Yannis Stournaras: Recent economic and financial developments in Greece

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The completion of the review is essential for an exit from the crisis

2016: a year of pragmatism and adjustment

According to Bank of Greece estimates included in the present report, the conditions shaping the path of the Greek economy in 2016 appear to be more favourable than a year ago. It is therefore reasonable to anticipate that the recession will bottom out and that the economy will see a slight recovery during the second half of this year, provided that political stability is maintained and uncertainty, which harms investor confidence, is eliminated.

This outlook is subject to strong uncertainties and high risks, associated, on the one hand, with global developments and, on the other, with the pace at which the Greek economy will return to normality and adjust to the new conditions.

The first set of risks relates to the refugee crisis and the manner in which the European Union (EU) as a whole will address it; a surge in geopolitical risks in the broader region; a slowdown of global economic growth and an overreaction of financial markets in this respect; a new Asian crisis originating in China; and finally, the possibility of a British exit from the EU. These risks in the global environment could reinforce centrifugal trends in the EU and undermine European cohesion, at a time when the stronger Member States of the euro area seem to have fundamentally different approaches to the architecture of the monetary union.

On the domestic front, the prospect of recovery crucially hinges on a number of prerequisites, including reaching an agreement on the first review of the programme and the adoption of the agreed measures by the Hellenic Parliament, commitment to implementing the programme, and action to restore political and economic stability and foster a return to normality. In order to respond and adjust to the fast changing global environment, the Greek economy, integrated into a globalised economy and exposed as it is to international competition, must first of all consolidate its position by effectively addressing its own problems. The country that fails to keep up with European developments and lags behind will be the one hardest hit, in case the global environment takes a turn for the worse.

Recent macroeconomic developments

Between 2008 and the end of 2013, the Greek economy lost a cumulative 26% of its Gross Domestic Product (GDP). After a short-lived rebound in 2014 that continued until mid-2015, it fell back into recession in the third quarter of 2015 (–1.9%). The rate of change in GDP remained negative (–1.9%) in the fourth quarter, coming to –0.7% for 2015 as a whole. Underlying this new downturn were political instability from the end of 2014 onwards, the protracted negotiations with our creditors in the first half of 2015, the bank holiday and the imposition of capital controls, as well as the new fiscal adjustment measures under the new Financial Assistance Facility Agreement, considered necessary to achieve the revised fiscal targets. The strengths of the Greek economy and of the domestic banking system were tested. However, the economy showed remarkable resilience, and the negative impact was more moderate than initially expected.

This resilience is associated with the implementation of the adjustment programmes since 2010, which – in spite of several delays and missteps – have succeeded in sharply reducing the major macroeconomic and fiscal imbalances. More specifically:

- The high fiscal deficit has been reduced, covering three quarters of the adjustment path towards the ultimate fiscal target (for a primary surplus of 3.5% of GDP by 2018, compared with a primary deficit of 10.1% of GDP in 2009).
- The current account deficit and the loss of competitiveness have been addressed, while labour market rigidities and constraints have been reduced, leading to an increase in exports.
- There have also been signs of sectoral reallocation towards tradable goods and services and, more generally, towards the more productive businesses across all economic sectors.

As opposed to the substantial progress made in recent years with fiscal adjustment, there have been delays with privatisations and the implementation of growth-enhancing reforms. These delays held back the beneficial effects on growth and employment, which only emerged in the course of 2014, with GDP growth returning to positive territory for the year as a whole (+0.7%) and in the first two quarters of 2015. The recovery would have gained traction and the overall outcome for 2015 and 2016 would have undoubtedly been positive and stronger, in line with the projections, if it had not been undercut by heightened uncertainty from the last months of 2014 until a new agreement was reached with our partners at the Euro Summit of 12 July 2015.

After a primary surplus of 1.2% of GDP in 2013, well above the target for a balanced primary budget, Greece's fiscal position deteriorated in 2014, on the back of political and economic uncertainty in the late part of the year. Nevertheless, the primary balance remained positive, albeit small and falling considerably short of the targeted 1.5% of GDP. In the course of 2015, fiscal aggregates showed strong fluctuations, reflecting developments in tax revenue, public investment expenditure and government arrears. Following a downward revision of the primary balance target to a deficit of 0.25% of GDP (from an earlier target for a 3.0% surplus) and the adoption of additional fiscal measures, the primary budget in 2015 is expected to have been balanced or slightly in surplus.

The major challenge of 2015: safeguarding financial stability

Against the background of uncertainty that prevailed in the first half of 2015, it became crucially important to safeguard financial stability under threat from a pick-up in deposit outflows, a spike in non-performing loans (reversing the picture that had begun to emerge in the course of 2014), the non-eligibility of Greek securities as collateral in Eurosystem monetary policy operations and, above all, the heated debate over a possible Greek exit from the euro area.

At these most difficult of times, the Bank of Greece fulfilled its primary duty arising from its participation in the Eurosystem and from its Statute, namely to safeguard monetary stability and support liquidity in the domestic banking system, while at the same time safeguarding its independence and credibility helping to restore normality. In this respect:

- it provided timely and reliable information to the government and political parties, while raising public awareness through its reports and public interventions;
- it ensured the uninterrupted funding of the banking system through the Emergency Liquidity Assistance (ELA) mechanism;
- it supplied credit institutions with banknotes, averting any cash shortages even in the remotest parts of the country;
- it developed, in collaboration with the government and the Hellenic Financial Stability Fund (HFSF), a strategy on non-performing loans (NPLs);
- it carried out the Asset Quality Review of banks;

- it completed the successful recapitalisation of significant and less significant banks, without shocks to the credit system;
- it engaged in close cooperation with the Single Supervisory Mechanism (SSM) through the participation of members of its staff in Joint Supervisory Teams;
- it helped to minimise the impact of capital controls, with the result that the recession was much more moderate than expected;
- it supported the work of the Committee for the Approval of Bank Transactions;
- it provided support to government operations, always in compliance with the Treaty on the Functioning of the European Union, which, among other things, delineates the relations between national central banks and Member States' governments.

The bank holiday and the capital controls managed to contain the deposit outflows and the capital flight. The ensuing distortions in the capital market, as well as in the goods and services markets, have had indirect repercussions that cannot be precisely assessed as yet. On a positive note, however, capital controls have encouraged the use of electronic money. There is already strong evidence that the widespread use of e-money has supported private consumption and tax revenue, by reducing the informal economy. Thus, one first policy implication is that the use of e-money needs to be strengthened further, through appropriate, mainly tax-related, incentives.

A stronger banking system in the wake of recapitalisation

The recapitalisation of Greek banks was successfully completed in December 2015, with a substantial participation of private investors. This new recapitalisation became necessary against the background of a deteriorating economic climate, heightened uncertainty and increased outflows of deposits during the first half of 2015, as well as amid rising non-performing loans. The four significant Greek banks managed to cover the capital needs identified by the ECB's stress tests. The necessary funds came from (a) foreign investors, who placed around €5.3 billion; (b) capital mitigating actions amounting to €0.6 billion; and (c) liability management exercises (voluntary bond swap offers to bank bondholders) that yielded about €2.7 billion.

For the two banks that did not fully cover their capital needs, based on the adverse scenario, from private sources (totalling about €5.4 billion), the necessary additional funds were drawn from the HFSF. Thus, the public resources used proved to be far lower than the amount of €25 billion foreseen by the Eurogroup in August 2015.

Moreover, banks' reliance on ELA has decreased, and the ceiling has been reduced by about €19.0 billion since end-August. The lower ceiling reflects the improved liquidity situation of Greek banks amid easing uncertainty and a stabilisation of private sector deposit flows, as well as, to a large extent, the progress with the recapitalisation of Greek banks.

In 2015, the stock of non-performing loans increased. Non-performing exposures as a percentage of total exposures (NPE ratio) rose to 43.6% at end-September 2015 (up from 39.9% in December 2014). This deterioration was visible and similar in size (roughly 4 percentage points) across all loan categories. In particular, the NPE ratio reached 55.4% for consumer exposures, 43.3% for business exposures and 39.8% for housing exposures. This can in part be attributed to the postponement of the implementation of the Code of Conduct on the management of NPLs and to the less active loan portfolio management on the part of banks, which seemed to focus mostly on short-term solutions. However, from the third quarter onwards, especially after the recapitalisation, banks appeared to step up their efforts towards more active NPL management.

The completion of the first review will enhance the prospect of recovery

Contrary to what was the case in 2015, 2016 could mark a new beginning leading Greece out of the crisis and onto a path of sustainable growth. As mentioned previously, however, there are a number of major challenges, arising not only from unpredictable developments in the international environment but also, more importantly, from potential risks to the domestic macroeconomy, such as delays in the completion of the first review of the new stabilisation programme or failure to implement the programme's actions.

Real GDP growth is expected to be negative, at least during the first half of 2016, largely reflecting a carry-over effect from 2015. However, as already mentioned, the objective conditions are in place for Greece to exit recession and come closer to positive growth from the second half of this year. This is also conditional on a number of steps that will help to avert risks and strengthen the prospect of recovery, which is feasible.

The first step, and the one with the most crucial bearing on future developments, is the successful completion of the first review of the programme, currently in progress. This will require, among other things, the completion of the social security reform and the alignment of farmer income taxation. These are not just prior actions for the review of the programme. They are necessary to ensure the sustainability of the social security system and of public debt and to restore social and tax equity both across generations and across taxpayer groups.

A positive review would boost the real economy and open the way for discussions on debt relief

A positive completion of the review would benefit the real economy in a number of ways:

- by bringing about a major improvement in confidence, thereby contributing to a faster return of deposits to the Greek banking system;
- by enabling a decision to reinstate Greek securities as eligible collateral in Eurosystem monetary policy operations, providing Greek banks with access to lower-cost funding from the ECB;
- by allowing Greek government bonds to be included in the ECB's quantitative easing programme;
- by bringing forward the further relaxation – and ultimately lifting – of capital controls.

All of the above, coupled with the successful recapitalisation of banks and the more efficient management of non-performing loans, will restore normality to the banking system: banks' higher funding capacity will in turn boost their capacity to lend to the real economy, translating into lower borrowing costs for businesses and households. These more favourable financing conditions will bolster growth.

Over the medium term, the successful completion of the first review will prove to be decisive, in that it will open the way for discussions with our partners on further debt relief measures. Such measures would ensure the sustainability of public debt in a manner that contains the government's annual financing needs at manageable levels. Among other beneficial effects, this would directly ensue in a further relaxation of the ultimate fiscal target and free up funds that could be channelled into investment, supporting output and employment.

Preconditions for an exit from the crisis towards sustainable growth

As already mentioned, an end to the recession and recovery from the second half of 2016 are within reach, provided that the problems and risks outlined above are effectively addressed. However, moving further along from recovery to sustainable growth will require strong commitment to implementing the new financial assistance agreement and long-term policies towards a new extrovert and competitive growth model. The factors that will ultimately determine success are: acceptance and ownership of the programme; perseverance and consistency in implementing the necessary actions; open dialogue; and political and social consensus.

Over the past years, the Greek economy has been following an arduous road of adjustment, at great social cost, but also with tangible results. Little remains to be done, compared to the bulk of the effort already made. Indicatively, ten steps are recommended in this direction:

1. Further strengthening of the banking system

The strengthening of the banking system entails addressing the high stock of non-performing loans. The effort towards long-term solutions to this major problem should benefit from the high-level operational targets for NPL resolution to be set by the Bank of Greece, in consultation with banks and the Single Supervisory Mechanism (SSM), applicable as from June 2016 and subject to monitoring on a quarterly basis. The requirement on banks to achieve these targets, coupled with the newly enacted legal and institutional framework, concerning, among other things, the establishment of a secondary market for NPLs, the speeding-up of judicial proceedings and the streamlining of the real estate collateral liquidation process, is expected to contribute to a gradual decline in the NPL ratio.

The strengthening of the banking system would be supported by:

First, bold and innovative initiatives for a substantial reduction of non-performing loans on bank balance sheets within the next two years. This cannot be ensured by the current "business as usual" approach, despite any refinements.

Second, a shift towards long-term workout solutions. The current practice of short-term arrangements only serves to perpetuate the problem.

Third, promoting multi-creditor workouts. Progress in this respect has been limited. In most cases, definitive solutions cannot be reached without coordinated action by all creditors. Almost all large non-performing business loans involve more than one creditor.

Fourth, an intervention to restructure viable businesses. Alongside loan restructuring, it is crucial to enable active initiatives to change uncooperative managements, structures and business plans of corporate debtors.

Fifth, enhanced internal controls to ensure equal and transparent treatment of borrowers.

2. Acceleration of reforms

The programmes implemented over the past years were focused on fiscal adjustment and succeeded in eliminating the twin deficits. However, there were delays in the implementation of reforms, which, if made from the very start, would have reduced the extent and severity of the recession. This is the area on which we now need to focus. Specifically, the reforms needed in the services sector and network industries (transport, energy, telecommunications, trade) involve lifting restrictive regulations that stifle competition. In the labour market, emphasis must be placed on establishing a new framework for encouraging apprenticeship and vocational education and training, tackling undeclared work and streamlining existing labour laws and consolidating them into a Labour Law Code. Finally, in the field of public administration, a reform programme needs to be implemented, geared towards modernisation and de-politicisation. Concrete steps need to be taken towards simplifying administrative processes, overhauling structures, expanding modern technology usage, optimising human resources, and strengthening transparency and accountability.

3. Privatisations and utilisation of public real estate

The scaling-up and successful implementation of the privatisations and public real estate utilisation programme are decisive to economic growth, as they will have a multiplier effect, with long-lasting gains for the domestic economy. Privatisation proceeds can be used to gradually pay off public debt, supporting fiscal adjustment. Furthermore, when accompanied by a strong commitment to future investment, privatisations enhance the inflow of funds for productive investments that stimulate employment and aggregate active demand. As estimated by the Bank of Greece, privatisations hold a huge potential, which could yield far more than the quantitative revenue targets. The public real estate, if properly utilised through an upgraded land use and spatial planning framework that will fully respect the environment, can attract substantial foreign direct investment.

4. Continued consolidation of public finances and of the social security system, through a redefined economic policy mix

The downward revision of the primary balance target for a surplus of 3.5% of GDP by 2018 frees up resources that can be channelled into the real economy. However, the current policy mix, focused on closing the remaining fiscal gap and ensuring the sustainability of the social security system, must become more growth-friendly. In other words, the emphasis should be on reducing non-investment government expenditure and raising productivity. The focus, so far, on increasing labour and business income tax rates, as well as social security contributions, provides incentives for tax and contribution evasion and encourages undeclared work, undermines the competiveness of Greek firms and discourages job creation. As a result, any improvement in the fiscal balance is self-defeating, preventing a lasting reduction of the debt-to-GDP ratio. Instead, the remaining fiscal gap can be covered more effectively and more permanently by rationalising public administration structures, introducing a modern performance assessment system, merging and reducing the number (currently about 1,800) of public sector entities, abolishing various exemptions from general tax and social security provisions for specific groups of taxpayers or workers, redesigning the regime of own resources of local government with a view to removing disincentives for cost-saving, reducing tax expenditure, cutting back on non-investment expenditure, better targeting social spending to remove the bias against the new generation and improving labour mobility from overstaffed to understaffed parts of the public sector.

5. Encouraging business investment and protecting private investors

Greece has been plagued by serious investment inertia. Between 2007 and 2014, total investment expenditure as a percentage of GDP fell by half. Underlying this disinvestment are anaemic demand, political and economic uncertainty, as well as financing constraints. The prompt rebound of business investment expenditure is key to sustainable growth. The restoration of economic and political stability that would strengthen investor confidence and encourage business investment plans, the rapid shift of the domestic production model from non-tradable to tradable goods and services and the easing of financing constraints are instrumental in stimulating business investment expenditure. A decisive contribution should also come from actions such as the enactment of a new development law with clear growth incentives, but especially initiatives from the financial system to address non-performing loans in the context of the new institutional framework, which also enables creditors to cooperate in restructuring productive businesses. Furthermore, the Greek State must help restore investor confidence and protect private investors by ensuring a stable, business-friendly economic environment. This can be achieved through the establishment of a clear-cut, simple and stable tax and legal regime fostering healthy entrepreneurship, and through initiatives to settle long-pending, and harmful for the country's investment appeal, disputes with major international investors.

6. Increasing exports

The competitiveness gains achieved by the Greek economy at considerable social cost do not seem to have been fully exploited. These gains, together with improved labour market flexibility, are strong incentives for investment initiatives. Despite the recouping of losses in international competitiveness, mainly in unit labour cost terms, exports have not yet recorded the anticipated upward dynamics. This can in part be explained by the lack of financing, the comparatively higher cost of long-term borrowing and the increased tax burden which weighs on the economy's overall competitiveness. In part, however, it is also due to a number of inherent structural weaknesses that hamper the penetration of Greek products in international markets and relate to non-cost aspects such as product quality, protected designation of origin and branding, red tape, etc.

7. Combatting high unemployment

The observed gradual decline in unemployment and the continued recovery of the employment rate have been supported by the active employment policies implemented through programmes and actions using resources from the National Strategic Reference Framework (2014–2020).

In order to fight high unemployment, in particular long-term and youth unemployment, the active employment policies and the vocational training programmes in place need to be constantly improved and expanded, while their effectiveness also needs to be increased, which requires results-based review and monitoring. Moreover, the enhancement of employment support schemes should go hand in hand with action against undeclared and uninsured work.

8. Education reform

The road to growth entails knowledge, research, innovation and lifelong learning. The exit of Greek society from the crisis can only be achieved through its transformation into a society of creative citizens, capable of preserving and expanding its human capital stock. In this context, the education reform currently being debated, which forms an integral part of the national growth strategy, must be based on five pillars: (a) evaluation of the Greek education system at all levels with a view to enhancing innovation and entrepreneurship; (b) rationalisation of curricula across all educational levels, as well as of the functioning and governance of higher education institutions, while enhancing the efficiency and autonomy of public educational units; (c) breaking the hold of corporatist interests on the education system; (d) increasing funding, which still remains low; and (e) transparency at all levels.

9. Halting the brain drain

Soaring unemployment and the deep economic recession have caused part of Greece's human resources to migrate abroad, with alarming implications for the country's demographics, public finances, pension system and, to the extent that it involves high-skilled people, the quality of the remaining labour force. In order to reverse this brain drain, the Greek State must take measures aimed at: (a) redefining the types and forms of academic and vocational specialisation needed to improve skill matching for young generations; (b) supporting business start-ups; (c) combatting mediocracy, the lack of transparency and nepotism; (d) promoting excellence; (e) expanding apprenticeship and internship schemes; and (vi) fostering a business-friendly environment.

10. Supporting social cohesion and tackling poverty

Sustainable growth hinges upon social cohesion, under threat at present from rising poverty, income inequality and social exclusion. Although based on the results of the latest EU-SILC survey (2014), both indices, namely the poverty gap and the relative risk of poverty in Greece decreased somewhat, the relative risk of poverty is still the third highest in the EU-28. Moreover, the number of households living below the poverty line has increased. Public debate should therefore focus on the need to redesign both the policy of social transfers, in order to increase their effectiveness in tackling poverty, and the education system, to ensure that it provides equal learning opportunities at all levels of education to those facing social exclusion.

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The Greek economy has already come a long way, and it is only a short distance from here to an exit from the crisis. In order to avert any setbacks and obstacles on the path towards growth, all existing potential must be fully exploited, avoiding past mistakes that only led to vicious circles and impasses.

Today, an exit from the crisis is within sight, but remains subject to prerequisites. In order to reach it, we must remain committed to honouring the terms of the agreement, which must not be seen as imposed upon us by our creditors, but as fundamental and necessary reforms that should have been implemented years ago. The Greek side must take ownership of the programme as a necessary means towards adjustment and reform. In addition, however, the ten steps mentioned above, which should ideally be incorporated into a national growth plan, are geared towards supporting (a) output and investment; (b) the “knowledge triangle” (education, research, innovation); and (c) the new generation. This national plan must be both a new growth and a social pact for the creation and mobilization of resources to support productivity, new businesses and jobs. These are the orientations that will enable the Greek economy to exit the crisis once and for all and return to a virtuous circle of growth and employment.