Supply, Demand, and Institutions[1]

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In most years since Greece's accession into the euro area, the Greek government collected less in taxes than it spent; the Greek economy consumed more than it produced and Greece imported far more than it exported. The Economic Adjustment Program has been a major force in the severe contraction since 2009, a "demand force," but there is also a "supply" force. Greece needs to improve its competitiveness vis-à-vis its eurozone partners. Debt relief in and of itself cannot address this need. To improve competitiveness Greece needs to improve its institutions.

The Greek population has suffered huge losses of income and wealth since the onset of the Greek crisis in 2009. They can only be offset by sustained increases in employment and economic growth. Huge increases in public and private capital formation are needed. Total factor productivity growth, that is productivity growth over and above what is explained by increased use of measurable factors of production, must accelerate.

At the same time, demographic problem is brewing. Fewer births, return of recent immigrants to their home countries, and out-migration of young, skilled and mobile Greeks will exacerbate the effects of an aging population. These demographic crisis has major fiscal implications. In particular, it makes it harder to deal with the debt.

As the crisis is one of both supply and demand, the need for productivity improvements and good institutions is urgent. One critical need is reform of the many impediments to growth in the Greek educational system. For Greece to be competitive in the global market place, and especially in the EU market place, institutional convergence is also needed. Greece has achieved considerable improvement in unit labor costs. But that needs to be complemented with improved institutions. By that I mean control of private and public corruption, an efficient legal system, state capacity and others, and a tax system favorable

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to growth.

Prolonged unemployment experience makes future reemployment harder because it causes loss of skills. Moreover, it hurts the next generation, the children of the long-term unemployed. Pessimistic expectations take their toll in reducing investment and thus wealth more than in proportion to the income loss.

Greece's circumstances are not unique. There are lessons to be learned from elsewhere. Latvia's experience with its internal devaluation efforts after its accession to the European Union was comparably severe to Greece's. Both the downturn and the upturn were faster than in Greece.

The Greek people lost real wealth in the form of decreases in the value of housing and business capital; they are further harmed by the decrease in public capital. Individuals have lost financial wealth in the form of pension rights and the value of other assets. The country has little fiscal space, if any, left, to subsidize pensions and still needs to carry out long-overdue reforms in the pensions area. The impact of such reforms on demand will need to be offset by productivity improvements.

Loss of disposable income has meant that people have fewer resources to save from. Bank closures and capital controls have affected people's confidence in the banks. Loss of wealth means that people simultaneously feel a greater need to provide for the future and have diminished resources out of which to save. The aging of the native-born population itself is another factor in declining savings. People are spending down their life cycle savings and more. Thus, the shortage of domestic savings constrains the massive investment that is necessary. Given modest (if any) government savings, we will need to be very friendly to foreign investment.

Greece's population fell by 1.3% over 2001–2011. From 1951-2010, the ratio of individuals 65 and over to those in the prime work age groups15–64 has tripled from 11.1% to 28.4%. The ratio of those 0–14 to those 15–64 has fallen from 41.9% by one-half. Total fertility index has fallen from 2.3 per woman in 1950s to 1.46 in 2010. While the phenomenon is EU-wide, Greece's problem is extreme even among all of the southern European debtor nations in the

Eurozone.

The demographic shock has major fiscal implications in the longer run and places greater onus on total factor productivity growth. Out-migration is selective: individuals leaving are disproportionately younger, skilled and more enterprising. This will cause net fiscal losses as well as losses of human capital.

How about productivity? Over the last couple of years, I have taken a great interest in the specifics of OECD's "How to Get Growth Going." OECD's suggested improvements look small, but they apply to many areas and they complement each other. The power of compound interest is enormous.

At a rate of 1.69% per year, Greek real GDP per capita grew 12.3 times during 1864 to 2009. Most of that growth came over 1950–2009, when the growth rate of Greek GDP per capita was at 3.24% per year, remarkably high, allowing living standards to rise by 7 times since 1950. Thus, small differences led our economy to huge changes over long periods of time. Can we match that earlier record?

Product market deregulation is an important reform that can affect growth in two important ways. Abolishing monopolistic and monopsonistic structures and eliminating barriers to entry allows the economy to produce more. It would also facilitate adoption of productivity-boosting innovations. This second effect helps narrow the gap from the technological leaders. It is vastly more important because it is long-lasting. Since Greece's entry into the adjustment program, TFP growth has declined in Greece by much more than in other program countries. The fundamentals so far make a revival of TFP growth, mainly because of too little spending on education and on research and development, as well as poor connections between universities and industry. Greece's spending on research and development is less than one-half of of the euro zone average, now at 2.0 percent of GDP.

The necessity of structural reforms is enhanced in the presence of downward nominal wage rigidities, fixed exchange rates, and high debt levels, which characterize all the members of the euro area. As Mario Draghi (2015) has emphasized, 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 making it easier for a uniform monetary policy to work.

But product market reforms have not been given priority. The interventions implemented have addressed only some of the problems and at best only partially. A slow improvement did take place in in the business environment during the period leading up to the January 25, 2015, parliamentary elections. Some international indicators have also improved, including the Global Competitiveness Index, the World Banks ease of doing business ranking, and the OECD's Product Market Regulation Index. There is still a long way to go if Greece is to have an economy on an institutional convergence path with core Europe. That distance has not narrowed.

For implementation to succeed, institutional reforms need to be "owned," (beyond the sphere of politics), by the groups that will implement them. For example, product market reforms that free up competition in trades such as legal services and pharmacies, let alone more far-reaching ones that may be threatening to broader groups of the population, may need to be eased in gradually and to incorporate alternative means of support for affected workers in the transition, since removal of entry barriers and legislated mark-ups will shrink the affected sectors. I don't have in mind How about ill-begotten gains and exorbitant privileges. 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 the passage of more than five years since the initial agreement with the troika (in May 2010) to free up competition, we have seen several professions and sectors of the economy jealously guarding their privileges. Decisive politics is called for.

Even if reforms were successfully implemented, there would be a time lag of about 3 to 4 years before they can have an impact on the real economy. The German experience is telling. There, the Hartz reforms were implemented over three phases, from 2003 to 2005, with full cooperation and **trust** among unions, employers, and government. The effects showed up in the German labor market only starting in 2007. They were not popular: they reduced the real wage between 2003 and 2008 by 4% but they did improve employment.

The current absence of trust and the resistance to reform in Greece suggests that Greece would require help from the international institutions for a **significantly longer** period than the current three-year agreement signed on August 19, 2015, even if the country were to effectively reform starting now.

Labor market reforms have been given greater priority in Greece than product market reforms, mistakenly in my view. The sequencing of reforms brought about the large fall in wages ahead of any price adjustment. As a result, the impressive decline in unit labor costs, in effect steadily reversing the increase during 2000–2009, has not been fully reflected in improvement in competitiveness, domestic and international. Labor cost improvements were not translated to export competitiveness. It is now acknowledged that the sequencing of reforms was a serious error. Labor market reforms reduced the purchasing power of the public and so added to the contraction. Then because the benefits from increased competitiveness were not realized promptly, we have seen further erosion of purchasing power.

The design of the fiscal adjustment under MoU I, MoU II, and I fear under MoU III, was unfavorable to growth, aiming as it was in immediate increase in tax revenue instead of rationalization and modernization of the tax code and administration. Cutbacks on public investment, to make up for tax receipts and to meet deficit targets, has delayed productivity improvements. Improved efficiency of the public sector would have been pro-growth, as would improved efficiency in the provision of public services.

We know from other recoveries that the economy cannot just return to its previous state. The Greek economy will be very different when the crisis ends. Productivity improvements and greater internationalization will make the economy look very different.

A very successful educational system is typically behind all economic successes. We know this from Finland, whose sophisticated labor force helped during its recovery in 1990–1996, and together with business R&D spending facilitated development of the Finnish ICT sector. I know that Nokia's current misfortunes are adding to Finland's woes. But a tradition of successful start-ups can help in other industries. Finland has invested in biotechnology, which could be its next growth area. The value of investment in R&D, a highly skilled labor force and a business model aiming at a massive global market are key lessons from Finland's experience. This can work even traditional industries; one Greek example is Fage. (During a visit to North Dakota, my hosts apologized because their supermarket was out of Fage.)

A skilled labor force, equipped with general and specific skills, is a *sine qua non* of economic growth. Reform is needed throughout the Greek educational system. For example, extensive vocational training has been singled out as a factor in the improved unemployment performance of those OECD countries, like Germany or Finland, with rich vocational education and training programs. In Greece, poorly developed vocational training is an important factor in the incidence of unemployment.

In redesigning the Greek educational system one important observation from international comparisons that cries out for attention. Greece is an outlier in teaching methods. Students rarely work in groups. Teachers mainly lecture while students mainly take notes from the board. Moreover, the gap between vertical and horizontal teaching being higher than any other European country. generalized trust is lowest. Generalized trust in a society is strongly correlated with such attributes. Examining the consequences of values inculcated at home shows that a distrust index is negatively correlated with the importance parents assign to children's being taught "tolerance and respect," show that Greece is an outlier, lowest on tolerance and respect, and highest in distrust. These problems have been there for a long time. They are becoming more acute as the impoverishment of the Greek middle classes makes it harder for families to cope with even more demands on them.

We also know now from powerful evidence studied extensively by James Heckman of the University of Chicago that it is not only cognitive skills that matter for economic success for also non-cognitive skills in the contemporary workplace. Non-cognitive skills can also be taught and deficiencies be mitigated, if recognized early. While we cannot reconfigure Greeks to be more like successful foreign models, and perhaps we do not want to, the international macroeconomic evidence points to trust as a very important factor is stimulating economic growth. Trust can be taught.

We need to train teachers. They need to acquire and teach the right skills to the Greek youth so that they can compete in the global market place. The wave of disrespect for knowledge that is sweeping the country will stand in the way. The hostility the current government has shown to the newly instituted External Boards of Greek institutions of higher education is indicative of this disrespect; it has set back sorely needed administrative reforms in Greek higher education.

There is no single parameter, no simple trick to solve our economic problems. The hard reality is that there is no magic. Patience along with trust are needed to guide us forward, provided that we are capable of reforming and coping with the future. The alternative is to accommodate to a lower level of welfare in the foreseeable future. Even that alternative is easier said than done; could such an accommodation be peaceful? Structural reforms are crucial if Greece is to survive in the Eurozone. Institutional convergence is just as important. Each eurozone country's own prosperity ultimately depends on each country putting itself in a position to thrive within the Union. Sovereignty over relevant economic policies, above all structural reforms, has to be exercised jointly.

There is great talent in Greece. Skilled people have been adept in redesigning school curricula.We have successful entrepreneurs in cutting-edge technologies, some of them are here at this event. Greece has a tradition of entrepreneurship that needs help to flourish.

Reforms are necessary to make Greece more productive, help it attract investment, and aid in developing forward-looking export industries. This will inevitably require deep restructuring of the economy, the process that typically follows crises and has began. But reforms involve short-term costs and are thus painful, albeit necessary. Targeted smart reforms, including institutional reforms, are under our nation's control. It would be a tragedy if Greece did not undertake them, especially while under assistance. Debt relief alone will not solve the competitiveness problem.

For a small country like Greece in a geopolitically volatile area of the world, there is no alternative to the development of a vibrant economy to reverse our current immiseration and impoverishment and launch the country on a growth path. It is under a nation's control, but sadly, politics does stand in the way. We need inspired, transformational approaches, broad political support and patience. Political forces will need to bury their hatchets and agree on a minimum program to help the country get out of this harrowing crisis! **Thank you!**