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13 November 2015

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December 9, 2015

Abstract

Greece and its creditors concluded negotiations over a third bailout by signing a Memorandum of Understanding on 19 August 2015. The dominant view among most economic policy analysts and commentators seems to be that the actions of the Greek government in the months before the deal had been erratic and lacked coordination. In this paper we argue instead that the decisions of the Greek negotiators, including asking the voters to reject the earlier terms demanded by the creditors in a referendum, can be explained by the logic of brinkmanship. We develop a game-theoretic model to show that the actions of the Greek government are consistent with a strategy aimed at securing concessions, which can be used to bolster domestic approval.

JEL codes D78 · E65 · H12

Keywords Greek debt crisis · Brinkmanship · Crisis management

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1 Introduction

> How to make sense of a process in which Greek voters loudly spurn a euro-zone bail-out offer in a referendum, only to watch Alexis Tsipras, their prime minister, immediately seek a worse deal that is flatly rejected by the euro zone, which in turn presses a yet more stringent proposal to which Mr Tsipras humbly assents? Better, perhaps, not to try (The dark clouds of peace, 2015).

What to make of the third Greek bailout deal? To the Economist, an advertent observer of the Greek crisis, and many other commentators the answer is clear: "[R]ational actors would never have got this far" (The way ahead, 2015). We beg to disagree.

We argue instead along the lines of Evans-Pritchard (2015) that the behaviour of the first SYRIZA/ANEL government led by Prime Minister Alexis Tsipras from January until August 2015 can be consistently explained as that of an actor who "is playing an escalating game of brinkmanship, trying to force Europe to give ground" on concessions that the Greek leadership needed to garner domestic support. The actions of the Greek leadership nevertheless reflect a notable departure from the strategy of earlier Greek governments. In the previous bailout negotiations Greece was "able to combine the threat of default (which would create an unknown and potentially massive risk for the EU), a promised commitment to economic reforms that would put it on the road to self-sufficiency, and its 'too small to fail' status to gain extraordinary financial support" (Bulow and Rogoff, 2015). In our interpretation of the third bailout negotiations, the Greek grand strategy was not based on the outright threat of default. It instead involved the indirect threat of a 'Graccident,' *viz.*, an accidental exit from the eurozone under the worst possible circumstances, to gain concessions that otherwise would not have been achievable. The reasons for employing this strategy were most probably two: First, the eurozone felt much better prepared for the fallout from a possible orderly 'Grexit' and, second, contagion effects within the eurozone failed to materialise. As we see it, the brinkmanship strategy was a rational response to the new circumstances. In this paper, which combines reporting on recent developments with game-theoretic analysis, we offer a political-economy perspective on this.[1]

We emphasise several themes. First, many observers of and commentators on the Greek bailout negotiations seem not to have grasped the essence of the Greek brinkmanship strategy. The very logic of brinkmanship is to *avoid* having to actually prove that one is prepared to do something irrational. Instead brinkmanship revolves around convincing the other side that one is prepared to take higher and higher risks of *accidentally* pulling everyone over the brink: "If two climbers are tied together, and one wants to intimidate the other by seeming about to fall over the edge, there has to be some uncertainty or anticipated irrationality or it won't work" (Schelling, 2008, 99).[2] By engaging in brinkmanship the Greek government was probably able to induce the creditors to make a bailout offer that would otherwise not have been made.

Second, the brinkmanship strategy of the Tsipras government could work because Greece was, on the one hand, totally unprepared to leave the eurozone in an orderly manner but also, on the other hand, committed not to give in to the demands of the creditors for as long as possible. On the tactical level this meant that the country was exposed to the risk of a Graccident due to the consequences of insecurity and capital flight. Yet the strategy of applying pressure by keeping the eurozone future of Greece in limbo actually gave the Greek government a bargaining advantage. It is well possible that the creditor countries and institutions kept a harder than necessary line initially, hoping that being in trouble would bring the Greeks to heel sooner or later. In fact, the pressure seems to have worked the other way round: As long as the Greek economy was in limbo, it was also in danger of going over the brink, and the longer this was the case, the greater became the risk of a Graccident—something that everyone wanted to avoid.

[1] This paper reflects the state of affairs at late September 2015.

[2] The fact that the very leader of the Greek negotiating team, Yanis Varoufakis, constantly confronted and provoked his interlocutors certainly reinforced the impression that the danger of an inadvertent but permanent rift was there. Throughout the negotiations Varoufakis played this role remarkably well. Once the brinkmanship strategy had succeeded however, he did not suit his purpose any more and was consequently asked to resign.

Third, by holding a referendum the embattled Greek government did a perfectly rational thing from a strategic bargaining perspective. This, too, seems to have been completely misunderstood by many observers, who asked what sense it made to vote on a proposal that was already off the table. For instance, the president of the German Institute for Economic Research (DIW), Marcel Fratzscher, lambasted the referendum as a political and economic catastrophe for Greece (Fratzscher, 2015). In our view, the referendum was instead a shrewd tactical move, serving two purposes: It further delayed the negotiations and worked as a commitment device, ensuring that the creditors would need to accommodate the fact that the terms of their proposal were unacceptable by improving the terms of the bailout. Put differently, the referendum was a stratagem to hold out for a better deal. In fact Tsipras kept telling the voters precisely that the rejection of earlier-offered terms should not be seen as "a mandate for rupture with Europe, *but a mandate that bolsters our negotiating strength to achieve a viable deal*" (Marsden, 2015, emphasis added). The decisive 'no' vote was supposed to leave Europe with two options: Give us concessions (forgive some debt) or, worse, face the risk of a Grexit (Whelan, 2015).

Fourth, although the third bailout definitely amounts to a brutal diktat of terms that reflects the great differences in the actors' bargaining power, it in fact contains a number of points which Tsipras can certainly cite in his favour. First of all, he secured refinancing of the new Greek government, which was not sustainable without external assistance. Indeed, one cannot avoid the impression that the creditors gradually accommodated the Greeks in the months before the third bailout agreement. To start with, according to media reports, there was in December 2014 "already broad agreement on the scope of the aid. Greece is expected to be granted around €10 billion, and the [European Stability Mechanism (ESM)] will not be required to raise any additional funds for it" (Pauly et al., 2014). After the election of Tsipras the creditors then appear to have offered Greece loans of around €15.5 billion ($17.6 billion) in return for a five-month extension of the existing financial assistance agreement. Greece, in contrast and despite of all the talk about a rejection of austerity, did ask for considerably more money and a new bailout. Then, in January 2015, reports spoke of behind-the-scenes talks over a third bailout "amounting to €30 billion" (Steinbock, 2015). One month later, it was reported that "a third Greek bailout could run as much as €37.8 billion if Varoufakis' plans are adopted in full" (Spiegel, 2015a). In March 2015 "Spain's economy minister said euro zone countries were discussing a new rescue plan for the country worth between €30-50 billion [...] but European Union (EU) officials said there were no such talks" (Ellyatt, 2015). Clearly, the promised amount of further financial assistance accommodated the increasing needs of Greece. Yet it also became clear at the same time that the creditors wanted to see that political cost would be paid (Strupczewski, 2015).

Another point Tsipras can sell his voters is that the third bailout is covered by the ESM (for legal details see Megliani, 2014, 586), since it can be argued that the ESM facilitates, due to its inclusion of standardised and identical collective action clauses (CAC), an orderly restructuring of government debt (Stephanou and Gortsos, 2012, 24). Tsipras can definitely also cite in his favour to have secured the five-year "Juncker investment plan," the magnitude of which (€35 billion ($38 billion)) actually exceeds the fiscal savings Greece is required to realise in the same period. Under the terms of the third Greek bailout, the primary surplus targets are also reduced, which amounts to an easing worth €20 billion ($22 billion). The perhaps most important achievement of all, yet certainly not something the Greek leadership will tell the public, is that the fiscal bill of the third bailout would not immediately be picked up by the Greek voters but only after the next election—which was duly announced immediately after the bailout deal was signed. As we see it, securing a grace period, during which elections could be held before austerity would kick back in, was most probably an important objective of the Greek leadership's grand strategy.

However, the Greek negotiators did obviously not secure the most important prize: A formal commitment of the creditors to provide debt relief. Exactly this is what would have made the deal "viable." Of course, that would also have given Tsipras a huge boost in popularity. On the other hand, he did at least secure the endorsement of debt relief by the International

Monetary Fund (IMF) and public promises of European leaders that some restructuring of the debt would be considered in the future.

The remainder of this paper is structured as follows: In section 2 we recall the most important events leading to the third Greek bailout. In section 3, after some preliminary remarks (3.1), we explore the strategic bargaining situation between Greece and its creditor countries/institutions by help of a strategic bargaining game (3.2). Section 4 sums up and concludes.

2 A narrative of events leading to the third Greek bailout

Five years into the debt crisis, with the country having experienced a loss of more than 25% of its GDP and a catastrophic increase in unemployment, the new Prime Minister of Greece, Alexis Tsipras, came to power in January 2015 on the ticket of having promised an exhausted electorate to undo painful economic reforms, and to insist in a write-down of the country's €320 billion ($344 billion) of debt. Initially some commentators expressed the hope that the victory of his ultra-left wing alliance SYRIZA, which ended a 40-year era of alternating rule by the socialist PASOK and the conservative New Democracy, could inspire both the Greeks to get their house in order and Europe to seriously discuss the idea of debt relief (Hope and Barber, 2015a).

Those commentators were quickly let down. The new Greek coalition government of SYRIZA and the right-wing ANEL party, mostly represented abroad by the combative finance minister Yanis Varoufakis, immediately embarked on a collision course with the very countries and institutions that had already helped Greece twice to stay afloat financially. The increasingly tumultuous events that followed were just what the media were waiting for. On 9 April 2015 the government, having apparently raided the state coffers, met an IMF loan payment deadline of €459 million ($493 million) and thus avoided at the last possible moment a credit event. However, on the very day of payment—and to the intense displeasure of not only his European partners—Prime Minister Tsipras met with Russian President Vladimir Putin in Moscow to discuss the prospects of deeper bilateral cooperation. In a move that "could bring the euro crisis to a head" (Rachman, 2015) the Greek government had two days earlier angered particularly eurozone powerhouse Germany by floating the staggering figure of €278.7 billion ($300.6 billion) in demand for reparations from World War Two. Even the German Vice Chancellor Sigmar Gabriel, who belongs to the country's Social Democratic Party and who had expressed understanding for the social hardships austerity had brought to Greece during an earlier visit of Tsipras to Berlin, bluntly called the demand "stupid" (ibid.).

Tsipras' visit to Berlin in March came two weeks after German public opinion became heavily polarised over the 'Fingergate,' as a rather absurd blame game over whether Varoufakis had once, during a conference presentation years before he entered politics, literally given Germany the middle finger, became to be known (Sauerbrey, 2015). Greece had by the end of March failed to secure an endorsement of its list of proposed economic and structural reforms from the 'Brussels Group,' consisting of EU and IMF representatives advising the 'Euro Working Group,' which in turn directly reports to the eurogroup finance ministers. With an agreement an earlier promised €7.2 billion ($8.1 billion) of undisbursed funds from the second bailout could have been unlocked quickly, and Greece could have secured valuable breathing space. This would also have lowered the risk that Greece might be running out of cash and be forced to choose between meeting the next loan payment deadline and paying pensioners and public employees.

Months of tense negotiations—and a media-reporting firestorm—ensued. Just when all seemed to imply a compromise and an end of the prolonged deadlock the negotiations were broken off on 26 June 2015. Existing hopes of reaching a compromise solution did almost completely dissipate when Tsipras unexpectedly announced that a referendum on the creditors' demands would be held on 5 July 2015. This move not only surprised his European partners but also people in Greece and the global financial markets. Apparently the Greek leaders were completely convinced that "[i]n the months of negotiations, deadlock, and stalemate that led up to this [...] dramatic referendum vote, somewhere along the way Greece took on new significance, transforming from a peripheral member of the West that accounts for a mere 3 percent of the eurozone's GDP to a pivotal country" (Bechev, 2015). By announcing a referendum Tsipras clearly escalated the crisis: The country's on-going bailout program expired on 30 June 2015 and the Greek authorities announced that they would not pay the equivalent of €1.6 billion ($1.74 billion) to the IMF due the same day. In order to stem the outflow of capital from the already struggling Greek banking system, a bank holiday and strict capital controls were imposed in Greece. Bank withdrawals were limited to €60 ($65) per day for ordinary depositors and €120 ($130) for pensioners. Now "[t]he question of Greece's euro-zone membership [had] been officially opened" (Gordon and Kennedy, 2015).

With Greece having effectively become "the first advanced economy to default to the fund in its 71-year history" (Donnan, 2015) the IMF now faced a dilemma: Letting Greece off the hook would, on the one hand, raise serious questions about the fund's impartiality and integrity. On the other hand, a Greek default to the IMF could trigger cross-default clauses in Greece's Master Financial Assistance Facility Agreement with the European Financial Stability Facility (EFSF), which would then give the right to Greece's European creditors to frontload payments on EFSF loans (Ruparel, 2015). An officially acknowledged default could then have wider consequences because cross-default clauses of Greek private-sector bonds might set forth a chain reaction of credit events. The European Central Bank (ECB) on its part could then sooner or later be forced to cut the only lifeline of the Greek banking sector and cancel the provision of Emergency Liquidity Assistance (ELA); it decided to keep steering a middle course and maintained ELA at the same level as the one fixed in the previous review (European Central Bank, 2015a). All this meant that some solution needed to be found until the critical deadline of 20 July 2015, when Greece would need to repay around €3.5 billion ($3.8 billion) in bond redemptions to the ECB. The time to find a solution became increasingly short.

The referendum in Greece was held on Sunday, 5 July 2015. The government had campaigned for a 'no' vote and opinion polls predicted a head-to-head race. In the evening of the same day it became clear that the Greeks had indeed rejected the latest proposal of the creditors with almost a 62% majority (Nationwide referendum results, 2015). In the words of one analyst, Greece had hit the self-destruct button by voting no (McArdle, 2015). The key question was how long the countdown towards self-destruction would last. Greece meanwhile officially requested a new bailout from the ESM. Yet an agreement on this could not be simply pulled from a hat (for the following see Spiegel, 2015b): What would happen next depended on the political response from the pivotal actors in the Greek bailout drama; these however did not have completely aligned interests and needed to co-ordinate far-reaching decisions in a very short period of time. First, the European Commission (EC) would need to evaluate whether the requested bailout could pose risks to financial stability in the euro area. Next the eurogroup would need to officially open negotiations on the conditions of the bailout, which would require votes in several parliaments, including the German Bundestag. Even if the eurogroup could conclude these negotiations quickly—which seemed unlikely—the terms of the bailout would require fresh parliamentary votes. The only thing Greece could hope for in the short term was a clarification of the terms of the requested bailout.

In the limited time available to find a solution several things could have happened that would have led to an unprepared and involuntary Greek exit from the eurozone—a so-called 'Graccident' (for this and the following see Dabrowski, 2015): If the ECB would have reduced or cancelled ELA altogether the Greek banks would have become insolvent and would have closed immediately. This would have imposed considerable additional hardship on the cash-based Greek economy, destroy trust and certainly further reduce prospects of future growth. Perhaps the economy could have staggered on for a while with banks closed. Yet sooner or later the government would have needed to choose between reverting to a national currency, by converting existing euro-denominated bank accounts into the new currency, or forcing the Bank of Greece (BoG) to provide Greek banks with unauthorised euro-denominated liquidity.[3] Such a hostile takeover of the BoG—which was apparently exactly what the so-called Left Platform of communist hardliners within SYRIZA wanted (cf. Hope and Barber, 2015b)—would certainly have led to a rupture with the ECB. Another possibility was that the Greek government might run out of cash. Capital flight and uncertainty had already negatively affected the growth prospects of the Greek economy (European Commission sharply cuts Greek growth, primary surplus forecasts, 2015). As a result, the government was not enjoying a primary surplus any more, which meant that it did not even have a choice between paying pensions or salaries and honouring its financial obligations: Already Greece could do neither of these two things.

With analysts putting a 50% chance of a chaotic Greek exit from the eurozone, leaders gathered in Brussels for last-ditch negotiations on 12 July 2015—"the most critical moment in the history of the EU" (The way ahead, 2015, 11) according to the president of the European Council, Donald Tusk. After arduous talks behind closed doors—and apparently some pretty nasty political manoeuvring—Tusk announced tongue-in-cheek on the morning of 13 July 2015 "we have an a-Greek-ment" (Pain without end, 2015, 8). The deal thrashed out over 17 hours would avert a Grexit and a Graccident for the time being, address Greece's refinancing needs with a promised package of €82 billion - €86 billion ($90 billion - $94 billion), including a buffer of €10 billion - €25 billion ($11 billion-$27 billion) for bank recapitalisation and resolution costs, promised a short-term EU Commission investment plan in the magnitude of €35 billion ($38 billion) and provided for a bridge financing package of €7 billion ($7.7 billion) (European Council 2015b, 2ff., European Council 2015a).

What did Greece have to do to make the money flowing again (for this and the follow-

[3]Interestingly, it seems that Greece's finance minister Varoufakis had devised an alternative route to secure transactions could be conducted in euro as part of a clandestine contingency plan, as he revealed in a teleconference with private investors on 16 July 2015. This plan seems to have involved the creation of reserve accounts secretly attached to every taxpayer's ID that could be used to make payments to other taxpayers outside of the 'official' banking system. According to Varoufakis, "[t]hat would have created a parallel banking system while the banks were shut as a result of the ECB's aggressive action, to give us some breathing space" (Spiegel and Hope, 2015). The plan apparently also entailed that "at the drop of a hat it could be converted to a new drachma" (Babington, 2015). An intriguing option would have been to design the new drachma as a purely electronic currency, which would then work as a powerful antidote against the notoriously high Greek shadow economy (for more on the latter see Berger et al., 2014)

ing see What Greece must do to receive a new bail-out, 2015)? On 15 July 2015—exactly two days after the euro summit—the Hellenic Parliament had to pass legislation on pension cuts, value-added tax reform, collective wage bargaining and the establishment of quasi-automatic public spending constraints. One week later, on 22 July, a second set of reform laws, including the adoption of the EU Bank Resolution and Recovery Directive, needed to be enacted. As if all this were not enough, Greece will have to, among other things, reform her pension system and labour markets, open hitherto closed professions, 'de-politicise' her administration—and do all this under scrutiny from observers that will represent the institutions formerly known as the troika. From now on Greece will be drip-fed bailout funds only in return for enacting reform legislation. Most humiliatingly however, the Greek authorities are required to deposit "valuable Greek assets" with an independent privatisation fund that is supposed to raise €50 billion ($55 billion).

The new Memorandum of Understanding (MoU) was signed on 19 August 2015. The very next day, eight months after he came to power for the first time, Tsipras stepped down to trigger elections. In the evening of election day on 20 September 2015 the exit polls showed Tsipras had won by a significantly bigger margin than expected. While Tsipras was obviously not able to put an end to austerity, it seems that his brinkmanship strategy had worked at least insofar as to ensuring his re-election. But is the new deal a good deal for Greece as well? In the damning words of the former Greek Finance Minister Yanis Varoufakis, who seems to have sincerely believed that austerity could be negotiated away, the third Greek bailout is doomed to fail and will "go down in history as the greatest disaster of macroeconomic management ever" (Greece debt crisis: Reforms 'will fail' - Varoufakis, 2015). Other observers are more optimistic. According to Holger Schmieding, the deal "is a good deal, warts and all" since it keeps reform pressure up and "actually offers a slight if probably backloaded fiscal stimulus for Greece over time, with a sensible redirection of funds from public consumption to public investment" (Schmieding, 2015). Especially the moderate fiscal stimulus can have positive medium-term macroeconomic effects (cf. Weisbrot et al., 2015).

3 Brinkmanship in the Greek bailout negotiations

3.1 Preliminary remarks

> A central feature of all crises is a sense of urgency, and in many cases urgency becomes the most compelling crisis characteristic. Situations change so dramatically and so rapidly that no one seems to be able to predict the chain of events or the possible outcomes. An important aspect of such crisis situations is the dynamics that evolve during days, hours, and even minutes. [...] Leaders and decision-makers are often caught by surprises after surprises produced by many forces (Farazmand, 2001, 3-4).

In this section we interpret the decision of the Greek government to escalate the crisis as a of "coercive diplomacy," where the objective of the coercer is to induce behavioural change in the coerced; pressure is applied by communicating the own willingness to face disaster. Put differently, we contend that an escalation may serve as a deliberate risk-generation mechanism with ultimately strategic aims (cf. Schelling, 2008, 101).

We can most probably safely assume that both Greece and its creditors understand that cohesion of the euro area is both in the collective as well as in the national interest: "Every member of the euro area has a vital interest in ensuring that its partners are meeting the membership requirements—and not just at the point of entry, but continuously" (European Central Bank, 2015b). At the same time, in order to ensure that a country stays in the euro, both the eurozone as well as the country in question need to be at least not worse off in the union: "If there are parts of the euro area that are worse off inside the Union, doubts may grow about whether they might ultimately have to leave" (European Central Bank, 2014). Certainly, if the euro area were a full-fledged economic and fiscal union, it would be much more capable of absorbing asymmetric shocks than it is in its current shape. Yet as things stand, the very incompleteness of the monetary union in conjunction with great differences in national shock-absorption capabilities challenge the notion that the euro is irrevocable in all member states (cf. Fidrmuc, 2015).

Seen from a strategic bargaining perspective, the ambiguity surrounding the irrevocability of euro membership means that both a coordinated as well as an unplanned and thus potentially disastrous exit from the euro is a possibility rational actors should take into account. This in turn means that countries with better shock absorption capabilities as well as less capable countries in need of support can strategically employ the explicit or implicit threat of a euro exit. Yet whereas the announcement of a euro exit means the initiation of *certain* disaster, "one can initiate a moderate *risk* of mutual disaster if the other party's compliance is feasible within a short enough period to keep the cumulative risk within tolerable bounds" (Schelling, 2008, 91, with emphasis). We contend that the rational manipulation of the risk of an accidental euro exit can be interpreted as a key component of Tsipras' strategy. Early remarks of the Greek ex-Finance Minister Yanis Varoufakis indeed seem to imply that this was right from the start of the negotiations the Greek negotiators' game plan:

> The only thing you can really do is negotiate with the rest of Europe [...]. But to negotiate, to be taken seriously, you have to have a credible threat. *You have to be prepared to blow the whole thing up, simply by being intransigent if you are not taken seriously.* So, this is my recommendation: Prepare for a very tough, very painful, potentially explosive negotiation (Nasiripour, 2015, emphasis added).

While it is true that Tsipras had promised to put an end to austerity in his 2014/5 election campaign and to cancel unpopular measures like the consolidated tax on property ownership (ENFIA), one should not discount *a priori* that Tsipras was not prepared to soft-pedal after becoming prime minister. Yet, in order to cut down on his promises, he would need to come back to Greece from the bailout negotiations with a package deal having in it enough to show to the voters. In any case, seen from a strategic bargaining perspective, during the negotiations the grandiose campaign pledges worked as a commitment device: Every deviation by the Greek leadership from them would be perceived as a humiliation; in a deal the Greek leadership would then demand some form of compensation, for instance lower budget surplus targets, a stimulus package from the EU commission or—ideally—debt relief.

In what follows we argue that one can both consistently interpret the course of events in line with the theme that the strategic calculus of the Greek negotiators combined brinkmanship with commitment in order to force the creditors to give in on key demands. We thus militate against the view held by some that the Greek government did *not* have a strategy; the fact that "[t]he Greek red lines—the points of principle on which this government refuses to budge—on labour rights, against cuts in poverty-level pensions and fire-sale privatizations—have been in plain view from day one" (Galbraith, 2015) does not at all mean that the Greek leadership was not prepared to play ball. Yet the claim to have unmovable red lines needs to be backed up with something real—perhaps a referendum?—if it is to be credible, otherwise it is just cheap talk.

We also militate against the view that the SYRIZA/ANEL government came to a gunfight armed only with a knife—meaning that it had the wrong strategy for the right purpose. Observers of the negotiations holding this view argue that Greece did in fact play the brinkmanship card yet did not, for some reason, understand that the game was over before it began, since it could only credibly threaten with a default as long as it had a large enough primary surplus to pay for domestic public expenditures (Kaletsky, 2015). We argue that there is a difference between threatening openly to default and running the deliberate risk of an accidental euro exit, with all the disastrous consequences this would entail for all sides.

Last but not least we are completely unconvinced that the Greek government not only had a rational strategy but in fact enjoyed an extremely strong bargaining position because it had the "diabolical plan B" (Bershidsky, 2015) of "escalating tensions between the country and its creditors" for the purpose of "driving up the costs [. . .] for the other side, by allowing capital flight by its citizens" in order to maximise euro-denominated TARGET2 claims vis-à-vis the BoG. With this ace up its sleeve Greece were allegedly be able "to secure a far more favourable outcome—including increased financial assistance and reduced reform requirements—than it could have gained at any point in the past" (Sinn, 2015; cf. Moro, 2014, S19ff.).[4] We instead share the view of Karl Whelan that, even if the exact effects of a hypothetical euro breakup for European central banks are still open to dispute, the risks for German citizens due to the TARGET2 balance are most probably over-hyped (Whelan, 2014); it is therefore unlikely that the threat of a critical hit to the Bundesbank should have featured in the strategic calculus of the Greek negotiators.

In our view, the negotiations between Greece and its creditors can best be described as a game of reciprocal coercive diplomacy. Alexander George defines coercive diplomacy as "efforts to persuade an opponent to stop and/or undo an action he is already embarked upon" (George, 1997, 5). It is a response to an encroachment already undertaken and thus different from deterrence, which aims at making sure that an opponent will not undertake an encroachment in the future. Put differently, the objective of coercive diplomacy is to persuade the opponent to change course by threatening or actually using some form of force, *viz.*, capability to inflict pain, not to trigger a catastrophic event.

The eurozone creditors, on the one hand, clearly perceived that the SYRIZA/ANEL government was back-pedalling on reforms and wanted to make the them change course on this. They also did definitely not want to reward populist campaign pledges with their taxpayers' money. The SYRIZA/ANEL government, on the other hand,—most probably having already the next elections in mind—needed to get some politically valuable concessions. To reach their objective, they employed the tactic of deliberately increasing the reform costs (as a commitment device) coupled with brinkmanship, *viz.*, "the tactic of deliberately letting the situation get somewhat out of hand," (Schelling, 1980, 200) in order to make it more intolerable to the other side and force its accommodation: "It means harassing and intimidating an adversary by exposing him to a shared risk, or deterring him by showing that if he makes a contrary move he may disturb us so that we slip over the brink whether we want to or not, carrying him with us" (ibid.).

[4]TARGET stands for Trans-European Automated Real-time Gross Settlement Express Transfer System.

3.2 The game

In this subsection we explore the strategic bargaining issues of the Greek bailout negotiations by help of a sequential asymmetric-information game with two players, the creditor countries and institutions (henceforth the eurozone player), on the one side, versus the Greek government (henceforth Greece player) on the other side. Of course this model is not supposed to fully reflect the complexity of the bargaining situation during the Greek bailout negotiations, but it can still offer some insights into how the actors' grand strategies perhaps looked like. Table 1 shows the variables; the sets of players, strategies and payoffs are self-explanatory. The game tree, decomposed in two halves for the convenience of the reader, is shown in Figures 1 and 2. We are searching for subgame-perfect Nash equilibria.

The game tree tells the following story: The eurozone player E and the Greece player G face negotiations about a bailout for the latter. For G, implementing economic and structural reforms, exiting in an orderly fashion from the eurozone to avoid reforms, crashing out of the eurozone in a chaotic fashion and holding out to deliberately generate the risk of an accident are all painful. Yet running the risk of a Graccident allows G to hold out for a better deal by rejecting the terms of an initial bailout. The game begins by E choosing between offering G a package deal (financial assistance combined with conditionality). If E chooses not to offer G a bailout, and the latter does not hold out for a better deal, G must choose between either exiting the eurozone, which is costly to both players, or implementing reforms that will enable it to stand on the own feet financially. In this case G must bear the (political-economic) costs of reforms. This choice is the same for G if a bailout offer was made but rejected and G does not hold out. If a bailout offer was made and immediately accepted, G gets a positive payoff in the form of politically relevant benefits—think of increased popularity for having secured concessions—like credible promises of future debt relief, which can be exploited domestically. However, the benefits of a bailout will invariably be reduced by the political costs of the structural reforms, R, demanded in return. In accordance with the dictum that "[r]elations between the euro zone and Greece are defined in terms of the "concessions" each has screwed out of the other" (My big fact Greek divorce, 2015), we assume that concessions to G (V_1 at this stage of the game) are being perceived as politically costly by the eurozone player. Put more simply: Concessions are a zero-sum game.

If G chooses to hold out, a different subgame develops. Holding out means that a later reform may become much more costly. To reflect this, we introduce a variable D that expresses the severity of the negative consequences caused by delaying a resolution of the impasse—think of capital flight and closed banks, reduced short-term growth prospects, etc.—, which of course translate into political costs for G, but also increase the amount of resources that need to be redistributed from E to G in case of a bailout agreement. Holding out does moreover mean that implementing reforms may become even more costly if the population rejects them. In order to reflect this, we introduce a move by nature which determines whether reforms are politically feasibly and thus not costly ($L = 0$ with a probability h), or rejected by the population ($L > C_G^X - R$ with the probability $1 - h$). The first outcome is meant to capture the effect of the Greek leadership losing the referendum in the model, the second outcome is meant to capture the effect of winning the referendum.[5]

In each of these two cases the game continues with the commitment subgame. The first move here is made by N who decides with a probability q the type of G: The tough type of G is firm in its commitment; if this is so, G can deliberately run the risk of a Graccident in order to extract concessions from E. The probability q is known to both players; yet the type of G is private information and only known to the Greece player. The true state of the world after the initial act of nature is thus unknown to the eurozone player, who has to move next and decide on whether it offers G a bailout or not. Commitment to brinkmanship works the following way: It rules out the option for the Greece player to respond to the move of E by avoiding the risk of a Graccident. The game thus reflects the strategic case that "when both parties abhor collision the advantage goes often to the one who arranges the status quo in his

[5]We of course assume in our game that the common knowledge assumption holds, that is, that the eurozone player knows the possible moves of the Greece player, one of which is the referendum. Given that such a move was from early on deliberated within the Greek government (see e.g. Barker and Hope, 2015), this assumption is certainly not unrealistic.

favour and leaves to the other side the "last clear chance" to stop or turn aside" (Schelling, 2008, 44).[6]

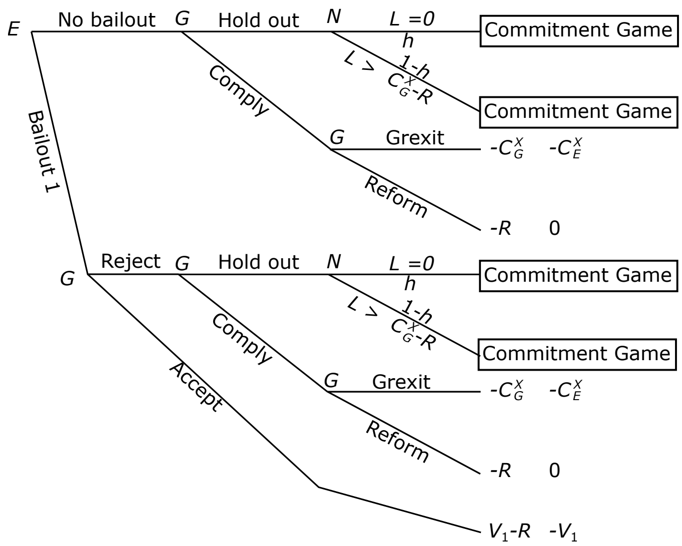
If no bailout is being offered by E, a committed Greece player cannot but run the risk of a Graccident. If that event occurs, both players will be burdened with the costs of a chaotic Greek exit. If no such thing occurs, G can choose to implement those painful economic and structural reforms needed in order to live within the own means; the reform costs are given by R; yet these costs are increased by two factors: The costs D of holding out, which definitely accrue to G if it enters the negotiation game, plus the political fallout from the referendum. The Greece player can alternatively opt for an orderly exit from the monetary union, which would mean certain costs for both players. In contrast to this, a noncommitted Greece player can choose between the Graccident risk and playing safe; this means then the choice between reform and Grexit.

Table 1: Variables

Variables	Description
$i = G, E$	Players: Greece (G), eurozone (E)
R	Costs for G of economic reforms ($R > 0$)
D	Costs for G of holding out ($D > 0$)
L	Cost increase for G in terms of political fallout from referendum ($L > 0$)
C_i^X	Costs for player i of an ordered Greek exit from the eurozone (Grexit) $\left(C_i^X > 0\right)$
C_i^A	Costs for player i of a chaotic Greek exit from the eurozone (Graccident) $\left(C_i^A > 0\right)$
p	Probability of a Graccident ($0 < p < 1$)
q	Probability of a successful commitment ($0 < q < 1$)
h	Probability of significant costs of delayed reforms ($0 < h < 1$)
V_1	Payoff of initial bailout offer in terms of concessions that can be exploited domestically ($V_1 > 0$)
V_2	Payoff of improved bailout offer in terms of concessions that can be exploited domestically ($V_2 > 0$)

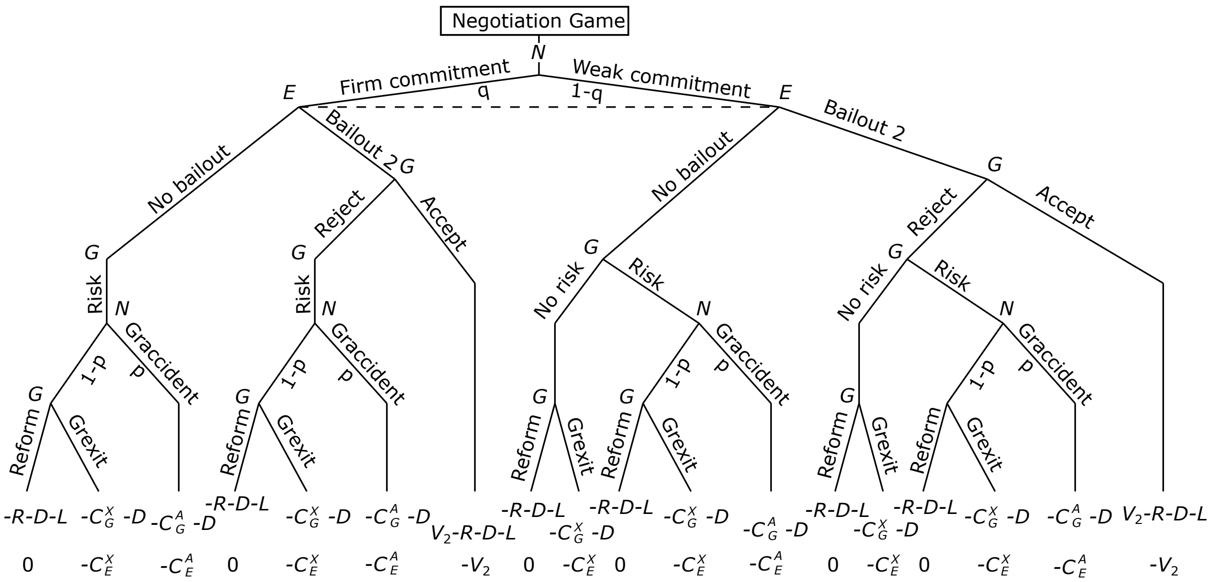
[6]Schelling actually illustrates this case with an example from ancient Greek history: "Xenophon understood the principle when, threatened by an attack he had not sought, he placed his Greeks with their backs against an impassable ravine. "I should like the enemy to think it is easy-going in every direction for *him* to retreat." [...] The "last chance" to clear out was left to the enemy when Xenophon had to take the initiative, but denied to himself when he wanted to deter attack, leaving his enemy the choice to attack or retire" (Schelling, 2008, 45). Schelling is perhaps referring to Xenophon, *Anabasis*, 4.2.11 (Xenophon, 1922, 271).

Figure 1: Game tree of the negotiation game



In what follows we explore parameter constellations of the model that result in different equilibria. The parameter constellations (1), (2) and (3) defining the following cases describe solutions of the commitment game tree, which are being anticipated by the Greece player in its solution of the negotiation game. Since a complete solution of the game would be beyond the scope of this paper, we confine the analysis to three cases: The good, the bad and the ugly, as seen from the perspective of the Greece player. We will not only show that non-empty sets of equilibrium parameters exist, but also that these cases are not unrealistic. Put differently, we show that the actions of the Greek government can be explained by assuming that it followed a strategy aimed at securing the concessions it needed to garner domestic support. We restrict the parameter space to such constellations that fulfil certain conditions: First of all, we assume $R + L > C_G^X > R$, which simply means for the Greece player delayed reforms are worse than an immediate Grexit and the latter worse than immediate reforms. We also assume $V_2 - R - L > -C_G^X$, which means that an improved bailout offer by E must ensure that G remains in the eurozone, even given the negative effects of holding out for the

Figure 2: Game tree of the commitment game



improved bailout package V_2.[7]

3.3 Case I: The good

This is the case of high risk costs that the Greece player is firmly committed, relative to bailout costs V_2. It is defined by the parameter constellation

$$V_2 < pqC_E^A < C_E^X + pq\left(C_E^A - C_E^X\right). \tag{1}$$

The term pqC_E^A expresses the expected costs caused by the risk that the Greece player could be firmly committed and that therefore a Graccident is likely. The term $C_E^X + pq\left(C_E^A - C_E^X\right)$ expresses the expected costs for E if it encounters the Greece player for which $L > C_G^X - R$ in the commitment game. Note that in this case (and the other two cases) if $L = 0$ the Greece player would prefer implementing reforms over Grexit. It would then never get a second-

[7]We also assume $V_2 > D$; $V_2 > L$; $V_2 - L > D$; $C_G^A > R + D + L$ and $C_G^A > V_2 + R$ to ensure the outcomes of the game are not illogical. For example, the last assumption ensures that for the Greece player a Graccident is the worst possible outcome.

round offer V_2 as long as the costs associated with this for the eurozone player exceed the risk costs.

In Case I the Graccident risk is so high relative to the value V_2 of improved bailout terms that E would definitely offer them in the commitment game, independently of the value of L; this will of course be anticipated by the Greece player. G, solving the game backwards, will choose its strategy by comparing the payoffs of different courses of action. If G chooses to hold out for a better deal the payoff will be

$$\pi_G^D = (1-h)(V_2 - R - D) + h(V_2 - D - L - R).$$

If G opts against brinkmanship and does not enter the commitment stage, it would immediately implement reforms and realize the payoff

$$\pi_G^{nD} = -R.$$

For comparison, if G does not hold out and E would have made an offer V_1 in the negotiation game, the payoff would be $\pi_G^{ac} = V_1 - R$. Since we have assumed $V_2 > D + L$, holding out is dominant. In this case G would accept any bailout offer that fulfils

$$V_1 > V_2 - D - hL.$$

At the same time, as long as $V_1 < V_2$ the eurozone player would already make an initial bailout offer in the negotiation game. This would be the ideal outcome for the Greece player: E would make an adequate initial bailout offer, which G would accept; there would be no need for brinkmanship and the costs for all actors would be minimal. Such a nice outcome depends of course on the parameters of the game; with different parameters the outcome may change considerably, which leads us to the next case.

3.4 Case II: The bad

This is the case of low risk costs that the Greece player is firmly committed, relative to bailout costs V_2. It is defined by the parameter constellation

$$pqC_E^A < C_E^X + pq\left(C_E^A - C_E^X\right) < V_2. \tag{2}$$

In this case the Greece player is under increased pressure and will shy away from brinkmanship. Regardless of whether G is willing to implement reforms, the eurozone player would never make an second bailout offer in the commitment game and also no initial bailout offer in the negotiation game. In that case G's payoff amounts to

$$\begin{aligned}\pi_G^D = &(1-h)\left\{q\left(p\left(-C_G^A - D\right) + (1-p)(-R-D)\right) + (1-q)(-R-D)\right\} \\ &+h\left\{q\left[p\left(-C_G^A - D\right) + (1-p)\left(-C_G^X - D\right)\right] + (1-q)\left(-C_G^X - D\right)\right\}\end{aligned}$$

if it nevertheless holds out, and

$$\pi_G^{nD} = -R$$

if it opts to comply by choosing reform in the negotiation game. Interestingly, G would never opt to hold out, since it cannot induce E to make an offer and would choose reform anyway. Such an offer would only make sense to E if $V_1 < 0$, which is excluded by our assumptions. If that were possible, we would have an equilibrium in which actually the Greece player would have to transfer resources to the eurozone player in order to avoid being forced out of the eurozone.

In our view this scenario provides a valuable lesson for how the strategy of Greece's creditors may have looked like. Obviously the tactic of increasing the political costs of giving further support to an unruly Greek government, or taking the position that the fallout from a Graccident were manageable, is a rational thing to do in the negotiation stage of the game: The Greek leadership would be forced to bow to the inevitable and implement reforms without further ado. Perhaps the expectation that an outcome like this could be achieved induced the eurozone to take a hard line. But it seems the game played out much more messily, as in the next case.

3.5 Case III: The ugly

This is the case where the costs of the second bailout V_2 are higher than the costs of the risk that the Greece player could stumble into a Graccident, yet lower than the costs E faces when nature reveals that reforms are especially costly for G, which was exactly what happened in the Greek referendum. Under these circumstances things get really ugly. Case III is defined by the parameter constellation

$$pqC_E^A < V_2 < C_E^X + pq\left(C_E^A - C_E^X\right). \tag{3}$$

In this case the equilibrium of the game is that G holds out for a better deal and E does not make an adequate initial offer V_1, despite the fact that both players would be better off by finding an agreement during the negotiation game and thus avoiding the commitment stage altogether. The intuition behind this result is that both players bet on the value of L: The Greece player, on the one hand, makes a wager that L will be high, that is, that the implementation of reforms will be even harder after holding out, which should of course be taken into account by a rational eurozone player; the eurozone player, on the other hand, makes a wager that L will be low and that therefore no need to accommodate the demands of G will arise.

In Case III, if $L = 0$ (*viz.*, the Greek leadership loses the referendum), which happens with the probability h, E would not make an offer V_2. The reason for this is that, due to the condition $R + L > C_G^X > R$, the Greece player would then prefer to implement reforms over exiting the eurozone. If however L turns out as high (*viz.*, the Greek leadership wins the referendum), which happens with the probability $1 - h$, E would come up with a better deal. Since, by assumption, $V_2 > R + L - C_G^X$ this offer would definitely be accepted by G. Faced with the choice between holding out or not G will compare the payoffs of both strategies, solving the game by backwards induction. If G choses to hold out for V_2 the payoff is

$$\pi_G^D = (1-h)\left\{q\left[p\left(-C_G^A - D\right) + (1-p)(-D-R)\right] + (1-q)(-D-R)\right\} + h(V_2 - D - L - R).$$

If G choses not to hold out for V_2 the payoff is

$$\pi_G^{nD} = -R.$$

For comparison, if the eurozone player made an offer V_1 and G accepted immediately its payoff would be given by

$$\pi_G^{ac} = V_1 - R.$$

G will only hold out for a better deal (if it did not receive an initial offer V_1) as long as $\pi_G^D > \pi_G^{nD}$. Whether the Greece player prefers the strategy of holding out, thus running the risk to go over the brink, depends on the probabilities of losing the referendum (h), the probability that G is definitely committed to risk a Graccident (q) and the risk associated with it (p). The strategy of holding out is preferred if h lies either in the interval

$$\frac{D}{V_2 - L} < h < \frac{C_G^A + D - R}{C_G^A - L - R + V_2} \tag{4}$$

and p and q lie in the intervals

$$0 < q \leq \frac{h(L - V_2) + D}{(h-1)\left(C_G^A - R\right)} \qquad \text{with} \qquad 0 < p < 1 \tag{5}$$

or

$$\frac{D - h(V_2 - L)}{(h-1)\left(C_G^A - R\right)} < q < 1 \qquad \text{with} \qquad 0 < p < \frac{D - h(V_2 - L)}{q(h-1)\left(C_G^A - R\right)}, \tag{6}$$

or h lies in the interval

$$\frac{C_G^A + D - R}{C_G^A - L - R + V_2} < h < 1 \qquad \text{with} \qquad 0 < q < 1 \qquad \text{and} \qquad 0 < p < 1. \tag{7}$$

Even if the conditions (4)/(5), (4)/(6) or (7) hold, G would immediately accept a first bailout offer V_1 if $\pi_G^{ac} > \pi_G^D$. For this to happen, the first offer basically has to be high enough as to compensate the Greece player for refraining from brinkmanship and thus forgoing a potentially better offer V_2. All parameter values

$$V_1 > h\left[pq\left(C_G^A - R\right) - L + V_2\right] + pq\left(R - C_G^A\right) - D \tag{8}$$

meet this condition. Interestingly, even if (8) holds and a mutually acceptable first bailout deal V_1 could be struck by the players, there are are parameter constellations where E still does not make a such an offer. This happens if

$$C_E^A < \frac{V_1 - hV_2}{(1-h)pq},$$

which means that the Graccident costs for the eurozone player are too low to deter it from entering the commitment stage. This is an important case: Here unnecessarily high costs are being caused by both players' attempts to screw concessions out of the other side. Although the eurozone player has a sufficient willingness to compensate the Greece player for relinquishing brinkmanship, it does not offer an early deal but prefers instead to enter the commitment game, betting that $L = 0$, that is, that the referendum shows that G will prefer reform over Grexit.

In our interpretation, this outcome of the game is very similar to what transpired in the months and weeks prior to the bailout: Probably an agreement may well have been possible as early as March. However, the eurozone representatives, probably trusting in the solidity of the firewalls constructed for the purpose of containing financial contagion originating from a débâcle, apparently decided that the negative consequences of a Graccident could be dealt with. The Greek negotiators, realising that early concession were off the table since the scenario of Greece leaving the eurozone did not instil terror any more, decided to hold out and to take their chances with the referendum, the result of which made unmistakably clear that the Greek government was committed to remain on the brink. As a result of risk-taking on both sides, the deal struck between the two actors became more costly for everybody. The result thus resembles a classical prisoners' dilemma: If both sides had acted in the common interest right from the start, a better deal for all would probably have been feasible. Instead both sides decided to trump the other and, by doing so, ended up with a much worse deal.

4 Summary and conclusion

In this paper we offered an alternative political-economic explanation of the actions of the Greek government in the months before the agreement on a third bailout for the country. In contrast to many other observers we conclude that the actions of the Greek leadership, especially the decision to ask the voters to reject the earlier terms demanded by the creditors in a referendum, appear to be consistent with a clear strategic calculus. We develop a game-theoretic model to show that the actions of the Greek government can be understood as an attempt to get concessions, which can then be used to garner support at home, most probably already with the next elections in mind.

In our sequential asymmetric-information game we reproduced three cases of parameter-constellations, the good, the bad and the ugly, which help to better understand the complexity of the negotiations between Greece and its creditors. Especially the 'ugly' third case is informative: Here an early agreement is possible, yet the eurozone player decides that the negative consequences of a Graccident can be dealt with. The Greece player in turn decides to hold out and to take its chances in form of the referendum, which increases the political costs of a deal. Because of risk-taking on both sides the outcome for the two actors is clearly suboptimal while at the same time individually rational.

Our article emphasised several themes. First of all, we underlined that, by engaging in brinkmanship, it is well possible that the Greek government was able to induce the creditors to make a bailout offer that would otherwise not have been made. Second, the Greek brinkmanship strategy has not been understood well by many observers. The Greek leadership did not directly threaten with default or Grexit but instead remained obstinate in the face of rapidly increasing risks of an accidental euro exit. Of course capital flight from Greece and the imposition of capital controls made things much worse for the Greek economy, but they also meant that the government was hell-bent on falling off the cliff if necessary. We emphasised, third, that holding a referendum was a stratagem designed to increase the political costs of having to accept exactly those terms the voters had already rejected. This, too, seems to have been completely misunderstood by many observers. The referendum was a tactical move to enable the government to hold out for a hopefully better deal. Of course the country would pay a high price for the government's obstinacy, yet the referendum definitely played into Tsipras' hands in the final phase of the negotiations. Fourth and last, we argued that what made the final deal better in the eyes of the Greek leadership was that it could be sold better to the own electorate than what had been on the table until then. As we see it, Tsipras' rather unexpected re-election in September 2015 shows that there must have been enough in the deal that could be sold to Greek voters. For these concessions, however, a high price had to be paid. Had the new Greek government and the eurozone acted in the common interest right from the start, they could certainly have reached a better deal much earlier. Instead both sides decided to put the other on his mettle and thus ended up with a less-than-ideal one.

Acknowledgements

The authors kindly thank Peter Bernholz, Jamus Lim, Panu Poutvaara, Jan-Egbert Sturm and other participants in the 24th Silvaplana Workshop in Political Economy at Pontresina, Switzerland for comments and sometimes lively discussions. The usual disclaimer applies.

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