LUISS SCHOOL OF EUROPEAN POLITICAL ECONOMY

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Greece, the Non-Obvious Lesson Of A Crisis

Changing a country's institutions, and changing Europe's economic geography as well

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In the crucial days at the beginning of July 2015, the Greek crisis has turned more political than ever. The victory of the NO at the Greek referendum on the European agreements has tightened the leeway for negotiation. On one hand, the outcome forbids Tsipras from compromising further. On the other hand, the European partners and institutions engaged in the negotiations seem to have lost patience with the Greek government.

The potential for a Grexit, i.e. Athens abandoning the euro, has never been larger. The consequences go far beyond the loss of one critical link in the European chain. It means weakening the most ambitious among the European projects. Opening the exit door from the euro implies consolidating a hierarchy among safer and less safe countries, one that might change the nature of the euro-area itself.

If they want to avoid this scenario, or if they are not prepared to integrate more rapidly with or without Greece, European leaders should offer to the Greek people a convincing plan for staying in the euro area. In fact, as this brief analysis maintains, this may still mean developing a new vision for the European economy as a whole, one in which the country's diversity fits into a comprehensive picture of the country's specialization, or one based on complementing geographical integration of economic structures.

For decades, the West has been helping Greece, aiming to keep it away from the Russian orbit. This strategy has been consistently applied for a long time without much or any regard for the quality of Greek governments. In 1947, US President Harry Truman proclaimed the doctrine of aid to free peoples while Greece was in a civil war, one where the US financed the defeat of pro-Soviet forces. In 1952, Athens joined NATO as part of an authoritarian block–Greece, Turkey and Iran–containing the expansion of the Soviet Union beyond its southwest border. Finally, between 1967 and 1974, the US supported the dictatorship of the colonels.

After the re-establishment of a democratic regime, and in order to consolidate the Greek people's commitment to democracy, the popular parties—Nea Dimokratia and PASOK—significantly increased public spending and bloated the number of civil servants employed by the State. After 1981, Athens joined the European Community and received, every year thereafter, development aid equivalent to 4% of its GDP. In 2002, Greece was allowed to enter the Eurozone, despite it being well known that the country could not respect the fiscal requirements prescribed in the Maastricht Treaty. Following the recent financial crisis, the European partners have allocated around 240 billion between 2010-12 to prevent a Grexit.

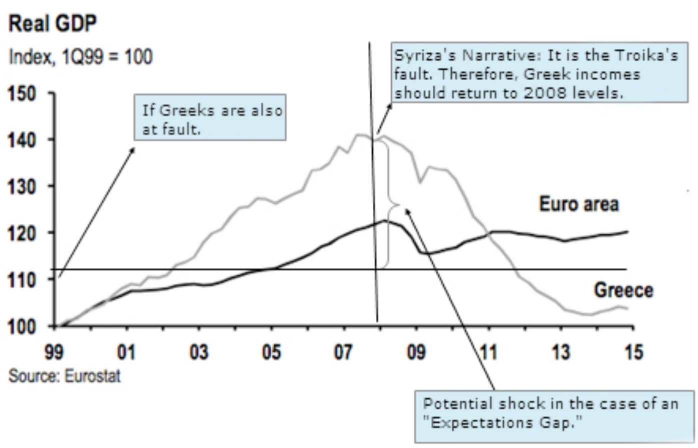
The Syriza government represents a marked rupture in the previous controversial relations between Greece and the West. The Syriza program contemplates Greece abandoning NATO and withdrawing troops from Afghanistan and the Balkans. Moreover, Syriza's political platform demands that the country deny any participation in military missions outside Greek borders. Athens was also expected to abolish military cooperation with Israel and renegotiate relations with Turkey. Finally, the program of the new party foresees the closure of all US military bases in Greece.

Once in government, the rhetoric of the new executive took a turn toward more nationalist and anti-Western tones. Syriza's coalition with a nationalist, right-leaning entity such as ANEL (Independent Greeks) sidelined its original ideological and pacifist markings. The Minister of Defense, ultra-nationalist Panos Kammenos, proposed to leave the EU and ally with Moscow. Since its first days in power, Kammenos burnished the anti-Turkish rhetoric using aggressive tones, engaged in maritime military maneuvers in the Eastern Aegean, and organized military parades in front of the Athens' Parliament. In order to distance Greece from the West, the government turned to China, Russia, Abu Dhabi, and even Tehran for financial aid. Prime Minister Alexis Tsipras repeatedly and visibly sought tighter cooperation with Moscow.

More significantly, just after its election, the government announced that it would never sign the TTIP (Transatlantic Trade and Investment Partnership). TTIP represents the juridical agreement that the U.S. and Europe see as a fundamental platform giving certainty and solidity to Western rules, principles, and interests in the next phase of globalization. Approval of the TTIP is maybe the most urgent item in the transatlantic agenda and must be shored up before Asian influence on the global economy becomes too large to be harnessed.

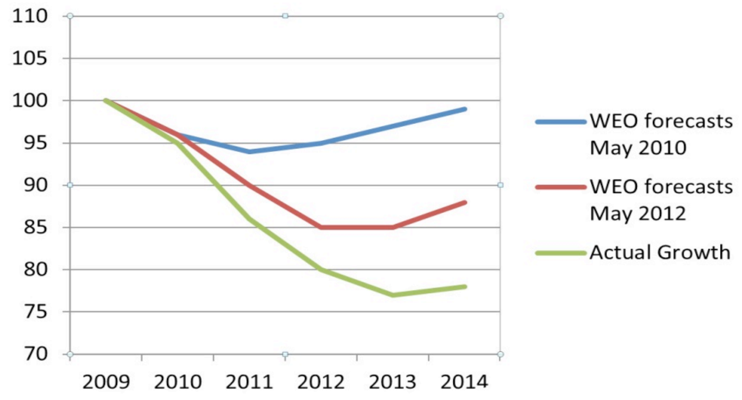
The political breakthrough embodied by the new government has had immediate repercussions on the management of the Greco-European crisis. Graph 1 shows the development of real GDP per capita in Greece and in the euro-area. It highlights how Greek incomes had skyrocketed in the first years of Greece's adhesion to the common currency, before plunging abruptly after 2008. The old parties that had been in power before 2015 acknowledged their responsibility in the mismanagement of the economy. Syriza's narrative is instead entirely concentrated on the period after 2008, coinciding with its own existence as an anti-system, political formation critical of Greek traditional politics and of the European management of the Greek crisis. Consequently, while traditional parties accepted that Greek incomes might have normalized at a level somewhere mid-way between the current lows and the euro-area average, Syriza maintained that the blame had to be laid entirely at the Troika's feet, and that Greek incomes should have returned to where they had been in 2008. This different approach in representing and legitimating citizens' expectations explains the massive support that the electors devoted to Tsipras in the ballots. Unfortunately, the "expectations gap" represented in the graph by the brace–encompassing a 30% differential in expected income–also gauges the potential shock Greek households might suffer should Syriza's narrative be proven false or ineffective in the negotiations.

Graph 1: Real GDP



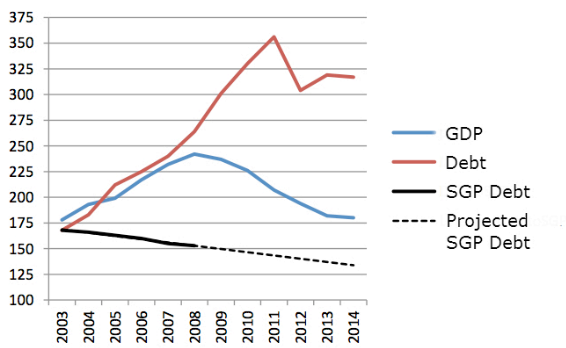
Syriza's main rhetorical strength is grounded in the clear perception that the Troika's management of the crisis has gone awry. This is due not only to a lack of acknowledgment of the pre-2008 period, but rather to the evidence of miscalculations in economic forecasts provided by the Troika during the course of assistance programs. Graph 2 highlights original forecasts of the first program (2010), which predicted the economy returning to growth in two years and a full recovery to pre-crisis income levels in six years. A second round of forecasts in 2012 significantly revised expected growth, but it failed to entirely capture the collapse in actual growth that occurred and caused a decline in Greek GDP by 23%.

Graph 2: The Revision of Expected GDP



A more controversial piece of evidence of crisis mismanagement is represented in Graph 3, which again shows the development of Greek real incomes (blue line) and nominal public debt (red line). The graph highlights how public debt exploded with GDP decline. It was thus credible that crisis mismanagement was the prime cause of Greece's fiscal misery.

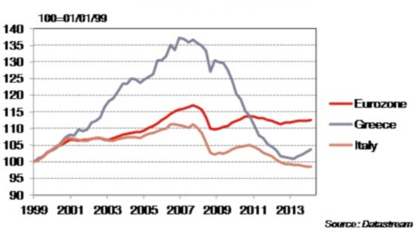
Graph 3: Nominal Debt



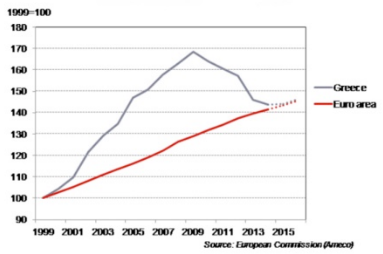
In fact, if one adds a third curve showing where Greek public debt would have been if the country's government had conducted a fiscal policy in line with what European rules prescribed, one comes to the conclusion that Greece would have been one of the fiscally soundest countries in Europe in 2008, and it would have survived the global financial crisis unscathed. The history of Greece's public debt is thus an indictment of both the pre-2008 domestic political management, as well as the post-2008 period.

Graphs 4-6 show how the severe downturn of the Greek economy needs to be given some historical perspective. In particular, complaints about loss of income are not entirely on solid ground, especially once Greek real income is confronted by the Italian one, which has been slashed even more since the beginning of the common currency. Analogously, indicators of wage compensations show that Greek salaries had increased more than in the rest of the euro-area until 2014. Finally, public spending—a possible indicator of the level of austerity—has been significantly stronger than in the rest of the euro-area.

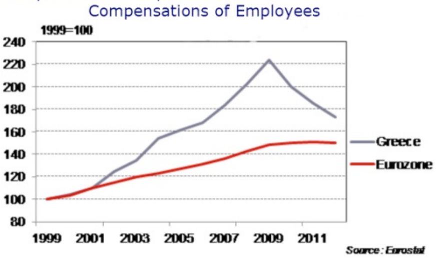
Graph 4: Real GDP Per Capita



Graph 5: Nominal Compensation per Employee



Graph 6: Public Expenditures - Compensations of Employees

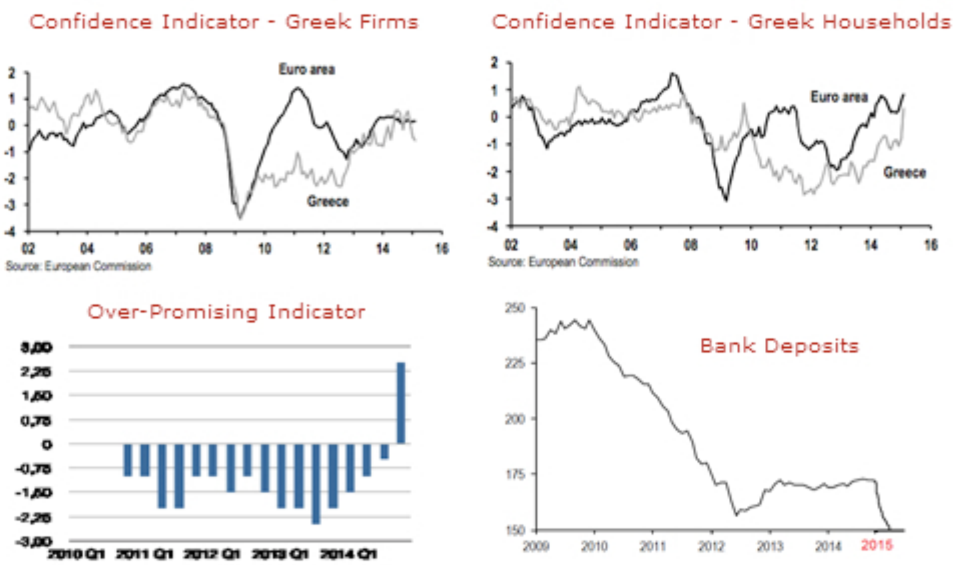


Can we thus conclude that Syriza is a populist party that has stoked a false rhetoric victimizing the Greeks? This uncomfortable question requires some more work on the available data to be answered.

The four-paneled Graph 7 elaborates on the change of confidence induced by Syriza's electoral campaign. The top-left panel shows how the Greek firms' confidence in the economy took a significant hit at the end of last year as polls were indicating a good showing of Syriza at the coming election. The top-right panel shows how the confidence of households went up very strongly.

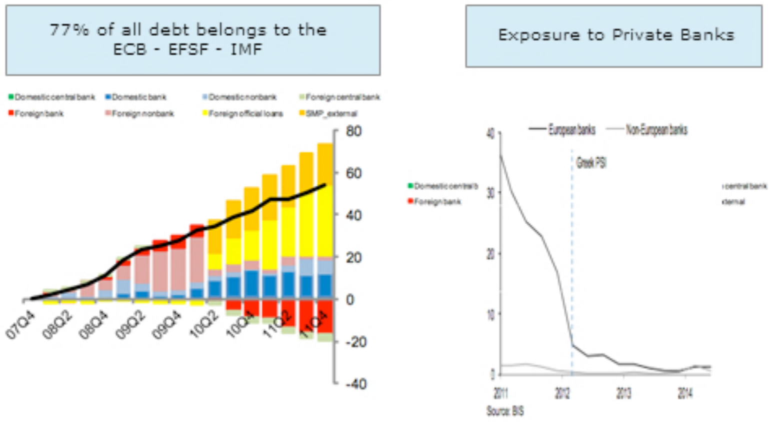
Normally, those two indicators should move hand-in-hand since higher expected household income is received as an encouraging sign by firms as well. Conversely, a good business climate can bring higher employment and better income conditions for workers. The bottom-left panel shows the differential between the two confidence indicators on the top of the graph and highlights the unusual divergence in expected climate between businesses and households. This unique, different perception could be taken as a symptom that businesses considered the promises that Syriza was making unrealistic, and that they were stoking enthusiasm among voters. The political dynamics could be termed as "over-promising," and it was, in fact, not entirely credible, as shown in the final panel where the volume of deposits in domestic banks shrank, demonstrating that a portion of depositors were running away.

Graph 7: "Is Syriza a Populist Party?"



If past interpretations of the crisis are politically relevant, the future stabilization of Greece is probably the real issue when a convergence around the negotiating table is vital. In this context, the issue of public debt restructuring has already been a bone of contention dividing negotiators. It is well known that 80% of Greek public debt is in the hands of institutions, while banks and private investors have both ran for the door over the past years, as shown by Graph 8.

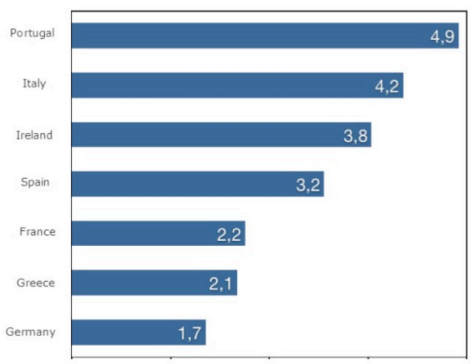
Graph 8: Holders of Greek Debt



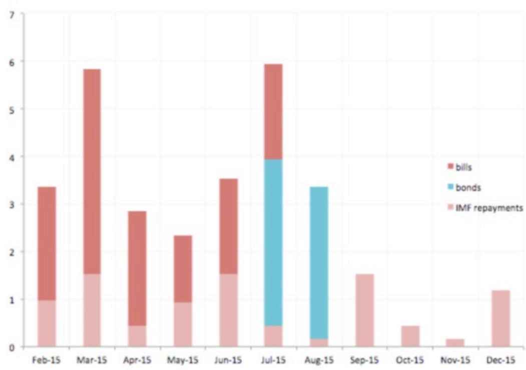
About 80% of Greek debt is in the hands of the public sector: bilateral loans from other countries or institutions such as the Greek Loan Facility, IMF, and EFSF, as well as securities in the hands of the ECB and National Central Banks. On those loans, there is a sort of "grace period" that significantly lowers the debtor's burden for the next ten years.

Interest rates on bilateral loans are 50 basis points above Euribor, which is now 0.56% per annum. The GLF has a maturity of 16 years. The EFSF rates are equal to one tenth of a basis point above the cost of funding of the EFSF itself and have an average maturity of 25 years. The last loan runs out in 2051. The profits made by the creditors on loans are returned to Greece. All in all, the average maturity of the Greek debt grew from 6.3 years in 2011 to 16.5 years at the end of 2014. Against this backdrop, the Bank of Greece estimated debt service at 4.3% of Greek GDP in 2014, but once one factors in the lower interest rates set by the ECB, the fact that profits by the ECB on Greek operations are returned to Athens, and that rates on EFSF loans are postponed for ten years, the actual cost of Greek debt should be near 2.6%. Finally, taking into account the fall in interest rates in recent months—also due to QE on other countries—interest expenditure Greek will be close to 2% of GDP in 2015.

Graph 9: The Burden of Servicing the Debt



Graph 10: Redemption in 2015 (bn €)



Graph 9 shows that the burden of servicing Greek debt is lower than the relative cost for most other countries of the euro-area, with the exception of Germany. The Greek burden is half as heavy as the Italian, and even lower if compared to the Portuguese. Moreover, once the summer period passes, the schedule for refinancing becomes very tolerable, as shown in Graph 10.

The fundamental equation for debt sustainability is:

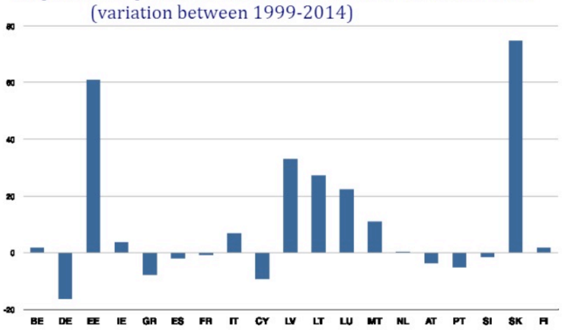
$$\Delta Dt = (Rt - gt) \times Dt\text{-}1 + \text{primary}$$

where D is the ratio of debt to GDP, R is the nominal interest rate on the debt, g is the nominal growth rate, and "primary" is the primary deficit (without interest payments) of the budget (or surplus, in this case a negative), also in relation to GDP.

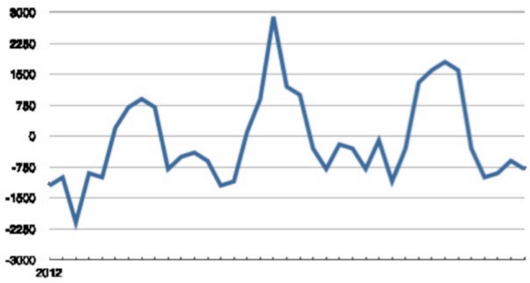
In order to prevent the debt from increasing, the growth of the Greek economy must be equal to the interest rate on the debt minus the primary budget surplus. Therefore, growth should be equal to 2.1% minus 1.5%. Consequently, the Greek debt can be stabilized by a nominal growth between 0.5% and 1%. It will decline with a growth rate over 2%, or with inflation above zero but below the European average. A recovery of competitiveness against the trade partners should easily ensure the required positive growth for the whole economy through the contribution of a positive current account balance. Why not resort to a Grexit to immediately achieve, through devaluation of currency, the required gain in competitiveness?

In fact, the Greek economy has already undergone a process of significant devaluation, although not through the currency, but through "internal devaluation," which is the reduction of domestic costs of productive factors. Graph 11 indicates the variation of unit labor costs in the euro area countries between 1999 and the second half of 2014, or, more precisely, a harmonized competitiveness indicator based on unit labor costs (indices for the total economy). The indicators prove that Greece has regained competitiveness and ranks just behind Germany and Cyprus.

Graph 11: Competitiveness Indicator Based on Unit Labor Costs (variation between 1999-2014)



Graph 12: Greek Current Account



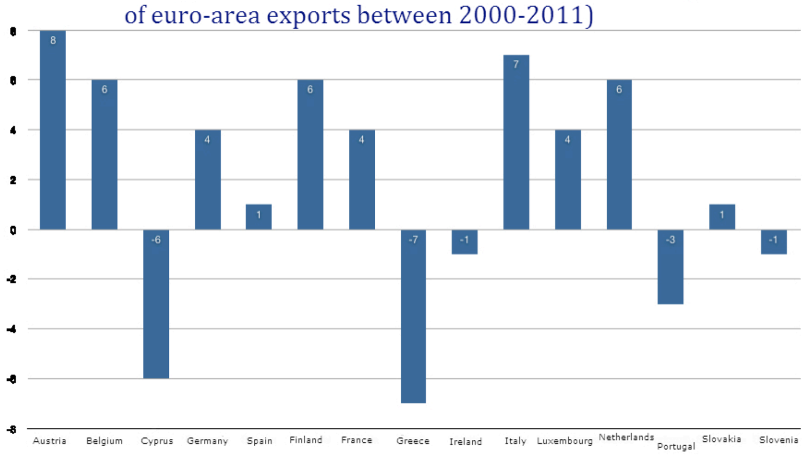
However, this has not been enough to restore a positive balance in the current account as shown in Graph 12 (monthly data of the Greek current account on the balance of payments after 2012).

The contribution of the external balance is still negative despite the massive recovery of competitiveness through labor costs. When the devaluation—in this case, "internal devaluation" through the reduction of production costs—has no effect on the value of exports compared to the value of imports (i.e., when it does not produce a positive balance with foreign countries), we say that Marshall-Lerner conditions are not met in that economy. As a matter of fact, since 2008, we see that export prices in Greece increased more than export prices in other European countries. The Greek real exchange rate—calculated by the price deflator for exports—increased since 2008 from 115 to 125, thus preventing the recovery of competitiveness from spreading through the whole economy. This is one reason why European institutions negotiating with Greece insist on calling for structural reforms that can provide a better business environment.

Against this backdrop, we cannot expect a Grexit to prove beneficial for the economy, but we already see all its negative effects even before it happens, out of sheer fear of the eventuality. A Grexit leads to a deterioration in the financial condition and liquidity of companies and households. The economy has already entered a recession, triggering a flight of bank deposits. If a Grexit takes place, the fall in confidence would be dramatic, and there would be a parallel drop in income, lower labor force participation, and higher unemployment. The drop in tax revenues would require further fiscal tightening, together with capital controls or the freezing of bank deposits. The gains in competitiveness from the currency's devaluation would only be temporary, because monetary tightening would be required to dampen inflation expectations. Eventually, even restoring monetary sovereignty would not be possible. Monetary policy would not be independent because the primary objective of the Central Bank would be to stabilize the value of the currency against the euro. Since a central bank cannot pursue two objectives contemporaneously, the determination of interest rates would remain completely dependent on the currency stabilization, failing to provide the expected support to the government's economic policy.

Rather than indulging in the Grexit chimera, Greco-European negotiations should focus on what is necessary to align the Greek economy with the rest of the euro-area. A clue can be found in Graph 13. The bars indicate the variation in the quantity of imports included in each country's exports since the beginning of the euro until 2011. This indicator can be considered a measure of how well an economy is integrated in the global value chains. This is one of the big challenges a monetary union faces: how one country's structure adjusts to global competition once it can no longer manipulate its currency.

Graph 13: "Integration" Index (variation in the imported components of euro-area exports between 2000-2011)



Apparently, the countries that have experienced a deterioration in their degree of global integration are the same as those needing assistance from the European institutions: more evidently, Greece, Cyprus, Portugal, and Ireland.

If this indicator tells us anything, it probably reveals that the required convergence in the euro-area depends on the development of European value chains, one disregarding the nationality of the activity. This would call for watching the euro-area economy as a complementary and comprehensive system that should be an object of a common economic strategy. Greece and other ailing countries need to be engaged in the European system through a non-national industrial or economic strategy. The variation of labor costs between 1999 and 2008 seems correlated with the geographical distance of each economy from Germany, Europe's industrial catalyzer. Under pressure from unprecedented global competition, social partners, firms, and trade unions are informally internalizing the proximity of competitors, making neighboring regions more homogeneous than policymakers understand, while making the divergence of distant regions' more striking. How long should this keep on happening under the political radar? In Greece, this has provoked a disruption of competitiveness and the endless crisis with which we are still struggling to cope.

If integration is impossible, due to geographic distances or other relevant factors, then Europe should take stock of structural divergence and accept some degree of income transfer aimed at reducing inequalities within its borders. In both cases, either via the conscious de-nationalization of industries or via solidarity, the spirit of European coexistence would markedly change for the better.