George A Provopoulos: The state and prospects of the Greek economy and economic policy challenges

Speech by Mr George A Provopoulos, Governor of the Bank of Greece, at the Annual Meeting of Shareholders of the Bank of Greece, Athens, 27 April 2010.

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The Greek economy is in the midst of a deep, structural and multi-faceted crisis. The exit from this crisis will therefore require a multi-annual, persistent and systematic effort. It will require a break with the past.

The main features of the crisis are the large fiscal deficit, the huge debt and the continuous erosion of the country's competitive position. These problems were already present prior to the global crisis of 2008 and it was inevitable that, in the absence of bold and decisive action, they would sooner or later lead to an impasse. As no such action was taken, the situation deteriorated. Meanwhile, the global crisis amplified the cumulated effects of the chronic weaknesses and accelerated the downturn of the economy. The outcome is the present situation, which is reflected in the twin deficits and twin debts, and in the close intertwining of the public deficit and debt with the external deficit and debt.

Today's crisis does not simply reflect a temporary cyclical downturn. Nor, of course, is it solely reflected in the public sector and in the worrisome competitiveness deficit. It concerns the entire economy, its structures, the mentality and patterns of behaviour that prevailed for years, the distorted growth model that we followed. This means that it is not possible to overcome the crisis by resorting to short-term remedies. On the contrary, what is needed is a persistent and systematic effort: an effort that is sustained, concerted and groundbreaking. Sustained, because changing the structures that have led us to where we are today will be an arduous task that cannot be easily achieved in the short term. Concerted, so that we can ensure a smooth aftermath, by minimising the shocks. Groundbreaking, because today's problems cannot be addressed if we keep on thinking the same way as we did when we created them. Overcoming the crisis will, in other words, require a break with the past.

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The Bank of Greece had issued timely warnings about the gravity of the situation, stressing in its reports that the macroeconomic imbalances would only become more severe as the global economic situation worsened. Clear warning was also given that the cost of borrowing was likely to rise. Moreover, the Bank stressed the need to send a clear message to the markets that Greece is determined to implement a multi-year plan of far-reaching fiscal consolidation and bold structural reforms.

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The developments that followed confirmed these dire warnings. The economy has entered a vicious circle and there is unprecedented uncertainty, which led to a series of downgradings in Greece's creditworthiness. These downgradings led to a large widening in spreads, resulting in an increase in the cost of government borrowing and debt servicing. This situation, to the extent that it persists, worsens Greece's fiscal position, makes fiscal consolidation even more difficult to achieve, seriously hurts the real economy and the banking system, and refuels the climate of uncertainty, thus exerting a general debilitating effect. The only way out is to restore confidence, by drastically reducing the deficit and the debt and by recovering the competitiveness that has been lost.

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The crisis of the Greek economy is unfolding in a global environment characterised by high uncertainty, in spite of the existing signs of recovery. The recovery of the world economy, proceeding so far at an unsteady step, on the one hand has been supported by accommodating monetary policies and on the other by expansionary fiscal policies; the latter, however, now increase the risks concerning the sustainability of public finances.

These risks in the advanced economies are compounded by: (a) the large increases in the fiscal deficits and the public debt; (b) the adverse demographic prospects due to population ageing; and (c) the assessment that a return of potential growth and employment to their pre-crisis levels should not be expected soon. Additional risks stem from the fact that public finances are exposed to shocks originating in the markets. The uncertainty about the timing and the intensity of "exit policies" from the fiscal stimulus measures leads to a widening in spreads of government bond yields. Therefore, the cost of financing the public debt is expected to rise, while growth rates will be lower than prior to the crisis. The wider the gap between the interest rate on the public debt and the growth rate, the larger the fiscal adjustment needed to halt the upward trend in the public debt-to-GDP ratio. This is why structural reforms are needed in order to boost potential growth. It goes without saying that these remarks apply a fortiori to Greece.

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The crisis that the Greek economy is currently experiencing is reflected in the sharp weakening of economic fundamentals and in the deterioration of the economic outlook.

1. What triggered the particularly adverse developments was the derailing of fiscal aggregates: in 2008 and 2009 the situation deteriorated and in 2009 the deficit, as the Bank of Greece had warned in time, widened to a double-digit percentage of GDP. According to the latest revised data, the deficit in 2009 reached 13.6% of GDP.

2. The public debt increased to 115.1% of GDP, the highest ratio in the euro area, following that of Italy. According to projections based on plausible assumptions, the debt-to-GDP ratio will continue to rise and will tend to stabilise only in 2014, and then again at very high levels (130%). Indeed, if the 2009 debt is eventually revised to 120% or 122% (as is considered possible by Eurostat), these projections will have to be revised unfavourably.

   Large fiscal deficits and debts can, of course, be found in other countries as well. Unlike Greece, however, these countries are able to finance their deficits mainly from domestic saving. Greece's gross national saving, public and private combined, was just above 5% of GDP in 2009. This shortfall in national saving is primarily due to Greece's large fiscal deficits, but also to the fast increase in private consumption over the past few years.

   Due to the low level of saving, the public debt cannot be financed from domestic sources, resulting in a widening current account deficit and a growing external debt. Thus, the fiscal problem becomes intertwined with the external deficit and debt problem, and the twin deficits feed each other in a dangerous vicious circle.

3. The current account deficit reached 14.6% of GDP in 2008 and, after a temporary decrease to 11.2% of GDP in 2009, began to widen again in the first two months of 2010. The large trade deficit is directly attributable to the loss in competitiveness, which has cumulatively exceeded 20% in the 2001–2009 period. Further, it is estimated that, in terms of relative consumer prices but also in terms of relative unit labour costs, the decline in competitiveness is likely to continue through 2010.

4. The real economy has entered a recession since 2009, as GDP contracted by 2% last year, mainly on account of a sharp drop in investment, but also because of falls in private consumption and exports. In its latest Report on Monetary Policy released in March, the Bank of Greece estimated that GDP would decline by around 2% in the current year. Given the present circumstances, this projection is surrounded by high uncertainty and is subject to high upside risks.

5. The recession spread across all sectors of activity in 2009, negatively impacted employment, and caused an increase in the rate of unemployment. Total employment declined by 1.1%, the number of employees fell by 1.6% and the unemployment rate climbed to 9.5%. A further drop in employment is projected for 2010, while the rate of unemployment will come close to 11%.

6. The adverse developments, mainly in Greece's fiscal aggregates, together with the blows to market confidence, ultimately took their toll on the banking system. Whereas in many other countries the crisis first broke out in the financial system and from there spread to the real economy, in Greece things worked the other way round. The Greek banking system only began facing liquidity constraints when the severe fiscal imbalances led to successive downgradings of the country's credit rating – and consequently the credit ratings of Greek banks, thereby restricting their access to international capital markets. Meanwhile, the slowdown in deposit growth, due inter alia to the recession, affected the domestic supply of credit. It is worth noting that, in spite of these problems, the annual rate of credit expansion to the private sector remained positive throughout 2009, contrary to the situation in the euro area as a whole, where there have also been periods of negative credit growth rates. The Greek banking system showed remarkable resilience during the global crisis; the provision of ample liquidity from the Eurosystem at low cost was one of the reasons for this. For the banking sector, retaining this resilience in the future, especially in view of the gradual phasing-out of the extraordinary measures for the provision of liquidity, will be conditional upon dealing with the fiscal crisis, which affects its functioning, and restoring market confidence in the future of the economy.

Even after this happens, however, the new conditions that will emerge will be quite different from the ones in which the banks used to operate. The lessons drawn so far from the crisis will lead to a revision of the supervisory framework, now under examination by the Basel Committee. Greek banks must therefore adapt to the new situation with insight, bearing these impending changes in mind. At the current stage it is imperative that they:

- maintain sizeable capital buffers, above the regulatory minimum capital requirements;
- set aside adequate provisions for credit risk;
- rationalise their operating costs;
- manage available sources of funding flexibly and prudently;
- and, more importantly, adopt realistic and prudent medium-term strategies that will allow for consolidation.

A sound financial condition, effective risk management and the establishment of bigger and more robust formations will be key conditions for enhancing banks' shock absorbing capacity and for unfettered access to sources of funding. In my opinion, in the medium term changes in the banking sector are inevitable. The Bank of Greece, on its part, will continue to keep a close eye on developments and intervene as necessary to ensure that the next difficult steps can be made in the most effective manner.

Economic policy

In order to address the major challenges, economic policy has been steered toward decisions which, if effectively implemented and enriched with bold structural reforms, will lay sound foundations for the serious and far-reaching effort required.

So far, the decisions have mainly aimed to reduce the fiscal deficit and restore market confidence in the future of the economy. As far as the first objective is concerned, the supplementary measures announced in early March are in the right direction and were favourably received by the EU institutions. Even after the announcement of these additional measures, uncertainty remained strong. The markets continued to maintain a wait-and-see attitude, as suggested by the subsequent ongoing widening of bond yield spreads.

This attitude of the markets is basically due to the serious confidence and credibility deficit that the Greek economy still faces. To this, however, one must add the concerns about the competitiveness and the growth outlook of the Greek economy, i.e. the parameters which will determine the smooth servicing of the public debt in the future. In other words, the markets still have their attention focused on public debt dynamics.

Against this background, it is particularly positive that the Greek government requested the activation of the support mechanism.

It is assessed that the use of this mechanism will play an important positive role in overcoming the crisis, for the following reasons:

1. In the short term, it secures borrowing funds at relatively low cost, alleviates market pressures and contributes to the normalisation of liquidity conditions for the banking system as well.

2. In the medium term, the operation of the mechanism, with the involvement of the European Commission, the ECB and the IMF, imposes a tighter discipline in respecting time schedules, provides a valuable source of know-how in elaborating and implementing economic policy, and bolsters market confidence.

3. In the long term, the relatively lower cost of borrowing reduces the interest burden on public debt, thereby providing further support to fiscal consolidation.

The aim of the support mechanism is to facilitate and ensure the implementation of structural reforms which, apart from being absolutely essential, should have been carried out long ago. Under no circumstances, however, should the existence of the mechanism lead to complacency or a relaxation of efforts. The brunt of the task falls to the Greek State, which holds full responsibility for convincing that the economy is irrevocably engaged on a new trajectory. The concerted and consistent implementation of the measures announced will help to gradually improve the climate.

In order to bring about a definitive reversal of the negative trends, we must surpass ourselves and favourably surprise the markets, by achieving even greater improvements than the ones projected. In particular, it will be of crucial importance for the overall economic climate, if fiscal consolidation on the expenditure side progresses even further than currently planned and achieves a deficit reduction this year of more than 5% of GDP, especially considering that the deficit figures for 2009 were revised upward to 13.6% and may undergo further revision. Such consolidation can be achieved by aiming, with greater decisiveness and at a quicker pace, to curtail the squandering of public funds and to merge or eliminate public sector entities that are not really productive. Cutting expenses is in any case the suitable option for achieving the ambitious fiscal targets over the next two years, given that any further increase in tax rates would have very adverse repercussions on economic activity and would prove counter-productive – in the sense that it would lead to a contraction, instead of an increase in revenue.

The recommended acceleration – as of this year – of fiscal consolidation, through reducing expenditure and rationalising the operation of the public sector, will indeed favourably surprise the markets and contribute to restoring confidence faster. This will help reduce further the cost of government borrowing, with favourable chain reactions on bank borrowing costs and, consequently, on borrowing costs for businesses and households. Greece can and must enter a lasting virtuous circle as soon as possible.

Today, fiscal consolidation is the first and foremost tool for promoting growth. But it does not suffice by itself. Our response to the crisis must have twin targets, in response to the twin causes that have led us to where we stand today. Thus, fiscal consolidation must be undertaken together with a systematic effort to recover the losses in competitiveness, by setting specific quantitative targets each year. Further, under the present circumstances, Greece's growth model cannot be based on consumption, public and/or private, as unfortunately was the case in the past. Instead, it must rely on investment and exports. Greece, one of the most closed economies in Europe, must now become more open. This, however, will be impossible, unless competitiveness is effectively restored, through bold structural changes. These changes must aim at:

(a) reorienting the production model, with an emphasis on two interconnected elements: first, investment that raises productivity and, second, an orientation towards exports;

(b) increasing competition in the product and labour markets, so that, on the one hand, unit labour costs can support an improvement in competitiveness as well as job creation and, on the other, these costs are not unduly passed on to the final prices of goods and services;

(c) improving the business environment by reducing red-tape, stamping out corruption and modernising the functioning of public administration;

(d) prompt and efficient utilisation of EU funds available under the National Strategic Reference Framework (NSRF);

(e) promotion of clean or "green" growth and change of the current pattern of energy production and consumption, and

(f) upgrading the education system and encouraging innovation, research and entrepreneurship.

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The required reforms are of the utmost urgency. The big problems, which we were reluctant to address for years, stand before us now. This is why the responsibilities that we must all assume in the face of this huge challenge are of historical importance. The road to the exit from the crisis will be long and hard. This is why a greater effort will be required from all of us over a longer time. Our course in the forthcoming years will largely be determined by the target we set ourselves and our commitment to achieving it. Do we want a country that is trapped in a low-level equilibrium or do we want to make Greece modern and dynamic? And since we obviously want the latter, what is certain is that we can no longer rely on recipes of the past, characterised by:

- a myopic focus on the present, at the detriment of the future,
- a consumption behaviour, verging on overindulgence, that has been exceeding the productive capacity of the economy by far,
- selective and at will compliance with laws and regulations,
- shifting of responsibility onto others,
- a refusal to make the slightest effort towards consensus-building,
- dogmatic interpretations of reality,
- claims to maintain acquired privileges which go against the interest of society as a whole,
- a short-termist and an easy-profit culture.

All these will have to change if we want to overcome the present deep crisis. We must now shift our focus to the future and carry out the necessary reforms at a rapid pace. Today's crisis is unlike anything we have seen before, at least in our post-war history, and it cannot be tackled with the logic of the past. The recognition, by all of us, of the severity of the problems at hand will help build the social consensus that is needed on the difficult course that lies ahead – a course that can support the growth prospects of the economy, thus securing social cohesion.

This highlights the complex role that the government is assuming today, being called upon, with perseverance and resolve, to overcome obstacles, break up the rigidities of the past, open up new pathways and demonstrate in a convincing manner that the gains to be reaped at the end of the long effort outweigh the costs that we will have to bear along the way.

The decisions taken so far are promising, as economic policy is gradually shifting in this direction and is attempting to define a new course. On this course, it must have support from all of us.

The course will be long and arduous. However, there is no other option: we have the historical duty of pursuing it to the end, mobilising the forces, capabilities and talents of this nation, which have come to the surface in previous periods of crisis bringing about amazing results.