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THE STATE AND THE MARKET:
THE GREEK ECONOMY ON THE EVE OF THE
MAASTRICHT TREATY

I. INTRODUCTION

On the eve of the 1992 Program, Greece found herself in the weakest possible position among the European Community (EC) members. This was not a surprise. The writing had been on the wall for some time. The absence of structural change, low rates of growth in gross domestic product, productivity and capital formation, and high fiscal deficits, inflation, and interest rates combined with foreign penetration of the Greek market produced economic stagnation. The first decade of Greece's full membership in the European Community was a decade of unrealized expectations. The drive for full membership in the Community was primarily for political rather than economic reasons, because Greece wished to move from the political margin of Europe to a position of an equal partner and participant in the shaping of a future Europe. However, political influence cannot be achieved without economic clout, and Greece lacks economic clout.

There is a catching-up process that requires lagging countries to achieve rates of economic growth far above those of the more advanced countries, otherwise there will be no convergence. The length of time to converge depends on the initial gap between poor and rich countries as well as on the differential rates of growth. Starting far behind her European partners, Greece grew much faster than the rest of the OECD countries in the 1960s and the 1970s, but fell behind in the 1980s. In the 1960s, gross domestic product at constant prices grew by an arithmetic average of 7.6% per year. This rate was reduced to 5.3% in the 1970s and 0.3% in the 1980s (International Monetary Fund 1991: 160-161). The catching-up process came to a halt. Had the Greek economy experienced the economic growth of the rest of the European Community, Greece would have been able to play an important role in the reconstruction of the shattered economies of her northern neighbors. The chance for a leading role in the reconstruction of the Balkans was lost.

This paper will examine (1) the domestic forces that shaped the course of the Greek economy in the 1980s, (2) the international linkages, and (3) the prospects for the 1990s.

II. THE DOMESTIC FORCES

1. Macroeconomic Imbalances

Up to 1974, the Greek economy was growing faster than the composite of the EC. This is not surprising, since Greece had achieved levels of industrialization and income below the rest of the EC except Portugal. 1974 was a turning point for most of Europe. The energy crisis and its recessionary effects took a toll of capital formation. However, Greece had the additional misfortune of the Turkish invasion of Cyprus. Compared with 1973, gross fixed capital formation (GFCF) fell by 26% in Greece and an average of 3.4% in the OECD area. No other OECD country experienced a threat to its national security, and no other country experienced such a deterioration of the investment climate. Yet, by 1976 the Greek economy recovered its self-confidence and grew rapidly. Greece escaped the general malaise of "Euroclerosis".

The 1980s present a different record. The Greek economy entered a pronounced stage of stagflation—high rates of inflation and stagnant output. Defence expenditures continued taxing the economy. The ratio of military expenditures (ME) to gross domestic product (ME/GDP) was three times as high in Greece as it was in NATO-Europe¹. The conflict with Turkey has had lasting effects on the Greek economy. In 1989, while Greece and Portugal had about the same population, the former had 2.7 times higher armed forces on active duty than the latter, and Greece had the highest ME/GDP ratio among the developed market economies (UN 1992: 111). Given that the Greek domestic defence industry is in its infancy, these defence expenditures increased both the domestic and balance-of-payments deficits, as well as deprived the economy of the badly needed capital formation in the private and public sectors. Thus when we make comparisons between Greece and the rest of the EC, we must remember that Greece has unique neighborhood problems that affect both the economy and foreign trade.

Defence expenditures are not the only cause of the stagnation observed

1. See Eleftherios N. Botsas, 1988.

in the 1980s. While the 1980s witnessed an almost universal retreat of the state from economic affairs, Greece moved in the opposite direction, increasing etatism. The government followed an income and employment policy at the expense of economic restructuring. Politically driven policies are risky and, as experience shows, of questionable merit. It is true that the state could be an engine of growth, and the Greek state has been a prominent direct and indirect actor in economic affairs throughout Greece's modern history. However, state failures have overshadowed state successes. Louka Katseli (1990: 256) has, in what she calls "state corporatism", argued that this prolonged mode of social organization has created a dualistic market in Greece: one "official" which has access to state subsidies, information etc., and one unofficial. However, Japan, France and other highly developed countries discriminate among industries without creating dualistic markets. Indeed, many firms and whole industries flourished in Japan in spite of the economic policies of the Ministry of International Trade and Industry (MITI).

Table 2 shows a comparative record of the Greek and European economies in the 1980s. The "visible hand" of the state turned the 1980s into a decade of high rates of inflation, economic stagnation, deficit spending, and ever widening trade deficits for the Greek economy. In real terms, per capita income increased by less than one percent, while interest payments to the rest of the world ballooned. The state became a *de facto* guarantor of employment. Government expenditures increased far beyond what the government could collect in the form of taxes (see Table 2). In addition, there was a general feeling that consumer satisfaction had been postponed long enough to demand new attention. These policies could not be sustainable, because they discouraged risk taking and innovations. The Greek economy diverged from the rest of the European Community.

As Table 1 shows, between 1981 and 1990, consumption and current government expenditures rose faster than gross domestic product (GDP). Therefore, domestic gross fixed capital formation (GFCF) fell, all estimated at constant 1970 prices². During the period of 1979-90, EC's GDP and GFCF grew by an average annual rate of 2.3%, while Greece's GFCF fell by 0.9% per year. In the case of Greece, GFCF presents a U-shaped curve reaching a minimum in 1987 and then rising to just below its 1979 level in 1990. That is why there is no trend in the exponential estimates³.

2. Least-squares estimate as $Y_t = Y_0 (1+r)^t$, where Y_t = GDP etc in 1988, Y_0 = the value of the same variables in 1979, and r = the estimated rate of growth.

3. The quadratic equation yields statistically significant relationship between GFCF and time (t)

$$\text{GFCF} = 93.97 - 6.32t + 0.604t^2 \text{ for } 1981-90$$

The growth of private consumption and government expenditures far above the growth of GDP, and the corresponding fall in national saving, deprived the economy of investment growth. "It is worth noting that the gross national savings ratio declined from 26.2 per cent in the seventies to 14 per cent in the eighties — the lowest among the OECD European countries" (Bank of Greece 1990: 23). Compared with the rest of the "South", Greek saving fell dramatically. The ratio of gross national savings to GDP fell from 27.4% in 1979 to an average of 15% for the period 1982-1990, while the ratio was 20% in Portugal and 21% in Spain during the same period of 1982-1990 (OECD 1992: 213). Moreover, Spain's and Portugal's accessions in 1986 were followed by an increase in the ratio, just the opposite of what happened in Greece. Greece's fall in national saving could be accommodated by foreign direct investment, but it was not.

The growth of public expenditures had many undesirable effects. First, the public debt increased from 39% of GDP in 1980 to 109% in 1990 (OECD 1991b: 13), and the fiscal deficit increased from 0.9 percent in 1971 to 19 percent of the gross domestic product in 1989. "Reflecting unsound policies in the 1980s Greece has entered the 1990s facing what are probably the largest imbalances of all OECD countries" (*ibid.*: 11). Secondly, the budget deficit had a crowding out effect. In order to finance the deficit, the government engaged in domestic and foreign borrowing. Domestic borrowing increased the real interest rates, and this discouraged domestic investment. Taking 1979 as the base year, private gross fixed capital formation fell by an average annual rate of 3.8% between 1979 and 1988⁴ and, using the depressed level of 1981, as Table 1 shows, by 1.9% between 1981-88, all estimated at constant 1970 prices. As percent of GDP, private investment did not reach the rates of the 1970s in any single year in the 1980s. It fell from 13.4% in 1981 to 9.8% in the mid-1980s, compared with 16% for the Community.

A comparison of budgetary expenditures is quite revealing. Salaries and wages accounted for 26.7% of the total Greek expenditures in 1983-85, while the average of the industrial countries was 11.86% (IMF 1990: 72). The Greek percentage remained high during the rest of the 1980s. Moreover, as Table 1 shows, total government expenditures increased disproportionately in the 1980s. This growth was for current consumption at the expense of public investment in the much needed modernization of the infrastructure. The increased urbanization and travel required higher levels of public investment;

4. Estimated according to the equation in note 2.

yet public investment shows no trend, in spite of the fact that Greece lags behind the Community in infrastructure.

Thirdly, there is a vicious circle between borrowing and interest payments. Since both the amount of deficit and the interest rate increased through time, interest payments became a significant part of the budget. They accounted for 25% of the ordinary budget expenditures and 40% of the revenues in 1991 (Bank of Greece 1992), percentages that are too high for proper fiscal management. Moreover, these payments represented 11.2% of the gross domestic product (Bank of Greece 1991: 36).

Greek politicians, like their counterparts in other democratic societies, have been very sensitive to political costs. Governments have pursued policies that were least attractive for long-run growth, but had highly visible short-run benefits. Public-sector employment increased during election years, and subsidies to various domestic groups have followed the political cycle. The peaks of subsidies "correspond to general election years" (Katseli 1990: 247). Subsidies and transfers increased from 9.7% of GDP in 1970 to 17.9% in 1989, and pensions from 7% to 15.1% (OECD 1990: 42-43). The generosity of the public sector increased the proportion of general government expenditures to GDP from 22% in 1971 to 48% in 1989 (OECD 1991a: 189).

2. Microeconomic Imbalance

Macroeconomic policies affect, favorably or unfavorably, the responses of the microeconomic actors. The state played the role of favoritism rather than of promoter of economic efficiency. Etatism could perform a very useful function by identifying and promoting sectors, not firms, that could have dynamic comparative advantage. Moreover, etatism has been a way of life for a long time in all Balkan economies. That was necessitated by the relative backwardness of the region. However, it reached the point where managers and entrepreneurs perhaps spent more effort on bargaining with the state bureaucracies than on the production floor.

The state became both the regulator and protector. Protection from foreign competition, protection from domestic competition, protection from failure, and protection from losing one's job created risk aversion in decision making for both labor and the entrepreneurial class. Enterprises should be free to succeed as well as to fail. This is the essence of risk taking. Governments are not known for their ability to pick winners better than the market, and the Greek governments are no exception. In order to save jobs, the state

took over highly indebted and unprofitable enterprises that had no reason to exist. Since employment in manufacturing increased while output remained constant or fell, productivity per employee fell.

The general index of industrial production almost doubled between 1970 and 1979, but it stagnated between 1980 and 1989. The overall index of manufacturing output (1980 = 100) fell in spite of the dramatic increase in the food and chemicals sectors. Although industrial output fell in the Community in the early 1980s, it recovered quickly in the second half of the decade, but not in Greece.

The divorce between productivity and rewards from employment has negatively affected the labor market. There are several reasons for this, but two are prominent. (1) The generous transfers to the agricultural sector have discouraged labor mobility. For the period 1985-88, 26.5% of Greek labor was in agriculture and only 19.9% in industry, compared with an average of 7% and 24.3% in the Community (UNDP 1991: 183). Additionally, these transfers have prevented the much needed structural changes and preserved specialization of resources in traditional products and methods of production and distribution. The "substantial improvement of the agricultural income has during the past ten years been due mainly to transfers..." (Bank of Greece 1991: 21). (2) The pervasive overmanning of the public sector (including public enterprises and problem-firms) has prevented real wages from falling to levels commensurate with productivity. This increased the unit labor cost of Greek products. Since the real exchange rate of the drachma did not depreciate enough to reflect inflation and unit labor cost, Greek exports lost their competitiveness in the international market.

State policies have contributed to the fact that the Greek economy has remained an agriculture and service-based economy. In 1989, the employment shares were: agriculture 25%, industry 27% and services 47%. No other European country had such a high proportion of its labor force in agriculture. Yet, Greek agriculture's contribution to GDP was only 13%. The smallness of farm holdings is the main cause. Eighty-five percent of the Greek farms are less than 16 hectares, compared with 5.6% in the United Kingdom, 11% in Denmark, and 14% in France (IMF 1988: 35). Additionally, farm support transfers, coupled with the absence of growth in the industrial sector, kept more of the labor force in agriculture than justified on economic grounds.

Attempts to maintain high employment by preserving problem firms misallocated resources away from dynamic investment. Traditionbound policies could not move the economy in step with international demand and the necessary restructuring. The number of manufacturing establishments increased

from 121,357 in 1973 to 144,463 in 1984 (NSSG), an increase of 16%, but the number employing more than 29 people increased by only 1.7%. Therefore, the first characteristic of Greek manufacturing is the smallness of its size and the resulting inability to exploit economies of scale. The size of the domestic market should be irrelevant, since the whole EC market has been domestic after 1981. It is the stagnation of investment that has permitted the existence of so many small and inefficient manufacturing establishments. The sector's contribution to GDP fell from 21% in 1980 to 18.5% in 1990 (OECD 1992a: 106). The share of the manufacturing sector in total investment remained at around 18% throughout the 1980s (*ibid.*). Whatever investment took place, it was in the services sector.

III. THE INTERNATIONAL SECTOR

The merchandise account has been in deficit for as long as there has been a Greek state. Recent trends are shown in Figure 1. The ratio of the value exports to imports (X/M), which shows the proportion of imports covered by exports, has fluctuated, but it has remained below 50% if one includes fuels. Therefore, trade deficits are not phenomena of the 1980s. What is new for the 1980s is (1) the inability of Greek exports to take advantage of the enlarged EC market, (2) the absence of structural change in export composition, and (3) the disassociation of capital inflow and export expansion. Thus, while the export volume increased by an average rate of over 10% per year in the 1950s, 1960s, and 1970s, the rate fell to just 3.1% between 1980 and 1990 (IMF 1993: 72).

As Table 3 shows, the trade deficit, expressed as a percentage of gross domestic product, increased from 13.7% in 1978 to 18.7% in 1990, before it fell to 17.9% in 1991 because of reduced expenditures on oil imports and increased exports of foodstuffs. If we exclude oil imports, the deficit increased by 1.8% in 1991 (Bank of Greece 1992: 24). The permanence of substantial deficits in the trade account has been the result of the absence of structural change in the Greek mode of production, and it has been sustained through surpluses in the invisible and capital accounts. However, capital inflows were associated mostly with the Greeks in diaspora investing in Greek real estate. Foreign direct investment remained anaemic between 1981 and 1988 and was directed mainly in acquisition of existing Greek firms rather than new venture capital. Indeed, foreign direct investment followed the trend of Greek domestic investment. Accession to the Community did not increase foreign direct in-

vestment as it did in Spain and Portugal. Foreign investment in the Community tends to favor the North, but in the case of Greece the high fiscal deficits, rates of inflation, and the lack of investment in infrastructure did not constitute incentives for foreign investors. Andre Sapir (1990: 77) has argued that "neither Greece nor Portugal will remain in the periphery if they succeed, like Spain, in building a sufficient infrastructure".

As we have seen, Greek manufacturing is characterized by smallness of size and its inability to change in the face of global restructuring of demand. We lack original data for conclusive statements, but OECD (1990: 76) estimated that: (a) the share of resource-intensive manufacture imports of OECD fell from 32.1% in 1975-79 to 17.6% in 1985-87, while the share in Greek exports remained high at 35.4% in the latter period; (b) the share of differentiated products was 21% in OECD imports, but only 3.9% in Greek exports in the latter period; (c) the share of scale-intensive goods was 33% in OECD imports and 13.9% in Greek exports, down from 18.2 in the earlier period; and (d) the share of science-based industries in Greek exports was only 2% in 1985-87. The UN Economic Commission for Europe (UN ECE 1990: 329) found that Greek specialization in skill-intensive engineering goods remained in just one product group between 1970 and 1987. The traditional labor-intensive sectors of food, beverages and tobacco, textiles, clothing and footwear accounted for 41% of the value of manufacturing output in 1973 and 46% in 1986 (NSSG). Thus, while the proportion of GDP originating in manufacturing fell, the proportion of the traditional sectors increased between the two periods.

Greece has specialized more in the traditional commodities that face stiffer competition from the Asian NICs (new industrial countries) and a relative fall in demand. Food, textiles, cement, aluminum and steel (a very narrow specialization) account for about 75% of earnings from exports. Exports of manufactures account for about 70% of OECD Europe, and about 90% of the Asian NIC's exports, but only 54% of Greece's exports. The relative shares of the NICs in world exports of the main Greek exports increased by an average annual rate of 17% in 1985-87 (OECD 1990: 104). "Greece's main competitors are among the most cost-efficient in the world" (*ibid.*: 78).

Accession to the Community in 1981 redirected trade in favor of the EC area. In terms of value, the relative share of EC in Greek exports, estimated as

$$RL = (X_{ec}/X_w)$$

where X =the value of exports and the subscripts ec for the community and w for the world, increased from 49% in 1980 to an average of 65% in 1987-91. The share of foodstuffs in total exports represents a falling percentage for

Portugal and Spain, but a constant and high percentage for Greece, where they account for about one-quarter of the value of all exports. However, the share of Greek exports in EC imports, expressed as

$$RL_{\text{Gec}} = (X_g/M_{\text{ec}})$$

has remained constant at just below 0.5%, while Portugal's share has increased from 0.47 to 0.81 percent, an increase of 72%, and Spain's share from 1.75 to 2.47, an increase of 41% between 1983 and 1990⁵. Geographic propinquity has played some role, but its extent is not known. Membership in the Community did not (and could not) reverse the falling export performance of Greece. It worsened the trade account of Greece with the Community, giving rise to a cumulative trade deficit of \$43.188 billion from 1981 to 1991.

The Community's share in Greece's overall imports increased from 41% in 1980 to about 64% in 1990, while the share in manufactures reached 70%. EC penetration of the Greek market has taken place in almost all categories of goods, including foodstuffs, since the removal of all restriction on imports and subsidies on exports. This should be expected as the range of choices and quality increased for the consumers. The removal of trade constraints simply permitted consumers to substitute imports from the Community for domestically produced goods and imports from the rest of the world.

Fiscal and current account deficits increased the externally held public debt substantially. Servicing the debt absorbs resources and weakens the balance of payments. Table 3 shows the debt-servicing ratio (DSR), which includes interest and amortization, as percentage of the value of merchandise exports. The externally held public debt increased from 9% of the GDP in 1979 to 47% in 1985, before it fell to 33.4% in 1990 (Bank of Greece 1991: 27). Interest payments increased from 7% of the value of merchandise exports in 1979 to 27% in 1989-91. This represents a compound rate of growth of 12% per annum in the interest/exports ratio. In order to service the debt, export performance has to improve, and improvement depends heavily on the government's fiscal policies.

IV. THE FUTURE

The aim of the Single European Act (SEA) is to foster competition among Community and non-Community firms. "The 1992 program is the most sweeping commitment to promoting competition by deregulation that any

5. Estimated from data in International Monetary Fund, *Direction of Trade Yearbook*.

single nation, let alone any compact of nations, has made in history" (Rosenthal 1990: 303). Competition will create difficulties for enterprises sheltered under state protection for a long period of time. However, this is the only way for structural change to take place. A catharsis will take place, but this will be to the benefit of the economy in the long run. A Schumpeterian creative destruction will take place that will make the Greek economy a better performer than it has been in recent years. A "shock therapy" has been long overdue.

The Medium-term Adjustment Program has already reduced inflation, although not by as much as it was expected in order to meet the strict criteria of the Maastricht Treaty for the Economic and Monetary Union (EMU). Domestic as well as foreign investment has increased substantially, but the magnitude of the public debt is still a constraint on economic growth. The only way it can be reduced to 60% of GDP, as the Treaty provides, is for the government to drastically curtail tax evasion and public employment. Unfortunately, this is difficult for democratic governments approaching elections.

There is a tendency of foreign direct investment to move to centers of economic activity rather than the periphery, and this may cause a Myrdal (1957: 27-33) backwash effect, that is, a cumulative movement away from equilibrium. Neoclassical theory projects that capital and labor mobility converge the periphery's and center's rewards to resources, but the location preference of foreign direct investment by EC and non-EC firms has still been the center of the Community. For example, between 1981-1986, the United States accounted for 54% of the world's inward foreign direct investment, the United Kingdom for 14.5%, France for 6% and Germany for 3% (OECD 1989: 23). Japanese investment in Europe has been basically limited to the United Kingdom and Luxembourg, the former accounting for 44% of Japanese investment in Europe and the latter for 27% in 1987 (*Ibid.*: 38). Thus, spatial imbalances are likely to become more pronounced in the early years of the Single Market. As Krugman and Venables (1990) have shown, it is possible that 1992 may mean more deindustrialization for the periphery.

There is a trade-off between the attractiveness of the center and the wage cost of the periphery. Although compensation costs in the manufacturing sectors of the periphery tend to rise faster than of the center, the gap is still substantial. Compared with EC's average, in 1990 the hourly cost compensation was lower by 60% in Greece, 79% in Portugal and 32% in Spain⁶.

Industrialization of the periphery will cause wage costs to rise faster

6. Estimated by the author from data in U.S. Department of Labor, 1991, p. 5.

than in the center. This is what neoclassical theory predicts, and it is what has been the experience of all newly industrialized countries. Convergence between the periphery and the center will take place and, given that Greece is rich in human resources, the catching-up process will come to a successful conclusion. Greece has started the difficult process of adjustment, and the economic slow-down in Europe makes it more difficult in the short run. There is, however, no way back to the 1980s state policies.

TABLE 1

Regression analysis of Greece's Main Macroeconomic Magnitudes, 1981-1990

<i>Sector</i>	<i>Period</i>	<i>Rate</i>	<i>R²</i>	<i>t-statistic</i>
GDP	1981-88	1.7	0.94	9.346
	1981-90	1.9	0.96	13.44
Consumption	1981-88	2.0	0.97	13.442
	1981-90	2.2	0.97	16.508
Government*	1981-88	2.1	0.94	9.675
	1981-90	2.2	0.96	13.924
GFCG**	1981-88	-1.6	0.06	-2.913
	1981-90	0.3	0.02	not significant
Public	1981-88	-1.0	0.02	not significant
	1981-90	-1.3	0.07	not significant
Private	1981-88	-1.9	0.22	not significant
	1981-90	1.1	0.07	not significant

* Current government expenditures.

** Gross fixed capital formation, private and public.

TABLE 2

*General Government Revenues, Expenditures, National Saving,
and GFCF as percent of Gross Domestic Product, Greece and EC, 1971-90*

	<i>1971-80 average</i>	<i>1981-84 average</i>	<i>1985</i>	<i>1986</i>	<i>1987</i>	<i>1988</i>	<i>1989</i>	<i>1990</i>
<i>Receipts</i>								
Greece	28.4	32.4	34.6	35.5	37.0	35.1	32.5	34.7
EC	39.0	43.3	44.1	43.8	43.9	43.4	43.6	41.2
<i>Outlays</i>								
Greece	26.4	37.8	43.7	42.9	44.8	45.2	46.4	50.9
EC	42.4	49.3	49.8	49.2	48.7	47.9	47.4	48.7
<i>Natl Saving</i>								
Greece	26.0	18.4	13.1	14.5	14.6	17.2	15.4	13.6
EC	23.0	19.8	20.1	20.7	20.5	21.1	21.6	21.1
<i>GFCF*</i>								
Greece	3.5	-4.1	5.2	-6.2	-5.1	8.9	10.0	4.8
EC**	1.3	-1.3	2.5	4.2	5.2	8.2	7.1	4.3

* Annual percentage change from previous year in gross fixed capital formation.

** 1987 weights and exchange rates.

Source: OECD, *OECD Outlook*, No. 51 (July 1992).

TABLE 3

Ratios of Exports/Imports, Trade Deficit, and Debt Servicing, Greece, 1979-1991

Year	X/M % (1)	X-M/GDP % (2)	DSR* % (3)	(i/X)** % (4)
1991	36	-17.9	26.1	26.7
1990	34	-18.7	21.4	27.2
1989	40	-16.7	22.2	27.5
1988	44	-14.9	23.7	25.7
1987	45	-15.2	25.5	24.4
1986	44	-16.7	21.7	26.9
1985	41	-18.7	21.8	25.2
1984	45	-15.8	19.2	21.0
1983	43	-15.1	16.0	17.7
1982	41	-15.4	14.5	15.5
1981	42	-17.2	12.1	14.7
1980	37	-16.6	9.1	8.6
1979	39	-15.7	8.1	7.0

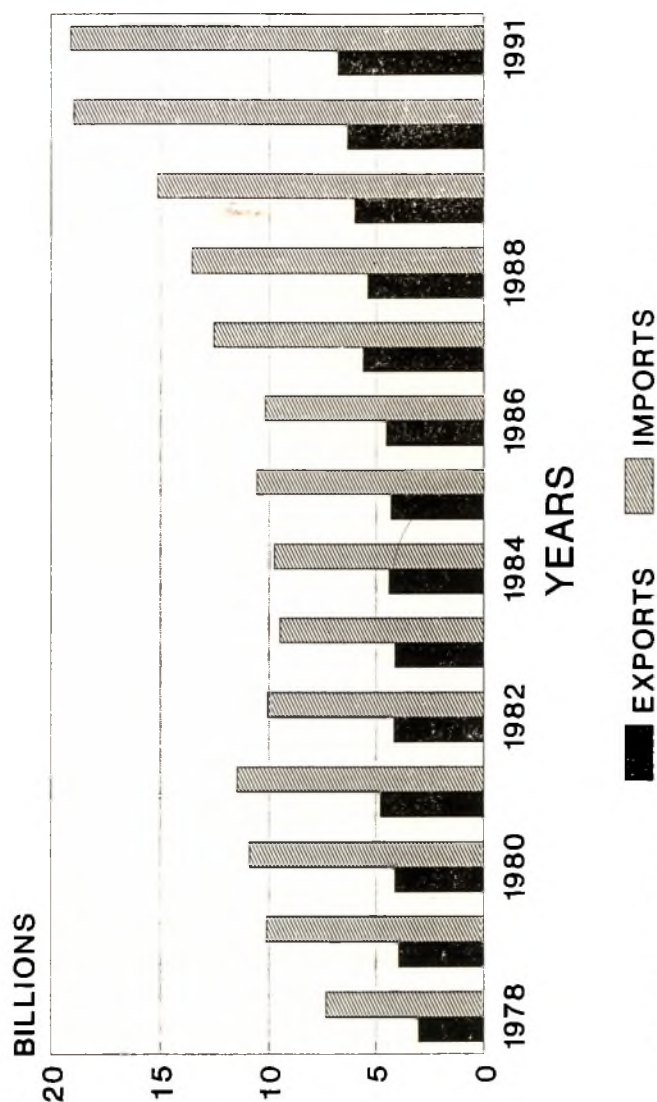
Notes: X=exports; M=imports; * (interest + amortization) / exports of goods and services; ** interest/value of merchandise exports.

Sources: Bank of Greece, *Monthly Statistical Bulletin* and *Report* various issues, and International Monetary Fund, *Balance of Payments Statistics*.

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Figure 1. Greek Trade
(BILLION US DOLLARS)



Source: Bank of Greece, Monthly Statistical Bulletin.