Is the Greek Crisis One of Supply or Demand?¹

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November 16, 2015

1. Introduction

Greece joined the European Union in 1981 largely on political grounds, to protect democracy after the malfunctioning political regimes that followed the civil war in 1949 and the disastrous military dictatorship of 1967-74. Not much attention was paid to the economy and its ability to withstand competition from economically more advanced European nations. A similar blind eye was turned to the economy when the country applied for membership of the euro area in 1999, becoming a full member in 2001.

It is now blatantly obvious that the country was not in a position to compete and prosper in the European Union’s single market or in the euro area. There are a myriad of restrictions on free trade that were introduced piecemeal after 1949, with the pretext of protecting those who fought for democracy, and which do not allow Greek companies to develop, adopt new technology and grow into world leading exporters - with the exception of shipping, which is subject to different rules because of its international nature. Professions are protected and there is political interference with the economy from the basics all the way to the top, through state-controlled enterprises, rules and regulations that have accumulated over the years and party-political appointments of officials who control licensing offices down at local level. As a

¹ Prepared for the Fall 2015 Brookings Papers on Economic Activity, Brookings Institution, September 10-11, 2015. We are truly grateful to the editors, David Romer and Justin Wolfers, for their very helpful suggestions that improved the paper, to Anna Hardman, Gikas Hardouvelis, John Lipsky, Vasilis Nicoletopoulos, Enrico Spolaore, and Nikos Vettas for their generous comments on drafts prior to the conference, and to George Dimitriou for his help with data. Pissarides and Dimitriou’s work were funded by the European Research Council through the project Employment in Europe at the University of Cyprus. We are entirely responsible for the content.
result, Greece is the most protected and most monopoly-ridden economy in the euro area and no attempt was ever made to reform the economy to raise its productivity to the level of its European partners.

These features of the economy should have been obvious to those examining the Greek case for entry into the European Union and the euro area. Whether they were or not is immaterial at the current juncture: the key point today is that they were ignored until the debt crisis of 2010. Entry into the European Union kept Greece going through transfers and foreign (mostly European) investment, and entry into the euro area gave it access to cheap finance, which was used to finance consumption and residential investment. This growth model was obviously unsustainable but it was not exposed until after the onset of the global financial crisis, and highlighted in a series of reports by international organizations, mostly associated with the Troika’s periodic reviews.2

It is clear that the urgency for the long run viability of the economy and Greece’s survival in the eurozone is structural reform. But implementing deep and effective structural reform in an economy used to protectionism and political meddling is met with resistance at every level, leading to public protest, political instability, frequent elections and the rise of political extremism. So, although since the onset of the crisis in 2010 several rounds of legislation went successfully through Parliament, the implementation of reform has been very poor. In practice there is no such a thing as an independent public sector that will implement the reforms impartially according to any new legislation. In private conversations economists brought in to government to help with reform acknowledge that once in office huge pressures are brought to bear on them to make exceptions that offset the impact of legislation to the point of complete irrelevance.3

The problem that should be occupying Greece’s lenders is how to give incentives to achieve effective structural reform. Instead, their focus on fiscal austerity, ever higher taxation, cuts in earnings and debt sustainability has provided disincentives for reform. Reform is politically easier to implement and economically more effective when demand in the economy is at a healthy level, demand in the country’s trading partners is expanding, the country’s financial sector is in a position to support new ventures and its fiscal authorities are in a position to help with infrastructure investments and private-public partnerships. All of these things characterized Germany when it embarked on its reform program in 2003-2005, which were controversial at the time and included running a bigger budget deficit than allowed by the Maastricht treaty in order to facilitate the transition to a new economic order. But all of these things are denied Greece, reinforcing its reluctance to implement reform; and making

2 The European Central Bank (ECB), the European Commission (EC) and the International Monetary Fund (IMF) jointly administered the Economic Adjustment Program for Greece. They issued periodic reports, the latest of which is EC’s fourth review (European Commission, 2014) and the IMF’s fifth review (IMF, 2014). The EC’s fifth review was interrupted in December 2014. See Hardouvelis (2015).

3 This is common knowledge in Greece. Most recently it was reiterated to us by Gikas Hardouvelis, who served as finance minister before the Syriza election victory in January 2015.
ineffective the small number of successful reforms that have taken place, such as Enterprise Greece, which enables the speedy establishment of new companies for which currently there is no demand.

Our message is that ignoring Greece’s problems when it first applied for membership of the single market and the euro area was a mistake, and the fiscal austerity and wage cuts enforced by its international lenders are also a mistake that compounded the first mistake, because they stunt the necessary structural reform efforts. The distorted structure of the Greek economy, especially the concentration of economic activity in a small number of hands, introduces price inflexibilities, so the fiscal austerity and wage cuts have caused a catastrophic fall in demand. Such features are behind the IMF’s underestimate of the fiscal multipliers; the fall in demand is behind the deep recession and the rise in unemployment. It is also partially behind the failure of the 2012 sovereign debt restructuring⁴ to deal once-and-for-all with the Greek debt. The high debt, however, is a consequence, rather than a cause of the current situation. Although more debt relief now would enable Greece to implement reforms with more flexibility because it would somewhat relax the austerity, we believe that even a complete right-off will not transform Greece to the modern growing economy that can prosper in the euro area.

Greece’s problem is one of both supply and demand. The supply problems have been present since its acceptance into the European Union in 1980; the demand problems caused by austerity and wage cuts added to the supply problems, making them worse.

The remainder of this paper is organized as follows. Section 2 discusses the severity of the demand contraction and its impact on economic activity, which, as we argue, is due to a large extent to Greece’s distorted economy. Section 3 discusses product market reforms and their potential impact on competitiveness and the economy. Section 4 switches to labor market reforms, many of which have been implemented, and discusses their impact. Section 5 argues in favor of eurozone-wide policies that would help propel Greece on the road to recovery. It also discusses how the linking of reforms with debt relief can increase the motivation for reform. Section 6 concludes.

## 2. Demand contraction

The main ingredients of the reform program forced on Greece by its international lenders and the main thinking behind it consists of three pillars. Fiscal contraction to reduce the massive budget deficit and eventually pay off the debt; reductions in wages, pensions⁵ and other costs to increase the competitiveness of Greek industry; and a structural reform

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⁴ See Zettelmeyer et al., 2013 for the full details of the 2012 restructuring, which is also known as the 2012 PSI (Private Sector Involvement).

⁵ An antiquated pension system was at the root of the fiscal explosion, requiring ever increasing contributions by the government. An ambitious reform effort, that recognized the adverse demographic trends and was initiated in 2001, was not completed. The 2010 Program mandated extensive pension reforms.
program to modernize the economy and increase productivity. The expectation of the institutional lenders was that the fiscal contraction would have very small negative multipliers, the “internal devaluation” that would result from reductions in unit labor costs would increase exports and help also domestic demand, and the structural reform would increase productivity and improve expectations about future prospects, giving access to more and cheaper finance for investment and output growth.

In practice fiscal austerity led to bigger negative multipliers than estimated by the IMF (as acknowledged by the IMF itself in IMF 2013) and a bigger fall in output than expected. The internal devaluation helped exports to some extent but the wage reductions that brought it about, combined with sticky prices, brought much bigger reductions in domestic demand (Pissarides 2013). And structural reform has been ineffective either because of its limited scale or because several of its dimensions have not been implemented.

Greece’s large trade deficit declined since the onset of the crisis, from 11.2% of GDP in 2009 to 2.3% in 2014. This was partly due to the absolute fall in imports (although they increased as a share of GDP) but also to an increase in exports from 19% of GDP to 33% (with exports of goods increasing from 8.4% to 17.3% of GDP). Hourly productivity declined during this period, in contrast to the rest of the euro area, but real average earnings fell by even more (Figure 1, Table 1). As a consequence, real unit labor costs fell, improving the competitiveness of Greek exports despite the falling productivity.

Both the fall in wage costs and productivity were due to the collapse of aggregate demand and investment. Whereas fixed capital formation in the euro area in 2014 was at about 19% of GDP, only slightly below the pre-crisis levels, in Greece it collapsed from more than 20% in the pre-crisis years, to 16.3% in 2009 and to 8% in 2014, with dwellings construction accounting for a large portion of the collapse.

According to the OECD 2013 Survey, p. 53, the adjustment program has so far failed to restore price competitiveness, growth and public debt sustainability and the fiscal contraction has deepened the depression. There is no doubt that there have been errors in policy design by the Troika. The fiscal multiplier assumed in the design of the program was much smaller than might have been at work, 0.5 instead of numbers above 1, which are more widely used now. These would have had a large impact on the estimated contraction, with everything else constant. We believe that of more importance, however, are the peculiarities of the Greek economy, which had largely been overlooked. The Greek economy is subject to more frictions and is less open than other euro area economies in crisis, such as Ireland and

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6 There are two different positions by IMF staff. Bi et al. (2013, p.26) argue that projections would not have been very different if higher multipliers had been assumed. Instead, they claim that the error was in the forecast of potential GDP, anticipating a contraction of about 7%, instead of the observed 20%. Blanchard (2015) attributes the underestimation to “other things not being equal”, namely interest rates being close to zero and monetary policy not offsetting the effects of fiscal stance. IMF (2010) examines in depth the different aspects of macroeconomic effects of fiscal consolidation, finding that fiscal consolidation “typically reduces output and raises unemployment in the short run.” The process is more painful, the less monetary stimulation might be available and the greater the reliance on taxes, both of which have been features of the Greek stabilization.
Portugal.\textsuperscript{7} In such an economy prices do not fall and the decrease in aggregate demand that is brought about by wage decreases translates into a contraction of aggregate activity and unemployment (Pissarides, 2013). Wage reductions were reflected in greater increases in profit margins rather than reductions in prices.

As a result of the demand contraction and the large multipliers, output declined in Greece dramatically more than in other countries under stabilization programs (Figures 2, 3). In early 2013, GDP was 25\% below its 2008 level, in sharp contrast to the 10\% or less in the other countries. Figure 2 also compares with Finland during its "great depression," 1990-1996, and the US during the Great Depression, 1929-1938. Even more striking is Greece's performance in relation to other European countries. Between 2009 and 2012, Greek income per capita fell from 96\% to 75\% of the European Union average, below its level in 1995. Between 2010 and 2012, annual real income contraction in Greece has been almost 3 percentage points more than the OECD and Troika forecasts, while nominal GDP contraction was 3.5 percentage points deeper. Relative to the 3.8\% trend growth rate in 1997-2007, the fall of GDP in 2007-2013 was 38\% (Mueller et al. 2015). Much of the gain made since Greece's Eurozone accession has been lost. From 2009 to 2014 real GDP per person declined by 21\%; relative to the EU-28 average, it declined from 93\% in 2003 to 70\% in 2014.

3. Structural Reforms and Competitiveness

With sticky prices and barriers to entry the fall in wages, by reducing aggregate demand, and in unit labor costs, by failing to spur competition, so far have contributed to the recession instead of reversing it. In such circumstances it makes much more sense to target product market reforms, which could improve price flexibility and the structural competitiveness of the Greek economy. Labor market reforms are also essential but they could come later, when the economy was performing well and so would be easier to implement. Labor market reforms are resisted by workers and their unions and they can be disruptive, both politically and economically. Product market reforms are resisted by the professions and owners of capital, who ultimately are more likely to comply if sufficient compensation to the losers is given.

The issue of the urgent need for structural reforms has figured prominently in all discussions of the Greek crisis. There are two important senses in which product market deregulation can affect growth, which are not typically clarified in public debates. One is abolishing monopolistic and monopsonistic structures and eliminating barriers to entry, which would benefit productivity. A second channel is the impact of market deregulation on total factor productivity (TFP) growth. Boosting TFP growth is essential if Greece is to recover and catch up with other European countries, but since entering the reform program TFP growth has

\textsuperscript{7} Total exports (goods and services) as percent of GDP, 2008-2012 average: Greece, 23.4; Ireland, 93.1\%; Portugal, 33.2. Greece's intra-EU exports and imports, as shares of respective totals are the lowest among comparable size EU countries. The share of intraindustry trade is probably not very large, thus the greater the need for adjustment via the exchange rate, and the smaller the productivity-like potential benefit from "task trading" (Grossman and Rossi-Hansberg, 2008).
declined in Greece by much more than in other program countries (Figure 4). The fundamentals are against the revival of TFP growth, mainly because of too little spending on education and R&D, and poor connections between universities and industry (Pissarides, 2015). Greece’s spending on R&D increased slightly from 0.6% to 0.8% of GDP between 2002 and 2013, but these numbers are well below the figures for the average of the euro area, 1.8% to 2.0% respectively.

The first channel through which deregulation can affect growth has served as a key objective of deregulation efforts that break barriers to competition and has been an important part of the reform programs in the European Union. Its main impact is a jump in potential output, moving the country closer to the technological frontier. The second channel is an important component of EU’s Agenda 2020, which includes a Digital Agenda for Europe. The impact of this reform is mainly on growth, through the beneficial effect of structural reform on R&D and trade competitiveness, and is thus vastly more important because it is long-lasting.

The importance of structural reforms is enhanced in the presence of downward nominal wage rigidities, fixed-exchange rates and high debt levels, which characterize the members of the euro area. For this reason they have been repeatedly emphasized during the European crisis by politicians and leading figures in European institutions. Notably, as the President of the European Central Bank Mario Draghi (2015) eloquently argues, slow-adjusting countries within the Eurozone are likely to suffer higher unemployment, which can become entrenched and structural, whereas structural reform can bring the European economies closer together and thus improve the chances of success of a uniform monetary policy.

Writing in 2009 an IMF team identified many key weaknesses in the Greek economy (Moreno-Badia et al. 2009). It argued that the imputed equilibrium real exchange rate was overvalued relative to fundamentals and implied a competitiveness gap of 20–30 percent; the weaknesses of Greek labor markets were glaring, with low employment rates, especially for females and the young, and relatively high employment protection legislation; structural impediments hindered product market performance, including cumbersome business practices and high costs to start a business; internal competition was insufficient due to high regulation and limited liberalization of utilities, which implied higher energy costs and poorer supply chains for the whole economy.

Those observations motivated an important part of the Economic Adjustment Program for Greece, which was agreed in May 2010. Drawing examples from other countries that reformed, the IMF team concluded that were Greece to move toward best practices in each of those areas, the corresponding employment gains could be significant, estimated between 5 and 10 percentage points.

As the Economic Adjustment Program of 2010 gave way to the second one of 2012, the need for reforms were further specified and the demands became more pressing. But product markets were not given priority and whatever interventions were implemented, they amounted to partial dealing with some of the problems. Price inflation increased from 1.3% in 2009 to 5% in 2010, before going down to -1% in 2013 (Figure 5), as wage growth decreased sharply from 2010 to 2014 (Figure 6). The net effect on the real wage is dramatic;
see Table 1 and Figure 7. It has fallen by more than a quarter since 2007. The labor share fell from 56% in 2009 to 48% in 2013 (AMECO, 2015). At the same time reformers had to tackle fierce opposition from vested interests and were hampered by lack of political commitment. Product markets continue to be dominated by oligopolies, with numerous barriers to entry, protecting incumbents.

As of the time of writing, many of these conditions remain unsatisfied and are part of the latest agreements as “Prior Actions” (European Commission, 2015). A slow improvement did take place up to the January 25, 2015 parliamentary elections. Some international indicators have improved, including the Global Competitiveness Index, from 96 in 2012 to 81 in 2014, the World Bank’s Ease of Doing Business shows improvement from 65 in 2014 to 61 in 2015, and OECD's Product Market Regulation Index improved from 2.21 in 2008 to 1.74 in 2013. But such indices are still a long way behind the levels that one would consider to be suitable for an economy on a convergence path with the rest of Europe.

Regulation remains high and is an obstacle to catching up with the rest of the euro area. Eble et al. (2013) calculate, using the IMF’s Global Integrated Monetary and Fiscal model (GIMF), that policies that could close roughly half the gap in measures of product and labor market regulation between Greece and the rest of the Eurozone would raise real GDP by about 4% after 5 years rising to 10% in steady state. Vargas et al. (2013) show that reforms in product and labor markets and knowledge and innovation (as measured by R&D subsidies and the skill composition of the labor force) can account for about 78% of the gap between Greece and the top euro area performers in 2012, measured in per cent deviation from the base line. Reforming the product market yields the highest GDP gains in Greece.8

Papageorgiou and Vourvachaki (2015) use calibration techniques with Greek data to measure the macroeconomic and growth impact of structural reforms. They find strong positive long-run gains from implementing structural reforms in the product and labor markets: 10 percentage point reductions in non-tradable price and private-sector wage mark-ups lead to 9% of GDP. The results also suggest that the fiscal policy mix matters for the impact of the simultaneous implementation of structural reforms and debt consolidations in the short to medium-term. In the long run, the gains of the two policies complement each other with additional GDP gains being in the range of 0.4%---4%. Structural reforms by improving the economy’s productive capacity on a permanent basis also improve the tax base. While reforms create additional fiscal space, thus conferring benefits in the long run,

8 That structural reforms are associated with growth may be easily verified by means of Barro regressions with the growth rate of per capita income as the dependent variable and initial income and a whole host of variables measuring structural reforms as independent variables. Cheptea and Velculescu (2014) report that 121 such structural reforms variables, which includes measures of corruption, research and development, corporate governance and infrastructure, are statistically significant. Such regressions are known not to be causal, but they are nonetheless qualitatively informative about the scope for improvement in growth performance from narrowing the gap between actual and “benchmark” performance. For example, these authors report that the “average growth effect” from institutional reforms is at 1.3% for Greece the third largest in the EU, after Bulgaria and Romania, both at around 1.5%. 
they generate losses in the short and medium run, that is, not only pace matters, but also the mix of fiscal tools.

Ultimately, a bigger impact of structural reform in Greece would be one that worked its way through higher TFP. With lower entry barriers and less state control a faster process of catch-up to best-practice technologies in manufacturing industries could be attained. Nicoletti and Scarpetta (2003) find that changing governance structures, as by privatization, would bring along improved competitive pressures and entrepreneurial incentives, especially if competition is promoted in the markets where privatized industries operate, such as energy, telecommunication and transport companies that provide inputs to the entire economy. In particular, they argue that a gradual (over ten years) move to the OECD-wide average share of state-owned firms in total value added is estimated to boost annual TFP productivity growth by about 0.7 percentage points in Greece. They also find that entry liberalization in service industries is estimated to boost annual TFP growth in the overall business sector by about 0.1-0.2 percentage points in countries like Portugal, Greece and Italy.

Against the background of some OECD countries showing, over 1975–2003, impressive TFP growth performance and others the opposite, changes in TFP growth are positively correlated with ICT spending as a share of GDP (Kent and Simon, 2007). The authors also find that the share of ICT spending is negatively correlated with the level of product market regulation. Greek industry is dominated by micro-firms (accounting for about 58% of the non-financial business community, with larger firms accounting for only 13%) and does especially poorly in ICT penetration. The ongoing restructuring (see below) of the Greek economy is thus promising in this regard. Underlying Greece’s competitiveness problem is that the Greek economy does not mobilize enough knowledge (Hausmann, 2012; Phelps, 2015), as expressed through the knowledge composition of the country’s exports, relative to the rest of the world. Among 128 countries, Greece has the largest gap between its level of income and the knowledge content of its exports. The same set of calculations suggest that Greece ranks second only to India in terms of how easy it would be to move to exporting more complex goods. The average over 1995-2008 domestic value added of Greek exports is at around 10% of GDP lowest among all EU countries (and Turkey), which suggests huge room for improvement via a greater role for vertical supply links (Ch. 10, IMF 2014a). Greece is economic neighbor of some of the world’s most advanced countries, which ought to facilitate diffusion of innovations and technologies.

\[9\] IMF (2015), Ch. 3, reports empirical results with OECD country data which are somewhat mixed on the effects of structural reforms on TFP but generally the impact is positive. Econometric estimates suggest that lower product market regulation and more intense use of high-skilled labor and ICT capital inputs, as well as higher spending on R&D activities, contribute positively and with statistical significance to total factor productivity. The effects vary across sectors and are typically larger the closer the sector is to the technological frontier. For example, product market deregulation has larger positive total productivity effects in the services sector, but high-skilled labor and R&D expenditure have the strongest effects in ICT-related sectors.
Despite all these potential gains from product market reforms, there is resistance to the adoption of any reform. We believe that if implementation is to succeed the reforms ought to be "owned," beyond the sphere of politics, by the groups that will implement them.\textsuperscript{10} For example, product market reforms that free up competition in trades such as taxis and pharmacies, let alone more far-reaching ones that may be threatening to broader groups of the population, must be eased in gradually and give affected workers alternative means of support in the transition, as removal of entry barriers and legislated mark-ups will shrink the affected sectors. Indeed, the rationale of IMF support to restructuring countries is to provide a cushion to the losers and help them in the transition to a new economic order. But despite the availability of ample finance for this purpose and more than five years since the initial agreement with the Troika in May 2010 to free up competition, several professions continue to jealously guard their privileges, by restricting access to licensing and only slowly letting go of gross over-billing practices for services provided through public sector projects.\textsuperscript{11}

We should also note that even if reforms were successfully implemented, there would still be a time lag of about 3-4 years before they had an impact on the real economy. We know this from the experience of other countries that have reformed, for example Germany. The Hartz reforms were implemented over three phases from 2003 to 2005 with full cooperation between union, employers and government, but their impact shows up in the German labor market starting 2007 (Pissarides, 2013). Research by Dustmann et al. (2014) also emphasizes the importance of trust in wage-setting institutions and other aspects of employment decisions in driving productivity improvements. With the absence of trust and the resistance to reform, Greece will require help from the international institutions for longer than the current three-year agreement of August 14, 2015 (European Commission 2015), even if it effectively reformed starting now.

4. The impact of labor market reforms

Labor markets reforms were given greater priority than product market reforms, mistakenly in our view. Whether this was because successive Greek governments found it easier to reform labor markets than product markets, or whether this was because the Troika insisted\textsuperscript{12} more on them is a moot point. The sequencing of reforms brought about the large fall in wages ahead of any price adjustment, with the demand consequences that we have

\textsuperscript{10} The Memorandum of Understanding, p.3, which the Greek government recently passed through Parliament, specifically states: “Success requires ownership of the reform agenda programme by the Greek authorities.” European Commission (2015).

\textsuperscript{11} Overbilling is common knowledge in Greece and it is one of the reasons that businesses were keen to get public sector contracts – only to discover recently that payments are not forthcoming because of the state of public finances. Business people who asked not be named told us that they are discounting public sector contracts by more than 50% and still making substantial profit.

\textsuperscript{12} Gikas Hardouvelis states (in a private communication) that from his experience as chief economic adviser to Lucas Papademos as prime minister of Greece, November 2011-May 2012, during negotiations in Spring 2012, it was clear that the Troika insisted on labor market reforms to precede, arguably because of convenience, product market reforms.
outlined. Several changes have taken place in the structure of labor market institutions. Numerous firing restrictions, restrictions on overtime work, and the minimum wage used to provide a rigid framework for Greek labor markets. Collective bargaining at the national level, the industry level and then at the firm level determined many outcomes, and so did many other frictions. Relaxation of all those restrictions does facilitate sectoral reallocation. Compliance to the various regulations, however, was not universal. Except for some large firms, the predominance of many Greek firms that are family-owned and very small and widespread made it easy to avoid labor laws. Labor inspections were minimal. Moreover, the shadow economy in Greece is much larger than in the rest of the eurozone, estimated to be at 24% of GDP as against 15%. These features of the Greek economy also explain why the reform of the collective bargaining law had a limited impact so far, largely because it involved a small number of firms (Lyberaki, Meghir, and Nikolitsas 2014).

Of greatest macroeconomic significance is the sharp reduction of the minimum wage (in both the public sector and the private sector, which was reduced by 22% in February 2012 from a monthly rate of 751 to 581 euros), the decentralization of wage bargaining to the firm level, and extensive relaxation of employment protection. The aggregate contraction and the increased flexibility of labor markets have been associated with a large decline of unit labor costs by about 20% since 2009 (see AMECO, 2015). The ULC-based real exchange rate has depreciated by 16.5% since 2009, though the CPI-based one has depreciated by only 5.6% since 2009.

Did the extensive labor market reforms undertaken in Greece have any positive impacts? The impacts were on the whole small and fragile. In 2014 the Greek labor market started to show signs of recovery. Employment contracted at a slower rate than in 2013, by -0.9% y-o-y in Q1:2014, compared with -2.9% in Q4:2013 and -4.9% y-o-y in FY:2013. The evidence from business cycle and forward-looking indicators signaled, in July 2014, an expansion in employment in Q3:2014 (National Bank of Greece, 2014), which did occur at 1.4% y-o-y in Q3:2014 and increased to 1.5% y-o-y Q4:2014 (National Bank of Greece, 2015). More than two thirds of employment losses in the private sector (730,000 jobs) had been due to the closure of about 220,000 small firms (30% of the existing small enterprise count) together with layoffs in that sector. Most of those jobs were lost in firms with a domestic orientation and with less flexible labor market structures, and thus reflected the Greek economy's adjustment to a greater role for larger and more export-oriented firms. Indeed, job losses in medium and large sized firms were half that of the small firms (-17% cumulatively since 2008). The contribution of larger firms (those with turnover exceeding 50 million euro) increased from 27% of total turnover in 2008, to 36% in 2013, thus getting closer to the EU average of 43% in 2013. The number of firms started growing in 2014, after several years of decline, either due to existing firms' getting back to business or to new ones being established (National Bank of Greece 2015).

The fact that wages fell by 23% in the period 2009-2013 and employment contracted by 24% cumulatively during 2009-13, caused the wage share in the economy to fall to the low level

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of 48% of GDP -- 13 pps below its 25-year average. On the other hand, capital income, mainly comprising the gross operating surplus of the business sector, has proved more resilient -- reflecting an ongoing corporate restructuring and lower labor costs -- declining by 19.7% in the five years to 2013. These developments are increasingly favorable for new hiring, as improving business profit margins should lead to higher investment and business expansion. National Bank of Greece (2014) forecasts, by linking employment to corporate profitability and output growth, that it should be profitable for Greek firms to increase their employment by an average pace of 2.5% per annum until 2020, or 19.6% cumulatively during 2014-2020 (720,000 employment positions), pushing the unemployment rate below 21% in 2016 and 12% by end-2020. "Such employment creation will clearly depend on the timely implementation of the programme, including its growth-enhancing structural reform agenda" (ibid). However, these optimistic assessments were not realized, with the uncertainties introduced by the change of government in January 2015 playing a critical role.

Having examined the Greek case in some detail, it is natural to wonder whether or not the EU’s institutional environment is more conducive to implementation of reforms. Alesina, Ardagna, and Galasso (2010) examine theoretically and empirically the linkages between the adoption and facilitation of structural reforms in the euro area. They find that within the small sample of eleven countries that they work with, the euro has indeed been associated with an acceleration of product market reforms, which did come first, but not labor market ones.

5. Dealing with Greece’s large debt

A central tenet of the Greek program is that it would enable Greece become sufficiently competitive so as to regain access to the international capital markets. With its external trade balance being persistently negative, a central hope is that economic restructuring will alter fundamentals sufficiently so that an improved goods balance along with tourism earnings (a traditional Greek mainstay) will narrow the gap to be covered by capital flows, in the form of fresh borrowing and investment. Therefore a central question is to assess the main forces affecting Greece’s accumulated external liabilities so as to be able to predict its ability to deal with its large debt.

The mainstream view is that Greece, Ireland, Italy, Portugal and Spain have accumulated external liabilities due to loss of competitiveness following relative increases in their unit labor costs. Chen et al. (2013) question this view by pointing to factors that are seemingly external to those countries and have affected them as a group. First, there has been, among European economies, an asymmetric trade interaction with emerging Europe, fast-growing China and oil exporters. Germany has captured fast-growing markets for its exports, such as China, and integrated its production chains with Central and Eastern Europe, a factor that was also decisive in its ability to expand production without incurring domestic wages increase. Second, during 2000–2009, the real exchange rate appreciation in those eurozone periphery countries reflects substantial nominal exchange rate appreciation.
If this is a correct diagnosis, a more accommodative ECB policy by strengthening growth in the eurozone North would “lift all boats” in the Eurozone periphery (Pissarides 2013). In addition, to the extent that the debtor countries are affected by the changing terms of trade in roughly the same manner, they could also benefit from eurozone-wide policies to further improve their competitiveness. That is, infrastructure investments and R&D spending aimed at improved competitiveness will generate spillover effects, while such spending will benefit from larger multipliers than there were typically assumed by the design of stabilization programs in the eurozone periphery.14

Chen et al. is not the entire story, however, at least as far as Greece and Spain are concerned. During 1999-2007, both Greece and Spain experienced economic booms financed by borrowing and increasing exports (Galienanos 2014). Greek exports, in particular, increased, from 19% to 22% of GDP, and at the fastest rate than almost any other Eurozone country during that period of time. Yet, imports increased even faster, outrunning exports. Current account balance, as a share of GDP, averaged nearly -8% for Greece over 1999-2008; in 2014, it was down to -2.6% of GDP. The Greek program can boast of success in the external trade area, as we have already argued. Yet, despite the large fall in the trade deficit, more needs to be done in view of the country’s obligation to service its huge debt.

The ECB’s “Expanded Asset Purchase Programme,” while principally aimed at offsetting deflationary pressures within the Eurozone it can also improve competitiveness in the eurozone as a whole. That is, because of lower euro interest rates the resulting downward pressure on the international demand for the euro will likely bring about its nominal depreciation. The Expanded Asset Purchase Programme will likely help improve Greece’s external competitiveness for two main reasons: One, offsetting deflationary pressures throughout the Eurozone would suppress Greece’s real exchange rate vis-a-vis its EU trading partners, especially while it remains under its stabilization program; and two, through reducing the borrowing costs of the Greek sovereign when it returns to the international markets.

If nominal depreciation of the euro continues, it would help Greece vis-a-vis its non-European Union trading partners. But, its competitiveness problem would remain, especially vis-à-vis its European Union trading partners, and would require a targeted approach.

There is long history of linking debt relief with reforms that improve economic efficiency. As Eichengreen et al. (2015) discuss, in 1991 Western governments, via the Paris Club, offered Poland a 30 per cent cut in the present value of its debt, in return for agreeing with the IMF

14 There have been prominent voices, including that of Olli Rehn, EU Commissioner for Economic and Monetary Affairs, 2010-2014, in favor of policy initiatives by the European North. As he put it, “As the two largest Eurozone economies, Germany and France together hold the key to a return to growth and employment in Europe. If Germany can take steps to lift domestic demand and investment, while France embraces reforms to its labor market, business environment and pension system to support competitiveness, they will together do a great service to the entire eurozone providing stronger growth, creating more jobs and reducing social tensions” (Rehn 2013). Most recently, Blanchard et al. (2015) quantify substantial benefits upon the periphery of fiscal expansion by core Europe, but those are shown to be present only in a liquidity trap environment.
on the terms of a structural adjustment program. Poland received subsequently a further 20 per cent cut contingent --- importantly --- on fulfilment of the structural conditions of its IMF program. The politics are vastly different, but Greece, too, has been offered conditional debt relief: First, in the Eurogroup Statement, November 27, 2012; then most recently, in the Eurogroup statement of August 14, 2015. However, in this latest instance, relief is conditional on its being deemed necessary for debt sustainability.

Debt overhang affects the policy space of the Greek government and in addition fuels adverse expectations through the effect on individuals' perceived wealth. Given the loss of wealth associated with the unprecedented contraction since 2010, such expectations have a strong impact on the economy. Because a sovereign can always walk away from a deal, especially if it is running surpluses, and refuse servicing the outstanding debt, it makes intuitive sense for the creditors to provide incentives associated with implementation of structural reforms in the form of debt relief.

Müller et al. (2015), motivated by the events surrounding the Greek and eurozone crisis, develop a theory of sovereign debt to examine the properties of the optimal dynamic contract between a planner and a sovereign when the country cannot commit to honoring its debt. The main implication of this theory for Greece is that at high debt levels the incentive to reform is reduced, because most of the benefit from reform will go to the creditors. The optimal program requires that, whenever a credible default threat is on the table, the lenders should give in and improve the terms of the agreement for the debtor by granting her higher consumption and a lower reform effort. In other words, the austerity program should be relaxed over time whenever this is necessary to avert the breakdown of the program. These results clearly bear upon the negotiations between Greece and its creditors.

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15 Eurogroup Statement on Greece, November 27, 2012, after having granted Greece relief of its debt in a number of ways, states that: "Euro area Member States will consider further measures and assistance, including inter alia lower co-financing in structural funds and/or further interest rate reduction of the Greek Loan Facility, if necessary, for achieving a further credible and sustainable reduction of Greek debt-to-GDP ratio, when Greece reaches an annual primary surplus, as envisaged in the current MoU (Memorandum of Understanding), conditional on full implementation of all conditions contained in the program, in order to ensure that by the end of the IMF program in 2016, Greece can reach a debt-to-GDP ratio in that year of 175% and in 2020 of 124% of GDP, and in 2022 a debt-to-GDP ratio substantially lower than 110%." Eurogroup Statement on Greece, August 14, 2015, states: "The Eurogroup considers the continued programme involvement of the IMF as indispensable and welcomes the intention of the IMF management to recommend to the Fund's Executive Board to consider further financial support for Greece once the full specification of fiscal, structural and financial sector reforms has been completed and once the need for additional measures has been considered and an agreement on possible debt relief to ensure debt sustainability has been reached." [Emphasis added.]

16 Debt sustainability, which debt relief is meant to ensure, remains a bone of contention between the IMF and the eurozone due to different definitions and policy objectives. Such differences have, however, been played down by the eurozone in recent informal statements. See Spiegel (2015).
6. Concluding Remarks

During most of the time since Greece’s accession into the euro area, the Greek government collected less in taxes than it spent, as indicated by increasing fiscal deficits as a share of GDP of 4.5% to 15.6% during 2001-2009, and the Greek economy consumed more than it produced and had to import way above its exports, as indicated by current account deficits as a share of GDP of 7.2% to 14.6%, during 2001-2008. As a result, Greece experienced an increase of its external public debt as a share of GDP from 103.7%, in 2001, to 129.7% in 2009, in spite of generous help from the EU’s structural funds. The Economic Adjustment Program has been a major “demand” force in the severe contraction since 2009, but there is also a “supply” force. Greece must further improve its competitiveness vis-a-vis its eurozone partners, and debt relief in and of itself cannot address the competitiveness problem. That requires a targeted approach that involves structural reforms, especially ones that improve competitiveness in the market for goods and services. Reforms are necessary to make Greece more productive, help it attract investment and develop forward-looking export industries. This will inevitably require deep restructuring of the economy, a process that typically follows crises, and is to some extent already under way in Greece.

Reforms have effects over and above the impact of price and wage changes on unit labor costs. They are critical for another reason, too, namely an adverse demographic outlook of population decline that would make it harder for Greece to pay off its debt (Ioannides, 2014). Reforms involve short-term costs and are thus painful, but necessary. Targeted, “smart” reforms are under a nation’s control, and it would be a tragedy if Greece did not undertake them, especially while under assistance. Debt relief alone would not solve the competitiveness problem. Yet, it could help if it is designed as an incentive to improve competitiveness.

References


Figures and Tables

Figure 1: Hourly Productivity, Greece vs. the Eurozone, 1983-2014.
Table 1: Real Earnings, Greece, Ireland, Portugal, Spain, 2009-2014.
Figure 2: GDP level, Greece, Ireland, Portugal, Spain, Finland (1990-96), US (1929-1938).
Figure 3: Real GDP Growth rate, Greece, Ireland, Portugal, Spain, 2007-2014.
Figure 4: Total Factor Productivity Growth, Greece, Ireland, Portugal, Spain, 2000-2014.
Figure 5: Inflation, HICP, Greece, Ireland, Portugal, Spain, 2007-2014.
Figure 6: Wages, avg. annual growth rate (OECD), Greece, Ireland, Portugal, Spain, 2007-2014.
Figure 7: Greece, Growth rate CPI, Core CPI (monthly, y-o-y), wage indices.
Figure 1: Greece, Euro Area, Ireland, Portugal and Spain. Source: OECD.

Table 1: Greece, Euro Area, Ireland, Portugal and Spain. Source: OECD.

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Figure 2: Greece, Ireland, Portugal, Spain, Finland (1990-1996) and US (1929-38). Source: Eurostat, US BEA.

Figure 3: Greece, Ireland, Portugal and Spain. 2007-14. Source: Eurostat.
Figure 4: Greece, Ireland, Portugal, Spain 2001-2014. Source: The Conference Board.

Figure 5: Greece, Ireland, Portugal, Spain 2007-2014. Source: Eurostat.
Figure 6: Greece, Ireland, Portugal, Spain 2007-2014. Source: OECD.

Figure 7: Greece, CPI, Core CPI, Wage indices, y-o-y Monthly Growth rates, 2010.1—2015.7. Source: ELSTAT.