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Revisiting the Latvian and Greek Financial Crises: The Benefits of Front-Loading Fiscal Adjustment

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“Nowhere have austerity policies been more aggressively tried – and generally failed to live up to results promised by advocates – than in Greece.”¹

¹ Suzanne Daley, “Greek Patience with Austerity Nears Its Limit,” New York Times, December 29, 2014. Surprisingly, this assertion came in the news section of the newspaper, and not the editorials.



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Abstract

This paper discusses why Greece has done so poorly in comparison to all other European Union countries since the onslaught of the global financial crisis in 2008. To show what was wrong with its fiscal adjustment, this paper compares Greece with the other European Union country that was hit by the most severe fiscal crisis, namely Latvia. The conclusion is that front-loaded fiscal adjustment works much better. Greek economic policy has been a popular topic among opinion writers, notably Nobel Prize winner and New York Times columnist Paul Krugman, who claimed that Greece suffered from austerity. Because of his prominence in the international public debate, the paper scrutinizes his arguments on the Greek crisis. The paper also examines what policy the International Monetary Fund has pursued with regard to Greece, and how its views have been influenced by the debate and Greek economic developments. Finally, the paper assesses what lessons that can be drawn from the contrasting experiences of Latvia and Greece. The conclusion is that a fiscal adjustment should be sufficient to resolve the crisis to restore confidence and that it should be as front-loaded as is practically and politically possible.



1. Introduction

The far left party Syriza won the Greek parliamentary elections on January 25 by campaigning against austerity. Its victory is a cause to look back upon the experiences of fiscal adjustment in Europe, in general, and Greece, in particular, since the global financial crisis hit in 2008². Why did Greece do so poorly in comparison with all other European Union countries?

Greece has suffered a long and severe economic recession, more than necessary. In the last six years, its GDP plummeted by 23% (IMF 2014d). What was wrong with its fiscal adjustment? To answer that query, this paper will compare Greece with the other European Union country hit by the most severe fiscal crisis, namely Latvia.

Second, Greek economic policy has been a popular topic among opinion writers. Their leader has been Nobel Prize winner and New York Times columnist Paul Krugman, who has led the camp claiming that Greece suffered from austerity. Because of his prominence in the international public debate, I shall focus on him and scrutinize his arguments on the Greek crisis.

The third part of this paper examines what policy the International Monetary Fund has pursued with regard to Greece as well as how its views have been influenced by the debate and Greek economic developments.

Finally, I conclude with what lessons can be drawn from the contrasting experiences of Latvia and Greece. The conclusion is that a fiscal adjustment should be sufficient to resolve the crisis and to restore confidence and that it should be as front-loaded as is practically and politically possible.

The purpose of this paper is to analyze fiscal policy. It explores and evaluates the impact of different strategies of fiscal adjustment from 2009 to 2014. It is not suggesting what should be done in Greece today, but it assesses what policies are preferable in an acute fiscal crisis. Today, we can benefit from having the record of half a decade of economic policy and economic outcomes.

The standard method for analyzing such policies is regression analysis, but it suffers

This paper has been inspired by the lively internal debate at the Peterson Institute for International Economics, involving mainly Ajai Chopra, Bill Cline, Jacob Kirkegaard, Paulo Mauro, Edwin Truman, Angel Ubide, Nicolas Veron, and Steve Weisman. I want to thank Vijay Khosa for having provided me with excellent research assistance.

from many shortcomings and may confuse more than it clarifies. Financial crises vary greatly both by nature and dignity. Many variables are at play, and one has to control for irrelevant variables, but the more variables that are the same, the less there is to control for. The difference is big between a minor and a major fiscal crisis. Therefore, I am focusing on the two extreme cases, Greece and Latvia, with the biggest fiscal deficits, the biggest required fiscal adjustment, and the most substantial output falls. Both countries were also members of the European Union and had many international institutions in common. Latvia maintained a fixed exchange rate to the euro, while Greece adopted the euro in 2001, allowing us to sidestep the exchange rate issue³. Monetary policy differed greatly, because Greece had access to ample liquidity from the European Central Bank (ECB), while Latvia did not, putting Greece at a major advantage in 2008-09.

To start, we need to define “austerity”. An ordinary definition of “austerity” is “measures taken by a government to reduce an excessive budget deficit by cutting expenditures or raising revenues”. I prefer the more technical term fiscal adjustment. The issue is not how much government expenditure was cut or revenues increased, but how the budget deficit evolved as a share of GDP.

2. Contrary Crisis Policies

The financial crisis hit the world with massive force, with a sudden stop of international financial flows after the bankruptcy of the Lehman Brothers on September 15, 2008. Most countries faced a temporary liquidity freeze leading to a deterioration of their fiscal situation, and many ended up in fiscal crisis. Among the then-27 members of the European Union, all but one (Poland) recorded an output contraction in 2009.

Table 1 – Latvia’s Fiscal Adjustment from 2009 to 2012

<i>(Percent of GDP)</i>	2009	2010	2011	2012	Cumulative
Total	8,8	5,9	2	0,8	17,5
Total Revenue	1,9	2,1	1,7	0,4	6,1
Total Expenditure	6,9	3,8	0,3	0,4	11,4

Source: Bank of Latvia, “Latvia’s Experience with Fiscal Adjustment,” 2014, http://ec.europa.eu/economy_finance/events/2014/20140211-meeting/documents/sessioniii4traidase_en.pdf.

³ I think it would have been disastrous for Greece to abandon the euro and for the Baltics to have devalued (the IMF preference), as I have discussed elsewhere (Åslund 2010, Åslund and Dombrovskis 2011).



Estonia, Latvia, and Lithuania experienced the greatest general overheating. They had large current account deficits and high inflation, with economies operating beyond their actual capacity. The global financial crisis delivered a sudden stop to international finance, which led to a sudden and sharp fall in output of 14-24% in two years. Latvia's contraction was 24% in two years.

Table 2 – Greece's Fiscal Adjustment from 2010 to 2013

(Percent of GDP)	2010	2011	2012	2013	Cumulative
Total	2,5	4,1	2,4	2	11,1
Total Revenue	0,5	3	0,8	-0,3	4
Total Expenditure	2	1,1	1,7	0,5	5,3
Structural Reforms*				1,8	1,8

* = Improvement in budget control and processes as well as improved tax administration. Listed as expenditure measures in Greece's LOI/MEFP on May 2010.

Source: "Greece: Ex Post Evaluation of Exceptional Access under the 2010 Stand-By Arrangement," IMF Country Report No. 13/156, June 2013.

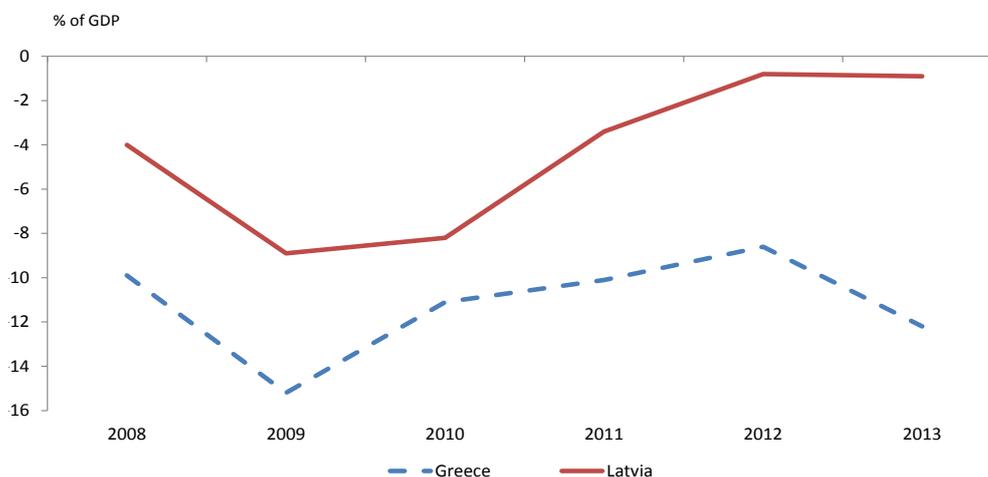
As the global financial crisis arrived in late 2008, the World Bank (2010, 21) calculated a baseline scenario that, without any adjustment, Latvia was heading to a budget deficit of 21.4% of GDP in 2010, with public expenditures of 58% of GDP. The Latvian government understood the severity of the situation. It carried out a fiscal adjustment of 8.8% of GDP in 2009 and of 5.9% of GDP in 2010, amounting to a fiscal adjustment of 14.7% of GDP in the course of two years and a total of 17.5% of GDP in four years, according to IMF calculations (Table 1). Already by July 2009, the Latvian government had restored investment confidence. Although the budget deficit for that year was 8.9% of GDP, the policy action and direction were sufficient to convince the market. Funds started flowing into the country and the Latvian recession lasted only two years (Åslund and Dombrovskis 2011, 102-110).

When its crisis erupted in 2010, Greece faced the most severe fiscal crisis. Among the EU countries, it had the largest budget deficit and public debt, though it also had the worst corruption and business environment (Transparency International 2010). In 2009, Greece's fiscal mismanagement had boosted its budget deficit to 15.2% of GDP and its public debt to 127% of GDP (Eurostat 2014). In early 2010, Greece lost access to international financial markets.

Greece had a long history of bad economic policy, eminently analyzed by Nikos Tafos (2013) in his book *Beyond Debt: The Greek Crisis in Context*. Since Andreas Papandreou came to power in 1981, Greece had stood out for its fiscal irresponsibility. From 1981–99, Greece had an average budget deficit of no less than 8.7% of GDP. Papandreou ruled for 11 of those years. His was a parasitical and oligarchic regime that used socialism to rebuild an old clientele

system. Multiple Greek governments had grossly doctored their statistics and the real average budget deficit was 6.1% of GDP (Eurostat 2014) during the years 2000-08. Not one single year did Greece fulfill its EU obligation to maintain a budget deficit of less than 3% of GDP, the Maastricht ceiling.

Figure 1 – Figure 1. General Government Balances, 2008-2013



Source: Eurostat.

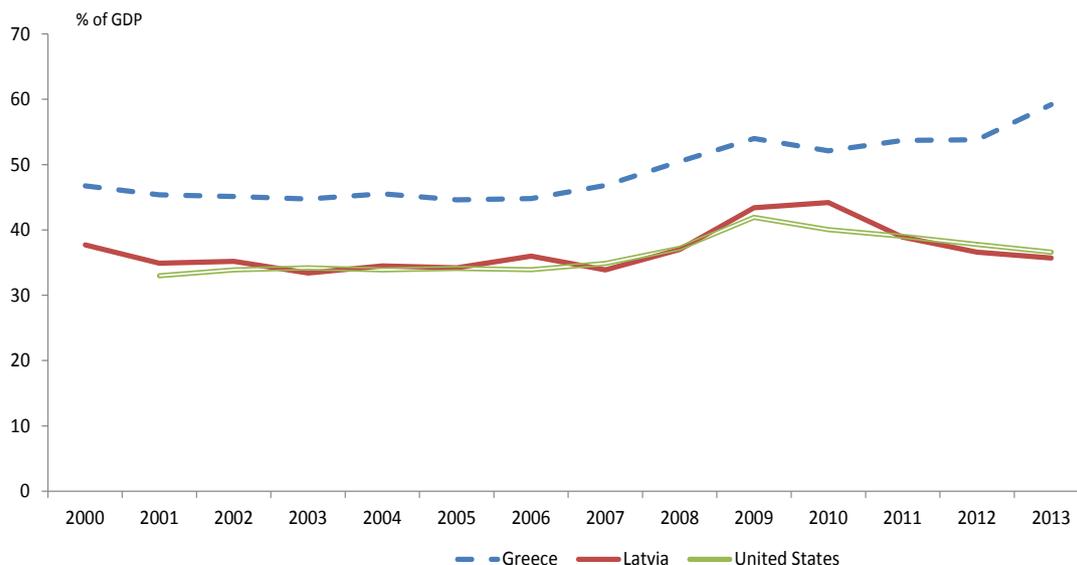
Greece could have tried to replicate the successful Latvian crisis resolution, but it did the opposite. According to the IMF, its fiscal adjustment in 2010 was a paltry 2.5% of GDP and in 2011, only 4.1% of GDP, a total of only 6.6% of GDP in two years, when Latvia had carried out a fiscal consolidation of 14.7% of GDP. Greece's total fiscal adjustment over four years was only 11.1% of GDP, compared with 17.5% of GDP in Latvia (Table 2). The attempted therapy fell far short of the disease, precluding any cure. Needless to say, no financial confidence was restored.

The key to the resolution of a financial crisis is to get ahead of the curve, to pursue a sufficiently fast fiscal adjustment so that the budget deficit as a share of GDP falls. Latvia did so. In its fourth year of fiscal adjustment, Latvia had an insignificant budget deficit of 0.8% of GDP. Alas, because of its inadequate fiscal adjustment, the Greek government never managed to get ahead of the curve and reduce its budget deficit as a share of GDP, since the size of GDP was declining as well, as is usually the case in a severe crisis. Hence, market confidence was never restored. During the four years from 2010-13, Greece had an average budget deficit of 10.5% of GDP, peaking at 12.2% of GDP in 2013 (Figure 1)⁴. By our definition, this was not austerity.

⁴ I use Eurostat statistics. A major difference between Eurostat and IMF WEO is that Eurostat includes bank recapitalization costs, while IMF WEO does not. That explains the rise in budget deficit in 2013. By its measure, the IMF assessed the budget deficit at only 3.8% of GDP in 2013.



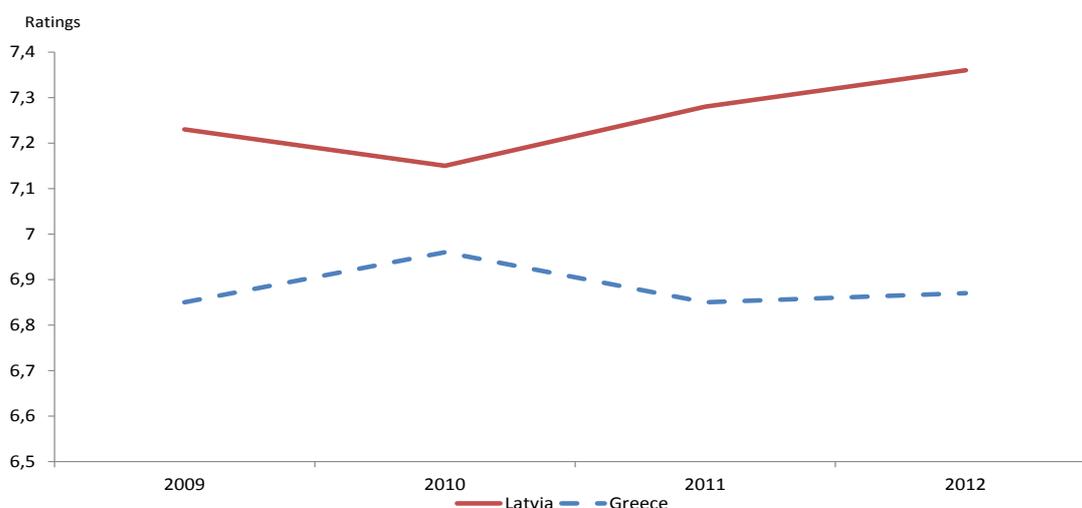
Figure 2 – Total Public Expenditures, 2000-2013



Sources: Eurostat; Greece data from 2000 to 2005 and United States data from IMF WEO October 2014 database.

In a fiscal crisis, the most important measure after the fiscal balance measured as a percent of GDP is public expenditures as a percent of GDP. The contrast between Latvia and Greece in terms of public expenditures as a share of GDP was even greater. In the crisis year of 2010, Greece had public expenditures amounting to 52% of GDP, while Latvia’s were close, at 44% of GDP. By 2013, Greece’s public expenditure share of GDP rose to 59% of GDP, while Latvia’s had fallen to moderately 36% of GDP. In particular, Greece spent much more on public sector employee compensation than other European countries, at 12.4% of GDP as compared with 8% of GDP, for example, in Germany (IMF 2014 b, 2014c).

Figure 3 – Economic Freedom of the World Ratings, 2009-2012



Note: Higher ratings indicate higher levels of economic freedom.
 Source: Economic Freedom of the World database, 2014.



Relatively poor countries with high public expenditures, such as Hungary, Ukraine, and Greece, do not grow much. An obvious explanation is that the marginal public expenditures were being spent wastefully for the dubious benefit of the politically powerful public employees. Incidentally, the Latvian share of public expenditures has followed the US share almost exactly, while Greece had the highest public expenditures in Europe in 2013 (Figure 2), even beating France, Denmark, and Sweden. The Greek government did cut real public expenditures substantially, but too slowly to reduce their share of the rapidly declining GDP.

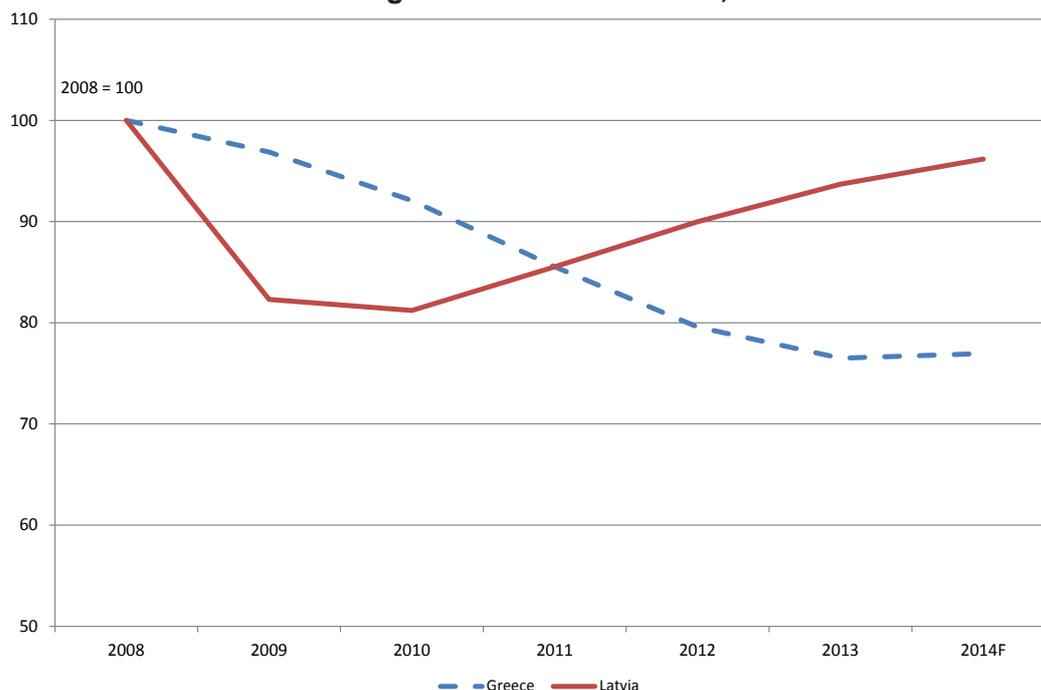
Contrary to widespread misperceptions, Greece has had no particular problems with its state revenues. As Tables 1 and 2 show, Greece has increased its already high tax burden substantially, more so than Latvia, which has had a far lower tax burden all along. Greece's taxes are among Europe's highest, deterring investors, who are also scared away by the worst business environment in Europe, and keeping much of the economy underground. Europe needs structural reforms to achieve economic growth. Also, in this regard, Latvia did far more than Greece. One important reason is that big cuts in public expenditures cannot be even for all. Therefore, they necessitate structural reforms. The broadest empirical index for structural reform is the Economic Freedom Index of the Fraser Institute. Unfortunately, its latest measure is for 2012, but it shows that from 2010-12, the business environment in Greece deteriorated, while it improved in Latvia (Figure 3). According to the European Commission, Greece carried out substantial structural reform in 2013-14, while structural reforms stalled in Latvia, so Greece might have caught up somewhat, though late in the day.

3. Resulting in Very Different Outcomes

The consequences of the tepid fiscal stabilization in Greece have been devastating: six years of declining output, while the Latvian economy has revived. In 2013, Latvia's GDP at constant prices was 4% lower than in 2008, while Greece's was 23% less than in 2008, according to the IMF (Figure 4). A cumulative difference in GDP development of 19 percentage points over six years cannot be subject to statistical aberrations. It is real.

Latvia suffered an output fall of 24% in the course of two years from 2008–10, but the cause was external: a severe liquidity freeze that Greece avoided thanks to being a member of the European Monetary Union (EMU) and, therefore, enabling it to enjoy the abundant liquidity of the European Central Bank (ECB). Having restored its public finances after two years, Latvia has geared up to a solid economic growth of an average of 4.3% a year from 2011-14 (Figure 5).

Figure 4 – Cumulative GDP Change with Constant Prices, 2008-2014

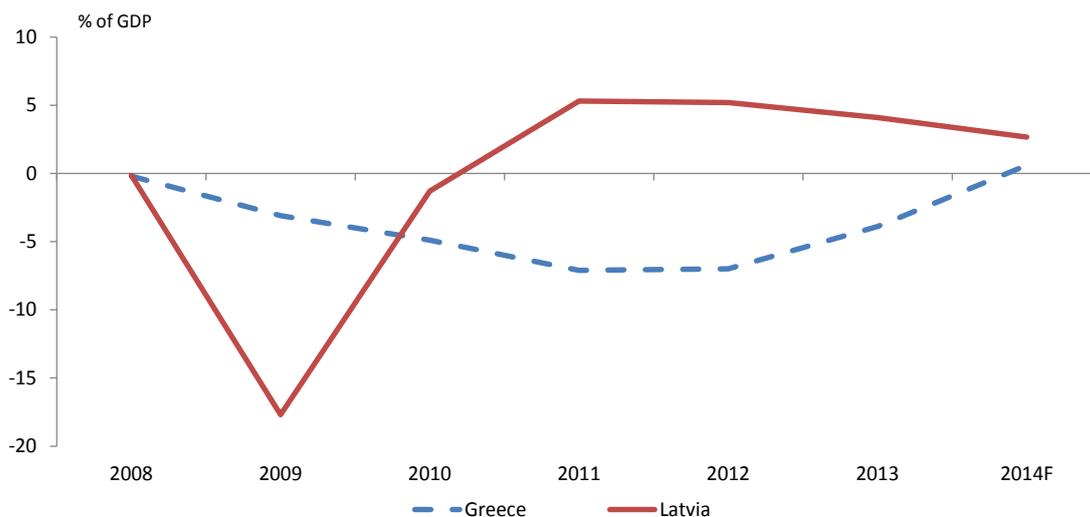


Sources: IMF WEO October 2014; Own Calculations.

One of the most obvious outcomes of a front-loaded fiscal adjustment is that a country incurs less public debt. In spite of Greece having received a substantial write-off of its privately-held public debt in 2012, its public debt rose from 146% of GDP at the end of 2010 to 174% of GDP at the end of 2014, while the Latvian public debt declined from 47% of GDP to 36% of GDP, far below the Maastricht ceiling of 60% of GDP (Figure 6).

The most striking development is the expansion of exports. Throughout Europe, exports hit a nadir in 2009 and recovered afterwards. Greek exports increased respectably by 45% from 2009-2013, but Latvia's exports skyrocketed by 85% during those same years (Figure 7). The export growth is a reflection of structural reform and other efforts to enhance supply. Latvia did more than Greece early on, which has resulted in an earlier export growth. The conclusion is that the radical reforms in Latvia unleashed a supply effect that led to previously unachievable exports.

This outcome corresponds to what economic common sense would suggest. The first task in a financial crisis is to restore stability and the confidence of markets. Thanks to its front-loaded fiscal adjustment, Latvia did so in 10 months, from October 2008 to July 2009. As a result of its unsustainably loose fiscal policy, Greece failed to restore the confidence of the markets for five years. The presence or absence of market confidence results in very low interest rates in Latvia and very high interest rates in Greece, which, in turn, leads to corresponding differences in both investment and consumption and, thus, growth.

Figure 5 – Real Annual GDP Growth, 2008-2014

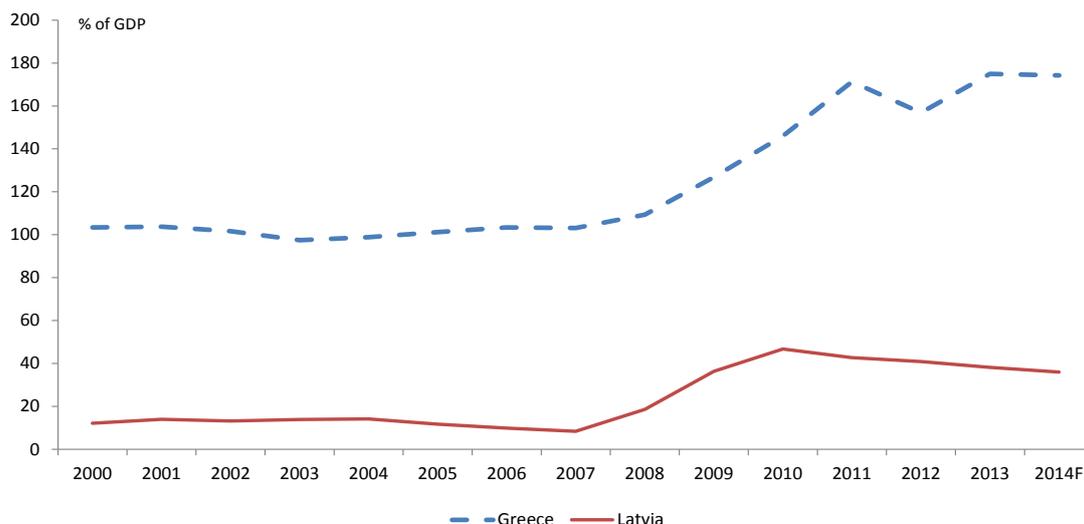
Sources: 2008-2013: Eurostat; 2014: IMF WEO October 2014.

More important is political economy or what is politically possible. Fiscal adjustment and structural reforms should be carried out when politically possible. As the global financial crisis hit the United States, President Barack Obama's chief of staff Rahm Emanuel made the pointed statement: "A crisis is a terrible thing to waste". This is borne out by a substantial academic literature that crisis often offers opportunities for profound changes (Drazen and Grilli 1993, Olson 1982). The Baltic countries lived up to that wisdom. All three carried out fiscal adjustment of about 9% of GDP in 2009. Their experience of fiscal adjustment has brought out the universal advantages of carrying out as much of the belt-tightening as possible early on. Hardship is best concentrated in a short period, when people are ready for sacrifice, what the great Polish reformer Leszek Balcerowicz (1994) calls a period of "extraordinary politics". The Baltic countries succeeded because they concentrated fiscal adjustments to the first year of combating the crisis. Later rounds of belt-tightening have been more limited but politically more cumbersome.

There are many other aspects as well. Social equity is important. The Latvian government hit against the privileged with new taxes, pursued a political campaign against corruption and the oligarchs, and marginalized two of Latvia's three dominant oligarchs. Consecutive Greek governments, on the contrary, left the wealthy and the oligarchs alone. The Latvian government closed half of the state agencies and sacked one third of the public employees, which turned out to be a popular move. The Greek government hesitated for years before it reduced the overbearing, privileged, and inefficient public administration. The Latvian government concluded an early social compact with trade unions, employers' associations, and pensioners' associations at the midst of the crisis to get their support for public cuts, while nothing of the kind was even attempted in Greece (Åslund and Dombrovskis 2011).



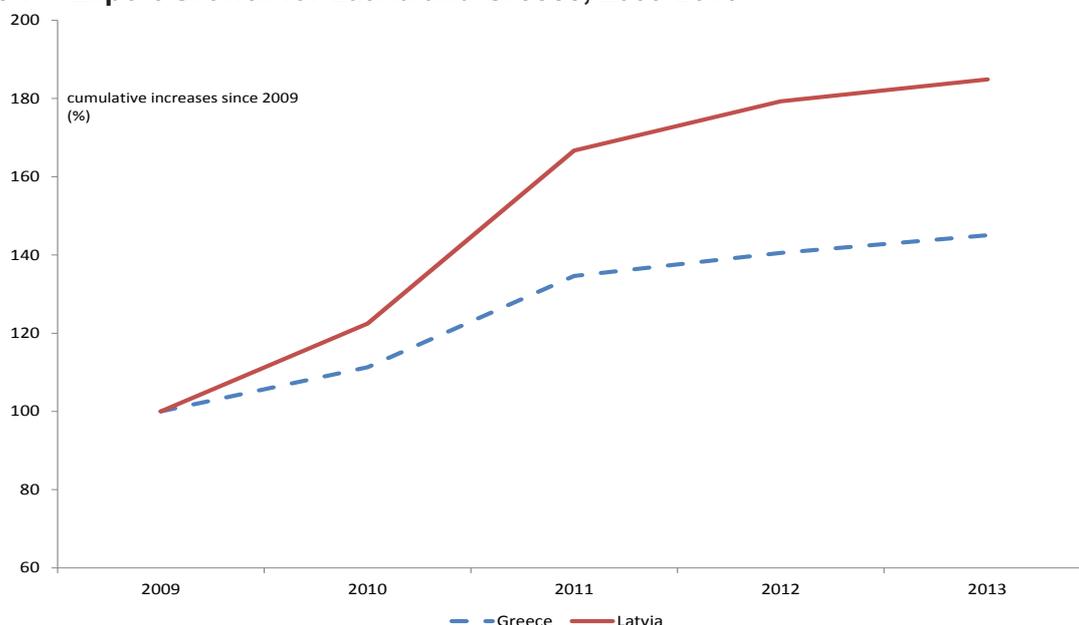
Figure 6 – Total Public Debt, 2000-2014



Sources: Eurostat; Greece data from 2000 to 2005 from IMF WEO October 2014 database, 2014 forecasts from IMF WEO October 2014 database.

The May 2010 IMF/EU stabilization program for Greece was a spectacular failure in comparison to the other stabilization programs in Europe. It has led to remarkably slow and limited fiscal adjustment and has contained uncommonly little structural reform, while it caused major economic, social, and human costs. It has also been the most expensive IMF program ever implemented.

Figure 7 – Export Growth for Latvia and Greece, 2009-2013



Sources: IMF Direction of Trade Statistics; Own calculations.

How could the IMF and European Union come up with such a bad program? The reasons were many. The Greek government of George Papandreou wanted to minimize reforms



and fiscal consolidation, especially in the public sector. The European Union did not realize that a financial crisis could occur in the euro area and was unprepared in all regards. Initially, it did not want to engage the IMF although it lacked the relevant instruments and expertise. It indulged in the rich man's folly, to let funds substitute for thoughts. Politics in Greece and the European Union played an important and detrimental role.

The failure of the IMF/EU program for Greece was no surprise. At the time, on May 3, 2010, I published a blog posting that argued:⁵

The program represents two substantial steps forward. First, the funding is impressive, \$145 billion, which might be a sufficient amount. The other progress is that it is the right form of an agreement: a standard three-year IMF standby loan and EU co-financing rather than a new invention. The EU has abandoned its idea of reinventing the wheel in the midst of a crisis in the form of a new EU stabilization facility.

Even so, the program does not appear credible. First, the austerity measures announced are insufficient. A gradual decline of the budget deficit to 3% of GDP in 2014 will not do with 120% of GDP in public debt. Moreover, to judge from the details made public, this is approximately the old program, perhaps with some more front-loading of the measures.

Second, the balance of spending cuts and revenue measures seems inappropriate. The spending cuts are only 5.25% of GDP over all three years, while the revenue measures are 4% of GDP. The cuts are far too small to be taken seriously, while the revenue aspirations seem unrealistically high. Revenues tend to fall rather than rise in a severe crisis. Expenditure cuts of 6 to 10% of GDP during the first year would have been more appropriate, as is usually done in such a serious crisis. This looks like a very weak program.

Third, this program would leave Greece with a public debt of 140 to 150% of GDP in 2014, which will be far more than Greece can finance. Assuming an interest rate of 6% per annum, this would amount to 9% of GDP in debt service each year. No country can manage such a burden. Greece needs a debt restructuring. It would be reasonable to write off approximately half the public debt of \$400 billion – that is, \$200 billion. The Greek financial crisis is not likely to be resolved until that is done. The euro countries and the IMF are simply lending into arrears, which is no good policy.

This was not very original but common sense. Yet rereading these words today, I am afraid

⁵ Anders Åslund, "The Greek Stabilization Program Does not Appear Credible," Realtime Economic Issues Watch, Peterson Institute for International Economics, May 3, 2010.



that the failure of the Greek program was all too predictable. It was always more political than viable.

4. Paul Krugman's Advocacy

Since the financial crisis erupted in Europe in late 2008, Paul Krugman has been the strongest media voice on fiscal policy in Europe.⁶ From the pulpit of the *New York Times*, he has persistently argued that austerity is wrong. In 2008–10, when Latvia, as well as Estonia and Lithuania, carried out their successful fiscal consolidations, Krugman complained loudly about the terrible consequences of austerity. When they all recorded high economic growth, he refused to concede his defeat.

Early on in his European intellectual odyssey he claimed: "Latvia is the new Argentina"⁷. As many others,⁸ he insisted that Latvia should devalue. His parallel with Argentina also indicated that he saw default as inevitable. But few countries are more different than Argentina and Latvia in size, fiscal policy, economic openness, political organization, history, culture, traditions, and location.

Contrary to Krugman's advice, Latvia, as well as its neighbors Estonia and Lithuania, did not devalue but instead carried out a front-loaded and rigorous fiscal adjustment. As a consequence, not one of them defaulted. Instead, they restored market confidence and swiftly achieved financial sustainability. Their fast fiscal adjustment necessitated substantial structural reforms, and they all started growing quickly after only two years of recession, reaching a high growth trajectory. Because the Baltic governments acted fast and decisively, they could pursue vested interests in both the private and public sectors, which enhanced their political support. The Estonian and Latvian governments were even reelected. Latvia's output had been overblown by its large current account deficit of 22.5% of GDP in both 2006 and 2007. Its economy operated far above its actual production potential. The IMF assessed that Latvia's actual output exceeded its potential by no less than 9% in 2007, meaning that output had to contract (IMF 2008, 5). A cooling down and economic contraction seemed both desirable and inevitable, but Krugman protested that "the idea that real GDP and employment can be hugely inflated above sustainable levels by a bubble is questionable"⁹. Krugman criticized Jörg Asmussen, Germany's man at the ECB for asserting in Riga that

⁶ I have discussed his contributions repeatedly (*Åslund and Dombrovskis 2011, 54-60; Åslund 2012, 2013a, 2013b*), but never received any reply.

⁷ Paul Krugman, "European Crass Warfare," *The New York Times*, December 15, 2008; Paul Krugman, "Latvia Is the New Argentina (Slightly Wonkish)," *New York Times Blog*, December 23, 2008.

⁸ Edward Hugh, "Why the IMF's Decision to Agree on a Latvian Bailout Programme without Devaluation Is a Mistake," *RGE Monitor*, December 22, 2008; Nouriel Roubini, "Latvia's Currency Crisis Is a Rerun of Argentina's," *Financial Times*, June 11, 2009.

⁹ Paul Krugman, "Baltic Brouha," *New York Times Blog*, May 1, 2013.



“the Baltic experience shows that austerity and internal devaluation actually do work.” Krugman added: “Notice that his evidence comes entirely from one year of fairly fast growth after an incredible decline. So it’s important to say that this proves very little”¹⁰. Well, four years of high growth does prove something.

The IMF held a conference in Riga in June 2013 to celebrate the Latvian economic achievements. One would expect that an economist who had written at least a dozen columns condemning the Baltic economic policy would congratulate the victors upon such a success, but Krugman stuck to his guns. In May 2013, he argued that “output is still well below the peak [in Latvia and the Baltics], and unemployment still very high despite drastic out-migration,” ignoring the return to the highest growth rates in Europe¹¹. On another occasion, Krugman exclaimed “the best the defenders of orthodoxy can do is point to a couple of small Baltic nations that have seen partial recoveries from Depression-level slumps, but are still far poorer than they were before the crisis”¹². All three Baltic states have now happily adopted the euro and, thus, have achieved the full access to ECB liquidity they were missing in 2008-09 that actually caused their sharp output fall. They have been the most fast-growing countries in Europe since 2011. I have found no pronouncement of his after May 2013, while the Baltic economies have grown impressively.

Presumably, no one has written as many articles and blog posts about the Greek financial crisis as Krugman. Although his recommendations had not panned out in the Baltics, he advocated the same ideas for Greece, defending the various Greek governments for resisting the imposition of fiscal discipline and structural reforms. Krugman paid no attention to Greece’s large and lasting budget deficits, its big public debt, and its great corruption (Transparency International 2010). Instead, he called Greece a victim, laying all blame for its predicament on the European Union, the European Monetary Union, and Germany. He claimed that “this isn’t a Greek problem, or even a Spain/Italy problem; it’s a European problem.” He blamed “the arrogance of European officials, mostly from richer countries, who convinced themselves that they could make a single currency work without a single government”¹³.

On the odd occasion, Krugman acknowledged “Yes, there are big failings in Greece’s economy, its politics, and no doubt its society. But those failings aren’t what caused the crisis that is tearing Greece apart... No, the origins of this disaster lie father north, in Brussels, Frankfurt, and Berlin, where officials created a deeply-perhaps fatally-flawed monetary system”¹⁴. He went on to blame the euro. Niall Ferguson noted that Krugman “wrote about the imminent

¹⁰ Paul Krugman, “Why the Baltics Matter,” *New York Times* Blog, June 8, 2012.

¹¹ Paul Krugman, “Baltic Brouha,” *New York Times* Blog, May 1, 2013.

¹² Paul Krugman, “Europe’s Great Illusion,” *New York Times*, July 1, 2012.

¹³ Paul Krugman, “Not a Greek Problem,” *New York Times* Blog, May 17, 2012.

¹⁴ Paul Krugman, “Greece as Victim,” *New York Times*, June 17, 2012.



break-up of the euro at least eleven times between April 2010 and July 2012”¹⁵. Well, that did not happen. Nor did his prediction that Greece would be forced to leave the euro come true.

In parallel, Krugman noted that “I’ve argued that worries about the deficit are, in fact, grossly exaggerated”¹⁶. He claimed that “the rush to austerity in Europe largely reflected the surge in sovereign debt spreads after Greece got in trouble; the bigger the spread, the harsher the austerity... But it turned out that the spreads didn’t reflect underlying fiscal fundamentals”¹⁷. However, at present, the Greek 10-year bond yields are around 9%, while the former EU crisis countries of Italy, Portugal, and Spain have bond yields below 2%.

Strangely, Krugman discusses money as an infinite resource. He does not recognize any budget constraints or that financing would dry up as happened to so many European countries during the financial crisis. In particular, in the case of Greece, Krugman’s disregard for both the risk of sovereign default and absence of funding is perplexing. Krugman never acknowledges the simple fact that Greece has pursued insufficient fiscal responsibility. His persistent advocacy of even less fiscal adjustment has contributed to worse fiscal policy and thus greater social suffering.

For five years, Krugman has advocated fiscal stimulus¹⁸, but rapid fiscal adjustment turned out to be the best cure for both public finances and economic growth. He ignored that all EU countries had excessive public expenditures and needed structural reforms¹⁹. Nobody has written so much about the Greek economy, and nobody appears to have been less interested in combating Greece’s profound problems of corruption, bureaucracy, and oligarchy. Only with Syriza’s victory in the Greek parliamentary elections on January 25 did Krugman find a winning party that shared his view of austerity in Europe²⁰. After five long years, one of the 28 EU countries had elected a government of which Krugman approved. Syriza insisted that it would reverse the few reforms that the previous government had managed to carry out. It would restore the excessively high minimum wages, rehire the public servants that the previous government had managed to lay off, reintroduce collective work agreements, and stop privatizations²¹.

After three days, the Greek markets had plummeted by a fifth, and Krugman backpedaled. “Markets are panicking,” he asserted. Then, he added: “It’s important to understand that this is not a verdict on the new Greek government, or at any rate only the new Greek

¹⁵ Niall Ferguson, “Krugtron the Invincible, Part 1,” *Huffington Post*, October 10, 2013.

¹⁶ Paul Krugman, “Looking for Mister Goodpain,” *New York Times*, January 31, 2013.

¹⁷ Paul Krugman, “Paul De Grauwe and the Rehn of Terror,” *New York Times Blog*, February 22, 2013.

¹⁸ Paul Krugman, “Self-Destructive Europe,” *New York Times Blog*, March 2, 2013.

¹⁹ Paul Krugman, “European Crisis Realities,” *New York Times Blog*, February 25, 2012.

²⁰ Paul Krugman, “Ending Greece’s Nightmare,” *New York Times*, January 26, 2015.

²¹ Gideon Rachman, “Syriza and Voodoo Economics,” *Financial Times*, January 29, 2015.



government; it's a judgment that the risk of no agreement, and a disorderly breakdown of the whole process, is high"²². But as his readers so well know, the European Union is always at fault, never Greece, and certainly not Krugman.

Finally, Steven Rattner has summed it up well:

“the thousands of words that [Krugman] has written about the Euro crisis don't suggest that he has spent any time trying to understand how the private sector actually functions (or doesn't) within the Eurozone... For Krugman, the problems of Europe are all about the classic Keynesian slant of insufficient demand, brought on by miserly monetary policy and fiscal austerity insisted upon by Germany and its factotums in the Eurozone's command post in Brussels”²³

5. The IMF Followed Krugman's Lead

In the midst of the financial crisis, desperate G-20 leaders threw well-established economic insights overboard and embraced old-style Keynesianism once again, focusing on maximizing aggregate demand. At the November 2008 G-20 summit in Washington, leaders declared their intention to “use fiscal measures to stimulate domestic demand to rapid effect, as appropriate, while maintaining a policy framework conducive to fiscal sustainability” (G-20, 2008).

The IMF translated the G-20 recommendation into action. It recommended all countries that had “fiscal space” to pursue fiscal expansion. In the winter of 2008-09, the world as a whole was in a liquidity freeze, a truly Keynesian situation, and stimulus made sense. However, there are at least two big problems with fiscal stimulus.

First, it is close to impossible to determine when fiscal space exists, and it varies quickly with international financial markets. In late 2008, for example, Latvia and Romania lost market access when their public debt was less than 20% of GDP, showing how minimal their fiscal space was.

Second, temporary fiscal stimulus tends to become permanent, leading to chronic budget deficits. Cyprus and Slovenia offer excellent illustrations. In 2008, both countries had relatively limited public debt (22% and 49% of GDP, respectively). In 2009, however, both expanded their budget deficits to 6% of GDP, where they stagnated, eventually ending up in financial crisis.

²² Paul Krugman, “Thinking about the New Greek Crisis,” *New York Times* Blog, January 28, 2015.

²³ Steven Rattner, “Paul Krugman Refuses to Acknowledge Some Critical Failings of the Eurozone,” *Business Insider*, February 10, 2015.

The IMF's chief economist Olivier Blanchard wrote an excellent academic paper on the Latvian boom, bust, and recovery together with two IMF colleagues (Blanchard, Griffiths, and Gruss 2013). They pointed out that “the timing of events makes it clear that fiscal adjustment was not responsible for much of the drop in output” (p. 364). They also noted that there “is some evidence that the announcement of a clear fiscal path was associated with increased confidence” (p. 364). However, without much of an argument they claim: “Whether the front-loading aspect of the fiscal adjustment made the whole adjustment program more credible cannot be settled” (p. 364). They conclude swiftly that “the experience of Latvia sheds little light on the issue of the optimal speed of fiscal consolidation” (p. 364). This appears to deny obvious facts because the authors did not like them. Adding the experience of the two neighboring Baltic states and several years of success, evidence does not come much stronger.

Table 3 – IMF Forecasts and Outcomes

Latvia	2009		2010	
	Forecast	Outcome	Forecast	Outcome
GDP Growth (% Change)	-5	-17,7	-3	-1,3
Current Account Balance (% of GDP)	-7,3	8,6	-5,5	2,9
Budget Deficit (% of GDP)	-4,9	-7,8	-4,9	-7,3

Sources: IMF, Republic of Latvia, “Request for Stand-By Arrangement,” December 19, 2008, 1, www.imf.org (accessed February 9, 2015), IMF, WEO October 2014 database.

Greece	2010		2011		2012	
	Forecast	Outcome	Forecast	Outcome	Forecast	Outcome
GDP Growth (% Change)	-4	-4,9	-2,6	-7,1	1,1	-7
Current Account Balance (% of GDP)	-8,4	-10,3	-7,1	-9,9	-5,6	-2,5
Budget Deficit (% of GDP)	-8,1	-11	-7,6	-9,6	-6,5	-6,4

Sources: IMF, “Greece: Staff Report on Request for Stand-by Arrangement,” IMF Country Report No. 10/110, May 2010; IMF WEO October 2014 database.

After having discarded this obvious evidence, Blanchard dove into the esoteric. In January 2013, he and his colleague Daniel Leigh (2013) published a working paper arguing that fiscal multipliers—the change in output induced by a change in the government’s budget deficit – were larger in current circumstances than previously thought. Tight fiscal policy, in other words, would squeeze output more than economic modelers had typically supposed. The implication was that fiscal adjustment should be delayed. There were many problems with this paper. It was based on forecasts of economic growth, but in the early stage of a crisis, forecasts tend to be widely off the mark.



Economic forecasts in the midst of a financial crisis are next to impossible to make because so many factors are unknown, notably economic policy and international financing. IMF forecasts at the beginning of the crisis in Latvia and Greece illustrate the degree of uncertainty. In December 2008, the IMF predicted that Latvia's GDP would fall by 5% in 2009, but the outcome was a fall of 18%; that is, 13% more. Similarly, in May 2010, the IMF predicted that Greece's GDP in 2011 would contract by 2.6%, but it declined by 7.1% (Table 3). The forecasts of other variables are hardly better. In December 2008, the IMF predicted that Latvia would have a current account deficit of 7.3% of GDP in 2009, but instead it showed a surplus of 8.6% of GDP. This is not a criticism of the IMF, because it is nearly impossible to make reasonable predictions in the midst of a crisis, but it makes little sense to use such forecasts to calculate any fiscal multiplier.

The Blanchard-Leigh argument also presumes that a country has access to the capital market, but the IMF intervenes when a country has lost such access. Moreover, in the midst of a crisis, the political economy is conducive to radical reform, while reform becomes much more difficult later on. A crisis is a terrible thing to waste, but that became the official IMF advice. Finally, the Blanchard-Leigh paper is entirely short-term, focusing on GDP in the year after a fiscal adjustment. But what matters is long-term economic growth, and that depends on structural reforms.

Such an influential IMF paper changes the policy of that institution. An eminent example of its transmission from the esoteric to the practical was the IMF public evaluation of its Greek experiences: *Greece: Ex Post Evaluation of Exceptional Access under the 2010 Stand-By Arrangement* (IMF 2013). As argued above, the Greek financial crisis was a classical public finance crisis, and the IMF had failed in its first task to solve the fiscal crisis.

The IMF authors did not even mention this failure. Instead, they posed the biased question, "Should the fiscal adjustment path have been more gradual?" (p. 20). Their second question was equally one-sided: "Should the adjustment path have been more flexible?" (p. 21). Why not pose an open question: "Was the fiscal adjustment size and speed appropriate?" The obvious answer is that fiscal adjustment should have been much faster and front-loaded to restore confidence and fiscal sustainability. The Fund authors adopted a thoughtless attitude: "The required adjustment in the primary balance, 14.5 percentage points of GDP, was an enormous adjustment with relatively few precedents..." (p. 20). Well, not really. The Baltic countries had just done more, and all post-Soviet countries carried out greater fiscal adjustments (Åslund 2002, 226).

The IMF evaluators were better when it came to evaluating the mix of fiscal measures Greece had been requested to undertake, asking whether they were appropriate. Sensibly, they stated



that the “large dose of revenue measures... can be questioned, particularly since tax changes constituted almost half of the measures targeted for the first two years of the program” (p. 23). They rightly complained that the burden of adjustment was overwhelmingly put on the private sector. Strangely, the authors did not draw the obvious conclusion that Greece had excessive public expenditures that were bound to harm economic growth.

For unknown reasons, the fund’s evaluators posed only Krugmanite questions. The implicit starting point of this “evaluation” was that the budget deficit could not have been cut more or faster, which was incorrect. The authors realized that additional financing in the last three years was not possible. These assumptions led to the logical conclusion: “An upfront debt restructuring would have been better for Greece...” (p. 28). But a debt restructuring has been carried out and it did not save Greece because the public expenditures and budget deficit remained far too high.

6. Conclusion: Front-Load Fiscal Adjustment in a Crisis

Among the EU countries, Latvia and Greece stand out because, in the midst of the crisis, they had the largest potential budget deficits and they experienced equally large cumulative real output contractions of nearly a quarter of GDP in comparison with their 2008 peak GDP. But their governments pursued the opposite fiscal strategies when the crisis hit. One strategy was successful and the other amounted to a failure. Obviously, the first strategy is preferable. This leads to a broader conclusion.

In severe financial distress, three policies are normally enacted. First, the country in trouble needs to cut its budget deficit so that its public finances become sustainable. Second, the suffering country must carry out substantial structural reforms so that economic growth can be unleashed. Third, the international community, mainly the International Monetary Fund (IMF), possibly with some support from others like European authorities, provides sufficient low interest rate credits so that the public and international debt can be managed.

The conclusion of this paper is straightforward. The first year of fiscal adjustment was decisive for the success of Latvia and the failure of Greece. If a country is in a serious financial crisis because of an excessive fiscal deficit, it is well advised to front-load its fiscal adjustment as much as is practically and politically possible. More often than not, the radical front-loading of fiscal adjustment has proven popular with voters, as Estonia, Finland, Latvia, Luxembourg, and Sweden proved during the crisis, because this is a matter of political leadership.²⁴ Latvia’s Prime Minister Valdis Dombrovskis was reelected twice, while George Papandreou lost massively. The crucial task is to restore market confidence.

²⁴ Anders Åslund, “Europe’s Voters Wisely Stick with Frugal Leaders,” Bloomberg, September 29, 2013.



No size fits all. The greater the fiscal crisis, the more fiscal adjustment is needed. If a country is big, the market may offer substantial international financing, allowing it a much larger budget deficit than it would for a small country. The Eurozone has reinforced confidence so that the market has been very tolerant (too tolerant) also of small countries with large public debts. How large the fiscal adjustment has to be is ultimately a matter of judgment and not of sophisticated mathematics.

It is strange that many economists, notably Krugman, still believe that fiscal stimulus can be beneficial even if a country enjoys no market confidence. Nor can any fiscal multiplier be operative if elementary financial stability and international financing are absent. In addition, all too many American economists discussing Europe do not realize how severe the structural barriers are in many European economies. If potential growth is zero as in Italy, no fiscal stimulus is likely to be effective, while supply-increasing policies can be.

This paper deals with only two countries to make the difference obvious, but it is all too evident that an expansion to more countries would not contradict the thesis. Estonia and Lithuania pursued the same policies as Latvia. Among the crisis countries in the Eurozone, Ireland has done the best thanks to the most far-reaching fiscal adjustment and structural reforms. One would only hope that the IMF would adopt this policy of demanding front-loaded fiscal adjustment rather than focusing on dubious fiscal multipliers.

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