Narratives matter
Daniel Gros
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Especially when they are intertwined with hard interests. The Greek crisis, which was moving towards a disaster, provides a vivid illustration of how conflicting narratives can lead us close to a lose-lose result. The Council of the heads of state of the euro area of July 12th-13th almost failed because the two sides went into the negotiations with diametrically opposed narratives of what caused the problem in the first instance.

How did we get to this unhappy state of affairs?

In early 2010, when the government of Greece could no longer finance itself, it turned to the IMF and its European partners for financial support. It received the largest-ever IMF loan, loans from other euro area countries and later from the euro area’s bail-out funds. Over the years these loans grew to hundreds of billions of euro.

But this financial assistance, was perceived very differently in Greece than it was among the creditors. In Greece the deteriorating economic situation fostered the feeling that all these loans had not benefitted the country because “they only served to bail out German and French banks”. This narrative had the advantage of explaining the economic failure without having to admit that the own governments had also made bad policy choices. The feeling on the creditors’ side was of course different: “we saved your country from bankruptcy” after your government overspent for years. This narrative had the advantage that it allowed policymakers in Germany to claim that its own banks had financed Greece for too long.

Both narratives contained a large proportion of truth: a substantial part of the loans given to Greece until early 2012 was used to pay off maturing debt in part. However, it is likely that the holders of the debt were at that time no longer French or German banks, but rather hedge funds and other investors with strong nerves. The banks had probably sold part of their holdings at a loss because they have little stomach for the uncertainty that persisted until the haircut was actually agreed in March of 2012. Moreover, those banks and insurance companies (and some hedge funds) still holding Greek debt in March 2012 lost more than one half of the value (close to €100 billion). It is thus not true that there were no losses to investors, whether French or German.

Furthermore, this massive financial assistance also allowed Greece to reduce its fiscal deficits at a slower pace than it would have had if it had gone into full bankruptcy already in 2010. The popular narrative of heartless creditors imposing mindless austerity is thus wrong (at least until 2014): without financial assistance, the Greek government would have had to cut back on expenditure even more quickly as it would have been cut off from the markets.

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This gulf in expectations caused by these contrasting narratives could be contained as long as the situation on the ground improved, as it did in 2014, with a first quarter of growth and some drop in unemployment.

However, just when the situation was improving, the clash of narratives caused a deleterious spiral that led from the election of a new left-wing government in January this year, to the imposition of capital controls and the referendum. Earlier this year it still looked as if the Greek government could achieve a primary surplus, however small. The only reason why the country needed a new loan was thus to be able to make some large payments on old loans coming due now. In other words, Greece had ceased to be a ‘bottomless’ pit. At this point the country did not need any fresh money, just some financial engineering to postpone some large debt repayments, which everybody had known in advance that they could not make at this stage.

It did not make sense for the creditors to impose tough conditions on Greece for a loan that would only be used to pay them back (the Greek side knew this, as the proposal from Prime Minister Tsipras of June 30th stated explicitly: “The loan will be used exclusively to meet the debt service payments of Greece’s external and internal debt obligations” (http://blogs.ft.com/brusselsblog/2015/06/30/leaked-tsipras-letter-requesting-a-3rd-bailout/).

Much has also been written about the punitive nature of the conditions imposed by the creditors. However, closer inspection reveals that even in this area simplistic narratives hide a complicated truth. Right before the abrupt end to the talks, agreement had been reached over the fiscal targets, and the remaining disagreement concerned how these targets were to be reached. The Greek side wanted to increase some taxes, whereas the creditors thought that this would stifle growth even more and wanted to increase the tax base, for example, by eliminating the lower VAT tax rates for Greek islands. The intention was laudable, but this approach was resented by the Greek side as an intrusion into their sovereignty, and turned into a narrative of national pride.

Both sides knew of course during all the tortuous negotiations over the last months that, if they did not agree, they would lose. Greece would see its economy contracting even further. And the creditors would have to write down the value of their claims. They were caught in what economists call a ‘prisoner’s dilemma’. Both sides would be better off cooperating, and both would lose from not cooperating. However, both sides were prisoners of their own narrative. It was only after 16 hours of tough negotiations among heads of state that reason prevailed.

Heads of state could overcome their differences behind closed doors. But back home, the conflicting narratives have taken over fully. On the creditors’ side, there is anger over the perceived lack of trustworthiness of the Greek government (and after the referendum, of the Greek electorate). On the Greek side, the rejection of the creditors’ demands in the referendum was couched in terms of national pride and the sovereignty of Greece.

Saving Greece was always going to be difficult given its previous fiscal excesses and the absence of a strong export base. But last year it seemed that success was within reach, until conflicting narratives took over. The first half of 2015 was wasted in this useless conflict, which was not supposed to happen within the European Union. It remains to be seen whether this, third, package can create the conditions that allow Greece to grow again. The main obstacle to its implementation might actually be a new twist to the existing narrative, namely that Greece was blackmailed by Germany into accepting these humiliating and counterproductive conditions.