The London School of Economics and Political Science

The Eurozone crisis and the 'intermediate' economies: The Political Economies of Greece and Portugal

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Declaration

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// Abstract

It is well documented that the EU and IMF bailout programmes led the crisis-hit Eurozone countries to a weak economic recovery. However, the existing theories have so far failed to provide comprehensive explanations of the post-crisis economic performance in the periphery of the Eurozone. This thesis' starting point is to identify what policies were introduced in Greece and Portugal and how effective they were at addressing the causes of the crisis. To answer this question, it draws on qualitative primary data, documents, archives, and elite interviews. In contrast to the neoclassical explanation that stresses the 'backwardness' of the countries in the periphery, as well as more critical Keynesian/'victimisation' approaches that understand the crisis-hit countries as 'victims' of the creditors, this thesis -by building upon Comparative Political Economy literature- provides a Growth Model explanation of the crisis and the post-crisis economic performance of Greece and Portugal. It shows why the EU and IMF internal devaluation policies failed to boost export-led growth in both countries and brings to light the much overlooked ways in which Greece and Portugal have been through a productive transformation in recent decades. The Growth Model perspective goes beyond the VoC literature, showing how the historical capital formation (i.e. the difficulty of creating economies of scale, and low-added value production), the fiscal policies, and the European and international economic developments (i.e. EU Eastern Enlargement, and the rise of the large-scale emerging economies in Asia) led Greece and Portugal into an 'intermediate' trap. The 'politics' of the crisis management -based on the neoclassical versus 'victimisation' narratives- reinforced the 'intermediate' status of Greece and Portugal after the crisis. Although the existing literature tends to focus on the creditor's role in the management of the crisis, this thesis brings evidence from the EU-IMF bailout negotiations showing that both the creditors and the anti-austerity governments in the debtor countries kept the structural aspects of the crisis out of the negotiations to maintain the status quo in the Eurozone. Overall, this thesis brings the Growth Model perspective and VoC into a productive dialogue, contributing the concept of the 'intermediate' economies to the European Political Economy.

Acknowledgements

In 2008 I was in the first year of my bachelor studies, when Lehman Brothers collapsed and the Global Recession shook the world. A year later, I was 'fortunate' enough to live in Athens when the revelations about the Greek government's public finance triggered the Eurozone crisis. Having spent the early stages of my life in a prosperous Europe, such a crisis was an absolute shock to me, Greece, Europe, and the whole world. At the time, I could not imagine the extent to which I would devote my life to dissecting the roots of the crisis and analysing the post-crisis economic reality in the Eurozone. This has been harder than I thought and a more rewarding journey than I could ever have imagined.

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Glossary of Concepts

The **'Iphigenia-in-Aulis'/'victimisation' explanation** comes from the Greek poet, Homer, and narrates the sacrifice of an innocent victim to serve the interests of powerful actors. It was widely used by the Keynesian economists and political scientists to explain the Eurozone crisis and the post-crisis economic performance in the periphery. It presents the crisis-hit countries as victims of the creditors that managed the crisis in a way that protected their interests, causing a long recession in the periphery of the Eurozone.

'Intermediate economies' is a concept that describes the status of the countries in the periphery of the Eurozone. 'intermediate' economies are the fruit of the historical process of capital formation and economic development in the European periphery in recent decades. The origins of those economies can be tracked back to before the creation of the Eurozone. However, the economic and political developments in the 2000s were of critical importance in their formation. Those economies are based on a demand-led model of economic growth and remain specialised in traditional low-tech sectors producing low added value goods. They are stuck between the high-tech core countries and the large-scale emerging economies. 'Intermediate' economies differ from the 'middle income' countries as the former maintain limited policy tools and are subject to EU policy rules and constraints.

Internal devaluation is a policy to decrease nominal wages and prices. The EU and IMF forced internal devaluation -in the absence of currency devaluation- through wage cuts in the public sector and labour market reforms as a mechanism to restore price competitiveness and boost export-led growth in the crisis-hit countries.

'PIIGS' is a term that was used offensively for Portugal, Italy, Ireland, Greece, and Spain. It was widely used by the mass media and influenced public opinion across Europe.

'Ants versus grasshoppers' is a concept based on Aesop's fable that describes a careless grasshopper that spends the summer singing while an industrious ant works hard to store up food for winter. When the winter comes, the hungry grasshopper begs the ant for food. The story sums up lessons about the virtues of planning and hard work and the consequences of irresponsible behaviour. The latter should -according to the fable- be punished. Such a concept was used by the creditor governments and international institutions to explain the crisis that triggered the dividing lines between the surplus and deficit countries in the Eurozone. This narrative has been predominant in the public discourse and spread through the mass media across Europe.

'Expansionary austerity'/'expansionary fiscal contraction' is a hypothesis claiming that fiscal contraction can lead to higher GDP growth rates. Contrary to the Keynesian model, the proponents of 'expansionary austerity' argue that fiscal contraction can raise expectations for households' future disposal income, increase investors' confidence and thus stimulate private consumption and investment.

'Pretend and extend' is a term used in academic and public discourse to describe the creditors' tactics to reject debt relief for Greece in 2010, arguing that the Greek debt was sustainable.

The **'Divide and conquer' strategy** comes from Julius Caesar's famous tactic used to divide the forces of his enemies. This term is used in this thesis to explain creditors' tactics in dividing the deficit countries, to protect their economic interests and preserve the status quo in the Eurozone.

There Is No Alternative (TINA) is an acronym that was first used by the Victorian British intellectual and philosopher, Herbert Spencer, who defended classical liberalism, responding to critics that there was no alternative to capitalism in the 19th century. British Prime Minister, Margaret Thatcher, used this as a slogan against the critics of her market-oriented policies and the rollback of the welfare state in the 1980s. The 'there is no alternative' dogma was used by creditors to legitimate the internal devaluation and market-oriented reforms during the Eurozone crisis.

The **'Goliath versus David'** concept comes from the Bible and describes the fight of the giant, Goliath, against the young, tiny David. It denotes a contest where a weak opponent faces a stronger adversary. It has been used allegorically in the public discourse to describe the overwhelming power of the creditors against the debtors during the bailout negotiations in the Eurozone crisis.

The **'North- South'** concept is used to highlight the division between the surplus (e.g. Germany, France, Austria, The Netherlands) and deficit countries (e.g. Greece, Portugal, Ireland, Italy, Spain) in the Eurozone. The 'North- South' or 'core-periphery' concepts have been used primarily in economic rather than geographical terms.

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13. The Greek Debt, current US$ billion, September 2010.

List of Abbreviations

AfD	Alternative für Deutschland (Alternative for Germany)
CDS–PP party,	Centro Democrático e Social-Partido Popular (People's Portugal)
CEE	Central and Eastern Europe
CMEs	Coordinated Market Economies
DSA	Debt Sustainability Assessment
EC	European Commission
ECOFIN	Economic and Financial Affairs (European Union)
ECB	European Central Bank
EEC	European Economic Communities
EFSF	European Financial Stability Facility
EMU	Economic and Monetary Union
ESB	European Safe Bonds
ESM	European Stability Mechanism
EU	European Union
FDI	Foreign Direct Investment
FPÖ	Freiheitliche Partei Österreichs (Freedom Party, Austria)
GDP	Gross Domestic Product
GSEE	General Confederation of Greek Workers (Greece)
IMF	International Monetary Fund
LABREF	Labour Market Reform database
LMEs	Liberal Market Economies

M5S	Five Star Movement
MMEs	Mixed Market Economies
MONA	Monitoring of IMF Arrangement
MoU	Memorandum of Understanding
NATO	North Atlantic Treaty Organisation
ND	New Democracy (Greece)
OECD	Organisation for Economic Co-operation and Development
OMT	Outright Monetary Transactions
ÖVP	Österreichische Volkspartei (People's party, Austria)
PASOK	Panhellenic Socialist Movement (Greece)
PIIGS	Portugal Ireland, Italy, Greece, Spain
PS	Partido Socialista (Socialist party, Portugal)
PP	Partido Popular (People's party, Spain)
PSD	Partido Social Democrata (Social Democratic party, Portugal)
PSOE	Partido Socialista Obrero Español (Socialist Workers' party, Spain)
R&D	Research and Development
SGP	Stability and Growth Pact
SMEs	Small and Medium Enterprises
SMP	Securities Market Programme
SPÖ	Sozialdemokratische Partei Österreichs(Social Democratic party, Austria)

SYRIZA	Synaspismos Rizospastikis Aristeras (Radical Left coalition, Greece)
TEU	Treaty of the European Union
TFEU	Treaty on the Functioning of the European Union
TFGR	Task Force for Greece
VoC	Varieties of Capitalism
WTO	World Trade Organisation

Chapter 1: Introduction

On July 5th 2015, Syntagma Square was overrun -once more- by foreign media correspondents waiting for the national referendum results over a third bailout agreement between Greece and its creditors. All eyes in Europe and the world were now on Athens. The Greek people confronted a bitter dilemma; a new bailout that would prevent the country's default in exchange for new austerity measures, or a 'Grexit' and a potential disorderly default.

In less than five years, Greece's gross domestic product (GDP) had shrunk by 25 percent, over a million of citizens had lost their jobs and hundreds of thousands -mostly the young generation- had left the country. Almost all indicators of economic activity had dramatically declined, and the society found itself on the brink of collapse. A country that accounts for 3 percent of the European population and 2 percent of the European Union's GDP had become the epicentre of the Eurozone crisis in 2010. In July 2015, Greece was once again making media headlines across the world.

The financial crisis that began after the bubble burst in the housing market in the United States (US) in 2008 spread to the Eurozone in 2009. Years of excessive deregulation of the financial sector and rising income inequality in the US, along with increasing imbalances in the global economy, caused the outbreak of the worst economic crisis since the *Great Depression*. The effects of the crisis varied across the world; however, several countries witnessed a slowdown of economic activity, difficulty financing their deficit and servicing their external debt, along with high and persistent unemployment and declining living standards.

The financial crisis in the US and the domino effect triggered a banking crisis in the Eurozone with major European banks facing a capital shortfall and, thus, liquidity and solvency issues. The crisis in the banking sector led to a sudden stop to the continuous massive credit inflows -that acted as driver for growth in the 2000s- towards the peripheral European countries. The governments in crisis-hit countries such as Ireland, Spain, and Cyprus were no longer able to bailout the collapsing banks, while Greece and Portugal faced difficulties refinancing their accumulated debts (De Grauwe and Yuemei, 2013). To prevent the contagion of the crisis and to calm down the

markets, the countries at the centre of the crisis agreed bailout programmes with the EU (European Commission and European Central Bank) and the International Monetary Fund (IMF).

Greece had been in the ‘eye of the storm’ since 2009 because of its loose fiscal policy and its mounting public debt. Greece’s current account deficit and public debt had climbed to an unsustainable level, reaching 14.9 % and 167 % of GDP respectively in 2009 (Eurostat, 2012). As a result, the Greek government had lost access to private capital markets and it became the weakest link in the European crisis. Greece agreed with the European Union and the International Monetary Fund upon a €110 billion adjustment programme for three years in May 2010 in order to improve its financial situation, restore its competitiveness and return to growth. However, the country’s economic indicators declined in late 2011, leading to a new crisis the following year and a second revised programme in 2012. Finally, a third programme -despite people’s aspirations in the 2015 referendum- was implemented in 2015- 2018.

Portugal had also been suffering from a high fiscal deficit and external debt since the early 1990s. After a decade of stability, the sudden stop to credit inflows in 2009 led Portugal out of the financial markets just one year after Greece (Münchau, 2013). In May 2011, Portugal signed a 3-year €78 billion bailout programme with the EU and the IMF. Portugal was in a much better position vis-à-vis Greece; however, the EU and IMF promoted a similar policy recipe to address the unsustainable public finance and high external debt, and increase the country’s competitiveness (Gonçalves, 2014). In comparison with the Greek programme, the bailout in Portugal was less demanding with moderate fiscal consolidation and less reform conditions (De Grauwe, 2016).

Based on their massive lending capacity, the EU and IMF played a crucial role by providing extensive financial assistance to prevent Greece and Portugal from economic collapse. Such economic assistance was conditioned on the implementation of fiscal consolidation and market reforms. Greece and Portugal implemented fiscal measures to put their public finances back on a sustainable trajectory. They decreased public expenditure through wage cuts in the public sector as well as lower government spending and public investments. Moreover, the Greek and Portuguese governments were forced to push the labour cost down through internal devaluation (i.e. cuts in public sector wages) and the deregulation of the labour market. Such policies caused a

deep recession in both countries. Economic activity stagnated, the number of unemployed became sky high, and millions were pushed into poverty.

The heavy cost of the EU and IMF response to the economic crisis in Greece and Portugal therefore raises many heavily contested issues and intense debates about the effectiveness of those policies to boost economic recovery in the periphery of the Eurozone.

This thesis will therefore address the following central research question:

- Were the EU and IMF internal devaluation policies effective to address the causes of the crisis in Greece and Portugal?

To answer this research question, it is critical to understand the complex interplay between 'politics' and 'economics' in the Eurozone crisis. For this reason, this central research question is disaggregated into the following sub-questions:

- Why did the internal devaluation fail to boost an export-led growth in Greece and Portugal?
  Beyond 'economics', we should also shed light on the political aspects of the management of the crisis that set the internal devaluation policies as a treatment for the Eurozone crisis. Therefore, this thesis will also address the following sub-question:
- Why did creditors insist that internal devaluation (i.e. austerity) was the solution to the Greek and Portuguese crises?

The Eurozone has become the theatre of political developments that have drawn attention from across the world. Academics from various social sciences and disciplines have contributed to an expanding body of literature offering various perspectives on the crisis and the crisis response in Europe. These many different accounts in the existing literature fit into two broad perspectives: the neoclassical and the Keynesian/'Iphigenia-in-Aulis' explanations.

The *neoclassical explanation* is associated with the EU, the IMF, the creditor countries and the neoclassical economists, all of which played a key role in the

management of the crisis, designing the bailout programmes in the Eurozone. According to this approach, the Eurozone's problem can be attributed to individual countries that suffered from fiscal 'profligacy' and were ineffective in fighting vested interests and corruption (European Commission, 2010). Greece has a 'prominent position' in this narrative as a country where populist politicians led public finance out of control and triggered a crisis across the Eurozone (Lagarde, 2015; Schäuble, 2011). In the eyes of the neoclassical economists, Greece has 'lived beyond its means' and 'consumed more than it has produced' for decades. Greece has been a backward country in the sense that it has failed to modernise its economy and society through economic and institutional reforms over recent decades. It still suffers from a hypertrophic public sector, a rigid labour market, overregulated product markets, and corruption. In this context, according to the neoclassical orthodoxy, the 'only cure' for the indebted countries -such as Greece and Portugal- was fiscal contraction to mitigate profligacy, and market reforms to boost recovery and stabilise the Eurozone as a whole (European Commission, 2010; 2011; Schäuble, 2011). For them, Greece's long recession and poor performance -despite the EU and IMF bailout- shows that the country has failed to do what it should have done. Greece is considered a 'unique' case that has failed to recover from the crisis, while Portugal is a 'success story' that has consolidated its public finance and reformed its economy.

The *Keynesian/'Iphigenia-in-Aulis' explanation* criticises the EU and IMF's ability to manage the crisis effectively. According to this perspective, the European leaders were in 'denial' in the early stages of the crisis. They failed to react in a determined way to prevent the crisis from spreading in the Eurozone (De Grauwe, 2011). Based on a neoclassical economic orthodoxy, creditors refused to offer substantial debt relief to the insolvent countries -especially to Greece in 2010- and left the door open to speculative attacks against the Euro. For the Keynesian economists, the creditors insisted on austerity programmes that undermined the recovery in the periphery (Stiglitz, 2017; De Grauwe, 2011; Varoufakis, 2017). Austerity pushed Greece and Portugal into a deflationary spiral and led them into a long recession. On top of this, the bailout loans -subject to high interest rates- were accompanied by tough and front-loaded fiscal measures, and 'too much to do' reforms that exhausted the national governments and pushed them into a deeper crisis. The European Central Bank's '*whatever it takes to save the Euro*' and purchasing of sovereign bonds programme

came too late. Therefore, both the EU and IMF proved rather ineffective in safeguarding the insolvent countries perpetuating the crisis in the South.

In this thesis, I review the theoretical debates and the existing explanations in a critical way. The neoclassical explanation -supported by creditors- uses market economic principles to explain the causes of the crisis and the post-crisis economic performance in the periphery. Although it provides some valid claims regarding the role of the governments and policies that exacerbated the crisis, it fails to bring to light the deep roots of the crisis in the Eurozone. It underestimates the complex realities, diverse local practices and special features that interacted with each other and shaped the economic performance in the periphery. Moreover, it fails to account for the difficulties confronting the peripheral countries in regard to maintaining their competitiveness in a currency union without devaluation or protectionist tools.

The neoclassical economists fail to show how the 'Europeanisation' and financialisation affected the peripheral economies after the creation of the European Communities. The deregulation of the banking sector allowed governments in the periphery to borrow in a manner that - under uneven development conditions - has triggered large macro-economic imbalances in the last decade. The neoclassical framework provides a partial and therefore inadequate understanding of the crisis, leaving the structural causes unexplored. Therefore, the neoclassical economic policies that the creditors designed for the peripheral countries were not appropriate for them to recover from the crisis.

The proponents of this approach insist on shaky explanations and simplifications of the complex reality in the periphery of the Eurozone. They rely on 'Greek exceptionalism', overemphasising corruption, clientelism, and vested interests, and underestimating other critical structural factors that shaped the post-crisis economic performance.

The Keynesian/'Iphigenia-in-Aulis' explanation recognises the substantial EU and IMF mistakes and omissions in the management of the crisis. On a first level, the critics bring to light the EU's institutional deficiencies in dealing with such an asymmetric shock and preventing the periphery's insolvency crisis in 2010. They show how the European leadership was largely unprepared to respond to the crisis in an effective way. On a second level, Keynesian economists offer an interesting critique of the role of austerity programmes in exacerbating the crisis across the periphery.

This thesis recognises the validity of some of these criticisms, but also highlights that this explanation fails to provide us with a deep understanding of the historical processes, and the economic and political dynamics that have undermined the ability of the peripheral countries to remain competitive in the changing European and global economy. The Keynesian/'Iphigenia-in-Aulis' approach fails to provide an in-depth understanding of the impact of the bailout programmes on the productive structures in those countries and, therefore, it does not offer a comprehensive explanation.

Unable to bring the deeper mechanisms that caused the Eurozone crisis to light, the Keynesian/'Iphigenia-in-Aulis' explanation overemphasises the role of the creditors in fuelling the crisis in the periphery. It tends to present Greece as an 'exception', a 'sacrificial lamp' that creditors pushed into a deep depression after 2010.

This thesis will show the theoretical fallacies in the existing explanations and argue in favour of a Comparative Political Economy perspective, taking a Growth Model approach to show that the problem of the Eurozone lies in capitalist diversity across Europe and the growth model in the countries in crisis. I argue that the current crisis in the Eurozone is a symptom of the uneven development that led the peripheral countries, especially Greece and Portugal, into a competitiveness crisis at the end of the 2000s.

Such a crisis of uneven development was not new phenomenon in world economic history. Several developing countries in Sub-Saharan Africa and Latin America had been through similar economic crises in the 1980s and 1990s. The economic crisis in the developing world triggered an academic debate over the causes of the long recession and the prospects of recovery (Williamson, 1990; Krueger, 1998; IMF, 1997; Rodrik, 2006; Stein, 2008; Kahn, 1990). A compelling body of literature has brought to light the structural aspects of such crises in recent decades (Rodrik, 2006; Babb, 2005). In his insightful book, 'The World Economy since the War: The politics of Uneven Development', E.A. Brett argues that '*the problems of uneven development are a function of the problem of production- more precisely, of production in weaker areas whose lack of capital, entrepreneurial skills and social organisation makes it difficult for them to compete on equal terms with those are already strong*' (Brett, 1985: 264). Based on such a theoretical starting point, I build upon the current Comparative Political Economy and the Growth Model literature to set out the foundations for a structural understanding of the Eurozone crisis. The foundations of the Comparative Political Economy have been set in 1960s, however, the current Varieties of Capitalism

perspective and Growth Model approach brought new insights and renew the interest in Comparative Political Economy literature. Varieties of Capitalism offers an alternative approach by focusing on the role of institutions (e.g. the state, the market, and firms) in the comparative political economy. It provides an advanced framework for the evolutionary study of the economic structures: mainly the supply-side factors, the production sectors, the firms, the human capital (i.e. skills, and age), the political and social aspects (i.e. state, education, and rule of law), and the socio-economic features (i.e. property, and family assets). The complex interplay of those factors offers a new framework to understand national variations and the 'big picture' of the peripheral countries' economic performance (Hancke, 2013; Hall, 2018; Johnston, 2016). Varieties of Capitalism brings to light different divisions among European countries (i.e. co-ordinated market economies, liberal market economies, mixed-market economies) and emphasises the competitiveness crisis in the Eurozone. Contrary to the *neoclassical* and *Keynesian/Iphigenia-in-Aulis* explanations, the Comparative Political Economy and Varieties of Capitalism recognise that Greece and Portugal faced similar economic and institutional weaknesses.

This thesis takes a Growth Model approach to show the historical process of the creation of import-led economic models in the periphery of the Eurozone. Instead of VoC's emphasis on institutions, the Growth Model approach focuses on both the fiscal policies and structural weaknesses that reproduce the asymmetries in the Union. My thesis goes beyond the schematic VoC categorisation of the Eurozone countries and analyses the complex productive transformation that Greece and Portugal have been through in recent decades. Moreover, it sheds light on Greece's and Portugal's roles, not just in the Eurozone, but in the global economy.

In this context, I argue that Greece naturally has its own history, polity, and special features, but that it was far from an exception in the Eurozone crisis. I shall argue that Greece and Portugal faced similar challenges that led them to low competitiveness and stagnation. The programmes were inappropriately designed to address the chronic and persistent structural weaknesses of the Greek economy. The same applies to the Portuguese economy. Both countries have been through a similar process of productive transformation in the past decades and are currently facing substantial structural challenges that have remained even after the completion of the bailout programmes.

By bringing evidence from the EU-IMF and national governments' bailout negotiations, this thesis shows how both creditors and debtors remained reluctant to set policies to mitigate the asymmetry in the Union, reinforcing the economic and political status quo in the Eurozone. Finally, in the aftermath of the crisis, numerous myths and national stereotypes arose in Europe. The superficial and conventional views regarding individual countries (i.e. 'lazy Greeks' and 'Nazi Germans'), the causes of the crisis (i.e. fiscal profligacy), and the creditors- debtors division (i.e. 'ants versus grasshoppers' and 'good Europeans versus cheaters') were spread through the mass media across Europe. Those stereotypes offered simple and populist explanations of complex phenomena, significantly influencing European and global public opinion. All of the above left the real causes of the crisis in the dark and divided European citizens. This research identifies and 'isolates' those stereotypes. It aims to shed light on the flawed foundations of the 'conventional wisdom' and debunk the myths regarding the Eurozone crisis.

This thesis is based on personal observation, scientific evidence and in-depth analysis of the economic and political aspects of the Eurozone crisis. It acknowledges that the macroeconomic analyses and data have broadened our understanding of the world economy and individual countries. However, the isolation of macro-economic data fails to explain how local economies function and to shed light on the underlying processes that shape economic performance. This research uses macroeconomic indicators; however, it aims to explore the implicit processes and the interplay of those indicators with the local realities and to explain what has happened in the periphery of the Eurozone and why. Therefore, it draws on qualitative research methods (document analysis, interviews, and fieldwork), personal observation of the production structures in the crisis-hit countries, and a wealth of primary data, with the aim of offering a comprehensive analysis of the processes that determined the evolution of growth model and the post-crisis economic performance in Greece and Portugal.

This thesis is intended to be of interest to those who wish to understand the causes behind the stagnation in the periphery of the Eurozone and those who are curious about the reasons why neoclassical policies failed to free those economies from the 'low-competitiveness' trap. The evidence provided in this explanation shows that we should reconsider the way that the structural adjustment was designed in the crisis-hit countries. Moreover, we should rethink the economic policy in the peripheral countries in the future. Greece and Portugal should follow a new structural paradigm to upgrade

the production structures and to transform their economies to make them sustainable in the long term. The periphery's renaissance will also transform the Eurozone itself.

1.1 The rationale of the comparative analysis: Greece and Portugal

This thesis examines the bailout programmes, their implementation, and the post-crisis economic performance in Greece and Portugal comparatively. The comparative examination of those case studies is based on the following rationale. First, Greece and Portugal are both located geographically in the southern European periphery and have been an integral part of European political, economic, and cultural history. Both countries have a similar population size and similar productive capabilities, and have achieved a comparable economic performance in terms of Gross Domestic Product (GDP) and GDP per capita in the last decades.

Second, they have a parallel historical and political trajectory in modern European history. Greece went through a politically turbulent period that led to a devastating civil war immediately after the end of World War II. The volatile recovery process after the economic destruction of the War and the fragile democratic institutions opened up the path for a far-right military dictatorship that established a nationalist economic policy and civil liberties in the late 1960s. In Portugal, the longest-lived dictatorship in Western Europe, *Estado Novo*, also placed authoritarian restrictions on the economic and social life from the early 1930s.

The authoritarian regimes influenced the economic development in both countries. They favoured business cronies and vested interests leading to market distortions and uneven economic development. They also pursued a model of economic nationalism and protectionism -that occasionally turned into isolationism- impeding the creation of business networks between the local producers and the European and global economies. In both countries, the repressive regimes were overthrown under the rising social and political unrest and Greece and Portugal moved to a Western-type liberal democracy in the mid-1970s.

Third, they have also been actively involved in the economic and political integration process in Europe since the early 1980s. Greece and Portugal joined the European Communities (EC) in 1981 and 1986, respectively. They also joined the Eurozone together after signing the Treaty of Maastricht (1992) and adopting the single currency, the Euro, in 2002. In the context of the European Union, Greece and Portugal have been under the European framework of common policies, rules, and restrictions in the last four decades.

Fourth, Greece and Portugal faced a debt crisis in 2010. The Greek crisis was undoubtfully the extreme case; however, both countries were unable to sustain their current account deficits and rising debts in the late 2000s. To deal with such a crisis, they agreed -as mentioned above- with the European Union and the IMF bailout programmes conditioned on internal devaluation policies and market reforms after 2010.

Despite its political and economic trajectories being similar to Portugal, Greece failed to return to the financial markets after the first bailout programme and signed a second one in 2012, and a third in 2015, to restore its access to capital markets. Portugal, in contrast, completed its bailout programme on time and returned to the markets in 2015. The above led the European Commission and IMF officials to claim that Greece was a ‘unique’ case far from any other peripheral Eurozone economies (European Commission, 2010; 2014; Lagarde, 2015; Schäuble, 2014; interview with the former Vice President of the EC, 2019). Such a hypothesis also gained substantial support among Political Economy scholars and researchers from different theoretical perspectives in the emerging literature about the Eurozone crisis (Blanchard, 2015; Featherstone, 2011; Paraskevopoulos; 2017; Stiglitz, 2015; Varoufakis; 2018). For some of those scholars associated with the neoclassical economic explanation, Greece is a ‘failed-state’ that was not able to recover from the crisis, while Portugal implemented the bailout programme in a successful way and achieved a strong economic recovery. For others associated with Keynesian economic thought, Greece was again -for different reasons- a ‘special case’ that was ‘sacrificed’ by the creditors to serve their economic and financial interests. Such crisis management led Greece into a prolonged depression while Portugal and other southern Eurozone economies achieved a quick recovery. Despite the different starting points, the mainstream neoclassical and Keynesian explanations perceive Greece as a ‘unique’ case in the context of the Eurozone crisis.

This thesis acknowledges that Greece and Portugal have been through a similar political and economic trajectory in the last decades, and it examines the validity of the hypothesis that perceives Greece and Portugal as countries that achieved very different economic recoveries after the bailout programmes. To test this hypothesis, the thesis provides a comparative analysis of the national growth models with a focus on the productive capabilities, fiscal policies, structural weaknesses, and broader economic and political developments that shaped the Greek and Portuguese economies on the eve of the crisis. Such a comparative analysis offers an in-depth understanding of the underlying economic and political mechanisms that led those countries into the crisis in 2010. The thesis also analyses the EU and IMF internal devaluation policies and market reforms and their implementation comparatively in both countries since 2010. Based on archives, descriptive statistics, and interviews with officials in those countries, I analyse the growth models, the structural weaknesses, and the overall economic performance in the Greek and Portuguese economies after the bailout programmes. Such a comparative perspective provides new substantial evidence to test the influential hypothesis that treats Greece and Portugal as extremely different recovery cases in the periphery of the Eurozone. Most importantly, it provides a new framework to analyse the evolution of the growth models in Greece and Portugal after the Eurozone crisis.

1.2 Methods and Sources

I had the 'good fortune' to live in Greece both during its 'golden age' in the 2000s, as well as during the economic crisis from 2010 onwards. Athens was the theatre of the Eurozone drama from the beginning of the crisis. I also worked in the Headquarters of the European Commission in 2014. That was the moment when Portugal celebrated its exit from the programme, but Greece experienced suffocating political pressure to approve a third bailout agreement. My personal observation and involvement provided me with critical insights into the nature of the political game in the Eurozone.

However, this research aspires to step beyond any national and regional perspectives or any sense of patriotism. It is also worth mentioning that this thesis reflects my own scientific perspective and by no means represents the European Commission or any other European Union institution. I consider the economic crises in Greece and Portugal as case studies in the broader context of the Eurozone periphery and the world economy. I shall make an argument that goes beyond the national or European boundaries and make the case for the outcomes of the chronic uneven development -in terms of output, technological capacity, and innovation - that leads countries -having tied their hands in dysfunctional currency areas- into crises. This asymmetry is likely to produce new crises in the world economy in the future.

This research is based on extensive data collection through qualitative research methods and, particularly, document analysis, elite interviews, and fieldwork. Firstly, I collected public documents from the European Commission and the International Monetary Fund including the Memorandums of Understanding (MoU) for Greece and Portugal, the reviews of the MoU implementation, the decisions of the European Council and the Eurogroup, the IMF debt sustainability assessments (DSA), and reports from the central Banks, national Statistics Institutes, and Parliaments in Greece and Portugal. The data collection included EU and IMF officials and national representatives' (i.e. Greece, Portugal, Germany, France) public statements in the press and books, as well as monographies and personal testimonies where available (e.g. Ashoka Mody, James Galbraith, George Papakonstantinou, Yanis Varoufakis). The detailed comparative analysis of the bailout programmes (i.e. the level of financial assistance, interest rates, and duration), the fiscal adjustment (the fiscal targets, and labour and product markets conditions) and the implementation revealed the differences and similarities between Greece and Portugal.

Beyond the public documents, I conducted a document analysis of internal documents, mainly the minutes from the IMF executive board and European Commission documents. I also used my extensive notes and my experience from the internal meetings and informal discussions during my mandate in the European Commission Headquarters in Brussels. Finally, to fully understand the legal and political framework of the Eurozone, I went through the Treaties of the EU, especially the Treaty of the European Union (the Maastricht Treaty of 1992), which introduced the 'four freedoms', the institutional framework of the Eurozone, and the Treaty of Lisbon

(2007), which defines the EU's powers in several policy areas, such as the EU trade policy and the EU common policies.

I also conducted interviews with almost all of the key policy-makers that played an active role in the negotiations or that had an executive role in the national governments and bailout implementation. My sample selection was based on the following criteria: i) the interviewee's position within the organisation, ii) the interviewee's personal involvement in the Eurozone crisis, iii) their personal influence both on the organisation and in the bailout agreements and implementation, and, iv) their knowledge of, and expertise in the economic adjustment in Greece and Portugal. I interviewed various officials from different departments and positions in the EU, IMF, and EU Task Force of Greece (TFGR), and national officials including Prime Ministers and ministers (e.g. finance, economic development, and labour issues).

In most cases, I used a face-to-face, semi-structured interviewing method including a questionnaire with open-ended questions (Marshall and Rossman, 2006). I conducted 'pilot' interviews in the early stages of my research to ensure a smooth interviewing process with experienced participants and to acquire in-depth and specific information. This proved valuable to ensure the quality and the reliability of the data. I used several methods and questions to trigger a substantial discussion with the interviewees to capture their reactions and arguments. I took extensive notes after each of the interviews and meetings in the European Commission and IMF to ensure the accuracy of the quoted statements. This work is also the result of several conservations I had with Greek officials that handled the crisis at various stages. Some of those discussions took place in Greek and I translated them into English for the purpose of this thesis. I conducted thematic analysis using the NVivo software to follow emerging patterns deriving from all of these interviews.

Interviewing officials and national representatives enabled me to understand the controversial issues, especially regarding i) the amount of financial assistance, ii) the programme's duration and iii) the impact of the internal devaluation on the peripheral economies. Secondly, I was able to identify the underlying national economic and political incentives, and the role of the international organisations and national governments (e.g. Germany and France) in the management of the crisis. Moreover, the interviewing process allowed for the comprehension of the power relations in the negotiations that shaped the economic policies (i.e. austerity) and led to the refusal of policy alternatives.

1.3 Ethics

With regard to the research methods, both the elite interviewing and the fieldwork involved several ethical considerations. To overcome such ethical issues, I followed the process below. Firstly, I informed all of the interviewees about the purpose of the study, and the confidentiality and anonymity issues. I used a consent form to inform them about their rights and address their confidentiality concerns. I was flexible in accommodating their preferences in the interviewing process (i.e. regarding the duration and interview recording). In most cases, officials preferred not to be recorded and, therefore, I had to take notes while interviewing them. Similar concerns arose during my fieldwork in Athens as I interviewed government officials from different departments and hierarchy levels. I had to reassure the interviewees of their anonymity and ensure that my research would not put their employment conditions, personal relations, or even their jobs at risk.

I decided to use code numbers for my personal records and I have used anonymous quotes where appropriate in order to respect their confidentiality concerns. Finally, all of the notes and materials that comprise the anonymous data will be destroyed soon after the thesis' completion (Wiles *et al*., 2008).

Finally, I informed all of the interview participants that they had the right to review, clarify and verify the accuracy of their interview transcripts, but that they could not influence by any other means the results and final text of the study or hinder its publication. I used this strategy to address both the interviewees' concerns and my academic and research rights (Wiles *et al*., 2008).

1.4 Overview of the thesis' chapters

Overall, I analyse all of the complex themes mentioned above in different -but related chapters- as reflected in the structure of the thesis developed below.

The second chapter outlines the theoretical assumptions that framed the bailout programmes in the Eurozone and compares them with those in the developing world in the 1980s and 1990s. It provides a critical review of the neoclassical economic

principles and the Keynesian/ 'Iphigenia-in-Aulis' approach, making the case for a Growth Model understanding of the crisis and the post-crisis economic performance in Greece and Portugal.

In chapter three, I provide an analytical framework that enables us to dissect and evaluate the Eurozone crisis. This chapter offers a brief historical analysis of the creation of the Eurozone, its institutional features and inefficiencies, and the asymmetry of economic development in the region that led to the Eurozone crisis. I also analyse the political economy of Greece and Portugal since the restoration of democracy in both countries in the mid-1970s, and particularly the fiscal policies, financialisation, chronic de-industrialisation, low competitiveness, and poor export performance in exposing them to the crisis in 2010.

In chapter four, I examine the EU and IMF conditionality and comparatively assess the bailout implementation in Greece and Portugal. This chapter offers an advanced understanding of what policies were introduced and to what extent these policies were implemented in both countries.

In the fifth chapter, I assess the complex impact of the EU and IMF internal devaluation and neoliberal reforms on the economic structures in Greece and Portugal. Taking a comparative approach, I review the impact of the bailout programmes on the post-crisis economic performance in both countries.

Chapter six sheds light on the political dimension of the management of the crisis in the Eurozone as a whole. It explores the nature of the power dynamics between the creditors and debtors -going beyond Greece and Portugal- that shaped the economic policy recipe that favoured internal devaluation (wage cuts and labour market deregulation) and declined policy alternatives. The 'politics' of the bailout programmes had a dynamic impact and to a large extent shaped the economic outcomes in the periphery of the Eurozone. The economic outcomes of the bailout programmes along with the way that the creditors and debtors managed the crisis in the periphery triggered diverse political phenomena in the aftermath of the crisis (i.e., anti-austerity movements in the South, and a backlash against the bailout programmes in the North). The competitiveness crisis in the periphery turned into a political crisis in the Eurozone as a whole.

Finally, the concluding chapter, chapter seven, reviews the theoretical approach and main research findings. I recapitulate the contribution of this thesis to the Comparative Political Economy and European Political Economy literature. This

chapter also sums up the economic and political aspects of the management of the crisis in the Eurozone and aims to open up a discussion regarding an alternative economic paradigm that would allow the crisis-hit countries to escape the 'intermediate trap' by upgrading their production structures and mitigating the asymmetry in the Eurozone as a whole.

Chapter 2: Theoretical framework

2.1 The neoclassical explanation

After the outbreak of the Eurozone crisis, prominent economists, social scientists and researchers contributed to an increasing body of literature, offering various perspectives and explanations for the turbulence in Europe. The *neoclassical explanation* is associated with the European Institutions, particularly the European Commission and the ECB, that dealt with the crisis in Europe. Despite the diverse voices within its Executive Board, the IMF adopted the neoclassical explanation in the unfolding Eurozone crisis.

According to the mainstream narrative, the Eurozone's problem can be attributed to individual governments that took advantage of the low interest rates and pursued a reckless fiscal policy (Magone, 2004; Diamantouros, 2011). This is the 'winning narrative' that has emerged in the public discourse since 2010 (Matthijs and McNamara, 2015: 230). Greece is the 'prominent case' in this narrative, as a country where populist politicians led to a massive fiscal crisis in 2009. In the eyes of the creditors, the Greek governments have been reluctant to fight vested interests and have turned a blind eye to corruption for decades. Even after the crisis, Greece failed to modernise its economy and is still suffering due to distortions in its market economy. Beyond Greece, reckless fiscal policy and reform fatigue were widespread in the periphery of the Eurozone. Portugal was considered to be a highly regulated labour market and a 'closed' economy too (OECD, 2013).

From this perspective, the economic crisis was the result of deep weaknesses that had been ignored by the national politicians for decades. The Eurozone periphery - particularly Greece and Portugal- suffered from fiscal derailment, stagnant productivity, and a chronic deterioration in their competitiveness. All of the above were largely the fruit of the irresponsible fiscal policy that increased wages and prices. Beyond that, they were the result of the obsolete labour market institutions: collective bargaining, inflexible hiring and firing laws, along with entry barriers in product markets (e.g.

protection against incomers) (Manasse and Katsikas, 2018). All of the above led to an unprecedented crisis in the Eurozone periphery in 2010.

2.1.1 The 'expansionary' austerity

The influential German minister of Finance, Wolfgang Schäuble, who played a key role in managing the Eurozone crash, set out the foundations of the 'medicine' for the unfolding economic crisis early on. In his own words, the 'only cure' for the indebted countries such as Greece and Portugal was fiscal contraction to mitigate profligacy and reforms to boost recovery. Schäuble's words summarised the EU and IMF orthodoxy: "*western democracies and other countries faced with high levels of debt and deficits need to cut expenditures, increase revenues and remove the structural hindrances in their economies…Only this course of action can lead to sustainable growth as opposed to short-term volatile bursts or long-term economic decline*" (Schäuble, 2011). This would stabilise the Eurozone as a whole. In other words, the longer politicians delayed the reforms, the worse it would be in terms of a recovery.

This narrative became the mainstream thinking among policymakers in Europe. In line with a new kind of *There Is No Alternative* (TINA) dogma, Schäuble turned a blind eye to the rising critical voices at the time, by arguing "*there is some concern that fiscal consolidation, a smaller public sector and more flexible labour markets could undermine demand in these countries in the short term… I am not convinced that this is a foregone conclusion, but even if it were, there is a trade-off between short-term pain and long-term gain… These efforts will inevitably bear fruit, but it will not come overnight*" (Schäuble, 2011).

How was such an economic orthodoxy shaped? Austerity is hardly a brand-new concept in the mainstream macroeconomic theory. As Blyth showed in his insightful book 'Austerity: the intellectual history of a dangerous idea', austerity dates back to the nineteenth century, while its foundations were laid even earlier in the work of David Hume and Adam Smith (Blyth, 2013). In Schumpeter's work, austerity is under *efficient market* conditions the driver for progress in capitalist economies.[1] According to his early work, capitalism progresses through *creative destruction* (Schumpeter, 1942).

[1] For a detailed historical account of austerity, see Blyth (2013).

Once a firm or an investment fails, it creates the conditions for new investments, innovation and, therefore, economic progress. Government intervention through public spending (i.e. subsidies and public services) negatively affects the natural process of *creative destruction* (i.e. through price manipulation) and delays economic recovery and progress.

Based on those principles, the *Austrian School* economists -with Friedrich Hayek and Ludwig von Mises being prominent among them- argued that in times of crisis, economies must adapt themselves to the real values by restricting spending and consumption (Mises, 1949). Expansionary fiscal policy or the manipulation of interest rates to keep the latter low prolong the recession, creating new bubbles. Any kind of government effort to maintain cheap credit flows opens up the path to new crises. Although stimulus policies could indeed boost growth in the short term, the realisation that growth is monetary inflation -a bubble- triggers panic in both investors and the public. This inevitably leads to a new crisis. Government interference through monetary and/or fiscal expansion in booms and/or busts just makes the crisis worse and delays recovery. Austerity is the way to curtail consumption, realise banks' and businesses' losses and kick-start recovery.

Those ideas gained momentum with the emergence of *Monetarism* in the 1960s and 1970s. Milton Friedman's work revived the arguments regarding fiscal contraction and paved the way for new austerity policies across the world. For monetarists, active fiscal policy or a high supply of money is in principle inflationary and harmful. Breaking themselves away from the Keynesian legacy, monetarists claimed that monetary policy should be taken away from the hands of politicians in favour of independent -meaning independent from political and electoral interests- central banks. Free from any political interference or pressure, the central banks would prevent stimulus, keeping inflation and prices low.

Based on those early ideas, austerity emerged as a dogma in the Eurozone. Such an austerity dogma was based on two main assumptions: 'credibility' and 'expansionary austerity'. The former was what highly indebted countries needed to rebuild investors' trust. But how can 'credibility' be built?

'Business confidence' theory -which was resurrected in the Eurozone- has its roots in the economic thinking in the United States in the 1920s. Herbert Hoover, President of the United States, was the pioneer who -under the banking sector's influence at that time- turned the confidence 'theory' into practice. The underlying

assumption is that governments are at risk of defaulting as long as they remain indecisive regarding turning a primary budget deficit into a surplus. To ameliorate those risks, governments should tighten their fiscal policy rapidly early on (Wren-Lewis, 2012). When governments are reluctant to reverse fiscal expansion or say 'no' to the bitter pill of austerity, 'credibility' is at risk. Creditors lose their trust and default comes closer. In the eyes of mainstream economists, no alternative exists. Governments must send the 'right signals' to markets. In that sense, 'confidence' constitutes a causal mechanism for growth rather than the opposite. Hoover followed the 'credibility' path to deal with the upcoming economic crisis in the early 1930s (Blyth, 2013: 127). However, the *Great Depression* came soon after that.

Despite the discouraging historical evidence, the 'credibility' theory has been influential among Eurozone leaders. Jens Weidmann, President of Bundesbank, claimed: "*we can only win back confidence if we bring down excessive deficits and boost competitiveness….in such a situation, consolidation might inspire confidence and actually help the economy to grow*" (Atkins and Wiggleswort, 2012). As Pedro Coelho, Prime Minister of Portugal in 2011-2015, also emphasised, "*we had to execute the Memorandum to make markets confident for us, for our economy*" (interview with the Portuguese Prime Minister Pedro Coelho, 2019). Those ideas also influenced the European Commission's Director General for economic and financial affairs, Marco Buti, and his colleague Lucio R. Pench. While they both recognised that a gradual consolidation is preferable in normal conditions, they claimed that "*the superiority of a gradual strategy tends to evaporate for high levels of debt and is also less pronounced for consolidation episodes following a financial crisis*" (Buti and Pench, 2012). Therefore, rapid fiscal consolidation -shock therapy- would make the insolvent countries 'credible' again for creditors and investors. In contrast, a gradual approach or any attempt to spread out the consolidation over several years would be seen by the markets as an insufficient fiscal effort to end the crisis. This would presumably push the struggling countries deeper into the crisis. Austerity was the way to a healthy and sustainable recovery. The markets would be reassured only if the governments had credible plans to bring the deficits down. As soon as business confidence was restored, the growth would gain momentum. Only then would sustainable growth resume.

The second assumption was the belief that fiscal contraction can be 'expansionary'. In a controversial study, Reinhardt and Rogoff (2010) showed[2] that an increasing level of public debt that exceeds 90% of GDP in Europe, even beyond the periphery, is harmful for medium-term growth. A number of recent studies have brought new evidence to support this argument (Kumar and Woo 2010; Cecchetti *et al*. 2011). Alberto Alesina and Francesco Giavazzi went a step further by reversing causal inference. They paradoxically claimed -deviating from the Keynesian economic principles- a positive relationship between fiscal contraction and economic growth.

Almost three decades ago, Giavazzi and Pagano (1990), through examining Demark and Ireland in the 1980s, argued that government fiscal consolidation through austerity increases private economic activity and can sustain high growth rates. In their influential paper they claimed -violating the primary Keynesian principles- that Ireland was "the most prominent example of an expansionary cut in public spending". A similar argument was put forward by Drazen and Bertola (1993), who examined the relationship between government spending and private consumption, a central question in neoclassical economics. They argued that in the case of fiscal adjustment through government expenditure cuts, private consumption actually rises.

Alesina and Perotti (1995) later examined the relationship between fiscal contraction and debt to GDP ratio in twenty OECD countries over 32 years, arguing that 'successful adjustments' can only be achieved through public expenditure cuts. They found that expenditure cuts increase private investment as a percentage of GDP. They declared that, "the good news is that major fiscal adjustments do not cause major recessions" (Alesina and Perotti, 1995). This was a complete reversal of Keynesian thought.

Alesina and Ardagna (1998) expanded their work with a new study examining the OECD countries to identify the causal mechanism that makes fiscal adjustment 'expansionary'. 'Fiscal adjustment' was defined as "a year in which the cyclically adjusted primary balance improves by at least 2 percent of GDP or a period of two consecutive years in which the cyclically adjusted primary balance improves by at least 1.5 percent of GDP per year, in both years" (Alesina and Ardagna, 1998). They found that out of 51 cases of tight fiscal policy, 19 were 'successful' and 23 were

[2] Their data were heavily contested (Gongloff, 2013).

‘expansionary’.[3] All of the ‘expansionary’ cases were, according to the econometric model, achieved through expenditure cuts, while the ‘successful’ cases went through a rapid investment increase after the fiscal adjustment. However, they claimed that the evidence was not robust. Despite the weak evidence, their findings proved rather influential when the crisis hit the Eurozone.

In 2009, Alesina and Ardagna updated their work, testing the same hypothesis that they had proposed eleven years earlier (Blyth, 2013: 130). In a new article entitled, ‘Large Changes in Fiscal Policy’, they tracked 26 cases of ‘expansionary adjustment’ in nine countries. They argued that in contrast to Keynesian macroeconomics, “a one percentage point higher increase in the current spending to GDP ratio is associated with a 0.75 percentage point lower growth”[4] (Alesina and Ardagna, 2009). They argued for a fiscal adjustment based on spending cuts rather than raising taxes. Their explanatory mechanism was that “wealth effects on consumption arise most directly in case of government spending cuts perceived as permanent… the consumers would anticipate a permanent increase in their lifetime disposable income due to the reduction in the tax burden” (Alesina and Ardagna, 1998). According to their expectation-based model, consumers and investors will invest more as they believe that “the large tax increases will not be necessary in the future” (Alesina and Ardagna, 1998). Therefore, when governments cut spending and wages, expectations are high. Their bottom line is that “*spending-based stabilisations ... are often accompanied by an increase in output within a year*” (Alesina and Giavazzi, 2012). Therefore, austerity -based on spending cuts- can boost growth. Based on those principles, governments in the Eurozone should change their fiscal policy, turning budget deficits down straight away.

‘Expansionary austerity’ gained support among European leaders. Alesina presented his work at an ECOFIN meeting with all of the ministers of Finance in the Eurozone in April, 2010 in Madrid. Those ideas proved to be astonishingly influential on the President of the ECB, Jean Claude Trichet and other Eurozone leaders, and

[3] A tight fiscal policy is defined as ‘successful’ if a) in the three years after the tight period, the ratio of the cyclically adjusted primary deficit to GDP is on average at least 2 percent of GDP below its value in the year of tight policy, or b) three years after the tight period, the ratio of the debt to GDP is 5 percent of GDP below its level in the year of the tight period. A fiscal policy is ‘expansionary’ ‘if the average growth rate of GDP, in difference from the G7 average, in the period of the tight policy and in the two years after is greater than the average value of the same variable in all episodes of tight policy’ (Alesina and Ardagna, 1998: 498).

[4] The IMF debunked Alesina and Ardagna’s claims (Guajardo *et al.*, 2011).

shaped the management of the crisis in the Eurozone. Academic research and political will converged. This was the beginning of Europe's austerity moment.

2.1.2 The internal devaluation

Under the austerity dogma, the crisis-hit countries were forced to pursue an internal devaluation policy to deal with the crisis. In the context of the Eurozone, countries enjoy limited economic and monetary power to face the negative effects of any kind of asymmetric shock. Eurozone member states cannot devalue their currencies -as countries in balance of payments deficit usually do- to boost exports and combat trade imbalances. In the past, the IMF and World Bank's bailout programmes have pushed almost all developing countries to pursue large-scale currency devaluations to restore competitiveness (Williamson, 2004-5: 197). Currency depreciation plays a dual role. First, domestic goods become inexpensive to foreigners, meaning that it gets easier for local producers to enter into international trade and compete with foreign producers. Second, foreign products become expensive for domestic consumers and thus the latter move away from foreign goods and towards local production. Therefore, currency devaluation can improve the trade balance, as it sets the conditions to boost a country's exports and limit the local demand for imports. As evidence from the bailout programmes in the developing world shows, currency devaluation raised exports' price competitiveness and volume[5] in some cases (e.g. Ghana, Tanzania, Turkey, Côte d'Ivoire). However, other developing economies -suffering from land, production scale and technology constraints- failed to achieve a dynamic export recovery[6] (e.g. Malawi, Niger, Congo).

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[5] Ghana proceeded to a gradual currency (cedi) devaluation in 1983-1986. GDP growth returned to a relatively high level, and exports grew at an annual average rate of 9% over the next decade. Tanzania also devalued its nominal exchange rate by 60% in 1986 and then again several times. The nominal exchange rate devaluation was 95% between 1986 and 1992. Tanzania's GDP per capital started growing from the mid-1990s. Both Ghana and Tanzania increased their non-primary sector share of total added value to GDP (Maehle *et.al*, 2013). Turkey devalued its currency by 51 % and cut real wages by 20 % in 1999 (Yeldan, 2008). The programme crashed 14 months later and kicked off a new crisis in February 2001. The IMF provided a new concessional package, raising the previous $ 9. 4 billion credit to $ 19 billion (Arconian, 2013). The Turkish economy grew at an average of 6% per annum from 2002- 2007. This was one of the highest growth rates in the world during that period.

[6] For instance, Malawi has depreciated its currency (kwacha) several times since 1984. In almost all cases, the currency depreciation has resulted in high inflation and low GDP growth. Malawi suffered from

In the absence of currency devaluation in the Eurozone, the EU and IMF substituted currency depreciation for a large-scale internal devaluation. As Oliver Blanchard, chief Economist at IMF, said: "*in countries with flexible exchange rates, the improvement of competitiveness can be achieved through currency depreciation. In a country which is part of a common currency area, it has to be achieved by decreasing nominal wages and prices*" (Blanchard, 2012). Therefore, internal devaluation was the driver for adjustment in the Eurozone. Although the academic literature on internal devaluation is limited, its main economic assumptions have their roots in neoclassical economic theory (Layard *et al*., 1991; Bean, 1998; Layard and Nickell, 1998; Boeri *et al*., 2000). Internal devaluation was seen as the means to achieve a rapid adjustment in the 'profligate' periphery. A radical cut in public sector wages would automatically mean fiscal account adjustment. Beyond fiscal purposes, internal devaluation would be the driver for export-led growth. For the mainstream neoclassical thinking, the underlying cause of the crisis was the rising labour cost in those economies. The high labour cost presumably pushed the southern countries into an unpleasant position in relation to their counterparts in Europe and beyond. It increased the production cost in the peripheral countries and thus their international competitiveness fell rapidly.

Internal devaluation is the way to kick-start a process to achieve price competitiveness. In neoclassical theory, the competitiveness of a country is the maximum level of production with stable inflation. To achieve this, governments need to suppress the minimum wage and deregulate the labour law (i.e. employment protection and collective bargaining). Internal devaluation through wage suppression improves competitiveness, leads to higher external demand for local production, and improves the balance of payments. Wage moderation in the public sector exerts downward pressure on wages in the private sector, leading to a substantial fall in production costs in the economy as a whole. Price depreciation against trading partners will restore international competitiveness. Under those conditions, higher exports and lower imports will improve the balance of payments, and the longstanding trade deficit will go down (Obstfeld and Rogoff, 1996).

Beyond the above assumptions, internal devaluation will presumably have positive externalities in regard to foreign direct investment. In the global economy, countries compete to attract global investors and multinational corporations. Wage rates

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inefficient production capacity and low diversification. It was largely dependent on tobacco and failed to diversify its production to sustain the benefits of the currency devaluation in the long term.

are among the factors that investors consider before investing abroad. Therefore, pushing the labour cost down would allow the crisis-hit economies to attract new foreign investments. Investors are eager to invest in well-developed economies - members of a large single market- with advanced infrastructure and a relatively low labour cost. Overall, internal devaluation has been the most important component of the bailouts in Europe.

2.1.3 Neoliberal market reforms

Beyond internal devaluation, neoliberal market reforms would -according to neoclassical economics- boost the sluggish productivity in the periphery of the Eurozone. Such market reforms -based on the 'Washington consensus' principles- were used by the IMF and the World Bank in the developing countries a few decades earlier. Most of the developing countries were forced under the structural adjustment programmes to transform their import substitution industrialisation (ISI) system to an open free market economy in the 1980s and 1990s. This was achieved by the elimination of any kind of trade protection (i.e. subsidies, tariffs), shrinking the role of the state (i.e. planning, public enterprises), and large-scale privatisation programmes. Although the EU and IMF encouraged such neoliberal reforms, which had been used in the past, the Eurozone countries did not pursue a complete transformation from a socialist-type economy to free-market capitalism. The Euro countries had abolished trade tariffs among themselves with the creation of the European Custom Union (1958) and any trade protection when they joined a well-advanced Singe Market in 1993. Therefore, the EU and IMF bailout programmes aimed to 'correct' specific market 'distortions' in the labour and product markets rather than pursuing a full-scale economic liberalisation.

In neoclassical theory, 'excessive' regulation in the labour and product markets distorts the market function, producing negative spillover to the economic activity. In the European periphery, chronic reluctance in relation to reforms led to poor allocation of resources, market distortions, and a productivity gap with the frontier European countries. Excessive regulation set barriers to productive investments.

In a recent report, the European Central Bank (ECB) stated that "robust evidence has been collected showing how excessive regulation in certain sectors negatively affects productivity growth and helps to explain the productivity gap between countries operating at the frontier and the followers" (European Central Bank, 2017: 65). Poul Thomsen, Director of the European Department of the IMF, also claimed: "*we have found that the lack of convergence mainly reflects persistent gaps in productivity growth across countries... structural reforms can help improve productivity is obvious… But what our analysis shows is that not only do they boost productivity, the boost is larger in countries with lower levels of productivity. This is good news… It confirms that even if all countries pursue structural reforms this helps close the productivity gap between countries with lower per capita incomes and those with higher per capita incomes"* (Thomsen, 2017). Klaus Regling, Managing Director at European Stability Mechanism (ESM), referring to the bailout programmes in Greece and Portugal, stated that "*with the full implementation of the agreed reform packages…the economy will become more efficient, more productive and that will improve growth prospects*" (Regling, 2016). In the eyes of the EU and IMF, the so-called 'structural' reforms, meaning the deregulation of labour rights and the opening up of the product market, would transform the struggling economies.

Market reforms were based on an extensive body of literature claiming that there is a causal relation between deregulation and productivity growth (OECD, 1994; 2002; 2007; 2008; Alam *et al*., 2008; Bassanini *et al*., 2009; Cingano *et al*., 2010). In neoclassical economic theory, competition ensures that the market allocates resources via price mechanism resources to the most productive sectors. Any intervention limits the efficient market forces and therefore is harmful to productivity (Coase, 1988).

In line with this perspective, stringent labour market conditions -for instance wage rigidities or high employment protection- distort the efficient allocation of resources, negatively affecting productivity (Bassanini *et al*., 2009; Bernal-Verdugo *et al*., 2012). First, excessive labour protection means less hiring and firing among firms and sectors. This hinders the recruitment of more productive workers (Blanchard and Portugal, 2001; Autor *et al.*, 2007). Barriers to the reallocation of human capital mean labour productivity loss (OECD, 2015).

Second, in a 'closed' economy, the adjustment cost is high. Firms cannot adjust the labour cost to absorb shocks and restore competitiveness quickly. In a moment of

crisis, the government must deregulate the labour market quickly to ensure that firms can adjust the number of employees they have and, therefore, the cost of production.

Third, a flexible labour market sets the conditions for a technological upgrade. Under conditions of excessive regulation, firms are reluctant to experiment with introducing new technologies due to the high cost of workforce adjustment combined with the uncertain outcome of innovative investments (Bartelsman *et al.* 2003; Malcomson 1997; Flanagan 1999; Bassanini and Ernst 2002; Scarpetta and Tressel 2004). Deregulation would presumably allow the peripheral countries to upgrade their production capacity by experimenting with new technologies and/or management techniques. This would be less costly than before.

Fourth, the provision of generous (high and long-term) unemployment benefits induces *moral hazard* by allowing the recipients to substitute the benefits of productive work or job hunting (Hansen and Imrohoroglu, 1992). Generous benefits relax the constraints on household budgets and manipulate labour-leisure decisions in a way that is harmful to productivity (Katz and Meyer, 1990; Meyer, 1990; Cullen and Gruber, 2000; Lalive, 2008; Cheptea *et al.* 2014). A substantial reduction in unemployment benefits will supposedly make free-riders return to the job market. This will reduce unemployment and force workers to be more productive.

In parallel, the opening up of 'closed' professions -lawyers, pharmacists, notaries, and accountants, among others- will infuse competition in sluggish sectors. In a 'closed' economy, regulation limits the access of incomers to those professions. Furthermore, regulation sets the rates that can be charged for services and protects the 'exclusive rights' of a privileged minority working in those sectors. In the eyes of free-market economists, all of the above violate competition and hold back the performance of these sectors. Reforms should expose those professions to competition, facilitating the mobility of qualified professionals across the single market, and cross-border services. Competition means gains for consumers and firms, and higher economic growth (Canton *et.al*, 2014).

In a product market, 'structural' reforms induce tougher competition in 'closed' sectors in favour of the reallocation of resources (i.e. labour, capital) in low-productivity economies. In theory, under conditions of undistorted competition, most productive firms expand into the domestic and foreign markets and push the less productive firms out (Melitz and Trefler, 2012; Canton *et.al.*, 2014). The exposure of low-productivity firms to international competition shrinks their market share and profits, pushing them

to use higher level technology and better management to increase their productivity (Perla et al., 2015). This becomes a necessary condition for them to survive.

Finally, the opening up of those economies would create room for trade expansion and foreign investment inflows (Crespi *et al*., 2008; Duguet and MacGarvie, 2005). Open trade would connect local firms with efficient foreign producers and get the former closer to the advanced economies (Alvarez et al., 2013; Acemoglu and Linn, 2004). Knowledge exchange between foreign corporations and local firms would be in benefit of the lagging crisis-hit economies (Puga and Trefler, 2010). Overall, 'free-market' reforms would -through the *invisible hand* of the market- accelerate the re-allocation of labour and capital in an efficient way. Firms would be encouraged to restructure themselves and upgrade their production capabilities. Know-how infusion would accelerate this transformation. The crisis-hit countries -Greece and Portugal, among others- would be able to shrink the productivity gap and achieve a speedy economic recovery.[7]

2.1.4 Greece versus Portugal

For the creditors, this was the way that Greece and Portugal should have gone in the aftermaths of the crisis in 2010. These 'profligate' economies brought the whole Eurozone to the verge of collapse in the late 2000s. From the perspective of the 'winning narrative', Greece and Portugal have followed different paths since 2010. Greece's long recession -in spite of the bailout programme- shows that the country has failed to do what it should have done. From this perspective, Greece is considered to be a special case that has failed to recover from the crisis, while Portugal is a country that has consolidated its public finance and reformed its economy. Greece was the only country that went through three bailout programmes and yet did not manage to return to the financial markets.

For the EU and IMF, the underlying cause of the deep recession in Greece was its lack of commitment to the reforms. Christine Lagarde, IMF Managing Director at the time, claimed that "*Greece was unique*" (Lagarde, 2015) as it failed to implement the

[7] The European Union promoted productivity growth and competitiveness for convergence within the Union horizontally in the recent decades (i.e. through the European Employment Strategy, Lisbon Strategy).

"*unpopular but necessary*" fiscal consolidation, and "*the programme was beset by recurrent political crises, pushback from vested interests, and severe implementation problems that led to a much deeper than expected output contraction*" (Lagarde, 2016). Greek politicians were reluctant to go against vested interests, combat tax evasion, open up the closed professions, and permit public sector dismissals. They were trying to 'buy' time in the negotiations and defer the programme's 'tough' measures. The Greek populist politicians refused to take on the political cost of reforming the backward economy (Featherstone, 2015). Only a few of the EU and IMF conditions have been implemented since 2010. Greece is a stubborn 'sick man' who has refused to take his medicine.

Jose Manuel Barroso, President of the European Commission, was also concerned about the backlash against the reform effort in Greece. He conveyed the message to the Greek Prime Minister, Antonis Samaras in 2012: "*to maintain the trust of European and international partners, the delays must end. Words are not enough. Actions are much more important... the key word here is: deliver, deliver, deliver*" (Barroso, 2012). The old-fashioned public administration system and its staffing with poorly qualified employees hindered the implementation of the reforms too (Featherstone and Papadimitriou, 2008). According to Poul Thomsen, Head of the IMF mission in Greece, *'growth assumptions were too optimistic because of the limited administrative capacities of Greece'* (Spiegel and Hope, 2013). Rent-seeking and corruption within the Greek government authorities have also been factors that have restrained the success of the programmes. All of the Greek governments have persistently refused to track down tax evasion (Kalyvas *et al*., 2012).

Several political crises have negatively affected the bailout programme implementation since 2010. Those political developments along with Grexit fears have hurt the reform momentum and destabilised the economy. Moreover, the social resistance against the programme and the emergence of an 'anti-austerity' government in 2015 that was openly against the programme undermined the recovery prospects (Blanchard, 2015). For the creditors, the 'populist', left-wing Syriza party opposed any reform in 2012-2015, and blocked the programme's implementation when it came to power in 2015. Syriza's negotiation tactics led the Greek economy to the verge of bankruptcy in 2015.

Overall, for the EU and the IMF, Greece is a 'special case' in comparison to other crisis-hit countries that have successfully completed the programmes and returned

to the financial markets. For the influential former Vice President of the European Commission, '*the bailouts in Ireland, Portugal, and Cyprus were -leaving the social consequences aside- successful in economic terms. Greece was a unique case*' (interview with the Vice President of the EC, 2019). For Wolfgang Schäuble, German Minister of Finance, 'no-one else is responsible for Greece's mistakes' (Schäuble, 2015).

On the contrary, Portugal has been praised for its macro-economic performance. The EU highlighted that "*Portugal's implementation of the programme has succeeded in improving public finances, stabilising the financial sector, and setting the economy onto a path towards recovery*" (European Commission, 2014). Beyond fiscal consolidation, Portugal has been successful in implementing several reforms to recover from the crisis (European Commission, 2014). Portugal has indeed implemented the programme under rather different political conditions. Pedro Passos Coelho, the Prime Minister who implemented the Memorandum in Portugal (2011-2015) stated that: "*There were protesters in Portugal, too. Many people were in the streets especially in 2012. But the unions were mature. We had a common strategy with unions and the representatives of the enterprises. This made a big difference*" (interview with the Portuguese Prime Minister Pedro Coehlo, 2019). The programme was concluded with a few months' delay. According to Wolfgang Schäuble (2014) *'Portugal's reform efforts have paid off. Portugal no longer needs European assistance and can stand on its own two feet again…this is a major success'*.

2.2 The Keynesian/'Iphigenia in Aulis' explanation

2.2.1 Eurozone 'in denial'

The second Keynesian explanation -called '*Iphigenia in Aulis*'/'*victimisation*' in the rest of this thesis- gives a different perspective on what happened to Greece, Portugal and the periphery as a whole. It consists of an amalgam of Keynesian assumptions against the neoclassical explanation. For Keynesian critics, the European leaders failed to act decisively to prevent the crisis from spreading in the Eurozone. The EU was slow in identifying the early signs of the crisis in Greece. Criticism came from various perspectives. However, all of those different perspectives emphasise the creditors' crisis response as the 'triggering factor' that turned a manageable debt crisis in Greece into a large-scale Eurozone crisis.

Academics and economists criticised the European Union for failing to react swiftly soon after the outbreak of the crisis. The Eurozone leaders seemed to be in denial in 2009-2010 and had no mechanisms to support Greece (De la Dehesa, 2011). The management of the crisis in the Union was indeed a complex process of compromise between various interests and bureaucratic organisations. Credibility issues arose at the most critical moments of crisis. In many cases, the Eurozone leaders were sending contradictory messages to the markets even from the early stages of the crisis. In 2009, Peer Steinbruck, the German Finance Minister at the time, stated, '*Eurozone member states would have to rescue those running into difficulty*', while Angela Merkel stated later on a German public TV channel that, '*there is absolutely no question of it (a Greek bailout) ...we have a European Treaty under which there is no possibility of paying to bail out states*' (Matthijs, 2016). This was just one of a series of episodes that fuelled the markets' mistrust against the Euro. In October 2011, when *Moody's* put France's AAA rating at risk, Wolfgang Schäuble, the German Finance Minister who succeeded Peer Steinbruck, said that no 'bazooka' would be used to solve the crisis, triggering further turbulence in the Eurozone (Matthijs, 2016: 386). In a public statement in 2011, Jean-Claude Juncker, President of the Eurogroup and then President of the European Commission, argued, referring to Greece, that "*when it becomes serious, you have to lie*" -a phrase that made investors much more concerned about

Greece's finances. Unsurprisingly, these contradictions among the EU leaders caused confusion and fuelled the markets' scepticism, leaving insolvent countries at the mercy of speculative attacks.

Several meetings had to be conducted between the German and French leaders to coordinate their actions to deal with the crisis. According to one of the former Vice Presidents of the Commission, "*the Union had no mechanisms to deal with the crisis in 2009. The EFSF was created in 2011. In 2009, Greece had to proceed with bilateral loans from other countries. It was not easy to make quick decisions under those conditions. Many players in the game…governments…national money*" (interview with Vice President of the EC, 2019).

In many respects, the crisis brought to light the deep divisions in the Eurozone. Contradictions arose over various issues. The role of the IMF was one of them. At the early stages of the crisis, Nicolas Sarkozy, President of France, was firmly against any external support, claiming: "*I will never allow the IMF in Europe*" (World Finance, 2012). In the same line, Axel Weber, President of Bundesbank in 2009, stated that "*there is no role for the IMF* (in Europe)". Angela Merkel, Chancellor of Germany, declined those claims, stating that "*Europe itself is not in a position to solve such a problem*" (World Finance, 2012). The internal contradictions among the key players involved in the management of the crisis fuelled uncertainty and -in line with this narrative- deepened the crisis (Truman, 2013: 18). Yanis Varoufakis, Minister of Finance of Greece, who tried to renegotiate the bailout conditions with Greece's creditors in 2015, wrote in his influential book, 'Adults in the room: my battle with the European establishment', that the European leaders were in denial in terms of seeing the European 'nature' of the crisis in 2010. They believed that this was just a Greek crisis that should be ended within Greece's borders. For Varoufakis, the European politicians exhausted themselves by being in "*a pointless bargaining mood that considered nothing other than the details of non-solutions*" (Varoufakis, 2011).

2.2.2 The 'lender of last resort'

The Keynesian critics argued against the European Central Bank, which failed -due to suffering a problematic structure- to act as a *lender of last resort* and thus pushed

the indebted countries deeper into crisis. The peripheral economies -as De Grauwe's analysis shows- having surrendered their monetary policy to the ECB, were defenceless at the moment of the crisis. The ECB was reluctant to react decisively. This turned Greece's liquidity issue into a large-scale insolvency crisis in the periphery (De Grauwe, 2016).

Panicked by the enormous liquidity outflows, investors lost their trust towards Greece, Portugal and Spain. They started selling government bonds on mass, pushing interest rates to unsustainably high levels. This was the beginning of the Eurozone's solvency crisis. The ECB -stuck to its 'principal' monetarist duty- could not purchase sovereign bonds (Article 123, TFEU; Matthijs and Blyth, 2011). Jean-Claude Trichet, the powerful President of the ECB, remained faithful to the 'low inflation' dogma when the periphery was facing an economic Armageddon. According to the Keynesian economists, the monetarist ideas remained powerful against proposals for quantitative easing and interest rate relaxation policies. Even a few days before the bailout agreement for Greece, on May 6^{th,} in Lisbon, Trichet denied that the ECB would buy bonds, making it clear that, "*we did not discuss this option*" (Bastasin, 2016: 187). Angela Merkel, the German Chancellor, also defended him against voices -mainly from France,[8] whose banking sector was heavily exposed to the sovereign bonds of the periphery- asking for active ECB intervention to support the European banks: "*the European currency union is based, and this was a precondition for the creation of the Union, on a central bank that has sole responsibility for monetary policy… I am firmly convinced that the mandate of the European Central Bank cannot, absolutely cannot, be changed*" (World Finance, 2012).

As the crisis spread, investors started selling Spanish, Portuguese and Italian governments bonds -as the Greek ones seemed unsellable at the time- in their portfolio. Only then did the ECB make the decision to buy sovereign bonds in the secondary market, extending the Securities Market Programme (SMP) to Ireland, Portugal, Spain and Italy, with the aim of bringing down the climbing borrowing costs in 2013. For Keynesian economists, this was 'too little too late'. The ECB had failed to prevent the crisis from spreading in the periphery (Krugman, 2017).

[8] French minister, Francois Baroin, claimed at the end of 2011 that, "the best response to avoid contagion in countries like Spain and Italy is, from the French viewpoint, an intervention [or] the possibility of intervention or announcement of intervention by a lender of last resort, which would be the European Central Bank" (World Finance, 2012).

Mario Draghi, who replaced Trichet in the ECB, promised in a memorable speech that the ECB "*is ready to do whatever it takes to save the Euro… and believe me it will be enough*" (Draghi, 2013). Draghi launched the Outright Monetary Transactions (OMT) to expand government bond purchases for insolvent countries in the secondary market of bonds -expanding the SMP- to unlimited amounts. This political move finally made the ECB an institution resembling a *lender of last resort* for banks and sovereigns. Unfortunately, this was not before 2013.

2.2.3 European Financial Stability Facility (EFSF): 'too little too late'

The Eurozone had -according to its critics- no structures to deal with the crisis (Truman, 2013: 12). Such mechanisms had to be created from scratch. A consensus among sixteen Eurozone countries at that time was hard to achieve. Amid the fire of the crisis, the Eurozone leaders set up a temporary European Financial Stability Facility (EFSF) -an international agreement rather a mechanism subject to the EU law- to assist countries facing refinancing issues in May 2010. Its lending capacity reached €440 billion. According to Horvath and Huizinga (2011), the size of the EFSF and its lending capacity was 'too little' to provide guarantees to indebted economies and 'too late' to prevent the insolvency crisis. The EFSF was a slow and bureaucratic mechanism. Unanimity was needed to utilise the pool of resources for distressed countries (Brunnermeier *et.al.*, 2016: 128). Beyond that, no provisions were made for the EFSF to buy debt in the secondary markets to relax the pressure on the economies at risk (De la Dehesa, 2011). Unsurprisingly, the EFSF was not enough to calm the markets. In October 2011, the Eurozone leaders recognised that. They leveraged up its capacity to €780bn and granted the EFSF powers to offer credit lines to countries under attack, to recapitalise banks, and to purchase bonds from of countries in the secondary market (Wyplosz, 2011; Horvath and Huizinga, 2011).

The EFSF's problematic mandate and the ECB's reluctance to act as a lender of last resort caused the second phase of the Eurozone crisis, where Italy's and Spain's debts were at risk (Delbecque, 2011). According to Keynesian critics, the Eurozone should have followed an alternative course of action: it should have set up financial supervision early on, created an EU budget as a crisis management tool, and established

a European Monetary Fund (Brunnermeier *et al,* 2016: 20). Without those mechanisms the contagion of the crisis from Greece to Portugal and the whole periphery was inevitable.

On top of the above, the EFSF loans were subject to high interest rates (close to 6%). Such interest rates were far higher than the growth rates in those economies and, therefore they caused a snowballing effect, increasing the debt burden much faster than those countries could service their debts (Gros, 2011). In reality, the Eurozone leaders added expensive debt on top of the existing unsustainable debt, pushing peripheral economies -especially Greece- further into debt crisis (Wyplosz, 2011). For Keynesian critics, this seemed to be a 'punishment' rather than a real rescue programme (De la Dehesa, 2011; Eichengreen, 2010).

2.2.4 'Pretend and extend'

The Keynesian economists shed light on the EU and IMF's neoclassical economics dogmatism. The Eurozone leaders -Jean Claude Trichet being prominent among them- were firmly against any kind of debt restructuring with private sector involvement (PSI) in 2010. For Keynesian critics, the Greek debt was, by any means, unsustainable in 2010. The European authorities and the IMF Board of Directors were aware that Greece could not refinance its accumulated debt (IMF BoD, 2011). However, the Europeans pursued a *pretend and extent* dogma. For the Eurozone leaders, an early Greek debt restructuring in 2010 -before the first Greek bailout agreement- would have had tremendous negative consequences for the European banks -the French and German ones among them- that had been largely exposed to Greek government bonds. Debt restructuring in 2010 would have put those banks at risk. This would have had consequences not just for the banks in France and Germany, but for the whole European banking sector. Therefore, debt restructuring was off the table until 2012. According to the former Greek Minister of Finance, who negotiated the first bailout agreement for Greece: "*Trichet from the ECB was concerned that a debt restructuring would be destructive for the banking sector in the Eurozone. He believed that this would turn other countries insolvent too. The debt issue was 'out of discussion' in the Eurogroup. It was clear that Germany and France did not want to open a discussion about our debt*

and any kind of debt restructuring…Of course, we believed that our debt needed restructuring. We believed that debt relief was not necessary. But we knew that we needed more time to repay the debt, so a debt repayment extension would be a solution. Of course, we asked for this in the bilateral meetings with Germany and France. The answer was again that this issue should not be discussed" (interview with the former Greek Minister of Finance, 2019). Indeed, it was not discussed. The former Vice President of the Commission argued: "*we had no discussion about the Greek debt in the College of Commissioners. Commission had no authority to discuss about this topic. There was no discussion. This topic was discussed in bilateral level with the banks, not the Commission*" (interview with former VP of the European Commission, 2019).

The delay in taking action against the mounting debt further destabilised the European periphery (Wolf, 2011). The rising Greek debt caused concerns for other peripheral economies as well. Portugal was expelled from the markets, while Spain's sovereign rating was downgraded by *Standard & Poor's* from AA+ to AA. Investors started selling off Italy's government bonds too (Bastasin, 2016: 177).

For Varoufakis, '*in 2009 even Germany's Chancellor Merkel panicked when told that her government had to inject overnight 406 billion Euros of taxpayers' money into the German banks…A few months later, Mrs Merkel's aides informed her that, just like the German banks, the over-indebted Greek state was finding it impossible to roll over its debt. Had it declared its bankruptcy, Italy, Ireland, Spain, and Portugal would have followed suit, with the result that Berlin and Paris would have faced a fresh bailout of their banks greater than 1 trillion. At that point, it was decided that the Greek government could not be allowed to tell the truth, that it, confess to its bankruptcy. To surrender, Athens was given, under the smokescreen of solidarity with the Greeks, the largest loan in human history, to be passed on immediately to the German and French banks*' (Varoufakis, 2018). According to Eichengreen and Wyplosz, creditors agreed to continue pretending that Greece could pay all of the money back in just a few years (Eichengreen and Wyplosz, 2016).

This *pretend and extend* dogma found supporters within the IMF. Despite the critical voices, the Fund turned a blind eye to the rising concerns over the Greek debt, declaring Greece a 'systemic exception' (IMF BoD, 2011). Strauss-Kahn, former Managing Director of the IMF, declined a debt restructuring before the first bailout for Greece, saying "*I think Greece can make it*" (Wearden and Inman, 2011). For

Varoufakis, this *pretend and extent* dogma "will not allow Greece to escape its economic death trap" (Varoufakis, 2015).

What should have happened instead? Eichengreen and Wypolsz claimed that the Eurozone leaders should have agreed on an early debt restructuring in Greece and elsewhere in the periphery (Eichengreen and Wyplosz, 2016). This was necessary in economic terms. It was historically imperative too. In world economic history, several countries have agreed on debt restructuring with their creditors to recover from sovereign debt crises. After the oil crisis at the end of the 1970s, most countries in Sub-Saharan Africa and Latin America faced a debt crisis. Under the heavily indebted poor countries (HIPC) initiative, the IMF and the World Bank have agreed with 36 countries -30 of them in Africa- on substantial debt relief since 1996. Some of the HIPC countries -taking advantage of the debt relief- achieved a high GDP growth after the bailout programme: Ghana, Mozambique, Tanzania, and Uganda, among others.[9] However, other countries that relied on primary commodities failed to diversify their exports and started accumulating debt soon after the debt relief (Benin, Malawi, Niger, Senegal, Congo, Sierra Leone, Zimbabwe).

Based on such historical evidence, Keynesian economists insisted that the Eurozone leaders should preventively restructure the debts in countries with public debts above or close to 90-100 % of their GDP (Wyplosz, 2012). For Keynesian economists, the Greek, Portuguese and Irish debts together were less than 700 billion, accounting for roughly 9% of the Eurozone public debt. Therefore, a debt restructuring would not have been destructive to the Eurozone economy in economic terms (Baltasin, 2016:133-134). Instead, it would have prevented a contagion and allowed countries to

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[9] Mozambique, after substantial debt forgiveness under the Heavily Indebted Poor Country (HIPC) initiative, returned to fiscal sustainability and achieved a gradual economic acceleration. The World Bank's financial assistance for investments in infrastructure projects and public services facilitated the modernisation of its economy. Funding along with incentives for investments in new small and micro business ventures supported small scale production and enhanced diversification. Mozambique has achieved high growth rates in recent decades (World Bank, 1994). Tanzania has received large inflows of IMF and World Bank financial support since 1986. After the relief of 85 % of its total debt, and through the establishment of financial incentives to foreign investors such as tax exemptions, it achieved a gradual development of its mining and manufacturing sectors (Mahamba and Levin, 2005). Tanzania has achieved high growth rates-with an average of 7% a year - since 2000 (World Bank, 2010). In Ghana, creditors accepted early debt forgiveness to avoid an economic default and pressured for a dramatic exchange rate depreciation (Konadu- Agyemang, 1999). The country achieved a quick economic recovery in the 1990s (Loxley, 1990). Finally, Uganda agreed with the IMF and World Bank over a structural adjustment programme in the late 1980s. Creditors agreed to debt relief of 85 % of the total debt, and to a flexible exchange rate policy. The country increased its exports of construction materials towards its neighbouring countries (Brett, 1998).

resume growth soon after the crisis. Debt restructuring was agreed only when the *too big to fail* European banks sold off the toxic bonds in March 2012. The Greek debt of €100 billion was indeed written off. This was *too little too late* (Sandbu, 2015: 68, Pisani-Ferry *et.al*, 2013).

2.2.5 The self-defeating austerity

Moreover, the European leaders' refusal to restructure the rising debt in the periphery set the foundations for the Eurozone's draconian austerity. As will be shown, politics played a major role in Europe's austerity moment. For Keynesian economists, 'confidence' theory was largely a problematic concept. In neoclassical orthodoxy, the 'wealth effect' on consumption is based on the expectation of lower taxes in the future. Credibility arises when governments are determined to make spending cuts. 'Confidence' supposedly follows a rapid and permanent adjustment.

The Eurozone economies, including Greece and Portugal, were forced to follow a 'decisive' fiscal policy, reducing public spending to mitigate the default risks and restore confidence. Any delay in fiscal austerity would -according to neoclassical thinking- push the economy on to an inevitable path of a downward spiral. Paul Krugman and Joseph Stiglitz, among Keynesian critics, argued that harsh austerity in terms of speed and intensity in the Eurozone caused the opposite effects of what 'confidence theory' suggests (Krugman, 2010).

'Shock therapy' was largely used in the developing world a few decades ago (Stiglitz, 2003). In a recent paper, Reda Cherif and Fuad Hasanov[10] (2013) showed that an 'austerity shock' in weak economies is self-defeating, while it also fails to decrease the public debt ratio. The harsh austerity in the Eurozone sabotaged the recovery efforts. In his *Financial Times* article entitled, 'Give Greece Time to Prove It Can Do the Job', George Papakonstantinou, who had to implement the first bailout programme, criticised the bailout agreement as "*flawed* ..." and one that *"had to be subsequently corrected*". According to Papakonstantinou, Greece needed a longer repayment period and a gradual adjustment process (Papakonstantinou, 2011). The 'shock therapy' pushed Greece into an 'austerity trap' along with other Eurozone economies that were in stagnation, and

[10] IMF staff members.

this made the markets sceptical rather than 'confident' in terms of the prospects for the Eurozone economy.

Several voices associated with Keynesian economic thought criticised the second neoclassical belief, 'expansionary austerity', which was the cornerstone for the bailouts in the Eurozone. 'Expansionary austerity' is, in principle, a provocative term that questions the substance of Keynesianism. The debate took an interesting turn. Paul Krugman argued that "*policymakers* (in the Eurozone) *knew what they wanted to hear…the doctrine of expansionary austerity quickly became orthodoxy in much of Europe*" (Krugman, 2015a). For Krugman, Alesina's argument was based on a problematic statistical work that reversed the substantial macroeconomic principle that spending cuts in a depressed economy exacerbate economic slowdown (Krugman, 2015a). In fact, Alesina's statistical model includes several misidentifications in the 'adjustment cases'. Finland, for instance, was identified by Alesina as an 'adjustment case', but in reality achieved a deficit reduction through a stock market boom rather than through a fiscal contraction policy (Blyth, 2013: 127). The belief that austerity in depressed economies would "inspire business-boosting confidence and all would be well" proved, as expected, to be harmful, wishful thinking. Alesina's 'wealth effect model' was heavily criticised. Instead of confidence, cuts in public spending fuelled pessimism, uncertainty, and fear. For Rendahl, a "*gruesome outlook can set the economy on a downward spiral in which fear reinforces fear; thrift reinforces thrift; and unemployment rates are sent soaring. But the same mechanisms that may cause a vicious circle can also be turned to our advantage. A tax- or debt-financed expansion in government spending raises output and sets the economy on a steeper path to recovery. Pessimism is replaced by optimism and spending begets spending*" (Rendahl, 2012). For Krugman, "*fiscal policy contraction, austerity, one way or another was imposed at the wrong time*" (Krugman, 2017).

Beyond the timing of austerity, Nobel laureate Joseph Stiglitz and Yanis Varoufakis criticised the essence of Alesina's argument: the belief that lower taxes will stimulate investment. For Stiglitz, "*this is sheer nonsense…what is holding back investment (both in the United States and Europe) is lack of demand, not high taxes*" (Stiglitz, 2014b). In an economic downturn -as Yanis Varoufakis claimed- private-sector expenditure shrinks rapidly. Under those conditions, "*a government that cuts public spending in response to falling tax revenues inadvertently depresses national income (which is the sum of private and public spending) and, inevitably, its own*

revenues. It thus defeats the original purpose of cutting the deficit" (Varoufakis, 2018a). Under crisis conditions like those in the Eurozone periphery, where credit inflows suddenly dry up and private investments fall, any cuts in public sector wages and government investment inevitably lead to lower consumption and an economic downturn. 'Internal devaluation' sows the seeds of a self-defeating recession (De Grauwe, 2016). This constitutes the recipe for depression, not expansion.

For Keynesian critics, the experiment in Europe brought new evidence against austerity policies. "*Austerity has failed...but its defenders are willing to claim victory on the basis of the weakest possible evidence: the economy is no longer collapsing, so austerity must be working!... To say that the medicine is working because the unemployment rate has decreased by a couple of percentage points, or because one can see a glimmer of meager growth, is akin to a medieval barber saying that a bloodletting is working, because the patient has not died yet*" (Stiglitz, 2014b). For Keynesian economists, "*Keynes is still right, after all: "the boom, not the slump, is the right time for austerity at the Treasury"* (Taylor, 2013). 'Expansionary austerity' - according to this line of arguments- was a catastrophe. Fiscal contraction pushed the peripheral economies -including Greece and Portugal- into a recession that consequently reduced government revenue further, led to persistent unemployment, and forced them to intensify the austerity measures. This was an 'austerity trap'-a deflationary spiral- where the debt to GDP ratio increased further (House *et al*., 2017).

2.2.6 Reforms: 'too much to do'

Beyond recession, austerity hindered reform efforts in the periphery. An insider of the Eurozone crisis, James Galbraith -who served as unofficial advisor to Yianis Varoufakis, Greek Minister of Finance, during the six months of turbulent negotiations with Greece's creditors in 2015- criticised the reform programme imposed on Greece. He claimed that "*reform in any true sense is a process that requires time, patience, planning, and money*" (Galbraith, 2015). In many respects, countries in the periphery had to balance a tight fiscal policy with highly demanding reform programmes. For Keynesian economists, structural reforms do not work in times of tight fiscal policy and austerity. Although countries like Greece 'desperately needed structural reforms', the

policy mix of austerity and reforms did not work out (Katsikas and Manasse, 2018). According to recent research findings, the availability of resources is crucial for market reform implementation as it allows the state to compensate potential losers, reversing the potentially negative short-term effects of the reforms (OECD, 2010; Gruner, 2013). Reforms in time of recession -as in the Eurozone- might become self-defeating (Romer, 2012).

Greece had to implement a high number of reforms in many different sectors in a very short time. This caused a "too much to do" problem that reversed the reform efforts. Critics argue that a 'gradual' reform policy would have been much more efficient for the peripheral economies (Rodrik, 2016; Bordon *et. al* 2016). In line with this view, the intense reform programmes in countries with slow, incoherent, and largely inefficient public administration put the brakes on the national reform process.

Beyond this, the lack of 'ownership' -meaning that the reforms were designed and enforced by external technocrats- limited the chances of success (Manasse and Katsikas, 2018). Political and social consensus is of critical importance for reform success. Paolo Manasse and Dimitris Katsikas (2018) claimed that, "*when the economy has deteriorated substantially, achieving political and social consensus on – and not back-tracking from – reforms becomes virtually impossible*". The external intervention sowed the seeds of a social backlash against the reforms in Greece. In parallel, the problematic reform sequencing, which prioritised labour market reforms, resulted in a tremendous fall in aggregate demand. The latter limited the benefits of the product market reforms (Manasse and Katsikas, 2018). Any 'political capital' for reforms was largely spent early on. In this context, the rise of political parties against the EU-IMF programmes constrained the reforms in many of the peripheral countries. According to Manasse and Katsikas (2018), the EU and IMF "eventually played into the hands of anti-reformers".

2.2.7 Greece versus Portugal again

Keynesian economists have indeed shed light on some problematic aspects of the management of the crisis in the Eurozone. Keynesian critics have offered a new approach, beyond the *neoclassical* perspective, to understanding the periphery's

economic performance since 2010. For most of the critics, Greece was seen as *Iphigenia in Aulis;* that is to say, it was overwhelmed by loans to be 'saved' from a disorderly default that would have tremendous consequences for the Eurozone. According to this perspective, Greece was again a 'unique case' that was 'sacrificed'[11] to save those European banks that were highly sensitive to Greece's potential default. Greece's bailout was seen as a bailout of the European banks (Varoufakis, 2018b). The EU and IMF declined a debt restructuring to relieve Greece of its mounting debt. Instead, they provided expensive loans and forced Greece to implement harsh austerity programmes. This pushed the Greek economy into a long and deep recession. The 'pretend (that Greek debt is sustainable) and extend (austerity)' dogma impeded any attempt on behalf of Greece to restructure its economy and recover from the crisis. The '*Iphigenia in Aulis*'/'victimisation' explanation presents Greece as a 'victim' of its creditors - especially the Germans- that led Greece to an economic odyssey. Greece is therefore again considered as a 'special case' by Keynesian critics, though for different reasons than those of the neoclassical explanation.

Portugal is, in contrast, seen as 'collateral damage' of the crisis contagion in the periphery. The Portuguese economy suffered from low growth rates and rising debt (mainly private debt) in the 2000s. However, its fiscal policy was largely on track the decade before the crisis. The lack of mechanisms to prevent the crisis from spreading in the Union and the indecisiveness of the Eurozone leaders left the country susceptible to the crisis storm in 2010. For critics, the ECB's delay in acting as a lender of last resort pushed other peripheral economies beyond Greece towards being at risk of default. Portugal was one of those countries. Once Ireland and Greece lost access to the financial markets, investors became sceptical to the periphery as a whole. This made Portugal – which was experiencing problematic management of the crisis - insolvent. Under those circumstances, Portugal was forced to sign an 'unnecessary' bailout agreement with the EU and IMF in 2011. The Portuguese programme was much less austere in comparison to Greece and it allowed Portugal to recover quickly. For critics, the ECB could have clearly prevented the crisis in Portugal. The ECB's intervention under the Draghi's mandate in 2012 restored confidence and enabled Portugal to return to the markets. This ended the Portuguese crisis.

[11] J. Stiglitz called Greece 'the sacrificial lamp' (Stiglitz, 2015)

Overall, both the neoclassical and Keynesian explanations emphasise the role of Greece in the Eurozone crisis. Under the neoclassical view, Greece is a 'profligate' sinner that failed to reform its economy as other peripheral economies did. Keynesian economists instead perceive Greece as a 'victim' of the crisis response in the Eurozone. Both explanations tend to present Greece -though for different reasons- as an exception in the periphery. As will be shown in the next chapters, the emphasis on Greek 'exceptionalism' is seriously limited and has been misleading in understanding the deep roots of the crisis and the post-crisis economic performance in the southern peripheral economies.

2.3 The Comparative Political Economy and the Varieties of Capitalism perspective

The existing *neoclassical* and *Keynesian/'Iphigenia in Aulis*' explanations provide different perspectives on the complex crisis in the Eurozone. However, they are both largely problematic. The first explanation -which was supported by the creditors- uses neoclassical economic principles to explain both the causes of the crisis and the post-bailout economic performance. Although the neoclassical explanation provides some valid claims regarding the role of the southern governments that fuelled the crisis, it has been problematic in terms of explaining the causes of the crisis. It emphasises the role of 'individual' governments in causing the crisis and undervalues the fact that the government policies were influenced, to a large extent, by the Eurozone's institutional and political framework. It also underestimates the complex realities that shape the economic performance in the periphery. In the Eurozone, the proponents of this explanation assumed that a rapid drop in wages would make exports competitive and trigger a robust export-led recovery and that the deregulation of the labour and product markets would bring investors back and set the foundations for high economic growth. For neoclassical economists, the labour cost decrease would automatically mean higher price competitiveness against trade competitors. Action against the 'rigid' regulation -meaning the 'harmful' role of the state- would, firstly, push for the reallocation of resources (i.e. production factors) towards those activities in which countries enjoy a

'comparative advantage'. Secondly, the vigorous market forces would infuse competitiveness in less productive sectors. Overall, competitiveness and higher productivity -achieved through market forces- would drive the economies out of the crisis. This means that governments' duty in the indebted countries was to deregulate their economies and leave the *invisible hand of the market* to do all the rest. 'Free markets' would push those economies towards a higher equilibrium.

The neoclassical explanation provides an inadequate framework to explain how those economies function. Its proponents have largely failed to design effective policies for them to recover from the crisis. They insist on simplifications of the complex reality in the periphery of the Eurozone. They turn from 'Economism' to 'Exceptionalism' to explain the post-bailouts' mediocre performance, emphasising corruption, clientelism, backwardness, and vested interests. They use Greece as an exceptional case, overemphasising the existing problems of the Greek economy and society, while leaving other critical factors that affect its economic performance unexplored. The neoclassical explanation offers a relatively advanced description of the fiscal crisis in the peripheral countries, but fails to explain the deep causes of the Eurozone crisis. Therefore, the neoclassical policies have proved ineffective to solve the crisis in Europe.

The *Keynesian/* '*Iphigenia in Aulis*' explanation brings to light the substantial EU and IMF mistakes during the Eurozone crisis. In line with this explanation, the European leaders were indecisive at the most critical moments of the crisis, triggering a major credibility issue for the Eurozone as a whole. They largely failed to respond to the crisis effectively and put other peripheral countries at risk. On a second level, critics associated with Keynesian economic thought argue that, early on, the EU and IMF sowed the seeds of the long and painful recession in the Eurozone. The self-deafening austerity and the overwhelming reform programme held back the recovery efforts in Greece.

This thesis acknowledges some aspects of the *Iphigenia in Aulis* criticism of the EU and IMF, which is that they pushed Greece into a debt trap, hindering a quick recovery. However, this explanation is far from providing a deep understanding of the crisis and the struggle of the peripheral economies to recover from it. Greece is presented as a scapegoat -'Iphigenia in Aulis'- while Portugal is perceived as 'collateral damage' of the Greek crisis.

'Iphigenia in Aulis' is largely an ahistorical approach that fails to explain the historical process and political dynamics that created diverging growth models in the

Eurozone. It criticises austerity and the overwhelming reform programmes but does not add to our knowledge on why the internal devaluation and the neoliberal reforms were not the appropriate treatment for those economies. It fails to provide an in-depth understanding of the complex impact of the bailout programmes on the economic structures of those countries and, therefore, to offer a well-documented explanation. It argues for a Keynesian-style economic recovery through a boost in domestic demand (i.e. 'Marshal Plan for Europe', higher public spending) to restore growth in the crisis-hit countries. However, such a prospect -which was politically unrealistic during Europe's *austerity* moment- would only provide temporary relief for the indebted countries. It would not solve the structural problems of those economies and would possibly reinstate the consumption-led economic model that led them into the crisis in 2010.

This thesis will show the theoretical fallacies of both explanations and argue in favour of a new perspective emphasising that the problem of the Eurozone lies in the variety of growth models in the countries in crisis. Therefore, we need to go beyond the *neoclassical* and *Keynesian/* '*Iphigenia in Aulis*' explanations to understand the deep structural weaknesses in Greece and Portugal that triggered the crisis in 2010. We should also move beyond the blame game between creditors and debtors and explanations that reproduce misperceptions and biases.

Building upon the Comparative Political Economy literature, this thesis sets out the foundations for a structural understanding of the Eurozone crisis. It also explains -based on a historical political economy analysis- the reason behind the failure of the neoclassical economic recipe to transform the Eurozone periphery. The Comparative Political Economy emerged as an interdisciplinary inquiry between political economy, history, sociology, and political science in the late 1970s. It offers a broader and intellectually advanced school of thought that 're-embeds' the economic analysis within the historical, social and political framework (Clift, 2020: 4). It aims to study the economy in a richer manner, which economics largely fails to do. It provides analytical tools to study the state-market relations and the power within those relations from a historical and comparative perspective. The intellectual roots of Comparative Political Economy can be traced back to classical political economy in the 18th and 19th centuries. Such theoretical roots and the evolution of the political and economic thought in the 20th century provide the theoretical starting points to understand modern capitalism (Clift, 2020: 7). Comparative Political Economy is a broad research field

with contributions that vary significantly. However, the CPE scholarship has established some common themes and research areas that have made CPE a distinct field of research in the last fifty years (Clift, 2020: 20). Comparative Political Economy offers a new research agenda that studies the formation of the production process, company structures, the investment and innovation policies, the welfare systems, the labour markets, the ideology, and public policy (Gamble et al., 1996). CPE scholars focus on the evolution of models of capitalism, and the role of interests, institutions, and ideas to understand capitalist societies and change.

The emergence of neoclassical economics as a predominant paradigm in academic research and policy-making almost worldwide placed Comparative Political Economy at the margins of the discipline in the last decades. However, the weakness of neoclassical economics in terms of providing convincing explanations about the world economy and the difficulty that modern capitalism has in tackling emerging crises have triggered an increasing interest in the study of production regimes, growth models, industrial policies, labour markets, and welfare states from a comparative perspective that has revived the Comparative Political Economy research.

The most influential research agenda in contemporary Comparative Political Economy was launched by Peter Hall's and David Soskice's Varieties of Capitalism perspective in the early 2000s. The VoC literature gave birth to a new wave inside Comparative Political Economy in the 21st century. Hall and Soskice bridged historical institutionalism and institutional economics together to explain capitalism formation in different countries (Clift, 2020: 114). The foundations of VoC are based on the modernisation approach and the role of institutions in maintaining growth. The VoC literature is also based on neo-corporatism, and particularly on the capacity of states to formally or informally maintain systems of cooperation or competition in the production process. The comparative study of institutions in modern capitalist societies has emerged as the cornerstone of the recent Comparative Political Economy literature. Such an approach has brought to light the role of institutions as mechanisms to understand the production and innovation features in different economies. The matrix of the above theoretical foundations offers an approach to understand the strategic interaction among agents (i.e. the state and the firms) and the formation of the modern capitalist economies.

Varieties of Capitalism scholars set institutions as the explanatory mechanism in shaping different models of industrial relations, labour markets, education and training

systems, corporate governance, and the legal framework for the capital-labour relations in different capitalist countries. The state plays a primary role in sustaining institutions through its regulatory action and its authority to force through its legal framework the reproduction of reliability of the market transactions. The comparative analysis of the institutional variation provides a significant understanding of how capitalism really works in different countries.

Peter Hall and David Soskice (2001) also locate firms at the centre of the political economy analysis. Firms are the central actors in a capitalist economy (Hall and Soskice, 2001). Institutions play a key role in setting the framework of how firms and other actors interact. They regulate economic behaviour and implement sanctions for rule-breakers, affecting economic interaction.

Based on this analytical framework, Hall and Soskice (2001) introduced a distinction between two types of political economies, *liberal market* and *coordinated market* economies. In liberal market economies (LMEs), firms coordinate their economic activities through market competition and formal contracts. Firms' behaviour is set based on competitive markets and their rules. In coordinated market economies (CMEs), firms coordinate their actions based less on market rules and more on collaborative -as opposed to competitive- methods to interact with other actors. Such coordinated interactions between firms and other agencies produce economic cooperation rather competition. For instance, in coordinated market economies, firms tend to develop long-term relationships with other firms, their employees and other stakeholders to ensure credibility and cooperation, and produce long term outcomes (Hall and Soskice, 2001).

In other words, in some countries, firms are built upon highly competitive markets and in others they are built upon coordinated action. Coordinated market economies provide a cooperative framework for interaction (e.g. state- firms, suppliers-clients) through collaborative research and development, long-term labour contracts, and private-public partnerships to achieve common economic objectives (Hall and Soskice, 2001). In contrast, in liberal market economies, under competitive conditions, actors independently employ resources (e.g. skills and technology) to achieve higher returns. Hall and Soskice (2001) classified the OECD countries as liberal market (USA, Canada, Australia, Britain, New Zealand and Ireland) and coordinated market economies (Germany, Austria, Japan, the Netherlands, Belgium, Sweden, Denmark, Norway and Switzerland).

They also identified Greece, Portugal, Italy, Spain, France and Turkey as *Mediterranean* or *mixed market* economies. The latter are another 'variety' of capitalism that is marked by a large agriculture sector, cooperative corporate governance and liberal labour markets (Hall and Soskice, 2001). Mediterranean market economies tend to have more fragmented production systems in terms of territory and firm-size (Molina and Rhodes, 2007). Wage bargaining is less coordinated because the trade unions are relatively strong but fragmented, while enterprise associations compete with each other and lack the capacity to restrain wage increases. Employers' associations also play a secondary role in training the workforce (Royo, 2008). Firms have limited capacity to provide cooperative training schemes (Hall, 2016). Therefore, the production is fragmented, and the workforce is relatively low-skilled. Mixed or Mediterranean economies are poor performers in terms of innovation. Such mixed market economies had, until recently, been understudied in the VoC literature. However, the outbreak of the crisis has drawn attention to this 'variety' of capitalism in Southern Europe.

2.3.1 Varieties of Capitalism and the Eurozone crisis

The Eurozone crisis triggered a growing interest in the Comparative Political Economy. VoC scholars have studied aspects of the crisis that the existing neoclassical and Keynesian explanations failed to bring to the fore. The VoC literature provides a new framework to understand the national variations and their role in the economic performance in the Eurozone (Hancke, 2013; Hall, 2018; Johnston, 2016). This growing body of literature argues that the Eurozone crisis was not primarily a fiscal crisis. Instead, the fiscal crisis was a result of the competitiveness crisis in the Eurozone periphery. Hancke (2013) and Johnston et al. (2014) showed how wage-setting differs between the northern co-ordinated market economies and the Mediterranean market economies in the South. They brought evidence showing that Mediterranean market economies lack the institutions to effectively coordinate wages (Hancke, 2013; Molina and Rhodes, 2007).

For Johnston et.al (2014) the lack of coordination in wage-setting led the Mediterranean countries to substantially increase wages. From the perspective of

Varieties of Capitalism, Greece, Portugal and other peripheral countries failed to control wage increases in recent decades (Johnston, 2016; Hancke, 2013). In contrast to co-ordinated and liberal economies, which managed to keep wages low through either cooperative institutions or market forces, the Mediterranean market economies failed to do so. Coordinated market economies like Germany maintain a coordinated wage bargaining system between employers and employees that keeps wages reasonable and at internationally competitive levels. Under this effective mechanism, Germany sets exports -that maintain more than 50% of its GDP- as the engine of its economic growth (Iversen and Soskice, 2013). Beyond a coordinated wage-setting system, coordinated market economies maintain strict fiscal rules to keep domestic consumption at low levels and to sell local production to foreign markets. CMEs maintain high-level political and social cooperation among the major political parties, employers and unions to achieve their economic goals. There is a broad consensus regarding the economic priorities and policy-making. Under such a cooperative economic system, governments and employers subsidise training schemes for employees to advance human capital skills. The latter advances production processes and improves the quality of production and innovation. Based on such mechanisms, Germany, Austria, the Netherlands, and other coordinated European countries have developed a comparative advantage in regard to high value-added products. By keeping the labour cost down, the northern European countries have become highly competitive in the global economy (Hall, 2012).

On the other hand, the Mediterranean or mixed market economies maintain a much less cooperative system of economic development. Although the state maintains an interventionist role in some areas of the economy, those countries lack the institutional capacity to coordinate wages across sectors. Greece, Portugal, Spain, and Italy have complex features of dualism between the formal and informal sectors. In the former, employees receive relatively high salaries and benefits, and enjoy a high level of employment protection and security. In the formal sector, public sector jobs and other professions are highly regulated while the unions are relatively strong but not well-coordinated. In the informal sector, employees are compensated with low wages and benefits, enjoy very little job security, and in many cases work in precarious conditions. In these sectors, the trade unions are weak and maintain less bargaining power (Iversen and Soskice, 2013). Therefore, the formal sector, which includes export-oriented sectors (except tourism), cannot maintain wages at international competitive levels. At the same

time, domestic prices are kept down through low wages in the informal sector. The increase in wages in the export sectors led Greece, Portugal, Spain and other Mediterranean economies to rapidly lose their competitiveness. Unable to control labour costs, the southern countries lost their competitiveness in favour of the northern European coordinated market economies. Beyond wage levels, weak cooperation between governments and employers leads to a low level of vocational and skills-related training in those economies. Firms do not have the capacity or remain unwilling to substitute capital for labour to improve the low value-added production (Hall, 2012). The Mediterranean market economies score low in both the competitiveness and innovation rankings.

Overall, the Varieties of Capitalism literature emphasises the role of institutional differences in the Eurozone economies to explain the crisis. It is argued that the European co-ordinated market economies -Germany, Austria, Belgium, the Netherlands, Denmark and Finland- achieved high export performance based on a highly coordinated wage system and an advanced training system for skilled workers. The former keeps the labour cost at an internationally competitive level while the latter boosts innovation (Hall and Soskice, 2001). In these countries, economic growth depends less on domestic demand and more on international markets. On the other hand, the mixed market economies in the South -Greece, Portugal, Spain and Italy- have less co-ordinated wage bargaining systems. Employers' associations are less institutionalised and less active in terms of providing high-quality vocational training (Royo, 2008). All of the above exacerbated the rapid competitiveness loss and led the southern periphery into the crisis in 2010.

For the Varieties of Capitalism literature, the underlying reason for the Eurozone crisis was that different varieties of capitalism bound together in a single currency, the Euro. VoC scholars argue that different economies led by institutional asymmetries caused a growing trade imbalance and the accumulation of private and public debt in the southern periphery. Hancke (2013) argues that the rise of the unit labour cost in manufacturing diverged rapidly between the North and the South in the Eurozone. This was primarily because public sector employees set themselves away from the national wage setting system and were protected by strong employment legislation that keeps the risk of unemployment very low. Hassel (2014) emphasises the ability of vested interests to lobby for state protection, which undermines institutionalised wage-setting processes and allows the unit labour cost to rise in the Mediterranean economies. Johnston and

Regan (2016) argue, based on a regression analysis of 14 European countries before the crisis, that domestic inflation is largely determined by the public sector, which is not exposed to international competition, leading the labour cost to rise. The weak wage bargaining coordination in the periphery allowed wages to grow faster than those in the North. At the same time, the low interest rates in the Eurozone context boosted wages further in the South. The absence of currency devaluation did not allow the peripheral countries to restore competitiveness. The wage setting difference between the North and the South led to a crisis after the first decade of the Euro.

2.4 The Comparative Political Economy criticism of VoC and the emergence of the Growth Model perspective

The Varieties of Capitalism perspective has been very influential among Comparative Political Economy scholars and has dominated the CPE field in the last two decades. However, its theoretical assumptions have not been unchallenged (Thelen and Streeck, 2005; Deeg, 2010; Thelen, 2010; Baccaro and Howel, 2011; Baccaro and Pontusson, 2016; Stockhammer and Ali, 2018; Clift, 2021). The global financial crisis in 2008 triggered a new wave of Comparative Political Economy literature that challenged the VoC perception of political economy, its analytical tools, and its concepts. The constructive debate between VoC and new perspectives opened the way for the renewal of the Comparative Political Economy. Scholars associated with the new wave of Comparative Political Economy provided a broader and far more pluralistic framework to understand capitalist diversity.

For CPE scholars, the formation and the evolution of state-market relations are critical to explain the diversity in the national growth models. According to CPE scholars, the VoC perspective puts 'institutions' and 'firms' at the centre of its analysis leaving the state-market relations at the margins of its research agenda (Clift, 2021: 176). It fails to account for the role of the state bureaucracy and government intervention in different capitalist economies and societies. The Varieties of Capitalism literature implies a different role of the state and market in the 'co-ordinated', 'liberal', and 'mixed' market economies. However, the VoC scholars fail to provide a rigorous analysis of the historical, political, and social conditions that shape those 'different' state-market relations in different economies (Streeck, 2001).

Amable (2016; 2017) and Palombarini (Amable and Palombarini, 2009) criticised Varieties of Capitalism as a deductive and determinist approach that puts the emphasis on economic agents such as 'firms' and 'sectors', leaving the complexity of the interplay between social aspects and economic structures at the margins of their analysis (Amable et al, 2019: 434). They claimed that VoC scholars underestimate the diversity of the economic interests and political demands that affect the growth patterns in societies. Thelen argues that VoC fails to account for the politics and the power struggles that shape and reshape institutions at a national level (Thelen, 2010). The

heterogeneity of socio-economic interests and conflicts shapes the growth model at the local and national levels (Amable et al, 2019: 435). In this context, CPE scholars examine the 'politics' and cross-class coalitions in regard to the formation of growth models in different countries. They show how economic elites interact with state bureaucracies to shape economic policies at the national level (Bohle and Regan, 2021: 79). For Bohle and Regan (2021) the 'state-economic elites' relationships set the foundations of the growth models. Based on their economic power, the economic elites maintain a favourable position to influence policymaking and government policies (Bohle and Regan, 2017: 82). Other CPE scholars emphasise the role of social coalitions, electoral dynamics and growth strategies (Beramendi et. al, 2015; Regan et al, 2019; Dancygier and Walter; 2015; Oesch and Rennwald, 2018). They provide new evidence on how the current shifts in labour markets affect electoral preferences and therefore the political dynamics in growth regimes.

The analysis of how politics are embedded in institutions and institutional evolution is key to understanding the formation and evolution of different models of capitalism (Clift, 2020: 121; Jackson and Deeg, 2008). According to Streeck and Thelen (2005: 1), VoC lacks the analytical depth to capture such political and social dynamics and therefore provides a static view on national models of capitalism. They claim that, 'arguments in support of the idea of distinctive and stable national models lack the analytical tools necessary to capture the changes that are indisputably going on in these countries'. The Varieties of Capitalism literature indeed suffers from a conservative understanding of models of capitalism and lacks a sophisticated framework to explain evolution and change. The institutions and market relations in different 'co-operative' and 'liberal' market economies are presented as stable, uncontested, and isolated from international and domestic dynamics and changes. Thelen calls upon CPE scholars to move beyond the traditional comparative statics and to provide a more dynamic analysis of the change in different capitalist economies (Thelen, 2010: 45-46).

A similar criticism came from another wave of the CPE literature, which argues that VoC focuses on domestic institutions and fail to account for the complex international economic and political developments (i.e. rise of Neoliberalism, liberalisation, financialisation) that affected national and local economic realities in the last decades. Such criticism brought the field into a productive dialogue with International Political Economy and set a new research agenda on global economic phenomena and international organisations, and their effects on capitalist diversity.

The study of the complex interplay between 'international' and 'local' institutions and policies opens up a new path in the field of Comparative Political Economy. In this context, CPE scholars provide a breakthrough analysis of the current global economy and its impact in different countries. The emergence of Neoliberalism as a predominant paradigm worldwide, based on 'free-market' economics, economic liberalisation (i.e. mainly through the movement of capital, and the deregulation of labour markets), and rapid financialisation has transformed the global economic order and the national models of capitalism (Harvey, 1982; Guttman and Plihon, 2008). The CPE scholars argue that in the Neoliberal era, the economic liberalisation and labour market deregulation have transformed the industrial relations, production process, labour-capital balance of power, and value chains across the world (Streeck, 2009; Baccaro and Howel, 2011). Taking advantage of the global economic developments, employers have concentrated overwhelming power in setting wage level within sectors and firms. At the same time, trade unions have faced a rapid decline in terms of membership and power. Across the capitalist world, the number of precarious jobs has - even in the coordinated market economies- increased in the last decades (Bosch and Weinkopf, 2008). Such global economic developments have transformed the national economies in ways that the VoC literature fails to account for. Thelen argues that the 'coordinated' institutions are mechanisms that are dependent on the balance of power within societies and global economic developments. Such a balance of power has been changed in favour of pro-liberalisation political forces. Although the 'coordinated' market economies maintain cooperative institutions to organise production processes, employers use the flexible labour market to push labour costs down. For Thelen, the stability of 'coordinated' market economies is internally and externally contested (Thelen, 2010; 2014). To emphasise the importance of the liberalisation process, Thelen (2014) turns the concept of 'Varieties of Capitalism' into 'varieties of liberalisation'.

Beyond liberalisation, CPE scholars argue that the VoC literature has also failed to account for the complex issue of the financialisation and its impact on the national financial systems and national economies. The expansion of capital market activity in terms of scale and speed has dramatically increased since the mid-1980s. Financialisation based on the transformation of financial services has become an integral part of the growth process in the advanced economies (Clift, 2021: 209). The deregulation of financial services and the new financial products have changed the traditions and practices in capitalist societies (Langley, 2010). The relations among

capital markets, states, firms, and consumers have been affected in diverse ways in the last decades. Scholars associated with CPE have brought new insights about the role of financialisaton in varieties of capitalism (Aglietta and Bretton, 2001; Arrighi, 2010; Deeg 2010). They have studied the international financial mechanisms and their role in shaping national investment, wages, and industry policies (Van Gunten and Navot, 2018; Clift, 2021; Alvarez, 2015; Berghoff, 2016; Engelen and Konings, 2010). The international capital markets and the national financial systems generate incentive mechanisms for economic and political actors (Clift, 2021: 200). The financial system influences the investments, savings, and spending decisions of governments, firms, and ordinary people. VoC scholars have failed to accommodate those shifts in their analytical framework and their different models of capitalism. The overwhelming expansion of international capital market activities and credit flows has affected different countries asymmetrically (Clift, 2021: 207). Financialisation has undermined the coherence of national financial systems and led to the overgrowth of the financial sector vis-a-vis the real economy, transforming the traditional growth model across the developed world (Deeg, 2010).

Finally, the CPE literature criticises VoC's schematic classification of the different economies. Thelen argues that VoC's 'ideal types' are vague dichotomous concepts that are far from real different political economies (Thelen, 2010: 45-50). For Jackson and Deeg (2008), VoC scholars underestimate the role of the societal norms that influence economic activity, and the political interventions that reproduce or transform the market relations in each society (Clift, 2021: 184). For Hay (2004), capitalist diversity is the result of different processes of state-market relations that generate distinct historical, economic, and political trajectories. The VoC's 'ideal types' of 'co-ordinated', 'liberal', and 'mixed' (Mediterranean) market economies seem to be simplified 'models' that cannot explain the complex political and economic changes that took place at the international and national levels. CPE scholars perceive capitalist diversity as an open-ended process rather than a static reality (Levy, 2016). They claim that the VoC literature requires a more pluralistic research framework and further empirical investigation to explain the diversity in modern capitalism (Crouch, 2005). VoC's 'ideal types' have been 'abused' in many cases (Clift, 2021: 181).

With a similar line of argument, Baccaro and Pontusson criticise the Varieties of Capitalism's categorisation of coordinated, liberal, and mixed or Mediterranean market economies, proposing a new conceptual framework for advanced economies (Baccaro

and Pontusson, 2016: 177). They argue instead that capitalist economies are divided into different growth models -based on aggregate demand as the driver of economic growth- shaped by the historical capital formation, domestic economic constraints, class structure dynamics, technology, and international competition (Baccaro and Pontusson, 2016: 177; Streeck, 2016: 244). The Growth Model's historical approach provides a more adequate framework to explain the evolution and change of the political economy at the national and local levels (Stockhammer and Ali, 2018). Based on the Growth Model perspective, this thesis aims to shed light on both the 'demand-side' and the 'supply-side' aspects that the VoC's ideal types cannot reach. Such a theoretical perspective allows for understanding political economy away from 'static models'.

2.5 The Growth Model approach

The new emerging Growth Model literature recently opened up promising paths for Comparative Political Economy. After the global financial crisis in 2008, a new wave of Comparative Political Economy emerged to overcome VoC's static analysis, limited research framework, and supply-side focus. This new perspective builds primarily on a post-Keynesian perspective to show the role of aggregate demand in the formation of growth models. It turns the focus to macroeconomic factors (Bohle and Regan, 2021: 77). Based on Kaleckian economic foundations, Baccaro and Pontusson placed demand-side factors and particularly income distribution at the epicentre of their theoretical approach (Baccaro and Pontusson, 2016: 176). Their analytical framework is based on the main components of aggregate demand: government spending, public and private investment, consumption, and net exports and their role in wage-led growth models. Such a framework brings new insights on the role of national macroeconomic policies and global economic shifts in shaping capitalist diversity.

Baccaro and Pontusson take a historical perspective, arguing that most advanced countries pursued wage-led growth after the end of World War II. The Fordist model, which was the predominant economic paradigm after WWII, was based on Keynesian demand management, large and generous welfare states, strong trade unions, and coordinated bargaining (Ryner, 2015: 27). The increase in wages fuelled investment and consumption in capitalist economies from the late 1940s. Based on the Fordist model,

western capitalist economies enjoyed decades of economic stability and relative prosperity. However, the crisis of the Bretton Woods system and the emergence of a new Neoliberal world order based on neoclassical economics opened up the path for the gradual demise of the Fordist model of mass production in the late 1970s (Ryner, 2015: 27). As we have seen above, the financialisation and rapid deindustrialisation in the western capitalist world transformed the traditional growth models. At the same time, the rapid economic liberalisation through the deregulation of labour markets and the decline in trade unions' power opened up the way for an even more asymmetrical distribution of income in the advanced capitalist societies. The above complex economic and social shifts triggered different growth strategies in different countries that led to new diverging growth models. Baccaro and Pontusson state that advanced economies found different paths to replace wage-driven growth. Baccaro and Pontusson introduce the Growth Model approach, which offers an alternative way of theorising the key issue of capitalist diversity in Comparative Political Economy. They distinguish between two main models: export-driven and consumption-led growth regimes.

Growth Model theorists bring macroeconomics into their analysis and set the foundations for an in-depth understanding of the growth model at the national level. According to Baccaro and Benassi (2017: 90), distributive policies play a significant role in the formation of growth models. Macroeconomic policies affect aggregate demand and therefore investment, wages, and consumption in societies. Governments may boost growth through higher public spending and real wage increases (i.e. in the public sector), opening up the way for higher consumption levels. They claim that consumption-led growth can either be pursued through increasing real wages or through household indebtedness (Baccaro and Benassi, 2017: 91). This may have a positive impact on growth rates. However, consumption-led growth may conflict with the determinants of export-led growth. Higher wages are expected to increase imports and reduce exports as consumers spend more on imports and domestic production is more expensive for consumers abroad. The increase in consumption tends to increase prices and make domestic production less competitive in the global market. Therefore, consumption-led growth may lead to higher current account deficits, and public and private debts. Moreover, the expansionary effect of consumption may be offset by the fall in net exports, especially when exports are a large part of the aggregate demand or the demand for exports is price sensitive (Baccaro and Benassi, 2017: 91). Instead, governments may take a different approach to boost growth through exports. In export-

led models, governments tend to cut wages to stimulate exports via a price mechanism. However, wage cuts can stimulate exports only if foreign demand is price-sensitive and the export sectors are large and dynamic (Baccaro and Pontusson, 2016).

This thesis contributes a supply-side analysis of the growth model at the national level by emphasising the role of productive capabilities, technological capacity and innovation, the labour force, and production quality in economic performance. I analyse the historical evolution of productive capabilities, the transformation from industrial to service-led economies, de-industrialisation, and the shifts in the balance of power between capital and labour. The study of all of those factors in relation to competitiveness and export performance turns the Growth Model perspective into a new interesting research path. By analysing both macroeconomic policies and 'supply-side' factors in 'co-shaping' different growth patterns in capitalist economies, this thesis makes a substantial contribution to theorising capitalist diversity. The history of the formation of production capabilities, market institutions, industrial relations, and macroeconomic policies gives birth to different growth models. The evolution of a post-Fordist economic paradigm triggered diverging growth models in the developed capitalist economies (Streeck, 2016: 246). As will be shown below, the co-existence of such diverging growth models was not sustainable in the context of the Eurozone.

2.5.1 The Growth Model approach and the Eurozone crisis

As we have seen, Growth Model theorists argue that capitalism is characterised by particular 'regimes of capital accumulation' that differentiate themselves due to different historical trajectories, the evolution of capital-labour relations, fiscal policies, technology and production methods. According to the Growth Model approach, Fordism, which was born in the United States, influenced the formation of European capitalism after World War II. However, as Stockhammer et al. (2016) argue, economic globalisation and financialisaton have transformed the European political economy since the mid-1970s. The emergence of Neoliberalism as the global economic paradigm and the European integration process influenced the European countries in an asymmetric way and led to different post-Fordist growth strategies across Europe

(Streeck, 1992). Based on Post-Keynesian economics and Marxist approaches in Critical Political Economy, Growth Model theorists offer an interesting reading of European integration (Macartney, 2009). In Europe, Neoliberalism took the form of gradual economic co-operation and integration among the European countries. The creation of the Single European Market and later the Maastricht Treaty accelerated trade among European countries and set the foundations for economic liberalisation across Europe. The launch of the Euro and the new Stability and Growth Pact prevented countries from devaluing their currencies and set new rules for governments' fiscal policies that would presumably limit the rising macroeconomic imbalances (Stockhammer and Kohler, 2016: 38). The European integration took a radical neoliberal form through a dogmatical belief in market efficiency, the decline of state intervention, and policies to dilute labour rights (Stockhammer, 2008; Stochammer and Kohler, 2016: 37). The Single European market and the common currency changed the capital-labour balance of power in favour of capital-holders in advanced European economies. The deregulation of the labour market and the abolition of collective bargaining ended the traditional wage-led growth model in Europe.

Furthermore, the Growth Model approach criticises Varieties of Capitalism for underestimating the role of financialisation and fiscal policy in the formation of diverging growth models in Europe (Stockhammer and Ali, 2018: 360). The deregulation of capital markets opened up the path for easier access to credit and accelerating financialisation across Europe. It led to a rapid shift in financial institutions' role in influencing firms' investment and households' consumption in Europe (Stockhammer et al, 2016: 1809). Financialiation created credit-based consumption for households through new financial instruments such as mortgages and credit cards, which provided the opportunity for consumption that would not have been possible at such levels before. It also raised investment in the stock market and housing, leading to price rises and new bubbles. The deregulation of the capital market and financialisation transformed European countries in asymmetrical ways.

According to Growth Model scholars, such a process of economic development triggered different types of growth models in Europe. Stockhammer (2011) and Hein (2013) criticise VoC for providing static concepts in regard to the 'co-ordinated' market, 'liberal' market, and 'mixed' market economies in Europe (Stockhammer et al, 2016: 1807; Streeck, 2012; Heyes et al., 2012). Instead, they provide a new distinction of debt-driven and export-led growth regimes to explain the role of capitalist diversity

in the Eurozone crisis. They offer an advanced analysis of the growth trajectories in the first decade of the Eurozone. Hein (2013) and Stockhammer (2011) show that the first decade of the Eurozone was falsely considered to be one of convergence. The models of growth were diverging before the crisis in 2008. The creation of debt-led and export-led growth models took place from the early years of the Eurozone. Stockhammer et al. (2016) provide a dynamic empirical explanation of the emergence of different growth models in the 2000s. For Stockhammer, the export performance in the North was based among other things on wage suppression, trade unions' power decline, and outsourcing to the European Eastern countries (Stockhammer, 2016: 1805). In the South, the debt-led growth model was more a result of the relatively fast increase in wages, and a slower and moderate -in comparison with the North- decline in trade unions' power. Hein et al. (2020) found that all Mediterranean countries -except Italy in 2000-2008- pursued debt-led growth after the creation of the Eurozone. They argue that aggregate demand aspects of growth are important to understanding capitalist diversity in Europe. Public investment, private and public consumption, and net exports play a key role in the formation of different growth models. In export-led models, growth is largely based on low domestic demand, a large export sector, and a positive balance between good and services. Governments tend to maintain high net exports and current account surpluses (Hein et. al, 2020; 7). In debt-led models, growth is dependent on domestic demand and households' and corporate balances. Such growth models lead to current account deficits, and high public and private debts (Hein et. al, 2020; 8).

For the Growth Model approach, the wage suppression in the North led to a real devaluation as the unit labour cost was growing in slow terms compared to the EU average. In Germany, the wage suppression took place through the Hartz reforms, which created a new low-wage sector within its economy. At the same time, German firms outsourced part of their production to Eastern Europe, where wages remained far lower, leading to a downward trend in wages inside German industry (Stockhammer et al., 2016: 1810). In the North, the export-driven economies, especially Germany, Austria, the Netherlands, and Sweden, kept domestic demand low and pursued growth based on exports and surpluses. Such a process shaped a dynamic export model of growth in the North.

On the other side, Stockhammer et al. (2016: 1810) argue that the South went through a rapid credit-led expansion that created bubbles in different sectors in different countries. This was made possible through the financial deregulation that took place

decades before the outbreak of the crisis and through a low-interest policy that was established after the creation of the Euro. In the South, the growth model, especially in Greece, Portugal, and Spain, was based on credit and consumption that boosted economic growth (Stockhammer and Ali, 2018: 358). Most of those peripheral countries achieved high growth rates in the first decade of the Euro. However, the consumption-led growth increased property prices and households' debt in southern Eurozone economies (Crouch, 2009). Such a process boosted financial investment in low-productivity and non-tradable sectors in the periphery of the Eurozone. Baccaro and Pontusson (2019: 451) argue that some sectors are interest-rate sensitive, like construction and real estate, while others are real exchange rate sensitive, like manufacturing. The economic growth was largely based on the overgrowth of interest-rate sensitive, non-tradable sectors. The latter accelerated de-industrialisation in the peripheral countries. Human capital was transferred to the expanding non-tradable sectors. The shift in sectoral development played a key role in the South's economic performance and opened up the path for the debt-driven growth model in the South (Crouch, 1998, Garrett and Way, 1999). Such a growth model led to high household debt, rising current account deficits, and unsustainable public debts (Hein et. al, 2020; 8). Although under normal conditions, governments can adjust those deficits with a substantial reduction in wages and imports, the capital markets gave politicians the chance to continue financing such unsustainable deficits through large credit flows (Baccaro and Pontusson, 2019: 450). Such massive credit loans relaxed the public finance constraints, exacerbating the indebtedness in the periphery of the Eurozone.

Although such trends took place globally, the Eurozone system was particularly fragile in setting the rules for the operation of those contradictory and diverging varieties of capitalism. Such growth models tend to operate in a complementary way. The export-led growth model required asymmetrical trading relations with debt-led economies (Stockhammer et al, 2016: 1809). The European integration process opened the path for the diverging debt-driven and export-led growth models in Europe (Stockhammer, 2016: 365). The low interest rates led to increasing credit flows that boosted spending, wages and consumption in the peripheral countries. The export surpluses were recycled in credit flows in the southern economies (Stockhammer, 2014: 9). The rigid rules of the Stability and Growth Pact failed to reverse the crisis in the Eurozone. Both of these growth models were inherently unstable and prone to create new debts. The debt-driven growth in the South led to higher private and public debts.

In the North, the German, Austrian and Dutch export-led growth model required trading partners with increasing capacity to buy German, Austrian, and Dutch exports, maintaining increasing levels of debt. The debt-driven growth in the southern Eurozone consumed the Northern exports in a symbiotic but unsustainable way. These diverging growth models fuelled macro-economic imbalances that led to the crisis in 2010.

The crisis hit both growth models hard; however, the North had managerial debt levels while the South had accumulated very high levels of debt that were not sustainable. Under the EU economic policy response, the demand-led economies that faced a competitiveness crisis had only the wage mechanism to adjust their current accounts (Stockhammer, 2014). Stockhammer et al. (2016) and Lavoie (2009) argue that wage adjustment is not sufficient for countries to adjust their competitiveness (Stockhammer et al., 2016: 1807; Mazier and Petit, 2013). The management of the crisis -based on internal devaluation policies- led to a quick but fragile recovery in the northern European economies and a long recession in the South (Stockhammer, 2014: 9). Stockhammer and Sotiropoulos (2014) found that the cost of internal devaluation in the southern countries has been very high in economic and social terms due to a deflationary adjustment.

Contrary to the *neoclassical* and *Keynesian* explanations, the Growth Model literature acknowledges that Greece and Portugal faced similar economic, productive, and institutional weaknesses. The Growth Model approach goes beyond the 'Greek exceptionalism' and puts Greece in the broader context of the demand-led economies in the South. The latter faced a competitiveness crisis that burdened the current accounts across the European periphery. This approach goes beyond the mainstream understanding of the crisis and provides an advanced framework to study the roots of the crisis in the Eurozone.

Growth Model scholars have provided a dynamic and enriched approach to advance the VoC research with the macro-economic policies that prevailed during the first decade of the Euro. Such an approach offers an advanced framework to explain the deep roots of the competitiveness crisis and to show the role of macroeconomics in the creation of divergent growth models in the Eurozone. Baccaro and Pontusson (2016) have indeed provided an interesting understanding of the export-led and debt-driven growth models in the Eurozone. They also offer an in-depth critique of VoC's static understanding of the 'varieties of capitalism' in Europe. This thesis, based on a Growth Model approach, builds upon VoC's limitations to provide a comprehensive

understanding of the structural imbalances in the Eurozone. Varieties of Capitalism tends to explain the economic asymmetry in the Eurozone through institutional divergence. In other words, the coordinated market economies have advanced 'co-operative' institutions that promote strong economic growth while the Mediterranean countries face institutional barriers to achieving export-led growth. However, Varieties of Capitalism offers only a partial understanding of the competitiveness gap in the Eurozone. It focuses on the wage-setting mechanisms and the labour cost level to explain the competitiveness gap between the northern and southern economies. The Growth Model approach criticises VoC's emphasis on the wage setting issue as the primary reason for the competitiveness divergence in the Eurozone. Storm and Naastepad (2015) argue that the real unit labour cost does not account for the competitiveness divergence among Eurozone countries but, rather, non-price matters such as technological capacity and production capabilities play a much more important role in export competitiveness. Using a similar approach, Onaran and Galanis (2012) found that the elasticity of exports with respect to the unit labour cost is very low in the Eurozone and therefore the relative unit labour cost is again far from important in regard to competitiveness divergence. Others such as Stockhammer (2017) agree that the real unit labour cost played a secondary role in the rising macro-economic imbalances in Europe. Non-price competitiveness is important to understand the competitiveness gap in the Eurozone. Several other factors (i.e. export composition, technology level and export networks) play a major role in competitiveness. This thesis emphasises the productive factors to provide an advanced understanding of the Eurozone crisis and explain why internal devaluation failed to kick-start export-led growth. It goes beyond the institutional variations among the Eurozone countries and shows how persistent productive divergence reproduces the asymmetries in the Union.

Moreover, VoC's ideal types of 'coordinated market', 'liberal market' and 'Mediterranean market' economies are too simplistic and cannot account for the complex historical and institutional evolution of the political economy in Europe. Although there has been a growing interest in the Mediterranean market economies since the 2010 crisis, the complex reality in those countries is largely understudied. Therefore, this is a novel effort to show how Greece's and Portugal's economies work, their structural weaknesses and why they failed to achieve a strong export-led recovery after the crisis.

This thesis provides a historical analysis of the creation of the consumption-led models of capitalism in the Eurozone. According to Hein et al. (2020) the current CPE is focused on the growth models before the crisis and scholars associated with the Growth Model approach have failed to account for the evolution of the growth models and the economic performance in the post-crisis era. This is a novel effort to account for both the historical roots and the complex evolution of the consumption-led growth models in the periphery after the Eurozone crisis. Such a scientific effort is based on substantial empirical evidence based on fieldwork and primary data, from specific cases, Greece and Portugal, that have not been examined in depth so far.

This thesis also argues that both supply and demand side factors are equally important to understand the growth models in depth. The Growth Model provides a comparative perspective of the macro-economic factors in different economies. It also offers a heterodox approach that is well advanced to show the role of the demand-side aspects in the formation of the growth models. Therefore, this thesis aims to reconcile the widely used separation between the 'supply-side' and 'demand-side' approaches, arguing that these different perspectives are not mutually exclusive but, rather, analyse different aspects of the growth models in the modern political economy. Therefore, the thesis provides a comprehensive analysis of the growth models in the pre-crisis and post-crisis eras in the periphery of the Eurozone.

This thesis also moves a step further by providing a novel explanation of the international position of those countries in the global economy and introducing the new concept of 'intermediate' economies. I introduce the concept of 'intermediate'[12] economies to describe in a more accurate way the features of the peripheral countries - especially Greece and Portugal- that went through the competitiveness crisis in 2010. How were those 'intermediate' economies created? As we have seen, those economies are the fruit of a historical process of capital formation and development in the European periphery. The origins of those economies can be traced back to before the creation of the Eurozone. The launch of the European Single Market through the

[12] The 'intermediate' economies are the fruit of the historical process of capital formation and economic development in the European periphery during recent decades. The origins of those economies can be tracked to before the creation of the Eurozone. However, the economic and political developments in the 2000s were of critical importance for their formation. Those economies are based on a demand-led model of economic growth and remain specialised in traditional low-tech sectors producing low value-added goods. They are stuck in between the high-tech core countries and the large-scale emerging economies. The 'intermediate' economies differ from the 'middle income' countries (World Bank, 2017; Agénor and Canuto, 2015), as the former are members of a currency union that has limited economic policy tools and is subject to external political rules and constraints.

elimination of barriers to capital, products and labour movement had complex effects on the southern economies. It prevented those countries from taking protective measures against the competition from other economies in Europe. In the context of the single market, those countries abandoned national industrial policies in favour of 'horizontal' policies. The governments surrendered their authority to intervene to support the most productive sectors of their economies through large public investments. As the Growth Model literature shows, the gradual financial integration through the adoption of EU Directives[13] concentrated investments in less productive sectors and domestic consumption (Dooley, 2018). This process accelerated the creation of debt-led models of growth in the 'intermediate' countries.

The economic and political developments in the 2000s were of critical importance to the 'intermediate' economies' formation. The introduction of the Euro -as will be shown in *chapter three*- triggered complex dynamics within the Union. The export-oriented economies, based on a rising demand for their products that went far beyond the borders of the EU market, achieved ongoing and, on some occasions, high economic growth from the early 2000s onwards. In parallel, the demand-led economies remained focused on 'traditional', low technology sectors, producing low value-added goods. As Growth Model theorists have shown, most of them achieved growth through massive external credit, increasing their domestic consumption in the 2000s. The Euro's appreciation against the dollar in 2002 had a complex impact on the price competitiveness of exports for those economies. The high-tech economies improved their competitiveness, but the traditional, low productivity ones failed to do so. A stronger domestic market, combined with the appreciation of the Euro, created incentives for the expansion of the non-tradable sectors (i.e. construction, retail trade and financial services) against the tradable ones.

In parallel, global economic developments, mainly the rise of the export economies in Asia and the expansion of the European single market to include the Eastern European countries, increased competition in traditional sectors in Greece and Portugal. Asian and Eastern European countries could produce the same products on a larger scale and at much more competitive prices. This led to a substantial decrease in FDI -which was diverted towards competitors- in tradable sectors. The size of the tradable sectors further decreased due to the harsh competition. In both Greece and

[13] For instance, the 'Second Banking Directive' in 1989 and the Financial Services Action Plan in 1999 played a key role in financial integration in Europe.

Portugal, the manufacturing sector shrank from 2000 onwards. The above developments led those economies towards 'structural regression'. The latter created the 'intermediate' economies, meaning countries 'stuck' between the 'high-tech' and the 'large-scale' competitors on a global level. Therefore, 'intermediate' is an analytical concept that goes beyond VoC's 'Mediterranean' market economies. It provides the 'big picture' of the role of those countries in the global production chain. It goes beyond a Eurocentric perspective to place those countries within the broader world economy. Those were largely the dynamics behind the increasing trade and current account deficits that led to the debt crisis at the end of the 2000s.

This thesis goes beyond Varieties of Capitalism in many more ways. Although VoC provides an interesting analytical framework, it converges with neoclassical economics in its policy recommendations. According to the VoC literature, based on slow wage growth in the 2000s, Germany and other coordinated market economies managed to take advantage of the rapid increase in wages in the periphery and gain a competitiveness advantage vis-a-vis the peripheral countries. Similarly to the neoclassical explanation, VoC insists that wage restraint through internal devaluation was the best way to restore the competitiveness of the Mediterranean market economies. A rapid labour cost decrease pushes export prices down and restores competitiveness. However, as will be shown in *chapter five*, the internal devaluation was rather ineffective in addressing the non-price aspects of competitiveness. The neoclassical economic policies were largely inappropriately designed to address the chronic and persistent structural weaknesses of the Greek economy. The same applies to the Portuguese one. I argue against the following principles:

1. Internal devaluation increased the export competitiveness of the 'intermediate' economies.
2. The labour and product market reforms transformed the consumption-led 'intermediate' economies to high-productivity, export-led growth model economies.
3. The deregulation of the labour and product markets increased productive investments.

In neoclassical economics, those assumptions are presumably valid at any 'place and time'. However, 'intermediate' economies such as Greece and Portugal face specific structural weaknesses that the neoclassical policies failed to address: (1) difficulty in creating economies of scale, (2) low-added value production and low

capacity for technology diffusion, (3) problematic aspects of human capital, and, (4) high barriers to government intervention to guide the market, and plan and intervene in the production process.

Therefore, I shall argue the following: (1) labour cost reduction does not automatically lead to competitive production, especially when the export composition remains problematic; (2) the market does not always allocate resources efficiently towards the most productive sectors; and, (3) deregulation does not mean higher and more productive investment in those 'intermediate' economies.

This thesis aims to enrich the debate over the origins of the Eurozone crisis and provide an in-depth understanding of why the neoclassical economic recipe failed to kick-start export-led growth in the 'intermediate' countries. I argue -based on this novel reading of the Eurozone crisis- that the response to the crisis should have included extensive state intervention to transform those economies and free them from the competitiveness trap. Although the analysis of such policies is beyond the scope of this thesis, the European Union should have designed an industrial policy to mitigate the divergence among the European countries and put those economies back on a trajectory that was convergent with the northern countries. This would have made the 'intermediate' countries competitive in the global value chains and the Eurozone less vulnerable to new asymmetric crises in the future.

Chapter 3: From the birth of the Euro to the Eurozone crisis

3.1 From the birth of the Euro to the Eurozone crisis

3.1.1 The birth of the Eurozone

A common currency for all Europeans would be unthinkable on a continent that was the theatre for two World Wars within a few decades. In December 1969 -a decade after the launch of the European Economic Communities (EEC)[14]- the European leaders made their first commitment to creating a monetary union at a European Council meeting at the Hague, in the Netherlands. This was the first step in a prolonged and turbulent process that ended with the signing of the Treaty on the European Union (TEU) in 1992 in Maastricht, in the Netherlands, where the European leaders paved the way for the single currency, the Euro.

The creation of the Eurozone and the unprecedented crisis it faced ten years later caused a debate about the reasons behind its unfortunate trajectory. In the context of this heavily contested academic and policy debate, it is widely argued that the Euro was a political project that ignored 'economics' (Minkkinen and Patomaki 1997; Andrews 1993; Garrett 1993; Baun 1996) and was therefore bound to fail. According to this perspective, the founders of the Eurozone reached a rough compromise to proceed with the single currency, overlooking economics to form a sustainable monetary union. On the contrary, I shall argue that both political interests and economic thinking were central to the genesis as well as the crisis of the Eurozone.

The European elites -from very early on- saw the single currency as an opportunity to multiply the benefits of trade integration in Europe. The introduction of a common currency would complete the single market, making the *one market, one money* mantra a reality (Commission of EC, 1990). The collapse of the Bretton Woods system of fixed exchange rates along with the oil crisis in the early 1970s caused currency swing and turbulence in the global economy. In response the European leaders agreed to form a European Monetary System in March 1979 by fixing the exchange

[14] As the European Union was called until 1993.

rates on to an accounting currency -the European Currency Unit- to counter currency fluctuation and control inflation (James, 2012; Ludlow, 1982; Mourlon-Druol, 2012). A new single currency for all Europeans would make Europe a large market and the Euro a credible competitor against the dollar for the international currency leadership.

The election of Francois Mitterrand in France and Helmut Kohl as a German Chancellor fuelled the negotiations over monetary integration. In 1987, the Single European Act- the first revision of the Treaty of Rome- opened up the path for a single market for goods and services that had to be completed by the end of 1992. In parallel, member states agreed to delegate a committee chaired by Jacques Delors – the then president of the European Commission - to propose a plan with realistic steps and a timeline for the monetary union. According to the Delors committee, the first stage required member states to proceed further towards economic coordination by gradually abolishing the exchange controls and any restrictions on the movement of capital. The second stage provided the creation of the Eurozone institutions and, the final one, the introduction of the new common European currency. The 'Delors reports' was the intellectual foundation of the Maastricht Treaty that launched the Euro a few years later.

The Euro was born in a changing international environment and coincided with the decline of the Keynesian paradigm on a global level. The Reagan presidency in the United States and Thatcherism in Britain shaped a new model for economic growth based on free-market economy principles, low inflation, a flexible labour market, financial deregulation and privatisation. Neoliberalism emerged as the predominant economic paradigm influencing economic policies across the world. At the same time, economic globalisation and the rapid financialisaton changed the traditional patters of economic growth in transnational and national levels. The emerging neoliberal thinking in its monetarist acceptation -associated with the work of Milton Friedman (1960)- influenced the economic policy in the region and laid the foundations for the Euro (McNamara, 1998). In the eyes of the founders of the Eurozone, a common European currency would, firstly, eliminate the exchange rate fluctuation and any inter-state currency antagonisms, preventing their destructive effects on trade and transnational investments.

According to the monetarist principles that dominated the prolonged Maastricht Treaty negotiations, the expansion of the money supply or any activist fiscal policy was inherently inflationary and thus would destabilise the economic cycle. Therefore, the monetary authorities should focus on inflation and price stability (Friedman and

Schwartz, 1986). The currency area supposedly needed a single independent central bank for all European economies to control inflation and new strict fiscal rules to guarantee a smooth macroeconomic policy in the whole region. The underlying principle of the emerging economic thinking was that the market was inherently stable and any intervention (i.e. a fiscal stimulus or subsidies) in the economy would -in principle- be counterproductive. Under those theoretical principles, a central mechanism to coordinate the economic policy was seen as obsolete.

Despite the rising optimism of the elites regarding the Euro, the monetary integration was not a linear process; it stalled several times as disagreements erupted between the countries (Eichengreen, 2007). According to the mainstream literature, the national disputes and political imperatives led to an incomplete and problematic Eurozone architecture. However, those claims underestimate the economic ideas behind the political debate over the Euro.

Two distinct approaches -within the monetarist tradition- have developed to explain the process of the monetary integration. The debate has been mainly about the nature of the transition to the Eurozone and the institutional design of the monetary policy (Torres, 2008).

The *gradual* approach associated with Germany, the Netherlands, and Austria involved them insisting that economic policy coordination should precede the introduction of a common currency, and arguing that the harmonisation and convergence of economic policies should ensure stability and prosperity. Therefore, they were in favour of a prolonged integration process without any set dates for the launch of the currency zone (Collignon, 2004). Germany had been persistently against any commitments to fiscal transfers, stabilisation mechanisms, or risk-sharing institutions and policies. Reluctant to transfer economic sovereignty to the Euro institutions, Germany argued that an independent European Central Bank would be enough to maintain low inflation and stability. Price stability and ongoing supply-side reforms in line with the US neoliberal model would be the driver for growth and prosperity.

On the other hand, France -and to a lesser extent Italy, Belgium, and Luxembourg- in line with pure *monetarist* thinking were in principle against the 'gradual' integration process and prioritised the creation of the common currency that would act as a 'catalyst' to drive further integration (Torres, 2008). According to this perspective, the Eurozone would create its own institutions after the introduction of the

Euro. France was in favour of transferring economic powers to the European institutions, claiming that national uncoordinated fiscal and economic policies would probably lead to macro-economic divergence and national or regional disequilibria. Both Germany and France had a long way to go to reach a compromise.

Beyond the disagreements between Germany and France, concerns were raised in other countries. National Parliaments, especially in Italy, Greece and Portugal, raised issues especially for the transfer of political powers to a hegemonic Union, the surrendering of their national competencies in relation to economic policy, and the threat to their national sovereignty. Concerns were also raised regarding the absence of mechanisms to mitigate national and regional asymmetry across Europe (Pelagidis and Mitsopoulos, 2014).

The reluctant slow steps towards monetary integration were accelerated in the light of the tectonic political shifts. The fall of the Berlin Wall in 1989 and the prospect of Germany's reunification was a major political concern for its European partners. A unified and *de facto* predominant Germany brought fears back to Europe. In the eyes of the French elite, further European integration -in the form of a monetary union- would allow the French and Italian governments to counterbalance (e.g. through veto power) Germany's rising economic power (Garrett, 1993). In parallel, Germany's initial position regarding gradual monetary integration was abandoned. With the political shifts, Germany expressed support for a rapid transition to the Euro, seizing the opportunity to relay concerns about its reunification and exercise influence in the new monetary structure. According to Jacques Delors, '*Kohl sensed his partners' unease. He knew that economic and monetary union gave him an instrument to calm them down. And so he used that instrument*' (Sandbu, 2015; p. 14).

The Euro was born, indeed, as a complex endeavour to balance various political imperatives. Germany envisaged a monetary union that would not transfer substantial economic powers to the Eurozone institutions. For France, the single currency would mean the end of the inferiority of its own currency compared to the *Deutsche Mark*. For Greece, Portugal and Spain, the monetary unification was a way to exit the cycle of high inflation and low productivity, and gave them hope that they would be able to converge economically and politically with the western European societies.

Although in principle all member countries participated in the intergovernmental conference, the French and Germans took the lead in the negotiations in Maastricht in 1991 (Dyson and Featherstone, 1999; Marsh, 2009). The Maastricht Treaty set the

convergence criteria that candidate countries had to fulfil to join the Eurozone. To a large extent, the convergence criteria and Eurozone structure reflected Germany's emphasis on discipline against *moral hazard*. The German leadership insisted on an "independent" European Central Bank (ECB) -based on the Bundesbank model- that would be responsible for maintaining price stability (Blyth, 2013; Bulmer *et al.* 2000). Fiscal discipline emerged as a prominent feature of the new structure. Governments that intended to join the Eurozone had to limit their deficits and debts (less than 3% for deficit and 60% of GDP for debt). The four criteria for countries to enter the common currency were defined as follows, "*the achievement of a high degree of price stability; the sustainability of the government financial position; the observance of the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other Member State; and ... the interest rate convergence*" (art. 109, TEU).

The Euro was indeed a political project, but it mirrored the prevailing economic idea of its era: monetarism. 'Economics' -particularly neoclassical economics- fundamentally influenced the birth and structure of the Eurozone. The founders of the Euro argued that, through market forces, the single currency would increase productivity and growth in the whole region. The belief that macro-economic and structural disparities would miraculously disappear in the context of the Eurozone was falsified. Those disparities were the fruit of the production structure and the uneven development within and across European countries. The fiscal discipline and market forces alone failed to shrink them. On the contrary, the deprivation of Eurozone member states' own exchange rate, monetary policy, and industrial policy mechanisms made them vulnerable to the upcoming economic shock. The birth of the Euro created hopes that were soon dashed.

3.1.2 Eurozone: the flawed architecture

Several voices were raised -even at the time of the founding of the Euro- that emphasised the problematic architecture of the Eurozone (De Grauwe 1999; Kennen,1995; Bayoumi and Eichengreen, 1993; McKinnon, 1995; Mundell, 1997). These longstanding concerns have come to the surface since the outbreak of the crisis

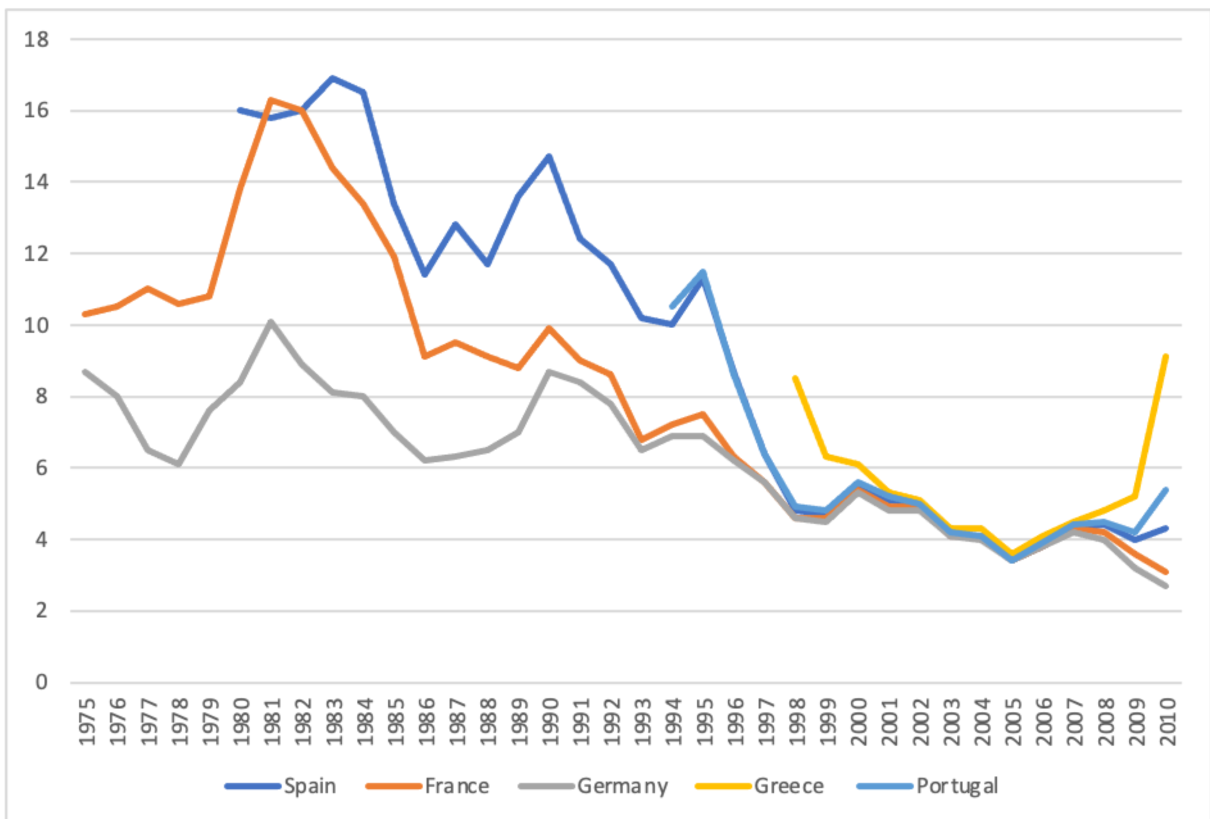
(De Grauwe, 2013; Dullien and Guerot, 2012; Eichengreen, 2014; Schelkle, 2013; Stiglitz, 2016).

The founders of the Eurozone were -under the monetarism orthodoxy- against any central authority to coordinate economic and fiscal policy (Issing, 2008). Any political institution or actions were seen as a harmful intervention in the economy. Under the new structure, the European Central Bank (ECB) concentrated the monetary power at the expense of the national central banks. The ECB was created under the assumption - which was fashionable at the time- that inflation is all that matters, and was designed with the single goal of controlling inflation and achieving price stability. The ECB managed to keep aggregate inflation low in the whole of the Eurozone, but inflation diverged among individual countries.

The ECB was also responsible for setting the benchmarks for the interest rates in the Eurozone. Several countries that had to pay high interest rates before 2000 now had privileged access to low interest rates under the ECB guarantee. The nominal interest rates converged -as shown in graph 1- for government bonds and corporate loans across the Eurozone in the 2000s (OECD, 2010).

Graph 1

Long-term interest rates, total % per annum, 1975- 2010 (Source OECD)



The financialisaton that took place across the world had been accelerated in the Eurozone. Suddenly, capital was available to peripheral economies on the terms enjoyed by Germany. As will be discussed below, the artificially low interest rate for all was destabilising in the asymmetric monetary union. This practice that fuelled macroeconomic imbalances had been largely uncontested until the financial crash in 2008. By taking control of the interest rates in a fixed exchange rate regime, the ECB left national governments deprived of two of the most important ways to adjust their economies. Under normal conditions, when two countries are on diverging trajectories, they use different interest rates and a flexible exchange rate to stabilise the trade balance. In the Eurozone this has been impossible. In contrast, adjustments in the Eurozone could, supposedly, be achieved through supply-side reforms -cuts in labour costs and labour market deregulation- to boost competitiveness and output. This proved a theoretical fallacy. As will be discussed in *chapter five*, internal devaluation was not effective in boosting competitiveness in the peripheral economies.

Furthermore, the ECB was not authorised to play the role of *lender of last resort* -to ensure solvency of governments and the banking sector- to stabilise the Eurozone in case of asymmetric shocks (De Grauwe, 2013). Both public and private debts have been in a currency that countries do not control in the sense that they cannot -as usually expected- print money to meet their obligations (Stiglitz, 2016). The latter had fateful effects as countries in crisis had to turn to the ECB and their European partners to get the money to repay their debts. Therefore, the Eurozone was transformed into a union of creditors and debtors.

In the absence of a central authority, the founders of the Eurozone agreed on new fiscal rules that were binding for all: the stability and growth pact (SGP) to control fiscal policy and synchronise business cycles. The Stability and Growth Pact required member states to keep their public deficit at less 3% of GDP and their debt at less than 60% of GDP under any conditions to ensure countries' credibility and investors' confidence. This would -according to those assumptions- prevent any fiscal imbalances in the Eurozone. Any active fiscal policy was seen as a threat to stability and smooth macroeconomic performance.

The deficit and debt ratio targets proved both counterproductive and unrealistic on a long-term basis. First, the fiscal rules -contrary to what was claimed- failed to synchronise the business cycles among countries. The fiscal policy -based on *one size fits all* targets- had not been designed to take into account the impact of economic

policy in one country on others, and thus it failed to synchronise the business activity in the whole region. Beyond that, the restrictive fiscal rules proved largely counterproductive -especially under crisis conditions- where austerity became self-defeating, exacerbating the recession and further increasing the debt ratio.

Second, member countries were unable to commit to those rules. Some countries violated the SGP, either by sustaining high surpluses (i.e. Germany) or by accumulating debt (i.e. Greece). Under accelerated financialisaton, the peripheral countries were now able to relax fiscal rules and consume increasingly imports from the North. The hypocritic emphasis on fiscal targets left unaddressed the cause of the fiscal imbalances: uneven development. Ironically, the fiscal rules that would supposedly make economies converge limited the tools for a real synchronisation and convergence. Beyond the structural divergence, the absence of a political institution raised concerns over the democratic legitimacy and accountability of the new structure. The "independent" central bank and the fiscal rules -that are not subject to democratic change- have been a trauma for democracy on the continent (Elster, 1979). The dogma that states that the 'economy' should be protected by political interventions hurts the heart of democracy.

Finally, the structure of the Eurozone failed to consider a central budget and risk-sharing mechanisms to distribute funds (i.e. fiscal transfers) to mitigate macro-economic imbalances. This was critical -according to the Optimal Currency Area (OCA) theory (Mundell 1961; Kenen, 1969; McKinnon, 1963)- to ensure smooth economic development and stability in the Eurozone (De Grauwe, 2013). Only limited EU resources -up to 1% of the EU GDP- are transferred among the Union's member states, mainly through agriculture subsidies. Concerns -especially in Germany- against *free-riding* turned northern European governments against risk-sharing institutions or bailout mechanisms (Baldwin, 2006). The Eurozone was built under the hypothesis that one state's liabilities should not be treated as other states' obligations (*no bailout clause*). Article 125 of the founding Maastricht Treaty prevented any kind of bailout mechanisms in the Eurozone.

Overall, in the aftermath of the Maastricht Treaty, the European leaders made a commitment to a new single currency, the Euro, that has been extraordinarily costly to reverse. The Maastricht Treaty was based on the assumption that compliance with the fiscal rules -under low inflation- would be enough for the member states to converge and prosper in the Eurozone. The unsynchronised economic cycles, the variety of local institutions, and the lack of political coherence were largely ignored in the new

structure. No provisions were made to take into account the different production structures, to transfer funds, or to bail-out countries in case of asymmetric shocks (Wyplosz, 2006). The economic governance was focused on fiscal discipline while production asymmetry and competitiveness divergence widened. Member states were not able to adjust their exchange rates, use interest rates, or proceed to fiscal stimulus to prevent an economic slowdown. The absence of a European political authority to coordinate economic policy exacerbated the uneven development in the Eurozone. Under the influence of Neoliberal dogma, national economic planning and industrial policies were at best discouraged.

Overall, it is widely argued that the Eurozone was a political compromise and, thus, that it is an incomplete and problematic monetary union. Although this claim contains elements of truth, it is -if seen alone- misleading. The Eurozone was indeed a political project initiated by the Northern economies -mainly Germany and France- to expand the markets for their products and keep transaction costs low. However, the structure of the Eurozone was dictated as much by political interests as by the predominant neoliberal economic ideas at the time. As will be shown, the outbreak of the crisis -ten years after the Euro was launched- revealed the limits of those economic ideas.

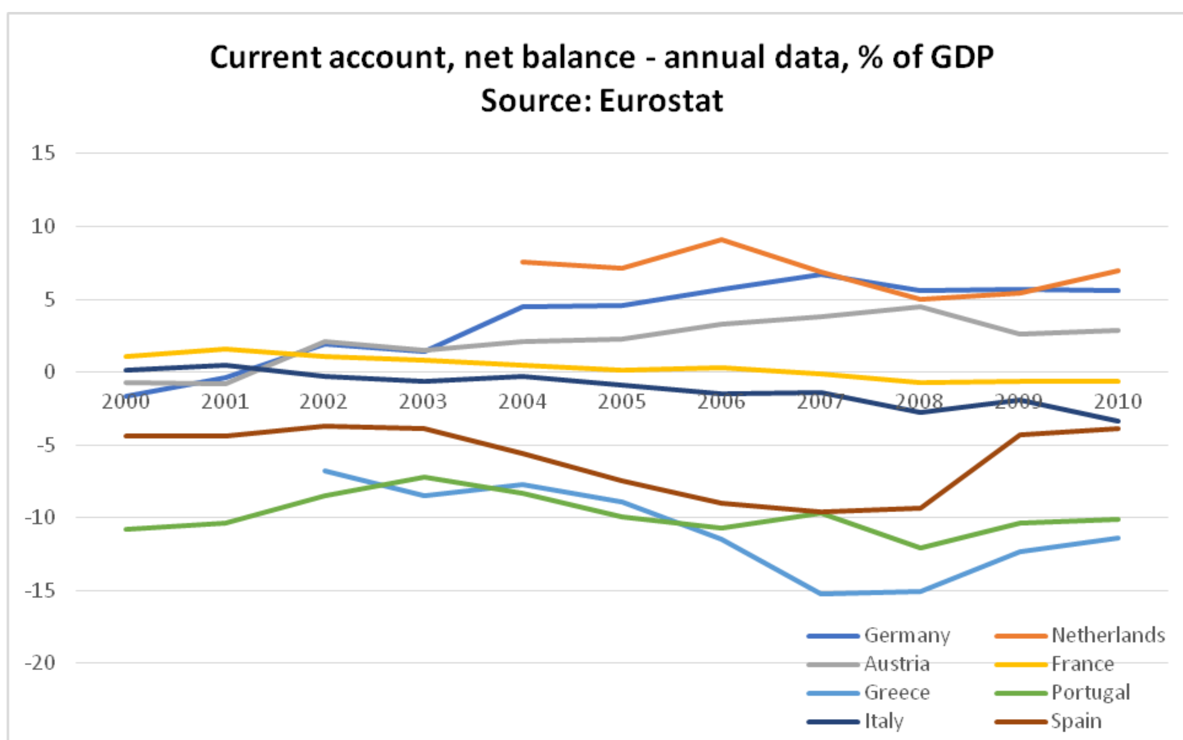
3.1.3 The rising macroeconomic imbalances in the Eurozone

The creation of the Eurozone, according to neoclassical economic theory, was expected to protect countries from speculative attacks -via exchange rate stability, and the removal of transaction barriers (i.e. capital controls)- improving countries' credibility and preventing asymmetric shocks (Giavazzi and Pagano, 1988). The single currency would reduce transaction costs and, under the free trade conditions (i.e. no tariffs and no import tax), would increase trade among countries, increasing GDP growth and, supposedly, accelerating convergence.

In parallel, free capital mobility -under financial deregulation conditions- would encourage foreign direct investment inflows towards the most productive sectors in the peripheral economies. The macroeconomic imbalances would gradually decline and the economies would converge (TEU, 1992).

In many respects, countries showed signs of economic growth and convergence during the first decade of the Euro. Several peripheral countries -Greece being a prominent case among them- indeed witnessed high growth rates in terms of GDP and per capita income in the 2000s. However, this was a period of growing divergence in terms of current accounts (Graph 2).

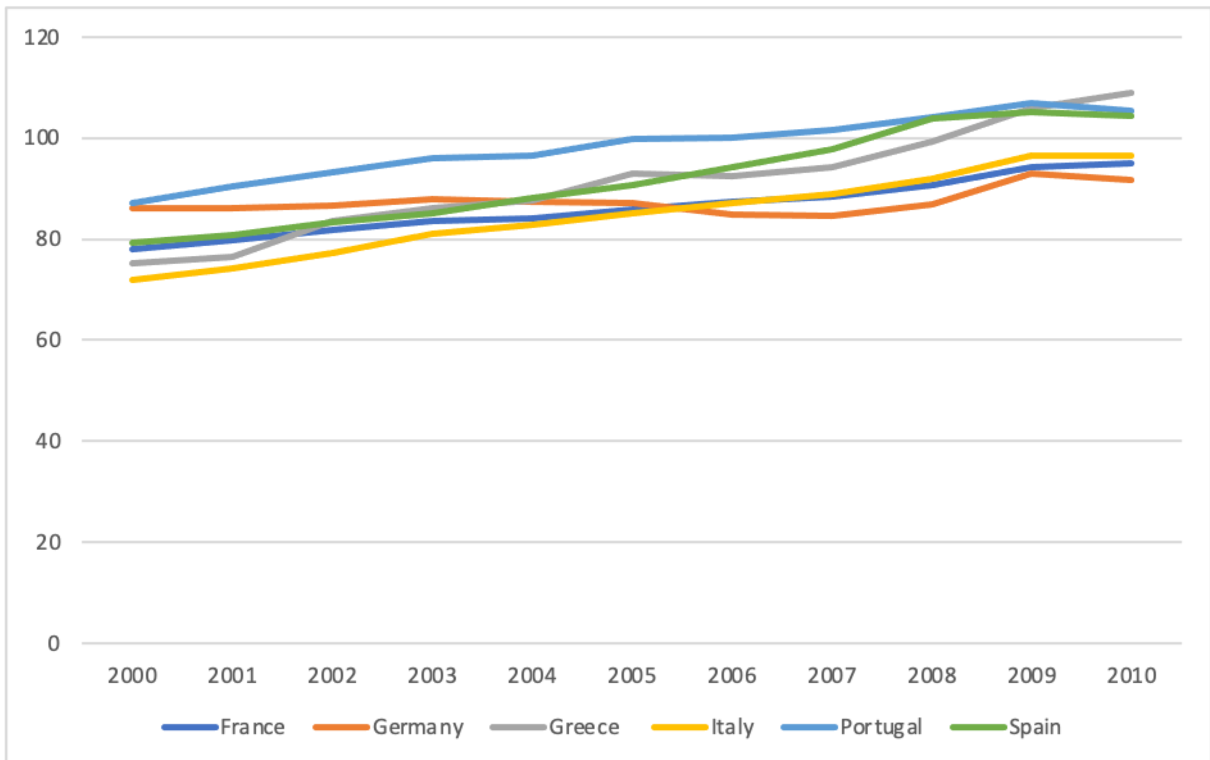
Graph 2



The northern economies accelerated their export performance soon after the creation of the Eurozone. Germany entered the Union financially burdened by the cost of its reunification; however, it achieved high growth rates from the late 1990s. Gerhard Schröder's -the social-democrat German Chancellor- 'Hartz plan' pushed for a wage moderation policy in the 2000s. His policy achieved a substantial decrease in labour costs, keeping Germany's domestic demand low. In the late 1990s, the German government and employers started to pressure the trade unions to accept a tight policy on wages. In 1999, the labour unions agreed to maintain low wages and 'reserve productivity growth for employment' (Flassbeck and Lapavitsas, 2015). The tradition of increasing wages according to productivity was ended. Wages would now be shaped according to the inflation target of 2 per cent. This policy led to a substantial divergence

in nominal unit labour costs among the Eurozone countries, as these costs remained stable in Germany while increasing in southern countries (graph 3) (Stockhammer, 2011; Bonfiger, 2015).

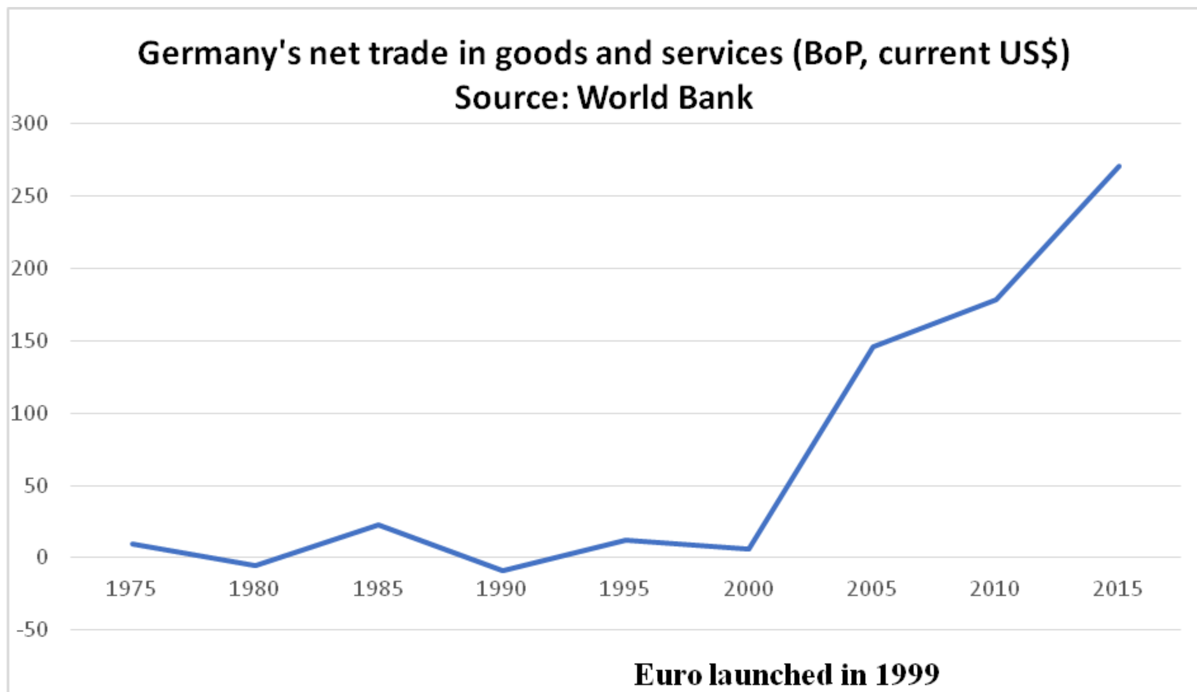
Graph 3
Nominal Unit Labour cost (2015=100)
(Source: OECD)



Therefore, the 10th anniversary of the Eurozone found Germany with a 25% difference in labour costs and prices compared to southern Europe and a 15% difference compared to France (Flassbeck and Lapavitsas, 2015). Germany's pressure to push wages down, in an environment of increasing wages in its trading partners, decreased the price of German products and widened the share of its export market. Germany and other northern economies that followed such a policy gained an advantage in comparison to their European neighbours. Despite the non-existence of different currencies, the northern economies depreciated, while the southern economies were overvalued in real terms. What happened was another form of competitive devaluation -

through wage moderation- that made the real exchange rate of the northern countries lower than that of their neighbours. Germany's impressive economic growth and current account surpluses were largely based on its outstanding export performance, as shown in graph 4 (World Bank, 2016).

Graph 4



The northern countries' export accomplishment is usually attributed exclusively to the wage moderation policy in the 2000s; however, the reality is much more complex. Undoubtfully, the wage moderation increased the price competitiveness of Northern products abroad, but non-price competitiveness factors should not be underestimated. For instance, Germany relied on its production specialisation and advanced technology, which placed it in a superior position in the competition with other Eurozone member states (Storm and Naastepad, 2015; Gabrisch and Staehr, 2014). Beyond German industry, Nordic countries that also followed the export-led path based on technology and innovation increased their competitiveness and achieved trade surpluses in the 2000s. On the other hand, peripheral economies -based on traditional low-technology production- with the appreciation of the Euro, witnessed a rapid de-industrialisation and became import-oriented countries that were largely dependent on credit to sustain their high deficits in the 2000s.

In the North, the profits from exports were not used to boost consumption, as domestic wages had stagnated; instead, they ended up in the banks, which lent them abroad. Those banks, in high-performing countries, channelled massive credit flows towards the periphery, financing its rising current account deficit (Baldwin and Giavazzi, 2015). From the late 1990s, the major European banks engaged in an enormous lending programme that governments were not able or willing to restrain. The credit flows supplied the growing demand in the periphery and created a dynamic market for the Northern exporters. In the context of the Eurozone, the surpluses of the North were the other side of the deficits in the South.

The deficit countries, which had witnessed a substantial loss of competitiveness, were unable to depreciate their currency or to follow a different trade policy; neither was an option in the Eurozone. The consumption-led countries had to play a vicious game; they had to increase wages and use the low interest rates -under the ECB - to boost domestic demand, as this was the only way to maintain growth. This was the mechanism behind the rapid debt accumulation in the periphery. This mechanism created a new division between the export-oriented and import-led economies in the Eurozone.

The excessive public and private borrowing boosted demand-led high growth rates and increased per capital income in the peripheral countries. Most of those economies -except Italy and Portugal- expanded in the 2000s. The high growth rates masked the structural divergence among the countries, at least until the crash in 2009-2010.

In parallel, the global political upheavals accelerated the structural transformation of the peripheral economies. Firstly, the emerging economies -especially China and India- dominated the low-cost mass production and put at risk economies that were based on low value-added and low-technology products. The appreciated Euro, which, before the crisis, had reached double its value against the *dollar* and *yuan*, was disastrous for the southern periphery competitiveness (Boyer, 2010). Secondly, the EU enlargement towards its Eastern borders had complex economic effects. The German industry took advantage of the short-distance, cheap labour, and relatively good infrastructure of the former socialist regimes and moved a part of its production process into those Eastern European countries. This had a reverse impact, leaving the southern periphery largely with less productive investments. The capital flows towards the southern periphery took the form of short-term opportunistic investment rather than a

long-term commitment in a particular production sector. The real problem was not credit inflows per se, but the form they took and their destination. Under the EU and WTO, national governments exercised limited influence over investment features (i.e. technology transfer to local production) and allocation. The credit flows financed housing bubbles in Spain, Greece and Ireland, and consumption in Portugal, Italy and Cyprus. Non-export economic activities such as retail and wholesale trade, real estate, hotels, and the finance and insurance sectors expanded in most of the southern peripheral countries in the 2000s (Hopkin, 2015).

The substantial divergence among the economies in terms of their production structure, technology and innovation was exacerbated in the context of the Eurozone. As Kaldor (1957) claimed, applying uniform rules to divergent countries can increase the divergence, making the management of the monetary union even harder. In many respects, rising government deficits and accumulated debts were the outcomes rather than the cause of the crisis.

The Eurozone became an equilibrium in the sense that the two geographies (core- southern periphery) were complementary in terms of the supply-demand and export-import dynamics. The European architecture, as shown earlier, was inappropriate to prevent the rising imbalances. Structural winners and losers emerged. The northern countries' economic success was largely the result of those dynamics.

This emerging structural divergence was barely noticed in the 2000s, when high growth rates in the periphery brought euphoria in the Eurozone. The rapid economic boom and the accompanying bubbles fuelled optimism in the Eurozone (Portes and Baldursson, 2007). To a large extent, the Eurozone structure underestimated the allocation of production capabilities, specialisation and structural dynamics among the countries. The persistent macro-economic imbalances -that surfaced at the moment of the crisis- have been attributed to 'reckless' countries (Giavazzi and Spaventa, 2010) and the 'lack of reforms' in the periphery. Neo-classical macroeconomics and neoliberal beliefs proved problematic, bringing the Euro to the brink of collapse in 2010.

Overall, the Eurozone should not be seen as just a political compromise between the German and French elites, but as the fruit of neoliberal ideas, which was fashionable at the time too. The absence of a central political authority and/or mechanisms to coordinate collective action was the result of both an opportunistic political compromise as well as the prevailing ideas of monetarism. The latter consider any political intervention -in principle- harmful for economic growth. The commonly used criticism

against the 'politics' of the Euro alone leaves the problematic economic ideas behind the failure of the Euro largely in the dark.

The architects of the Eurozone deprived national governments of economic tools without replacing them with adjustment mechanisms. The ECB 'one size fits all' monetary policy was short-sighted and thus failed to prevent the upcoming crisis. The fiscal rules (SGP) and supply-side reforms proved largely inadequate to mitigate the underlying structural imbalances within the Eurozone. The structural divergence among export-led and consumption-led countries widened. The neoclassical belief that market forces alone would shrink the long-lasting deep structural divergence proved fallacious. Policies to restructure the less competitive economies and infuse technology were neglected in the first decade of the Eurozone. The export-oriented and consumption-led division became soon a surplus-deficit dividing line in Europe. Soon after its creation, the Eurozone became an unsustainable monetary union. The high growth rates masked the structural divergence among the countries in the first *golden decade* of the Euro. However, the financial crash in 2008 brought those structural imbalances to the surface.

3.2 The Political Economy in Greece and Portugal before the crisis

3.2.1 The political economy of Greece on the eve of the crisis

As we have seen in the previous chapter, the mainstream literature has dealt with Greece as a 'special case' that, due to its fiscal 'profligacy', put the Eurozone at risk. Greece, as is widely argued, is a 'backward' country that failed to reform its economy and society in line with other European societies in the second half of the century. For some of the creditors (Schauble, 2015; Lagarde 2015), but also academics (Ioakimides, 2011; Diamandouros, 1994; Pelagidis and Mitsopoulos, 2014; Voulgaris, 2008; Kalyvas *et al*, 2013) the Greek crisis was the result of the deep-rooted reform fatigue, the hypertrophic public sector, and fiscal derailment in the 2000s. According to this narrative, the successive governments -despite their occasional modernisation attempts- failed to reform the Greek economy due to resistance from organised interests that considered any modernisation effort an 'existential threat' (Pelagidis and Mitsopoulos, 2014). As argued by neoclassical economists, those interest groups were opposed to market reforms and modernisation. Despite the election of pro-EU reformist governments in the 1990s and 2000s, Greece achieved poor results in terms of reviving its economy and society and was therefore prone to crises.

The overthrow of the 7-year military dictatorship (1967- 1974) and the abolition of the monarchy after a national referendum in 1974 opened up the path for a long and relatively smooth democratisation of the Greek society. The governments in the late 1970s took the first steps towards the national rapprochement (i.e. the legalisation of the Communist Party), stabilisation of the economy and the preparation of the country's accession to the European Communities (now the European Union).

Aspirations for economic acceleration, modernisation through the Community's cohesion funds (i.e. the Delors packages) and convergence with the high performing economies in Europe encouraged Greece to request to join the Community in the late 1970s. In the eyes of the Greek political elites, accession to the European Community was also an identity issue. As Costantinos Karamanlis, the first democratically elected Prime Minister after the junta, emphatically claimed, 'Greece belongs to the West' (Karamanlis, 1976). The promise of 'Europeanisation' and mostly the advanced security

conferred by being under the European 'umbrella', which would provide protection against threats on Greece's eastern borders (i.e. due to the long dispute with Turkey), were the drivers for the country's accession to the European Community. In January 1981, Greece became the 10th member of the Community and, by the end of the year, Andreas Papandreou, the leader of the Panhellenic Socialist Movement (PASOK) had won -under the '*change*' mantra- the majority of the Parliament seats. His social-democratic government implemented a Keynesian wage-led growth programme increasing the minimum wage, pensions, and public spending to build a national welfare system through the establishment of a National Health System (NHS), a higher education system, maternity allowances, care centres for the elderly and state-subsidised tourism for low-income families. On the social level, new laws were introduced to protect labour rights, enhance the legal status of women (i.e. equal pay for equal work), and democratise the education system (i.e. students to participate in university governance) (Voulgaris, 2008).

The increase in public expenditure in the early years of the PASOK government (1981- 85) led to the accumulation of a large government deficit and debt. The fiscal burden forced the government to reverse its economic policy by adopting stabilisation programmes in the second half of the 1980s, which aimed to 'curtail domestic demand, reduce the public sector borrowing requirement, and enhance competitiveness through currency (*drachma*) devaluation' (Pagoulatos, 2000; p.157).

In parallel, Greece's entry into the European single market triggered a rapid economic transformation. Greece's exposure to high external competition along with the gradual abolition of its industrial policy led to a dramatic degradation of the country's production capabilities. A number of large and medium sized firms - exposed to aggressive competition - collapsed and were replaced by small and flexible firms (Giannitsis, 1988). At the same time, under the Union's free movement of capital principle, firms moved to neighbour countries to take advantage of the lower labour cost and potential higher profits. Greece went through a long and painful process of deindustrialisation from the early 1990s.

In 1990, New Democracy, a right-wing liberal party, came to power -after PASOK government economic scandals were revealed- which was determined to implement an ambitious reform programme and comply with the *convergence criteria* to enter the Eurozone. Under the EU's neoliberal economic policies, governments pursued further deregulation in labour and product markets. The new government

proceeded to undertake fiscal consolidation and product market deregulation. A number of neoliberal reforms were introduced, mainly centred on the abolition of price controls (i.e. in fuels and rents), the revision of company law, and the liberalisation of the insurance, accountancy and fertiliser markets.

The neoliberal reform agenda, introduced by New Democracy, was accelerated by PASOK in the mid-1990s onwards. The preponderance of the modernising pro-European wing within PASOK under the new Prime Minister, Costas Simitis, -under the '*modernisation*' mantra- dominated Greece's political life from 1996 to 2004. To a large extent, PASOK followed the historical evolution of the traditional social-democratic parties in Europe (i.e. Blair in the UK, Schröder in Germany), adopting a neoliberal agenda in the 1990s (Riley, 2012). The new 'reformist' government considered the Eurozone and the 'Maastricht criteria' an indispensable opportunity to modernise the Greek economy and society. Under the surprising motto '*Greece belongs to the strong core of the Eurozone*', the government pursued a policy to control inflation and undertake neoliberal reforms in the labour market, through the introduction of part-time work (1998), the introduction of fixed-term contracts in the public and private sectors (2003), and a decrease in the cost of overtime work (2005). These policies were accompanied by the deregulation of the services market, the opening up of the telecommunications market (2000), the introduction of private-public partnerships (2005), and a law to reform the operation of state companies (2005). A privatisation programme was also pursued, mainly in Hellenic Petroleum (23% of the company, 1998), Commercial Bank (2006), Hellenic Telecommunications Organisation (25% sale to Deutsche Telekom, 2007), and Olympic Airways (2009).

Since 1974 successive governments have indeed used public sector employment for clientelist purposes. However, the claims that overemphasise the size and the cost of the public sector in Greece have led to misunderstandings about the underlying structural problems that made the country vulnerable to a crisis. Despite its notorious inefficiency, Greece's public sector has been in line with other European countries in size and cost terms. Greece has a larger public sector (22.2%) in terms of employment than Austria (19.9 %), Spain (17.1%), but it is smaller than Denmark (36.3%), or Sweden (29.6%) as a percentage of total employment (ILO, 2010). Greece's primary government expenditure, albeit high, has been lower than that in the Northern economies and some peripheral countries.

At the turn of the millennium, Greece followed an expansionary fiscal policy to boost growth and witnessed growth rates higher than the EU average. Indicators such as GDP per capital showed that Greece had been in a process of convergence with the other EU countries. However, the economic growth sowed the seeds of its own failure. Behind this economic expansion lay a rapid transformation of the Greek economy and a new fragile consumption-led growth model.

Greece witnessed a substantial decline in the agriculture and industrial sectors (combined) -which was accelerated after tis access to the European Single market- from 49.7 % in 1970 to 16.8 % of GDP in 2011. At the same time, Greece witnessed a rapid expansion of introvert economic activity, mainly retail and wholesale trade, banking services, and construction (Eurostat, 2016). The degradation of the agriculture and industrial sectors led to a dramatic decline in tradable products in favour of non-tradable services. The country's specialisation in low technology goods led to a substantial loss of competitiveness. Investments in Research and Development (R&D) -to reverse this trend- have remained stagnant. Greece has been the worst performer in terms of R&D expenditure. It has never exceeded 0.6 % of GDP and business R&D has always been extremely low at around 0.15 % of GDP in the Eurozone (Eurostat, 2016). The appreciation of the Euro and the higher international competition increased the trade deficit dramatically in 2000s.

Greece's -along with other peripheral countries'- privileged access to low interest rates -under the financial deregulation- positively affected the government and private investments in the 2000s. Greece had higher fixed investment than most of the EU countries (Eurostat, 2016). Beyond investment, the credit inflows acted as demand injections for the Greek economy. The cheap credit had covered the needs of a large part of the population (i.e. mortgages and general consumption loans) that would never have been able to acquire such loans.

The high-growth performance before the crisis was, to a large extent, the fruit of this consumption-led growth model in the 2000s. The credit inflows -based on a short-term market rationale- were directed towards the housing construction, athletic infrastructure (especially before the Olympic Games in 2004), and services sectors (i.e. real estate and financial services), fostering economic bubbles (i.e. in real estate). Greece's 'economic miracle' -as it was named the most developed economy in South-East Europe- fuelled the Greek foreign direct investment outflows towards Southeast Europe. Greek banks and other companies had been opening up in cities like Sofia,

Bucharest, Istanbul, and elsewhere in its neighbourhood. The high growth rates and the expansion of sectors such as tourism, shipping and banking masked the problematic trajectory of the Greek economy.

Greece, like all other Eurozone countries, was not able to devalue its currency, adopt protective measures, or boost domestic production to cover its domestic demand by its own means. The transformation towards a consumption-led growth model and the massive credit inflows towards Greece created the conditions for the future crises: 'twin deficits' (government and current account) and the banking crisis (Kutlay, 2019). The Greek government and households were in a vicious circle where the former had to boost consumption to maintain growth and the latter to borrow to service their existing loans.

The outbreak of the crisis in the United States fuelled the concerns about a bubble burst in the Eurozone and then credit inflows suddenly stopped. The economic Armageddon for Greece had just begun.

3.2.2 The political economy of Portugal before the outbreak of the crisis

From the perspective of neoclassical economists, Portugal was, due to its high public spending, systematically accumulating public deficits and debt in the 1990s (Blanchard 2007; Perera and Wemans 2012; OECD 2013). The active fiscal policy along with Portugal's economic stagnation in the 2000s led the economy to the verge of collapse after the downturn in the periphery. On the other hand, Keynesian economists consider the crisis in Portugal to be the result of the speculation attack against the Euro in 2009- 2011 (Fishman 2011, Kalbaska and Gatkowski 2012). According to this narrative, in the aftermath of the crisis in Ireland, and moreover in Greece, in 2010, the financial markets worried about the solvency of the Eurozone periphery as a whole. The crisis contagion and rating agencies' attacks led to a rapid rise of interest rates that pushed Portugal out of the financial markets to negotiate a bailout programme with the EU and IMF. Both perspectives -although containing elements of truth- miss the underlying structural conditions that made the Portuguese economy vulnerable to the crisis in 2010.

The overthrowing of Marcello Caetano and the 40-year dictatorship of Olivier Salazar (*Estado Novo*) with the 'Carnation revolution' in 1974 signalled the end of the longest-lived authoritarian regime in Western Europe in the 20th century. This was the beginning of a new era in the political economy of the country. In the aftermath of the revolution, the radical wing of the revolutionists gained power, dominated the newly elected Constituent Assembly and influenced the new constitution in April 1976.

The new constitution (1976) to a large extent reflected the revolutionary ideas that defined Portugal as a '*Republic… engaged in the formation of a classless society*' and the role of the state to "*socialise the means of production and abolish the exploitation of man by man*". It paved the way to a long and turbulent democratisation of the Portuguese society by establishing a democratic parliamentary system, releasing political prisoners, establishing democratic principles (i.e. free and fair elections, an independent judiciary, and freedom of speech) and social rights. The revolutionary regime ended the Portuguese Empire, abandoning the country's colonies overseas and welcoming hundreds of thousands of Portuguese citizens from abroad. The revolutionary ferment, on the other hand, led thousands of people -mainly managerial staff and technicians- to leave Portugal for neighbouring European countries and its former colony, Brazil (Dooley, 2018).

In the economic sphere, the new constitution led to the nationalisation of the country's banking sector and large private companies. The rapid nationalisation process accelerated the concentration of capital through the merger of small enterprises to form state monopolies in various sectors (e.g. construction, tourism, insurance, and the media) and to some extent in agriculture, through land seizures. The radical nationalisation of the economy expanded the government and public services.

The Carnation revolution along with the international developments, mainly the collapse of the Bretton Woods system and the oil shocks, created a long period of instability in the early 1970s. The expansionary fiscal policy and the rapid increase in labour costs generated a high balance of payments deficit, inflation, and debt accumulation (Dooley, 2018). The Socialist party (SP) formed the first government -after the adoption of the new Constitution- led by Mario Soares, who returned from exile after the revolution. The new government, under suffocating pressure, reached an agreement with the IMF on a financial assistance programme in 1977-79, and another such programme was implemented by the Social Democratic Party (PSD) government

in 1983-85. The IMF agreed on a painful programme of contractionary policies that decreased the real labour costs and devalued the national currency (the *escudo*).

In the elections in 1979, the centre-right Social Democratic Party (PSD) -after a period of short-lived governments- won a majority in the Parliament and formed a new reformist government under Francisco Sa Carneiro. The PSD dominated the political sphere over the following decades. The PSD governments led the institutional transformation -via Constitution revisions in 1982- gradually abolishing the radical aspects of the revolutionary Constitution; the engagement of the military in politics, the President's power to veto legislation and dismiss Parliament, and the constitutional provisions for nationalisation. The PSD promoted a model of a 'free market' and open economy.

The PSD -under the leadership of the liberal economist Anibal Cavaco Silva- guided the country's accession to the European Community (1986) and shaped a new programme of reforms to liberalise the Portuguese economy in the 1990s. The access to the European Community has accelerated the neoliberal transformation of the economy and society. The Portuguese economy was stabilised with high growth rates -an average of 4.1 % of GDP- increasing domestic demand and decreasing unemployment during that decade (Eurostat, 2015). This period was critical for the future of the Portuguese economy. At that time Portugal went through a transformation that had many faces.

From a high regulated economy with government policies in the agriculture and manufacturing sectors, Portugal was transformed into an open liberal economy. The deregulation of the financial sector- according to the Capital Adequacy Directive in 1991 and the EU Banking Directive in 1993- gave the banks an unprecedented opportunity to create new banking products, take higher risks, and increase consumption loans for individuals (Dooley, 2018: 79). In parallel, credit was directed -according to a short-term rationale- towards low-productivity and non-tradable sectors, creating a consumption bubble in the Portuguese economy. The credit boosted domestic demand and consumption and tripled household debt in the 1990s.

Increasing domestic demand led to a gradual degradation of Portugal's traditional tradable sectors (agriculture, mining and manufacturing) and reinforced the inward-looking non-tradable sectors of the economy, mainly construction, utilities, real estate, services, wholesale and retail trade. Portugal -along with Greece- faced a faster rate of de-industrialisation in Europe. The Social Democratic Party -under the

Europeanisation process- created a debt-driven, consumption-led model of growth (Dooley, 2018).

In October 1995, Antonio Guterres, leader of the Socialist party (SP), won the legislative elections, terminating the 10-year period of successive PSD governments. Antonio Guterres continued the neo-liberal reform agenda -on the road towards the Eurozone- and accelerated the privatisation of state-owned companies in the late 1990s.

Following the boost in the 1990s, the Portuguese economy stagnated between 2000 and 2010, reaching the second lowest average growth rate (after Italy) in the European Union. In contrast with most of the peripheral countries, which accumulated their debt during the boom in the 2000s, Portugal was highly indebted at the end of the 1990s.

The ECB decision to increase interest rates from 0.25% in 1999 to 3.5% in 2000 dramatically affected credit flows towards the economy and, therefore, domestic consumption, growth, and finance of the public debt. The government reacted -differently than its southern neighbours- by implementing tough fiscal policies to control the deficit and improve the debt ratio. The Social Democratic party -under Prime Minister José Manuel Barroso, who later served as president of the European Commission- pursued a 'tight' fiscal policy to decrease the public deficit to within the limits of the Stability and Growth Pact (3% of GDP). Portugal has been under the Union's Excessive Deficit Procedure since 2001. Austerity was destructive in a demand-led economy and led to a rapid fall in consumption and a growth slowdown.

The accession to the Eurozone and the changing international economic environment accelerated the loss of competitiveness of the Portuguese economy. Portugal, with a manufacturing sector concentrated on low value-added products, mainly clothing, textiles and footwear, has faced increasing competition from the low-cost manufacturing sectors in Eastern Europe and Asia since the 1970s. In 2000, the adoption of an overvalued currency made its exports more expensive in comparison with its competitors. The Portuguese producers were exposed to aggressive competition in Europe and beyond (Amaral, 2013). Under those circumstances, domestic investors were forced to rely on the domestic demand rather than competing in the European and global markets (Lopes, 2012). The collapse of the Multi-Fibre Arrangement in 2005 ended the restriction on clothing exports from developing to developed economies, leading the Portuguese production into further decline.

Domestic producers attempted to transform their production towards higher value-added and technology-advanced activities (i.e. electronics, machines). However, this attempt to upgrade the specialisation profile of the economy crashed due to the persistently low-skilled labour force (Alves *et al*, 2010) and low FDI flows towards the southern periphery. Despite the efforts to improve the skills of the workforce several indicators remained problematic; in 2012, only 38.7% of the working population had completed secondary education, while the EU average was 70.8% (Eurostat, 2012). In parallel, most of the Northern European countries redirected their foreign investments and transferred parts of the production process to the new members of the European Union -after the EU enlargement in 2004- in Eastern Europe. In the 2000s, Portugal faced a dramatic decline in manufacturing exports and a high and persistent trade deficit. Although the successive governments managed to keep the government deficit and debt at manageable levels, through austerity, the growth model of the Portuguese economy was clearly unsustainable at the turn of the millennium.

Portugal has indeed followed a different trajectory than most southern European economies. Despite the claims that the crisis in 2010-2011 was the result of the fiscal derailment in recent decades, the successive governments followed a disciplined fiscal policy in the 2000s. The contagion of the crisis forced the government and the opposition to agree on a bailout with the EU and IMF. However, the crisis was the fruit of the long-term structural and production degradation and gradual loss of competitiveness. The ongoing transformation of the Portuguese economy from 1976 -under the neoliberal economic paradigm- created a demand-led growth model based on the expansion of the non-tradable sectors and low value-added production. This model proved fragile in the face of the changing dynamics of global trade.

In contrast with Greece, Portugal followed an austerity path that led to economic stagnation in the 2000s. However, the structural transformation and the loss of competitiveness have been analogous in both countries in recent decades. Despite the different fiscal policies, Portugal faced a tremendous crisis at the end of 2000s too.

Overall, Greece and Portugal have been among the losers of the Eurozone. Although the mainstream literature treats Greece as a scapegoat, the reality is much more complex. Greece and Portugal are not ‘backward’ countries, but structural weak economies. The mid-1970s was a turning point for both countries. Despite the different democratisation processes, Greece and Portugal became liberal democracies in the late 1970s. Following the global neoliberal wave, Greece and Portugal pursued a neoliberal

agenda in the 1990s and 2000s. Both countries went through several reforms in favour of market deregulation, economic liberalisation, and privatisation beginning in the late 1980s. The entry to the European Communities -and the IMF programmes in Portugal- was the turning point for the economic paradigm shift in both countries. It is now clear that those neoliberal reforms failed to make them resilient to the crisis. The economic transformation – along with the changing global trade dynamics - dramatically affected the production capabilities in both economies, increasing the structural imbalances in the Eurozone.

The Eurozone placed major restrictions on the national governments in regard to reversing this calamitous trend. The global financialisaton and the massive credit inflows under the ECB blessing accelerated the conversion of Greece and Portugal to credit-driven and import-led economies. Greece had to keep borrowing to feed its domestic demand to maintain high growth rates in the 2000s. This was a vicious game. Portugal accumulated high debt in the 1990s, but it followed a different trajectory under Manuel Barroso's bold leadership, maintaining a tight fiscal policy in the 2000s. However, Portugal, as shown above, went through a structural degradation -similar to Greece- that made its economy vulnerable to the crisis. Although Greece and Portugal followed different paths in the 2000s, the credit-led and debt-driven model of growth was not sustainable in the long term.

Chapter 4: The bailout programmes and their implementation in Greece and Portugal

4.1 The bailout programmes in Greece and Portugal

4.1.1. 1st bailout programme in Greece

Running current account deficits for about a decade, Greece was on the verge of bankruptcy in April 2010. The Greek government had borrowed from the markets for last time - issuing €10 billion of bonds- at a high price in March. The average interest rate exceeded 6%. A few weeks later, Greece lost market confidence and was forced to request assistance from the EU and IMF. The Eurogroup endorsed bilateral loans from member states amounting to €80 billion. On top of this, the IMF Board approved a €30 billion Stand-By arrangement in May 2010.

According to the programme, Greece was expected to pursue a massive fiscal and balance-of-payments adjustment through cuts in wages and pensions in the public sector, and reductions in public and social spending. Beyond the fiscal adjustment, the programme aimed to boost productivity and increase competitiveness. High labour costs were identified as the main barrier to competitiveness: "*the real wage growth consistently outpaced productivity gains over the past decade, in part reflecting spillovers from very high public wage increases. The resulting increase in unit labour costs eroded external competitiveness, not least with respect to the rest of the Euro area*" (European Commission, 2010: 7). The 'rigid' working-time, wage bargaining system, and generous unemployment benefits were also seen as the cause of the low labour turnover and long-term unemployment (European Commission, 2010: 12).

Based on such a crisis diagnosis, the Memorandum set out a number of policies for Greece to recover from the crisis. In regard to fiscal policy, the programme called for a macroeconomic adjustment, aimed at reducing the fiscal balance - which was about 14% in 2009 - to less than 3% of GDP by 2014. The frontloaded fiscal adjustment was designed in such a way as to 'maximise credibility' based on consolidation

measures of "*8 percent of GDP in 2010…4 percent of GDP 2011…2 to 2 ½ percent of GDP- in 2012, 2013, and 2014*" (European Commission, 2010: 20).

According to the agreement, the adjustment should rely "*primarily on expenditure cuts…*'' as "*experience shows that expenditure-based consolidation has more chance of success*" (European Commission, 2010: 19). Large cuts in public sector wages and pensions were considered 'inevitable' (European Commission, 2010). The measures included the cut of the 13th and 14th wages, the elimination of 'solidarity allowances', 13th and 14th pensions cuts, lower public investment, and a reduction in the operation costs of public entities. On the revenue side, the measures included an increase in VAT rates, an excise tax on fuel, alcohol and cigarettes, a luxury goods tax, gaming loyalties and licences, and a special levy on profitable firms. Concurrently, the government had to improve its revenue-raising capacity, and confront corruption and tax evasion. 'Modernisation' of the public sector meant lower operating expenditure, a redefining of its functions and the elimination of non-cost-effective services. Those measures would set Greece back on the right fiscal track.

In the medium-term, the programme projected that economic recovery would come through competitiveness and a change in the economy's structure towards a more investment-friendly and export-led growth model (European Commission, 2010: 15). According to the programme, "*wage cuts in the public sector are expected to contribute to wage moderation in the private sector…wage moderation will contribute to more dynamic exports*" (European Commission, 2010: 17). Besides that, the Greek authorities had to revise the Labour law to (1) extend the probationary period for new jobs to one year, (2) reduce the overall level of severance payments for both blue and white collar workers, (3) raise the minimum threshold on collective dismissals, especially for larger companies, (4) facilitate the use of temporary contracts and part-time work, (5) guarantee that current minimum wages remain fixed in nominal terms for 3 years, and, (6) adopt legislation on minimum wages to introduce sub-minima for groups at risk such as the young and long-term unemployed. In parallel, the Greek government had to (7) introduce variable pay at the firm level, (8) reduce overtime pay, and, (9) revise the arbitration regulation (European Commission, 2010: 17). For the creditors, the "*labour market reforms are the key to improve growth prospects and recover competitiveness*" (European Commission, 2010: 17).

The programme also provided the following measures to improve the business environment: (1) simplify the start-up of new businesses and create a General

Commercial Registry, (2) simplify and accelerate the process of licensing enterprises, and (3) change the legislation to mitigate the tax obstacles to mergers and acquisitions (European Commission, 2010).

In the services sector, the Greek government had to implement the EU Services Directive and proceed with the opening up of restricted professions. The measures included (1) sector-specific legislation to remove restrictions to trade in the legal, pharmacy and notary professions, as well as for architects, engineers, and auditing services, (2) the implementation of the Professional Qualifications Directive to recognise qualifications from third countries, (3) the liberalisation of road freight transport by removing restrictions on admission to the occupation of road haulage and minimum fixed prices, (4) a restructuring plan for the railway sector including the privatisation of its assets, (5) liberalisation of the wholesale electricity market (6) legislation to unbundle electricity and gas activities, and (8) the restructuring of the Energy Regulatory Authority (European Commission, 2010).

According to the Memorandum, Greece would achieve negative GDP growth of -4% in 2010 and -2.6% in 2011, and then positive GDP growth of 1.1% in 2012, 2.1% in 2013, and 2.1% in 2014. The gross debt would reach 133.2 % in 2010, 145.2% in 2011, 148.9% in 2012 and 149.7% in 2013, and would then start to decline, reaching 148.4% of GDP in 2014.

4.1.2 2nd bailout programme in Greece

After the crash of the programme in late 2011, the Troika -as the ECB, EC, and IMF were called- agreed to give Greece a new loan. A new bailout agreement was signed in March 2012. A package of €130 billion was agreed with revised targets for 2012 and subsequent years. Under the first Memorandum, Greece indeed achieved a painful fiscal adjustment, decreasing the government deficit from 15.75 % in 2009 to 9.5 % of GDP in 2011 (European Commission, 2012: 2). While progress had been made with the reforms, the Greek economy remained in recession and most of the economic forecasts were revised downwards. Predictions for a quick recovery were falsified. Greece was still not able to return to the markets.

The second bailout agreement stated: "*several factors hampered implementation: political instability, social unrest and issues of administrative capacity and, more fundamentally, a recession that was much deeper than previously projected*" (European Commission, 2012: 1). Under those circumstances, creditors agreed that Greece needed 'additional time' to complete its fiscal adjustment and reforms. The new programme claimed that the "*objectives are the same as under the first programme*" (European Commission, 2012: 1). Greece had to restore competitiveness through "*an ambitious internal devaluation, a reduction in prices and production costs relative to its competitors, as well as a shift from a consumption-led to an export-led economy*" (European Commission, 2012: 2). Put simply, the new agreement endorsed a *do more of the same* approach. The Greek authorities had to run the new reforms, particularly in the labour and product markets, to reduce production costs, and increase competition and productivity (European Commission, 2012: 2).

The fiscal effort had to be continued based on cuts in many different areas, including the health sector, public administration, and the public investment budget (i.e. subsidies to private investments) (European Commission, 2012: 25). The programme envisaged further cuts to central government expenditure, including a reduction in administrative costs, the placement of 25,000 ordinary civil servants on a mobility scheme, 5,000 dismissals, the closure of small social security funds, and the reduction of 'non-priority' social security spending.

The reforms had to be accelerated. In the labour market, it was highlighted that, *"the continuing deterioration in economic activity, the increase in unemployment, as well as the persistence of large external imbalances is a clear indication that further labour market reforms are necessary*" (European Commission, 2012: 37). The programme revised the wage floors in the National General Collective Agreement (NGCA), reducing wages by 22 percent, or even by 32 percent for those younger than 25. The reduction in the minimum wage "*creates additional room for downward wage adjustment to be decided by employers and employees in each firm or sector*" (European Commission, 2012: 38). The above would presumably allow Greek firms to decrease their production costs and to expand their market share abroad.

The programme also provided changes in the Labour law through (i) the removal of the "after effects" of contract expiration; (ii) the elimination of "tenure" in all existing legacy contracts; (iii) the freezing of "maturity" in all private contracts; and (iv) the abolition of compulsory arbitration (European Commission, 2012: 40).

The ‘structural’ reforms in the products and services markets included the removal of barriers to ensure access by foreign investors to the energy sector and transportation, and the privatisation of state-owned enterprises and infrastructure assets (i.e. ports, airports). Greece needed to proceed further with the tax, pension and judicial system reforms. Other measures aimed to improve Greece’s business environment through fast-tracking investments, speeding-up licensing procedures, and facilitating electronic business registration (European Commission, 2012: 111). The Greek government had to draft legislation to strengthen the *Invest in Greece* agency to facilitate ‘strategic investments’ (European Commission, 2012: 42).

The second bailout programme projected stagnation in 2013, and recovery in 2014; the GDP growth rate should reach 2.5% of GDP in 2014. The unemployment rate should reach 17% and then start to decline to 16.7 % of the total population in 2014. The general government debt should reach a peak of 165.4% in 2013, and then decline to 162.1% of GDP in 2014.

4.1.3 The bailout programme in Portugal

Portugal had suffered from low growth and productivity rates along with persistent current account deficits for two decades before the crisis. According to the bailout agreement, “*the output growth has been on a steady downward trend, with competitiveness being undermined by rising unit labour costs and deep-rooted structural problems*” (European Commission, 2011:1). The EU and IMF agreed with the Portuguese government on a €78 billion bailout programme to cover the period 2011-2014.

The programme aimed to “*put the public finances on a sustainable footing; underpin a return to economic growth, supporting an orderly unwinding of external and internal imbalances, while increasing the growth potential of the economy through in-depth structural reforms*” (European Commission, 2016: 135). As shown in the previous chapter, the Portuguese economy had stagnated before the crisis. In the 2000s, the average annual real GDP growth was about 1 percent, the second-lowest across the European Union (Eurostat, 2011). The EU and IMF identified challenges in the Portuguese economy similar to those in Greece: “*since the introduction of the euro,*

Portugal has experienced significant real exchange rate appreciation vis-à-vis its trading partners, due to wage growth largely outstripping productivity advances… rigidities and inefficiencies in labour and product markets, weak enforcement of competition rules, a dysfunctional judicial system…have all hampered an efficient use of resources and the dynamism of the economy" (European Commission, 2011:5). Presumably, the bailout policies aimed to ensure fiscal sustainability and the neoliberal reforms aimed to address the 'deep-rooted structural problems'.

In the first pillar, the programme aimed at putting fiscal policy on a sustainable path. The projection was that the Portuguese authorities would be able to set the debt-to-GDP ratio on a downward path from 2013 onwards (European Commission, 2011:16). The consolidation measures were based largely on a reduction in government wages that '*expected to contribute to wage moderation in the private sector…wage moderation will contribute to more dynamic exports and the reduction of the external deficit*' (European Commission, 2011:17). They also included increasing the VAT rate by 2 percent, and cuts in social transfers including unemployment and family benefits (European Commission, 2011:19). For 2012-2013, the adjustment included a reduction in public sector staff, promotion freezes, and a reduction in transfers towards local and regional governments (European Commission, 2011: 20). A revenue increase was to be pursued through: (i) higher property tax revenues, (ii) higher consumption tax revenues, through increasing excise rates and broadening the VAT base, and (iii) broadening the base of corporate and personal income taxes. The programme set the fiscal targets at -5.9 % of GDP in 2011, -4.5 % of GDP in 2012, -3.0 % of GDP in 2013, and -2.3 % of GDP in 2014.

Like Greece, Portugal had to proceed with a number of reforms broadly divided into three categories. First, the Portuguese authorities had to increase the flexibility in the use of production factors (especially labour). Second, they had to eliminate distortions and rents in the functioning of the market. The assumption was that competition infusion would make the economy more efficient. Third, the programme aimed to improve the business environment (including through reforms to the judicial system, and the easing of administrative rules) to attract foreign investments (European Commission, 2011: 23).

In the labour market, the programme stated that "*excessively strict employment protection reduces job creation, hinders mobility to dynamic sectors and favours a disproportionate use of temporary contracts...the generous unemployment benefit*

system does not promote job search effort and raises the risk that unemployment becomes entrenched" (European Commission, 2011: 24). Portugal was a country manifesting high overtime costs and inflexible working time arrangements (OECD, 2013). The above had negative externalities for firms' competitiveness and their ability to adjust to sectoral shocks (European Commission, 2011: 25). Under those assumptions, the Portuguese government agreed (i) to revise the minimum additional pay for overtime in the Labour code to reduce the maximum of 50%; and (ii) to eliminate the compensatory time equal to 25% of overtime hours worked. The public sector employment rules were revised to comply with the private sector Labour code. The reforms included more flexible working time, fewer holidays, the elimination of compensatory resting time, an increase in the statutory retirement age, and less compensation for the termination of temporary contracts. The working week was extended from 35 to 40 hours. Finally, the programme revised the unemployment benefits regulations, reducing the maximum duration to 18 months.

The deregulation of the product and services markets provided: the complete liberalisation of the electricity market, the withdrawal of gas tariffs, the elimination of barriers to entry in the telecommunications sector, and the privatisation of the freight branch of the state-owned rail operator and some of its suburban lines. It also called for the liberalisation of regulated professions (i.e. lawyers, accountants and notaries). Having 'open' products and services sectors would bring productivity gains.

Portugal had to agree on extensive privatisation (EUR 5 billion) to contribute to decreasing the government debt. According to the bailout, "*the state still holds a relatively large and complex web of companies, either fully or partly…the involvement of the state is economically not justified*" (European Commission, 2011:22). Portugal had to proceed to the privatisation of a wide range of companies in the transport sector (Aeroportos de Portugal, TAP, and the freight branch of CP), as well as in energy (GALP, EDP, and REN) and communications (Correios de Portugal).

The Memorandum projected that GDP growth would reach -2.2% in 2011, -1.8% in 2012, 1.2% in 2013, and 2.5% in 2014. Debt would reach 101.7 % in 2011, 107.4 % in 2012, and 108.6 % in 2013, and would then start declining, reaching 107.6 % of GDP in 2014.

Overall, the programmes -which were largely based on neoclassical assumptions- were expected to push both countries towards a fiscal surplus and to reverse their persistently low productivity and competitiveness (European Commission,

2016: 49). They would presumably lead to a new export-oriented growth model for Greece and Portugal.

4.2 The bailout programme implementation in Greece

Greece has been through several austerity packages and reforms since the outbreak of the crisis in 2009. As mentioned in previous chapters, the implementation of the Memorandum has been a contested issue, and controversy remains. According to the *neoclassical* perspective, the successive Greek governments have not been reliable in terms of the fiscal adjustment and reforms since 2010. Are those claims fair?

In 2010, amid market panic, the Greek government -led by George Papandreou- undertook tough measures with the aim of reversing the country's trajectory towards bankruptcy. However, this course could not be reversed. After the bailout agreement, as shown above, the centre-left government had to implement a tough Memorandum, including cuts in public sector wages, reductions in pensions, and an increase in VAT and other taxes. Not surprisingly, Papandreou's government -which was elected with an overwhelming win in 2009- faced political turmoil. The general strikes and protests gained momentum in the streets of Athens at the end of 2011. Beyond the domestic turmoil, as will be analysed in *chapter six,* the Greek Prime Minister was under suffocating pressure from the European leaders after the G20 Summit in Cannes, France. His decision to announce a referendum over a new bailout brought him harsh criticism (Spiegel, 2014). In the middle of the crisis, Papandreou resigned and was replaced by an interim three-party government under the ECB Vice-President, 'technocrat' Lucas Papademos.

The new 'national unity' government -consisting of PASOK, New Democracy, and a small far-right political party, Popular Orthodox Rally (LAOS)- took office in November 2011. Its mandate was to execute the debt restructuring (PSI) and to call a general election soon afterwards. After the election in May, a new coalition government, led by the centre-right Prime Minister, Antonis Samaras, forced new cuts in wages in the public sector and further deregulated the labour market.

The successive austerity programmes fuelled social resistance. A marginal left-wing political party, Syriza, that criticised austerity, quickly became a cornerstone in the political scene, expanding its power from 4.1% in 2009 to 36.3% in 2015. Having increased its political influence in movements against austerity,[15] Syriza formed a new government together with a right wing party -'Independent Greeks'- under the motto '*we change Greece, we change Europe*'. Syriza's promise was to re-negotiate the bailout conditions with the country's creditors to end austerity. Despite the 6-month negotiations between the Syriza-led government and the EU- IMF, Greece signed a new (the third) austerity programme for 2015-2018.

Greece has gone through a painful fiscal and reform effort since 2010. Reviewing the bailout implementation is a complex task due to the high number, range and overlap (i.e. fiscal measures and internal devaluation policies) of the measures. To review the implementation in Greece and Portugal, I used data from the Monitoring of Fund Arrangement (MONA) of the IMF, a dataset that records programme implementation.[16] I also used data from the LABREF database of the European Commission, which records all reforms in the labour market in EU member states. Beyond the descriptive statistics, I undertook a number of interviews with staff in ministries, public administrations, confederations of enterprises, and workers' associations.

The first bailout included 51 reforms,[17] while the second programme included 110 reforms. Successive Greek governments had to implement a high number of reforms in a short time. Each bailout lasted about two years.[18]

The first programme consisted of about 25% frontloaded fiscal reforms, 20% financial sector reforms, and 7% labour reforms, while the remaining reforms were focused on taxation, the product market and the business environment. In the second Memorandum, fiscal reforms covered about 20% of the programme, 25% were financial sector reforms, 20% were taxation reforms, 7% were labour oriented and 11% were business reforms. Despite contrary claims, 84.3% of the measures in the first

[15] Syriza exercised political influence in the grassroots political protests such as the 'I don't pay' movement and the 'indignant citizens' movement ('aganaktismenoi')- a series of demonstrations similar to the 'occupy' movements.

[16] I have calculated the reform implementation by excluding any reforms that were replaced/modified during the programmes' implementation to avoid double counting.

[17] For the purposes of this study, structural reforms include prior actions. According to the IMF, prior actions are measures that governments must consent to prior to the IMF executive board decision for a bailout programme or review completion.

[18] Both bailout programmes ended earlier than was officially expected.

programme were implemented: out of a total of 51 measures, 43 were met, met with delay, or partially met, while eight remained outstanding. Despite delays, the programme was largely on track. The regular reviews were successfully completed. A few measures remained outstanding after the 5th review due to the early ending of the programme in November 2011. The remaining reforms were related to fiscal policy (3), the financial sector (2), taxation (1), the labour market (1), and the business environment (1).

The second bailout programme was executed by the Samaras government in 2012- 2014. The programme reached nearly a 75.4% implementation rate; 83 measures were met, met with delay, or partially met, 16 measures were not met, 1 was waived, while 10 remained outstanding. After the end of the first programme in 2011, the 'outstanding' reforms were transferred as 'prior actions' to the new bailout agreement. The Greek authorities had to legislate all of the 'prior actions' to open up the path for the new bailout.

After a colossal effort in 2010-2012, the Greek authorities faced difficulty in implementing the second programme in a smooth way. The new Samaras government had to implement a very high number of measures, twice as many as in the first bailout. On top of this, in many cases measures that remained 'outstanding' in the previous reviews had to be completed in the next ones. This made the reform effort much more complex. Massive political capital was needed. As one senior official in the Ministry of Finance claimed:

"*I personally tried my best. My team had to process several reforms -that haven't been in place for years- in just two or three days. For example, before the programmes we had to adopt a long list of measures -'prior actions'- in few days to avoid bankruptcy. We definitely needed more time*" (interview with employee in the Ministry of Finance, 2019). It was clear that Greece was overwhelmed by the large number of ambitious reforms.

In September 2014, the Troika's mission arrived in Athens to complete the fifth review of the second programme. The latter should ideally have been completed a few months later. The negotiations between the Samaras government and the Troika were interrupted early in December 2014. The Parliament had to elect a new President of the Republic. According to Greece's constitution, the President of the Republic is elected to Parliament with a large majority. After three unsuccessful parliamentary votes, the government called a general election -while Syriza's opposition was mounting- for 25th

January 2015. The electorate vote brought Syriza to government and led to a 6-month negotiation with the Troika. A compromise to conclude the fifth review could not be reached. Faced with a stalemate, the newly elected government committed itself to a new list of reforms and the creditors agreed to extend the programme for four months. The second programme expired on 30th June 2015.[19] The early ending of the second programme meant that 10 measures remained outstanding.

Overall, despite the neoclassical claims, the Greek authorities have made a substantial reform effort since 2010. In the first bailout, despite delays, the centre-left PASOK government completed all of the structural reforms until the fifth review when the programme ended prematurely. Greece achieved a high implementation rate -about 84.3 %- of the programme between 2010 and 2012. In the second bailout, the Samaras government implemented about 75.4% of the programme's conditions. The election of the President of the state led to the programme being ended early, leaving a few structural benchmarks outstanding.

4.2.1 Labour market reforms implementation in Greece

Since 2010, Greece has been the champion of the labour market reforms across Europe. According to the first programme, the reforms would adjust labour costs, improve competitiveness and trigger an export-led recovery. To review the implementation of the labour market reforms, I used the LABREF database, which includes all of the reforms in EU countries, classified into the following categories: labour taxation, unemployment benefits, job protection, early withdrawal, wage setting, working time, welfare-related benefits, and active labour market policies.

Greece implemented 125 reforms, undertaking a substantial revision of its Labour law in 2010-2014. Most of the reforms were pursued in the areas of wage setting (31), job protection (20), working time (10), labour taxation (24), unemployment benefits (7), welfare benefits (4), and active labour market policies (29). Under the first Memorandum, the reforms revised mainly job protection and working time setting. In the second programme, the EU and IMF -considering the stagnated competitiveness-

[19] A few days later, on 5th July, a referendum took place for a third bailout for Greece.

called for a "*reduction in nominal wages to shrink the competitiveness gap*" (European Commission, 2012). After 2012, the reforms focused on wage setting and, again, on employment protection.

In the job protection category, the successive Greek governments proceeded to: extend the probationary time from 2 months to one year (2010), extend the maximum work period under temporary work agencies (2010), lower the thresholds for collective dismissals (2010), abolish the principle of the 'implementation of more favourable provision' (2010), shorten the notice period for terminating white collar workers' contracts (2010), expand the use of fixed-term contracts (2011), reduce severance pay on dismissal (2012), and terminate the special protection against dismissals (2012). Those changes triggered diverse trends in the labour market, which will be analysed in the next chapter. A representative from the General Confederation of Greek Workers (GSEE) claimed that the "*reforms caused chaos in the labour market. More than 50% of the youth is unemployed, or they work in two or three jobs to survive. In many cases, in small firms one worker has to work for two or three now*" (interview with a representative of GSEE, 2019). The Memorandum also amended the rules regulating temporary agency employment (2012 & 2013), reduced bureaucracy on hiring process (2014), and eliminated the prohibition of the use of temporary agency workers in the construction sector (2014). A representative of the Enterprises Confederation mentioned: "*all governments proceeded indeed to several reforms especially in the labour regulation. This was important as our labour law was strict. However, this did not make the situation much better. Yes, we could pay less for a young worker or we can have more part-time employers, but this does not make a big difference. The market was down. Those reforms are nothing without economic growth*" (interview with an Enterprises Confederation representative, 2019).

In the wage setting category, the Hellenic Parliament voted for wage cuts in the public sector (2010), a reduction in the minimum wage for workers under 25 years (2010), the freezing of the minimum wage (2010), the introduction of the possibility for employers to derogate from conditions set in a higher level agreement on wage bargaining (2010), the freezing of the government wage drift (2011), an increase in working time in the government sector to 40 hours per week (2011), the suspension of the extension of sectoral collective agreements to give flexibility to firms to agree on wage policies (2011), the facilitation of firm-level wage bargaining (2011), the possibility of undercutting wages set in collective agreements for hiring young workers

(18-25) (2011), the abolition of the remainder of the Christmas, Easter and summer allowances (2012), the reduction of the minimum wage by 22%, and by 32% for young people under the age of 25 (2012), and the suspension of automatic wage increases (2012). Another representative of the Enterprises Confederation claimed: "*making labour cheap is helpful, but not enough. We needed other ways of support to become competitive again. We had to pay much more for energy, we still faced bureaucracy in all aspects of the public sector, we could take loans from the banks. Firms cannot work under those circumstances*" (interview with Enterprises Confederation representative, 2019).

In the unemployment benefits sector, the Greek government revised the labour law to reduce the level of unemployment benefits by 22% (2012) and the duration of the benefits for those unemployed more than once in a period of four years (2011), and to extend the coverage of unemployment benefits to freelancers and the self-employed (2014). In the area of working time, it adopted an extension of part-time shift work (2010), the reduction of overtime costs by 10% (2010), the introduction of working time arrangements at firm-level (2010), and the abolition of regulations limiting commercial shop opening hours (2012). Overall, Greece achieved high implementation rates in its labour market reforms in both programmes.

4.2.2 Product market and business environment reform implementation in Greece

Beyond the labour market, the bailouts included a number of reforms in the product market and measures to improve the business environment. Greece had been considered -according to the OECD- as one of the most regulated economies with high barriers to business activity. Greece had been ranked low in the World Bank Doing Business dataset (World Bank, 2010) for decades. Both Memoranda considered the reforms as a prerequisite for the efficient reallocation of resources, higher productivity, and foreign investment.

In the product market, the following were agreed: (i) the implementation of the OECD competitiveness toolkit, (ii) an extension of the sales period, and (iii) the

opening of shops on Sundays. Greece agreed to implement the first OECD toolkit, which consisted of 329 proposals, in March 2014. The actions included the elimination of the barriers to accessing markets (e.g. the definition of “fresh” milk, which set the maximum shelf-life at five days, the exclusive distribution of over-the-counter medicines by pharmacies, and minimum requirements for touristic activities as well as cruise regulation), the elimination of price distortions (such as the regulated prices for pharmacies, and the requirements for price notifications and approvals), the elimination of regulations that constrained the operation of businesses (e.g. the restrictions on Sunday trading, the regulation of promotions and sales, and restrictions on pharmacy licences), the abolition of third-party levies (such as the levy on cement, and on the wholesale price of medicine and flour), and finally, the elimination of obsolete regulations that restrained economic activities (such as the provision in the Code of Foodstuffs and Beverages, for instance in regard to bottling or importing certain types of products).

The deregulation of the product market caused reactions from various interest groups in the Greek society. For instance, the trade unions resisted Sunday trading and taxi drivers and pharmacists took strike action against the licensing deregulation. Despite the social backlash, the Samaras government passed a large majority of the measures in the Parliament: out of 329 proposals 290 were fully implemented, 27 were partially implemented, and 12 were not implemented. The Greek authorities implemented fully or partially about 96.3 % of the reforms in the product market.

Overall, Greece made a significant improvement in opening its economy. Greece was among the worst performers in the World Bank’s ‘ease of doing of business’ before the crisis. It was ranked 109th out of 175 countries in 2007. Namibia, Ethiopia and Uganda, which are among the least developed countries, were ahead of Greece. Romania and Bulgaria -countries that joined the European Union decades after Greece- were in 49th and 54th position respectively. Moreover, Greece ranked 140th in the ‘starting a business’ index as a new firm needed to complete up to 15 procedures in 38 days. The Greek economy was indeed suffering due to an obsolete public administration and persistent bureaucracy. Greece was also ranked 166th in the ‘open’ labour market

dexes.[20] In the 'registering property' rankings, Greece was in 94th position; a firm needed to fulfil 12 procedures in 23 days to register its property.

In 2016, Greece jumped to 60th position out of 189 countries in the 'ease of doing business' rankings. This is the best position Greece has ever had. Moreover, the Greek economy improved in other areas. In the 'starting a business' list, Greece moved from 140th to 54th position, by eliminating more than half of the procedures (5 in 2016) and time (13 days) needed to start a new firm in 2016. The Greek governments also managed to reduce firms' property registration procedure to 10 procedures and 20 days. Greece made a big jump in the OECD competitiveness indicators too. By making its labour market flexible, it rose from 32nd position in 2008 to 23rd position in 2013 in the 'strictness of employment' index.[21]

4.3 The bailout programme implementation in Portugal

Portugal faced political turmoil due to fears of bankruptcy in 2011, too. The centre-left government under Jose Socrates adopted austerity measures to calm the financial markets and prevent an all-out crisis. After his unsuccessful attempt to pass a new austerity package in Parliament, Socrates was forced to resign in March and a general election was called for early June 2011. Socrates 'caretaker' government requested financial assistance from the EU and IMF in April of the same year. After Ireland and Greece, Portugal was the third country that signed a bailout agreement in May 2011. A month later, the PSD, led by Pedro Passos Coelho, achieved a historic win against Socrates and formed a new coalition government with the conservative CDS People's Party. Despite occasional turbulence -especially due to the CDS-PP reaction against the austerity measures in 2013- the coalition government was committed to the Memorandum'ss execution. For Prime Minister Pedro Passos Coelho: "*the implementation was smooth, but tensions existed in the 6th and 7th reviews. The Court and the President of the Republic were against the measures for political reasons. In my view the Court's interpretation was 'rigid'*" (interview with the Portuguese Prime

[20] In 2016, World Bank's doing business report did not include the 'employing workers' ranking any more.
[21] The OECD published the latest 'strictness of employment' data in 2013.

Minister Coelho, 2019). The Supreme Court's decision to decline cuts in civil servants' wages led to a political crisis in 2014. However, Portugal completed the programme -in contrast with Greece- with only a few weeks' delay in June 2014.

After the programme ended, government partners PSD and CDS-PP created an electoral alliance (PaF) and won the electorate vote again, with 38.6%, in October 2015. However, the new Coelho government remained in power for just a few weeks. In November 2015, a new government led by António Luís Santos da Costa took office leading a large left-wing alliance consisting of the Socialist Party, the Extreme Left, the Green Party, and the Communists, and aided by the abstention of the Animal and Welfare Party (PAN).

In Portugal, the programme included 67 reforms (both 'prior actions' and structural benchmarks) that were implemented between May 2011 and May 2014. Out of a total of 67 structural reforms, about 16% were fiscal measures, 20% were financial reforms, 13% were labour reforms, 20% were product market and business environment reforms, and the rest were related to taxation, pension reforms, and privatisation. Portugal's implementation rate was high: 64 were met, met with delay, or partially met, one was not met, and two remained outstanding after the 11th review in April 2014. Despite delays, Portugal achieved a high implementation rate, meeting 95.5% of the bailout conditions. Contrary to the Greek case, the adjustment process in Portugal was smooth. Portugal failed to meet just one reform in the labour market, and two reforms in product market.

4.3.1 Labour market reform implementation in Portugal

After Greece, Portugal is the country that has legislated the most reforms in the labour market since the beginning of the Memorandum (LABREF, 2018). The rationale of the programme was similar to the Greek one. The Portuguese authorities agreed to deregulate the 'rigid' labour market under the assumption of a rapid competitiveness recovery and easier transition of human resources towards most productive sectors (European Commission, 2011: 12). What kind of reforms did Portugal execute?

Portugal implemented 65 reforms in the following areas: wage setting (11), job protection (10), working time (5), labour taxation (7), unemployment benefits (5), early withdrawal (1), welfare benefits (5), and active labour market policies (21).

The reforms transformed the Labour code, making the Portuguese labour market one of the most deregulated across Europe (OECD, 2013). In regard to job protection, the coalition government proceeded to abolish the 3-month minimum severance payment and reduce severance payments from 30 days to 20 days (per year of service) for new hires (2011). It also eased the 'fair dismissal' definition (2012) and introduced a maximum number of renewals of fixed-term contracts (2012). Those measures indeed made it easier for businesses to hire and fire staff. As a representative of the Enterprises Confederation claimed: "*in theory, we can hire and fire easily now, but in crisis conditions we can only fire people. Beyond that, the labour cost was only a part of the problem. We struggle to find personnel with skills to make our products better. This is still the problem*" (interview with enterprises representative, 2019).

In the wage setting area, Portugal adopted a 3.5-5% pay cut for salaries higher than €1500 per month (2011), a minimum wage freeze at €475 during the adjustment programme (2011) and the suspension of the close-to-automatic extension of wage agreements (2011). Furthermore, it amended the regulation on the Christmas allowance to be paid in twelve instalments (2012), facilitated bargaining at firm level (2012), suspended the previous collective agreements on the payment of extra hours above the new code (2012), and shortened the expiry and survival periods of collective agreements and increased the possibility of opt-outs (2014). Despite the fact that those measures made it through the Parliament, the Constitutional Court voted for the reinstatement of the 13th and 14th wages for public servants (2013) following the cuts in 2012. Prime Minister Coelho claimed: "*we tried to pass the legislation to decrease the civil servants' salaries from 14 to 12 per year. But the Court said, 'this is too much'. The end of the story was that we had to find another way to reach the targets without cutting the salaries. We had to increase taxes to make it. This was bad*" (interview with the Portuguese Prime Minister Coelho, 2019).

In the area of working time, the Portuguese government legislated the following: the suspension of four public holidays (2012), a reduction in annual leave (2012), a reduction in additional pay for overtime (2012), and an increase in working hours from 35 to 40 hours a week for civil servants (2013). The government also suspended early retirement (2012).

In relation to unemployment benefits, the Portuguese authorities agreed on an extension of unemployment benefits to a specific category of self-employed (2012), the reduction of a necessary contributory career for eligibility for benefits from 15 to 12 months (2012), the reduction of the benefits duration to a maximum of 18 months (2012), and the introduction of a 6% tax on unemployment benefits (2013). The active labour market policies included the creation of a national microcredit programme to support those facing difficulty in accessing the labour market and at risk of social exclusion (2011), the *Stimulus 2012* to support employers who hire unemployed people on a full time basis (2012), the full or partial reimbursement of the Single Social Tax payed by companies that hire young people under a permanent or fixed-term contract of up to 18 months (2012), the contribution -full or partial- to social security for hiring in start-up enterprises (2012), support for hiring unemployed people aged over 45 years, via reimbursement of all or part of the Single Social Tax (2013). Portugal implemented almost all of the labour market measures of the Memorandum in 2011- 2014.

4.3.2 Product market and business environment reform implementation in Portugal

Portugal had been considered one of the most regulated economies in the European Union (OECD, 2007). The Memorandum brought substantial changes to the country's product market. The reforms included: (i) the full transposition of the Services Directive into Portuguese law -about 67 out of 70 Portuguese legal regimes have been aligned with the EU Services Directive (2011), (ii) the 'Zero Authorisation' project- an online procedure to simplify business operations by replacing licensing with an online platform, (iii) the introduction of the "one-in/one-out" rule for burdensome new regulations (2011), (iv) the adoption of the Professional Qualification Directive to ensure open access to highly regulated professions (19 professions were fully deregulated) (2012), (v) the modification of the public procurement code to eliminate exemptions permitting direct awards, (vi) the removal of requirements for businesses to invest in R&D projects on contracts above €25 million (2012), and (vii) the adoption of the Late Payment Directive to reduce the high stock of arrears in the Portuguese administration (2013). Moreover measures were taken to (viii) transpose the EU

Regulatory Framework for Electronic Communications to facilitate the establishment of telecoms operators and cross-border communication services (2013), (ix) adopt the Third Postal Directive to liberalise the entire sector, which opened up the path for privatisation of 68% of the postal services company (2013), (x) adopt a new Framework Law on the functioning of the National Regulatory Authorities and the Competition Authority to make them fully independent and autonomous (2013), (xi) introduce an online platform for VAT, which would lead to a reduction in the average time needed to complete a VAT reimbursement application from 42 to 8 days (2013), (xii) adopt a new Code of Civil Procedures to improve the efficiency of the courts (a reduction in the number of courts, increased flexibility in the allocation of staff, and the introduction of performance targets) (2013), and (xiii) establish a Single Point of Contact for entrepreneurs (2013).

Overall, at the beginning of the crisis, Portugal was among the low performers in the World Bank 'ease of doing of business' rankings. It ranked in 40th position out of 175 countries in 2007. In relation to 'starting a business', Portugal was 33rd, as it had less and much quicker procedures than Greece (eight in eight days). In 'employing workers', Portugal was far behind. It was placed in 155th position, as it had one of the most rigid labour markets in the world. In 'registering property', Portugal was in 98th position, as businesses needed to complete five procedures in 81 days to register their property.

After the bailout programme, Portugal advanced to 23rd position in the World Bank 'ease of doing business' rankings. This was an important step forward. As mentioned in the previous chapter, Coelho's government eased the barriers to starting a new business. A new firm needed to complete 3 procedures and needed about 2.5 days to launch. This was among the fastest in the world. In 'registering property', firms now had to fulfil one procedure in one day. According to the World Bank, Portugal became one of the friendliest countries for investments. Portugal also jumped from last position (36th) in 2008 to 30th among all of the OECD countries in 2013 in the 'strictness of employment' rankings. It also moved up 19 positions in the OECD Product Market Regulation (PMR) index.[22]

Therefore, both countries implemented most of the reforms in the Memoranda. The reform process was not linear. Setbacks existed in both cases. In Greece, full

[22] It ranked 7th out of 36 OECD countries in 2013.

implementation seemed unattainable in many cases. The long recession made the reforms more painful. In Portugal however, the programme seemed more feasible. But, what was the economic impact of internal devaluation and those reforms on the Greek and Portuguese economies? This will be analysed in *chapter five*.

Chapter 5: The economic outcomes of the bailouts in Greece and Portugal

5.1 The Economic outcomes of the bailouts in Greece and Portugal

As analysed in *chapter four*, both Greece and Portugal have been through draconian austerity since 2009. Greece suffered the consequences of the crisis like no other Eurozone country. In less than five years, its GDP contracted by more than 22%, and about 750,000 people lost their jobs between 2010 and 2015, meaning that unemployment reached 27.5% in 2015. The wage cuts devastated the middle class in the urban centres and pushed millions into poverty. Portugal faced major deprivation too. The unemployment rate surpassed 28% among young employees (Eurostat, 2017). Hundreds of thousands of young Portuguese were forced to leave the country for the northern countries or for the old colonies in America, especially Brazil. Was all of this pain worth it?

In the eyes of the EU and the IMF, internal devaluation would not only lead to the adjustment of the chronic fiscal imbalances in deficit countries but would also work as a mechanism to boost competitiveness and growth. According to the neoclassical perspective,[23] a reduction in labour costs would restore competitiveness, boost exports, and transform the consumption-led growth model to an export-led one (European Commission, 2012: 2). Greece and Portugal would bring their mounting debts back to sustainable levels, and higher levels of competitiveness and exports would bring recovery closer.

Have those promises been fulfilled? Revisiting the evidence from the Eurozone periphery, this chapter acknowledges that Greece and Portugal have indeed managed - under harsh austerity- to adjust their 'twin deficits' during the last decade. However, rising public debt remains a key concern for both countries in the future. Did the internal devaluation boost export-led growth? This chapter brings new insights regarding why the internal devaluation failed to push export prices down. It also explains why, despite the neoclassical belief, the bailouts failed to trigger a re-allocation

[23] For a detailed account of the neoclassical economic approach and the theoretical foundations of internal devaluation see *chapter two*.

of the productive factors towards export-oriented sectors. The credit crunch and the collapse in investment impeded the transition of economic activity towards tradable sectors. Finally, this chapter sheds light on the causal mechanisms of the competitiveness loss in the peripheral economies. The latter have faced chronic productive weaknesses that have impeded high economic performance. Greece and Portugal remain stuck in an intermediate position between the high-tech countries and the large-scale emerging economies in Eastern Europe and Asia. The bailouts tried to fix the symptoms, leaving the roots of the crisis in the Eurozone unaddressed. Therefore, as will be shown, it is not a paradox that the economic gap in the Eurozone is widening, a decade after the financial crash in 2008.

5.1.1 An unprecedented fiscal adjustment

As mentioned in the previous chapter, the fiscal adjustment took the form of frontloaded austerity in the South. In Greece, the adjustment was primarily based on public expenditure cuts in 2010-12, followed by a large increase in taxes in 2012-2016. Greece was indeed vulnerable as its deficit reached 15% of GDP in 2009, as revealed by the revised Eurostat fiscal data in April 2010. The PASOK government – having just won the general election- took some initial measures in an attempt to sidestep bankruptcy. However, this was too little too late. The Greek government signed a bailout agreement in May 2010. Under the bailout programme, the Greek authorities achieved the largest fiscal adjustment ever in post-WWII history. However, the fiscal targets were overoptimistic. The IMF forecast that the Greek debt would again be sustainable -at 120% of GDP- by 2020. This meant that Greece had to achieve surpluses of up to 4.5% of GDP and maintain 3% growth rates for about a decade. The Greek government indeed achieved a painful fiscal adjustment. After decades of high fiscal deficits, Greece reached a surplus of 0.5 % of GDP in 2016 (graph 5, Eurostat, 2017). The adjustment was based on dramatic cuts to public expenditure, mainly in health and social services (Matsaganis, 2011; Karamanoli, 2015). In real terms, government spending fell significantly from about €109 bn in 2007 to a little more than €86 bn in 2016 (Eurostat, 2017). The government's health expenditure decreased from 6.8% in

2010 to 4.9% of GDP in 2016 (OECD, 2017).[24] Due to the public expenditure cuts, the Greek government struggled to deliver even primary health care, education and social security services. In many respects, the consolidation was uneven. Despite the cuts in spending, defence expenses remained high. Greece continued to take on a disproportional burden, paying the second highest military expenses, after the United States, of all of the countries in the North Atlantic Treaty Organisation (NATO) (as a share of GDP) (NATO, 2017).

A revenue-based consolidation through higher taxes took place after 2012. The Greek governments changed the country's tax system in an effort to increase revenue. After its election win, the PASOK government had initially decreased corporate and personal income taxes in 2009. However, successive governments have raised them significantly since then. Among other new taxes, the Greek government voted for the Unified Property Tax (ENFIA) to tax land, commercial, and residential buildings in 2014.[25] This tax caused a further downturn in construction and real estate, which had been the driver of economic growth in the pre-crisis era. VAT also increased from 19% to 23%. Under the ECB's tight monetary policy, austerity measures had a tremendous impact on economic activity. The wage drop along with the tax rise pushed purchasing power down. Households could not spend as they had before and consumption fell dramatically. In a demand-led economy, austerity caused a long and painful recession. Thousands of enterprises and stores closed down. The retail sector suffered and the commercial centres of Athens and Thessaloniki became 'ghost towns'. The cumulative loss of retail trade turnover was over 50 per cent between 2008 and 2016 (Eurostat, 2017). For the neoclassical economists, this was a natural process. 'Creative destruction' was part of the economic restructuring that Greece and other crisis-hit economies needed. The crash of low-productivity firms in non-tradable sectors would liberate productive forces and the *invisible hand of the market* would re-allocate them to export sectors. This 'creative destruction' would open up the path for a sustainable recovery. Overall, despite its massive fiscal effort, Greece could not return to the capital markets. Interest rates remained sky-high in 2014. After long lasting political turmoil, the country had to sign a third bailout in 2015.

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[24] The expenditure-to-GDP ratio shows a modest decrease in government spending. This is due to Greece's rapidly falling GDP. The real expenditure fall was significant.
[25] The land tax was first introduced in 2011.

Portugal was in an unfavourable position too. Its deficit reached 10% of GDP in 2009. Under the conditions of the bailout, the Portuguese authorities had to push the deficit down gradually: to -5.9% in 2011, -4.5% in 2012, and -3% in 2013. The aim was that the debt should reach a peak and start declining in 2013 (European Commission, 2011). A major fiscal effort was needed. However, the adjustment was not as rapid and deep as in the Greek case. About half of the austerity measures were taken early on in 2011, while the rest were allocated to 2012 and 2013. By reducing fixed contracts and new hires, the Coelho government decreased the number of public sector staff by 2% in 2014. Cuts to the 13th and 14th monthly payments for public sector employees and pensioners reduced public expenditure further. At the same time, the Coelho government decreased spending for health from 7.3% to 6% and for education from 7% to 4.7% of GDP respectively between 2010 and 2016 (OECD, 2017). Beyond this, the government approved pension and social benefits cuts. The consolidation took the form of temporary measures to reach fiscal targets rather than a clear reform plan to transform the public sector and pension system.

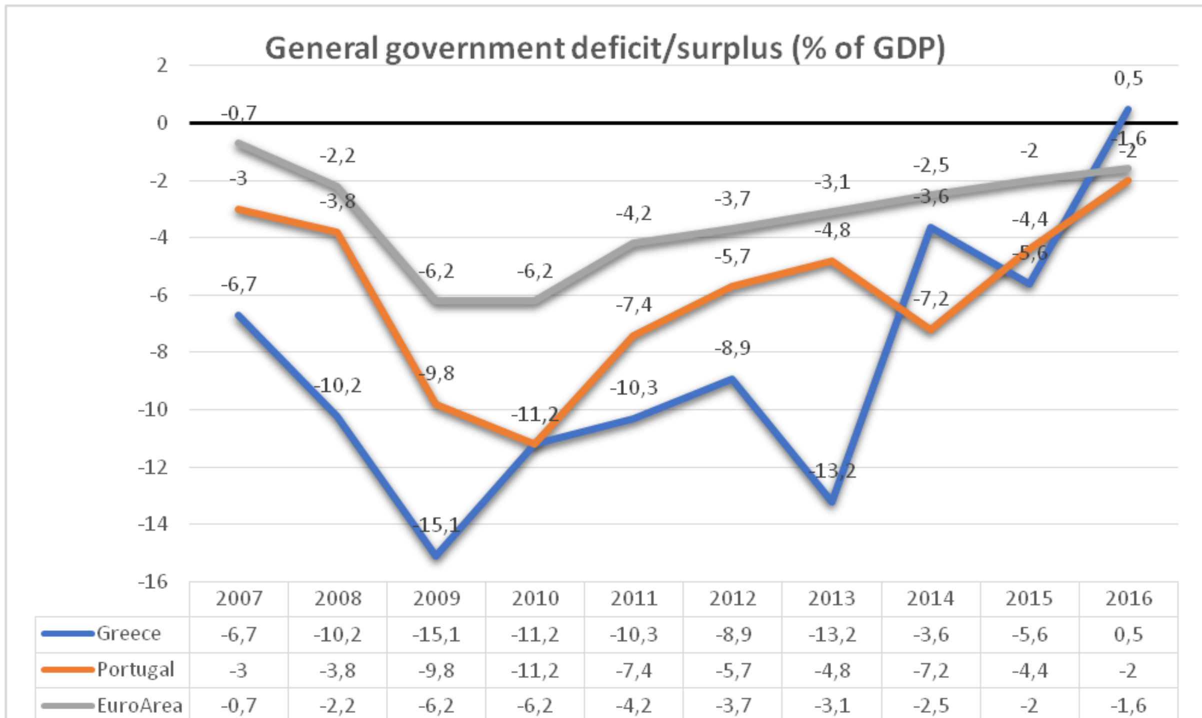
Despite the massive fiscal effort, the Coelho government was still far from meeting the Troika's overambitious fiscal targets. The Constitutional Court's decision to reinstate the 13th and 14th monthly payments in the public sector put the fiscal adjustment at risk. This forced the government to turn towards a revenue-based consolidation. Personal income tax was revised, increasing its contribution from €9.6bn in 2010 to €13bn in 2013. VAT also increased from 21% to 23% in 2011. In parallel, the Portuguese government broadened the VAT application base by limiting the reduced rates. The government was again behind the targets as shrinking consumption brought less tax revenue for 2012-2013. The failure to reach the targets pushed the government to move forward with further horizontal cuts. The disposable income of the middle class collapsed and economic activity stagnated.

After three years of painful adjustment, Portugal balanced its 'twin deficits': the government and current accounts. Portugal returned to the capital markets, but at a high cost; 4.89% and 5.67% for 5-year and 10-year bonds respectively in 2013. The ECB's quantitative easing pushed the sovereign yields lower. Portugal was then able to exit the bailout and issue 10-year bonds at 2.3% in 2014.

There is no doubt that fiscal adjustment was indeed necessary to put the public finances in order in Greece and Portugal. Both countries achieved a substantial fiscal adjustment, but with massive economic and political costs. Portugal was praised for its

determination to stabilise its current account from -9.8 % in 2009 to -2.0 % of GDP in 2016. Greece achieved a large fiscal adjustment, decreasing its deficit from -15.1% to 0.5 % of GDP in the same period (Graph 5, Eurostat, 2017).

Graph 5. General government balance



	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Greece	-6,7	-10,2	-15,1	-11,2	-10,3	-8,9	-13,2	-3,6	-5,6	0,5
Portugal	-3	-3,8	-9,8	-11,2	-7,4	-5,7	-4,8	-7,2	-4,4	-2
EuroArea	-0,7	-2,2	-6,2	-6,2	-4,2	-3,7	-3,1	-2,5	-2	-1,6

Despite the EU's and IMF's criticism, Greece achieved a rapid adjustment- deeper than that of than Portugal- and succeeded in stabilising its finances in record time. However the recession was much deeper and more prolonged than expected. The GDP growth rate started recovering weakly only after 2014. However, it has been far below expectations. Overall, although Portugal was praised for its completion of the programme and its quick recovery, the GDP growth rate is still fluctuating; it was -1.1 % in 2013, 0.9 % in 2014, 1.6 % in 2015, and 1.4 % of GDP in 2016, while in Greece, it was -3.2 % in 2013, 0.4 % in 2014, -0.2 % in 2015, and 0.0 % of GDP in 2016 (Eurostat, 2017). Therefore, both countries remained in stagnation after the bailout programmes. On top of this, public debt remains a common concern for the future.

5.1.2 The debt keeps rising

As we have seen, austerity has been presented as a medicine to end the debt crisis in the Eurozone. The fiscal adjustment was intended to return the rising Greek debt to sustainable levels. In Portugal, the debt should have started declining, too. This

was the Troika's promise. As we have seen in the previous chapters, Greece was on the brink of default in 2010. Voices calling for an early debt restructuring were ignored under the 'pretend and extend' dogma. Faced with economic collapse, the PASOK government agreed to borrow from the EFSF -with sky-high interest rates- to repay its private bondholders. The Greek debt escalated from €301 bn in 2009 to €356 bn in 2011. This was clearly an unsustainable path.

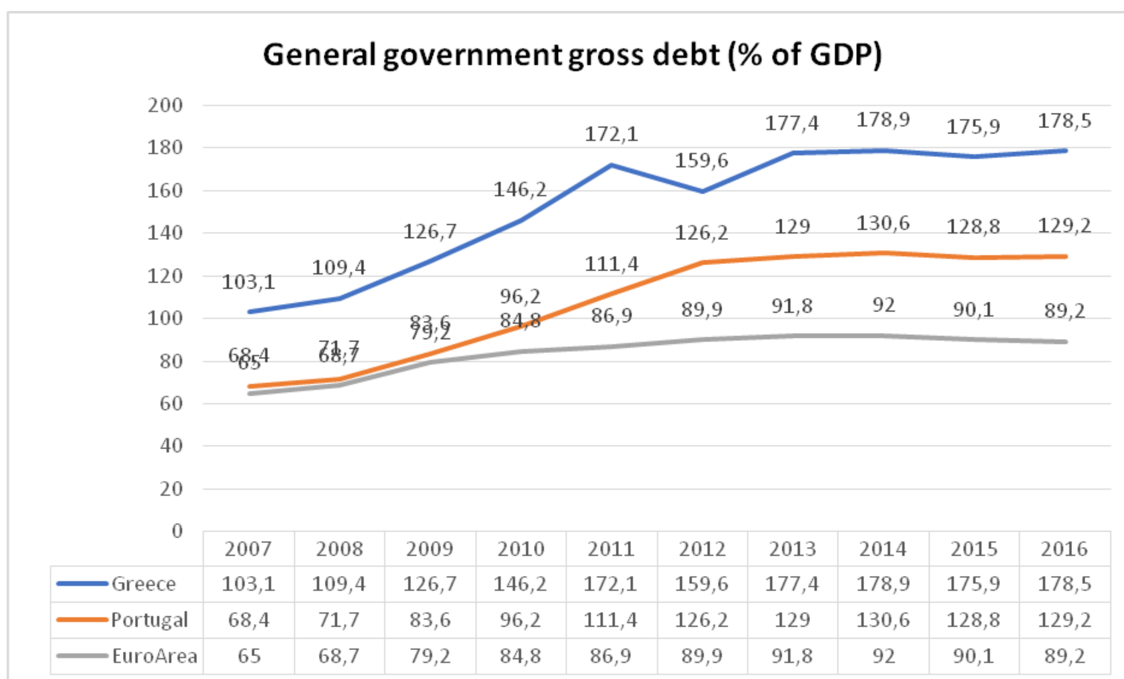
Amid the political disagreements, any kind of debt relief was off the table when the crisis hit the Eurozone. The debt restructuring was not approved by the country's creditors before February 2012. The bondholders agreed to debt buyback on a 'voluntary basis' -Private Sector Involvement (PSI)[26]- by exchanging the old Greek bonds with new ones at a reduced nominal price of 46.5%. This was the equivalent of a 53.5% debt restructuring. Bonds to the value of €198 bn were replaced with new ones, leading to a debt relief of €106 bn. However, the PSI proved destructive for the Greek banks and pension funds. In contrast with the major French and German Banks, which had sold the toxic Greek bonds in their portfolios, the Greek banks and pension funds (being among the remaining major bondholders) shouldered the burden, with €38 bn and €13 bn losses respectively (Zettelmeyer et.al, 2013). The debt fell to €305 bn in 2012. However, it started climbing again soon afterwards. Despite the primary surplus achieved by the Greek government, the debt continued rising. The Greek debt rose from 126.7% in 2009 to 178.5% of GDP in 2016. Greece was stuck in a debt trap.

Contrary to Greece, Portugal went through a less harsh fiscal adjustment. Socrates' government signed the bailout agreement when the Portuguese debt reached €196 bn in 2011. Austerity could not reverse the debt's upward trajectory. The debt escalation triggered political pressure in the Headquarters of the European Union in Brussels. The European leaders remained divided. In October 2011, the European Council finally cancelled the interest margins for all EFSF loans for the bailout countries. Although this was a step in the right direction, it was not enough. The debt reached €212 bn in 2012, €219 bn in 2013, and €226 bn in 2014. Even after its exit from the bailout, Portugal continued to have the third highest debt (as percentage of GDP) in the Eurozone. At the moment of writing, the Portuguese debt remains highly sensitive to exogenous factors (i.e. market shocks), without a clear downward trajectory.

[26] After the PSI, all new Greek bonds were governed by English law and were subject to the English Court jurisdiction. The Hellenic Republic surrendered its authority to pursue -under the Hellenic Parliament's decision- a 'haircut' or debt restructuring in the future.

Although the EU and IMF projected a gradual debt decline after 2013,[27] the debt continued rising across the Eurozone. Despite Portugal's timely exit from the programme, its gross debt increased from 83.6% in 2009 to 129.2% of GDP in 2016, and likewise in Greece, it rose from 126.7% to 178.5% of GDP in the same period (Graph 6, Eurostat 2017).

Graph 6. General government gross debt



	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Greece	103,1	109,4	126,7	146,2	172,1	159,6	177,4	178,9	175,9	178,5
Portugal	68,4	71,7	83,6	96,2	111,4	126,2	129	130,6	128,8	129,2
EuroArea	65	68,7	79,2	84,8	86,9	89,9	91,8	92	90,1	89,2

Both countries achieved a major adjustment through a similar mix of fiscal consolidation measures. However, the variations between them are notable. Greece went through a rapid adjustment and, despite the debt restructuring, faced a longer and much more painful recession. Portugal took a different path. It achieved a relatively smoother adjustment and completed the programme on time. However, both countries still face a rising debt. Why did those different paths lead to the same endpoint? Firstly, in both countries, high interest rates -under the EFSF- and the recessionary fiscal policy triggered a *snowball effect*. The difference between the growth rate of the economy and the debt interest expenses sent public debt to its highest ever level. Despite Greece and Portugal balancing their fiscal policy, the debt remains on an upward path. As long as austerity keeps growth rates lower than interest rates, those countries will remain in a debt trap. This is a vicious cycle.

[27] For the government debt targets see the Memorandum of Understanding for Greece and Portugal (European Commission, 2010; 2011).

Secondly, Greece and Portugal have been rather unsuccessful -under the Troika's policy- in transforming the growth model that triggered those fiscal imbalances before the crisis. Fiscal discipline forced them to adjust their finances; however, it is unlikely that the 'intermediate' economies will be able to maintain their fiscal balance in the future. It is therefore no surprise that the IMF has admitted that the Greek debt is still unsustainable and that Portuguese debt's sustainability remains fragile (IMF, 2016). The transformation of the consumption-led growth model is crucial to make Greece's and Portugal's public finances sustainable in the future.

5.1.3 A relentless internal devaluation

Beyond the fiscal consolidation, both countries agreed to pursue a drastic internal devaluation. According to the Troika, the latter would improve their competitiveness and trigger export-led growth. This was the neoclassical economists' promise. As analysed in *chapter two*, the creditors believed that the increasing labour cost was the cause of the sluggish competitiveness in the South. A radical labour cost decline would make the crisis-hit economies competitive again. Greece and Portugal did manage to push labour costs down.

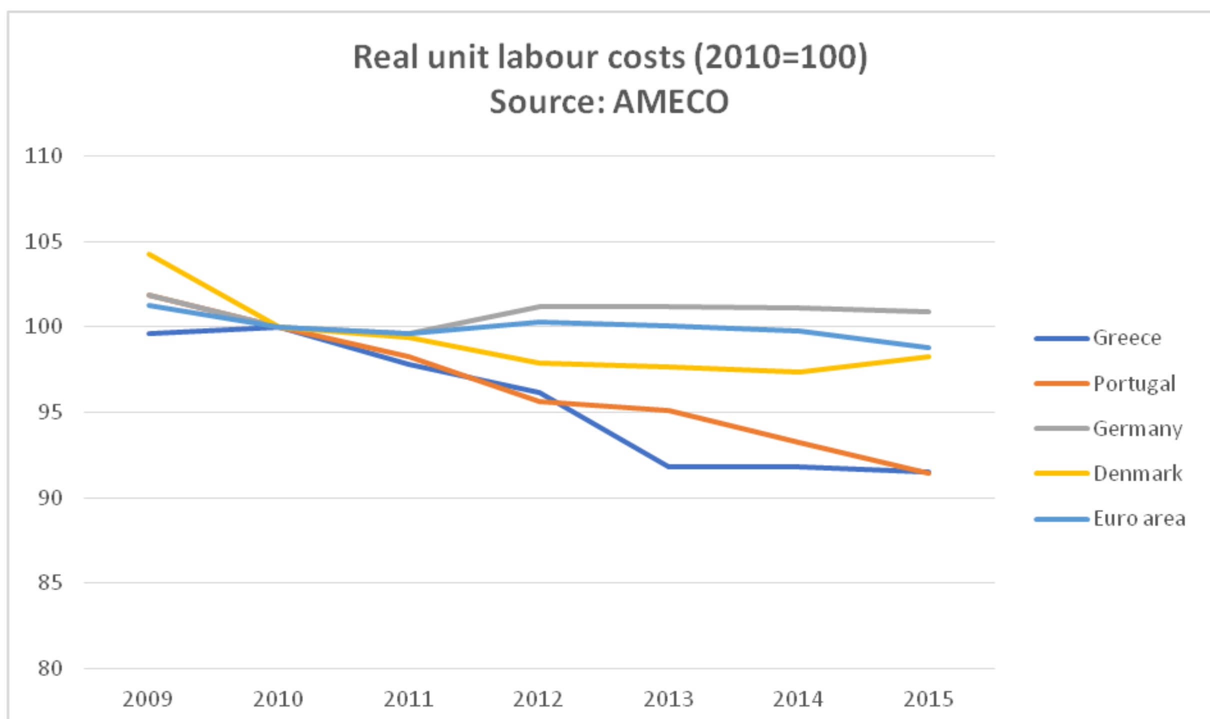
Both countries went through a relentless internal devaluation. As mentioned in *chapter four*, the successive Greek governments eliminated the 13th and 14th monthly payments for public sector employees, pushed the minimum wage down and established a sub-minimum wage for young employees aged under 25. At the same time, labour market reforms (i.e. restrictions on collective bargaining, and free dismissals) pushed employees' compensation down in the private sector too.

In Portugal, the first effort towards internal devaluation -the suspension of the 13th and 14th wage monthly payments in the public sector- was reversed by the Constitutional Court in 2012. However, public sector wages decreased in indirect -and not easily visible- ways. The Coelho government agreed to freeze all government wages and promotions from 2012-2014. Working hours were extended from 35 to 40 per week. Such labour market policies led to a downward spiral across the economy. In the private sector, the Portuguese government prohibited any minimum wage rise between 2011 and 2014 and the minimum wage remained at €485 per month. Despite the

nominal minimum wage freeze, due to flexible working hours, real wages fell further across the economy. Under the new working regulations, four national holidays were eliminated, working time was extended by up to 7 days per week, and overtime was paid less. All of the above opened up the path for further falls in labour cost. Employers pushed wages closer to the minimum wage, while the number of employees paid the minimum wage increased like never before (PORDATA, 2017).

Overall, the internal devaluation was successful in both countries. As graph 7 shows, the unit labour cost has been decreased significantly in both countries since 2010. It has also declined in comparison to the other Eurozone countries.

Graph 7. Real unit labour costs



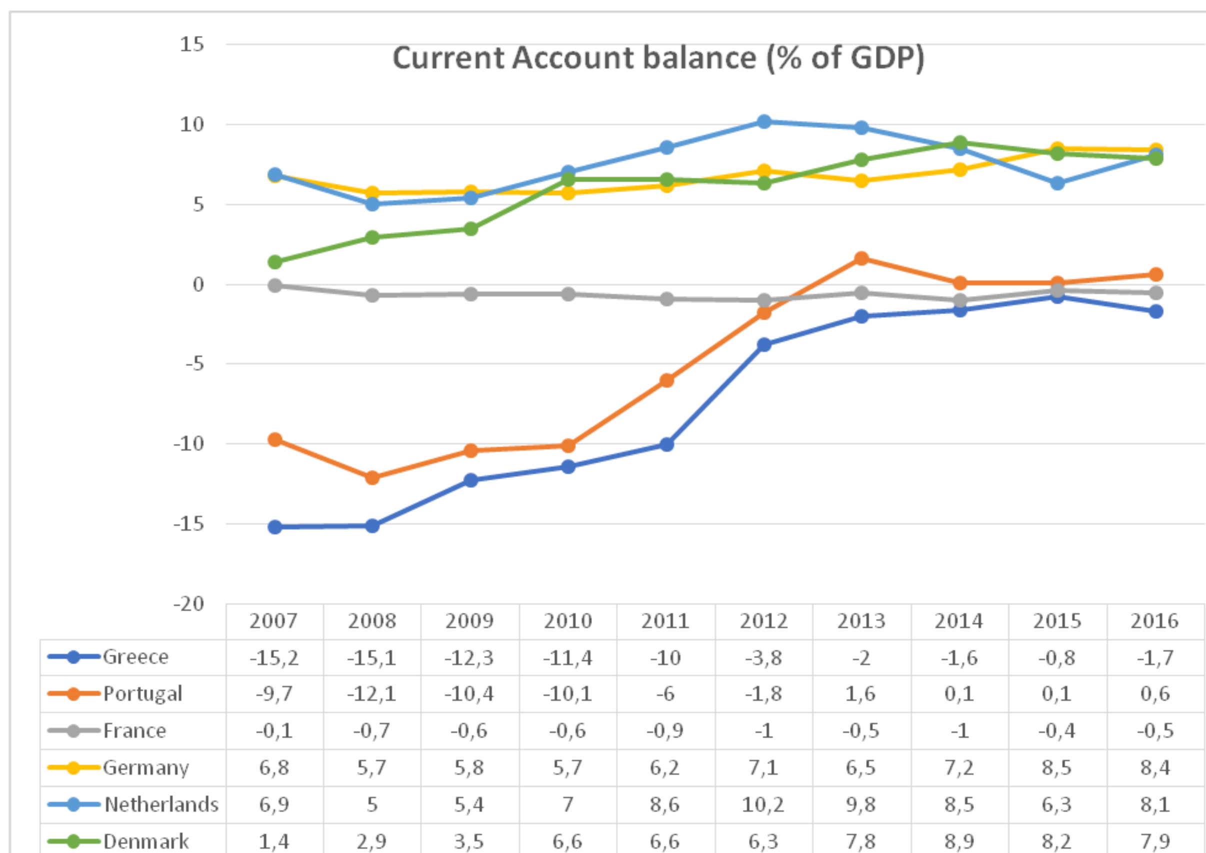
Beyond internal devaluation, Greece and Portugal performed well in opening up the labour market and making their business environment attractive. However, questions remain. Did the internal devaluation kick-start export-led growth in those economies?

5.1.4 Trade balance adjustment without export boom

Greece and Portugal both made an unprecedented effort to adjust their longstanding trade deficits. The Coelho government achieved a remarkable turn in the

trade balance (graph 8, Eurostat, 2017). After almost 20 years, exports surpassed imports, turning a persistent trade deficit into a surplus. From a 12.1% current account deficit in 2008, Portugal achieved a 0.6% of GDP surplus in 2016 (graph 8, Eurostat, 2017). Greece followed a similar path. From 15.1% in 2008, the successive Greek governments reduced the trade deficit to 1.7% of GDP in 2015 (graph 8, Eurostat, 2017). Taking into consideration that both countries were facing current account deficits for decades, this was a remarkable accomplishment. Does this massive trade adjustment indeed reflect robust export-growth? Has internal devaluation made exports competitive?

Graph 8. Current Account balance



	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Greece	-15,2	-15,1	-12,3	-11,4	-10	-3,8	-2	-1,6	-0,8	-1,7
Portugal	-9,7	-12,1	-10,4	-10,1	-6	-1,8	1,6	0,1	0,1	0,6
France	-0,1	-0,7	-0,6	-0,6	-0,9	-1	-0,5	-1	-0,4	-0,5
Germany	6,8	5,7	5,8	5,7	6,2	7,1	6,5	7,2	8,5	8,4
Netherlands	6,9	5	5,4	7	8,6	10,2	9,8	8,5	6,3	8,1
Denmark	1,4	2,9	3,5	6,6	6,6	6,3	7,8	8,9	8,2	7,9

Neoclassical economists celebrated this as a jump towards export-led growth in the South. However, the trade adjustment was the fruit of the economic contraction that pushed purchasing power and imports down, rather than an export boom. The massive fall in household income led to a consumption collapse in both economies. For decades, Greek and Portuguese firms had been servicing domestic demand through imports.

Domestic retail trade had replaced export activity. The rapid fall in household income - since 2010- could not sustain such an import momentum any more.

Despite the neoclassical economists' promise, the export performance was still stagnant. A close look shows that the total export value in Greece decreased by more than $3 billion in about a decade. Greek exports fell from $56.6 bn in 2008 to $53.1 bn in 2016 (UNCTAD, 2017). Oil refinery is the only export sector that has continued to grow (+$900m) during the last decade. All other exports have fallen significantly. Aluminium products stagnated at $1.5bn, machinery fell by $100m, pharmaceuticals fell by $100m, plastics fell by $200m, machinery and electronics fell -due to global pressure from the emerging Asian economies- by $300m, and the food industry fell by $100m between 2008 and 2016 (UNCTAD, 2017). At the same time, Greece's export services[28] also fell from $47.4bn to $27.6bn in 2016 (UNCTAD, 2017). The export concentration of refined oil products became sky-high in 2016[29] (SEV, 2019: 5).

The export destinations have changed tremendously too. Greece's exports rapidly turned away from the developed countries (mainly the European Union) towards low-income economies. Greece lost its market share in Italy (-$100m), Germany (-$900m), Cyprus (-$300m), the USA (-$400m), and the UK (-$200m) between 2008 and 2016. France disappeared from Greece's top 10 export destinations. Instead, Lebanon ($1.2 bn) and Egypt ($830m) upgraded to eighth and ninth positions in the top 10 destinations list respectively (UNCTAD, 2017). The major trade partners of Greece changed over time towards low-income countries. Greece faces increasing difficulty in competing in sophisticated products in highly competitive value chains. The Greek economy cannot maintain its market share in the European Union anymore.

At first sight, Portugal seemed to follow a different path. Portuguese exports started recovering after a rapid drop in 2009-2010. Exports fell significantly when the crisis hit the Eurozone in 2008, but in less than two years, by 2011, exports had recovered, as Portugal's trading partners got back on their feet after suffering a shock. Exports reached $61.7bn in 2013 and $62.7bn in 2014. Despite the Troika's celebration of Portugal as a 'success story', as will be shown in the next section, the early export increase was temporary and not related to the internal devaluation.

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[28] Shipping and tourism have been among the major Greek services abroad that have been used mainly by the USA ($11.7bn), the UK ($7.4bn), Germany ($4.7bn), Switzerland ($2.5 bn) and Italy ($2bn).

[29] Greek exports are highly concentrated on refined oil products, which account for $7.6 billion, while the second export sector, aluminum products, accounted for $1.5 billion in 2016 (UNCTAD, 2017). The export concertation has increased as refined oil exports have increased ($900m) but all other exports have fallen since 2008.

Hopes for export-led growth were not realised. Exports started declining again after 2014. The total value of Portuguese exports fell from $56.4bn in 2008 to $54.3bn in 2016. Portugal witnessed a significant fall in many sectors: electric equipment fell by $1.6bn, vehicles by $700m, machinery by $800m, and clothing by $200m (UNCTAD, 2007). While high-tech exports dropped, traditional products experienced a relative increase: oil products rose by $300m, footwear by $200m, paper by $300m, and furniture by $400m between 2008 to 2016. Portugal also lost part of its share in the European markets: in Spain (-$1.6bn), Germany (-$700m) and Belgium (-$100m) between 2008 and 2016 (UNCTAD, 2017). In the services sector, Portuguese exports increased from $26bn in 2008 to $29.5bn due to a tourism boom. Tourism flourished in Europe's South after the revolts and chaos in the Arab world in 2011- 2012 (i.e. Egypt, Tunisia). New visitors from the United States, Germany, Russia, Spain and France travelled to southern European countries. All of the rest of the export services were in decline.

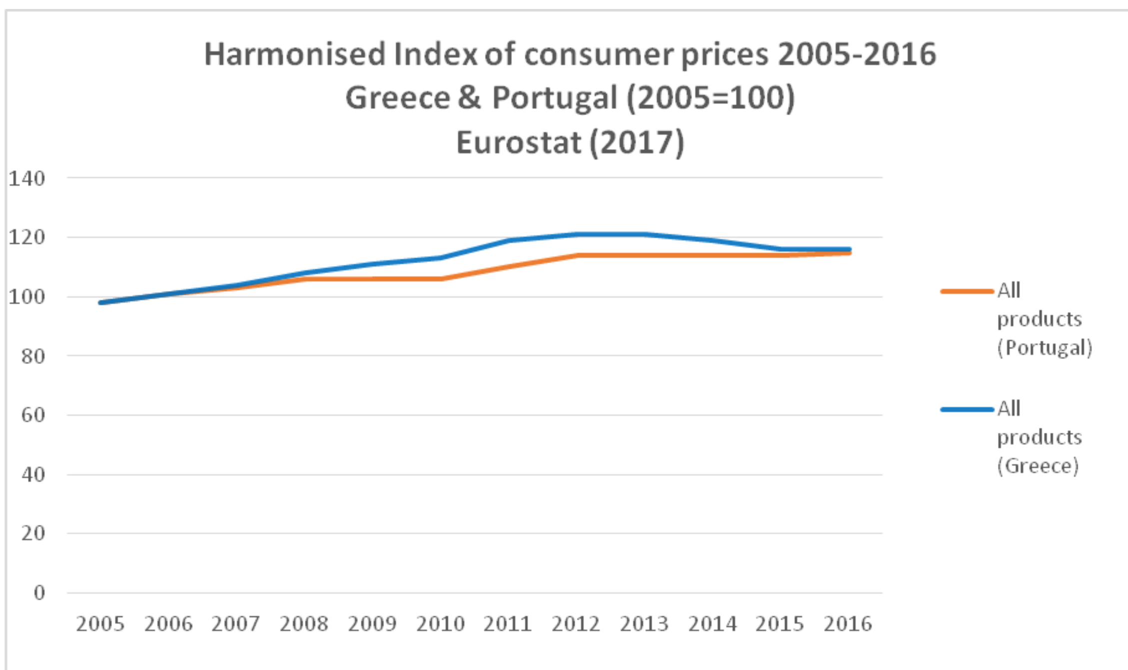
Overall, both Greece's and Portugal's export shares shrunk across the OECD countries. Greece's export share dropped from 0.66% to 0.47% while Portuguese exports dropped from 0.66 % to 0.65% of all OECD exports between 2008 and 2016 (OECD, 2017). Moreover, Greece's and Portugal's positions in global trade worsened. Greece's exports decreased from 0.42% in 2008 to 0.29% of global exports in 2016 (UNCTAD, 2017). Despite Portugal's early increase, its exports fell from 0.42% in 2008 to 0.21% of global exports in 2016 (UNCTAD, 2017). The internal devaluation did not boost either Greek or Portuguese exports. Both countries have remained far behind in the global competition during the last decade. Why did the internal devaluation fail to kick-start export-led growth in the crisis-hit economies?

5.1.5 Labour cost came down, prices did not

As mentioned above, in the eyes of the Troika, the labour cost was the reason behind the periphery's loss of competitiveness. The nominal labour cost had indeed increased in the periphery in the 2000s. Between 2000 and 2005, wages in Greece and Portugal increased faster than the average in the Eurozone, while in the second half of

the 2000s they continued growing at a similar rate to most of the Eurozone countries (Eurostat, 2017). In theory, internal devaluation would push the labour cost down, putting prices on a downward path. Consumers in the European capitals would prefer the cheap Greek and Portuguese products and exports were expected to boom. However, the reality is much more complex. Labour costs -as shown above- decreased dramatically in both countries. However, prices did not (graph 9, Eurostat, 2017).

Graph 9. Harmonised index of consumer prices



Labour cost is just one aspect of production costs. Other factors affect final prices too. The simplistic belief that a lower labour burden means lower production costs is falsified. Firstly, the internal devaluation -as a 'one size fits all' approach- overlooked the national varieties in production in the peripheral economies. The Troika's policy underestimated the productive structure of the Greek economy and therefore was not effective in pushing prices down (Pelagidis and Mitsopoulos, 2014: 55). The Greek economy is largely dependent on three main economic activities: oil refinery, shipping, and tourism. Those sectors and related activities contribute more than 30% of the country's GDP (ELSTAT, 2017). Greek oil refinery has boomed during the last three decades. Taking advantage of its geographical position, Greece invested in the largest oil refinery infrastructure and gas station network across the Balkans. Two

Greek companies, Hellenic Petroleum and Motor Oil Hellas, are among the largest oil companies in Southeast Europe, operating refineries in Elefsina, Aspropyrgos and Thessaloniki. Petroleum exports have increased by six times and they now represent at least 30% of Greece's total exports (ELSTAT, 2017). The internal devaluation has been rather ineffective in terms of boosting this sector. In oil refinery, the cost of the final product (i.e. lubricants) depends mostly on the capital cost (i.e. refinery infrastructure) and oil prices. The labour cost is a marginal factor in the final prices. Therefore, the internal devaluation was not effective in pushing prices down. Instead, with sky-high oil prices and increasing global demand, oil refinery prices reached a peak in the last decade.

The short-sighted policy of making exports cheaper by pushing the labour cost down was rather ineffective for shipping and tourism too. Shipping has been a vital economic activity for Greece since ancient times (Doxiadis, 2013: 71-81). It accounts for about 10% of the country's GDP (IOBE, 2013). Greek shipowners own the largest merchant marine fleet in the world[30] (UNCTAD, 2017). Again, the labour cost and labour market regulations in Greece affect the wages in shipping anaemically. The latter is rather international in nature, operating with staff from all over the world. Shipping accounts for just 1% of employment in Greece (IOBE, 2013). At the same time, most of the shipping-related services (i.e. shipbuilding, ship repair and maintenance) take place away from Greece in Asian maritime countries, mostly in China, Japan and South Korea. Global shipping is a capital-intensive sector and is largely dependent on trade and price fluctuations worldwide. The internal devaluation only had marginal effects on shipping service prices.

Finally, Greece is one of the most visited countries especially in the summer months due to its natural beauty, history and culture. At first glance, it could be assumed that the internal devaluation would push the wages of seasonal workers down and would make touristic services attractive for European, American, and Russian visitors. However, this proved a fallacy. The tourist sector in Greece is structured in a different way than in other countries. It is based on low-capacity houses and small-scale hotels that are spread across the mainland and the most touristic areas of the Greek islands (Hellenic Chamber of Hotels, 2017). In contrast with the highly concentrated tourist accommodation in other popular travel destinations, such as Turkey, Spain and

[30] In terms of cargo carrying capacity (UNCTAD, 2017).

Dubai, small Greek hotels are run mostly by the owners themselves and their family members (IOBE, 2012; Doxiadis, 2013: 116-120). Those family-owned touristic firms rely mostly on self-employment and therefore make limited gains from any labour cost decrease. The official wage regulations have an anaemic effect on workers' real compensation. Therefore, it is not a paradox that prices in tourist services did not come down either (Eurostat, 2017).

On top of this, the internal devaluation took place under draconian austerity. Taxes increased significantly after 2010. The VAT rate jumped from 19% in 2010 to 24% in 2016. The Greek governments also broadened the tax base by transferring goods and services from the reduced and intermediate VAT tax rates to higher ones (European Commission, 2016: 53). Despite the labour cost fall, the higher VAT rate kept prices high.[31] Moreover, the implicit tax on energy[32] increased by about 125% between 2009 and 2016, i.e. much faster than the labour cost decrease. Energy-intensive sectors were affected tremendously (Pelagidis and Mitsopoulos, 2014: 62). High taxation offsets any price reduction related to internal devaluation. Despite the wage drop, production costs and prices did not come down. Instead, most Greek exports became more expensive.

Portugal experienced a rapid fall in exports once the crisis hit the Eurozone in 2008. After the first shock in 2008-2010, exports started recovering. However, this early export increase had little to do with the internal devaluation. In 2008, the country's exports fell significantly from $57.2 bn in 2008 to $44.2 bn in 2009. The recession in the southern periphery -especially in Portugal's main trading partner, Spain- led Portuguese exports into freefall. Portugal lost $13bn in exports in less than a year. It also suffered a loss in its share of exports to Spain of $3.9bn, to Germany of $1.5bn, to France of $1.2bn, and to the UK of $600m in 2008-2009. Portugal made up for the lost ground quickly. Spain and most of Portugal's trade partners recovered in 2011. Portuguese exports reached pre-crisis levels, at $59.6 bn, in 2011. Despite neoclassical economists' claims, the export recovery was not due to the internal devaluation.

[31] Although exports are VAT-exempt, local producers pay VAT throughout the production process. The state provides a VAT return at the end of the fiscal year. However, the Greek state delays its VAT return from 12 to 36 months. Therefore, most local producers are forced to pass the burden on to consumers. At the same time, the tax system structure favors non-tradable production. This is because tax evasion is prevalent in non-tradable products (Moutos, 2015). The Greek state's tax collection capacity is obsolete, and tax-monitoring remains slow (i.e. SDOE). The shadow economy reached 26.45% in 2017 (Medina, Schneider, 2018). In an attempt to evade VAT (i.e. by not issuing receipts), local producers prefer to keep their production for the domestic market rather then turning their products abroad.

[32] The tax on electricity remained at about €1 per MWh in the Eurozone while reaching about €5 per MWh in Greece.

Portugal reached its pre-crisis export levels months before the Socrates government signed the bailout agreement with the EU and IMF in May 2011. The first internal devaluation measures were taken by the Coelho government at the end of 2011. Therefore, the effects of those policies started to become visible only from 2012 onwards. The increase in exports was the result of the rising demand in Portugal's neighbours rather the success of the internal devaluation. After this early recovery, the growth rate of Portuguese exports fell by three times from 2013 to 2016. Under the devaluation policies, Portugal was not able to maintain a sustainable export performance in the aftermath of the crisis. Why was export recovery so short-lived?

Portugal succeeded, as Greece did, in pushing labour costs down. However, export prices continued to rise, as shown above. The fragmentation of global production triggered fundamental changes in the world economy in recent decades. Different stages of production are now performed in different countries and continents. Portugal maintains an intermediate position in the global value chains (Mamede *et.al*, 2014). It exports mostly products -raw materials, electronic equipment and vehicles- that are imported at a relatively advanced stage from other industrialised countries. The Portuguese labour contribution to the final products remains marginal (Reis et.al, 2013). In manufacturing, employee compensation was 13% of gross value-added in 2008. Portugal managed, as Greece did,[33] to push employees' compensation down to 10.9% in 2016. However, such a decrease was ineffective in pushing export prices down.

On top of this, Portugal has been through an economic transition from labour-intensive towards capital-intensive sectors during recent decades (Reis *et.al*, 2013). The rise of the large-scale economies -mostly in Eastern Europe and Asia- has changed global production and trade. Those economies have dominated the labour-intensive sectors, pushing Portugal -among other developed economies- towards capital-intensive production. Portugal has gradually moved away from sectors such as agriculture, the food industry, and textiles. Portuguese manufacturers have invested in capital-intensive activities -raw materials, chemicals and pharmaceuticals- where the labour cost remains a marginal component of the final product (Mamede *et.al*, 2014). Due to overlooking

[33] Greece had the lowest employee compensation (as % of gross value-added) - -7.7% in 2008- in the Eurozone and OECD. Countries such as Lithuania (15.4%), Slovenia (19.4%) and Poland (15.3%), or even developing countries beyond the Eurozone like Mexico (8.1%) and Costa Rica (10.6%) have higher labour compensation as a percentage of gross value-added (OECD, 2017). This does not mean that Greece has the lowest labour cost in the OECD. Instead, it means that Greece produces low value-added products and services. Greece's low competitiveness is not due to the high labour cost, but to low value-added production.

Portugal's productive transition, the Troika's policy was not effective in pushing prices down. Due to higher taxes and intermediate costs -especially in energy and transportation (Caldas, De Almeida, 2014)- prices continued to rise during the last decade.

Overall, the Troika misdiagnosed the nature of the crisis in the periphery. Labour costs can only partly explain the loss of competitiveness. The internal devaluation failed to make Greek and Portuguese exports competitive. The low-competitiveness in the 'intermediate' economies is -as will be shown below- a structural problem.

5.1.6 The bailouts failed to boost the export sectors

Beyond the failure to bring export prices down, contrary to the Troika's promises, the bailouts failed to re-allocate productive forces to the export sector. As we have seen in *chapter two*, the neoclassical economists argued that the internal devaluation and reforms would facilitate the transfer of resources -through the *price mechanism*- towards high-productivity sectors.

The uneven development arose as the dominant feature of the world economy in the post-war era. In Europe, the asymmetric economic development pushed the peripheral economies towards a low-productivity, introvert model of growth.[34] Both Greece and Portugal have faced a dramatic overgrowth of the services sectors and a parallel shrinking of the industrial sector, particularly the manufacturing sector, in the last few decades. Although this phenomenon has taken place in several developed economies, it has been much more rapid and intense in the 'intermediate' economies. Productive capital has flowed out of those economies towards the high-performing core economies in the Eurozone. The export sectors have gradually declined, too. Did the bailouts reverse this trend? Did the internal devaluation and the market reforms trigger a transfer of resources to productive and export-oriented industries?

For the neoclassical economists, the first promising export signs are visible. According to this view, the export-oriented sectors are starting to get stronger and

[34] The large capital flows -mainly credit flows- from the Eurozone's core towards the periphery led to a further expansion of countries' low-productivity, non-tradable sectors from 2000 to 2010 (Reis et.al, 2013; De Grauwe, 2011). For a detailed account, see *chapter three*.

increasing their contribution to the countries' production. There has indeed been an increase in the gross added value of the tradable sectors to GDP. In Greece, the contribution of the export-sectors (both products and services) increased from 23.4 % in 2008 to 30.1% of GDP in 2016 (OECD, 2017). Similarly, in Portugal, the export sectors increased their added value to GDP from 31.1% in 2008 to 40% in 2016 (OECD, 2017). At first glance, this might be seen as a sign of structural change in both economies. However, in fact this was due to the collapse of the over-expanded introvert sectors: real estate, construction, and financial services.[35] Export activity remains lethargic. Greece and Portugal still have the weakest industrial sector in the Eurozone. In 2016, manufacturing's contribution to GDP reached 10.5% in Greece and 14% in Portugal, while the average in the Eurozone was 17.1% (OECD, 2017). Only Cyprus and Luxembourg have smaller manufacturing sectors than Greece and Portugal. Moreover, the industrial sector remains focused on low-technology and low value-added products. Exports of high technology products have declined further in both countries. At the same time, domestic services remain the highest contributor to the Greek and Portuguese gross domestic product. In Greece, they contributed about 79% of GDP, while in Portugal up to 75% of GDP in 2016 (Eurostat, 2017). Despite the neoclassical projections, the allocation of capital and human resources has barely changed. The structure of employment remains largely unchanged, too.

A decade after the outbreak of the crisis, the market reforms have had anaemic effects on the productive base in both economies. The peripheral economies remain stuck in an introvert, low-productivity model of economic growth. As will be analysed in the next section, the credit crunch and the long lasting underinvestment have impeded a dynamic re-allocation of resources to the export-oriented sectors.

5.1.7 The sluggish bank credit flows

The transition to an export-led growth model requires a large transfer of productive capital to the export sectors. However, this was out of the question in the

[35] Construction (i.e. the Olympic Games infrastructure in Greece and housing in Portugal) and real estate boomed in both countries in the pre-crisis era. The sudden stop of cheap credit inflows led to a bubble burst.

broken peripheral economies. The outbreak of the crisis and the ongoing recession had a tremendous impact on credit. Banks in the crisis-hit economies were on the brink of collapse in 2009. The exposure of holes in most French and German banks' balance sheets -due to low interest rates prior to 2008- caused a sudden stop to credit flows towards the periphery. The tradition of a single interest rate for all Eurozone countries was over.[36] Greece, Portugal, Spain and Ireland could not secure cheap credit for businesses and households any more. Austerity burdened the banks further. Businesses and households were struggling to respect their loan commitments. Several loans became non-performing ones. Unsurprisingly, Greek banks accumulated the highest ratio (after Cyprus) of non-performing loans in the Eurozone. The latter increased from 4.6% in 2008 to 36.2% of total gross loans in 2016 (World Bank, 2017). Portugal has also been well above the Eurozone average as its non-performing loans rose from 3.6% in 2008 to 17.1% of total loans in 2016 (World Bank, 2017). The banking sector across the South is now in a worse position than in 2008.

On top of this, Greek banks were among the largest Greek debt holders. The debt restructuring (PSI) led them to realise massive losses in 2012 (Zettelmeyer et. al., 2013). According to Gkikas Hardouvelis (2017), -who served as minister of Finance in 2014- the Greek banks were forced to approve a 78% cut in their Greek bonds, meaning a total loss of about €39bn. Most Greek banks became zombie ones.

The ongoing debate over Greece's potential exit[37] from the Eurozone has been the 'sword of Damocles' for the Greek banking system. Grexit has been in the top news headlines for years. Although such a scenario is off the table at the moment, the political uncertainty over the country's future fuelled the banking sector crisis. A massive *bank run* broke out. Massive flows of bank deposits left Greek banks in favour of foreign banks at the end of 2011. The bail-in in Cyprus caused further turbulence, as depositors were concerned about a potential bail-in in Greece, too (Pelagidis and Mitsopoulos, 2014: 77; Michaelides and Orphanides, 2016). Deposits declined from €237.5bn in 2009 to €150bn in the summer of 2012. They started recovering and reached €164.3bn in November 2014. However Syriza's election victory triggered a new fall to €124bn by the end of 2016 (Bank of Greece, 2017). This had tremendous effects on economic

[36] For the evolution of the interest rates in the Eurozone, see *chapter three*.
[37] The Grexit threat was the *sword of Damocles* for all of the Greek governments. Even at the G20 meeting in Cannes in 2010, Sarkozy and Merkel put the Greek Prime Minister, George Papandreou, in front of the Grexit dilemma for first time (Papadimitriou and Zartaloudis, 2015). Since then, Grexit has been a constant threat to all of the successive governments (Blustein, 2016: 247).

activity. Bank credit to SMEs fell from €12.9m in 2009 to €1.1m in 2015 in Greece and from €23.1m to €11.8m in Portugal in the same period (OECD, 2016). Liquidity froze. Several Greek and Portuguese firms closed down.

For neoclassical economists, 'creative destruction' would push low-productivity firms to destruction and new extrovert and productive firms would replace them. However, in both Greece and Portugal this process was not 'creative' at all. The collapse of the domestic market indeed pushed firms to consider -as neoclassical principles state- turning their products towards markets abroad. However, this was not an easy way forward. A turn from local consumers to the uncharted waters of the foreign markets required complex firm restructuring. Local firms should have invested in upgrading their production to high value-added products and building trade networks with foreign markets. The massive credit crunch foiled this process. Instead, small Greek and Portuguese businesses froze their investments (i.e. in management, technology and human capital). Under credit asphyxiation, a structural transformation - complete 'creative destruction'- in favour of an export-led growth model was unrealistic.

5.1.8 The collapse in investment

Beyond the credit crunch, the long lasting underinvestment impeded the re-allocation of resources towards export-oriented sectors, too. According to the neoclassical economic principles, by pushing wages down, the internal devaluation would generate incentives for new investments. By offering a competitive labour cost, the peripheral economies would attract German, Chinese and American investors. At the same time, the anaemic domestic consumption would make local entrepreneurs willing to invest in the export sector. However, this did not happen.

Starting from Ireland in 2007, the investment shrunk across the Eurozone's southern periphery. Greece, Portugal, Spain and Ireland did not manage to recover to the pre-crisis investment level by 2016. Greece and Portugal are notable cases of under-investment. In Greece, the gross fixed capital formation collapsed from €57.6 bn in 2008 to €21.2 bn in 2016 (ELSTAT, 2017). This was an unprecedented fall. Greece now has the lowest investment rate- -11.7% of GDP- in the Eurozone (Eurostat, 2017).

How did this happen? Austerity budgets after 2010 pushed public investment down from €9.6 bn in 2008 to €6.3 bn in 2016. Foreign investment stagnated, too. Despite the neoclassical projections of a quick boost, net foreign investment inflows fell from €3.1 bn in 2008 to €2.8 bn in 2016 (ELSTAT, 2017). Due to chronic structural weaknesses,[38] the Greek economy provides low investment returns.

Before the crisis, investment had been largely directed towards consumption. Most investments used to be placed in construction, real estate, retail trade and tourism. Did this consumption-oriented investment trend change? The economic depression in Greece was so harsh that almost all economic activities fell into disinvestment. The latter was a snowball phenomenon that hit all sectors. Investment in real estate has fallen by more than 90%; in agriculture, forestry, and fishing it has fallen by more than 40%; in construction it has fallen by more than 50%; and in manufacturing it has fallen by about 20%, between 2008 and 2016. New foreign investments[39] have been directed mostly towards tourism and the privatisation of the Greek regional airports since 2010 (Bank of Greece, 2017). The allocation of investments remains in favour of low-productivity sectors.

Portugal suffers from underinvestment, too. However, it has been through a different experience. In contrast with other southern economies, the country has had a falling investment rate since 2000. The crisis decelerated investment further. Portugal now has the third lowest investment rate across the Eurozone after Greece and Cyprus: 14.7% of GDP in 2016 (AMECO, 2017). The gross fixed capital formation fell from €40.8bn in 2008 to €28.8bn in 2016. The gap with the core EU countries is widening.

Public investment decreased by more than 50% in less than ten years (INE, 2017). The fall accelerated when Portugal started running austerity budgets in 2012. From €6.6bn in 2008, public investment fell to €2.8bn in 2016. In contrast to Greece, foreign investment increased from €5.4bn in 2008 to €8.5bn in 2016 (PORDATA, 2017). However, both countries remain significantly lower (as a percentage of the global total) than the average FDI inflows from 2000 to 2007 (UNCTAD, 2017). The new investment came mostly from China. Under the Troika's privatisation programme, the energy companies -Energias de Portugal (EDP) and Redes Energéticas Nacionais (REN)- the insurance company -Caixa Seguros- and Banco Comercial Português were

[38] The chronic structural weaknesses will be analysed in the next section.
[39] Greece has historically had very low foreign investment inflows. The latter took place in the financial services (i.e. banking sector) and telecommunications (i.e. Hellenic Telecommunications Organisation, OTE) in the 2000s (Bank of Greece, 2017).

sold to Chinese enterprises. The Portuguese government approved a scheme to give 'golden visas' to non-EU citizens who invest at least €500.000 in real estate (Silva, 2013). The programme was successful in maintaining the real estate momentum. However, the foreign investment allocation shows a continuation rather than a change. In contrast with the real estate bubble burst in Greece, real estate continued to maintain a high share of Portuguese domestic investment (about 20% of GDP). Investment in low value-added activities such as agriculture, forestry and fishing, textiles and basic metals also remained at the same level in the 2010s. Despite neoclassical beliefs, no real turn towards export-oriented activities has been seen yet.

Both countries seem to be stabilised at very low investment levels. This threatens the prospect for both countries of settling their debts for many years to come (Papadimitriou and Wray, 2012). Productive investments have gradually moved from the South to the new members of the European Union in Eastern Europe. Romania (24.9%), Estonia (22.5%), Slovakia (20.7%), and Bulgaria (20.5%) have been far ahead of Portugal and Greece in the last decade (Eurostat, 2017).

Overall, in the context of a massive credit crunch and underinvestment, the programmes failed to trigger an investment wave to the export and high-productivity sectors. The *invisible hand of the market* failed to transform those economies into export-led ones. Such a structural transformation needs the state to have an active role in order to reallocate resources towards productive sectors. The state needs to employ an advanced industrial policy and direct productive investments in key industries to upgrade production and boost exports. Such state policies have taken place in neither Greece nor Portugal.

5.2 The causes of low-competitiveness remain alive and well

5.2.1 The chronic failure to create economies of scale

The EU and IMF misdiagnosed the nature of the crisis in the peripheral economies. The roots of the loss of competitiveness go beyond the increasing labour

cost in the periphery of the Eurozone (Storm and Naastepad, 2015). The Greek and Portuguese economies suffer from chronic and persistent structural weaknesses. The latter are the fruit of a complex interplay between the evolution of the productive forces in those economies and the external economic developments during recent decades. The Troika overlooked the real causes behind the macro-economic imbalances in the Eurozone. It tried to fix the symptoms of the crisis, leaving the causes unaddressed. The structural weaknesses in the 'intermediate' economies are firstly related to the weak production base and the chronic failure to create *economies of scale*. Secondly, they stem from the structure and quality of the human capital, and thirdly, from the position of the 'intermediate' economies in global trade.

The southern periphery of the Eurozone has a long tradition of small firms and family entrepreneurship. Historical processes (i.e. evolution of capital-labour relations) and institutional reasons (i.e. property rights) led to a weak and small-scale production base. Greece and Portugal are dominated by small and family-owned firms. Compared to other Eurozone countries, self-employment is very high, too. Only 111 and 263 companies operate with more than 250 employees in Greece and Portugal respectively (Eurostat, 2017). Most firms operate with less than 10 employees. This is far below the average firm-size in the Eurozone. Small and family-owned firms are flexible, but on the whole they are less productive, and they tend to produce less competitive products (Giannitsis, 2013; Doxiadis, 2013: 108-115). Most of them suffer from a low-division of labour and resource scarcity in terms of investing in upgrading their operations and building networks towards markets abroad. They struggle to compete with companies in core European economies. It is not a paradox that the exports in both countries are highly concentrated in large companies. According to the Greek Statistics Authority, about 80% of Greek exports are conducted by firms with more than 50 employees. At the same time, 500 companies contribute 75% of the country's exports (ELSTAT, 2017).

Greek and Portuguese firms have been largely dependent on the domestic demand, rather than on exports. The introvert consumption-led growth model did not provide incentives to local producers to export. The latter have barely developed networks to facilitate export activity. They have failed to develop synergies across the production process and to work complementarily to explore markets abroad. The cooperative economy has been in decline during recent decades.

In the late 1970s, after the end of the dictatorships, the new democratically elected governments approved the creation of new cooperative economic structures, mostly in the agriculture and farming sectors. In both countries, the cooperative networks expanded significantly in terms of geographical coverage and cooperative membership (Giannitsis, 2013; Rebelo and Caldas, 2015). However, this ended quickly. In Greece, the cooperative structures have been politicised since the 1980s. The political parties -PASOK and New Democracy- manipulated the cooperatives to increase their political influence, mainly using EU funds, building social alliances among the neglected local populations in the rural areas. This political interference triggered mistrust among the agricultural population of the cooperative economic activity. Politicisation has been destructive. Most of the regional cooperatives started declining in the early 1990s. Greece maintains the highest number of cooperatives after Italy; however, it produces one of the lowest cooperative outputs in the European Union (Iliopoulos and Valentinov, 2012). In Portugal, the large network of cooperatives quickly started to decline, too. The obsolete regulation on property rights opened up the path for free-riding behaviour and corruption across the agriculture cooperatives (Rebelo et.al, 2010). Non-professional management and the chronic skills shortage[40] -which will be analysed in the next section- led most cooperatives to short-termism and economic decline.

The small-scale entrepreneurship and the decline of the cooperative economy impeded the creation of *economies of scale* in the 'intermediate' economies. The state failed to support the cooperative economy and to facilitate export networks.[41] At the same time, local producers remained dependent on domestic demand and therefore barely developed modern networks towards foreign markets. Small and medium sized enterprises invested only marginally in export promotion and marketing strategies. They barely invested in training their staff in market research, branding the local production

[40] According to Texeira (2001), about 80% of farmers in wine cooperatives had only primary education.
[41] The Greek government failed to improve logistics. Greece remains one of the worst-performers in the Logistics Performance Index (LPI). Greek exports are highly burdened due to the high transaction costs. For instance, the rail network is poorly connected with the port of Piraeus and its logistics zones are established in inappropriate areas -mixed with residential areas- that fail to serve the industrial needs i.e. warehouses in Elaionas of Attica. The railway does not operate cargo transportation. Therefore, despite its high cost, road transportation remains the major transportation method for exports. It accounts for about 98% of all land transportation, while it reaches 72% in the EU. Family-owned firms usually have their own trucks to transport their products. This accounts for over 90% of trucking transportation (Arvis et.al, 2013:14). Greece's exports go either through land transportation to EU countries via Balkans -Serbia, and North Macedonia, or sea transport via Italy. This means a high transit burden.

or product campaigning abroad. It is no surprise that Greek and Portuguese products gradually lost their market share in the European and global markets.

5.2.2 The dysfunctional structure of human capital

Beyond the weak production base, Portugal and Greece face human capital weaknesses. The political developments in both countries have affected the quality and structure of the workforce during recent decades. As analysed in *chapter three*, Portugal experienced a persistent political crisis in the turbulent 1960s and 1970s. Under Salazar's authoritarian regime, the growing middle class in Lisbon was suffocating. Social tensions mounted. The political repression led dynamic parts of the middle class to leave Portugal for other European capitals. At the same time, Salazar's colonial war against the rebels who were trying to liberalise the Portuguese colonial territories (i.e. Angola, Mozambique, Guinea) led to a massive loss of human lives. The political uncertainty, which continued even after the Carnation revolution, triggered emigration flows towards Europe in the 1970s. Portugal faced a massive loss of the young and educated generation.

At the same time, the country has failed to modernise its education system during recent decades. It has been among the worst performers in terms of educational attainments and literacy. Portugal has among the lowest percentages of schooling of the working population (OECD, 2006). About 60% of the workforce have just nine years of schooling. This is just above Turkey and Mexico. Compulsory schooling was extended from six to nine years only in 1986. Even today, the early dropout rate is far higher than the EU average (OECD, 2017). Student performance on PISA surveys is also far below the EU average (PISA, 2017). Despite the recent reforms, advanced skills are still scarce (OECD, 2017). This remains a major barrier to Portugal's transition to high-productivity export-led growth model.

Greece reinstated democracy after the overthrow of the Junta in 1974. The smooth transition to democracy in *Metapoliteusi*[42] paved the way for reforms in primary and higher education in the 1980s. Greece scores higher than Portugal in most education

[42] Metapoliteusi is the period in Greek modern history that began after the fall of the military junta in 1974.

and human capital metrics. However, the structure of the human capital remains dysfunctional. For decades, the urban population has been oriented towards the non-tradable sectors, mainly public administration, retail trade and domestic services. Amid the economic uncertainty in the 1980s and 1990s, the middle class turned towards the safety of public sector jobs.[43] Generations have been raised dreaming of a job in public administration. The governing political parties, PASOK and New Democracy, facilitated the expansion of public sector employment for clientelist purposes (Featherstone, 2005; Lyrintzis, 2005). At the same time, introvert professions such as doctors, lawyers, and professors have been synonymous with social success (Doxiadis, 2013: 271-276). Therefore, the middle class moved to domestic services, mainly in the education, health and justice sectors. Finally, the small family-owned firms -Greece has the highest level of self-employment in the Eurozone[44]- have been focused on the domestic market. Human skills in the export sectors remain largely underdeveloped. Expertise in industrial design, market research, marketing, and sales has been scarce.

Despite the neoclassical beliefs, the internal devaluation did not make the export sectors stronger. The collapse of the domestic market indeed triggered a domino effect. Hundreds of thousands firms closed down in both countries. They failed due to the credit crunch and underinvestment to transform themselves. Human capital did not move towards the export sectors. Instead, the economic activity fall pushed human capital to destruction. Greece had the highest and Portugal the third highest unemployment rates in the Eurozone in 2016. In Greece, unemployment increased from 7.8% in 2008 to 23.6% of the active population in 2016, and in Portugal, it also increased from 8.8% to 11.2% in the same period. The rate of unemployment among the younger population (15-24) increased from 21.9% in 2008 to 47.3% in 2016 in Greece and from 21.6% to 28.2% in Portugal in the same period (Eurostat, 2016). Chronic unemployment had set in.

At the same time, firms pushed wages down under the new labour regulations and extended working hours to survive. Greece has the highest and Portugal the fourth highest number of weekly hours of work: 42.2 and 39.4 respectively, with 36.5 hours being the average in the Eurozone (graph 10, Eurostat, 2016). They used precarious

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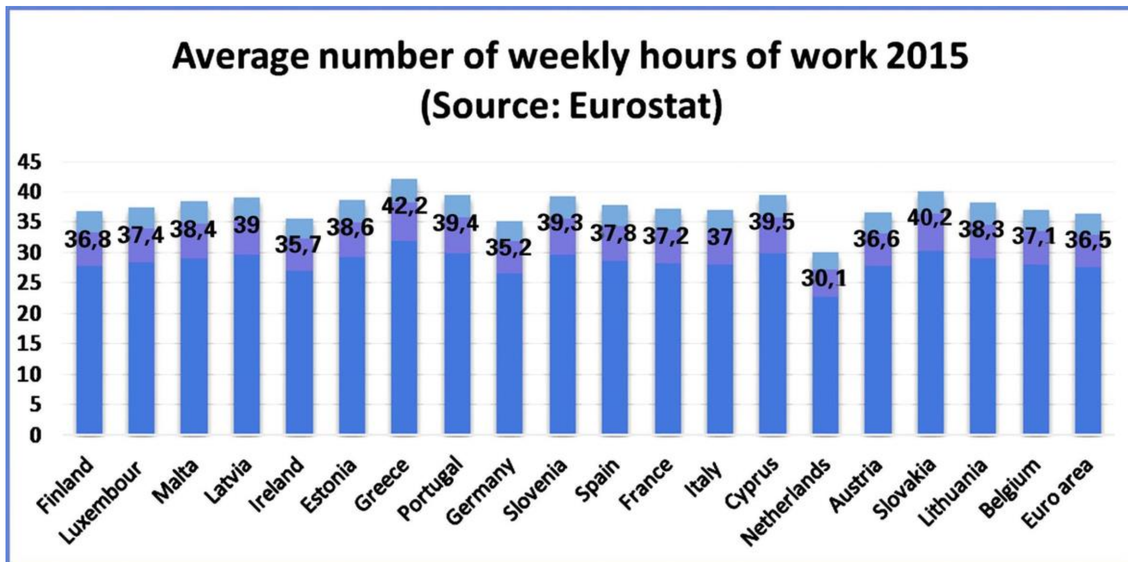
[43] Most public sector jobs were permanent and well-paid. For a detailed account of Greek public sector employment see Jacobides (2017), 'Public administration and the tragic trident: understanding the organizational and drivers of the Greek malaise' in Meghir et.al (2017), *Beyond austerity: reforming the Greek economy*, MIT Press.

[44] Self-employment reached 35% of total employment in 2016 (Eurostat, 2017).

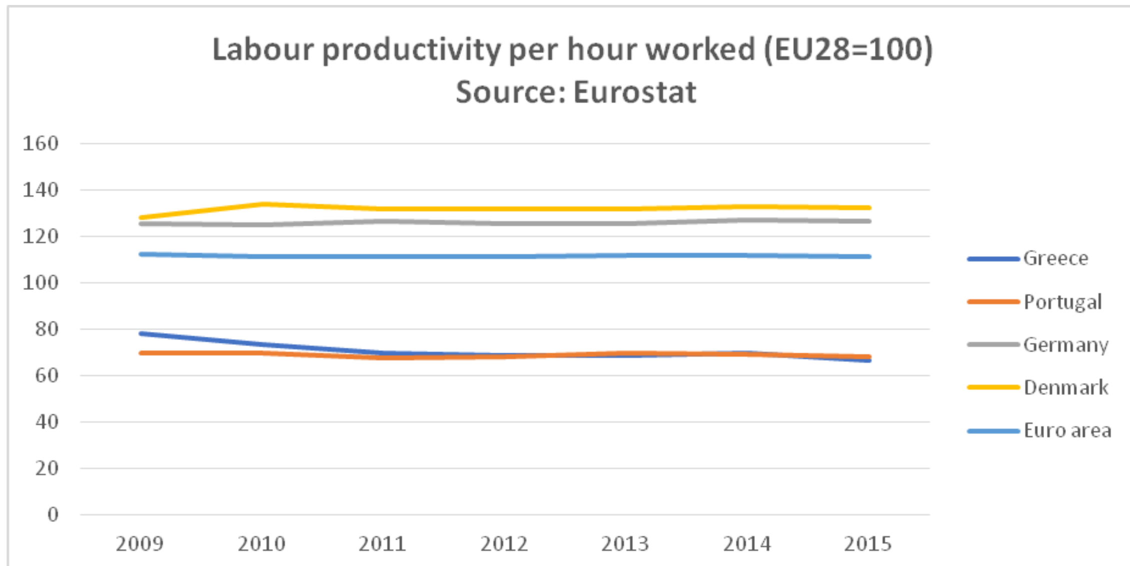
employment to offset the losses from their sluggish economic activity: the proportion of precarious jobs reached 11.9% in Greece and 22% in Portugal in 2015 (OECD, 2016). However, due to the dysfunctional allocation of labour, the long working hours have not been effective in increasing output.

Graph 10. Average number of weekly hours of work



Instead of moving to the export sectors, a large number of educated young people have been leaving both countries since 2010. Graduates and young professionals face a bitter dilemma: precarious employment in their home countries or immigration. Between 2011 and 2014, 427,000 people left Greece and 485,000 people left Portugal, on a long-term basis (Bank of Greece, 2016; INE, 2016). The massive emigration of a dynamic young workforce has negatively affected the human capital in both countries, both quantitatively and qualitatively. Therefore, it is not a paradox that, despite the EU and IMF projections, labour productivity has been sluggish since the beginning of the bailouts in both countries. The productivity gap between Greece and Portugal and the rest of the Eurozone countries has widened.

Graph 11. Labour productivity per hour worked



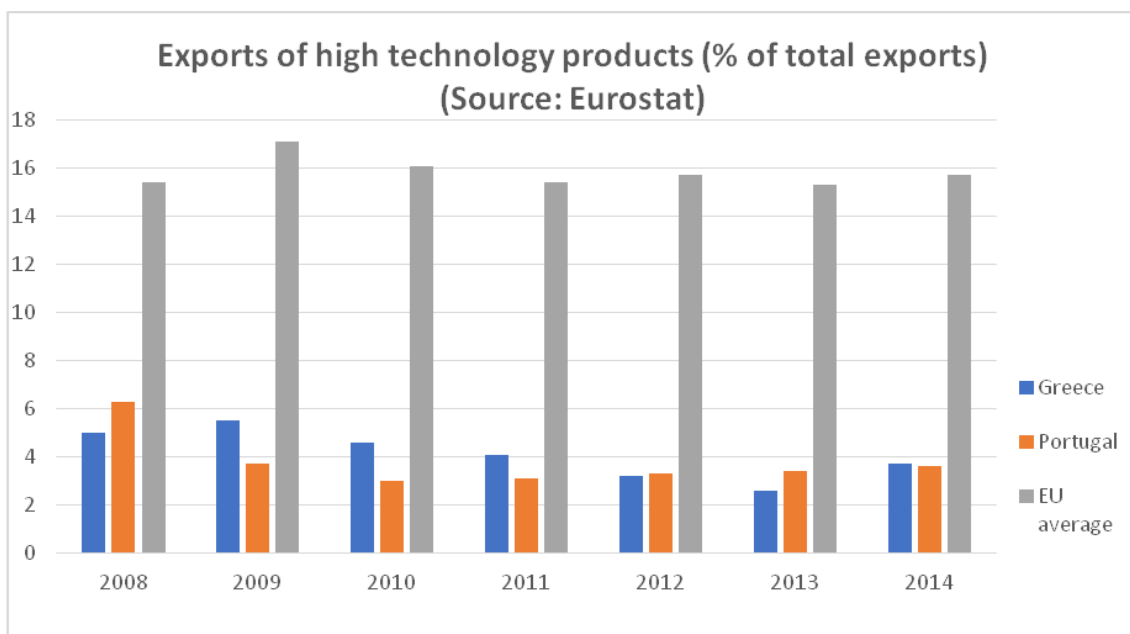
The neoclassical belief that the bailouts would automatically push the workforce towards the more productive export sectors was overoptimistic. The human capital ended up in chronic unemployment or abroad. The 'creative destruction' was not 'creative' at all.

5.2.3 The low-tech production and the global competition

As analysed above, the EU, IMF, and neoclassical economists largely underestimated the role of structural supply-side factors in competitiveness; the specialisation in international trade, the innovation, the quality of labour skills, the types of exports, and the exports' orientation (McCombie and Thirlwall, 1994, Blecker, 1999; Arestis and Sawyer, 2004; Stockhammer, 2008; Britto and McCombie, 2009). The competitiveness gap between the northern export-led countries and the South was not due to labour costs. Non-price competitiveness remains the real challenge going forward.

Greek and Portuguese exports are concentrated in low- and medium-technology sectors (Athanasoglou et al. 2010). Exports of high technology products have declined in both countries, from 5.0% in Greece and 6.3% in Portugal in 2008 to 4.6% and 3.8% of total exports in 2014, respectively. This is far below the average in the European Union, which reached 15.4 % in 2008 and 17 % of total exports in 2014 (Graph 12, Eurostat, 2016). They are stuck at a medium level of technology and they are caught in a competitiveness trap.

Graph 12. Export of high technology products (% of total exports)



Greece ranked 54th and Portugal 36th, while core Eurozone member states such as Germany, Austria and France, ranked 3rd, 6th and 18th respectively in the world economic complexity rankings in 2015, which measure the knowledge intensity of countries' exports (ECI index, 2015). Germany's exports of highly complex products represent 18% of world exports, against Greece's 0.02%, and Portugal's 0.04% (Felipe and Kumar, 2011). Greece's and Portugal's exports are concentrated in the least complex products, reaching 33.1% and 21.7% of their total exports respectively (Felipe and Kumar, 2011). This means that Greece and Portugal have a different export basket both in quantitative and qualitative terms and are unable to compete with the high-tech economies in the core of the Eurozone, mainly Germany, Austria and France. The latter, which are technologically advanced economies, have a comparative advantage against

the 'intermediate' economies. Greece and Portugal remain far below the high-performing Eurozone economies according to the European Innovation Scoreboard (EIS). Using a comparison of the aggregate unit labour costs between the core and the periphery of the Eurozone to measure competitiveness is misleading. Wage suppression is not enough to reinstall competitiveness in the peripheral economies.

Furthermore, the expansion of the European Union towards Eastern Europe -the former Soviet Union and *Visegrád* countries- triggered a new complex reality in the Union. The inclusion of Poland, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Slovakia and Slovenia changed the economic dynamics in the European single market. Under the Austro-Hungarian and Prussian Empires, the eastern countries developed a large-scale productive base. Under the socialist state's economic planning, the socialist regimes accelerated the concentration of production factors in the 1970s (Lipton and Sachs, 1990). The launch of secondary and higher education opened up the path into the educational system for the excluded rural population. Most of those countries have a relatively skilled workforce today. The EU enlargement brought significant foreign investment from the core countries to those economies. Due to their geographical proximity and low labour costs, the Eastern economies became an arm of Northern Europe's supply chain. Large German outsourcing and sub-contracting (of local firms) took place in the Czech Republic, Poland and other Eastern economies (Myant, 2016). Central and Eastern European countries produce advanced tech, automotives, machinery and electronics. The alleviation of the productive investment towards Eastern Europe pushed the southern economies, Greece and Portugal among them, further towards underinvestment. Those economies remain focused on traditional low-tech sectors. The Eastern economies have been upgraded to *second-tier* countries in the European Union, leaving the southern economies behind in the *third-tier*. This process has accelerated the structural regression in Greece and Portugal during the last decade. The internal devaluation was not able to reverse this process. The wage decrease was not enough to boost the southern economies in the European competition. Firstly, wages in Poland, Hungary, Lithuania and Latvia are still much lower than in southern periphery (Eurostat, 2017). Secondly, beyond cheap labour, those countries offer an attractive package of medium-tech manufacturing bases and economies of scale, and a large and relatively skilled workforce. The Southern periphery is falling behind.

Beyond the rising competition in Europe, Greece and Portugal have been in the middle of a changing global environment in recent decades. Although the European core-periphery relations have been analysed in the recent literature (Lapavitsas et.al, 2012; Nölke, 2016; Dooley, 2019), the southern countries' position in the global competition remain a neglected topic in the academic research. The rise of the emerging economies, mainly China, India and other Asian economies, has had tremendous effects on the global economic environment. China's economic opening up and shift towards export-led growth was a turning point for the world economy. China's entry into the World Trade Organisation changed the dynamics of global trade. Its cheap labour costs and large workforce have made China the leading exporter in low value-added products globally. Countries specialised in traditional sectors -textiles, agriculture and raw materials- have faced unprecedented competition. China's exports have increased over 500% during the last three decades. They have also evolved rapidly towards more sophisticated products. Other large-scale economies, including India, Bangladesh and Vietnam have also emerged as leading exporters in traditional sectors. The Southern European economies, which rely on low value-added production, remain stuck in a marginal position in the global value chain. The crisis-hit economies are 'trapped' between the high-performing, technologically advanced Eurozone economies and the large-scale, low-labour cost emerging economies (Eastern Europe and Asian countries). The neoclassical economic policies did not reverse this trend. Lower wages could neither upgrade the specialisation profile nor push them towards high-added value exports (Mamede et.al, 2014: 261). The bailout programmes did not open up the way for a real structural change.

5.3 Overall

The outbreak of the crisis left the southern peripheral economies on the brink of an economic Armageddon. Two developed economies and well-functioning democracies were now the weakest links in the Eurozone. Greece and Portugal have been going through an adjustment programmes, under the Troika's supervision, since 2010. They have indeed achieved an unprecedented fiscal adjustment. They have closed

the deep fiscal imbalances that mounted in the late 2000s. This has been a remarkable but also painful adjustment. However, the public finances in both countries remain far from setting the public debt on a downward path. Despite spending cuts, due to stagnation and high interest rates the Greek debt remains clearly unsustainable in the long-term, while the Portuguese debt's sustainability is vulnerable to external shocks. Debt will be a common concern for both countries in the future. Greece and Portugal have also managed to adjust their long-standing trade deficit. This was undoubtedly a significant attainment. However, as shown above, it was due to the massive fall in imports, rather than a promising export performance. Despite the EU's and IMF's projections, the internal devaluation provided few gains in terms of getting the economy out of its slump and failed to transform the consumption-led to export-led countries. Although the EU and the IMF celebrated Portugal's exit from the programme on time, the Greek and Portuguese economies still face similar challenges: increasing external debt, poor competitiveness and low export performance.

The internal devaluation was based on the simplistic assumption that lower labour costs mean lower production costs and therefore competitive exports. It did not push production costs down. Despite the tremendous decrease in labour costs, non-labour costs (i.e. VAT, energy cost) neutralised the internal devaluation. Beyond this, the internal devaluation failed to address the structural factors associated with non-price competitiveness that constrain export performance in the periphery of the Eurozone. Those chronic structural weaknesses are rooted in the historical process of capital accumulation and the development of a consumption-oriented growth model in those economies. The neoclassical economists failed to take into account the dysfunctional economic structures: the weak productive bases, the inefficient allocation of labour and capital, and the poor technology and innovation performance. They overlooked the complex economic and political realities in the peripheral countries (i.e. poor access to credit) and failed to trigger the transformation of the 'intermediate' economies.

The 'intermediate' economies, based on a traditional specialisation profile and low-tech production, have been pushed to a marginal role in global trade. They face a rapidly decreasing demand for their exports and they barely attract productive investment from foreign investors. The bailout programmes failed to push those economies out of the competitiveness trap. Evidence shows that Greece and Portugal are making a decreasing contribution to the Eurozone's economic output. The gap between those two countries and their counterparts in the North has been widened.

The adjustment failed to open up the path for an export-led recovery in the 'intermediate' economies and a sustainable Eurozone as a whole. The neoclassical assumption that the *invisible hand of the market* would transform those countries to high-productivity, export-led economies proved a theoretical fallacy. The transfer of productive factors to the export sectors through 'creative destruction' has not been completed. On the other side, potential higher public spending -as many Keynesian economists argue- to increase consumption is not a panacea. A boost in domestic demand through higher public spending or lower interest rates would provide temporary relief. Such a policy would not solve the structural problems of these economies. Instead, it would push towards the old consumption-led economic model that led to the crisis in 2008. Acknowledging that the source of low competitiveness is a structural problem of modern production, the 'intermediate' economies need to follow a different path. They need to reconsider the role of the state in their economic policy. They need to employ an industrial policy using policy tools (i.e. a sector development policy and incentives) and resources (i.e. technology transfer, investment schemes, and R&D) to upgrade their economic structures and kick-start a structural change towards a sustainable export-oriented model of growth.

The economic outcomes in Greece and Portugal have triggered a heated debate over the 'politics' that shaped the economic decisions and policies during the crisis. The political framework of the management of the crisis will be analysed in *chapter six*.

Chapter 6: The politics of the management of the crisis in the Eurozone

As we have seen in the previous chapter, the neoclassical economic policies that the creditors designed were rather ineffective in terms of kick-starting a strong recovery and export-led recovery in the 'intermediate' economies. Although Greece and Portugal achieved a painful fiscal and current account adjustment, the internal devaluation failed to improve their competitiveness or the chronic structural weaknesses that led to the crisis in 2010. The Keynesian economists ignored the structural origins of the crisis too. Instead, they insisted on demand-oriented policies to reverse the economic stagnation. However, such policies would reinstate the debt-led growth model that led to the crisis in the periphery. Why did the creditors insist that austerity (i.e. internal devaluation) was the solution to the Greek and Portuguese crises? Why did neither the creditors nor the debtors bring the structural features of the crisis -analysed in the previous chapter- into the negotiations?

To answer these questions, we need to turn from the cases of Greece and Portugal to the broader context of the political interests, power relations and conflicts in the Eurozone as a whole. It was considered essential to have an extensive chapter about the politics of the management of the crisis, as the political framework shaped the economic decisions during this time. The analysis of the complex political game between the creditors and debtors is of importance to understand the nature of the policies introduced to deal with the crisis in deficit countries and in the Eurozone as a whole. I argue that the crisis management aimed hardly to solve the economic crisis, but rather to maintain the power relations established in the context of the Eurozone. The current literature on the political aspects of the crisis in the Eurozone is booming. As mentioned in *chapter two*, academics from various social sciences have offered different viewpoints on the response to the crisis. However, the literature remains limited in its scope.

The many different accounts[45] in the existing literature fit under two broad perspectives: the neoclassical and the Keynesian/'victimisation' explanations. As analysed in *chapter two*, based on neoclassical economic theory, the creditors presented austerity as the 'medicine' for the 'profligate' countries in the South. Austerity was seen as the way for the countries in crisis to balance their fiscal and current account deficits. In Madrid in June 2010, Alberto Alesina claimed in front of the ministers of Finance of the Eurogroup that austerity would be 'expansionary' (Alesina, 2010). The creditors enthusiastically welcomed his remarks. Austerity was the way to go. On top of this, the internal devaluation policies were seen as the only way to bring about an export-led recovery. Greece and Portugal would achieve sustained export-led growth soon after the crisis. On top of this, the neoliberal reforms were necessary to modernise the 'backward' economies in the periphery.

On the other hand, the debtors perceived austerity and the bailout conditionality as a 'punishment' (De la Dehesa, 2011; Eichengreen, 2010). Scholars associated with the 'victimisation' explanation argued that the EU and the IMF wanted to punish the 'profligate' governments that had led to the crash in 2010. The creditors declined debt relief for Greece and, due to the 'German stubbornness', insisted on austerity just to save the German and French banks (Varoufakis, 2017). Other Keynesian critics claimed that the ECB's 'wait-and-see' policy -under the German orthodoxy- had, through austerity, turned a manageable debt crisis in Greece into a crisis across the European South (De Grauwe, 2015; Mody, 2018). Both of these narratives produced biases that impede our understanding of how Greece and Portugal ended up after the crisis. The creditors blamed the 'reckless' governments in the South, the PIIGS,[46] for the crisis and the post-crisis sluggish economic growth. On the other side, the debtors blamed the Germans[47] which managed the crisis in such a way as to produce prolonged stagnation in the periphery.

This chapter provides a distinct approach that deconstructs the mainstream thinking regarding the crisis management. The Growth Model approach -which I argue for- criticises both the neoclassical and Keynesian/'victimisation' explanations. Such approaches failed to acknowledge that both the creditors and debtors insisted on an unproductive 'neoclassical vs Keynesian' debate and failed to bring the structural

[45] *Chapter two* provides a detailed analysis of the different accounts in the literature.
[46] PIIGS has been used offensively for Portugal, Italy, Ireland, Greece, and Spain.
[47] The German government was criticised for punishing the countries in crisis.

origins[48] of the crisis -as analysed in depth in *chapter five*- into the negotiations over the response to the crisis. This thesis goes beyond the conventional wisdom that relies on the superficial biases in the existing blame narratives and shows that both the creditors and debtors were responsible for how the peripheral countries ended up after the crisis.

Based on extensive interviews with key senior officials from the EU, the IMF, and the national governments, I bring new evidence related to the negotiations between the creditors and debtors. Such evidence questions the Greek 'exceptionalism' that both the neoclassical and Keynesian perspectives used to explain the post-crisis economic performance in the periphery. As we have seen in *chapter two*, both explanations, for different reasons, perceive Greece as an 'exception' in the periphery. By showing why and how Greek 'exceptionalism' is used by these two mainstream explanations, this thesis makes an important contribution to the literature.

It also goes beyond the one-sided views that argue that the creditors dealt with the crisis just to save the banks (Varoufakis, 2017) or to 'punish' the debtors (Eichengreen, 2011). It brings to light the 'big picture' of the negotiations. It shows that the creditors aimed to maintain the uneven development and the status quo that have benefited them in recent decades rather than to just 'save the banks' or 'punish' the deficit countries. It also goes beyond the mainstream understanding that sees the negotiations as a 'Goliath versus David' struggle. Although the creditors' power was overwhelming, the debtors were also responsible for how Greece and Portugal performed after the crisis. The existing literature is mainly focused on the creditors' 'camp' and therefore leads to one-sided analyses that fail to account for the complex interaction between the creditors and debtors. In contrast, I shed light on the debtors' 'side' too. Despite the 'conventional wisdom', I found evidence showing that the anti-austerity parties in the debtor countries pursued a domestic, election-driven political agenda against the EU/IMF/Germany, rather than aiming to mitigate the uneven development and challenge the status quo in the Eurozone. Overall, after a decade of long negotiations, political clashes and social turmoil, the economic paradigm that produces structural imbalances -and potential new crises- in the Eurozone has barely changed.

The creditors prevented a 'grand bargain' over the structural origins of the crisis. They acted solely to serve their own interests: (i) to prevent crisis contagion in their

[48] As shown in *chapter five*, the structural weaknesses in Greece and Portugal that led to the crisis remained unaddressed even after the bailout programmes.

economies; (ii) to prevent the rise of a pan-European anti-austerity movement; and (iii) to keep the Euro stable. Based on those primary political aims, they took action through (i) setting the agenda in the negotiations with the debtor countries; (ii) employing a 'divide and conquer' policy to divide the South; and (iii) initiating reforms to enforce fiscal discipline and declining alternative policies in the Eurozone. The creditors' prescription for the response to the crisis in Greece and Portugal was a recipe for sustaining their primacy. As the influential German Minister of Finance, Wolfgang Schäuble, claimed, '*we are not defending Greece, we are defending the stability of our currency*' (EurActiv, 2010).

On the other side, the debtors did not bring the structural features of the Eurozone crisis to the fore at any stage of the negotiations. They acted to serve their election-driven interests by: (i) framing anti-austerity election campaigns, shifting the blame on to the creditors - Germany, the EU and the IMF; (ii) insisting on Keynesian claims (i.e. debt relief, and a Marshal plan for Europe), leaving the asymmetry and the growth model division in the Union in the dark; and (iii) breaking the anti-austerity promises once in government. The debtor governments served their own domestic political interests rather than challenging the status quo between the creditors and debtors. In the rest of this chapter, I analyse the 'politics' of the crisis not only in Greece and Portugal but also in other European countries to shed light on the major players' motives and to present the 'big picture' of the management of the crisis in the Eurozone.

6.1 The creditors' side: the German-Franco engine in the management of the crisis

The management of the crisis has been a complex process shaped by various forces: international financial institutions, capital markets, governments, banks, credit rating agencies, political parties and individual politicians that have served conflicting interests. These have played a role in managing, controlling and overcoming the unfolding crisis in the Eurozone since 2009. The Eurozone member states have their own interests (i.e. voters' demands and international alliances) and have exerted an asymmetric influence over the decision-making process in the Union (Moravcsik, 1998;

2018; Hix *et al.*, 2002). Parliaments and citizens have also had their say in the political decisions. Although all of the above complicate the picture, some players, especially the German and French governments, have played a more important role in the decision-making process than others. Despite the emerging contradictions and national dynamics, Germany's and France's power on the creditors' side has been overwhelming.

Germany is the largest economy in the Eurozone and the highest net contributor to the European Union's budget. Germany and France combined provide about 48% of the ECB capital and enjoy a strong position in the financial markets: Germany is graded AAA and France AA+ by the credit rating agencies.[49] Together they provided about 50 percent of the funding guarantees to the European Financial Stability Facility (EFSF) and European Stability Mechanism (ESM), which were launched to bailout the insolvent economies in the Eurozone. Beyond the above, Germany and France have maintained an influential role in the regular European Council and Eurogroup[50] meetings (Bulmer and Paterson, 2019). On top of this, since 2009, Germany and France have coordinated their own policy actions prior to the official EU negotiations. The German Chancellor Angela Merkel and the French President Nicholas Sarkozy initiated unofficial meetings with the presidents of the ECB, the European Council, Eurogroup, the European Commission and, occasionally, the managing director of the IMF[51] prior to the important decisions (Schild, 2013: 34).

As the literature suggests, agenda setting and the definition of alternatives in the negotiations are the supreme instrument of power (Schattschneider, 1961). Based on such power, Germany and France have negotiated bilaterally, drafting common proposals before the crucial decisions in the European Union. Germany and France have also exercised influence through political alliances across the Union. Building political alliances has been crucial to overcome political opposition to their political goals (Schild, 2013: 35). Germany led the northern countries, insisting on fiscal discipline and resisting further steps towards deeper European integration. France gained support in Belgium, Luxemburg and periodically in the southern countries, such as Greece, Cyprus and Spain. Some of the southern European leaders saw France -especially after François Hollande's election victory- as the ally that could make their voice heard. Using such a

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[49] France was downgraded from AAA to AA+ in January 2012.
[50] The Eurogroup is the regular meeting of the Ministers of Finance of all of the member states in the Eurozone. It is an unofficial decision-making mechanism and acts outside the European law.
[51] For a detailed account of the unofficial meetings between German and French officials prior to important EU summits or other crucial decision-making meetings see Schild (2013: 32-33).

proactive negotiation strategy, Germany and France have influenced the crucial decisions in the management of the crisis (Schild, 2015). However, the German and French coordination has never been a 'directorate' of the Eurozone (Degner and Leuffen, 2019). The management of the crisis led by Germany and France has not, by any means, been a coherent and unchallenged synthesis. Rather, it reflects a reciprocal set of relations between Germany, France, other national governments, political parties and citizens in the Union. All of them have interacted in asymmetric ways to manage the crisis.

6.1.1 Preserving the status quo: from saving the banks to 'whatever it takes'

6.1.1.1 Greece on the brink of collapse

As shown in *chapter two*, the creditors were very concerned once the global financial crisis hit the Eurozone. This was the beginning of a turbulent decade for Europe. Investors were alarmed about Greece's ability to service its rising public debt. In December 2009, all of the credit rating agencies -*Moody's*, *Standard & Poor's*, and *Fitch*- downgraded their ratings of the Greek economy (Blustein, 2016: 90). Greek sovereign bond prices became sky-high and Greece was *de facto* out of the capital markets. Amid growing market speculation, the German Chancellor Angela Merkel and the French President Nicholas Sarkozy had a bilateral meeting ahead of the European Council to discuss the 'Greek problem' on 11th February 2010. Germany, with the support of the Netherlands, Austria and Finland, resisted any kind of financial assistance towards the insolvent Greek government, invoking the EU's 'no-bailout' clause (Art. 125 TFEU). According to the Greek Prime Minister, George Papandreou, the European leaders were reluctant to take action as '*the conventional wisdom and dominant view among EU leaders was that 'this is a Greek problem*' (Papandreou, 2014). Over the following weeks, the German government started softening its position (Degner, 2016; Degner and Leuffen, 2019). After intensive lobbying from the German banks, the German and French governments started acknowledging the spillover effects of a potential Greek default (Fuhrmans and Moffett, 2010). As the table 13 shows, the

French and German banks were among the major Greek sovereign debt bondholders. A Greek default would affect the German and French economies through the banking sector.

Table 13

The Greek Debt, September 2010 (in $ billions)

Type of exposure	Germany	France	US
Public sector	23.1	27.0	5.4
Banks	10.5	3.9	3.1
Non-bank private	10	40.2	5.2
Total foreign claims	43.6	71.1	13.6
Other exposure	7.4	40.5	27.5
Total	**51**	**111.6**	**41.2**

Source: BIS Consolidated Banking Statistics, www.bis.org

This was a turning point for the management of the crisis in the Eurozone. In a new round of bilateral meetings, Angela Merkel and Nicholas Sarkozy agreed on a package to rescue Greece from an all-out default ahead of the European Council on 25th March 2010. In parallel, the Greek government started secret negotiations with the IMF in April 2010. In a conference hall kitchen in Davos, Prime Minister George Papandreou, the IMF managing director, Dominique Strauss-Kahn, and the Greek Minister of Finance met secretly to discuss the possibility of an IMF contribution to the Greek bailout programme (Papaconstantinou, 2016: 98-99). Nicholas Sarkozy and Angela Merkel, together with the President of the European Central Bank, Jean-Claude Trichet, insisted that debt relief should remain off the table to prevent a banking

crisis in France and Germany (interview with VP of the European Commission, 2019). The negotiations focused solely on the amount of financial assistance, the austerity measures, and the duration of the programme (interview with former Greek Minister of Finance, 2018). As one former Greek senior official, said: '*we just discussed how much austerity was needed…the fiscal targets…and how we can reach them on time*' (interview with Greek senior official, 2018). The bailout agreement was presented as 'take it or leave it'. The Greek Minister of Finance claimed, '*we had no time… we had to find a solution to prevent a dramatic Greek default*' (interview with former Greek Minister of Finance Papaconstantinou, 2018).

6.1.1.2 The European influence inside the IMF

At the same time, the European creditors -led by France and Germany- exerted influence over the top level of the IMF management to approve the Greek bailout. The IMF was deeply divided. At the staff level, there were voices -based on the debt sustainability analysis (DSA)- in favour of a debt restructuring (Blustein, 2016). However, the European Department and the Fund's managing director, Dominique Strauss-Kahn, disagreed, emphasising the risk of contagion through the banking sector across Europe (interview with ex. director in the IMF, 2017). Concerns were also raised inside the Fund's management level over *'an extremely austere programme with limited prospects of success'* (interview with IMF staff, 2019).

Despite the voices for debt relief, the board of executive directors approved the Greek programme (interview with ex. director in the IMF, 2017). Among others, the Swiss Executive Director, Rene Weber, claimed at the board meeting on 9th May 2010: '*we have considerable doubts about the feasibility of the program…we have doubts on the growth assumptions, which seem to be overly benign. Even a small negative deviation from the baseline growth projections would make the debt level unsustainable over the longer term…why has debt restructuring and the involvement of the private sector in the rescue package not been considered so far?*' (IMF board minutes, 2010).

Brazil's and India's executive directors -representing several developing countries- also raised concerns. India's executive director called the Greek bailout a

'mammoth burden' (IMF board minutes, 2010). Brazil's executive director said in the same meeting on 9th May 2010: '*the risks of the program are immense…as it stands, the programs risks substituting private for official financing. In other and starker words, it may be seen not as a rescue of Greece, which will have to undergo a wrenching adjustment, but as a bailout of Greece's private debt holders, mainly European financial institutions*' (IMF board minutes, 2010).

Despite the disagreements from many countries in the Fund, the European creditors influenced the top ranks of the IMF management in favour of the Greek bailout. Dominique Strass Kahn, IMF Managing Director, Jean-Claude Trichet, ECB president, and the German Chancellor, Angela Merkel bypassed the concerns and agreed to proceed with the Greek rescue programme in a trilateral meeting on 28th April 2010 (interview with senior official in the IMF, 2019). The IMF management exercised pressure in favour of the Greek programme during the board meeting. John Lipsky, the Fund's deputy managing director, who chaired the meeting about the Greek bailout, said to the executive directors, '*there is no plan B…there is plan A, and determination to make plan A succeed. And this is it*' (IMF board meetings minutes, 2010).

On 3rd May 2010, the European Council and the IMF activated the financial assistance to Greece under three conditions: no debt restructuring, high interest rates, and draconian austerity. The Fund had approved a bailout for a country whose debt was considered as sustainable with 'high probability' (IMF, 2013a: 26). The decision was made to prevent 'a high risk of international systemic spill-overs' (IMF, 2013b: 20).

With the IMF management's implicit consensus, the German Chancellor and French President managed to prevent German and French bank losses that would have put their economies into crisis too. However, the chronic structural weaknesses that put the Greek economy into a vicious circle had been kept out of the negotiations. Therefore, the rescue programme, as shown in *chapter five,* had limited prospects of success. The high interest rates and draconian austerity pushed the Greek economy into a deep recession, reducing its GDP by 7 percent in 2011 and making its debt profile worse.

6.1.1.3 Ireland and Portugal turn insolvent too

Beyond Greece, other peripheral countries, especially Ireland and Portugal, were now at the mercy of market speculation. The German government was still against the creation of a permanent bailout mechanism for the crisis-hit countries (Degner and Leuffen, 2019). The 'Celtic Tiger', as Ireland had been called due its high growth rates in the past, was now facing an economic Armageddon. Based on massive credit flows from the core countries, the Irish 'miracle' of the banking sector's overgrowth and real estate bubble collapsed in 2009.[52] The *Lehman Brothers*' default and the markets' concerns over the Greek economy pushed the Irish bond spreads to a new high. Bankers started checking their balance sheets, trying to minimise their losses. Without new credit, the property price bubble burst. Banks' liabilities collapsed as did property prices. Insolvency knocked on the door of the major Irish banks.[53] With the ECB's blessing, the Irish government nationalised the Anglo Irish bank and the Allied Irish Banks. The private banks' losses were now transferred to the Irish government (Dellepiane-Avellaneda and Hardiman, 2015: 211). The government's deficit exploded, and Ireland was *de facto* locked out of the capital markets.

At the same time, most of the Portuguese banks became insolvent too. Prime Minister Jose Socrates claimed, "*we won't let a single bank fail ...the top priority is to stabilize the financial system*" (Reuters, 2008). His government approved a rescue plan for the collapsing Banco Portugues de Negocios (BPN) and Banco Privado Portugues (BPP). Concerns over the Portuguese government's solvency mounted. The credit rating agencies started downgrading its sovereign ratings, as they had done previously for Greece and Ireland.

The Portuguese government was now forced to start negotiations with the creditors. According to one senior Portuguese official '*the negotiations were tough…we knew that wages cuts and austerity would be resisted by the Portuguese people… we knew that this might not work in our country…but we had no choices*' (interview with senior Portuguese official, 2018). There was no room left for alternatives to austerity. A former VP in the Commission asserted, '*the Commission is not a think tank to talk*

[52] Mortgage loans exploded from about €16 bn in 2003 to €106 bn in 2008. This was about 60 percent of the country's GDP in 2008. Property assets prices reached sky high levels.

[53] The Bank of Ireland, the Anglo Irish Bank, the Allied Irish Banks, Irish Life & Permanent and Irish Nationwide Building Society.

about different policies, we make decisions' (interview with VP of the Commission, 2019). Amid political pressure, the German Chancellor and French President agreed to set up the European Financial Stability Facility (EFSF) to bailout Ireland and Portugal. The new mechanism, with a lending capacity of €750 billion, was endorsed by the rest of the European leaders at the Euro summit on 9th May 2010. Under the EFSF, the European leaders agreed with the IMF on a €85 billion loan for Ireland in December 2010 and a €78 bn bailout for Portugal in May 2011.

In this first phase of the crisis, Germany and France manged to minimise the economic spillover to their economies, leaving the indebted states to pay a disproportional cost. The German and French banks -which were highly exposed due to sovereign debt bonds of the crisis-hit countries- now had time to sell off the toxic bonds from their portfolios (Tarlea *et al*., 2019). However, through austerity, the creditors led the South into prolonged stagnation.

6.1.1.4 Greece falls again

A new phase of the crisis was about to begin. Austerity pushed Greece deeper into recession while its debt-to-GDP ratio continued rising in 2010-2012. Faced with the mounting Greek debt, Merkel and Sarkozy continued their meetings in summer 2011.[54] After the German and French banks' sell-off of the Greek bonds, Germany and France were now free to proceed with a common proposal for debt restructuring -on a 'voluntary' basis- of 50 percent and a new €130 billion loan in exchange for further austerity and reforms.

However, the political situation in Athens had changed. Austerity had caused a new wave of general strikes and protests across the country. Amid political pressure, Prime Minister Papandreou announced a national referendum to endorse the debt restructuring and the accompanying second bailout agreement on 31st October 2011. The creditors worried about the referendum result. Sarkozy -backed by Angela Merkel- asked Papandreou to conduct a referendum on 'the membership of Greece in the Euro area and the European Union' at the G20 summit in Cannes in November 2011, (Spiegel, 2015; Blustein, 2016: 270).

[54] For a detailed account of the German and French bilateral meetings during the Eurozone crisis see Schild (2012).

For the Greek Minister of Finance, Vangelis Venizelos, who was also at the meeting in Cannes, '*the position of Sarkozy was very offensive…in order to put Greece in a dilemma: in or out*' (Spiegel, 2015). Jean-Claude Juncker, President of the Eurogroup at that time,[55] also said, '*I strongly insisted when I was talking to Papandreou and Venizelos don't have this referendum, it's bad. The financial markets do not understand. I'm not driven by financial markets, but I know they exist… I always had in mind that we have to pay attention to the financial markets… So, I asked George Papandreou and Evangelos Venizelos to skip the idea of having a referendum. And they finally did that'* (Juncker, 2020). Under such political pressure, George Papandreou,[56] who was facing domestic political turmoil too,[57] resigned in November 2011 (Godby and Anderson, 2016: 139). The French and German governments had prevented a national referendum in Greece that may have put their crisis management strategy at risk. However, in the eyes of the Greek citizens this was direct interference in their domestic politics.

6.1.1.5 The crisis spreads from the periphery to the core

The austerity programmes had turned the recession into a depression in the periphery. The markets' concerns against Italy and Spain were rising, especially since the bail-in in Cyprus.[58] The 4th and 5th largest economies were now on the brink of

[55] Jean-Claude Juncker was also the President of the European Commission from 2014 to 2019.
[56] George Papandreou claimed: 'I tried unsuccessfully to hold a referendum on the adjustment programme, and I would have liked to have more referenda on other issues. This did not happen in the end, because of reactions both from outside and inside Greece. It was a lost opportunity for Greece' (Papandreou, 2015: 255).
[57] The protests against austerity started to take place even before the first bailout agreement in May 2010. More than 500 strike actions took place in Greece mainly against austerity in 2011, and about 700 took place in 2012. General strikes were being called every 5-6 weeks (Laskos and Tsakalotos, 2013: 120-121). Job losses, precarious employment and falling wages were at the forefront of the protestors' claims. Their slogans and placards were against austerity, government and the European Union: 'bread, education, freedom…the dictatorship did not fall in '73', 'we do not owe, we will not sell away, we will not pay', 'oust EU and IMF…people have the power'. Voices against the political system as a whole started becoming stronger.
[58] The Cypriot banks -which were highly exposed to the Greek sovereign bonds- were on the verge of bankruptcy in spring 2012. During the previous decade, Cyprus had been an international financial hub in the Eastern Mediterranean where global depositors parked their money safely and confidentially. Its banking sector's assets were considered to be about eight times the size of the Cypriot economy (Blustein, 2016: 360). The capital markets panicked as the Cypriot government was unable to save its banks. *Fitch* and *Moody* downgraded the government sovereign bonds to BB+ in March 2012. Under massive pressure, the Cypriot government asked the ECB and IMF for a loan in June 2012. Instead of a bail-out, a

insolvency. The crisis was knocking on the door of the Eurozone core countries. Italy's and Spain's plunge into crisis put the Euro at risk. Merkel and the French President, Hollande -who had succeeded Sarkozy- were aware that Spain and Italy were 'too big to bailout' (interview with VP of the European Commission, 2019).

For Spain -like everywhere in the periphery- the arrival of the Euro had sparked a credit and property boom in the 2000s. But now the housing bubble had burst, as it had in Ireland and Greece a few years ago. The credit rating agencies started downgrading the Spanish banks (Sanchez-Cuenca, 2012). To 'restore confidence' in the capital markets, Prime Minister Zapatero -under political pressure from the ECB's president, Jean-Claude Trichet[59]- took a €30 billion cut to the Spanish budget (Dellepiane-Avellaneda and Hardiman, 2015: 203). However, this was not enough. The newly elected Rajoy government negotiated with the German Chancellor and French President over a €100 bn bailout to recapitalise the Spanish zombie-banks: Bankia, NCG Banco, Banco de Valencia and Catalunya Banc (Dellepiane-Avellaneda and Hardiman, 2015: 208).

The banking crisis in Spain triggered further speculation about the Italian sovereign debt. Italy was now in recession. After the Italian government's failure to pass the budget in the Parliament, Prime Minister Berlusconi resigned and a former European commissioner, Mario Mondi, took over (Godby and Anderson, 2016: 139; Blustein, 2016: 263; Walker et. al, 2011; Blustein, 2016: 264). The recession hit households and small and medium sized enterprises that were not able to service their loans. The banks -the largest one among them being UniCredit- were burdened further by mounting non-performing loans. Negotiations over a new bailout began in July 2012. At the same time, France seemed to follow Italy into recession. *Moody's* revised

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deposit haircut was proposed (interview with former Cypriot Minister of Finance, 2018). A proposal for a€10 bn loan in exchange for a one-off bank deposit levy of 6.7% for deposits up to €100,000 and 9.9% for deposits over that was put in front of the Cypriot government. This was a bitter dilemma for the Cypriot Parliament. The ECB warned -via Jorg Asmussen- that the proposal should be approved by the Cypriot Parliament; otherwise, the ECB's emergency liquidity flows towards the collapsing Cypriot banks would stop immediately. In reality, this meant that the banks would collapse, and Cyprus would be out of the Eurozone (Blustein, 2016: 366). Despite the political pressure, the Parliament rejected the EU-backed deal. Under German and French political pressure, the ECB sent an *ultimatum* stating that it would end the emergency funding to the Cypriot Banks. Jeroen Dijsselbloem, the President of the Eurogroup, said before the crucial Euro summit on 25 March 2013, '*a week ago you could have a political debate. There was still manoeuvring space for politicians, but in the present situation there was very little choice. You have to do this. You have to accept it*' (Spiegel, 2013). With this economic chaos, the Cypriot government approved -amid harsh criticism from the Russian government (Spiegel and Chaffin, 2013)- the bail-in, protecting depositors under the €100,000 threshold (Blustein, 2016: 364).

[59] Zapatero revealed in his memoir a secret letter from Jean-Claude Trichet that asked him to make an 'unconditional commitment' to fiscal austerity (Trichet, 2011).

France's rating from a triple A to AA1, declaring that the country's economic outlook remained 'negative' (Willsher, 2012). Almost all of the Eurozone economies -including core economies such as the Netherlands, France and Austria- were now in recession.

Faced with the risk of the collapse of the Euro, for the first time, Merkel and Hollande opened up the path for a larger bond-purchasing plan to stabilise the Eurozone (Euobserver, 2012). In summer 2012, they met at the G20 Summit in Mexico and decided to take '*all necessary policy measures to safeguard the integrity and stability of the Euro area, improve functioning of financial markets and break the feedback loop between sovereign and banks*' (Pop, 2012). The ECB employed monetary policy tools that had been ignored during the previous years, such as the emergency liquidity assistance (ELA) programme and a long-term refinancing operation to offer liquidity to the European banks and countries in crisis. This was a decisive step to calm the markets down. In July 2012, Draghi's 'whatever it takes [to save the Euro]' speech -as mentioned in *chapter two*- was a turning point. In September 2012, the ECB announced its decision to deploy unlimited monetary firepower, purchasing government bonds in the secondary market to address 'distortions in the financial markets' (Steen *et al*., 2012). The interest rates of France, Italy and Spain started declining. The creditors protected the stability of the Eurozone, keeping the economic and political status quo as before. However, the management of the crisis had major consequences for the future of the Eurozone.

6.1.2 The creditors' 'divide and conquer' strategy

Beyond leading the management of the crisis, the creditors employed a 'divide and conquer' strategy to divide the debtors, enforce their neoclassical paradigm, and preserve their political and ideological dominance in the Union. The creditor countries -based on mainstream neoclassical economics thinking- dealt with the financial crash in the Eurozone as an overspending crisis in the 'profligate' periphery. A simplified narrative of the Aesop's fable 'ants versus grasshoppers' has been used to 'explain' the complex structural crisis that the EU was facing. According to this narrative, the rich northern countries managed to keep public spending and wages low and reform their

economies in the 2000s. On the other side, the 'profligate grasshoppers' spent recklessly, leaving their economies unreformed during the Eurozone's *golden age*. When the crisis hit, the 'grasshoppers' started seeking bailout money from the industrious 'ants'. As the former Greek Minister of Finance, Yanis Varoufakis, explained in his monograph, 'And the weak suffer what they must': '*the story...went something like this…the Greek grasshoppers did not do their homework and their debt-fuelled summer ended abruptly one day. The Calvinist ants were then called upon to bail them out, together with various other grasshoppers from around Europe. Now the ants were told, the Greek grasshoppers did not want to repay their debt; they wanted another boot of loose living, more fun in the sun and another bailout so that they could finance it. They even elected a cabal of socialists and radical lefties to bite the hand that fed them. The grasshoppers had to be taught a lesson, otherwise other European, made of lesser stuff than the ants, would be encouraged to adopt loose living*' (Varoufakis, 2016: 6).

According to this populist narrative, the Greeks, Irish, Portuguese, Spanish and Italians were the 'grasshoppers' begging the industrious 'ants' for bailouts. Although this narrative is based on simplistic beliefs and shaky economic foundations,[60] it was used widely during the Eurozone crisis. The President of the Eurogroup, Jeroen Dijsselbloem, referring to the Greek crisis, claimed: *'you cannot spend all the money on booze and women and then ask for help*' (Dijsselbloem, 2016). The German Chancellor Angela Merkel also asserted, '*a good European is one that respects the European treaties and national rights so that the stability of the Eurozone is not damaged…we should put an end to using tricks*' (EurActiv, 2010).

The dividing lines -'ants versus grasshoppers' and 'successes versus failures'- were the foundations of the creditors' 'divide and conquer' strategy. As we have seen, Portugal was presented as a 'success story' while Greece was seen as a 'failure'. As shown in *chapter five*, Greece and Portugal in fact faced similar structural weaknesses that impeded a strong export-led recovery after the crisis. However, by taking advantage of such dividing lines, the creditors managed to keep Greece separated from the rest of the indebted countries in the European periphery.[61] The 'divide and conquer' policy

[60] For a critical review of the neoclassical economic explanation of the Eurozone crisis see *chapter two*.

[61] The 'divide and conquer' strategy prevented a counter alliance against the creditors when an anti-austerity government emerged in Greece in 2015. After years of austerity, Syriza won the general elections in January 2015 and formed a coalition government to re-negotiate the bailout terms with the creditors. The 'divide and conquer' policy has been successful in keeping Greece isolated in the

indeed prevented a political alliance against austerity in the South. Although, as shown above, the crisis had similarities across the periphery, the southern governments tried to disassociate themselves from the 'black sheep' of the Eurozone, Greece. The Irish, Portuguese, Italian and Spanish governments now had to choose which side they were on: either Greece or the responsible 'good Europeans'. The Spanish Prime Minister, Mariano Rajoy, repeatedly claimed when the crisis hit the Spanish banks that: '*Spain is not Greece*' (La Gaceta, 2015). For the Portuguese Prime Minister, Pedro Passos Coelho, '*the Greek Prime Minister, Samaras was a friend of mine, but we did not want to show that Portugal is on the same side with Greece to our fellows in Berlin and Paris*' (interview with the Portuguese Prime Minister Coelho, 2019). The Irish, Portuguese and Spanish governments directly negotiated rescue programmes with Berlin and Paris rather than coordinating their action to formulate an alternative 'European' solution to the crisis. Germany and France, based on such narrative politics, managed to build hierarchical political alliances, preventing a counter political alliance that could potentially have put into question the crisis management paradigm in the Eurozone.

6.1.3 Enforcing fiscal discipline without alleviating the uneven development

As we have seen, the 'divide and conquer' strategy left little room to challenge the dominant crisis management paradigm in the Eurozone. In parallel, the Franco-German coordination initiated a set of reforms of the European economic governance to ensure fiscal compliance for the 'rule-breakers' in the South. The Franco-German *Deauville Declaration* in 2010, which set the foundations of the management of the crisis, stated, '*a wider range of sanctions should be applied progressively in both the preventive and corrective arm of the [Stability and Growth] Pact. These sanctions*

periphery. The Portuguese, Spanish, Irish, and Italian governments, which faced similar economic challenges to Greece, turned against Syriza. For the Portuguese Prime Minister, Pedro Passos Coelho, '*Syriza's political agenda was stories for children*' (Wise, 2015). After six months of unfruitful negotiations, the creditors agreed with the Greek government over a new austerity package in exchange for further liquidity.

should be more automatic' (Franco-German Declaration, 2010). On 5th December 2011, Merkel and Sarkozy finalised a common proposal for a new Treaty on stability, coordination and governance (TSCG) to make the existing fiscal rules (Stability and Growth Pact) stricter for all European governments. A few days later, on 8-9th December, the European Council started formal negotiations over the *Stability and Growth Pact* revision. The German Chancellor said ahead of the European Council: '*I want to stress that we are going to Brussels with the goal of treaty changes*' and specifically '*to change the basis of the European co-operation…to create a fiscal union with powers of enforcement… effective answers to continued rule breaking*' (Pidd, 2011). The new Treaty obliged member states to enshrine a balanced budget or 'golden rule', pushing countries to keep their deficits at 0.5% of GDP.[62] It also provided a new 'automatic correction mechanism' to discipline the 'rule-breakers'. The European Council[63] endorsed the German- Franco proposal in March 2012[64] (Schild, 2013: 35). It was clear that the new Treaty was designed to enforce fiscal discipline rather than to mitigate the growth model division and structural imbalances in the Union.

6.1.3.1 'No Eurobonds as long as I live'

At the same time, alternative proposals were declined. As the crisis was deepening, voices in favour of a debt sharing mechanism, a so-called 'Eurobond', that would allow Eurozone governments to issue common debt, mounted. Eurobonds or other European Safe Bonds (ESB) would be swapped for individual states' debt and would be guaranteed by the Eurozone as a whole (Wyplosz, 2011; Micossi, 2011; Gody and Anderson, 2016: 135). By issuing joint bonds, Eurozone countries would be able to return to affordable interest rates. Although this would not be a silver bullet to end the deep macroeconomic imbalances in the Eurozone, it would provide temporary relief for the stagnated peripheral economies.

'Eurobonds' started gaining political support in the periphery. The Italian, Spanish and Greek Prime ministers, Mario Monti, Mariano Rajoy and George

[62] For countries with public debt lower than 60% of GDP, the deficit should be less than 1% of GDP.
[63] The UK and Czech Republic disagreed, and they never ratified the fiscal component -the Fiscal Compact- of the Treaty.
[64] For a detailed account of the French and German coordination to reform the economic governance in the Eurozone see Schild (2013) and Schoeller (2018).

Papandreou were in favour of such a prospect (Monti and Goulard, 2011; Hollinger *et al.*, 2011). For the creditors, the 'Eurobond' or any other pooling of sovereign debt tools, would relieve the 'profligate' countries from market pressure and make them 'free riders' using Germany's credit rating (interview with VP of the European Commission, 2019). From this perspective, the crisis-hit economies would take advantage of the northern European guarantees to sidestep the reforms (Gody and Anderson, 2016: 135). Any kind of Eurobond was declined. The German Chancellor claimed emphatically: '*no Eurobonds as long as I live*' (Spiegel, 2012).

Overall, once the crisis hit the Eurozone, the creditors in effect said to the debtors: 'you messed up, but we know how to fix this'. Despite the neoclassical beliefs being in doubt after the 2008 crash, the creditors insisted on austerity and neoliberal reforms. The neoclassical explanation was what the creditors needed. It was used as a smokescreen to sidestep changes to how the Eurozone works. The creditor countries have long benefited from the asymmetry in the Union and have had no interest in alleviating the uneven development.

The EC and IMF did not aim to accommodate the growing capitalist divergence between the export-led countries in the North and the consumption-led economies in the South. The creditors resisted any mechanisms or policies to mitigate the gap between the North and the South. They 'kicked away the ladder'[65] and tried to impose upon the debtor states a set of internal devaluation policies unsuited to their economic conditions and in line with their own political interests. Austerity pushed Greece and Portugal into a long and painful adjustment, leaving their productive weaknesses unaddressed. The South remained stuck in an 'intermediate' position and therefore subordinated economically and politically to the North. The creditors' prescription for the response to the crisis in Greece and Portugal was a recipe for sustaining their primacy.

[65] In Friedrich List's memorable phrase.

6.2 The debtors' side: the anti-austerity rhetoric as an election strategy

On the other side, the debtors used a 'victimisation' narrative to present themselves as 'victims' of the creditors. Although the mainstream literature perceives the national politicians as having been forced to accept and implement the reforms -against their will- under pressure from the creditors, evidence -presented in this thesis- offers a new understanding of the 'politics' in the debtors' 'camp'. The anti-austerity parties that emerged across the periphery pursued a domestic, election-driven political agenda rather than challenging the roots of the asymmetry and growth model division in the Eurozone. They framed their election campaigns against austerity, blaming the EU, Germany or the 'Fund' for the crisis. Based on such an anti-creditor rhetoric, they won the elections in both Greece and Portugal. However, they broke their promises soon after the elections. They turned a blind eye to the structural weaknesses that were - as shown in *chapters three* and *five* - the roots of the crisis in Greece and Portugal.

In Greece, even from the early stages of the crisis in spring 2010, when the centre-left PASOK government agreed with the EU and IMF on a bailout, it was evident that the bailout (or 'Memorandum') would be a dividing line in the Greek political system. The leader of the centre-right New Democracy, Antonis Samaras, began a political campaign against the agreement with the creditors. He openly criticised his centre-right fellows in the European People's Party for enforcing 'destructive' austerity policies in Europe. He argued that the bailout was '*unfair, painful, and unproductive*' (To Vima, 2010). For Samaras, '*the bailout will not take us out of the crisis…it leads to higher deficit and public debt…it is destructive for the middle class*' (To Vima, 2010).

New Democracy voted against the first bailout agreement in the Greek Parliament in summer 2010. Samaras presented himself as '*the architect of the anti-bailout struggle*' (Kathimerini, 2012). In Zappeio conference hall in Athens, he launched an election platform calling for the 'renegotiation' of the bailout with the creditors. He claimed, '*I will convince Merkel that the Memorandum is a mistake*' (Samaras, 2010). At the same time, he made unrealistic promises that would never have been able to fulfil. Based on such generous election promises, Samaras won the elections and became Prime Minister of a coalition government in 2012.

In Portugal, the Socrates government was -as we have seen in *chapter three*- under high pressure from the markets, too. The interest rates on Portuguese bonds soared to an unprecedented level. To avoid an all-out default, the socialist government passed austerity packages in the Portuguese Parliament in May and September 2010. The announcement of austerity measures triggered waves of protests in Lisbon. The PSD -under Pedro Passos Coelho's leadership- decided to abstain in the Parliament, criticising the Socrates government for bringing 'counterproductive' austerity measures (interview with Prime Minister Coelho, 2019). Despite the political pressure from its fellow centre right parties in Europe, the PSD announced that it would reject public spending cuts or higher taxes. For Coelho, '*Socrates brought austerity that was destructive for our economy…the new measures were a huge burden for the people who had suffered the most …I had to stop this*' (interview with the Portuguese Prime Minister Coelho, 2019). Coelho indeed voted against the austerity package and Socrates was forced to start negotiations for a bailout. Before the elections, Coelho called the bailout 'a serious political failure' and promised that he would strike a better deal with the creditors. He insisted that he would implement the programme leaving harsh austerity aside (Wise, 2011). On 5 June 2011, the PSD won the elections and formed a new government.

In the meantime, Greece entered a new era of unrest.[66] The anti-austerity sentiment -fuelled by the opposition parties- mounted.[67] The radical rhetoric made Syriza[68] the largest opposition party in Greece in 2014. Alexis Tsipras, leader of Syriza, criticised the austerity that had led Greece to 'destruction' (Tsipras, 2014). He called for

[66] The coalition government -under the centre-right Prime Minister Antonis Samaras- tried to borrow money for the first time after almost four years away from the capital markets. It issued a 5-year bond offered at 4.95 percent. Samaras' government wanted a clear exit from the bailout to show that the Greek people's sacrifices were worthwhile and to turn a page in Greece's *dark moment*. However, interest rates remained unsustainably high. At the same time, the chasm between the Greek authorities and the Troika could not be bridged over the 5th review of the second bailout. Samaras' government was getting less and less popular.

[67] Syriza's anti-bailout opposition managed to get broader support among the middle- and lower-classes. Faced with the Presidential elections, Samaras proposed Stavros Dimas for the position of President; however, his coalition government failed to secure the necessary parliamentary support for its candidate. The government lost its majority in the Parliament.

[68] Syriza was the leading power in the large Greek cities, in the younger generations, and among the lower middle-class voters (Laskos and Tsakalotos, 2013: 127). Syriza was a leftist party in origin -having Eurocommunists, Trotskyist and Maoists members, too; it was created after the split in the Communist party in 1989. Synaspismos, the largest party involved in the Syriza coalition, was influenced by the Eurocommunist movements in Europe and turned towards a progressive social-democracy platform like other parties in Europe -i.e. the Democratic party in Italy- in the 1990s (Laskos and Tsakalotos, 2013: 128). Syriza was involved in peace movements such as the anti-war demonstrations at the end of the 1990s (i.e. NATO war in Yugoslavia, Iraq war in 2003), as well as political demonstrations against private education, and regarding human rights for LGBT communities and climate change.

a 'peaceful revolution' against the creditors and promised to 'cancel the bailout agreement' and end the 'humanitarian crisis' (Tsipras, 2012). In one of his pre-election speeches, Tsipras said emphatically, '*go back, Madame Merkel; go back, Mr. Schäuble; go back, you people from the Troika!*' (Tsipras, 2014).

Based on a Keynesian policy platform, Syriza called for a new 'Marshal Plan' for Greece and Europe. In his pre-election *Thessaloniki Programme*, he promised to restore the wage cuts that the creditors had imposed after 2010. Tsipras called for the writing off of the Greek debt and a new 'European New Deal' to boost demand in Greece and the South. He claimed that the '*only realistic way to move forward is to reject the bailout conditions'* (Avgi, 2014). Taking advantage of the anti-Germany rhetoric, Syriza took the lead in the opinion polls. Soon afterwards, in mid-2014, he won the European Parliament elections, followed by the national elections in January 2015.

6.2.1 Breaking the anti-austerity promises

Based on an anti-austerity rhetoric, all of these political forces managed to expand their political influence over the middle and lower classes. They won elections in both Greece and Portugal. Despite their electoral promises, they accepted the creditors' agenda and finally endorsed the austerity policies. In Greece, the election of New Democracy in 2012 did not revert the deprivation of the country. Prime Minister Samaras backtracked on his promise to 'renegotiate' the bailout agreement. Instead, he claimed that Greece needed to first regain 'credibility' before making changes to the existing agreement. Turning down the electorate's expectations, as shown in detail in *chapter four*, Samaras implemented almost all of the bailout conditions.

In some cases, the Greek government overachieved in relation to the creditor's fiscal targets, especially on health spending and public sector dismissals. Adonis Georgiades, Minister of Health, claimed: '*if we conclude that some people have to leave their jobs…please do not blame the troika… this is my decision…I don't want the troika to take the glory from me…I am sick and tired of making good changes and leaving Poul Thomsen* [IMF official] *taking the glory…I will do it!...because it is right…and we must learn in our country to do the right thing*' (To Vima, 2013). Another Minister of

the Greek government also asserted, '*the Memorandum was an opportunity to make all the reforms we hadn't done all the previous decades…we could then make changes in the obsolete public administration…in labour code… and attract foreign investments… this was an opportunity, not a curse*' (interview with Greek minister, 2018). From criticising the austerity policies, Antonis Samaras made an impressive U-turn, claiming at the Hellenic Association of Enterprises (SEV) annual meeting that, '*for first time, we reached all Memorandum's fiscal targets in full… and we overachieved in some of them*' (Samaras, 2013). The breaking of Samaras' promises fuelled resentment that was now channelled towards the radical left opposition.

The Coelho government in Portugal followed a similar path. Once in government, Coelho -loyal to his fellow centre-right leaders in Europe- began implementing harsh fiscal measures. He blamed the Socrates' government for this. He claimed, '*I haven't been involved in the negotiations with the Troika…I had to implement a programme I had never seen before… even if I wanted to revise it, the EU and IMF would never allow changes'* (interview with the former Portuguese Prime Minister Coelho, 2019). It is clear that he capitalised on local resistance to austerity to make electoral gains. He gradually came to sympathise with the creditors' requirements, saying, *'I will surprise them…I will go beyond the rescue programme requirements…it is a unique opportunity to make essential changes that all previous governments have avoided for the past 30 years. This is the difference between Socrates' government and us…PSD believes in the changes we have to make'* (Coelho, 2012). On top of this, Coelho pursued his own reform agenda that went further than what the creditors had asked for. He openly criticised the Constitutional Court's decision to reverse the highly controversial wage cuts in the public sector in 2013. He believed that wage cuts were a step in the right direction. He argued that '*the Judges showed a lack of good sense…they opposed wages cuts and put our effort at risk…the problem was not the Constitution…but its interpretation'* (interview with Prime minister Coelho, 2019). Moreover, he initiated highly contested labour reforms in agreement with the employers' association (Tavora and Gonzalez, 2016). For Coelho, '*labour reforms were necessary to boost competitiveness…I knew it was not easy to make such changes…but this was our duty*' (interview with Prime Minister Coelho, 2019). Coelho's government, like Samaras', changed from being critical against creditors to being in favour of the Troika's policies soon after his election victory.

In Greece, after six months of negotiations, Syriza's government approved a new tough austerity programme. Although the Greek citizens voted against austerity in the national referendum[69] in summer 2015, the Greek government endorsed the third Memorandum. Alexis Tsipras abandoned his radical rhetoric of the 'bloody Troika', and began calling the creditors 'institutions' and/or 'partners'. Syriza accepted the creditors' negotiation agenda and continued bargaining in secret. Tsipras' and Varoufakis' strategy was to ease austerity without questioning the nature of the asymmetry that had led to the mounting Greek debt in recent decades. They insisted on the Greek debt issue but failed to bring the reasons behind the debt accumulation to the negotiation table. The structural weaknesses that -as shown in *chapters three* and *five*- had led to the crisis in Greece and Portugal were kept out of the negotiations. In the highest ranks of the government, it was understood that Syriza would never question the status quo in the Union. A former minister of Syriza's asserted, '*we knew that it was unrealistic to change the EU, but it was imperative to win the elections, to change Greece*' (interview with minister of Syriza's government, 2018). Syriza quickly abandoned the *Thessaloniki Programme* that Tsipras had presented along with other pre-election promises in September 2014. Tsipras emphatically named the new Memorandum -that the creditors had imposed- a 'mutually beneficial agreement'. Similar to Samaras' and Coelho's governments, Syriza's government implemented harsh austerity measures and favoured domestic interests. It refused to tax the Greek shipowners that had been granted tax-exempt status for decades. Despite political pressure from the creditors, Syriza refused to legislate a permanent tax for shipping. Instead, he proceeded with a private agreement with the Union of Greek Shipowners (UGS) on a temporary 'voluntary' tax. The collapse of the voters' anti-austerity inspirations fuelled anti-European sentiment in Greece and beyond.

[69] The referendum question was the following: 'Should the plan of agreement be accepted, which was submitted by the IMF, the European Commission, the European Central Bank in the Eurogroup of 25.06.2015 and comprises of two parts, which constitute their unified proposal? The first document is entitled 'Reforms For the Completion of the Current Program and Beyond' and the second 'Preliminary Debt Sustainability Analysis'. NOT ACCEPTED/ No ACCEPTED/ YES'.

6.2.2 Reinforcing the status quo

The 'victimisation' narrative -which was widely used by the debtors- presented the national politicians in the debtor countries as 'pupils' that were being forced by the creditors to implement neoliberal reforms (Ladi, 2014; Clauwaert and Schomann, 2012; Varoufakis, 2017). In fact, as shown, it was used by the debtors primarily to win national elections and favour domestic economic actors. The debtors insisted on an anti-creditor rhetoric before the elections. They periodically shifted the blame for the painful neoliberal reforms on to the Germans, the EU, and the 'Fund'. They emphasised the 'unfairness' of austerity without explaining the roots of the competitiveness loss in these countries and the emerging export/consumption-led division in the Union.

Both centre-right and leftist governments employed their discourse and played with the expectations of their audiences (Moury and Standring, 2017). They maintained an ambiguous stance towards the bailout conditionality at different times and in front of different audiences. Governments tended to adopt an anti-austerity rhetoric or frame the reforms as 'necessary' closer to elections or when addressing domestic public audiences. In contrast, they framed them as 'imperative' and 'desired' away from national elections and in front of sympathetic audiences (i.e. employers' associations). Both centre-right and leftist governments approved and implemented the creditors' policies. All of them -although some of them implicitly- went beyond the creditors' requirements and pursued policies to reward domestic actors.

Based on such a strategy, the anti-austerity governments discouraged a cross-national alliance that could bring policies to mitigate the asymmetry in the Eurozone to the fore. In many cases, those governments overemphasised their national demands (i.e. Greek debt relief and lower fiscal targets) and failed to inspire other crisis-hit countries to negotiate together for a genuine European crisis response. For the Greek Minister of finance, Yanis Varoufakis, '*from the beginning I knew there was no possibility to create a negotiation strategy with the other southern governments…this is why I did not try it…there was no room for any alliance…The southern governments had said 'yes' to anything Troika asked for. For me, the only possible agreement was with Ms Merkel not the countries in the South…I was firmly against any alliance with the South*' (interview

with former Greek Minister of Finance, Yanis Varoufakis, 2020). The debtors were rather unsuccessful in shaping the national reform agendas to upgrade production capabilities and improve the competitiveness loss. They continued to rely on neoliberal policies -that the EU and IMF had designed- to recover from the crisis.

Overall, based on their crisis management strategy, the creditors managed to protect their own interests. They preserved their economic and political dominance in the Eurozone. Taking advantage of their overwhelming power in the Union, Germany and France played a crucial role in shaping the response to the crisis. The Franco-German policy coordination has not been an unchallenged synthesis; however, based on common action it managed to shape the economic policies during the crisis. France and Germany acted complementarily to broker a consensus over the management of the crisis across the Eurozone. The political fragmentation in the South empowered Berlin and Paris. The creditors used the neoclassical approach as a smokescreen to protect the status quo; to keep the crisis away from their economies, to prevent a pan-European anti-austerity movement, and to save the Euro. On the debtors' side, the anti-austerity parties managed to capitalise on the anti-austerity sentiment to make political gains. They used a counterproductive discourse against the creditors that impeded both a deeper understanding of the competitiveness loss in the periphery and a genuine 'European' response to the crisis. In spite of breaking their promises, they maintained political power and pursued reforms to favour vested interests of Greece and Portugal.

The 'neoclassical versus Keynesian' debate caused polarisation between the debtors and creditors. Such polarisation spread across the economic, political and social levels. At the economic level, the insistence on 'austerity' versus 'stimulus' agendas impeded an in-depth discussion over the diverging growth models in the periphery of the Eurozone. At the political level, the Northern and Southern governments trapped themselves in a 'dialogue of the deaf' through the blame game and malevolent negotiation tactics. At the social level, the 'PIIGS' and 'German authoritarianism' stereotypes spread throughout the European societies. Such stereotypes triggered unforeseen social dynamics that pitted the Europeans against each other. These dynamics affected the negotiations themselves. The radicalisation of public opinion limited the room for manoeuvre for both the creditors and debtors in the negotiations. Despite the poor post-crisis economic performance in both Greece and Portugal from 2010 to 2015, the creditors were reluctant to revise the bailout programmes. They insisted, instead, on the neoclassical economic crisis response. The status quo prevailed

in the Eurozone. After a decade of long negotiations, political clashes and social turmoil in the Eurozone the crisis-prone economic paradigm had barely changed. However, the management of the crisis itself had opened up the path for an ongoing political crisis in the Eurozone.

The European societies have been through hard times. In the South, the recession has been long and painful. Greece has lost more than 25% of its GDP, while Portugal has remained in stagnation. Unemployment is still high. In Greece and Spain, youth unemployment is about 50 per cent, while more and more young Italians, Greeks, Portuguese and Spanish were leaving their home countries for the North. The social contract within the crisis-hit countries broke. Facing a rapid collapse of living standards, Southern Europeans turned against the political systems in their countries and lost trust in the European project. Austerity fuelled Eurosceptic movements across the periphery. In Greece, radical political movements turned against austerity, the mainstream political parties, and the European Union.[70] However, Greece is no exception to other southern European countries. Eurosceptic political parties from both the Left and Right have appeared in other peripheral countries.[71]

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[70] Active social movements emerged on the streets of Athens after the outbreak of the crisis. Spontaneous strikes started, taking the form of an *Occupy*-style movement, in Syntagma square in Athens and White Tower in Thessaloniki. Those protests soon became massive. Hundreds of thousands of protestors gathered in the squares every Sunday across Greece. At the same time, other movements against taxes, highway tolls and public transportation fees emerged. Although those movements were not associated with any party or trade union, they interacted with both leftist and right-wing political groups. Political slogans against the Greek government and austerity gradually turned against the Troika and the European Union: 'Troika keep calm and go to hell', 'stop Merkel, start democracy', and 'we didn't join EU for this'.

[71] In Portugal, new social movements such as the *Precários Infléxiveis* (Inflexible Precarious Workers) and the *Assembleia Popular arreirense* (Barreiro Popular Assembly) rose up. An *Indignant Citizens*-style movement, the *Geração à Rasca* ('Desperate Generation'), occupied squares in the largest Portuguese cities (David, 2018). In mid-2012, hundreds of thousands of protestors took to the streets carrying placards reading, 'austerity kills'. This was the birth of a new massive social coalition, *Que se Lixe a Troika* ('To hell with the Troika: we want our lives back!'), against the Troika and the European Union. Throughout this turbulent time, Eurosceptic political forces -the Communist Party (PCP) and the Left Bloc (BE)- expanded their political influence over the middle class in Lisbon. In Spain, the increasing unemployment, poverty and job insecurity brought thousands of people on to the streets of Madrid in 2011 (Clua-Losada, 2018: 142). Various new grassroots movements appeared in the political landscape. On 15th May 2011, a network of social movements, *¡Democracia Real YA!* organised a march against austerity in the largest Spanish cities. In Italy, a new social movement, the *Pitchforks*, consisting mainly of small business owners and unemployed youth, joined forces with the far-right protestors and football fans -*Veneto Independence*- against the Italian 'political establishment' and the European Union. The demonstrations spread throughout the country in 2013.

Beyond domestic politics, the political management of the crisis fuelled old divisions among European countries. The sense of humiliation turned public opinion in the debtor countries against the northern countries. The break-up of the 'convergence' illusion made southern Europeans feel like 'second-class passengers' in the EU's train. Most of the European governments and political parties associated with austerity policies paid a massive political cost. The '*There is no alternative'* (TINA) dogma -that the mainstream political parties were committed to- left millions of citizens without political representation. New political forces claimed back their national sovereignty and campaigned against the Euro and the Union as a whole. The political systems across the South were shaken.

In the creditor countries, the backlash against the bailout programmes -largely based on the neoclassical explanation and the misleading 'ants versus grasshoppers' narrative- turned the northern Europeans against their southern fellows. In the North, Europeans saw the Euro as a mechanism to send their money to the 'profligate' South. Far-right and Eurosceptic voices gained momentum in western and central Europe[72]. The European governments turned one against the other. In the long-term, the management of the crisis turned a competitiveness crisis in the South into an economic recession and a massive political crisis across Europe. It opened up the path for centrifugal forces throughout Europe. Right-wing political parties took advantage of the political dissatisfaction and developed their own anti-EU policy platforms. The divisive 'ants versus grasshoppers' narrative broke the sense of unity and made the Eurozone vulnerable to future crises. Moreover, a 'European' policy that would mitigate the widening gap between the North and the South seems politically difficult, at least in the foreseeable future.

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[72] In Germany, a new far-right party, *Alternative für Deutschland* (AfD), called for action against the 'ongoing wealth transfers into EU member states' and for a national referendum over Germany's membership of the Eurozone. AfD started to have greater political influence in Eastern regions of Germany, especially in Saxony, Thuringia and Brandenburg. Soon, the rhetoric against the bailouts in Greece, Portugal and Ireland became a far-right, xenophobic, nationalist political platform. In France, the far-right party, the *National Front,* campaigned against any financial support for the southern indebted countries. It was claimed that the bailouts would increase taxes for French taxpayers and put France's public debt on to an unsustainable trajectory. For the leaders of the National Front, the creditors '*throw their money in the hole of the European debt without solving any problem*' (National Front, 2017). Finally, other leaders in central Europe turned also against the financial assistance to the 'irresponsible' governments in the South (Cienski et.al., 2010). In the eyes of the Slovakians, Hungarians, Polish and Czechs, financial assistance meant that the poorer countries would pay for the Southern countries' high living standards (Cienski and Spiegel, 2011).

Overall, political tensions have grown like never before in the history of the European Union. The decision of the sovereign British people to leave the European Union has now opened up the path for other countries to rethink their role in the Union. Such political dynamics have brought the Eurozone to the brink of collapse. The survival of the Euro is now not only a complex economic challenge, but also a political one.

Chapter 7: Conclusions

Europe has been through a turbulent era since 2010. Despite the fact that the economic and political status quo remains resilient even after such an unprecedented crisis, the political tensions among the European states along with the domestic discontent have put the Eurozone on a rough path that will continue into the decades to come. In bringing this thesis to a close, it is important to emphasise its contribution to the relevant literature and its broader importance for the political economy of Europe.

This research makes a novel contribution to the existing thinking regarding the Eurozone crisis. The thesis' starting point was to identify the policies that were introduced in the crisis-hit countries and how effective they were in addressing the causes of the crisis. Starting from this question, it explored further questions: Why did the internal devaluation fail to boost export-led growth in Greece and Portugal? Why did the creditors insist that internal devaluation was the solution to the Greek and Portuguese crises?

I started this thesis by recognising that the literature has not been able to fully explain why the crisis response did not lead the indebted Eurozone countries into a dynamic export-led recovery. As shown, the existing explanations failed both to diagnose the real causes of the crisis and to provide an adequate policy framework to overcome the deep roots of the stagnation in the periphery. Both the mainstream and the critical accounts use different versions of the *neoclassical* and *Keynesian/*'*Iphigenia in Aulis*' explanations that are influential but also very problematic.

The *neoclassical* explanation emphasises the role of fiscal derailment, 'backwardness' and corruption in the crisis-hit countries. It claims that these governments failed to maintain a reasonable fiscal policy and to reform their economies before the crisis and therefore triggered the crash in the Eurozone as a whole in 2010. Austerity through internal devaluation was the means to achieve a fiscal adjustment in the reckless countries and begin a recovery. Among others, Alberto Alesina (2012) popularised the pro-austerity argument, claiming that there was a positive relationship between fiscal contraction and economic growth ('expansionary austerity'). Internal

devaluation would be the driver for export-led growth. Furthermore, the labour market reforms would push for an efficient re-allocation of resources in favour of the tradable sectors (Bassanini *et al*., 2009; Bernal-Verdugo *et al.*, 2012). These reforms should enable the *invisible hand of the market* to lift these economies out of the crisis. Based on these theoretical assumptions, the neoclassical narrative positioned Greece as a special case in the Eurozone that resisted the 'painful but necessary' reforms -in contrast with Portugal and other peripheral countries- and therefore failed to recover from the crisis.

However, it overemphasises the fiscal aspect of the crisis that was actually a symptom of a deep competitiveness crisis in Greece and Portugal. The neoclassical economists underestimated the uneven development that produces growth model division and macroeconomic imbalances and therefore new crises in the Union. They failed to account for the complex historical capital formation and productive weaknesses in the crisis-hit countries. The internal devaluation was not designed to address the structural causes of the poor economic performance in Greece and Portugal. It largely failed to mitigate the roots of the competitiveness loss in these countries.

On the other hand, the *Keynesian/*'*Iphigenia-in-Aulis*' explanation criticised different aspects of the management of the crisis in the Eurozone (Stiglitz, 2016; Varoufakis, 2017; Krugman, 2014). Keynesian economists argued that, early on, the EU and IMF sowed the seeds of the long and painful recession in the Eurozone. They refused to approve debt relief for Greece, whose debt reached unsustainable levels in 2010. This was the reason behind Greece's long struggle to recover. For Keynesian critics, austerity and Germany's reluctance to approve debt relief for the indebted Europeans held back the recovery efforts (Varoufakis, 2018). Nobel laureate Joseph Stiglitz and Yanis Varoufakis criticised Alesina's 'expansionary austerity', arguing that austerity inevitably leads to lower consumption and a deeper recession (Stiglitz, 2014; Varoufakis, 2017). For the Keynesian critics, the bailouts seemed to be a 'punishment' for the weak countries in the periphery (De la Dehesa, 2011; Eichengreen, 2010).

However, while the Keynesian economists showed why austerity could be expected to fail, they did not identify the historical process and the economic and political dynamics that created diverging models of capitalism in the Eurozone. They failed to provide a deep understanding of the causes of the crisis and the struggle of the peripheral economies to recover from the long stagnation. The treatment of Greece as a 'scapegoat' of the German management of the crisis failed to bring the deeper structural aspects of the Eurozone crisis to light. The Keynesian explanations fail to account for

the complex global economic developments that shaped the precarious growth patterns in those economies. They tend to present Greece, Portugal and other peripheral economies as 'victims' of Germany and the core countries without focusing on the complex fiscal policies, national productive weaknesses, and global economic developments such as the neoliberal economic transformation, financialisation, and de-industrialisation, that transformed the peripheral economies during the recent decades. Keynesian policies to boost domestic demand through higher public spending or lower interest rates would not solve the underlying structural problems, but would reinstate the consumption-led economic model that led them into the crisis in 2010.

7.1 Looking beyond Varieties of Capitalism: The Growth Model approach

I also acknowledge that Comparative Political Economy and the influential Varieties of Capitalism brought fresh air into the unproductive 'neoclassical versus Keynesian' debate that dominated the efforts to explain the Eurozone crash and the post-crisis performance in the periphery. They provide a better framework to understand the productive and economic diversity. VoC theorists perceived the Eurozone crisis as a competitiveness crisis. They introduced a schematic classification of 'coordinated', 'liberal', and 'Mediterranean' economies to show how countries operated different models of capitalism in a common currency union, which gave the Northern European economies an institutional advantage over the Mediterranean countries. The Varieties of Capitalism literature rightly identifies that the root of the crisis was the competitiveness gap and the increasing economic divergence. It acknowledges that Greece and Portugal faced similar economic and institutional weaknesses.

Contrary to the *neoclassical* and *Keynesian/*'*Iphigenia-in-Aulis*' narratives, VoC goes beyond the 'Greek exceptionalism' and blame narratives (e.g. 'sinner vs good Europeans') and positions Greece in the broader context of the countries in the South. However, the VoC literature cannot provide a comprehensive explanation of the post-crisis economic performance in the Eurozone. Despite VoC's assumptions, the drop in labour costs failed to boost competitiveness in those economies. VoC's emphasis on

institutions leaves other factors such as fiscal policy, growth patterns, and global economic development unexplored.

The Growth Model approach goes beyond the VoC literature in many ways. It provides a much more adequate framework to understand why Greece and Portugal were hit by the crisis in the late 2000s. The Growth Model approach opens up paths to Comparative Political Economy by incorporating both the demand-side and supply-side aspects that led Greece and Portugal into the crisis. It also offers an advanced understanding of the role of fiscal policies, neoliberal transformation, and the gradual competitiveness loss in the periphery of the Eurozone. It provides a unique framework to answer the main research question of why the internal devaluation failed to kick-start export-led growth in Greece and Portugal.

First, as I have shown, the problem of competitiveness loss in Greece and Portugal is far more complex than what the VoC literature says. VoC and neoclassical economics converge on the crisis response needed for the crisis-hit countries to recover. Both endorse the internal devaluation as a prescription to improve competitiveness in Greece and Portugal. However, as the extensive evidence, presented in *chapter five*, shows, the drop in labour costs was not effective in boosting export-led growth. Competitiveness is more than just a wage-related issue. Evidence shows that non-price competitiveness factors played a key role in the post-crisis poor economic performance in Greece and Portugal.

Second, the Growth Model approach goes beyond the VoC's emphasis on institutions and examines the role of productive capabilities and production processes in Greece and Portugal. VoC tends to identify institutional variation as a causal mechanism behind economic divergence. However, institutions are just part of the complex production process that shapes economic performance. The Growth Model approach acknowledges that institutions play a key role but provides a more advanced framework that brings macroeconomic factors to the fore. In Greece and Portugal, the tight fiscal policy, the fragmented production base, the concentration of factors of production into low-productivity sectors, and the exports' composition kept those countries in a competitiveness trap even after the bailout programmes.

Third, the Growth Model approach provides a historical analysis to show how the economic and political changes have shaped the current economic status of these countries and their relations with other countries in the Eurozone and beyond. It sheds light on how Greece and Portugal ended up in a competitiveness trap and offers a

comprehensive understanding of the structural transformation of those economies. The Varieties of Capitalism literature provides a limited framework to explain the divergence within the Eurozone. The schematic classification of 'coordinated', 'liberal' and 'Mediterranean' market economies is static and therefore inadequate to show the real causes of the competitiveness crisis in the Eurozone. VoC turns to the unproductive 'neoclassical vs Keynesian' debate and the stereotypes used during the management of the crisis. In contrast, by taking a Growth Model approach to the political economy of Greece and Portugal, I have explained the mechanisms that led them to a complex productive transformation. As we saw in *chapter three*, domestic political factors (e.g. fiscal policy, economic liberalisation, and the neglect of industrial policy) interacted with external changes (e.g. the rise of Neoliberalism, financialisation, and the creation of the Single Market) and led to a consumption-led growth model. The study of the complex interaction between international economic trends and national growth models opens up new International Political Economy research areas.

Fourth, this thesis provides a comprehensive analysis of both the demand-side and supply-side aspects of the Greek and Portuguese crises. It shows how the fiscal policies and the chronic structural weaknesses along with the international economic developments interacted and formed fragile consumption-led growth models in the periphery of the Eurozone. It therefore reconciles the demand-side and supply-side approaches, showing how those different aspects of growth are complementary and co-shape growth models in the global and European economy. It also provides a novel analysis of the evolution of those growth models after the EU and IMF bailout programmes in the Eurozone.

Fifth, I go beyond the Eurocentric VoC concept of 'coordinated vs Mediterranean' market economies. VoC analyses the institutions and economic performance in those economies, turning a blind eye to the complex global economic developments in recent decades. This leads to an incomplete understanding of the competitive pressure that Greece and Portugal faced before the crisis and are still facing today. Going beyond the consumption/export-led growth models, this thesis sheds light on the position of Greece and Portugal in the global economy too. I offer a wider view of the trading relations and the effects of the global economic developments on those countries. Such global and regional political developments have had systemic effects on the southern European economies, and particularly on Greece and Portugal. Based on all of the above, I challenge the VoC concept of the 'Mediterranean' economies as not

well-developed and limited in scope to explain the real challenges that the southern European countries face. Instead, I introduce the concept of 'intermediate' economies to visualise the role of those countries in the global economy.

As shown in *chapters two and five*, the 'intermediate' economies are the fruit of the history of economic development in the European periphery in the last decades. Under the EU Maastricht Treaty, these countries are subject to rules against protectionism, tariffs, and trade policies. They face strict regulations (i.e. constraints on state aid towards industries and firms) that were designed primarily to serve the Northern countries' economic interests. As members of the Eurozone, they cannot devalue their currency to improve their competitiveness relative to their trading competitors. Moreover, as we saw in the earlier chapters, they have committed themselves to the *Stability and Growth Pact*, which means keeping their fiscal policy under specific rules independent of the economic conditions. All of these constraints leave the 'intermediate' countries very limited room for manoeuvre. They maintain limited mechanisms to change the course of their economic development and upgrade their position in the European and global value chains.

Lacking such mechanisms, the 'intermediate' economies cannot maintain their competitiveness vis-à-vis the Eurozone's industrialised countries. Greece and Portugal found their industrial sector in a state of rapid decline after the early 1990s. Under the suffocating EU rules, the governments had limited tools to reverse the deindustrialisation. The national governments, influenced by the economic paradigm change in favour of monetarism, abolished most aspects of their industrial policy. They took advantage of the EU structural funds and cheap credit to fuel domestic consumption. The latter solidified the electorate success of the Keynesian-oriented governments in both Greece and Portugal.

At the same time, the expansion of the European Union towards Eastern Europe triggered a new complex reality in the Union. The Eastern European economies became an arm of Northern Europe's supply chain. The alleviation of productive investment towards Eastern Europe pushed the southern economies, Greece and Portugal among them, further into underinvestment. The internal devaluation was not able to reverse this process.

Beyond the rising competition in Europe, the emergence of the dynamic economies in East Asia has had tremendous effects on the global economic environment. Their cheap labour costs and large workforce have made these countries

leading exporters in low value-added products globally. Countries based on traditional sectors have faced unprecedented competition. Greece and Portugal are 'intermediate' between the technologically advanced Eurozone economies and the large-scale, low-labour cost emerging Eastern Europe and Asian economies.

7.2 The Greek case

As mentioned in *chapter two*, much of the existing literature treats Greece as a special case because of its obsolete public sector, slow judiciary system, bureaucracy and poor tax collection system. But, I have shown that the Greek crisis is just one manifestation of the broader competitiveness crisis in the southern European periphery.

After the establishment of the Third Hellenic Republic in 1974, the new governments managed a gradual transition from a state-led to a market economy to join the European Communities. Greece's entry into the European single market triggered a complex productive and economic transformation. The exposure of Greek firms to relentless competition from the industrialised economies led to a rapid decline in the country's production capabilities. Many firms went bankrupt or moved to Eastern Europe. This caused rapid deindustrialisation in the 1990s while the privatisation of public enterprises and the banking sector's deregulation sowed the seeds of the future crisis. Under the accelerated financialisation, government spending and credit flows concealed these underlying weaknesses and led to consumption-led growth in the 1990s and 2000s.

High credit-led growth was accompanied by a decline in the agriculture and industrial sectors and a shift to introvert economic activities, especially construction, real estate, banking services and retail trade. Greece's privileged access to cheap credit boosted public investment and overall consumption. Greece achieved impressive GDP growth rates in the 2000s. It was seen as a 'miracle' of economic growth in Southeast Europe. However, the consumption-led growth model encouraged firms to turn their production towards the local market, thus leaving the highly competitive foreign markets. Greek producers remained focused on low-technology and low-value-added products. The non-tradable sectors expanded at the expense of the tradable ones.

The high GDP growth rates and the expansion of sectors such as real estate, banking and tourism could not reverse Greece's course towards the crisis. Greece could not devalue its currency or adopt protective measures against European and global competition. Its current account deficit reached unsustainable levels and made Greece vulnerable to the crisis in 2008. The fiscal crisis that erupted in 2010 was largely a symptom of the productive transformation that Greece had faced during the previous decades.

As we saw in *chapter four*, Greece implemented most of the EU and IMF austerity measures and neoliberal reforms to open up its economy in the 2010s. However, the austerity caused by the internal devaluation did not change the Greek growth model. It led to a much needed adjustment of the fiscal and trade deficits. Nevertheless, despite the EU's and IMF's projections, the internal devaluation failed to kick-start export-led growth. As shown in *chapter five*, Greece's major industries, especially oil refinery and shipping, are international and capital-intensive sectors and therefore wages in Greece have marginal effects on export (products and services) prices. Moreover, higher taxes -due to austerity- and the rise of energy costs counterbalanced the effects of the internal devaluation on prices. The EU and IMF's 'one size fits all' approach failed to account for the production patterns in Greece. On top of this, the internal devaluation and market reforms could not improve the chronic structural weaknesses. Similar to Portugal, Greece suffers from difficulty in creating economies of scale and producing at scale. It remains focused on low value-added production and is far behind its European and global competitors. Moreover, a dynamic part of the skilled workforce left the country after the outbreak of the crisis. Greece is therefore 'stuck' in a competitiveness trap.

The implementation of austerity measures in a consumption-led economy caused long lasting human suffering. Although Greece has been through a long and painful adjustment process during the last decade, the roots of the crisis have not been addressed. The *invisible hand of the market* failed to transform the Greek economy and put it on a sustainable export-led growth path. After a decade of long negotiations, political clashes and social turmoil in Greece, the economic paradigm has barely changed in Greece and the Eurozone as a whole.

7.3 The Portuguese case

Turning to the Portuguese case, I tested the mainstream hypothesis that Portugal was a 'different story' to Greece. In line with this perspective, Portugal was a fiscally healthy economy that lost its access to the capital markets after persistent speculative attacks against the Euro after 2010. Contrary to the predominant narrative, as shown in *chapters three and five*, I found strong evidence that Portugal followed a similar path to Greece to the crisis in 2010. Comparing to the Greek government, Portugal had indeed pursued a prudent fiscal policy in the 2000s. However, the Growth Model approach and empirical evidence in this thesis brought to light the productive patterns that made Portugal vulnerable to the 2008 recession.

In the aftermath of the 'Carnation revolution' in 1974, the state maintained a central role in economic activity. The governments that came to power created monopolies in several sectors, nationalised the banking sector, and established a welfare system, generating gradually high deficits and debts.

The neoliberal reforms introduced by the government that followed them in the 1980s and 1990s turned it into a liberal market economy. Riding the neoliberal wave, Portugal managed to accelerate its economic growth through credit. The cheap credit was directed towards consumption, expanding the country's non-tradable sectors. Investments turned from the agriculture, manufacturing and mining sectors to introvert sectors, especially real estate, tourism, wholesale and retail trade. The cheap credit fuelled its GDP growth but tripled Portuguese private debt by the end of the 1990s. Contrary to Greece, Portugal was the European 'champion' of private debt a long time before the launch of the Eurozone. The new consumption-led model of growth led to high current account deficits and a mounting debt, even from the late 1990s.

Its entry into the Eurozone pushed the Portuguese economy further into the competitiveness trap. Concentrated on low value-added products, manufacturing faced growing competition from the Eastern European and Asian economies. The adoption of the appreciating Euro made Portuguese exports more expensive in foreign markets. Portuguese firms, especially in textiles and low value-added manufacturing, pushed it out of the market.

Contrary to Greece and other peripheral countries, the Portuguese government took a different fiscal policy path. To control the rising government and current account

deficits, the government introduced austerity measures in the first decade of the Eurozone. However, austerity pushed the consumption-led Portuguese economy towards a long period of stagnation throughout the 2000s. Despite their different fiscal policies, both Greece and Portugal faced a similar productive transformation towards consumption-led growth models. The latter was not sustainable in the long-term.

After a relentless internal devaluation -under the EU and IMF bailout- Portugal made a rapid fiscal adjustment. Both the government and the trade deficits returned to sustainable levels. However, Portuguese exports stagnated again after a temporary short-term increase in 2010-2012. Although the Portuguese government pushed labour costs down, real export prices increased. Higher taxes and labour security contributions made prices go up. On top of this, Portugal has gradually moved away from labour-intensive sectors in favour of capital-intensive activities in recent decades. Based on a neoclassical diagnosis of the crisis, the EU and IMF underestimated the reality of the local economies and pursued wage suppression measures that were ineffective in pushing Portugal out of the competitiveness trap.

Although Greece has been considered an 'exception' and Portugal as 'collateral damage' of the Greek problem, this thesis presents evidence showing that both countries faced a similar crisis in 2010. Although this was manifested as a fiscal derailment in Greece and a private debt crisis in Portugal, both countries have been through a similar process of competitiveness loss. The internal devaluation failed to make Greek and Portuguese exports competitive. The central argument of this thesis is that Greece and Portugal have been through a 'structural decay' in the last decades. The national and global economic developments have played a key role in transforming those countries into debt-led economies. The 'intermediate' economies, as I identify them in this thesis, face chronic structural weaknesses: (1) difficulty in creating economies of scale, (2) low value-added production and a low capacity for technology diffusion, (3) problematic aspects of human capital, and (4) high barriers to government intervention to guide the market, and plan and intervene in the production process. The neoclassical policies failed to address all of the above. The market does not always allocate recourses efficiently towards the most productive sectors especially under low public investment and limited credit flows. Finally, market deregulation does not mean higher and more productive investment in those 'intermediate' economies.

7.4 The 'politics' behind the management of the crisis

As we have seen, the existing literature tends to underestimate the 'politics' that kept the peripheral countries in the 'intermediate' position after the crisis. For mainstream economists the crisis response -led by the EU and IMF- was presented as 'non-political' or 'technocratic'. As shown in *chapter six*, this is rather misleading. The 'politics' of the management of the crisis and the power dynamics between the creditors and debtors shaped the economic policies. To answer the question of why the creditors insisted on austerity and declined alternatives, I have brought extensive evidence from the creditor/debtor negotiations. Both the creditors and the governments in the debtor states reinforced the political status quo in the Eurozone.

Based on neoclassical economic principles, the creditors blamed the 'reckless' governments in the South, the PIIGS, for the crisis and the post-crisis sluggish economic growth. On the other side, the debtors, who adopted a Keynesian-type crisis management -based on the 'Iphigenia-in-Aulis narrative- blamed the Germans, who managed the crisis in such a way as to produce prolonged stagnation in the periphery. As analysed in *chapter five,* such an unproductive 'neoclassical vs Keynesian' debate fails to bring the structural origins of the crisis and the growth model division to the fore. Taking advantage of this unproductive confrontation, both the creditors and the debtors managed to serve their own political interests. The creditors have long benefited from the asymmetry in the Union and have no intention of alleviating the uneven development in the Eurozone.

On the other side, the governments in the debtor countries acted to serve their election-driven interests by framing their election campaigns to capitalise on the anti-austerity sentiment for political gains. They shifted the blame onto the creditors and left the asymmetry of the Union in the dark. They broke their anti-austerity promises once in government, implementing reforms that in some cases went further than the creditors' requirements. They did not challenge the balance of power between the creditors and debtors and the status quo in the Union prevailed.

Overall, the northern economies -mainly Germany and France- initiated the single European market as a way to expand the markets for their products. They pushed transaction costs down and encouraged trade within the European borders. The single market has worked well for Germany and France and other Northern economies that

have achieved a high export performance in recent decades. Moreover, the EU policies deregulated the banking sector in the European countries, opening up the path for extensive credit flows from the core countries to the periphery. Such credit flows have been used by the southern countries to buy products and services from the northern countries. The EU institutional framework benefited the northern exporters at the expense of the South. Later, the creation of the Euro and the institutional framework of the Eurozone placed policy restrictions on the peripheral countries in regard to pursuing independent monetary, fiscal and industrial policies to reverse the deindustrialisation, upgrade their production, and improve their stagnated export performance. In real terms, the northern exporters kicked away the ladder through the Eurozone's institutional framework for the rest of the Europeans. In the aftermath of the crisis, the creditors initiated new mechanisms to bailout the structural 'losers' of the Eurozone. Such bailout mechanisms were set up to prevent potential disorderly defaults and mitigate political reactions against the status quo in the region.

The fact that the asymmetry in the Eurozone remained untouched even after the crisis, along with the management of the crisis itself, opened up the path for a political crisis in the Eurozone. In the South, European citizens faced a substantial collapse in living standards and turned against their local governments. The social contract within these countries broke, triggering radical political and social movements against the European project. From Athens to Lisbon, Europeans felt humiliated by the creditors and turned to political forces, campaigning against the Euro and the European project as a whole. In the North, the management of the crisis and the blame narrative caused a backlash against the bailout programmes in the South. Northern Europeans turned against their southern fellows. Eurosceptic parties rose across northern and central Europe. Old national divisions emerged once again. Such political dynamics put the European unity into question. The Eurozone is now at a crossroads. The persistent asymmetry along with the 'politics' that placed the periphery at the margins of the European integration could put the whole Union at risk of disintegration in the future.

7.5 Rethinking the crisis response in the Eurozone

I will bring this thesis to a close by recapping the significance of my argument for the literature regarding the response to the crisis in the Eurozone. First of all, this thesis calls for Political Economy scholars to move beyond the existing explanations associated with the neoclassical and Keynesian/'Iphigenia-in-Aulis' approaches. Although these explanations have dominated the academic research so far, no-one has adequately explained the reasons why the EU and IMF policies failed to kick-start an export-led recovery in the crisis-hit countries. Comparative Political Economy and the Growth Model approach provide a more advanced and comprehensive explanation of both the demand-side and supply-side aspects of the crisis. However, it is important to highlight the following assumptions. By showing the limitations and inconsistencies in the existing narratives, the Growth Model does not take the responsibility away from Greece and Portugal regarding the crisis. Beyond this, it does not absolve the creditor countries and institutions from their own mistakes in the response to the crisis. However, by overcoming the limitations of these explanations, my argument aims to contribute to the existing literature in the following ways. The Growth Model approach speaks to important debates about the causes of the crisis, the capitalist diversity and asymmetry in the Eurozone, the management of the crisis and the status quo in the Union. I deconstruct the conventional wisdom regarding the causes of the Eurozone crisis that attributes the blame to 'individual', 'irresponsible', 'exceptional' cases in the periphery. I show the structural mechanisms that triggered the crisis and led the neoclassical economic response to it to fail. The Growth Model approach also challenges the 'victimisation' narrative that blames the Germans for the management of the crisis. The persistence of elements of such narratives in different accounts shows that the unproductive debate between the neoclassical and Keynesian/'Iphigenia-in-Aulis' explanations has not gone away. Therefore, this thesis aims to open up a new path in the current research on the response to the crisis in the Eurozone. It does not aim to shut down the existing debates but to enhance them in an unbiased and dynamic way.

The Growth Model approach opens up a productive and fruitful discussion with the VoC literature. I call upon VoC scholars to enrich their analytical framework by looking beyond the domestic institutions. As shown, the analysis of the history of capital accumulation, the evolution of the productive factors, the fiscal policies, and the

international economic developments can bring an advanced understanding of the causes of growth model divergence and competitiveness loss in the southern European periphery. Such a pluralistic framework can provide more adequate explanations regarding the international political economy. Therefore, I argue that the VoC literature needs to move beyond the domestic-level and Eurocentric approaches and bring a pluralistic perspective into its analytical approach. Growth Model scholars should also account for the international perspective in their theoretical framework. This thesis calls for more dynamic and evolutionary Comparative Political Economy literature. It broadens the scope of the existing research and opens up the potential for a new pluralistic research agenda.

My argument also aims to contribute to a growing research area on development patterns in the crisis-hit countries. It brings to light the common productive patterns that led Greece and Portugal into a crisis. The historical approach offers an advanced understanding of the complex transformation of Greece and Portugal in recent decades. Based on extensive evidence from the local economic and political realities, it provides new insights into how those economies ended up in such a crisis in 2010.

It introduces the novel concept of 'intermediate' economies to show the complex mechanisms that keep Greece and Portugal in a competitiveness trap. It brings extensive evidence on the productive patterns and structural weaknesses in those countries. It also provides a historical analysis of the effects of Greece's and Portugal's entry into the European single market and soon after into the Eurozone. Finally, it offers a better understanding of the economic pressure -under the neoliberal economic restructuring- that Greece and Portugal face in the global economy. The 'intermediate economies' concept is an advanced framework to explain the position of Greece and Portugal in the global political economy. It offers a reference point on the role of productive transformation and uneven development in the contemporary European Political Economy.

This thesis also calls for new research to bring further evidence regarding other countries that might fit under the 'intermediate' economies analytical concept. On top of this, political economists need to study viable 'growth strategies' that could transform those consumption-led economies and free them from the competitiveness trap. It is evident that the predominant neoclassical economic paradigm can hardly resolve the economic challenges of contemporary capitalism. It failed to mitigate the rising imbalances and to produce durable and sustainable economic policies for these

countries. Therefore, I argue that the state should play an active role through a modern industrial policy to upgrade the production capabilities and reverse the productive decadence in those economies. This thesis does not intend to focus on the specific policies that these countries should pursue to restructure their economies. However, it offers an analytical theoretical framework that can be seen as a starting point for relevant future research. Policy prescriptions that are adequate for those economies need to be further investigated by Political Economy scholars.

Appendices

Appendix I: Timeline of the European Union

Timeline of the European Union

1951: Belgium, France, West Germany, Italy, Luxembourg and the Netherlands (the 'Original Six') sign the Treaty of Paris to create the European Coal and Steel Community (ECSC). They establish the European Court of Justice (ECJ).

1955: The European Coal and Steel Community (ECSC) agrees to remove tariffs and encourage free trade between its member states.

1957: The ‘Original Six’ sign the Treaty of Rome to establish the common market, customs union, and free movement of capital and labour. The European Economic Community (EEC) and European Atomic Energy Community are established.

1965: The ECSC member states sign the Merger Treaty to create the European Communities (EC).

1973: Denmark, Ireland and the United Kingdom join the European Communities.

1974: Democracy is restored -after the overthrow of the military juntas- in Greece and Portugal.

1977: The European Communities member states abolish the customs duties in trade among each other.

1979: The first direct European Parliament elections take place to elect the new member of the European Parliament (EP).

1981: Greece joins the European Communities.

1985: Jacques Delors, as President of the Commission, proposes the Single European Act -as a revision of the Treaty of Rome- to accelerate the process of economic and political integration.

1986: Portugal and Spain join the European Communities (EC).

1987: The EC member states agree on the Single European Act (SEA) that modifies the Treaty of Rome to launch the single European market by 1992. The European Communities introduce the Qualified Majority Voting (QMV) in the Council of Ministers for specific policy areas. The Single European Act is the first step towards creating a 'European Union'.

1992: The member states sign the Maastricht Treaty to turn the European Communities into the 'European Union' (EU).

1997: The EU member states sign the Treaty of Amsterdam, strengthening the Qualified Majority Voting in the EU decision-making procedures.

1999: The EU establishes the European Security and Defence Policy (ESDP).

2001: The EU member states sign the Treaty of Nice, which reforms the decision-making processes and opens up the path for the EU's enlargement.

2004: Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia join the European Union. The EU leaders agree on the Constitutional Treaty.

2005: France and the Netherlands hold national referenda and reject the Constitutional Treaty. Therefore, the European Union continues to rely on the existing Treaties.

2007: Bulgaria and Romania become members of the European Union. New rounds of negotiations on the Constitutional/Lisbon Treaty begin.

2008: Ireland rejects the Lisbon Treaty by 53.4% in a referendum.

2009: After a second referendum, 67% of Irish voters vote 'yes' to the Lisbon Treaty. It comes into force at the end of the year.

2010: The EU establishes -under the Lisbon Treaty- the President of the European Council and the High Representative of the Union for Foreign Affairs and Security Policy.

2012: Twenty-five EU countries (except UK and Czech Republic) sign the Treaty of Stability, Coordination and Governance to endorse stricter budget discipline.

2013: Croatia also joins the EU.

2016: The United Kingdom holds a referendum to leave or remain in the EU. Leave wins by 51.9% to 48.1%.

Appendix II: Timeline of the Economic and Monetary Union (EMU)

Timeline of the Economic and Monetary Union (EMU)

1970: The Werner Report opens up the path for the creation of the Economic and Monetary Union (EMU).

1972: The European Communities harmonise exchange rates, allowing currency fluctuation within a range of +/- 2.25% between member states.

1979: All EC member states (apart from the UK) agree on the European Monetary System (EMS) that sets a common exchange rate (Exchange Rate Mechanism). This is the first step towards the creation of the Eurozone.

1990: Two Intergovernmental Conferences (IGC) encourage further financial integration. This is the first stage of the monetary union.

1992: The Maastricht Treaty establishes the Economic and Monetary Union and sets the convergence criteria for joining the single currency.

1997: The member states of the Eurozone agree on the Stability and Growth Pact (SGP), which provides new fiscal rules and penalties in order to join the Eurozone.

1998: The European Council and European Parliament endorse the decision of 11 member states to join the Eurozone. Under the Eurozone structure, the European Central Bank (ECB) is established to set the monetary policy in the currency union.

1999: Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain join the Euro.

2002: Twelve EU member states -Greece and Portugal among them- introduce the Euro.

2007: Slovenia joins the Eurozone.

2008: Malta and Cyprus join the Euro.

2009: Slovakia joins the Eurozone.

2011: Estonia joins the Eurozone.

2012: Eurozone finance ministers agree to set up a permanent bailout mechanism: the European Stability Mechanism (ESM).

2014: Latvia becomes a member of the Eurozone.

2015: Lithuania also becomes a member of the Euro.

Appendix III: Memoranda of Understanding in Greece

Memoranda of Understanding Reforms in Greece (2010-2015)

2010	2011	1012	2013	2014	2015
1st bailout programme	2nd bailout programme	2nd bailout programme	2nd bailout programme	2nd bailout programme	3rd bailout programme
- VAT increase by 4%	- Introduction of higher income tax	- Reduction of the minimum wage (by 22%)	- Establish shorter notice for dismissals (from 24 to 4 months)	- Freeze in public wages and pensions	- Increase of the VAT tax for more products (23%)
- Public sector wages cuts and elimination of the Christmas and summer bonuses	- Further revision of the Labour Law	- Deregulation of the wage bargaining system	- Abolition of the compulsory arbitration	- Further public services cuts	- Elimination of 30% VAT discount for the Greek islands
- Freeze in public sector recruitment	- Acceleration of the privatisation programme	- 15,000 dismissals in the public sector		- New privatisation of public assets programme	-Introduction of new Solidarity tax
- Softening of the Employment Protection Legislation: extension on probationary periods for new jobs, raise the collective dismissals threshold, reduction in severance pay entitlements		- Elimination of 'tenure' in all existing legacy contracts			- Increase of pensioners' health contribution (from 4% to 6%)
- Raise of the retirement age (from 60 to 65)		- Reduction in unemployment benefits (by 22%)			- Increase in retirement age (from 65 to 67 years)
-Privatisation of public assets		- Cuts in social benefits			
		- Taxes increase			
		- Government spending cuts (i.e. education, public health)			

Appendix IV: Memorandum of Understanding in Portugal

Memorandum of Understanding Reforms in Portugal (2010-2015)

2010	2011	1012	2013	2014	2015
	Bailout programme	Bailout programme	Bailout programme	Bailout programme	
- Introduce higher VAT (+2%)	- Further VAT increase (from 21% to 23%)	- Reduction in unemployment benefits	- Introduce a new labour Law	- Cuts in public sector wages	
- Increase income and corporate taxes	- Cuts in public sector wages (by 5%)	- Cuts on employment benefits (by 10%)	- Cuts in severance payments (from 30 to 20 days per year)	- Reform of the pension system	
- Cuts in public sector wages (by 5%)	- Extension of the working week (from 35 to 40 hours)		- Weakening the dismissals rules legislation		
	- Abolition of holiday bonuses in public sector		- Privatisation of public assets (i.e. transport, communications, energy)		
	- Reduction in public spending (welfare provisions, health, education)				

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