George A Provopoulos: Overview of recent developments in the Greek economy

Speech by Mr George A Provopoulos, Governor of the Bank of Greece, at the 80th Annual Meeting of Shareholders, Athens, 25 February 2013.

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The outlook is improving – efforts should continue in order to ensure that the sacrifices are not in vain

The improvement in Greece's economic prospects is visible

The ten months since the last General Meeting of Shareholders have seen important developments, which are now shaping a new and clearly improved economic environment.

A year ago many analysts anticipated that a Greek default and exit from the euro area was almost inevitable. Today, such an eventuality is significantly reduced and the economy can look forward to a gradual exit from the crisis.

The turnaround in sentiment has been due to a number of factors, which helped the Greek economy to avoid the risk of collapse and get back onto the track of rebalancing and stabilisation.

The ***first*** among these factors was *the affirmative answer of the Greek people to the historic dilemma concerning Greece's continued participation in the euro area*. The coalition government explicitly stated its determination to safeguard the country's European path. This key choice, along with progress in making up for the major delays associated with the two consecutive national elections, made it possible for the Eurogroup to decide to support Greece financially. These developments had a beneficial effect on economic sentiment.

On *the domestic front*, pessimistic expectations have dissipated considerably and confidence is improving. The Economic Sentiment Indicator stood at a two-year high in December 2012–January 2013. An improvement in confidence is also evidenced by the fact that domestic banks are now less reliant on refinancing from the Eurosystem. This is attributable to a reversal of the downward trend of deposits (which have increased by EUR 15 billion since the elections of last June), while it also partly reflects the first successful attempts of Greek banks to regain access to international money markets.

Abroad, the climate as far as Greece is concerned is also turning around. Negative references to Greece are less frequent, while EU officials express unequivocally their desire to support Greece. The changed climate is reflected in a sharp narrowing of the yield spread between Greek and German ten-year government bonds.

The ***second*** *factor which has contributed to this improvement is the progress made in the implementation of the adjustment programme, particularly in addressing the twin deficits – fiscal and external. This progress is a sign of incipient rebalancing and restructuring in the economy.*

- In the *fiscal domain*, deficit reduction has been remarkable. Between 2009 and 2012, both the general government deficit and the corresponding primary deficit were reduced by 9 percentage points of GDP, while the fall in the structural deficit, at 15 percentage points, was even larger.
- Regarding the *external sector*, the current account deficit shrank to 2.9% in 2012, down from a peak of almost 15% of GDP in 2008. More importantly, between 2010 and 2012, Greece recovered more than 75% of the loss in cost competitiveness incurred over the 2001–2009 period.

A ***third*** crucial factor was the *success in safeguarding financial stability and confidence in the banking system*. Today we would not be talking about the prospect of recovery, had the banking system collapsed making Greece's exit from the euro area inevitable. This risk was averted. In a period marked by record levels of uncertainty, not one depositor suffered the slightest loss. Not only was systemic stability fully preserved, but the groundwork was also laid for a robust banking system.

The ***fourth*** factor behind the improvement in confidence has been the *continued financial support from official lenders, which gives Greece time for the structural transformation of its economy to proceed smoothly*. This support, provided on favourable terms, is unprecedented by international standards.

A ***fifth*** factor that also bolsters confidence are *the steps being taken towards supplementing the institutional architecture of both the European Union and the euro area*. The ongoing discussions and decisions taken in this direction have helped to turn the international climate around; in turn, this affected sentiment in Greece favourably. For instance, the adoption of the proposal to move to a banking union will lead to a deepening of economic and monetary union. The announcement of "Outright Monetary Transactions" by the Eurosystem in September 2012, which by itself helped to restore relatively normal conditions in euro area financial markets, was of particular importance.

In conclusion, the risk of collapse has been averted, the possibility of a Greek exit from the euro area is now significantly reduced, and confidence is gradually being restored. Yet, these encouraging developments leave no room for complacency.

2013 will be another year of recession and unemployment will continue to rise

The Greek economy is still going through a deep crisis, and the risk of a derailing has not been completely eliminated.

In 2012, GDP contracted for the fifth year in a row, bringing the cumulative decline for the five-year period 2008–2012 to 20.1%. This percentage will be bigger for 2008–2013, as the recession is expected to continue, albeit at a slower pace.

The recession led to a dramatic decline in employment and pushed the unemployment rate up to a historically high annual average of 24.5% in 2012; a further rise is expected in 2013.

This crisis, unprecedented in magnitude and duration, has multiple adverse effects as it:

- reduces per capita income and living standards;
- leads physical and human capital to become obsolete;
- causes savings and banks' deposit base to shrink, thereby leading to liquidity constraints;
- feeds uncertainty and discourages investment;
- hampers fiscal consolidation, as lower incomes mean less revenue for government. This fuels a vicious circle of deficits and recession that leads to repeated revisions of deficit and debt targets, undermining the credibility of the consolidation programme.

The deeper-than-expected recession makes a faster pace of structural reforms imperative

Over the last few years, the recession has turned out to be deeper than initially forecast. The reasons behind this should be sought in the way the adjustment programme was implemented: in the wavering, the mistakes and omissions and, above all, the lag in implementing structural reforms. This lag prevented the contractionary effects of fiscal consolidation from being mitigated and hindered the return of confidence. The same reasons also explain the unfavourable financial conditions that prevail. By contrast, if the structural reforms envisaged in the programme had been implemented consistently and from the programme's inception, their favourable effects would already have made themselves felt and would have reduced the duration and severity of the recession. On a positive note, the depth of the recession and its implications have, in fact, been taken into account as shown by the revisions to the programme: the implementation horizon, the cost of borrowing and the maturities of the loans provided to Greece, the size of financial support and the measures to reduce the level of sovereign debt.

In any event, the recession cannot be used as an excuse for not honouring the commitments made and, particularly, for any relaxation in the effort to promote the necessary reforms. If this were to happen, it would seriously undermine the gains in confidence that have come at the cost of painful sacrifices.

2013 will be a difficult year, but recovery will be visible in the course of 2014

As long as the prospect of an exit from the crisis is not clearly in sight, the continuing recession creates an unfavourable climate and feeds social tensions. Nevertheless, we are now at a turning point. There is no doubt that 2013 will be a difficult year, mainly due to the continuing recession and high unemployment. But we can expect recessionary forces to weaken gradually and the Greek economy to return to positive growth rates in the course of 2014. Positive effects are expected from:

- a boost to liquidity and confidence as a result of the recapitalisation of banks and the return of deposits to the banking system;
- a further improvement in cost competitiveness – expected in 2013 to more than offset the competitiveness losses of 2001–2009 – and a resulting increase in exports;
- a speeding-up of the privatisation process, leading eventually to investments several times larger than the initial ones;
- progress in the deregulation of markets;
- the restarting of major infrastructure projects such as highways;
- the implementation of private investment projects, with the support of the National Strategic Reference Framework (NSRF) and European Investment Bank funds;
- the planned repayment of public sector arrears.

In order to ensure that the above factors will deliver the expected results, it is necessary to safeguard the recent improvement in confidence. Any extreme or untimely demands put forward by different social groups would be counterproductive. Society as a whole stands to make a lasting gain when the economy gets back on its feet again. It also goes without saying that unlawful incidents against business operations – no matter how isolated – are particularly harmful to the investment environment and undermine the prospect for a recovery in employment.

Pressing ahead with the implementation of the programme is a prerequisite for recovery

Where we stand today bodes well for the future. It can be reasonably expected that real economic recovery will come fairly soon, provided that certain conditions are fulfilled. The most important is ***the continued implementation of the adjustment programme, with strict adherence to the targets and timetables set***. This will ensure continued funding and eliminate once and for all the risk of exit from the euro area, consolidate confidence in the economy's future, attract new investment and convey a clear message that the worst is behind us and an exit from the crisis is in sight.

Implementation of a new model of outward-looking growth

The rebasing of the country's productive capacity on new foundations must be driven by strengthening its export orientation. This, in turn, requires shifting resources towards the production of competitive, internationally tradable goods and services. But if we are to succeed in transforming the economy, we must realise that the adjustment programme highlights only the minimum changes that need to be made. Thus, in no way does the programme relieve us from our primary responsibility as a nation to implement a broader national action plan for growth, incorporating policies for the transition to a new model of sustainable growth. Now that public finances are stabilising, it is essential that we proceed faster with fundamental reforms that will ensure:

- an efficient public sector, both citizen- and business-friendly;
- modern infrastructure; and
- open, competitive markets.

Effective use of EU funds

Following the recent European Council decision, the Structural Funds available to Greece for 2014–2020 will total EUR 18.3 billion. These resources can play a decisive role in bringing the recovery forward and in implementing a long-term strategy for the transformation of the economy's productive base.

Under current circumstances, EU resources could help to address serious gaps in the financing of new investment projects. So far, EU funds, despite their positive contribution, have not been used to maximum advantage. This is precisely why such resources will function at this time as powerful tools for growth, provided they are integrated into a broader national plan for growth.

Creating the conditions for lightening the tax burden of those who already pay taxes

The central goals of the tax reform agenda should be to broaden the tax base and curb tax evasion. Indeed, fiscal adjustment should focus, first, on cutting down those expenditure items that are not conducive to growth and increasing the return on other items of expenditure and, second, on modernising tax administration in order to effectively tackle tax evasion. Action along these lines will create scope for reducing the heavy tax burden that has, increasingly in the last few years, been shouldered by those who already pay taxes. This will help foster a sense of equity in tax matters and will generate positive expectations that will partly offset the contractionary impact of spending cuts.

The reform of the banking sector is key to restoring normal liquidity conditions

Since the onset of the crisis, Greek banks have borne the brunt of the repeated downgrades of Greek sovereign debt. They were cut off from international markets, while the prevailing uncertainty led to large deposit outflows and a loss of more than one third of the banks' deposit base in less than three years.

The banking system's funding constraints impaired its capacity to finance the real economy, causing problems for production, investment and export activity.

Liquidity tensions were significantly eased by Greek banks' recourse to the monetary policy operations of the Eurosystem and to emergency liquidity assistance (ELA) from the Bank of Greece. Thanks to the ample provision of liquidity from these sources, the decline in bank credit to households and businesses was much milder than the shrinking of the banks' deposit base. Thus, the Bank of Greece contributed to mitigating the adverse impact of the sovereign debt crisis on economic activity.

Heightened uncertainty in the first half of 2012 posed major risks to the banking system

In the January–September 2012 period, the banking groups listed on the Athens Exchange recorded losses of EUR 5.1 billion. These losses reflected, on the one hand, additional write-downs on their Greek government bond holdings as a result of PSI and, on the other, impairment charges on loans to the private sector. Accumulated losses led to a sharp decline in banks' capital adequacy; thus, their recapitalisation became necessary. The NPL ratio for the banking system as a whole rose to 22.5% by end-September 2012, from 16% at end-December 2011.

Despite the adverse conditions, the risk of instability was averted

The uncertainties that prevailed during the prolonged election period led to successive surges in cash outflows from banks, requiring the latter to be supplied with an exceptionally large amount of banknotes to banks. The banks' needs for banknotes were fully and efficiently met by the Bank of Greece. Even in the direst of circumstances, there was not the slightest doubt as to the banks' ability to repay customer deposits. Otherwise, there would have been a collapse in confidence, with devastating consequences for financial stability and Greece's membership of the euro area. *Despite the extremely adverse conditions, action taken by the government and the Bank of Greece ensured that the banking system weathered the shock and that not one depositor lost a single euro of their savings. This response averted a collapse in confidence in the banking system and ultimately an exit from the euro area.*

The recapitalisation of banks is under way

In May and December 2012, the four big banks identified as viable by the Viability Assessment Exercise of the Bank of Greece received an advance payment from the Hellenic Financial Stability Fund (HFSF) to replenish their capital above the regulatory minimum. The next steps of the recapitalisation process involve the issuance of contingent convertible bonds and the completion of capital increases by the end of April 2013. Private shareholders will retain control of HFSF-supported banks, provided that they subscribe no less than 10% of the new common shares to be issued. According to the Memorandum, the other banks will have to raise private capital by the end of April 2013. If they fail to do so, the Bank of Greece will activate the steps envisaged in the resolution framework, at the latest by June 2013, in a manner that will safeguard financial stability.

Considerable progress to date in the consolidation of the banking system

In 2012, despite the deep crisis, the groundwork was laid for the banking system to turn the page. Banks are already taking their first steps towards internal reorganisation, by adapting their business models. The entire banking sector is being reshaped through mergers. The size of the Greek economy and the excess capacity prevailing in the banking system call for fewer and stronger banks, which in the long run will be more resilient to exogenous shocks.

This process of consolidation will be to the benefit of depositors and borrowers alike. Larger banks typically have easier access to international markets and, given their greater efficiency, have fewer incentives to undertake high-risk investments.

At the onset of the crisis, there were 17 banks in operation. There were also 16 cooperative banks, with a combined market share of just 1%. The resolution and restructuring process is well under way, as evidenced by the following facts and data:

- So far, the resolution framework has been used to resolve seven banks – four commercial banks and three cooperative banks.

- At present, a merger between the two largest banks, the National Bank of Greece and Eurobank, is in the process of being completed.
- Alpha Bank, the third largest bank, has absorbed Emporiki Bank, a subsidiary of Crédit Agricole.
- Piraeus Bank has absorbed Geniki Bank, a subsidiary of Société Générale, as well as the sound assets and the deposits of the state-owned ATEBank; it is currently negotiating the acquisition of Millennium Bank.

It is therefore expected that, in a few months from now, when the process is completed, the banking system will comprise three large, strong groups, as well as a few smaller banks. The market shares of these smaller banks, along with the presence of foreign banks, will ensure competition. The Greek banking system is clearly becoming more compact and efficient, as conditions are being put in place to enable it to exploit synergies and economies of scale. It is becoming stronger and better-capitalised. At the same time, it has retained its significant presence in south-eastern Europe.

A robust banking system capable of financing economic recovery

The restructuring and recapitalisation of the banking system are pivotal reforms that contribute to strengthening confidence in the prospects of the Greek economy. The gradual return of deposits is a first sign that developments in the banking sector are being positively assessed. The continued return of deposits and the successful completion of the recapitalisation process will help Greek banks to gradually regain access to international money and capital markets. We are already witnessing an incipient return of Greek banks to the international markets. On a more general note, the relaxation of banks' capital and liquidity constraints is creating conditions for stronger credit flows to finance production, investment and exports. Having navigated through very troubled waters, the banking system is emerging stronger, more resilient, and able to finance growth.

Challenges and opportunities

The economic crisis has brought about not only acute problems, but also significant opportunities.

The two most important opportunities, which pose a challenge for Greece, are:

- ***First,*** to restructure the economy towards high-productivity and high-value-added sectors that would produce internationally tradable goods and services that can prove competitive both in the external and in the domestic market.
- ***Second***, to modernise public administration and rationalise the boundaries and the management of the public sector, while making it more citizen- and business-friendly.

The ability to rise to these major challenges hinges on building and strengthening social consensus as regards the implementation of the appropriate policies, so as to bring the recovery forward and create the conditions for sustainable growth.

Comparing the current situation with the one prevailing just a few months ago, it is clear that much has changed for the better. Most importantly, the risk of default and exit from the euro area is now remote. Thus the main factor that had fuelled unprecedented market uncertainty with debilitating effects on the Greek economy is weakening. We can now expect, with reasonable certainty, that the steps made so far are indeed leading Greece out of the crisis and onto a path of growth. As this expectation is consolidated, sentiment in Greece will continue to improve, setting in motion a virtuous circle. For this to happen, though, the implementation of the adjustment programme must continue without deviations or delays. Commitment to achieving the targets, and where possible, overshooting the targets, will remove any remaining uncertainties and strengthen positive prospects, with very beneficial effects on social cohesion and the country's economic development.

We have already come most of the way on a long and difficult road at tremendous cost to Greek citizens and businesses. The distance still to be covered, though shorter, will be equally difficult, as it will require additional effort on top of the earlier sacrifices. However, the groundwork for dealing with the long-standing problems of the Greek economy has been laid. Now that the end of this difficult road is finally in sight, we need to intensify our efforts and quicken our pace in order to cover whatever distance remains and ensure that the citizens' sacrifices will not be in vain and that, better yet, a promising future lies ahead.