

The Causes of Crisis: Greek Indiscipline Versus The Perils of Monetary Union

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Abstract

The Greek Debt Crisis and the prospects of both sovereign default and contagion to other troubled Eurozone economies are quite sobering, especially in the wake of the recent global recession. One bailout to Greece has already been orchestrated, with the likelihood of others to follow, proving to be extremely costly both politically and economically. The objective of this paper is to determine the various causes of the Greek crisis from three levels of analysis: the micro-level of the Greek state; the embeddedness level of Greece into the Economic and Monetary Union (EMU); and lastly the overarching structure of the EMU. Each level will provide a unique window into the causes of crisis, where the multifaceted nature of the causes will be explored. Drawing on relevant literature, economic data, reports, and media, this thesis attempts to answer the question “Why Greece?,” in hopes to outline a case study of warning to other troubled states.

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Introduction

On 23 April 2010, the Greek government requested a rescue package for its burgeoning public debts worth €45 billion, issued jointly by the European Union and the International Monetary Fund. Collective action was necessary in order to placate the international financial markets and signal to them that Greece would not default on its sovereign debt. Despite the existence of a “no bailout” clause in the Maastricht Treaty, the European Union was forced to work around it in order to restore confidence in the euro as a currency and credibility in its members as debtors. The move was bold, but apparently not enough to settle fears and reduce the risk of contagion¹. Spreads on Greek bonds rose to historic levels, amidst fears that even with prolonging maturity, Greece would be insolvent.² Ironically referred to as the “Greek Tragedy” in the press, the severity and repercussions of the crisis are still being felt today not only in Greece, but the entire Eurozone as well.

The 2008-2009 global financial crisis wreaked havoc on global trade, output, and the international financial system as we know it. Plummeting worldwide demand and an extreme credit freeze forced national governments to spring into action and rescue their fledgling economies. Government bailouts of key industries such as the US rescue of General Motors and various Wall Street firms such as American International Group (AIG) lent some stability to the system in order to keep it from complete meltdown. Panic spread quickly, and soon it was not just the United States spending public money to save private firms. France injected €10.5 billion into its banking system in order to improve liquidity and restore confidence.³ Germany, by far the largest economy of the Eurozone, announced a €500 billion rescue package to its banking and insurance sectors.⁴ The Keynesian economic theory behind such policy tools is that by stimulating

¹ Spain and Portugal, well as Ireland to a different extent, were all feared to become the next “Greece” due to high debt to GDP ratios, high (structural) unemployment, and few growth prospects after the global recession halted their bombing economies.

² “Greek 10-Year Bond Yield, Spread Rise to Euro-Era Records,” *Bloomberg Businessweek* (21 April 2011), <http://www.businessweek.com/news/2011-04-21/greek-10-year-bond-yield-spread-rise-to-euro-era-records.html>. (Accessed 29 May 2011)

³ “France unveils bank rescue plan,” *BBC News* (20 Oct 2008), <http://news.bbc.co.uk/2/hi/7681112.stm>. (Accessed 29 May 2011)

⁴ “Banking crisis: Germany Earmarks €500bn for Rescue Package,” *The Guardian* (13 Oct 2008), <http://www.guardian.co.uk/business/2008/oct/13/germany-banks-europe>. (Accessed 29 May 2011)

demand and increasing liquidity, national governments can encourage investment, lower unemployment, and create growth—effectively reducing the burdens of recession. The merits of this school of economics are not to be debated in this paper, yet it should be noted that increased indebtedness—which in the long run has serious macroeconomic consequences—in without a doubt a consequence of such policy choices, and must be dealt with accordingly.

The end of the recession in nominal terms did nothing to alleviate the effects of its real damages. Although the recession did not directly cause the Greek crisis, the rigidity that it provoked in the credit and liquidity markets served as a catalyst for events that were already unfolding in the Eurozone. The euro as a currency and the Economic and Monetary Union (EMU)⁵ as its framework were barely in existence ten years before the recession hit hard. Before that, times were good. Nominal convergence among member states was increasing, with the hope that real rates would quickly follow. Countries such as Spain and Greece were growing above the EU-average in terms of real GDP growth⁶. The euro had even gained in value against the dollar, prompting some analysts to suggest it could be the new reserve currency⁷. Despite such bright prospects, the massive accumulation of debt as a run up to the recession by Greece has brought the validity and stability of the euro and the euro area into doubt. At the time of writing, there is not a permanent solution to the debt crisis. Austerity measures are not helping to reduce fears of default, as spreads continue to reach record highs.

Amidst the uncertainty and hardship, this thesis aims to take a step away from the heat of the moment and discern the true causes of the crisis. Regardless of what the technocrats at the European Union and the IMF determine to be the “solution” to the problem, it will ring hollow of the true causes. The solution will be a matter of accounting. Burdens will be shifted, debt will be written off, and maturities will be prolonged. What will remain are the harsh burdens of adjustment that the Greek people will have to face—most significantly lower wages, reduced social welfare benefits, and

⁵ The official name is the Economic and Monetary Union, abbreviated as EMU—but it is also commonplace to refer to the same institution as the European Monetary Union. For the purposes of this paper the two are used interchangeable and equivocally.

⁶ See Appendix I for actual data table.

⁷ “Euro could replace dollar as top currency-Greenspan,” *Reuters* (17 Sept 2007), <http://www.reuters.com/article/2007/09/17/greenspan-euro-idUSL1771147920070917>. (Accessed 30 May 2011)

lower standards of living. It is true that discovering the true causes of the crisis will not save Greece from the pain it will endure; it will not lighten the load it must shoulder. Yet it is still useful.

Determining the causes of the debt crisis can help future countries avoid the same fate. The crisis in Greece is unique because Greece is not an emerging or developing economy—so much of the “relevant” sovereign debt literature and wisdom simply does not apply. Greece’s economic, political, and social environment is very different from that of Argentina or Thailand. Greece has a relatively high GDP/capita, 98 percent literacy rate and life expectancy.⁸ Politically, it is a member of the North Atlantic Treaty Organization (NATO), the European Union (EU), Economic and Monetary Union (EMU), the Organization for Economic Cooperation and Development (OECD), the World Bank (WB), and the International Monetary Fund (IMF). Historically, Greece is one of the oldest civilizations, renowned as the birthplace of democracy, drama, and the Olympic Games. Greece, despite its small size, is a big deal. Its place in the international system is not on the same footing as, for example, Germany or France, but it is a developed, wealthy country. As such, it needs to be treated, in the realm of research to say the least, differently. It cannot be compared to emerging and underdeveloped countries.

Literature Review

This thesis has a tripartite structure, and as such, has three distinct parts which draw on different styles and forms of “literature.” There is not an overarching theoretical framework from which the argument is framed, because as this is an impartial case study, there is not an agenda or political aim⁹. It is also useful, before surveying the appropriate literature for each part, to briefly identify some general theoretical concepts touched upon over the course of the thesis. The twin doctrines of political liberalism and neoliberal economics are the foundations supporting the EU and

⁸ “World Factbook: Greece,” *Central Intelligence Agency (CIA)* (17 May 2011), <https://www.cia.gov/library/publications/the-world-factbook/geos/gr.html>. (Accessed 29 May 2011).

⁹ If there is such a thing as *impartial*, of course. It is impossible to escape bias. This will be touched upon in the Conclusion.

the EMU. The underlying idea is that through mutual dependence and linkages, everyone is better off, be it politically or economically.¹⁰

The first section of literature to be looked at deals with the internal structure of Greece in regard to its political, social, and economic workings. One of the most important contributors concerning the functioning of the Greek state is Featherstone. Featherstone (2005) discusses the structural constraints of the Greek economy, taking into particular account the Simitis' government tenure.¹¹ He argues that rent-seeking and clientelistic behaviors have become cultural norm, leading to ineffective policies and little movement toward *Europeanization*. In a later study, Featherstone (2010) expands upon his previous work in order to highlight Greece as a "failing state," arguing that endemic corruption and ineffective bureaucracy has made Greece unable to respond to the challenges it faces.¹² He concludes that the unsuccessful monitoring of economic activity and policy formation, even by external agents, leaves Greece prone to further crises. Other studies have noted the lack of oversight and accountability of the Greece state.¹³ Mouzelis (2005) makes an attempt to link corruption and debt, yet lacks sufficient economic data.¹⁴

Lyrantzis (2011) provides an excellent account of the historical development of the political party structure in Greece and its salience for today's economic and political climate.¹⁵ As introduced in Featherstone (2005, 2010) there is a link between an inefficient political structure and poor response to macroeconomic conditions. He concludes by focusing on the path dependence and collective social memory associated with the struggle between the two main political parties—PASOK and the New Democracy (ND)—and how their politics since 1974 leave little hope for change.¹⁶ This

¹⁰ This is a deliberately simplistic view. The debate over the forces driving EU integration is not relevant to this paper, and thus is skipped over. Pollack (2000) provides a good account of the different IR perspectives on EU integration, ultimately noting that the advancing debate among the schools and convergence around a single, rationalist model.

¹¹ Kevin Featherstone, "Introduction: 'Modernisation' and the Structural Constraints of Greek Politics," *Western European Politics* Vol. 28, No. 2 (2005), 222-241.

¹² Kevin Featherstone, "The Greek Sovereign Debt Crisis and EMU: a failing state in a skewed regime." *Journal of Common Market Studies* (forthcoming).

¹³ Dimitrius Sotiropoulos, "A Colossos with Feet of Clay: The state in Post-Authoritarian Greece," *Greece, the New Europe and the Changing International Order* (New York: Pella 1993).

¹⁴ Christos Lyrantzis, "Greek Politics in the Era of Economic Crisis: Reassessing Causes and Effects," *Hellenic Observatory Papers on Greece and Southeast Europe* (March 2011). Google Scholar, http://eprints.lse.ac.uk/33826/1/GreeSE_No45.pdf (Accessed 29 May 2011).

¹⁵ *Ibid*, 7.

¹⁶ *Ibid*, 22-3.

point is particularly salient (and sobering) regarding the prospects of Greece to pull itself out of economic and political turmoil. Studies concerning social welfare spending are also of interest, because such programs tend to consume large amounts of government budgets, without being able to subsidize their own costs.¹⁷ Studies concerning tax evasion and the informal economy depict another, and arguably more damage, form of corruption for Greece. Danopoulos and Znidaric (2007) discuss at length the differences between an informal economy and tax evasion—concluding the two tend to be concurrent.¹⁸ More research is needed, however to link these activities with fiscal imbalances. It is my aim to try to line up economic data with the theories represented.

The second group of literature focuses on the EMU and the Maastricht Treaty. Reinhart and Rogoff (2009) discuss various instances of debt and default and quirks of instance over the past eight centuries. It is most useful in distinguishing patterns and national trends, and in noticing that history really does repeat itself.¹⁹ Furthermore, Lynn (2011) provides an excellent summary of the events leading up the Greek crisis, usefully grouping them into national and EU-level chapters.²⁰ He tends to take too much of a broad focus at time, however, and loses sight of the hard data to back up more emotion-driven claims.

The third area that requires a brief literature review concerns the very core ideas behind the creation of the EMU and its designed purpose. Its foundations can be derived from Mundall (1961) and his *optimal currency area* theory—which argues that regions can be better suited to carry currencies than the nation-state.²¹ He even noted that the European Community would make a suitable area, claim which nearly forty years later would earn him the Nobel Peace Prize in Economics. The EMU is also built upon the belief that countries who share the same currency trend to trade more with one another, thus strengthening their mutual dependence.²² Implicit in this theory is the caveat that as things move together upward, they can easily move together downward. Featherstone (2003) notes specifically the relationship

¹⁷ See, for example Dimitris Tsarouhas and H. Tolga Bolukbasi, “Exogenous Pressures and Social Policy: Greece and Turkey in Comparative Perspective.” *EUI Working Papers, Mediterranean Programme Series* (2008), 5. Google Scholar, <http://cadmus.eui.eu/bitstream/handle/1814/7686/RSCAS_2007_38.pdf;jsessionid=EB9D68C1409BF273FDF85F57A6848E19?sequence=1>. (Accessed 25 May 2011).

¹⁸ Constantine P. Danopoulos and Boris Znidaric, “Informal Economy, Tax Evasion, and Poverty in a Democratic Setting: Greece.” *Mediterranean Quarterly* (Spring 2007) 68.

¹⁹ Carmen M. Reinhart and Kenneth S. Rogoff, *This Time Is Different: Eight Centuries of Financial Folly* (Princeton, NJ: Princeton University Press, 2009).

²⁰ Matthew Lynn, *Bust: Greece, the Euro, and the Sovereign Debt Crisis* (New Jersey: John Wiley & Sons, Inc, 2011).

²¹ Robert Mundall, “A Theory of Optimal Currency Areas,” *The American Economic Review*, Vol 51, No. 4, (Sept 1961), pp. 657-665.

²² See, for instance, Alesina and Barro, “Currency Unions,” *Quarterly Journal of Economics* (May 2002), 409-436.

between Greece and the EMU, questioning the country's fitness to join the union and its real convergence, citing the mismatch of EMU policy requirements and actual macroeconomic indicators of Greece.²³ The advantage of hindsight shows that indeed, Greece was not ready to join the EMU in 2001, so Featherstone's assessment of the situation at such an early juncture is impressive. Further research regarding the effectiveness of the control mechanisms in the EMU, and the possible consequences of soft mandates will be necessary to link it to the causes of the Greek debt crisis. Questions of convergence will also need to be answered.

Thus, while there is a fair amount of literature about the causes of the Greek debt crisis, it is all extremely fractured and poorly linked with solid economic data. Levels of analysis tend to either be too narrowly focused or too broad in scope—so that the levels become disconnected and linkages are lost. This is the void I intend to begin to fill with my thesis.

Therefore, this thesis will attempt to discover the causes of the debt crisis as they pertain to Greece. It attempts to answer the question “Why Greece?” by using a tripartite analytical structure. The first level of importance is that of Greece's internal structure and operations—consisting of governance, political culture, and economic organization. At this level I will look for weaknesses and efficiencies that could have triggered debt problems. The second level is more macro than the first, and involves Greece's membership in the EU and the EMU. Motivations for joining and economic convergence will be studied in order to see the effect such a move has had on the country's debt profile and fiscal health. The last level uses the broadest lens, in that it looks at the concept, structure, and reality of the EMU. It will serve as a foil to the first two levels, and thus to my research question.

Methodology

In order to investigate the causes of the Greek debt crisis, I provide a historical overview of Greece, focusing on post World War II political, economic, and social phenomena. Chapter 1 is thus necessarily a piecemeal analysis of various historic events and political economic structures present in Greece prior to and during the debt crisis. In reviewing these phenomena, my main goal is to determine areas of weakness

²³ Kevin Featherstone, “Greece and EMU: Between External Empowerment and Domestic Vulnerability,” *Journal of Common Market Studies* Vol. 41, No. 5 (2003), 923-940.

and inefficiency in hopes to pinpoint possible starting points of the crisis. Much of the content analysis in this chapter comes from secondary literature, reports from national governments, The European Union, International Monetary Fund (IMF), think tanks, and non-governmental organizations. In addition, media analysis of major outlets such as the Financial Times, the Economist, and the BBC are consulted in order to determine real-time reactions and information. In particular, I will look at the instances of political culture and corruption (in the forms of tax evasion and the informal economy) and the effect it has on the economy, and they translate to public debt accumulation. Another area of significance is the structural makeup of the Greek economy and how revenues are spent by the state. Path dependence in a country such as Greece, with its long and tumultuous—yet significant—history and accomplishments, is expected to be quite strong, which I will argue produces significant obstacles to change.

The aim of Chapter 2 is to widen the perspective, moving away from a microanalysis of Greece's internal affairs, and instead focusing on the context of the crisis. Greece has set itself within the European Monetary Union (EMU) and as such, must adhere to community rules and procedures. Despite the loss of monetary sovereignty, joining the EMU was generally seen as a positive for Greece, although the advantage of hindsight calls this into question—and will be discussed later. Data analysis is essential at this level in order to determine how, if at all, the Greek economic and political landscaped changed with EMU membership. Media analysis is also useful in determining real-time reactions, which are useful in identifying the motivations of key actors. Although debt began to accumulate in the 1980s, it ballooned at the time Greece joined the EMU. In this section, I hypothesize that skyrocketing debt after joining the EMU is not a coincidence—and thus that membership was a salient cause to the current debt crisis.

Chapter 3 takes an even broader view of the situation, building on the data analysis of Chapter 2 and the historical framework of Chapter 1. It serves as a foil to the first two in that it analyzes the creation of the EMU in terms of practicality and sensibility. First, a lengthy historical analysis of the “road” to monetary union is conducted, in order to determine the true objectives and motivations behind its creation. Much of the events and policies analyzed in Chapter 2 should be particularly relevant, and add context as well as a multidimensional understanding of the role of the

EMU played in the Greek debt crisis. Second, the policies and structure of the EMU will be analyzed by looking at mandates, reports, and statistical data in order to identify possible areas that could have led to the Greek crisis. Here, it is important to look at other members of the EMU alongside of Greece (Germany in particular) so as to see the affects policies have had on others. The point of this is to neither reinforce nor refute Chapter 1's analysis of problems within Greece and their relation to the debt crisis—but merely illustrate the interconnectedness of the situations.

It is the ultimate goal of this thesis to identify, at various levels, the causes of the Greek debt crisis. It is my belief that there is not a singular cause to the crisis. Rather, that path dependence, political culture, economic structure, societal values, history, politics, and poor decisions at both the micro and macro levels each contributed uniquely to the debt crisis. Exasperated by the global recession and credit crunch beginning in 2007, the volatile mixture of policies and practices that Greece pursued eventually brought its economy and confidence crashing down. However, such forces could not have been put into play without the existence of the EMU structure and Greece's place in it.

Chapter 1—Issue of Political Culture and Governance

There is quite a strong case to be made regarding Greece's political culture and governance in creating the current debt crisis. These range from inefficient government structure and a culture of political corruption, to a lengthy bureaucracy, to failure to raise tax revenue, to expensive social welfare programs. Under each umbrella there is valid and wide criticism of how Greece handles its internal affairs. The results of such mismanagement and impractical spending practices have left Greece with unsustainable amounts of external debt, chronic budget deficits, and an uncompetitive society with perverse incentives.

1.1 Government Structure and Political Culture

Government structure is a main major concern and contributing factor to debt accumulation in that to some extent, all other weaknesses can be traced back to inefficient processes or policies. One criticism is that the public administration sector as a whole lacks the strength to implement policies, coupled with poor intra-governmental coordination. Poor coordination creates overlap which exasperates the problems already inherent to the bureaucratic machine—low-skills, low technology, legalistic operating norms, and strong union power.²⁴ Featherstone goes on to argue that this mixture created budgetary problems for Greece, and that the 2009 government budget was based on some 14,000 separate 'budget lines' where each 'line' represents grouped items of expenditure within part of the public administration, obscuring public spending records. Inaccurate and misleading accounting information leads to higher levels of government spending and subsequently more public borrowing to pay for the overlaps and inefficiencies.

Another significant problem with Greece internally has to do with its long-standing political culture and path dependencies, stemming from the last thirty-five years. Corruption and clientelism have become embedded into the functionality of the Greek political system leading to inefficiencies, waste, and poor decision-making. The

²⁴ Kevin Featherstone, "The Greek Sovereign Debt Crisis and EMU," 3.

two major political parties in Greece, New Democracy (ND) and PASOK worked to reinvent and reinforce the patronage networks through the use and abuse of their mass party organizations which were exploited in order to penetrate the state machine as well as the organized interests and parts of civil society.²⁵ This means that systemically, the political system in Greece is structured in such a way as to encourage nepotism and populist politics. Lyrantzis goes on to argue that because of the two party system, competition for votes and influence has led to political polarization and after each governmental change, patronage to supporters is expected and dished out. He states,

The often irrational growth of the public sector was the result of both PASOK's attempt to create a welfare state and of the subsequent strategy of the major political parties to create new public structures—universities, hospitals, new administrative services and public agencies, research [centers]—on the basis of electoral rather than the rational economic/functional criteria.²⁶

This assertion can be further demonstrated with economic data concerning the ballooning Greek spending since regaining its democracy in the early 1980s. Graph 1.1²⁷ depicts the increasing levels of Greek debt.

²⁵ Christos Lyrantzis, "Greek Politics in the Era of Economic Crisis," 3.

²⁶ Ibid, p. 4

²⁷ Michael G. Arghyrou and John D. Tsoukalas. "The Greek Debt Crisis: Likely Causes, Mechanics, and Outcomes," *The World Economy* (2011), 183. Google Scholar,

<http://onlinelibrary.wiley.com/doi/10.1111/j.1467-9701.2011.01328.x/pdf> (Accessed 01 Jun 2011)

Graph 1.1: Evolution of Greek Public Debt

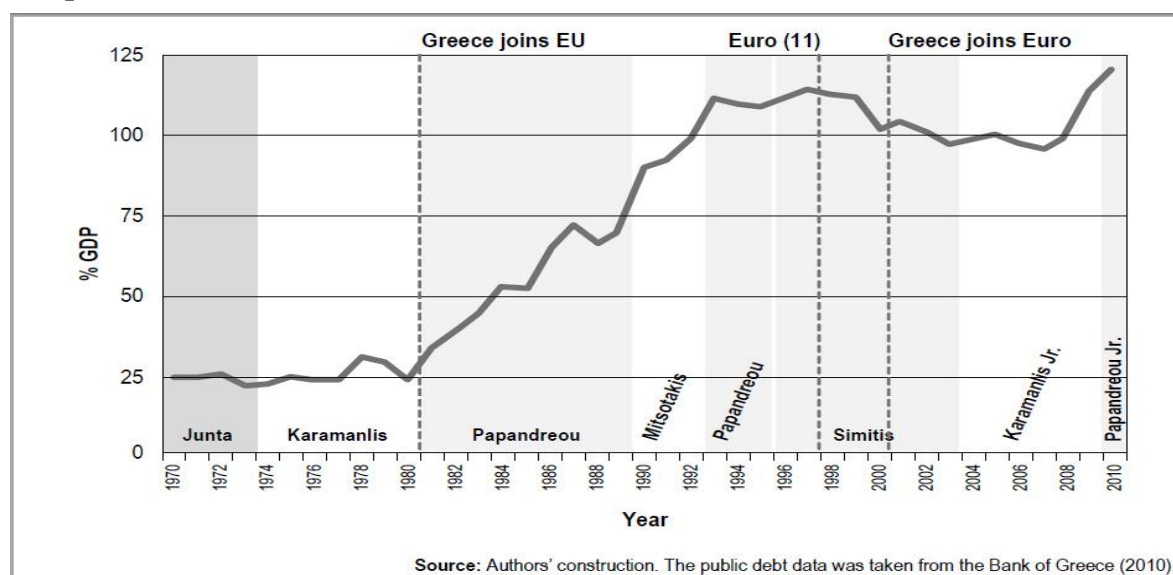


Figure 2 Evolution of the Greek Public Debt

As is evident from Graph 1.1, the aforementioned pattern of increasing public spending and financing of said spending with subsequent government changeovers can clearly be seen. Increasing the public debt burden of Greece is one of the many changes that occurred with the return to Greek democracy. This historical pattern has had lasting influence into today's economic and political situation and climate.

The way in which political parties function and achieve goals and power is thus one of the main causes of Greece's inability to pay its debts and keep its fiscal budget under control. Sotiropoulos (1993) notes that despite the increased size of the Greek state...it was nonetheless still weak and fragmented—"a colossus with feet of clay."²⁸ The weakness of the structure and lack of oversight and accountability has had several implications for Greece today, largely contributing to the current failings of the state in servicing its outstanding debts. Mouzelis (2005) argues that the inefficiencies of the public sector, the proliferation of corruption and nepotism, as well as the weakness of civil society are all precursors to the current public debt of the country.²⁹ So, we can see that the internal political workings and structure of Greece has had a major impact on its current situation. Poor governmental structure and transparency has led to

²⁸ Dimitrius Sotiropoulos, 43-56.

²⁹ Christos Lyrintzis, 7.

inefficiencies and overspending to cover up misdoings and in order to achieve desired political outcomes.

A further fundamental problem with a political system dictated by patronage and corruption is the failure to pass meaningful and effective reforms in crucial policy areas. The key features of Greek politics since the Civil War and *metapolitefsis*³⁰ can be described as follows, with provisions once again stemming from the dual party structure. Featherstone (2005) provides an excellent summary of the key findings concerning the political culture and climate of Greece in this way. The interactions and relationships between political parties are often conflictual and based on patronage networks.³¹ In a similar vein, he shows that the public policy process is structured around 'heroic leadership,' which are prone to populism and have weak ideological identities—as well as a cumbersome top-heavy structure or chain of command.³² Behavior is classified as 'rent-seeking' with different sects competing for favors, resources and subsidies, and a 'disjointed corporatism,' which entails difficulties concerning social dialogue and fair representation.³³ Furthermore, Featherstone describes state-economy relations as being marked by, "on the one hand, heavy legalism and over-regulation and, on the other, an incestuous and sometimes corrupt relationship with respect to the allocation of favors and contracts."³⁴ Due to the aforementioned factors, civil society is weak and there is an atmosphere of mistrust of the state, especially concerning its "regulatory and distributive roles... alongside rent-seeking behavior."³⁵ These problems are only enhanced by a highly centralized government radiating from Athens. This means that regional authorities and governments are dependent on the central government for direction and resources. The result is more bureaucratic clientelism and rent-seeking. The cycle is self-fulfilling, creating instance after instance of inefficiency and waste.

³⁰ Greek for the transition process to democracy.

³¹ Kevin Featherstone, "Introduction:," 229.

³² Ibid.

³³ Ibid.

³⁴ Ibid.

³⁵ Ibid, 230.

The money spent on patronage and clientelism has to come from somewhere. Pet projects and government contracts awarded to political friends still cost the government money. The political culture of Greece is certainly part and parcel of its economic woes and current debt crisis. However, this culture of favoritism and patronage has existed for centuries in Greece and in several other states whose economic situations are much more promising than in Greece. Therefore, while cyclical levels of corruption at high levels and inefficient bureaucracy cannot be the entire cause behind the debt crisis.

1.2 Informal Economy, Tax Evasion, and Fiscal Problems

The size and scope of the informal economy in Greece has led to decreased tax revenue for the central government, creating substantial annual fiscal deficits. Danopoulos and Znidaric (2007) note the difference between the existence of an informal economy and tax evasion. Tax evasion includes avoiding taxes on wages and interest and direct or indirect taxes that legally should have been collected and paid to the state.³⁶ However, they describe that the presence of an informal economy and/or tax evasion has negative effects on government. First, reliability and trustworthiness of government statistics is called into question, which makes policy planning and implementation difficult—possibly leading to more corruption and unauthorized activities. Second, governments cannot accurately predict the amount of revenue, making budgetary planning ineffective and leaving gray areas about actual spending. Third, it weakens monetary policy by leading to a lack of transparency and damaging the functioning of capital markets. Fourth, discrepancies between real and official income make wealth distribution programs and government statistics less effective/efficient. Lastly, because clear and factual economic data is nearly impossible to obtain, actual unemployment and the development of “black” sectors are not known to government officials. This makes crafting policy difficult and often ineffective.³⁷

³⁶ Danopoulos and Znidaric, 68.

³⁷ Ibid, 71-2.

The Greek tax code is also problematic and responsible for fiscal distress on the revenue side of the government ledger. It is estimated that the Greek government has lost as much as \$30 billion a year to tax evasion.³⁸ A recent study published by Friedrich Schneider, chairman of the economics department at the University of Linz, estimates that the size of the underground economy in Greece from 2008 to 2010 was 24.3, 25.0, and 25.2 percent of GDP, respectively.³⁹ The World Economic Forum's 2000 *Global Competitiveness Report* gave Greek tax officials a score of 2.7 of 5.5 concerning fairness and partiality, the 2nd lowest in the European Union.⁴⁰ Furthermore, the same report ranks Greece 46th out of 59 countries in regard to the prevalence of tax evasion.⁴¹ This is troubling, because without proper revenue streams and efficient and trustworthy/transparent bureaucracy, it is difficult to see the situation in Greece improving in the near future. The failure of the Greek government to generate revenue from tax collection creates large budget deficits—estimated at 13 percent of GDP in 2009⁴²—that have to be remedied with increasing amounts of public debt to cover the gap.

In a recent effort to crack down on tax evasion, the government has instituted an amnesty plan, allowing citizens to settle past disputes at a discount of 55 percent. While the immediate revenue stream it provided, just over 1 billion euro, helped alleviate the 3.4 billion euro shortfall on the revenue side of the budget, it also creates perverse incentives. Amnesty programs have been offered in the past, and the prospect of future ones encourages cheating when citizens know that they can “even up” at a discount in

³⁸ “Greek Wealth is Everywhere but Tax Forms,” *The New York Times*, (1 May 2010),

http://www.nytimes.com/2010/05/02/world/europe/02evasion.html?_r=1, (Accessed 25 May 2011).

³⁹ Friedrich Schneider. “The Influence of the economic crisis on the underground economy in Germany and the other OECD-countries in 2010: a (further) increase.”

<http://www.econ.jku.at/members/Schneider/files/publications/LatestResearch2010/ShadEcOECD2010.pdf> (Accessed 25 May 2011).

⁴⁰ Danopoulos and Znidaric, 79.

⁴¹ *Ibid*, 81.

⁴² “Greece Grapples with Tax Evasion,” *The Wall Street Journal*, (10 Feb 2010), <http://online.wsj.com/article/SB10001424052748704182004575055473233674214.html>, (Accessed 25 May 2010).

the future.⁴³ While efforts to close the revenue gap are encouraging more reform needs to take place in order to make the budget add up and reduce Greece's overall debt level.

1.3 Social Welfare Spending

Karl Polanyi stated that the "the Greeks of antiquity, whose genius was already credited with giving birth to our politics, philosophy, science, and art, were also the initiators of all advanced human economy."⁴⁴ In his opinion, the Ancient Greeks developed their society and made decisions based not solely on markets or economic rationality, but rather took into serious account politics, welfare, family, and the livelihood of the citizen; the coexistence of the market and the state.⁴⁵ For Polanyi, the role of the state was to control or influence the markets in order to produce its desired objective—protecting the necessities of its citizens.⁴⁶ Polanyi's assessment of the interplay between in the state and the market in Ancient Greece is particularly salient and applicable to modern day, for presently Greece is a modern welfare state. Thus, much like with the embedded history of clientelism and political party politics, government intervention in the economy is path-dependent.

Modern Greece became a welfare state with the election of the socialist Papandreou government (the PASOK party) in the early 1980s. Government spending on social services and programs increased dramatically. In 1980, Greece spent a little over 10 percent of its GDP on social expenditures. However, by 2001 that amount had risen to nearly 25 percent of GDP, with reductions in social expenditures⁴⁷ few and far

⁴³ "Despite Efforts by Greece to Limit Tax Evasion, the Payments Still Only Trickle In." *New York Times*, (11 Feb 2010), http://www.nytimes.com/2011/02/21/world/europe/21greece.html?_r=1&n=Top%2fReference%2fTimes%20Topics%2fSubjects%2fTax%20Evasion, (Accessed 24 May 2011).

⁴⁴ Karl Polanyi, *The Livelihood of Man*. (Posthumously edited book, organized by Harry Pearson). New York: Academic Press, 1977, 146.

⁴⁵ Bernardo Stuhlberger Wjuniski and Ramón García Fernández, "The Athenian Economy in Light of the Welfare State: Karl Polanyi's Work in Perspective," *Journal of Economic Issues*, Vol. 43, No. 3 (Sept 2009), 590.

⁴⁶ Karl Polanyi, *The Livelihood of Man*, Chapter 12.

⁴⁷ See Appendix II for a table showing Greek Social Expenditures (1980-2005) as a percentage of GDP.

between.⁴⁸ For example, the minimum pension levels rose by more than 50 percent in the 1980s and were extended to both the rural and urban social insurance coverage. Nektarios (2007) describes the Greek pension system as extensively segmented, with very high payroll taxes coupled with inadequate pension benefits.⁴⁹ Furthermore, he argues that the ageing population will ultimately crumble the system, unless reforms are instituted. Given Greece's low labor force participation rate, there are not enough new/current workers to pay for those already on pension or approaching that point.⁵⁰ Thus Greece's "pay as you go" pension scheme will need serious reform in order to accommodate changing demographics, as well as slow economic growth due to the recession and austerity measures.

The structure of the welfare/pension system creates structural problems in the Greek economy, which has undesirable affects on macroeconomic indicators and competitiveness. For instance, the World Bank ranks Greece 142 out of 183 countries in its most recent Doing Business report, with respect to the regulation of employment. The rigidity of the employment index is almost twice as high as the OECD average.⁵¹ High labor costs make Greek exports more expensive compared to its European counterparts. Furthermore, the structure of the Greek economy, in that it is highly service-oriented with 78.5 percent of GDP,⁵² exasperates the problems of corruption and tax evasion. Tourism is the largest part of the service sector, mainly consists of small, old-fashioned, family-owned establishments such as inns, restaurants, and mom and pop shops.⁵³ In this environment, cash is the preferred method of payment because it is easy to manipulate receipts and alter tax forms, as discussed in Section 3.2. The

⁴⁸Dimitris Tsarouhas and H. Tolga Bolukbasi, "Exogenous Pressures and Social Policy: Greece and Turkey in Comparative Perspective." *EUI Working Papers, Mediterranean Programme Series* (2008), 5.

<http://cadmus.eui.eu/bitstream/handle/1814/7686/RSCAS_2007_38.pdf;jsessionid=EB9D68C1409BF273FDF85F57A6848E19?sequence=1>

⁴⁹ Milton Nektarios, "Public Pensions and Labor Force Participation: The Case of Greece," *Geneva Papers on Risk & Insurance - Issues & Practice* Vol. 32, No. 4 (Oct2007), 553-569.

⁵⁰ Ibid.

⁵¹ Datamonitor, "Greece: Country Analysis Report—In-depth PESTLE Insights," August 2010, (Accessed via EBSCOhost, 30 May 2011), 17.

⁵² "World Factbook: Greece," *Central Intelligence Agency (CIA)* (17 May 2011), <https://www.cia.gov/library/publications/the-world-factbook/geos/gr.html>. (Accessed 29 May 2011)

system feeds off of itself, encouraging more and more tax evasion and black market activity, ultimately resulting in lower government revenues and ever-increasing debt.

Chapter 3 will take a broader approach the Greek debt crisis in order to include the effects the structure of the EMU has had on Greek finances. Here, questions about Greece's role in the EMU—and if it should have been a member at all—are addressed in more depth than Chapter 2. It is intended that taking an alternative perspective will help to shed light onto the interconnected and multifaceted nature of the Greek debt crisis.

⁵³ Danopoulos and Znidaric, 78.

Chapter 2—Road to Economic Union; Ruin

This chapter will discuss Greece's pursuit and membership of the European Monetary Union (EMU) and the single currency. First, a brief history of the political and economic policies of the country since the end of World War II is needed in order to lend perspective and appreciate the path dependencies inherent in Greek political culture. It also serves as motivation for joining the single currency, as a means to unite with Western Europe. Next, preparations and policy choices for the EMU will be studied in order to see how each contributed to current sovereign debt crisis. Lastly, Greece's use of creative accounting will be analyzed, ultimately demonstrating that joining the EMU on false pretenses significantly hurt the economy and ruined its credibility within the European Union and financial markets.

2.1 Brief History of Greece Since 1945

Greece's struggle with corruption, clientelism, and political patronage has left its mark on the psyche of the Greek people and public officials. Practices, decisions, and omission have been committed to collective social memory, thus expecting little to change.⁵⁴ For too long, the Greeks were left out of the club of Western Europe; a Europe which owes its affinity for democracy and high culture to those very Greeks it had left behind. After the brutal Nazi occupation of Greece during World War II, the country found itself engulfed in a civil war. Vicious infighting occurred from 1946 and 1949 between communists and anti-communists, leaving the country in ruins and causing great economic and social disturbances. The Marshal Plan, and economic recovery package consisting of aid and loans, initiated by the United States of America, helped to ease the economic hardships associated with war. In 1974 the monarchy was overthrown, and Greece entered into conflict with Turkey over the territory of Cyprus.

⁵⁴ Christos Lyrantzis, 22.

A new democratic constitution was created and ratified in 1975, initiating an aura of hope for the Greek people. Finally, in 1981, the PASOK party came to power under the socialist leader Andreas Papandreu, who would pass sweeping reforms and dramatically increase the size of the state bureaucracy and social programs. Greece rejoined the North Atlantic Treaty Organization (NATO) in 1980, and triumphantly entered the European Union in 1981. It seemed at least that Greece was part of the “club” again, and wanted to continue on its upswing.

The next step in leaving behind its violent and turbulent 20th century history was to join the European Monetary Union (EMU) and adopt the common currency—the euro—along with the European Union’s economic powerhouses. Greece was not deemed economically or fiscally fit to join the EMU by the desired date of January 1999. As Reinhart and Rogoff note in their book, *This Time is Different*, “From 1800 to well after World War II, Greece [has] found itself virtually in continual default.”⁵⁵ In fact, since the foundation of the Greek state in 1829, it has defaulted on its debts three times; in 1843, 1860, and 1893.⁵⁶ Furthermore, Reinhart and Rogoff note that since 1800, Greece has spent a greater percentage of the years in default than any other European country—with default occurring in 50 percent of those years. The Civil War immediately following World War II severely handicapped Greece’s economic recovery and isolated it from much of the rebuilding that was happening across Western Europe. Then again in the 1980s, when much of the West was privatizing and embracing neoliberal⁵⁷ economic reforms, Greece became more state-centered. The Socialist PASOK government dramatically increased wages and pensions and strengthened trade unions. The state-controlled banking system was used to prop up inefficient and unprofitable industries in order to secure jobs. In 1980 the central government of

⁵⁵ Reinhart and Rogoff, *This Time Is Different*, Preface, xxx.

⁵⁶ Practically four times, since Greece also defaulted in 1826—just three years the formation of the Modern Greek state.

⁵⁷ *Neoliberal* refers to economic policies advocating privatization of government-run industries such as pension systems, healthcare, airlines, and other manufacturing segments, as well as the importance of the free market.

Greece controlled 30 percent of GDP, and by 1990 it had risen to 45 percent—one of the fastest growing rates within the European Union.⁵⁸ According to the World Bank, inflation in Greece reached 20.4 percent in 1990.⁵⁹ By comparison, an inflation rate of 25 percent is the commonly noted point when the value of money is more or less worthless, so it is easy to see that economically Greece was anything but stable. Getting its economic situation under control would be no small task, but the country had to make significant changes to its fiscal and monetary policies before it would be qualified to join the EMU.

2.2 Mission: Economic and Monetary Union

In order to be able to join the EMU, Greece had to fulfill the various economic criteria set into place in the Maastricht Treaty, developed by EU leaders in February of 1992, known as the convergence criteria. This Treaty also set 1 January 1999 as the third and final stage of the Economic and Monetary Union (EMU), wherein the euro would be introduced and the monetary union would come into full being and operation. The convergence criteria are laid out in the Maastricht Treaty in order to ensure that members of the euro are economically compatible and moving in the same direction—a smoothing process to demonstrate the viability of union and reduce risks to the entire EMU. As stated in the Treaty, the convergence criteria are as follows:

- The rate of inflation must not exceed by more than 1½ percentage points that of, at most, the three best-performing Member States in terms of price stability
- The observance of the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System (replaced by the new exchange-rate mechanism on 1 January 1999), without severe tensions and without devaluing against the currency of any other Member State for at least two years
- An average nominal long-term interest rate that does not exceed by more than 2 percentage points that of, at most, the three best performing Member States in terms of price stability over a period of one year
- A government budgetary position without a deficit that is excessive, i.e. the annual

⁵⁸ Matthew Lynn, 42.

⁵⁹ The World Bank, "Inflation (Consumer Prices)," <http://data.worldbank.org/indicator/FP.CPI.TOTL.ZG?page=3>, (Accessed 22 May 2011)

- Government deficit does not exceed 3 percent of GDP and the ratio of government debt to GDP is below 60 percent.⁶⁰

The convergence criteria displayed above would prove to be incredibly challenging for Greece to meet by the 1999 deadline. As previously discussed, Greece's economic situation in the early 1990s was not in good shape. According to the International Monetary Fund (IMF), in 1995 Greece's government debt to GDP ratio was 99.21 percent—an increase from the 1990 level of 73.32 percent⁶¹. Clearly, Greece was taking its public finances in the opposite direction required by the Maastricht Treaty, which states that the debt to GDP ratio has to be below 60 percent. Table 2.1 (below) shows the Greek levels of debt to GDP ratio since 1990, using the aforementioned IMF dataset.

Table 2.1: Greek Debt to GDP Ratio (1990-2009)

Table 2.1: Greek Debt to GDP Ratio (1990-2009) ⁶²				
Year	Percentage		Year	Percentage
1990	73.32		2000	103.44
1991	74.85		2001	103.72
1992	80.14		2002	101.66
1993	100.51		2003	97.44
1994	98.51		2004	98.57
1995	99.21		2005	99.99
1996	101.6		2006	97.12
1997	98.74		2007	95.56
1998	96.58		2008	99.19
1999	102.51		2009	115.16

As can be inferred from Table 2.1, Greece's debt to GDP ratio never reached the threshold limit as stated in the Maastricht Treaty, to which Greece was a party.⁶³ Not

⁶⁰ Banque de France, "The Maastricht Treaty,"

http://www.banque-france.fr/gb/eurosys/telechar/docs/Maastricht_treaty.pdf, (Accessed 22 May 2011).

⁶¹ IMF DataMapper, <http://www.imf.org/external/datamapper/index.php>, (Accessed 22 May 2011).

⁶² Data from the IMF, Table 1 is an author construction.

⁶³ Although this is the case with Greece, in reality it was not the only country to abuse or ignore the Maastricht Treaty convergence criteria. This will be discussed further in Chapter 3.

surprisingly, Greece was not in an economic position to join the initial euro countries in 1999.⁶⁴

Their next chance to qualify for the single currency would be in 2001. Yannis Papantoniou, the Greek Economy Minister at the time, stated that Greece “must enter the euro with a clean sheet on all the criteria,” amidst fears that the high inflation rate faced by the country in 1999 would ultimately be the nail in coffin of its EMU dreams.⁶⁵ Papantoniou went on to elaborate on the importance of joining the EMU for Greece:

Along with the restoration of democracy after the colonels' junta, joining the euro would be the most important event in Greece for 50 years. We joined the EU as the outcome of political [maneuvering], but this time we'd be accepted on the basis of our economic achievement.

However, with inflation hovering stubbornly around 3.6 percent in July of 1999, getting the number to below 2 percent in order to qualify for the euro under the Maastricht Treaty would not be an easy task.⁶⁶

2.3 Mission Accomplished, Sort Of

In March of 2001, Greece applied once again to join the EMU by submitting its economic progress report to the European Commission. Despite missing entry by a large margin the first time around, this time Greece's economic figures were impressive. Their deficit had showed to be in decline for three consecutive years, a way around the 60 percent debt to GDP ratio. Romano Prodi, president of the European Commission at the time, stated that, “an enlarged euro area will be positive both for the euro zone area

⁶⁴ The data here is the adjusted data from the IMF, not the original data that Greece submitted to the European Commission. The point still remains that Greece was not ready for monetary union—and even less so than thought—when looking at the revised data.

⁶⁵ “Greek Euro-Zone Ambitions Tempered by Inflation Fears,” *World News* (23 Aug 1999),

http://article.wn.com/view/1999/08/23/GREECE_Eurozone_ambitions_tempered_by_inflation_fears/ (Accessed 24 May 2010).

⁶⁶ As per the convergence criteria, Greece's inflation rate could not exceed 1.5 percentage points of the three best inflation performers in the euro-zone. The numbers discussed are a snapshot of the situation in July 1999, not the adjusted numbers presented by the IMF in its historical inflation database.

and for the countries joining.”⁶⁷ Thus, we can see that expanding the membership of the EMU was also a political tool, stretching beyond sensible economics and monetary policy. This is a significant point to note, and will be discussed at length in Chapter 3.

With much pomp and circumstance, Greece officially shed the world’s oldest currency—the drachma—on 1 January 2001 by adopting the euro and joining the EMU. Prime Minister of Greece at the time, Costas Simitis triumphantly remarked,

Today is a landmark moment in the national aim of the Greek people on their way to increase our standard of living to that of the other European people; to achieve real economic and social convergence. It is also a landmark moment in the cooperation of the European people, in efforts to promote the further European integration. A Europe even stronger, a Europe more social.⁶⁸

Indeed, further integration for Greece with Europe is a positive thing. Given its turbulent yet glorious past dating back to Ancient times, Greece and its contribution to democracy and modern politics, thought, and art is an integral part of Western Europe. Joining the euro was a political move, a way to demonstrate not only to the Greek people but to the world that Greece could not be kept down.

The scene was much different in November of 2004. Gone was the celebration and talk of optimism, and in its place was embarrassment and questions. With a new government elected in 2004, it came to light that Greece’s seemingly impossible economic transformation was just that—not true⁶⁹. In reality, the reason Greece’s economic figures looked so promising from 1997 to 1999 is because they were made up—or at the very least, misrepresented. Greece massively understated its budget deficit numbers to the European Commission in order to gain entry into the EMU. Manipulation of defense spending by the PASOK (socialist) party at the time appeared to be the method of choice for hiding the true deficit—which Greek officials claimed

⁶⁷ “Greece Applies to Join the Euro,” *The Guardian*, (09 Mar 2009), <http://www.guardian.co.uk/business/2000/mar/09/emu.theeuro> (Accessed 24 May 2011).

⁶⁸ Speech by the Prime Minister of Greece, Costas Simitis, delivered to the Greek people, Athens, 02 Jan 2001.

<http://www.greekembassy.org/embassy/Content/en/Article.aspx?office=4&folder=333&article=9657>, (Accessed 24 May 2011).

⁶⁹ It is, of course, unclear whether or not EU official has some idea of Greece’s “accounting” before they were announced. It is impossible know what is said behind closed doors, but it seems unlikely for such a huge secret to be kept from such powerful people.

“had not fallen below 3 per cent in every year since 1999.”⁷⁰ Despite the severity of the situation, Greece escaped without sanctions, but this was the first significant blow of Greek credibility in eyes of the European Union and the international financial community.

Greece’s manipulation of its financial data in order to gain entry into the euro is significant on many different levels. The long and the short of it, quite simply, is that Greece’s economy was not fit to join with the likes of Germany and France. Unqualified economic data signified that Greece was not actually converging with the rest of Europe, which poses its own set of problems for the single market, but also for Greece. In reality, what it means is that Greece’s economy could not (and would not) be able to compete with the other members. By joining the single currency, Greece surrendered a very important tool for staying competitive—the power to devalue its currency in order to realign prices and wages to a more favorable or beneficial balance. This is a main cause of the current sovereign debt crisis in Greece, and it is one that Greece made for itself.

2.4 Be Careful What You Wish For, You Just Might Get It

When Greece joined the euro on 1 January 2001, there was optimism not only from the political elites of Greece and the European Union, but from the financial markets as well. On 3 July 2001, 2.7 billion euro of Greek debt was traded in a single day, more than seven times the normal amount.⁷¹ More significantly, bond spreads between Greek government debt and German government debt had significantly narrowed since Greece announced its intention of joining the single currency. In 1994, the nominal interest rate on 10-year Greek government bonds declined from about 20 percent to less than 3.5 percent in early 2005.⁷² Furthermore, from 2002 to 2008, interest rates fluctuated

⁷⁰ “Greece admits deficit figures were fudged to secure euro entry,” *The Independent*, (16 Nov 2004), <http://www.independent.co.uk/news/world/europe/greece-admits-deficit-figures-were-fudged-to-secure-euro-entry-533389.html>, (Accessed 24 May 2011).

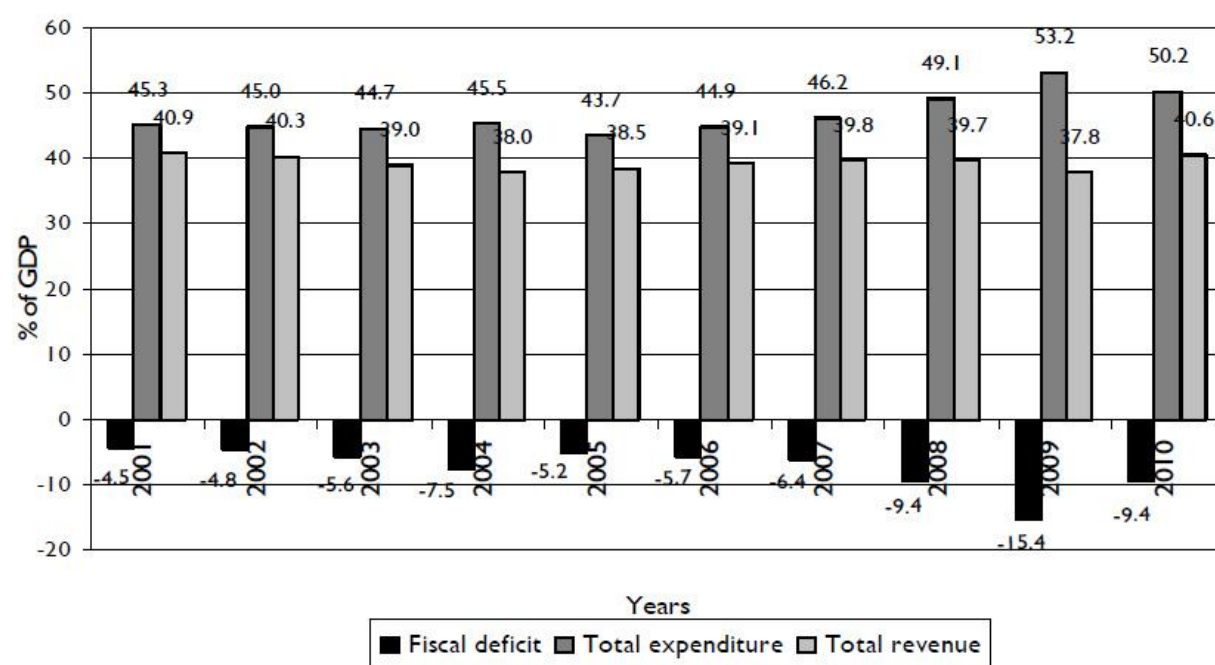
⁷¹ Matthew Lynn, *Bust*, p. 53.

⁷² Heather D. Gibson, Stephan G. Hall, and George S. Tavlas, “The Greek Financial Crisis: Growing Imbalances and Sovereign Spreads,” (working paper) *Bank of Greece*, (March 2011), 5.

between 3.5 and 4.5 percent, on average 1.5 percentage points lower than the year prior to joining the EMU.⁷³ What these [historically] low interest rates meant was that Greece, upon joining the EMU, was able to pay less to borrow money long term. In effect, Greece became less of a credit risk, and thus its debt was seen to be increasingly safe in the eyes of the financial markets. With this newfound access to cheap credit, Greece was able to borrow money cheaper than before, and that is exactly what the government did.

Figure 2.1 (below) illustrates Greece's fiscal deficit, total expenditure, and total revenue as a percentage of GDP since joining the EMU in 2001.⁷⁴ From the figure it is quite clear that expenditures outpaced its revenues by significant amounts. The increasing deficits were financed largely via the newfound lower-interest sovereign bonds Greece was now able to sell on the market.

Figure 2.1



⁷³ Ibid, 7.

⁷⁴ Ibid, 29. Figure is reproduced directly from report, original data from the European Commission.

Greece clearly took advantage of the credibility granted to it by joining the EMU and adhering to the European Central Bank's tight control of inflation and low nominal interest rates. Increased government spending in the economy led to an average 6 percent annual fiscal deficit since EMU membership, requiring more and more debt in order to service the country's outstanding obligations.

The Greek government's refusal to control spending and keep it in line with the Stability and Growth Pact⁷⁵ is a serious cause of the sovereign debt crisis the country now faces. Part of the problem with the fiscal deficits, in addition to what was discussed in Chapter 1, was Greece's hosting of the 2004 Summer Olympic Games in Athens. Massive public funds were used to improve infrastructure and build stadiums, hotels, and other spaces necessary to host such an international event. The event cost the Greek government a little over 7 billion euro, or nearly 5 percent of GDP in 2004. Of that amount, 39.7 percent was spent on infrastructure improvements, 29.9 percent on sporting facilities, and 15.4 percent on promoting Greek culture, the environment, landscaping, and housing athletes. The final 15 percent, nearly 1 billion euro, was for security—which after September 11th was at a heightened level and priority.⁷⁶ These are huge costs for the country to absorb, and double the original budget for the Games. Another problem here is that the total costs of hosting the Olympic Games, aside from being double the original budget, was that it was concealed from public knowledge and likely inflated in order to make the deficit appear smaller in subsequent years. At this point in 2004 and 2005, ECOFIN was becoming increasingly concerned with the large deficits Greece was racking up despite the protocols in the Stability and Growth Pact. As mentioned in Chapter 1, party politics was at play in this case, with the Socialist (PASOK) government predicting a 1.2 percent deficit in 2004 before the election in March. In reality, when the New Democratic Party took over, it became clear that that

⁷⁵ The Stability and Growth Pact (SGP) is part of the Maastricht Treaty and serves as fiscal and budgetary guidelines for members of the EMU. Its purpose is to ensure the stability of the monetary union and provide member states with goals/consequences for policy choices. The validity and authority of the SGP will be discussed further in Chapter 3.

⁷⁶ "Cost of Athens 2004 Olympics," *Embassy of Greece*, Press Office Washington, D.C. (13 Nov 2004), <http://www.greekembassy.org/Embassy/content/en/Article.aspx?office=3&folder=200&article=14269> (Accessed 29 May 2011).

number was severely understated, and that the fiscal shortcoming was closer to 5.3 percent of GDP.⁷⁷

2.5 Debts Fall Due, More Accounting Problems

It has become clear that the Greek government made significant and numerous attempts to skew its financial data and conceal its growing debt from lenders and EU officials in Brussels. It has been alleged that Goldman Sachs helped hide billions of debt from the Commission. In 2001, just after Greece was admitted to Europe's monetary union, Goldman helped the government quietly borrow billions, people familiar with the transaction said. That deal, hidden from public view because it was treated as a currency trade rather than a loan, helped Athens to meet Europe's deficit rules while continuing to spend beyond its means.⁷⁸ In addition, currency swaps were also used to mask debt accumulation. In 2002 a currency swap of about \$10 billion of debt issued by Greece in dollars and yen with the Greek government declaring an unrealistically low rate of interest on the forward swap, which meant Goldman paying (lending) \$1 billion to Greece in an off-the-books deal. In reality the transaction was neutral to Goldman and increased Greek debt.⁷⁹ These practices—while technically legal—served the purpose of disguising Greek debt accumulation from both the public and bond markets. The process fueled Greece's borrowing habit until the country got caught in its own risky game. Eventually, these debts too will fall due, adding more pressure to Greece's already stressed fiscal situation.

⁷⁷ "Greek Debt Spirals After Olympics," *BBC News*, (12 Sept 2004), <http://news.bbc.co.uk/2/hi/business/3649268.stm> (Accessed 28 May 2011).

⁷⁸ "Wall St. Helped to Mask Debt Fueling Europe's Crisis," *The New York Times*, (13 Feb 2010), http://www.nytimes.com/2010/02/14/business/global/14debt.html?_r=1, (Accessed 28 May 2011).

⁷⁹ "Creative accounting and government debt – another fine mess." *QFinance*, (15 April 2011), <http://www.qfinance.com/blogs/anthony-harrington/2011/04/15/creative-accounting-and-government-debt-another-fine-mess-regulation>, (Accessed 01 Jun 2011).

From the evidence provided in this chapter and the previous one, we can see that Greece's current debt problem is by and large a product of its own doing. Path dependence and trying to shake its sordid past and solidify its place in Western Europe led to poor financial decisions and illusions of grandeur⁸⁰. The only way Greece could join the European Monetary Union was to finagle its way in, and continue to misrepresent data to avoid embarrassment and rebuke. In reality, embarrassment and rebuke is exactly what it got, in addition to harsh internal devaluations that will hamper growth and reduce living standards for years to come. Policy choices are exactly that—choices—and ones that Greece clearly botched.

Chapter 3, in contrast to the first two chapters, will discuss the problems and shortcomings on the structural side of the European Monetary Union. This will provide a counterargument, demonstrating that perhaps Greece is not solely to blame for the debt crisis, and that poor fiscal decisions were enabled by the “softness” of the Stability and Growth Pact and the Maastricht Treaty.

⁸⁰ Perhaps ‘delusions of grandeur’ would also be permissible. The temptation to listen to iPods and drive BMWs, to “Keep up with the Jones” can nearly impossible to resist. Especially when confronted with it on a daily basis vis-à-vis tourists, bankers, and EU officials. Not to mention the media.

Chapter 3—Structural Failure of Monetary Union

The concept of uniting the nations of Europe of under a single currency is neither modern nor revolutionary. In 1885, Victor Hugo envisioned a “continental currency, resting on all Europe as its capital, and driven by the activity of 200 million men...,” a currency which would “replace and bring down all the absurd varieties of money that exist...with their effigies of princes, those symbols of misery.”⁸¹ The French champion Hugo’s sentiments about a single currency for Europe as much as they revere and marvel at his works of poetry and prose. However, it is apparent from Hugo’s own words that a currency union is more than mere economic policy—that is a political tool that emanates (or distributes) power by its very existence. Conceptualizing the European Monetary Union in this vein is the first step to understanding its existence, policies, triumphs, and failures.

This chapter will serve as somewhat of a foil to the previous two, in that it will analyze and discuss the shortcomings and pitfalls of the European Monetary Union. Most importantly, it will look at the role these have played in regard to the Greek debt crisis. The theory, motivation, and politics behind a single European currency will be discussed first. Next follows a section concerning the structural features of the EMU, focusing primarily on the roles of the European Central Bank and the Stability and Growth Pact. The next section will look at the winners and losers of monetary union, with particular attention paid to Germany and Greece. Finally, using the unmistakable advantage of hindsight, I will discuss whether or not Greece should have joined the EMU, subsequently setting up the conclusion of my thesis.

3.1 Theory, Motivation, Politics of the Single Currency

The theoretical concept behind the creation of the European Monetary Union (EMU) has been most famously put forth by Robert Mundall in the 1960s⁸². Mundall argued that in a global economy where flexible exchange rates were increasingly becoming the norm, the frame of ‘nation’ was also becoming less appropriate as an

⁸¹ “French Hail Victor Hugo as Euro Visionary,” *Los Angeles Times*, (07 Jan 2002).
<http://articles.latimes.com/2002/jan/07/news/mn-20920>, (Accessed 31 May 2011).

⁸² Robert Mundall, 1961, 657-665.

optimal currency area. Mundall foresaw a workable system in which currencies were established along regional lines, rather than national borders—subsequently requiring different sovereign nations to surrender their monetary freedom. In the 1960s these concepts were theoretical at best, because most of the world was still using the “gold standard,” under which various worldwide currencies were pegged to the US dollar, which in turn was pegged to actual gold reserves. However, the breakdown of the Bretton Woods system and the gold standard opened up the possibility of optimal currency area theory becoming a reality.

After a failed attempt at limiting the fluctuations among the European Communities⁸³ in the 1970s, a new plan was needed in order to bring the goal of a currency union to fruition. In 1989, the Delors Report—named after Jacques Delors, the President of the European Commission at the time, set into place a three-stage plan for monetary union. The Maastricht Treaty, signed in February of 1992, effectively created the framework for the euro—which would be the single currency of all signatory and future members of the European Union.⁸⁴ The intention of merging the currencies of the EU together was to strengthen the common market by reducing various trade barriers. The neoliberal doctrines of the 1980s advocating free trade and increasing growth via mutual dependence were clearly influential in pursuing such a lofty political and economic goal.

According to Alesina and Barro (2002), countries that trade more with each other benefit more from using the same currency.⁸⁵ The revelation is particularly salient for creation of the EMU, because the EU was already a common market—designed to increased trade among member states. In addition, Barro and Gordon (1983) find that if an inflation-prone country (client) adopts the currency of another, more stable country (anchor), it mitigates inflation-based bias.⁸⁶ In reality, what this

⁸³ Precursor to the European Union, consisting of three “communities”—the European Coal and Steel Community, the European Economic Community, and the European Atomic Energy Community.

⁸⁴ A few important things to note: (1) At this time, the European Union was known as the European Community, but the former term is used for reasons of efficiency and clarity; (2) Not all current members were required to adopt the euro—Great Britain, Sweden, and Denmark—but can in the future should they meet the convergence criteria and there is national support; (3) Future membership to the euro is contingent upon completion of the convergence criteria and is thus not automatic, but understood that it is an end goal.

⁸⁵ Alberto Alesina and Robert J. Barro, “Currency Unions,” *Quarterly Journal of Economics* Vol 117, No. 2 (May 2002), 409-436.

⁸⁶ Robert J. Barro and David B. Gordon, “Rules, Discretion, and Reputation in a Model

means is that the inflation-prone country will be perceived as more credible after surrendering its control over monetary policy, thus reducing the risk of easing the debt burden via devaluations which hurt creditors.⁸⁷ In general, this scenario works best with a relatively small country adopting the currency of a larger one.⁸⁸ Alesina et al (2003) note that the costs of the client surrendering monetary policy to the anchor are smaller if the association of shocks between the two are high.⁸⁹ Furthermore, the more that the shocks are related, the more appropriate the policy of the anchor will be for the client. If, however, there is little correlation between the outputs of each country, policy choices of the anchor will be counter-cyclical to the needs of the client, thus making the loss of monetary policy incredibly costly for the client.⁹⁰ Much of this theory can (and will) be applied to the case of the EMU and Greece in particular.

Increased trade and lower costs of borrowing are very persuasive incentives for countries such as Greece, Italy, and Spain to join in the EMU. However, the argument for the anchor countries—namely in this case Germany and France—is somewhat different. The European Union itself is of French and German decent, in that its roots are in the formation of the European Coal and Steel Community⁹¹ in 1951, an alliance between said industries of the two countries. Its intention, among stabilizing prices and production, was also to reduce the risk of war by linking economies—more or less investing in the other to ensure that ever-elusive mutual dependence. Thus, from its inception, what was flaunted as an economic alliance was in reality wrought with political underpinnings. The same can be said for the European Union of today, in that politics is often the case more important than economics.

Chapter 2 described in detail the measures taken by Greece in order to “qualify” for the euro in 2001. Its miraculous economic transformation turned out to be more

of Monetary Policy,” *Journal of Monetary Economics* Vol. 12, No. 1, (July 1983), 101-121.

⁸⁷ As discussed in Chapter 2, this is precisely what happened when Greece joined the EMU in 2001.

⁸⁸ Alberto Alesina, Robert J. Barro, and Silvana Tenreyro, “Optimal Currency Areas,” *NBER Macroeconomics Annual* Vol. 17 (Jan 2003), 309.

⁸⁹ *Ibid.*

⁹⁰ This theme will be extrapolated and applied to Greece in the coming sections of this chapter. Still, it is useful to emphasize the underlying importance of convergence in the success of a currency union between two, let alone several different economies.

⁹¹ The European Coal and Steel Community (ECSC) first proposed in 1950 by the French Foreign Minister Robert M. Schuman, as a way to “make war not only unthinkable, but materially impossible.” Thus, the Treaty of Paris was signed in 1951 between France, Germany, Italy, Belgium, Luxemburg, and the Netherlands. After several treaties, names, and new members, the group would eventually become what is today the European Union.

due to creative accounting rather than real convergence with the more developed countries of the North. Greece was deemed “willing but unable” to join the Eurozone in 1999, and was thus forced to wait until it successfully completed the Maastricht requirements. After rigid reforms and a currency devaluation, Greece posted successful enough indicators to warrant accession in 2001, a mere two years late. However, Greece’s economic turnaround was still problematic, despite it getting confirmed by the European Council in June 2000. Featherstone (2003) notes about the accession;

The two main exceptions to this positive picture have been the continuing high levels of public debt and unemployment. Whilst the convergence criterion for public debt under the terms of the Maastricht Treaty was 60 per cent of GDP, Greece in 1996 had levels of 111.3 per cent, and it was still 104.9 percent in 2002. The forecast is that it will be 87.9 per cent by 2006. In 2002, Greece had the second highest level of unemployment in the EU (10.0 percent), reflecting major structural weaknesses in its economy.⁹²

Clearly, given the data, Greece was still far behind the rest of the EMU in terms of economic development and convergence. Greece benefitted from joining the EMU in many ways, providing incentive to further the process of integration despite lackluster economic performance. For instance, since 1993 Greece has benefitted from EU transfers consisting of 3 to 4 percent of its GDP annually—not an insignificant amount at all. These transfers are more or less acknowledgments from the EU level that Greece cannot compete with the rest, and thus needed funds in order to level the playing field. The obvious concern here is that, if Greece couldn’t handle the transition, why did it occur, and should it really be punished for the aftermath?

The obvious answer is politics. How could the EMU—the supposed culmination of European integration and path toward a more united Europe—leave behind countries that simply weren’t “fit”? Europe’s social model, if anything, had given the elites a mandate to help the less-fortunate, should that not apply to states as well? Initial proposals suggested a two-tiered system for monetary integration, but was deemed politically incorrect and was as such abandoned. The economically stronger countries acknowledged the economic risks of convergence⁹³, but ultimately decided that the

⁹² Kevin Featherstone, “Greece and EMU,” 930-931.

⁹³ What is meant by risks of convergence is the difference between real and nominal convergence. Since the creation of the EU and announcement of the EMU, nominal indicators among members appeared to be converging. In reality, however, Germany was the only country running a balance of trade surplus—and employment/growth figures varied widely between North and South. Thus, real convergence wasn’t

political ramifications of two separate currency regimes was far more costly. Perhaps importance of monetary union, and the role of politics in its creation, can best be described by Wim Duisenberg, the first president of the European Central Bank (ECB): “The process of monetary union goes hand-in-hand, must go hand-in-hand, with political integration and ultimately political union...EMU is, and always was meant to be a stepping stone on the way to a united Europe.”⁹⁴

Nevertheless, wealthy and economically sound countries—most notably Germany—were not going to throw their principles, hard work, and lifestyle to the wind and jump blindly into monetary union. After all, the German turnaround of its economy after World War II is nothing short of spectacular, something certainly to be proud of. The Bundesbank was renowned for its highly successful pursuit of low inflation, and the deutschmark was a currency that rivaled the US dollar in stability, if not at times value. German growth was modest, but stable. Wage increases were lower on average than other countries in Europe, but that only added to German competitiveness—helping to make it the largest net exporter in Europe. Hyperinflation was seen as the window through which Hitler and the Nazis crawled to power, only to leave their irrevocable stain on history. Thus, post war economic policy demanded stability, which is exactly what it got: from 1960 to 1998, the deutschmark retained 30 percent of its original value, compared to 20 percent for the US dollar, 13 percent for the French franc, and 8.5 percent for the British pound, and 6 percent for the Italian lira.⁹⁵ Clearly, monetary stability was a precursor for Germany’s economic turnaround.

The collapse of the Soviet Union in 1989 was significant not only as an end to the Cold War and a validation of the capitalist system. It was also the catalyst for monetary union. Indeed, it presented an opportunity for the reunification of Eastern and Western Germany, albeit with complications. Western Germany was more developed, wealthier, and part of the European Union—Eastern Germany was in shambles. Economically the two were farther apart than Germany and Greece—yet nationally, socially, they were all Germans. Fears of a stronger, united Germany spread through the European Union—

happening at the same rate, which would prove to be problematic, and will be discussed more in Section 3.3.

⁹⁴ Wim Duisenberg, from *The Rise of Europe’s Economic Government* (London: Open Europe, 2010). <http://www.openeurope.org.uk>, (Accessed 30 May 2011).

⁹⁵ Matthew Lynn, 83.

lead by France and Great Britain. Ultimately, in exchange for reunification and integration of East Germany into the European Union, Germany had to commit to monetary union⁹⁶. And so, reunification proved to be a critical political chip used to convince Germany to surrender its Bundesbank and deutschmark in favor of the euro.

3.2 Structural Flaws of the EMU

Political pressures aside, Germany was nevertheless the most dominant and powerful member of the European Union, and knew that monetary integration would not be successful without its cooperation and support. In order to give up its bank, currency, and discretion over monetary policy, it wanted to be sure that the values it held dear—the ones that pulled it out of the nightmares of WWII—would remain intact and guarded. Thus, Germany pushed not only for the convergence criteria of the Maastricht Treaty, but also for the creation of the Stability and Growth Pact. Germany also lobbied heavily for an independent central bank, despite France's preference for more compromise between politicians and technocrats, not to mention softer policies and controls concerning debt accumulation and interest rates. After fierce negotiations, the final terms and conditions of the EMU were finalized. Despite careful crafting, certain flaws within the structure of the EMU would prove to shake its foundations nearly ten years later, ushering in the Greek debt crisis.

The first flaw in the creation of the EMU lies with the enforcement mechanisms of the EMU and the Stability and Growth Pact. The inclusion of the Stability and Growth Pact and its “hard rules” was due to the insistence of Germany. The country was, rightfully so, concerned about other members racking up large fiscal deficits, undermining the stability of the entire system. Thus, the Stability and Growth Pact was designed as a rules-based framework in order to ensure the coordination of national fiscal policies, encourage sound public finances, and serve as a preventative and dissuasive arm of the European Commission and ECOFIN.⁹⁷ The SGP states that members cannot have deficits in excess of 3 percent of GDP, except during times of

⁹⁶ Diplomatic cables and archives detailing the matter were released in 2009. A thorough summary of the events preceding unification can be found at <http://www.dw-world.de/dw/article/0,,4861759,00.html>. (Accessed 30 May 2011).

⁹⁷ European Commission Economic and Financial Affairs, “Stability and Growth Pact,” http://ec.europa.eu/economy_finance/sgp/index_en.htm, (Accessed 30 May 2011).

“severe recession.” The threshold for such a recession is a 0.75 percent drop in GDP—which is a trivial amount. Furthermore, there were no significant penalties for breaching the deficit rule, signaling that members could more or less do what they want in regards to fiscal policy.⁹⁸ Table 3.1 shows the fiscal deficits since 1999 for select EMU members through 2009.⁹⁹

Table 3.2: Fiscal Deficit as a Percentage of GDP (1999-2009)											
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
France	-1.8	-1.5	-1.6	-3.2	-4.1	-3.6	-3	-2.3	-2.7	-3.3	-7.6
Germany	-1.5	1.3	-2.8	-3.7	-4	-3.8	-3.4	-1.6	0.3	0.1	-3
Greece	-3.1	-3.7	-4.3	-4.8	-5.7	-7.4	-5.3	-6.1	-6.7	-9.5	-15.4
Italy	-1.8	-0.9	-3.1	-3	-3.5	-3.6	-4.4	-3.3	-1.5	-2.7	-5.3
Portugal	-2.7	-2.9	-4.3	-2.9	-3	-3.4	-5.9	-4.1	-2.8	-2.9	-9.3

Table 3.2 clearly demonstrates that after the first few years of EMU membership, the 2 percent SGP rule was breached on a regular basis. For Greece and Portugal, that threshold was never actually met. Even Germany ran fiscal deficits in excess of the SGP maximums after 2001. The Excessive Debt Procedure (EDP) is a mechanism of inquiry and enforcement for the SGP, but in reality cannot impose policy changes on members; it can only make recommendations and monitor the implementation of said recommendations. As such, member states have little incentive¹⁰⁰ to follow the rules, especially during times of slow economic growth or recession. Worldwide recessions in 2001 and then again in 2007/2008 prompted increases in government spending and borrowing—in part causing the massive accumulation of and exposure to debt which would ultimately culminate in the Greek/Eurozone crisis that is still ongoing.

The second flaw is in the mandate and power of the European Central Bank and the European Commission. The Germans insisted on an impartial and independent central bank, with a hawk’s eye for inflation. The stated goal of the ECB is to keep inflation levels below or close to 2 percent in the medium term, based on the based on

⁹⁸ Matthew Lynn, 27-29.

⁹⁹ Author construction using data from the IMF, which can be found at <http://www.imf.org/external/datamapper/index.php>, (Accessed 30 May 2011).

¹⁰⁰ This can easily be conceptualized as *moral hazard*, and will be discussed in the Conclusion.

the Harmonized Index of Consumer Prices (HICP), for the euro area as a whole. Very significantly the mandate for the ECB, as Fontana (2007) discusses at length, places price stability (low inflation) at a premium over maximum employment—resulting in high unemployment and low demand in the long run.¹⁰¹ This singular mandate, he argues, limits the policy choices of the ECB to the detriment of employment, output, and growth. In real terms, what Fontana is arguing is that a policy solely concerned with low inflation is not necessarily the best policy for all members of the EMU.

Low growth rates in Northern Europe provoked the ECB to lower interest rates in order to spur growth¹⁰². An excellent study by Hayo (2007) discusses whether or not European Monetary Policy is appropriate for the EMU member states,¹⁰³ concluding that interest rates would have been different in most member states had their central banks kept control¹⁰⁴. He finds that the ECB interest rates tended to be lower than the national target rate, even after accounting for a lower real interest rate in the EMU period. These findings mean that most nations, under EMU membership, experienced less restrictive monetary policies than they would have under the policies of their own central banks. Furthermore, lower interest rates suggest that by joining the EMU, members gained from its credibility and became seen as less risky.¹⁰⁵

As stated above, Greece as a member of the EMU instantly became more credit-worthy on the international markets, and thus benefitted greatly from low interest loans. Borrowing became cheaper, and Greece was able to finance its budget deficits easily with short term loans, creating construction bubbles that eventually burst. For example, over 1999-2006 nominal house prices increased by 75 percent in Greece and household borrowing increased significantly. Furthermore, starting from a balanced position in the mid-1990s, in 2007 the current account deficit reached the

¹⁰¹ Giuseppe Fontana, "The Federal Reserve and the European Central Bank: A Theoretical Comparison of Their Legislative Mandates," *Journal of Post Keynesian Economics*, Vol. 28, No. 3, (Spring 2004), 433-450.

¹⁰² Michael G. Arghyrou, "Real interest rates in the EMU: Facts and implications," *Roubini Global Economics*, (22 Jul 2008), http://www.roubini.com/euro-monitor/253069/real_interest_rates_in_the_emu_facts_and_implications, (Accessed 30 May 2011).

¹⁰³ Bernd Hayo, "Is European Monetary Policy Appropriate for the EMU?" In *The Travails of the Eurozone* ed. David Cobham (New York: Palgrave MacMillan 2007), 67-88.

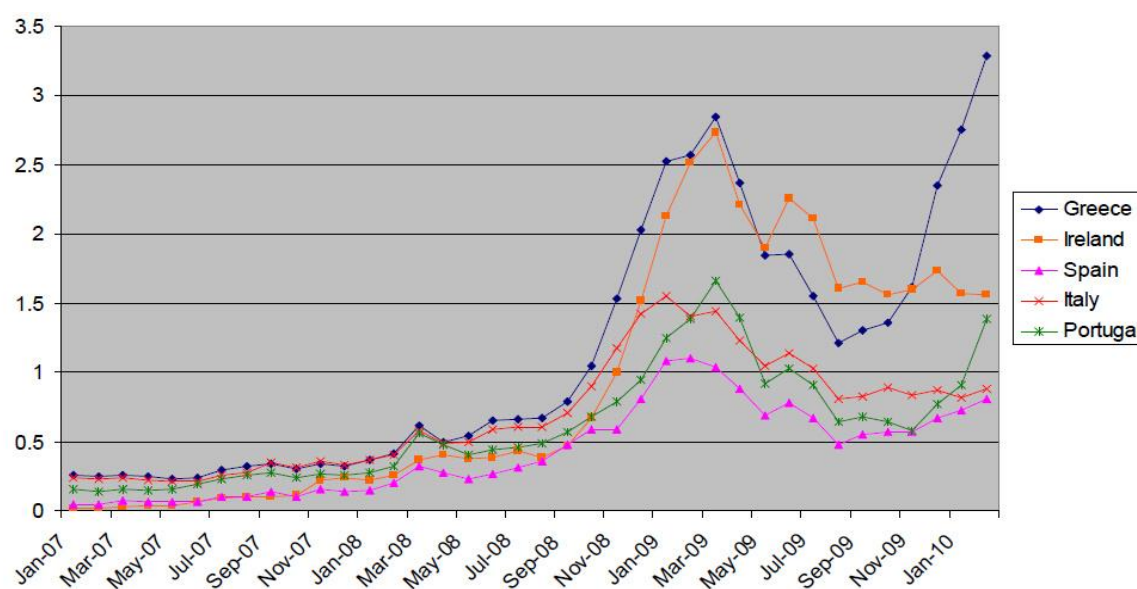
¹⁰⁴ Hayo (2007) used counterfactual interest rate path in order to calculate estimated rates had the ECB not assumed control in 1999. These methods are described in detail on pages 69 to 84, along with graphs and other visual indicators.

¹⁰⁵ Hayo, p 86.9

unprecedented value of 14 percent of GDP in Greece.¹⁰⁶ These statistics indicate an imbalance manifested in the form of a housing bubble—which we now know burst in 2009 after the US mortgage/financial crisis spread internationally. Featherstone (2010), in a similar vein as Fontana (2007) states, the “incompatibility between the ‘one-size fits all’ monetary policy and Greece’s macroeconomic fundamentals overheated the domestic economy....[in effect highlighting] the contrast between nominal convergence and real convergence.”¹⁰⁷ Chapter 2 contains much more detail and data on the explosion of Greek debt since joining the EMU in 2001.

There is another problematic dichotomy with the structural setup of the EMU. While the ECB sets interest rates for all member states, each state is still responsible for issuing its own bonds or sovereign debt. Importantly, each state had its own interest rate which is set by international bond markets. The difference in bond spreads between Greece and Germany is staggering, even though they are each subjected to the same ECB interest rate. Graph 3.1¹⁰⁸ (below) charts the diverging spreads of the Eurozone since January of 2007.

Graph 3.1: Spread of Ten-Year Government Bond Yields Against Germany



¹⁰⁶ Michael G. Arghyrou. “Real interest rates in the EMU, (2008).

¹⁰⁷ Kevin Featherstone, Euro at Ten p. 176

¹⁰⁸ Michael G. Arghyrou and John D. Tsoukalas. “The Greek Debt Crisis,”175.

This situation was made extremely dire due to the global financial crisis. The same system that allowed Greece to borrow beyond its means is now punishing the country so that it is unable to stimulate its economy and try to grow its way out of recession.¹⁰⁹ Greek public debt accumulation has been increasingly since gaining entry into the EMU. Thus, EU and EMU accession allowed Greece to significantly increase its borrowing and rack up public deficits, which largely contributed to the debt crisis faced in 2009 and 2010.

Of course, the argument against this position is that Greece should have been more responsible with its newfound “wealth.” This is undoubtedly true and persuasive. Yes, Greece should have been more responsible. Still, as stated above, the other EU members let Greece into the club despite lackluster numbers, and greatly profited from Greece’s economic weakness—especially Germany. These accusations about the faulty EMU structure require EU and EMU level policy changes in order to rectify the situation in Greece and ensure that it does not get repeated in other EU member states.

3.3 Greece and Germany

There were many reasons for Greece’s inclusion into the EMU despite its apparent shortcomings. First, the point of the EMU was (and is) to strengthen the single market of the EU and reduce cross-border transaction costs, boosting trade among members. Germany is a net producer of manufactured goods and functions by running a large trade surplus vis-à-vis other EU members. Since 2001, Germany has had a surplus in its current accounts, whereas Greece has run an increasing deficit. Table 3.1¹¹⁰ illustrates these figures.

Table 3.2: German and Greek Current Account Balance (% of GDP)

Table 3.2: German and Greek Current Account Balance (% of GDP)									
	2001	2002	2003	2004	2005	2006	2007	2008	2009

¹⁰⁹ Paul De Grauwe and Wim Moesen. “Gains for all: A proposal for a common euro bond.” *Intereconomics* Vol. 33, (2009), 132-141.

¹¹⁰ Author construction using data from the IMF, which can be found at <http://www.imf.org/external/datamapper/index.php>

Germany	0.02	2.03	1.92	4.68	5.13	6.48	7.64	6.78	4.97
Greece	-7.17	-6.5	-6.58	-5.84	-7.5	-11.2	-14.39	-14.65	-11.23

In this way, Germany needed a trading partner in order to sell its goods and a state that its banks can make loans to. For instance, in 2009 Greece imports from Germany were 12.9 percent of the total, by far the highest from any trading partner, and over 50 percent from the EU in general.¹¹¹ In addition, according to the Greek Ministry of Foreign Affairs, its relation with Germany is incredibly salient, stating that Germany is basic source of goods imported into Greece, valuing 13.4 percent of all imports throughout the first eight months of 2005.¹¹² Perhaps even more illustrative of the Greek-German trade relationship is that in the fourth quarter of 2009, Germany's trading surplus with Greece rose to €4.7 billion, exporting three times as many goods as the reverse.¹¹³ Not only did Germany export goods to Greece, but they also exported cheap credit.¹¹⁴ Greece, since the 1970s, was a newly formed democracy (despite its heralded history with the institution) badly trying to shed its past overlords in the Turks. In this way, Greece joining the EU and the EMU was a political tool—it was win-win for both sides. Germany found an eager [and largely untapped] market for its goods and services, whereas Greece gained international credibility, access to low interest loans, and a chance at developing a consumer society.

Of course, increased trade among member states was the ultimate goal of the European Union and the EMU, from an economic standpoint at least. Germany was the only nation running consistent trade surpluses, bolstered by modest wage increases and productivity. The Germans are a prudent people. The combined growth, from 2000 to 2008 of corporate, consumer, and government debt grew by just 7 percent—compared to 157 percent in the UK and 150 in Spain.¹¹⁵ Despite that interest rates were

¹¹¹ Datamonitor, "Country Analysis—Greece," (August 2009).

¹¹² "Relations with EU Member States: Germany," *Greek Ministry of Foreign Affairs* <http://www.mfa.gr/www.mfa.gr/enUS/Policy/Geographic+Regions/Europe/Relationships+with+EU+M+ember+States/Germany/>, (Accessed 20 May 2011).

¹¹³ "Greece-German Relations Roiled by Reference to Nazi Occupation During World War II," *The Wall Street Journal* (25 Feb 2010), <http://online.wsj.com/article/SB10001424052748703510204575085822102779364.html>, (Accessed 30 May 2011).

¹¹⁴ Kevin Featherstone, "The Greek Sovereign Debt Crisis and EMU," 10.

¹¹⁵ Matthew Lynn, p. 89

marginally higher than they would have been without the ECB determining policy, Germany still benefitted from EMU membership, according to Hayo (2007):

The export-oriented German economy would have participated [in] this relative expansion of the other European economies,¹¹⁶ which would have helped to stabilize German output... Given the increase in the euro... interest rate at the end of 2005... [for] the last two years the ECB regime has provided an additional stimulus to Germany.¹¹⁷

So, we can see that the ECB policies and those implicit in the EMU have affected Greece and Germany in fundamentally different ways. Growth rates and accumulation of debt varied between the two states, which we now know has had contributing factors to the Greek debt crisis that is still on-going at the time of writing.

These criticisms of the structure of the SGP, ECB, and EMU as well as their policy choices are much easier to lobby and valid with the advantage of hindsight. Such an economic and monetary union had neither been attempted nor accomplished before. It was a dream of the political elite, but at the time it seemed like a good dream. It was based on a spirit of mutual dependence and a common destiny shared among European nations. However, going back the Mundall's theory of an optimal currency area, the obvious question is whether or not Europe really is one. That is not the purpose of this thesis, but it should be kept in the back of the mind. The Conclusion will briefly summarize the findings of the three chapters and explore gaps and make connections and recommendations as to the final solution to the Greek debt crisis.

¹¹⁶ Most notably: Greece, Spain, and Portugal.

¹¹⁷ Hayo, p. 87

Conclusion

The purpose and aim of this thesis was to determine the causes of the Greek debt crisis. In order to accomplish this task, it was necessary to take a multilayered approach and focus on various factors at each level of analysis that could have contributed to the crisis. This was never meant to be an exhaustive study, and there are obviously areas that could have been looked at to provide more a definitive verdict on the matter. However, this thesis was a good catch-all to discovering the causes of crisis.

One of its most useful applications is that it really allowed for a blending of frameworks and elements to be brought into the research. The three layered approach is useful because it allows for isolation of key variables, yet is flexible enough to be able to witness their interactions. This is important because, as stated in the Introduction, I do not believe that the Greek debt crisis was caused by only *this* thing or *that* thing. The complex nature of the international financial system, the billions of actors that make decisions on a daily basis, the path dependence, and sometimes regular bad luck. The hope is, that despite our inability to predict the future, we can identify patterns and processes that lead to likely outcomes. There will be another sovereign debt crisis, and judging by the economic situation of Portugal and to a lesser extent (but just as serious) Spain, it could come very soon.

This thesis has clearly presented that at the micro-level of analysis, Greece has some serious structural weakness that will not be easy to address. First, tax evasion, bureaucratic clientelism, the informal economy, and decreasing competitiveness are difficult problems for any government to fix, let alone one faced with crushing debt payments. However, there are inherent biases in these scenarios that need to be addressed. Condemning such practices as “wrong” or “wasteful” trivializes the good that can come from them. The government might not receive the tax revenue it needs, but in general, the informal economy keeps people

employed so that they can provide for their families and live their own lives. It is not fair to directly correlate the “black market” with mafias and drug lords. Greece is a good example of this in some ways—as many government services are lacking, people turn to the informal economy to provide for their needs. This includes healthcare, private security, and education.

Second, it is useful to note that there is something very unique and alluring about the Mediterranean lifestyle. The culture is so very different than in Northern Europe that it is difficult to make societal comparisons. The long summers and mild winters have brought with them a sense of calm where time has a different meaning. Greeks, much like their Italian and Spanish counterparts, are never in a hurry to do anything. Living life is more important—family, friends, food—all tend to take a backseat to deadlines and business. This is not a criticism; it is something to be envied. Greece was blessed with a natural beauty and proximity to the sea—the Germans and Brits wish that their beaches were so lovely. While it is difficult to quantify the effect of lifestyle into this study, it should be noted that Greece society operates on different priorities than those of Northern Europe. More than anything, it is anecdotal evidence against the prospects for real convergence in Europe. Not only are the Northern and Southern member states different economies—with strengths, weaknesses, and peculiarities—but they are also cultures and people.

This brings us to another issue, that of judgment. It is briefly touched upon in some of the footnotes throughout the thesis, but it deserves to be explored more in depth here. If the Northern and Southern member states are so fundamentally different, what is a reasonable measure of judgment or expectation? Is comparing Greece to France really in either country’s best interest? Perhaps, it would be better to look toward the Eastern Enlargement states in order to gauge where Greece is/should be—since they share a lot of structural

similarities.¹¹⁸ Chapters 2 and 3 question at length the reasons behind Greece joining the EMU and how that choice has affected its financial situation. Monetary integration is a very delicate situation because of such great divergences in the economies of the EU. Germany is a net contributor to the EU budget and therefore demands considerable respect. However, the implicit argument there is that they also receive a lot back in the form of balance of trade surpluses. Such is the nature of international trade and a political system (the EU) that serves to promote it. In this way, it is difficult to assess blame to a single party because each should have known what they were signing up for. Nominal convergence might have been encouraging, but real convergence was never there. It is fair to ask if it will ever be.

Thus, Greece is faced with a lot of challenges, not all of them their own doing. There is also something to be said about the debtor-creditor relationship in regard to political culture as well. In the Anglo-Saxon viewpoint, if the debtor cannot pay back their loans—they are clearly irresponsible and deserve the punishment that courts impose upon them. This can be said of an individual, family, corporation or state. However, there is an alternative way of thinking---present in the Greece as well as Eastern Europe—which highlights the duality of the loan contract. They believe that the creditor has a responsibility to lend prudently and to be sure of the credit worthiness before making the loan. Individuals get turned down for loans based on poor history, so the same goes for countries. This is an interesting concept and one that will surely be explored in future research circles. Just like critics argue that debt forgiveness or a “haircut” is an instance of moral hazard—so too is a “bailout” or government purchase of toxic assets. The major difference is the winner of the outcome, the debtor or creditor. What needs to happen in order to prevent future crises and mitigate this one for both

¹¹⁸ Not the least of which is corruption. However, that is an entirely different research paper—it would be interesting to compare the two and see if debt accumulation occurs at comparable rates in the East.

sides to accept responsibility and more importantly losses, and solidify this relationship with meaningful legislation.

There are several more tangent subjects to this MA thesis that I could spend an entire other thesis musing about. The main point that I wanted to make with the ones mentioned above is that the causes of the Greek debt crisis (and others as well) are just about as difficult to discern as it is to find a solution to the uncertainty they create. As a more official conclusion to my thesis, I want to reiterate that the purpose of this endeavor was not to assign blame to a single party. In actually, I had hoped that the tripartite analysis would effectively demonstrate the complexities and interdependencies of the situation. Structural adjustment for the Greek economy is certainly needed, and it will be painful for citizens who will suffer from the lower wages and living standards. Growth prospects will remain low. Still, the Greeks made the choices to borrow and spend, to join the EMU,¹¹⁹ and ignore serious inefficiencies in their economic and political institutions. And yet, even with “promising” economic indicators and no signs of real convergence, Greece was let into the EMU. Mandates were ignored, but Greece wasn’t the only country doing that. It was a mutually beneficial relationship until the global credit crunch brought things to a screeching halt. It is easy to point blame in any direction, but that does not solve anything. Hopefully, the Greek crisis can serve as a lesson to other states—that nothing is ever as it appears to be.

¹¹⁹ Under false pretenses, of course.

Appendix I

Real GDP Growth (Annual % Change)										
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Spain	5.1	3.6	2.7	3.1	3.3	3.6	4	3.6	0.9	-3.7
Greece	4.5	4.2	3.4	5.9	4.4	2.3	5.2	4.3	1	-2
EMU Average	3.9	1.9	0.9	0.8	2.2	1.7	3.1	2.9	0.4	-4.1

Source: Data comes from the IMF DataMapper, which can be accessed at <http://www.imf.org/external/datamapper/index.php>, (Accessed 01 Jun 2011).

Appendix II: Greek Social Expenditures (%of GDP), 1980-2005

Table 1: Greek Social Expenditure, 1980-2001

Total Social Expenditure as a % of GDP	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
	11.5	13.8	16.2	16.9	17.2	17.9	17.7	17.7	16.4	17.5	20.9	20.1	20.2	21.1
	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	-
	21.2	21.4	22.1	22.1	22.8	23.6	23.6	24.3	23.8	23.6	23.6	24.2		

Source: Dimitris Tsarouhas, "Social Policy in Greece: Continuity and Change," *Middle East Technical University (METU), Department of International Relations, Working Paper*, (2008), 6.

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