Yannis Stournaras: Greece and the eurozone at a crossroads

Speech by Mr Yannis Stournaras, Governor of the Bank of Greece, at an event organized by the Young Presidents' Organization, Athens, 23 September 2016.

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It is a great pleasure to be here today and have the chance to share with you my thoughts on the policy steps that Greece and the euro area should take in order to address crisis legacies and to ensure the long-term prosperity of our people.

1. Brief overview of the Greek and euro area crisis

The euro area crisis can be regarded as a current account crisis. Before 2008, capital flows from euro area core countries were invested in non-tradable sectors (public consumption and residential sector) in the periphery. The increase in domestic spending, whether public or private, caused upward pressures on wages and prices harming competitiveness and export performance and further worsening the current account of peripheral countries. Over time, stock imbalances accumulated with private and/or public sectors becoming over-leveraged. The fallout from the international financial crisis of 2008 was a sudden stop in inflows to the periphery, triggering a sovereign debt crisis in Greece and banking crises in Spain and Ireland as property markets collapsed. In Greece, the sovereign crisis weakened banks, resulting in increased financial fragility and a banking crisis. In Ireland, and to a lesser extent Spain, the banking crisis weakened the sovereign.

As banks and sovereigns lost market access, private sector capital was replaced by official sector financing, accompanied by strict adjustment programmes to correct the flow imbalances – the current account and fiscal deficits. For Greece, at least, the consequences were severe – a fall in GDP of over 25% and a sharp rise in unemployment. This deterioration in the macroeconomic environment caused debt servicing problems in households and companies with the consequence that non-performing loans (NPLs) rose, weakening the asset quality of banks. Similar, if less severe, consequences were observed in the rest of the periphery.

Hence, the root causes of the euro area crisis and the delayed and interrupted recovery reflect failures in the area of what we call today macroprudential supervision, government failures, especially on the fiscal front, and several structural weaknesses at the level of individual Member States, as well as in the design of the Economic and Monetary Union (EMU). Many analysts have said that if in the pre-crisis period we had the instruments of macroprudential supervision that we have today, then the crisis would, most likely, not have occurred. Structural weaknesses include, among others, the excessive reliance on bank credit in the euro area which, due to a weakened banking system because of the crisis, has delayed recovery. At the same time, labour and product market rigidities in euro area countries, as well as institutional deficiencies in the management and resolution of NPLs (e.g. lengthy judicial procedures, inadequate insolvency laws) delayed the much needed adjustment.

There were also deficiencies in the initial design of the monetary union. First, the Stability and Growth Path (SGP) failed to avert the burgeoning public debt in the pre-crisis period. Second, there was no monitoring and control over macroeconomic imbalances and the evolution of private debt. Finally, at the outbreak of the Greek crisis in 2010, euro area crisis management and resolution tools were poor or non-existent on account of concerns over moral hazard, and due to the lack of an appropriate institutional setting. There was no provision for risk-sharing in the setup of the EMU.

2. Policy steps taken by the Greek and euro area authorities

In recent years, both Greece and the euro area have gone a long way towards addressing the causes of the crisis, while the ECB has taken decisive action to maintain price and financial stability and support economic recovery in the euro area.

2.1 Greece: economic adjustment over the past six years

The economic adjustment programmes implemented in Greece since 2010 have succeeded in eliminating the major macroeconomic and fiscal imbalances, in spite of delays and missteps. In more detail:

- The high primary deficit, which in 2009 was above 10% of GDP, has turned into a surplus.
- The external deficit, the loss of competitiveness and labour market rigidities and constraints have been addressed through structural reforms in labour and product markets as well as in public administration.

In addition, there has been a sectoral reallocation towards tradable goods and services. Moreover, bank recapitalization and considerable consolidation have been implemented amid difficult conditions, while various policy steps to address non-performing exposures (NPEs) have been taken.

2.2 The euro area: steps taken to strengthen the governance of the EMU and to address the crisis

After the ad hoc Greek Loan Facility that financed the first Greek bailout programme, the euro area set up the European Financial Stability Facility (EFSF) to provide financial assistance to distressed Member States. The EFSF was replaced by the more powerful European Stability Mechanism (ESM) in October 2012.

In response to the strong negative feedback loops between banks and sovereigns as well as contagion among national financial markets, European leaders, in 2012, initiated the Banking Union. Its three pillars are: the Single Supervisory Mechanism, the Single Resolution Mechanism and the still-to-be completed common Deposit Insurance Scheme.

Significant progress has also been made as regards fiscal and economic surveillance. The Stability and Growth Pact (SGP) was substantially strengthened by the adoption of the so-called “Six Pack”, and surveillance and coordination were enhanced through the so–called “Two Pack”. The European Semester, the Macroeconomic Imbalance Procedure and the Country Specific Recommendations contributed to stronger macroeconomic surveillance.

Last but not least, the ECB has been addressing the severe and persistent disinflationary forces in the euro area economy with a broad set of non-standard measures. To a great extent, these measures have helped to improve financial conditions and boost the recovery in the euro area. Macroprudential policy tools are also now available to secure financial stability.

3. The way forward

Current forecasts point to gradual recovery in both Greece and the euro area. However, the recovery faces several headwinds, relating both to political risks linked to the rise of populism and anti-EU rhetoric, the refugee crisis, Brexit and the crisis legacy, namely high unemployment, high public and private debt.

In view of these risks and challenges, the way forward should involve structural reforms in order to improve the growth potential and to make Greece and the euro area more resilient to future shocks, as well as greater economic policy coordination, convergence and risk-sharing inside the EMU.

3.1 Improve the growth outlook and make Greece and the euro area more resilient to

future shocks

As noted in the Five Presidents' Report, euro area economies should be able to absorb shocks internally. Building such a capacity implies removing rigidities in the labour, product and capital markets, so that the relative price adjustment mechanism can work in a flexible and timely manner (in the absence of exchange rate adjustment) and for resources to be re-distributed rapidly to their most productive uses.

Structural reforms in the labour and product markets, as well as improvements in the business environment and the functioning of the public sector will attract private investment, increase employment, productivity, and long-term growth, and will ensure more resilience to future adverse shocks.

Furthermore, some of these structural reforms (for example cutting red tape) will raise expectations of future income, and thus boost confidence and demand in the short term, supporting the recovery. In addition, policies that raise labour force participation and reduce structural unemployment are essential in order to boost future growth and employment.

In Greece, the unwavering implementation of the structural reforms described in the new ESM programme is a prerequisite for economic recovery. Structural reforms are expected to encourage innovation and the introduction of new technologies by increasing competition in various sectors and attracting new investment, both domestic and foreign.

These developments will improve the quality of Greek exports, expand the export base and strengthen the non-price competitiveness of the economy. In this way, the elimination of the current account deficit that has occurred over the last six years will prove sustainable and potential output will rise in the medium to long term.

In addition, putting idle public property to good use and speeding up privatisation processes are strong tools not only to boost investment activity and foster sustainable growth, but also to support fiscal adjustment, insofar as they reduce public debt. The Greek State, for historical reasons, owns real estate, the development of which could attract investment and reduce public debt. This is an opportunity, which has not been exploited yet, but necessitates appropriate legislation for land use.

Alongside structural reforms, and in order to facilitate the current euro area recovery through a stronger pick-up in lending, it is urgently needed to address the private debt overhang problem. On the one hand, the high stock of NPLs reduces bank profitability and thus constrains the supply of credit, which primarily affects bank dependent SMEs. On the other hand, high NPLs delay corporate restructuring and thus thwart the ability of viable firms to finance new investment projects.

Tackling the high stock of non-performing loans is the greatest challenge facing the Greek banking system and the Greek economy. Greece has the second highest NPE ratio in Europe (after Cyprus), with non-performing exposures at the end of the first half of 2016 reaching 45% of total exposures or €108.7 billion.

A number of initiatives are underway with the goal of setting up an accelerated and efficient framework of private debt resolution. These initiatives, amongst others, include: (a) the recently voted amendment of Law 4354/2015, which paves the way for the development of a secondary market for non-performing loans; (b) the establishment of an enhanced framework for out-of-court workouts and the pre-bankruptcy procedures; (c) the elimination of a series of tax obstacles both for borrowers and lenders; (d) the recently revised Code of Conduct for Banks for the transparent, effective and, where appropriate, flexible treatment of cooperating borrowers facing difficulties in servicing their debt obligations; (e) amendments to legislation to ensure the cooperation of old shareholders in the restructuring of the underlying businesses; (f) the launch of a comprehensive monitoring framework in relation to banks' non-performing exposure resolution activities, and, finally, (g) a series of targets and key performance indicators that aim at reducing overall non-performing exposures by 40% by the end of 2019.

3.2 Reforms in the institutional setting of the EMU to improve economic policy coordination, convergence and risk sharing

The adjustment mechanism within the EMU should be facilitated by ensuring that it works both for countries with sustained external deficits and for those with sustained external surpluses. To this end, the Macroeconomic Imbalance Procedure should be strengthened and foster reforms in countries that have been accumulating large and sustained current account surpluses. Crisis stricken countries have improved their external positions on account of both higher exports driven by structural reforms and lower imports due to the economic recession. By contrast, countries that had high pre-crisis current account surpluses have not contributed to the much needed rebalancing due to insufficient domestic demand and low growth potential.

Risk-sharing in the EMU should be enhanced along the lines proposed in the Five Presidents' Report. Private risk-sharing can take place through actions that lead to a true financial union with fully integrated financial and capital markets. These involve completing the Banking Union, by creating a common Deposit Insurance Scheme and by setting up a credible common fiscal backstop to the Single Resolution Fund that underlies the Single Resolution Mechanism. Such steps are necessary to improve confidence in the banking system and break the bank-sovereign feedback loop.

A genuine Capital Markets Union can be promoted through legislative changes that impose harmonization towards best practices on securitization, accounting, insolvency and corporate law, property rights etc. Such changes will allow for deeper integration of bond and equity markets and will ensure that companies (and in particular SMEs) can gain access to capital markets on top of bank funding. The Capital Markets Union will enhance cross-border investment and consequently strengthen private sector risk-sharing across countries, as returns on assets and access to credit become less correlated with domestic economic conditions in each Member State.

Besides enhancing the channels of private risk-sharing, a fiscal stabilization tool to cushion large macroeconomic shocks i.e., public risk-sharing, is warranted in the euro area as a whole. Such a tool would provide essential insurance to asymmetric shocks, while, in case of symmetric shocks, it would complement the single monetary policy, in particular, when the policy rates are at the zero lower bound.

Whilst there appears little appetite at present for full fiscal union, there are alternative ways to go ahead as proposed both by policy makers and academics. For example, building on the European Fund for Strategic Investments (Juncker's Plan) and as proposed in the Five President's Report, a common pool of EU funds for financing EU wide investment projects could provide the impetus for closer integration in the future. These EU funds could possibly come from Eurobonds issued by the ESM. Alternative options involve a common unemployment insurance scheme, financed through social insurance contributions, or an all-purpose "rainy day" fund financed by annual contributions of Member States in good times.

To avoid moral hazard, public risk sharing has to go hand-in-hand with greater coordination of economic policies and could be linked to the implementation of country specific recommendations and structural reforms, as well as sound and responsible fiscal policies in compliance with the existing EU rules.

4. Conclusions and final remarks

Concluding, I would like to emphasize that indeed both Greece and the euro area are at a crossroads, as they face several challenges and risks ahead. Some of the challenges are of a political nature, related to populistic and anti-EU views driven by the refugee surge, while others are related to the euro-area crisis legacies. Significant progress has been achieved in recent years both in Greece and the euro area, while the accommodative monetary policy is supporting the recovery.

However, further action is imperative, aiming at stepping up structural reform efforts and incentivizing investment, in order to sustain the recovery and boost medium to long-term growth and employment.

As regards Greece, the gradual relaxation of capital controls, along with improvements in confidence and liquidity, are expected to contribute to the normalisation of economic and financial conditions. In addition, the commitment of our European partners to take action, in order to ensure the sustainability of public debt in the short and medium-to-long term, is a positive step forward. However, the envisaged public debt management measures need to be specified, quantified and frontloaded. This would enhance the credibility and acceptance of the policies pursued, thereby helping to further consolidate the climate of confidence and strengthen economic recovery.

In this context, a lowering of the medium-term fiscal target from a primary surplus of 3.5% of GDP from 2018 onwards, to 2% of GDP, without affecting public debt sustainability prospects is feasible, if coupled by mild debt relief measures. Such fiscal relaxation would have beneficial effects for the Greek economy, as it would allow taxation to be lowered, freeing up resources for supporting economic activity, while making fiscal targets economically and socially feasible.

The actions described above will attract foreign direct investment and set in motion a virtuous circle signaling the exit from recession and a gradual recovery of the economy.

The completion of the EMU along the lines of the Five Presidents' Report, by allowing more economic policy coordination and greater private and public risk sharing, is a prerequisite for its long-term viability and the long-term prosperity of its Member States.

Last but not least, the euro area along with other areas of the world should confront certain of the undesirable consequences of globalization and technical progress. The failure to tackle unemployment, reduction of wages, worsening income distribution and tax evasion – mostly related to uncontrolled offshore activities – give rise to what we call failure of elites and worldwide populism.

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