Yannis Stournaras: Recent economic and financial developments in Greece

Speech by Mr Yannis Stournaras, Governor of the Bank of Greece, at the 84th Annual Meeting of Shareholders, Athens, 24 February 2017.

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THE GREEK ECONOMY COULD START GROWING AGAIN EURO AREA MEMBERSHIP IS A PROTECTIVE SHIELD FOR GREECE

Remaining in the euro area is a vital condition for Greece

In a constantly changing globalised environment, the economic and monetary stability afforded by euro area membership provides the Greek economy with a protective shield against unanticipated risks. The sequence of political and economic external shocks that emerged last year demonstrated the resilience of the euro area and its capacity to prevent spillovers across member countries' economies. For Greece, active participation in the euro area is of the utmost importance for economic, social as well as national reasons. It is a vital condition for surviving in a turbulent European and international environment; it provides an anchor of economic, social and political stability. And we must not overlook the fact that in the course of history no country has received more financial assistance than Greece, which would not have been possible outside the euro area.

The credible implementation of the current financial assistance programme, which is generously financed by euro area member countries and contains actions that improve the competitiveness and creditworthiness of the Greek economy, creates the necessary conditions for Greece to return to positive growth, while participating on equal terms in the European crisis management arrangements and in the processes to improve the euro area architecture.

The Bank of Greece is of the view that, if our partners, the institutions and the Greek government all show flexibility and pragmatism, substantial progress can be achieved very soon. The Eurogroup decision on 20 February to resume negotiations with the institutions shows the willingness of the Greek government and our partners to continue the effort towards consensus-building, overcoming existing differences. But if the negotiations drag on with no agreement in sight, then Greece will enter in a new cycle of uncertainty, deteriorating relations with our partners and creditors, and a backslide of the economy into stagnation.

REINING-IN OF THE RECESSION IN 2016, GROWTH IN 2017

Over the past two years, the Greek economy has shown remarkable resilience:

- In 2015, GDP contracted by just 0.2% despite the particularly adverse conditions prevailing especially during the first half of the year, when uncertainty peaked about Greece's euro area membership, but also during the second half, when strict – at least in their first phase – capital controls were imposed.
- In the first half of 2016, the recession turned out milder than expected, and in the second half the economy posted positive growth. For 2016 as a whole, GDP at constant 2010 prices increased by 0.3%, deflationary pressures were contained, employment picked up and unemployment decreased, though still remaining very high.

These developments are a strong indication that the Greek economy has growth potential, which, after remaining idle for so long, stands ready to be tapped into, as soon as the right conditions are in place. Besides, despite the mistakes and the backsliding, despite the heavy economic and social costs of the crisis, the economic adjustment programmes implemented over the past years have succeeded in addressing chronic weaknesses and structural shortcomings of the Greek economy, thereby facilitating the improvement in the medium-to-long term growth potential. More specifically:

- the twin deficits, i.e. the primary fiscal deficit and the current account deficit, were eliminated;
- the substantial cumulative loss in labour cost competitiveness vis-à-vis our trading partners has been fully recouped;
- exports as a percentage of GDP have significantly increased (almost twofold);
- recapitalisation and restructuring have taken place in the banking system; and
- major structural reforms have been implemented in the labour and product markets.

The reforms implemented so far have contributed to an emerging restructuring of the economy towards a new, extrovert growth model, based on tradables.

Against this background, it is reasonable to anticipate positive growth of 2.5% in 2017, with the economy poised to move on to a new and more virtuous growth trajectory. The driving factors behind this outlook are: (a) an upward trend in private consumption; (b) a further strengthening of business investment and a rise in foreign direct investment, in terms of capital inflows and of reinvested profits by multinational firms; and (c) rising goods exports.

Fiscal policy

The year 2016 saw the enactment of a large number of fiscal measures, mainly related to tax and social security reforms and the establishment of an automatic fiscal adjustment mechanism. Progress with the new financial assistance programme was reflected in the successful completion of the first review, the disbursement of the second loan tranche, part of which was injected into the real economy through the payment of government arrears, and the finalisation of short-term debt relief measures. The new fiscal measures, together with the widespread use of electronic payments, broadened the tax base, contributing to a significant increase in public revenue.

Based on data currently available, the primary surplus in 2016 is expected to turn out at around 2% of GDP, while the target for a primary surplus of 1.75% of GDP in 2017 appears to be within reach. Downside risks to this outlook are associated with uncertainties about: the carry-over of the strong revenue performance; the containment of non-productive public expenditures; and, most importantly, the immediate completion of the second review, given its catalytic effect on macroeconomic developments. Further uncertainties relate to the Single Social Security Fund (EFKA) and its funding, due to changes in the calculation method for the social security contributions of the self-employed.

The banking system and private insurance companies

The pressures on the banking system in 2015 eased in 2016, with a small net inflow of deposits and redeposits of hoarded cash, a repatriation of funds and some decline in bank interest rates. Capital adequacy ratios remained high, after the successful recapitalisation with the participation mostly of private investors in late 2015, and banks maintained a very prudent provisioning policy. Furthermore, based on data for the second and third quarters of 2016, banks returned, even if only marginally, to pre-tax profitability. Meanwhile, the deleveraging of assets continues, mainly in the form of shedding of subsidiaries as part of restructuring plans. Importantly however, the annual growth rate of credit to businesses showed signs of stabilising, for the first time after several years of decline.

The downward trend in non-performing exposures (NPEs) continued into the fourth quarter of 2016. At year-end, NPEs were €106.3 billion, down from €107.6 billion at end-September 2016.

This implies that the banking system as a whole once again in the fourth quarter attained the NPE reduction target jointly agreed by the Bank of Greece and the ECB. This reduction was achieved mainly through the implementation of more effective workout solutions, leading to a higher cure rate, as well as through write-offs of non-recoverable loans. The accumulated stock of NPEs, despite showing signs of stabilising and of even receding slightly, still remains the most significant source of risk to the stability of the domestic financial system and (together with the sharp contraction of the deposit base) an obstacle to the financing of the economy and to the fulfilment of banks' intermediation role.

A welcome development is that several steps have been taken in the area of legislation and regulation, but also action on the part of banks to address the problem. The most recent developments concern: the regulatory framework for the authorisation and supervision of credit servicing and credit acquiring firms; the modernisation of bankruptcy law; the shift of banks to long-term workout solutions and the requirement that banks meet specific operational targets in terms of non-performing loan management. The target is for non-performing loans to be reduced by nearly €40 billion by end-2019. Most of this reduction is expected to come from the corporate loan portfolio. The achievement of the overall target will rely initially on long-term forbearance and resolution and closure solutions, selective write-offs and collateral realisation, while loan sales should be brought into play mainly from 2019 onward. However, reaching this target will also require that several legal and other pending issues be addressed such as: (a) out-of-court settlement; (b) the legal protection of bank, public entity and special liquidations staff involved in corporate debt restructuring processes; (c) the accounting/tax treatment of losses arising from loan sales or write-offs; and (d) the establishment of an electronic auction system.

These pending matters, coupled with the uncertainty associated with the slow progress of negotiations with the institutions on the completion of the second review, pose a risk to the attainment of the above target. Although the volume of non-performing loans declined in 2016, January 2017 apparently saw a pick-up in new non-performing exposures and a drop in borrowers' responsiveness to offered workout solutions. Meanwhile, the situation once again seems to be favourable to strategic defaulters, since deliberate default on loan obligations does not incur the prescribed sanctions. Against this background, reducing non-performing loans is imperative, all the more so given its multiplier effects both on banks and on the real economy: banks would benefit from higher asset quality, higher liquidity, lower financial risk and hence lower funding costs; this would translate into higher loan supply, as well as demand; and ultimately a restructuring of the economy's production model through the freeing-up of resources for financing productive investment.

Turning to the private insurance sector, the main developments in 2016 concerned the transposition into Greek law of the Solvency II Directive and the conduct of an EU-wide stress test. The adjustment of the sector to the new framework is seen as overall satisfactory and, despite the adverse economic environment which obviously has negatively affected premium volumes, the insurance market is well-capitalised. However, there is no room for complacency, given the serious challenges posed by macroeconomic developments, low interest rates and the search for yields. Consequently, the managements of private insurance companies must continue to improve their governance systems, personnel training, and transparency through the solvency and financial condition reports they publish under the responsibility of their respective boards of directors.

PRECONDITIONS FOR GROWTH

(i) An immediate completion of the second review

The Bank of Greece as well as international organisations forecast robust positive GDP growth for 2017. However, the realisation of these positive forecasts hinges upon the timely and effective implementation of the current financial assistance programme 2015–2018, which would signal a return to normality. This is why, as already mentioned, the successful completion of the second review is imperative. Among its numerous positive effects, it would:

- secure the financing of government borrowing requirements and a smooth execution of the 2017 budget;
- pave the way, together with the completion of the public debt sustainability analysis, for the inclusion of Greek government bonds in the ECB's quantitative easing programme;
- bring about, in turn, a decline in borrowing costs for the real economy, facilitating restructuring in the private sector;
- restore depositor confidence and allow a further easing or even full lifting of capital controls, thereby providing a boost to the export sector of the economy;
- improve the confidence of global markets and investors in the growth prospects of the Greek economy and allow Greek firms to access international capital markets;
- provide fresh impetus to the reform effort, geared to restructuring the economy towards a new, extrovert growth model; and
- reinforce political and economic stability.

(ii) Acceleration of reforms

As indicated by OECD and Bank of Greece estimates, the reforms can substantially increase Greece's growth potential. According to the OECD, the reforms implemented in Greece from 2010 through 2016, together with those planned under the programme, can be expected, ceteris paribus, to raise real output by about 13% over the next ten years.

This estimate by the OECD is corroborated by relevant Bank of Greece research, indicating that structural reforms have positive effects, mainly in terms of total factor productivity growth.

For the positive effects to materialise in the economy, an essential condition is that the agreed reforms are fully and consistently implemented without further delay. The cumulative gains from implementing only two thirds of the reforms in the services and labour markets over a 5-year horizon would fall short, during the first three years, by approximately 4% of GDP, compared to full implementation over the same 5-year period.

(iii) Tackling the problem of non-performing loans (NPLs)

The reforms are expected to further speed up the recovery and the restructuring of the economy. At the same time, however, the financing of the economy must be improved. This hinges crucially on the effective management of the high stock of non-performing loans (NPLs), which would impact positively on economic activity and productivity through two channels: by increasing bank credit supply and by restructuring the production model. This is why the relevant legislative framework must be complemented and completed as soon as possible.

Bank of Greece analysis indicates that a reduction in NPLs would help reduce the financial risk of banks and their funding costs, while also boosting their capital adequacy ratios. This would result in higher loan supply as well as lower bank intermediation margins and borrowing costs for businesses and households. At the same time, the restructuring of overindebted but viable businesses could serve as a vehicle for attracting investment capital, thereby further stimulating investment demand. Finally, the resolution of NPLs will free up resources, which if redistributed to the more productive businesses and sectors will lead to an increase in total productivity.

RISKS TO THE RECOVERY OF THE ECONOMY

In 2016 the Greek economy found itself halfway between recession and growth. In 2017 it is expected to recover, although this outlook remains subject to risks. A first category of risks relates to a volatile global environment.

Uncertainties related to the global environment in which the Greek economy is expected to operate are:

(a) a series of crucial elections and a rise in euroscepticism across the EU. A strengthening of anti-European forces would influence the decisions of leaders of several EU countries, thereby threatening to weaken EU institutions;

(b) uncertainties associated with changes in US foreign and economic policies under the new administration, which generate ambiguity about the future global role of the US;

(c) emerging protectionist trends, accompanied by a shortfall of private productive investment and a decline in world trade;

(d) possible adverse developments in the refugee-migrant crisis and a failure to properly address it could heighten public concerns about security and migration and make societies less inclusive;

(e) a deterioration in global security conditions, with significant economic losses in terms of trade, transport and tourism;

(f) geopolitical instability in the broader South-Eastern Mediterranean region; and

(g) the new European economic landscape to emerge from the negotiations between the EU and the United Kingdom on their post-Brexit relationship.

On the domestic front, the uncertainties and risks are mainly associated with the delays in implementing the programme, as reflected by the difficulty in concluding the second review. Allowing these delays to drag on would severely impede the anticipated growth, with negative repercussions on the overall climate and a new round of uncertainty regarding the completion of the programme.

Uncertainty would be exacerbated if Greek government bonds were to remain excluded from the ECB's quantitative easing programme. All of the above would undermine confidence and serve as a deterrent to foreign investment, which, as mentioned previously, is one of the fundamental conditions for growth.

Risks also arise from delays and procrastination in implementing reforms already agreed on or from distortions to competition that could hurt crucial sectors of the economy. A case in point is the electricity market, where recently enacted legislation introduced distortions, causing major problems even to companies that form the cornerstone of the electricity generation system.

STRATEGY FOR SUSTAINABLE STRONG GROWTH

The performance of 2016 suggests that the projected recovery in 2017 is feasible under the strict condition that implementation of the programme will continue without delays.

However, for the economy to move from recovery to sustainable strong growth, active medium-term policies are needed to eliminate the existing obstacles to growth, as well as to establish an environment of stability conducive to the revitalisation of investor interest. These obstacles include:

- the excessive tax burden on an overstressed tax base;
- the volatile and unclear tax and overall legal regime of investor protection;
- red tape and cumbersome administrative procedures, which delay progress with investment projects already approved;
- long delays in the delivery of justice;
- banks' low lending capacity and high lending rates;

- capital controls; and
- market distortions, notably in the electricity market, from ineffective regulatory interventions.

Lifting these obstacles should be a top priority of the growth strategy, which should focus on four key areas: changing the fiscal policy mix; encouraging foreign direct investment; fostering innovation; and safeguarding social protection.

(a) Changing the fiscal policy mix

The most serious obstacle that needs to be gradually removed is the excessive tax burden on businesses and households. The overachievement of the fiscal target for a primary surplus in 2016 was predominantly driven by an overperformance of tax revenue and to a much lesser extent by a containment of public spending. The increase in tax revenue is attributed to increases in direct and indirect tax rates, but also to a broadening of the tax base as a result of the widespread use of electronic payments that reduced the scope for concealing income. However, the current fiscal policy mix weighs heavily on economic growth, contributes to the increase in private sector arrears to the government and encourages tax evasion and undeclared work.

Steering the economy onto a growth trajectory calls for a change in the current "tax-centred" fiscal policy mix. Emphasis must be placed on: containing and systematically restructuring non-productive expenditure; reducing the excessive burden of taxes and social security contributions on the productive economy; and a more efficient use and management of state-owned property. In other words, there is a need for a fiscal environment capable of supporting the growth effort. This fiscal environment would additionally benefit from the implementation of short-term debt relief measures, the specification of medium-to-long-term ones and a possible quantification of realistic fiscal targets for beyond 2018. More specifically, higher-than-targeted primary surpluses, together with the implementation of the agreed reforms, could facilitate the progressive easing of the tax burden without jeopardising fiscal sustainability. It should be noted that the benefits to economic activity would be maximised if the fiscal space generated by the overperformance of tax revenue or by the reforms is used towards reducing income tax rates. At the same time, fiscal policy should support growth by ensuring a stable, internationally competitive and equitable tax system.

(b) Encouraging foreign direct investment

Given, first, that private investment as a percentage of GDP currently falls far short of its pre-crisis level (11% against 24% of GDP) and, second, that chronically low domestic saving is insufficient to finance the level of investment required for strong growth, there is an urgent need to attract foreign capital for joint investments with domestic firms. Apart from tourism, the economy has a number of other sectors with noteworthy growth potential, export-orientation and highly-qualified human capital. Attracting foreign direct investment (FDI) will require: a stable, modern and favourable tax system; reducing businesses' non-wage costs; encouraging innovation and exports; and a predictable, business-friendly economic environment.

Attracting and maintaining FDI would support Greece's exit from the crisis and sustainable growth. FDI would entail significant benefits for the Greek economy: introduction of new technologies and promotion of innovation; physical and human capital deepening; development of new higher-value added activities and products, notably in the tradables sector; higher competition; and job creation.

More specifically, export-oriented FDI is an effective tool that can speed up the restructuring of the domestic production model. The integration of Greek firms into global supply chains, the transfer of knowhow and foreign market expertise, as well as the upgrading of production processes and technology content to catch up with foreign competitors would make Greek businesses more competitive and improve their export dynamism.

Delays, procrastination and unwillingness to move forward with privatisations that have already been approved and planned are serious disincentives to the attraction of productive investment.

(c) Innovation and education

Fostering research, technology diffusion and entrepreneurship are key to harnessing human capital towards creating added value by linking the currently sidelined public research system to the productive economy, thereby contributing to Greece's return to sustainable growth. Generally speaking, public policy intervention can encourage technology transfer, i.e. the commercialisation of academic and scientific research (licensing and patents), and at the same time open up career opportunities for talented young graduates. To attain this dual objective, it is necessary: first, to embed in society a culture of entrepreneurship and excellence and, second, to utilise the resources of the existing guarantee and financing funds. The use of the finance instruments available from the European Investment Fund (EIF), part of the EIB Group, and the National Strategic Reference Framework (NSRF) 2014–2020 offers a solution to the funding problems of innovative small and medium-sized enterprises (SMEs).

(d) Reducing income inequality and tackling poverty

The relative at-risk-of-poverty rate based on 2014 income fell for the second year in a row, but still remains the seventh highest in the EU-28 and significantly above the EU-28 average. As percentages of the total population, the number of people at risk of poverty or social exclusion edged down slightly, while the number of people suffering from material deprivation has risen. The fact that the largest increase was recorded among children under 17 years is a serious cause for concern. At the same time, the income inequality indicators for Greece, albeit unchanged, are worse than the EU-28 averages. The targeted planning of social transfers has proven to be effective in helping to reduce poverty. Actions taken in this direction include: (a) the implementation as from February 2017 nationwide of a Social Solidarity Income programme (succeeding the minimum guaranteed income scheme); (b) measures to protect the unemployed and tackle extreme poverty; and (c) an increase in the child support benefit.

Furthermore, the composition of unemployment and its slow decline, coupled with the high percentage of young people "Not in Education, Employment or Training", highlight a need to focus on life-long learning and a better matching of skills. The active employment policies and the vocational training programmes of the Greek Manpower Employment Organisation (OAED) can contribute in this direction, with appropriate planning and targeting and the optimal utilisation of available, mostly EU, funds.

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In an uncertain global environment marked by unpredictable and successive episodes of turbulence, euro area membership today provides Greece with a protective shield against emerging risks. This is why Greece must consolidate its position as equal partner and be part of the efforts to strengthen European cohesion.

But for this to happen, Greece must return to normality, by successfully completing the economic adjustment programme. Greece must take ownership of the reforms, which are for its own benefit, and take immediate action to modernise and commit to the highest European standards of public administration, institutions and the rule of law, which no memorandum alone can achieve.

Now that we have reached the final stretch, very little remains to be done compared to the massive changes made since 2010. The process of economic adjustment has largely been completed, as suggested by the latest available economic data. With specific regard to fiscal adjustment, since 2010 about 90% of the adjustment required by 2018 has already been completed. The Greek economy has made a strenuous effort and has succeeded in eliminating significant structural weaknesses and imbalances that had accumulated over decades, displaying remarkable resilience. Its growth potential and high-quality skills pool, so far unexploited, stand ready to be mobilised under the right conditions and to launch the economy back onto a virtuous circle of growth.