Panayotis Thomopoulos: The Greek economy and its outlook

Speech by Mr Panayotis Thomopoulos, Deputy Governor of the Bank of Greece, at the Covered Bonds Conference, organised by Barclays International, Athens, 1 September 2006.

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Ladies and Gentlemen,

I am delighted to address this meeting devoted to an issue of growing importance to the financial community. Experts will speak on the subject of this conference as for me I shall try to introduce the subject of Greece.

It is two years since the successful conclusion of the Athens Olympics and I am glad to observe that the Greek economic performance since then has vindicated those of us who have remained optimists all through the last decade. While two years ago many feared that the Greek economy would slide into a protracted period of slow growth or even recession when the spending for the Olympics ended, and cited Spain as a precedent, we now see that the Greek economy remains one of the strongest in the EU. This performance, achieved in the context of a very significant domestic fiscal adjustment and the Eurozone' s slow growth until recently, indicates that Greece has a dynamism that reflects important changes on the supply side. In the rest of my speech I will highlight the main strengths of the Greek economy, the risks facing us and the necessary policy measures needed to avoid those risks and maximize the benefits from our strengths.

As I alluded to before, many feared that the demand-led expansion in the run-up to the Olympics would be followed by a significant slowdown and some even predicted that Greece risked falling back into a vicious circle of stagflation. Indeed, between 1980 and 1994, economic performance was abysmal: GDP grew only at 0.7% annually and inflation averaged 16% combined with a rising fiscal deficit, culminating at 13% of GDP in 1993.

Considering the significant initial disequilibria it is not surprising that in the 1990s few believed that Greece would satisfy the strict criteria for Euro area membership, and even after joining the Euro area in 2001 many doubted that it would be able to sustain for long the high rate of GDP growth of 4% p.a. experienced in the 9 years to 2004, compared with only 1.9% for the Euro area as a whole. Indeed, the fears increased as the deterioration of the fiscal situation, associated with the Olympic Games' overruns partly due to sizeable additional expenditure for security as well as the budgetary relaxation called for a substantial fiscal adjustment, with inevitable dampening effects on growth. Similarly, it was pointed out that the turn-around from a rising trend in net EU transfers in relation to GDP to a falling trend would also impact negatively on growth. Indeed, net transfers fell, from 4.7% of GDP in 1995-1997, to 2.1% of GDP in 2005, but growth continued unabated. In addition, since 2004 Greece, which is heavily dependent on oil imports, suffered from the rapid rise in energy prices as well as from the appreciation of the Euro, which affected especially Greece's main manufactured export products – textiles, garments, shoes – which after the lifting of the quotas had to confront strong competition from the emerging markets in Asia and the countries in transition in South-East Europe.

The fact that Greece avoided the problems faced by other countries, such as Portugal, after a period of excessive demand growth is a sign of underlying improvements on the supply side. However, equally important is the restoration of the historical links between Greece and the countries in South-East Europe, around the Black Sea as well as with Egypt. For more than 2000 years large Greek communities, in some cases numbering hundreds of thousands, had settled and prospered in these countries. The communist regimes, revolutions and nationalism caused the amicable relations with our wider neighbours to be suspended, and many of these communities disappeared towards the end of the 1940s and in the 1950s: for example, in the 1950s more than 250000 Greeks had to leave Egypt. After 1990, the historical forces of gravity have been re-established; nationalism, as is the case in all EU countries, is now taught only in history books. As a result, friendly relations with our neighbouring countries have been restored. Greece has been a key supporter of Bulgaria's and Romania's EU membership, and eventually Turkey's, as well as of the other South-Eastern European countries. A little story of the weight of history is the immigration to Greece in the last ten years of thousands of Greeks, whose ancestors had settled in Russia between the 1st and 3rd century B.C. and who, in spite of the fact that they were cut off from Greece for almost 800 years, spoke some Greek and preserved many Greek traditions.

Until almost the end of the 1990s, Greece had a big handicap: it was located at the periphery of Europe without direct land connections to the main EU members and was surrounded by countries whose economic development had stalled for about 50 years. Nowadays, its geographical location has become an advantage, almost all of its neighbours are growing fast, much faster than the EU as a whole, and very soon two of them will become EU members.

Greece is offering these countries entrepreneurship, expertise and capital as well as a market for their products and surplus labour. Indeed, the Greek private sector has responded quickly and positively to the opening of the region. Greek firms and individuals who spoke the language and knew the culture are establishing themselves in large numbers. Some 5000 Greek firms have set up businesses in these countries in diverse activities, ranging from small bakeries, restaurants, hotel chains, to supermarkets, food processing plants, mines, cement factories, metallurgical and aluminium factories, I.T. companies, including telecommunications, trading, shipping and other service companies. Likewise, attracted by the low labour costs and tax rates, many Greek firms relocated their plants, mainly textile, garment, shoe making plants as well as other light industries, from Northern Greece to Bulgaria, FYROM, Albania, i.e. they moved some 30 to 80 kilometres over the other side of the border. This opening and the establishment of a network of Greek firms in all our neighbouring countries, which are moreover growing rapidly, has given a new impetus to the Greek economy - the size of the market is no longer the 11 million Greeks but about 60 to 80 million consumers and many more if we include parts of Turkey which are close to Greece.

The economic interdependence between Greece and its neighbours is now reflected in the sizeable Greek direct investment to South-Eastern European countries. Greeks are among the first two or three foreign investors in these countries. The enlarged market gave the opportunity to Greek firms to increase their size and to establish different processing plants in different countries, according to their cost advantage, with the result that their international competitiveness has been greatly enhanced. This development has been particularly noticeable in the banking sector, as I shall refer below.

Contrary to the direction that capital was taking, labour migrated to Greece: the number of immigrants who have settled in the last 13 years is estimated at about 1 million (mainly from the wider neighbourhood) raising the population to 11 million and causing the labour force to increase by up to 20%. For developed countries, this probably represents the largest foreign worker inflow in such a short space of time. In total, the whole region of South-East Europe is becoming a unified economic space as it used to be for centuries, first in antiquity, then under the Byzantine and, later, the Ottoman Empire.

It is true that Greece is located in, and oriented towards a region of relatively high growth, including the rapidly growing Middle-Eastern countries, whose governments and their nationals have a long tradition of friendship with Greece. The outlook for all these countries remains favourable and indeed, since the start of this decade import demand from our trading partners has systematically exceeded the growth of world trade. While this is significant, it is more significant to note that in 2005 Greece increased its market share in its export markets for the first time after more than a decade of retrenchment, associated with the decline of textile production, and we are on track to repeat this good export performance this year, as exports of goods increased by 13½ percent in the first half of this year, excluding idiosyncratic items such as refined petroleum and ships. A number of indicators suggest that this development is not a statistical artefact but may indicate a more permanent improvement in economic performance. The good export performance is not restricted to a few countries of destination or sectors, but is quite widespread. The opening of the economic space of South-East Europe coincided with a sustained effort to improve domestic economic performance and this has been underpinned by three factors.

- First fixed investment has grown robustly: 7.3% annually since 1995, and 10% for private non-residential investment; this compares with 3.3% for the Euro area as a whole. Moreover, the investment boom affected all sectors: in the second half of the 1990s industry benefited mostly, with fixed investment rising at over 15% annually, whereas in the first half of this decade investment in the service sector, including tourism as well as the construction sector, recorded very high rates of growth.
- Second, extensive privatisations and liberalisations unleashed entrepreneurial spirits and led to the creation of competent new managerial class, which is progressively taking up the reins of the business sector, which, until recently, was almost exclusively run by family members of the owners. This development owes much to the growing interest of foreign companies to buy or take a strategic position in Greek companies following Greece's decision to join the

Euro area. Foreign firms recruit Greek senior staff to run their businesses. Out of the 200 biggest Greek companies a very large proportion is fully or partly owned by foreign companies who prefer to buy existing Greek firms, so as to avoid the heavy and lengthy bureaucratic procedures in setting new companies in Greece. The new managerial class has promoted the restructuring of firms and focused on efficiency, with the result that labour productivity grew by 3% annually in the ten years to 2005 compared with 0.8% for the Euro area and 2.2% for the US, the country which mostly benefited from the I.T. boom.

- Third, although the Government sector is still a drag on the economy, the progress towards fiscal consolidation and the tentative efforts to reduce state intervention and to simplify bureaucracy have started bearing some fruits.

The fact that industrial production has started growing again after a protracted period of retrenchment is another signal in the same direction and indicative of a newfound dynamism. Greece has traditionally been a service economy, with a relatively small manufacturing sector. Although Greek manufacturing firms, with the exception of the declining sectors such as textiles, show healthy profitability – with profit rates above most other European counterparts– and we see new firms being set up in dynamic sectors, the contribution of manufacturing to GDP will continue to be much smaller than in the rest of the EU. The service sector is the engine of growth in Greece and here we see an encouraging performance not only with respect to our main export product, that is tourism, but also with many other export-oriented services in higher value-added sectors which are showing buoyancy. Again, over the last two years the number of tourists arriving in Greece has grown faster than world tourism, indicating that the positive image generated by the Olympics is now producing tangible results. Shipping, a sector of traditionally strong Greek presence has been doing well recently and contributing significantly to Greece's export earnings (about $15 billion). In effect, over 15% of world shipping and more than 20% of world tankers are owned and run by Greeks all over the world. More importantly, Greek ship-owners are using the current propitious circumstances to renew their fleet, thus ensuring a significant future presence in a sector, where Greeks have thrived for over 3000 years.

The success of the Olympic Games is one reason behind the favourable turn of events. It has helped not only tourism, where benefits were expected all along, but even more merchandise exports, as well as other service sectors as it has reinforced the image of Greece as a stable and reliable partner. That was a positive side-effect that was not much foreseen, as the focus was on promoting tourism. Nowadays, many foreign firms use Greece as a gateway to South-Eastern European countries or in partnership with Greek firms penetrate these markets. Thessaloniki, the second biggest Greek port is expected to play a pivotal role in the economic integration of the Southern-Eastern European countries. The border of Bulgaria, and of landlocked Fyrom are about 80 kms from Thessaloniki and for their respective capitals, Sofia and Skopje, Thessaloniki is the natural outlet to the Mediterranean Sea. Likewise, the southern provinces of Serbia and parts of Romania can equally be served efficiently by the port of Thessaloniki, which, in addition has an interesting cultural life and a pleasant life style. The advantageous location of Thessaloniki will become even more evident after the completion of the planned and partly financed by the EU of the North-South EU road and railway axes.

The renewed optimism about the Greek economy is now reflected in many areas. I wish to refer to the example of construction and housing. There was a widespread belief that construction would be the main victim of a slowdown in the post-Olympics period. There was talk of a housing bubble and of a supply glut. Indeed there was a construction slowdown in the immediate aftermath of the Olympics and a levelling off of housing prices, but since last year we are seeing a renewed dynamism in this sector, unexpected in its degree. In addition to Greeks, many more foreigners than in the past are building secondary residences in the Greek islands and in the mainland.

Total credit growth at around 20% annually and 30% for credit to households since 2001 has been one factor underpinning strong private demand in recent years and has been fuelled by the low Euro area interest rates. I fully accept that we should monitor developments in this area but we are far from becoming alarmed. Greece is a country with a still relatively low household debt-to-GDP ratio – 38% compared with 56% for the Euro area. The rapid credit expansion in this area reflects fundamental changes in the Greek economy and has underpinned the transformation of a fragmented stagnant inward-looking banking sector into a dynamic modern banking sector with strong international competitive presence. The lifting of foreign exchange controls in the mid-1990s and of household credit restrictions in 2001 as well as privatisations and the mergers between a large number of smaller banks since 1997 has created Greek champions (up to the second half of the 1990s almost 2/3 of Greek banks were controlled by the State and were moreover, badly run, compared with about 15% presently, which are managed by professionals).

The biggest 5 banks with a 78% market share have been very active is modernising their business not only in Greece but also in acquiring or setting up new banks in all the South-Eastern European countries, where the market share of Greek banks is more than 20% on average, with a high of over 33% in FYROM and a low of somewhat less than 20% in Romania. In this region Greek banks employ around 16.000 employees in their subsidiaries or branches, and few thousand more in EU countries, US, Australia, Canada etc. The recent acquisition of Finansbank, the fifth largest private bank in Turkey by the NBG and of a smaller Turkish bank by Eurobank, as well the purchase of an Egyptian bank by the Bank of Piraeus, is transforming the scenery of the Greek banking sector, which is becoming more international.

The size of Greek banks is increasing so that the disadvantage of their small size is gradually being removed and banks are now in a position to extend their activities into more profitable lines of banking, e.g. private banking, consultancy for M&A, investment banking, asset management etc. Greek banks can now start enjoying economies of scale and scope. These factors are all reflected in their high profitability: This year the return on equity is expected to exceed 20%. At the same time, Greek banks are reinforcing their role as a vehicle facilitating trade in goods and services, investment and capital flows as well as migration between the countries in the wider region. This has led to intensive competition between the Greek banks both in the home market and abroad, with the result that the high Greek interest rate spreads over most Euro area countries' bank loans has considerably diminished to the benefit of the consumer.

Indeed, competition and financial liberalization allows households to better manage their portfolios of assets and liabilities and in a fast growing economy most households would find it preferable to bring forward the benefits of their expected higher incomes in the future. There is also a stock adjustment issue; starting from a very low level of indebtedness and realizing that Greece has entered a period where interest rates are much lower and risks have diminished, as well as because of their rising wealth, households find it acceptable to carry a larger stock of debt. The flow of borrowing as households adjust to their higher level of desired debt may be very high for a protracted period.

Undoubtedly, as regulators of the banking system we are concerned and we know that many things have to be improved. There is a need for better consumer protection and better education of borrowers about the risks of bad financial choices. We should not forget that the experience of Greeks over the last 15-20 years has been one of falling interest rates first as they converged to the Euro area's average and then as the ECB relaxed its monetary policy. Now that the ECB is undergoing a phase of monetary policy tightening, the experience of rising interest rates may come as a shock to many households in Greece. In spite of this, between 2002 and 2005, we saw a reduction in the ratio of non-performing loans, a reduction that was particularly steep in the case of mortgage loans where the ratio dropped from 6.9 percent to 3.6 percent over the period.

As far as the Bank of Greece is concerned, our supervisory role obliges us to ask banks to increase provisions, to tighten credit standards and in general to introduce efficient credit control mechanisms, including state-of-the-art risk management units so that even if non-performing-loans increase their CAR will still remain well above 10%: today it is almost 14%. At the same time in collaboration with the host supervisors in the South Eastern European countries, the Bank of Greece monitors closely developments at home and abroad.

An area that we should look into is whether immigrants to Greece can become a valuable bridge and help trade between Greece and their home countries. There is some anecdotal evidence that this is already happening. I should like to note that Greece has always been a country of immigration and has successfully absorbed all the successive waves of immigration throughout the centuries. Greek society has always been open to foreigners: in antiquity, the orator Isocrates (in 380 BC) defined as Hellenes all those who shared our culture, and by definition spoke Greek, and not those who shared a common blood, i.e. of Greek ancestors. Even in the Oath of Alexander the Great (324 BC), it is stated that: *"Unlike the narrow minded, I make no distinction between Greeks and Barbarians. The origin of citizens, or the race into which they were born, is of no concern to me. I have only one criterion by which to distinguish them. Virtue. For me, any good foreigner is a Greek and any bad Greek is worse than a Barbarian"*. The word Barbarian had a different meaning that to-day and was then referred to people speaking a language that Greeks could not understand, as it sounded "bar-bar".

I believe that Greece is now seeing also the fruits of the significant infrastructure investments that took place over the last decade, partly financed by the EU, and of the more tentative structural reforms enacted over this period. There is also a deepening understanding among the population at large, and the business community in particular, that Greece should embrace globalization at last if it is to further improve the living standards. Indeed, it is striking to note that globalization until recently passed Greece by. We were a much more closed economy than most other economies of similar size and level of development. Apart from our location at the periphery of Western Europe, this was the result of an undue reliance on the state to provide the stimulus to growth and job creation and the corresponding over-regulation of the economy, as well as the lack of intra-industry trade as our production was basically oriented to cater for home needs. I believe this was an aberration in Greek history. Greeks embraced globalization long before it became a fad. Notice our strong shipping and merchant traditions, the prospering Greek communities established all over the world, the Greek scientists and researchers that thrive in foreign universities and research centres.

Continuing the adjustment to the new international economic order is a one-way road for Greece. We must start by admitting that Greece cannot compete in labour-intensive, low-wage sectors. Rather than trying to sustain such industries, we should look to what activities we should develop for the future. We should also realize that the public sector, already burdened by debt and facing the pressures of an ageing society cannot continue acting as the engine of employment creation. But let's note the positive facts: Greece possesses an enormous stock of highly qualified scientists and researchers, both here and abroad. Greek students studying in foreign universities represent a very high percentage of these universities' foreign student body but unfortunately many remain abroad enticed by higher earnings and the better research facilities than Greece. But in recent years reflecting the rapidly growing living standards and the significant improvements in urban amenities there is a growing number of Greeks returning to Greece. Greece has also moved further than most countries to becoming a service economy. We are thus at a good starting point to thrive in a knowledge-based world economy. Membership of the eurozone provides a stable macroeconomic framework with low interest rates and inflation as well as legal certainty that should allow private business to plan for their long-term growth.

A change that is now bearing fruits was the gradual emergence of Greece as a source, instead of as destination, of foreign direct investment, particularly toward neighbouring countries. While at the time there were fears of an exodus of jobs, we now see that those investments abroad conferred multiple advantages to Greek firms. First of all, they entered new markets, learning a lot about what is demanded there. While much of the demand is filled locally, high-value added exports from Greece play a significant role. Also, the move of the labour-intensive parts of the production process abroad allows the parent firm to survive and prosper, safeguarding the high-end, mainly managerial and research, jobs located in Greece. It is noteworthy that most of the outward investment, which on average has amounted to about half the inward flows, is concentrated in sectors where Greece has enjoyed a comparative advantage, such as food and beverages, finance, trading companies construction, cement, even textiles. They form thus part of Greek firms' strategies to maintain and enhance their competitive position. Contrary to popular beliefs, outward Greek investment flows are not directed exclusively to low-cost countries. The UK and the US figure prominently among the recipients of Greek FDI, where the four largest foreign subsidiaries of Greek firms in 2005 were located. This indicates that such flows are used mainly to enter foreign markets or acquire necessary know-how and technological expertise.

I find it extremely encouraging that this year we are seeing significant gross flows of foreign direct investment, even if the final net amount may turn out to be small. Indeed, outward FDI flows have been about half the level of inward flows in recent years; as a result, Greece now has a stock of investments abroad exceeding 16 billion dollars, and this may well underestimate the true amount if we take into account the complex statistical problems that surround the collection of this data and the fact that many Greek firms retain (without declaring) in the South-Eastern European countries their exports earnings in order to finance their investment there instead of borrowing at a higher interest rate from the local bank. It is becoming clear that Greece should now actively support efforts to enhance the stability of the international financial system and provide guarantees to cross-border investments.

The inward investment flows not only show that Greece is becoming an advantageous place in which to invest, they also bring with them important benefits, such as know-how. Outward flows should be seen as our entry ticket to foreign markets and as a way for Greek firms to regain their cost advantage.

While much in Greece bodes well for future development, we must not shy away from confronting and solving existing problems. There is a need for government activism, if only to redress the mistakes of the past. In addition, the new environment brings with it new challenges and the need for action. Bureaucracy, despite some progress in the last 10 years, is still stifling entrepreneurial initiative;

simplified procedures, personnel which are better acquainted with international practises, especially at higher echelons, and less duplication of work are necessary both in order to boost private activities but also in order to reduce the operational cost of the state.

Much has been said about the fiscal imbalances and I would be the last to downplay the need for fiscal consolidation. The accumulated public debt is a burden we should get rid off as soon as possible. Not only does it consume a large part of tax revenues, it is also a source of uncertainty. Small changes in interest rates impose a heavy toll on public finances, as is the case with changes in investors' sentiment and risk preferences. A similar argument can be made about addressing the lingering problem of our social security systems. Both the explicit public debt and the contingent pension obligations form a source of uncertainty for the private sector, which may reasonably fear revenue-enhancing tax measures in the future. Putting the public finances in order, as planned by the government, by achieving at least a balanced budget should reassure investors and help promote investment in the country.

While the aim should be the elimination of the fiscal deficit, this macroeconomic objective should be reconciled with the microeconomic objective of reducing the tax burden on the economy, and, especially, continuing to alleviate the taxes on entrepreneurship. This aim has become even more pressing as we are facing increased tax competition, especially from neighboring countries and new members of the EU. You may have noticed regular advertisements trumpeting some country's low tax rates. Combating tax evasion can provide significant revenues, even in the short-run, while at the same time improving efficiency by leveling the playing field. The long-run solution is to have a more efficient and focused public sector that will absorb fewer resources to deliver its necessary services.

I now turn to two particular areas of concern, perhaps interrelated ones, the high level of unemployment, and inflation persistence.

A black spot in the otherwise bright picture of the Greek economy is the stubborn persistence of unemployment. After almost ten years of continuous robust growth, unemployment remains unacceptably high. Unprecedentedly low and falling interest rates, both real and nominal, have played a role by encouraging capital deepening and substitution away from labor. There was also significant labor hoarding at the start of the period for various reasons. Likewise, agricultural employment still represents 8% of the labour force, 4 times as high as the EU average and, to the extent that it diminishes, the outflow of rural labour will continue to inflate total unemployment. Still, no one can deny that there has been insufficient employment creation and so it is worth taking some time to analyze the reasons for that.

First, let's dispose of some erroneous arguments. Trade and globalization cannot be blamed for this situation. Greece was an unusually closed economy and still has one of the highest unemployment rates in Europe. Indeed, unemployment has fallen, albeit slowly, in the last couple of years just as Greece started opening up to international competition. By the same token we should not look to immigrants as the scapegoats. They are performing jobs that the locals would not undertake. In some cases, by providing low-cost input they help keep production in Greece, thus helping better-remunerated Greek workers. This is much more evident in the case of agriculture where production of several crops would have become uneconomic save for the abundant labor supplied by immigrants.

Instead of looking to put the blame on outsiders for our unemployment problem, it is better to admit that domestic policies are the main reasons for this unacceptable situation. First, there is obviously a mismatch between demand for specialized labour and supply, which calls for a better professional orientation of the tertiary educational level. Likewise the regulatory regime, supposedly created to safeguard jobs, is now discouraging job creation and leads firms to try and minimize the labor input. We should adapt to an economic system that is changing fast and where overly-rigid labour relations together with laws encouraging oligopolistic practices in the business sector, have a detrimental effect on employment itself. There is also a need to reduce the wedge between wage costs to firms and the wages received by employees. This wedge is one of the highest in Europe and is due to the very high social security contributions. It is necessary to reduce this difference in a non-distortionary way.

Another issue for concern is the lack of competition and the rigidities that pervade many product markets in Greece. As I travel quite often abroad I am very often struck by how much dearer some goods and, especially, services are in Greece than in other European countries with higher wage levels. Opening up to foreign entrants and international trade as well as lifting entry barriers to various professional jobs should help induce greater competition and reduce the power of local oligopolies. A strengthened Competition Authority is also a useful tool, and its increased activity is certainly welcome.

To sum up Greece, as the other EU countries, is facing its domestic problems but also the challenges arising from the unprecedented rapid globalization. Developments so far shows that Greece is responding successfully by recording the second highest growth rate, over 4% on average since 1996, in the Euroarea and more than twice as high as the Euroarea average. However, the continuation of this successful record requires sustained efforts towards budget consolidation and simplifying bureaucracy. Indeed, provided policies remain focused on promoting the necessary structural reforms and that there are no disorderly upheavals on the international front, the Greek economy should continue to perform well.