The Greek economy: Can the 13-year expansion streak continue?

by
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Since 1994, Greece is going through a remarkable uninterrupted 13-year expansion, surpassing all expectations. Since 1996, it grows at rates well above the corresponding rates in the EU-15 countries (Figure 1) and its citizens witness their standard of living getting increasingly closer to the EU-15 average - now at 79%, but in reality a lot closer as the new upward-revised GDP numbers will soon show. The main culprit for this positive momentum can be traced back to the mid-1990s and Greece's decision to prepare for joining the Euro Area, as politicians were then forced to put the government's fiscal house in order and contain inflation. The subsequent drop in nominal and real interest rates and the stable macroeconomic environment generated a boom in investment activity, bringing investment up from 19% of GDP in 1995 to 26% in 2006. A rapid credit expansion to households also unleashed a property and consumption boom across the country. Structural reforms and extensive privatizations in the banking sector, the telecoms industry and other public utilities improved private sector efficiency. Greek firms grew larger in size, became more competitive and crossed the border, selling more aggressively to the new democracies of the former Eastern block and establishing subsidiaries in the neighboring countries, taking advantage of the cheap labor. The creation of independent regulatory agencies formed a new system of checks and balances on the authority of government and of large companies, improved transparency and brought a new level playing field into traditional business operations and practices. At the same time, a large inflow of immigrants from Albania and other Eastern European countries, most of them illegal, increased the labor force by approximately 20% and satisfied the low-skill needs of an ever expanding and service-oriented economy.

The expansion is expected to continue into 2007, with rates of approximately 4%, driven by domestic demand in the form of both consumption and investment. Yet, many observers question the sustainability of a prolonged future expansion. They point to a satiated consumer, who may have reached his upper limit regarding his capacity to accumulate additional debt. Household debt is now at 44% of GDP,

less than the EU-average (see Figure 2), but high enough to suggest that credit expansion will soon slow down, pushing consumption growth downward – and, parenthetically, banks scurrying to safeguard their profit margins by expanding outside Greece.

Inflation is a second worry. Although substantially lower than 10 years ago, it still remains above the Euro Area average inflation by 1-1.5 percentage points, which may seem small in a given year, but over time it cumulates into a substantial loss in competitiveness – 13% since the year 2000, according to the Bank of Greece (Figure 3).

Yet, a third and bigger vulnerability is Greece's mushrooming current account deficit, which reached the unprecedented level of 12.1% of GDP in 2006 (Figure 4). This level can no longer be ignored or justified as the outcome of adverse temporary factors like the movement in oil prices or the number of ships bought under the Greek flag. The persistent and large current account deficit suggests that the country suffers from a serious lack of competitiveness: Its productive capacity is incapable of satisfying the consumption and investment needs of its population. This major discrepancy between abilities and desires can no longer be addressed via a currency-devaluation, as was done in the past. Competitiveness has to be attained the hard way, via policies that improve business internal practices and the business environment – stable taxation, minimal bureaucracy, minimal corruption, transparent rules, etc. Perhaps, competitiveness can also improve by strategic country decisions to facilitate sectors in which the country does have a competitive advantage.

A more subtle, yet equally worrying fourth vulnerability is the current and future state of the country's public finances. The debt-to-GDP ratio remains stubbornly high, above 100% and the second highest in the EU-15, showing that politicians do not have the courage and political will to make the necessary reductions (Figure 5). Meanwhile, Greece's aging population is expected to strain the finances of the social security funds, hence a reform is urgently needed. The debt-to-GDP ratio is bound to rise in the future as pensioners would demand a larger piece of the government's revenue pie. The estimates of the net present value of those future liabilities under the rules of the current pension system are staggering, anywhere from

two to three hundred percent of current GDP, the worst in the EU-15! Yet, it is important to take hold and reduce the size of public debt not only in order to secure that the debt can be financed at reasonable rates, but also because a large debt annihilates the ability of any government to perform discretionary fiscal policy: The Greek government would not be able to use its tax and spending power to avoid a recession because a move that would worsen the size of its debt would not be "acceptable" by financial markets. In other words, the government would be completely helpless, with no policy tools at its disposal, since its other tool, monetary policy, is also ineffective. It is a tool driven by the ECB and by concerns of the full Euro Area, not the specific Greek concerns.

The previous vulnerabilities have obvious solutions, which, however, require political will and social consensus. The final goal is an ever improving standard of living, more choices and opportunities for everyone who is willing to work hard inside the country, plus a more secure working environment and a better distribution of income with low unemployment. It seems that the present government wasted precious time and an unprecedented 5 percentage point electoral lead in the first half of its term in office in order to learn about the problems rather than deliver immediate solutions. The economy was then simply carried on by momentum. Yet, momentum can carry a country for so long. In a few months we will have new elections. I would like to envision the new government with a specific plan for the first six months in office and, figuratively speaking, its head as the managing director of the company called "Greece," In that plan, he ought to have specific policy priorities and goals that are achievable and easily understood by the public. I am optimistic that despite the economy's vulnerabilities, our citizens and politicians do have the level of maturity to push for many more years the 13-year expansion streak.

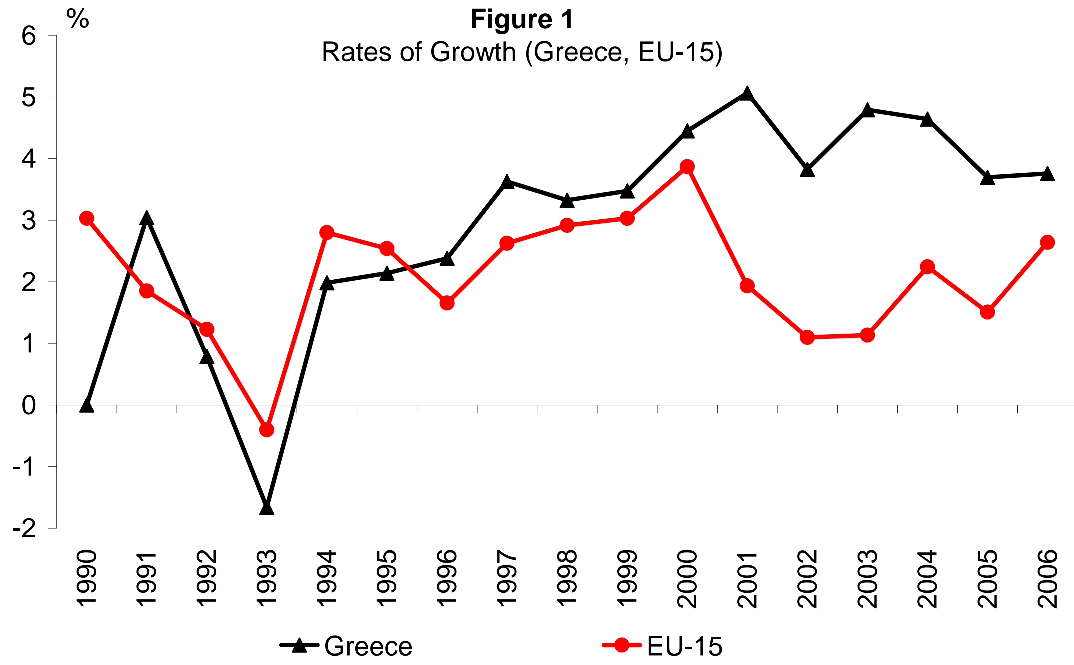
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Figure 1
Rates of Growth (Greece, EU-15)
6
5
4
3
2
1
0
-1
-2
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
Greece
EU-15

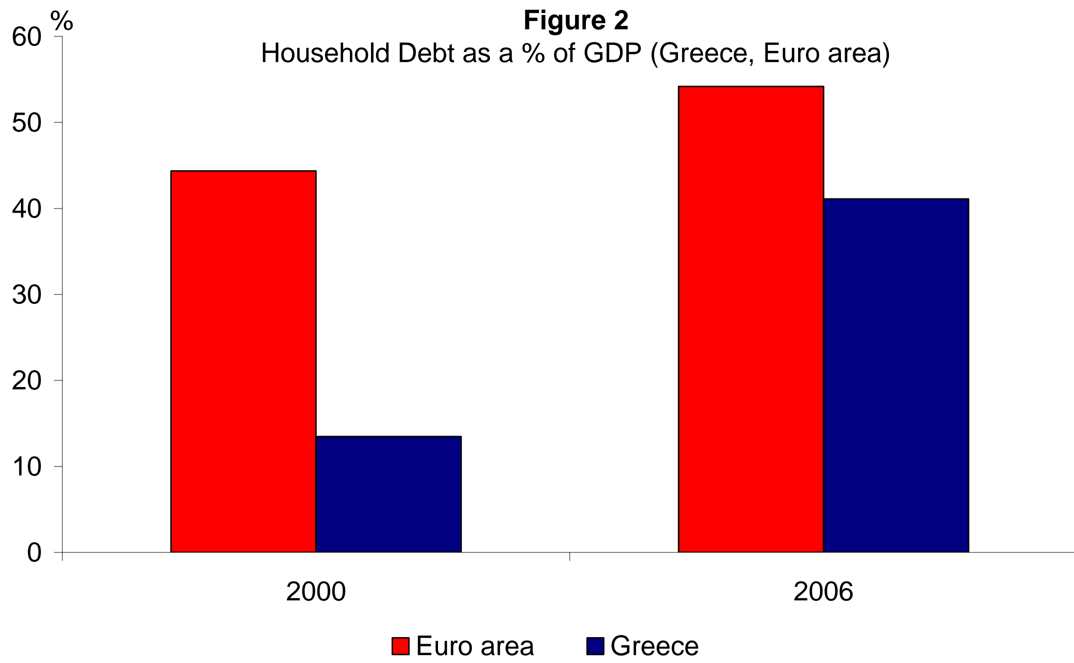
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Figure 2
Household Debt as a % of GDP (Greece, Euro area)
60
50
40
30
20
10
0
2000
2006
Euro area
Greece

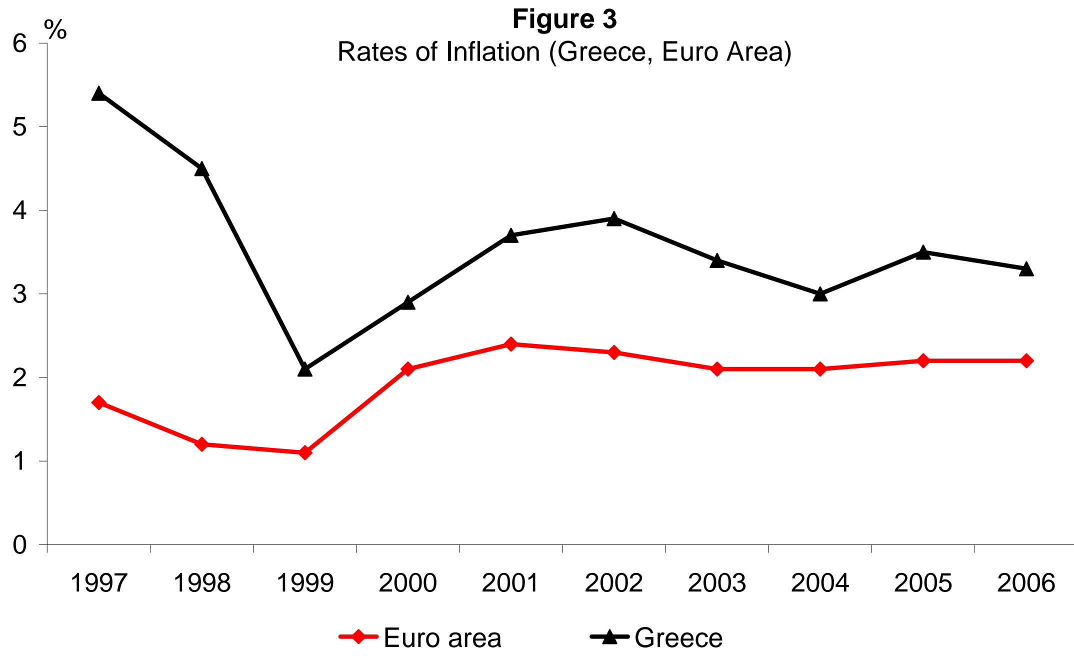
Figure 3
Rates of Inflation (Greece, Euro Area)
%
6
5
4
3
2
1
0
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
Euro area
Greece

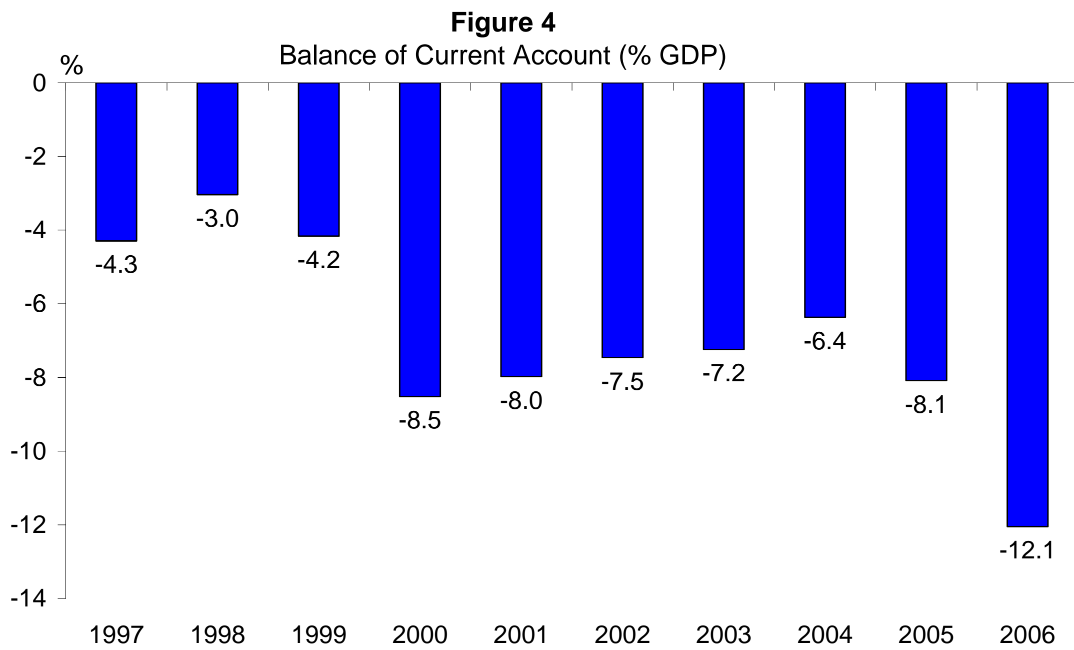
Figure 4
Balance of Current Account (% GDP)
%
0
-2
-4
-6
-8
-10
-12
-14
-4.3
-3.0
-4.2
-8.5
-8.0
-7.5
-7.2
-6.4
-8.1
-12.1
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006

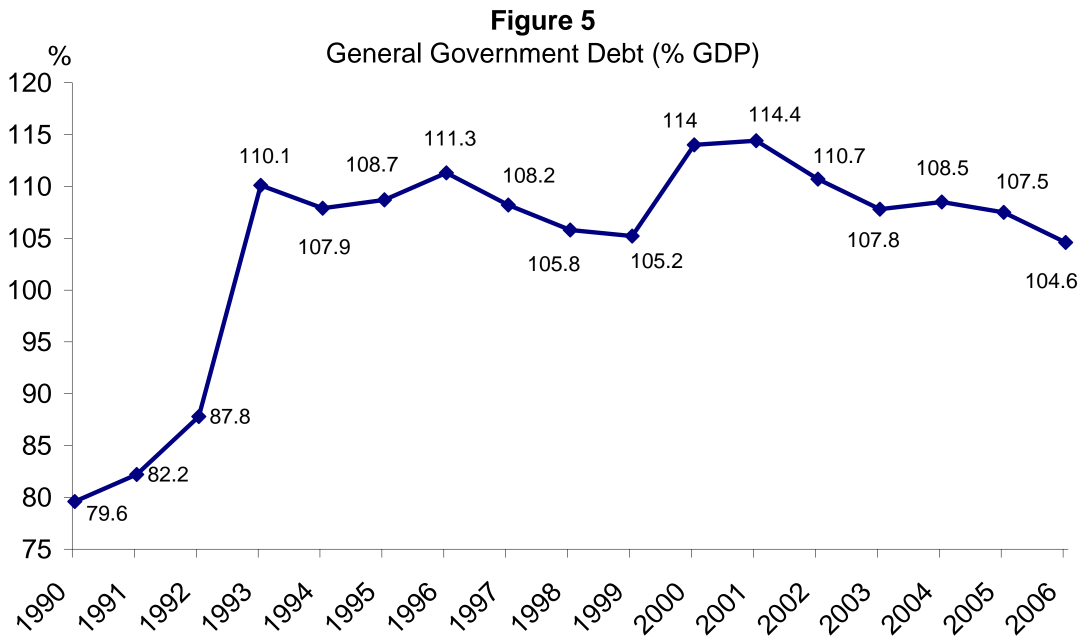
Figure 5
General Government Debt (% GDP)
%
120
115
110
105
100
95
90
85
80
75
79.6
82.2
87.8
110.1
107.9
108.7
111.3
108.2
105.8
105.2
114
114.4
110.7
107.8
108.5
107.5
104.6
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006