The Greek crisis and its structural features: some insights from a comparative exercise

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Abstract

This paper looks into the recent experience of Greece and addresses why Greece has so far failed to put in place the social and economic changes necessary to resume growth. Economic and institutional features of the country as well as social values and cultural factors play a role in the judgement about such failure. Each of them needs to be considered and addressed in order to shape a different future for the country, but most have received only limited attention. This helps to explain why the internal devaluation that came along with the adjustment programmes (and the financial support) did not on its own deliver a rapid return to growth. The comparison between the southern regions of Italy (the "Mezzogiorno") and Greece suggests some stunning similarities. The experience and perverse effects of certain policies adopted in the Mezzogiorno serve as a warning that risks could arise in the relationship between Greece and the EU should serious and far-reaching reforms not be implemented soon.

Keywords

Greece; Greek crisis; structural reforms; Mezzogiorno; eurozone crisis, internal devaluation

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Introduction

Although the long-running Greek crisis has not ended yet, the 2015 agreement with the EU, the ECB, the IMF and the ESM to meet the most urgent financial needs and start the negotiation of a third macroeconomic adjustment programme may have reduced pressure on the country to reform.[1] The sense of urgency for further action has somehow faded, and faded even further thanks to the refugee crisis and the terrorist attacks in France which have moved the EU debate from economic matters to security and border issues.

While this greater calm regarding the Greek crisis should improve conditions for the implementation of changes, in reality it is hardly conducive to good outcomes. Complacency risks a loss of momentum for designing and implementing deep reforms in Greece. This is of utmost importance given that, as we shall endeavour to argue, the reforms that Greece needs the most are those associated with changes in the profound societal and economic features that underpinned the build-up and persistence of the crisis.

This is certainly not to argue that Greece has not achieved macroeconomic adjustment or undertaken changes and reforms since the outset of the crisis. Fiscal consolidation and external adjustment that typically represent the bulk of structural adjustment programmes have contributed to improving sustainability (at least in terms of flows) and to reducing distortions, even at the cost of a prolonged period of negative growth. Greece has also implemented a significant number of reforms, reflecting the unbalanced compromises between the political platforms of the Greek ruling parties and the requests put forward by the ECB, European Commission and IMF (hereafter, "the institutions"). According to the widely used Doing Business Indicators of the World Bank, for instance, Greece has recently made remarkable progress in various areas associated with doing business. Labour market reforms were also implemented, although mostly with the second programme in 2012, after much fiscal correction, heavily relying on tax increases, had materialised. This had placed a heavy burden[2] on firms generally, and impaired the already limited ability of surviving firms to expand into foreign markets. The overall result was mass redundancy, especially in small and medium-sized enterprises, which had to face much tougher conditions to access credit as well as falling domestic demand.[3]

Notwithstanding these interventions, as we maintain in this work, there are at least two problems with the observed pattern of reforms, in terms of their ability to address the country's weaknesses.

First, the composition and timing of the reforms implemented under the two programmes reflect a belated attempt to improve the business environment and to liberalise product and service markets (IMF, 2014). The timing is not incidental, but rather reflects the political economy of reforms in Greece, where coalition groups in the non-tradable sectors of the economy have long managed to delay or even derail effective policy initiatives. Second, the strategy of internal devaluation, which was necessary to make Greece eventually regain the ability to access foreign markets, could not ensure a sustainable new growth model: i) the fall in nominal wages was very slow and not matched by an equivalent contraction of good and service

[1] The Greek crisis started in early 2010. The country has signed three adjustment programmes, in 2010, 2012 and 2015, and received financial support for a total of about €300 billion provided by other euro area member states (through the Greek loan facility), the IMF, the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM).

[2] Besides the increase of taxes on firms and VAT, taxation resulted in a dramatic increase in the cost of energy, a key factor of production in the Greek manufacturing sector, which is very energy intensive.

[3] See Gros (2015b) for a sceptical account of the role of the credit crunch.

prices, due to the persistence of market barriers preventing adjustment[4] and possibly combined with profit dynamics internal to firms which had experienced substantial wage increases until 2009; ii) the engagement of the country in international trade was too limited and got complicated further by measures (meant to raise additional fiscal revenues) that increased non-wage costs.

As Greece shares various traits and cultural factors underlying the unsatisfactory functioning of the economy and society in various regions of Europe's so-called 'southern periphery', we argue that a cursory parallel between Greece in the context of the eurozone and the "Mezzogiorno", i.e. southern Italian regions, in the context of Italy may provide insights to the relationship between societal and institutional failures on the one hand, and unsatisfactory economy performance on the other. The opposition of the core countries of the euro area to transforming the eurozone into a transfer union (see Bonatti & Fracasso, 2013) can be better understood by referring to the parallel of Mezzogiorno in Italy.[5]

We suggest that future efforts should be directed toward tackling those institutional weaknesses and uncommendable societal values and beliefs that constituted the backdrop of the recent traumatic events. We are certainly not suggesting that Greek society should change so as to mimic any specific country which has proved not to be in distress. Rather, we warn that failing to address certain historically rooted societal vices may ultimately backfire, leaving the country in a situation of limbo characterised by limited growth, an unequal society and a high dependence on external financial assistance.

Given the recent overwhelming electoral advantage obtained by parties in favour of a third programme of financial assistance and adjustment, structural reforms could be easier to pursue than in past.[6] Most likely, those who have a relatively secure job in the formal economy, retirees and the wealthy have realised that a 'Grexit' option could do them more harm than good. Hence, it is possible that the reform implementation gap will be closed and the pace of change will accelerate both *de facto* and in the population's perception.

However, Greek government officials have repeatedly claimed that the current negotiations with the institutions are difficult because several creditors' demands appear to them politically difficult to accept and, above all, socially explosive: as the impact of the proposed reforms and additional fiscal measures on social stability is great, they argue, implementing such measures may risk gutting political support in the country for the programme. While country ownership is a key element for the success of any reform programme, experience with past programmes suggests that the country does not have administrative capacity to actually implement even reforms passed in the national parliament. This adds to the fact that one may wonder whether the legitimate attempt to preserve programme ownership may in fact ultimately hide, again, the protection of powerful vested interests and coalition groups refusing to come to terms with reality.

The paper is organised as follows. Section 1 provides an overview of the socio-economic conditions of Greece, highlighting some key structural features. Section 2 focuses on the internal devaluation and structural reforms, and explains why they failed boost exports as well as the causes of the dramatic fall of Greece's GDP. Section 3 draws a parallel between Greece and the southern regions (Mezzogiorno) of Italy,

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[4] This in turn aggravated the impact of such a strategy on domestic demand, inequality and poverty.

[5] At the end of July 2015, the headlines of the Italian newspapers were dominated by the news that the annual report of SVIMEZ (the Italian public research institute focusing on the economy of the Mezzogiorno) was documenting how – according to many indicators – the economic performance of southern Italy had been substantially worse than that of Greece over the last 15 years.

[6] Indeed, all parties involved have an interest in the success of the programme, i.e. not only the Greeks, but also the European Commission, which invested much political capital in the process.

by examining economic factors, social values and cultural characteristics and discussing how they have affected the economy and the impact of policies. This section also contrasts the relationship linking the Mezzogiorno to the rest of Italy with that linking Greece to the rest of European Monetary Union (EMU). The last section concludes.

1. Socio-economic conditions in Greece

1.1. A small closed economy

By standard measures of trade openness, Greece appears to be a closed economy. According to Bower et al. (2014), Greece has typically exported one-third less than that predicted by a gravity trade model considering Greek GDP, size of the trading partners and bilateral geographical distances.

As shown in Figure 1, if one excludes mineral fuels, which Greece does not produce, exports of goods have remained almost flat in nominal terms for more than a decade, regardless of the economic cycle. As percentage of GDP the share of export goods has always been below 10% of GDP.

Greece is the rare country where the share of exports of services is larger than that of goods. As illustrated in Figure 2, two sectors, i.e. maritime transport services and tourism, represent almost all of it.

Such structure of exports affects the creation of value added. According to OECD data, the domestic value-added content of Greek gross exports in 2009 was 79%, putting Greece in line with the average of OECD countries: this is evidence of the limited participation in international global value chains for the standard of a small economy and largely reflects the dominance of services. Direct exports by the “transport and telecoms industry” and by the “wholesale, retail and hotels” sector (including tourism and distribution services) accounted in 2011 for, respectively, over one-quarter and 14% of the total value added of Greek exports: this reflects the country’s specialisation in sea transport and tourism-related services, whose trade shares have increased remarkably since the mid-1990s. It should be noted that the increase in (the value of) transport services is not unrelated to the super-cycle in commodities, which had increased substantially their prices and the value of related services.

A relatively high share of foreign value added in total gross exports can be found only for two sectors: “transport and telecoms” and “coke and petroleum” industries. While the unitary share of foreign value added of the former is relatively low but applies to large export values, production in “coke and petroleum” industries is characterised by the highest share of foreign value added in Greek exports (about 70% in 2011) but is small in size. A peculiarity of petroleum exports is that the vast majority are exported either to non-EU countries, mostly Turkey (Eurostat[7]) but also North Africa, or countries like Cyprus and Bulgaria and the overseas territory of Gibraltar. Hence, on the one hand Greece has to compete with other regional producers that are not only refining but also extracting, while on the other some of these countries are unlikely to be the final consumers, which suggests that tax shifting might play a role in this business. Hence, large foreign added value figures do not suggest high integration in the global value chain but indicate that Greece exhibits a commodity-exporter structure even though it is not naturally endowed with commodities and natural resources.

Focusing on the destination of the domestic value added in the manufacturing sector, it is worth noting that the share accounted by foreign final demand has been low since the mid-1990s: it has fluctuated

[7] From 2004 through 2013 75% of mineral fuels went to non-EU countries.

around 30%, which is 15-20% lower than Italy, France, Spain and Portugal. The industries exhibiting the highest share of domestic value added in foreign final demand are small sectors, i.e. ICT and electronics, chemicals, and basic metals, representing less than 10% of total gross exports. This is in line with Sufrauj et al. (2015), who show that Greece performs very poorly in terms of the number of large single-product bilateral trade flows, i.e. big hits, a measure that can be associated with the sophistication and development of the manufacturing exporting sector. Another feature of the manufacturing sector is that the value added it generates does not exhibit correlation with exports. Correlation computed over the period 1995-2014 is zero. As a benchmark for comparison, in Germany, where exports are driven by the manufacturing sector, such correlation is close to 90%; but even in Portugal, which before the crisis exhibited features similar to those of Greece, such correlation is about 60%.

Hence, once trade numbers are adjusted to account for re-exports and foreign value-added contributions, Greece appears to be an extremely closed economy, whose GDP growth cannot but be dependent on the expansion of domestic aggregate demand. It is then not surprising that the economy managed to grow at satisfactory rates only during the period in which the private sector could expand demand by accumulating relatively cheap debt and the governments could run large budget deficits as well.

Given that small countries tend to be relatively more open than large countries, such a limited degree of openness is puzzling, even more so when considering the EU and EMU membership of Greece. The single market and the single currency clearly failed to integrate the Greek real economy with other European economies.

In fact, this is not the only unusual economic feature for an old member state of the EU. Greece, for instance, has typically counted on a restricted employment base (with low female and youth employment rates), exhibited a large fraction of population employed in the public sector, tolerated a relatively large share of irregular and informal activities (above 25%, according to Schneider et al., 2010), and developed a small manufacturing sector.[8]

Greek companies tend to be small[9] and to operate in low valued-added service sectors, where R&D expenditures and innovative actions are not as necessary to survival. In the 2000s Greece was among the lowest-ranking countries in Europe in terms of business R&D expenditures (see the contribution by Veugelers & Cincera in Veugelers et al., 2015) and of total R&D expenditures per capita. According to the Innovation Union Scoreboard developed by the EU Commission, moreover, Greece has been among the worst performers. Overregulation and unnecessary administrative practices have traditionally stifled competition and served the interests of incumbent companies, at the expense of development and adoption of innovation.

Such an economic structure reflects the endemic competitiveness problem of the country, whereby GDP and employment growth depend on externally funded domestic demand, falling particularly in the non-tradable sectors of the economy. The share of tradable sector in the Greek private sector has fallen from

[8] According to Williams (2014), although the overall level of informality in Greece is close to that in Italy and other countries, it presents different features. In Greece, informality has particularly to do with informal waged work, i.e. totally unregistered work, in addition to the other usual types, e.g. envelope wages, informal self-employment and paid favours, which are also present in other countries.

[9] According to the Structural Business Statistics Database (Eurostat) and Greece's National Statistical Institute, in 2009 Greece had 531,059 enterprises, of which only 378 were large while more than 95% of the total were micro-enterprises (http://ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/performance-review/files/countries-sheets/2013/greece_en.pdf).

around 58% in the early 2000s to 51% in 2007: the period of sustained growth for Greece after its admission to the euro area was thus associated with a greater reallocation of resources towards domestic activities.[10]

According to the Global Competitiveness Index developed by the World Economic Forum, Greece was among the least competitive EU member states in 2007 and in 2014 (WEF, 2014). The global rise of China and Eastern Europe, as well as the introduction of the euro in the 2000s, represented two major shocks for the country: both exacerbated the problems associated with the fact that Greece's cost structure was typical of a rich country but its overall productivity was not in line with it. It is not surprising that in the mid-2000s the authorities had to boost fiscal expenditures (and cook the books), as well as turn a blind eye to the expansion of a foreign-funded real estate boom (Gros and Alcidi, 2011 and Alcidi and Gros, 2015c) in order to ensure politically desirable levels of employment and growth.

1.2. Structural imbalances and social dysfunctions

The burst of the debt bubble and the resort to external official financial assistance *cum* conditionality did not instantaneously change Greek political priorities. As noted by Mitsopoulos (2015), while Greek authorities surrendered to most of the requests made by the institutions and engineered improvements in cost competitiveness through the contraction of the productive sector wage bill, they postponed and even refused to address those regulatory and red tape excesses that simultaneously reduced competition and weighed on the most productive companies. In particular, only the second Greek programme focused on product markets and non-wage competitiveness factors, and the implementation by Greek authorities was slow, partial and delayed (IMF, 2014; Terzi, 2015). Recent figures suggest that Greece has recently achieved substantial progress in product market reforms, and in 2013 the OECD composite indicator suggested Greece was ahead of the other euro area countries. As noted by Gros et al. (2014), however, this index is based on legislation and not on output; indicators based on surveys, such as the Global Competitiveness Index by the World Economic Forum, reveal limited change.

According to Maselli (2015), participation in the labour market of people over 55 increased by 50% in the euro area between 2000 and 2014, whereas it remained constant and low in Greece. While one could argue that there is no intrinsic merit to having a large share of the elderly in the labour market, budget-related concerns should have led Greek authorities to reform the pension system. Pension-related expenditures (most of which are non-means tested and intended for anticipated old-age pensions) doubled during the period in Greece, whereas they increased by 50% in the euro area. This may help to explain why, notwithstanding the brutal impact of the crisis, the rate of severe material deprivation for those over 65 diminished (from 17% to 14%) between 2007 and 2013. Even more interestingly, while in 2007 the rate of severe material deprivation for those over 65 was 1.5 times the figure for those under 16, in 2013 the rate for the latter doubled to almost twice the (falling) rate for those over 65 (Eurostat). A pattern, we believe, consistent with a generous pension system and a weak social protection system.[11]

[10] Similar trends can be observed in all countries under financial assistance programmes, while Germany exhibits an almost constant value over the same time span (see Darvas, 2015).

[11] Data on income inequality strengthen the observations above. According to the *EU Employment and Social Situation Quarterly Review* (Supplement, September 2014) income inequality in the country, measured either in terms of the gap between the upper and the lower income quintiles, i.e. the 80/20 income quintile ratio, or with the Gini index, increased remarkably after 2010. Incomes of the poorest declined the most as real income in the bottom quintile fell by more than the other quintile groups.

A form of "disjointed corporatism" could be observed as well, whereby the main union federations (over-representing the public sector) and the employers' organisation (SEV) failed to establish effective social pacts (Featherstone, 2011). This helps explain the stubbornly high rate of structural unemployment, especially among the young people, and the problems encountered over a long period to reform labour market regulations.

Private and public dysfunctional behaviour did not cancel out but, rather, reinforced each other: weak control over public expenditures was combined with corruption and problems in raising tax revenue. Tax evasion is estimated to be at around 25% of Greece's GDP. Moreover, according to the World Governance Indicators published by the World Bank, there has been a severe deterioration in the degree of control over corruption throughout 2000-14 (see Figure 3). Diffuse rent-seeking activities, low levels of generalised trust and of altruistic attitudes, widespread opportunistic behaviour, and pervasive clientelism and cronyism appear all to be connected with a weak culture of legality and poor endowment of social capital and civic mindedness.[12]

As observed by Katsimi & Moutos (2010) the restoration of democracy in 1974 and EEC accession failed to reduce corruption, nepotism and tax evasion. As the authors claim, the dismantling of the political system in place before 1974 forced incumbent governments to build consensus through social and economic policy measures. Strong trade unions and employer associations, as well as a politicised bureaucratic apparatus, added to this trend. "During this period the older individualistic (or family-based) system of patron-client relationships was supplemented by one dependent on favours bestowed on party members by the party machine" (p. 571). Many civil servants started using discretion to favour politically-connected citizens, and bureaucratic complexity and over-regulation was instead applied to the majority of citizens. This, in turn, enabled corruption, nepotism and private interests to capture the functioning of public administration. To a certain extent, the admission of Greece into the EEC fuelled societal demands and did not correct behaviour, as the optimistic expected. Interestingly, the observed attachment to statism in service delivery has typically not been matched by an efficient public administration: notwithstanding high costs associated with the public education and health systems, Greece has exhibited among the highest values of private expenditures for private health care and education in the EU.

Syriza owes its success to a population having reckoned with a past political elite elected and re-elected for decades but that had done little to improve the social and economic fabric of the country. As argued by Featherstone (2011), a "paradox of Greek governance has been the juxtaposition of liberal democratic formal structures alongside a political culture marked by clientelism, rent-seeking and corruption. The short-term, piecemeal political attitudes that stem from this culture severely constrain reform initiatives on politically sensitive issues such as the pension, health or labour market systems." Such a dismal context did play a role in keeping the attractiveness of the country low: as pointed out by Pelle (in Veugelers et al., 2015), the sub-indicators of the WEF Global Competitiveness Index suggest that Greece performed poorly in terms of attraction and retention of talent.

Although this cultural, social, institutional and political background could not block the reforms demanded by the institutions, which attached conditions to their assistance programmes, it has nonetheless contributed to deferring and slowing down a number of urgent measures that address strong interest

[12] This is consistent with Phelps (2015), who argues very effectively that Greece's current economic ills have little to do with austerity policies but are rooted in structural causes that are closely intertwined with widespread societal values and beliefs.

groups. This is one of the reasons why we believe that interest groups remain a serious hindrance to the country's future prospects.

2. Internal devaluation and institutional reforms

The fundamental assumption of standard IMF adjustment programmes is that fiscal consolidation, usually a key part of the programme, combined with a limited capacity to import, induced by restricted access to external funding, reduces domestic demand and hence wages and prices, i.e. internal devaluation. The devaluation accompanied by structural reforms is expected to improve competitiveness and to boost exports. This should allow external demand to compensate for the fall in domestic demand and contain the recession or open the way to recovery. Such mechanisms clearly did not work in Greece, as they did in other programme countries.

There are both macroeconomic and institutional explanations for such failure.

2.1. Failure of internal devaluation

As argued above, Greece represent a rare case of small closed economy (Gros, 2015a) and in addition to this, the structure of its exports, where imported commodities play a crucial role, suggests that only a limited amount of them is sensitive to wages and other cost-competitiveness measures (Alcidi & Gros, 2015a).

Since the start of the first adjustment programme and up to 2014, wages fell by over 20% in absolute terms according to Ameco data and even more relative to the euro area average. Such a wage compression has been the result of the deep recession and the dramatic increase in unemployment, as well as of the labour-market measures undertaken in the framework of the adjustment programmes.

It should be recognised that until 2009, the correlation between wages and unemployment was very weak in Greece (see Figure 4). Fluctuations in unemployment had remained very limited during the boom years while wages had increased substantially. By contrast, the large adjustment in wages that happened later seems to be proportionate to the increase in unemployment, at least according to what one could expect from the Phillips curve relationship, and comparable to the experience of other countries such as Portugal, where wages fell less but also unemployment increased less. The emergence of a Phillips curve kind of relationship between wage inflation and unemployment after the start of the crisis is also supported by Daouli et al. (2015). Using micro data, they find evidence of a wage-unemployment rate relationship, at regional level, for groups of workers with relatively limited bargaining power (the young, those with secondary education, and those residing in rural areas) for the first time after 2012. The authors attribute this change to labour market measures undertaken during the adjustment programmes and in particular to the abolition of the extension principle, i.e. the application of collective agreements to non-members. While this may be the case, given that most labour market measures were implemented late and only partially and that the majority of employment is concentrated in small and very small enterprises where wage bargaining is informal, it seems quite unlikely that the liberalisation of collective dismissals had a strong impact on wage formation. By contrast, cuts in public sector[13] and minimum wages (Yannelis, 2014) are very likely to have had a direct impact on wage formation in the private sector. Similarly, the dramatic increase in unemployment induced by a depressed domestic demand and numerous defaults of firms must have affected wage dynamics.

[13] See Christopoulou and Monastiriotis (2015) for differences in wage dynamics in the private and public sector.

Of course, this does not explain why the fall in wages translated only partially into lower prices. Price competitiveness, as measured by broad price indices, like the consumer price index (CPI), improved by much less than wage-cost indicators would suggest. Several concomitant explanations may be at work.

First, a rebalancing of income accruing to factors of production, labour and capital may have occurred. Following a period of excessive wage growth which reduced profit margins, firms may have benefitted from the wage fall by enjoying higher profits thanks to prices not adjusting to wages. Of course, this can only be possible where firms are not price takers and enjoy market power. As mentioned earlier, this is indeed the case in Greece in most sectors. A second explanation relates to the increase in the costs of other inputs of production, namely energy and capital. Energy plays a particularly important role in Greek industry and energy efficiency is very low. According to various sources,[14] electricity cost for business and households rose substantially between 2008 and 2013 and at higher rate than in other EU countries, this may have off set, at least partially, the gains from the fall in labour costs. Last but not least, credit gradually became more expensive and more difficult to access without collateral (Mitsopoulos, 2015), especially beginning in 2012, when banks were strongly hit by debt restructuring. A third explanation for the incomplete adjustment in domestic prices relates to taxation. Data suggest a large difference between changes in prices including or excluding taxes. The increases in VAT rates imposed by the adjustment programmes clearly led to an increase in the consumer price index, hence masking the adjustment in wages to prices.

A further aspect to be considered is that since a large percentage of goods consumed in Greece is imported and goods account for about half of the consumer price index, the CPI changed little even when wages had declined.[15]

It is difficult to establish which explanation is most relevant, but they were most likely all at work at the same time and all point to only one effect, a slow and partial internal devaluation. Other than these economic factors, institutional features of the Greek economy have led to the failure of the internal devaluation to boost exports.

2.2 An institutional problem

It is worth noting that even tax increases, which in principle apply to all sectors in the same way, might have, *de facto*, had a greater impact on the traded sector due to the existence of different degrees of tax evasion between the traded and non-traded sectors. The non-traded sector, which is dominated by (low-value) services providers, in many cases self-employed or employed in small enterprises, tends to use little capital, to engage only marginally in international trade and to rely excessively on cash transactions. All these conditions make tax avoidance and evasion easier. This implies that a rise in tax rates makes it relatively more attractive to remain in the non-traded sector and may even draw resources away from the traded sector. This is the opposite of the outcome that the programmes wanted to produce. Indeed, reallocation of resources from the non-tradable to the tradable sector was one of the explicit objectives of the second adjustment programme.

From this perspective, one way of thinking of Greece is as a country that has a production possibility frontier with a narrow tradable sector (see Figure 5). When this is the case, changes in relative prices (tradable versus non-tradable) have little impact on production in the tradable sector. This means that the structure of the Greek economy is such that changes in domestic prices and wages are deemed to produce only limited impact. External factors like global commodity prices are likely to have larger effects.

[14] http://greece.greekreporter.com/2014/10/31/greece-champion-of-electricity-hikes/
http://www.ekathimerini.com/151560/article/ekathimerini/business/greeks-pay-dearly-for-natural-gas-while-electricity-rates-keep-rising

[15] By contrast, in the case of service where labour is the main input, prices have adjusted more than for goods.

Overall, both economic and institutional factors suggest that not only the internal devaluation failed to reduce the internal prices enough to restore external competitiveness, but also that it would not have been in any case sufficient to deliver important positive effects for the economy. This notwithstanding, a drastic correction of relative wages and prices was inevitable if Greece was to stay in the eurozone: Greek wages and prices had been inflated by the credit bubble of the first decade of the euro and had to go back to a level consistent with the country's fundamentals. Similarly, Greece's domestic demand and GDP were fed by cheap borrowing from the rest of the world and were largely inflated with respect to the country's productive potential: external official support much greater than what Greece received from its partners would have been necessary to avoid a severe fall of its GDP. This was clearly politically unacceptable to some EU member states and unfair to others.

Given the features of the Greek economy, this led to an extremely painful situation: the economy relied dramatically on domestic demand funded by foreign debt and weighed down by excessive government; fiscal consolidation combined with a sudden end to private lending as well as falling wages led to a depressed economy, with great uncertainty and increasing inequality.

For all the reasons explained above, the Greek traded sector has always been small and it was very unlikely that it could expand when access to credit became more difficult and taxes increased. This suggests that internal devaluation, while at the same time inevitable and *conditio sine qua non* for change (Alcidi & Gros, 2015b), could not be the sole solution to Greek problems. Well-designed and well-implemented structural reforms are critical. Notwithstanding undeniable efforts to reform the country, the timing and composition of the reforms undertaken under the first and second programmes exhibit various shortcomings (see Terzi (2015) for a thorough assessment). Reforms under the first programme were almost entirely directed toward restructuring the public sector (tax system, transparency, public wage bill, privatisations, and pensions) despite the low administrative capacity of the public administration. Reforms under the second programme were better designed but implemented either partially or with delay, thereby reducing their overall effectiveness. Empirical evidence, in fact, indicates that the simultaneous and coordinated introduction of reforms in the labour and product markets could have delivered quicker and better results (see Anderson et al., 2014; ECB, 2015; Terzi, 2015).

As it will be argued in the next section, Greece necessitates also profound societal changes in values and culture in order to be a successful member of the euro area and undertake a sustainable growth pattern.

3. Greece and the Italian Mezzogiorno

While some of Greece's peculiar features were discussed in the previous sections, we would like to emphasise here a number of apparent similarities between the situation of Greece in the euro area and that of the Mezzogiorno in Italy. This has some relevance especially in the light of the fact that various commentators claim that large and long-run fiscal transfers within the eurozone risk transforming southern Europe into a large Mezzogiorno (Tilford, 2012; Wolf, 2012).

To start, there exist important similarities between Greece and the southern regions of Italy. In terms of GDP per capita, for instance, Greece looks closer to the Mezzogiorno than to other parts of Italy, as can be seen in Figure 6 and in Table 1. Similar findings hold for the share of manufacturing activities in local GDP; according to the data collected by SVIMEZ and the World Bank, manufacturing accounted in 2014 for 7.9% and 8% of the GDP in southern Italy and in Greece, respectively, whereas in northern Italy the share is 17.7%.

Limited trade openness appears to be an issue in most regions in southern Italy as well as in Greece, and exports to regional GDP ratios are low (Table 2). Notwithstanding the serious statistical problems in allocating the origin of exported goods within a country, for instance when wholesale retailers are based in a region but trade goods are produced in another one, the differences between the north and south of Italy are extremely marked (and cannot be explained by geographical differences). Furthermore, both the Mezzogiorno and Greece have a small manufacturing sector that suffers from a serious competitiveness problem, and small private companies are active in low-valued added sectors and hardly innovative.[16]

In addition, both the Mezzogiorno and Greece are characterised by problematic labour market conditions, such as limited participation (the ratio of NEET – not engaged in education, employment, or training – young citizens in 2014 was 38% in southern Italy, 30% in Greece and about 20% in northern Italy and Spain), a large share of workers in public employment, high long-term unemployment rates, and diffuse irregular occupations.

With all due exceptions, in both areas public institutions have tended to be weaker than in other OECD regions, corruption more widespread and the public administration relatively inefficient. The Mezzogiorno appears to share with Greece low levels of tax morale, social capital and generalised trust, together with a relatively high incidence of those forms of opportunistic behaviour that negatively affect market transactions.[17] Generous and protective welfare state provisions have often been abused with a view to entrenching political clientelism,[18] thus giving credit to the argument that transplanting to an environment poorly endowed with social capital institutions (like those typical of a modern welfare state) conceived for contexts richer in social capital tends to produce perverse results.

Following the lead offered in the famous book *The Moral Basis of a Backward Society* by Edward C. Banfield (1958), several scholars have noticed the existence in various areas of the Mezzogiorno of a value system of honour and shame, associated with what has been dubbed 'amoral familism' as well as patron-client relationships playing the dominant role of social integration.[19] This situation has been related to the difficulties encountered in making people share identification and interest in the political community, to the limited dimension of local voluntary organisations, and to the widespread diffusion of clientelism. Horizontal *un-personal* interactions among agents, helpful to contain transaction costs, could hardly emerge in such a context, whereas interactions based on personal links (often called 'improper intermediation') has increased. Even in post-modern urban contexts, people lacked the class solidarity typical of industrial societies and upward mobility has hinged on personal loyalty and familiar connections; cynical individualism has gone hand in hand with opportunistic behaviour and an instrumental approach to

[16] In 2012, the average number of employees per firm was equal to 3.2 in Greece, 4.3 in central-northern Italy and 2.8 in southern Italy (while the EU-28 average was about 6).

[17] According to Paraskevopoulos (2007), the index of social capital in Greece was equal to 0.06, at the same level of the new members of the EU, against an average value of 0.31 for the old members of the EU.

[18] As discussed in Piattoni (2001), clientelism and patronage in several countries have been used, on the one hand, to preserve power and, on the other hand, to protect particular interests.

[19] The founding principle of amoral familism can be summarised in the following terms: "Maximize the material, short-run advantage of the nuclear family; assume that all others will do likewise" (Banfield, 1958: 85). According to Sabatini (2009), the intensity and quality of intra-familiar relations in Italian regions exhibit an inverse relationship and the southern regions are characterised by strong but poor quality links.

the institutions, consumerism and short-termism (typical of those seeking to extract everything possible from any interaction without worrying about its consequences for others and its long-term implications).[20]

Moreover, both in southern Italy and Greece, one can find traces of a “consumer society without a production base”: consumption patterns are not consistent with the capacity of generating income, and wage and price dynamics are distorted and not conducive to market adjustment.

During the crisis, moreover, influential opinion leaders in both societies refused to explore the deep roots of contingent and recurring problems, whereas they started a search for scapegoats and blamed the EU and the euro, according to what Robert Hughes called a ‘culture of complaint’.

All this suggests that, short of profound reforms and a radical change in the systems of values and beliefs in Greece, there is indeed the chance that an automatic system of fiscal transfers turns the euro area periphery into a European Mezzogiorno. While it is possible that core countries’ great concerns for the risk of moral hazard consequences of fiscal union are somehow exaggerated, the parallel between Greece and the prolonged experience of the Italian regions in the Mezzogiorno is a warning to neither err on the other side nor underestimate the importance of properly establishing private and public incentives.

Of course, we are aware that there exist important differences between the Mezzogiorno and Greece as members of two different currency unions (respectively, Italy and the EMU).

First, from the early 1970s on, southern Italy has been subject to a policy mix (and its unintended effects) that one cannot observe in Greece. The existence of an automatic fiscal transfer mechanism in Italy and a firm political commitment of the national political elite to support the most backward regions were conducive to substantial and permanent transfers in favour of the south (close, on average, to 20% of the south’s GDP). These transfers supported (private and public) consumption and local employment. In contrast, Greece has not participated to a full-fledged fiscal union. Indeed, although it has been a net recipient of non-negligible amounts of European funds since its accession to the EEC in 1981 (as much as 2% of GDP since the early 2000s, but twice or three times this ratio in the previous decades), it is only in the aftermath of its accession to the EMU that Greece gained easy and cheap access to massive external funds (its external debt rose from 40% to 80% of GDP in the period 2000-09). Facing export difficulties and lacking large fiscal transfers from the other members of the euro area, GDP growth in Greece had to be sustained through the expansion of domestic demand financed by heavy private borrowing from the rest of the world.[21] This has exposed Greece – differently than the Mezzogiorno – to the sudden stops and reversals of private capital flows that are typical of global financial markets.

Both in Greece and in the Mezzogiorno, thus, the long-lasting gap between consumption and the capacity to generate income has made the respective societies addicted to external resources. Such persistent inflow of external funds has contributed to keep prices and wages high with respect to productivity and

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[20] This description captures only the general negative traits of a large and diversified territory. It certainly fails to capture several virtuous examples in several civil society organisations and institutions. As often observed, the existence of criminal organisations, such as Mafia and Camorra, led to the emergence of commendable civil society groups fighting against criminal practices, as well as an advanced legal code to fight such associations.

[21] The adoption of the euro allowed Greece to access foreign financial resources at relatively low interest rates. This is what allowed Greece to grow at a rate well above the EU average in the period preceding the crisis, although at the cost of accumulating an unsustainable amount of debt and of letting prices and nominal wages increase more rapidly than in the core countries of the eurozone.

hindered the functioning of basic market mechanisms of adjustment.[22] This is also reflected in the particularly low residential mobility and worker reallocation rates (OECD, 2015).

The second difference between the two areas is that the pronounced decentralisation which took place at the beginning of the 1970s attributed to all Italian regions new relevant competences (such as managing the public health system) and the faculty of spending large amounts of money received from the central government. Given the poor social capital endowment of the south and the clientelistic attitudes of the local elites, this power devolution has led to a systematic misuse of public funds and distorted resource allocation in the Mezzogiorno. As a matter of fact, the ability of local politicians to bargain with the central government over the inflow of substantial funds from the rest of the country has become relatively more important for the local population than the way in which these funds are used locally. Therefore, the external origin of a large percentage of the money spent by public entities in the south has reduced the incentive for the local population to exert control over how this money is spent. This is a less relevant issue for Greece in its relationship with the euro area, since – as stated above – the net transfers that it has received from the EU are substantially less (in proportion to GDP) than those received by the Mezzogiorno from the rest of Italy (and in addition they have decreased over time as a proportion of the country's GDP).

Finally, the wage bargaining process in Italy is mainly centralised, and negotiated wages are valid throughout the country in spite of the remarkable productivity and unemployment differentials across the regions. This has exacerbated the effects of having a less developed area (the south) sharing the same currency (and thus the same nominal exchange rate) with a more developed area (the north). No such thing occurred for Greece, since there is no centralised negotiation and common wages across the euro area.

All in all, while these differences suggest that the parallel between the Mezzogiorno in Italy and Greece in the euro area should not be stretched too far, the above discussion indicates that such a parallel is worth making, in particular when thinking of possible reforms in Greece and at the EU level.

4. Closing remarks

The crisis that started at the end of 2009 forced Greece to abandon its unsustainable growth model based on the accumulation of external debt and to undertake a painful adjustment. In the first months of the Tsipras government, many Greeks were induced to believe that the country could have the cake and eat it too, i.e. to keep the euro and interrupt the adjustment process under way. This would have been possible if the rest of the eurozone were willing to substantially subsidise the Greek economy for an indefinitely long period of time. In essence, this is what was at stake in the long months of harsh confrontation between the Greek government and the core countries of the eurozone. In the perception of both the population and the leading elite of these countries, permitting Greece to stay in the eurozone without completing the adjustment process, which it had committed to undertake in exchange for the great financial support already received from its partners, would have induced other member states to follow the same track. This would have transformed the eurozone into a transfers union and the euro periphery into an enlarged 'Mezzogiorno' subsidised by the rest of the countries in the EMU.

[22] In 2012, the average hourly wage in the manufacturing sector in Greece was three and four times that in Romania and Bulgaria, respectively. The mean and median hourly earnings for industrial and construction workers are reported in Table 3 and provide a similar picture. Using the data provided by SVIMEZ, in 2007 the unit labour costs in the manufacturing sectors (calculated as value added per employee over the labour cost per employee) were 12% greater in southern and central-northern Italy.

The strategy of the Greek negotiators in the first half of 2015 relied on the threat of leaving the eurozone if the other members would not accept the interruption of the agreed adjustment programme while, at the same time, ensuring all the financing necessary to keep the Greek economy going. Obviously, this threat appeared effective insofar as 'Grexit' would have caused major turmoil in European financial markets and possibly a collapse of the entire eurozone. However, the prevailing perception in the spring of 2015 was that the effects of a possible Grexit were manageable, without excessive risks and costs for the rest of the eurozone. A large majority of the Greek population, moreover, expressed a clear preference for sticking to the agreed adjustment programme if this was necessary to keep the euro. In other words, as soon as the threat on which the entire negotiating strategy of the Greek government relied was exposed as not credible, the Greek negotiators had to resign, an agreement was signed, and the Greek government had to pass through the ordeal of a new election to side-line those groups in the coalition opposing the deal.

The acknowledgement that the promise with which Tsipras had won the January 2015 elections – namely to stay in the eurozone while negotiating the reduction of public debt and putting an end to adjustment programmes signed with the Troika – could not be met, aroused hostility toward the European institutions and the core countries of the eurozone. Such hostility was encouraged by a culture of contempt and victimisation widespread in Greece among many unscrupulous political entrepreneurs searching for scapegoats toward whom to redirect popular resentment fuelled by the suffering caused by the crisis. However, in spite of this sentiment, a large majority of the Greek population ended up accepting the deal reached in the summer of 2015. One may wonder why. Probably, those who still have kept a relatively secure job in the formal economy, the retirees and those in possession of some wealth have realised that they have more to lose from a possible Grexit. It remains to be seen if this basis of consensus is robust enough to permit Greece to rebuild its institutions and relaunch its economy, as is necessary if the country wants to start to grow again at an acceptable and sustainable rate. This question is even more crucial if one considers that, for all the reasons explained in detail in the previous sections, Greece needs to act on the institutional, social and cultural causes of its low productivity and limited competitiveness in order to resume sustainable long-term growth.

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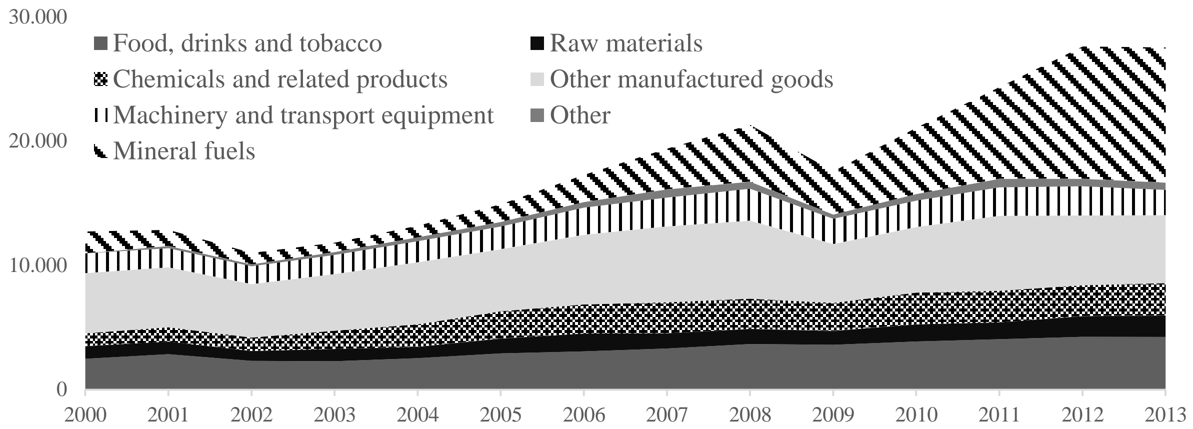
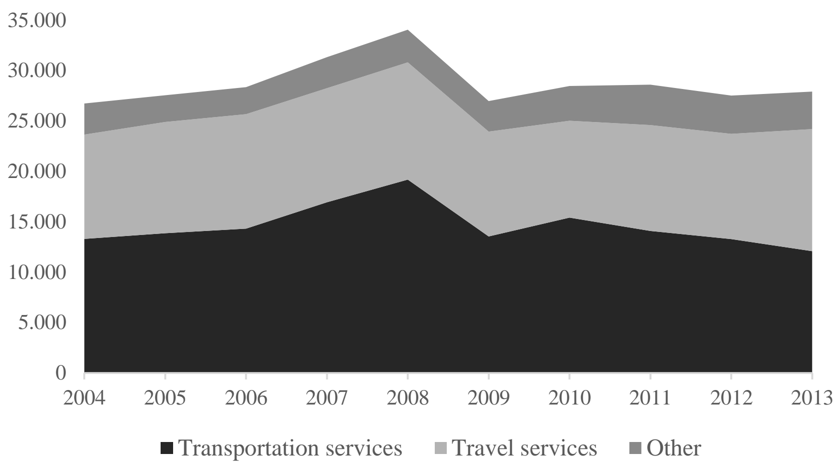
Figures and Tables

Figure 1. Export composition: Goods, millions of euro



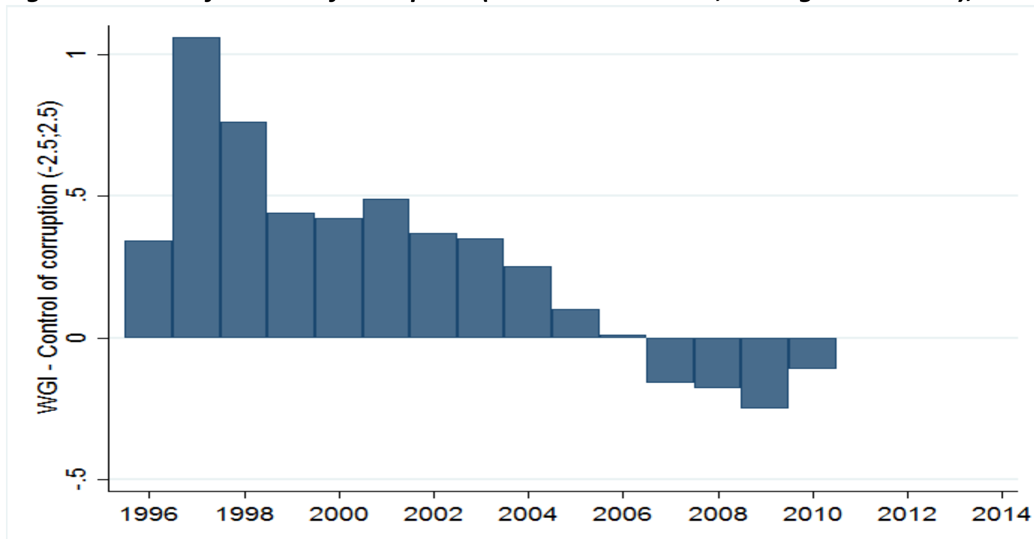
Sources: Eurostat, balance of payments statistics.

Figure 2. Composition of service sector exports (millions of euro)



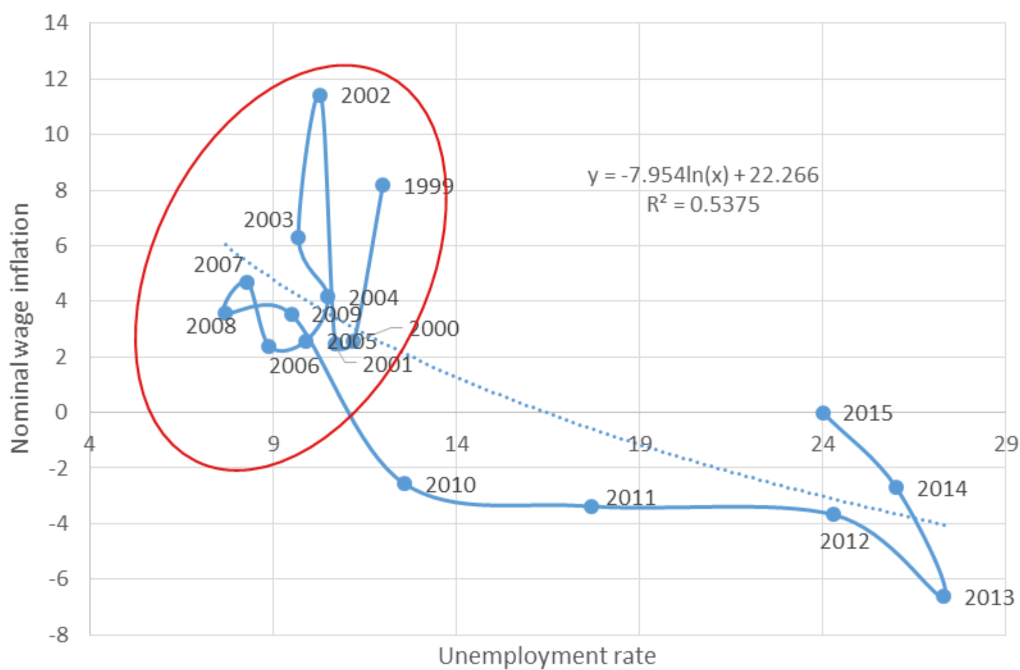
Source: Eurostat, balance of payment statistics.

Figure 3. Index of control of corruption (-2.5 lowest control; 2.5 highest control), 1996-2014



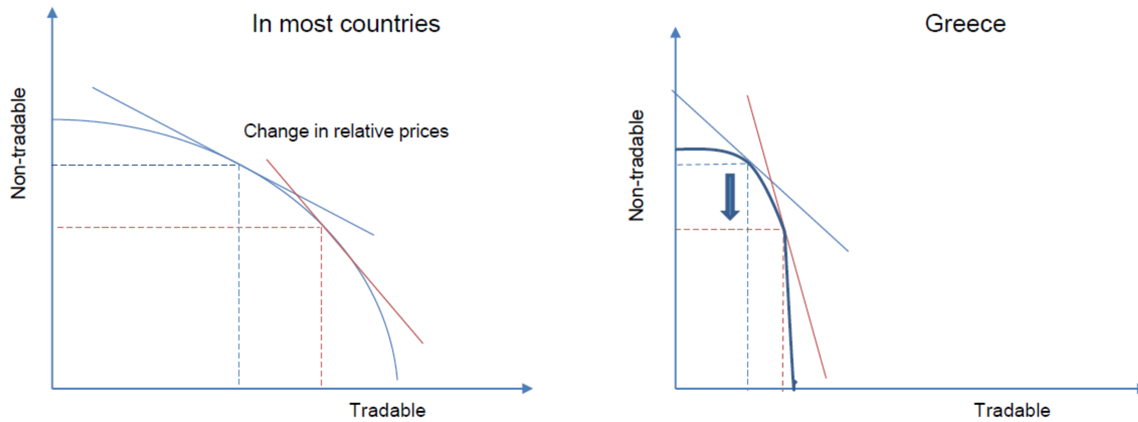
Source: World Government Indicators.

Figure 4. Phillips curve, Greece, 1999-2014



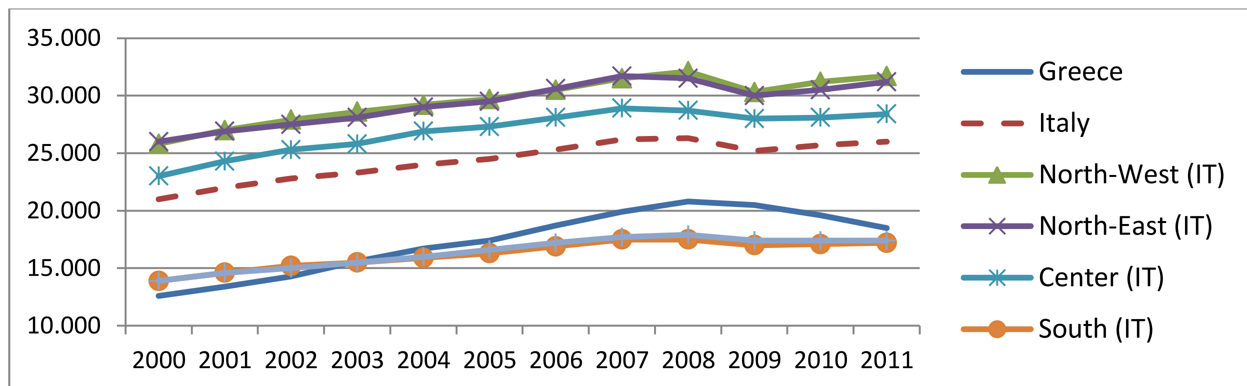
Source: Own elaboration based on Ameco.

Figure 5. Production possibility frontiers



Source: Authors' own elaboration.

Figure 6. GDP per capita (in euro) at current market prices, Greece and Italian regions, 2000-11



Sources: Eurostat (ESA95)

Table 1. GDP per capita (in euro) at PPS in Greece and Italy in percent of the EU average, 2001-11.

	2001	2003	2005	2007	2009	2011
Greece	87	93	91	90	94	80
Italy	119	111	105	104	104	102
North-west (IT)	146	137	128	125	125	124
North-east (IT)	145	134	127	126	124	122
Centre (IT)	131	124	117	115	115	111
South (IT)	79	74	70	70	70	67
Islands (IT)	79	74	71	70	72	68

Source: Eurostat (ESA95).

Table 2. Merchandise exports over GDP %, 2011-14

	Campania	Puglia	Basilicata	Calabria	Sicily	Sardinia	North-	North-

							west Italy	east Italy
2011	9.6	11.6	12.7	1.1	12.4	16	27.8	31.8
2014	9.6	12.1	10.6	1.1	11.7	15	29.8	34.7

Source: ISTAT, External Trade and internationalization

Table 3. Mean and median hourly earnings (in euro) in industrial and construction sectors

	Skilled manual workers						Elementary occupations					
	Mean earnings in euro			Median earnings in euro			Mean earnings in euro			Median earnings in euro		
	2002	2006	2010	2002	2006	2010	2002	2006	2010	2002	2006	2010
Euro area (18)	10.54	11.69	12.82	9.95	10.99	12.22	10.34	10.04	10.38	10.21	9.22	10.14
Bulgaria	0.77	1.04	1.74	0.63	0.78	1.5	0.52	0.68	1.2	0.42	0.55	0.99
Czech Republic	2.32	3.48	4.43	2.19	3.29	4.22	1.84	2.7	3.43	1.71	2.53	3.2
Germany	14.19	15.26	15.6	14.22	14.94	15.33	12.36	12.27	12.5	11.93	11.55	11.86
Greece	**6.6**	**9.03**	**10.41**	**5.79**	**7.98**	**9.09**	**5.07**	**7.5**	**7.9**	**4.53**	**6.44**	**6.99**
Spain	7.44	8.99	10.1	6.49	7.94	9.16	5.56	7.19	8.59	5.15	6.63	7.65
France	11.7	12.88	12.71	10.46	12.05	12.17	10.53	10.92	10.84	9.5	10.35	10.65
Italy	8.6	10.08	11.22	8.16	9.4	10.57	8.53	9.16	10.59	7.85	8.8	10.38
Hungary	2.08	2.71	3.49	1.81	2.36	3.04	1.61	1.95	2.53	1.42	1.71	2.19
Poland	2.67	3.15	3.88	2.35	2.8	3.53	2	2.41	3.18	1.77	2.1	2.83
Portugal	3.81	4.14	4.59	3.25	3.55	3.98	2.96	3.36	3.98	2.64	3.03	3.52
Romania	0.89	1.51	2.19	0.75	1.3	1.9	0.55	0.98	1.39	0.47	0.86	1.24
Slovenia	4.17	4.9	6.62	3.84	4.61	6.04	3.68	3.91	5.59	3.08	3.75	4.95

Source: Eurostat.