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Spain and Italy pose conundrum for IMF

By Alan Beattie in Washington

As Europe’s sovereign debt crisis threatens Italy and Spain, a question arises about whether the International Monetary Fund, the eurozone authorities’ partner in its rescue missions so far, will risk its cash and its credibility by getting more deeply involved.

If the fund were to maintain the one-third share of financing it provided in the joint EU-IMF bail-outs for Ireland and Portugal, Spain would be a stretch and Italy out of the question for its limited resources. But with the eurozone desperate for the credibility that some say the IMF can bring, the fund could take a leading role in enforcing conditions on the borrower countries while providing a rapidly shrinking share of the financing.

Ironically, Spain – and to some extent Italy – are much closer to the traditional candidates for IMF funding than is Greece. With a relatively low debt-to-GDP ratio, Spain can make a good case that it is illiquid but solvent. In theory, the IMF could make a reasonable contribution to a financing package for Spain: rough estimates of a likely rescue loan for Spain are €200bn-€300bn, and the IMF currently has about €280bn ($400bn) of “forward commitment capacity”, or lending war chest.

One possibility for Spain is the flexible credit line (FCL), a new IMF lending facility, which can lend large sums quickly to generally well-run economies facing sudden balance of payments problems. IMF staff are well disposed to Spain, where the government of José Luis Rodríguez Zapatero has put through difficult reforms which seem likely to continue after November’s general election. The informal rules governing the likely use of the FCL suggest the IMF could lend Spain at least €45bn and probably quite a bit more.

But Italy is too big for the fund to make a serious contribution. In any case, some experts say, if Italy faces a funding crisis the problem will have become a continent-wide conflagration requiring more than country-by-country solutions. “The IMF is equipped to support small to medium-sized economies,” says Domenico Lombardi at the Brookings Institution, formerly Italy’s representative on the fund’s executive board. “It cannot backstop the eurozone. That will have to be a job for the ECB.”

Any IMF involvement in Italy and Spain will be greeted with suspicion by some emerging market countries. Paulo Nogueira Batista, the Brazilian representative at the IMF, last week said that European shareholders were risking the IMF's finances and its credibility by dragging it into bail-outs such as Greece with too a low probability of success.

Still, the eurozone authorities may feel the need to import credibility from somewhere, having announced a second rescue for Greece on July 21 which failed to restore financial market confidence. Eswar Prasad, a former senior IMF official now at Cornell University, says the IMF's leverage in its dealings with the eurozone have shifted markedly since the first Greek bail-out in May last year. At that point, he says, the fund was still touting for business to prove its relevance.

"These days Europe needs the IMF a lot more than the IMF needs Europe," Prof Prasad says. The fund would now find it easier to play a gatekeeper role in a country such as Italy, enforcing tough conditions even with a shrinking share – perhaps 15 per cent rather than one-third – of an overall package. "The fund could be a junior partner in terms of financing but a senior partner in terms of negotiations," he says.

Whether the eurozone authorities, let alone Spain and Italy, would swallow their pride and allow the IMF to wield more power for less money is unclear. Simon Johnson, a former IMF chief economist at the Massachusetts Institute of Technology, says it once more comes back to European political will to spend what it takes to resolve the crisis. "The IMF is willing and able to help," he says. "But the Europeans broke it: they have to fix it."