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Greece in the Eurozone: Lessons from a decade of experience☆

Elisabeth Oltheten[a], Theodore Sougiannis[a,b,*], Nickolaos Travlos[b], Stefanos Zarkos[b]

[a] University of Illinois at Urbana-Champaign, United States
[b] ALBA Graduate Business School at The American College of Greece, Athens, Greece

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ABSTRACT

This study examines Greece's experience as a member of the Eurozone over the period 2002 to 2011. In evaluating the Greek experience within the Eurozone, we derive the following fundamental policy lessons that apply both to similar small peripheral EU countries that plan to enter the Eurozone, or any other economic union, and to the Eurozone itself in terms of facilitating their integration in a large monetary union. First, countries with inefficient public systems must re-engineer and restructure the decision making process in the public sector before they become members of an economic union. Second, countries must generate a friendly environment toward business and provide (a) a simple, stable tax system, (b) an effective and efficient justice system, and (c) a high quality educational system. Third, the living standards of the people are determined by the productivity and competitiveness of the economy and not by an inefficient and overspending public sector. Fourth, structural funds should be used to improve the competitiveness of the economy, not serve the political clientele of the party in power. Fifth, the admission requirements to an economic union must be strict and these requirements must be enforced. Sixth, capital market investors must always differentiate default risk within the country-members of a monetary union.

1. Introduction

Greece was admitted into the European Economic Community (EEC) in January of 1981 and, twenty years later, in January 2001, was admitted into the Eurozone, the group of European countries using the newly created common currency, the Euro. Both events were touted as milestones in the country's recent history. For Greece, membership in the EEC, renamed in 1992 to the European Union (EU), was viewed as a safeguard of the recently restored democratic institutions after the dictatorship of 1967–1974, and an opportunity to enjoy the political, social, and economic benefits that may arise from participation in a large economic area. Membership in the Eurozone was viewed as an opportunity to enjoy additional economic benefits from the use of a common currency and was welcomed by Greek citizens with much hype. However, eleven years into the experience, events have led many to question the wisdom of Greece's Eurozone membership, even to wonder whether the country should consider discontinuing that membership.

This study examines the experience of Greece from its membership in the Eurozone. We analyze key economic data that span the period before and after the admission of Greece into the Eurozone so that we can identify trends that will allow the evaluation of the Eurozone membership.

We derive several fundamental lessons that should apply to similar small peripheral countries now entering the EU and to the EU's ability to integrate them politically, socially, and economically.

Greece's comparative advantage lay in traditionally Mediterranean agricultural products. Prior to entry Greece also enjoyed a comparative advantage in labor-intensive manufacturing products such as textiles. However, it failed to maintain these advantages due to pressure from foreign competition and flawed domestic policies.

Greece entered the EU in a period of deteriorating economic performance. The Greek economy was not the only one adversely affected by the oil crises of 1973 and 1979, but the democratically elected governments that followed the end of the dictatorship in 1974 faced increasing demands for income redistribution and expansion of the welfare state and, consequently, domestic policies failed to address the implications of these crises. This resulted in an era of populist policies that inhibited efforts to restore macroeconomic stability. Nor were there mechanisms or common policy

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* Corresponding author at: University of Illinois at Urbana-Champaign, United States.
E-mail address: sougiani@illinois.edu (T. Sougiannis).

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requirements at the EU level to prevent Greek domestic policies from being driven by short-term voter demands. The role of the state in the economy was greatly expanded and minimal steps were taken in terms of structural reforms.

In the second decade, Greek economic performance improved significantly after a successful macroeconomic stabilization program. Membership in the Euro zone required adherence to the Convergence Criteria for fiscal and monetary policy. This external discipline proved to be a credible anchor for Greek economic policy in the 1990s. The return of macroeconomic stability fostered the country's economic growth. Greece was also a main beneficiary of the EU's decision to revise its regional policy and to allocate increased funds for economic and social cohesion. However, structural reforms during the 1990s had noticeable results predominantly in certain areas where the EU adopted common policies, such as in the case of banking and financial markets, not across the economy as a whole.

The paper is organized as follows. Section 2 reviews the economic performance of the country from the time modern Greece became an independent nation in 1829, to its admission into the Eurozone in 2001. Section 3 outlines the expected benefits from Greece's Eurozone membership. Section 4 reviews Greece's qualifications for Eurozone membership. Section 5 evaluates whether Greece enjoyed any benefits from joining the Eurozone and identifies reasons for the recent poor performance of the country. Finally, Section 6 presents the conclusions and lessons learned from Greece's Eurozone experience.

2. A brief historical economic overview

Greece is an ancient country but the history of modern Greece begins in 1829 when it became an independent nation after 400 years under the rule of the Ottoman Empire. Greece experienced significant turbulence in both fiscal and monetary affairs. Our overview is based on information in Lazaretou (2003), Oltheten, Pinteris, & Sougiannis (2003), and Reinhart and Rogoff (2009).

2.1. Fiscal discipline

Two independence loans in pounds sterling were extended to Greece to finance the war during 1824–1825. The default on both loans came quickly, in 1826. Greece was able to borrow again in 1832, but only because the loan was guaranteed by the Great Powers – Britain, France, and Russia – that also guaranteed its independence. The borrowed money was wasted in unproductive expenditures and by 1843 Greece suspended loan repayments on this loan as well. The Greek government then borrowed in the domestic market, but by 1860 had defaulted on these loans as well.

In 1878, Greece borrowed French Francs to finance infrastructure projects. However, by the end of 1893 Greece defaulted on these loans as well. After this default, foreign creditors demanded Greek economic policies be monitored by foreign experts. The fiscal discipline imposed on Greece helped to regain its credit standing and Greece was able to finance the Balkan wars of 1912–1913 using foreign loans. Although World War I did not affect Greece's foreign debt, the great depression of 1929 did. By the middle of 1932 Greece defaulted for a fifth time on its foreign debt.

By the dawn of World War II Greece had rebuilt some fiscal stability. During the German occupation, 1941–1944, the Greek economy collapsed. After the liberation, three stabilization efforts, of which the Greek–British agreement of 1946 for economic and technical assistance was the most important, helped the country go through a painful civil war that ended in 1949. These stabilization efforts also prepared the country to better benefit from other foreign aid, especially from the Marshall Plan. During the 1950s the fiscal situation of Greece stabilized and the country did not default on any foreign loans after 1932.[1]

2.2. Monetary discipline

The monetary history of modern Greece is equally full of major upheavals. In the early years of Greece's independence Turkish currency was used in transactions. In 1828 the Phoenix was introduced as the official Greek currency. It was replaced by the drachma in 1833. Greece devalued the Drachma in 1882 to achieve Drachma/French Franc parity (1:1) as a requirement to join the Latin Monetary Union (LMU). In 1885 Greece entered the LMU. This lasted for only nine months. The government could not control its fiscal deficits and interest payments on debt generated large gold outflows. In 1889, in an effort to achieve a balanced budget, Greece initiated a combination of reduced government expenditures and increased taxes. This resulted in a period of disinflation and a subsequent revaluation of the Drachma. By 1909 the Drachma rose again to the required parity with the French Franc. The Drachma enjoyed a brief golden era until 1914 and the outbreak of World War I when the LMU, effectively, if not officially, collapsed.

Greece funded its involvement in WWI and its war in Asia Minor by printing money. This lead to uncontrolled inflation and the Drachma started to devalue. In 1928 the Bank of Greece was established and the Drachma was devalued and pegged to the Pound, effectively joining the gold-based exchange rate standard. When Britain abandoned the standard in 1931 the Drachma was pegged to the US dollar. However, the drachma came under heavy selling pressure and in 1932 it also abandoned the dollar standard. During World War II Greece experienced hyperinflation but after the war a series of monetary reforms that included yet another devaluation and control over the issuance of new money led slowly to a more stable monetary environment by the end of the civil war of 1945–1949.

Fig. 1 shows the value of the Drachma relative to the European Currency Unit (ECU[2]) index from 1950 to 2001 when the drachma ceased to exist and Greece adopted the Euro. The figure reveals a sharp devaluation of the drachma in 1953 and a period of stability for about two decades as Greece joined the Bretton Woods gold-dollar standard of fixed exchange rates.[3] Fig. 1 shows a period of exchange rate volatility and devaluation of the Drachma from 1971 to 1976. This instability can be attributed in part to worldwide monetary instability and the oil shock of 1973–1974, but it also reflects the expansionary monetary policy pursued by Greece's military dictatorship from 1967 to 1974.

In 1975, the democratically elected government decided to abolish the policy of pegging the currency to the US Dollar and allowed the Drachma to float against a basket of currencies. The new exchange rate regime resulted in a policy of a continuous devaluation of the drachma in order to reduce the negative effects of continuous wage increases, induced by social demands, in order to maintain Greece's international competitiveness. This policy did not change when Greece became a member of the European

[1] It is interesting to note that Reinhart and Rogoff (2009) refer to Winkler (1928) who points out an early case of state default in ancient Greece. In the 4th century B.C. Dionysius of Syracuse had borrowed from his people but could not repay his debts. To fix the problem he withdrew all money in circulation, he stamped each one-drachma coin with a two-drachma mark and used the new coins to repay his debts.

[2] The European Currency Unit (ECU) was an international currency substitute or artificial currency. Like an index, it is a currency basket of all EEC currencies at a predetermined weight including the Greek Drachma at a weight of 0.437%.

[3] In 1953 the drachma devalued by 50% against the US dollar.