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Economic crisis in the European periphery: An assessment of EMU membership and home policy effects based on the Greek experience

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ABSTRACT

In this paper we examine the evidence on the impacts on the Greece economy of enhanced transfer assistance from the EMU as well as that of the domestic policies of the Greek government. A simple macroeconomic model is constructed to incorporate the issues related to the formation of the economic and financial crisis in Greece, and to analyze the impacts of Greek government's domestic policies. The model's solution is employed to highlight the outcomes that we believe could be related to EMU membership and Greek government policies after assuming membership. Our finding is that intervention by the Greek government either worsened the harmful impacts of the transfers, or altered the outcomes in a deleterious fashion; the policies which were put in place were of a nature leading unavoidably to a severe economic crisis and eventual bankruptcy.

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1. Introduction

When the economic crisis erupted in Greece in 2009, the view that prevailed was that its causes were idiosyncratic in the sense that they had to do with the structure of the Greek economy and the economic policies of Greek governments, at least since the country's entry into the European Monetary Union (EMU) in 2002. In the face of the available evidence, this view was quite convincing and Greece became the black sheep of the world, because of the risk its imminent bankruptcy represented for the stability of the Euro, and hence, the wider international financial system. But shortly afterwards, the economic crisis engulfed Ireland, Portugal, Spain and Italy, i.e. countries of the European periphery with much stronger fundamentals than Greece,[3] and experts started to suspect that some more systematic forces were amiss. So they turned their attention to the study of the shocks these countries experienced from ascending to the Eurozone and, of the economic policies they had adopted to deal with them or because of them.

The debate that ensued about the timing, the severity and the speed and pattern of diffusion of the economic crisis has evolved along three strands of thinking. The first of them centers on the perception that some of these countries succumbed to the crisis because of the ill-advised economic policies their governments put in place. The prime example in this regard is Greece, the governments of which mismanaged public finances to such an extent that, when Darvas, Pisani-Ferry, and Sapir (2011, p. 5) visited the data, they arrived at the verdict which is quoted in the following excerpt.

> The key indicator for assessing solvency is the size of the primary budget surplus that needs to be maintained over a period of years to achieve, in the medium term, a gradual return of the public debt to safe levels. Here the numbers for Greece stand apart from those for other countries. Even under the optimistic scenario, the primary surplus required to reduce the debt ratio to 60 per cent of GDP in twenty years would be 8.4 per cent of GDP. . .Over the last 50 years, no country in the OECD (except Norway, thanks to oil surpluses) has ever sustained a primary surplus above 6 per cent of GDP. Even less ambitious targets would require politically unrealistic surpluses.

Apparently, by 2009 government excesses in Greece had resulted in the amassing of an unsustainable amount of public debt and, whether Gartner, Griesbach, and Jung (2011) and others[4] are right or wrong about the role that global credit rating agencies played, sooner than later international financial markets would have closed on Greece, pushing it into an open bankruptcy.

Referring to the second strand of thinking, this places the brunt of the blame on the way these countries dealt with the shocks from their participation in the EMU. One proponent who advocates it is Hellwig (2011), who maintains that government excesses themselves could have been due to EMU membership via the mechanism known as "*Dutch Disease*".[5] For, if upon accession to the monetary union these countries attracted massive capital inflows, in the forms of foreign direct investment, financial assistance or even loans on un-expectedly easy terms, what we would expect to observe would be developments similar to those that transpired in Holland after the discovery of natural gas and in Great Britain after the discovery of North Sea oil.[6]

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[3] From among the countries that were affected, Greece was hit first and hardest. It almost went bankrupt in 2009 and it was spared from this misfortune only by accepting harsh austerity measures in 2010, which have reduced GDP per capita by 25% and raised unemployment to nearly 30%. By contrast, the economic crisis in the other countries turned out milder and at no time exposed any of them to the risk of bankruptcy.

[4] In addition to criticizing rating agencies, Nielsen (2011), Giollamoir (2011) and other researchers blame official government statistics for not providing a true picture. In particular, the point they stress is that when the new Greek government came to power in 2009, it had to revise the budget deficit forecast of the previous government from 6% to 8% of GDP to 15.4%. However, this criticism should be tempered in the light of more recent findings by Bitros (2013).

[5] The literature on the Dutch economic crisis is of rather old vintage. A well-known article is one by Corden and Neary (1982). Other contributions on this topic include those by Fender and Nandakumar (1987), Eastwood and Venables (1982), Forsyth and Kay (1980), Neary and Wijnbergen (1984) and Wijnbergen (1984).

[6] More specifically, in the case of Holland heavy income transfers from abroad due to the sale of gas or oil increased domestic spending. This, in turn, drove up the prices of the non-traded goods and services, for which the price levels are formed in the home market. Finally, as the higher prices of non-tradables translated into wage increases via inflation indexation, collective

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