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Edited by / Sous la direction de
Sotiris Ntalis

Contributors / Contributions de
Christos Baxevanis
Kostas Botopoulos
Nicos Christodoulakis
Theodore M. Mitrakos
Maria Papadaki
Stavros Zografakis

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Stephanos Constantinides
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1

The Greek Crisis in Perspective: Origins, Effects and Ways-out

Nicos Christodoulakis*

RÉSUMÉ

En 2011, l'euro a fait face à son plus grand défi depuis son adoption, plusieurs États participants affrontant des problèmes financiers sans précédent.

La Grèce a constitué le cas le plus grave, ce qui a nécessité une intervention de l'UE et du FMI pour stabiliser son économie et rembourser ses créances. Cet article explique le processus de l'évolution de la dette en Grèce depuis les années 1980 à ce jour, et décrit principalement ses causes et ses éléments. Il évalue également le Mémorandum du FMI et de l'UE et fait valoir que l'effondrement de la croissance inhibe les perspectives de stabilisation de la dette. Un autre scénario est examiné et qui montre que la stabilisation peut devenir plus efficace et réaliste si la récession est abordée en priorité, les réformes s'accomplissant moins brutalement.

ABSTRACT

In 2011 the Euro faced its toughest challenge since its introduction as several of the participating Member States faced unprecedented financial problems.

Greece was the most severe case requiring intervention from the EU and IMF to stabilize its economy and repay debt obligations. This article explains the debt process in Greece from the 1980s to date, and describes its main causes and episodes. It also assesses the IMF-EU Memorandum and argues that the collapse of growth inhibits the prospects of debt stabilization. An alternative scenario is discussed that shows that stabilization can become more effective and is realistic if the recession is tackled first and reforms follow on a steadier path.

1. Introduction

In the aftermath of the global financial crisis of 2008, a number of Eurozone countries were engulfed in a spiral of rising public deficits and explosive

* AUEB, Athens University of Economics and Business

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borrowing costs that eventually drove them out of markets and into bail-out agreements jointly undertaken by the International Monetary Fund (IMF), the European Union (EU) and the European Central Bank (ECB). Greece was by far the most perilous case with a double-digit fiscal deficit, an accelerating public debt which in GDP terms was twice as much the Eurozone average and an external deficit near 5,000 US Dollars per capita in 2008, one of the largest worldwide. No wonder that Greece was the first to seek the bail-out assistance and the last expected to exit its ever-changing conditionality terms.

Two years after the bail-out Memorandum was signed the situation remains highly uncertain. The economy faces an unprecedented recession, unemployment is rocketing, social unrest undermines the implementation of reforms and the fiscal front is not yet under control, despite extensive cuts in wages, salaries and pensions. In the summer of 2011 uncertainties multiplied at such a rate that the possibility of Greece exiting the Eurozone was widely discussed either as a punishment mechanism from abroad for not accepting the pains of adjustment or as a quick fix from within to avoid them for good.

In two subsequent EU summits, held respectively in July and October 2011, the Memorandum agreement was substantially broadened to include a radical debt restructuring and reduction by 50%, a second round of bail-out loans and a generous release of European structural funds to assist the real economy. The agreement was conditional on being approved by the national Parliaments of the lender states as well as by the European Parliament. Finally, the conditionalities of the Memorandum were approved by the Greek Parliament in a session on the 12th of February 2012 and this implies that a realistic horizon for concluding the debt-restructuring process and starting the financing of investment projects is the first quarter of 2012. Some of the envisaged measures may delay until the second quarter of the year, as a fresh election is likely to be set soon to provide new legitimacy for carrying on the reforms. It is obvious that the process of economic decisions will be strongly conditioned on political developments and a very careful implementation should be designed by both the European and the Greek authorities to go through. Hence, the economic and political analysis of the Greek problem is becoming crucial not only for understanding its origins and causes, but also for recognizing the constraints and setting realistic priorities.

The purpose of the present article is twofold: First to provide a historical account of debt accumulation, identify the main difficulties of fiscal stabilization and explain the factors that led to the present crisis and the failure to prepare for it. Second, to assess the main reasons for missing the targets set by the Memorandum agreement and the need for encompassing a growth strategy in order to make reforms acceptable and more effective to achieve debt sustainability in the longer run.

Section 2 describes the main episodes of debt escalation in the 1980s, Section 3 the stabilization effort on the way to EMU and Section 4 the combination of fiscal irresponsibility, external deficits and indecision that led to the present crisis. Section 5 describes some recurrent facts on fiscal policies that repeatedly hinder stabilization and growth. Section 6 attempts an ex post assessment of the policies conditioned by the Memorandum agreement to correct the economy while Section 7 argues why exiting the Eurozone is not an option for Greece.

An alternative scenario based on higher growth is shown to be more credible in achieving fiscal consolidation and stabilizing debt, while Section 8 concludes on the need to fight current recession as the only way for Greece to regain social coherence and debt sustainability.

Figure 1: Greek public Debt as %GDP for the period 1980-2011.
Source: Debt of General Government, ESA95 definition, Ameco Eurostat 2011. GDP at market prices, IMF WEO Database 2010.

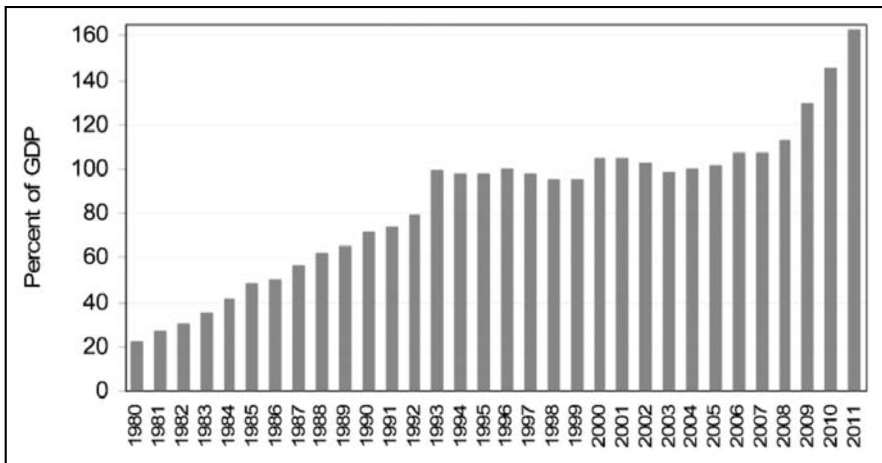
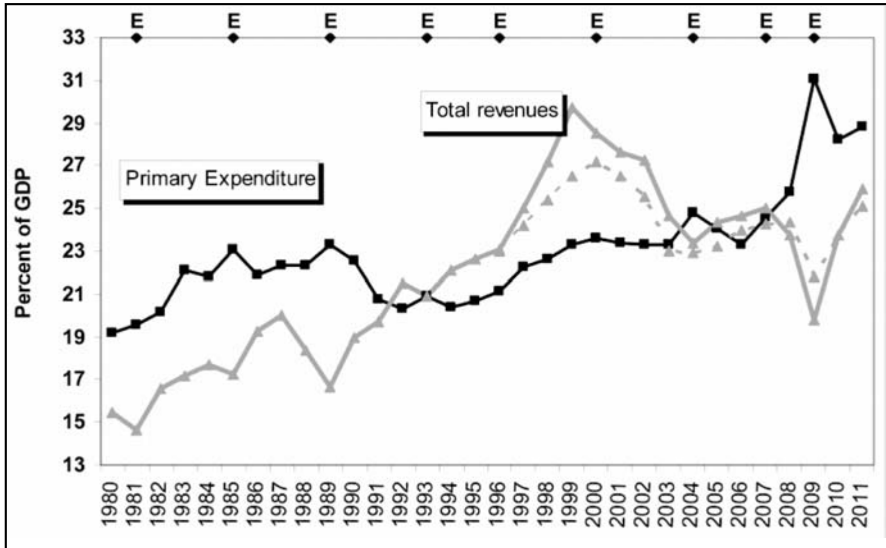


Figure 2: Primary public expenditure and total revenues (incl. privatisation proceeds) as % GDP in Greece, 1980-2011.



Election years denoted by (E). Dotted line denotes public receipts net of privatizations.
Source: Budget Reports. GDP at market prices, AMECO Database 2012.

2. The Period of Debt Escalation: 1980-1993

In 1980, Greece became a full-fledged member of the European Union. Looking at Fig.1, there are three distinguishable phases for the dynamics of debt: The first covers the period 1980-1993 during which public debt rose from slightly above 20% of GDP toward 100% in 1993. The second phase spans the period 1994-2005 in which public debt ends up again at around 100% of GDP after two mild reductions in between. The third phase covers the period 2006-2011 when public debt surpasses the 100% threshold, accelerates after 2008 and ends up exceeding 160% of GDP in 2011.

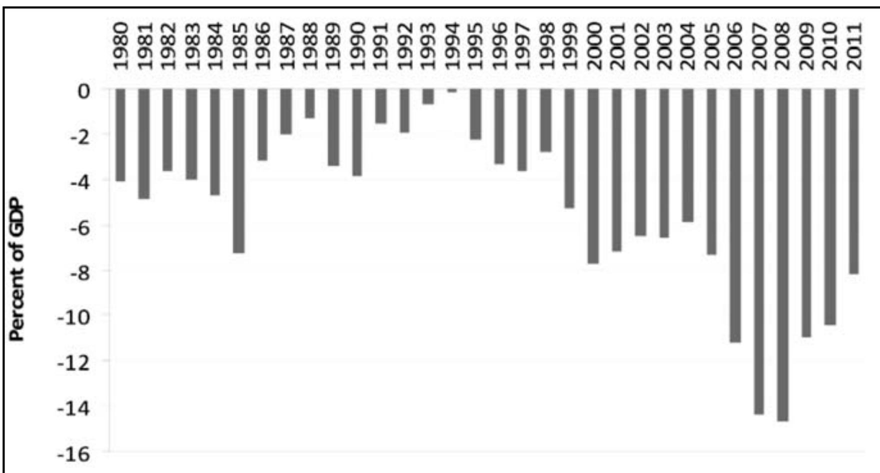
The above periodicity broadly coincides with substantial shifts in the context of economic policies, as suggested by developments in the fiscal patterns shown in Fig. 2 and in the Current Account depicted in Fig. 3.

Membership of the European Union was an event that inspired nationwide confidence in political and institutional stability but - at the same time - it fed

uncertainties over the economy. After a long period of growth, Greece faced a period of recession not only as a consequence of worldwide stagflation, but also because on its way to integration with the common market it had to dismantle its protectionist system of subsidies and tariffs. Soon after accession, many firms went out of business and unemployment rose for the first time in many decades.

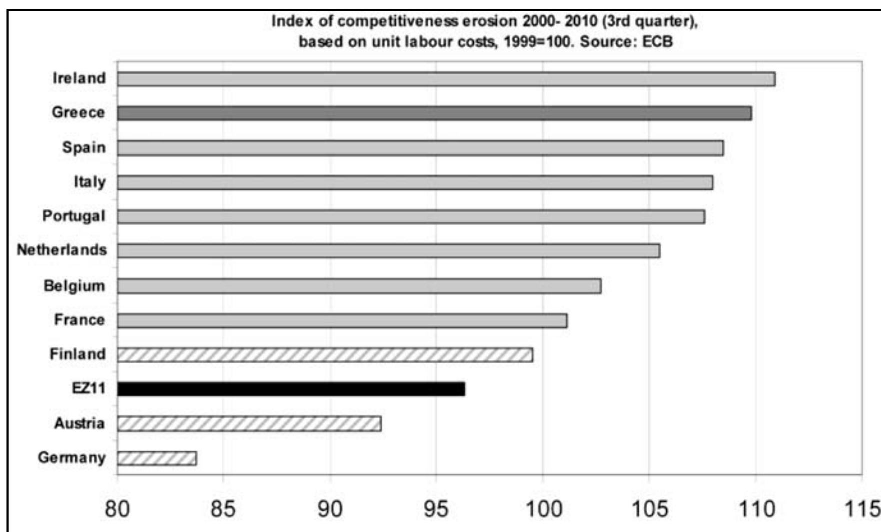
The Government opted for a massive fiscal expansion that included demand-push policies to boost activity and the underwriting of several ailing companies to maintain employment. The effect was quite predictable: private debts in turn became a chronic hemorrhage of public funds without any supply-side improvements. Similarly, the expansion of demand simply led to more imports and higher prices. Activity got stuck and Greece ended up in a typical stagflation, perhaps the quickest assimilation to European practices of the time.

Figure 3: Current Account in Greece as % of GDP, 1980-2011.



Source: IMF WEO Database 2011.

Figure 4: Development of unit labour costs in the Eurozone 2000-10.



Source: ECB, Competitiveness indicators, 2011.

For Portugal the ULC index was missing for 2010 and replaced by the CPI index adjusted for differences from ULC by using the estimates for 2011. In the more recent editions, the effect of Greek ULC on competitiveness is even less pronounced, due to the wage-cuts implemented in the last quarter of 2010 and through 2011.

Regarding fiscal developments, the main characteristic of the period was the substantial expansion of public spending and the concomitant rise in budget deficits and government debt. Revenues increased as a proportion of GDP, but were outpaced by the steadily growing expenditure. Both fiscal components appear to be volatile in the election years 1981, 1985 and 1989, suggesting the presence of a strong political cycle in public finances, as will be discussed later in more detail.

To maintain competitiveness, authorities had adopted, since the mid 1970s, a real exchange-rate target with a crawling peg. After the Government adopted an automatic wage indexation scheme in 1982, the only effect of the exchange rate policy was to fuel price increases and aggravate trade deficits. To break the vicious cycle of depreciation and inflation, a discrete devaluation combined with a temporary wage freeze was implemented in 1983, but it was

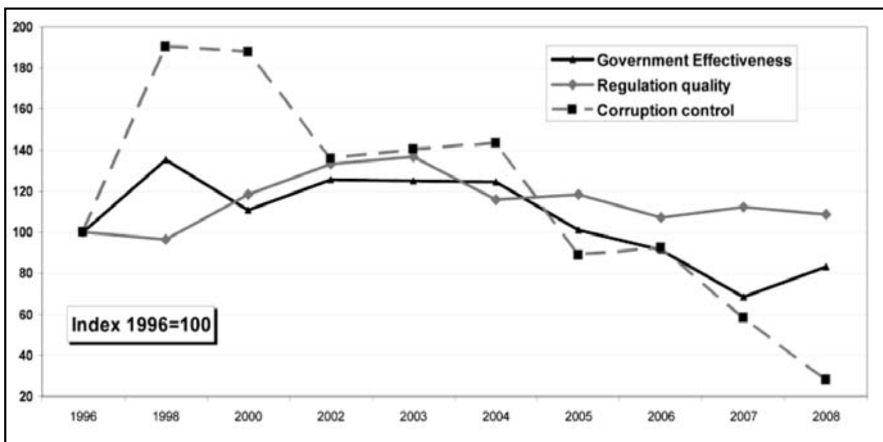
superseded by a new phase of expansion as elections were approaching leaving public debt at even higher levels.

The external deficit approached 8% of GDP in 1985, an alarming threshold as several Latin American economies with similar imbalances at that time were collapsing. A coherent stabilization program was called for in October 1985 enforcing a discrete devaluation by 15%, a tough incomes policy and extensive cuts in public spending. The program achieved a rise in revenues by beating tax evasion practices, and replacing previous less effective indirect taxes with the VAT system. Public debt was stabilized, but only until the program was fiercely opposed from within the Government and it was finally abandoned in 1988.

2.1. The First Fiscal Crisis

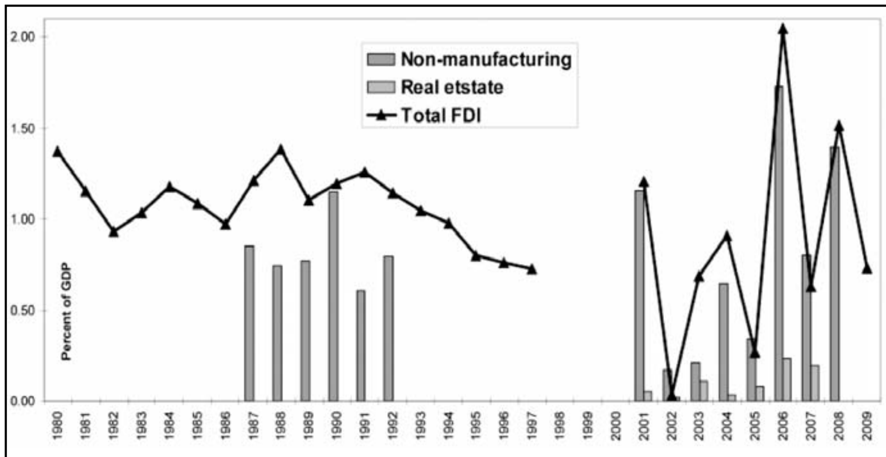
Two general elections in 1989 failed to secure majority, thus leading to the formation of coalition Governments and inflicting major harm on the economy. Stabilization policies are particularly difficult to implement through party

Figure 5: Quality indicators affecting the economic climate



Notes: Indicators are measured in various units with higher values corresponding to better outcomes; to ease comparison all are here indexed at 100 in 1996. Source: World Bank, WGI various editions.

Figure 6: FDI inflows to Greece expressed as percent of GDP.



Note: Missing observations are due to non-availability and do not necessarily imply poor flows. Source: OECD, FDI statistics.

coalitions, because each party tries to avoid the cost falling on its own constituency. Two characteristic episodes confirm this view: Despite looming deficits, in 1989 the coalition Government decided to abolish prison terms for tax arrears hoping to induce major tax evaders to reconsider their strategy. The move was interpreted the other way around, as a signal of relaxed monitoring in the future, thus effectively encouraging further evasion.

Another bizarre measure was to cut import duties for repatriates buying luxury cars, thus depriving the Budget of badly needed revenues and leading to black-market abuses of the scheme.

As a result, revenues collapsed and the country suffered a major fiscal crisis, until a majority Government was elected in 1990 and enacted a new stabilization program. Despite substantial cuts in spending and a rise in revenues, public debt as a ratio to GDP continued to rise because of the higher cost of borrowing worldwide and a stagnant output. The sharp rise in 1993 is due to the inclusion of extensive debts initially contracted by public companies under state guarantees but finally underwritten by the Budget. Except for the electoral years 1989-90, fiscal consolidation significantly improved the Current Account and a balanced external position was reached in 1994.

3. Debt Stabilization and EMU Membership

Although Greece was a signatory of the Maastricht Treaty in 1991, it was far from obvious whether, how and when the country could comply with the nominal convergence criteria required to join the Economic and Monetary Union. Public deficits and inflation were galloping at two-digit levels and there was great uncertainty about the viability of the exchange rate system; for a detailed analysis see Christodoulakis (1994).

In May 1994, capital controls were lifted in compliance with European guidelines and this prompted fierce speculation in the forex market. Interest rates reached particularly high levels and the Central Bank of Greece exhausted most of its reserves to stave off the attack; for an account see Flood and Kramer (1996). This episode proved to be a turning point for the determination of Greece to pursue accession to EMU and avoid similar attacks. Soon afterwards the "Convergence Program" was adopted that set time limits to satisfy the Maastricht criteria and included a battery of reforms in the banking and the public sectors.

However, international markets continued to be unconvinced about exchange rate viability. With the advent of the Asian crisis in 1997 spreads rose dramatically and Greece finally chose to devalue them in March 1998 by 12.5% and subsequently enter the Exchange Rate Mechanism wherein it had to stay for two years. The country was not ready that year to join the first round of Eurozone countries and was granted a transition period to comply with the convergence criteria by the end of 1999.

After depreciation, credibility was further enhanced by structural reforms and reduced state borrowing so that when the Russian crisis erupted in August 1998, the currency came under very little pressure. Public expenditure was kept below the peaks it had reached in the previous decade and was increasingly outpaced by the rising total revenues. Tax collection was enhanced by the introduction of a scheme of minimum turnover on SMEs, eliminating a vast number of tax allowances, by the imposition of a new levy on large property and a re-reorganization of the auditing system. Proceeds were further augmented by privatization of public companies and, as result, public debt fell to 93% of GDP in 1999. Although still higher than the 60% threshold required by the European Treaty, Greece benefited from the convenient interpretation "*to lean toward that level*" that was previously used by other countries to enter EMU.

3.1. The Implementation of Market Reforms

In the 1980s, structural reforms were hardly on the agenda of economic policy. For most of the time the term was a misnomer used to describe further state intervention in economic activity, rather than market-oriented policies. Market reforms were introduced for the first time in 1986 aiming at the modernization of the outmoded banking and financial system in compliance with European directives. A major reform in social security took place in 1992 curbing early retirement and excessively generous terms on the pension/income ratios. Throughout the 1990s, various reform programs were aimed at the restructuring of public companies whose deficits had contributed to the fiscal crisis in 1989. Privatization was attempted through direct sales of state-owned utilities as the quick way to reduce deficits. Despite some initial success, the program failed when applied to large public companies.

A new wave of reforms was launched in the course of the "Convergence Program". State banks were privatised or merged, several outmoded organizations were closed down, and IPO provided capital and restructuring finance to several utilities. Other structural changes included the lifting of closed-shop practices in shipping, the entry of more players into the mobile telephony market and a series of efforts to make the economic environment more conducive to entrepreneurship and employment.

3.2. Post-EMU Fatigue

After 2000, Greece emulated a number of other euro area members that had exhibited a *'post-EMU fatigue'* and the reform process gradually slowed down. As shown in Fig.9, proceeds from privatization peaked in 1999, but subsequently remained low as a result of the contraction in capital markets after the dot.com bubble and the global recession in 2003; for an extensive discussion of reforms in Greece over the period 1990-2008 see Christodoulakis (2012).

An attempt in 2001 to deeply reform the pension system led to serious social confrontations and was finally abandoned, to be replaced by a watered-down version one year later. Two other reforms followed in 2006 and 2010, but the social security system is still characterised by inequalities, inefficiencies and structural deficits that exert a substantial burden on the General Government finances.

The fatigue spread more widely after the Olympic Games in 2004. Since

then, reforms have been concentrated on small-scale IPOs, with important exemptions being the sale of Greek Telecom to the German state company and the privatization of the national air carrier after a decade of failed attempts.

3.3. Why Debt Reduction was Insufficient

Despite substantial primary surpluses achieved throughout 1994-2002, and around 1999 in particular, public debt fell only slightly. There are three reasons to explain this outcome. First, during this period the Government had to issue bonds to accumulate a sufficient stock of assets for the Bank of Greece as a prerequisite for its inclusion in the Euro-system, and this capital injection led to a substantial increase in public debt without affecting the deficit.

Second, after a military stand-off in the Aegean in mid 1990s, Greece increased defence procurement to well above 4% of GDP per year. In line with Eurostat rules, the burden was fully recorded in the debt statistics at the time of ordering but only gradually in the current expenditure according to the actual delivery of equipment. This practice created a considerable lag in the debt-deficit adjustment and, in 2004, the Government enforced a massive revision of the deficit figures by retroactively augmenting public spending on the date of ordering, prompting a major dispute over the statistics of public finances in Greece. Though a decision by Eurostat in 2006 made the delivery-based rule obligatory for all countries, Greece did not withdraw the self-inflicted revision. Perversely, the result was that deficits were augmented for 2000-2004 and scaled-back for 2005-2006 relative to what they should have been otherwise.

The third reason was the strong appreciation of the Yen/Euro exchange rate by more than 50% between 1999 and 2001 that significantly augmented Greek public debt as a proportion of output due to substantial loans in the Japanese currency contracted during the 1994 crisis. To alleviate this exogenous deterioration, Greece entered a large currency swap in 2001 by which the debt to GDP ratio was reduced by 1.4% in exchange for a rise in deficits by 0.15% of GDP in subsequent years, so that the overall fiscal position remained unchanged in present value terms. Although the transaction had no bearing on the statistics for 1999 on which EMU entry was assessed, Greece suffered extensively from criticisms that mistook it as a ploy to circumvent a proper evaluation. Values shown in Fig.1 are net of swap effects, and this explains the peak in 2001.

2.4. The Current Account

After the Eurozone became operational, hardly any attention was paid to Current Account imbalances, regarding Greece or any other deficit country. Even after they reached huge proportions, external disparities in the euro area continued to be surprisingly unnoticed from a policy point of view. It was only in the aftermath of the 2008 crisis that policy bodies in the European Union started emphasising the adverse effects that external imbalances may have on the sustainability of the common currency (see for example EC, 2009).

The reason for this complacency was not merely that devaluations were ruled out by the common currency. A widespread - and unduly comfortable - view held that external imbalances were mostly demand-driven effects and, as such, they would sooner or later dissipate as a result of ongoing fiscal adjustment in member-states. When, for example, Blanchard and Giavazzi (2002) asked whether countries such as Portugal or Greece should worry about and take measures to reduce their Current Account deficits they "*... conclude(d), to a first order, that they should not*". A few years later, this proved to be a misguided optimism and Blanchard (2006) remarked that Current Account deficits were steadily increase within the euro area and urged immediate action otherwise *implications can be bad*". As indeed they were.

Although it improved for a while after the country joined the common currency, the vast deterioration in the Greek Current Account played a crucial role in inviting the global crisis home. The reason behind the initial containment was that factor income flows from abroad increased as a result of extensive Greek Foreign Direct Investment in neighbouring countries while labour immigration kept domestic wage increases at bay. The deficit started to deteriorate after 2004 as domestic demand rose in the post Olympics euphoria, inflation differentials with other Eurozone countries widened and the Euro appreciated further. Unit labour costs increased and as shown in Fig.4 the relevant index rose by 10% in the period 1999-2010. It is worth noticing that a similar erosion of competitiveness took place in *all* other Eurozone countries that are currently in bailout agreements (Ireland by 12% and Portugal 8%) or considered to be at the risk of seeking one (Spain by 9% and Italy by 8%).

Compared to Germany, Greek unit labour costs increased by 27% causing significant bilateral imbalances. However, this erosion was gradual and cannot

have been the single reason for the rapid deterioration experienced after 2006. Other factors affecting the investment environment, such as the quality of the regulatory framework, elimination of corruption practices and overall Government effectiveness might also have been crucial in shaping productivity and competitiveness. Using the Worldwide Governance Indicators published by the World Bank as proxies for how the above factors evolved during the period from 1996 to 2008, Fig.5 shows that, after some improvement in the first years of EMU, there was a noticeable decline thereafter.

These developments were pivotal to the poor performance of Greece in attracting foreign direct investment in spite of the substantial fall in interest rates and the facilitation of capital flows within the Eurozone. As depicted in Fig.6, FDI expressed as percent of GDP hardly improves during the last decade relative to the 1980s. The composition has also changed, as most of the FDI inflows were directed to non-manufacturing sectors and, pointedly, with an increasing allocation to real estate.

It is a well established fact that when new investments are directed mainly to the tradeable sectors this leads to substantial productivity improvements and favours net exports. In contrast, investments going mostly into the real-estate sector boost aggregate demand, raise prices, cause the real exchange rate to appreciate and hinder competitiveness. These developments manifest a major failure of Greece - and for that matter of other Eurozone countries - to exploit the post-EMU capital flows in order to upgrade and expand production; for details see a study by Christodoulakis and Sarantides (2011) who use the differentiation in FDI composition to explain the diverging patterns of external balances in the Eurozone countries.

4. Unprepared for the 2008 Crisis

The fiscal decline started with the disappearance of primary surpluses after 2003 and culminated with rocketing public expenditure and the collapse of revenues in 2009, as shown in Fig.2. Revenues declined as a result of a major cut in corporate tax rate from 35% to 25% in 2005 and extensive inattention to the collection of revenues.

Increasingly, it was becoming evident that stabilizing the economy was not a policy priority and the Government actions soon confirmed this assumption:

concerned over the rising deficits in 2007, it sought a fresh mandate to redress public finances but - despite securing a clear victory - no such action was taken after the election. Only a few months before the global crisis actually erupted, the Government claimed that the Greek economy was *"sufficiently fortressed"* and would stay immune to the reverberations of international shocks. Even after September 2008, the Government was for a long time ambivalent as to whether implement a harsh program to stem fiscal deterioration or to expand public spending to fight off the prospect of recession. A final compromise included a consumption stimulus at the end of the year, combined with a bank rescue plan of Euro 5 bn and a pledge to raise extra revenues. The first two were quickly implemented, whilst the latter was forgotten.

Weakened by internal divisions, the Government continued to be indecisive on what exactly to do and, after a defeat in the European elections in June 2009, it opted for general elections in October 2009 as a new opportunity to address the mounting economic problems. The fiscal consequences were stunning: total public expenditure was pumped up by more than 5 percentage points exceeding 31% of GDP at the end of 2009. (In actual amount, it exceeded Euro 62 bn, i.e., twice the size in 2003). The rise was entirely due to consumption as public investment remained the same at 4.1% of GDP; details on how public spending was ballooned are given in Christodoulakis (2010).

Total receipts in 2009 collapsed by another 4% of GDP as a result of widespread neglect in collection and the fact that privatization proceeds turned negative since the Government had to finance the emergency capitalization of Greek banks. The deficit of General Government spiraled and was serially revised from an estimated 6.7% of GDP before the elections to 12.4% in October 2009, and finally widened to 15.4% of GDP by the end of the year triggering the fiscal crisis.

4.1. Post-election Inaction

In spite of the gathering storm, the new Government was far from being determined to achieve immediate fiscal consolidation, as it was constrained by pre-electoral rhetoric that *"money exists"* and its timidity in controlling trade union demands in public enterprises. Trapped in such attitudes, the Budget for 2010 included an *expansion* of public expenditure while completely *excluding* privatizations, rather than the other way around. Seeing that no

appropriate action to deal with the situation had been taken, rating agencies downgraded the economy, this sparked massive credit default swaps in international markets and the crisis loomed.

The problem Greece faced at that time was an acute shortage of financing for the deficit, not yet one of debt sustainability as it became later. In this regard, a significant opportunity was missed. In order to reduce the risk of spillovers to other markets after the credit crunch in 2008, the ECB invited private banks of Euro member states to obtain low-cost liquidity using sovereign bonds as collateral securitization; see De Grauwe (2010) for an assessment of this policy. As a result of this credit facilitation, yields on Treasury bills remained exceptionally low. But instead of borrowing cheaply in the short term as a means of gaining time to redress the fiscal situation, the Government kept on issuing long maturities despite the escalation of costs. This had dramatic consequences on the perception of the crisis by international markets. Feldstein (2012) aptly notes that:

> "What started as a concern about a Greek *liquidity problem* - in other words, about the ability of Greece to have the cash to meet its next interest payments - became *a solvency problem*, a fear that Greece would never be able to repay its existing and accumulating debt", (my emphases).

The option was unwisely undermined when the ECB threatened to refuse collateral status for downgraded Greek bonds, hence fuelling fears that domestic liquidity would shrink and precipitating a capital flight from Greek banks. Three months later the rating requirement was dropped for all Eurozone countries, but the damage was not reversible. In early 2010, borrowing costs started to increase for both short and long term maturities, Greece had become a front page story worldwide and the count-down began. In April 2010 the Government was financially exhausted and sought a bailout.

4.2. The Role of External Deficits

The global financial crisis in 2008 revealed that countries with sizeable Current Account deficits are vulnerable to international market pressures because they risk having a "sudden stoppage" of liquidity. Recent studies show that highly indebted EMU countries with large external deficits are found to experience the highest sovereign bond yield spreads. Along this line, Krugman

(2011) recently suggested that the crisis in the southern Eurozone countries had rather little to do with fiscal imbalances and rather more to do with the sudden shortage of capital inflows required to finance their huge external deficits.

This explains why immediately after the crisis sovereign spreads peaked mainly in economies with large external imbalances, such as Ireland, Spain, Portugal and the Baltic countries, which were under little or no pressure from fiscal deficits; for a discussion of the effects of credit crunch in emerging markets with large Current Account deficits see Shelburne (2008).

It is worth noting that countries with substantially higher debt burdens, such as Belgium and Italy, experienced only a small increase in their borrowing costs at that time.

Greece happened to have a dismal record on both deficits and its exposure to the credit stoppage was soon transplanted into a debt crisis. The Current Account was in free-fall after 2006, when pressure from three factors intensified: Domestic credit expansion accelerated, disposable incomes were enhanced by tax cuts and capital inflows from the shipping sector peaked as a result of the global glut. The external deficit exceeded 14% of GDP in 2007 and 2008 but no warning was raised by any authority, domestic or European. In fact, the Government acted pro-cyclically and decided to reduce surcharges on imported luxury vehicles responding to the pleas of car dealers. Replicating history back in 1989, the unfortunate decision to facilitate car purchases in order to favour particular groups caused again a significant deterioration of both the external and the public deficit. Additionally, nobody missed the signalling about the true priorities of the Government and this opened the way for the pre-electoral spree that followed.

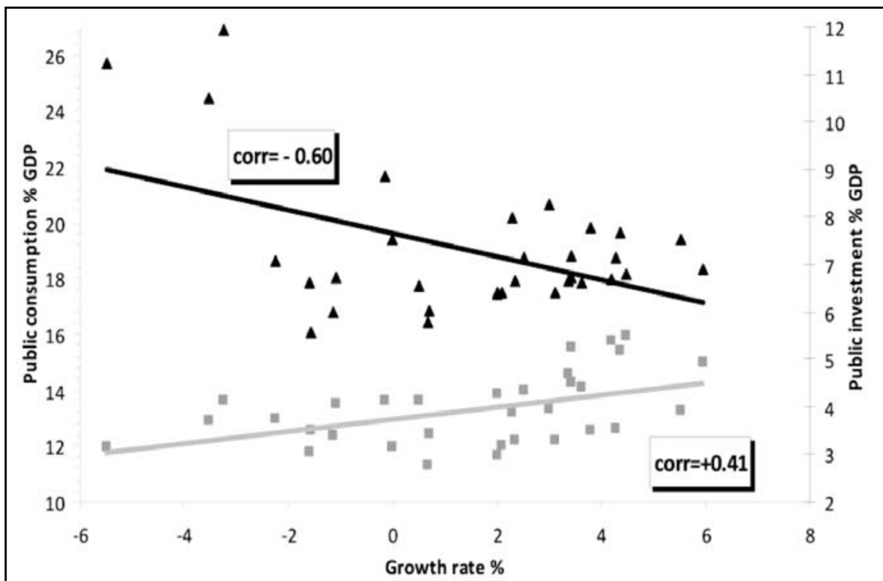
5. Two Important Policy Facts

Two stylized facts emerge from the historical account of fiscal developments. One is the fact that in periods of recession counter-cyclical activism usually takes the form of increased consumption, not public investment and this has detrimental effects on public and external deficits without contributing to higher growth. Another recurring characteristic is the propensity of Governments to increase public spending and to tolerate lower revenues in election years.

5.1. Cyclicality of Public Spending

As an indication of how the two main components of Government spending behave over the economic cycle, public consumption and public investment expressed as proportions of GDP are correlated with the growth rate; see Fig.7. Public consumption is found to have a strong negative correlation with growth rates, suggesting a counter-cyclical pattern. This finding implies that periods of economic downturn are likely to be associated with higher public consumption due to increased benefits and programs to contain unemployment. In a situation of fixed employment and nominal wage resistance, public consumption is expected to rise further relative to GDP.

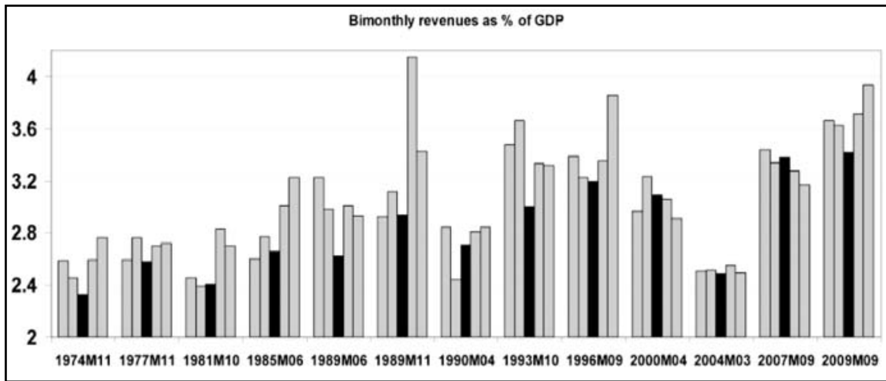
Figure 7: Growth rate correlations with public consumption (Lhs) and public investment (Rhs) expressed as a percentage of GDP.



Source: Government budget, various editions.

Bimonthly revenues as % of GDP

Figure 8: Comparison of bimonthly tax revues in pre-election periods.



Revenues are calculated for the period of two months before each election as % of annual GDP. Each election year (N) is denoted by black and compared with revenues collected over the same period during the previous (N-2, N-1) and the following years (N+1, N+2) denoted by grey. Frequency is bimonthly to account for the fact that the pre-election period lasts for 30-40 days, thus it extends over the prior as well as the poll month. Data are not seasonally adjusted, thus they reflect within year variations.

Source: Skouras and Christodoulakis (2011) where further details are available.

On the other hand public investment shows a strong positive correlation with growth. This implies that, in a downturn, public investment is likely to fall, thus hindering growth and causing more recession in the economy.

A clear manifestation of such behaviour over the cycle took place in recent years. With recession deepening in 2010 and 2011, the Government rather than curtailing the public sector found it more expedient to cut public investment in order to control the deficit. As a result, recession was made worse.

5.2. Electoral Cycles

The Greek economy was often subject to the electoral cycle, as incumbent Governments tried to appeal to voters by a variety of opportunistic policies, thus inflicting non-trivial fiscal losses. Practices included extra appointments of party affiliates, grants to favorable groups and allocation of petty projects to local constituencies, all of which affect current or next period expenditure.

It can readily be seen from Fig.2 that spending rises during the election years in the 1980s and, as deficits widened, the economy had to enter a period

of stabilization that was usually terminated before the next election. During the debt escalation in 1980-93 there were four stabilization programs and ten Finance Ministers - usually one to pursue the program and then another one to denounce it and prepare for a new period of spending rise. Though the electoral cycle subsided in the period before and after EMU membership, it returned full-steam in the elections of 2009.

Apart from direct actions on the expenditure side, the empirical evidence suggests that slacker tax auditing around elections causes further fiscal deterioration. An extensive investigation by Skouras and Christodoulakis (2011) found that flaws in tax collection arise either as a result of deliberate relaxation of audits as a signal to political supporters or as an indirect consequence of the slackness prevailing in public administration around elections.

Considering that a typical pre-election period has duration of circa 40 days, Fig.8 compares the revenue in the two months of the election period in each electoral year with the same two months in adjacent years. Simple inspection shows that in most of the elections held between 1974 and 2009, average bimonthly revenues expressed as a percentage of GDP were lower than the average of the respective figures in the two adjacent years, (with only two slight exceptions in 2000 that coincided with the entry to EMU and 2007 because it is compared with another - and a lot worse - electoral period in 2009). In the same study it is estimated that pre-electoral misgovernance causes a loss in revenues equal to 0.18% of GDP in each election year. For the 13 elections taken place in the period 1974-2009, this amounts to more than 5 billion Euros at 2010 prices.

6. An Ex-post Assessment of the Memorandum

EU authorities seemed to be unprepared to react promptly to the Greek problem and undertook action only when they recognized the risks it posed for the banking systems of other European states. After difficult negotiations, a joint loan of Euro 110 bn was finally agreed in May 2010 by the EU and the IMF to substitute for inaccessible market borrowing. The condition was that Greece follows a Memorandum of fiscal adjustments to stabilize the deficit and structural reforms to restore competitiveness and growth. More details are given in the Appendix. In the eventuality of success, Greece would be ready to tap markets in 2012 and then follow a path of lowering deficits and higher

growth. Nearly two years after implementation, the record remains poor and the economy is fiercely contracting. Some explanation is attempted below.

6.1. The Failure in Fiscal Adjustment

The decline of revenues as a share to GDP after 2007 and the collapse of the collection mechanism in 2009 in particular were instrumental for the explosion of public debt and deficit thereafter. Strangely enough, no serious effort was undertaken to remedy the situation after the elections. The ministerial post in the Inland Revenue remained empty for more than a year and two top executives resigned in protest that their proposals to beat tax evasion were turned down. The Government opted for an increase in the VAT rate from 19% to 23% in the spring 2010 and, as a result, CPI inflation jumped to 4.5%, further cutting purchasing power amid recession. Activity was reduced and revenues did not rise.

The Government continued to act as in a positive feedback loop, with lower revenues prompting higher taxation and this in turn causing further evasion. Unable to raise efficiency and under pressure to raise revenues, it imposed a heavy increase in fuel tax, substantial consumption surcharges and finally a lump-sum tax in exchange for settling previous arrears. By the end of 2010 revenues were practically at the same level as in the previous year and the Government opted for retro-actively raising the tax rate on the self-employed and imposing a new levy on property. Once again tax revenues ended up far below the target in a typical manifestation of elementary Laffer-curve predictions.

Only by the end of 2011 it was recognized that further tax measures are no more viable and attention should shift on collection efficiency. In its assessment of progress, the European Commission task force warns that tax and expenditure measures... substantially compress the households' disposable income and significantly tighten their liquidity constraints", (European Commission, 2011, p.2).

Regarding public expenditure, a slightly more optimistic picture emerged but at a huge cost in terms of growth and efficiency. Soon after the elections, the Government made clear signals that it had no real intention of containing the oversized public sector. Numerous appointments that were made before elections through a highly disputed process were approved, and a widely publicized operation to abolish and merge outdated public entities made no

real progress, to date. A novel scheme to push older staff onto a retirement-waiting status with a fraction of their salary misfired as it was soon discovered that most on the list were already exploiting the incentives of an early retirement. After this fiasco the Government announced a lengthy process of evaluation in the public sector as a precondition for staff redundancies, but without setting a time limit.

In the absence of any structural adjustment in the public sector, the reduction of spending was achieved by imposing universal cuts in salaries and this led to widespread shirking practices. Another tool for keeping expenditure low was to cut the budgetary co-financing of the European Community Support Framework, thus reducing public investment at a time when it was mostly needed to induce some growth in the economy. After the Decision by the European summit in July 2011, Greece was freed from the co-financing obligation, but when it started to be implemented at the end of 2011 it was already too late to rectify the damage to economic activity.

6.2. The Limits of Structural Adjustment

In order to rebalance the economy onto a more competitive path, the Memorandum agreement envisaged a long list of structural reforms ranging from reforming the social security system to removing closed-shop vocational practices, and liberalizing the licensing process for lorry and taxi drivers. The pension reforms initially succeeded in harnessing the deficits in the social security funds, but soon they reappeared when a wave of retirement took place in anticipation of imposing further age extensions in the future.

Despite the severity of clashes with trade union hardliners, the opening-up of lorry licenses failed to reduce transportation costs and enhance competitiveness for two reasons:

First because insiders took advantage of a two year postponement and decided to maximize rent-seeking by withdrawing previous price concessions. Second, because the economic gloom was thwarting potential investors by making the upfront cost of setting up a new business too high.

A similar attempt to open-up the taxi licensing system was abandoned after a protracted clash with insiders in the summer 2011. In other professions, such as lawyers and pharmacists, there was only a token liberalization without any reduction in consumer prices. Recognizing this failure, the new conditionality

measures impose a regressive mechanism with the aim of reducing the overall profit margin to below 15%, (see Memorandum II, 2012, para 2.8, *"Pricing of medicines"*).

Seeing that the structural adjustment program was derailed, the Memorandum sought alternatives. To enhance competitiveness in the labour market, liberalization measures extended part-time employment, imposed wage cuts across the board and removed collective bargaining agreements. Despite lowering labour costs by 12%, enterprises were overwhelmed by recession and unemployment became rampant, exceeding 17% of the labour force by the end of 2011. As with the positive feedback mechanism on the tax front, the rise in unemployment invited a new round of wage cuts in the private sector, shrinking further disposable income and fuelling new waves of social protest. Though the IMF mission in the autumn 2011 was explicit that "accelerated private sector adjustment... would likely lead to a downward spiral of fiscal austerity, falling incomes and depressed sentiment", it nevertheless urged for further structural measures in order to achieve a "critical of reforms needed to transform the investment climate" (IMF, 2011). Bringing-up some growth to the real economy is still not a top priority.

6.3. The Failure of Privatization

The failure of privatization is worth commenting on, as it reveals an unusual combination of strong rhetoric in theory with apathy in practice. Immediately after the elections in 2009, the Government showed that it had no intention of curbing the wider public sector. Its lack of resolve to tackle the excessive demands of public trade unions was made manifest in a dispute with a newly arrived investor in the Piraeus Port Company. The Government succumbed to paying enormous compensation for early retirement as a condition that the investment goes ahead. No privatization target was included in the 2010 Budget and none was actually implemented.

Thus it was viewed as a major shift of policy when the Government agreed in March 2011 to adopt a large-scale privatization plan of Euro 50 bn during the period 2011-2015, or roughly 4% of GDP per annum. The plan included extensive sales of public real-estate, privatizations of public enterprises in the energy sector and private partnerships in the operation of airports and ports throughout Greece.

After months of procrastination a market-friendly Privatization Fund was finally set up to replace the ineffectual authority that was in charge before, but its determination was this time hindered by adverse market conditions. With asset prices falling to abysmal levels, privatization would be embarrassing in political terms and inadequate in terms of revenue. There was no real demand either, as capital flight continued to be fuelled by fears of abandoning the Eurozone and funds from abroad were not forthcoming for the same reason. Despite initial ambitions, the program achieved little in 2011, selling only an option on Greek Telecom, future rights to the National Lottery and publishing a preliminary tender for the re-development of the old Athens airport. In 2012 the program aims at the privatization of selected public companies, lowering expected proceeds to Euro 2.8 bn, just a fourth of the amount initially announced.

7. The New Memorandum Conditionalities and Ways-out of the Crisis

Faced with a deepening recession and a failure to produce fiscal surpluses sufficient to guarantee the sustainability of Greek debt, the European Union intervened twice to revise the terms of the Memorandum. In the first major intervention in July 2011, the amount of aid was increased substantially by Euro 130 bn and repayment was extended over a longer period of time. To implement the Private Sector Involvement (PSI) in debt restructuring, a cut of 21% of the nominal value of Greek bonds and re-profiling of maturities was decided upon with the tacit agreement of major European banks.

Crucially, the EU authorities this time fully recognized the perils of recession and allowed Greece to withdraw a total amount of Euro 17 bn from Structural Funds without applying the fiscal brake of national co-financing. The plan looked powerful, except for the typical implementation lags. The Agreement was only voted through by all member-state Parliaments only in late September 2011 and the release of structural funds was approved by European Parliament in late November. Participation in the PSI had reached only 70% of institutional holders amid speculation that post-agreement buyers of Greek debt from the heavily discounted secondary market were expecting a huge profit through their offer to cut it!

Thus, a new intervention looked inevitable and in October 2011 a revised restructuring (the so called PSI+) was authorized, envisaging cuts of 50% of nominal bond value that would eventually reduce Greek debt by Euro 100 bn. Assuming that negotiations conclude in time and all other structural adjustments take place, Greek debt is expected to be stabilized at 120% of GDP by year 2020. The agreement was hailed in Greece as the definite solution to the debt conundrum, but euphoria turned sour a few days later when the Greek Government surprised everybody by seeking a referendum for its approval.

Many feared that the outcome could in all probability be negative as an expression of current misgivings, and this would be quickly interpreted as opting for exiting the Eurozone. In the ensuing *furore,* the decision was annulled, the Prime Minister resigned and a coalition Government was formed in November 2011 to implement debt restructuring and negotiate the terms for the new round of EU-IMF loans.

7.1. Is Exit from the Euro an Option?

The crisis in Greece had profound ramifications for the Eurozone, both in political as well as in economic terms. In the Euro area, Greece is routinely considered not only as devouring European taxpayers, but also as the habitual wrongdoer especially when compared with the other two countries (Ireland and Portugal) which are undergoing similar adjustment programs with more efficacy. In such a politically unyielding and increasingly suspicious framework, a Greek exit from the Eurozone started to attract attention both at home and abroad. Though complications and costs that would ensue in the banking sector will be enormous, the exit of Greece could prove opportunistically attractive to some European politicians who get angrier every time a new round of aid is discussed. However, they overlook the fact that a Greek exit would reverberate around other states and lead to an aggravation of the crisis; for how contagion will spread see Vehrkamp (2011). It may also serve as the convenient argument for consolidating and enforcing a two-tier model of Economic Governance, as has been advocated before the creation of EMU (e.g. Bayoumi and Eichengreen, 1992) and is recently on offer by commentators and politicians singing in the *"Grexit chorus"*. Based on an inner core of surplus economies in the north and a weaker periphery in the south, competitiveness in this model will be restored through the so called *"internal devaluation"* of labour costs, thus

perpetuating the gap that is already widening between the Eurozone countries, (see Christodoulakis, 2009).

For Greece, exit would trigger a prolonged economic catastrophe. As the entire Greek debt will remain denominated in Euros, the rapid depreciation of the new national currency will make its servicing unbearable and the next move will be a disorderly default. Isolation from international markets would drive investors even further away, while the financial panic would drain domestic liquidity at a massive scale. The creditor countries of the EU would start demanding repayment of their aid loans, and this would soon deprive Greece of its claim on the EU cohesion funds. Tensions are likely to produce further conflicts with EU agencies and the pressure to consider complete disengagement from the European Union will gain momentum both domestically and abroad.

7.2. Stay in the Eurozone and Grow More

The cost would be so immense that the single available option for Greece is to complete the fiscal adjustment and become reintegrated into the Eurozone as a normal partner. This requires Greece to undertake concrete actions that produce visible results within a short timeframe, so that society becomes more confident to pursue reforms. Some policy suggestions for this direction are as follows:

First, Greece needs to acquire credibility while also being properly understood abroad. The continued fiscal shortfall is easily translated as reluctance, causing continual friction with the European Union and the demand for a new battery of austerity measures. To escape this cycle, Greece must adopt as a matter of urgency a front-loaded policy to achieve key fiscal targets quickly and to change the impression of being a tactical waverer. If Greece succeeds in this front-loaded policy, it may be in a position to revise some of the pressing - although so far unattainable - schedules and ensure greater social approval and tolerance.

To ensure that there will be no spending spree in future elections, the best option for Greece is to adopt a constitutional amendment on debt and deficit ceilings, just as Spain did last August, alleviating market pressures, at least for the time being.

Second, Greece needs a fast-track policy for exiting the long recession. An amount of 17 billion Euro could be disbursed and routed immediately to

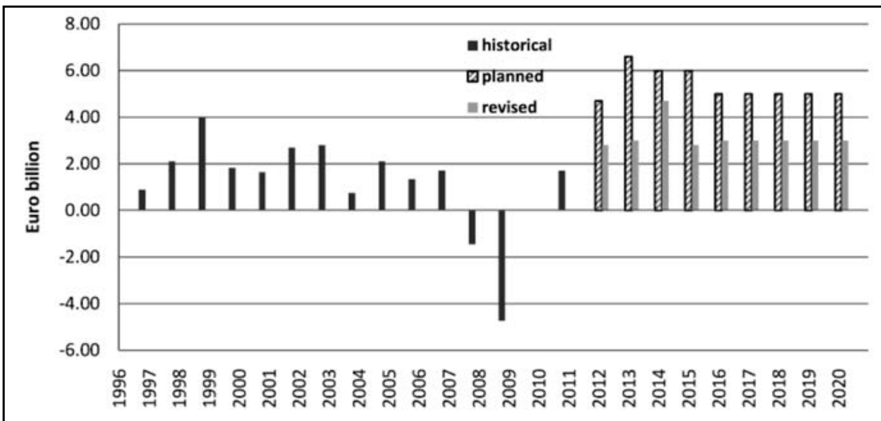
support major infrastructural projects and private investment in export-oriented companies. The growth-bazooka should be followed by structural reforms and privatizations that can attract significant private investment as market sentiment is restored. In addition, instilling growth will help to control the debt dynamics and reduce public deficits without ever-rising taxes, thus thwarting private investment and making economic recovery and sustainability unattainable. Feldstein (2012) leaves no doubt about the mechanics of stabilisation when he warns that "(t)o achieve a sustainable path, Greece must start reducing the ratio of its national debt to GDP. *This will be virtually impossible as long as Greece's real GDP is declining*" (my emphasis).

7.3. Two Alternative Scenarios

The dynamics of the debt-to-GDP ratio are sensitive to the prospects for growth, thus it is worth examining alternative paths that correspond to a low and to a higher growth profile respectively.

In both cases it is assumed that a 'haircut' of 50% is imposed on all private bond holders, so that repayments in the following years are cut by half. In nominal terms the reduction amounts to 100 bn Euro as announced in October 2011. As it now stands, Greek bonds held by public institutions and social security funds will be fully honored. The reduction in present value terms is still unclear as this depends on the yields and maturities that will actually apply and are currently under negotiation. The total amount also depends on the degree of private holders' participation. For simplicity, present calculations assume full participation.

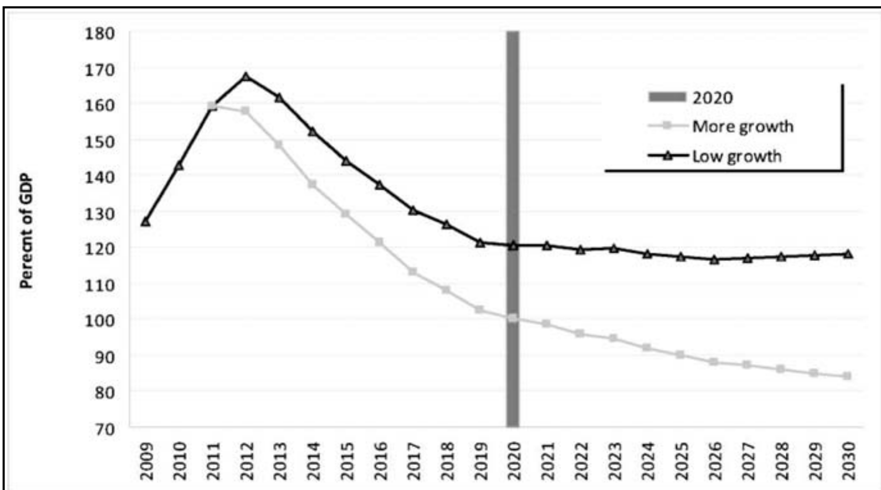
Figure 9: Proceeds from Privatisations



Note: Proceeds are net of capitalizations in state-owned enterprises. For 2008, 2009 and 2010 figures of proceeds are net of bank shares purchases, thus the negative sign.

Source: Privatization Report, Ministry of Finance, 2008. Data for 1996 and 1997 are taken from Budget Reports. Planned figures were set in May 2011, but then they were revised in 2012 (Memorandum II, para 2.1).

Figure 10: Alternative paths for public debt as % of GDP.



Data sources: Budget Report 2011, Bailout Memorandum as updated May 2011.

Privatizations are assumed to complete the 50 bn Euro target, albeit over a period that extends well beyond the initially envisaged window of 2015. The computation further assumes a nominal cost of borrowing at 5% per annum and annual targets of General Government deficits at 3% after 2014. Primary surpluses are computed as residuals. Results are depicted in Fig.10.

The low growth case is based on the official predictions of -2.5% in 2012, followed by a +2% rate for the rest of the period. Inflation is assumed at 2% throughout. In this scenario, debt is found to fall to 120% of GDP in 2020 in line with the official estimates. Primary surpluses are found to be 3% of GDP on average, plausibly close to the average that prevailed in the decade 1993-2002. (The arithmetic suggests that paying interest will be 0.05*120%=6% of GDP minus the primary surplus of 3%, so that deficit is at 3% of GDP). In the absence of further privatizations, the debt to output ratio remains stationary after 2020, unless a higher growth or a larger primary surplus is assumed afterwards.

To examine (in a highly schematic way) the effect of more growth on debt, the economy is assumed to grow at 3% from 2012 onwards. Inflation also picks up and stays at 3% throughout. All other assumptions regarding the debt reduction, public deficit and privatization targets remain the same as in the baseline. A serious decumulation of public debt takes place and its ratio to output approaches 100% of GDP in 2020, close to its in 2005, before it took-off. The higher growth supports a further decumulation of debt that approaches 80% of GDP by year 2030. It is worth noting that primary surpluses need not be higher than 1.7% of GDP in average. If budgetary surpluses are assumed to be at 3% of GDP as required in the baseline scenario, then debt will fall even further.

8. Conclusions

Exactly three decades after becoming a fully-fledged member of the European Union and ten years after joining the Eurozone, Greece sought a bail-out agreement in 2010 to avoid bankruptcy. A long history of stabilization programs proved incapable of achieving a lasting fiscal correction and adequately raising competitiveness, as fundamental weaknesses in the economic and political system continue to play a corrosive role. The oversized public sector and the frequent indulgence in pre-electoral spending sprees in exchange for political support led to protracted fiscal deficits and the accumulation of a large public debt. Equally, the chronic deterrence of productive investment by a multitude of

regulatory inefficiencies resulted in a thin tradeable sector and large Current Account deficits. The economy remains vulnerable to political developments which are often dictated by short-term partisan considerations with far reaching fiscal implications. This explains why, in spite of substantial reforms taking place over the last two decades and achieving high growth rates, EMU participation and moderate debt stabilization, the situation went once more out of control.

Regarding the current crisis, the article described how prolonged external and fiscal deficits were allowed to reach uncontrollable levels and, in the aftermath of the credit crunch, led to a further escalation of debt and the subsequent bail-out. Two years later, fiscal consolidation is still far from being sustainable in spite of augmenting the bail-out loans and implementing a debt reduction by 50% on private holders. The economy has cumulatively shrunk by nearly 15% since 2008, social tensions are multiplying and the future of Greece in the Eurozone is in jeopardy. Some consider such an outcome as a due punishment for past excesses, while others see it as an escape from further unemployment and recession. The article finds both angles of view as illusory, and argues that the only viable way out of the current crisis is to restore growth and to adopt a realistic plan for privatizations and reforms. The lesson of the past two years is that the deep recession will otherwise continue to hinder any existing possibility for exiting the crisis. Greece, and perhaps other Eurozone countries in the near future, are desperate of a *"corridor of confidence* ", to use Keynes' famous phrase, in order to put things in order before it is too late for anything meaningful.

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Appendix: A Brief Description of the Conditionality Programs for Greece

The adjustment program for Greece was laid out in three phases. The first Memorandum was signed in May 2010 and aimed at reducing the fiscal deficit to 3% in 2013. Specific measures that were actually implemented included universal cuts in public salaries and all pensions, a rise in VAT from 19% to 23% and similarly in other consumption surcharges, the abolition of collective agreements in favor of firm-level contracts, the lowering of private sector wages by 12% and a reform in the Social Security system. It also included the liberalization of red-tape practices in the transport sector, pharmacists and lawyers, but the outcome was heavily compromised through a series of delays and back offs. Fiscal deficit for 2010 ended up close to 11% of GDP, substantially lower than the horrendous 15.4% in the year before but still away from the initially set target.

Thus, in early 2011 a new round of negotiations resulted in a second round of measures voted by Parliament in June 2011. They included further taxation on past incomes, a lump-sum tax on professionals, further rises in indirect taxes and a new property levy that was imposed two months later. The program demanded the abolition of outdated public entities, the reduction in the number of civil servants and a further curtailment in their salaries. It also envisaged ambitious privatizations on utilities and public real-estate that could trim down public debt by Euro 50 bn within a four-year period. Fiscal deficit for 2011 is provisionally estimated to be 9.8% of GDP, revealing a major difficulty in further adjustment in the absence of growth.

The third round of adjustments was voted for in February 2012 as Memorandum II. (For the full text see "Memorandum of Understanding on Specific Economic Policy Conditionality", 9 February 2012, available at http://www.hellenicparliament.gr).

This time it was approved by the two major parties, but only after a line-up was imposed to avoid desertions and rising internal protest. Measures included a reduction of minimum wages in the private sector by 22%, an additional cut by 10% to new entrants as a means to beat youth unemployment, 15% cuts in various pensions, the abolition of several tax credits and explicit targets for cutting employment and entities in the wider public sector. Policies will start to be implemented together with the application of the PSI+ agr