Greece Bears Gifts

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While the UK is engulfed by Brexit, a battle for the strategic direction of the country, the European Union faces a low key but even deeper, existential crisis. Europe has tried to unite, shape its future through consensus rather than war and retain its economic and diplomatic weight in a global landscape increasingly dominated by giants. However, what seemed like a sound strategy for a core of European countries, started becoming problematic when the union extended its borders to 28 countries with, inevitably, different levels of economic development, social values and visions for the EU's future. As a result, politically the union is heterogeneous, with a weak centre in Brussels and centrifuge forces in its periphery. Economically -as the Greek crisis shows - the Eurozone remains fiscally uncoordinated and prone to spiralling imbalances.

These underlying weaknesses were inevitably sharpened and exposed when the prosperous years ended by the severe economic crisis of 2008, followed by a sovereign debt crisis in the union's South. And no case has tested the EU's resolve harder than the never-ending Greek problem: A Sisyphean burden created not just by the incompetence of a series of Greek governments and the economic culture of their electorate, but also through the lack of institutional forethought, oversight and power in Brussels. A problem moreover that unless tackled in earnest and systematically it is bound to resurface.

EU's dilemma and the largest bail out in economic history

The Greek crisis first came to global spotlight in 2009, when it was revealed that its government had lied about the country's deficit. The hole in the national accounts was a dizzying 15% of the GDP. The news sparked fears of a Greek default in the bonds market: the country already had one of the highest government debts in the EU and relatively low levels of economic development and capitalisation. Bond spreads for Greek debt started rising, reaching 35% in 2012, and Greece was effectively cut-out from the money markets. This is when the country turned to her EU partners to cover her deficits and re-finance her debts.

The Greek request came at a bad time for EU countries. The Eurozone was in recession, unemployment was high and Europeans were angry with their establishment. There were widespread calls from both the political Left and Right to abandon Greece and force her out of the Euro. Yet, to their merit, after a few grunts and some ambivalence, EU leaders and parliaments decided to support their ailing ally by lending Greece over 300 billion euros, by far the largest bail-out package in economic history.

Some have suggested that the EU's ulterior motive had been to protect their banks. The argument goes that a large percentage of the Greek government debt in 2010 was in the hands of the already weakened German and French banks. If Greece was to default on its debts then these banks would default too. This perceived weakness of the EU even led Varoufakis, the Greek minister of economics under the newly elected government of Syriza in 2015, to demand from the EU that the Greek debt be largely written off. His ethical justification was strong and based on moral hazard: European banks and private lenders sought to maximise their profit by lending money to a country with weak macroeconomic fundamentals – now they should accept their losses. Varoufakis also pointed out that under the terms of its first bail-out package in 2010, Greece had to use 45 billion of bail-out funds to buy private sector debt – this burden had now become a Greek taxpayer burden. Should taxpayers endure harsh austerity to cover the losses of risk-taking private investors? Syriza threatened to refuse European money and lead Greece to a controlled bankruptcy, damaging systemic Eurozone banks and re-fuelling the recession in Europe.

Varoufakis made good points but downplayed a few key facts, and most of all the need for reforms in the Greek economy. The fact is that in 2012 the EU did write off massive amounts of Greek debt held by the private sector in Greece and abroad. Banks and investors lost between 59 to 65% of their investments in Greek bonds and the Greek national debt was reduced by an unprecedented 107 billion euros, about 50% of the country's GDP at the time (Zettelmeyer, 2013)[1]. The Greek negotiating position was also weak: by the time the Greek government threatened to default their country, in 2015, only about 35 billion euros were still in the hands of private investors. This amount could not back a credible threat against a Eurozone whose GDP at the time was over 10.5 trillion euros. Most importantly, Syriza's political programme was fundamentally against the deep structural economic reforms that the Greek economy desperately needed[2] -- Syriza had gained power by promising the exhausted Greek voters that a successful negotiation with EU would bring not only a quick end to austerity but also a return to the spending habits that accumulated hundreds of billions of debt in the first place.

Much like in the Brexit negotiations, EU countries would not accept demands which might threaten the long-term stability of their union. Their concern was that if an even higher proportion of the Greek debt was written off, then a very dangerous precedent would be created. 2 trillion euros of Italian debt could be next. The EU asked the Greek government to start preparing the country's exit from the Eurozone, and then the Greek government capitulated and signed the EU deal. Brutal austerity continued for the Greeks and the country committed to produce high and continuous fiscal surpluses until the 2060s. These nearly impossible surpluses will be keeping taxes high, investments low, limit public services such as education and healthcare at critical levels, fuel brain drain and dampen growth in the country. Much like the punitive reparations imposed to the German people after the First World War, the imposition of such targets on the Greeks is a bleak promise for the future.

Greek background and dysfunction

At the height of the crisis, global media simply labelled the nation as reluctant to pay taxes but typically avoided to offer some analysis of the problem. Low tax revenues were indeed a part of the Greek problem. The fact is that Greek tax collection is inherently problematic because economic activity takes place in sectors and communities which are traditionally difficult to measure and tax.

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[1] Jeromin Zettelmeyer et al, The Greek Debt Restructuring: An Autopsy, 28 *Economic Policy* 513-563 (2013) DOI: 10.1111/1468-0327.12014

[2] https://www.nytimes.com/roomfordebate/2015/01/27/can-greeces-anti-austerity-government-succeed/greece-needs-broader-structural-reforms-than-syriza-has-proposed

The economy of this 10 million country historically consisted of small and very small businesses, often family managed. According to the latest Eurostat data, 11% of the Greek workforce are farmers, working a land that is often arid and broken into small production units – for comparison, in the UK the equivalent percentage is 1.5%. Tourism directly employs about 17% of the workforce in peak season and indirectly supports the incomes of an extra 25% of workers. It is inherently difficult to monitor production and tax on such a small scale. To that, we should also add the fact that for historical reasons local communities are tightly knit, especially when it comes to tax. This social capital allows them to protect their local income from what they perceive as a corrupt centre: the car mechanic will offer his services for cash in hand to locals, and so will the hairdresser, the private tutor and many others. A weak tax base does not necessarily lead to high government debt though; in fact low income countries tend to have relatively low debt as a percentage of their GDP. The Greek dysfunction lies elsewhere.

The Greek demise came from excessive government spending. Since the 1980's most governments won elections promising more and more, in everything. Pensions came from the age of 45 in some cases, subsidised heavily from state revenues. Various trades and professions received preferential tax treatment and subsidies. Healthcare expenditure was so generous that it ended up costing double per capita than in other European countries. Every year additional jobs in the civil service were created, addressing real or imaginary needs. Even bankrupt football clubs had their debts assumed by the Greek government. Greece spent more on arms as a percentage of its GDP than any other EU country except for Britain – Greeks are concerned that a 1974 Cyprus-style Turkish invasion to one of their islands is a real possibility and are locked into an arms race with Turkey, a country eight times the Greek population. And of course the country had to borrow 9 billion euros to host the 2004 Olympic Games – double the initial budget. Ironically, Greek citizens did not benefit from the spending spree as much as one would expect. High levels of corruption meant that the level of services offered remained low, while the country's economic and political oligarchy pocketed a hefty percentage of what was spent (and borrowed).

One can only wonder, how did the country that gave birth to democratic accountability end up pawning the future of her younger generations in a frenzy of spending? The answer is complex, extends far beyond economics and this article can only offer a few facts and thoughts. On a cultural level, Greece is a patriarchal society which expects the State to guide, protect and provide. On a political level, we find a country where the Right aggressively oppressed the Left after the 1945-49 Greek Civil War. And when the political Left eventually came to power in the early 80s with the first government of PASOK, its socialist economic policies were in turn aggressive – and expensive. These debt-fuelled socialist policies progressively permeated the Right too - indicatively the Greek government deficit of 15% mentioned at the beginning of this article came during the right-wing government of Kostas Karamanlis Junior. On a societal level, corruption has long been tolerated, factored in and expected by the Greek society, especially when it concerns public funds. Corruption dampens the economic performance of the country, its competitiveness, its expenses and its tax receipts.

Special mention should be given to the governance and leadership of Greece on a high level. More than other European countries, the country is ruled by an interlinked political and economic oligarchy. The international press often marvels at the fact that a mere three families seem to have ruled the country for many decades. Since 1944 when the country was freed from the Nazis, these three political dynasties governed Greece for about half the 75 years till our present day, supplying six prime ministers in the process. Indicatively, the current head of the main opposition party and prime-minister-in-waiting is yet another member of this political elite. The country's economy is not too different, with a handful of powerful families having a disproportionate power over the country's banks, the energy sector, construction, pharmaceutical provisions and more. Many of these families have stakes in large media and football clubs in a (successful) effort to extending their economic power into political influence. Greece is not a meritocracy and competition doesn't work well, particularly in the higher echelons of the society and economy. Greece is largely run by people with too much power and little skill, whose primary objective is the preservation of the status quo rather than reform. One of the key reasons behind Syriza's electoral successes was that fact that it was comprised by people largely perceived as idealists and outsiders to power and wealth.

Greek dysfunctions magnified by EU failures

It is not certain if the revelation about the magnitude of the Greek deficit was a complete surprise to EU leaders and institutions – what is certain however is that the EU was woefully unprepared to deal with it, on many levels. The European Union had to call in the IMF, partly in order to offer technocratic assistance as was advertised but also to offer assurances to angry European parliaments that the intervention would be assertive (and punitive) enough. The European Union lacked not only any bailout expertise but also the confidence and the political justification for helping one of its members. And this was only one of its many institutional shortcomings that magnified the Greek crisis.

To start with, economists and even Greek governments admitted that the country was not ready to enter the Eurozone, in 2001. The country had again faked its statistics and was far from attaining the minimum economic criteria set out in the Maastricht Treaty, in 1992. Specifically, annual government deficits had always been far above 3% and the total government debt nearly double the 60% stipulated by the treaty. The country's competitiveness would struggle in a monetary union with fixed exchange rates. However, Greeks were not alone in ignoring the rules and cooking their books. Other countries, such as Italy, France and Germany had done the same. EU economic decision making was subject to political rather actual reality. Rules were written down but were never really enforced and that was a bad start and a handicap for the Eurozone.

Then EU's bank regulatory framework made things worse for Greece by allowing the country to borrow more than it could handle. Banks could buy government debt without having capital themselves, encouraging a "carry trade" for bonds. So, German and French banks borrowed money cheaply from their central banks, bought relatively high-yielding bonds from the weaker Eurozone countries and made easy profits, without committing their own capital. Imagine a situation where an individual without their own funds or collateral can borrow money at 1% and lend it to someone else at 10%, creating an easy cash flow. The inevitable competition for such easy profits made banks compete for lending to Greece, lowering the country's interest rate further – from 10% to around 4%. This means that when Greece entered the Eurozone it gained access to an Eldorado of cheap lending money and eager lenders. The Greek political system couldn't handle the temptation. And the EU didn't handle the regulation.

Once in the Eurozone, countries found themselves monetarily bound but uncoordinated in terms of fiscal and supply-side policies. The European Commission lacks the legal and political tools to enforce even a general common direction for economic reform. For example, while France, Italy and Greece relaxed their fiscal discipline in the 2000s, Germany implemented an ambitious programme of fiscal discipline and cost-suppression for her industries. In an economic environment of fixed exchange rates where a devaluation of the local currency is impossible, increased German competitiveness and exports led to current account deficits and debts for other Eurozone partners. This imbalance threatens the very existence of the European Union, increasingly tempting countries such as Italy to leave the monetary union in order to regain their competitiveness through a devalued national currency.

When the money markets closed for Greece and the country appealed for help to her EU partners, a GDP fall was well overdue. The country had been spending above its means and that had to stop. However, eight years and 300 billion worth of loans later, the result of EU's intervention was devastation, not rejuvenation for the Greek economy. There has been a 25% drop in the country's GDP, severe hardship for the weakest members of the Greek society and migration of 15% of the country's workforce. Yet the pathogens that led to the Greek crisis remained largely intact. There were many episodes, referendums, changes of government and tweaks of policies but the key mechanism that triggered action was never a concerted effort to reform the Greek economy. What triggered action in the Greek case was the need to quickly reverse large deficits into large surpluses. Greek governments would initially resist and then succumb. And with each cycle the economy shrank further – even healthy businesses struggled and more of the country's labour force fled abroad, reducing the surplus and creating strong head-winds for the Greek recovery. Yet the EU and the IMF would demand even higher surpluses the next year, and all over again. These policies of enforced austerity have had the catastrophic multiplier effects of inverse Keynesianism in times of acute recession. And as the Greek economy and society suffered, so did the reputation of the European Union amongst the people that comprise it.

EU can be a force for good - but needs democratic capital

The European Union is a project that has ensured peace and economic cooperation in a troubled continent. Importantly, the EU can and should be a platform for progressive and moderate policies which can reduce inequality, promote education, shorten the working day and protect the environment.

The Greek crisis proved the European Union's determination to stick together and show solidarity to an ailing member – albeit inconsistently and with harsh strings attached. However, the crisis also exposed the deeply problematic economic architecture of the Eurozone: a monetary union that lacks fiscal and supply-side policy coordination. Fundamental to these weaknesses as well as to the way the Greek crisis was addressed is what I would call the union's lack of democratic capital and mandate.

The European Union needs to change and the fundamental question that needs to be addressed is: What *is* the European Union? Ultimately, *what do EU citizens want* it to be?

If Europeans prefer to retain their national autonomy then the EU is destined to be a confederation of countries with separate interests, negotiating compromises. In this case more countries could enter this loose union while other countries will eventually have to exit - depending on members' ever shifting national interests and priorities. EU mechanisms and legislation will need to adjust to this reality. And specific questions will need an answer: Can countries expect a bail out in the future? Can debt forgiveness be repeated? Is there any time and money limit for EU's support to members in trouble? Ultimately, under what conditions could members expel one of their number and how would that happen in a relatively orderly fashion?

On the other hand, if Europeans subscribe to a vision of ever-increasing integration, eventually leading to a United States of Europe, then a completely different course of action needs to be taken. The EU will need to stop expanding its borders and devote itself to the herculean task of consolidating its territories and start building its identity as one Nation. Fiscal unity and supply-side policy co-ordination will be inevitable, and so will the transfer of power from national parliaments to the European Parliament.

Both courses of action have distinct benefits and drawbacks. Possibly both could work in the long term. The problem with the European Union of our times however is that its institutions are geared towards great integration while many of its citizens seem to have a different opinion. Brexit as well as electoral results in Italy, France, Hungary, Poland and other countries indicate a growing discontent with the European Union.

It may seem absurd in a rapidly changing world presenting the EU will an endless supply of smaller or bigger crises, but the first priority of the European Union should be open dialogue. The EU needs to approach its citizens directly and explain its immense potential as a force for progress. It also has to listen to their concerns, seek their input and obtain their democratic mandate for any changes to come. If the union sleepwalks into an destination determined by past generations of citizens and their priorities, then the union will eventually break. The European Union's future depends on its democratic legitimisation.