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The Greek financial crisis and the outlook of the Greek economy ☆

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ABSTRACT

The paper consists of two parts. In the first part, a short review of the crisis in the Eurozone in 2008 and of the measures which have been taken is provided. The second part outlines the causes of the severe imbalances and high debt loads of government in Greece, which have become a threat to the country's solvency and to the stability and possibly the survival of the European Monetary Union. The paper considers the causes of the Greek crisis in order to indicate policies that would help avoid future problems in Eurozone countries facing severe and persistent fiscal imbalances. Measures taken, based on the First and Second Economic Adjustment Programme for Greece, are also reviewed. An assessment is made of the implementation of Greek Economic Policy in the context of the Euro crisis, in conjunction with the three crucial challenges that Greece faces, namely restoring growth and securing both fiscal sustainability and the financial system. The negative lessons from public sector adjustment in Greece show that positive measures must be taken.

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1. Aim[1]

The paper consists of two parts. In the first part, a short review of the crisis in the Eurozone in 2008 and the measures which have been taken, is provided. The second part outlines the causes of the severe imbalances and high debt loads of the government of Greece, which have become a threat to the country's solvency and to the stability and the possible survival of the European Monetary Union. The paper considers the causes of the Greek crisis in order to indicate policies that would help avoid future problems in Eurozone countries facing severe and persistent fiscal imbalances, as well as the measures taken based on the First and Second Economic Adjustment Programmes for Greece (2010, 2012).

2. The response of the Eurozone to the crisis

The crisis which hit in the mortgage market of the USA in 2007 has since spread to the world financial system. The crisis in the banking system climaxed in September 2008 and spread to Europe. Most economies experienced negative rates of growth, unemployment rose and remains high, a number of financial giants have closed or are having severe problems, private consumption and investment have shrunk because of uncertainty and asset devaluation. This crisis is different from previous ones, mainly because of its world-wide extent and because a vicious cycle links the problems in the financial sector to the deceleration of the real economy. The return to sustained growth presupposes, inter alia, a restructuring of corporate portfolios. It is therefore difficult to establish mechanisms for coordination and return to positive growth rates.

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Table 1
Financial balances in selected Eurozone and other countries (deficits % GDP in 2006–2012).

Country	2006	2007	2008	2009	2010	2011	2012
Eurozone							
Belgium	0.1	−0.4	−1.4	−6.1	−4.9	−4.5	−3.6
France	−2.3	−2.7	−3.3	−7.6	−7.4	−6.1	−4.8
Germany	−1.6	0.3	0.1	−3.0	−4.0	−2.9	−2.1
Greece	−3.9	−5.4	−7.8	−13.7	−8.3	−7.6	−6.5
Ireland	2.9	0.0	−7.3	−14.3	−32.3	−9.5	−7.4
Italy	−3.3	−1.5	−2.7	−5.2	−5.0	−3.9	−3.1
Netherlands	0.5	0.2	0.5	−5.4	−5.8	−4.0	−3.1
Portugal	−4.1	−2.8	−3.0	−9.4	−7.3	−5.0	−4.4
Spain	2.0	1.9	−4.2	−11.1	−9.2	−6.3	−4.4
Non-Eurozone							
UK	−2.7	−2.8	−4.8	−11.0	−9.6	−8.1	−6.5
Sweden	2.2	3.5	2.2	−1.2	−1.2	−0.6	0.6
Norway	18.5	17.7	19.3	9.9	9.5	8.7	8.8
Switzerland	0.8	1.7	2.3	1.2	−0.7	−0.4	0.0
Japan	−1.6	−2.4	−2.1	−7.1	−7.7	−7.5	−7.3
US	−2.2	−2.9	−6.3	−11.3	−10.5	−8.0	−6.8

Source: OECD (2010a), Economic Outlook, No. 87, May; OECD (2010b) No. 88, November.

Table 2
Financial balances in selected Eurozone and other countries (debt % GDP in 2006–2010).

Country	2006	2007	2008	2009	2010
Eurozone					
Belgium	91.3	88.0	93.2	100.1	103.0
France	70.9	70.0	76.1	86.4	92.0
Germany	69.4	65.0	69.0	78.2	80.0
Greece	107.9	105.0	102.6	114.9	129.0
Ireland	28.8	29.0	48.5	70.0	105.0
Italy	117.2	113.0	114.5	122.9	131.0
Netherlands	53.9	52.0	64.6	69.5	75.0
Portugal	73.1	69.0	75.2	87.0	93.0
Spain	42.0	42.2	46.8	58.4	72.0
Non-Eurozone					
UK	46.0	47.0	57.0	75.3	81.0
Sweden	50.3	47.0	44.0	52.0	51.0
Norway	60.5	58.4	56.0	59.9	59.0
Switzerland	50.3	46.0	44.0	44.4	42.0
Japan	172.1	167.0	172.1	189.6	198.0
US	60.8	62.0	70.0	83.9	93.0

Source: OECD (2009), Economic Outlook, No. 85, June; OECD (2010a), No. 87, May; OECD (2010b), No. 88, November.

Although the collapse of markets and economies has been avoided in the year 2010, the credit risks as a result of excessive deficits[2] remain at exceptionally high levels. The global financial crisis has shown fundamental weakness in the fiscal and monetary policies in the Eurozone. The sovereign debt[3] crisis in the euro area and the real economy during the spring of 2010 has revealed that the monetary and fiscal policy framework of the European Monetary Union (EMU) is still incomplete. It quickly became obvious that the rules-based framework for fiscal policy created by the Excessive Deficit Procedure (EDP) and the Stability and Growth Pact (SGP) when the EURO was introduced was insufficient to prevent a debt crisis despite its emphasis on keeping public sector deficits low and strengthening forward-looking budgetary planning, because it did not include arrangements for appropriate means to prevent and correct imbalances.

The questions I will attempt to answer with respect to the current economic crisis and methods of management thereof, include, among others, the following:

[2] Table 1 presents the situation regarding deficits in selected Eurozone and other countries in the period 2006–2012. The first observation is that financial balances deteriorated in the Eurozone in the aftermath of the Global Credit Crunch (2007–2008). Second, the deficit limit of 3% was not respected (and no sanctions applied). Third, Ireland had a balanced budget in 2007, while its deficit soared to over 32% of GDP in 2010. Fourth, the UK (not a Eurozone member) strongly increased its deficit from 2006 to 2009 and has since kept it on a relatively high level. Fifth, countries that are outside the Eurozone (Sweden) and outside the EU (Norway and Switzerland) apply the stability and Growth Pact criteria in an exemplary way. This implies that Swiss direct-democracy political system exercises control on government expenditure more effectively than the alternative systems (Jovanovic, 2012).

[3] Table 2 presents the situation regarding debt in selected Eurozone and other countries in the period 2006–2010. Debt in the Eurozone countries increased. There are several striking features. First, the non-Eurozone (Sweden) and non-EU member countries (Norway and Switzerland) apply the Maastricht debt criteria in an exemplary way. Second, the UK doubled its national debt in just three years following 2007. Ireland more than tripled in the period 2007–2010 (Jovanovic, 2012).

Table 3
Exposure of the ECB to Greece, Ireland, Portugal, Italy and Spain (2011).

ECB exposure (€m)	Greece	Ireland	Portugal	Italy	Spain	Total
Govt. debt (SMP nominal)	60 000	18 000	20 000	135 717		233 717
Govt. debt (SMP purchase price)	42 000	14 400	18 000	135 717		210 117
Bank lending	77 758	102 940	45 539	153 200	116 211	495 648
Total	119 758	117 340	63 539	221 059	184 070	705 765

Source: ECB, National Central banks and Open Europe calculations.

- what measures have been taken by the European authorities to confront the debt crisis in the Eurozone and how are they working (or not working) out?
- what kind of changes does the current crisis lead to in the legal and institutional basis of European integration?
- what adjustments took place in the Greek economy as a response to the crisis?
- what kind of conclusions can be drawn from the implementation of the Troika measures in the case of Greece?

2.1. A new European economic governance

Once the crisis broke out and financial turmoil went international, it became obvious that EMU did not have policy tools to manage and resolve the crisis. In the end, the European Union responded to the crisis first by agreeing on stabilisation for Greece and then by creating the European Financial Stability Facility (EFSF) that relatively succeeded in calming the markets. However, these responses were developed in an ad-hoc manner and on a temporary basis only and do not provide a sufficient basis for dealing with any possible future debt crises in the euro area.

Several proposals have been put forward for how to improve the euro area's capacity to deal with problems of excessive public debts. In order to prevent sovereign crises, the European Commission (2010) has proposed a number of measures to strengthen the Excessive Deficit Procedure (EDP) and the Stability and Growth Pact (SGP). These proposals focus mainly on making the rules of the current framework more effective while enhancing their enforcement, by introducing stiffer and more automatic penalties for violating these rules.[4]

The European Central Bank (ECB) made proposals (2010) going in the same direction and, at the same time, has called for the creation of a crisis management fund for the euro area, which might cover some lender of last resort characteristics (Gianviti et al., 2010). The ECB is keen on strong budget rules and sanctions as a way to mitigate the potential for "moral hazard" that comes with large-scale ECB bond buying, i.e. if given access to cheap credit from Frankfurt and relieved from market pressure, some governments may be less inclined to push for reform. The ECB is also concerned that, since many banks around the Euro zone are now largely dependent on ECB funding to stay afloat, once a government starts to receive large-scale funding, it may be very difficult to eventually disengage there of come of it.

At the end of November 2010, the Euro group agreed on the main features of a crisis management framework aimed at safeguarding the financial stability of the euro area as a whole. In October 2011, during the European summit, the option of having the ECB "print more euros" was, formally at least, turned down by the chancellor of Germany. On the occasion of the Special Summit of December 2011, markets were informed that the Greek case had to be considered very special and unique, giving up any future claim to involve private creditors in losses of possible restructuring. In March 2012 the voluntary restructuring of the debt turned into a total haircut of Greece for creditors exceeding 70% of the initial capital.

The decisions taken at the EU summit on 8 and 9 December 2011 on the EFSF are unlikely to supply adequate cover for the ECB to buy the hundreds of billions of government debt of the southern countries to fulfil this role. Through its government bond buying and liquidity provision to banks, the ECB's exposure to Greece, Ireland, Portugal, Italy and Spain has reached E706bn up from E444bn in the early summer. That is an increase of E262bn, over 50%, in only six months and shows, contrary to popular belief, that ECB is already intervening quite heavily in the markets (Table 3).

In September 2012, the ECB announced the new bond purchase programme. The ECB will buy sovereign bonds of one-to three year maturity, provided the issuing country has agreed to a fiscal adjustment programme with either the EFSF, or its successor, the European Stability Mechanism.

On March 15–16, 2013, the Eurogroup government confronted the new Cyprus president and the new finance minister with the following choice: either you haircut deposits or we shut down the economy; the ECB would cut off liquidity to the banks. The Eurogroup governments have created risk in what they were considered perfectly safe deposits. This implies that the cost of funding will increase in the periphery of Europe and as a result, the cost of financing for business and households will increase. That will add to the divergences that already exist and deepen further the recession in the periphery of Europe.

[4] In order to strengthen the SGP directives, the European Commission has provided for sanctions, even in the budget-planning phase, increasing those already existing in the corrective section. The countries that shift in a senseless and persistent way from the process of convergence toward the intermediate-term goals, without ensuring for correction in deviation, have to set up a non-interest bearing of 0.2% of their GDP. Greater automation in the application of sanctions is also provided for. The reform depicts that the corrective procedure for excessive deficits does not only deal with deficit limits that exceed 3% of GDP, but also allows for intervention for debt reduction, should the obligation of reaching the constraint of 60% of GDP not be fulfilled.

3. Adjusting the Greek economy in the light of the Euro crisis

The second part of the paper reviews the post-2009 public sector adjustment measures in Greece. Public debt was 126 per cent of GDP in 2009 and has now reached 170 per cent. Although Greek debt accounts for merely 1 per cent of global debt, the possibility of a sovereign default has endangered the survival of the euro and with it the world economy due to the interrelationship of the global financial system.

The structural adjustment measures constituted more a spasmodic fiscal adjustment programme than a carefully designed economic adjustment programme. The initial programme (The First Economic Adjustment Programme for Greece, 2010, May) was frontloaded with too many measures to be implemented quickly (2010–2013) without the benefit of prior of experience, functional or social impact reviews: as a result of this, Greece was drawn into a deep recession (23 per cent loss in GDP by the end-2012 from its 2008 level). Inflation only fell below the Euro area average in mid-2011 (around 3 per cent). Competitiveness gains are not clearly evident on an economy-wide basis, owing to relatively high inflation. Productivity growth has turned positive only at the end-2011, mainly due to the rapidly rising unemployment. The current account deficit has slightly reduced close to 9 per cent of GDP despite the deeper recession (European Commission, 2012).

A second programme followed (February 2012) that not only intensified fiscal measures and accelerated reforms in the public sector but also kept adding new measures in a sporadic way, notably targeting labour relations and employment in the private sector.

3.1. Overview of the Greek economy and debt

In 1974, the debt-to-GDP ratio stood at 18 per cent. In 1986, public indebtedness reached 58% of GDP, though volatility in growth performance, high inflation, successive currency devaluations and structural weakness could partially share the blame. Greece joined the EU in 1981, ahead of Spain and Portugal, and getting access to generous European funds, whose use could hardly be described as prudent. Nonetheless, public indebtedness continued to soar and by 1996 it doubled once again, reaching 113% of GDP. This is due to the disproportionate social benefits, such as increased salaries and redundant appointments in the public sector, increased pensions, early retirements, public enterprises with large deficits etc., which created substantial budgets to be financed by continuous borrowing (Halikias, 2011). The successive Greek governments were buying social peace and votes by the means of public spending and state borrowing. Being in the Eurozone, the government could continue borrowing at lower rates of interest than would be the case if Greece were on its own. Hence, deficits and debt in Greece did not appear suddenly as an earthquake, but were accumulating over decades. Such bad policies were tolerated over a long time (Jovanovic, 2012). Owing much to the "hard-drachma" policy that followed between 1996 and 1999, the economy seemed to have taken a slow turn back to a sustainable track. Excessive government borrowing took place in the next couple of decades and accelerated after January 2001, when Greek entry into the Euro allowed the government to borrow at practically zero spreads.

The decade prior to the onset of the crisis (2008), the economy averaged annual real GDP growth close to 4 per cent, making Greece one of the best performers in the European Monetary Union (EMU). This outstanding growth largely reflected a domestic demand boom, high real wages, low interest rates, rapid credit expansion and loose fiscal policy. Greece reached a high standard of living, among the top 30 countries in the world in terms of per capita income. In 2008, the per capita Gross Domestic Product (GDP) in Greece in PPP stood at 30 076 US dollars, which corresponded to 95 per cent of the European Union average (Eurostat, 2009). However, the country had failed to take advantage financing conditions favourable, to reduce the debt-to-GDP to sustainable levels.

By the end of the decade structural deficits were fairly contained and a tighter fiscal policy bore fruit as the debt-to-GDP ratio declined to 104%. Until 2003 public indebtedness declined even further to 98% also due to favourable terms of borrowing from the international markets. The decision to host the 2004 Athens Olympic Games marked the beginning of the reversal of the downward debt-to-GDP trajectory, as budget deficit increases fuelled debt dynamics. Due to the deterioration of its financial indicators, Greece was downgraded with respect to its borrowing credibility and the difficulty in securing funding at reasonable rates led the country to seek help from the International Monetary Fund, the European Union and the European Central Bank, known as the IMF-EU-ECB bail out (Halikias, 2011). The EU and the IMF have made the 110 billion Euros in loans (70 billion Euros from Eurozone and 40 from IMF) that Greece received available subject to serious reforms including wages cuts, layoffs of civil servants, privatisation of state properties, weakening of unions and deregulation. The bailout is also contingent on Greece's reduction of private debts (Kondonassis, 2012). It is already more than three years since Greece has been applying the policies associated with the two rescue packages that were provided under strict conditionality by the Euro area countries and the IMF. The policies associated with the First and the Second Memorandum were primarily focusing on reducing the fiscal and current account deficits, using horizontal policies to increase tax revenues, decrease government spending, reduce pensions and lower wages in the central government sector. Although the process towards the implementation of some of these reforms has started (e.g. pension and healthcare system, labour market flexibility, better governance) few have actually fully materialised. It seems that the horizontal tax policies have been proved unsuccessful, for in most cases considerable increases in the statutory tax lower, rather than increase, tax revenues. This is due to the deeper than anticipated recession and the continuing ineffectiveness of the tax collection system. Moreover, the "internal devaluation" policy, implemented via the horizontal decreases in the public sector wages as well as the cut in the private sector minimum wage, other than contributing to an unprecedented recession, so far, do not seem to be effective

in tackling the current account deficit or low growth (Kollintzas et al., 2012). Greece represents the worst case scenario so far as the European Union and the IMF are concerned. Apart from the inexcusable behaviour of Greek politicians, the Greek economy is clearly in bad shape in terms of deficit in GDP and unemployment (The Economist, May 5, 2012).

4. Outlook of the Greek economy[5]

Despite some minor signs of progress made by the Greek economy since the onset of the First Memorandum in 2010, it continues to face three crucial challenges:

Restoring growth. Greece is in the sixth year of recession, deeper than envisaged under the programme, with unemployment reaching unprecedented levels, particularly among youth, and slow progress in structural reforms. Restoring growth and creating jobs require a deep restructuring of the economy, to shift the engine of growth from consumption to exports and investment. Output decreased 6 per cent in 2012 and will be reduced about 4.0 per cent in 2013. Over the medium term, inflation in Greece is expected to decrease resulting in the reduction of the current account deficit. In nominal terms, the overall balance is expected to improve from a deficit of 13.8 billion Euros in 2012 to a deficit of 8.9 billion Euros in 2013 and an end point deficit of 1.3 billion Euros in 2016. In the light of developments in macro indicators, public debt is expected to fall to 124 per cent of GDP by 2020, although currently it appears to be around 170 per cent of GDP.

Securing fiscal sustainability. Despite the adjustment undertaken so far, further efforts are needed to restore fiscal sustainability. It is expected that the pace of fiscal consolidation will drop from 3 to 0 per cent of GDP per year over the period 2013–2014.

Securing the financial system. The deep recession combined with the recent public debt restructuring has taken a toll on banks' capital. Recapitalisation of the banking system is needed to strengthen depositor confidence and restart bank lending.

Building on this strategy, the adjustment package through 2014 focuses mainly on permanent spending reductions. The public sector wage bill, net of taxes and social contributions, will be reduced by 1.5 billion Euros from 2012 to 2014. From 1 January 2013, pension reform measures have been taken, which will yield 5.2 billion Euros during 2013–2014. Better targeting of social spending will yield net savings of 0.6 per cent of GDP. Health expenditure reforms will continue to reduce public pharmaceutical spending towards 1 per cent of GDP, in line with other EU countries.

5. Concluding remarks and policy implications

After the start of the global economic and financial crisis in 2008, the severe fiscal imbalances and high debt loads of the government of Greece continued with deeper recession and despite slow improvements in competitiveness. These have become a threat to the country's solvency and the stability and possible survival of European Monetary Union. A Greek bankruptcy, its exit from the Euro and the accompanying spread of financial turmoil in Europe and the rest of the world would impose very heavy costs on the world economy (Grubel, 2012).

In recent weeks even a conservative lending institution like the IMF has been critical of the European leadership for cutting budgets too quickly resulting in adverse effects on growth. In a recent meeting (2012) of the G8 at Camp David, a strong endorsement was made in favour of a policy stressing a balance between austerity and growth. On the other hand, the advocates of austerity measures claim that cutting spending and balancing budgets produce confidence in the management of the public sector which in turn helps economic growth (Kondonassis, 2012).

Given that some European economies such as Spain and Greece continue to experience high unemployment, it is reasonable to assume that economic recovery is their priority. Austerity measures in the midst of recessions, as stated above, are the wrong policy. We have also learned from the past that if private demand is weak, public demand can be an effective substitute. If recovery is pursued and attained, revenues are likely to rise and budget deficits would tend to decrease. At present it can be argued that what the USA and the European economies need is more emphasis on demand side economics and economic growth. Overall, a balanced policy has many merits.

The negative lessons from public sector adjustment in Greece show that for the situation to improve positive messages must be sent: employment adjustment should be based on competence and needs, wage adjustment should be progressive, reforms should be decided after social dialogue, social services and poverty reduction measures should be preserved, public sector adjustment should not call into question the role of the public sector (especially in productive investments and for preserving the drivers of economic growth), a social safety floor should be established for the protection of the poor and most vulnerable and a long-term horizon should be adopted.

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