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TITLE SLIDE

GREECE: A COMEBACK TO THE FINANCIAL MARKETS?
Are we near the finishing line?

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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 prospects of the Greek economy. I will focus on three issues: First, I will present the progress that has been made so far. Second, I will address to the remaining challenges. Finally, I will discuss the preconditions for a sustainable return to financial markets.

1. Progress so far

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.

SLIDE 1

- The general government balance from a deficit of 15.1% of GDP in 2009 turned into a surplus of 0.7% of GDP in 2016. Between 2009 and 2016, the primary balance improved by about 14 percentage points. In 2016 the primary surplus was 4.2 percent of GDP outperforming not only the 0.5 percent target for 2016, but also the 3.5 percent target for 2018. Practically, the required fiscal adjustment until the end of the programme in 2018 has nearly been made. This represents one of the largest fiscal adjustments ever undertaken.

- The current account deficit as a percentage of GDP has fallen by 15 percentage points. For the last two years the current account has effectively been in balance.

- Labour cost competitiveness has been fully restored. Price competitiveness is almost back at its 2000 level and can be expected to continue to improve with the implementation of further product market reforms that raise competition in various sectors of the economy.

- At the same time, sweeping structural reforms have been implemented covering the pension system, the health system, labour markets, product markets, the business environment, public administration, the tax system and the framework in which fiscal policy is conducted, while the privatization programme is on-going.

- R**ecapitalisation and restructuring have taken place in the banking system**, enabling it to withstand the crisis and the deterioration of banks' asset quality. In addition, significant institutional reforms have been initiated aiming at reducing the volume of non-performing loans.

SLIDE 2

On account of these developments, there is evidence that the economy has been undergoing a rebalancing towards tradable, export-oriented sectors. A few figures are indicative of the forces exerted.

- The share of exports in GDP increased from 19% in 2009 to 32% in 2016 with most of the 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.

- Between 2010 and 2015, the relative price of tradables versus non-tradables rose by about 10%. Whereas both sectors were hit hard by the recession, tradables performed better than non-tradables as outward-looking companies increased their exports, taking advantage of the improvement in competitiveness. As a result, the relative size of the tradables sector, 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 tradables sector increased relative to the non-tradables sector by around 8%.

These figures would improve further if the reforms already implemented were enhanced by those planned under the ESM programme. Based on estimates of the OECD, 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 further positive effects from structural reforms that cannot be easily quantified such as the modernisation of the 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 provides similar estimates of the effects of structural reforms with the main effect coming from higher total factor productivity (TFP) growth.

2. Challenges remain

In spite of these positive developments, considerable stock disequilibria remain:

- Unemployment, though falling, remains very high (at about 23%); Job creation, although robust, is dominated by temporary and part-time jobs.
- The general government debt to GDP ratio has risen to unsustainable levels (179% of GDP).
- The private debt overhang hampers banks' ability to support the recovery by granting new credit.

In addition, despite the fact that structural competitiveness improved over the period 2013-2014 (according to a number of indices compiled by the OECD, the

World Bank, and the World Economic Forum), Greece still ranks at the lower end of advanced economies, and progress has stalled or even retreated slightly in recent years.

3. Prospects for a sustainable comeback to financial markets

SLIDE 3

In order to address the remaining challenges, to improve the future growth prospects of the Greek economy, and to ensure a comeback to financial markets in 2018, several conditions should be met.

a. Implementation of 2nd review reforms

First and foremost, following the closure of the second review, it is necessary that there is a smooth and timely implementation of the agreed growth enhancing reforms.

Delayed closing of the second review increased uncertainty and reduced confidence which, coupled with the high tax burden, reversed the positive course of economic activity in 2016 Q4. As a consequence, following the mild recession in 2015, the economy stagnated in 2016. However, a positive medium-term outlook is still possible, conditional on a smooth implementation of agreed reforms. Consumption is expected to continue rebound, driven by robust employment, which is recovering faster than output, pointing to a job-rich recovery. Investment is projected to increase as confidence is restored and financial conditions improve. Exports are projected to benefit from the benign global economic outlook and past improvements in cost competitiveness. Finally, although the sizeable over-performance in 2016 is assessed to be mainly of a temporary nature, the 2017 target is expected to be met with a safe margin. Moreover, rebalancing the budget towards a more growth-friendly composition would support economic recovery.

b. Implementation of further growth enhancing reforms to boost exports and attract FDI

Second, further growth enhancing reforms are needed that will boost exports and attract FDI are needed. The economic adjustment and the structural improvements during the past six years made Greece more business friendly and have created significant investment opportunities. However, domestic savings are insufficient to meet the investment needs of the Greek economy that, after a long period of very low investment rates, are significant. Thus, besides restoring access of companies to capital markets, conditions should be encouraged to attract foreign capital, notably in the form of Foreign Direct Investment.

In order to attract both domestic and foreign investment, further emphasis should be given to reforms that improve the business environment, enhance competition and reduce excessive regulation, protectionism, bureaucracy and complex legislation. For example, investment licensing procedures need to be simplified, the administrative burden on businesses reduced, the remaining regulated professions and network industries opened up, the public administration modernised and strengthened, judicial efficiency enhanced, court proceedings speeded up and of course personal and corporate taxation lowered.

Additionally, a more effective use of the domestic high-skilled human capital (and the return of high-skilled scientists and executives who work abroad) requires the adoption of policies and reforms that encourage research, facilitate the diffusion of technology and boost entrepreneurship. Policies include providing incentives to increase investment in research and development (R&D), strengthening the links between enterprises and the academic/research community by allowing universities to commercially exploit research results and ideas, and effectively using available EU funds.

Alongside structural reforms, and in order to facilitate the recovery through a normalization of financial conditions, as a matter of urgency the private debt overhang problem is addressed, since it is the greatest challenge the Greek banking system and the Greek economy faces.

On the one hand, the high stock of NPLs reduces bank profitability and thus constrains the supply of credit, which primarily affects bank dependent SMEs. On the other hand, high NPLs delay corporate restructuring and thus thwart the ability of viable firms to finance new investment projects. 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. 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%, improving productivity-enhancing capital reallocation in the Greek economy.

A series of legislative and regulatory reforms have already been enacted as part of the strategy to reduce NPLs, such as the operational targets of individual banks, revisions of the insolvency law and the gradual setup of a secondary market for NPLs.

In addition, a number of new measures have already been legislated as prior actions of the second review, such as the introduction of an out-of-court workout framework, the revision of corporate insolvency law and the launch of a platform for electronic auctions.

Besides structural reforms and NPL management, growth prospects can also be improved by acting on the fiscal policy front in two ways:

- First, a growth friendly fiscal policy mix can be adopted. The increased emphasis on taxation needs to be reduced in favour of policies that focus on restraining and restructuring non-productive spending and making more effective and efficient use of the public sector's assets, especially land.
- Second, the medium-term fiscal target can be reduced. According to estimates by the Bank of Greece, a lowering of the general government primary surplus target from 2021 onwards 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.

c. Ensuring debt sustainability

A final condition for return to financial markets is to ensure debt sustainability. The ratio of general government debt to GDP is still high. In 2008 that ratio stood at around 110%. It is now around 179%. The debt path has been strongly affected by the so-called snowball effect – that arises from interest rates on debt being much higher than growth. Indeed, from 2010 to 2016, the snowball effect is estimated at some 82% of GDP. But whatever the causes of its rise, it is crucial that it is put on a sustainable path. In the context of the above proposals in the area of fiscal policy making, the Bank of Greece recently made specific proposals to ensure the sustainability and manageability of public debt.

The short-term measures decided at the Eurogroup meeting of December 5, 2016 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.

SLIDE 4

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. A simulation performed by the Bank of Greece defers interest on EFSF loans, extending their Weighted Average Maturity by 8.5 years – Option 1 in the right-hand diagram.

SLIDE 5

If, in addition to interest deferment, we assume a primary surplus target of 3.5 percent in 2018-2020 and a reduction to 2 percent thereafter, we can see from the left-hand diagram that the debt path is close to that where a primary surplus of 3.5 per cent for 10 years is assumed. 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.

However, as the right-hand diagram shows, in terms of gross financing needs, option 1 makes debt sustainable at the margin. Hence, further debt relief measures are necessary in order to reduce gross financing needs significantly below the 20% threshold and bring debt to a sustainable path. 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 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.

4. Conclusions and final remarks

The economic adjustment and the structural improvements during the past seven years have made Greece more business friendly, have created significant investment opportunities, and have generated positive prospects for the Greek economy.

The realization of these positive prospects requires a consistent and determined implementation of the reform and privatization programme including tackling the private debt overhang problem.

These enable the adoption of medium-term measures to ensure the sustainability of Greek public debt, which will pave the way for the inclusion of Greek government bonds in the ECB's quantitative easing programme. Such developments will set in motion a virtuous circle leading to Greece's return to international financial markets in 2018, the elimination of capital controls, the return to financial normality and the definite exit from the crisis.

In order to capitalize on the macroeconomic and fiscal adjustment achieved so far, the institutions and our European partners must act now in a decisive and bold manner by specifying the medium-term debt relief measures for the sustainability of Greece's public debt, which, as was agreed last year, will go into effect at the end of the current programme. This must be done because the markets on which Greece will need to borrow after the end of the programme in the summer of 2018 are demanding to know from now whether the debt will be sustainable or not. We are all aware of the fact that re-gaining access to financial markets after the end of the current programme is the only way forward. No one, neither the partners nor Greece, are in any mood for another memorandum.

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