

## **George A Provpoulos: The Greek economy and banking system – recent developments and the way forward**

Welcome remarks by Mr George A Provpoulos, Governor of the Bank of Greece, at the conference “The crisis in the euro area”, Athens, 23 May 2013.

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I would like to warmly welcome you to this conference on “The Crisis in the Euro Area”.

That such a conference is taking place here seems to be especially appropriate. After all, Greece is the country where the euro crisis started and which, for much of the past several years, has been at the epicenter of the crisis.

What I would like to do is to briefly discuss some developments that led Greece into the crisis and then take stock of the progress that Greece has made in adjusting its economy.

Before doing so, let me provide a preview of my main conclusion.

Although Greece has been through some very rough waters, both in terms of its real economy and its banking system, the situation is turning around.

Considerable progress has been made in addressing the weaknesses of the economy, making it much more competitive. Importantly, the country is well on the way to building a strong and competitive banking system.

As the Governor of the institution responsible for banking supervision and financial stability, I gain special satisfaction from the fact that, after three years of deep crisis, the stability of the banking system has not only been preserved but it has strengthened.

It has not, however, always been easy for the Bank of Greece.

Let me now turn to the underlying causes, and the policy responses, to Greece’s sovereign debt crisis.

How did this crisis come about?

The entry of Greece into the euro zone in 2001 was widely seen as marking a transformation in the country’s economic performance.

Entry into the euro area seemed to indeed mark a new regime.

Between 2001 and 2008, real growth averaged almost 4 per cent a year, inflation fell to the low single digits, and interest-rate spreads between 10-year Greek and German sovereigns dropped to between 10 and 50 basis points, from over 600 basis points in the late 1990s.

However, these were years when Greece was living dangerously.

Unsustainable fiscal and external imbalances were building up.

By 2009, the fiscal deficit had reached 15½ per cent of GDP and the share of government debt had increased to almost 130 per cent of GDP. Moreover, Greece’s cost competitiveness had deteriorated by 30 per cent, and the current account deficit had peaked at 15 per cent of GDP in 2008.

These large and growing imbalances should have sounded warning alarms to the financial markets, but they did not do so for some time.

Despite relatively low spreads on Greek sovereigns following the outbreak of the global financial crisis, as early as in 2008 the Bank of Greece began warning of the dangers inherent in the twin deficits.

## Outbreak of the crisis

These dangers became evident – belatedly – to the financial markets in the fall of 2009 with the news that the fiscal deficit for that year would be much higher than had been earlier projected.

Interest-rate spreads began a relentless upward climb and the sovereign became cut off from the global financial markets.

In May 2010, the government agreed to an adjustment programme with the IMF and Greece's euro-area partners in order to meet its financing needs.

This adjustment programme was built around two key pillars.

- a. Fiscal consolidation
- b. Structural reforms (including privatizations and measures to combat tax evasion)

The government placed more emphasis on the first and less emphasis on the second pillar. Moreover, the fiscal mix relied more on tax increases than on spending cuts.

The Bank of Greece had advised that the mix should include 1/3 revenue increases (mainly through broadening the tax base) and 2/3 spending cuts.

Fiscal consolidation led to a recession that was deeper than expected, partly because it relied heavily on increases in tax rates and was not combined with structural reforms to boost growth prospects.

What had started out as a sovereign debt crisis spilled over to the banking system.

Prior to the outbreak of the sovereign crisis, the banking sector had sound fundamentals – with high CARs, low loan-to-deposit ratios, and essentially no toxic assets of the kind that set-off the 2007 global financial crisis.

The size of the banking sector at the outset of the crisis – at 200% of GDP – was much smaller than in other countries that experienced crises.

In contrast to what happened in other countries, in Greece it was the sovereign crisis that led to a banking crisis, not the other way around. How did that happen?

First, in terms of liquidity. A series of sovereign downgrades, and then bank downgrades, forced the banks out of the global financial markets.

Uncertainty led to large deposit outflows.

Banks had to resort to central bank funding, at first through Eurosystem monetary policy operations, but gradually, due to the lack of eligible collateral, to emergency liquidity assistance from the Bank of Greece, at a higher cost.

Following the PSI last year, banks took huge one-off losses on their bond portfolios.

At the same time, the recession led to a continuous increase in non-performing loans.

What started out as a liquidity problem threatened to turn into a solvency problem.

The twin crises generated negative feedback loops, creating a general crisis of confidence, compounding the problems faced by the banking system, and exacerbating the contraction in GDP.

But a contracting GDP meant a shrinking denominator in the debt-to-GDP ratio. As a result, the debt dynamics worsened, and the crisis became self-reinforcing.

Last year, Greece was said to be on the road to the unthinkable – an exit from the euro! The markets even had a name for it; GREXIT.

So much for the bad news. Is there light at the end of the tunnel?

### **Adjustment: fiscal**

The word “crisis” originates from the Greek word that means judgment. I believe that historians will judge this crisis to be a positive turning point for the Greek economy.

Why do I believe this? Let me explain.

Consider, first, fiscal adjustment.

From 2009 to 2012, the fiscal deficit was reduced by some 9 percentage points of GDP.

The primary fiscal deficit was 10½ per cent of GDP in 2009. It is projected to swing into a small surplus this year.

What makes these achievements impressive is that they have taken place despite a contracting economy, which creates moving targets for fiscal consolidation.

Greece’s fiscal consolidation is one of the largest ever achieved by any country at any time.

Additional fiscal measures, amounting to 11½ per cent of GDP, are being implemented in 2013 and 2014. These measures will increase the primary fiscal surplus to 3 per cent of GDP in two years.

After many delays, positive signs are also emerging with respect to tax evasion and privatizations.

Further debt-reducing measures were announced by the EuroGroup last November, subject to Greece reaching a primary surplus, which the government expects to achieve this year.

### **Adjustment: external**

Consider, next, external adjustment.

As I mentioned, Greece had lost about 30 per cent in terms of cost competitiveness against its major trading partners in the period from 2001 to 2009. Since 2010, about 80 per cent of that loss has been recovered.

By the end of this year, the entire loss will have been recovered.

Competitiveness is also being promoted through structural reforms, which have increased the flexibility of labour and product markets.

As a result of the improvements in competitiveness, a rebalancing of the economy is taking place. The share of exports in GDP rose from 18 per cent in 2009 to 25 per cent in 2012. It will continue to rise.

The current account deficit, which reached 15 per cent of GDP in 2008, fell to 3 ½ per cent last year. It will continue to fall.

### **The banking sector strategy**

I now turn to the banking sector.

As I mentioned, what had started out as a liquidity problem threatened to turn into a solvency problem.

We had to step-in to preserve financial system stability.

The first step was to calculate the amount needed to recapitalize the banking system.

The determination of the losses on the bond portfolios was straightforward. What was challenging was to calculate, in a conservative manner, all possible losses on the loan portfolios of banks in the coming years.

For this purpose the Bank of Greece worked with BlackRock Solutions.

Once this work was finished, most pieces were in place for the calculation of the capital needs of banks.

The second part of our strategy was to assess which banks were good candidates for recapitalization with programme funds.

The Bank of Greece, in association with Bain, conducted a “viability assessment”.

The result of the “viability assessment” was that the four largest banks, now called “core banks”, were assessed as eligible for recapitalization with public sector funds. These banks were assessed as the most likely to repay such capital within a reasonable timeframe.

The total amount set aside under the adjustment programme for the restructuring of the banking system is €50 billion.

When our exercise started there were 17 commercial banks in operation: four core banks and thirteen non-core banks.

So far, the resolution framework has been used to resolve 8 banks (5 commercial banks and 3 co-operative banks).

All core banks have now concluded corporate decision-making processes to increase their capital by the amounts required by the Bank of Greece.

Shortly, we will end up with four well-capitalized core banks and a few non-core banks.

As a result, the banking system is becoming more compact and efficient, eliminating excess capacity and exploiting synergies and economies of scale. It is becoming stronger and is well-capitalized.

### **Other developments**

The recent progress that Greece has made in restructuring its economy reflects, in large measure, the determination of the government to take ownership of the adjustment programme.

The government has made it clear that Greece’s future lies within the euro zone.

The benefits of the country’s adjustment extend beyond the credibility and competitiveness effects of the reduced macroeconomic imbalances.

The adjustment means that Greece will continue to receive financial support from official lenders, so that it can complete the process of restructuring its economy and banking system.

After its restructuring, the banking system will be in a position to resume its role as the main source of financial intermediation, supplying funds to support real economic activity.

### **The euro area’s response to the crisis**

And what about the euro area as a whole? Here, there are two important factors at work that will make the euro area a stronger monetary union.

First, just as the Greek economy is undergoing a major restructuring to make it a stronger, competitive economy, similar processes are occurring in other peripheral economies.

Second, work is also under way to make the euro area a more complete monetary union, with:

- strong economic governance;
- procedures to prevent macroeconomic imbalances from emerging;

- strong backstops and initiatives – including the ESM and Outright Monetary Transactions by the ECB; and
- concrete steps towards the creation of a banking union.

Vitor Constâncio will address banking-union issues in his presentation.

## **Conclusions**

I have painted a picture of a Greek economy that is undergoing a major restructuring and I have argued that Greece has weathered its crisis.

Consider the following developments.

Since the peak of the crisis last June,

- Equity prices have more than doubled.
- Bond spreads have fallen by more than 2,500 basis points.
- Deposits of the private sector have increased by about 12 per cent.
- Hoarded banknotes – a key sign of uncertainty in the past – are returning to the banking system.
- Reliance of domestic banks on Eurosystem financing is down by almost 35 per cent.

As the overhaul of the Greek economy continues, I expect economic growth to resume starting in 2014.

Let me conclude by saying that, despite predictions to the contrary, there has been no Grexit from the euro.

Instead, I recently saw the word GREXIT had been replaced by the word GRECOVERY.

As usual, the markets are right, but a little late!