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The end of the bailout era in Greece: not out of the woods yet

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Key points

– Economic adjustment programmes have failed to stabilise the Greek economy. Austerity and internal devaluation have instead distorted all income-generating mechanisms, thereby provoking a deep liquidity crisis that has contracted internal demand and put strains on the country's fiscal solvency.
– Despite statements to the contrary, the outcome of the 21 June Eurogroup meeting on Greece constituted an admission of the failure of the creditors' austerity agenda. The activation of the enhanced surveillance framework has proven that the Greek economy remains fragile.
– The extra set of austerity measures planned to be implemented in 2019 and 2020 will further undermine the already fragile financial conditions in the Greek economy. Therefore, their immediate and unconditional abolition is urgently required in order to boost growth.
– Greece needs an alternative debt-restructuring scheme that would adjust annual interest payments to a predetermined sustainable primary surplus target. In this way, Greece would stop accumulating new debt, with favourable effects on its debt refinancing costs.
– To achieve sustainable primary surpluses Greece should embark on a growth-friendly strategy that gives priority to policies that improve working and living conditions. To this end, the full restoration of all collective bargaining institutions, along with an increase in the minimum wage, is essential.

1. Introduction

The most prolonged and intense stabilisation programme implemented in Europe since the eruption of the global financial crisis finally ended on 20 August 2018. Over the past nine years an enormous amount of loans, totalling 288.7 billion euros, have been disbursed to Greece in an effort to prevent a sovereign default. These loans came with the condition of implementing an extensive set of austerity measures that would supposedly help put the Greek economy onto a path towards stability and sustainable growth. However, despite recent official declarations about a 'stronger economy' and a 'new chapter' for the country,[1] the economic adjustment programmes have failed to fulfil their stated goals. Rather than stabilising Greece and making the country stronger, they have distorted virtually every income-generating mechanism in the economy, thereby making it weaker and vulnerable to potential risks.

The remainder of this policy brief is structured as follows: Section 2 exposes the current fragile state of the Greek economy, highlighting the unfavourable effects of the creditors' policy agenda on Greece's macro-financial and labour market conditions. Section 3 critically evaluates Greece's debt restructuring and post-programme surveillance framework decided upon at the 21 June Eurogroup meeting. Section 4 presents some preconditions and policy measures that could help Greece restore its fiscal solvency and permanently exit the crisis.

2. The disastrous legacy of Greece's austerity programmes

The recently concluded third bailout programme has left the Greek economy financially fragile, poorly performing and severely

1 See, for instance, Eurogroup (2018) and European Commission (2018a).

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damaged from the unprecedented socio-economic turmoil of the past nine years.[2] It is true that, following three years of virtual stagnation, economic growth finally turned positive in 2017 and is expected to gather pace in 2018, with real GDP expanding by 2%. However, such a performance is weaker than anticipated[3] and completely insufficient to offset the heavy losses of national income that occurred in the adjustment period. Assuming that Greece's annual growth rate will remain stable at 2% in the coming years, it is projected that it will take until 2032 for real GDP to catch up to its 2007 level.[4]

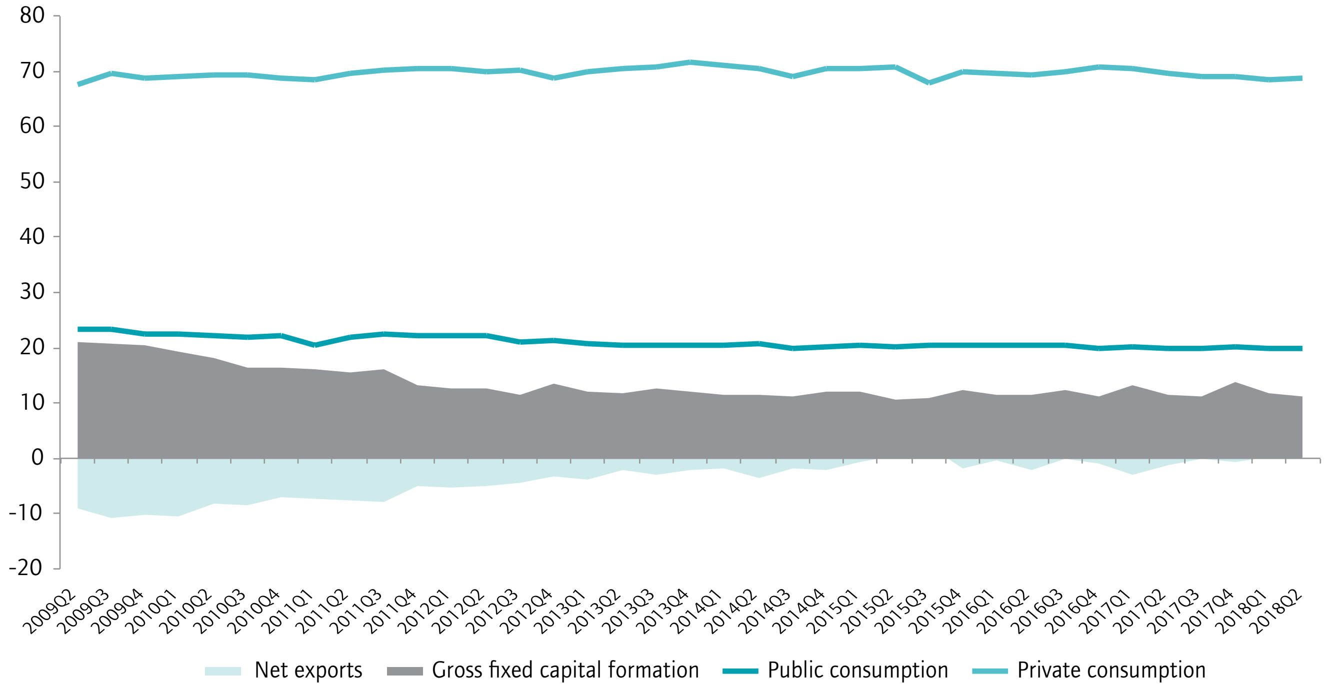
In our opinion, the main reason for Greece's unfavourable economic outlook is the absence of endogenous mechanisms of income and liquidity creation that could enhance the private sector's debt repayment and spending capacity and thus promote financial stability and economic growth. In fact, Figure 1 shows that contrary to creditors' expectations, during the macro adjustment period there has been neither an investment-led nor an export-led transformation of the Greek economy. For instance, since falling precipitately in the period 2009–2013, investment has nearly stalled, standing today at 11.3% of GDP.

Looking at the external sector, there has been a substantial correction of Greece's trade deficit, but this improvement has largely resulted from the deep plunge of imports due to the collapse of internal demand. Furthermore, while the external balance of services has remained positive over the entire adjustment period, Greece continues to display a strongly negative net balance of trade in goods because of the structural deficiency of the economy's productive basis. Indeed, the rise of export volumes of goods which began in 2014 has been relatively weak, at a rate similar to that of the 2003-2008 period, and insufficient to feed real GDP growth as it has coincided with a growth in imports. This evidence indicates the inappropriateness of internal devaluation and its obsessive focus on wage reduction to boost Greece's export performance,[5] as well as the strong import and liquidity leakages of the Greek economy related to its productive deficiencies.

Real private consumption, in contrast, was and still remains the single most important engine of economic activity, currently corresponding to 68.8% of GDP. In a consumption-led economy, such as Greece, attempting to increase national savings by means of tax hikes, wage suppression and labour market deregulation is destined to cause nothing more than lower disposable income, thereby suffocating private consumption and GDP.[6] In fact, in absolute terms real private consumption spending in the second quarter of 2018 remains almost frozen at a level 23.9% lower than it was in 2009. Aggressive public spending cuts have also squeezed the share of real public consumption to GDP to 19.8%.

Given Greece's lack of export competitiveness, the reduction of its budget deficit over the adjustment period has entailed a considerable flow of income from the private to the public sector, hence undermining the former's solvency status. This is particularly

Figure 1 **Components of aggregate demand (% of GDP, 2009Q2–2018Q2)**



Source: Eurostat (authors' calculations).

2 For a more detailed and comprehensive analysis on the impact of austerity on the Greek economy see Argitis *et al*. (2018).

3 In spring 2017, Greece's real GDP growth forecast for 2018 was 2.5% (European Commission 2017).

4 For a detailed analysis on the current state of the Greek economy see INE GSEE (2018).

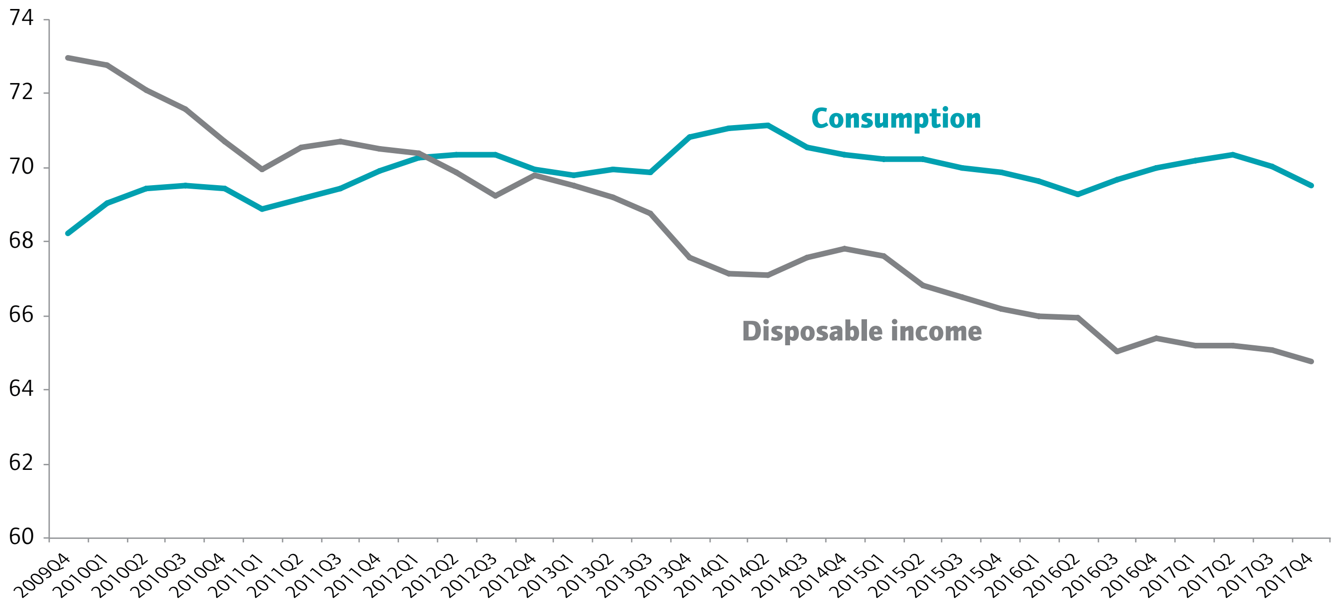
5 In fact, empirical evidence shows that internal devaluation helped firms in the manufacturing sector build their gross profit margins rather than improve price competitiveness (see Ioakimoglou 2018).

6 See, for instance, Argitis *et al*. (2017).

true for households, whose savings-investment balance has been consistently negative since 2009 due to the austerity-induced contraction of disposable income (see Figure 2) and savings. By contrast, the non-financial corporation sector registered a surplus over the same period, with savings exceeding investment expenditure. This was due to firms' negative net investment as a result of gloomy demand expectations and banks' impaired balance sheets that choked off credit expansion. Note that in early 2018 the ratio of non-performing loans to total loans had exceeded 48%, compared to 8.1% in early 2009, while the private sector's total arrears owed to the state exceeded 100 billion euros. This highlights the destructive impact of austerity on the private sector's repayment capacity and thereby on the solvency of the Greek banking and public sector.

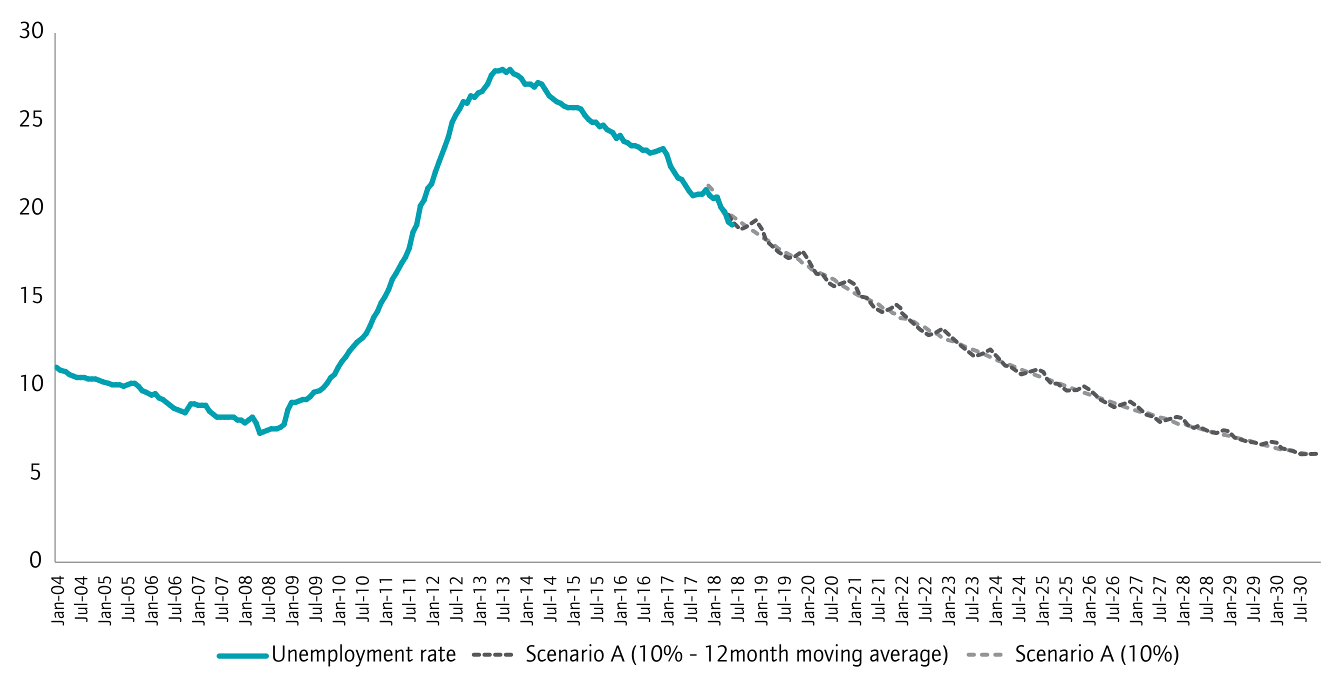
Turning to employment conditions, official figures show a gradual reduction of the unemployment rate from the record high level of nearly 28% in 2013 down to 19% in the second quarter of

Figure 2 **Households' consumption and gross disposable income (% of GDP, 2009Q4–2017Q4)**



Note: Four-period moving average.
Source: Eurostat (authors' calculations).

Figure 3 **Actual and projected unemployment rate (2004–2030)**



Source: ELSTAT, Labour Force Survey (authors' calculations).

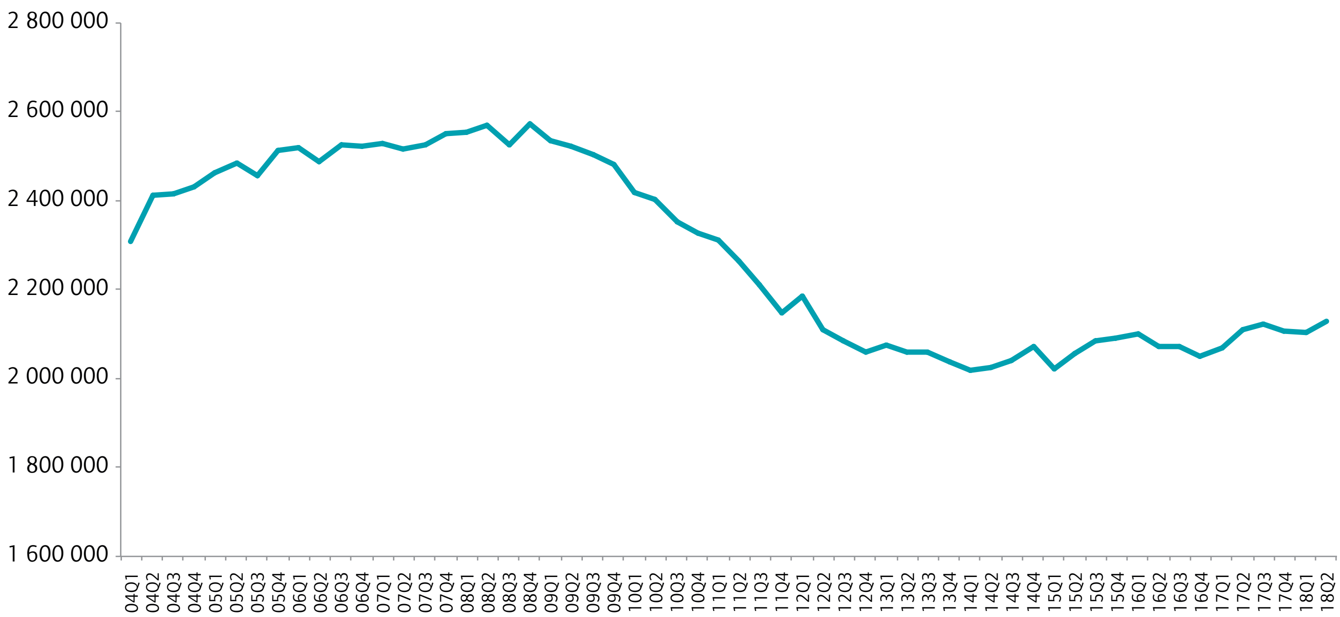
2018 (Figure 3). Although not negligible, this improvement is still small when compared to the staggering rise in unemployment that occurred in the period 2008–2013. At its current rate of decline, it is estimated that unemployment will fall below 10% in 2025, i.e. in almost seven years from now. A part of the reduction of the total number of unemployed persons has been attributed to state-financed employment programmes and the decline in undeclared work,[7] but also to the proliferation of certain troubling phenomena such as the 'brain drain' and the rise in precarious jobs. Compared to 2008, Greece's active population aged 20–44 has fallen by 682 thousand persons, mainly due to emigration. At the same time, in early 2018 the share of part-time employees to total employees reached 13.7%,[8] with 61% of new recruitments in poorly paid part-time or temporary contract jobs. These developments have translated into a mediocre employment performance (Figure 4). In the second quarter of 2018, total employment, measured in terms of total hours worked, was 15.6% lower compared to the same period in 2009.

High unemployment and worsening working conditions have also been reflected in wage developments. Over the period 2010–2018, average hourly wages and salaries were curbed in real terms by 14%, a figure far greater than the corresponding fall in labour productivity (6%), implying a shift in income distribution towards gross profits. Moreover, in the second quarter of 2018 more than 50% of employed persons were earning less than 830 euros per month, while in some sectors (e.g. agriculture, wholesale and retail trade, and accommodation and food services) the average net earnings stood below 730 euros. Wage compression, combined with drastic contractions in social welfare spending, has led to deteriorating living conditions. In 2017 the anchored at-risk-of-poverty rate exceeded 46% (compared to 18.9% in 2009), while the share of the population living under conditions of severe material deprivation reached 21.1% (against 11% in 2009).

3. Greece's new 'enhanced surveillance framework': the same thing all over again?

Greece's post-programme institutional surveillance framework and policy commitments were decided on at the 21 June Eurogroup meeting.[9] Specifically, it reconfirmed Greece's commitment to reach an annual primary fiscal target of 3.5% of GDP for the period 2019-2022, and 2.2% of GDP thereafter. In light of these targets, the Eurogroup also decided to conditionally activate some medium-term debt relief measures.[10] These measures, together with those decided on in May 2016, will supposedly ensure that Greece's gross financing needs (GFNs) stay below 15% of GDP in the medium term and below 20% of GDP in the long term, thereby setting the public debt on a sustainable trajectory. The Eurogroup finally agreed to place Greece under an 'enhanced surveillance framework' with a view to safeguarding the continuation and full implementation of all the reforms undertaken in the third programme. Such arrangements, combined with the

Figure 4 **Total employment (thousand hours worked, 2004Q1–2018Q2)**



Note: Seasonally and calendar-adjusted data.
Source: Eurostat.

7 According to the Ministry of Labour, Social Solidarity and Social Protection, the share of uninsured employees out of total employees in sectors with high rates of undeclared work was 12.4% in 2017 compared to 19.2% in 2014 (see Ministry of Labour 2018).

8 According to ELSTAT (2018), 68.2% of total part-timers (in the second quarter of 2018) would prefer full-time jobs.

9 See Eurogroup (2018).

10 In particular, the Eurogroup decided: a) to cancel the step-up interest rate margin of the European Financial Stability Facility (EFSF) debt buy-back tranche; b) to transfer the ANFA/SMP profits semi-annually as from December 2018; and c) to prolong both the grace and weighted average maturity period of the EFSF loans by 10 years.

creation of a 24.1-billion-euro cash buffer, partially built up by the programme's last tranche of 15 billion euros, will help strengthen Greece's debt-servicing capacity and policy credibility, thus enabling a return to market financing at a reasonable cost.

However, the Eurogroup decision was nothing more than a recognition of the failure of the austerity agenda to resolve the Greek crisis. In fact, by putting Greece under enhanced surveillance, European institutions have effectively admitted that, after nine years of painstaking stabilisation efforts, the Greek economy is still confronted with significant financial problems that may also pose a systemic risk to the stability of the euro area.[11] Furthermore, the agreed debt relief, together with the creation of a cash buffer, has confirmed that Greece is still dealing with a daunting solvency problem, with its public sector still facing low safety margins for new borrowing. Even more worryingly, the Eurogroup decision has not created any valid expectation of Greece exiting the ongoing solvency crisis in the foreseeable future.

There are many reasons for this. To begin with, the creditors' sustainability criterion, based on an arbitrary GFNs-to-GDP ceiling, mistakenly perceives the issue of debt sustainability solely as a liquidity (i.e. a lending flow) problem related to the borrowing requirements of the public sector. Therefore, by only focusing on the total size of GFNs, creditors have effectively disregarded a much more critical determinant of debt sustainability: the public sector's solvency and credit risk profile, which in turn depends on how the balance between interest payments and a sustainable level of primary surplus evolves over time.[12] By doing so, creditors' debt resolution plan has left open the possibility of interest expenses exceeding the annual primary surplus, even when the '15% criterion' is met. Yet if that should happen, particularly in an environment of weak growth, it will inevitably lead to interest capitalisation, thereby driving up Greece's future GFNs and solvency risk.

Furthermore, the Eurogroup decision extended the duration of Greece's fiscal straitjacket, which has destabilised its economy. In fact, sustaining a primary surplus of 3.5% of GDP until 2022 inevitably entails the absorption of valuable budgetary resources that could potentially be deployed for public investment or other growth-inducing purposes, hence preventing the economy from escaping the solvency trap. Even worse, the possible implementation of an additional set of austerity measures in 2019 and 2020 (i.e. a reduction in pensions and the income tax threshold), considered by creditors vital for Greece to meet its restrictive fiscal targets, will inevitably drag down economic growth, thus adversely influencing financial stability and the cost of public debt refinancing.[13]

11 See European Parliament and Council (2013), Article 2.

12 In our view, a sustainable primary fiscal surplus is that which is achieved in an environment of sustainable economic growth and social cohesion.

13 The very likely non-implementation of the pre-legislated 14% cut in the pensions of 1.4 million retirees originally planned to be put in place in 2019, along with the activation of some discretionary measures included in Greece's draft budgetary plan 2019, is certainly a welcome development. However, this is expected to come with the condition of a pension freeze until 2022 and the reduction in the public investment spending ceiling. Furthermore, there has as yet been no stated request of the Greek authorities to cancel the pre-legislated reduction in the income tax threshold planned for 2020 (see European Commission 2018b).

The same logic also applies in the longer term. The readjustment of the primary surplus target to 2.2% of GDP leaves virtually no room for authorities to use fiscal tools for stabilisation purposes, essentially entrapping Greece in a regime of detrimental fiscal discipline for the coming four decades. Moreover, the very sustainability of the target itself is questionable. In fact, sustaining such a large surplus for such a long period has no historical precedent. Reaching the 2.2% fiscal target, without intensifying financial instability, would also require a sufficiently strong, but highly uncertain, increase in private spending (i.e. private consumption and/or investment) and/or the transition of the Greek economy to an export-led growth model.

Bringing Greece's fiscal target down to 2.2% of GDP also entails serious risks to its solvency prospects. This is because in order to contribute to the country's creditworthiness, this readjustment should have been accompanied by a reduction of annual interest payments to below 2.2% of GDP for the period 2025-2060. However, under the existing financing architecture this rule does not seem to apply. This reveals creditors' failure to deliver a viable and credible debt restructuring scheme, thus prolonging uncertainty over Greece's creditworthiness and solvency profile.

4. Escaping from the crisis

In our view, the only way for Greece to exit the crisis is via a transition to high and sustainable economic growth. This is fundamental for improving the public sector's solvency and ensuring an orderly debt refinancing from financial markets. Generating high and sustainable economic growth is undeniably a very demanding task that requires time to take effect. Yet above all it calls for a proper set of economic policies geared to stimulating effective demand through the activation of mechanisms of income and liquidity creation in the economy.[14] In an economy with a narrow export base, such as Greece, this could only be achieved by spurring private and public investment to expand and restructure the productive sectors, as well as by increasing households' disposable income to increase consumption and thus further stimulate internal demand. To this end, creditors should consent to the immediate and unconditional abolition of all pre-agreed austerity measures planned to take effect in 2019 and 2020 that will further squeeze households' spending, thereby distorting the necessary liquidity-creating mechanisms in the economy.

To further increase households' disposable income, a comprehensive reshaping of labour market conditions is also vital. In this framework, the full abolition of all de-regulation measures taken in the past as part of the internal devaluation strategy, together with a raise in the minimum wage, would decisively contribute to endogenously stimulating income flows, boosting GDP growth, and thus restoring sovereign creditworthiness. Depending on the extent to which these effects would be diffused throughout the economy, this set of measures, along with a reactivation of public investment

14 For more on this policy proposal see Argitis and Koratzanis (2018) and Argitis *et al*. (2017).

programmes,[15] could also stabilise Greece's business climate while improving the creditworthiness of the private sector, with positive feedback effects on the portfolio quality of the banking system. As such, they would create suitable opportunities for credit expansion and real investment, thereby enhancing the country's productive capacity and creditworthiness in the long run.

Given all of the above, it is clear that the acclaimed 'new chapter' for Greece, following the supposedly 'successful' completion of the country's third stabilisation programme, is fraught with serious pitfalls and risks. Unfortunately, creditors have failed to grant Greece a debt restructuring scheme conducive to achieving fiscal credibility and sustainability. Moreover, being under enhanced surveillance, Greece is likely to adopt a series of recessionary policy measures that will impair its fragile economic recovery and solvency prospects. Therefore, despite public statements to the contrary, it seems that the Greek crisis is not over yet; once again its resolution has simply been put off to a moment in the distant future.

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15 Note that austerity has taken a heavy toll on public investment, with general government spending on gross capital formation plunging by 57.4% in the period 2009–2017 (INE GSEE 2018). Moreover, while Greece ranks first among EU member states in terms of the share of EFSI-triggered investment to GDP (European Commission 2018c), the Juncker Plan has not proven sufficient to combating the adverse investment climate in Greece alone.

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