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INTRODUCTION

In 1967, a shadowy group of officers known as 'the Colonels' staged a military coup and began their seven-year rule over Greece. I was still at school then but instantly decided that I would leave Greece as soon as possible and, a few years later, I moved from Athens to London. I wasn't one of the many young Greeks from a relatively privileged background who wanted to study abroad, intending to return to Greece afterwards. Instead I left determined to use the education I would acquire as a passport to try my luck elsewhere in Europe. The economy in Greece was in a dire state with sectors like tourism, within which my father worked, devastated by foreigners boycotting Greece in protest against the regime. And frankly, for much of my early years in the UK, I felt a sense of shock at seeing men in uniform rule a country still referred to as the cradle of democracy.

And yet I owe my love of economics to those terrible years of dictatorship. It was assumed that after my secondary education at the German School

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of Athens, which had been closed after the war and then reopened in 1952, I would attend university in Germany as lots of Greeks did in those days. As a teenager, however, I had been sent by my father to a summer school in Reading to improve my English, which was fast becoming the dominant foreign language. Instead of studying at the school, I followed a bunch of French girls on their daily trips to London and spent most of the time walking up and down the King's Road marvelling at the culture and the outfits (it was the period of hot pants!). The rest, as they say, is history. It had to be London and nowhere else and the London School of Economics was the only place to study. My always obliging father hired a well-known economics professor, Sakis Karagiorgas, who had to stop teaching at the University of Athens because of his left-wing views during the Colonels' regime but came highly recommended (a surprise to me, as my father was rather right-wing in those days). I started having lessons with him in the evenings after attending my German day school. The summer after my course had finished, I distinctly remember hearing on the radio that this same professor had been arrested following a bomb explosion in the basement of his house, where all my lessons had been held, and that in the process he had lost part of his hand! It seems that, all the time I was learning about economics, I was sitting above a bomb factory! He and his co-conspirators, including Vassilis Rapanos (who later held the post of President of the Board of the National

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Bank of Greece and, very briefly, the post of Finance Minister after the 17 June 2012 elections before resigning due to ill health), seemed to have all been jailed together. Vassilis Rapanos later said in a newspaper interview that he had learned his economics in jail while in adjoining cells with the very same professor.

Sakis Karagiorgas and Vassilis Rapanos were both later released. In 1974, the Colonels got Greece involved in a disastrous attempt to annex Cyprus, which resulted in a Turkish invasion of the island and its resultant partition. The regime in Greece promptly fell and its leaders were tried and imprisoned. Professor Karagiorgas resumed his academic life and became a well-known economics professor. A period of renewal started with the release from prison (and return from exile) of former politicians, leading to Greece's eventual membership of the European Economic Community (EEC) in 1981 and then entry into the euro in 2001. Both were politically motivated and the Greeks were especially keen to join the EEC given their precarious geographical position. On the border, the Communist Balkans reminded the Greeks of the civil war of 1946–9, which saw Greece almost become part of the Soviet bloc. Across the sea was arch-enemy Turkey, which under the Ottoman empire had ruled Greece for 400 years until the early 1800s. Memories of the forced evacuation of millions of Greeks from Asia Minor after the First World War still rankle. Greece was also not too far across the water from a tumultuous Middle East and, to the south, northern Africa,

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rarely a haven of stability. Being embraced by Europe was a sign that Greece had been accepted into the club of developed, democratic countries and would ensure its undemocratic past was firmly behind it.

All of Greece cheered. As a Greek abroad who had been ashamed of what had been going on under the Colonels, I could hold my head up high again. There were concerns, however, that, in the rush to accept Greece into the EEC, there was insufficiently rigorous scrutiny of its political system, its still developing market economy and the ability of its rather inefficient institutions, particularly the public sector and the banks, to nurture and support a move to an open competitive economy. Other countries thought Greece was too small to be a real threat to their economic interests, with countries like France more worried about the threat posed by greater competition in agriculture from later EEC members such as Spain.

Still, European Community – and, from 1993, European Union (EU) – membership brought benefits: barriers to trade were progressively removed and the movement of people and capital flows expanded. The Greeks enjoyed a period of rapid growth. I saw my family regain their earlier affluent status and flourish. Various sectors of the economy did very well, particularly shipping and tourism, and prosperity grew unhindered. This rapid development, however, obscured the structural flaws that still existed in Greece.

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THE EURO WAS A POLITICAL PROJECT

Joining the euro in 2001 made a lot less sense than joining the European Community, as Greece only met some of the criteria set for demonstrating convergence and suitability for the euro – and only with some fiddling of the figures. But Greece's eurozone partners were complicit in its entry – they wanted Greece in.

The need to unify Europe after the Second World War and ensure that conflict would never happen again gave rise to the Coal and Steel Community in the 1950s and progressed further with increasing efforts to achieve a single market in Europe throughout the 1980s. The benefits of the single market were well documented in the Cecchini Report[†] (to which I also contributed in my early days at the accounting and consulting firm KPMG, which I joined as Chief Economist in 1986, later becoming a partner). A single market for goods across the EU became a reality in the early 1990s, though services lagged behind. In bringing down tariffs, reducing price levels, achieving greater harmonisation of product regulation, allowing markets to function and enabling free movement of people, the single market was a great achievement. It was clear that the whole of Europe would benefit from lower inflation, higher investment, easier capital movements and the creation of a powerful trading bloc to rival the US and the growing challenge from China.

† Chaired by Paolo Cecchini, this 1988 report examined the benefits and costs of creating a single market in Europe, in accordance with provisions of the Treaty of Rome.

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But the end of the Berlin Wall in 1989 and German reunification came at a huge price. The cost to Germany itself was enormous. It has been claimed that as much as €1.3trn was transferred from the West to rebuild the East, with money transfers still occurring. Reunification led to many years of poor growth as the East German economy was shaken up and forced to adapt slowly to the market economy of West Germany – and the rest of Europe. Although the population in general was behind reunification it had the side effect of exhausting the German taxpayers' patience with bailing out unproductive countries – which East Germany at that time was perceived to be. It also bound Germany into embarking on a euro project that put it firmly at the heart of Europe.

Creating a monetary union was principally a political project, not an economic one. It is a myth to think that there can be a pure economic union. All economies require rules to operate and these rules are set by politicians – democratic or authoritarian. Intent on ensuring that Germany did not use its might as Europe's biggest country to outdo the rest, the euro project was pushed aggressively to bind Germany to its neighbours and reduce the power of the Bundesbank (the German central bank). The political objective was to tie Germany's competitiveness and prospects to those of the rest of Europe and not allow it to expand at other countries' expense. But monetary union was also seen as the way to achieve eventual political union by the back door. Arguably political union should have come

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first and economic union would follow. However, it was too early at that stage to go down that route as countries were not then ready for deeper political integration. The process did result nevertheless in countries losing some of their sovereignty, including Germany, something which was probably not entirely appreciated in advance by the electorate. There was, in fact, relatively little public debate about joining the euro at the time. Right until the euro came into being, the majority of Germans wanted the Deutschmark to remain. But the German political élites – of right and left – were worried that if a new mighty Germany emerged, old fears would resurface. The truth is that from 1950 onwards Germany had agreed to share or pool part of its sovereignty with its neighbours. The euro was seen by policy makers as just another step in that process of European integration.

Nevertheless, in order to justify the move to a single currency as an economic project and as the next natural step towards full economic integration, various studies were commissioned by the European Commission and books were written at the time outlining some of the benefits of an economic and monetary union. They argued that removing exchange rate costs and currency uncertainties would reduce the transaction costs involved in trade across borders and encourage greater movement of goods, services, capital and people. Charles Grant, of the Centre for European Reform in London, thinks that despite the fact that politics kept the euro momentum going,

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the economics were already well understood to tilt the balance of thinking in favour of the euro. Keeping the Exchange Rate Mechanism (ERM) – a system introduced in March 1979, linking European currencies together within agreed bands – as a permanent alternative would have meant, in the longer run, restricting capital movements to prevent constant pressure on those currencies within the ERM.

The euro would thus become a new international reserve currency with the benefits that this brought in its wake. But, except within a limited circle of politicians and senior officials, there was very little questioning or debate about this in Europe. Many of these benefits make sense and are valid if the countries that come together are able to converge (and there is a proper unified system of regulation in the financial sector to avoid bubbles emerging). In reality, despite some obvious merits, this was a political project sold as an economic one to the electorates across Europe. In the rush to bind Germany into a union covering most of the countries in Europe, very little thought was given to whether the result might bear any resemblance to an optimal currency area. Countries were admitted without consulting their electorates but also without seriously questioning their ability to adapt to a very different environment where the fiscal and monetary policy options available to them became severely limited.

So we ended up with a monetary union as a preamble to a political union that consisted of countries that simply did not form an optimal currency area. Greece

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was one of these countries. Interest rates were set by the European Central Bank (ECB) for the eurozone as a whole and the result in many countries was lower real interest rates, both for the government and also for companies and individuals – and the Greeks, like other countries, went on a spending spree. After all, they were now part of a large domestic market with a single currency; they no longer needed to worry about the balance of payments and falls in the value of their currency which had restrained them in the past. Something that is often forgotten in the current debate is that German exports to the 'periphery' countries of the eurozone (mainly in the south) rose substantially after the euro was created. And as wages started to rise in the poorer countries, something that was always meant to happen as a way of achieving economic convergence, unit labour costs rose across most of southern Europe, while those of Germany were stagnant or even declining as Germany itself implemented long overdue labour market reforms. German labour competitiveness in relation to its eurozone partners improved. The competitiveness of German exports to the rest of the world also improved thanks to the external value of the euro being kept down by the inclusion of many less competitive periphery economies in the eurozone.

MEMBERSHIP OF THE EURO LED TO GREECE'S ECONOMIC CRISIS

But Greece had not invested in increasing the productive capacity of its economy and rapidly lost competitiveness. Who, therefore, is to blame? Interestingly, when

the Greek nation expressed a real desire to join the EEC and then the euro, they were in reality secretly hoping that the Brussels bureaucrats would take over and free them from the control of their politicians, who they regarded as corrupt. Educated Greeks longed for a 'technocratic' government that would move them away from a rather Soviet-style economy subject to numerous controls and closed shops that killed entrepreneurship and discouraged initiative. Instead, very little attention was paid to what Greece was doing or to the worsening imbalances in trade, for example. As low interest rates and increasing wages fuelled strong consumer-led growth, the public sector grew to vast proportions. The number of state employees ballooned to 712,000 in a country with only eleven million people, many of these state employees recruited as political favours by the two main parties, the socialist Pasok and the right-wing New Democracy, that had run Greece since the departure of the Colonels. Corruption became endemic, tax avoidance and evasion the norm, and public spending grew out of control, with inefficiency widespread. When the global financial crisis hit in 2008, Greece had nothing to fall back on and the adjustment has been extremely painful. The conditions attached to the two bail-outs for Greece of €110bn in May 2010 and €130bn in February 2012 have led to living standards being slashed. Public sector wages and pensions have been cut by some 25–30% on average since the start of the crisis, with far deeper reductions for some categories of pensioners.

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Lucas Papademos, formerly Governor at the Bank of Greece and then Vice-President of the ECB, and who was briefly Greece's technocratic Prime Minister from November 2011 to May 2012, negotiated the second bail-out before the 6 May elections. In an interview in March 2012, he argued that the measures undertaken so far, which had been quite drastic, had already improved competitiveness and restored around half of what had been lost vis-à-vis Greece's eurozone partners in the previous nine years. This was before the latest set of labour market reforms had started to be implemented. This is good news for competitiveness but it is appalling to think of how all the gains in living standards made during the euro era have just been wiped out. It seems that hope has all but gone. By May 2013 unemployment stood at 27.6% of the working population and youth unemployment at 64.9%, both rates the highest in Europe. Although figures for Spain closely follow, the rates compare with a euro-area average of 12.1% and 23.3% respectively. It is reported that, since 2009, some 25% of all Greek companies have gone bust and that a similar percentage of small firms find it difficult to meet payments. Suicide rates have rocketed as poverty becomes widespread. Before 2009, Greece had one of the lowest suicide rates in the world – 2.8 per 100,000 people. A 40% rise in the first half of 2010 was reported by the health ministry and experts now say that the Greek suicide rate has probably doubled to about 5 per 100,000 people. For the first time Greeks, and not just illegal immigrants, are joining the queues

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for the soup kitchens. The latest notification I saw of where free food is being distributed in greater Athens listed 103 locations and another thirteen in Piraeus. When I was visiting my sister's home on election day on 6 May 2012, she and her friends were busy arranging food leftovers in Tupperware boxes to take to various families so they could feed their children. A year later, although many of the foreigners they were feeding had gone, either voluntarily or following arrest and deportation, the numbers of Greeks asking for help had swollen. Increasingly, the Greeks find themselves jobless and homeless, with a welfare system unable to support them.

WILL GREECE EXIT THE EURO?

The human cost of the last few years in Greece has been enormous. Data for the first quarter of 2013 show that the total output (GDP) was down on a year earlier by 5.3% and in the second quarter 3.8%, less than had been forecast as tourism receipts soared. But this will be the sixth successive year of decline as output fell by 6.4% in 2012, 6.9% in 2011, 3.5% in 2010, 3.2% in 2009 and 0.2% in 2008. Wages in the public sector have now fallen by more than 35% since the beginning of the crisis, pensions have been cut drastically and the minimum wage has been slashed by 22% for most workers and by 32% for those under twenty-five.

In 2012, increasing social tensions and violent demonstrations were extensively covered by the world media, who watched with amazement as a western

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country imploded. It was therefore hardly surprising that the only clear vote in the inconclusive general elections of 6 May 2012 was against austerity and the political parties responsible for it being inflicted on the Greek people. The voters brought an end to the two-party system of New Democracy and Pasok but gave no party an absolute majority. The great surprise was that the anti-austerity Syriza party (the Coalition of the Radical Left) came second, after New Democracy, with Pasok trailing a poor third. Many votes went to a host of smaller parties that either failed to make the 3% threshold required to be represented in Parliament or were represented in insufficient numbers individually to make a difference to the overall political arithmetic – including, in the latter category, the election to Parliament of members of the neo-Fascist Golden Dawn party. No coalition could therefore be formed and new elections were announced. The world shivered as the implications of a possible Greek exit – or 'Grexit' as it has now become known – began to sink in. The whole of the eurozone was affected. Spanish and Italian bond yields started to rise again and the break-up of the whole euro project started to seem possible, with the markets failing to be convinced that the political leadership of the eurozone could develop and implement a credible solution to the crisis despite numerous summits.

The fresh Greek elections held on 17 June 2012 were billed by the media as holding the key to the euro's continued existence. All eyes turned to Greece

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and in the process the various Greek leaders became household names across Europe: Antonis Samaras, of the New Democracy party; Evangelos Venizelos, from Pasok; and Alexis Tsipras, the charismatic young leader of Syriza.

As the election campaign got under way political leaders, all speaking rather good English, were interviewed in the wonderful sunshine beloved by the tourists and the discussions seemed to be conducted relatively calmly and with composure. Christine Lagarde, Managing Director of the IMF, irritated the Greeks by chastising them for not paying their taxes and hinted that she worried a lot less about the hardship of the Greeks by comparison to starving children in Africa. When it was revealed that she did not pay any tax herself as she is employed by the IMF, an international organisation that does not fall under any jurisdiction for tax purposes, the Greeks reacted angrily and Greek newspapers went to town in their attacks on Lagarde's comments. To add insult to injury, the British Prime Minister, David Cameron, was heard discussing contingency border control plans should Greece exit the euro, fearing that millions of Greeks would abandon their homeland and travel to the UK for work, causing even more chaos at passport control desks. Christine Lagarde or David Cameron may have thought they were stating the obvious but, for Greeks living on the edge of nervous exhaustion, every chance remark from abroad assumed gigantic proportions.

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But in a way such criticism and speculation might have been helpful, as it concentrated the minds of the voters in the edgy period before they went back to the polls. The May 2012 election had produced a giant protest vote. The result of the 17 June rerun showed that protest and rejection of austerity remained powerful voices, but they were accompanied by a realisation that Greece needed a working government. It was clear the Greeks did not want to leave the euro and the world's reaction over the previous six weeks had scared them. They also felt they had been mocked for their democratic choices. At the election, Syriza's share of the vote increased again and it came a close second, but New Democracy (under Antonis Samaras) was the largest party and was able to form a coalition with the third-ranking Pasok and a small left-of-centre party, the Democratic Left (DIMAR). The coalition announced its intention to work to honour the spirit of the bail-out but hoped to renegotiate some of its conditions, especially the speed of fiscal consolidation (spending cuts, tax increases and privatisation revenues) given the dramatic decline of the economy.

People's faith in the system has taken a dive. Whenever possible Greeks either continue to move money abroad or keep their euros under their mattresses. Armed burglaries, until now unknown in Greece, are becoming commonplace as a result. People are not spending or investing and the economy appears in free-fall.

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It is true that the Greeks, in dealing with their European partners, have generally not helped themselves. This has put the Greeks into the category of being ungovernable and untrustworthy negotiating partners. The Greeks' inability to implement what they had promised to do under the terms of the first bail-out package of May 2010 did not endear them to the Brussels bureaucrats or the IMF when they were negotiating the second bail-out. The Organisation for Economic Co-operation and Development report on the Greek administrative system of spring 2012 is one of the most damning indictments of any developed country that I have seen in more than three decades of professional experience as an economist, including working in Third-World countries and European states poorer than Greece. There has been some recent progress, particularly in the area of tax collection, but few public servants have been fired. While in Greece in August 2013, I experienced the OECD's indictment of the inefficiencies of Greek bureaucracy first-hand. I successfully managed to apply for a foreign resident's tax number online and assumed that this meant some bureaucracy had finally been cut. I was horrified to discover that I still had to appear in person to collect my number from a tiny airless office in central Athens, along with hundreds of others, some of whom had queued from 6 a.m. ahead of the office opening at 8 a.m.

The Samaras government nevertheless can claim with justification that it was voted in democratically

with a mandate to renegotiate a crippling debt. Samaras knew that continued talk about a euro exit would be destabilising. A few weeks after the June elections, for example, David Cameron was reported to have reiterated that it could be in the UK's interests to block Greek citizens from entering the UK if Greece were to be forced out of the single currency – although such a move would appear to be illegal under European law provided that Greece remained within the EU! What Samaras and his new widely respected Finance Minister Yannis Stournaras achieved was to convince the other EU leaders that they were serious about reform. As a result, prospects of an imminent Greek exit faded from the headlines and the country was visited in 2013 by the German Chancellor Angela Merkel and her Finance Minister Wolfgang Schäuble in a demonstration of solidarity. But the fundamental problems that Greece's membership of the euro has brought have not gone away.

How easy it is to forget that the single market was the original cornerstone of the EEC and one that has taken decades to get as near to it as we are now, a single market which includes the freedom of movement of people across countries. A number of EU members such as Poland have been enjoying the ability to work across Europe without for the moment being part of the eurozone. David Cameron has forgotten a few facts. For one, the unemployment rate in Greece is not very different, including youth unemployment, to that in Spain, a much larger country with a vastly

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larger working population than tiny Greece. Why not talk about this instead? And what's more, he needn't worry too much as the Brits tend to underestimate the young Greeks' attachments to their mother's cooking as well as to seeing the sun occasionally.

As *The Economist* noted laconically in late July 2012, when the heat turned on Spain, 'moderating austerity programmes is a priority'. There followed more articles expressing concern about what was being imposed on European countries in the name of fiscal consolidation, including by the celebrated Nobel prize-winner Paul Krugman, who took up the anti-austerity baton. The IMF itself admitted in July 2013 that it may have underestimated the impact of the fiscal tightening on the economies in Europe, particularly in Greece, and in mid-2013 it criticised the European Commission's competence in handling the Greek crisis. Alas, this wisdom was not at the time uppermost in the minds of those who required Greece to accept a reduction in income and social justice as great as any imposed in post-war Europe. Combined with this imposed poverty we have seen a kind of xenophobia developing across Europe which in fact makes political union, the ultimate aim of Europe's founding fathers as well as Jacques Delors, less likely rather than more likely. The issues that affect Europe are fundamental and should not be trivialised in terms of national caricatures which have distorted the underlying facts in people's perceptions.

In late June 2013, the *New York Times* printed a

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letter written by the son of a mother of three. He told how his mother had jumped out of the kitchen window of his family's Athens apartment and alerted the world to the human cost of the financial war that has engulfed many developed countries. It took thirty years of democracy and twenty years of socialist rule for Greece to build a large and prosperous middle class, gaining its place among the countries of the developed world. This was a country that was able to host a very successful 2004 Summer Olympic Games. It has taken just three years to eradicate most of that middle class and Greece is now one step closer to being categorised as an emerging nation by the credit rating agencies.

THE FLAWS IN THE EURO PROJECT, AND WHAT IS NEEDED TO PUT THEM RIGHT

The euro project had a number of flaws. While the going was good, capital and people were encouraged to move freely across Europe as exchange rate risk was eliminated but, if anything, as Europe prospered in the euro's early years, the pace of reform in many countries slowed down. There was no pressure to implement sometimes difficult structural reforms that might lead to greater long-term productivity and growth. Looking at all of the periphery countries – not just Greece – it was obvious that the balance of payments was taking a hit. In Spain, the current account gap also widened and it is only now that domestic incomes are being squeezed and people are no longer able to buy as many foreign goods, that the current account

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deficit will be eliminated. Competitiveness has been lost across the board. During the boom years there was little incentive to change governance structures or the system of patronage that so discourages competition and which has been endemic in many places.

The single interest rate did not help. It allowed countries with traditionally very high interest rates before they joined the euro to grow disproportionately fast for a while as a result of the sharp cut in borrowing costs once they joined. The governments of those countries were able suddenly to borrow cheaply, in fact at the same rate as the more productive and frugal northern Europeans, as the markets priced the risk of sovereign default as the same across the whole of the eurozone. That gave some instant relief to countries that were heavily indebted, like Italy, as the cost of financing the deficits fell. But, after a while, this allowed more borrowing and the public sector grew in almost every EU country. The markets believed that there was a 'lender of last resort' or at least that no country would be allowed to default on its debts as the system was now run by the ECB. We now know that this was a mistake. At the same time, the private sector was also able to borrow a lot more cheaply, which fuelled a spending spree and an import boom. The different structures of the countries' markets, however, meant that a particular level of interest rate could in fact produce higher inflation in some countries than in others, reducing their competitiveness. In addition, the disappearance of an exchange rate risk attracted

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capital inflows of the sort many of these countries had not seen before, all looking for high returns and often resulting in asset bubbles. Finally, balance of payment deficits or surpluses were no longer reflected in pressures on the exchange rate. In the past, this would have been dealt with by the need to implement adjustment measures of varying intensity. Trade deficits increased in many of these periphery countries, something which the markets should have always focused on.

At the heart of the misunderstanding was how 'convergence' would work. The poorer countries would gradually see their wages come up closer to the European average and there was an expectation, finally proved in the case of Germany for example, that wages in the richest countries would stay flat or even come down fractionally. With capital flows increasing everywhere, money freely available and companies now looking at Europe as a single market for wages and costs, prices in the periphery countries rose faster than in the central and northern European ones. Their competitiveness was hit even more and the external shock of the financial crisis brought the whole house tumbling down. Replace the word 'Greece' with 'Italy' or 'Spain' on any euro 'to do' list and the list would make just as much sense.

This was the unspoken wish-list that should have accompanied the introduction of the euro:

- Reduce size of public sector
- Reduce bureaucracy

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- Stop corruption
- Open up labour market
- Reduce the black market
- Reduce costs to SMEs (small and medium enterprises) and ensure funds continue to flow to deserving companies and individuals.

The problems are similar across many of the periphery countries but the intensity naturally differs. These things should have been foreseen. The fact is that they were not foreseen or at least, if discussed *sotto voce*, were not taken seriously by politicians. The eurozone was thus allowed to be created:

- Without a lender of last resort
- Without the institutional framework for occasional transfers to needy nations
- Without proper emphasis on structural reforms
- Without a firewall for crises
- Without a proper understanding of what a central bank should do during crises
- Without a long-term growth plan except completing the single market for goods and services.

Instead, what accompanied this flawed design was a Stability and Growth Pact (SGP). The pact, adopted in 1997, required all twenty-seven member states to move to a deficit of no higher than 3% of GDP and a debt-to-GDP ratio of less than 60%. The pact was in fact weakened in 2005 and has proved to be

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unenforceable (and it is not just Greece that has failed to meet its requirements – Germany and France have also ignored the pact in the past and ran excessive deficits for some time). It was a recipe for disaster. And we are now living through it.

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