

## **A Macroeconomic Analysis of Income Shocks and Expected Inequality Dynamic in Greece**

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**Abstract:** Top priorities for the Greek economy is sustainable growth which is needed for reducing poverty, creating jobs and ensuring fiscal sustainability. The purpose of this paper is to analyse the effects of income shocks on Greek macroeconomic aspects and to examine the size of the inequality under the concept of economic crises. Adopt key structural reforms to boost growth and enhance administrative capacity to improve overall reform implementation. The prolonged economic depression has taken a big toll in terms of poverty and employment. Make economic growth more inclusive by urgently adopting policies to reduce poverty and inequality and boost employment in the short run. Tax evasion is pervasive and reduces revenues needed to support social policies and increase fairness. Broaden the tax base and strengthen the tax administration by giving it more autonomy and freeing its resources for audits and enforcement. Weak growth and bank recapitalization needs have pushed up the already high public debt. Broaden the tax base and strengthen the tax administration by giving it more autonomy and freeing its resources for audits and enforcement. Ensure that the conditions for gross financing needs for public debt are placed at sustainable levels by continuing to credibly implement the ESM reform program and thus, if necessary, facilitate reaching an agreement on additional measures with creditors, such as, for example, extended grace and repayment periods.

**Keywords:** Financial crisis, Inequalities, Enterprises, Reforms, Labormarket, Fiscal Consolidation

**Jel Codes:** E01, E64, F36, F42, F62

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### **I. Introduction**

***The recovery has faced some setbacks, but extreme downside risks have receded***

Growth turned positive in 2014, but increased political uncertainty and prolonged negotiations with creditors sharply deteriorated business and consumer confidence undermined domestic demand and lead to a prolonged flight of deposits. To ensure the stability of the banking system, a bank holiday and capital controls were imposed in July 2015, limiting cash withdrawals from banks and cash transfers abroad. High levels of non-performing loans and deposit outflows during the first half of 2015 have been constraining credit. While capital controls have been eased gradually, they have added to the already tight financial situation facing many enterprises. According to the National Bank of Greece (NBG), SMEs have been more impacted than larger enterprises, with a year-on-year 15% decline in their sales in Q3 2015 compared to around 8% for large enterprises. The NBG's business confidence indicator for SMEs deteriorated also significantly in the second half of 2015. Construction and retail trade have been the most affected while chemicals, IT services and tourism were more resilient. Nonetheless, for now, the impact has been relatively modest as SMEs largely anticipated capital controls and kept cash and increased inventories (NBG, 2016). Despite some resilience, there are signs of a moderate decline in output for 2015. Unemployment is still very high, although it has been gradually falling. Employment is growing mainly in tourism, wholesale and retail sales, professional services, but also in manufacturing. Inflation was negative in 2015 due to large excess capacity and ongoing price adjustments from product and labor market reforms

### **A Theoretical Approach on Macroeconomic Aspects**

The new financing program agreed with the European Stability Mechanism in 2015 has removed short-term fiscal financing uncertainties and led to a new slower pace of fiscal consolidation, which will be good for growth. Together with diminished political uncertainty after the September 2015 elections and the gradual softening of capital controls, confidence has improved and bond spreads have been reduced. Output contracted in 2015 due to weak domestic demand, but is set to rebound in the second half of 2016 as confidence recovers and investment, consumption and exports gain some momentum. Despite the improved performance in the last quarter of 2015, mainly due to a rebound in investment, the deep dip in the third quarter of 2015 (-4.7% seasonally adjusted annualized growth rate) will still affect annual growth in 2016 because of the carryover

effect. The recovery is projected to gain further strength in 2017, as structural reforms (Causa and Johansson, 2009).

Reforms are needed to create a more dynamic economy. Product market reforms that reduce monopoly and oligopoly power in key economic sectors and efforts to reduce the regulatory burden should gradually raise output. These reforms will help to boost exports, which will be an indispensable engine for growth and job creation. Still, despite relatively swift approval of key reforms in recent months, the overall track record in implementing legislated reforms since 2010 has been weak, due to capacity constraints and opposition by vested interests and stronger external demand benefit investment and job creation. Export growth will help the current account, even as domestic demand and imports recover.

Inflation will only gradually move into positive territory as large economic slack will continue for some time, while VAT changes will contribute to raising headline inflation temporarily in 2016. This outlook is subject to both upside and downside risks. On the upside, swift and full implementation of structural reforms, which remains a challenge, and faster improvement in the liquidity and financing conditions of the banking system would boost confidence and lead to a stronger and faster economic recovery. Successful negotiations to lower the gross financing needs of the public sector could significantly improve the medium-term outlook of the economy by addressing debt sustainability risks. On the downside, larger negative effects of the credit crunch on domestic demand and lower than expected impact of reforms on exports and growth would negatively impact economic activity. Rising global risks such as weaker global trade and slowing growth in China would reduce exports as Greece is a leading global shipping provider, and the sector accounts for 20% of total exports.

## II. Empirical Findings

Weaker economic growth in the rest of the euro area, the destination of 30% of Greek exports, would increase deflationary pressures and undermine debt dynamics. Rising risk aversion in global financial markets may lead to a deterioration in financing conditions for the sovereign, banks and companies.

A number of other shocks would have large effects on the economy, but cannot be sensibly incorporated into the macroeconomic projections, because they are difficult to quantify or imply a large discrete change in outcomes. The refugee crisis could also pose significant problems for Greece. Official estimates suggest a preliminary cost of around 0.35% of GDP in 2015. If the foreseen contribution of the European Union turns out to be insufficient, it would result in added pressure on the Greek budget. The realization of the other exogenous risks would also have fiscal implications. In light of the fragile state of the economic recovery, it would be important to avoid further fiscal tightening if possible and thus reverse the benefits which came with the agreed slowing pace of fiscal consolidation.

**Table 1: Macroeconomic projections.**

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	Current prices € Billion		Percentage change, volume (2010 prices)			
	2012	2013	2014	2015	2016	2017
GDP at market prices	191.4	-3.1	0.7	-0.3	-0.1	1.9
Private consumption	133.7	-2.6	0.7	0.2	-0.1	1.3
Government consumption	41.7	-5.5	-2.4	-0.1	-2.1	-0.8
Gross fixed capital formation	24.1	-9.3	-2.6	0.9	8.6	5.7
Final domestic demand	199.5	-4.0	-0.3	0.3	0.5	1.4
Stockbuilding <sup>1,2</sup>	0.5	-0.2	1.4	-1.7	-0.6	0.0
Total domestic demand	200.0	-3.7	1.1	-1.2	-0.3	1.4
Exports of goods and services	55.0	1.7	7.4	-3.8	-1.7	5.5
Imports of goods and services	63.7	-2.9	7.8	-6.9	-1.9	3.6
Net Exports <sup>1</sup>	-8.7	1.5	-0.3	1.2	0.1	0.5
<i>Memorandum items</i>						
GDP deflator	-	-2.9	-2.3	-0.6	-0.3	0.6
Harmonised index of consumer prices	-	-0.9	-1.4	-1.1	0.5	0.5
Private consumption deflator	-	-2.0	-2.8	-1.3	-0.1	0.8
Unemployment rate	-	27.5	26.5	25.0	24.7	23.8
General government financial balance <sup>3,4</sup>	-	-12.5	-3.6	-6.0	-0.8	0.9
General government gross debt <sup>5</sup>	-	184.2	182.9	190.2	191.6	187.1
General government debt, Maastricht definition <sup>3</sup>	-	177.3	179.0	183.9	123.3	178.6
Current account balance <sup>6</sup>	-	-2.1	-2.1	1.0	1.8	2.2
Potential output growth	-	-1.1	-1.0	-0.5	0.1	0.5

1. Contributions to changes in real GDP, actual amount in the first column.

2. Including statistical discrepancy.

3. National Accounts basis, as a percentage of GDP.

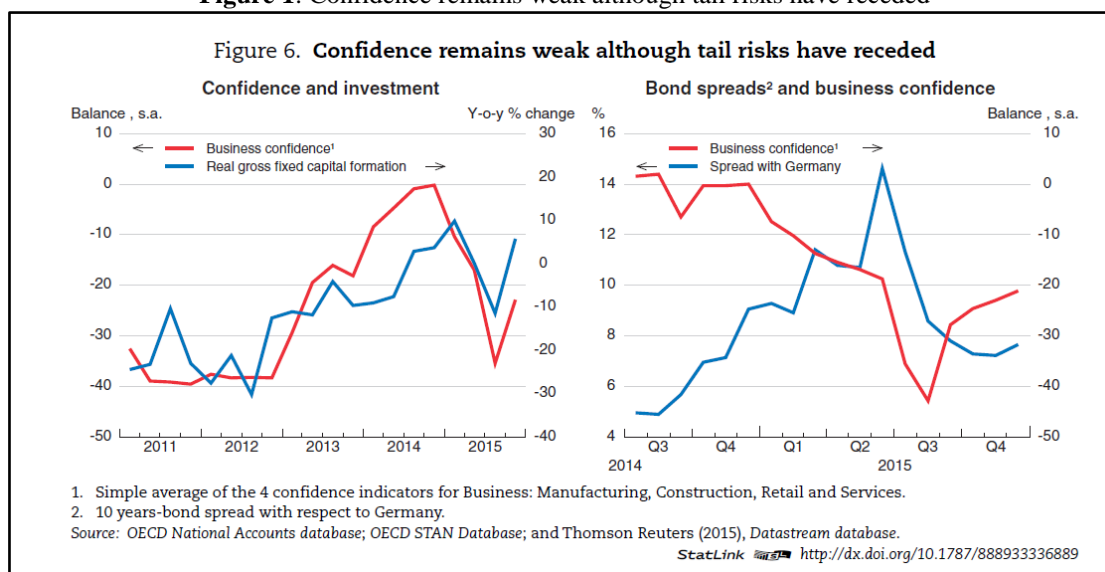
4. The data for the years 2012 and 2013 include the total impact of government support to financial institutions. Data also include Eurosystem bank profits on Greek government bonds remitted back to Greece. For 2015-17, data include the estimated government support to financial institutions and privatisation proceeds.

5. As a percentage of GDP at market value.

6. On settlement basis, as a percentage of GDP.

Source: Updated OECD Economic Outlook 98 database.

Figure 1: Confidence remains weak although tail risks have receded

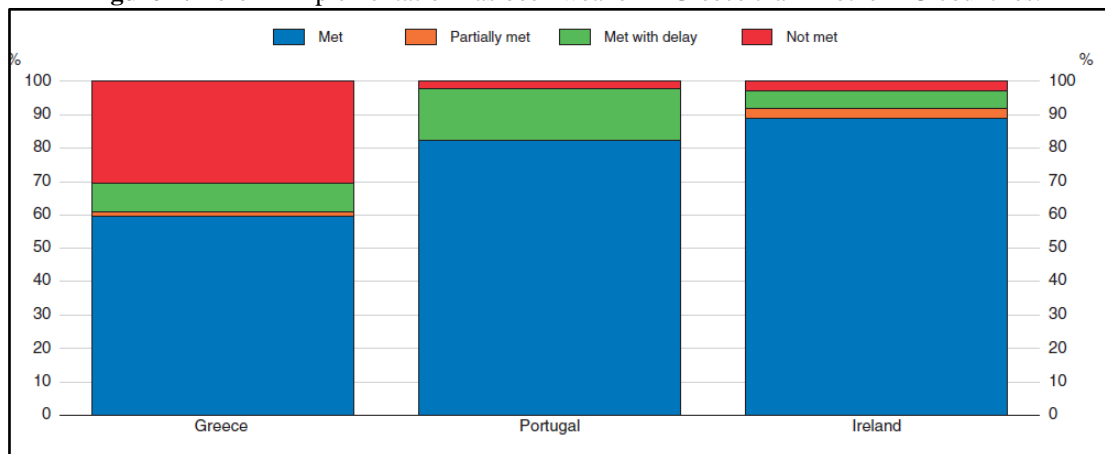


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**Reforms so far have not boosted growth as expected**

Reforms have delivered less growth than expected, or when compared to other European countries that underwent significant adjustment and reforms in recent years. Many structural reforms are less effective or might even have a short-term recessionary impact when implemented in an extremely weak aggregate demand context (Caldera Sánchez *et.al.*, 2015). The adjustment programs initially focused excessively on fiscal adjustment, while the reform agenda to boost growth was introduced rather late in the process. Furthermore, much of the adjustment was borne by labor, while product market reforms advanced only slowly, leaving monopoly power and other impediments in place in many sectors. (Eichengreen, Panizza, 2014) This sequencing resulted in large demand costs up front, making structural reform more difficult and less effective. Weak implementation has also undermined the effectiveness of reforms (IMF, 2014).

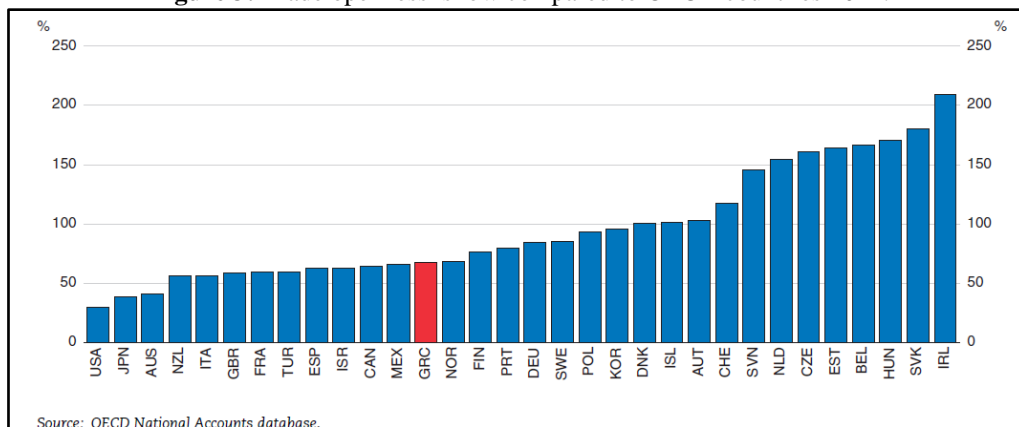
Figure 2: Reform Implementation has been weaker in Greece than in other EU countries.



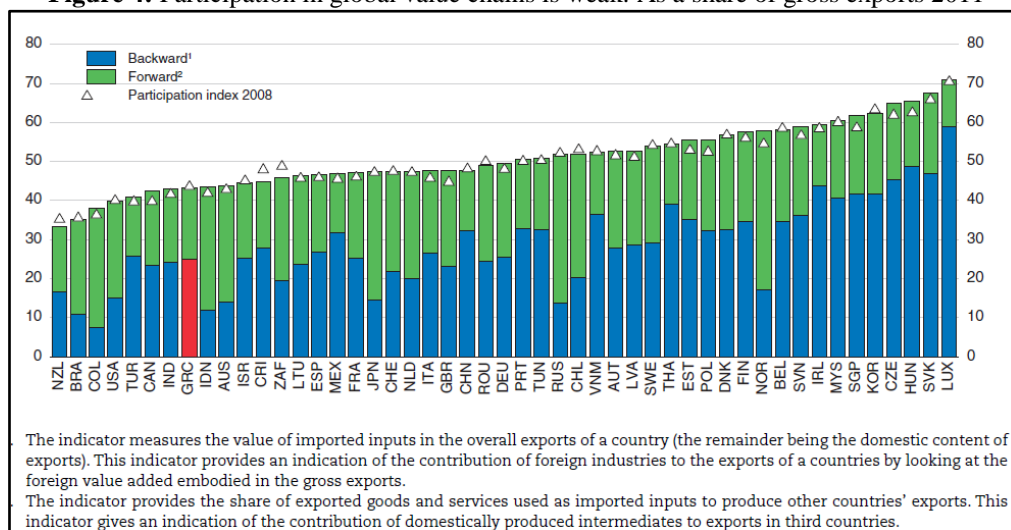
**Strong exports and investment are the keys to sustained recovery**

Greece has relatively low exports and imports, given its rather small size (Figure 3), has had a persistent trade deficit until recently, and is not well integrated into global value chains (Figure 4). As domestic demand is likely to remain weak for some time to come, boosting exports will be important for generating growth and jobs. Despite recent improvements, and in contrast to Portugal and Spain, export performance deteriorated significantly in the last decade particularly in the service sector. Shipping, which accounts for 20% of Greek exports, suffered from slow world trade growth (Figure 5). The decline in unit labor costs in Greece since the beginning of the crisis has restored cost competitiveness, but the response of exports has been sluggish in part because prices did not adjust as fast, severe liquidity constraints of exporters and lack of investment in export industries. Non-cost competitiveness is also weak as Greek goods exports are concentrated in low-tech products.

**Figure 3: Trade openness is low compared to OECD countries 2014.**



**Figure 4: Participation in global value chains is weak. As a share of gross exports 2011**



Source: OECD National Accounts Database

More investment would support exports and growth. For example, investments in infrastructure and logistics would make exports more competitive, while they could have positive demand spillovers. However, financing investment is a difficult task in a context of little fiscal space, weak credit, a higher corporate income tax and remaining structural rigidities. Therefore, in addition to implementing structural reforms that boost growth and undertaking reforms that take advantage of the better external demand conditions, measures to accelerate private investment, particularly foreign direct investment, which is very low in Greece are needed. In this sense, concessions and privatizations can be a useful tool. For example, making better use of the vast stock of idle public land through concessions or privatizations would crowd in private investment in logistics and infrastructure as well as tourism real estate. The multiplier effect of these types of investments is estimated to be large (IOBE, 2012), and it could help the tourism sector and facilitate export activity more generally. Liberalizing further the network industries would also increase the quantity and quality of infrastructure

investment. Moreover, EU structural funds should be better exploited to boost investment in education, research and innovation, and information and communication technology to enhance skills and human capital.

Tight financial constraints facing firms have a direct impact on economic performance and exports, in part by restricting the reallocation of capital and labor from non-tradables to tradables. Especially SMEs have faced high cost and difficult access to credit as risk premiums rose and banks weakened. It is therefore not surprising that, according to the ECB, access to finance is regarded as the most important problem of Greek SMEs.

Greek commercial banks offer a number of trade finance products, such as letters of credit, suppliers' guarantees, discount financing, and documentary credits. Export-oriented SMEs also benefit from a number of official programs both at local and international level but the take up of some of the existing schemes is low. In addition, lending facilities, guarantee programs and other public support programs are offered by the Greek government to local SMEs in cooperation with the European Investment Bank Group and the European Commission (Nassr, Robano, and Wehinger, 2016).

A development bank will be created to help SME funding. It will improve access to credit for SMEs by systematically organizing all the funding opportunities from available both national and international sources, as recently done in France. The Institution for Growth (IfG) which was created in December 2013 is already part of the financing tools available. The IfG SME Debt-Sub-Fund was established in May 2014 with EUR 200 million coming from the Hellenic Republic and the German KfW to provide liquidity for SMEs (EC, 2014). The recent experience of Portugal and Ireland, who have also created national development banks, could also be a helpful reference to create a good institutional framework. A successful operation of the development bank requires a clear assessment of potential synergies and overlaps with other institutions, adopting a strong corporate governance framework and avoiding competition with the activities of commercial banks.

The share of SME financing provided through equity markets in Greece is currently very small, particularly when it comes to risk financing. Venture capital investment has been historically underdeveloped in Greece, but the near inexistence of such funding is particularly relevant and crucial at the current juncture. Total venture capital investment for 2014 reached USD 0.26 million, by far the lowest in OECD countries. The creation of a venture capital ecosystem with important direct links to university research and innovation could be a way to boost entrepreneurship and promote the creation of high value added products and innovative SMEs. High-quality securitization of SME loans (and other liabilities such as leasing) can be seen as a market-based shortcut to indirectly foster SME financing, 'unclogging' the bank lending channel by transferring SME credit risk partially from originators to investors and achieving capital relief. Despite an increase in total securitization issuance in the past years, only a small minority of transactions was actually placed with investors, with the majority of deals being retained for repo funding with the ECB throughout the period when such collateral was eligible for central bank repo refinancing (Nassr, Robano and Wehinger, 2016).

### **III. Concluding Remarks**

#### ***More product market reforms would boost growth substantially***

OECD estimates show that over the next decade, the reforms introduced since 2010 combined with some of the reforms planned within the 2015 MoU would boost output significantly, thereby largely offsetting the loss in potential output due to the crisis.

Many of these reforms would also help the competitiveness of exports either directly by lowering costs of doing business or by lowering costs of key inputs to goods and services such as energy or transport. Recent product market reforms have paid little attention to reducing the many barriers to exports in Greece. Evidence shows that within EU countries, where barriers to trade have been reduced drastically within the Single Market, stringent regulation in product markets has a negative impact on exports (Fournier, 2015). In Greece, the lack of adjustment in product markets impedes export activity by increasing production costs (Arkolakis *et al.*, 2015).

#### ***Better implementation and more ownership are key to reaping these growth benefits***

Product market reforms have reduced barriers to entrepreneurship by creating one-stop shops to open a business, reducing the burden on filing taxes, opening up closed professions, and removing regulations that hindered market entry and competition in several sectors. Some horizontal issues such as truck licensing and advertising fees, were also analyzed (OECD, 2014c).

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