

Why Greece is different

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The seemingly never-ending theatre of the negotiations between the new Greek government and its international creditors – the International Monetary Fund, the European Central Bank and the European Commission – has now entered a more dangerous phase where a mistake on either side could lead to an accident.

The IMF seems ready to throw in the towel. The latest news that the budget for this year threatens to go into a small primary deficit, instead of the sizeable surplus originally planned, adds to the exasperation on the creditors' side. But as the Greek economy is tanking again, there is also a feeling in Athens that the programme imposed by the creditors is not working, and maybe cannot work.

The current predicament has cemented the narrative that Greece is the victim of a wrong treatment, namely an excess of austerity. However, this narrative overlooks the fact that the approach, which is supposedly the cause of all the problems Greece is facing, worked in other peripheral countries. Portugal, Ireland, Spain and even Cyprus, are all recovering visibly. They no longer need official financing, and unemployment is coming down, albeit slowly and from elevated levels.

What makes Greek different? The short answer is exports

In all the other peripheral countries (and indeed in most of the dozens of countries with an IMF programme over the past decades), growing exports have provided a vital support, providing at least a partial offset to the reduction in demand coming from the government, which has to slash expenditure and increase taxes to balance its books.

Looking at the need to re-balance the external accounts shows that the argument about 'self-defeating austerity' does not make sense for Greece. In a large economy, which does not have problems of external financing, like the US or the euro area, one can certainly imagine that the attempt to lower a deficit leads to such a fall in demand and therefore a decline tax revenues, thereby making austerity self-defeating. But Greece is not in this situation. It was running very large external deficits (over 10% of GDP) when external finance dried up suddenly in 2008-09, forcing an adjustment in domestic

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spending. If the Greek government had continued to spend as it had before, domestic demand and employment would certainly have been higher. But imports would also have remained much higher, and the current account would have remained in a large deficit. It is true that austerity caused a deep recession, but without the recession there would have been large external deficits. With less austerity Greece would have needed an even bigger bail-out (and would have an even-larger debt today).

Export performance is thus the key to escaping the austerity trap. At first sight one might think that Greece is not doing so badly since overall exports have been growing somewhat lately. However, closer inspection reveals that this is an illusion. Most of the growth of exports has come from petroleum products. As Greece is not a producer of oil, this can only mean that Greek refineries, which have now lots of spare capacity, are re-exporting imported crude oil in a slightly different form. Since refinery margins are usually less than 5%, this means that these exports generate very little value added for the Greek economy. A large proportion of other exports are of a similar nature (metals, etc.). Moreover, the largest item in service exports, namely maritime shipping, also has few links with the Greek economy as this sector pays no taxes, employs few people (the crews are from low-wage countries) and shipping rates depend mainly on the global commodity cycle, which has turned down.

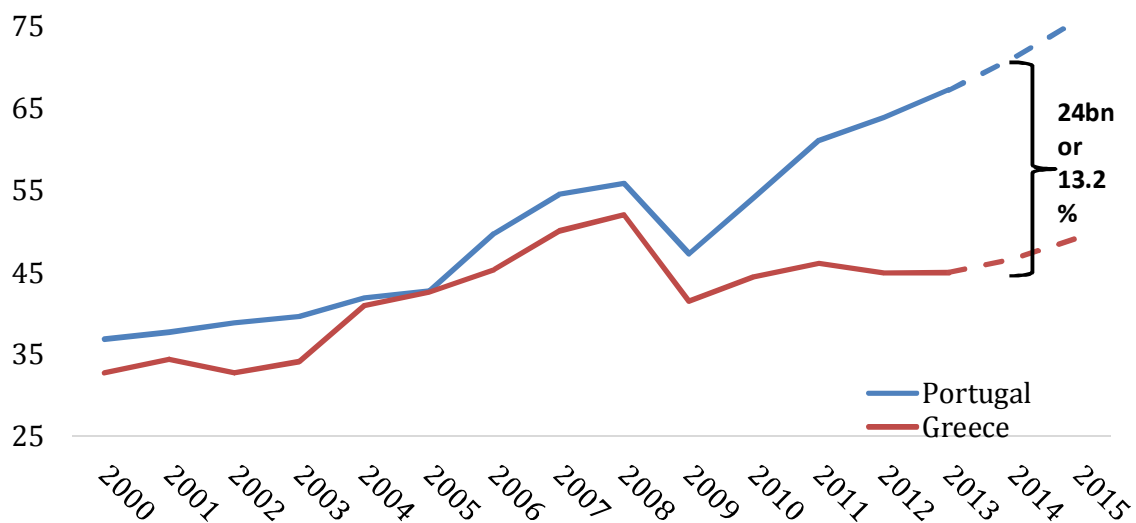
The exports of manufactured goods, which create domestic value added and employment, are thus a small part of overall exports and a surprisingly small part of the overall economy, accounting for only around 12% of GDP, much less than what one would expect from such a small economy.

The fact that trade accounted for such a small proportion of GDP is important because trade or current account deficits are usually measured as a % of GDP. But if one wants to measure the adjustment required from the tradable sector one should compare the deficit, not to GDP, but to the trade flows themselves. In the case of Greece this has stark implications: in 2008, the trade deficit (goods and services) amounted also to about 13% of GDP, higher than the weight of exports in GDP. This implies that exports (or rather those that should be stimulated by an internal devaluation) would have had to more than double in order to eliminate the external deficit if one wanted to avoid a fall in imports (and thus domestic demand).

In the case of Portugal, by contrast, the trade deficit amounted to 'only' about one-third of exports. Portugal thus required only an increase in exports of about one-third to close the external deficit, and still keep imports at the same level. This is indeed what happened over the last few years: Portuguese exports increased cumulatively by over a quarter, while imports are now at a slightly higher level than in 2007, but the trade balance has swung into surplus. In Greece, the trade balance has also adjusted (although it is not yet in surplus). However, the adjustment pattern has been the opposite: exports (if properly measured) have stagnated whereas imports have collapsed. This absence of growth in exports despite a fall in wages of over 20% is the real problem, not excessive austerity. If Greece had experienced the same growth in exports as Portugal (a country of similar size and per capita income), the recession would have been much shallower and the government would have found it much easier to achieve a primary surplus as tax revenues would have been much higher.

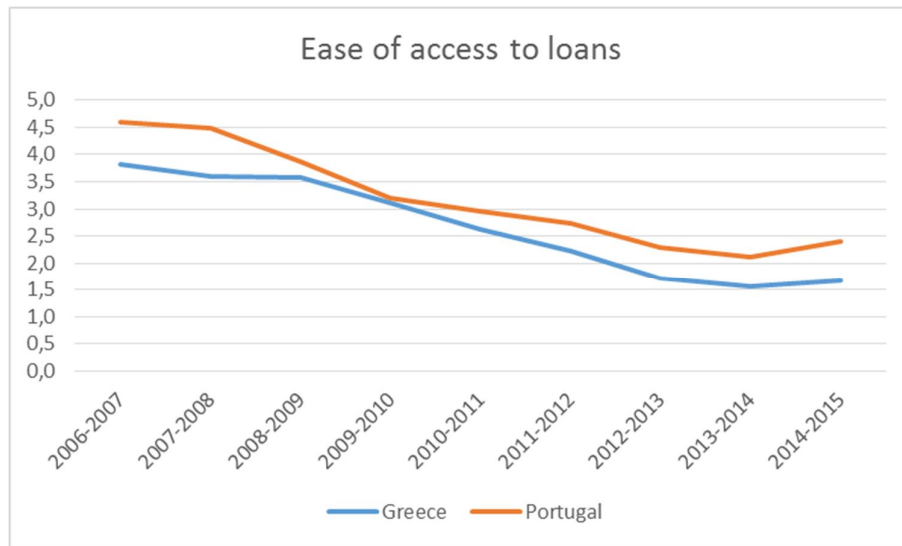
Figure 1 below shows the evolution of total exports of (non-fuel) goods and services for Portugal and Greece. Until 2008 both countries seemed to experience solid growth. However, in the case of Greece this was due to the commodity-price boom of those years, which artificially increased the recorded value of commodity exports (such as copper and aluminium) and the associated increase in freight rates. Since 2007-08, Greek exports have been flat, whereas those of Portugal have grown substantially, as mentioned above. The cumulative difference over the last six years amounts to over 13% of Greek GDP. With Portuguese-style export growth, the fall in GDP would have been less than one half. Moreover, government revenues would be at least 6% of GDP higher (given that taxes take about 45% of GDP), which would have made it easy for the government to achieve the primary surplus foreseen by the original adjustment programme.

Figure 1. Exports of goods and services: Greece vs Portugal



Many commentators and the Greek government itself argue that exports cannot grow due to a lack of credit. The ongoing credit crunch in Greece must indeed constitute an obstacle to export growth, but the importance of the phenomenon has been overstated. Enterprises in Portugal were apparently able to increase their exports considerably although that country also experienced a serious credit crunch at the height of the crisis. Moreover, in regular surveys by the World Economic Forum about the availability of credit, one finds that this is indeed perceived as an obstacle, but the difference between Greece and Portugal is minor (see Figure 2 below).

Figure 2. Ease of access to credit: Greece vs Portugal



The only other important case in which the standard approach of fiscal consolidation coupled with lower wage costs plus reforms to stimulate exports has not worked is that of Argentina. This country defaulted on its foreign debt in 2002, and broke a decade-long 1:1 peg to the US dollar. Unfortunately, Greece resembles Argentina in two key respects.

Both countries have only a small exporting sector, which made the external adjustment much more difficult. And, both countries have an export structure tilted towards commodities whose supply is unlikely to react much to either structural reforms or lower wages.ⁱ

This similarity does not mean that Greece is doomed to follow the path of Argentina and default as well. But policy-makers need to realise that it takes time to build a new export sector basically from scratch. They should concentrate talks on how to stimulate exports, rather than discussing only the budget.

ⁱ Argentina experienced a sharp turnaround after its 'Argexit' in 2002, because commodity prices started to increase soon thereafter. The huge increase in grain prices, and that of oil, over the next few years paid for an extended period of increasing living standards and unorthodox policies. But all of this was due to the global commodity boom driven by China. The huge devaluation of the peso did not improve export performance, on the contrary. During the decade before the devaluation (when the peso had been linked 1:1 to the USD), real export growth had averaged 9% per annum. Over the next decade it fell to only 3.3% although global trade growth remained close to 6%. Moreover, there was no diversification in the structure of exports, which remains concentrated in commodities.