

ECONOMIC CRISIS IN GREECE. EUROPEAN AND DOMESTIC MARKET AND POLICY FAILURES

George PETRAKOS*

***Abstract** - This paper provides a detailed account of the drivers behind the economic crisis in Greece, which has destroyed one quarter of the GDP of the economy and has led more than a quarter of labour force to unemployment in a period of five years. The paper claims that a mix of background factors at the European and the national level and the policy reaction to the crisis jointly reinforced a negative spiral that after some point accelerated and had snowball effects for the Greek economy. At the European level the background factor is the unbalanced European economic architecture, while at the national level the background factors include the structural weaknesses of the economy and the operation of the political system and the public sector. These factors, along with a number of serious policy deficits and the mismanagement of the crisis at the European and domestic level have transformed quickly Greece from a celebrated success story to a disappointing failure and the EU economy for a first time to an unsecure landscape with many slippery spaces in its periphery.*

***Key words** - ECONOMIC CRISIS, AUSTERITY PROGRAMS, GREECE, EUROPEAN ECONOMY*

***JEL Classification** - A1, B2*

* Department of Planning and Regional Development, University of Thessaly.
petrakos@uth.gr

1. INTRODUCTION

Taking a broader perspective in the understanding of the economic crisis in Greece, a critical and somehow uncomfortable question arises: How is it possible for an economy, member of the Eurozone, that was considered to be a ‘success story’ of convergence in Europe for more than a decade (in the period 1995-2009) to turn out to be considered as a profound case of failure in the early 2010 and beyond and subsequently suffer a deep and unprecedented economic crisis, in which it lost almost 25% of its GDP in a period of 5 years? This dramatic change in the perception of the Greek economy by international policy makers and markets in a period of a few months is a rare event in economic history that deserves a closer examination and a better understanding in the hope to avoid similar situations in the future.

This paper intends to discuss a number of important questions related to the Greek economic crisis taking a critical perspective and putting on the discussion table all these elements that have affected it, either as background factors, or as accelerators during its evolution. Although the discussion is highly diverse, there are clear interdependencies: The understanding or the perceptions about the causes of the crisis determine to a large extent the policy response to the crisis. The discussion about the policy mix becomes a more complicated issue when the causes of the crisis are both domestic and European.

We need to learn something concrete about the causes of the crisis, the policies that were applied in order to confront it and especially about the strength of the relationship between the causes of the crisis and the policy reaction mix. Finally, we would definitely like to know if there was an alternative policy reaction path and what is the eventual assessment of the effectiveness of the current ‘austerity plus reforms’ policy mix.

2. THE CHRONICLE AND THE EFFECTS OF THE CRISIS

After an audit ordered by the newly elected Socialist government, public deficit for 2009 was reported to be 12.7% and later 15.4% of GDP instead of roughly 6% stated by the previous government. The cost of borrowing started to increase dramatically (Table 1) and financial markets closed for Greece in a period of a few months (Bank of Greece 2011a). An *ad hoc* rescue mechanism¹ was decided by the EC, the ECB and the IMF (the Troika), according to which a €110 billion loan (and later a debt haircut) was provided in combination with an austerity program and a reform program (Monastiriotis 2013). The austerity measures were supposed to eliminate the public deficit in a period of 2-3 years,

¹ This rescue mechanism was not foreseen in the EU Treaties and was against their spirit, as they include a number of conditions that (in theory) prevent the accumulation of excess debt in the Eurozone countries. The mechanism was based on lending provided primarily by the other Eurozone countries in proportion to their size and after receiving permit from their national parliaments. IMF had a relatively small financial contribution and participated in the program because of its experience and expertise with austerity and reforms in over-debted countries.

mainly through wage and pension cuts and tax increases. In addition, a long list of structural reforms, including deregulation of markets, reorganization of the state and privatization were included in a Memorandum of Understanding that was signed between the Greek government and the EU, the IMF and the ECB. The austerity program was implemented according to schedule in a climate of severe political conflict and social protest with cross-the-board reduction in public spending, including wages, pensions and public investment and severe increases in taxation. On the other hand, the reform program and the privatization program were delayed in its implementation due to the indecisiveness of the government, the inability of the public sector to support the reforms and the strong public and political reaction. These programs were periodically evaluated, but also updated, with typically new conditions or goals being added after every review.

Table 1. Yields of Greek Government Bonds (Oct. 2009 - Dec. 2010)

		3-yrs	5-yrs	10-yrs
2009	October	2.26	3.37	4.57
2009	November	2.45	3.63	4.84
2009	December	3.72	4.67	5.49
2010	January	4.72	5.40	6.04
2010	February	5.92	6.30	6.46
2010	March	5.51	5.84	6.24
2010	April	7.91	7.87	7.83
2010	May	8.28	8.59	7.97
2010	June	9.41	9.50	9.10
2010	July	11.17	10.85	10.34
2010	August	11.65	11.33	10.70
2010	September	11.63	11.65	11.34
2010	October	9.64	9.64	9.57
2010	November	13.08	12.27	11.52
2010	December	13.75	12.89	12.01

Source: Bank of Greece (2011a).

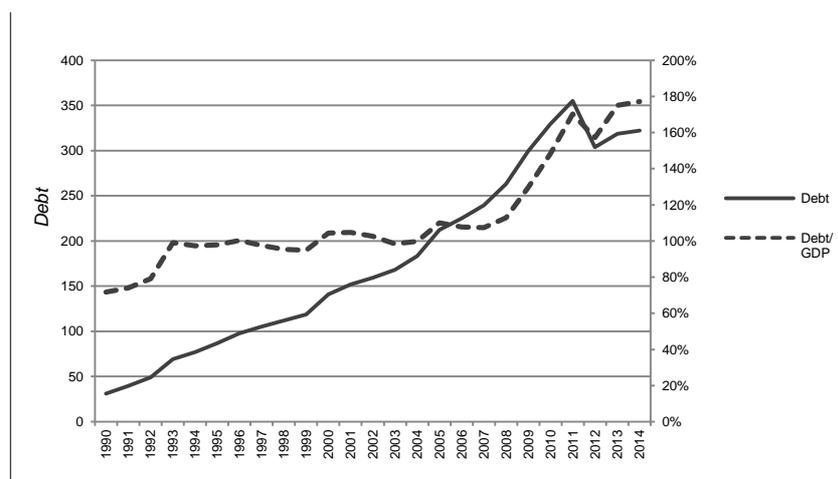
The impact of the crisis and the austerity programs was severe and beyond any projection. Greece experienced a deep recession and lost in a period of five years 25% of its GDP and about one million employment positions. Unemployment jumped in 2013 to 27% and youth unemployment reached 50% (INE, 2013). An undermining, for the long-term prospects of the country, process of brain-drain takes place during the crisis, where the young and educated Greek population leaves massively the country in search of employment and security in the advanced EU economies. The crisis resulted in a severe social polarization and poverty, as about one-fourth of the population lives below the poverty line and thousands of homeless people and beggars plunder the centers of large cities². The housing market collapsed, causing a severe reduction in the net wealth of the households, while hundreds of thousands of home owners are

² According to ELSTAT in 2011 24.8% of population lived in poverty (ELSTAT 2013). In the city of Athens alone, it is estimated that 20 thousand people live in the streets (Klimaka, 2013).

faced with the threat to lose their property because of their inability to serve their loans³. This will lead to a further polarization and an unprecedented in peace-time income redistribution at the expense of the weaker and more vulnerable groups. The inability of the two main center-left and center-right political parties to come up with a reasonable and sustainable ‘national rescue’ or ‘national development plan’ that will negotiate with the lenders has led to a serious political crisis, the undermining of democratic values and the rise of the extreme right⁴.

One of the striking characteristics of the period was the failure of the Troika and especially the IMF to predict or estimate the impact of the austerity program on the economy. The drop in output is much higher than initially expected because of a gross underestimation of the government spending multiplier in Greece. As a result, the debt to GDP ratio continues to be very high (Figure 1), despite the billions of euros of the bailout programs, questioning the sustainability of the debt and the effectiveness of the whole program (Christodoulakis 2011, 2013).

Figure 1. Public Debt and the Debt-to-GDP ratio of Greece, 1990-2014



Source: AMECO (2014).

Because of the reduction in public investment⁵, the only possible source of growth was the increase in private domestic and foreign investment. This, how-

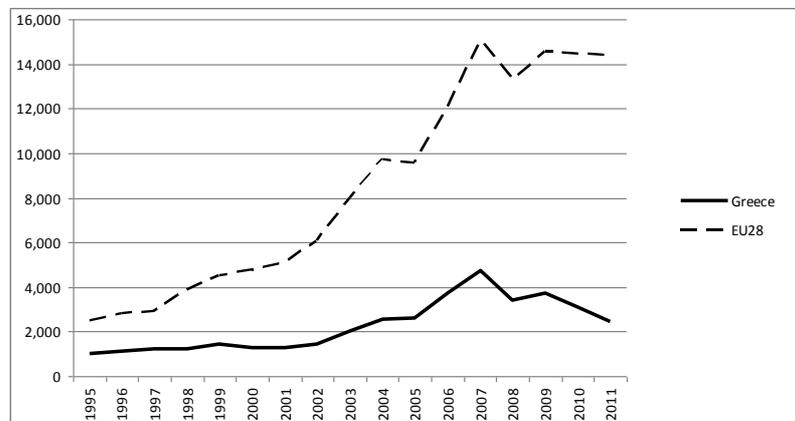
³ Non-performing loans reached 31% of total loans in 2013 (World Bank 2014).

⁴ The neo-Nazi party of ‘Chrisi Avgi’ received in the 2012 parliamentary elections 7% of the vote and in the 2014 elections for Regional Governors 9.3% of the vote, taking the third place in the preferences of the voters. Its support was much stronger in poor inner city areas with high presence of illegal immigrants and in the social groups that were hit harder by the crisis (unemployed, home owners, elderly).

⁵ From 9.5 billion in 2009 to 6.11 billion in 2012, that is a decline of 36% (Bank of Greece 2011b, 2014).

ever, did not happen. Private investment declined throughout the period⁶ despite the serious reductions in labor cost and despite the reduction in State bureaucracy, because of the uncertainty that surrounds the future of the economy and the dramatic increase in taxation. FDI has been limited, declining and well below the EU average level (Figure 2), while in most cases they take the form of acquisitions of obsolete public enterprises or buy-outs of over-debted firms, especially in the service sector. This type of FDI is not really associated with new investment and new capital formation in the economy, but with a transfer of productive resources from domestic to foreign hands.

Figure 2. FDI stock per capita, 1995-2011

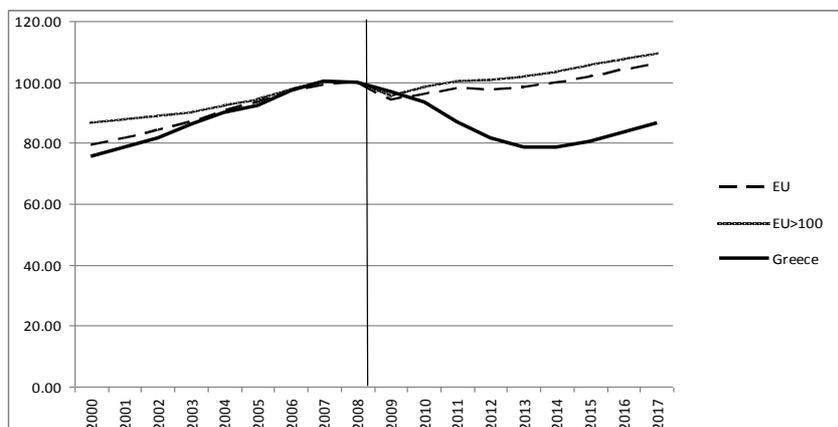


Source: UNCTAD (2013).

As a result, the recovery process of the economy is expected to be slow, even with the official IMF projections (Figure 3). This means that it may take Greece more than a decade to return to the GDP per capita ratio that it had before the crisis.

So, this is where we stand now: Dramatic losses in income and employment, an international rescue mechanism and a government with limited authority and under international supervision, continuous legislative reforms in nearly all aspects of economic life, but very little and slow progress in terms of recovery and for many people the wrong recipe. What has caused this ‘sudden death’ in the fastest converging Eurozone Member State in the pre-2010 decade (Argyrou and Tsoukalas, 2011)? What went so wrong and an excess deficit situation evolved to the largest economic, political and humanitarian crisis that the country has lived after the WWII? Answering this question is a requirement in order to discuss policy options and in order to prevent the next crisis in the European landscape.

⁶ In the period 2001-2008 average private investment was equal to 19.6% of GDP, while in 2012 it was only 11.2% of GDP. This accounts for a drop of 43% during the period of the crisis (Bank of Greece 2011b, 2014).

Figure 3. IMF projections of GDP: EU, EU>100 and Greece (2008=100)

Source: IMF (2014).

3. THE DETERMINANTS OF THE CRISIS

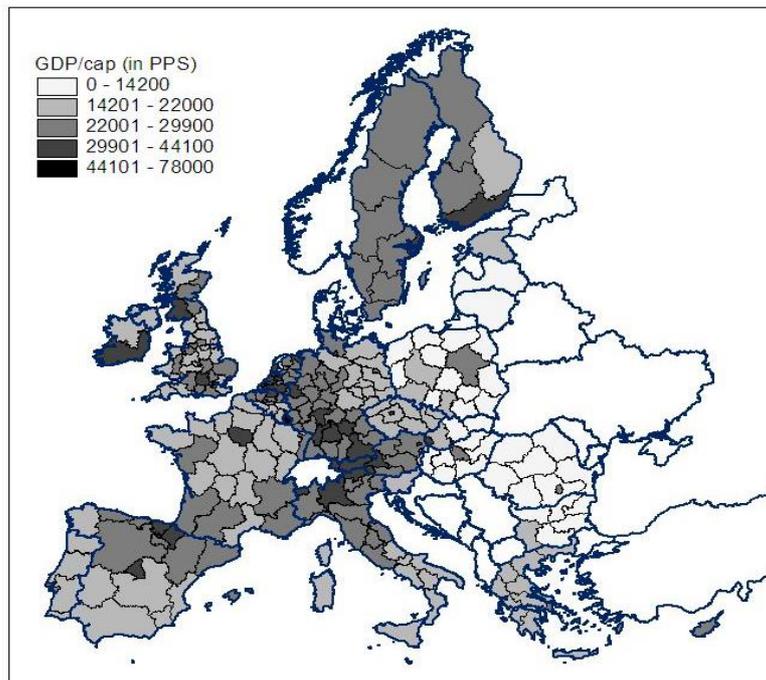
We are going to argue in this section that the Greek crisis is the outcome of the combination and the accumulated impact of several developments at the domestic and the European level and not the outcome of a single overriding factor. A mix of background factors at the European and the national level and the policy reaction to the crisis jointly reinforced a negative spiral that after some point accelerated and had snow-ball effects. At the European level the background factor is the unbalanced European economic architecture, which generates more competition and more deficits than the South and the East can take, while at the national level the background factors include the structural weaknesses of the economy and the operation of the public sector. These factors, along with a number of serious policy deficits and the mismanagement of the crisis at the European and domestic level have transformed quickly Greece from a celebrated success story to a disappointing failure and the EU economy (for a first time) to an unsecure landscape with many slippery spaces in its periphery.

3.1. Unbalanced European economic architecture

There is plenty of evidence now that the progress made in the European economic space has been highly selective. Growth has been driven by scale effects, agglomeration economies, knowledge embedded in the quality of human resources, an integration process that was particularly friendly to forerunners and initial conditions with respect to place, market size and development levels. These drivers typically favor more the larger, central, advanced and with better economic structure areas, triggering mixed processes of inclusion – exclusion that make the European economy as heterogeneous as ever (Figure 4) (Petrakos 2008, Petrakos et al 2011). As a result, in relative terms, the economic picture of Europe looks very similar from decade to decade. Persistent North-South,

East-West and Core-Periphery patterns, associated with increasing inequalities at the regional level raise the question to what extent the celebrated convergence of the East and the South has been based on technological progress or on the accumulation of public and private debt (Petraikos et al 2014).

Figure 4. GDP per capita in NUTS II regions of EU, 2008



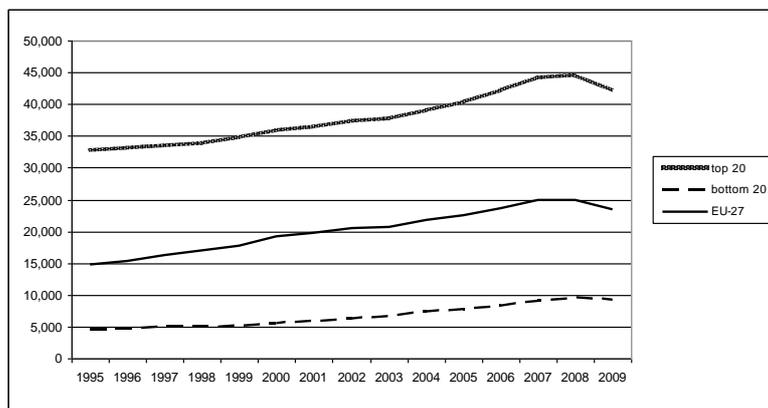
Source: Eurostat (2014).

These developments indicate that the European economic architecture, as it is presently shaped by the Single European Market, the Economic and Monetary Union, the Regulations and the Treaties produces more competition than the EU South (and East) could face. Serious and persistent differences in performances among the EU areas that were partially hidden in debt (Figures 5, Table 2) generated unsustainable trade and FDI imbalances.

It is clear that this particular type of integration is not a space neutral process. It is highly unbalanced and has combined open markets with increasing trade deficits and public deficits in the periphery, leading to a serious redistribution of income, wealth and resources at the expense of the less attractive or less productive places⁷.

⁷ A number of studies in the regional growth literature have provided evidence that the process of integration in the EU may increase inequalities and may have adverse effects in the less advanced regions that are mostly concentrated in the EU South and East (Petraikos et al. 2011; Fotopoulos et al. 2010; Petraikos et al. 2005; Petraikos 2003).

Figure 5. GDP per capita of top-20 and bottom-20 in NUTS II regions in EU-27, 1995-2009



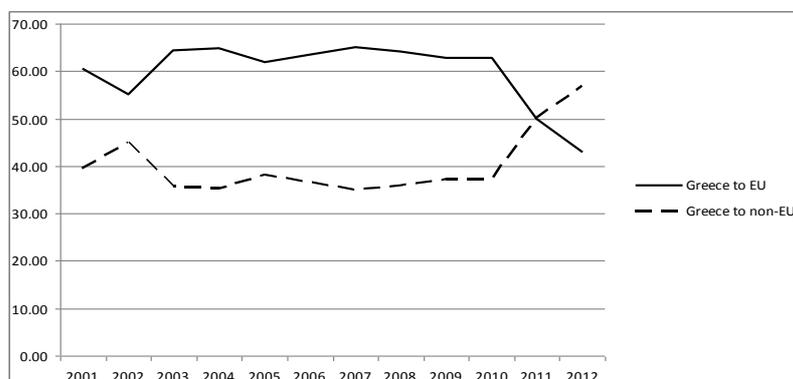
Source: Eurostat (2014).

Table 2. GDP per capita (EU=100) in the EU28 & subgroups EU<50, EU<75, EU<100, EU>100 for the years 1990, 1995, 2000, 2005, 2010 and 2013

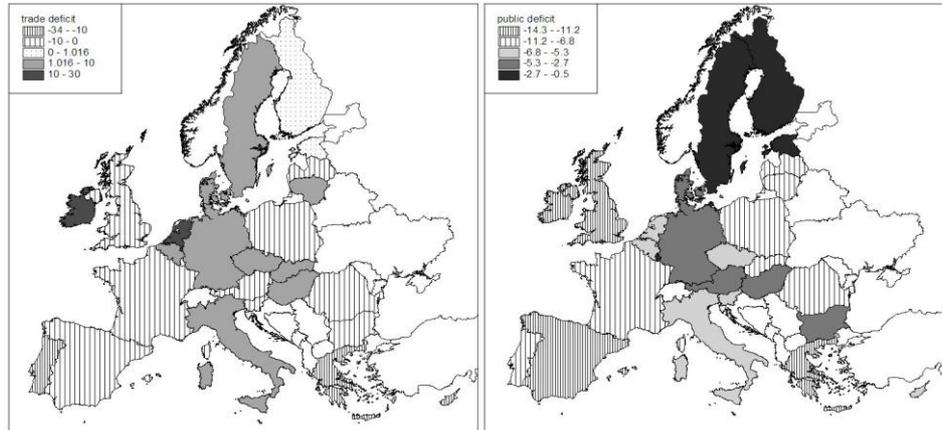
	1995	2000	2005	2010	2013
EU-28	100.00	100.00	100.00	100.00	100.00
EU<50	21.30	24.32	28.27	32.34	34.01
EU<75	29.10	32.21	36.11	39.39	39.29
EU<100	42.95	46.65	50.70	52.68	51.74
EU>100	129.50	128.71	126.33	124.98	125.19
σ -convergence in EU-28	0.56	0.52	0.47	0.45	0.46

Source: Eurostat (2014).

Figure 6. Share of exports to EU and non-EU countries, 2001-2012



Source: World Bank (2014).

Figure 7. Trade deficit and public deficit as a share of GDP, 2009

Source: World Bank (2014).

This unbalanced economic architecture has generated an interacting triple deficit of Europe. A high core-periphery competitiveness gap that has been based on serious differences in the availability, strength and quality of the drivers of growth among countries and regions triggers a serious core-periphery trade deficit that has been largely the outcome of a process of integration among unequal partners, where the more advanced run trade surpluses and the less advanced run trade deficits. Figure 7 shows that in 2009 only 9 (mostly advanced) EU countries were running a trade surplus. The remaining 19 countries were experiencing a trade deficit, while 10 of them were experiencing a trade deficit higher than 10% of GDP. These trade deficits imply excessive import penetration and lead to the contraction of the production base of the country and eventually to budget deficits, which depict to a large extent the inability of the private sector to generate enough employment and enough income and services in the less competitive Southern and Eastern economies⁸. There is a clear interdependence among the three deficits that in the absence of corrective policies takes a spiral form in the periphery: a continuous competitiveness gap leads to an increasing trade deficit, which in turn implies a higher import penetration and a contraction of the tradable part of the private sector. This results to a contraction in income (and tax revenues) and an increase in unemployment, which in turn leads to lower public revenues and higher public spending in terms of unemployment benefits and social protection measures. Therefore, an increasing competitiveness gap based on technological, institutional or geographical advantages quickly transforms to an increasing trade deficit and sooner or later to an increasing public deficit. Any attempt to stop this vicious cycle needs to understand the way of the causality and focus its attention on the deficiencies in the drivers of productivity growth (scale effects, agglomeration economies, the

⁸ Figure 6 depicts the 'paradoxical' type of EU integration for Greece, which exports less to the EU than to the non-EU countries, indicating an increasing difficulty of the Greek products to penetrate the EU markets.

quality of human resources, type of integration, technology and institutions) if it wants to have long-term effects.

Any attempt to reduce deficits by corrective measures alone (like increase in taxes or cuts in spending) foreseen in the EU Treaties will only make things worse, as contractionary policies deal with the symptoms and not the causes of the competitiveness problem⁹. In addition, in Western type of democracies, it is very unlikely to implement successfully a self-corrective mechanism that will suppress dramatically incomes, wages, social benefits and will increase the competitiveness of the economy, simply because the effects of such type of austerity violates established social contracts and arrangements and lead to social unrest that increase instability and kill investment and competitiveness.

Unfortunately, the Eurozone architecture did not pay the required attention to the huge North-South deficiencies in the drivers of growth and considered the Treaty provisions for public deficits (which are however endogenous) as a sufficient condition for systemic stability¹⁰. However, the participation of the weaker EU members in Eurozone removed the ability to exercise national monetary policy (Kotios 2011) and intervene in the exchange rate market (Konhler 2012). At the same time, the Eurozone imposed excessive budgetary discipline, practically removing fiscal policy from the policy options of the weaker states (De Grauwe and Ji 2013). Therefore, the crisis in Greece simply revealed in the most dramatic way the weaknesses of the European economic architecture and especially the restrictions of the Stability and Growth Pact and the Lisbon Strategy (Ioannou and Stracca 2014) that did not include any offsetting mechanisms aiming to reduce major imbalances in growth potential among countries.

The European economic architecture did not also include any provision of synchronization in economic policy among the member states. When Germany imposed restrictions in wage rises during the decade before the crisis in order to keep labor unit cost more or less stable, the Southern European economies experienced an increase in unit labor cost of about one-third. This was due to a spiral of higher prices and higher wages that accrued from a model of growth in these economies that had a higher consumption component¹¹. A decade later (in

⁹ To a large extent the North-South competitiveness gap in the Eurozone was fuelled by suppressed wages in Germany and increased consumption in the South (Monastiriotes 2011), which was – however – a necessary condition for the production surplus of the North to be absorbed (Lapavitsas et al. 2010). Without the deficits of the southern countries, surplus countries would put in danger their growth rates since domestic demand was lower than total supply (Tsakalotos 2010).

¹⁰ The EU architecture was based on the assumption that major economic shocks endogenous to the system are unlikely to come up considering unnecessary any mechanism for that kind of events (Tsakalotos 2010).

¹¹ Due to a complex set of transformations in the pre-crisis European division of labour the South was slowly replaced as a production space for traditional or labour-intensive products by the Eastern Europe and Asia) and was partly transformed to a consumption space intended to absorb the excess supply of the European North. To some extent, its function to prevent an over-production crisis in the North resulted to a debt-crisis in the South.

2011), the German economy had increased its competitiveness in the European and international market, while the South experienced a significant decline in international competitiveness and an equally significant increase in its trade deficit, which, to a large extent was the mirror-image of the German trade surplus (Miller and Sciacchitano 2012). If the economic policies of the EU member states were better synchronized at the European level in order to avoid undesirable side effects, if Germany had allowed for higher wages in order to support its economic expansion by an increase in domestic demand and not exports and if the Southern member states (and especially Greece) were more concerned about their cost base, Europe would have probably been a more balanced place and the crisis could have been avoided.

Finally, we have to notice that despite the high and recently increasing North-South and East-West inequalities in terms of development levels, the EU does not have yet an active fiscal policy that will complement monetary policy and pursue the provision of equal quality of infrastructure and public services to its citizen. In the current arrangement fiscal policy is the responsibility of the member states, which means that the more affluent states with better infrastructure, better universities and better public services can continue to spend more to improve them, while the less affluent with serious deficiencies in all the above must do anything they can with their own limited resources, without borrowing very much from the markets because there is a ceiling in the Stability and Growth Pact and because all types of financial analysts, rating agencies and speculators are waiting in the corner. The lack of fiscal policy at the EU level and the absence of policy-led redistribution mechanisms that would (partially) counterbalance the intense market-led redistribution that took place mainly through trade flows in the EU is an important deficit in the European economic architecture that has contributed to the rising imbalances and the eventual outbreak of the crisis. The fact that Europe ended up during the crisis with both low total investment and an even more uneven distribution of that investment between its surplus and deficit regions is a clear indication of the absence of reliable fiscal policy with a clear counter-cyclical orientation (Torres 2013, Varoufakis et al. 2013).

The institutional setting of the European financial markets has also contributed to the outbreak and the acceleration of the crisis in two important ways. The first one is related to the unequal borrowing conditions taking place for the European core and the European periphery in the early stages of the crisis. Typically, the weaker States in the South and the East borrow from the financial markets at a much higher interest rate than the advanced Western and Northern States. These differences are based on accreditation ratings provided by 'independent' rating agencies. The advanced EU countries have very high ratings allowing them to borrow at a very low interest rate and finance their budget in a more effective way, while the less advanced countries usually borrow at a higher or a much higher rate, with all the consequences that this may have in the formation of their debt. Apart from the discussions related to speculative games and the self-fulfilled prophecies of the rating agencies, a more fundamental problem arises here for the European economic architecture. How is it possible to expect convergence in the European economic landscape if the countries that

need investment funds the most are either excluded from funding or pay a much higher interest rate? Also, how is it possible for the countries with the higher debt to reduce it, if serving the debt cost significantly more to those that are less able to pay? Would it be acceptable for the weakest German Lander to borrow in order to maintain its public sector at a rate that is 2, 3 or 5 times higher than that of Munich, Frankfurt or the Federal State? Clearly, the idea that each EU country is at each own when faced with the international financial markets produces not only inequality, but also inefficiency, as it increases the average borrowing rate of the European economy and therefore its growth prospects. In the case of Greece, the rapid deterioration of the borrowing conditions and the final cut off from the financial markets was the major factor that triggered the debt crisis.

The second way that the architecture of the financial system has contributed to the Greek crisis is related to the absence of an EU-wide guarantee of the bank deposits. This has made the guarantee of the Greek State for the deposits in the Greek banks to look unreliable during the crisis and has contributed to a fly of deposits even from healthy banks. This was one of the main mechanisms that transformed a debt crisis to a banking sector crisis and reduced dramatically the ability of the banks to finance investment activity¹². When the discussion about default of Grexit among European policy makers, economic analysts and speculators took a critical momentum, about 80 billion euros fled the Greek banks because their owners did not want to risk waking up one day with (dramatically devalued) drachmas instead of euros¹³. The largest share of that money ended up in German and Swiss banks (Bank of Greece 2014)¹⁴. Therefore, the absence of a truly European banking system where the supervision of the banks will be the responsibility of the ECB and where deposits will be equally guaranteed in all countries has had a major role in transmitting the debt crisis to the banking sector and set in motion a negative spiral of deposit-fly, lack of liquidity in the economy and deeper recession.

It is clear that the mainstream economic model expectation that existing institutional arrangements were sufficient for the market forces to correct serious

¹² The banking sector in Greece suffered also from two more major negative developments: (a) the haircut of the Greek debt as it was holding a significant amount of Greek bonds and (b) the red loans that are related to the inability of households that lost their income and near bankrupt business to serve their loans. The recapitalization of the banking system by the ESF has increased the debt of Greece by 41 billion so far (Bank of Greece 2014).

¹³ The total deposits in the Greek banks in 2009 were 237 billion. During the crisis (and until 2012) the banks lost about 80 billion (one-third of the deposits) of which 60 billion were transferred abroad (Bank of Greece 2014).

¹⁴ As strange and unjust it may sound, the evidence shows that the German banks benefited from the Greek crisis by attracting deposits from Greece, but also from the rest of the European periphery, appearing as a 'safe haven' in a highly speculative and unstable environment for the deposits of the more affluent people in these countries. Therefore, the liquidity drought in the European South that made the exodus from the crisis more difficult was associated with an excess liquidity in the North that financed with very favorable terms the expansion of the economy.

imbalances was unrealistic. On the contrary, the market mechanisms revealed that the existing type of unfinished financial and economic integration was incapable to maintain the stability of the system for very long when the common currency was introduced (Mayer et al. 2012).

To summarize the argument, the economic crisis in Greece was simply the expression of an unavoidable Eurozone crisis, as the European economic architecture is ill-designed and generates imbalances that are very likely to lead to a debt crisis, typically by triggering speculation in the financial markets.

3.2. European and international policy failures: The response to the crisis

Judging from a distance, the most striking characteristic of the period was the slow reaction of the EU authorities to the rapid isolation of Greece from bond markets in late 2009 early 2010 (Christodoulakis 2011). This delay in decision making and the absence of a robust response resulted to a credibility crisis, attracted the attention of speculators and lead to the rise of spreads and eventually the fiscal crisis (Monastiriotis 2011). The existing EU mechanisms (Excessive Deficit Procedure and Stability and Growth Pact) failed to predict and prevent the crisis because they were too loose before and too strict after, producing a pro-cyclical bias (Collignon 2012).

This lack of reflex was often accompanied by negative rhetoric, changing positions and conflicting messages from the EC and some high level government officials from a number of advanced member states, who were mostly responding to the populist media in their countries and addressing domestic electorates. However, their views had high coverage in the media and were in line with the inclination of part of the political elites in some core EU countries to resort to punitive policies and actions.¹⁵ Although this rhetoric was progressively abandoned as the crisis was escalating and spreading to other countries, it played an important role in increasing uncertainty about the future of Greece in the Eurozone and in turning the debt problem of a tiny economy (with less than 2% of European GDP and debt) to a systemic risk for the Eurozone.

The early slowness was replaced by an overreaction and unrealistic and hasty rescue programs that reduced severely aggregate demand and jeopardized the credibility of the banking sector. The program was strongly pro-cyclical and included excessive cuts in public spending that had strong recessionary effects. The program was based on a gross misunderstanding of the realities of the Greek economy and a serious underestimation of the government spending multiplier. Troika (in fact the IMF) was expecting in the early 2010 that the first program will cause a limited recession that would be followed by strong growth by the end of 2010 (Christodoulakis 2013). All the subsequent estimates of the impact of the program on the economy were also far away from the reality be-

¹⁵ It seems that the view of severe punishment of Greece (including the exodus from Eurozone) was considered attractive in the early period of the crisis in some Ministries of Finance and some conservative circles, as it would include a very strong message that the EU will not tolerate any “irresponsible” behavior in the future.

cause of their basic failure to assess correctly the size of the multiplier (Blanchard and Leigh 2013, Petralias et al. 2013)¹⁶.

Table 3. Predictions for GDP change made by the EC, the IMF and the OECD for the 2011-2012 period

	EC	IMF	OECD	Actual figure
Prediction date for 2011	January 2011	October 2010	December 2010	
GDP percentage change in constant prices for 2011	-3.5	-2.6	-2.7	-7.1
Prediction date for 2012 figure	January 2012	September 2011	December 2011	
GDP percentage change in constant prices for 2012	-4.7	-2.0	-3.0	-6.4

Source: Petralias et al. (2013).

There is no doubt that a multiplier of 0.50 was very convenient for the designers of the austerity programs, as it implies a limited impact of cuts on GDP. However, it is not realistic to assume that an economy with a weak productive base and a dominant for years role of the public sector in stimulating aggregate demand will have such a low multiplier. Independent estimates have shown that the investment multiplier in Greece was greater than 1.00¹⁷. Continuous reviews of the austerity programs revealed the unrealistic calculation of fiscal multipliers on spending cuts and taxes (Papadimitriou et al., 2013). Although it is widely accepted now that the fiscal shock therapy caused more problems than it solved and that the reduction of the debt is infeasible in a period of a couple of years (Wyplosz 2013), IMF in its 2013 report on Greece addresses the failure in the multiplier calculation as a matter of secondary importance regarding the magnitude of the recession (IMF 2013). As Table 3 shows, the forecast made by the EC, the IMF and the OECD for the 2011 and 2012 decline in GDP was far away from the actual decline, implying that the rescue program was based on unrealistic assumptions and therefore it was almost impossible to meet its targets.

Despite the fact that some learning has taken place and some change in the rhetoric and the direction of policy has taken place since mid-2012, the initial reaction of the EU and the International Organizations to the crisis was damaging for the economy, while the timing and mix of policy continuous to receive serious criticism. The frontloaded character of the austerity program was ac-

¹⁶ According to the IMF estimates the size of the government spending multipliers was close to 0.50, while in reality it was close to 1.50 (IMF 2014).

¹⁷ Coenen et al. (2012) has found that the multiplier effect of government investments in Greece was equal to 0.95 and 1,13 in the long-run. Rendahl (2013) has indicated that government spending generates fiscal multipliers greater than 1 because the economy was in liquidity trap, with high and persistent unemployment; while Van Reenen (2013) claims that in crisis fiscal multipliers are much higher than in normal times, making contraction policies more damaging.

accompanied by a reform program that was delayed (Christodoulakis 2013) and also questioned for the reasoning of many of its provisions¹⁸. The reform program was criticized for favoring special interests¹⁹ and for removing all forms of social protection for the weaker, while in many cases it ignored the realities of the market structure in Greece.

In general, the implementation of the reform program has been under a continuous evaluation process by the Troika, through which its targets were reset in a way that attracted the attention of the public and was a constant source of uncertainty and social unrest. Although several measures and reforms modernized the public sector, the Program as a whole has been perceived in a negative way by the general public for its excessive taxation and for its impact on the labour market. Continuous labour market reforms adopted in the midst of the crisis that removed protection and cut wages led to more unemployment and failed to boost new recruitment as it was envisaged by the Troika (Torres 2013). As a result, the strategy of domestic devaluation was discredited in the eyes of the average citizen as it caused enormous social and economic cost (Weisbrot and Modestino, 2012).

3.3. Domestic market failures

One of the reasons that the crisis was so severe and its duration so long is unquestionably related to the characteristics of the productive system of Greece. The production base of the country is dominated by small and very small enterprises that enjoy practically no scale effects and has limited competitiveness (Petraikos et al 2012, Doxiadis 2013, Giannitsis 2013, Petraikos et al. 2008, Petraikos and Pitelis 2001). The average firm size in terms of employment in Greece is 4 employees, while in the EU is 15 and the advanced EU countries 17 employees per firm.

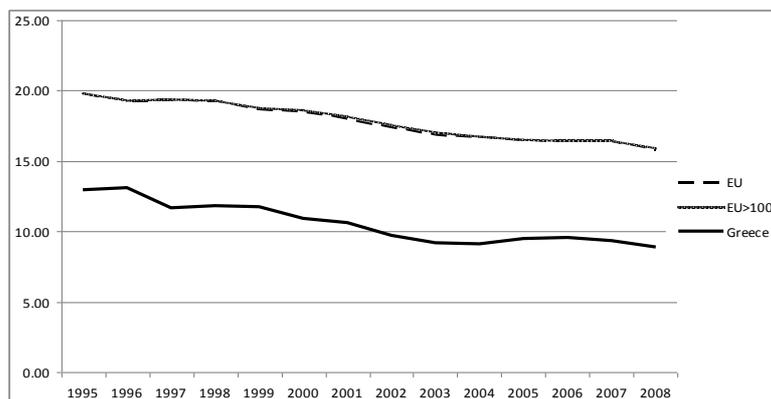
This fragmented economic base is mostly inward-looking and dominated by the non-tradable sectors of the economy, such as the public sector, retail, construction and consumer services (Doxiadis 2013). The manufacturing sector has shrunk dramatically during the last 2-3 decades from about 25% to 8% of GDP in 2012 (Figure 8) and specializes mainly in consumer, labor intensive and resource intensive products serving mainly domestic market. The tradable sector

¹⁸ It is difficult to explain why the reform of central government with new organizations for the ministries has not been completed five years after the first Memorandum. On the contrary, laws of minor importance (like the law for the price of milk that had the opposite effects in the market) or labor market deregulation laws that have a clear class bias against unions and collective negotiations were finished in time because of the pressure of the Troika.

¹⁹ In many negotiations between the Greek officials and the Troika it was clear that the latter had some sort of 'inside information', that is detailed information about the subject of the discussion that an international organization is impossible to have. This was due to the fact that the Troika office in Athens was approached by special interest groups that considered the crisis as an opportunity to change the legal basis of the economy in their favor.

of the economy is limited and includes mainly tourism (which is highly seasonal) and a small part of the manufacturing and agricultural production.

Figure 8. Share of manufacturing (%) in GDP, 1995-2008

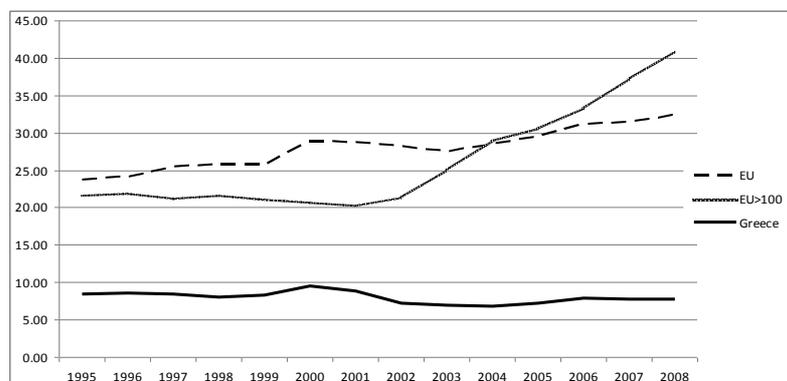


Source: World Bank (2014).

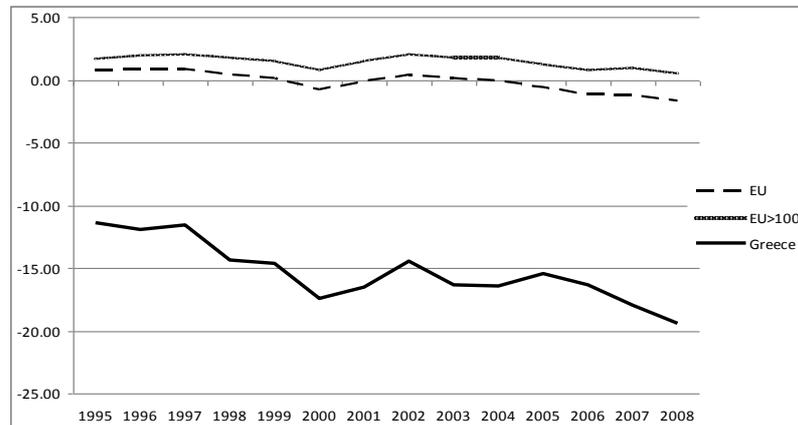
In addition to the small size and the unfavorable sectoral specialization, the economy suffers from limited forwards and backwards linkages between critical sectors, such as tourism–food industry linkages or tourism–agriculture linkages and therefore low domestic regional or sectoral output multipliers (Fotopoulos 2013).

The lack of export-orientation in the economy (Figure 9) is depicted in the trade deficit (Figure 10) and shows the low competitiveness of the economic base. Although there are significant historical factors behind the current structure of the Greek economy (Petrakos 2001), there is no doubt that the intensification of competition in the EU market, especially after the euro, generated a spiral of defensive adjustments and the concentration of economic activity in the non-tradable sectors.

Figure 9. Merchandise exports share (%) in GDP, 1995-2008



Source: World Bank (2014).

Figure 10. Merchandise trade balance share (%) in GDP, 1995-2008

Source: World Bank (2014).

Countries or regions with unfavorable initial conditions, weak productive structure and strong pressure from international markets have no other option than to adopt a proactive policy-driven development model that will try to compensate for inherent weaknesses and build a growth strategy on the basis of existing and potential advantages. This is a difficult and perhaps unpopular long-term perspective that was never adopted systematically during the 35 years of Greek membership in the EU.

On the contrary, the development model of the country took the easier way and was based on consumption and imports instead of investment, production and exports. Lower interest rates in the post-euro period facilitated the expansion of public and private borrowing, while expanding employment in the public sector was offsetting the loss of jobs in the contracted tradable sector. Most new jobs in the private sector were in non-tradable sector like retail, consumer services and construction that were directly dependent on the level of domestic demand and indirectly on public and private borrowing. Public spending and employment were possible only because of the continuous State borrowing, as the tax revenues were typically lagging public spending by 10% of GDP due to extensive tax evasion. To the extent that the public investment funds (which included the EU Structural Funds) were considered to serve a development policy, emphasis was always placed on public infrastructure (mainly the transportation networks), while policies for the development of human capital, entrepreneurship and R&D were systematically underfunded or neglected.

This inward-looking model developed significant rent seeking activities around the public sector, the stock market and the construction sector. In times, the rewards of consultants, stock brokers and real estate agents were so high that demoralizing paid employment in either sector. This model neglected the tradable sector of the economy which is the basis of international competitive-

ness and eventually collapsed with the debt crisis, which to some extent was the logical outcome of its faults and weaknesses.

3.4. Domestic policy failure: The political system, the public sector and the management of the crisis

The political system in Greece has operated on the basis of the two-party system²⁰ that replaced each other in the elections for a period of 40 years. Despite ideological differences and at times fierce political antagonism, the two parties shared similar practices when in power. Instead of long-term economic planning they usually followed a short term perspective and extensive clientele practices that persisted throughout the period despite some efforts to modernize both the political system and the public sector (Giannitsis 2013). Strong political antagonism for power and demagogic demands from the entire political spectrum did not allow for a minimum consensus in proceeding with reforms and some measures to control public spending and increase tax revenues before the crisis.

Primarily because of the clientele practices of the political system, the state mechanism became bureaucratic, over-regulating and in some cases corrupt (Tsakalotos 2010). About 22% of the labor force of the country was employed in the public sector, which grew dramatically in terms of employment in the 2007-09 period²¹. The public sector itself is highly centralized, with limited funding and authority allowed at the regional and local level, and in most cases it discourages investment activity. Its dependence from the political system, its sluggish structure and the equally sluggish European bureaucracy did not allow the public administration to quickly adapt to the realities of the crisis and direct Structural Funds to actions and programs that would support investment and employment.

In short, the political system is considered by the majority of the population as responsible for the crisis because it increased public spending and the debt²²,

²⁰ The Center-right party of New Democracy (ND) has ruled in the periods 1974-81, 1990-93, 2004-09, while the Center-left PanHellenic Socialist Party (PASOK) has ruled in the periods 1981-1989, 1994-2004 and 2009-11. The two parties usually counted for more than 80% of the vote, with smaller parties, mainly in the left, counting for the rest. After the 2012 elections the two parties have formed a coalition government that runs the fiscal consolidation and reforms program. Their electorate basis has been reduced significantly in the 2012 elections (ND: 29.7%, PASOK: 12,3%) while the Left opposition party of SYRIZA received 26.9%.

²¹ By the end of 2009 the public sector had 942,645 employees, while at the end of 2013 that figure was down to 675,530. This huge reduction (-29%) was due to the cuts in temporary staff, massive retirement of those eligible to leave in the fear of further cuts in wages or pensions and laying off of 8.500 employees from the permanent staff of the public sector (Ministry of Finance 2014).

²² A fierce political debate has erupted among the two ruling parties for the primary responsibility of the debt. Although Greece has a long history of high public debt, the evidence seems to indicate that public primary deficits were almost eliminated by 2004 and that the debt increased dramatically in the 2007-09 period when public consumption and employment increased significantly, at the same time that public revenues collapsed

it failed to modernize the public sector and also failed to fight bureaucracy, corruption and tax evasion²³. It is also blamed for its inability to confront more efficiently the crisis. The new socialist government that was elected in the 2009 elections was trapped in pre-election promises and was slow to realize the dangers of the rapidly changing international markets and the negative EU policy environment (Monastiriotis 2013). The new government did not come up with its own plan to deal with the crisis. Instead, it accepted the plan of Troika for deep spending cuts and reforms without negotiations, convinced by the EU and IMF assurances that the recession would be mild and of a short period²⁴. Spending cuts were sharper than required, because the government failed to broaden the tax base of the economy and fight tax evasion of the more affluent social groups²⁵.

The Reforms agenda was also problematic. Useful reforms were delayed due to pressure by interest groups and did not have an immediate growth effect, while other reforms that were implemented caused serious opposition and dissent without having a clear justification. Similarly, the privatization goals were unrealistic and set late with no significant impact on revenues due to bureaucratic obstacles and uncertainty that discouraged investors.

Finally, the political establishment of the country is accountable because in front of the most serious crisis in the post-war period was unable or unwilling to find a minimum basis for negotiations and political consensus during the first two years of the crisis, generating more friction and conflict, but also less viable solutions than it would otherwise. For many people the crisis and the management of the crisis was a lot of pain with no gain. It was also a lot of pain without justice. The profound costs of the austerity program for the weaker social classes have been the ground for the rise of extreme populism on the one hand and ethnocentric and xenophobic sentiments on the other.

(Christodoulakis 2011). According to Eurostat (2014) government spending in 2009 reached 53.1% of GDP compared to 44.8% in 2006.

²³ The inefficient tax system that provided one of the lowest tax/GDP ratios is considered to be a crucial factor for the development of the Greek debt and the economic crisis (Kaplanoglou and Rapanos 2013, Stathakis 2010, Theodoropoulou and Watt 2012).

²⁴ Even before the signing of the first Memorandum with the Troika there were voices in the Papandreou Cabinet arguing that cutting public spending by 36.2 billion (the size of deficit in 2009) in 2-3 years in an economy of 231 billion (the size of GDP in 2009) would not have a mild effect and will drop the economy into a deep recession. However, Papandreou and his Minister of Finance could never imagine that the assurances of the top international organizations were entirely worthless and their estimates of the effects of the crisis completely wrong.

²⁵ Tax evasion is wide spread in the economy and includes all social groups except employees. Typically, professionals like doctors, lawyers or engineers and small retail and service business were typically reporting on average an annual income that was much lower than earned and in some cases lower than that of the employees. As a result, even in 2011 that some reforms in the tax system were already in place, employees and pensioners were making up 70% of taxable income and paying 55% of total tax (GSIS 2012).

4. LEARNING FROM THE CRISIS: CHALLENGES FOR THE THEORY AND INTEGRATION POLICY

The experience of the European South has shown that a persistent core-periphery competitiveness gap within the Eurozone can be transformed to a serious trade deficit and that, in turn, to an unmanageable public deficit. This market imbalance combined with serious policy failures has triggered a profound economic crisis that widened the existing development gap between the EU core and the European periphery. In Greece, but also in other places, the current crisis has eliminated the progress that has taken place over the last 20 years, damaging the credibility of domestic and European institutions and undermining political stability and democracy.

Learning from failure is critical for policies of prevention, in the hope that similar situations will be avoided in the future in the EU. The first lesson from our analysis is that long-lasting imbalances in trade among EU members need to be confronted with appropriate economic policy measures. Persistent and high surpluses in the North are equally problematic with persistent deficits in the South and need to be under the scrutiny of the EC. A combination of active measures that will stimulate domestic demand in the European core, improve the productivity and the size of the tradable sector in the periphery and reduce the unit-labor cost differential among the export frontrunners and the laggards is required.

The second lesson is that once the crisis has erupted, only hard choices are available and the downwards adjustment will be unavoidable. This raises the issue of prevention that is relevant for both the European Commission and the National authorities, who did very little in the period before the crisis to avert it. It also raises the issue of speed, decisiveness and coordinated action at the EU level. It finally raises the issue of responsibility of public figures in making statements that result to negative exposure of troubled economies in the financial markets. In dealing with future crises, the EU has to make sure that it has a working plan ready, it acts quickly in order to avoid it or prevent its deepening and spreading up and that the public statements made are part of the solution and not part of the problem. Making hard choices even harder in order to satisfy domestic audiences in a number of core countries should be eliminated from the EU policy kit.

The third lesson of the analysis is that the external, higher-order, macro-level drivers of crisis are more important than internal, lower-order national-level ones. No matter how hard the domestic policies are trying to cope with the crisis, how much the deficit has been cut, how many reforms have been successful, how much the labor cost has been cut or the bureaucracy reduced, it is the decision of the European Council, the rating of Moody's, an article in the 'Financial Times' or the statements of a Finance Minister in Bloomberg that count more. Perhaps in the long-run what happens inside the country will make a difference, especially if the policy mix is consistent and leads to the same direction. During the crisis, however, the investment decisions and decisions in nervous financial

or stock markets are affected primarily by the positive or negative environment and the prospects created by far more influential international actors.

The fourth lesson has to do with the policy-mix applied during the crisis. It is now widely acknowledged that a slower pace of fiscal adjustment and a faster pace in reforms would have less damaging results on social, political and economic grounds. Fiscal shock therapies of the magnitude applied in Greece can be dangerous for economies with weak and inward-looking productive systems, where the public sector plays a critical role in the economy and fiscal multipliers are high. The reform program (assuming it is properly designed) will not lead to a recovery if investment activity is not well above its pre-crisis historical levels. A severe and front-loaded fiscal consolidation program that reduces public investment and spreads social unrest is very likely to discourage also foreign capital from investing in the country. The Greek economy needs currently additional investment equal to about 10% of GDP in order to return to the pre-crisis levels and this can be found only externally, in the form of a reduction of the debt-serving requirements, in the form of EU development funds, in the form of FDI or in a combination of the above. All this indicates the need for a return of development policy in the European agenda in order for depressed and crisis areas to be able to move from recession to development in a highly competitive environment. Supply side policies (reforms) will need to be decisively supported by demand side policies in order for the crisis-hit economies to assume a sustainable growth path in a reasonable time horizon.

The fifth lesson is that we need more Europe and better European institutions in order to overcome existing asymmetries and overcome the crisis. We need a more advanced, more inclusive and more balanced process of integration that will include a more coordinated economic policy, as well as financial and fiscal integration. Austerity in deficit countries should be offset by demand stimulus in the surplus countries, while macroeconomic policy should become more coordinated and more symmetric. A Fiscal Union may foresee a common liability for (part of) national debt, tighter fiscal coordination, redistribution mechanisms and Eurobonds funding for investment and development projects. A Banking Union may foresee common financial supervisory and bank resolution mechanisms and common deposit security for all EU countries.

We are not sure if the analysis offers any lessons for the improvement of the domestic political system of Greece or other countries in the South or East that is considered to be also responsible for the crisis. The interesting observation here is that the same people and the same parties that are held responsible for the accumulation of debt and the break out of the crisis are congratulated by the EC and the international organizations for the successful implementation of the austerity and reforms program. Can the same political system be both good and bad at the same time? The answer is probably not, but the observation leads to the reasonable hypothesis that the political system is an endogenous variable shaped by other factors that are related (among other things) to the condition of the economy. The political system in a country with a strong private sector and unemployment in the range of 5% receives different pressures from the electorate and behaves differently from that in a country with a weak private sector

and unemployment in the range of 15%. Therefore, one may assume that the quality of the political system of a country depends on the quality of the economy and the level of social cohesion within the country. Although the causality runs both ways, more advanced and more egalitarian economies have fewer chances to end up with populist and careless politicians and a clientele political system. The other observation is that these types of political systems in the South or the East are not very likely to survive the pressures of a competitive environment. Although this may sound promising, the worrying experience of Greece has shown that the economic crisis may lead to the rise of political extremism in the extreme right and the undermining of democratic values.

The final lesson is that behind the impressive policy failure in Greece may be hiding an even more impressive theory failure. The conviction of the mainstream theories that market-led integration will generate enough product and factor flows to spread growth in space in an equilibrating way, ignoring the importance of selectivity bias, all sorts of inequality in initial conditions and the cumulative nature of development processes, is to a large extent the founding stone of the crisis. By downplaying the role of the public sector in providing equal opportunities in infrastructure, knowledge and public services and illegitimizing its impact on the economy, the mainstream school has failed to understand the main causes of the crisis. Ignoring the roots of the problem or confusing causes with symptoms may end up in a situation where the medicine cures the disease but kills the patient.

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LA CRISE GRECQUE : LES ÉCHECS DES POLITIQUES NATIONALES ET EUROPÉENNES

Résumé - Cet article retrace les étapes de la crise financière, économique et sociale de 2008 en Grèce. Le pays a connu une baisse d'un quart du PIB par habitant tandis que le chômage a augmenté de l'ordre de 25%. L'article propose une analyse détaillée de la rupture des moteurs de la croissance qui s'est manifestée depuis 2008. Il montre les faiblesses structurelles de l'économie grecque, la défaillance des politiques nationales mais aussi des politiques de stabilisation mises en place par l'Union européenne.

Mots-clés - CRISE ÉCONOMIQUE, GRÈCE, UNION EUROPÉENNE, PROGRAMMES D'AUSTÉRITÉ