Nicholas C Garganas: The Greek economy – developments, prospects and economic policy challenges

Speech by Mr Nicholas C Garganas, Governor of the Bank of Greece, at the presentation of the Bank of Greece Annual Report to the Annual General Meeting of Shareholders, Athens, 22 April 2008.

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The main features of economic developments and prospects

The main features of economic developments during 2007 were the international financial turmoil and the rise in food and oil prices. These phenomena marked the second half of 2007 and have continued into 2008, leading to an intensification of inflationary pressures and a slowdown of economic activity.

These events in the international economy have, not surprisingly, adversely affected inflation and the rate of growth of the Greek economy. The annual growth rate of GDP showed a significant deceleration during the second half of 2007. Lower growth is also expected to be a feature of 2008. High uncertainty internationally increases the downside risks to growth. At the same time, inflation has accelerated in recent months, reflecting mainly increased imported inflation and, to a smaller degree, higher production costs.

The consequences of the international financial turmoil for the Greek banking system during 2007 were limited and, largely, indirect. Greek banks continued to have healthy profits and satisfactory capital adequacy ratios in 2007. Nonetheless, there is little room for complacency. Continued turmoil in international financial markets, the fast pace of domestic credit growth and the increasing penetration of Greek banks into new markets in Southeastern Europe all contribute to raising banks' risks. Hence, managing these risks effectively is of the essence.

Macroeconomic imbalances continue to pose a problem for the Greek economy. The current account deficit widened further in 2007 and reached a very high level as a percentage of GDP, as domestic savings (which are relatively low) fell well short of domestic investment (which is relatively high). Whilst the general government deficit remained for the second year in a row below 3% of GDP, imbalances remain high, as reflected in the debt-to-GDP ratio.

If the negative consequences of the continuing crisis in international financial markets are to be minimised, efforts to make the Greek economy more resilient to external shocks have to be stepped up. This highlights the importance of continuing fiscal consolidation and efforts to raise national savings, increase productivity growth and contain production costs, in order to improve the international competitiveness of the economy.

The international and European economic environment

The international financial turmoil had its origins in the sub-prime mortgage market in the United States. Rising delinquencies in that market disrupted various segments of the money markets, in particular the asset-backed commercial paper market. The drying up of liquidity in that market caused large losses and asset write-downs by a number of financial institutions which had significant exposures to complex structured finance products whose valuation was now very uncertain. More generally, international financial institutions are still reducing their leverage and the outlook for the international financial system continues to be uncertain. The process of significant market correction is still ongoing and has triggered a deep and candid review of practices, rules and procedures that influence the functioning of international financial markets and the behaviour of market participants.

Whilst the world economy continued to grow at a high rate in 2007, the fallout from this turmoil is expected to cause growth to slow to 3.7% in 2008, according to IMF forecasts, from 4.9% in 2007. This slowdown is also expected to affect the euro area, where growth – according to the ECB staff projections made at the beginning of March – is expected to be between 1.3% and 2.1% in 2008, compared with 2.6% in 2007. The risks to growth are clearly on the downside internationally. Aside from the fact that financial turbulence has been spreading to other markets, uncertainty remains high. Rapid economic growth in recent years has been accompanied by a build-up of global imbalances, as low US interest rates encouraged high consumer spending and lax lending standards. The problems in the sub-prime market could be interpreted as merely a manifestation of the deeper problems of the world economy, which might jeopardise growth prospects over the medium term.

At the same time, inflation has been accelerating, as oil and food prices rose sharply again in the first quarter of this year. Inflation in the euro area hit 3.6% in March and is expected to remain high in the coming months, falling back gradually later in the year.

Macroeconomic developments in Greece in 2007 and the outlook for 2008

Economic activity

These international developments had a limited impact on the Greek economy in 2007. The rate of growth was 4.0% in 2007, down slightly from 4.2% in 2006. Thus, the Greek economy continued to grow significantly faster than the euro area as a whole in 2007, with growth driven mainly, as in previous years, by the increase in domestic demand (both private consumption and investment); however, growth decelerated in the second half of 2007. According to Bank of Greece projections compiled at the beginning of the year and published in February, GDP growth was expected to be around 3.7% this year. However, the growth rate of the Greek economy will probably be lower, to the extent that the slowdown in world growth and external demand is sharper than initially assumed, rises in oil and food prices steeper and financing costs higher. That having been said, it is still expected that growth will be higher than in the euro area as a whole.

Employment and unemployment

The increase in economic activity in 2007 was accompanied by employment growth of 1.3% and a reduction in the rate of unemployment by around half a percentage point to 8.3%. Nonetheless, it seems that the Greek economy is still characterised by a smaller capacity to create jobs compared with other countries in the euro area. This can be attributed to the continuing restructuring of the Greek economy (most notably, the decline in agriculture and the ensuing heavy job losses), labour market rigidities (e.g. lower use of part-time employment), as well as some mismatches between supply and demand in the labour market. Because of these factors, employment rates, especially for women, remain much lower than the EU-15 average.

Inflation and international price competitiveness

Average inflation in 2007 fell to 3.0%, mainly as a result of oil price developments, which were later reversed, as well as a slowing of the annual increase in processed food prices (until September). However, inflation picked up significantly in the last quarter of 2007 and the first quarter of 2008, reaching 4.4% in March of this year. It is expected that inflation will remain at high levels in the coming months, mainly because of the sharp increase in imported inflation, but will gradually decline thereafter. According to Bank of Greece projections compiled at the beginning of the year and published in February, average annual inflation in 2008 was expected to be 3.4%. However, certain risks then highlighted now seem to have materialised, mainly as regards developments in oil prices internationally and unit labour costs domestically; hence, average inflation will be higher than initially projected and is expected to be around 4%. There are significant elements of uncertainty surrounding these projections as regards international developments; the outcome of wage negotiations will also be of particular importance. It is worth noting that the new National Collective Labour Agreement provides for average annual increases in minimum wages of 6.2% in 2008 and 5.7% in 2009, higher than under the previous two-year agreement (6.2% for 2006 and 5.4% for 2007). Therefore, the rise envisaged for this year is higher than the one in 2007.

Inflation in Greece remains significantly higher than in the euro area as a whole; as a result, the price competitiveness of the Greek economy continues to deteriorate. The persistent positive inflation differential can be attributed to both macroeconomic factors, related to developments in aggregate demand and production costs, and the fact that certain markets do not operate efficiently due to unsatisfactory conditions of competition.

External balance

Deteriorating price competitiveness and low structural competitiveness are two factors explaining the continuing increase in the current account deficit (from 11.1% of GDP in 2006 to 14.1% in 2007). In addition, high rates of growth of private consumption, which is the counterpart to low savings, have also contributed to the high and widening current account deficit. The impact of high trade deficits on the net foreign debt of the Greek economy is reflected in increased net interest payments, which act to further increase the current account deficit. Prospects for reducing the deficit are not particularly favourable and it is expected that in 2008 it will remain almost unchanged as a percentage of GDP, if not increase.

Fiscal developments and prospects

As regards fiscal aggregates, the general government deficit reached 2.8% of GDP in 2007, compared with 2.6% in 2006, mainly as a result of one-off factors. The consolidated general government debt fell only slightly from 95.3% to 94.5% of GDP and remains the second highest among the EU-27 countries.

The Updated Stability and Growth Programme for the period 2007-2010 envisages a fiscal tightening in 2008, with the general government deficit projected to fall to 1.6% of GDP and debt to 91%. Nonetheless, the pace of debt reduction remains slow, especially in the context of the expected increases in expenditure in the coming years as a consequence of population ageing.

Monetary policy, interest rates and credit expansion

In the euro area, the risks to the short-term inflation outlook are on the upside; the latest data on macroeconomic aggregates point to ongoing but moderating real GDP growth; uncertainty due to the financial turmoil remains high. In the light of these developments, the European Central Bank has kept its key interest rates unchanged since June 2007. In its last meeting on 10 April 2008, the Governing Council of the ECB confirmed, on the basis of an analysis of the latest data, its assessment of prevailing upside risks to price stability over the medium term. As price stability is the ECB’s primary objective according to its mandate, the Governing Council judged that stabilising medium- and long-term inflation expectations is its highest priority; hence, it kept the interest rates unchanged. Thus, the minimum bid rate on the main refinancing operations remains at 4%. The Governing Council also underlined that the current monetary policy stance will help achieve this objective and reiterated its strong commitment to preventing the materialisation of upside risks to price stability over the medium term.

The hikes in the minimum bid rate on the main refinancing operations of the ECB, along with higher money market rates, had an upward effect on interest rates on both deposits and loans in Greece (although their rise was, in general, smaller than in the euro area as a whole). However, whilst the rate of growth of the overall financing of the economy slowed during 2007, it remained at the relatively high level of 13.1% in the fourth quarter. This reflects the high rate of financing of the private sector (both firms and households), while the rate of financing of the government sector was negative throughout 2007. These figures suggest that the international financial turmoil had no impact on the supply of bank financing to the domestic private sector until the end of 2007.

Stability of the banking system

In spite of the continuing international financial turmoil, the stability of the Greek banking system has remained high, supported by – *inter alia* – satisfactory levels of profitability and capital adequacy. Greek banking groups' capital adequacy ratio, which stood at 11.2% at end-2007, continues to provide satisfactory leeway for ensuring the stability of the banking system. Greek banks had very little exposure to instruments associated with the US sub-prime mortgage market and this largely explains the fact that the impact from the international turbulence was limited and indirect.

Nonetheless, one should not lose sight of the fact that the current turmoil in the international financial system has acquired a dynamic driven by self-feeding and interdependent risks. Therefore, its impact does not regard only the degree of individual banks' direct exposure, but also the risk that the turmoil may take on a more systemic character. At the same time, competition in the domestic Greek banking market is becoming more intense and the cost of financing is increasing, leading to a small decline in net interest rate margins in 2007 over 2006 (at bank level). It is important that banks do not try to make up for this decline by further credit expansion, especially to borrowers of low credit quality. While the ratio of non-performing loans to total loans fell further to 4.5% at end-2007, from 5.4% at end-2006, it is still considerably higher than the EU average.

In the light of these developments, the points that the Bank of Greece has been stressing for some time have become even more relevant. In particular, banks need to further improve the quality of their loan portfolios by implementing stricter criteria when selecting borrowers. The implementation of the new supervisory framework ("Basel II") should help in this respect. Also, households must weigh carefully their ability to service a loan before resorting to lending.

Growth prospects, structural weaknesses and macroeconomic imbalances

The high levels of growth witnessed over the last 12 years have led to considerable progress in the real convergence of the Greek economy on the more advanced economies of the EU. However, Greece still lags behind in terms of levels of development and social welfare, as *per capita* GDP (in purchasing power parities) falls short of the EU-15 average by 11.6%, as a result of lower productivity (measured per hour of work) and lower employment rates. In addition, there are serious macroeconomic imbalances and structural weaknesses, which are reflected in relatively high inflation, a large current account deficit, which has pushed up Greece's external debt considerably, and high public debt. Finally, challenges such as population ageing, globalisation and, more immediately, a slowdown in world growth will make it difficult for such growth rates to be maintained in the future without more intense efforts to tackle the structural weaknesses of the economy.

The average growth rate of almost 4% achieved over the last 12 years was primarily driven by boosting domestic demand. Private sector consumption and investment were bolstered by the fall in interest rates following Greece's euro area entry, as well as by rapid credit growth. Relatively high fiscal deficits, although declining in recent years, also helped to boost aggregate demand, but at the same time contributed to a further accumulation of public sector debt. Productive capacity, which has increased, has responded to the growth of demand, but not to a sufficient extent, thus resulting in an excess demand situation.

Demand-led growth has its own natural limits. Based as it is on the build-up of debt (both private and public) to finance consumption, ultimately an increasing proportion of GDP will have to be devoted to its repayment. As a consequence, only through a transformation of the economy into a more productive and outward-looking one will it be possible to maintain such high growth rates. Such a transformation should focus on three areas: first, continuing fiscal consolidation; second, adopting wage and pricing policies consistent with price stability; and third, promoting structural reforms to improve productivity and the supply conditions of the economy and to strengthen competition.

Correcting fiscal imbalances

The demands that population ageing will place on government expenditure make the need for continued fiscal consolidation even more pressing. In particular, a reduction in public debt by 2015 (when the effects of population ageing on government spending will be first felt) to 60% of GDP is of the essence. Hence, more intense efforts are needed, focused on both the revenue and the expenditure sides of the budget. It is not in the interests of the low competitiveness of the Greek economy to raise tax rates; there is, however, still room to reduce tax evasion as a means of raising revenue. However, crucial to achieving surpluses is the control of expenditure, in particular of certain categories such as personnel outlays, subsidies or guarantees for public sector companies, which account for a large part of government expenditure and have been growing very fast.

Wage increases, pricing policy and competition

Wage bargaining should take into account productivity developments, the implications of wage increases for price competitiveness, as well as the level of unemployment. The rise in oil prices inevitably represents a transfer of income from oil-importing to oil-exporting countries, which cannot be effectively offset by nominal wage increases, since these lead to higher inflation which erodes the purchasing power of domestic incomes. At the same time, competition should be strengthened in markets operating inefficiently, so that firms can contribute, through their pricing policies, to an evolution of prices which is compatible with production cost developments and with keeping profit margins at levels that do not undermine price stability and competitiveness.

Structural policies for increasing employment and improving productivity

Structural reforms must continue in order to improve productivity and the structural competitiveness of the Greek economy.

Increasing employment

Greece has lower employment rates and higher unemployment rates in comparison with the EU-15 averages. Demographic projections suggest that Greece will experience over the coming years a decline in the working-age population. Growth will therefore depend, in part, on raising employment rates by increasing the flexibility of labour markets, bringing into the labour market sections of the population with relatively low participation rates (especially women and older people) and continuously upgrading the skills of the labour force.

Improving productivity

Growth should also be based on bolstering labour productivity. Improving productivity requires first and foremost a modernisation of the business environment. Policies in a number of areas could help here.

The strengthening of competition in product markets can encourage innovation and the implementation of measures to reduce production costs. Competition can be encouraged by removing barriers to business start-ups and reducing the complexity of the regulatory environment surrounding firms.

Productivity levels in business also depend on the efficiency of public administration. It is commonly agreed that inefficient staff allocation and the operational framework of public administration do not meet the requirements of the Greek society and economy in an efficient manner, while reform proceeds at a relatively slow pace. In order to reap the full benefits of the introduction of information and communication technologies in public administration, training of personnel and upgrading administrative procedures are essential.

Creating the conditions in which economies of scale can be exploited is also important for improving productivity levels. In the past, the small scale of Greek enterprises severely hindered their ability to exploit economies of scale. However, globalisation and the opening up of markets in the region have weakened this constraint. Additionally, the creation of clusters of firms with similar activities can also help smaller companies benefit from economies of scale by cooperating in cost sharing, know-how transfer and specialisation of services and products.

A second area which can contribute considerably to raising productivity is that of infrastructure. Despite the progress made, there is ample room for improvements in the areas of both transport (land, sea and air) and network industries (energy, water and communications).

Finally, investment in both human and physical capital has an important role to play. With the opening up of new markets in the region, investment in physical capital has now become more attractive. Of equal importance is investment in human capital through education and vocational training. Whilst in Greece the percentage of 20-24 year olds who have finished at least high school education is higher than in the EU-15 countries (84.1%, compared with 76.4%), the results of the PISA exams designed by the OECD to test knowledge and skills showed Greek students performing much worse than students from the other EU-15 countries. At the same time, although technology is evolving rapidly, the percentage of companies in Greece offering on-the-job training for their employees is lower than in the EU-15, while the participation of the population in life-long training programmes is low. These observations suggest a need for closer cooperation between the education system, firms and research centres.

Since many of the interventions proposed can be financed by the Community Support Frameworks, they will not place an undue burden on public finances.

Conclusions

The best way to minimise the negative consequences for the Greek economy from the continued crisis in the international financial system, external inflationary pressures and the expected slowdown in the growth of world economic activity is to continue the efforts to improve the fundamentals of the economy.

The aforementioned policies will bear fruit in terms of further raising living standards. In the last 12 years, real *per capita* GDP has risen by a cumulative 51%. However, despite strong growth, 13% of employed persons, 25% of pensioners and 33% of unemployed persons are still below the poverty line. Moreover, in between households that have already benefited from growth and enjoy increasingly high incomes, on the one hand, and poor households, on the other hand, there is also a considerable number of households living on the verge of economic and social insecurity.

While the establishment of the National Fund for Social Cohesion is a positive step towards tackling poverty and inequality, in itself it is not enough. It is also necessary to implement policies for reducing unemployment, raising the percentage of skilled workers and facilitating labour market entry.

To conclude, therefore, if living standards are to continue rising and the problems of poverty and inequality are to be tackled, it is necessary to place much greater emphasis on productivity-driven growth. Demand-driven growth which is not accompanied by rising productivity has its own natural limits and cannot be expected to shelter the Greek economy from the impact of a possible slowdown in world growth and a rise in world inflation. By contrast, policies to improve productivity can better insulate the economy from external shocks and lay more solid foundations for higher living standards in the future.