

“When the Bough Breaks” Making Sense of the Greek Economic ‘Waterloo’

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ABSTRACT: The purpose of the paper is to firstly provide a conceptual perspective on the existing European economic environment and secondly, to delineate the disastrous economic policies responsible for derailing the entire Greek economic establishment. The study expounds upon the very framework that EU policy has been conducted by scrutinizing the way some main economic indicators have fluctuated over the years. The main focus of the economic policies adopted by the EU countries should be on the strengthening of the monetary union and the euro in terms of strengthening the productive, technological, qualitative and redistributive efficiency and not in terms of weakening unions, dislocating labor market institutions, degrading and transforming the social state to “state charity”. The distorted model of development that has been religiously adhered to for many years, has caused production as well as primary surpluses to shrink dramatically, which in conjunction with inappropriate policy alternatives contributed to a prolonged recession that we are currently witnessing. The fiscal restructuring that is currently underway in Greece is bound to burden further the already crippled economic activity in so far as the new tax reforms constrain dramatically the purchasing power of its citizens. The latter in conjunction with the deregulation of the labour markets will reduce real wages markedly, causing in affect further decline in private consumption. The resulting decrease in aggregate demand will set off a self-feeding mechanism of declining production and increasing unemployment.

Keywords: EMU, Greek Economy, Economic Crisis

JEL Classification: E65

1. Introduction

Broadly speaking, the deflationary nature of the policies implied by the Maastricht Treaty in conjunction with years of public sector profligacy has caused the Greek economy to enter a period of unprecedented fiscal misery. Both deficit and debt criteria set by the Maastricht Treaty, intending to discipline Member States in the Euro zone have been utterly disregarded. Whereas the Maastricht criteria had set a 3 percent of GDP budget deficit limit for all Euro-zone members, by 2009 Greece's budget deficit had swollen to around 15 percent of GDP. Similarly, by the end of 2010, Greece's public debt to GDP ratio increased to 133.3 percent, whilst projection for 2012 paint an even grimmer picture of the Greek economy raising the figure to 159 percent (European Economy, 2011).

The recklessness permeating Greece's fiscal policy is thought to be the culprit for the wage and price inflation, which has been consistently exceeding that of its main Euro-zone partners since the mid 1990's. On the basis of the projections released by the International Monetary Fund, Greece has shed around 30 percent in international competitiveness over this period, which has contributed to a widening in Greece's external current account deficit to around 12 percent of GDP (IMF, 2011).

Stuck within the Euro-zone, unable to use currency devaluation to neither restore international competitiveness nor devalue its currency to boost exports as a cushion to offset the highly negative impact on its economy from the fiscal retrenchment that is currently taking place, Greece is desperately seeking answers to the mounting problems that the economy is facing.

It is beyond any shadow of a doubt that the Greek economy is in doldrums, experiencing excessive public deficit and public debt, plagued with sharp income inequalities, exorbitant levels of

unemployment, mediocre technological innovation and most importantly a collapsing productive base. In view of this rather distressing picture, it is imperative that a way out of this crippling scenario is envisaged. Towards this objective a strategy purporting to restore economic activity, creating thus the necessary conditions to recovery should be conjured up.

The present study purports to delineate the disastrous economic policies responsible for derailing the entire Greek economic edifice. In doing so, a close look at the European framework within which the implemented policies have been nurtured will be expounded upon. In addition, the way some main economic indicators have fluctuated over the years will be scrutinized providing hence a legitimate rationale as to how the economy has reached a 'dead-end'.

The remainder of the paper is organized as follows. Section 1 elaborates on the rationale behind the architecture of EMU whilst section 2, by tracing the trajectory upon which the Greek economy has been balancing itself on, calls for a change in the ineffectual, monetarist in nature, economic policies currently implemented in Greece and the greater EU region. At the same time, a close look at some key economic indicators provides a more comprehensive visualization of the Greek economic 'Waterloo'. Finally, section 3 provides some concluding remarks.

2. Setting the Framework Right

The *Stability and Growth Pact* (SGP) provides the framework within which the Member States in the euro area have to formulate their economic policies (European Economy, 2010). The rules set out in the SGP are summarized as follows: the Member States should avoid excessive deficits, i.e. deficits exceeding 3% of GDP, the European Central Bank (ECB) becomes independent from any political interference, the no-bail-out rule of national budget deficits is established. These set of rules were created to facilitate the efforts of the ECB to achieve its main objective, namely to maintain stable inflation.

Theoretically speaking, the SGP is based on four fundamental principles: *Firstly*, inflation is essentially a monetary phenomenon and can be controlled through monetary policy. The ECB by manipulating the interest rate can affect the monetary mechanism and through this future inflation. *Secondly*, the political and democratic processes cannot be regarded as credible due to the shortsightedness that characterizes the politicians. More specifically, economic policies tailored to deal with unemployment can be held responsible for a feedback mechanism that regenerates unemployment in the long run. It is for this reason that the think tanks of the central banks would like to insulate the economies from irresponsible fiscal policies. Monetary policy on the other hand has been fully entrusted with an independent ECB. *Thirdly*, the unemployment rate is supposed to be supply determined, fluctuating around its natural level i.e. the Non-Accelerated Inflation Rate of Unemployment (NAIRU). Any abnormal deviations from its natural level can be corrected through policies that promote labour market flexibility. *Fourthly*, fiscal policy cannot affect the real side of the economy, rendering thereby monetary policy the sole policy option available capable of controlling inflation. Notwithstanding, budgetary fluctuations during the economic cycle are possible in so far as these are associated with passive fiscal policy.

Currently, sacrosanct monetary policy that relies solely on the manipulation of the interest rate to avert the economy from overheating has derailed the entire European wagon creating thus an economic environment conducive to perpetual stagnation and austerity. The existing mediocre economic environment is further degraded by the absence of active fiscal and investment policies tailored to stimulate aggregate demand. In addition, the rather small in size European budget, cannot function either as a stabilizer or a redistributing income mechanism from the more affluent to less affluent areas of the Euro zone.

In sketch of the above arguments, it can be sustained that the existing mechanism implied by the SGP has put paid to any adjustment efforts to consolidate the economies, adding further to the problem by transferring the entire burden of adjustment to labor markets.

The adjustment channels.

According to the Broad Economic Policy Guidelines issued by the European Commission, the adjustment channels in a monetary union, are postulated as follows (European Commission, 2006):

(a) The transfer of resources to the areas affected by asymmetric shocks, crises, etc., through fiscal policy (unilateral transfers).

(b) Mobility of the workforce i.e. unemployed/workers seeking jobs/higher wages can easily move from economically depressed areas to more developed areas where employment prospects are evident.

(c) Wage flexibility is instrumental in the pursue of balanced trade between regions in so far as wages are kept to lower levels in regions of poor performance and relatively higher in the most competitive ones. As far as EMU is concerned, the question as to whether wages are sufficiently flexible in the countries of the euro area to assume the role of channel adjustment should be answered. Implementing the first channel of adjustment, namely the transfer of funds through fiscal policy, is rather questionable given the existing aversion expressed by the Member States (Alexiou, 2011).

As for the second channel, the mobility of the workforce, despite the fact that the legal framework for the movement of workers within the European Union is already in place, labor mobility remains rather dormant and is likely to remain so in the foreseeable future, due in the main to barriers erected by the language, cultural peculiarities, the non-recognition of professional rights etc¹.

Given the inability of the first two channels to serve their purpose, the entire burden of the adjustment is shifted on the wage flexibility channel (Artis 1998, Pissarides 1997). According to Pissarides (2008), and Vinals and Jimeno (1996) increased wage flexibility is predicated on labor market flexibility that is achieved through structural changes and institutional reforms. It is only through the wage flexibility channel that the economy can become internationally competitive, creating hence an economic environment conducive to both higher growth and employment (European Commission 1998; OECD 1999 and 2000; Soltwidel, Dohse and Krieger –Boden, 1999). According to this type of analysis the higher the nominal and real rigidities, the slower and more painful the adjustment process will be. Hence, a rapid and efficient adjustment of the economy to shocks requires flexible labor market, particularly in countries where the high deficit prevents the operation of automatic stabilizers as shock absorbers to function (Berthold, Fehn and Thode, 1999). On a different note however Allsopp and Vines (1998) argue that if markets were to be fully flexible, then macroeconomic stabilization would be rather needless.

In passing, it is worth noting that the in the mainstream literature the importance attached to the labor market flexibility is phenomenal, in a sense that even conceptual flaws of the EMU venture are ascribed to inadequate flexibility in the labour markets. A case in point is a study by Deroose, Langedijk and Roeger (2004), who find that, under EMU, the correlation between real exchange rates and interest rates might cause the economy to overheat. In the same spirit, Martinez-Mongay and Maza Lasierra (2009), Stavrev (2007) and Berk and Swank (2002) provide supporting evidence in favour of labour market flexibility.

In essence, the extant notion of labour market flexibility is being looked upon as an adjustment mechanism that promotes competitiveness, ensuring at the same time that the economy moves towards equilibrium (European Commission, 2010).

The notion that wages should be manipulated when the economy is entering a recessionary phase is shared by the majority of academics. Blanchard (2007) clearly expresses the widespread belief that in order to address economic disorders or crisis within a monetary union, it is essential to increase flexibility in nominal wages. Having said that, it is common knowledge that nominal wages are rigid downwards, making it rather impossible to reduce real wages when we are experiencing periods of low inflation.

For Keynes rigidity in nominal wages is regarded as given: ‘.....the Classical Theory has been accustomed to rest the supposedly self-adjusting character of the economic system on an assumed fluidity of money wages’ (Keynes, 1936, p.67). Nowadays, however, wage rigidity has come in for a lot of criticism (see for instance, Coenen, 2003; Kieler, 2003). Exemplary of such a behavior are Calmfors’ (1998, 2001a, 2001b) studies where in his attempt to come up with different ways to bend workers’ resistance so as reduction in nominal wages is achieved, is looking at the impairment of collective agreements.

At EU level, the main guidelines put forward by the European Commission in relation to how wages should be formed can be couched in the following terms:

a) Increases in nominal wages should not exceed that of labour productivity. Wage increases should ensure that price stability is maintained preventing thus the ECB from adopting restrictive monetary

¹ For more on this see for instance: Puhani (2001); Mazier, Oudinet et Saglio (2002); Jonung and Sjöholm (1999); Braunerhjelm *et al.* (2000)

policy. Price stability is believed to be a factor with immense significance, contributing positively to production and employment. Furthermore, modest wage increases reduce the real cost per unit and thus enhancing the competitiveness of European businesses.

b) The wage level should be adjusted in accordance with labor productivity by country, region and industry. For this to materialize however, it is imperative that labour markets are deregulated².

c) Any increases in real wages should lag that of labour productivity so that business profitability rises and through this fixed capital investment and ultimately employment are stimulated.

Time for reflection

Upon reflection, the first decade of monetary union could hardly be deemed successful. In particular, expectations about a harmonious development of national economies in the euro zone have never been truly realized. The perception of the euro as an instrument for imposing structural reforms in the labour markets has transpired to be a sham (Gros 2006, Arghyrou and Chortareas 2008, Ahearne and Pisany-Ferry 2006).

For some commentators the introduction of the euro aimed at firstly uniting the EU economies into a single economic power and secondly, at deregulating the labor market, weakening the labor unions as well as dismantling the labor market institutions (Burda, 2001). The inherent fragility of the euro is closely associated with the existing structural economic characteristics of the economies within the Eurozone, as well as the unequal rates of capital accumulation, which in conjunction with the uneven performance in international competition, have led the economies of the Member States to be diverging alarmingly. What causes even additional concern is that the observed divergence is more pronounced in the rates of inflation, GDP growth and worse of all, in the international specialization of national production systems (Matthes 2009, de Grauwe 2009). In addition to the above, one should also take into account the unsustainable accumulation of public debt of the Euro-zone countries. The management of the latter will most certainly in the coming years cause the nation states to compete against one another, for the allocation of losses.

According to the European Commission (2006) during the first decade of euro's implementation the progress regarding the structural changes in the labor market has been considerable slow. Potentially, if the euro does not fulfill its expectations will be judged as unsuccessful by the markets, receiving thus a treatment that will to a great extent undermine its viability. This implies that the if the social struggles of workers in southern Europe grow in intensity then the euro will be deemed as unsuccessful by the financial markets; thereby resulting in the collapse of the monetary union. Furthermore, Member States' failure to consolidate their public finances through reduction of public deficit will be perceived by the financial markets as a sign of inefficiency making it thus even harder for the euro to succeed.

It is imperative that the main focus of the economic policies adopted by the EU countries to be on the strengthening of the monetary union and the euro in terms of strengthening the productive, technological, qualitative and redistributive efficiency."

2. Tracing the Greek Economic Trajectory

It is beyond any shadow of a doubt that the slowdown of the Greek economic activity over the period 2005-2008 followed in 2009 by a sharp decline of GDP by 4% has ushered in an era of what is thought to be permeated by a prolonged and punitive recession ever felt in post-war Greece. A more comprehensive picture of how GDP has evolved over the last decades is documented in figure 1. According to the European Commission (2010) forecasts GDP will further decline in 2011 by around 0.5%. Cumulatively however, GDP over the years 2009-2011 is expected to reach 5.5%. Furthermore, OECD predicts an even deeper recession over the period 2010-2011 of approximately -6.2%.

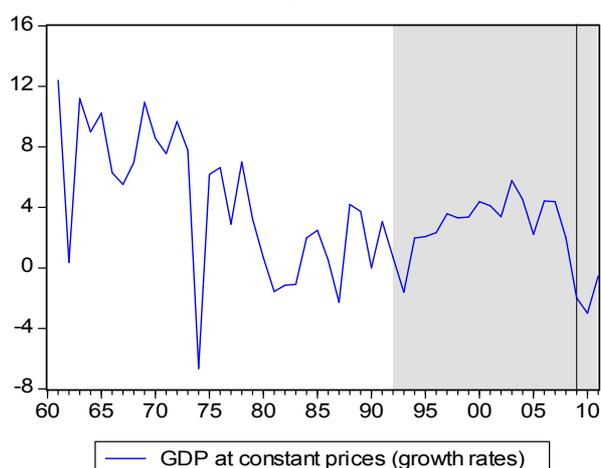
Generally speaking, the looming economic uncertainty currently experienced in conjunction with the turbulent global economic environment has put paid to any hopes of a quick recovery. In

² According to Blanchard and Katz (1992), Decressin and Fatas (1995), and Obstfeld and Peri (1998) labour movement within Europe compared to that in the USA is rather limited. As a result the only means of adjustment is left with regional wage flexibility. On the empirical front however, empirical studies in the 90's showed that differences in unemployment rates in different regions of Europe have not resulted in large differences in the growth rate of wages (Abraham 1996, Decressin and Fatas 1995).

contrast, contemporary commentators in view of the forthcoming Greek austerity measures warn of even more painful years to come (EEAG, 2011).

The expedients envisaged to allegedly deal with the unprecedented economic turmoil have thrown the entire economic establishment off the rails. More specifically, the fiscal restructuring that is currently underway in Greece is bound to burden further the already crippled economic activity in so far as the new tax reforms constrain dramatically the purchasing power of its citizens. The latter in conjunction with the deregulation of the labour markets will reduce real wages markedly, causing in affect further decline in private consumption. The resulting decrease in aggregate demand will set off a self-feeding mechanism of declining production and increasing unemployment.

Figure 1.



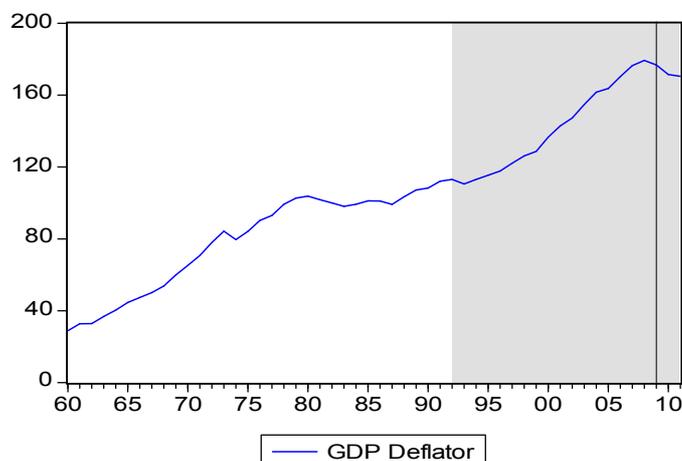
Source: AMECO Database.

The overall effect will be devastating for the Greek economy as prolonged recessions are associated with erosion in capital stock and degradation of human capital.

Over the period 2008-2009, the Greek economy appeared to be fit enough to withstand the impact of the credit crunch experienced by relatively stronger economies, elsewhere. More specifically, in 2008, GDP was growing at the rather prodigious rate of 2% whilst the EU average growth rate was confined to a mere 0.7%. In 2009, despite the fact that GDP growth was fluctuating in the red zone i.e. -2%, it was still doing better compared to the average growth rate of -4% of the rest of the European countries.

The annual rate of change of domestic prices in 2009 amounted to 1% compared to 3.5% in 2008 and 3% in 2010. According to forecasts released by the European Commission, the GDP deflator is expected to rise in 2011 to 1.7%, while the Harmonized Index of Consumer Price to 2.1%.

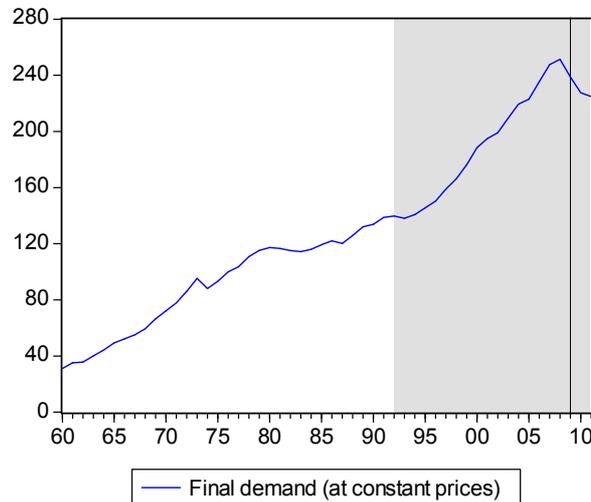
Figure 2.



Source: AMECO Database.

In view of the dwindling demand, the preservation of domestic inflation at relatively high levels suggests that firms, instead of promoting price competitiveness, aim at achieving higher profit margins. The latter might constitute a valid reason why inflation in Greece is growing faster than in other euro-zone countries, particularly Germany; thus undermining the competitiveness of Greek exports.

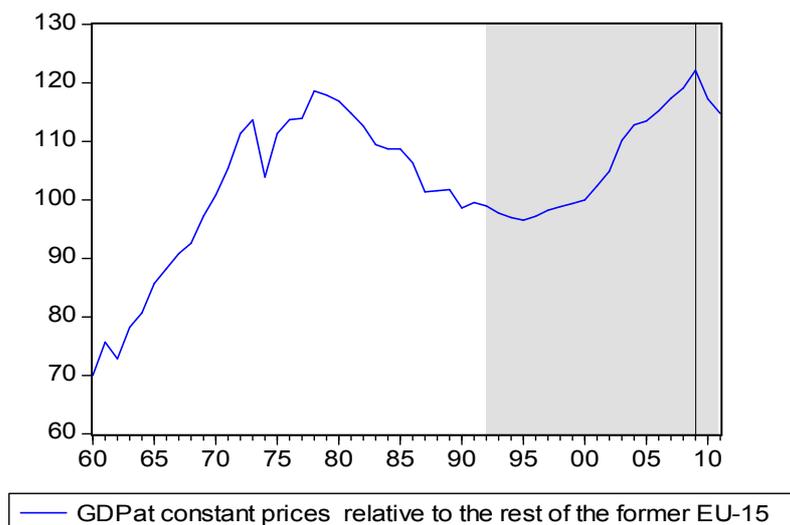
Figure 3.



Source: AMECO Database.

The performance of the Greek economy, in terms of GDP, was much better than the respective performances of the more advanced countries of the European Union over the period 1995 - 2008. The observed growth improved the overall standing of the Greek economy suggesting that real convergence was feasible. It is worth noting in passing that GDP per capita (PPP measure) in Greece at the time approached the average of the EE-15.

Figure 4.



Source: AMECO, Database.

Where do we go from here?

At the moment, the presumed saviours appear to be the ones that are to be held responsible for the global crisis. In particular the economic policies - monetarist in nature - put forward by financial institutions such as the IMF, and the ECB, have crippled economies around the world, failing thus to

provide an alternative policy mix. What is even more worrying is that even now at times where policies have to restore aggregate demand, the only policy alternative proposed is fiscal discipline to reduce public expenditure and deficits.

The rather harsh expedients put in place by the Greek government with the concurrence of the IMF and the EU will in all likelihood pose an additional burden on the economy as the imposition of fiscal discipline, will result in dwindling public/private wages, further reduction in demand and consumption, sinking in effect the entire of the economic establishment into deeper and prolonged recession. The prospect of such a development may transpire pernicious to the Greek society, as an eruption of public unrest and social tension is bound to occur.

A glance at the economic performance of Greece over the last twenty years reveals that the current crisis is the result of the specific economic policies adopted over the last two decades. In particular, two key elements that can be singled out and basically tell the entire story during the period 1994-2008 are as follows: the specific period was permeated by a) solid GDP growth, and b) uneven distribution of income (INE, 2010). For many, Greek policy makers at the time were presented with a unique opportunity to tidy up the country’s finances. Unfortunately, any room for manoeuvre was getting tighter and instead, a period of profligate spending set in, culminating in an explosive spiral that followed, derailing thus the entire economic system. In addition, Greece has been for many decades condoning an economic system where thriving tax-evasion, especially from those at the highest income brackets, is the norm. Instead, revenue collection has given way to external borrowing resulting thus in unsustainable levels of public debt (INE, 2010).

The unprecedented state of economic inertia in conjunction with the collapse in productivity have put paid to any prospect of developmental resurgence of the Greek economy. Should economic activity be restored, a novel strategic plan has to form the basis upon which a long run model of economic development is formulated. More specifically, a concerted effort has to be directed towards the improvement of a number of key areas in economic activity, such as technology, manufacturing, energy, environment and innovation.

Prior to the global financial crisis and its ensuing impact on the Greek economy, any developmental achievements in Greece were predominately put down to construction activity, tourism, shipping and trade. A closer look at the driving forces that led to, at the time, unparalleled high levels of economic development reveals that a concoction of policies designed to promote growth through *private consumption, borrowing, increasing competitiveness, tax and income inequality, decreasing unit labor costs, deregulating labor relations and degrading social health insurance*, were at work.

Furthermore, the distorted model of development in Greece caused production as well as primary surpluses to shrink dramatically, which in conjunction with inappropriate policy alternatives contributed to a prolonged recession that we are currently witnessing.

Essentially, the structural changes of the Greek economy should be targeting structural competitiveness (i.e. quality of production processes, quality of products and services, quality of labour relations, quality of income, quality of social protection, etc.). If the proposed structural reforms are not addressed promptly and effectively, then structural contradictions in the Greek economy will be further exacerbated by the outbreak of conflicts arising from increasing redundancies, and social misery.

An inspection of table 1 in Appendix, suggests that policies tailored to reduce expenditure or increase taxation could be utterly ineffectual unless additional external factors such as the international economic state, global economic recovery, lower interest rates, etc., are taken into account. In the absence of these basic requirements, the undertaken Greek restructuring economic program is not expected to achieve its objectives, either because the ongoing recession has caused tax revenue to decrease markedly compared to spending cuts, or deficit reduction has proved to be an extremely slow process associated with a very high social cost, failing at the same time to reduce public debt due in the main to anemic economic growth.

3. Concluding Remarks

Currently, policy in the EU has been reduced to dealing mainly with problems experienced by individual economies *per se*, failing hence, to provide a solid economic platform. Despite the fact that most of the Northern European banks were exposed to great risks, the Greek plight was presented to be a problem, the solution of which will come from the Greek government. At the same time, the absence of an effective mechanism to wind down important institutions that go bankrupt has not prevented banks from increasing their profits. The rather small, in size, European rescue budget cannot function either as a stabilizer or a redistributing income mechanism from the more affluent to less affluent areas of the Eurozone. Coordinating macroeconomic policy through the *SGP* has turned out to be highly restrictive, rendering it hence incapable of addressing the current turbulent European economic environment.

The unprecedented challenges that the Greek fiscal crisis has created, has received worldwide attention due in the main to the contagion involved as well as the potential conflagration on the international financial markets. The existing European strategy to curb the rampant 'wildfire' from spreading to other Member States is proving to be rather ineffectual. The looming economic uncertainty currently experienced in conjunction with the existing imbalances, have put paid to any hopes of a quick recovery.

In Greece, the distorted model of development that has been religiously adhered to for many years, has caused production as well as primary surpluses to shrink dramatically, which in conjunction with inappropriate policy alternatives contributed to a prolonged recession that we are currently witnessing.

Envisaging a way out of the crisis is a task that requires a great degree of boldness and pragmatism. Quick fix measures no longer provide the remedial recipe as these tend to initially mask the problem but at a later stage, the problem, which was lying dormant, resurfaces. The perennial problems deeply seeded in the Greek economic system will undoubtedly take years to address properly. The think-tanks of EU should try and devise ways to prepare the euro area for the coming decades. In view of the lower growth and ageing of the population, a generalized deterioration in public finances throughout the EU is imminent.

It is therefore imperative that the main focus of the economic policies adopted by the EU countries to be on the strengthening of the monetary union and the euro in terms of strengthening the productive, technological, qualitative and redistributive efficiency and not in terms of weakening unions, dislocating labor market institutions, degrading and transforming the social state to "state charity".

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APPENDIX

Table1. Comparison of fiscal austerity measures in selected European Countries
(Primary budget / GDP)

Fiscal consolidation period													
	Denmark	Finland	Greece	Ireland	Belgium	Ireland	Sweden	Italy	Greece	Spain	UK	UK	Portugal
Lowest point	1982	1993	2009	2009	1981	1981	1993	1985	1989	2009	2009	1993	2009
Maximum point	1986	2000	2014*	2014*	1990	1989	1998	1997	1994	1013	1014	1999	1013
Stabilization period (yrs)	4	7	5	5	9	8	5	12	5	4	5	6	4
Primary budget as a percentage of GDP (consolidation period)													
Beginning	-2.6	-3.9	-8.5	-12.2	-7.4	-6.3	-5.5	-4	-5.5	-9.4	-9.5	-4.9	-6.6
End of period	11.6	9.7	5	1	4.9	5.1	5.8	6.6	4.2	0.1	-0.7	3.8	0.2
Annual progress	3.5	1.9	2.7	2.6	1.4	1.4	2.3	0.9	1.9	2.4	1.8	1.4	1.7
Public debt as a percentage of GDP (consolidation period)													
Beginning	64.5	55.3	122	64	86.5	74.6	69.9	80.5	64.2	53.2	68.1	44.5	76.8
End of period	66.5	43.8	144	80.8	125.7	99.4	69.1	118.1	96.4	74.1	88.7	43.7	89.3
Progress	2	-11.5	22	16.8	39.2	24.8	-0.8	37.6	32.2	20.9	20.6	-0.8	12.5
Main economic indicators (consolidation period)													
GDP Growth rate (%)	9.2	6.7			6.5	10	5	7.7	17.1			6	
Demand (%)	1.7	2.1			2.4	2.2	1.4	2.4	1.6			-0.9	

Source: AMECO Database