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PERSPECTIVE

Greece: On a new "mission impossible"?

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- Greece has completed its third bailout program but will remain bound by a tight framework of fiscal targets and reform obligations for many years.
- Productivity-enhancing reforms need to continue, but the tight fiscal framework will hinder the economy's capacity to grow, given the existing vulnerabilities, high unemployment, and the large investment gap.
- Political risk has been substantially reduced. Despite the social hardship endured since 2010, the Greek political system is now aligned behind the pro-EU mainstream, especially if compared with several other EU member states.
- Shifting to a more export-oriented, higher value-added model able to sustain stronger GDP growth, raising productivity and rendering the economy attractive for foreign investment and business remain the country's major challenges on the medium and longer run.

What's left: the state of the Greek economy

Greece's formal graduation from the 3rd financial assistance program, on 20 August 2018, concluded an arduous and dramatic trajectory that had begun in April 2010, when it became the first Eurozone member state to be bailed out. Though symbolically important and a welcome development, the completion of the 3rd program leaves no room for celebration. A decade-long crisis has left behind a heavy toll: Greece has lost a quarter of its 2008 GDP, unemployment is at 20% (having reached 27% at its peak), one out of three Greeks are below the poverty threshold, youth unemployment affects four out of ten young Greeks. Over 400,000 people (some 9% of the country's labor force) are estimated to have emigrated during the crisis, including some of the best and brightest.

The economy has implemented unprecedented fiscal adjustment, turning a budget deficit of 15.1% in 2009 to a surplus of 0.6% in 2017. A primary budget surplus (net of interest payments on the debt) of 4.2% was registered in 2017, against a program target of 1.75%. Program fiscal targets were overachieved in 2015 and 2016 as well. A 15% wide current account deficit of 2008 has also been brought to balance, though mostly as result of recession reducing imports.

The excessive and prolonged austerity (steep cuts in government spending, tax hikes, sharp wage cuts) has left a lasting impact on the economy's productive capacity. In terms of GDP per hour worked, Greece was the only OECD economy with a negative performance during the period 2010-2016.[1] During the crisis years, the rate of GDP decline exceeded that of unemployment growth, which accounts for the negative growth of labor productivity. Fixed capital formation is now at 13% GDP (from 24% pre-crisis), and the employment rate is below 60% (against 72% EU average). Both the large investment gap and the low employment rate undermine the growth potential of the economy. Total factor productivity growth was poor as well, and historically among the lowest before the crisis, due to the relatively low openness of the economy and a high share of labor in non-tradable sectors.[2] Restoring productivity growth will be among the country's greatest challenges in the years to come, so that incomes can grow and the economy can expand in a healthy manner. Productivity growth has been the target of many of the implemented structural reforms, and those that remain on the agenda for the future.

Since its first year of recession in 2008, Greece has registered almost a decade-long equivalent of a Great Depression (as steep as the US in the 1930s, but twice as long). The economy posted GDP growth of 1.4% in 2017 (positive for the first time since 2014) and 1.9% growth is expected for 2018. The economic sentiment index in July 2018 reached the highest level since June 2014. But such recovery is subdued, and Greece remains among the worst performing economies in the Eurozone. Tax rates, combined with social security contributions, are among the highest in the EU, especially taking into account the now low per capital income, operating as a disincentive for formal employment and business. Banks remain fragile, burdened by a mountain of non-performing loans (slightly below 50% of their total loans), and will remain incapable of financing the real economy for several years.

On the positive side, huge adjustment has taken place. The country has eradicated its twin deficits, has restored price competitiveness in terms of unit labor cost, and has implemented a vast array of structural reforms (in tax administration, pensions, the health system, the labor market, services and product markets, public administration, etc.). Their positive impact will be felt by the Greek economy as it moves to recovery. Notably, the worst outcomes, both for Greece and the Eurozone (a disorderly default, a catastrophic exit from the Eurozone) have been averted. But at a cost that was unnecessarily severe.

An extremely ambitious fiscal framework

The Eurogroup statement of 22 June 2018 summarized the decisions of the Eurozone lenders on debt relief, conditionality, and the future fiscal path. Greece has committed to sustaining a primary surplus of 3.5% of GDP until 2022 and an average 2.2% of GDP for the period from 2023 to 2060. In addition, Greece has committed to continue and complete important

1. https://read.oecd-ilibrary.org/economics/oecd-compendium-of-productivity-indicators-2018_pdtvy-2018-en#page1
2. IMF, "Greece", Country Report No. 18/248, July 2018, p. 56.

reforms - enhancing fiscal sustainability and growth: these include tax administration, public financial management, pension system consolidation, health modernization, social safety nets, resolution of bad loans, the labor market, investment licensing reform, completion of the cadaster, liberalization in the energy sector, extensive privatizations, and public administration reform.

Practically, Greece remains bound by what is not too dissimilar to a 4th program, except for the lack of new funding: there is a tight fiscal framework spanning to 2060, specific reforms to be completed, legislated austerity measures (pension cuts and reduction of the income tax free threshold) to be implemented. The country's performance will be closely monitored on a quarterly basis by the EU institutional lenders and the International Monetary Fund (IMF) (which remains on in an advisory capacity), in a process framework of Enhanced Surveillance (under the Two Pack) more rigorous than the one applied in the cases of other post-bailout countries (Ireland, Portugal, Cyprus). This framework will ensure the continuing adjustment of the Greek economy even in cases where domestic political will may be found waning.

Importantly, Greece has secured sustainability of its debt obligations until up to approximately 2032. The Eurogroup agreed to provide an additional 10-year deferral of EFSF (European Financial Stability Facility) interest and amortization and a 10-year extension of the maximum weighted average maturity. The grace period on the EFSF loans is extended from 2022 to 2032, upon the end of which the Eurogroup will examine whether additional reprofiling measures will be needed to ensure debt sustainability, provided that Greece sticks to its commitments. It is most likely that by the end of that period, if not earlier, the Eurogroup will decide that a further round of grace period and maturity extensions is necessary to ensure that the debt can be serviced. So, the runway has been cleared up to 2032, but not beyond that, which makes it difficult for investors, companies, the Greek people to regain trust in the longer-term future of the economy.

The debt reprofiling measures are upfront. But certain other measures (mainly the return to Greece of the profits on Greek bonds purchased by the Eurosystem, totaling €5.8bn over 2018-22) will be conditional upon post-program compliance, to be approved every semester by the Eurozone parliaments. So, economic policy will remain under intense scrutiny, and a balanced combination of carrots and sticks is set to ensure that adjustment remains on track.

Debt sustainability has been defined in terms of gross financing needs (GFN), which should remain below 15% of GDP in the medium term and below 20% of GDP thereafter. Greece's public debt (at 180% GDP) is large in stock terms, but the actual financial flows needed to service it are lower than its size would suggest. This is because of the long-maturity profile, extended grace periods on the payments of interest and amortization, and the fact that the debt is overwhelmingly in the hands of the "official sector" (EU and the IMF), rather than subject to the vagaries and fluctuations of market financing.

Debt markets, so far, have reacted with skepticism to the completion of Greece's bailout program. Spreads have remained high, or even further increased, heavily subject to periphery contagion from Italy and Turkey. And that despite Greece's rating upgrade by all credit rating agencies, which is expected to continue. Importantly, the Eurogroup has secured a €24bn cash buffer for Greece, covering sovereign financial needs up to summer 2020. This minimizes the risk of Greece being unable to refinance its sovereign debt for the next two years. Optimally, the cash buffer should serve as a guarantee for accessing the markets (part of it to buy out the most expensive IMF loans) rather than the actual source of funding for meeting sovereign debt obligations.

Probably the weakest link in Greece's post-bailout framework concerns the agreed primary budget surplus targets over the following years and decades. These are generally considered to be extremely ambitious for a weak economy exiting such a severe crisis. The IMF has strongly challenged the assumption that the Greek economy, or even any economy, can realistically sustain such fiscal targets, for such an extended period of time. The IMF has provided evidence to back its claims. Examining a sample of 90 countries during 1945–2015, the IMF found only 13 cases where a primary fiscal surplus above 1.5% of GDP could be reached and maintained for a period of ten or more consecutive years. Only three cases can be identified if the primary surplus threshold is increased to 3.5 percent of GDP; and only one case if resource-rich countries are also excluded.[3]

So, international experience suggests that Greece has embarked on a near mission impossible. The IMF longer-term projections forecast a more realistic primary surplus of 1.5%. A major additional disadvantage is that the debt payments serviced by the large primary surpluses will be leaving the Greek economy, as the Greek debt is overwhelmingly held by official institutions and other foreign investors. This compares unfavorably with other high-debt countries, such as Italy, Japan or Belgium, where most of the debt was held by domestic banks, pension funds and other institutional investors, debt payments largely remaining in the domestic economy to become spending and investment.

Political risk has been reduced but political challenges remain

Greece has completed its 3rd bailout program amidst an environment of declining political risk. Political risk was severely destabilizing during most of the bailout period. Political risk was associated with failure to implement the program, government vulnerability and the major opposition party pledging to discontinue economic adjustment. In the early crisis years, there was widespread concern that the government would never manage to implement the magnitude of adjustment required, because of government collapse or radical political change. This in turn was translated into speculation on Greece eventually crashing out of the euro. The "Grexit" risk dominated press headlines and market analyses throughout 2010-12. It severely hampered recovery efforts. It subsided in 2013-14, after the then coalition between the centre-right ND (New Democracy) and the social democratic PASOK (Panhellenic Socialist Movement) took on to loyally implement the 2nd bailout program. The Grexit risk resurfaced and reached a dramatic peak in the first semester of 2015, during the erratic and confrontational negotiation of Tsipras-Varoufakis, which culminated in the July 2015 referendum and capital controls.

Subsequently, the second government of Alexis Tsipras, elected in September 2015, proceeded in completing a U-turn, implementing the obligations of the 3rd program it had signed, and the Grexit speculation gradually faded away. The risk of Grexit (currency redenomination), as an extreme version of political risk, is now out of sight. The main reason for this is that the coalition between SYRIZA (Coalition of the Radical Left) and ANEL (Independent Greeks), which once represented the most fervently demagogic coalition in the Eurozone, has now a track record of compliance to the Eurozone rules and the bailout program, even though they retain many of their old populist habits. The major opposition party, the centre-right ND, promises to expand and intensify pro-market reforms (such as market liberalization and privatizations), seeking to gain fiscal space to reduce taxation, while respecting Greece's obligations to the Eurozone and commitments to the lenders.

So, contrary to other countries where anti-EU, anti-euro or euro-skeptic parties have risen to power or broadened their parliamentary influence, the Greek political system remains remarkably anchored behind the EU and the euro acquis. One should remember that the 3rd bailout program was voted in July 2015 by an extraordinary majority of five parties and 222 MPs (out of 300), as a desperate act of political unity to avert a Grexit. This is no small achievement if one considers the gravity of the economic crisis, and the rising forces of anti-Europeanism, nationalism and populism in Europe and the US.

This is far from suggesting that political risk has been eradicated. However, the main political challenges ahead are associated with the normal political cycles in any European democracy.

Political developments over the next year will be defined by the timing and circumstances of the next general election. September-October 2019 is the latest that the elections can take place, upon completion of the 4-year government term. It is more likely that the Tsipras government will seek to bring the elections forward, calling a snap election to coincide with the European elections of 26 May 2019. A twin election (or in fact a triple election, as local elections could also be scheduled as well) carries the political advantage of allowing voter discontent to be defused through

3. IMF, "Greece", Country Report No. 18/248, July 2018, p. 60.

more anodyne channels, giving SYRIZA the chance to maximise its possible vote under conditions of heavy polarization.

A potential catalyst, and issue to watch, is the ratification process for the Prespes agreement. The bilateral agreement over the name Republic of North Macedonia has been backed by SYRIZA but opposed by its junior coalition partner, the nationalistic right-wing Independent Greeks (ANEL), as well as ND and KINAL (Movement for Change), the successor party to PASOK. If the agreement is ratified by the Parliament of the neighbouring country, on the assumption of a positive referendum outcome, then the Tsipras government would most likely bring the agreement for Parliament ratification around February or March 2019. This could lead ANEL to theatrically abandon the government coalition, depriving it of its Parliament majority. This process could conceivably lead to a snap election in May 2019, together with the European elections.

There are signs that the Tsipras government is already gearing up for what could prove to be a prolonged electoral campaign. There is now a shifted emphasis on the "return of sovereignty" and political ownership of the (limited) socioeconomic dividends of the program. The government has made clear its intention to raise the minimum wage, to abolish the subminimum (for workers below the age of 25), and to restore some elements of collective bargaining legislation. The Tsipras government is also strongly pursuing the Eurogroup's consent for deferring the legislated pension cuts of 2019 (total €1bn), which are to be included in the October 2018 budget. The IMF has already signalled disagreement. Any unilateral government initiative could seriously undermine credibility and the good will capital that was built over the previous period. Other distributive or social protection measures are also in the pipeline, seeking to politically capitalize on the overachievement of the budget surplus target.

The New Democracy (ND) party has been consistently leading in the opinion polls, with a safe margin from SYRIZA ranging between 6 and 12 percentage points. If the ND party, led by Kyriakos Mitsotakis, rises to power, it will face some formidable political challenges of its own.

First, the challenge of obtaining absolute majority in Parliament or, failing that, of forming a viable government coalition. The obvious candidate for coalition partner would be KINAL, the successor party of PASOK. PASOK had been the ND's coalition partner in 2012-14; KINAL has so far ruled out the possibility of participating again in an ND-led government.

Second, an assumed ND-led government of 2019 could be faced with the spectre of a new election, by March 2020, if it does not manage to gather a 180/300 cross-party supermajority in Parliament to elect President of the Republic. The elections after the next would be held under an electoral system of simple proportional representation (legislated by the current Tsipras government), under which the only possible majority coalition would have to comprise both major parties, ND and SYRIZA. This is why it is expected that among its first acts, an ND government will seek to reinstate a system of reinforced proportional representation, favouring the winner of the elections. This also entails the possibility of consecutive elections until a viable government is formed.

The economy remains the greatest challenge

Having done away with the most extreme versions of populism, Greece's foremost challenges remain economic. In the medium term, Greece will be challenged to meet its agreed primary surplus targets without emaciating the economy, ending up in a vicious cycle of perpetual fiscal austerity, stagnant growth, target slippage, additional fiscal measures, recession, and so on. This was the vicious cycle in which the Greek economy was locked under its consecutive bailout programs.

Achieving stronger economic growth is key. In the medium and longer term, Greece needs to continue, consolidate and expand the reforms that will allow it to complete the shift to a greater reliance on the tradable (as opposed to the non-tradable) sectors of the economy, with a greater and more systematic export-orientation, and an emphasis on higher-technology, higher value-added activities. Starting from a very low share, exports now constitute 34% of GDP. This is a clear improvement, yet still less than that of Portugal or Spain, and lower than what the economy requires in order to boost revenue from supplying more products and services to the international market.

The country needs to attract more foreign investment, on a much larger scale than current foreign direct investment inflows, and on an ongoing basis. Although foreign investment is rising, also due to privatizations, levels remain below the EU and Eurozone average. Apart from reducing the investment gap in the economy, foreign investment can also contribute to effectively interconnecting the Greek economy with the necessary international networks and global supply chains.

Notably, Greece will need to improve its ranking in all the indicators that affect international competitiveness and the country's attractiveness to domestic, and especially foreign, investors, as listed in the World Bank (Doing Business) and World Economic Forum (Global Competitiveness) surveys. These suggest reforms and improvements in a wide array of relevant areas: from streamlining the justice system, licensing and red tape, the effective protection of property rights and the cadaster, to a more investment-friendly tax system, greater connectivity of education and training with the business marketplace, more effective social safety nets. Such reforms, many of which have been initiated over the previous years, will allow the Greek economy to raise productivity and potential output, to also address the shrinking labor pool and ageing of the population. The challenges ahead are formidable, but so is the distance already covered.

About the Author

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