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Greece in the Euro Area: Odd Man Out, or Precursor of Things to Come?

LOUKAS TSOUKALIS

Greece has acted as a catalyst for the outbreak of the crisis of the euro area, following the bursting of the big bubble in the Western financial system. It remains today the most vulnerable link of the euro chain, even as the crisis has extended to other countries. Greece has also served as a test case for national and European policies in response to the crisis—more precisely, as a stress test for the domestic political system and the economy and society at large in the context of economic austerity, recession, and reform-induced change, as well as for the capacity of European institutions to devise new policies to deal with problems they had clearly not been prepared for.

Some believe that Greece is the odd man out among the beleaguered countries of the European periphery. If that is true, there is a wide variety of policy options that may follow, ranging all the way from special treatment and patience for a country expected to go through little less than a peaceful revolution amid punishing conditions, to orderly or less orderly default and/or forced exit from the euro area. There are others who suspect or fear that Greece may be the precursor of things to come—as it has already been to some extent—or possibly the first in a series of domino effects that could eventually lead to the disintegration of the euro area. The stakes are high, indeed. Hence

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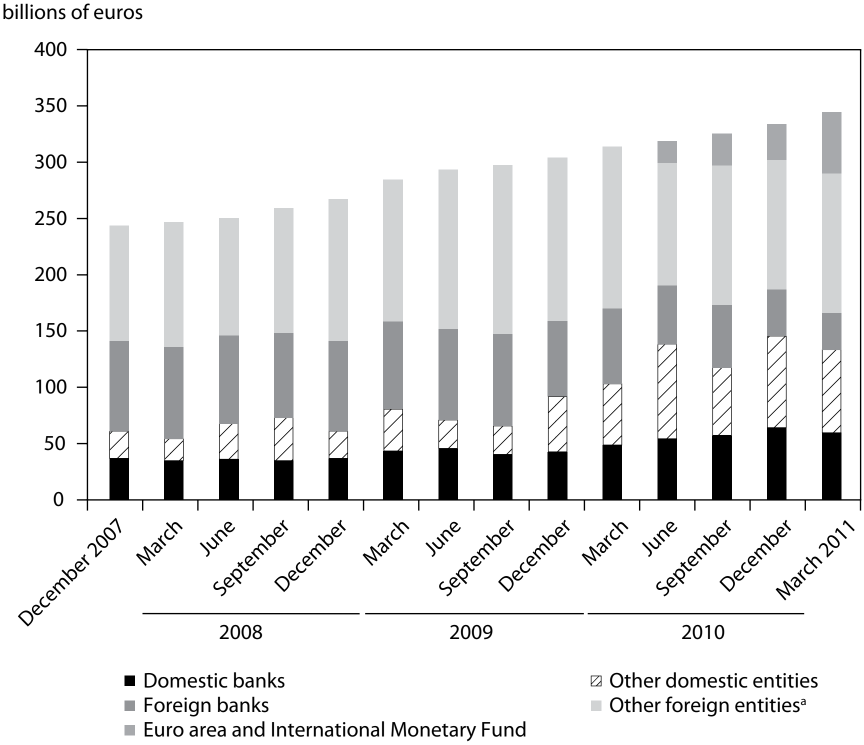
Figure 2.1 Holdings of Greek government debt, December 2007–March 2011



a. Including the European Central Bank.

Source: European Commission, *The Economic Adjustment Programme for Greece,* Fifth Review Draft, October 2011, p. 22, graph 21.

the disproportionate amount of international attention paid to Greece in comparison to its modest size, although admittedly the size of its public debt is less modest. As of June 2011, its public debt had risen to €354 billion, held in large part by foreigners, notably banks, other financial institutions, and increasingly European governments and the European Central Bank (ECB). The debt held by private institutions exceeded €200 billion (figure 2.1).

The Outbreak of the Crisis

It all began in October 2009, when the newly elected government of Greece, led by George Papandreou of the socialist party (PASOK), announced that the Greek budget deficit of 2009 was going to be much bigger than previously claimed by the outgoing center-right (New Democracy) government, well into double-digit figures. The announcement was not followed by serious

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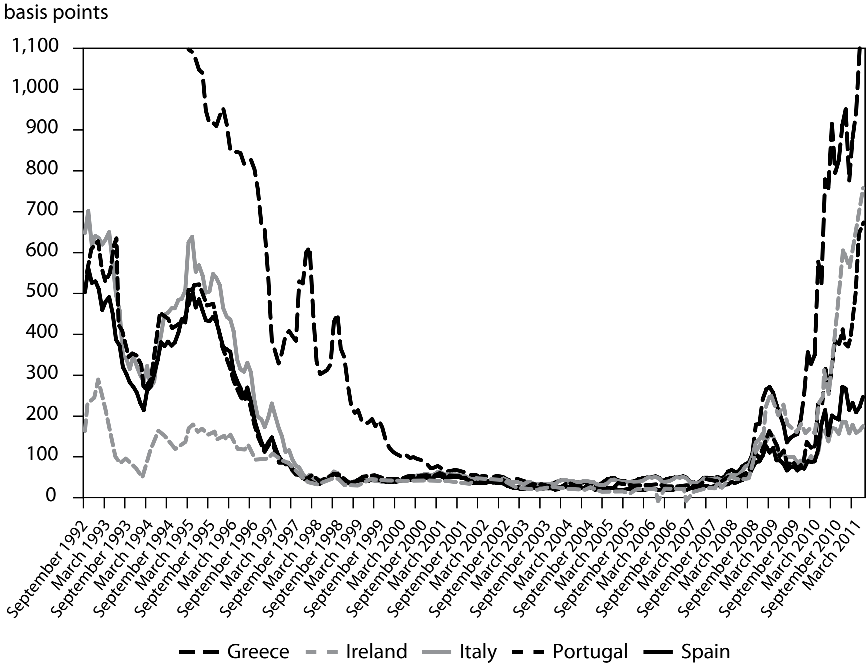
Figure 2.2 10-year interest rate spreads over German bunds, September 1992–June 2011



Source: Europe at a Crossroads, speech by Gikas Hardouvelis, Eurobank EFG, Belgrade, October 24, 2011, www.eurobankefg.rs.

measures to deal with the problem. Jittery markets, still under the spell of the Lehman effect, suddenly focussed on the prospect that the financial crisis could transform itself into a crisis of sovereign debt, as governments increased their borrowing to deal with the adverse effects on banks and the real economy. Spreads on Greek state borrowing rose fast as the Greek government and EU institutions dithered (figure 2.2).

Greece was the catalyst for the outbreak of the crisis of the euro area because it had the worst combination of three different deficits. First, it had a large budget deficit, which reached 15.4 percent of GDP in 2009 after a number of revisions (figure 2.3), on top of an already big public debt (at 127 percent of GDP in 2009, it was already the highest in the euro area). Second, it had an equally large, indeed unsustainable, deficit in its current account that was almost 15 percent of GDP in 2008 (figure 2.4)—a deficit of competitiveness, in other words. Finally, it had a serious credibility deficit, as people realized that Greek politicians had repeatedly been economical with the truth and creative with the use of statistics. Greece was surely not unique with respect to any of those three deficits among members of the euro area and the wider world. But

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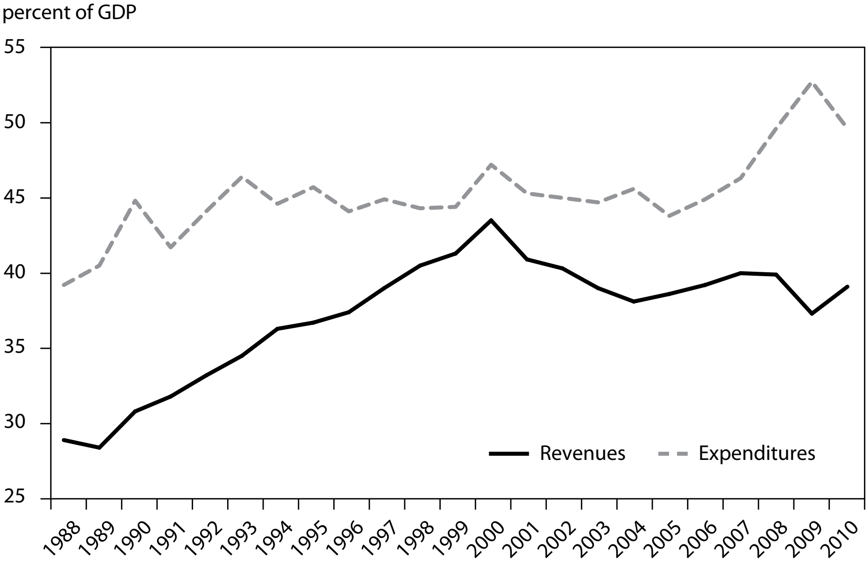
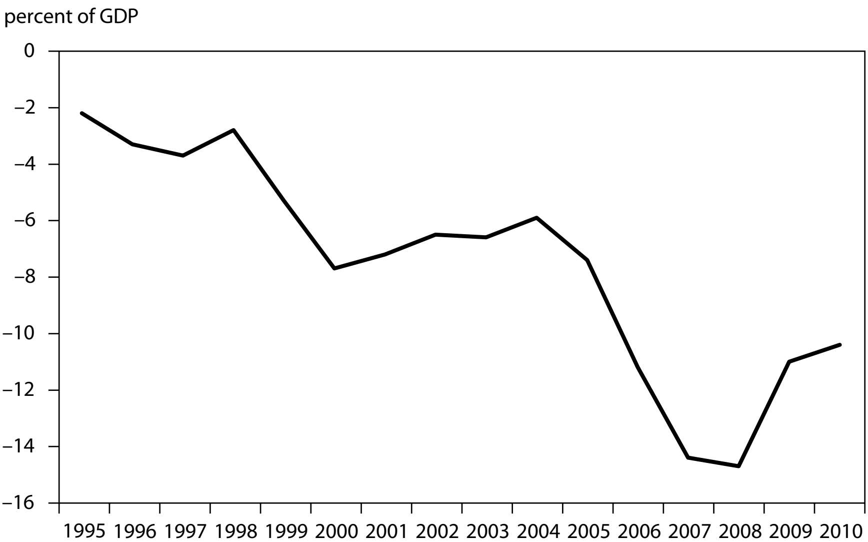
Figure 2.3 General government revenues and expenditures, 1988–2010



Source: Europe at a Crossroads, speech by Gikas Hardouvelis, Eurobank EFG, Belgrade, October 24, 2011, www.eurobankefg.rs.

Figure 2.4 Current account balance, 1995–2010



Source: Europe at a Crossroads, speech by Gikas Hardouvelis, Eurobank EFG, Belgrade, October 24, 2011, www.eurobankefg.rs.

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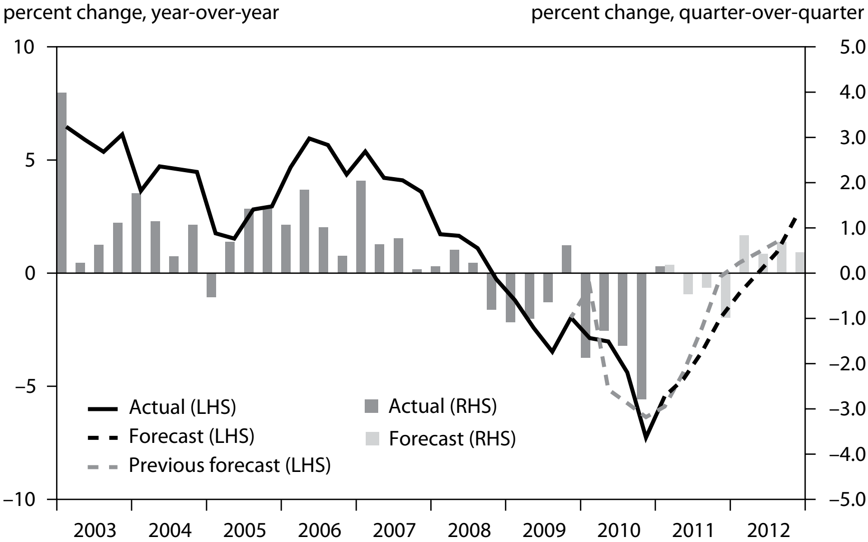
Figure 2.5 Real GDP growth, 2003–12



Sources: Hellenic Statistical Authority (EL.STAT.), www.statistics.gr; European Commission Services.

it had, undoubtedly, the worst combination of deficits when markets began to panic again, while governments, and notably Greece's own government, took their time in trying to get a grip on an admittedly very difficult situation.

The mess in which the country found itself stemmed from huge failures of government and political responsibility. Since Greece joined the euro in 2001, budget deficits have always exceeded the 3 percent Maastricht limit (figure 2.3), partly camouflaged through creative accounting but seen as manageable as long as nominal and real growth rates remained high (figure 2.5). They seemed manageable no longer when the international crisis hit. At the time, Greece had a weak government that, facing the prospect of early elections, allowed public finances to get completely out of control in 2008–09.

Greek politics is clientele politics par excellence: Political parties distribute money and favors to voters/clients. Greece is, of course, not unique in this respect. But the problem grew bigger with time: The quality of the Greek political class steadily deteriorated, the "*enrichissez-vous*" culture became dominant after many years of rapidly rising prosperity, and membership in the European Union, and the euro in particular, came to be perceived as an all-protective umbrella against adversity, as well as a provider of free or cheap money, rather than an agent for reform. The state became increasingly corrupt and dysfunctional, an instrument of parties in power and a victim of the clientele system which, if anything, grew stronger over the years. There was cheap money to spend. Organized interests and the forces of inertia in a basically conservative society that does not much like change combined to kill any attempt at struc-

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tural reform. The result was a deadlocked country in many ways, although one still enjoying a steadily rising standard of living.

It had not always been like this. Greece is a country that underwent a remarkable transformation during the second half of the 20th century, from economic underdevelopment and deeply flawed democratic institutions, interrupted by a spell of dictatorial rule, to high standards of living (Greece was classified before the outbreak of the crisis among the top 25 countries of the world according to United Nations indicators) and a full-fledged democracy. It is the country that organized the highly successful, albeit extremely costly, Olympic Games of 2004, the only country of its size to do so for several decades, and the one that played an important stabilization role in the Balkan region after the collapse of communist regimes, with Greek banks and enterprises acquiring in the process an important foothold in the area. It could be argued that Greece has often tried to punch above its weight. This tendency has largely to do with history going back a long way.

But there is something else contributing to it: a Greek elite, consisting largely of expatriates, with a strong global presence in the arts and sciences, in finance, and in shipping, but not directly participating in the running of the country. From the peak of success and self-confidence only a few years back, Greece has suddenly come tumbling down. The fall has been big, sudden, and painful, and most Greeks now realize it is far from over yet: hence, a society in a state of deep shock.

Of course, if responsibility and blame are to be attributed for the derailment of Greek public finances and the steady loss of competitiveness during the period of euro membership, the buck cannot stop at the door of Greek politicians. No doubt the main responsibility lies with those who governed the country and indirectly with those who entrusted them with their votes: in other words, Greek society in general. But at least part of the responsibility also lies with EU institutions and Greece's European partners. Successive Greek governments pretended that public finances were in order and reforms were under way, and the other Europeans pretended for different reasons to believe them. Greece is not unique in this respect either. The surveillance mechanism for the euro set up at Maastricht clearly did not work: The Stability and Growth Pact was inadequate in its conception, and it was poorly implemented. And when the crisis came, we all discovered (or were just reminded) that the European Union had no mechanism to deal with it—some had apparently been afraid of moral hazard (Tsoukalis 2011a, 2011b).

There was also manifest market failure. Greek governments and others kept borrowing at very low interest rates—at times, at negative interest rates. Spreads over German bunds remained at very low levels for many years (figure 2.2), thus implying that Greek government bonds were perceived by markets as presenting almost the same risk as German ones. Markets did not bother to look at the figures, or ask awkward questions. To be fair, the possibility of sovereign default for a member of the euro area was not at all an issue until two or three years ago; it belonged to the category of unthinkables. Now mar-

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kets know better, having often moved to the other extreme, and thus helping to make the nonsustainability of Greek public debt almost into a self-fulfilling prophecy.

The Weak Link of the Euro Chain

Much has happened since the late months of 2009, when the crisis hit. Rating agencies, markets, and analysts looked more closely at figures and institutional structures and began to doubt both the sustainability of Greek public finances and Europe's possession of either the instruments or the political will to deal with the more general problem that had arisen.

They placed their money accordingly. Those doubts were more pronounced in Wall Street and the City of London, where speculation about the viability of the euro, or even the European Union, has been particularly rife since the very beginning. There was surely an element of schadenfreude among people who had not welcomed the creation of the common currency in the first place, but a more complete explanation would require a much longer paper.

Many unthinkable things have happened since then—and in a big way. Crisis is, after all, the mother of change, helping to transform the unthinkable into reality. It has happened in Greece and in other vulnerable countries of the euro area. It has also happened in the countries of the European core, leading to the adoption of European measures that had been completely off the agenda only a short time ago. The trouble is that measures usually come late, they are often poorly implemented, and they invariably end up being judged by markets as insufficient. A growing number of critics now argue that the underlying strategy behind the adopted measures may also be flawed.

In Greece, PASOK was elected in October 2009 with a strong majority and a mandate to spend and to further strengthen the welfare state. Of course, PASOK should have known better. Lynched by reality (and the markets), it was forced to make a volte-face a few months later and ended up reducing the budget deficit by 5 percentage points of GDP in a year, something that had not happened in an Organization for Economic Cooperation and Development (OECD) country for decades. However, the deficit was still over 10 percent at the end of 2010 (European Commission 2011). The government raised taxes, cut public sector salaries and pensions, adopted fiscal and pension reform, changed the statistical service, and began to take measures to restore the international competitiveness of the economy. The latter included liberalization measures in the labor market and closed professions. Surely, these are not the kind of measures that most socialist parties identify with, especially not Greece's PASOK, with its strong populist tradition and with most of the party machine, or what is now left of it, safely and comfortably (or so its members thought until very recently) ensconced in the wider public sector. Internal resistance was, as expected, ferocious.

Macroeconomic adjustment, with the emphasis on fiscal consolidation, and structural reform were the Greek part of a deal reached at the level of

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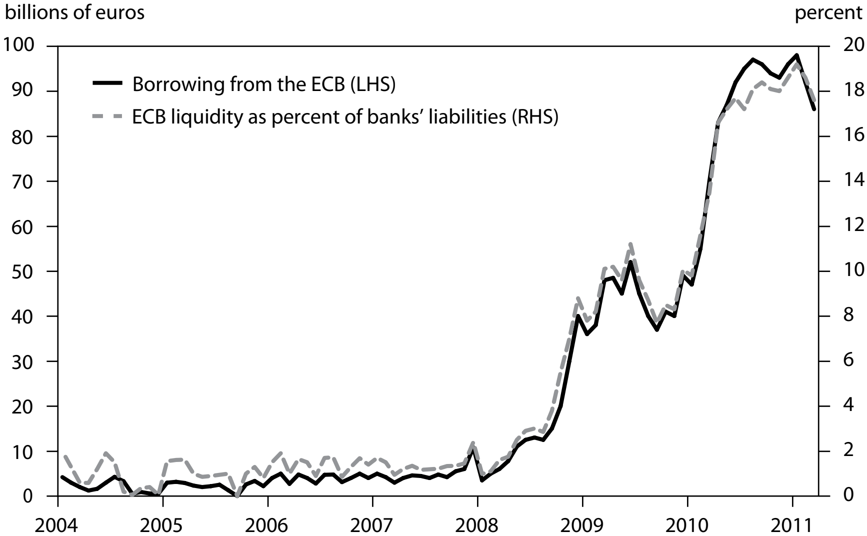
Figure 2.6 Greek banks' borrowing from the Eurosystem, 2004–11



ECB = European Central Bank

Source: European Commission.

the euro area in May 2010. The deal was intended to provide Greece with the necessary finance (€110 billion) until 2013 in order to continue servicing and financing its public debt, while also helping it to restore sustainable public finances, encourage competitiveness, and establish the conditions for healthy long-term growth. Since then, Greece has been on European and International Monetary Fund (IMF) life support: Disbursements to the Greek government had reached €65 billion at the time of writing, with another €8 billion on its way.[1]

Support has also been extended to Greek banks through the ECB. The banks have been the victims of the Greek sovereign debt crisis, and not the other way round as happened in Ireland and several other countries. Greek banks are big holders of Greek state bonds. As a result of the crisis, they were cut off from interbank lending, while domestic deposits shrank by more than 20 percent and nonperforming loans increased substantially, thus leaving the ECB and the Greek central bank as a key source of liquidity. Total borrowing from these two sources is now between €90 billion and €100 billion, which represents about 20 percent of liabilities (figure 2.6).

After a lot of agonizing and difficult negotiations, a new financial support package was agreed to by euro area leaders on July 21, 2011, with more money

1. For the latest review of the economic adjustment program for Greece at the time of writing, see European Commission (2011).

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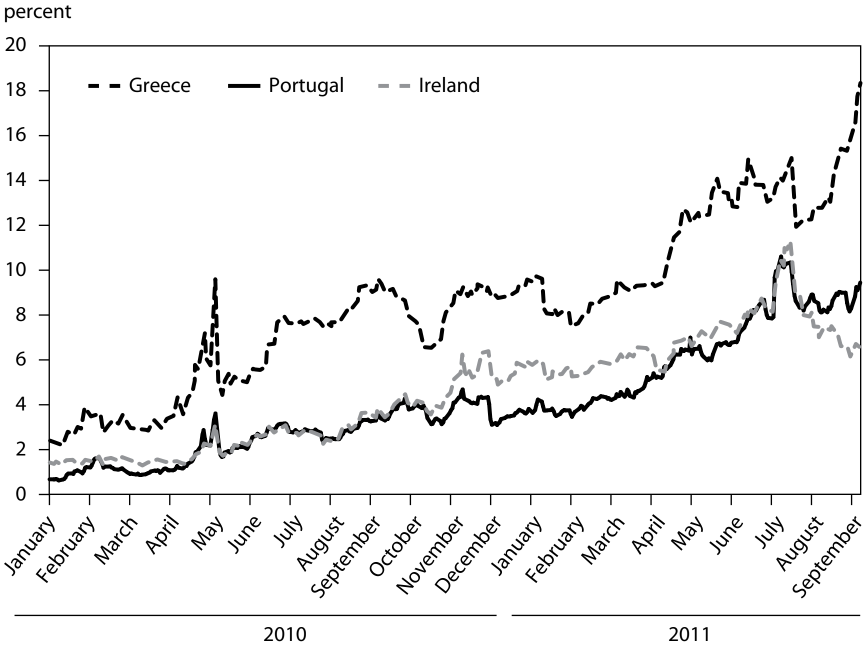
Figure 2.7 10-year interest rate spreads over German bunds, January 2010–September 2011



Sources: Europe at a Crossroads, speech by Gikas Hardouvelis, Eurobank EFG, Belgrade, October 24, 2011, www.eurobankefg.rs; Bank of Greece.

and new provisions for reduced interest burdens, extension of maturities, protection of Greek banks, measures to foster growth (including the frontloading of the use of EU structural funds in Greece), and some private sector involvement in the refinancing of Greek debt. It was another big package: a strong signal to Greece of European solidarity but also an attempt to correct some of the weaknesses and faults of the earlier package. A big taboo was also being broken with the provision for private sector involvement under strong German insistence. The intra-European debate on this highly controversial issue, pitting Germany against the ECB, had been highly destabilizing in terms of the effect it had on Greek spreads (and not only) before the July 21 decision. Figure 2.7 shows the evolution of those spreads, although they no longer mean very much since there is hardly a market for Greek sovereign bonds any more.

The decision of July 21, 2011, broke the taboo of sovereign debt default in the euro area, although it was only meant to reduce slightly Greece's debt burden. It proved difficult to implement, and it was soon superseded by another, much bolder decision, as the crisis took a turn for the worse in Greece and elsewhere in the euro area. In the early hours of October 27, 2011, the leaders

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of the euro area went much further, implicitly recognizing that the decision they had taken only three months earlier was no longer adequate. After a difficult negotiation with representatives of banks, an agreement was reached to proceed with a "voluntary" haircut of no less than 50 percent of the notional value of Greek sovereign debt held by private institutions. The objective was to bring Greek debt down to 120 percent of GDP by 2020, and thus make it more sustainable. They also agreed to a new multiannual assistance program for Greece that would add €100 billion to the amount already committed in May 2010, plus €30 billion as the official counterpart to the private sector involvement package: unprecedented amounts for an unprecedented crisis. Implementation of those decisions will not be an easy sail, judging from earlier experience.

The European system is slow and cumbersome, and implementation usually leaves much to be desired. Decisions reached at the European level are constantly prey to national politics, while there is less and less appetite for bailouts in the creditor countries or for any kind of "transfer union," a possibility that is haunting the minds of many German citizens and others. On the other hand, the task of convincing private creditors of Greece to accept a big haircut "voluntarily," thus averting a so-called credit event, will not be easy either. The crisis has already reached the bigger fish, most notably Italy.

There is also a question mark about Greece's capacity to deliver its part of the bargain. The Greek government has not proved to be strong on delivery on several fronts, even though much has already been achieved. The budget for 2011 has been off target, thus forcing the government under pressure from the "troika" (European Commission, ECB, and IMF) to pile on additional measures in order to fill the gap. More austerity, however, is increasingly difficult, if not impossible, as the recession is deepening (the decline in GDP is expected to be around 6 percent this year, substantially more than forecast), while unemployment is rapidly approaching 17 percent (figure 2.8). There is no end in sight as yet.

An austerity-recession downward spiral has been at work, reinforced by the shortage of liquidity provided by the banks. This situation is now recognized by the troika (European Commission 2011). On the other hand, it is true that the government was slow with structural reform intended to create an environment favorable to investment and growth, and that it was more willing to raise tax levels than cut expenditures. And these tendencies further penalized the private sector, at least those in it who pay taxes. The private sector has been shedding labor at a rapid pace as domestic demand shrinks fast. Experience suggests that structural reforms are particularly difficult in a rapidly worsening economic environment.

PASOK has been married to the state, and any ideas about even a velvet divorce are horrifying for many of its members. But the same is true of all political parties in Greece. The big and decisive battle today in Greece is about the restructuring and rationalization of a bloated, inefficient, and largely corrupt public sector. This will be the mother of all battles.

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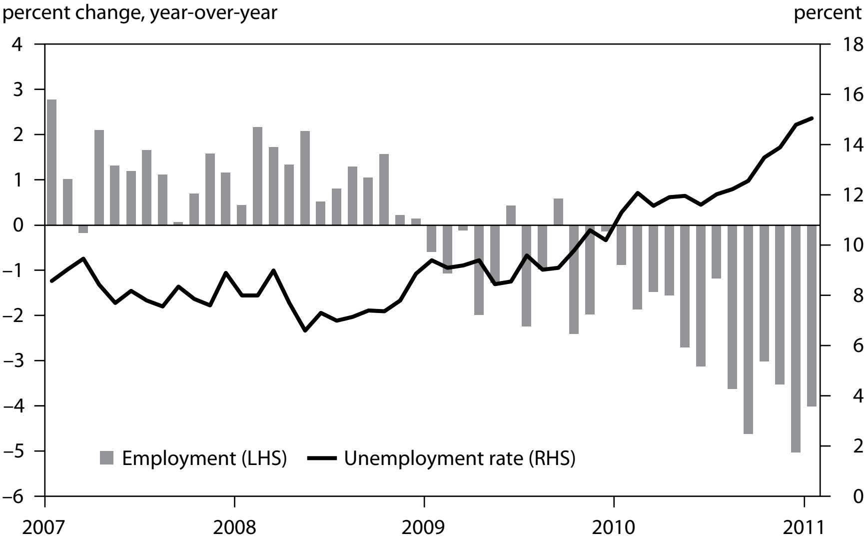
Figure 2.8 Employment and unemployment rate, 2007–January 2011



Sources: Hellenic Statistical Authority (EL.STAT.), Labor Force Survey, www.statistics.gr.

After long hesitation and much resistance, the PASOK government finally undertook to reduce substantially the numbers of those employed in public administration and the state-controlled enterprises, through shutdowns, restructuring, and extensive privatization. And the reaction from trade unions was fierce, as expected. The fight for a leaner state will be hard going, judging from earlier results and the strong opposition already encountered.

State assets are very large in Greece in comparison to many other European countries, for historical reasons among others. Hence the emphasis on the privatization program, which will bring money to the government coffers while also leading to a more efficient use of resources. The objective is to raise €50 billion by 2015, a highly ambitious target. A common objection to privatization is that carrying it out on a large scale will be selling Greece on the cheap—like holding a fire sale at a time when prices of stocks have hit rock bottom in the Athens exchange as a result of the crisis. This phenomenon has happened before in other countries in deep crisis, close to home in the Balkans after the fall of communism and the war in Yugoslavia, and also in the Far East following the financial crisis of the 1990s. There may be little choice in the matter, but it is still politically very difficult. It should be added, however, that most of the privatization will be in real estate and government concessions for mainly underutilized assets.

Tax evasion is a major problem. According to the OECD (2011), if Greece had the tax-collecting capacity of the average (not the best) member of the organization, its tax revenues would increase by almost 5 percent of GDP: not

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bad, since this would amount to more than half of the total fiscal adjustment still required. Tax evasion certainly stems from the poor state of tax collection in Greece, in turn the product of weak administrative capacity as well as corruption. But it also has to do with the structure of the Greek economy, which has the highest percentage of self-employed in the OECD, coupled with a predominance of small, family-run enterprises. Economic structures do not change from one day to the next. Tax collection may change more quickly, though, if the political will is there—and it should be.

Overall, there are indeed legitimate doubts about the will and capacity of Greece, notably its political system and society at large, to deliver what it has promised to its European partners and the IMF. There is, however, another side to the story. Greece's creditors have been arguably asking too much in a short space of time from a democratic government in a state of siege, while the frontloading of fiscal adjustment has been creating a deadly spiral for the economy, especially in the context of a deteriorating international economic environment. This situation may not change dramatically, whoever is in power in the country. The two sides of the story are not mutually exclusive. They are instead mutually reinforcing. Is there a way of getting out of the vicious circle?

Can Greece Do It?

The task facing Greece is simply enormous: fiscal adjustment of close to 13 percent of GDP in five years' time (2009–14), with about 7 percent still to go, depending on the final outcome of the haircut of its public debt. This is combined with the need for internal devaluation and structural reforms, including a major overhaul of the state machine and a wide range of liberalization measures. By the end of 2011, real GDP will have registered a cumulative decline of more than 10 percent since 2009. The decline is expected to continue in 2012, contrary to the forecasts made in the adjustment program. Admittedly, other countries have suffered a worse fate and survived.

The distribution of pain is crucial in political and social terms. The burden has so far fallen more than proportionately on the better off, although allowance has to be made for the still-large number of tax evaders. Dealing with tax evasion is a question of social justice as much as it is a question of macroeconomic balance. Unemployment is now hitting the middle classes, and the fat accumulated over the years of prosperity is being rapidly burnt.

We are dangerously close to the bone. Were it not for the Greek family, which remains by far the most efficient welfare provider in times of need, the social situation would be much worse. Young and less young Greeks are increasingly looking for job opportunities abroad, and there are also signs of a slow return from urban centers to the countryside, where there are better ways to survive a big economic crisis. A better utilization of the opportunities provided by Greece's comparative advantage in agricultural products would surely not be a bad thing. On the other hand, effective resistance to change does not come primarily from the weak. It is organized interests in the public sector and

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elsewhere (lawyers, pharmacists, owners of lorries and taxis, among others) that have been fighting hard to preserve privileges and rents acquired in the political domain. And they have people in parliament to defend their interests.

The decisions taken by the euro area leaders in July and October 2011 have broken the taboo about the sustainability of Greek public debt. International and EU organizations had until then produced different scenarios that tried to prove that under various assumptions Greece was illiquid but not necessarily insolvent. This was increasingly not the view adopted by markets and the majority of analysts.[2] The first, hesitant step toward accepting that Greek public debt was unsustainable was taken in July 2011 with a small "voluntary" haircut accompanied by expensive financial incentives offered to Greece's creditors. It was followed by a much more drastic step in October, with an agreement in principle for a 50 percent haircut of notional Greek public debt held by private institutions. If and when implemented, this step will cut more than €100 billion out of Greece's overall debt. Coupled with decisions taken in July concerning the reduction of the interest burden for the part of the debt owned by EU governments and institutions and the extension of maturities, this haircut will surely provide significant relief. But sustainability of the debt, of course, crucially depends on future growth, in turn a function of domestic reforms and the economic environment in Greece and outside. For a still relatively closed economy such as the Greek one, the export environment is not as important as it is for the Irish economy, for example. But it surely does matter. Greek exports have risen substantially since the outbreak of the crisis, thus partially closing a still unsustainable gap in the current account (figure 2.4). This is indeed one of the positive signs.

The Greek government generally adopted a low profile with respect to discussions about the restructuring of Greek public debt. The official line for some time was that Greece would meet all its obligations to debtors in accordance with the official statements made by its EU partners as well as by European and international institutions. The government seemed to mean it. In fact, this was one of the few issues on which the PASOK government and the main opposition party, New Democracy, were in agreement. The fact that the ECB was strongly opposed to any kind of debt restructuring surely played an important role in this stance, since the very survival of the Greek banking system remained entirely dependent on access to ECB liquidity. When, under pressure from Germany, the possibility of debt restructuring was opened, the Greek government continued to keep a low profile, which is more surprising. Allowing foreign governments and bankers to take the lead role in negotiating the restructuring of your debt is surely a big sign of weakness. The country had become marginalized.

At the time of writing, the crisis in Greece had reached a new climax. Following the European agreement of October 27, 2011, which was meant to offer Greece breathing space through a new multiannual rescue plan and a substan-

2. See also chapter 11 in this volume by William Cline.

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tial haircut of its debt, Papandreou committed a fatal error of judgment. Having for two years led a government under siege, having introduced bold and painful measures—but having failed to develop and articulate a coherent and consistent strategy for economic reform and adjustment, and aware that his popularity and that of his party were sinking rapidly in the polls—he decided to call for a referendum on Greece's rescue package. This would inevitably turn into a referendum on Greece's continued participation in the euro. The negative reaction from inside and outside Greece was very strong, as markets saw Greece as the new Lehman Brothers. Papandreou was forced to take back the plan for a referendum and paid the price by leaving the office of prime minister.

These events were the catalyst for further political developments in Greece. Domestic politics has always been strongly partisan and confrontational. The credibility of the Greek political class has sunk very low, and it is increasingly being seen as part of the problem and not part of the solution. Papandreou's government has been replaced by a coalition government led by Lucas Papademos, former vice president of the ECB, which has the main task of putting Greece's side of the October 2011 agreement on track and preparing for early elections. Given the enormity of the task facing any Greek government for the next few years, the optimistic scenario is that this transitional government may lay the ground for broader consensus and coalition governments after the next elections.

The main opposition party is ahead in the polls, although far from certain of gaining an absolute majority. There is no doubt that the New Democracy party bears a huge responsibility for the mess that Greece finds itself in. After all, it was this party that governed the country between 2004 and 2009, while PASOK, in opposition then, competed in terms of populist rhetoric. Under a new leader, Antonis Samaras, New Democracy opposed the government of PASOK and the program agreed upon with the European partners and the IMF, arguing that the economic strategy was wrong because it produced a vicious circle of austerity and recession. It called for tax reductions as an incentive for investment and growth, but remained reluctant when it came to cuts in the public sector. Samaras basically argued that there is an alternative strategy, and implied that he could convince his European partners and creditors to go along with it when he comes to the negotiating table with a fresh popular mandate. He was forced to compromise earlier as a precondition for Greece receiving the next installment of financial aid from its European partners and the IMF, after the formation of the new government, led by Papademos, in November 2011, with support from three parties, including his own, and with people from New Democracy in the cabinet. The solidity of Samaras' conversion, forced or otherwise, remains to be tested.

Not surprisingly under the circumstances, populism has been on the rise in a country where many people feel increasingly desperate. The radical Left, including an old-style Communist party, with a strong anticapitalist platform and in favor of a debt moratorium, represents 20 to 25 percent of the electorate today. This group is in no mood to compromise with the government,

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the European Union, or anybody else. They largely represent the angry, the *indignados*, and the desperados, but they have no serious alternative to offer.

Although support for European integration has suffered as a consequence of the crisis, there is no big wave of anti-Europeanism in Greece. When it comes to the crunch, nearly all Greeks apparently still realize there is no future for Greece outside the European Union. There is also a clear majority in favor of keeping the euro (about two-thirds majority, according to the latest opinion polls), which is also reflected in the stance adopted on this strategically important issue by most political parties, including the two major ones: a kind of bottom-line consensus. Most Greek citizens realize that a return to the drachma would be tantamount to economic and political disaster for Greece, although most also realize that the possibility of this happening is coming closer by the day as long as Greece fails to deliver its side of the bargain. The minority arguing for the return to the drachma speaks more about the alleged benefits of regained sovereignty and less about the possible benefits of a devaluation of the new currency. This group includes those who are banging on the patriotic drum and others who expect to buy assets on the cheap after an economic collapse—an unholy alliance indeed.

Populist media have resorted to racist and xenophobic messages, often in direct response to their counterparts (of the *Bildt Zeitung* variety) in other countries and Germany in particular. The exchange of stereotypes and insults is depressing. But most Greeks still reluctantly accept that the crisis is basically of Greek making. Looking for scapegoats outside the borders remains therefore an exercise for those on the fringes of the political system, yet fringes that are increasingly occupying parts of the old core.

There is a culture of protest in Greece, coupled with a high degree of politicization of just about everything. Clientele politics is part and parcel of the political culture. Politics is high-adrenaline stuff—Greece is not Scandinavia. Street demonstrations and other forms of social protest have increased dramatically as a result of the crisis. Some have been unruly even by Greek standards. Anomie has become a real issue, and the rule of law is being stretched. The problem with the young generations is the most serious. With around 40 percent of young people in their early 20s out of a job, there is the grim prospect of a lost generation in Greece and in several other countries (IMF 2011). This situation is a time bomb waiting to explode.

The reluctant acceptance of the inevitability of austerity measures, which had been registered by opinion polls in the early stages of the crisis, has been progressively replaced by ever bigger majorities against. Greeks are angry and afraid; they see no light and no end of the tunnel. The political scene has become extremely fluid: Party allegiance has weakened remarkably, shifts within the political system are happening fast, while more than 30 percent of those polled consistently refuse to express a preference. There is a big political vacuum that waits to be filled. It has not happened for a long time or on such a scale. A large part of the Greek political class is likely to be swept away by the tsunami caused by the crisis. Most of them will not be missed.

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Greece needs a radical renewal of its political class. Such a renewal is likely to happen within existing parties when the next election comes, a prospect that is not far away, and it may also happen with the creation of one or more new parties. An increasing number of opinion formers, intellectuals, and businesspeople in Greece are converging on the need for a reformist political movement, one cutting across traditional dividing lines between center-left and center-right, which would articulate and defend the vision of a reformed Greece. Whether the critical mass is already there and, perhaps more importantly, whether there will be somebody to lead it, remains to be seen. It could be a game changer.

Odd Man Out?

So, is Greece the odd man out in the euro area, a patient in the European intensive care unit with little chance of recovery? No doubt, the challenge of adjustment facing Greece is huge. I wrote above about the need for a peaceful revolution. Such a revolution would not just seek macroeconomic adjustment and regained competitiveness, as if those two tasks were not big enough. It would also offer a new model of economic development, a radical reform of the state, and the renewal of its political system. And it would finally promote a change of values.

Under normal conditions, the progress registered in the last two years or so—more than had been achieved for years—would have been truly impressive. But conditions are not normal. The country could end up with a disorderly default, while the possibility of an exit from the euro area is being openly discussed. If this exit were to happen, it would set Greece back many years and plunge it into uncharted territory.

Greece's political forces have had great difficulty in reaching any meaningful consensus, as the economy sinks and society is in a state of despair. In fact, Greece's political class, with some exceptions, is more part of the problem than of the solution. The country finds itself in that intermediate stage when the old is dying and the new has not yet been born. This stage could last for some time, but the trouble is that Greece may have little time left to avoid a major catastrophe.

The program imposed on Greece by its creditors is punishing, even though considerable improvements have been made in successive revisions of it. Arguably, it is still more than any government in a democratic country can deliver. And this is not meant as an excuse for the outgoing PASOK government, which wasted precious time, tried to protect the barons of the state sector at the expense of those working in the private one, sat on reform, and poorly implemented what it had itself legislated. At the time of writing, Greece had just entered the next phase, with a new government enjoying broader support in Parliament and with the task of setting the ground for the implementation of the European agreement reached on October 27, 2011. New elections are expected to be called a few months later. Now the ball is more in the court

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of the New Democracy party and its leader, Samaras. It remains to be seen how much the prospect of coming to power sooner rather than later will help to soften the rough edges of public stances taken while in opposition.

The European and international context does not always help—and this is a polite way of putting it. True, decisions adopted by the euro area leaders with respect to Greece would have been completely unthinkable only two years ago. They have paved the way for similar decisions for Ireland and Portugal. Yet the time and pain involved in reaching those decisions, the cacophony that often surrounds them, and the implementation gap that follows present real problems. Alas, such is the European decision-making system.

Euro leaders hoped in May 2010 that Greece would be a unique case requiring special treatment. They were proved wrong a few months later, when other countries followed Greece asking for European support. Again, in July 2011, euro leaders reiterated the same hope, while agreeing on a second and more generous rescue package for Greece. They took a big step further in October of the same year, by which time the crisis had reached Italy with no end in sight. While they have been trying to build a firewall around Greece, the fire has been spreading elsewhere.

Greece is, indeed, different and in several respects weaker than other countries of the euro area. But if Greece does not make it in the end, other countries could follow. The fear of the domino effect is in everybody's mind. Many of the problems Greece is facing are far from unique. The euro area will need to move further along the road of fiscal union as the necessary counterpart to the single currency. This being a long and painfully slow process, the role of the ECB (and the European Financial Stability Facility) will be crucial in the meantime. If the euro area crisis continues to get worse, nothing short of the ECB intervening on a large scale as a lender of last resort will be strong enough to restore calm in the financial markets. In a double-dip recession, existing European mechanisms will come under heavy pressure, while resistance to austerity will grow in many places. And Greece could then once more be the precursor of things to come. This is indeed a scary scenario.

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