Yannis Stournaras: The Greek economy – developments, opportunities and prospects

Speech by Mr Yannis Stournaras, Governor of the Bank of Greece, at the Federation of Industries of Northern Greece, Athens, 13 May 2016.

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Recent developments and the current state of play

In recent years, despite backtracking and, at times, political and economic uncertainty, significant progress has been made towards addressing certain chronic problems and weaknesses of the Greek economy. In particular, the economic adjustment programmes implemented in Greece since 2010 have succeeded in eliminating the major macroeconomic and fiscal imbalances, in spite of several delays and missteps. In more detail:

• The high fiscal deficit has been reduced and almost 80% of the fiscal adjustment path towards the ultimate fiscal target for a primary surplus of 3.5% of GDP in 2018, compared with a deficit of 10.1% of GDP in 2009, has been covered.

• The external deficit, the loss of competitiveness (in terms of unit labour costs) and labour market rigidities and constraints have been addressed.

• There has been relative sectoral reallocation towards tradable goods and services.

Still, despite the huge efforts to avert default and redress imbalances, Greece remains under an adjustment programme, unlike Cyprus, Ireland and Portugal, which have already completed their respective programmes, although they entered these programmes later than Greece did.

This lagging behind was due to several factors, including: lack of ownership of the necessary reforms and lack of commitment, by part of the political system, to correct past errors, the anti-bailout rhetoric, rivalry and failure to reach an understanding among political parties, and the various – small and large – vested interests that have resisted reform.

At the same time, however, the fact that our European partners have yet to deliver on their commitment to provide further debt relief, according to the Eurogroup decisions of November 2012, and the threat of default and euro area exit brandished against Greece by some of our partners whenever negotiations seemed to stall, even on account of technical matters, weighed heavily on market sentiment, further fuelling uncertainty and negatively affecting the economic climate in Greece.

In addition, delays in the implementation of privatisations and reforms, in particular in the public sector and the goods and services markets, postponed the beneficial effects on growth and employment, which only emerged in 2014, after six years of recession, with GDP growing by 0.7% in 2014 and showing positive year-on-year growth rates in the first two quarters of 2015.

However, GDP contracted by 1.7% year-on-year in the third quarter of 2015 and by 0.8% in the fourth quarter of 2015, driving the Greek economy to a slight recession of 0.2% for 2015 as a whole. Underlying this new downturn were political instability from the end of 2014 onwards, the protracted negotiations with our creditors and the rekindling of uncertainty in the first half of 2015, which triggered mass deposit outflows, the bank holiday and the imposition of capital controls (which succeeded in containing the deposit outflows, but had a negative impact on the financing of the economy), and 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 put to the test. However, the economy showed remarkable resilience, with the negative impact proving more moderate than initially expected in the summer of 2015 (a 2.3% decline in GDP according to the draft State Budget for 2016).

This resilience was associated with a number of factors, such as the gradual restoration of confidence after the agreement of 12 July 2015 that halted the adverse and uncertain course of the economy, the milder than expected impact on the economy from the imposition of capital controls thanks to their rapid relaxation, the buoyant tourism sector, the large drop in oil prices and the successful completion of the recapitalisation of Greek banks with strong private sector participation.

Although the contraction of economic activity was smaller than initially expected, several macroeconomic indicators so far provide a mixed picture. Specifically:

• Industrial production has been satisfactory since August 2015, rising by 0.7% in 2015, after falling by 1.9% in 2014. This trend was reversed recently, as industrial production fell by 2.4% year-on-year in February and by 4% in March 2016.

• The retail sales volume index fell by 1.5% in 2015, it declined by 1.7% in January 2016 and showed a sharp fall of 6.6% in February.

• According to data from the ERGANI information system of the Ministry of Labour, Social Security and Social Solidarity, net dependent employment flows in the private sector were positive (99,700 new jobs) in 2015, for the third consecutive year, marginally higher than in 2014. This development is fully consistent with the Labour Force Survey data of the Hellenic Statistical Authority (ELSTAT) for 2015, which point to a 3.7% rise in dependent employment and a respective decline in unemployment to 24.9% in 2015, from 26.5% in 2014. The positive picture of the labour market continued into the first four months of 2016, when, according to ERGANI data, net employment flows increased by 124,465, up by 16,078 jobs compared with one year earlier.

• Exports of goods and tourism receipts increased by 4.4% and 6.6% respectively in real terms during 2015. However, receipts from shipping services fell by 28.5% in 2015 in real terms, which is largely attributable to the capital controls. As a result, total real exports of goods and services declined by 3.3% in 2015, after increasing by 7.8% in 2014.

Meanwhile, the resilience of the Greek economy and the intensification of the fiscal effort through cuts in government expenditure and an increase in revenue (partly via one-off measures) in the second half of 2015 contributed to better than expected fiscal aggregates, as confirmed by the relevant Eurostat releases. Specifically, a general government primary surplus of 0.7% of GDP was achieved in 2015 (according to the economic adjustment programme definition), against a target for a primary deficit of 0.25% of GDP.

The gradual restoration of confidence and the easing of uncertainty are reflected in the evolution of several leading indicators of economic activity, which improved considerably between September 2015 and January 2016. The positive trend of leading indicators continued into the first four months of 2016, except for a weakening in February. For example:

• The economic sentiment indicator has been on the rise since September 2015, on the back of improvements in most business sub-indices. However, the consumer confidence indicator continues to decline, reflecting households' uncertainty about their future economic condition.

• Manufacturing PMI remained on an upward path between August 2015 and December 2015, when it exceeded the threshold of 50 (50.2), implying marginal expansion in manufacturing for the first time since August 2014. In February 2016 it fell below 50, but improved for two months in a row in March and April 2016. Meanwhile, the employment sub-index remained in positive territory, pointing to an improved outlook for manufacturing employment.

As a result of the July 2015 agreement, Greek government bond yields followed a downward path in the fourth quarter of 2015. However, the delays in the completion of the first review of the programme and turbulence in international capital markets reversed this trend in the first four months of 2016.

Developments in the banking system – liquidity

The aggravation of the economic climate and heightened uncertainty in the first half of 2015 led to mass deposit outflows, as well as a large increase in non-performing loans (NPLs). Against this background, a new recapitalisation of the banking system became necessary.

Banks' recapitalisation was successfully completed in December 2015 with strong private sector participation. The necessary additional funds for the two banks that did not fully cover their capital needs under the adverse scenario (about €5.4 billion) from private sources were drawn from the Hellenic Financial Stability Fund (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, Greek banks' reliance on Emergency Liquidity Assistance (ELA) has decreased, and the ELA ceiling has been lowered by more than €21 billion since July 2015, to stand at €69.1 billion today. The lower ELA ceiling reflects the improved liquidity situation of Greek banks amid easing uncertainty and the stabilisation of private sector deposit flows, the gradual restoration of their access to interbank funding against collateral not eligible for the Eurosystem's operations and their successful recapitalisation.

However, the stock of NPLs rose in 2015. Non-performing exposures (NPEs) came to 44.2% of total exposures by end-2015, up from 39.9% at end-2014. In order to strengthen the banking system and unlock resources that can be used to finance the economy, it is essential to tackle the bulk of NPLs within the next two to three years.

Effectively managing NPLs is key to the recovery of credit growth and to the restructuring of businesses and sectors in the real economy. The initiatives to be implemented in the next few months are expected to contribute to the restructuring and consolidation of the domestic banking sector. Specifically, it is necessary to step up efforts towards:

1. Establishing a secondary market for loans (both performing and non-performing) so as to bring in more stakeholders and enhance NPL management expertise,

2. Reforming the out-of-court debt settlement framework, to allow the rapid, effective and transparent settlement of arrears owed to private creditors and the public sector,

3. Enhancing infrastructures and capacities in the in the judicial system and

4. Addressing long-standing issues regarding the tax treatment of loan impairment charges, both for borrowers and lenders.

The Bank of Greece will adhere to its commitments, in particular regarding the modification of the Code of Conduct and the implementation of a framework for target-setting and monitoring the NPL management strategies of all Greek banks.

On their part, banks need to pursue a more active policy for NPL management, by promoting long-term solutions and multi-creditor workouts, as well as focusing on the restructuring of viable businesses. These lines of action, coupled with the economy's path out of the recession and back to growth, should bring about a stabilisation and, subsequently, a decline in the NPL ratio.

The outlook for 2016

The course of economic activity in 2016 crucially hinges on the successful completion of the first review of the programme and the implementation of the programme reforms.

So far, important progress has been made towards completing the first review. Specifically, a fiscal package of 3% of GDP until 2018 has been agreed upon, which will be instrumental to achieving a primary surplus of 3.5% of GDP in 2018. Two thirds of the programme measures have already been passed by Parliament, including the necessary social security reform and the income tax reform. The remaining measures, which include changes in indirect taxation and reform of the public sector wage grid, are expected to be enacted in the next few weeks.

The Eurogroup of 9 May took stock of the progress with the first review and the Eurogroup of 24 May is expected to make the final decisions on the review, the disbursement of the tranches and the methods of easing the burden of public debt.

Consequently, most of the distance to the completion of the review has been covered – as acknowledged by the European institutions. The establishment of a reliable contingency mechanism, which will be triggered in case of deviations, will increase the confidence of our partners and ensure the attainment of fiscal targets. This is expected to have a favourable impact on international markets' assessment of the prospects of the Greek economy and put in motion a virtuous circle signalling a definitive exit from the crisis.

The rate of change in real GDP is expected, at least in the first half of 2016, to remain in negative territory, mainly due to the adverse carry-over effect from 2015. According to the ELSTAT's flash estimates released today, GDP shrank by 1.3% year-on-year in the first quarter of 2016.

The necessary conditions for a gradual recovery of the economy in the second half of 2016 are a further improvement in confidence, an enhancement in the liquidity of the banking system and a further relaxation of capital controls. However, a deterioration of the refugee crisis could have negative repercussions on tourism and trade.

In more detail, household consumption expenditure is expected to decline in 2016, reflecting the increased tax burden. The recent data on the volume of retail sales are alarming, showing, as already mentioned, a 6.6% fall year-on-year in February. On the other hand, investment and exports are expected to pick up gradually and in line with the restoration of confidence and of credit flows to the economy.

The successful completion of the first review is crucial for the gradual recovery of the economy in the second half of 2016

The successful completion of the first review of the programme will definitely improve confidence and the recovery prospects of the economy in 2016. It is the key to the return of deposits to the banking system and will pave the way to: (i) the reinstatement of the waiver for Greek government bonds by the Eurosystem, which will enable Greek banks to obtain low-cost funding from the European Central Bank (ECB) and (ii) the inclusion of Greek government bonds in the ECB's quantitative easing (QE) programme. The reinstatement of the waiver and the ensuing cheaper refinancing of Greek banks, coupled with the inclusion of Greek government bonds in the ECB's QE programme, are expected to have a significant positive impact (potentially amounting to about €400-500 million) on banks' results over the next year. However, the indirect effects, such as the upgrading of the credit ratings of the Greek government and Greek banks, are expected to be much stronger.

Furthermore, the completion of the first review could lead to the implementation of the Eurosystem's commitment to pay Greece the profits from Greek government bond holdings excluded from the PSI. This commitment has been suspended due to the non-completion of the last review of the previous programme. The so-called ANFA/SMP revenue available to be released, in the order of €10 billion up to 2020, could play a decisive role in the financing of the Greek economy and in the reduction of public debt.

All the above, following the successful recapitalisation of banks and coupled with a more effective management of NPLs, will contribute to a further decline in borrowing costs and will increase Greek credit institutions' lending capacity, with a beneficial effect on the financing and, by implication, growth of the Greek economy.

The successful completion of the first review should also be accompanied by the launch of substantive discussions with our partners on debt relief measures. Such measures could include longer bond maturities and grace period for principal and interest payments, so that the government's financing needs remain at manageable levels. For example, deferred interest payments to the European Financial Stability Facility (EFSF) are scheduled to start from 2022 onwards. As a result, interest payments on a cash basis are expected to rise to 6% of GDP, from 2% of GDP in 2015-2021, given that public debt will then have to be refinanced at market rates after the completion of the programme in 2018.

We, at the Bank of Greece, believe that the discussion on debt relief measures should include a downward revision of the ultimate fiscal target. Namely, lowering the ultimate target for a general government primary surplus from 3.5% of GDP in 2018 and beyond to 2% of GDP should be considered, in order to bring forward the return of the Greek economy to sustainable and relatively high growth rates. Besides, experience shows that only one country, i.e. Ireland, has managed to maintain a primary surplus of 3.5% of GDP for a relatively long time period, as required of Greece from 2018 onwards.

According to the scenarios we have elaborated, a primary surplus of 2.0% of GDP from 2018 onwards, coupled with a smoothing out of future interest payments on loans from the EFSF, the European Stability Mechanism (ESM) and the Greek Loan Facility (GLF, i.e. the bilateral loans granted under the first programme) over a period of 20 years, and an extension of the maturities of the EFSF and GLF loans over a period of about 22 years, would:

• Bring about a significant reduction in interest payments (by about 2.8% of GDP),

• Reduce the government's annual financing needs to manageable levels, i.e. well below 15% of GDP, which is the IMF's ceiling in the assessment of public debt sustainability, and

• Reduce debt-to-GDP ratio to below 100% in 2030 and to 89% in 2035 (compared with 126% without debt relief measures).

In other words, these actions to restructure public debt, coupled with (a) a more effective and better-targeted policy for privatisations and for the utilisation of public real estate, (b) a reform effort focusing on opening up those goods and services markets that have not been fully liberalised yet and (c) a more aggressive management of the problem of NPLs by both banks and the Greek government, could directly lead to public debt sustainability, with the ensuing possibility of lowering significantly the ultimate fiscal target. This would be achieved, on the one hand, because these actions would reduce public debt servicing costs, thereby unlocking resources to stimulate the real economy, and, on the other, because privatisations would reduce the level of debt, while the speeding up of reforms and the effective tackling of NPLs would strengthen GDP growth.

At the same time, initiatives to restore the sustainability of public debt within this year would lower the risk premium of the Greek economy and reduce the cost of capital, enhancing the credibility and acceptance of the policies pursued, which would improve confidence, with multiple positive effects: new domestic and foreign investment, return of deposits to the banking system and reinvigoration of economic recovery.

Key conditions for a new, extrovert growth model

In addition to lowering the ultimate fiscal target, for the reasons explained above, and restructuring the high public debt with a view to ensuring its long-term sustainability, what is needed today is the timely implementation of privatisations and reforms under the new programme, which are the cornerstone for the return to economic and financial normality and the shift to a new, extrovert and viable growth model.

The implementation of reforms in the goods and services markets and the public sector will lead to higher investment and employment and is also expected to facilitate innovation and the introduction of new technologies through stronger competition. This will improve the quality of Greek exports, while helping to broaden the export base and improve total factor productivity of the Greek economy. In turn, this will make the reduction in the external deficit sustainable and increase potential output over the medium to long term.

As already mentioned, together with the implementation of the necessary reforms, utilising the public real estate and pressing ahead with privatisations are the strongest tools not only for boosting investment and achieving sustainable growth, but also for supporting the fiscal adjustment effort, as they would help reduce public debt.

Tackling the high stock of NPLs is the most important challenge for the banking system. Addressing this problem will not only alleviate the burden on cooperating borrowers, but will also allow banks to free up funds for lending to the more dynamic and extrovert businesses, thus supporting the shift towards tradable goods and services, which would lead to higher total factor productivity and potential growth, even over the short term.

Alongside the necessary reforms, there is a need for active employment policies and training programmes in order to address high long-term unemployment, which leads to marginalisation of parts of the population and loss of human capital. Moreover, social policies need to be redesigned and better targeted, in order to tackle the increased risk of poverty and social exclusion of social groups harder hit by the crisis.

As mentioned at the beginning, the restructuring of the Greek economy towards a new, extrovert growth model, based on tradables and a higher share of exports in GDP, is already underway.

In more detail, the relative prices of tradable goods and services have risen by about 7% in the 2010-2014 period, making their production more profitable. As a result, the share of tradables in the private economy has risen in recent years. For example, in gross value added terms, the relative size of tradable sectors has grown by approximately 18% in the 2010-2014 period, while in employment terms it has grown by around 8%. Structural changes and improved financing and liquidity in the economy are expected to speed up the restructuring of the economy in favour of tradables.

Moreover, thanks to the reforms implemented since 2010, the competitiveness losses (in terms of unit labour costs) of the 2000-2009 period vis-à-vis Greece’s main trading partners were fully recouped in 2015. As a result, the current account deficit fell substantially from its 2008 peak, to almost zero in 2015 (-0.1% of GDP).

Despite the recouping of losses in international competitiveness, exports have yet to record the anticipated upward dynamics. This can in part be explained by the lack of financing, comparatively higher long-term borrowing costs, as well as the higher tax burden, which slows or even halts progress towards restoring overall competitiveness. However, it is also due in part to a number of inherent structural weaknesses that hamper the international market penetration of Greek products and involve non-cost aspects such as product quality, protected designation of origin and branding, red tape, etc.

Nevertheless, the improvement in cost competitiveness in Greece in recent years provides considerable room for higher exports in the near future. However, new investment will be needed in order to strengthen the export base of extrovert firms. The further opening-up of international trade, the participation in global value chains and the closer trade links with countries and businesses with cutting-edge technology internationally will enable the adoption of new technologies by export firms and their diffusion across the Greek economy, strengthening its long-term growth prospects.

Conclusions

The Greek economy has the potential and prospects of returning to growth, relying on a new, extrovert growth model and taking advantage of the emerging opportunities. The successful completion of the first review of the new programme after Greece's strong commitments, which is expected to be decided by the Eurogroup of 24 May, will contribute decisively in this direction.

The Eurogroup should in turn live up to the circumstances and deliver on its own commitment, dating back to November 2012 and repeated twice since, to implement actions that will make public debt sustainable and the government's annual financing needs manageable. The markets seem to have already started to price this in, as reflected in the narrowing in Greek government bond spreads.

The Bank of Greece considers that the return of the Greek economy to sustainable and high growth rates will be supported by a lowering of the ultimate fiscal target from a general government primary surplus of 3.5% of GDP in 2018 and beyond to 2% of GDP, without compromising the sustainability prospects of public debt.

At the current juncture, it is necessary to implement the privatisations and reforms included in the new programme, with a view to boosting growth. As already mentioned, we should draw on the experience of the other three Member States that have also been under adjustment programmes. These Member States entered the adjustment programmes later than Greece, but managed to exit them before us and, in some cases, their economy is growing impressively. For example, according to the recent spring forecasts of the European Commission, the Irish economy grew by 7.8% in 2015 and is projected to grow by 4.9% in 2016, while Portugal and Cyprus posted moderate but positive growth rates (1.5% and 1.6% respectively) in 2015 and are expected to remain in positive territory also in 2016 (1.5% and 1.7% respectively).

The Greek authorities, following the enactment of the required fiscal measures and the expected completion of the first review at the Eurogroup of 24 May, should promptly shift their focus to implementing the reforms in goods and services markets, taking action to tackle the problem of banks' NPEs and giving new impetus to the privatisation programme. Such actions will have a positive effect on international markets' assessment of Greece's prospects and put in motion a virtuous circle, signalling a definitive exit from the crisis.

Today, there are big opportunities for Greece that should not be missed. To give one example, China, in an effort to rebalance its growth model, wants to invest abroad. One of the countries it wishes to invest in is Greece. I do not only mean investment in infrastructures and networks, but also in other sectors of the economy, such as industry and finance. To exploit these opportunities, we must appropriately adjust our growth strategy and adopt an extrovert growth model relying, among other things, on privatisations and the utilisation of public real estate, with a view to making Greece a growth hub in the broader region. And, above all, we must have the will to attract foreign investment and not to miss once again the opportunities opening up before us.