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An ever More Polarized Union: The Greek Problem and the Failure of EU Economic Governance

Author: Ton Notermans

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Author:

Ton Notermans

Biography:

Ton Notermans has studied political science at the University of Amsterdam, the Freie Universität Berlin and MIT. He currently is associate professor of European Politics at the Tallinn School of Economics and Business Administration, Tallinn University of Technology.

ABSTRACT

As the Greek economy continues on its downward trajectory, the policy debate has degenerated into a re-enactment of the neoclassics versus Keynesians controversy. Yet, the Greek crisis can be solved neither by more austerity and structural reforms nor by Keynesian reflation. The core problem lies in a form of integration that has systematically weakened the Greek economy while stabilizing a clientelistic mode of interest intermediation. In order to recover, Greece needs a substantial devaluation plus an interventionist industrial policy. Yet, such a form of integration is not palatable to the North West European creditor countries, nor is it attractive to the Greek government as it would require a break with the clientelistic organization of political power while removing the scapegoat of the EU.

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An ever More Polarized Union: The Greek Problem and the Failure of EU Economic Governance

1. Introduction [1]

With its 10.7 million inhabitants and a GDP of €184 billion Greece is a minor economy in the 506 million strong European Union (EU) with a combined GDP of over €15132 billion. Yet, more than five years after the onset of the Eurocrisis, the EU is more removed than ever from a solution to the Greek predicament. After two economic adjustment programs with of total value of €237.3 billion, a Greek state bankruptcy and exit from the Euro remains an acute possibility. Despite a "haircut" in 2012, Greek public debt, which stood at €301 billion by the end of 2009, had increased to €317.1 billion by late 2014. Meanwhile the Greek economy continues on its downward trajectory with GDP having shrunk by 29 percent between the third quarter of 2010 and the first quarter of 2015, implying a rise in the debt to GDP ratio from 126 percent to 176 percent. At the same time, unemployment remains at record levels. Greek PPP per capita GDP, which stood at 97.2 percent of the EU average in 2009, has dropped to 72.8 percent in 2014. Economic crisis, moreover, brings political instability in its wake as extremist parties gain popularity and political relations between Greece and its northern EU partners, Germany in particular, seem irreparably damaged.

As the crisis drags on, the EU is increasingly divided over the causes of the Greek malaise. For the North West European creditor countries the problem is of a political nature. A deeply clientelistic political system provided generous rents to a multitude of interest groups such that not only the dynamics of the Greek economy was stunted but public finances were set on an unsustainable course. Accordingly, the seemingly straightforward solution consists of austerity in combination with structural reforms that liberate the Greek economy from the stranglehold of public interference. For the current Greek government and a growing number of sympathizers in other South European countries, the root cause of the problem, instead, lies in the neo-liberal ideas that inform the conditionality imposed on Greece by the EU, the International Monetary Fund (IMF) and the European Central Bank (ECB). Austerity in this view is the main problem, as cutting public expenditure in a crisis will further depress aggregate demand (Krugman 2012; Stiglitz 2015). The EU, it would seem, is bent on repeating the mistakes of the Great Depression when stubborn austerity policies not only precipitated the worst economic crisis in recorded history, but swept in place authoritarian regimes in a significant number of countries (Crafts 2013; De Bromhead, Eichengreen & O'Rourke 2012; Eichengreen & Temin 2010; Krugman 2010)

The crisis, in short, has revived the debate between liberal and Keynesian approaches to economic policy that, since the 1980s, had been considered concluded in favor of the former. The neo-liberal villain of an interventionist state shackling market forces is again pitted against the Keynesian villain of a state which has fallen prey to the dogma of self-healing markets and stubbornly ignores the rapidly mounting evidence of the disastrous economic, political and social consequences of its policies. However, rather than resulting from a detailed analysis of the Greek case, such attribution of blame follows directly from the core assumptions of both models. Starting from the assumption of market efficiency, observed deficiencies by default must be attributed to political intervention. Conversely, on the assumption that unstable markets can be stabilized by appropriate macroeconomic policies, the occurrence of prolonged crises must mean that governments have fallen prey to erroneous doctrines.

Though this set-up makes for an enticing morality play, the analyses of both camps are economically and politically inadequate. The Greek story in essence is one of a failed developmental state that, in the context of a deeply fragmented polity, came to employ its extensive micro and macroeconomic policy toolbox to provide protection from competition and allocate favors to its clientele. The end of the unprecedented period of growth

in Europe in the 1970s together with a stronger exposure to competition through EU membership since 1981 further increased economic pressures on what was an increasingly unsustainable growth model. Yet, the peculiar form of regional integration adopted in the EU enabled successive Greek governments to stabilize a debt-financed clientelistic growth model, while the EU's crisis response since 2010 has precipitated an economic and social catastrophe. In other words, the Greek crisis is the outcome of three interrelated failures: government failure in the form of misguided developmentalism, market failures that promoted income divergence while allowing Greece to run up excessive debts in compensation, as well as a failure of EU governance.

As a result, both Greece and the EU have maneuvered themselves into a trap. Economically Greece would require a flexible currency, substantial debt restructuring and an industrial regeneration strategy, but the engrained structures of clientelistic policy intermediation, cemented by 35 years of EU membership, suggest that such a policy of shedding the Euro straitjacket might be unviable. Conversely, the Greek case demonstrates the EU's continued inability to the devise an effective strategy. While the shortsighted adjustment programs, designed to primarily serve the interest of the creditor countries, have exacerbated the crisis, a form of differential integration designed with the recovery of the Greek economy in mind remains anathema to the EU and the creditor countries.

The structure of the paper is as follows. Section two argues that neither the Troika program of austerity cum structural adjustment nor Keynesian reflation can provide a solution to the Greek crisis. Instead only a substantial devaluation of a reintroduced Drachma together with debt restructuring can provide the much needed growth stimulus, while a vertical industrial policy will be required to allow Greece to embark on a sustainable growth model.

Section three argues that the lack of an effective crisis response by the EU is primarily inspired by the desire of the core EU countries to preserve a model of integration that has served them well, but at the price of economic instability in the periphery. Section four, argues that, in view of the dysfunctionalities of the Greek state a strategy of devaluation and industrial regeneration would ideally need to be assisted by the EU. Section five concludes.

2. Déjà Vu, Austerity versus Reflation

The common trigger that led five Eurozone countries to request assistance from the EU/IMF was a classic sudden stop in which a prolonged period of rising foreign indebtedness was followed by a loss of confidence on the part of international financial markets with the resulting inability to roll over debt (Lane 2012). Nevertheless, Greece holds a peculiar position amongst these five program countries. Table 1 depicts current account and budget deficits since the introduction of the Euro. In Spain, Ireland and Cyprus, the boom conditions sparked by the Euro and the single market in financial services had produced budget surpluses by 2007 such that mounting foreign debt largely resulted from dis-saving in the private sector. In Spain and Ireland, in particular, capital inflows, largely from North West European countries, provided the fuel with which local banks stoked a real-estate boom. Though also the Greek private sector recorded permanent deficits between 1998 and 2008, the main contribution to the rising debt did come from the public sector. Accordingly, the adjustment program prescribed by the Troika would seem to directly address the causes of the problem.

In terms of public revenues and expenditures, the austerity program booked impressive results. By means of higher taxes and a reduced incidence of tax evasion total government revenues rose from 38.7 percent of GDP to 45.6 percent by 2014. If anything, the turnaround in expenditures was even more impressive. Between 2009 and 2014 general government expenditure dropped by over 31 percent from €128.3 billion (54.0 percent of GDP) to €88.4 billion (49.3 percent of GDP). Nevertheless, the program spectacularly failed to reach its goal of reducing public indebtedness as deficits and public debt rose in absolute terms and even more dramatically so relative to GDP. Even the Private Sector Involvement (PSI) program of late 2012, in which some creditors accepted a 50 percent cut in the nominal value of their debt, only managed to make a temporary dent in a rising trend such that the debt to GDP ratio increased from 126 percent in 2009 to 176 percent in 2014.[2]

Table 1: Current Account (CA) and General Government Net Lending (DEF) as a Percentage of GDP

	Cyprus		Greece		Ireland		Portugal		Spain	
	CA	DEF	CA	DEF	CA	DEF	CA	DEF	CA	DEF
1999	-3,57	-4,0	-6,80	-3,1	-0,04	2,4	-8,84	-3,0	-2,97	-1,3
2000	-5,85	-2,2	-9,59	-3,8	-0,41	4,9	-10,95	-3,2	-4,12	-1,0
2001	-3,61	-2,1	-9,03	-4,5	-0,57	1,0	-10,25	-4,8	-4,14	-0,5
2002	-4,11	-4,1	-9,44	-4,9	-0,42	-0,3	-8,76	-3,3	-3,81	-0,4
2003	-2,62	-5,9	-10,79	-5,8	0,59	0,8	-7,41	-4,4	-3,94	-0,4
2004	-4,74	-3,7	-9,32	-7,5	-0,16	1,4	-8,80	-6,2	-5,65	0,0
2005	-5,49	-2,2	-9,73	-5,6	-2,98	1,3	-10,22	-6,2	-7,56	1,2
2006	-7,68	-1,0	-12,70	-6,1	-3,73	2,8	-10,69	-4,3	-9,00	2,2
2007	-11,05	3,3	-15,86	-6,7	-5,52	0,3	-10,02	-3,0	-9,63	2,0
2008	-13,02	0,9	-16,50	-9,9	-5,72	-7,0	-12,59	-3,8	-9,22	-4,4
2009	-10,40	-5,5	-13,28	-15,3	-3,05	-13,9	-10,06	-9,8	-4,31	-11,0
2010	-9,24	-4,8	-11,43	-11,1	0,57	-32,5	-10,41	-11,2	-3,88	-9,4
2011	-3,35	-5,8	-10,44	-10,2	0,81	-12,7	-5,60	-7,4	-3,25	-9,4
2012	-5,68	-5,8	-4,36	-8,7	1,56	-8,1	-2,02	-5,6	-0,42	-10,3
2013	-2,00	-4,9	-2,30	-12,3	4,37	-5,8	0,89	-4,8	1,47	-6,8
2014	-4,00	-8,8	-2,21	-3,5	6,18	-4,1	0,55	-4,5	0,61	-5,8

Source: AMECO

Part of this failure can be accounted for by the fact that fiscal multipliers proved much larger than expected (Blanchard & Leigh 2012). Yet the main problem lies in the failure of the adjustment program to provide for a stimulus to counteract the contractionary effects of austerity (Gros et al 2014). The architects of the Greek program had expected such stimuli to arrive via two avenues. First, in a Ricardian framework public spending cuts can have expansionary effects as they signal future tax cuts to consumers and business, while a shift in financing the deficit from borrowing to taxation is neutral as it merely replaces future taxation with current one (ECB 2010 84-86, Trichet 2010B). As, the then President of the ECB Jean Claude Trichet (2010A) remarked in July of 2010: "Economies embarking on austerity policies that lend credibility to their fiscal policy strengthen confidence, growth and job creation." Secondly, confidence would be stimulated by structural reforms that reduce government intervention and give more play to market forces. Of prime importance here were wage cuts and improved labor market flexibility as well as the reduction of red tape and the opening up to market forces of the many protected professions such as pharmacists, taxi drivers, road haulage and ferry services.

However, by now the Troika has also buried the belief in the Ricardian equivalence hypothesis. Due to its restrictive assumptions, such as the dominance of Ricardian consumers, infinitely lived individuals and the absence of liquidity constraints, the model is of little use outside of textbooks. Indeed, empirical examination of cases of expansionary austerity have generally found that expenditure switching effects such as devaluations, strong international growth or cheap money policies, accounted for success (IMF 2010). Ironically, by late 2014 empirical research by the ECB itself pointed in a similar direction as it concluded that "[fiscal] consolidations, and in particular their unanticipated components affect confidence negatively." (Beetsma et al 2015).

Nor has the structural reform program provided the much-needed stimulus. Structural reforms essentially focus on reducing wage costs and productivity by increasing labor and product market flexibility. Though they met with at times fierce resistance, here the overall outcomes have also been impressive. According to the OECD's reform responsiveness index, which measures reform activity in a host of growth-promoting areas such as labor costs, labor market regulation, scope of state intervention and barriers to entrepreneurship, Greece performed best of all OECD countries in the period 2007-14 (OECD 2015: 109).

This lack of correlation between micro-economic reforms and growth points to two further weaknesses in the adjustment programs. First, expecting a boost to (macroeconomic) growth from microeconomic reforms generally involves a fallacy of composition.[3] Efficiency improving reforms will reduce the costs of the goods and services produced by a firm and thus may increase output, but to the extent that all competitors experience the same reduction there is no a priori reason to expect an overall increase in output. Similarly, a reduction in labor cost can only be expected to improve a firm's overall output to the extent that competitors do not enjoy the same advantage. Growth impulses from structural reforms may thus reasonably be expected only to the extent that external competitiveness improves. Although unit labor cost have been substantially reduced since the onset of the crisis, as the OECD (2015: 46) notes: "this decline remains small relative to the increase that, in the pre-crisis period, led to large losses of competitiveness in these [Greece, Portugal, Spain] and other Euro area countries."

Secondly, the attempt to improve external competitiveness through internal devaluation increasingly undermines growth impulses as it provokes deflation. Since Knut Wicksell (1898), it is well known that a persistent fall in the price level is apt to promote a cumulative process that will destroy the financial system and the rest of the economy with it. Deflation implies a growing real debt burden and thus a higher rate of nonperforming loans, which will generally induce banks to tighten credit rationing. At a time when the value of money is rising in terms of goods and services, hoarding instead of consumption and investment is the more appropriate strategy for individual actors so that the demand for credit also collapses. Indeed, in Greece the consumer price index has fallen in every month since March 2013, while the share of non-performing loans is increasing steadily from 9.1 percent of total gross loans in 2010 to 33.5 percent in 2014.[4] To stem deflation, the ECB has resorted to the unconventional measure of quantitative easing [5] since September 2014. Yet, as Keynes (1936, Ch. 19) already pointed out, the nominal wage rather than the volume of money is the anchor of the price system. Indeed, ECB president Mario Draghi seems to have recognized as much when he explained in May of 2015 that "there were strong signs that the [downward] trend [of the price level] was being driven by weak aggregate demand. This was visible both at the macro level in a still wide output gap and a declining rate of core inflation; and at the micro level in subdued negotiated wages and low pricing power among firms." (Draghi 2015, emphasis in the original). Nevertheless, the Troika continues to insist on labor market flexibilization thus de facto engaging in what increasingly is a contradictory and self-defeating strategy.

Though the austerity program has aggravated the crisis, a Keynesian fiscal stimulus would be equally inappropriate. The Keynesian justification for countercyclical fiscal spending ultimately rests on the anthropological constant of animal spirits such that public deficits or surpluses can stabilize GDP by compensating for the swings in investment spending driven by fickle expectations. But what precipitated the Greek crisis was not an exogenous downturn of investment activity but the inability to further finance a burgeoning public debt that had resulted from almost permanent deficit spending since the end of the military regime. Budget deficits in Greece did not function as a compensation for swings in investment activity but instead became the main engine of growth in an economy marked by an increasingly uncompetitive private sector and anemic private investment activity.

Since the start of a hard Drachma policy in the 1990s, Greece has almost permanently suffered real appreciation versus North Western Europe and in particularity Germany. Moreover, due to the Eastern enlargement of the EU and competition from emerging economies such as China, the low to mid-tech Greek manufacturing sector (Simonazzi et al 2013) has found it increasingly difficult to export, while five years of a shrinking economy have greatly accelerated the process of de-industrialization. Though Keynesian reflation might serve to stabilize consumption and thus mitigate some of the social hardships, in the current situation it will do more to stimulate imports than promote domestic output. But even if reflation should create incentives to invest, the state of the current Greek banking system makes it unlikely that sufficient investment finance will be forthcoming. With a still substantial exposure to

Greek sovereign debt, roughly one third of the loan portfolio non-performing, and a continuous hemorrhaging of funds as depositors seek to protect themselves from a possible Grexit, the only thing that protects the Greek banking system from collapse is the emergency liquidity assistance (ELA) of the ECB.

With both internal devaluation and reflation counterproductive, the urgently needed impulse to the Greek economy must come from an (external) devaluation of a reintroduced Drachma. Devaluation could immediately redress the loss of competitiveness Greece has suffered since the 1990s. Moreover, devaluation will impart an inflationary impulse to the economy which is highly desirable in the current context of deflation. Finally it would serve to repatriate many of the funds that are currently leaving the Greek banking system in fear of a possible Grexit. However, as its debt is nominated in Euro, a devaluation would make the debt burden even more unsustainable, such that a debt moratorium and substantial debt restructuring would be called for. Finally, due to their exposure to sovereign debt, debt restructuring may make a recapitalization of the Greek banking system necessary, just as occurred in the wake of the PSI of October 2012.

The example of Iceland, whose (private) debt far exceeded that of Greece, testifies to the viability of such a strategy (Wade & Sigurgeirsdottir 2012). Though by no means painless, the Icelandic strategy of default and devaluation has proven much less costly in terms of output and unemployment than the policies in any of the five EU countries that were subjected to adjustment programs, so that even the IMF (2012) argues that Iceland may hold valuable lessons for other countries.

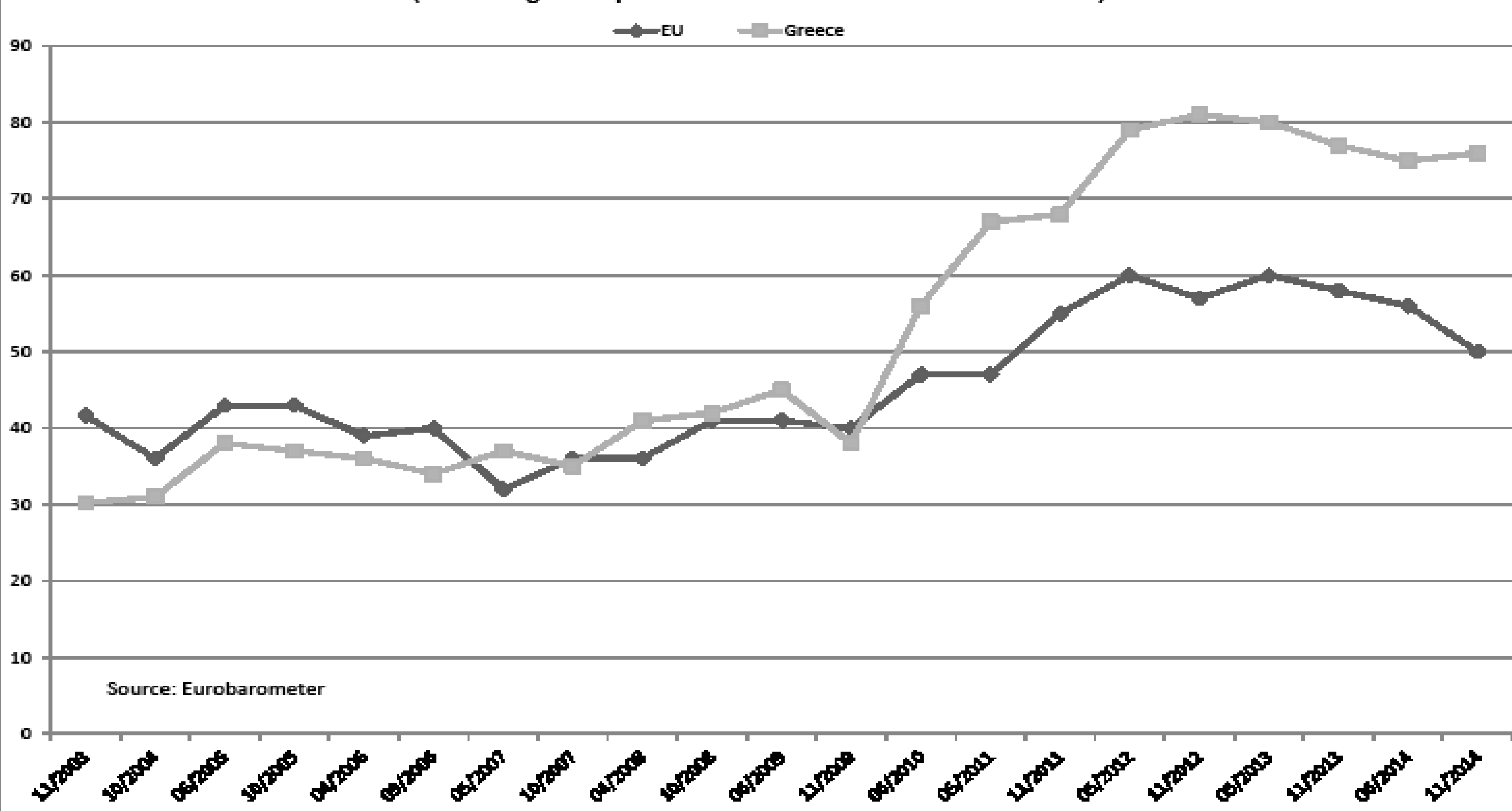
However, even though devaluation may restart growth, this is a low wage strategy that works by impoverishing the country and as such further reinforces the trend towards per capita income divergence in the EU. Given that Greece's manufacturing base has continuously weakened since 1981, establishing a sustainable growth model in Greece will require that the macroeconomic strategy of a flexible exchange rate be accompanied by industrial policies.

As the next section will argue, currently there would seem to be insurmountable political difficulties to such a strategy as neither the EU would allow such a reorientation nor would the Greek state have the required capabilities to pursue such policies

3. The failure of EU Economic Governance

As democratic contestation is much suppressed in the EU (Mair 2013) due to its technocratic setup and the institutional incentives of the EP to increase its own role, the legitimacy of the EU, more so than its member states, rests on policy output. Not surprisingly, therefore, the Eurocrisis has engendered a radical rise in integration-critical sentiments. Eurobarometer surveys indicate that since late 2011 50 percent or more of Europeans tend not to trust the EU (Figure 1). Of equal importance is the rapid rise of Eurosceptic parties, especially in traditionally Euro-friendly countries such as the Netherlands, Finland, France and Italy. After five years of failing to come to terms with the problems of tiny Greece, the puzzle becomes why the EU doggedly persists in its original course? Why is the EU risking a major political crisis that may sound its death knell rather than to adjust its policies?

In essence, the failure of EU economic governance to resolve the crisis centers on the interest of the North-Western creditor countries in what largely has come to be interpreted as a zero-sum international environment. By resisting any substantial debt restructuring and the introduction of a resolution mechanism for sovereign debt, the EU creditor countries have managed to turn what would have been a problem of the domestic financial sector into an issue of political mismanagement in Greece. By refusing to contemplate a Grexit the creditor countries are defending the export-oriented growth model that has ensured their political cohesion since the 1980s. Moreover, in a world in which international competitiveness is seen as the key to economic success any form of differential integration to the benefit of less developed member states necessarily becomes interpreted as a zero sum game.



Though generally framed as a sovereign debt crisis, the Eurocrisis might just as easily be labelled the second banking crisis of the 21st century. After all, the origins of the crisis in Cyprus, Ireland and Spain are very similar to the excessive risk-taking by financial institutions that precipitated the U.S. sub-prime crisis. Only in Greece would the epithet sovereign debt crisis seem justified. Yet, it takes both a debtor and a creditor to create debt. Though residents, held the largest share of Greek sovereign debt, in 2011 about 38.5 percent, amounting to roughly €70 billion, was held be non-residents (excluding the ECB) (Merler & Pisany-Ferry 2012). Since the state of Greek public finances and the quality of governance were not unknown, it can reasonably be argued that those institutions that invested large sums in Greek sovereign debt failed to perform an adequate creditworthiness appraisal. Indeed, as Abelshauser (2010: 45) shows, major investors, meeting in Berlin in April 2009, were well aware of the high risk involved but counted on a public bailout in case problems should arise. Had the crisis been labelled a banking crisis, Greece's inability to roll over its debt in the spring of 2010 would have implied a write down of the value of Greek sovereign bonds, so that losses would have accrued on the lender side. Since both German and French banks in late 2010 each held Greek sovereign debt for a value of around €15 billion, this would have put part of the problem in the court of the creditor countries. Instead, the EU/IMF loan facilities allowed the banks to divest themselves of these investments [6] so that in early 2015 the exposure to Greek sovereign debt is estimated to have been drastically reduced to around €181 million for German banks and €102 million for France (Dor 2015). Indeed, the IMF seemed initially predisposed to debt restructuring as, according to its rules, Greek debt was unsustainable which precluded a standby program. Yet this position met with fierce resistance from the EU, eventually leading the IMF to flout its own rules [7] by participating in the first package (Blustein 2015). Moreover, in the 1990s the IMF had already proposed a (global) orderly restructuring mechanism for sovereign debt, and has reissued this call in 2013 (IMF 2013) but failed to get approval up to now.

The Troika's solution thus not only deflected attention away from shortcomings on the lender side; it also substituted private holding of Greek debt with substantial public holdings by the EU and the ECB such that any future Greek debt restructuring would now incur direct losses for taxpayers. In short by refusing to contemplate any lender responsibility and trying to recover the full amount through im-

posed fiscal austerity, creditor countries did avoid further politically highly unpopular bank bailouts but at the price of multiplying the costs of resolving the crisis and unnecessarily exacerbating tensions between creditor and debtor countries. As a result, they have created a climate in which Eurosceptic parties in Northern Europe were given an opportunity to fan further resentments by harking on the theme of the alleged South European "PIGS".

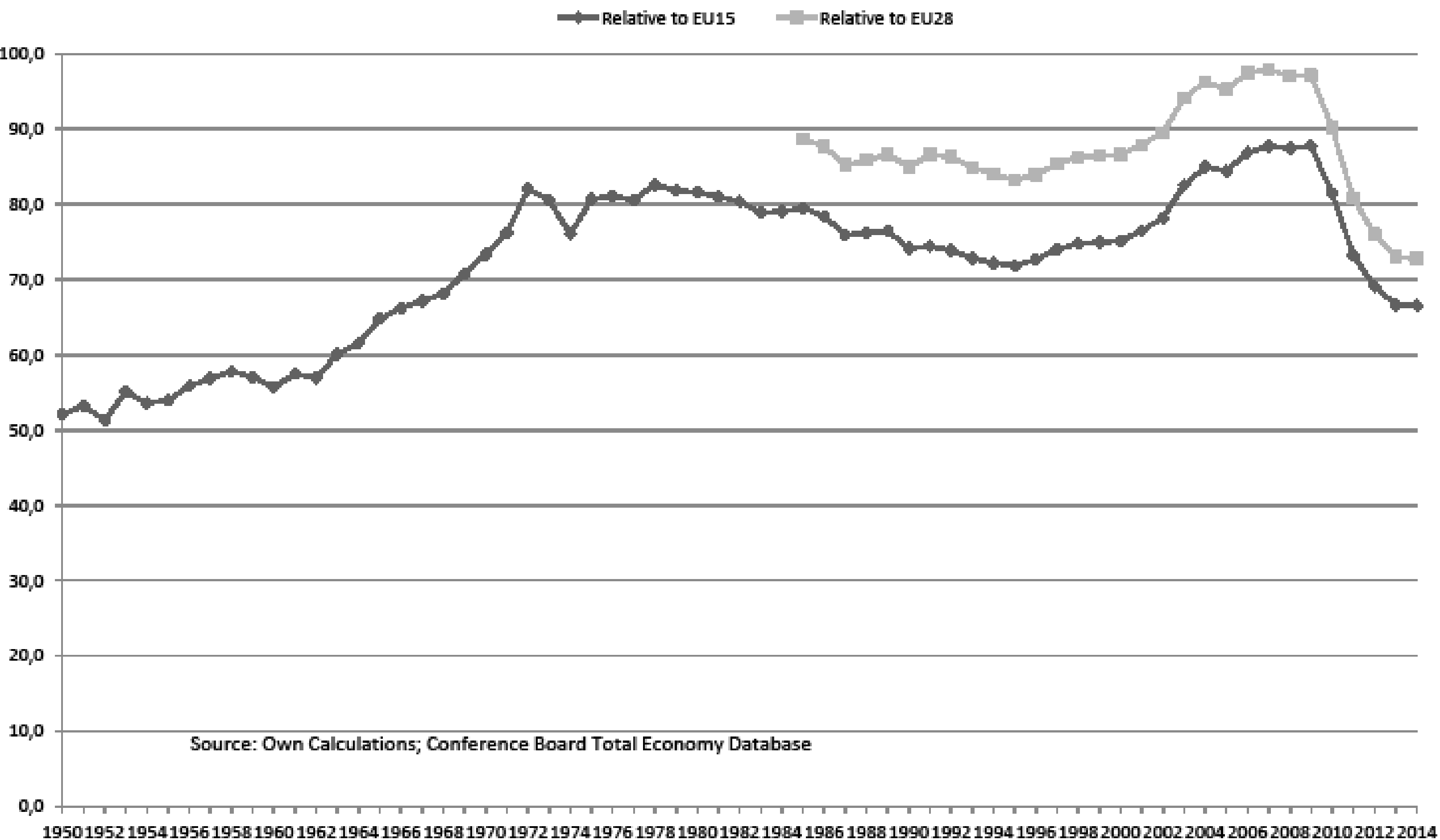
Secondly, International economic arrangements generally contain escape clauses that may be activated in case of unforeseen hardships. The WTO, for example, allows for temporary suspension of concessions if domestic companies are hurt much more than initially expected. Similarly, in the monetary field Bordo & Kydland (1999), have interpreted the pre-1914 Gold Standard as a contingent commitment mechanism which owed its stability in part to the fact that it allowed countries to temporarily exit in case of unforeseen circumstances without losing the policy credibility the arrangement bestowed. The common currency did not include any of such clauses on the argument that contingent commitment was impossible due to moral hazard. One of the main goals of the common currency was to extend the rigid nominal framework of the Bundesbank to the rest of Europe. If escape clauses were included, so it was felt, this would both undermine the incentives of wage bargainers and fiscal authorities to limit their claims to what was compatible with the low inflation target. Yet, such clauses might have been introduced afterwards, in particular once the originally unexpected continuous real appreciation of peripheral countries had become apparent. After all, after the no-bail out clause of the Maastricht treaty, which was considered a core pillar of the common currency, was revoked in the spring of 2010.

Allowing Greece a temporary exit from the Euro so as to gain time to put its house in order was never even contemplated by the creditor countries. In part this may have been due to the desire to prevent a loss of face if serious adjustments had to be made to the EU's flagship project. In part it also reflected the unwillingness to dent a project that was to have increased Europe's global standing by creating a currency that could challenge the U.S. Dollar. More important was the fact that the Euro played, and continuous to play a crucial role in stabilizing the mercantilist models of political economy that have come to characterize Germany and its neighbors (Bonatti & Fracasso 2013: Notermans 2012). Due to its high capacity for wage moderation, the Euro implied a continuous real depreciation for Germany which greatly contributed to its growing current account surpluses. Secondly, Euro membership provided a way out of the contradiction involved in a strategy of tight money and current account surpluses. Such a strategy is vulnerable to market forces that would tend to make such currencies appreciation candidates thus forcing a choice between either dear money or a current account surplus.[8] Moreover, as the forceful appreciation of the Japanese Yen in the 1980s showed, such a strategy was also vulnerable to political pressures from the main deficit country, the USA. The common currency instead managed to deflect these political and market pressures by creating a larger block of countries with irrevocably fixed exchange rates.

Finally, industrial policies, the third essential element in solving the Greek crisis, equally stands little chance of being implemented as it is not in the interest of the core countries. Its own history teaches Western Europe that industrial policy can make a potent contribution to economic development. Economies such as France, Finland and Italy, which had an acute sense of economic backwardness after 1945, generally had recourse to industrial policies aimed at creating national champions, not unlike the developmental strategy pursued in many east asian countries (Breznitz 2007; Jäntti & Juhana Vartiainen 200; Kim 2004; Kohli 2004). As a result, barriers to trade remained numerous not only within Western Europe but also between Western Europe and the USA. However, since the 1980s the EU gradually outlawed such policies. During the 1980s, the EU acquired an effective competence in competition policy, with increasingly strict rules on state aid, while the Single European Act (SEA) of 1986 dismantled the overwhelming part of non-tariff barriers. With the spectacular catch up staged in the first three decades after the war completed, such policies not only seemed no longer necessary, they also created the risk of sparking self-defeating subsidy races. More importantly, allowing peripheral countries access to such policies implies a form of differential integration that imposes limits to the market access of the more advanced countries. In

deed Jacoby (2010) has aptly characterized the EU's approach to its latest and poorest members in Eastern Europe as a strategy of maximizing the opportunities and minimizing the threats; maximizing the contribution to the competitiveness of West European companies by integrating Eastern Europe as low wage producers in production chains, while minimizing the risk of the emergence of serious competitors.[9]

What came to replace industrial policies in the enlarged Europe were cohesion policies. Cohesion policies can be interpreted in two different ways (Leonardi & Hoguin 2015). One way is to view them as transfers that compensate poorer member states for the negative economic effects of integration thereby allowing for an increased standard of living notwithstanding a weakening of their economies. The other is as a tool designed to make the productive capacity of these economies converge with the richer countries. Irrespective of what the intention of policy makers may have been, due to its horizontal orientation which focuses on upgrading infrastructure, education and employability and assumes that such public goods will automatically give rise to the advanced industries that require them, the first interpretation is the more accurate one (Notermans 2015). As figure 2 shows, after joining the EU in 1981 a long period of income convergence abruptly gave way to divergence in Greece, which was only halted when the prospect of ERM and Euro-membership allowed for the debt-financed boom. By 2014 Greece's relative income position is back to where it was in the latter half of the 1960s. Having been one of the main beneficiaries of EU cohesion spending, the Greek case suggests the same conclusion the World Bank is reaching on developmental policies, namely that the combination of open markets and horizontal development aid is not an effective recipe for convergence [10] but that instead stepwise liberalization and interventionist industrial policies are of the essence. (Lin 2009; Stiglitz & Lin 2013; Wade 2012).



4. Can Greece Survive Outside the Euro?

If a recovery of the Greek economy is indeed obstructed by Euro membership, the question arises why no government since 2010 has shown any intention of leaving. Indeed, even the Syriza government of Alexis Tsipras, which was elected on the platform of putting an end to Troika interference, adamantly excluded this option and instead placed its hope on being able to pressure the EU and IMF into debt restructuring and less onerous conditionality. Moreover, in October 2014 59 percent of the Greeks surveyed still responded that having the Euro was a good thing for their country.[11]

Even though the reintroduction of a national currency would give Greece the leeway to pursue a more effective recovery strategy, such skepticism towards national monetary autonomy rests on good grounds as it is by no means clear that the government possesses the capability and autonomy to successfully implement such policies. Though EU and Euro membership may have weakened the Greek economy, they became essential for stabilizing a highly clientelistic from of policy making based on the distribution of rents by the state. Policies of exchange rate flexibility in combination with industrial regeneration, in order to be pursued successfully, however, require a broad societal consensus on the distribution of income and a strict adherence to performance criteria; something the Greek polity has not been able to establish up to now (Featherstone2011; Karagiannis & Kondeas 2012). With little or no rents to distribute and the scapegoat of the Troika as well as the external constraint of the Euro removed, Greece may prove even less able to pursue effective economic policies than it has been hitherto.

In Western Europe, the spectacular post-1945 recovery was based on a broad societal consensus between the state, business and labor, in which the priority for economic growth was underpinned by a concern for distributional fairness. Claims on the national product were to be limited to what growth afforded while productivity oriented wage policies, taxation and the gradual expansion of the welfare state assured that the fruits of growth were distributed fairly. Greece instead descended into a 4 year civil war in 1945 while the authoritarian democracy established afterwards as well as the subsequent military regime excluded large sections of the left. The end of military rule in 1974 might have been the occasion for such a consensus to be established. Though the new government legalized the Communist party and thus signaled its desire for an inclusive democracy, social consensus on the road to be taken proved beyond the ability of the Greek political system.

To some extent the timing was unlucky as the end of the military regime coincided with the end of the Trente Glorieuses so that increased expectations collided with a diminished distributive space. The crucial weakness, however, resulted from the combination of polarization and fragmentation. Under a constellation of two cohesive and well organized camps, such as e.g., in Austria after 1945, a corporatist consensus along the lines of most west European countries after 1945 might have been feasible. However, the fragmentation of both business and labor meant that in effect no functional peak organization existed that could make a claim to comprehensive representation and would have had the ability to enforce cooperation, while the two main parties essentially were weak coalitions of a large number of diverse interests. In this constellation, the newly founded Socialist Party (PASOK) embarked on a populist strategy of mobilizing a large electoral following by means of distributing rents. Though its counterpart, the Conservative New Democracy (ND), initially was reluctant to engage in similar tactics (Pappas 2014) electoral considerations soon brought a change of mind.

Commonly such strategies should not be sustainable for long as the resulting current account and budget deficits will come to pose clear limits to the amount of public and or private debt that that can be financed. Astonishingly, the limits of that strategy were only met in 2009, i.e. roughly 35 years after its start, during which period a vicious circle of a weakening economy and increasing reliance on the state for the distribution of rents was maintained.

With a very tightly controlled financial system the initial strategy consisted of forcing the domestic banking system to hold government debt and direct credit to ailing companies while keeping real interest rates negative. That not only saddled the banks with

an increasingly weak assets structure, it also created incentives for depositors to bypass the official financial channels. For deficit spending to remain sustainable, government debt had to be offered at market-determined rates, which was indeed one of the main reasons behind the domestic and external financial liberalization in Greece since the mid-1980s. But, as interest rates rose, so did the debt service.

Given the mounting problems with financing debt through financial repression, monetization of debt through the central bank was increasingly employed in the 1970s and 1980s. But with debt largely used to finance government consumption and the survival of ailing firms, higher inflation instead of higher growth ensued. To prevent a rapid deterioration of the current account due to above average inflation rates, devaluations had to be resorted to but with the sum of the claims on the national product exceeding 1, devaluation rather prepared the ground for more inflation as higher import prices were passed on into domestic wages and thus prices. A devaluing currency and high inflation in turn came to hinder the strategy of financing the debt through the market. Not only did interest rate differentials increase, but rationing of credit and the eventual inability of Greece to issue debt in its own currency, as is typical of developing countries, would have resulted. The limits of the strategy seemed to have been reached in 1985 when the newly elected PASOK government needed to embark on a program of fiscal and monetary consolidation, with the support of an EU balance of payments loan. Yet the consolidation program was abandoned after less than 2 years, due its negative impact on the electoral popularity of the ruling party. By the early 1990s, however a watershed seemed to have been reached. Rampant inflation and escalating budget and current account deficits convinced both main parties that consolidation had become inevitable. Moreover, a broad consensus emerged that the road to economic stability lay in membership of the common currency. Supported by another EU balance of payments loan in 1991, both ND and PASOK governments thus set out to reach the Maastricht convergence criteria. Inflation decreased throughout the decade from a peak of over 20 percent in the 1990s, and so did the budget deficit. On January 1, 1999 the Drachma entered the Exchange Rate Mechanism (ERM) and two years later Greece joined the common currency. Towards the end of the decade growth rates also started to pick up such that Greece came to record one of the highest GDP growth rates in the EU for the 1999-2009 period. Indeed, to several observers Greece finally seemed to be overcoming the problems of dysfunctional economic policies (Pagoulatos 2003:128-9; Vamvakidis 2003,).

Yet, as we know now, this success largely was a chimera. The hard Drachma policy aimed at bringing down inflation set in motion a process of real appreciation that further weakened the economic structure of Greece. Unemployment increased throughout the 1990s and remained high afterwards, while the employment rate was amongst the lowest in the EU. The current account gradually worsened, and towards the end of the decade ERM and Euro membership relaxed the constraints on private and public indebtedness such that by 2009 Greece found itself with a higher stock of debt and a weaker economy than had been the case in the early 1990s.

EU and Euro membership proved essential for Greece to postpone the day of reckoning. Two mechanisms were at work. First, EU, ERM and Eurozone membership improved the creditworthiness of Greece as it served to reduce jurisdictional risk in increasingly liberated EU financial markets and eliminated exchange rate risk. Since ERM entry in 1999, capital inflows, especially from the North Western EU members that enjoyed large current account surpluses, rapidly increased, effectively eliminating constraints on the build-up of debt (Alogoskoufis 2012: 12). Secondly, from the beginning Greece used the veto position EU membership awarded it to obtain major transfers. As a result, the country would become the main recipient of structural and regional funds in per capita terms. By threatening to veto the accession of Spain and Portugal, a first major increase in regional funds was obtained in the form of the Integrated Mediterranean Programs. The Greek signature under the Single European Act came at the price of a doubling of regional funds, while its ratification of the Maastricht treaty required the creation of the Cohesion Fund. Since in practice the setting of priorities and the disbursement of funds largely remains under the control of the member states, in the Greek case regional and structural spending rather served to compensate the Greek government for the

negative economic effects of the successive steps at deepening integration by increasing its rent distributing capacity (Saravelos 2007). As Euclid Tsakalatos p. 124: points out: "Indeed, all too much of the EU funds available for structural change, necessary for Greece's integration with the EU, were used to shore up existing economic structures and to support the least competitive strata in society."

As the 35 years of Greek EU membership have stabilized a debt financed growth model in which the economy progressively weakened and the state came to occupy a central role in allocation, it cannot be taken for granted that the Greek state could successfully establish a new growth model based on industrial upgrading and external competitiveness. Three issues come to mind. First, after devaluation and default Greece would be temporarily excluded from international financial markets [12] and thus would not be able to finance new debt. The retreat of the state from its customary role, however, would not necessarily promote a larger reliance on market allocation but might just as easily lead to a crisis of legitimacy with the state progressively becoming unable to enforce its rules, a further expansion of corruption and the black economy, and in the extreme case a failed state scenario. Indeed many of the riots Greece has experience since 2009 were directed against the state as such and not against a particular government (Pappas 2014: 79ff). Simultaneously, distrust of the government, according to Eurobarometer data has gradually increased from 54 percent in November 2009 to 89 percent in November 2014, and is currently the highest in the EU.

Secondly, a reintroduced Drachma might fail to gain the trust of financial markets. While Conservative and Liberal parties generally justified their support for the introduction of a common currency with the need to curtail the excessive intervention of leftist governments, the Left in turn argued that there was no alternative as the German Bundesbank dominated monetary policy under a fixed exchange rate while devaluation of the currency would undermine trust thus preparing the stage for a next devaluation. The emblematic case was the policy U-turn executed by French socialist president François Mitterrand in 1983. Though frequently interpreted as such, the French U-turn did not signal that there was no alternative in macroeconomic policies. Rather it signaled that such alternatives only existed to the extent that the political system was able to handle the trade-offs involved. In an environment where the major economies, Germany and the USA first of all, were pursuing tight money and fiscal austerity a policy of demand driven domestic reflation had to run into insurmountable balance of payments problems. Only if the wages cuts implied by devaluation were domestically acceptable could the autonomy that a flexible exchange rate awarded be enjoyed. If instead devaluation would set off a wage price spiral, there was indeed no alternative. Between 1975 and the hard Drachma policy of the 1990s Greece has had similar experiences with a soft currency policy (Featherstone 2008: 45ff). However, with unemployment currently around 25 percent and the price level falling, a threat of a wage price spiral would seem remote in the short-run and some inflation indeed would be highly desirable, though the traditionally radical public sector unions may pose a problem in this respect.

Finally, the recent history of Greece does not give much reason for optimism concerning its ability to successfully run an industrial policy. In the framework of a highly clientelistic polity, the import substitution policies pursued in Greece from the 1950s to the 1980s saddled the country with a substantial share of permanently uncompetitive industries that constituted a continuous drain on the budget mainly because clientelistic patterns of interest mediation made consistent enforcement of modernization targets illusory.

In sum, given the risks involved, substantial EU involvement in a Greek recovery strategy might be essential, though this would require a complete turnaround of the current Troika approach, based on the recognition that restoring Greece to prosperity rather than recovering the debt should be the first priority. The ideal strategy would seem a combination of real convergence criteria tied to both structural policies and a return to the Euro in combination with the technical assistance the EU is already providing in creating a more efficient and effective bureaucracy. As the 1990s suggest, the only reasonable effective antidote against Greek clientelism is a combination of a severe economic crisis together with the pros-

pect of an EU solution. During the 1990s, qualifying for Eurozone membership had become a matter of national pride as being left out would have been seen as recognition that Greece is a second-class member. Under this constellation both ND and PASOK governments did manage to muster the political autonomy to reduce the budget deficit and inflation rates substantially. While the nominal convergence criteria did much to further weaken the Greek economy and structural funds fueled clientelism, the strategy could be inverted. A return to the Euro, in this case would be tied to real convergence criteria in terms of per capita GDP, labor productivity unemployment and employment rates and current account balance. Structural policies instead would take its cue from the industrialization policies pursued with so much success in East Asian countries and would thus primarily have a vertical orientation, while disbursements would be tied to strict performance criteria such as export performance, production targets and new products.

5. Conclusion

Though the Eurozone crisis has reduced the two main Greek parties to insignificance, their successor in political power has not broken the traditional mold of Greek politics. The Syriza government under Alexis Tsipras was elected on a platform of putting an end to Troika interference and reversing some of the cuts in public employment and welfare benefits, but completely lacked a program for reviving the Greek economy without Troika support. Undoing the foreign imposed austerity program, it was suggested would solve most of Greece's trouble while a discussion of necessary, but possibly unpopular reforms was conspicuously absent.

A Grexit, which would have implied a wage cut and a reduction of the value of financial assets, was adamantly ruled out, and while funds were rapidly draining from the Greek financial system, the government refused to contemplate any restrictions on cross-border capital movements until the temporary breakdown of negotiations on June 27 made this inevitable. Tsipras' strategy apparently rested entirely on confidence in his ability to browbeat the IMF and the other 18 Eurozone countries into concessions. The referendum on the Troika conditionality, held on July 5, was allegedly to strengthen the Greek' government's' hand in the negotiations with its creditors. Simultaneously, the rapid deterioration of the economic situation provoked by Tsipras' confrontational strategy seemed intended to convince the creditors that a fundamental change of policy was in order. A cessation of the ECB's ELA support and a possible state bankruptcy would interrupt the provision of essential services and provoke a humanitarian crisis.

A credible Greek threat to exit from the Euro would have tested Germany's willingness to go down in history as the executioner of the common currency as well as the EU's readiness to say goodbye to its flagship project. Without an alternative to the Euro, however Tsipras' strategy could not but fail.[13] The large majority against the reform program that emerged in the July 5 referendum did not imply a democratic majority for further concession in the creditor countries. Apart from undermining the credibility of the Eurozone countries, additional support to Greece while abandoning core points of the reform program would have met with fierce resistance from parliaments in e.g. Germany and the Netherlands. Though the creditors did offer some concessions such as a lower primary surplus, [14] the main points of further tax increase and pension reform were not negotiable. Nor did Greece find any allies amongst the Eastern and Southern Eurozone countries. Eastern countries increasingly resented having to support a country with a substantially higher GDP that was apparently unwilling to implement the painful adjustment program they themselves had undergone after the 2008 crisis. Southern European governments under pressure from populist and Eurosceptic parties at home had no interest in seeing Syriza succeed.

Indeed, shortly after the July 5 referendum negotiations resumed and on July 13, the Syriza government accepted a reform program that in some respects was even harsher than what had been on offer before June 27. The privatization program now was de facto place under foreign control as Greek assets were to be transferred to an independent fund, while Tsipras also had to agree to "backtracking on previous programme commitments or identify clear compensatory equivalents for the vested rights that were subsequently created" (Eurosummit 2015).

In the end, the political crisis precipitated by the June 27 Eurogroup decision to interrupt negotiations has served to cement a strategy that will benefit neither party. Alexis Tsipras' may currently have strengthened his political position by demonstrating that despite his resolve to stand up to the creditors no meaningful changed to the current reform program can be gained, but the apparent lack of a political alternative is likely to promote political apathy and cynicism and possible support for the neo-fascist alternative of the Golden Dawn.

Nor can the EU be confident that the crisis is over. As repeated ad nauseam by the avalanche of documents the many EU processes and strategies produce, promoting economic prosperity and social inclusion is amongst the principal objectives of European integration, but for the Brussels institutions, an ever-closer union has long become an end instead of a means. Greece was accepted into the EU and the Euro at a point when it was manifestly not ready and the negative consequences of those decisions, which had been in clear view from the beginning, were generally ignored in favor of self-congratulatory messages about the success of yet another step in deepening integration. Similarly, the North Western creditor countries have adamantly refused to make any design change in a model of integration that has served them well but increasingly is condemning not only Greece but many other peripheral EU countries to a permanent future as the poor cousins of the family. Unlike many other international economic arrangements, the idea of escape clauses to be activated in case of unforeseen consequences is utterly alien to the EU. Though this insistence on the irreversibility of any further integration step undertaken was hoped to cement the gains of European integration, it has evolved into the major threat to integration. Unable to live up to its promises and unwilling to take into account the differential needs of its members, European Integration has more than ever has become an elite project.

At the end of the Second World War the U.S. hoped to replace the manifold barriers in the crisis prone pre 1940 world economy with a liberal system to the benefit of all. But the U.S. administration never lost sight of the fact that integration was a means to prosperity and not an end. When it became clear that the ravaged west European economies would not be able to stand up to U.S. competition for a considerable time, the plan was dumped in favor of a system in which West European government were allowed to actively discriminate against the USA, encouraged to employ the toolbox of an interventionist state to promote recovery while receiving substantial Marshall aid to eliminate the initial bottlenecks. The EU instead seems to have lost sight of the fact that its main objective must be the recovery of the Greek economy and that the means must be subjected to this end. Indeed, the strategy of the creditor countries in the Greek tragedy frequently is more reminiscent of Clemenceau' position in Versailles where the overriding purpose was to punish Germany for its misdeeds rather than to steer it on a course to economic prosperity, stability and democracy. Irrespective of whether Greece will remain in Europe or not, for its own sake the EU cannot ignore the problem of a failing economy and state within its geographic borders, and thus eventually will need to address the question of how to bring about economic recovery. The blueprint for such a policy it can find it the post 1945 recovery of Western Europe.

ENDNOTES

1. This paper was written during a stay as visiting professor at the European Union Center of Pusan National University. Many thanks to the Center's director, Kim Dong-Jin, as well as Nam Sang-Hoon, Won Yoo-Kyung and Richard Shannon for their help and hospitality.

2. Source of all data: AMECO.

3. It is no coincidence that the global turn to so-called neo-liberal policies that rested on a restrictive macroeconomic framework in combination with structural reforms have ushered in a period of permanently lower growth.

4. Source: World Bank.

5. Purchase by the ECB of asset backed securities, covered bonds and public sector securities.

6. In addition, the German public financial institution FMSW ended up with a substantial holding of Greek sovereign debt after taking over the assets of the failed Hypo Real Estate and its German-Irish subsidiary Deutsche Pfandbriefbank (DEPFA).

7. Diplomatically called the systemic exception by the IMF.

8. Indeed, Germany's policy of creating "a zone of monetary stability" in Europe, from the first proposal for a common currency at the Hague summit in 1969 via the European Monetary System (1979) to the Euro can be interpreted as an attempt to overcome this contradiction (Notermans 2012).

9. Although entirely compatible with the EU's level playing field principle and rules on state aid, the Eurozone finance ministers rejected a Greek proposal for the establishment of a development bank. See point 10.7 of the Greek reform proposals of April 1, 2015 (Government of Greece 2015).

10. Ironically, the EU Commission, in its report of January 29 1976 had argued against Greek EU membership, mainly on the ground of its backward economy. The Council of Ministers, however, decided to overrule the Commission for what essentially were geopolitical reasons.

11. Flash Eurobarometer 405, p. 8.

12. Though the IMF (2015: 13) argues that a partial default would allow an immediate return to international financial markets.

13. Tsipras would probably have been brought to heel earlier if the other Eurozone countries had not immediately rejected Wolfgang Schäuble's proposal for a temporary Grexit.

14. President Hollande and chancellor Merkel's much heralded last minute €35 billion investment program for Greece, however, was merely a reminder of the funds Greece was entitled to anyway over the next couple of years under the various cohesion programmes.

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