AN INSTITUTIONAL PROPOSAL FOR ECONOMIC ADJUSTMENT IN THE EUROAREA[1]

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Abstract
Economic adjustment programmes and euro area state compliance to stability and growth pact rules have received rising academic attention over the last decade. European scholars examine the effectiveness of programmes in different ways, focusing on national economic efficiency, macroeconomic imbalances, and fiscal sustainability. Various studies underlined that economic adjustment strategy has deficiencies at the heuristic level, (how the fundamental problems of adjustment are framed in euro area states), at the ontological level, (what are the key hypotheses about the structure of an economy in adjustment), at the methodological level (what methods are implemented to test economic adjustment programme effectiveness) and at the policy level (how to match adjustment austerity measures with economic strategies looking for both efficiency and welfare). This analysis evaluates the deficiencies of adjustment programmes and assesses the economic results of crisis management, taking into consideration five criteria: regaining market access, achieving debt sustainability, attaining primary fiscal balance, restoring external competitiveness, and restoring sustainable growth.

Key words*: Economic adjustment programs, Euro area, institutional economics, European economic governance*

Introduction

The euro area debt crisis underlined the necessity for effective economic adjustment and the restoration of macroeconomic equilibria (Kotios et al, 2011). The literature argues that adjustment can be attained in two ways. First, it could take place through external adjustment, that is, the depreciation or devaluation of the nominal exchange rate. Alternatively, it could be realised through internal devaluation, which includes macroeconomic stabilisation and structural reforms (Larch et al, 2014). Both policy strategies target international competitiveness and the shift of factors of production from non tradables to the tradables sector. Analysing macroeconomic adjustment from institutional perpective demands a detailed explanation of how institutional options are and should be made. No institutional choice is ever made without the application of specific criteria, according to which the selection takes place. Highly valuable to this effort is the analysis of norms, values

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and principles relating to economic agents, economic structures and decision making procedures.

The article examines the political economy determinants of success and failure in four programme countries, which received financial assistance in 2010-2015: Cyprus, Greece, Ireland, and Portugal. What makes all four programmes special is the fact that they were undertaken within a monetary union. Indeed, the absence of monetary policy independence means that national supply-side disturbances do have disruptive effects on income and employment unless labor-market flexibility and regional factor mobility increase significantly. Therefore, the key adjustment mechanism in a monetary union is price and wage flexibility as they directly impact on the real exchange rate, and thus on a country's competitiveness. More specifically, in the absence of independent monetary policy the two relative price adjustments to achieve "internal devaluation" are on the one hand a decline in the price of domestic tradable goods and production costs relative to foreign tradable goods and production costs (to enforce exports and improve domestically produced tradable goods status relative to imports) and on the other hand an improvement of the profitability of tradable goods relative to non-tradable goods.

Based on the methodological tools of new institutional economics (Hodgson, 2009; Thelen, 1999; North, 1990) the analysis evaluates the deficiencies of economic adjustment programmes (EAPs) and assesses the economic results of crisis management, taking into consideration the performance criteria used by Hazakis in the examination of an alternative macroeconomic adjustment framework in euro area (Hazakis,2015:834) regaining market access, achieving debt sustainability, attaining primary fiscal balance, restoring external competitiveness, and putting the foundations for sustainable growth. The latter is based primarily on the improvement of real unit labor cost, on the rise of gross fixed capital formation and on the maximisation of structural reforms spilovers.

The article proceeds as follows. Section one set the problem while section two underlines the major pillars of institutional analysis concerning economic adjustment programs. Section three presents the key features of a successful economic adjustment program (EAP) while section four focuses on the experience of the four euroarea countries. Finally, section five concludes and provides key policy implications for EAPs in euroarea.

An institutional approach on economic adjustment programs (EAPs) effectiveness

Economic problems are too often problems of institutional malperformance or non performance. Answers to macroeconomic disequilibria always involve institutional adjustment. The latter is vital to restore macroeconomic fundamentals and to orient economic behavior towards economic rationality.

The article argues that to understand adjustment in the euro area, one should obtain knowledge on how policy making is constrained by institutional choices. Too often, policy gaps emerge between the intentions of the economic adjustment programme designers and the capabilities of institutions undermining adjustment performance.

Can policy makers identify and support efficient adjustment mechanisms? Experience demonstrates that it depends on a number of variables, including the institutional-productive capacity of a state as well as the ability to decide which social groups will be asked to make the sacrifices necessary to resolve the macroeconomic disequilibria. Evidently, efficient economic institutions distinguish between 'what is' and 'what ought to be' during adjustment, and even shape alternative routes of adjustment. Equally important, they identify the rate and scope of reforms that will be confronted.

Accordingly, there is always the question which purposes and whose interests are to be served by institutional adjustment. In a nutshell, international and domestic political economy factors determine the national adjustment attempt to realise economic recovery. Which are the key methodological traits of an institutional perception analysis of economic adjustment?

First, economic and political agents are continuously engaged in appraising economic reality and in adapting to and modifying conditions in search of economic stability and welfare. They make choices of institutional adjustments reflecting cognitive and developmental capacities. North (1990) illustrates that belief structures get transformed into societal and economic structures by institutions and that the relationship between mental models and institutions is an intimate one. Adaptation and learning are two key mechanisms in national economic decision making for effective implementation of adjustment strategies. Thus, adjustment process involves significant transformation in formal/ informal national institutional setting as well as in euroarea mental models of macroeconomic behavior, (according to Douglass North, mental models are systems structuring the available information and helping to interpret reality). Similarly, EAP reforms target not only at fiscal equilibria, but also at the basics of national economic/institutional organization, and at the process that generates an economic actor's subjective representation of economic reality.

Equally important, EAP trajectories differ with respect to which organizational traits are involved in the adjustment process, how economic knowledge is diffused through EAP frameworks, which EAP cooperative patterns affect economic performance, and how EAP institutions are modified and transformed in organizational terms or in policy terms. Taking into consideration that euro area dominant macroeconomic and monetary policies favor stable and positive fiscal balances and low interest rates, countries which apply memoranda should adapt their policies in order to achieve positive primary fiscal balances, low bond yields and sustainable debt to GDP ratios.

Second, institutional analysis emphasises the need not only of macroeconomic stabilization but of growth oriented adjustment. In current EAPs adjustment is de facto identified with stabilization and the priority of fiscal stabilization overrules all other targets of adjustment. EAPs require states to adhere to fiscal stabilization irrespective of national macroeconomic cycle dynamics. According to institutional analysis the prerequisities for sustainable growth rates are improvements in real unit labor cost, in gross fixed capital formation and in implementaton of structural reforms. Third, it is highly important to perceive adjustment within the available portfolio of institutional choices for the euro area which define the political economy of decision-making, the degree of risk sharing and the distribution of costs and benefits among member states. Taking into consideration the definition of D.North (1990) that institutions are "the rules of the game of a society (…) the humanly devised constraints that structure human interaction. They are made up of formal constraints (rules, laws, constitutions), informal constraints (norms of behavior, conventions, and self-imposed codes of conduct)", one should observe that there were significant policy failures and deficiencies in the institutional framework governing adjustment programmes in euro area.

More specifically, institutional analysis emphasizes the initially ad hoc content of rescue mechanisms in euro area. In 2010, there was no permanent mechanism for debt management.Very soon, the member states of the euro area implemented temporary and later permanent financial stabilization mechanisms whose lending capacity and scope of instruments were enlarged to accommodate the negative spillovers of the debt crisis in the Eurozone (Belke, 2013). Member states provided loans to each other under strict conditionality and the International Monetary Fund (IMF) became an integral part of the crisis management together with the European Commission and the European Central Bank (ECB). Moreover, the crisis brought to the surface persistent problems in the set-up of the EU's

Economic and Monetary Union (EMU), such as the fact that the economic governance component had been severely underdeveloped compared with the monetary one.

Fourth, institutionalists underline that the politics of adjustment influence the content, speed and efficiency of adjustment programmes and thus ownership of the programme and distribution of costs and benefits of fiscal adjustment are critical for success in policy implementation. Indeed, the literature suggests that debt crises lead to political conflicts over how the burden of adjustment will be distributed (Reinhart and Rogoff, 2014; Mian et al, 2014b; Alesina et al, 2006). Thus, strong domestic ownership of the programs as well as an ongoing evaluation about how EAP benefits, burdens, and responsibilities should be distributed between social groups in euro area countries following austerity programs are highly significant for programme implementation.

Furthermore, the prolonged austerity programmes favour populism and in some cases even the rise of extreme political forces (Bromhead et al, 2012; Lindvall, 2014). Mian et al. (2014) showed empirically that financial crises are associated with increased political polarization while Reinhart and Rogoff's (2014) listing of the 30 most serious systemic (national) banking crises since 1857 underlines that at least half of them were linked with political upheavals. Kriesi (2012) also argued that when economic agents are confused as to what the impact of an adjustment program will be on them, they may prefer to avoid the application of the policy. Finally, in Fernandez and Rodrik's (1991) analysis adjustment is welfare-improving, but people are unsure as to whether they will have advantages or not from the adjustment policy, leading to a strong bias against reforms. Evidently, effective governments should design and implement measures in a consensual way, through social coalition-building, legitimising the stabilization policy. It follows then that incremental and processual adjustments are better pursued. Thus, one should also examine unemployment rates and distribution of incomes in countries following adjustment programmes.

Finally, asymmetric information during negotiation and implementation of an adjustment programme impacts heavily on the content of the program and distorts the true intentions and power of other parties to the negotiation. Achieving a Pareto improvement can be difficult if the commitments made by the various agents are not credible, since improvements included in the adjustment mechanism involve tradeoffs. If those who need to be compensated do not believe that the promises made to them will be realised, they have no incentive to go along with the deal. For example, distrust in the third memorandum negotiations between Greece and IMF (January 2015 - July 2015) seriously threathened the achievenment of an agreement on the terms of conditionality. Thus, the quality of relations with the Troika (European Commission, European Central Bank, IMF) influences the success of crisis management, given its critical influence on the conditions attached to financial rescue packages.Ownership of the adjustment programmes reduces transaction cost of memoranda implementation and improves the speed of structural reforms. Moreover, to what degree adjustment is proved efficient in the long term depends on the efficiency of EAP structures, on the patterns of daily cooperative interaction among involved agents and on the ability of EAP processes to manage cooperation/conflict in regular meetings with the troika representatives.Overall, the foregoing five tenets and their implications constitute a sufficiently comprehensive framework with which to appraise the success/failure of economic adjustment in euroarea periphery.

Which are the key problems with the conventional policies in the case of the eurozone crisis?

Conventional responses to banking, sovereign debt or balance of payments crises do not reduce the total debt burden of the affected country (Werner, 2012). Despite eurozone public debt increase, Troika conditions focus on fiscal retrenchment and do not include an explicit growth policy (Karger, 2014; Maris and Sklias, 2016). Continued stagnation means that fiscal deficit/GDP and national debt/GDP ratios remain high due to a falling denominator.

As economic stagnation persists, more bank assets become non - performing deteriorating the sovereign debt crisis and further undermining banking systems.

Thus, a sustainable solution without euro exit or default must address the two core issues, namely the need to generate economic growth (without which government finances and the banking sector deteriorate) and the urgency to cut through the Gordian knot of the negative feedback between banking sector stability and sovereign credit rating.

On the effectiveness of economic adjustment programmes

The issue of adjustment effectiveness is a complicated one. The question “are EAPs effective?” is often another way to ask “do EAPs accomplish their initial targets”? Answering the question demands political economists to define the targets against which they will assess EAP performance. Taking into consideration the specific traits of assistance programmes implemented by the Troika in the euro area, the article suggests an alternative framework of economic adjustment programme. Whatever criterion one chooses to implement the common ground is “problem solving effectiveness” (Young, 1989), that is, whether EAPs contribute to initial expectations of European economic governance (EEG) and to euro area policymaking targets (basically stability of prices, detection of problematic economic trends such as excessive government deficits or public debt levels which put economies at risk, automaticity in the operation of the preventive and corrective arms of the surveillance framework, compliance with the rules of the governance framework and coordination their fiscal policies).

Related to this problem-solving criterion, a counterfactual criterion asks whether EAPs brought reforms that would not have happened otherwise, even if they fall short of completely solving national imbalances in certain euroarea states. Thus, effectiveness is linked not only to restoration of macroeconomic fundamentals through usual nominal convergence procedures but also to real convergence through structural reforms. Which are the pillars of such an alternative EAP? First, all EAP incentives can be seen as mechanisms of a regulatory regime - creating opportunities for macroeconomic action. Similarly, EAPs ameliorate receptivity and absorptive capabilities in national decision-making systems through EEG cooperative network interaction. Third, the more open the economies under adjustment are, the less exposed to the tradeoff between austerity and growth are, since the openness of the economy can reduce both the fiscal multiplier and fiscal costs through the Ballassa-Samuelson effect. Equally important, the alternative policy route considers an expenditure-based adjustment more successful than a revenue-based one.

The ideal type of such an EAP has been analysed by Hazakis (2015), who illustrates the rationale of current EAPs and points to hierarchy of issue areas that emerge from collective deliberation. The objective is not only to uncover factors in each stage of EAP implementation but to underline patterns of interactions that influence state compliance to agreed targets of adjustment, to stress incentive structures for national compliance to EEG rules, and to underline limits of EAP implementation. It is suggested that the cooperative interaction of involved agents should be based more on an incentive-driven model of compliance including domestic ownership of programmes (in all stages of EAP) accountability of surveillance mechanisms to European Parliament (through relevant modifications in EEG decision making) and transparency of programme policies. Tranches of loans should not be conditional upon all targets of an agreed adjustment framework but should take into consideration hierarchy of issue areas and policy priorities. On the other hand, a penalty driven conditionality in the programmes lacks flexibility and does not permit compliance to EEG rules.

Which are the innovative traits of this new adjustment procedure? First, reforms alter the informational conditions of market discipline because they establish greater transparency over economic conditions within member states and they reduce risks and uncertainty. Second, incentives for mutual surveillance and incentives for compliance take the preponderance over a punishment-driven perception of adjustment.

Obviously, EAPs can prove ineffective because of three failures: failures of knowledge (concerning national economic path dependency conditions as well as national economic priorities for development); failures of implementation (concerning state ability and resources) and failure of strong political will (due to inexistent reform-oriented electorate and strong vested interests with rent-seeking behavior). EAPs also face problems because of policy uncertainty and lack of knowledge about what policies will move adjustment towards the intended direction (i.e. initial institutional inertia in euroarea policy making in 2010). Further, many EAPs fall short of their potential simply because euro area states want to resolve a problem but are unwilling to take the steps and bear the costs necessary to do so. Political considerations could also overestimate targets, and so even if adjustment rules are perfectly applied, nominal goals would not be achieved. Finally, complex interplays of policy application and context that include factors such as timing of decision making procedures, the nature/quality of national institutions and informal routines/practices of national macroeconomic policy influence significantly EAP performance.

According to our analysis, EAPs are effective if they induce structural reforms with national ownership, keeping positive and steady momentum in achieving fundamental macroeconomic and growth targets even if they fall short of or differ from full compliance with initial EAP targets. Thus, the essence of compliance is not evaluated only in absolute targets set out initially but refers to the extent to which a state gathers reform momentum and conforms to the rules and targets of euro area institutional framework, taking into consideration usual design errors (i.e. multiplier impact). When outcomes fall short of what states agreed to accomplish, political economists should seek out explanations in terms of both national failures and euro area inertia. If deviation persists, adaptation of agreed programmes in new macroeconomic conditions is required, and obviously adequate resources are needed to keep reform momentum in place. **The common features of EAPs in the four euro area states.**

Although the institutionalist approach underlines the differences of national crises in the euro area (i.e. Ireland and Spain faced mainly banking crises, linked with real estate overexpansion, Greece experienced the negative spillovers of long-term government deficits and public debt while Portugal faced over-indebtedness of economic agents), it is important to uncover the common traits of national adjustment routes (European commission, 2010; European commission, 2011a; European commission, 2012; Gros et al, 2013; European Commission, 2014c). Sapir et al (2014) assessed the four programmes in euro area states, stressing forecast errors, programme targets and different degrees of programme application by the troika.

In Greece, Ireland and Portugal, the fall in domestic demand was bigger than projected and unemployment increased by much more than anticipated (European Parliament, 2014). The greater-than-anticipated contraction of domestic demand was due to several factors. First, a perception of increased risk linked with possible exit from the euro area led to capital outflows and a collapse of investment. Second, fiscal consolidation measures had a much stronger macroeconomic impact on economic activity due to fiscal multipliers. Indeed, during the early years of the crisis the IMF insisted that the fiscal multiplier equaled 0.5 but later Blanchard and Leigh (2013) showed that the size of the multiplier was severely underestimated and was well above unity. Third, credit constraints deprived crucial capital from the private sector and restricted growth potential.

A way to evaluate programmes is to examine to what extent their terms have been attained. Economic adjustment programmes in the euro area involve three types of conditionality: fiscal measures targeted at public debt and deficit reduction, financial measures to ameliorate the fundamentals of the financial sector and structural reforms to restore competitiveness. In order to understand the determinants of success and failure it is indispensable to define what we mean by success and failure. Following on the discussion of sections two and three and taking into account earlier efforts to evaluate adjustment programs (Hazakis, 2015) this section presents specific indicators to assess the adjustment in countries implementing memoranda in euro area.

First, the assessement examines the achievement of primary balance in all four countries. In line with Alesina et al. (2012) a consolidation is defined as revenue or expenditure-based depending on which contribution is larger.

Figure 1: Primary fiscal balances of general government as a percentage of GDP (2009-2016)

Year	Greece	Cyprus	Portugal	Ireland	Euro area
2007-2011 Five year average	-5.2	0.0	-3.8	-11.0	-1.0
2012	-3.7	-2.9	-0.8	-3.9	-0.6
2013	-9.0	-1.8	0.0	-1.4	-0.2
2014	0.4	-6.0	-2.3	0.2	0.1
2015*	-3.4	1.8	0.2	0.8	0.3
2016*	0.8	2.2	1.8	1.7	0.4

Source: Eurostat, June 2016 (for 2015 and 2016 the data are preliminary-the data reflect net lending/borrowing excluding interest expenditure)

All four countries succeeded in fulfilling fiscal deficits reduction but there is a considerable difference in the number of years, in which the fiscal conditionality of the original programmes was not fulfilled or the deficit remained over 3 percent. More specifically, in Portugal efficient tax collection and lower unemployment expenditure were the main contributors to the reduction in the headline deficit (European commission, 2014a) while Greece and Ireland implemented expenditure-based consolidations.

In Ireland, revenue performance was primarily driven by corporate income tax receipts, which were 50 % higher (1.1 % of GDP) than under budgetary plans (European commission, 2014c). In Cyprus, fiscal developments have largely out-performed the primary balance targets that were set at the onset of the programme (European commission, 2014d).

The second criterion is to judge whether programmes are successful in creating the conditions for regaining market access. From this viewpoint, the Irish programme is successful since the country was able to make a full exit from the programme at the scheduled time, in December 2013, and issue debt at affordable rates. The Portuguese programme is also judged to be on track for success, but doubts remain over the structural weaknesses of the economy.

The Greek programme cannot be judged as successful at this stage (European commission, 2014b; IMF, 2013b). Not only was the first programme discontinued and replaced by a second programme (after a haircut on privately-held government debt) and a third programme (August 2015), but there is widespread doubt that the country will be able to regain market access without some form of write-down of its publicly-held debt (IMF, 2016). In Cyprus, robust programme performance, the economic recovery and continued access to the ECB's expanded asset purchase programme have contributed to decreasing yields on Cyprus's foreign-law bonds and Treasury bills. In February 2016, the yields for ten-year-to-maturity bonds and three-month Treasury bills stood at 4.1% and 0.5%, respectively. Cyprus' government bond credit rating has been also increasing since mid-2013, but remained below investment grade in 2015. However, the remaining weaknesses in the financial sector, higher public debt and anemic domestic demand and investment are likely to continue weighing on Cyprus' credit ratings.

One can measure regaining market access by long-term interest rates. The three countries regained access to financial markets and face interest rates below their pre-crisis rates. The only exception is Greece, where the government's insistence on populist macroeconomic strategy reopened the question of 'Grexit' in June 2015 and delayed official assessement by the troika until the mid 2016.

Figure 2: EMU convergence criterion-bond yields-monthly data, Eurostat database, June 2016

	Greece	Italy	Portugal	Ireland	Cyprus	Euro area
May 2010	7.97	3.98	5.02	4.86	4.60	3.52
May 2011	15.94	4.76	9.63	10.64	4.60	4.46
May 2012	26.90	5.78	11.59	7.12	7.00	4.14
May 2013	9.07	3.96	5.46	3.48	7.00	2.65
May 2014	6.38	3.12	3.66	2.71	6.00	2.22
May 2015	10.95	1.81	2.41	1.25	3.96	1.30

Source: Eurostat, June 2016 (for 2015 and 2016 the data are preliminary)

Third, the adjustment programmes are assessed by debt-to-GDP levels which have unfortunately increased more than originally foreseen. This was mainly due to the larger-than-expected fall in economic output. Many factors are responsible for this error in assessment among others the larger-than-expected fiscal multipliers, the deterioration in the external environment and investor confidence, an optimistic evaluation of the initial conditions, an over-estimation of the state administration capabilities and a lack of political ownership.

Figure 3 : General gross government debt as a percentage of GDP (2009-2016)

Year	Greece	Cyprus	Portugal	Ireland	Euro area
2007-2011 five year average	131.5	55.0	86.3	64.8	76.5
2012	159.6	79.3	126.2	120.1	91.3
2013	177.7	102.5	129.0	120.0	93.4
2014	180.1	108.2	130.2	107.5	94.4
2015*	176.9	108.9	129.0	93.8	92.9
2016*	182.8	108.9	126.0	89.1	92.2

Source: Eurostat, June 2016 (for 2015 and 2016 the data are preliminary)

Concerning Portugal there was a modest decline in public debt in 2015 despite important fiscal costs related to financial sector operations. Public debt fell from 130.2 to 126.0 percent of GDP, primarily reflecting a large drawdown of deposits, as the authorities used large cash reserves accumulated in recent years to help finance early Fund repurchases. A modest decline in public debt is projected to continue through 2021 as the headline fiscal deficit stabilizes just below 3 percent of GDP, but public debt would still remain elevated at 124 percent of GDP in 2021 (European Commission, 2016).

It is well worth noting that high public debt implies a smaller fiscal margin for manoeuvre to absorb adverse macroeconomic shocks and cope with possible rises in interest rates. In particular, sustainability can be safeguarded only if budgetary discipline is maintained over time. This implies adequate yearly progress towards the medium-term budgetary objective (a structural balance target currently set at -0.5% of GDP) and maintaining compliance once that objective is met. However, Portugal’s private sector indebtedness is still among the highest in the EU (189.6% of GDP by the end of 2014) and it poses serious risks to the economic recovery. Moreover, the lack of FDI and the prominence of international bank lending and portfolio flows implied additional vulnerabilities for the Portuguese economy.

Ireland’s private sector debt as a percentage of GDP continued to decline steadily relatively to 2015. At the end of June 2015, private sector non-consolidated debt represented 266.3 % of GDP, down 21.8 percentage points from the end of 2014 and 61 percentage points from a peak of 327.1 % of GDP in mid-2012 (euro area average 166.9 % of GDP). However, the large build-up in the stock of debt between 2002 and 2012 by corporates (300 billion euros increase) and households (150 billion euros increase) means that debt levels remain very high in spite of the significant deleveraging achieved over the past few years. Although non-performing loans are reduced, they represent over 20 % of GDP, compared with less than half this rate for the euro area.

Ireland’s gross government debt is largely long-term and at low interest rates and the debt to GDP ratio is expected to reach 91.5 % in 2017 and 60 % of GDP in 2026 due to surging nominal GDP growth (plus a statistical revision of the nominal GDP level in 2014), coupled with a primary surplus that partially offsets the impact of high debt servicing costs. Equally important, 87.5 % of gross government debt has a maturity of more than one year and around 28.2 % of that represents official loans from the EU-IMF programme partners. The terms of the financial assistance were significantly improved in favour of the Irish government as the lending rate margins on the EFSM and EFSF were eliminated and the average maturity extended from 7.5 to 12.5 years in 2011 and again to 19.5 years in 2013.

Cyprus private debt-to-GDP ratios are among the highest in the euro area. Private debt in Cyprus has been steadily growing as a share of GDP since 2004, reaching over 340% of GDP (among the highest in euroarea). Part of this debt (about 75% of GDP) corresponds to the liabilities of special purpose entities (companies registered in Cyprus but with most of their operations abroad), which are counted as residents according to ESA 2010, but whose links with the domestic economy are limited. At around 55% in September 2015, the non-performing loans ratio for households and corporate loans remains among the highest in the euro area and has not yet been put on a sustainable declining route.As far as it concerns the official debt-to-GDP ratio, it is projected to decline to about 80% of GDP in 2020. Finally, IMF (2016) underlines that there is a substantial gap between projected outcomes and the sustainability objectives in the Greek programmes suggesting that debt will be around 174 percent of GDP by 2020, and 167 percent by 2022 (the initial targets were 124 percent by 2020 and well under 110 percent by 2022). Moreover, gross financing needs will cross the 15 percent-of-GDP threshold already by 2024 and the 20 percent threshold by 2029, reaching around 30 percent by 2040 and close to 60 percent of GDP by 2060.

The fourth criterion looks on export and price competitiveness indicators. Ireland managed to substantially boost exports, thereby partially compensating for the collapse in domestic demand. Greece is the country in which exports did not pick up and actually performed much worse than initially designed. As a result, the correction in the Greek current account can almost exclusively be attributed to the drop in imports.Indeed, the decline of of unit labor costs in Greece and Portugal certainly did not come from an increase in productivity but rather from fall in wages which was probably facilitated by severe unemployment rates reaching a peak of 27, 5 percent in Greece in 2013 (European Commission 2015:170). In terms of regaining price competitiveness, figure 4 shows (Kyrkilis and Hazakis, 2014) that relative price adjustment is well underway in all countries. It started in Ireland and was followed by Portugal and Greece, with the adjustment in the latter starting relatively late.

Figure 4: Real Unit Labor Cost (RULC) growth, % annual change (2009-2016)

Year	Greece	Cyprus	Portugal	Ireland	Euro area
1996-2011	0.5	0.0	-0.4	-0.9	-
2012	-1.6	-2.1	-2.8	-1.1	0.7
2013	-5.0	-2.0	-0.5	-1.0	-0.2
2014	-0.4	-2.1	-1.8	-1.7	0.1
2015*	1.1	-0.3	-2.5	-9.0	-0.6
2016*	0.2	0.7	-0.3	-2.6	-0.3

Source: Eurostat, June 2016 (for 2015* and 2016* the data are preliminary)

In Portugal the share of exports in GDP has risen from below 30 percent before the crisis to 41 percent which is low compared with other small and open euro area economies. A sectoral analysis of exports reveales that Portugal has lost market share in half of its ten largest export sectors, which account for more than 80 percent of total exports. Total labour productivity in Portugal stayed at around 60% of the euro area levels in 2013-2014, although it varies across sectors. Finally, Portugal's R&D spending and innovation are relatively low, taking into consideration the low share of exports of high-tech products. The low average skill level of the Portuguese labour force influenced negatively investment activity and innovation. Despite all aforementioned factors, Portugal has retained its comparative advantage in the production of labour-intensive and low to medium value added activities such as the processing of beverages, mineral products, paper and wood.

In Ireland, the rebalancing of the Irish economy has been characterised by different wage levels in tradable and non-tradable sectors. Between 2010 and 2014, unit wage costs have fell in non-tradable sectors, including construction, and increased in tradable sectors. It is very important to underline that between 2000 and 2008, nominal unit labour costs grew by about 20 percentage points more in Ireland than in the euro area. In contrast, unit labour costs have fallen significantly since 2008 while they continued to increase in the euro area. Productivity growth also contributed significantly to the downward trend in unit labour costs.

In Cyprus, slowing productivity growth is evident not only at the beginning of a recession but also after 2010 demonstrating that market failures and institutional problems are still present (i.e. low competition in business services comparatively to other European states).

Figure 5: Current account balance as a percentage of GDP (2007-2016)

Year	Greece	Cyprus	Portugal	Ireland	Euro area
2007-2011 Five year average	-13.1	-13.2	-9.7	-3.6	0.2
2012	-4.2	-5.6	-2.0	-1.5	1.9
2013	-2.2	-4.5	0.7	3.1	2.5
2014	-3.0	-4.6	0.0	3.6	3.0
2015*	-0.2	-3.5	-0.1	4.4	3.6
2016*	0.6	-4.2	0.3	4.6	3.7

Source: Eurostat, June 2016 (for 2015* and 2016* the data are preliminary)

Is there a clear impact of adjustment strategy on current account balances? Many economists believed that within the euro area balance-of-payments hurdles would not exist since capital markets would have been able to fund all economic agents regardless of national location and thus interregional flows within countries would almost automatically restored any emerging economic imbalance. However, Portugal’s Net International Investment Position remains negative, and thus Portugal would need to post annual current account surpluses of around 1.8% of GDP over the following years so as to stop the negative trend by 2024. On the other hand, Ireland is taking advantage of its specialisation in pharmaceuticals and information technology services, led by transnational firms operating in its territory. Goods exports in sectors with local enterprises presence account for about 40 % of the total and increased 10.3 % in the first nine months of 2015 compared with the same period in 2014. In any case one should take into account when studying the Irish current account balance the impact of the International Financial Services Centre, the activities of transnational firms, the redomiciled private limited companies and the aircraft leasing operations.

Finally, in Cyprus, the current account balance has improved from about -15.6% in 2008 to around -4.2% in 2016. Rebalancing Cyprus's very negative net international investment position is considered a key priority since it remains among the most negative in the European union, at around -140% of GDP.

The fifth criterion focuses on social policy effects of adjustment mainly on unemployment. The common ground for all four countries is that austerity measures were not socially balanced and extreme downward real wage adjustments took place.

In Portugal, the adjustment did not impose individual large cuts such as those to the Greek pensions and public salaries (in Greece real wages fell by more than 30% since 2009) but it called for a lower public sector wage bill, imposing wage and promotion freezes and a gradual reduction in staff. Moreover, there were smaller transfers to local and regional governments and state owned enterprises (European Commission, 2011b:20), lower and shorter-term unemployment benefits, and cuts in capital spending (European Commission, 2011b:24). In Ireland, the adjustment involved a large reduction in expenditure as well as a variety of tax increases. Controlling public sector expenditures took place through a wage freeze, voluntary retirements in the public sector (European Commission, 2012:24) and reduction of social benefits.

As a result of fiscal austerity indicators of poverty and social exclusion have deteriorated in all four states despite some mitigating measures which were taken to protect the most vulnerable groups. In Portugal, the at-risk-of poverty rate rose from 17.9% in 2010 to 19.5% in 2014 and the poverty gap in working age 18-64 continued to rise reaching 30.3% in 2014 (the EU average was 24.7% in 2014). Disposable income, including at the lowest income deciles, has decreased due to rising levels of unemployment levels and following fiscal measures motivated by deleveraging needs. Moreover, the number of jobless poor (at risk of poverty and living in low work intensity households) reached 556.000 in 2014. Equally important, the disparity between the top and bottom 20% of the income distribution widened in 2014, and the Gini coefficient has increased to 34.5% (EU average level of 30.9%). The evidence clearly suggests that the main reason for the increase in inequality is the loss of earnings in the bottom and middle sections of the income distribution.

In Ireland relative poverty and income inequality have also increased. In 2014, the risk of poverty rate increased to 15.3 % from 14.1 % in 2013, in part due to rising median incomes (however, relative poverty is below the EU average of 17.2 %). In Cyprus, the risk of poverty and social exclusion also increased in the context of a deteriorating labour market. The number of people at risk of poverty or social exclusion rose reaching 27.8 % of the total population in 2013 while in 2014 it slightly decreased to 27.4 % but remained above the EU average (24.5 %).

Figure 6 : Unemployment rates (number of unemployed as a % of total labor force, (2007-2016)

Year	Greece	Cyprus	Portugal	Ireland	Euro area
2007-2011 Five year average	11.3	5.4	10.7	10.3	9.0
2012	24.5	11.9	15.8	14.7	11.4
2013	27.5	15.9	16.4	13.1	12.0
2014	26.5	16.1	14.1	11.3	11.6
2015*	24.9	15.1	12.6	9.4	10.9
2016*	24.7	13.4	11.6	8.2	10.3

Source: Eurostat, June 2016 (for 2015* and 2016* the data are preliminary)

Concerning unemployment, Portugal's rate fell to 12.6% in 2015 due to improving labour market conditions and a shrinking labour force (0.6% on average) reflecting demographic and migration trends. However, outward migration has been a channel of labour market adjustment, as net migration has been negative since 2011. On average, the number of people leaving Portugal exceeded arrivals by about 30 thousand per year between 2011 and 2014. While geographic mobility and migration eases labour market adjustment in the short run, large-scale emigration poses a risk to long-term growth. It goes without saying that the low skill level of labour force acts as a barrier to the state's competitiveness. In Ireland economic growth has led to sustained job creation across sectors and regions, even though the pace has slowed somewhat since 2013 and most jobs created since 2014 have been full time positions. In the first nine months of 2015, employment grew by over 56 000 or close to 3 % of the active labour population. In Cyprus youth and long-term unemployment remains high. The recession that started in 2011 put long-term unemployment (more than 12 months) on an upward path, reaching 7.7 % of the labour force in 2014 and as a result long term unemployed gradually become more detached from the labour market.

In Greece there is a tremendous fall of welfare since nearly 3.9 million Greeks were classified as “at risk of poverty or social exclusion”, with a 7.6% increase to 35.7% in 2015 from 28.1% in 2008 (to be classified as facing the risk of poverty a citizen should earn less than 60% of the average national available income). Greece ranked third amongst its European partners for the percentage of the population at risk of poverty and social exclusion, only behind Bulgaria with 48% and Romania with 40%. In addition, Greece had the highest EU percentage of households with very low work intensity (18.3%), compared with the EU average of 10.7%. In the EU as a whole, up to 120 million people, or 24.5% of its population, were defined as at risk of poverty and social exclusion, an increased of 0.7% since 2008.

Moreover, there is a rise of income inequality in countries following adjustment programmes. The most widely used measure for income inequality is the Gini coefficient. The maximum possible value of the Gini coefficient is 1 (when one individual has all the income in a country), while the lowest value is 0 (when everyone has the same income). In the EU, the value of the Gini coefficient in 2012 ranged from 0.24 (in Slovakia and Slovenia) to 0.35 (in Bulgaria and Latvia) while at the top of the ranking were Lithuania, Portugal, Greece and Romania with Gini indices around 0.34. The other measure of income inequality commonly used in the EU as an indicator is the ratio of the income share of the richest 20% of the population to the share of the poorest 20% (the S80/S20 ratio). The higher the value of this, the more unequal is the distribution. While in the Netherlands the top 20% has approximately 3.5 times the income of the bottom 20%, in Bulgaria, Romania and Greece they have incomes more than 6 times higher than the poorest fifth of the population.

Lastly, intra-euro area convergence deteriorates as it is evident by the following figure. The GDP per capita of Greece was 71.13% of the German GDP per capita in 2009 but was 50% in 2015.The same holds true for Italy (88.21% in 2009 but 74.45% in 2015), for Portugal (55.20% in 2009 but 48.51% in 2015) and for Cyprus (76.89% in 2009 but 60.47% in 2015).

Figure 7: GDP per capita (constant 2010 US$)

	2010	**2011**	**2012**	**2013**	**2014**	**2015**
Cyprus	30,438.9	29,792.1	28,623.3	26,986.0	26,603.3	27,377.2
Germany	41,788.0	43,306.5	44,223.7	43,433.6	44,755.2	45,269.8
Ireland	48,260.7	49,329.7	49,295.4	49,878.5	52,256.8	56,053.7
Italy	35,851.5	35,996.3	34,887.4	33,882.4	33,457.7	33,704.7
Portugal	22,540.0	22,160.8	21,354.5	21,229.4	21,537.5	21,961.4
Spain	30,737.8	30,322.5	29,508.8	29,110.6	29,595.1	30,587.6
Euro area	37,604.3	38,113.5	37,865.3	37,454.9	37,806.3	38,341.2
Greece	26,919.4	24,497.2	22,831.9	22,262.5	22,557.9	22,648.4

Source: IMF, World Development Indicators, GDP per capita (constant 2010 US$)

The final evaluation criterion concerns the basics for bridging the gap between actual and potential gdp growths. A major component of this criterion is gross fixed capital formation (GFCF) relative to GDP and structural reforms. In the exception of Greece, it seems that all countries succedded in restoring GFCF positive trends.

Figure 8: Gross fixed capital formation, annual percentage change, 1996-2016

Year	Greece	Cyprus	Portugal	Ireland	Euroarea
% GDP (2014)	11.6	1.5	14.9	19.3	19.6
1996-2011	1.1	1.7	0.6	4.3	-
2012	-23.5	-20.5	-16.6	8.6	-3.3
2013	-9.4	-15.2	-5.1	-6.6	-2.6
2014	-2.8	-18.0	2.8	14.3	1.3
2015*	0.7	14.0	3.9	28.2	2.9
2016*	-0.9	9.1	1.6	13.4	3.8

Source: European Commission, European Economic forecast vol.|2016, European economy, Brussel (for 2015* and 2016* the data are preliminary)

Undeniably, structural reforms do impact heavily on GDP performance. Reforming product markets improves productivity and promotes growth. By reducing costs, reforms of services and network industries depreciate the real exchange rate and thus ameliorate labor demand in tradables without putting in place nominal wage cuts. Product market reforms can further improve the quality and availability of intermediate inputs, particularly from services and industries inputs.

The structural reform agenda of the Troika programme aims at boosting competitiveness and redirecting economic activity from non-tradable to tradable activities. These measures, however, take time to implement and bear fruit (Anderson et al, 2014;

Canton et al, 2014). A major question is the capacity of the government to pursue the necessary reforms, in both product and labour markets, after the end of the programme (Varga et al, 2013). It is evident from figure 9 that all four countries have by-and-large adopted the fiscal consolidation measures prescribed by the Troika.

Figure 9: Adjustment Progress Indicators (2014 and 2015)

	Total Score	External Adjustment	Fiscal adjustment	Labor cost adjustment	Reform drive
Country	2015(2014)	2015(2014)	2015(2014)	2015(2014)	2015 (2014)
Greece	7.6(8.8)	7.4 (7.5)	8.5(9.7)	7.7(7.9)	6.9 (10.00)
Ireland	7.7(8.2)	7.4 (8.4)	6.6(6.9)	9.2(9.1)	7.5 (8.5)
Portugal	6.5(6.7)	5.9 (6.0)	7.1(7.9)	5.6(5.2)	7.3 (7.8)
Cyprus	6.0(6.0)	4.8 (5.2)	6.4(6.2)	6.9(6.5)	n.a (n.a)
Italy	4.3(4.3)	4.2 (4.2)	4.3(5.1)	2.9(3.1)	6.0(5.0)
Euro-18	4.0(4.0)	4.3 (4.0)	4.0(4.5)	2.4(2.4)	5.5(5.2)

Source: The Lisbon Council, 2015

However, the situation in terms of growth-enhancing structural reforms is more complex. The four countries are divided into two groups. Ireland enjoyed fairly healthy structural conditions before the crisis. Hence, structural reforms are less important than the need to change their growth models by reducing the importance of the financial sector. Greece and Portugal, meanwhile, had already suffered from weak structural conditions for a long time and reforms did not deliver the expected results.

In Portugal the regulatory burden on service providers remains high according to an in-depth assessment of the regulation of business services published by the Commission in October 2015 (European commission, 2016).

On the other hand, Greek underperformance in crucial issue areas of adjustment is apparent namely the low share of tradables, the anemic capacity of tax and public administration, rigid product markets, lack of ownership of the program. Additionally, political uncertainty and turbulence undermined credibility and led to dramatic capital flight from domestic banks.

Figure 10 : Output gap relative to potential GDP (deviation of actual output from potentaila output as percentage of potential GDP, 2007-2016)

Year	Greece	Cyprus	Portugal	Ireland	Euro area
2007-2011 Five year average	-0.2	2.5	-0.9	-0.8	-0.5
2012	-12.9	-2.5	-5.0	-3.4	-2.2
2013	-12.7	-6.5	-5.1	-3.9	-2.8
2014	-9.5	-6.4	-3.8	-1.9	-2.5
2015	-7.7	-3.6	-2.3	1.6	-1.7
2016	-6.3	-1.4	-1.1	1.7	-1.1

Source: Eurostat, June 2016 (for 2015 and 2016 the data are preliminary)

In Cyprus, the crisis influenced negatively growth potential and investment. To revive its potential, Cyprus has put forward a list of pro-growth reforms that form the basis for the Cypriot Action Plan for Growth. The plan targets the terms for businesses operations, human capital enforcement and stepping up high-quality investment projects, including those supported by EU initiatives and EU funds to increase the export potential of the economy and its ability to attract foreign investment. Tradable services sectors, which rely significantly on external demand, are leading the recovery.

On the whole EAPs record has been mixed. Although they have proved effective in many facets of fiscal consolidation they did not revive long term sustainable growth rates, intra Eurozone real economic convergence and did not achieve de-escalation of sovereign debt.

Application of adjustment efforts faced a key problem as time lags exist between reforms and deliverable results distorting a clear link of reforms to adjustment and competitiveness. Moreover, the asymmetry between fiscal and adjustment efforts is evident in Greece. Finally, EAPs are deprived of a well-designed, properly financed, front loaded and unconditional poverty reduction policy framework (PRPF).

5. Conclusions and policy implications

The euro area deficit states followed intensive policies of internal devaluation based on front loaded fiscal austerity and wage cuts with negative effects on demand.
To the question “what is an economic adjustment process?” the article suggests that it is a process of restoring macroeconomic-fiscal fundamentals influenced by deliberate economic/ institutional action, intended to bring about concrete results and realized over a specified and path dependent institutional framework. EAP effectiveness is too often undermined by a lack of knowledge on the specificity of local economic structures, by negative spillover effects through fiscal-investment tax multipliers, and by overestimation of positive results through real adjustment issues (i.e., real unit labor cost improvements).Why some states were more successful than others in adjustment policies application?The article clearly identified four reasons namely national differences in the institutional foundations for growth, in domestic ownership of programmes, in the application of front- loaded structural reforms and in citizens support for structural adjustment.

On the critical issue of competitiveness and productivity, Greece, Ireland, Portugal, and Spain attained larger reductions of ULCs in the tradable than non-tradable sector, which is conducive to the reallocation of production. More specifically, Ireland reduced ULCs by 15–20 percent based on wage cuts and labor shedding while in Portugal and Spain, the reductions in ULCs (5–10 percent) have been realized due to labor shedding. However, ULC adjustments have not been always linked with export price competitiveness. The price of exports relative to the price of goods produced was improved much more in Ireland and Spain than in Greece and Portugal and the adjustment in relative prices did not put in place processes of resource reallocation from non-tradable to tradable sectors.

Internally, the four programs differed in two important respects: the degree of local ownership and institutional constraints. Whereas in Ireland institutional constraints were minimal, in Greece, and to a lesser degree in Portugal, they posed a major stumbling block in the design and delivery of the fiscal adjustment. More specifically, Greece’s institutional capacity in the judicial process, tax administration, expenditure control, and statistical services was below that in practically any other Euro area economy. The Irish programme was characterised by domestic ownership, especially when compared to the Greek one. The Troika set the program targets and let the government decide on the measure to achieve such goals. Ireland complied by and large with the program terms, although one should note that its economic structures were much more flexible and thus the structural reform effort required was smaller than the one to which the other three states were called. The export sector performance helped Ireland to compensate for employment losses in the non-tradable sector and limited the negative impact of fiscal adjustment.

The mixture of the fiscal consolidation also varied significantly across the four programmes. In Portugal the adjustment in the primary budget deficit was based equally on revenue hikes and spending cuts and in Greece the major part of the consolidation took place in the form of increased revenue. Ireland preferred expenditure reductions putting in place two fundamental fiscal tools which were the adoption of a rule based fiscal framework and an independent fiscal council. Lastly, EAPs were deprived from adjustment adaptation mechanisms, and several social groups thus faced practical and ideological problems to adopt stabilization policies. However, such a political environment offers opportunities for extreme right-wing and extreme left-wing populist mobilization along issues related to national identity politics.

Based on the methodological pillars of institutional analysis the article points out that without a clear, transparent and incentive driven organizational framework for adjustment, EAPs deliver organizational failures and modest reform effects. Effective assignment of EAPs targets without real domestic ownership of programs and in the absence of long term collective intentionality of involved agents is fragile. On the other hand, the two pillars (intentionality plus domestic ownership) create a common cognitive framework and link in a legitimate and predictable way the ordering of adjustment norms/targets to the ordering of adjustment actions/policies. Collective intentionality in EAPs is the basis of success and covers not only common economic intentions of agents but also European collective beliefs and commonly agreed directness of adjustment. A successful adjustment on its turn reinforces collective intentionality further since mutual gains to all involved agents and joint commitment to commonly accepted rules strengthen eurozone group identity and credibility and face economic uncertainty. To minimize the associated costs a new type of EAP allows states adequate flexibility in policy means permitting “differentiated obligations” in euroarea states in adjustment that is creating incentives for compliance in situations where demonstrable progress is undisputed. This approach reduces considerably negotiation cost and transaction cost in adjustment policies, enforces positive expectations and guarantee compliance of a state in programme with collective euroarea rules, norms and principles.

It is also apparent that more open economies are less exposed to the tradeoff between austerity and growth and that expenditure-based adjustment is more successful than revenue-based ones. Further, the quality of relations with the Troika influences the success of national crisis management and the presence of strong public support for the government and effective economic institutions helps considerably the management of national economic crisis. Finally, it is necessary to implement poverty reduction stategy policies from the beginning of adjustment so as to mitigate the adverse effects of consolidation.

Conclusively, it becomes evident that adjustment should equally target from the beginning structural and fiscal consolidation taking into consideration the necessity to protect the most vulnerable social groups and maintain programmes with positive spillover effects in economy. It looks like that euroarea states should apply new normative and cognitive rules for adjustment giving an end to a vicious circle of depression.

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