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The Economic Adjustment Program of Greece (2010-15): Why Failure?

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Abstract

On May 2, 2010 the Eurogroup and the IMF agreed to a 3-year €110 billion loan to Greece (which was deprived from the private capital markets) in order to avoid a sovereign default. The loan was conditional on the implementation of austerity measures to restore the fiscal balance, privatization of government assets to keep the debt pile sustainable as well as implementation of structural reforms to improve competitiveness and growth prospects. In October 2011, the Eurozone leaders consequently agreed to offer a second €130 billion loan for Greece, conditional not only on the implementation of another austerity package (combined with the continued demands for privatization and structural reforms outlined in the first program), but also on a restructuring of all Greek public debt held by private creditors. Five years after the launch of the first economic adjustment program, Greece is still deprived from the private capital markets. The purpose of this paper is to give explanations as to what has gone wrong.

1. Introduction

Is the case of Greece a success story? The answer is not as simple as it looks like because:

- The programs are based on forecasts that might change due to external shocks. However, this does not mean that these programs fail.
- The program parameters are often subject to renegotiation. Hence, initial conditions are very likely to change.
- Not all policy decisions taken by a country result from the adjustment program, i.e national authorities often decide to implement policies that are not compatible or consistent with the program.

- Program success is contingent on implementation by national authorities. If the government is unable or unwilling to fully implement the program, this does not necessarily mean that the program itself was defective.
- Finally, Program outcomes are affected by spillovers from other countries.

So having these five points in mind, let us then focus on some issues which raise doubts and which are examined by researchers and academics. Let us start by comparing some key macroeconomic variables of Greece in 2008 (one year before the crisis) and in 2013, which was the last year with a negative growth rate.

2. Greece 2008 vs Greece 2013.

So what were the fundamentals of the Greek economy in 2008 (Table 1 & Figure 1)? In 2008 the country recorded a rather disappointing performance as regards fiscal management (fiscal deficit of about 10% of GDP). There was also a huge deficit in the Current Account balance of about 15% of GDP. On the other hand, Greece's unemployment rate was at a record low (7.7%). GDP per capita was at a record high, reaching 21.000 euros. A completely different picture appears in 2013. GDP per capita has fallen to 16.500 euros, unemployment has skyrocketed to 27.3% and people at risk of poverty or social exclusion have reached 35.7%. At the same time, the fiscal situation has improved considerably with positive primary and current account balances. Two questions arise: Can a growth model with high consumption, low unemployment and increasing deficits be sustainable overtime? By the same token, can a growth model with balanced fiscal situation along with social imbalances be sustainable overtime? Based on the Greek experience, the answer is negative in both cases.

Table 1. Fiscal and social indicators in Greece, 2008 & 2013.

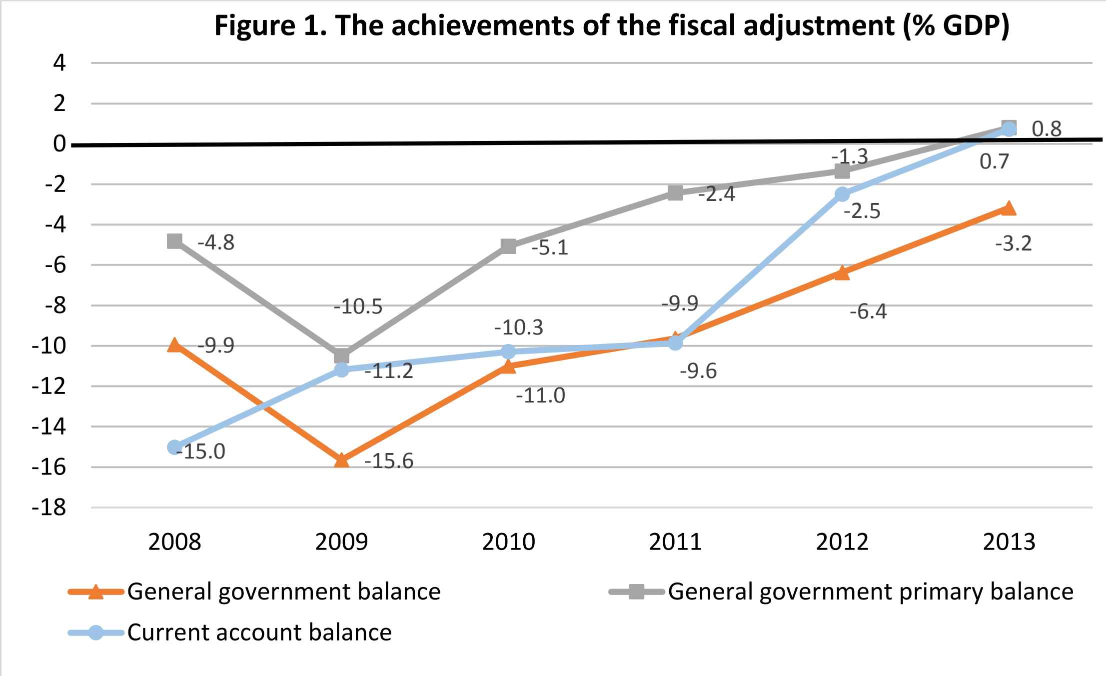
Variables	2008	2013
General government primary balance*	-4.8	0.8
General government balance*	-10	-3.2
current account balance*	-15	0.7
inflation**	4.2	-0.9
General government gross debt*	113	175
People at risk of poverty or social exclusion	28.1	35,7
unemployment rate ***	7.7	27,3
GDP per capita****	21,000	16,500

Note: * % GDP, ** percent change, average consumer prices, # percentage of total population, *** percent of total labor force, **** current market prices in €.
Source: *IMF World Economic Outlook database, October 2014, Eurostat*

The Greek economy collapsed soon after the onset of the global financial crisis in 2008. One reason for that was the absence of an EU mechanism to protect member states from such crises.[1] However, the root causes of the crisis can be found at the chronic problems of the

[1] For an analysis of the problems with the EMU architecture, see Liargovas (2013).

Greek economy (inefficient institutions, corruption and unwillingness to implement key structural reforms etc).



Source: *IMF World Economic Outlook database, October 2014*

3. What went wrong?

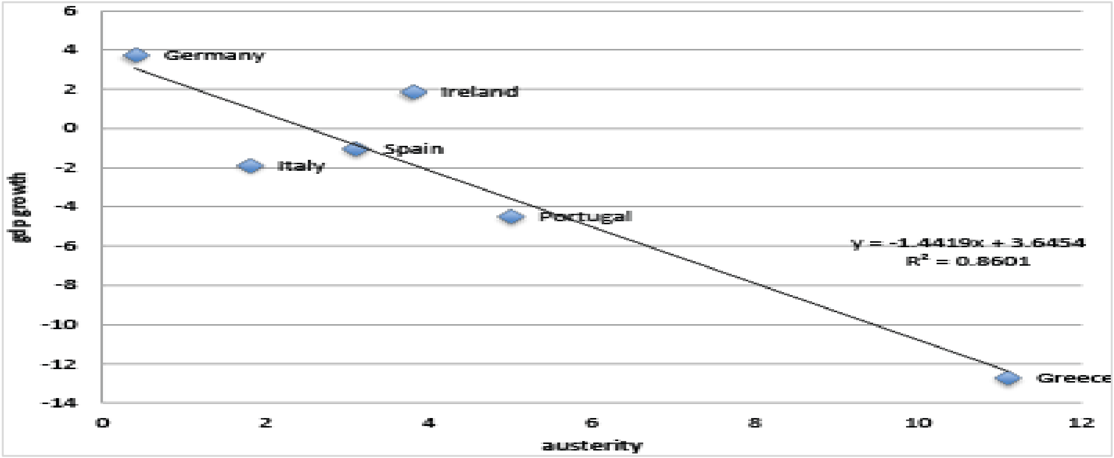
The previous section highlighted the main difficulties that Greece faces in achieving both macroeconomic and social stability. In this section we try to explain what went wrong in Greece's recent fiscal adjustment program by looking at the academic and empirical literature.

3.1. Extremely frontloaded austerity

Until recently, the dominant perception was that austerity should be the priority of the economic policy, i.e. the rapid elimination of fiscal deficits and therefore the implementation of a tight income policy.[2] Austerity aims to reduce the public debt. This choice is based on a theoretical background: the fiscal adjustment (through expenditure cuts and/or tax increases) is a good signal to the international capital markets; the yield on government bonds declines and this is a very favorable condition for growth. The extremely frontloaded austerity was the basic requirement in order for Greece to take financial assistance from its international partners. However, there are counterarguments, too: austerity decelerates growth and may also be completely ineffective above a critical threshold.[3] Expenditure cuts or tax increases reduce aggregate demand and public revenue leading to a vicious cycle. Evidence from Greece and other countries shows that the more severe the austerity, the deeper was the recession of the economy (Figure 2) and the larger is the subsequent increase in the debt-to-GDP ratios (Figure 3). Recession then leaded to explosive public debt dynamics (Figure 4).

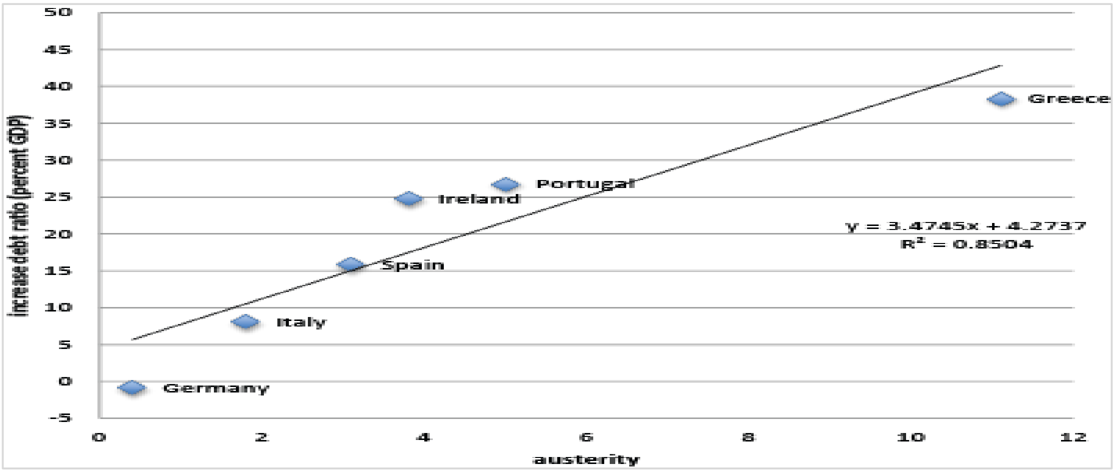
Figure 3. Austerity and GDP growth

[2] See Alesina and Ardagna (1998).
[3] See Brender and Drazen (2008).

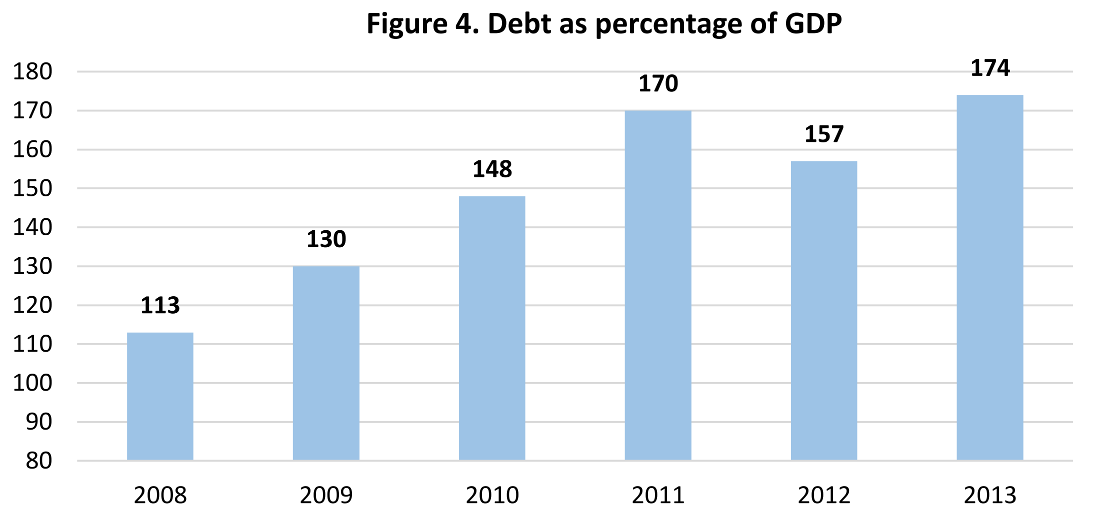


Source: Paul De Grauwe, Yuemei Ji (2013)

Figure 3. Austerity and debt to GDP growth



Source: Paul De Grauwe, Yuemei Ji (2013)



Source: *IMF World Economic Outlook database, October 2014*

Turning to more expansionary (Keynesian) policies seems quite attractive. This argument is based on economic theory and evidence from the Great Depression in 1929-1932. But Greece was unable to use expansionary policies because of high accumulated public deficits.

Empirical studies have offered one more argument which was used (rather prematurely) to quit austerity programs: the models that estimate or predict the impact of austerity policies on GDP and unemployment used much smaller multipliers and this led to the underestimation of the consequences of the austerity measures on economic activity.[4] Note that fiscal multipliers show the impact of 1 percentage point of fiscal adjustment on GDP. The IMF was the first to recognize that it had underestimated fiscal multipliers and therefore the consequences of the austerity measures on Greece's GDP. In other words, austerity led to a much deeper recession than originally projected (Figure 5 & Figure 6). As a result, it was believed that the austerity required by the IMF was ineffective or even self-defeating. This debate affected the political environment concerning the implementation of austerity measures. However, in 2013 it was realized that further austerity measures could not be easily implemented (due to the prolonged recession and unemployment that they brought to the Greek economy, Figure 5). It was also realized that severe austerity could not be socially approved and that it favors the rise of nationalism and threatens the European integration.

[4] See Blanchard and Leigh (2013).

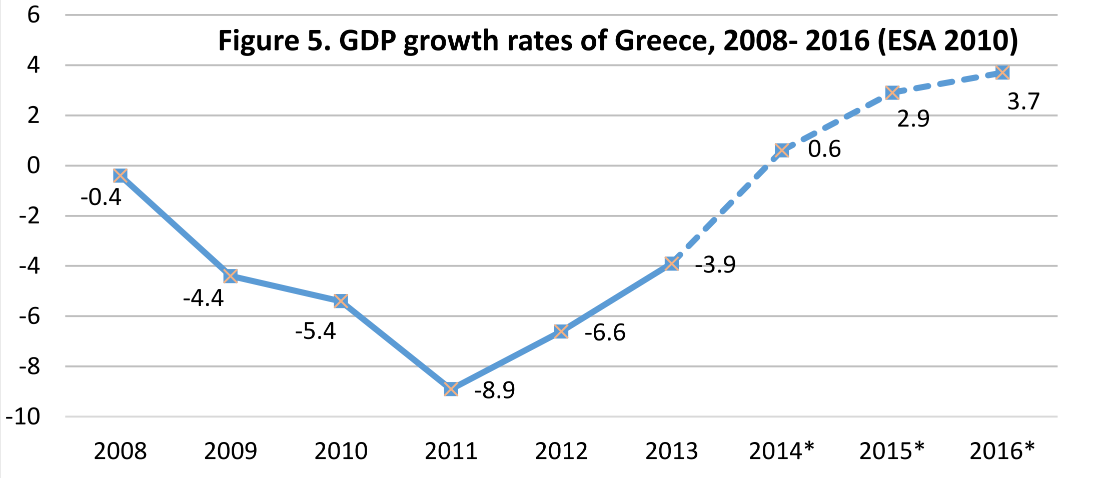


Figure 5. GDP growth rates of Greece, 2008- 2016 (ESA 2010)

Source: *European Commission, Autumn Forecasts, 2014*

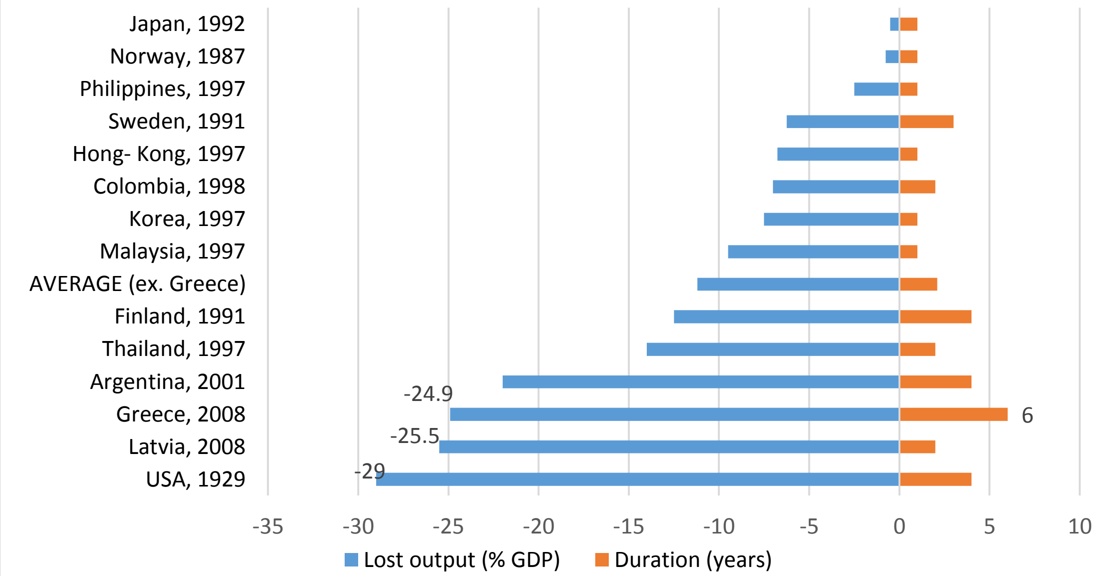


Figure 6. Economic crises and lost output

Source: IMF, Reinhart & Rogoff(2009), Budget Introductory Report 2012 & 2013, Hellenic Statistical Authority

3.2. The role of expectations

According to Giavazzi and Pagano (1990) expectation play a crucial role in the effectiveness of fiscal adjustment programs. Since 1975, there have been two large-scale fiscal adjustment programs in Greece. The most recent one is the ongoing since 2010 and is projected to continue until 2016 at least, according to the Memoranda signed by Greece in order to achieve fiscal sustainability, restore competiveness and return to the international markets. It is an adjustment in the general government's deficit of about 13 percentage points of GDP, according to figures of the Revised MTFS (from 15.6% in 2009 to 2.3% in 2016). The other large-scale adjustment programs had taken place during the period 1990-1999. At that time the deficit from 15.9% of GDP in 1990 dropped down to 3.2% in 1999. That period was accompanied by significant primary surpluses (and indeed sustainable for a nine-year period). The adjustment was then enforced by the Maastricht criteria on the way to EMU.

These two adjustments programs have some similarities and one key difference, which is their effect on GDP. They are both almost of the same size and have almost the same duration .They both started with rather high deficit ratio (2009 figures were worse, but in any case they were both well above the critical limits). Both of these adjustments were based mainly on the efforts to increase revenue rather than on a permanent reduction of expenditures which is believed to be a better policy.

The critical difference, however, was the impact of these two adjustment programs on the country's GDP. The latter caused a great depression and as result it caused the unprecedented rise in unemployment and an increase in the debt-to-GDP ratio. Negative expectations for the future developments of the Greek economy were also created. In contrast, the case of the period 1990-1999 differs considerably since that adjustment effort was accompanied by significant growth rates, which allowed the achievement of sustainable primary surpluses and the decrease of the debt ratio (achieved after 1996). Cumulatively, according to the World Bank, the Greek GDP was increased by almost 20% (!) in the period 1990-1999. Therefore, the view that a de facto fiscal adjustment causes a recession seems to be disputed, at least in the case of Greece. Of course, the measures taken during a fiscal adjustment program can cause a fall of the GDP (to a greater or lesser extent), but there existed other factors that determined the developments. Expectations seem to have played that crucial role.

During the period of convergence before the adoption of euro, the Maastricht criteria were a reliable anchor for the economic policy of Greece. Governments had been convinced that they must implement the necessary measures with consistency, continuity, credibility (the 3 c's of the fiscal policy) and devotion. Therefore, positive expectations were created. The belief was that the Greek economy will eventually enter the euro area and, as a result, interest rates will fall significantly and the country will have a sustainable budget (due to the rules of the Stability and Growth Pact) and credible monetary policy (due to the ECB).

The adjustment policy initiated in 2010 was very different though, when the memorandum of understanding completely failed to be a reliable anchor for the Greek economy. The retractions in the presentation and implementation of the program, the governmental hesitation, the lack of ownership, the negative international reports, the careless statements of government officials abroad, the defects of the first Memorandum (with excessive frontloaded austerity measures) and the unstable environment of the Euro zone were some of the factors that embedded uncertainty in the Greek economy leading to a negative outlook. They formed negative expectations, which in turn caused consumer and investor uncertainty and eventually, a great recession of the Greek economy.

3.3. Policy mix

Expenditure cuts or tax increases to reduce the fiscal deficits? The answer can be given both from a theoretical and an empirical point of view (Alesina and Perotti, 1996, Alesina, Favero, and Giavazzi, 2013).[5] The theoretical arguments come from the so- called supply side economics, which were very popular in the '80s, especially in the USA, known as "Reaganomics". They are still very popular and influential through the press (e.g. The Wall Street Journal) and relevant books. The founders of this theory are the American Economists Robert Mundel and Arthur Laffer.

According to supply side economics, it is better to cut expenditure because:

a) Tax increases bring more public revenue, more available liquidity and therefore, government officials tend to spend more.
b) Tax increases create incentives to consume more and work less. Also, to tax evade more. Let's think of a woman who has to choose between leisure and labor. Leisure increases her happiness, but labor gives her income. When labor tax-rate is low, labor supply increases and the disposable income increases as well. As labor tax-rate increases, labor supply decreases because the disposable income decreases, too. In this case, it is very likely that the individual will choose leisure or may decide to work in the so called grey economy. This is known as the Laffer curve. It shows that there is a threshold beyond which any increase in tax coefficients is completely inefficient and leads to lower tax revenues.
c) Tax increases creates disincentives for investments, which can boost growth.

There is also significant empirical research (Alesina & Ardagna (2009), Giavazzi & Pagano (1990, NBER), IMF, OECD etc) pointing out that expenditure cuts are growth friendly.

They indicate that cuts in public expenditures reduce production costs and therefore favor the activities of the private sector, boost growth and reduce the fiscal deficit. In this context, it is crucial to specify the expenditures that should be cut. The answer is related to the efficiency of public expenditure. The government should cut those expenditures with low efficiency- something that did not happen in Greece. According to Arin et al (2011), corruption appears to play an important role in the choice of the policy mix (tax increases rather than expenditures cuts). Corruption also discourages healthy entrepreneurship, is a disincentive for foreign direct investments and tends to undermine cohesion of the society. Furthermore, corruption had a negative impact on macroeconomic performance and decelerated growth. According to Kaufmann (2010), reducing corruption could also reduce the fiscal deficit by 4 or even more percentage points.

However, apart from corruption, there is one more factor which seems to have played an important role on the choice between expenditures cuts or tax increases: rent seeking behavior. Countries with poor and corrupted political structures tend to prefer tax increases in adjustment programs. This is probably the reason why privatizations always lagged behind

[5] Based on current empirical research, the empirically optimal is on average 60% on the expenditures side (except for public investment) and (at most) 40% on revenue side (see among others Alesina and Ardagna (1998)).

the program, there was enough tolerance towards corruption in the Tax Administration and other public entities etc.

The Greek adjustment was not sufficiently based on permanent cuts on primary expenditure. Only in 2010 and 2013, this fact was hardly implemented. In the depression years 2011 and 2012 (cumulative loss of 15.5% of GDP), only 45% and 49% respectively were on the expenditures side. At the same time there were excessive cuts on the Public Investment Program even in 2015.

3.4. Inefficient institutions

According to Acemoglu and Robinson (2012), the good quality of domestic institutions and governance contribute significantly not only to economic growth in general, but also to the successful implementation of adjustment programs. Rapanos and Kaplanoglou (2014) made a comparative study on the Greek and the Cypriot adjustment programs. Using several indicators, they showed that the prolonged economic crisis in Greece is due to the low quality of the domestic institutions and the bad governance. On the other hand, it is very likely that the good governance and the high quality institutions have helped the economy of Cyprus return to growth earlier than Greece. The authors believe that Greece had much worse institutions and governance both before and during the crisis.

Indeed, Greece has a major institutional problem. It is associated with the pursuit of sustainable growth. Institutions could amplify the positive outcomes of the consolidation and not undermine them. For example, tax administration enhancement should have been prior to the large tax increases in 2011. This could lead to increased tax revenue. Also, goods market liberalization should have been prior to the private sector's wage cuts. The result would be reduced prices. The institutional problem in Greece is probably associated with values such as trust, respect for the others, the sense that success depends on individual's effort etc. Hence, it is a rather hard task to change them, especially in a short period of time. Academic research suggests that beliefs affect the way that institutions work within the modern society. Politics, education, justice and Public Administration are major areas of testing this hypothesis. Therefore, the starting point should be the creation of stable institutional environment that provides the appropriate incentives and reduces decisions that favor the few at the expense of the many.

But besides domestic institutions, the Eurozone, as such, was not ready to cope with the crisis. The crisis found Europe unprepared: without a satisfactory immunity — there was only the Stability and Growth Pact. The euro was a significant Institutional innovation, but like any other innovation it was not complete from the very beginning. It was like the first car that was invented many years ago. The first cars didn't have high safety standards (e g. belts, airbags) to protect the driver. Accidents were rare because few cars were on the streets. When they started to become common, (a) manufacturers developed security systems and (b) the State regulated the issuance of driving licenses. The euro was created without airbags or other safety standards to protect countries from debt crises. Analysts believed that existing mechanisms were sufficient. But they were not. Accidents could happen due to inappropriate behaviour or external factors. And accidents did happen. In 2012, Europe created mechanisms and rules (six Pack, two Pack), but it was rather late.

3.5. Fairness

About one and a half months after Greece's fiscal consolidation program, in the summer of 2010, the IMF's Chief Economist Olivier Blanchard and Carlo Cottarelli set out "Ten Commandments" for fiscal consolidation in advanced economies.[6] Commandment VI states that "*you shall be fair*". Based on these "commandment", three prominent Greek economists, Rapanos, Kaplanoglu and Bardakas made a research on the relation between fairness and effectiveness in fiscal adjustment programs. They tried to examine whether fairness is necessary for the success of these programs.[7] In their detailed research, they used data of 29 members of the OECD for 40 years. They showed that the Blanchard's and Cottarelli's IV commandment is right: the distribution of the burdens should be fair and the disadvantaged groups of the society should be protected in order for an adjustment program to be successful.

There are two typical cases of successful implementation of such programs, in Sweden and in Finland. Sweden had to implement an adjustment program between 1994 and 1997, after a banking crisis in 1990.[8] It reduced significantly the budget deficit, but on the other hand, it provided for cuts in the VAT of foods. Finland adopted an ambitious adjustment program, after an economic and banking crisis in early '90's, which was considered quite successful as well.[9] Despite extensive cuts in several expenditures, transfers to the disadvantaged groups of the society increased by almost 14% on an annual basis.

3.6. Exports

Exports (as a percentage of GDP) and the openness of the economy in general are strongly believed to be crucial factors for the success of an adjustment program as well. Between 2011 and 2013, exports increased by 8.18% in Spain, 10.3% in Portugal and 6.1% in Ireland, while in Greece they increased hardly by 1.5%. According to Daniel Gros (2014) what went wrong in Greece was not the fiscal adjustment.[10] The really important target for any country starting an adjustment program with a double-digit current-account deficit must be export growth. Missing this target is what has set Greece apart.

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[6] http://blog-imfdirect.imf.org/2010/06/24/ten-commandments-for-fiscal-adjustment-in-advanced-economies/

[7] See also Rawdanowicz, et al. (2013), for a similar study.

[8] See Flodén (2012).

[9] See Blöchliger, Song and Sutherland (2012).

[10] https://www.project-syndicate.org/commentary/daniel-gros-asks-why-the-greek-economy-remains-mired-in-recession

Source: *Eurostat*

According to Monastiriotis (2014), focusing on the implementation of austerity measures in order to achieve debt sustainability is rather problematic in countries with a low degree of openness such as Greece.

4. Conclusions

The message that derives from our analysis is not an unequivocal 'yes' or 'no' on the question as to whether economic adjustment programs work. Rather, our message is that the recipe of the economic adjustment program which was applied in Greece along with weak economic base, institutional shortcomings and negative expectations, resulted in an "austerity trap" which led to worse economic outcomes and little gains in terms sustainability.

In the medium and long-term the expectations for the continuity of the achievements so far and the return to sustainable growth are of utmost importance. However, sustainable growth depends on: a) The relief of the public debt, b) The quality of the outstanding structural reforms, c) The political stability and d) Any sudden external shocks.

Finally, the inevitable focus on what to do or not to do distracted the public attention from the developments in Europe. But the Greek problem is part of a general European problem of competitiveness and fiscal governance and the recent developments in the EU favor solutions such as: Less austerity, more and deeper structural reforms plus European solidarity (joint initiatives for growth and employment). We should not underestimate the potential of a country that faces difficulties to raise funds from the ESM on favorable terms and to use the new tools provided by the ECB and the EIB.

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