George A Provopoulos: The Greek financial crisis – from Grexit to Grecovery

Speech by Mr George A Provopoulos, Governor of the Bank of Greece, for the Golden Series lecture at the Official Monetary and Financial Institutions Forum (OMFIF), London, 7 February 2014.

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I want to thank David Marsh for inviting me to be here today. Since its establishment just 4 years ago, OMFIF has quickly become an important platform for the exchange of ideas on issues that concern the global economy, with an emphasis on Europe.

In this connection, let me mention that I became Governor of the Bank of Greece in mid-2008. During the following year – that is, in 2009 – the Greek sovereign- debt crisis erupted. Consequently, I have been at the battlefront of the euro crisis throughout the turmoil, and I would like to share with you my perspectives about what went wrong and what needs to be fixed to make the euro area a better-functioning economic and monetary union.

My presentation will be structured as follows. I will begin by discussing the origins of the euro-area crisis. Next, I will describe the adjustment that has taken place within the stressed countries. With Greece at the epicenter of the crisis, my focus will be on what has happened in my own country. I will then turn to some related issues, notably, the reasons for the deep economic contraction in Greece and the problem of debt-sustainability. Finally, I will discuss changes that are being made to the euro-area's institutional set-up and their implications for the single currency's future.

Origins of the crisis

Five years ago the thought of a euro-area crisis seemed counter-intuitive. After all, as David Marsh points-out in his book on the euro, European monetary union was undertaken to make the kind of crisis that occurred impossible. However, when deciding on what architecture to give to the monetary union, policymakers settled on a "bare-bones" approach.

The approach rested on a single independent, price-stability-oriented central bank – the ECB – and fiscal discipline by the member countries, fostered by the rules of the Stability and Growth Pact and enforced by the markets. The Maastricht Treaty called on countries to pursue sound economic policies that would support the ECB in maintaining its price-stability goal. The founding fathers of EMU thought that, since the euro would eliminate exchange-rate risk from national interest rates, the single currency would make it easier to evaluate risk characteristics and, therefore, investment opportunities across countries. In other words, the elimination of exchange-rate risk would lead to greater transparency and increased market discipline on governments.

The dominant view at the founding of the EMU was that current-account imbalances among countries in the monetary union would become as irrelevant as they are among regions of individual countries. Persistent current-account deficits were interpreted as capital flows from countries offering relatively-low returns on investments to countries offering relatively-high returns. In other words, they were part of an equilibrating process under which the fast-growing periphery caught up to the core.

This architecture proved inadequate for several reasons. First, the fiscal rules were poorly designed and under-enforced. Second, instead of increasing the pressure for structural reforms and policy adjustments needed to strengthen competitiveness in the periphery, market forces acted in the opposite direction. The markets mis-priced credit risk, underpinning large capital flows into the periphery and reducing interest rate spreads. The reduction in spreads led to a relaxation of the budget constraints that the peripheral countries faced and made it difficult to distinguish between those countries that were performing well in terms of policy adjustment and those that were performing poorly. To make matters worse, the current-account deficits in the periphery were financed through sources of volatile capital, such as debt securities and bank loans, rendering the periphery vulnerable to sudden reversals of capital flows. Third, the founders of EMU underestimated the importance of financial stability in a monetary union. Thus, whereas they focused on the prevention of fiscal imbalances and inflation, they made no provision to deal with private credit booms and busts or with the feedback loops between banking crises and fiscal crises.

Under the original architecture, national authorities were solely responsible for banking supervision, resolution, deposit insurance, and financial stability. The combination of a lack of adequate fiscal rules, the absence of market-enforced discipline, the lack of attention to the interconnections between the banks and the sovereign, and increases in public and private indebtedness financed by volatile capital inflows was toxic.

A tale of two crises

Broadly speaking, the euro-area crisis has consisted of two separate crises – a sovereign-induced crisis and a banking-induced crisis, as I will explain. A sovereign debt-crisis mainly occurred in Greece.

What the crisis countries – Cyprus, Greece, Ireland, Portugal and Spain – have had in common was large current-account deficits prior to the crisis. In the run-up to the outbreak of the crisis, Ireland had a current-account deficit of around 5 per cent of GDP. That was small relative to those of the other crisis countries. In Cyprus, Greece, Portugal and Spain, the deficits ranged between 12 and 15 per cent of GDP.

The initial tremors of the euro-area crisis occurred in Greece in the fall of 2009 following news that the country's fiscal deficit would be much higher than had been expected by the markets. The country suddenly found itself at the center of a sovereign-debt storm, and interest-rate spreads began a relentless upward climb. The outbreak of the Greek sovereign-debt crisis took the markets by surprise. It should not have done so.

Greece joined the euro area in 2001. From that year until 2009, large and growing fiscal and external imbalances should have sounded loud warning alarms in the financial markets. During those years:

- Fiscal deficits consistently topped 5 per cent of GDP, peaking at 15.6 per cent at the end of the period.
- The widening of the fiscal deficits was mainly expenditure driven; the share of government spending in GDP rose by 9 percentage points – to 54 per cent.
- The share of government debt in GDP rose from about 100 per cent at the beginning of the period to 130 per cent at the end of the period.
- Greece's competitiveness, measured in terms of unit labour costs against those of its major trading partners, deteriorated by 30 per cent.
- The erosion of competitiveness, coupled with growth rates generated by consumption and an unsustainable fiscal expansion, led to a widening of the current-account deficit.

Upon becoming Governor of the Bank of Greece in 2008, I began to publically warn the government – in not very subtle terms – that it needed to urgently take measures to address the fiscal and external imbalances. My warnings were overlooked.

Once the crisis started in late 2009, it rapidly became self-reinforcing. The sovereign-debt crisis spilled over to the banking system, even though the banking sector had sound fundamentals – including high CARs, low loan-to-deposit ratios, and low ratios of total-bank-assets-to-GDP – prior to the outbreak of the sovereign crisis. As a result of the crisis, over the period from the end of 2008 until the end of 2013 real GDP contracted cumulatively by 25 per cent, intensifying the debt dynamics and contributing to the self-reinforcing nature of the crisis.

In the remainder of the periphery – especially Ireland, Spain and Cyprus – it was the banking sector that generated a sovereign crisis, not the other way around as in Greece. Capital inflows were channeled mainly through national banking systems to help finance construction. Private indebtedness financed by the capital inflows surged, leaving the countries prone to the unwinding of the capital inflows. As with the case of Greece, the inflows fueled large competitiveness losses as rises in the prices of non-tradables spilled over to the tradables sector, setting the stage for a boom-bust cycle.

In these countries, the bust came through the banking systems. What happened was that the large size of the banks relative to national GDPs undermined confidence in the sovereigns, creating doom-loops between banking systems and the sovereigns.

To explain why this happened, consider the following difference between banks in the United States and those in the euro area. Although the largest banks in the euro area and the United States are of roughly the same size in terms of euro-area GDP and U.S. GDP, respectively, the largest euro area banks represent a much larger share of any individual national economy compared with the situation of U.S. banks. Consequently, banking crises in individual euro-area countries placed large fiscal burdens on governments, calling into question their solvency and making the use of counter-cyclical fiscal policy infeasible.

In light of the exposure of the banks to the debt of their sovereigns, the deteriorating fiscal positions, in turn, affected the banks. The lesson from this experience was clear; an effective economic and monetary union needs to include a banking union.

A crisis-induced economic adjustment

The euro-area crisis served two vital purposes. First, it acted as a wake-up call to policymakers in economies that had become uncompetitive. Second, it brought to the surface fundamental weaknesses in the EU's institutional structure. Consequently, since the onset of the crisis, policymakers in the stressed countries have made significant progress in addressing fiscal and external imbalances. At the same time, institutional flaws in economic and financial governance are being addressed.

In what follows I will first focus on the adjustment that has taken place in Greece.

Consider, first, fiscal adjustment. From 2009 to 2013, the fiscal deficit was reduced by some 13 percentage points of GDP. The structural fiscal deficit – that is, the deficit that corrects for the business cycle – has shrunk by 19 percentage points of GDP. The primary fiscal deficit – that is, the deficit that excludes interest payments – was 10½ per cent of GDP in 2009. Last year it swung into a small surplus. What makes these achievements especially impressive is that they have taken place despite a contracting economy, which creates moving targets for fiscal consolidation.

Greece's fiscal consolidation is one of the largest ever achieved by any country under an IMF program. In gross terms, fiscal-adjustment measures amounting to more than 30 per cent of GDP were implemented between 2010 and 2013. In net terms, the figure is, of course, smaller since the gross measures have the effect of making GDP contract. Additional fiscal measures are being implemented this year. These measures will increase the primary fiscal surplus to 1 ½ per cent of GDP this year. The new measures place emphasis on expenditure cuts to reduce the size of the government sector and allow the tradables sector to expand, so that exports can help generate growth.

Consider, next, external adjustment. As I mentioned, Greece lost about 30 per cent in terms of cost competitiveness against its major trading partners in the period from 2001 to 2009.

Since 2010, the situation has been reversed. As of the end of last year, the entire loss – and more – had been recovered. Competitiveness is also being promoted through structural reforms which have increased the flexibility of labour and product markets.

As a result of these improvements in competitiveness, a rebalancing of the Greek economy is taking place. The share of exports of goods and services in GDP rose from 18 per cent in 2009 to 28 per cent last year. This share continues to rise. The current account, which was in deficit to the tune of 15 per cent of GDP in 2008, moved into surplus last year.

Two factors about the improvement in competitiveness stand out. First, it has been achieved without the benefit of a nominal exchange-rate devaluation. Reflecting extensive labour-market reforms, it has been based on reductions in unit labour costs – an internal devaluation. Second, it has been achieved against a backdrop of low inflation in the economies of Greece's trading partners, a situation that makes it difficult to attain improvements in competitiveness.

Consequently, in a matter of several years Greece has been able to transform its enormous external and primary fiscal deficits into surpluses – a remarkable achievement.

The banking sector

Let me now turn to the restructuring of the Greek banking system. It has been enormous. With the deepening of the crisis, the Bank of Greece stepped in to preserve banking system stability. Our efforts focused on two fronts:

- Preserving banking system liquidity, and
- Restoring capital adequacy.

Ample liquidity was provided to banks, both through monetary policy operations and emergency liquidity assistance. Regarding capital adequacy, the first stage of our strategy included a viability assessment of the banking system. Based on this study, viable banks were fully recapitalized using a combination of state and private funds. State funds were provided by the Hellenic Financial Stability Fund, which had been established with a backstop of € 50 billion for that purpose. Non-viable banks, which were unable to raise private capital, were resolved, using state-of-the-art resolution tools – tools that are now being introduced in other EU countries. Before the crisis, the Greek banking system comprised almost 20 banks. Today we have four well-capitalized, viable pillar banks and a few smaller ones.

We are now implementing the second stage of our strategy. This stage involves a new banking model that will allow banks to repay state aid and finance the recovery of the Greek economy. Having acquired the clean portfolios of resolved institutions or having merged, banks are now exploiting synergies and economies of scale, further eliminating excess capacity, and becoming more efficient. They are also refocusing on their core activities – selling non-core assets and rationalizing their networks and activities abroad.

Late last year, we re-engaged BlackRock to update credit loss projections for banks' loan portfolios up to 2016, and to study the efficiency of banks' procedures in managing non-performing loans. The efficient use of the backstop during recapitalization and resolution has left a buffer of around € 8–€ 9 billion, should additional capital needs arise. Moreover, the sale of non-core assets and the exploitation of synergies arising from mergers could add some €5 billion to the buffer.

A "code of conduct" for banks' dealings with distressed borrowers is being drawn up and will be implemented as of 2015. It has two objectives: first, to ensure the maximum repayment of non-performing loans; second, to alleviate pressures on borrowers whose ability to repay their debts is at present reduced. Improvements in NPL management will lower capital requirements, freeing up resources that can be used to finance a new growth model for the Greek economy.

Some important outstanding issues

I will now touch upon two important issues.

- Why has the economic contraction been so deep in Greece?
- Is the present level of Greek government debt sustainable?

When Greece agreed to an adjustment programme with the troika – the IMF, the ECB, and the Commission – in May 2010, a recovery was projected for late-2012. Clearly, no one expected that the contraction, which began in late 2008, would last for 5 years and would cumulate to more than 25 per cent.

Why did the projections go so severely off track? There are several reasons.

The first reason concerns the magnitude of required fiscal adjustment. The magnitude of fiscal consolidation was bound to be substantial, because the size of the initial imbalances was very large. What increased the effects of the fiscal consolidation was the mix of policies adopted. Experience shows that fiscal consolidation programmes based on spending cuts lead to smaller economic contractions than those based on tax increases.

For this reason, I have been calling for fiscal adjustment comprised of two-thirds expenditure cuts and one-third revenue increases – mainly generated by expanding the tax base – since the inception of the programme. During the initial stages of the programme, however, the adjustment measures comprised a mixture of 60 per cent revenue – largely tax – increases and 40 per cent expenditure cuts. The tax increases reduced after-tax income, restraining private consumption, and decreased the after-tax return on investment, reducing the incentive to invest. They thereby had a negative effect on consumer and investor psychology, contributing to a cycle of pessimism that engulfed the economy.

The second reason for the deeper than expected economic contraction was that the Greek economy is relatively closed. In closed economies, any decline in demand hits domestically-produced goods more than imports. The decline in demand for domestic production, then, affects output more than if the economy were more open. I called attention to this matter in an article I wrote for the Financial Times in early 2012.

The third reason that economic contraction reached unprecedented levels concerns the implementation of structural reforms, privatization, and measures to improve tax collection. For an adjustment programme to be effective, all the inter-connected parts must be in place. In the early stages of the programme, that did not happen. Implementation in each of these areas was slow and inefficient, exacerbating the contraction. The slow pace of implementation of structural changes contributed to a rise of uncertainty, including widespread speculation of a Greek exit from the euro. In turn, the uncertainty – and the fact that it inflicted a paralysis on the economy – magnified the size of the fiscal multiplier.

Then, there is the issue of the sustainability of Greece's public sector debt. Presently, the debt-to-GDP ratio stands at about 175 per cent and it is projected to decline to 110 per cent in 2023. Decisions agreed by the Eurogroup in November 2012 – including a reduction in interest rates and lengthening of maturities on official sector loans – have not yet been implemented. Those decisions were conditioned on the achievement of a primary fiscal surplus. That condition has now been achieved; the exact amount of the surplus will be announced in April. With that announcement, I expect that the Eurogroup will agree to measures to help improve Greece's debt dynamics.

That agreement, however, is not all that can be done to improve the debt dynamics. The major reason for the rise in the debt-to-GDP ratio during the past several years has been the sharp decline in GDP. What, then, can be done to boost growth, so that the denominator of the debt-to-GDP ratio acts in a stabilizing way? My earlier discussion points to several areas that need attention.

- First, the pace of reform of the product and services markets, and the restructuring of the wider public sector need to be stepped-up. This would lower production costs and improve competitiveness.
- Second, the size of the government sector should be reduced to facilitate a shift in production from non-tradables to tradables, allowing a competitive export sector to flourish.
- Third, more emphasis should be placed on scaling-back government consumption instead of public-sector investment, since the latter can be a key contributor to the country's future economic growth.
- Fourth, a high priority needs to be given to privatisation and improving the ease of doing business, so as to attract more foreign direct investment. FDI has traditionally been low in Greece. Creating a more growth-friendly environment and speeding up privatization would clearly facilitate FDI.

Addressing all of these areas would improve the business climate and reduce uncertainty, creating what I call a "new growth model". That, in turn, would reduce the still-very-high borrowing costs faced by Greek firms while encouraging banks to begin lending to the real economy.

Initiatives at the EU level

What about the policy responses to the crisis? They have included actions in both the ECB's monetary policy and in EMU's architecture.

The actions of the ECB have been decisive. The ECB has kept policy rates at historically-low levels; it has satisfied the liquidity needs of banks, and has expanded its collateral framework. The announcement of Outright Monetary Transactions – the OMT – has helped reduce tail risks of a euro break-up. Furthermore, under its forward guidance the ECB has made it clear that policy rates will be kept at present or lower levels for an extended period of time.

Changes in the architecture include both improvements in macroeconomic surveillance and efforts to establish a banking union.

Economic governance has been improved through three main pillars: the so-called "six-pack", the fiscal compact, and the "two-pack". These pillars involve stronger macroeconomic surveillance designed to identify imbalances earlier, monitor them effectively, and thus ensure their timely correction. These measures should go a long way to preventing the build-up of the large imbalances that were present before the crisis.

Banking union is being designed to break the negative feedback loops between banks and the sovereign, as well as to create an integrated, stable and well-capitalised banking sector. The Single Supervisory Mechanism, which will become fully operational this November, will lead to the transfer of the supervision of almost 85 per cent of total euro-area bank assets to the ECB.

A necessary complement to a supervisory mechanism is a resolution framework to deal with non-viable banks. Our experience with the successful resolution of 12 banks in Greece has shown that resolution mechanisms need efficient decision-making procedures, allowing resolutions to be done within a weekend, in order to safeguard financial stability. Resolution will also need a credible back-stop. The Fund envisaged will be built up by contributions over a maximum 10-year period. I favour a shorter period to ensure that a credible backstop will be available sooner.

Finally, the harmonisation of Deposit Guarantee Schemes will help prevent the emigration of funds in search of higher coverage. The scheme will begin operation in January 2016.

Concluding remarks

I would like to offer some concluding remarks. For too long, the countries at the euro's periphery sacrificed long-term gains for short-term gratification. We have seen the results.

The policy reforms that the euro-area's crisis countries are now implementing follow an established recipe. That recipe worked for the U.S. and the U.K. in the 1980s, Sweden and Finland in the early 1990s, Asia in the late 1990s, Germany in the early 2000s, and in many other countries. That recipe stresses the need to improve competitiveness, and includes fixing social security, strengthening employment incentives, privatisation, and streamlining the public sector.

Some of these measures – especially those related to structural reforms – take time to work. The gains do not come overnight; they require patience and the ability to ignore the siren calls of those who offer quick fixes. Supported by the ECB's policies and the strengthening of the EU's architecture, that recipe is now working.

- We have seen an end to the recession in the euro area.
- Spreads have declined sharply in peripheral countries, despite recent disturbances in emerging markets.
- Slowly – but surely – the monetary transmission mechanism has become less fragmented.
- As progress toward banking union continues, fragmentation will further diminish.
- Crisis countries have gone a very long way toward eliminating their imbalances.
- Confidence is increasing.

The case of Greece perfectly illustrates the progress that has been achieved. Since the peak of the crisis in mid-2012:

- Spreads against 10-year German sovereigns have fallen by around 1,800 basis points, to around 700 basis points.
- The Athens stock exchange has risen by about 85 per cent.
- Bank deposits have increased by 9 per cent.
- Reliance of banks on Eurosystem financing is down by about 50 per cent.
- Economic sentiment has recently reached a 5-year high.
- The twin deficits have been transformed into twin surpluses.
- The recent release of the PMI for manufacturing for January 2014 points to expansion for the first time in 53 months.

It is now generally expected that 2014 will be the year in which growth – although very modest at first – returns to the Greek economy. Underlying this expectation of growth are the following factors.

- The substantial progress achieved in terms of competitiveness, including the effects of structural reforms in labour and product markets, will lead to an improved export performance.
- The return of confidence will help support a rise in consumption and investment.
- Fiscal drag will be considerably less than in previous years.

Nevertheless, the euro's financial storm clouds have not yet completely cleared. Here, again, the case of Greece illustrates the situation in the euro-area more broadly. The economic and financial environment in Greece remains fragile and sensitive to negative developments. The very high unemployment rate and the large sacrifices undergone by the Greek people led to social and political polarization. Political uncertainty, and the risks associated with that uncertainty, could escalate ahead of the European Parliamentary and local Greek elections that will take place in May, undermining the recovery.

It is my hope that such an unfortunate scenario will not occur. Greek citizens, like the citizens in the other crisis countries, have had to undergo tremendous sacrifices during the past few years. These sacrifices are now bearing fruit and it would be tragic to see them washed away. Despite these risks, I am confident that Grecovery is on the way.

The financial storm served an important purpose. It set in motion policy reforms at both the individual-country level and the euro-area level that will help foster a stronger and more secure Europe, improving the welfare of its citizens and enhancing its position as a major player on the world stage.