

# More Pain, No Gain for Greece: Is the Euro Worth the Costs of Pro-Cyclical Fiscal Policy and Internal Devaluation?

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February 2012



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## Executive Summary

This week the Greek government reached agreement with the European authorities and the IMF for 130 billion euros in lending, as part of a new adjustment package to replace the current IMF program that began in May of 2010. Although the agreement should allow the government to avoid default in March, there are grave doubts as to whether the agreed upon program will lead the country to a point where it returns to growth, has a sustainable debt burden, and can borrow from private markets.

The most important problem with the commitments that Greece has made in the past two years is that its fiscal policy is pro-cyclical – that is, the government has been, and is committed to, tightening its budget while the economy is in recession. In 2010-11, the Greek government adopted measures to cut spending by 8.7 percent of GDP.

But the economy continues shrinking and this makes it even more difficult to make revenue targets. The IMF has consistently underestimated the loss of GDP for Greece, lowering its projections by a huge 6.9 percent since its First Review of the Stand-By Arrangement in September 2010. Two-thirds of this drop came in the five months between its Fourth and Fifth Review (December 2011).

Although most of the planned adjustment for 2012 is in the form of revenue increases, the IMF's Fifth Review states that there must be a shift toward spending cuts in 2013-2014. This will increase the risk of further prolonged recession.

The IMF program also assumes very large revenues from privatization – about 15 percent of GDP over the next two years, and 22 percent of GDP by 2017. But very little in the way of revenues has been forthcoming from privatization in the past two years, and the Fifth Review notes that lower revenues from privatization could by themselves put the 2020 debt/GDP ratio at 138 percent, instead of the target 120 percent.

The program could also easily be derailed by lower growth. Given the current shrinking of the eurozone economy, this seems quite possible.

On Monday, there were press reports based on a leaked document prepared for the European finance ministers, which contained a much more pessimistic scenario for the Greek economy. In this scenario the debt was explosive and Greece would need “about €245bn in bail-out aid, far more than the €170bn under the “baseline” projections eurozone ministers were using.” Debt would be 160 percent of GDP in 2020. Given the underestimation of GDP losses by the IMF so far, and the failure of the European authorities to recognize the negative impact of fiscal contraction, the more pessimistic scenario may turn out to be more realistic.

The economic costs of Greece's adjustment have already been quite high; using the IMF's projections and updating them with the most recent data, if the economy begins its recovery later this year it will have lost 15.8 percent of GDP from its pre-recession peak. This would put Greece among the worst losses of output from financial crises in the 21<sup>st</sup> and 20<sup>th</sup> centuries.

Greece also now has the highest interest burden on its public debt of any EU country, at 6.8 percent of GDP; only two other countries are even in the 4 percent range (Italy and Portugal). There are

very few countries in the world with a higher interest burden than Greece, and it is unlikely that it will be brought below 6 percent even with the planned debt restructuring.

The social and human costs of Greece's recession have also taken a large toll. By the Greek national measure, unemployment hit a record high in November at 20.9 percent of the labor force. The IMF's last projections show Greek unemployment still at 17 percent in 2016, and this is likely to be raised. The IMF's projections for unemployment in 2013 have increased between the first and fifth review, by more than a third, from 14.5 percent to 19.5 percent. Employment as a percentage of the working age population is now less than it was in 1994. There have been large increases in suicides and violent crime, and access to health care has declined.

The Greek government has agreed to reduce government employment by 150,000 workers by 2015, to cut the minimum wage by 20 percent (and by 32 percent for those under the age of 25); and to weaken collective bargaining. All of this will have the effect of reducing living standards for workers and redistributing income upward.

The economic theory behind these changes is that of "internal devaluation," in which wage costs, lowered by the recession and high unemployment, are pushed down far enough so that the economy becomes more competitive internationally and can recover through exports. But after four years of recession and reaching record-high unemployment, Greece's Real Effective Exchange Rate is still higher than it was in 2006. In other words, there has still been no internal devaluation.

The paper also briefly looks at the alternative of a planned default and exit from the euro, considering that such an outcome might happen in any case due to recurrent crises and continued recession. The case of Argentina's successful default and devaluation is one relevant comparison. Argentina unsuccessfully tried an internal devaluation during three and a half years of recession beginning in mid-1998. After default in December 2001 and devaluation a few weeks later, the economy shrank for just one quarter (a 4.9 percent loss of GDP), but then recovered and grew by more than 63 percent over the next six years. It took three years for Argentina to reach pre-recession GDP; Greece is currently projected to take more than a decade. Contrary to popular assertions, the Argentine recovery was not a "commodities boom," nor even an export-led growth experience. Rather, it was led by domestic consumption and investment, which was only possible after Argentina was able to abandon the "internal devaluation," pro-cyclical policies that the government – like that of Greece today – had been committed to. It's also worth noting that Greece's exports of goods and services are currently about twice the level of Argentina's before its default/devaluation, relative to GDP.

The authors conclude that the default/exit option should be taken seriously for Greece as an alternative to the current projected scenarios.

## Lower Projections and Downside Risks

Since May of 2010 Greece had been operating under an agreement with the International Monetary Fund (IMF). The terms of this agreement are decided by what has come to be described in the press as “the troika” – the European Central Bank (ECB), the European Commission, and the IMF – in negotiations with the Greek government. The ostensible purpose of the agreed upon policies is to reduce Greece’s fiscal deficit and debt to a sustainable level, implement “structural reforms” that are alleged to make the economy more efficient and competitive, and allow government finances to recover to the point where Greece can return to borrowing from private financial markets at sustainable interest rates.

Yet nearly two years later, the economic situation of Greece has become drastically worse. This paper will look at some of the impacts of recent and current policy, as well as projections into the future. It will also consider briefly whether there are better alternatives to the policies now being implemented – with or without the co-operation of the troika.

Greece is now in its fifth year of recession. In the IMF’s “Fifth Review Under the Stand-By Arrangement”<sup>1</sup> published in December of 2011,<sup>2</sup> the Fund projects that Greece will lose a total of 14.4 percent of GDP from its peak in 2007 to a projected trough in 2012.<sup>3</sup> This is a large loss of income and compares to some of the worst downturns associated with financial crises in the 20<sup>th</sup> and 21<sup>st</sup> centuries.<sup>4</sup>

Adjusting the IMF numbers in accordance with the most recent data gives us a total output loss of 15.8 percent. However, there are a number of reasons to believe that the losses could be considerably greater.

First, the IMF has consistently underestimated the depth of Greece’s current recession. **Figure 1** shows the IMF’s projections for real GDP in Greece since its first review of the Stand-by Arrangement, published in September 2010. The most recent projection for 2012 GDP made in the fifth review, is a huge 6.9 percent below the projection in the first review. More ominously, two-thirds of the drop in projected growth since the first review has been quite recent and sudden, in the five months between the fourth and the fifth review.

The projections for unemployment, perhaps the most important economic indicator for a high-income country, are even more off the mark and have been worsening sharply. These are shown in **Figure 2**. Projections for unemployment in 2013 have increased between the first and fifth review by more than a third, from 14.5 percent to 19.5 percent. These are sure to be revised upward soon, since October 2011 unemployment already hit 19.2 percent; by the national Greek measure, the unemployment rate is currently even higher, reaching a record 20.9 percent in November.

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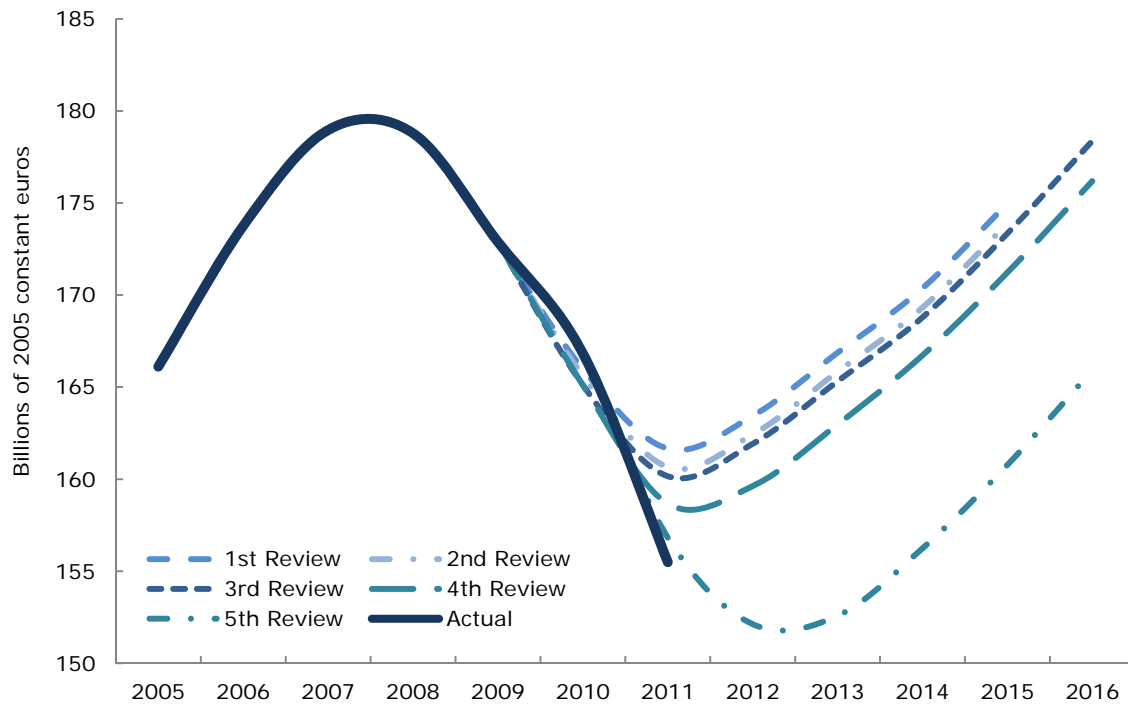
1 IMF (2011a).

2 Since this is the last published IMF review of Greece, we will use the IMF’s data and projections from here; however, we will also use updates where more recent official data is available.

3 IMF (2011a), p. 37.

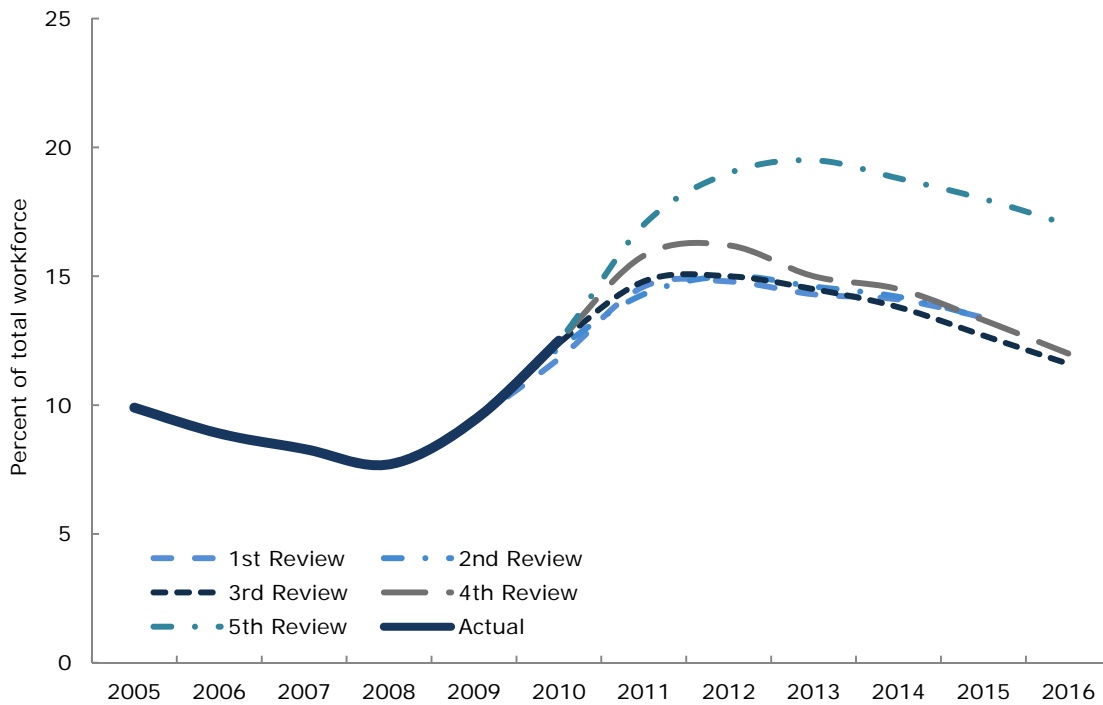
4 Reinhart and Rogoff (2009).

**FIGURE 1**  
**Real GDP Projections**



Source: IMF, Various and Hellenic Statistical Authority.

**FIGURE 2**  
**Unemployment Rate Projections**



Source: IMF, Various.

The IMF's fifth review contains multiple warnings about downside risks, and hints that Greece could very easily do quite worse than its projections indicate. For example:

*There is a growing risk that the economy moves towards an even more accelerated macroeconomic adjustment. The assumed reinvigoration of structural reforms may yet be further delayed, while a new hit to consumer and business confidence from drawn-out PSI discussions or an intensifying credit crunch cannot be ruled out. Accelerated private sector adjustment, on top of fiscal retrenchment, would likely lead to a downward spiral of fiscal austerity, falling disposable incomes, and depressed sentiment.<sup>5</sup>*

The IMF projections also rely heavily on large revenues from privatizations – about €35 billion, or 15.4 percent of GDP over the next two years. This is part of a total of 22 percent of GDP from privatizations, which has now been pushed back to 2017. But these are very likely to fall short of targets, as they have so far:

*Proceeds through end-September [2011] amounted to €390 million, well short of the anticipated €1.7 billion. The Privatization Fund has been confronting difficult market conditions, with the price of several listed public companies down by more than 50 percent since the start of the second quarter.<sup>6</sup>*

About 70 percent of the assets to be privatized are real estate, and the Fund has noted that:

*If market conditions do not improve, there is a risk that sales objectives will not be met, particularly for the very high peak privatization expected in 2013–14, which already involves more difficult-to-market assets. In this instance, the overall privatization objective could be preserved, but sales would have to be spread out over a longer period of time, with program targets recalibrated further.<sup>7</sup>*

If even a third of the privatizations do not happen in the next two years, this means that the government would have to come up with another 5 percentage points of GDP in revenues – or similar cuts on the spending side to meet the program targets for the debt/GDP ratio.

Each time Greece falls short of program targets, it provokes another crisis, pushing down investor and consumer confidence, and making it more difficult to meet the next set of targets that is ultimately agreed upon.

Finally, it is worth noting that the projected recovery of Greece is so slow – unlike other financial crises characterized by large losses of output – e.g. Argentina (1998-2002) or South Korea (1997-1998) – which were followed by rapid recovery, that Greece is expected to take more than a decade to reach its pre-crisis level of GDP.

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5 IMF (2011a), p. 11.

6 IMF (2011a), p. 9.

7 IMF (2011a), p.34.

## Moving Targets

One of the biggest and most basic problems facing Greece under the IMF program is that the measures that the government is adopting are pro-cyclical. In other words, the fiscal tightening reduces aggregate demand in the economy, causing the economy to shrink further. This reduces government revenue, since tax payments fall with income. There are also some components of government spending, such as unemployment insurance, that increase automatically when the economy is shrinking. This will make the fiscal target even more difficult to achieve.

If GDP is shrinking, then cutting spending by, e.g. 5 percent of GDP will not improve the fiscal balance by the same percentage, because by the next year the denominator (GDP) is smaller. This is important to keep in mind, because the government is taking measures to cut spending that are much bigger than what shows up in spending reduction as measured by the share of GDP.

This difference can be seen in **Table 1**, which shows Greece's general government spending and revenue, as a percentage of GDP. The table shows the measures taken by the government to cut spending, as a percent of GDP at the time that they are adopted; and the actual reduction of spending as a percent of GDP. In 2011, for example, the government cut spending by 4.1 percent of GDP, but this only resulted in spending being reduced by 1.9 percent of GDP, because of the large fall in GDP throughout the year.

**TABLE 1**  
**Fiscal Adjustment (percent of GDP)**

	2009	2010	2011	2012	2013	2014	2015
Revenue	37.9	39.5	40.6	42.8	43.2	43.6	44.0
Primary Expenditure	48.3	44.6	42.9	42.6	40.8	38.7	39.1
Primary Balance	-10.4	-5.1	-2.2	0.2	2.4	4.9	5.0
Interest Payments	5.3	5.5	6.8	4.9	6.3	6.4	6.1
Overall Balance	-15.7	-10.6	-9.0	-4.7	-3.9	-1.5	-1.0
Change in Expenditure		-3.7	-1.7	-0.3	-1.8	-2.1	0.4
Measures		-4.6	-4.1	-1.5	-1.5	-1.2	1.6
Growth Effect		0.9	2.4	1.2	-0.3	-0.9	-1.2
Nominal GDP (€billions)	232	228	216	210	212	217	223
Nominal Growth Rate		-1.9	-5.0	-2.8	0.7	2.3	3.1

Source: IMF and Author's calculations.

For 2010 and 2011, there were spending cuts totaling 8.7 percent of GDP. These are enormous cuts – for those who are used to thinking about the U.S. economy, imagine the federal government eliminating about \$1.3 trillion of spending in just two years.



For the current year, 2012, the program – according to the IMF’s fifth review – is targeting 2.8 percent of GDP in new budget tightening measures.<sup>8</sup> About three-quarters of the measures are on the revenue side. In terms of their impact on the economy, we would expect revenue increases to have less of a negative impact on the economy than the same amount of spending cuts, because the multiplier for tax changes is generally lower than for changes in spending. Much of the proposed increase in revenue for 2012 is in the form of tax collection on high-income taxpayers who have evaded taxes. Since tax evasion by the wealthy is a major structural problem in Greece, this part is one positive aspect of the adjustment program. However the rest of the revenue comes mainly from privatization, which is problematic for the reasons mentioned above; and also because it will result in a loss of assets that belong to the public, probably sold off at low prices, and that in some cases have more to contribute to the economy and/or public revenue if left in public hands.

Still, 2012 is different from the past two years in that it focuses on revenue increases rather than spending cuts. And the Fund warns in its 5<sup>th</sup> review that 2013 and 2014 will have to focus more on spending cuts, including “pensions, social transfers, and defense spending.”<sup>9</sup> So if Greece continues to adhere to the troika’s program, we can expect more serious spending cuts in the years ahead.

## Social and Human Costs

One of the biggest and worst social costs of the current program is the enormous loss of jobs. As noted above, unemployment hit a record 20.9 percent in November. By 2016 it is still projected to be at 17 percent, far above the 7.7 percent pre-crisis level, and a level that is generally seen as a national tragedy.<sup>10</sup>

Another way to see these losses is to look at employment. **Figure 3** shows employment as a percentage of the working age population. By 2011 it had fallen to below its level of 1994, almost six percentage points below its 2008 peak.

The government has committed to cut 150,000 jobs from public employment for 2010-2015, about 22 percent of public employment. The IMF notes that:

*...these reforms would bring general government employment to 12 percent of the labor force, 3 percent below the OECD average (2008), and given the planned wage reforms, would reduce the public wage bill to about 9 percent of GDP, matching some of the lowest spending OECD countries (e.g. Czech Republic and Slovakia).<sup>11</sup>*

The current negotiations appear to have reached agreement on a cut of 22 percent in the minimum wage, with 32 percent for workers under the age of 25. The minimum wage in Greece is about €880 euros a month. This will hit these wage earners quite hard, and have a significant impact on income

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8 IMF (2011a), p. 15.

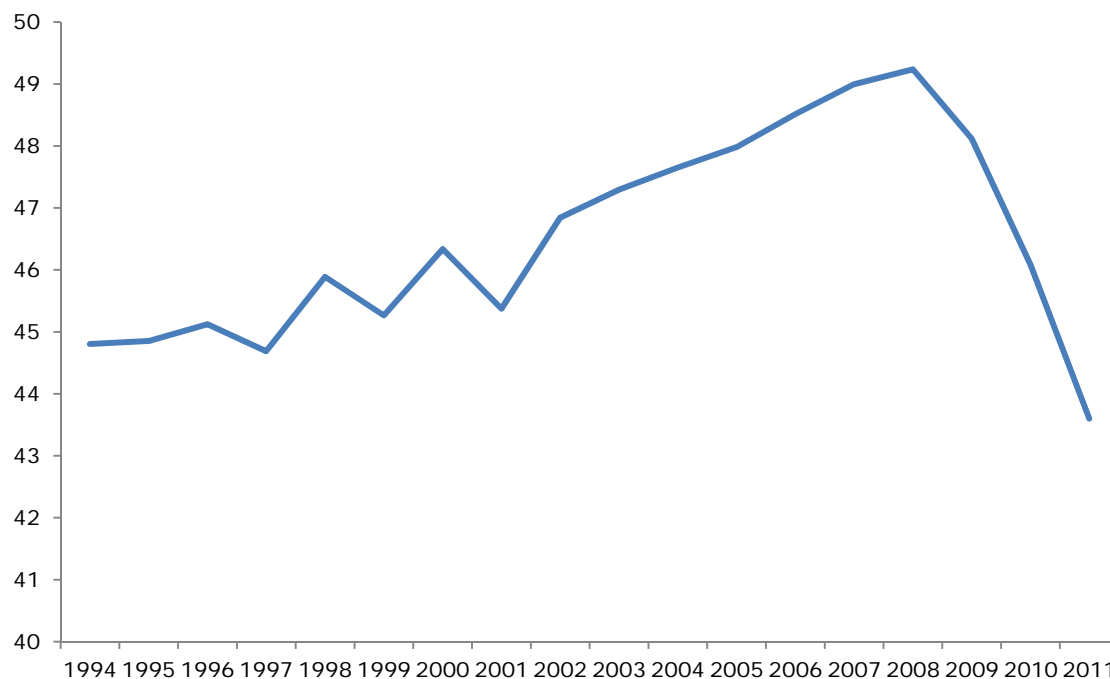
9 IMF (2011a), p. 23.

10 The IMF projections are based on the EU harmonized unemployment rate, which tends to be lower than the national estimates.

11 IMF (2011a), p. 16.

inequality and poverty. It will also affect many other wage earners, since changes in the minimum wage are often used as a reference for other wages up the income ladder.<sup>12</sup>

**FIGURE 3**  
**Employment as a Percent of Working Age Population**



Source: Eurostat.

Greece's agreement with the IMF/troika also contains measures designed to weaken collective bargaining, which the IMF Fifth Review refers to as a "flagship reform."<sup>14</sup> The measures are to weaken sector-level bargaining by unions, in order to "allow wages to fall below existing sectoral floors," according to the IMF.<sup>15</sup>

The recession and budgetary measures also appear to be having a significant impact on health and other social indicators. From the U.K. medical journal, *The Lancet*:

*Suicides rose by 17% in 2009 from 2007 and unofficial 2010 data quoted in parliament mention a 25% rise compared with 2009. The Minister of Health reported a 40% rise in the first half of 2011 compared with the same period in 2010 [...] Violence has also risen, and homicide and theft rates nearly doubled between 2007 and 2009.<sup>16</sup>*

The authors also find evidence that there has been reduced access to health care as well as a 52 percent increase in HIV infections from 2010 to 2011. Since most of the data is from the first year

12 See Du Caju et al. (2009).

14 IMF (2011a), p. 9.

15 IMF (2011a), p. 25.

16 Kentikelenis et al. (2011).

or two of the crisis, it is likely that some of these statistics have worsened with the accelerated downturn of the last two years.

## Internal Devaluation

The economic theory behind the adjustment program adopted by Greece is that of “internal devaluation,” which is mentioned in the IMF’s fifth review in describing the expected weak, slow recovery from Greece’s deep and prolonged recession:

*Growth is expected to remain below the pre-crisis average for an extended period of time, within the range of experience of countries experiencing internal devaluations. In fact, the needed reallocation of resources towards the tradable sector suggests that the current downturn has a significant permanent component.<sup>17</sup>*

It is not clear that “internal devaluations” are ever successful, at least compared to feasible alternatives. In theory, the deep recession and unemployment drives down wages enough so that the country’s unit labor costs fall and it becomes more competitive internationally. Other policy changes are also designed to drive down wages: the minimum wage cuts and weakening of collective bargaining noted above. The country can then grow through demand for its exports, despite the weakness of internal demand. Domestic consumption and investment would be expected to recover, in this situation, when fiscal deficits and the public debt are brought down to a sustainable level.

After four years of recession, with unemployment more than tripling, there appears to be no progress in Greece toward accomplishing an “internal devaluation.” The Real Effective Exchange Rate based on Unit Labor Costs, according to the IMF, was slightly higher in 2010 than it was in 2006; based on the Consumer Price Index (CPI) it was about 6-7 percent higher in January 2011 as compared with 2006. In other words, four years of recession and relentless downward pressure on wages have failed to depreciate the currency in real terms for Greece.

The IMF’s Fifth Review notes that in 2011, the Real Effective Exchange Rate remained the same, despite a modest 2.5 percent decline in unit labor costs. The latter was negated by an appreciation of the euro in the first part of the year. At any time, a rise in the euro can easily swamp the lowering of unit labor costs that might take place in Greece. Of course, there is always the possibility of a serious crash in the euro; but given that the ECB does not want this, the kind of crisis that would cause the euro to crash would likely have a devastating impact on the Greek economy.<sup>18</sup> Despite the enormous economic and social costs that have already been incurred, and more forecast by the IMF, a successful internal devaluation has not yet even begun, and is nowhere in sight.

## The Public Debt

The IMF’s Fifth Review, and the current negotiations with the troika, are based on the premise that debt will follow a path from its current 161 percent of GDP to 120 percent of GDP by 2020. At the

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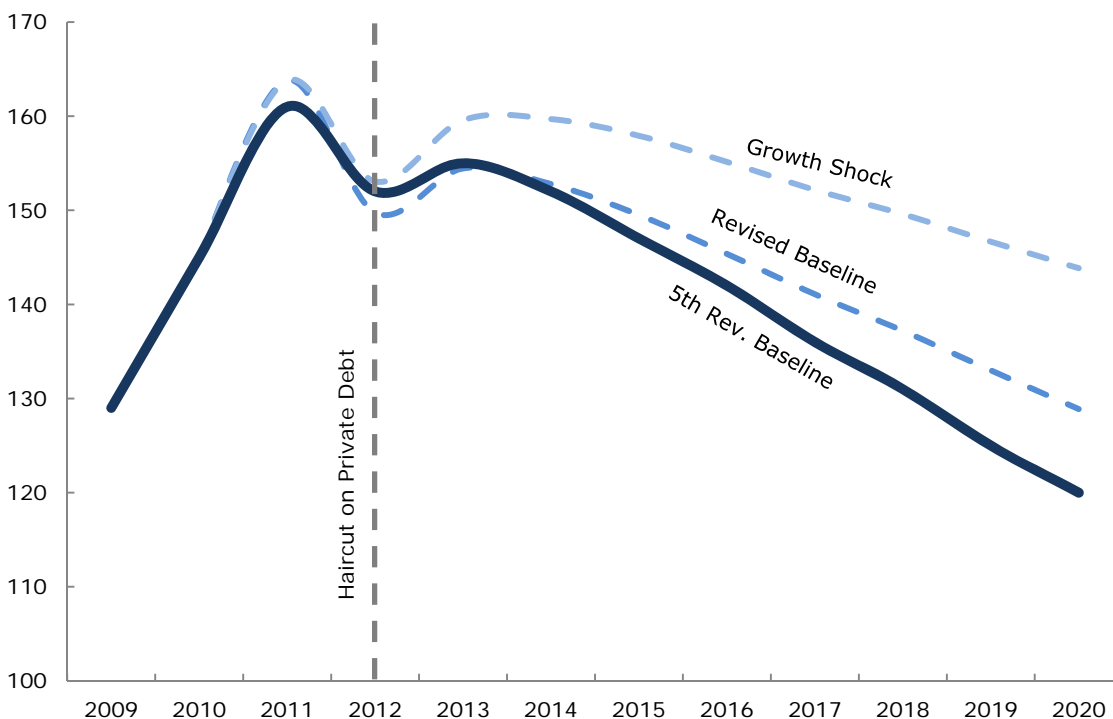
<sup>17</sup> IMF (2011a), p. 10.

<sup>18</sup> Of course a fall in the euro doesn’t help Greece’s competitiveness vis-à-vis its trading partners within the eurozone.

end of this section we will look at breaking news (February 21, 2012), including press reports of a leaked document from the European Finance Ministers that confirms the worst warnings of the IMF's Fifth Review, as well as the concerns of this paper. But the Fifth Review is less than three months old and represents the most recent official document from the IMF on Greece's program. Its debt sustainability analysis is the basic framework for anything that has happened in the last few days. The main questions that we are concerned with here are: (1) how likely is this progression to the target debt/GDP ratio to take place under the current program? (2) Will this path result in a sustainable debt burden, or are there likely to be more economically damaging, recurring crises along the way, even if the targeted path is eventually achieved?

**Figure 4** shows the IMF's most recent (December) projected path for Greek sovereign debt until 2020. We also include two alternative projections: a revised baseline scenario updating the IMF projections using the latest data for 2011, and a "growth shock" scenario where the recession is deeper than currently expected in 2012. The original IMF baseline projection shows the debt reaching a peak at 161 percent of GDP last year and declining to 120 percent of GDP in 2020, which the IMF considers sustainable.

**FIGURE 4**  
**Gross Debt to GDP Projections**



Note: The Revised Baseline and Growth Shock scenarios both maintain the assumptions of the original IMF baseline debt sustainability analysis. The Revised Baseline incorporates the latest 2011 GDP data and assumes real growth will be lower by 1 and 0.5 percentage points in 2012 and 2013, respectively. The Growth Shock Scenario introduces a one standard deviation shock to real GDP growth, or 2.5 percentage points, in 2012. The shock has an autocorrelation parameter of 1/3, decaying each subsequent year by 2/3. Both the Revised Baseline and Growth Shock scenario allow growth to feed back into revenue, assuming a growth elasticity of revenue of 1.5.

Source: Authors' Calculations and IMF.

Taking this as the troika's latest official projections, there are so many downside risks that it is not easy to imagine that this latest baseline scenario would play out. First, the scenario could easily be derailed by lower economic growth. As noted above, the IMF's growth projections have been consistently and increasingly off the mark. With the eurozone economy now shrinking, and the European authorities showing little inclination to adopt the counter-cyclical macroeconomic policies that would promote a recovery, there are big external risks to the underlying projected growth rate of the IMF's most recent baseline scenario.

The IMF also notes that "a key assumption underpinning the sustainability result is that the PSI operation achieves a near-universal participation rate."<sup>19</sup> PSI refers to Private Sector Involvement – the participation of private bondholders in the "voluntary" haircut of at least half of their debt, with a debt swap arrangement under which they receive long-term bonds at an agreed upon interest rate for their remaining debt. This is by no means assured.

In addition, the Fund notes that failures with privatization, which have been the pattern so far, would alone raise the debt/GDP ratio from the targeted 120 percent in 2020 to 138 percent of GDP.<sup>20</sup>

Official government figures released last week show that in 2011 GDP contracted more than what was assumed in the IMF's baseline projections: 6.8 percent instead of the projected 6 percent.<sup>21</sup> Moreover, the IMF has also said that it expects 2012 growth to come in lower than what is currently projected. Our revised baseline projection, shown above, incorporates these developments while maintaining all of the other IMF assumptions in place. As can be seen in Figure 4, the revised growth numbers on their own are enough to push the level of debt as a percent of GDP in 2020 to 129 percent. In other words, even assuming near universal participation by bondholders in the debt swap and keeping all other parameters unchanged, Greece would still miss the 2020 target of a gross debt level of 120 percent of GDP.

However, in light of the magnitude of the fiscal adjustment being undertaken in Greece and the IMF's consistent failure to adequately consider the full recessionary impact of tightening, even our revised baseline may turn out to be overly optimistic. That is why we also present a third "growth shock" scenario assuming a deeper recession in 2012 than what is currently forecast and slightly lower subsequent growth. Growth is lowered by one standard deviation, or 2.5 percentage points in 2012 and the shock subsequently decays by 2/3 every subsequent year. The scenario also allows the impact of growth to feed back into revenue, making it harder for the government to meet its primary balance targets as the recession lowers tax revenue.

According to this alternative scenario, which keeps all other assumptions unchanged, the overall debt level would only decline to 144 percent of GDP by 2020, well above the 120 percent of GDP level considered sustainable by the IMF.

It is important to keep in mind that it is not only the debt/GDP ratio that matters for debt sustainability, but also the interest burden of the debt. The IMF's projections for this interest burden are shown in Table 1. This is currently at 6.8 percent of GDP for 2011; under the

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19 IMF (2011a), p. 70.

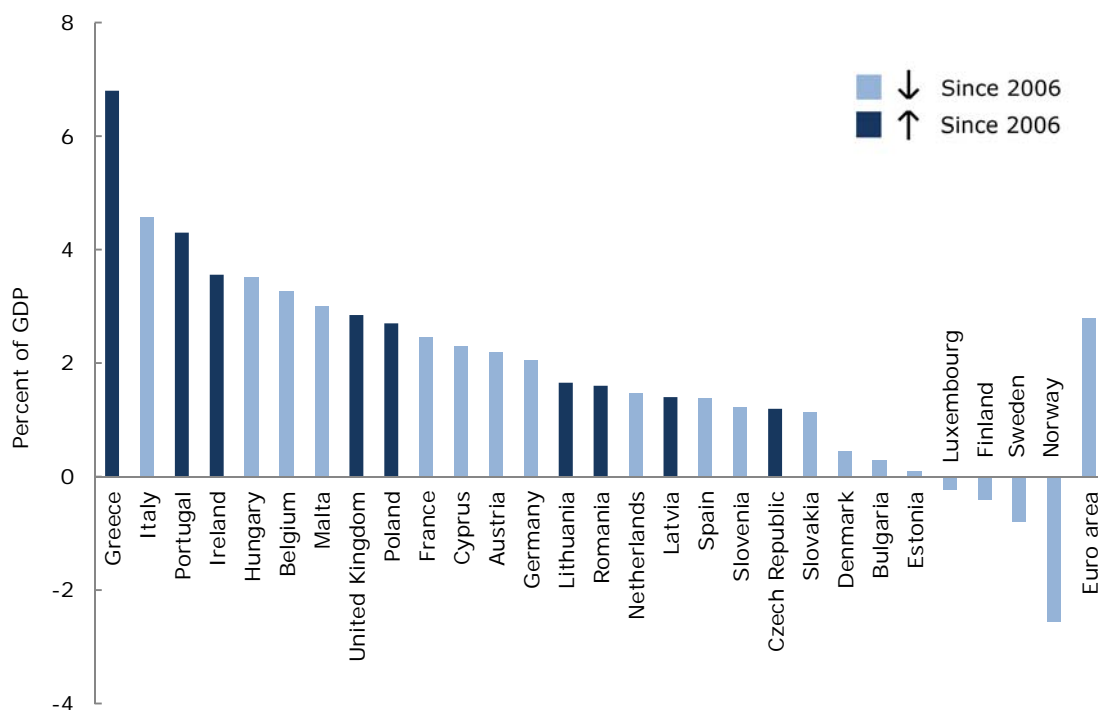
20 IMF (2011a), p. 68.

21 Hellenic Statistical Authority (2012).

assumption of a successful debt swap agreement, including a haircut now estimated at 100 billion euros, this drops temporarily to 4.9 percent of GDP for 2012; but it bounces back up the next year and remains over 6 percent through 2015.

This is a very high interest burden by any international comparison. **Figure 5** shows Greece's interest payments on sovereign debt, as compared with the rest of the EU. The only countries that even have interest payments surpassing 4 percent are Italy and Portugal. In the entire world, there are only a handful of countries with a higher interest burden than that of Greece. And it is questionable whether these debt burdens are sustainable, as, for example, in Jamaica.<sup>22</sup> For Greece, which will be under enormous pressure to cut its budget over the next few years – according to the IMF's Fifth Review – an interest burden of this size is likely to be a serious problem from a political, social, and budgetary standpoint.

**FIGURE 5**  
**Net Interest Burden of EU Members in 2011**



Source: Data for Greece, Ireland and Portugal come from the latest IMF program reviews. All other data comes from the IMF World Economic Outlook and Eurostat. Gross interest payments as percent of GDP are used when net figures are not available.

As this paper goes to publication, the anticipated agreement between the Greek government and the troika for the 130 billion euro loan installment has been reached, after protracted negotiations. The agreement assumes that there will be a successful debt swap with Greece's creditors in the coming weeks. Press reports indicate that the troika's projections, with the results of the debt swap included, would allow Greece to reach a debt burden of 120 percent of GDP in 2020.

<sup>22</sup> Johnston and Montecino (2011).

However, at the same time *Reuters* and the *Financial Times* have reported on a leaked “sustainability analysis” prepared for the European Finance Ministers which appears considerably more pessimistic. Among the points reported in the press:

- “The baseline scenario sees Greece being able to cut its debt-to-GDP ratio to 129 percent by 2020, but only if the country manages to follow through on all its structural reforms, fiscal obligations and its privatization program.”
- “A critical concern is that a deeper recession ‘would result in a much higher debt trajectory, leaving debt as high as 160 percent of GDP in 2020 . . . Given the risks, the Greek program may thus remain accident-prone, with questions about sustainability hanging over it.’<sup>23</sup>

The *Financial Times* reports, citing what appears to be the same leaked document:

- Under the pessimistic scenario cited above, “Greece would need about €245bn in bail-out aid, far more than the €170bn under the ‘baseline’ projections eurozone ministers were using in all-night negotiations in Brussels on Monday [February 20].”
- “Even under a more favourable scenario, Greece could need an additional €50bn by the end of the decade on top of the €136bn in new funds until 2014 being debated by finance ministers on Monday night. That ‘baseline’ scenario includes projections that the Greek economy stops shrinking next year and returns to 2.3 per cent growth in 2014.”
- “A recapitalisation of Greek banks, originally projected to cost €30bn, will now cost €50bn.”
- “A Greek privatisation plan, originally to raise €50bn, will now be delayed by five years and bring in only €30bn by 2020.”<sup>24</sup>

Given the track record of previous projections, the impact of pro-cyclical policies and the shrinking economy of the eurozone, and all of the downside risks and problems that have been discussed in this paper, it appears that this latest agreement, even with the anticipated debt restructuring and 100 billion euro debt write-off, will be highly unlikely to provide a sustainable debt trajectory for Greece.

## Are There Alternatives to the Current Program?

From the above discussion it is clear that the IMF/troika program of the last two years has failed to move Greece closer to recovery, and in fact has made the economy worse. The most important cause of failure is of course the pro-cyclical fiscal policy. Given that Greece, under the euro, has no control over its monetary or exchange rate policy, the negative impact of pro-cyclical fiscal policy

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23 Strupczewski (2012).

24 Spiegel (2012).

was pretty much predictable and predicted.<sup>25</sup> And the country's economic prospects going forward, as noted above, do not look much better.

Before briefly looking at the question of alternatives, it is worth noting the mixed objectives that the European authorities may have, some of which conflict with Greece's recovery. While the authorities would like to avoid a chaotic default, and other spillover effects that could adversely affect the European economy, these are not their only objectives.

Ten years ago, writing in the wake of Argentina's default on its public debt – then the largest sovereign default in history, George Soros noted that creditors as a group have an interest in punishing such defaults: “sovereign states do not provide any tangible security; the only security the lender has is the pain that the borrower will suffer if it defaults. That is why the private sector has been so strenuously opposed to any measure that would reduce the pain.”<sup>26</sup>

The European authorities look at Greece's situation mainly from a creditor's point of view. From this point of view it is not necessarily bad that the adjustment is painful. Furthermore, if the Troika were to provide a program that allowed Greece to recover quickly, then Portugal, Ireland, Spain, and Italy would also expect something similar. That is another concern that the European authorities are likely taking into account, which can motivate them to back policies that are bad for Greece.

The European authorities also have ideological and political interests that can have a large impact on their policies. These two are difficult to separate, but they are very much on display in the documents and statements of the troika. Ideologically/politically, they want a smaller government in Greece, with less regulation, much lower wages, and weaker unions. By 2020, government primary spending – according to IMF projections – would be 33.6 percent of GDP – down from 42.8 percent in 2007. This would make Greece more like the United States, which has about this level of government spending (including state and local), than Europe. The IMF lists reducing the size of the public sector as an “essential element” of its program. As noted above, the programs reforms would push Greece toward the bottom of OECD countries in its public wage bill. To the extent that these ideological/political priorities are more important to the European authorities than an economic recovery in Greece, there could be a lot of continued and even permanent, unnecessary suffering for the majority of Greeks.

In terms of economic theory, the programmed policies are justified in terms of the strategy of internal devaluation and making the Greek economy more efficient and competitive. But as we have seen, there is little evidence that a “restructured” Greece will be able to recover and prosper on the basis of lower unit labor costs in the foreseeable future. At some point the economy may begin to recover, especially if the external environment improves, but a newly competitive export sector is unlikely to be the driving force.

It is also disturbing that the troika is so much in denial about the macroeconomic impacts of their pro-cyclical economic policies. When the Fund or the troika reports on downside risks or worse-than-expected outcomes, it is attributed to the failure of the Greek government to institute some structural reforms. When the IMF states that “the program has entered a difficult phase,” and that “investor sentiment has not improved as hoped,” then it follows that “the most important factor has

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25 See, e.g., Mark Weisbrot, “Why Greece Should Reject the Euro,” *The New York Times*, May 9, 2011.

26 Soros (2005). Soros was not endorsing the viewpoint of the creditors, but merely describing it.



been the slowing pace of structural reforms this year.<sup>27</sup> This is not plausible; the most important factor is, more obviously, lagging demand in the economy, which is driven by budget tightening.

For these reasons, and because the projected Greek recovery looks so slow and painful, and perhaps even nonexistent over the next few years; and because there is a substantial probability of a chaotic default even after the planned restructuring is agreed upon, it is necessary to consider alternatives.

Of course, there are plenty of good alternatives if the European authorities were interested in a speedy recovery in Greece. In December, the ECB loaned \$638 billion to European banks, at one percent interest. It will soon make some hundreds of billions of dollars more available to the banks. The ECB, if it wanted to do so, could facilitate a debt write-off bigger than the one that is currently being negotiated, and with very low-interest loans, allow for Greece to pursue a fiscal stimulus and recover relatively quickly. But at present there is no sign that the European authorities are going to go in this direction. In fact, the ECB at this point is not even willing to accept the debt write-down that the private sector bondholders are expected to accept – a rigidity that appears extreme in light of the situation. It is therefore worth considering what might happen if Greece left the euro and defaulted on its foreign debt.

The closest historical example we have to such a default and devaluation is Argentina in 2001-2002. After unsuccessfully pursuing an “internal devaluation” through a three-and-a-half year recession, losing about 16 percent of GDP and accumulating an unsustainable debt burden in the process, Argentina defaulted on its sovereign debt in December 2001. A few weeks later, in January 2002, it abandoned its fixed exchange rate (the peso had been pegged one-to-one with the dollar). The immediate result was a worsening of the financial crisis and a collapse of the banking system. Argentina lost about 5 percent of its GDP in the first quarter of 2002.

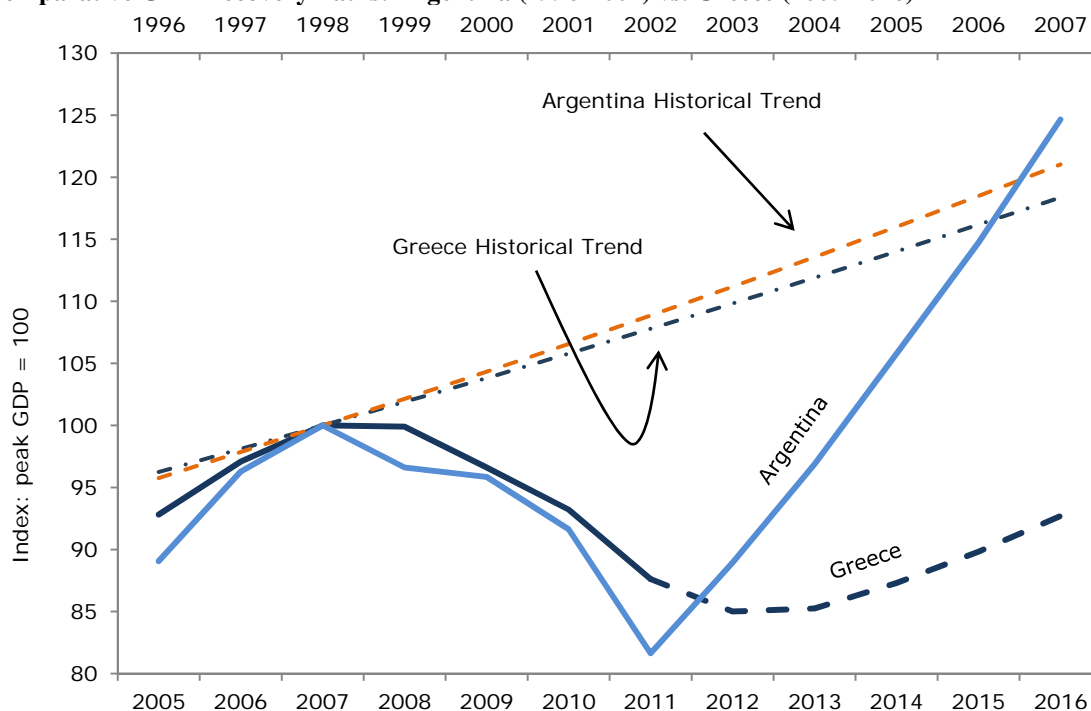
However, the decline was just for one quarter; over the next six years the economy would grow by 63 percent, and in the nine years since the default it has grown by more than 90 percent. Within three years, in the first quarter of 2005, Argentina had passed up its pre-crisis level of GDP. By 2007, it had passed up trend level – i.e. the level of GDP that it would have if it had avoided recession altogether and continued to grow at its average historical growth rate.

This is shown in **Figure 6**, which shows Argentina’s recovery path (top axis) and Greece’s actual output performance during the recession and projected recovery (lower axis). In both cases the pre-crisis peak GDP is set to 100. As can be seen, on Greece’s current path, neither trend nor pre-crisis GDP are anywhere in sight.

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27 IMF (2011a), p. 33.

**FIGURE 6**  
**Comparative GDP Recovery Paths: Argentina (1996-2007) vs. Greece (2005-2016)**



Note: Argentina's historical trend uses its average real GDP growth rate from 1980 to 1997 (1.9%) while Greece uses its average growth rate between 1980 and 2007 (2.1%).

Source: Authors' Calculations and IMF Various.

It is worth noting that the social consequences of Argentina's recovery were enormous. Even though the economy had a brief downturn during the world recession in 2009, employment in Argentina is at record levels. Poverty and extreme poverty have been reduced by two-thirds, and social spending has nearly tripled in real terms, since the default.<sup>28</sup>

There is no doubt at this point that Argentina made the right move in defaulting on its foreign debt and exiting from its pegged exchange rate, rather than continuing its prior policy of internal devaluation. Yet most commentators insist that a similar move would be a disaster for Greece. It is worth examining why this might or might not be true.

The most common argument is that Argentina recovered by means of a "commodities boom," based mainly on soy exports. But this is not true. In real terms, exports contributed just 12 percent of Argentina's growth in the expansion of 2002-2008.<sup>29</sup> And only about half of these exports were commodities. And in terms of demand, net exports had a negative real contribution after the first six months of the recovery. During the first six months, net exports did contribute very significantly to aggregate demand; but even in this brief but important period, most of the new demand came from reduced imports, as local production rapidly replaced imported goods that were made more

<sup>28</sup> The numbers cited here are based on non-governmental estimates of inflation, which have been much higher than the government's estimates since 2007. See Weisbrot et al (2011) for more detail.

<sup>29</sup> Weisbrot et al. (2011).

expensive by the devaluation.<sup>30</sup> The main drivers of real growth during Argentina's recovery were domestic consumption and investment.

Of course, exports did contribute to Argentina's recovery after the devaluation in other ways. One of the most important contributions was to provide the necessary foreign exchange to cover important imports. This is the primary constraint for a country that does not have its own "hard" currency, e.g. the U.S. dollar. A country can pay its internal bills in its own currency, but it must have enough foreign exchange to avoid a balance of payments crisis. And a tax on the windfall profits of exporters was also important in terms of government revenue during the first part of the expansion.

But exports would also play a similar role in a Greek recovery. In fact, Greek exports of goods and services, including tourism, are about twice as high as a percentage of GDP as they were in Argentina at the time of its default/devaluation. And as in Argentina, these exports would increase in importance relative to the economy with the devaluation – not just because they would be cheaper to the world, but also because every euro or dollar earned from exports would buy more internally. The common myth that Greece would not benefit from a devaluation as much as Argentina did, "because it has nothing to export," is wrong on both counts: Greece exports much more relative to its economy than Argentina did, and Argentina's recovery was not an export-driven recovery.

How did Argentina recover if it was not a "commodities boom," as is often wrongly stated? There were a number of policies that were important to Argentina's recovery,<sup>31</sup> but the main thing was that Argentina was freed from an unsustainable debt burden, and perhaps even more importantly, it was freed from the pro-cyclical policies that were making its recovery impossible, and therefore it was able to adopt pro-growth macroeconomic policies. It was these policy changes – which Greece would be able to adopt if it left the eurozone and defaulted on its foreign debt – that made the difference between endless recession/stagnation and a remarkable economic recovery.

In some ways Greece is much better situated than Argentina was to recover from the immediate crisis that would follow a default/devaluation. The majority of its sovereign debt is held by foreign institutions, which would reduce the impact of a default on the domestic financial system. Most of its debt is currently covered by domestic law, which might limit the options that creditors would have in taking legal action against the government.<sup>32</sup> (However, the new bonds offered by the Greek government in the bond swap would be issued under English Law).<sup>33</sup> Also, should the European authorities decide to try to punish Greece for its default/exit, Greece has many more potential sources of foreign exchange and investment than Argentina had in 2002. Argentina had nowhere to turn for loans during the first few years. Today, there are many countries with large stocks of reserves that might be willing to invest in Greece once its growth prospects are revived, regardless of any creditors' desire for punishment.

Argentina was cut off from international borrowing after its default. But it was even worse than that: the biggest official lenders, led by the IMF, drained a net \$4 billion, or four percent of Argentina's GDP, out of the economy in 2002. Most economists and almost all of the business press predicted

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30 Frenkel and Rapetti (2007).

31 Weisbrot et al. (2011).

32 Gulati and Buchheit (2010).

33 Hellenic Republic Ministry of Finance (2012).

that Argentina was in for a long nightmare following its default/devaluation. The IMF put a lot of pressure on Argentina to pay more to the foreign creditors, and to accept a number of economic policies that the Argentine government believed would cut short its recovery. When Argentina refused to give in, and technically defaulted to the IMF in September 2003 rather than accept its conditions, there was a great fear that the country would be cut off even from trade credits – since the IMF supposedly had the power to do that.<sup>35</sup> No middle-income country, or non-failed-state, had ever defaulted to the IMF. But when Argentina defaulted to the Fund in 2003, the IMF quickly backed down and rolled over the country's debt.

This part of the story is important because it shows that efforts by even the most powerful creditors to punish defaults are not likely to be successful. In recent history at least, some defaulting countries have done reasonably well or even remarkably well, as in the cases Argentina of in 2001, Russia in 1998, or Ecuador in 2008. Indeed, a common theme in the recent empirical literature on sovereign defaults is the failure to identify any statistically significant costs associated with default episodes.<sup>36</sup> And Greece is already at the point, given the size of the anticipated write-down that is already in the works, and the bleak prospects going forward, that it will be a long time before it can even borrow on private markets. At this point its credit might return sooner if the government were able to wipe more debt off the books and return to growth.

On the negative side, the biggest obstacle that some have pointed out would be the fact that Greece no longer has its own currency. It would have to re-introduce the drachma. While this poses some potentially serious logistical problems, it is difficult to see that, by itself, this would make Greece different from all other countries that were faced with otherwise similar situations.

Of course there were other countries besides Argentina that have suffered severe financial crises associated with devaluations, for example South Korea, Indonesia, and Thailand during the Asian financial crisis of 1997-98. But none of them suffered the combined loss of output and slow recovery that is Greece's current projected path.

A default/exit option for Greece would be a difficult decision, and of course it is fraught with risks. A lot would depend on how skillfully and quickly the authorities could move from the financial crisis that would ensue, to economic recovery. As noted above, it took just one quarter for the economy to resume growth in Argentina after the default/devaluation.

In the case of Greece, there is no way to know in advance how severe the financial crisis, and associated loss of output and employment, would be if the government were to decide to default and exit from the euro. And that is what makes this decision difficult for the government or any political party: on the other side of the equation, it is not known when the Greek economy will begin to recover under the current program. So, although the current program has failed miserably and can be expected to continue to fail in the foreseeable future, there is considerable uncertainty regarding the effects of either choice. And for political leaders, it may be easier to accept the troika's program as though –as the European authorities and most of the media frame it – there is no choice.

But, the idea that default/exit would be a catastrophe on the order of a Great Depression is false. The Great Depression was not the result of any one-time event; it was a long series of bad policy

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35 Smith (2003).

36 See, for instance, Levy-Yeyati and Panizza (2011).

decisions over years – in some ways similar to the path of “internal devaluation” that the European authorities have currently laid out for Greece. A default/exit would likely bring on a financial crisis, but it would not by itself cause a Great Depression. Given the prognosis for Greece under the current program, and the probability that it will be plagued with recurrent crises and could even end in a chaotic default, a planned default/exit option could very well be the more prudent choice. It should be taken seriously as an alternative.

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