

George Provopoulos: International financial turmoil and its impact on the Greek economy

Key remarks by Mr George Provopoulos, Governor of the Bank of Greece, at the meeting with the Presidency and Members of the Hellenic Federation of Enterprises, Athens, 14 July 2008.

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The international financial system

It will take some time until normality is fully restored...

1. The international financial turmoil, which began almost a year ago, is still ongoing and continues to affect financial markets and macroeconomic aggregates. **Extreme situations have been avoided**, thanks to the action taken by major central banks (in the form of fine-tuning operations to restore normal liquidity conditions) and by governments, in particular those of the United States and the United Kingdom, aimed at averting the risk of a broader systemic crisis.
2. **However, it remains uncertain how long it will take before credit markets return to normal conditions.** This continued uncertainty is reflected in, at times, strong tensions in money and credit markets (which are more sensitive to risk factors— whenever these appear) and in equity markets (where there are occasional swings of investors' risk aversion and, thus, liquidity preference, as well as of their uncertainty regarding the macroeconomic outlook of the United States or other countries).
3. Due to globalisation, uncertainty in the global economy also affected the Greek economy and the economies of the wider SE European region, although these economies have proved quite resilient.

Impact on the real economy:

Despite the slowdown, the economic fundamentals of the euro area are sound. Greece needs to intensify, rather than simply not relax, efforts to address structural weaknesses and macroeconomic imbalances...

1. The uncertainty surrounding the global economic outlook remains higher than usual. It seems that **the adverse effects of the financial turmoil on world economic activity will be stronger and more protracted than initially thought.** This is the case in particular with the US economy (where the housing crisis is serious and is spilling over to other sectors). Any prolongation or deepening of the economic slowdown in the United States could have repercussions on the euro area and thereby on the Greek economy.
2. I should clarify that by "uncertainty" I mean the possibility that downside risks to the growth projections made until recently could materialise. According to these projections made by international organisations, the growth rates of the global economy and of the European economy are slowing down, but growth is continuing, despite the fact that a small number of euro area countries recorded zero or negative GDP growth in the first or the second quarter of 2008.
3. According to available projections, while some downward revision during the next two months cannot be excluded, **growth rates should remain positive in 2008, of the order of 1.5-2.1% in the euro area and 3.4-3.5% in Greece.** In both cases, exports and domestic demand will remain the main drivers of growth, although their contribution to growth will be smaller than in 2007. However, **in spite of the shocks experienced during the last twelve months, the economic fundamentals of the euro area as a whole remain sound.**

4. As far as Greece is concerned, the adverse international environment makes it imperative to intensify, rather than simply not relax, efforts to address the macroeconomic imbalances and structural weaknesses which are reflected in:

- the large current account deficit;
- the still high public debt-to-GDP ratio;
- the persistent inflation differential vis-à-vis the euro area as a whole; and
- the unemployment rate, which despite its decline remains relatively high.

The increase in the world prices of oil and food commodities

This increase presents a major, but not unprecedented, challenge.

This time we have to deal with the challenge in a correct and, above all, timely manner, ensuring that it does not trigger a second round of endogenous, broadly-based inflationary pressures.

Targeted relief of economically weaker groups must be prioritised.

This will require a brave effort from all parties involved, enterprises and households alike, to adapt to the new conditions.

We must not repeat the painful mistakes of the past.

1. Adding to the credit-related macroeconomic uncertainties are those that arise from the possibility of further increases in the world prices of oil and other raw materials as well as food.

2. **All of us, i.e. policy makers and social partners, have a duty to make sure that the fundamentals of the Greek economy improve and that heightened macroeconomic risks do not materialise.** As our economy now faces the effects of exogenous and to some extent temporary shocks, it is of the utmost importance to ensure that the adverse effects of domestic factors – i.e. the macroeconomic imbalances and structural weaknesses that I mentioned earlier – on our medium-term prospects of output, employment and incomes are contained. **Should we fail, hard times for all of us will last longer, while most of the burden will be shouldered by the most vulnerable, economically weaker social groups.**

3. **Increases in the world prices of oil and other commodities (in particular food) are, for the countries importing these commodities, a type of compulsory levy or tax in favour of commodity-exporting countries.** In other words, it is an unavoidable transfer of income from the households and enterprises of commodity-importing countries to commodity-exporting countries. This transfer reflects a shift in relative prices at the global level. **Neither households nor enterprises can ever make up for this loss of income, therefore efforts to pass the cost on to each other only serve to ultimately aggravate the adverse consequences for all parties involved.** This is the lesson we have learnt from the oil shocks of the 1970s and from the ensuing adventures of countries that failed to recognise this hard reality in time.

4. **The mistakes made when we were facing the first two oil shocks (i.e. the relaxation, of fiscal, monetary and incomes policies in the 1970s and the 1980s) must not be repeated.** Let me recall, for those who have not experienced or have forgotten those episodes, that inflation (in Greece) had exceeded 33% by early 1974 and remained at double-digit levels throughout the next twenty years (until 1994). During that period, the fiscal deficit also reached double-digit levels as a percentage of GDP, and debt, which has been accumulating ever since, will take a long time before it can be repaid. Lending rates, which at the time of the first oil shock were administratively set, soared during the gradual interest rate liberalisation (1984-1993) to almost 30% (specifically, interest rates on short-term lending to businesses ranged between 27.5% and 29.5% in 1990-1994). These facts should be kept in mind when we decide on our actions and responses today.

5. **Priority should initially be given to alleviating the impact of the oil shock on the more vulnerable social strata. In Greece, this can and must be achieved through targeted interventions and in a manner that would not jeopardise fiscal prospects.** At the same time, business firms and households should realise that the irrecoverable losses of purchasing power entailed by higher oil and other commodity prices can be effectively offset in the long run only through policy interventions and initiatives, mainly by the government and by businesses, aimed at strengthening productivity and the forces of competition in all markets.

6. Of course, apart from the structural factors that determine the growth prospects of productivity and of real incomes, the establishment of conditions of price stability in the medium term can also make a crucial contribution. Actually, achieving and securing price stability over the medium term is the primary objective of the monetary policy conducted by the ECB, according to its Statute.

Monetary policy in the euro area

Monetary policy in the euro area will remain fully committed to the mandate, the institutional responsibilities and the primary objective entrusted to the ECB by the 320 million of European citizens.

Following the recent increase in the ECB interest rates, the rise in medium-term inflation expectations among credit market participants came to a halt.

Business firms and consumers can be assured that the ECB will not allow second-round inflationary pressures to threaten price stability in the medium term. The ECB does not make a pre-commitment on the future level of its interest rates. It takes into account a comprehensive set of information available at any given time and decides on the basis of its current assessment of prevailing risks to price stability over the medium term.

1. In an economic environment like the present one, **the only effective contribution that monetary policy can make to the cause of economic growth is through its firm commitment to the objective of price stability in the medium term.** I emphasise the words "in the medium term", given that monetary policy cannot offset the short-term fluctuations of inflation around its medium-term trend level which are due to exogenous factors such as developments in world prices of oil and other commodities.

2. **What monetary policy can and must do is ensure that inflation in the medium term remains consistent with promoting economic growth and job creation.** To ensure achievement of this goal, monetary policy must above all ensure that exogenous inflationary pressures do not trigger second-round effects, through firms' price-setting behaviour, wage agreements or other developments that anticipate a rise in inflation over the medium term. Such phenomena turn what is a temporary problem into a permanent one, aggravate short-term rises in inflation and strengthen medium-term inflation dynamics.

3. The Governing Council of the ECB decided the recent increase in interest rates for a dual purpose: first, to prevent broadly based second-round effects on inflation as those I just described; and second, to counteract the increasing upside risks to price stability over the medium term, evidenced by the facts summarised below:

- Between the autumn of last year and June 2008, inflation rates have risen significantly. June data showed clearly that inflation in the euro area as a whole would be above the medium-term target of 2% for a more protracted period than previously thought.
- Moreover, the continuation of vigorous money and credit growth and the absence thus far of significant constraints on bank loan supply in a context of ongoing financial market tensions confirm the assessment of upside risks to price stability over the medium term.

- At the same time, while the assessment is made that real GDP growth weakened over the first half of this year (despite satisfactory figures for the first quarter which reflected temporary factors), the economic fundamentals of the euro area remain sound.

4. In the first few days after the recent increase in the ECB interest rates, the signals coming from credit markets indicated that the upward trend of inflation expectations has come to a halt. Last week's indications were that expectations have started to decline. These are encouraging signs, which, however, should not lead to complacency. Indeed, headline inflation rates of around 4% in the euro area and 4.9% in Greece are disconcerting. According to recent surveys, both in Greece and in the euro area, citizens cite inflation as their number one problem and source of concern.

5. Let me assure you that the ECB, as it has always done, will stand ready to achieve its primary objective and fulfill the mandate entrusted to it by 320 million European citizens. That is, it will continue to take any action necessary to ensure the firm anchoring of inflation expectations at sufficiently low levels and to safeguard price stability over the medium term.