George A Provopoulos: The strategy for the Greek economy's exit from the crisis – what is at stake?

Speech by Mr George A Provopoulos, Governor of the Bank of Greece, at the 79th Annual Meeting of Shareholders, Athens, 24 April 2012.

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THE NEW ADJUSTMENT PROGRAMME PROVIDES MORE FAVOURABLE CONDITIONS THAN PREVIOUSLY, BUT EXIT FROM THE CRISIS WILL DEPEND EXCLUSIVELY ON THE COUNTRY'S WILLINGNESS AND ABILITY TO RISE TO THE HISTORIC CHALLENGE

The historical stakes are still high

Two years after the first Memorandum, we are now faced with a new challenge, one that is especially crucial for the country's future. Despite the progress made, the failure to act in a resolute and timely manner, along with the recession, resulted in a worsening of the dynamics of public debt, making a new agreement for financial support necessary. The new loan agreement and the economic adjustment programme provide more favourable conditions than before for a return to growth. The new agreement offers conclusive evidence of our partners' willingness to support us. However, uncertainty continues to surround the global economy, reflecting, in part, the sovereign debt crisis in European economies.

The economic situation, both at home and abroad, leaves no room for complacency. To take advantage of the new opportunity, we must promptly implement what we have agreed to and make up for previous delays. There is no easy way out of the crisis. The adjustment must be pursued with determination.

The current pre-electoral period has temporarily sidelined planned reforms. If, after the elections, there is any question about the will of the new government and society to implement the programme, today's favourable prospects will be reversed; the country will then be at risk of finding itself very soon in a particularly adverse situation, which will impact negatively on citizens' morale.

What is at stake is the choice between:

An orderly, albeit painstaking, effort to reconstruct the economy within the euro area, with the support of our partners;

or

a disorderly economic and social regression, taking the country several decades back, and eventually driving it out of the euro area and the European Union.

Past failures to act in a resolute and timely manner have magnified the actual costs of adjustment

The second adjustment programme, along with private sector involvement in the restructuring of Greece's public debt, leading to its substantial reduction, mark the end of one phase of the crisis. With the help of our partners, and with a hard effort and at considerable cost, under the first programme changes were made that were important, but still insufficient in relation to the size of the economic problem at hand. This explains the repeated underperformance with respect to the targets of the adjustment programme after the first Memorandum. The related revisions would have been avoided had we accepted from the outset our full responsibility for the necessary change in course, once it had become clear that the growth model followed was no longer sustainable.

The needed adjustment did not take place to the extent required. The Memorandum, which, in any case, contained reforms that should have been implemented long ago, was handled defensively and treated as an external imposition. This defensive stance, however, proved to be totally counter-productive – it magnified the costs of adjustment and deepened and prolonged the recession.

A promising new start: a battle has been won, but the war is not over

The lack of sufficient policy adjustment brought us to the restructuring of debt and the new loan agreement – choices which, given the circumstances, had become unavoidable. The restructuring improves the dynamics of public debt and creates a more favourable framework for the economy. Thus, a very difficult phase of the crisis comes to an end, at great social cost, but without any devastating effects. We now find ourselves at a promising new starting point. In this sense, a battle has been won, but not the war. This is why there can be no slackening off or complacency. On the contrary, continued vigilance, an intensification of efforts and a faster pace are required. In order to succeed now, we need to promptly make fundamental qualitative changes [mainly] to the functioning of the state, the operation of the public administration and, more broadly, institutions, the political system, the judicial system, the social partners, as well as the values and attitudes that shape our behaviour.

The agreement of society and of political forces is needed on the main issue: the country's European prospects and growth

For these changes to proceed, what is needed is the broadest possible consensus across society and the spectrum of political views.

Citizens must be convinced of the necessity of the changes stemming from the country's choice of euro area membership; further, they must understand that an eventual failure to implement the changes would entail losses many times greater, as well as an irreparable break-up of social cohesion.

It is to be hoped that political forces will agree on the issues that unite them, namely the country's European prospects and its growth potential; in this way the continuity of the state will be ensured.

The necessary changes can be realised today

Today we are better positioned than just a few months ago to take effective action. The objective conditions that make this possible are in place:

- The restructuring of the public debt substantially reduces the country's obligations and the cost of servicing them, thereby facilitating fiscal adjustment.
- The loan agreement and the accompanying economic adjustment programme were passed by Parliament with a large majority.
- Whilst the fiscal deficit remains high, it has been substantially reduced. The objective of achieving primary surpluses from 2013 onwards is clearly attainable.
- There is now broader public awareness of the gravity of the situation and of the need for radical change if Greece is to remain within the European Union.
- The banking system proved resilient during a difficult period and today looks forward to its restructuring, which will enable it to operate more effectively to the benefit of the overall economy.

  These factors will help the economy, first, to recover from the crisis and, then, to settle onto a sustainable growth path. Nevertheless, the risks remain high and uncertainty is still considerable.

The recession and unemployment turned out worse than initially expected

- The recession that began in 2008 continues. In 2011, real GDP contracted by 6.9%. The situation worsened in the fourth quarter, reflecting, among other things, the fact that uncertainty remained high. The decline in GDP was driven by the fall in both consumption and investment, the latter dropping by more than 20%.
- A further reason for the deterioration in GDP in the fourth quarter of 2011 was the halt in the upward trend in real exports of goods, after four successive quarters of growth. Exports of goods increased on average in 2011, but more slowly than in 2010 (3.6% against 5.4%). The decline in exports in the fourth quarter can be attributed not only to the slowdown in economic activity in our trading partners, but also to financial constraints faced by exporting firms (in particular, limited access to bank and trade credit).
- On the supply side, output of the secondary sector fell sharply (almost twice as much as in 2010: –12%, compared with –6.1%). The decline in output of the tertiary sector intensified as well (–5.9%, against –3.1%). By contrast, agricultural output increased by 2.5%, but, because of the sector's small size, this positive development had little effect on GDP as a whole.
- The decline in production was the main cause of the net loss of some 300,000 jobs and the surge in the number of the unemployed by approximately 250,000 people in 2011.
- Conditions in the financial sector deteriorated. The rate of credit expansion to the private sector, which has been steadily decelerating since 2008, turned negative in 2011. While this development can be partly attributed to reduced demand for credit on account of the recession, an important factor was also the liquidity squeeze experienced by banks, resulting from the loss of confidence brought about by the fiscal crisis. Today many sound businesses are suffering the consequences of that squeeze.

The general government deficit was reduced in 2011, but meeting the fiscal targets for 2012 will require persistent efforts

The general government deficit as a percentage of GDP was reduced by 1.2 percentage point in 2011, according to figures released yesterday, while the primary deficit was reduced by 2.5% of GDP. Furthermore, in the first quarter of 2012, the central government deficit, on a cash basis, decreased markedly year-on-year, while a primary surplus in the order of 0.5% of GDP was recorded, compared with a primary deficit of 0.5% of GDP over the corresponding period in 2011. Primary expenditure fell, albeit less than targeted, due to increased subsidies to social security funds. Attaining the full-year targets will obviously require persistent efforts.

Meanwhile, there is considerable uncertainty in the international environment as well

Global economic activity slowed in 2011 on account of the sovereign debt crisis in advanced economies, the general decline in confidence, and the high prices of commodities.

The global economy's recovery suffered a blow in late 2011 from the rise in uncertainty caused by the intensifying sovereign debt crisis in the euro area. As a consequence, the risks surrounding projections for 2012 remain elevated. GDP growth is expected to slow both in emerging and developing economies. In 2012, the euro area is expected to experience a mild recession. This projection is subject to considerable downside risks, relating in particular to an intensification of the debt crisis as well as further increases in commodity prices.

In response to these challenges, the Eurosystem resorted to standard and non-standard monetary policy measures. At the same time, and in a move to restore market confidence, the firepower of support mechanisms was increased.

The Greek economy: projections of key macroeconomic aggregates for 2012

The available short-term indicators for the first months of 2012 suggest that the recession will continue this year.

- The Bank of Greece forecasts an average annual rate of decline in GDP of close to 5%; implying that the recession will be less pronounced than in 2011; this forecast assumes that the necessary structural reforms will be implemented without delay.
- The average unemployment rate is projected to increase this year and exceed 19%, up from 17.7% last year.
- Forecast reductions in unit labour costs for 2012–13, together with projected price developments, should lead to a marked improvement in competitiveness, thereby contributing to export growth and import substitution. In particular, it is estimated that by the end of 2012, two-thirds to three-quarters of the total cost competitiveness lost over the period 2001–2009 will have been recovered and that, by end-2013, all of the loss will likely have been recovered.
- The current account deficit is projected to decrease from 9.8% of GDP in 2011 to roughly 7.5% of GDP in 2012 and that this downward trend will continue in the years to come.
- The downward trend in inflation will also continue in 2012, with average annual inflation expected to be around 1.2%. In 2013 inflation is projected to fall further, possibly to below 0.5%.

The recession is negatively affecting expectations and fuelling the vicious circle

Delays with fiscal adjustment and the implementation of structural reforms, negative developments in the real economy and adverse conditions surrounding the provision of bank finance to the economy, apart from their direct impact on incomes and unemployment, are also contributing to uncertainty about the economic outlook. As long as the vicious circle of fiscal contraction-recession-uncertainty continues, the prospects for meeting deficit and debt targets will tend to weaken, thus refuelling negative expectations.

Some consider the vicious circle to be due to the tight fiscal policy pursued. Though not without foundation, this interpretation is incomplete. It fails to take into account that, while fiscal consolidation does bring about a decrease in aggregate demand, it also affects expectations. Positive expectations can be generated when:

- a fiscal consolidation plan convincingly forms part of a credible medium-term programme, aimed at reducing the share of the public sector in the total economy,
- there is strong evidence that the economic adjustment programme is likely to succeed and that its continuity is ensured, regardless of changes in the political landscape.

When these two conditions are in place, positive expectations can take hold, indirectly boosting consumption and investment. These indirect effects can, to some extent, offset the decline in demand brought about by the fiscal deficit reduction and gradually lead to economic recovery.

A STRATEGY FOR EXITING THE CRISIS AND FOR SUSTAINABLE GROWTH MUST BE IMPLEMENTED CONSISTENTLY AND WITHOUT DELAY

A national strategy for the orderly reconstruction of the economy

It has now become clear that the changes undertaken thus far are insufficient.

- Both the fiscal and the external deficits remain high, implying that the country continues to live beyond its means, by relying on the financial support of its partners.
- Major structural weaknesses in the public sector still remain, even in cases where measures to eliminate them have been legislated.
- Market distortions undercut competition and hamper growth.
- Whilst cost competitiveness has improved, structural competitiveness still lags.

It is therefore clear that the difficult task which we have before us calls for a persistent effort over many years.

Recovery and growth through the mobilisation of the private business sector

A strategy for recovery and growth is of utmost priority. Failure to tackle the recession could compromise our ability to meet the targets of fiscal consolidation. In the current context, growth requires the mobilisation of the private business sector; this cannot be achieved as long as the state continues to dominate the economy. Nor can it happen so long as the fiscal deficit and public debt are persistently high. Moreover, there cannot be growth so long as there is a climate of uncertainty and distrust exists about the prospects of the economy.

The prerequisites for growth are therefore:

- The restoration of confidence and the elimination of uncertainty;
- the creation of an environment favouring entrepreneurship;
- the transfer of resources from the bloated public sector to the production of goods and services by the private sector and – more generally – from the sector of non-tradable goods and services to that of the tradable.

Actions for growth

As early as in 2010, the Bank of Greece pointed out the need for a comprehensive Action Plan for Growth, which would run in parallel with fiscal consolidation, specify needed structural policies, and provide a framework for coordinating the growth-enhancing activities of the public sector that do not put the fiscal targets at risk.

Such a plan is all the more urgent today. It includes the following goals:

Measures with immediate returns

- Reforms to improve the business environment, including measures to deal with red tape and reduce the administrative burden on businesses, to simplify the regulatory framework, and to restore market competition.
- A speeding-up of the privatisation programme. Apart from generating proceeds that reduce the debt, privatisation may also entail further investment in order to fully exploit the assets to-be-acquired. Privatisations open up opportunities for foreign direct investment, which leads to technology transfer, efficiency increases, and productivity gains.

- A faster absorption of the funds for the National Strategic Reference Framework (NSRF) and the securing of funds from international institutions, such as the European Investment Bank; such funds will ensure that important infrastructural projects that have been put on hold can be resumed.

Structural changes for a transition to a new growth model

Apart from measures with immediate returns, a long-term growth policy is needed. Such a policy must as of today strive for reforms to foster the transition to a new, export-oriented, growth model. These reforms must focus on changing the structure of production and on removing distortions. Greece's euro area entry did not bring about any significant differentiation in the structure of production; as a result, the level of structural competitiveness has remained low.

The last two years have seen an improvement in Greece's cost competitiveness, mainly as a result of lower relative unit labour costs. While this is definitely a positive development, it is not sufficient. An improvement in competitiveness is sustainable only when it is based on productivity increases. For this to be achieved, structural reforms are required in order to remove barriers and allow the transfer of resources to the production of internationally-traded goods and services. The ultimate objective is export growth and import substitution, i.e. a strengthening of the position of domestic products in both the external and the home markets. Structural reforms aimed at a business-friendly environment and at attracting foreign direct investment make a decisive contribution to progress in this direction.

Such reforms involve:

- bolstering competition in the markets for products and for factors of production;
- modernising public administration;
- ensuring a stable and growth-friendly tax system;
- speeding up judicial procedures;
- rationalising and simplifying the regulatory environment;
- encouraging innovation, research and export-oriented activities; and
- increasing the effectiveness of education at all levels.

None of this is new. The need for such reforms is widely recognised, and in many of these areas measures have already been adopted. However, the pace of implementation remains slow, meaning that the benefits are not yet visible. At the present critical juncture, all of these reforms must be pushed forward simultaneously, with boldness and resolve and without being watered down.

THE RESTRUCTURING OF THE BANKING SYSTEM WILL CONTRIBUTE TO ECONOMIC RECOVERY AND GROWTH

The recession and the evolution of credit flows interact

The fiscal crisis and the climate of uncertainty have significantly worsened financial conditions during the past two years. Doubts as to the Greek economy's ability to break out of the vicious circle affected Greek banks, with the result that they were shut out from international markets and experienced a continuous decline in deposits: from end-October 2009 to end-February 2012, domestic bank deposits by the private sector decreased by over €70 billion, an equivalent to approximately one-third of Greek GDP. The deposit outflows markedly constrained banks' ability to provide credit to the economy.

The economic recovery hinges upon the setting in motion of a virtuous circle, whereby an improved economic outlook fosters the strengthening of the banking system, so that the latter can, in turn, supply credit to the real economy, with positive feedback effects on expectations, and so on.

It is possible to improve the funding potential

Improving the funding potential for the economy can be achieved in the following ways:

First, by restoring confidence, which could initially lead to a return of bank deposits of some €10–15 billion of cash now being hoarded and then encourage capital repatriation. This would substantially improve banks' liquidity positions.

Second, by attracting funds from sources other than the banking system. Two sources can be mentioned in this regard. The privatisation programme, with expected proceeds of €19 billion by 2015, mainly in the form of capital inflows from abroad, will lead to much greater total inflows if the additional investments required to fully exploit the assets to-be-acquired are taken into consideration. Credit flows to businesses could be supported by an additional €15 billion, provided that our absorption rate of NSRF funds is improved. To this, one should add the funds available from the European Investment Bank.

The restructuring of the banking system

The key factor to improving financial conditions is the strengthening and restructuring of the banking system, currently in progress.

2012 will be a critical year in shaping the future structure of the banking system in Greece. Banks now face losses originating from the fiscal crisis. First, they are dealing with the implications of having invested in Greek government bonds, an instrument considered safe until recently. Banks' published annual statements show that the related impact is quite substantial. Second, banks also face the consequences of the increased difficulty that households and businesses have in servicing their debt obligations on account of the protracted recession. These developments imply that it is imperative for banks to strengthen their capital base – a process which is already under way.

Anticipating these challenges, early in 2011 the Bank of Greece, in cooperation with the International Monetary Fund, the European Commission and the European Central Bank, began planning a number of measures to safeguard financial stability. These measures include:

- meeting short-term liquidity needs through the Eurosystem,
- formulating, in cooperation with the government, a resolution regime for credit institutions, and applying it where necessary;
- securing €50 billion from the financial support programme for the banking system's recapitalisation and restructuring.

The objective: a sound, strong and competitive banking system

The banking sector, following its restructuring, will be more sound, efficient and robust. The publication of banks' capital needs will substantially increase transparency, which will in turn help banks to gradually regain the confidence of markets and depositors. This will enable them to better perform their fundamental role of financial intermediation and contribute to the return of the Greek economy to a path of sustainable growth.

THE FUTURE OF THE COUNTRY IS IN OUR HANDS

Projections for domestic economic developments in 2012 are fraught with uncertainties. The economic outlook for the euro area is also subject to uncertainties, linked to the possibility of an intensification of the sovereign debt crisis. It is against this challenging backdrop that the Greek economy needs to make steady progress. To this end, work to win the war on all fronts has to continue uninterrupted from the very first day of the post-election period, starting with the construction of an efficient and flexible state that will serve both the competitive functioning of markets and social cohesion. This will avert conditions leading not only to our sacrifices going to waste, but also to a drastic deterioration in the standard of living. Thus, the speedy implementation of the policies contained in the second adjustment programme will place the economy back on track to recovery by the end of 2013 and gradually into a virtuous circle of confidence-fiscal balance-growth.

Therefore, we all must assume the historical responsibility of making the choice – as a society, as a political system, as responsible citizens. The future of the country is today in our hands.