Yannis Stournaras: Bank of Greece's Monetary Policy Report 2015-2016

Speech by Mr Yannis Stournaras, Governor of the Bank of Greece, to the Standing Committee on Economic Affairs of the Hellenic Parliament, Athens, 11 July 2016.

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1. The completion of the first review has a positive effect on confidence and enhances the growth prospects

The completion of the first review has a positive effect on confidence and enhances the growth prospects, with direct and indirect benefits, including:

- First, the disbursement of successive loan tranches totalling €10.3 billion. The first tranche of €7.5 billion has already been disbursed; of this amount, €5.7 billion will be used for public debt servicing and €1.8 billion will be used to settle part of general government arrears. The remaining amount of €2.8 billion (of which €1.7 billion will be used to pay general government arrears) will be released by autumn 2016, conditional on a number of prior actions in the following areas: the pension system; bank corporate governance; energy; privatisations; the general secretariat of public revenue; and the labour, product and services markets. This should have a positive impact on liquidity and economic activity in the second half of 2016.
- Second, the recent decision of the ECB Governing Council to reinstate the waiver for Greek government bonds, enabling Greek banks to obtain low-cost financing from the European Central Bank (ECB). This development, along with a dissipation of uncertainty, the stabilisation of private sector deposits and the progress achieved in restructuring Greek banks, has contributed to the lowering of the emergency liquidity assistance (ELA) ceiling for Greek banks by €9.5 billion since late June, bringing it down to €58.6 billion.
- Third, the eligibility of Greek government bonds for inclusion in the ECB's quantitative easing programme towards the end of 2016. This, together with the reinstatement of the waiver for Greek government bonds and the resulting refinancing of Greek banks at a lower cost, should have a sizeable beneficial effect, potentially amounting to €400-500 million, on banks' results. However, the indirect benefits, through e.g. upgrades of the credit ratings of the Greek sovereign and Greek banks, are expected to be even greater.

The above developments are expected over the medium term to encourage a return of deposits to the Greek banking system, which will allow an easing and, ultimately, lifting of capital controls. Coupled with a more effective management of non-performing loans, this will contribute to reducing borrowing costs and will gradually increase the lending capacity of Greek banks, with positive effects on the financing, hence the growth performance, of the Greek economy.

In general, the completion of the first review is impacting favourably on the Greek economy, by strengthening confidence and removing the uncertainty that has weighed heavily on the economic climate and led to a postponement of investment decisions.

The gradual restoration of confidence as a result of the completion of the first review is reflected in several leading indicators of economic activity. For example:

- The industrial PMI index, which had fluctuated below the growth/contraction threshold from February to May 2016, rose above that threshold in June 2016 (to 50.4, from 48.4 in May), indicating a marginal increase in manufacturing output and posting its highest value since May 2014.

- The economic sentiment indicator stabilised in June (at 89.7), as the decline in service and retail confidence was offset by an improvement in industrial and consumer confidence, with the latter reflecting households' more optimistic expectations about the overall economic situation and their financial condition over the next 12 months.

At the same time, the completion of the first review contributed to a decline in the yields of Greek government bonds and corporate bonds issued by Greek non-financial firms on the international market. However, the global capital market turbulence in the wake of the UK referendum, in which a majority of British citizens opted to leave the EU, has contributed to a reversal of this downward trend and an increase in yields.

Building on the elimination of macroeconomic and fiscal imbalances and the significant improvement of unit labour cost competitiveness over the 2010-2015 period, economic policy focus must now shift to the reforms and privatisations agreed upon between the Greek government and the institutions, as well as to the utilisation of idle state property, which can serve as a catalyst for attracting investment. These actions would support growth, while facilitating the achievement of future budgetary targets of the programme.

2. The Eurogroup's commitment to take action on debt relief

The successful completion of the first review is accompanied by a commitment from our partners to take action to reduce the Greek debt burden. The Eurogroup statement of 25 May describes the timeframe and outlines a number of actions to be implemented, if deemed necessary, in order to bring the gross financing needs of the general government down to more manageable levels, i.e. below 15% of GDP in the medium term and below 20% in the long term.

The Bank of Greece takes the view that, in the first place, the expressed will of our partners to provide debt relief strengthens confidence in the future of the Greek economy. However, the measures included in the Eurogroup statement have not been specified or quantified, whereas the final decisions on debt will be re-examined after the completion of the programme and are conditional on (i) a positive final assessment of the programme implementation; and (ii) the outcome of an updated debt sustainability analysis to be produced in 2018.

The Bank of Greece considers that there are important reasons to act now.

- First, global interest rates are at historical lows and the term structure is relatively flat, implying that, at the same cost, debt relief could be much more beneficial to Greece now than a few years down the road, when global interest rates might be higher.
- Second, debt relief now will contribute to improved confidence of international investors in the country, hence, to lower risk premia, lower cost of financing, stronger investment and improved growth prospects for the Greek economy.

Sensible debt relief measures could include:

(a) extending maturities;

(b) smoothing interest payments over time;

(c) restoring the transfers of ANFA and SMP profits;

(d) swapping IMF for ESM loans.

In the view of the Bank of Greece, debt relief measures should be accompanied by a lower medium-term fiscal target. Specifically, the final target for a general government primary surplus of 3.5% of GDP could be reduced to 2% of GDP after 2018, enabling a faster return of the Greek economy to robust and sustainable growth rates. Besides, past experience has shown that very few countries have been able to maintain high primary surpluses of 3.5% of GDP over relatively long periods, as required in the case of Greece from 2018 onwards.

An important argument supporting this view is that, given the current debt dynamics, one percentage point higher growth is 80% more effective in reducing the debt-to-GDP ratio than a one percentage point of GDP higher primary surplus.

Public debt sustainability scenarios explored by Bank of Greece staff show that primary surpluses of 2% of GDP from 2018 onwards are consistent with public debt sustainability, assuming:

(a) an extension of loan maturities by 20 years; and

(b) the smoothing of capitalised deferred interest payments over a 20-year period.

Moreover, the easing of fiscal targets will allow a lowering of taxation. This would alleviate the consequences for the real economy, thereby strengthening growth in the medium-to-longer term, which could speed up the reduction of public debt.

3. Developments in the banking system: liquidity, non-performing exposures and capital controls

(a) Liquidity

The completion of the review will largely dispel the remaining uncertainties. Combined with the anticipated exit of the Greek economy from the recession onto a path of sustained growth as adjustment and reforms bear fruit, reduced uncertainty should lead to a return of deposits to Greek banks and the improved access of domestic credit institutions, as well as of healthy extrovert Greek businesses, to international financial markets.

From the beginning of the crisis, the Greek banking system suffered the consequences of successive sovereign downgrades, followed by bank downgrades that forced Greek banks out of the global financial markets. Meanwhile, uncertainty led to large deposit outflows, amounting to some €90 billion, i.e. one third of the initial deposit base, in less than three years. Banks had to resort to a large extent to central bank funding, at first through Eurosystem monetary policy operations, but gradually, due to the lack of eligible collateral, to emergency liquidity assistance (ELA) from the Bank of Greece. It should be noted that ELA funding peaked at €120 billion in 2012, before gradually declining and coming to zero in the first half of 2014.

Thanks to the broad liquidity support from the central bank, the decline in bank credit to businesses and households was much weaker than the contraction of the banks' deposit base.

The deteriorating economic climate and heightened uncertainty in the first half of 2015 led to widespread deposit outflows, totalling some €45 billion. Of this amount, about one third involved the withdrawal of banknotes (for hoarding "under the mattress"); one third was transferred to banks abroad; and one third was invested in foreign money market instruments. The bank holiday and the imposition of capital controls (including restrictions on cash withdrawals from bank accounts, cross-border payments and cross-border capital movements) managed to contain the deposit outflows and the capital flight. At the same time, capital controls encouraged the use of electronic payments. In fact, there is strong evidence that the widespread use of electronic payments have boosted tax revenue by reducing the informal economy.

The recapitalisation of Greek banks was successfully completed in December 2015, with a substantial participation of private investors. The four significant Greek banks managed to cover the capital needs identified by the ECB's stress tests. The necessary funds came from (a) foreign investors, who placed around €5.3 billion; (b) capital mitigating actions amounting to €0.6 billion; and (c) liability management exercises (voluntary bond swap offers to bank bondholders) that yielded about €2.7 billion. For the two banks that did not fully cover their capital needs, based on the adverse scenario, from private sources (totalling about €5.4 billion), the necessary additional funds were drawn from the Hellenic Financial Stability

Fund (HFSF). Thus, the public resources used proved to be far lower than the amount of €25 billion foreseen by the Eurogroup in August 2015.

Moreover, banks' reliance on ELA has decreased and, since end-July 2015, the ceiling has been lowered by more than €31.5 billion to €58.6 billion. This lower ceiling reflects the improved liquidity situation of Greek banks amid easing uncertainty and a stabilisation of private sector deposit flows; the gradual and improving access regained by banks to interbank market funding (in fact using collateral not eligible for Eurosystem operations); and progress with the recapitalisation of Greek banks. It also reflects progress with the restructuring of Greek banks (with the sale of Finansbank by the National Bank of Greece), and the impact of the ECB Governing Council's decision, on 29 June, to reinstate the waiver. With particular regard to deposits, more than €2 billion returned to the banking system between 20 July 2015 (when the bank holiday was abolished although capital controls remained in force) and the end of 2015. During the first half of 2016, deposits showed signs of stabilising. Meanwhile, there has been a gradual but steady return of banknotes, with a deposit inflow of about €4 billion since 20 July 2015.

The acceptance of Greek government securities as eligible collateral for open market operations, through which the Eurosystem refinances euro area banks on highly favourable terms, will reduce funding costs for banks, which are expected to increasingly participate in the Eurosystem's targeted longer-term refinancing operations (TLTROs) and in other non-standard monetary policy instruments.

More generally, the Greek banks have benefited from a number of monetary policy measures taken by the ECB, such as interest rate cuts and targeted longer-term refinancing operations (TLTROs). They have also benefited from the public sector purchase programme (PSPP), by selling to the Eurosystem notes (of up to an amount of €19 billion) that had been issued and contributed by the European Financial Stability Facility (EFSF) to strengthen the capital base of Greek banks. The sale of EFSF notes could bring capital gains of some €200 million to Greek banks.

Now that the waiver has been reinstated, the ECB Governing Council will at a later stage also examine possible purchases of Greek government bonds under the public sector purchase programme (PSPP) (a nominal amount of about €3.7 billion after the end of July 2016), taking into account, as stated in a relevant ECB announcement, the progress made in the analysis and reinforcement of Greece's debt sustainability, as well as other risk management considerations.

More generally, as mentioned above, access to lower-cost refinancing from the Eurosystem, coupled with the participation of Greek government bonds in the ECB's quantitative easing programme, should have a sizeable beneficial effect, potentially amounting to €400-500 million, on banks' results. Even greater, however, would be the indirect benefits, through e.g. upgrades of the credit ratings of the Greek sovereign and Greek banks.

(b) Non-performing exposures

The major problem facing the Greek banking system today is the high stock of non-performing exposures (NPEs) in bank portfolios.

Greece has the second highest NPE ratio in Europe (after Cyprus), with non-performing exposures at the end of the first quarter of 2016 reaching 45% of total exposures or, in absolute terms, €108.6 billion. In particular, the NPE ratio came to 67% in the SMEs sector, 42% for housing exposures and 55% for consumer exposures.

The above NPE ratios have yet to top out, moving inversely to GDP. In the first quarter of 2016, NPEs increased further by €600 million. Yet, a trend towards deceleration seems to have set in, considering that the increase in 2015 as a whole surpassed €4 billion.

Despite the size of the problem, the capital base of the banking system remains strong, with the provision coverage ratio standing at 50%. If one adds to this the value of collateral pledged, total risk coverage comes to 101%, one of the highest in the EU.

Recognising the seriousness of the problem, the Bank of Greece, as early as in 2013, took a number of initiatives, either by conducting studies or by issuing legal acts and regulatory provisions to address NPEs.

Following a thorough analysis of the situation (Troubled Assets Review), Executive Committee Act No. 42/2014 was adopted, establishing a supervisory framework for the management of loans in arrears and non-performing loans, whereby banks are required to report, on a quarterly basis, in the most detailed manner at European level, data on their NPEs and the actions they have taken for their management, as well as their internal reorganisation for this purpose.

A few months later, in the autumn of 2014, the Bank of Greece introduced a Code of Conduct for Banks for the transparent, effective and, where appropriate, flexible treatment of cooperating borrowers facing difficulties in servicing their debt obligations. The Code ensures that borrowers are provided with timely and comprehensive information and are protected against unfair treatment by creditors, and is geared towards promoting permanent and sustainable arrangements, whether forbearance or resolution and closure solutions.

The Bank of Greece has worked closely with the relevant ministries on the preparation of legislation enabling the effective tackling of NPEs, such as Law 4307/2014 ("corporate insolvency for SMEs"), amendments to Law 3869/2010 ("household insolvency") and, more recently, amendments to Law 4354/2015 to permit the assignment of the management and the transfer of loan portfolios to specialised non-bank entities. By authority of that law, the Bank of Greece adopted Executive Committee Acts Nos 82/2016 and 95/2016 detailing the licencing framework for credit servicing firms, striking a balance between speed, transparency, efficiency and borrower protection.

Last but not least, the Bank of Greece, jointly with the Single Supervisory Mechanism (SSM) of the European Central Bank, decided to set binding operational targets for all Greek banks with a view to ensuring a reduction of NPEs over a horizon of three years. On 24 June, as instructed, banks submitted their detailed targets by NPE category for the remaining two quarters of 2016 and their annual targets for 2017, 2018 and 2019. They also provided specific documentation on their NPE management strategies and the instruments that they plan to use to achieve the targets set.

More specifically, according to the targets of the four systemic banks, NPEs should be reduced by 40% or €41 billion by 2019. This reduction is expected to result from: first, the economic recovery envisaged in the Programme and the ensuing return to profitability for a large swath of businesses; and, second, successful debt forbearance/restructuring whereby non-performing loans will become performing again. A small percentage of non-performing loans (about 5%) are likely to be sold, while no more than 7% of total NPEs are likely to be subject to collateral realisation.

The Bank of Greece evaluates and approves banks' NPE management strategies on the basis of the following key priorities:

- avoidance of short-term solutions and provision of sustainable long-term forbearance solutions or resolution and closure solutions;
- promotion of multiple creditor workouts;
- the restructuring of indebted viable businesses through new business planning and, if necessary, new management along with loan restructuring;
- active use of the existing stock of provisions and collateral for the permanent removal of troubled assets from bank balance sheets;

- development within banks of new organisational methods and processes for the objective and transparent selection of workout solutions.

To sum up, the size of NPEs is the most critical long-term challenge for both the banking system and the real economy. However, under certain conditions, it can also serve as a catalytic opportunity to attract investment and remedy the unhealthy situations that have long hindered the restructuring of production and hampered the competitiveness of the Greek economy.

(c) Capital controls

Following the bank holiday and the imposition of capital controls on 28 June 2015, it became an utmost priority to ensure the smoothest possible functioning of the Greek economy. Since then, the restrictions have eased considerably, also on the back of progress in various areas, notably the recapitalisation of Greek banks towards the end of 2015 and the recent successful completion of the first review. This latter fact will allow us to proceed to a further, albeit always cautious, relaxation of restrictions.

Throughout this period, the Bank of Greece has been working closely with the Ministry of Finance on developing a roadmap towards gradually lifting restrictions in line with progress in achieving important milestones for the Greek economy.

In this context, a proposal was submitted today to the institutions, with a new set of relaxation measures, accompanied by relevant documentation, aimed both to facilitate the operation of Greek enterprises and to further enhance banks' liquidity situation, thereby serving to improve sentiment among depositors, investors and businesses.

The new relaxation measures include:

- lifting the restriction on cash withdrawals in cases of new deposits in cash ("new funds");
- full lifting of the ban on early loan repayments;
- increasing the percentage of cash withdrawals from deposit accounts to which funds are transferred from abroad, from 10% to 30% of the total funds transferred;
- allowing cash withdrawals of up to €840 every two weeks.

At the same time, our goal is to shorten the execution times for fund transfers abroad and to reduce the costs arising from the imposition of capital controls. The Committee for the Approval of Bank Transactions, which has played a substantial role towards achieving this goal, is currently in the process of amending its decisions in order to:

- increase the limit up to which bank subcommittees may approve transactions (currently €250,000 per customer per day) and the amounts directly executable by banks in transactions without the requirement of prior history (currently €20,000 per customer per day). Our target is for businesses to be granted approval up to the next business day, in order to protect their reputation with their foreign partners;
- increase the limits on the use of cards abroad, and re-open almost all international websites for online purchases, thereby facilitating the transactions of both legal and natural persons with foreign counterparties;
- increase the monthly limit (currently €1,000) on fund transfers abroad from banks and payment institutions.

Meanwhile, following an intervention from the Bank of Greece, banks have stepped up procedures for the supply of POS terminals not only to retailers but also to independent service providers, restaurants and cafés, etc. Apart from offering convenience to consumers, this also helps to curb tax evasion.

In this regard, it should be mentioned that the fees charged by Greek banks on POS usage correspond, on a weighted average basis, to about 1.1% of the payment amount, compared with 1.8% in the US and 1.3% in the EU, and that the bulk of these fees goes to international card clearing houses and not the banks themselves.

Finally, it is important to note that Bank of Greece inspections of compliance with the capital controls legislation have shown that the banks' management and staff have effectively ensured the compatibility of their operations with the regulatory framework, despite the various implementation difficulties.

In conclusion, the Bank of Greece is preparing the next steps and making every effort for the fastest possible return to normality. The next changes, like the ones made so far, will need to be well-designed, so as to effectively improve the functioning of the economy, without hampering liquidity in the system, and, once macroeconomic and financial stability has been consolidated, to ultimately remove the restrictions.

4. Prospects of economic recovery and potential risks

In the first months of 2016, economic activity was adversely affected by the imposition of capital controls and by the delays in the completion of the first review of the new programme, initially expected in the fourth quarter of 2015. These developments, coupled with the negative carryover effect from 2015, caused GDP to contract for a third quarter in a row. Specifically, after the decline of GDP on an annual basis by 1.7% and 0.9% respectively, in the third and the fourth quarter of 2015, economic activity fell in the first quarter of 2016, both year-on-year (-1.4%) and quarter-on-quarter (-0.5%).

The forecasts of the Bank of Greece point to a recovery starting from the second half of 2016 and continuing through 2017 and 2018. Specifically, GDP is projected to post a small decline of 0.3% in 2016, but then to grow by 2.5% and 3% in 2017 and 2018 respectively. These projections assume that the completion of the review in the first half of 2016 will, from the second half of 2016 onwards, bring about significant positive effects for the liquidity of the financial system, reduce uncertainty and improve the economic climate, with important implications for the evolution of key components of domestic demand. They also assume that the accommodative monetary policy of the ECB will continue.

Regarding the inflation outlook, the downward trend of prices is projected to come to a halt in 2016, followed by a gradual increase in 2017 and 2018. For 2016, continued weak demand and low oil prices are expected to offset the recently enacted increases in indirect taxes. For 2017 and 2018, prices are projected to rise slightly as a result of expected higher oil prices, a gradual recovery of demand and the effect of indirect taxes.

The downward trend in unemployment is expected to continue at a slower pace during 2016. The rise in employment, in conjunction with the expected dynamic return to growth during the period 2017-2018, should contribute to a faster reduction in the unemployment rate.

Nevertheless, risks to the outlook of the Greek economy remain. Furthermore, any delay in the implementation of reforms and privatisations envisaged in the programme would dampen economic growth, thereby refuelling uncertainty, undermining confidence and weakening the prospects of a definitive exit from the crisis.

In addition, an exacerbation of the refugee crisis could hurt tourism and trade, slowing economic recovery.

Meanwhile, there remain risks and uncertainties regarding the course of the global economy, stemming, among other things, from the prospect of a Brexit in the wake of the recent referendum. These risks could slow down the recovery of the Greek economy, both through negative effects on tourism and trade and through the slower-than-expected decline in yields on Greek government bonds due to the risk aversion of global investors.

In any event, the impact from the outcome of the UK referendum cannot be fully assessed and will depend on the next moves of the British government and the subsequent negotiations with the European Union. In the medium term, any impact from the UK referendum will depend on the decisions of the EU Member States and the relevant EU institutions and bodies with a view to further strengthening and deepening the Economic and Monetary Union.

5. Key requirements for a return to sustainable growth

Based on the developments in the real economy and the expected positive impact of the first review, it is reasonable to predict that the end of the recession is close and that clear signs of recovery will become visible in the latter part of 2016. Moving on from this recovery to sustainable and strong growth will require a number of tangible and concerted actions, aimed to restore a "growth environment". These actions comprise:

1st. Consolidating confidence and strengthening the view that the Greek economy has returned to normality and there will be no backtracking. To achieve this, reforms and privatisations need to be implemented with consistency and continuity.

2nd. Utilisation of public property. As suggested by the Bank of Greece long ago, together with the implementation of necessary reforms, putting idle public property to good use and speeding up privatisation processes are the strongest tools for boosting investment activity and achieving sustainable growth, but also for supporting fiscal adjustment, insofar as they serve to reduce public debt.

3rd. Tackling the high stock of non-performing loans, which is the greatest challenge facing the banking system. Addressing this problem will not only alleviate the burden on cooperating borrowers, but will also enable banks to free up funds for channelling into more dynamic and extrovert businesses. This would contribute to a comprehensive restructuring of the economy in favour of tradable goods and services, leading to a rise in productivity and potential output, even in the short run.

The actions described above, together with an exit from recession and a gradual recovery of the economy, will bring about stabilisation and, subsequently, a decline in the NPL ratio, with beneficial effects on the economy as a whole.

4th. Gradual lifting of the capital controls. The relaxation of the capital controls described earlier, along with improvements in confidence and liquidity, are expected to contribute to the normalisation of economic conditions by facilitating both enterprises and individuals in their transactions.

5th. Reforms to support extroversion. The implementation of reforms in the markets for products and services and in the functioning of the public sector will lead to an increase in investment and employment, while it is also expected to encourage innovation and the introduction of new technologies by increasing competition. In turn, these developments will improve the quality of Greek exports and expand the export base and overall competitiveness of the Greek economy. This will ensure that the decrease in the current account deficit is sustainable, while also increasing potential output in the medium-to-long term.

These actions will attract foreign direct investment and set in motion a virtuous circle signalling the definitive exit from the crisis and a sustainable increase in total productivity of the Greek economy over the medium-to-long term.

6. Conclusions

The completion of the first review creates positive prospects for the recovery of the Greek economy in the second half of 2016. At the same time, the commitment of our European partners to take action in order to ensure the sustainability of public debt in the short and medium-to-long term is a positive step forward.

The Bank of Greece is of the view that the envisaged public debt management measures need to be specified, quantified and frontloaded. This would enhance the credibility and acceptance of the policies pursued, thereby helping to further consolidate the climate of confidence and strengthen economic recovery.

Moreover, the Bank of Greece considers that a return of the Greek economy to realistic and sustainable rates of growth would be further supported: ***First***, by the unwavering implementation of the necessary reforms and privatisations described in the recent agreement between the government and the institutions, and the utilisation of idle public property through appropriate measures to improve land use. ***Secondly***, by a lowering of the medium-term fiscal target from a primary surplus of 3.5% of GDP from 2018 onwards, to 2% of GDP, without affecting public debt sustainability prospects, through mild debt relief measures including an extension of loan maturities and a smoothing of capitalised deferred interest payments. This would allow taxation to be lowered and would free up resources for supporting economic activity, while making fiscal targets economically and socially feasible.