# A World of Crisis and Shifting Geopolitics: Greece, the Eastern Mediterranean and Europe

*A Conference Report*

THE FLETCHER SCHOOL
OF LAW AND DIPLOMACY

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# A World of Crisis and Shifting Geopolitics: Greece, the Eastern Mediterranean and Europe

*A Conference Report*

Michalis Psalidopoulos, Editor

The 10th Anniversary
of the Constantine G. Karamanlis Chair
in Hellenic and European Studies
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I. SIDERIS Publications
116 Solonos Street, 106 81 Athens, Greece
T. 210 3833434, F. 210 3832294
E. contact@isideris.gr, S. www.isideris.gr

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# INTRODUCTORY REMARKS

*Kostas Ah. Karamanlis*

This report is a written record of a successful international meeting at The Fletcher School in Medford, Massachusetts, on October 28, 2011. Scholars and policy-makers from Europe and the United States engaged in a lively debate under the broad title: "A World of Crisis and Shifting Geopolitics: Greece, the Eastern Mediterranean and Europe".

The purpose of the meeting was to analyze and discuss the recent momentous developments in and around Greece, including the ongoing economic crisis, while celebrating the 10th anniversary of the Constantine G. Karamanlis Chair in Hellenic and European Studies at The Fletcher School, Tufts University.

The Chair bears the name of, and honors the legacy of Greece's late president and leading statesman, Constantine Karamanlis. It is the only chair of its kind. Rather than having a permanent chair, it is based on rotation and has been held by seven professors to date, representing the broader spectrum of social sciences, including history, politics and international relations. Instead of dealing with Greece's glorious past, the focus of the Chair is the politics of contemporary Greece. Over the years, it has also provided a much needed welcoming environment for the study of modern Europe.

This linkage between Greece and Europe becomes even more appropriate since it was Karamanlis' central political goal. Karamanlis was born in the crumbling Ottoman Empire and lived through the turmoil and upheavals of an impoverished, unstable and polarized Greece. He devoted his life to helping lift Greece out of its centuries-old poverty and endow it with a stable, modern and democratic constitution. Karamanlis' crowning achievement was Greece's early entry into the European Union in 1981, as he was a firm believer in European unity and Greece's Western and European vocation.

Three decades later our thoughts are being dominated by the serious and worsening crisis that has afflicted Greece and, to a lesser extent, Europe as a whole. For Greece, this is rapidly becoming an existential threat and of which many of the constants of life my compatriots and I have been taking for granted are being shaken to their core.

Furthermore, Europe itself is being put to the test. An inescapable crossroad and a fundamental choice is fast approaching: either Europe will move towards an economic union in support of the euro with all the implications such a move carries for enhancing the solidarity of the rich north towards the struggling south or, Europe will unravel, with the euro in its present form, falling victim to the lack of political will, wisdom and leadership.

Because the costs of failure are so high, I remain optimistic that a resolution will be reached. Already, many of the orthodoxies upon which the monetary union rested have been abandoned, gradually and, often, quietly. But, the ultimate challenge remains the reconciliation of Europe's bureaucratic politics with democracy. It is only with the provision of a strong democratic mandate that Europe will be able to complete its integration and find a stable equilibrium.

These issues, and many more, in all their complexities and inter-connectedness, were debated during the meeting. An effort is made to preserve some of the vitality of the oral exchanges in this report while presenting, in a systematic form, the arguments and counter-arguments. This includes the lively debate that took place on the re-introduction of the drachma, in the presence of Lucas Papademos, who took over as Greece's premier only a few days after the meeting.

I would like to thank and congratulate the current holder of the Chair, Professor Michalis Psalidopoulos, and his colleagues, for organizing this gathering and for all their work in enriching and expanding the Chair. I am grateful to all the speakers, and now writers, for investing their time and joining our efforts to enrich the intellectual and policy debate on a matter of crucial importance for Greece, Europe, and the world at large.

The Karamanlis Chair was established to provide a bridge of understanding between the old and the new worlds, between Greece and America. In these trying times, such an understanding is more vital than ever before. This report validates our original vision and reconfirms the belief that meeting the policy challenges of today presupposes serious, open-minded, and open-hearted research and analysis.

Athens, February 10, 2012

# EDITOR'S INTRODUCTION AND ACKNOWLEDGMENTS

*Michalis Psalidopoulos*

The 10th anniversary of the Constantine G. Karamanlis Chair in Hellenic and European Studies at The Fletcher School, Tufts University, was a productive academic meeting that enabled scholars and interested participants to engage in intensive and rewarding discussions, promoting scientific inquiry and advancing a better understanding for Greece, Europe, and the Southeastern European region. The present publication captures the presentations at the conference and testifies to the quality of scientific exchange that took place.

I would like to thank the conference participants for sending their papers. The papers provided by Gerhard Knaus and Lucas Papademos were transcribed from their oral presentations and are published without having been edited by them. The responsibility of these two titled papers lies with the present editor. References and forms of citation differ as each author had the freedom to use his own style.

I would also like to thank The Fletcher School's Dean Stephen Bosworth and Academic Dean Peter Uvin, as well as the Karamanlis Foundation in Athens for their encouragement and support. Financial assistance from the National Bank of Greece is gratefully acknowledged. We extend our gratitude to Peter Uvin, Lucas Papademos, Elaine Papoulias, and Dante Roscini who moderated the four panels. Finally, I would like to express my appreciation to Jennifer Weingarden, head of the Office of Development and Alumni Relations at The

Fletcher School as well as to Georgia Koumoundouros, Kathleen Bobick, Deirdre Smith, for their support and assistance in organizing this conference and to Michail Vafeiadis and Annette Rondos for making this report possible.

Michalis Psalidopoulos

# EUROPE AND THE UNITED STATES IN THE NEW WORLD ORDER

*Robert L. Pfaltzgraff, Jr.*

This conference is timely. It commemorates the 10th anniversary of the establishment of the Karamanlis Chair on Hellenic and European Studies at The Fletcher School. The inauguration of the Chair took place during a magnificent dinner on the cloudless evening of September 10, 2001. We all know what happened several hours later on the equally cloudless morning on September 11, 2001. My remarks represent a selective focus on transatlantic relations over the decade since 9/11. I focus briefly on four crises of the last decade and the transatlantic response with some possible implications for the future. I conclude with some additional issue areas in which NATO is presently engaged or in which the Alliance should, and probably will, be taking a more active role in the near future.

## *I. NATO and 9/11*

Let us recall that Article 5, for the first and only time to date, was invoked on September 12, 2001, based on the conclusion that the 9/11 attacks had been directed from abroad. For this reason, they fell within the scope of the Article 5 collective defense commitment. However, 9/11 quickly unmasked a problem that has long confronted NATO, differing levels of importance attached to security issues among NATO members reflecting contrasting threat perceptions and interests as well as great disparities in capabilities:

- For the United States, 9/11 was the beginning of a protracted war against terror producing a multifaceted US response.
- For Europeans, 9/11 was a major event but not the beginning of a war even though there were subsequent terrorist attacks in Madrid and London.

The NATO allies quickly agreed to several broader measures, including: enhanced intelligence sharing and cooperation; stepped-up security for US facilities on their territories; backfilling selected NATO assets to allow the US to deploy its forces elsewhere; blanket airspace clearances for the US and other NATO aircraft; access to ports and airfields; and deployment of NATO AWACs to help patrol US airspace, liberating US aircraft capabilities for use in Afghanistan.

### *II. Afghanistan*

The second challenge came in Afghanistan, stemming from 9/11. It began shortly after 9/11 and continues today, a decade later. This led the US to launch a major military campaign against Taliban leadership in Afghanistan but also maintained tight US control over operations. There was concern in Washington, D.C. that involving NATO as an organization would unnecessarily complicate decision-making and unduly hamper operations. Rather than conducting military operations in this early phase through the NATO integrated command structure, the US put together a coalition of the willing and sought help from allies, largely on a bilateral basis.

In late 2001, the US invited a select group of allies to work with it to provide security after the initially remarkably successful effort to break the Taliban's control over most of Afghanistan. A United Nations Security Council Resolution (1386) adopted in December 2001 called for the establishment of an International Security Assistance Force (ISAF). ISAF has operated in parallel with but initially was separate from the US-led Operation *Enduring Freedom* (OEF) that had decimated the Taliban. In subsequent years, as the al-Qaeda/Taliban insurgency returned and escalated, the distinction between ISAF and Operation *Enduring Freedom* became increasingly blurred, with ISAF forces assuming greater combat roles. In contrast to the initial phase back in 2001, more recently we have had US forces operating under NATO Command with the US Commander (General McChrystal and then General Petraeus) reporting both to SACEUR through the ISAF Chain of Command and US Central Command, as the US chain of command. Thus we have seen a transition in Afghanistan from a US command structure to one that includes NATO.

### *III. The Iraq Crisis*

The third challenge for US–European relations came as the Iraq crisis escalated in the period leading up to Operation *Iraqi Freedom,* as it was called. The US saw Iraq as part of the terrorist problem. Although Europeans to some extent shared the US position, especially the United Kingdom under Tony Blair's leadership, most NATO-European countries were not prepared to go to war against Saddam Hussein. The Iraq question produced deep divisions not only between Europe and the US, but also among the Europeans themselves. This was most notable in the case of opposition to the US from Germany and France, contrasted with the support provided by Britain under Prime Minister Blair. President Chirac famously criticized Central and East European countries supporting the US for having missed "an opportunity to shut up". From this debate and disagreement emerged the conclusion that, in place of multilateral approaches favored by many Europeans, the United States was becoming increasingly unilateralist. Perhaps it is best to assert that the greater the perceived threat to an important national interest and the greater the ability to mobilize one's own resources, the greater the propensity to go it alone – or unilaterally. In any event, Iraq revealed major differences separating the US and some of its most important NATO allies. As a result, the US formed a coalition of the willing that included some NATO allies such as Poland, Spain, and Italy, as well as outside partners such as Australia.

### *IV. Libya*

The fourth NATO challenge has been Libya. NATO operated under UN Security Council Resolutions 1970 and 1973 calling for "all necessary measures" to protect civilians in Libya. Military action began on March 19, 2011 under initial US leadership (Operation *Odyssey Dawn*) in a phase which ended on March 31, 2011 when NATO assumed overall command in what has been called Operation *Unified Protector.* In recent months NATO-European countries, notably France and the United Kingdom, have flown thousands of sorties against targets in Libya. Non-American aircraft flew 75 percent of all sorties. Non-American alliance warships carried out 100 percent of the missions to enforce the arms embargo at sea. An arms embargo against Libya has been enforced by nearly 20 ships provided by NATO members to patrol the central Mediterranean. The Operation has had political direction from the North Atlantic Council and has had SACEUR leadership under the Joint Force Command Naples and Canadian Command of Operation *Unified Protection*. While European forces have carried the principal burden, it is questionable that they could have succeeded without supplies and intelligence as well as other military capabilities provided by the US. The US had a near monopoly in intelligence-gathering aircraft – tremendously important in a setting in which NATO had no troops on the ground to help identify targets. NATO increasingly relied on US UAVs (Predators) to fly high overhead for hundreds of hours for purposes of target identification. Without US support it is generally conceded that the operation would have taken substantially longer with possibly inconclusive results. With more extensive US participation, it is likely that it could have been completed more quickly. Downward trends in NATO-European defense spending do not augur well for changes that would shift greater burdens to NATO-European countries.

From today's vantage point, the present situation bears an uncanny resemblance to the condition that prevailed in

Iraq in 2003. Although we were militarily successful, we now know that we faced years of instability. Of course, Libya is not Iraq. However, Libya is a country that could splinter into warring factions. The question for us is what, if any, role should NATO now play. Should NATO become more active in assuring that weapons do not get into the wrong hands, if not in the infinitely more complex tasks of nation-building?

Several conclusions emerge from these brief summaries:

1. The US essentially acted on its own where it was able to do so and where the threat perception was greater and different than that of its NATO allies as revealed by 9/11 and even more sharply by the military campaign against Saddam Hussein which produced deep transatlantic and intra-European division.
2. The US was prepared to leave to NATO-European allies the principal role in which US interests were deemed to be less fully at risk. The US chose, in the case of Libya, to lead from behind.
3. In Afghanistan and Libya NATO, operating under a UN mandate, provided a framework for the formation of coalitions of the willing that included several NATO members operating under differing national caveats, with some countries conducting combat missions and others working in support missions. This was probably inevitable given the original purpose of NATO's Afghanistan involvement in the form of ISAF.
4. NATO has provided an organizational instrument, including command structure, for multinational coalitions in the case of Afghanistan and Libya. NATO, it can be argued, has been necessary but not sufficient, with non-NATO members also participating as essential partners. For example, Australia in Afghanistan and the UAE in training missions in Libya: the NATO Libya operation provided evidence that effective military operations can be carried out without putting American forces on the ground. This is in keeping with the success of the air campaign in 1998 against Milosevic's forces in Kosovo leading to the ouster of Milosevic.
5. Transatlantic relations of the past decade point to the fact that NATO continues to lack consensus on when,

where, or how forces will be used on a more global basis beyond Europe. Since this is a situation that shows no sign of being changed, we will probably continue to base operations on a coalition of the willing even when we have NATO authorization because only several member countries are likely to be active participants.

6. Another conclusion is the fact, as former Secretary of Defense Gates pointed out, that we have a two-tiered alliance, in which some members have military capabilities to bring to the table and others do not.
7. Given the nature of the global issues facing the United States and Europe, it will be increasingly necessary to work with non-NATO countries. Such coalitions, with US-European core membership, have emerged in the past decade, as we have seen in the case of the Afghanistan and Libya operations within NATO and the Iraq case outside NATO.

Finally, the global landscape presents many other continuing challenges and opportunities for NATO in arenas that are likely to increase in importance in the years ahead. These are issues that, in some cases, are an outgrowth of 9/11 and, in other cases, the result of new forces shaping the global setting:

- Greater intelligence sharing across a spectrum of security issues that came to the fore with 9/11 and can be expected to grow in importance in the years ahead.
- The cyber domain, with the cases of Estonia and Georgia having already led NATO to establish a cyber center and to think about the implications of cyber war for Article 5 and other NATO issues. When, for example, is a cyber attack on one member's systems regarded as an attack on all NATO members and what should be the responses, kinetic or otherwise?
- Countering piracy with NATO members with maritime forces already working together to interdict piracy off the Horn of Africa and elsewhere and to protect vulnerable sea lines of communications.

- Special Operations Forces, with the establishment of a NATO headquarters for special operations and under the realization that NATO members have niche capabilities in special operations that form an essential 21st century capability.
- Increasingly, there are Alliance discussions of a "Smart Defense" approach to security requirements. Principally, this includes ways of more fully pooling and sharing resources among Alliance members as defense budgets shrink. It focuses on role specialization around the Alliance's core capability requirements (collective defense, crisis management and cooperative security) as set forth in the Alliance's New Strategic Concept adopted at last year's Lisbon NATO Summit and to be a focal point of discussion at the next NATO summit in Chicago in May 2012.
- A final point for us to consider is the fact that the United States not only plans to cut overall defense spending and force structure, but also in Secretary of Defense Panetta's words, to engage in a "realignment" of US interests to the Asia-Pacific area. Increasingly the United States will maintain a large military presence in the Pacific as a counterweight to China. This comes at a time when NATO-European countries will also continue to downsize their forces.

Each provides the basis for extended discussion and action. All point to the need for transatlantic cooperation but extend well beyond NATO's historic perimeter as we consider Europe and the United States in the New World Order.

# SOUTHEASTERN EUROPE: CURRENT ISSUES AND PERSPECTIVES

*Gerald Knaus*

In my book "Can Intervention Work?" I argued that the international interventions of the 1990s worked in the Balkans while they failed in Afghanistan and Iraq and that has a lot to do with the hubris that came out of the Balkan experiences which has affected the way we think about interventions.

But the question I have been working on mostly is whether the European Union is inspiring people, not just in Europe but in the Southeastern European region. During the 1990s we needed power in the Balkans and we witnessed there the closest possible US-European cooperation. In the last 10 years, this region has been largely EU's court and the big question today is whether the current European crisis is also fatefully undermining the ability of the European Union and its soft power in this strategically vital region of Europe.

I will present two visions and how they coincide in the Balkans; one is the vision of a Europe without borders. It all started in 1985 when five European countries met and agreed to abolish physical borders on the continent. The vision of Schengen, the vision of a border-free Europe, is one of the grand visions of the last 20 years. The second one is this: the vision of Helsinki; the promise at the European Council in Helsinki in the wake of the shock over the Kosovo war and the determination that Europe should put the 1990s behind itself, the vision of a huge European enlargement, which was essentially decided in Helsinki. In Helsinki, the EU decided to open accession talks with Bulgaria and Romania, a combined population of 30 million, to give a perspective to the rest of the Balkans, which was then clarified in Thessaloniki four years later and above all, to give candidacy status to Turkey. This Helsinki vision is of a Europe that would have, upon implementation, 600 million inhabitants, of whom 100 million will be European Muslims. A very bold vision and easily understandable, this was a vision that would take a lot of persuasion beyond the quick decision of the leaders in Helsinki in 1999. In 1999 the EU had only one small foothold in Southeastern Europe, Greece. By 2009 the EU included the rest of the Balkans when Romania and Bulgaria had joined and, of course, Central Europe - and this was the Helsinki vision. A Europe that would include all the Balkans (only the status of Kosovo is currently uncertain) and, of course, Turkey. EU borders moved to the East. I recently calculated that in 1989 Europe had 25,000km of land borders. After 1989, the creation of new states in the Soviet Union and Yugoslavia added another 12,000km of land borders. This is rather dramatic; no part of the world has undergone such political change as the old continent. In the meantime, because of Schengen almost 16,500 kilometers have disappeared, have actually been erased. If you compare this to the 24,500 that used to be there, you will understand why I call it Europe's border revolution; an incredibly bold project of just abolishing borders.

The lessons of the 1990s also led to more assertive EU diplomacy. For example, the crisis in FYROM in 2001, but the EU moved quickly and even the US intervened to stop the civil war from spreading. In 2008 it seemed as if the last open state issue, Kosovo, would be resolved with Kosovo's declaration of independence recognized by 22 EU members. A new generation of leaders put behind them the memory of Tudjman and Milosevic and acted with statesmanship in all Balkan states. Josipovic from Croatia went to Bosnia last year to apologize for the crimes committed in the name of Croatia in Bosnia and Boris Tadic cooperated with the Hague tribunal and handed over Serbian war criminals. New politicians emerged, such as Vesna Pusic who is very likely to be the next Croatian foreign minister and Nazim Bushi, an Albanian in FYROM, in Skopje, the chairperson of the EU integration department.

The jewel in Europe's crown in the last 10 years is undoubtedly the reformation of Turkey. A country that was really the sick man of Europe in the 1990s, with 60% inflation, governments falling and being recomposed, six foreign ministers in five years, economic disaster, a war in the southeast, hundreds of thousands of people displaced, and torture as an instrument of daily policing. In the last decade it experienced the fastest growth rate in Europe. It is a country undergoing regime change. The loss of power of the Turkish military in the last five years is unprecedented and this summer, for the first time ever, the highest military council was chaired only by the Turkish prime minister with no chief or general staff at his side. Today Turkey is knocking on the EU's door, but it is being viewed with suspicion.

The promise of a different kind of politics in Albania was evident in the demonstrations which took place in Tirana and a messy polarization that began after joining NATO. This was not what was expected.

Furthermore, the denationalization of politics in the Balkans was not reversed but in fact deepened as a result of the current economic crisis. And even Greece, the proudest member in this region, a member of the European Union for decades, suddenly started projecting images of instability on television screens throughout Europe.

As far as catching up is concerned, GDP in 2010 as a percentage of GDP in 1989 was 70% in Serbia, 85% in Bosnia, and 87% in Montenegro, and now, of course, they are in a deep crisis. Youth unemployment is not only high in Spain and Greece. It is also high in Bosnia, Serbia, and Croatia. The question is, is the EU betraying the Helsinki promise? Is the stabilizing idea - that all of this region will join the EU - being betrayed by the leaders of Europe's biggest nations? As Angela Merkel stated two years ago in the campaign for the European parliament of her party, the CDU, after Croatia, enlargement should stop. Is the dream of freedom of movement turning into nightmare? A few months ago, the Danes were contemplating restoring border controls on their 17 kilometer-border with Germany and the bridge of Sweden. And has the idea of European soft power moved away from Catherine Ashton and, of course the grand vision of the Lisbon Treaty, to Tayyip Erdogan? Is it now he who is going to Egypt and preaching about the virtues of secularism and receiving a rapturous welcome? Currently the debates in Tunisia are not what can be learned from France, but what can be learned from Turkey.

Is the EU losing the Balkans? You might all remember the happy image of Greece's northern neighbor, erecting statues of unnamed warriors from the past and renaming squares, streets, highways, and airports after having been an EU candidate for six years. The feeling in Skopje is that they may as well give up on the EU as a credible vision.

I will end with a few concrete ideas and a slightly radical notion that European pessimism might affect its leaders. The EU has enormous soft power, it just needs to know how to use it, and it is possible to use it even in these difficult conflicting times. On the one hand, young people in the Balkans celebrate the achievement of visa-free travel. Europe's border revolution is in fact continuing. In the last few years, the Western Balkan population was given something it had desired for 20 years, visa-free travel to the EU. Conditionality still worked. The EU actually proposed 45 very demanding conditions and reforms that were expensive and difficult to implement and each country was eagerly fulfilling them in a competitive race. On the other hand, it is of crucial importance that Montenegro, following the Commission's recommendation, is given a date for starting accession talks early next year. If this happens, Mrs. Merkel's proposed halt or pause in EU enlargement will no longer be a threat, but, on the contrary, enlargement will continue.

Let me return to Turkey and the EU. The EU-Turkey relationship is, in my view, despite all its problems, a "Catholic marriage" where divorce is not an option. Turkey has been flirting with the Middle East during the last few years, but is actually returning to its traditional allies as its relations with Syria and Iran have greatly deteriorated recently. All relationships have their challenges but there is no room for complacency. It is well-known that there is one area that Turkey and the EU can make headway - the Greek-Turkish border.

Eighty percent of illegal immigrants caught last year in the EU passed this border. This is a major burden for Greece; it is a major burden for Europe. Turkey's point of view is that if it helps resolve this issue, it should be treated in the same way as the Balkan countries and be given a visa roadmap with the promise of visa-free travel. Turkey has a re-admission agreement on the table, it has finished negotiating and wants to sign it, but demands to be treated the same way as Albania, Bosnia, Serbia. Many European countries, including Greece, are in favor of Turkey's membership. If this would happen immediately, Turkish trust in the EU will be restored, because this is a core issue that concerns EU citizens. Visa-free travel for Turks would be good for the Greek economy. Note that the new Turkish middle class is travelling domestically three times as much by air now than it did eight years ago, and the Turks going abroad have increased from 5 million in 2002 to 12 million in 2010. Turkey is rapidly developing a middle class that travels and spends money.

In the meantime there are some bilateral disputes. For more than a year Croatia and Slovenia disputed over a land and a see border. In the end a compromise was found because there was a common interest. These borders would disappear anyway. But it also took a lot of political maneuvering and a little bit of investment by the big European countries, silently in the background finding a compromise. Perhaps, this is possible also in the case of FYROM.

Meanwhile, there are some bilateral conflicts. For more than a year Croatia and Slovenia disputed their land and sea borders. Finally, they compromised due to a mutual interest, but it also took a lot of behind-the-scenes silent political maneuvering and some investment by the big European countries. Perhaps this is possible also in FYROM.

One year ago we, the ESI, made a proposal on how to overcome the name dispute and presented it to Mr. Gruevski. The easiest way to revive the European vision of the Balkans is for FYROM to start EU accession talks as soon as possible, which would also inspire Albania and Montenegro. This is the only option which would be acceptable to Greece and the Greek government could present it as its success. Our proposal offered an agreement on a name which may already be on the table but the name does not seem to be the biggest problem. The real problem seems to be the lack of trust on both sides. A new name, for instance, Republic of Northern Macedonia, would replace FYROM wherever FYROM is used today, and a change in the constitution in Skopje which would state that this name would be used *erga omnes* on the day the "Republic of Macedonia" joins the European Union. The Greek government could then justifiably claim that it has managed to achieve more on this issue than any government in the past 20 years. The government in Skopje can claim that it is not making a concession which could be endangered if, say, after three years, another Greek government would block chapters – as Slovenia has done with Croatia. This lack of trust in Skopje is what I found to be the biggest problem. We presented this idea to leaders in Skopje and we talked to some people in Athens. This would be the best way to jumpstart the process of accession of other countries, because the Germans are currently hiding behind Greece and they are not all together unhappy that the EU accession of the Balkans has hit a new obstacle.

Let me finish with a true story: In 1986 Italy asked Germany to allow Italians to visit Germany without passports. Finally, in 1996, Romano Prodi met Helmut Kohl and told him that the German conditions were extremely tough, creating continuous obstacles, humiliating successive Italian governments. He told Kohl "Helmut this is unacceptable, we have been waiting for 10 years, we are founding member of the EU, help us," and Helmut Kohl overruled his minister of interior. In the end of course, this was just one step in the expansion of a border-free Europe. Europe has always been in crisis. The French have signed the Schengen agreement and then blocked implementation for four years because they were so afraid of the Dutch and the drugs coming from Amsterdam. So, in a sense perhaps what we see today in Southeastern Europe, might, if the right decisions are taken in the near future, look like just another episode of a continent still in the grips of a major geopolitical revolution.

# AFTER THE CRISIS: EUROPE'S EXISTENTIAL DILEMMA

*Dimitris Keridis*

The process of European integration has been rightly hailed worldwide as one of the most positive achievements of the postwar era. It produced a peaceful, prosperous and democratic Europe[1], far exceeding the highest ambitions of its founding architects after 1945.[2] As a result, this success has, at times, become the envy of the world and has set an example for similar processes in far-away places such as Latin America and Southeast Asia.[3]

1. Whereas Europe consists of more than the 27 member states of the European Union, for the purposes of this paper, the two are used interchangeably.
2. Judt Tony, *Postwar: a history of Europe since 1945*, New York, NY: Penguin Press, 2005.
3. According to Fraser Cameron: "In Africa there is the increasingly important Africa Union, as well as a number of regional (e.g. ECOWAS) and sub-regional organizations. In Latin America there is the Andean Pact and Mercosur as well as the Central American Free Trade Agreement (CAFTA) and the Caribbean Community (CARICOM). The North American Free Trade Agreement covers the US, Canada and Mexico. In the Middle East there is the Gulf Cooperation Council (GCC). In Asia there is the association of South-East Asian Nations (ASEAN), the South Asian Association for Regional Cooperation (SAARC) and the Asian regional forum (ARF)," in "The EU Model of integration-relevance elsewhere?", *Jean Monnet/Robert Schuman Paper Series*, Vol. 5 No. 37, Miami, FL: Miami European Union Center, University of Miami, December 2005, p. 1.

For most Europeans and many outsiders, Europe's success is embodied in its generous welfare state that has provided previously unimaginable benefits to Europe's citizens - from free public health care and education to unemployment compensation and early retirement. In a sense, it is this generous welfare state that is primarily responsible for overcoming the deep historic divisions and political polarizations between the elite and the people, the left and the right, the church and the anti-clericals, which had plagued pre-1945 Europe.[4]

Today, Europe spends more public money on social policy than the rest of the world combined.[5] However, although the export-oriented and highly competitive economies of Europe's north have been able to finance this spending through taxation, much of Europe's south has resorted to borrowing and, as a result, has accumulated high debts which, in the case of Greece, have proved unsustainable.[6]

The current debt crisis that has afflicted Europe's south is the result of choices made by a European leadership that sought European integration on the cheap. The south under-

4. In France, for example, "class cleavages and working-class consciousness have been moderated by the gradual democratization of primary and secondary education... and the somewhat enhanced possibilities of the recruitment of children of working-class and lower-middle-class parents to the lower echelons of the national civil service. Class cleavages have also been reduced by the expansion of the welfare state and the introduction of paid vacations and a statutory medical-care system." Safran William, *The French Polity*, New York, NY: Longman, 1991, p. 28.
5. It is interesting to note that, according to data published by OECD, in most EU countries gross public social expenditure as a percentage of GDP is around 30% whereas in the United States it is 18.2% and, even, in socially-minded Canada it is only 19.6%. In Mexico, the poorest OECD member state, the percentage falls to a mere 8%. See Adema, W., P. Fron and M. Ladaique, "Is the European Welfare State Really More Expensive?: Indicators on Social Spending, 1980-2012; and a Manual to the OECD Social Expenditure Database (SOCX)", *OECD Social, Employment and Migration Working Papers,* No. 124, Paris: OECD Publishing, 2011, p. 84.
6. According to the *OECD 2004 Social Expenditure Database* in Greece, in particular, social spending grew from 11.5% of the GDP in 1980 to 24.5% in 2005, with most of the increase occurring during the 1980s under PASOK's (the Greek socialist party) first two terms in office.

estimated the demands and difficulties of being integrated with the stronger and more competitive north. It sought a quick convergence of living standards without the full and real adjustment needed of its economic, political and social structures. It aimed for growth without development. This was particularly evident with the proliferation of a number of "bubbles": a real estate bubble in Ireland and Spain, a private borrowing bubble in Ireland and a public deficit spending bubble in Greece. As a result, income per capita converged but on a basis that has proved, at least, partially unsustainable. When the bubbles burst and credit financing dried up, the southern economies deflated.

In a sense, Europe's south suffers from a variation of the East German condition after the German unification in 1990. On the one hand, West German monetary transfers built a very modern infrastructure in the former East Germany, with state-of-the-art highways, subways, telecommunication networks etc. On the other hand, the monetary union between the two Germanies, on a one-to-one exchange rate of the old eastern mark with the deutschmark, wiped out East Germany's economy and complicated its transition and recovery, even when compared to the cases of neighboring Poland or the Czech Republic.[7] For all the billions in deutschmarks and euros that the West German taxpayer paid and despite the massive exodus of East Germans towards West Germany, East German unemployment remained persistently higher

7. "Historical and contemporary factors ought to have ensured the best outcomes of any transition economy. Before the Second World War, East German GDP per capita was slightly above the German average (Sinn and Sinn 1992), and both at that time and under communism, East Germany was richer than (other) eastern European countries. East Germany's relatively small population – 20 per cent of unified Germany – made feasible the large financial transfers from its rich cousin, West Germany. East Germany has benefitted from West German institutions, know-how and investment. Yet the Czech Republic had a GDP per capita only 13 per cent lower in 2004 (OECD in Figures 2005), and if post-1999 trends continue, the Czech Republic will converge with West Germany before East Germany does.", Hunt Jennifer, "German unification, economics of," in Steven N. Durlauf Steven N. and Lawrence E. Blume, eds, *The New Palgrave Dictionary of Economics*, Second Edition, New York, NY: Palgrave Macmillan, 2008.

than Polish or Czech unemployment for most of the 1990s and 2000s.

In a similar way, while EU subsidies upgraded the physical infrastructure of most of Southern Europe beyond recognition, they also oiled a system of corruption and encouraged a hypnotic sense of fake convergence. With the adoption of a hard, German-like common currency, the euro, and the credit-fuelled rise in labor costs, the competitiveness of local industries was undermined. Rather than learning from it, the failure of the developmental policies in Italy's *mezzogiorno* was allowed to repeat itself elsewhere in Europe's south.

Furthermore, the euro was introduced without first having secured a solid foundation.[8] A monetary union was assembled without placing effective monitoring and corrective mechanisms, not to mention an economic union that should have provided a minimum of fiscal coordination among the member states.

The euro itself was born in haste out of the anxiety the French and German elite felt and understood respectively and caused by an enlarged Germany after unification.[9] But, while Germany was ready to sacrifice its venerated deutschmark and monetary hegemony over much of Europe, it remained unwilling to agree to an economic union which might entail large fiscal transfers.

Thus, the EMU project remained unfinished. It worked for a while during the good times but was vulnerable to asymmetrical shocks. Such a shock came in 2008, when the credit-financed construction and consumption booms in the south, including Ireland, came to an end, and quickly exposed all the internal inconsistencies and contradictions of the world's second most important currency. Since then, European lead-

8. There has been a lively academic and policy debate on the merits and risks of EMU as established in Maastricht in 1991. For a summary, see Grauwe De Paul, "What Have we Learnt about Monetary Integration since the Maastricht Treaty?", *Journal of Common Market Studies*, Volume 44. Number 4., 2006, pp. 711–30.
9. Dyson Kenneth and Kevin Featherstone, *The Road To Maastricht: Negotiating Economic and Monetary Union*, Oxford, UK: Oxford University Press, 1999.

ers have been struggling, at an increased cost, to paper-over some of the genetic deficiencies of the project.

The main tool chosen to combat the euro crisis has been a combination of emergency funding by EU governments and the European Central Bank, with some support from the IMF, together with the application of fiscal austerity, through a combination of tax hikes and spending cuts. In a sense, Europe's south is going through a conventional IMF-stabilization program minus devaluation, which makes the adjustment all the more difficult and painful. In the absence of a currency devaluation, an internal devaluation is needed to restore competitiveness. But this entails a suppression of incomes that depresses fiscal revenues and increases rather than decreases fiscal deficits. Moreover, such a suppression is politically costly and complicated. In some instances, as in the case of Greece, it is of dubious legality when it mandates wage ceilings against the will not only of employees but, also, of private employers.

Southern European societies are too wealthy and too densely institutionalized to be seriously threatened by a populist, let alone a revolutionary, backlash of the kind witnessed elsewhere in the Third World, where the strictly-conditioned funding of the IMF was preceded or followed by political instability and coups.[10] Even in a country like Greece, where the austerity and the consequential recession have been harsh,

10. "Despite more than forty years having elapsed since this finding, political scientists still have no established explanation for this relationship. Just recently, a sophisticated analysis of democracy and development by Przeworski, Alvarez, Cheibub, and Limongi (2000) has argued that higher income has no discernible causal effect on transitions from dictatorship to democracy. Rather, they claim that the relationship between income and regime types is the result of the impact of higher incomes on the stability of democracies – once democratic countries (regardless of how or why they became democratic) reach a certain level of income (roughly $10,000 in 1996 real PPP GDP/capita), they are extremely unlikely to revert to dictatorship. Thus the higher income level acts as a 'sink' for democratic countries – once they enter this state, they seem to enter a highly stable equilibrium." Goldstone Jack A. and Adriana Kocornik-Mina, "Democracy and Development: New Insights from Dynagraphs," Center for Global Policy Working Paper No. 1, Washington, DC: School of Public Policy, George Mason University, 2005.

democracy is not in doubt and popular protests have not been very different from the Greek norm.

However, Europe as a whole is currently navigating in unchartered waters and the consequences of the present crisis, either way, will be grave. The present equilibrium cannot hold; Europe will come out of the crisis either stronger and more united, or it will fold.

The latter outcome will be an economic, political and geostrategic disaster with global implications, threatening the prosperity and stability not only of the European periphery but of the core as well. What is certain is that it will accelerate the decline of Europe's relative power in the world.[11] It will weaken Europe's benevolent global influence as a harbinger of liberty, democracy, and tolerance. This will be felt particularly where Europe counts the most, in its Balkan, Mediterranean, and East European borderlands.

Given what is at stake, European leaders should be able to find a way out of the present calamity. But the resolution of the crisis will not come free of charge. Already, they had to abandon, gradually and, often, quietly many of the orthodoxies upon which the monetary union was built. The old equilibrium of more integration without giving away fiscal, let alone political, sovereignty is no longer feasible. However, the latter is particularly hard to contemplate: there is a limit to what the Europhiles can achieve without a strong democratic mandate.[12] This inability to reconcile the bureaucratic politics of Europe as a whole with the democratic ones of its nation-states will remain the single largest challenge for the integrationist process as it tries to move forward.

Complicating the picture further, the crisis has overturned the two pillars on which European integration has rested politically. The first pillar was Europe's control over Germany. Originally, European integration was France's answer to its German problem. To avoid a German Europe, there had to be

11. Robert Kappel, *The Decline of Europe and the US: Shifts in the World Economy and in Global Politics*, Hamburg, Germany: German Institute of Global and Area Studies, No 1, 2011.
12. The British *Economist* has argued strongly in that regard, see "Charlemagne: How much closer a union," July 30, 2011, and, "Charlemagne: Angela the lawgiver," February 4, 2012.

a European Germany, well integrated into Europe and jointly controlled by Franco-German elites.[13]

The second pillar was the partial reversal of the natural flows of classical capitalism that historically favored the center to the detriment of the periphery. In the process of European integration, special care was taken for the convergence of Europe's periphery with its advanced center. Borderlands, such as Finland, Ireland or Spain, which historically were outside the European core, advanced rapidly. By 2009, at the beginning of the current crisis, Greece had almost reached, in per capita terms, the European average.[14] This was a tremendous success for a historically poor Balkan nation.

These two processes, Germany's restraining and the convergence of the periphery to the core, made the project of European integration politically acceptable to the majority of Europeans. This is because people are more concerned with relative, rather than absolute, gains and losses. Keeping Germany on a tight leash and spreading the benefits of growth to the outlying regions of the continent have made possible the voluntary union of Europe's "little nations" with the German behemoth next door.

The problem is that the current economic crisis has weakened, if not altogether demolished, both pillars upon which European integration has rested and has turned its logic upside down. The crisis has strengthened Germany's relative power and has reversed a decades-long process of convergence into one of rapid divergence. Instead of a European Germany Europeans are confronted with the prospect of a German Europe, something which is particularly feared in

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13. As William I. Hitchcock nicely puts it: "It wasn't that Europeans had started to like the Germans. They hadn't. Rather, during the 1950s Europeans figured out how to control them. Starting in 1950, a number of key leaders and their advisers in France, Germany, Italy, and the Benelux countries began crafting a new political and economic structure for Europe designed to harness and contain Germany's economic power while limiting Germany's political role." *The Struggle for Europe*, New York, NY: Anchor Books, 2004, p. 147.
14. According to the *Eurostat Newsletter* 186/2011 published on December 12, 2011, Greece had a per capita GDP in purchasing power standard of 92% of the EU average and a per capita actual individual consumption (AIC) of 104%.

France and other countries with painful memories of past German misconduct.

Furthermore, Germany, more than concentrating power in its own hands, seems to want to remake the rest of Europe in its image – a particularly difficult proposition to sell in the south. For Berlin, if Germany can go through painful reforms in the 2000s to make up for the lost competitiveness caused by unification, EU enlargement and globalization, Europe's periphery should be able to do the same in the 2010s. In southern eyes, German chancellor Angela Merkel appears as a medieval theologian preaching the pains of austerity and recession as the purgatory through which the sinful needs to pass to absolve his past sins of excessive borrowing and attain the heavens of euro-stability.

In the meantime, the crisis has led to a capital flight from Europe's south towards the center, especially Germany, where rates have dropped and capital has become even cheaper than what it was before the crisis began.[15] Consequently, parallel to the economic crisis a political one is rapidly brewing and the combination of the two has led to an existential dilemma for Europe as a whole, the severity of which would have been inconceivable only a few years ago.

In sum, what began as a sovereign debt crisis in a few small euro-economies before threatening the monetary union, has now questioned the sustainability of the European integration process as a whole. Given the consequences of failure, European leaders should be able to preserve their euro and their Europe. But, euro-mandated austerity has poisoned the pro-European sympathies of Europe's south and has questioned the old contract upon which north-south cooperation and integration rested. Unless this contract, which provided

15. According to *The Wall Street Journal* "Investors agreed to pay the German government for the privilege of lending it money. In an auction Monday, Germany sold €3.9 billion ($4.96 billion) of six-month bills that had an average yield of negative 0.0122%, the first time on record that yields at a German debt auction moved into negative territory. This means that unlike most other short-term sovereign debt, in which investors expect to be repaid more than they lend, investors agreed to be paid slightly less. And they are willing to do that because they are so worried about the potential for big losses elsewhere.", "German Yields South of Zero," January 10, 2012.

for the convergence of the south with the north and the curtailing of German hegemony over Europe, is restored, it will be difficult for Europeans to lend their support to "more" Europe in the future.

# THE SINGLE CURRENCY TEN YEARS ON: TROUBLE AHEAD?

*Laurent Jacque*

The euro is celebrating its 10th birthday in upbeat mood. But the single currency has failed to deliver significant benefits to the countries that signed up for it. Whether it can survive, unscathed, the crisis engulfing it and whether it can survive, unscathed, the crisis engulfing the global economy, are open questions.

Will the tsunami devastating the global financial system undermine the stability of the euro? Its advocates say not. Doomsday scenarios of a partial break-up of the eurozone have, as yet, failed to materialize. They argue that over the past 10 years the eurozone has become a haven of peace and stability, giving the second world economy a stable currency. In January, the Eurozone acquired its 16th member, Slovakia. And even the eurosceptics (Denmark, Sweden, and the United Kingdom) who snubbed the launch of the single currency in 1999 are having second thoughts: the Danish krone may join shortly.

The fiercely independent European Central Bank (ECB) has single-handedly reined in the growth of money supply, bringing inflation down to approximately 2%. Average nominal interest rates have stabilized at around 2.5%, while real interest rates are at their lowest since the 1960s. And the abolition of 15 national currencies eliminated exchange risks[1]

1. Risks due to exchange rate fluctuations. Prior to the creation of the euro, investors would routinely speculate against the franc, lire or pound. In September 1992, George Soros successfully speculated

and transaction costs, galvanizing intra-eurozone trade and investment, which now form a third of its GNP. In 2008 the euro reached its highest value against the dollar as the pound collapsed and Iceland went bankrupt. Reassuringly for those in the eurozone, the euro is emerging as an alternative to the mighty US dollar: today it accounts for more than a quarter of all central banks' foreign exchange reserves and has become the currency of choice, ahead of the US dollar, for all international bond issues. As ECB chairman Jean-Claude Trichet said cheerfully: "We are contributing every single day to an ever-higher level of prosperity and we are therefore playing a critical role in the unification of Europe".[2]

For all these glittering achievements, there are signs of malaise. During the last decade the eurozone's economic growth was sluggish, unemployment continued stubbornly high and many EU members' budgetary deficit exceeded the 3% GDP ceiling mandated by the Growth and Stabilization Pact. By contrast, the eurosceptics had far lower rates of unemployment (half the eurozone average), higher growth rates and very low budget deficits (if not surpluses). The euro has failed to deliver any significant benefits to eurozone countries, mainly because of structural economic problems for which the euro was never meant to be the panacea. Even so, hopes of reduced unemployment or higher economic growth have not come true. So could the euro be partly responsible for the vicissitudes of the last decade? And will it survive unscathed the crisis engulfing the global economy?

The launch of the euro in 1999 was a politically motivated event which never met the acid test of what economists call an "optimal currency area". A group of countries (or regions) is deemed to constitute an optimal currency area when their economies are closely interwoven by trade in goods and services, and characterized by mobility of capital and labor. The United States is the longest surviving and most successful example of a well-functioning currency area. Is the European Union also an optimal currency area? Intra-EU trade hovers at around 15% of the eurozone's GNP – significant, but con-

against the pound as the United Kingdom abandoned the European Monetary System.

2. Interview in Die Zeit, Hamburg, 23 July 2007.

siderably lower than in the US. While footloose capital is increasingly the EU norm, labor mobility across Europe is only a fraction of what it is in the US and remains very low within each of its national economies.

Ignoring these problems, the EU launched the euro in 1999 and created a single monetary policy, establishing a central bank and depriving each country of two (out of three) critical policy instruments: an independent monetary policy to tame inflation or spur growth through interest rate adjustments and a flexible exchange rate to keep its economy competitive. Furthermore, fiscal policy –the third critical instrument– is sharply constrained by the Growth and Stabilization Pact which caps the budget deficit for each country at 3% of GDP. National debt should not exceed 60% of GDP, with notable exceptions such as Italy and Greece, which breached the ceiling at 104% and 95% of their GDP respectively. Structural and cyclical differences between individual EU members are clear; so the eurozone's reduced economic policy deftness is of particular concern in the event that one member country suffers an economic shock that does not affect the rest.

*Conditions not met*

If the eurozone was really an optimal currency area, a country in trouble would be able to adjust through the mobility of its labor force within the rest of the eurozone, the flexibility of wages and prices, and/or a budgetary transfer from Brussels to help it out. None of these conditions were met when the euro was first launched, nor is there any sign that member countries are putting in motion structural reforms to bring the eurozone any closer to becoming an optimal currency area. The third condition – which is easier to meet – calls for a hefty dose of "fiscal federalism" and would transfer significant taxing and spending power away from national governments to the EU. This transfer remains elusive for fear of further diluting national sovereignty. Indeed the EU – which itself has limited taxing power (no more than 1.27% of GNP) – cannot make stabilizing fiscal transfers to smooth out national shocks. The brunt of the responsibility for fiscal policy remains in the hands of national governments, with Brussels accounting for less than 3% of eurozone government expenditures. This stands in stark contrast to the United States where more than 60% of government expenditures occur at the federal level. The US also has high labor mobility and greater wage flexibility than Europe. Even Germany's reunification, which joined east and west in a single mark in 1991, hardly created an optimal D-mark zone: in spite of fiscal transfer in excess of †200bn over a 10-year period, unemployment remained stubbornly high (close to 20%) in East Germany.

*Two 'asymmetrical' shocks*

In its first 10 years the eurozone has experienced at least two main "asymmetrical" shocks which did not impact all its members uniformly: the overvalued dollar from 1999-2002 and the oil shock from 2005-2008. In the case of the US dollar, those eurozone countries dependent on international trade have experienced faster imports-induced inflation than those oriented to Eurozone trade. Ireland – more of an international than a European trader – experienced inflation at the rate of 4.1% over the 1999-2002 period, whereas Germany – more of a European than an international trader – remained in the slow inflation lane at 1.2% over that same period. Similarly, the quadrupling of the price of crude oil is impacting on national rates of economic growth and inflation more or less in proportion to their dependence on oil. France, with its lower dependence on oil (35% of its energy supply because of its high dependence on nuclear power), is less affected than Greece, Ireland, Italy, Portugal or Spain, which rely on oil for more than 55% of their energy supply.

The combination of centralized monetary policy and decentralized fiscal policy is resulting in localized differences in inflation which are affecting the euro's purchasing power in each eurozone country. Under a national exchange rate, this is easily corrected through monetary policy and "competitive" depreciation/appreciation of the national currency. But this is no longer a possibility: the straightjacket of the euro killed the exchange rate policy instrument and froze monetary policy at the national level. Because of this inability to respond flexibly to inflation, the purchasing power of the euro is rapidly eroding in several countries.

*Problem of overvaluation*

On the basis of labor cost indices in Italy and Germany over the period 1 January 1999 to 30 September 2008, the euro in Italy is overvalued by 41% against the euro in Germany, and Spain and Greece are not far behind. Unless countries suffering from overvaluation can correct the problem through faster gains in productivity and/or wage and price downward flexibility, the problem is not reversible. More importantly, overvaluation is a cumulative process which becomes harder to correct over time. In this vein, the latest round of EU enlargement may – to a limited extent – bring about some price and wage downward flexibility to the eurozone as firms can make increasingly credible threats to outsource from or to relocate manufacturing operations to Eastern Europe to take advantage of cheaper labor.

To make matters worse, EU countries cling to their own electoral calendars for presidential, parliamentary or municipal elections. This exacerbates cyclical discrepancies across the eurozone: the run-up to an election is often accompanied by expansionary fiscal policy. As the world economy digs itself in a deeper hole, the main economic policy goal is becoming to combat the relentless rise of unemployment, which could rapidly reach 10-12%. Spain's unemployment has already skyrocketed to 13% in the last six months. But fighting unemployment will result in massive budget deficits, which will unravel the Stabilization Pact and jeopardize the stability of the single currency. Stimulus plans that are being implemented are blowing big holes in the deficit ceiling set at 3% of GDP, pushing national debts way beyond the threshold of 60% of GDP and raising new threats to the independence of the ECB.

Under duress, and facing the bleak prospect of a prolonged economic crisis and deepening structural unemployment, some countries may be tempted to follow the example of the brutal devaluation of the pound. Greece, Italy, Portugal and Spain (whose unemployment often exceeded 10% in the last decade) will not agree to remain "under-competitive" because of the "over-valuation" of the euro. However traumatic it may be to reinstate national currencies, some countries could decide to abandon the euro to recover their economic competitiveness. This scenario is reminiscent of the major currency crises that rocked the Bretton Woods system of fixed exchange rates between 1944 and 1971, and more recently the European Monetary System from 1979-99.[3] But this is unlikely in the short term, if only because national debts denominated in euros would become very expensive to service with a newly restored but devalued currency for the seceding country. Even so, further deterioration of an already fragile social climate (such as the recent demonstrations in Greece) fuelled by a brutal acceleration of unemployment, may push some countries to this solution of last resort.

3. The European Monetary System was established in 1979 and aimed at stabilizing exchange rates among European currencies, in effect reenacting on a European scale the Bretton Woods system of pegged exchange rates. Each currency was pegged to an artificial currency unit known as the ecu, the predecessor of the euro.

# CHALLENGES IN THE EUROZONE

*Eleni Louri*

The financial crisis that first manifested itself in 2007-2008 with problems of non-performing loans in what might have been thought of as a corner of the US mortgage market, the sub-prime market, quickly took on the character of the worst financial crisis that the world economy had seen since the Great Depression. By the beginning of 2010, following swift action by governments and central banks, it appeared that the worst was over. Economies were beginning to come out of recession; banks were returning to business as normal.

Monetary policy, in particular, contributed positively to countering the worst consequences of financial crisis. Interest rates in the eurozone were kept at historically low levels, in line with the mandate of the European Central Bank to keep inflation below, but close to 2% over the medium term. In addition, nonstandard measures were employed to restore the functioning of the monetary transmission mechanism – to ensure that the monetary policy stance was indeed transmitted at all maturities and to all financial markets.

In the eurozone, however, a new crisis was brewing. Markets, still scarred by their experiences from the consequences of over-leveraged banks and poor risk management in the financial sector, turned their attention to the state of sovereign finances in Europe, and, at least initially, Greece. Greek sovereign spreads, which in the mid-2000s had converged to within 10-20 basis points of those on the German Bund, rose sharply, causing the interest rate at which the Greek sovereign had to borrow to rise to levels which put debt sustainability in question. Now we have come full circle. The sovereign crisis has spread beyond Greece not only to other peripheral countries, but also to core European countries such as Italy and Belgium. This new crisis has in turn raised questions about the stability of the European banking system.

Worse still, fundamental questions are now being asked about the ability of the eurozone to survive, at least in its present form. It is important to recognise that the prevailing situation in the eurozone is a combination of both a sovereign crisis and a banking crisis. In some countries, it was the initial banking crisis back in 2008 which has subsequently led to a sovereign crisis as governments were forced to intervene to protect their financial systems; in others, it is a sovereign crisis which has led to a banking crisis stemming from the sharp fall in the value of government debt and the prospect of haircuts and, even, defaults. I believe that the way out of this crisis requires action on two levels. First, there is the immediate problem created by the sovereign-banking crisis. Second, there need to be some fundamental changes to the rules that accompany monetary union.

Let me deal briefly with each in turn. The immediate situation calls, first, for a strengthening of European banks and, second, for continued efforts in countries with high deficits and/or debt to press on with fiscal consolidation. The ECB and the National Central Banks of the eurozone have warned repeatedly about the dangers of the crisis spreading. To this end, any solution for the Greek problem must avoid a credit situation. This implies that the involvement of the private sector in debt write-downs should be voluntary. It also implies the need for some means of credit enhancement for Greek bonds if they are still to be acceptable as collateral in eurosystem refinancing operations. In the 21 July 2011 decision, where the extent of private sector involvement took the form of a loss to banks on Greek debt of 21%, these two conditions – voluntarism and credit enhancement – were met. These would have ensured continued access by Greek banks to eurosystem funding using the enhanced Greek bonds as collateral. At the same time, the decision was taken to allow the European Financial Stability Fund to provide funds, via governments, to recapitalise banks if necessary.

The 26 October 2011 agreement envisages a much greater private sector involvement (approximately €100 billion), while at the same time, the official contribution has risen from €109 billion to €130 billion. Credit enhancement remains as does the possibility to recapitalize European banks through the European Financial Stability Fund. The goal is a debt/GDP ratio for Greece in 2020 of 120%. This, according to IMF projections, compares to an expected debt/GDP ratio of around 150% if private sector involvement were not to take place. In short, private sector involvement is expected to reduce Greece's debt/GDP ratio by some 30 percentage points. This reduction, combined with continued fiscal consolidation, will deliver stable debt dynamics. Over the longer term, however, the rules of the game that accompany monetary union need modifying.

Central banks in the eurozone, including the ECB, have always attached great importance to the need for governments to respect the Stability and Growth Pact. It cannot be said that the Pact was respected in the first 10 years of monetary union – deficits of greater than 3% were not uncommon and went uncorrected; countries with high debt-to-GDP ratios did not reduce those ratios at a satisfactory rate towards 60%.

These observations suggest the need for stronger fiscal surveillance, both by eurozone countries of each other and by the Commission, and the adoption of immediate corrective measures in the event of the rules being broken. The so-called six-pack of measures agreed upon in early October 2011 along with the European Semester aim at strengthening economic governance in the eurozone, particularly in the area of fiscal policy. But it is not just in the area of fiscal deficits where surveillance and corrective actions are necessary. Current account deficits within the eurozone also tended to diverge in the first 10 years of monetary union. This observation suggests the need for surveillance of competitiveness and imbalances within the eurozone. Indeed, to prevent the build-up of imbalances in the future, the Commission and the European Council have now adopted a framework for monitoring imbalances and ensuring corrective action is taken (the Euro Plus Pact). This new initiative should be welcomed if the success of monetary union is to be secured going forward.

Personally, I am optimistic about the success of the eurozone. I strongly believe that it can overcome its current difficulties. History would support such optimism. Steps towards further European economic and political integration have, historically, been prompted by significant events. The most recent example is, perhaps, the crisis in the Exchange Rate Mechanism in 1992 and 1993. The effective breakdown of this mechanism led to a sense of urgency and many believed it provided the impetus to move towards monetary union and speed up the implementation of the stages envisaged in the Maastricht Treaty. Thus, in conclusion, there are strong reasons to believe that the latest challenges for the eurozone are likely to prompt progress towards even further integration.

# POLICY CHALLENGES AND THE OCTOBER 26TH EU SUMMIT: AN ASSESSMENT

*Lucas Papademos*

It is a great pleasure and privilege for me to participate in this workshop. Constantine Karamanlis was a great Greek and European political leader who was instrumental in securing the accession of Greece to the European Union 30 years ago.

Today, 30 years on, the European Union, in particular the eurozone countries and even more specifically, Greece, are facing formidable challenges in the context of the ongoing debt crisis. The debt crisis in Europe, as you know, and as we said earlier in the previous session has really deepened and spread over the last six to ten months and policy makers and commentators on both sides of the Atlantic have underscored the financial stability risks associated with this crisis not only for Europe but also for the global financial system; as well as for the potential implications for the performance of the global economy. Now, we are in the middle of a very serious crisis both for Greece as well as for the eurozone. And as you know, two days ago the EU and eurozone leaders reached an agreement on a new package of measures which aims on one hand to resolve the crisis and second, to try to mitigate its effects on the banking system and the real economy. Now, the package of these measures - it has actually been called by some the 'globuster' package – involves, on one hand, a deal in order to reduce the sovereign debt of Greece and to improve the debts and stability for the country and on the other hand involves a number of important measures to strengthen the firepower of the eurozone bailout fund as well as to enhance the capital of the largest European banks in order to cushion the impact of the crisis and contain the effects on credit expansion and the real economy.

I will try, if possible, to touch upon three topics. First, I would like to outline what I see as the five main policy challenges in order to resolve the crisis. I will focus partly on Greece but also on eurozone systemic issues. Second, I would like to provide a brief assessment of the recent conclusions of the eurozone summit, and third, I will touch upon similar issues on what more has to be done in order to be able to resolve the crisis once and for all and try to establish an environment that will prevent the recurrence of deficits like this one in the future.

The five policy challenges that I have identified very much relate to one and considered and described as the five main characteristics of the eurozone debt crisis as it has evolved over the past ten months, for this crisis which was erupted almost two years ago has evolved over time. First, there is a continuous and rising pressure in the sovereign bond markets that has adversely affected bank's liquidity as well the capital position. As a result they are affecting credit expansion and economic activity. Second, since the summer, specifically, cross-border financial contagion has significantly increased and indeed contagion risks materialized significantly and now have affected not only the countries under programs, but also some of the large core countries, notably Italy and Spain. Third, is that the credit growth has continued to decelerate in the eurozone countries and indeed, in some countries the outstanding amount of credit is declining. So credit growth is negative and this is partly due to the decline in credit demand but it's also due to factors that affect the supply of credit by firms as a result of the interactions between sovereign debt markets and the banking systems and the real economy. I have no time to describe this today but there are various adverse feedback groups among the real economy, the capital markets and the banking system that are reinforcing each other and are affecting the situation both in the banking system and in the real economy. As a result of the previous observations, the fifth characteristic is that economic activity in a number of eurozone countries and in the eurozone as a whole has weakened more than previously anticipated and this is not only a consequence of the implementation of the fiscal consolidation programs in a number of countries that by now include Italy and Spain, account for almost 50% of the eurozone GDP, but is also the result of the influence of the impact of the previous factors on market evaluations and credit availability and confidence. And finally, the last feature is that the enhanced uncertainty both about the economic outlook as well as about the conditions of banks has really affected greatly confidence, both public confidence and market confidence, with consequently negative effects on economic activity.

If these are the five characteristics of the present face of the crisis then the challenges we are facing are: first, to eliminate or at least to mitigate the spillover effects from sovereign bond markets on the banks and the adverse feedback between them - so as to force the credit growth to the private sector and therefore to support the recovery of the economy; second, how to contain cross-border financial contagion. Important steps have been taken not only during the last summit but also in the July 2011 EU summit when at the time the leaders decided to expand the scope of the activities of the EFSF so that it can provide also precautionary funding to countries and banks and also intervene in the bond markets. However, at the time they did not enhance the resources of the ESFF and, therefore, these decisions were not particularly convincing to the markets; third, a challenge which I think in some sense is the most important and most difficult to address and which is relevant for many eurozone countries at present, how to combine the policies of fiscal consolidation in order to contain debt with reforms and other growth enhancing measures so that the adverse effects of fiscal consolidation and aggregate demand can be, if not offset, at least mitigated by policies that would enhance competitiveness and increase the productive capacity of the economies. I find this particularly important not only because obviously for fiscal consolidation purposes it is essential to enhance growth, but if growth is not enhanced social tensions and political difficulties are going to mount.

Two more challenges, that are more specific to Greece, are how to address the implementation gaps and delays. The implementation gaps and delays have increased in 2011 – after, I would say, a rather impressive start in the implementation of the program in 2010 - and this is due to a variety of factors, mainly, the inadequate capacity of the public administration to implement and the limited willingness of political authorities to guide the public administration to introduce the reforms and implement the appropriate programs. In addition, I would say that the lack of political cohesion and political consensus concerning the program itself is also not contributing to the efficient implementation of the program and is also not helping strengthen confidence and mitigate social tensions.

The final challenge, again very specific to Greece, is how to address the sovereign debt problem because of the size of the Greek debt, the projected dynamics and the expectation for a number of years the access to the markets is not going to be favorable. In July 2011, the European leaders agreed on a package that had one element that has been actually quite de-emphasized in the press, but which is quite important in terms of improving the sustainability of public finances in Greece and this was a decision to reduce interest rates and extend the maturity of the loans, of the official loans, both of the existing facility and of the future facility. But, at the same time, there was this novel element to invite the private sector to be involved in the financing of the debt on the basis of a bond swap which according to the agreement in July 2011 would entail, roughly speaking, a 20% loss in the net presence value of the bonds to be swapped. In light of recent developments, economic and financial, and in light of new analysis about the dynamics of the debt, it was considered that this amount was inadequate. And this was changed during the summit.

This brings me to my next topic -what is the assessment of what it achieved. I am bit more optimistic in assessing the outcome of this last summit of the European Union and eurozone leaders although it was agreed that a lot of work remains to be done in the coming weeks in order to provide the necessary details that are required in order to implement the summit conclusions. But I think the package that was agreed upon by the leaders was comprehensive and ambitious, it has many components including some that relate to the improvement of the economic governance of the union but the core of it comprises of what can be called a three-pronged plan. First, to address Greece's debt problem and the future financing needs, second, to prevent financial contagion and third, to contain the effects of the debt crisis on the banking system. The results of the summit are quite encouraging with regard to addressing these challenges although the outcome will depend on the details and in the capacity of everyone to implement the decisions.

Now, let me say a few words about the agreement on the financing of the Greek debt. This has two elements. The first is that private investors have been invited to develop a "voluntary" bond exchange that will involve this time a haircut of 50% in the notional face value of the Greek debt held by the private sector. The amount of debt held by the private sector, is about 200 billion euro out of a total of 366 and although the precise parameters and features of the bond exchange have not been specified, a lot of work was done before and after the first summit, and on the basis of that work I think further details can be rather quickly elaborated, provided of course that the private sector will be ready to participate in this arrangement. If there is a high degree of participation which is expected, then the Greek sovereign debt is going to decline by about 70 billion which is about 20% of the total if we take into account the cost of recapitalizing banks and supporting the pension funds which partly offsets the debt reduction and the debt relief that has been agreed. But there is a second element of the package, and the second element of the package is a commitment of the official sector to provide an additional 130 billion euro support until 2014 which includes 30 billion in order to support the credit enhancement of some sort the PSI package and also includes a certain amount of funds that will be used in order to recapitalize Greek banks.

On the whole, I think this agreement is positive. However, I agree that details still have to be finalized and what is quite important, and which we will see in the next few days in order to judge the overall consequences of the agreement, is how the rating agencies and the relevant fora will assess the voluntary nature of the bond exchange with the haircut of about 50%. I think the second part of the agreement, which is quite important, is what is called in general terms "the strengthening of the firepower of the EFSF." Although all details have not been specified I think it is a rather ingenious proposal that includes two options. The first option involves the guarantee of bond losses rather than the buying of sovereign debt outright. And this option will leverage the resources of the EFSF and provide credit enhancement to new debt to be issued by countries. It does reduce the funding costs. This is one channel through which EFSF firepower is enhanced. The second option is more traditional, it is the creation of a special fund which would be partly financed by EFSF, but would also be financed by emerging market economies that would provide actual resources to the EFSF in order to buy bonds and provide support to banks. Details have not been given on how much the resources of the EFSF will be increased. It would depend on a number of factors and I agree that it is important that these details are elaborated very quickly in the coming weeks but official shareholders have said that they estimated that the firepower of the EFSF will increase from 440 billion euro to more than 1000 billion euro. It sounds better in dollars; it's $1.4 trillion on the basis of the funding that will be provided through these options. And finally, the other part of the package which is strengthening the capital of banks, I think it's also essential, although so far the leaders have not provided information on the sources of funding for achieving the recapitalization of banks.

Overall, my assessment is rather positive. I think once again the European leaders showed that they are ready "to do what is necessary in order to safeguard financial stability in the eurozone" and to support the credibility of the euro, but, needless to say, further work is necessary in order to complete the details in an efficient and timely manner.

What about the future? As I already mentioned it is important both for resolving the crisis and preventing future crises in the future that we would welcome a strengthening of economic governance in the eurozone. And there is the so-called six-pack of legislative actions, which aims at improving economic surveillance, strengthening the Stability and Growth Pact, both its prevention arm and also its arm relevant to enforcing deviations of fiscal policies from guidelines and recommendations. I think on the whole this is going to be an important step towards strengthening the economic governance in the European Union. But, I do not think this is going to be sufficient. It will improve the effectiveness of economic governance, but will not be sufficient to resolve the inherent tensions in the current structure of the European and monetary union. And I think it was conceptually clear before the launch of monetary union that the economic policy framework and the institutional foundation of EMU was not complete, it was not appropriate and eventually it would have to be reinforced and complete.

I think we have to go one step further, which is a very difficult step, but I would like to simply say that there is need for a quantum leap towards a higher degree of economic and fiscal integration in the eurozone. This leap need not be quantitatively large. It need not imply a fiscal union or an economic union. This would not be realistic and it would not be acceptable by a number of countries. But it could be a leap which is qualitatively significantly and meaningful and which will help to impose a greater degree of integration of fiscal policies. It would also help in order to lead to a greater degree of centralization of regulatory and supervisory policies as well as of resolution regimes and third, I think it should have an additional non-European element. I think it should also be national. I think it would have to impose, to improve, to create, more credible fiscal frameworks in individual countries so as to contain future buildup of fiscal imbalances.

I realize that these concepts might sound quite vague, but I can tell you that they are very much in the minds of policymakers who are responsible for the next steps to be taken. If the choice is to face a disintegration of the eurozone and to move in the direction of greater economic and financial integration, and although we are at a very crucial juncture at this point and time, my reading is that the eurozone leaders are going to opt towards completing and reinforcing the framework of economic and monetary union by strengthening the economic pillar of the EU.

# GREECE, THE EUROZONE, AND THE DEBT CRISIS

*Yannis Ioannides*

## *Introduction*

The central cause of the Greek crisis is the decline in competitiveness that Greece suffered ever since its accession to the Monetary Union its adoption of the euro since 2001. It is perhaps harder to see that because of the Greek economy's growth performance since the mid-1990s and up till the emergence of the Great Recession of 2007. But Greek economic growth was simply not sustainable, because Greece lacked (and failed to develop) the institutions needed to sustain growth, namely improvements in education and investment in research and development and massive investments in infrastructure. Its legal system is archaic and does not provide incentives for foreign investment and indeed for all economic activity [Papaioannou (2011)].

Monopolistic structures, oligarchic labor relations favoring certain groups of the labor force, and the lack of any deliberate effort to contain costs and implement structural reforms have led to a rapid increase in unit labor costs, making Greece's manufacturing industry one of the most expensive in the European Union. See Figures 2 and 3. This growth of nominal unit labor costs began in 2001 and continued to 2010, but the forecasts for the period 2011-2012 do show a negative growth which is well below the respective one for the eurozone. The contemporary view on growth emphasizes the central importance of total factor productivity growth, namely growth of the economy over and above what can be explained by the growth of the measured inputs. Table 1 compares GDP growth and total factor productivity growth (TFPG) for Greece, Portugal, Ireland, and Italy. While TFFG for Greece lags behind that for Ireland, it outperforms Portugal and Italy, during 1995-2003, but it lags behind of all these countries over the 1986-1995 period.

### *Greek overconsumption during 2001-2008*

European interest rates both declined during the first decade of the 21st century, following the introduction of the euro, and converged to during that same period. These dramatic outcomes are shown in Figures 4 and 5, respectively. The Greek government took advantage of those historically low interest rates to borrow in order to finance transfer payments, pensions, and a bloated public sector. As Figure 5 demonstrates, although spreads shrunk considerably, they did allow banks to borrow at German interest rates and lend at a profit to such peripheral EU countries as Greece, Spain, and Ireland.

That this has been associated with overconsumption is clear in Figure 6. The larger the private and public consumption on average is, over 2001-08, as a share of GDP, the larger is the current account deficit. Interestingly, while Greece and Portugal are “bad” outliers, Ireland is a “good” outlier.

What emerges from these developments is that The EU North was saving more than the EU South. More specifically, Greece having been an exceptional saver in the early 1970s, became the greatest dissaver by 2009 (see Figure 7). Ireland, on the other hand, improved its saving performance from the late 1980s, when it was considered a problematic economy, to the late 2000s, when it was the star performer.

It clearly appears to be a solid feature of the eurozone that the capital-rich North is lending to the capital-poor South. The key question here is whether this is inevitable. The present writer believes that it is not and cites the example of Finland, whose economy was comparable to the EU South until the last quarter of the 20th century. If the EU South had developed, it would be running trade surpluses from selling to the North, which is definitely true of Finland

and Ireland prior to the onset of its crisis - a crisis that is very different from that of Greece and Portugal. This contrasts with an argument, frequently presented, that the North retains its first-mover advantage. Yet, trading relations depend on comparative advantage, a very powerful economic force: all a country needs is to be relatively better, relatively more efficient in certain activities. Of course, this is necessary but not sufficient. Economic geography has taught us that clustering of activities is also very important.

### *Greek public sector deficits and debt*

The current condition of the extreme indebtedness of the Greek economy has not developed overnight. A steady increase in deficits (see Figure 8), which were run by the two PASOK governments of the 1980s and hit a peak of 15% in 1990, contributed to an increase of gross debt as a share of GDP from 20% in 1981 to nearly 100%, by the time PASOK returned to power in 1993. From then on and in spite of some effort by successive Greek governments to meet the Maastricht criteria for the deficit and the debt, Greece did not succeed. It was always the most problematic among the EU members aspiring to accession to the EMU.

An analysis of the cumulative debt over 1990-2009 by Moutos and Tsitsikas (2010) shows that nearly two-thirds of it were associated with new obligations by the Greek government, such as assumption of losses and debt of public corporations, Olympic Games spending, social spending. That is, mostly public consumption, and not investment. This is also confirmed by Figure 9, that shows the cyclical component to be very small and of vanishing influence. Overall, as Figure 10 shows, a considerable portion of the debt is held by Greek banks. Specifically, as of mid-Fall of 2011, of a total of 366 Billion Euro, the EU countries and the IMF held 78 Billion, the European Central Bank 62 Billion, and the remainder was held by the private sector, 202 Billion. Of this, Greek banks own about 50 Billion, Greek pension funds about 30 billion, and Greek insurance companies about 4 billion. This underscores the urgent need to recapitalize Greek financial institutions, too, if debt renegotiations currently under way result in a substantial haircut."

*What went wrong since the May 2010 agreement with the Troika?*

As evidenced by the Troika's latest report (October 2011), reforms stalled and the Greek economy is in deep recession. What we can say about the program design and outcome is that major rigidities and dysfunctionalities (economic and political) in the Greek economy we ignored and/or neglected. The population never took *ownership* of the program. Then, expectations collapsed, investment and private initiative collapsed, and the Greek economy has experienced a decline in national income of nearly 20% over three years since the beginning of 2009.

The numerous inflexibilities and dysfunctionalities of the Greek economy and society are all factors that prevent smooth adjustment to a lower price and wage level, and their role was not properly anticipated. Note that decline of wages does not leave workers worse off if prices are simultaneously declining. But things cannot always be so uneventful. Many individuals and firms face financial obligations that are nominally fixed, in which case reduction of nominal incomes would force some people into severe financial distress.

The Troika has also operated under the assumption that fiscal consolidation is compatible with economic growth, precisely because it may encourage investment. Still, a recent very careful study conducted by IMF economists show that a 1% of GDP fiscal consolidation reduces real private consumption by 0.75% within two years, while real GDP declines by 0.62%. In particular, even large spending-based fiscal retrenchments are contractionary, as are fiscal consolidations occurring in economies with a high perceived sovereign default risk. So, it looks as though the IMF is finding out that the solution was not well researched. Years of neglect of long-overdue investments activities promoting education and research, that are badly needed to prepare Greece's labor force for a competitive world economy, are taking their toll.

*How to move forward?*

The only way forward is vast reduction of the wasteful and bloated Greek public sector coupled with dramatic new measures to restore confidence and improve competitiveness. According to Azariadis, Ioannides and Pissarides (2010; 2011), confidence can be restored internally and externally, only if things are done in Greece that have never been done before. This also agrees with numerous public pronouncements by officials of the European Commission and the IMF, and to an encouraging extent with part of Greek public opinion, as well. But we all acknowledge that even with the internal devaluation as forseen in the stabilization program , it will take a long time and very high growth rates for the Greek economy to recover. The debt burden is enormous. The original lending programs included punitively high interest rates, a fact that has been recognized in the latest round of agreements. Specifically, in the October 2011 agreement, the central focus is t to secure the decline of the Greek debt to GDP ratio with an objective of reaching 120% by 2020. "Eurozone Member States will contribute . . . up to 30 billion euro. The nominal discount will be 50% on notional Greek debt held by private investors. . . . . A new EU-IMF multiannual program financing up to 100 billion euro . . . accompanied by a strengthening of the mechanisms for the monitoring of implementation of the reforms. . . .A significant strengthening of economic and fiscal coordination and surveillance. . . .A set of very specific measures, going beyond and above the recently adopted package on economic governance, will be put in place. . . . [and] Ten measures to improve the governance of the Eurozone."

This promising set of desiderata has been difficult to implement as of this writing [January 28, 2012], Greece and representatives of its creditors via the Institute of International Finance are locked in acrimonious negotiations, with support from the IMF and Eurozone government leaders arguing in favor of lower interest rates. Press reports suggest that the IMF favors official debt relief. And, a critical issue in the negotiations is whether or not the European Central Bank will also be required to incur a haircut. The latter possibility poses critical issues for the entire Eurozone, because a haircut of the magnitude being talked about would wipe out ECB's capital, prompting member governments to recapitalize it.

*Official debt relief is necessary*

I have argued, somewhat hesitantly originally but increasingly firmly more recently, that Greece will not be able to sustain a recovery without official debt relief. To see this, we need to go back to the early beginnings of European economic integration. Considering the broader political and historical context leads us to what was the burning question in 1945, how to avoid another world war. Questions like "Who was responsible for World War II" gave way to "How to avoid mistakes of the end of World War I." Many answers are possible, and it is not my subject, but among the solutions proposed were: (a) Morgenthau Plan "Neutered Germany"; (b) Communism; (c) European integration as a restraint on Germany. European economic integration, largely successful (except for the monetary part) by now, was not at all a certainty when it was first conceived in the late 1940s.

Yet, at the very foundation of European post World War II recovery and the very inception of European economic integration is a number of key financial decisions by the US, which completely reinitialized Europe's economies. After World War II, the US forgave French World War II debt, while Britain paid off its Lend/Lease debt to the US completely (and very expensively). In 1953 *all* of Germany's creditors forgave German debt. The US forgave German pre-World War II debt. The adjudication, if any, of Greek war reparations are shrouded in secrecy, but it looks like Greece did not press any claims after the reunification of Germany in 1990.

Writing in the *Guardian*, July 5, 2011, the eminent historian Mark Mazower argued that "the members of today's political class in Europe are Margaret Thatcher's heirs, not George Marshall's. . . . They find it hard to understand that the markets need to be saved from themselves if Europe is to survive in anything resembling its present form. . . . They forget that Germany itself was allowed to cancel its prewar debts in 1953, one of the preconditions for its subsequent boom. . . .Poland in 1991, [was] allowed to write down their debts . . . and they too prospered".

In effect, Mazower posed the need for a *New Marshall Plan* for Europe. The numbers are interesting. The original Marshall Plan amounted to USD13 billion, or roughly 5% of the US' 1948 GDP. This is to be contrasted with the fact that the total debt of Greece, Portugal, and Ireland is about 4.5% of the EU's GDP. In other words, in the same ballpark as the Marshall Plan! The Marshall Plan was of course a political project. Now, should EU peripheral country debt be written off? What are the intentions of European electorates? What should European electorates do?

Pressures for official relief also come from unexpectedly unwitting bedfellows." Former German Chancellor Helmut Schmidt has been reminding German audiences that the German *Wirtschfastwunder* became possible only because of the official debt relief. Nationalists and other groups in Greece are dusting off old claims for unpaid reparations. Under the title "Does Germany Owe Greece 70 Billion Euro?" *Die Welt*, September 17, 2011 argued in favor of this claim. It is clear that for a number of political and geopolitical reasons that are not fully known as of now - and are certainly not the expertise of the present writer - Greece seems to have neglected its claims of reparations from Germany, including the forced loans and requisitions of goods during the World War II Axis occupation of Greece.

Whether or not such claims might be officially sanctioned, the writer's opinion is that one way or another Germany will at the end provide substantial assistance to Greece, provided that Greece truly undertakes reforms which are necessary for its survival in the EU, let alone in the Eurozone.

### *What needs to be done*

The present writer believes that eurozone should do nothing unless Greece is placed under virtual receivership and be guided in its overhaul of its public sector. The Agreement of October 26-27, 2011 talks of "Monitoring Capacity on the ground," which presumably will be part of the new loan agreement, if indeed the different parties get that far. In addition, Greece needs to amend its constitution in order to facilitate thorough overhaul education and labor union law, shrink and rationalize public sector, and in the immediate future prosecute egregious embezzlers of public funds and other eliminate all kinds of corrupt practices. The latter had made Greece fall below African countries in terms of corruption, as reported by *Transparency International*. See Figure 11.

Recall that the US union works in part because of federal authority in prosecuting criminals and other transgressors. Rod Blagojevich, the former governor of Illinois, who is imprisoned for 14 years, has been convicted for merely hinting that he would have be rewarded for appointing a particular individual to succeed US Senator Obama after his election to the US Presidency. And, of course, unless growth starts, nothing will happen.

### *Azariadis, Ioannides, and Pissarides "17 Proposals"*

As originally published in *Kathimerini*, October 12, 2010, and is available in more detail at http://greekeconomistsforreform.com/wp-content/uploads/A-I-P-DEVELOPMENTw.-abs100610.pdf Azariadis, Ioannides, and Pissarides propose a number of quantified proposals which they think will allow Greece to escape its current predicament and launch itself on a path of sustained growth. They recall that in 1981, Greece, with a per capita income of 9,080 euro, was very comparable to Finland and Ireland, whose respective per capita incomes were 9,770 and 6,170. In 1994 Ireland surpassed Greece. Finland was at that time already ahead of Greece (in spite of Finland's "Great Depression," 1990-1994). In 2008 Greece stood at 29,290, Ireland at 37,440 and Finland at 37,820 euro per capita.

These accomplishments were made possible by the development of economic and social forces. Greece needs to emulate Finland, modernize its institutions, by improving education, health and research and development, and the rule of law, and thus become more competitive. The choice for Greece is between *virtue* and *vice.* A virtuous path will make Greece a Mediterranean Tiger. "Vice," on the other hand, will be underscored by poor public services, persistent tax evasion, inequality, poverty, social unrest, a political life ruled by an oligarchy of special interests associated with labor unions and numerous corrupt practices.

*Is this possible?*

However exotic a prospect this may appear at present, the present writer along with his collaborators Costas Azariadis and Christopher Pissarides and their other colleagues on GreekEconomistsforReform.com firmly believe that it is indeed possible. There are a number of favorable factors. Yes, there exists a huge public debt, but Greek households and firms are not overdebted. Private loans at only 110% GDP are small by EU standards. Private debt at only 81% GDP plus a lot of private wealth (that generally and scandalously evades taxes) is also notable. A Eurobank study shows internal devaluation would be most important for manufacturing and agriculture, and not to the same degree by the entire economy. These factors along with generous international assistance, plus some official debt relief, plus the implementation of real reforms can make it possible. In addition, the EU-wide austerity that Germany demands is clearly counterproductive for the following simple reasons that Paul Krugman has talked about repeatedly. Namely, the nature of the EU as an entity vis-à-vis the rest of the world makes it fairly closed economy. Consequently, there are no leakages in the implementation of fiscal policy, which would work to stimulate all EU economies, allowing them to reduce their dependence on increased taxes, which act as a drag. Austerity in Germany to avoid inflation has the effect of reducing imports from the South, which in turn reduces income in the South and thus reduces imports from Germany reducing income there. There is a vicious cycle through inherent fiscal interdependence of the EU countries. A little inflation in the North would have made it much easier for Greece, along with the right policies, to keep its unit labor costs growing more slowly than in the North.

*How about reform of the eurozone itself?*

The present author thinks that the problems facing European integration at the moment may not be resolved without political union. While even energetic pursuit of European integration would not yield immediate fruit, a number of design issues need attention. De Grauwe (2011) has drawn attention to an inherent design problem in the eurozone. With a national currency, when a country borrow in its own currency to carry out fiscal policy, experiencing loss of credibility leads to currency depreciation which improves competitiveness, while currency does not leave economy, and liquidity does not fall. In contrast, when a eurozone member borrows in effect it is like borrowing in a foreign currency: its borrowing costs (in euro) go up, but there is no improvement in competitiveness. A risk of a self-fulfilling prophecy appears: increasing interest rates, worsening deficits, taxes rise to close the deficit, income declines. The country is trapped in high-yield, low-borrowing area of its demand for borrowing. This entrapment is prevented only if there is assistance from the union without need to negotiate it in each case, and the markets know it.

Similarly, a fiscal federation works to stabilize the federated economies, by transferring income automatically between states when one is doing well and another badly. The US federal fiscal system provides automatic, mechanical transfer of income across its subeconomies, the economies of different states, and markets know it. Of course, a fiscal union requires substantial political integration.

Have European leaders recognized this? The Agreement October 26-27, 2011, No. 25. p. 7, states: “Being part of a monetary union has far reaching implications and implies a much closer coordination and surveillance to ensure stability and sustainability of the whole area. The current crisis shows the need to address this much more effectively. Therefore, while strengthening our crisis tools within the eurozone, we will make further progress in integrating economic and fiscal policies by reinforcing coordination, surveillance and discipline. We will develop the necessary policies to support the functioning of the single currency area". Unfortunately, this falls far short of endowing ECB with a mandate to act as lender of last resort and guarantor of financial stability, as well, not price stability. The new European Financial Stability Facility (EFSF) and its successor, the European Stabilization Mechanism (ESM) is regarded by many economists as a strange institution. Economists unhappy with the fundamental design of the EMU are still unhappy.

So without serious steps towards fiscal union the eurozone will fail. In addition, the EU institutions need real legal teeth." i.e.., the EU Court of Auditors must acquire real teeth, which necessitates changes in the treaties etc., which would criminalize certain activities at the EU level. EU members should not be allowed to get away with diverting funds. Investment means investment: governments should not get away with diverting their use of EU resources. In Greece, EU resources functioned like petrodollars in petroleum-rich countries, being diverted to consumption instead of investment.

## *Conclusion*

So, where are we? The Troika did not, it is now clear, anticipate such as a sharp contraction. What could have happened instead? If the government were to reduce deeply wasteful spending, it should at the same time have promoted small and large investments, either by shifting spending that it could afford to keep and/or by drawing on EU resources, by cutting red tape and giving sharp incentives to individuals, that have already been allocated to Greece. Social strife and party politics made it hard for the government to rationalize its activities and a highly politicized, unwieldy and inefficient government bureaucracy that continues to resist effort to shrink it did not help.

The world expected Greece to acknowledge the serious difficulties and tackle the crisis right away. As several of us have argued elsewhere repeatedly, the world needed to see things in Greece that have not been seen before, a new Greece, which itself would have helped boost confidence internally, as well. Egregious tax evasion going unpunished causes further erosion in the government's credibility as it tackles its deficit problem. Greece new prime minister is a breath of fresh air, at the top, and a steady force in favor of a rational approach to the enormous problems facing the country. Unfortunately, we are hardly seeing party politicking diminishing, which at this juncture is indeed toying with disaster by party bosses, hitherto essentially "unreconstructed" fanatics who fail to see how responsible they are for Greece's looming demise.

With the same fundamentals, meaning its people, its machines, its knowledge, its resources, an economy can move up, down or stay the same. If Greece had its own currency, manipulating the currency can provide a nudge, but unless expectations also move, changing the currency can end up in inflation, that would offset the effect, at the very minimum.

Greece does not control its currency, and as a result money must come into the country to pay for the difference between what we want to import and what we export, and for the government to finance the excess of its spending over its tax revenue. Confidence in the future and pursuit of productive investments is the only way to reduce those twin deficits in the long run, thus increasing income and thus tax revenue and by increasing exports more than imports. Even if we had our own currency, it would be worthless if we did not believe in its value. Greece's best option at the present juncture lies in making possible for it to stay in the Euro and thrive. It will be long and painful, but there really is there no other palatable alternative, politically and socially for Greece.

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## GDP Growth and Total Factor Productivity Growth: Greece, Portugal, Ireland, Italy

### Total Factor Productivity Growth

- Data from Antonakopoulos and Sakellaris, *Information Economics and Policy* 21 (2009) 171191.

GDP Growth rate versus TFP Growth, 1986–1995, 1996–2003
Greece, Portugal, Ireland, Italy

| | 86–95 GDP | 86–95 TFPG | 96–03 GDP | 96–03 TFPG |
|---|---|---|---|---|
| GR | 1.428 | -.136 , -.410 | 3.672 | 1.346 , 1.106 |
| PT | 2.985 | 1.489 | 2.525 | .395 |
| EI | 5.478 | 3.723 | 7.989 | 3.552 |
| IT | 1.827 | 0.806 | 1.549 | -.346 |

Table 1

## Growth Rates: Greece and EU-15

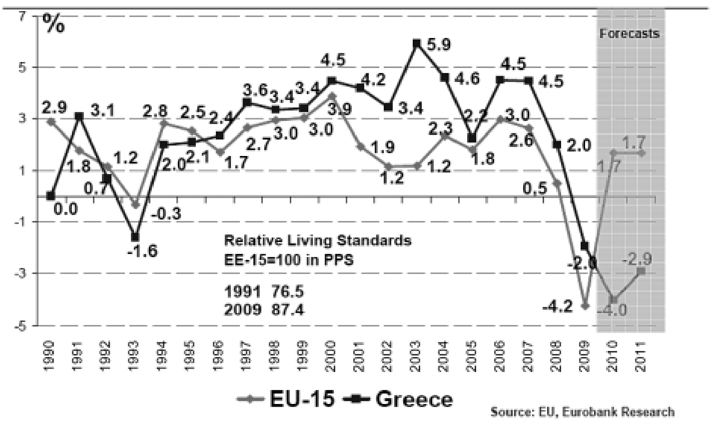
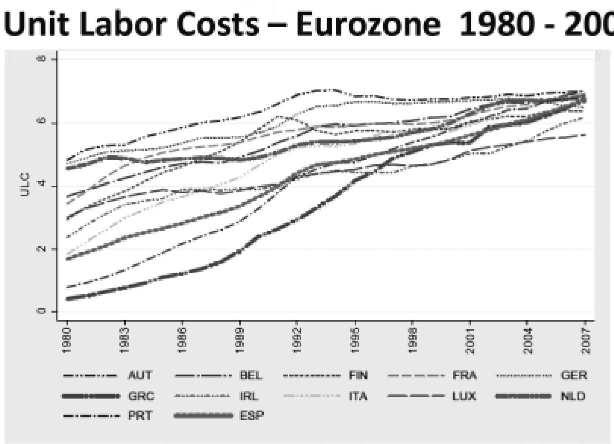
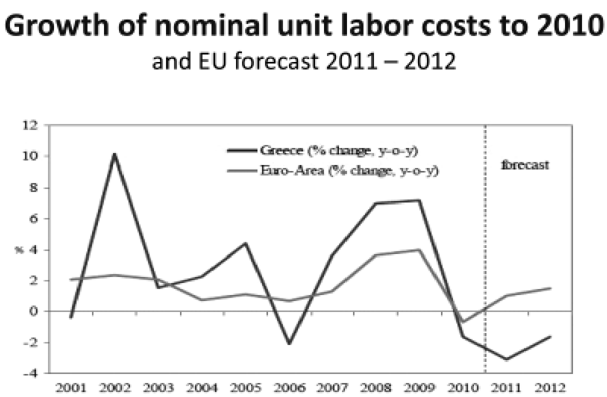



Figure 1




**Source:** OECD and authors' estimates
**Note:** AUT-Austria, BEL-Belgium, FIN-Finland, FRA-France, GER-Germany, GRC-Greece, ITA-Italy, LUX-Luxembourg, NLD-Netherlands, PRT-Portugal, ESP-Spain

Figure 2




*Source :* Commission services.

(% change year-on-year of unit labor costs)

Figure 3

## After 2001 the Eurozone brought low interest rates for Greece: 1998-2009


Figure 4

## Not just Greece: Euro-Zone 10-year bond yields 1992-2011

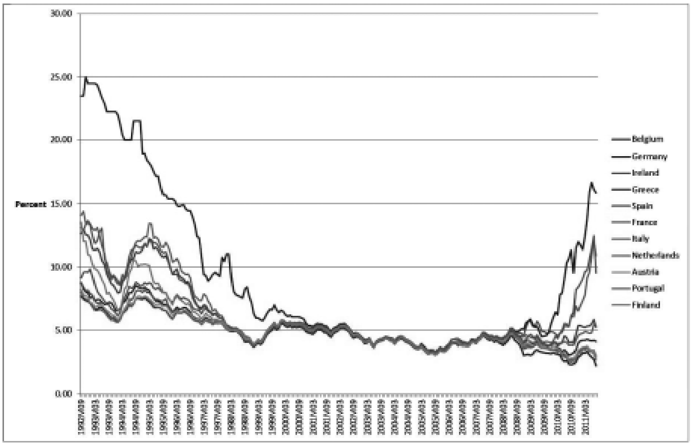
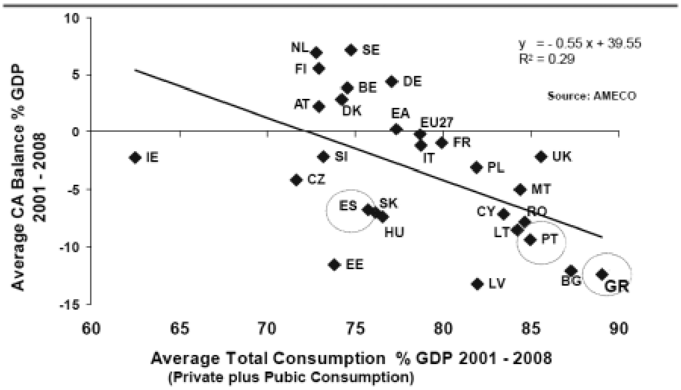



Figure 5

## Consumption and the Current Account Balance:

The EU North was saving more than the EU South

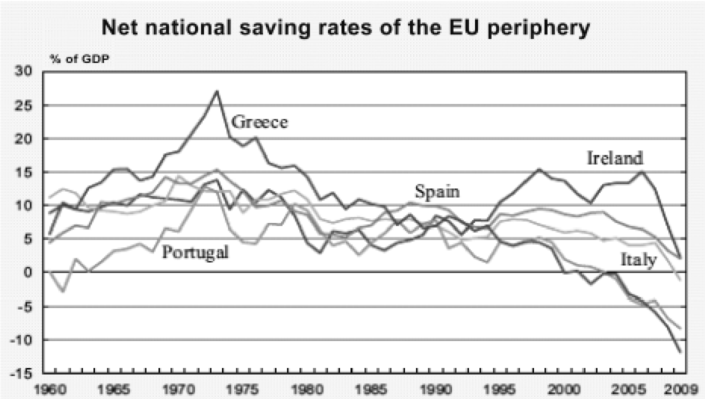



Gikas A. Hardouvelis

Figure 6

17

## Savings declined in the EU South – and particularly in Greece




Source: Ameco: Capital Formation and Saving, Total Economy and Sectors, Net-Saving, National (USNN), ec.europa.eu/economy_finance/ameco/user/serie/SelectSerie.cfm, data extracted on 11 January 2011; own calculations.

Figure 7

## Greek Deficits and Debt: 1974-2010

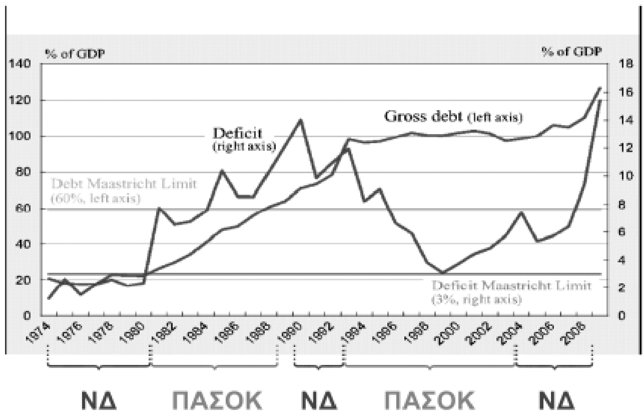
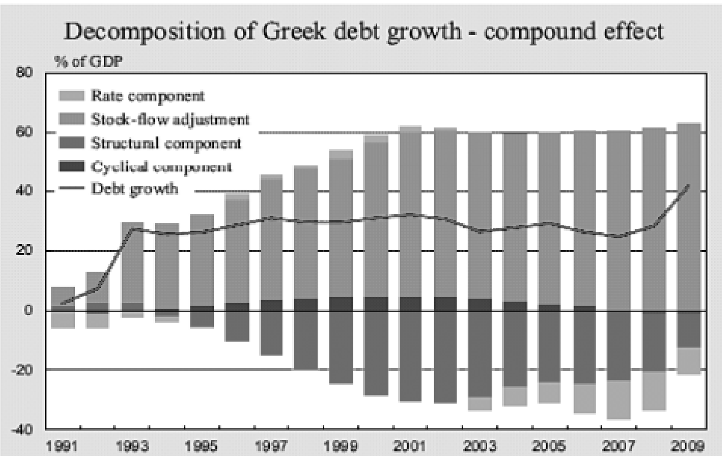


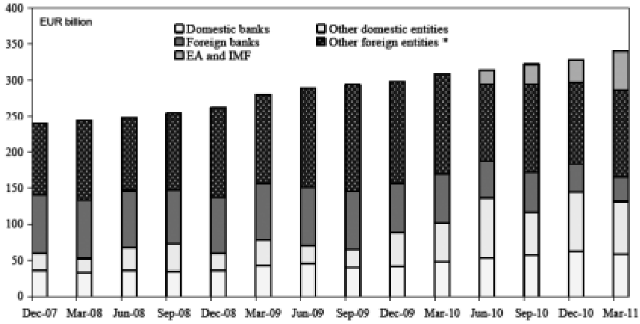

Figure 8

## What does increase in public debt reflect?
**1990–2009**




Source: Moutos and Tsitsikas (2010), p. 182.  Figure 9

## Who owns Greek Government Debt?




Note: "Other foreign entities" includes ECB.
*Source :* Commission services.

Figure 10

## Corruption: The Picture in 2010

(178 countries)

Source: Transparency International Annual Report, 2010

Very Clean: 9.0 - 10.0, 8.0 - 8.9, 7.0 - 7.9, 6.0 - 6.9, 5.0 - 5.9, 4.0 - 4.9, 3.0 - 3.9, 2.0 - 2.9, 1.0 - 1.9, 0.0 - 0.9 :Highly Corrupt; No data

| RANK | COUNTRY TERRITORY | SCORE | RANK | COUNTRY TERRITORY | SCORE | RANK | COUNTRY TERRITORY | SCORE | RANK | COUNTRY TERRITORY | SCORE |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 1 | Denmark | 9.3 | 24 | Uruguay | 6.9 | 46 | Macau | 5.0 | 69 | Cuba | 3.7 |
| 1 | New Zealand | 9.3 | 25 | France | 6.8 | 48 | Bahrain | 4.9 | 69 | Montenegro | 3.7 |
| 1 | Singapore | 9.3 | 26 | Estonia | 6.5 | 49 | Seychelles | 4.8 | 69 | Romania | 3.7 |
| 4 | Finland | 9.2 | 27 | Slovenia | 6.4 | 50 | Hungary | 4.7 | 73 | Bulgaria | 3.6 |
| 4 | Sweden | 9.2 | 28 | Cyprus | 6.3 | 50 | Jordan | 4.7 | 73 | El Salvador | 3.6 |
| 6 | Canada | 8.9 | 28 | United Arab Emirates | 6.3 | 50 | Saudi Arabia | 4.7 | 73 | Panama | 3.6 |
| 7 | Netherlands | 8.8 | 30 | Israel | 6.1 | 53 | Czech Republic | 4.6 | 73 | Trinidad and Tobago | 3.6 |
| 8 | Australia | 8.7 | 30 | Spain | 6.1 | 54 | Kuwait | 4.5 | 73 | Vanuatu | 3.6 |
| 8 | Switzerland | 8.7 | 32 | Portugal | 6.0 | 54 | South Africa | 4.5 | 78 | China | 3.5 |
| 10 | Norway | 8.6 | 33 | Botswana | 5.8 | 56 | Malaysia | 4.4 | 78 | Colombia | 3.5 |
| 11 | Iceland | 8.5 | 33 | Puerto Rico | 5.8 | 56 | Namibia | 4.4 | 78 | Greece | 3.5 |
| 11 | Luxembourg | 8.5 | 33 | Taiwan | 5.8 | 56 | Turkey | 4.4 | 78 | Lesotho | 3.5 |
| 13 | Hong Kong | 8.4 | 36 | Bhutan | 5.7 | 59 | Latvia | 4.3 | 78 | Peru | 3.5 |
| 14 | Ireland | 8.0 | 37 | Malta | 5.6 | 59 | Slovakia | 4.3 | 78 | Serbia | 3.5 |
| 15 | Austria | 7.9 | 38 | Brunei | 5.5 | 59 | Tunisia | 4.3 | 78 | Thailand | 3.5 |
| 15 | Germany | 7.9 | 39 | Korea (South) | 5.4 | 62 | Croatia | 4.1 | 85 | Malawi | 3.4 |
| 17 | Barbados | 7.8 | 39 | Mauritius | 5.4 | 62 | FYR Macedonia | 4.1 | 85 | Morocco | 3.4 |
| 17 | Japan | 7.8 | 41 | Costa Rica | 5.3 | 62 | Ghana | 4.1 | 87 | Albania | 3.3 |
| 19 | Qatar | 7.7 | 41 | Oman | 5.3 | 62 | Samoa | 4.1 | 87 | India | 3.3 |
| 20 | United Kingdom | 7.6 | 41 | Poland | 5.3 | 66 | Rwanda | 4.0 | 87 | Jamaica | 3.3 |
| 21 | Chile | 7.2 | 44 | Dominica | 5.2 | 67 | Italy | 3.9 | 87 | Liberia | 3.3 |
| 22 | Belgium | 7.1 | 45 | Cape Verde | 5.1 | 68 | Georgia | 3.8 | 91 | Bosnia and Herzegovina | 3.2 |
| 22 | United States | 7.1 | 46 | Lithuania | 5.0 | 69 | Brazil | 3.7 | | | |

12.7.11 Michael Haliassos CRETE 2011 27

Figure 11

# GREEK MARITIME PROWESS AND THE ASTAKOS PROJECT: A GEOPOLITICAL DISCONNECT

*Andrew C. Hess*

## *Introductory remarks*

Despite current financial difficulties, the discovery of a potentially large gas fields off the southeastern coast of Cyprus will certainly involve Greece further in the latest commercial and technical revolutions in the globe spanning development of energy resources. At nearly the same time that drillers discovered major gas fields along the Eastern Mediterranean shore line the Deputy Energy Minister of Qatar informed the Foreign Ministry of Greece that Qatari companies participating in a consortium for the creation of an energy hub at Astakos (a port on the Western shore of Greece) have concluded that the project is not economically viable. This apparently cancelled a large part of an investment designed to include Greece in the future growth of gas supplies for global energy markets and the ability of the country to diversify its supply of energy.

In the public discussion following the news about the Astakos project representatives of both Greek and Qatar governments minimized its consequences. Qatar did not blame the failure on a broken relationship between Qatar and Greece, rather the cause of the collapse of negotiations was apparently a disagreement on gas prices between the businessmen participating in the consortium. The Deputy Foreign Minister of Greece hastened to advise the press that relations between Greece and Qatar were not impaired by this event; and the Memorandum of Understanding recently signed in New York City with Qatar for investments worth five million dollars was not affected in any way.

Upon the publication of this news, the opposition party (Coalition - *Synaspismos*) promptly issued a statement that the project was a non-transparent investment and not in the public interest. Moreover, according to their statement the whole affair also represented a major risk to the local environment. The Coalition (opposition party) then called upon the government to submit all of the documents concerning the failure of the Astakos project for public review. But the details of this business proposal that might have attached Greece's commercial interests to the world's largest supplier of Liquefied Natural Gas (the Government of Qatar) disappeared in the whirlwind of political discussions concerning Greece's current financial situation.

I will make the argument the Astakos affair is not a minor set-back in Greece's international business affairs. Rather it was an event that should be understood in a much larger global energy context than that employed in government statements made shortly after the consortium collapsed. While the issues that I wish to address are quite complex, they can be grouped into arguments at local, regional and global levels about why the Greek government and its private sector allies should make every effort to reengage in negotiations to make the Astakos project viable.

Recent events are probably responsible for the absence of detail on the details of how the Greek Qatar joint venture was structured. However, it is clear that the overall objective of the both states in this venture was to establish, on the western coast of Greece, an energy hub related to the joint interests Qatar and Greece have in marketing the products it is producing from its enormous gas reserves located in the Arabian/Persian Gulf.

In my opinion, there are three general reasons why this proposal has major benefits for Greece that cannot be ignored even in the short term. First, according to plans, Astakos was to be the place for a Greek energy hub that would serve local needs and at the same time connect with massive pipeline networks linking the gas resources of Central Eurasia (Caspian Sea and Gulf fields and now Eastern Mediterranean offshore reserves) with regional and global markets for Gas. Second, the proposal to establish energy facilities in Astakos combines modern technical and managerial abilities in the global energy arena for which Greece is uniquely qualified. For example, the Greek shipping industry has the size and technical capacity to scale-up its operations to meet new production and marketing conditions at all geographical levels for liquefied natural gasoline (LNG) and its by-products. Third, the continuation of negotiations on this complex political and commercial business will confirm that Greece has a unique capacity to diversify, in both terrestrial and maritime arenas, its access to petroleum resources; and this will express itself in a Greek foreign policy that is international, multi-polar and environmentally conscious for meeting energy and environmental demands of an expanding world economic order in which “gas is the future”.

### *Pipelines and the geopolitical position of Greece*

While the global financial crisis tends to concentrate its attention on current national financial affairs, the Greek participation in the Astakos consortium was an on-going act in an already established terrestrial trend for the distribution of Eurasian energy supplies: one involving a global convergence of supply through pipelines. Various maps of this affair demonstrate that Greece’s geography also confers a position of advantage upon its shipping industry that has deep roots in the history of its naval commerce and for our time involves participation in the use of modern tankers to supply of central and western economies of Eurasia.

Again details of present and near term projects aimed at moving energy products along the Eastern Mediterranean coastline, across the top of the Black Sea and from Anatolia to Greece are beyond the scope of this paper. That said it is possible to visualize the geopolitical importance of an emerging energy network in the shape of four major rather well known construction projects.

On 3 July 2005 the Greek and Turkish Prime Ministers, Kostas Karamanlis and Recep Tayyip Erdogan signed an agreement to complete a new gas infrastructure connecting the Caspian Sea and Middle Eastern gas producing areas with European gas grids. This project with its lengthy name (Interconnector Turkey, Greece and Italy) intends to extend a "Southern Gas Corridor" through the middle of Turkey to Greece, Italy, and on to Europe. A Turkey-Greece portion of this pipeline network was completed in 2007 as part of the overall effort to move new gas resources into the Balkans; and accordingly, Bulgaria sought to join this structure in 2009.[1]

This expansion of both Greek and Turkish interests in the gas arena was certainly based upon the energy and environmental pressures that resulted from anticipated energy demands in Turkey, the Balkans, and Europe. But a more weighty calculation associated with the Southern Gas Corridor may have resulted from reactions in Europe to Russia's use of natural gas as an instrument of state power during the first decade of the twenty first century in its disputes with Ukraine and Belarus over transit payments and operational conditions. When Russia temporarily closed its pipeline supplies of gas to Ukraine in the cold European winter of 2009 the 14-day fall-off of gas transfer affected 20 nations. It followed that Europeans became concerned with the diversification of their supply of Russian gas, which amounts to approximately 30 percent of European demand.[2]

During this same period Azerbaijan on the basis of widespread European political and financial support completed in 2005 the construction of the oil pipeline from Baku to the Turkish port of Ceyhan on the southwest coast of the Mediterranean Sea. Although this move on the chessboard of energy politics involved pumping oil from the Caspian Sea region to an eastern Mediterranean port without passing through Russian territories of oil and not gas, it certainly prompted the European Union to encouraged Azerbaijan to increase

1. Ioannis Michaletos, "Transformations in the Greek Natural Gas Market: EU Strategy, Azerbaijan, and a Regional Role for DEPA," Balkananalysis website, November 1, 2011. Available at: www.balkananalysis.com.
2. Daniel Yergin, *The Quest: Energy, Security, and the Remaking of the Modern World*, Penguin Press, New York, 2011, 336.

the supply the gas from its Caspian Sea reserves to Turkey's internal gas network that leads northward toward Greece: to the Southern Gas Corridor. But more importantly EU officials also supported an Azerbaijan Turkmenistan plan to construction a trans Caspian pipeline aimed at providing large quantities of natural gas from the world's fourth largest possessor of gas reserves. This would be a project that will transfer gas from a new nation to non-Russian suppliers of Europe that previous had only one customer: the Soviet Union.[3]

While it might an exaggeration to say the Eurasian scale of the international response to new gas projects and plans involved Greece in geo-politics of a "global" nature, the fall-out of these Eastern Mediterranean energy decisions was indeed large. In the political arena the Baku Ceyhan pipeline may have been a factor in the Russian invasion of Georgia in 2008 and in its continuing political problems with Ukrainian politicians. But the most well- known reaction to European security concerns in gas arena is embedded in the European support for the Nabucco pipeline proposal. When constructed this large (56-inch diameter pipe) line will transfer gas from Caspian Sea and Middle East producers to Europe through Turkey, the Balkans, and on to Central Europe.[4]

The Russian counter-stroke to this mega plan is the South Stream. It is a trans-national gas line beginning at the Russian compressor station of Beregovaya on the eastern edge of the Black Sea for an undersea route that will end at the port of Varna. From Bulgaria its land lines will run through the Balkans northward and westward to Italy and Central Europe. While both of these extraordinarily expensive projects are in the planning stages, their geography does give one a sense of the geopolitical advantage Greece has in the future supply of natural gas to Europe.[5]

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3. "Vassilev: 'Energy and economic co-operation key to Black Sea region growth,'" New Europe Online, Energy section, November 23, 2011. Available at www.neurope.eu.
4. Alexander Ghaleb, Natural Gas as an Instrument of Russian State Power, The Letort Papers, Strategic Studies Institute, US Army War College, Carlisle, PA, 2011, 127-130.
5. "The Balkan natural gas pipelines," Serbianna Analysis website, November 28, 2009. Available at serbianna.com.

To conclude this argument in terms of the geo-politics of energy, Greek strategists are in a geographical position to benefit from new supplies of fuel from the Caspian Sea and Gulf regions to meet increasing local and regional demands for a very large already establish energy system that is interested in the diversification of sources for a primary fuel, natural gas, a fuel that also has environmental advantages over fuel oil and coal.

### *In the medium term the future is down stream*

During the last two decades the rate of technological developments in upstream activities for both oil and gas reserves has accelerated. But by 2011 previous assumptions associated with what was thought to be an era of declining oil and gas reserves, compelled the strategists of major producing organizations to reconsider their investment plans. This motivated large oil producers, such as Saudi Aramco, to switch its focus on up-stream development of additional oil fields to place a new effort to develop internal gas reserves and to invest major financial resources in the down-stream processing of gas supplies. So this shift in emphasis, away from cruel oil production to gas production and treatment, is a huge movement in the energy business that is also accompanied by the technological advances in NGL industry located in Qatar. (Pearl Gas to Liquid GTL plant)[6]

Other recent technological developments in the oil and gas business that will involve Greece's ability to diversity its supply of fuels should also be understood. Despite some spectacular failures, oil companies are now able to accurately drill and produce oil and gas at depths of 5,000 feet and more below the surface of the ocean. This has stimulated a dramatic expansion in deep water drilling. Global oil production from off-shore wells has increased in the last 11 years from 1.5 million barrels of oil a day (mbd) to roughly 7mbd or 8% of the world's oil supply. Production from the above fields will probably double by 2020.[7]

6. "Qatar set for Pearl GTL inauguration on Nov 22," Gulf Times, November7, 2011. Available at www.gulf-times.com.
7. Daniel Yergin, *The Quest*, 242-253.

But this is only a beginning, so most experts claim. According to some geological investigations only about 10% of the world's deep water oil and gas fields have been investigated; and at the moment the new prospects are on the eastern Mediterranean shore line, in the Gulf of Mexico, off-shore in Brazil, India, and Australia and along the west coast of Africa. Given the replacement rates and size of the Greek merchant marine it is safe to assume that the global scale of off-shore development is easily within the reach of its business capacities. The point is that a commitment to the gas industry as part of a terrestrial system creates a degree of inflexibility and diplomatic complexity if the pipelines cross through other state boundaries on land or under sea - conditions that require international negotiations. The advantage Greece has on the supply side of the energy business is the large size and high level of efficiency of its merchant marine. However, since the future of the gas and oil business for Greece after financial recoveries will be substantial, the need for more sophisticated port facilities is certainly in the cards; and this is another reason for reviewing the importance of the Astakos project.

But if the Saudi Arabian plans are any gage of where the future of the oil and gas industry lies, it is in the downstream operation of gas refining and petro-chemical production.[8] On the basis of the limited information available on the Astakos project, it is a project situated on the frontier of the oil and gas industry.

According to Daniel Yergin, natural gas is the fuel that best represents the technological breakthroughs of the recent era. The global consumption of gas has tripled in the last three decades, and he estimates demand will grow another 50% in the next two decades. Its share of the total energy market is also increasing for a number of reasons, one of which is its relatively "clean" nature as compared to fuel oil and coal. It is connected often with improvements in the generation of electrical power as well as being the raw material base for numerous petro-chemical products. Thus its ad-

8. "Sadui Aramco focus on gas, downstream rather than oil expansion: CEO," Platts, Riyadh, November 21, 2011. Available at www.platts.com.

vantages are part of the reason why nations with ambitions to enter the global energy market are gradually removing old geo-political barriers that hampered the transnational trade in energy resources.[9]

It is possible to see this happening at the financial level in the investment rhetoric of senior officials at the November 2011 conference on energy and economic co-operation in the Black Sea region. According to Tzvetan Vassivev of the Corporate Commercial Bank, economic growth of the Black Sea region calls for the creation of a single energy market that will diversify energy supply and transport routes, increase sales, attract larger investments, and enhance competitiveness. Since technologies necessary to accomplish the above goals are already in place and are more or less global in nature, it would follow that the gas business in the Black Sea region will have global dimensions.[10] Of course, it is risky to make predictions about a very complex gas industry; and this certainly is the case when new technological developments such as the exploitation of shale gas are concerned. But this new resource for gas is at its infancy and the already embedded productions and distributions of both natural gas and LNG are in place.

This overview of the broader conditions under which the Atascosa project was proposed and then cancelled simply demand even at a time of financial uncertainty, a re-engagement of negotiations because the future in this energy area for Greece is Gas!

9. Daniel Yergin, *The Quest*, 340-1.
10. "Vassilev: 'Energy and economic co-operation key to Black Sea region growth,'" New Europe Online, Energy section, November 23, 2011. Available at www.neurope.eu.

# THE EASTERN MEDITERRANEAN IN WORLD POLITICS

*Elizabeth H. Prodromou*

## *Introduction & Context*

In thinking about the Eastern Mediterranean within the context of this 10th anniversary celebration of the Karamanlis Chair, I was struck by the fact that, within the space of a mere decade, since the Chair's establishment, the Eastern Mediterranean has undergone and continues to undergo the kind of changes that amount to nothing less than a complete political and cultural transformation of the regional landscape. I was also struck by the fact that, within the short time span of a decade, most of the familiar assumptions about order and stability, about hierarchies of power, within the region have been called into question. Indeed, the changes which have received so much recent attention by scholar-practitioners under the rubric of the Arab Spring, were well beginning to unfold when the Karamanlis Chair was established, and now, those developments have accelerated, deepened, and intensified, such that their effects are being felt well beyond the geographical boundaries that we conventionally attach to the Eastern Mediterranean.

## *A "Karamanlis Moment": An Instructive Construct*

Today's workshop and the current historical moment provides an opportunity to pause, to analyze and to deconstruct, and perhaps, to make some tentative suggestions about, the near future, when it comes to the transformative events underway over the last decade in the Eastern Mediterranean. In this respect, it is worth pointing out that the origins, dynamics and the potential effects of the changes underway in the region over this past decade—and, especially, since the catalyzation of the Arab Spring with the Tunisian episode of December 2010—can be understood as a "Karamanlis Moment."

When I speak of the current historical conjuncture as a "Karamanlis Moment" for the Eastern Mediterranean, I attach two connotations to the construct. The first connotation of the "Karamanlis Moment" is narrative, or more specifically, descriptive. The Eastern Mediterranean as a region of extraordinary geopolitical and strategic importance to Greece, and by extension, to Europe (whether conceived in geographic or spatial terms), was a constant throughout the nearly 60 years of Constantine Karamanlis' public service as a statesman whose imprimatur extended well beyond Greek politics to the European and global contexts. The political leadership in Athens would do well to recognize the continuing importance of the Eastern Mediterranean as a region of increasing geo-political and strategic importance.

The second connotation of the "Karamanlis Moment" is analytic. Specifically, the strengths of Karamanlis' leaderships as a statesman are amplified by the particularities, opportunities, and risks, of the current balance-of-power and hegemonic shifts in the Eastern Mediterranean. A brief elaboration on each of these two connotations of the construct of a "Karamanlis Moment" is instructive in thinking about the region over the last decade and into the near future.

### *Contours of the Region in Terms of the "Karamanlis Moment"*

How might we apply the narrative or descriptive connotation of the "Karamanlis Moment" to the Eastern Mediterranean over the past decade? Simply put, the region has been characterized by a remarkable, ongoing, reconfiguration in the balance of power and competition for hegemony. Furthermore, the significant fluidity in the power structure of the region is inextricably linked to global, systemic factors—to geo-strategic trends—that only serve to reinforce the longstanding importance of the Eastern Mediterranean for Greece and for Greece's hegemony and the specific parameters of the shifting regional hegemony.

The reconfiguration in regional hegemony is illustrated by a brief review of three countries, whose regional relations and associated global positions have shifted quite remarkably over the last decade. These countries are Turkey, Israel, and Cyprus. Turkey's power, whether measured in combined hard terms (e.g. the second largest standing army in NATO, absolute dominance of conventional military forces vis-à-vis other countries in the region, and the recently completed agreement to transfer US Predator drones to Turkey for use in the region) or soft terms (e.g. the largely peaceful, politically-driven, redefinition of secularism away from dogmatic Kemalism to the controlled pluralism of neo-Ottoman Islamism), has undergone a measurable increase over the last year, to the point where it is plausible to speak about the realization of Turkish aims of hegemony in the Eastern Mediterranean and Near East.

The enhancement of Turkey's regional power has occurred concomitant with the rupture in the country's special relationship with Israel; strains in the Ankara-Tel Aviv axis that were thrown into sharp relief with the Erdogan-Perez fracas at Davos in 2009 reached a zenith with the Mavi Marmara flotilla incident in 2010. Indeed, Turkey's hardline rhetoric and, some would argue, provocative actions, vis-à-vis Israel have reinforced Ankara's claims of regional hegemony and have contributed to what most regional experts agree is Israel's unprecedented diplomatic and strategic isolation in the Greater Middle East.

As part of the effort to recalibrate its own position in a hostile strategic-security environment, Israel has engaged the Republic of Cyprus on regional energy security initiatives (i.e. bilateral agreements to exploit natural gas reserves in the Mediterranean Sea off the coast of Cyprus) that Nicosia also recognizes as crucial to the balance-of-power in Southeastern Europe and the Near East. By the same token, Nicosia has been remarkably pragmatic and effective in maximizing opportunities created by the shifting regional balance of power, engaging efficaciously with Israel on energy security initiatives, maximizing Nicosia's position in the European Union (including the benefits that may accrue from assuming the EU Presidency in 2012), and overall, aiming to calibrate its position in the regional power structure according to global geo-strategic trends.

Time constraints prevent an extensive treatment of the parameters of the shifting power order in the Eastern Mediterranean, but the above three cases illuminate the key questions that are driving broad change in the region as a whole. The most urgent questions include the following: the renegotiation of religion-state relations, whether through constitutional or other mechanisms; related questions about the limits of political and social pluralism, with recognition of the implications for the formal and qualitative dimensions of democracy; constitutional and institutional (especially those of a judicial and/or security type) questions about the robustness of rule-of-law democracy built on universal principles and norms of human rights; challenges and opportunities associated with economic competitiveness in a globalized marketplace, where predatory capitalism and financialized economic regimes reveal deep differences in worldviews regarding social justice; and finally, the capacity of Westphalian states to meet traditional and non-traditional security threats.

The above narrative summary offers strong evidence that the Eastern Mediterranean can be characterized as undergoing a "Karamanlis Moment" insofar as the changes in the region extend far beyond its geographic and spatial limits, to have geopolitical and strategic relevance in today's world. In terms of applying the leadership connotation of the "Karamanlis Moment" to the Eastern Mediterranean, a brief review of the some of the defining features of Karamanlis' approach to leadership is instructive. First and foremost, Karamanlis' long tenure as Greece's pre-eminent statesman of the 20th century was the product of his recognition of the inextricable connection between leadership and legitimacy. More specifically, Karamanlis demonstrated an increasing recognition of and respect for the popular legitimacy as both reflection of and support for effective leadership. Whether in his ministerial portfolios of labor and public works or his integration of Greece into the European Union (Community), Karamanlis grew to understand that the results of visionary and decisive leadership were, to no small degree, contingent upon popular legitimacy; conversely, popular legitimacy could enable original and bold leadership choices and outcomes. On a related note, Karamanlis came to appreciate and excel at the practice of coalition-building as a means of building popular support and, especially, as a mechanism for reconciling and resolving historical sources of trauma and division. In the latter regard, Karamanlis' leadership also demonstrated his commitment to making short-term, tactical adjustments designed to accomplish long-term, strategic goals.

The pattern of change in the contemporary Eastern Mediterranean—evolution or rupture, violent or non-violent—can be analyzed in terms of the presence or absence of the leadership qualities that Karamanlis brought to bear in six decades of political life in Greece—from his election to the parliament in 1935 to his appointment to government ministries in the post-WWII years, to his prime ministerial positions pre- and post-junta, to his presidential years in the 1980s and 1990s. Furthermore, the trajectory and consequences of the shifting balance of power parameters in the Eastern Mediterranean will be shaped by the degree to which the regions leaders enjoy popular legitimacy, are successful in coalition-building and reconciling historical cleavages, and are capable of tactical adjustments that remain focused on strategic results.

### *Conclusion*

By way of conclusion, it is helpful to return to the title of this panel as it relates to the overall theme of this workshop: namely, the purchase that derives from considering the Eastern Mediterranean in world politics within the context of Constantine Karamanlis' legacy as a statesman in Greece, Europe, and international affairs. In short, the concept of a "Karamanlis Moment," in narrative-descriptive and analytic terms, offers nuanced insights into how we understand the balance-of-power and competition for hegemony that define the region today, the linkages between these regional changes and global geopolitics and strategy, and the definitive effects of leadership on the possible outcomes of conjunctural changes at play in the region. In a word, the legacy of Constantine Karamanlis for the scholar-practitioners being trained at The Fletcher School is impressive.

# EUROPEAN UNION ENLARGEMENT TO SERBIA AND CROATIA: EMERGING GERMAN FOREIGN POLICY ASSERTIVENESS[1]

*Ana S. Trbovich*

The idea of European integration has long stood as the bedrock of peace and stability in post- World War II Europe. From the end of that cataclysmic war, European leaders have continuously believed that the only way to prevent a tragic reprise was to push aggressively for political unification of the continent and end the political tensions that had led to two devastating world wars. Consequently, the goal of continent-wide peace and stability has been the primary concern of European policymaking, subsuming even the better-known efforts towards economic integration and the establishment of the common currency.

Ironically, just as Europe seems to have achieved this historic national security objective the economic crisis that erupted in 2008 so disrupted the continent's political and economic landscape that the EU's long-term prospects are now in jeopardy, straining member relations to the point that many countries doubt the EU's continued relevance. This has become evident as aspiring EU members in the Balkans have watched Greece, once a Balkan success story, and its economy teeter on the verge of collapse while generating such

1. Research for this article has been supported by a Grant of the Ministry of Education and Science of the Government of Serbia, no. 47028: "Enhancing Serbia's Competitiveness in the Process of EU Accession".

tensions that many now consider its exit from the eurozone inevitable. The aftershocks of this economic crisis have generated significant concern throughout the region about the EU's continued ability to maintain peace and stability, especially since the relationship between economics and EU unity is one of friction in times of crisis. While EU's political weight currently acts as an anchor to the financial mayhem and the primary source of optimism that crisis will be overcome, the economic crisis is simultaneously undermining the political union and its contribution to stability in EU's utmost vicinity.

Many within the Balkans are also looking, with increasing alarm, at Germany's growing assertiveness in the region, harkening back to the early years of the Yugoslav wars when a newly reunified Germany aggressively pushed for early recognition of Croatia, Slovenia, and Bosnia, escalating tensions in the region. Today, given its central role in resolving the European economic crisis, Germany is again engaging in policies out of consonance with its partners, acting increasingly outside the framework of the European Union not just on general foreign policy concerns but—of most relevance to the Balkans—enlargement policy, which is one of the most important common EU policies. Given Germany's preeminent position in Europe and its long tradition, with France, of supporting, and even engineering Europe's continued integration, this is an alarming shift in a policy of vital importance to the continent.

The European Union's Enlargement Policy and Neighborhood Policy were developed not merely out of the need to create a practical framework for EU's complex relations with bordering countries, but also as the chief means to end the Cold-War division of the continent and prevent and suppress conflicts in the periphery. As declared in the EU founding treaties, creating an "area of freedom, security, and justice without internal frontiers" takes priority over the important but secondary policies of economic integration.

The enlargement policy, in particular, has become a policy where a set of ever-stricter conditionality criteria is applied as a stick in return for the carrot of EU membership. The vague condition of geographic location alone, referenced in the original founding treaties ("in Europe"), was transformed into more elaborated Copenhagen Criteria, devised in 1992 for enlargement that followed the fall of the Berlin Wall. The new enlargement criteria required an aspiring member to demonstrate democratic governance, respect for the rule of law, minority and human rights, and adoption of *acquis communautaire* with practical ability to compete in EU's internal market. The integration of the Western Balkans further necessitated the demonstration of «regional cooperation» among the former warring factions. Finally, the rapid expansion of the EU to include 12 new member countries since 2004, called for yet another condition of "administrative capacity" both for the candidates and EU institutions, to manage the increasingly complex integration process.

The onset of the global economic crisis, now turned into a political crisis threatening the future of the European Union itself, has rendered the EU enlargement process even more challenging. In the 1990s the fall of the Berlin Wall, the collapse of the Soviet Union, and the first Gulf War, diverted the EU's attention away from the disintegration of Yugoslavia with disastrous consequences. Today we are witnessing once again how a wider, global context is impacting the EU's focus on its own neighborhood. Many within the EU have become consumed with the ongoing economic crisis, the EU's own institutional struggles caused by the protracted adoption of the Lisbon Treaty, the implications of the Arab Spring, climate change, and the impact of a series of local elections across the continent, but particularly in Berlin, slowing the accession process of the former Yugoslav nations, aside from current EU member Slovenia - and Croatia.

EU leaders once pledged strong support for the enlargement of the EU to the western Balkans primarily for fear of creating a "black hole" of non-member states so near to Western Europe. However, since the last enlargement of 2007, even that concern no longer drives EU policy in the region. The EU is not merely exhibiting "enlargement fatigue" but in particular "Balkans fatigue" as interest in the region has waned dramatically, especially in comparison to level of interaction seen 1990s and early 2000s. However, despite its heavy burdens, Germany's interest in the region surprisingly remains strong. Backed by its ever-growing power as

Europe's uncontested economic leader and EU savior, its influence in determining the conditions for accession is now paramount. Nonetheless, Germany's massive responsibilities have so divided its attention that it has arguably produced important policy mistakes with regard to the region.

Germany can be described as a strong but vigilant supporter of EU enlargement, not just in its position toward the Balkans, but also generally towards Eastern enlargement. In 1990s, for example, Germany had advocated a case-by-case approach in contrast to the group approach for enlargement that had been favored by the Scandinavians and the United Kingdom and which ultimately prevailed. The United Kingdom's support for EU enlargement through the incorporation of 10 new EU members that joined in a large accession wave in 2004 was so steadfast that it even led some cynics to interpret this as evidence of the UK's interest in weakening the Union.[2] Germany's more careful, conditional approach, on the other hand, can be explained by its interest to further integrate and deepen the EU's institutional structures instead of simply enlarging the Union, combined with significant support of elites specifically for enlargement to Central and Eastern Europe. This support existed even in the face of low public support in Germany stemming from the fear of losing jobs to the skilled but less expensive labor force in the East.[3] While such fears have since partly subsided, the concern of the elites—including Germany's political leadership—over migration and the cost of prolonged conflicts remains heightened. The former German President Roman Herzog has most succinctly expressed the German concern: "If we do not stabilize the East, the East will destabilize us".[4]

Germany is an important investor and trade partner to the entire region of the Western Balkans. Its attachment to Croatia has been strong and open, ever since its support for Croatia's secession from the former Yugoslavia, and despite the

2. *See*, for example, Barbara Lippert, Kirsty Hughes, Heather Grabbe and Peter Becker, *British and German Interests in EU Enlargement* (Royal Institute of International Affairs, 2001), 7.
3. Ibid, 15.
4. President R. Herzog, Die Grundkoordinaten deutscher Aussenpolitik, IP, 4/1995, p. 7.

fact that a number of human rights issues, including those related to refugee return, have not been fully resolved. Many German political leaders viewed Croatian claims as expressions of self-determination rather than nationalism and were dismayed that other EU members distrusted their motives in supporting Croatia's independence. Some German politicians were so embittered that they openly stated that other EU foreign ministers (then EC) member states had failed in their policy response to Yugoslavia's disintegration.[5]

However, the recent daring and appalling statements by Croatia's high officials are a testimony to the uneven application of EU human rights criteria in this aspiring EU member. Notably, in August 2011, then Croatian Prime Minister Jadranka Kosor publicly praised the former Croatian generals Ante Gotovina and Mladen Markac, both convicted of war crimes committed during "Operation Storm" which, 16 years ago, displaced an estimated 200,000 people. Amnesty International reacted, stating that such statements fueled the atmosphere of impunity and reflected the lack of political will for the investigation and punishment of war crimes committed by Croatian forces during the 1991-1995 war. The Chief Prosecutor for the International Criminal Tribunal for the former Yugoslavia (ICTY) also condemned these statements.

Germany did not react. Instead, in an official visit just weeks later, the German Chancellor Angela Merkel praised Croatia as a political and economic role model for the region, even calling upon Croatia to help mediate regional disputes: "I am going to stress that Croatia use its experience with resolving disputes to engage constructively in the region".[6] Such statements are in line with the past official statements of German high officials, who have gone as far as to openly defend Croatia's lack of cooperation with the Hague Tribunal. For instance then German Chancellor Gerhard Schroeder stated: "You cannot arrest someone who is not there. [...] and there should be more understanding of this".[7] And while the

5. For more, *see* Scott Erb, *German Foreign Policy; Navigating a New Era* (Lynne Rienner Publishers, 2003), 160.
6. Spencer Kimball (AFP, Reuters, dpa), "Merkel campaigns for regional stability in Croatia, Serbia," *Deutsche Welle*, 23 August 2011.
7. "Germany backs Croatia's EU bid," *BBC News,* 30 October 2003.

Netherlands, in particular, felt strongly about ICTY cooperation and pushed Croatia to arrest its remaining indicted general, there were no strong advocates among EU members for a more effective refugee return and, more generally, minority rights for the remaining Serbs in Croatia.

In the case of Serbia, however, Germany's support for EU entry has been accompanied by increasing conditionality. In part, this is because Germany is not willing to "import" another conflict, perceiving the entry of a divided Cyprus to the EU as a mistake, and in part, because Germany is more willing to demonstrate its power on the international scene. Consequently, the group approach for the enlargement process will not be repeated now that Germany is more outspoken and firm in its views concerning enlargement, having gained substantial political weight as a result of its role in overcoming the global financial crisis.

In June 2011, members of the German Parliament made a set of radical demands, saying that Serbia must recognize the independence of Kosovo or Germany will block Serbia's accession to the European Union. In August 2011, German Chancellor Angela Merkel, officially demanded *de facto* if not *de jure* recognition of the seceding Kosovo province by the Serbian government:

- "If Serbia wants to achieve candidate status, it should resume the dialogue and achieve results in that dialogue, enable Eulex to work in all regions of Kosovo, and abolish parallel structures and not create new ones".
- "One of the preconditions for Serbia is Kosovo, that relations between those states get normalised".[8]

The statement was made in the wake of local elections in Berlin and tarnished Serbian hopes of EU official candidacy status, which was expected as a certainty following the arrests of remaining ICTY fugitives earlier in 2011. This led many cynics to conclude that the local elections in Berlin turned the fate of the Balkans, most of all Serbia.

8. "Germany's Angela Merkel ties Serbian EU hopes to Kosovo", BBC News, 23 August 2011.

It is important to note that Germany's position does not represent an official EU policy because the EU remains conflicted with regard to Kosovo's status. As of January 2012, 22 EU member states have recognized Kosovo's unilateral declaration of independence yet five EU member states have refused. These are Cyprus, Greece, Romania, Slovakia, and most importantly of all, Spain. The global opinion is even more fractured, with the majority of UN members i.e. 108 of 193 UN members refusing to recognize Kosovo's unilateral declaration of independence, including China, India and Russia, among others. Yet, Germany blocked Serbia from receiving the status of official EU candidate, which was expected in December 2011, and which would render the EU accession process irreversible, multiplying EU's political and economic assistance to Serbia to assist the process.

Serbia's *de facto* recognition of the self-proclaimed Kosovo institutions is unpalatable. Not only does it represent a politically unacceptable position, but it would also very likely lead to another flood of displaced persons and further the "ethnic homogenization" of Kosovo rather than lead to the creation of a multiethnic democracy. Germany's insistence on this issue may send the wrong message, rewarding the Kosovo Albanians' resort to violence and mistreatment of other ethnic groups.

The picture of Kosovo today is rather bleak, with weak rule of law, thriving crime, and the poorest population in Europe with a per capita GDP of $2800, 30% living under poverty line and another 13% listed as extremely poor, heavily relying on remittances that contribute from 13-15% of Kosovo's GDP (source: World Bank), along with weak prospects for growth, low levels of education, and staggering unemployment rate of at least 40% (with 50-75% of Kosovo's youth unemployed; source USAID). These figures include the artificial employment of the Kosovo Serbs by means of over-employment in public institutions (municipality, public enterprises, educational and health organizations) under Serbian control and financing as part of a social policy, essentially subsidizing people to live in difficult conditions of constant threat and limited freedom of movement. Serbian financial support, in addition to several donor projects, has been vital in maintaining what remains of ethnic diversity in the Kosovo province. According to UNHCR, only 18,060 displaced Serbs have officially returned of the 245,000 displaced Serbs since the height of the conflict in 1999 and 2000. To illustrate this displacement even more vividly, 312 of 437 towns and villages have been "ethnically cleansed" of Serbs since the self-proclaimed independence of Kosovo. In essence, the opposite of a multiethnic society has been created in this part of the Balkans. Testimony to this is the OSCE demographic map from 2005 (to the right, as compared to the demographic map before 2000 on the left), and which has only been worsened since:

All this indicates that Serbia's recognition of Kosovo would lead to consequences that would be detrimental to, rather than supportive of, human rights in Europe. Consequently, the German position should be reconsidered.

Furthermore, the denial of official candidacy for Serbia would imply that Serbia's reforms, including significant economic and legal reforms and full compliance with ICTY, which has been reached in June 2011 when the remaining indicted war criminals were arrested, have not been recognized and rewarded, thus taking the carrot out of the conditionality formula. Adding to the resulting confusion regarding the rules for EU accession, Serbia has been a leader in regional cooperation, as demonstrated by its contribution to the negotiation and full implementation of the regional free trade agreement (CEFTA), support for the Dayton Peace Accords, and in making an official apology for crimes committed in 1990s, efforts that considerably supersede those of all of the other regional actors.

Serbia's response to German's position can be summarized as shock, disappointment, and bitterness, leading to a decrease in public support for EU membership to under 50% (compared to close to 75% in 2002), and an increase in the number of those openly opposing the EU to 25%. Chancellor Merkel's demands reinforced the perception of many Serbian citizens that the EU has double standards and interprets political criteria arbitrarily, 'adding ever new conditions'. At present there is a sense of utter confusion as to the direction of the country, which is undermining the reform process and thus undermining the EU's underlying objective of peace and stability in the region.

Although fully aware of the public's opinion, Serbia's political leaders have been reserved in their criticisms of German policy; this is a pragmatic position because there exists no serious alternative to EU's membership despite the Russian weekly Pravda's columns exclaiming: "Russia to rescue Serbia from NATO's claws" or Turkey's example of an aspiring EU member who is no longer focused on EU entry, choosing to embrace only the economic benefits of its relationship with the EU. A resolution of the current political discord between Serbia and Germany requires not just compromises by the Serb government of a country that is both a political and economic dwarf in comparison to Germany, but also an enhanced understanding of Germany, both of the political differences with regard to the Kosovo status and of the possible detrimental effects should Serbia be forced to cease its support to the endangered Serbian population in the province. Other EU members are advocating for Serbian and German rapprochement on the Kosovo issue, and generally supporting Serbia's official candidacy status, possibly to be decided in spring 2012. Some European officials, including Austrian Defense Minister, have openly criticized Germany's position and even demanded that Serbia be treated "similarly to Croatia" since it has fulfilled the previously defined conditions.[9] Germany, however, has not yet retracted.

Public diplomacy must now be re-energized, educating EU citizens about the numerous reforms undertaken by Serbia on its path to membership, and reassuring Serbian citizens that EU conditions are fair. This means that the Kosovo conflict may not be formally solved but that in practice both the EU and Serbia would work together to improve the livelihood of people in this province. In an idealistic scenario this compromise would swiftly be concluded, but in a more realistic and a more likely scenario there will be a prolonged standstill, with a very slow EU accession process for Serbia, further reinforcing rather than ending both the Union's enlargement and its "Balkans fatigue" while deepening Serbia's distrust for the accession process. The cost would be borne for the most part by the citizens of Serbia, including Kosovo, while Europe as a whole would be further from its goal of peace and stability.

9. See Interview with Austria's Defence Minister Norbert Darabos, published in *Der Standard*: "Die Deutschen schätzen die Situation falsch ein", 30 December 2011.

# EXITING THE GREEK CRISIS IN THREE STEPS

*Stathis Kalyvas*

A three-step plan to exit the Greek crisis sounds a lot like a get rich quick scheme; hopefully this is not the case here. My central argument is that Greece's current crisis is not just an economic one, as often portrayed in the media. Rather, it is an economic crisis, nested inside a socio-cultural crisis, and expressed as a crisis of governance. Once we conceptualize the crisis in those terms, we are able to visualize the exit from it in terms that are not purely economic ones.

## *I. The economic crisis*

Let's begin with the facts. The immediate cause of the Greek crisis can be located in excess public borrowing made possible by historically low interest rates, themselves an outcome of the combination of mass global liquidity and a generalized perception in lending markets that sovereign risks were more or less constant across the member states of the eurozone. This last element helped bring attention to the eurozone-wide problem of a fundamental imbalance between a common currency and diverging, national fiscal institutions.

In Greece, excess borrowing was primarily channeled into private consumption through a steep rise in wages. This resulted in a fall of productivity and a corresponding collapse of the economy's competitiveness. These trends were reflected in all key economic indicators: productivity, competitiveness, balance of payments, public deficit, and public debt.[1] However, these economic trends failed to alarm political elites and public opinion alike and, thus, did not result in appropriate policy adjustments. In fact, people came to view the rise in their living standards as both natural and deserved, particularly since the rise in consumption was associated by vigorous growth rates. As a result, the collapse in both productivity and competitiveness went unnoticed. During the 2009 elections campaign, the outgoing Prime Minister and New Democracy leader Kostas Karamanlis, who was in charge when the economy went through this catastrophic decline, issued several warnings about the dangers lying ahead, only to be dismissed by his rival, PASOK leader George Papandreou, who went on to win the election and implement a set of economic policies that all but ignored the problem, while at the same time calling attention to the falsification of economic indicators by the previous government. Unlike countries where the economic crisis is associated with years of economic stagnation or an unpopular autocratic regime, in Greece bad economic policy was associated with an era of unprecedented prosperity, an association bound to undermine political support for painful economic reforms.

The problems faced by Greece call for radical economic reforms, because Greece must retool its entire economy away from a public sector domination and debt-fuelled private consumption of imported goods and toward a competitive, export-focused economy.[2] This means that on top of the

1. In 2009, the public deficit jumped to an estimated 13.6 percent of GDP, while the public debt rose to over 115 percent of GDP in 2009. When, in May 2010, Greece was forced to seek the assistance of the IMF, the ECB, and the EU (the so-called Troika), it had a deficit of €300 billion and a deficit reaching 13.8 of its GDP, later revised to 15.6%. On the 2011 IMD World Competitiveness Scoreboard, which includes rankings for the 59 economies covered by the WCY, Greece occupies the 56th position, with a score of 51.882 (out of 100), ahead only of Ukraine, Croatia, and Venezuela.
2. "Greece must export its way out of the crisis or face ruin. Greece has a large external deficit, reaching 8.6 per cent of gross domestic product in 2011. This gap is funded by an unsustainable level of external debt that markets are no longer willing to fund. At present it is being paid by official sources, who expect this to be temporary. Greece will

well-known fiscal issues of deficit control and debt servicing, Greece must transition to a different growth model. The analogy with the *perestroika*, the reform program undertaken by Mihail Gorbatchev in the Soviet Union, is useful in supplying a sense of the magnitude of the adjustment required.

### *II. The socio-cultural crisis*

The prosperity of the decade prior to 2009 magnified and reinforced a broad range of widespread attitudes, social norms, and behaviors which lie at the root of the economic problem. I am referring to tendencies such as low levels of interpersonal trust, aggressive individualistic behavior, a deficit of collective action (what Edward Banfield described as "amoral familism"),[3] and a deeply contradictory perception of the state as both a provider of public and private goods and an enemy of the individual and his/her family. To these attitudes, which have been present for a long time, the newfound prosperity of the past decade added additional layers, including a pronounced dependence on the state, which simply did not exist when Greeks had to fend for themselves, along with a definite sense of entitlement. For many people, an unwillingness to contribute their fair (or legal) share to the state coexisted with a militant request of being taken care by the state, whether this had to do with public goods (retirement, health-care, guaranteed income) or private ones (job provision, individual employment tenure for life, exemptions from sanctions for illegal behavior). Encouraged by the mass media and the political and intellectual elites of the country, many people failed to see the contradiction between their behavior and expectations. The result was widespread free-riding, whose clearest but hardly unique manifestation is generalized tax evasion, leading to the depression of state revenue, and exacerbating the twin problems of public deficit and debt. A parallel and related problem was the growth

have to bring its current account deficit down to zero at some point." Ricard Hausmann, "Ireland Can Show Greece a Way out of the Crisis," *Financial Times*, 8 February 2012.

3. Edward Banfield, *Moral Basis of a Backward Society*. New York: Free Press, 1967.

of corruption at all levels of society, from multi-million state procurement contracts to everyday issues such as speeding ticket evasion.[4] To summarize: the Greek crisis lies at the confluence, on the one hand, of deep-seated problems that can be traced in the distant historical past and political and, on the other hand, economic developments of the past decade.

### *III. The crisis of governance*

After 1981, when the Socialist Party PASOK rose in power and dominated Greek politics for a period of over thirty years, an implicit social contract was established, serviced by both the Socialists and the central-right New Democracy party. This social contract consisted of an exchange of votes and political support more generally for public sector jobs and extensive group privileges. It reflected the social norms and attitudes described above, was bankrolled by the cheap credit of the euro years, and led to the uncontrollable growth of both deficit and debt.

Let me illustrate the way this implicit social contract operated in Greece, by describing what I call the "Greek IRS." I am not referring here to the US Tax Agency, the Internal Revenue System, but rather to the Greek "Institutionalized Riot System," a concept that I have borrowed and adapted liberally from the literature on Indian politics.[5] Google "Greek crisis" and what you will get is a profusion of photographs of rioting. There is a widespread perception that Greece today is an ungovernable country, one literally out of control. The European Central Bank president Mario Draghi put it succinctly when he said that "Greece is unique for everything."[6]

4. Greece's Corruption Perception Index, as measured by Transparency International in 2011, was 3.4 on a ten-point scale, higher than Bulgaria and just below Romania (http://cpi.transparency.org/cpi2011/results/).
5. See Paul R. Brass, *The Production of Hindu-Muslim Violence in Contemporary India.* New Delhi: Oxford University Press, 2003.
6. "We said that Greece was unique and Greece is unique … for everything" (http://blogs.ft.com/the-world/2012/02/eurozone-crisis-live-blog-23/#axzz1m6i1p4pU).

The perception of ungovernability stems, in large part, from the frequent rioting on the streets of Athens, which is widely perceived as a popular expression of opposition and resistance to the austerity measures imposed by the "Troika" of the EU, ECB, and IMF.

The perception of ungovernability is not necessarily wrong, but it is based on erroneous premises because it presumes that the rioters represent social forces which prevent an unpopular government from governing. However, when it comes to rioting in Greece, one must note a few puzzling facts. First, Portugal and Ireland had to swallow equally bitter austerity cures as Greece, and yet no rioting took place there—at least nothing of comparable dimensions. Second, rioting was a very common occurrence before the crisis hit Greece. In fact, the worst case of rioting took place in December 2008, and was unrelated to economic policy matters.[7] Overall, Greece has generally been a high producer of public disorder, following the 1974 transition to democracy. Yet, if riots (and public disorder, more generally, a term that refers to socially disruptive public protests, including the occupations of public buildings, public space, and roads) are not the exclusive result of austerity, what are they all about? I argue that they can be understood as being part of an institutionalized process of political bargaining that was part of the country's implicit social contract.

More specifically, socially disruptive public protests can be seen as a process through which social groups signaled their bargaining capacity and obtained side-payments--or resisted their reduction or abolition. These groups were happy to let radical fringe elements riot, as a way to increase the strength of their signal. For politicians, this type of social protest became a way to escape demands for tighter fiscal management (a process that became known in Greece as "political cost"). As for society at large, it put up with such disruptions because it is an aggregation of groups that relied on the same process. In the short-term, this looked like a win-win situation for everyone. In other words, what appears as a clash between diverging interests (social groups on the one

7. It ostensibly referred to police brutality.

hand, the government on the other) was in fact an institutional collusion between them.

Eventually, institutionalization led to ritualization; the proliferation of disruptive protest became part and parcel of the country's basic political vocabulary.[8] After the crisis broke out, however, it became obvious that politicians could no longer deliver its side of the bargain. Public protests became more frequent and disruptive as a result but, if my analysis is correct, they should eventually decline, or become marginal, as the implicit social contract is abolished and expectations align with realities.

The creation and institutionalization of the Institutionalized Riot System, illustrates the political dimension of the crisis. In the same way as economic default was prompted by political practice, it reverberated back into the political realm, leading to the equivalent of a political default. Public opinion surveys indicate that the credibility of Greek politicians has collapsed and the two major political parties face an existential crisis, as their standard way of doing politics has all but expired.

### *IV. Three steps*

Exiting the crisis can be achieved in three steps. The first one consists in transforming the Greek economy by making it more competitive. Obviously, this is difficult and takes time. Fiscal measures and structural reforms are necessary to make this happen: Greece must identify its competitive advantages and invest in them.[9] Yet, these reforms are not sufficient.

This suggests the second step, a condition for the first one's success: institutional reform, and especially the reform of public administration, which has been a prime casualty of the social contract described above. Having been inter-

8. See Stathis N. Kalyvas, Why Athens is Burning?, *International Herald Tribune*, 11 December 2008, http://www.nytimes.com/2008/12/11/opinion/11iht-edkalyvas.1.18595110.html.
9. For an analysis of what the Greek competitive advantage consists of, see McKinsey & Company, Athens Office, *Greece 10 Years Ahead. Defining Greece's New Model and Strategy*. Athens, September 2011.

nally corroded by the clientelistic practices of Greek politics, public administration was underperforming under normal circumstances; it has come close to collapse under conditions of crisis and generalized salary cuts.[10] In many ways, the Greek state brings to mind a post-conflict state, unable to enforce the law and with the judicial system in a state of effective paralysis.[11]

Without institutional reform, fiscal and structural economic reforms will likely fail. To put it in a different way, Greece must build state capacity. Like in most post-conflict settings, and given the incentives of the Greek political elite, this calls for both robust external assistance (accompanied by strict conditionality) and bold moves, such as the creation of new state agencies in lieu of trying to reform existing malfunctioning ones.[12]

A key question is whether it is possible to achieve institutional reform against the wishes of the political elite and given the dominance of the negative social norms described above. It is fair to speculate, however, that the crisis will transform the political elite. As for norms, Greek history points to a remarkable level of flexibility and adaptability that made it possible for the country to recover in a remarkable fashion from two major disasters, the Asia Minor defeat in 1922 and the Greek Civil War in 1949. As politicians and the wider public alike come to the realization that the post-1974 social contract has reached its end, they will adapt to a new structure of incentives. On the one hand, politicians will realize that they now must compete on the basis of delivering growth rather than disbursing public and private goods. On the other hand, the public will begin to select politicians on the basis of performance rather than clientelistic practices. As the fiscal situation stabilizes, institutional reform will accelerate.

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10. See the OECD's scathing assessment in OECD Public Governance Reviews, *Greece: Review of the Central Administration*, 2011.
11. Elias Papaioannou, "The Injustice of the Justice System," Unpublished Paper, March 2011.
12. For instance, Tax, customs, and excise evasion must be addressed head-on by abolishing current structures and instituting new ones. See *Greece: The Way Forward*. White Paper, London Business School, 27 October 2011.

In turn, this will spur gains in competitiveness and growth. Without underestimating the possibility of accidents, I think that this scenario is more likely to be realized than many observers believe.

# CHRONICLE OF A CRISIS FORETOLD? GREECE IN SEARCH OF A NEW CONTENT FOR EUROPE

*Konstantina E. Botsiou*

## *The legacy of democratization*

The collapse of the seven-year military dictatorship in Greece (1974) prompted many historians and political scientists to address its causes. A central question was: "How did we end up here? Why did Greece lose grip of democracy and became an outcast of Western Europe?"

Revisiting the entire postwar era seemed then an indispensable method of analysis. In the bulk of scholarly work, the blame was laid on the assignment of non-parliamentary actors to the safeguarding of the quintessentially anti-communist political order that had been established to meet the interconnected challenges of the Greek Civil War and the Cold War: the monarchy, the army and foreign - read: American - interventions. Lacking democratic accountability, this triptych was claimed to have deprived the Greek governments of their legitimacy and Greece altogether of its national sovereignty.[1] This anomaly was historically linked with the

1. From the rich bibliography see Alivizatos, Nicos, *Oi Politikoi Thesmoi se krisi, 1922-1974: Opseis tis hellenikis empirias* (Political Institutions in Crisis, 1922-1974: Aspects of the Greek Experience), Athens: Themelio, 1995. Mouzelis, Nicos, *Modern Greece: Facets of Underdevelopment*, London, Macmillan, 1978. Couloumbis, Theodore A., Petropoulos, John and Harry Psomiades, *Foreign Interference in Greek Politics*, New York: Pella, 1976. Roubatis, Yannis P., *The United States*

incapacity of the Greek political forces to deal with the leftist insurgency in the aftermath of World War II. Political weakness had necessitated American assistance coupled with a high degree of interventionism (Truman Doctrine, Marshall Plan).[2] The urgency of military victory had resulted in the build-up of an unprecedentedly strong national army that grew independent of political parties and the Crown.[3] Last but not least, the leftist challenge had resuscitated the Greek monarchy itself into a pivotal political position after decades of decline.[4] According to this analysis, the military takeover

*Involvement in the Army and Politics of Greece, 1946-1967*, Baltimore: The Johns Hopkins University Press, 1981. Kofas, Jon V., *Intervention und Underdevelopment: Greece during the Cold War,* University Park and London: The Pennsylvania State University Press, 1989. Linardatos, Spyros, *Apo ton Emfylio stin Chounta* (From the Civil War to the Junta), 5 volumes, Athens: Papazisis, 1978.

2. Iatrides, John O. (ed.), *Greece in the 1940s: A Nation in Crisis*, Hanover and London: University of New England, 1981. Stathakis, George, *To Dogma Truman kai to Schedio Marshall. He historia tis amerikanikis voithias stin Hellada* (The Truman Doctrine and the Marshall Plan. The History of American Aid to Greece), Athens: Vivliorama, 2004. Botsiou, Konstantina E., "New Policies, Old Politics: American Concepts of Reform in Marshall Plan Greece", *Journal of Modern Greek Studies*, 27/2 (2009): 209-240.
3. About the organization of the Greek army in the postwar years see especially Hatzivassiliou, Evanthis, "Aftapates, dilemmata kai he apotychia tis politikis: O stratos stin poreia pros tin diktatoria" ("Illusions, Dilemmas and the Failure of Politics: the Army on the Way to the Dictatorhsip"), in: Vasilakis, M., *Apo ton Anendoto stin Diktatoria* (From the Relentless Struggle to the Dictatorship), Athens: Konstantinos K. Mitsotakis Foundation/Papazisis, 2009, pp. 417-442. See also Charalambis, Dimitris, *Stratos kai politiki exousia. He domi tis exousias stin metemfyliaki Ellada* (Army and Political Power: The Structure of Power in Post-Civil War Greece), Athens: Exantas, 1985. Stavrou, Nikolaos A., *Symmachiki politiki kai stratiotikes epemvaseis. O politikos rolos ton Ellinon stratiotikon* (Allied Strategy and Military Interventions. The Political Role of the Greek Military), Athens, s.d.
4. Botsiou, Konstantina E., "He arxi tou telous tis vasilevomenis: Stemma kai krisi hegemonias tin dekaetia tou 1960" ("The beginning of the end of the monarchy: Crown and hegemony crisis in the 1960s"), in: Rigos, Alkis, Seferiadis, Serafim and Evanthis Hatzivassiliou, *He 'syntomi' dekaetia tou 1960: thesmiko plaisio, kommatikes stratigikes, koinonikes sygrouseis, politismikes diergasies* (The 'short' 1960s: Institutional framework, party strategies, social conflicts, cultural processes), Athens: Kastaniotis, 2008, pp. 103-125.

of 1967 seemed as the natural result of a dysfunctional political regime. Ironically, the Turkish invasion and occupation of Cyprus in 1974 had been the nemesis of the regime in the realm of national security which constituted its very raison d'être.[5]

The perceptions of the past echoed strongly the z*eitgeist* of the democratization process that followed the fall of the dictatorship, the so-called *Metapolitefsi*. Literally, *Metapolitefsi* indicated the regime change and drastic reform that was carried through by the Konstantinos Karamanlis governments between 1974 and 1976: abolition of the monarchy by plebiscite, legalization of the communist parties, trial and life imprisonment of the 1967 coup leaders, purge of junta collaborators from the state apparatus, introduction of a new constitution. *Metapolitefsi* was also marked by Greece's withdrawal from the military wing of NATO as a reaction to the inertia shown by the alliance towards the second Turkish invasion in Cyprus (August 1974) – Greece returned to NATO's military command structure in 1980. That decision did not alter the fundamental Western orientation of the country, but it accommodated swiftly the widespread anti-Western feeling in the fragile early days of democratization. [6] At the same time, a whole new emphasis was attached to the achievement of fast membership in the European Communities (EC). Actually, the process of Europeanization – to be served ahead by further waves of reforms - was meant to secure and promote democratization.[7]

The term *Metapolitefsi* outlived that initial transitional period. It soon became the label for the entire political and eco-

5. Diamantopoulos, Thanassis, "He diktatoria ton syntagmatarchon 1967-1974" ("The dictatorship of the colonels 1967-1974"), in: *He historia tou Hellenikou Ethnous* (The History of the Greek Nation), 16 volumes, Athens: Ekdotiki Athinon, 2000, vol. XVI, pp. 266-286, especially p. 286.
6. Svolopoulos, Constantine, *Helleniki Exoteriki Politiki 1945-1981* (Greek Foreign Policy, 1945-1981), Athens, Estia, 2002, vol. II, pp. 198-217.
7. Botsiou, Konstantina E., "Anazitontas ton chameno xrono: He evropaiki trochia tis Metapolitefsis" ("In Search of the Lost Time: The European course of Metapolitefsi"), in: Arvanitopoulos, Constantine and Marilena Koppa, *30 Chronia Hellenikis Exoterikis Politikis, 1974-2004* (30 Years of Greek Foreign Policy, 1974-2004), Athens: Livanis, 2002, pp. 99-121.

nomic paradigm that was established in Greece after 1974, but acquired its permanent characteristics under the socialist governments of the 1980s. This paradigm was shaken up by the global financial crisis which erupted in 2008. Today, many scholars pose similar questions with their colleagues back in the 1970s: "How did we end up here? Why is Greece facing collapse again?" Who is responsible for this?" A critical difference from the 1970s is that now the blame is being put directly on the shoulders of the parliamentary actors who have been operating without the postwar and Cold War pressures of the 1950s and 1960s.

### *The content of democratization*

Above all, *Metapolitefsi* meant democratization. From an institutional point of view, this indicated initially the relocation of real power from non-parliamentary actors to the parliament and the government. This transfer was greatly facilitated by the weakening of the old triptych which had been held responsible for the collapse of democracy in 1967: the monarchy was abolished, the army was depoliticized and national sovereignty was declared to be the cornerstone of the new constitutional and political order.

From a political point of view, democratization brought compensation for previous political marginalization or discrimination. Compensation policies embraced various social groups: leftists identifying with the vanquished of the civil war; a young "protest" generation which had been politicized by the dictatorship, but was also representative of the Western youth culture of the 1960s and the 1970s; middle and lower middle class groups that had experienced political and fiscal austerity as barriers to social and economic mobility.[8] A rising university and press intelligentsia that

8. Moschonas, Andreas, *Paradosiaka Mikroastika Stromata stin Hellada*: *He periptosi tis Helladas* (Traditional Petty Bourgeoisie: The Case of Greece), Athens: Foundation for Mediterranean Studies, 1986. Moschonas, Andreas, *Taxiki Pali stin Hellada kai stin EOK, Tomos A: entaxi kai koinonika symferonta* (Class Struggle in Greece and the EEC. Volume I: Accession to the EEC and Greek Social Interests), Athens: Foundation for Mediterranean Studies, 1990.

merged the local spirit of independence with Western New Left influences and neutralist Third-World agendas.[9] They all denounced the postwar establishment as responsible for various exclusions and demanded the defense of the "people's democratic rights". Political mobilization proliferated through political parties, labor unions and pressure groups. Quite a few political leaders of the post-1974 era emerged from the protest generations of the junta-years, designated as the "Polytechneio-generation", a term borrowed from the student revolt against the colonels' regime in the Polytechnic School of Athens back in November 1973.

From an economic point of view, *Metapolitefsi* promised economic democratization on the basis of ever-growing state paternalism. As a counterpart of political democratization, voters-friendly economic development should make up for the exclusion of weaker social groups from postwar economic growth. In some cases, economic democratization served directly political democratization (e.g. through pensions provided to the members of the leftist resistance against the Axis in the 1980s). At first, protectionist measures were supposed to provide a safety net towards the rigorous competition that came with EC-membership.[10] The lack of competitive entrepreneurship provided further arguments in favor of a state-oriented growth model that would generate employment and would care for social cohesion.[11] It was anticipated that democracy and prosperity would be mutually reinforcing. Konstantinos Karamanlis himself was considered to qualify for socialist bias because of his decision to nation-

9. Great was the influence of the dependency theory projected on the perception of Greece as a country located in the periphery of the developed world, see Mouzelis, *Facets of Underdevelopment*. See also the emergence of influential leftist political magazines like *Anti*.
10. Kazakos, Panos, "Epiloges exoterikis politikis kai esoterikes prosarmoges" ("Choices of Foreign Policy and Domestic Adjustment"), in: *Ho Konstantinos Karamanlis kai he Evropaiki Poreia tis Elladas* (Konstantinos Karamanlis and the European Course of Europe), Athens: Konstantinos G. Karamanlis Foundation/Patakis, 2000, pp. 43-48.
11. Kazakos, Panos, "Socialist Attitudes toward European Integration", in: Kariotis, Theodore C. (ed.), *The Greek Socialist Experiment*, New York: Pella, pp. 257-278.

alize major private enterprises in crucial sectors (banking, transportation).[12]

In the course of years, state protectionism increased rather than decreased. Measures that were once introduced as temporary solutions became gradually the nucleus of ever-intensifying state interventionism. Emphasis shifted from competitiveness to protectionism, from market-oriented to state-sponsored employment, from productivity to consumerism. Paradoxically, this sort of economic "democratization" was made possible only thanks to the constant inflow of generous EC development funds since the 1980s,[13] coupled after 2002 with almost unlimited access to low-cost eurozone credit. In the end, EU-membership bolstered unintentionally local state capitalism.[14]

The lax conditionality of EC funding - which became even more generous after the founding of the European union (EU) - helped create powerful local administrators, who derived power from their capacity to champion the insatiable demands of their growing political clientele. Under the circumstances, clientele politics made a dynamic comeback despite increasing urbanization, spreading education and swelling immigration. Within three decades, this policy introduced over half a million excessive public servants into the state budget, created a labyrinth of closed professions and distorted the rules of economic and political competition. Economic democratization was soon derailed from its original purpose. The state budget ceased to finance primarily productive investments, as it was fragmented into the financing of incalculable salaries, economic privileges and bottomless spending for social policies ravaged by corruption (e.g. healthcare).[15] The single dogma of equal opportunity for all was thus distorted into

12. Psalidopoulos, Mihail, *Panagis Papaligouras: Omilies-Arthra* (Panagis Papaligouras: Speeches, Essays), Athens: Eolos, 1996, pp. 41-47.
13. Plaskovitis, Ilias, "EC Regional Policy in Greece: Ten Years of Structural Funds", in: Kazakos, Panos and P. C. Ioakeimidis (ed.), *Greece and EC Membership Evaluated*, London: Pinter 1994, pp. 116-127.
14. On the local interpretations of capitalism see Lewis, Michael, *Boomerang: Travels in the New Third World*, New York: W.W. Norton & Co., 2011.
15. Davaki, K. and E. Mossialos, "Health Policies", in: Kazakos, Ioakeimidis, *Greece and EC Membership Evaluated*, pp. 260-278.

countless networks of economic opportunism. The tolerance of tax evasion was just another variation of paternalistic manipulation.[16] The state grew indefinitely in size and decreased enormously in effectiveness.

Populism became the name of the game and a formidable opponent for programs of economic orthodoxy. By usurping the early ideals of democratization, populism emerged as the dominant "value-setter" in politics, economy and society. At first, it was identified with the Third World socialism that had been preached by the first socialist governments of the 1980s.[17] But it soon penetrated the entire party system. The premature fall of the Konstantinos Mitsotakis government (1990-1993) in its effort to liberalize the economy, left a lasting memory among reform-minded politicians from all parties.[18] The PASOK-governments of Kostas Simitis (1996-2004) and the Nea Demokratia governments under Kostas Karamanlis (2004-2009) opted for piecemeal reform only. These could not reverse the tide of bad practices that drove Greece to economic failure. Political leaders who dared question the sustainability of the economic model -as outgoing Kostas Karamanlis himself did in 2009- faced political marginalization. A general assumption was that sustainability was guaranteed by EU- and Euro-zone membership. In this regard, moral hazard spiraled the economics of superficial prosperity. The EU was ritually considered to be an inexhaustible "pipeline" that made national responsibility irrelevant.[19]

Political competition found a more suitable arena in TV talk shows rather than in Parliament. For the vast majority

16. On tax evasion see Danopoulos Constantine P. and Boris Znidaric, "Informal Economy, Tax Evasion, and Poverty in a Democratic Setting: Greece", *Mediterranean Quarterly*, 18/2 (2007): 68-74. Kalyvianakis Konstantinos et al., *Forologiko Kathestos, Paraoikonomia kai Forodiafygi stin Ellada* (Tax system, grey economy and tax evasion in Greece), Athens: Papazisis, 1993.
17. Clogg, Richard (ed.), *Greece, 1981-89: The Populist Decade*, London: Macmillan, 1993.
18. On the stabilization program of that period see Kazakos, *Between State and Market*, pp. 426-480.
19. From the term "Euro-oil" as crafted by Thomas L. Friedman in his article "Can Greeks Become Germans?", *New York Times*, 20 July 2011, p. A27.

of talented people working in the private economy, politics remained at best unfulfilling, at worst suspect. The Euro debt crisis revealed the dearth of technocrats in decision-making. The formation of a coalition government in November 2011 under Former Director of the Greek Central Bank and former Vice-President of the European Central Bank Lucas Papademos, was processed with great difficulty by the political and the economic establishment. This indicated clearly a predisposition to view the pan-European campaign for fiscal austerity as an anti-political movement, what Jürgen Habermas has called "the silent coup d'état of the technocrats" ("Der stille Putsch der Technokraten").[20]

The transformation of governance from a political art to a communication technique produced tremendous political power for the communications industry. This was translated, first, into an extreme influence of public opinion polling on policy-shaping and policy-making. Second, dozens of journalists were appointed to temporary or permanent positions of state agencies, others were driven into the national parliament or the European parliament. Third, many media companies occupied center-stage in Greece's 30-year construction boom (1980s-2000s) by developing their own powerful construction firms. This correlation became the symbol of state-sponsored corruption. The net loss for democracy was twofold: on the one hand, politics was more about virtual reality; on the other hand, the Press was disinclined to question authority, as it eventually became an ultimate authority itself. The expansion of the executive government and the thriving of the "fourth power" undermined the classical separation of powers. The coincidence of huge political and economic power in executive government fortified its authority against the control of the legislative and judicial branch of government. Only a few procedures demanded a qualified majority of votes (e.g. the election of the President of the Republic every five years). Each government could practically legislate on the basis of its own parliamentary seats alone. The need for cross-party consensus arose frequently only when Greece

20. Interview of Jürgen Habermas to Georg Diez, *Der Spiegel*, 47/2011, 21.11.2011, pp. 134-138. Jürgen Habermas, *Zur Verfassung Europas. Ein Essay*, Berlin: Suhrkamp, 2011.

was obliged to pass long-term reforms with reinforced majority in order to avoid bankruptcy in 2010-2011.

Justice suffered the most vital blow. The appointment and ultimate control of court authorities by the government set one serious issue. Another problem lay in the increasing workload for understaffed courts that compromised justice through year-long trial delays. The situation has routinely favored law-breakers and wrongdoers with direct or indirect political power. The upsurge of crime and tax evasion, as well as declining foreign investments, have been directly connected with the obscurities of the justice system. As a major source of social ethos, justice is instrumental in shaping mentalities and public behavior. Greece did not escape this rule. The diminution of justice vis-à-vis political power accentuated corrosive sociological characteristics and alienated lawful citizens who did not only have to cover the fiscal damage through eclectic and absurd taxation laws, but also had to live with the fact that unlawful behavior appeared to be a rational economic choice. Greece was in effect divided between an abstract flow of democratization and the obvious ebb of the rule of law.

### *The impact of history and Europe*

Where did the European Union stand along Greece's economic and democratic development? Low-cost prosperity and unbalanced state capitalism ran contrary to the initial spirit of Europeanization, which constituted the single most important strategic choice of Greece since 1974.[21]

Konstantinos Karamanlis had invested heavily on the potential of the European Communities to remedy the defects of the Greek political and economic conduct. The force of integration was expected to break historical rigidities that prevented home-grown reform. Karamanlis intensified his effort for EC-membership as he foresaw that Greece would enter the EC when anti-European PASOK-socialism would win elec-

21. Moschonas, Andreas, "European Integration and Prospects of Modernization in Greece", *Journal of Modern Greek Studies*, 15/2 (1997): 325-348.

tions. According to the socialists, Greece was unprepared for the challenge.[22] Karamanlis' approach was different: Greeks would never be ready enough to join; only fast EC-accession could spark off the dynamics of Europeanization.[23]

By signing the EC-Accession Treaty as early as 1979, Karamanlis sought to commit the socialists a priori to his vision for Europe-driven modernization. Integration into the European family was the grand strategy which all other policies should serve. Europeanization and democratization were two sides of the same coin. EC-membership was anyway achieved as a celebration of European democratic principles against authoritarian regimes, as was the case also in Spain and Portugal.[24] Indeed, the European factor has been ever since the most effective guide for fiscal stability, economic liberalization and political credibility. Twice in the 1980s the European Communities exerted great pressure on Greece to bring its economy back to track as a condition for retaining economic support and equal participation in the EC's agenda-setting. The first time was in 1985, when Kostas Simitis, as Minister of Finance in the second PASOK government (1985-1989), undertook the task to regenerate competitiveness through currency devaluation and fiscal austerity. The final abandonment of his unpopular policies led him to re-

22. Verney, Susannah, "From the 'Special Relationship' to Europeanism: PASOK and the European Community, 1981-1989", in: Clogg, *Greece, 1981-89: The Populist Decade*, pp. 131-153.
23. Molyviatis, Petros, "Stratigikoi stochoi kai exoudeterosi antidraseon" ("Strategic Goals and Defense against Reactions"), in: *Ho Konstantinos Karamanlis kai he Evropaiki Poreia tis Elladas*, pp. 72-77. Valinakis, Yannis, "He diapragmateftiki stratigiki" ("The negotiations strategy"), in: *Ho Konstantinos Karamanlis kai he Evropaiki Poreia tis Elladas*, pp. 33-37
24. Verney, Susannah, "Political Conditionality and the Quality of Democracy: The Case of Greek Association and Accession to the European Community", in: Kabaalioglu, H., Darta, M., Akman, M. and C. Nas, *Europeanisation of South-Eastern Europe: Domestic Impacts of the Accession Process,* Istanbul: Marmara University\Turkish Universities Association for European Community Studies, 2005, pp. 69-94. Chilcote, Ronald H. et al., *Transitions from Dictatorship to Democracy*, New York: Taylor & Francis, 1990. Pridham, Geoffrey (ed.), *The New Mediterranean Democracies: Regime Transition in Spain, Greece, and Portugal*, London: Better World Books, 1984.

sign in 1987.[25] A few years later, in 1990, Greece came again to the brink of collapse as the reform program of 1985 had not been allowed to produce the expected stabilization results. Greece was warned by the European Commission that mounting foreign debt put at stake its participation in the integration process. As it had done in 1985, the European Community provided finally the necessary loans that spared Greece a strict stabilization program under the auspices of the IMF. The results were meager, though, despite the stabilization measures of the Mitsotakis government. Inflation and fiscal deficits remained high together with the rate of unemployment, whereas productive investments dropped. The control of public deficits and foreign debt were postponed. The ECOFIN approved a Greek "convergence program" in 1993 promised more aggressive harmonization while Greece would be preparing to join the EMU (1993-1998).[26]

The initiation of the European Union and the planning for a single European currency found Greece in the opposite direction from the one it had been supposed to take in the 1970s. The resistance to change had proved stronger than European pressure. The key lay in the weak conditionality of

25. Tsakalotos, Euclid, "The Political Economy of the Social Democratic Economic Policies: The PASOK Experiment in Greece", *Oxford Review of Economic Policy*, 14/1 (1998): 114-138. Tsakalotos, Euclid (1991), 'Structural change and macroeconomic policy: the case of Greece (1981-1985), *International Review of Applied Economics*, 5/3 (1991): 253-276. Garganas, Nikos Thomopoulos, Takis and Yannis Spraos, *The Policies of Economic Stabilization*, Athens: Gnosi, 1989.
26. About both stabilization programs see Kazakos, *Between State and Market*, pp. 376-389, 428-437, 459-463. See also Kollintzas, Tryfon and George Bitros, *Anazitontas tin elpida gia tin helleniki oikonomia* (In Search of Hope for the Greek Economy), Athens: Institute for the Study of Economic Policy, 1992. Alogoskoufis, George, *He krisi tis oikonomikis politikis* (The Crisis of Economic Policy), Athens: Kritiki, 1994. Featherstone, Kevin, Kazamias, Georgios and Dimitris Papadimitriou, "Greece and the Negotiation of Economic and Monetary Union: Preferences, Strategies, and Institutions", *Journal of Modern Greek Studies*, 18/2 (2000): 393-414. Pelagidis, Theodore, "Economic Policies in Greece 1990-1993", *Journal of Modern Greek Studies*, 15/1 (1997): 67-85. Pagoulatos, George, *Greece s New Political Economy: State, Finance, and Growth from Postwar to EMU.* New York: Palgrave Macmillan, 2003.

EU funding. Greece would have probably not realized a vast program of wealth redistribution without the wealth generated by EC-membership. But the valuable resources were fully welcome with no strings attached. Thus, EU-driven modernization was only partially implemented. Low absorption of harmonization programs was a usual phenomenon, whereas Greece was also often confronted with the European Court of Justice for non-compliance with EU policies (e.g. notably in environmental issues).[27] Borrowing Alan Milward's concept, it can be argued that EU-membership secured the "rescue of the Greek nation-state".[28] This idea of Europeanization worked finally *against* modernization and democratization.[29]

In 2002, Greece welcomed the Euro against this political background. Easy access to low-cost bank credit aggravated the local idiosyncrasy and provided further disincentives for reform. The state budget was burdened routinely with high deficits as state expenses grew wild to support state capitalism. Missing taxation was compensated with vast borrowing from international capital markets on Euro-guarantee and was duly converted into convenient political electoral results. Hence, the European common currency lent Greece many attributes of a parochial rentier state.

Since 2009, hundreds of analyses have been dealing with the Greek debt crisis. Naturally, they first focused on its financial and economic aspects. So did the troika of the IMF, the European Commission and the European Central Bank

27. Kozyris, John P., "Reflections on the Impact of Membership in the European Communities on the Greek Legal Culture", *Journal of Modern Greek Studies* 11/1 (1993): 29-49. Makridimitris, A. and A. Passas, *He helleniki dioikisi kai o syntonismos tis evropaikis politikis* (Greek Administration and the Coordination of European Policy), Athens: EKEM, Working Paper No. 20, 1993.
28. Milward, Alan S., *The European Rescue of the Nation State*, London: Routledge, 2000.
29. See Tsardanidis, Charalambos and Stelios Stavridis, "The Europeanization of Greek Foreign Policy; a Critical Appraisal", *European Integration*, 27 (2005): 217-239. Economides, Spyros, "Karamanlis and the Europeanization of Greek Foreign Policy", in: Svolopoulos, Constantine, Botsiou, Konstantina E. and Evanthis Hatzivassiliou, *Ho Konstantinos Karamanlis ston Eikosto Aiona* (Konstantinos Karamanlis in the Twentieth Century), 3 volumes, Athens: Konstantinos G. Karamanlis Foundation/Rodakio, 2008, here vol. II, pp. 163-176.

that was assigned with a plan for fiscal stabilization in 2010. After almost two years of futile efforts to regenerate faith in Greece's economic prospects, the problem is now examined increasingly from a political angle, too. The colossal Greek debt is definitely the most salient feature of the Greek problem. But the stabilization program failed mainly because of political resistance to reform. The troika's financial plan attacked the sacrosanct fundaments of state protectionism and clientele politics that have supported the post-1974 organizational model of Greece. Among the four basic proposals of its program a) reduction of public servants, salaries and pensions, b) reform of the insurance system c) privatization of state assets and, d) a new taxation system, only the cuts in salaries and pensions were carried out in the first year of implementation–the easy horizontal measures; all the rest were either partially implemented or indefinitely postponed. The pace of reform did not match the urgency of the crisis. So did also domestic political competition.

The announcement of a plebiscite to determine whether Greece would remain in the Euro-zone just a few days after the EU agreement on a new plan for the Greek debt (October 26, 2011), was the most striking among many political signals that cast doubt on Greece's likelihood to exit the debt crisis. This "political" behavior, presented as legitimate resistance to "technocrats", increased defeatism in the public opinion over the feasibility of any rescue plan. Certainly, it cost George Papandreou the Premiership and questioned his leadership of the ruling party, PASOK. But big losses were also detected in the readiness of Greece's political forces to act in concert at times of emergency. The political tradition of one-party governments runs contrary to considerations of coalition governments. Accordingly, the coalition government of Lucas Papademos was assigned with a very limited mission by the supporting political forces: to conclude the voluntary Private-Sector Involvement in bond swaps (PSI), the centerpiece of the October 2011 Euro-Summit agreement for granting a new EU rescue package to Greece in the spring of 2012, the second in 18 months.

The uniqueness of the Greek debt crisis within the general eurozone turmoil lies in the extreme state-dependency of the real economy. Changing the economy means literally to demolish fundamental pillars of the state's political and social architecture. The uncertainties of a radical transition toughen objections towards the rescue program. This context offers fertile ground for the propagation of an ostensibly easier solution to boost national competitiveness: exit from the eurozone and devaluation of the drachma. Such a scenario also promises to re-produce familiar patterns of economic and political organization. The open or tacit objections that are heard across the political spectrum on the wisdom of following a strict stabilization program have been aptly described by the Greek Press as "the invisible party of the drachma".[30] Still, the vast majority of Greeks (70-80%) turns out to reject Greece's withdrawal from the Euro-zone.[31]

Eventual exit from the eurozone would, thus, be a dangerous bet for the Greek political forces. As the menace of insolvency set in, it started to spill over into a crisis of political legitimacy. It is very doubtful, whether the existing political forces could remain intact from the cataclysmic reversal of the Greeks' security and standard of living that would follow a return to the drachma. The big Greek parties already suffer deep internal rifts because of their reluctance to adopt the principles of the rescue program.

Crises of political legitimacy have often produced epochal changes in modern Greek politics. The last military dictatorship opened the door to drastic regime change. Prior to that, a legitimacy crisis had been the threshold of a new party system in the 1950s, as the old political forces failed to meet the challenges of the Cold War era. Their reluctance to liberalize and reform was confronted with the exigencies of the Marshall Plan (European Recovery Program, ERP) that made the granting of assistance conditional upon reforms fostering stable and market-oriented governance.[32] Conditionality

30. Athanassios Papandropoulos, "He epelasi tou kommatos tis drachmis" ("The onslaught of the drachma party"), *Estia*, 28 January 2012.
31. Results of public opinion surveys by three leading opinion polling agencies (Marc, Alco, Public Issue), *Eleftherotypia*, 27 January 2012.
32. Botsiou, Konstantina E., "Mia 'pyrrheios niki: He diavrosi tou Laikou Kommatos meso tou Emfyliou" ("A Pyrrhic Victory: The decline of

touched upon a wide range of issues, from monetary policies and military re-organization to electoral laws that produced effective governments. This process led to the formation of the first stable Greek government after the civil war under Field-Marshall Alexandros Papagos (1952) and paved the way for the rise of Konstantinos Karamanlis as leader of a new generation.[33] The old parties that governed Greece between 1946 and 1952 were washed away by this generation. Westernization, political stability and economic development became swiftly Greece's absolute priorities.[34]

One century earlier, aid conditionality had also been the key to success for the International Economic Control which supervised Greek finances after the 1897 Greek-Turkish War and created the sound economic basis upon which Greece fought successfully the Balkan wars.[35] The Greek party system changed radically through that process. Eleftherios Venizelos emerged as the natural leader of a new political generation that managed to fulfill Greece's irredentist cause and modernize the country on a clearly pro-Western path.[36]

In these cases, the catalyst for long pending reform was either pressure from an external factor or a recent national disaster, or both: e.g. Greek defeat in 1897-International Control, civil war-American intervention through the Marshall Plan. Failure in the field of national security activated radical

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the Popular Party through the Civil War"), in: Gounaris, Vasssilis K., Kalyvas Stathis N. and Ioannis D. Stefanidis, *Anorthodoxoi Polemoi: Makedonia, Emfylios, Kypros* (Unorthodox Wars: Macedonia, Civil War, Cyprus), Athens: Patakis, 2010, pp. 332-359.

33. Hatzivassiliou, Evanthis, *He anodos tou Konstantinou Karamanli stin exousia, 1954-1956* (Konstantinos Karamanlis' Rise to Power, 1954-1956), Athens: Patakis, 2001, pp. 39-45, 111-120.
34. Hatzivassiliou, *Karamanlis' Rise to Power*, pp. 85-92, 284-310.
35. Psalidopoulos, Mihail, "Apo tin ptochefsi tou 1893 sto Goudi" ("From the bankruptcy of 1893 sto Goudi"), *He Kathimerini*, 4 July 2011. Psalidopoulos, Mihail and George Pagoulatos, "Eikones apo to Parelthon" ("Pictrures from the Past"), *He Kathimerini*, 18 April 2010. Dertilis, George, *Historia tou Hellenikou Kratous, 1830-1920* (History of the Greek State, 1830-1920), 2 volumes, Athens: *Estia*, 2006, here vol. II, pp. 581-591, 825-891.
36. Mavrogordatos, George Th. and Christos Hadjiiosif, *Venizelismos kai astikos eksygxronismos* (Venizelism and Bourgeois Modernization), Crete: Crete University Press, 1988.

change also after 1922 (defeat in the Greek-Turkish War in Asia Minor) and after 1974 (failure of the colonels to block the Turkish occupation of a part of Cyprus). They all revealed another key aspect of modern Greece: its perennial dependence on foreign aid. Decade after decade, foreign assistance sponsored reform, but also prevented Greece from asserting its own strengths. As a matter of fact, foreign assistance was often sought by Greek governments as an easier way to finance development and social cohesion rather than imposing the political limitations of effective governance.[37] This mentality proved a great handicap both in the low-credit Eden of the 2000s as well as in the Euro debt-crisis in the 2010s.

The apocalyptic local effects of the global economic crisis made Greece feel gain the joint pressure of political instability and aid conditionality. The pressure is enormous: first, by the troika; second, by Greece's single European partners; third, by the Greek people themselves who experience the debt-crisis as a national disaster. The troika program promises to help Greece through a severe punishment. The haircut of the Greek debt imposes strict conditionality. On the financial level, it imposes privatization and liberalization. On the political level, it imposes long-term EU-supervision over the Greek economy. Both functions are politically relevant. The revision of the EU Treaties has been also put on the table as a means to enhance political conditionality in the economic governance of the eurozone - in other words, as a means to advance political integration.

Reform in Greece will have to engulf many areas of public life. Definitely, economy and justice stand out. Because of the deep current crisis, EU-driven modernization may have a better chance to make both economy and democracy work. The condition is that Greece remains in the EU and the EU asserts itself as a closer political union. Otherwise, a Greek crisis could happen again.

37. About the politics of dependency on foreign aid see Varvaressos, Kyriakos, *Ekthesis epi tou oikonomikou provlimatos tis Ellados* (Report on the Economic Problem of Greece), Athens: Savvalas, 2002. Psalidopoulos, Mihail, *O Xenophon Zolotas kai he helleniki oikonomia* (Xenophon Zolotas and the Greek Economy), Athens: Metamesonylkties Ekdoseis, 2008.

# DEVELOPMENT MODELS IN THE GREEK ECONOMY, FROM POST WWII TO THE PRESENT, AND BEYOND

*Michalis Psalidopoulos*

John Maynard Keynes in his "General Theory of Employment, Interest and Money" (1936) concluded in his final chapter, that the political power of economic ideas is more powerful than is commonly understood and indeed, he argued, the world is governed by little else; statesmen-madmen in authority, he continued, are usually the slaves of some defunct economist. These were the last sentences in his book, a book that was intended to change the way economists thought about the macro economy. Keynes' views about the latter didn't go unchallenged, the thesis about the importance of ideas in the battle to conquer the hearts and minds of the electorate in every parliamentary democracy is still with us and is regarded as extremely important, if someone wants to change the way the economy works.

Development models are like this. They consist of a set of ideas meant to mobilize the masses around a certain political platform and party. They are the constructs of individuals or collectives and from the moment they are disseminated, debated, accepted, modified, passed from one generation to the next, they set the stage for exchanges and controversies. The New Deal, Peronism, and other examples can be cited as economic schemes and models that rallied the electorate and transformed economies and societies leaving behind a legacy that is still the object of scientific inquiry. Greece had many intellectuals in the past, many of whom succeeded in capturing the hearts and minds of the Greek people with their economic proposals.

Dimitris Batsis and his "Heavy Industry in Greece" (1947) was the hero of the political left. He advanced the idea to overcome underdevelopment in Greece by way of promoting the creation of industrial sectors in an up to then mostly agrarian/commercial society. His very detailed plan set the stage for a big debate in the country that ended because of the defeat of the communist left in the civil war and the execution of Batsis.

Kyriakos Varvaressos was a man of the political center. As a very prominent economist of the interwar years, governor of the central bank, professor at the University of Athens, and member of the Academy of Athens, he held important political positions twice and was, among other things, present at the creation of the Bretton Woods agreements. He later worked as an executive director at the World Bank, and returned to Greece in early 1952 to submit his report to the Plastiras government, the well-known "Report on the Economic Problem of Greece" (1952). Again, this was a very impressive, visionary report, a development plan still read and debated today. But Plastiras and the center-left were voted out of office in 1952, and so his proposals were not put into practice.

The two development models that prevailed in post WW II Greece were the Xenophon Zolotas/Panagis Papaligouras model from 1955 to 1981 and the Andreas Papandreou model from 1981 until the present. It is these models that will attract our attention below. At present and with the financial crisis of 2008 with its dire consequences for the Greek economy setting the stage, the Papandreou model has, in my view, exhausted any possible usefulness it had possessed. Many economists in Greece are presently trying to circulate new ideas about models for future growth and the future will tell which model or models will prevail.

Let us however focus our attention on the Zolotas/Papaligouras model. Starting in 1955, Professor Xenophon Zolotas became governor of the central bank of Greece and Panagis Papaligouras became the right-hand of Constantine Karamanlis in his successive governments of the 1950s and the early 1960s. Both men remained close disciples of Constantine Karamanlis when he returned to power in 1974. Zolotas' views about the Greek economy are best expressed his 1964 book "Monetary Equilibrium and Economic Development". This treatise captures his vision about the development path of the Greek economy. Central to Zolotas was the theme of monetary stability in the country: the devaluation of the drachma and the stabilization of the Greek currency in 1953 had to be defended at all costs, because it was very important for the Greek economy to have a sound monetary base. Individuals would know that their savings would be worth their value, businesses would make sound investment plans, and foreign capital would be attracted to invest in the country. Next to monetary stability, and possibly zero inflation, in a country that had witnessed horrendous inflation for 13 years, from 1940 to 1953, the budget of the central government had to be balanced. Of course, the country was poor and the need for public investment was high. But the rationale for Zolotas was to keep the current budget balanced; he recommended the introduction of a new account, the budget of public investment. This could eventually be a deficit budget, but it would be covered by loans from the outside world and through public savings. Public investment in Greece from 1955 to the mid-1960s and beyond was financed through the budget of public investment. The economic system of Greece was highly regulated. Zolotas did not have a high regard for liberal theories as those advanced by Friedrich von Hayek. He was not in favor of Keynesian economics either. He was a moderate monetarist and a believer in sound regulation and oversight of the economy. He had been explicit about this in his books. (Psalidopoulos 2007). Hayek's approach was too abstract/theoretical for him, and Zolotas was a practical liberal who wanted good results. He found in Papaligouras a practical politician who delivered results. Papaligouras shared the same values, he transformed them into policies and called his way of economic governance "realist liberalism" (Papaligouras 1996).

The record of Constantine Karamanlis as a prime minister was impressive, a metamorphosis of Greece from a very poor to a very prosperous country, with an annual growth rate of on average 6.5% from 1955 to 1981 while prices increased by 3%. There were, of course, negative sides in this policy. There was high unemployment in the early 1960s and a push in society for a more expansionary policy. Indeed during the dictatorship this model came into question; the dictatorship was more expansionary in its economic policy in a vain effort to get political legitimization. It was also unable to master the course of the economy after the collapse of Bretton Woods in 1971. Overall however, the model was reintroduced after the restoration of democracy in the midst of the oil crises of the 1970s. At that point, however, the Zolotas/Papaligouras model had given to the Greek economy all it could deliver and started losing its political appeal.

Andreas Papandreou was a prominent economist in the United States before returning to Greece. In the 1950s and 1960s he played a critical role in mainstream economics of the time (for details on the evolution of his economic thinking, see Psalidopoulos 2011). He came to Greece at the invitation of Constantine Karamanlis to establish the Center of Planning and Economic Research and the first books he wrote in the early 1960s advanced the notion of structural change within the then existing paradigm. His clash with the military dictatorship and the way the Center Union had been ousted from office in 1965 radicalized him. After he went into exile, he became a radical economist and his books "Man's Freedom" (1973) and "Paternalistic Capitalism" (1974) are analyses that seek to redefine the relationship between the individual and business interests in late capitalism. He shared common themes with the so-called Monthly Review School on the North/South analysis of the world economy, distinguishing between rich and poor countries, and unequal exchange in trade by means of economic imperialism. His books in the 1970s became sacrosanct texts for his followers, especially "Socialism in Greece" and "The Way to Socialism," both published in 1977.Papandreou's greatest concern in these books was the importance of popular support of any government wanting to implement "change" in the Greek economy as vested interests of the "establishment" would try to overthrow his rule, as they had done with the

Centre Union in the past. In order to secure the loyalty of the popular masses Papandreou wanted, what he called, "social consumption" to grow. This meant big raises in wage income, especially in the public sector. The public sector was a tool to control the economy, to boost growth and to absorb the unemployed. Next to social consumption, the banking system had to be nationalized and supply the public sector, including public enterprises and agricultural cooperatives, with loans. Papandreou called this a "socialization" of the banking system since oversight was relegated to boards of overseers who represented unions and boards of trade. Finally, foreign trade had to be centrally controlled in order for the national economy to remain immune from changes in international economic relations. The policies introduced after 1981 were along these lines. Political support for PASOK was secured, but economic results were catastrophic: almost zero growth and double digit inflation during the whole of the 1980ies. Despite this economic outlook the voters did not matter, so they re-elected Papandreou in 1985 and even stood by his party in 1989/1990 and after 1993.

Papandreou's model had some positive sides. Public money spent, stirred the economy. It introduced regional development and boosted transfer payments. However, winning elections through this sort of economic management proved to be everlasting for, despite shifts and efforts to move away from this pattern, all three prime ministers after Papandreou, namely K. Mitsotakis, K. Simitis, and K. Karamanlis, didn't challenge the prevailing economic paradigm - they tried to reform it. These reforms were meant to secure compliance with the rules of the European Union and the process of Economic and Monetary Union of Europe. The debt ratio, however, as low as 20% of GDP in the year 1980, grew to be 100% and higher, a decade later. The budget deficit to GDP ratio was double digit in the early 1990ies. Economic transfers from the European Union concealed the fact that there was a fiscal derailment, a bubble being created in the economy from that period onward. Next to this was legal tax evasion, and special treatment given to certain professional groups that paid little or no taxes, despite their large incomes. Of course, this model experienced a transition during the 1990s after Papandreou's illness and ultimate death, but it wasn't challenged in principle. After the introduction of the euro in the Greek economy, the lowering of inflation and high rates of growth because of investment in infrastructures funded with EU money, a further element boosted consumption: interest rates fell and a new credit bubble was created within the deficit bubble. This situation met very mild opposition because elections could be won, by either the left or the right parties, through the manipulation of public expenditure and transfer payments at the right time of the electoral cycle. The delay of important reforms, most obviously the failure to overhaul the insurance system in 2001, added a further boost to the bubble that burst when in 2009 the real numbers of Greek macroeconomic indicators was publicly revealed to Eurostat and to international markets.

Today, this way of running the economy, mainly through government deficit spending can't be sustained anymore. First, there is no access to low interest borrowing and second, because now its statistics are European statistics. Future governments would have very limited ways to create public employment without having first secured the revenue to pay for it. One is tempted to recall that because of the oil shocks of the 1970s the Karamanlis government had introduced, next to the regular budget, and the budget for public investment, the so-called oil account, which was a special deficit account meant to carry only oil as a single item. This was a bad start since in the 1980s and the 1990s another 13 special accounts had been created, next to the regular budget. When, in 2008, an effort was made to consolidate Greek public finances (Government Gazette 194, September 25, 2008, law 3697) it was revealed that the fiscal management of the country was catastrophic. This is something that cannot happen anymore and as long as Greece is a member of the EU and the eurozone.

My conclusion is that the Andreas Papandreou model to develop the Greek economy is now defunct and that we have to contribute to the creation of a new one. This won't be easy; it won't be the work of one person only. In fact, currently there are groups at IOBE, at Eurobank and elsewhere, working in that direction. It is a sad fact, however, that any discussion in

Greece after May 2010 remains almost totally focused, not on the question "what brought the economy to its knees?", but around the "struggle" and the need to resist reforms and convince the Troika (EU, ECB, IMF) that their recommendations are failing. In the meantime, the Greek economy is still creating new debt, for revenue is less than total expenditure. This is partly due to the depressed economy, but also to the fact that the majority of the Greek political class still holds to the Papandreou model; it seems it is still unable to understand that overspending through borrowing, a model that brought the Greek economy to its present status, has no future. This doesn't imply that the Troika recommendations are sound and not myopic. They are aimed at covering the public deficit at all cost, as fast as possible, in order to balance current expenditure with taxes, and to reform the labor market. It is hoped that these policies will bring growth sometime in the future. Growth is, however, needed since yesterday, if not today, for without it, no debt can be repaid. It is, therefore, of great importance that Greek economists develop a new model for the Greek economy, a model that will show the way forward and will be adopted and implemented by politicians aimed at leading the country to prosperity again.

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# PAST ACTIVITIES SPONSORED BY THE CONSTANTINE G. KARAMANLIS CHAIR IN HELLENIC AND EUROPEAN STUDIES

*Challenges to the 21st Century: European and American Perspectives Series*

The Constantine Karamanlis Chair in Hellenic and European Studies, The Fletcher School, Tufts University, in collaboration with the Security Studies Program at The Fletcher School, co-sponsored and hosted the following events at The Fletcher School. The events were organized by Ms Renee Haferkamp, under the auspices of the Minda de Gunzburg Center for European Studies at Harvard University, and in collaboration with the Weatherhead Center for International Affairs, the Kokkalis Program, and the Nicolas Janssen Family Fund in Brussels.

*Events*

- 10/12/11 Pierre Vilmont, Executive Secretary General of the European External Action Service
  *"Europe and the Challenges of Today's Global World"*
- 10/26/10 Joao Vale de Almeida, Head of the European Union Delegation to the United States
  *"In Search for European Foreign and Security Diplomacy"*
- 9/27/10 Baroness Catherine Ashton, High Representative for Foreign Affairs and Security Policy of the European Union
  *"Europe's Global Role after Lisbon"*

- 9/18/09 Javier Solana, European Union High Representative for the Common Foreign and Security policy
*"Europe's Role in Confronting Global Security Challenges"*
- 10/8/08 Stavros Dimas, Commissioner of the European Union: Environment
*"Environmental Policy-Making in the European Union"*
- 10/29/08 Alain Lamassoure, Member of the European Parliament, Member of the EPP Bureau
*"Transatlantic Relations after the US Elections: What Does Europe Expect?"*
- 10/18/07 Jacek Saryusz-Wolski, Chairman of the Commission of Foreign Relations: European Parliament
*"Enlargement of the European Union: Past and Future"*
- 12/7/07 Andris Piebalgs, Commissioner of the European Union: Energy
*"The European Energy Policy: Challenges and Responses"*
- 10/10/06 Hans-Gert Poettering, MEP, Chairman of the EPP-ED Group in the European Parliament
*"EU and US- Common Responsibility in the World"*
- 11/1/06 Robert Cooper, Director General for External and Politico-Military Affairs, Council of the European Union
*"Europe as a Foreign Policy Actor. What it isn't. What it is. How it (really) Functions. Why it is good for the USA"*
- 12/4/06 Jamie Shea, Director-General for External and Politico-Military Affairs, Council of the European Union
*"Global NATO: Overdue or Overstretch?"*

## COURSES TAUGHT AT THE FLETCHER SCHOOL BY THE KARAMANLIS PROFESSORS IN HELLENIC AND EUROPEAN STUDIES

**Spring 2012**

| | |
|---|---|
| DHP P285 | South-Eastern Europe in the World Economy<br>Michalis Psalidopoulos |
| DHP D285 | The External Action Service and the EU's post-Lisbon CFSP: Challenges, Processes and Outcomes<br>Michalis Psalidopoulos (with A. Henrikson and E. Lagadec) |

**Fall 2011**

| | |
|---|---|
| EIB E270 | History of Financial Turbulence and Crises<br>Michalis Psalidopoulos |

**Spring 2011**

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|---|---|
| DHP P285 | South-Eastern Europe in the World Economy<br>Michalis Psalidopoulos |

**Fall 2010**

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|---|---|
| EIB E270 | History of Financial Turbulence and Crises<br>Michalis Psalidopoulos |

**Spring 2010**

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| DHP P218 | Religion and Nationalism<br>G. Mavrogordatos |

**Fall 2009**

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| DHP P213 | Charismatic Leadership and International Relations<br>G. Mavrogordatos |

**Spring 2009**

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| DHP P285 | The Geopolitics of the Wider South Eastern Europe and Black Sea Regions<br>Alexandros Yannis |

**Fall 2008**

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| DHP P281 | European Union Foreign Policy: Theory and Practice<br>Alexandros Yannis |

**Spring 2008**

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| DHP D283 | The USA, Turkey, and Greece: Past, Present, and Future<br>Kostas Lavdas |

**Fall 2007**

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| DHP P283 | Europeanization and the Domestic Impact of European Integration<br>Kostas Lavdas |
| DHP P284 | State, Nationalism and Ideology: The Case of Southern Europe<br>Kostas Lavdas |

**Spring 2007**

| | |
|---|---|
| DHP P285m | Modern Turkey & Its Region: Domestic Politics and External Relations<br>Dimitris Keridis |

**Fall 2006**

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| DHP P286m | Political Violence and Ethnicity (1/2 cr)<br>Dimitris Keridis |
| DHP P212 | Democracy, Democratization and Nation-Building<br>Dimitris Keridis |

**Spring 2006**

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| DHP P212m | Democracy and Democratization (1/2 cr)<br>Dimitris Keridis |
| DHP P287m | European Security: History, Politics and Institutions (1/2 cr)<br>Dimitris Keridis |

**Fall 2005**

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| DHP P285 | Greek-Turkish Relations in the Era of Globalization: From Rivalry to Partnership?<br>Dimitris Keridis |
| DHP P286 | War and the Politics of Ethnicity and Democracy: The Case of Southeastern Europe<br>Dimitris Keridis |

**Spring 2005**

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|---|---|
| DHP P282 | The Return of Diasporas: Ethno-National Networks, Multi-Cultural Societies and Global Threats<br>George Prevelakis |

**Fall 2004**

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| DHP P283 | European Enlargement Geoplitics: Greece, Turkey, Cyprus and the Balkans<br>George Prevelakis |

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| DHP P284 | Modern Greece: Europeanization's Geopolitical Miracle or Eastern Question's Lesser Evil?<br>George Prevelakis |
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| DHP P285 | Southeastern Europe in Perspective<br>Thanos Veremis |
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| DHP P286 | The Foreign Policies of the European Union's Mediterranean States<br>Thanos Veremis |

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| DHP P285 | Southeastern Europe in Perspective<br>Thanos Veremis |
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# ANDREAS A. DAVID SCHOLARSHIP AT THE FLETCHER SCHOOL

The Andreas A. David Foundation established a scholarship at The Fletcher School in 2003. Its goal has been to strengthen the human capital of the Greek Foreign Service so that it better meets the challenges of the 21st century. The scholarship is offered to a mid-career level diplomat from the Greek Ministry of Foreign Affairs for a one year fellowship to obtain a Master of Arts (MA) degree. In 2011, the Andreas A. David Foundation expanded the scholarship program to include fellowship opportunities for representatives from two additional Greek ministries, the Ministry of Defense and the Ministry of Homeland Security. The generosity of the Andreas A. David Foundation encourages and sustains the recipients of the fellowship to implement new ways of thinking in their respective ministries upon their return to Greece.

*The Fellowship has been awarded to the following recipients:*

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| **2003-2004** | Ioanna Efthymiadou |
| **2004-2005** | Angelos Ypsilantis |
| **2005-2006** | No scholarship awarded |
| **2006-2007** | Dmitri Goudkov and Sujata Tuladhar |
| **2007-2008** | Nicolas Sigalas |
| **2008-2009** | Athina Makri |
| **2009-2010** | Alexios Mitsopoulos |
| **2010-2011** | Gina Andreadi |

**2011-2012** Alexandros Ioannidis, *Ministry of Foreign Affairs*
Christos Eleftheriou, *Ministry of Homeland Security*
Vasileios Loukovitis, *Ministry of Defense*

*Background Information on Andreas A. David*

Andreas A. David was born in 1934 in Petra, a small village in Cyprus. Andreas began his business career in Ghana at the first Coca-Cola bottling plant owned by his uncle A.G. Leventis. He mastered every single aspect of the bottling operation and acquired a thorough grounding in the economics of the business. He used this knowledge to lead the family-owned business, and with vision, passion, and sheer hard work he extended the business to acquire and consolidate bottling plants in 11 countries ranging from Nigeria, Ireland, Greece, and the emerging Eastern European countries.

He further consolidated the business by merging with the Coca-Cola company in Europe to create the Coca-Cola Hellenic Bottling Company which covered 23 countries, served 400 million people, and offered jobs to many thousands, becoming the second largest Coca-Cola bottling company in the world. Andreas's death in October 2000, was deeply mourned by many people around the world, as they remembered his openness, warmth, charm, ready laugh, and, above all, his deep-seated belief in quality and integrity, which personified him.

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The National Bank of Greece established a term scholarship at The Fletcher School in 2008. Preference for the scholarship is given to students from Greece and Southeastern Europe who have an interest in finance. The National Bank of Greece also provides programmatic support for The Constantine G. Karamanlis Chair in Hellenic and European Studies at The Fletcher School. We are grateful for the generosity of the National Bank of Greece as the scholarship provides it's recipients vast opportunities to return to Greece to implement new ways of thinking and the programmatic support provided allows for the Karamanlis Chair to organize such events as the successful international conference in celebration of the 10th Anniversary of The Karamanlis Chair at The Fletcher School.

*The Scholarship has been awarded to the following recipients:*

**2008-2009** Jelena Lukic, Tihomir Tsenkulovski, Natasa Jokic

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