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The Greek Economy under Reform:

A Sisyphean task or a victorious way to Ithaka?[1]

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Introduction

Greece faces an economic crisis that turns out to be one of the most severe over the last decades. The costs are already significant and are illustrated on the strong negative impact on real economic activity: Greece has lost more than 20% of its GDP from 2008 to 2012, while increasing unemployment (nearly 25%) threatens social cohesion. At the same time political uncertainties during the last couple of years changed rapidly the nexus of political parties and their governing rules, as more radical voices emerged and gained power, although not dominating yet. Meanwhile, increasing currency risk questioned the position of the country in the Eurozone and hence in the European Union, as anti-European voices (less than 10% of the population at the beginning of the crisis) proliferated.

With a fiscal consolidation process underway, the Greek economy tries to implement quickly a wide range of reforms in almost all aspects of the economy. The aim is to support at the short term a restarting of the Greek economy and gradually a recovery of structural and cost competitiveness, while at a more long term to create the conditions and the mechanisms for a more sustainable growth model.

[1] Paper presented at the Konrad-Adenauer-Stiftung multipliers' workshop "Greece – The Unknown Neighbour: Political, Economic and Societal Perspectives", Berlin and Athens, December 2013.
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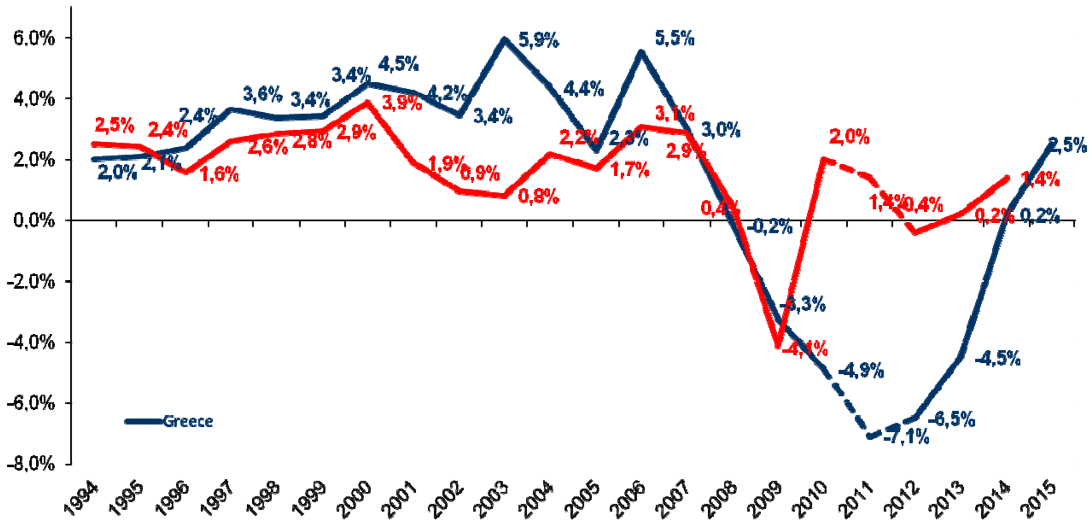
How did Greece get here?

The Greek economy was growing at an impressive rate in the years before the outburst of the global financial crisis. The average growth rate achieved by Greece during 2000-2008 was 3.7% while the Eurozone average was only 2%.

Figure 1

Real GDP growth



Source: Medium-Term Fiscal Strategy Framework 2013-2016 (Greek data), Eurostat (EZ data)

But this model of economic growth was not sustainable. It relied excessively on domestic consumption, which in turn was largely fuelled by credit expansion and unrealistically low interest rates, instead of a sustainable allocation of resources, especially to the tradable sectors. In a small economy like Greece this is not a sustainable pattern for a long-run period, without the necessary adjustments taking place at the same time on the supply side of the economy.

The fundamental imbalance of the Greek economic growth model is clearly depicted on the structure of the GDP (from the demand side). Data for the 2000-2010 indicate that Greece was consuming on average 91% of GDP (70% of which was private consumption), which is the largest portion observed in the Eurozone. Greece has also the lowest share of exports to its GDP as compared to other Eurozone countries, exporting only 22% of GDP on average during 2000-2010.

Table 1
GDP components (% of GDP)

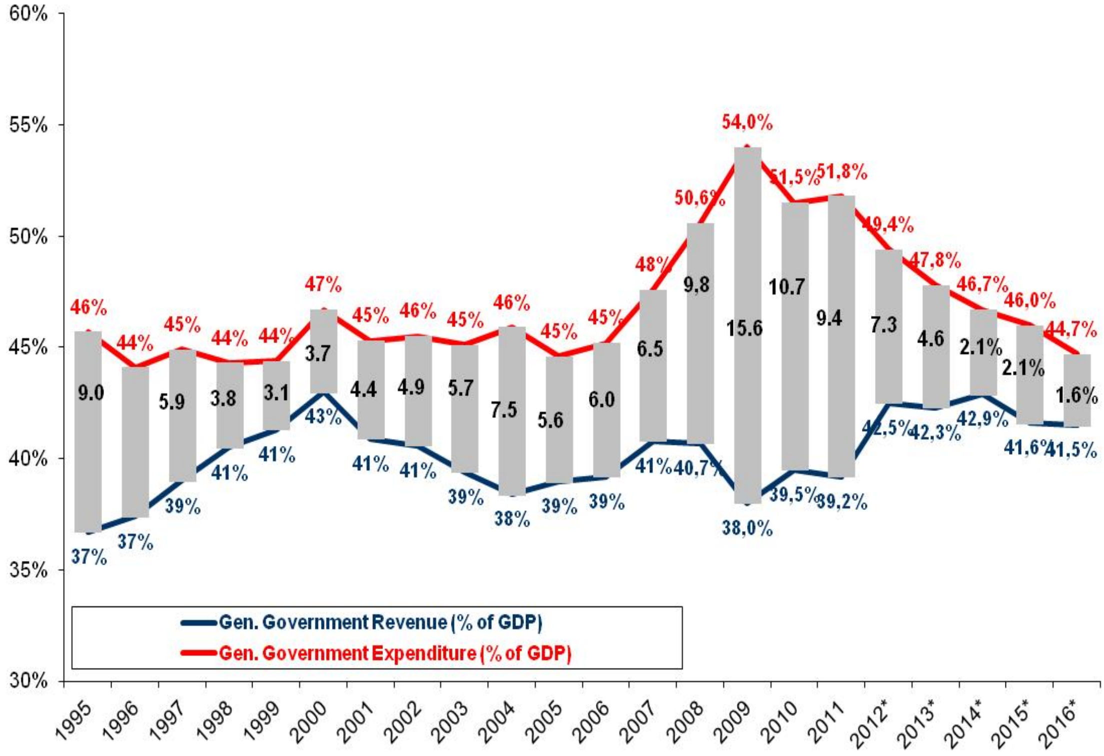
	Final Consumption (% of GDP)	Investments (% of GDP)	Exports (% of GDP)	Imports (%of GDP)
Eurozone-17	**77,4%**	**21,2%**	**41,6%**	**40,3%**
Belgium	**74,0%**	**21,7%**	**88,0%**	**83,9%**
Germany	75,6%	19,5%	44,0%	39,2%
Esthonia	73,8%	33,7%	79,2%	90,3%
Ireland	**63,1%**	**21,7%**	**101,6%**	**85,0%**
Greece	**90,7%**	**22,3%**	**22,4%**	**35,3%**
Spain	78,9%	27,2%	29,5%	35,9%
France	80,8%	19,7%	29,3%	29,9%
Italy	79,5%	21,0%	26,7%	27,2%
Cyprus	86,2%	19,9%	51,9%	57,1%
Luxembourg	54,0%	23,6%	170,0%	147,8%
Malta	85,3%	16,4%	91,4%	93,1%
Netherlands	**72,8%**	**20,3%**	**78,0%**	**71,0%**
Austria	**72,4%**	**22,8%**	**55,2%**	**50,5%**
Portugal	**85,3%**	**24,4%**	**32,9%**	**42,8%**
Slovenia	73,8%	27,9%	65,2%	67,1%
Slovakia	74,0%	26,8%	86,4%	86,8%
Finland	**70,8%**	**20,1%**	**46,4%**	**38,5%**
Sweden	**72,4%**	**18,5%**	**50,8%**	**41,4%**
United Kingdom	84,4%	17,5%	28,5%	32,1%

Source: Eurostat

Hence, the main problem of the Greek economy lies in the area of fiscal imbalances and persistent competitiveness losses, especially during the previous decade. The main characteristic of this period is the large expansion of the state economic activity, with employment in general government almost doubling since the 1980s and a general increase of employment in sectors producing non tradable goods and services. Greece's fiscal deficits were increasing faster than the EU average, a trend which gradually led to fiscal derailment. More specifically, on the expenditure side, data show that general government spending in Greece amounted to 45% of GDP on average from 1995 to 2007, a level not exceeding during that period the Eurozone average (48.3% of GDP). Nevertheless, there was a sharp increase in public spending from 2007 onwards (from 47% of GDP in 2007 to 54% of GDP in 2009), which was mainly the result of increases in public sector employment, in the remunerations of civil servants and in transfer payments (pensions, allowances). On the revenue side, for the period 1995-2007, general government revenue attributed to 39% of GDP on average in Greece (vs. 46% of GDP in EZ-17). Thus, state revenues were permanently deviating from a level that would retain the sustainability of public economics. The main causes of that were high tax evasion due to the wide share of self-employment in the workforce, inefficiencies of the tax collection mechanism but also inertia of the public administration to tackle these issues and set specific quantitative targets, represent some of the reasons for the fiscal derailment. To a great extent these factors persist, hampering the state budget balance.

Figure 2

General Government Revenue / Expenditure / Deficit (% GDP)



*Estimations

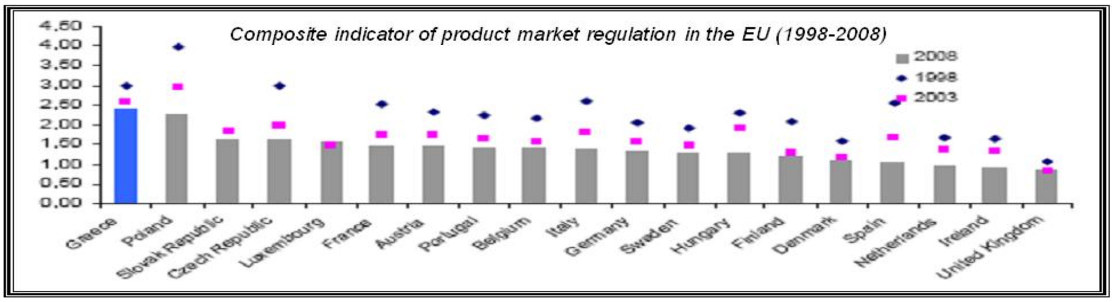
Sources: AMECO database, ELSTAT, Medium-Term Fiscal Strategy Framework 2013-2016 (Greek data)

As a result of the aforementioned trends of the budget components, fiscal deficits widened, especially during 2007-2009, reaching 15.4% of GDP in 2009. In the rest of the Eurozone and in an effort to cope with the global financial crisis the trend was also upward but milder. Looking at historical data, it can easily be inferred that the Greek public administration was a deficit generating mechanism, with a tendency to overshoot expenditures and underestimate revenues.

Apart from the high fiscal deficits and chronic mismanagement of public finances, Greece also suffers from large structural competitiveness loss. Competition is hindered by various restrictions, regulations and barriers making Greece one of the most regulated OECD countries.

Figure 3

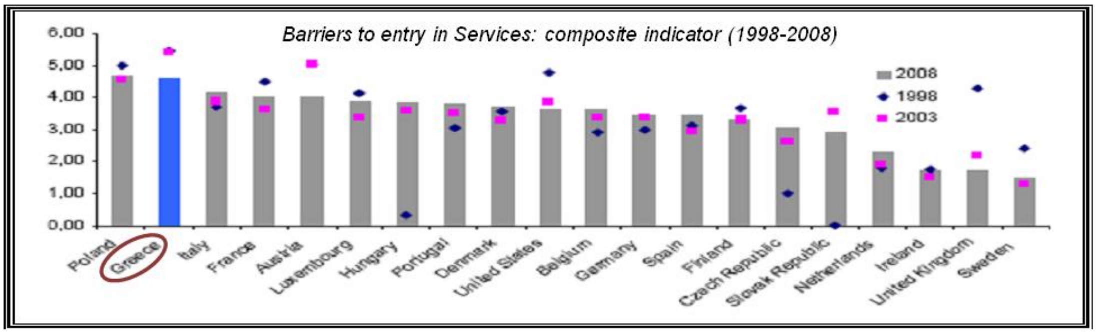
Overregulated product markets



Source: OECD, from European Economy, Occasional Papers, no. 68, Aug 2010, European Commission

Figure 4

Restrictions in Services

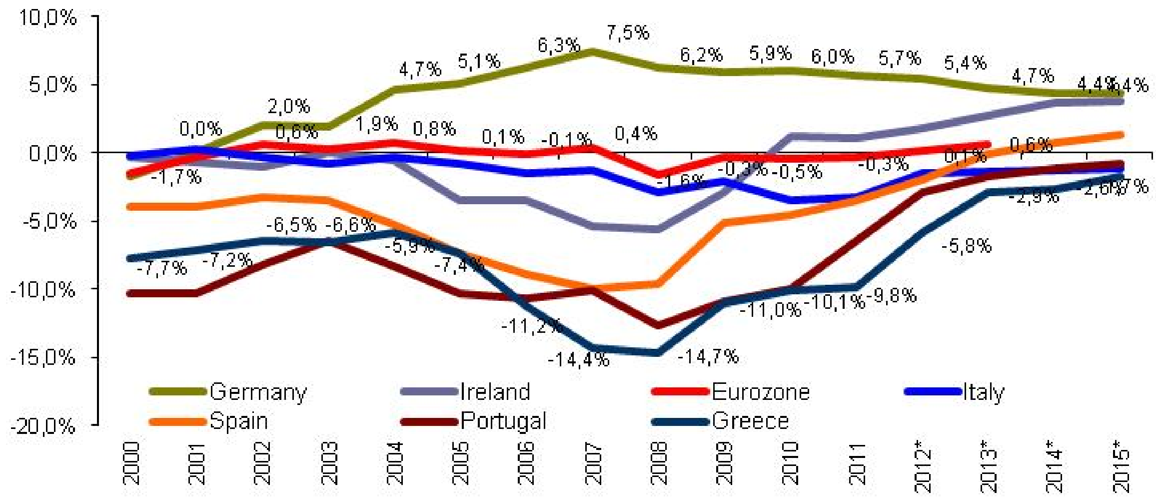


Source: OECD, from European Economy, Occasional Papers, no. 68, Aug 2010, European Commission

Due to the overregulated market framework and because of numerous, overlapping restrictions in many product / service markets, in the labour market, concerning entrepreneurship and investments, the average profit margin in the non-tradable goods & services sector was 15% higher than its respective Eurozone level, while in the labor market the margin was 10% higher from the Eurozone average.

Figure 5

Current Account Balance, Euro Area Periphery



Sources: IMF/ European Economic Forecasts, European Commission, Autumn 2012

The most widely used indicator for the examination of competitiveness of a country is its performance on the Current Account Balance index. For more than a decade, Greece has been experiencing a wide deficit in its current account, stemming mainly from deficits in its trade balance (i.e. imports exceeding exports) and capital flows balance. Greece's Current Account Deficit lies over 5% of GDP from 2000 onwards, while it climbed to 14.7% of GDP in 2008. Of course we should not overlook the fact that almost all Southern European economies bore Current Account Deficits at the same time, while many countries of Northern Europe illustrated Current Account Surpluses. Thus, there was clearly an underlying trend in the Eurozone, with current account deficits of the south funding surpluses of the north. Consequently, the Eurozone as a whole had a balanced current account.

The worsening of Greece's structural competitiveness is depicted in its very low ranking in various international competitiveness indices[3], effectively indicating the loss of credibility by international investors towards the country and their restrain from doing business in Greece. Shortly speaking, the main problem was the lack of intention in resolving some of the chronic structural weaknesses of the Greek economy. This inertia combined with the reduction of financial liquidity due to the global financial crisis, exacerbated the problem of fiscal imbalances in the country, affected the country risk, thus leading not only to the fiscal derailment of

[3] IMD World Competitiveness Yearbook, World Economic Forum: Doing Business Report (World Bank)

the period 2007-2009, but also to the inability to access funding to international markets.

Hence, by 2009 Greece was a country in a structural fatigue with the global financial crisis only highlighting its systemic weaknesses. A distortionary productive system on the supply side: introvert production, oriented towards domestic consumption rather than towards exports with many micro and small-sized firms and few large competitors with global presence and a very limited number of branded Greek products in the world market. At the same time, this structure was preventing penetration of innovation and ICT in the domestic production system. Furthermore, entrepreneurship in Greece faces numerous obstacles that hinder economic activity and affect its structural competitiveness, with too many barriers of entry in many product markets and distortions that do not allow firms and the public sector to operate efficiently. The Greek state itself is also too big and unable to support the private sector effectively.

Now what: prospects for growth

Since May 2010, Greece is implementing a very ambitious fiscal adjustment program, aiming at reducing the budget deficit to below 3% of GDP by 2016. The current program – updated in February 2012 - addresses all economic imbalances of the Greek economy as it includes reforms in the fiscal sector, in the social security system, the deregulation of goods/services/labour markets and the stability of the financial sector. However the main question today – after five years of significant contraction of the Greek economy - is to identify those necessary conditions for its restarting. The tormenting question nowadays concerns the type of growth that must be pursued and the suitable means and mechanisms for this process.

Greece needs a new growth model based less on consumption and more on exports, at least through the substitution of imports. This relies on a new type of productive - business system that builds on:

- the development of a stronger connection between technology and innovation, institutions and norms of the productive system
- a knowledge-intensive entrepreneurship: we need viable firms capable to compete in international markets with value added products / services, even under credit crunch conditions

– an intelligent and efficient Public Sector that minimises the administrative burden it imposes on the economy.

Under the current macroeconomic circumstances, the Greek economy should quickly adjust to this new growth model. This process seems to require a new social deal that builds on the enhancement of the adaptive capabilities of the Greek economy, as well as to the broader technological, economic, social and geopolitical developments. This deal involves:

- Improvement of the ability of the Greek economy to produce, acquire and systematically use the new knowledge produced

- Incorporation and operational use of ICT technologies. To this extent, investment in technology diffusion in all aspects of the production process, and especially in the public sector activity, could significantly strengthen competition, increase the quality of offered services, boost exports and narrow the economy's long-run competitiveness deficits.

- Support knowledge-based entrepreneurship that builds on the use of knowledge and innovation. Competitiveness in developed economies is not only about the relative costs and prices, but depends also on the technological content, diversification and quality of products and services.

- Extroversion of the Greek economy through focusing on market niches at a global scale, especially for manufacturing SMEs

- Efforts to attract foreign investments at the production and infrastructural level that will allow efficient use of innovation and knowledge and will "fertilize" local entrepreneurship

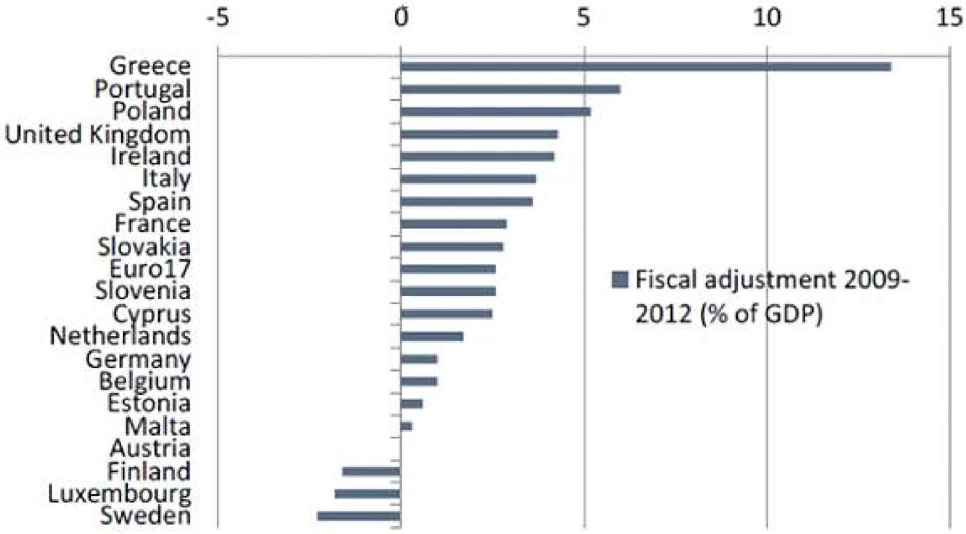
- Promotion of innovation as a way of thinking and acting (knowledge transfer networks and experience encoding, innovation, competition, etc)

- Treatment of the side effects and gaps (social, technological, educational, peripheral etc.) that arise as a result of this restructuring and technological modernization

Is this transformation possible? Though this is not an easy task and laborious multi-dimensional work is necessary in order to home the first accomplishments, some signs of success are already emerging. According to the "**2012 Euro Plus Monitor",** *Greece, is the fastest Adjusting Economy in the Eurozone, as it is the* *country with the highest fiscal adjustment during period 2009-2012, despite the Economy's weaknesses.*

Figure 6

Fiscal adjustment 2009-2012



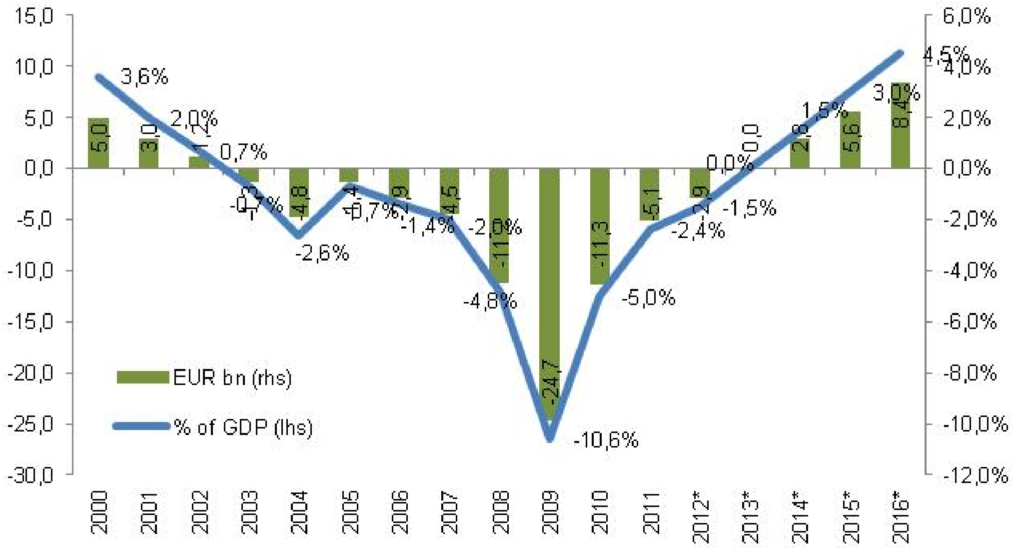
Sources: Medium-Term Fiscal Strategy Framework 2013-2016, Europlus Monitor: The Rocky road to balanced growth, 2012

In "**OECD Going for Growth 2012"** Greece ranks 1st in adapting to OECD recommendations, while intense legislative activity helped in improving Greece's ranking in Doing Business report: From the 89th position in 2011, in 2012 it ranked at the 78th position in 2012.

On the fiscal front the effort is impressive: The state budget primary deficit was reduced from €24.7bn in 2009 to €2.9bn in 2012 (9 percentage points of GDP), with a small primary surplus expected for 2013. (Figure 7)

Figure 7

Primary Balance

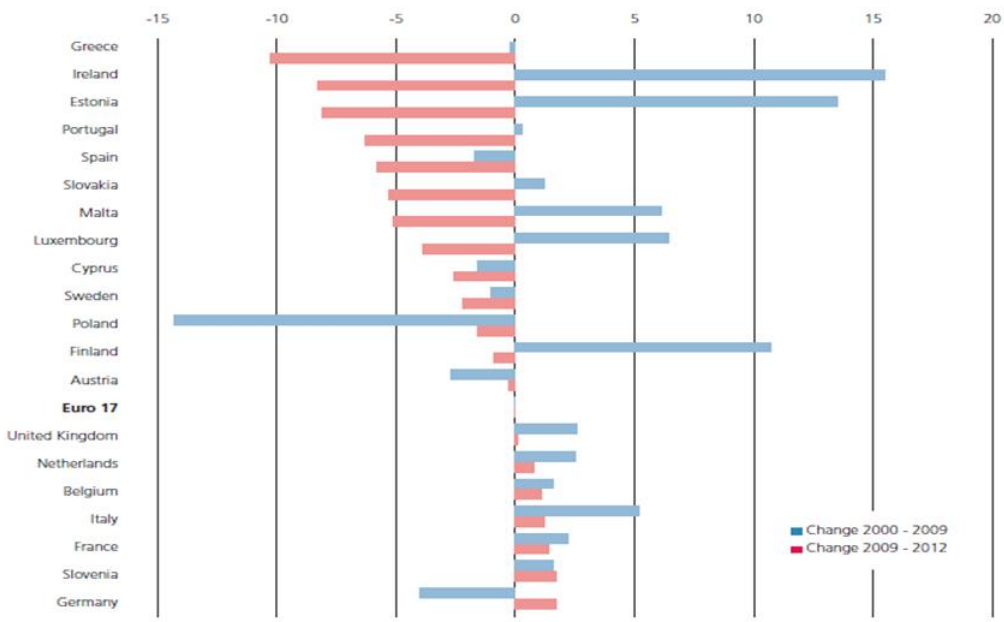


Sources: Medium-Term Fiscal Strategy Framework 2013-2016

Furthermore, in terms of *cost competitiveness during* 2010-2011, real unit labor cost adjustment was outstanding. The change from 2009 to 2012 will be above 10% (Figure 8)

Figure 8

Real unit labor cost adjustment 2009-2012



Source: Europlus Monitor 2012

The aforementioned signs of improvement are the quantitative result of a massive reform effort that has been underway since 2010. Although the implementation process during 2012 cannot be considered as satisfactory, mainly due to the political uncertainty and the two general elections, listing the whole range of reforms that were promoted during the last 2.5 years would be very difficult to do[4]. Only during autumn 2012, 72 prior actions (to the disbursement of the next loan tranche) were implemented. We pinpoint here the following reforms as the most important ones, not only because of their objective but because they can significantly support the transformation process of the Greek economy, as they have structural implications, not just fiscal.

a) Labour market reforms: reduction in minimum wages and sub-minimum wages to facilitate youth employment, along with a decrease of non-wage labour cost has significantly affected the labour cost. In terms of improving flexibility, numerous changes have been implemented during the last 2,5 years: changes in the arbitration system; suspension of the favorability clause in firm-level collective agreements; suspension of the automatic extension to those who are not represented in the negotiations; abolition of "legacy contracts" in ex-state owned enterprises; phasing-out of all collective agreements of infinite duration; changes in the rules governing the “after effects” of collective agreements; increase of special firm-level collective agreements are only some of the changes.

b) Improving the business environment: Various laws have been promoted touching upon the simplification of licensing procedures; acceleration of access to main permits, setting binding deadlines for necessary opinions, shortening procedures for environmental studies/licenses. But the most important action was the action plan labeled as **“Business Friendly Greece”** which aims at lifting various barriers to entrepreneurship and to innovation.

c) Enhancing competition in product / services markets : Liberalization of over-regulated professions and lifting of various conditions have been legislated. The implementation of this reform is slow, but involves already some 139 professions and will boost competition in respective markets, with positive results at the level of prices as well. Moreover minimum capital requirements for company creation and the mandatory presence of a lawyer to draft the articles of association of companies with capital in excess of €100,000 were also legislated.

[4] An extensive list is provided both at “The Second Economic Adjustment Programme for Greece, First Review (December 2012)” but also to the Quarterly report of the Task Force for Greece (December 2012):

d) Restructuring of the public administration: A significant downsizing of the public sector is underway, along with a rationalization of the wage bill, especially in some key public entities. The Single Public Procurement Authority that is about to start to operate aims both at increasing transparency but also at achieving cost savings from reorganizing public procurements.

Apart from the pace of the necessary reforms, it is sometimes argued that there do not exist growth opportunities in the Greek economy. Clearly this does not hold. From traditional manufacturing sectors like Agriculture, Fishing and Food Processing, Mining-Manufacture of basic metals and non-metallic mineral products, pharmaceuticals to more service oriented sectors like the ICT sector, there are investment opportunities that can be exploited by either foreign or domestic investors. The so-called «usual suspects» in Greece, Tourism and Energy production represent also two areas, where further entrepreneurial activity is expected in the next decade. Furthermore, a wide eco-system of activities including Land freight transport, related infrastructure and logistics could also support the country’s transformation to a crucial geo-strategic hub, to a regional and global trade portal.

Conclusions

By means of a concluding remark it should be stressed that progress in reforms cannot be evaluated as unsatisfactory, taking into consideration their magnitude but also the pronounced economic recession. But as always “still the devil of inertia hides in the details of the implementation”. The submission of the relevant enabling laws that need to accompany the main legislation has sometimes been significantly been delayed. However, time is an element that should not be underestimated and needs to be incorporated when reviewing progress. Reforms do not happen overnight and actual results may take more time to occur. The magnitude of the reforms taking place in Greece is huge. This means that it is not realistic to expect reform designing, implementation and actual results on GDP or employment at the same quarter or even at the same year!

Moreover as unemployment is rising, the social cohesion is in danger. There is an urgent need to reverse that trend, by creating favourable conditions for attracting private investments. If we fail to tackle unemployment, not only the reform implementation will become more difficult, but the political stability will be jeopardized.

Finally current credit crunch conditions do not allow for higher levels of private investments, at least from domestic capital. That is why the banks' recapitalization is crucial for restoring liquidity in the economy. Furthermore, leveraging of any other sources of funding (EIB, IfW) would offer additional support.

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