

Ingredients of growth in a shrinking economy

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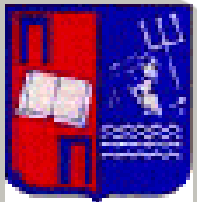


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I.A DESPERATELY SEEKING ... A NEW GROWTH PARADIGM

- ❖ Greeks over-consume and under-produce. They need a new growth paradigm with an emphasis on exports and investment.

	Greece		EA17	
	2009	2012f	2009	2012f
Private consumption	72.3%	74.5%	57.5%	57.5%
Public consumption	20.6%	16.9%	22.3%	21.5%
Private investment	16.7%	12.2%	16.6%	16.5%
Public investment	3.2%	1.8%	2.8%	2.1%
Exports	19.3%	27.8%	36.8%	45.6%
Imports	30.7%	33.2%	35.5%	43.1%
GDP (€bn)	231.1	195.0	8922.2	9503.0

- ❖ The switch away from consumption towards exports and investment cannot happen overnight, as it would contribute to the on-going collapse of aggregate demand and the on-going recession

I.A DETERMINANTS OF LONG-TERM ECONOMIC GROWTH

- ❖ According to the traditional model, in Greece, during 1990-2008, average growth was 3%, caused by three determinants: **Capital (1.10 pp.)**, **Labor hours (0.90 pp.)**, **Total Factor Productivity (1.00 pp.)**
- ❖ In the 1990s economists emphasize investment in technology
- ❖ Then in the 2000s, institutional characteristics like corruption, rule of law, efficient organization of the State sector, etc. were thought to be the deeper causes of growth
- ❖ The empirical literature makes cross-country comparisons over decade-long time intervals. Variables found important:
 - I. (+) Investment as a % of GDP (affecting size of physical capital)
 - II. (+) Rate of human capital increase, ~ by % population in sec. education
 - III. (-) Initial income, capturing convergence
 - IV. (-) Government consumption, thought not to be productive (e.g. military exp.)
 - V. (-) Inflation, which destroys the price mechanism
 - VI. (-) Real effective exchange rate, showing the competitiveness effect
 - VII. (+) Openness
 - VIII. (+) Quality of institutions
 -
 - IX. (-) FX risk premium in countries that have flexible exchange rates

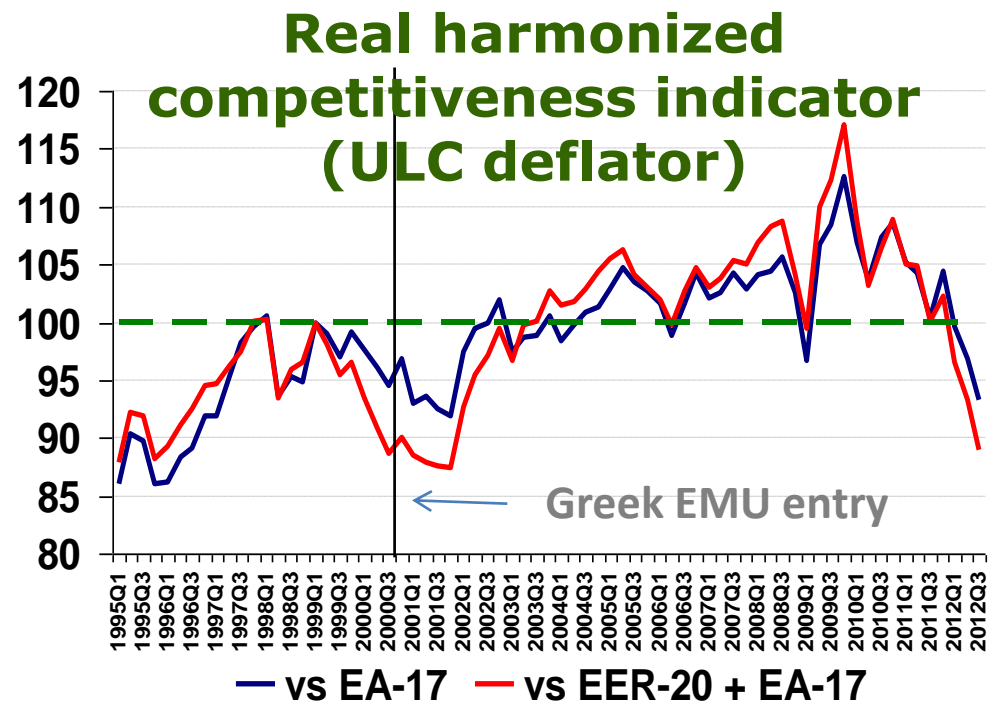
I.A PROGRESS IN: COST COMPETITIVENESS

NOMINAL UNIT LABOR COSTS

% Δ	GR	CY	DE	FR	IT	ES	IE	PT	US	EA17	EU27
2000 - 2009	33.2	31.0	5.6	22.4	31.4	33.8	34.6	26.8	18.2	21.0	23.2
2009 - 2012	-10.5	2.0	3.1	3.9	2.7	-6.0	-10.3	-6.1	3.3	1.5	2.4

Source: European Commission

- ❖ Unit labor costs in Greece are adjusting faster than in Spain, Portugal or Cyprus
- ❖ Improvement similar to Ireland's
- ❖ Gains of over 25 points in competitiveness from the peak in 2009
- ❖ Greece has regained the lost competitiveness



Source: ECB

I.A PROGRESS IN OTHER SOURCES OF GROWTH

2. Openness is **improving**: (Exports + Imports)/GDP from the 57.7% average over 2001-2009 is 61.0% in 2012
3. Inflation is **improving**: From 3.3% in 2001-2009 to 1.0% in 2012
4. The size of government consumption is **declining**, from 18.4% in 2001-2009 to 16.9% in 2012 .
 - Another way to measure the shrinking public sector is through primary expenditure, which declines from half the economy to about a third
5. The initial condition will be **lower** at the end of 2014, which makes convergence easier

Relative Living Standards

EE-15=100 in PPS

1991 75.6

1995 71.7

1999 71.0

2003 80.7

2007 80.9

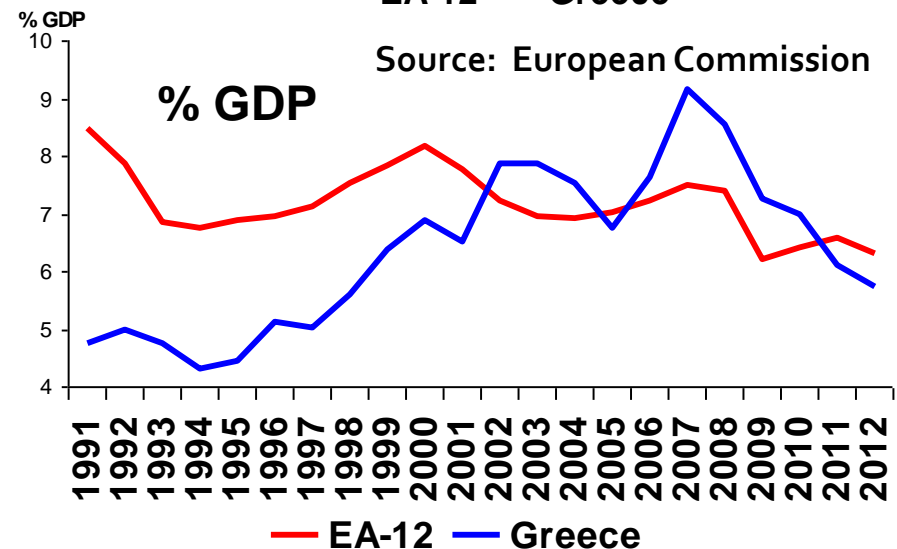
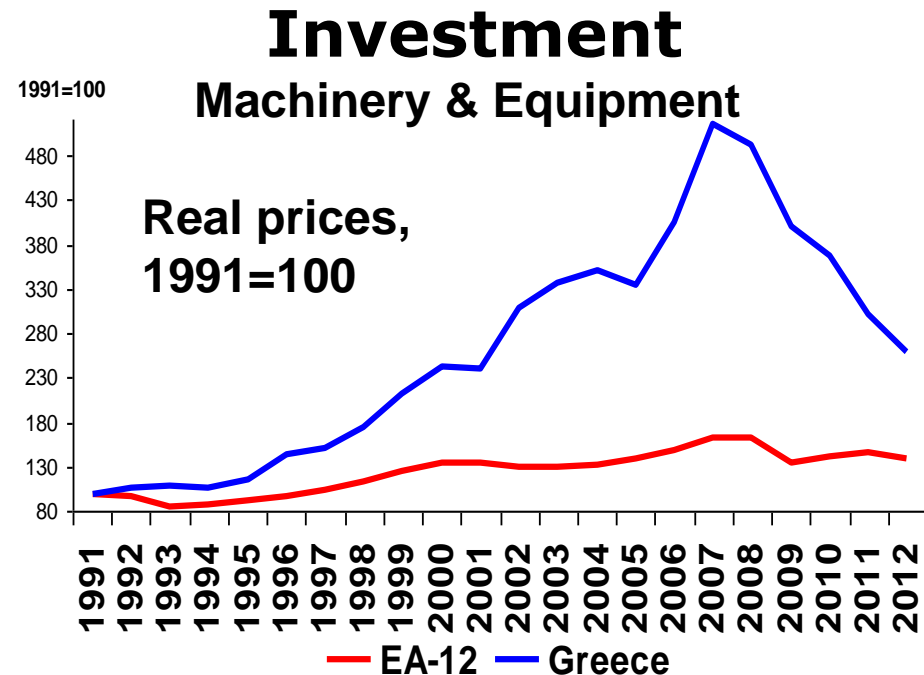
2014 65.5

I.A LAGGING BEHIND IN OTHER SOURCES OF GROWTH

	<u>Greece</u>	<u>EA-12</u>
1. <u>Investment</u> (% GDP)		
2001-2009	22.8	20.6
2012	14.0	18.6
2. <u>Corruption Perceptions Index</u> 2012 (0-100)	36.0	70.6
3. <u>Rule of Law</u> 2011 (score -2,5 to 2,5)	0.57	1.41
4. <u>Government Effectiveness</u> 2011 (score -2,5 to 2,5)	0.48	1.36

Source: EUROSTAT, Transparency International, World Bank

5. Labor force participation and quality of education are also factors that lag behind



I.A STUDIES SHOW GREEK GROWTH POTENTIAL CAN IMPROVE

Recent studies on Greece:

1. **Tavlas & Petroulas (2010) examine the importance of institutional characteristics during 1980-2000, concluding that:**
 - ✓ if Greece reached the institutional development of Nordic (EE-15) countries, growth would be 31% (22%) higher every year
2. **Eurobank Research (forthcoming, 2013) explores 2000 -2010, and claims**
 - ✓ **Growth (in per capita PPP) can increase by 1.4% every year**
 - a) Government consumption share in GDP: A decline from an average of 18.4% of GDP in the 2000s to 13% could add about 0.80% to Greece's long-term growth
 - b) Terms of trade interacted with openness: An increase in the relative price of exports to imports from an average annual growth of -0.7% in the 2000s to 0.5%, combined with an increase in openness from 57.6% to 70%, could contribute about 0.23% to Greece's long-term growth.
 - c) International Openness: An increase in the ratio of exports plus imports to GDP from 57.6% to 70% could add about 0.17% to Greece's long-term growth.
 - d) Inflation: A decline in CPI inflation from an average of 3.3% in the 2000s to 1.0% could contribute positively by about 0.06% to Greece's long-term growth.
 - e) Investment share in GDP: A decline in gross capital formation from an average of 23.2% of GDP in the 2000s to 20.0% subtracted 0.20% from Greece's long-term growth. This can be reversed adding the lost 0.20%.
3. **Anastassatos & Maliaropulos (2013) claim competitiveness gains of 30% alone can push export growth to 8%, closing the gap in the current account by 2020**

I.B REFORMS NEEDED AS "EASE OF DOING BUSINESS 2013" SHOWS: 78th FROM 185 COUNTRIES IN 2012

	Rank	$\Delta(2011-12)$	Starting a business (days)	Protecting Investors (0-10)	Exporting Goods (days)	Resolving insolvency (years)	Paying Taxes (hours/year)
OECD			12	6.1	10	1.7	176
US	4	0	6	8.3	6	1.5	175
GR	78	11	11	4.7	19	2.0	202
CY	36	1	8	6.3	7	1.5	147
DE	20	-2	15	5.0	7	1.2	207
FR	34	-2	7	5.3	9	1.9	132
IT	73	2	6	6.0	19	1.8	269
ES	44	-2	28	5.0	9	1.5	167
IE	15	1	10	8.3	7	0.4	80
PT	30	0	5	6.0	13	2.0	275

- ❖ The first improvement in years in a competitiveness index (from 89th). Columns include selected questions that compose various sub-indices
- ❖ Greece is among the 10 economies globally that improved the most
- ❖ The DB 2013 covers 185 countries and describes the regulatory environment of each country measured from June 2011 through May 2012.

I.B MoU and REFORMS

MoU includes 11 categories, which are grouped below as:

(a) Sectoral (b) Labor (c) Internal Competition, (d) Government restructuring

a) Sectoral

1. Financial Sector Reform

- Hellenic Financial Stability Fund, Temporary recapitalization, ATE bank, viability of insurance companies

2. Growth enhancing structural reforms

- Liberalization of Transports;
- Energy: Competition on electricity generation, Regulated tariffs, Renewables, Regulation of Gas;
- Plan for R&D and innovation,
- Absorption rates of structural and cohesion funds

b) Labour supply

1. Labour market reform

- Min W reduction, severance payment reduction, elimination of unilateral recourse to arbitration, maturity freeze or abolition, reduction in non-wage labour costs, etc.

2. Education reform

- Restructuring and evaluation of Greek universities

I.B MoU and REFORMS (cont.)

c) Internal competition

1. Business Environment

- Competition, Fast track licensing, exports imports facilitation, land registry and spatial planning

2. Regulated Professions

d) Government restructuring

1. Structural Fiscal Reforms

- Asset Management & Privatization, Tax Policy, Revenue Administration

2. Public Sector Modernization

- Public Administration: Census, Single Payment Authority, local gov. reforms
- Public Sector Wages (Wage Grid) and HR, Public Procurement

3. Pensions reform

- Increase in retirement age an in line of life-expectancy, disincentives for early retirement, future expenditure increase not to exceed 2.5% of GDP

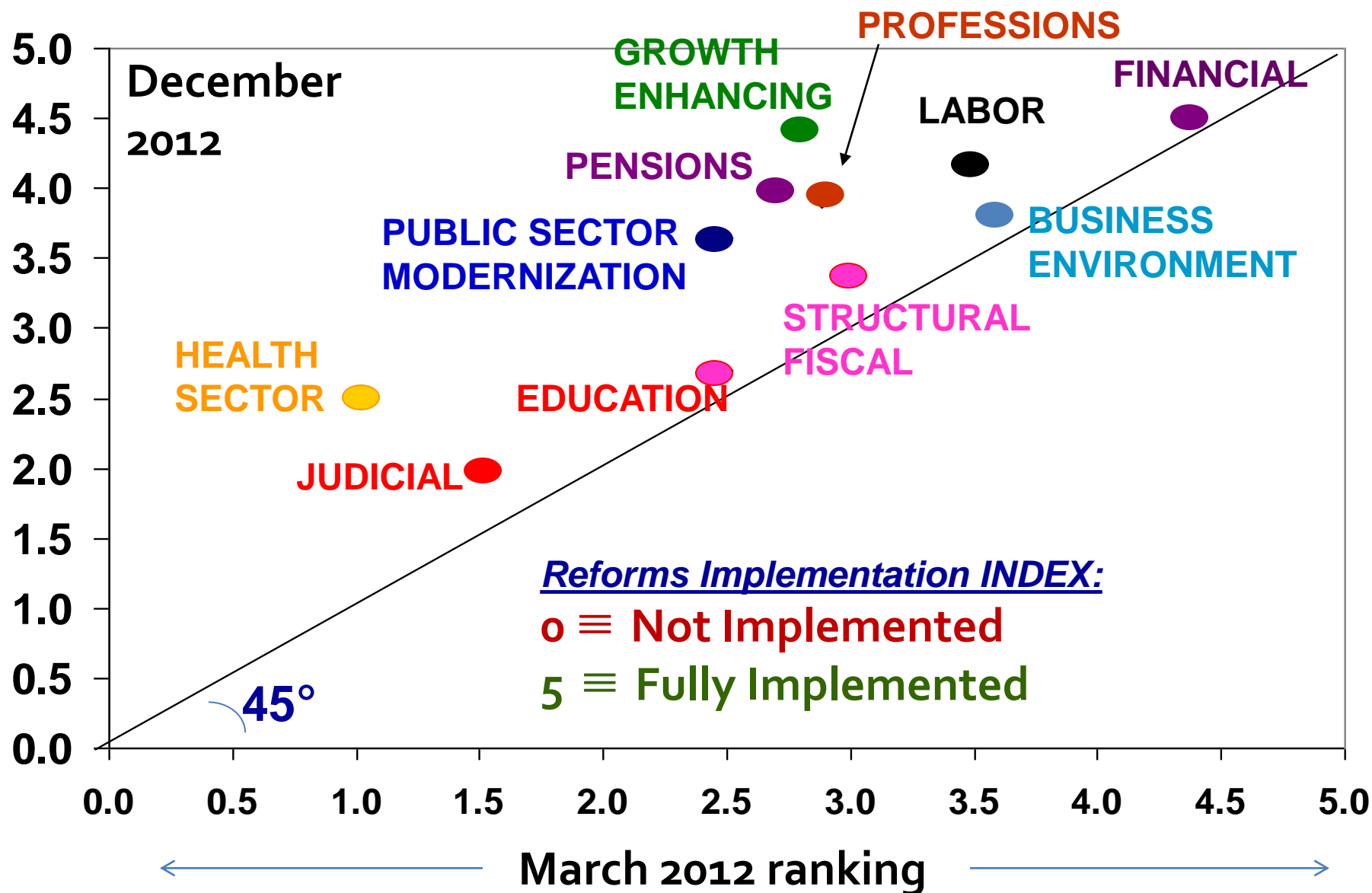
4. Health sector reform

- Merging of social security funds, stricter disability criteria, reduction in pharmaceutical expenses, health expenditure < 6% GDP

5. Judicial reform

- Clearance of backlog of tax & non-tax cases
- Code of civil procedure in line with international standards (small and dormant cases to go outside the courts, relief from non-adjudicatory work)

I.B QUANTIFYING THE PROGRESS IN REFORMS FROM MARCH 2012 TO DECEMBER 2012



I.B REFORMS: PRIORITY WORK REMAINING AHEAD

a) Sectoral

1. Financial Sector Reform

- Complete the bank recapitalization, viability of insurance companies

2. Growth enhancing structural reforms

- Absorption of structural and cohesion funds
- Regulatory framework for gas and renewable energy markets even after privatizations

b) Labour supply

1. Labour market reforms

- Independent assessment of labour inspectorate structure and activities
- Unify Collection of taxes and social contributions plus Audits, for largest tax debtors

2. Education reform

- Evaluation of Higher-education is behind targets
- Clearance of the various legal problems, which prevent the operation of the newly elected external governing bodies in the universities

I.B PRIORITY WORK REMAINING AHEAD (cont.)

c) Internal Competition

1. Business Environment

- Delays in the process of simplification of export and customs formalities, portal pending
- Spatial planning: Simplify Urban plans, codify legislation on forests, two disposal sites for hazardous waste
- Full land registry by 2020, digitalizing operations of Mortgage & Notary offices by end 2015

2. Regulated Professions

- Delays in various aspects of the deregulation of legal profession
- Point of Single Contact for services not operational yet
- Open access to non-Lawyers for mediation

d) Government restructuring

1. Structural Fiscal Reforms

- Anti-corruption plan (penalties for tax evasion, protection of whistle blowers, empower the internal audit of tax offices)
- Complete Restructuring of the tax system (closure of offices, increase number of inspectors to 1.000 from 235, audits of large tax payers not operational yet)
- IT system that interconnects tax offices: on-going
- Legal Clearance of real estate for future privatizations

I.B PRIORITY WORK REMAINING AHEAD (cont.)

2. Public Sector Modernization

- Transfer of redundant staff to the labour reserve started. Uncertainty remains on what will happen after 12 months (dismissals?)
- Speed-up of the public procurement framework (pilot process in hospitals)

4. Health sector reform

- Pharmaceutical spending reduction (reduction of profit margins in the chain of pharmacists, wholesalers, companies; claw-back rebate, generics to reach 60% from current ~ 30%)
- Centralized procurement not covering all parties yet
- Quarterly revision of positive price list to include all medicines
- Review of the price list for diagnostic services
- Double entry accrual accounting for ~ 70% of hospitals

5. Judicial reform

- Update the existing plan for the reduction of the backlog of tax cases as previously specified targets (50% reduction by June-end & 80% reduction by December-end) are already missed
- Non tax cases: Not even the study of the problem is ready, the plan is supposed to be operational by June 2013
- Reform of the magistrates court to expedite cases
- Opening access to mediation services for non-lawyers
- New Code of Civil Procedure to be ready by end 2013

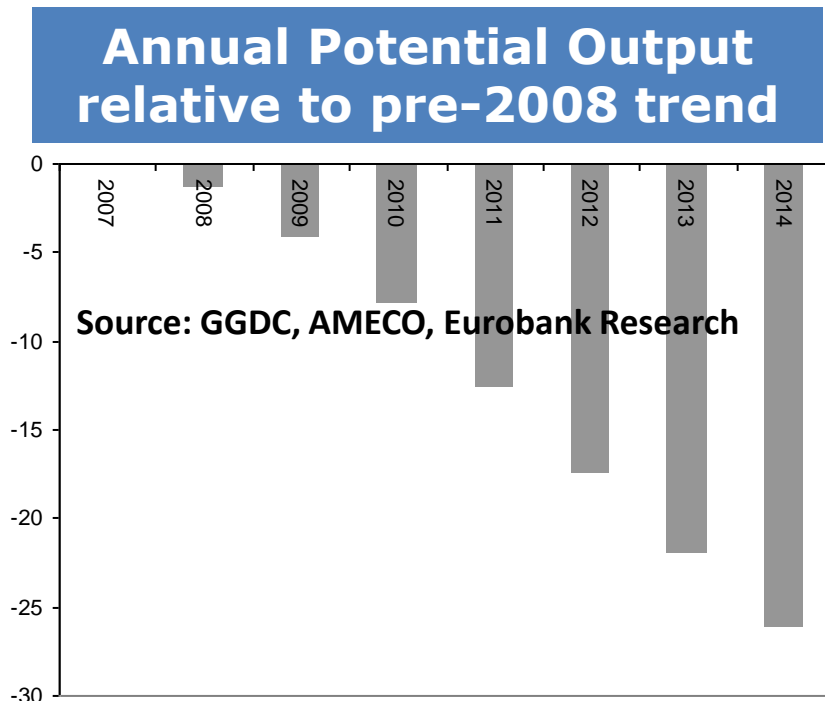
II.

- I. A new growth paradigm & reforms for long-term growth
- II. Getting started by stopping the recession**

II. THE COLLAPSE IN AGGREGATE DEMAND CAUSES HYSTERESIS IN SUPPLY

- ❖ The earlier discussion focused on growth rates after the economy stabilizes. Yet, the economy will stabilize at a lower level of potential output
- ❖ Will the bottom be reached soon?

❖ Potential GDP is now falling



- ❖ By 2014, potential output will be 26% lower than previous trend

❖ HYSTERESIS:

- Current depression **destroys human capital**, increases long-term unemployment and reduces labor force participation
- Current depression **destroys capital stock**
- ❖ Hardouvelis – Malliaropulos estimate of hysteresis parameter $\eta = 0.4$, that is, for every 1% of recession, potential GDP declines by 0.4%
- ❖ Before economy jump-starts, the recession has to stop. Will the recession stop? This is the demand side of the problem

II. GDP OUTLOOK IN 2012 AND 2013

	2011 €bn, Nominal	Share in 2011 GDP	2012 %yoy Real	2013 %yoy Real
Private Consumption	162.3	75.5%	-9.6%	-8,5%
Government Consumption	37.5	17.5%	-7.8%	-7%
Total Consumption	199.9	92.9%	-9.2%	-8,4%
GFCF	31.3	14.5%	-18%	-4%
Domestic Demand	231.1	107.5%	-10.4%	-8%
Exports	67.7	24.0%	2.5 %	5,7%
Imports	51.7	31.5%	-12,9%	-9,4%
Real GDP	215.1		-6.7%	-3,8%
GDP deflator			-0.5%	-1%
Unemployment			24%	27%

II. UPSIDE POTENTIAL

- ❖ The **fiscal drag** from fiscal consolidation measures (€2.185bn from the carry-over of previous measures and €9.374bn from measures agreed in October 2012) can be **counterbalanced** by the following **Liquidity Boosts**:
 - ✓ Improved absorption of **EU Structural Funds**: gov. budget accounts for €5.7bn or 3.1% of GDP of net inflows from the EU (comparable to previous non-recessionary years)
 - ✓ Planned **reduction of gov. arrears** of €9.5bn or 5.0% of GDP, €0.7bn disbursed in Dec 2012 , and remaining throughout 2013
 - ✓ **Recapitalization of Greek banks** (€23.5bn) and its impact on banks' cost of funding, as well as by a possible return of deposits (this factor is mitigated by the need to reduce exposure to the Eurosystem for liquidity- no assumed impact)
 - ✓ Better outlook of investment and consumption due to **resolve of uncertainty regarding Euro participation** (no assumed impact)
 - ✓ **€1bn of EIB funding** agreed for 2013 for SMEs (this will probably be larger due to leveraging/co-financing of projects by banks)

- ❖ **Net liquidity injection is positive**

II. DOWNSIDE RISKS

- ❖ If private sector **liquidity squeeze** persists, it could lead to a **non-linear** increase in the number of –otherwise healthy- firms closing down with severe repercussions on unemployment and GDP
- ❖ **Liquidity constraints** for households which consume > 100% of their disposable incomes and a **negative wealth effect** (falling house prices and stock prices, bond haircuts) could increase pass through on consumption
 - Estimations above implied a 0.9 elasticity of consumption w.r.t. disposable incomes; if e.g. elasticity is increased to 1.3, private consumption could be reduced by -12.2% and the subsequent GDP fall would enlarge to **-6.4%**.
 - If, in addition, investment falls by -20%, instead of -4%, due to firms' closing down, GDP fall would enlarge to **-8.5%**.

Other Downside Risks:

- ❖ Political or Social turmoil
- ❖ Euro accident
- ❖ Slippages in privatizations & budget execution that have to be dealt by extra measures, thereby enlarging the fiscal drag

SUMMARY: *Ingredients of Growth in a shrinking Economy*

1. HOW will long-term growth come back?

- ❖ By addressing the factors which drive long-term growth: (i) **Investment/GDP**, (ii) **quantity** plus **quality** of **human capital** (iii) reduction in the size of government, (iv) inflation (v) cost competitiveness, (vi) openness, (vii) **quality of institutions** like Government functioning & effectiveness, rule of law and corruption
- ❖ The MoUs addresses all 7 factors, and we can already claim success in improving a number of factors

2. WHEN will the economy stop shrinking?

- ❖ When aggregate demand stabilizes, implying a delicate balance between fiscal austerity and pro-growth policies.
- ❖ We failed in this balance partly due to the loss of credibility of Greek politicians and the economy is in a **depression**
- ❖ There is a bifurcation point over the next 4 months as households and companies are being squeezed by higher taxes, declining wages and pensions, rising unemployment and a shortage of liquidity. We either survive the crash, public revenue projections materialize and regain the ability to see a way forward, OR **we enter a rapid vicious economic and political cycle that takes the country down to the 1960s.**

3. The reform recipe ought to go ahead even if the negative growth scenario prevails



**Thank you
for your attention**

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I wish to thank my colleagues at Eurobank for their comments