George A Provopoulos: The adjustment process of the Greek economy at a decisive juncture – critical challenges for economic policy

Speech by Mr George A Provopoulos, Governor of the Bank of Greece, at the 78th Annual Meeting of Shareholders, Athens, 18 April 2011.

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The Bank of Greece stressed from the start that the financial support agreement would play an important role in addressing the crisis, by securing the necessary funding at a time when Greece was virtually excluded from the markets, imposing disciplined adherence to timetables, offering economic policy expertise and facilitating fiscal consolidation.

The financial support agreement averted bankruptcy and imposed a reorientation of economic policy

Indeed, the financial support agreement has not only secured the necessary funding, but also acted as a catalyst for a fundamental reorientation of economic policy in two main directions: rapid fiscal consolidation and the implementation of structural reforms. This reorientation should of course have taken place years ago, when conditions were more favourable. By April 2010, all room for procrastination had been exhausted and the change in direction was imperative. The policy package that began to be implemented was the only way to halt the country's marginalisation, the only hope of creating the conditions to proceed down a new path in an orderly manner and as soon as possible.

The interventions of the ECB and the liquidity support measures averted a credit crunch

During that same period, when the downgrades of the credit ratings of the Greek sovereign led to the downgrading of Greek banks, normal liquidity conditions were secured thanks to the policy and interventions of the Eurosystem. With interest rates kept at low levels, the stance of monetary policy remained accommodative. Meanwhile, the Eurosystem continued to use non-standard monetary policy measures, which improved the liquidity position of banks and the economy at a time when Greece was facing extremely adverse conditions. Most importantly, the Eurosystem took the very important decision to provide funding to Greek banks against collateral of debt securities issued or guaranteed by the Greek government, irrespective of their credit ratings.

Businesses have, of course, been facing difficulties in their access to credit. One need only consider, however, the insurmountable obstacles that would have arisen, in the absence of these rescue measures, which indeed averted a credit crunch.

Adjustment began in 2010 with tangible results on the fiscal front

The effort to turn developments around began with interventions in several areas and produced tangible results, mainly on the fiscal front. The general government deficit as a percentage of GDP was reduced by approximately 5 percentage points. The European Commission and the IMF, in three successive reviews, acknowledged the progress made, rendering possible the smooth inflow of funding under the financial support agreement. This averted the disastrous developments that seemed inevitable one year ago and a time margin was given to carry out the changes in the economy that, in any case, would have to be implemented, with or without the Memorandum of Understanding.

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Delays, but also objective difficulties, continue to feed market uncertainty

Within the past year, a lot has been achieved. However, in spite of the positive results and the great effort, the factors that generate uncertainty and feed the markets' wait-and-see attitude remain strong.

- First, the ***debt dynamics*** remain unfavourable, because of the size of the accumulated imbalances and because progress in adjustment has so far not been fast enough in order to reverse these dynamics quickly and decisively.
- Second, ***competitiveness*** has improved slightly, mainly as a result of decreases in production costs. However, structural competitiveness, which is linked to the creation of a business-friendly environment, has not. Furthermore, cost competitiveness gains in 2010 were small compared to the cumulative losses of the past decade.
- Third, in spite of reforms to the ***functioning of the public sector***, substantial improvement has yet to be made in the areas where deficits are initially generated i.e. public administration, numerous agencies, local government – or in the efficiency of tax collection. Thus, fiscal adjustment, after getting off to a strong start, by early 2011 is already showing signs of fatigue and deviating from targets. In 2010, although there was a large reduction of the deficit, the initial target was missed. Deviation from targets has also been recorded in the first quarter of 2011.
- Fourth, in the area of ***structural changes***, important legislation has been passed on the pension system, healthcare, closed-shop professions and the labour market, and in several cases there has been progress. In certain cases, however, the reforms do not go deep enough and their implementation is often delayed, either because of administrative inefficiencies or because of a reluctance to push ahead, in the face of opposition.
- Fifth, the ***real economy*** performed worse than expected. GDP in 2010 contracted by 4.5%, due to a decline in private consumption by 4.5%, in public consumption by 6.5% and in gross fixed capital formation by 16.5%. However, the recession would have been milder, if the reforms to improve the business environment, the utilisation of Community funds under the National Strategic Reference Framework (NSRF) and improving the efficiency of public spending had all progressed faster.
- Sixth, the recession has led to ***job losses*** across all sectors of the economy and to a rise in unemployment. In the last quarter of 2010, employment fell 4% year-on-year, which translates into 180,000 jobs lost, while the rate of unemployment reached 14.2% of the workforce. The average annual decrease in employment (–2.7%) was smaller than the decline in GDP, causing productivity to fall (by 1.8%).
- Finally, ***information and public debate*** on the causes of the crisis, the actual state of the economy and, especially, the objective circumstances that make this policy package imperative have been fragmented and incomplete. The Memorandum of Understanding is often seen as responsible for the symptoms of the crisis and not as an inevitable response to the crisis. Furthermore, it has not been sufficiently explained that the Memorandum has actually mitigated the symptoms of the crisis, which would have been far more acute without it. The backing of reforms in several cases has proved timid, while in the public debate the symptoms of the crisis are blown out of proportion, without any mention of the reasons that make the changes imperative.

As a result of this information deficit, ***a section of public opinion*** remains perplexed and reserved in the face of the unfolding changes, as the new policy package calls into question certainties long considered unchallengeable, while a convincing case has not been made for the proposed way-out. The resulting uncertainty has kept social forces from actively joining together in support of the effort. Of course, there have also been reactions which seek to avert change and return to practices of the past.

The projections for 2011 leave no room for complacency

The ***projections*** for 2011, in spite of some positive signs, leave no room for complacency.

- The ***recession*** will continue. GDP is projected to decline by 3%, and a slightly larger decline cannot be ruled out.
- ***Unemployment*** will continue to rise and will exceed 15%.
- Average annual ***inflation*** will slow down significantly compared with 2010, but will be close to 3¼%.
- The annual rate of ***credit expansion*** to the private sector, already negative in the first two months of the year, is expected to remain negative throughout 2011.
- ***Competitiveness*** will continue to improve in 2011, as unit labour costs continue to decline and inflation recedes.
- The ***current account*** deficit will narrow to below 9% of GDP, as a result of the recovery of exports and receipts from tourism and the continuing fall of consumer good imports.

The old is on its way out, but the new is not yet here

Today we find ourselves at a critical crossroads. On the one hand, the old growth model, dominant for so long, is collapsing. On the other hand, the new practices, new institutions and new mentalities that will revitalise the economy have not begun to emerge. The key desideratum would be a rapid transition from an unsustainable growth model to a new one capable of instilling confidence in a positive outlook for the economy, mobilising productive forces, restoring market trust and improving the overall climate.

This is a crisis of the growth model, not of the Memorandum of Understanding

The growth model that has exhausted its limits relied on domestic consumption, both public and private, and was fuelled by borrowing. The business sector did not manage to sufficiently tap into the opportunities opened up by Greece's participation in the euro area, while the boost in households' expectations generated by this participation and the swelling of the public sector encouraged consumerism. This led to negative net national saving from 2002 to the present and to a continuous transfer of resources from the business sector to the oversized, low-productivity public sector. This model favoured present consumption at the expense of the future and was underpinned by the illusion that growth could be driven by the public sector ad infinitum. The rise in consumption, characterised by a high propensity to consume imported goods, encouraged and supported a "shallow" domestic entrepreneurship, focused on the distribution sector and the final consumer. However, as the factors that previously underpinned consumption have now been eliminated, this type of business activity has inevitably suffered a serious blow. At the same time, the necessary conditions to foster a new type of entrepreneurship have not yet been created. The current crisis of the economy is the crisis of a growth model that could no longer be sustained. The cost that society is summoned to pay today is also due to the delay in moving to the new model.

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Focusing on the future: A new growth model

The new growth model that Greece needs implies a shift of focus from consumption to saving, investment and exports, from statism and the perpetuation of privileges to competition and business initiative. In other words, it means a new model of consumption, entrepreneurship and public administration; it means increasing the share of investment and exports in GDP; reducing the share of private and public consumption; giving a substantial boost to saving; shifting entrepreneurial initiative to the competitive sector of production and orienting it towards the international markets; ensuring that public administration functions in a way that does not discourage investment and does not tolerate tax evasion.

A dynamic re-launch of our efforts is needed in order to give new impetus to reform policies

Today, the Greek economy is at a watershed. Progress with adjustment has been made but is still slow if debt dynamics are taken into account. What is now needed is a strong re-launch of our efforts, to make up for the delays and give fresh impetus to reform policies. The key prerequisites for this to happen are:

- To demonstrate in practice that the government is firmly committed to moving forward, without ambivalence and without hesitation, on the difficult path that it has mapped out.
- To inform the public regularly about where the economy stands, which policy goals are being pursued, what difficulties and risks are present, how much ground still needs to be covered, what the ultimate goal is and what the consequences of failure would be.
- To highlight clearly the benefits of the reforms, which are not only necessary, but also morally right, abolishing privileges and aiming at equal and better opportunities for all.
- To reach a minimum of consensus among the political and social forces so as to ensure continued adjustment, the duration of which will extend well beyond any one government's term.

Priorities of economic policy

a) Stabilisation through measures for structural adjustment

There is absolutely no doubt that speeding up the recovery and economic growth will be key to success in the years ahead. However, there will not be any recovery, if we do not address the fundamental causes that led us into the crisis: the huge swelling of public deficits and debts and the serious erosion of the country's competitive position. Therefore the first step towards economic growth is to stabilise the economy. As international experience has also shown, large public deficits and debts cannot foster growth; on the contrary, they undermine it.

Speeding-up reforms in the public sector

The stabilisation process has entered its second and most difficult phase. Following across-the-board wage cuts and tax increases, it must now focus with determination on structural reforms in the public sector, so as to permanently reduce spending which stems from its inefficient operation.

There is actually ample room for such changes. At the same time, we must seize two crucial opportunities, present today, which could act as a catalyst for re-launching the reform effort.

- First, the ***Medium-Term Fiscal Strategy Framework*** provides the chance to follow a fiscal policy with clear objectives, well-specified measures and a definite timetable, rather than piecemeal interventions and stop-gap measures. If the objectives of this Framework are to be achieved, the factors generating the deficit must be eliminated – most importantly, spending must be cut.
- Second, the ***Privatisation and Public Property Development Programme***, if boldly and rapidly implemented, could contribute to a substantial reduction of the debt and encourage the inflow of foreign direct investment.

b) Mitigating the impact of the recession and speeding up recovery

Economic policy, without concessions in terms of fiscal adjustment, must aim simultaneously to mitigate the effects of the recession and to bring GDP growth back to positive territory as soon as possible.

- To start with, any further increase in the tax burden of those businesses, workers and pensioners who pay their taxes regularly must be avoided; instead, tangible progress must be made in the fight against tax and social-security contribution evasion. This is also crucial for bolstering a sense of equity and increasing consensus for the adjustment programme.
- At the same time, all possibilities must be exhausted to:
  - cut spending by eliminating the squandering of public funds and merging or eliminating public-sector entities that are unproductive;
  - re-allocate total expenditure towards growth-enhancing and socially beneficial uses and increase the efficiency of public spending.

  These actions will make it possible to support the more vulnerable groups of society, to facilitate labour mobility across sectors and jobs and to increase the share of public funds allocated to investment.
- The EU funds that are at the country's disposal need to be absorbed at a quicker pace, by using the instruments introduced by the new development law and by fully activating the National Hellenic Fund for Entrepreneurship and Development (ETEAN).
- Finally, the implementation of structural reforms that entail zero or low budgetary costs but which can yield quick results must begin immediately; such reforms include those that reduce red-tape, tackle corruption and remove product and labour market rigidities.

c) Attracting foreign investment

Given that domestic resources available for financing growth are currently very limited, imported saving, in the form of foreign direct investment, must be encouraged. It is true that conditions are unfavourable, as the climate is negative and large uncertainties prevail. However, some positive side effects can be expected from the Privatisation Programme and, of course, from all the urgently-needed measures to upgrade the business environment.

d) Improving competitiveness by speeding-up reforms

Growth hinges upon a rapid improvement in competitiveness. This means fostering new competitive enterprises that are oriented towards the international markets. Growth also hinges upon a radical change in the business climate, to be brought about by creating an environment friendly to initiatives in the areas of production and investment. A much faster pace is now needed for structural change in markets and especially in the public sector – i.e.

for reforms that, apart from recouping the losses in international cost competitiveness, will improve structural competitiveness as well.

The main lines of reform – several of which are already in progress – should include:

- Bolstering competition in markets for goods and services.
- Enhancing flexibility and mobility in the labour market.
- Improving the absorption of Community funds, encouraging and facilitating investment and enhancing the export orientation of the economy.
- Increasing the effectiveness of education at all levels and encouraging innovation and R&D.
- Changing the present patterns of energy production and consumption.

e) Tapping into the growth potential

The main sources of growth are:

- Large investments in the ***energy sector***;
- Upgrading ***tourism***, by attracting higher-income visitors, encouraging well-off pensioners and active professionals from other countries to take up permanent or seasonal residence in Greece, promoting convention tourism, facilitating cruises and attracting foreign visitors to Greece's mainland and mountain areas.
- The further development of the ***merchant shipping industry***.
- The expansion of those ***manufacturing industries*** that have shown noteworthy export dynamism, as well the performance of many dynamic businesses in all sectors.
- ***Taking full advantage of agricultural production***, with the processing of farming and livestock products.
- Turning Greece into a major ***hub for the transit of goods through***, for example, the country's ports, as well as the provision of high quality ***healthcare*** and ***education*** services to consumers from the wider Balkan and Eastern Mediterranean region. The development of these service activities could avert an exodus of trained scientists and at the same time encourage Greek scientists working abroad to return home.

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The banking system up against serious challenges

Liquidity support through the government guarantee scheme remains necessary

It is a well-known fact that Greek banks did not cause the crisis, contrary to what happened in other countries, but suffered the consequences of the fiscal derailment. The downgrading of banks' credit ratings, consequent on the downgrading of the country, meant that banks were shut out from the markets, while they also lost a significant proportion of deposits. Against this background and in order to meet their liquidity needs, banks had recourse to the liquidity support measures adopted by the Greek government including a State guarantee scheme. Such measures had been adopted by all EU countries in 2008 at the height of the global financial crisis.

It should be recalled that under this scheme the State, for a fee, guarantees debt securities issued by banks; it does not provide banks with cash. These guarantees enable banks to obtain liquidity from the Eurosystem by providing them with eligible collateral. It should also be noted that, because of the haircuts applied, the liquidity that credit institutions can obtain using government-guaranteed securities as collateral falls significantly short of the nominal value of such collateral.

The ability of banks to raise liquidity from the Eurosystem by making use of government guarantees has averted a credit crunch. Although nominal GDP fell by 2.1% in 2010, the outstanding amount of bank credit to the private sector in December 2010 remained unchanged year-on-year. Given the financial environment, without the extraordinary provision of liquidity by the Eurosystem the banks would have been forced to expedite the collection of their claims, cut back on loan rescheduling and reject applications for new loans even from creditworthy customers.

However, the extraordinary liquidity support measures taken by the ECB and the government are temporary in nature. They aim to give banks time to adjust their business model to the new circumstances. This adjustment must be performed in an orderly manner, so as not to further aggravate the current economic downturn nor dampen the recovery, once it begins. In other words, banks must, as soon as possible, be in a position to intermediate between savers and investors relying on their own resources, rather than on the extraordinary support provided by the ECB or the State.

The new conditions make it imperative for the banking sector to change its business model

The banking sector, just like the economy as a whole, has found itself up against unprecedented challenges and has had to deal with a number of factors that have affected its performance and generated conditions of uncertainty.

Today’s reality is a given and, with regard to the future, the message is clear as to the basic parameters of the economic environment and the regulatory framework. Banks will therefore have to adjust their business models accordingly, by mustering all their forces. Reorganisation and alliances are most successful when they are carried out with foresight and are the outcome of informed decisions and friendly negotiation.

The reorganisation of the banking sector will considerably enhance its contribution to the growth process, once the economy begins to recover. It will also support financial stability, on condition of course that the primary factor for stability is in place, i.e. that the confidence of economic agents, markets and the international community is restored and consolidated. No reorganisation of the financial system can substitute for the need to pursue fiscal consolidation and speed up structural reforms in the public sector and the economy at large.

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Creative adjustment to the European and international environment

As Greeks, we often interpret prevailing international conditions subjectively, with a perspective that places Greece at the centre of things.

However, if we accept the fact that the international environment shapes an objective reality that cannot be overturned just because that is our wish, we will realise that our prospects ultimately depend on the consistency with which we adjust to this reality. This is especially true of our relations with the European Union and the euro area, which are governed by explicit rules that have been formulated with our participation. In fact, these rules are currently being modified as the EU and the euro area work towards new terms of economic governance that would avert a recurrence of crises and develop new mechanisms for intervention. The European Stability Mechanism and the “Euro Plus Pact”, the main principles of which were recently decided, will create a new framework requiring all Member States to make long-term commitments, in particular in the areas of fiscal discipline and the focus of their economic policies on improving competitiveness – i.e. precisely the two major challenges that Greece has to face one way or another.

Therefore, the developments under way in the EU and the euro area support and reinforce the conclusion that we need to intensify our efforts for fiscal consolidation and a substantial improvement in competitiveness.

Adhering to these guidelines would also be the best answer to the often-repeated scenaria surrounding debt restructuring. Since last October the Bank of Greece has clearly explained that such an option is neither necessary nor desirable. It is not necessary, because we can achieve our goals if we properly implement the policies outlined above. Nor is it desirable, because it would have disastrous consequences for the access of the government and of Greek enterprises to international financial markets, as well as very negative effects on the assets of pension funds, banks and individuals holding Greek government securities.

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Today, we are at the start of a long course of reconstruction of the economy, a path with many obstacles and risks, but also opportunities that we need to exploit. The mobilisation of all of the country's political and social forces is imperative for this effort to succeed. The final outcome will depend on:

- our collective will and determination;
- our foresight and long-term perspective;
- the ability to work out a well-coordinated and coherent plan of the necessary actions and to implement it quickly and efficiently.

All of the above presuppose strict adherence to the final goal: to transform Greece into a modern European country with economic prosperity and social cohesion.