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Greece: A Sovereign Debt Crisis within the Eurozone

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Index

Introduction p.3

Chapter 1: The prologue to the Greek Crisis p.7

1.1) The accession to the European Economic Community p.8
1.2) The widening of the fiscal problem p.10
1.3) The Maastricht Treaty p.14
1.4) The path toward the third stage of the EMU p.16
1.5) The incomplete process of reform p.21
Summary p.25

Chapter 2: The Financial crisis in Greece p.27

2.1) A flow of capital from the core to the periphery of the Eurozone p.27
2.2) The effects of the US crisis p.33
2.3) Greece announces its real deficit p.36
2.4) The first adjustment program p.38
2.5) The path toward a second rescue program p.43
2.6) The second adjustment program p.46
2.7) On the edge of 'Grexit' p.49
2.8) Turning the corner p.55
Summary p.57

Chapter 3: The Eurozone faces up to the crisis p.59

3.1) The development of the fiscal surveillance framework p.60
3.2) The creation of the financial assistance mechanisms p.67
3.3) The actions of the ECB p.74
Summary p.77

Chapter 4: The impact of the crisis in Greece p.79

4.1) The macroeconomic cost of the adjustment p.79
4.2) The impact of austerity on Greek society p.85
4.3) The impact on the sustainability of public debt p.89
4.4) Could the impact be reduced? p.93
Summary p.96

Conclusions p.97

Bibliography p.99

Introduction

This thesis analyses the main causes and consequences of the Greek sovereign debt crisis. This topic is particularly relevant as Greece is part of the Eurozone, a highly integrated system of states that have decided to adopt a common currency. As the crisis of a single member was able to spread to the entire Eurozone, the other member states and the common institutions strongly intervened in the management of the crisis and changed its dynamics. This type of intervention was unprecedented in the Eurozone and had effects that deserve to be analysed.

How can the management of the Greek crisis be assessed? Did the intervention of the Eurozone institutions help Greece out of the crisis or did it worsen the country's already fragile situation? These questions have been at the centre of political and economic discussions for almost a decade, and it is not easy to answer them.

As the impact of the crisis on the Greek population has been particularly harsh, the debate has been heated. According to the institutions and leaders who pushed for the intervention, the programmes implemented in Greece, albeit with flaws and delays, were able to mitigate the effects of an inevitable reform process. An opposit position emerged among those, like former Finance Minister Yanis Varoufakis[1], who argue that the programmes have exacerbated the crisis and put Greece in a hopeless situation. A third position was expressed, among others, by Paul Krugman[2], according to whom the crisis is the direct result of an 'original sin': the introduction of a single monetary policy in a region that was not ready for this kind of integration. Even though these three

[1] Y.Varoufakis (2017) Adults in the Room. My Battle with Europe’s Deep Establishment, The Bodley Head, London.
[2] P.Krugman (2012) Revenge of the Optimum Currency Area, *The New York Times*, 24 June 2012.

positions seem to contradict each other, there is some truth in all three. However, they have often been simplified in the wrong way, leading to a polarisation of the public debate that does not contribute to a clear understanding of what happened.

This thesis is divided into four chapters. The first chapter analyses the path that led Greece from the return to democracy in 1974 to the introduction of the euro in 2001. This phase is fundamental for understanding the following years, as the imbalances that emerged during the crisis had their origins in this period. By tracing the events of this period, one can better understand the reasons that led Greece to join the Eurozone.

The second chapter describes the economic and political situation of the country from the introduction of the euro until the end of the last adjustment programme in 2018. This chapter covers all the major events of the crisis years up to the slow return to normality in the late 10s. A clear idea of the chronology of events is particularly important, as the situation changed very quickly and required measures that were considered unthinkable only a few years earlier.

The third chapter looks at the measures taken in the European framework to respond to the Greek crisis. In 2008, the architecture of the Eurozone did not contain the instruments to respond to such an asymmetric shock. It is therefore particularly interesting to look at the extraordinary measures taken by the institutions, the member states and the ECB to prevent a collapse. The main focus is on the strengthening of the fiscal surveillance framework, the creation of the financial assistance mechanism and the unconventional measures taken by the ECB to stabilise the euro area.

The final chapter focuses on the impact that the crisis and adjustment programmes have had on Greece. The assessment considers three main aspects: some macroeconomic indicators, the impact on fundamental rights and the impact on debt sustainability. Understanding the impact on Greece is the most important point to consider when assessing the management of the crisis.

The crisis had a serious impact on Greece and therefore it is difficult to define the crisis management measures as a success. The lack of a pre-existing procedure to deal with such situations and the delay in recognising the extent of the crisis have hindered a quick and effective response. The crisis was faced with a "learning by doing" approach and in retrospect, many mistakes can be identified. However, it is clear that European and international intervention mitigated the impact of the crisis, which would have been far greater if Greece had managed the crisis alone. The system implemented in Greece has been heavily criticised for the austerity measures required, but it is difficult to find another system that would have had a lesser impact.

Various sources were consulted for the preparation of this thesis. Since the literature on the subject is vast, many books were consulted in order to understand the general lines of debate on the subject. Newspaper articles, especially those specialising in economic issues, were used to reconstruct events as they unfolded. They also make it possible to understand how the events were perceived when they took place.

However, this work is mainly based on primary sources. A large number of documents were produced by the institutions that managed the crisis. This is the most important source of information about both the development of the crisis and the development of the strategies that were implemented. The official databases of institutions such as Eurostat and the World Bank were used extensively. Direct access to the data allowed this work to draw independent conclusions.

Finally, the sources used for this work include two interviews. The first was with Fabio Colasanti, a former European Commission official who wrote a discussion paper on financial aid to Greece in 2016[3]. The second was with Georgios Papakonstantinou, the Greek Finance Minister from October 2009 to June 2011.

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[3] F.Colasanti (2016) Financial Assistance to Greece: Three programmes, European Policy Centre, Brussels.

Chapter 1: The prologue to the Greek Crisis

When Greece was hit by the financial crisis in 2008, it found itself in a critical situation. Despite its participation in the European Monetary Union (EMU), Greece had chronic budgetary problems and it soon became clear that its debt was unsustainable. Even huge international loans and stringent austerity measures were unable to restore the credibility of Greece's finances. Eventually, it was recognised that at least a partial default was inevitable. This possibility, unthinkable until a few years before, finally occurred in 2012. But why was Greece in such a bad position?

The problems did not arise overnight but were the result of inadequate policies in the preceding decades. This chapter looks at the period between the end of the dictatorship in 1974 and the introduction of the euro in 2001. This is the period during which most of the public debt was accumulated along with a delay in structural reforms. Total public debt rose from 27% to 110% of GDP and economic growth was quite slow, at least compared to other countries in similar conditions. The path was however not uniform: there were also years of strong economic growth and periods of successful fiscal consolidation programs. One of the main problems was the fact that policies did not follow a coherent path, but often responded to the electoral requirements of political parties.

The process of European integration that took place during these years greatly affected domestic politics. Only in the two periods before joining the EC and the EMU were Greek governments able to implement financial consolidation plans.

1.1) The accession to the European Economic Community

The dictatorship of the colonels ended in Greece in 1974. After the invasion of the northern part of Cyprus by Turkey in response to the military coup supported by Greece, the government had lost all its credibility. Its only option was to resign and return power to the civilian population[4]. The centre-right Nea Demokratia party emerged victorious from the subsequent democratic elections with 54,37% of the vote[5]. The main point of its electoral program was the resumption of the process of European integration, which had been abandoned in 1967. The new Prime Minister, Kostantinos Karamanlis, believed that Greece could only complete its transition to democracy by joining the European Community. The two main opposition parties, the PASOK (Socialist Party) and the Communist Party, strongly disagreed with this international position. They regarded the EEC as a political instrument of NATO and wanted to break off all relations with the USA, since the latter had supported the previous regime.

The country had signed an association treaty with the EEC in 1961, but it had been frozen after the military coup of 1967. In 1975, Greece applied to join the EU, opening a new chapter in this relationship[6]. EEC's member states responded positively to the application, although not all countries shared the same opinion. France and Germany were in favor of accession because of the strong political message that this event would have sent. Others, such as Italy and the United Kingdom, were skeptical because of the country's economic problems and because low wages could affect their

[4] A.N.Hatzis (2019) A Political History of Modern Greece, 1821-2018, in Encyclopedia of Law and Economics, Springer, New York, p.11.
[5] Official results in the official website of the Hellenic parliament are available at: https://www.hellenic parliament.gr/en/Vouli-ton-Ellinon/To-Politevma/Ekloges/Eklogika-apotelesmata-New/.
[6] E.Deschamps, C.Lekl (2016) The accession of Greece, CVCE accessible at: https://www.cvce.eu /obj/the_accession_of_greece-en-61a2a7a5-39a9-4b06-91f8-69ae77b41515.html.

competitiveness in the agricultural sector[7]. The toughest position was taken by the European Commission, which pointed out that Greece had not yet fully implemented the Association Treaty. For this reason, and because of the weak conditions of the Greek economy, the Commission recommended a long pre-accession period.

Despite the Commission's negative opinion and the skepticism of the Danish, Irish and Belgian governments, the accession process was launched. The negotiations were long and difficult, with several interruptions and crises. In 1977, the applications of Spain and Portugal increased the doubts of the EEC's member states, as the accession of three backward countries would have meant an enormous economic effort. However, Karamanlis managed to separate the negotiations on Greece's accession from those on Spain and Portugal. In May 1979, the Treaty of Athens was signed, stipulating that Greece would become the 10th member of the EEC from 1 January 1981[8].

Despite its accession to the EEC, the Greek economy remained far weaker than that of the other member states. The country was still largely agricultural and suffered from inflation, unemployment, and a trade deficit. Like the other European countries, Greece had suffered from the first oil crisis and its growth had fallen from an average of 8.5% per year in the period 1958-1973 to less than 5% in the years up to 1979. Its growth was still higher than that of the members of the Community, but convergence was too slow and reversed in the following years. Moreover, budgetary discipline began to erode from 1975 onwards, as government expenditure continued to rise, only partly offset by an increase in revenue. This trend,

[7] E.Calandri, M.E.Guasconi and R.Ranieri (2015) Storia politica ed economica dell'Unione Europea dal 1945 ad oggi, Edises, Napoli.

[8] Act concerning the conditions of accession of the Hellenic Republic and the adjustments to the Treaties, Official Journal of the European Communities, available at: https://eur-lex.europa.eu /legal-content/EN/TXT/PDF/?uri=CELEX:11979H/ACT&from=EN.

which was very slow in the early years, would intensify sharply in the 1980s.

1.2) The widening of the fiscal problem

At the beginning of 1981, the centre-left PASOK party won the elections. The new Prime Minister Andreas Papandreou completely changed the country's attitude towards the process of European integration[9]. Greece soon became, together with the United Kingdom, the main representative of the euroskeptic front. Papandreou's efforts to obtain special conditions for Greece led to the approval of the Integrated Mediterranean Programs in 1985.

Papandreou also reversed the liberalization process initiated by his predecessor in domestic policy. Karamanlis had in fact introduced several reforms to increase the competitiveness of the Greek economy in preparation for joining the European Community. Papandreou took exactly the opposite path and the norms protecting workers led to a decline in investment in the country. Very restrictive rules on dismissals, which imposed severe restrictions or high severance payments, had indeed created an unfavorable environment for businesses. In 1982, an automatic wage indexation system was also introduced, whereby wages were adjusted to past inflation at four-month intervals. The rise in labor costs and stagnant productivity contributed to a progressive reduction in profit margins. The result was a strong reduction of investments and a loss in competitivity towards the European partners[10].

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[9] A.Nafpliotis (2018) From radicalism to pragmatism via Europe: PASOK's stance vis-à-vis the EEC, 1977-1981, in *Journal of Southeast European and Black Sea Studies · September 2018*, available at: file:///C:/Users/len3/Downloads/FromradicalismtopragmatismviaEurope-OA.pdf.
[10] R.C.Bryant, N.C.Garganas and G.Tavlas (2001) Introduction in Greece's Economic Performance and Prospects, Bank of Greece and The Brookings Institution, Athens. p.4

Greece was not the only European country to experience stagnant growth during these years. The first 5 years in the Community coincided with a general recession in all EEC countries. However, the weak growth of the Greek economy continued during the following 5 years, when the other European countries experienced an economic boom. A comparison of Greece with all other European countries is less meaningful than a comparison with the other GIPS states (Ireland, Portugal and Spain). Indeed, their economic situation was similar to that of Greece when they were admitted to the European Community. Looking at the data it is clear that in the first 20 years in the EEC, Greece did not grow as it could have[11] (see Fig.1.1).

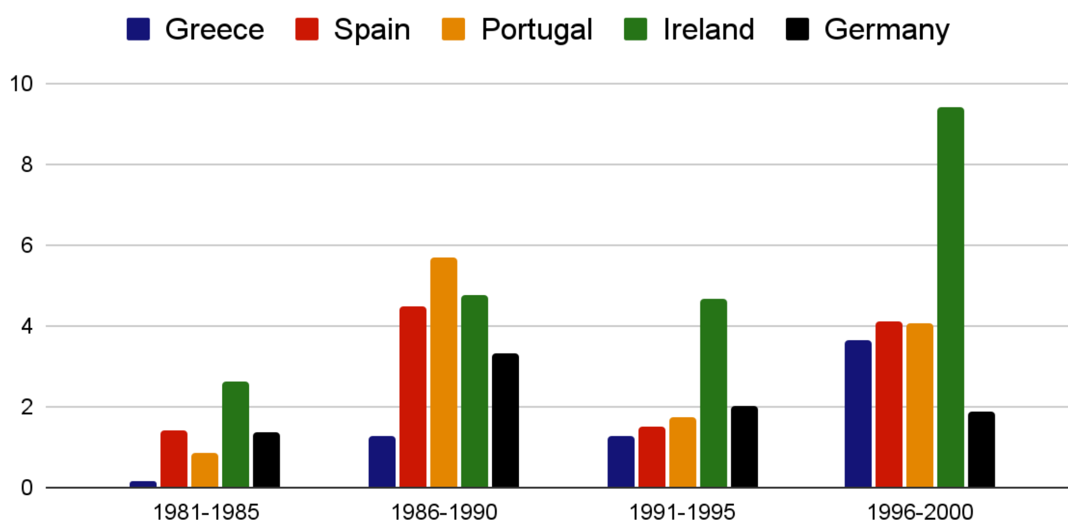

Fig.1.1- Real GDP Growth in Greece, the other GIPS countries and Germany from 1981 to 2001. The other GIPS countries are used for comparison because their situation was similar to that of Greece. Germany was added to have a comparison with the GDP development of the core countries.
Source: World Bank database, https://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG ?end=2001&locations=GR-ES-PT-IE-DE&start=1980. Last access on 1 March 2022.

[11] B.Bosworth and T.Kollintzas (2001) Economic Growth in Greece: Past Performance and Future Prospects, in Greece's Economic Performance and Prospects, Bank of Greece and The Brookings Institution, Athens. p.157.

Papandreou also decided to greatly increase general government spending. When this process began in 1980, spending (and, of course, revenues) were far below the European average. In the following ten years they increased dramatically, from 29.5% of GDP in 1980 to 48% of GDP in 1990. In the same period, public revenues increased by only 5%, reaching 32% of GDP. This led to a sharp increase in public debt and high interest payments[12].

The increase in public expenditure did not lead to growth because it was not directed towards investment. It led mainly to an increase in health spending, pension payments and public employees' salaries. These are, of course, fundamental sectors and, globally, it is not a negative decision to increase spending in these sectors. The only problem is that increasing spending in these sectors does not increase future growth, so financing them with public debt creates problems for the future.
A second and equally important problem was the poor management of public spending. The Social Security system was highly fragmented, consisting of more than 300 separate funds[13]. This led to a convoluted system in which many workers did not pay full Social Security contributions and many retirees received multiple or inflated pensions. At the same time, more and more new government departments were created, leading to a sharp increase in the number of government employees. Their hiring was mostly based on social criteria rather than qualifications. These positions became very attractive as the wages of government employees increased faster than those of employees in the private sector[14]. This, of course, further reduced the country's competitiveness. Because of all these structural weaknesses, Greece was not able to benefit from joining the

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[12] V.G.Manessiotis and R.D.Reischauer (2001) Greek Fiscal and Budget Policy in EMU in Greece's Economic Performance and Prospects, Bank of Greece and The Brookings Institution, Athens. p.118.
[13] R.Neubäumer (2015) The Prologue to the Greek Crisis, *Vierteljahrshefte zur Wirtschaftsforschung*, Berlin, Duncker & Humblot, Vol.84. p.13
[14] Ibidem p.15

EEC[15]. Greek products became less and less competitive and exports fell instead of rising, while imports remained constant.

The high budget deficit was also one of the main causes of the high inflation rates in Greece. From 1981 to 1994, Greece recorded an average inflation rate of 18%, far higher than that of the other GIPS countries (see Fig.1.2).

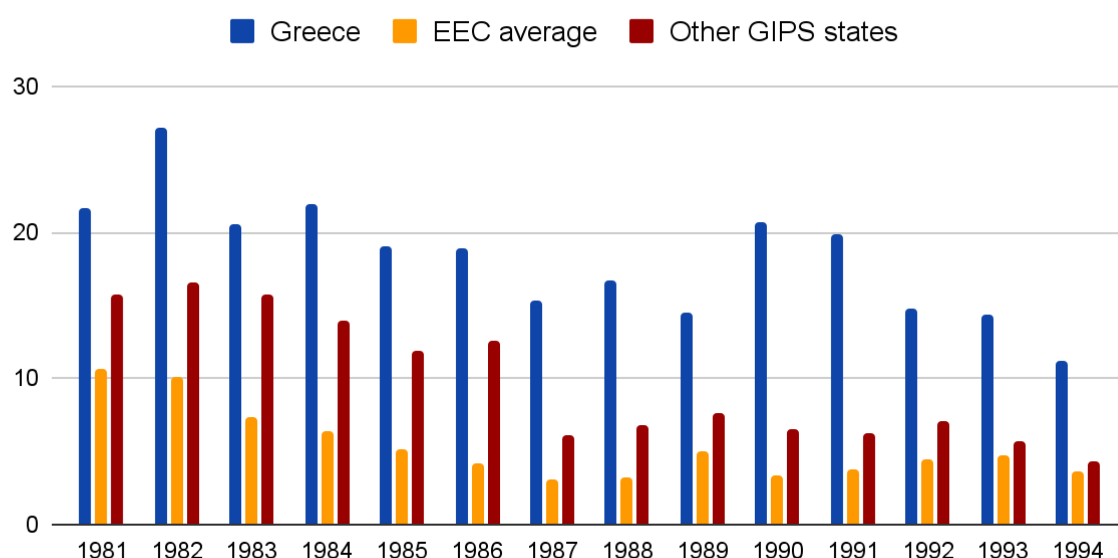

Fig.1.2- Inflation in Greece, the EEC and the other GIPS states from 1981 to 1994. Source: The World Bank database at: https://data.worldbank.org/indicator/NY.GDP.DEFL.KD.ZG? end=1994&locations=GR&start=1981. Last access on 2 March 2022.

At that time, the Bank of Greece was not fully independent. Under pressure from the government, it increased the money growth rate to finance the large budget deficit. The public sector enjoyed preferential access to credit:

[15] B.Bosworth and T.Kollintzas (2001) Economic Growth in Greece: Past Performance and Future Prospects, in Greece's Economic Performance and Prospects, Bank of Greece and The Brookings Institution, Athens. p.169.

Banks were required to invest 37 percent of their deposits in Treasury bills, so the real interest rate remained negative (it was lower than inflation) at least until 1985. This mechanism kept borrowing costs low but fuelled inflation, which was already high due to the oil price shock of 1973/74.

From 1986, Greece began to adapt its financial system to European standards. The share of capital that banks had to invest in treasury bills was gradually reduced, and in 1993 this requirement was finally abolished. The elimination of this distortion of the financial market led to a sharp increase in the interest rates paid on debt as the government began to sell Treasury bills to non-banks. With a high primary deficit and real interest rates on Treasury bills exceeding real GDP growth, the situation was no longer sustainable[16].

1.3) The Maastricht Treaty

The system of clientelism introduced under Papandreou's first government became a structural problem in the Greek society. The change of government did not change this practice. Instead of being based on the needs of the citizens, the expansion or reduction of spending depended on the election cycle. Even when the financial situation was clearly unsustainable, no party could win elections proposing a reduction in public spending or an increase in taxes. For this reason, the process of European integration was also seen by the ruling class as a way to create an external incentive for more sustainable fiscal policies. Indeed, the Greek population was in favor of the integration process and was prepared to accept more conservative economic policies if this was necessary to achieve this goal.

[16] V.G,Manessiotis and R.Reischauer (2001) Greek Fiscal and Budget Policy in EMU in Greece's Economic Performance and Prospects, Bank of Greece and The Brookings Institution, Athens. p.112

From the end of the 1980s, the process of European integration underwent a strong acceleration. The Delors Commission report of 1989 for the first time mentioned the introduction of a common currency as an objective for the Community[17]. This proposal came at the end of a twenty-years process to ensure monetary coordination among European states after the collapse of the Bretton Woods system in 1971[18]. The new proposal was very ambitious but a favourable converge of events[19] accelerated the process and led to an agreement on the issue in 1991.

When the discussion on the new political and economic structure of the Union began, Greece took a positive stance. Nea Demokratia had won the 1990 elections, ending the 10-year government of the euroskeptic Pasok. The new government was more interested in the political than the economic side of the treaty. Fearing Turkey's military strength and the negative effects of Balkan disintegration, Greece wanted to participate in further integration. It also hoped that the Western European Union (WEU) would be opened to all members of the Union and become its military arm. Economically, the government viewed the creation of a common currency as an opportunity to improve the balance of payments and lower inflation. The existence of rules that came from outside would have forced Greece to implement reforms that had been necessary for decades, but which met with strong resistance from public opinion[20].

[17] Report on economic and monetary union in the European Community, committe for the study of Economic and Monetary Union, available at: https://ec.europa.eu/economy_finance/publications /pages/publication6161_en.pdf.

[18] The collapse of the Bretton Woods system caused the end of the fixed exchange rate system based on the dollar convertibility with gold. In the following years European states tried to reestablish a fixed exchange rate system among them, first with the 'Snake in the tunnel' and then with the 'European Monetary System'.

[19] In particular, the emergence of the possibility to reunify the two parts of Germany was a fundamental element in the negotiation that followed. According to the prevailing literature on the issue, Germany only accepted the single currency as a counterpart to the approval of the partners on the reunification with its eastern part.

[20] B.Hertz and A.kotios (2000) Coming Home to Europe: Greece and the Euro, *Intereconomics*, available at: file:///C:/Users/len3/Downloads/coming-home-to-europe-greece-and-the-euro%20(1).pdf.

The treaty was signed on February 7, 1992, and entered into force at the beginning of 1993[21]. It provided for many institutional reforms,, but by far the most important step concerned monetary integration. The new system provided for a division of powers: Monetary policy was to be decided at the European level by a newly created institution, while fiscal policy was to remain under national competence. According to the treaty, the transition to the new system was to be achieved through three successive stages. The date set for the start of Stage 3, i.e. the introduction of the single currency, was 1 January 1999.

Even though Greece had participated in the negotiations with enthusiasm, its economic situation was far worse than that of its partners. Admission to the third stage of the Economic and Monetary Union (EMU) was non-automatic but depended on the fulfilment of several criteria. All partners agreed that a common monetary policy with very unstable partners could be very dangerous, and so the situation of each state had to be carefully assessed. The criteria for assessing a state's situation were the level of inflation, the deficit and debt-to-GDP ratios, the interest rates on long-term bonds and the stability of the currency's exchange rate. When Greece signed the treaty, it did not meet any of the criteria.

1.4) The path toward the third stage of the EMU

The will to join the third stage of economic and monetary union led to a change in Greek policy. Starting in 1990 and throughout the decade, the country implemented reforms to meet the European criteria. Considering the initial conditions, the goal was very ambitious, but the reforms carried out were considered credible. In the end, even though Greece did not meet the "debt criteria", it was admitted to the third stage of EMU.

[21] Treaty on European Union, Official Journal of the European Communities, available at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:11992M/TXT&from=EN.

A significant reduction in inflation was necessary, so in 1990 the Greek Central Bank decided to implement a 'strong drachma' policy. It consisted in raising interest rates in order to increase the value of the drachma and lower inflation. This policy was effective and between 1990 and 1994 inflation was reduced from 20% to 11% (See Fig.1.2). In 1990 the inflation rate had been particularly high also because of the second oil crisis (in 1989 the inflation rate had been 13%), so the decrease was not only due to the monetary policy implemented. However, these efforts continued and in 1995 the central bank was able to announce for the first time a limit on the annual depreciation of the drachma against the ECU. This was a fundamental step that allowed Greece to join the European Exchange Rate Mechanism in 1998[22].

From 1991, the fiscal policy changed fundamentally, as deficits were reduced by more than 40%[23]. From 1992 onwards, the primary balance turned positive and the debt would have started to reduce, had it not been for the mandatory consolidation of the government's accounts with the central bank. Indeed, the second phase of EMU required the conversion of Greek central bank loans to the government into formal debt. This step led to an increase in the debt ratio to 111.6% of GDP in 1993.

[22] R.Neubäumer (2015) The Prologue to the Greek Crisis, *Vierteljahrshefte zur Wirtschaftsforschung*, Berlin, Duncker & Humblot, Vol.84, p.16

[23] V.G.Manessiotis and R.D.Reischauer (2001) Greek Fiscal and Budget Policy in EMU in Greece's Economic Performance and Prospects, Bank of Greece and The Brookings Institution, Athens. p.122

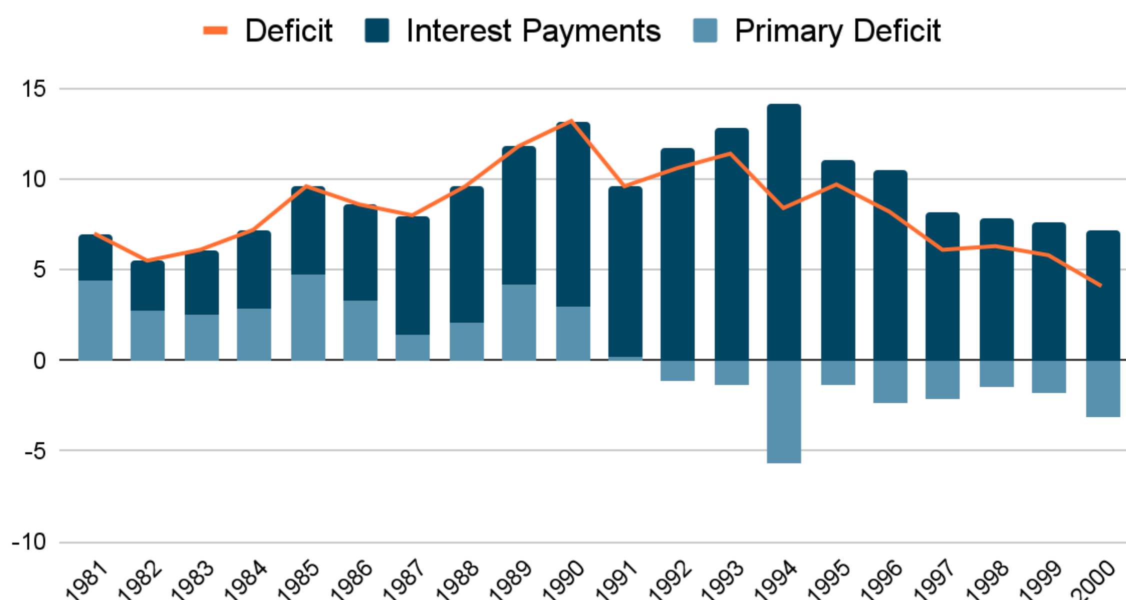

Fig. 1.3- The evolution of the Greek deficit from 1981 to 2000.
In the graph, two elements that compose the deficit, the interest payments and the primary deficits, are separated in order to better understand the general trend. For graphic reasons, the primary deficit is indicated as positive (+) in the case of deficit and negative (-) in the case of surplus.
Source: R.C.Bryant, N.C.Garganas and G.S.Tavlas (2001) Greece's Economic Performance and Prospects, Bank of Greece and The Brookings Institution, Athens Annex I, p.143-144.
As the figures in the publication were all collected before 2001 and they have been corrected several times in the following years, I have decided to adjust them with data from the Eurostat Database:
https://ec.europa.eu/eurostat/databrowser/view/GOV_10DD_EDPT1
__custom_2191402/default/table?lang=en. Last update 22 October 2021.

In the following years, the debt-to-GDP ratio stabilised and then began to decline. From 1994 onwards, primary surpluses were achieved and the debt ratio was stabilised. In 1994, the real GDP growth rate also began to accelerate, leading to a reduction in the debt ratio by the end of 1997, despite very high interest rates. By 2000, the debt-to-GDP ratio had fallen to about 103% of GDP. Moreover, the average maturity of the debt had tripled between 1990 and 2000 due to the substitution of Treasury bills with

bonds. In 1990, the government relied heavily on short-term financing with an average maturity of two and a half years, while in 2000 it averaged more than six years. This change reduced the sensitivity of government debt to changes in short-term interest rates[24].

Despite all these efforts, the Greek economy was still considered unsuitable for the Eurozone in 1998. In 1998, the EMI (European Monetary Institute), the institution that had replaced the Committee of Central Bank Governors, assessed the situation of the member states that wanted to join the eurozone. The United Kingdom, Denmark and Sweden had obtained a derogation and were allowed to keep their currency. Of the twelve countries that had applied to join the single currency, Greece was the only one to be rejected because it did not meet the criteria[25]. The EMI acknowledged Greece's efforts in the right direction, but stressed that the country did not meet any of the criteria under consideration.

There were 4 criteria under consideration. The first concerned the level of inflation. The target was set at the average inflation rate of the three countries with the lowest inflation plus 1.5%. Since the average inflation of the three best performing countries was 1.2%, the reference value was 2.7%. In 1998, inflation in Greece was 5.2%, although it was falling steadily.
A second criterion concerned the government budgetary position. The reference values were a debt-to-GDP ratio not exceeding 60% and a deficit-to-GDP ratio below 3%. Greece was not the only country whose debt level exceeded 60%: in fact, only France, Finland and Luxembourg complied with this criterion, while other countries such as Belgium and Italy had a higher debt-to-GDP ratio than Greece. Due to the general non-compliance and positive trend of this ratio, the EMI decided to be a bit

[24] V.G.Manessiotis and R.D.Reischauer (2001) Greek Fiscal and Budget Policy in EMU in Greece's Economic Performance and Prospects, Bank of Greece and The Brookings Institution, Athens. p.124
[25] C.Bohlen (1998) Joining Euro a dim hope for Greece, *The New York Times*, 2 April 1998.

more flexible with this value. It focused instead on the deficit-to-GDP ratio: Greece was the only country to exceed the reference value in 1998, recording a deficit of 4.0%.
As regards the stability of currencies, the Maastricht Treaty required countries joining EMU to have participated in the European Exchange Rate Mechanism (ERM) for the last two years without devaluing their currency. While all other countries met this criterion, Greece did not join the ERM until 1998.
The last criterion concerned the long-term interest rate. The reference value was calculated by taking the average long-term interest rate of the three countries with the lowest inflation and increasing it by two percentage points: The average for the 12-month period ending in January 1998 was 5.8%, so the reference value was 7.8%. Again, Greece was the only country in which the long-term interest rate, which was around 9.8% in 1998, exceeded the reference value[26].

Despite this failure, the process of consolidation of the Greek economy continued. In 2000 a report by the Newborn ECB came to different conclusions. The inflation rate had reduced to 2%, while the reference value was 2.4%. The debt ratio was 104.4%, well above the reference value, but the deficit to GDP ratio was only 1.6%. Greece had joined the exchange rate mechanism in March 1998 and since then its exchange rate against ECU (and then the euro) had remained sufficiently stable. As regards long-term interest rates, the average rate for Greece in 2000 was 6.4%, 0.8 percentage point below the reference value of 7.2%.
Although the figures indicate a marked improvement in the Greek situation, ECB underlined that not all problems had been solved. The fall in inflation was partly due to temporary factors such as the reduction in indirect taxes and would therefore rise again once they were removed. A modest improvement in the fiscal position had required a strong privatization

[26] EMI (1998) Convergence report of the European Monetary Institute, Frankfurt, March 1998, available at: https://www.ecb.europa.eu/pub/pdf/conrep/cr1998en.pdf.

process and high primary surpluses: debt interest constituted a heavy burden and high primary surpluses would have to be maintained for many years to restore a sustainable situation. Despite the weaknesses identified, Greece was considered ready for Stage Three of EMU and officially joined the Eurozone in January 2001[27].

1.5) The incomplete process of reform

By joining the Eurozone, Greece achieved the goal that justified all the efforts of the last decade. Far from being an end point, joining the eurozone was a new challenge for Greece: with the single currency, any policy option for a nominal exchange rate adjustment disappeared. The only way to promote external adjustment and strengthen competitiveness was through sound fiscal and debt policies and effective structural reforms. As the situation of Greece remained problematic, it is useful to analyse the main problems that needed to be addressed at the beginning of the new millennium.

The first problem was the negative external balance. Indeed, with a current account deficit of 6.8% of GDP in 2000, Greece was importing far more than it was exporting. Part of this problem was caused by temporary factors, such as the rise in world oil prices, which had led to unusually high import payments for oil in 2000. However, there was also a structural problem of competitiveness of Greek firms. Greece was at the same time the country with the most burdensome regulation framework in the EU for starting a new business, and the one with fewer services to businesses: a simplification of the regulatory environment and investment in education

[27] ECB (2000) Convergence report of the European Central Bank, Frankfurt, April 2000, available at: https://www.ecb.europa.eu/pub/pdf/conrep/cr2000en.pdf.

and communication facilities were needed[28]. Greece made up for the current account deficit with large remittances from Greeks living abroad and with the import of capital from other European countries. The dependence on foreign capital was one of the factors that exacerbated the country's weakness when the financial crisis exploded in 2008.

Greece was also dependent on transfers from EU structural funds. In the late 1990s, these transfers were over 3% of GDP. However, these were funds that Greece could no longer count on in the following years: an enlargement of the European Union was planned, and Greece's share would be reduced in the next support programme. Since the programme would run until 2006, Greece still had a few years to benefit from these funds. It was therefore necessary to use them efficiently to be ready for their progressive reduction.

Greece also had to address the structural problems that had driven up public expenditure and reduced revenues in recent decades: dysfunctions in the pension system and the labour market.

The pension system granted a low retirement age and unsustainably high benefits compared to contributions. It was highly fragmented and complex at the time, resulting in people receiving multiple or inflated pensions. By the late 1990s, spending on pensions was 12% of GDP. Without reform, this would likely reach 20% in the next decade due to the ageing of the Greek population. By the end of the 1990s, a consensus had been reached on the need for reform. However, no reform had been implemented yet[29].

At the same time, Greece had a very weak and rigid labour market. This had a negative impact on the unemployment rate, the highest in the

[28] R.C.Bryant, N.C.Garganas and G.S.Tavlas (2001) Introduction in Greek Fiscal and Budget Policy in EMU in Greece's Economic Performance and Prospects, Bank of Greece and The Brookings Institution, Athens. p.22

[29] A.Börsch-Supan and P.Tinios (2001) The Greek Pension System: Strategic Framework for reform in Greek Fiscal and Budget Policy in EMU in Greece's Economic Performance and Prospects, Bank of Greece and The Brookings Institution, Athens.p.385

European Union after Spain. A large part of the labour force was employed in small or family businesses, as they are better able to circumvent the legal restrictions on working conditions and avoid the obligation to pay contributions. Tax reform to either reduce the private cost of creating legal jobs or increase the incentives for small businesses to pay their contributions was very necessary.

Finally, maintaining sound fiscal policies was a fundamental challenge. Debt was still very high, and to reduce it, high primary surpluses had to be achieved because of interest rates. But now that the single currency was no longer a goal to be achieved, it was more difficult to reach consensus on it. Moreover, the results that had been reached in the previous period of consolidation were not so solid because they were based mainly on tax increases rather than spending cuts. Since monetary policy could no longer be used and the funds transferred to Greece were to be reduced in the following years, very great efforts were still required.

1.6) The doubts on the adoption of a single currency

Was it a sensible decision for Greece to adopt the euro? And was it a sensible decision for its partners to let Greece into the eurozone? This question is embedded in a much broader debate about the wisdom of introducing a common currency among the member states of the European Union. Since the early 1960s, economists have attempted to examine the criteria by which to judge whether adopting a fixed exchange rate (or a single currency) might be a good choice. The branch of economics that deals with this question is known as the 'theory of optimal currency areas'. It is beyond the scope of this paper to describe the results of this theory and even to decide whether the European Union is an optimal currency area. This is indeed a rather complex question for which there is no clear and definitive answer. However, mentioning the main

points of this debate may be useful to get a better understanding of the advantages and disadvantages of adopting a common currency.

According to the theory of optimal currency areas, having a common monetary policy is useful when the countries that participate in it are sufficiently similar and integrated. In particular, when the inflation rate of different countries is similar, there is high labour mobility, the country has a high degree of openness, production is diversified, there is fiscal integration and real wages are flexible. Strong integration and a high degree of openness allow benefiting from the reduction of transaction costs and uncertainty about price developments. Similar conditions across countries allow reducing the damage of the main disadvantage: the absence of an independent monetary policy. The more countries differ, the more they are hit by asymmetric shocks. In this situation, a single monetary policy would have to respond to opposing needs[30].

When the Euro was introduced, it was unclear whether the Eurozone could be considered an 'optimum currency area'. Eurozone countries had similar levels of inflation and a good output diversification, but did not score well on other criteria such as labour mobility, the degree of fiscal integration and the flexibility of real wages[31]. The situation of Greece was particularly worrying: it had the lowest degree of openness in the euro area and its economic situation exposed it to asymmetric shocks more than any other country in the euro area. However, two aspects must be taken into account when assessing the choice to adopt the Euro.
The first is the fact that economic advantage was not the only factor that led European countries to adopt the Euro[32]. Political considerations were

[30] P.Krugman, M.Obstfeld, M.Melitz (2018) International Economics: Theory and Policy, Pearson Education, Boston.
[31] P.Krugman (2012) Revenge of the Optimum Currency Area, *The New York Times*, 24 June 2012.
[32] For some countries the political importance of adopting the euro was greater than the economic one. This is certainly the case of Greece. Before joining the euro, the country had refused to join the EMS: it was not very interested in the stability of its exchange rate. The euro was important because it was a symbol of its will to integrate into the European community. The advantages were mainly indirect: a

at least as important in this choice, but the benefits that were produced in this field are not considered by the optimum currency area theory.
The second is that the optimality of a currency area is not fixed in time, but changes depending on the policies pursued by the States and the EU institutions. Continuing a process of integration progressively increases the benefits and reduce the risks of having a common monetary policy.

Summary

The period from 1974 to 2001 was characterised by two trends: the emergence of structural financial problems and the progressive integration with European partners. Excessive spending and the inability to implement the necessary reforms led to a sharp increase in public debt and a decline in competitiveness. Even though this trend was clearly unsustainable, the political class was too weak to implement necessary but unpopular reforms. Only the concrete goal of adopting the euro was able to create a consensus for a consolidation process. However, the decision to join the Eurozone was controversial as it removed the possibility of using monetary policy to face an asymmetric crisis.

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framework that would favour sound fiscal policies and the possibility of counting on the European core countries when it came to the threat of the wars in the Balkans and Turkish military power.

Chapter 2: The Financial crisis in Greece

The strong polarisation of the narration on the Greek crisis makes it very difficult to analyse it objectively. A basic requirement for any productive discussion is to list the main events and reach a consensus on what happened. This chapter will focus on the main events regarding Greece from its entry into the Eurozone to 2018. The decision to include the first period of the eurozone's life in this chapter is justified by the fact that the flow of capital from the core to the periphery of the eurozone that took place during this period is considered one of the main causes of the crisis. The year 2018 was instead chosen because the completion of the third adjustment programme, which took place in that year, can be considered the formal end of the crisis.

2.1) A flow of capital from the core to the periphery of the Eurozone

In 2002, Olivier Blanchard and Francesco Giavazzi analysed in a paper[33] the strong flow of capital from the core to the periphery of the euro area. In the first years after the creation of the eurozone, Portugal and Greece recorded very large current account deficits: in 2001, the difference between exports and imports was estimated at 10% of GDP in Portugal and 6-7% of GDP in Greece, and it was forecasted to continue on similar values in subsequent years. This was not an usual trend for the two countries, as both had an estimated current account deficit of about 2% a decade earlier. The reason for this change was, of course, the entry into the euro zone.

According to the study, what happened in Portugal and Greece was "exactly what theory suggests can and should happen when countries become more

[33] O. Blanchard and F. Giavazzi (2002) Current account deficits in the Euro Area: the end of the Feldstein-Horioka puzzle?, *Brookings Papers on Economic Activity*, available at: https://www.brookings.edu/wp-content/uploads/2002/06/2002b_bpea_blanchard.pdf

closely linked in good and financial markets." The explanation for the rise in current account deficits is quite simple. When a country decides how much money to borrow, it must consider two elements: the interest rates it faces and the cuts it must make to generate enough export revenue to repay the debt. By joining the eurozone, both these factors were reduced: financial integration led to lower borrowing costs, while greater integration of goods markets led to more elastic demand, reducing the price cuts that would be required in the future. As a result, it was considered "sustainable" to borrow much more money than before.

Even if this process was considered 'natural' or even 'positive' by the two authors, they emphasised the fact that similar processes have led to financial crises in the past. Examples given were some Latin American countries in the 1990s and some European countries in the 1980s. In both cases, exchange rate stabilisation had led first to an increase in growth and then to a real appreciation of currencies and a reduction in competitiveness, ending with a withdrawal of capital and forced devaluation.

Two elements suggested that the new situation was different from the previous one: the fact that there was virtually no risk of inflation getting out of control within the euro area, and the fact that there was no risk of devaluation.
As for the first reason, it should be remembered that the Latin American and European countries used as examples had come from periods of high inflation. This had led to rapid real appreciation when the exchange rate had been stabilised. This was not the case for Greece and Portugal, as their overvaluation process was much slower. However, inflation in Portugal and Greece was still above the euro area average of almost 1.5% (3.7% in Portugal and 3.4% in Greece versus a euro area average of 2.1%). An adjustment of relative prices therefore had to be envisaged.
The elimination of the possibility to devalue a currency had, of course, reduced the reasons for financial market anxiety. However, the possibility of capital flight still existed and was considered by the authors of the article. Since the capital

flow to Greece amounted to more than 5% of its GDP, it was clear that a stop would have caused enormous problems. To prevent market confidence from fading, the authors suggested increasing the government surplus. This advice was not followed.

After joining the euro, the consensus on improving the fiscal situation had disappeared. Efforts to reduce expenditures and increase revenues were abandoned because they were no longer justified by the will to join the third stage of EMU. The reduction in borrowing costs reduced the pressure to reduce public debt and favoured an increase in deficits. The plan to reform the pension system was not implemented and the already high number of public employees increased by almost a quarter. In these early years, public spending increased from 45.5 to 47.5 percent of GDP, while the tax-to-GDP ratio fell from 26 to 22.5 percent. From 2000 to 2007, the average public deficit was 6%, well above the criterion set in the Maastricht Treaty[34].

Greece's excessive deficit was not sanctioned by the European Commission until 2004, when the actual figures for Greek public debt became known. In September 2004, the European Statistics Authority (Eurostat) published data showing that Greece's deficit and debt had been underreported for the years 1997 to 2004. The 90% of revisions concerned only three elements: the under-recording of military expenditures, the overestimation of the surplus of social security funds and the downward revision of tax revenue estimates[35].

[34] R.Neubäumer (2015) The prologue to the Greek Crisis, *Vierteljahrshefte zur Wirtschaftsforschung*, Berlin, Duncker & Humblot, Vol.84, Iss.3, pp. 9-28.
[35] Eurostat (2004) Report by Eurostat on the revision of the Greek government deficit and debt figures, 22 November 2004, available at: https://ec.europa.eu/eurostat/documents/4187653/5765001/GREECE-EN.PDF.pdf/2da4e4f6-f9f2-4848-b1a9-cb229fcabae3?t=1414777146000.

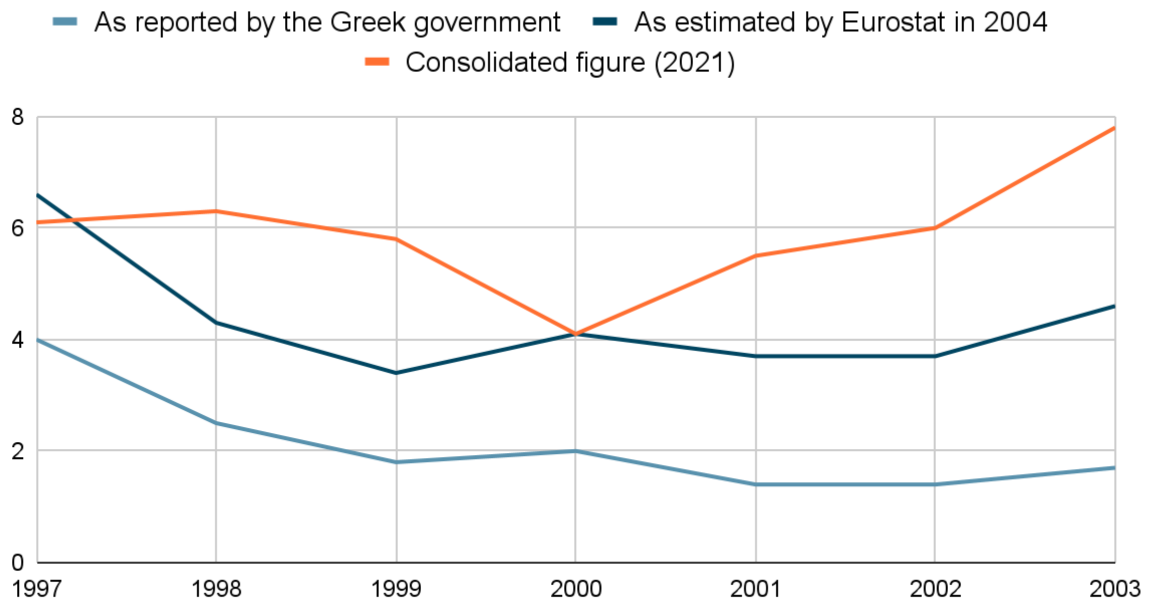

Fig. 2.1 - The difference between the deficit (% of GDP) reported by the government, revised by Eurostat in 2004 and consolidated.
Source: Eurostat Database. https://ec.europa.eu/eurostat/databrowser/view/gov_10dd_edpt1/default/table?lang=en, last update 22 October 2021.

This report showed that Greece had been violating the Maastricht Treaty rules on the size of the deficit since its accession. It also revealed that the data that had allowed Greece to join the third stage of EMU were incorrect and that Greece had never fulfilled the conditions for accession. However, the Commission stated that Greece's membership in the eurozone was not in question and only initiated an infringement procedure for excessive deficit. The procedure was closed in 2006, when the recorded deficit was 2.5% of GDP.

This incident was an alarm signal about the quality of the data collected from Greece, as the corrections required were of a magnitude that caused real concern. Eurostat, which normally trusts the statistical information provided by the member states, decided to send a mission to Greece to get a more accurate picture. At their December 2004 meeting, eurozone finance ministers urged Greece to improve the quality of the statistics provided. They agreed, however,

that it would be better to retain the national statistical offices rather than create a centralised statistical authority[36].

Due to opposition from some member states, including France, Germany and the United Kingdom, the Commission's proposal to extend Eurostat's powers to verify national figures was shelved[37].

Along with high government deficits, Greece was experiencing a sustained growth. From 2001 to 2007 its average GDP growth exceeded 4%, qualifying as the second most dynamic eurozone member after Ireland.

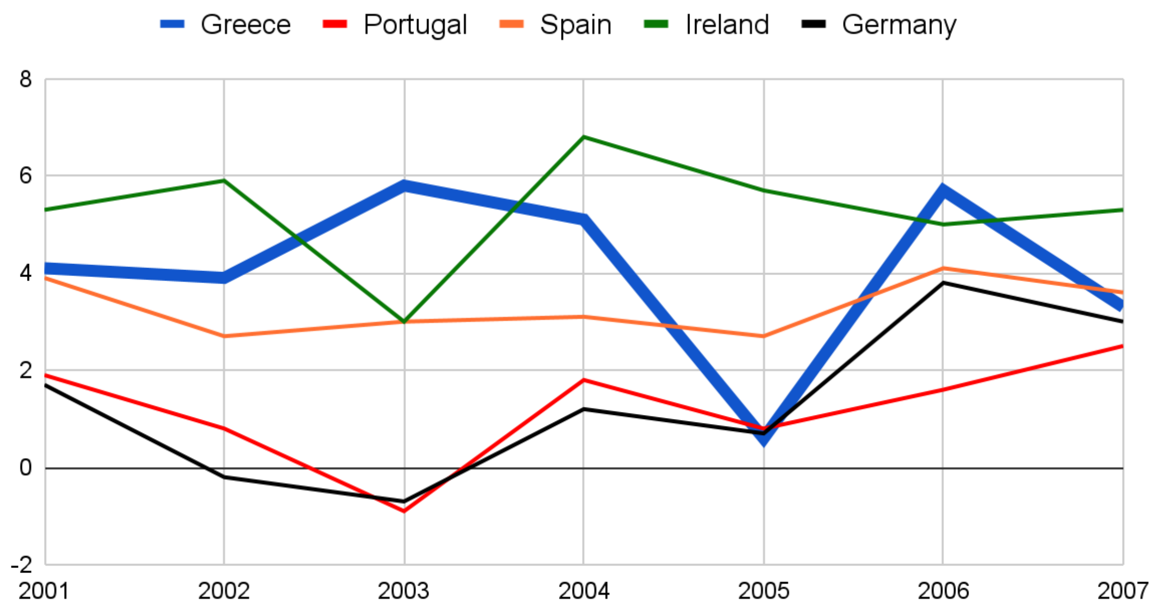

Fig. 2.2 - GDP growth (% of GDP) of Greece, Portugal, Spain, Ireland and Germany from 2001 to 2007. The other GIPS countries are used for comparison because their situation was similar to that of Greece. Germany was added to have a comparison with the GDP development of the core countries. Source: Eurostat Database, https://ec.europa.eu/eurostat/databrowser/view /NAMA_10_GDP__custom_2222519/default/table?lang=en. Last update 4 March 2022.

However, the mere data on GDP growth could be deceptive. In the case of Greece, growth did not result from innovation or firm expansion, but was based

[36] P. Maller (2004) EU looking into Greek debt figures, *The New York Times*, 24 September 2004.
[37] G. Parker (2005) EU strives to establish statistical reporting standards, *Financial Times*, 1 March 2005.

on a demand-side boom. The increase in demand was caused by an inflow of capital from the core eurozone countries, especially Germany and France. The increased demand was not met by increased production, but by a further widening of the current account deficit. Between 2001 and 2007, the import ratio increased from 36% to 38%, while the export ratio remained stable at 24%. Exports did not increase because the imported capital was mainly invested in the production of non-tradable goods such as housing and services for residents. The increase in demand for real estate began in 1996 due to the sharp decrease in interest rates caused by the imminent entry into the Eurozone. Housing investment increased by 20% in the period from 1996 to 1999 and by another 50% in 2000, when entry into the Eurozone was secured. The trend continued after joining the Eurozone and the share of this sector in GDP increased from 6% in 1999 to 12.5% in 2007. This process was also favoured by low mortgage rates and the granting of mortgages to subprime borrowers. Investing the imported money in the production of tradable goods could have provided an alternative to imports or an opportunity to export. Instead, the influx of capital inflated a housing bubble that burst in 2007: GDP fell as fast as it had risen, dropping back to 2001 levels by 2013[38].

What was supposed to be real growth turned out to be only growth in indicators, while productivity remained almost unchanged. In the 6 years after joining the eurozone, Greece lived beyond its means, consuming imported goods paid for with imported capital. The inflation process also reduced the country's competitiveness and exacerbated the structural problems that had characterised Greece in the previous period. The system worked until 2008, when the inflow of capital stopped due to the financial crisis.

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[38] R.Neubäumer(2015) The prologue to the Greek Crisis, *Vierteljahrshefte zur Wirtschaftsforschung*, Berlin, Duncker & Humblot, Vol.84, Iss.3, pp. 9-28.

2.2) The effects of the US crisis

It is beyond the scope of this paper to explain in detail the causes and effects of the US subprime crisis. However, this crisis had an impact on Europe and Greece that is worth analysing. While it is not correct to say that the crisis in Greece was a consequence of the US crisis, this is the event that started the process that led to the crisis.

The US housing bubble began to burst in early 2007. This is the period when the first banks suffered large losses on their subprime investments[39]. This process also affected some European banks, such as IKB Deutsche Industriebank, a small German bank that announced in July 2007 that it was facing large losses from its subprime investments. While the losses had been considered isolated cases up to that point, the situation changed after IKB's announcement. Other European banks acknowledged their losses and in August BNP Paribas, the largest French bank, announced that it was no longer possible to withdraw money from 3 of its funds that had invested in US subprime mortgages[40]. In response to this event, the ECB acknowledged a lack of liquidity and provided unlimited funds to banks[41].

The problem, however, was far more serious than a temporary lack of liquidity in European banks. While the Federal Reserve was quick to recognise this and responded by gradually lowering interest rates, the ECB did not move in this direction until a year later, in late 2008[42]. This difference was due not only to a misjudgment of the severity of the crisis, but also to the different statutes of the

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[39] R. Kjetland (2007) IKB posts 67% fall in net profit on widening credit spreads, *The Wall Street Journal*, 1 October 2007.

[40] A.Mody (2018) Euro tragedy - A drama in nine acts, Oxford University Press, New York.

[41] ECB (2007) The ECB additional open market operations in the period from 8 August to 5 September 2007, ECB Monthly Bullettin September 2007.

[42] D.W.Kang, N.Ligthart, A.Mody (2016) The ECB and the FED: a comparative narrative, *VoxEu*, 19 January 2016.

two central banks. While the sole objective of the ECB was to maintain price stability, the FED also had the mandate to promote employment.

While the FED actions also helped European banks by easing the dollar shortage, the ECB continued to view the crisis as a foreign problem. By the end of 2008, Trichet, the president of ECB, viewed inflation as the main risk and also tried to curb it by raising interest rates. Furthermore, the European banking system had some elements that made the possibility of a financial crisis far more dangerous than in the US. First, there was no lender of last resort, as the ECB had no mandate to do so. This role was to be taken on by each country separately, but the banks were very large compared to the countries' GDP[43]. The banks in the EU were then highly interconnected, leading to a high risk of the crisis spreading from one country to the others.

The crisis finally became visible to all when Lehman Brothers filed for bankruptcy on September 15, 2008. By that time, all banks in both the US and the EU had been bailed out, which reduced investor fear. The decision not to rescue Lehman Brothers caused panic in the financial markets. Even in Europe, where governments officially intended to bail out the banks, creditors began to doubt that countries were truly capable of saving their banks.
In the US, the problem of bank solvency was addressed at the federal level. All banks were stress tested and those that were struggling had to raise capital from the Troubled Asset Relief Program (TARP). In this way, confidence in the banks was restored and all costs were covered at the federal level without burdening the budgets of individual states. This was not the case in the European Union, since the Community institutions did not have the authority to do so. Negotiations for the creation of a European TARP began, but the core countries, especially Germany, were not willing to share the costs of bank bailouts with the countries on the periphery. As each country was left to deal with the crisis and bailout its banks on its own, financial markets began to

[43] R.Baldwin, D.Gros, L.Laeven (2010) Completing the Eurozone rescue: what more needs to be done?, Centre for Economic Policy Research, London.

realise that the risk of failure was not the same for them. At this point, the flow of capital from the core countries to the periphery of the eurozone stopped and began to reverse. Interest rates on the sovereign debt of eurozone countries, which had converged sharply when the eurozone was created, began to diverge. The most important criterion for measuring interest rate divergence was the percentage difference from Germany: the so-called "spread".

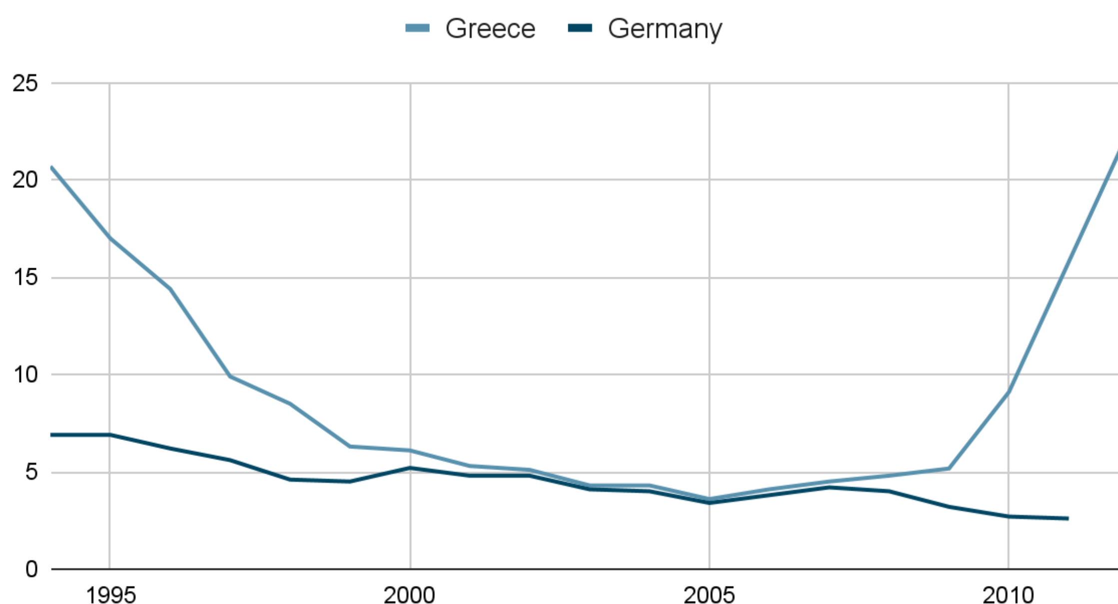

Fig. 2.3- The convergence and divergence of Greek and German 10-year bond yields. Source: Eurostat Database, https://ec.europa.eu/eurostat/databrowser/view/irt_lt_gby10_a/default/table?lang=en. Last update 6 January 2022

The capital outflow caused particular problems for countries such as Ireland, where bank exposure far exceeded GDP. However, the process was not traumatic because of the liquidity provided by the ECB. By November 2009, the worst seemed to be over. The recession had been damaging, causing large losses and a rise in unemployment. However, Europe had suffered less than the United States. Now that the situation on the other side of the Atlantic was slowly beginning to improve, it was expected that this would also happen in Europe.

2.3) Greece announces its real deficit

Until the end of 2009, the situation in Greece was considered quite stable. The deficit had reached 5% of GDP in 2008 and was projected to reach 6% in 2009, but this was mainly due to a decline in GDP. An infringement procedure was initiated, but the situation was not exceptional, as many countries had exceeded the 3% limit due to the recession. Even though public debt was high, austerity measures that had been taken were considered adequate by the IMF in its annual review of the Greek economy. In the same report, Greek banks were considered stable and the only concern was the quality of economic statistics[44].

In October 2009, Greece held parliamentary elections. Karamanlis, the leader of the centre-right Nea Democratia party that had led the country since 2004, was voted out of office and Georgios Papandreau, the leader of PASOK, was named the new prime minister. When he came to power, he was warned by the governor of the Bank of Greece that the state of public finances was far worse than officially stated. According to internal estimates, the deficit this year was expected to reach 10% of GDP, rather than 6% as predicted. The fiscal situation was further clarified on October 19 during the Eurogroup meeting in Luxembourg. On that occasion, Greek Finance Minister Georgios Papakonstantinou admitted that the deficit would reach 12.5% of GDP in 2009 and that it had reached 7.7% of GDP the previous year (instead of the 5% previously indicated).

[44] IMF (2009) IMF country report No.09/244 of August 2009, available at: https://www.imf.org/external/pubs/ft/scr/2009/cr09244.pdf.

With government finances far worse than anticipated, the Fitch rating agency downgraded Greece's credit rating to A-[45] on October 22. As government bonds were deemed riskier, yields on them began to rise. Greek banks, which held huge amounts of government debt, saw their holdings reduced and this caused what has been called a 'doom loop'. Since Greece and its banks were heavily intertwined, the fear of one defaulting amplified the fear of the other defaulting, in a loop that seemed impossible to stop from within. An immediate collapse was avoided thanks to the liquidity facilities of the ECB: the ECB accepted Greek government bonds as collateral to lend money to Greek banks; as Greek banks used this money to buy new government bonds, the yield on them was kept under control. However, the situation deteriorated visibly and in December Greece's credit rating was further downgraded to BBB+.

With the beginning of the new year, the situation did not improve. Greece seemed to be stuck in a crisis for which there were no visible ways out. Interest rates continued to rise and with them the burden of public debt on the Greek economy. In order to return to a sustainable situation, the government had raised taxes and cut public spending, with the only result being a further decline in output. It quickly became clear that the situation was not sustainable and that Greece could not recover on its own. Borrowing on the financial markets became excessively expensive, so Greece could only count on the funds it could collect through taxes. Considering that the deficit had exceeded 10% of GDP in the previous year (the final figure estimates it at more than 15% of GDP), it was not credible that Greece would have been able to achieve a balanced budget. Moreover, GDP was forecast to fall by at least 2%[46], and the Greek population was already demonstrating against the austerity measures imposed on it by the government.

[45] A complete explanation of the meaning of credit ratings can be found at: https://www.fitchratings.com/products/rating-definitions.

[46] Bank of Greece (2010) Monetary policy 2009-2010, Bank of Greece Printing Works, Athens.

In February 2010, European leaders began to discuss the possibility of a bailout for Greece. This happened at the European Council, which took place on 10 and 11 February[47]. No concrete action was taken, but the mere declaration that euro area member states would have acted if necessary eased the pressure on Greek government bonds. European leaders hoped that the mention of this possibility would be enough to calm the markets and reverse the interest rate trend. But this was not the case: Greek titles amounting at €9 billion to bondholders were to arrive at maturity on 19 May, and investors feared that the government would not be able to pay them in full. European governments decided there was no alternative to keeping their promise and on 11 April announced a €45 billion financial package to support Greece. Under pressure from German Chancellor Angela Merkel, the International Monetary Fund (IMF) joined the support for Greece[48], contributing €15 billion.

2.4) The first adjustment program

Even after the announcement of the aid package, financial markets were still uncertain about Greece's future. Not only were they not sure whether all member states would actually approve the funds, but they also strongly doubted that the 45 billion euros would be enough to stabilise Greece. Moreover, since the IMF and European leaders would become 'senior lenders'[49], not all investors felt that official financial assistance would give them more chance of getting their money back. As Greek citizens continued to withdraw their bank deposits, Papandreou was finally forced to ask for the promised bailout to prevent failure of Greek banks. The request was made on 23 March in a video conference from Kastellorizo.

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[47] Eurogroup (2010) Eurogroup statement, 11 February 2010, available at: https://www.consilium.europa.eu/media/20485/112856.pdf

[48] The decisions that led to the Greek bailout and to the involvement of the IMF will be discussed further in chapter 3 and 4.

[49] That means that they would have a priority on the restitution of loans over private lenders.

The negotiations that began after Papandreou's statement lasted only ten days: on 2 May, the Eurozone finance ministers announced that they would provide Greece with a bilateral credit line of €80 billion. A week later, on 9 May, the IMF announced its decision to grant the country a 'stand-by loan' of €30 billion. This was the highest sum ever lent to a country, both as an absolute figure and in comparison to the IMF participation rate. The sum of €110 billion was the result of a calculation that estimated Greece's financial needs for the following 3 years at €190 billion and assumed that Greece would be able to raise €80 billion on the financial markets[50]. The granting of the loans was conditional on the signing of a Memorandum of Understanding[51] (MoU). The MoU contained a series of reforms aimed at achieving a balanced budget in the medium term. The funds were to be released in quarterly tranches and linked to the implementation of specific measures planned in each quarter.

The conditions concerned both fiscal consolidation (i.e. an increase in taxes and a cut in government spending) and the implementation of structural reforms. The main objective was to help Greece increase its competitiveness. Since Greece had adopted the euro, it was no longer possible to devalue the nominal value of the currency: the only solution remained real devaluation through disinflation of the Greek economy. Austerity measures were to encourage disinflation, while structural reforms were to eliminate distortions and waste. Meanwhile, loans from the IMF and eurozone members were to be used to secure the liquidity needed to restore the credibility of the system and pay off the government deficits until 2011. After a period of recession, which was seen as inevitable, Greece was projected to start growing again in 2012. Structural reforms were concentrated in 7 sectors:

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[50] IMF (May 2010) IMF Country Report No. 10/110 - Greece: Staff Report on Request for Stand-By Arrangement, available at: https://www.imf.org/external/pubs/ft/scr/2010/cr10110.pdf.
[51] European Commission (2010) Greece: Memorandum of Understanding (3 May 2010) Specific Economic Policy Conditionality, available at: https://crisisobs.gr/wp-content/uploads/2013/03/Mou_03_05_20101.pdf.

- Public administration: the most important measures were the merging of local authorities, the obligation to publish online all decisions involving the commitment of funds, the simplification of the remuneration system for the basic salaries of public sector employees, the initiation of independent functional audits of public administration and existing social programmes, the creation of a single payment authority for the payment of public sector wages, the introduction of a central procurement authority and the establishment of an electronic platform for public procurement;

- Labour market and wages: the labour market should be made more flexible by simplifying the rules for registering new employees, reducing employment protection and stopping the increase in minimum wages;

- Pensions: A reduction in the number of funds to three, a gradual increase in the retirement age, the introduction of a 'pro rata' system and a reduction in the list of heavy occupations to include no more than 10% of employees;

- Health care: the introduction of a new legal framework for health supplies and the improvement of recording of health care expenditure;

- Business environment: competition should be improved by simplifying the norms for establishing new businesses, opening up restricted professions and liberalising the transport and energy sectors;

- Investment and export promotion: the legal framework for investment should be amended to increase foreign direct investment in innovative and strategic sectors, and a new programme for public research should be introduced;

- Structural and Cohesion Funds: reforms were needed to improve the capacity of the Greek administration to use Structural and Cohesion Funds.

The measures included in the MoU were mostly reforms that had been on the agenda for decades, but no government had had the courage to adopt them. The inability to implement these reforms had been the main obstacle to Greece's development. That the reforms were necessary can hardly be doubted, as government spending was undoubtedly far above what was reasonable and sustainable for Greece. However, the programme led to a further deterioration of the situation due to two problems: the lack of a credible assessment of the sustainability of Greek public debt (and thus the conclusion that restructuring could be avoided) and the underestimation of the negative impact of the reforms and fiscal consolidation on the Greek economy[52].

The forecasts about the development of the Greek economic situation were clearly too optimistic. The fact that it was assumed that Greece would raise 80 billion euros on the financial markets also shows that the seriousness of the problem had not been fully understood: after Papandreou's declaration Greece could not borrow on the financial markets until 2017 (with the exception of a small titles emission in 2014). As will be explained further in chapter 3, the projections were too optimistic because this was the only way to get it together with the funds that the other eurozone members could provide and assuming that restructuring Greece's sovereign debt was not an option.

The result was a programme that deepened the recession in the short term and offered no plausible way to return to sustainable public debt in the medium term. PASOK parliamentarians tried to soften the austerity measures proposed in the plan, but fearing economic and financial collapse, they eventually accepted its implementation. The Nea Demokratia opposition wanted to avoid

[52] An explanation of the factors that were underestimated is contained in: O. Blanchard and D.Leigh (2013) Growth Forecast Errors and Fiscal Multipliers, *IMF Working Paper* 13 January 2013.

responsibility for the austerity measures and voted against the programme. In the meantime, when the traditional parties seemed to have failed, two new parties began to court approval at the two opposite poles of the political spectrum: the far-right Golden Dawn and the radical left Syriza. Golden Dawn was an ultra-nationalist party that won approval with an anti-Euro and anti-migrant platform. Syriza, on the other hand, was a coalition of socialist, ecologist and Marxist parties that rejected austerity policies. PASOK was therefore the only major party to vote for the programme. As a result, its approval rate collapsed in the following months.

The Greek people felt betrayed as their standard of living deteriorated abruptly in just a few years and their elected government was forced to implement unpopular reforms decided from outside. Public anger was mainly directed against the institutions responsible for drafting the programme, namely the Troika, which consisted of the IMF, the ECB and the European Commission. Being the main creditor country, Germany - and especially its Chancellor Angela Merkel - was considered the main responsible for the austerity policy. On the other hand, the German public considered Greece a lazy and wasteful country and disapproved of the use of taxpayers' money to bail Greece out. This polarisation of public opinion was a factor that made it more difficult to find a reasonable way out of the crisis.

After a few months, it became clear that the first programme would not solve the crisis. The recession turned out to be much stronger than expected, also due to the fiscal consolidation measures. From 2009 to 2012, economic growth declined by 17% instead of the estimated 5.5%. The unemployment rate, which was expected to reach 15% arrived at 25%, affecting young people in particular and triggering a wave of emigration. Poverty and income inequality increased steadily until in 2012 real GDP per capita fell below the level of 2000, the year before the introduction of the euro[53]. In the meantime, the implementation of the

[53] ESM (2020) The Crisis in Greece: missteps and miscalculations, *Discussion Paper Series no.9/Programme evaluation II special*, Publications Office of the European Union, Luxemburg.

ambitious reform package was proving very difficult due to the shortcomings of the Greek administration and the shrinking economy. Statistics remained inadequate and the lack of reliable data was a major obstacle. An impressive shortcoming was the lack of a common register for civil servants[54], which made it impossible to determine the exact number of civil servants in Greece. Tax collection efficiency did not improve, privatisation was much smaller than expected and labour market reform slowed down due to the recession. Targets were not met and as GDP continued to shrink, the debt burden grew. The first adjustment programme had failed and it was necessary to act quickly to change course.

2.5) The path toward a second rescue program

In January 2011, almost a year after the first bailout programme was approved, there were no signs of economic recovery. On 14 January, Fitch became the last of the three major agencies to downgrade Greek debt below investment grade (BB+). The credit downgrade continued until the end of July, when Greece became the lowest-rated country in the world[55].GDP was still shrinking and the country continued to run deficits, the only difference being that these deficits were now covered by official institutions instead of private creditors. The gradual replacement of private creditors[56] by public institutions did not increase the stability of the securities. Since the IMF and the Eurozone were 'senior creditors', private bondholders would have been the first to bear losses. The main problem with this replacement, however, was that the taxpayers of the Eurozone countries had to pay for the risks taken by the investors, while the

[54] Thomas Wieser (2019) "Runaway train: Greece sounds the alarm", *Safeguarding the euro in Times of crises: The inside story of the ESM*, Publications Office of the European Union, Luxemburg, pp.31-44.
[55] G.Georgiopoulos, W.Brandimarte (2011) Greece falls to S&P's lowest rated, default warned, *Reuters*, 13 June 2011.
[56] As the public debt titles detained by private investors arrived at maturity, they were paid with the money borrowed by the eurozone members and the IMF; in the long term this would have led to a total substitution.

investors got all their money back. Eurozone leaders did not want to put more money into Greece, but the start of a recovery was still far away.

In March, an emergency EU summit decided to ease the pressure on Greece by lowering interest rates and extending the maturities of loans granted by eurozone members. The need for a stronger change of course became clear in July, when the fourth (and final) review of Greece's first programme was published[57]. The review confirmed what observers had known for months: the recession was much worse than expected and the implementation of reforms was not progressing. As the programme failed to move forward, euro area leaders were less and less willing to continue paying out their taxpayers' money. In order to decide on a new strategy to deal with the Greek debt, the Eurogroup decided to meet in Luxembourg on 20 June 2011. A few days before this date, the Greek Finance Minister Papaconstantinou was replaced by Evangelos Venizelos, a long-time politician who had less experience with the financial markets but more credibility with the Greek people. At the Eurogroup meeting, Eurozone ministers recognised that Greece needed more money and that it would not regain access to the private market any time soon[58]. They agreed to prepare a second adjustment programme, but stipulated that private sector bondholders should share in the cost of the operation. This private sector participation was initially envisaged on a very small scale and consisted only of the voluntary rescheduling of existing Greek bonds at maturity.

In order to create the conditions for a further adjustment programme, the Greek government introduced new fiscal consolidation measures. Even though progress was considered too slow by the creditors, the norms implemented since 2009 meant a sharp cut in government spending and a huge deterioration in the living conditions of the Greek population. In implementing the reforms, the

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[57] European Commission (2011) European Commission, Directorate-General for Economic and Financial Affairs (2011) *The Economic Adjustment Programme for Greece fourth review*, Occasional Paper 82, July 2011.

[58] Eurogroup (2011) Statement by the Eurogroup on Greece, 20 June 2011, available at: https://ec.europa.eu/commission/presscorner/detail/en/MEMO_11_426

government faced strong domestic opposition and had to deal with daily demonstrations. European leaders said they were aware of the sacrifices Greek citizens would have to make, but claimed there was no other way to provide a lasting solution to the country's declining competitiveness[59].

At the end of July, the second programme began to take shape. It was based on 3 main elements: a second concession of loans from the IMF and European sources, private sector participation and the continuation of the fiscal consolidation programme. Over the next few months, negotiations focused mainly on the appropriateness of private sector participation and how it should be realised. It was clear that a reduction in Greek debt was necessary, but sceptics pointed out that imposing losses on bondholders would lead to a loss of credibility for bonds issued by other countries. It was necessary to ensure that the measure was absolutely exceptional and would not be repeated. Another problem was the fact that private sector participation was to remain legally voluntary in order to avoid an official default.

Less than a week later, on 31 October, Greek Prime Minister Papandreou called for a referendum on whether to approve a second bailout programme for Greece[60]. Papandreou was aware of the fact that the measures his government was taking were very unpopular and he was not prepared to take sole responsibility for them. However, European leaders reacted very angrily to this announcement. They had committed their taxpayer's money to bail out Greece and now it was unacceptable that Greece claimed its right to reject the terms. They immediately made it clear that by rejecting the bailout programme (and it was likely that this would have been the outcome of the referendum) Greece

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[59] Statement by the Heads of State and Government of the Euro area and EU Institutions, 21 July 2011, available at: https://www.consilium.europa.eu/media/21426/20110721- statement-by-the-heads-of-state-or-government-of-the-euro-area-and-eu-institutions-en.pdf.

[60] K.Hope, P.Spiegel and T.Demos (2011) 'Greece calls referendum on EU bail out', *Financial Times,* 31 October 2011.

would also have signed its exit from the Eurozone[61]. Only three days after this announcement, on 3 November, Papandreou cancelled the referendum. Aware that both European leaders and the Greek people had lost confidence in him, Papandreou resigned on 10 November. The next day, a government of national unity was formed, led by former ECB vice-president Lucas Papademos.

2.6) The second adjustment program

The new government was the result of an agreement between Papandreou and Antonis Samaras, leader of Nea Demokratia. All other parties refused to participate, with the exception of the Orthodox Rally, a small right-wing party. Nea Demokratia had until then criticised the austerity measures, but agreed to support them when it came to government. The government was to last only for a few months. Its mandate was to reach an agreement on the second adjustment programme and then lead the country to new elections at the beginning of the following year. The most urgent and complex objective to be achieved was the agreement on the exchange of private sector debt. Negotiations were difficult and it was not until early February 2012 that the terms of the exchange were agreed with the representatives of the private sector bondholders. Once this obstacle was overcome, all the other pieces were in place. At the end of a Eurogroup meeting on 21 February 2012, the main elements of the agreement were announced: a 53.5% haircut on the face value of Greek bonds, a payout of up to €130 billion by the Eurozone[62] and the IMF, and the implementation of new fiscal consolidation measures[63]. The conditions included a reform of the pension system, higher taxes, a 20% cut in the minimum wage, a reform to make employment conditions more flexible and the

[61] G.Papaconstantinou (2019) “From bailout to bail-in: towards a new programme for Greece”, *Safeguarding the euro in Times of crises: The inside story of the ESM*, Luxemburg, Publications Office of the European Union, pp.165-174.
[62] The funds from the eurozone were no longer provided through ad hoc bilateral loans but through the European Financial Stability Facility (EFSF).
[63] Eurogroup (2012) Eurogroup statement, 21 February 2012, available at: https://www.consilium.europa.eu/media/25716/128075.pdf

elimination of 150,000 public sector jobs. The restructuring of the public debt began on 9 March and the agreement was officially signed on 14 March.

The 'private sector involvement' resulted in the biggest sovereign writedown in history. The holders of 96.9% of the bonds (amounting to about €199 billion) voluntarily participated in the proposed deal: it consisted of exchanging the old bonds for new bonds with a face value 53.5% lower than the previous ones. The EFSF itself contributed to the issuance of securities to facilitate the exchange[64]. The move reduced Greece's outstanding debt by about €107 billion. The operation went surprisingly smoothly, but it also contained some problematic elements. First of all, it was made possible by the Greek parliament passing a law on 23 February that retroactively changed the terms of the bonds issued by introducing a Collective Action Clause (CAC). The CAC allows a majority of bondholders (holding at least 75% of the bonds) to agree to a debt restructuring that is legally binding on all other bondholders. A second element that could give rise to criticism is the fact that bondholders who held back bonds issued under different jurisdictions and refused to participate in the operation were fully compensated. This possibility had been explicitly excluded, but apparently there was no other viable option. In the end, the operation was successful and did not lead to the collapse of the credibility of European securities feared by some observers.

Following the approval of the deal, Prime Minister Papademos stuck to the agreement that had led to his appointment and called for new elections in May. The new parliament that emerged was very fragmented, as no party had reached 20% of the ballots. The main party was now Nea Demokratia (18.9%), followed by the radical left Syriza (16.8%). PASOK, which had passed the 40% mark only 3 years earlier, collapsed at 13%. The leaders of the 3 main parties were successively asked to form a government, and after they all failed, new elections were called in June. Here Nea Demokratia emerged victorious (29.7%) and its leader Antonis Samaras was able to form a new government

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[64] Reuters Staff (2012) Factbox: terms of the Greek bond swap laid bare, *Reuters*, 7 March 2012.

with external support from PASOK and the small centre-left party DIMAR. The main opposition party was Syriza (26.9%), which had abandoned its Eurosceptic views but whose main proposal was to reject austerity.

The new government immediately resumed negotiations on the implementation of the adjustment programme. The government achieved a slower pace of fiscal adjustment with the setting of more achievable targets. The primary surplus target for 2014 was lowered to 1.5% of GDP, instead of the previously planned 4.5%. The measures to be implemented were divided into 89 policy steps and payment instalments were disbursed only when certain targets were reached[65]. Throughout 2013 and the first half of 2014, the programme was implemented as planned. The first cautious signs of recovery were visible. In 2013, Greece achieved a primary surplus of 1.2 billion euros. In 2014, GDP recorded modest growth (0.7%). This was the first time since 2007. As ten-year bond yields were consistently around 6% in the summer of 2014, the government decided to borrow from the financial markets on two separate occasions.

However, the recovery was still fragile and not destined to last. In the second half of 2014, reforms began to slow down and it became clear that Greece would not reach the conditions for completing the programme. The second programme was supposed to end in December 2014 and the disbursement of the last tranche was linked to the achievement of the final targets. Samaras had used up all his political capital and was no longer able to continue with structural reforms. After six years of recession, he felt he no longer had the political backing to get parliament to approve another round of cuts and structural measures. By the end of 2014, the conditions had not been met: the target of a primary surplus of 1.5% of GDP was not reached and the final structural reforms to complete the programme were not implemented. At the Eurogroup meeting on 8 December, Eurozone ministers declared that it was not possible to

[65] Thomas Wieser (2019) A ‘big mistake’: Greece’s second rescue stumbles, *Safeguarding the euro in Times of crises: The inside story of the ESM*, Luxemburg, Publications Office of the European Union, pp.189-200.

complete the review of the programme and disburse the remaining €1.8 billion. They proposed an extension of the programme until the end of February 2015 to allow the Greek government to implement the remaining reforms[66]. As it was clear that Greece was not yet ready to sustainably take all the money it needed from the markets, the Eurogroup also declared its support for a third programme financed by the European Stability Mechanism (ESM).

Samaras found himself in a stalemate because, on the one hand, he could not convince the parliament to adopt further reforms and, on the other hand, he could not convince the European leaders of the need for a change of strategy. In an attempt to break the stalemate, Samaras anticipated the elections for President of the Republic by two months. The President of the Republic had a largely ceremonial role and could not change the situation. However, Samaras felt that an election within parliament could break the deadlock. In the vote that followed, the parliament was unable to elect a new president[67] and in late December Samaras was forced to call new parliamentary elections for 25 January 2015[68].

2.7) On the edge of 'Grexit'

The elections took place in a climate of great tension and uncertainty. From 8 December 2014, interest rates on government debt began to rise again in anticipation of a period of instability. The two main candidates were Samaras, which stood for continuity, and Alexis Tsipras, Syriza leader, whose main proposal was a renegotiation of the agreements with creditors. On 25 January,

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[66] Eurogroup (2014) Eurogroup statement on Greece, 8 December 2014, available at: https://www.consilium.europa.eu/en/meetings/eurogroup/2014/12/08/.

[67]According to the Greek constitution in force until 2019, a President of the Republic is elected with ⅔ of votes in the first two ballots or with ⅗ of votes in the third. If after the third ballot the President is not elected, the parliament is dissolved and new elections are held. This norm was then changed in 2019 when the link between the election of the President and the dissolution of the parliament was eliminated.

[68] The Economist staff (2015) Samaras's failed gamble, *The Economist*, 3 January 2015.

Syriza emerged as the clear winner. It won 36.4% of the vote and 149 parliamentary seats, only two short of an absolute majority[69]. Alexis Tsipras was appointed the new prime minister the next day. The absolute majority was achieved through an agreement with ANEL, a nationalist and Eurosceptic party that shared with Syriza the rejection of austerity policies. Nea Demokratia, which won 27.8% of the vote, became the main opposition party, while PASOK almost disappeared with less than 5% of the vote.

The new government had a clear mandate from the Greek people to reject the policies of the last six years. As it prepared for tough negotiations with the Troika, Tsipras appointed Yanis Varoufakis as chief negotiator and finance minister. Varoufakis was an economist and university professor who had become known for his opposition to the Greek bailout and austerity measures. He believed that there was no way out of the crisis without changing the terms of the adjustment programmes. For this reason, he believed that leaving the Eurozone would have hurt Greece less than sticking to austerity. Grexit, as the exit from the eurozone was called by the newspaper at the time, was not his preferred solution. He would prefer a fair agreement with the Troika. However, he was prepared to lead Greece out of the Eurozone if his counterpart refused to change his position. This negotiating position was designed to change the rules of the game: while his predecessors had accepted the conditions imposed by the Troika under the threat of a forced exit from the Eurozone, the same threat was retorted toward the European counterparts.

European leaders did not react positively to the new government's positions. Keeping Greece in the Eurozone had required and was still requiring an enormous amount of taxpayers' money. Greece still had high deficits (see fig. 2.4) and since it did not have access to the financial markets, these deficits were financed by international loans from 2010 onwards. Under these conditions, European leaders would not have allowed higher deficits. Another

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[69] Greece's electoral law consists of a proportionate system for 250 seats and a majority bonus of 50 seats for the party that obtained the relative majority of votes.

solution of the Greek negotiator was further debt restructuring. However, after 2012, more than 80% of Greek government debt was held back by official institutions[70]. Restructuring would have meant losses borne by European (and, in the case of the IMF, also non-European) taxpayers. The 2012 restructuring had only been acceptable because the losses were borne by the bondholders who had accepted the risks by buying Greek bonds.

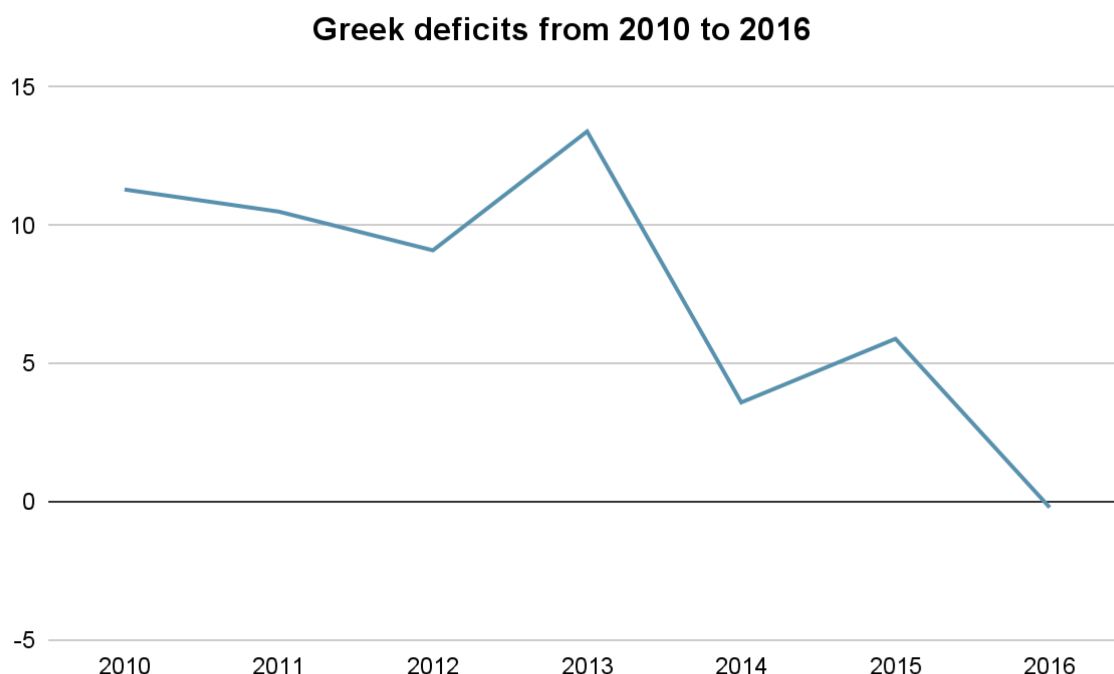

Fig. 2.4- From 2010 to 2016 Greece continued to run high deficits even if it did not have access to financial markets.
Source: Eurostat database. Last update 22 October 2021.

As the positions of the two counterparts were irreconcilable, the fragile cooperation with the international institutions ended. The first concrete result of the new situation was the decision by ECB to no longer accept Greek bonds as collateral for the Eurosystem's monetary operations[71]. The decision was legitimate because the rating of the Greek bonds was below investment

[70] Public Debt Management Agency Website: https://www.pdma.gr/en/public-debt-strategy/public-debt/composition-of-debt/maturity-profile-en.
[71] ECB (2015) Eligibility of Greek bonds used as collateral in Eurosystem monetary policy operations, Frankfurt, Directorate General Communications, 4 February 2015.

grade[72]. They had been accepted as collateral by ECB only because of the commitment to stick to the adjustment programmes[73]. Since the completion of the bailout programme was in doubt, the exemption that allowed the ECB to accept Greek bonds as collateral no longer had any justification. However, the decision was interpreted by Greek negotiators as a political move to put pressure on the new government. The immediate situation of the Greek banks did not change, as they could still borrow money from the Bank of Greece (BoG) through the Emergency Liquidity Assistance (ELA)[74]and the BoG could still borrow money from the ECB. However, Greek banks were no longer able to borrow money directly from the ECB and stopping the ELA would have blocked the supply of liquidity to Greek banks.

The first issue negotiated between Greece and the Troika was the extension of the deadline for the second adjustment programme. This was supposed to be completed by the end of February, but Greece had not met the conditions for the disbursement of the last tranche. After 10 days, an agreement was reached on a 4-month extension until the end of June. This extension also indirectly set the deadline for the negotiations.

Then the actual negotiations began, but no progress was made as the positions of the two sides seemed irreconcilable. The Greek negotiators demanded an end to budget cuts, an increase in wages and the concession of a new loan. Since Greece was still running deficits financed by international loans, an increase in government spending was not acceptable to European leaders. A stalemate soon ensued, as both sides seemed to prefer Grexit to a compromise. Syriza knew that by agreeing to continue it would have lost all its credibility, as it had only won the election on its promise to radically change the conditions of the programme.

[72] According to the Eurosystem rules, the ECB cannot accept as collateral bonds whose rating was below investment grade. According to this rule, Greek bonds would have been unacceptable since 2010.
[73] ECB (2010) ECB announces change in eligibility of debt instruments issued or guaranteed by the Greek government, Frankfurt, Directorate General Communications, 3 May 2010.
[74] Reuters Staff (2015) Factbox: What is ECB Emergency Liquidity Assistance (ELA)?, *Reuters*, 22 June 2015.

It was clear that without a deal Greece would default as it did not have the money to repay the loans as they came due. Greek titles were further downgraded to CCC as financial markets became increasingly pessimistic. The Greek government began to look for alternatives. In search of money from Russia, Tsipras visited Russian President Vladimir Putin[75]in April. He did not achieve any result, but the move further alienated the positions of the negotiators. Both sides began to draw up plans in prevision for the exit of Greece from the eurozone[76]. At the end of April, Varoufakis was replaced as chief negotiator by Eukleidis Tsakalotos. Varoufakis had indeed become a very divisive figure, and having him as chief negotiator was seen as an obstacle to reaching a compromise. The tone of the negotiations improved, but a compromise was still far away.

In May, it became clear that Greece was running out of money. On 12 May it used its reserve account with the IMF[77] to repay €750 million to the IMF itself. This was a very unorthodox move and increased tensions with the IMF, but since the Greek government had no other money, it was the only way to avoid default. The problem recurred on 4 June when Greece was forced to postpone a payment of €300 billion to the IMF. The meetings were not producing steps toward an agreement: the creditors' proposal was rejected by Greece, which submitted a counter-proposal. As there were major differences between the two proposals, the talks were broken off.

In mid-June, just two weeks before the deadline, the Eurogroup asked Greece to submit a new reform proposal in the following days[78]. A week later, on 22 June 2015, the President of the European Council, Donald Tusk, called

[75] D.M.Herszenhorn and L.Alderman (2015) Putin meets Alexis Tsipras of Greece, raising eyebrows in Europe, *The New York Times*, 8 April 2015.
[76] Klaus Regling (2019) Moving towards Grexit: at the cliff's edge,*Safeguarding the euro in Times of crises: The inside story of the ESM*, Luxemburg, Publications Office of the European Union, pp.311-320.
[77] According to the IMF rules, member countries have two accounts with the IMF: one where they deposit their annual quota and another where they store reserves, including gold, for emergencies.
[78] Eurogroup (2015) Eurogroup statement on Greece, 18 June 2015, https://www.consilium.europa.eu/en/meetings/eurogroup/2015/06/18/.

Eurozone leaders to Brussels for an emergency summit on Greece. On this occasion, Greece presented a new reform proposal, which was taken as a starting point for the negotiations. The aim of the emergency meeting was to negotiate directly in order to reach an agreement by 30 June. Failure to reach an agreement before the end of June would mean losing the possibility of receiving the remaining loan tranche from the second programme. However, on 26 June, the negotiations broke down again and the Greek negotiators decided to walk away from the table. On 27 June, Tsipras announced a referendum to let the Greek people decide whether or not to accept the bailout terms proposed by the creditors.

Calling the referendum was a big step towards leaving the Eurozone. With the Greek banks now highly likely to become insolvent, the ECB decided not to extend the ELA ceiling[79]. It was a forced step (ELA can only be granted to solvent banks and against adequate collateral), but it was also interpreted as a way to put pressure on the Greek government and population.A run on the banks began and on 28 June Greece announced the introduction of capital controls and a bank holiday from the next day[80].On 30 June, the second adjustment programme was officially closed[81] and Greece missed an IMF payment of €1.5 billion[82].

On 5 July the referendum was held and the Greek people rejected the creditors' proposal by 61% to 39%. It was a clear denunciation of the harsh conditions imposed on the Greek people since 2009. Although he had campaigned for the rejection of the proposal, Tsipras decided after the vote to resume negotiations with the creditors. The first step was to replace Yanis Varoufakis, who was

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[79] ECB (2015) ELA to Greek banks maintained at its current level, Frankfurt, Directorate General Communications, 28 June 2015.

[80] L.Papadimas, G.Georgiopoulos (2015) Greece imposes capital controls as crisis deepens, *Reuters*, 28 June 2015.

[81] ESM (2015) 'EFSF programme for Greece expires today', Press release, 30 June 2015, available at: https://www.esm.europa.eu/press-releases/efsf-programme-greece-expires-today.

[82] IMF (2015) 'Statement by the IMF on Greece' Press release, 30 June 2015, available at: https://www.imf.org/en/News/Articles/2015/09/14/01/49/pr15310.

asked to resign, with the more diplomatic Tsakalotos. On 8 July, Tsipras asked for the start of a new ESM-funded programme and the next day a programme was presented with a set of new reform plans. The European Commission and the ECB responded favourably to the Greek request and cleared the way for the third adjustment programme.

2.8) Turning the corner

The first two weeks of July 2015 were the closest Greece came to leaving the Eurozone. In those days, the German Finance Minister Wolfgang Schäuble proposed a temporary exit of Greece from the Eurozone for 5 years. The decisive moment for Greece's membership in the euro was an outright negotiation that took place on 12 July between Tsipras, Merkel, Hollande and European Council President Donald Tusk[83] The next morning, an agreement was reached. The Eurogroup accepted the opening of a third bailout programme on the condition that Greece implemented a number of tough reforms. The agreement also stipulated that the Greek parliament had to approve a list of reforms[84] in the following 10 days as a precondition for the talks to proceed. On 17 July, Greece was granted a €7 billion bridge loan from the European Financial Stabilisation Mechanism (EFSM) to cover the country's immediate needs. This liquidity enabled Greece to clear its arrears with the IMF and allowed the banks to reopen after three weeks.
The third adjustment programme was approved on 14 August 2015 and provided loans from the ESM of up to €86 billion. The IMF did not participate in the programme as it considered that Greek public debt was still unsustainable in the long run. The plan had a duration of three years and the disbursements were divided into tranches and linked to the achievement of certain conditions. The main reforms concerned VAT, income tax, the pension system, insolvency

[83] A.S.Chassany, A.Barker and D.Robinson(2015) Greece talks: ''Sorry, but there is no way you are leaving this room'', *Financial Times*, 13 July 2015.
[84] Eurogroup (2015) Euro summit statement, 12 July 2015, available at: https://www.consilium .europa.eu/en/press/ press-releases/2015/07/13/euro-summit-statement-greece/.

law, public revenue collection, product markets, privatisation, public administration and social protection. Since the Syriza government had done exactly what it had been elected not to do, Tsipras felt that he had to call new elections to legitimise his position. New elections were held on 20 September 2015 and Syriza retained its position with 35.5% of the vote. Tsipras remained prime minister and now had a mandate to implement the new reform programme.

After the adoption of the third adjustment programme, Greece seemed to have finally turned the corner. The effects of the austerity measures still hit the Greek population hard, but the economy began to show clear signs of recovery. One of the first steps was the recapitalisation of the 4 core banks. Their financial needs were estimated by the ECB at between €4.4 and €14.4 billion[85] In the end, only 5.4 billion euros were needed, as the banks were able to cover most of their needs on the financial markets. The recapitalisation of the banks was a fundamental step as it restored confidence in the solvency of the banks and allowed the situation to stabilise.

The programme proceeded as expected in the months and years that followed. All necessary measures were implemented and the ESM approved all agreed disbursements. On 9 May 2016, the Eurogroup agreed on debt relief measures for Greece[86]. As a cut to the nominal value of Greek debt was politically impossible (public opinion in the creditor countries would not accept this), the debt relief was to be granted by reducing interest payments and extending the maturity of the securities. Therefore, the repayments of the loans granted through the EFSF and the ESM are scheduled between 2034 and 2060[87]. Once confidence in Greek solvency was restored, the government decided on a gradual return to the financial markets. On July 25 2017, after a 3-year absence

[85] ECB (2015) ECB finds total capital shortfall of €14.4 billion for four significant Greek banks, Directorate General Communications, Frankfurt, 31 October 2015.
[86] Eurogroup (2016) Eurogroup statement on Greece, 9 May 2016, available at: https://www.consilium.europa.eu/en/press/press-releases/2016/05/09/eg-statement-greece/.
[87] ESM (2018) Explainer on ESM and EFSF financial assistance for Greece, 20 August 2018, available at: https://www.esm.europa.eu/assistance/greece/explainer-esm-and-efsf-financial-assistance-greece.

from financial markets, Greece raised €3 billion in 5-year bonds. The process continued and in February of the next year, €3 billion was raised in 7-year bonds.
Based on the progress made by the Greek economy at the end of July, the Eurogroup declared that the adjustment program would soon be completed and that no follow-up program would be needed[88]. The final disbursement of €15 billion by the ESM was made in early August, and the program formally ended on August 20, 2018.

Summary

After the introduction of the single currency, the convergence of interest rates on the sovereign debt of member states led to a huge flow of capital from the core to the periphery of the Eurozone. Greece was one of the countries that benefited most from this trend, but was unable to turn it into a long-term advantage. The increased funds were mainly used for current expenditure instead of productive investment. This situation reduced Greece's competitiveness and led to an unsustainable situation, as the large deficit in the balance of payments was paid for by an increase in public debt. When the financial crisis began in the US, the flow of money reversed and put Greece in an unsustainable situation. The public debt was too high to be sustained and was set to rise further as Greece exported far more than it imported.

To avoid a Greek default, the other Eurozone member states prepared an aid programme in 2010. The aim of this programme was to facilitate the process of internal devaluation that Greece needed to become competitive again. However, the Greek economy continued to deteriorate as the measures of the

[88] Eurogroup (2018) Eurogroup statement on Greece, 22 June 2018, available at: https://www.consilium.europa.eu/en/press/press-releases/2018/06/22/eurogroup-statement-on-greece-22-june-2018/#:~:text=The%20Eurogroup%20welcomes%20the%20commitment,strategy%20by%20the%20Greek%20authorities.

first programme exacerbated the recession. Two years later, a second programme was adopted, this time also including a sharp debt cut. The second programme was an important step towards a sustainable situation. However, the living conditions of the Greek people had continued to deteriorate for 6 years and in 2015 the newly elected government refused to abide by the terms of the programme. This breach almost led to Greece's exit from the Eurozone. However, at the end of a difficult negotiation, this option was avoided and an agreement was found for a third adjustment programme. The last programme was successfully completed at the end of 2018, with Greece still vulnerable but finally out of the crisis.

Chapter 3: The Eurozone faces up to the crisis

With the outbreak of the sovereign debt crisis in Greece, it became clear that the Eurozone was not prepared for such an eventuality. The architecture of the Eurozone did not have instruments to respond to crises that specifically affected one country: the so-called asymmetric crises. Not only was there no provision for a response, in the fundamental treaties (the Treaty on European Union and the Treaty on the Functioning of the European Union) there were norms deliberately created to avoid supporting a particular state: article 123 TFEU, which prohibited any kind of credit facility with the ECB or national central banks for a public authority; and article 125 TFEU, which prohibited the Union and any member state from assuming obligations from public authorities of other member states.
The idea behind these rules was that the fiscal surveillance framework was sufficient to ensure cooperation in economic policy and to avoid asymmetric shocks.

The failure of the existing fiscal surveillance framework to prevent the sovereign debt crisis led to a response at three levels. First, it was decided to strengthen the fiscal surveillance framework to prevent future crises and restore the credibility of the Eurozone. Second, a mechanism was created to provide financial assistance to member states facing a severe economic downturn. And finally, the ECB took unconventional measures to stabilise the eurozone, going beyond its traditional role and filling a gap in the Eurozone's architecture. These three reactions did not take place in an orderly manner, but in a situation of great uncertainty and urgency. For this reason, many mistakes were made and the system was built according to the principle of "learning by doing".

3.1) The development of the fiscal surveillance framework

With the introduction of a common currency, it was clear that it was no longer possible to maintain different levels of inflation. Member states were not prepared to give up the opportunity to determine their own economic policies. The choice, therefore, was to maintain an independent economic policy and merely introduce a limit on the excessive deficit and debt. The control of the excessive deficit and debt was the only lever on which the European institutions could rely to coordinate the economies of the Eurozone. This lever was not able to provide a response to the crisis, but since it was the only instrument available to the institutions, tightening the rules was the first response to the crisis.

The Maastricht Treaty did not specify the rules to be applied to coordinate the economic policies of the member states. The only provision that applied to the states in the first phase of EMU was to "consider their economic policies as a matter of common concern and coordinate them within the Council" (Art. 103)[89]. Once states reached the second stage of EMU, the Treaty required them to "avoid excessive government deficits" (Art. 109a), which became an explicit obligation in the third stage. The rule for assessing the existence of an excessive deficit was adopted by the Amsterdam European Council on 17 June 1997 and became known as the Stability and Growth Pact (SGP)[90]. The SGP consisted of two regulations (No 1466/97 and No 1467/97), which created a 'preventive arm' and a 'dissuasive arm' respectively.
According to Council Regulation No 1466/97[91], Member States undertake to present each year a 'stability programme' containing the budgetary objective

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[89] Treaty on European Union, *Official Journal of the European Communities*, Maastricht, 29 July 1992 - https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:11992M/TXT&from=IT.
[90] European Council (1997) Resolution of the European Council on the Stability and Growth Pact, *Official Journal of the European Communities*, Amsterdam, 17 June 1997.
[91] Council of the European Union (1997) Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, *Official Journal of the European Communities*, Brussels, 17 June 1997.

and the measures envisaged to achieve it. The medium-term budgetary objective should be a budget close to balance.
Council Regulation 1467/97[92] instead laid down the rules for the correction of an excessive deficit and thus also had a deterrent effect. It defined an excessive deficit as an other-than-temporary and exceptional excess over the value foreseen in the stability programme[93]. In order to correct this deficit, the Council, acting on a proposal from the Commission, could authorise the opening of an 'infringement procedure'. This procedure could lead to sanctions of up to 0.5% of the GDP of the state concerned.

These rules were changed in 2005 towards greater flexibility. Since the introduction of the euro, many states had reached what was defined as an 'excessive deficit', but not all of them were in a problematic situation. Considering the deficit alone was not a good criterion to assess the sustainability of a state's position. The rules also had a pro-cyclical effect, as states were forced to reduce their spending precisely at the time of greatest difficulty. The system had then been delegitimised by the fact that the Council had decided not to take measures in response to the excessive deficits of Germany and France in 2003[94]. The Council's decision was legitimate (the decision to initiate infringement proceedings was at the Council's discretion), but had created the impression that the SGP was not the right instrument for coordinating the economic policies of the member states. In September 2004, the Commission proposed a reform, which the Council adopted in June 2005. The reform consisted of two Council Regulations that gave more flexibility to the SGP to sanction only those states with problematic situations.

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[92] Council of the European Union (1997) Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure, *Official Journal of the European Communities*, Brussels, 17 June 1997.
[93] It refers to the case of an unusual event outside the control of the member state or the case of a severe economic downturn (fall of GDP of at least 2%). To be temporary and exceptional, the distortion must disappear following the end of the unusual event or of the severe economic downturn.
[94] Council of the European Union (2003) Economic and Financial Affairs Council Meeting, 14492/1/03 REV I, Brussels, 25 November 2003.

Council Regulation 1055/2005[95] amended Regulation 1466/97. It stipulates that each Member State shall have a different medium-term objective (MTO), which shall be reviewed regularly. In particular, the MTO is changed each time a major structural reform (which has a cost in the short term but a high benefit in the long term) is implemented. In this way, the target will take into account the specific situation of each state and the reform carried out, rather than looking only at the deficit.
Council Regulation 1056[96] instead amended Regulation 1467/97, expanding the cases in which an overshoot of the deficit target could be considered exceptional and temporary and thus not subject to sanctions. It then provided that the assessment of a state's situation should take into account its medium-term economic and budgetary situation.
This was the set of rules for the coordination of member states' economic policies that was in force when the financial crisis broke out.

With the outbreak of the financial crisis, the dramatic inability of the existing rules to maintain a balanced budget situation in the member states became apparent. Even though the SGP played a positive role in spurring member states to adopt more virtuous fiscal policies, it could not stop the imbalance that emerged in the early years of the eurozone. Greece had systematically violated the SGP, was not sanctioned and had continued to pursue unsustainable economic policies. As this was the only leverage they had, the European institutions responded by tightening the rules for fiscal surveillance. While the first adjustment programme was being implemented, the European institutions engaged in long negotiations that ended in November 2011 with the adoption of the so-called Six-Pack. The Six-Pack consisted of five regulations and one directive and aimed to strengthen and expand the framework for budgetary surveillance:

[95] Council of the European Union (2005) Council Regulation (EC) No 1055/2005 amending Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, *Official Journal of the European Union*, Luxemburg, 27 June 2005.
[96] Council of the European Union (2005) Council Regulation (EC) No 1056/2005 amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure, *Official Journal of the European Union*, Luxemburg, 27 June 2005.

- Regulation No 1173[97] increases the clout of the "preventive arm" of fiscal surveillance. It introduces the possibility of imposing fines on states that fail to take action on a Council recommendation by requiring them to deposit a non-interest-bearing deposit of up to 0.2% of GDP. Fines can also be imposed on member states that intentionally or grossly negligently misrepresent deficit and debt data. The most important reform, however, concerns the introduction of 'reverse qualified majority voting', whereby a Commission recommendation to initiate infringement proceedings can only be rejected by qualified majority[98].
- Regulation No 1175[99] amends Regulation No 1466/97 and introduces the 'European Semester'. The European Semester establishes a common framework to discuss the fiscal, economic and employment challenges of EU countries within a common annual timetable[100]. New areas are added to the traditional area of economic surveillance, and as these are jointly assessed, coordination between member states is strengthened.

- Regulation No 1177[101] amends Regulation No 1467/97 and shifts attention from the annual deficit to debt sustainability. The Commission's surveillance powers are strengthened by introducing the possibility to carry out missions to assess the 'actual economic situation'.

[97] European Parliament and Council (2011) Regulation (EU) No 1173/2011 of the European Parliament and of the Council on the effective enforcement of budgetary surveillance in the euro area, *Official Journal of the European Union*, Strasbourg, 16 November 2011.
[98] This voting system reversed the previous one that required a qualified majority to approve the recommendation.
[99] European Parliament and Council (2011) Regulation (EU) No 1175/2011 of the European Parliament and of the Council amending Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, *Official Journal of the European Union*, Strasbourg, 16 November 2011.
[100] A wider explanation of the European Semester can be find in the official website of the European Commission at: https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/european-semester_en.
[101] Council of the European Union (2011) Council Regulation (EU) No 1177/2011 of 8 November 2011 amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure, *Official Journal of the European Union*, Brussels, 8 November 2011.

- Directive 2011/85/EU[102] lays down detailed rules for Member States' budgetary frameworks. Its main objective is to obtain credible data that are comparable between member states. According to the directive, public accounting must cover all government sub-sectors, ensure that fiscal data are publicly available and that the data are subject to internal control and independent audits.

- Regulation No 1176/2011[103] introduces a set of rules for the detection of macroeconomic imbalances. This issue had never been monitored before, but no sanctions are foreseen in case of breach of the Commission's recommendations.

- Regulation No 1174/2011[104] applies only to the Member States of the Eurozone. It introduces the possibility of penalising states that do not take the measures recommended by the Commission to correct their macroeconomic imbalances with up to 0.1% of their GDP.

The six-pack was a direct consequence of the outbreak of the crisis and the Greek situation in particular (Directive 2011/85/EU was specifically designed to solve Greece's problems with national statistics. The regulations were rather a reaction to the fact that the monitoring mechanism had not been able to stop and sanction the growing imbalance in Greece). However, it was not an instrument that could respond to the critical situation Greece found itself in. As Greece was in a 'severe economic downturn', the SGP had been de facto suspended[105]. However, the European institutions considered it necessary to

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[102] Council of the European Union (2011) Council Directive 2011/85/EU on requirements for budgetary frameworks of the Member States, *Official Journal of the European Union*, Brussels, 8 November 2011.

[103] European Parliament and Council (2011) Regulation (EU) No 1176/2011 of the European Parliament and of the Council on the prevention and correction of macroeconomic imbalances, *Official Journal of the European Union*, Strasbourg, 16 November 2011.

[104]European Parliament and Council (2011) Regulation (EU) No 1174/2011 of the European Parliament and of the Council on enforcement measures to correct excessive macroeconomic imbalances in the euro area, *Official Journal of the European Union*, Strasbourg, 16 November 2011.

[105] ECB (2011) The stability and Growth Pact, crisis and reform, *Occasional paper series No 129*, Frankfurt, September 2011.

introduce a stricter and more effective framework, also to reassure the creditor states.

By the time the Sixpack came into force, the situation had changed again and the need for even stronger regulation was recognised. In November 2011, negotiations began on the so-called 'Two-Pack'. It consisted of two regulations that only affected member states whose currency is the euro[106]:

- Regulation No 473/2013[107] established a common timetable for budget planning, according to which each year eurozone member states must: publish their national medium-term fiscal plans by 30 April at the latest; publish a draft budget plan for the coming year by 15 October at the latest; adopt the central government budget by 31 December at the latest. By 30 November, the Commission must issue an opinion on the draft budget. If it finds serious violations, it can request a revision of the draft.

- Regulation No 472/2013[108] applies specifically to those Member States of the Eurozone that are in serious difficulties and have received financial assistance from the European Union or another relevant international financial institution. For these states, enhanced surveillance is foreseen, including regular review missions and the adoption of six-monthly reports. In this case, the Commission, with the involvement of the ECB and, if possible, the IMF, must assess the sustainability of the Member State's public debt. On the basis of this assessment, the member state

[106] Art. 136 of the TFEU allows the Council to adopt specific measures for Eurozone member states to strengthen the coordination and surveillance of budgetary discipline. This norm is justified by the strong interdependence and the reciprocal spill-over effects that could derive from the budgetary decisions of eurozone member states.

[107] European Parliament and Council (2013) Regulation (EU) No 473/2013 of the European Parliament and of the Council on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area, *Official Journal of the European Union*, Strasbourg, 21 May 2013.

[108] European Parliament and Council (2013) Regulation (EU) No 472/2013 of the European Parliament and of the Council on the strengthening of economic and budgetary surveillance of Member States in the euro area experiencing or threatened with serious difficulties with respect to their financial stability, *Official Journal of the European Union*, Strasbourg, 21 May 2013.

must then prepare a draft economic adjustment programme in agreement with the Commission and the ECB (and possibly the IMF).

The Two-Pack only came into force in May 2013 after very long negotiations. Even though it contained many controversial aspects, both in terms of form and content[109], this package created the legal framework for the implementation of the Greek adjustment programmes.
In parallel to the negotiations on the Two-Pack, the Eurozone member states decided to negotiate a new international treaty to strengthen the fiscal governance network. The new treaty[110] included the so-called 'fiscal compact', which stipulated that all Eurozone member states should introduce fiscal balance norms into their national law, preferably at the constitutional level. The Treaty entered into force on 1 January 2013.

In subsequent years, the rules on budgetary surveillance were not changed, but the European Commission granted more flexibility in their application. Indeed, the rules were seen as too rigid and were attacked for the austerity measures they allowed. In 2014, the Juncker Commission presented a document[111] indicating how budgetary surveillance should be interpreted in the following years. The new interpretation allowed a temporary deviation from the medium-term targets if the change was compensated by productive investments or structural reforms that increased competitiveness or potential growth. Then cyclical conditions were taken into account by excluding from the assessment those developments that were beyond the control of governments.

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[109] Formally, the introduction of such important changes through secondary legislation was very controversial. On the content, it introduced a control on the economic policy of states under enhanced surveillance that went far beyond the 'coordination of economic policies' that had been envisaged by the Maastricht treaty.
[110] Treaty on Stability, Coordination and Governance. vailable at: https://www.consilium.europa.eu/media/20399/st00tscg26_en12.pdf.
[111] European Commission (2015) Communication from the Commission (2015), Making the best use of the flexibility within the existing rules of the Stability and Growth Pact, Strasbourg, COM(2015) 12 final, 13 January 2015, availabje at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52015DC0012&from=EN

3.2) The creation of the financial assistance mechanisms

When the financial crisis erupted in Europe, the Eurozone lacked a mechanism to provide financial assistance to its members. When the Eurozone was designed, the rules on fiscal surveillance had been considered sufficient to avoid the emergence of major imbalances. The only provision that contained a reference to financial assistance was Article 122 of the Treaty on the Functioning of the European Union (TFEU)[112]. This article states that "where a Member State is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control, the Council, on a proposal from the Commission, may grant, under certain conditions, Union financial assistance to the Member State concerned". However, it was unclear whether a sovereign debt crisis could be considered "beyond the control" of the member state in difficulty. Then there was the problem of where the funds for the assistance would come from: it was clear that the Union aid provided for in Article 122 could not exceed the Union's own resources. These funds were far less than what Greece needed in 2010.

In the absence of an instrument to provide aid within the European legal framework, it was decided to support Greece through bilateral loans from each Eurozone member. The European Commission then combined these into a single loan: the 'Greek Loan Facility'. The quota that each member state paid into the Greek Loan Facility was proportional to the corresponding ECB capital amount.
Greece's financial needs for the period from 2010 to 2013 were estimated at €190 billion. It was to come from 3 different sources: €80 billion from the Greek Loan Facility, €30 billion from the IMF and the rest from the financial markets

[112] The full text of the treaty can be consulted at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:12012E/TXT&from=EN.

(Greece was expected to return to the financial markets in early 2012)[113]. The Eurozone and IMF loans were to be disbursed in quarterly tranches and their disbursement was linked to the achievement of certain targets agreed in a Memorandum of Understanding[114].
As the crisis was thought to be temporary, the Greek Loan Facility had similar conditions to those granted by the IMF. The loans granted by the IMF had an interest rate equal to the cost of the loan plus 300 basis points. After three years without repayment, the loan was to be repaid in eight equal quarterly instalments, which meant an average loan term of four years. The Greek loan facility initially had the same maturity as the IMF loans, but applied a slightly higher interest rate: It was set by adding 300 basis points (400 after the third year) to the three-month Euribor[115]. To this was added a one-time commission of 50 basis points on the amount of each disbursement to cover technical costs. These interest rates were high[116] to encourage Greece to implement the adjustment programme and return quickly to the capital markets.

The difficulties that arose after the programme was approved led to some changes. One change in the quotas was determined by the fact that Slovakia refused to participate in the Greek credit facility. The quotas of Portugal and Ireland were subsequently lowered as they were also recipients of financial assistance programmes. The need to introduce a new adjustment programme led to the expiry of the first programme in 2011, and as a result only €52.9

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[113] European Commission (2010) European Commission, Directorate-General for Economic and Financial Affairs (2010) The economic adjustment programme for Greece, Luxemburg, *Publication Office of the European Union*, 26 July 2010.
[114] Greece: Memorandum of Understanding on Specific Economic Policy Conditionality, Athens, 3 May 2010, available at: https://crisisobs.gr/wp-content/uploads/2013/03/Mou_03_05_20101.pdf.
[115] The Euribor (acronym of EURo Inter Bank Offered Rate) is a reference rate, calculated daily, that indicates the average rate at which the major European banks conduct their transactions in euro.
[116] The cost was still far lower than the cost of borrowing on financial markets. In May 2010, the Euribor rate was around 0,7% (see https://www.euribor-rates.eu/en/current-euribor-rates/2/euribor- rate-3-months/), leading to an interest rate of 4.2% for the Greek Loan Facility. In the same month Greece would have paid interest rates around 8.5% on titles with the same maturity (see https://www.bankofgreece.gr/en/statistics/financial-markets-and-interest-rates/greek-government-securities?year=2010&order=asc&page=1).

billion of the planned €80 billion was disbursed through the Greek Loan Facility (see Figure 3.1).

In view of the difficulties Greece was facing, the interest rates on the Greek Loan Facility were gradually reduced from the beginning of 2011 and the maturity was extended. In March 2011, it was decided to reduce the interest rate by 100 basis points (i.e. Euribor plus 200 basis points in the first three years and Euribor plus 300 basis points in the fourth year) and the average maturity was extended from four to seven and a half years. In February and December 2012, two further changes were made that reduced the premium on the Euribor rate to only 50 basis points. The average maturity was extended by 15 years, with repayment expected to start in 2020 and end in 2041.

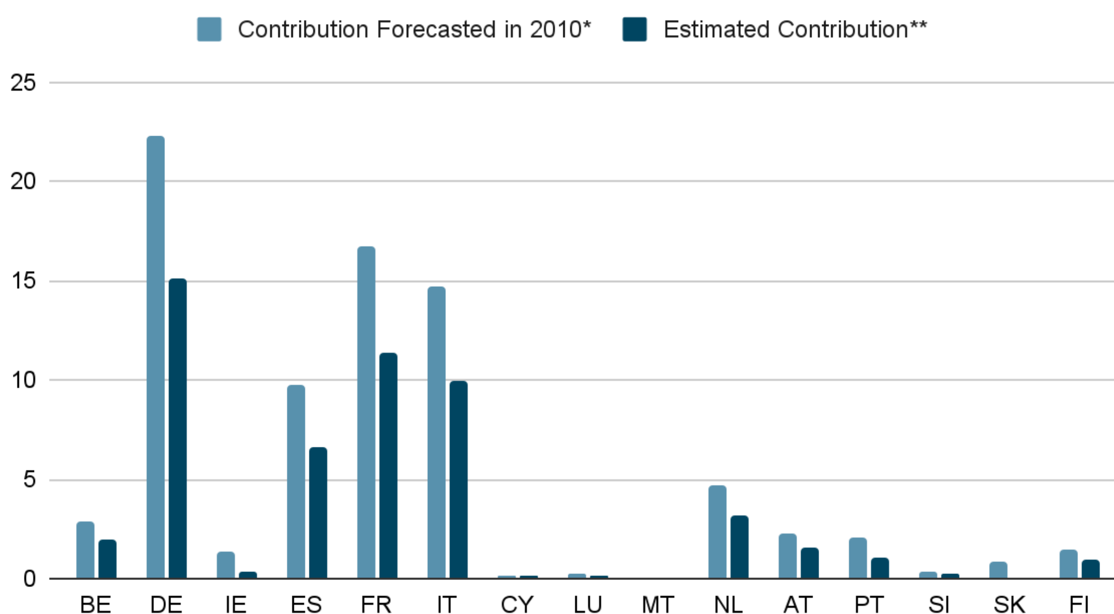

Fig. 3.1 - The contribution (in billion euro) of each Eurozone member state to the Greek Facility Loan.

* The forecast was contained in the first assessment of the Economic Adjustment Programme to Greece from the European Commission. Can be found at: file:///C:/Users/len3/Downloads/gp_eudor_WEB_KCAH10068ENC_002.pdf.en%20(1).pdf

** The estimate on the actual contribution of each state was found in F.Colasanti (2016) Financial assistance to Greece: three programmes, Brussels, European Policy Centre.

With the outbreak of the crisis in Greece, European leaders realised the need for a permanent mechanism to deal with such situations. For this reason, in May 2010, the European Council adopted Regulation No 407/2010[117] establishing the European Financial Stabilisation Mechanism (EFSM). The new mechanism was based on Article 122 of the TFEU (see above) and allowed for the granting of loans or credit lines to Member States in need of financial assistance. To raise the money for the loans, the Commission was authorised to borrow up to €60 billion on the financial markets (own resources ceiling for payment appropriations). The loans were to be subject to general economic policy conditions to be laid down in an agreement between the Commission and the Member State.
This mechanism was used to provide financial support to Ireland (€22.5 billion) and Portugal (€26.5 billion), but was not large enough to cover Greece's financing needs. For Greece, was used only in July 2015 to grant a bridging loan of €7.16 billion that allowed for a smoother transition from the second to the third adjustment programme.

Even after the establishment of the EFSM, the Eurozone still needed an instrument to help states with higher financial needs. As European own resources were not sufficient to cover these needs, European leaders decided to create a special purpose vehicle outside the European legal framework. The new instrument was announced at the Ecofin meeting of 9 May 2010[118]. It was to raise up to €440 billion on the financial markets and was backed by a €779,783.14 billion guarantee from participating member states.
The second adjustment programme for Greece, launched in October 2011, was financed by the EFSM with €110 billion. To this amount was added €20 billion from the IMF[119] plus the amounts not yet disbursed under the first programme.

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[117] Council of the European Union (2010) Council Regulation (EU) No 407/2010 establishing a European financial stabilisation mechanism, *Official Journal of the European Union*, Brussels, 11 May 2010
[118] Council of the European Union (2010) Economic and Financial Affairs extraordinary council meeting press release, Brussels, 9 May 2010.
[119] The funds from the IMF were disbursed using the so-called Extended Fund Facility (EFF) that grants a longer maturity: loans are to be paid in 12 equal semiannual instalments from the 4th to the 10th year. Of the €20 billion envisaged, only €12 billion were disbursed.

At the end of the programme, €130.9 billion had been disbursed from the EFSF[120]. These loans had maturities between 2023 and 2070[121] and an average interest rate of 1.35% (it was set based on the cost of borrowing by the facility plus a 'guarantee commitment fee' and a 'servicing fee'. In November 2012, the guarantee commitment fee was removed).

As the legal status of the EFSF was unclear, the European member states decided to create a new instrument that was better integrated into the EU's legal system. The decision was taken at the Eurogroup meeting of 28-29 October 2010[122] and the main features of the new mechanism were set out in a statement published a month later[123]. The European Stability Mechanism (ESM) was created at the Eurogroup meeting of 16-17 December 2010, as a permanent mechanism to safeguard the financial stability of the Eurozone. It was not based on Article 122 TFEU, but on a specific provision to be added to Article 136 TFEU[124]. Because it required an amendment to the TFEU, the ESM did not enter into force until January 2013. Unlike its two predecessors, the ESM enjoyed preferred creditor status, junior only to IMF loans, and provided for the possibility of private creditors participating in it. It was not directly controlled by the European institutions but had its own governance structure capable of making independent decisions. Its initial lending volume was €300 billion and was increased to €500 billion by the Eurogroup in its decision of 30 March 2012[125].

[120] The total amount envisaged was of €144.7 billion, but €10.9 billion that had been destined to the recapitalisation of banks were not used and the last instalment of €1.8 billion was not disbursed as the objectives had not been reached.
[121] The initial maturities had been established between 2018 and 2054. Two extensions of the maturities were then approved in January 2017 and November 2018.
[122] European Council (2010) Conclusions of the European Council of 28-29 October 2010, Brussels, 30 November 2010.
[123] Statement by the Eurogroup on European Stability Mechanism, attached as Annex II to the Conclusions of the European Council of 16-17 December 2010, Brussels, 17 December 2010.
[124] The new paragraph reads as follows: '*The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality*'.
[125] Eurogroup (2012) Statement of the Eurogroup, 30 March 2012 (https://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/129381.pdf).

The ESM provided the funds to finance the third adjustment program for Greece, which was agreed at the end of July 2015. The agreement foresaw the disbursement of €86 billion from the ESM (this time the IMF was not involved), but in the end only €61.9 billion was used because less money than expected was needed to refinance the banks.
The interest rate was linked to the ESM funding costs and was around 1%, while the loans will arrive at maturity between 2034 and 2060[126].

In total, Greece received €277.8 billion from eurozone member states, the EFSF, the ESM and the IMF during the three adjustment programs. The loans granted to Greece were used to cover four main items of expenditure: debt servicing (repayment of maturing bonds plus the repayment of part of the IMF loans), costs of restructuring measures, recapitalization of banks and Financing of the Greek budget. Since the three programs were administered in different ways and complete data are available only for the third program, it is difficult to put an exact figure on the use of these funds by the Greek government. However, an estimate that does not claim to be absolutely accurate can be produced (see fig. 3.2).

[126] ESM Website: https://www.esm.europa.eu/assistance/greece/explainer-esm-and-efsf-financial-assistance-greece

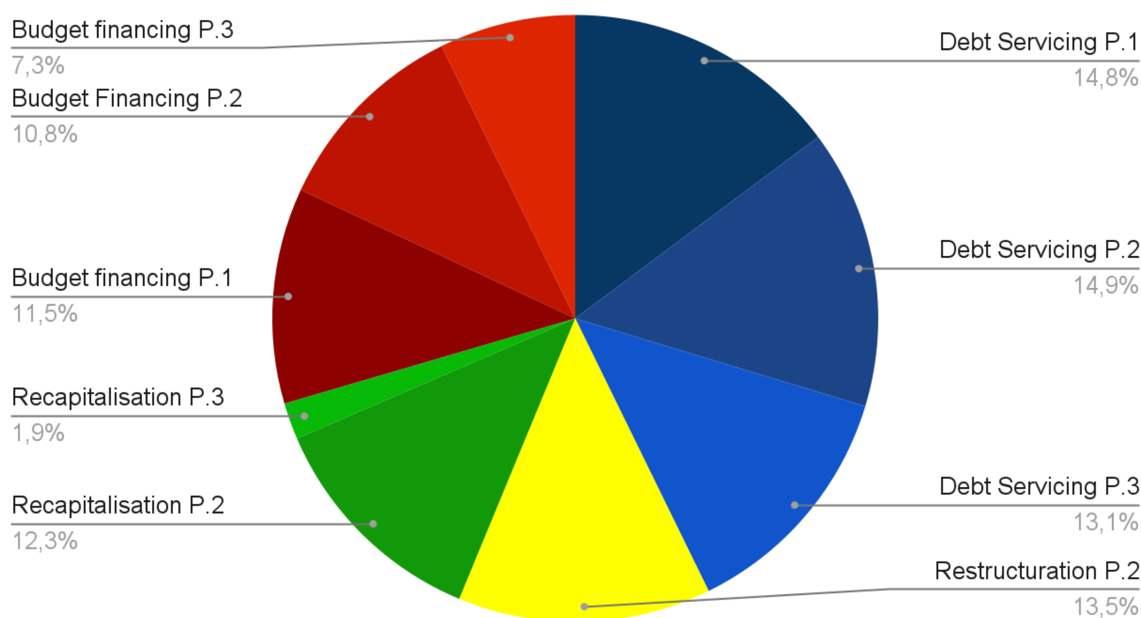

Fig. 3.2. - The use of the financial support to Greece.
The data on the first two programs (P1 and P2) comes from the estimate in Annex II of F.Colasanti (2016) Financial assistance to Greece: three programmes, Brussels, European Policy Centre[127].
The data on the third programme comes from the ESM website and can be consulted at: https://www.esm.europa.eu/assistance/greece/explainer-esm-and-efsf-financial-assistance-greece[128].

The question of the compatibility of financial support with EU law was addressed by the ECJ in November 2012. In its judgement in the *Pringle* case[129], it affirmed that Article 122 TFEU cannot provide a legal basis for the

[127] The only difference is the fact that I have considered the €13,1 billion reimbursed to the IMF during the second program as part of 'Debt Servicing P2', while in the paper this amount is simply deducted from the amount borrowed. As a result: the €73 billion of the first programme are estimated to be spent in the following way: €41,1 billion for debt servicing and €31,9 billion for budget financing; the €142.8 billion of the second programme are estimated to be spent in the following way: €41,3 billion for debt servicing, €37,5 billion for the restructuring of the debt, €34,1 for the recapitalisation of Greek banks and €29,9 billion for budget financing.
[128] According to the ESM, the €61,9 billion of the third programme were spent in the following way: €36,3 billion for debt servicing, €5,4 billion for the recapitalisation of Greek banks and €20,2 billion for budget financing.
[129] ECJ full court (2012) Judgement of case C-370/12 Pringle, *Reports of Cases*, Luxemburg, 27 November 2012.

establishment of a permanent financial assistance mechanism, but that the establishment of the ESM does not violate any provision of the fundamental treaties. The most important question concerned the compatibility of the ESM with Article 125 TFEU, which contains the so-called "no-bailout" clause: on this point, the ECJ clarified that ESM assistance is admissible because it protects against "moral hazard"[130] and is subject to strict conditionality.
The court concluded that an amendment of the fundamental treaties was not strictly necessary as a legal basis for the ESM, as it could simply be based on the general principles of international law.

3.3) The actions of the ECB

The role of the ECB during the financial and sovereign debt crisis was fundamental in stabilising the Eurozone. The measures it took were unconventional and went beyond its traditional mandate. The mandate of the ECB is primarily to maintain price[131] stability and secondarily to support general economic policy in the Union[132]. Unlike other central banks (such as the Federal Reserve), the ECB does not act as a '*lender of last resort*'[133] (this role is ultimately assumed by the states) and cannot grant preferential terms to individual states or other public entities.
In normal situations, the ECB can use three main instruments to achieve its objectives: open market operations, which provide commercial banks with liquidity in euros; standing facilities, which provide or absorb liquidity with an overnight maturity; and the holding of minimum reserves with the ECB and national central banks.

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[130] The expression 'moral hazard' refers to the possibility to increase excessively the sovereign deficit counting on the fact that the other Eurozone member states or the Union institutions will pay for it.
[131] Price stability has been defined by the ECB as an inflation level below, but close to, 2%. (https://www.ecb.europa.eu/mopo/strategy/pricestab/html/index.en.html).
[132] Art. 127 of the TFUE. The full text of the treaty can be found at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:12012E/TXT&from=EN.
[133] A lender of last resort is an institution, usually a country's central bank, that offers loans to banks or other eligible institutions that are experiencing financial difficulty or are considered highly risky or near collapse.

The ECB was involved in the reform process that led to the strengthening of fiscal surveillance rules and the creation of the financial assistance mechanisms. It used its credibility and position to exert pressure on member states to adopt virtuous fiscal policies. It even sent letters to Italy and Spain to encourage the establishment of pro-reform governments.
In addition, it decided to adopt a series of unconventional actions that took the name of non-standard measures. This decision was controversial, but it was in line with the need to achieve its objectives when the standard measures proved ineffective. In fact, the deflation that set in after the financial crisis could not be stopped even by the sharp reduction in interest rates that was implemented between October 2008 and May 2009. As the recession threatened price stability, the ECB reacted by increasing liquidity provision, extending the maturity of refinancing operations and conducting dollar liquidity operations as several European banks found it difficult to obtain dollar funding[134].

The intervention of the ECB, which had become necessary with the outbreak of the financial crisis, became even more important with the onset of the sovereign debt crisis. Yields on the government bonds of the weakest states began to rise, incorporating the risk of default. As this undoubtedly posed a risk to price stability, the ECB intervened to lower and stabilise interest rates. By adopting the Securities Market Programme (SMP)[135], it was able to buy government bonds on the secondary market[136] and private debt instruments on the primary and secondary markets. As Greece was the state where interest rates on government debt instruments increased the most, it was the main beneficiary of this measure.
In response to the immediate needs of Greek banks, the ECB approved a waiver that allowed Greek government bonds (which were below investment

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[134] P. Cour-Thimann and B. WinklerECB (2013) The ECB's non-standard monetary policy measures the role of institutional factors and financial structure, *European Central Bank Working Paper Series* No 1528, Frankfurt, April 2013.
[135] ECB (2010) Decision of the European Central Bank 2010/281/EU establishing a securities markets programme, *Official Journal of the European Union*, Frankfurt, 14 May 2010.
[136] Due to the prohibition on article 123 TFEU it was not possible to purchase sovereign bonds directly.

grade) to be accepted as collateral[137]. This derogation was only possible because Greece had accepted an adjustment programme.
The ECB proceeded with further measures to increase liquidity. In December 2011, it announced a package of measures that included the introduction of two long-term refinancing operations (LTROs), the reduction of the minimum reserve ratio from 2% to 1% and the decision to allow national central banks to accept bank loans that meet certain eligibility criteria as collateral for monetary policy operations[138].
Another measure to increase commercial bank liquidity was Emergency Liquidity Assistance (ELA). This measure allowed national central banks to support commercial banks facing temporary liquidity problems.

In July 2012, the President of the ECB, Mario Draghi, gave a speech at the Global Investment Conference in London in which he announced that the ECB would do 'Whatever it takes' to save the Eurozone. This speech had a powerful effect on investors, restoring confidence in the solvency of Eurozone member states and halting the actions of speculators. Draghi gave substance to his speech by announcing the Outright Monetary Transactions (OMT) programme a few weeks later[139]. The programme allowed the ECB to purchase on the secondary markets government bonds of crisis-stricken member states that were subject to an ESM adjustment programme. This instrument was never used, but its very existence was sufficient to ensure stabilisation of government bond interest rates.
In early 2015, the ECB announced an expanded asset purchase programme to support investment and consumption[140]. This programme, known as

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[137] ECB (2010) ECB announces change in eligibility of debt instruments issued or guaranteed by the Greek government, Frankfurt, Directorate General Communications, 3 May 2010.
[138] ECB (2011) ECB announces measures to support bank lending and money market activity, ECB official website (https://www.ecb.europa.eu/press/pr/date/2011/html/pr111208_1.en.html), Frankfurt, 8 December 2011.

[139] ECB (2012) Technical features of Outright Monetary Transactions, available at: https://www.ecb.europa.eu/press/pr/date/2012/html/pr120906_1.en.html.
[140] ECB (2015) ECB announces expanded asset purchase programme, available at: https://www.ecb.europa.eu/press/pr/date/2015/html/pr150122_1.en.html.

Quantitative Easing (QE), added government bond purchases to its existing programme of private sector asset purchases, bringing the total amount of purchases to €60 billion per month. These operations were only possible because the Eurozone was experiencing a prolonged period of low inflation and the issuance of liquidity was in line with the ECB mandate to maintain price stability.

The strong intervention of the ECB during the financial and the resulting sovereign debt crisis was the subject of much criticism. Especially in Germany, the ECB was criticised and accused of exceeding its mandate. The compatibility of the OMT and of QE with the fundamental treaties of the European Union was questioned. In response to these accusations, the European Court of Justice (ECJ) confirmed the legality of the ECB measures with the Gauweiler[141] (for the OMT) and Weiss[142] (for the QE) judgments. In particular, the ECJ affirmed that the purchase of government bonds on secondary markets is only prohibited under Article 123 TFEU if the purchase of such bonds is automatic and unconditional: in this case, it would be equivalent to a purchase of bonds on the primary market and would create a moral hazard. Since this is not the case with either the OMT or QE, they are compatible with EU law.

Summary

Since the Eurozone was not designed to respond to an asymmetric crisis, the necessary mechanisms were created in parallel with the development of the crisis, according to the principle of 'learning by doing'. The fiscal surveillance mechanism was not able to prevent the outbreak of the crisis: in order to be more effective in the future, surveillance was strengthened and its capacity to assess the actual situation of member states was improved. A mechanism was

[141] ECJ Grand Chamber (2015) Judgement of case C-62/14 Gauweiler and others, *Reports of Cases*, Luxembourg, 16 June 2015.
[142] ECJ Grand Chamber (2018) Judgement of case C-493/17 Weiss and others, *Reports of Cases*, Luxembourg, 11 December 2018.

created to provide financial support to member states. As this mechanism is linked to reforms that allow the state concerned to return to a sustainable financial situation, it does not violate EU law. Finally, the ECB took unconventional measures to ensure the stability of the Eurozone. To do so, it was forced to go beyond the role it had played until then.

Chapter 4: The impact of the crisis in Greece

After completing its third adjustment programme, in 2019 Greece finally appeared to have reached a stable position. It had sharply reduced its external deficit, recorded a large primary surplus, and GDP grew at a sustained pace. These indicators suggested that the adjustment programmes had been a success.

However, these results were achieved at a very high price. In 2019, GDP was still far from the level it had reached before the onset of the crisis, and the primary surplus had been achieved by reducing consumption rather than increasing production. This may seem obvious since the main cause of the crisis was an excess of public spending financed with foreign investment. Disinflation of the Greek economy was inevitable, and the adjustment programmes did not aim to avoid it: the goal was to do so in the most orderly way possible. Nevertheless, the effects were severe and could have been mitigated if Greece had had more resources and more time to adjust its position.

This chapter assesses the impact of the crisis in Greece, considering some macroeconomic indicators, the impact on fundamental rights, and the impact on debt sustainability. It then discusses whether the damage to the Greek economy was unavoidable or whether things could have gone better in other ways.

4.1) The macroeconomic cost of the adjustment

The long parenthesis of the crisis ended in 2018 with the completion of the third adjustment programme. Greece was now able to finance itself in the financial markets and no longer relied on external assistance. Despite the crisis, the programmes had succeeded in bringing Greece back to a sustainable position. However, the costs of this adjustment had been very high.

A first indication of the extent of the damage caused by the crisis is provided by a look at the development of real GDP (see Fig. 4.1). Real GDP in 2019 was not only far below that of 2008, but even below the level Greece had reached when it joined the Eurozone in 2001. Similar levels to 2019 were only recorded in the first half of the 1990s: the sovereign debt crisis set Greece's GDP back by about 25 years.

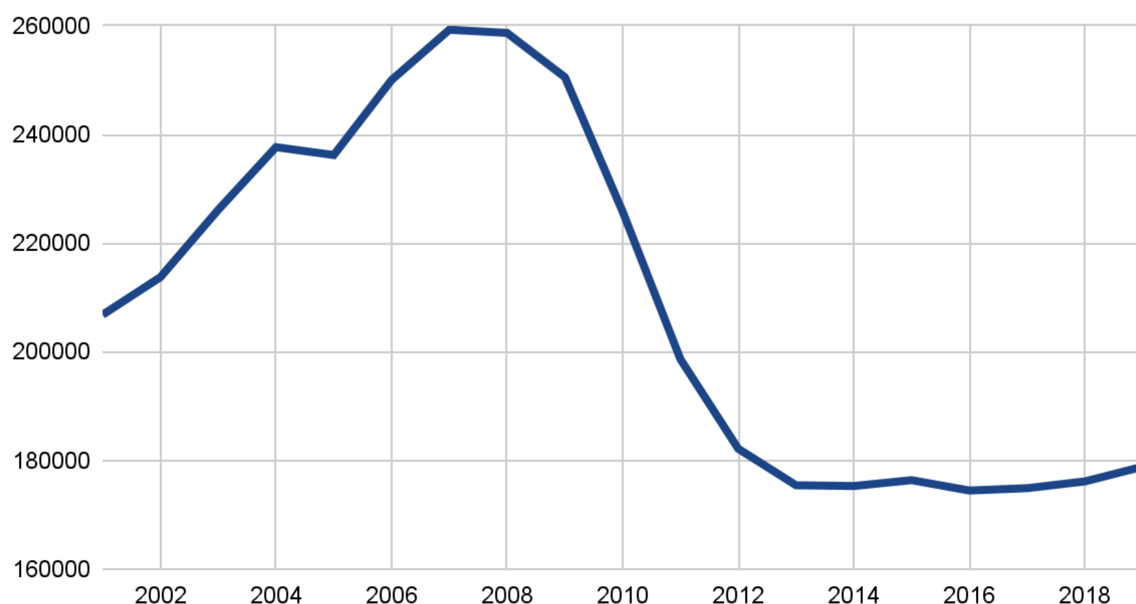

Fig. 4.1 - The evolution of the Real GDP of Greece from 2001 to 2019 (Billions of 2015 euros). Source: EUROSTAT Database. As a figure on real GDP was not present, it was calculated by the author based on figures on national GDP and on the level of inflation (HICP).
The data on the GDP was found at:
https://ec.europa.eu/eurostat/databrowser/view/NAMA_10_GDP
__custom_2122769/default/table?lang=en. Last update on 16 February 2022.
The data on HICP was found at:
https://ec.europa.eu/eurostat/databrowser/view/PRC_HICP_AIND
__custom_2122727/default/table?lang=en. Last update on 20 January 2022.

Of course, the high GDP achieved in the first years of the Eurozone's existence was not the result of a real improvement in the Greek system. It was only achieved through an unsustainable increase in domestic demand financed by

the inflow of foreign capital. When Greece experienced no more capital inflows after 2008, it was clear that GDP would shrink.
However, the fact that spending was unsustainable did not lessen the impact of its reduction. The impact of the financial crisis on domestic demand, combined with the austerity programmes implemented from 2009 onwards has been enormous. In 2019, domestic demand was still 30 % lower than in 2008.

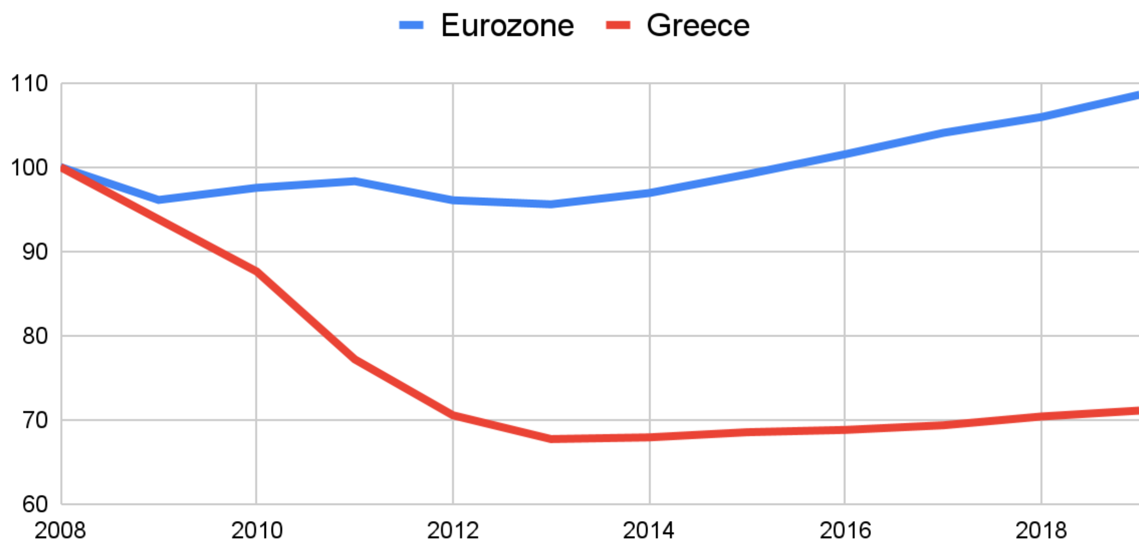

Fig. 4.2- The evolution of the domestic demand in Greece and in the Eurozone, compared to the 2008 levels.
Source: OECD (2022), Domestic demand forecast (indicator). doi: 10.1787/cf2732d3-en (Accessed on 27 February 2022).

The contraction of the Greek economy naturally had an impact on the level of unemployment, on real wages and on the number of people who decided to leave the country. These effects were self-reinforcing and led to very strong changes.

In 2008, the unemployment rate in Greece was quite low at 7,8%, in line with the Eurozone average (see Fig. 4.3). With the onset of the crisis, there was an increasing divergence. In 2019, after almost six years of recovery, the

unemployment rate was still more than twice as high as in 2008. The increase mainly affected less protected categories. Young people, who are more often employed on fixed-term or more flexible contracts, were the category that experienced the largest increase in unemployment.

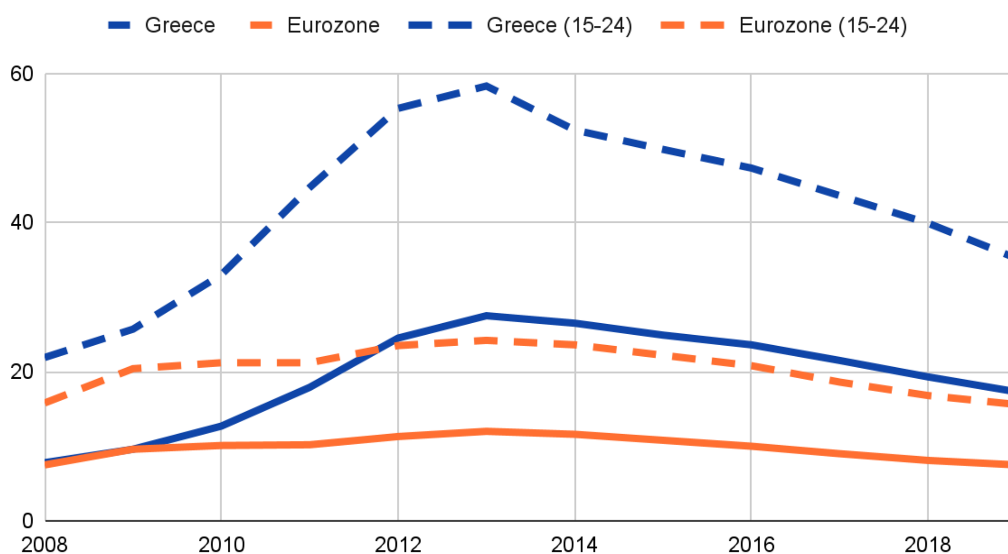

Fig. 4.3- The unemployment rate (total and for young people) in Greece and in the Eurozone from 2008 to 2019.
Source: Eurostat Database, https://ec.europa.eu/eurostat/databrowser/view/UNE_RT_A_H__custom_2126308/default/table?lang=en. Last update 2 February 2022.

The impact of the crisis on labour markets was not limited to those who lost their jobs. Even those workers who were able to keep their jobs suffered severe wage losses.

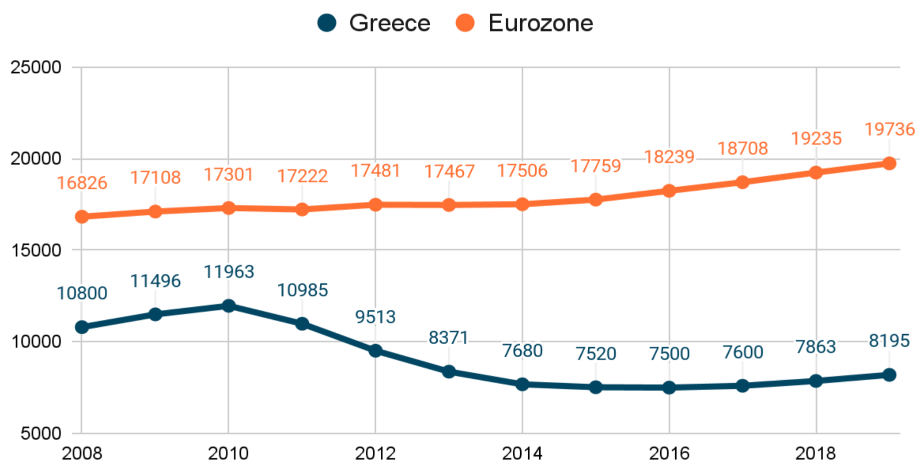

Fig. 4.4- Median net income in Greece and in the Eurozone from 2008 to 2019. Source: Eurostat Database, https://ec.europa.eu/eurostat/databrowser/view/ILC_DI03__custom_2126224/default/table?lang=en. Last update 25 February 2022.

The reduction of income did not equally affect the whole population. The reduction of the median income was accompanied by an accentuation of income inequality. Lower incomes were in proportion reduced more than high incomes (see figure 4.5).

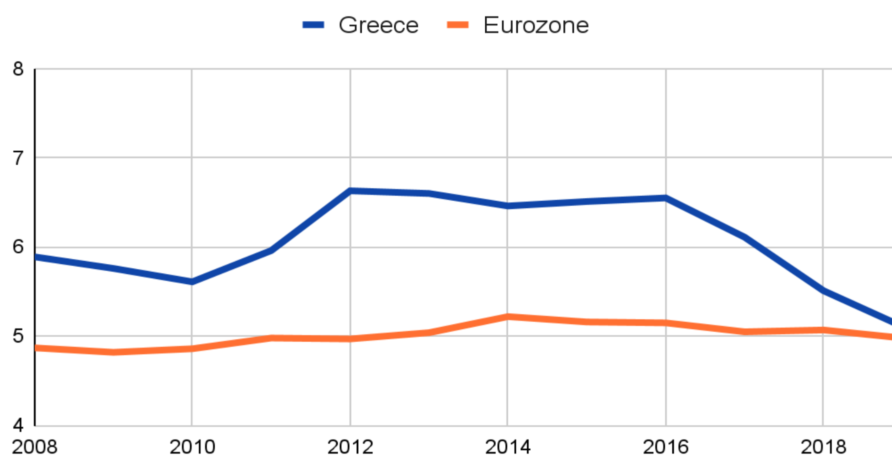

Fig. 4.5 - Income Inequality in Greece and in the Eurozone from 2008 to 2019. Source: Eurostat Database, https://ec.europa.eu/eurostat/databrowser/view/ILC_DI11__custom_2132872/default/table?lang=en. Last update 25 February 2022.

A combination of the effects of the crisis, austerity measures, recession and general disillusionment with the political system in the country also led to a sharp increase in emigration (see Fig. 4.6). The number of emigrants per year almost tripled between 2009 and 2012. This process is particularly noteworthy since, before the beginning of the crisis, Greeks were among the Europeans least positive about long-distance mobility[143]. The emigration after 2010 was comparable in numbers to that of the post-war years and was unprecedented since the return to democracy. Emigration was mainly directed towards the other European countries, especially Germany and the United Kingdom: these two countries alone were the destination of more than 50% of emigrants[144].

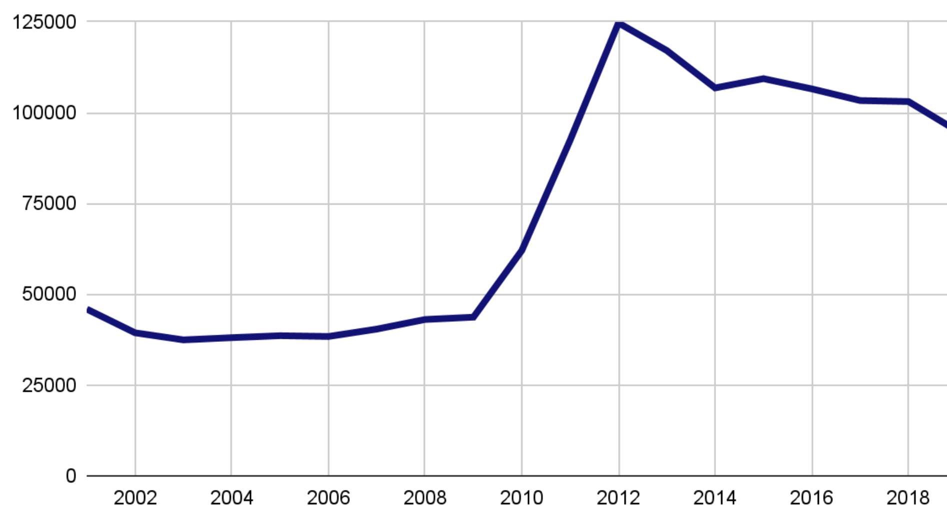

Fig. 4.6 - The emigration from Greece from 2001 to 2019.
Source: Eurostat Database, https://ec.europa.eu/eurostat/databrowser/view/migr_emi2 /default/table?lang=en. Last update 7 March 2021.

[143] European Foundation for the Improvement of Living and Working conditions (2005) Analysis of the 2005 Eurobarometer survey on geographical and labour market mobility, Luxembourg, Office for Official Publications of the European Communities, 2006.
[144] OECD (2019) International Migration Outlook 2019: Greece, OECD Publishing, Paris. https://www.oecd-ilibrary.org/sites/dc50087d-en/index.html?itemId=/content/component/dc50087d-en.

The strong emigration contributed to a decrease in unemployment in the short term. In the long term, however, it will harm the Greek economy, as those who leave the country represent the most dynamic part of society. According to the Hellenic Observatory[145], more than two out of three of those who emigrated after 2010 were university graduates and a quarter of the total outflow involved people who have postgraduate degrees or are graduates of medical and polytechnic schools. The search for better opportunities during the crisis has thus taken the form of a real brain drain.

4.2) The impact of austerity on Greek society

The adjustment programmes implemented in Greece since 2010 aimed at rationalising public administration. The structure of the public sector was improved and many wastes were eliminated, but the cutbacks also led to severe cuts in fundamental areas. This section focuses on the impact of the austerity measures on specific sectors[146].

a) Education

The rationalisation of spending on education affected 4 main areas: a cut in the budget for the Ministry of Education and Culture; the merging or closing of school units; a reduction in the recruitment of teachers; and cuts in the remuneration of civil servants in the education sector.
The reduction of the budget for the Ministry of Education resulted in a reduction of the state budget available for school operating costs from €110 million to €80

[145] L.Labrinidis and M.Patsinakis (2016) Greece's new Emigration at times of Crisis, Hellenic Observatory Papers on Greece and Southeast Europe, London.
[146] A general overview of the impact of the austerity measures on different sectors of the Greek society was found in: European Parliament (2015) The impact of the crisis on fundamental rights across Member States of the EU - Country report on Greece, Policy Department C: Citizens' Rights and Constitutional Affairs, Brussels.

million. The cut in expenditure on heating, stationery and maintenance of school facilities led to some difficulties in ensuring that pupils' basic needs were met[147].
The closure or merging of schools led to a more efficient network and an increase in weekly teaching hours. However, this led to an increase in the number of students per classroom (often up to 30 students per classroom), which was perceived negatively by ⅔ of the students. The closure of schools also led to greater difficulties in transporting students, as they had to travel longer distances[148].
The procedure for assigning teachers to the school was improved and a compulsory transfer procedure reduced the need for substitute teachers. However, the staff cuts led to a shortage of teachers in primary and secondary schools.
The cuts mainly affected the rights of vulnerable groups of students, such as children with disabilities and Roma children, as their special needs were rarely met.

b) Healthcare

The austerity measures introduced during the crisis were grafted onto a system that was already often unable to meet the needs of the Greek people. Again, the austerity measures were useful in improving the organisation, but they reduced the resources available. The main reforms involved the creation of a single provider of health services, the restructuring of the National Health Service and the reduction of public expenditure on medicines and health services in general.
The creation of a single provider (EOPYY) and the rationalisation of the National Health Service reduced spending in a system that was widely perceived as inefficient. However, the cuts led to a shortage of staff (the recruitment of 4500 new doctors was blocked due to a recruitment freeze) and

[147] See the document in note 4 at p. 39.
[148] See the document in note 4 at p. 40.

hospital beds[149]. The new system then created indirect incentives for hospitals to discharge patients as quickly as possible, even before they had fully recovered[150].

Controlling drug costs reduced government spending but led to an internal shortage of medicines. This also led to an increase in direct costs for citizens. Other consequences of the health budget cut were the reduction of preventive measures and an increased search for alternative treatments.

c) Work

The right to work was the most affected by the crisis. As mentioned above, unemployment increased significantly and wages were drastically reduced. The increase in unemployment was mainly caused by the severe recession (to which austerity measures also contributed), while the programmes focused mainly on reducing the number and wages of state employees and on making the labour market more flexible.

In the period between 2009 and 2013 alone, more than 250,000 state employees were laid off and public sector wages were cut by over 25%[151].

In the private sector, job insecurity increased dramatically: while in 2007 only 8% of employed people thought it was likely that they would lose their job within the next six months, by 2012 this figure had risen to over 30%. Of the people who kept their jobs, many had to accept part-time or rotating contracts because they could not find full-time work[152].

While employment in the formal sector plummeted, estimates of employment in the informal sector showed a different trend. In 2012, the Labour Inspectorate

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[149] FIDH and Hellenic League for Human Rights Report (2014) Downgrading rights: the cost of austerity in Greece, available at: https://www.fidh.org/IMG/pdf/grece646a2014.pdf.

[150] See the document in note 4 at p. 55.

[151] V.Monastiriotis (2013) 'A very Greek Crisis' in 'Austerity Measures in Crisis Countries - Results and Impact on Mid-Term Development', Intereconomics 2013 - Number 1, p. 7.

[152] Interestingly, in Greece part-time contracts were still far less used than in the rest of the Eurozone (they were around 7% in 2011 while the average of the Eurozone was about 19%). The fact is that while in other countries part-time contracts are an instrument to better meet the needs of employees, in Greece the main cause for part-time contracts was the lack of full-time employment.

estimated employment in the informal sector at around 36%, a sharp increase from the estimated 25% in 2010[153]

d) Pensions

The structure of the Greek pension system was considered problematic long before the financial crisis began. Even at the time of joining the Eurozone, reforming the pension system was seen as the biggest challenge to achieve a sustainable fiscal position. The share of pensions in the national budget was the highest in the Eurozone and was expected to increase sharply due to the ageing of the population. The measures in the programme aimed to reduce the increase in expenditure to 2.5% of GDP by 2060[154]. This was done by raising the retirement age, reducing the special categories granted early retirement, abolishing the Easter, summer and Christmas bonuses and reducing the amount of pensions above €1000 per month.
The reduction of funds for the pension system worsened the living conditions of people of retirement age. However, this segment of the population was less affected by the crisis than the others. This difference is visible in the data on people at risk of poverty or social exclusion: unlike the rest of the population, these data only deteriorated in 2011 and have been below pre-crisis levels since 2012[155].
A controversial issue was the fact that only pensions above €1000 per month were affected. This decision raised a question of equality[156] but made it possible that 67.5% of pensioners were not affected by this reduction[157].

e) Other affected sectors

[153] See the document in note 4 at p. 85.
[154] According to the estimates, without a reform the expenses were destined to increase by 12,5%. European Commission (2010) The Economic Adjustment Programme for Greece, Publication Office of the European Union, Luxembourg.
[155] Eurostat Database: https://ec.europa.eu/eurostat/databrowser/view/ILC_PEPS01__custom_2150225/default/table?lang=en. Last update 3 February 2022.
[156] It sometimes produced the effect of granting to people placed in superior pension scale, a lower pension than pensioners who met different retirement requirements. See document in note 4 at p. 101.
[157] See document in note 4 at p. 101.

The adjustment programmes also included measures to reform the Greek judicial system to address the problem of excessively long court proceedings. The measures had a positive impact on reducing the backlog of cases. However, the austerity measures also had two negative effects: an increase in the cost of court proceedings for citizens, which indirectly led to a reduction in the right of access to justice; and the reduction of funds allocated to the judicial system[158].

The strong protests against the austerity measures and the measures to control them raised concerns about freedom of expression and assembly. Even though the majority of demonstrations were peaceful, a minority of them turned violent, negatively affecting economic activity in the centre of Athens. In response, restrictions were passed to control and limit outdoor demonstrations. Concerns on this issue were mainly related to incidents of police violence against demonstrators[159].

The number of tax burdens imposed and the restructuring of public debt with the participation of the private sector certainly affected the right to property, but were considered constitutional by the Greek courts[160].

Press freedom was restricted by an increasingly hostile legal, political and economic environment and a reduction in media diversity.

Finally, the years of crisis saw a sharp increase in racist violence and discrimination. This phenomenon is directly linked to the deterioration of the economic situation.

4.3) The impact on the sustainability of public debt

Before the financial crisis began, Greece had one of the highest debt-to-GDP ratios in the Eurozone. It was over 100% and rising rapidly, as Greece had

[158] See document in note 4 at p. 116.

[159] The most shocking event was the death of three people during a protest following the approval of the first adjustment programme in 2010. L.Papadimas and R.Maltezou (2015) Greek anti-austerity march erupts in violence, 3 dead, Reuters, 5 May 2010.

[160] See document in note 4 at p.130.

never recorded a deficit below 6% of GDP after the introduction of the euro. When these figures became known at the end of 2009, it was no surprise that Greece's situation was considered unsustainable. The surprising fact is that after almost a decade of painful adjustment programmes and debt restructuring in 2012, in 2019 Greece still had a higher debt than in 2009[161]. Considering that GDP had declined in the meantime, the debt-to-GDP ratio increased (see Fig. 4.7).

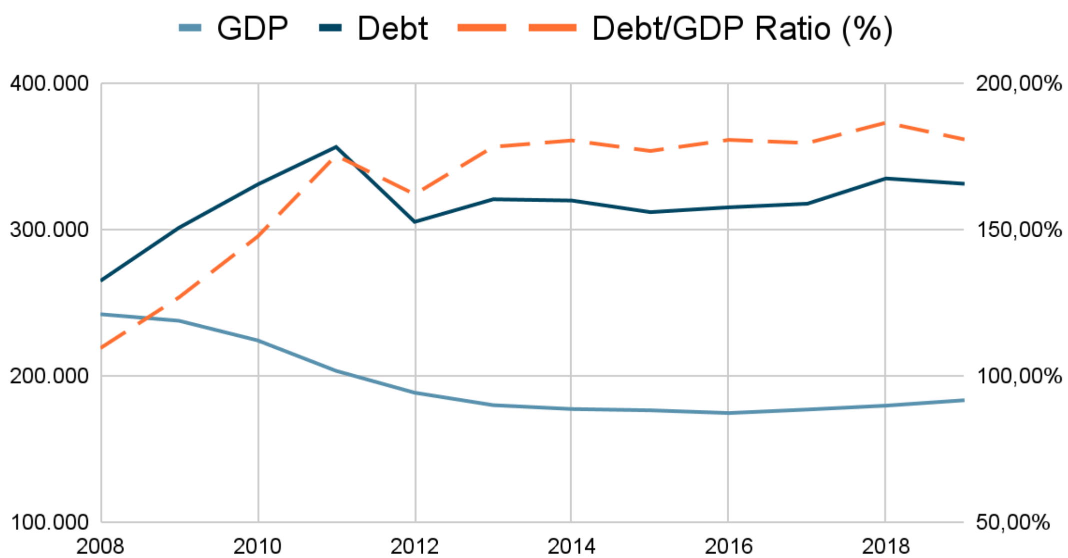

Fig. 4.7 - The trends of Greek GDP and Debt in billion euros (left axis) and the Debt/GDP ratio (right axis).
Source: Eurostat database:
The data on the Greek GDP can be found at:
https://ec.europa.eu/eurostat/databrowser/view/NAMA_
10_GDP__custom_2107923/default/table?lang=en. Last update 16/02/2022.
The data on the Greek debt can be found at:
https://ec.europa.eu/eurostat/databrowser/view/GOV_
10DD_EDPT1__custom_2107631/default/table?lang=en. Last update 22/10/2021.

[161] 2009 is taken as a benchmark because this is the last year before the implementation of the first adjustment program. Of course 2009 cannot be considered as the 'normal situation' as the financial crisis had already break out and the debt had strongly increased compared to 2007. 2019 is instead chosen as it is the first year after the end of the last adjustment program. As the adjustment programs are supposed to grant benefits in the long term it would have been useful to consider more recent years. The outbreak of the pandemic of covid 19 makes however impossible to take the years from 2020 onward as term of comparison.

From 2009 to 2019, Greek public debt increased from €301 billion to €331 billion. This figure is even more impressive when one considers that in 2012 some €107 billion in government debt was cancelled. As GDP shrank over the same period, the debt-to-GDP ratio rose from 103.1% in 2009 to 180.7% in 2019[162].
Looking at these figures, one might spontaneously ask why the situation in 2019 was considered more stable than that in 2009. To answer this question, the main elements to be considered are the composition of Greek government debt and the Greek budget deficit.

From 2009 to 2019, the composition of Greek public debt changed radically. While in 2009 Greek government debt was held by private investors, by 2019 this ratio had fallen to 20%, while about 80% of the debt was in the hands of public institutions (see Fig. 4.8).

The fact that public debt was mainly held by official institutions allowed for major changes in both interest rates and maturities. Maturities were gradually increased, rising from a weighted average of 7.9 years in 2009 to 20.5 years in 2019[163]. Over the same period, the effective interest rate on the public debt fell from more than 4% to 1.58%[164]. This means that Greek government debt in 2019 had an average maturity that was almost three times longer than that of 2009, while the cost of servicing the debt has fell by almost two-thirds.

[162] EUROSTAT Database: https://ec.europa.eu/eurostat/databrowser/view/GOV_10DD_EDPT1__custom_2112008/default/table?lang=en. Last update 22 October 2021.
[163] Public Debt Management Agency Website: https://www.pdma.gr/en/public-debt-strategy/public-debt/weighted-average-maturity.
[164] Public Debt Management Agency Website: https://www.pdma.gr/en/public-debt-strategy/public-debt/annual-service-cost-eng.

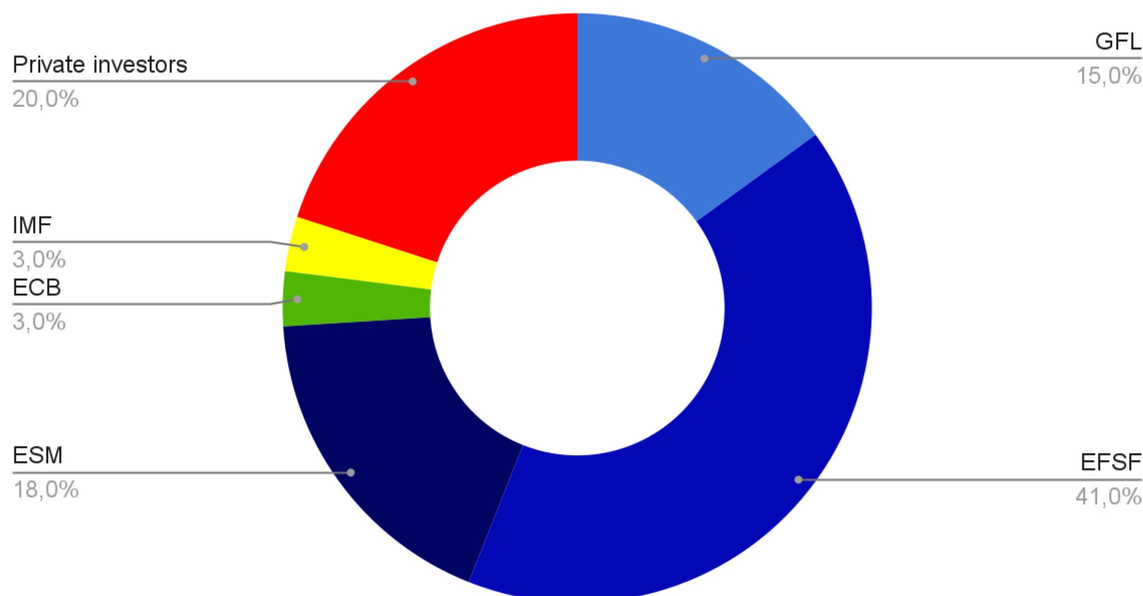

Fig. 4.8 - The creditor composition of Greek Public Debt in 2019.
Source: IMF (2019) Greece Staff Report for the 2019 Article IV Consultation, IMF Country Report No 19/340, Washington, 28 October 2019.

The second and most important element explaining the return to sustainability is the reduction in the annual deficit. While in 2009 the debt was in a strongly ascending trajectory, with a deficit of over 15% of GDP, in 2019 the debt was higher but declining due to a surplus of 1.1%[165].

The international intervention in Greece through the adjustment programmes could not prevent a rise in public debt at that time, but it made it possible to keep it under control.

[165] Eurostat Database: https://ec.europa.eu/eurostat/databrowser/view/GOV_10DD_EDPT1__custom_2107631/default/table?lang=en; last update 22 October 2021.

4.4) Could the impact be reduced?

The management of the Greek sovereign debt crisis has been heavily criticised for the impact of the austerity programmes on Greek society. Were these effects avoidable? Was there a better option than the austerity programmes? It is useful to understand why certain decisions were taken and whether other solutions would have been better. Of course, analysing what would have happened if other choices had been made is beyond the scope of this paper. However, a general discussion of other possible paths and their outcomes can be very useful. This is all the more true since an important part of public opinion remains convinced that the adjustment programmes bear the main responsibility for the effects of the crisis.

As we saw in Chapter 2, the decision to bail out Greece was taken in early 2010. The key elements of this decision were the disbursement of €110 billion over the following three years, the implementation of a programme of structural reforms and the maintenance of all existing financial commitments. These three elements were in line with a clear logic:

- The programme of structural reforms was aimed at reducing the budget deficit. The deficit had exceeded 15% of GDP in 2009 and this was clearly unsustainable. No reduction in the existing public debt could have enabled Greece to return to a sustainable situation as long as the deficit remained at this level. An alternative way to keep public debt under control would have been a sharp increase in GDP, but no credible growth could have compensated for this kind of deficit. So it was clear that the Greek deficit had to be reduced by cutting public spending and increasing revenues.

- Maintaining all existing financial obligations posed some problems, as the debt was unsustainable and the expenditure to refinance it

represented a huge burden on the Greek economy. However, the other solutions were at least as problematic as the maintenance.
Unilaterally refusing to repay creditors would have eliminated the debt burden, but it would also eliminate all possibilities of obtaining financial aid. In 2009, Greece had a current account balance of more than €29 billion (more than 12% of Greek GDP): moving from this situation to a balanced one would have meant a level of austerity incomparable to what was actually implemented.
Another solution would have been an agreement to restructure the deficit already in 2010[166]. This type of agreement was not unprecedented: was in fact the standard procedure used by the IMF in its interventions in developing countries. However, it had never been done in the Eurozone and was considered unthinkable before the crisis erupted.
As the Eurozone was highly interconnected, a restructuring of Greece would have led to losses for its partners and would have called into question the solvency of other Eurozone members. In other words, the Eurozone feared contagion that, starting from Greece, would have led to the collapse of the Eurozone[167]. The restructuring was accepted only after very long negotiations and it required the passing of special laws and the realisation that there was no other way out. The time it took to get approval brought losses to Greece, but it was also necessary to show that restructuring was an exception that would not be repeated[168].
That said, it is not certain that early restructuring would have led to greater debt reduction, even if the debt retained by the private sector was much higher in 2010 than in 2012[169].

- The disbursement of €110 billion was supposed to smooth the difficult transition from a huge deficit to a balanced position. It turned out that this

[166] B.Eichengreen (2010) It is not too late for Europe, *VoxEU*, 7 May 2010.
[167] J.Toyer, J.Strupczewski (2010) EU works on mechanism to stop Greek contagion, Reuters, 8 May 2010.
[168] Reuters staff (2012) Merkel says Greece is special case, needs PSI, *Reuters*, 9 January 2012.
[169] F.Colasanti (2016) Financial Assistance to Greece: Three programmes, European Policy Centre, Brussels, p.55.

was not enough to meet Greece's needs and a second and then a third programme were required. A higher disbursement from the beginning would probably have reduced the necessary austerity effort and given more credibility to the adjustment process. However, €110 billion was the maximum that the Eurozone members were willing to grant[170], as they were also going through a severe crisis[171]. Moreover, this package was seen as an incredibly high sum when it was adopted: the Greek government itself started the negotiations asking for around €30 billion[172].

What can be seen as a clear mistake was the decision to charge high interest rates and relatively low maturities[173]. Charging lower interest rates and higher maturities from the beginning, would have lent credibility to the path to restoring debt sustainability[174].

The first programme was issued in a moment of emergency and was therefore fraught with many problems. These problems were partially solved with the second and third programmes, which reduced the debt burden. However, the basic idea remained the same.

According to Giorgos Papakonstantinou, who was Greek finance minister from October 2009 to June 2011, there was no easy way out of the crisis. A return to a balanced budget was necessary, he said, and the only way to get there was through an austerity programme. A restructuring of the overall debt was also necessary, but that was not politically possible in 2010. The only plausible thing that could have reduced the impact was an increase in credit and time to

[170] According to F.Colansanti, the figure of €110 billion was not only the result of a technical analysis on the financial needs of Greece. This figure was reached as a political compromise between the financial needs of Greece and what Eurozone partners were actually willing to grant. Interview to Fabio Colasanti, 7 January 2022.

[171] It must be remembered that all the other Eurozone members were implementing austerity measures and demanding sacrifices to their populations.

[172] T.Barber and K.Hope (2010) Greece grasps for €30bn rescue package, *Financial Times*, 23 April 2010.

[173] Of course, as showed in Chapter 3 the interest rates were still far lower than those that Greece would have paid on financial markets.

[174] According to F.Colasanti, this decision was not taken in order to punish Greece, but because of a mistaken perception of the severity of the crisis. In his opinion, at the beginning many considered the Greek as a temporary problem of liquidity. Interview to F.Colasanti, 7 January 2022.

implement structural reforms, but that was very difficult for creditor countries to accept[175].
Of course, many mistakes were made and there are many specific measures that could have reduced the impact on specific sectors. However, it is difficult to identify another possible system that could have significantly reduced the impact.

Summary

The impact of the crisis on Greek society was very severe. The combined effect of the crisis and the austerity programme implemented was a contraction of the Greek economy. The result was a sharp increase in unemployment and inequality and a huge brain drain during the years of the crisis. The reduction in resources affected many fundamental areas of the Greek state, which emerged from the crisis severely weakened.
The adjustment programmes enabled Greece to return to a sustainable situation by reducing the deficit and changing the composition of the debt. However, the overall debt has not been reduced and remains a major problem to be addressed.
The management of the Greek crisis has been heavily criticised for the austerity measures imposed. However, it is hard to argue that a different scheme to manage the crisis would have done less damage.

[175] Interview to G.Papakonstantinou, 11 February 2022.

Conclusions

The aim of this thesis was to analyse the causes and consequences of the Greek crisis in order to evaluate its management. The topic is particularly relevant because Greece did not manage the crisis alone: the other members of the Eurozone, as well as the European and international institutions, strongly intervened in the crisis and influenced its evolution. In order to evaluate this intervention, it was necessary to analyse the evolution of the crisis and its impact on Greece.
At the end of the analysis, it was possible to conclude that, given the situation, the strategy used in Greece was probably the best available.

From the first chapter emerges that the problems faced in the crisis did not arise overnight, but had their origins in the three preceding decades. A weak economic and political system had led to a progressive increase in public debt and a structural inability to implement the necessary reforms. The decision to join the Eurozone was also taken in order to create a consensus on an adjustment process. After the introduction of the euro, this consensus disappeared and the strong need for structural reforms was not addressed.

The second chapter traces the timeline of the Greek crisis. This aspect is fundamental, as the evolution of the crisis led to decisions that were considered unthinkable just a few years earlier. This explains why necessary measures such as the granting of additional funds, the decision to restructure the debt and the reduction of interest rates were not taken from the beginning.

The third chapter explains the measures taken at the European level to deal with the crisis. As the Eurozone lacked the tools to deal with an asymmetric crisis, the emergency was approached with a "learning by doing" approach. This, of course, prevented a quick response. However, the Eurozone was able to reform itself and create an effective framework of rules to deal with the crisis in just a few years.

The last chapter shows that the combined impact of the crisis and the austerity measures was severe. Despite the aid programmes, Greece experienced a severe recession, which led to a sharp increase in unemployment and a brain drain. The lack of resources affected several basic sectors such as education and health. Even though the adjustment programmes succeeded in restoring debt sustainability, the total amount of public debt was not reduced. However, there were no strategies to deal with the crisis that would have had a lesser impact.

It is difficult to call the management of a crisis that has hit the Greek population so hard a success. Some of the damage caused by the crisis could have been avoided by intervening more quickly or by dealing with the problems before the crisis began. However, given Greece's situation at the time the crisis erupted, it is difficult to imagine an alternative strategy that could have had a lesser impact. The imbalances that led to this crisis have been building up in Greece for more than three decades. The last opportunity to address them without producing traumatic effects was wasted in the first years after the introduction of the euro. When the crisis erupted, it was too late for a painless adjustment and the path taken was probably the best available option.

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