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# Greek Tragedy, European Odyssey: The Politics and Economics of the Eurozone Crisis

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*For our European friends*

*And*

*For Madeleine and Chloe*

# Acknowledgements

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# Chapter I: Introduction to the Eurozone Crisis: Where there's smoke, there's fire

As smoke hung heavily over Athens and unforgiving winds blowing out of central Europe spread searing flames toward Greece's ancient capital, residents fled the scorching embers and deadly heat, leaving behind homes and livelihoods. Escaping the late August 2009 wildfires, none could have known that the conflagration pursuing them was only the beginning of a Homeric ordeal that would dash the dreams of millions, ruin personal fortunes, topple governments, and threaten to destroy the aspirations of an entire continent. In the ashes of the pine trees, olive groves and burned foundations, the seeds of an economic and political crisis would soon germinate, with repercussions affecting financial markets across the globe. Athens would enflame again, although desperation and frustration, not tinder-dry woods, would fuel future fires.

In the weeks following the wildfires, perceived failures in the Greek government's response to them, coupled with years of apparent neglect of the firefighting service, and suspicions that the forest fires were the product of unscrupulous land developers using arson to avoid the bureaucracy involved in clearing protected forests, ignited new calls for the ousting of the sitting center-right New Democracy Party. The party, already stung by a string of earlier corruption scandals and holding only a one-seat majority in the Hellenic Parliament, made a strategic blunder. In an attempt to gain greater parliamentary leverage, prime minister Kostas Karamanlis called a snap election in hopes of consolidating his party's power over the main opposition Pan Hellenic Movement (PASOK) and several smaller parties. That early September decision proved disastrous: the voters punished New Democracy, giving it its lowest vote share in party history (up to that time). Unbeknownst to the electorate, however, the returns of the Greek legislative election of October 2009 would set in motion the events of what has since come to be known as the eurozone crisis.

The newly elected center-left PASOK government, led by George Papandreou, assumed office and began to sort through the ledger left by its predecessor. The audit revealed a much larger deficit than expected. For years, previous Greek governments had hidden massive debts from the rest of the European Union (EU), apparently to obscure the fact that Greece had not met the necessary debt and deficit commitments that "eurozone" countries, are required to meet.[1] Countries failing to meet such commitments in the EU were not unusual. Other countries in the recent past, including the largest economies in the bloc, France and Germany, had also failed to meet these targets, especially the deficit target set at three percent of gross domestic product (GDP). More recently, the 2008 global financial crisis and the ensuing government actions across the continent to stabilize markets had also left several other member states outside EU-mandated fiscal guidelines. Deficits were not unusual. What shocked markets was the scale of the revelation: Greece's estimated government deficit for 2009 more than tripled, revised from a previous 3.7 percent of GDP to 12.5 percent shortly after the new government took office. By April 2010, new EU figures suggested the deficit was even larger – nearer to fourteen percent.[2] The implications of this admission forced investors worldwide to reconsider their faith in the safety of sovereign debt, a faith that had already been tested in rescuing the world financial system in the aftermath of the 2008 global market crash. Questioning the solvency of sovereign debt threatened to undermine the only source of seeming certainty in a still fledgling financial recovery.

Such revisions in official statistics are rare; in Greece, however, such revisions were part of a repeated pattern of obfuscation. Since 2005, the EU had expressed reservations no fewer than five times regarding the biannual reporting of Greek debt and deficit figures. The EU's own statistical agency, Eurostat, had first suggested Greece was guilty of misreporting these numbers in 2004. Following the most recent post-election revelations, on 10 November 2009, the European Economic and Financial Affairs Council (ECOFIN) once more issued a statement imploring the Greek government to rectify the reporting issues and called for an investigation of the ongoing accounting problems in Greece.[3] In its August 2010 follow-up report, the

1 The eurozone consists of eighteen countries. Greek deficit and debt had been hidden using several tactics for years, including using special financial accounting practices to present misleading government expenditure statistics. See http://www.nytimes.com/2010/02/14/business/global/14debt.html?pagewanted=1&hp (accessed 31 August 2015).

2 These figures come from the European Commission, Report on Greek Government Deficit and Debt Statistics, Brussels, 8 January 2010 COM(2010) 1 Final. Eventually the deficit would be re-estimated to be 15.6 percent of GDP http://ec.europa.eu/eurostat/documents/4187653/6404656/COM_2010_report_greek/c8523cfa-d3c1-4954-8ea1-64bb11e59b3a (accessed 31 August 2015).

3 The ECOFIN statement declared the following: "The Council REGRETS the renewed problems in the Greek fiscal statistics. The Council CALLS ON the Greek government to urgently take measures to restore the confidence of the European Union in Greek statistical information and the related institutional setting. The Council INVITES the Commission to produce a report before the end of 2009. Moreover, the Council INVITES the Commission to propose the appropriate measures to be taken in this situation. In this context, the Council WELCOMES the commitment by the Government to address this issue swiftly and seriously and CONSIDERS the measures announced recently, such as those aiming to make the National Statistical Service fully independent, to be steps in the right direction" p. 4

European Commission identified two primary causes of the repeated pattern of upward debt and deficit revisions: Greece's accounting procedures; and poor governance influencing fiscal reporting. The latter problem was far more troubling than the former as it implied the reported state of Greek finances could be more dependent on electoral and political cycles than on the true state of affairs. While it was stated more diplomatically in official terms, Greece was charged with allowing official agencies to "cook the books" when politically expedient. A quiet suspicion all along, the new deficit revisions in 2009 created a tipping point in financial markets. These problems would no longer be ignored or overlooked. What else had been discounted or misreported in other member states? Was sovereign debt really as safe as credit agencies had rated it?

Just as fraud issues in the US housing crisis led to a loss of investor confidence in what was considered very safe assets, mortgages, and eventually led to the 2008 global financial crisis, Greek reporting of fraudulent numbers led to a loss of confidence in the ultimate safe investment, sovereign debt, that is debt backed by national governments, and eventually led to the eurozone crisis. Unlike in 2008, however, Europe would feel the effects of this crisis for years instead of months. Angela Merkel warned it would be a marathon.[4] According to the EU's Web site, "the inspiration for the € symbol itself came from the Greek epsilon (Є) – a reference to the cradle of European civilization – and the first letter of the word Europe, crossed by two parallel lines to 'certify' the stability of the euro."[5] Ironically, Greece would come to 'certify' the instability of the euro.

## The European Union: A Model for the World?

Part of the mystique of the euro is its symbolic power. The euro would allow the EU to displace the United States as the dominant economic superpower. At the turn of the millennium, both T.R. Reid, in his book *The United States of Europe: The New Superpower and the End of American Supremacy* and Mark Leonard in *Why Europe will run the 21st Century* argued that the European model was superior to the American one, and would become the world's new benign hegemon. The euro was the symbol of this new reign:

Council of the European Union, Council conclusions on EU Statistics, 2972nd Economic and Financial Affairs Brussels, 10 November 2009, http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/111007.pdf (accessed 3 August 2015).

4 Euronews "Merkel warns of marathon to solve euro-crisis" 2 December 2011 http://www.euronews.com/2011/12/02/merkel-warns-of-marathon-to-solve-euro-crisis/ (accessed 3 August 2015).

5 http://ec.europa.eu/economy_finance/euro/cash/symbol/index_en.htm.

> In pursuit of economic union, Europeans have thrown their marks, francs, lira, escudos, drachma, and so on into history's trash can and replaced them all with the new common currency, the euro, a new currency that has more daily users than the US dollar. … Europeans want to see the euro replace the dollar as the world's reserve currency…, [b]ut Europe's new money is more than money. It is also a political statement – a daily message in every pocket that cooperation has replaced conflict across the continent.[6]

As a symbol of the EU's success, the euro's image graces more than bills and coins; it has been the ubiquitous emblem of Europe idealized in many art forms, including a neo-classical statue in front of the European Parliament building in Brussels (see image 1-1).


Image 1-1: A neo-classical statue of the euro displayed in front of the European Parliament building in Brussels. Photo by Stephanie Anderson.

Despite hopes that the creation of the euro would allow the EU to rival the US as global hegemon, many observers have worried about the currency's underlying administrative structure. Ultimately, the euro required an economic 'leap of faith' that it would be managed prudently. Skeptics have long worried the euro was vulnerable to crises and economic mismanagement. As

6 T. R. Reid, *The United States of Europe: The New Superpower and the End of American Supremacy* (New York: The Penguin Press 2004,) 2.

early as 1997, Martin Feldstein, a Harvard economist, argued "there is no doubt that the real rationale for EMU is political and not economic. Indeed, the adverse economic effects of a single currency on unemployment and inflation would outweigh any gains from facilitating trade and the capital flows among the EMU members."[7]

Once trouble began, the structure of the currency union would not create the incentives necessary for union members to take corrective action to avoid ever worsening outcomes. In a 2005 HSBC report called "European Meltdown?", Robert Prior-Wandesforde and Gwyn Hacche warned:

> The eurozone's current path is unsustainable. We believe the single currency has helped create significant economic strains which look set to become more and more extreme if nothing is done. In particular, it is probably only a matter of time before Germany and the Netherlands are dragged into deflation, while Italy seems destined to move in and out of recession for years to come.[8]

Some even doubted the ability of the common currency to survive, being used by so many different countries, each with potentially different goals and objectives and likely most concerned with their own self-interests. In 2006, Frits Bolkestein, the former EU internal market commissioner, questioned the chances of survival for the euro in the long term as he thought leaders would put short term political interests ahead of the long term interests of the union. He argued that states "will be forced by political pressure to borrow more and increase their budget deficit, with consequences for interest rates and inflation," so "the real test for the euro is not now, but in ten years time."[9] Not incurring a deficit requires reducing spending, politically an unpopular decision that could cost an election. Deficits among countries would, however, threaten the currency union. This chain of events is exactly what happened and resulted in the European financial crisis.

As long as the eurozone continued to show good growth, however, the early naysayers were ignored, that is until the eurozone crisis gave the cynics their day in the sun. Feldstein almost gleefully said 'I told you so' in his article titled, "The Failure of the Euro: The Little Currency that Couldn't".[10] Rather than becoming a model for the world, Europe, in the months – and

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7 Martin Feldstein, "EMU and International Conflict," *Foreign Affairs* (1997): 60.

8 Robert Prior-Wandesforde and Gwyn Hacche, "European meltdown? Europe fiddles as Rome burns" HSBC Global Research, July 2005, http://quantlabs.net/academy/download/free_quant_instituitional_books_/%5BHSBC%5D%20European%20Meltdown%20-%20Europe%20Fiddles%20as%20Rome%20Burns.pdf (accessed 3 August 2015).

9 Mark Beunderman, "Ex-commissioner questions survival of euro" *EUObserver.com*, 26 January 2006.

10 Martin Feldstein, "The Failure of the Euro: The Little Currency that Couldn't" *Foreign Affairs* (January/February 2012): 91:1, 105-116.

now years – since the crisis began, has seemed in decline. In 2014, almost a full five years after the crisis began, European Council President Herman Van Rompuy went so far as to say the EU was in "a survival crisis!"[11]

The crisis, apparently caused by one of the monetary union's smallest member states, has had dramatic effects, not only on the economies of Europe, but also on human lives. While other countries, for example the United States, have been able to find the path to economic recovery relatively quickly after the financial crisis, the EU has unfortunately not. The International Federation of Red Cross and Red Crescent Societies (IFRC) published a report in 2013 stating that the humanitarian impact of the crisis had only begun to rear its ugly head. The report chastised the EU: "Whilst other continents successfully reduce poverty, Europe adds to it."[12]

This long-lasting economic crisis surrounding the euro has had inevitable political consequences too, ones that have undermined the very reason for its existence. As unemployment and even suicide rates increased across the most affected by the crisis, the extreme right, including neo-Nazi parties, the antithesis of European integration, has increased in popularity and with it calls for a return to national currencies and a rollback of the European Union. In France, in May 2012, the National Front took eighteen percent in the presidential elections, the best results the party has ever received. In the same month, Golden Dawn, an extreme nationalist party, which some have accused of being openly racist, won a seven percent share of votes in Greek legislative elections. In recent polling, the anti-immigrant Freedom Party is the third largest party in the Netherlands, as is the Danish People's Party in Denmark. Austria's Freedom Party has similarly been running second in opinion polls. Jobbik, currently polling second, is the fastest growing party in Hungary. Its leader, Gabor Vona, has accused the EU of colonizing its nation; its MPs removed the EU flag from the Representatives' office building.

The widespread suffering caused by economic conditions, coupled with political opportunism by parties hoping to gain from the general dissatisfaction of the electorate, has generated a great deal of negative press and cast a pall on the idea of European integration. According to the Pew research center, many Europeans are second-guessing whether EU membership is a "good thing" for their country.[13] Eurobarometer, the EU polling organization, notes

11 Herman Van Rompuy, Speech by President Herman Van Rompuy at the Brussels Economic Forum 2014 – 4th Annual Tommaso Padoa-Schioppa Lecture, Brussels, 10 June 2014 EUCO 127/14, 5 http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/143160.pdf (accessed 3 August 2015).

12 The International Federation of Red Cross and Red Crescent Societies (IFRC), *Think Differently: Humanitarian Impacts of the Economic Crisis in Europe*, (Geneva: IFRC, 2013) 10, http://www.ifrc.org/PageFiles/134339/1260300-Economic%20crisis%20Report_EN_LR.pdf.

13 Pew Research Center, "European Union: The Latest Casualty of the Eurozone Crisis" http://www.pewglobal.org/european-union-the-latest-casualty-of-the-euro-crisis/.

that a majority of Europeans are worried about the effects of the crisis on their personal finances, and are pessimistic about the future. Such feelings are reflected in numerous political cartoons where the EU is sometimes depicted as a sinking ship.

Is the EU really sinking? Hope for the union is not completely lost. Truth be told, polling data and electoral results still indicate a majority of Europeans, even within the eurozone, support the ideals of European integration, the EU, and the common currency. Despite the growth of fringe parties and people's worries, the European Union has still maintained support, even in the worst days of the crisis. For example, in October 2011, Eurobarometer reported that a majority of Europeans, fifty-five percent, believed that coordinated economic action within the EU would provide better protection in the current crisis. Moreover, the Europeans are willing to put their money where their mouth is: according to one poll, fifty percent considered it "desirable" for their countries to give financial help to other EU member states.[14] According to polls in 2012, a majority of people in eurozone countries thought the euro was good for their country and two-thirds thought it good for the EU.[15] Europeans in the eurozone do not want to abandon the currency, at least not yet. In other words, in the very short period of ten years, the euro may have succeeded in its political goal of creating a sense of unity among Europeans, but the crisis has certainly tested that unity. Subsequently, support for the EU, the euro and other EU institutions has fallen, and in the worst affected countries such as Greece, it may be the case that a majority no longer supports these ideas.

Extreme right and populist parties very often increase their support during times of uncertainty and crisis. The question is whether such political changes will result in an undoing of what has been over fifty years of integrative effort. If EU presidents and prime ministers can demonstrate coordinated leadership on the issue and return economic stability to Europe, the EU model could still prove itself. German chancellor Angela Merkel has declared that, in response to the eurocrisis, the EU is on the inevitable path of political union. Perhaps; however, if Europe's leadership cannot find the political will and resources to make difficult decisions, the euro could still fail, and with it, the European ideal could become bankrupt as well. Understanding these issues is the purpose of this book.

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14 http://ec.europa.eu/public_opinion/topics/eb76_europeans__and__the__crisis_analytical__summary_en.pdf.

15 http://ec.europa.eu/public_opinion/flash/fl_362_sum_en.pdf.

## Understanding the Eurozone Crisis: Layout of Book

The eurozone crisis is particularly difficult to follow because of the intertwining of economics and politics among the now nineteen countries sharing the euro in not-quite-confederal European Union, against the backdrop of the international financial system. The book focuses on three key questions:

1. Why has the eurocrisis been so severe?;
2. Why did Europeans choose the sets of policies they did in reaction to the crisis?; and
3. Why not abandon the euro altogether?

First, why has the eurozone crisis been so long and so severe? After the 2008 global financial crisis began in the US, Europe and most of the developed world, fell into recession. In the US and Europe, the financial crisis-induced recessions officially ended in the second quarter of 2009, with economic contraction lasting six quarters in the US and five in the EU and eurozone. Afterward, stronger growth occurred in Europe relative to the United States, until the European financial crisis started in late 2009.

The structure of the monetary system left the eurozone sharing a common currency, but not a common treasury, allowing excessive debts to build up within the currency union that eventually led to the crisis. Once the crisis began, the common currency that tied member states together also allowed the crisis to spread more easily to other countries. By the last quarter of 2011, European economies began to contract as the crisis worsened, and its contagion spread to most of the economies on the continent. Europe would not emerge from recession until 2013.

"Emerge" might be too strong a term. As of 2015, this lack of growth has produced high unemployment across most of the continent, leaving some countries with Great-Depression-like conditions. Youth unemployment has hovered around fifty percent in Greece and Spain, while general unemployment rates are double or more what they were before the crisis, with the worst affected countries experiencing unemployment rates for the entire population in excess of twenty percent.

Why has this crisis lingered for so long? In part, the answer lies in the cause, a financial crisis, which, when one occurs, results in worse conditions than the usual recession. There is also a strong case to be made that the policies European leaders chose to counteract the crisis actually exacerbated it. Given the severity of the eurozone crisis, policymaking would have been difficult under any circumstance, requiring difficult political and economic choices. The structure of the EU, however, made effective policy-making more difficult, as it created incentives within countries to act in their own interests and not necessarily in those of the entire Union's.

Why did the eurozone member state governments choose the policies they did? Economics has typically provided an orthodox toolkit for use during crises: Keynesianism. Keynesianism prescribes increased government expenditure to offset the drops in private sector spending that occurs during recessions, plus an expansion of the money supply to create growth in the economy through greater lending. The financial crisis, however, left crisis countries unable to borrow to finance the deficits Keynesianism requires. Moreover, eurozone countries were initially unable to come to agreement regarding expansion of the money supply for fear it would touch off inflation in those countries not yet affected by economic contraction. As a result, the only policy choice left was "austerity", i.e., cutting government spending in an effort to reduce deficits and balance the books. This policy choice, unfortunately, led to even greater economic contraction as economies now saw more reduction in economic activity and worsening unemployment.

Such outcomes appear to have worsened the crisis, or at best prolonged it, as well as resulting in the deterioration of political support for the Union. The following chapters explain these issues in more detail.

Second, why did the European Union member states, whose economic policies, in the past, have been much more interventionist than those of the US, now reject these policies? Because many attributed the crisis to a case of poor Greek management rather than to structural problems within the eurozone. To many in Europe, the narrative of the European financial crisis began with Greece accumulating excessive debt and deficits prior to the crisis, making the government dependent on borrowing to maintain government operations, social entitlements, and to finance interest payments. When the crisis hit, lenders were no longer willing to support such a situation with more loans. The clear solution was to reduce the debt through government cutbacks; however, doing so required massive cuts to spending and entitlements. Such cuts were both massively unpopular and insufficient to balance the books. Without borrowing, interest payments could not be met and a Greek national default loomed. Avoiding this would require Europe bailing out Greece, but who should pay?

The question of "who should pay" led to issues of morality, sovereignty, and national pride: Should Germans and Finns pay for what many in these countries perceived were caused by a corrupt government of Greece? Would bailing out Greece only encourage such behavior in the future, undermining a long-term solution to the real problem – excessive debt? Understandably, countries in Europe, especially those in the richer north, did not want to pay for the mistakes of Greece, or, later, of other southern countries. Rather, some leaders and EU citizens felt these countries needed to learn the true costs of profligate spending and to reform in order to regain the confidence of credit markets. At the same time, the other member states had to save their own financial systems, which were deeply intertwined with those of Greece and the rest of Europe.

The result was limited bailouts in return for austerity in aided countries. Fearing default, the markets cut off access to credit leaving the governments of the affected economies high and dry. To qualify for bailouts, the governments had to adhere to austerity measures causing these economies to contract, thereby reducing tax revenues and worsening deficits, instead of correcting them. Instead of improving the crisis, Europe's reaction actually led to a death spiral in many troubled economies. Was this result inevitable or would other policies have avoided such a situation? While this book argues in the affirmative, it also attempts to equip readers with the tools to draw their own conclusions.

Finally, considering all the economic problems, why does the euro continue to exist? Why has the euro been able to withstand the stress? Why has it not broken? European Central Bank president Mario Draghi once likened the euro to the bumblebee: it should not have been able to fly.[16] Why did it, and does it still? Did the very idea of the euro, that is this new symbol of European unity, contribute both to its ability to defy gravity and its tensile strength in withstanding all the economic pressures of the international financial markets? This book analyzes and evaluates the political power of the euro as a symbol to rally people and governments to withstand severe austerity measures. However, can this symbolic power sustain the euro indefinitely? The rise of anti-euro and anti-Europe parties across the continent as well the disunity and dissension among member states begs the question of whether the eurozone crisis will breed so much mistrust among the peoples that popular support for the European project will decline or possibly even evaporate completely.

This book explores the crisis in detail. Chapter two provides an historical background and explains how the European Union itself functions. Next, it explains the economic, political, and symbolic importance of the euro as well as the evolution of economic and monetary union.

Chapter three discusses the economic theory behind the single currency. It compares the requirements necessary for a perfect currency union to those existing in the European Union.

Chapter four delves into the specific economic, political and cultural differences that make up the eurozone member countries. By comparing the so-called PIIGS (Portugal, Ireland, Italy, Greece & Spain) or GIPSI (Greece, Ireland, Portugal, Spain & Italy), both offensive acronyms, countries with each other and with the wealthier countries in the eurozone, the authors

16 Speech by Mario Draghi, President of the European Central Bank at the Global Investment Conference in London, 26 July 2012, https://www.ecb.europa.eu/press/key/date/2012/html/sp120726.en.html.