Yannis Stournaras: Prospects of the Greek economy and the banking sector

Speech by Mr G Yannis Stournaras, Governor of the Bank of Greece, at the Eurobank Investor Forum, Athens, 7 July 2014.

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Ladies and Gentlemen,

It is a pleasure to speak today at this Investor Forum, organized by Eurobank. I would like to share my thoughts with you on the prospects of the Greek economy and the banking sector. My speech will focus on three topics. First, what has been achieved so far during the difficult years of adjustment. Second, where does the economy and the banking system stand currently and what are the future prospects. Third, what are the challenges and the risks looking forward.

What has been achieved so far

Since the start of the crisis, four years ago, Greece has come a long way in adjusting its fiscal and external imbalances and implemented a bold programme of structural reforms.

First, there has been drastic fiscal consolidation.

In 2013, Greece returned to a primary surplus for the first time since 2002. Moreover, by achieving a primary surplus (as defined in the programme) of 0.8% of GDP, it outperformed the programme target of a balanced primary general government account.

This outcome implies an 11.3 percentage point improvement in the primary budget as a percentage of GDP in the period 2009–2013, despite the deepening recession. Adjusting for the effect of recession, the improvement in the "structural" primary budget deficit over the same period reaches 18 percentage points.

Second, competitiveness has been restored.

Greece has now more than recovered all of the cost competitiveness it had lost relative to its trading partners since joining the euro area. According to the ECB's Harmonized Competitiveness Indicators Greece has been the best performer in labour cost competitiveness after Germany.

This development reflects the effect of structural reforms in the labour market, which have allowed more flexibility in the process of wage bargaining, as well as the impact of the sharp rise in unemployment on labour costs.

Improvements in competitiveness on a price basis still lag due to relatively slower progress with product market reforms, higher indirect taxes and higher energy costs. However, it is gaining momentum and the inflation differential with the euro area has been negative since 2012.

Third, external adjustment has been significant.

The current account as a percentage of GDP posted a surplus of 0.8% of GDP in 2013, marking a significant turnaround of 16 percentage points since 2008. Adjustment came primarily through a decline in imports. However, after 2009, adjustment was equally shared between exports and imports.

It is worth highlighting that, during the last three years, exports of goods have rebounded, with growth rates outpacing those of the euro area. Moreover, the share of goods exports in extra-EU trade has nearly doubled and the share in world trade has increased by about 30% since 2010. These developments have occurred despite the adverse liquidity and financial conditions faced by Greek exporters.

By contrast, exports of services underperformed largely as a consequence of uncertainty, which negatively impacted on tourism, and global factors, which affected the performance of the shipping industry.

Fourth, the policy agenda has included structural reforms.

A series of structural reforms were also implemented in labour and product markets and in public administration.

In the labour market significant changes were adopted aiming at:

- better aligning wage developments with firm performance; and
- enhancing labour mobility across sectors.
- More specifically, reforms involved measures to decentralise wage bargaining to firm level, reduce minimum wages and relax employment protection (the index reflecting OECD Employment Protection Legislation improved significantly in the period 2008–2013).

Progress with structural reforms in goods and services markets, by contrast, was relatively slower than in the labour market. Nevertheless, according to the OECD, Greece ranked first in responsiveness to structural reform recommendations made by the Organisation.

Important progress was also made in lifting barriers to competition in various sectors, including building materials, food processing, retail trade and tourism. The closed professions (e.g. lawyers) were opened up, licensing procedures were overhauled and the cost of starting a business reduced. It can be noted that Greece shows the biggest improvement in World Bank's Ease of Doing Business Report in 2014 vis-à-vis 2011.

This period also witnessed significant institutional changes geared towards streamlining the public administration and downsizing the public sector. In the period 2010–2013, public sector employment fell by more than 25% or 200,000 employees.

- New institutional reforms were adopted that lay the foundations for ensuring the better control of public spending and improving public financial management. The Fiscal Compact, which provides for the establishment of an independent Fiscal Council to oversee fiscal developments, was transposed into national legislation.
- Finally, the Greek authorities have greatly reshaped the taxation system by adopting the Income Tax and Tax Procedures Codes and the new unified Property Tax. Measures have also been adopted to bolster the autonomy of the revenue administration in order to strengthen the collection of current and overdue revenue.

Lastly, bank recapitalization and considerable consolidation has taken place.

The landscape of the banking system has changed significantly with the number of banks being reduced though mergers, takeovers and resolution. Today the system comprises four core banks and a number of smaller banks. The four core banks, following recapitalization, are well-placed to meet the new challenges that the banking system faces going forward.

Confidence has been restored, improving financial conditions in the economy

The progress achieved so far has allowed confidence in the prospects of the Greek economy to be restored. This turnaround in sentiment was the result of the consistent implementation of the adjustment programme. The restoration of confidence has led to an improvement in financial conditions in the Greek economy, in particular with respect to financing through capital markets.

- First, the Greek government has returned to international bond markets after three years, raising €3 billion through a five-year bond issue.
- Second, core banks raised a combined total of €8.3 billion in new equity, with strong participation from foreign investors and €2.25 billion from senior bond issues.
- Third, since December 2012, large Greek companies raised a total of €5.5 billion in foreign corporate bond markets.
- Fourth, interest rate spreads have narrowed significantly both for the sovereign and the private sector. Over the past 18 months, sovereign spreads against bunds have narrowed by about 550 bps (from more than 1000 bps in early 2013 to 450 bps currently). Over the same period, corporate bond yields have declined from more than 9% to less than 5%.
- Fifth, funding conditions of Greek banks have improved as ELA financing has fallen to zero and reliance on central bank liquidity has declined significantly. Wholesale markets have reopened to Greek banks and funding costs have declined.

Encouraging signals from the real economy

Encouraging signals are also present from the real economy, with both soft and hard data showing signs of stabilization and gradual recovery:

- The recession has eased considerably since early 2013. If this trend continues, GDP should grow by about 0.5% in 2014.
- Private consumption, the most important component of GDP, turned positive in the first quarter on a year-on-year basis, for the first time after fifteen quarters of steep declines. Exports increased significantly, driven by buoyant tourism receipts and upward trending shipping receipts, reflecting an upswing in world trade.
- Industrial production also shows signs of stabilization and indicators, such as retail sales, travel receipts and new car registrations, suggest that the recession is gradually coming to an end. Soft data (such as the Economic Sentiment Indicator and the Purchasing Managers' Index) indicate a more optimistic outlook for the months ahead.
- Lastly, encouraging indications are emerging with regard to employment. Over the first five months of the year, dependent employment flows have been positive and significantly higher than previous years. However, unemployment still remains exceptionally high and is expected to fall only gradually.

Recovery in 2014 is feasible

Overall, recent developments in the Greek economy support the forecast of a gradual return to positive growth in 2014. By 2014:

- the fiscal drag will be considerably lower compared to previous years;
- competitiveness gains and higher external demand for Greek products and services will bear fruit in terms of better export growth;
- liquidity constraints will loosen further; and
- the benefits of structural and institutional reforms will be more evident.

However, recovery hinges upon, first, a reversal of the decline in investment and, second, a faster growth of exports.

Improvements in business and overall confidence strengthen the prospect of a recovery in investment as:

(i) firms are gaining access to alternative sources of financing, such as corporate bond issues;

(ii) the absorption of EU funds has increased (by April 2014, the absorption rates for the programming period 2007–2013 rose to 79.3%, bringing Greece to third place in the EU);

(iii) the creation of a Greek Investment Fund will have a positive effect on foreign capital inflows; and

(iv) the first quarter of the year marked the restart of major infrastructural projects.

The second factor expected to contribute favourably to growth is a rise in exports. Historically, export performance has been closely related to cost competitiveness, in particular unit labor costs relative to trading partners. In fact, over the period 2000–2009, wage competitiveness has declined by about 25%. Exports of goods and services (excluding receipts from shipping) have underperformed exports of the EU17 by a similar margin.

However, this close relationship between wage competitiveness and relative export performance broke down after 2009: while wage competitiveness has improved by more than 25% since 2009, exports of goods and services (excluding receipts from shipping) have outperformed EU17 exports by just 5%. Historical correlations would have predicted an outperformance of 25% instead.

This pattern has been recently termed "the puzzle of the Greek missing exports" by some researchers. The fact that Greece ranks low in term of structural competitiveness – despite significant progress in the past few years – is certainly one of the main factors explaining the puzzle. Structural reforms with the aim to improve the quality of institutions will unlock export potential and allow competitiveness gains of the past to translate into export dynamic.

However, there are other factors too, which explain why competitiveness gains have not impacted yet on exports to the extent one would expect based on historical correlations. One important factor is uncertainty, which peaked in mid-2012 with markets discounting a possible GREXIT. This has impacted on tourism, Greece's biggest export industry. The second factor was the lack of credit. Exporters faced a significant credit squeeze which affected both trade credit and the financing of investment in new capacity.

Looking forward, however, the negative effect of these two factors on exports will gradually dissipate. Tail risks have largely receded, allowing the tourist industry to rebound significantly in 2013 and in 2014. Also, financial conditions improve as markets open up to Greece and corporates gain access to funding and trade credit. This will allow investment to recover, which, in turn, will allow the country to broaden its export base and capitalize on its improved competitiveness.

Challenges and risks, looking forward

However, challenges remain. The cumulative decline in real GDP since the start of the crisis amounts to 25% and unemployment in 2014:Q1 stands at 27.8% with the long-term unemployed accounting for over 70%. Active labour market policies can mitigate the hysteresis effect and should be given priority, along with measures to strengthen the social safety net.

Downside risks to the outlook exist.

- The main risk is due to ***political uncertainty***, related to the election of a new President in early 2015.

- A second downside risk relates to a slowdown in the global economy and an increase in risk premia in international asset markets. Lower growth elsewhere would hurt exports and higher risk premia would worsen already tight financial conditions, with negative consequences for investment.
- Finally, ***geopolitical risks*** in Russia and the Ukraine could weigh on exports. Oil prices are also a risk factor, which could derail the recovery.

However, there are also ***upside risks***.

- First, ***exports could perform better***. Tourism receipts may surprise on the upside this year, as they did last year. More importantly, shipping, which has acted as a drag on export revenues since 2008, could well perform better than expected as excess supply in the industry declines and world trade picks up. ***Receipts from shipping*** are an important component (ca 50%) of exports of services. Due to the crisis in the global sector, receipts from shipping have declined by 35% over the period 2009–2013, acting as a drag on Greece's overall export performance. By contrast, in the first four months of 2014, they have rebounded sharply and are up by 22%. As the sector gradually returns to a normal level of activity, receipts from shipping will contribute significantly to overall export growth.
- Second, figures for private ***consumption*** in the first quarter of 2014, at +0.7% year-on-year, were ***better than expected***, implying consumption could surprise on the upside for the year.

In the long term, the growth outlook of the Greek economy is expected to improve:

- structural reforms in product and service markets will boost productivity, competitiveness and private investment; and
- a better institutional environment – easier to do business, more efficient public administration – will add to potential growth.
- The above will increase the economy's openness, thus raising the contribution of net exports to growth.
- Finally, a smaller public sector will produce positive crowding-in effects.

Reforms must continue in order to ensure recovery

Today, the central focus of economic policy should be to maintain and strengthen the emerging positive momentum. To this end, determined efforts towards the following objectives must continue:

- ***A more efficient public sector offering high quality services and friendly towards business.*** Progress so far has been made in downsizing and rationalising the public sector. However, there are certain areas in which there have been delays and gaps that need to be addressed promptly. For example, creating an efficient judicial system, improving the quality of public sector services, establishing a national land registry and clarifying land use definitions.
- ***Reducing public debt***. Continued fiscal adjustment is required to put public debt on a downward path and ensure sustainable access to global capital markets. Over the medium term, efforts will need to be focused on a rationalisation of expenditures and the improvement of the tax administration. The better-than-expected fiscal adjustment achieved in 2013 paves the way for the implementation of the Eurogroup decisions of November 2012 regarding possible debt sustainability measures. This commitment from our European partners was recently reiterated in the Eurogroup statement released on 5 May 2014.

- ***The third objective is the reorientation of the production model*** to ensure rapid and sustainable growth in the long term. The Greek economy is not simply emerging from a cyclical recession. At the same time, it is shifting towards a new growth model. Thus, economic policy needs to generate conditions that favour supply-side restructuring of the economy. This requires that structural reforms are stepped up to ensure the efficient and competitive functioning of product, labour and capital markets. At the same time, a recovery of investment requires a business environment with a low administrative burden for businesses, an efficient public sector and a stable tax environment that will ultimately facilitate the easing of the tax burden on businesses and individuals.

A question that arises is the extent to which this growth model will be viable on the demand side. That is, will a rise in investment and net exports offset the gap in demand resulting from the squeeze on private and public consumption expenditure? Given the size of adjustment in the economy, such an outcome is in my view feasible in the long run, even under fairly conservative assumptions regarding the dynamics of exports and investment.

Banking sector developments

Let me now turn to issues related to the banking sector. Important and promising developments are taking place in the Greek banking system.

The banking landscape today is very different from that prevailing at the start of the crisis.

- Core banks' capital adequacy ratios have been restored and excess capacity has largely been eliminated. The stress test exercise was well-received in the markets and the market capitalisation of Greek banks has been significantly boosted.
- Funding conditions have improved. As I also mentioned, ELA has been eliminated and recourse to central bank financing has fallen sharply since its peak in 2012. Additionally, Greek banks have regained access to wholesale markets, allowing them to tap market funding. Private sector deposits have now stabilised and initially recorded a sharp increase in the wake of the elections in mid-2012.
- Pre-provisioning operating profitability is improving. This can be attributed to cost containment, primarily, from the funding side and, secondarily, from the operating side. Positive developments are also present on the revenue side with Net Interest Income and Fees and commissions recording rises.
- The deterioration of asset quality appears to have been slowing down.
- Finally, consolidation has occurred. Fewer but stronger banks are in operation and the first benefits from the exploitation of synergies are already visible. More gains in both cost savings and revenue enhancement are expected in the coming years as a result of merger synergies and the improved macro environment. Synergies are expected to raise the efficiency of Greek banks to levels comparable to European peers. The rebound of economic activity will improve revenues and the quality of banks' balance sheets.

Challenges ahead

The positive developments outlined above must not make us complacent. The banking sector still faces significant challenges, with the most significant one being the accumulation of non-performing loans. This, makes banks reluctant to extend new credit, deprives them of income that could otherwise be recycled into new loans and forces them to tie up more capital for future loan-loss provisions.

The resolution of the challenges surrounding non-performing loans has two preconditions.

First, the economy has to return to a positive growth path and falling unemployment that, in their turn, will improve the repayment ability of borrowers.

Second, a framework has to be put in place at the level of individual banks to ensure a more pro-active management of non-performing loans. Emphasis should be placed, on the one hand, on the alleviation of the burden on borrowers facing temporary difficulties in servicing their debts and, on the other hand, the finding of a more permanent solution to loans which are unlikely ever to be fully repaid. Such a strategy will not only help individual borrowers, but in the long term will unlock funds for the financing of the economy.

To this end, two important developments have taken place. The government has established the Government Council for Private Debt Management. The Bank of Greece has prepared a framework of supervisory requirements for banks' NPL management, as well as a Code of Conduct for the management of private sector arrears. Both have laid the ground for the creation of a mechanism for resolving the issue of non-performing loans.

Banks, for their part, must continue undertaking the necessary organizational actions to enhance the operating units that deal with these loans.

They also need to continue implementing value-enhancing, capital-enhancing and funding-enhancing strategies in light of the latest stress test, the Basel III requirements and the slow pick-up in deposits. At the same time they face pressures to reduce their reliance on Eurosystem refinancing and are due to face pressures relating to the change in ECB collateral rules in early 2015.

Up until now, the only sector in the economy to have undergone radical restructuring is the banking sector. Lessons learned from this experience can be valuable for other sectors and banks are in a unique position to contribute to the transformation of other sectors. Banks can advise and, when possible, actively participate in the consolidation of other sectors of the economy. In this way, they will contribute to the sectoral restructuring of the Greek economy.

New credit must target dynamic, outward-looking enterprises with growth prospects. In other words, banks must channel credit into truly viable enterprises, whether new or old, encourage business partnerships and support initiatives conducive to bold sectoral restructuring. In this way, they will maximise the growth potential of the Greek economy.

Let me summarize my main message to you.

As investors, you will know very well that there are two main types of investments: those focusing on underlying value and those focusing on growth prospects of an asset. Both investments come with their specific risk characteristics and, at the end of the day, it is the reward-risk relationship which counts.

Investing in the Greek economy is likely both a value and a growth trade. Value, because investors have turned their back to the country for a long time. Growth, because during this time, the country has gone a long way towards improving its fundamentals and, hence, future growth prospects.