RODERICK MACDONALD

EUROCRITICAL

A CRISIS OF THE EURO CURRENCY

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Preface

The euro crisis followed on the heels of the global financial crisis. So also the present book follows on the heels of my previous publication with Palgrave Macmillan, *Genesis of the Financial Crisis*, which appeared in 2012. I fell ill in 2013, with after effects lingering for several years, diminishing my capacity for work. As a result, six years will have elapsed between books, and the events of the euro crisis have continued to unfold. The purpose of this current book, however, has remained unchanged: to explain the genesis of the euro crisis rather than its subsequent handling by the European Commission, the European Central Bank and the International Monetary Fund (IMF). Hopefully, though, the insight offered by this book will promote discussion and critiques of the procedures and policies by which the euro project is administered.

The availability of abundant sources of data on the Internet, such as World Bank and OECD data bases, national statistics and so on, greatly facilitated my work. The Eurostat ESA-2010 revision of statistics was implemented in 2013 but I did not change to this format. There are small discrepancies between the OECD data and ESA 2010.

Electronic access to books and both academic and journalistic articles also greatly facilitated my work. As a result, my book references are rarely to precise pages but rather to chapters since the printed pagination was not always available to me.

I suppose that the reader also has more or less ready access to the Internet and for this reason do not include a glossary. For example, most English dictionaries omit the word "subsidiarity." A quick search on an Internet browser will return definitions and also the information that the principle of subsidiarity is defined in Article 5 of the Treaty on European Union. Similarly, there are definitions and brief descriptions of the European Commission and of other entities such as the Eurogroup.

There are numerous references to unsigned IMF and OECD documents throughout this book. The complete references are given in the text and are not repeated in the reference list at the end of each chapter.

George Ekins, Dermot Hodson, Erik Jones, Theodore Pelagidis, Sebastian Royo and Christos Triantopoulos have read sections of this book. They are not necessarily in agreement with my conclusions and should not be held responsible for any errors. They did contribute to the improvement of the manuscript and for this I thank them.

Montreal, Canada
November 1, 2017

Roderick Macdonald

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Introduction: Europe, the Euro and a Crisis

This introductory chapter consists of six sections. The first section provides a geographic and historical background that suggests part of the motivation for the creation of the euro. It could be skipped by those familiar with Europe, but may be useful to others. The next section, *The road to the euro*, lists and describes the treaties and agreements that prepared the introduction of the euro on January 1, 1999. The third section then describes fiscal and monetary policies of governments within the euro regime. The fourth section, entitled *The crisis*, explains the two meanings of "euro crisis," describes the crisis according to each meaning and notes different explanations of the crisis. In the fifth section, *Europe in the wake of the global financial crisis*, the symptoms of crisis are listed for various countries participating in the euro, showing that something went wrong in the economy of Europe and that the problems were more acute in some countries than others. The sixth and final section, *Outline of this book*, describes the content of the subsequent chapters of this book.

R. Macdonald, *Eurocritical*, https://doi.org/10.1057/978-1-137-34628-5_1

Europe, the European Union and the Euro

Europe's population in 1940 was about 416 million, about half that of Asia and three and a half times that of Africa—both far poorer than Europe—and four times that of the USA, which was more wealthy on a per capita basis. Europe was the densest zone of independent advanced military powers in the world. This fact, along with the ideologies driving the conflict, explains why the ongoing European conflict became the Second World War. It also explains why, when the conflict finally came to an end, a solution was sought to rally these independent countries into some sort of unity in order to assure peace.

Europe consists of the lands between the North Atlantic on the West, beginning with Ireland, until and including Russia as far as the watersheds of the Ural Mountains. The United Nations Statistics Division divides Europe according to the points of the compass, although in practice Western Europe and Central Europe are the more frequently used terms. The Nordic countries and the Baltic countries are to the north of Europe, while Italy, Portugal and Spain to the south are often considered as part of Western Europe, without making a distinction about North and South. "The periphery" is also used as catch-all term to designate mostly the southern countries: Cyprus, Greece, Italy, Portugal and Spain. Ireland, clearly on the West, is currently considered to be part of the periphery, but that designation may fade as its economy strengthens.

The greatest ambiguity in defining Europe is to the East—what is central, and where does Eastern Europe end? Greece lies south of Central Europe, beyond Albania, Macedonia and Bulgaria. Turkey is also south of Bulgaria and, although it is usually considered part of Asia, its most populous city Istanbul stands on the European shore of the strait separating the main continental bodies of Europe and Asia. Georgia, Armenia and Azerbaijan are to the north and northeast of Turkey, and the residents racially resemble the natives of Europe. However, it is more customary to put the southern boundary of Eastern Europe at the watershed of the Caucasus Mountains, excluding Georgia, Armenia and Azerbaijan. The Ukraine is east of Moldova and Romania, while Belarus is east of Poland. Lithuania, Latvia and Estonia are northeast of Poland, the first separated from Poland by a small enclave that is part of Russia. North of these lie the Nordic countries of Denmark, Finland, Norway and Sweden. East of the Ukraine lies the vast reach of Russia through central Asia (the fascinating lands briefly conquered by Alexander the Great) all the way to the Pacific. The part of Russia east of the Urals is generally considered to be part of Asia.

Europe is a thus plurality of cultures and societies with some common roots:

1. Indigenous tribes temporarily conquered by the Romans and eventually converted to Christianity.
2. The slow build-up of technical and scientific knowledge fed by trading as well as conflictual contacts with the Arab and some Asian civilizations, eventually exploding as larger numbers of persons became involved with science, engineering and invention and as the communication between those persons grew.
3. An evolution in patterns of power, as cities rose in importance and then came under the dominion of nation states; this dominion in turn eventually developed into an almost absolute power over individuals as exemplified by the Sun King, and that then eroded in the face of revolution or more moderate uprisings that advanced the rule of law. Of course, this near absolutism fell far short of the powers of the sultan in Turkey.
4. The accelerating movement of the primary locus of economic value from resources to technology to human capital, contributing in part to the evolution of power both by giving a new importance to cities and by reducing the economic importance of the aristocracy.

Several cities dominated the European landscape from the fourteenth to the seventeenth centuries. Nation states then began to coalesce around dominant socio-linguistic groups as ambition, geography and military power facilitated. The word "nation" comes from the latin *natus*, to be born, and refers to the people born on the land. The sixteenth-century jurist, Jean Bodin, argued that the nation state brought law and order upon the chaos of competing fiefdoms, invoking the divine right of the monarch in a convenient interpretation of St. Paul. The frontispiece of

Thomas Hobbes's (seventeenth century) Leviathan shows a crowned giant, composed of numerous individuals, carrying a sword and a sceptre. The crowned head is not composed of individuals: Hobbes was also a champion of the absolute sovereign, but this right issued from the social contract by which citizens submitted to gain the monarch's protection.

The sovereigns sought to increase their wealth by increasing their resources: viz., land. To the warfare over territory and the empire-building that followed upon explorations for trade, there was added another realm of conflict—the realm of ideas—as experience of absolutism and colonialism, the ever-greater importance of trade and technology in the production of wealth, and the access of multitudes to land ownership and suffrage in the English New World led to a distaste for the absolute state.[1]

The Spanish, Portuguese, Dutch, British and French empires waxed and waned, each at its own pace and in its own time. The German empire, last of the European empires to rise, was peculiar in its restricted territory and in occurring after the industrialization of the home territory.

Total dominion by the sovereign in the person of a king is characteristic of the Renaissance years and reached its apogee in Louis XIV of France who died September 1, 1715. His successor Louis XV is generally perceived to have been a weak ruler, while Louis XVI tried to reform according to Enlightenment notions. This included some free market ideas that were implemented naively and led to periods of food scarcity. The French Revolution rejected the "ancien régime" but retained the notion of nation state, singing "les enfants de la patrie"—the children of the fatherland.

Meanwhile, the debates and discourse over liberty versus order imposed by the state proliferated in many flavours. Various resolutions of this debate were achieved in Britain, France and other countries prior to the twentieth century. Groups and individuals striving for power in the early twentieth century used both discourses (liberty and order). In the first third of the century, the dominant alternatives were grouped under the terms "fascism" and "communism." Nazism resurrected the notion of nation state with the slogan Blut und Boden (blood and soil). It went even further, adulating the Aryan race and introducing eugenic efforts and racial discrimination to assure the "purity" of the Aryans who supposedly were destined to be the master race of the world.

Nazism offered a different kind of liberation: the individual (if Aryan) freed equally from chaos and from arbitrary despotism to achieve the status his talent and effort permitted. Oswald Spengler's ideas were important for the foundations of Nazism, although he later became targeted as a critic of Adolf Hitler. One of Spengler's aphorisms was that "peace is a desire, war is a fact; and history has never paid heed to human desires and ideals." Many other ideas were present in Nazism, but the notions of master race and that of the necessity of war were quite sufficient ideological motivation for initiating the Second World War. Necessity, struggle and fitness had been frequent notions among nineteenth thinkers.

Thus, although Hitler was the one person responsible for the outbreak or the Second World War, there was a centuries-old lineage of ideas that led to tension between the countries of Europe. There was also the terrible economic burden that the Treaty of Versailles had placed upon Germany in resolution of the First World War, which had led to the dissatisfaction and unrest that gave purchase to Hitler's populist discourse. In the aftermath of the war, besides universal fatigue, there was a conviction that something had to be done to avoid a new eruption by a nation state. Winston Churchill, prime minister of Britain and one of the leaders of the Allied war effort, gave a speech at the University of Zurich on September 19, 1946, in which he declared, "We must build a kind of United States of Europe. (…) The first step in the recreation of the European Family must be a partnership between France and Germany." Europe had been the heartland of the Second World War and much of the impetus that led to the creation of the euro derives from a desire to intertwine the countries of Europe more closely together in order to decrease the probability of armed conflict between European nations.

The Road to the Euro

Belgium and Luxemburg had entered into a Customs Union in 1921. Exiled during the Nazi occupation of the Second World War, the governments of these two countries joined that of the Netherlands in the September 1944 London convention, a treaty that created the Benelux

Customs Union that came into force in 1948. It would last until 1960, at which time it was superseded by the Benelux Economic Union. The Customs Union was one inspiration for some sort of European Community. The Council of Europe, founded in 1949 by Belgium, Denmark, France, Ireland, Italy, Luxembourg, the Netherlands, Norway, Sweden and the UK, is an organization that promotes democracy and human rights, but is not a direct antecedent of a European Community. On May 9, 1950, the French Foreign Minister, Robert Schuman, proposed that Franco-German production of coal and steel as a whole be placed under a common High Authority, within the framework of an organization open to the participation of the other countries of Europe. This declaration led to the first direct antecedent in April 18, 1951, when the Treaty of Paris created a common market between Italy, France, Germany, Belgium, Luxemburg and the Netherlands for two commodities essential to industrialization and the rebuilding of Europe: coal and steel. These were also two commodities that would have been essential to any nation's war effort.

Meanwhile in 1945, Belgium, France, Scandinavia and the UK had re-established Interpol (which had been co-opted by the Nazi regime) as the International Criminal Police Organization. Next, the North Atlantic Treaty (April 4, 1949) had established the North Atlantic Treaty Organization (NATO), grouping the USA, Canada and the five European countries Belgium, France, Luxembourg, the Netherlands and the UK. Germany did not join until 1955, after Greece and Turkey (both 1952). This organization brought limited pooling of defence resources.

NATO superseded the defence portion of the Treaty of Brussels (1948) that covered economic, social and cultural collaboration as well as defence.

The Euratom Treaty of March 25, 1957, established a more or less common market for nuclear power. The Treaty of Rome of the same date established the European Economic Community effective January 1, 1958. The founding nations were Belgium, France, Italy, Luxembourg, the Netherlands and West Germany. The Brussels Treaty merged the institutional structures of these two and those of the European Coal and Steel Community effective July 1, 1967, so that the same institutions thereafter governed the three organizations. Denmark, Ireland and the

UK joined the European Communities on January 1, 1973, Greece on January 1, 1981, while Portugal and Spain joined on January 1, 1986.

In 1985, Belgium, France, West Germany, Luxembourg and the Netherlands had entered into the Schengen Agreement which proposed the gradual abolition of border checks. It was not fully implemented. The Schengen Convention (1990) proposed the abolition of border controls and a common visa policy.

The road to the euro began with the creation of the European Economic Community through the Treaty of Rome, effective January 1, 1958. Twelve years later, the "Report to the Council and the Commission on the realization by stages of economic and monetary union In the Community" proposed a monetary union without a central bank. This was not acted upon, partly due to lobbying by the USA, but in March 1971 members of the European Economic Committee expressed their political will to pursue monetary union. The creation of the European Monetary System in 1979 was an attempt to govern the exchange rates between European currencies, and a basket of these currencies, the "European Currency Unit," was thereafter used as the unit of account. The Single European Act of 1986 foresaw the creation of a single economic market and a gradual realization of a monetary union. The European Council of June 1988 mandated a committee (under the chairmanship of European Commission President Jacques Delors) with the task of studying and proposing specific steps towards a monetary union.

In 1989 the committee tabled its report on economic and monetary union in the European Community. Paragraph 18 argued "The Treaty of Rome, as amended by the Single European Act, provides the legal foundation for many of the necessary steps towards economic integration, but does not suffice for the creation of an economic and monetary union" (p. 13). At least one additional treaty would be required (and would come to light in Maastricht in 1992). After reviewing the process of unification to date, the report observed that in "order to create an economic and monetary union the single market would have to be complemented with action in three interrelated areas: competition policy and other measures aimed at strengthening market mechanisms; common policies to enhance the process of resource allocation in those economic sectors and geographical areas where the working of market forces needed to be reinforced or complemented; macroeconomic coordination, including binding rules in the budgetary field" (p. 17). Macroeconomic coordination was necessary because monetary union would only be made possible through "mutually consistent and sound behaviour by governments and other economic agents in all member countries" (p. 19). Monetary union would be consummated in three stages.

A new treaty, the Treaty of European Union, dated Maastricht February 7, 1992, and its accompanying protocols further specified these stages. The first stage foresaw the free movement of capital between participating states. During the second stage, member nations were required to achieve certain performance criteria prior to commencement of the third stage of the introduction of the euro.

The protocol on the excessive deficit procedure stipulated that the deficit must be no greater than 3% of gross domestic product (GDP) and the national debt must be no greater than 60% of GDP.

The protocol on the convergence criteria stipulated:

- "a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1.5 percentage points that of, at most, the three best performing Member States in terms of price stability."
- remaining within "the normal fluctuation margins provided for by the Exchange Rate Mechanism of the European Monetary System without severe tensions for at least the last two years before the examination."

These (Maastricht) criteria applied to general government, which includes central government, regional or local government and social security funds, to the exclusion of commercial operations.

The Maastricht Treaty was amended in 1997 (Treaty of Amsterdam), 2001 (Treaty of Nice) and 2009 (Treaty of Lisbon), but the deficit and inflation criteria were retained and applied both to continuance within the euro currency once introduced and to accession to euro participation. A Resolution of the European Council on the Stability and Growth Pact, Amsterdam, June 17, 1997, combined with two Council Regulations, one on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies and another on speeding up and clarifying the implementation of the excessive deficit procedure, further specified the application of the Maastricht criteria.

The Maastricht Treaty created the European Union effective November 1, 1993. The treaties of Amsterdam, Nice and Lisbon added amendments. Besides the architecture of the supranational union, the treaty also established an obligation for member nations to follow sound fiscal policies, defined as maximum annual deficits at 3% of GDP and maximum debt at 60% of GDP, and to maintain reasonable interest rates. This treaty also foresaw a common currency. There were 12 member countries at this time: Belgium, France, Italy, Luxembourg, the Netherlands, Germany, Denmark, Ireland, the UK, Greece, Portugal and Spain. Austria, Finland and Sweden joined in 1995. The euro was introduced into financial markets on January 1, 1999. It replaced the European Currency Unit, which had replaced the European Unit of Account (1975–1979). It was more than a unit of account however, as travellers' cheques and electronic transfers already could be made in this new currency. The physical coins and notes were introduced three years later. The accounting units that preceded the euro allowed a smooth introduction into the market. Although it lost one-third of its US dollar exchange value over the first 30 months, it did so in an orderly way, regaining and surpassing its original issue value from mid-2003 to January 2005.

Not all members of the European Union use the euro. Sweden and the UK desisted from the beginning, while Greece did not manage to meet the Maastricht criteria (having annual deficits over 3% of GDP, a debt over 60% of GDP and a high interest rate as well). It would not be allowed to adopt the euro until 2001, a year before physical notes and coins came into circulation. By January 2015, seven more countries had been admitted to the euro zone. Only members of the European Union can be admitted to the euro zone. A few small states that are not European Union members also officially use the euro currency without being part of the euro zone: Andorra, Monaco, San Marino, Vatican City (with the recognized right to issue a limited number of coins), Kosovo and Montenegro (with no formal agreements and thus no rights). None of these states has a sufficiently large economy to influence the course of the euro. The total population of the euro zone is slightly greater than that of the USA.

Adopting the euro meant that participating countries reduced their economic sovereignty to fiscal and industrial policies: taxes and government spending and economic planning. Indeed, even fiscal policy was somewhat circumscribed by excessive deficit and excessive debt criteria, although to date these have been sanctioned with a light hand. The participating countries had already ceded some control over immigration as Europeans began to freely move from country to country, and other aspects of control were also ceded as the European Union has (a sometimes nebulous) authority over issues as varied as pollution and family law.

Thus, this European project diminished national economic and political sovereignty. It was seen nonetheless as the recognition of a common heritage and also as having a potential for increased prosperity. The introduction of the euro was seen as a culmination of economic integration; further developments are pending before we see even greater economic integration. Power and economics are difficult to separate, and for this reason fiscal policy may also become a target for political integration as well as an instrument for economic integration. Certainly the Maastricht criteria—if strictly applied—would constitute a quasi-regulation of the fiscal policy of participating nations.

The European project does not rally unanimous support, of course, nor does anyone like to cede power as much as they do responsibility, so that the extent of future integration remains to be determined. Nor do all countries participate fully in the European project.

The loosest definition of Europe is the continent, the geographic reality. Next is the European Union, that today numbers 28 states and to the South East includes Cyprus (which, as an island just south of Turkey and west of Syria, is arguably in West Asia or the "Middle East") and Bulgaria. To the northeast, Poland, Lithuania, Latvia and Estonia lead to the three Nordic countries of Finland, Sweden and Norway. The core of the European Union is Western Europe, centred on France and Germany. The UK has so far been an important member, although neither on the mainland nor a participant in the euro. The European Union is a political entity to which members cede sovereignty over certain economic and other issues.

Fiscal and Monetary Policy in the Euro Zone

Nations joining the euro are confronted by a very real separation of treasury and central bank. Their governments borrow money by issuing bonds; the interest rate on these bonds is influenced by the prime rate set by the European Central Bank. In theory this is unimportant, because central banks act on more or less scientific principles, adjusting interest rates according to economic imperatives and independently of fiscal ambitions. In practice, this is problematic because economic imperatives vary within any economy. Michael A. Kouparitsas (2001) found that some regions of the USA did not fit with the economic imperatives of the whole.[2] In Canada, Western and French Canada often felt disadvantaged by the monetary policy of the central bank. The same could happen within Europe, with the central bank seen as favouring one or another nation, such as Germany and France rather than Greece and Italy.

At the onset of the euro, all participating nations benefitted from decreasing interest rates on their bonds. However, decreasing interest rates were also widespread beyond Europe's borders.

The European Central Bank publishes data and a chart for the euro area 10-year Government Benchmark bond yield. There is no such euro bond, however. External bonds are a class of financial instruments that are simply bonds issued in a currency other than that of the country in which they are issued, such as eurodollars and euroyen. That class is sometimes misnamed eurobonds. As of the fall of 2017, there is no bond issued by a European central authority, although such a bond has been proposed.

The chart of the euro area 10-year Government Benchmark bond yield must be understood as similar to the old "European Currency Unit": it is an accounting concept derived from economic realities. These economic realities are the "real" bonds of nations participating in the euro.

How should one price such bonds? The issuing treasuries attempt to assess the (lowest) interest rate that the market will offer for loans, and issue accordingly. At what rate were the second parties in the market willing to lend money to euro zone governments?

A number of factors influenced this rate downward, to the benefit of the issuing governments. The first was the fiscal discipline required by the Maastricht criteria. Any government respecting such criteria should be capable of repaying its debt and thus was a credible borrower. The second was belief that the entire euro zone bloc would stand behind any reasonable debt of a participating government in the case of temporary financial embarrassment, thus ensuring funds to avoid delays or default. Third, there was the historical performance of that fictitious 10-year euro area government benchmark: the interest rate had dropped from a high of 15% in the last months of 1981 to less than 5% at the introduction of the euro. That overall downward trend continues as of 2015, in spite of temporary increases. This downward trend was as much a consequence of worldwide economic conditions as it was of the health of European economies, but it remained a reference point nonetheless.

The yield on ten-year bonds of the government of Greece dropped from about 8% in 1998 to below 4% in 2005, with only minor perturbations of the steady downward trends. Ireland similarly dropped from 8% in 1996 to 4% in 2005. The same indicator for Spain dropped from 10% in 1996 to 4% in 1999, then rising again to 6% the following year and then dropping to around 4%. Italy dropped from 12% (1996) to 4% (1999), then up to nearly 6% (2000–2001) and then down to about 4%. The euro area 10-year Government Benchmark bond yield also dropped, but much less dramatically and with wider fluctuations: from a little over 5% in 1998, to a little under 4% in 1999, up to nearly 5.7% in 2000, and then down to a little over 3.5% in 2005. The sweet spot for yields on the bonds of euro zone governments seemed to be converging on 4%.

In this way, a number of euro zone countries clearly had access to cheaper money than had been the case before committing to the euro zone. This permitted an increase in fiscal spending.

The Crisis

A number of European countries entered into crisis in the wake of the global financial crisis of 2007–2010. All had passed through the abundance and availability of capital that characterized the first years of the new millennium, the new monetary constraints of the euro zone, but each had experiences peculiar to their country.

When the politicians of these countries sought help from The European Central Bank, the European Commission and the International Monetary fund (IMF), their governments were deep in debt and had difficulty borrowing on the international bond market. Anyone searching for "euro crisis" on the internet in 2017 returned dozens of articles informing him or her on the European sovereign debt crisis. One might easily conclude that the euro crisis was indeed a debt crisis, but it was not.

Perhaps the crisis of the euro is a crisis of design—a sort of original sin dooming it to repeatedly falter in the vicissitudes of economic life because shocks can affect the euro zone asymmetrically. This would seem to have been the case in Europe at first glance. It would seem that the participating economies were affected in different ways by the global financial crisis. Some entered into a serious crisis and required outside aid, while others weathered the storm on their own. However, closer examination reveals that the global financial crisis was not so much the cause of the crises in different countries as it was a circumstance that brought internal problems to a head. Italy was little affected by the global financial crisis. The subsequent economic recession was its downfall. The global financial crisis did not cause the problems in Ireland, Greece and Spain. That crisis made the markets more jittery and sensitive to their internal problems, leading to still higher interest rates. The worldwide shortage of credit in 2007–2008 accentuated the problems of these countries and accelerated the reaction of the markets, but, with or without the global financial crisis, eventually their very real problems would have provoked a market reaction, raising the interest rate on their bonds. If the emperor has no clothes, he will be cold in winter.

Then again, the design problem might be administrative and remediable rather than a damning original flaw that cannot be overcome. Certainly the officials of the European Central Bank and the European Commission have been criticized for their actions, and they have changed course—somewhat—on issues such as austerity. It is good to criticize them in order to keep them accountable. However, it is also true that the euro project is a novelty and its administration is a learning process. Rather than criticizing individuals, scholarly work has proposed additional mechanisms to supplement those in place or modify existing arrangements such as the emergency liquidity agreement by which the European Central Bank governs the manner in which national central banks provide liquidity to national financial institutions.

Economics and finance deal with abstractions, many of them quantified estimates regarding real transactions by individuals and organizations. Real people are hidden behind the numbers. Few of these persons were of voting age when the notion of monetary union arose, and few of them understand the implications of the policies and actions of their national governments, or of the actions at the level of the European Union. Yet all of them live with the consequences. Many of them are vocal in their reactions.

Greece was the theatre of the most spectacular reactions: demonstrations, strikes, riots and the rise of alternative political parties. Half a dozen people have died and over 300 have so far been injured in civil unrest. Syriza, the dominant party in the current (2017) governing coalition, was founded in 2004. Its rise to power was in great part due to being completely unsullied by the crisis in Greece.

Spain was the scene of many protests, particularly in the summer months of 2011. The *Movimiento 15M* emerged from the various social networks organizing the demonstrations by an estimated 7 million people. A survey in 2012 found popular support to several times that number. The year 2014 saw the foundation of *Podemos*, a political party critical of the economic and financial establishment. In 2015, *Podemos* won 69 of 350 seats in the *Congreso de los Diputados.*

Protests began in Ireland by October 2008. These continued in the subsequent years, becoming especially frequent towards the end of 2011, most of 2012 and the first half of 2013. The years 2014 and 2105 saw continued protesting. Solidarity, formerly the Anti-Austerity Alliance, was founded in 2014, but met with marginal success in elections. Voters punished the governing Fianna Fáil party by voting in its traditional opponents.

Italy saw few demonstrations and strikes. Some 200,000 protested against the government and the troika (the IMF, the European Commission and the European Central Bank) in Rome on October 15, 2011.

Anti-austerity protests were repeated in October and November 2012, October 2013 and April and November 2014. The political party *Movimento 5 Stelle* had its beginnings in 2005 but gained in popularity because it attacked corruption in mainstream politics and also was critical of Italy's participation in the euro. The party currently (2017) holds 91 seats out of 630 in the *Camera dei deputati* and 17 out of a possible 73 in the European Parliament.

As of 2017, polls put the party on even popularity with the governing centre-left Partito Democratico party.

All of this was a series of popular reactions to crises in various participating countries in the form of civil unrest and political upheaval. Just what was being protested? The people in the streets and the voters were protesting their experience of a local crisis, specifically, the diminution of their wealth and living conditions. But what precisely was the euro crisis?

The euro crisis can be conceived in two ways: as a crisis in the value of the euro currency and as a crisis in the administrative system supporting that currency.

As a crisis in value, the euro crisis consists in a series of troughs in exchange rates for the euro that took place over the years 2010–2012. The value of the euro decreased with respect to the US dollar from mid-2009 to early 2010 and again from early 2011 to mid-2012. However, these variations are not exceptional in the short history from the inception of the euro in 1999–2017. One could easily argue that the variation derived from the strong recovery of the US dollar after the global financial crisis. If these drops are explained by internal causes, these would be the series of financial crises occurring in countries of the euro zone following the 2007–2010 global financial crisis that originated in the USA. In effect, these individual crises brought two pressures to bear on the euro currency. First, the euro zone as a whole was seen as engaged in the isolated crises and thus vulnerable to contagion. Second, the euro project itself would be called into question if the zone did not stand behind the individual countries.

Another factor that complicated this situation was a series of economic trade-offs for the richer participating nations. Helping the nations in crisis meant that funds of the richer nations went to the countries in crisis.

No one likes to pay taxes or fund someone else's prodigality. On the other hand, sending money to those countries should ultimately allow them to honour loans from their creditors who were often financial institutions of the richer nations. Some even have gone so far as to blame euro zone institutions for irresponsible lending to profligate governments, as the funds from the IMF and the European commission flowed into and out of sovereign coffers and ultimately into the banks that had originally lent funds to the nations now in crisis.

As a result, the euro crisis was also conceived as a crisis in the administrative system supporting that currency. There are three popular explanations given for this administrative crisis of the second decade of the twenty-first century.

The first is an old prejudice recycled for the euro crisis. In this vision, some countries in Europe are destined for mediocre economic performance because of their cultures, either because they are in the South or because they are Catholic. Thus, the people of Greece, Italy, Spain and Portugal are lazy and not industrious enough to produce much wealth. The people of Ireland are Catholic and drink far too much to form an industrious country.

Ireland and Spain had debt-to-GDP ratios among the best fiscal positions in Europe previous to the crisis, and Greece is second only to South Korea in hours worked per year among Organisation for Economic Cooperation and Developement (OECD) nations. No further time will be wasted on this vision.

The second frequent explanation is that economies of some countries are simply not as productive or advanced as those of other countries in the euro zone. Monetary union can do nothing to change this. Thus, the "crisis" was a reappearance of this difference and the problem has been festering since the creation of the euro.

The third belief is that the European monetary union itself caused the crisis. The idea is that the monetary union standardized certain aspects of disparate economies without making other aspects uniform. Specifically it imposed a single monetary policy upon economies that had different fiscal governance and different social, cultural and economic circumstances.

A variation of this third belief is that intentionally or unintentionally, two countries, Germany and France, dominated the policy decisions of the euro zone to such an extent that decisions were made in monetary policy which were favourable to these two economies and unfavourable to the remaining European economies. As a consequence, the euro zone would thus have functioned as an economic pump, favouring the economy of Germany and to some extent that of France by creating markets for their industry and also by favouring exportation of other produce beyond the European Union, thanks to the effect of the weakened monetary unit. The most cynical version of this perspective views Angela Merkel as having manipulated the policies of the European Central Bank and other agencies of the European Union by political pressures in order to favour the German economy and thus return her to office.

An extension of this is the notion that the handling—or mishandling—of the crisis has been more the product of a concern for the creditors (banks in France, Germany and Holland) than of any concern for the economic hardship experienced by the citizens of other European countries.

Erik Jones (2015, 2016) has summarized the academic and professional literature on the euro crisis in four strands of narrative:

1. Design flaw: there is a crisis because the euro monetary union is based on a design flaw.
2. Competitiveness: there is a crisis because some countries lost their ability to devalue their currency upon joining the monetary union and thus are unable to compensate for uncompetitiveness.
3. Government and household debt: there is a crisis because governments and/or households spent too much and became too greatly indebted.
4. Market rejection: there is a crisis because actors in the international bond markets were spooked, liquidated their current holding as best they could and would not buy bonds except at a very high spread with respect to German bonds.

These narratives are cumulative, not mutually exclusive. Further, the effects of the last three expose the first, so that dynamics two, three and four reveal an underlying structural flaw. This flaw is not one of monetary integration, such as in not being an optimal currency zone, but one of financial integration. Improving financial integration would address this flaw.

Professor Jones argues that market dynamics must be addressed in priority to the other two because the troika of the European commission, the European Central Bank and the IMF have a more realistic and direct impact upon them and because financing affects the other two dynamics.

Europe in the Wake of the Global Financial Crisis

The 1990s and early 2000s were characterized by a loss of ground by the middle class in wealthy countries, the rapid growth of wealth in some less wealthy countries, the continued growth in sovereign wealth of oil-producing nations, and the ageing populations of the West drifting towards slightly more rent-generated household incomes. There was a greater abundance of capital than experienced by any living businessman or financier.

Besides this, Germany was nurturing an ever-increasing trade balance that grew from the equivalent of around 3 billion euros in the mid-1990s to 20 billion in late 2007. This meant that there was even more money in the German banking system, and those banks had to park that money somewhere.

Financial institutions in Germany and France suffered the effects of the 2007–2011 crisis that emanated from the USA. Indeed, the difficulties of these institutions in Germany were making headlines in 2007, a year before most people were aware of the crisis in the USA.

In 2001, GDP for the euro area was US$6253 billion. This grew steadily until 2009, when it reached US$13,581 billion. It then dropped to US$12,456 billion in 2010 and again to US$12,058 billion in 2011, recovering in 2012 and dropping again slightly in 2013. The next few paragraphs detail the economic performance of various European countries before and during the crisis.

After nearly tripling from the year 2000 until 2008, the GDP of Greece fell from US$341 billion in 2008 to US$249 billion in 2012, a 30% drop. In terms of using purchasing power parity to gain a sense of the impact upon the life of the citizens of Greece, the drop was from US$29,600 per capita in 2008 to US$25,331 in 2012, a drop of about 15%. Of course this drop did not fall evenly across the population, and those already tight for money were the hardest hit.

Another way to understand the economic situation of Greece is to look at unemployment figures. In the middle of 2008, there was 8.6% unemployment in Greece. By July 2013, the unemployment figure had risen to 27.6%. This is quite different from the popular supposition that many Greeks hold several positions—one that brings revenue but requires little or no presence, and then one or two real jobs. A drop in the number of job vacancies accompanied the rise in official unemployment figures. In January 2009 there were a few more than 50,000 job vacancies in all of Greece. By the end of 2012, there were fewer than 10,000 job vacancies. Again, the portion of the population gainfully employed dropped from a high of 63.05% in 2008 to 52.10% in 2012.

A similar story can be told of Ireland. The GDP of Ireland had risen from a little under US$100 billion in 2000, to US$275 billion in 2008, then dropped to US$221 billion in 2010. Unemployment rose from about 4% in 2008 to about 15% in 2011.

Spain nearly doubled its GDP from US$872 billion in 2000 to 1538 billion in 2008. This measure then began to drop from US$1503 billion in 2009 to 1193 billion in 2015. Much more striking was the variation in the debt-to-GDP ratio, from 35.6% in 2007 to 100.4% in 2014, after which it began to slowly decrease. Unemployment was as low as 8% in 2008, rose to over 25% in 2013 and then began to drop to about 17% by mid-2017.

Italy offers somewhat similar figures, although they are somewhat more complicated. GDP rose from US$1104 billion in 2001 up to US$2307 billion in 2009. It then dropped to US$2042 billion in 2011, rose a little in 2012 and then dropped to US$2013 billion in 2013. In per capita terms, Italy displays a bumpy growth from US$27,717 in 2001 to 29,008 in 2008, dropping dramatically to 26,729 in 2010 and then again to 26,327 in 2013 after mild recoveries in 2011 and 2012. The unemployment figures are more indicative of the flow of the crisis: unemployment has dropped from about 10.5% in the year 2000 to about 6% in late 2007; from there it rose to above 12% at the end of 2012. As in Spain, unemployment was higher among youth. Youth unemployment dropped from about 27% in the year 2000 to around 18% in early 2007. From there, it rose up to above 40% by late 2012. The impact upon hourly wages was somewhat delayed. On an index of 100 at the year 2006, wages have risen from about 78 in January 2000 up to nearly 120 in 2012 and then dropped dramatically down to about 105 in early 2013. If we compare with the wages in France the general trend is the same until mid-2012 when the Italian wages took their sudden 10% drop and French wages continue to increase.

France also seems to have experienced some effect of the global financial crisis of 2007–2010. The growth rate had always been modest, dropping from a little over 4% in 2000 to almost no growth in 2002 and reaching about 2% in 2006 and remaining near there until 2008. Then, in 2008 the growth dropped and became negative, reaching −4% in 2009. If we look solely at the GDP of France the trend is simpler. From a low of US$1326 billion in 2001, France's GDP rose to US$2832 billion in 2009. This dropped to US$2548 billion in 2011, then rose again in 2012 and dropped a little in 2013. The unemployment rate in France also followed this trend, although in a somewhat complicated way: it had dropped from 9.5% to 8% in two years, from 2000 to 2002. It then rose to 9.5% by 2006 and dropped to 7.5% by 2008 and since then has increased up to 11% in January 2012. Once again unemployment is higher among youth. From about 16% in 2001, it rose to 23% in 2006, dropping to 18% in early 2008 and has since risen to 26% in 2012. In summary, France was impacted by the worldwide crisis but does not seem to have had as hard time as Spain, Italy, Greece and Ireland.

Germany's GDP increased from US$1886 billion in 2001 up to 3624 billion in 2009. It then dropped to about 3300 billion in 2010 and 2011, rose again to 3600 billion in 2012 and dropped to 3400 billion in 2013. Similar figures apply for GDP per capita in Germany: under US$30,000 per capita in 2000 increasing to US$33,829 in 2009 with a drop in 2010 and then growth to US$34,766 in 2013. Although there was a blip in the German economy in 2010, it seems that Germany has not had to weather much of an economic crisis in spite of having to deal with the *Landesbanken* financial crisis over 2007–2008.

The mass of figures in the preceding paragraphs shows that something went wrong in the economy of Europe, and that the problems were more acute in some countries than others. However, was there any difference between the euro area and the rest of the world? For example, how do these economic figures compare with the USA? Surprisingly, in the USA, the crisis of 2007–2011 had a smaller impact upon the US economy, which grew from US$10,301 billion in the year 2000 to 14,720 billion US dollars in 2008, followed by a drop of about 330 million in 2009 and returning to growth thereafter rising to US$15,685 billion in 2013. In purchasing power parity terms, GDP per capita increased from US$30,386 in 2002 to US$43,636 in 2008, and then dropped to its low of US$41,367 in 2010 and then began to rise to US$43,063 in 2013. The unemployment rate in the USA followed a somewhat more complicated pattern but in general rose from 4% in 2000 and about 4.5% in 2007 to 10% in 2010 dropping off to about 7% at the end of 2012.

Because of the importance of its financial sector relative to its overall economy, the UK was far more exposed to the global economic and financial crisis of 2007–2011. Britain's GDP doubled from 2000 to 2007: US$1635 billion in 2000 to US$3063 billion in 2007. It then dropped 30% by 2009 to US$2367 billion. Since then it has increased, reaching US$2999 billion in 2014.

Canada's GDP grew from US$661 billion in 2000 to 1549 billion in 2008. It then dropped to 1371 billion in 2009 and then increased, reaching 1843 billion in 2013. Canada's exposure to the worldwide crisis had been mostly through the importance of the USA as a trading partner.

The economy of Singapore has shown strong growth since the Second World War from a relatively impoverished zone to one of the wealthiest zones on the planet. At first glance, the curve looks almost exponential, and GDP almost doubled from 2007 (the year before the crisis) to 2013. However, GDP was affected there as well, with little difference in GDP from 2008 to 2009.

Clearly, the economies of countries outside of the euro zone were also impacted by the financial crisis of 2007–2010. Although there has been an obvious strain upon the economies of Europe, it is not all that clear that Europe's economic problems stem from any other source than the worldwide financial crisis. It is only by delving into the specific histories of individual countries that we can come to realize that there is something distinct that is happening in its national economies.

Outline of This Book

This book argues that understanding the roots of the crises in individual countries is a prerequisite to understanding the challenge posed to the euro. To this end, the following chapters describe and explain the crises in Greece, Ireland, Spain and Italy. Although the real crises in Cyprus and Portugal are relevant, they are excluded to simplify the argument and because these smaller economies have a lesser potential for disturbing the euro currency.

The chapter on Greece begins by listing the symptoms that indicate the reality of a crisis; the following sections describe the prelude to the crisis. The first deals with the incubation of modern Greece—and of the behaviour of recent Greek governments—within the Ottoman Empire, continuing with economic and political developments in the decades immediately subsequent to the Second World War. The next section examines developments in the 1980s and early 1990s, with particular attention to fiscal policy, monetary policy and the macroeconomic environment. A third section discusses the slowing productivity growth that characterizes the last quarter of the twentieth century. This is followed with a caveat regarding the statistics provided by the Greek government in the past. Access to the European monetary union is the topic of the next section. Then comes a discussion of the apparent boom brought by accession to the euro. The chapter ends with a simplified model of the dynamic of the crisis in Greece.

The third chapter describes the crisis in Ireland. After noting the admiration in which other countries held the economy of Ireland previous to the crisis, it lists symptoms indicating there was indeed a crisis. The following sections provide a prehistory of this crisis. The first offers a condensed history of Ireland's economy up to the Second World War. The next section continues with a post-war history of the Irish economy, covering ideas and actors before describing political and economic action and policy changes. The subsequent section pursues with a history of the Irish economy in the 1970s and 1980s. After this, the Celtic Tiger (1993–2007) is described, both in terms of the genetic factors or blueprint and in terms of the resulting economic performance. The onset of the crisis is then related. The final section proposes a dynamic of the crisis in Ireland.

The fourth chapter is about Spain and the crisis that occurred there in 2010. After a consideration of the symptoms revealing the crisis, an economic (and political) historical background follows. A description of the financial situation of Spain in 2007 is next. After this come two sections on the real estate bubble in Spain. The first section deals with spurious explanations of the bubble. The second of these sections dwells on underlying factors such as the law governing zoning (*la ley del suelo*), and the corruption of local officials, before examining two illustrative cases, that of La Muela and that of Marbella. It then considers the contribution of money laundering to the real estate boom before considering other factors contributing to the rising demand for housing. After this examination of the underlying factors, the next section examines the *cajas de ahorro* and the role they played in the bubble, particularly by financing developers. The last section proposes a simplified dynamic of the financial crisis in Spain.

The fifth chapter is about the financial crisis in Italy. After purveying the symptoms that reveal the crisis and contrasting the crisis in Italy with those in other euro zone countries, the chapter offers a brief history of Italy from its reunification to the post–Second World War years. The second section describes the economy of Italy in the Golden Age from 1953 to 1971, with particular attention paid to the impact of state-owned enterprise (SOE). Next comes an overview of the economy in the 1970s and 1980s. The electoral revolts from 1992 to 1994 are then covered, with a description of the evolution of the economy in the 1990s. Then comes the experience of Italy participating in the euro, including the onset of the crisis. The final section proposes a dynamic of the crisis in Italy.

The sixth chapter is a conclusion. It reviews the previous chapters and notes similarities and discrepancies in the experiences of the different countries. In particular, it notes the diverse roots of the crises and thus the diverse remedial measures necessary to bring each economy back into sufficient convergence for participating in the euro. The challenge of remedying these crises is an opportunity to renew the administrative apparatus of the euro and to increase financial integration.

Notes

1. This is a simplification: Frederik the Great of Prussia saw himself as the servant of the nation—although the ultimate decider—and the Poles had a form of democracy for all nobles under an elected king in the fourteenth-century Rzeczpospolita Szlachecka.
2. Robert Mundell's conceptual work on optimal currency areas provides the conceptual basis for this research. Depending on hypotheses about governance, the euro zone may or may not be considered an optimal currency area. Robert Mundell was in favour of the euro project.
3. Note: Complete references to unsigned IMF and OECD documents are given in the text and are not repeated here.

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A Financial and Economic Crisis in Greece

Introduction

This chapter is about the crisis in Greece. It somewhat resembles the crisis in Italy in that both countries suffer from massive general government debt, well over 100% of GDP. It differs in that the debt in Greece is greater in proportion to GDP, and also in that the debt, consequence of decades of overspending, triggered the crisis. In contrast, the Italian crisis was provoked by the need to bail out several banks, even though Italy has had a high debt-to-GDP ratio for many years. Most treatments of the crisis in Greece recognize a period of enviable growth with the approach and advent of the euro, and then try to explain the crisis in spite of this growth, by recourse to the hostile business environment (scarce credit, byzantine regulations, unreliable juridical process, etc.) created by past governments and the influence of special interest groups over the use of funds. This chapter takes a slightly different approach. The hostile business environment had its most detrimental impact in the years of introduction of free trade with the rest of Europe by impeding business adjustment to the new environment. As a consequence, Greek manufacturers were unprepared for free trade, and could only compete by dropping prices, squeezing prof-

R. Macdonald, *Eurocritical*, https://doi.org/10.1057/978-1-137-34628-5_2

its and their already weak capacity for investment. The reforms of the 1990–1993 government (spending cuts and deregulations) and those required for participation in the euro were too little, too late. The apparent improvement in performance with the onset of the euro is explained mostly by ballooning government expenditure that increased GDP and all measures that are GDP derived, such as productivity.

Interest rate variation revealed the financial crisis. The yield on ten-year Greek government bonds had hovered around 5% previous to 2008 and even had sunk as low as 3.2%. That rate began to rise at the start of 2010, reaching 38% in February 2012. Government debt as a ratio of the GDP varied around 100% from 1992 until 2008. Thereafter it soared, reaching 179% in 2016. If we take the maximum of both indicators, Greece would be paying over 80% of its GDP as interest on government borrowing. This is not the case, of course—the interest rate decreased and the debt was composed of bonds issued at different dates with varied interest rates. Nonetheless, it is obvious that Greece has been in financial crisis since at least 2010 (Figs. 1 and 2).

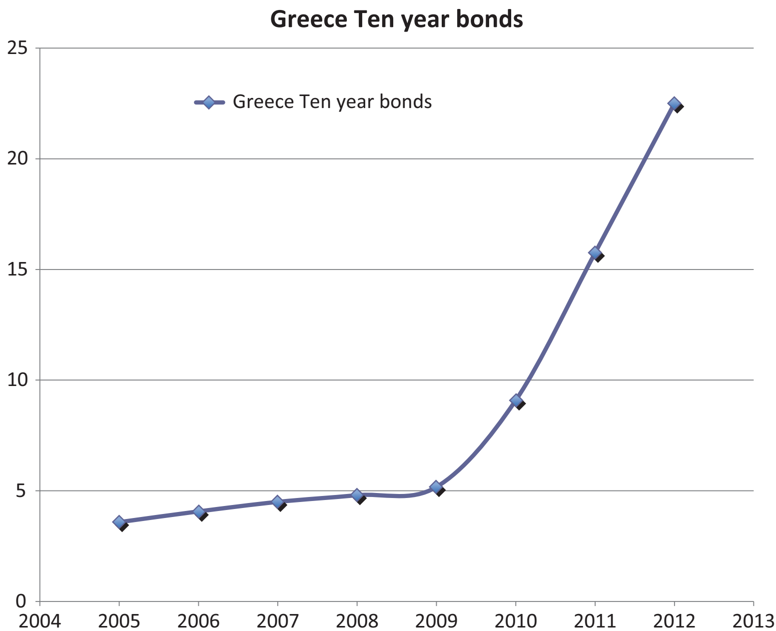


Fig. 1 Greece, long-term interest rates

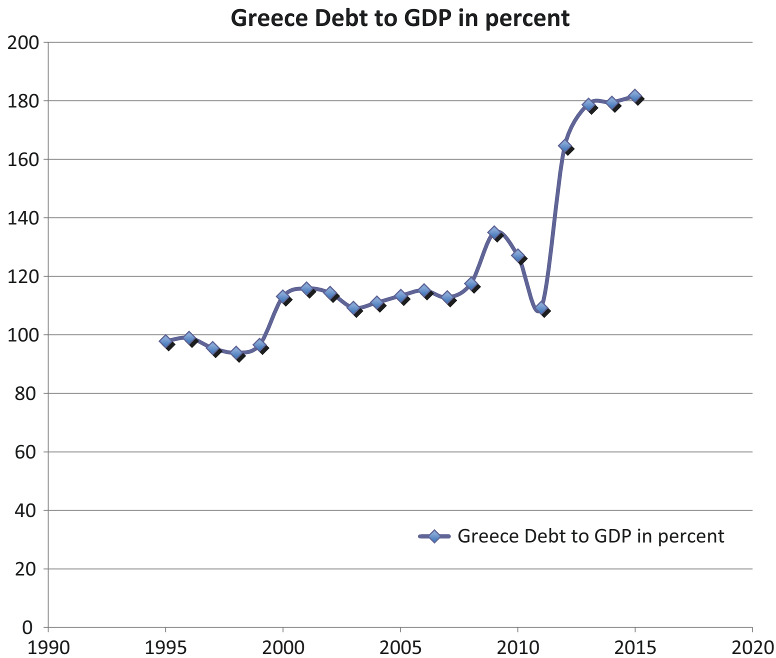


Fig. 2 Greece, debt as percent of GDP

An economic crisis is associated with this financial crisis. This crisis came in part as a consequence of the austerity measures imposed upon Greece. After a near 40% increase in GDP from the year 2000 until 2007, Greece underwent a drop in this GDP from US$332 billion in 2007 to US$244 billion in 2013, a 26.5% drop. In parity purchasing power terms, giving a sense of the way the drop affected individual Greeks, the drop was from US$32,408 per capita in 2007 to US$24,159 in 2013, a drop of 25%. Of course, the impact of this difference was not uniform across the population (Giannitsis and Zografakis 2015), and those who were already tight for money, with less or no cushion to absorb the shock, were the hardest hit (Fig. 3).

Another way to recognize the economic crisis in Greece is to look at unemployment figures. There was 8.6% unemployment in Greece at the end of 2008. By July 2013, the unemployment figure had reached 27.9%. A drop in the number of job vacancies accompanied this. In January

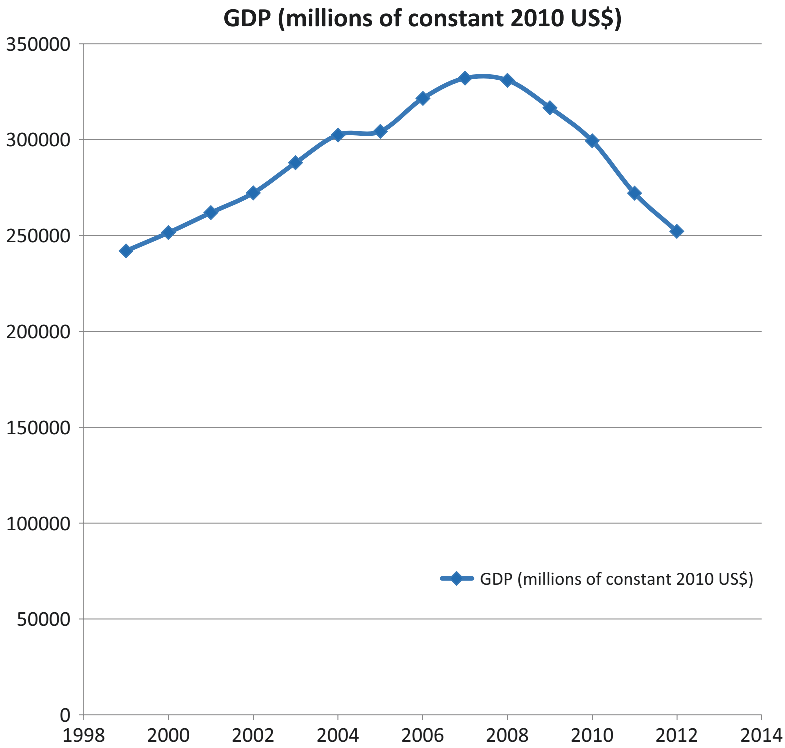


Fig. 3 Greece, gross domestic product

2009, there were a little over 50,000 job vacancies in all of Greece. By the end of 2012, there were fewer than 10,000 job vacancies. Again, the portion of the population gainfully employed dropped from a high of 63% in 2008 to 52.1% in 2012 (Fig. 4).

The data cited in this chapter should be interpreted even more sceptically than most, as they are somewhat distorted by at least two factors. First, to meet the European Standard of Accounts, revisions of statistics posterior to 1988 and then from 1960 to 1988 attempted to incorporate estimates for the informal economy, resulting in a discontinuity, ambiguity as to version of statistics and disputability of the distribution of revised figures across categories. Second, all statistics prior to 2010 were subject to manipulation and methodological errors according to a 2010 Eurostat

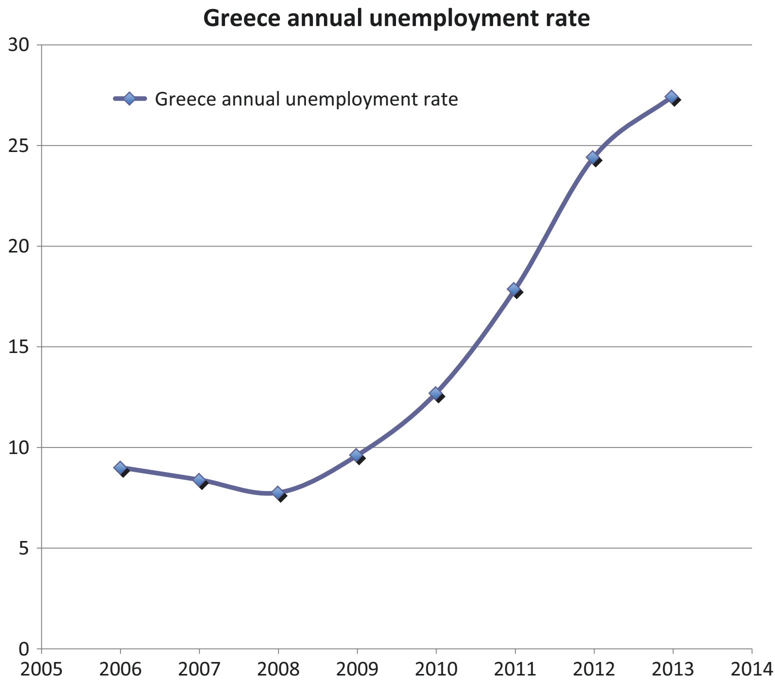


Fig. 4 Greece, unemployment rate

report (Eurostat 2010; Batzoglou 2011; Little 2012). The OECD Country Survey for Greece 1991/1992 goes so far as to state "Greek statistical series are relatively few compared to other OECD countries, many of them are unreliable, some are published with long delays and their presentation is such that it gives no clear view of trends" (p. 91).

The following sections describe the prelude to the crisis. The first deals with the incubation of modern Greece—and particularly of the clientelistic behaviour of recent Greek governments—within the Ottoman Empire, continuing with economic and political developments in the decades immediately subsequent to the Second World War. The next section examines developments in the 1980s and early 1990s, with particular attention to fiscal policy, monetary policy and the macroeconomic environment. A third section discusses the slowing productivity growth that characterizes the last quarter of the twentieth century. This is followed with a caveat regarding the statistics provided by the Greek government in the past. Access to the European monetary union is the topic of the next section. Then comes a discussion of the apparent boom brought by accession to the euro. The chapter ends with a simplified model of the dynamic of the crisis in Greece.

The Incubation of Modern Greece

Three groups competed for power in Greece under the Ottoman Empire (fifteenth to nineteenth century): the *Phanariotes*, the *Armatoloi* and the *Klephtes*. The *Phanariotes* were families in Constantinople who were recruited by the Ottomans to govern Greek territories in their stead. They were analogous to, if not part of, the network of *muhtar* through which the Ottomans administered their territory. The *muhtar* were the equivalent of village headmen who had a feudal relationship with their villagers and with their Ottoman superiors. The *Phanariotes* were thus part of the Ottoman system and enjoyed a feudal relationship with their villagers. They conflicted with the *Klephtes* who avoided Ottoman governance and lived by brigandry in the more rugged areas of the Greek hinterland. The *Armatoloi* were various Greek militia recruited by the Ottomans to police the *Klephtes*. In fact, however, the *Armatoloi* were often recruited from the most powerful of the local *Klephtes*.

As Ottoman power waned, the *Armatoloi* and the *Klephtes* gave rise to military resistance, while the *Phanariotes* indirectly contributed to the intellectual resistance. Although they had the liability of adhesion to the Ottoman regime, their tradition as patrons of culture and education both introduced modern ideas into Greek intellectual circles and (in doing so) served as exemplar to a new source of support for intellectual and cultural foment: wealthy merchants in the shipping centres. As a result, the periphery was at least as important as the capital in the assertion of Greek nationhood. Further, the intellectuals' efforts to purify Greek, for example, created a gap between themselves and the populace.

Greek resistance to the Ottomans would have been insufficient to gain independence had it not been for the intervention of three great European powers of the time: Great Britain, Russia and France. These powers instituted a monarchy in the person of Otto von Wittelsbach, the second son of the King of Bavaria. The monarchy thus added another rallying point for factions for and against, so that subsequent Greek political life has been fragmented from its inception, and some of the calculating participation and rebelliousness of the *Klephtes* have continued to prosper, perhaps among most Greeks.

When Greece did become independent of the Ottoman Empire in 1832, it took only a few months for the country to become bankrupt. This is somewhat understandable after emerging from under the oppression of the Ottomans. There was very little infrastructure and expertise in terms of governance. More serious than the economic failure of the first year of existence, however, was the reality of that no political faction dominated. The next 150 years of Greek social history would be marked by that fact. In fact, feudal relationships persisted under the thin veneer of succeeding monarchical, democratic and dictatorial regimes.

A notable contribution to Greek progress in the nineteenth century was the political life of Charlilaos Trikoupis who both curbed the power of the (basically foreign) monarch and spent state monies on infrastructure, the Corinth canal in particular. Unfortunately, this spending would lead to another Greek bankruptcy in 1893. The Balkan wars (1912 or 1913) and the First World War (1914–1918) led to an expansion of Greek territory that was later somewhat reduced by the Treaty of Lausanne of 1923. This expansion further added to the burden of governance in a country that was already suffering from a weak and divided central government. The Greek and Turk populations were not all situated within the boundaries of the respective countries and this would lead to massive migration of ethnic Greeks back in to their old land as well as the exodus of Turks. Again, the expanded territories were marked by both ethnic and religious diversity, with Muslims and Jews present as well as Christians. While such diversity can be a beautiful thing in a stable regime with a stable economy, it contributed to the volatility of politics in Greece.

Anecdotal evidence suggests that another circumstance can be added to this list of destabilizing factors: the ease of subsistence on the Greek Islands and the ability of locals located there to live comfortably in relative isolation from the central government.

In the decades before the Second World War, Greece abolished the monarchy (1924), restored it (1935) and then tried a right-wing dictatorship (1936) under Ioannis Metaxas.

During the Second World War, even the fiercely effective Greek resistance under German occupation manifested a deep political divide within the nation: the National Liberation Front, by far the largest of the three principal resistance groups, was affiliated with the Greek communist party, whereas the National Republican Greek League and the National and Social Liberation were both anti-communist and republican.

Unsurprisingly, the close of the Second World War and the liberation from the Nazis led to a civil war between the communists and anti-communist factions. Foreign influences were important for the evolution of this civil war: US-led North Atlantic Treaty Organization (NATO) wanted a non-communist regime, whereas Tito in Yugoslavia supported the communist forces (Stalin in Russia saw this as being an unrealistic objective). The final outcome was victory of the anti-communist faction and a purging of the pro-communist ranks, leading to a series of governments where the political influence of the left was markedly diminished. These governments benefited from the Marshall Plan's modest improvements of economic conditions. Britain was no doubt influential in this regard, and the transfer of the protectorate from Britain to the USA brought Greece into the fold of the Truman doctrine. The monies coming in with the Marshall Plan were accompanied by large foreign investments that helped build up infrastructure and placed in some key industries such as shipping, the chemical industry and tourism. The economy grew an average 7.7% annually from 1950 until 1973, which was to be the strongest period of real growth for the Greek economy in the twentieth century, as it was for the rest of Europe. Although growth was very strong, the industrialization of Greece remained incomplete (Pagoulatos 2003). The obvious growth in prosperity perhaps distracted attention from the continuing political uncertainty.

The monarchy had remained a factor during this time. A 24-year-old Constantine came to the throne in 1964.[1] Amid numerous transactions, influences and scandals involving various factions, the new king played midwife to a series of governments through to April 1967. When the next election threatened to return a communist government, a military coup on April 21 initiated a new series of military governments, the "Regime of Colonels," that came to an end with Turkey's invasion of Cyprus in 1974 (Allison and Nicolaïdis 1997; Frucht 2004).

Multiparty elections were held in November of that year and a new republican constitution was declared in June 1975. Democracy had arrived for the duration, but the history of Greece over the last few centuries had led to a situation where extreme pork-barrel politics (spending money locally strictly to garner support without reference to an overall economic plan) would be the norm while democracy remained a veneer over the almost feudal reality of clientelism (political power maintenance via the distribution of privileges and favours).

The Economy in the 1980s and Early 1990s

The Greek economy performed well until 1980, then faltered. The following subsections examine fiscal policy, monetary policy and financial regulation and the macroeconomic environment (in particular, the evolution of the GDP) in order to have a better understanding of this change in economic performance and of the state of the Greek economy both when it prepared to enter into the euro monetary union and at the time of crisis.

Examination of fiscal policy will show that the main contributor to the growth of Greece's debt was a form of Europeanization consisting in transfer of payments to households: establishing a social support net with health services, unemployment insurance, pensions and so on. This occurred with a lag of 20 years behind the European welfare state and continued on until the crisis. The de facto monetary policy was more the economic consequence of other policies and was characterized by a series of devaluations of the drachma (that should have made Greek produce more competitive) and serious inflation. Still, the 1980s and 1990s saw increasing deregulation of finance as both this inflation and requirements of the European Community brought pressure to bear. Examination of the macroeconomic environment will reveal slowed growth of GDP and raise the question of productivity, subject of a subsequent section.

Fiscal Policy[2]

Greece joined NATO in 1980 and in 1981 became a member of the European Community (and ultimately the European Union). This led to an influx of funds and a context of apparent increase in prosperity. Greece began to resemble the rest of wealthy Europe.

The appearance of increased prosperity was then enhanced by the fiscal policies of the various governments elected to power. While the economy grew anaemically, the government budget quadrupled in 15 years from 112 billion drachmae in 1977 to 482 billion drachmae in 1992 (in constant 1970 prices) (Charalambis et al. 2004, p. 349). The country began to run deficits from the mid-1970s onward (Fig. 5) and these deficits

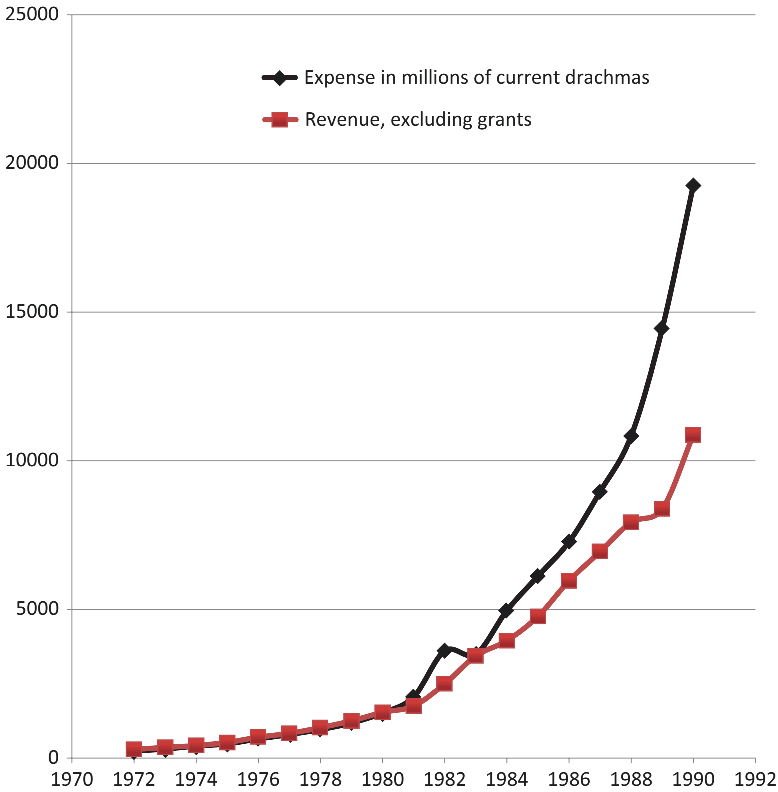


Fig. 5 Greece, government revenues and expenses 1972–1990

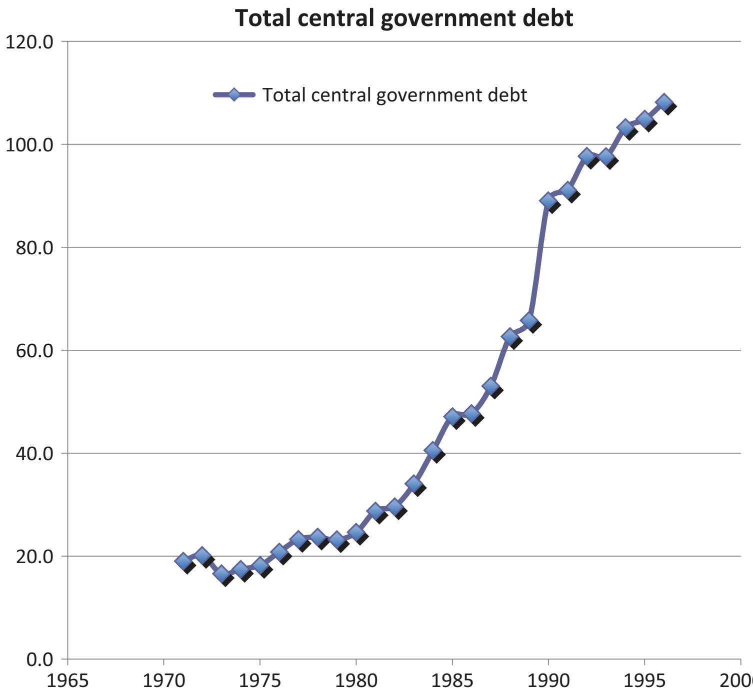


Fig. 6 Greece, central government debt as percent of GDP (Source: Reinhart, Camen M. and Kenneth S. Rogoff, "From Financial Crash to Debt Crisis," NBER Working Paper 15795, March 2010. Forthcoming in American Economic Review. http://www.carmenreinhart.com/user_uploads/data//222_data.xls. Accessed July 8, 2017)

accumulated to constitute a huge public debt equal to the annual domestic product (Fig. 6). Servicing this debt proved expensive from the late 1980s up to the onset of the euro, at which point Greece was flooded with cheap money until creditors learned to discern between the European Union and the diverse economies of its member countries. The interest rates for Greece then soared because of the danger that the country might default on its accumulated debt. Such was the crisis.

A few unsustainable gestures towards a balanced budget were made in the 1980s and 1990s, but the reality is that both socialist and conservative Greek governments spent more money that the economy could bear, let alone justify. Governments of most OECD countries were outspending the wealth-producing capacity of their economies in the 1980s and

1990s, but Greece outspent most. The only exception was the 1990–1993 Konstantinos Mitsotakis government, which cut spending, introduced reforms and then, as a result, lost the elections.

A government's budget redirects the wealth produced by a country to two purposes: (1) covering the cost of governing and (2) redirecting part of the wealth to ends imperfectly serviced by market forces (sanitation, education, etc.). The more wealth produced, the greater the ability of the government to supplement the market. Occasionally, government can finance the country's way out of a current impasse by spending future wealth: stimulating the economy deficit spending.

Clearly, the funds were spent for other reasons than increased costs of governing or stimulating the economy. Although governments from 1974 until recently have been formed by either the Panhellenic Socialist Movement (PASOK) or Karamanlis's conservative New Democracy Party, the diversity of influences and the trafficking of feudal-like favours and services (such as contracts or preferential regulations) continued, reaching a greater, national scale via fiscal policy.

This is not merely an impressionistic portrayal of Greek government. At the turn of the twentieth century, government was completely decentralized in Greece, with local elites running schools, hospitals, and so on. After the First World War, Kamaras (2011) tells us, as local trustees were replaced by centrally appointed bureaucrats, "Long-established, autonomous local elites were displaced in the 1920s, their place taken by a new group of people adept at managing a rent-seeking relationship with the state." This proficiency involved buying off union leaders, hanging-on with one faction or another and spending money to do favours. "Not a single region or city of note mobilized its resources in pursuit of economic success, based on international competitiveness. Instead all major localities channelled central government resources into patronage" (ibidem).

After the regime of colonels, this system was restored under the cover of democratic elections of two opposing parties controlled by Greece's two or three most powerful families (the Karamanlis, Mitsotakis and Papandreou) (Barber 2015).

An analysis of government budgets from the regime of colonels until the adoption of the euro reveals no particular strategy, with the only noteworthy development being the mushrooming importance of the finance ministry. Eventually, expenditures were first debt service and second tactical, with tactics reduced to maintaining the power base of the governing party. As for the debt, the can was repeatedly kicked down the road: there was no attempt to contain it or manage it.

The power base of political parties was nurtured and maintained partly by government spending on households while in power. An examination of government expenditures makes it clear that such a transfer of funds did occur.

Table 1 gives the revenue and expenditure for the central Greek government from 1978 to 1990 using data collected on an administrative basis. As a reference, since the relevant statistics are not adjusted for inflation, prices in 1990 are roughly eight times higher than in 1978.[3] Government revenue goes up almost 12-fold, but expenditures increase 18-fold. When inflation is taken into account, revenue increased 50% and expenditures 225%.Unfortunately, the OECD surveys that are the source of the data (ultimately supplied by the Greek authorities) are not consistent from year to year, so it is not possible to further analyse expenditures. However, the surveys also furnished data based on national accounts-based collection, and these data are more consistent in their detailing of expenditure items.

Table 2 gives the revenue and main expenditure items for the central Greek government from 1978 to 1990 as reported on a national accounts basis. Revenue goes up 11-fold which is 35% more than the inflation rate. Current expenditure increases 16-fold, double the inflation rate. The most exceptional expenditure item is interest on public debt, which increases almost 60-fold. The consumption of goods and services by government increased tenfold, only marginally greater than inflation. Transfers and subsidies increased 15.59 times, about twice the rate of inflation.

Interest payments are not at the discretion of government but are a consequence of debt due to previous choices. Thus, transfers and subsidies are the obvious causes of discretionary increases in government expenses. These are not detailed as part of the central government expenses but are available in the general government data. "General government" includes central government, local governments, the social security system and a few other government-related items.

Table 1 Greece central government revenues and expenditures in billions (thousands of millions) of drachmae, 1978–1990, based on data collected on an administrative basis, not for national accounts

Item/year	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
Revenue	248.2	312.3	358.2	431.7	634.5	809.9	1010	1310	n.a.	1724	1929	2126	2878
Current expenditure	239.7	312.6	369	602.8	766.7	956.1	1181	1514.4	n.a.	2117	2573	3297	4299

Adapted from OECD Country Surveys 1981–1982, 1985–1986 and 1991–1992. The figures are taken from tables for "Budget plans and outcomes" and are presumed to be for central government where this was not specified. Detailing of expenditure items varied across surveys so this table does not provide a breakdown of expenditures. Capital expenditure was not always specified and so was not included. The data were supplied by national authorities and are not perfectly consistent across survey years. In the case of discrepancies, the most recent survey data were used. The variations were rarely over 3% and do not obstruct the discernment of general trends

Table 2 Greece central government revenues and expenditures in billions (thousands of millions) of drachmae, 1978–1990

Item/year	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
Current revenue	214.5	267.7	315.0	340.8	471.6	581.4	762.3	901.2	1174.6	1395.1	1558.5	1662.9	2333.4
Current expenditure	241.4	289.8	354.0	512.4	622.8	748.2	965.2	1285.2	1477.4	1829.3	2327.0	2869.6	3843.9
Goods and services	147.7	180.0	212.8	282.2	358.3	432.0	540.8	675.7	751.0	863.4	1051.2	1259.1	1526.1
Interest on public debt	19.7	30.8	41.2	65.3	66.6	103.0	162.3	238.8	295.2	407.9	549.4	631.2	1164.0
Transfers and subsidies	74.0	79.0	199.0	165.0	197.9	213.2	262.1	370.7	431.2	558.0	726.4	979.3	1153.9
Deficit	−26.8	−22.1	−39.0	−171.7	−151.3	−166.8	−202.9	−384.0	−302.8	−434.2	−768.5	−1206.7	−1510.6

Adapted from OECD Country Survey 1991–1992, p. 98, and 1986–1987, p. 64. Data collected on a national accounts basis and differ from that collected on an administrative basis. The figures for 1988–1990 were provisional

Perhaps an examination of general government revenue and main expenditure items can give a better insight into the evolution of fiscal policy in Greece over the 1980s. Table 3 gives the revenue and main expenditure items for general Greek government from 1978 to 1990. Detailed expenditures for transfers to businesses and to households are missing for 1978–1980, but can be estimated based on the ratio to total transfers for 1981. Using that estimate, transfers to individuals or households increase 17-fold, about twice the rate of inflation, while transfers to business increase fivefold, markedly less than the inflation rate.

Converting these same figures to a percentage of GDP (Table 4) allows an appreciation of the importance of these expenditures within the economy of Greece. Current expenditures represented 59% of the economy in 1990. Again, the two items of expenditure that grow the most are transfers to households and interest payments. Strikingly, the importance of transfers to business actually decreases. Government was giving more and more to households, thereby going deeper into debt and paying increasing interest as a result.

There are at least two interpretations of government actions in sending so much money to households.[4] One is an effort to "Europeanize" Greece, bringing the social security net to the level of wealthier European countries. The other interpretation is that of rampant clientelism. In either case, it is clear that the governments were spending more than the economy could bear, given the macroeconomic environment examined in the next section. A poor couple may wish to send their child to Princeton, but that child may have to begin working instead. Not only can the parents not afford the academic fees, but also they need the additional income from the young man or woman's job. Government spending by Greece was expanding, but the economy was not (Fig. 7). GDP in constant dollars increased minimally in the 1980s. Better health care, unemployment insurance and more generous pensions were all desirable, but the economy was not producing enough wealth to provide them. So the government borrowed. And debt accumulated, as Fig. 8 shows. The government had crippled the wealth-producing capacity of the nation, but spent wealth to "Europeanize" it. It could only borrow money.

Table 3 Revenue and expenditure items, general government 1981–1990

Item/year	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
Current revenue	349.7	437.7	516.8	590.8	823.5	1021.5	1303.1	1581.3	1938.1	2255.3	2549.3	2778.7	3584.1
Current expenditure	347.4	425.0	517.9	730.4	943.3	1163.7	1508.0	2001.3	2345.2	2747.9	3331.2	3998.0	5210.9
Consumption	185.2	233.5	280.1	368.6	471.2	579.4	742.8	942.1	1067.2	1224.8	1507.6	1803.3	2229.1
Interest payments	19.7	30.8	41.2	65.3	66.6	113.0	173.3	247.0	316.4	448.9	592.1	722.8	1262.5
Transfers and subsidies	142.5	160.7	196.6	296.6	405.4	471.3	591.9	812.2	961.5	1074.3	1231.5	1471.9	1719.3
Business	n.a	n.a.	n.a.	76.3	75.7	66.3	76.5	137.6	153.8	152.1	122.0	143.6	176.2
Households	n.a	n.a.	n.a.	218.5	326.6	399.6	511.6	670.3	802.6	918.1	1104.4	1323.1	1537.5
Rest of the world	n.a	n.a.	n.a.	1.8	3.1	5.4	3.9	4.3	5.1	4.1	5.2	5.2	5.6
"Saving" or loss	2.2	12.7	–1.0	–139.6	–119.8	–142.2	–204.9	–420.0	–407.0	–492.6	–781.9	–1219.3	–1626.8

Source: Adapted from 1991–1992 OECD Country Survey for Greece, p. 98, and 1986–1987, p. 64. The figures for 1988–1990 were marked provisional, probably pending the revision for the European Standard Account

Table 4 General government revenue and expenditures as percent of GDP

Item/year	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
Current revenue	29.29	29.73	29.23	28.82	31.98	33.17	34.24	34.24	35.14	36.04	33.87	36.70	40.64
Current expenditure	29.10	28.87	29.29	35.63	36.64	37.79	39.62	43.34	42.53	43.91	44.26	52.81	59.09
Consumption	15.51	15.86	15.84	17.98	18.30	18.82	19.52	20.40	19.35	19.57	20.03	23.82	25.28
Interest payments	1.65	2.09	2.33	3.19	2.59	3.67	4.55	5.35	5.74	7.17	7.87	9.55	14.32
Transfers and subsidies	11.94	10.92	11.12	14.47	15.75	15.31	15.55	17.59	17.44	17.17	16.36	19.44	19.50
Business				3.72	2.94	2.15	2.01	2.98	2.79	2.43	1.62	1.90	2.00
Households				10.66	12.68	12.98	13.44	14.52	14.55	14.67	14.67	17.48	17.43
Rest of the world				0.09	0.12	0.18	0.10	0.09	0.09	0.07	0.07	0.07	0.06
"Saving" or loss	0.18	0.86	−0.06	−6.81	−4.65	−4.62	−5.38	−9.10	−7.38	−7.87	−10.39	−16.10	−18.45

Source: OECD Country Surveys of Greece

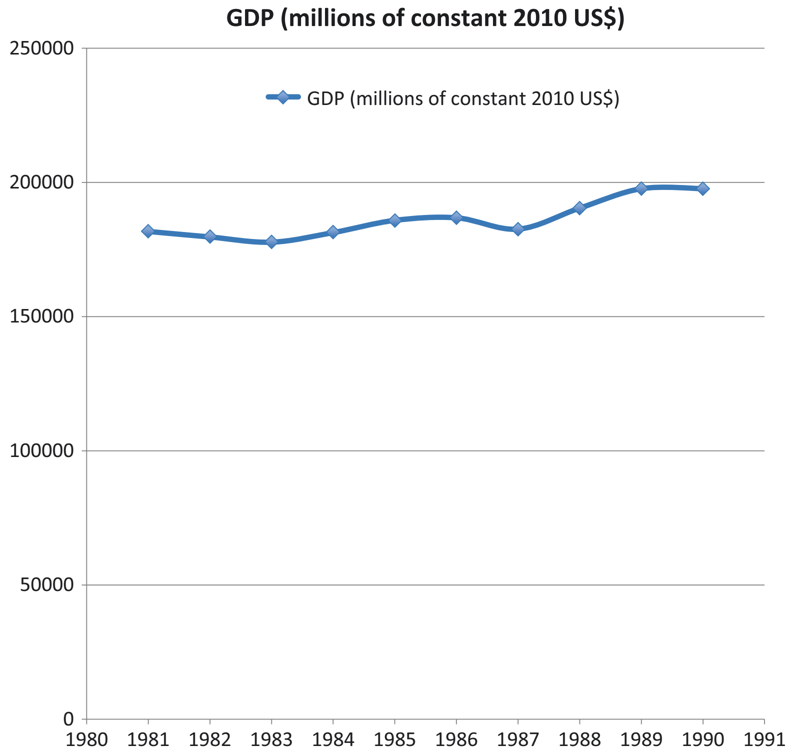


Fig. 7 Greece, GDP in constant US dollars

Monetary Policy and Financial Deregulation

The Greek government set up the Currency Committee after the Second World War [1946] with the mission of controlling the exchange rate, money supply and interest rates as well as bank credit in Greece. The Minister of National Economy was chairman, and four other ministers sat on the committee, assuring proximity to the government. The governor of the Bank of Greece also sat on the committee.

The dismantlement of Bretton Woods and the first oil shock led to higher inflation in the mid-1970s. The Currency Committee responded by reducing bank credit (already mostly limited to SOEs) and the money supply. The drachma was pegged to the dollar until 1975, and so

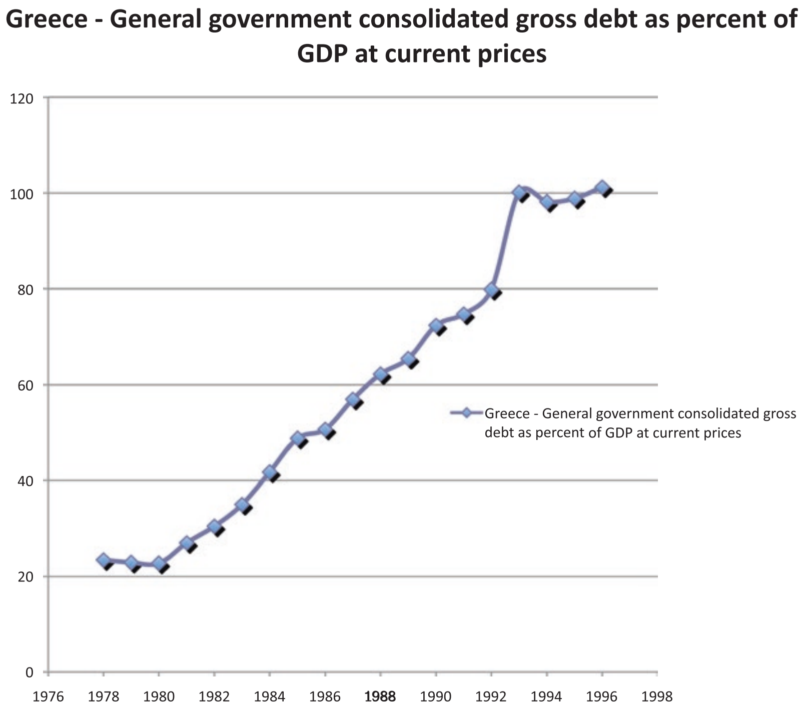


Fig. 8 Greece, general government debt as percent of GDP 1978–1996

accompanied it in devaluations in 1971 and 1973. After 1975, a crawling peg to a basket of currencies (of principle trading partners) was set up. Under this system, the Currency Committee revised the exchange rate to correct for the balance in the current trade account—in other words, devaluing the drachma to promote exports when there was a deficit. The result was effectively a 9% annual devaluation until 1982 (Pagoulatos 2003, p. 86). In 1982, a new government dissolved the Currency Committee and made the Bank of Greece into an implementer of monetary policy as conceived by the government. Two devaluations of the drachma followed. In 1983, the drachma was devalued 15.5% against the US dollar. In 1985, the drachma was devalued another 15%. These devaluations occurred in a context of high inflation, in part the fruit of the expansionary policies (increased spending) of government from mid-1970s. Since interest rates were regulated, the high inflation translated into negative real interest rates until 1987.

The Maastricht treaty was signed a few years later on February 7, 1992. As a consequence, subsequent policy sought to fight inflation. Greece entered the European Exchange Rate Mechanism in March 1998 at an exchange rate of 357 drachmae to one European currency unit, an implied devaluation of 12.1%. Large inflows of capital and other factors strengthened the drachma, and it eventually converted to the euro at 340.75 drachmae to a euro in 2001.

The 1982 dissolution of the Currency Committee was a first step towards liberalizing finance in Greece. Pagoulatos (2003, Appendix 3) lists nearly 60 measures of deregulation introduced from that time until 2000. A ceiling on short-term lending and credit restrictions to most businesses were abolished in 1988. In 1989, interest rates on loans to SOEs were deregulated. The year 1990 saw the election of the *Nea Dimokratia* party with its liberal economic philosophy, and the pace of deregulation quickened. These measures proved unpopular and 1993 saw PASOK come to power. However, PASOK had warmed to the project of the European monetary unit and continued the liberalizing policies of the party it had defeated in elections. Consumer credit (to some degree in 1994) and housing loan interest rates (1996) were deregulated. The 1990s provided consistent liberalization of finance. Private business gradually acquired the financing needed to become competitive[5] and its domestic clientele was getting the funds to make purchases. The question was whether this funding had arrived in time, since trade liberalization had already occurred earlier.

The Macroeconomic Environment

The average annual growth rates of the GDP, which had been 7.6% in 1961–1970, dropped to 4.7% in 1971–1980 and then to 1.4% in 1981–1990. Growth had slowed when the regime of Colonels ended. The GDP per capita of Greece in "1990 international dollars" quadrupled in 22 years, from 1951 in 1950 to 7779 in 1972 and then grew a mere 50% in the next 20 years (to 10,314 in 1992) (Fig. 9). Real per

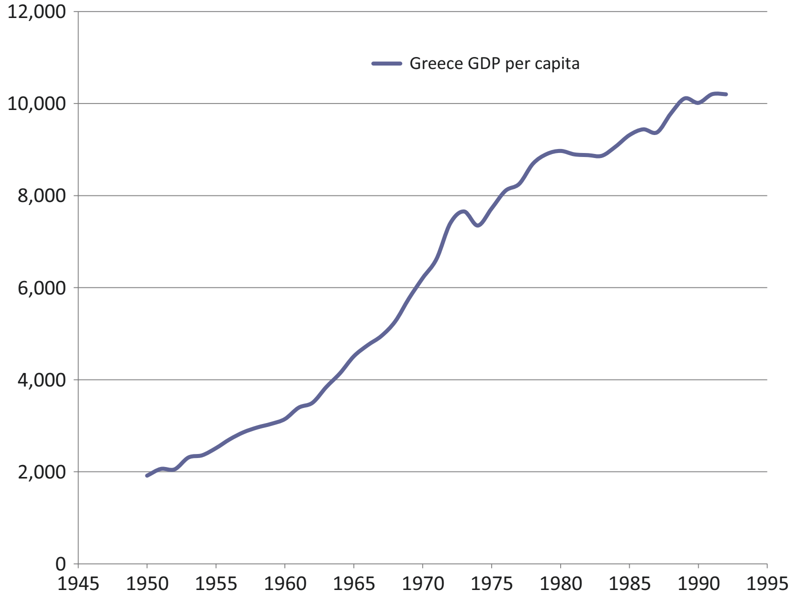


Fig. 9 Greece, GDP per capita

capita GDP growth for those periods was 6.2% and 1.5%, respectively; annual average compound GDP growth rates were 7.0% and 2.1%. The profile of faster growth from 1950 to 1972, followed by slower growth until the early 1980s, was shared with Europe and most of the rich West. Greece had been expected to grow more quickly than these other countries because supposedly it was catching up to them.

GDP per capita stutters twice in the 1970s and then flattens in the 1980s (Fig. 9). The impact of the oil shocks in 1973 and 1979 could presumably explain this behaviour, and indeed the curve is similar for other countries, as shown by Fig. 10, but with the difference that OECD countries by and large recovered more quickly and went on to manifest growth in GDP per capita from 1983, while Greece continued to flounder.

Many things happened to and in Greece in that decade, and it is difficult to discern between causes and circumstances: in 1981, Greece joined the European Union and elected a Socialist government (the

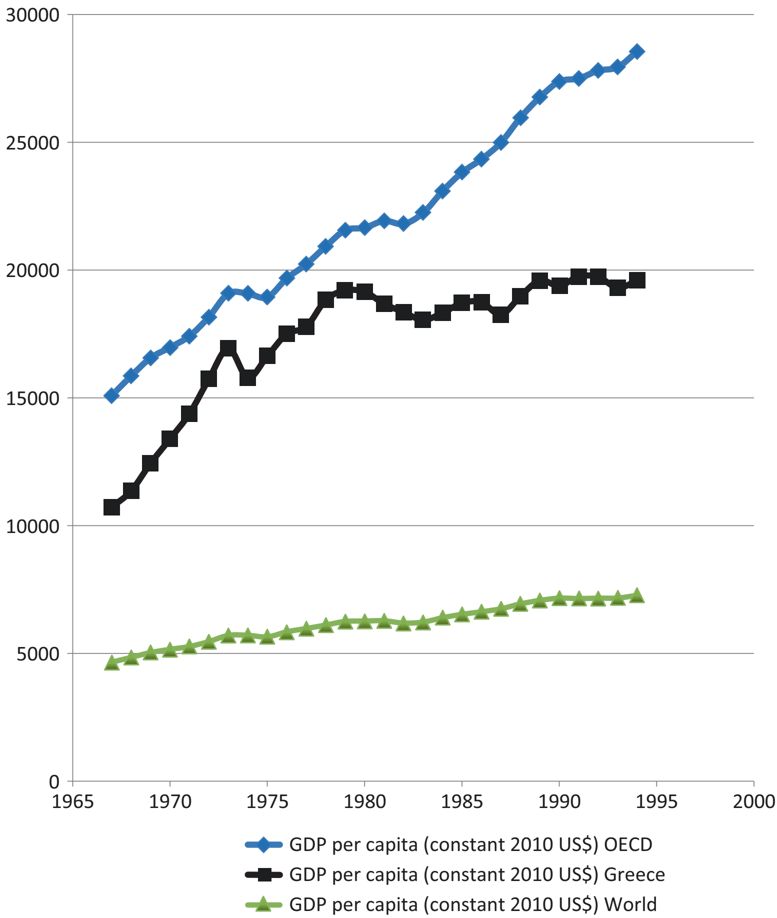


Fig. 10 GDP per capita compared 1967–1993

PASOK party) that remained in power until 1989/1990. Some blame the entry into the European Union for the poor economic performance, while others blame the change of policies with the new government. Both factors were important, but it is important to understand the mechanisms involved rather than invoking ideology. The policies of government were examined in the earlier subsection on fiscal policy. The next section analyses the factors explaining the variation in GDP.

A number of other events are also linked to the change in Greece's growth rate: the end of the military dictatorship, the two oil shocks of the 1970s and the low liquidity of the early 1980s. Although any one of these events or their combination might possibly explain a temporary slowdown in economic growth, they are insufficient to explain why Greece today has yet to catch up with the richer countries of Europe (Mylonas and Papaconstantinou 2001, p. 501; Cordon 2001, p. 599).

Slowing Productivity Growth as a Prelude to Access to the Euro[6]

Slowing GDP growth meant that the growth in Greece's production of wealth was slowing. This section explains why this happened.

Changes in labour and changes in capital contribute to GDP growth. More people working, or the same people working longer, will produce more. The same people working with better tools and materials (acquired with capital) also produce more.

There are statistics for investment and capital formation in most countries, as well as statistics on the labour supply, allowing economists to estimate the contribution of each to GDP. For example, a growth in population or in the participation rate increases the number of workers producing and thereby the GDP at a given level of productivity. There remains a portion of growth unexplained by either labour or capital, and this portion might be explained by a multitude of other factors, from technological change to variations in organizational efficiency and ease of doing business. This is called total factor productivity or multifactor productivity, or sometimes multiple factor productivity.

Bosworth and Kollintzas (2001) analysed the sources of growth for Greece over different time periods and also relative to the sources of growth in Europe. They found that the "rate of capital accumulation accounts for about 40% of the slowdown" with the remainder explained by the residual multifactor productivity component (p. 157). They further found that "relative to the rest of Europe, the break in performance seems more pronounced at about 1980, rather than 1973" (ibidem; see also p. 160) just as the above examination of the GDP per capita curve suggested.

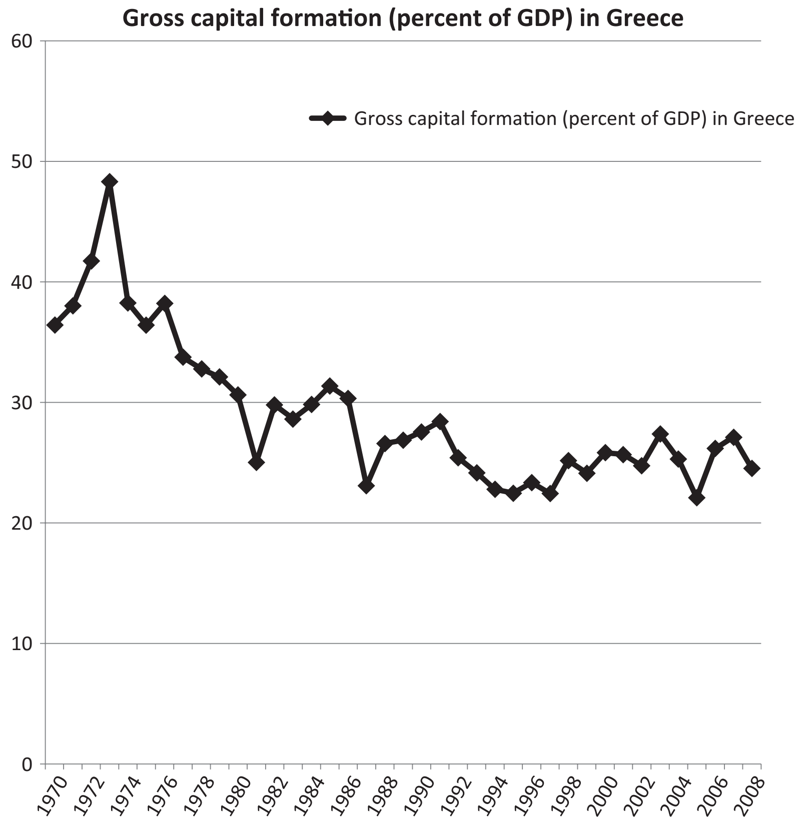


Fig. 11 Greece, gross capital formation as percent of GDP

Figure 11 illustrates the very dramatic drop in capital formation from nearly 50% of GDP in 1973 down to half that amount by 1981. Since then, it has oscillated within 5% of that value until the financial crisis. This seems damning evidence until compared with the curve of the same statistic for the euro area (Fig. 12). The rate of capital formation in Greece remained superior to that of Europe right up until the financial crisis.

Why did this superior rate of capital formation not result in greater growth? Did incompetent managers run Greek businesses? No. The reality was that much of the capital formation was happening outside of private business. Greek business paid for new machinery from profits,

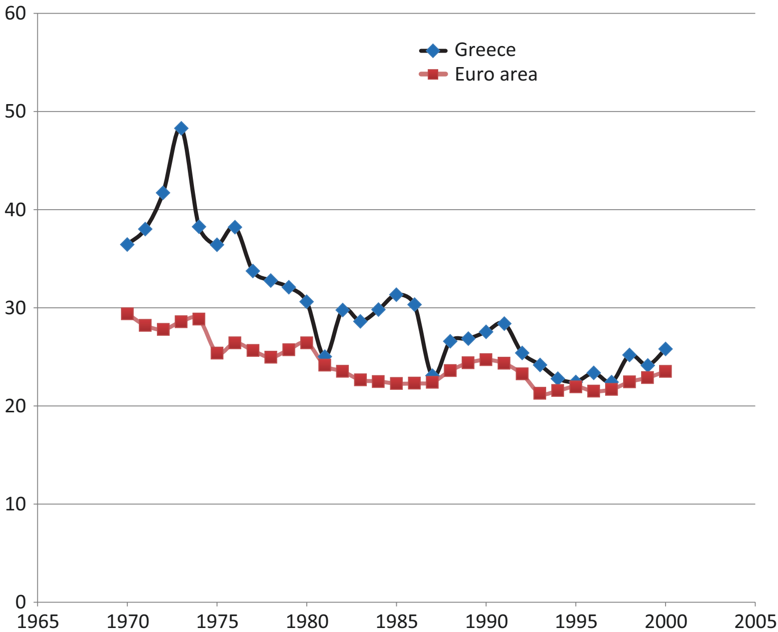


Fig. 12 Gross capital formation as percent of GDP, Greece and euro area

not with loans. Greece was a credit-starved economy and most of the little credit available was ill applied. Figure 13 shows that the Greeks got half the credit of other euro area economies as measured by credit to GDP. Much of the little credit there was went to SOEs or to supporters of the current governments. Ioakimidis (2000, p. 78) states, "the Greek state exercised decisive regulatory powers through the asphyxiating control of the banking system. The banking system was actually in the hands of the state, which distributed loans and other banking favours for purely political, clientelistic purposes." Most of the capital formation would thus be in the public sector,[7] including state-controlled enterprise and friends of the government, and was financed by state subsidies of various sorts more than by profits or by bank credit. As a result, output grew little in spite of massive capital formation.

Greece's productivity growth was greater from 1960 until 1973 than it has been since then. Of course, this is true for most of the Western world

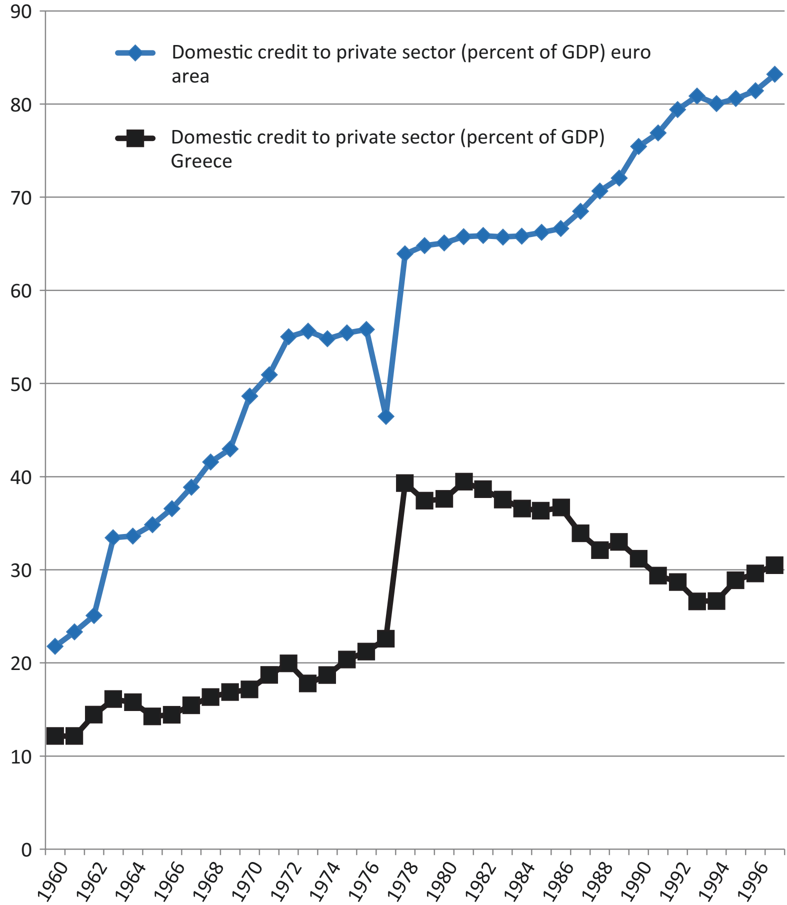


Fig. 13 Domestic credit to the private sector compared

and most of the developed economies. For example, the oil embargoes of the 1970s provided severe shocks to the economies of most countries and most experienced severe inflation and a recession in the early 1980s. Further, an element of the pre-1974 period is restrictions that limited wage demands and labour unions' power. What is striking, however, is that the change of growth rate is far more dramatic for Greece than it was for the rest of Europe. The growth rate for output per worker in Europe

Table 5 Contributions to growth of output for Greece 1960–2000

Period	Contribution by component: Growth of output per worker	Education per worker	Physical capital per worker	Multifactor productivity
1960–2000	3.6	1.8	0.5	1.3
1960–1973	9.7	4.2	0.4	4.9
1973–2000	1.0	0.7	0.5	−0.3
1973–1980	2.1	1.2	0.9	−0.3
1980–1990	−0.3	0.4	0.4	−1.1
1990–2000	1.4	0.5	0.4	0.6

Adapted from Bosworth and Kollintzas (2001, p. 158)

after 1973 was a little less than half the rate before that time (Maddison 2005, p. 11). The rate of growth for output per worker in Greece 1973–2000 was barely a tenth of that before 1973 (Table 5).

Massive misuse of capital meant that capital was not an important source of productivity growth, but were there no other factors that could increase productivity? Could not labour have contributed more to productivity growth? The population of Greece was stable, and the rigid labour market meant that there was little change in the number of hours worked, so labour on its own could not produce more. The explanation is to be found in the elusive residual factors (such as the organization of production economy wide, the ease of doing business, etc.) covered by "total factor productivity."

One might be tempted to look for a political cause since Greece was transformed into a democracy at that time. One might think that the cause of slowed growth was that the new governments used fiscal policy to garner the favour of the electorate. Examination of the data—questionable though those data are—will lead us to discern other forces at play without discounting the role of fiscal profligacy. In particular, much of the economic growth of the 1960s had been due to structural changes in the economy, with human resources moving from agriculture into industry and services, where they were far more productive. From a nineteenth-century-like proportion of 70% agriculture, 20% industry and 10% services, Greece had evolved towards a somewhat more modern profile. The reallocation of labour then slowed and, to a large extent, this explains why productivity had increased up until 1973 and then stagnated.[8]

Table 5 illustrates how the contribution of capital to labour productivity remained stable through the 1980s after a push from 1973 to 1980, while the multifactor contribution to productivity diminished substantially after 1973.

After hovering around a 30% improvement compared to 1960, labour productivity in Greece actually began to *decrease* in the 1980s. Even the curve for GDP per capita in Fig. 9 above manifests this decrease. Somehow, the value of output per worker was diminishing. Why was this?

Popular opinion can conjure up images of lazy Greek bureaucrats taking two different salaries and doing very little work. Two facts about the Greek economy belie this image: a large portion of the Greek population has been self-employed and, among those gainfully employed, the working week is the longest in Europe at 42 hours. Also, "Greece comes second [for annual working hours, after South Korea] in the OECD's rankings with 2052 hours worked on average each year" (Olson 2008). Of course, this does not dispel the myth of lazy Greeks. One might argue that the "lazy Greeks" were the cause of the productivity drop and, because of the productivity drop, they had to work longer just to keep their head above water. Or again, if you count the hours in two different (and simultaneous) "jobs" you will quickly break records for the number of hours "worked." It should be added that the European workweek is short even for the average advanced economy, let alone one that was dominated by agriculture a generation earlier.

Nonetheless, there are no hard data to explain Greece's stagnating economy on "the lazy Greeks," and libel is not necessary to explain the productivity drop and the stagnation of the Greek economy.

Were the Greeks suddenly working less diligently? Or did Greek machinery enter a decline, suddenly becoming less reliable because they were poorly maintained? The explanation is not to be found within the borders of Greece but rather in its relations with the outside world.

As Greek businesses became exposed to European competitors, they were obliged to drop prices, so that the measured value of similar production levels decreased: the same number of items sold brought in less money. The erosion of trade protection began in the 1960s and by 1981 was complete (vis-à-vis Europe) for goods without Greek competitors and reduced by 60% (as measured by tariffs) for goods also produced in

Greece. The additional 40% reduction, along with the abolition of quotas, import taxes and other barriers, removed all trade protection of the Greek economy when Greece entered the European Union in 1981. Later, over the years 1987–1992, subsidies for exports to the European market were gradually eliminated. Thus, the domestic market became more challenging for Greek vendors, then the export market. Koukouritakis modelled the impact of the 1981 European Union accession upon Greece's trade balance and arrived at the following estimate: "In brief, it appears that if Greece had not entered the EU, the country's trade deficit in 1993 would have been about 65% lower than the actual figure. The cumulative impact of the EU accession amounts to 23% in terms of the Greek GDP in constant prices" (Koukouritakis 2004, p. 61).

The price of Greek products had to decrease to make Greek firms competitive. To an extent, this was achieved by the devaluations of the drachma in 1983 and 1985. There was thus a decrease in the value of the produce of Greek labour, with the consequent reduction in the measure of productivity as price produced per unit of time.

This explains the drop in productivity, but does not explain why business had not responded to the challenge of free trade by increasing productivity to compete for the domestic market (1981 and onward) and the greater European market (1987 and onward) (ibidem, p. 63).

There are two primary ways to improve productivity (excluding barbarous measures such as the introduction of whips and forced labour). The first way is to optimize the use of current resources. For example, it makes more business sense to offer employees a few hours week of overtime rather than to hire a new employee (who probably requires a period of formation, leading to unused hours of labour for that new employee) when the incremental increase of demand is insufficient to occupy the employee full time. That is better organization of current resources. The second way is to improve the resources used. For example, management can replace old equipment and machinery with more recent models that are more efficient. This requires capital. However, private businesses had limited access to capital beyond their own meagre profits.

There was little pursuit of increased productivity either way in the Greece of the post-1974 democracy. Entry into the European Union foresaw a grace period of transition for business and government to modernize production and logistics, restructuring Greece's economy to compete with its European confreres. This was not done. The structure of the economy was left relatively unchanged and businesses did not revamp to increase productivity. It is necessary to understand multifactor productivity, the great negative in the Bosworth and Kollintzas above, to appreciate why these changes were not forthcoming. Besides measurement errors, multifactor productivity covers management practices, organizational change, imperfect competition, rigidities and complications in the business environment and other factors that affect the optimal operation of businesses.

Rigidities in the institutional arrangements frustrated or complicated efforts to optimize business activity. The weak competitiveness of Greek firms should have led, in theory, to business decisions to improve productivity… unless there were obstacles to implementing those decisions. At that time, unions pushed for and the Greek government provided European-standard labour laws before Greek labour was productive enough to produce sufficient wealth under these laws.[9] As a result, businesses had to jump the gap between making minor improvements by using the same machinery for longer hours, to making major improvements by changing the machinery or the scale of factories. It would seem that this jump did not make business sense, because again, these changes were not made.

At the government level, few incentives were created to nudge the economy towards a competitive structure—for example, via larger firms.[10] The investment/savings profile of Greece (Pelagidis and Mastroyiannis 2003, p. 612) during the last two decades of the twentieth century meant that there was also very little in the way of machinery and equipment modernization at that time. Previously, Greece had maintained the higher level of investment and the higher level of capital formation necessary for convergence, but descended to the level of more advanced euro economies in the 1980s.

Mitsopoulos and Pelagidis (2011) observe that the mechanics of Greek society preclude reform. Their observations are of contemporary (2000–2020) Greek society, but apply all the more strongly to Greek society in the last quarter of the twentieth century. Interests that exploited the economy through the extraction of rents, corrupting or co-opting the administrative actors, dominated political activity. The political and administrative actors also co-opted the media. The political actors founded their support upon a voting population that was both misinformed and implicated in corruption. They were implicated in corruption because the most necessary acts from buying an apartment to consulting a doctor required them to acquire an apartment with illegal specifications, or to conclude an undeclared transaction. They were misinformed and ignorant because most government action was not transparent and was not a matter of public knowledge. Also, a small proportion of the population supplied most of the tax revenue, but these revenues were spent in the interest of the tax-evading majority. The end result is that the

> administration does not have the capacity to produce legislation that is adequate in the context of a global and competitive world market and that forces economic activity. Instead the administration is stuck in a mud of vague, contradictory and often irrational legislation that pushes up administrative costs, encourages the violation of these irrational laws, creates rents and provides the members of the administration with the ability to blackmail those who are economically active by issuing illegal remunerations and granting favours. This process can only be described as a failure of the legislature that results in high administrative costs. Any business initiative in Greece requires excessive time and costs, both legal and illegal. These costs are the revenue of the interest groups, which will of course defend them with all their powers. Meanwhile entrepreneurs that consider to incorporate these costs in their sale prices are quickly labeled by the media and the majority of the politicians as black-marketers and as guilty of "profit seeking." (Mitsopoulos and Pelagidis 2011, page19)

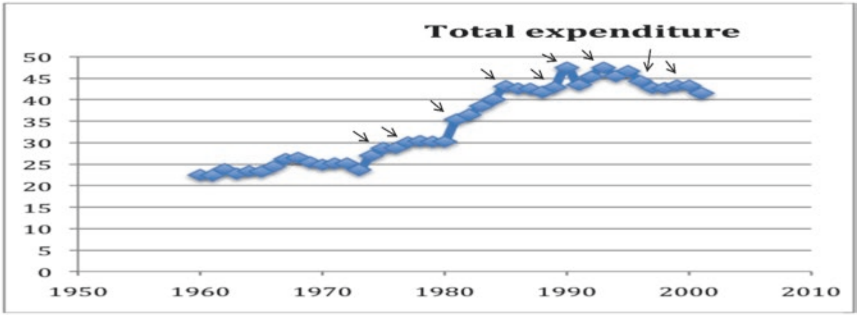
The hostile environment stifled any desires on the part of Greek business to improve productivity. When barriers to trade with the rest of Europe dissolved, this stifled effort manifested itself in decreasing productivity as prices dropped. When Greece joined the European Union in 1981, it appeared to come closer to the rest of Europe. However, Greece was not ready for that intimacy, because the transition period of the 1980s had been squandered. In the end, the only change was that the rest of Europe could more easily sell goods in Greece.

On the Statistics Provided by the Greek Government

There is room for scepticism regarding the data on Greek economic performance in general. Two sets of considerations nourish this scepticism: (1) political events and (2) comments in both OECD reports and a European report on the data furnished by Greece.

The first consideration regards political events, and one event in particular: government spending in the 1996 election year. The PASOK party came into power in 1993 under the leadership of Andreas Papandreou and remained in power until 2004. The party had originally rejected the European project, but warmed to it once in power and ultimately would run the government that made the bid to join the euro. Andreas Papandreou fell ill in November 1995 and died in June 1996. Costas Simitis was elected party president in the summer of 1996. He then called an election that the party won. "Simitis, indisputably one of the most pro-European figures in Greek politics, upon assuming power initiated a vigorous programme for Greece's Europeanization by, among other things, seeking to achieve the so-called 'convergence criteria' for the accession of Greece to the euro" (Ioakimidis 2000, p. 80). A deficit under 3% of GDP and a debt less than 60% of GDP were among the convergence criteria, so supposedly, the new government's efforts would involve a decreased deficit and eventually a surplus to decrease debt.

The government seemed to be delivering on this, although it contradicted standard election campaign practice in Greece. Increased expenditures are a classic technique to increase popular satisfaction with the incumbent government. Yet the figures indicate no increase in 1996. Over two decades, 1996 is the only election year without a notable increase in government expenditures (Fig. 14). One possible interpretation is that the succession of leadership and the suddenness of the election call distracted the party from the habitual increase of expenditures in preparation for the 1996 elections. Again, it could be that confidence in the new leadership made such expenditures seem unnecessary. However, such interpretations suppose the inner machinery of the party to have



Elections and victorious parties 1974-2009

Parties	'74	'77	'81	'85	'89	'89	'90	'93	'96	'00	'04	'07	'09
New Democracy (ND)	•	•			•	•	•				•	•	
Panhellenic Socialist Movement (PASOK)			•	•		•		•	•	•			•

Fig. 14 Greece, expenditures and elections 1974–2009 (Sources: OECD General government spending [indicator]. https://doi.org/10.1787/a31cbf4d-en [Accessed on August 23, 2017]; Nicolacopoulos 2005)

been impractical. Pragmatism and a killer instinct are more likely in politics, and the incumbent party did win the 1996 election. The suspicion is that expenditures did increase in reality, but that the data were massaged to bring Greece closer to the convergence criteria for joining the euro.

The second consideration nourishing scepticism about statistics on the Greek economy derives from reports from both the OECD and European authorities.

Commenting on an exceptionally dramatic revision of statistics by Greek authorities, a Eurostat[11] report observed that revenue and expense "figures for 2003 were revised by almost 3 percentage points of GDP. The government debt figures were also significantly revised (by more than 7 percentage points). Data revisions of such a scale have given rise to questions about the reliability of the Greek statistics on public finances… The reliability of Greek deficit and debt statistics has been the object of particular attention by Eurostat in the past… Statistical issues in this field were debated with the Greek statistical authorities far more frequently than with any other Member State" (Eurostat 2004, p. 2). The report further mentions that there had been discussions with Greek authorities regarding social security accounts since 1998 because of the magnitude of the surplus in contrast with other European Union states.

Several OECD Country Surveys on Greece bear witness to exceptional revisions of data or difficulties with the data supplied for the reports. These led to a substantial increase of deficit and debt figures from 1997 to 2003 (2005, p. 47); to upward revisions of GDP figures, for example, by 26% for GDP in the year 2000 (2007, p. 22); to an increase in deficits of 1¾% of GDP in 2008 and 2009 and an increase in debt of over 11% of GDP after correcting for errors due to methodological and governance issues (2011, p. 37).

The political and technocratic considerations suggest that the data for the 1990s are not reliable and cannot provide a basis for meaningful interpretation. However, the major upward revision of GDP estimates does imply that revenues as well as expenditures are key to the growing debt of Greece over the 1980s and early 1990s. Many authors point to tax evasion, particularly in election years.

A final element that destroys confidence in these figures is the revelation that Greece used a currency swap contract with Goldman Sachs to reduce accounting debt levels at the critical moment of evaluating Greece's compliance with the convergence criteria (Dunbar 2003; Phillips 2010). This suggests that other means also may have been used to improve the appearance of the performance by Greece.

Access to the European Monetary Union

After hesitant variation in GDP over the first few years of the 1990s due in part to accounting adjustments (Manessiotis and Reischauer 2001, pp. 121–123), Greece finished the twentieth century with steady growth in GDP (Fig. 15). Greece reported stable debt from 1994 to 2007.

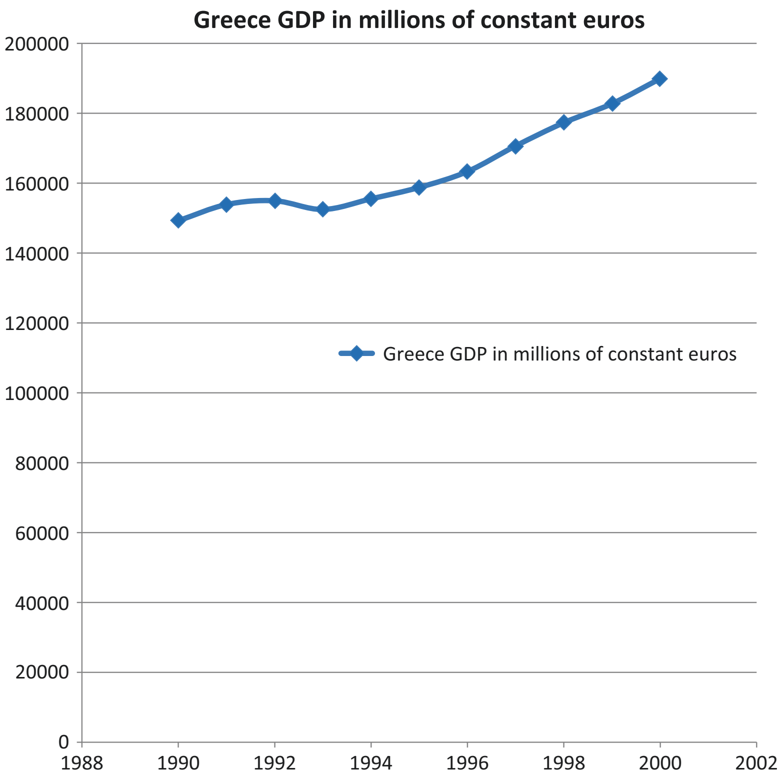


Fig. 15 Greece, GDP in constant interpolated euros

Interest payments decreased from 1994 onwards. This decrease can be explained by a sequence of two factors:

- the US dollar weakened over 1994–1996, easing the burden of debt in US dollars;
- later, interest rates for Greece dropped from 1996 onwards.

This drop in interest rates in turn would be explained by:

- the context, as the future euro area had dropping interest rates to 1999 (Fig. 16)
- the access for government funding from international markets (bonds, longer maturity, etc.)

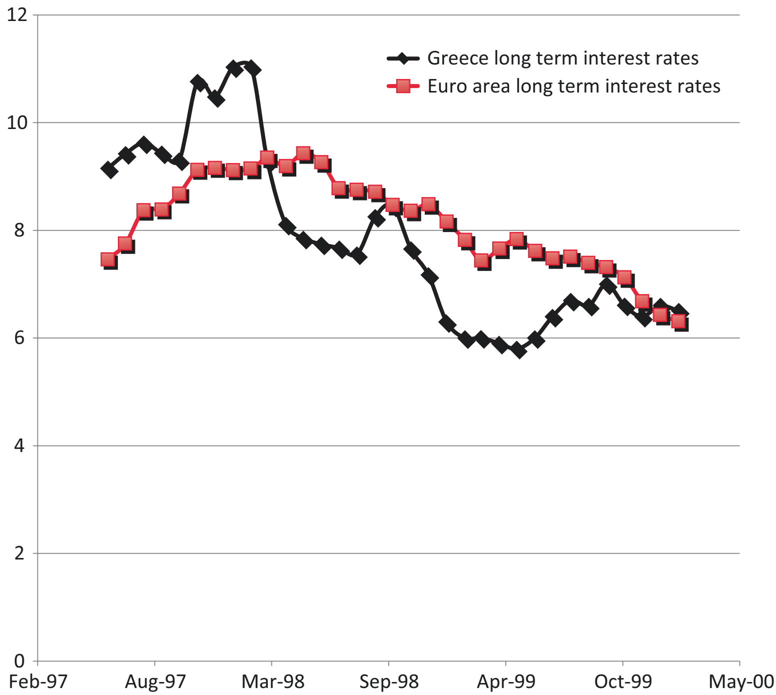


Fig. 16 Interest rates compared

- the fact that improved official figures would also inspire confidence in creditors
- finally, a confusion of the credit ratings for participating nations with the introduction of the euro.

The published data showed an improvement in Greece's economic performance, and it was on the basis of this apparently improved performance that Greece would be invited to participate in the euro.

On January 1, 1999, the national currencies of 11 European countries (Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain) were locked in fixed rates exchange against each other as the euro currency was introduced in electronic transfers and other non-physical forms. The physical currencies (bills and coins) were replaced by the euro on January 1, 2002.

In 1999, Greece was judged as not meeting the criteria established in the Maastricht (European Union) treaty. Few countries truly met the debt criterion in fact. Although Greece clearly did not meet with the debt and deficit criteria (Table 6), the cases of Belgium and Italy seemed similar. It is only when inflation and interest rates are taken into account that Greece stands apart, with quadruple the inflation and near double the interest of the three best-performing nations and rates well above those of any other nation.

Table 6 Contenders for euro participation with deficit and debt outcomes. All figures are in percent of GDP. Negative figures for deficit indicate surplus

	Debt 1997	Debt 1998	Deficit 1997	Deficit 1998
Austria	66.1	64.7	2.5	2.3
Belgium	122.2	118.1	1.9	0.6
Finland	55.8	53.6	1.1	−0.3
France	58	58.1	3	2.9
Germany	61.3	61.2	2.7	2.5
Ireland	66.3	59.5	−0.9	−1.1
Italy	121.6	118.1	2.7	2.5
Luxembourg	6.7	7.1	−1.7	−1.0
The Netherlands	72.1	70.0	1.4	1.6
Portugal	62	60	2.5	2.2
Spain	68.8	67.4	2.6	2.2
Greece	108.7	107.7	4.0	2.2

So, although Greece was not a participant for the electronic introduction of the euro, it is not that surprising that the grey zone of interpreting a trend towards compliance permitted Greece to join the euro on January 1, 2001, a year before the circulation of physical euro notes.

However, Eurostat, the statistics directorate general of the European Commission, repeatedly refused to validate data supplied by Greek authorities over the years 2002–2004, and this eventually led to the 2004 Eurostat Report on The Revision of the Greek Government Deficit and Debt Figures mentioned above.

In that same year Greece hosted the 2004 Olympic Games, which cost €9 billion euros to produce. The finance minister claimed that revenues were greater than these costs. Subsequent maintenance of the Olympic installations costs further hundreds of millions of euros per year. These figures were sources of controversy in the context of the financial crisis of Greece, but pale in comparison with the near €200 billion of debt and €17 billion of deficit in 2004. Still, Greece reported its largest deficit of the pre-crisis years in 2004.

An Apparent Boom

The update of Greece's Stability and Growth Program submitted by Greece to the European Commission in December 2006 reported "The positive macroeconomic developments of 2005 continued during 2006. Almost all short-term indicators of domestic demand and the external sector, following the upward trend of sentiment indicators, showed a significant acceleration, accompanied by a deceleration of core inflation and a decrease of the unemployment rate" (p. 5) and foresaw nominal GDP growth of over 7% through 2009 with inflation continually decreasing (p. 7), and a positive primary balance (surplus) from 2006 to 2009 (p. 12). These and similar figures led the IMF to summarize the progress of the Greek economy:

> Since the mid-1990s, the Greek economy has returned to strong growth, partly closing the income differential vis-à-vis the EU-15 average. In the last decade, GDP growth averaged 3.7 percent a year following, and partly

> coincident with strong macroeconomic adjustment: the general government deficit fell from almost 16 percent of GDP in 1990 to an average of 5½ percent since 2000 and consumer price inflation from around 20 percent to 3½ percent. (IMF 2006, p. 4 IMF Country Report No. 06/5)

There did indeed appear to be a boom in the economy of Greece from 1995 until the crisis. GDP per capita exploded from €15,033 in 1995 to €22,557 in 2008—an increase of about 50% in constant euros! (Fig. 17). The productivity difficulties also seemed to have been resolved, given that GDP per capita is a standard measure of productivity.

Why had GDP increased? Were Greek businesses suddenly more competitive and able to exploit the domestic and foreign markets with greater success? There were some real business booms in at least two key service

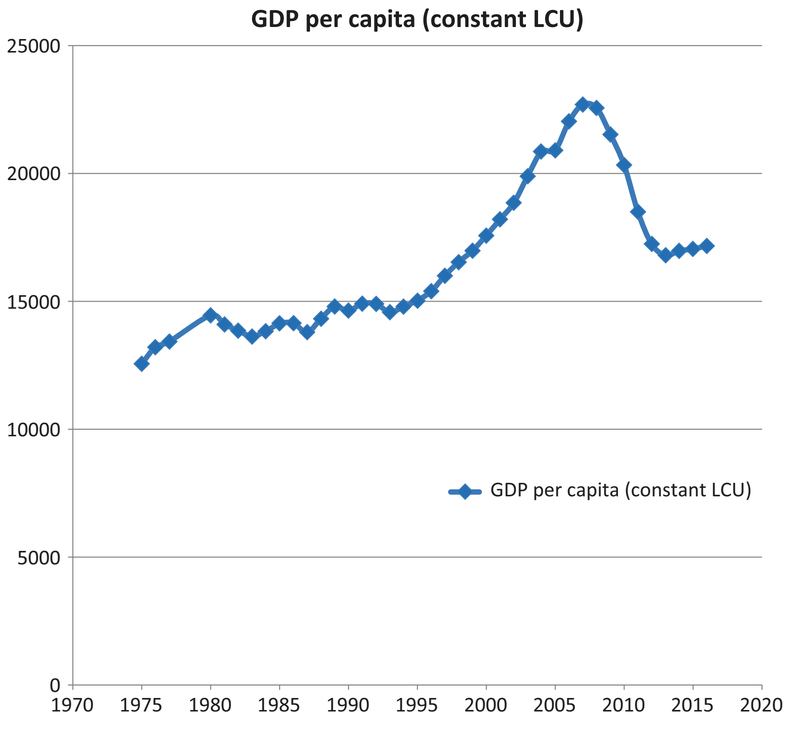


Fig. 17 Greece, GDP per capita in constant euros

industries that classify as exports: shipping and tourism. The rise of China and India's economies led to a great demand for Greek shipping services (de Quetteville 2004; Granitsas 2005) and the impact of the terrorist attacks of September 11, 2001, moved tourists from North Africa and the Middle East to Greece (Manolopoulos 2011). Exports of goods also increased, from current €5112 million in 1993 to €28,866 million in 2008. The prices in the euro zone had increased only about 30% during the same time span, so clearly Greek businesses were doing much better. Greek businesses were making room for their goods in the export market. Mitsopoulos and Pelagidis (2011) argue that the reforms of the 1990–1993 government and those required for accession to the euro created a more benign environment for businesses and led to this improvement.

However, the feat becomes less impressive when compared with other countries. Exports for the euro area were US$1.5 trillion in 1993 and US$5.6 trillion in 2008. World exports were US$4.9 trillion in 1993 and 19.7 trillion in 2008. Greece outperformed the euro area and the world in growth of exports by about 25% (Fig. 18). Dividing the figure for exports in one year by that for exports in the year previous gives us a measure of year-on-year growth in exports. The result curve shows inconsistent growth, and the notion of growing competence in the euro and domestic markets becomes even less convincing Fig.19 for year-on-year growth of Greece exports.

When imports are compared with exports (Fig. 20), it is clear that imports continued to be greater than exports and showed a more precipitous growth. Some of these imports were perhaps supplies to Greek exporters of goods, but it is clear that Greek consumers were consuming more than ever (Fig. 21). The contrast with the world trend is greatest from 1994 to 2002.

How was the rapid increase in consumption possible if Greek business was doing well, but only about 25% better than world performance in exports? What was the source of the monies for consumption? There are two parts to the explanation: household borrowing and government expenditure.

The first part of the explanation is that interest rates dropped with the onset of the euro, and Greek households took advantage of the low rates to increase debt (Fig. 22). In spite of this expansion of household debt,

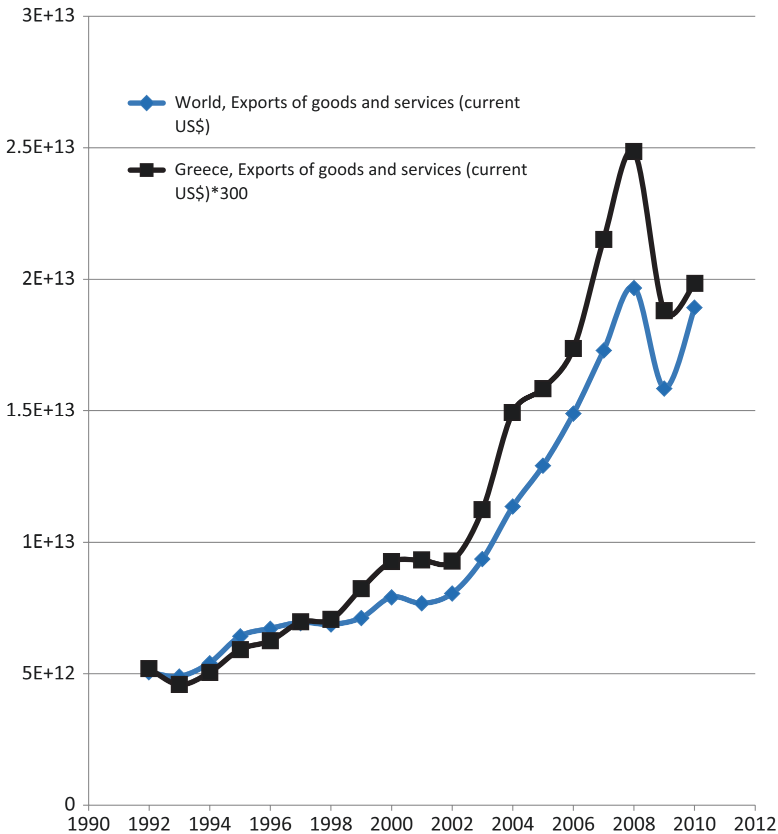


Fig. 18 Greece, World and Greece exports compared. The numbers for Greek exports have been multiplied by 300 for the purposes of visual presentation. Intersection points thus have no meaning; only the slope and shape of the curves are important

Greek households remain among the least indebted among wealthy European countries (Fig. 23). Further, this debt was predominantly domestic. As Greek banks became less regulated, more credit became available to the private sector, both business and households.

The second part of the explanation is to be found in government expenditure (Athanassiou 2007). General government expenditure, and in particular final consumption expenditure, was growing almost as fast as household expenditure and was in fact feeding it.

Fig. 19 Greece, year-on-year growth of exports

Where did the government of Greece obtain its funds for expenditure?

The government was not financing its expenditure with increased tax revenue. Tax revenue increased, but basically kept pace with the growth in GDP and was not driving expenditure (Fig. 24). It had been insufficient in the late 1980s and early 1990s, and remained insufficient thereafter, with a couple of temporary gestures towards improvement. Mitsopoulos and Pelagidis (2011) have shown how the extreme progressivity of the Greek tax system led to a skewed distribution of wages, where the vast majority of employees earned approximately the minimum wage and paid no taxes. The progressivity of the tax scale was a disincentive for earning a somewhat higher wage. Further, self-employed persons claimed only as much as would not be taxed. As a result, the tax burden fell on the shoulders of a reduced set of high-wage-earning employees, and tax receipts as a percentage of GDP were among the lowest in the euro area. Income tax receipts were the second lowest, after the Slovak Republic.

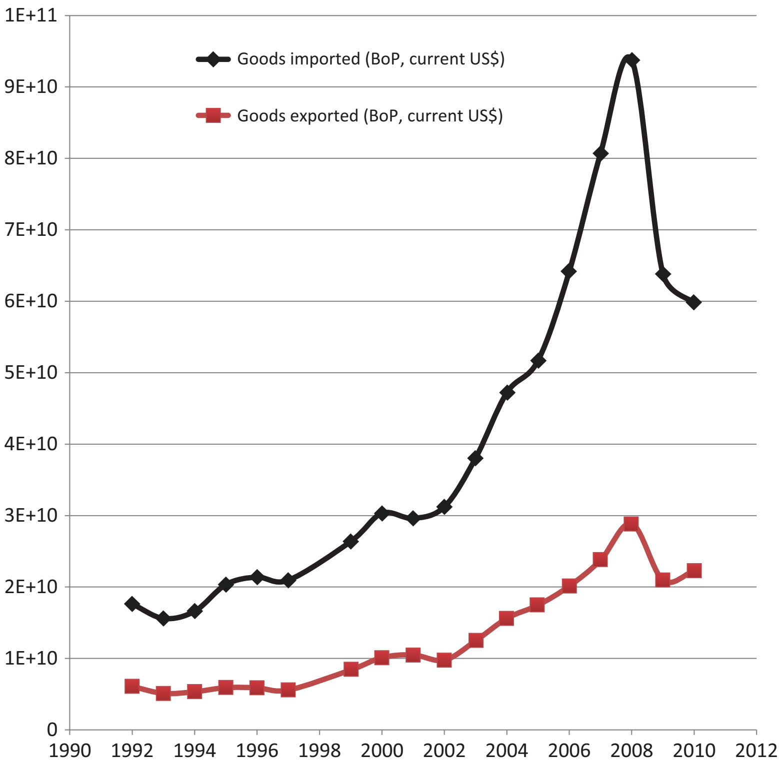


Fig. 20 Greece, goods imported and exported

Government was financing the growth in expenditure not through taxes, but through increased debt (Fig. 25).

Four periods of different fund sourcing and allocation characterize Greece: the period previous to 1986, a transition period from 1986 to about 1993, the period from 1993 to 2008 and the crisis period (Table 7).

First period (until late 1980s). Before 1986, primarily domestic banks funded the government by purchasing treasury bills. Government ensured cheap funding in two ways. First, the government dictated interest rates well below the inflation rate. Second, banks were required to purchase enough bonds to reach the equivalent of 37–40% of their deposits. This had two effects beyond assuring cheap finance for the government. It meant first that little credit was left over for private businesses, especially

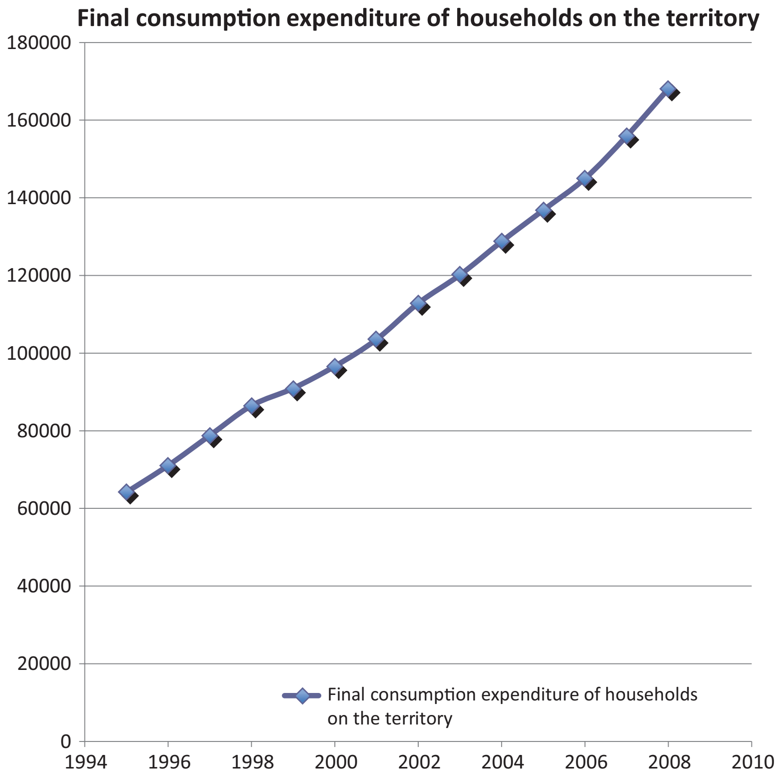


Fig. 21 Greece, final consumption expenditure of households on the territory

since government influenced the banks to provide credit to businesses of supporters and to SOEs. Second, given that the residual loans and the bulk of state subsidies went to rescuing inefficient enterprise, much of the capital formation of the economy was squandered. Further, this capital formation had been decreasing ever since the government had begun to "Europeanize" Greece by ever-greater transfers to households.

Second period (1990–1995). The government reduced and then abolished the mandatory purchase of bonds by banks over the years from 1991 to 1993. Meanwhile, it had slowly also begun selling bonds to the general public in 1986. The portion of funds purchased by the general public had reached over 70% by 1992. There was no mandatory purchase

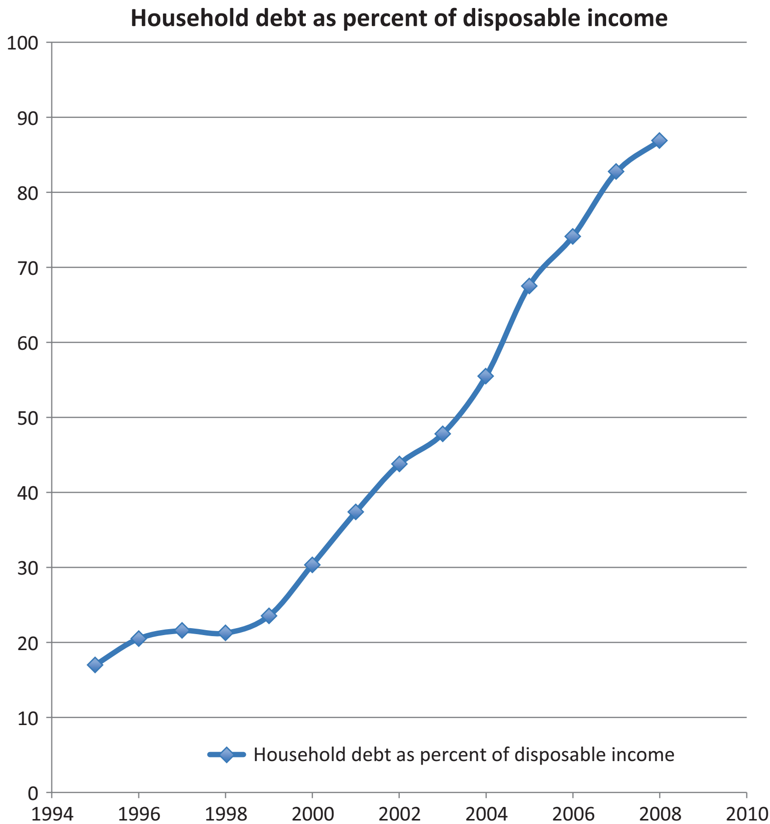


Fig. 22 Greece, household debt as a percent of disposable income

by a public that was motivated by attractive interest rates several percentage points above inflation. Relatively expensive financing thus characterized this second period of fund sourcing. There was increased credit available to private business from banks, although government continued to favour SOEs and supporters with its subsidies. There was thus a somewhat more rational allocation of funds in the sense that businesses judged promising by banks received funding.

Third period (1995–2007). This period begins in the mid-1990s and continued until the eruption of the crisis. The apparent performance of Greece as it prepared for participation in the euro and came under the discipline of the European bureaucracy began to convince financial mar-

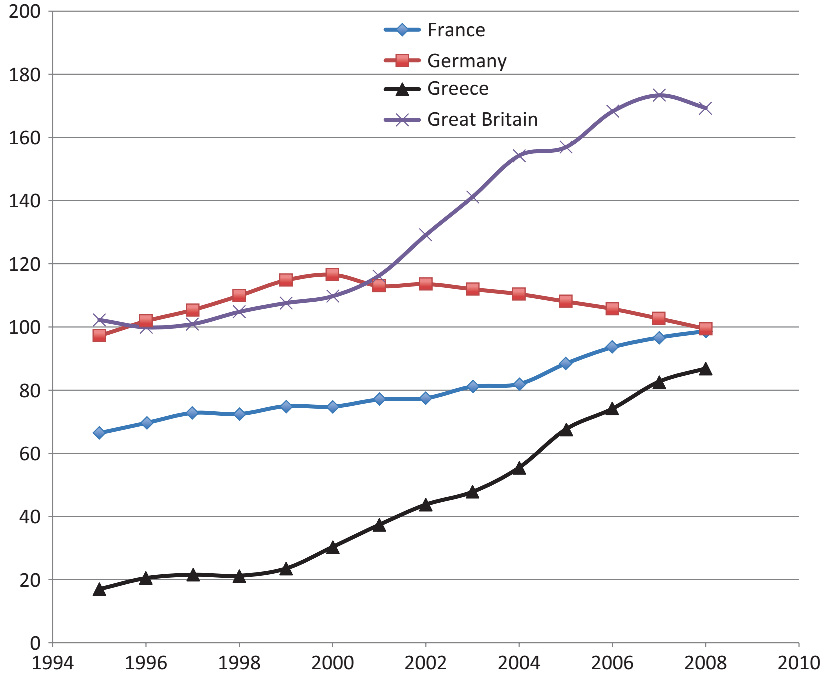


Fig. 23 Household debt compared

kets of its credit worthiness, particularly as the primary balance became a surplus in 1994 and the deficit reduced over 1995–2000. The door opened for cheaper financing in the international bond market. The government had relied on short-term financing before introducing ten-year fixed interest bonds for the first time in 1997, and this introduction also had the effect of reducing interest rates. This third period is characterized by cheap financing for the government. It is also a period of change from domestic debt to external debt. More than 80% of Greece's government debt was domestic in 1995; nearly 80% was foreign held in 2007 (Andritzky 2012, p. 22). Although private businesses continued to enjoy credit from the banks, the government applied much of its expenditure to transfers to households, and these increased their consumption of imports, leading to a widening current account deficit for Greece.

Fourth period (2008–2017). With the onset of the crisis, the international bond market suddenly became expensive until the troika of the

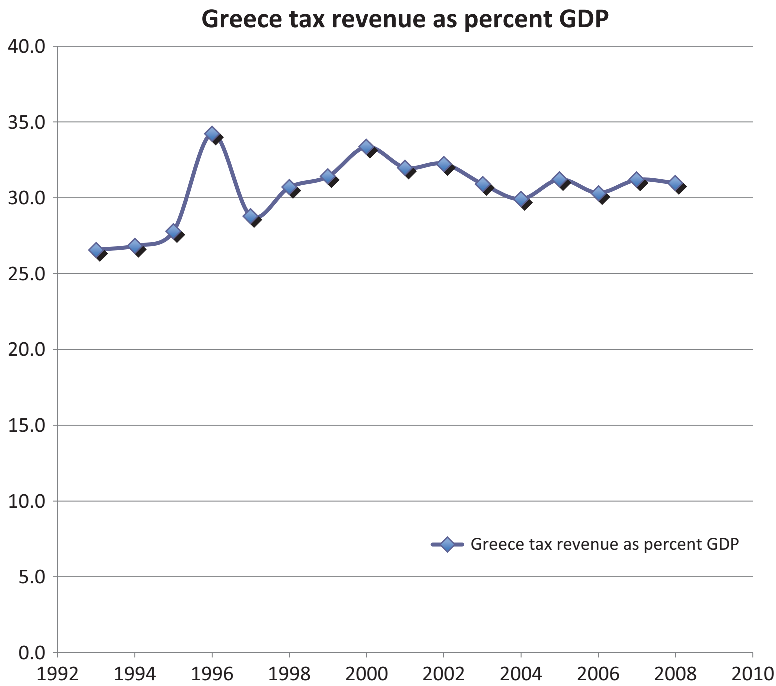


Fig. 24 Greece, Greece tax revenue as percent of GDP

IMF, the European Central Bank and the European Commission provided funding at modest rates conditional on certain requirements, including fiscal austerity.

The surge in GDP had led to an increase of GDP per capita and thus a statistic of improved productivity. The improvement was mostly fallacious however as it was not based on the improvement of Greek business so much as it was on debt, household and government, being used to increase expenditures. The figures for growth were real enough, but the underlying reality was not a healthy economy.

There was a spurt of growth in GDP from the mid-1980s to 1992, another in 1994–1996, and then steady growth after the euro replaced the drachma. Thus, on paper, the economy of Greece had exhibited an admirable degree of growth for 1993–2008, better than that of most other European countries before crashing. Why is it that this growth did not give the Greek economy sufficient depth to weather the financial crisis of 2010?

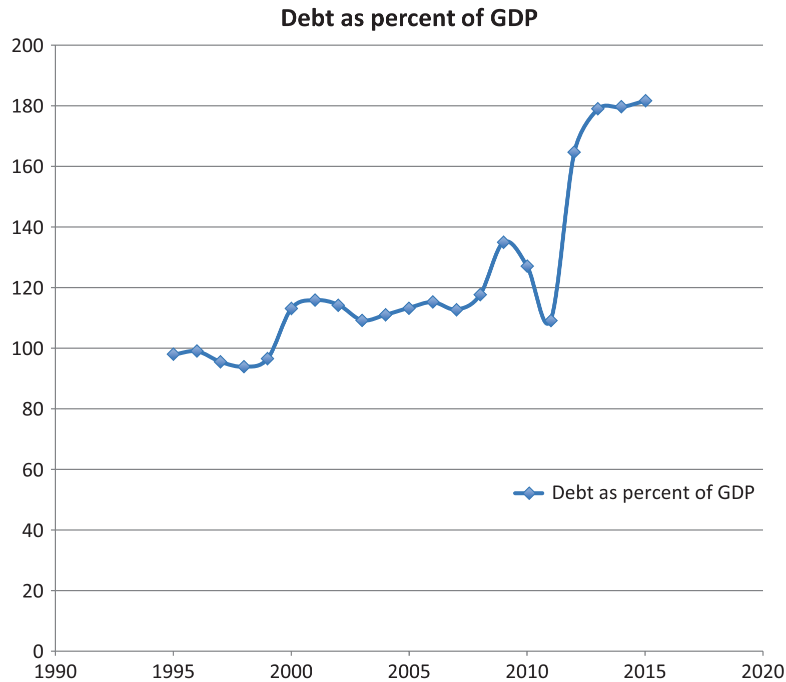


Fig. 25 Greece, Greek debt as percent of GDP

Table 7 Evolution of the funding of the government of Greece

Period	Principle source of funds	Relative cost of funding	Domestic or external	Government debt/GDP	External debt
Until late 1980s	Banks	Negative: very cheap	Domestic	1981 = 27% 1989 = 65%	Low
1990–1995	Household overtake banks	Moderately expensive	Domestic	1995 = 99%	Low
1995–2007	International bond market	Cheap	External	1999 = 99% 2007=103%	Soars
2008+	International bond market; *ECB; European Commission	Expensive until the troika intervenes	External	2016 = 179%	High

*European Central Bank

The reason is that much of this growth was increased government expenditure, and the improved productivity statistic thus did not correspond to improved competitiveness. Indeed, the "real" component of that growth probably was the result of the fiscal discipline and reforms of the 1990–1993 government (Pelagidis and Mitsopoulos 2014, p. 7 and 13).

The global financial crisis began in 2007 and came into the view of the general public in September 2008 with the bankruptcy of Lehman Brothers. It affected the credit market, so that countries with large debt were adversely affected. It also led to an international recession that affected the advanced economies in Europe. In September 2009, Greece's New Democratic finance minister revised his estimate for the annual deficit from 3.7% to 6%; after the parliamentary elections of October 4, 2009, the new PASOK finance minister corrected that estimate to 12.5%. To the credit shock of the financial crisis, the Greek government had added a credibility shock. Then, on Sunday November 29, the government of Dubai issued a statement clarifying that it did not guarantee the debts of Dubai World, a state holding company that had previously announced a six-month delay in paying back funds. This announcement made financial markets nervous about sovereign debt. On December 8, 2009, Fitch cut ratings on Greek debt from A minus to BBB plus with a negative outlook. The yield on Greek government ten-year bonds began to rise, reaching a peak of nearing 40% in 2012. The Greek financial crisis had begun.

Dynamic of the Crisis in Greece

The particular history of Greece gave rise to an overwhelming presence of government in the economy, and that presence was used for political ends rather than the promotion of the economy. As a result, the Greek economy never caught up with the rest of Europe and was unable to finance a more recent "Europeanization" that consisted in a massive transfer of funds to households in the form of health services, unemployment insurance, pensions and other social benefits. The government sought funding on the international bond market, while the populace increasingly spent its new wealth on imports. The result was extensive government external debt paired with limited capacity to generate the wealth to pay it back. The problem in Greece was that the government channelled borrowed funds to household consumption of imports rather than encourage efficient capital formation by private businesses.

The government of Greece obtained funds in various ways (some taxes and much borrowing) and applied them to ailing SOEs and increasingly to household transfers. Households in turn had a choice between saving and consumption. Figure 26 shows the evolution of household saving since 1995 (previous data are not available; gross domestic savings dropped from 40% in 1973 to 17% in 1987 and 14.2% in 1995). Net household savings plunged from about plus 10% in 1995 to nearly minus 3% in 2005. This suggests that the transfers were increasingly applied to consumption (Fig. 27). A portion of this consumption was of local goods and services, such as health services. However, imports constituted a growing portion of consumption from the late 1990s on, as Fig. 28 reveals. Local businesses were not able to satisfy consumer demand, at least not competitively, and imports rose. In effect, the government of Greece was financing the purchase of foreign goods.

How was the government obtaining its funds? This debt was predominantly external, not domestic, since it took the form of bonds sold on the international market.

The previous section exposed four periods in the sourcing of funds by the Greek government. The wealth-producing capacity of Greece was starved for funding for much of that time. On the one hand, government crowded private enterprise out of the credit market. On the other hand, subsidies went to SOEs and usually to hide problems or compensate for inefficiencies. They did not build the wealth-producing capacity of the nation. As a result, the economy of Greece did not produce enough wealth to fund the Europeanization (increased expenditures on health, education, pensions, etc.) of the country. At first the funds came from domestic banks (period one), then from the Greek public (increasing during period two) and finally from the international bond market (period three). Thus, funds were domestic during periods one and two while Europeanization was beginning. They would have been better used if a larger portion had been invested in efficient business, and the dynamic does not appear to have been sustainable except by continually increasing debt. With period three, the debt became external and eventually mushroomed.

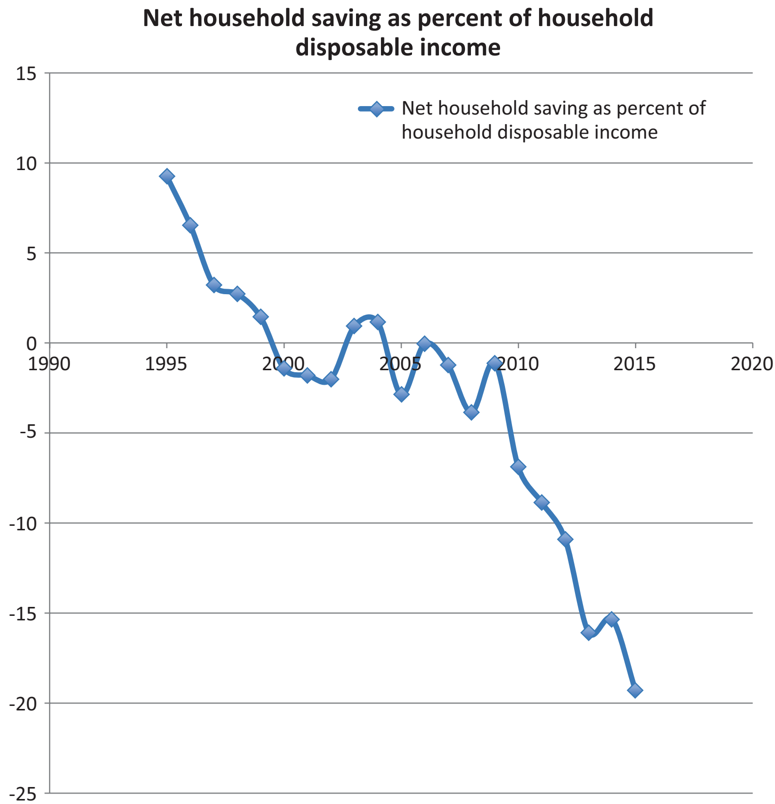


Fig. 26 Greece, net household saving

Increasing transfers to households constitutes part of government expenditure and as such had the effect of increasing GDP. Still, the consequent increase in household consumption contributed more to imports than to local businesses. The increased GDP combined with apparently greater fiscal discipline led to a decreased debt-to-GDP ratio. However, funding the transfers led to an increased external debt as the government owed its financing to the international market. The use of the transfers led to a current account deficit as imports exceeded exports. Access of households to cheaper credit than in the past exacerbated the situation. As a result, the external debt of government was financing the purchase

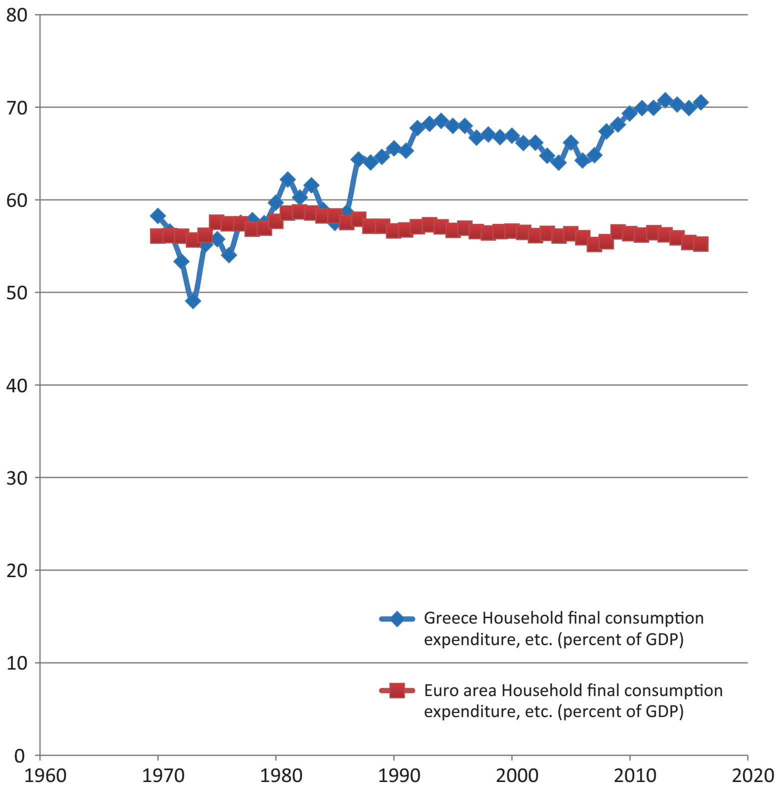


Fig. 27 Greece, final consumption expenditure of households

of foreign goods, not strengthening the wealth-producing capacity of the nation. (Funding from the IMF and from European authorities has since only increased external debt.)

The algebra of GDP statistics gives further insight into the current account deficit. The sources of spending approach give the equation:

$$\text{GDP} = \text{C}\left[\text{consumption}\right] + \text{I}\left[\text{investment}\right] + \text{G}\left[\text{government spending}\right] + \left(\text{X} - \text{M}\right)\left[\text{imports minus exports}\right]$$

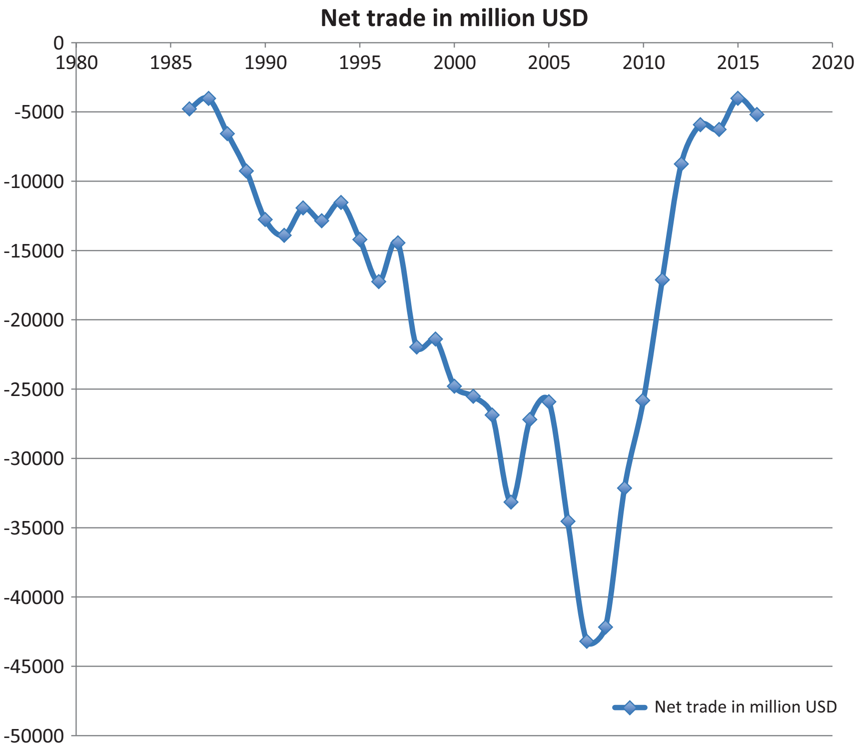


Fig. 28 Greece, net trade in US dollar million

The use of income approach gives the equation:

$$GDP = C + S[\text{savings}] + T[\text{taxes}]$$

Equating both right-hand sides and removing consumption from both, we get the equation:

$$I + G + (X - M) = S + T$$

This rearranges as:

$$X - M = S + T - I - G$$
$$X - M = S - I + T - G$$

When imports are greater than exports, either (S–I) or (T–G) or both are negative. In other words, there is a savings gap because savings are insufficient for investments, a tax receipt gap because government spends more than it receives in taxes or both. Both are the case in Greece (Fig.29 for the savings gap). Greece needs to save more to maintain its level of investment. And the government needs to spend less, or else increase its tax base. Neither has happened, or has happened insufficiently, with result that the current account has been financed by government debt (Fig.30). If Greece sees fit to revamp its tax system, it would best do so in a way that encourages saving. If new taxes were to diminish saving, the underlying problem would remain.

Fig. 29 Savings gap Greece and euro area

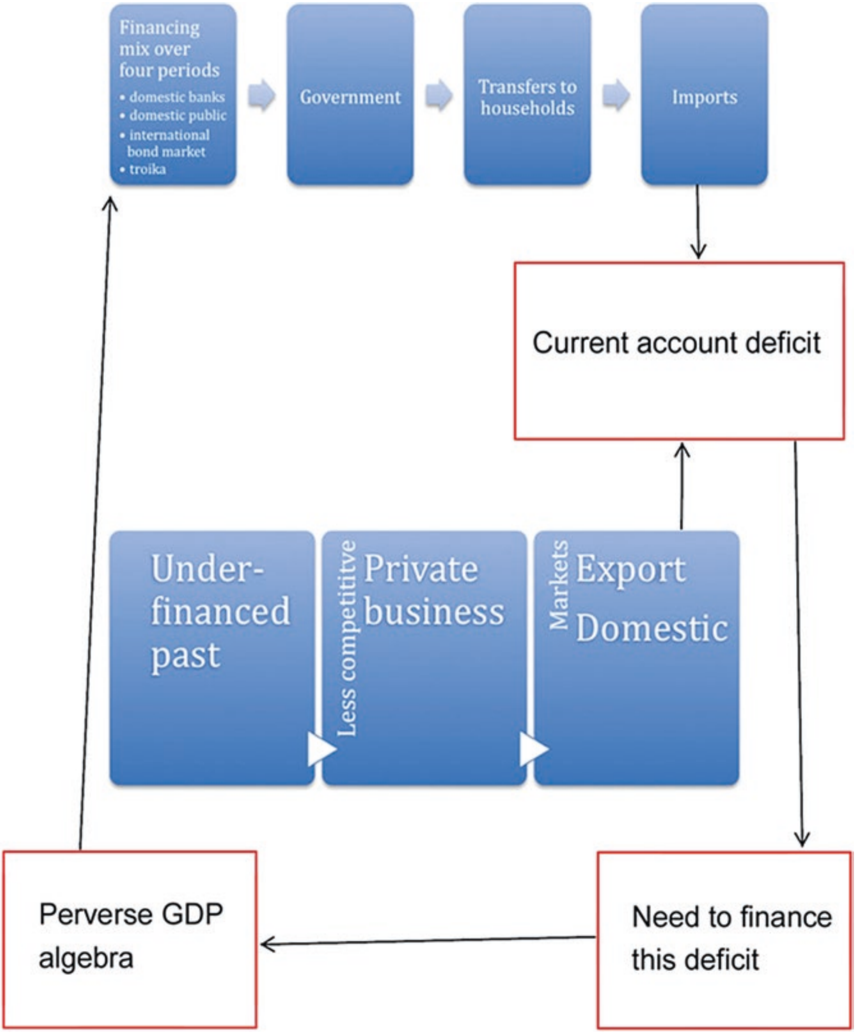


Fig. 30 Dynamic of the crisis in Greece

Notes

1. The tensions between King Constantine and Prime Minister Georgios Papandreou led to the resignation of the latter and a series of unstable governments followed by a military coup. The military junta abolished the monarchy on June 1, 1973.
2. The central idea for this section is taken from Manessiotis and Reischauer (2001).
3. Many national statistics take into account inflation by using constant currency units, such as 2010 US dollars. However, the revenue and expenditure accounts of a nation are tabulated in current local currency units, so it is useful to have a sense of the inflation rate when evaluating the evolution of fiscal policy expressed in these current units. The ideal is to have one year as a base on which other years are indexed. In the case of Greece, 2010 is the base year when the index is 100; the value for January 1978 is 3.37 and the value for January 1990 is 26.9 (OECD (2017), Inflation (CPI) (indicator)). (It should be noted that the OECD data are based on euro converted from historic drachmae figures at the official 1999 conversion rate.) The prices for 1990 are roughly eight times higher than in 1978.
4. Family in Greece had/(to a degree has) a significant role as an **informal social protection institution** that benefited from a wide range of economic and social policies, functioned as a social safety net and was linked to the micro and very small business sector (Christos Triantopoulos, personal communication).
5. Besides limiting credit, earlier state intervention in finance had induced perverse effects. For example, funds provided to large manufacturers often had been used to finance the client trade businesses rather than to invest in new machinery and plant. See Pagoulatos (2003, especially pp. 64–66).
6. The central idea for this section is taken from Bosworth and Kollintzas (2001).
7. The figures for gross capital formation and gross fixed capital formation are somewhat mysterious in the light of the financing available: government fixed capital formation (at 10–12% of government expenditures or 5% of GDP) and transfers to enterprise (between 2 and 10% of government expenditures or 1–5% of GDP), even if that latter were used only

for capital investment, would only explain about half of fixed capital formation, leaving private enterprise to explain the other half under conditions of limited credit.

8. There is one caveat, however: the composition of the services sector. "One in six Greeks or one in three employed in the tertiary sector were working for government" (Ioakimidis 2000, p. 77). Employment in the public sector doubled over the 1980s (ibidem). Another important component of the service sector was tourism of a sort in which real estate was more important than moderately skilled labour.
9. In this regard, Christos Triantopoulos (personal communication) observed that labour unions (dominated by the employees in the public sector, SOEs and banks) were characterized by a party-politically minded pseudo-corporatism that was mainly oriented to the achievement of myopic and narrow collective benefits rather than the establishment of institutions focused on strategic coordination among stakeholders.
10. During 1983–1990, the average share of self-employed to total employed was around 50%, while the share of employers to total employment amounted on average around 5.5%. In both cases, these levels were higher than the European Union levels and, especially, the level of self-employed. Apart from a high proclivity to tax evasion, the small-sized and self-employed economic activity was linked, among others, to the inability of achieving economies of scale, low investment in human capital, innovation and R&D, and the weakness of entering foreign markets (Christos Triantopoulos, personal communication).
11. Eurostat is the statistical office of the European Union.
12. Note: Complete references to unsigned IMF and OECD documents are given in the text and are not repeated here.

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Ireland: From Prosperity to Crisis

Introduction

The whole world admired the economy of Ireland at the start of the millennium. Impoverished for most of the twentieth century, the Irish had managed to nurture an economy so strong that the GDP per capita surpassed that of the USA. Ireland had suffered net emigration for much of the twentieth century, but the strong economy at the turn of the century attracted many people so that it enjoyed net immigration as the twenty-first century began. The economy of Ireland was a success story.

The crisis seemed to hit all the harder because of this success. The yield on ten-year bonds rose from around 3% in 2005 to 11% in 2011. GDP per capita stopped its upward surge and plummeted 10% from 2007 to 2010. The general government debt of Ireland surged from 27.4% of GDP in 2007 to 132.7% in 2013. An economic recession accompanied this financial crisis, and unemployment soared from 4.3% in 2005 to 13.9% in 2010. (See Figs. 1, 2, 3 and 4.)

Ireland was in crisis and the timing suggested the crisis was provoked by the global financial crisis. However, why precisely did the contagion

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Fig. 1 Ireland, long-term interest rates

take hold in Ireland when many other countries were able to recover quickly? If the Irish economy has been so strong, why was it unable to counteract the effects of contagion? Or had the strength of the Irish economy been nearly apparent, based on a fragile foundation? And how precisely had contagion entered into Ireland? Had Irish banks invested heavily in toxic financial instruments based on American real estate?

Although the global financial crisis brought the increase in interest rates that triggered the crisis in Ireland, the crisis itself was purely home grown. A local boom in real estate turned into a bubble that burst when interest rates jumped. This led to government bailing out the banks that had financed the bubble, increasing general government debt and thus the burden for Irish taxpayers.

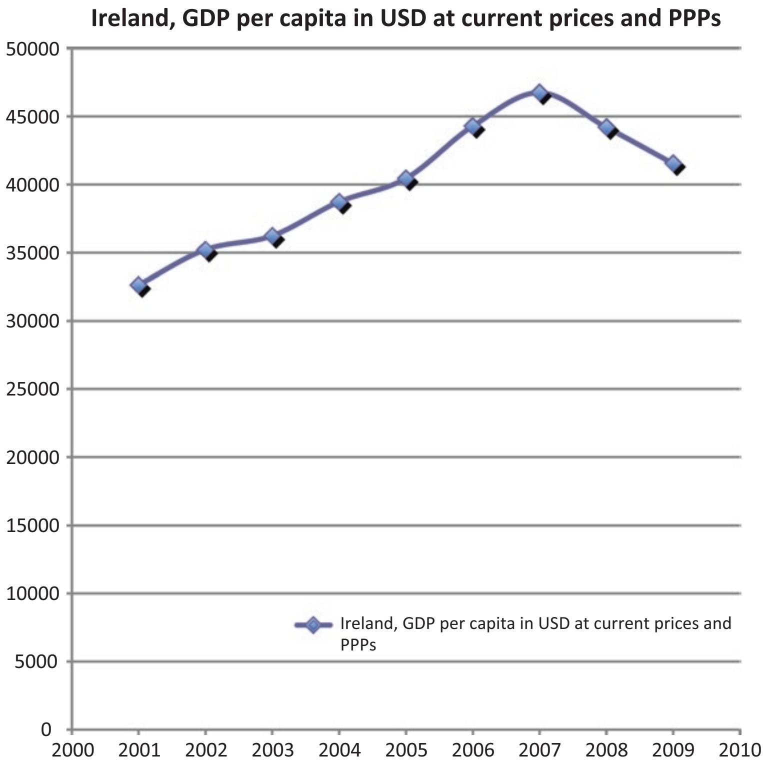

Fig. 2 Ireland, gross domestic product per capita

The next few sections provide background information. The first section provides a prelude in the form of a condensed history of Ireland's economy up to the Second World War. The following section continues with a post-war history of the Irish economy, covering ideas and actors before describing political and economic action and policy changes. The next section adds a history of the Irish economy in the 1970s and 1980s. After this, the Celtic Tiger (1993–2007) is described, both in terms of the configuration of factors that gave rise to it and in terms of the resulting economic performance. The onset of the crisis is then related. The final section proposes a dynamic of the crisis in Ireland.

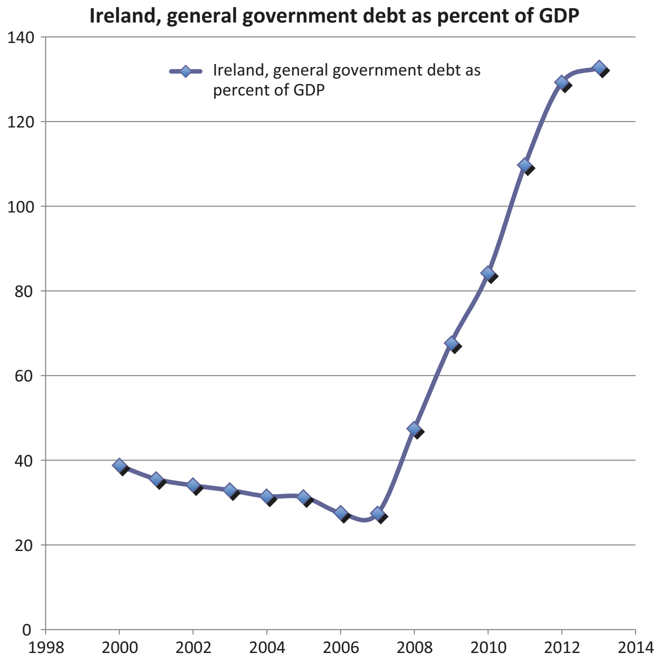

Fig. 3 Ireland, debt as percent of gross domestic product

Fig. 4 Ireland, unemployment rate

A Condensed Prehistory of Ireland's Economy

The Statute of Drogheda, a 1495 act of the parliament of Ireland recognizing the authority of England's monarch and Privy Council, formalized a British influence upon Ireland that predates the existence of England. This influence waned in the late fifteenth century and waxed in the mid-sixteenth century; religious wars marked the seventeenth century (some English and Scot colonizers were not Roman Catholics) and left sectarian scars which lasted into the twentieth century. Anglicans became the dominant class in the eighteenth century, so that Britain could "safely" cede legislative power to the Irish government … that it appointed. That century ended with a failed rebellion by the Catholics and Protestant Dissenters and the unification of the realms of Great Britain and Ireland.

Britain did not develop industrial potential in Ireland—in part because of scarcity of resources, in part because no industrial development strategy could predate the industrial revolution and in part because the mid-century potato famine led to massive emigration as well as political unrest until the end of the century. Belfast shipbuilding and linen were the only industries in Ireland at the end of the nineteenth century. Guinness and Belleek Pottery were two of the largest manufacturers.

Ireland thus entered the twentieth century with a predominately agricultural economy. The preoccupation of Britain with the First World War created the opportunity for an uprising in 1916, and its subsequent suppression by Britain led to widespread popular support for resistance within Ireland. Sinn Fein, a party in favour of independence, won the general elections of 1918 and proclaimed the Free State. The representatives of this new government concluded a treaty with the British government in 1921 that gave Ireland her independence but recognized the possibility that some counties in the north of Ireland remain as part of the UK. Greater independence was achieved in the years leading up to the Second World War. However, the Free State was not that "free," because the treaty foresaw the payment of "land annuities" to Britain—some £3 million a year, equivalent to more than 10% of the new government's revenue.

The citizens of the Free State voted in favour of the constitution of the Republic of Ireland in 1937.[1] Ireland remained desperately poor during this time, with an economic structure based on agriculture, and many Irish emigrated after the Second World War.

The Post-War History of the Irish Economy

The history of the Irish economy following the Second World War until the euro crisis can easily be divided into four periods (see Table 1) marked by variations in government policies and in the consequent success of the Irish economy period:

1. The Irish government follow policies of nationalism and protectionism until 1955.
2. Since 1956, the government has pursued ever-freer trade, opening up the boundaries of Ireland and seeking markets in Europe, America and elsewhere.
3. From 1970 to 1987 the Irish government expanded: higher taxes, greater expenditures and more rules.
4. Reduction of government from 1987 until recently.

Ideas

Three new ideas and an enduring attitude were crucial to the changes about to be introduced to the Irish economy. The three ideas were economic planning, free trade and government spending to improve the

Table 1 From the Second World War to the rise of the Celtic Tiger

Period	Policy	Results
WWII to 1955	Protectionism	Poor economic performance
1956–1970	Freer trade	Improved economic performance
1970–1987	Expansion of government	Deterioration of economic performance
1987–2008	Reduction of government	Celtic Tiger

economy. The attitude was dissatisfaction with the state of the economy. Economic planning was learned from the USA. Free trade was also picked up from the USA, but worked its way slowly into the Irish psyche, espoused by portions of the civil service before others, embraced by farmers and eventually even accepted by manufacturers. The notion of spending to improve the economy came from Keynes deficit spending as a solution to recessions. The following paragraphs describe the acceptance of these ideas and the presence of dissatisfaction within Irish society.

Economic planning. The Republic of Ireland had remained neutral during the Second World War, but did receive some aid under the Marshall plan. This took the form of loans as well as outright grants, but perhaps the biggest contribution was that the Irish government—politicians and civil servants alike—was exposed to a new perspective on the economy as something which government could influence positively if it planned carefully. Hitherto, economic planning had been associated with communist dictatorships, and the Department of Finance of the Irish civil service managed tax revenues (as generated by previous legislation) and oversaw the expenditures made by other civil service departments. Anything in the way of industrial strategy had issued from the Department of Industry and Commerce, which had established itself as the champion of protectionist policies.

Free trade. In 1933 Maynard Keynes gave a lecture at the University College of Dublin in which he supported the Irish government's economic policy of self-sufficiency—in other words, protectionism.

This optic fit in well with the nationalism of the founding fathers of free Ireland. It was also the economic orthodoxy of the time because the years between the two wars were ones of growing protectionism in Europe and the entire Western world.

The USA had begun to preach free trade not only for itself (although in practice many American industries successfully lobbied for protection) but also within Europe under the Marshall plan following the Second World War. Indeed, European leaders took to the idea of developing more intimate economic ties as a way to diminish the threat of war within Europe. The General Agreement on Trade and Tariffs (GATT) was signed in 1947, and subsequent rounds reducing trade barriers continue even to present, with the World Trade Organization continuing the work begun with GATT. Robert Shuman, the French foreign minister, proposed the European Coal and Steel Community in 1950. It was formally established in 1951 and created a common market for coal and steel.

The Irish civil service was inherited from Britain, a waning empire at the time Ireland gained her independence. A strong sense of duty and patriotism characterized its culture. Civil servants were selected by competitive exams and merit was a requisite to promotion, not seniority alone. The consequence is that these civil servants were men of their time, so that the younger generation learned their trade from superiors whom they respected but whose ideas were on the way out. The new guard of the 1950s saw the independence of Ireland menaced by an economy that drove an ever-growing number of young people to emigrate, and believed that protectionism and the predominantly agrarian structure of the economy were the problems.

Many farmers in Ireland were pastoral, raising sheep, beef and dairy cows and exporting a great part of their produce. It was the most profitable way to farm in Ireland: minimize inputs rather than maximize output. These farmers were also a significant portion of the electorate, and became more organized, with the consequence that politicians in touch with their electorate would have to be sensitive to events affecting the exports of these farmers. And such events were occurring. Britain was the largest market for these farmers, and their obvious competitors in that market, British farmers, were enjoying guaranteed minimum prices as a consequence of Britain's Agricultural Act of 1947, with increasing benefits added in subsequent years. This act attempted to eliminate the shortages of the war years, but also changed the export market for Irish farmers. The government of Ireland, lobbied by farmers' organizations and in touch with this constituency, entered into trade agreements with Sweden and Germany in 1947 and made overtures to France in that same year. The next year it concluded the 1948 Anglo Irish trade agreement. In the late 1950s Britain considered entry into the European Economic Community (EEC) and made a formal application in 1961; although unsuccessful, this application raised the spectre of Ireland's farmers remaining outside of the EEC and thus facing a tariff wall.

The main beneficiaries of protectionism had been manufacturers. Séan Lemass did his best to change their complacency in the late 1940s, most notably with his 1947 Control of prices and Promotion of Industrial Efficiency bill of 1947. This was resisted by the Federation of Irish Manufacturers, trade unions and the old school Department of Finance, and defeated by conservative elements within the interparty government at the time: the government did not introduce the bill (Murphy 1996, p. 10). Everyone seemed comfortable under the protectionist security blanket. Surprisingly, one decade later, industrialists were not strongly against free trade (which could only be met by efficient firms). Their interest was real with respect to both foreign markets and domestic markets, the latter because untariffed imports would reduce costs for materials and parts. Again, many businessmen were aware of the dangers of free trade for Irish businesses but held a "not me" attitude towards this danger. And business organizations in general were becoming more favourable to free trade towards the end of the 1950s. Exports of manufactured goods quintupled in 1950–1960. Both businesses and trade unions showed little opposition to entry to the EEC in 1973.

Government spending to improve the economy. Keynes' ideas on fiscal policy were also spreading. The eclipse of protectionism in Ireland would come in tandem with the growing influence of Keynesianism fiscal policy in the civil service, the universities and finally the government of Ireland in the 1950s. This Keynesianism was not simply one of government expenditure to stimulate the economy.[2] The most successful application of Keynesian economics for long-term *sustained* growth is government expenditure and investment that increase productive work. All the better if these increase net exports.

This implied a new way of looking at state revenue and expenditures. In a stable economy, the state should be parsimonious and prudent in expenditures, whereas in recession, the state should stimulate demand by deficit spending. This would stimulate the economy and ultimately lead to an increase in state revenues, balancing the budget and repaying debt.

The pervasiveness of these new ideas—economic planning, free trade and expenditure to improve the economy—created a context favourable to a change in the economy of Ireland, and a relatively small number of human actors seized the opportunity. Leadership is generally attributed to the figure of Kenneth Whitaker, a civil servant promoted to the Secretary of the Department of Finance in 1949, abetted by Charles

Murray and other civil servants with similar views, as well as the academics Charles Carter, Patrick Lynch and Louden Ryan. But change would have to come about through legislation, so the patronage of Lemass was critical. Taoiseach (head of government) from 1959 until 1966, Lemass had fought in the 1916 uprising, and was Member of Parliament first for Sinn Féin (1924–1926) and later for Fianna Fáil (1926–1969).

Actors

Frank Aiken, Minister of Finance, introduced what was probably the first timid investment in the economy in 1946, with the creation of a £5 million Transition Development Fund. An interparty government came into power in 1948, but Patrick McGilligan, the new finance minister, built on Aiken's initiative by introducing a state capital budget in 1950. The years 1948–1953 were marked by tentative efforts to build exports. This was linked to industrial development not only in fact, but also in the minds of at least a few of the leading figures of the day. Lemass wrote the following in a letter to industrialist William Dwyer:

> It has always been a handicap of our industrial progress that the best of our industrial leaders show a tendency to exhaust their initial impetus and to slow and stop when they have reached the stage of development which gives them maximum-security with the minimum of additional effort… The function of Government as I see it, is to keep on pushing development to the limits of practicability whether individual industrialists like it or not. (O'Sullivan 1994, p. 118 as cited in Murphy 1996, p. 17)

The discourse of one architect of Ireland's economic revival, Whitaker, emphasized the importance of state capital spending. In 1953 he argued "that no government could cut down capital expenditure while the external balance is satisfactory but unemployment and immigration are relatively high" (Fanning 1978, p. 494, as cited by Chambers 2014, Chapter 4). Chambers, with full access to documentation, further asserts that internal memos by Whitaker were already emphasizing the importance of productive investment by late 1954. In 1957, Whitaker criticized a few academics: "I see no reason for facilitating… the waste of reserves for unproductive purposes, whether the reserves are under the control of the banking system or some other authority. I would repeat that the difficulty is not lack of finance but rather lack of specific plans for productive development" (quoted in Chambers 2014, Chapter 4).

The years 1953–1957 were crucial because they saw the reinforcement of the reorientation in Irish economic policy: changes of persons, innovative measures and a heightening crisis in public finances even more acute than the stagnation of the economy.

In 1953, the minister of finance fell ill and was substituted by the acting finance minister Aiken, and the top civil servant for that ministry, the Secretary of the Department of Finance, was also changed. The new secretary, Owen Redmond, was about to retire. A new coalition government was formed in June 1954 and Gerard Sweetman became the next minister of finance. When Redmond retired in May 1956, Sweetman named Whitaker as the Secretary of the Department of Finance. With these changes of persons came a gradual softening of old ideas (centred on protectionism and limited government expenditure) and the exploration of new ideas (free trade and government expenditure to promote growth).

A committee of inquiry into the policy of protectionism was launched in January 1954. In November, the new government approved an interdepartmental (i.e., of several branches of the civil service) committee that examined the state capital programme and produced its report in December of the next year. Several ministers also proposed ideas for cultivating economic growth. In 1956, and in a departure from the usual anonymity of the civil service, the Secretary of the Department of Finance presented and later published the essay "Capital Formation, Saving and Economic Progress." The consequence was the depolitization of the new ideas. It also underscored the lamentable state of the economy: largely stagnant, with underproductive agriculture and underdeveloped industry. The Irish were poor, and the best opportunities for young Irish people of talent and ambition were abroad. The population of Ireland was 8.2 million in 1841, before the potato famine. Half a million died in the famine and many more emigrated. By 1950, the population of Ireland was around 3 million, and the economy struggled to feed these few.

The state of the economy was leading to a funding crisis for Ireland's successive governments.

When Fianna Fáil came back into power in March 1957, James Ryan, the new finance minister, commented to Whitaker "You look after the administration. I'll look after the politics" (Chambers, Chapter 5). Thus, Whitaker would write the draft of Ryan's first budget.

There was a change of the guard among senior politicians in 1959: Éamon de Valera (head of the Fianna Fáil government) retired, and the leaders of other political parties also changed. Older ideas were leaving the political arena, while Lemass, the new Taoiseach, had converted to the new ideas, and the finance minister James Ryan backed them. As a consequence, the new ideas incarnated in the person of Whitaker and his circle would influence policy changes well into the 1960s, the only disruption (beyond the challenges of a stagnant economy!) being the propensity of some individual ministers to spend their way to popularity and importance while invoking an overly simplistic version of Keynes.

Action and Policy Changes

In August 1955, the Minister of Industry and Commerce, William Norton, visited Germany with the message that their manufacturers would be able to export to many countries tariff-free by setting up plants in Ireland, thanks to bilateral agreements between Ireland and various partners (Australia, Canada, New Zealand and South Africa). In October of that same year, Ireland and the USA signed an agreement allowing Ireland to participate in the US Investment Guarantee Program targeting American foreign investment abroad. In November, James Betty, Chief of the Irish Development Authority, told German businessman that Ireland welcomed foreign industrial investment.

The Irish government (an interparty coalition) introduced tax relief for export in 1956. The origin of this measure is a 1945 proposal by the Department of Industry and Commerce that had been actively resisted by the Department of Finance. William Norton continued his search for foreign investment, visiting the USA in January, seeking, in particular, investors for manufactured goods for export and assuring them that their capital would not be locked into Ireland. The national sentiment in Ireland mistrusted the notion of foreign investment, and so John Castillo, Taoiseach or head of the Irish government, had to ensure his constituency that this investment would be for export rather than for competing with native manufacturers.

The celebrated white paper *Economic Development* was presented to the government in May 1958 and then published in November of that year. It was a blueprint for policy in the coming years. The year 1958 also saw the introduction of the Industrial Development Act, by which the government formalized the pursuit of foreign investment.

These are only the primary measures taken in the last half of the 1950s. The 1960s were occupied by an effort to join the European Community in the face of opposition by France (more in distrust of the UK, to whose currency Ireland had tied its own), and by the eventual rise of ministers eager to spend the new wealth that had begun to accumulate.

Rejected in 1961 as an underdeveloped economy, Ireland would accede to membership in the EEC in 1973. Richard Burke (late Irish European Commissioner) describes the 12 years as “a long and frequently anguished phase during which we want to join, try to join, were rebuffed, tried again, were accepted in principle, begin to negotiate, were delayed, were finally given terms of which as a people, we could decide, did so, waited one more year – and at last achieved our end, a little tired from all the waiting, but with – I think–some sense that a page in our history was being turned” (Hennessy and Kinsella 2013, pp. 6–7). This delay allowed Ireland to work on dismantling tariff barriers (beginning with the UK) as well as gain experience both with foreign direct investment (FDI) and with the new kind of economic policies. The positive effects of policy changes had been absorbed, and the Irish economy was far stronger in 1973, poised to benefit from its new status.

The conventional view is that Whitaker was the primary expert behind the change in economic policy. Some academics disagree or at least moderate the popular tendency to idolize. For example, Frank Barry points out that the Department of Finance (Whitaker’s department) bitterly resisted any export tax relief proposal. Since Whitaker espoused ideas very different from his department head (previous to May 1956), this does not seem to be a very strong argument. However, Barry goes on to show that, as department head, he continued the department's opposition to export tax relief on the grounds "that it is production which should be aided rather than exports" (Barry 2011). Again, Whitaker's *Economic Development* discussed agriculture, fisheries and forests far more than industry. The pragmatic reality, however, was that agriculture represented 40% of Ireland's exports even in 1973, even though only 18% of GDP (Hennessy and Kinsella 2013, p. 7). Since short-term results are a requisite for implementing a longer term strategy, it would seem to make sense to particularly emphasize the productivity of agriculture. A further consideration is that increased productivity in agriculture, while it involved an increase in production, was more than anything a reduction of the agricultural labour force using the same natural resources. Whitaker did not want to promote unemployment, so logically this manpower would have to move into industry and services. Both agricultural and industrial productivity required massive exportation because Ireland represented such a limited demand for merchandise. In any case, this sort of debate is not central here. The essential point is that several persons of reasonable technical and/or political ability and with the national interest in mind managed to design and legislate policy changes and implement them effectively.

Democracies tend to a cacophony of voices, but the government of Ireland in the late 1950s and early 1960s achieved somewhat of Henri Fayol's *unity of command* not by iron party discipline, but by shared ends and dialogue regarding means. This involved a great portion of the Irish nation both as individuals and as a patchwork of independent organizations. Thus, the founding of Irish Congress of Trade Unions in 1959 and other workers as well as farmers association later on would be important in future efforts to synchronize wage increases with productivity and economic growth. While these groups did defend the interests of their constituents, they shared in patriotic values and, through dialogue, in an understanding of the economy's dynamics. Again, both the government and its civil service (at least through the economic development branch of the finance department) invited businesses and community groups to propose productive projects for financing—productive meaning profitable and preferably for export. In the Department of Finance, at least, this had the added benefit of maintaining the momentum for change built up in preparing *Economic Development* (Chambers, Chapter 7).

The new policy was influenced by Keynes and involved government spending as an instrument for growth. However, it bore little resemblance to the discourse of current (more accurately, about to retire) Neo-Keynesians who focus on creating demand by welfare spending and creating jobs regardless of their utility. The new policy combined government spending with parsimony on welfare, including education. Eventually education did begin to receive more funding in the 1960s, but this was in spite of the policy, not because of it. The core idea was to sacrifice present consumption to increase production and thus wealth, eventually accumulating sufficient wealth to begin directing funds to education, health and other areas with only a longer term and perhaps indirect contribution to wealth production.

The production was for export, so domestic demand was not immediately critical. Eventually, as domestic demand became critical, the somewhat less spectacular employment increase of production-oriented spending would have boosted it. Essentially, one generation of the Irish workforce would sacrifice itself to build a better future, the inverse of what the baby-boomer generation did in the richer countries.

There was no parallel in Europe or in the Americas. A few other countries were following this kind of policy, however: Japan and the Asian Tiger economies of Singapore, Hong Kong, South Korea and Taiwan.

The policy was a robust one as long as a social consensus reigned in a democracy such as Ireland. The consensus held. Government measures in the 1960s were by and large reinforcement of and amendments to the reorientation of the years 1948–1959: Industrial Development Act, Industrial Grants Act, Industrial Relations Act (amendment of the 1946 Act) and so on. In addition to the various incentives to attract capital investment for export, social spending also increased (health, education and a push for full employment), contrary to the plans of Whitaker.

The new kind of policy seemed to be having an effect. As Table 2 reveals, GDP grew slightly in the 1950s, increased by 50% in the 1960s, 60% in the 1970s, 40% in the 1980s and doubled in the 1990s. Foreign capital was rapidly increasing Irish GDP. OECD surveys from the 1960s

Table 2 Evolution of Ireland's GDP

Year	GDP in millions of 1990 International Geary-Khamis dollars
1950	10,231
1960	12,127
1970	18,289
1980	29,047
1990	41,459
2000	81,716

Source: Maddison (2005) data set

frequently state that FDI inflow was high, although the present author was unable to find precise figures previous to 1974.

An examination of the statistics for the 1960s by sector shows the movement from agriculture into industry, although agriculture, forests and fishing still occupied 20% of the labour force by the end of the decade (see Table 3).

Closer examination reveals that the role of this sector was greater than even that 20% might suggest. Industry and construction already represented a greater part of GDP than agriculture, forests and fishing in 1961. Construction by its very nature counts for little or no export, and protected industry output would be for local consumption with few exceptions. The services of the time were not exportable. It follows that agriculture remained important for Irish exports and thus for the development of the economy, and that there was to be a lag before industry and certain services would play predominant roles.

1966–1973

When Lemass retired in 1966, Lynch was elected leader of Fianna Fáil and thus Taoiseach almost a full Dáil term before the next general election. He pursued continuity of policy and persons, with Lemass' liberal and modernizing orientation and giving his ministers free reign within their ministries. He retained the entire Cabinet of his predecessor, with minor shuffling. One such change was the appointment of Charles Haughey as Minister for Finance. Two sets of initiatives marked Haughey's ministry. A series of socially inclusive measures such as free travel on public transport

Table 3 Distribution of the Irish economy across sectors, 1961–1969

Year	Employment agriculture, forests and fishing (000)	Employment industry and construction (000)	Employment other (000)	GDP percent agriculture, forestry and fisheries	GDP percent industry and construction	GDP percent services
1961	409	284	n.a.	25	30	45
1963	360	274	418	22	33	47
1966	330	289	423	20	33	47
1969	301	315	445	20	34	46

Source: OECD Economic Surveys for Ireland, various years, some figures rounded or interpolated for pensioners, subsidized electricity for pensioners, special tax concessions for the disabled and tax exemptions for artists boosted the popularity of the government but also the person of the finance minister, who later would become Taoiseach. These initiatives had the advantage of costing the government little.

The other set of initiatives sought to increase government revenue, although in a dubious way that involved speculation against the Irish pound. The government borrowed foreign currencies and held them in German and American deposit accounts before converting them and depositing them in the Exchequer. This was in fact unconstitutional so that Haughey was obliged to introduce a law with retrospective effect to sanitize his actions, at least legally.

1970s and 1980s

Context

Three aspects of the context of the 1970s must be kept in mind while considering the coming events. First, Keynesianism dominated the popular understanding of economics as well as the understanding of many politicians. In the latter case, an over-simplified version of Keynesianism also had the charm of allowing ministers to spend money and increase in power. Second, terrorism was growing worldwide, perhaps because of Soviet intervention (Lockwood 2011). The political situation of Northern Ireland was one hot point for terrorism that reached London, and became an important political issue also within the Republic of Ireland. Third, the early 1970s was the time of the first oil crises and the late 1970s of the third oil crisis. There was a massive wave of inflation into the double digits throughout the west in the 1980s. A fourth consideration not particular to the 1970s is that government in Western democracies requires politics, the effort to gain and remain in power. As a consequence, those who govern us tend to be at least somewhat obsessed with power.

The Bretton Woods exchange system[3] had been having the unpopular secondary effect of inflating the value of the US dollar, weakening US exports and leading Charles De Gaulle to announce that France would sell its US dollar reserves to purchase gold at the Bretton Woods exchange rate. This occurred in 1965. First, West Germany and then the USA exited the Bretton Woods system in 1971. Immediately, the US dollar began to depreciate. Meanwhile, when Gaddafi had taken over Libya in 1969, he had pursued an aggressive oil policy that appropriated a greater portion of oil profits for his country. Oil producing for export countries (OPEC), founded in 1961, now had to resolve the problem of contracts based on the rapidly depreciating US dollar. Working as a cartel controlling oil reserves and the global oil trade market, they attempted to negotiate contracts on more favourable terms.

It was the Yom Kippur war in 1973 that led to a marked increase in the price of oil. After replacing Gamal Abdel Nasser as the president of Egypt, Anwar Sadat managed to persuade King Faisal of Saudi Arabia to use oil prices and supply as a diplomatic tool in global politics. On October 14, the USA flew munitions into Israel. The plan had been to fly them in discreetly by night, but the execution was off, and the munitions arrived in full daylight, a more blatant affront to the Arab world. The six "Gulf Nations" (an important subset of OPEC) took two steps. First, they increased the selling price of their oil by 70% on October 16. On October 17, they declared an oil embargo on the US and close allies. On October 19, Richard Nixon announced US$2.2 billion in aid to the Israeli war effort. On December 22, 1973, with the war long ended, OPEC set the price at US$11.65 per barrel. Nixon had announced the military and financial aid, but the whole non-OPEC world ended up paying dearly. As Sorkhabi formulates it:

> In hindsight, the Arab oil embargo did not cause a significant shortage of oil supply. According to Daniel Yergin, it removed about 4.4 MMbopd [million barrels of oil per day] from the international market, and only for five months. This amounted to 9% of the total 50.8 MMbopd in the non-Communist world. However, the "oil weapon" was something the world had not seen before; it thus created uncertainty, speculation and fear not only among industrial countries, which were nervous about being subjected to the embargo, but also among ordinary people whose consumption of oil had [previously] rapidly increased. (Sorkhabi 2015)

Meanwhile, a series of oil management measures by Nixon and then Jimmy Carter had the unintended consequence of increasing US dependence on imported oil, and thus world demand for oil. The price of oil followed a rising trend until it spiked from 1979 (the Iranian revolution) to 1980.

One consequence is that a historical study of any of the euro zone countries in crisis from 2007 to present might find the roots of the crisis in the oil shocks of the 1970s. A dramatic rise in the price of oil leads to dramatic inflation and unemployment. However, the same logic applies to other countries, many of which dealt handily with the crisis.

What happened in Ireland? In spite of the rapid growth, policy had an Achilles heel: the propensity of ministers to revert to the "simplified" Keynes to justify their exaggerated spending both on external programs and expansion of the civil service, in the pursuit of self-aggrandizement ("solo initiatives emanating from a band of strong-willed, independently-minded ministers pursuing indulgent, populist policies that frequently ran counter to budgetary and financial constraints and were pursued often with a view to the enhancements of their own public profiles, sometimes their own purses." Chambers, Chapter 7). The onset of the 1970s brought a chain of events that greatly magnified that propensity.

The over-simplified interpretation of Keynes came to the fore, as ministers vied to inject funds into the economy to provide stimulus, gradually abandoning Whitaker's approach of incrementally building productivity by delaying consumption. Ireland differed little from other OECD countries in this regard and, like them, built up considerable debt by the mid-1980s. The government had to borrow to cover current expenses.

This must be put into context. Governments in most of the developed world were increasing expenses. UK total public spending increased fivefold in the 1970s (see http://www.ukpublicspending.co.uk). Meltzer (1979, p. 122) makes the following comments:

> [Re France] if the authorities wish to stabilize the economy they must implement a credible program to control the growth of government expenditures (including social security expenses)

> … the gap between government expenditures and revenues should be smaller
>
> [re Germany]
>
> What is required is a reduction in the nominal growth of government expenditure so that the government's share in nominal GNP does not increase above its current 47%. (Ibid., p. 125)
>
> [re Italy]
>
> The uncontrolled surge in public expenditures is the single most important problem facing Italy today. (Ibid., p. 125)

Two things were happening. First, the oil shocks were increasing the price of other stocks and commodities both via transport and via feedstock (as for plastics), so government expenditures increased somewhat. Second, and more importantly, simplified Keynesianism was the order of the day as the post-war boom foundered under the oil shocks. Governments spent in order to "save" the economy. There were two problems with this policy. If the oil shocks increased prices, government spending would only seem to put oil on the fire by contributing to inflation. Second, when first Paul Volcker in the USA and then other central bankers dramatically increased the prime interest rate, the cost of new government debt jumped.

Politics and Policies

Liam Cosgrave led the Fine Gael/Labour Party coalition government that came into power in 1973. Fine Gael had lost the 1965 elections, and James Dillon retired as leader at that time. Cosgrave was both senior in the party and the son of William Thomas "W. T." Cosgrave who had been the first president of the Executive Council of the Irish Free State from 1922 to 1932. His authority within the party was thus at least partly based on fidelity to the vision of the pioneers of modern Ireland.

Loss of the 1969 election and his law-and-order stance on terrorism weakened that authority. Terrorism is usually inspired by a cause, and in Ireland that cause was reunification and the lot of Catholics in Northern Ireland. The reuniting of all counties on the island of Ireland remained a dream of many patriots, quite independent of what might be the majority will in the separated counties. This reunion sentiment was to be found among members of both parties, but the Fine Gael party, sitting in opposition to the current government, had the luxury of being radical without concern for consequences beyond popular sentiment. In spite of this, Cosgrave exerted his influence over the government by pushing the Taoiseach to procure the resignation of two ministers who seemingly were indirectly involved with arming the terrorist Irish Republican Army. This both established his power within his party and weakened the support from some members. He supported the Fianna Fáil government's Offences Against the State Amendment in late 1972, in defiance of popular sentiment within his party. This surely weakened his support within his party, but the party's coalition with the Labour Party came into power in 1973 and he was named Taoiseach.

The need for coalition was also itself a curb to his authority as would soon be the reaction to austerity measures and tax increases of his government. The National Coalition was oriented by a written agreement between Fine Gael and the Labour Party. The agreement made the coalition drift left: government policy became more left wing, in line with Labour Party policy rather than the usual Fine Gael position (Laver 1992). This forced Richie Ryan, the new finance minister, to create a wealth tax that alienated farmers as well as the better-off city dwellers, while bringing in fewer revenues than the death duties it replaced. The written agreement and coalition may also help to explain the organizational and policy approach of Cosgrave's government: he ceded great leeway to his ministers (many of who were comparable political heavyweights) and applied the policy approach of the written agreement. As a result, the relatively conservative Ryan was outgunned and unable to deal effectively with the challenges of the oil crisis. The coalition failed to win the next election.

There followed (1977–1992) a period marked by internal dissension and politicking within the Fianna Fáil party. In summary, the leadership of Jack Lynch was challenged and defeated by Haughey. Jack Lynch had developed his governing skills under Lemass and thus tended to respect the needs of the economy although he was not beyond promising economic candy to the electorate. Haughey built up his power both by garnering grass roots support among the new and younger members of parliament (numerous enough when the party won the 1977 elections) and by brazen courtship of the electorate by lavish expenditures.

Thus, when Haughey became Taoiseach, the country was deep into financial crisis, thanks to his own spending and the energy crises of the 1970s. Now that he had obtained power he had the ironic luxury of a statesman-like speech:

> *The figures which are just now becoming available to us show one thing very clearly. As a community we are living away beyond our means. I don't mean that everyone in the community is living too well, clearly many are not and have barely enough to get by, but taking us all together we have been living at a rate which is simply not justified by the amount of goods and services we are producing. To make up the difference we have been borrowing enormous amounts of money, borrowing at a rate which just cannot continue.* (Cited by O'Malley 1981, p. 54)

Haughey then proceeded to worsen matters with overspending. He then called a general election which various events delayed, leading him to ever more spendthrift campaign promises to win the June 1981 election. His party won 77 seats, more than either Fine Gael (65) or the Labour Party (15), but forcing him to cede to the coalition of these two parties. Garret FitzGerald took over as Taoiseach and, in the face of the tattered finances of the state and the condition of the Irish economy, he abandoned campaign promises and allowed his finance minister to introduce austerity budgets, the second of which led to the government's defeat on January 27, 1982, and the calling of new elections in February 1982. Fine Gael lost only two seats and was out of power. Fianna Fáil formed the new government without an overall majority and Haughey's spending to purchase support led to misgivings among many party members and efforts to oust him. He quelled the revolt with savage manoeuvring, and then attempted to introduce austerity measures, lost the support of the splinter left wing in the Dáil (parliament) and the government fell. The subsequent election returned a coalition government that enjoyed (as coalition) an absolute majority. The Taoiseach, FitzGerald, was able to stabilize the state of public finances, but unable to turn around the economy. Ireland was in recession, as was much of the West. Fine Gael sought to redress the country's fortunes by reducing spending and the deficit, whereas the philosophy and the immediate political necessity of the Labour Party were to maintain services at the very least. Only an exception relationship between FitzGerald and Dick Spring (leader of the Labour Party) maintained the coalition in the face of disagreements such as the initiatives of the Fine Gael finance minister. Fianna Fáil in opposition, meanwhile, had the luxury of voicing populist protests against government efforts to control spending. The coalition survived the entire mandate; the intention of reduced public spending did not or at least was compromised.

Alan Dukes, Minister for Finance, circulated a secret memo in September 1984 warned "the financing of public expenditure even for the remainder of this year cannot be assured… If the government are forced to approach the European Community or the IMF for assistance, this will be given only on conditions which will impose on the economy from without decisions far harsher than those now contemplated" (Gartland 2014). Indeed, Ireland's debt had increased tenfold over the ten years since 1974. Yet this debt level was relative: at 53% of gross national product (GNP), it was at a very modest figure by current (2017) standards. The Western countries were in a debt race at the time and Ireland was merely leading.

The reality was that Fine Gael wished to correct the financial situation, but the coalition with the Labour Party obliged it to increase revenue rather than dramatically decrease spending.

Public consumption at £1942 million in 1986 was only marginally higher than the £1927 million level of 1982. Taxation, on the other hand, had increased substantially from less than 27% of GNP in 1979 to a little over 36% in 1984, where it held steady (Anonymous 1984, p. 118). Perhaps this eventually led to the Fine Gael loss of the 1987 elections, which saw the rise of the Progressive Democrat Party at the expense of Fine Gael and the Labour Party, and thereby a dilution of the opposition seats. Fianna Fáil campaigned by attacking Fine Gael's efforts to right government finances by increasing taxes and promised increased services and spending. This message appealed to at least part of the population, and Haughey thus found himself once again Taoiseach of a minority Fianna Fáil government. Once in power, however, he reneged on his promises and undertook to cut expenses and increase government revenue. Dukes, former finance minister, became the leader of the opposition Fine Gael. His understanding of Ireland's financial and economic situation still held and he showed statesman-like qualities in a famous speech at the Tallaugh Chamber of Commerce stating "I will not play the political game which produces the sort of phoney economic analysis which has passed for opposition in the past" (Regan 2010), he promised he would not oppose any government economic policy that proved to be in the national interest. Thus, Haughey had sufficient support for spending cuts within the Dáil (Irish house of parliament) even though he led a minority government.

Two years later, sensing an opportunity for a majority in the Dáil, Haughey called a snap election and formed a new government in 1989, this time in coalition with the Progressive Democrat party. Neither Dukes nor his party benefited from his statesmanship, although the country would.

The outcome of the previous 20 years of politicking was an anaemic economy and growth of government expenditures, government deficits and government debt. Shrinking government and a growing economy would mark the coming years.

Up to that point, ever-larger deficits and debt had occurred in spite of government efforts to increase revenue. These efforts become obvious through studying records of the Irish Revenue Department during those years. A value-added tax was created in 1971. Joining the EEC in 1973 brought in funding from the Community. In the same year, the Department began collecting Pay Related Social Insurance contribution on behalf of another department (Social Welfare). In 1974, the Minister for Finance raised the issue of the farming community paying taxes. A Capital Gains Tax was introduced effective as of fiscal 1974–1975. In 1978, the excise tax on tobacco began to be charged on the retail product rather than on the cheaper leaf. Diverse legislation in the 1970s closed tax loopholes but simultaneously increased the complexity of taxation. The Revenue Department would consequently grow, opening Special Enquiry units in various locations and beefing up staff. Thus, "Almost half of the 7,588 people working in Revenue during 1981 were engaged on taxes work" (Revenue n.d.). The year 1982 saw the introduction of value-added tax at the point of import, as well as on legal and other services. Value-added tax rates were increased 5% in 1983. All of these measures worked to increase revenue *and* the size of the Revenue Department.

The same source (Revenue n.d.) mentions only three measures over the following ten years: "Self-Assessment was introduced for Income Tax [in 1988], followed by Corporation Tax and Capital Gains Tax. Self-Assessment was preceded by an interest and penalties Amnesty to clear old arrears and get taxpayers' affairs up to date. Over £500 million was collected for the Exchequer. The Government's 1993 Amnesty was successfully implemented by Revenue and brought in some £260 million for the Exchequer. This Amnesty, … included the 15% Incentive Amnesty for pre-1991 income and gains…" (ibid.)

With Dukes' support of the Haughey minority government, the tide to big government and booming expenditures finally had been turned. The figures for government expenditures, deficit and debt reinforce this impression (cfr. Tables 4, 5 and 6): the growth of debt stalled over 1984–1986 and reversed in 1987.

The erection of the International Financial Services Centre, soon to be a source of growth of GDP, was also in 1987.

The in-house support of spending cuts increased in a 1989 general election that resulted in a coalition of Fianna Fáil with the four-year-old free-market-centric Progressive Democrat party. This latter party was to participate in four of the five coalition governments that oversaw the shrinking government (relative to the size of the economy) and the rise of the Celtic Tiger (1989–1992, 1997–2002, 2002–2007, 2007–2009).

Table 4 Annual average expenditure of Irish public authorities in millions of pounds, 1960–1980

Years	Expenditure	Expenditure/GDP
1960–1962	231	33.9
1962–1965	314	35.5
1966–1968	434	38.7
1969–1971	686	41.9
1972–1974	1190	45.0
1975–1977	2532	55.1
1978–1980	4338	58.0

Source: OECD Report on Ireland 1982, p. 42

Table 5 Deficits, debt interest and servicing for the Republic of Ireland, 1975–1982

Year	Deficit as percent of GNP	Debt interest as percent of current expenditure	Debt servicing as percent of current expenditure
1975			17.9
1976			20.2
1977	3.7		20.6
1978	6.2		21.1
1979	7.1		21.4
1980	6.4	6.8	21.4
1981	7.9	7.8	22.1
1982	5.5 estimate in March	9.8	23.9

Source: OECD Report on Ireland 1982, p. 28 and 29; 1985, p. 17

Table 6 Percent change in debt/GNP ratio for the Republic of Ireland, 1981–1992

Year	Change in debt/GNP ratio in percent
1981	3.0
1982	6.0
1983	9.5
1984	6.0
1985	7.8
1986	6.6
1987	0.4
1988	–6.0
1989	–9.5
1990	–5.6
1991	–3.5
1992	–3.6

Source: OECD Economic Surveys: Ireland 1991, p. 50

The coalitions of the previous governments of the 1970s and 1980s had resulted in a tendency to increase spending. The presence of the Progressive Democratic Party led to diminished income tax and controlled expenditures relative to GDP (at least in the twentieth century).

What was Ireland in the last two decades of the twentieth century? Ireland was a wonderful mix of promise and realization, of an old culture and modernity. But Ireland was and is a small country, with a population under 5 million. This meant that the elite, drawn from a smaller population, were never separated by more than a friendship or two. Second, Ireland was united by a still fresh and somewhat naïve patriotism: the heritage of the Rising was still strong, stronger than the conflict between political parties vying for power. Ireland has not yet met its Vietnam. It was to meet it in the banking crisis. As a result, the electorate still trusted leaders, harsh though its criticism be. As a result, the professionalism of the professions was often tainted with an old boys network culture. Accounting firms would tolerate or only mildly comment anomalies, as did regulators. Civil servants did their job, and the top civil servants did the top civil servants jobs. No more than that. No Irish equivalent of "the buck stops here." On the contrary, professionals feared adopting adversarial positions as an appearance of personal animosity and thus … unprofessional.

Although a new spirit of the age occupied the Dáil, it is not to be supposed that government actually shrunk. As Fig. 5 shows, the 1980s was the only period during which government spending stalled. Public service payroll increased 70% in real terms from 1997 to 2003, but the greatest increase was in health—136% real increase from 1997 to 2003. The 2014 Expenditure Report of the government of Ireland (p. 9) observed five phases in government spending, four of which interest us here:

1. 1980–1990: This decade saw nominal growth in GDP, but expenditure relative to the size of the economy fell dramatically, driven by the consolidation in the second half of the decade.
2. 1990–1994: This trend reversed at the beginning of the 1990s, when economic growth was less than half the growth seen in expenditure (GDP grew by 28% but expenditure grew by 66%).
3. 1995–2000: Expenditure growth accelerated, but it did not keep pace with economic growth (GDP over this period grew by 97% while expenditure grew by 56%).
4. 2001–2007: After 2001 the trend reversed again—between 2001 and 2007 GDP grew by 60%, peaking at €188.7 billion, while expenditure rose by 80%.

An apparent boom in the economy seemed to allow for increased spending even as the new spirit repeatedly eroded the tax base by diminished income tax rates, compensated for by pro-cyclical[4] revenues such as

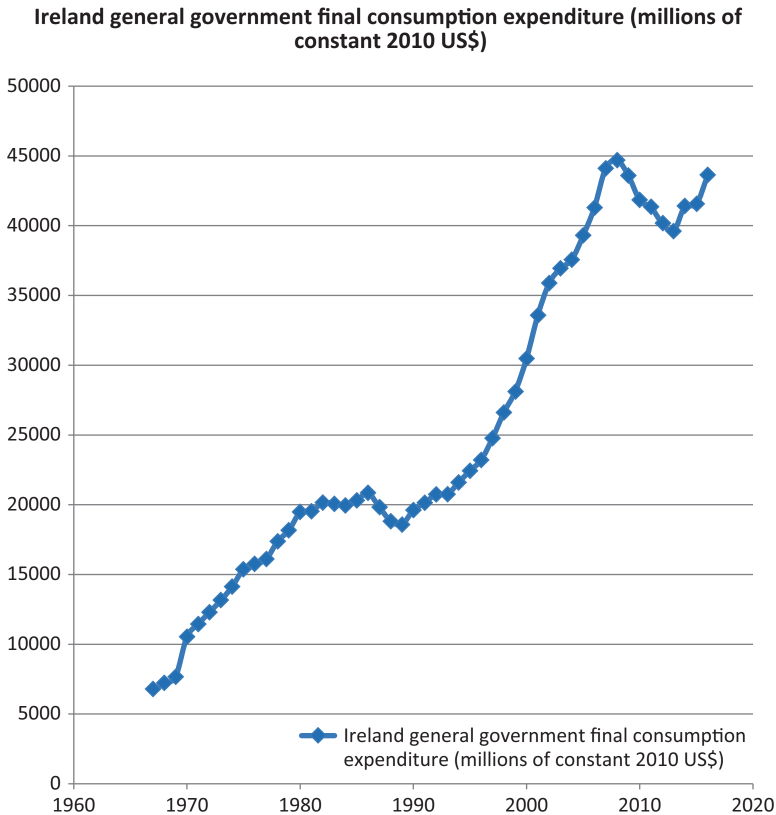

Fig. 5 Ireland, general government final consumption expenditure

corporate tax (on business profits), capital tax (on the capital of corporations) and stamp duties (lump-sum tax on the purchase of property or land). This would lead to a brutal reduction in government revenue when the economy slowed in 2007, just when the government would wish to contemplate emergency expenditures.

The espoused philosophies of the governments of Ireland from 1987 to 2007 contrasts with the fiscal policies of those governments as indicated by expenditures as a percentage of GDP. In spite of the "smaller government" discourse of both Fianna Fáil and Fine Gael at time, as well as the pro-market shrinking government philosophy of the Progressive Democratic Party, their governments and coalitions were characterized by increased expenditures not only in absolute terms, but also relative to the growing GDP. Surprisingly, it was under coalitions with the Labour Party and the Democratic Left party that expenditures over GDP decreased. Indeed, if we combine the two series available for government current expenditures in Ireland from 1970 to 1996 and from 1996 to present, we see an uninterrupted growth of current expenditures up to the crisis.

The major impact of the Progressive Democratic Party was thus to eradicate much of the tax base of government, replacing income tax with pro-cyclical sources of revenue such as corporate profits and such taxes.

It was indeed government action that gave birth to the Celtic Tiger, but it was action taken much earlier than the policies from 1987 to 2007.

Lower tax rates, FDI, social partnerships, moderating wages, evolving labour input, a timely devaluation of the Irish pound, the state divesting itself of public capital in the 1980s, improved economic planning, improved infrastructure, language, geographic location and membership in the European Union are the principal reasons given for the rise of the Celtic Tiger. Together they provide an intentional but unforeseen blueprint for economic growth at the close of the twentieth century.

The next few pages examine each by turn.

The Celtic Tiger 1993–2007

A Blueprint for Economic Growth

Lower Tax Rates

Part three of the 1956 Finance [Miscellaneous Provisions] Act provided 50% relief from both income tax and property tax to Irish corporations exporting goods of Ireland, for those good exported in excess of the 1956 baseline. This relief was extended to all goods exported in 1960. Services were excluded (Walsh and Sanger 2014; Act). This act was a direct consequence of a growing awareness among some civil servants, such as Whitaker, and some politicians, such as Lemass, that Ireland urgently needed economic growth to be viable as an autonomous political entity. The growth would eventually require a move from agriculture to industry, but more immediately required a more open economy to sell Irish goods and also attract foreign investment. The Irish economy was soon expanding at the rate of 4% or 5% per year.

Membership in the European Union

Joining the European Union was a key element in Ireland's strategy for development. However, the European Union would not accept 0% tax rate for export as opposed to a 50% tax rate on corporate profit for non-exports. Ireland joined the European Union in 1973, abrogated the tax relief for exporting goods while "grandfathering" it until 1990. In 1981, Ireland revised corporate taxes and introduced a 10% corporate tax on all trading manufacturing profits. This was later extended to services in the International Financial Services Centre (created in 1973) and in Shannon airport. The European Union rejected this state of affairs in 1998. Ireland again revised its taxes: 12.5% on all trading profits (services as well as manufacture), 25% on non-trading profits, and 20% capital gains tax. This became effective on January 1, 2003.

None of this has any meaning until compared to corporate tax rates in other countries as Table 7 permits. Ireland had a lower tax level than all countries.

The effect of this low tax rate has been twofold. First, it encouraged manufacture for export, which in Whittaker's view was the key to modernizing

Table 7 Corporate tax rates compared

Country	Main effective corporate tax rate for country in percent
Ireland	12.5% (for trading income; 25% for non-trading income)
Germany	Over 50% on joining euro, approximately 30% in 2017
France	40% on joining euro, 33.3% since 2007
Greece	40% on joining euro, 3% in 2017
Italy	27.9% (24% for IRES[a], 3.9% for IRAP[b])
Spain	25%
UK	30% in 2000, under 20% in 2017
USA	39%

Sources: Walsh and Sanger 2014, p. 7, Trading Economics
[a]IRES = Imposta sul reddito delle società
[b]IRAP = Imposta regionale sulle attività produttive

the Irish economy. Second, it encouraged FDI, also crucial in Whittaker's view as providing a greater capital base as well as introducing more advanced technologies and management techniques.

Wages

Moderately priced manpower was another attraction for FDI (Fig. 6). Not only was there wage advantage for Ireland, Ireland also boasted a well-educated workforce with mastery of English, the language of business in the twentieth century and the language of the USA where many large companies were interested in serving the European market. This, in combination with the low tax rate for exports to Europe, provided a compelling argument for opening operations in Ireland. The wage advantage was reinforced by wage agreements in 1987, 1991, 1994, 2000, 2003 and 2006. Two factors contributed to the conclusion of these wage agreements: the political will of Haughey, Taoiseach at the time of the first

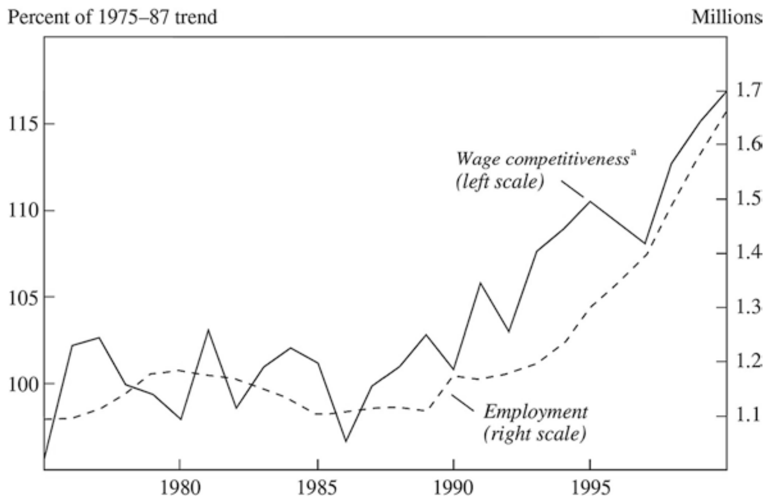

Fig. 6 Ireland, wage competitiveness and total employment (Taken from "Wage competitiveness and total employment 1975–2000" in Walsh, Brendan and Patrick Honohan, Catching up with the Leaders: The Irish Hare, Brookings Papers on Economic Activity, 2002, No. 1. Reproduced with permission)

agreement, and the existence of an appropriate institutional venue in the National Economic and Social Council (NESC).[5] The memorial website for Haughey perhaps claims more credit for his initiative than it deserves, but does provide an interesting insight into the Taoiseach's inclination:

> Chancellor Schmidt of Germany and I were chatting together when I asked him what he would spend the forthcoming week-end on. He said: "This week-end is the most important one in my annual calendar – I meet with the employers and the Trade Unions to hammer out an agreement on the rates of pay and salaries appropriate for the coming year in the light of the economic situation anticipated". I was immediately struck with this commonsense approach and began, in my mind, as I listened to Chancellor Schmidt, to develop and expand the concept. (Haughey 2011)

While Haughey was in opposition (1983–1987), the NESC, chaired by the secretary general of the Department of the Taoiseach, was in serious discussions that would bear fruit in the form of reports to the Taoiseach Office. These reports laid the groundwork for a series of government programmes (see Table 8) that captured the wage agreements. Thus, for example, the NESC published A Strategy for Competitiveness, Growth and Employment in January 1994, and the government acted upon this with the Program for Competitiveness and Work in February of that same year.

The NESC was neither the brainchild of Haughey's government nor that of FitzGerald. The Council, established in 1973, was an expanded reincarnation of the National Industrial Economic Council founded in

Table 8 Wage agreement programmes 1987–2007

Title	Years covered
Programme for National Recovery, 1988–1990	1987
Programme for Economic and Social Progress	1991–1993
Programme for Competitiveness and Work	1994–1996
Partnership 2000	1997–2000
Programme for Prosperity and Fairness	2000–2002
Sustaining Progress	2003–2005
Towards 2016	2006–2007

Table 9 The Road to the National Economic and Social Council

Year created	Name of entity
1959	Irish National Productivity Committee
1961	Committee on Industrial Organization
1963	National Industrial and Economic Council
1973	National Economic and Social Council

1963 and already tripartite: "created to study and advise on the development of the economy, was composed largely of public service, representatives of the Irish Congress of Trade Unions, and employer bodies" (Chubb 1987, p. 223). The National Industrial and Economic Council (NIEC) itself was not created ex nihil but, beginning in 1959, evolved from a series of antecedents (see Table 9) that became increasingly more tripartite in character (Pratschke 1979) in spite of the fact that Irish society itself leaned to free collective bargaining and away from corporatism.

Three elements thus came together to produce the wage agreements: the dire economic context of the mid-1980s Ireland, a long tradition of tripartite consultation and even complicity for the good of the country and the political will of the Haughey government. The further observation of Rory O'Donnell, director of the NESC, is that the operation of the NESC evolved over time, in terms of both content of discussion and method of arriving at a consensus. The content evolved from a macroeconomic perspective such as GDP growth to structural and supply side issues such as education and childcare. The method evolved from high-level bargaining (among the national officers of the social partners) to multilevel problem solving (via discussion in work groups with members from various levels of the social partners) (O'Donnell et al. 2005). In retrospect, this seems to be a code for a change from unity in a patriotic desire to create prosperity, to divvying up the prosperity that already appeared to have been created. Certainly the testimony of Robert Wright is that the social partnerships had decayed at the turn of the century:

> An overheating economy generated labor shortages and higher wage demands. These pressures overwhelmed private sector wage negotiations and, through the partnership process, also inflated public-sector outcomes. (Wright 2010, p. 24)

> Wage competitiveness is an average of the wage rate (hourly earnings) in the main trading partners divided by the same for Ireland, all taken to a common currency and expressed as a percentage of the 1975–87 linear trend projected. The higher the value the more competitive is Ireland. Total employment in thousands. (Walsh and Honohan 2002 note to Figure 5)

Interest in accessing Europe's markets also serendipitously contributed to relative wage moderation. The oil crises of the 1970s had led to higher inflation rates worldwide. This disturbed the European exchange rates because this inflation was not simultaneous across countries. The response of the Jenkins European Commission was the creation of the European Monetary System, wherein member countries agreed to keep their currencies within a band of variation (2.25% for most countries, 6% for a few others). This ultimately leads to such pressure on the Irish pound that it was devalued 10% on January 30, 1993, effectively reducing wage rates in foreign currency terms as well as the price of Irish goods in those currencies.

Privatization

Another factor applies only to a portion of the Irish economy, albeit a significant fraction: the government divested itself of several industries for nearly €8 billion between 1981 and 2001. Of course, the mere fact of government divestment does not automatically produce efficiency and competitiveness gains. According to Palcic and Reeves (2010) "with the exception of one enterprise (Irish steel) we find that all of the former SOEs [State owned enterprises] accrued static efficiency gains in the run up to privatization. Most companies implemented large-scale reductions in employment along with other cost-cutting measures in the drive towards commercialization in the 1980s" (p. 3).

The same authors note that the privatized performance of these firms was at best mixed so that the principle contribution of the state divestment was the anticipatory streamlining. A secondary contribution was to allow the market to deal with inefficiency by acquisition and by closure.

Ireland also eliminated several state monopolies without or before divesting itself of participation in the markets, or distanced itself from other monopolies. For example, Barry (2000, p. 7) observes "In 1979 a new state agency, separate from the department, was set up to run the [telephone] system on a commercial basis."

Air transport between Ireland and the UK was deregulated in 1986, leading to a doubling of traffic. As airfares halved, sea fares also reduced.

In both cases, the elimination of monopolies boosted the economy not only by reducing the cost of transport, but also via revenue such as by increasing tourism and attracting call centres into Ireland.

Telecommunications merits greater attention, both because of its impact upon the Irish economy (51% of new employment in the 1990s was either with direct users of telecoms such as call centres, or with major consumers of telecoms such as financial services (Burnham 2003, p. 554)) and because it illustrates the interplay of decisions by influential players (government policy in this case) and uncontrolled external events (the evolution of telecommunications technology in this case). Ireland's phone system lagged far behind European and world benchmarks in the 1970s, leading to the 1978 Dargan Report and its recommendation to separate telecommunications from the postal service. This became a reality in the 1980s, which also saw the introduction of digital switching and cellular systems. The 1990s completed the modernization of Ireland's telecommunications and brought private competition (ahead of the USA) and the privatization of the formerly state-owned Telecom Eireann. Meanwhile, the telecommunications equipment industry, predominantly centred in the USA, experienced a bubble that grew from 1996 and burst in 2001. The US telecom industry was deregulated in 1996, leading to numerous new entrants buying materials and equipment from manufactures such as Lucent, Cisco and Northern Telecom (Starr 2002). Unit costs plummeted and technical improvements were rapidly introduced to market. While much of the bubble was US centric, the technological and costs effects were global. The result was that the timing of investment to modernize Ireland's telecommunications infrastructure was very good not only with respect to other evolving elements of the Irish economy (improved technical schooling with the Regional Technical Colleges, policies to encourage FDI and other elements listed in the preceding

Table 10 Telecommunications timeline Ireland

1922	New Irish government forms Department of Posts & Telegraphs (P&T)
1978	The Dargan Report: Ireland communications are antiquated; recommends that P&T be split into two entities, Post and Telecom
1979	Telecom Eireann is formed
1980	Digital switching introduced
1983	Telecom Eireann formally takes charge of Ireland's national system
1986	Eircell, first mobile telephone network, goes live
1993	First private competitor (Esat) to Telecom Eireann
1999	Telecom Eireann becomes a public company; changes its name to Eircom

Sources: Call Cards (2012); Hamilton 2017; Irish Independent 2014; Telearchives n.d.

paragraphs) but also with respect to the evolution of the technology and of costs in the telecommunications industry.

World class telecommunications made Ireland all the more attractive to many kinds of foreign investment (see timeline in Table 10).

Participation in the European Union and Workforce Dynamics

Participation in the European Union (since 1973) also had beneficial effects. The European Union structural funds programmes had little direct impact on Irish GDP—Barry (2000, p. 12) estimates a half percent contribution to GDP—but the consequent improved infrastructure enhanced Ireland's attractiveness to FDI. Further, the European bureaucratic requirements for this infrastructure funding helped improve Irish government planning processes.

A hidden asset of the Irish workforce was its resilience: If unemployment (see Fig. 7) and immigration (see Fig. 8) characterized previous decades, this meant the workforce could grow both by fuller employment and by reversal to positive migration (from emigration to immigration) of workers.

This indeed happened: the unemployment rate dropped from nearly 18% in 1987 to around 4% from 2000 to 2007. Further, net migration increased from negative 40,000 in 1988 to over plus 70,000 in 2006. This combined increase in the labour force would have a terrific impact on the GDP of the country. Even had productivity per worker remained stagnant, which it did not (see Fig. 9), the number of man-hours worked in Ireland increased each year, resulting in an increase of the domestic

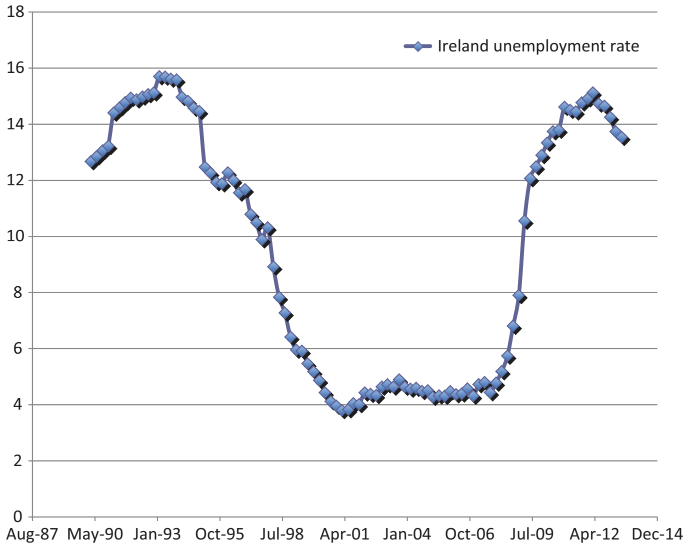

Fig. 7 Ireland, unemployment rate

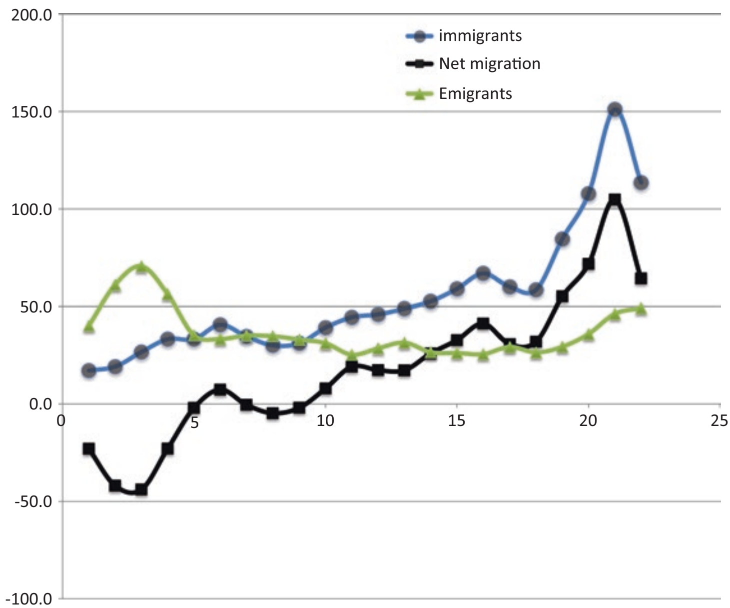

Fig. 8 Ireland, net migration

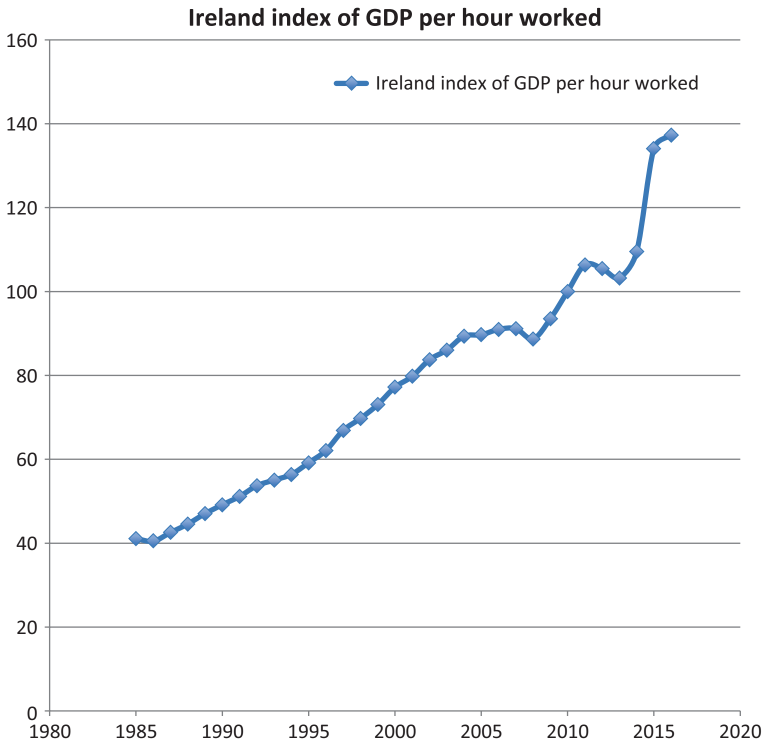

Fig. 9 Ireland, GDP per hour worked

product. To the absolute increase in labour was added an increase in labour productivity measured in GDP for hours worked, as Ireland caught up to the level of other western European economies such as Italy.

Productivity increased not only per unit of labour (Cassidy 2004, p. 88), but also per unit of capital and other inputs. The share of the population at work in low-income agriculture had decreased (see Fig. 10).

Results

In summary then, many factors on many orders contributed to the rise of the Celtic Tiger. While fortuitous timing of events played a role, it is also true that human initiative was crucial—with individuals of influence and groups united in patriotism.

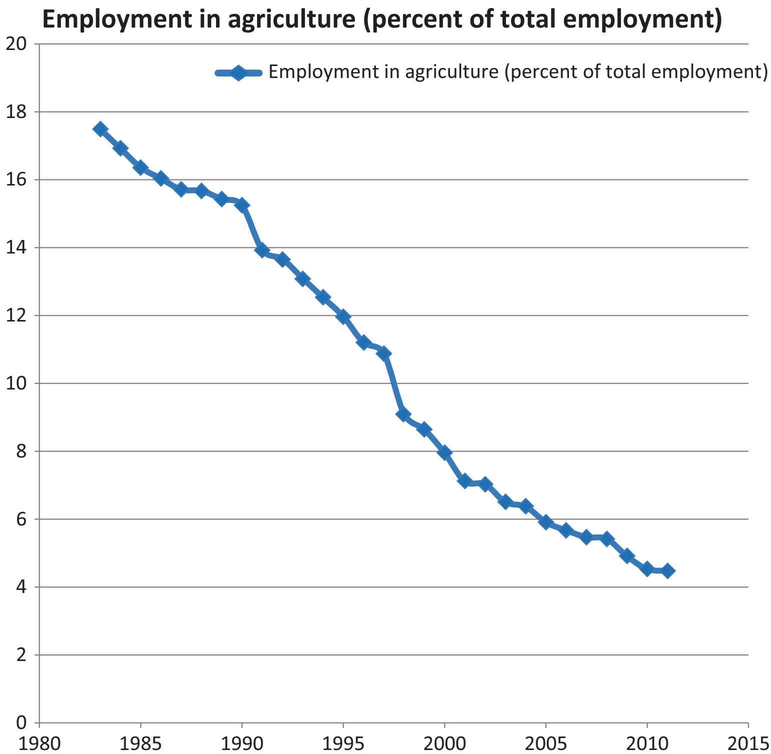

Fig. 10 Ireland, employment in agriculture

Table 11 Comparative figures for the Celtic Tiger years

Year	1993	1997	2007
GNP (PPPUS$ billion)	50.87	73.45	176.9
GDP per capita (US$)	14,642.43	22,496.14	61,215.49
Unemployment (%)	>15	12	<5
GDP growth rate (%)	2.7	10.8	4.9

Table 11 provides an overview of the Celtic Tiger years. The GNP more than tripled in 25 years. The poorest of the OECD countries in 1993, Ireland produced over US$60,000 per capita in 2007, the year in which the USA itself achieved under 50,000 per capita. Unemployment dropped from nearly 16% to under 5% in the same time span.

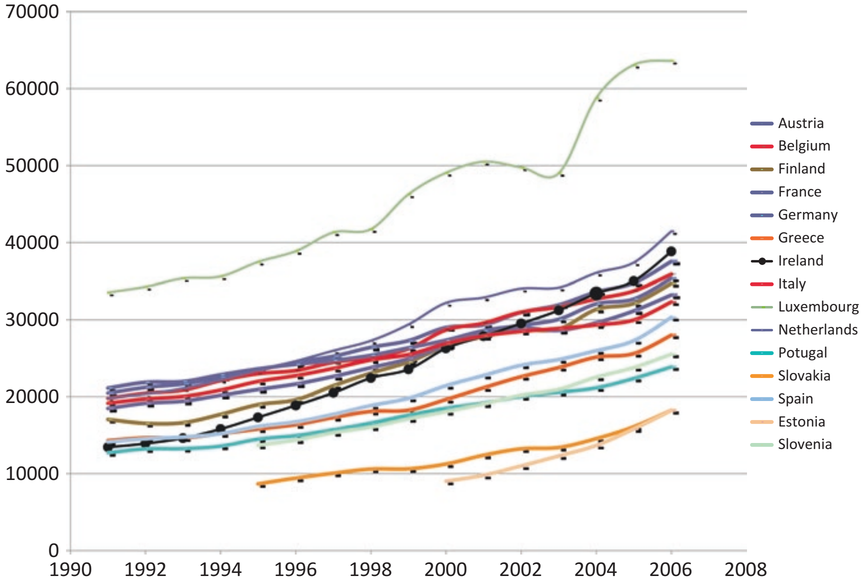

Fig. 11 GNI per capita compared

Perhaps the best indicator of the Celtic Tiger years is the evolution of gross national income (GNI) per capita. Figure 11 presents Ireland in bold with other euro area countries as faint lines. The majority of curves are above Ireland's in 1991, while only two remain above Ireland's in 2006. We have already seen (Fig. 7) that unemployment dropped from 1986 to 2002, rose a little, and then remained more or less stable thereafter until the crisis. The growth in the workforce, combined with increasing productivity, resulted in the upsurge in GDP seen in Fig. 12.

This enviable record led the Economist to comment:

> Fifteen years ago Ireland was deemed an economic failure, a country that after years of mismanagement was suffering from an awful cocktail of high unemployment, slow growth, high inflation, heavy taxation and towering public debts. Yet within a few years it had become the "Celtic Tiger", a rare example of a developed country with a growth record to match East Asia's, as well as enviably low unemployment and inflation, a low tax burden and a tiny public debt. (October 14, 2004)

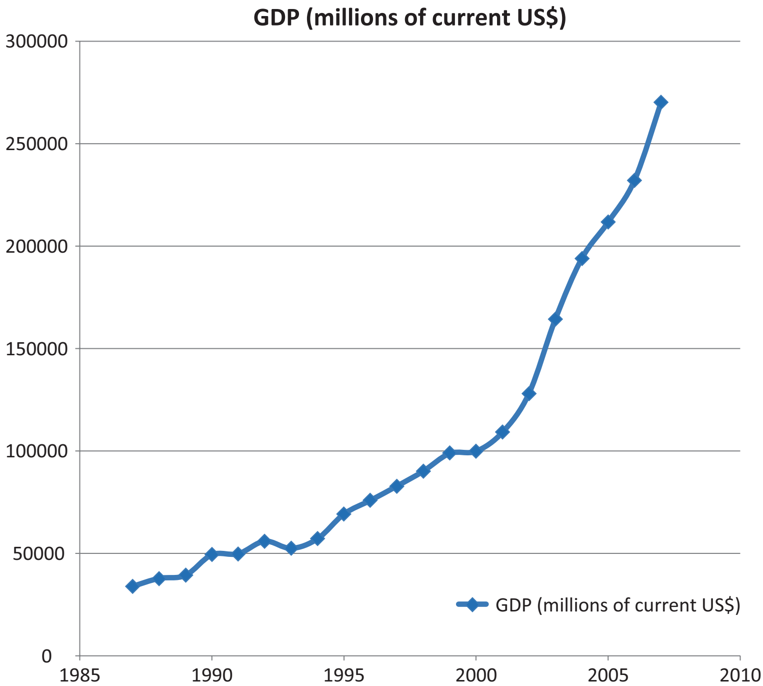

Fig. 12 Ireland, GDP in US$ millions

Yet all this changed in 2008. That year the economy shrunk by 2.6%, and by a further 6.4% in 2009. GNP shrunk to PPPUS$157.3 billion by 2009. Unemployment was back up to 15% in 2010. The economy was in crisis. The government shared in the crisis of the economy. After a string of surpluses from 2003 to 2007, the government deficit grew from 7% of GDP in 2008 to 32.3% in 2010.

What had happened? We have seen that the 25 Tiger years had a basis in fundamentals put into place by a multitude of decisions and by opportune events. How could such a strong economy suddenly pivot into catastrophe?

The following explanation (see Fig. 13) was taken from a newspaper article of 2010 (which will not be identified) and represents the common and inaccurate assumptions about the crisis in Ireland:

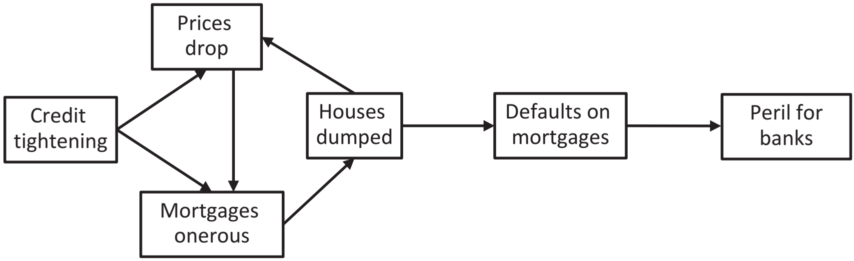

Fig. 13 One myth about the Irish crisis

> *How did Ireland melt down so quickly? One of the key factors was a U.S.-style, easy-money real estate bubble, in which banks provided cheap credit to almost anyone who wanted to buy or build houses, dramatically hiking prices. The boom lasted for more than a decade, but when the global recession hit in 2008, home prices collapsed and people could not pay back their loans, imperilling the banks holding the debt.*

There is much that it is true in these sentences. There was easy access to credit, real estate played an important role, there was a boom that lasted more than a decade and banks were imperilled (and effectively failed). However, it is not clear that easy credit alone cause the price increases. Although real estate played a role, mortgages were not the first problem to menace the banks. The boom lasted more than a decade, but the bubble did not. Most importantly, asserting that easy credit caused higher prices or that real estate caused the crisis is vague in the end, leaving us only part way to an understanding of the dynamics that brought about the crisis. To go further we must examine events in more detail and try to discern the difference between the context—circumstances that facilitated or motivated action—and the agents that brought about the catastrophe.

The Onset of the Crisis

A Hiccough

Many OECD countries underwent a recession or near recession a little after the turn of the millennium. Several countries of European Union underwent it in 2001 and nearly again in 2003; the USA entered into a small recession in March 2001.

Kanda (2008) did a vector autoregresssion on data from 1997 to 2006 in order to capture the spillover effects on Ireland's economy, finding a substantial part of the variance of Ireland's GDP to be explained by shocks to US GDP while, in "contrast, shocks to quarterly euro area and U.K. GDP have a strong contemporaneous impact on Irish GDP, but no significant effect thereafter."

It would have been no surprise, then, if Ireland's growth slowed in 2001 and remained weak through 2003. In practice, Ireland's GDP growth slowed somewhat over 2001 through 2003, while the GNI barely hiccoughed.

Nonetheless, Philip Lane (2011) saw the international recession in 2001 as a turning point for the Irish economy. Although Ireland's rapid growth resumed afterward, it no longer had productivity growth as its basis, but rather a surge in construction activity ultimately fuelled by rapid credit expansion.

The data support this contention. The harmonized competitive index rose (see Fig. 14), meaning Ireland became less competitive, while the seasonally adjusted Value of Production Index in Building and Construction (a measure of the volume of construction activity) increased from 207.2 in the first quarter of 2003 to 341.6 in the first quarter of 2006—a 65% increase in three years. The figures for residential construction are even more imposing. The index was 454.7 in the first quarter of 2003 and reached 820.4 by the first quarter of 2006, an increase of over 80% in three years. The index is based on the 2010 value = 100, underlining the dramatic drop in value from 2006 to 2010.

The real estate cycle easily lends itself to booms and busts because of positive feedback among credit, demand, prices and collateral value: cheap mortgages raise demand, leading to higher prices and thus higher nominal value of the collateral for mortgages, and increased profitability for mortgagers (banks or other), leading to a greater supply of mortgages (cfr. Herring and Wachter 1999; Hilbers et al. 2001; Levitin and Wachter 2012; the 2011 article of Philip Lane explains the dynamic in the case of Ireland). Inexperience or cynical opportunism may lead one bank to inflate its investment in real estate during the boom, leaving its assets vulnerable to a bust if supply overshoots the capacity of the market.

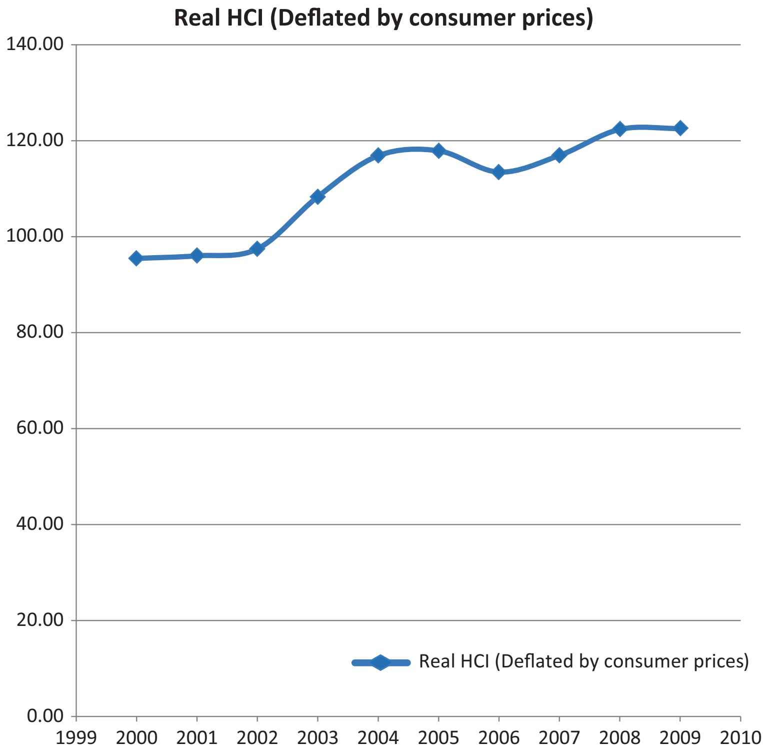

Fig. 14 Ireland, harmonized wage competitiveness

Other banks may be drawn in by the herd effect. The danger is all the greater in a narrow market (i.e., when a small number of creditors dominate most of the market). This was the case in Ireland.

Real Estate and a Few Prophets

Real estate had boomed before the hiccough. The increasing employment rate, return of emigrés, new immigrants and the arrival of more women into the work force all meant that there were more households with more money. Add to this the Irish preference for ownership over renting, and a strong demand for housing could easily be foreseen. Since supply is slow to catch up to demand (rezoning land, design and construction take time), it was natural that prices rose dramatically in the face of this demand. Over the years 1996–1998, new house prices increased between 10% and 19% annually, depending on the size and location of the house.

There are accelerators built into any housing market and perhaps more so in small markets such as that of Ireland: (1) construction is labour intensive, and thus growth of the industry leads to increased employment and thereby growth in housing demand; (2) rising prices brings increased value of collateral and thus comfort with larger mortgages; (3) easier access to mortgages can lead to an increase of house prices and, when there are relatively few suppliers of mortgages, there is danger either of collusion or else groupthink among mortgagers: increased house prices are in the mortgagers' interest as larger mortgages bring larger profits.

At first glance, one might think that 1994 is the start of a housing bubble as housing prices outpaced growth in income. Certainly the early to mid-1990s was the start of an impressive boom. However, other factors should be taken into account. First, supply is sluggish as new land needs to be developed and construction itself is a long process. Second, simply witnessing increases in price would be to compare apples to oranges because the quality of housing was changing as the Irish commanded a higher income.

David McWilliams was the first economist in Ireland to predict a crash of the Irish real estate market. On prime time television in 1998 and again in 1999 he predicted a crash of the Irish real estate boom by about 2000 or 2001. He was not alone in seeing a bubble around 2000. Roche (1999) argued that there was a bubble in the Irish housing market although declined predicting when it would burst beyond estimating "estimate the probability of a crash in the Irish housing market to have increased to around two percent by the end of 1998." Hardly bearish. Other authors (Bacon 2000) were even more circumspect, noting a departure of price from fundamentals without declaring a bubble.

McWilliams got the crash right. The real estate boom stalled in 2001. Prices for new homes dropped by 4.6% and used homes by 10% (Donovan and Murphy 2013, p. 61). However, demographics, real growth in income per capita (based on productivity fuelling exports), the move to higher quality housing, all pointed to strong boom without a bubble. The deflation of the telecom and dot.com bubbles weakened Ireland's IT sector, and the major terrorist attacks on American soil of September 11, 2001, weakened trade worldwide: these could explain the end of the boom, as could a slowing of the fundamental factors such as GDP growth. Whatever the case, there was fear that prices would fall still further. Ireland's government intervened (December 2001) with tax relief measures on interest payments and a reduction in stamp duty (the cut government took on real estate transactions). The banks were not outdone, as they introduced higher loan-to-value ratios (even exceeding 100%) and extended terms from 25 to 30 or 35 years.

Housing prices began to rise again in 2002, and did not stop for five years. This was the real bubble.

Morgan Kelly (2006) is considered by most to have been the prophet of the 2008 crash, although he did not set a date and the bubble was bursting by the time his prediction was published. Rossa White, economist with Davy stockbrokers, observed that house prices in Dublin varied from 34 to 96 times annual rent and trending to 100 times annual rent. (A ratio of 15–20 is indicative of an equal trade-off between renting and buying a house. Above 20 indicates that rentals are the better use of funds.) Further, "On a countrywide basis, (…) since April 2001, house prices are up 52% on average nationwide but rents are down 2%!" (White 2006). This led to the conclusion that "the fundamentals suggest that it will be an adjustment in prices, rather than rents, that will eventually bring valuations down to more realistic levels."

After the bubble burst, Kelly (2009) further argued that neither lower interest rates (for the importance of interest rates in Ireland, see Honohan and Leddin 2006; McQuinn and O'Reilly 2006) nor growing population had as great an impact on house prices as did the massive availability of mortgages. This assertion is based on an ordinary least squares regression analysis of the data. This supposes exogenous variables, which seems reasonable at first glance: interest rates were determined by the European Central Bank (ECB) acting in the world market, the population by demographic changes, and the availability of mortgages was an investment decision by bankers. However, although bankers could err or could (and did) exaggerate, their decision could never be independent of population size, so it is difficult to accept population and mortgage availability as completely exogenous. This does not mean that the result of the analysis is wrong; it simply underlines fragility in the conclusions. A further consideration is that GDP per capita rose rapidly over the period covered by Professor Kelly's data set, and this could perhaps be more important than any of the three variables considered in his analysis (for the impact of income on pricing, cfr. Kenny 1998). Although rising prices were supposedly outpacing fundamentals such as growth of income, one of the most important consequences of increased household income would be the pursuit of higher quality housing, an area of convergence with the richer countries in Europe understandably ignored by the plethora of authors following up the pioneering work of Professor Kelly. Although there are limited data available (Shinnick 1997 and Lyons 2013 have led this work in Ireland), it would seem obvious that the standard of new housing improved dramatically in Ireland from 1990 to 2010. Since many other household expenses are relatively inelastic, and since home ownership was traditionally a priority for the Irish, the "fundamental" contribution of income could hardly be a linear function of that income. As incomes increased, households spent a greater portion of income on home purchases.

How the Real Estate Boom Came to an Abrupt Pause

Three waves of concern for the housing market preceded the crash: at the end of the 1990s (e.g., Roche 1999; Bacon 2000), around 2003 (McCarthy et al. 2003; Roche 2003) and again in 2006 (Ahearne 2005; Kelly 2006; Rae and van den Noord 2006). Regarding the 2003 moment, McQuinn (2004) concluded that prices were in line with fundamentals, while Woodall (2003) argued houses to be 42% overvalued. Approaching the 2006 moment, Murphy (2005, p. 23) found that "In the absence of good measures of financial liberalization, it is difficult to quantify the deviation of Irish house prices from fundamentals."

The common thread in all of this concern was that house prices might be unsustainable and thus subject to a correction that would be ominous for the mortgage portfolios of Irish Banks. Outstanding mortgages stood at €123,002 million in December 2007 (the population of Ireland was 4.4 million at the time). The figure for total *domestic* loans to construction (€10,280 million) and real estate (€96,019 million) was comparable

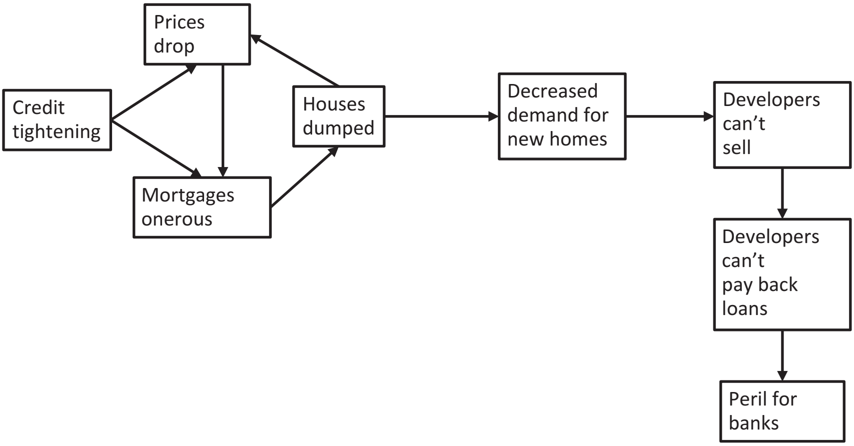

Fig. 15 Another myth about the Irish crisis

at €108,299 million. Donovan and Murphy (2013) point out that inclusion of foreign activity by Irish banks brings this figure well above that of mortgages. It was these commercial loans that failed long before the mortgages. It is remarkable that developers continued to invest in new projects for 15 months after real estate prices began to drop, peaking only when the crisis became obvious to the general public in September 2008. Although the gradual but steady drop in household prices did eventually lead to defaults in mortgages, the failure of Ireland's banks and the fiscal crisis this failure brought about were the result of loans to property developers, and not the result of mortgage defaults (Fig. 15).

Understanding this business decision (loaning to developers) is the key to understanding the evolution of real estate in Ireland. To understand it, we must examine the case history of the bank emulated by others in the pursuit of loans to real estate developers: Anglo Irish. The best source for this is Simon Carswell's Anglo Republic (2011) to which the following paragraphs are heavily indebted.

Anglo Bank (later to become the Anglo Irish) increased deposits in the 1970s by advertising and promotional activities aiming at higher end market and staying open at lunch time (when other banks closed) and then pursued acquisitions to expand capital, increase deposits and acquire talent and contacts. From 1978 to 1982, Anglo offered bridge loans to professionals waiting for mortgages with larger, sluggish banks to come through. The focus changed to commercial mortgages in the mid–1980s. Anglo's advantage was thus to focus on a niche (£15,000–£100,000) neglected by larger banks. Anglo also offered fast decision-making and portrayed their services as an addition to client's accounts with big banks, not an alternative. Explaining this brought them into a relationship with the clients. This relationship emphasis was reinforced with the acquisition of Irish Bank of Commerce in 1988, a bank centred around a relationship culture. It also had numerous builders and property developer accounts. Anglo remained loyal to developers caught in the slow period at the end of the 1980s and the early 1990s (Carswell 2011, p. 29), but focussed on hospitality clients (hotels, pubs, restaurants) for new clients at the start of the 1990s. Anglo continued to grow through acquisition of other banks or at least loan books of other banks through the 1990s.

As the property market improved from 1993 on, Anglo supported the developers who now returned the loyalty. Between 1996 and 1998, Anglo took the lead in this market and improved its ability to approve loans quickly. This differentiated its services from those of other financial institutions and allowed Anglo to charge a slightly higher premium on interest and higher arrangement fees than other banks. The developers had banks of undeveloped and sometimes un-zoned land; as parcels of zoned land were developed and sold, the remainder increased in value and thus created accounting profit. Anglo would lend more against this new equity (Carswell 2011, p. 31).

Of course, developing the land meant construction, so further financing would be required to realize the profits. Development projects thus possessed a momentum that drew in new funds after old (Carswell 2011, p. 71).

Anglo Irish built its business on trust and loyalty born of having stood by clients in an earlier (1993) crisis in real estate, and on nurturing the business relationship. This approach differentiated their service, as did their speed of decision-making. The bank thus was able to charge a premium for its services. This was the asset side of the banking business; on the liability side (deposits), Anglo Irish also offered better service (by being the only bank open at lunch time) while competing with better rates. Eventually the asset side of the business outstripped the deposits, and Anglo Irish began to borrow from foreign banks.

This was a profitable business model and the lenders within the Anglo Irish bank were the stars, earning good bonuses as they brought new business to the bank.

There were a few problems, however. One problem is that the loans were secured both by the real property whose real value would drop if the loan failed, and by the personal net worth of the developers—which would also drop in adverse circumstances and was in any case insufficiently researched. A more important problem was the internal dynamic of this loans business. Profits entered accounting but were not actually collected until loans were closed. The bank was also aware that the healthy appearance of the loan pipeline required new loans (Carswell, p. 70), and individual lenders within the bank had incentives to make new loans, not to vet them. Further, because the business model was so good, the cash did not enter Anglo Irish coffers even then because the loans were usually rolled over into new projects, thus increasing profitability on the accounting books. Anglo Irish was like a gambler on a roll, repeatedly increasing the ante.

The extent of the housing market ultimately represented a limit to the growth of property development. Unfortunately, this limit was very loosely linked to the dynamics of loans to developers. The latest market transactions were not visible to banks making the loans; rather, they saw the 12- to 20-month-old financial results of developers, as well as their rosy prospectus and the solid, matured relationship with this client. Eventually, this would lead to sending good money after bad. Figure 16 illustrates the flow of funds. With limited outlet other than property, the result was a crescendo of development loans. The limit of the market was still real, however, and was attained by late 2005 when prices stalled and began to slowly drop.

Anglo Irish enjoyed enormous growth from the mid-1990s to 2007, and other banks moved to emulate this success. As a result, the increase in lending to the builders and developers by Irish banks was far more important than the growth in mortgage lending. Since retail prices are usually higher than wholesale prices and materials, this was a clear signal of non-sustainability—unless one dreamt of an explosion of purchases five years down the road. Individual banks might be unaware of the extent of mortgage lending by rivals, but the governance of the banks should have noticed this discrepancy.

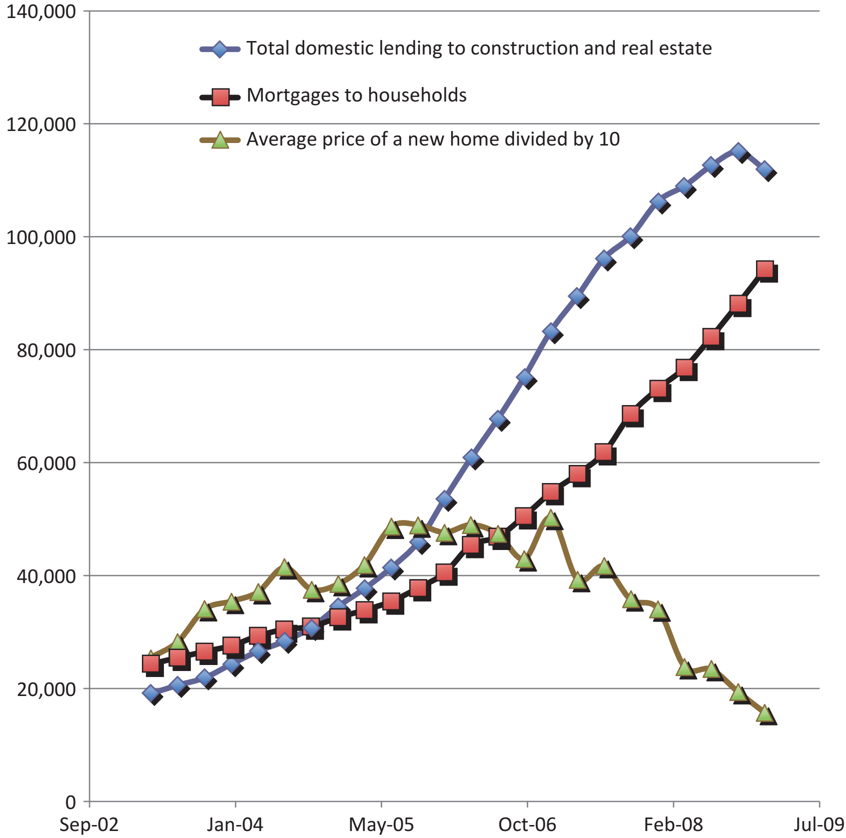

Fig. 16 Ireland, comparison of housing prices, mortgages and lending to developers. The data have been manipulated to permit visual presentation in one chart. Thus, for example, the quarterly "house price" is represented as a multiple of the 2000 average price. This multiple is again multiplied by 200 to produce the visually comparable data point. As a consequence, intersection points have no meaning. The chart serves only to compare the flexion point for each series

There were two stages to the bust of the real estate market in Ireland. The first was that of the developers in 2006 and led to the failure of Anglo Irish and weakness of other banks, the bailout by Ireland's government, and subsequent government deficits and debt. The second, and more gradual, was the decline in residential prices, halving from 2008 to late 2012. During this time, mortgage payments in arrears grew to 18.5% by the end of June 2013.

Although the value and volume of residential construction peaked in the fourth quarter of 2006, it dropped gradually and did not reach bottom until the fourth quarter of 2012, when both began to rise again. Employment in construction peaked in 2007 (Central Statistics Office 2008, p. 6).

Prices were slower to change than construction employment, construction (housing) transactions and value. Large real estate agents were faster to leave the business (by selling out) than were the developers (Ross 2009, Chapter 7).

Again, the general unemployment rate did not rise until February or March 2008, breaking 8% in 2009 and 14% in 2010. Further, GDP did not drop until a year later, from US$274.71 billion in 2008 to US$235.39 billion in 2009, similarly for GNP. The drop in GDP is thus general and not mainly explained by the slowing of construction.

This suggests that the residential real estate boom was not a bubble, but the residential construction industry experienced bubble-like conditions because of the miscalculations of some developers who built ghost developments. Then, the mismanagement of the Anglo Irish Bank (and others in herd effects) as well as the management of the bank bailout by Ireland's government influenced by ECB caused a more general economic crisis that, together with media coverage of the supposedly bursting bubble, eventually led to a deepening drop in residential prices.

Tightened credit meant that growing unemployment met with the impossibility of refinancing mortgages and an increase of arrears.

Although euro zone interest rates doubled to 4% from 2006 to 2009, Ireland's private sector credit peaked in 2009, so we would expect residential prices to peak at that time if availability of credit were the principle factor. However, increased mortgage rates meant an increase in the effective monthly rate at a given sales price, so residential prices peaked with the low interest rates of 2006, dropping gradually while credit continued to be available after prices had peaked. This suggests that developers were offloading more and more residences (peaking private sector credit) at ever-lower prices from 2006 onwards.

A Dynamic of the Crisis in Ireland

Blessed with a competent and unpoliticized civil service, Ireland's succeeding governments slowly managed the nation's growth from one of the poorest economies in Western Europe to one of the wealthiest as indicated by GDP per capita. This growth was most pronounced during the Celtic Tiger period, 1993–2007. Increased disposable income and shrinking household size, combined with increasing population, contributed to a rising demand for quality housing which led to a real estate boom. This boom turned into a bubble after the international recession of 2001–2003. One bank in particular, Anglo Irish, had been fostering relationships with real estate developers and met with astounding success. This led to imitation by other banks that over-committed to the real estate market. The aggressiveness of the lending was such that the proceeds of one project were turned over the next, leading to a crescendo of projects. The time lag between land development and housing sales meant that developers stopped committing themselves years after the demand had begun to diminish. As a result, the developers found themselves with ongoing projects that had lost much of their value and were unable to pay back the banks. The banks thus found themselves with massive non-performing loans and ran into liquidity and then insolvency problems. The government of Ireland first guaranteed the banks and then began to bail them out. It ran up a massive debt in doing so and had to get support from the European commission and the ECB. The president of the latter required the protection of senior bondholders so that the taxpayers of Ireland eventually were saddled with net €10,000 debt per capita for the bailout. Ireland's problem was caused by a relatively small number of persons working in banks and in the developers.

Succeeding governments of Ireland built up a solid economy over the span of several decades. Many of the measures taken such as tax reduction, wage moderation and privatization took on new relevance as Ireland joined the European Union and then prepared for participation in the euro. Combined with the potential of the workforce (migration dynamics, language and education level), these measures gave rise to the Celtic Tiger. The Celtic Tiger was characterized by very rapid growth, and in particular led to a notable differential between GDP and GNI as a portion of the profits on FDIs were repatriated.

This economic success led to immigration and thus an increase of population. This larger population also possessed a higher disposable income than in the past. And household sizes were shrinking—from a little over 3.1 in 1996 to as low as 2.7 in 2011. All this combined to increase demand for quality housing. Interest rates dropped from 1995 to 1998, reinforcing the boom. Following an international recession in 2001, interest rates dropped again in 2002. The real estate boom turned into a bubble. Banks began to lend, both to home buyers and to developers. Although the volume of mortgages outpaced that of loans to developers (somewhat in the way retail pricing is higher than wholesale pricing), many banks were particularly aggressive in supplying credit to developers. Interest rates began to rise in 2006 in prelude to the global financial crisis and demand for housing began to weaken. Developers lowered their prices to clear inventory, but they were deeply committed to ongoing projects. Developers fell in arrears and failed, leaving banks with bad loans secured by dubious collateral. This appeared at first to be a liquidity problem, but many banks were in fact near insolvent. The government of Ireland first guaranteed the banks, and then began to bail them out, spending €5.5 billion to bail out banks in December 2008 alone and ultimately €70 billion gross (and currently €41 billion net according to Ireland's Comptroller and Auditor General). The debt of the government of Ireland swelled from 24% of GDP in 2007 to 120% in 2012. Interest rates rose 1% in 2009, and then jumped from 4.5% in February 2010 to 11.7% in June 2011. Ireland turned to the ECB for liquidity assistance in November 2010. It received funding from the International Monetary Fund (€22.2 billion) and from the European authorities, mainly through from the European Financial Stability Mechanism (€22.5 billion) and the European Financial Stability Fund (€17.7 billion), as well as loans from Sweden, the UK and Denmark (Fig. 17).

The circumstances of the crisis were the factors contributing to the real estate boom; the key instigating factor was the herd behaviour of the banks lending to developers. See Fig. 18.

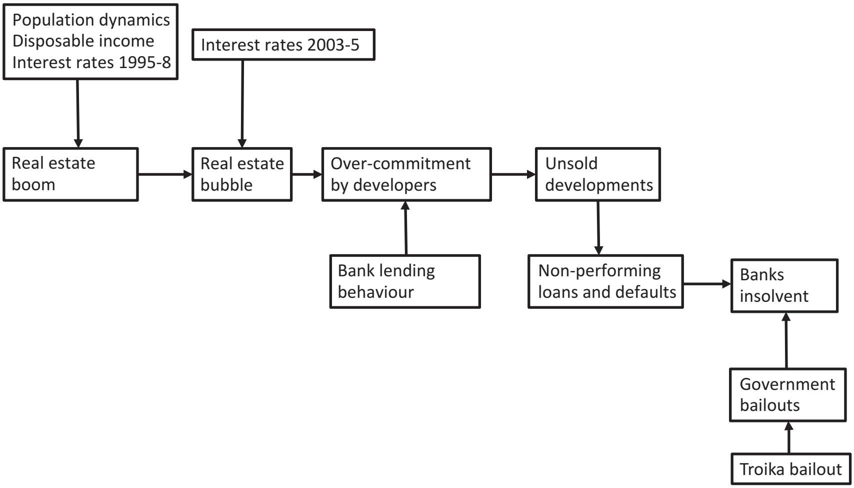

Fig. 17 Dynamic of the financial crisis in Ireland

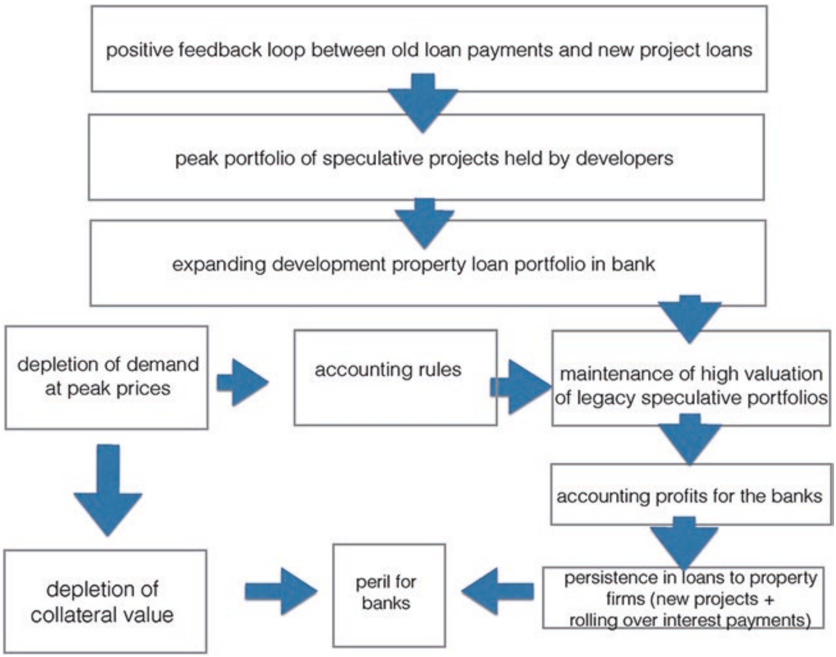

Fig. 18 The dynamic behind the bursting real estate bubble

Notes

1. Northern Ireland, which remained part of the UK and is not a participant in the euro, was the scene of much violence from the 1960s until 1998. The crisis that is the topic of this chapter was a crisis in the Republic of Ireland, so that Northern Ireland will be excluded from the rest of this chapter.
2. Karl Marx wrote that capitalism is doomed to failure because the concentration of wealth would lead to the extinction of demand and thus a seizure of the economy. This theory involved several assumptions (static technology, no government intervention, absolute private property of the means of production, etc.) that made it unrealistic, although suggestive. Keynes, basing himself on the algebra of the measurements we make of economic activity, inverted the insight of Marx, arguing that the state can revitalize a stagnant economy by expansionary policies that increase demand. Demand includes—in addition to consumption—investment, net exports and government purchases.

   The simplified version of Keynesian-influenced policy is this:

   > In times of economic crisis, the government should spend money to create work even if that work is unproductive. This will stimulate the economy, bring a return to growth and make everyone more prosperous.
   >
   > There is an element of truth in this simplification. Both the math and the plumbing analogy (of the economy as a hydraulic system of interconnected tubes and reservoirs), as well as several case histories support this simplification. Unfortunately, this simplification provides a convenient justification for governments proposing populist deficit spending to retain power.

   The simplification also kicks the can down the road.

   Two sentences in the third and fourth paragraphs of the introduction to Book II of Adam Smith's The Wealth of Nations give a requirement for policies targeting *sustained* growth:

   > As the accumulation of stock is previously necessary for carrying on this great improvement in the productive powers of labour, so that accumulation naturally leads to this improvement.
   >
   > The quantity of industry, therefore, not only increases in every country with the increase of the stock which employs it, but, in consequence of that increase, the same quantity of industry produces a much greater quantity of work. (Smith 1811, 193)

In modern everyday language, the accumulation of wealth permits us to produce more wealth. Deficit spending, to some extent, is the use of future wealth in the present, and thus can permit us to create even more wealth as long as this more than covers the interest payments.

However, Adam Smith makes a distinction between productive and unproductive work at the start of chapter III. This distinction leads him—via examples that may appear dated and a logic convoluted by the emphasis on the genesis of economies rather than their steady-state operation at his time—to the following conclusion:

> When we compare, therefore, the state of the nation at two different periods, and find, that the annual produce of its land and labour is evidently greater at the latter that the former, that its lands are better cultivated, its manufactures more numerous and more flourishing, and its trade more extensive, we may be assured that its capital must have increased during the interval between those two periods.... (Smith 1811, p. 244)

It is the use of wealth as capital by spending on machinery, tools and factories that multiply the fruits of human labour that leads to an increase of prosperity. While this insight was begotten in the context of the first industrial revolution (whence the importance of machinery), the heart of it is perennial: the secret of prosperity is the snowball effect of applying wealth to the production of more wealth. And the more prosperous we are, the lesser portion we need to spend on consumption.

3. A currency exchange system that tied currency values to the price of gold. The system lasted from 1941 to 1971.
4. In other words, these tax revenues increased as GDP increased.
5. Its function is to advise the Taoiseach on strategic policy issues relating to sustainable economic, social and environmental development in Ireland.
6. Note: Complete references to unsigned IMF and OECD documents are given in the text and are not repeated here.

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Spain, the Euro and a Crisis

Introduction

This chapter is about Spain and the crisis that occurred there in 2010. This crisis bore a resemblance to the crises in Ireland and in Italy because it required the government to bail out financial institutions. As was the case in Ireland, both the banks and the fiscal position of the country were healthy previous to the crisis, whereas in Italy debt was already around 100% of gross domestic product (GDP), and the otherwise healthy banks suffered from a high incidence of non-performing loans. The crisis in Spain was also similar to that of Ireland in that it involved a real estate boom. It differed in that the crisis in Ireland was much more acute, with the size of the bailouts larger relative both to the GDP and to the population of the country. The crisis in Spain bore some resemblance to the crises in both Greece and Italy in that politicians played a key role, but that role was different because the politicians acted through central government in Greece and Italy but not in Spain, where their impact was felt primarily as directors of *cajas de ahorro*[1] and as regional and municipal administrators.

R. Macdonald, *Eurocritical*, https://doi.org/10.1057/978-1-137-34628-5_4

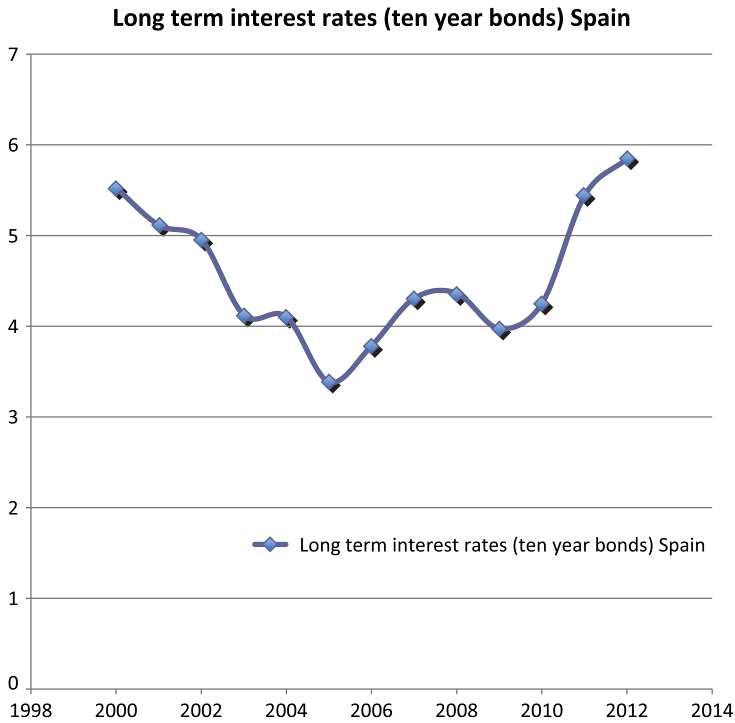

Fig. 1 Spain, long-term interest rates (ten-year bonds)

Numbers reveal the Spanish crisis. In October 2005, Spanish ten-year bonds carried a yield of 3.09%. That yield had been mostly dropping since the turn of the millennium (see Fig. 1). Then followed a series of bumps from 2007. In October 2010, the yield began to rise from 4.09%, reaching a peak of 6.8% in July of 2012. The interest rate Spain's government paid for funds had risen nearly 70% in 20 months. Nonetheless, this compares well with the cases of Ireland (where rates quadrupled) and Greece (where the interest on government bonds reached 38%). The increased yield reflected the rise in Spain's sovereign debt during that time: from 40% of GDP in 2007 to 93% in 2012 and eventually 119% in 2014 (see Fig. 2). This increase in debt was generated by several years of deficit spending. These deficits were caused in part by decreased revenues,

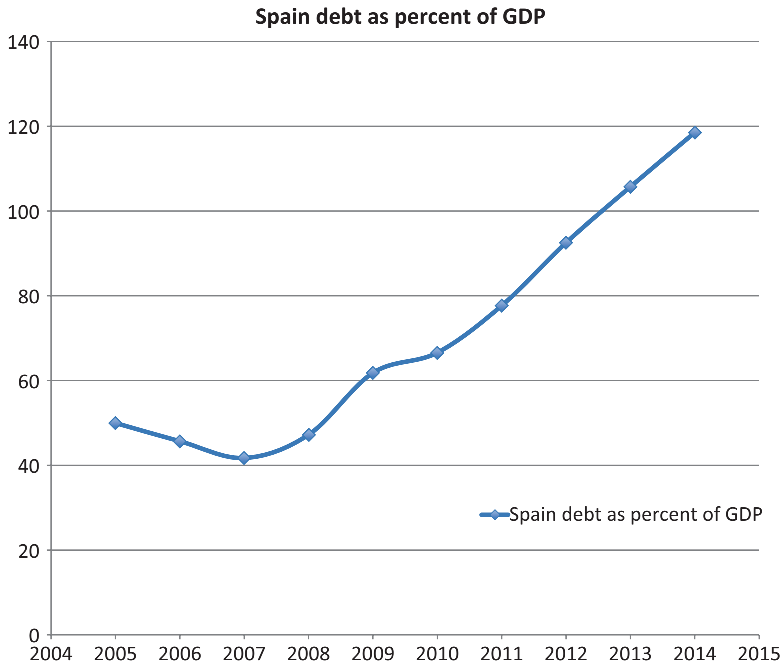

Fig. 2 Spain, general government debt as percent of GDP

as the Spanish economy had entered into a recession, reducing tax revenues. However, an important contribution to the deficits was a series of expenditures to bail out certain *cajas de ahorro*, a type of Spanish savings banks with a mission of regional development. Government spending in 2005 was around €40 billion (see Fig. 3). The government would spend over €50 billion bailing out banks and *cajas de ahorro*. Indeed, funds from the European Commission went directly to the bank bailout and were not officially requested because of any difficulty to access the bond market. It is nevertheless clear that Spain did face a financial crisis. It appeared that financial institutions would fail without government intervention that was burdensome for the Spanish economy.

The financial crisis was accompanied by an economic crisis that had two causes: the worldwide recession caused by the global financial crisis

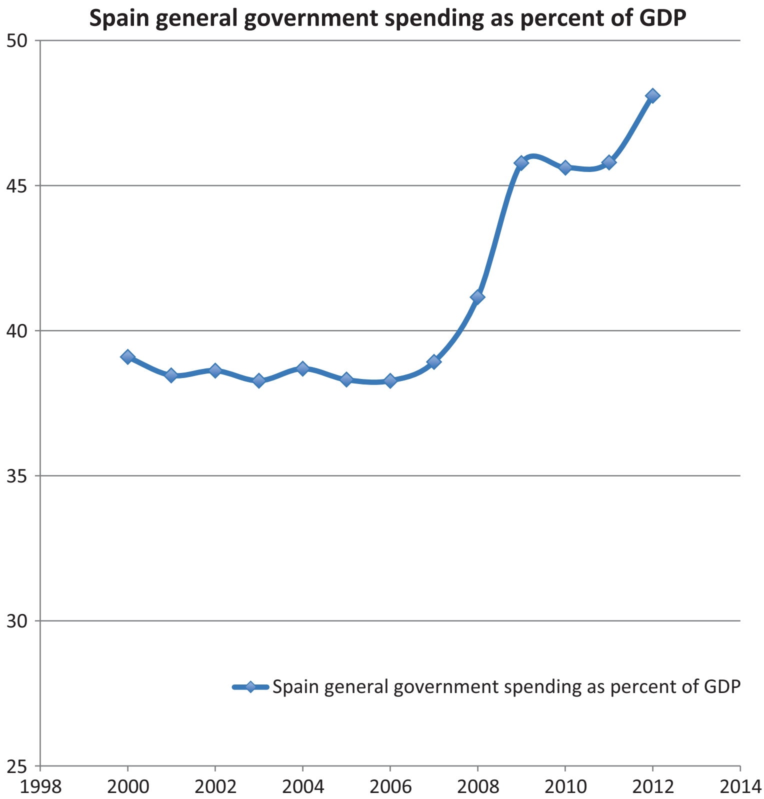

Fig. 3 Total general government spending as percent of GDP

of 2007–2010, and the crash of the real estate industry in Spain. GDP for Spain (see Fig. 4) provides a measure of the recession in Spain.

There are several more symptoms of recession: from 8.2% in 2007, the unemployment rate tripled to 26.1% in 2013. Bankruptcies climbed from around 250 per quarter in 2007 to 3000 in 2013. Government revenues, sensitive to business success and personal incomes, dropped from a little over US$442 billion in 2007 to under US$376 billion in 2009, a drop of 15% just when expenditures were increasing to cover the bailouts.

The financial crisis in Spain originated in the need to bail out the *cajas de ahorro*, and that need in turn arose from the bursting of the real estate bubble in Spain. But what was the source of that bubble, why were the

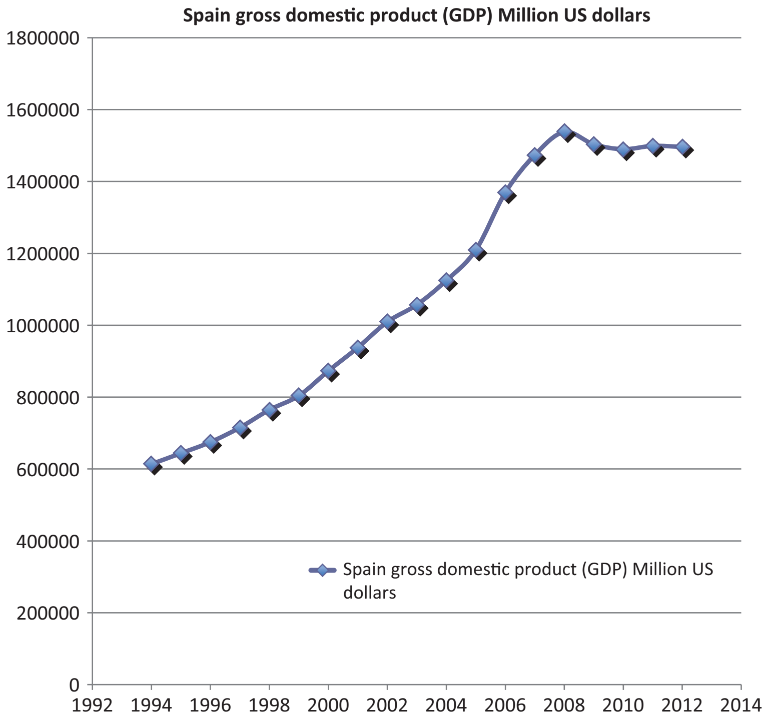

Fig. 4 Spain, gross domestic product (GDP) million US dollars

cajas the principle financial institutions to fail, and why were these bail-outs a sufficient financial burden to provoke a crisis?

The following section provides an economic (and political) historical background. A description of the financial situation of Spain in 2007 then follows. After this come two sections on the real estate bubble in Spain. The first section deals with spurious explanations of the bubble. The second of these sections dwells on underlying factors such as the law governing zoning (*la ley del suelo*) and the corruption of local officials before examining two illustrative cases, that of La Muela and that of Marbella. It then considers the role of money laundering in launching the real estate bubble before considering other factors contributing to the rising demand for housing. After this examination of the underlying factors, the next section examines the *cajas de ahorro* and the role they played in the bubble, particularly by financing developers. The last section proposes a simplified dynamic of the financial crisis in Spain.

Spain Before 2007

Nineteenth-century Spain was a land of great instability. Only towards the end of the century was there a time of relative peace, but the end also brought 1898, the year Spain lost its last colonies (Cuba, Puerto Rico and the Philippines) and had to recognize that it was no longer a world power. The first third of the twentieth century was also marked by great strife. But again there was also a short period of relative peace within that time. These two periods of peace help us to understand both the Spanish Civil War and the politics of Spain after Franco.

The first period of peace in the last couple of decades at the end of the nineteenth century is known as the Restoration under King Alfonso the 12th. The peace was achieved by what is known as the pact of El Pardo, signed in 1885 by two dominant political parties—the Conservative party and the Liberal Conservative party. They agreed to alternate in power. This was possible because both parties were well established with their network of supporters. This understanding would last until the death of Alfonso 12. It is the support base of each party that is most instructive: the Conservative party represented the aristocracy and wealthy landholders, while the Liberal Conservative party represented professionals, business people and the middle class. What Marxists and many social scientists call the working class was not represented. Thus, the stability gave no voice to workers. Nonetheless, this was a period of economic growth in spite of the loss of the last major colonies in 1898.

The second period of relative peace and economic growth was under a dictatorship: the 1920s dictatorship of Primo de Rivera. This dictator called upon the Partido Socialista Obrero Español (PSOE), Spain's Socialist party and one of the oldest Marxist parties in Europe, to govern the state under his dictatorship. The point here is that the PSOE, while founded upon Marxist principles, was not solely seeking confrontation according to the orthodox interpretation of the dialectical materialist analysis of politics, but rather sought to improve the plight of workers by a presence in governing institutions. This attitude would once again resurface in the PSOE party under Felipe González in the 1980s. The second interesting point about the Primo de Rivera dictatorship is that it pursued an economic policy characteristic of the late nineteenth century and the early twentieth century: protectionism. Primo de Rivera's dictatorship ended with the Great Depression. This end led to political strife that became more and more radical, extreme and, ultimately, violent, ending in the Spanish Civil War. This war will not be analysed because it is extremely complex. Further, both sides saw themselves as a champions of good versus evil and there is still some of such sentiment remaining today both among Spaniards and among many intellectuals worldwide.

The war lasted for three years. At the end Spain was devastated. The population had increased somewhat, but the most active working population had been decimated. Further, many cities have been bombed or shelled and the infrastructure of the country had been laid waste—far greater than would be the case of the rest of Europe after the Second World War. There was a food shortage as well as a shortage of manufacturing resources. The country had lost its gold reserves (these had left for Russia on a train; Spain would later be able to compensate partially for this as some Axis-looted gold was stored within her borders). Nor did the country have foreign currency reserves. In summary, the country found itself in sad financial shape, and only had a fraction of the productive capacity that it had enjoyed three years earlier. And that capacity already had been inferior to the productive capacity of the rest of Europe.

A new problem was added to this disheartening panorama: Spain's neighbours quickly became involved in a second bloody world war. Spain had remained neutral in the First World War and, already on her knees and devastated by years of violence, had no choice but to remain neutral in the Second World War. Further, the government of Spain was trying to calculate who would actually win the war before showing any sign of allegiance. Throughout the Second World War then, Spain remained isolated as shipping lanes were patrolled by armed forces from both sides of the conflict.

The close of the Second World War brought no relief. While the Marshall Plan helped rebuild much of Europe, Spain was excluded. On the one hand, Spain had not been a participant in the war and thus could be justified as not being a candidate for the Marshall Plan. Secondly, Spain had shown some sympathy for the Axis cause during the first part of the war (up to 1944) and, although she had collaborated with the USA in the logistics of the Allied side, this collaboration was seen as being opportunistic since the Allies (at least in retrospect) seemed to be winning at that point in the war. On the other hand, Italy, a belligerent on the Axis side and arguably opportunistic in entering and exiting the war, did receive funding under the Marshall Plan.

Besides this exclusion from the Marshall Plan, a much harsher sentence fell upon Spain: intellectuals and popular opinion condemned the Spanish regime of Generalísimo Franco as an enemy of liberty, and worked to isolate Spain from trade. In essence Spain was under boycott. This ostracism was policed to some extent as the General Assembly of the United Nations not only denied membership to Spain, but threatened further action if the regime was not replaced by an elected government (see UNGA Second Session Resolution 39). George W. Bush was not the first world leader to believe that democracy is a panacea. No help would come to Spain from the outside world with the exception of beef: Peron's somewhat similar regime in Argentina did continue trade relations with Spain.

The result was impoverishment of Spaniards and reinforcement of Franco's regime. GDP per capita had dropped some 30% with the onset of the Spanish Civil War, with meagre growth during the Second World War, and dropped again as that war ended.

This isolation of Spain was exacerbated by the economic policy followed by Franco's regime: for the next 15 years, Spain would continue to follow the early twentieth-century economic philosophy of protectionism. The boycott simply radicalized this policy into autarky. Spain would try to work its own way to self-sufficiency. And the road to this self-sufficiency lay in state intervention. The controls and the presence of government pervaded all aspects of economic life: investments, distribution of resources, prices and the little exterior trade were all subject to regulation.

This might have brought some results with minimal international trade, but with almost none… The unsurprising result was that Spain's economy continued to degrade. Productivity dropped both in industry and in agriculture. In addition, the black market, corruption and smuggling were on the rise as citizens sought to overcome (and some to exploit) the hardships and inequities of the situation.

There was some hypocrisy underlying the West's ostracism of Spain. Although Spain was a dictatorship where the head of state had a military background, several other countries in the West had heads of state (e.g., de Gaulle and Eisenhower) with military backgrounds following the Second World War. Spain was extremely interventionist in economic policy, reducing economic freedom to some extent, but so were most western governments. The Spanish dictatorship permitted almost no political freedom: that was the major difference. However, Spaniards remained as free as their poverty would allow in all other aspects of life.[2]

Franco's dictatorship also brought the advantages and disadvantages of a police state: little in the way of violent crime or any crime and little in the way of political freedom.

Things began to change as strategic realities forced US President Harry Truman to overcome his personal dislike for Spain (where he felt his fellow protestants had no freedom of religion) and begin to explore collaboration with Spain as early as 1948. US funds began to arrive in 1951, and Spain and the USA signed the Pact of Madrid in 1953: the USA could establish military bases in Spain and would provide military and financial aid in exchange. This development of external circumstance was followed ten years later by a change in policy makers in Spain. In 1959 new generation of "technocrats" came to guide policy under Franco, arguing for a liberalization of the economy and international trade. This new administration did much to improve the economic situation, and the years from 1959 to 1973 were called the Spanish economic miracle. The workforce moved into cities from the countryside, and only 20% of Spanish manpower was employed in agriculture by 1971. The new economic measures involved some austerity, however, and a significant portion of Spanish manpower went abroad for work, thereby generating a source of income through foreign remittance.

However, the miracle was a modest one. Spain's economy was still closed off from the rest of the world. According to some, this was because Franco had isolated Spain. According to others, it was because the "beautiful people" in Western Europe and America rejected his dictatorship and boycotted Spain. For example, Spain's application to join the nascent European Economic Community was rejected in 1962. Whatever the reason for this isolation, Spanish economic growth, although providing a small breath of fresh air, remained moderate. And, in spite of this insularity, Spain's trade (imports plus exports) grew from 15% of GDP in 1960 to 31.7% of GDP in 1974. There was a settling period after the death of Franco, followed by an increase in trade up to 41.6% in 1984. Another spurt during the years previous to the introduction of the euro saw that ratio grow to over 61% in 2000.

The years immediately following Franco's death in 1975 revealed both the polarization of the country and an almost childlike curiosity and exultation in trying on different ideological jackets. The first government was nominally a moderate one, a compromise between what journalists call right-wing and left-wing tendencies. Subsequent governments varied between those two tendencies, more or less as can be found in most Western democracies, although the rhetoric and to some extent the practice were somewhat more polarized and radical.[3] King Juan Carlos played a crucial role in this amazingly peaceful transition to democracy.

Spanish access to world trade increased after the death of Franco. After joining North Atlantic Treaty Organization in 1982, Spain was finally admitted to the European Economic Community in 1986, and, three years later, the Spaniard Enrique Baron Crespo was elected president of the European Parliament. However, the benefits of an open economy clashed with major increases in the price of oil, which Spain needed to import. The oil shock hit a Spain that was undefended by an appropriate pricing policy or any non-market effort to reduce consumption. It was only upon the accession to majority power by the PSOE, led by a more pragmatic than socialist Felipe Gonzalez, that Spain adjusted to the new price of oil and much of the economy improved. The November 30, 1983, decree on "Reconversión y Reindustrialización" set the scene for a withdrawal of the state from private industry and a liberalization of the economy. Key industries such as oil, coal, electricity, steel, chemicals, shipbuilding, automobiles and textiles were all affected.

This eventually led to some economic growth although not full employment by any stretch of imagination. And it must be understood that this modernization and liberalization were incomplete. For example, men with work experience had their jobs protected, while women and those entering the work force enjoyed less protection (Pérez Diaz 1999, p. 42).

The economy also enjoyed an influx of cash. Part of this was money coming to Spain to purchase real estate, both from wealthier countries in Europe and from the Middle East. This led to an inflation of real estate prices that had a real social impact since young adults in Spain are expected to purchase housing rather than rent. This put greater pressure on young people to continue to live with their parents. The sudden availability of birth control combined with an influx of more promiscuous sexual values from elsewhere in the Occident probably contributed to the severe modification of Spanish mores in the late 1970s, 1980s and 1990s as indicated by plummeting birth rate, more abundant nudity on state and private television and so on.

The world economy suffered two shocks in the 1990s: the real estate crash and subsequent stagnation of the economy in Japan, and the increasing price of petrol caused more or less directly by the Gulf War. These lead to slowed growth for OECD countries, but the impact was delayed for Spain, where a series of large government projects expended enough money to keep the economy growing: celebrations marking the 500th anniversary of Columbus's discovery of the Americas including a world's fair in Seville, preceded and accompanied by massive investments in road and train infrastructure, and the 1992 Olympic games in Barcelona; finally, the Hispasat project launched the first Spanish communication satellite in 1992. Later that year, however, Spain's economy began to contract. Government debt had risen considerably (at nearly 70% of GDP in 1997, compared to 40% at the start of the 1990s and 20% in the mid-1980s) and unemployment now began to increase (three-quarters of a million jobs lost in 15 months).[4] Unhappily, a draught then hit Spain for several years, with a particularly brutal impact upon agriculture in Andalucía and leading to water rationing in several cities. Spain was a participant in the European Exchange Rate Mechanism, and the peseta was devalued three times between mid-September 1992 and mid-May 1993. Britain, Portugal and Italy also had to devalue their currency at this time. The recession ended within a few years: 1999 GDP (US$633,194 million) surpassed that of 1992 (US$629,202 million).

Although the unemployment rate dropped from its alarming 24% for 1995, it still remained high at 15% at the turn of the century. Meanwhile, real estate prices began to inflate.

Still, the economy was booming. Virtually all households disposed of greater wealth, infrastructures improved and quality of life in general was better. The euro was introduced in Spain and ten other countries in 1999, and the peseta was removed from circulation in 2002. A number of economic indicators were moving: the unemployment rate plummeted from 15% (2000) to 7% (2006), and Spain began to import workers from elsewhere in Europe. Residential and business construction increased while residential real estate prices rose from a little over €1000 per square metre to €2000 per square metre (2006).

The Financial Situation of Spain in 2007

The economic indicators seemed healthy enough for Spain in 2007: inflation had varied between about 2% and 5% for 25 years, GDP had grown sevenfold in the previous 30 years, while GDP per capita at constant prices had doubled. Bankruptcy rates were stable from year to year. Business attitudes seem to reflect this state: perennially morose (the industrial confidence indicator has been almost always negative, often at minus 20 and a few times well below minus 30) the confidence indicator was frequently positive in the years 1995–2007.

Perhaps it was sound economic government that contributed to this state of affairs. Government debt to GDP had always been under 70%, and had actually been decreasing steadily since 1997. Much of that debt had been acquired in the 1990 years of megaprojects under the González government that temporarily eased unemployment, only to see it return as high as ever. In 2007, Spain's debt to GDP was 39.6%, which compared rather well with Germany's 67.6%. About 25% of government revenues went to civil service salaries. Social insurance (33.3%), education (11.2%) and health (14.6%) accounted for half of expenses; defence (2.6%) and public order and security (4.9%) were modest for a country that had undergone the traumas of civil war and dictatorship.

Even the unemployment rate, which had always persisted at alarmingly high levels, had dropped from nearly 25% in 1994 to about 8% in 2007.

There was one troubling statistic, however: household debt. As a fraction of gross disposable income (total personal income minus personal current taxes) household debt in Spain grew from 81.5% in 2000 to 139.4% in 2007. Moving from abstract figures into the field affords an understanding of the cause of this trend as well as the dynamics of the entire crisis experienced by Spain.

The Real Estate Bubble in Spain, 1997–2008: Spurious Explanations

Several spurious explanations of the real estate bubble in Spain present themselves: (1) assuming the Spanish case to be identical to the real estate bubble in the USA, (2) making a more general argument of an overabundance of capital and a scarcity of non-risky assets available for investment and (3) the participation of Spain in the euro. This section argues that these explanations are unsatisfactory.

(1) The crisis in Spain shares in some of the factors behind the financial crisis of 2007–2010 in the USA: the context of abundant cheap capital and the investment of large amounts of that capital in dubious real estate projects. The financial crisis in the USA was characterized primarily by an oversized financial services sector and secondarily by an oversized construction industry; in Spain it was primarily the construction industry that was oversized. The crisis in the USA was triggered by the burgeoning awareness of the riskiness of investments reaching the critical mass necessary to provoke widespread panic; in Spain, however, it was the global financial crisis emanating from the USA that triggered Spain's own local crisis.

    The mechanism behind the US crisis was the unlinking of investment incentives from investment performance. This occurred with all actors:

from the agencies rating derivatives of derivatives through to mortgage sales persons and even their clients who were flipping their second residences by selling them at times to clients who could not afford them. The mechanism behind the Spanish crisis was very different and, while perhaps it was almost as complex as the mechanism that foundered the US financial system, the individual elements are easier to understand.

(2) The average price per square metre for new living space in Spain was about €1000 in 1997; ten years later it was approaching €3000. The Ministerio de fomento of Spain gives these figures for the price index for all living space: €702.8 per square metre in 1997 and €2085.6 in 2007. By way of comparison, the cumulative general inflation for this period had been about 50%.

Clearly there had been an overinflation of the price of real estate—a bubble, since it burst in 2008—but what caused it?
The temptation is for economists to say that there was an overabundance of capital and a scarcity of non-risky assets in which to invest (e.g., Andrés 2009). But surely this begs the question—or worse, excuses incompetence or negligence on the part of investors.[5] The oversupply of capital and the scarcity of non-risky assets may describe the context of a crisis, but does not isolate the specific mechanism behind it.

(3) Another frequent explanation of events is that the participation of Spain in the euro deprives it of control of monetary policy, and thus the key instrument by which a country can control recourse to debt within its borders. By raising interest rates, Spain could have made mortgages more costly on a monthly payment basis, thereby inducing potential buyers to purchase homes at a more modest multiple of their income.

This argument is made all the more attractive by considering the case of Germany. In just under nine years from the third trimester of 1999, shortly before the introduction of the euro, until the first trimester of 2008, the German housing real price index plunged from 119.11 to

98.66, about 17%. Since home ownership is an important part of most citizens' net worth, low interest rates were clearly in the interest of the German economy because they keep house prices from dropping too low. Perhaps Germany was influencing the monetary policy of the European Central Bank in its own favour.

There are two problems with this argument.

First, it is not clear that the economic interests of Germany (and France, according to the proponents of this argument) dictated the European Central Bank monetary policy in isolation from financial conditions and from the dictates of the world monetary environment. The reality was that the influential USA was setting the standard for low interest rates. In part this was a choice in the aftermath of the telecommunications and dot-com crash at the turn of the millennium, and in part it was a necessity in the face of the reality of overabundant capital with respect to investors' capacity to find good investment opportunities.

The second problem is that it is doubtful that Spain would have had recourse to higher interest rates to cool down the real estate market and thus the construction industry even if it had the autonomy to do so. On the one hand, it would have faced the same world context as the European Central Bank did. On the other hand, neither the Partido Popular nor the PSOE governments acted in any other way to cool down real estate. The Partido Popular denied any problem until the crash occurred, while the PSOE denounced the bubble while campaigning for office, but seemed afraid to stop the party once in power. Stopping the party might have been good government, but it would have been bad politics. Caballo Cruz (2011, p. 313) notes three strong motivations for politicians to support the boom: increased tax revenues, increased net worth for the majority of voters and reduction of unemployment.

El País (2003), the most prestigious newspaper in Spain, published a survey of "expert" opinions as to the existence of a real estate bubble in 2003. The publication itself of the article already indicates some level of awareness. The division of opinions: leaders linked to the real estate and construction industries denied the rising prices were a bubble, leaders from the government in power denied the bubble, the opposition denounced the bubble, a governor of the bank of Spain avoided the word bubble but wanted to act to moderate prices and economists said it was hard to tell because of insufficient evidence. A few clairvoyant persons made incisive remarks:

> Julio Rodriguez López, president of the Caja General de Ahorros de Granada, stated that "There is a real estate bubble in Spain today, and the cost of land is more a reflection than a cause of the rise in prices."
>
> Carlos Hernández Pezzi, president of the Consejo Superior de Colegios de Arquitectos de España, stated that "It is hard to accept the real estate bubble that we are experiencing today in Spain given that we are in the process of constructing 600,000 new homes that do not correspond to any increase in population."
>
> One can conclude from these varied opinions that the indicators of a bubble were there for all to see, but some persisted in denial.
>
> One hundred university professors and other intellectuals signed the *Manifesto por una nueva cultura del territorio* on March 10, 2006, beginning with the words "There is an alarming trend in the use of land in Spain, caused mostly by a growing massive urbanization of at times inappropriate lots." [*La evolución que están experimentando los usos del suelo en España principalmente a causa de los avances de una urbanización realizada de forma masiva y sobre terrenos no siempre adecuados, es muy preocupante*.]

Was any action taken?

The Partido Popular were in power from 1999 to 2003 and denied there was a bubble. The PSOE came into power in 2003 on a campaign that, among other things, denounced the excessive importance of the construction industry and real estate in the structure of the economy as well as the real estate bubble. However, the party did little to intervene for the years it remained in power (El País 2009).

The Real Estate Bubble in Spain, 1997–2008: Underlying Factors

The *cajas de ahorro* overinvested in opportunities presented to them by real estate developers in collusion with local officials. That is the ultimate cause of the bubble and is the topic of a later section. However, understanding four issues is a preliminary requisite for examining this cause.

These issues are the demographic situation, jurisdictional matters in Spanish land law (*la ley del suelo*), the corruption of local officials who possessed jurisdiction over the land and finally the impact of money laundering upon real estate in Spain.

The Demographic Situation

Because the growth of the real estate market is now seen to have been a bubble, one might easily assume that the cause of rises in demand was merely "irrational exuberance."[6] But there are several underlying factors that led to the start of the real estate boom in Spain.

One was the state of the Spanish economy and society. In most Western countries, there was a population boom in the 15–20 years following the Second World War. Spain did not participate in the Second World War, had been impoverished beforehand and remained impoverished after it. The boom came when the economic measures taken by the technocrats under Franco began to produce results. Baby boomers in Spain were born in the 1960s and 1970s. They did not have the same economic impact as the baby boomers elsewhere in Europe and in the USA, mainly because of the scandalously high youth unemployment rate in the Spain. However, the effect of accumulating savings as cohorts approached or reached retirement did reinforce the trend to increasing wealth. This is in part because of the mutation of the population pyramid: post-Franco Spain was characterized by a change in mores which included recourse to birth control and a drop to one of the lowest fertility rates in the West.

The change in mores (combined with increasing wealth) also led to another trend: households became smaller.

Households became smaller, but the population increased. Although Spaniards were having fewer and fewer children, more and more people were migrating to Spain. As a result, population increased a little over 21% from 1991 to 2011. In comparison, the UK grew 10% over that period, and France grew 11.5%. From this population increase and the decrease in household size, it follows that the number of households and thus demand for housing grew very quickly over that period.

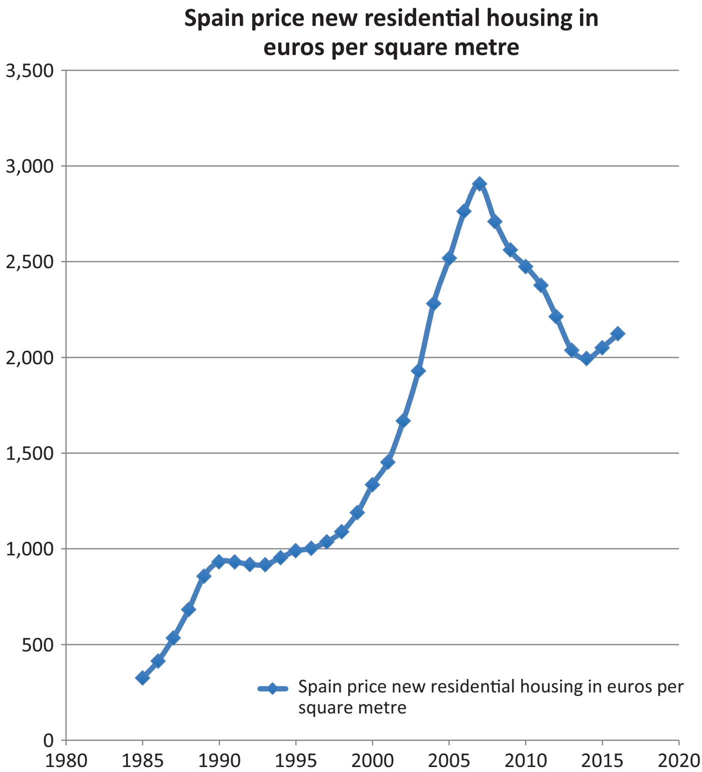

Fig. 5 Spain, average price per square metre for new residential housing in euros

Interest Rates

Figure 5 shows the pricing for a square metre of new housing in Spain, with the climb beginning in 1993 and accelerating in 1997. This in itself does not constitute a bubble, and may simply reflect an imbalance of supply versus demand.

Figure 6 shows that, in spite of a decreasing supply, housing prices dropped from 1990 to 1995 in the city of Madrid, then decreased ever so slightly with varying supply until 1999, after which both supply and price increased dramatically. This suggests that decreasing interest rates were converting the boom into a bubble.

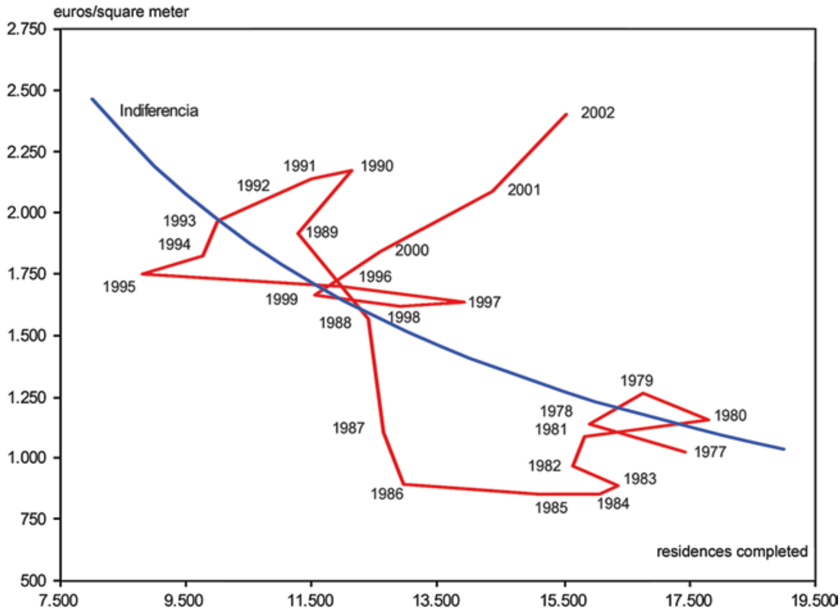

Fig. 6 Price per square metre versus supply of new housing in Madrid (Source: Vergés Esquín 2002; CSCAE 2002, p. 4)

Figure 7 confirms this vision, and suggests that the bubble should approach its end after 2005 if mortgage rates, dependent on long-term rates, are the key factor.

Mortgage rates were indeed a key factor in the demand for new housing, but housing supply was subject to several rigidities that made it less responsive to variations in demand.

La ley del suelo

Spanish land law was formulated and promulgated several times in the past 60 years (1956, 1975, 1990, 1997, 1998 and, though not relevant here, 2007), and the liberalizing formulae of the Aznar government (1997 and 1998) is sometimes blamed for creating the conditions that led to the real estate bubble. In practice, however, legislation in 1978 and jurisprudence in 1997 and 2001 were far more crucial in creating the unhealthy

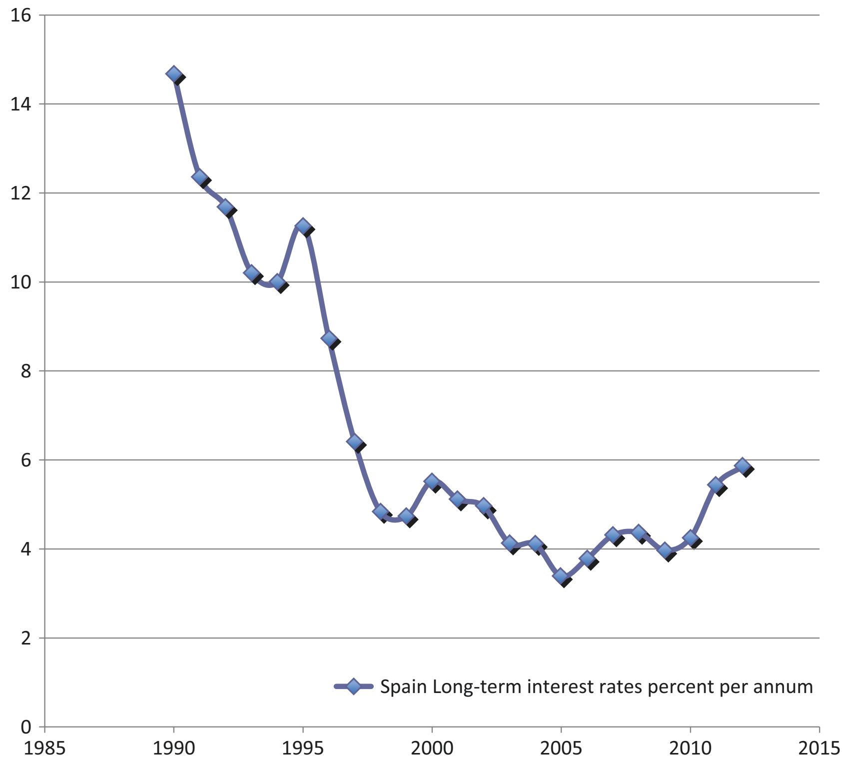

Fig. 7 Spain long-term interest rates percent per annum

atmosphere in which the bubble was born. The Spanish Constitution of 1978 recognized the existence of autonomous regions within Spain with their respective jurisdictions regarding territory and matter. Judgments by the constitutional court in 1997 and 2001 struck down most of the *ley del suelo* passed by the government of Felipe González in 1990 and that passed by the government of Aznar in 1998. Much of legislation and the administration of land were to be under the diverse authorities of the different autonomies. There are 17 autonomous regions, each with its own law, and at least four different administrative approaches to urbanization (Beltran Aguirre 2006; Iglesias González n.d.; see also Bilbao Terol et al. 2006). Although this decentralization made for a complex situation, it did not by itself make for bad administration. What it did do was to increase the possibility that at least one or a few of the autonomous regions do a poor job of administering its land.

When bad administration in one region leads to rapid wealth, it tends to spread to other regions.

Certain liberalizing elements of the 1998 law remained. In order to reduce the price of real estate, the Aznar government had attempted to ease the administrative process first by removing the barriers protecting professionals of real estate (and thus reduced the transaction costs for real estate) and second by simplifying the classification of land.

The first element was to remain untouched. However, even as competition increased among the various facilitators to real estate transactions, interested parties could overly influence the transaction process, as it became less necessary to maintain a healthy separation between one facilitator and another by profession. The developer, the owner and the agent could be related organizationally.[7]

The judgement of 2001 modified the second liberalizing element, however.

Cities and towns continue to expand, and thus urbanization—already characteristic of the nineteenth and twentieth centuries—remains one of the great sources of value creation in national economies. Unfettered urbanization is not in the general interest—anyone having visited ugly towns in beautiful settings knows this. Cultural, historical, ecological and health factors are among many considerations to make before allowing land to be urbanized. On the other hand, as towns and cities expand, the potential value of neighbouring land increases—on the condition that it can be used to erect residential, commercial or industrial buildings (with their concomitant services such as water and electricity) that can be sold. The right of the owner of the land to do so is contingent upon this land being recognized as developable, in a hispanicism, "urbanizable." The 1998 *ley del suel*o had simplified the categorization of land into three classes: urbanized land (where the right had already been exercised), non-developable land (the onus was upon the (local government's land) administrator to demonstrate that it was not in the general interest to urbanize the land), with all remaining land called developable. As a result, the autonomous regions and their municipalities had to make a specific effort to prevent land from falling into the "developable" category. Furthermore, the local government would have to compensate the owner if the administrative process was prejudicial to the value of the land. The effect of the 2001 judgement was to give the autonomous regions more freedom of action in this regard. Most of the power to increase land value by urbanization—an important property right—passed into the hands of local governments.

The problem here was not the decentralization of power, because the central government had effectively devolved much of that power into the hands of landowners. The judgement was rather than the central government never had that power to devolve, because it was a prerogative of the autonomous regions (and not of private citizens).

Corruption of Local Officials

Local officials instantly became interested parties in urbanization, firstly because the administrative procedure (which involved a tax on transactions) was a source of revenue for the autonomous regions and secondly because urbanization brought new tax revenues into municipal coffers as well as tracts of land (10% of reclassified land had to be ceded to the municipality for public service infrastructure, and not all would necessarily be used) that could be resold.

There was a third and darker reason for this interest.

Urbanization involved large sums of money, and some of those monies could find their way into the budgets of individual officials or, worse still, into their pockets.

As a result, quite possibly urbanization was more rapid in some regions and municipalities than it would have been under the simple (liberalizing) classification scheme of the 1998 *Ley del suelo.*

It is difficult to estimate the impact of these interests upon the bubble, and ridiculous to think that they are the sole cause. The examination of a couple of instances of corruption, however, will illustrate the relevance. The first is a simple case of a small town in which urbanization was simply a part of a larger web of corruption woven into the exuberance of rapid growth. The second is a large coastal city where the urbanization and revaluation of real estate was at the centre of corrupt activities.

La Muela

La Muela is a small town about 23 km (by road) from Zaragoza, Aragon. In 1996, shortly before the bubble in Spanish real estate, the population of La Muela was 1100 persons. Fifteen years later, in 2011, the population was over 5200. This rapid growth was not necessarily as remarkable (although the highest growth rate for Spain—in 2007—was only 1.85%) as it may at first seem, since a dynamic mayor can have a dramatic effect upon a small town, which had already grown from a population of 800 in 1987. However, the ambition and the details of this growth were very remarkable. The municipal government hoped to reach a population of 45,000 in 2016, which would have made this town the third largest municipality in Aragon. Such growth meant a crescendo of funds coming into municipal coffers.

Thirty thousand of these newcomers were foreseen in one project called Ciudad Zaragoza Golf.

The only problem was that the government of the autonomous region to which La Muela belonged had a different opinion about a few of the projects and delayed approvals, slowing growth in 2006. And growth was ebbing away from real estate across Spain in 2006. By 2008, some of the construction companies had put a hold on their projects in Ciudad Zaragoza Golf, although the developer, Wilcox, denied that work was suspended (Faci 2008).

La Muela had the same mayor for 22 years, from 1987 until her arrest in 2009 for various charges of misappropriation of public funds, influence peddling, breach of trust and bribery.

Windmills had been part of the history of the small town of La Muela long before she first took office in 1987. However, in May of that year a small wind farm of 12 turbines was inaugurated, a project which involved the previous administration, Instituto para la Diversificación y Ahorro de la Energía (IDAE), la Consejería de Industria Energía del Gobierno aragonés, y la Empresa Nacional de Electricidad, SA (ENDESA). Forty percent of the monies came from ENDESA, 40% came from the IDAE and the remainder from government sources. The electrical energy produced was transmitted to the main grid of the electrical company of the autonomous region of Aragon, Eléctricas Reunidas de Zaragoza. La Muela had been chosen for this project because it was in a zone with great potential for wind farms (Ortega 1987).

In 1992, all the wind farms of Spain produced a total of 5 megawatt-hours per year (Ruiz 1992). By 1999, Parque eólico La Muela I and II had a production of 14 megawatt-hours (Info Eólica n.d.). In 2002, there were 181 turbines in eight wind farms operated by seven different companies.

Each turbine produced about €1800 per annum revenue for the municipality (population of about 2000 at the time), and some of this funding was used to promote and develop an industrial park named Centrovia. By 2004, the fourth phase of the development of Centrovia had sold most of its lots and a fifth phase was envisaged (Ayuntamiento de La Muela n.d.). This government of the autonomous region of Aragon facilitated things by not subjecting the project to the usual environmental damage appraisal (Gimena 2006). Aranade was the developer of the fourth phase (Aranade n.d.).

The city hall foresaw 500 businesses in the completed development, generating 10,000 jobs. Already there were five restaurants, branches of five banks, a medical centre and a hotel (Ayuntamiento de La Muela n.d.). Centrovia represented a new source of income for the municipality.

At least some of these new monies were applied to social benefits for citizens. Beside private residences, many public buildings were constructed. Three different museums, a bullfighting ring (plaza de toros) and a luxurious sports complex were built for this town that had grown to a population of about 4000. Julio Iglesias was part of the inauguration show for the plaza de toros—the equivalent of Celine Dion inaugurating a football field for a small town in the USA or in Canada.

The city hall made an effort to provide social benefits above and beyond those enjoyed by Spanish citizens in other municipalities. Some examples: the San Roque Social Centre and Nursing Home for the elderly, the organization of trips for seniors, including Mediterranean cruises, on very favourable terms, and activities for woman (such as yoga courses) and youth (a work programme for the summer holidays and university scholarships with modest academic requirements).

All the locals enjoyed free lung cancer and breast cancer screening through the University Clinic of Navarra (private and arguably the best hospital in Spain) and annual subsidized trips to countries such as the Dominican Republic, Finland, Mexico or Canada.

A nice place to live, Centrovia seemed to be generating a huge sum of money for this little town.

On September 29, 2006, the municipal council approved a budget change in order to cover a €3.5 million debt to the central government of Spain. It did so by a reallocation of 10% of funds to be generated by the reclassification and sale of land (Heraldo 2006). It follows that, above and beyond municipal taxes on residential and business properties, the municipal council of La Muela foresaw revenues of €35 million in 2007, the equivalent of perhaps €25,000 per household. That is a lot of money for any government, and it was part of an *in crescendo* trend in the mass of funds that seemed to be pouring into the city.

The few minority opposition city councillors wanted to know why there was a debt to the Spanish government if so much money was floating around. Although their protests may have been politics as usual, their misgivings turned out to be well founded.

In 2004, Aranade had sold a parcel of land to Brocover, a residential construction firm. Brocover purchased the land with the insider information that it would later be reclassified as developable land. It was only later that the president of Brocover, José Carlos Fernández Delgado, also learned that the owners of the land sold by Aranade were precisely the mayor of La Muela and her husband, who no doubt had benefited from the insider information even earlier. It can be supposed that Brocover had obtained the insider information at a price (Garú 2009). In that same year another property developer, Sagain, purchased land at €150 per square metre in January 2010, and then resold half of it at €826 per square metre. The land would be incorporated into the Centrovia business park. Again, it would seem that insider information had permitted Sagain to turn such a rapid astronomical profit.

On March 18, 2009, after a year of police work by the Unidad de Delincuencia Económica y Fiscal, and years of suspicion and the circulation of rumours, 18 persons were arrested for influence peddling, breach of confidentiality, money laundering and so on, including the mayor of

La Muela, her husband and one son. The case is still ongoing as of late 2014. The prosecution is seeking 37 years imprisonment for the mayor, as well as 165 years of disqualification from public office and a 22 million euro fine. She is accused of eight offenses of corruption, bribery and against the Treasury. In a recorded conversation with a leader of the Partido Aragonés, her political party, there was mention of a €500,000 bribe for the vice president of the autonomous region of Aragon. He has been charged for this, but the case is still in the courts at the time of writing (Gaceta 2014; Lobo 2011).

In 2013, her successor as mayor made a public plea for her to restitute €33 million in funds owed to the city council of La Muela (Heraldo 2013).

As for Ciudad Zaragoza Golf, the government of the autonomous region of Aragon stopped the project of 10,000 homes at the first phase of 2300 homes equipped with swimming pool, gardens, shops and other services. Promoted as a luxury setting at €6000 per square metre, today it consists of 20 families occupying a single building in a ghost neighbourhood 5 km from La Muela, with no mail service, garbage collected once a week, lighting on one side of the street only, no telephone service and unreliable gas distribution. Skeletons of unfinished buildings decorate the paved streets (Abril 2011; Viana 2012; Ulla 2012).

Marbella

As the name suggests, this is a beautiful seaside city whose attractions bring in wealth from abroad. Wikipedia informs us that King Faud and his entourage spent €5 million a day when visiting Marbella. Although the population is only 30 times that of La Muela, the monies involved are several orders larger and the power of the actors that much greater. The criminal offences appear more serious, but the sentences eventually received were less severe. For example, Juan Antonio Roca, after facing a possible sentence of 30 years in prison and €810 million in fines, received only 11 years and a fine of €240 million (Esparza 2013).

Fernando del Valle was a young lawyer who emigrated from Chile to Spain just two years after the death of Francisco Franco. After three months working in the law firm of Sánchez Stewart to learn the particulars of the Spanish legal environment, he started a new law office with the Catalan lawyer Antonio Fortuny. The partnership was dissolved in 1980 and del Valle began to build his destiny. When the Internet became an important channel for lawyers, he set up all his web pages in English. This gives some indication of his clientele: foreign clients interested in investment opportunities, corporate structures and real estate and tax laws.[8] Some of his clients were innocent foreigners he betrayed ("We are here to help") to rapacious real estate developers such as Ocean Estates (Eyes on Spain 2007–2010; Prophet 2006). Other clients were less innocent and undoubtedly more lucrative.

Like many lawyers, he had a large collection of corporations. He managed 523 companies, and had some ownership of nearly 200, of which 143 were incorporated in Delaware and 39 in other permissive havens, from The Cayman Islands to Gibraltar. His activities prospered, particularly from 2001 onward, although many turned out to be illegal: the police began building the case against him in 2005. It would seem that much of the funds in all those companies originated in drug and arms trafficking by his various foreign clients.

At least one source mentions the existence of six or seven other law offices with similar profiles in the area.

But laundering the money of foreign criminals was not the only form of "residential corruption" to be found in Marbella. Some of the local developers and builders had discovered a tolerance for bending the law in that municipality and frequently exploited that flexibility.

One such builder was Jesus Gil y Gil. His fortunes had improved since 1969 when the roof of a building in a Madrid project he had developed and constructed collapsed, killing 68 persons. Sentenced to prison for five years, he was released after one year through the intervention of Luis Carrero Blanco, Admiral of the Spanish navy and confident of Francisco Franco. Ordered to pay compensation to the families of the deceased, Jesus Gil built up his fortune again, moving the bulk of his activity to Marbella while maintaining a presence in Madrid.

Gil was elected president of the Atlético Madrid Football Club in 1987. He managed to win four championships as president of the team … by spending large sums on the signing of 130 players and the hiring and firing of 30 coaches. The year of the first championship, 1991, was pivotal in his career: he founded a political party, the Grupo Independiente y Libre (note the initials), and brought it into a majority government of the municipality of Marbella, where it was to remain in absolute control for the next 15 years. He had openly announced that he would be in office to sell real estate, but apparently with sufficient enthusiasm to build up wide support. He personally remained in office as mayor of Marbella for 11 years in spite of the numerous criminal cases brought against him from his first years in office. Perhaps his acme was in 1999, when the GIL party won 93 seats in 13 different municipalities in the Costa del Sol. While in office he carried out few of the more spectacular projects he promised, but he did carry through on many mundane efforts to improve the value of real estate in Marbella. And he also capitalized on his position of power to increase his own wealth. At least two persons were key to his operations: Julian Muñoz and Roca. The former was an ex-waiter who accompanied Gil in his 1991 victory and rose to be the number two man in municipal government in 1998 and then, when Gil resigned from office after being arrested in 2002, acting mayor and finally elected mayor in 2003. Roca was a bureaucrat, not an elected official, and ran the urban development office. Muñoz ousted him for involvement in the scandals that had led to Gil's arrest, and then was himself in turn ousted from power as mayor as municipal councillors from diverse parties brought a motion of censure against him. Muñoz and Roca were both condemned to prison sentences and fines, and ultimately so were several of the city councillors who had ousted Muñoz. Every mayor of Marbella since and including Gil has been condemned to prison for residential corruption, with the exception of the current (2014) mayor. However, at least one of her residences, a thousand-square-metre mansion, has been under embargo for renovations because the land had originally been classified as "rustic"—in other words, not available for development. The land had been reclassified when her municipal government ceded the land to a neighbouring municipality.

The original developer was Vega Colorado, a real estate company created by Fernando Valle in 1990.

It would seem that there indeed was considerable corruption in at least two of Spain's municipalities. Tezifon (2008) lists Spanish mayors facing accusations of residential corruption, and the Fiscalía de Medio Ambiente of the autonomous regions of Valencia demanded a report on illegal housing from the mayors of all its 265 municipalities—with 87 of them late in reporting. Vavel.com lists 127 active Spanish politicians accused of corruption as of 2012 (Redacción de Vavel 2012).

The Role of Money Laundering in Launching the Real Estate Bubble

Laundering money acquired illegally occurs in all countries, and in all countries real estate provides a convenient venue to launder money, either by purchases made partially in cash or by renovations made partially in cash. Some countries are more vulnerable than others, however because of their geographic location and the insufficiency of their legal and policing infrastructure. This was the case of Spain in the 1990s and the first decade of the twenty-first century. Part of the Schengen area of 26 European countries where travel does not require passports or border control, Spain was also next to Gibraltar and next to Africa and enjoyed cultural links to Latin America. Although it had inherited a professional police force from Franco, it lacked an effective anti-money laundering apparatus. The present section attempts to estimate the importance of money laundering for the 1990s real estate market in Spain and to appreciate the nature of its influence (Table 1).

Table 1 Estimate of the 1997 volume of real estate market transactions in Spain (*vivienda libre*[a]) interpolated from Ministerio del Fomento statistics

Year	New houses	Total value of market transactions (*vivienda libre*)	Multiplication factor
2004	818.630 (datum)	€23,177,792,000 (datum)	28.3
2001	374.019 (datum)		
1997	300,000 (interpolation)	€8.5 billion (calculated from interpolation and the 2004 multiplication factor)	
1991	248.022 (datum)		

[a] *Vivienda libre* refers to residences sold on the free market without any state subsidy or controlled access

Fomento of Spain publishes statistics on housing transactions, but provides no systematic historical data for the total market value of transactions before 2004. Perhaps this is the reason that research sources on the real estate bubble give statistics for housing prices per square metre but not for total market value when circumscribing the Spanish real estate bubble.

Assuming some correlation between market volume and annual growth in the number of housing units permits a crude estimation of the total market volume of real estate transactions in 1997. This procedure suggests that there were a little under €8.5 billion in transactions for "unprotected" real estate (in other words, not reserved for low-cost housing or some other such social purpose). This is probably an overestimate, as it does not take into account the rise in house prices.

The Walker model of global money laundering estimates that Spain was the destination of 1.2% of global money laundered in 1997, or about €35.5 billion. Several sources indicate that a significant fraction of these funds were invested in real estate (Cardume 2008; Bureau for International Narcotics and Law Enforcement Affairs 2012, p. 163). Based on our estimate above, 10% of laundered funds would represent 40% of the real estate market for "vivienda libre."

Another source suggests that most of the €2.4 billion wealth of Roca came from bribes over a 15-year period (Hernández Jiménez n.d.), but this figure for his wealth may confuse the figure for all funds frozen by a police investigation, not only the assets of Roca. Narváez and Gómez (2006) asserted that the fortune of Roca was the lion's share of goods seized estimated worth €2400 million. However, much of this fortune came not from bribes, but from windfall profits obtained by the reclassification of lots he received as bribes or purchased with bribery money (Mendez 2006). Roca himself only admitted to €210 million (Rivera 2013), although this may have been after some fines and restitution. Using the second intermediate and most credible estimate, supposing the windfall profits to represent 90% of his fortune and bribes 10%, and putting the bribes—or extorted moneys (Pérez 2006)—at 3% of profits, would indicate that the better part of €8 billion in the real estate activity in Marbella over 15 years involved illicit transactions (although not necessarily laundered money). Considering that the province of Malaga, of which Marbella is one city with 10% of the population, had €5.7 billion in real estate transaction in 2004 (excluding "protected" real estate such as low-cost housing), and assuming a similar estimate of threefold growth arrived at above for all of Spain over 1997–2004, the entire province of Malaga may have had €42 billion of real estate transactions from 1991 to 2005, the years he was in power. That would mean that between 25% and 50% of transactions involved the bribery of Mr. Roca, even supposing Marbella accounted for 100% of all real estate transactions in Malaga (excluding protected real estate such as low-cost housing).

Both of these crude guesses about the importance of illegal transactions in the Spanish real estate market suggest that the nature and volume of this market was overwhelmingly influenced by these funds.

But what is the nature of that influence? At first glance, one would think that the prices would rise, since more finds means higher demand and thus higher prices. But the impact could be more subtle and complex in reality.

For the transmission of property to be recognized by the state, a visible, legal payment must be made and some tax paid on the transaction. As a result the market receives a clear signal for a (in reality partial) payment by cheque while it remains relatively opaque to any signal by the accompanying cash payment. This would seem to have an effect of lowering prices, not raising them. On the other hand, it may well be that everyone in the local market is quite aware of the use of cash payments although without precise information as to their value.

Further, there is a second stage in money laundering by real estate: the unit is then renovated, partly with cash, and returned to the market at an increased price by which the cash is recovered, now nicely laundered (Cardume 2008). This second stage has the effect of moving the market to higher quality housing.[9] This stage of money laundering does lead to increase of average transaction size, increased prices per square metre and total market volume.

John Walker, an authority on money laundering, indicated that money launderers pay a premium price for real estate (Smith 2011; cfr Walker 1998, Ferwerda 2012, chapter 6). This pre-empts other investors. In this scenario, the moneys are already available in cheque form, although the mediation of numerous offshore companies can render accounting for the origin of funds complex. The signal sent to the market with this method (common to most countries) would serve to increase housing prices.

What impact does the bribing of municipal (and autonomous region) officials have upon market volume? Bribes may or may not involve funds from illicit sources (and thus involve money laundering). Bribes make lucrative development projects possible, either because the reclassification of land produces windfalls, because highly desirable parcels of land are not subjected to environmental or other socially beneficial restrictions, or else because costly redistribution of economic and social benefits is overlooked. Frequently these advantages are temporary because of procedures to contest decisions, but with delays sufficiently long for the cash gains to be realized before accountability mechanisms and/or other controls have their effect.

It would seem then that bribes contribute to the bubble on the supply side, and that the projects involved are loosely connected with demand because of windfall gains, and in some cases the willingness of developers to accept lower real returns in order to spend and thus launder cash. Accounting assumptions (that the units will sell) and cannibalization of competing projects further distance the initiation of such projects from real demand.

Money laundering via the purchase of real estate contributes to the demand side, both via volume and via prices (although possibly via a two-step impact process). Bribery of officials contributes to the supply side.

Systematic illicit activities—money laundering and either bribery of or extortion by municipal and other officials—made a significant, direct and positive contribution to the real estate bubble in Spain. Moreover, this growth of the bubble enhanced the attractiveness of Spanish real estate for money laundering, as well as the potential for illicit gain by municipal officials. The result is a positive feedback loop.

A sense of the importance of these factors can be garnered from an examination of the mortgage market in Spain in 1999. Although mortgage rates increased that year, the demand for mortgages increased (see Fig. 8). The reason was that everyone in the country with a hoard of

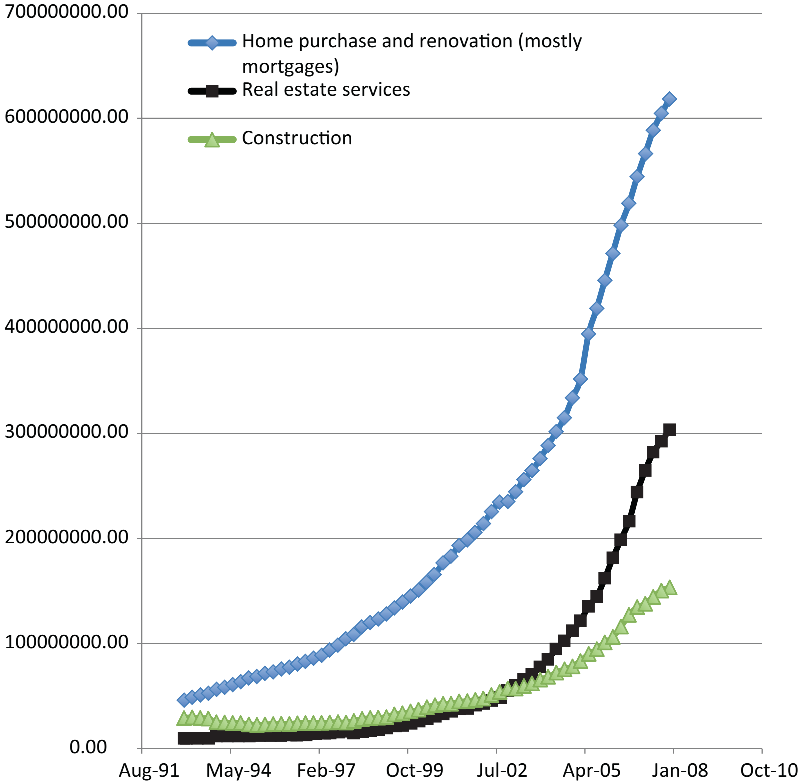

Fig. 8 Breakdown of real estate-related loans in Spain 1992–2007

unexplained pesetas was in a rush to spend them before the peseta was replaced by the euro.

It remains true however that, in spite of rising prices, legitimate household purchase of residential housing in Spain continued, and was not simply replaced by illicit purchases.

This far we have seen five main factors in the Spanish real estate bubble that are preliminary to examining the principle cause: the demographic situation, interest rates, the *Ley del suelo*, corruption of local officials and money laundering. The next section is dedicated to the principle effective cause, namely, the role of the *cajas de ahorro* in the real estate boom.

Financing Real Estate: The *cajas de ahorro*

Normally five parties were involved in new housing: the developer, the local government (*autonomía*), the builder, the purchaser of the home and the financial institution. There could in fact easily be three financial institutions, one each for the developer, the builder and the home purchaser, although often the developer would cede the property with an ongoing mortgage. Local government had jurisdiction over land: it had the authority to declare whether or not land could be developed for residential housing. The value of the land increased with this new classification. Developers could purchase the land at this increased price, but often purchased parcels of land in the hope they would be reclassified, perhaps as part of an educated guess given the quality of the land and its proximity to a growing population, perhaps thanks to insider information or some undue influence over the classification decision. Reclassification of land could take years. The local government also issued the certificate of compliance (delay of 60 days) and the building permit (delay 45 days), both required before the developer could contemplate hiring a construction company. Construction itself averaged about 18 months, so the developer could have taken a loan out on the land for two years or more, and more financing also would be required for the construction company, long before the sale to the ultimate householder. In other words, the developer committed to a project at least two years before reaching the market. This explains the slow response to leading indicators of a decrease in demand such as rising interest rates, slower growth in purchases, slower population growth and so on. Such indicators appeared mid-2006, but construction continued on into 2009, as Fig. 9 illustrates. This is because the developers had committed to projects and negotiated loans some three years earlier, and the builders 18 months to two years earlier. Thus, even in the best of circumstances, financial institutions would be prone to funding projects that were doomed to fail.

The circumstances were not the best, however, since the ex-politicians who managed local *cajas* were not always at arm's length from the executive of the local *autonomía* and perhaps also overlapped socially with the top management of the developers. This would make it harder to refuse

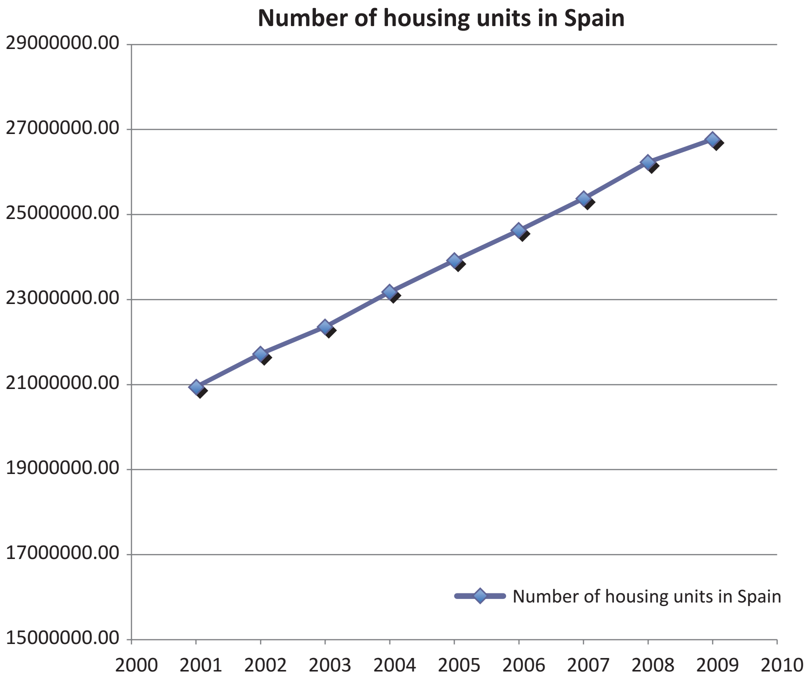

Fig. 9 Spain, number of housing units 2001–2009

projects even when market signals became clearer, and also would make it easier for enthusiasm to overrule rational analysis. The existence of extensive corruption as mentioned above reinforces this weakness. Financial institutions were far too heavily engaged in real estate, and remained far too heavily engaged long after the market turned sour. They had supplied mortgages to householders, seed money and bridge financing to the developers and business loans to the builders, and much of this lending began to fail as developers and builders went into bankruptcy and some homeowners proved unable to meet the increased interest rates on their mortgages when they doubled for a short period 2008–2009, and again, when many lost their employment as Spain went into recession.

Who was financing real estate in Spain? Manzano (2005) states that "the expansionary behaviour of the residential building market has been financed directly through the banking system, mainly banks and savings banks [his translation of *cajas de ahorro*]" and not through specialized institutions. The data in Fig. 10 confirm that the *cajas* took the lion's share of this market. Since the *cajas* were in general smaller institutions than the banks, and had a bigger share of the market than the banks, it follows that they had a heavy concentration of their assets in the real estate industry. Table 2 confirms this. Indeed, even the bank levels of concentration seem professionally inacceptable in terms of risk management, although the profits taken during the boom years make the temptation somewhat comprehensible.

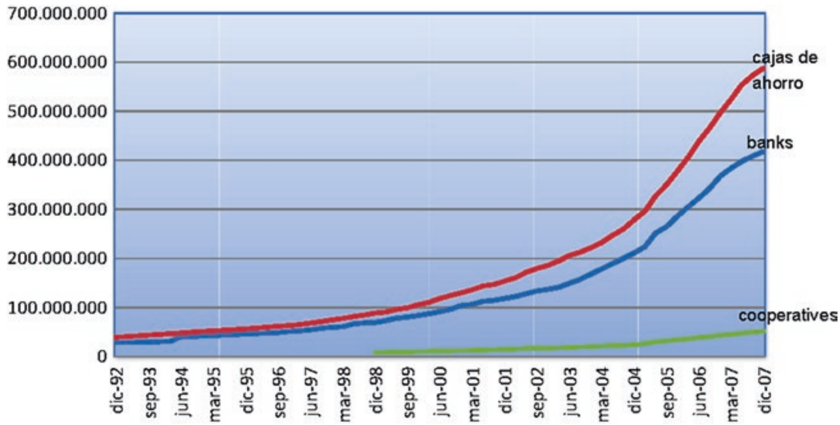

Fig. 10 Market share of *cajas de ahorro,* banks and cooperatives in financing real estate (acquisition, construction and services) (Source: Rallo 2008, p. 6. With permission)

Table 2 Concentration of assets in real estate-related loans, banks and *cajas de ahorro*

Date	Credits to real estate/total assets	
Quarter	Banks (%)	Cajas (%)
December 2004	22.39	43.05
December 2005	24.42	46.14
December 2006	27.95	49.34
December 2007	26.88	50.18

Source: Adapted from Rallo (2008)

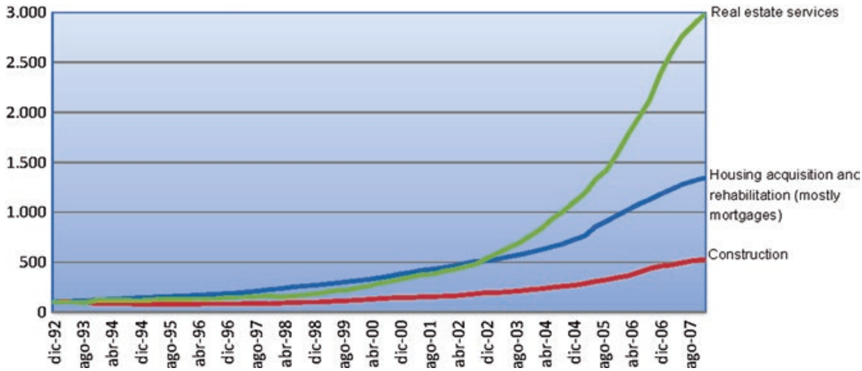

Fig. 11 Growth rates of real estate services (mostly development), construction and housing acquisition and rehabilitation (mostly mortgages). Base of 100% for four-month period ending in December 1992 (Source: Rallo 2008, with permission)

The concentration of the *cajas* in real estate continued well after the close of the real estate boom. The mass of real estate loans went to mortgages (as indicated by the statistic for acquisition and rehabilitation of housing), and these should have ceased to grow as demand faltered. Yet the growth of real estate assets of the *cajas* continued. The reason is that a growing portion of real estate loans was going to development, as Fig. 11 indicates.

As a consequence, the *cajas de ahorro* would face two problems: one because many retail mortgage holders were losing jobs or income due to the recession and another because many developers were beginning to go out of business or at least were delinquent in paying back loans. However, both government and financial institutions acted to facilitate mortgage repayment, and this problem did not become very important for a few years. Developers began to have problems much earlier. Various Spanish blogs on the Internet list numerous small developers who disappeared for various reasons beginning in 2006. Larger developers ran into trouble one by one: Astroc lost 60% of its share value on April 18, 2007 (Casillas 2010); Martinsa-Fadesa filed for bankruptcy in July 2008 (El País 2008) and Nozar went into bankruptcy in May 2009 (La Opinión Coruña n.d.). Reyal Urbis fell much later (in 2016), but illustrates the plight of the large developers. Founded in 2006, it began to show losses in 2007 and was unable to meet payments as of May 2009 (Ruiz 2017). The *cajas* had lent €243,000 million to builders and real estate services (Maudos 2010) and now risked seeing those loans tied up in *concursos de creedores*—the Spanish equivalent of bankruptcy proceedings. The Ahorro Corporation—a holding company jointly owned by the major cajas—created a real estate subsidiary to market real estate collateral (El Mundo 2009), but this faced the same downturn as had the developers, and served only to expedite the movement of discounted assets.

The government of Spain possessed two mechanisms to deal with failing financial institutions. The Fondo de Garantía de Depósitos de Entidades de Crédito had been created in 1977 and functioned more or less as deposit insurance. The Fondo de Reestructuración Ordenada Bancaria (FROB) was established on June 26, 2009, by the Real Decreto Ley 9/2009 to deal with the cases that could not be resolved by the older mechanism. When implemented, the Bank of Spain would replace the directors of a given financial institution with the FROB, which then applied a restructuring plan that either closed operations partially or completely, or else imposed a merger with other institutions. The justification for the latter was to reduce the overextensive retail network (branches) of financial institutions in Spain, reduce the personnel that had increased during the real estate boom and clarify asset valuation more rapidly.

There were 47 *cajas de ahorro* in 2005; Caixa Ontinyent and Caixa Pollença are the only two remaining in 2017 (Intereconomía 2017). Most of the others survived as parts of banks created from the ashes of *cajas*. Thus, for example, today's Caixabank is centred on La Caixa to which was amalgamated Caixa Girona in 2010, then by stages over 2010–2012, Cajasol, Caja de Guadalara, Caja Navarra, Caja de Burgos and Caja Canarias.

Bankia was created through the July 30, 2010, merger of Caja Madrid, Bancaja, La Caja de Canarias, Caja de Ávila, Caixa Laietana, Caja Segovia and the Caja Rioja. This proved less felicitous, and Bankia would require €22,424 million in government funding by 2013. At least three major scandals (misleading initial public offering (IPO) information, credit card misuse and faulty products sold to clients) have marred the short history of Bankia, although today it seems to operate on a healthy basis.

Fiscal Impact of the Crisis

In the end, bailing out the *cajas de ahorro* cost €60.7 billion, of which nearly €41.8 billion came from the government of Spain (via FROB) and 18.9 billion came from the private sector. The government amount (€41.8 billion) is over 10% of the tax revenues of Spain in a given year and was required at a time when the government was under pressure to increase social spending because of the recession. Spain's government had a surplus of 2% of GDP in 2007 but this turned into a deficit of 10% in 2009 (see Fig. 12), at which level it remained for the following years—about €100 billion. Bailing out the *cajas* was a major contributor to the

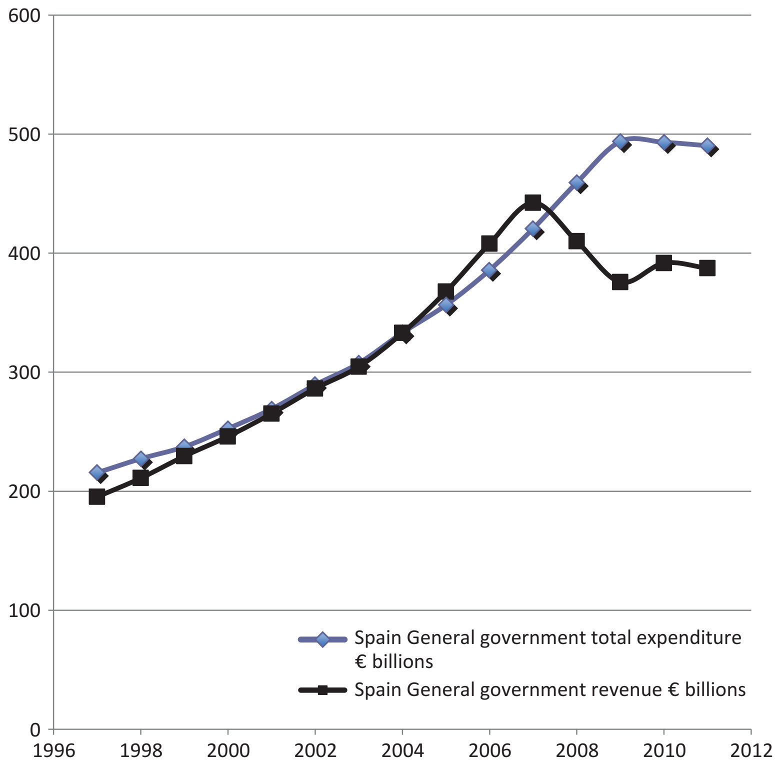

Fig. 12 Spain general government revenue and expenditures

increased deficit, but clearly it could not be the only factor. Tax revenues decreased about €67,000 million from 2007 to 2009, so the impact of the economic downturn was greater than that of bailing out the cajas.

The boom in real estate had meant a boom in GDP and in tax revenues for the government. The boom also had affected the structure of the GDP: "while construction represented 11.5% of Spain's GDP in 1997 (a level comparable with that of the euro area), this rose to 16% of GDP in 2004 (by which time it was only 10.5% in the euro area)" (Yaniz Igal 2006). To this 5% tumour in the GDP was added the rise in real estate services, from a little over €5000 million in 1997 to about €23,000 million in 2008, about another percent. Supposing profits no higher during the boom—a very conservative supposition—we could expect greater revenues for the Spanish government. Indeed, the government took a higher portion of the GDP as the boom progressed, so that an increase of expenditures was possible while putting in an apparently good fiscal performance as measured by budget surpluses and modest government debt. When the boom ended, government revenues decreased, but expenditures continued to increase as before with the justification of stimulus spending and then later, also to cover the costs of bailouts. The reality is that inflated government revenues gave the appearance of fiscal discipline while the government in reality was overspending from the structural viewpoint. Admittedly, this is clearer with the benefit of hindsight.

Spain's GDP dropped from US$1.625 trillion in 2008 to US$1.381 trillion in 2012, about 15%. One question is how much of this downturn was due to the bursting of the real estate bubble, and how much was simply a recession provoked by the global financial crisis. It may not be a realistic question, because of the interaction between the real estate market and the global financial crisis—and that sort of interaction is precisely why recessions were being provoked. Still, there is some meaning in the question and attempting to answer it can be instructive. There are two ways to make guesses to answer this question.

The first way is to examine two other countries that entered into recession in step with Spain: France and Germany. France's GDP shrunk about 8% from 2008 to 2012; Germany's shrunk 5.5%. A 7% recession in Spain due to the global financial crisis seems a reasonable guess, leaving 8% due to the close of the real estate boom.

A second way to guess is to estimate the gap created by the real estate slow down. GDP from construction halved from 2008 to 2012, a reduction of about 7% or 8% of GDP, while real estate services increased about €5000 million (CEIC 2017), about a third of a percent of GDP. This again leaves about 7% or 8% of the downturn as "purely" a participation in the international recession provoked by the global financial crisis.

Although the results from the two methods are almost identical, they are still only guesses and should be considered warily. The second method is in fact incomplete, because it should also add a guess about the contagion of real estate to other industries, such as building materials and catering, which were also affected by the real estate bubble. The important point to retain is that the bubble was a major and perhaps principle contributor to the crisis in Spain, and Spain might very well have weathered the crisis as well as or better than Germany were it not for the bubble. The real estate bubble was the weakness that made Spain more vulnerable to the global financial crisis and the resulting international recession than were other countries, and the reason why Spain went into crisis when other countries merely suffered a brief if severe recession. The crisis was much less severe than that of Ireland, however, and Spain merely requested aid in bailing out the banks. Spain went deeper into debt by borrowing to fund the bailout. It did not turn to Europe for emergency funding because its debt levels had made more borrowing difficult.

Dynamics of the Financial Crisis in Spain

Spain's history placed it in a situation of advanced catch-up, giving it a reasonably strong economy—although a patchy employment record—and an enviable fiscal position compared to most European governments. This growing economy provided a context for a boom in real estate that was distorted by money laundering and accelerated into a bubble by the lower interest rates that accompanied Spain's participation in the euro. The *cajas de ahorro*, regional financial institutions led by political appointees with limited technical competence and considerable interest in obtaining a local influence, committed enthusiastically to the bubble. They were perhaps too intimate with the developers they financed and the regional bureaucracies that regulated the land. This intimacy, combined with the rigidities of land development with respect to feedback from the retail housing market (see above in the section Financing real estate: the *cajas de ahorro*), led to overcommitment to housing developments that undersold or were not sold at all if indeed they were completely developed. The cajas found themselves with bad loans secured by low value real estate assets, and many were threatened with insolvency. The government of Spain intervened first by imposing mergers and then by injecting capital with the financial support of the European Commission and the European Central Bank. The problem in Spain was caused largely by a few incompetent and compromised individuals.

An increasing population combined with a trend to smaller household increased the demand for housing in Spain in the 1990s. Money laundering catalysed the boom, and this boom transformed into a bubble with the onset of lower interest rates as Spain prepared for the euro (see Fig. 13). Incompetent and sometimes perhaps crooked management in the *cajas de ahorro* became too friendly with local developers and furnished credit too easily.[10] These developers overextended themselves and were caught with extensive finished and unfinished development projects when the bubble burst. They were unable to pay back principal or interest to the *cajas de ahorro*, and these found themselves short on liquidity and sometimes insolvent. After attempting to manage the problem via forced mergers and the creation of bad banks, the government began to

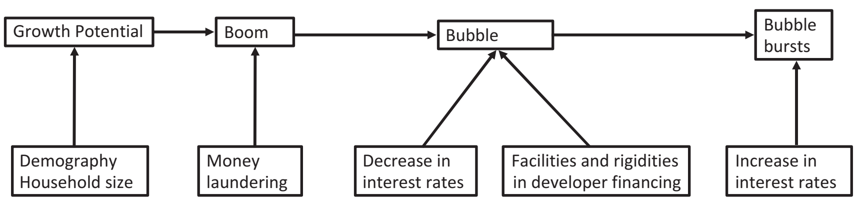

Fig. 13 Dynamics of the real estate bubble

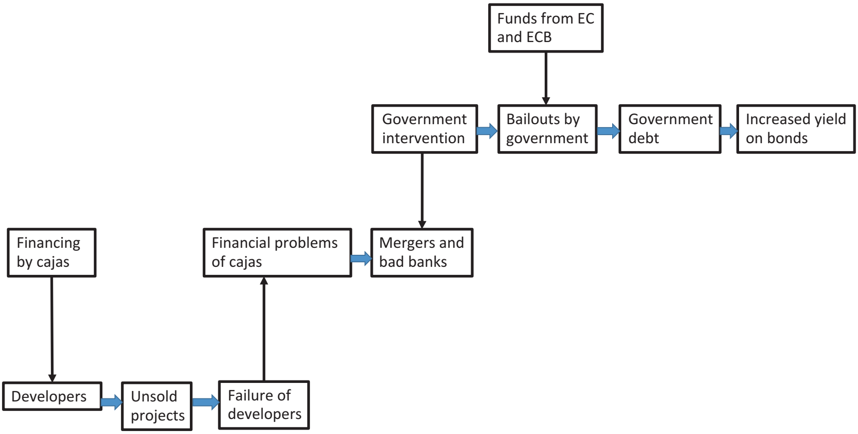

Fig. 14 Dynamics of the crisis in Spain

bail out the remaining actors. Because of the volume of funds necessary, the government was forced to turn to the European Commission for help in recapitalizing Spanish banks (see Fig. 14).

Had the *cajas de ahorro* not been so intimate with developers, the bursting of the bubble would have found the developers and the *cajas* less committed to ongoing projects, so that bailouts would have been fewer and less massive, perhaps remaining within the capacity of the government's finances.

The 2017 failure of Banco Popular underlines that this dynamic is a simplification. Banks also overrode the prudential limits of risk management in the level of activity in real estate, although to a lesser extent. Probably the *cajas* would have been unable to attain the volume of commitment to real estate had there not been an abundance of capital available in the first decade of the twentieth century—in the euro zone and globally. The purpose of presenting this abridged dynamic of the crisis is precisely to simplify rather than to cover every possible contributing factor. Further, had this limited set of factors been absent, perhaps Spain would have been able to deal with any issues in the natural course of things without recourse to European authorities.

Notes

1. *Cajas de ahorro* were a kind of regional savings banks. They resembled the *Landesbanken* in Germany, where the top management was usually politicians (not in the sense of holding office in government, but in the sense of being active in a political party). In Germany the *Landesbanken* made dubious overseas investments because the management was operating beyond its level of competency, while in Spain the management of the *cajas de ahorro* funded local real estate developers, often without the sufficient arm's length separation from the clients' activities.
2. Although some articles make much of the lack of religious freedom, this must be qualified. Article 6 of the first chapter of the Fuero de los españoles of 1945 states: *La profesión y práctica de la Religión Católica, que es la del Estado español, gozará de la protección oficial. El Estado asumirá la protección de la libertad religiosa, que será garantizada por una eficaz tutela jurídica que, a la vez, salvaguarde la moral y el orden público*. In practice, this meant that religions other than Catholicism were restricted to the private sphere. This is the current policy towards all religions in Quebec and France. It had not been so in Communist Europe, where party power was used both to eradicate opposition and to avenge petty resentments. Although many academics and intellectuals continued to extol the advantages of Marxism in general and the Soviet regime in particular, the most basic intelligence could not fail to inform Western governments of the reality of life under Stalin. Further, although Stalin seemed to put most of his efforts into subjugating the Soviet Union, the International continued to be an active presence in the politics of most Western nations. Even if most local Marxists and "harder" socialist parties were more a threat to each other than to the entrenched parties in most nations, the proselytizing nature of the Marxist revolution was known to most governments, which responded by seeking to contain it. The Berlin Wall stood high and clear as a testimony that beyond lay a regime very different from those of the West. Spain had nearly come to have this same political system. Thus, the staunch anti-bolshevism of Franco's Spain was understandable, and it was also convenient outcome for Western Europe that otherwise would have found itself squeezed between two sources of Marxist revolution, on the Northeast and Southwest.

3. Effective results of the two kinds of government correspond poorly with the discourses of those governments. The same can be seen, for example, in the USA where Republican governments, with their discourse of small government and free enterprise, typically have been associated with increased federal budgets representing a larger part of the economy than is the case with Democratic governments. In Spain, the major economic indicator of this paradox was the measure of unemployment. Spain since Franco's time has been characterized by remarkably high level of unemployment. The lowest level of unemployment occurred under the Partido Popular of Aznar—what journalists would call a right-wing government. When the socialist regime (PSOE) took over after Aznar blamed Basque terrorists for the 2004 Madrid bombings, the unemployment rate began to rise: it continued to rise until the financial crisis of 2007, it continued to rise on through that crisis, the onset of the euro crisis and continued to 2013, after which it began to decrease with the Partido Popular back in power. In the end, however, little can be demonstrated with the data, since the number of instances of alternating governments is so low, the delay between discourse, action and effects upon the economy so debatable, and the impact of the economic trends outside of Spain so exaggeratedly marked.
4. Tony Judt tells us that "Spain, which very quickly lost any comparative advantage that accrued to it from being one of Western Europe's more backward economies, shed 600,000 jobs in the 20 years following the transition to democracy. At the height of the recession of the mid-1990s, 44 percent of the country's under-25 workforce was unemployed." (Judt 2005, chapter XXII).
5. Scarcity of non-risky assets is an avowal of ignorance about alternative assets. The problem for investors is threefold: risk, uncertainty and cost of analysis and governance. Risk is a function of the ignorance of the investor with respect to a project, in contrast to uncertainty that is inherent in the project independent of the level of knowledge of the investor. If non-risky assets seem scarce, then the solution is for the investor to educate himself or herself about alternative assets. This leads to the problem of cost in learning about alternative assets. The cost of analysis and governance is the typical problem of microfinance: small investments bring a high rate of return (e.g., a bicycle can multiple the productivity of an African farmer bringing produce to market), but the size of the

transaction is modest compared to the effort of analysing the loan proposal and policing its repayment.

6. This expression is linked to Alan Greenspan (1996), but the concept is even older. The business literature, for example, uses the term capital market myopia (Sahlman and Stevenson 1985, p. 7), a more rigorous and defined concept than the quarter century more venerable marketing myopia (Levitt 1960) where firms continue to invest after the market has changed.
7. Completing the circle of influence, the developer could play golf with the director of the local *cajas de ahorro* that both financed the developer and provided the mortgage to the house purchaser. Of course, this relation did not depend upon the liberalization of the professions.
8. Those pages—dva-lawyers.com—were no longer accessible in October 2014 although still listed on Google.
9. The present author noted a similar phenomenon (although with different dynamics) in the US housing bubble (Macdonald 2012), and this suggests that the term “bubble” covers at least two kinds of price increases: the pure bubble of increased price for a static commodity, and mixed bubbles where some of the price increase involves a migration to higher quality. It seems probable that these two kinds of bubbles have different dynamics. Studies of financial and economic bubbles would gain by revisions that take this distinction into account. Of course, even a move to higher quality remains a bubble if the market does not have the financial capacity to comply with the complete terms of the transactions. The trick lies in the time dimension of financial transactions: as long as the bubble continues to expand, the market can comply with the terms of transactions. For example, in the USA, increasing market prices allowed purchasers to flip houses and surf from smaller to larger mortgages.
10. Sebastián Royo has pointed out that the Bank of Spain was at best timid in overseeing the *cajas*. Caruana (governor of the Bank of Spain 2000–2006) foresaw the dangers and admonished the *cajas* but acted no more strongly. Fernández Ordóñez (2006–2012) was critical of the over-importance of the construction sector until he became governor. See Royo (2013, pp. 171–175).
11. Note: Complete references to unsigned IMF and OECD documents are given in the text and are not repeated here.

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How Italy Experienced the Euro Crisis

Introduction

The global financial crisis seemed to have little impact on Italy at first. The yield on ten-year bonds barely rose in 2008. It was not until 2011 and 2012 that these rates rose, and then by only two percentage points (see Fig. 1). Debt as a percentage of GDP did increase more quickly from 2008 to 2009, but then settled until increasing greatly from 2011 to 2014 (see Fig. 2). The international recession that accompanied the global financial crisis did seem to affect Italy. GDP per capita had been slowly increasing, but faltered to US$34,269.20 in 2009 before returning to a slower growth (See Fig. 3). Unemployment (Fig. 4) rose slowly from 2008 to 2011 and then jumped to 10.7% in 2012 and 12.1% in 2013. Unemployment for youth was much higher (about 40% in 2013).

These statistics suggest that there was a recession in Italy, but not necessarily a financial crisis. If Italy has a slightly higher debt to GDP than Belgium, then that ratio is far below the ratio for Japan. Both Belgium and Japan shrugged off the global financial crisis, although Japan continues to underperform economically. Only a closer look at Italy's banking system reveals a financial problem. Figure 5 shows the banks of Italy to be burdened with a high percentage of non-performing loans, reaching 18%

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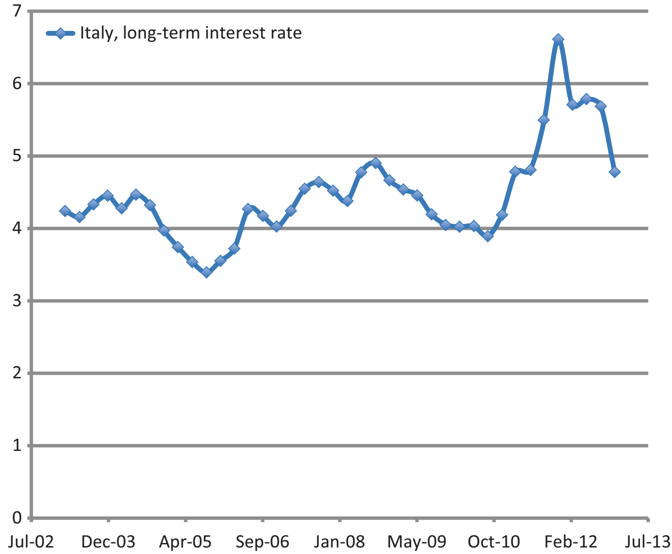

Fig. 1 Italy, long-term interest rates

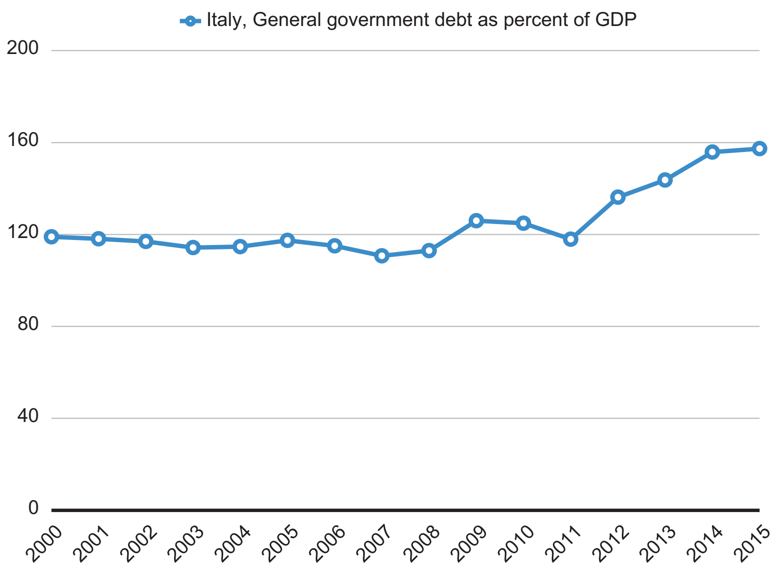

Fig. 2 Italy, debt as percent of GDP

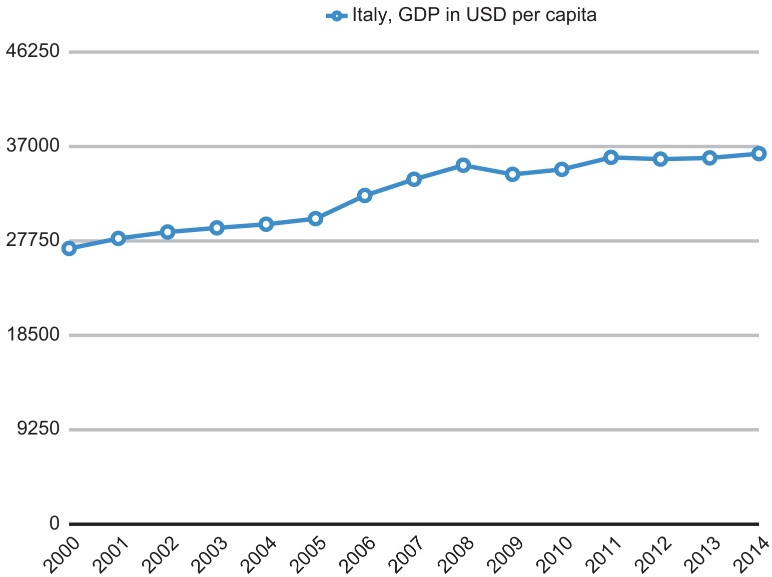

Fig. 3 Italy, GDP per capita

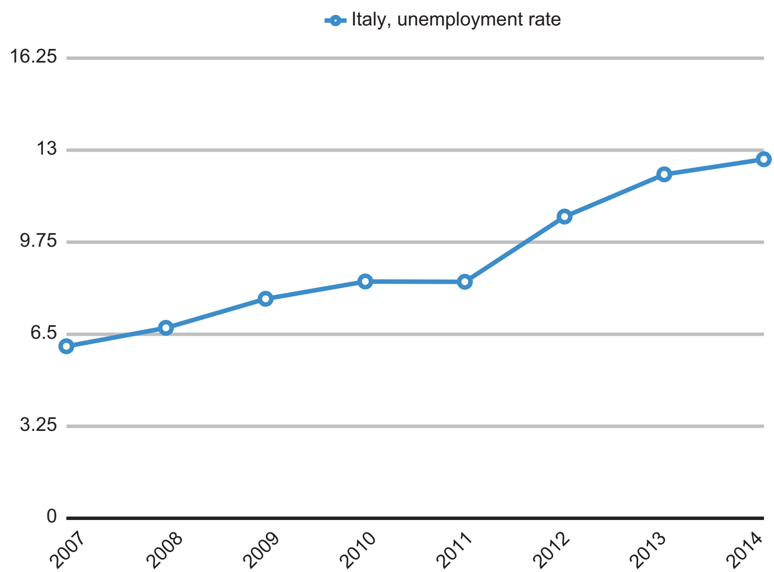

Fig. 4 Italy, unemployment rate

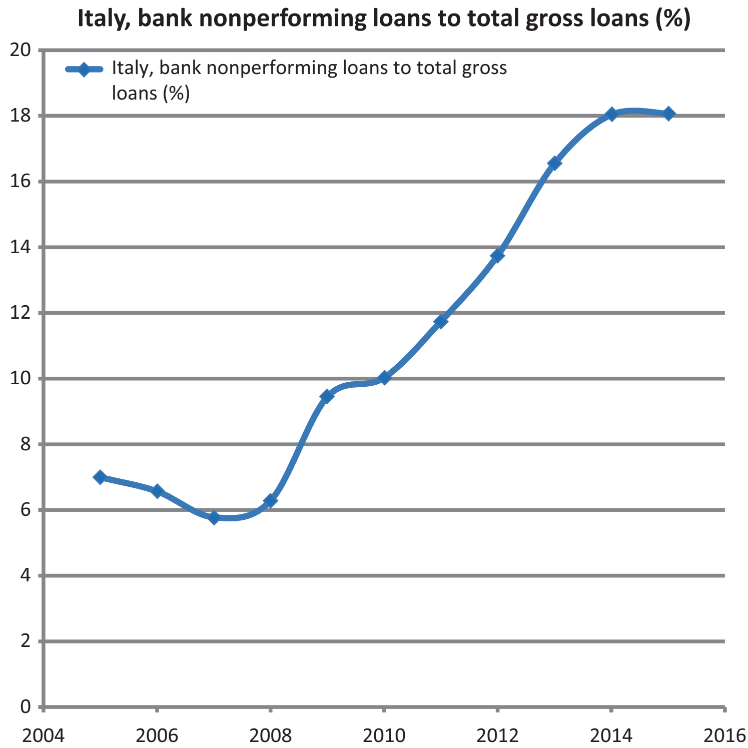

Fig. 5 Italy, bank non-performing loans to total gross loans (%)

in 2014 and 2015. This puts pressure on the profit and loss results and may even threaten to wipe out the capital of some banks, a serious problem for the financial system of any country.

There was a financial crisis in Italy, but the timing was different from the timing in other countries. The dynamics behind the crisis were also different. Why did the recession in Italy put such pressure on the banks? Was this recession more severe than in other countries? Or were the banks more vulnerable to the inevitable effects of a recession than were the banks of other countries?

The following sections will attempt to answer these questions. The first section offers a brief history of Italy from its reunification to the post-Second World War years. The second section describes the economy of

Italy in the Golden Age from 1953 to 1971, with particular attention paid to the impact of SOEs. Next comes an overview of the economy in the 1970s and 1980s. The electoral revolts from 1992 to 1994 are then covered, with a description of the evolution of the economy in the 1990s. Then comes the experience of Italy participating in the euro, including the onset of the crisis. The final section proposes a schema of the dynamics of the crisis in Italy.

A Condensed History of Italy's Economy

Germany and Italy are the youngest countries in Western Europe, though at their founding both possessed more than a thousand years' more history than America.

Italy's "unification" combined the culturally and linguistically disparate regions of the Italian peninsula: seven political entities in 1859, six in 1860. The kingdom of Venetia-Lombardy and the Papal States remained separate until 1870. Two ideas were the motor of Italy's unification: the notion of the Italian national identity, present among the elites since the seventeenth century (Cochrane 1989, chapter 9), and the notion of a citizens' republic inherited from the French revolution via Napoleon. These were ideas circulating among intellectuals and artists, not among the great mass of the population, as an 1820 mutiny by an army regiment in the kingdom of the Two Sicilies demonstrated. Nonetheless, romantic leaders sent younger men to their death and destruction for a near half century of revolutions and wars between the fall of Napoleon and the unification of 1861.

The Bourbon King Bomba (Ferdinand II) in Naples had his own progressive liberal ideas that he wished to install at his own pace. When this proved too slow for the intellectual and artistic elite, his regime turned suppressive beginning in 1837, when he violently crushed a demonstration that demanded a constitution. From that point onward the Bourbon rule garnered a reputation as tyrannical so that Garibaldi's arrival in 1860 was hailed not for uniting Italy but for bringing the promise of good government.

Whether viewed as a civil war or as a colonial war of conquest by the North over the South, the brutal confrontation of the forerunner of the current regime on the one hand and the Mezzogiorno or South on the other did not lead to a true union of equals. The South is legally and politically equal to the North, but the South was the losing side in the foundational confrontation. Further, the South resembles Greece in that brigandage played an important role in the government of society in the past, leaving real traces in the present. Finally, the South was unindustrialized and underdeveloped economically and remains economically disadvantaged to this day.

Piedmont-Sardinia in the North was more advanced economically than the other regions, having at least some experience of the first industrial revolution. At the start of the new millennium it had slipped slightly, but its immediate neighbours Aosta Valley (part of Piedmont in 1861), Lombardy and Trentino (all in the North) are now the most economically advanced regions of Italy.

Little infrastructure was in place in 1861, within or between the regions of the new Italy. Piedmont-Sardinia was also the only region with anything close to administrative structure (in the sense of a civil service). The neighbouring presence of the Holy See did provide some exposure to administrative structure and procedures. On the downside, Italy's venerable universities produced large numbers of lawyers. This would eventually lead to an administrative system caught up in complex procedures and dominated by these procedures rather than by technical goals.

It took Italy a quarter century to build up sufficient infrastructure and the beginnings of an administrative apparatus. While the rest of Western Europe embarked on a period of economic growth, Italy dawdled until 1896. Thereafter it grew more quickly than the other countries of Western Europe until hitting a wall in 1992.

The development of the Italian economy during the first half of the twentieth century can be divided into four periods: 1896 until the start of the First World War, the First World War and its aftermath, the first few years of the Fascist regime (1922–1925) and the Fascist regime from the onset of the Great Depression until the close of the Second World War.

1896–1913. The consolidation of a physical and administrative infrastructure brought years of growth to the Italian economy, although this growth was concentrated in the northwest with the cities of Milan, Turin and Genoa accounting for 55% of value added in 1911. Italy had a little in the way of coal, so that these years were also years for the rise of hydroelectric power.

The First World War saw a rapid expansion in steel, shipbuilding, engineering projects and the chemical industry, as well as strong investment in the hydroelectric industry. This was a war economy, however, and the GDP dropped 9% between 1917 and 1921 because of the overcapacity of much of industry.

The Fascist regime began in 1922 and was marked by 6.1% annual growth in the first few years, due both to pro-business policies and the low starting point. Unfortunately, the regime moved in the direction of autarky (self-sufficiency, which meant borders closed to trade) starting in the year 1925. This had negative effects for a resource-poor country such as Italy, and growth slowed.

1929–1945. Up to this point, the banks were the major investors in industry, collecting short-term deposits and committing themselves long term to various companies. This worked well until the onset of the Great Depression, at which point the banks found themselves with rapidly devaluing assets. The government had tried to compensate for or supplement the banking industry's involvement in industry (and concomitant concentration of assets in the form of both loans and equity) by the creation of the Istituto Mobilare Italiano (IMI) in 1931,[1] a credit agency financed by bonds guaranteed by the state. The situation grew more severe, and in 1933 the government created the Istituto per la Ricostruzione Industriale (IRI). This agency also supplied credit to industry, but further had a section that acquired industrial assets from the troubled banks. This marked the beginning of more aggressive involvement of the state in the economy via SOEs (Toniolo 2003). As the situation of the banks persisted, the IRI began to buy into the capital of the banks.

> [In 1933] the IRI held 83.13% of the telecommunication sector, 55.88% of the shipping, 38.92% of the banking, 37.92% of the heavy industry, 34.28% of the shipping, 32.18% of the financial sector, and 29.33% of the electric industry. (Russo 2012, pp. 418–419; cfr Blinkhorn 2006, p. 45)

The 1936 Banking Law[2] intensified government intervention as it "gave the state more intrusive controlling powers over banking activities" (Russo 2012, p. 422). This was at least in part necessary because of the incestuous ties between banks and industry.

This period was not a good one for Italy: the 1% annual growth rate of the 1930s was lower than that of the rest of Western Europe, and from 1940 to 1945 the war economy saw GDP decrease 10% annually, so that by 1945 the GDP was roughly the same as it had been in 1906.

Amatori summarizes government intervention in Italy prior to the Second World War as purchase orders (directly by government and by SOEs such as the railways), credit institutions such as those financing the electrical and chemical industries, and rescues of large corporations that faltered (Amatori 1997, 257–258).

Recovery from the Second World War is an experience shared by all European countries. Italy is different, however, in that this country was non-belligerent until June 1940 and surrendered in September 1943. The Allies occupied Southern Italy, Sicily and Sardinia, while the German forces in Italy set up a puppet government in northern Italy before being defeated in May 1945. Under-exploited industrial capacity, easily improved agricultural practices and the eventual availability of foreign aid facilitated the reconstruction of Italy from the war's end until the early 1950s. By 1954, industrial production was almost twice the pre-war level (Saraceno 1957). Further economic growth (per capita income more than doubled from 1952 until 1970) in Italy would take place in the same economic circumstances as other European countries: a long-term tendency towards globalization of trade goods, capital and, eventually with Europe, labour. This long-term trend bridged the three stages of the (i) Bretton Woods monetary system (until 1971), (ii) the era of oil shocks (1973 and 1979 and a period of high interest rates lasting into the 1980s) and (iii) the Great Moderation (mid-1980s–2007).

The evolution of Italy's economy across these three stages depended not only on the changing circumstances (which affected its performance much more than its structure) but also on the de facto industrial policy of the Italian government (which did affect structure and thereby, indirectly, performance). An appreciation of post-war Italian politics is required in order to comprehend the industrial policy.

Unlike Spain, Italy experienced no ideologically based civil war which hardened hearts to reject opposing viewpoints. Pre-war and post-war Italy was nonetheless split between a more or less atheistic or agnostic left and an amalgamation of an electorate guided by Catholic social doctrine, with conservative protectors of the status quo. Neither side was homogenous, but both were united in their opposition to the other side of the ideological divide.

June 2, 1946 was the date of both a referendum (should Italy be a monarchy or a Republic?) and the election of a constituent assembly (i.e., mandated with designing a new constitution). The election returned 60% in favour of the Republic, and the constituent assembly approved the final text of the Constitution of Italy on December 22, 1947. General elections were held on April 18, 1948.

These elections were held near the start of the Cold War.

The dominant political parties were the Democrazia Cristiana (centre right, with religious influence), the Partito Comunista Italiano and the Partito Socialista. The latter two parties combined obtained more votes than the Democrazia Cristiana, and they came into a coalition in the hope of forming the first government. This was certainly enough to give pause to the anti-left American powers. Comintern, the Soviet regime and the CIA were all active both with funding and with propaganda. Catholic clergy rejected the atheism of the communist ideology as well as part of the social platform of the socialists.

The election result was 48% of the popular vote for the Democrazia Cristiana. The leftist coalition received less than a third of the popular vote, and the Partito Comunista did better than the Partito Socialista. Although the Democrazia Cristiana would never again obtain such a high percentage of the popular vote, this first election established the profile of all election results until 1992: a Democrazia Cristiana-led government combined with a strong Communist presence. Indeed, the *Compresso Storico*, a working alliance between the Democrazia Cristiana and the Partito Comunista, would mark the 1970s.

The Democrazia Cristiana had obtained the highest number of votes, but the number of parties returning a significant number of candidates obliged it to seek coalitions and thus compromise on policy. Furthermore, a plurality of factions lurked behind the DC label (e.g., cfr. Carnevali

2000, p. 255). The policies of the party were thus the result of internal bargaining and compromise, as were government policies compromises between the members of the various governing coalitions. Add to this the use of government policies and actions to garner electoral support (such as subsidizing unproductive employment), and it becomes unsurprising that the industrial policy, the fiscal policy and the monetary policy of Italy have more often than not been a soup of opportunistic measures.

The Golden Age, 1953–1971

At the start of the Golden Age, the Italian economy was characterized by the following:

1. Momentum from the catch-up with OECD economies and reconstruction after World War II;
2. Great room for structural change, whereby abundant cheap manpower would exit agriculture and enter industry (often moving from southern to northern Italy);
3. Extensive state ownership of large firms;
4. Family control (as opposed to professional management) of 48 of the largest 100 firms (Amatori 1997, p. 272);
5. An administrative apparatus composed of a legalistic civil service and agencies that, created for technical purposes and manned by technocrats, were under ministerial control and would eventually succumb to political and electoral objectives;
6. State-owned banks holding 70% of credit system assets (De Bonis et al. 2011, p. 6) with the remaining banks tightly disciplined by government. Mauro Rota (2013, citing Federico and Gianetti 1999) summarizes Italian industrial policy of the 1950s and 1960s as credit-centred.

The period following the Second World War up until 1973 is considered the Golden Age of Western European growth, particularly from 1953 onward. Germany was one country that was among the fastest growing (measured in gross domestic product per capita), having faced a tremendous reconstruction at the end of the war. The remaining fastest growing countries were the poorest at the end of the war: Greece, Portugal, Spain and Italy. Ireland was also among the poorest but did not experience rapid growth (see the chapter on "Ireland"). Italy grew even faster than most of the countries of rapidly growing Western Europe.

This growth and wealth translated into improvements in most aspects of human life: more years of schooling, longer life expectancy, a better welfare support net and a better-perceived quality of life: *la dolce vita*. As of 2017, Italy is among the longest-lived nations on the planet.

However, there was no change in Italy's economic rank. Italy was the 12th richest country in Western Europe as measured by GDP per capita in 1950, and it was still the 12th richest country in 1973. This is not an indication of mediocre improvement, but rather resulted from Italy beginning far behind the pack.

This becomes clear if we consider the ratio between Italy's GDP per capita and the average of Western Europe for the years 1913, 1950 and 1973: 0.695228, 0.697888, 0.874722. The ratio is essentially the same in 1950 as in 1913. It increases markedly between 1950 and 1973. Figure 6 presents the curve for the ratio for the years 1870–2003 using the Maddison data set.[3] The data for the First and Second World Wars are clearly outliers, and two periods of growth stand out if the war years are excluded. The first decade and a half of the twentieth century is characterized by catch-up[4] after having lost ground in the first years of nationhood. The years following the Second World War are the other period of rapid growth. Italy was clearly catching up to the rest of Europe during the years 1950 to 1973. In fact, at least one author (Toniolo 2003) argues that the rate of growth was even faster than catch-up alone can explain.

Although some of the change was due to improved productivity within the different businesses of Italy, most of it was due to a change in the structure of Italy's economy: manufacturing and services grew much faster than agriculture so that by the end of this period, agriculture had become the smallest sector of the Italian economy, as already had been the case for more advanced economies at the beginning of that period. There is far greater scope for productivity improvement—the increase in value produced by the same amount of work—within some services and especially within industry, compared to agriculture. For many industries worldwide, this potential for increase was realized particularly during the

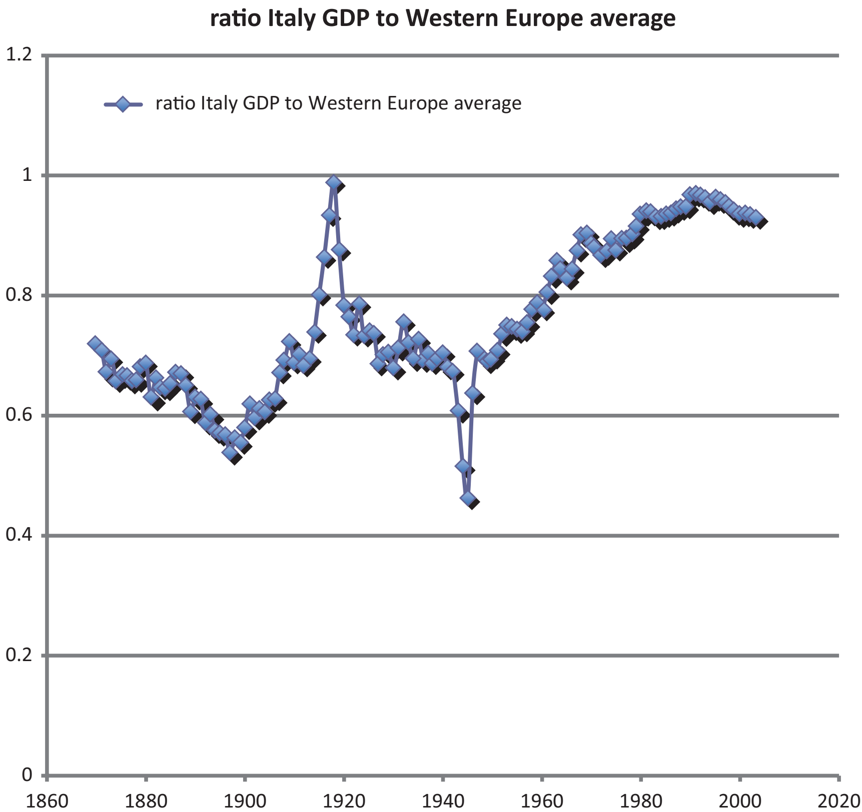

Fig. 6 Ratio of Italy's GDP per capita to the average for Western Europe

years of Italy's industrialization. Most industries experienced growth and economies of scale from the nineteenth century to more or less the end of this period: mid to late 1970s. Scale economies then became more complex with the introduction of distributed manufacturing, involving groups of factories whose products could be assembled in any of several final locations, as is the case of automobile manufacture. In other cases, larger scale brought diminishing returns or even increase in costs either in manufacture or in logistics. The important point is that the spurt of industrialization in Italy's economy coincided with a wave of increasing economies of scale.

The Impact of SOEs

SOEs are considered to be a central channel of state influence leading to the success of the Golden Age. While this is true, the influence was not without any deleterious effects upon Italy's economic system. This is best understood by examining those enterprises through the golden years. A relation of the history of one such enterprise should suffice to provide a notional understanding.

Ente Nazionale Idrocarburi (ENI)

In January 1924, Sinclair oil entered into a joint venture with the Fascist government of Italy, with 25% of profits going to the state. In the opposition, the socialist Giacomo Matteotti added accusations of fraud and corruption regarding this venture to his frequent complaints about the methods the Fascists had used to get into power. Matteotti was murdered by a group of Fascists in June of 1924, but in any case a royal decree (Italy remained a kingdom under the fascists) in 1926 established the Azienda Generale Italiana Petroli (AGIP) to completely manage and operate the venture. The name translates as General Italian Petroleum Agency. It would come to hold various subsidiaries and participations in joint ventures. Examples are: ANIC (a joint venture with Montecatini), Industria Raffinazione Oli Minerali or IROM (a joint venture of AGIP with the Anglo-lranian Oil Company), STANIC (a 50% joint venture of ANIC with Standard Oil of New Jersey), Società Nazionale Metanodotti or SNAM (held 88% by AGIP to build and operate methane pipelines), and Società Azionaria Imprese Perforazioni or SAIP (a state owned consortium of drilling companies) (Cfr Cecola 1984, p. 94; Chapter 1 Dechert 1963; ENI SPA n.d.).

In 1945, after the Second World War, any Fascist roots were an embarrassment, and the government was under pressure from the allies to distance itself from the relics of Fascism. The government appointed a partisan, Enrico Mattei, to dismantle and privatize AGIP. Further, there was a strong Liberal (which in Europe means economic liberal and thus free market) presence in the government that argued against government intervention and presence in the economy.

Mattei sought to retain and promote the Italian presence in the petroleum industry as a protection against domination and exploitation by the "Seven Sisters" (Mattei coined this expression used to refer to the multinational petroleum firms that dominated the industry at that time) and to ensure that Italian industry and consumers had access to reasonably priced energy.

A long debate ensued. Mattei resigned and AGIP was nearly suppressed, but a change of government led to his reinstatement in 1948 and the 1953 creation of the Ente Nazionale Idrocarburi (ENI) to take over the assets and activities of AGIP and to exercise exclusive exploration and exploitation rights in the Po Valley and later elsewhere in Italy.

Mattei led ENI for nine years until the crash of his executive jet in 1962 ended his life. He reorganized the various entities into four main groups: AGIP for sales, AGIP Mineraria for exploitation, SNAM for distribution and ANIC for refining (see Fig. 7).

Although ENI's oil discoveries in Italy were disappointing, leaving Italy heavily dependent on the importation of crude, natural gas deposits in the Po Valley proved to be massive. Private production tripled ENI crude oil production in the early 1960s, but ENI produced over 30 times more natural gas than did the private companies. ENI effectively controlled the natural gas market, but not that of petroleum (although innovative advertising and aggressive distribution won ENI a huge share of the retail trade). Italian firms able to operate on gas managed an energy cost advantage of 30% over oil and 50% over coal (Magini 1975, p. 105, cited by Carnevali, p. 260). A further advantage for Italy was that nearly a fifth of the natural gas was exported, reducing the balance of payments deficit by 10% (Carnevali 2000, p. 259).

ENI had to purchase crude oil from foreign multinationals, and the cost disadvantage was passed on to Italian manufacturers. Facing the reality of limited deposits in Italy and the market dominance of several large oil multinationals, Mattei offered an innovative deal to other countries with extensive oil deposits and was able to obtain crude oil from Egypt, Iran, Morocco, Louisiana, Sudan, Tunisia and even from Nigeria in the sub-Sahara. Following the lead of West Germany and France, but on a greater scale, Mattei reached an agreement with the USSR. ENI imported an estimated 2.5 million tons of crude oil from the USSR in 1962 (Dechert

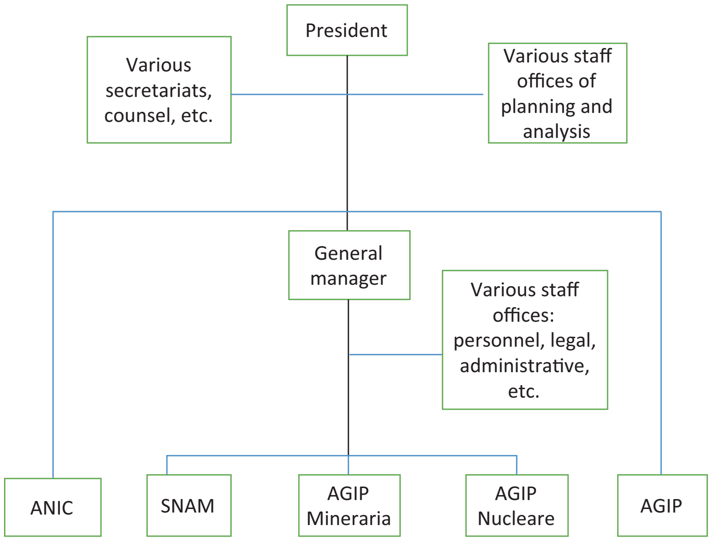

Fig. 7 Headquarter organization chart of ENI circa 1962 (Source: Adapted from Dechert 1963, p. 15)

1963, p. 11). The result of all these negotiations was the diversification of source and reduction of the cost of crude. The latter benefit was passed on to both industry and consumers of gasoline and diesel.

Thus far described, Mattei and ENI had a real impact upon the economic capacity of the Italian industry by providing access to cheaper energy. However, political manoeuvring and compromise were part of the effort required. While Mattei had sought to achieve autonomy from government interference through profitability (providing sufficient internal funding for his various projects), this autonomy was far from perfect. Governments pressured him to acquire firms in various industries either to save jobs or to extend government influence. The result was reduced profitability and thus greater dependence on government funding. This would increase greatly after Mattei's death in 1962.

One of the discoveries of AGIP Mineraria was a deposit of natural gas near Ravenna in Northeastern Italy. This 1954 discovery was exploited four years and 72 billion lire later when ANIC began to operate a petrochemical manufacture of synthetic rubber and fertilizers. This was a strategic and even organizational change for ENI. Although a downstream integration from the petroleum industry, petrochemicals brought new processes, new logistics and new customers. Since Mattei had publicly spoken against the idea in 1954, we can deduce that political pressure explains the diversification—petrochemicals created more jobs per billion lire invested than did petroleum (Carnevali 2000, pp. 269–270).

This diversification brought ENI into direct competition with Montecatini, a private chemical manufacturer.

Founded in 1888, Montecantini was a powerhouse in Italy's chemical industry throughout much of the twentieth century. In 1960, it was twice as large as SNIA Vicosa, the number two domestic producer. Although ownership devolved from the Donegani family to banks to the IRI to dispersed ownership, Guido Donegani remained the ultimate authority until 1945 and a decentralized multidivisional organizational structure was not adopted until the 1960s (Amatori 1997, p. 269). Donegani's leadership was effective, and the company was a strong global competitor at the end of the Second World War.

Montecatini invested 18 billion lire in new nitrogen-based fertilizer plants at its Ferrera complex (in northern Italy, about halfway between Venice and Bologna) as the 1940s closed. Azienda Nazionale Idrogenazione Combustibili (ANIC), a subsidiary of ENI, invested aggressively (72 billion lire) in competing plants in Ravenna (also in northern Italy, nearer the coast). These plants came online in 1958. Montecatini made 31 billion lire of additional investment in Ferrera, but the realities of overcapacity and a price war meant its gross profit figure shrank from 19 billion lire in 1956 to 3 billion in 1961. Besides its (probably) more efficient plants, ANIC possessed a cost advantage because her sister companies within ENI gave her access to cheap natural gas. Further, ANIC converted a tactical disadvantage into an asset: having no distribution network, ANIC signed an agreement with a farmers' consortium (Federconsorzi) for distribution, and offered uniform pricing for both northern and southern (more distant) clients. As a result, Montecantini's share of the nitrogen-based fertilizer market shrank from 80% to 30% over the years 1953 to 1964. Once ANIC had obtained a considerable chunk of the market, the firms set up a cartel and fertilizer prices were held high, high for fertilizers that were, in the end, a small, low-margin business. (For more data on ENI in English, see Dechert 1963.)

While the price war was still in process, law n° 634 of July 29, 1957, ("Provvedimenti per il Mezzogiorno"), combined with financing from the Cassa per il Mezzogiorno and government promises to provide sufficient infrastructure, motivated Montecatini to construct a new plant for petrochemical cracking at Brindisi (Southern Italy). The design and feasibility studies were mismanaged so that the first two plants were obsolete by the time they were brought into operation. A third plant, twice the size of the previous two combined, was then built. By 1962, Montecatini had disbursed 150 billion lire. The result was a further fiasco. The CEO resigned in 1962 and a more decentralized multidivision structure was adopted. The new leadership clearly had not possessed Donegani's genius for managing a complex organization (which had remained centralized; cfr Dechert 1963, p. 14), and the new structure hopefully would make the organization manageable by mere mortals. In practice, the transition in structure was superficial (Amatori 1997, p. 271; for Italian industries in general, cfr Binda 2012).

Electrical Interlude

Energy is a prerequisite of any economy in the twentieth and early twenty-first centuries, and all the more so for the industry-based growth that characterized the Golden Age. Italy is bereft of coal, so that almost all coal was imported and this impacted the balance of payment. Oil (imported crude refined in Italy), gas and electricity were the main energy sources for industry. Twentieth-century electricity was generated by hydroelectric power and from fossil fuels, the former accounting for 80% of production in the 1950s and early 1960s, with fossil fuels growing and surpassing hydropower thereafter. Seven of the top ten hydro plants are in the northern provinces. This is explained in part by the proximity of demand, and in part by the proximity of the Alps. The Apennines is a mountain range that forms the North–South backbone of the Italian peninsula, but perhaps does not provide as many potential sites as the Alps.[5]

The industry of hydroelectricity requires both engineering and financial expertise. Engineering is required as in any other industry for operations, repair and research and development. Finance is required because the massive investments of hydroelectric plants are recouped over decades. Nationalization of the electricity industry would separate these two sets of expertise and resources (plant and capital).

The strategic importance of this industry had already garnered unwanted attention from government in the 1940s and 1950s in the form of price controls that ultimately slowed the pace of investment in the industry once private enterprise had disbursed billions of lire to reconstruct the war-ravaged installations. The mid-1950s ten-year Vanoni plan had seen electricity as crucial and laid out investment and capacity objectives for the industry. By the 1960s there was an international movement towards the nationalization of the electrical industry, and in Italy this was expressed by the creation of the Ente nazionale per l'energia elettrica (ENEL) in 1962.

Private electric companies had long seen the writing on the wall and responded by slowly diverting funds into other investments. One such company was Edison S.p.A., the oldest European energy company, founded in 1881. Edison began moving into the chemical industry in the 1950s so it was among the largest chemical companies in 1962, when it ceded all electrical generation and distribution capacity except that used for the consumption of its chemical plants. It was a brilliant financial move that did not work in the marketplace. Another electricity company, Società Adriatica di Elettricità (SADE), founded in 1905, was ultimately absorbed by Montecatini in 1964 (Anonymous 1964). Edison also merged with Montecatini in 1966, under the name Montedison. The financial expertise of the management of the ex-electrical and the massive indemnity funds received from government for the electrical business, combined with a hodgepodge of chemical companies and enclosed in a newly minted multidivision structure marrying the organizational structures of the two electrical companies under a leadership inherited from Edison's top management, simply did not work. Part of the problem preceded the fusions. As the chemical industry moved towards specialization and profit margins were to be found in high-quality and advanced technologies (such as life sciences and specialty chemicals[6]), Montecatini, partly distracted by its competition with ENI, simply modernized and increased scale for the mature generic products that were commodity chemicals. But much of the problem came from the fusions and the midwifery of Mediobanca,[7] the credit institution that crafted the latter fusion. If Montecatini's management had suffered from a weak track record, they at least had been specialists of the chemical industry. Electricity managers moved into chemicals because they were pushed out of their field. They enjoyed near absolute power at the highest level of the new entity, as described by Amatori (1997):

> In fact the two [Montecatini and Edison] merged into a new corporation that is structured as a holding company with a small headquarters staff which leads the complex by guidelines that combine the worse aspects of an autonomy at the peripheral stage, similar to anarchy, with autocratic decisions by the central layers, taken without adequate knowledge of the problems. (p. 271)

Mediobanca engineered the purchase of 20% of Montedison's shares by a holding company, Sogam S.p.a—Societa Gestione Azioni Montedison—jointly held by ENI and Istituto per la Ricostruzione Industriale. 1971 saw Eugenio Cefis, former chairman of ENI, named president of Montedison, which he used for his political ends. At that time of his accession, 40 of the 193 factories of Montedison operated at a loss and he believed there was no other choice for Montedison than to depend completely upon the state financially (Anonymous 1972) while maintaining business decisional independence and supporting the Democrazia Cristiana politically (Tolliday 2000, p. 188). Cefis did try a foray into fine chemicals, but failed. Short of cash in 1977, he reapproached Mediobanca for funds but was turned down. He then resigned and disappeared from Italian economic life. (Turani 2004)

Conclusions on ENI and SOEs

ENI is considered to be central to the success of the Golden Age in Italy. From the very marginal beginnings of post-war precariousness, it rose to provide Italy with an important source of cheap energy (natural gas) and to moderate the pricing of another (petroleum). This was an important contribution. However, other aspects of its success can be called into doubt. Under political pressure, ENI ventured into the chemical industry. The effect of this was a price war in commodity chemicals, diverting the Italian incumbents of that industry from more lucrative strategies that would have seen them move their portfolio of products into higher-margin chemicals an at earlier stage. Montecatini had been a strong international competitor after the Second World War, but became a sorry domestic fiasco after absorbing capital from the fugitives of the nationalized electricity industry. Thus, the two-fold state intervention, via ENI and the nationalization of electricity, had the unintended side effect of hamstringing Italy's chemical industry. This came just when international competition in the chemical industry was becoming fierce (Sundberg 2017, section 3.4).

The attempted solution for this would be, inevitably, more state planning. For example, the Comitato interministeriale per la programmazione economica (CIPE) was created by government in 1967, presided over by the president of the Council of Ministers and chaired by the Minister of Economy and Finance (who is vice president) and three other specified minsters, with the governor of the Bank of Italy, the Secretary of Programming and others in attendance as technical advisors.

> Regarding the activity of industrial enterprises, CIPE has three basic means of intervention.
>
> First of all, [1] it takes decisions concerning the granting of financial incentives for the initiatives planned by all enterprises in the under developed areas of the south. [2] This committee can also express its disagreement, which carries official weight, to the carrying out of production initiatives planned by large and medium sized firms in any part of the country.
>
> In its third, more general line of intervention, [3] the CIPE is called upon to approve investment programmes for firms with State participation. Thus, in theory, almost all the decisions on investments relating to large or medium sized firms for the whole national territory and all single decisions on investments which request facilitation of financing from the State, may be subject to this committee of ministers of the economy. (Pagano and Delugan 1973, p. 21)

The Close of the 1960s

The propensity for state intervention, the strong ideological presence of the radical left both in politics and in unions, and the structural evolution of the economy that migrated massive numbers of workers from agriculture to industry led to a cocktail of civil unrest that the government pretended to resolve with increased expenditures. While the unions drew the lines of membership clearly between the haves (experienced males who were already members of the union) and the have-nots (youth and women who could not get the increasingly rare unionized jobs), the government sought to stimulate the economy by (the permanent measures of) increasing public pensions and giving a pay raise to civil servants (provoking demands for higher wages in the private sector). One result was growth in consumer demand at the expense of investment in the 1960s (De Rosa 2008, p. 102). A more important result was to reinforce the role of government in the popular mindset as allocator of funds in the economy.

The onset of the oil crisis, followed by inflation induced at first by rarity and later by the increased cost of this energy input for most of the economy, followed in turn by hikes in interest rates, led to a flow of capital into bonds. Given the added context of anti-Vietnam War demonstrations and the various protests of 1968 in much of the West, and in 1969 for Italy, there was also a flight of capital to security. Italy had only moderate interest rates, considerable civil unrest and violent terrorists. Capital began to move out of Italy at a time when she needed new investment. The government disposed of much of the capital that remained and had been diverting it to consumption via social benefits to all citizens. "The public sector's investment effort has slowed considerably and accounted for only 6.3 per cent of total public sector expenditure in 1973 compared with 10.2 per cent in 1960 and 7.3 per cent in 1965" (1977 OECD economic Survey of Italy, p. 28). Education and public works were neglected (De Rosa 2008, p. 111). The general government deficit grew from 1159 billion lire in 1965 to 6397 billion in 1973—about 8% of the GNP of 80,574 billion lire in 1973 (ibid., p. 28). Debt began to mount, and the interest on public debt doubled from 1969 to 1972 (1975 OECD economic Survey of Italy, p. 57). Deficit per GDP peaked at 12% in 1975, then was stabilized around 8% thereafter (1981 OECD Economic Survey of Italy, p. 28).

Politicians began to debate the need for increased investment. A medium-term programme for 1981–1983 proposed improving the productive system and thus increasing productivity by increased investment in "twenty sectors selected on the basis of various criteria such as the easing of external constraints (energy, agriculture, tourism); reallocating resources by restructuring sectors in serious difficulties (chemicals, steel, ship-building); improving social infrastructures (housing, health, transport); developing high-productivity sectors (agro-industry, electronic components, telecommunications)" (ibid. p. 27) all within SOE or through state agencies. However, the shift from current (operating) to capital expenditure did not materialize because of "protracted and complex administrative procedures, dispersion of responsibilities, administrative rigidity" (ibid.). Meanwhile, losses of SOE and agencies cumulated to more than 6000 billion lire (about US$7.5 billion) from 1977 to 1980. There would be little investment from internal financing.

The 1970s and 1980s

The chapter on Ireland referred to Adam Smith's vision of the capitalist engine: the key to growing wealth lies in the portion of funds generated that is reinvested into profit-generating assets. The consumer society invests little and spends much on consumption. The purely capitalist society reinvests massively and spends little on consumption.

There is no optimal level of investment versus consumption. Environment and technology (and its rate of evolution) will influence how much investment is needed in a given industry. Social mores will also have a great impact. The time horizon also impacts our judgement on what is the most advantageous level of investment. In the short term, it may seem more advantageous to have no children and send both men and women into the marketplace on a permanent basis. Within a generation, however, the burden of white hair upon the new cohorts becomes unbearable and the economy unsustainable. Again, funds "spent" on education and research are arguably investments in the future. Prudential judgement about investments (as well as luck) is also important as varied investments bring varied returns.

The principle remains, however, in spite of all reservations: a society that has the discipline to choose investment over consumption harvests greater wealth in the mid-term, and this wealth snowballs as discipline is maintained.

The years immediately following the Second World War had seen competent patriots appointed heads of the diverse SOEs and agencies. These persons were in a position to direct funds to productive or unproductive purposes. As the 1950s progressed, however, there was a transition from patriots to political appointees chosen among Democrazia Cristiana supporters:

> In the first part of the century, these decisions [about political intervention in the economy] were implemented by professional civil servants and experienced managers, while after World War II the pressure of politicians on management was much stronger. The goal of obtaining political consensus clearly prevailed on the market result. (Amatori 1997, p. 274)

At the time, the social infrastructure was somewhat inadequate, and the wage share of income was modest to say the least. In spite of this modest share, the savings rate of Italians was high, and this had a positive impact on the rate of investment and thus the growth of productivity. As a result, while wage share was small, wages and purchasing power were growing.

In the 1960s, the state-owned corporations were called to absorb losses in the economy (acquiring money-losing firms, making overly capital-intensive investments, managing for social/political objectives). The *autunno caldo* and *annos de plombo* followed: years of industrial strife that led to wage share increases in the late 1960s and 1970s. One positive result was the reduction of poverty. According to Felice and Vecchi (2012, p. 32), “The rate at which poverty decreased in the 1970s was about three times that recorded during the 1950s and 1960s.” The category of poor people went from 20% of the population in 1970 to 5% in 1980. It is in great part thanks to that decade that the growth in wealth of Italy is exceptional in that it is characterized also by an increasingly equitable distribution of that wealth as measured by the Gini coefficient.

However, the major impact upon the economy was not so much via specific wage increases of each collective agreement as through the wholesale introduction of wage indexation (cfr. OECD Economic Survey of Italy for 1980, pp. 16–18), known as *scala mobile*. "Wage developments in 1979 in the street illustrate how the wage-formation mechanism operates in Italy, with negotiated increases only playing a limited role and the main factor in wage growth being indexation, the impact of which has increased considerably since the reform of 1975." (Ibid., p. 18).[8]

Automatically increased wages led to rises in manufacturing costs and thus in wholesale prices, diminishing considerably the purchasing power of wage gains and feeding into a vicious circle of wage indexation and inflation. The increasing prices led to depreciations of the lira, and thus to increases in the lira prices of imported goods both for consumers and for manufacturers.

While social spending increased, taxes lagged and the resultant deficit financing was monetized by policy: the central bank purchased bonds issued by the Treasury. Thus, the Treasury would receive a deposit at the central bank in return for debt obligations and spend the deposit, thereby placing funds in the hands of the public; when these funds were deposited in commercial banks, the multiplier effect took hold. This led to inflation and devaluation, thus, in theory, neutralizing wage increases for the effects of international competition. Meanwhile, however, profits had turned into losses. Lubitz (1978, p. 5) observes that the "national accounts data include in the non-wage share various types of income which obscure the true relationship between wages and profits," before referring to a Mediobanca study where 795 firms accumulated losses over 1968–76[9] and capital fled the country (De Rosa 2008, 110). Private capital left the country while politicians borrowed funds.

Meanwhile, a hidden disinvestment was taking place. Italy's fertility rate dropped from 2.65 in 1964 to 1.64 (a 40% drop) in 1980 to 1.19 in 1994. This is an effective diversion of resources away from building future human capital. Although some might have argued at the time that children would be getting better treatment and more attention, in practice funds were applied to more expensive vacations, additional cars and televisions, etc. The current unemployment rate for youth may make this phenomenon seem irrelevant, but it may also be argued that the reduced cohort has a weaker political and social clout than it would otherwise enjoy, rendering the cartel of privileged workers less vulnerable to social pressures. Furthermore, the decision to forego children is already a decision to prioritize the older generations. A complication is the fact that this is not only a decision about consumption versus investment, since non-mothers would more easily participate in the labour market.

The problems around the government deficits were threefold. First, their very existence was already a diversion of resources to government projects, in this case especially to social benefits, rather than to projects maximizing economic return. Second, the nature or cause of the deficit in this case was the current account rather than investment, thus promising little or no return. The third problem was the manner in which the deficit was financed: it was monetized, thus feeding into inflation and *scala mobile* (wage indexation) and thereby into a vicious circle of increasing wage share and government subsidies of money-losing firms.

What was the impact upon the economy? When the 15 years from 1970 to 1985 are isolated, Italy seems to follow the general trend of other countries in what would become the euro area. There is one difference, however. Italy's performance exaggerates this trend, increasing and decreasing more abruptly than the rest of the euro zone. This is most evident if we look at GDP growth for that period (see Fig. 8).

In summary,

> There had been a radical change in Italy's development model beginning in the mid-sixties. Up to then living standards had improved mostly as a result of continuous, accelerating growth in production and employment, i.e. from the bottom up. After that date, the goal had been to achieve the objective from the top down; the functioning of industry and the rest of the productive economy had begun to falter and continued to deteriorate in the seventies. This process of degradation gradually gave birth to the new model of the Italian economy, based entirely on the rapid expansion of the public sector, the inflationary financing of government debt and the erosion of the rights of private property. (De Rosa 126)

On the other hand, if we examine the same years (1970–1985) and place them within the longer-term trend, the variations appear to be less important. Further, when we compare Italy with other West European

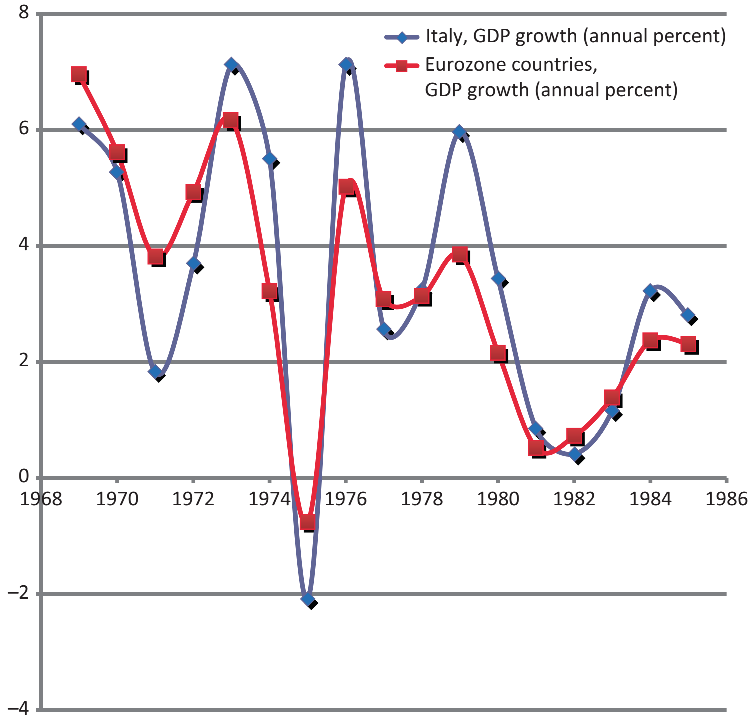

Fig. 8 GDP growth for Italy and the countries of the euro zone 1970–1985

countries, little difference is apparent either in policies or in performance. In fact, Boltho (2011) has pointed out that, for the years 1973–1979, Italy outperformed other European countries on many measures such as GDP growth and competitiveness. An opinion widely held among economists (Bruno and Sachs 1979) is that US policy (contractionary monetary policy combined with expansionary fiscal policy) had a contractionary effect on most European economies in the late 1970s and early 1980s (Fig. 9).

The second half of the 1980s was a time of growing wealth as measured by GDP. This growth was stimulated by deficit. The population of Italy was stagnant rather than growing and so, in spite of increasing female

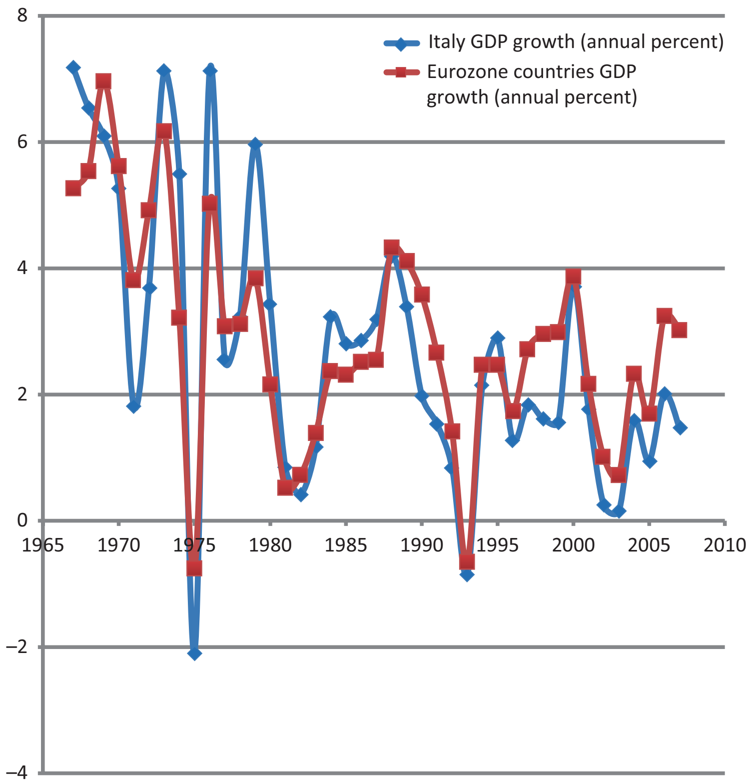

Fig. 9 GDP growth for Italy and the countries of the euro zone 1967–2007

participation in the workforce, we find there is increasing GDP per capita along with growth of GDP (Fig. 10).

If Italy's economy was simply behaving as most other West European economies, what important issue is to be found in the 1970s and early 1980s? What is important is the entrenchment of a change in the structure of the economy (especially wage indexation), rather than the short-term impact of that change. What is important is the hardening of the status quo regarding governance of an economy divided among SOEs used for political purposes, a number of large third- or fourth-generation

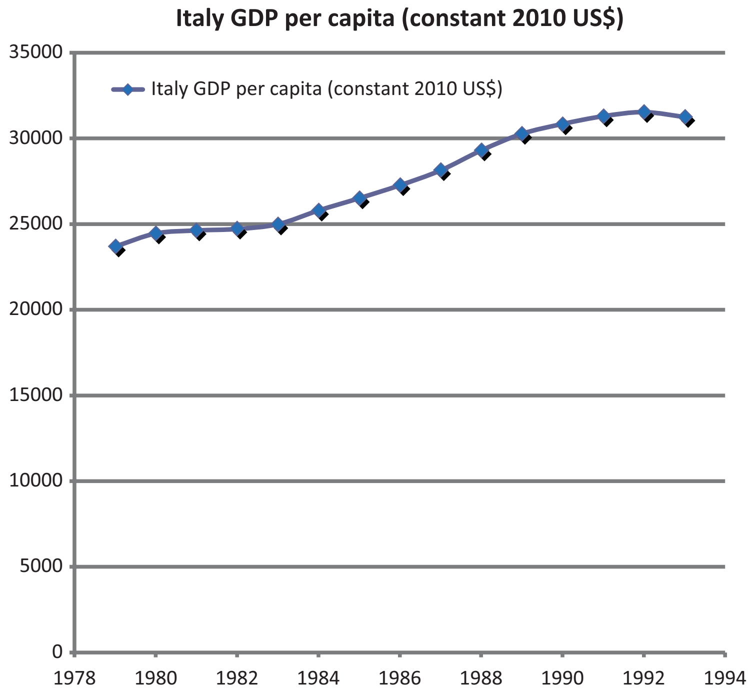

Fig. 10 Italy GDP per capita 1979–1993

family-owned firms, and a host of small to mid-sized firms considered innovative in the 1980s (Porter 1989, p. 691) but less so as the years passed. A time would come (in 1993) when attempts were made to redress that structure, and then the trajectory of Italy's economic performance diverged from that of the rest of Europe, as indicated by GDP growth, GDP per capita, productivity growth, competitiveness, etc.

The Electorate Revolts 1992–1994

Much of the world entered a recession in the late 1980s and early 1990s. Italian politicians and electors shared in the growing conviction in the West (from New Zealand to Canada) that fiscal spending needed to be reined in, although the Italian political system proved to be far more dependent on patronage and fiscal spending than those of most other countries. Italians also shared in the 1992–1993 crisis of the European monetary system that saw the United Kingdom exit the system and Italy exit the next day after devaluing the lira. The lira lost 20% of its value relative to the Deutsche Mark between May and September 1992.

As a result, the governments of Giulio Andreotti (July 1989–April 1991; April 1991–June 1992) and Giuliano Amato (June 1992–April 1993) initiated a series of reforms. When Amato's government fell, the President Massimo D'Alema asked Carlo Azeglio Ciampi, former central banker and non-politician/parliamentarian, to form the new government as prime minister. The rising tide of discontent with things as they stood and calls for reform are documented in Della Cananea 1996. Ciampi formed a technocratic government, reappointing several of the reformist ministers of Amato (April 1993–May 1994), and pursued the technical reforms initiated under Amato and Andreotti:

1. In October 1990 the "Norme per la tutela della concorrenza e del mercato" was introduced as the first piece of Italian legislation promoting competition.
2. In 1987, public enterprises had made up nearly 20% of value added. Four of these were transformed into joint stock companies and a fifth, EFIM, was liquidated in July 1992; most of the public banks became joint stock corporations by the end of 1993. A January 29, 1992, law established a legal basis for the transformation of public economic entities into private corporations and the sale of state-owned companies and assets. A September 1993 decree foresaw such sales by public offer.
3. Privatization required a healthy financial system, and this was liberalized. January 1992 legislation gave the central bank greater independence from Treasury (among other things, no more credit or overdrafts to the Treasury). The Interministerial Committee for Credit and Savings extended the operations permitted to private banks. The Stock Market Law of January 1991 reformed the legal framework of the securities markets.

4. The labour market was also liberalized somewhat. The *richiesta numerica* had required enterprises to recruit labour through recourse to state employment agencies. This arrangement was terminated in July 1991 for firms of 15 employees or fewer. The *scala mobile* was suppressed in July of 1992 and replaced in July 1993 by the Incomes Policy Accord of July 1993 wherein the government granted wage increases in accordance with its own inflation targets.

Several factors particular to Italy added to the more universal sources of discontent. February 1992 saw the arrest of socialist party member Mario Chiesa for accepting a bribe. (The Italian judiciary is independent of the executive branch [Ginsborg 1995, p. 12].) This signalled the beginning of *Manu Pulite*, a judicial investigation into political corruption of the major political parties (Democrazia Cristiana, Socialista and Comunista) leading to the fall of Adreotti, Bettino Craxi, Gianni De Michelis, Arnaldo Forlani and a host of lesser figures. "There were 685 requests to the Chamber of Deputies to remove immunity, in a house with 630 members" in the 1992–94 legislature (Golden 2002, p. 26). In May and July 1992, two high-profile magistrates in the struggle against the Mafia were assassinated in separate and spectacular bomb attacks, galvanizing public resentment against the Mafia's corrupting influence. Towards the end of August, the Italian Treasury attempted and failed to place 3.3 billion lire (a little under 2 million euros) in bonds, reinforcing public discontent with government debt.

The result was an apparent revolution in Italian party politics as the traditional parties disappeared from the scene. The revolution was only apparent because the 1994 victory of Forza Italia in alliances with the Lega Nord and the Alleanza Nazionale, all three new political parties, brought in Silvio Berlusconi as prime minister. Berlusconi had been a protégé of the disgraced Socialist Craxi, and some argued that he had entered politics in order to gain immunity from the ongoing judicial investigations into political corruption. A further indication that the revolution was only apparent was that the propensity for short-lived governments continued: the Berlusconi government lasted eight months, and there were five different governments between May 1994 and April 2000, although all were dependent on the L'Ulivo (Olive Tree) alliances.

All these governments pursued reform. Traditional resistance also continued. Although privatization was a success in terms of sequencing of sales, diversity of investors, capacity of the domestic market to absorb sales and transparency, the State retained a majority stake in many SOEs, and thus corporate control (Goldstein 2003). The labour market was indeed liberalized but "around 1 million jobs were lost between mid-1992 and mid-1994" (OECD Economic Survey of Italy 1995, p. 6), and it was not until the turn of the millennium that unemployment began to decrease. The gains in productivity came early while the creation of new jobs came late. The government deficit shrunk from 7% of GDP in 1996 to less than 2% in 2000, helped in part by a one-time "euro tax" (voted by the Prodi government in November 1996) and decreased interest payments due both to perceived improvements in fiscal discipline and to proximity to the euro. This might appear to be a success. Indeed, Italy met most of the Maastricht criteria and made the cut for the euro, resulting in widespread satisfaction in Italy. True, some accounting magic was used, but as much could be said of the other entrants to the euro as even Germany and France had difficulty in meeting the government debt criterion of a maximum 60%. Efforts by Italy's government and electorate had achieved access to the euro, contrary to expectations in 1992. However, no accounting magic could erase the fact that Italy's government debt stood at over 110% of GDP in 1998—nearly double the Maastricht criterion of 60%. The European Union simply declared Italy to be approaching the reference value at a satisfactory pace.

The debt spectre had begun to arise in the 1980s when the state committed to a new economic structure (including the *scala mobile*) by paying off social unrest and by continuing to purchase political support through its enterprises. To compensate, the state gradually increased tax revenues from 25.27% of GDP in 1979 to 41.67% in 1997, at which point it remained more or less stable. The problem was that the government still showed some deficit despite the effort of the taxpayers. There was broad political support among them as entry to the euro was desirable, but the persistence of the deficit was worrisome.

The severity of the debt problem becomes apparent on examination of the primary balance. The 1995 OECD economic survey observed (p. 33), "the pace at which the structural budget deficit (as estimated by OECD) has been reduced during the 1991–93 downswing has been faster than in other major OECD countries. On a cyclically-adjusted basis, the general government deficit shrank to 6.9 per cent of GDP in 1993, 1.6 point lower than in 1992 and 3.6 points lower than in 1989, the year of the last cyclical peak … For the second year in a row, the primary balance showed a surplus, which, in cyclically-adjusted terms, amounted to 4 per cent of GDP…" The government was making a real effort to rein in expenses while increasing revenues, but with insufficient impact because the interest payments on outstanding debt overwhelmed the primary surplus. The governments of the 1990s gave it their best shot, but this was not good enough.

The ever-changing executive was simply too weak politically to increase revenues and decrease expenses to an extent that would resolve the debt problem.

A comparison with Canada highlights this weakness. According to 2000 report for the OECD, "…adverse debt dynamics have been very prominent in most OECD countries during the 1990s, especially in countries that had high debt levels from the outset such as Italy, Canada and Belgium" (van den Noord, Paul 2000, p. 15). "Turn around and check out Canada, which has now become an honorary member of the Third World in the unmanageability of its debt problem," John Fund wrote in a January 12, 1995 article in the *Wall Street Journal*. Canada's debt, downgraded by Moody's in 1995, was restored to a triple A rating in 2002. This was achieved by spending cuts and increased taxes maintained over the years. Paul Martin, who had been finance minister at the time, said, "The actions have to be primarily on cutting expenditures, but the fact is that you cannot do it unless everybody is willing to come to the party, and if you eliminate tax increases… you're never going to make it" (Palmer and McCrank 2011). "Everybody willing to come to the party" means that there was support from the main opposition party in the majority government. The consensus on debt reduction was so strong that any politician contemplating deficit spending would have risked damaging his career. There was no such

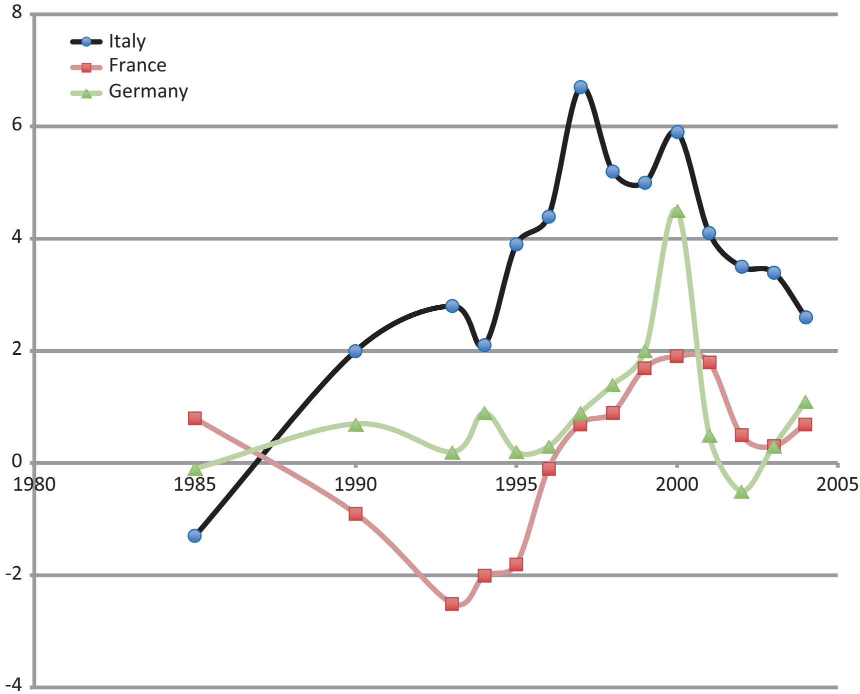

Fig. 11 Primary surplus of the three largest euro economies compared, 1985–2004

support or consensus in Italy, with a multiplicity of parties even within the governing coalitions, and a far more pervasive tradition of clientelism requiring expenditures.

A further consideration would have been the dampening effect of austerity, had the political will and power been present. Italy's GDP was heavily dependent on government spending, and the cuts of 1992 onward dropped GDP per capita from US$23,167 in 1992 to 18,677 in 1993. Part of this drop was contextual, as France also dropped from US$23,167 to 22,503, but the drop was far more severe and lasting in Italy (Figs. 11 and 12).

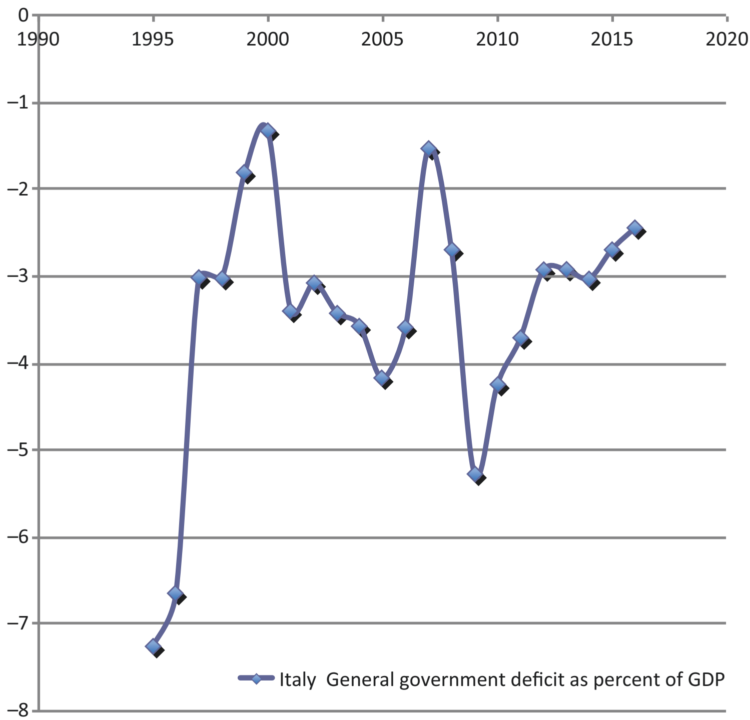

Fig. 12 General government deficit as percent of GDP

Italy in the Euro

The literature, academic and journalistic, has made much of Italy's supposed degeneration under the euro. Some argued this occurred because of the euro (e.g., De Cecco 2007) while others argued that it occurred in spite of it (e.g., Jones and Mackenzie 2014; Weissman 2011). In these views, Italy is stagnant, without real growth in GDP or GDP per capita, and this is because Italy is becoming less competitive and thus loses ground in world markets. Common to both perspectives is the notion that the euro deprives Italy of its secret competitiveness weapon: the devaluation of the lira. Italy can no longer mask dwindling productivity by indirectly reducing wages with devaluation. Thus, an IMF report states, "the difficult business environment, fragmented labour market, and limited service competition have contributed to Italy's weak growth performance and loss in competitiveness" and again, "Low productivity was the main factor behind Italy's poor growth performance" and "Italy has experienced a loss in competitiveness, which if left unaddressed, will remain a drag on growth" (IMF Country Report No. 12/167, pp. 1 and 13). And far more important than the dwindling productivity of labour (see Fig. 13), it is argued, are the institutional inefficiencies that render business uncompetitive. Perhaps the reader could add that these institutional inefficiencies impact the statistic for labour productivity. The following country report on Italy nuanced that of 2012: "In Italy, as in many countries, price-based competitiveness measures have not always served as an accurate guide to subsequent trade developments … Italy's future competitiveness will thus depend on the institutional and macroeconomic conditions that allow productive firms to innovate, expand, and attract inward FDI; which in turn will require the successful imple-

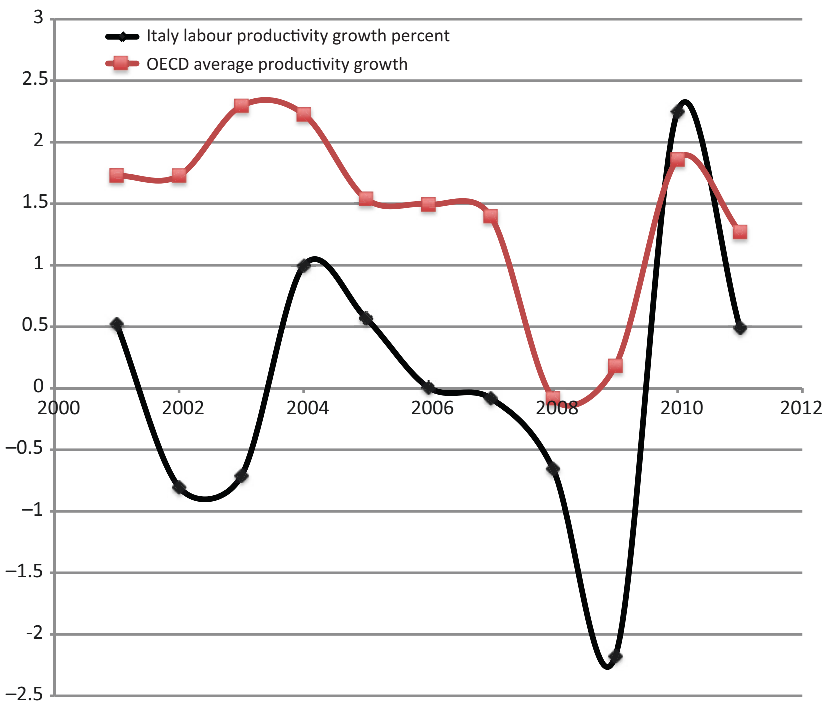

Fig. 13 Italy, productivity per person employed, 2001–2011

mentation of the authorities' full structural- and institutional-reform agenda." (IMF Country Report No. 13/299, p. 15) The argument was that higher labour costs are less important when products and services target upscale niches in the market.

Italy and the rest of the rich West have difficulty competing against emerging economies, from Bangladesh to Vietnam. Further, the world market share of these economies has increased while the share of the rich countries has necessarily decreased for many products. This is not necessarily a cause for concern for the rich countries, but rather a motive for congratulating the emerging economies. A comparison with other euro zone countries is more relevant, and the statistics used to compare are important. The *Economist* pointed out that Italy's unit labour costs rose "5% in Italy since 2002, against a 20% fall for Germany. But other measurements suggest that the true gap is much smaller than this. Measures based on producer price index data, for instance, suggest that Italian industry has not materially become less competitive than it was in 1999." (C.R. 2013)

Far more important are the years chosen for comparison, as Professor Jones (2009, p. 44) has pointed out. Germany and Italy had two very different experiences in the years preceding the introduction of the euro. German reunification in 1990 had a tremendous impact upon the German economy; tax increases and spending cuts in Italy had a more modest but still important impact on the Italian economy. Looking at the respective economic performances of these countries from the year 2000 includes the after-effects of these events without taking them into account. Examining the data beginning ten years earlier makes this apparent. Both the German and the Italian curves show a return to the old "normal" after the disturbances of the 1990s, with Italy maintaining part of the productivity gains from the 1990s (Fig. 14).

Similar arguments hold for GDP and GDP per capita. GDP soared from 2000 until the onset of the recession, in part because the austerity measures of the 1990s had been mitigated (see Fig. 15). GDP per capita also rebounds, though slightly, from the austerity measures (see Fig. 3). Letting the figures speak for themselves by standing back from the curves to include decades of economic history and denuded of any prejudice regarding what is happening, it is hard to discern any sudden degeneration of Italy's performance.

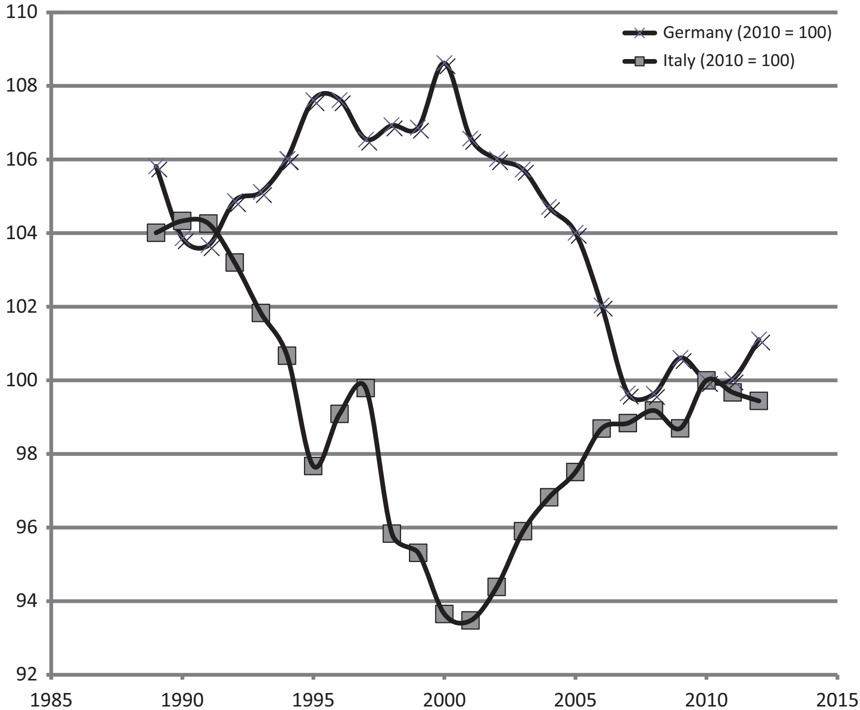

Fig. 14 Competitiveness of Germany and Italy compared. Lower means better productivity

Yet, all economists agree that Italy is in financial crisis in 2017. There are two reasons: government debt and the banks.

The European commission had stated that Italy was progressing in the reduction of debt in 1997, and certainly Italy had reduced the ratio of debt to GDP, and would maintain that containment for a few years. Still the debt continued to grow in absolute terms, perhaps even accelerating a little with the advent of the euro. There are many vicissitudes hidden behind that steady growth—some fiscal restraint and some relaxation, economic cycles and even dealing with the onset of the global financial crisis. However, the implacability of that growth in debt is evident (see Fig. 16).

The debt to GDP curve tells another story (see Fig. 17). Why is that? There are three relevant sections to the curve, each contributing part of

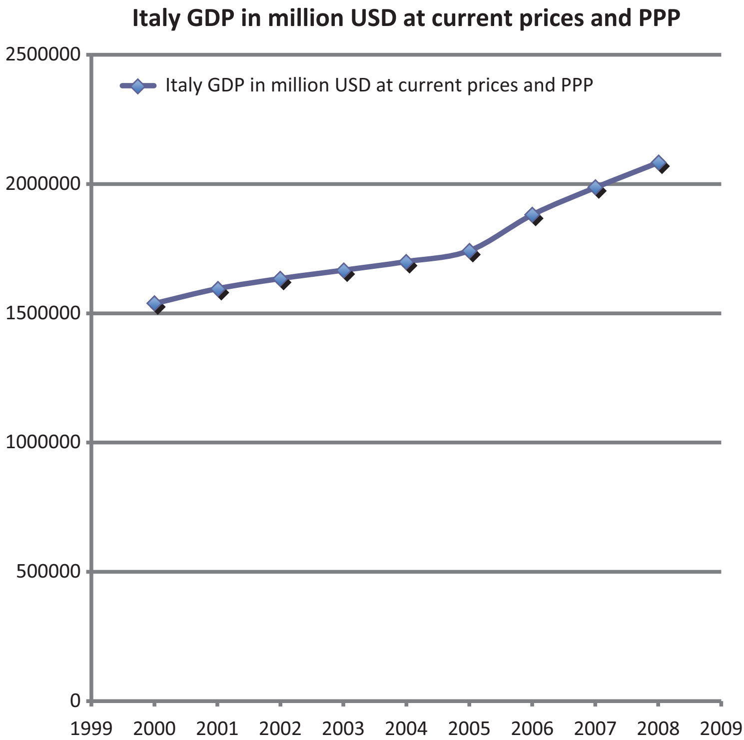

Fig. 15 Italy GDP in million US dollars at current prices and purchasing power parity (PPP)

the answer. From 1992 to the advent of the euro, the government of Italy and taxpayers had made a special effort to bring the debt and deficit under control, and did so with some success under conditions of austerity. From the advent of the euro until the financial crisis, this special effort dwindled, but the GDP of Italy grew quickly, with the end result that debt to GDP oscillated around 100%. Finally, with the onset of the global financial crisis, GDP shrunk and thus the growing debt produced the increasing debt to GDP shown in Fig. 17.

The slowdown in Italy caused by the global financial crisis of 2007–2010 was somewhat similar to that of other countries, as Fig. 18 shows, even though a smaller portion of its economic activity is provided by exports than is the case for other euro zone countries. However, two major differences between Italy and the other countries are apparent in Fig. 18. First,

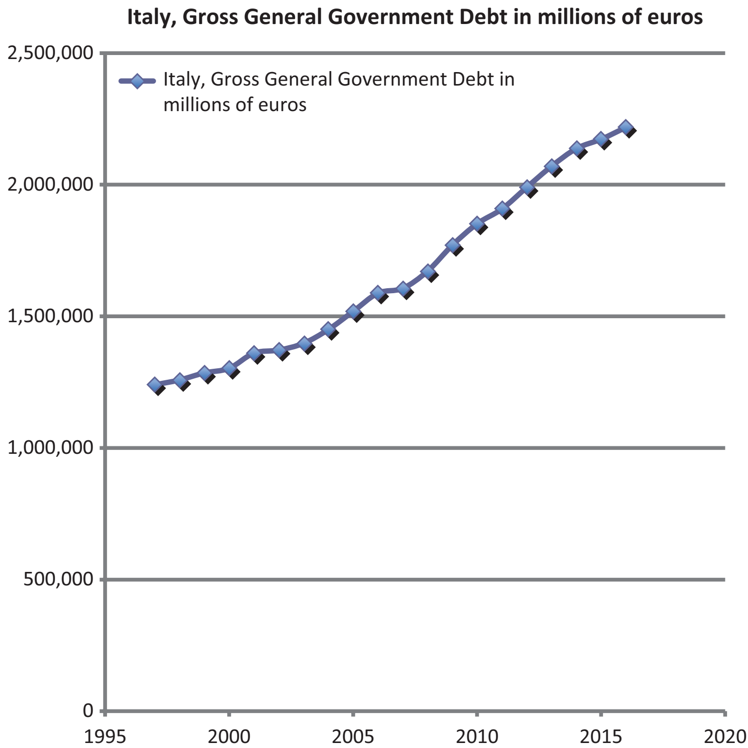

Fig. 16 Italy, general government debt in millions of euros

Italy had been growing more slowly than other countries for 20 years. Second, the dampening effect of the global financial crisis was longer lasting than in other countries.

A Dynamic of the Financial Crisis in Italy

Post-war Italy inherited a corporatist approach to economic governance from the earlier Facist regime. The captains of the many SOEs were by and large competent patriots after the Second World War, but this situation changed as economic advantage gave way to political convenience. Although the Democrazia Cristiana led every government until 1993,

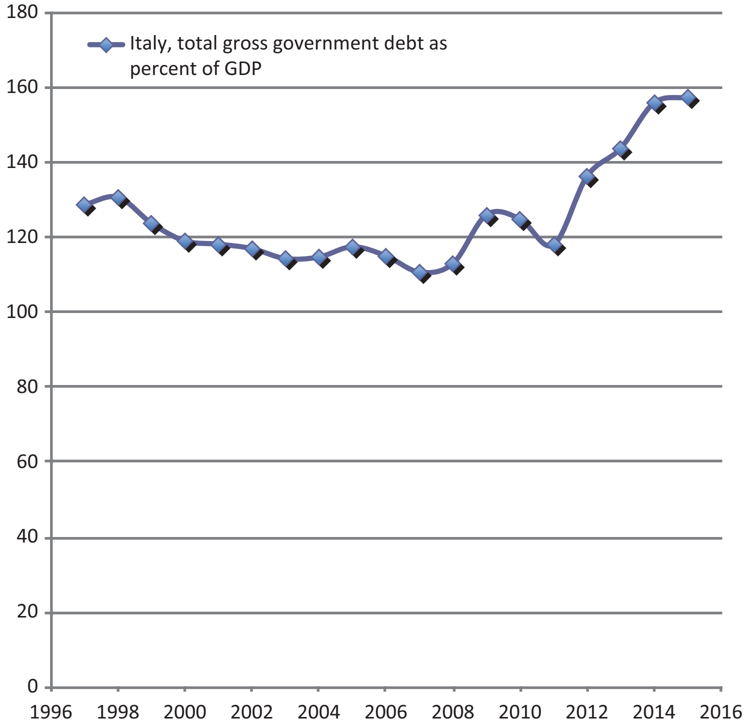

Fig. 17 Italy, total gross government debt as percent of GDP

they always did so in coalition with one or more different parties. Further, a multiplicity of factions operated behind the single-party banner. Compromise and political opportunism thus marked the governance of SOEs, the economy as a whole and fiscal policy. Because of this, SOEs handicapped an important portion of the economy. Concessions of social benefits in the late 1960s and 1970s began to build up government debt. Changes to the labour market such as *scala mobile* increased the cost of business and made business more complicated. Thus, businesses were weakened and non-performing loans became more frequent in banks' portfolios. Reforms in the 1990s improved the situation, but reduced debt to GDP insufficiently. Italy thus arrived at the global financial crisis saddled with debt equal to 100% of GDP and a basically sound banking

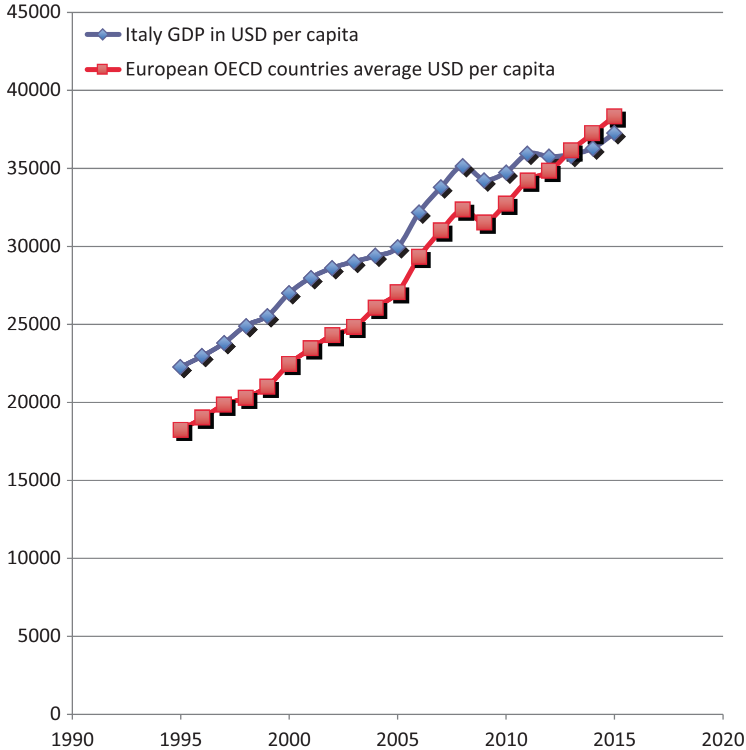

Fig. 18 GDP compared

system with one weak point: a moderately high ratio of non-performing loans. The global financial crisis did not affect Italy very much. The ensuing recession, however, led to an increase in non-performing loans to the extent that some banks began to have solvency problems. The government intervened to save the nation's financial system but soon required the support of the troika of the International Monetary Fund, the European Common Bank and the European Commission. The problem in Italy is past management of the economy combined with massive transfers to households begun half a century ago.

Understanding the dynamic of the financial crisis in Italy requires an awareness of the Achilles heel of Italy's banks prior to the crisis and an appreciation of the state of the Italian economy going into the crisis. This appreciation requires familiarity with three sets of businesses in Italy (see Table 1), as well as knowledge of the fiscal and regulatory behaviour of the Italian government in the latter half of the twentieth century (see Table 2).

The previous sections alluded to three sets of organizations important to the economy of Italy: SOEs, large family-owned enterprises and small to mid-sized businesses characterized by innovation.

Table 1 Key organizational sets in the evolution of the Italian economy

Organizational set	Characteristic	Result	Impact
State-owned enterprises	Growing political convenience	Strategic errors	Basic industries weakened
Large family enterprises	Centralized organizational structure	Poor performance in complexity	Diminished contribution to the economy
Small to mid-sized enterprises	Innovative, move to high end	Good export performance in small high-end niche	Small contribution to current balance

Table 2 Impact of government decisions on government debt

Period	Government policy or action	Implied effect	Debt
1960s–1990s	Social benefits	Increased government expenditure	Increases
Late 1960s–1990s	*Scala mobile*	Lower profits and thus lower corporate taxes	Increases
1990s	Increased tax rates	Improved government revenues	Decreases slightly
1990s	Liberalized labour market, suppression of the *scala mobile*	Increased GDP, profits and government revenues	Decreases, masked by large interest payments
1990s	Retrenchment of social benefits	Decreased government expenditure	Decreases slightly

While originally captained by competent patriots who sought to improve the economy of Italy, the SOEs soon succumbed to imperatives of the political convenience of government coalitions and factions within the dominant Democrazia Cristiana party. Not only did this lead to the underperformance of the SOEs and the neglect of promising growth opportunities, this also undermined the effective development of private enterprise in contiguous industries.

Large family enterprises tended to be led by exceptionally competent leaders at one stage, leaving a heritage of centrally controlled organizational structures that overwhelmed less gifted managers and responded poorly to the more complex environments these organizations entered as they evolved. As a result, many of these large organizations became less effective as time passed.

A large number of SMEs, in contrast, provided a success story. By building on a network of local suppliers and sub-contractors while focussing on high-end niches, they were able to develop a winning strategy within the global market. Unfortunately, neither marketing strategy nor financial resources permitted much upscaling, and the impact upon the economy remains limited.

These three organizational sets represent an important portion of the Italian economy and explain why this economy manifested a mediocre performance in the prelude to the financial crisis. The regulatory and fiscal action of the Italian government in the latter half of the twentieth century further crippled this performance.

The most relevant government action occurred in two periods: the 1960s and the 1990s.

During the 1960s the government overspent and increased business expenses; during the 1990s the government reduced expenditure, increased taxes and liberalized the market, thereby reducing businesses expenses. In response to the civil unrest of the 1960s, the government introduced generous social benefits in the form of improved health care, better pensions and unemployment insurance. This increased government expenditure and began a trend towards increasing general government debt. The Italian government also introduced the *scala mobile*, an indexation scheme that automated the increase of wages. The effect of this indexation was to increase business expenses, thus lowering profits and reducing government tax revenues. It also brought a positive feedback loop whereby inflation led to more inflation.

The government attempted to eliminate these ill effects in the 1990s. It increased tax rates and devoted resources to fight tax evasion. It reduced social benefits moderately. It privatized SOEs and liberalized the business environment, particularly the labour market. The measures hurt, as they brought higher taxes and increased unemployment, but the impact was nonetheless insufficient to reduce general government debt.

It can be added that the Italian government pursued its efforts while participating under the euro regime, posting several annual primary surpluses previous to the crisis. While beneficial for the debt, this may have contributed to the difficulties of Italian businesses.

In summary, then, the economy of Italy was muddling through at the onset of the crisis. A difficult situation had been seeded in the 1960s, then cultivated in the 1970s and 1980s. Attempts to redress the situation in the 1990s and in the twenty-first century had mixed results. In particular, fiscal restraint seems to have been too little to be effective, although there is little basis for comparison with similar scenarios in other countries.

The banks of Italy entered the crisis with a high non-performing loans (NPL) ratio. The reasons for this are not clear and no data previous to the mid-1990s were obtained. This will have to be left for future research. Perhaps the overall performance of the Italian economy in adverse circumstances could explain an acceptance of a higher NPL ratio. The fact remains in any case: banks were vulnerable to the downturn of the Italian economy as the international recession hit in 2009, and the Italian economy further faltered in 2011.

This leads us to the dynamic illustrated in Fig. 19. The dynamic is a simplification of a more complex phenomenon and permits a comprehension of the main lines of causality.

Even as fiscal policy stimulated the economy of Italy with generous social benefits, regulatory policy stifled businesses, many of which (including SOEs and many large family businesses) were tending to underperformance already. Expenditures led to a high debt to GDP ratio, while the weakness in the economy led to a higher NPL ratio for Italy's banks. When the international recession hit Italy, the NPL ratios rose

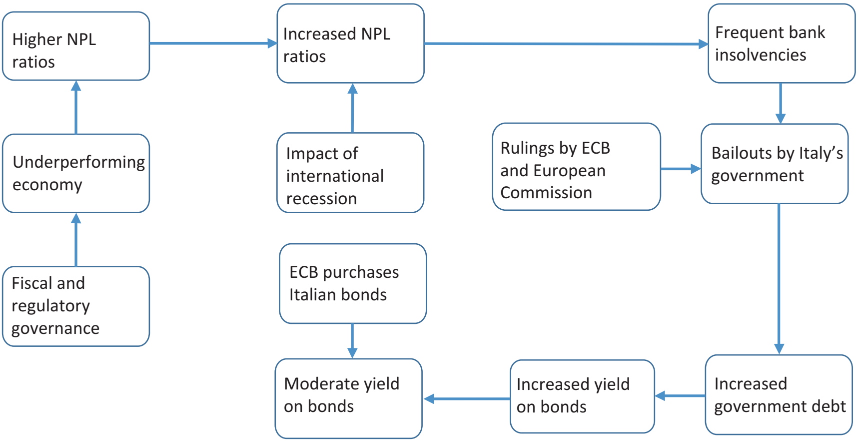

Fig. 19 Dynamic of the crisis in Italy

further, eroding the profitability of banks, as well as causing liquidity and insolvency problems among them. The government intervened to save the financial system by bailing out some banks. This increased general government debt and eventually led to high yield on government bonds, particularly given developments in Greece's debt and the treatment of that debt by the European authorities. The government of Italy then turned to seek financing from the "troika" of the European Commission, the European Common Bank and the International Monetary Fund.

Notes

1. The government had previously created two credit agencies: CREDIOP in 1919 to finance public works and ICIPU in 1924 to finance electric and telephonic infrastructure.
2. Available at http://www.isaonline.it/mag/RDL375-1936.html Accessed September 12, 2017.
3. The Maddison data set combines the best available estimates for economic data worldwide from the year 1 A.D.
4. There is a widely accepted hypothesis in economics that poorer economies' per capita incomes will tend to grow at faster rates than richer economies. This is called convergence or catch-up.

5. Much current and historical data for electricity in Italy are available at https://www.terna.it/it-it/sistemaelettrico/statisticheeprevisioni/datistatistici.aspx Accessed April 11, 2017.
6. The products of the chemical industry are broken down into commodities (low margin, low growth), specialty chemicals (chemicals that have a function in various industrial processes), polymers and life sciences (chemicals that relate to human and animal health, usually regulated but high margin and high growth).
7. Mediobanca was founded by three banking subsidiaries of IRI in 1946 (Mediobanca n.d.).
8. This wage indexation was modified in 1983 as part of the "Protocolli Scotti," replacing the actual inflation rate with government-planned inflation, making wage increases a part of government planning. The Protocollo del 23 luglio 1993 established a new procedure and structure for collective bargaining and superseded the automatic indexation mechanism.
9. The archive of Mediobanca surveys is available at http://www.archiviostoricomediobanca.it/pubblicazioni/le_principali_societa_italiane.html. Accessed May 25, 2017.
10. Note: Complete references to unsigned IMF and OECD documents are given in the text and are not repeated here.

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Conclusion: The Crisis and Lessons for the Administration of the Euro

Six sections constitute this short concluding chapter. The first section situates the book with respect to explications of and approaches to the euro crisis found in the media and in academic works. It reasserts the mission of the book: founding the explanation of the euro crisis upon an understanding of the crises in individual countries. The second section provides an overview of the book, summarizing each chapter. The third section examines similarities and differences in the crisis experience of the various countries. Following this, lessons are drawn from the different crisis experiences. Next comes a lesson to be drawn from the overall euro crisis, drawing predominantly from the crisis of Greece. The chapter then ends with a few brief afterthoughts.

Understanding the Euro Crisis

Researchers and the media have offered various explanations for the crisis of the euro.

Some have argued that a fault in the original design prevents the euro from prospering and renders it vulnerable to the vicissitudes of economic life. One classic argument is that some regions of the euro zone experience

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external shocks more severely than do others, so that the euro zone is not an ideal candidate for a monetary union in the first place. Another argument, less academic but more popular, is that the cultures on the periphery are less industrious than that of Germany, so that it is not possible to unite the economies of these countries with a single currency. In either case, the euro project is doomed to failure.

Others have argued that the administrative apparatus and procedures behind the euro are insufficient and need reform to ensure the success of the project. The crisis of the euro has revealed flaws, and experimentation with remedies is slowly bringing about the changes that are necessary. In particular, greater financial integration is necessary to support the monetary union.

The treatment of national economies by the European authorities is important because financial markets react to this treatment as well as to the evolution of the economies, as illustrated in Fig. 1. To simplify understanding, the continuous mutual adjustment is broken down into three

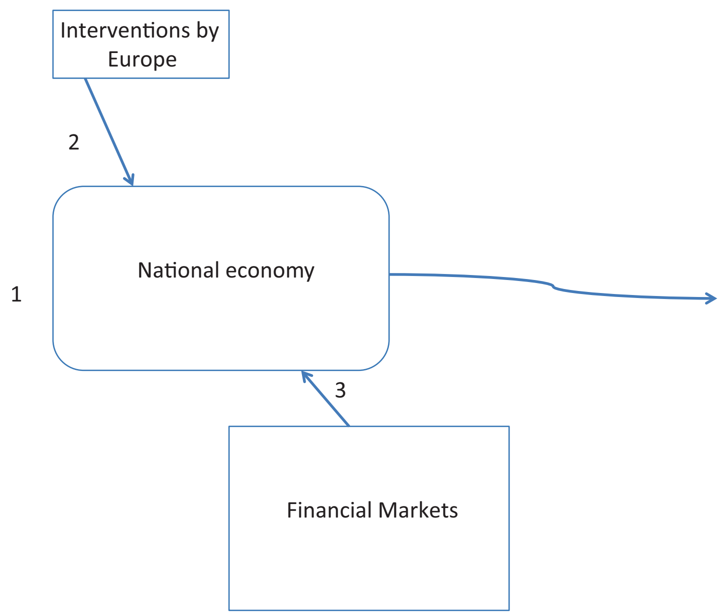

Fig. 1 The reaction of financial markets to European intervention

discrete stages in this figure. In the first stage, the national economy evolves, perhaps incurring a high deficit. In the second stage, the European authorities intervene according to foreseen procedures. In the third stage, the financial markets react to the new conditions. Given the European intervention and the reaction of the financial markets, the national economy evolves in the new conditions.

This book accepts the opinion that greater financial integration is necessary to support the monetary union, but argues that an understanding of the individual crises in the various participating countries is a prerequisite to understanding and dealing with the overall euro crisis. The alternative is to paint all the national crises with the same brush of sovereign debt, or to ascribe the crisis in the euro to defects in the original concept or its implementation. As for dealing with the crisis, financial integration will cause funds to be channelled to troubled economies and, typically, these funds have been tied to conditions. These conditions need to target the specific weaknesses in the targeted economies so that the funds are not simply thrown into a black hole. This is necessary for any financial integration to be effective. It is also a prerequisite for financial integration to be fair and politically palatable.

Consequently, this book has attempted to convey an understanding of the financial crises in four of the nations participating in the euro: Greece, Ireland, Spain and Italy. In each case, a brief overview of the history of each national economy offered an appreciation of the economy as it unfolded previous to the onset of any crisis. In each case, a chronology of the crisis revealed specific actors and forces at play. A dynamic of the crisis specific to the nation closed each chapter. These dynamics captured the gist of admittedly more complex phenomena.

Overview of This Book

This book began with the geographical and historical motivations for the Euro project, as well as an overview of the treaties and agreements that prepared the way for its implementation. The introduction then noted that participation in the euro requires a concession of some control over monetary and even, under the Stability and Growth Pact, fiscal policy.

Then it observed the popular reaction to crises in various participating countries in the form of civil unrest and political upheaval. Just what was being protested? The people in the streets and the voters were protesting their experience of a local crisis—specifically, the diminution of their wealth and living conditions. The notion of euro crisis should be understood in relation to the real troubles among populations, and two related meanings of the expression "euro crisis" were derived from it. The first meaning refers to variations in the value of this currency unit caused by the crises in the various countries. The second meaning is the administrative challenge posed by these crises.

The subsequent chapters examined the crises in each of four countries participating in the euro: Greece, Ireland, Spain and Italy. These countries were chosen because their economies and troubles were sufficiently important to menace the edifice of the euro project.

The second chapter studied the crisis in Greece and began by listing symptoms that indicated Greece entered into crisis in 2009. A pre-history of the crisis was then provided. There were two parts to this pre-history. The first covered an incubation of Greek society and the modern state that fomented a clientelistic relation between government and electorate. The second part covered government policies and actions, as well as the performance of the economy in the second half of the twentieth century. There was a Golden Age of growth spanning from a few years after the Second World War until the double shock of the end of Bretton Woods and the rise of the OPEC cartel. Performance was mixed at best after that, particularly after the reintroduction of democracy in 1974. Greece gradually lowered its trade barriers vis-à-vis the rest of Europe, but neglected to prepare its businesses for competition. Specifically, private businesses were credit-starved until after the introduction of free trade, and so could not renew their competitive capacity until the mid- to late 1990s. The massive capital formation of Greece in the 1970s and early 1980s was diverted to state enterprise, where it was used to create unproductive jobs and for other clientelistic purposes. At the same time as it throttled the wealth-producing capacity of the economy, the Greek government, no doubt motivated by clientelism, borrowed from its banks to finance ever-growing transfers to households. Had the motor of the economy been powerful enough to support this "Europeanization," this would have been a reasonable consumption of wealth. This was not the case, however, and the government was killing the goose that should have been allowed to lay the golden eggs. At the onset of the euro, Greece enjoyed a reduction in the interest rate on its government bonds. This led to massive borrowing on the international market, with two effects. The first effect was to finance ever-increasing transfers to households and, indirectly, household consumption. The second and lesser effect was to create a hospitable environment for businesses that finally enjoyed both greater access to credit and greater demand. Unfortunately, they were still far from competing on an equal basis against firms from other European nations, and imports surged far more strongly than exports. Analysis of the macroeconomic algebra of the situation in Greece indicated that there was a double gap to address: a savings gap to finance investment, and a tax gap to cover government spending. This had arisen in particular because of government policies from 1974 to 1991.

The chapter "Ireland: From Prosperity to Crisis" dealt with the crisis in Ireland. After noting the enviable reputation of Ireland's economy just previous to the crisis, it listed a series of statistics indicating Ireland had entered into crisis in late 2009 or early 2010. A short history of Ireland and her economy then followed. Three important factors emerge from the pre-history: poverty and underdevelopment (instigating emigration on a massive scale), patriotism due to a sentiment that Ireland was still being established as an independent nation, and the legacy of the British civil service. As a result, Ireland's economic history after the Second World War was characterized by effective policies far more than by political convenience. However, because of underdevelopment, Ireland had a predominantly pastoral economy (agriculture based on raising livestock rather than growing crops) and benefitted far less than other European nations from a Golden Age in the decades between the Second World War and the fall of Bretton Woods. Ireland's economy grew slightly over that period but grew at an even faster pace after it, as policies seeded in the 1960s began to germinate. Politicking dominated somewhat in the 1970s and early 1980s, with government expanding to the detriment of economic performance. This was turned around from 1987, and the edifice of the Celtic Tiger was founded upon the groundwork of lower corporate tax rates, wage moderation, rationalization and privatization of state monopolies, and participation in the European Union. Much of that groundwork had been laid down earlier. Net emigration turned into net immigration, so that even population dynamics contributed to the upsurge in Ireland's production of wealth. Both GNI and GDP skyrocketed, and Ireland gained the moniker of Celtic Tiger. Greater wealth led to greater disposable income, while smaller households and increased population made for a larger number of households. Both contributed to a strong demand for quality housing. Reduced interest rates brought about by both the performance of the economy and the abundance of capital worldwide strengthened the housing boom, while loaning practices transformed the boom into a bubble. When the bubble burst, the banks found themselves burdened with extensive defaults on developer loans, and the threat of problems with mortgages. The state moved in to guarantee and then to bail out the banks, but the scale of bank overextension into real estate development was such that Ireland in turn had to be bailed out by Europe. (Some controversy remains over the responsibility of the European Central Bank in requiring Ireland to request this bailout.)

The chapter "Spain, the Euro and a Crisis" was about the crisis in Spain. Previous to the crisis, Spain enjoyed an enviable fiscal position and a decreasing unemployment rate. An examination of economic and financial statistics indicates Spain entered into crisis in 2010. The economic and political history of Spain indicates strong ideological differences that nonetheless have not impeded the functioning of effective government, and also the delayed economic growth of Spain due to its isolation over three-quarters of the twentieth century. The end of Bretton Woods and the rise of OPEC combined with the death of Franco to provide a demanding initiation of the new democracy into economic policy and planning. This eventually led to strong economic growth, although with persistent recurring problems of unemployment. Growth in disposable income led to growing demand for housing; the desirability of Spain as a retirement destination may have also contributed to this demand. A section of the chapter demonstrated that money laundering also contributed to the boom, particularly on the price side. Examination of the pricing and supply dynamics, particularly in Madrid, suggests that this boom transformed into a bubble as interest rates dropped as the introduction of the euro approached. Closer examination of the supply side, however, revealed that unprofessional and possibly corrupt management of the *cajas de ahorro* led to over-extensive lending to real estate developers. This problem was compounded by corruption in municipal and autonomous (regional) administrations. The end result of this was massive defaults on loans for development, restructuring and bailouts of the *cajas*, and the eventual recourse to Europe under the guise of Spanish bond purchase by the European Central Bank and loans under the European Stability Mechanism. These were loans to finance the bailout of the *cajas* (at this point consolidated and transformed into banks), and should not be perceived as a bailout of Spain's government or of the Spanish economy.

The chapter "How Italy Experienced the Euro Crisis" described the financial crisis in Italy. The statistics suggest that Italy began to enter into crisis late in 2010, peaking in 2012. The short history of Italy and its economy reveals that it is a nation of disparate regions, with a particularly notable division between northern and southern Italy. The geographic and ideological dividedness of Italy is most noticeable in politics: although the Partito Democrazia Cristiana formed virtually every post-war government, it always did so in coalition with other parties and was itself characterized by marked internal factionalism. Although Italy did indeed enjoy a Golden Age from 1953–1971 and the achievement of *la dolce vita* by many, the second half of the twentieth century was marked by (1) the importance of SOEs which gradually became tools of political convenience rather than of economic development and (2) important economic concessions by government to end civil strife, that had the effect of restructuring the economy, particularly through an automatic wage-scaling mechanism. New policies and actions in the mid to late 1990s redressed this situation, but the impact had already been felt in diminished economic performance and the prevalence of non-performing loans that Italian banks had to tolerate. The global financial crisis had little impact upon Italy because of the prudential regulation of its banks. However, the subsequent economic recession did have an impact, and the incidence of non-performing loans soared, leading to liquidity and solvency problems and eventually to a need for bailouts. The scale of the bailouts eventually led Italy to seek financial aid from the European

Central Bank in the form of bond purchases, and from the European Commission. Italy had entered into crisis because of an economy weakened by economic policies in the mid to late twentieth century.

Similarities and Differences in the Crisis Experience

There is an obvious similarity between the cases of Greece and Italy because both are the result of government's mismanagement of the economy. In both cases, SOEs were managed for political convenience. In both cases, social benefits over-burdened a financial capacity of the economy. In both cases, government debt was greater than GDP. There are important differences, however. The first difference is political. A multiplicity of factions hid beneath the dominance of the Democrazia Cristiana in Italy, whereas the political arena of Greece saw the confrontation of two parties and, behind them, a handful of influential families. The confrontation was thus far more intense in Greece and recourse to all political leverage was the rule. This led to the second difference, one of degree: the degree of subordination of SOEs to political convenience, the degree of general mismanagement of the economy and ultimately the ratio of debt to GDP. The political difference also explains the third difference: the quality and independence of the administrative apparatus, of which the unreliability of statistics is a symptom. The fourth difference is the difference of timing. The massive transfers to households occurred in Italy in the late 1960s. It occurred in the 1990s and 2000s in Greece, by which time Italy was attempting to redress her structural problems. This is not only a different date but a difference of context as well. Italy counted on moderately priced financing in the 1960s whereas Greece met with a dramatic drop in interest rates in the 1990s. All of these differences result in Greece being a much more difficult case than that of Italy. As of 2017, Italy seems to be showing some signs of recovery, whereas Greece continues to be mired in crisis. This suggests that rather than imposing austerity, the European Commission should target the underlying problem by setting objectives for capital formation for Greece, requiring that the greater portion be invested by private businesses. Europe's principle of subsidiarity may prevent her from specifying how this objective is to be attained, but it does not prevent her from requiring sufficient information to verify that it is indeed attained.

Another obvious comparison is that between Ireland and Spain. Both countries were in good economic health before the crisis. Both crises stemmed from a real estate boom and bubble. In both cases, the key problem was over-commitment to development projects by financial institutions that subsequently became insolvent. In both cases, a small number of persons were able to bring a whole country to the point of catastrophe. There are also major differences. The crisis was far more severe in Ireland than in Spain. The financial crisis itself was a major burden of €10,000 per capita for Irish taxpayers. While the Spanish bailout was sufficient to desire the European authorities' aid in recapitalizing the banks, the true unease came from a double whammy of recession: in part caused by the contagion of the international recession following the global financial crisis and in part caused by the near destruction of an oversized real estate industry. The most interesting difference is in the small group of persons bringing on the financial crisis. Bankers and developers were involved in both countries. Bankers behaved unprofessionally in both countries. Professional preparation arguably played a part in both, as the CEO of Anglo Irish had studied accountancy and many of the top managers of the *cajas de ahorro* were ex-politicians. It was the political interests of the latter that led to their unprofessionalism. In the Irish banks, the failure was one of organizational design. Risk management simply had no impact upon how decisions were made. In Spain, the unprofessionalism was at times found to be criminal. There were only a handful of such cases in Ireland, yet the degree of harm was much greater.

Another important difference is the context of the unprofessionalism of financial institution management in both countries. The *cajas de ahorro* had a social mandate and this makes it more difficult to determine whether a given decision obeys the mission of the organization or diverts from it. The banks in Ireland had an economic mission, and each decision could be evaluated as contributing more or less to the achievement of economic goals. The riskiness of any action could be estimated and indeed the expectation was that banks were to be governed with an eye to risk management. Not to do so was at least a professional fault. The fuzziness of the mission of the *cajas de ahorro* created an opportunity for political convenience and also personal interest to easily take precedence over the true mission of these institutions. That the transgressions were found to be criminal in such a vague context is a measure of the degree to which the fiduciary responsibility was betrayed. Perhaps it is better not to name politicians to posts with a social mandate not clearly enough specified to permit performance evaluation.

Money laundering had an impact on the real estate boom and bubble in Spain. Spain has since improved in detecting and prosecuting money laundering, at least in the opinion of the Paris-based Financial Action Task Force. This body produced its 2014 mutual evaluation report on Spain noting the increasing strength of Spain's anti-money laundering system, laws, regulations and sound institutions, although the current terms of imprisonment were judged too lenient. Other countries would do well to consider the role of money laundering in their economy. Martini (2017) draws attention to problems in Australia, Canada, the United Kingdom and the United States.

Table 1 compares the behaviours of the political and administrative apparatus across three countries: Greece, Ireland and Italy. The contents of individual cells are necessarily caricatures and must be understood relative to the contents of the cells corresponding to the other two countries. Thus, Irish voters would not consider their politicians to be merely political animals, although at times political convenience has given way to the national interest; certainly, the civil service of Ireland had more

Table 1 Comparing the political and administrative apparatus in three countries

Country	Corporatist/liberal	Patriot/political convenience	Long-term impact on businesses pre-2000	Debt pre-2000
Greece	Corporatist (but shadow economy)	Convenience	Weakened but shadow economy	High
Ireland	Liberal	Patriot	Strengthened	Low
Italy	Evolving corporatist to liberal	Convenience	Weakened	High

independence than that of Greece in the twentieth century. Ireland was characterized by the professional patriotism of the civil service, whereas the Greek civil service was politicized so much as to prioritize the venal interests of its political masters. When Ireland's Kenneth Whitaker pushed for capital spending in the 1950s, he did not worry that it would be squandered on political convenience in SOEs. When finance minister James Ryan told Whitaker, "You look after the administration. I'll look after the politics," he was recognizing that political activity should ultimately serve the good of the nation. Allan Dukes suffered politically for his so-called Tallaght Strategy, but made the deliberate decision of prioritizing the good of the nation over political advantage.

Liberalism argues that free individuals exercising enlightened self-interest constitute a mechanism that is beneficial for the whole of society. It militates for measures that promote such freedom in the economy and in politics. Yet individuals can freely organize into groups and factions—business firms and cartels or political parties and factions. The power of such groups can overwhelm the freedom of individuals. As a consequence, any measures promoting freedom are necessarily relative. Further, liberty is not only the absence of external constraints. It is also a consequence of internal power. The greater one's wealth, the greater one's economic freedom. A wealthy person has more freedom than a poor person because he or she can do more under the same external constraints. Table 1 shows that extreme liberalism in politics led to decreased economic freedom in Greece and Italy over two stages: first by the application of external constraints (throughout the twentieth century in Greece, 1960s to early 1990s in Italy) and second by the diminished economic power of businesses.

Ireland, Italy and Spain have all had to bail out banks, but with an evident difference in degree. Ireland has spent €43 billion net in saving its banks, or almost 15% of GDP. Spain has spent €38 billion net, or about 2.6% of GDP. Italy is still in the process of bailing out its banks, and no total figures are easily obtainable.

Germany also felt the heat of the global financial crisis. German banks had participated directly in that crisis by buying into mortgage-based assets and other financial instruments related to the real estate bubble in the United States. The *Landesbanken* (similar to the Spanish *cajas de ahorro* in being regional and having political appointees in charge) were the first to feel the impact, although the private Deutsche Bank, after proudly refusing bailouts, entered into crisis in 2016. The international recession that followed the global financial crisis hit Germany particularly hard as her foreign customers could not obtain credit to make purchases. GDP dropped 10% in 2009 and stayed equally depressed in 2010. The German government reacted vigorously, launching "an extensive package of stimulus and bailout measures, which included €480 billion for ailing banks, €115 billion for financially weakened companies and €80 billion for two programs to stimulate the domestic economy" (Spiegel 2010). A 2010 Deutsche Bank research report (Schildbach 2010) estimated the net fiscal cost of bank rescues as being inferior to 1% of GDP, about €30 billion. Compared to Italy, the German government had a margin for manoeuvre to overcome the recession with stimulus. Compared to Spain and Ireland, the banking problems were investment in risky overseas assets rather than the nation's real estate industry. The *Landesbanken* accounted for a third (Dominion Bond Rating Service 2006) of Germany's total banking assets of €7188 billion (Statista n.d.) in 2006 at around 2.3 trillion euros (a little over two-thirds of Germany's GDP at that time). The *cajas de ahorro* had €871 billion in assets in 2006, equivalent to over 80% of Spain's GDP at that time, of which 50% were in real estate. Although the *cajas* were only slightly larger in Spain's economy than the *Landesbanken* in Germany's, their commitment to risky assets was even greater than that of the *Landesbanken* and their insolvency problem more severe. Germany was able to deal with the crisis without recourse to European authorities. The contrast with Ireland is stark: with only 5% of the population and 10% of the GDP, Ireland paid out 50% more than Germany to rescue her banks.

Lessons from the Crises in Europe

Ireland's experience offers a lesson for the entire Eurogroup and for finance ministers and central banks worldwide. The heart of the problem was that banker enthusiasm for opportunities in real estate overwhelmed basic risk management in banks. This should not happen. Regulations, even if imperfect, are needed to limit this sort of behaviour, and sanctions should fall on both institutions and their managers. If bank failure impacts the viability of a nation's economy, then clearly any bank has a fiduciary responsibility to the nation, and so does its management. As of 2014, the European Central Bank has a supervisory role for the financial stability of banks, with obligatory participation for euro zone countries, via the Single Supervisory Mechanism. The creation of this mechanism represents a step towards greater financial integration and a sign that the European authorities have learned from the cruel lessons of the crises in various countries. Currently, the European Central Bank seeks to guide financial institutions in implementing international best practices in risk management. It does not sanction non-compliance, or require participating countries to sanction non-compliance. Perhaps one of the conditions of funding for Ireland could have been the requirement of such a sanction, providing a precedent and model for other countries. European documents on risk management to date underline the importance of issues that plagued the Anglo Irish Bank, whose unsafe practices spread to other Irish banks: the culture of risk (concentration of assets in real estate) and dominance of debate by one or few voices (the overbearing behaviour of the chief executive and a few others). Merely pointing out these pitfalls seems inadequate; at least it seems unlikely that a dominating individual would be cowed by such considerations. The liability of officers and top managers should be limited, but not eliminated.

The problems of Spain also provide lessons for Europe and beyond. First, money laundering has a real impact upon an economy, and the control of money laundering is beneficial for the purchasing power of the country's residents. Second, appointing political protégés rather than professional bankers to lead and guide financial institutions with a social mandate is an unwise practice. Professional bias (using opportunity to build and consolidate power), professional interest (favouring one's own party and its supporters) and personal interest may overwhelm a vague social mandate. It should be noted that promoting local housing and local real estate businesses both fall within the social mandate of local development typical of the *cajas*. As with Ireland, the problem was too high a concentration of assets in real estate; unlike Ireland, the cause was often political convenience and at times corruption. The German Landesbanken, also possessed of a social mandate and managed by politicians or their protégés, did not over-concentrate on real estate but on relatively sophisticated financial instruments that turned out to be toxic. In retrospect, the problem was the limited relevant professional formation of the Landesbanken management, although one could wonder whether even professional bankers foresaw the toxicity of those instruments. Spain has already addressed both lessons to be drawn from its crisis, pursuing corrupt politicians in court and improving its surveillance of money laundering. Only two *cajas* remain, although there is still a legal basis for the erection of new *cajas de ahorro*.

Italy's crisis provides a more difficult lesson. This crisis has been less acute, but its causes lie deeper and the challenge to the euro more severe. While both Spain and Ireland were well within the constraints of the 1997 Stability and Growth Pact before their crises, Italy already had a heavy debt burden that primary surpluses seemed unable to eliminate. Spain and Ireland encountered unfortunate accidents, whereas the trouble confronted by Italy derived from the poor health of its economy, in turn the fruit of past government policies. It would appear that here is the sort of problem foreseen by those claiming an original design fault: the shock of the recession that followed the global financial crisis provoked a different effect in Italy than in other regions of the euro zone. The real question, however, is not whether the euro zone fits the preconceived notion of optimal design,[1] but whether the European authorities have the capacity to successfully deal with the issue presented by Italy's crisis. They do in theory, because the various addenda and adjustments of the Stability and Growth Pact give them the power to require and sanction fiscal adjustments.[2] In practice, what precisely are the fiscal adjustments required to turn around the economy of Italy? Both Europe and the IMF are providing expertise as well as imposing requirements. There is a danger, however, that the complex bureaucracy of Europe contradicts the latest expertise. An example is the growing awareness of the limits of austerity in the circles of expertise, while the whole thrust of the Stability and Growth Pact is to avoid excessive public deficit or debt. As long as the economies of the participating countries are different, a single economic policy for all will not work. While there is flexibility built into the rules and procedures of the Pact, the European Commission seems to have difficulty in requiring changes of Italy without simultaneously slowing its economy. Thus, the Commission may or may not require austerity as a condition for emergency funding; in either case, the Stability and Growth Pact has in practice brought the same excessive debt and deficit rules to bear on all with little discernment, so that a country faced with an emergency requiring growth as part of the remedy still undergoes some form of austerity.

This would seem to be a fine opportunity to improve the administrative apparatus and financial integration of the euro zone, but requires further revision of the Stability and Growth Pact in the light of the lessons from Italy's crisis. The danger is that such a revision will take on the form of additional rules, adding to the already daunting complexity of the bureaucracy of convergence. It would be far preferable to find the flexibility already present in the rules, and discover why this flexibility has not been exploited.

A Lesson from the Euro Crisis

Greece also poses a challenge to the euro project. Its malaise stems from decades of government throttling business and garnering popular support through the transfer of borrowed monies to households. Remedying this is a challenge. It is also an opportunity for Europe to rethink its administrative apparatus.

It would be a mistake to observe that the government has been spending too much and then conclude that therefore it simply must cut spending. Government spending is a massive part of GDP in Greece and probably an even more massive part of the demand for the produce and services of Greek businesses. Cutting spending outright is a good way to weaken Greek businesses. While there should be no desire to keep Greek businesses dependent on government spending, businesses need present success to prepare for the future. Comparison with the success of austerity in Ireland is misleading because the businesses of Ireland were strong before the crisis. This is not the case of Greek businesses.

Being a net importer implies that either savings are insufficient for investment or taxes are insufficient for government expenditure, or both.[3] It also would be a mistake to try to adjust one or two components of this perverse GDP algebra. Other components would be affected automatically. Increased taxation would reduce saving, for example. GDP algebra is based on the sum of a series of components being equal to GDP. The secret is not to change components at a given level of GDP, but to change the GDP.

It might appear possible to adjust one side of the equation without changing GDP by instead injecting massive amounts of money into the system. However, this also would be a mistake. Directly and immediately addressing the two gaps of saving and taxes by injecting outside funds into the economy to eliminate the gaps might resolve the symptoms if properly administered. It would not cure the causes. If the money took the form of loans, this would simply increase the external debt while providing only temporary relief. And even if the money were a gift (very unlikely, given the quantities involved), the dynamics that led to the perverse algebra would still be unaddressed and the situation simply would arise again at some point in the future.

The economy of Greece must become powerful enough to permit taxation equal to (and temporarily greater than) spending. It must become powerful enough to fund investments with savings. Mitsopoulous and Pelagidis (2011) have argued that liberalization is the path: Greece must reduce the regulation of product and service markets, and decrease the administrative burden of business, as well as truly pursue the goals of monetary union (page 193). The European Commission has begun to require this. This should aid Greece to build a more prosperous economy. The European authorities (the European Central Bank, the European Commission and the Eurogroup) can further help by setting objectives for capital formation for Greece, requiring that the greater portion be invested by private businesses rather than SOE or government capital expenditure. This would seem to contradict the effort to reduce the savings gap—greater investment means even more savings would be required to close the gap, and more of the GDP directed to investment leaves less for taxation. However, business must be ready to exploit the opportunities afforded by greater liberalization of markets if the economy of Greece is to become a powerhouse of wealth production. This is a point in which Ireland does provide the relevant example of tax relief for exports.

Again, it would seem that one half of the double gap mentioned earlier could begin to be addressed: the tax gap to cover government spending. Greece's extremely progressive tax rate has the perverse effect of grouping 50% of wage earners near the minimum wage rate (and leaving them there to pay little or no tax) and another 8% at the highest wages (in contrast with 2% or less at the various intermediate levels—see Mitsopoulos and Pelagidis 2011, Figure 5.41). Revamping this might tax low-income earners, but it would improve the Gini index of the economy (by facilitating an increase in the number of mid-range wage earners). At the same time, it would help balance the government budget. It could also lead to a migration from those forms of self-employment that are less efficient to those jobs in larger businesses that are more productive and higher paid. Further, tax incentives could induce a higher savings rate, and begin to address the savings gap, but this can only work among those who pay taxes.

Whatever is done will be painful, because the harm was already done in the past. All that can be done in the present is to choose the pain that does least damage to the capacity of the nation to produce wealth. This choice belongs to the Greek government and to the Greek people. The choice for Europe is to use this opportunity to improve its own administrative apparatus, increasing financial integration while respecting its principle of subsidiarity. It can do so by setting more incisive objectives relevant to the specific problems of Greece, without allowing the generic rules of the Stability and Growth Pact to become an obstacle on the path to achieving those objectives. Again, it is important to do this by reducing the burden of bureaucratic regulation, not augmenting that burden.

Professor Stiglitz (2016, chapter 9) proposes two improvements to the manner in which the euro zone deals with crises: (1) cure with growth rather than with austerity and (2) restructure debt when this is necessary (as he argues is the case for Greece). Both would seem to apply to the plight of Greece, and the former probably is relevant to the case of Italy.

There are two problems in implementing these improvements, however, and they constitute opportunities for furthering financial integration.

The first problem is the Stability and Growth Pact and its many amendments. Their effect remains an automatic inducement of an austerity response to past overspending. Such a response has the appeal of apparent justice. It has the further appeal of appearing to correct a previous error and lead the errant sheep back to the fold of compliance with convergence criteria. Unfortunately, as Greece demonstrated in the last quarter of the twentieth century, it is possible to overspend and still stifle business. Simply requiring a balanced budget (and in fact imposing a primary surplus) does not remedy this. Balanced budgets are not the path to a balanced budget. The euro zone must be able to stipulate other objectives that are more specific than merely balancing the budget, such as targeting a level of capital formation by private business, savings of households across social classes, and so on.

The second problem is trust. Can Europe trust the governments of participating nations not to squander whatever financial aid is provided? This may well be the true source of the knee-jerk austerity response in the case of Greece, for example. Past governments of Greece used money to reinforce support among citizens rather than prepare the economy to compete in the European market. How can the European Commission prevent this from happening with new funds? Austerity may not help the economy, but it has been effective in putting governments out of power in Greece and it appears to reduce debt—although at a pace, in the case of Greece, that prolongs the agony indefinitely. The real solution is the same as for the previous problem: require the attainment of fiscal and financial objectives that are more precise and specific than balancing the budget. If these objectives are sanctioned with procedures for non-attainment, Europe could permit itself to be more generous in restructuring debt. Further, the current practice imposes the means rather than the end, and thus does not respect Europe's principle of subsidiarity.

Afterthoughts

One observation about these crises remains: that they were avoidable. Greece's political class could have prioritized the wealth of the nation. The large Irish banks could have resisted the temptation to imitate Anglo

Irish, or at least have allowed risk management to rein in and override that temptation. The management of the *cajas de ahorro* could have been more professionally accountable rather than politically accountable. The governments of Italy could have attempted to turn around the economy much earlier and to greater effect. In part, this is expecting too much of humans given the current state of our nature. The dark side of promoting selfish or factional ends to the detriment of the common good is not only frequent, but often eases access to positions of influence. It would be a shame if such behaviour were confused with the notion of enlightened self-interest promoted by classical economists.

The cases of Italy and Greece point to another dimension of evitability. Clientelistic behaviour by governments is made possible when the voting population is bereft of knowledge about economics. This has been true in Greece and Italy; it is also true in Germany, Canada, the United Kingdom, the United States and most countries. Basic economic concepts, macro as well as micro, need to be part of the obligatory curriculum to form a competent electorate—and competent politicians as well. A few fundamental concepts need to be taught with abundant historical examples to bring them within the reach of all.

Greece consumer spending increased while Germany spent its money on mortgage-backed assets and… Greece. The Greek tragedy is not that its money was spent while the German banks got their money back. The tragedy is that investing in Greece should have been a better bet than loans to Greece. The economy of Greece is and was in a position for catch-up, and the potential of the entire economy is enormous. Of course, the potential of Africa is also enormous, but few would invest there and for similar reasons. Africa disposes of vast resources and the African peoples by and large are willing to study and to work hard to better their situation. Unfortunately, the vision and behaviour of African governments limits that economic potential.

Although the previous section glibly announces how the crisis of Greece is an opportunity for improvement in the administration of the euro, the real situation is discouraging. Both Greece and Europe expect a breakthrough, but they both expect a breakthrough on the other side of the negotiating table. Both sides need to break out of the mental prisons that have them captured. Changing mental schema is not easy. Asking either side to change is asking a lot. However, change on one side alone is insufficient.

Since change of mentality is difficult, and since each expects change from the other party, the danger is that the can be kicked down the road, with apparent solutions merely prolonging repayment over several generations and nothing done to induce the improvement in the wealth-producing capacity of Greece.

Greece must change the relationship between government and electorate. The electorate must become more sophisticated and cognizant of economic realities. The government must aim to cultivate the economy of Greece rather than simply dispense gifts bought with borrowed money. Of course, there are fewer gifts to distribute under austerity. It would be better if the government could be trusted to allocate more abundant funds wisely without the constraints of austerity.

Europe must make it possible for Greece to crawl out of the hole it has dug for itself. Europe already has arranged forgiveness of part of Greece's debt and restructured the remainder. It must have the courage and trust to do so more aggressively still, so that the debt to GDP ratio of Greece can be brought to a reasonable level within a reasonable amount of time. Germany faced the Treaty of Versailles after the First World War. After the Second World War, Germany faced the Potsdam Conference and the Marshall Plan. The Greeks need a Marshall Plan, not a Treaty of Versailles.

Notes

1. In particular, optimal currency area theory does not apply. Robert Mundell is considered the original authority on optimal currency area theory and was a supporter of the euro project. He did not think that this theory counter-indicated the euro. See Swoboda (1999).
2. The European Commission provides a summary of the Pact and its amendments at https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/stability-and-growth-pact/history-stability-and-growth-pact_en. Accessed October 1, 2017. Subsequent references to this pact in this chapter include its many amendments, adjustments and interpretations.

3. GDP is calculated both through the sources of spending approach and through income approach. Equating the two approaches gives us (X–M) = (S–I) + (T–G). In words, net exports are equal to the savings minus investments, plus taxes minus government spending. See the final section of chapter "A Financial and Economic Crisis in Greece", "Dynamic of the Crisis in Greece".
4. Note: Complete references to unsigned IMF and OECD documents are given in the text and are not repeated here.

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[1]Note: Page numbers followed by ‘n’ refer to notes.

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