The Greek crisis is a crisis of production, not of public finance

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The Greek economic crisis is a crisis of production. Its key actor is a unique feature of the economy, the Greek family firm. Seen through that prism, the crisis is simply another episode in the story of how small firms tried to fit into the world economy as that was becoming increasingly globalized.

'Putting a face in impersonal developments' provides the economic and sociopolitical context in which the macroeconomics and fiscal developments operate. It unifies the course of economic history from the 1960s and, in this way, poses questions usually ignored: How did the Greek economy turn from the successful EC applicant and convergence poster child of the 1960s and 1990s into the Eurozone basket case of the 2010 crisis? Why was a coping strategy which had proved successful in the past fail the country after 2010? Answering the question '*why is Greece different?'* provides historical continuity. More importantly though, it allows us to approach the question of '*how can Greece finally exit the crisis'?*

A production-centered approach, is different from economic analyses that stress the macro-economic and fiscal character of the imbalances in the run-up to the crisis. Though these factors are definitely part of the mechanism of the crisis, they are far from being its cause. The emphasis on production takes a longer-term view of economic performance, going back to why Greece evolved from a relatively successful developing economy in the 1960s and 1970s, into a faltering European Community member on the fringe of convergence and then slipping into the role of a failing Eurozone member.

As such, my approach is in stark contrast with all the usual crisis narratives –stressing either the inadequacies of European institutions or technicalities relating to the design, implementation and sequencing of the bail-out programs for Greece. The dominant narratives around the Greek crisis adopt as their starting point the creation of the Eurozone. The mainstream story goes like this: the real issue that triggered the Greek crisis was a debt-financed growth bubble, inflated by EZ membership. The easy flow of credit within the EZ removed all pressures for addressing structural problems. Within this framework, the emphasis can be placed either on *the incomplete architecture of the EZ, or on problematic Program design and technical flaws (m*iscalculations such as the fiscal multiplier controversy, wrong sequencing of reforms and inefficient monitoring of program implementation). Finally, an additional angle in crisis narratives stresses political economy and political agency obstacles feeding endless blame games between the troika and the authorities, lack of reform ownership, disregard of low governance capacity and pressure groups' resistance, combined with weak institutions.

All the above are true but they bypass the real question: why wasn't the EZ the protected nursery within which difficult decisions concerning the structural fundamentals of the economy could be addressed? It is useful to recall that Greece opted for EZ membership in order to deal with its longer term structural problems. With the benefit of hindsight it is now clear that the attempt was ultimately unsuccessful – witness the 2009 bankruptcy *and* the inability to exit the crisis. What is less clear is why.

In order to address the failure dynamics one needs to take a long-term view of production vulnerabilities –building up before the crisis and clearly exacerbated thereafter. The depth and length of the Greek crisis and the inability of three bail out programs to turnaround the economy, is less about institutional failure at the EU level (other program countries saw the end of their tunnel) or about technicalities and implementation shortcomings (although these played a role too). The problem is that the Greek production system has long been suffering from an idiosyncratic *Dutch Disease problem*. In short, it has suffered from weak productive capabilities glossed over by supply of funds from abroad; initially, from the “invisible payments”, i.e. shipping, emigrants' remittances and tourism. Later on, from EU transfers from structural funds and lastly, from easy borrowing at low interest rates. As a result, the sources of real trouble (low productivity, cumbersome business environment and risk-averse business culture) remained hidden in the background of a prosperity bubble.

Three ingredients are crucial for a production-based account of the Greek impasse.

First, while the consecutive rescue programs dealt with the fiscal aspects of the crisis, they failed to influence the production dynamics. Hence, both macro-economic and trade rebalancing in fact exacerbated production vulnerabilities (tax hikes and arrears in payments to the private sector, and dramatic import restraint). In theory, structural reforms (lower wages, looser employment protection and improvement in ease of doing business) should have led to export recovery. And although trade models would predict a 25% increase in exports, in reality exports stalled and then declined, while prices proved much stickier than anticipated.

Second, this apparent lack of response to text-book incentives begs the question of the production agents and their adaptive capacity. It is important to examine who is not responding in order to see why. This means trying to examine the crisis from the viewpoint of the firms in the real economy. The missing agent of mainstream analyses of the crisis is the small family business that forms much more than the backbone of the Greek productive system.

Third, small family firms remained “unseen” throughout. However, the Greek economy has the lowest average size of firms and the lowest proportion of employment in large firms. Within manufacturing, Greek micro firms (employing up to 9 people, including the owner) account for 46% of employment and 32% of value added (versus 14% and 7% respectively in EU27). Small firms showed remarkable resilience up to the crisis. They survived the European Community accession and the EZ membership. The crisis, however, has been extremely harsh on them (more than 2/3 of employment losses in the private sector (730.000 jobs) are due to the closure of one out of three small firms). This amounts to extensive destruction of the productive system.

It is crucial to understand why small firms weathered all previous challenges but failed in the current recession. Here comes the role of the Dutch Disease, operating under the surface for many decades prior to the crisis. Besides the narrow meaning of the Dutch disease – denoting the macro-economic chain reaction following the abrupt appreciation of the real exchange rate the term has been expanded to include all possible negative macro-economic effects associated with the “resource curse” hypothesis and pre-mature deindustrialisation. The Dutch Disease is not limited to the discovery of mineral resources; it can also be caused by booming service-exporting sectors such as tourism or by surges from remittances from workers living abroad. So, a case could be made for a Greek version of the Dutch Disease, with emphasis on production and firms.

A time-line of the Dutch Disease in Greece would distinguish three periods:

First, in the *pre-1981 (pre-accession)* period the Greek economy financed its trade deficits through *Tourism, Shipping and Emigrants' remittances,* together accounting for more than 40% of total imports (Spraos, 1984). These inflows of capital had limited linkages to manufacturing, but they nurtured the evolution of a large state sector and the protection of large swathes of Greek production from international competition. In this sheltered environment, incomes were rising and so did the share of small and medium enterprises. These were mostly oriented to the domestic market and only few of them were extrovert and dynamic; the latter prospered as international subcontractors in the context of the New International Division of Labour.

Second, in the *post-accession* and up to 2008 ‘non-production-enhancing' inflows of capital continued (fewer remittances but higher income from tourism and EU funds -2.5 to 3.5 per cent of GDP annually). These inflows were supplemented by cheap public (and to a lesser extent private) borrowing *after* EZ entry (2001). Consumption was boosted, and so was the public sector (accounting for 60% of GDP just before the crisis), while trade openness remained modest. Migration from Eastern Europe post 1992 provided a new lease of life (via flexibility) to the productive firms, but overall the net result was a retreat from manufacturing: Under the surface of stable (even slightly increasing) numbers of firms, functions changed: many firms switched from production to imports of the same goods. Others found an easy life by relying on public procurement. Few dynamic SMEs expanded in the Balkans and Eastern Europe and formed mini-value chains.

Third, *during the crisis* years, bank finance dried up (together with internal and informal sources of funding), interest payment increased, direct and indirect taxation soared, property tax transformed the store of value of most family firms into a liability, tax regulations multiplied to a confusing degree, penalties for non-compliance increased dramatically and uncertainty became more acute. This environment was more hostile for smaller firms because internal and family sources of finance dried up, at the same time as access to Bank credit became harder to access. Lower wages were, in any case, not especially important for SMEs: On the one hand, undocumented and unpaid family work was ubiquitous. On the other hand, the multi-skilled workers on whom SMEs relied remained well-paid. Hard times for small business overturned migration dynamics: Previous immigrants left the country discouraged. They were followed by an exodus of potential entrepreneurial talent of young, well-qualified Greek graduates seeking business opportunities abroad. The final act was a wave of businesses relocating both their activities and their headquarters, in order to escape the Greek doldrums – over-taxation, capital controls and low expectations.

Is that exodus of business talent the final retreat in a downward spiral of exit replacing loyalty? A 'do-nothing approach', placing hopes on outside agency or simply on the passage of time, is unlikely to suffice.

If recovery is to come, it must come to grips with the problems of small firms. It must be based on small firms, building on a new type of industrial policy. Key ingredients would be: stability and predictability of macro-economic framework (together with some debt relief), a new fiscal balance with fewer taxes and lighter regulatory burden, a business environment facilitating the creation and closing-down of business, and more importantly, the encouragement of export-oriented production networks, involving active support for firms to link up with global value chains. In the absence of real effort to deal with the underlying productive vulnerabilities (caused by long-term exposure to the Dutch Disease) it is unlikely that sustained recovery will break the vicious circle of the recessionary spiral in the foreseeable future.

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