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No pain, no gain? Economic adjustment programmes in Greece and Portugal

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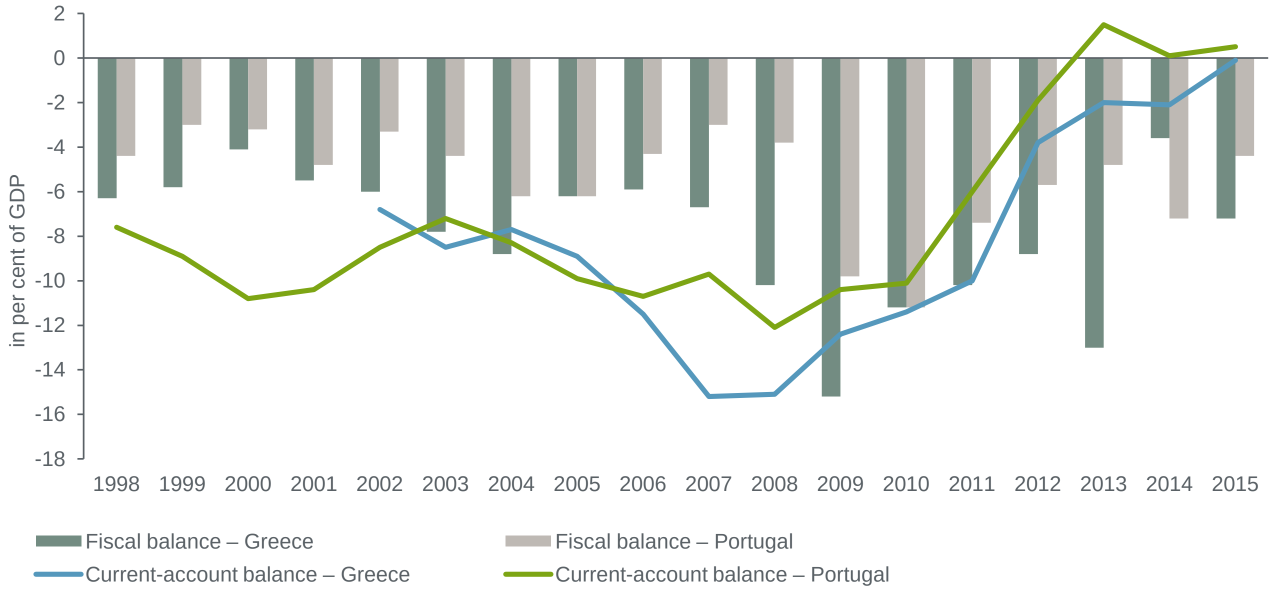
Greece and Portugal were both bailed out by rescue packages from European partners and the IMF. At the start of the programmes, both countries were facing similar economic challenges such as high (new) debt and a high current account deficit. The programmes called for austerity measures and structural reforms to restore their competitiveness and enable them to quickly return to the capital markets. This adjustment process was more successful in Portugal than in Greece, among other things because of less austerity requirements, faster export growth and greater political planning certainty. A successful exit from the programmes, however, is only a first milestone in the return to economic normality, as the tense situation in Portugal currently illustrates.

In the spring of 2010, Greece was the first country in the euro area requiring financial support to meet its government's payment obligations. The support was linked to a macro-economic adjustment programme imposed by the troika (the European Commission, the European Central Bank and the International Monetary Fund). As the euro crisis began, Portugal also ran into trouble refinancing its public debt and in April 2011 was the third country after Ireland to apply for financial support from the European Union and the IMF.

At first glance, Portugal and Greece have a lot in common. Both are "small" economies, both lie in the European periphery and both were facing similar economic challenges at the time they applied for support. Their public debt levels were high and access to the capital market restricted; and both countries had a "twin deficit", that is, a negative fiscal balance and a current-account deficit (Figure 1).

One major difference, however, is the fact that Portugal was able to end the economic adjustment programme earlier than expected in the year 2014 and return to the international capital markets. At that time the Portuguese adjustment programme was rated a success[1]. Nevertheless, the tense situation in the banking sector and the looming downgrade of its creditworthiness show that the patient is not yet out of the woods. Nonetheless, the situation in Greece is fundamentally different. Since the first rescue package was not sufficient, two more had to be put together in 2011 and 2015, accompanied by numerous crisis summits in Brussels and the threat of a "Grexit". To understand why Portugal succeeded (initially) in exiting from the financial assistance, unlike Greece, it is worthwhile to compare the programme assumptions and the economic reality, especially in the phase between 2010 and 2014.

Figure 1: „Twin deficit" in Portugal and Greece



Source: Eurostat, own calculations

The objective of the first programmes

The adjustment programmes for Greece and Portugal were designed in a very similar way. The overarching programme objectives were: 1) to stimulate economic growth and rebalance (external) imbalances, 2) to enable a return to the capital market by consolidating public finances, and 3) to ensure financial stability both in the programme countries and in the euro area. To achieve these objectives, the troika's financial assistance was tied to specific conditions. These included, for example:

- Austerity measures

Greece and Portugal had lost access to the capital market as a result of their high public (external) debt, among other reasons. Fiscal consolidation was intended to restore investor confidence. To this end, the programme established specific annual deficit targets. The countries were expected to lower their high debt to a sustainable level through an ambitious and credible austerity policy.

- Structural reforms

The programmes include a specific list of structural reforms ranging from flexibilisation of labour markets through the opening up of product markets and reforming social security systems to improving the efficiency of public administration. The reforms aim to enhance competitiveness and create the prerequisites for export growth and more investment.

Mismatch between expectations and reality

Although the programmes are similar, the results they achieved differ considerably. This is visible, for one thing, in the discrepancy between the GDP forecasts underlying the first programmes and the values actually realised (Figure 2).

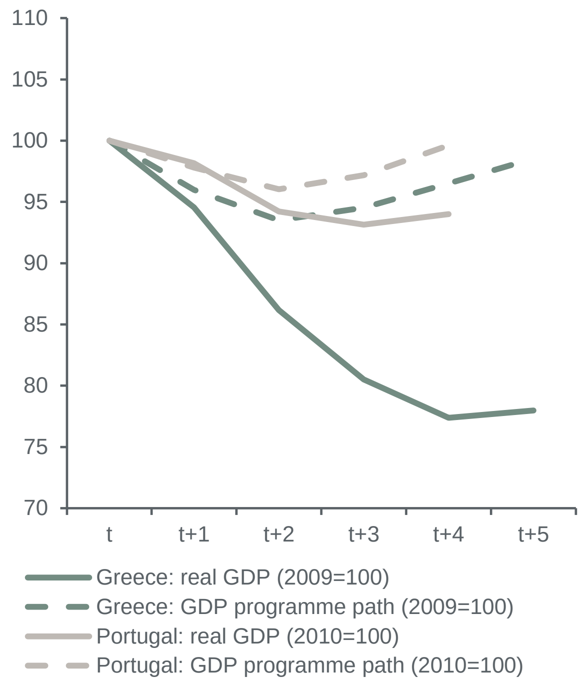
In retrospect, the growth assumptions for both economies turned out to have been too optimistic, especially for Greece. Its actual GDP in 2014 was around 20 % below the forecast levels. Evidently, the first programme for the country remained significantly behind expectations. But where exactly was the snag?

Prosperity through austerity?

Portugal and Greece had also lost access to the capital market because of their high public debt. In order to lower their accumulated debt to a sustainable level, the programme imposed specific austerity targets on the countries.

Thus, they were expected to improve their primary balances, that is, the difference between state revenues and expenditure minus interest payments due, and generate surpluses. For Greece, both the planned and the actual austerity measures achieved were higher (Figure 3). The structural deficit – adjusted for cyclical fluctuations – as a further measure of the consolidation course also illustrates that Greece in particular tightened its belt. Between 2009 and 2012 it fell by around 13 percentage points in Greece but by a mere five percentage points in Portugal.

Figure 2: Path of actual real GDP and programme path



Sources: Eurostat, EU Commission, own calculation

A reduction in public demand, however, affects economic growth. The exact correlation is measured by what is referred to as the fiscal multiplier. Generally, the higher the value of the multiplier, the more strongly GDP reacts to changes in public spending.

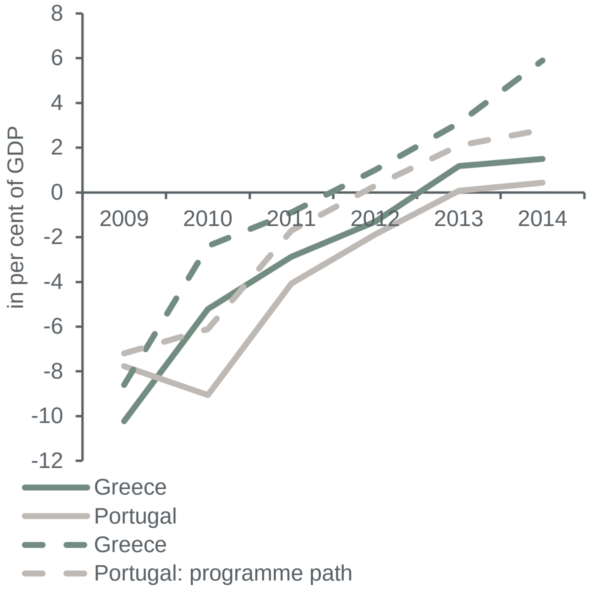
There is ongoing disagreement among economists regarding the exact size of the multiplier. What is certain is that the multiplier varies from country to country. It is likely to be higher in times of economic downturns[2] and financial crises[3]. Besides, an IMF study shows that the size of the fiscal multiplier was grossly underestimated at the beginning of the crisis[4]. When we consider macroeconomic conditions such as people's propensity to save, the degree of openness of the economy or the tax burden, Greece has a higher multiplier relative to Portugal[5].

As a consequence, the austerity policy in Greece affected economic growth more strongly through two factors: a) the stricter austerity targets and b) the (probably) higher multiplier – which was underestimated by the forecasters.

A look at the drivers of growth

The programmes already factored in a moderate decline in economic activity. However, the plan was for the dampening effect of reduced public demand to be offset by other components. Structural reforms were expected to improve competitiveness and boost export growth. So it is worthwhile to look at the drivers of growth (Figure 4).

Figure 3: Primary balance



Sources: EU COM, IMF WEO, own calculation

Before the crisis, the high economic growth in Portugal and Greece was driven primarily by private and public consumption while the trade balance, measured as the difference between exports and imports, was negative. During the crisis the weight of the drivers of growth shifted, as was expected. The balance of trade turned positive on average for Portugal and Greece. At first glance, the programmes appeared to have fulfilled their purpose of generating growth through higher exports. On closer inspection, however, a major difference becomes apparent. While the contribution of exports to economic growth more than doubled in Portugal, it fell slightly on average in Greece, where the positive trade balance was instead brought about by the collapse of imports.

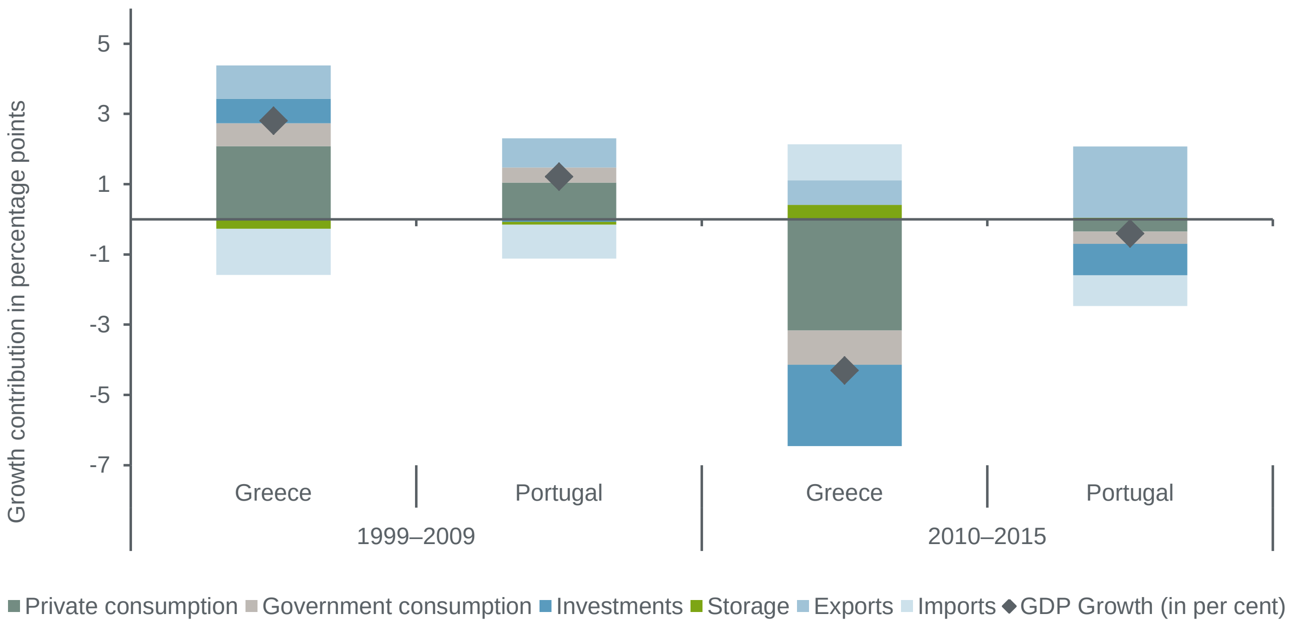
Greece's exports have been flat

A national economy with a currency of its own can lower the nominal exchange rate to restore price competitiveness and thereby boost export growth relatively quickly. This option is not available to Portugal and Greece as they are members of the euro area. They have to take the slower and more difficult path of internal devaluation: to restore their competitiveness, they have to adjust domestic prices and wages.

They have already made some progress. While unit labour costs in the euro area rose by 5 % between 2010 and 2015, they actually fell by 5 % in Portugal and by as much as 10 % in Greece. As well, the real effective exchange rate depreciated for the two programme countries in the same period: by 2 % in Portugal and by around 8 % in Greece. Their competitiveness has thus improved.

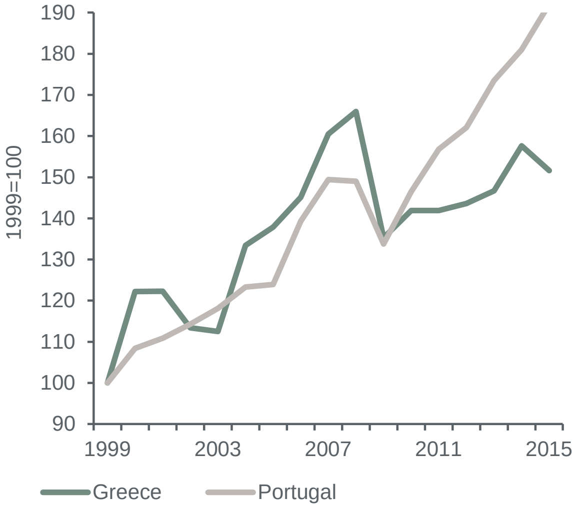
Unlike Portuguese exports, Greek exports of goods and services responded only sluggishly to these changes (Figure 5). They remained nearly unchanged since 2010 and it was not until 2014 that they rose again slightly. This contrasts with the programme assumptions of around 5 % annual export growth. Thus, in the case of Greece, the decline in domestic demand was not offset by impetus from abroad, so growth turned out lower than expected. The "puzzle" of the missing Greek exports can be attributed to several structural factors.

Figure 4: Average changes in contributions to growth



Source: Ameco, own calculation

Figure 5: Greek exports remain below pre-crisis level



Source: Eurostat

- A narrower export base

As a general rule, closer integration into the global market indicates competitive advantages in the export sector. But Greece's economy is relatively closed. In 2010 the export ratio was only 22 % of GDP, while that of Portugal was eight percentage points higher. By comparison, the export ratio of Germany, a successful exporting country, was 42 % in 2010. Portugal is hence generally in a better starting position for strong export growth than Greece.

- Institutional deficits

Based on the Ease of Doing Business Indicator, which rates the quality of corporate regulation, Greece improved from rank 109 in the year 2010 to rank 60 in 2015, while Portugal climbed from rank 31 to 23 in the same period. These successes are noteworthy. Nevertheless, institutional factors appear to be a stumbling block, particularly for export growth in Greece.

It is estimated that Greece exports around one third less than the country's fundamentals would actually suggest[6]. A large part of this gap can be explained by relatively weak institutional factors. Thus, Greece generally scores lower on indicators of institutional quality, the rule of law and corruption than the EU average. According to the OECD, Greece is also clearly below the euro area average with respect to product market regulation. Rather anti-competitive and inflexible regulation is slowing down the necessary adjustment processes and preventing new, dynamic and export-oriented enterprises from entering the market, among other things.

- More small businesses

Expanding into foreign markets involves certain fixed costs, and the smaller the business, the harder it is to shoulder these costs. In Greece the density of micro-businesses (firms with fewer than ten employees) is 96.7 %, far above the EU average of 92.7 % and higher than in Portugal (95.2 %). These micro-businesses employ some 60 % of the workforce in Greece, but only around 42 % in Portugal.

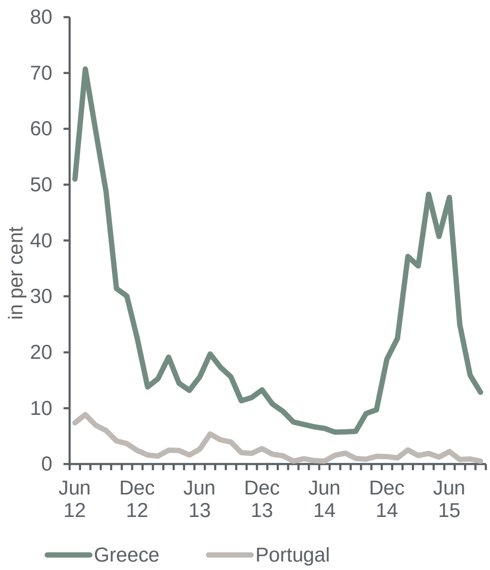
Policymakers also have influence

At the start of the adjustment programme in Portugal the three major political parties supported its implementation. As the programme progressed their poll ratings dropped somewhat, but at the same time no radical party was able to establish itself. Despite the change in government in 2015 and although today the political situation is tense, during the programme phase it appears to have been more stable in Portugal than in Greece. The political process there was marked by strong turmoil including votes of confidence, changes of government and a referendum. That turmoil can also be attributed to the dramatic collapse of the Greek economy, which it also accelerated.

Figure 6 shows survey-based assessments on the likelihood of Portugal and Greece remaining in the euro area[7]. Uncertainty over Greece remaining in the monetary union is significantly higher overall. What is striking are the spikes in the index during political events such as the new elections in June 2012, or during the referendum of June 2015. The increased likelihood of an exit also influenced language usage. Terms such as “Grexit” or “Graccident” were invented in specific reference to Greece's possible withdrawal from the monetary union.

Political uncertainty generally has a dampening effect on the real economy. For one thing, it unsettles entrepreneurs, causing both nationals[8] and foreigners[9] to either defer or altogether cancel investments. For another, uncertainty causes households to make higher ‘precautionary savings’ to prepare for more difficult times, so they consume less. Both factors lead to subdued growth.

Figure 6: “Euro break-up” Index



Source: Sentix

A cooling of the economy also has a negative impact on the banking sector. It causes the portfolios of non-performing loans to expand. In order to consolidate their balance sheets, affected institutions restrict lending to their customers, which has consequences for the private sector. Lack of access to funding is currently one of the most pressing problems for Greek entrepreneurs.[10] The interdependencies between politics, economics and the banking sector are multi-layered and difficult to separate. What is undisputed, however, is that an unstable political environment and uncertainty over the planned economic-policy course tend to negatively impact on the economy and banks.

Thus, the success of adjustment programmes is influenced not solely by economic but also by political factors. These were generally more stable in Portugal than in Greece.

Conclusion

Both Greece and Portugal applied for a rescue package from the troika. Although similar in design, the programmes' results differed substantially. While the Greek economy evolved much less favourably than the programme had assumed, Portugal largely remained on course.

Various factors played a role in Portugal's better outcome: 1) a more moderate austerity course that had less of an impact on business; 2) a fast-growing export sector as a result of closer integration into the global economy and better institutions, which bolstered the shrinking domestic demand, and 3) political stability and continuity. Portugal also benefited from lessons learned by the troika. Its looser austerity requirements were probably also a consequence of the failed programme for Greece.

The comparison illustrates that similar economies such as Portugal and Greece seemingly responded very differently to economic-policy measures. That was due in large part to their different economic structures. Future programmes will have be tailor-made to adequately take into account the specific country conditions. Moreover, adjustment programmes should be supported by a broad political majority.

A successful programme exit is an important first step in restoring normality. However, it is too early to give the all-clear and return to business as usual. Portugal serves as a warning. Its policymakers' willingness to enforce structural reforms has waned noticeably since 2015. In addition, some already implemented reforms are being reversed, which often causes additional costs. This is a cause of concern given the strained fiscal situation. Portugal was already called upon by the EU Commission to implement additional austerity measures in 2016 to meet the agreed budget targets. In addition, various structural problems are still waiting for a long-term solution, among them the consolidation of the banking sector, which is under pressure from weak profitability and a high rate of sub-performing loans. A further exacerbation of the situation combined with high public debt levels and falling economic growth could quickly upset the fragile balance in Portugal. This shows that putting the economic model back on a sustainable growth path is a long-term process that is more similar to a marathon than a sprint and therefore requires stamina and unwavering commitment. ■

[1] IMF (2015): "Portugal: Concluding Statements of the 2015 Article IV Mission", available at: https://www.imf.org/external/np/ms/2015/031715.htm.

[2] Auerbach, A. J. and Y. Gorodnichenko (2011): "Fiscal Multipliers in Recession and Expansion," NBER Working Papers 17447, National Bureau of Economic Research.

[3] Müller, G., Meier, A. and G. Corsetti (2012): „What determines government Spending Multipliers?", IMF Working Paper No. 12/150.

[4] Blanchard, O. and D. Leigh (2013): "Growth Forecast Errors and Fiscal Multipliers", IMF Working Paper No. 13/1.

[5] Gros, D. and C. Alcidi (2012): "Why is the Greek economy collapsing? A simple tale of high multipliers and low exports", CEPS Commentary.

[6] Böwer, U., Michou, V. and C. Ungerer (2012): "The Puzzle of the Missing Greek Exports", European Economy Economic Papers No. 518.

[7] The authors wish to thank Sentix for providing the data free of charge.

[8] Bernanke, B. S. (1983): "Irreversibility, Uncertainty, and Cyclical Investment", Quarterly Journal of Economics, Vol. 97, No. 1, pp. 85–106.

[9] Julio, B. and Y. Yook (2012): „Political Uncertainty and Corporate Investment Cycles", Journal of Finance, Vol. 67, No. 1, pp. 45–83.

[10] See World Economic Forum at: http://reports.weforum.org/global-competitiveness-index/country-profiles/#economy=GRC