Growth, Debt and Sovereignty
Prolegomena to the Greek Crisis

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GreeSE Paper No.91
Hellenic Observatory Papers on Greece and Southeast Europe

May 2015

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Acknowledgement

An early version of this paper was presented at a conference titled "Debt, Sovereignty and Civil Society" at Simon Fraser University, Vancouver B.C. in April 2012. I thank conference participants for comment and discussion. I thank Emilio Avgouleas, George Dertilis, Eliza Papadaki, Vasilis Rapanos, Yannis Voulgaris and an anonymous referee who contributed many valuable suggestions. Yannis Katsampoxakis provided excellent research assistance. Responsibility for all factual error and controversial views rests with the author.

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ABSTRACT

The paper reflects a basic premise: *Greek participation in the Euro-zone marked a definitive institutional break in the process of contracting and managing public debt*. Instead of internal debt, used extensively in earlier decades, euro-denominated sovereign issues were now placed in the international market. Thus, the Greek state became a net 'exporter' of financial claims to an extent unprecedented in its recent history. In assessing the prolegomena to crisis, I offer a review of the post-junta, *pre-euro* period, the forces leading to accumulation of (mostly internal) debt and the predominance of a 'money illusion' in distributional politics; I also engage an argument that the institutional shift that occurred with Euro-zone entry brought about a fundamental change to the very 'sovereignty' of Greek public debt. It expunged 'money illusion' but created the ground for policies that embodied 'financial' and 'fiscal' illusions. The entrapment of elites and electorates in various 'illusions' reflected a persistent tendency to underestimate the limits imposed by globalization on Greek economic policies. In the euro era, Greek policy became trapped in a self-feeding loop of debt-driven growth that effectively undermined the country's sovereignty.

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1. Introduction

Participation in the European Monetary Union was a landmark development for Greece. It bestowed on its government and private sectors a rare historical privilege: the ability to borrow in open financial markets on the same terms as other Union members, without the encumbrance of exchange risk.

To gain that status, Greece had undertaken successful stabilization policies in 1996-2000, bringing under control long-standing public deficits, domestic inflation and the drachma exchange rate. An important part of pre-entry policy was the liberalization of capital flows and of the domestic financial sector. Contrary to prior fears of risk of capital flight, significant inflows occurred in the late 1990s. The Greek financial sector (stock exchange, mutual funds and commercial banks) flourished. Domestic financial flows (credit, savings and stockholding) boomed. Investment and growth accelerated. On the eve of EMU membership, Greece was nothing less than a star performer in Europe[1]. Nine years later the privilege became a curse. In the midst of a deep international financial crisis, the Greek State found itself over-borrowed with Greek external payments registering their largest gap since the 1970s. Greece was expunged from financial markets and its outstanding bonds devalued substantially. Currency devaluation was impossible

[1] See for example OECD [2000] *Country Report: Greece*

within the Euro-zone. The lack of European institutional machinery for tackling macroeconomic crises proved critical, heightening uncertainty both in Greece and Europe. Greece suffered large capital flight because of this, throughout the period of the crisis.

In mid-2010, an ad-hoc program of official loans (that would eventually exceed 250 billion euro) was put together by Euro-zone governments and the IMF. This program imposed heavy conditionality on Greece for rapid fiscal adjustment and structural reform. As the program came too late, had a short horizon and was heavily front-loaded, it created a demand shock and failed to reduce uncertainty. Capital flight worsened, Greece suffered a severe liquidity crisis and the economy sank into a great depression. Between 2009 and 2014 GDP declined by 25 percent and unemployment soared to 26 percent. Social unrest and political conflict inflated the intrinsic uncertainties of the Greek predicament, postponing hopes of early recovery. The Greek crisis has now flared up again after the recent election in January 2015 of a government of the Greek left for the first time after the Civil War of the 1940s. This government is now attempting to reverse the austerity imposed by earlier conditionality, under very adverse economic and diplomatic circumstances. In a sense, the dire present condition represents the full transformation of fiscal to political crisis within Europe. It underlines further the need to understand the prolegomena to the crisis.

The metamorphosis of a financial privilege to a fiscal curse is a complex historical outcome. The worst global financial crisis in eighty years, the absence of Euro-zone arrangements for insurance against macroeconomic risks, misguided Greek policies and long-standing fault lines in Greek public and social structures jointly produced the curse that has now morphed into a great depression.

In complex outcomes, it is possible to isolate one aspect and construct reductionist argument. North European elites, for example, have promoted a narrative of bad Greek policies and unproductive social habits. Populists in Greece put the blame on German imperialism; left analysts have criticized Euro-zone architecture for Greek indebtedness [Lapavitsas 2011]. The present Greek governing coalition persuaded the electorate that the blame is on post-crisis policies, which they are now attempting to reverse. Among scholarly critics of the endogenous weaknesses of Greek development, some have chosen to focus on policy after euro-zone accession [Christodoulakis 2012, Voulgaris 2012] while others refresh the perspective of long-enduring structural deformities of the political and economic system [Featherstone 2012, Kazakos 2012]. In a notable exception to contemporary narrative, Dertilis (2013) looks over two centuries and underlines persistent factors that have thrown Greece into recurring fiscal crises. This perspective reconstructs deep links between chronic indebtedness, military expenditure, war and geopolitics.

In the modern era wars, and especially the world wars, bequeathed a heritage of heavy public indebtedness. Monetary instabilities and reforms have been a constant aftermath of war as a result. In the post-world war II era nonetheless, Europe has enjoyed a very long period without war within its borders (excepting Yugoslavia in the 1990s). European integration and Monetary Union represent a project with a deep long-term objective: economic cooperation and monetary stability as banishment of war. The destabilization of European economies since 2008 has not been the outcome of war but of financial crisis. Joining the European Union at first and the euro-zone later Greece partook in the geopolitical security of the European project. This implies that the state of over-indebtedness has not been the outcome of shocks, such as war preparations, but an endogenous accumulation over a period of peace[2].

My inquiry is therefore focused on *peace-time over-indebtedness* and the incentives, policy failures and structural fault lines that conspired to produce a new tragedy for Greece. Inasmuch as over-indebtedness poses a deep threat to the sovereignty of any state, very simple questions arise: Why and how can the elites managing the state violate limits of prudence that ensure its (and their) self-preservation? Why and how do informed citizens in a democracy, who aspire to break out from the status of superpower client, opt for choices that lead to renewed external dependence? The organization of this paper reflects the premise that *Greek participation in the Euro-zone marked a definitive institutional break in the process of contracting and managing public debt*. Given this premise, I undertake an analysis of modalities that make up the prolegomena to the Greek crisis of 2010.

The second section reviews the early post-junta period, summing up mechanisms that promoted the accumulation of *mostly internal* debt. This was a period in which politics and social dynamics were mired in a 'money illusion'. The third section discusses the period of adjustment and growth that paved the way to Greece's accession to the Euro-zone.

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[2] For a broad view on war and debt see Reinhardt and Rogoff [2009]. Focusing on peacetime indebtedness the paper does not engage further on the issue of military expenditure as a a propelling factor of public borrowing. This does not imply however, that military spending was unimportant in the period under review.

The fourth section discusses the institutional shifts that occurred with Euro-zone entry and the qualitative change to the 'sovereignty' of Greek public debt. The penultimate section offers an analysis of structures and policies that led to a new cycle of debt accumulation while in the euro-zone, which is characterized as a period of a 'joint financial and fiscal illusion'. The last section concludes with remarks on euphoria, crisis and democracy.

2. Redistribution without Growth: Early Stabilization of Democracy with Internal Debt

The restoration of democracy in Greece in 1974 was an uplifting milestone for those who experienced it. For the first time since the end of World War II the promise of open society was within citizens' grasp. For the citizenry of democratic Greece this was a historic turning point. The prospect of openness would materialize with the elimination of constraints on domestic politics (no banned parties, no ideological and political barriers) and with European integration on the international front.

Coming out of dictatorship, Greeks had a deep-felt vision of breaking international dependency on the US which, as many believed, was responsible for the colonel's junta. European integration was the route by which a small peripheral country could escape the status of superpower client, a condition which underpinned both the Civil War of 1946-48 and the illiberal anti-communist democracy that prevailed in its aftermath.

The historic achievement of post-junta democracy was not simply the restoration of liberal politics but also a newfound drive for social inclusiveness. A new state of political participation was achieved through the empowerment of social organizations such as labor and university student unions. Empowerment implied agendas seeking the expansion of social controls in the economy that translated into a constantly growing perimeter of the public sector. This outcome was not simply grounded in political ideology. *It intertwined with long-repressed social aspirations for redistribution of power and wealth*. The years since the Civil War had seen the accumulation of repressed demands for redistribution and democratic participation, as the State had created a divisive social structure: it offered protections and privileges to one part of the population while persecuting the other. This amounted to a deeply illiberal and regulated order in which neither liberal politics nor markets could function effectively.

The energy crisis of the early seventies put an end to the era of prosperity in the West and, along with it, to the Greek 'economic miracle' of the 1960s. Thus, democratization in Greece came at a time of burgeoning social need in a system that had been exclusive, unequal and repressive from inception[3]. Accordingly there was a perception across the political spectrum that the young democracy was fragile and that special measures were required to consolidate it. On the internal front, protection of incomes and employment led to inevitable increases in

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[3] Yannis Voulgaris believes that Greek 'populist largesse' in the period of democratic consolidation was excessive as compared to analogous conditions in Portugal and Spain. The reinstatement of democratic rights in the two other Mediterranean democracies was probably more heavily weighted in citizen aspirations since the repressed demand for 'political goods' had gone on much longer in these societies. In any case, Voulgaris' point is vindicated, as post-dictatorship fiscal expansions were noticeable in both countries but were also brought under control much sooner than in Greece. See my comparative analysis in Thomadakis [2006].

public expenditure, focused on social transfers and on bailouts of insolvent firms which leaned heavily on state-owned banks. On the external front, rapid accession to the European Community was the strategy that was hoped to bolster institutional stability and geopolitical security.

These broad strategic choices however imposed inescapable collateral requirements for the economic order and its institutional arrangements. Tax reforms were needed to accommodate the funding of expanded public expenditure. Administrative reforms were needed to raise the effectiveness of social spending in combating inequality. Microeconomic reforms, mainly industrial policy, were also required to restructure industrial and service sectors for competing in the open European economy. The inability to fulfill these collateral requirements is really the story of bypassed or unfinished reforms, the missed opportunities for building a solid economic foundation to the new Greek democracy, in short, the dark side of Greek politics that paved the way to crisis.

Let me offer two examples of unfinished reform. In the area of productive restructuring, initiatives for large projects, which were sponsored by the public sector and would serve as the core of new development, were undertaken in 1982-84. Industrialization of mineral resources such as bauxite, technological innovations in areas with large domestic demand such as telecom and transport equipment, and infrastructural initiatives were planned but hardly ever materialized. The failure was largely due to financial shortage; Greek banks were overburdened with bailouts of moribund firms; credible foreign partners were wary of Greek economic conditions and political intentions. An

International financial crunch was also proceeding due to the adoption of severe monetary policies in the US in the early 1980s.

In the area of fiscal reform, stabilization policy undertaken in 1985 by economy minister Simitis met with fierce opposition from both within and outside the governing party, in a rhetorical hailstorm that equated fiscal consolidation to suppression of popular rights. This was destined to be a permanent motto in polemics against fiscal control, perpetuating the illusion that fiscal balance was a reactionary trick rather than a necessity for the reproduction of the state. Stabilization policy appeared to bear fruit in mid-1987, but was overturned as elections and the threat of political defeat for PASOK loomed, two years later.

Table 1 presents summary indices of economic performance through the end of the 1980s. *(Please see Appendix A)*

Reform projects in the Greek public space have proved to be a Sisyphean adventure. The tendency to abandon semi-finished projects under political pressure became symptoms of the emergence of macroeconomic populism in Greece, a form quite distinct from traditional clientelism. This involved the use of macroeconomic policy for the attainment of mass political outcomes[4]. The consolidation of a strongly bi-partisan political system, the empowerment of mass organizations of social representation (labor, public employees, farmers, small businessmen, industrialists) and *the absence of* a *stable institutional mooring for social protection* were the foundations on which the new populism was erected. Its major manifestation was the

[4] For a discussion of Macroeconomic Populism see Dornbusch [1991]

emergence of a strong electoral-fiscal cycle[5]. This involved systematic fiscal expansions shortly before election periods, either catering to demands for redistribution or attempting to enhance growth by injections of public money into the economy. I have estimated elsewhere that over the 20 years 1974-93, each of the seven electoral contests increased the public deficit by 1.83 percent of GDP on average, which implies that pre-election populism alone translated into cumulative deficits of about 13 percent of GDP[6].

The displacement of economic reform by macroeconomic populism amounted to a historic failure of the reestablished democratic order in Greece. It allowed the perpetuation of public and external deficits. It also allowed the systematic use of 'stopgap' measures of fiscal and monetary management as an escape valve: accumulation of public debt on one hand, currency devaluation on the other. Neither was part of true strategic management. They were last-resort measures that made up for the lack of coherent policy; nevertheless, they offered political advantage as they facilitated macroeconomic populism: their long-term implications were hidden behind the 'money veil'. This kept alive the fiscal illusion, and its attendant political culture, that deficits did not matter. Diagram 1 shows the cumulative outcome of these policies. (Please see Appendix A)

The increase in public indebtedness until the mid-1990s was primarily funded from domestic sources[7]. It therefore tended to restrain investment and growth, producing stagflation and cultivating a culture

[5] The argument was empirically developed earlier in Thomadakis and Seremetis [1992].
[6] This estimation comes from Thomadakis [1997], p. 55.
[7] External debt amounted to 25 percent of GDP at the end of the 1990s. BANK OF GREECE, Governor's Report [1999] p. 241.

of distributional struggles: the salaried classes pressed for higher wages. The professional classes resisted taxation and lobbied for political controls of prices, incomes and competition. Businesses also fought against increased taxes: large ones by political interconnection and small ones by withdrawing into the 'underground' economy and the non-tradable sector[8]. In effect the missing taxes were reincarnated as inflation, devaluation and high nominal interest rates. The whole system was mired in money illusion: political parties would promise prosperity and social movements would bask in gains from 'democratic struggles' all in *nominal terms*. In reality redistribution and social policy were constructed on deficits, currency devaluation and debt[9].

3. Stabilization and Reform: Growth and the Risk of Openness

The end of the decade of the 1980s was marked by political crisis in Greece fuelled by scandals and scandal-mongering. Yet, the true challenge of the time was a full-fledged fiscal crisis in 1989-90, when the public deficit climbed to 15 percent of GDP and forced the government to borrow at exorbitant cost, to obtain an EU loan and to undertake strict measures for fiscal retrenchment, including the first privatizations of public sector companies. The shock ushered in a decade of economic adjustment that would eventually lead to Greek entry in the Euro-zone. In fact, the adjustment of the 1990s was so effective that, by the middle

[8] See Doxiadis [2010] for a perspective on family enterprise and small entrepreneurs as contributors to the growing perimeter of the non-tradable sector. In my view, the underground economy operated as an area of 'natural' protection from intensifying international competition. See Thomadakis [2011], 'introductory remarks'.
[9] See Thomadakis and Seremetis ibid. pp. 244-7.

of the decade, Greece began to partake in global growth trends and to attract private capital inflows, a confidence vote missed since the 1960s. Investment accelerated, deficits came under control and inflation started to converge to European levels. Basic indices of economic performance in 1991-2000 are summarized in table 2. (Please see Appendix A)

The transition from stagflation to growth was doubtlessly helped by modest tax reforms and enforcement which raised the ratio of tax revenues to GDP, as seen in the table. Nevertheless tax revenues only gradually caught up with the persistent rise in expenditure, so that public debt would not stabilize until the later part of the 1990s.

Fiscal stabilization and the inflows from European funds enabled the revival of public investment through large new infrastructural projects (e.g. roads, airports, urban transit)[10]. These mostly promoted the international 'connectivity' of the economy by improving domestic and international transportation facilities. Improvements in outward looking capabilities were a double-edged instrument: they facilitated the movement of exports but also the penetration of imports. Thus, they could accommodate either a potential export or an import boom (or both). As things developed, it was an import boom that prevailed[11]. In any case, these infrastructures fed also into the medium-term prospect of higher economic efficiency. Thus, twenty whole years after democratization, an important cornerstone of economic restructuring was finally pursued with ample European assistance.

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[10] For the contribution of EU funds to the Greek balance of payments and growth see Manassaki and Koltsida [2010]. As a general magnitude, EU transfers have amounted regularly to 4-5 percent of GDP per year.

[11] I am indebted to Eliza Papadaki for this point.

Probably the most important structural change in the period of adjustment was a far-reaching reform of the financial sector. This was the single most successful 'industrial policy' undertaken by the Greek governing elites that paved the way for capital inflows and a renewal of Greek participation in the fast-growing international financial system of that period. The process of financial reform followed a blueprint analogous to what other western countries had followed earlier. Liberalizations of banking and the stock exchange were achieved through a wave of deregulation in the early 1990s[12]. Regulatory arrangements for the new 'liberalized' financial order came with a delay and would be completed only by the end of the decade[13]. This implied that financial liberalization proceeded with few regulatory constraints initially, and this allowed the embedding of behaviors and strategies that would make the financial system more prone to instabilities[14].

In any case, there were tangible benefits of financial reform. First, banks managed to break the long servitude to government which state ownership and top-heavy regulation had imposed for many decades, managing at the same time to outgrow the semi-bankrupt status to which they had been relegated since the 1980s. Second, they fulfilled the necessary conditions for a wave of large privatizations of erstwhile public companies in telecommunications, energy, electricity and other utilities. Third, financial reform transformed the Greek economy into an attractive location for foreign portfolio investments. Fourth, it enabled Greek banks to export capital and services to the newly opened Balkan

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[12] Karatzas Report [1987]
[13] For a summary of the corpus of new market regulation in 1996-2002, see Hellenic Capital Market Commission [2003]
[14] For an early prophetic essay on deregulation and instability see Diaz-Alejandro [1985].

region and beyond. This expansion also enabled non-financial firms to initiate international expansion and become significant foreign investors in South-eastern Europe. Thus, an aura of Greek international influence was erected that contributed to the credibility of the Greek claim for participation in the 'European core'.

Last but not least, another effect of financial reform related to new domestic credit patterns. The resurrection of a lively banking sector had indirect effects on economic restructuring, not only because it encouraged the internationalization of Greek enterprise, but also because it determined new patterns in the allocation of credit within the economy. Banks competitively pursued the development of new business in mortgage finance and consumer credit. Indicatively, of total bank lending to the domestic private sector, the stock of mortgage and consumer lending rose from about 10 percent in 1988 to 24 percent in 1998 and to 49 percent in 2008[15]. Clearly this was the fastest growing area in bank credit before and during the euro era. It represented a 'catch-up' of Greek credit patterns to north European norms. Notably, however, it was precisely this credit expansion that enabled strong restructuring of domestic demand towards the non-tradable sector (housing construction for example) and imports. It is perhaps indicative that the spectacular growth of the overall economy did not coincide with growing export potential but with an inward-looking re-composition of domestic demand, that were no doubt partially attributed to these new credit patterns.

[15] Bank of Greece, Statistics on Credit 1980-2014.

Liberalization of capital movements was the necessary complement to domestic financial reform and capital inflows materialized in large scale especially as stabilization of the drachma was achieved in 1998[16]. Inasmuch as capital inflows were directed to private sector assets, there was space created for the stabilization of public debt. Privatizations of public sector companies alone amounted to about 25 billion euro over the period 1997-2001[17]; these enabled substantial reductions in the stock of public debt. The financial boom of the late 1990s also contributed to increased revenues from profit taxes on newly listed companies, stock exchange transaction taxes and related sources.[18] Furthermore, the acceleration of economic growth, domestic transactions and incomes also improved indirect and direct tax receipts.

In Diagram 2 are shown fiscal and debt magnitudes as they evolved in the period preceding Greece's Euro-zone entry. (Please see Appendix A)

The virtuous picture of Diagram 2 presented a stark contrast to economic performance of the prior decades. But it had a dark side too. As in so many other cases, financial liberalization also opened Greece to the vicissitudes of short-term capital movements, and a large financial bubble made its appearance in 1998-2000, in tandem with analogous phenomena in other countries[19]. The burst of the Greek stock exchange bubble in 2000 coincided with that of the internet bubble in the US. Although this did not affect materially macroeconomic and fiscal

[16] Bank of Greece, Governor's Reports 1998-2000, especially sections on the capital account of the balance of payments.

[17] Author estimate based on Hellenic Capital Market Commission's annual reports, various years.

[18] I thank Vassilis Rapanos for bringing this point to my attention.

[19] It is common knowledge that stock markets experienced bubbles around the world in the 1990s. These were abruptly reversed in the period 2000-2001. That stock market cycle has been since characterized as the 'internet bubble', despite the fact that it engulfed whole markets and not just internet stocks.

performance, it carried an important implication. Its deeper significance was that private securities issued in Greece lost a portion of their 'export potential' and would soon be superseded by another, presumably more secure and therefore more powerful, financial export: the sovereign securities issued by the government in international markets which took off for good in the era of the euro. Even this however had a dark side, mainly because of the high levels of public debt that were inherited from earlier periods as shown in Diagram 2. High levels of inherited debt exercise a direct influence on policy choices and political incentives even in periods of 'virtuous cycles' such as the one that was initiated in Greece in the mid-1990s. I return to this point below.

In summary, Greece made a remarkable adjustment in the 1990s, involving both reform and improved fiscal enforcement, which was to a large extent incentivized by consensus around the goal of euro-zone entry. Despite the unhappy economic heritage of the early post-junta years, Greece managed to become once again a growth economy. At the epicenter stood the radical change of the financial sector and the transformation of Greek financial assets into exportable values. Capital inflows for the acquisition of Greek financial assets (in private companies or privatizing public enterprises including banks) supported domestic liquidity and investment. They enabled the stabilization of public debt relative to a GDP that had now acquired a growth dynamic. However, they also exposed the economy to the prospect of instability due to sudden capital flow reversals and, more generally, due to the volatility of global financial markets and speculative movements. The burst of the Greek stock market bubble of 1998-2000 had offered a palpable foretaste of this risk.

4. Institutional Fault Lines in Euro-zone Architecture and the Management of Risks

The burst of the Greek stock market bubble Euro-zone entry had large implications for the institutions of national economic policy and the margins of policy discretion, especially for small member states as Greece. Monetary policy was ceded to the European Central Bank. Monetization of debts and currency devaluations were removed from the toolkit of the government. These were the very tools that the Greek Republic had used extensively in the period of democratic consolidation in lieu of reforms in taxation, public spending and industrial structure. Prima facie the elimination of these tools created renewed pressure for reform.

However, the elimination of monetary sovereignty was accompanied by a 'sweetener': the ability to issue liabilities without exchange risk, i.e. to borrow in the common currency. This meant that a previous barrier to market access was removed for both the government and private agents. The removal of the exchange-risk barrier was unprecedented in Greece's modern history, which has been crowded with recurring monetary crises. Yet, there was an important converse side which amounted to a qualitative change in the 'sovereignty' of sovereign debt. *Monetary and debt sovereignty are intertwined. Without the former, there is great limitation in the latter*. Once Greece entered the Eurozone the distinction between 'internal' and 'external' debt ceased. The government could service, refinance, or default on its debts but could not unilaterally monetize them. Furthermore, fiscal policy was restrained as deficit constraints were part and parcel of the euro-pact. The (quite arbitrary) deficit limit of 3 percent of GDP left very little space even for counter-cyclical policies. It mandated that member states found in violation would be subjected to an 'excessive deficit procedure' enforced by the European Commission. For a country with the behavioral record of Greece, these limitations implied no less than a full revamping of fiscal management, including the tax and social security systems, expenditure management, especially social transfers and military outlays.

A distinction is important: Whereas the monetary constraint is a constitutional rule that carries monetary policy to a supra-national level, the fiscal constraint operates through discretionary actions of member states and the regulatory intervention of the Commission. This has enabled various degrees of flexibility and 'interpretation' which devolved on the relative power of states vis a vis the European Commission. Already by 2003-4 Germany and France violated the fiscal limit, but they escaped the 'excess deficit procedure' because of their political weight. These exceptions reduced visibly the power of the Commission as enforcer of the Treaty and created a double standard. Smaller states, such as Greece, did not have the same treatment. Yet, the double standard boosted perverse incentives to engage in creative accounting.

Euro-zone architecture was decidedly a 'fair weather' system that would work well in normal times but had no machinery to deal with serious crisis[20]. The absence of any mechanism of co-insurance on public debt of member states; the lack of a mechanism for outright fiscal transfers to

[20] See for example 'mainstream' critiques in Wyplosz [2006], Lane [2012].

buffer local shocks, as would exist in a federal state; the explicit prohibition to the Central Bank to purchase public debt outright; the famous ‘no bailout’ clause of the Treaty, all these meant one thing only: Macroeconomic, banking, and broader financial risks remained absolutely within the responsibilities of member states.

If crises were singular and diversifiable events in specific member-states, the arrangement could probably survive: any state facing distress could seek emergency funding in the markets, paying the proper premium, and so being ‘disciplined’ by the market. In that fashion, market discipline would enforce fiscal discipline. If however markets themselves failed, crises of a systemic nature could arise (as the present one) and governments would be unable to fund themselves at any price! But then, there was no Euro-zone insurance facility to fill the gap. Nor was there a capability to mutualize a portion of national debts, so that the problem member-state could avoid default.

This lop-sided vision of monetary union would have been workable either if the virtuous policies imposed by the Treaty were sufficient to expunge forever the possibility of a large crisis, an expectation that could only be ascribed to policy arrogance and historical ignorance; or if all member states, besides being virtuous about deficits, worked to build up enough reserve resources as self-insurance against the risk of a major shock. Building public self-insurance capacity however was not equally accessible for member states, due to opposing external positions, with some being persistently ‘surplus’ and some being ‘deficit’ states *in the course of the normal function of the Euro-zone*. That feature clearly foreshadowed the present divide between ‘north’ and ‘south’ in the zone of the euro.

5. Greece in the Euro-zone: Growth Traps and the Sirens of Debt

5.1 Post-entry performance, the exhaustion of consensus and market complacency

At the point of entry in the Euro-zone Greece was a star performer with an impressive rate of growth and a track record of fiscal adjustment after many years of persistent deficits. Its weakness was high public indebtedness, around 100 percent of GDP, and a persistent deficit in current external payments counterbalanced by export of financial claims, private and public. These weaknesses were well known to policymakers and market agents. However, the international environment was growth-friendly. The advanced economies were basking in the comforts of the ‘Great Moderation’; financial markets were enjoying euphorically low interest rates, after the market crashes in 2000-2001 had prompted an increase in Central Bank liquidity. Faith in the ‘safety’ of sovereign debt securities was reinforced. Risk – premia on Euro-zone debt issues had practically vanished, including Greek ones.

Diagram 3 shows Greek 10-year bond spreads over German rates in the 1997- 2009; critical fiscal magnitudes as tax receipts, social expenditures, and employee compensation in the public sector; primary fiscal deficits (i.e. results before interest payments on public debt) and current account deficits, all as a percentage of GDP. (Please see Appendix A)

The yield curve in panel A reveals that, in effect, Greek bonds were a very close substitute of German issues; the markets assessed almost no risk-premium on Greek borrowing between 2001 and 2007. This flew in the face of publicly known Greek weaknesses. Additional considerations from that period can be gathered from panels B and C of Diagram 3.

In panel B, tax receipts as percentage of GDP peaked in 2000 but declined and stabilized at a lower level thereafter; public employee compensation was stable from 1997 to 2001 but shifted to a growing path thereafter; and social expenditure was steadily increasing throughout. In fact, it expanded faster than any other expenditure, gaining about 10 percentage points of GDP over 2000-9. An obvious conclusion is that Greece had attained its goal of euro-zone entry with maximum fiscal effort, but that post-entry fiscal management relaxed, foreshadowing a renewed deficit cycle. Pre-entry discipline gave way to a renewal of distributional pressure. I will come back to the political-economic and social interpretations of these observations below.

In panel C we note additional critical signs. The first is that over the period 1997-2003 the primary fiscal balance (expenditures before interest less receipts) was in surplus, enabling reduced net borrowing for government. In part the surplus was the result of financial activities (a stock market boom) that reached unprecedented levels in that period. As this waned however, and as funds from privatizations came to a halt, borrowing requirements increased rapidly, creating a new upward trend in public debt. The turnaround from primary surplus to deficit occurred in 2003-4. Last, but not least, the external current account deficit did show small improvement until 2004 but worsened considerably afterwards, moving rapidly far beyond 5 percent of GDP. With hindsight, these signs were clear precursors of the crisis in 2009. But, even without hindsight, the shifts were decisive and concurrent enough to instill doubts about the prospective performance of a country entering the Euro-zone with an overhang of high public debt.

In sum, on the basis of publicly available macroeconomic information, there was a visible transition from stability to deteriorating trends in 2003-4. Yet, as can be clearly discerned in panel A, this shift made no impression on the markets: the risk-premium on Greek debt remained very low until 2008. *How could that be and why did not market discipline provide Greece with counter-incentives to the accumulation of debt?*

There are plausible complementary explanations to this question. The first is that markets were euphoric and risk factors were discounted in the context of buoyant market sentiment. The successful execution of the Olympic Games in 2004 added to Greece's international luster and offered an alibi to fiscal derailment as a temporary displacement. Greece, after all, maintained a high rate of growth until 2007 and this calmed fears of a serious macro-economic turndown[21]. Furthermore, the Commission had placed Greece under supervision in 2004, after the newly elected government had revised upward previous deficits, changing accounting conventions related to military expenditure[22]. It was generally assumed that Commission pressure would result in

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[21] The general euphoria of the two decades ending in 2007 has also been characterized as the 'Greenspan put' implying that US monetary policy was feeding expectations that crises would be effectively absorbed by policies of monetary expansion.

[22] In 2004, newly elected finance minister George Alogoskoufis fashioned a 'fiscal census' which imposed new accounting rules that increased past deficits and embellished the picture for his own term. This exercise posed for the first time the issue of whether Greece had entered the Euro-zone on false data. This would be correlated later to the furor over 'Greek statistics' in 2009. See European Commission [2010] "Report On Greek Government Deficit and Debt Statistics". See also a later response by ex-prime minister Simitis [2011] who noted that most of the change in 2004 was due to a reshuffling of the accounting treatment for military expenses.

reinstating balance in Greek fiscal affairs. But, conversely also, Commission pressure was probably tempered by the fact that market perceptions of increasing Greek risks were non-existent. Lastly, and more importantly, European bank regulators continued to encourage the holding of sovereign issues as virtually riskless assets for bank portfolios; banks therefore received a strong incentive to load up on sovereign euro-zone debt, including Greek issues. In the circumstances, Greece could manage Commission pressures for fiscal adjustment by continuing to have privileged access to markets for its sovereign issues.

The configuration of market optimism and correlated policy choices was the fundamental reason for Greek debt to continue to enjoy subsidized rates. In my opinion, the key to the low risk-assessment on the part of financial markets was *the maintenance of the Greek rate of growth at a level among the highest in Europe*. This acted as a strong palliative to pessimist fears, keeping them from surfacing as long as growth was maintained. Greek political elites clearly perceived the centrality of growth as a passport to subsidized borrowing, implicitly assuming this was a permanent feature of markets. Yet, underlying trends were worrisome as the process of growth did not correlate with increasing fundamental strength of domestic production and industrial restructuring [Pitelis, 2012]. Rather, growth hinged on increased consumption which was import-based, and increased investment in non-tradables (e.g. housing construction) which did not enhance international competitiveness. Thus, *the rate of growth was contingent on the ability of Greece to obtain increasing amounts of external finance* and this increased the risks against an international financial crisis. In effect, a self-feeding loop – an incipient growth trap - lurked below the surface of market calm: growth was dependent on continued external finance but the sustainability of external finance was itself based on maintaining perceptions of growth. So when growth was endangered from external causes, i.e. the spreading financial crisis beginning in 2008, the whole 'fair weather' loop of growth and cheap debt was threatened from both sides. The prospect of failing external demand put downward pressure on growth and financial market failures put simultaneously upward pressures on interest rates and risk-premia. The Greek risks that had remained unrecognized that far, loomed and became a stark reality. Was Greece in a position to handle such a double squeeze? Its only realistic option was in the direction of regaining fiscal balance. Yet, as we see below, the opposite course was followed.

5.2 The early triumph of stasis

Whether the shift away from fiscal balance shortly after euro-zone entry was indeed a transitory phenomenon, as markets appeared to assume, or whether they expressed deeper and more permanent pressures is critical for any analysis. We must turn to Greek idiosyncratic features to assess this question. It is important to consider whether the high rate of growth for the economy as a whole offered restitution to long-standing structural and behavioral weaknesses or whether, on the contrary, it provided an incentive to complacency about needed reform.

Once again, let us recall that Greece gained admission to the Euro-zone in 2001 carrying mixed baggage: the heritage of its earlier failures was reflected in high public debt and uncompetitive productive structures except in services and finance where competitive advantages can be very volatile; more recent credentials encompassed fiscal adjustment, debt stabilization and growth performance. Its subsequent course as Euro-zone member would be marred by the tension between these two legacies. For example, the persistent proliferation of very small firms and a large stratum of self-employed professionals in the social structure meant that large areas of economic activity remained below the radar of tax authorities. This led to a persistent deficiency in tax (and social security) collections and to inability of the tax revenues to follow the growth of private incomes in the normal course of events. Every time that tax revenues increased relative to GDP, this was the result of extraordinary measures and effort rather than normal function[23]. By the same token, the same strata of small firms and self-employed professionals also clamored for political protection, unable as they were to face competition in the renewed opening of the economy after Euro-zone entry. In fact, as the worsening balance of payments testifies, the non-tradable sectors were growing more rapidly than the export sector which meant that growing volumes of labor and capital were acting within 'protected' spaces in the economy. Protection however does not come for free. How would its costs be funded, given the elimination of monetary sovereignty and the deficit constraints? And if protection were indeed provided using up resources that should be held in reserve in good times, what would happen in bad times?

It is notable that, besides marginal changes in taxation, reforms in the public sector that would respond to the new institutional requirements of the Euro-zone were not forthcoming. A prime example was the cancellation of proposed social security reform in 2001. The need for

[23] See Kaplanoglou and Rapanos [2013]

such reform had been signaled at least since 1990[24]. Demographic change, underground employment, a mosaic of early retirement options and special pensions and the long period of stagnation had made the existing ‘pay-as-you-go’ system increasingly untenable, producing ever larger deficits which fed the demand for public debt.

After many ineffective attempts at reform, a well-rounded proposal was put out for public dialogue, soon after Euro-zone entry. Instead of dialogue however, the plan was literally shouted down by a tremendous alliance of voices (labor unions, the left within and outside the then governing socialist party, public employees, small businessmen and even university students). After such vociferous opposition it was retracted[25]. This was a symbolic ‘tour de force’ by powerful social and political groups who vented their displeasure at the ‘sacrifices’ that were imposed in order to gain euro-zone entry. The cancellation of the plan was a resounding victory of short-termism, a refusal to come to grips with realities that would sooner or later catch up with the economy and with the fundamental issue of burdens on future, politically unrepresented, generations. The argument behind the refusal was simple: social security deficits had to be financed from the public budget. But this only rolled over the problem to another level. Thus, the most important system for social protection was left in a perilous condition, accumulating risks and finally surfacing forcibly in the midst of the crisis of 2009. This was the clearest example not only of a lack of foresight but also of the expectations of social actors who perceived pre-euro fiscal adjustment as a temporary retreat that should be

[24] See Angelopoulos Commission [1990]
[25] See a protagonist’s view in Giannitsis [2011].

rectified. It was the resounding symptom of a more general social attitude of stasis and resistance to premeditated reform, before an actual crisis hits. The shelving of social security reform signaled a broader defeat of the reformist stance of the Simitis government.

5.3 Autonomous fiscal expansion by a Eurozone member: a reckless response to declining growth

The widely held expectation of a return to normal ways (which meant early abandonment of the pre-entry consensus on fiscal discipline) along with the flawed system of fiscal control determined the character of the transition that is visible in the data in 2003-4. This was no temporary hiatus but the prelude to a new fiscal derailment. The conservative government of Kostas Karamanlis came to power in mid-2004 promising fiscal rectitude and public reform. They managed to maintain a reasonable fiscal condition and stable debt until 2006, but lost control thereafter, as can be seen in panel C of Diagram 3. In the years 2007-2009 large fiscal expansion took place. The public deficit neared 7 percent of GDP in 2007, 10 percent in 2008 and 16 percent in 2009. The debt-to-GDP ratio shot from 107 percent to 129 percent in this period. This derailment was the proximate cause of fiscal crisis in 2010. Diagram 4 focuses on the period 2004-2009 and shows total government receipts and expenditures, visualizing the magnitude of fiscal expansion in panel A. Panel B shows the GDP growth rate and panel C shows the current account deficit over the same period. (Please see Appendix A)

A very visible syndrome is evident from the successive diagrams in panels A-C. As of 2007, a negative trend emerged in the growth rate. Furthermore, a very steep increase in the external deficit is also visible.

Faced with these negative indications, policy choices were limited. A policy of contraction would be very costly politically. A policy of expansion was far less painful and corresponded to the built-in mindset of the Greek political class. But why would that occur? In my interpretation, the only plausible explanation of the derailment of 2007-9 is that overspending was a conscious policy choice that was legitimized by the goal of preventing the growth rate from declining any further.

Prior Greek experience, as I noted, showed a negative relation between cost of borrowing and growth expectations. This led to a facile policy empiricism that embodied the traditional reflexes of populist fiscal management and its illusory premise that the economy would respond to fiscal stimulus as a closed system: If a boost of domestic demand could be engineered by public spending and income creation, this would protect growth expectations and maintain the high valuation (low interest) on debt. Unfortunately (and predictably) this proved completely wrong in an economy with free capital flows and, especially, with an unprecedented crisis looming. Domestic income creation proved unable to maintain the growth rate and fed a huge external account deficit. The circumstances were clearly much different from the earlier precondition that had watered the plant of populist fiscal expansions of the recent past.

In 2008 the growth rate went into negative territory (-0.2 percent) after having been in positive territory for fifteen years. Yields on Greek debt rose considerably in 2008, for the first time in the euro era. By 2009, the inertia of fiscal expansion could not be reined in as all the dormant faults of the Greek fiscal system came alive. The new socialist government of

George Papandreou, which took over late in that year, also was captive of expansionist reflexes and proclaimed further expansion as a cure, misreading completely both the size of the crisis and the force of contagion in financial markets and open economies. The now famous phrase of Papandreou that 'money can be found' uttered in late 2009 has a tragic ring to it, upon careful reading of the increased macroeconomic risks of Greece foreshadowed in 2003-4, and very visible as of 2007. Thus, the path was laid for a full-blown debt crisis in 2010. The Greek debt crisis energized all the dormant faults of euro-zone architecture, ushering in the adventure of ad-hoc, painful policies implemented since 2010.

For a small open economy such as Greece, growth was indeed the path for maintaining social peace and mitigating distributional conflicts among powerful interest groups. In the 1980s, this was achieved by inflationary growth and monetized debt. In the euro-era it was real growth based on external debt that acted as the lynchpin of domestic coherence. Thus, its maintenance through fiscal expansion appeared almost as a natural political response of last resort, which however proved both myopic and very toxic in the lopsided institutional environment of the Euro-zone that came face to face with unprecedented financial crisis.

6. Epilogue: crisis management, strategic insurance and democracy

Uncertainty, as John Maynard Keynes and Frank Knight had noted many decades ago, is never really measurable in probability terms. There are always surprises and unanticipated turns or combinations of events. No mechanism for perfect prediction of crises has ever been possible in human history, nor will there ever be. There can only be imperfect defences against knowable but unpredictable threats.

The state itself is such a mechanism of defence. Among its multiple functions, it has the duty of 'insurer of last resort': its very sovereignty affords powers of enforcement that allow it to marshal resources for unforeseen contingencies. But resources are not simply stocks of food, fuel or money capital. They are also human and organizational capabilities that can be devoted to crisis management and to a system of protection of last resort. Yet in every crisis, there is dislocation of some kind and choices must be made on the allocation of protection. Democracy and its underpinning humanitarian foundations legitimize allocation in descending order of needfulness. Crises always increase inequality because the poor have no private means of protection and need public help. Yet, crisis management is also a dictatorial type of exercise: it requires large managerial discretion and centralization of information and coordination.

When the crisis produces economic distress of the state itself, crisis management and the role of "insurer of last resort" suffer endogenous threats. It is not implausible that reserves held for bad times (stocks of goods, money capital, unused debt capacity) may be used up in last-minute efforts to avoid (or postpone) crisis, leaving less room for handling events when the crisis actualizes. Nor is it implausible that a state in crisis suffers deterioration of its organizational and human capital, as revenues and expenditures are violently constricted. These plausible results imply an endogenous vicious circle: as the state becomes weaker or collapses, its ability to offer crisis management also vanishes. Greece, in the succession of events and policies that I recounted, was unprepared for a big crisis. It used up reserves to maintain social balance simultaneously with a rate of growth that could not be sustained for long. Its quality of public administration was (and still is) low and its inability to coordinate various parts of public policy even in good times was a harbinger of disaster, if and when bad times hit.

Greece's political class, its economic elites, its organized interests and its middle classes felt reassured that European participation provided them with safety and that the powerful European Monetary Union was impervious to crisis. Their complacency was certainly aided and abetted by optimistic markets and self-assured European bureaucrats. Yet, much of this reassurance was due to euphoria generated by a fair-weather system during good times. Institutional illusion, financial illusion and fiscal illusion merged into a grand illusion of perpetual peace, linear growth and stable prosperity. But the same complacency was blind to the fact that within the European artefact Greece was one of the weakest members and that its internal structures and institutions exposed it to greater risks than many other Euro-zone members.

In the last analysis democracy, in the context of capitalism, is the bulwark of last resort for all legitimate social orders, but it must arm itself with structures that simultaneously promote innovative productivity while containing the growth of inequality. Ways must be found to enrich democracy's survival toolkit with institutions of governance and regulation that will assure foresight, reserve capacities, strategic thinking and resistance to consuming bouts of financial euphoria and fiscal illusion.

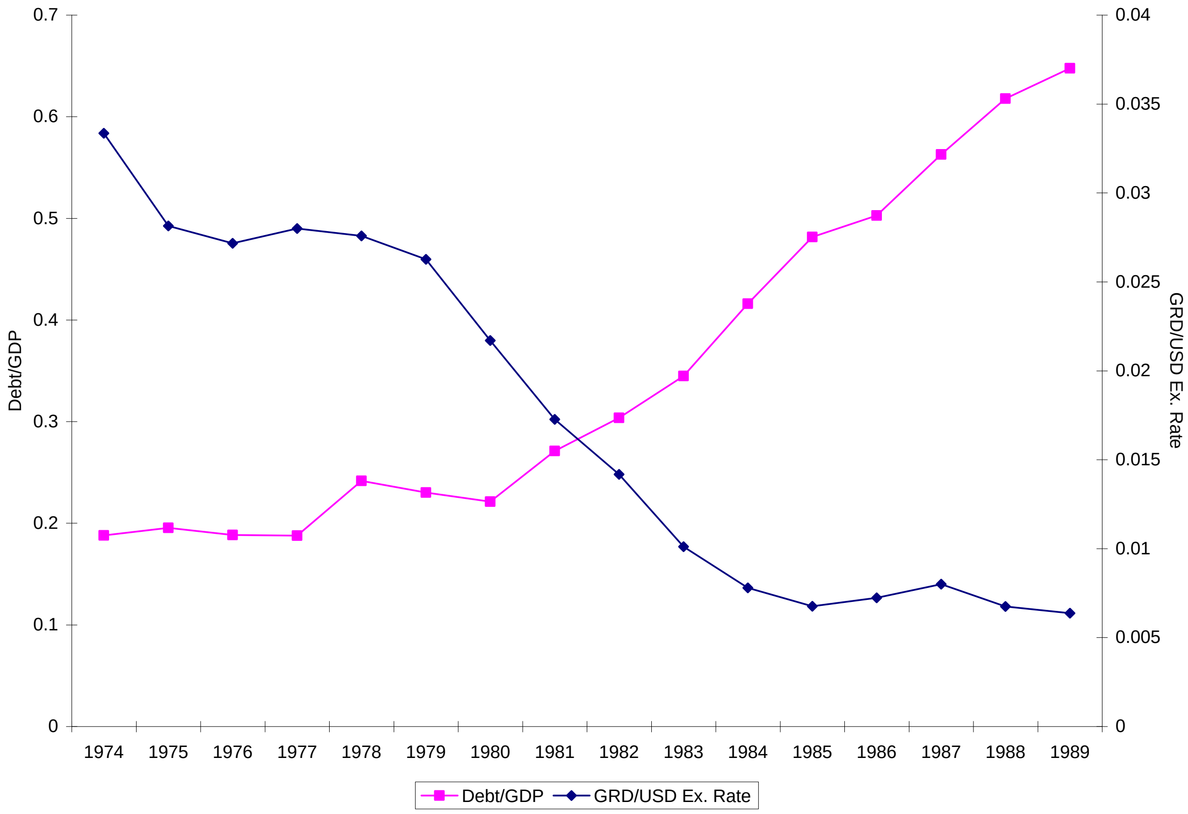
Appendix A

Table 1: Indices of Economic Performance 1974-1989 (3-year averages)

	1974-77	1978-80	1981-83	1984-86	1987-89
Growth Rate of GDP	2,43%	3,74%	-1,25%	1,68%	1,94%
Annual Inflation	16,43%	18,82%	21,92%	20,26%	14,54%
Fiscal Deficit / GDP	NA	NA	-6,61%	-9,06%	-10,67%
Current Account Deficit / GDP	NA	NA	-4,18%	-5,03%	-2,25%

Source: Ameco (2012) Database

Diagram 1: Debt and the Exchange Rate 1974-1989



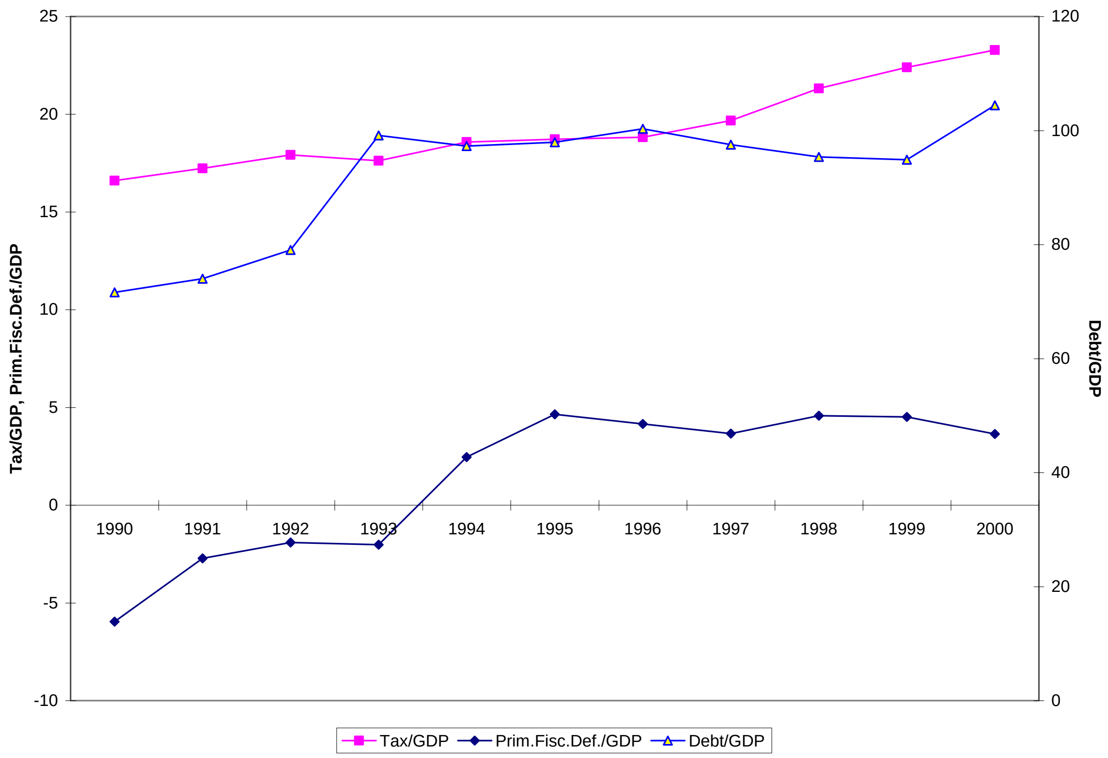
Source: Ameco (2012) Database, Bloomberg

Table 2: Indices of Economic Performance 1990-2000 (3-year averages)

	1990-91	1992-94	1995-97	1998-2000
Growth Rate of GDP	1,55%	0,37%	2,70%	3,75%
Annual Inflation	19,94%	13,72%	7,56%	3,52%
Taxes / GDP	16,92%	18,04%	19,07%	22,33%

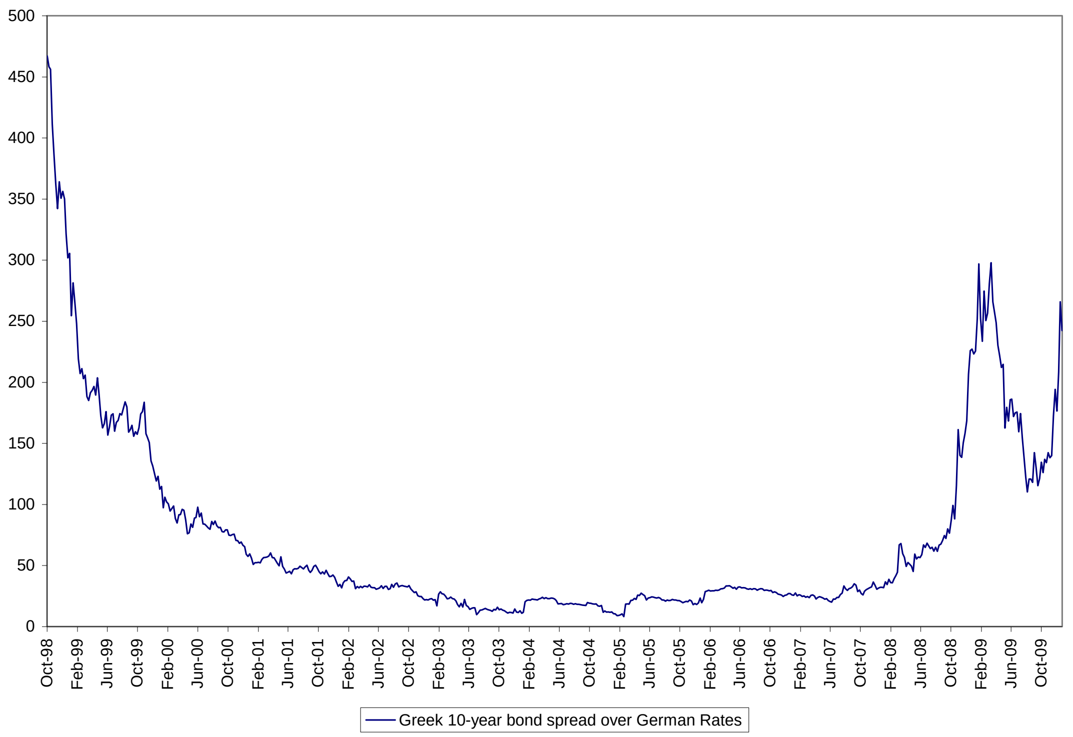
Source: Ameco Database

Diagram 2: Fiscal Performance 1990-2000



Source: Ameco (2012) Database

Diagram 3: Financial and Fiscal Indices 1997-2009
Panel A: Spread of Greek 10-year bond over German Rates

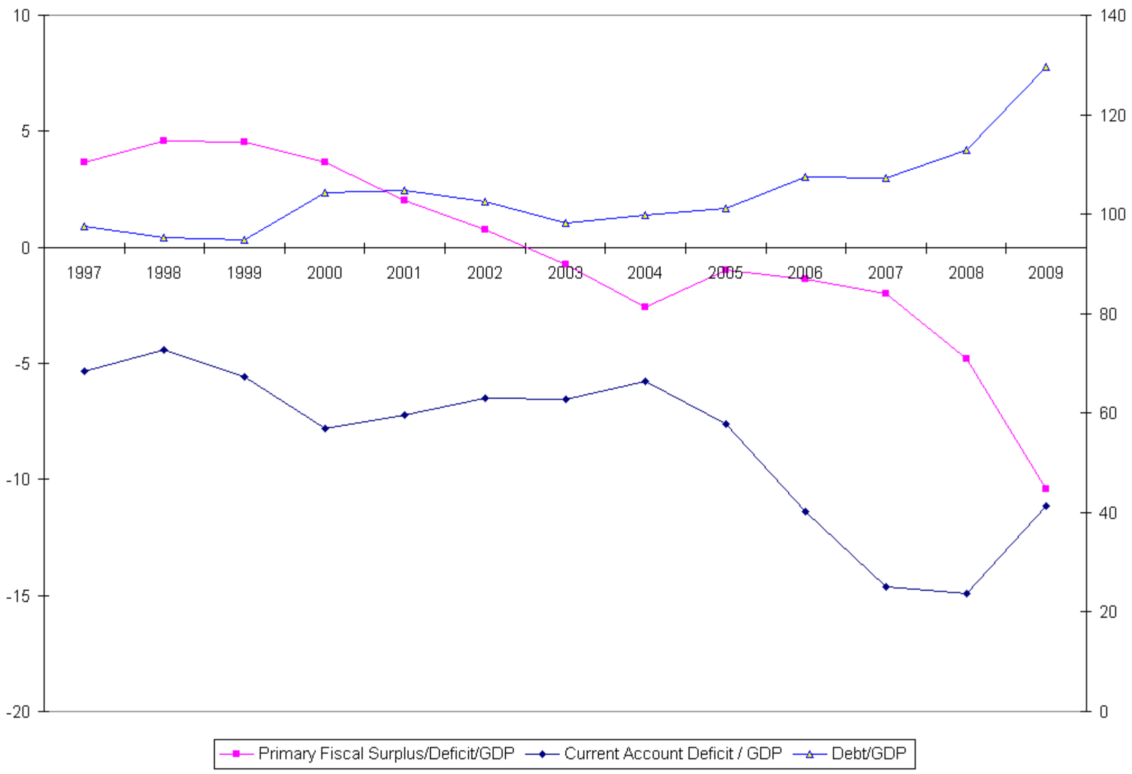


Source: Bloomberg

Diagram 3: Panel B: Critical Fiscal Magnitudes 1997-2009

Source: Ameco (2012) Database

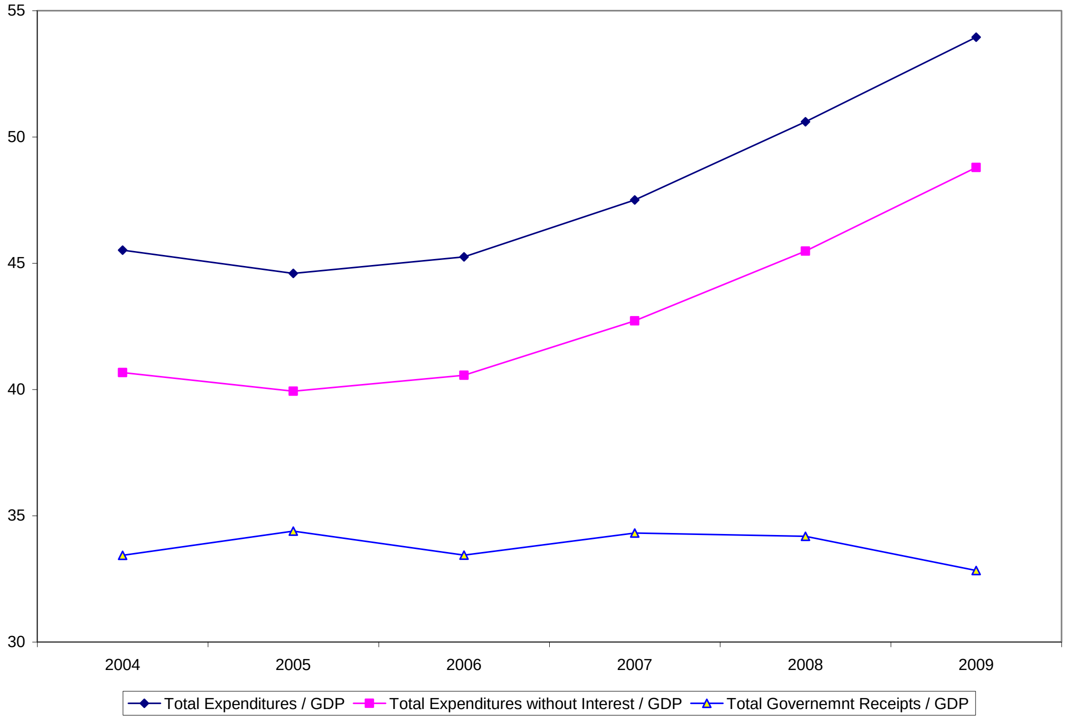
Diagram 3: Panel C: Primary Fiscal Deficit – Current Account Deficit 1997-2009



Source: Ameco (2012) Database

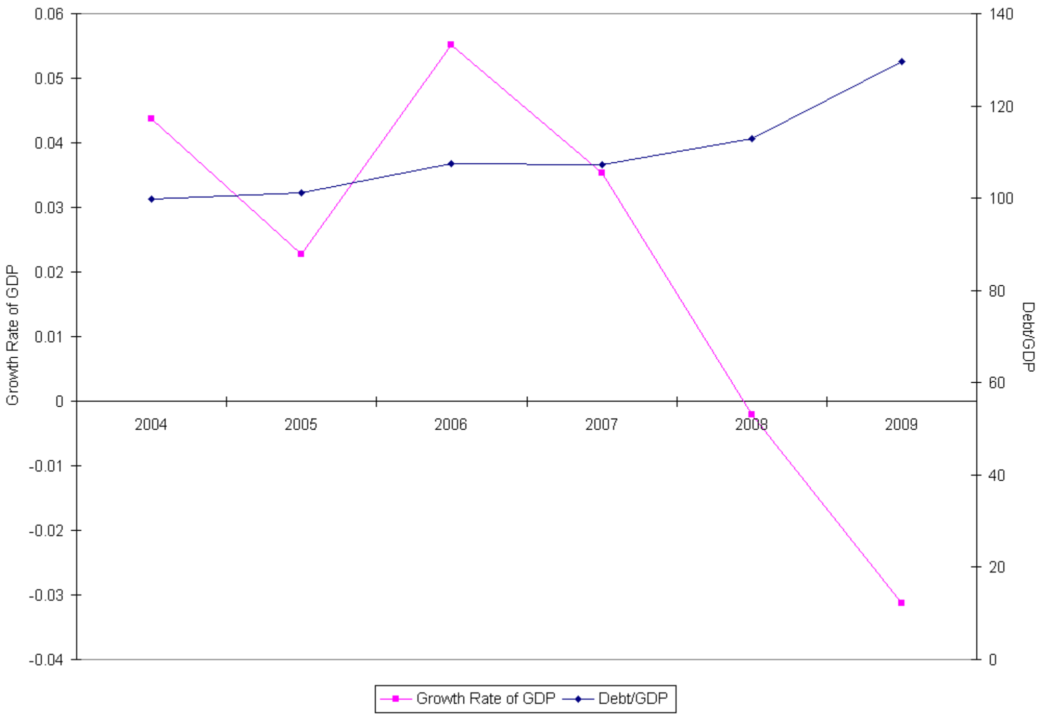
Diagram 4: The Process of Destabilization

Panel A: Total Government Receipts and Expenditures 2004-2009



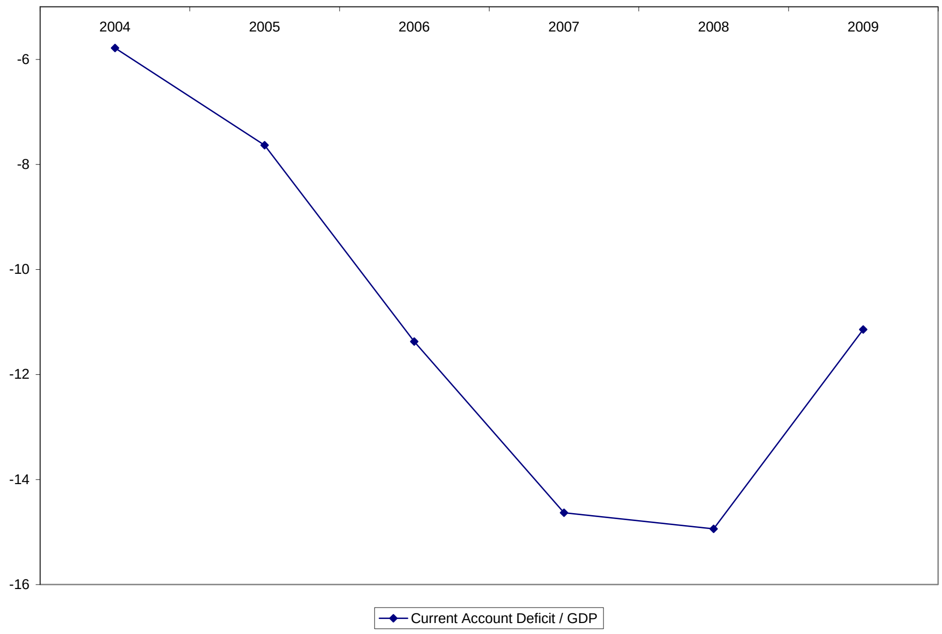
Source: Ameco (2012) Database

Diagram 4: Panel B: Growth Rate of GDP 2004-2009



Source: Ameco (2012) Database

Diagram 4: Panel C: Current Account Deficit 2004-2009



Source: Ameco (2012) Database

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