

CEPS COMMENTARY



Thinking ahead for Europe

The Greek elections and the third bailout programme: Why it could work this time round

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The Greek people were called to their polling stations on September 20th for the third time this year. It is thus not surprising that the rate of abstention was particularly high. But perhaps this was also due to the fact that the passions aroused by the first Syriza victory and the referendum of July have subsided. A consensus seems to have developed in Greece that if the price of staying in the euro is another bailout, then this price has to be paid. The parties that broadly accept the deal reached in July got over 70% of the votes and the groups that left Syriza to campaign essentially for a return to the Drachma did not even manage to attract the low threshold of 3%.

The fact that Syriza could maintain its share in the vote almost unchanged despite the capital controls and all the other damage created by the turmoil of the first half of this year, constitutes a personal victory for Tsipras, who was able to sell his position that the bailout programme was the least-bad option available to Greece. It is only due to the very strong preference the Greek electoral system gives the largest party that with 35% of the vote he will have close to 48% of the votes in Parliament. He thus needs the support of only one smaller party. That he has chosen once more to rely on a small right-wing independence party is not a good sign, but it should be workable.

The key question is now whether the third bailout programme can work where the previous two programmes failed. Most observers argue that the third one cannot work because it merely represents a continuation of an approach that has manifestly failed. However, a closer inspection of the conditions today suggest reasons for cautious optimism.

The two adjustment programmes that Greece accepted in 2010 and 2012 went off-track for one main reason: the recession was much deeper than anticipated. The exceptional downturn of the Greek economy was attributable to two main reasons: the extraordinary fall in investment and the lack of export recovery.

The fall in investment was of course also due to the political uncertainty, resulting *inter alia* from the strong opposition to the bailout programmes. This factor should be much less strong going forward after these elections results.

But the key problem for Greece was that it started the adjustment with an outsized fiscal deficit, which had to be reduced. Many have argued that austerity was overdone and might

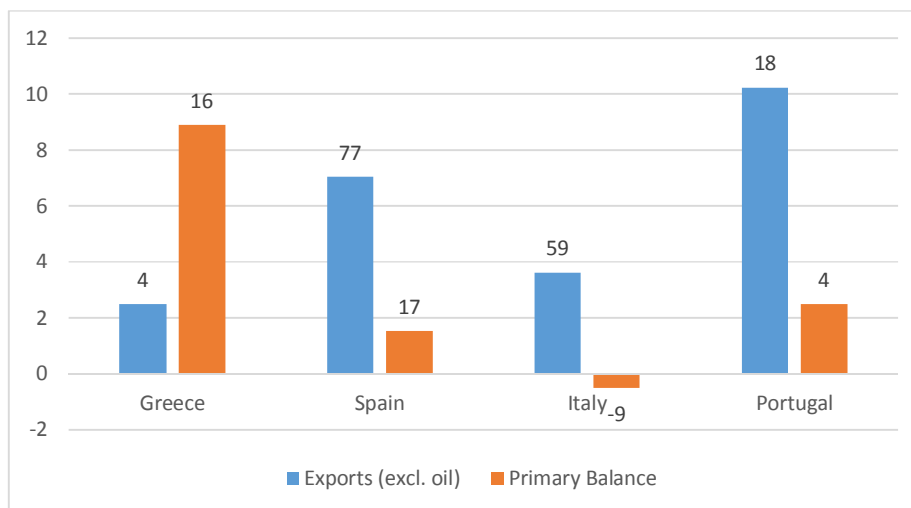
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have been self-defeating, but this was not the case in the other programme countries. The reason was that in a small, open economy the impact of a large fiscal adjustment can be contained if strong external demand compensates for the weakness of internal demand. This is what was expected in the first two adjustment programmes, which were predicated on the following logic: reduce the fiscal deficit; its impact will in any event be offset by a surge in exports (driven by lower wages).

Figure 1. Exports and primary balance as % of GDP, change 2008-2014 (€ bn)



Sources: Eurostat and ComTrade.

As shown in Figure 1, this expectation clearly turned out to be true for Portugal and Spain but very wrong for Greece, where the fiscal correction was far larger than the increase in exports.

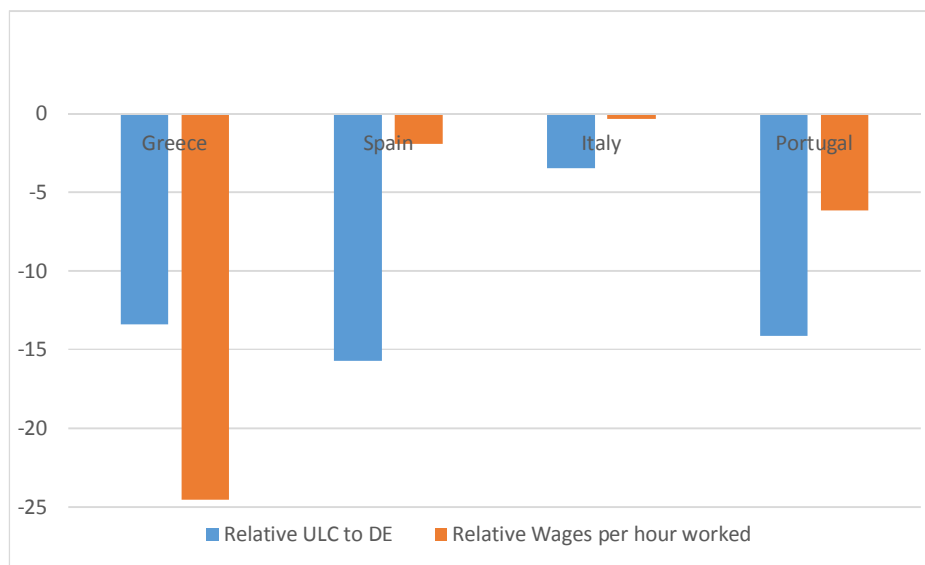
There are several partial explanations for the country's bad export performance. Some relate to the structure of the Greek exports, composed largely of commodities and maritime shipping, which tend to respond little to a real devaluation. But what remains difficult to explain is the lack of growth in the (small), non-oil, non-commodity goods exports and services, such as tourism. Sluggish export markets were not the reason, as the average growth rate of the Greek export markets was actually higher than for most euro-area member countries. The fundamental puzzle that remains is why the impressive fall in wages did not result in real increased competitiveness.

During the first two adjustment programmes, Greece recovered a considerable amount of wage competitiveness. As shown in Figure 2, wages fell by close to 25% in absolute terms, and even more relative to the euro-area average. If one compares this to the wage adjustment that took place in Spain, Italy and Portugal, this is justly impressive.

It is difficult to assess how much of this predicament can be ascribed to the labour-market measures of the adjustment programmes and how much to the deep recession combined with the record-high unemployment. Before 2009, the correlation between wages and unemployment was very weak in Greece. Fluctuations in unemployment had remained limited during the boom years, when wages actually increased. By contrast, after 2012, the fall in wages that occurred seems to be commensurate with the increase in unemployment, comparable to what one would expect from the Phillips curve relationship of other countries.

Moreover, as suggested in Figure 2, the change in wages was not reflected in unit labour costs in the same way across countries. Indeed, the change in unit labour costs (ULC), relative to Germany, was almost the same in Greece, Spain and Portugal, despite the difference in the wage adjustment. This is evidence of Greece's inability to translate the drop in wages into an increase in competitiveness.

Figure 2. Percent change in nominal ULC and wage compensation per hour worked



Sources: Eurostat and Ameco.

So, the natural question now is: Can it work this time round?

The answer should be 'possibly yes'. The current situation is completely different from 2010 and 2012. The economy is in worse shape, given the GDP losses, yet fundamentals have adjusted. Most of the fiscal and external imbalances have been corrected.

Despite a lack of control over public finances during the first half of this year, the primary balance is not that far away from balance, whereas it had been in deficit for over 10% of GDP in 2009. The primary-balance targets contained in the new programme will not require much of an effort if the economy recovers, as should be the case given the considerable drop in wages already achieved.

The task of structural reform should also be easier. Implementation has always been the main problem, with only a small fraction of the reforms really implemented. But if another small fraction, say a further 25%, is implemented over the next few years, the Greek economic context may look completely different compared to four years ago.

The banking system which had been frozen by political uncertainty over Grexit for a long time should now also be able to function better once it has been recapitalised.

And finally, the political context is changed. There is now bipartisan support for the programme. The political uncertainty that held back investment and exports should thus also abate. In 2014, the Greek economy had already shown some signs of recovery, which was nipped in the bud by the political drama that seized the country in the first half of this year. The same forces behind that change should now become even stronger allowing for sustainable growth.