Yannis Stournaras: Entrepreneurship, NPL resolution policies and economic growth prospects in Greece

Speech by Mr Yannis Stournaras, Governor of the Bank of Greece, at an event hosted by Piraeus Bank, Athens, 28 March 2017.

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It is a great pleasure for me to be here with you today and have the opportunity to share my thoughts on the growth prospects of the Greek economy and the role of entrepreneurship and NPL resolution policies. Today, the long-term growth prospects of the Greek economy are significantly improved compared to seven years ago as the economy has been undergoing significant rebalancing and adjustment, despite the missteps and delays that occur from time to time.

The improved macroeconomic fundamentals open up significant investment opportunities. Entrepreneurship can transform these improved opportunities in actual economic growth, new jobs and social prosperity. Banks play an important role in providing finance to entrepreneurs to make this transformation possible.

Greek banks have not been able so far to provide the necessary credit to companies as they are burdened with a high share of non-performing loans (NPLs). This may change in the future due to a number of ongoing initiatives. Resolution of NPLs may foster economic growth significantly as it will enable a productivity-enhancing reallocation of capital and employment from non-viable to viable companies and sectors.

Since the beginning of the sovereign debt crisis, Greece has implemented a bold programme of economic adjustment that has eliminated fiscal and external deficits and improved competitiveness. Between 2009 and 2016, the general government deficit shrunk by approximately 14 percentage points of GDP. The primary balance, adjusted for the effect of the business cycle, improved by about 17 percentage points of potential GDP. This achievement represents one of the largest fiscal adjustments ever undertaken and is twice that of the adjustment in other Member States that were under EU-IMF programmes.

On external adjustment, the current account also marked a significant turnaround improving by about 15 percentage points of GDP compared to 2008; in the last two years, it has effectively been in balance. Competitiveness has been restored, reflecting the effect of structural reforms in the labour and product markets. As a result, the share of exports in GDP increased from 19% in 2009 to 30% in 2016 with most of this increase stemming from exports of goods. In fact, according to Eurostat data, Greece's exports of goods have increased by 43% since 2009 in real terms, compared to 42% for the euro area and 47% for Germany, Europe's export engine.

This rebalancing of the economy towards a new, outward-looking growth model has particular significance for the prospects for entrepreneurship. A few figures are indicative of the forces at work. Between 2010 and 2015, the relative price of tradables versus non-tradables rose by about 10%. Whereas both sectors have been hit hard by the recession, the tradable sector has performed better than the non-tradable sector as outward-looking companies increased their exports, taking advantage of the improvement in competitiveness. As a result, the relative size of the tradable sectors, measured by Gross Value Added, grew by approximately 12% in volume terms and by about 24% in nominal terms. Finally, in terms of employment, the size of the tradable sector increased relative to the non-tradable sector by around 8%.

These figures would improve further if the already implemented reforms were to be enhanced by those planned under the ESM programme. Based on estimates of the OECD, the full implementation of all reforms, both those undertaken and those scheduled, is expected to boost real GDP over a 10-year-horizon by about 13%. And this figure excludes a further positive effect from structural reforms which cannot be easily quantified such as the modernisation of public administration and the judiciary system, the strengthening of insolvency regulations and the resolution of non-performing loans. In-house work by the Bank of Greece points to similar estimates of the effects of structural reforms with the main effect coming from higher total factor productivity (TFP) growth.

The strengthening of the long-term prospects of outward-looking firms requires a further opening-up of international trade, participation in global value chains and closer trade links with countries and businesses with cutting-edge technology. In this way, inherent structural weaknesses that hamper the market penetration of Greek products (such as product quality, protected designation of origin and branding, red tape, etc.) can be overcome. Additionally, improved financing terms and conditions would be forthcoming.

But prospects for entrepreneurs are also closely related to the paths taken by the various programme reviews. After the successful completion of the first review, a positive momentum developed which affected confidence and liquidity. A number of key indicators of economic activity, such as industrial production, retail sales, dependent employment flows and private consumption, improved. Bank deposits stabilised and emergency liquidity assistance (ELA) for Greek banks fell. These developments pointed at that time to a recovery starting from the second half of 2016 and continuing through 2017 and 2018.

This outlook is still possible in principle despite the deterioration in confidence and the weakening of short-term indicators in recent months, which is associated with the delay in closing the second review. For the time being, the delay in closing the second review has weakened but has not reversed the positive momentum of economic activity. However, any further delays could derail the recovery of the economy and put at risk the growth, fiscal and financial targets.

But entrepreneurship does not just require confidence. Reforms, that are part of the programme measures, also need to be implemented. Particular emphasis should be put on simplifying investment licensing procedures, reducing the administrative burden on businesses and facilitating competition, opening up the remaining regulated professions and network industries, modernizing and strengthening public administration, enhancing judicial efficiency, speeding up court proceedings and of course reducing personal and corporate taxation. Emphasis needs to be placed on restraining and restructuring non-productive spending and making a more effective and efficient use of the public sector’s assets, creating in this way incentives to increase investment and employment which will contribute to increased potential output.

For their part, the Institutions should show more flexibility in the area of fiscal targets and government debt relief. According to estimates from the Bank of Greece, a lowering of the general government primary surplus target after 2020 to 2 per cent of GDP, from the 3.5 per cent that is envisaged now, would be consistent with debt sustainability if combined with some mild debt relief measures and structural reforms to raise potential growth. The easing of the primary surplus targets, together with the implementation of the agreed structural reforms, would put the necessary conditions in place for a gradual lowering of tax rates, with positive multiplier effects on economic growth.

Finally, there is the issue of what debt relief measures. The short-term measures decided at the Eurogroup meeting of the 5th of December last year are a positive step and are expected to reduce public debt as a ratio of GDP by 20 percentage points by 2060.

However, to ensure the sustainability of public debt going forward, additional medium-term measures are necessary. When the debt-to-GDP ratio is above 100%, measures that reduce interest payments on debt can improve the ratio quicker than a rise in the primary balance. For example, with a debt-to-GDP ratio of 180%, a 1 percentage point reduction in the effective interest rate on debt will reduce the ratio of debt to GDP by 1.8 percentage points. By contrast, a rise in the primary surplus by 1 percentage point of GDP lowers the debt-to-GDP ratio by only 1 percentage point (assuming that the fiscal multiplier is 0 which, as we well know, is not).

Now, the interest burden of Greek public debt is low until 2021 but increases substantially thereafter because of payments of deferred interest on the EFSF loans and interest on new debt issued in financial markets. An exercise done at the Bank looks at the impact of smoothing interest payments for EFSF loans over time. The results of these simulations suggest that, extending the Weighted Average Maturity of interest payments for EFSF loans by 8.5 years, while simultaneously allowing primary surpluses to decline to 2% of GDP after 2020, debt sustainability is safeguarded.

This exercise is indicative of how admittedly mild debt relief measures can have significant effects on the debt profile with no cost for the creditors. Of course, were the interest smoothing accompanied by higher growth, as a consequence of lower primary surpluses, then the debt-to-GDP profile and gross financing needs would be even more favourable. Alternatively, if interest rate smoothing were to occur and the costs shared equally between Greece and the ESM, this would also lead to more favourable outcomes.

Turning now to the role of the banking sector in providing necessary credit to finance dynamic businesses, the issue of non-performing loans remains the greatest challenge. The stock of non-performing loans (NPLs) has reached unprecedented levels, with the deterioration in asset quality being widespread. There is no doubt that one of the main drivers of the sharp rise of NPLs has been the deep and prolonged economic recession and its impact on the financial condition of households and the non-financial corporate sector. However, other factors related to structural impediments also played a role: the ineffectiveness of judicial procedures; excessive borrower protection; the preferential claims of the State and Pension Funds on the proceeds of liquidations as against other classes of creditors; the unfavourable tax treatment of provisioning and write-offs; the lack of an out-of-court-workout framework; and the absence of a secondary market for distressed debt.

The Bank of Greece and the government have implemented several measures to address the long-standing impediments that dampened banks' efforts to deal with the problem. As a first step, the Bank of Greece conducted a troubled asset review to assess the operational preparedness and effectiveness of banks' established policies and practices to deal with the large scale resolution of troubled assets. Following this, the Bank enhanced the supervisory and regulatory framework. It issued guidelines regarding NPL management with a key requirement being the establishment of a well-defined governance structure with an internal independent NPL workout unit. It introduced the Code of Conduct regarding the interaction of credit and other financial institutions with borrowers in arrears.

Recently, the Bank of Greece, in close cooperation with the banking supervision arm of the European Central Bank, has designed an operational targets framework for the reduction of NPLs, supported by several Key Performance Indicators. The selected targets and key performance indicators are both action-oriented and results-oriented and provide a granular view of the key asset quality metrics of the bank, the management actions to reduce NPEs and the effectiveness of these actions. Banks have agreed ambitious but achievable targets, which were submitted at the end of September 2016, with a 3-year time horizon. The goal is to reduce NPLs by around 40 billion euros by end-2019. The targets set take into account the intrinsic characteristics of each bank's portfolio, organization and capacity. At the same time, banks have developed tailored models to calibrate the operational targets, taking into account macroeconomic assumptions.

The key performance indicators are monitored on a quarterly basis through extended prudential reporting, and the Bank of Greece, to enhance transparency and market discipline, has committed to publish a relevant progress report every quarter. Based on the first report already published, the targeted reduction of NPLs is on track, although the main reduction is not expected to take place before the end of 2018-beginning of 2019.

The government, for its part, has improved the regulatory framework related to the law on overindebted households. It has amended the Code of Civil Procedure, with a focus, inter alia, on changing the hierarchy of creditors and how proceeds are allocated in cases of liquidation. The capacity and efficiency of the judicial system have been enhanced, albeit with implementation being somewhat behind schedule. In addition, the government and the Bank of Greece have developed a framework for non-bank credit servicing firms and the sale of NPLs, with two companies having received a license so far, while other applications are being reviewed.

The above initiatives are about to be significantly enhanced by the implementation of further policy actions that are in the pipeline. Specifically, important steps are being taken regarding the revision of the out-of-court workout in order to facilitate coordination among banks and other creditors, including the State and social security funds. Significant focus will be on standardizing procedures for small business professionals and small and medium enterprises to ensure a rapid, effective and transparent resolution of arrears. In addition, the revision of bankruptcy law is expected to streamline procedures, allowing for creditor-led restructuring for companies with negative net worth, while the tax treatment of impairment losses and loan write-offs is in the final stages of being legislated. On the remaining steps, it is important that bank managers and employees acting in good faith in managing non-performing loans should be protected from criminal prosecution, while the platform for electronic auctions should become operational. Additionally, the full deployment of debt information / counseling centres across the country will facilitate borrowers' understanding of the optimum solutions to managing their loans.

The full implementation of the above reforms, in conjunction with a more active NPL management policy on the part of banks is beneficial from both a micro and a macro prudential perspective. It can improve the financial soundness of banks; it will free-up capital that can be directed to productive sectors of the economy, resulting in an increase in productivity and potential growth. Finally, it will diminish the power of strategic defaulters who, until now, see no immediate consequences from failing to pay. A conservative estimate, based on a sample of 13,000 firms with loans that exceed one million euro, indicates that, on average, one in six companies appear to strategically default, while anecdotal evidence suggests that this value is significantly higher for smaller businesses and households.

On the macroeconomic implications of NPLs, the academic literature has established a strong two-way relationship between macroeconomic developments and asset quality. The profound and well-documented negative relationship between economic growth and NPLs is enriched by recent studies that also identify a negative feedback effect from the banking sector to the economy. The size of that feedback is related to the ability of banks to channel savings to investment, to allocate risks and to transmit monetary policy decisions to the real economy. This ability has also been found to be related to bank-specific drivers, such as management quality, the level of capital, cost efficiency and risk preferences.

In particular, one of the main channels through which financial developments can have a feedback effect on the macro economy is through the capacity of banks to lend to the economy, the so-called "balance sheet channel". The reduction in NPLs can weigh positively on the supply of credit by unlocking bank capital and funding for the financing of productive companies. The reduction in NPLs improves the profitability of banks through higher interest income, reduced provisioning or write-offs and reduced administrative expenses for the monitoring and management of NPLs. At the same time, by removing doubts about the bank's future revenues, it allows banks to benefit from lower funding costs. Such developments positively affect loan supply. In addition, as impaired assets carry a higher risk weight, a lower level of NPLs allows banks to be more aggressive in funding investment opportunities, unconstrained by a scarcity of capital or the distraction of managements' attention to the management of a large-scale troubled assets portfolio.

In addition, a lower level of NPLs improves the allocation of credit from non-viable firms that are kept artificially alive to viable firms. According to research by the OECD, when more industry capital is sunk in non-viable ("zombie") firms, the average viable firm undertakes less investment than otherwise[1]. Hence, a rise in the fraction of non-viable firms in the economy crowds out the growth of more productive firms, thus reducing the efficiency of capital allocation and causing a slow-down in multifactor productivity growth. Simulations by the OECD suggest that reducing the share of capital of non-viable firms in Greece to the minimum across OECD countries would be associated with a gain in investment for a typical viable firm of 4.7% per annum. This number is economically very significant. It is indicative of the potential gains of NPL resolution for corporate investment, aggregate productivity and long-term economic growth. The policy implication is that there is considerable scope for policy reforms that facilitate NPL resolution in order to improve productivity-enhancing capital reallocation in the Greek economy.

On top of the above, the economy is also positively affected from the demand side, the so-called "borrower balance-sheet channel". From a debt overhang perspective, non-financial corporations with loans in arrears might have less incentive to invest in new projects in order to avoid using the upside potential to service current debt. In addition, higher lending rates seen in countries with prolonged NPL problems weigh negatively on credit demand. Higher lending costs drive firms to utilise internal sources of financing, resulting, on average, in the avoidance of large investment projects. A reduction in NPLs has the reverse effect, improving the willingness, incentives and ability of economic agents to invest in new projects.

The practical implications of NPLs for growth opportunities are evident when looking at European data on bank lending to non-financial corporations and households. The contraction of bank lending is particularly pronounced in countries suffering from high levels of NPLs. At the same time, Member States with high NPL ratios have also experienced below average GDP growth, consistent with the below-average propensity to invest that NPLs generate. The opposite picture is found for the Member States that exhibit a lower level of NPLs.

Therefore, the effective management of NPLs is of the utmost importance for a country's growth opportunities. Banks − benefiting from improved asset quality, profitability and liquidity − will be in a better position to reduce the cost of credit risk and lending spreads. This amounts to a pivotal development for the competitiveness of the non-financial corporate sector in an international environment of ultra-low interest rates. It also facilitates the reduction in the debt servicing costs of households that mitigate the impact of reduced household gross disposable income. The above is to the benefit of the real economy as the unlocking of funding and the improved business climate impacts positively on the setting-up of new businesses, investment, employment and growth. In sum, we would move to a virtuous circle where improved asset quality positively affects GDP growth, in turn leading to a further reduction of NPLs and so on.

In conclusion, Greece is poised to return to economic and financial normality and to shift to a new, outward-looking and sustainable growth model, based on tradable goods and services. The economic adjustment and structural improvements over the past years have opened up significant investment opportunities. To reap the benefit of these opportunities though, there are certain preconditions: **first**, the completion of the second review with no further delay; **second**, the consistent and determined implementation of the programme in conjunction; **third**, a more realistic approach by all parties to the fiscal mix and government debt burden. Such developments, together with the cleaning-up of banks' balance sheets will set in motion a virtuous circle, paving the way to the full return of the Greek economy to normality.

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[1] Adalet McGowan, M. D. Andrews and V. Millot (2017): The walking dead: Zombie firms and productivity performance in OECD countries. OECD Economics Department Working Papers No. 1372.