

## *Introduction*

This book attempts to identify strategic mistakes in the adjustment program of Greece and in that way to identify the improvements needed to achieve the ultimate and desirable goals of both improving the living standards of the Greek population and ensuring the solvency of the Greek sovereign. To do so we draw both on historical precedent and on an analysis of the more recent developments. Then we attempt to provide some additional insight into growth-enhancing policies that have yet to be explored in efforts to identify growth potential for the country. The first chapter explores the process that led to the accession of Greece to the euro area, a decision that many, both inside and outside of Greece, now question. Nonetheless, it is useful to recall what Greek politicians thought as they put the country on the path to accession, despite the numerous weaknesses and challenges already obvious at the time. Similarly, it is helpful to review the weaknesses that accumulated after accession and led to the current crisis, as well as document how the IMF and entities within the European Union tracked and responded to these developments. The insights resulting from this process can deepen our understanding of the current situation and suggest policy choices that have the potential to turn the economy around. One major insight in particular emerges: the problems now facing Greece and Europe appear to arise less from the conditions of the Greek economy at the time of its accession to the euro area and more from an inability to deal with the problems that existed beforehand and new challenges that emerged after the accession, in the context of the monetary union.

Chapter 2 analyzes the various sectors of the economy, in particular the specific characteristics of labor costs within each sector. The official

lenders to the Greek government emphasized, sternly and consistently, the need for a significant “internal devaluation,” meaning a reduction of incomes and asset prices in general, rather than an increase in the nonlabor cost-competitiveness of the country. This was a controversial strategy from the outset, and it continues to be so. Today, the old Greek paradox of “rapid growth in spite of the low national competitiveness” has been replaced with the new Greek paradox of “faltering exports despite falling wages.” The strategy of driving down wages to increase competitiveness was focused aggressively on “internally devaluing” the private sector; however, the pressure to apply this constraint to the public sector was much weaker, especially during the critical 2010–12 period. Even worse, an effort to substantially reform the public sector, in particular, during the same period was not a priority. Understanding why this strategy failed to secure the desired outcomes is still important since it can help correct a fundamental flaw in the design of the Greek adjustment program while there is still time to do so. An understanding of both the developments in the Greek financial sector and the qualitative aspects of the internal devaluation is critical for an understanding of how the costs and risks caused by the inability of the Greek government to implement a useful reform agenda were pushed onto the Greek private sector. This approach, which sought to reduce private sector wages, employment, and profits while gradually allowing the emergence of a full-blown liquidity crisis—in a country with a very hostile business environment, extremely high administrative burden, and much increased energy prices—had, in the end, rather limited beneficial effects.

In the third chapter, we focus on how the support of research-based innovation can restore competitiveness to the Greek economy, without relying on the suppression of labor costs. The aim here is not to provide a comprehensive growth strategy for Greece.<sup>1</sup> Rather, we select a topic that has not been studied by such efforts so far and concentrate on research and development activities by businesses. We are motivated by research from Hausmann and others (2011), McKinsey (2012b), and the World Economic Forum (2013), among others, that argues that an efficient and diverse manufacturing base connected with research centers is essential for the development of a modern, competitive economy. It needs to be stressed that support for research-driven manufacturing does not need to come at the expense of support for sectors that are usually identified as growth drivers for Greece, such as tourism and shipping—even when the economy is competing for scarce resources and capacity. On the contrary,

there are numerous opportunities to enhance both, for example, by reviving manufacturing activities related to the shipbuilding industry or creating opportunities for medical tourism.

In particular, we investigate why Greek companies spend so little on research and development (R&D)—an issue that has received little attention from researchers who are suggesting ways for the Greek economy to grow. We examine the role of R&D for two principal reasons. First, existing studies and literature strongly indicate that research-based innovations play an increasingly crucial role in the ability of an economy to maintain a competitive manufacturing base, which in turn appears to be a prerequisite for maintaining a competitive economy that can support a high standard of living. Second, Greek policymakers often point to the low R&D expenditure of Greek companies while calling for them to increase it. However, if the R&D expenditure of Greek companies is constrained by the policy environment in which they operate rather than by corporate strategies and choices, then policymakers must remove these bottlenecks if they want to improve the competitive performance of the country in this aspect; this holds especially since there is compelling evidence that these bottlenecks hamper a mutually beneficial collaboration between the noteworthy state-financed research capacity available in the country and the business community.

A review of the extensive literature reveals numerous conditions that must be met to create an environment conducive to innovation—in particular to research-based innovation. This review is complemented with our observations on the current reality in Greece, based on the collection and evaluation of hard data, examination of related laws, and numerous interviews with innovative entrepreneurs and researchers over the past five years. The analysis of available data further corroborates the assertion that policy variables crucially affect R&D performance in the private sector. We conclude with a number of specific policy proposals for those key areas where policy initiatives could help reverse the current unfavorable situation and restore the competitive edge of the Greek economy by fully exploiting the potential of existing assets.