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Highlights in this issue:

- Both rising investment and falling savings have led to a deterioration in Greece's lending position
- Widening external imbalances have led to the accumulation of substantial foreign debt
- Macro/structural policies can help to reduce the risks associated with growing external indebtness

External imbalances of the Greek economy: the role of fiscal and structural policies

*By George Moschovis & Mateo Capo Servera**

Summary

The deterioration in the lending position of the Greek economy mirrors an increasing gap between savings and investment, resulting from a combination of both rising investment and falling savings. Public and private sectors have alternated as the driving force of the deterioration in the country's net lending position. The growing and persistent external imbalances have led to the build-up of substantial foreign debt, bringing with it a risk to medium-term growth and jeopardising the real convergence. Moreover, the pace of external debt accumulation may not be sustainable in the long-run and will eventually need to be corrected by appropriate macroeconomic and structural policies. In the context of the ongoing economic crisis, the implied re-pricing of risk and possible implications regarding the financing of large current account deficits, this article focuses on the factors underlying the external imbalances of Greece.

Introduction

In the last ten years, the Greek economy has recorded buoyant growth and remarkable success in terms of real convergence, with real GDP growing at 3¾% per year, which compares with 2% in the euro area. Especially after 2001, the real growth rate accelerated significantly, fuelled mainly by the preparations for the 2004 Olympic Games. As a result, living standards, measured in terms of GDP per capita in purchasing power standards (PPS), rose from 84½% in 1997 to almost 95% of the EU-27 average in 2007. In spite of high growth, the general government deficit remained on average well above 3% of GDP over the whole period (with a maximum of 7½% of GDP in 2004). Together with large debt-increasing below-the-line operations, high deficits contributed to the accumulation of public debt, which at almost 97¾% of GDP in 2008 is the second highest in the EU.

During the same period, price-stability-oriented macro-economic policies reduced inflation rates from above 5% in late-1990's to around 3% in 2007, but the differential with the euro area still remains high at around 1¼ percentage points. This is due not only to the so-called Balassa-Samuelson effect, associated with catching-up economies, but also to structural factors linked to the malfunctioning of domestic markets[1]. As a result, nominal wage growth has been outpacing productivity gains, pushing up unit labour costs and eroding the competitiveness of the Greek economy, not least with respect to the rest of the euro area.

The combination of high economic growth, persistent fiscal imbalances and deteriorating competitiveness in the last decade has worsened the external balance

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of the Greek economy, with the current account deficit gradually peaking at 14% of GDP in 2007, from a close-to-balance position in the mid-1990's.

Analysing the causes and remedies of the external deficit is highly relevant because the build-up of external imbalances affects both medium-term growth prospects and the sustainability of the real convergence process. In this context, fiscal and structural policies can play an important role in attenuating the risks associated with widening external imbalances. This article assesses the evolution of the external imbalances in the last decade and discusses the factors behind the deterioration of the net lending position, in particular the sources of the persistent inflation differential with the euro area and, accordingly, the gradual erosion in price competitiveness.

The evolution of external imbalances of the Greek economy

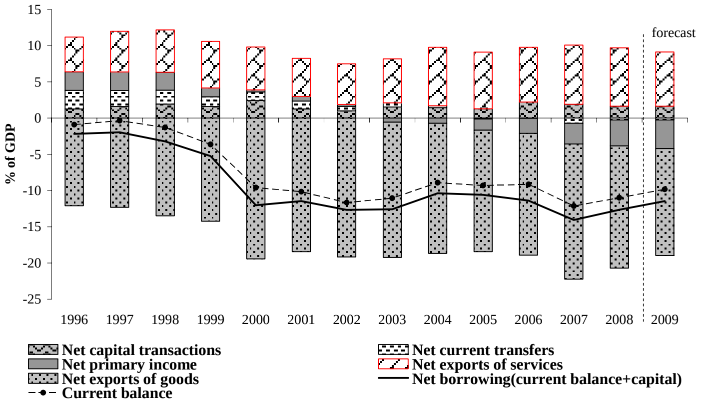
The external balance of the Greek economy deteriorated rapidly from 1997 onwards (Graph 1), with the current account deficit reaching 14% of GDP in 2007 and declining somewhat to 12¾% of GDP in 2008. This development was mostly due to a growing deficit of the trade in goods, which registered 17% of GDP in 2008 (almost 4 percentage points more than in 1997). More specifically, the performance of merchandise exports was disappointing over the last decade, while import growth was strong, in line with buoyant domestic demand. Trade in services, on the other hand, has gone in the opposite direction. The balance of net exports of services has improved over time attaining a surplus of more than 8% of GDP in 2008, 2 percentage points higher than in 1997. However, this improvement fell short of compensating for the deterioration of the balance of trade in goods.

The combination of high economic growth, persistent fiscal imbalances and deteriorating competitiveness in the last decade has worsened the Greek external balance.

The relatively poor export performance of goods can also be explained by the geographic structure of external trade. Almost half of Greek exports are directed to extra-EU countries, mainly to the Balkans, Turkey and Northern Africa. Although some of these countries have been recording relatively high growth rates (i.e. the newer EU Member States), the size of their markets is relatively small compared to the euro area. Moreover, in the recent past, exports have been increasingly directed towards countries with relatively high economic instability (Northern Africa, Eastern Europe), and away from those countries with higher growth prospects, thus aggravating further the external trade performance. In addition, the high share of extra euro-area trade has increased the exposure of the economy to the exchange rate fluctuations of the euro, which is especially important now that the currency of some of Greece's main trade partners are depreciating, thus aggravating competitiveness losses further.

With the share of imports of goods in the GDP increasing over time from 24% in 1997 to around 28% in 2008 – implying a high import elasticity with respect to domestic demand – there is evidence that the economy is facing structural difficulties in adjusting to external competition. In contrast, the growth rate of exports of goods has been slower than that of GDP, leading not only to a further gradual decline of their already low share in GDP, but also to a reduction in market shares since the rate of change of Greek exports also lags behind the pace of increase in global demand.

Graph 1: External balance of Greece



Source : AMECO

In parallel, the balance of primary income and current transfers has deteriorated over time, reaching a deficit of around 3¾% of GDP in 2008, from a surplus of more than 4½% of GDP in 1997. This reflects a dynamic feedback between the current account deficit and debt accumulation, through increasing interest rates. Surpluses on the capital transfers account, on the other hand, remained largely stable overtime at around 1¾% of GDP per year. Nevertheless, while in late-1990's capital transfers were enough to contain the external imbalance and the net borrowing position of the Greek economy, they gradually diminished in the beginning of the new millennium and the current account deficit increased rapidly. As a result, the net external borrowing position of the economy exceeded its historical high of 12% of GDP in 2007, before declining somewhat in 2008. While FDI inflows are relatively small (less than 1½% of GDP in 2008), the growing external imbalance is being financed mostly through portfolio investment and government bonds, reflecting the role of the public sector in the origin of the current account deficit[2].

The role of the public sector

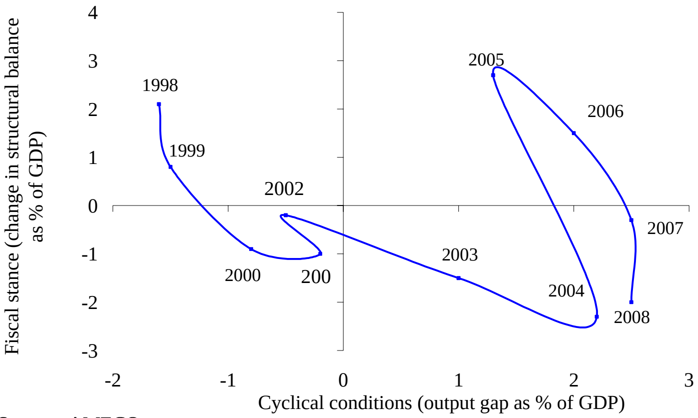
The persistent deterioration of the current account reflects both rising investment and falling savings. The public and private sectors have alternated during the last decade as the driving force of this deterioration. In particular, three different periods can be distinguished: a first period of fiscal consolidation and private sector dis-saving (1997-1999); a second period of dis-saving in the public sector and strong investment activity, mainly in infrastructure (2000-2004); and a third period of fiscal adjustment and strong private investment, mainly in dwellings, which started in 2005.

Public and private sectors have alternated, during the last decade, as driving forces of this deterioration…

On the road to the euro, the government implemented a revenue-led fiscal consolidation programme that cut the deficit by nearly 2½ percentage points of GDP. Rising private investment, however, led to dis-saving by the corporate sector and a fall in household savings, thus pushing the combined net balance of the private sector into deficit by 1999. As a result, while in mid-1990's private sector savings largely compensated for public deficits, the public deficit could no longer be financed by domestic saving in early 2000's, thus increasing further the external borrowing needs of the country.

Fiscal consolidation came to a halt in 2000. During the period 2000-2004, fiscal policy became expansionary, as reflected in the downward trend of the cyclically-adjusted general government primary surplus, which turned into a deficit in 2003, in a context of high output growth and output gaps becoming rapidly more positive (see Graph 2). Although part of the increase in public deficits had financed public works and other major projects linked to the organisation of the Olympic Games, infrastructure investment contributed only marginally to the mounting public deficit, which reached a peak of 7½% of GDP in 2004. While the private sector slightly improved its financial position, the growing public deficit offset these gains.

Graph 2: Fiscal stance



Source : AMECO

With the current account deficit remaining high, the fiscal stance became restrictive again in 2005. The government implemented a significant fiscal adjustment programme that cut the budget deficit to 2¾% in 2006[3]. At the same time, the cyclically-adjusted deficit was reduced by the same amount. The structural balance, in turn, (i.e. the cyclically-adjusted-balance net of one-offs and other temporary measures) improved by 3½ percentage points of GDP. Despite the containment of the public sector deficit, the financing needs of the economy still remained high and growing, reflecting further significant dis-saving by the private sector due to rising private investment (mainly in housing) associated with improving economic prospects and a buoyant housing market. As a result, given the lower but still present public deficits and the worsening net financial position of the private sector, the net borrowing position of Greece vis-à-vis the rest of the world deteriorated further.

In 2007 the fiscal stance eased mainly on account of current primary expenditure slippages and, in spite of still good economic times, the structural balance deteriorated by a ¼ percentage point of GDP. The fiscal deterioration continued also in 2008, with the headline deficit reaching 5% of GDP and the structural deficit widening by 2 percentage points of GDP. A further fall in private (mainly households) sector savings led to the jump in the net lending position of the country to double digit levels, exceeding 12% of GDP in 2007 and remaining at 11% of GDP in 2008 (see Graph 1).

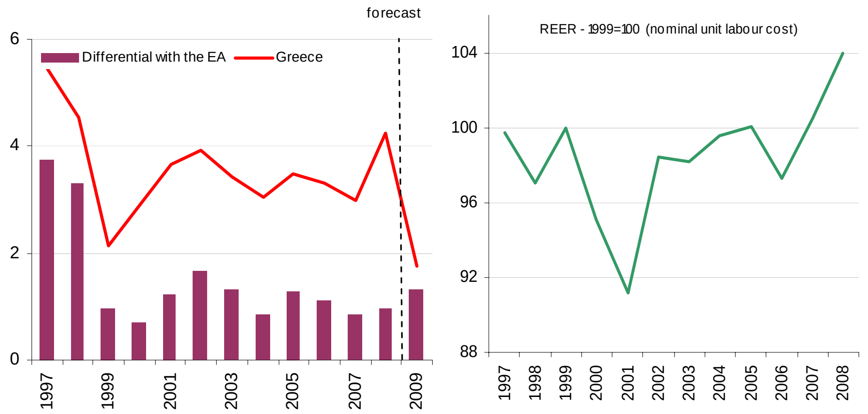
Competitiveness and structural policies

The evolution of the current account mirrors developments in labour costs and productivity, which have been at the origin of persistent inflation differentials with the euro area in the recent past and the observed deterioration in the competitive position of the tradable sector.

…which also mirrors developments in labour costs and productivity

More specifically, mounting competitiveness losses over the last ten years are reflected in the sizeable appreciation of the real effective exchange rates (REER) vis-à-vis the euro area, both in terms of price competitiveness - represented by the REER based on the HICP (almost 8% since 1997) – and in terms of cost competitiveness, as measured by the REER based on unit labour costs, which has appreciated by around 13%. The rapid rise of wage costs and mark-ups in excess of productivity growth, as well as the persistence of the inflation differential with the euro area, has contributed to a wage-price spiral.

Graph 3: HICP inflation differential with EA and REER (Greece vs EU27)



Source: *AMECO/Commission services*

Several factors may lie behind this relatively high inflation differential and the concomitant erosion of the Greece's competitive position. The large growth differential with the euro area in the last decade, mirroring buoyant domestic demand, suggests that cyclical factors and overheating were at play. Indeed, between 1997 and 2007, Greek real GDP was growing consistently faster than the euro-area average. Fuelled by the surge in credit growth in late 1990's, domestic demand was the most important contributor to the buoyant GDP growth, through dynamic private consumption and investment, mainly in housing. On top of this, the expansionary fiscal policy of the early 2000's, in a context of high output growth and rising output gaps, also boosted domestic demand and put further pressure on inflation.

Persistent inflation differentials with the euro area have been at the origin of the erosion of competitiveness in the tradable sector.

Although the credit and fiscal shocks have undoubtedly contributed to feeding inflation in Greece, the relationship between the relative cyclical position and the inflation differential with the euro area is far from straightforward. On the one hand, the average inflation differential has registered around 1¼ percentage points since the early 2000's, when the economy was growing faster than the euro area[4], but was even higher during the second half of the 1990's, when the growth rate was similar to or below that of the euro area. On the other hand, high inflation rates have resulted in negative real interest rates, which contributed to the expansionary cyclical position of the country.

The positive and persistent growth differential with the euro area tend to support the notion of Greece as a catching-up country and high inflation could in this context be the result of a real convergence process through higher price increases in the non-tradable sector[5]. Although productivity has been growing almost four times faster than in the euro area, there is little evidence of a predominance of the so-called Balassa-Samuelson effect. In principle, inflation in catching-up economies has its origin in the higher wages paid in the tradable sector of the economy, where productivity grows faster. In Greece, however, wages have been growing faster in more sheltered sectors, in particular non-market services (European Commission, 2007).

Second, also of a structural nature, the persistently high inflation could be the result of the malfunctioning of domestic markets. Indeed, labour market rigidities and wage-setting institutions seem to explain high wage growth in Greece. Despite relatively high unemployment, labour market rigidities[6] and strict labour regulations hinder labour mobility, create mismatches between skills available and firm's needs, and lead to a relatively tight labour market and upward pressure on wages[7]. In addition, wage bargaining in the private sector remains rather centralised[8], hindering flexibility and the alignment of wage growth with productivity developments at the company level, and introducing further distortions in the functioning of the labour market. Moreover, the public sector, which is by far the largest employer of the economy, plays a leading role in aggregate wage developments and has not always fostered wage moderation. Over the last decade, wage increases in central government, as well as in public enterprises and entities of the wider public sector, have on average outpaced wage increases in the private sector (excluding the banking sector), while it is only since the end of 2005 that the central government has restrained average gross earnings growth[9], in a context of fiscal consolidation[10].

Finally, persistently higher inflation in Greece could also be related to imperfections in the functioning of product markets, as reflected by fast-growing mark-ups[11]. Specifically, wholesale and retail trade, personal services (hotels/restaurants) and financial intermediation/business activities have been recording significantly higher mark-ups since 2001[12], also revealing a more rapid evolution of mark-ups in services, compared to the manufacturing sectors (export sector). The reasons behind higher mark-up growth in services are linked to the insufficient degree of competition in the sector, which remains to a large extent sheltered. Although the regulatory environment has become more supportive of product market competition in Greece since the late 1990's[13], the Internal Market Restrictiveness Index in Services (IMRIS)[14] suggests that the services sector is less exposed to competition than the goods sector, both domestically (such as the heavily regulated professional services by lawyers, accountants etc.) and internationally. In parallel, the income convergence process has led to a demand shift towards those service activities with higher income elasticities (e.g. private healthcare services), thus putting further pressure on prices in these sectors and contributing to the inflation differential with the euro area.

Conclusion – the need for adjustment

At this juncture, the implied re-pricing of risk and the mounting concerns regarding the financing of large current account deficits requires an adequate mix of macroeconomic and structural policies to tackle the factors underlying the widening external imbalances in Greece.

A combination of macro and structural policies should be put in place to correct widening external imbalances

The structural nature of the factors underlying the external imbalances implies that the emphasis should be put on policies aimed at tackling the rigidities in the product and labour markets and promoting innovation designed to enhance productivity growth – in other words, implementing the Lisbon agenda, which might ease the persistence of the inflation differential between Greece and the euro area, which is in turn the main factor explaining the erosion of competitiveness. Despite labour shortages in specific sectors, labour market rigidities hinder the reallocation of labour and keep unemployment high, pointing to possible mismatches between skills in supply and firms' needs, while labour force participation, especially of women, is low by EU standards. Although labour productivity growth is healthy, unit labour costs are increasing at a faster pace than Greece's main trade partners in the euro area, thus worsening the competitive position of the country.

Macroeconomic policies in turn can also play an important role in correcting external imbalances. Prudent fiscal policies with a view to ensure a credible budgetary consolidation towards a balanced position, together with measures to control current primary expenditure and prevent a pro-cyclical behaviour of the public sector, would contribute to easing inflationary pressures, thus supporting a recovery of competitiveness losses. In addition, policies to improve tax collection and the functioning of the public administration would strengthen public resources, which could be channelled towards investment in knowledge, human and physical capital. Taken together, this would increase the potential of the economy and improve its attractiveness for direct productive investment in the long run.

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[1] ECB (2005).

[2] According to the successive annual monetary reports of the Bank of Greece, foreign investors' purchases of Greek government bonds have been the main source of the substantial net inflows under portfolio investment.

[3] Council Decision 2007/465/EC 7 June 2007 abrogating Decision 2004/917/EC on the existence of an excessive deficit in Greece.

[4] The cyclical position of the Greek economy has been improving since the early 2000's leading to positive output gaps.

[5] Kröger, Jürgen and Redonnet, Denis (2001) argue that this is equivalent to a situation of higher productivity growth, which together with a high expected real rate of return, implies an appreciation of the real exchange rate in a context of liberalised capital flows. With Greece having adopted the euro, the real appreciation is generated by higher cost and price inflation relative to other countries.

[6] According to the OECD Economic Survey for Greece, Volume 2007/5, a range of indicators, including the high incidence of long-term unemployment, low monthly outflows from unemployment, low average job tenure, low gross labour flows between industries and sectors, provide evidence for the existence of rigid labour market institutions.

[7] Since 2003, nominal unit labour costs (ULCs) have recorded higher growth rates in Greece than in the euro area as a whole (European Commission, 2007). This gap in unit labour costs result from a positive wage increase differential, which has been especially significant since 2002 and remains the major determinant of increasing labour costs, putting pressure on inflation.

[8] National General Collective Labour Agreements are negotiated between the Greek General Confederation of Labour (GSEE) representing private employees and a number of organizations representing employers' interests. However, less than 20% of the dependent employees are unionised.

[9] According to the Bank of Greece (2007), if nominal earnings since 2003 had converged towards the sum of productivity growth and the inflation rate in the euro area, then inflation would have been brought down to the euro area average, employment growth would have been stronger and the ex post increase in real earnings would only have been marginally weaker.

[10] See http://epp.eurostat.ec.europa.eu/portal/page?pageid=1073,46587259&_dad=portal&_schema=PORTAL&p_product_code=KS-EK-08-002

[11] See also "Measuring and analysing profit developments in the euro-area", page 62 of *ECB Monthly Bulletin*, January 2004.

[12] EU KLEMS and STAN databases (available at http://www.euklems.net/ & www.oecd.org/sti/stan)

[13] OECD Product Market Regulation database (web site).

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