George A Provopoulos: Indications are that 2013 was the last year of recession

Speech by Mr George A Provopoulos, Governor of the Bank of Greece, at the 81st Annual Meeting of Shareholders, Athens, 27 February 2014.

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At the previous General Meeting of Shareholders of the Bank of Greece in February 2013, I had stated that, according to the Bank's assessment, the Greek economy would soon stabilise. At the time, our forecasts indicated that the recession would gradually ease and that positive GDP growth rates would be observed in 2014. The developments in the past year have confirmed this assessment.

More specifically, in the past twelve months:

First, economic policy remained committed to the stabilisation programme. Consistent implementation of the programme boosted international markets' confidence in Greece. As a result, the spread between Greek and German 10-year government bonds fell to 655 basis points at end-2013, from 1,000 basis points at end-2012.

Second, the improvement in confidence is gradually feeding through into the real economy. The fall in GDP in 2013 turned out to be milder compared both with 2012 and with projections in early 2013, mainly on account of the robust performance of exports, especially tourism, and smaller declines in consumption and investment.

Third, the risks to gradual stabilisation did not materialise. The most serious of these risks was the Cypriot crisis, which was dealt with promptly and effectively, without repercussions for confidence in the domestic banking system.

Fourth, the recapitalisation of Greece's four core banks was completed successfully, and major steps were taken towards restructuring and consolidating the banking system. These changes were carried out smoothly, without impact on the safety of deposits and financial stability.

The year 2013 marks a turning point, with the elimination of the twin deficits and the restoration of the economy's cost competitiveness

The increasingly brighter outlook during the course of 2013 gradually led to stabilisation and permitted noticeable improvements in fiscal and macroeconomic aggregates:

The *first* noteworthy development is the estimated achievement of a primary surplus for the first time since 2002. This is a remarkable achievement, considering the severity of the recession.

Second, according to provisional data from the Bank of Greece, the current account posted a small surplus in 2013. The substantial improvement in the current account balance over the last four years was due to lower imports, as a result of the recession, and to increased exports. Between 2010 and 2013, while imports of goods and services in nominal terms contracted by 15%, exports rose by 21%.

Third, after more than two decades of almost continuous losses in international competitiveness up to 2009, by 2013 Greece had recovered all of the cost competitiveness it had lost relative to its trading partners. This was due mainly to a decline in unit labour costs throughout the economy in the context of a deep recession with a surge in unemployment, and greater labour market flexibility. Price competitiveness, by contrast, has not yet fully recovered, as inflation only started to respond to weak demand and lower labour costs during 2013. Negative inflation of –0.9% in 2013 has contributed to improving the economy's price competitiveness and supports real incomes.

Structural reforms were implemented between 2010 and 2013 that had been overdue for decades

The elimination of both domestic and external macroeconomic imbalances came as the result of a gradual adjustment of the economy from 2010 to 2013. During the same four-year period, a series of structural reforms were implemented in labour and product markets and in public administration.

Structural changes in labour and product markets

In the labour market, significant changes were adopted, aimed, first, at better aligning wage developments with firm performance and, second, at enhancing labour mobility across sectors. Progress with structural reforms in goods and services markets, by contrast, was markedly slower than in the labour market. Nevertheless, according to OECD estimates, Greece ranked first in responsiveness to structural reform recommendations made by the Organisation.

Institutional changes to public administration

The fiscal measures taken during the period 2010–2013 aimed at improving the budgetary balance as quickly as possible. They consisted mainly of increases in direct and indirect taxes, as 60% of the adjustment achieved came from increased tax receipts, while the remaining 40% came from expenditure cuts.

Nonetheless, this period also witnessed significant institutional changes geared towards streamlining the public administration and downsizing the public sector. At the same time, new institutional reforms were adopted that lay the foundations for improving fiscal management and ensuring the better control of public spending.

It should, however, be stressed that progress with several critical reforms, such as administrative reform and the restructuring of public entities through mergers or closure, was slow, thereby delaying an effective restructuring of public administration and an improvement in public services. Efforts have also been made to upgrade the tax collection mechanism. However, here as well, despite clear improvement, the necessary progress in curbing tax and contribution evasion has yet to be made.

Financial stability was safeguarded by the bank of Greece with the support of the government

During the crisis, Greek banks were cut off from international markets and, until June 2012, experienced an unprecedented outflow of deposits, equivalent to one third of the deposit base. In response, they resorted increasingly to short-term financing from the Eurosystem. At the height of the crisis in June 2012, total central bank financing to credit institutions came close to €140 billion.

In addition, although Greek banks entered the crisis with satisfactory capital adequacy ratios, the heavy losses they suffered from 2010 onwards and especially the impact of Private Sector Involvement (PSI) resulted in nearly all banks being faced with a capital shortage at end-2011. The recapitalisation of Greek banks thus became imperative, in order to fully protect depositors.

Under these adverse circumstances, the government and the Bank of Greece took a number of decisive actions aimed at safeguarding financial stability and protecting depositors. The most important of these actions involved:

- the uninterrupted coverage of banks' short-term liquidity needs and the public's demand for cash;
- the securing of adequate public funds for the recapitalisation and restructuring of the Greek banking sector;

- the resolution of weak banks under a new legal framework; and
- the recapitalisation of core banks.

Steps towards the restructuring of the banking system

The establishment of an appropriate resolution framework allowed for a smooth restructuring of the banking sector. By end-2013, twelve banks had been resolved, mainly via the transfer of their healthy assets to another bank. Also, following a bidding process, the assets and liabilities of Cypriot bank branches were transferred smoothly to a Greek bank.

With the completion of the recapitalisation process by mid-2013, banks' capital adequacy ratios had been restored. The Hellenic Financial Stability Fund (HFSF) is now the largest shareholder in each of Greece's four core banks and has a buffer of over €8 billion to meet any further capital needs.

The banking landscape today is different from that prevailing at the start of the crisis. Excess capacity has largely been eliminated, fewer but stronger banks are in operation, and the first benefits from the exploitation of synergies are already visible.

Institutional reforms to reinforce EU economic governance

The crisis served as a catalyst for strengthening economic governance in the EU, in general, and the euro area, in particular. Support mechanisms were created. Economic policy coordination and budgetary surveillance have been reinforced.

The new fiscal framework, laid down in the "Fiscal Compact", came into force in January 2013. Member States that have signed up to the Compact are required to adopt national fiscal rules to ensure that the annual structural government deficit does not exceed 0.5% of GDP, as well as a correction mechanism to be triggered automatically in the event of deviation from either the Medium-Term Objective (MTO) itself or the adjustment path towards it.

At the same time, decisions were taken towards enhancing the institutional framework for financial supervision and safeguarding financial stability. Top priority was given to the establishment of a banking union. The approval of the Single Supervisory Mechanism, scheduled to become operational in November 2014, as well as the European Council's agreement on a general approach to a Single Resolution Mechanism are important steps towards the completion of the banking union. In 2013, agreement was also reached on directives on deposit guarantee schemes and a framework for the recovery and resolution of credit institutions.

As far as Greece is concerned, the institutional improvements to the EMU architecture will ensure that past mistakes in fiscal management are not repeated and will contribute in the long run to economic stability, while the banking union is expected to boost confidence in the banking system.

Prerequisites for the materialisation of the forecasted recovery in 2014

Based on all the available data, it is reasonable to forecast that 2013 was the last year of recession. However, if this forecast is to become a reality, not only must the conditions contributing to the improved outlook remain unchanged, but they also have to be taken further. The prerequisites for this to happen are:

- Resolve and consistency in implementing the stabilisation programme. The positive outcomes so far leave no room for complacency. On the contrary, they call for a continuation of fiscal adjustment for maintaining a sustainable and increasing primary surplus so as to ensure debt sustainability and consolidate the climate of confidence.

- Elimination or at least minimisation of the risks and uncertainties that might be triggered by a deterioration in the social and political climate, as a result of growing confrontation in the run-up to the European and local government elections.

Today, as we are near the end of a protracted recession, a comprehensive national policy that will lead us safely out of the crisis and onto a path of sustainable growth is required. To be effective, such a policy requires consensus building and compromise. Both, however, are difficult to achieve in a polarised climate, which acts only to amplify differences and thwarts the convergence of views.

A prerequisite for growth is the continuation of fiscal adjustment. In this regard, top priority must be given to:

- ensuring consistency in the execution of the 2014 Budget, thereby providing a strong signal that the fiscal adjustment is sustainable;
- markedly upgrading the tax administration and the tax collection mechanism;
- speeding up the resolution of tax cases pending before the courts;
- cutting red-tape and the administrative burden on the private sector;
- enhancing the quality of public services;
- evaluating the performance of public services and civil servants according to transparent and objective criteria; and
- further strengthening the institutional framework for budget preparation, execution and monitoring.

Financing the economic recovery

With the start of the fiscal crisis in 2009 and the deep recession that followed, both the supply and demand for credit contracted sharply. Against this backdrop, banks' lending capacity was inevitably constrained, as the fiscal crisis strongly affected the credit ratings of both the country and domestic banks. Thus, bank credit to the private sector gradually declined, causing a large number of businesses to have difficulty financing their production activities.

Subsequently, the banking landscape in Greece has changed. Recapitalisation and restructuring of the banking system are gradually restoring confidence and are creating the conditions necessary for the supply of bank credit to the economy to increase over the medium term. However, several factors continue to limit new lending in the short term. The most important are the following:

First, net deposit inflows, a critical determinant of banks' capacity to supply credit to the economy, remain low.

Second, the loan-to-deposit ratio needs to be kept at a conservative level. This ratio has risen largely because of the loss of deposits during the crisis.

Third, the reliance of domestic banks on short-term financing from the Eurosystem remains high, in contrast to other euro area countries, and must be gradually brought down to more reasonable levels.

Fourth, despite the boost in confidence achieved after the recapitalisation, the accumulation of non-performing loans gives rise to concern. This accumulation makes banks reluctant to extend new credit, as it signals a high level of credit risk. Moreover, the non-servicing of loans deprives banks of income that could otherwise be recycled into new loans. Accumulating non-performing loans force banks to tie up more capital for future loan-loss provisions.

The capacity for credit expansion will remain limited on account of these factors. This credit squeeze can, however, be offset in the short term by companies turning to alternative sources of funds, such as internal capital generation, corporate bond markets, equity markets, private placements and other modern financing tools, as well as resources available from EU Structural Funds and the European Investment Bank. In the medium term, though, the improvement in macroeconomic aggregates will pave the way to a gradual normalisation of credit expansion.

Policy to speed up the restructuring of the economy and move quickly to sustainable growth

The main objective of policy today is the strengthening of the productive capacity of the economy so that the emerging recovery can be the start of sustainable growth in the years ahead. The economy is in a process of transition from a growth model that has exhausted its limits to a new model, capable of ensuring robust, sustainable growth in the future. As the Bank of Greece has repeatedly stressed, this new growth model must be based on a shift:

- from production of non-tradables to production of tradables;
- from consumption to savings and investment.

Admittedly, while the old growth model was discredited suddenly and violently, the new model has yet to emerge clearly into sight. Transformation is, by its very nature, slow and painful, as it entails a shift of capital and human resources across sectors and activities. It presupposes the emergence of new poles of attraction for capital, innovative investment and cutting-edge entrepreneurship. It can be facilitated by a reorientation of the banking system and policies to enhance labour mobility. The restructuring of the economy towards tradables production has already begun, but remains weak, against the backdrop of recession and heightened uncertainty. Restructuring can, however, be accelerated if economic policy assigns top priority to generating the necessary conditions conducive to the desired transformation.

Such a policy objective requires:

- Well-functioning markets for products, labour and capital.
- A business environment in line with best international practices, with a low administrative burden for businesses, an efficient public sector and a stable and favourable tax framework.
- A steady commitment to reducing the tax burden, especially on businesses. Declining taxation would both increase the incentive to invest and make more funds available for investment.
- Accelerated implementation of the privatisation programme and strengthening of the legal framework for investor protection to attract foreign investment.
- A shift on the part of companies to market-based financing.
- The productive use of programmes for the co-financing of loans and guarantees with resources from EU Structural Funds and the European Investment Bank.
- The active role of the banking system in the restructuring of businesses and sectors, with specific actions to support truly viable businesses and to encourage initiatives that promote bold sectoral restructuring. By adopting such a stance, banks could speed up the transition to the new growth model that Greece so urgently needs.

The challenges and role of the banking system today

As the only sector to have undergone such radical restructuring, the banking system today is well-positioned to play an active role and spearhead the restructuring of the business sector. What the banks have learned from experience can be equally valuable for businesses in other sectors. The banks should therefore see it as their duty to make an essential contribution to the transformation of production along the lines of the new sustainable growth model.

To this end, bank strategy must be reoriented so as to avoid a recurrence of the trends of the previous decade, when credit was largely used for residential investment and consumption. New credit must now go to dynamic outward-looking enterprises with growth prospects. In other words, the limited liquidity available should be channelled into the real economy in a way that maximises its growth potential. It is pointless, and even dangerous, to let weak, non-viable businesses and saturated sectors to continue operating as usual.

More reforms now in order to turn stabilisation into dynamic growth

After a protracted period of deep recession, the Greek economy is showing signs of recovery. We now face the challenge of turning the incipient signs of stabilisation into dynamic growth built on solid foundations. This, today, is the main item on the national agenda, the only way to ensure that the sacrifices of the past years will not have been in vain. The front-runners in this effort will be dynamic firms that shift their activities to new products and markets, generating a virtuous circle of growth. Economic policy can and has to facilitate this effort. The banking system must also lead the way by effectively supporting the restructuring of the business sector.

The Greek economy, after years of complacency, during which the twin deficits and debts rose to unsustainable levels, ultimately culminating in a crisis of unprecedented scale and depth, is now stabilising. The country has come a long way in terms of adjustment. However, the effort has not yet been completed. Now that we have succeeded in overturning the twin deficits into twin surpluses – a primary fiscal surplus and an external surplus – we must focus our attention on structural reforms and speed up their pace. It is in this area that our actions have not been broad and deep enough to ensure that structural changes can steadily feed through into sustainable growth. Regrettably, attempts at structural reform so far have been timid, characterised by wavering and delays. We all know of reforms that have been announced repeatedly over the past four years and yet have still not been implemented. If we want to move forward, we have to overcome these weaknesses. The anticipated recovery will prove hesitant and fragile, undermining the country's growth prospects, if we fail to implement reforms, aimed to ensure:

- a fundamental reorganisation of the state;
- modernisation of the institutions of education, health care and justice;
- the creation of competitive markets, including the opening-up of closed professions; and
- the design of a stable tax system, friendly to entrepreneurship and labour, but strict with tax evaders.

Only through such reforms can an environment conducive to sustained and healthy growth, as well as to economic and social progress, be created.