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Now It's Up to the IMF to Make Greece Shape Up

The fate of the euro may depend on the IMF's awkward partnership with the EU

By Sandrine Rastello, Maria Petrakis and Jonathan Stearns

Even as Europe's leaders pledged a $1 trillion package to stop the Continent's financial crisis, doubts persisted about the nation that started it all. Greece, which has a separate bailout of $140 billion, still scares investors. Its stocks trade marginally higher than before the unveiling of the trillion-dollar plan, while its 10-year bonds, shunned by all but the most adventurous, still offer Western Europe's highest yields. The markets just don't trust Greece to clean up its fiscal act.

Three institutions—the International Monetary Fund, the European Commission, and the Greek government—must prove the markets wrong and, in the process, restore the reputation of the euro. "If not mission impossible, it's certainly mission highly improbable," says Morris Goldstein, a senior fellow at the Peterson Institute for International Economics in Washington and a former IMF deputy research director.

Fixing Greece will be a complex exercise. The aim is to cut Greece's budget deficit to below 3 percent of its gross domestic product by the end of 2014, from 13.6 percent last year. IMF officials, including First Deputy Managing Director John Lipsky, have conceded that the cuts, such as freezing pensions and cutting civil servants' pay, will be "painful." IMF Director Dominique Strauss-Kahn warned that success hinges on Greek support "beyond political party lines."

The European Commission, which enforces the policies of the European Union, will handle quarterly reviews of Greece's progress. If the Greeks meet their targets, every quarter they will get another piece of the $140 billion, which will fully cover Greece's financing needs into 2012. If the Greeks don't reach their goals, the commission and the IMF can withhold funds or even ask for more austerity measures.

PLAYING THE HEAVY

Policymakers hope this strategy succeeds better than their usual tactics of chastising fiscal renegades. The original, German-inspired approach was to threaten fines against countries that didn't respect the EU's limit on budget deficits of 3 percent of GDP. This arrangement failed because it largely relied on peer pressure, which Europe's consensus-driven leaders were reluctant to apply.

The question is whether the EC will hold the Greeks' feet to the fire. It is working with the IMF, which is providing $38 billion of the total aid package. Since the EC is senior partner, the IMF must play an unfamiliar supporting role.

The IMF has bailed out nations from Turkey to Korea and has far more experience playing the heavy than the EC. It suspended payments to Romania in November after political infighting toppled the government, and only paid up when a new government passed an austerity budget. The IMF in March 2009 froze a $256 million payout to Latvia after the country failed to commit to budget cuts.

The IMF may need to be especially strict with Greece because its reputation is at stake, says Eswar Prasad, a senior fellow at the Brookings Institution in Washington and a former IMF official. "If they ease up, markets may set less store in the IMF's ability to effect policy changes," he says. The wild card is the commission. It may act tough to please the Germans, who balked for months at bailing out Greece. Or it could bend to the will of European governments more sympathetic to the Greeks.

GREEK RESOLVE

Then there are the Greeks themselves. On May 6 lawmakers in Parliament voted for austerity measures, 172 to 121—a good margin of victory for an ordinary bill but not the unanimous show of resolve European leaders had hoped for. Polls conducted for the *Proto Thema* newspaper showed 55 percent of Greeks favor the measures. A majority had opposed them a week earlier.

Paul Mylonas, chief economist at the National Bank of Greece, anticipates social unrest will moderate this year as Greeks grow resigned to their fate. Yet he adds: "There's a higher risk of opposition in 2011 and 2012 if light doesn't appear at the end of the tunnel."

Greek business is behind the reforms, up to a point. "Our will is a given," Dimitris Daskalopoulos, head of the Federation of Greek Industries, said on Apr. 29. "Businesses can and will contribute." On May 3, though, the federation protested a government plan to impose a special tax on Greece's most profitable companies.

"The real challenge is whether the Greek people can endure painful restructuring," says Lee Keon Hyok, who as an IMF officer worked on Indonesia's bailout in 1997-98, and who now works at Samsung Economic Research Institute in Seoul. He recalls his own country's 1997 bailout. South Korea repaid its $57 billion loan from the IMF in 2001, three years ahead of schedule, "as the people united and donated gold rings to help restore foreign currency reserves," says Lee. It's hard to imagine the Greeks are ready to do that yet.

The bottom line *The European Commission will control the overhaul of Greece, but needs the IMF's experience.*

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