The two adjustment programmes that Greece accepted in 2010 and 2012 went off track for one main reason: the recession was much deeper than anticipated. The exceptional downturn of the Greek economy was attributable to two main reasons: the extraordinary fall in investment and the lack of export recovery.

The convertibility risk combined with the ‘sudden stop’ in private capital inflows, which Greece has experienced since 2010, along with the political uncertainty that was exacerbated by the more recent capital controls, were largely responsible for a slump in investment from which the economy never recovered. This resulted in a large and persistent fall in GDP, which led to a larger-than-expected shortfall in tax revenue and contributed to disappointing budgetary results. One of the assumptions of the programme, which also reflects the typical expectation from economists about the performance of a small open economy was that even a large fiscal adjustment is not necessarily very painful if external demand compensates for the weakness of internal demand.

As shown in Figure 1, this expectation clearly turned out to be true for Portugal and Spain but very wrong for Greece, where the fiscal correction was far larger than the increase in exports.

There are several partial explanations for the country’s bad export performance. Some relate to the structure of the Greek exports, composed largely of commodities and maritime shipping, which tend to respond little to a real devaluation. But what remains difficult to explain is the lack of growth in the (small), non-oil, non-commodity goods exports and services, such as tourism. Sluggish export markets were not the reason, as the average growth rate of the Greek export markets was actually higher than for most euro-area member countries. The fundamental puzzle that remains is why...
the impressive fall in wages did not result in real increased competitiveness.

During the first two adjustment programmes, Greece recovered a considerable amount of wage competitiveness. As shown in Figure 2, wages fell by close to 25% in absolute terms, and even more relative to the euro-area average. If one compares this to the wage adjustment that took place in Spain, Italy and Portugal, this is justly impressive.

It is difficult to assess how much of this predicament can be ascribed to the labour-market measures of the adjustment programmes and how much to the deep recession combined with the record-high unemployment. Before 2009, the correlation between wages and unemployment was very weak in Greece. Fluctuations in unemployment had remained limited during the boom years, when wages actually increased. By contrast, after 2012, the fall in wages that occurred seems to be commensurate with the increase in unemployment, comparable to what one would expect from the Phillips curve relationship of other countries.

Moreover, as suggested in Figure 2, the change in wages was not reflected in unit labour costs in the same way across countries. Indeed the change in unit labour cost (relative to Germany) was almost the same in Greece, Spain and Portugal, despite the difference in the wage adjustment. This is evidence of Greece’s inability to translate the drop in wages into an increase in competitiveness.

In view of the fact that Greece is now starting programme number 3, the natural question is whether it can make it work. Will the country be lucky the third time round? Or will the third time be easier?

It is often argued that the third bailout programme cannot work because it is just the same as the previous two. Yet, this comment misses a crucial point. The current situation is completely different from 2010 and 2012. The economy is in worse shape, given the GDP losses, yet fundamentals have adjusted. Most of the fiscal and external imbalances have been corrected.

Despite a lack of control over public finances during the first half of this year, the primary balance is not that far off-balance, whereas it had been in deficit for over 10% of GDP in 2009. The primary-balance targets contained in the new programme will not require much of an effort if the economy recovers, as should be the case given the considerable drop in wages already achieved. The task of structural reform should also be easier. Implementation has always been the main problem, with only a small fraction of the reforms really implemented. But if another small fraction, say a further 25%, is implemented over the next few years, the Greek economic context may look completely different compared to four years ago.

Moreover, the political context looks different. There is now bipartisan support for the programme. The political uncertainty that has held back investment and exports should thus also abate. In 2014, the Greek economy had shown already some signs of recovery, which was nipped in its bud by the political drama that seized the country in the first half of this year. The same forces behind that change should now become even stronger allowing for sustainable growth.

**Figure 2. Per cent change in nominal ULC and wage compensation per hour worked**

![Graph showing per cent change in nominal ULC and wage compensation per hour worked for Greece, Spain, Italy, and Portugal.](Source: Eurostat and Ameco)