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# In the Name of the Euro: What Have the EU's Policies Achieved in Greece?

**This paper reviews the novel policy measures developed by the EU to deal with insolvent member states and assesses their impact on Greece's political economy. Greece represents a major test case as a recipient of two bailout loans plus debt relief from private creditors. The paper examines the degree to which EU policies have been successful, evaluates the challenges that remain after four years of reforms and traces their implications for the future of European integration.**

The financial crisis that erupted in 2008 posed a severe test to the policymaking capacity of the European Union. Faced with member states on the verge of default and fearing financial contagion that would place the euro in potential peril, EU governments and the European Central Bank partnered with the International Monetary Fund to arrange rescue loans. In May 2010, the EU approved its first-ever bailout loan for a member state, contingent on strict austerity measures and structural reforms, to prevent Greece from defaulting on its sovereign debt. Three additional rescue loans were extended to avert defaults by Portugal, Ireland and Cyprus. A fifth country, Spain, received a special loan to save its banks.

Lacking traditional fiscal tools such as a central budget and conventional fiscal policy, the EU devised a new model of macroeconomic governance. Its main features include the management of a sovereign debt crisis with rescue loans that sidestep the no-bailout clause of the Maastricht Treaty; contractionary macroeconomic policies; structural reforms of product and factor markets, including radical changes in the systems of labor relations, employment, compensation, pensions and social security; and financial and technical assistance provided by the IMF, a non-EU institution.

This paper reviews the novel policy measures developed by the EU to deal with insolvent member states and assesses their impact on Greece's political economy. Greece represents a major test case as a recipient of two bailout loans (the second approved in October 2011) plus debt relief from private creditors. The paper examines the degree to which EU policies have been successful, evaluates the challenges that remain after four years of reforms and traces their implications for the future of European integration.

## EU policies to deal with the crisis

The EU's policy responses consisted of two types of measures: rescue loans and "austerity" policies, namely contractionary macroeconomic measures involving cuts in public spending and increases in taxes, as well as structural reforms aimed at liberalizing product and labor markets.

Rescue loans were the EU's first line of defense to avert defaults by member states on their sovereign debt. After several summit meetings, eurozone leaders developed a package of "defenses against default". The lenders, referred to as the "troika" (the EU Commission, the ECB and the IMF), set up a rescue fund of up to €750 billion of emergency loans and credit guarantees for troubled countries; the rescue facility has since evolved into the European Stability Mechanism (ESM) as protection against the potential of future defaults. The size of the ESM has been criticized as insufficient for an economy the size of the EU, but the EU has devised additional methods to economize on the use of ESM funds for

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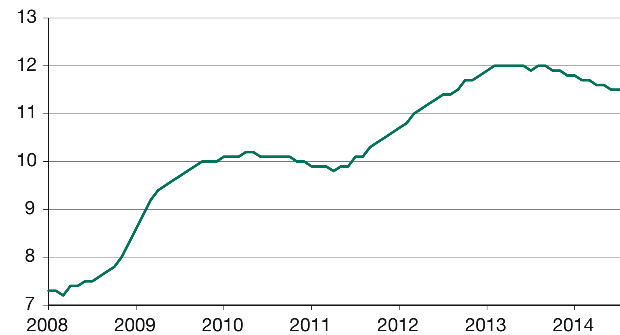
rescue loans. A special debt-relief measure, used only once in the case of Greece, involved so-called private sector involvement (PSI), a 50 percent write-off of Greek sovereign debt held by banks, hedge funds and private investors. Another special debt-relief measure was the "bail-in" used in the case of Cyprus, where special levies on bank deposits over €100,000 were imposed as a condition for the rescue loan.

On top of rescue loans, contractionary policies were imposed as conditions for loan disbursement. As would be expected, pro-cyclical fiscal policy exacerbated pre-existing imbalances, made worse by recessionary forces. The level of indebtedness of eurozone countries rose from an average of 85.5 percent of GDP in 2010 to 92.7 percent in the second quarter of 2014.[1] Even the largest EU economies, France and Germany, are more highly indebted than allowed.

With the application of pro-cyclical measures, prospects for economic growth deteriorated further. Core EU economies went into recession as well, including the Netherlands, traditionally deemed among the strongest in Europe. Growth estimates have been lowered across the board. They remain the worst in Greece, where the recession has entered its sixth year. Greek GDP has fallen by 25 percent since 2008 and may shrink further in 2014.

Structural reforms comprised the third set of EU policies to deal with countries in receipt of rescue loans. The aims of these policies were to force internal devaluation in the form of falling wages and prices. In theory, structural reforms can improve competitiveness, especially in the absence of flexible exchange rates. The EU's reforms brought about changes that have transformed the European economic landscape: reduction of welfare benefits, expansion of temporary and part-time work, big cuts to the minimum wage, pay freezes, elimination of salary bonuses, cuts to pensions, increases in the retirement age, drastic cuts to severance pay, reductions of vacation days, easing of restrictions against firings and layoffs, reduced duration and level of unemployment benefits, negotiation of salaries and working hours at the company level rather than by unions, and collective bargaining agreements that are no longer automatically applicable economy-wide. The combination of fiscal retrenchment and structural reforms resulted in higher unemployment across the eurozone, as shown in Figure 1. Worst hit were Spain and Greece, the latter with an

Figure 1
**Euro area unemployment rate, 2008-2014**
in % of the labor force




Sources: www.tradingeconomics.com, Eurostat.

unemployment rate around 28 percent and youth unemployment over 50 percent.[2]

## Effects of EU policies on Greece's economy

After Greece's accession to the European monetary union, cheap money and easy credit led to a growth bubble in the 2000s that burst in 2009.[3] The IMF identified two significant triggers: first, the crisis threatened the continued financing of Greece's government-led growth model through foreign funding of fiscal deficits; second, the Greek government's announcement that data revisions unmasked a higher budget deficit led to the downgrading of the country's sovereign debt rating.[4] Greece's cost of borrowing skyrocketed and default became imminent without external assistance. The newly-established troika prepared a program to avert default, which was approved in May 2010. Total financing amounted to €110 billion, of which the IMF committed €30 billion, while the remainder took the form of bilateral loans from eurozone countries.

The EU's policies for Greece combined an unprecedented mix of huge rescue loans, austerity and structural

1 Eurostat news release 64/2014, 23 April 2014; and Eurostat news release 160/2014, 23 October 2014.

2 Eurostat.

3 According to the IMF, "[t]he economy turned down in the wake of the Lehman crisis and the general government deficit reached 15½ percent of GDP..., up from 4 percent of GDP in 2001. Public debt was 129 percent of GDP at end-2009, with 75 percent held by foreigners. There were also significant contingent liabilities due to public enterprises borrowing under state guarantee, while the pension system had become underfunded as a result of increasingly generous entitlements and an aging population." IMF: Greece: Ex Post Evaluation of Exceptional Access under the 2010 Stand-By Arrangement, June 2013, p. 5.

4 Ibid.

reforms. As stated by the IMF, the primary objective of Greece's May 2010 stand-by arrangement (SBA) was

> to restore market confidence and lay the foundations for sound medium-term growth through strong and sustained fiscal consolidation and deep structural reforms... Greece was to stay in the euro area and an estimated 20-30 percent competitiveness gap would be addressed through wage adjustment and productivity gains.[5]

The program showed signs of failure after just one year, as its aims and the ways in which these aims were perceived by the public, the body politic and Greece's lenders were diverging. The lenders' objectives were to avert a Greek default, save the euro and restore fiscal discipline to enable Greece to pay back the rescue loans. Forced to take a plethora of unpopular measures over the course of months rather than years, the Greek government sought to minimize the political cost of the bailout, avoided taking ownership of the program and delayed implementation of required reforms. The Greek public became enraged at the unfairness of the reforms, which were perceived as placing the greatest burden on those least able to carry it. The perception that the terms of the rescue loans constituted an unacceptable violation of national sovereignty gave rise to strong political opposition. By June 2011, it was clear that the first rescue loan was not sufficient and a second, larger loan of €130 billion was deemed necessary.

Many of the reforms that were imposed as conditions for the bailout were long overdue and could promote a more open, transparent, meritocratic and competitive economy. But the attached timelines were unrealistic. Implementation of big, structural changes was tied to a short-term default avoidance program, on top of severe fiscal contractionary measures. In its 14 March 2011 review of Greece's implementation of reforms, the IMF stressed that tax collection must be improved, spending further curtailed and the privatization program scaled up.[6] Reform of the Greek public sector, which includes a historically corrupt tax collection system and rampant tax evasion, had the potential to make a big budgetary impact. But how long would it take to set up a new tax collection authority that operated with integrity and transparency? How quickly could Greece's bloated and wasteful public sector be tamed, reduced in size and made more efficient? The Greek government undertook its first-ever census of government employees in late 2009 to determine the number of workers on the public payroll, their salaries and other compensation, and their job responsibilities. It has taken years to organize and conduct the census, which is still not complete. How long would it take to reorganize ministries, offices and jobs, even if the Greek government were truly committed to such an undertaking? On a much smaller scale, reorganizations at the IMF and the World Bank in the 1990s were demanding and time-consuming affairs that took years to complete. How could the Greek government enact similar reforms in less time?

The rescue loans included requirements to secure €50 billion from privatizations of companies, such as the Hellenic Post Bank and the Hellenic Telecom Organization. The troika considered privatization vital, for it would generate proceeds to reduce the public debt and boost efficiency in the economy. However, privatization program timelines were highly unrealistic. How long might it take to establish an agency to sell off public assets? Germany's post reunification experience suggests that such an undertaking could require years of work. The lenders, aware that the Greek government did not have the capacity, organizational know-how and administrative experience that Germany employed, set up a Task Force for Greece to provide technical assistance.

However, placing a foreign entity in overt charge of such an undertaking turned out to be a political liability by reinforcing the sentiment that national sovereignty had been further undermined. For its part, the Greek government had been unable to complete an EU-funded national land registry it had been working on for more than a decade, despite penalties imposed by the EU. Even if lack of political will or administrative competence had not been factors, the prompt sale of public assets would have been complicated if not administratively and judicially impossible because of incomplete or missing public property records. Indeed, in its April 2014 review of the program, the EU Commission noted that "the expected cumulative privatisation proceeds have been revised downward somewhat to EUR 22.3 billion by 2020".[7]

5 Ibid.

6 IMF Press Release No. 11/77, 14 March 2011.

7 European Commission: The Second Economic Adjustment Programme for Greece, Fourth Review – April 2014, Occasional Papers No. 152, p. 27. The Commission report states: "Progress has been made in completing privatisation deals. Following the completion of the privatisation transactions for State Lotteries (EUR 133 million) and OPAP (EUR 622 million), the authorities are moving forward with the certification process of the gas transmission operator (DESFA), which has been adjudicated for around EUR 187 million… As the preparation of key assets for privatisation is advancing and the majority of state-owned enterprises have now been transferred to the privatisation fund, the focus is now on designing and implementing appropriate arrangements to ensure appropriate regulation and oversight."

Unrealistic timelines for fundamental, long-term changes were indicative of a basic flaw in the troika's assumptions and recommendations, namely that there is a public administration in Greece with the capacity and political will to carry them through. As an OECD review of Greece's central administration concluded in December 2011, reforms depend crucially on a well-functioning public administration:

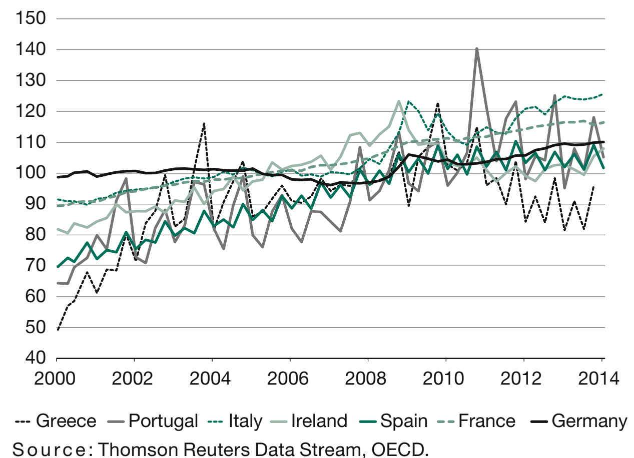
> Strong measures, starting now, to improve the effectiveness, accountability and integrity of the public administration so that it is "fit for purpose" are a priority. The success of reforms such as privatization, fiscal consolidation, debt reduction, tax collection and enhanced competitiveness is at stake.[8]

In its May 2011 report to the troika, the Greek government stated that it had achieved "the largest fiscal consolidation in the Eurozone; that it had undertaken deep expenditure cuts and tax measures and implemented far-reaching structural reforms";[9] lowered public sector wages, bonuses, pensions and benefits; eliminated positions; and increased taxes. Real wages fell by almost eight percent in 2010, and the decline continued in 2011. Unemployment rose to 17 percent. According to an estimate by the *Financial Times*,[10] by November 2011 the average household income in Greece had been reduced by 14 percent, a reduction twice as big as the reduction suffered by Irish and Portuguese households. By the IMF's own estimates, the combination of fiscal measures and structural reforms enacted in 2010-2013 accounted for a cumulative 11 percent of GDP; the largest components were tax increases (four percent) and spending cuts (5.3 percent). The troika and the Greek government hailed Greece's impressive deficit reduction: in 2014, Greece's primary deficit, which excludes interest and some one-off costs, turned positive. But a more realistic reflection of fiscal position is the conventional budget deficit-to-GDP ratio: in Greece's case, its value in 2013 was 12.7 percent, up from 10.9 percent in 2010.

The EU's structural reforms were aimed at improving the competitiveness of Greece's economy through reductions in the cost of labor. Labor market reforms included:

- a reduction in the minimum wage by 22 percent to about €680 a month

Figure 2
**Eurozone unit labor cost index, 2000-2014**



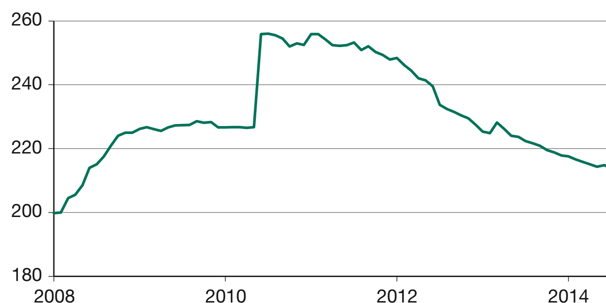

Source: Thomson Reuters Data Stream, OECD.

- new limits on wage bargaining to prevent costly arbitration over wages
- a new rule that for every new worker hired in the state sector, at least five must go
- a reduction of the government's wage bill by 1.5 percent of GDP by 2015
- plans to liberalize 20 service sector professions seen as too protectionist
- pension reform, including an increase of the retirement age to 67 (up from 58-62, depending on the profession) and a further round of pension cuts of 5-15 percent
- salary cuts for police officers, soldiers, firefighters, professors and judges
- a cut in holiday benefits
- a 35 percent cut to severance pay
- a reduction of redundancy notice from six to four months.

Greece's labor costs have fallen significantly since the start of the crisis, more so than in any other crisis-hit country, as shown in Figure 2. But falling wages (and living standards) as a result of recession and joblessness do not necessarily lead to a more competitive economy. Factors like know-how, research and development, business organization, innovation, knowledge-based production, and cultivation and utilization of scientific

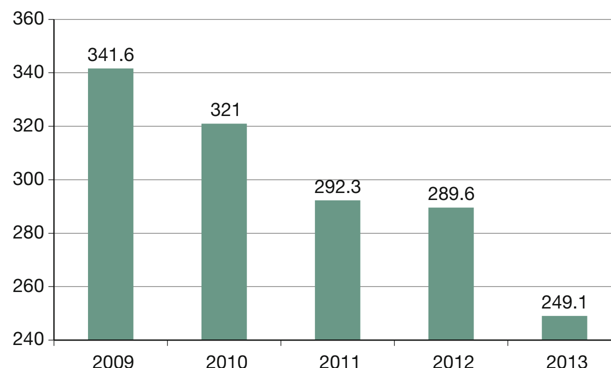
8 OECD: Greece: Review of Central Administration, 2 December 2011.
9 Hellenic Ministry of Finance Policy Programme Newsletter, 19 May 2011.
10 Greek austerity plans threaten growth, in: Financial Times, 17 October 2011.

Figure 3
**Loans to private sector, 2008-2014**
in billion euros




Sources: www.tradingeconomics.com, Eurostat.

Figure 4
**Greece GDP, 2009-2013**
in US$ billions




Sources: www.tradingeconomics.com, Eurostat.

and engineering talent are at the heart of a modern, competitive economy.[11] Unlike fiscal reforms, however, human resource and labor market reforms require time, especially in a country on the verge of default, with outmoded and dysfunctional economic and political institutions. Greece's current account deficit has improved, but this is mostly due to a significant fall in imports in a contracting economy. Taking this into account, Greece's international competitiveness is about the same as it was in 2006.

A critical failure of the austerity implementation program was the disregard for fairness in the distribution of the adjustment burden. The Greek government's choice of across-the-board wage and pension cuts placed a disproportionate burden on lower income earners and retirees, contributing to a widely shared perception of grave injustice.[12] Public sector employment remained shielded from firings as unemployment exploded in the private sector. The burden of indirect taxes, to include a new property tax, increased significantly. The administrative chaos and lack of records across the spectrum of ministries was reflected in the Ministry of Finance's decision to outsource property tax collection to the Public Power Corporation (DEI). Further, use of DEI's customer database to collect the tax linked failure to pay with electricity cut-offs to businesses and households. This tax, on top of other levies, surcharges and revelations of rampant tax fraud, enraged the Greek public. In a poll taken in May 2011, a significant majority of respondents had a negative image of the IMF and felt that the program was a bad decision that hurt the economy and the country. Over 90 percent feared for the future, their jobs and their businesses. Two-thirds of respondents felt that the possibility of default was likely, and over half said that the best solution to the debt problem was to repay only part of it after negotiation with the lenders.[13]

The public's assessment of the depth of the crisis was accurate. Greece's economy continued to contract. Two rounds of drastic austerity measures taken in July 2011 and February 2012, as required by the troika, deepened the recession and increased unemployment even further while growth stalled across the eurozone. In March 2012, Greece was granted a second bailout loan of €130 billion that included a large write-down of Greece's debt, the so-called PSI (private sector involvement, or "haircut") of €100 billion. The PSI and the ensuing deposit flight devastated Greek banks; bailout loan funds will be used for their recapitalization. Restriction of credit to Greece's business sector, as reflected in the level of bank loans to the private sector, has further depressed economic activity, as shown in Figure 3.

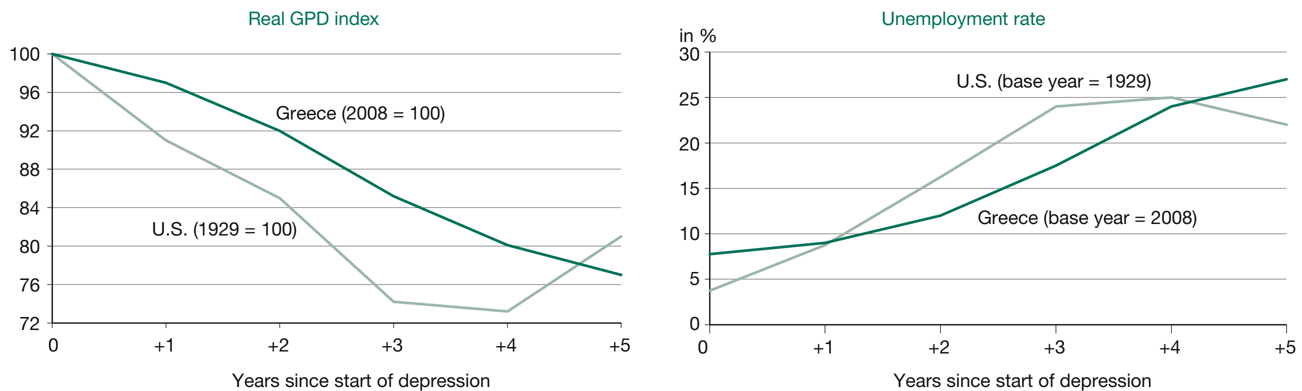
Greece's nominal GDP has continuously fallen, as shown in Figure 4. Purchasing power has been signifi-

11 The importance of these factors is stressed in a comprehensive OECD Report, Greece at a Glance Policies for a Sustainable Recovery, 2011.

12 The IMF's 2013 report notes: "Greece's recent experience demonstrates the importance of spreading the burden of adjustment across different strata of society in order to build support for a program. The obstacles encountered in implementing reforms also illustrate the critical importance of ownership of a program, a lesson that is common to the findings of many previous EPEs. Other lessons drawn concern the need to find ways to streamline the Troika process in the future and for Fund staff to be more skeptical about official data during regular surveillance. The detailed nature of the structural fiscal conditionality in the Greek program also bears scrutiny given the premium attached to parsimony in Fund conditionality." See IMF: Greece: Ex Post . . . , op. cit.

13 Public Issue: Memorandum & Debt: One Year Later, 20 May 2011, available at http://www.publicissue.gr/en/1574/debt-afieroma/.

Figure 5
**Greece and the U.S. – comparing two Great Depressions**




Source: B. D. Papadimitriou, M. Nikiforos, G. Zezza: The Greek Economic Crisis and the Experience of Austerity, A Strategic Analysis, Levy Economics Institute, July 2013, p. 2.

cantly eroded. Industrial production has declined and business failures are at the highest levels recorded in the post-WWII period. Overall unemployment has risen to 27 percent, while unemployment for women is 40 percent and youth unemployment is over 50 percent.

A comparison of the U.S. during the Great Depression years 1929-1934 and Greece during 2008-2013 in terms of GDP decline and unemployment increases shows that Greece's economy has suffered a greater shock, as shown in Figure 5.

### Were the EU's goals achieved?

Have the EU's policies achieved their intended results? On the whole, they have largely satisfied the objectives of the lenders. Greece did not default. The risk of financial contagion has been reduced significantly. Confidence in the euro has remained solid. Financial markets are no longer rattled by the prospect of "Grexit"; after a four-year absence, Greece sold $4.2 billion of new five-year bonds in April 2014 at a rate of 4.75 percent. Fiscal discipline has improved, and a large number of structural reforms have been implemented.

The troika's program worked as intended. The first loan bailed out Greece's creditors, including European banks and taxpayers. The second loan helped Greece's foreign creditors minimize their losses but decimated domestic investors, including Greek banks and insurance funds, which had been required to convert part of their assets to Greek sovereign bonds, a practice that spanned several decades. The structure of the bailouts was primarily oriented to meet the needs of international creditors, especially European banks, who were in direct receipt of about one-fourth of the second loan value. The remaining €100 billion, payable in installments contingent on successful program reviews, was meant to facilitate debt repayment. But the bailout did not contain measures to promote growth.

Without growth, Greece's ability to sustain a debt of 175 percent of GDP would require prolonged and continuous internal devaluation. In its June 2013 debt sustainability analysis, the IMF, principal designer of Greece's Economic Adjustment Program, discussed several risks. For example, under the "three percent more deflation" scenario, the debt-to-GDP ratio would remain at 175 percent through 2020. In the "combined adverse shocks" scenario, the ratio could climb to 220 percent.[14] Indeed, the IMF had misgivings about Greece's debt sustainability from the outset. Yet, as matters stand, the economics and politics of Europe's debt crisis are not favorable to fundamental changes in Greece's bailout program. More likely, another debt restructuring will follow, offering easier financing terms.

The collapse of the Greek economy is a byproduct of EU policies aimed at saving the euro and preserving monetary union. Greece was admitted to a club in which it did not rightfully belong. Although Greece's political class bears the heaviest share of the blame for the performance of the economy, EU decision-makers are also responsible for the resulting tragedy. The EU sidestepped the issues of transparency and competence of Greece's public administration as well as the lack of competitiveness, structural impediments and market dysfunc-

14 See IMF: Greece: Ex Post . . . , op. cit.

tionalities that have plagued the country's economy for decades. The EU's monitoring and auditing mechanisms were slow in enforcing fiscal discipline. Finally, faced with the prospect of Greece's default in the spring of 2010, both the Greek government and its official lenders agreed upon rescue loans containing harsh terms and unrealistic objectives. The EU's policies have saved the euro but left the Greek economy in a depression. This unhappy legacy represents the greatest challenge to EU policies in the aftermath of the debt crisis.

### Implications

Austerity policies rest on a controversial but key assumption advanced primarily by Germany along with several other eurozone states, namely that fiscal discipline is a prerequisite for growth. Whether the EU's policies can foster improved long-term economic performance is an open question. European policy makers have pledged more austerity in the future. At Germany's initiative, a new Fiscal Compact was signed by 25 EU member states. It includes a "golden rule", consisting of a balanced budget requirement in national constitutions and automatic correction mechanisms for the imposition of penalties if the rule is breached.

Fiscal retrenchment is set to continue over the long term. According to a study sponsored by the European Parliament, the EU may be at the beginning of two decades of austerity for public budgets, including spending on defense.[15] The economic and financial crisis has led to drastic consolidation measures affecting military spending in most EU member states. As a result, regional shifts in economic power may be accelerated.[16]

The socioeconomic impact of austerity measures is grave. A recent report by the International Labor Organization concludes:

> Together with persistent unemployment, lower wages and higher taxes, these measures have contributed to increases in poverty and social exclusion, now affecting 123 million people in the European Union, 24 per cent of the population, many of them children, women, older persons and persons with disabilities... The cost of adjustment has been passed on to populations, who have been coping with fewer jobs and lower income for more than five years... The achievements of the European social model, which dramatically reduced poverty and promoted prosperity in the period following the Second World War, have been eroded by short-term adjustment reforms.[17]

Austerity policies have significantly affected electoral politics. In countries that have resorted to fiscal contraction and structural reforms in response to the crisis, governments have been voted out of office. In addition to the governments of periphery countries, the Dutch government fell in late April 2012 as a result of disagreements over the nature and extent of further fiscal tightening. On May 6 of that year, French voters elected an anti-austerity president, Francois Hollande, the first socialist president in France in 17 years. On the same day, Greek voters punished the mainstream parties and elevated an anti-austerity, radical left-wing party to second place. In June 2012, after a second round of elections that attracted worldwide attention for their implications, Greece's Syriza (a socialist and radical left coalition) became the main opposition party. In the May 2014 EU-wide elections for seats in the EU Parliament, extreme parties such as the National Front in France and Syriza in Greece saw their support grow. Increasingly, the EU may be perceived as unwilling or unable to protect the welfare of its citizens.

The specter of austerity and its consequences have reintroduced issues long considered resolved: the size and membership of the eurozone, the future of the euro as the world's second reserve currency, and the role of national capitals in EU governance. With financial and technical assistance from the IMF, the EU has managed the rescue loans within the limits of the eurozone's existing firewall. However, the costs of preventing future contagion, renewed financial turmoil and more defaults could become much larger, perhaps truly prohibitive, in economic and political terms. The EU's once-compelling vision of pooled sovereignty in return for prosperity, solidarity and internal peace seems less persuasive now. The economic and political backlash against austerity has the potential to reverse the course of European integration.

15 C. Mölling, S.-C. Brune: The Impact of the Financial Crisis on European Defence, Directorate-General for External Policies of the Union, Directorate B, Policy Department, 2011.

16 With the exception of Sweden, Poland, France, Finland and Denmark, significant cuts in defense budgets are under way, especially in Germany and the UK. Large cuts on the order of 30 percent are planned in smaller states. The majority of mid-sized states are expected to enact average cuts of ten percent. By contrast, most East Asian countries' defense budgets continue to grow in parallel with the economy. See Swiss Federal Institute of Technology: Defense Spending: Economy Trumps Strategy, 15 February 2012.

17 International Labor Organization: World Social Protection Report 2014/15. Building economic recovery, inclusive development and social justice, p. xxiii.