THE PENNSYLVANIA STATE UNIVERSITY
SCHREYER HONORS COLLEGE

DEPARTMENT OF POLITICAL SCIENCE

THE ECONOMICS OF THE EUROPEAN UNION: AN ANALYSIS OF THE GREEK DEBT CRISIS

TORILYNN M. BELL

Spring 2012

A thesis
submitted in partial fulfillment
of the requirements
for baccalaureate degrees
in International Politics
and in Economics
with honors in International Politics

Reviewed and approved* by the following:

Glenn H. Palmer
Professor of Political Science
Thesis Supervisor

Michael B. Berkman
Professor of Political Science
Honors Adviser

*Signatures are on file in the Schreyer Honors College

Abstract

The European Union (EU) is an unprecedented example of international integration and cooperation. The economic integration of 27 European states makes it the largest world economy. Due to its large scale and unprecedented nature, the EU has faced criticism and numerous challenges. In this paper, I explore and analyze the EU's most recent challenge—the Greece debt crisis. In order to accomplish this, I considered the history of the EU, the current world wide economic crisis, and the history leading to Greece's debt crisis. After examining the background leading to this crisis, I consider the possible solutions and current negotiations. This crisis has the possibility to impact more than just Greece or the EU. There are wider consequences of the crisis which must also be considered.

This paper is up to date with negotiations and policies as of November 2011.

Table of Contents

Introduction

The global recession beginning in 2008 is considered to be the worst financial crisis since the Great Depression of the 1930s. The recession resulted in the collapse of large financial institutions, the bailout of banks by national governments, and the downturn of stock markets globally. As the world continues to recover from the global recession, economic problems of the European Union could threaten worldwide recovery. The European Union has the largest world economy. The states making up the European Union currently share a common currency, the euro, which is in danger.

The global recession was triggered by the economic crisis in the United States. The combination of misevaluations and liquidity problems caused the collapse of the US banking system in 2008. The US had a housing bubble—houses were priced and bought for well over their actual value. US citizens were buying houses well above their means. When the housing bubble broke, many were left with mortgages which were larger than the value of their homes. Credit availability declined, and the integrity of investors was damaged. These two problems led to the crash of the stock market and a negative effect on economies around the world. The US government responded by bailing out large institutions, implementing monetary policy expansions, and providing fiscal stimulus packages.

The current economic crisis in Europe threatens to cause even more of a ripple effect than the US banking crisis. After the integration of twenty-seven European countries, the EU now makes up the largest economy. The integration of European countries began after World War II in response to the horrific loss of life during the war. European leaders sought to find a way to prevent such a war from ever occurring again. They felt the best way to prevent another world war was to create interdependence between their economies. The initial interdependence led to further integration and eventually a common currency, the euro.

While the idea of an integrated Europe is admirable, it also comes with potential consequences which must be resolved. The euro is a significant currency in the world market, and its failure would have significant ramifications. In this paper, I will discuss the economics of the European Union. First, I will discuss the history of the European Union. As part of this discussion, I will include discussions on the treaties which created the European Union, the governing bodies that allow the European Union to function, and its policies for expansion. Second, I will discuss the European Union's potential problems. As part of this discussion, I will consider the European Union's dilemmas regarding social policy, democracy, and external relations. Third, I will examine the current economic crisis facing the European Union. As part of this discussion, I will examine the case of Greece. Specifically, I will look at Greece's social policy, the history of its public debt, its current situation, and the EU's plans for Greece's rescue. Fourth, I will examine the potential impacts the European Union's financial crisis will have on the rest of the world. Fifth, and finally, I will conclude with a summary of the main points of this paper.

History of the European Union

World War II was the most destructive and deadly war in history. European leaders knew that they had to take action to prevent such a war from ever happening again. Several western European countries formed economic, social, and political ties to help upstart their economic growth, military security, and reconciliation with other European countries. These ties have led to formation of the European Union.

The European Coal and Steel Community

On April 18, 1951, the leaders of six countries—Belgium, France, Italy, Luxembourg, The Netherlands, and West Germany—signed the Treaty of Paris. The Treaty of Paris created the European Coal and Steel Community (ECSC). The formation of the ECSC was the first step towards integration. However, the ECSC's more immediate goal was to prevent further conflict between France and Germany. European leaders believed that the best way to avoid further conflict was to link the economies of France and Germany through their two most fundamental industries: coal and steel (Thody 1). European leaders believed that a strong economic link would make war economically unfeasible. In the 1950s, 70 percent of the energy needs of Western Europe required coal. Furthermore, no country could have an effective army without steel. Jean Monnet and Robert Schuman, European political leaders, believed that if the coal and steel from France and Germany were controlled by a higher international power, then it would become impossible for two member states to go to war with each other again (Thody 14-15). Thus, the ECSC created a free trade area for several key economic and military resources: coal, coke, steel, scrap, and iron ore ("European Union").

The treaty established several supranational institutions to manage the ECSC: a High Authority to administrate; a Council of Ministers to legislate; a Common Assembly to formulate policy; and a Court of Justice to interpret the treaty and resolve related disputes. A series of further international treaties and revisions based largely on this model eventually led to the creation of the European Union ("European Union").

The European Economic Community

On March 25, 1957, the six ECSC members signed the Treaty of Rome to establish the European Economic Community (EEC). The EEC created a common market for the member states. The common market eliminated barriers for the movement of goods, services, capital, and labor. The common market also prohibited most public policies or agreements which limited market competition. Furthermore, common agricultural and common external trade policies were created.

EEC members were required to eliminate or revise important national laws and regulations. For example, internal tariffs had to be abolished by July 1968. Member states had to eliminate their national regulations favoring domestic industries. They created common laws on anticompetitive and monopolistic behaviors. They also created common inland transportation and regulatory standards. The EEC, like the ECSC, established four major governing institutions: a commission, a ministerial council, an assembly, and a court of justice.

In addition to the EEC, the Treaty of Rome established the European Social Fund and the European Atomic Energy Community (EURATOM). The European Social Fund's purpose was to enhance job opportunities by increasing labor mobility. EURATOM's purpose was to facilitate cooperation research programs for peaceful uses of nuclear energy.

In 1965, the members of the EEC signed the Brussels Treaty. The Brussels Treaty merged the commissions of the EEC, EURATOM, and the High Authority of the ECSC into a single commission. The councils of the three organizations were combined into a common Council of Ministers. The three organizations were then collectively referred to as the European Communities and later became the main institutions of the European Union.

In 1979, the European Monetary System was established to manage the member state's exchange rates. Throughout the 1970s and 1980s, the EEC gradually expanded its membership:

1973: The United Kingdom, Denmark, and Irelands

1981: Greece

1986: Portugal and Spain

The Single European Act

On July 1, 1987, the Single European Act (SEA) expanded the EEC. Due to the expansion, there was a substantial increase in funding for social and regional programs. The European Regional Development fund was formally added to the treaty to help the development of economically depressed areas in the member states. The SEA required the EEC member states' economic policies to incorporate provisions for the protection of the environment. The SEA also provided for a common research and technological-development policy to fund transnational research efforts.

The SEA created a timetable for the completion of the common market which had been initiated by the EEC. Despite past efforts, legal, technical, fiscal, and physical barriers continued to limit the free movement of goods, labor, capital, and services. The SEA's goal was to complete the common market by 1992. In order to accomplish this, the legislative process was modified. The original requirement for a unanimous vote was changed. The new requirement was for a qualified majority of two-thirds for all voting purposes dealing with the common market. Each member was allotted votes based on its national population. ("European Union").

The Maastricht Treaty

On February 7, 1992, the members of the European Community signed the Maastricht Treaty which formally created the European Union (EU). However, the EU was initially met with resistance. National governments and their citizens worried about the EU's possible infringement on their national sovereignty. Voters in Denmark defeated the first referendum for the treaty, and voters in France only narrowly approved the treaty.

The Maastricht Treaty organized the EU by creating three pillars: the European Communities, a common foreign and security policy, and greater cooperation in home affairs and justice. The name of the European Economic Community was changed to the European Community (EC). The EC became the main component of the EU.

The EC had broad authorities relating to community integration methods. The EC's authority encompassed control of the ECSC and EUROTROM. The EC was also expected to create policies to integrate economic policies. These policies included the creation of a single economic and monetary customs union and free movement of labor and goods. Other EC integration policies were related to agricultural policies, EU citizenship, social policies, and integration policies.

In addition, the Maastricht Treaty established EU citizenship. EU citizens were then allowed to vote and run for office in local and European Parliament elections in their country of residence. Their national citizenship did not matter for these elections.

The EEC's institutions and decision-making processes were greatly modified after it became the EC. The commission had more accountability to the parliament. The term for office for commissioners was lengthened to five years and the commissioners had to be approved by the parliament. The European Court of Justices (ECJ) was given authority to impose fines on members for noncompliance. Several new institutions were also created, including the European Central Bank, the European System of Central Banks, and the European Monetary Institute. In addition, the Maastricht Treaty created a regional committee to serve as an advisory body for commissioners and the Council of Ministers for issues dealing with sub-national, regional, and local citizenries. The legislative process encountered radical reformation. Policies requiring a qualified majority vote were broadened. Parliament was given some rejection powers and even some veto rights.

The second pillar created by the Maastricht Treaty was the Common Foreign and Security Policies (CFSP). The CFSP's main focus was to create intergovernmental cooperation methods. The CFSP had authority over issues such as democracy, human rights, and foreign aid. They were also in charge of formulating common security and defense policies, EU battle groups, and peacekeeping.

The third pillar created by the Maastricht Treaty was the Police and Judicial Co-operation in Criminal Matters (PJCC). The PJCC's main focus was similar to the CFSP's in creating policies for intergovernmental cooperation. However, the PJCC had authority over drug trafficking, weapons smuggling, human trafficking, terrorism, organized crime, bribery, and fraud. This pillar was created in response to concerns related to the free movement of people within the EU borders. After the EC created laws allowing for the free movement of labor and goods, EU citizens could easily move from country to country. Criminals, traffickers, and immigrants then had the opportunity to come into a country with weak policies and later move to any other country within the EU. For example, if Greece was tolerant of immigration, someone wanting to go to Germany could enter the EU through Greece and then easily make his way to Germany without German consent. Furthermore, if a crime was committed in an EU country, the criminal could easily move to another where the police force has no authority. Thus, policies and further cooperation were required to solve these problems.

The Maastricht Treaty created an agenda for incorporating monetary policies of EC members which had been in the planning stages since the late 1980s. The treaty laid out a plan to replace national currencies with a common currency. The common currency would be monitored by a common monetary institution. The treaty created criteria that each country would have to meet to join the common currency. A country's annual budget deficit could not exceed 3 percent of gross domestic product (GPD), public debt had to be less than 60 percent of GDP, inflation rates had to be within 1.5 percent of the three lowest inflation rates in the EU, and the exchange rates had to be stable. The members who qualified would then be able to adopt the single common currency, the euro.

Several countries such as Italy and Belgium failed to meet the criteria due to their public debt. However, the commission qualified most members for the monetary union. On January 1, 1999, eleven countries—Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, The Netherlands, Portugal, and Spain—adopted the euro, thus giving up authority over their exchange rates. Denmark, Sweden, and the United Kingdom chose not to apply for membership for the euro. Greece did not qualify until 2001. Initially the euro was only used by financial markets and businesses. It was made available for the general public on January 1, 2002 ("European Union").

After the Maastricht Treaty

On January 1, 1995, Sweden, Austria, and Finland joined the EU. Iceland, Norway, and Switzerland were then the only major western European countries outside of the EU. Norway tried to join two times, once in 1972 and once in 1994, but its voters rejected membership both times. However, Norway and Iceland were both part of the European Economic Area along with the EU members. Norway and Iceland were granted the privileges allowing free movement of goods, services, capital, and people.

The Treaty of Nice, signed in 2001, entered into force on February 1, 2003. The Treaty of Nice was negotiated in preparation for expanded membership for eastern European countries. The maximum number of seats on the Commission was capped at twenty-seven seats.

Many eastern and central European countries applied for EU membership after the Cold War. However, many of these countries were not economically developed enough to be fully integrated in the EU. Economic development was an important requirement because once the countries used the same currency their economies would be interlocked. The failure of one member state's economy could have significant consequences on the economies of all other member states. The EU members considered allowing them to participate in free trade areas without being allowed to join the euro. Turkey also applied for membership which is still a controversial issue. Turkey is a predominately Islamic country and was accused of human rights violations. Turkey also had historically poor relations with Greece. Many feared that EU expansion would lead to problems within the EU and would inhibit its development. However, ten countries were admitted in 2004—Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia. Bulgaria and Romania joined in 2007. Turkey is still awaiting membership as negations continue.

The EU has not yet replaced the nation-state and become the "United States of Europe," as originally envisioned. However, its institutions have created unprecedented integration and cooperation. The degree of legal integration, supranational political authority, and economic integration by the EU has greatly exceeded any other international institution. The EU now greatly resembles a parliamentary democratic political system ("European Union").

Problems the facing the European Union

Despite the good intentions of the EU to facilitate cooperation, economic interdependence, and peaceful relationships, the EU has and will continue to encounter a number of problems as it tries to further its integration. The three fundamental problems are centered on European social policy, questions of democracy, and the EU's external relations.

Social Policy

When the EEC was formed in 1958, its major goals were all based on economics as described by the previous discussion. The Treaty of Rome specified the mechanics of achieving a free trade area and customs union. It also laid out goals and a plan to form a common agricultural policy. The Treaty of Rome, in essence, provided an "economic constitution" to restore the economic prosperity to each of the member states after WWII. The EEC did not include any detail about social policy other than in Article 119. Article 119 called for equal pay for equal work. Social policy was intentionally left out of the treaty because it would have been too difficult to gain cooperation and consensus. The member states greatly differed in their social policies. Even by the time of the Single European Act in 1987, no social policy had been agreed upon. Welfare states are tightly secured to their social policies which in turn are tightly secured to the electorate. It is doubtful that European leaders would have been willing to risk letting their social policies be mandated at the EU level (Caporaso 4-5).

Social policy can be defined as "the use of political power to supersede, supplement, or modify operations of the economic system in order to achieve results which the economic system would not achieve on its own." Therefore, we can think of social policy as government activity and laws implemented to facilitate social objectives such as aid to the poor, minimum wages requirement, childcare allowances, and the education or retraining of workers. Laws would include the protection of children, the disabled, or elderly. The welfare state was formed during the late 1800s and the 1920s. Pension and social security programs were established for the workers and poor citizens in Europe. These social programs led the way for income support and social insurance (Caporaso 15). The first dilemma of social policy for the EU is the relationship between national social policy and European regional social policy. The second dilemma of social policy for the EU is the question of citizenship as determined by either political participation or market participation (Caporaso 38).

Democracy in the European Union

Democracy can broadly be defined as a political system where people choose who make the decisions and the procedures by which these decisions are made. Democracy usually implies political competition as opposed to a monopoly. However, democracy can come in many different forms and take many different meanings.

David Martin, a former vice president of the European Parliament, claimed that if the EU were a state and applied for membership to the EU it would be denied for not being sufficiently democratic. Democracy is a prerequisite for membership, but the institution is not itself democratic (Caporaso 48). The EU will have to decide if it will be like a "democratic state" and how it will be organized as a democracy.

External Relations of the EU

Finally, the EU will face the dilemma of defining how it will interact with nonmember states. The EU will face decisions about whether or not to be open or closed. They will have to make decisions about widening or deepening. Widening would spread the EU's influence, thus furthering security. However, the EU would then risk becoming too big to be successful. The bigger the EU became the more difficulties they would have reaching decisions and integrating.

The EU may be better served by increasing the integration with current member states. The EU will also need to tackle the construction of a common foreign and security policy without forcing members into relinquishing too much national sovereignty (Caporaso 84).

Widening and deepening would both serve different purposes. They will have to decide if integration or widespread security is more important. As the EU further defines its goals, the member states will be more able to make better decisions. Furthermore, better decisions can be made on issues of democracy and social policy.

Economic Crisis

The integration accomplished by the EU is unprecedented, and the EU is continuously developing and changing its goals. However, crises that come along may hinder that development or make its goals more clear. Currently, some EU member countries are suffering from economic crises which are threatening to encompass the entire EU and possibly the rest of the world.

On November 16, 2010, European Union President Herman Van Rompuy warned that the Eurozone economic crisis threatened the existence of the EU. He said, “We’re in a survival crisis. We all have to work together in order to survive with the Eurozone, because if we don’t survive with the Eurozone we will not survive with the European Union.” The success of the euro symbolizes European unification and, thus, the European Union. While the Euro was originally successful, it quickly met economic crisis along with the rest of the world in 2008 (Scaliger).

In the fall of 2008, the three major banks in Iceland failed, thus creating the first major problem the euro would face. The banks fell due their difficulties in refinancing their short term debt and a run on deposits in the UK. However, Iceland's economy was relatively small, and the EU was able to quickly respond. The EU bailed Iceland out of total financial crisis; however, Iceland's meltdown was the largest in history relative to its size. The EU members proved that they could facilitate cooperation and work together over issues of economic importance. However, Iceland was only the EU's first test at economic difficulties. The next country to face an economic meltdown was Greece (Scaliger).

The Greece Problem

Greece's debt crisis creates a number of problems. Not only does the member state's economy present a threat to the entire Eurzone, but the success or failure of the EU in handling this problem will set a precedent. This first major crisis could prove the strength of the EU's policymaking ability or highlight its weaknesses (Hirst). As Greece continues to drown in its debt, EU members consider how Greece became so indebted, how to prevent a default, and what a default by Greece would mean for the rest of the EU.

Greece's Social Policy: The Welfare State

Greece has a generous social policy which centers on its retirement policy as the traditional the core of its social policies. In 2001, more than 90 percent of state benefits fell under the "retirement" category. Retirement benefits comprise old age pensions, farmers' pensions, invalidity and widowhood pensions, and national resistance and war pensions. Social insurance is organized along the lines of IKA, the National Social Insurance Organization; the rural workers' fund; and the fund for the self-employed. Family allowances and unemployment insurance made up only 2.8 percent of social benefits. Also in 2001, more than 50 percent of social expenditures went to old age and survivors' pensions. Healthcare expenses absorbed 32 percent of social expenditures. Greece's social expenditures as a percentage of GDP also increased substantially from 1980 to 2005. In 1980, Greece spent approximately 10 percent of its annual GDP on social expenditures. In 2005, Greece spent approximately 25 percent of its annual GDP on social expenditures (Tsarouhas).

Therefore, despite attempts by the EU to restrict Greece's social policy, it has continued to increase. Greece's government has been unwilling to reform or cut its welfare cost since they have became heavily relied on by Greek citizens. In 1981, the PASOK administration won the 1981 elections promising radical reforms and the redistribution of wealth to serve low and middle-income citizens. The importance of social insurance was reinforced through the PASOK administration's policies. The center-left societal coalition demanded an increase in their coverage. The pension levels proceeded by increasing by more than 50 percent in the early 1980s. Pension levels were also extended to cover both rural and urban social insurance coverage. The Social Insurance Organization then began covering social groups whom had never contributed by order of the government. This pattern continued raising expenditures, reliance on the welfare state, and debt. Additionally, social assistance of the uninsured elderly was introduced. The government also relaxed the rules for retirement eligibility. Consequently, more people were receiving aid, and fewer people were paying taxes. It was estimated that 1 in 5 Greek citizens were employed by the government. The social insurance funds' deficit reached

3 percent of GDP (McDonald). When the Greek government tried to reduce its citizen's social benefits, it faced constant opposition by the public which had come to depend on early retirement and high pensions. This problem may have been adverted by a common EU social policy. The Greek social policy was way more generous than the typical policy in Europe. Citizens from other states may end up paying for Greece's social policy.

How did Greece's debt problem happen?

Partially due to their unmanaged social policy, Greece's budget deficit and public debt dramatically increased during the 1980s. According to data from the Organization for Economic Cooperation and Development (OECD), the budget deficit increased from under 3 percent in 1981 to 11 percent in 1991. During the same time period, Greece's public debt rose from 30 percent of GDP, to 82.2 percent in 1991, and to 114.4 percent in 2001 (McDonald).

Since World War II, Greece's economy has depended on foreign aid. During Greece's civil war in the late 1940s and during the wars in the 1950s, 1960s and 1970s, the United States provided military aid. The military aid from the United States allowed Greece to focus its national resources on domestic development programs (McDonald). The aid from the United States started Greece's pattern of receiving and relying on foreign aid.

Greece entered into the European Economic Community in 1981. European countries began to provide aid for Greece's various civilian aid programs as the United States began to pull out its aid. Greece had received approximately 55 billion euros from the Integrated

Mediterranean programs and community support programs. Greece is also expected to receive another 24 billion euros by 2015 for development aid (McDonald).

Despite massive amounts of aid, successive Greek governments have continued to accumulate huge amounts of debt especially under the socialist governments of the 1980s under the Pan-Hellenic Socialist Movement headed by the party's founder Andreas Papandreou, the late father of the current prime minster (McDonald). In 1980, before the socialists came into office, Greece's debt to GDP ratio was 39 percent. Nine years later the debt had grown to 104 percent and since then has not been lower than 100 percent (Scaliger).

The servicing for Greece's growing debt has been a huge drain on budget resources. Payments for past loans took away the finances required for developmental programs. However, as long as the economy was growing, Greece was able to make the payments on its debt. Today, interest payments absorb one in every four euros of net ordinary budget revenue, and there is a primary deficit. The primary balance is the budget balance without interest payments. Once there is a primary surplus the government will be in a position to begin to pay back some of the debt. As it is, the aggregate level keeps mounting (Scaliger).

Ordinarily, the government would be able to keep functioning by borrowing small amounts to cover new debt and large amounts to cover old debt after it matured. However, presently, the cost of aggregating debt is increasing exponentially. By next year, experts expect that Greece's debt will reach approximately 160 percent of GDP. This figure correlates to approximately 30,000 euros of debt for each man, woman, and child living in Greece (Scaliger).

The present appeal to the European Union is not the first time that Greece has been provided with loans from Brussels as well as other forms of aid. In 1985, the public sector borrowing requirement had risen to 17.9 percent of GDP and national reserves dwindled to the equivalent of merely five weeks of imports. By that point, Greece's government could only borrow expensive, medium-term credit due to uncertainty at the government's ability to pay back the loans. Greece then requested a cheaper loan from the European Community. Greece was provided with 1.75 billion euros. The loan was conditional on Greece's agreement to reduce its public sector borrowing. Greece also had to agree to reduce its current account deficit to sustainable levels without the need to have more debt accumulation from foreign capital (Scaliger).

Costas Simitis was the economy and finance minister during that time period. (Simitis later succeeded Andreas Papandreou as prime minister in the mid-1990s.) Simitis implemented policies to meet the Community's conditions. First, he devalued the drachma by 15 percent. Second, he created an income policy which reduced real income of salaried employees by 11 percent over a two year time period. Simitis wanted to extend such measures for several more years in an attempt to restore skewed economic fundamentals from previous political terms. However, Andreas Papandreou, fearing the possibility of early elections, forced Simitis' resignation and appointed a more controllable successor who then created more lax series of policies to the approval of the Greek public (Scaliger).

The conservative New Democracy government elected in 1990 faced an even higher demand for public sector borrowing which was the equivalent of 21 percent of GDP. The new government was forced to once again turn to Brussels for assistance. The European Community once again provided Greece with a loan of 2.2 billion. This loan was again conditional on policies for debt reduction: a 10 percent reduction in public sector employment, a cap to be placed on public sector wages, and for subsidies for public sector enterprises to be cut in half. Greece was also required to systematically privatize companies (Scaliger).

The EEC loan set to be disbursed in three payments. The first was 1 billion drachma, and the second and third were each 600 million drachma. The second and third payments were contingent upon the implementation of the required policies. At the end of the first year, Brussels informed Greece's government that its performance had been far from sufficient. If Greece were to apply for the second payment, it would be rejected. Greece, at Brussels' advisement, did not apply for the second loan but as a result faced early reelections (Scaliger).

Greece's Hidden Debt

In 1992, Greece's government had signed the Treaty of Maastricht which had transformed the European Economic Community into the European Union and set the framework for a common currency with a unitary monetary policy. Countries that had signed the treaty were eventually able to become part of the European Monetary Union (EMU). As part of the EMU, member states switched from their national currencies to the euro. However, joining the Euro was conditional on meeting a set of criteria (Scaliger).

The criteria for the EMU included that deficits could not exceed 3 percent of GDP, and debt could not exceed the equivalent of 60 percent of GDP. Furthermore, other criteria included exchange rate stability, inflation regulations, and long term interest rate regulation. In 1998, when the European Council decided which of the twelve countries wishing to become members were eligible, Greece was the only one that did not qualify. Greece's deficit stood at 4.6 percent of GDP and its debt at 108.5 percent of GDP. Greece's inflation rate was more than double the reference rate, and its long-term interest rates were nearly 2 percentage points higher than the reference rate.

The PASOK government of that time period, headed by Costas Simitis, was completely devoted in 1999 and 2000 to meeting the EMU criteria for eligibility. To meet the criteria, Greece's government used certain "accounting practices." They claimed these methods were approved by Eurostat. The methods reduced the estimated general government budget deficit for the year 2000 to 0.8 percent of GDP and reduced the general government debt to 104 percent of GDP. Inflation was squeezed through a series of administrative measures, and interest rates appeared to fall below the reference level. In March 2000, Greece was declared to have met the eligibility targets, and on January 1, 2001 Greece became the 12th member of the EMU (McDonald).

Member states of the Economic and Monetary Union are required to present a Stability and Growth Program to the European Commission each year. The program should detail the policies that each country intends to follow in order to continue to meet the EMU's criteria for membership (O'Brien).

For three years, Greece produced programs which appeared to show that it was abiding by the rules. However in 2004, the New Democracy party once again took office and administered a fiscal audit. The New Democracy party claimed that PASOK government had only achieved the targeted numbers through “creative accounting” practices. Among other things, the New Democracy party suggested that the PASOK government had kept the deficits down by keeping an off-balance-sheet with many items of expenditure. By the New Democracy party’s calculations, the 2004 deficit, which had been officially forecast to be 1.2 percent of GDP, was actually 3.2 percent of GDP. They also found that interest rates were actually increasing rather than decreasing (Scaliger).

The EU’s statistical agency, Eurostat, became involved in the fiscal audit of deficit and debt figures for the year 2000. Eurostat’s re-calculations revealed deficits three and four times previous estimates (between one and two percentage points above the reference level each year) while debt was re-adjusted until it stood, in 2004, at 112 percent of GDP, 14 percentage points higher than officially estimated (Scaliger).

Eurostat then turned its attention to the years 1997 – 1999 the years which Greece had been assessed for Eurozone membership. Its analysis showed deficits in these years were twice those declared to Brussels, and therefore, Greece had never met the criteria for EMU membership (Scaliger).

The increases of debt can be attributed to a ballooning public sector, substantial industrial subsidies, generous social benefits, and increasingly large debt service payments. In 2009, approximately 850,000 people were employed in the public sector. Greece’s national population is only 11 million people. Furthermore, most of Greece’s large companies are state run or state managed (Scaliger).

Successive administrations accused their predecessors of manipulating their accounts to present a good financial outlook. This in turn would garnish more votes. After coming into office, each administration promised to resolve imminent economic disaster. Andreas Papandreou promised this in 1981. Constantine Mitsotakis promised this in 1990. Andreas Papandreou promised this again in 1993. Constantine Karamanlis promised this in 2004. Instead of accepting blame for the problem, each leader shifted the blame away from themselves. No leader was willing to make an unpopular decision to fix the long term economic situation. Instead each leader only considered what was popular in the short run, continuing to do what previous leaders had done (Scaliger).

George Papandreou made the same promises when he came into office in 2004. However, his decisions had more severe ramifications. First, global attention was shifting from the excesses of the private sector and financial meltdown to the excesses of the public sector. Second, the magnitude of data correction and the consequent loss of credibility are more dangerous. Greece's government concealed additional expenditures of approximately 16 billion euros in 2009 (McDonald).

Standard and Poor's downgraded Greece's sovereign debt rating to a BBB+ on December 17, 2009. The downgrade increased Greece's borrowing costs. Greece announced a round of austerity measures promising to bring the deficit down from 12.5 percent (later revised to 13.6 percent) to 8.7 percent in 2010 and to less than 3 percent by 2012 (later delayed to 2014). On January 12, 2010, the European Commission formally condemned Greece for falsifying data on public finances. Greece reacted to this by announcing a second round of austerity measures.

However, investors remained weary and dumped Greek government bonds further increasing the yield spread by close to four hundred basis points above the Greek benchmark. Greece was then desperate to amass credibility and announced a third round of austerity measures on March 3, 2010 with a goal of saving 4.8 billion euros. Greek officials had estimated that the loss of purchasing power would be the equivalent to a 10 percent decrease in GDP (McDonald).

Greece's austerity measures led to a deep recession. Furthermore, Greece could no longer afford to invest in its future through education and research programs. It then seemed that the immediate solution may lead to bigger problems in the future.

Even after austerity plans, Greece was still not able to sustain borrowing. Papandreou turned to the EU for help. They failed to agree on what to do. While endorsing the Greek austerity program, the EU's political divisions and the lack of details failed to reassure investors. Greece insisted it was not asking for a bailout, but the EU's lack of ideas, indecisiveness, and institutional incapacity fueled uncertainty. Uncertainty further drove up costs and quickened the very outcome almost everyone is trying to avoid—sovereign default. Finally, on March 25, 2010, EU leaders agreed to provide 25 billion euro (later raised to 45 billion) to Greece, if needed. The aid would be in the form of bilateral three-year loans from other Eurozone member states and the International Monetary Fund (IMF).

German chancellor Angela Merkel initially insisted that the interest on the loans be at market rates, but on April 11, 2010, they agreed to a maximum interest rate ceiling of about 5 percent—below the 7.5 percent the Greeks had been paying to that point but still large enough to appease German voters who were at the time wondering why they should work their entire lives to pay for Greeks to retire at the age of 55. George Papandreou and several EU leaders indicated they would have favored a Europe-only solution, but Germany wanted IMF participation, fearing paying for the majority of the bailout. (Scaliger).

The aid amount was vague on the actual amounts but made clear that aid could be used only as a last resort. Eurozone members would coordinate activities, but Germany and the Netherlands, among others, would retain veto over use of the aid. To provide loans, the creditors demanded additional cuts in Greek wages and pensions, affecting every aspect of the country's economic activity to an extent not seen since the civil war days of the 1940s. On April 23, 2010, Eurostat increased its estimate of Greece's budget deficit to 13.6 percent. The new estimate resulted in Greece's two year bond rates to rise to 10 percent (Scaliger).

Unable to borrow on such terms, Greece informed its partners it would activate the package. The package of 110 billion euros would be available over a three year period. Initially it was to be made available in three-month tranches on the basis of specific progress assessed by the IMF and the European Commission. The goal of the aid was to help Greece meet its payment obligations to external borrowers at an affordable interest rate. Chancellor Merkel said that it was "the only possibility we have to ensure the stability of the euro." To receive the aid, Greece agreed to a series of strict austerity measures designed to reduce its public sector; to cut salaries and pensions; and to increase tax revenues. Tax revenues were to be increased by tax hikes of value-added tax; the taxes on tobacco, gas, and alcohol; and through better collection processes (Scaliger).

Greece's parliament voted on the aid package as a whole, except for the terms by which they could receive they aid. The terms were agreed to without a vote, but each measure (except for tax hikes) was debated in parliament. Greek voters were stunned, confused, and angry over the unexpectedly imposed austerity measures (Rehm).

Greece had created a public debt crisis from the period of easy credit after becoming an EU member. The bond markets felt Greece was less of a risk since ts inflation or deflation was now controlled by the euro. Greece has public debt around 120 percent of GDP, a government budget deficit of 12.7 percent of GDP, and an external deficit of 11 percent of GDP. Greece lost credibility from repeatedly cheating on budget reports. Greece will have to undergo adjustments in government finances if they are to become sustainable again. However, in the case of Greece, fiscal adjustments may not be enough to bail it out this problem ("A very European crisis").

The Greek collapse is not a surprise, and many believed this crisis inevitable since the day Greece was admitted into the EU. While the economy grew at over 4 percent per year from 2000 to 2007, the socialist government had been running extraordinarily high deficits for decades. The ratio of public debt to GDP had been 100 percent or more since the early 1990's. Greece was able to conceal its real national balance and was welcomed into the European Union. Greek's government had paid global finance banks, such as Goldman Sachs, hundreds of millions of dollars to help hide Greece's actual debt. This allowed Greece to continue to live well beyond its means. When the world economy hit a crisis, Greece's true debt was quickly revealed to investors. Greece's sovereign debt was downgraded to junk bond status (Rehm).

Greece's "austerity" plans do not actually do much to help scale back its debt and budget. The number of government owned companies decreased from 6,000 to 2,000. Government workers will receive slight pay cuts, but the number of government employees does not change significantly. Greek pensioners will still receive large benefits, and the government will not change its strict controls on the economy. Greece's taxes on citizens will increase severely on high pensions, company profits, and on luxuries such as alcohol, cigarettes, and fuel (Rehm).

While the crisis was temporarily alleviated by the bailout, Greece still has a very high chance of defaulting. According to Bloomberg, there is a 98 percent chance that Greece will default on its debt in the next five years if Prime Minister George Papandreou fails to convince investors that Greece can survive in the Eurozone. It now costs $5.8 million upfront and $100,000 annually to insure $10 million of Greece's debt for five years using credit-default swaps (Moses).

Papandreou had pledged to adhere to deficit targets which were set by the European Union and the International Monetary Fund for the bailout. However, Greece's budget gap increased by 22 percent from January 2011 to September 2011. Greece's government now believes that its economy will shrink by more than 5 percent this year due to the austerity measures. When Papandreou approved a plan to help fix the budget deficit, he was met with strong resistance from his public. Greece has also left Germany's government debating how it will support its own banks if Greece should fail to mean the terms of the bailout (Moses).

Recently, the EU agreed that the bailout of Greece is not working. Proposals for a 50-60 percent write down of Greece's sovereign debt were being considered. A write down this large will have consequences for the Greek economy, its banking system, the capital base of the European Central Bank, the capital bases of all Europe's banks exposed to Greek's debt, and the sovereign bond markets of Italy and Spain. The Greek public is opposed to the large write down because they believe that it will harm them more than help their situation. A big write down could cause a collapse of Greek banks (O'Brien). If plans are not put in place to contain these problems, Greece's default will cause a widespread ripple effect.

The Deal

On October 27, 2011, European Leaders finally came to a compromise and made a deal on the debt crisis measures. Under this plan, Greek bondholders agreed to voluntarily write down the value of Greek bonds by 50 percent. This percentage translates to 100 billion euros. The write down will reduce Greece's national debt to 120 percent of GDP by 2020 (Rooney). Under current conditions, European leaders expected the debt to grow to 180 percent of GDP ("Greece PM Survives Vote"). The private sector agreed to the loss of 50 percent on the condition of a 30 billion euro contribution from the public sector. The agreement also called for a 100 billion euro financing program for Greece. The new financing program will be partially funded by the International Monetary Fund (Rooney).

The plan also considered how to make the EU's bailout fund, the European Financial Stability Fund, stronger. Each part of the plan would increase the fund reserves by four or five times to reach a total of approximately 1 trillion euro. The European Financial Stability Fund will insure new issues of government bonds. The Fund will also be supplemented by the creation of investment opportunities open to the private sector. China has already expressed interest in participating in the investment opportunities (Rooney). The bigger bailout fund will also help insure that other at risk economies like Italy and Spain can be protected. Italy and Spain's economies are much larger than Greece, and they are each too large to be bailed out of debt by the EU. The insurance of the bailout fund will make Italy and Spain's bonds more attractive to investors ("Greece PM Survives Vote").

Furthermore, EU governments agreed to raise capital reserve requirements for banks vulnerable to losses on euro government bonds. The banks will be required to increase their capital reserves to 9 percent. Based on recent data, the banks would need to raise a total of 106 billion euro to meet these new requirements. The deadline for meeting the requirement is June 2012 (Rooney).

The Greek Referendum

Unexpectedly on Monday, October 31, 2011, Prime Minister Papandreou announced that he would put the European bailout plan up for popular vote. A referendum has not been held in Greece since 1974. Under a new law passed in September, a referendum can be called on issues of great national importance. However, many questioned Papandreou's motivation to call a referendum for the bailout plan ("Debt Deal Referendum Throws Greece in Chaos."). Papandreou said the referendum was "a supreme act of democracy and of patriotism for the people to make their own decision" ("Turmoil in Greece Vexes Wall Street.").

Greece's lawmakers in the Socialist party revolted because of Papandreou's decision to hold a vote on the largely unpopular plan. The lawmakers of the Socialist party were not informed of Papandreou's decision for a referendum beforehand. Even the finance minister was not informed. Lawmakers realized that if the plan was voted down it would have severe consequences. One Socialist lawmaker quickly defected. Another lawmaker called for an early election to replace Papandreou. Some lawmakers started setting plans for a transitional cross-party government to be created to help ensure the passage of the bailout plan. Six other lawmakers requested Papandreou's resignation ("Debt Deal Referendum Throws Greece in Chaos.").

If the bailout plan failed to pass and Greece subsequently defaults, the consequences would reach a global level. Europe would likely fall into a recession which would in turn hurt American exports, and banks would be forced to majorly reduce lending ("Turmoil in Greece Vexes Wall Street."). Papandreou's announcement for a vote sparked uncertainty for the plan to pass among investors and quickly affected markets. Italy's main stock index dropped 6.8 percent, France's main stock index dropped 5.4 percent, and Germany's main stock index dropped 5 percent. The value of the dollar rose, and bond prices increased significantly. Investors fear that if the vote fails in Greece, the crisis would consume the entire EU, the largest world economy.

A confidence vote for Papandreou was scheduled for Friday, November 4, 2011. Many lawmakers said they would not back Papandreou unless he agreed to resign and begin talks for a temporary national unity government. Papandreou abandoned his plan to hold a referendum on Thursday, November 3, 2011 after the severe negative reactions in the market, by his own government, and by other European leaders (Nellas). Papandreou survived the confidence vote with a vote of 153-145. Prior to the vote Papandreou agreed to resign if necessary as well as to create a transitional cross-party government to ensure the passage of the bailout plan ("Greece PM Survives Vote").

Plans for the transitional cross-party government continued over the few days after the confidence vote. Papandreou agreed that the transitional government would oversee the bailout plan and then Greece would hold early elections. Papandreou agreed to resign once the details for the transitional government were completed. The decision to create a transitional government devoted to solving Greece's debt crisis should have positive effects. It shows EU leaders and investors that Greece is devoted to solving their debt problem.

However, Papandreou and the leaders of the opposition, Antonis Samaras, had difficulty agreeing who should be the transitional prime minister. The slow decision making process adds fuel to fears of Greece's acceptance of the bailout plan (Donadio).

The EU finance ministers demanded a letter from each Greek political party to confirm their commitment to the bailout plan before releasing 11 billion euros needed by Greece to pay its debts in December 2011 (Donadio).

Wider Consequences of Greece's Debt Crisis

European leaders fear that a Greek default would result in a series of other member state's defaulting on their government debt. Widespread defaults would result in a severe European recession. The economies of Portugal, Italy, and Spain remain particularly fragile. Portugal, Italy, Greece, and Spain are collectively known by the acronym "Pigs." Together these four countries account for 40% of the Eurozone's total public debt (Hirst). Furthermore, if Greece agrees to the bailout plan and still fails, Germany and France's banks would be in severe danger since Germany and France were major contributors for the loans.

Italy

Specifically, Greece's acceptance of the plain is believed to be crucial to the containment of Italy's debt crisis. Italy's political leaders have also struggled to cut budgets and manage their debt through their economic crisis. However, Italy's economy is much larger than Greece's, and its default would have much greater ramifications. Yields on Italian bonds recently rose to 6.6 percent. This percentage is the highest since the introduction of the euro (Donadio).

The United States

Over $400 billion of US exports in 2010 went to the EU. If the EU were to go into a deep recession, the US would lose a great portion of this market. Furthermore, the euro depreciation against the dollar would make European firms' goods more attractive compared to US. This would result in the further loss of US jobs.

US firms also have more than $1 trillion of direct investments in the EU. Other investments in states outside of the EU would also decline as many other states would also be hurt by the EU's crisis.

Furthermore, the US banks and their subsidiaries have approximately $2.7 trillion in loans, as well as other commitments to European governments, banks, and corporations. The US has another $2 trillion of exposures to the United Kingdom alone. Credits from European States have had a great impact on the US. The credits helped to US to get out of its financial crisis. The loss of these credits among the other factors could result in a double dip recession for the US (Elliot).

China

China, like the US, exports a significant amount of goods to Europe. The loss of this market would slow China's growth. If the bailout plan were to fail, China would also lose a significant investment opportunity (Elliot).

Conclusions

In this paper, I discussed the economics of the European Union. First, I discussed the history of the European Union. As part of this discussion, I included the inspiration for the European history, the various treaties that created the European Union, the various governing bodies that allow the European Union to function, and its policies for expansion. Second, I discussed the European Union's potential problems. As part of this discussion, I considered the European Union's dilemmas on social policy, democracy, and external relations. Third, I examined the current economic crisis facing the European Union. As part of this discussion, I examined the case of Greece. Specifically, I looked at Greece's social policy, the history of its public debt, its current situation, and the plans for its rescue. Fourth, I examined the potential impacts the European Union's financial crisis will have on the rest of the world.

This paper is up to date from November 7, 2011, as talks for Greece's transitional government devoted to solving Greece's debt problems began. The problems resulting from

Greece's financial debts are far from recovered. The European Union will have to continue to working through this problem and continue to make adaptations to their union. The European Union is unprecedented, and thus, no institution has had to face the problems the EU will face. The EU will have to continue to compromise and forfeit sovereignties for it to succeed. However, the compromises and sacrifices that member states continuously made for Greece is a positive indicator of their future success. Only time will tell if the EU will be able to survive and become "The United States of Europe" as originally envisioned.

Works Cited

"A Very European Crisis; Greece's Sovereign-debt Crunch" *The Economist* 6 Feb. 2010: 75-77. *ProQuest*. Web. 20 Mar. 2012. <http://search.proquest.com.ezaccess.libraries.psu.edu/docview/223980000?accountid=13158>.

Caporaso, James A. *The European Union: Dilemmas of Regional Integration*. Boulder, CO: Westview, 2000. Print.

"Debt Deal Referendum Throws Greece in Chaos." *CBS News*. CBS, 1 Nov. 2011. Web. 20 Nov. 2011. <http://www.cbsnews.com/8301-202_162-20128482/debt-deal-referendum-throws-greece-in-chaos/>.

Donadio, Rachel, and Niki Kitsantonis. "Anxieties Stir as Greece Plans Referendum on Latest Europe Aid Deal." *Europe*. The New York Times, 31 Oct. 2011. Web. 1 Nov. 2011. <http://www.nytimes.com/2011/11/01/world/europe/greece-to-hold-referendum-on-new-debt-deal.html?_r=1&ref=racheldonadio>.

Elliott, Douglas J. "Crisis in Europe: Why You Should Be Worried - Oct. 25, 2011." *CNNMoney.com*. Cable News Network, 25 Oct. 2011. Web. 1 Nov. 2011. <http://money.cnn.com/2011/10/25/news/international/europe_crisis_fallout/index.htm?iid=EL>.

"European Union." *History.com*. Ed. Matthew Gabel. A&E Television Networks, 2011. Web. 04 Dec. 2011. <http://www.history.com/topics/european-union-eu>.

"Greece PM Survives Vote, May Step aside - World News - Europe - Msnbc.com." *Europe on MSNBC.com*. Associated Press, 5 Nov. 2011. Web. 11 Nov. 2011.

<http://www.msnbc.msn.com/id/45161095/ns/world_news-europe/t/greece-prime-minister-survives-confidence-vote-may-step-aside/>.

Hirst, Tomas. "GREECE: Monumental Risk." *The Economist* 15 Mar. 2010: 25. *ProQuest*. Web. 20 Mar. 2012. <http://search.proquest.com/docview/214613809?accountid=13158>.

McDonald, Robert. "The Greek Deficit and Debt Crisis: an End or a Beginning?" *Economia*. 23 May 2011. Web. 04 Dec. 2011. <http://www.economia.gr/index.php?dispatch=pages.view>.

Moses, Abigail. "Greece Has 98 percent Chance of Default on Euro-Region Sovereign Woes." *Bloomberg News*. Bloomberg, 13 Sept. 2011. Web. 20 Oct. 2011. <http://www.bloomberg.com/news/2011-09-12/greece-s-risk-of-default-increases-to-98-as-european-debt-crisis-deepens.html>.

Nellas, Demetris. "Dissent Grows Ahead of Greek Confidence Vote." *The Washington Examiner*. Associated Press, 4 Nov. 2011. Web. 11 Nov. 2011. <http://washingtonexaminer.com/news/world/2011/11/greeces-papandreou-faces-crucial-confidence-vote>.

O'brien, Dan. "Why a Greek Default Might Unleash Uncontainable Forces - The Irish Times - Tue, Oct 25, 2011." *The Irish Times*. The Irish Times, 25 Oct. 2011. Web. 1 Nov. 2011. <http://www.irishtimes.com/newspaper/finance/2011/1025/1224306446903.html>.

Rehm, Diane. "Lack of Trust Underlies Greece's Debt Problem : NPR." *NPR : National Public Radio : News & Analysis, World, US, Music & Arts : NPR*. National Public Radio, 17 Nov. 2011. Web. 21 Nov. 2011. <http://www.npr.org/2011/11/17/142437694/lack-of-trust-underlies-greeces-societal-problems>.

Rooney, Ben. "Finally, Europe Has a Deal." *CNNMoney*. Cable News Network, 26 Oct. 2011. Web. 29 Oct. 2011. <http://money.cnn.com/2011/10/26/news/international/european_union_crisis_summit/index.htm>.

Scaliger, Charles. "European Dis-Union." The New American Jan 24 2011: 17-20. *ProQuest Research Library*. 5 Dec. 2011.

Thody, Philip Malcolm Waller. *An Historical Introduction to the European Union*. London: Routledge, 1997. Print.

Tsarouhas, Dimitris. *Social Policy in Greece: Continuity and Change*. Thesis. Middle East Technical University, 2010. PSA. 2010. Web. 20 Oct. 2011. <http://www.psa.ac.uk/2008/pps/Tsarouhas1.pdf>.

"Turmoil in Greece Vexes Wall Street." *CBS Money Watch*. CBS, 1 Nov. 2011. Web. 11 Nov. 2011. <http://www.cbsnews.com/8301-500395_162-20128398/turmoil-in-greece-vexes-wall-street/>.

Academic Vita of ToriLynn M. Bell

ToriLynn M. Bell
112 Forge Road
Boiling Springs, PA 17007
Tmb5217@psu.edu

Education:
Bachelor of Arts degree in International Politics, The Pennsylvania State University, Spring 2012
Bachelor of Arts degree in Economics, The Pennsylvania State University, Spring 2012
Honors in International Politics
Thesis Title: Economics of the European Union: An analysis of the Greece Debt Crisis
Thesis Supervisor: Glenn H. Palmer

Related Experience:
Research Assistant for the Militarized Interstate Dispute Project
Supervisor: Glenn H. Palmer
Fall 2011 and Fall 2012

Awards:
Phi Beta Kappa Honor Society
Phi Eta Sigma National Honor Society
Dean’s List

Activities:
President of Phi Eta Sigma National Honor Society
Presidential Leadership Academy