Greece’s Institutional Gap

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Breaking the Bottlenecks

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In a nutshell…

The best way to make your **dreams** come true is to **wake up**.

Muhammad Ali

“A sigh is just a sigh. The fundamental things apply, as time goes by.”

Dooley Wilson [*Casablanca*]
On the Fundamental Issues of Development

Institutions. “the humanly devised constraints that structure human interaction”

[Douglass North]

— **Formal.** Law; protection of investors; courts; regulation; corporate governance; property rights; red tape; absence of corruption; bureaucratic quality; checks and balances; regulation.

— **Informal.** Trust; civicness; social capital; beliefs; social norms (family ties)

Institutional Features. The Rules of the Game

— Bureaucratic (administrative) capacity and quality
— Property rights protection
— Checks and balances
— Courts (time, quality, formalism)
— Legal protection of investors (creditors, shareholders) from expropriation
— Corporate governance mechanisms (regulation, auditing)
— Red tape (administrative barriers to entry and firm expansion)
Structure

— The Debate – Discussion
— The Facts – Reality
— The Response & the Failure
— Current Situation
— The Way Ahead
The Greek Crisis. The Policy Discussion

— Debt Issues
  • debt overhang,
  • debt restructuring, debt sustainability

— Banking system
  • NPLs,
  • deposit withdrawals, capital controls,
  • Regulation

— Fiscal policy
  • budget deficit; primary, total
  • role of fiscal consolidation (Keynesian ideas)
Readings of the Crisis

1. Disciplinary/punitive; Fiscal Profligacy
   - fiscal deficits during booming years (esp. 2004, 2007-2009)
   - consumption;
   - private and government debt

2. Fiscal policies during the crisis
   - Debate on the size of the “aggregate fiscal multiplier”

3. Competitiveness Loss
   - trade deficits
   - economic structure (internal/external demand)
The Discussion on the Street. *The Blame Game*

— The “troika” (now “quartet”, “institutions”)
  • European Union (specific countries), ECB, IMF
— Political parties (“old”, “new”)
— Economic (business, political, academic) elites
— Media
— The unions
— The banks (and bankers)
  • Greek; Europeans; Americans
Non-Economic Features of the Blame Game

— **Populism** (“easy-fixes”, “other’s mistakes”)
— **Lies and misinformation** (captured and bankrupt media; mistakes of Greek administrations; propaganda)
— **Noise**
— **Divide-and-rule strategies**
The Reality

— Deep structural deficiencies of Greek economy
  • contractual institutions and property rights institutions
  • weak state capacity (fiscal, legal, security)

— Fiscal Position (fiscal deficit and debt)
— External Position – Competitiveness (current account deficit)

➤ poorly-performing and captured institutions (insiders, oligarchs);
➤ supply and demand for populist and ineffective policies;
➤ distorted beliefs, distrust, lack of civicness.
Abstracting. The Greek Problem from the Ivory Tower

— External developments
  • “Short-run” issues
    • Global meltdown in 2008-2009 (reassessment of risk)
    • European Union (and ECB’s) response to the crisis in the periphery (banking, debt restructuring, monetary policy, etc.)
  • “medium-long-run issues”
    • European Union institutional design; policy making in Europe

— Internal developments
  • “short-run”; business-cycle frequency \(\rightarrow\) employment, private and government investment and consumption
  • “medium-long” run; structural/fundamental issues (institutions, cultural traits) \(\rightarrow\) total-factor-productivity
A Primer on Total-Factor-Productivity

— Exports in globally competitive sectors
— Imports in intermediate goods for higher value-added (rather than on consumption)
— Schumpeterian creative destruction (entry, exit, innovation)
— Technology adoption
— Knowledge-generation, innovation
— Entrepreneurship

50%-65% of total variance on output per capita across the world
Institutions and Well-Being. Relevance

— Efficiency
  • Investment (foreign and local)
  • Innovation
  • Entrepreneurship
  • Etc

— Equality
  • Income distribution
  • Equality of opportunity
  • Upward mobility
  • etc
An Example. Legal Institutions and Economic Efficiency

Mechanisms

Justice - Law
- De facto
- De jure

Investment
Entrepreneurship
FDI
Trade (exports)
Reshuffling
Corruption

Development
Inequality
The Institutional Gap at the Onset of the Crisis

Investor Protection and Economic Development

Unconditional Relationship in 2008

Strength of Investor's Protection (Index range 0-10)

Investors Protection across Euro area Countries in 2008

Composite Investor’s Protection Index (range 0-10)

Source: World Bank Doing Business Project

Karatza and Papaioannou (2016)
Institutional Gap in 2008. Another Example
Legal Formalism in Courts

The Institutional Gap

Karatza and Papaioannou (2016)
Institutions in the South since Euro’s Inception

Evolution of Control for Corruption in the European South

Source: World Bank Governance Matters Indicators
Institutional and Total Factor Productivity Divergence

Source: Micossi (2016)
Competitiveness Divergence across the Euro Area

Real effective exchange rate (1995=100)

Source: Micossi (2016)
Institutional Divergence and European Imbalances

Current account balance (% of GDP)

- Max-Min Eurozone
- CORE excluding Germany
- PIIGS
- Germany

Source: Micossi (2016)
Institutional Gaps and Divergence across the Euro Area

— Considerable gaps in various proxy measures of institutional efficiency
  • Greece scores the lowest across EU 27 in a plethora of measures
  • Gap between the “core” and the “periphery” and “eastern Europe”

— Non-negligible institutional divergence (especially after euro’s inception)
  • Public administration (quality of bureaucracy)
  • Regulatory quality (product markets, banks, labour markets)
  • Red tape and control for corruption
  • Legal capacity, court efficiency, and legal quality

— Also gaps divergence of beliefs, trust, social capital, civicness [Papaioannou, 2011; Algan, Guriev, Papaioannou, and Pasari, 2016]
Economic Adjustment Programmes (MoUs)

— **Priority on fiscal issues (and social security); system**
  
  • Taxes (all sorts)
  
  • Increases in social security contributions
  
  • Cuts in government expenditure (consumption and investment)
  
  • Debt restructuring (with delay…)

— **Banking System & Financial Stability**

— **Institutional Reform**
  
  • Limited in scope at the early stage
  
  • Some subsequent reform.
    
    • Questionable prioritization (labour markets rather than product markets)
    
    • Some driven by the Greek administrations rather than the “troika”
Institutional Reforms

— **Labour markets** (not much of an impact)
— **Product markets, incl. entry, “closed professions”, cartels** (late)
— **Capital markets** (consolidation via M&A, regulation)
— **Justice system** (incremental though multi-facet)
— **Public administration** (various small steps)

— Some improvement in some quantitative measures of competitiveness (World Bank Doing Business Project; OECD rankings), though the initial base was abysmally low
Underlying Reasons for Failures

1. Short policy horizon, lack of expertise, and lack of vision;
2. Lack of “ownership”;
3. Powerful “insiders”;
4. Distorted beliefs and massive distrust;
5. Reforms coincided with austerity, so people’s reformist desire weakened
6. Absurd, catholic opposition, even on “basic” stuff (e.g., independence of tax collection agency, removing formalism in courts)
7. Impact of crisis (e.g., courts, public administration)

8. Differences across “troika” members (and EU countries)
9. Lack of support from “troika” (myopic focus on “nominal” convergence);
Current Situation

— Institutional reform almost absent from 3rd MoU
  • Taxes, taxes, taxes
  • Cuts, cuts, cuts
  • Automatic destabilizer (taxes and expenditure cuts)

— Policy initiatives in the opposite direction!!
  • Rule of law; checks and balances
  • Education system

— EU still in an “extend-and-pretend” attitude
  • Debt reprofiling
  • Punitive attitude
Institutional Gap in 2014. Back to the Example

**Court Inefficiencies (Delays) in 2014**

Number of Days to Resolve in Courts a Simple Dispute


Karatza and Papaioannou (2016)
Institutional Gap in 2014. Back to the Example

Bankruptcy-Insolvency Practices across the Eurozone


Karatza and Papaioannou (2016)
Institutional Deficiencies in 2016. A European Problem

Institutional Gap across the Eurozone

Control of Corruption  Government Effectiveness  Rule of Law

World Bank. Governance Matters Database
Institutional Divergence, cont.

The Institutional Gap

Source: Papaioannou (2016)
Moving Forward

Step 1. Change Policy Debate
   — National Level
   — EU level

Step 2. Design

Step 3. A New EU Architecture
   — Institutions (and institutional targets)
   — Beliefs and trust
Dual Approach

— Institutions EU-EZ level.
— Institutions National Level
EU-EZ Institutions. Towards an Institutional Union

— Treaty?
— Role of ECB.
  • Legal issues, authority, hierarchy. CB part of the troika/quartet
— Single Supervisory Mechanism
— ESM (small, peculiar governance)
— EU Commission

— Issue of distrust
— Exogenous risks
National Institutional Reform and Convergence

— Endogeneity of reforms (e.g., beliefs, distrust, culture, complicated process); crisis offers a window of opportunity
— EU help is needed. Targeted aid is needed, specific projects (e.g., ICT infrastructure, public procurement, bypass captured institutions)
— Share best practices
— Measuring - monitoring
Summary

— Huge short-term risks
— Medium-long term issues. [not well-defined objectives, erroneous policies; legacy of policy mistakes that due to institutional persistence may be hard to reverse]
— Global environment (emerging market turmoil)