

DEFLATIONARY POLICIES IN EU COUNTRIES – BALTIC AND GREEK MODEL

Helena Horská – Daniela Milučká – Jan Marek

Abstract

Unsustainable development of Greek economy raises the question on appropriate economic policy measures that was adopted to avert full blown sovereign bankruptcy of Greece. The prescribed and adopted restrictive measures caused an economic depression of the Greece that was associated with very high social costs (e.g. historically high unemployment or an unprecedented fall in incomes). Actual economic misery of Greece calls in question whether the strict deflationary policies might themselves rebuild the economic balance or they finally do the opposite. This paper has ambition to analyse the appropriateness and the success of the applied policy mix in Greece in respect to identified key shortcomings of the Greek economy and triggers of the subsequent financial crisis. The cross-country comparison with the managed deflationary policy in Latvia or other EU countries might help us to confirm or exclude the hypothesis that the misery of Greek economy has been caused by inappropriate policy-mix adopted in Greece or failure to promote advised policy measures.

Keywords: deflationary policy, financial crisis, Greece, Latvia, internal devaluation, commitment

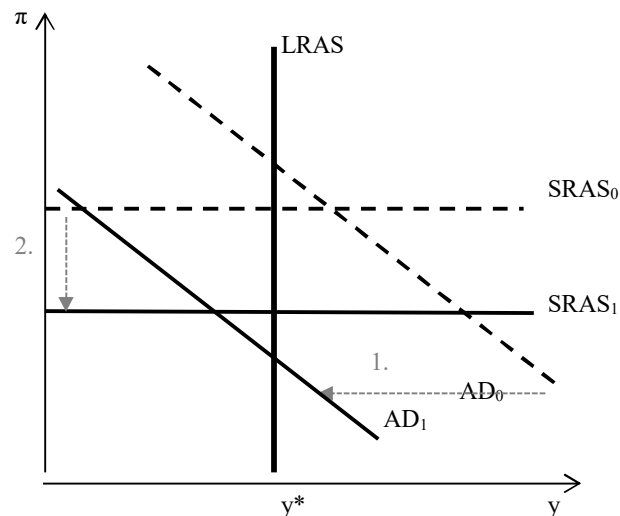
JEL classification: E120, E 620, F340, F450, G180

Introduction

Recent economic crisis, which spread throughout the old continent after 2008, unveiled the major cracks in the stability pillars of the European economies. Doubtful sustainability of social and pension systems, loose government policies, missing regulation measures in some fields of banking industry and other flaws in the structures of European economies gave rise to destructive wave of plummeting GDP growths, deepening government deficits and failures of the banking systems. Devastating wave washed up on shore only the strongest and most stable economies (as France, Germany), leaving them breathing though seriously crippled. Fragile economies mostly from the Southern Europe (Greece, Portugal and Spain) got almost drown but lifelines were thrown to them from the international institutions (European Commission, ECB or IMF) in a form of adjustment programs.

Adjustment programs aim to restore fiscal sustainability, support economic growth, reorganize selected sectors and reinstitute confidence in markets. Each country in the program is dosed by prescribed medicine. In order to obtain another dose of cure, country must fulfill criteria established by the international institutions within certain period of time. This prescribed medicine is a mixture, which corresponds in economic literature to the links *deflationary fiscal policy* and *internal devaluation*¹. Main aim of the deflationary policy is to restore the balance in the economy by intentionally pushing down aggregate demand, which reflects in decreasing prices. Deflationary (tight) fiscal policy includes the mix of higher government income (tax or non-tax revenues) and lower spending that should lead to improvement of budget deficits and reduction of government debt. Usually tight fiscal policy, which is demonstrated as a shift of AD curve down to southeast in Figure 1, goes hand in hand with internal devaluation. Internal devaluation aims to decrease wages and simultaneously increase productivity and this effect reflects in downward shift of aggregate supply (see the modified Keynesian model of AS-AD with inflation as an exogenous variable and assumption of sticky prices in the short run).

Fig.1: Modified Keynesian model of AS-AD



Source: Adopted from Frank, Bernanke (2009) and Horská (2011)

Note: π ...inflation, y ...real GDP growth rate, y^* ...growth rate of potential output, AD...aggregate demand, SRAS...short-run aggregate supply, LRAS...long/run aggregate supply, 1. ...impact of fiscal restriction on AD, 2. ... impact of cost reduction or internal devaluation.

Mixture of deflationary policy and internal devaluation thus affects both demand and supply side, which may help attain the market balance faster. Building upon this economic theory, our paper has ambition to

¹ For more details on internal devaluation, please, see our forthcoming paper Internal Devaluation In Eurozone – Cross Country Comparison.

analyse the appropriateness and the success of the applied policy mix in Greece in respect to identified key shortcomings of the Greek economy and triggers of the subsequent financial crisis in cross-country comparison with Latvia, Ireland and Portugal – countries also in adjustment programs but with clearly better macroeconomic results than Greece.

The paper is organized as follows. Chapter 2 offers an insight into literature review on deflationary and internal devaluation policies cross European countries. Chapter 3 shortly answers the question why we consider Latvia as an example of successful deflationary policy and analyses steps of Greek government and its implementation of deflationary policies, using simple cross country comparison with Latvian examples.

1. Literature review

Success of aforementioned fiscal measures on future economic development depends mostly on the commitment of current government to the program and its willingness to implement strict fiscal restrictions. Due to different levels of government commitment we can find examples of successful programs (as Latvia and arguably Ireland) and contra-examples. Many economists agree that Latvia could serve as an example for successful implementation of deflationary policy and internal devaluation. IMF's director Ch. Lagarde stated that Latvia's incredibly impressive economic achievements after tough crisis were thanks to their willingness to take their medicine quickly instead of suffering from the pain of fiscal restrictions over several years (IMF conference, 2012). Similarly, ECB Board Member J. Asmussen stated that the speed is essence of fiscal consolidation (Asmussen, 2012). Blanchard, Griffiths and Gruss (2013) are also supporters of Latvian success. The authors claim that the effect of deflationary policy was mostly indirect; however, it coincides with starting the economic growth in Latvia. Greater gratitude to Latvian rebound is yet attributed to the internal devaluation. Irrelevantly whether deflationary policy or internal devaluation should be more attributed to economic growth, their correct ratio managed to increase Latvia's output by 18 percent since the bust, rebalance fiscal accounts and get financial sector back in shape (Blanchard, Griffiths and Gruss, 2013).

In contrast, Krugman (2012) and Weisbrot (2012) clearly oppose Lagarde's opinion on successful implementation of austerity programs as a possible solution for sustainable recovery from economic recession. Weisbrot (2012) argues that Lagarde ignores social and human costs connected with austerity measures. According to Weisbrot (2012) Latvia failed to move its real exchange rate enough to cause improvements in trade balance. Krugman (2012) complements Weisbrot's argument claiming that Latvia's success in changing its current account deficit into surplus is nothing more than effect of recovering from economic contraction, since the dependence between current account and GDP growth is considerable. As

bottom line, both Krugman (2012) and Weisbrot (2012) conclude that economic data do not support the success of Latvia’s fiscal measures to the extent to which they are praised for.

Obviously, success or failure of implemented austerity measures may be rather subjective opinion. Word “successful” can be thus misleading depending on the economic scale, which defines the success of fiscal policy. Therefore, in the upcoming chapter we clarify economic scale on which we built our analysis on.

2. Can be Latvia a “success” example?

The economic slump of Greece is in terms of real GDP loss extant comparable with the last economic recession in Latvia. During 2008-2009 Latvian real GDP plummeted as much as in Argentina during 1998-2002 (Weisbrot and Ray, 2010). Also the damages in the US output during the Great Depression (1929-1933) could be comparable to the greatness of Greek and Latvian losses (see Fig.I in Appendix). However, the USA suffered these losses within 5 years unlike Latvia’s striking 2 years. In December 2009 Latvia signed up for the adjustment program from the European Commission for 7.5 bn. EUR until January 2012. Deflationary policies in adjustment program included increase in income, property and VAT taxes. Austerity measures with a light touch of internal devaluation combined pension, benefits and wage cuts (see Tab.1). Instead focusing on external devaluation, Latvia implemented fiscal adjustments summing in 15 percent of GDP (IMF, 2012).

Tab. 1: Deflationary Policies in the European countries

Type of measure	Greece	Ireland	Latvia	Portugal
Benefit and/or pension cuts (or freezing)	Yes		Yes	Yes
Increased income taxes and/or reduced tax concessions	Yes	Yes	Yes	Yes
Increased worker social insurance contributions	Yes	Yes	Yes	Yes
Public sector pay cuts	Yes	Yes	Yes	Yes
Increased property taxes	Yes		Yes	Yes
Increased standard rate of VAT	Yes	Yes	Yes	Yes
Start period of measures	2010	2011	2009	2009

Source: Avram, S. et al. (2013)

Note: Temporary measures which were reversed by mid-2012 are excluded.

More detailed overview of restrictive fiscal measures in selected countries is available on request.

In order to evaluate deflationary policy in Latvia, we first reasonably contradict arguments from economists who do not support this hypothesis. Development of main macroeconomic variables suggests that Krugman's and Weisbrot's arguments can be quite easily challenged using their own weapons. Taking deeper insight, Krugman clearly omits effect of external demand on Latvia's current account, which appears to have a stronger impact on current account movements than changes in domestic demand (see Tab.2). Furthermore, Tab. 2 shows that real effective exchange rate does not seem to have a considerable impact on movements of current account (the regression coefficient is almost zero in Model 1) and its omission improved even the parameters of the model (see Table 2 Model 2). Weisbrot's (2012) arguments on social costs can be also challenged. Figure 4 shows that confidence of Latvian consumers into domestic economy did dramatically drop at the beginning of 2008 and it did not continue deepening nor remain fluctuating around its lowest level. Instead, consumer confidence in Latvia rebounded back relatively fast and reached its pre-crisis level already in 2012. In contrast, this argument cannot be raised against Greece where consumer confidence kept gradually falling down until 2012 and it still has a long way to go to regain the same level as before the crisis (see Fig. II in Appendix).

Political side cannot be missed out from our argumentation. Entrance into the adjustment program is mostly political decision. Therefore, changes in the ruling government can have considerable impact on success or failure of implemented fiscal measures. Fig.2 nicely captures lack of confidence of Latvian inhabitants towards their government on the background of economic slowdowns (grey areas). It shows that confidence of Latvian people clearly increased after entering into adjustment program, however bounced back close before the end of program (presumably due to increased uncertainty about future economic development when the program ends).

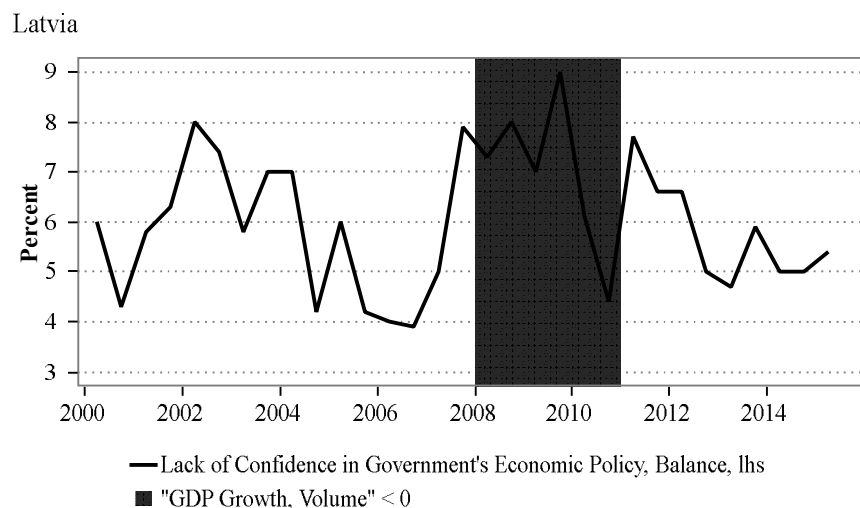
Aforementioned arguments support our presumption that Latvia succeeded to implement fiscal (deflationary) measures fast and effectively. Mixture of fiscal reforms, austerity measures, and strong commitment from government and confidential support from Latvian people thus rewarded Latvia with impressively fast economic rebound, which may evoke the feeling of successful policies.

Tab. 2: Impact of domestic and foreign demand on current account

Model 1				
Current Account/ GDP ratio	Coeff.	Std. Error	t-Stat.	Prob.
change in domestic demand (yoy)	-0.349614	0.101848	-3.432699	0.0012
change in EA gdp (yoy)	-0.766243	0.537526	-1.425501	0.1599
REER	-0.000328	7.21E-05	-4.544313	0.0000
R-squared	0.469351	Durbin-Watson stat	0.310671	
Adjusted R-squared	0.449326	Akaike info criterion	-2.804074	
		Nr. Observations	56	
Model 2				
Current Account/ GDP ratio	Coeff.	Std. Error	t-Stat.	Prob.
change in domestic demand (yoy)	-0.294438	0.113868	-2.585791	0.0126
change in EA gdp (yoy)	-1.068811	0.526224	-2.031096	0.0474
AR(1)	0.884030	0.067404	13.11534	0.0000
R-squared	0.841457	Durbin-Watson stat	2.219478	
Adjusted R-squared	0.835359	Akaike info criterion	-3.999286	
		Nr. Observations	55	

Source: Author's calculations, Macrobond, April 2015.EViews.
 Note: EA...Euro Area.

Fig. 2: Lack of confidence against ruling government in Latvia



Source: **Macrobond**

Source: Macrobond, April 2015.

3. Cross-country comparison of deflationary policies in selected EU countries

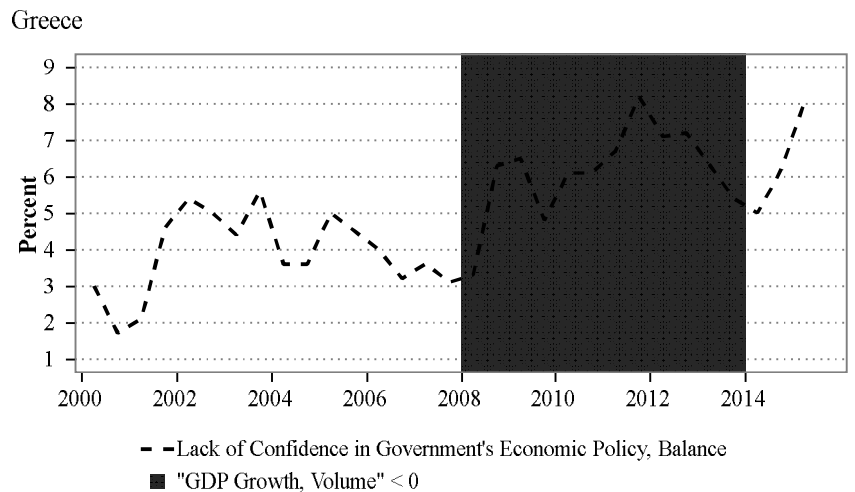
After optimism attained from reading about Latvia's successful path of recovery, one has to ask whether this type of medicine can be mixed also for the European troublemaker – Greece. Therefore, this paper has

ambition to analysis the appropriateness and the possible success of the applied policy mix in Greece in respect to identified key shortcomings of the Greek economy and triggers of the subsequent financial crisis in a cross-country comparison analysis, taking particularly Latvia as an example of successful deflationary policy.

3.1 Selected criteria for deflationary policy

Our comparative analysis focuses on the EU member countries that in the same stage of the recent financial crisis (2008 -2014) adopted deflationary (tight) fiscal policy measures of at least 9.5% of GDP as was the case of Latvia in the first year of its adjustment program. To turn our focus towards the managed deflationary policy we added the second criterion into our country selection - systematic deflation in consumer prices over specified period of time (see Fig.III in Appendix) that lasted more than couple of months as the generally recognized definition of deflation says and was simultaneously accompanied by declining inflation expectations disrupted by short term recovery (see Fig.IV in Appendix). Based on these criteria we selected four countries for further analysis: Ireland, Greece, Latvia and Portugal. These countries in our view had applied so called managed deflationary policies as part of the adjustment programs from the European Commission. However, because of very limited extent of this paper we will focus primarily on comparison between Greece and Latvia from this point forward.

Fig. 3: Lack of confidence against ruling government inGreece



Source: **Macrobond**

Source: Macrobond, April 2015.

3.2 Political commitment is a key

Political stability and reform commitment played a crucial role in success of acquired adjustment program for Greece. Due to severe political crisis fulfilling of agreed reform targets went off the track for short period of time. This time delay had considerable macroeconomic repercussions as Greece focused on recessionary rather than productivity-boosting channels (IMF, 2013). Often change in the Greek government does not seem to be reflecting very positively on Greek people either. As Tab.I in Appendix shows, change in the Greek government occurred relatively often (6 times in about 7 years) and progressed from center-right to rather far left party (e.g. Syriza). Irregular changes in the government parties reflected also in the confidence of Greek people towards their government. No-confidence against the Greek government has been gradually increasing since 2008 reaching its top (logically) when no-government stage transpired. Despite continual decrease after 2012, mistrust against Greek government in the past year bounced back to its highest levels (see Fig.3) in contrast with a recovery of confidence into Latvian government.

3.3 Deflationary (fiscal) measures in Greece

Greece entered first adjustment program from the European Commission in May 2010 (obtaining total EUR 72 bn), which was superseded in March 2012 by second program (total EUR 130 bn) until 2014. Greece signed up for the fiscal measures, which clearly put more weight on the expenditure side rather than increasing the government revenues (see Table 5). Greece agreed to painful cuts in the public wages and pensions, including 13th and 14th allowances, by more than 0.5% GDP only in 2010. Fiscal expenditure measures for 2011-2014 included mostly public investment cuts and pension freezes, which, however, were not planned to exceed 0.1% GDP per year. Revenue side of the Greek government budget had an ambition to increase VAT and excise taxes (fuel, tobacco) and introduce special taxes (green tax) and further broaden the VAT base (European Commission, 2010). Despite a promising growth of budget revenue to GDP ratio since 2011 (see Fig. 4), tax reform administration in Greece significantly stalled in 2012, tax collection suffered and consequently budget targets were missed (IMF, 2013). Conversely, Latvia managed to reduce its budget deficit from 9.8% of GDP in 2009 through 8.2% in 2010 to 3.5% in 2011 mainly due to expenditure cuts (see Fig. 4) accompanied by robust government revenues that over-performed the expectations (European Commission, 2012).

Tab. 5: Planned fiscal (deflationary) measures in the adjustment programs (% GDP) – Greece

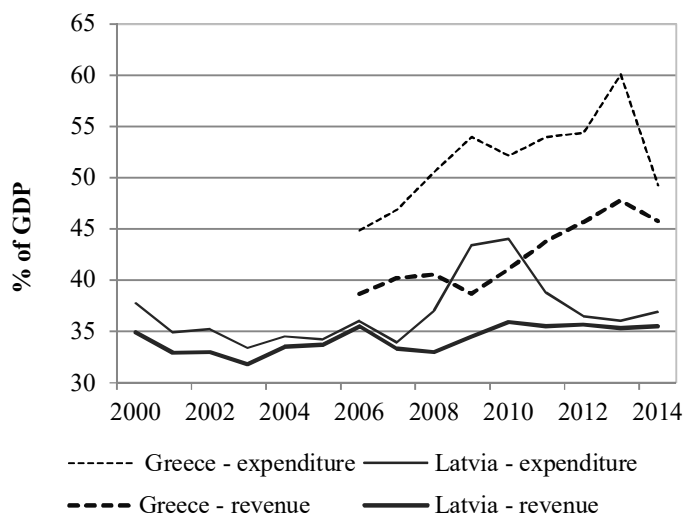
	Revenue measures		Expenditure measures	
2010	0.5%	increase in VAT and	1.9%	wage, benefit and pension cuts, public investment reduction, Kalikrates savings)
2011	2.9%	excise taxes, special	1.2%	
2012	0.7%	taxes (green, luxury	1.7%	
2013	-0.3%	goods), gaming	2.3%	
		royalties,		

Source: European Commission

Note: Detailed structure of all available fiscal measures (%GDP) for Greece, Latvia, Portugal and Ireland upon request.

The overall progress, the speed of reforms and effective implementation of the adjustment programs were undoubtedly affected by often political changes in Greece. These together with very weak commitment of the Greek government to (any) reforms caused the mismanagement of Greek economy crisis. In our view, the key shortcoming of the Greece economy that should be tackled are: (1) clientelism, (2) corruption, (3) extended shadow economy (at least 25% of the whole economy according to available estimates), (4) low effectiveness of the tax collection and wide-ranged tax evasion, (5) high presence of the state in the economy, (6) outdated economic structures with only 8 % share of industry according to Eurostat figures and (7) reducing still very generous early retirement schemes.

Fig. 4: General government revenue and expenditure – Latvia and Greece



Source: Eurostat, April 2015.

And the Greek reality? The very ambitious privatization program announced in 2011 with the target of EUR 50bn by 2015 (out of roughly EUR 81bn assets identified as available) was reduced to EUR 8.7bn in 2013 and again by EUR 2bn in 2014. To first quarter of 2014 the Hellenic Republic Asset Development Fund

collected only EUR 2.6bn. Regarding the effectiveness of tax collection and problem of tax evasion, the data speak with the clear language: though the tax burden in Greece kept growing since 2008, it remained below the Euro Area average. Both Latvia and Greece were the countries with the largest VAT gaps in European Union in 2011. VAT tax efficiency ratio (the ratio of VAT revenue to GDP divided by the standard VAT rate) gradually declined until 2012, where it reached the bottom and stayed at those low levels afterwards. Even though Greece agreed to some VAT increase and VAT base broadening, VAT tax efficiency ratio in Greece is still one of the lowest in Europe (European Commission, 2013a,b). Moreover, Greece also has the highest self-employment in EU (above 32% of total employment in 2014 according to Eurostat), which widens the room for shadow economic activity, since it is relatively easy for self-employed (compared to employees) to evade income tax and social-security contributions for example through undeclared work. The strong incentive to do it, it is the very high tax levies on labor income in Greece that account for 33% of labor costs compared with the OECD average of 23%. And the last but not least, the generosity of the Greek retirement system is documented by the above-average share of pension expenditure in Greece (16 % GDP in 2013), compared to 12 % in Euro Area or 10 % in Germany and 7,7 % in Latvia. According to European Commission, about 30 % of old pensioners receive pensions above 1000 EUR and two out of three pensioners receive supplementary pensions (European Commission, 2013a). Average exit age from the labor force in Greece is at age 61 (OECD average at 62), gross pension replacement rate at astonishing 75 % (for example replacement rate in the USA is 45 %, in Germany 42 %, OECD average 57 %). Early retirement age has increased in Greece from 53 to 60 years; however, it is still lower than the EU average.

Conclusions

The deflationary policy implemented in Latvia can be viewed, according to our analysis, as an example of successful economic program that aimed to correct the profound economic imbalances. So, Latvia could be used as the good policy practice for other countries that targeted huge but manageable economic imbalances. The adjustment programs for Greece were all above mismanaged. Often political changes in Greece and progressed from center-right to rather far left government contributed to very weak commitment of the Greek leaders to the unpopular but highly demanded reforms. As far as the adjustment programs for Greece are concerned, they were in our view focused too strongly on expenditure side of the budget, while the weak ability of the government to collect effectively revenues including taxes and privatization receipts was not really handled. The Greek restructuring economic program should in the future focus on Greek clientelism, corruption, wide-spread shadow economy, low effectiveness of the tax collection and extended tax evasion, high presence of the state in the economy, outdated economic structures, reducing still very generous early retirement schemes and finally assure the political independence of National Statistical Service of Greece.

Among other things, we stress that there is a huge space for privatization in Greece that would visibly improve its fiscal position and debt burden, restore the economic growth, improve in the medium term the productivity and competitiveness of the Greece economy and would attract further foreign capital into local economy and shattered banking sector. Hence, further progress in privatization and improvement in public governance are highly needed in Greece and national government together with its creditors should insist on it.

Further research might focus on the way how to restructure the Greek economy into more effective and modern economy with respect to the national specifics or to widen the cross-country comparison by other EU reformed countries.

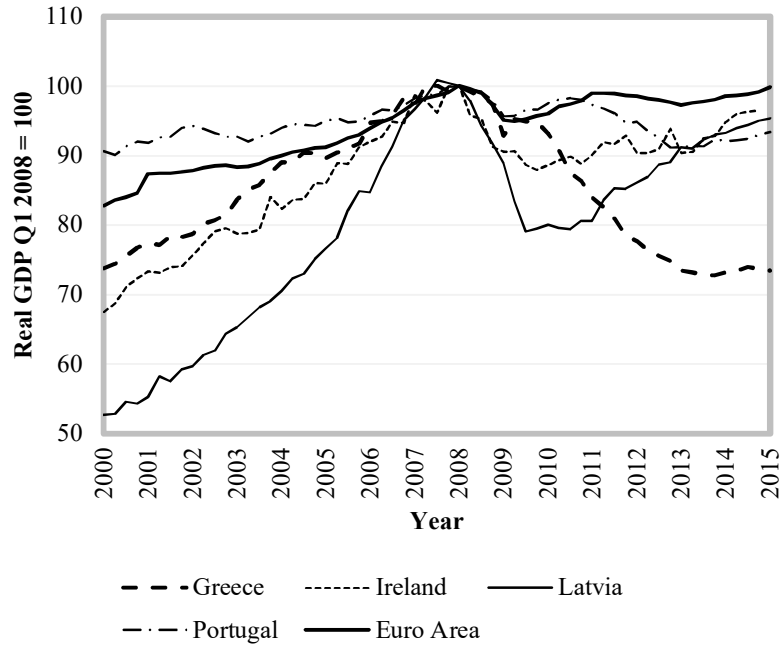
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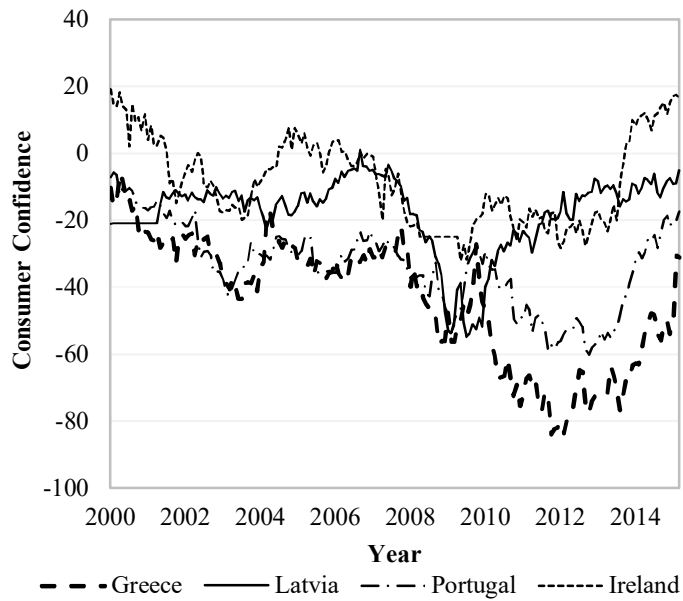
Appendix

Fig. I: Real GDP growth



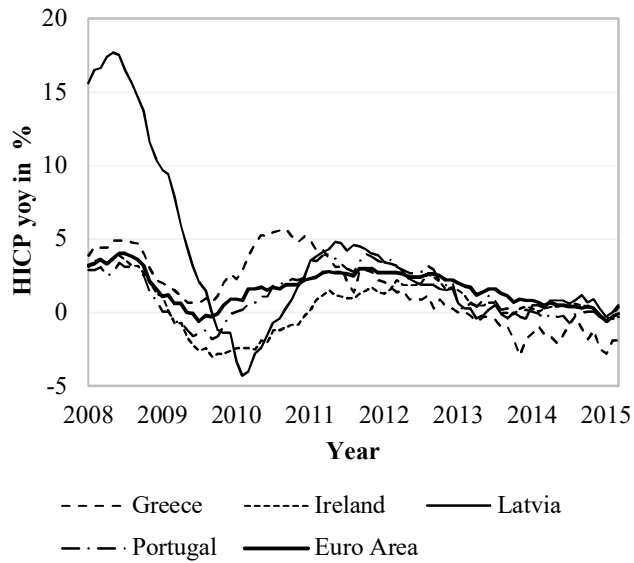
Source: Macrobond, April 2015.

Fig. II: Consumer confidence



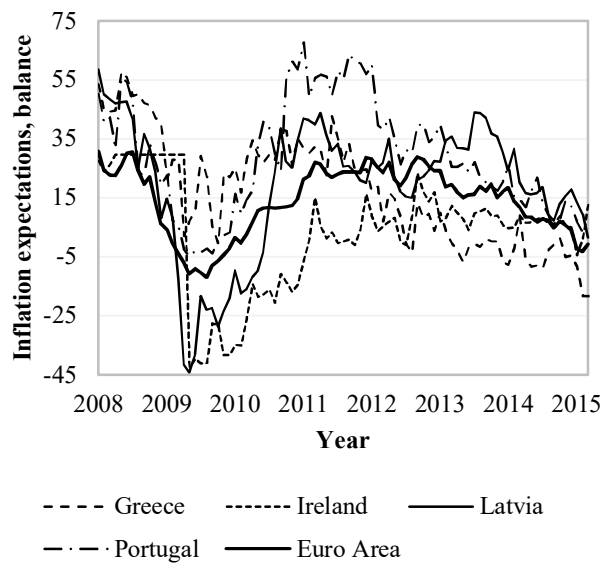
Source: Macrobond, April 2015.

Fig. III: HICP inflation



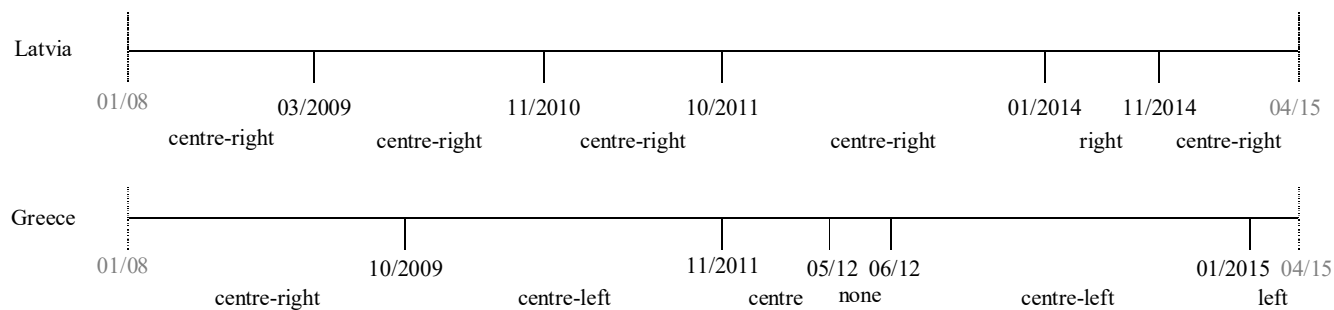
Source: Eurostat, April 2015.

Fig. IV: Inflation expectations



Source: Eurostat, April 2015.

Tab. I: Change in the government



Source: European election database (Norwegian Social Science Data Services)

Contact

Helena Horská

ŠKODA AUTO VYSOKÁ ŠKOLA o.p.s., Na Karmeli 1457, 293 01 Mladá Boleslav

helena.horska@rb.cz

Raiffeisenbank a.s., Hvězdova 1716/2b., 140 78, Praha 4,

Daniela Milučká

Raiffeisenbank a.s., Hvězdova 1716/2b., 140 78, Praha 4,

daniela.milucka@rb.cz

Jan Marek

Raiffeisenbank a.s., Hvězdova 1716/2b., 140 78, Praha 4,

Univerzita Karlova v Praze, IES, Opletalova 26, 110 00 Praha 1

honzamarek92@gmail.com