Yves Mersch: Intergenerational justice in times of sovereign debt crises

Speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at the Minsky Conference in Greece, organised by the Levy Economics Institute, Athens, 8 November 2013.

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Ladies and gentlemen,

The last time I gave a speech here in Athens was in early January 2008. How much the world has changed since then.

Yet it has not always changed in the ways that observers predicted. I still remember clearly, in the early weeks of May 2010, the prophetic claims that Greece would leave the euro area within weeks, that other countries would follow within months, and that the collapse of the euro would be complete before the year was out.

Those claims were wrong – and the Greek people have played an important part in proving them so.

Since the loss of market access in early 2010, the Greek people have made extraordinary efforts to refute the naysayers and turn the economy around. They have executed a fiscal adjustment of historic proportions and embarked on the difficult road of structural reforms. The results of these actions have accrued first and foremost to Greece – but they have also accrued to the wider euro area.

However, this turnaround is still only half complete. There is still much work to do. And what I would like to emphasise in my remarks today is that staying on the path of reform is essential not only for the citizens of today. It is also essential for those of tomorrow.

Like all Western societies, and some rapidly ageing Eastern ones, Greece faces long-term fiscal challenges linked to high public debt levels and demographic developments. These challenges raise profound questions about intergenerational justice. And it is only through reforms that they can be answered in a fair way.

For all ageing societies, this implies, first, ensuring sustainable public finances and, second, achieving stronger economic growth. Both are necessary because they are mutually reinforcing: fiscal sustainability creates the stability and confidence necessary for future growth; and higher growth creates the revenues and debt-to-GDP ratios necessary for fiscal sustainability.

Let me therefore deal with each in turn, starting with what is being done to ensure fiscal sustainability in the context of intergenerational justice.

Strengthening sustainability

The fiscal challenges that Greece is facing today, while more severe than others, are not unique to this country. All Western societies are being confronted with difficult questions about the distribution of consolidation and spending between current and future generations.

A first question is how the burden of high public debt levels in Western societies will be shared between generations. This question is particularly pertinent in the euro area because all countries are bound by law to start reducing their debts to below 60% of GDP – and average public debt levels in the euro area are currently in excess of 95% of GDP.

If fiscal consolidation starts today, then the generation which has benefited most from this debt will play the largest role in reducing it. But if consolidation is delayed, then future generations will have to bear the burden of debt reduction – this would constitute a direct transfer from our children and grandchildren to ourselves.

And it is only us who are taking the decision. Our children and grandchildren have no power to raise their objections.

A second question with intergenerational consequences is how to spread the costs of demographic change. In the EU, it is projected that by 2060 there will be just two working-age people for every person over 65, compared with a ratio of 4:1 today. This means the weight of supporting an ageing population will rest on ever fewer shoulders.

If current generations are proactive in reforming pension systems, they can reduce the load that the shrinking working age population will have to carry. But if they choose instead to preserve their entitlements, then they make the lives of future generations commensurately harder. They would be effectively sacrificing their descendants' quality of life for their own.

In other words, all Western societies are facing choices about the distribution of responsibility. Do we, the current generation, take responsibility for the long-term fiscal challenges that we have played a large part in creating? Or do we delay and pass the consequences of our choices onto our children and grandchildren? I think it is fairly clear what a perspective of intergenerational justice would imply.

This perspective is of course not new. The so-called "demographic time bomb" has been predictable for many years. Indeed, I pointed to this issue when I spoke here in Greece in early 2008. But what has changed today is the urgency for action. The crisis has meant that these difficult choices can no longer be delayed. One might say it has pressed the fast-forward button and brought the challenges of the future into the present.

This is the broader context for the ongoing consolidation process in Greece. Certainly, it is about increasing spending control and tax collection. But it is also about putting Greece on a sustainable path for the future; limiting the load that is bequeathed to our descendants; and ensuring that those that created fiscal problems take responsibility for them.

What Greece has achieved

And indeed, this is what is happening in Greece today. The commitment the Greek people have shown to fiscal consolidation has been remarkable, even in international comparison.

The primary deficit has declined by almost 10 percentage points of GDP between 2009 and 2012. Taking into account the deep and prolonged recession, the underlying fiscal adjustment has been even larger. The OECD estimates that structural adjustment was nearly 14 percentage points of GDP in this period.

As Greece is one of the smaller euro area Member States, the scale of its efforts is not always appreciated appropriately. If the level of expenditure consolidation we have seen in Greece were applied in Germany, it would be equivalent to a permanent reduction in public spending of 174 billion euro. That is more than the total sum of social spending.

Greece has also made important progress in addressing the long-term fiscal challenges linked to its ageing population. There is little doubt that before the crisis the Greek pension system was unsustainable. In the Commission's 2009 Ageing Report, age-related spending in Greece was projected to increase from 22% of GDP in 2007 to a staggering 38% of GDP in 2060. By contrast, the average for the euro area would be under 30% of GDP in 2060.

But thanks to the pension reforms the authorities have introduced, the Greek system is now comparable to others. In the 2012 Ageing Report, age-related spending in Greece was projected to increase to just under 30% of GDP in 2060 – so around than 8 percentage points lower than the previous estimate. This is almost identical to the euro area average. If we take into account as well the recently legislated increase in the pension age, Greece may even be ahead of others.

In short, the Greek people have taken vital measures to ensure long-term fiscal sustainability. This will reduce the burden that will be passed to future generations. And I

recognise that in doing so, current generations have made considerable sacrifices. Real earnings have fallen by over 20% between 2009 and 2012, undoing the gains made since adopting the euro. Far too many people are currently without work, with unemployment at over 27% and youth unemployment reaching 57%. For so much potential to be lying idle is a tragedy.

What remains to be done

Nevertheless, this is the painful cost of reversing the misguided economic policies and lack of reforms in the past. And fiscal sustainability – and hence intergenerational justice – is not yet assured. While the government appears to be on track to meet its 2013 primary balance target, Greece still has some way to go to reach the primary surplus targets of 1.5% of GDP in 2014, 3% of GDP in 2015 and 4.5% of GDP in 2016. This means that fiscal consolidation has to continue.

Based on current projections, a fiscal gap has emerged for 2014. It comes mainly from delayed gains from the tax administration reform, shortfalls in the collection of social security contributions and the continuing underperformance of the instalment schemes for outstanding tax obligations. Measures will have to be identified to close it.

Looking forward, failure by the authorities to proceed with tax administration reform and to accelerate the fight against tax evasion will unavoidably widen the fiscal gap – and imply the need for higher savings on the expenditure side. This simple truth should provide sufficient incentives for stepping up the pace of tax administration reform.

To put tax collection in Greece in context, according to the most recent OECD data, the tax debt in Greece as a share of annual net tax revenue was almost 90% in 2010, compared with an OECD average of under 14%. Fighting tax evasion now is therefore key to enhancing social fairness – both on an intra-generational and an inter-generational basis.

To this effect, the recently legislated semi-autonomous tax agency will need to become fully operational and be shielded from political interference.

Beyond that, accelerating the implementation of public administration reform is key to the success of the wider reform agenda. Significant delays have occurred in finalising staffing plans and transferring employees to the new mobility scheme, and this is slowing down the identification of redundant positions and the necessary modernisation of the public sector.

Of course, consolidation would be made easier by higher rates of growth. But we should not treat growth as an exogenous variable. On the contrary, it depends critically on the decisions of the Greek authorities – namely on their willingness to implement the growth-enhancing measures in the programme. The relatively closed and rigid nature of the Greek economy is both a challenge and an opportunity: it makes the process of reform harder, but it also means that the potential for reforms to raise growth is commensurately greater.

Let me therefore turn to the subject of growth, which forms the second part of my remarks today.

Strengthening growth

The economic situation in Greece has started to pick up this year, with the economy stabilising and seasonally-adjusted real GDP increasing by 0.2% quarter-on-quarter in Q2 2013. Overall, GDP growth is expected to turn positive next year at 0.6%.

But while these are welcome developments, they still represent a relatively weak recovery, especially given the depth of the recession that preceded it. In my view, to add momentum to this recovery and lay the foundations for medium-term growth, the authorities need to address three challenges. First, increasing the economy's external competitiveness; second,

ensuring the banking sector can fund the recovery; and third, attracting productive foreign investment.

Increasing external competitiveness

As Greece is undergoing a simultaneous deleveraging in its public and private sectors, sectoral accounting tells us that its external sector must go into surplus. The key for growth is to ensure that this happens as much as possible through higher exports rather than import compression. The best way Greece can achieve this is by improving its price competitiveness.

Price competitiveness is particularly important for Greek firms as their exports are largely concentrated in low-tech products. At the end of the last decade, high-tech or intermediate-tech products represented only 28% of total exports, compared to nearly 50% for the EU average. Yet since euro entry price competitiveness in Greece has actually been on a worsening trend. According to the Commission, the real effective exchange rate (on an HICP basis) in Greece was still rising until 2011.

To facilitate an export-led recovery, this trend has to be corrected and there is no way this can be achieved in the short run other than by adjusting prices and costs. I know the difficulties that such adjustment creates and the criticisms that are levelled against it. But we are in a monetary union and this is how adjustment works. Sharing a currency brings considerable microeconomic benefits but it requires that relative prices can adjust to offset shocks.

This process has already begun in Greece today. Thorough labour market reforms have reduced labour costs significantly. costs have now fallen by around by 18% since 2009, with wage adjustment being the main driver of that fall. Indeed, compensation per employee has fallen by about 20% in this period.

But the translation of cost competitiveness gains into prices has been too slow – notwithstanding the encouraging recent trend of disinflation. This is largely because reforms in product markets have not kept pace with those in labour markets. And this not only limits the potential for the external sector to generate growth, but also lowers citizens' real incomes.

Speeding up the pace of product market reforms is therefore a priority. The authorities have introduced several recent reforms, for example removing barriers to entry in transportation services, repealing restrictions in the retail sector and removing mandatory recourse to services for a number of regulated professions. However, as of today product market regulations are still among the most restrictive in Europe. Further reform will help remove unjustified privileges and the related excess profits, and by helping prices adjust, this will in turn strengthen social fairness.

Funding the recovery

While product market reforms are an essential part of building a more competitive economy, their ability to generate growth depends also on other developments – in particular, the condition of the banking sector.

If banks do not make new loans, this impedes the entry of new players into liberalised sectors, which then reduces competitive pressures and price adjustments. And if banks do not write off loans to insolvent debtors, in particular "zombie" companies, this slows down the necessary reallocation of resources toward exports and higher-productivity sectors.

In other words, cleaning up bank balance sheets and ensuring a well-functioning bank lending channel is an equally important part of the adjustment process. This is the second challenge for growth.

The authorities in Greece have taken important steps to preserve the stability of the banking sector. The recapitalisation of the four core banks was completed in June 2013, while the consolidation of the banking sector has continued through the resolution of non-viable banks and the absorption of Greek subsidiaries of foreign banks. Deposit inflows have continued, in part offsetting the deposits lost between the end of 2009 and the middle of 2012.

But despite these improvements, credit growth to the private sector remains very weak, in particular for the small and medium-sized enterprises (SMEs) that make up about 60% of business turnover in Greece. The last ECB survey on SME financing showed that 31% of SMEs had applications for bank loans rejected, well above the euro area average of 11%. Moreover, the sectoral allocation of credits has not substantially shifted towards export-oriented sectors since 2010, suggesting that banks are not facilitating internal rebalancing.

To some extent, these developments are cyclical: the weak economic environment means banks are attaching higher credit risk to SMEs. But there is also a more structural explanation. Non-performing loans (NPLs) increased from 16% at the end of 2011 to 29% of total loans in the first quarter of 2013. This is acting as a barrier to new lending to higher-growth sectors.

Unfortunately, this problem is in part being created by government policy. The ongoing moratorium on auctioning the properties of debtors in default has slowed down resolution of NPLs and balance sheet restructuring. Moreover, suggestions by policy-makers about horizontal debt relief for bank debtors are leading to a steep rise in strategic defaults, with banks estimating that 25% of NPLs in the mortgage and SME sectors are now strategic.

This deterioration in the payment culture, even if it helps individuals on a micro level, is deeply damaging to the economy as a whole. If it continues, it will ultimately lead to higher costs for banks, new recapitalisation needs and further constrictions in bank lending. In my view, to restart lending to the real economy, this self-fulfilling cycle must be broken.

I welcome the fact that the Greek authorities have established an inter-agency working group to identify ways to improve the effectiveness of debt resolution processes. Its priority should be to establish a time-bound framework to facilitate the settlement of borrower arrears using standardised protocols. This would help to remove expectations about future debt relief, and as such, remove the debilitating moral hazard this is creating.

Otherwise, the ultimate result would be that excessively high risk premia become structural and choke off investment and job creation – thus punishing the whole of society for the actions of those in strategic default.

Attracting productive foreign investment

The third challenge for growth is to attract higher foreign investment. This is important to add momentum to the recovery in the short term, while also increasing the capital and knowledge base of the Greek economy over the medium term. Indeed, before the crisis, investment in knowledge-based capital in Greece was among the lowest in the euro area.

From the available signals, there seems to be significant investor interest in Greece. While total investment in Greece has fallen by around 43% from 2008–2012, foreign direct investment (FDI) flows have recently been positive, driven largely by investment in the banking sector. But anecdotal evidence suggests that foreign interest in the real economy is also growing, with several multinational companies announcing plans to increase their output at Greek units in the coming years. To maximise such investments, I see three actions as key.

First, the authorities need to redouble their efforts to improve the business environment. Product and labour market flexibility is certainly a part of this, but there is also a wider challenge related to reducing bureaucracy, red tape and corruption. Progress has been

made in these areas but Greece still ranks second to last among euro area countries on the World Bank's Ease of Doing Business Index.

Second, foreign investment would naturally rise if privatisation were increased. In 2012 only 0.1 billion euro was derived from privatisation receipts, instead of the 3.6 billion euro originally forecast. Yet the example of the Port of Piraeus shows what well-targeted privatisation can achieve. Since the transfer of management of part of the port to the company COSCO in 2009, container traffic has tripled and its market share in the Mediterranean has risen from 2% to 6%.

Third, it is crucial for foreign investors that uncertainty about Greece's medium-term outlook is dispelled. The greatest source of such uncertainty in the past was persistent questions about Greece's place in the euro area, but thanks to the joint efforts at the European and national levels, this seems to have significantly declined over the last year. The main source of uncertainty today is the continued commitment of the authorities to the programme. I therefore trust that the authorities will do everything possible to remove such doubts.

Conclusion

Let me conclude.

Greece has made tremendous progress in recent years to close its fiscal deficit. By any standards, what has been achieved is remarkable.

But the process of restoring sustainability and growth in Greece is not yet complete – and neither is the progress so far secured. If the authorities fail to address the remaining challenges, they will put at risk what has already been achieved.

In other words, Greece today stands at a crossroads.

In the one direction lies the path of difficult choices. This is the steep and thorny way, and it requires great commitment to negotiate, but it is the one that will lead to a reformed state, a sustainable economy and justice between generations.

In the other direction lies the path of easy answers. This path is littered with false alternatives, such as recurrent proposals for debt restructuring.

To some, debt restructuring or larger haircuts on government bonds may seem politically attractive. But such practices can only be a last resort. They are by no means a sustainable option to ease a government's financial obligations. They would not help to promote fiscal discipline and could create higher costs in the long run. And they would do nothing to address the fundamental weaknesses in the Greek economy.

In short, the path of easy answers leads to stagnation, decline and an over-burdening of the young and future generations.

From what I see today, I trust that the Greek people know which path they need to take. A recent poll shows that 69% of the public supports the euro – and being part of the euro means taking tough but necessary decisions.

Responsible choices and reliability are the preconditions for solidarity. Greece has already received support from other euro area countries equivalent to 17,000 euro per Greek citizen. And, provided that it complies with the programme, those countries are committed to supporting Greece until it regains market access.

In short, all the conditions are present for Greece to return to prosperity – and for the sake of both current and future generations, I trust that Greece will make the most of them.