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An overview of Greece's financial crisis and its implications

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Acronyms

BOG	Bank of Greece
ECB	European Central Bank
EU	European Union
FDI	foreign direct investment
GDP	gross domestic product
IMF	International Monetary Fund
UNCTAD	United Nations Conference on Trade and Development
VAT	value-added tax

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Summary

Greece's economy has shown resurgent growth since its multi-year crisis of 2009–2018. External financial support and Greece's unprecedented fiscal adjustment were essential in reversing the country's recession. There is now thought to have been an initial overemphasis on fiscal consolidation and an underemphasis on growth-enhancing reforms. However, a rebalancing to the tradable, export-oriented sectors augurs well. Further diversification of the economy towards a digital, knowledge-based and export-led growth model will be key to building resilience to future shocks. The country's wide-ranging structural reform agenda – which has boosted inward investment and trade – holds lessons for potential policy interventions for Sri Lanka.

1.1 Introduction: the implications of Greece's financial crisis

Since its debt crisis, which lasted from 2009 to 2018, Greece has shown significant recovery, and is now thought by some, to represent an economic success story (The Economist, 2023). Greece's inward investment and its trade-to-gross domestic product (GDP) ratio have accelerated significantly, the latter surpassing those of many of its European counterparts. Greece's fiscal consolidation and wide-ranging structural reform agenda – which have boosted inward investment and trade – hold lessons for potential policy interventions to aid Sri Lanka with its recovery.

Following the 2008 global financial crisis, Greece's long-standing macroeconomic imbalances and institutional shortcomings became evident. Debt-led consumption growth, in both the private and the public sector, was compounded by fiscal mismanagement. The country's underreporting of its fiscal deficit was the trigger for its crisis in 2009. Meanwhile, Europe's lack of a banking union at the time and the ambiguity of the European Central Bank's (ECB's) role as lender of last resort exacerbated the crisis (Wyplosz, 2017).

Greece's crisis experience was unique and unprecedented in that it occurred in the context of its membership of the Economic and Monetary Union of the EU – which both constrained its policy options and enabled its recovery. The lack of an independent exchange rate narrowed policy options but, at the same time, Europe's institutions ultimately facilitated and financed Greece's stabilisation while it embarked on its fiscal and structural adjustment.

Both the magnitude of Greece's fiscal indebtedness, and the 'sudden stop' (see Calvo, 1998) associated with the spike in risk aversion linked to its funding ability, induced the need for a prolonged macroeconomic adjustment (Gourinchas et al., 2016). EU financial support (totalling approximately €256.6 billion between 2010 and 2018) represented 0.29% of euro area GDP (Council of the EU, 2018). This paper examines the timeline of Greece's multi-year crisis and its interplay of reforms, including fiscal adjustment, competitiveness, debt renegotiation and banking consolidation.

1.2 Greece's financial crisis: issues and challenges

The magnitude of the financial assistance to Greece, in the form of guarantees and three significant bailout packages totalling $330 billion, owed in part to the systemic nature of the country's crisis. What is more, the International Monetary Fund (IMF) rewrote its rule book (Papaconstantinou, 2016) and altered its lending terms. Greece's government debt overhang remains an ongoing risk to its outlook. It continues to maintain a twin deficit in its current and fiscal accounts.

Greece's bailout packages, in 2010, 2015 and 2017, were necessitated by a number of policy developments, including overly optimistic debt projections by domestic authorities, an initial lack of debt restructuring, the growing difficulty of borrowing in the capital markets and domestic resistance to austerity. Greece's debt position was stabilised while it undertook an unprecedent fiscal adjustment.[1]

Greece's first IMF–EU bailout package, in 2010, encompassed its first economic adjustment programme, worth €110 billion ($146 billion), and was predicated on a new blueprint for recovery. Cuts in benefits and wages were expected to boost investment-led growth (IMF, 2010). Greater trade was targeted, though an export-led recovery failed to materialise (see de la Maisonneuve, 2016) and economic transformation remains a priority.[2]

Greece's second bailout package, in 2012, worth €130 billion ($172 billion), included a significant debt write-down for private bond-holders in exchange for a reduction in the debt-to-GDP ratio from 160% to 120.5% by 2020 – the largest such restructuring in history. This debt restructuring represented over 50% of 2012 GDP (Zettelmeyer et al., 2013).

The third (and final) bailout package, in 2015, of €85 billion ($95 billion) was a renewed attempt at reform implementation (Schrader et al., 2015), after the Tsipras-led government engaged in brinksmanship with Greece's creditors (Pagoulatos, 2018), defaulted on a €1.5 billion payment to the IMF (IMF, 2015) and imposed emergency capital controls (Papadimas and Georgiopoulos, 2015).

Drivers and catalysts in Greece's crisis

The crisis 'trigger' stemmed from government revelations that the country's fiscal accounts had been misreported (Barber, 2010). This then led to significant upward revisions in Greece's fiscal deficit, a loss of credibility and investor confidence, and difficulty borrowing in global financial markets. This occurred against the backdrop of the 2008 global financial crisis, which also exposed Greece's over-indebtedness.

Once the crisis had commenced, an initial lack of debt restructuring and delays in guaranteeing a backstop exacerbated problematic funding conditions. Fears of contagion into the banking

1 Personal communication with Professor Georgios Papakonstantinou, 22 February 2024.
2 Greece's export share typically exhibited limited value-added potential; this is similar to the export patterns of low-income countries given the focus on raw materials and labour-intensive goods (Schrader et al., 2016).

system then triggered fears of a bank run and wider financial instability, which then resulted in emergency capital controls. Crucially, the lack of upfront debt restructuring meant that the fiscal adjustment had to be larger, which made the economic downturn even more severe (Stournaras, 2019).

The sequencing of reforms was mis-calibrated. Greece's nominal wages declined faster and more strongly than prices, which had catastrophic economic and social consequences for the population and deepened the recession. There was a significant underestimation of the extent to which the economy would contract with the fiscal adjustment that had been undertaken. The unemployment rate for younger females peaked at nearly 65% during the crisis.

Greece's long-standing deficits in both its current and fiscal accounts, made it more vulnerable to external shocks. In this context, there was an overemphasis on fiscal consolidation and an underemphasis on growth-enhancing reforms, resulting in a larger-than-expected growth downturn. Greece's sizeable import share made the country vulnerable to a loss of purchasing power, given its internal devaluation.

Greece's broad policy interventions

Greece's financial crisis resulted in a wide-ranging domestic reform agenda, enacted as a part of the troika's financial assistance.[3] Between 2010 and 2018, the sequence of institutional reforms, policy interventions and coordinated measures constituted an unprecedented fiscal and macroeconomic adjustment. During the crisis, the Greek Parliament is estimated to have passed 14 austerity packages.

Fiscal tightening was at the forefront of Greece's reforms. In its first adjustment programme, in 2010, Greece agreed to austerity amounting to €30 billion, including cuts in pension payments, raising the retirement age and stricter penalties for tax evasion. The second bailout extended the debt repayment period, with reduced interest rates, and the third further streamlined and digitalised tax compliance.[4]

Competitiveness-inducing measures were introduced. Pension payments were highlighted as a key constraint to Greece's competitiveness and to its long-term economic growth prospects. Greece's pension system was considered to be 'highly fragmented across occupations, types of pensions and benefit rules' (Nikolopoulou, 2022). And its wage structure represented 'a complex collective bargaining system with a generous minimum wage system decoupled from productivity' (ibid.).

Privatisation was scaled up in part through the Hellenic Republic Asset Development Fund, established in 2011, to separate the privatisation process from the Greek state (UNCTAD, 2011). The mechanism was thought by some to lack neutrality, given that the privatisations occurred in the context of the urgency of the bailout

3 The troika – the triumvirate of the European Commission, the ECB and the IMF – was established in 2010 as a decision group for the financial support packages disbursed to Greece and other southern European economies during the European debt crisis (see Dijsselbloem, 2019).

4 Greece's VAT lottery scheme is estimated to have had a significant impact on tax revenue (Nicolaides, 2023).

agreement (Vlachogiannis, 2019). Greece's privatisation push has coincided with higher levels of inward foreign direct investment (FDI).

The ECB was a key stabilising factor for Greece. It held considerable quantities of Greek public debt (Gerlach, 2010) and its continued debt purchases until end-2024 effectively containing Greece's borrowing costs (Fitch, 2021), thus mitigating the recessionary impact. Any loss of trust, and re-emergent risk premia, would have risked further destabilising the Greek economy (Dimakopoulou et al., 2022).

The Bank of Greece (BOG) was pivotal in stabilising the banking system, particularly in coping with the 49% decline in bank deposits it reported between September 2009 and December 2015. The finance–growth nexus was essential given Greece's predominantly bank-based financing (Migiakis and Louri, 2019). BOG liquidity provision, recapitalisation and restructuring led to renewed trust. Greece's non-performing loans have now declined, owing in large part to state-backed securitisation.[5]

Gauging Greece's success in its reform efforts

Greece's economic acceleration, and its re-entry into financial markets following its crisis, is a testament to its unprecedented policy push. The composition of Greece's growth has also become increasingly diversified. Greece's inward investment and its trade-to-GDP ratio have accelerated. Although there are continued risks, key elements of Greece's economic turnaround are outlined below.

Greece's inward FDI has now surpassed pre-crisis levels, led in part by its push for privatisation and an improved investment ecosystem. Inward FDI has spurred Greece's vibrant start-up ecosystem: 78% of its start-up investments are funded from abroad (Found.ation and EIT Digital, 2024). Cisco's investments (Diedrich, 2023) and Microsoft's first Athens data centre in its 'GR for GRowth initiative' (Microsoft, 2020) are emblematic of this.

Greece's tourism inflows have surged – a significant development, given the sector's near-20% share in the economy.[6] Construction projects, and property prices, have jumped, driven by surging demand for hotels and Airbnb rentals and by Greece's golden visa programme, which facilitates non-Greeks obtaining a visa with the purchase of Greek real estate. Tourism flows are expected to increase despite new restrictions (Mouzakis, 2024).

Greece's rebalancing, including towards the tradable, export-oriented sectors, has been essential. Sector splits show that value-added has increased in manufacturing compared with agriculture, and economic complexity index readings[7] for trade are indicative of broad improvement. However, Greece's comparative ranking has yet to improve significantly compared with those of other European economies.

5 For further details of the Hellenic Asset Protection Scheme, see https://hfsf.gr/en/banks-asset-quality/

6 See www.mfa.gr/usa/en/about-greece/tourism/for-sustainable-tourism-industry.html

7 Economic complexity is based on the complexity that emerges between the number of individual activities taking place within an economy. Indices are based on interpreting countries' trade data as a bipartite network in which a country's economic complexity is connected to the products it exports (Hidalgo and Hausmann, 2009).

Successful and effective debt management has been a key marker of Greece's success. Greece now has a robust Public Debt Management Agency in place, which has played an integral part in Greece's sovereign debt upgrades back to investment grade status, thanks to its proactive approach to debt management, including through its swaps programme (Becker, 2018).

1.3 Conclusion: growth interventions for Sri Lanka's growth

Greece's financial crisis, and its experience with an unprecedented fiscal adjustment, underscores the benefits of regional monetary union and the importance of competitiveness and of transparent debt management. Domestically, too, the strengthening of Greece's banking system, supported by the BOG and the ECB, was essential as an anchor for the economy. The BOG has since been pivotal in stabilising Greece's banking system.

Despite delays in debt restructuring and past domestic political resistance to the reform process, Greece has made significant strides in its post-crisis period. Its economic adjustment programme, the rapid elimination of its fiscal imbalance and the streamlining of its public sector all indicate ongoing resilience. The rebalancing to the tradable, export-oriented sectors also augurs well promoting economic diversification to safeguard against future shocks.

Notwithstanding Greece's significant economic turnaround, significant wage cuts are deemed to have undermined social welfare. This has largely been through the dismantling of collective bargaining, the flexibilisation of working time and the easing of employment protection (Kouzis, 2017; Nikolopoulou, 2022). Greece's real effective exchange rate drop[8] was in line with those of other euro area economies, though the recession was at par with the US Great Depression of the 1930s (Thomsen, 2019).

Ultimately, it took three consecutive economic bailout packages, each of a duration of about three years, and an unprecedented fiscal adjustment to restore the Greek economy. Emergency EU and IMF institutional support was also essential and was effectively mobilised to preserve the credibility of the euro area. Greece's fiscal consolidation and its structural reform efforts are ongoing under the Mitsotakis-led government.

8 Calculation based on the World Bank measure of Greece's real effective exchange rate.

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