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**The Greek Paradox of Falling Competitiveness  
and Weak Institutions in a High GDP Growth  
Rate Context (1995-2008)**

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# The Greek Paradox of Falling Competitiveness and Weak Institutions in a High GDP Growth Rate Context (1995-2008)

Theodore Pelagidis<sup>#</sup>

## ABSTRACT

In this paper, we deal with some pieces of evidence that are necessary to explain the paradox of rapid GDP growth despite the dismal competitiveness of the Greek economy during 1995-2008. It is shown how the structural weaknesses of the Greek economy have hit the domestic economy investigating their impact on the current turmoil. It is argued that the previously favourable global economic environment acted as a locomotive to domestic growth, whereas now that it is gone, structural problems of poor governance, low competitiveness, and a ballooning public deficit and debt have come to the surface. We offer a specific explanation of the current unfortunate state of the economy briefly considering avenues of necessary reforms to overcome it.

Keywords: Macroeconomy, Institutions, Competitiveness, Greek Economy.

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# **The Greek Paradox of Falling Competitiveness and Weak Institutions in a High GDP Growth Rate Context (1995-2008)**

## **1. Introduction**

Since the mid 1990s, Greece's economy enjoyed an average growth rate of 4% (Figure 1), which let the country converge, more or less, with the Eurozone standards of living. Despite that, many structural weaknesses continued to prevail, if not deteriorate. During the last 15 years or so, Greece substantially succeeded in improving the 'private standard of living', but remained behind in the organization of its society, economic institutions and provision of public goods to the citizens. As a result, when the global economic crisis hit, all the mess behind the glittering and superficial 'nominal growth' came to the surface.

To find a way out of this mess we need first to understand the basic flaws of the Greek economy, the distortions, injustices, perverse institutional incentives that dominate today our economy. Then we will be able to find out the crucial link, the link of cardinal importance that could bring a wave and a domino of progressive structural reforms.

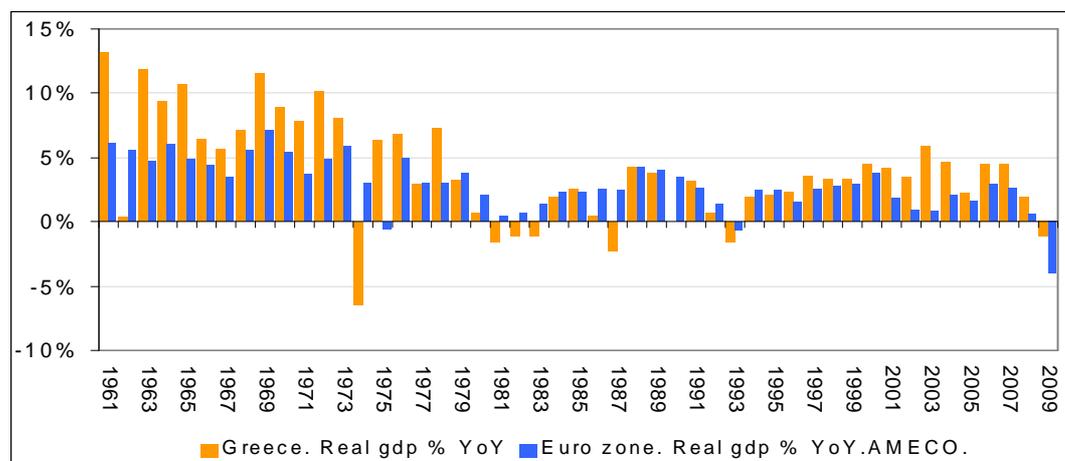
In this context, section 2 presents and analyzes the engines of high growth rates that the Greek economy experienced during 1995-2008. Section 3 focuses on

the facets of low competitiveness, while section 4 deals with the facets and evidence of institutional weakness and poor governance. Section 5 investigates the paradox of the underlying ‘high labour productivity’ in a low competitiveness context, and section 6 concludes.

## 2. The engines of growth, 1995-2008

Certain positive developments led to the strong growth performance observed in Greece since the mid-90s and up to 2008. Figure 1 shows how Greece clearly outperformed, since 1995-96, the benchmark Eurozone economy. However, it is absolutely crucial to look at the factors of ‘growth’ to see why - at least in the greater part- this performance was superficial and fragile; i.e. not based on the improvement, the deepening, or the expansion of domestic production.

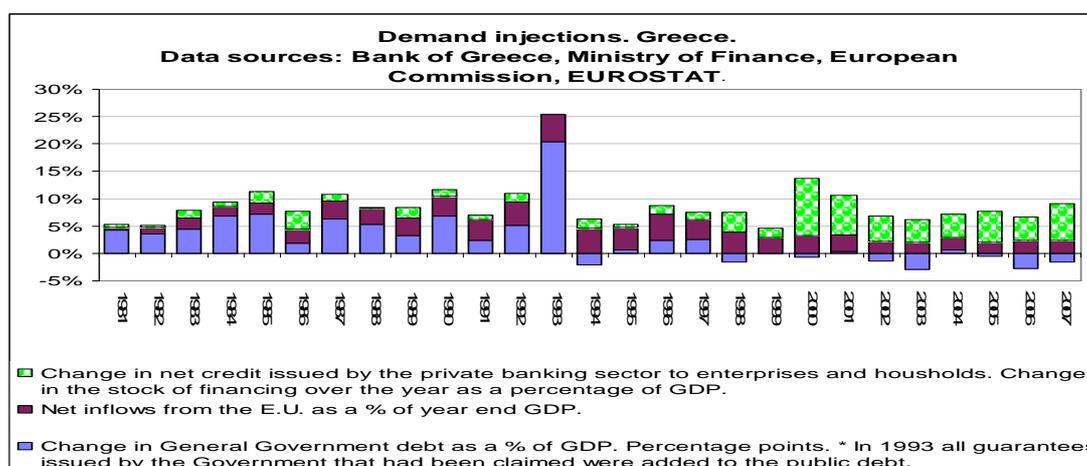
**Figure 1**



Source: AMECO

These developments include, primarily, the proper liberalization of the credit markets at the beginning of the 1990's, completed by the end of the 1990's. This was coupled with entry to the Economic and Monetary Union. These two developments combined led simultaneously to macroeconomic stabilization and a steady increase of private credit after 2000. It should be stressed that the expansion of private credit replaced, since the early 1990s, the government deficit spending as the main way to finance the expansion of consumption in Greece (although data should be treated with caution). It is most likely, that fiscal expansion reinforced private credit and the expansion of private consumption. Figure 2 shows the demand injections to Greek GDP.

**Figure 2**

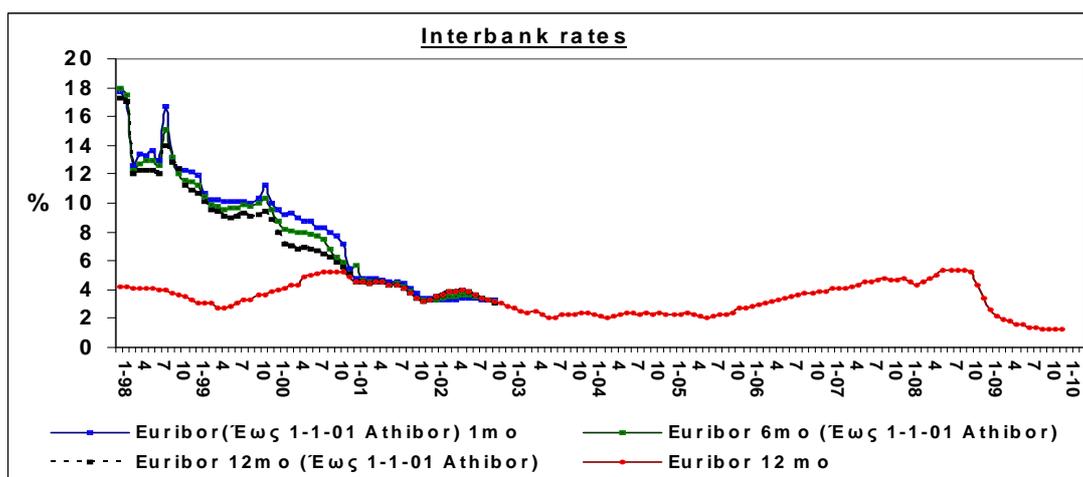


Source: Bank of Greece, Ministry of Finance, European Commission Budget and EUROSTAT.

The impact of these injections was significant as a percentage of GDP for every year during the prolonged period of Greece's strong performance.

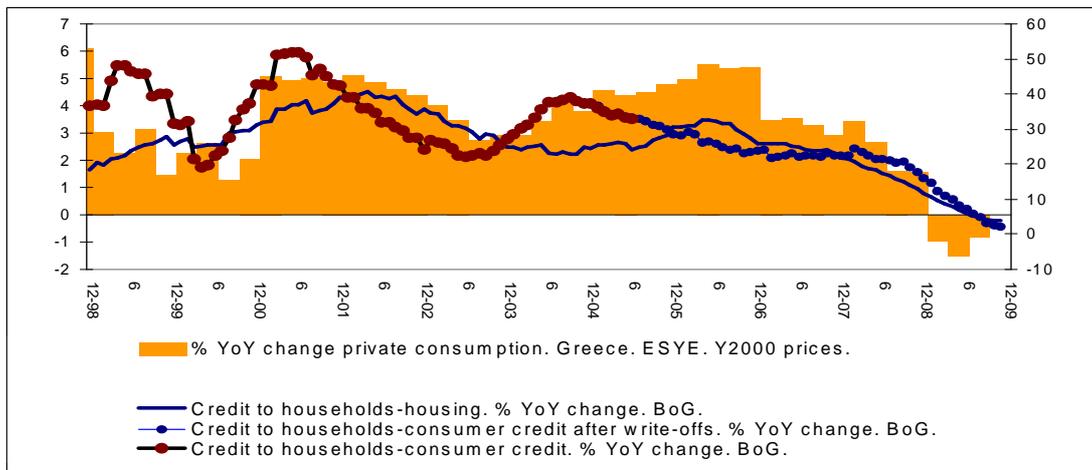
Additionally, the rapid fall of interbank rates after 1998 (Figure 3) shows the significant contribution of the stabilization of the macroeconomic outlook of Greece. This stabilization took place in the run up to EMU accession and allowed the expansion of private credit.

**Figure 3**

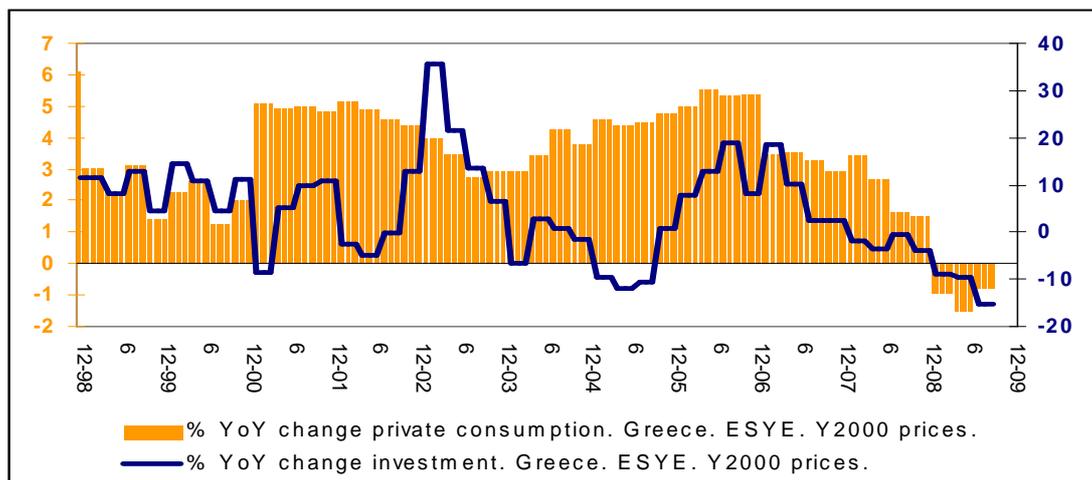


The fall of interbank rates also reflects the decline in the rates offered by commercial banks to households and businesses (bringing also a significant fall of the inflation differential of Greece with respect to the euro zone average). The expansion of credit to households fuelled the growth of private consumption during the past years (as clearly shown in Figure 4). Only during the period preceding the completion of the infrastructure projects (for the 2004 Olympic Games), private consumption kept accelerating in spite of a lull in the explosive growth of private sector credit. But this exception is easily explained by the peak in the investment growth rate during that time (figure 5).

**Figure 4**

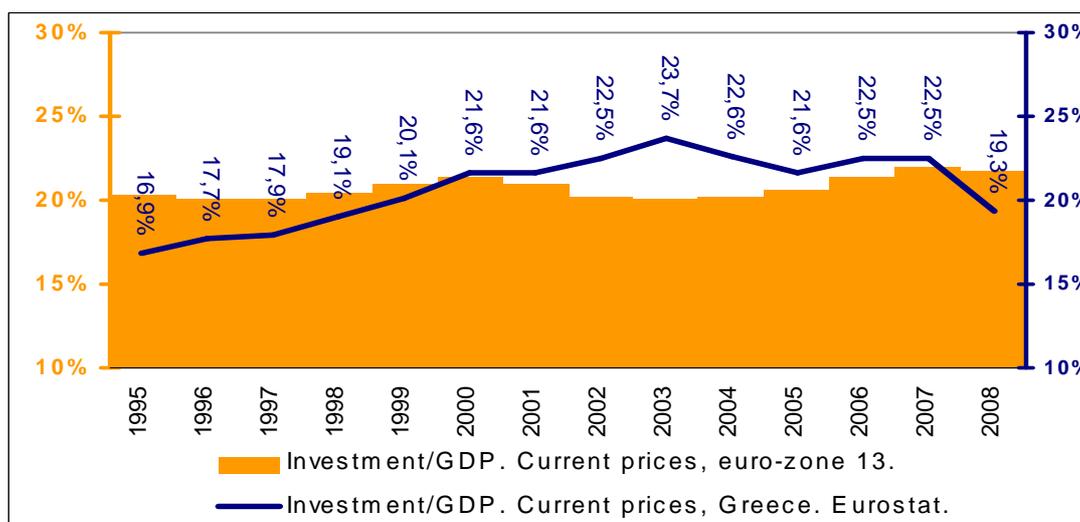


**Figure 5**



Besides the credit expansion, two other factors contributed significantly to Greece's growth performance during the 2000s. First, the shipping and tourism sectors secured significant annual revenue inflows of about 25% of GDP that were added to the domestic demand and helped mitigate the huge trade balance deficit. Second, the fiscal stimulus given by the 2004 Olympic Games was nourished through public borrowing and led to the improvement of certain key infrastructure facilities.

**Figure 6**

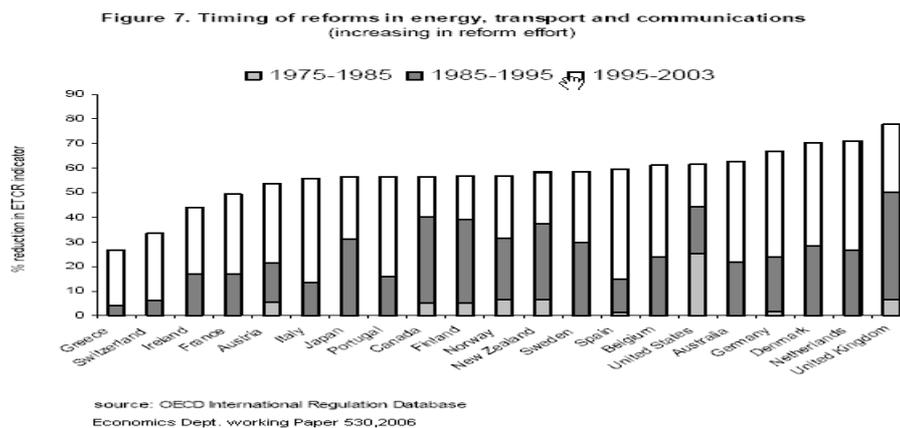


The rapid increase of new investment, both public and private (Figure 6), also demonstrates the impact of the infrastructure investment that was largely financed by EU structural funds. Still, the rush into EU-financed infrastructure investment did not only contribute to investments and consequently to the creation of new jobs. Many of these projects, when finished, actively boosted the productivity in the area surrounding Athens. In other words, the inflow of funds from the European Union, in the framework of EU Structural Funds and Common Agricultural Policy, also contributed largely to the improvement of key productivity enhancing infrastructure facilities.

Last but not least, the improvement in the regulation of certain product markets (Figure 7) contributed to accelerated economic growth. Regulation was reduced from a very high level, even though it still remains very high compared to other OECD countries according to Conway and Nicoletti (2006) (see graphs/figures 18, 19, 20, below). Still, this contributed significantly to Greek growth

performance during the 2000s. This improvement included mainly the liberalization of the telecommunications market at the beginning of the 1990's and to a lesser extent to the liberalization of the transportation and energy sectors.

**Figure 7**



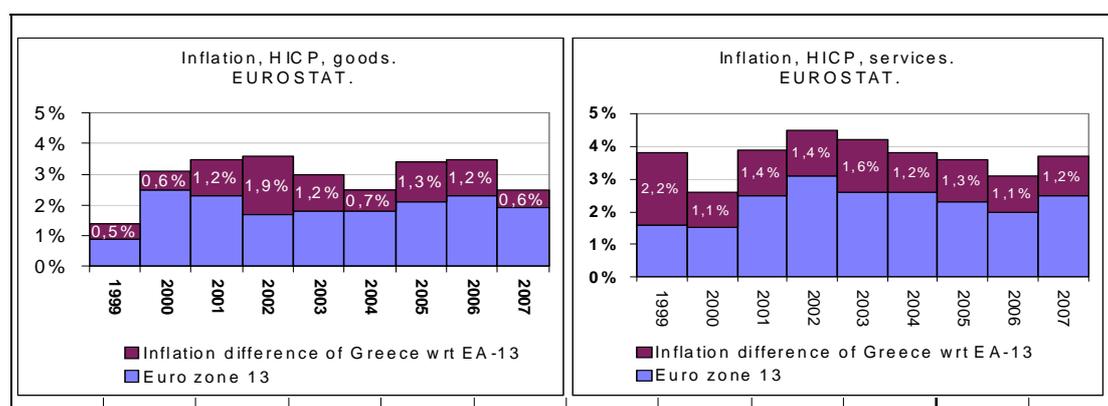
### 3. The four facets of low competitiveness

At the same time, a wide range of factors contributed towards the persistently poor performance in the competitiveness of the Greek economy, which is documented by numerous databases and surveys by international organizations and researchers. These factors include: (i) the persistent current account deficit in double-digit numbers (as a % of GDP), (ii) the positive differential with the euro zone average inflation, and (iii) the unattractiveness of Greece to foreign direct investments that are practically zero (inflows minus outflows). Research by OECD and the World Bank indicate that the various institutional

weaknesses that prevail in Greece account for this dismal competitiveness performance.

Starting with the inflation differential of Greece with the Euro-zone (Figure 8), it could be explained with the Balassa-Samuelson effect stemming from the rapid growth rate of the country. However, the differential seems to emerge both in the goods (tradable) and services (non-tradable) sectors sub-indexes, something that initially seems to refute the Balassa-Samuelson argument.<sup>1</sup>

**Figure 8**



A comparison with Ireland is most revealing. The inflation of goods in Ireland is much lower than the inflation of services, and that emerges as a textbook Balassa-Samuelson case. Therefore, the high Greek inflation seems to emerge as a result of the demand increase. The latter is largely driven by the expansion of credit, the inflows from the EU-structural funds, the inflows from tourism and shipping industry, and public borrowing. This increase is not matched by a similar increase in the domestic supply of goods and services. In the case of

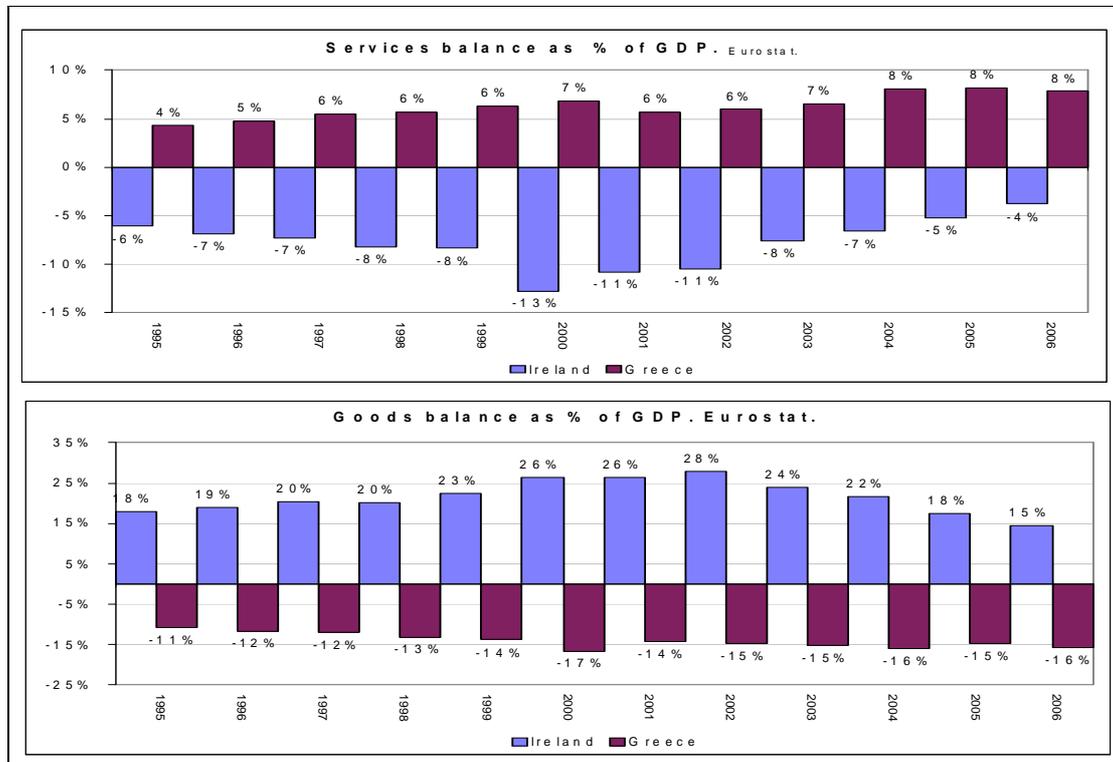
<sup>1</sup> Although to a certain extent, tourism that constitutes a significant part of services, should be considered also as a ‘tradable service’.

Ireland, the surplus of the goods balance seems to finance a deficit in the services balance, following a pattern that fits the standard predictions of the Balassa-Samuelson model.

The second piece of evidence that supports this argument is the excessive –and increasing- deficit of the goods trade balance, as a percentage of GDP (Figure 9). As a matter of fact, the deficit is of such a magnitude that has never been observed in any country without severe repercussions. In the case of Greece, participation to the Euro-zone seems to have averted developments like the entrance into a spiral of high inflation and currency devaluations. As a result, the trade deficit in Greece can clearly demonstrate the existence of a serious discrepancy between the growth of domestic demand and the increase of the domestic supply of both goods and services. It should be stressed that in the case of non-tradable services, the inflation differential is sufficient to document the discrepancy between supply and demand, but the emergence of such a differential for goods as well suggests the peculiarity of the Greek case. Therefore, the evidence at hand would make it more appropriate to label Greece as a unique case of ‘quasi Balassa-Samuelson’, where exports are replaced by EU-transfers and domestic credit expansion, and the price level is pushed upwards both in the goods and the services sector in line with similar arguments presented elsewhere (Gibson 2007; Pelagidis and Toay, 2007). The increase of the goods deficit follows as a natural consequence in this case, as increases in demand are satisfied by competitive and available imported goods

as there is no sufficient domestic supply of goods that can compete with the imports.

**Figure 9**



This persistent deterioration of the goods balance has been financed (besides from the surplus of the services account) through foreign inflows in both Greek government bonds as well as into the stocks of Greek companies -until the recent financial turmoil. However, it should be noted, rarely were these inflows of the FDI type. FDIs during the last three years were close to zero (\$0,9 bil. for 2006, \$-2,5 bil. for 2007 and \$1.3 bil. for 2008, according to the Bank of Greece). In fact, FDI inward flows for Greece as a percentage of GDP are very low for almost all years, something that is in line with the link between the

attractiveness of the business environment and FDI as described by authors such as Hajkova et al (2007).

The performance of the goods balance together with the inflation differential with the euro zone for tradable goods suggests that the cost of importing and distributing these competitive imported goods is higher compared to the Euro-zone. Furthermore, it suggests that the imports remain competitive in the domestic market in spite of this high cost of importing and distributing, which seems to be really damning for the competitiveness of the domestic supply of goods.

In spite of the mitigating effect of the surplus of the services balance, which is mainly driven by the performance of the shipping industry and tourism, the current account balance has remained for many years at a level (15% to GDP), that in any other country would have been associated with serious repercussions. It should be noted, that the two sectors that contribute to the services account surplus are less affected by the regulatory environment of the Greek economy. For the case of shipping, it operates almost completely outside the Greek jurisdiction and administrative reality, while for the case of tourism, it draws its competitive strength largely from the geographical attractiveness and cultural heritage of Greece.

These pieces of evidence manifest themselves in the compelling case for the low competitiveness of the Greek economy, documented by a number of surveys (Table 10). Interestingly, a wide selection of different surveys -

including those that measure governance and corruption- rank Greece in a roughly similar way, even though they often use different methods; either evaluation of hard evidence or responses to questionnaires (or both).

**Figure 10: Competitiveness indexes**

Doing Business in 2009, World Bank. No of countries	Ease of Doing Business Rank.	World Economic Forum 2008	GCI 2008-2009 rank	Transparency International	2008 Corruption Perceptions Index Country Rank	UN	Rank per capita income in US \$
	181		134		180		214
Greece /total	53%		50%		32%		19%
Singapore	1	United States	1	Denmark	1	Luxembourg	2
New Zealand	2	Switzerland	2	New Zealand	2	Norway	4
United States	3	Denmark	3	Sweden	3	Iceland	6
Hong Kong	4	Sweden	4	Singapore	4	Ireland	7
Denmark	5	Singapore	5	Finland	5	Denmark	8
UK	6	Finland	6	Switzerland	6	Switzerland	10
Ireland	7	Germany	7	Iceland	7	Sweden	13
Canada	8	Netherlands	8	Netherlands	8	Netherlands	14
Australia	9	Japan	9	Australia	9	Finland	15
Norway	10	Canada	10	Canada	10	Australia	16
Iceland	11	UK	12	Luxembourg	11	UK	17
Japan	12	Austria	14	Austria	12	United States	18
Sweden	17	Norway	15	Hong Kong	13	Austria	19
Belgium	19	France	16	Germany	14	Belgium	22
Switzerland	21	Taiwan	17	Norway	15	Canada	23
Estonia	22	Australia	18	Ireland	16	Australia & NZ	24
Korea	23	Belgium	19	UK	17	Germany	25
Mauritius	24	Iceland	20	Belgium	18	France	26
Germany	25	Ireland	22	Japan	19	Italy	32
Netherlands	26	New Zealand	24	USA	20	Japan	33
Austria	27	Luxembourg	25	Chile	23	Spain	35
France	31	France	28	France	24	New Zealand	37
South Africa	32	Spain	29	Uruguay	25	Hong Kong	39
Slovakia	36	China	30	Slovenia	26	<b>Greece</b>	<b>40</b>
Chile	40	Estonia	32	Spain	30	Cyprus	42
Hungary	41	Czech Rp	33	Cyprus	31	Bahrain	43
Tonga	43	Thailand	34	Portugal	32	Puerto Rico	45
Armenia	44	Kuwait	35	Dominica	33	Israel	46
Bulgaria	45	Tunisia	36	Taiwan	39	Slovenia	47
United Arab Emirates	46	Cyprus	40	South Korea	40	Portugal	48
Romania	47	Puerto Rico	41	Latvia	52	Czech Republic	55
Portugal	48	Slovenia	42	Slovakia	53	Estonia	56
Spain	49	Portugal	43	South Africa	54	Saudi Arabia	60
Luxembourg	50	Lithuania	44	Italy	55	Hungary	61
Turkey	59	Slovak Rpb	46	Seychelles	56	Slovakia	62
Italy	65	Italy	49	<b>Greece</b>	<b>57</b>	Antigua	63
Dominica	74	Turkey	63	Lithuania	58	Latvia	66
Albania	86	Brazil	64	Poland	59	Lithuania	67
Marshall Islands	93	Montenegro	65	Turkey	60	Croatia	68
Serbia	94	Kazakhstan	66	Namibia	61	Poland	69
Papua New Guinea	95	<b>Greece</b>	<b>67</b>	.....	.....	Russian Federation	73
<b>Greece</b>	<b>96</b>	Romania	68	.....	.....	Venezuela	74
Dominican Republic	97	.....	.....	Sudan	175	.....	.....
.....	.....	.....	.....	Afghanistan	176	.....	.....
.....	.....	Mauritania	131	Haiti	177	.....	.....
Guinea-Bissau	179	Burundi	132	Iraq	178	Zimbabwe	212
Central African Republic	180	Zimbabwe	133	Myanmar	179	Congo	213
Congo, Dem. Rep.	181	Chad	134	Somalia	180	Burundi	214

#### 4. Facets and evidence of institutional weakness and poor governance

The OECD Regulation Database, the World Economic Forum competitiveness survey, the World Bank “Doing Business” and Governance Indicators and European Commission estimates (EC, 2006; EU 2002), to name a few, all reach similar conclusions. Indicatively, they find that in Greece the administrative burden is exceptionally high (Figure 11), that regulation of markets is excessive, that government intervention limits competition as well as resource allocation and pricing decisions in crucial network industries, that the regulation of professional services (Figure 12) is high as far as entry and price setting is concerned. At the same time, qualitative standards are excessively lax (Paterson et al. 2003), and the business environment on the whole is unattractive.

**Figure 11**

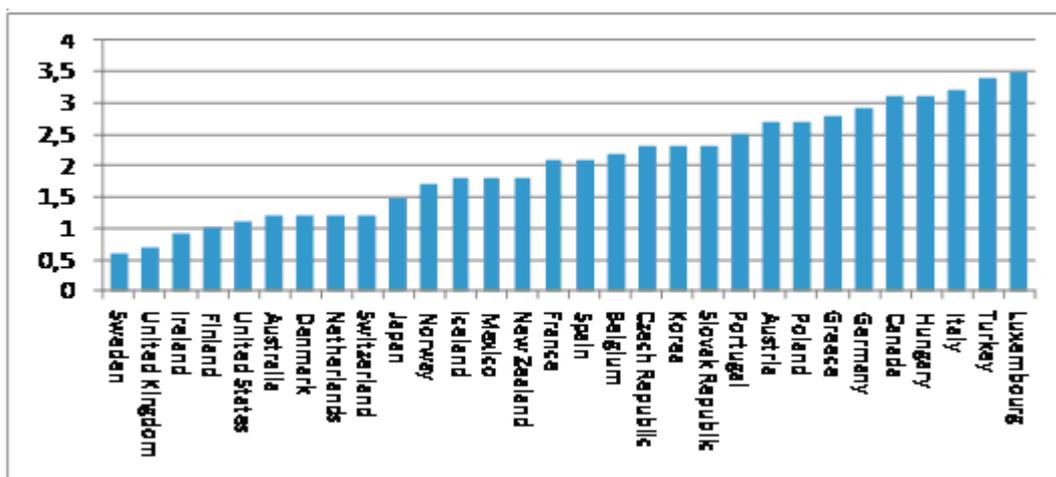
Administrative costs by Member State																					
	AT	BL <sup>2</sup>	CZ	DE	DK	ES	FI	FR	UK	GR	HU	IE	IT	NL	PL	PT	RE <sup>2</sup>	SK	SI	SE	EU-25
Administrative cost share in GDP (in %) <sup>1</sup>	4.6	2.8	3.3	3.7	1.9	4.6	1.5	3.7	1.5	6.8	6.8	2.4	4.6	3.7	5.0	4.6	6.8	4.6	4.1	1.5	3.5
<sup>1</sup> Based on Kox (2005): Intra-EU differences in regulation-caused administrative burden for companies. CPB Memorandum 136. CPB, The Hague.																					
<sup>2</sup> BL combines Belgium and Luxembourg; RE combines the Baltic Member States, Malta and Cyprus; EU-25 figures are GDP-weighted averages																					

These findings are complemented by more general statements that indicate weak institutions, poor governance (Kaufmann et al, 2005), while high levels

of corruption seem to be a result of the high administrative burden and the poor governance (Ackerman, 2006).

As a matter of fact, the magnitude of the weaknesses documented above matches the size of the competitiveness deficit documented for Greece in the previous section. Not surprisingly, Greece is found to be the OECD country which has the most to gain in terms of productivity from rectifying deficiencies like product market regulation (Conway, et al. 2006). The Greek competitiveness can be labeled “dismal” not because of its absolute level, but because of the large discrepancy between those weaknesses and the per capita GDP rates achieved in the past. In particular, following the strong performance till the 70’s and the strong performance of the past years, per capita GDP is relatively closer to that of other OECD and EU member countries.

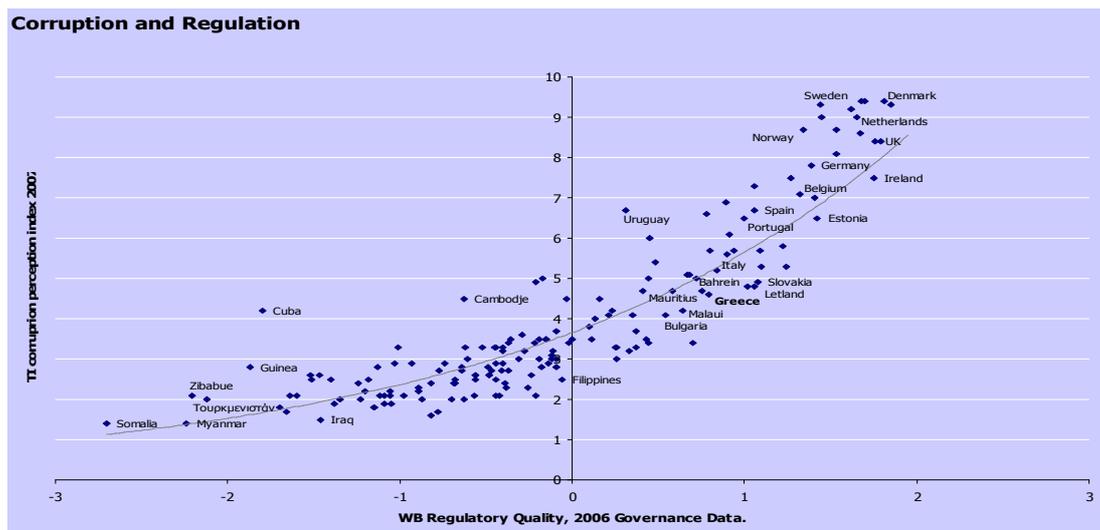
**Figure 12**



Source: OECD indicator for regulation in professional services, 2007.

While Greece remains among the poorer members of these groups, it still can distance itself clearly from countries not participating in these organizations. On the other hand, all the other performance indicators are clearly much weaker than the performance of many OECD and EU member-states. Greece is clearly placed in the middle of the global rankings, and not in the top 20% of the world, as is the case with per capita GDP. In sum, Greece emerges as a country with almost first-class GDP per capita GDP, but second-class in terms of governance, institutions, business environment, and corruption (Figure 13).

**Figure 13**



The factors analyzed in the second section, document why Greece grew so fast in spite of the governance and institutional shortcomings. This discussion is in line with the extended literature, mainly of OECD Economic Department Working Papers<sup>2</sup>, that directly link the performance of an economy with the

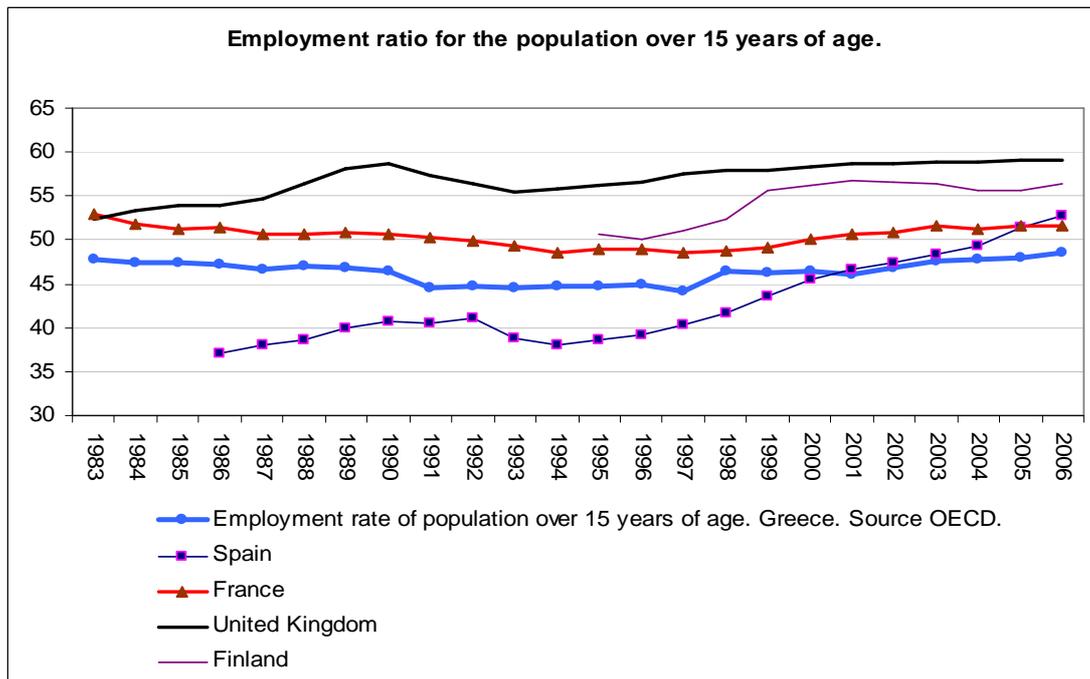
<sup>2</sup> An indicative selection of related OECD and non-OECD related publications is: OECD (2007a); Conway et al, (2006); Bassanini et al, (2006); Nicoletti et al, (2005); Nicoletti et al, (2006); Conway et al, (2005); Bassanini et al, (2002); Scarpetta et al, (2002); Scarpetta, et al, (2002); Nicoletti et al, (2003); OECD (2003); Alesina et al, (2003); Nicoletti et al, (2001); Conway et al, (2006).

quality of the regulatory framework and the prevalence of competitive markets. In a similar way one can reconcile also almost all of the other weak performances of the country, that range from research and innovation (Bassanini et al, 2000) to the protection of the environment, the quality of public health services, and performance of schools and higher education system (Bassanini and Scarpetta, 2001; Mitsopoulos and Pelagidis, 2007; OECD, 2007b). Even the weak performance of the judiciary can be ultimately linked to this pattern (Mitsopoulos and Pelagidis, 2007; Djankov et al, 2002).

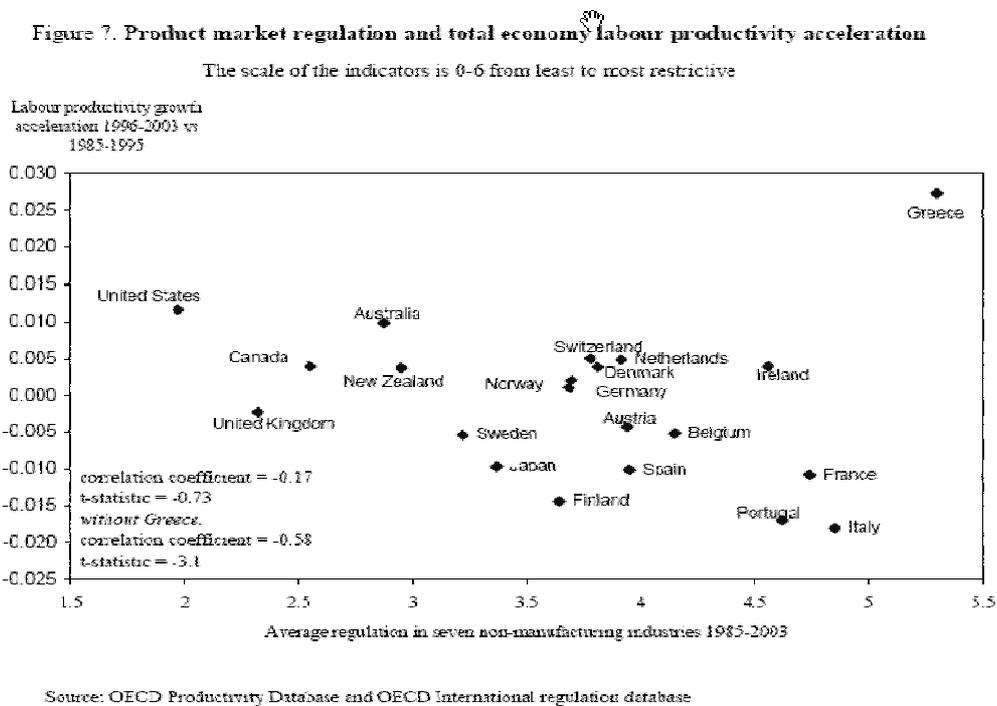
### **5. A note on the labor factor of production. The paradox of the underlying ‘high labour productivity’ in a low competitiveness context**

The result of the strong demand growth -that is not driven by an increase in domestic supply that follows from an increase in employment- (Figure 14), directly affects the reliability of productivity indices that measure GDP to labour input in various forms (giving around 2.5-3% for Greece during these years). This is the result of an increase in the numerator (GDP), matching a restrained increase in the denominator (as can be seen in Figure 14), thus measuring a large increase in the productivity per worker or per hour worked. This large increase is observed in spite of the dismal performance of the Greek economy as measured by the rigidity index of product markets (Fig.15).

**Figure 14**



**Figure 15**



Source: Conway et al (2006). Note: 0=less regulated. 6=more regulated, rigid.

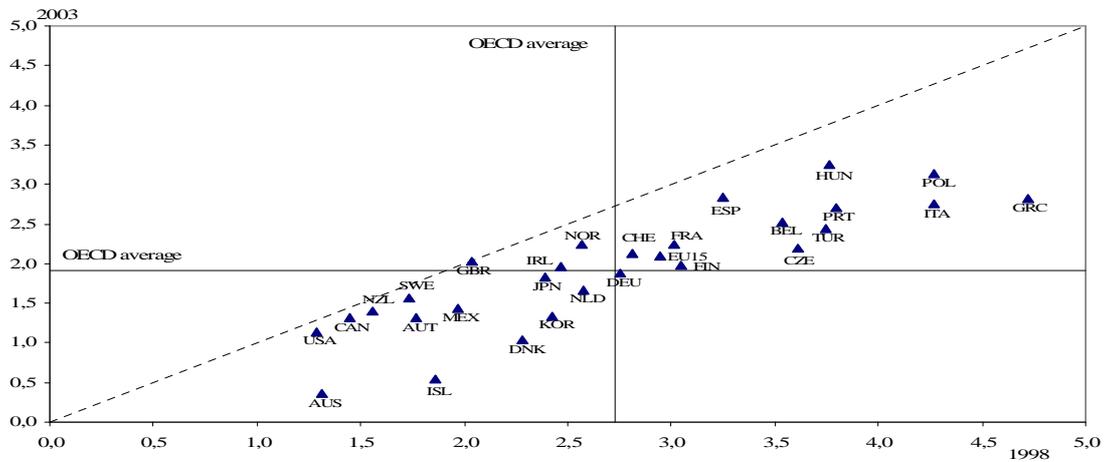
It follows from the above analysis that the use of such indicators is not fully capturing the variety of the parameters that shape the performance of the Greek economy during the past decade, and they often depict Greece in a position that doesn't favour the drawing of reliable conclusions. This gives also an explanation to the puzzle of having on the one side high GDP and productivity rates, and on the other side low competitiveness with twin deficits. At least to the extent that we take into account only domestic forces without taking into account factors such as euro's overvaluation<sup>3</sup> and the asymmetric demand shocks.

Therefore, it is worth looking more on some other aspects of institutional rigidities which complement very well low competitiveness. In particular, Figure 16 summarizes the product market regulation, including private governance and product market competition such as state-control and legal barriers to entry in a competitive market. Greece, after Poland and Hungary, has the most regulated product market, with harmful microeconomic effects such as price distortion and an unfortunate low usage of labour.

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<sup>3</sup> At least to the extent that Greece's trade take place with outside EU partners (around 50% of total).

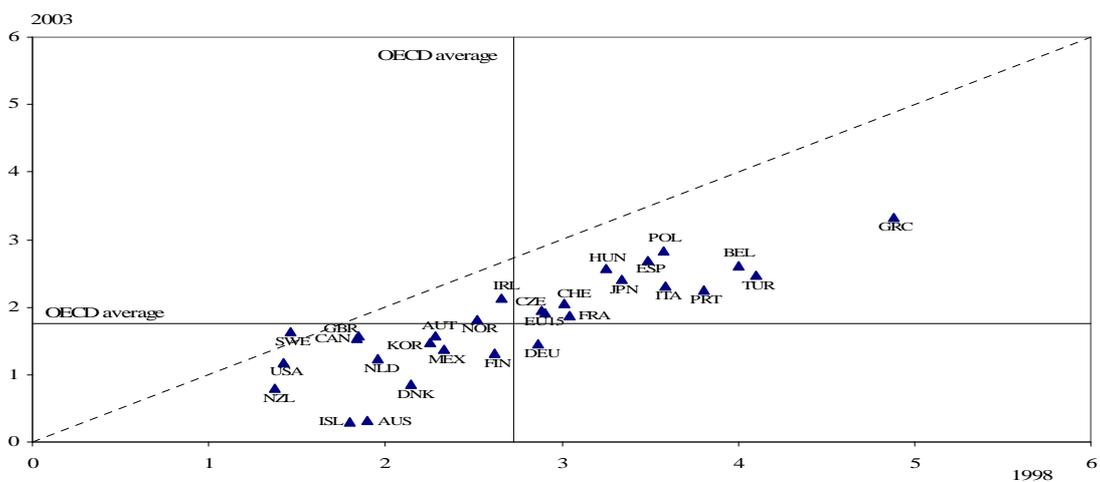
**Figure 16 Product market regulation. Degree of restrictiveness of regulation having an impact on economic behaviour**



Source: OECD (2006). Note. 0=less regulated. 5=more regulated, rigid.

Additionally, Figure 17 concerns the state involvement in business operations via price controls or the use of command and control regulation. ‘Command and control’ includes a lot of administrative mechanisms to hinder entrepreneurial activity/organization, in sectors such as ‘road and railway transports’ and retail trade.

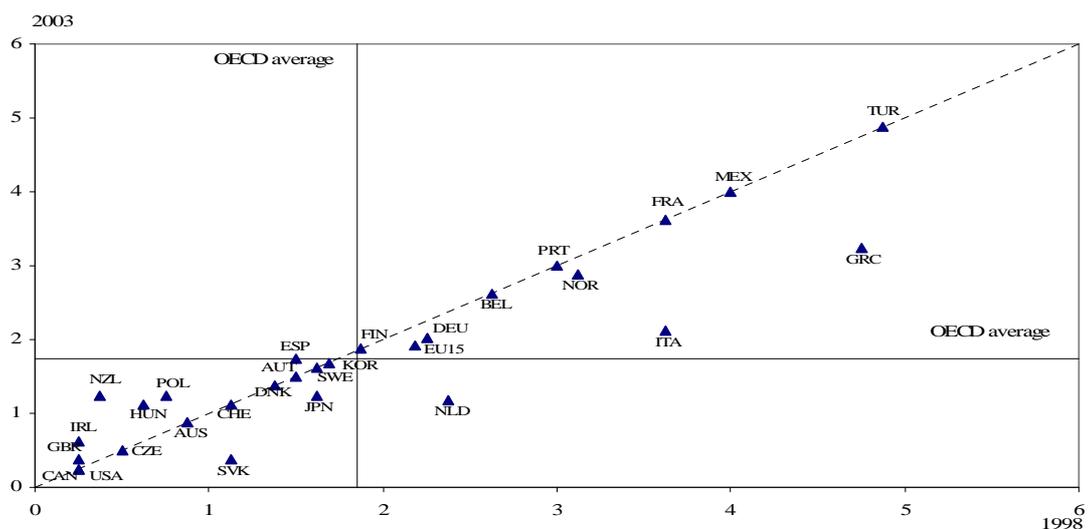
**Figure 17 Restrictiveness of regulatory burden on business procedures**



Note: 0=less regulated. 6=more regulated, rigid.

Product markets rigidities are of critical importance for rigidities in the labour markets as well. Figure 18 shows Greece among OECD countries with the highest employment protection legislation (EPL). It should be noted that the market for non-permanent, temporary employment in Greece is the main reason for the exceptional rigidity of the Greek labour market overall, but also the market for permanent contracts is relatively rigid when compared with other OECD countries.

**Figure 18: Employment Protection Legislation.**



Note: 0=less regulated. 6=more regulated, rigid.

These kind of structural institutional rigidities constitute a true cost to society in the environment of a non-competitive economy like the Greek. It leads to the exclusion of many others from the labor market, and especially the young that

seek salaried labor. Youth unemployment (under 26 years old) is more than 35% and 20% for women and men correspondingly today. This should be read as underutilization of a dynamic labor force, and should not be considered solely as a major social or ethical issue. Also, one should be right to suppose that the riots of December 2008 had their roots on the marginalization of huge masses of unemployed young people.

## **6. Conclusion**

In this paper we have started out with a brief description and analysis of the prosperous years and at the same time of the falling competitiveness of Greece's economy. We have shown that -paradoxically at first sight- high GDP growth rates can very well co-exist with falling competitiveness and continued institutional weakness. We have traced an idiosyncratic disease; that is, massive 'inflows' (tourism, structural funds, shipping, public borrowing) that fueled GDP growth rate, but left the real economy and economic institutions with obsolete and rigid structures.

We looked at extensive regulation of markets, high administrative costs, a business environment that is not favorable to entrepreneurship and, in the end, weak convergence and widespread corruption as drivers and causes of this low competitiveness. In spite of the reforms in the credit and telecommunications markets and the benefits accruing from EMU accession, these weaknesses persist. Therefore, Greece seems to have benefited from certain reforms in

terms of potential output, while it retained other weaknesses that undermine the long-term growth potential of the country. These weaknesses are ultimately described as rigidities, weak non-independent institutions and governance. Their proliferation is deeply built in the equilibrium that is formed today between the interest groups that accrue the rents through the regulation of markets and the inflation of the administrative costs (Pelagidis and Mitsopoulos, 2009). One could also argue that the strong growth of the past years has also made the need for further reforms less pressing.

The stakes are the long term growth prospects of the Greek economy, once the impact of the reforms of the EU and EMU membership peter out, and what is needed is the relocation towards a new equilibrium in which rents that are accrued from –and through– state intervention and high administrative costs are replaced with profits that accrue from competitive, transparent, well-regulated markets. Instead of an income distribution on the basis of the ability to secure favors from the executive and legislature, income should be generated from innovation-driven entrepreneurship in competitive markets.

The current situation requires for a group of reform-minded politicians that will not yield to the pressures of the interest groups and will have sufficient knowledge to use the powers of the government, in spite of the fact that the administration is a weak tool for policy implementation. They will have to significantly change the “rules of the game” by setting the legislative framework for free and competitive markets across the board. This effort must

also be complemented with the establishment of sufficient checks and balances and the setting of the legal basis for the widespread establishment of transparency and accountability in all levels of the government and administration, which are also topics for a further research.

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