1) The ECB's radical resistance to a restructuring; 2) the risk that, if the IMF pushed for a restructuring, damaging contagion could have led to adverse consequences for his own political future in France; 3) France's traditional objective of controlling the power of Germany by roping it ever deeper into EU integration through an ever costlier full bailout of Greece. Thus, DSK might have been leaning in favor of Plan A+ (lend more and pray more) rather than Plan B, even if he and the IMF knew that Plan A was a failure. But the fact that the Greek program is seriously off track undermines the argument for Plan A+.

For Plan B to be followed, it is obviously necessary that all the members of the "Troika"—the IMF, the EU and the ECB—are convinced that this is the best route. So far, the ECB—especially its governor, Jean-Claude Trichet, and Lorenzo Bini Smaghi, a member of its executive board—has been the most vocal in its public opposition to a debt restructuring in Greece, with concerns about the collateral damage and contagion. Other ECB executive board members (or members to be) such as Jurgen Stark and Mario Draghi may have somewhat more flexible views on this matter; but with Banca d'Italia governor Draghi expected to be approved for the ECB presidency, it is certainly not the time for him to present controversial views.

While the ECB may have legitimately taken this view, the ideological blindfolds that led to it not being able to seriously consider the possibility of an orderly restructuring and the ways of avoiding contagion, have left the institution in an awkward spot. Its asset ledger is now piled high with hundreds of billions of euros of claims against PIIGS banks that are poor collateral—being mostly public debt or bank debt guaranteed by governments—for its lending to PIIGS banks. And on top of that, there is also another pile of PIIGS public debt that is the result of its outright limited purchases of PIIGS government debt. Thus, in part, the ECB's opposition to a debt restructuring may now be coming more from concerns about the effects of such a restructuring on its balance sheet than a rational consideration of the pros and cons of a restructuring. Also, the ECB, by cornering itself in opposition to any mention of a restructuring, did not do the necessary homework and scenario analysis of what an orderly restructuring might look like. This is an institutional failure that borders on recklessness; any serious institution would properly consider and analyze—in complete and private confidentiality—a Plan B, in case Plan A fails. This time, ideological bias has led the ECB to fail to do the necessary homework on Plan B that would have led to it realizing that there are ways to accomplish orderly debt restructurings and to limit the contagious effects of such restructuring.

For an orderly restructuring to occur, the Germans also need to be convinced that this is the way to go. A month ago, all the signals from senior policy makers in Germany were that an orderly restructuring of debt—Plan B—was preferable to continuing with a failed Plan A or moving to a Plan A+ of more bailout money. In recent weeks, the Germans have been starting to wobble: Finance Minister Wolfgang Schaeuble has signaled tentative support for Plan A+; but among the Germans he is the most robust supporter of a fuller European integration, even if such integration may lead (as in Option 6 of the RGE matrix) to a full assumption of all Greece's debt by its official creditors (i.e. a full 100% bailout of the private creditors of Greece and additional official financing of continued Greek deficits for as far as the eye can see).

Instead, so far, Merkel has been sitting on the fence, wobbling between Plan A+ and Plan B. To go for Plan A+, she would have to take three political risks: 1. Go against her own political base and electorate, which was already skeptical of Plan A and would now to have to ingest even more bailout resources for Greece; 2. Go against those in her own party and coalition (especially the FDP) who will vote against additional resources for Greece, thus forcing her to rely on the votes of the Social Democratic Party opposition to win a vote for Plan A+; 3. Possible legal challenges to Plan A+ in the German Constitutional Court as Plan A+ — in the face of a failing Plan A —looks like a more clear-cut case of a bailout. So, all in all, it is still not obvious that Germany will go for Plan A+. It is more likely now than a month ago, but the very important factors discussed above may lead Merkel to take a different stance.

Certainly, the now missed meeting this past Sunday between her and DSK was key: DSK might have made a strong argument for Plan A+ and he could have made a similar argument in front of the EU

Finance Ministers today; or he could have nudged the Troika towards Plan B. That is why his arrest in New York is actually very consequential; he is the only European in the Fund's senior management and the only one with the political gravitas and influence to make a strong case for any option. With him for now out of the picture, any other IMF official will have to take a more wishy-washy and cautious attitude to inter-European matters. The tragedy of the DSK arrest is that, at this key and critical moment in the eurozone crisis, when serious and consequential decisions need to be made, there is no European representing the IMF's views in the Troika.

The IMF MD Succession Race Has Started: Lagarde in Pole Position

As far as the IMF MD succession is concerned, we at RGE expressed the view last month that the next IMF MD will likely be Christine Lagarde. As we wrote in our April 18 "Washout in Washington" piece:

***"**Ideally, the French would like…the widely well-regarded finance minister, Christine Lagarde, to run the IMF …And if they want Lagarde at the IMF, then they have to let someone else run the ECB; and it would be harder to veto Draghi in favor of lower-key candidates from the Netherlands and Finland… It would not be too difficult for the Europeans to sell the idea of another European running the IMF (despite all the talk about choosing the managing director based on merit and possibly having an EM representative run the Fund): The U.S. has not given up on its monopoly of the World Bank; so the Europeans can reassert—at least for the last time—their monopoly of the Fund. Moreover, the biggest mess and crises that the Fund will have to deal in the next few years are not in EMs, but rather the new submerging markets, i.e. the eurozone; thus, there is the need to have a European in charge. Additionally, EMs have an able Singaporean to head the IMFC, which for the time being is a step in the right direction in terms of rebalancing the chairs of the Bretton Woods institutions. As if a few relatively homogenous, fiscally and structurally challenged Western countries with less than a billion people collectively should continue to enjoy the same degree of ascendancy over the global commons as the other five billion people distributed around a wide range of heterogeneous countries…"*

There are plenty of very capable candidates from EM economies that may be deserving of the IMF leadership, such as Kemal Dervis, Stanley Fischer, Mohamed El-Erian, Montek Singh Ahluwalia, Andrew Sheng, Trevor Manuel, Augustin Carstens, Arminio Fraga and Angel Gurría. But, while there had been a lot of talk about opening the IMF MD succession to a fairer process based on merit that would leave the door open for the first time to a non-European and non-Westerner, EU-U.S. realpolitik may lead to another European (and indeed another French person), specifically current French economy minister Christine Lagarde.

It is true that the French have been running the Fund for three-quarters of the past three decades. But technocratic (with the finest bureaucratic and ENA schooling and training) Frenchmen with political and diplomatic savvy—Jacques de Larosière, Michel Camdessus and DSK—have done a much better job than other Europeans have done, such as Horst Kohler and Rodrigo de Rato. And Lagarde has the skills, the smarts, the diplomatic skills and the political gravitas to run the IMF. Moreover, with France having accepted Draghi—who had been another potentially excellent option for the IMF—as ECB governor, it can certainly make the claim to its fellow EU members that another French person should take over the Fund. Indeed, Italy got the ECB slot and Germany did not have a candidate for the ECB (let alone the IMF); while former UK prime minister Gordon Brown doesn't have the support of his own government. So, it if is another European, it is certainly Lagarde. Her only problem is the recent allegation of some impropriety in the way a financial scandal was settled; but unless this issue turns out to be more serious than it appears now, it is very hard to think of a different European candidate for the Fund.

EMs may try to push for a candidate of their own, but a blocking coalition of the U.S. and EU will lead to another European running the Fund. The U.S. has certainly not given up its de facto privilege of being able to choose the World Bank's head; so, unless it formally gives up this option, the Europeans would push for another European. And the fact that the Fund's biggest clients are likely to be European for the next few years—what an irony and paradox!—will strengthen the EU's claim to again run the Fund.

Also, the world of EMs is divided. The problems of MENA are a valid reason for someone from the region being picked. But the brilliant El-Erian may be happy to keep on running PIMCO; while the as-brilliant Fischer—who was supported by many EMs in 2000—including some in the MENA region—would have a harder time now getting the support of MENA given the political changes there and the fact that he has now been governor of the Bank of Israel for years. The able Dervis was Turkey's finance minister for only two years and was involved more in development than macro issues. It may be too early or unlikely for EMs to coalesce around an African candidate (Manuel). Latin America countries are likely to push for a regional candidate (Carstens, *Gurría,* Fraga), but they may have a hard time convincing the Asians, who could effectively veto a Latin American. Asia, meanwhile, will have a hard time finding a candidate around which it can rally: The Chinese may not want an Indian (even a very able candidate such as Ahluwalia) to run the Fund. And Asia now has the chair of the IMF's political body—the IMFC—following the choice of the smart Singaporean, Tharman Shanmugaratnam. Thus, there are no clear EM candidates that one could see most EMs rallying around. For their part, the Europeans will rally around Lagarde, who is also very well respected by the White House and the U.S. Treasury.

And with Lipsky departing the IMF by November, the U.S. will have a chance to choose the IMF's number 2, the First Deputy MD. David Lipton, now a senior member of the NEC and formerly Under Secretary for International Affairs at the U.S. Treasury, is the leading candidate.