Yannis Stournaras: The Greek economy - challenges and prospects

Speech by Mr Yannis Stournaras, Governor of the Bank of Greece, at an event organized by the British Hellenic Chamber of Commerce, Athens, 28 September 2017.

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I am very pleased to be with you tonight. Let me share some thoughts about the developments, the risks, the challenges and the prospects of the Greek economy.

1. Greece and the United Kingdom are historically linked by close bonds of friendship and cooperation

Greece and the United Kingdom (UK) are historically linked by close bonds of friendship and cooperation. These bonds are reflected in trade and in the increased weight of tourist flows from the UK in travel receipts. By way of illustration, in 2016 tourism receipts from the UK amounted to about €2 billion, while the respective tourist arrivals reached 2.9 million. The UK has a share of 15% in total receipts and 12% in total arrivals. Our trade balance versus the UK remains in deficit, but has improved significantly since 2009. This is due both to a rise in exports and a decline in imports. Specifically, exports of goods to the UK increased in nominal terms by about 47% during the 2010–2016 period, accounting for approximately 4% of total Greek exports. On the other hand, imports decreased in nominal terms by 31% over the same period, accounting for roughly 3% of total Greek imports.

The long-standing ties with the UK are also reflected in the strong presence of Greek students and academics at UK universities and in general of Greeks working in UK firms, as well as in the notable presence of the Greek shipping community in London and, respectively, the large number of British nationals who live here, often having purchased holiday homes in our country. Among other Greeks, both my wife Lina and I completed our post-graduate studies in the UK and embarked on our professional and academic careers there.

Against the background of the historical and multi-faceted links between our countries, we hope that Brexit negotiations with the European Union will lead to an agreement acceptable to both sides. Our wish is that the future relationship of the UK with the EU remains close. This will safeguard the interests of both EU citizens in the UK and British citizens in the EU, while at the same time the mutually beneficial trade ties which promote economic growth and prosperity in both economic areas will continue. The recent speech by Prime Minister May in Florence gave hope for an acceptable agreement, but it is only a first step.

2. The Greek economy on a growth track

The Greek economy is currently on a growth track. This was made possible thanks to the completion of the second review and its positive effect mainly on confidence and liquidity. The fact that the economy's growth dynamics has gained traction is primarily reflected in the positive path of GDP as well as in the improvement of short-term indicators:

- Real GDP grew y-o-y by 0.4% in the first quarter and by 0.8% in the second quarter of 2017. Overall, in the first half of 2017 real GDP increased by 0.6%, year-on-year. Real GDP growth in the second quarter was mainly driven by an increase of 9.5% y-o-y in exports of goods and services, as well as by a rise in public (3.3%) and private consumption (0.7%), whereas gross fixed capital formation had a negative contribution, largely on account of delays in Public Investment Programme disbursements.
- Industrial production increased y-o-y by 1.7% in July 2017 for the tenth consecutive month. Overall, between January and July 2017 industrial production increased by 5.3% relative to

the corresponding period of 2016.

- The volume of retail sales in the first half of 2017 rose by 2.4%, year-on-year.
- The positive momentum of the economy is also mirrored in the labour market, which has been showing signs of improvement since mid-2014, on the back of structural reforms which allowed for a shift towards more flexible forms of employment. In more detail, employment rose y-o-y by 2.4% in the second quarter of the year, while the unemployment rate stood at 21.2% in June 2017, down from 23.5% one year earlier.

The improved economic outlook and the completion of the second review contributed to a decline in Greek government bond yields to their end-2009 levels, thereby facilitating Greece's return to international markets on 25 July. At the same time, the yields of corporate bonds issued by the non-financial sector declined considerably as well. Furthermore, Fitch upgraded Greece's credit rating, citing sustained recovery and reduced political risk.

Other key developments that should be pointed out are: the successive reductions in the emergency liquidity assistance (ELA) ceiling for Greek banks, the increase in deposits, the attainment of the operational targets set so far for banks to reduce the stock of their NPEs, and the rise in a number of leading indicators of economic activity and confidence.

- On 20 September the ELA ceiling for Greek banks stood at €33.6 billion, compared with €50.7 billion at end-2016 and €90 billion in June 2015.
- Deposits by the non-financial private sector increased by €1.4 billion to €119.4 billion in August 2017. In particular, from end-May 2016, when the first review of the programme was completed, until August 2017, deposits by non-financial corporations and households increased by 5.3% or €7.3 billion, while total deposits gained about €11 billion.
- The economic sentiment indicator rose to 100.6 in September, from 99.0 in August, also amid strong consumer confidence, which recorded a two-year peak.
- The manufacturing PMI suggests expansion for the third month in a row, and came to 52.2 in August, from 50.5 in July, reaching its highest level since August 2008.

In the same vein, since the beginning of this year there has been progress with the issue of banks' problem loans. More specifically, on the basis of June 2017 data, the stock of non-performing exposures (NPEs), including off-balance sheet items, decreased by 3.2%, compared with end-December 2016, coming to €102.9 billion or 44.9% of total exposures. The NPE reduction was mainly driven by extensive loan write-offs and to a much lesser extent by collections, liquidations and sales of loans. Loan write-offs amounted to €3.3 billion in the first half of 2017.

Lastly, significant headway has also been achieved in the area of reforms despite several delays. According to a recent report by the Lisbon Council (EuroPlus Monitor, September 2017 Update), Greece continues to rank first in the EU-28 in terms of the Adjustment Progress Indicator. Greece's high score in this area is mainly attributable to its adjustment efforts in 2010–2013, but also to the fact that since mid-2015 there has been a reversal in the negative course that had started in late 2014 and peaked in summer 2015 amid heightened uncertainty and strong confrontation with the institutions, thereby weakening the country's position.

3. Positive prospects for 2017–2019

In the light of the data I mentioned briefly, it is now safe to predict that economic activity will continue to pick up at a stronger pace in the near term. In 2017 as a whole, according to Bank of Greece estimates, GDP will increase by about 1.7%. In 2018 and 2019, growth is projected to gather pace and quicken to 2.4% and 2.7%, respectively, driven by rising investment, consumption and exports of goods and services.

The forecasts of the Bank of Greece are based on the assumption that the reform and privatisation programme will be implemented consistently and according to schedule. In order to capitalise on the progress achieved so far, strengthen favourable prospects and enhance investor confidence in the future of the Greek economy, a strict adherence to the implementation of the structural reforms that have been agreed upon under the programme is warranted. This is expected to have strong positive effects on the liquidity of the financial system, the easing of uncertainty, the improvement of the economic sentiment and expectations, and the reduction of borrowing costs for the Greek State, thereby allowing for sustainable access to international markets in August 2018, after the programme's completion.

4. Risks and challenges

Despite the positive signs and the progress achieved so far, risks to the outlook of the Greek economy remain.

The most significant and immediate risk relates to a delay in completing the third review of the programme, as was the case with the first and second reviews. This should be avoided, as it would trigger a new cycle of uncertainty leading to the suspension of investment plans, undermine the growth dynamics of the economy and weaken the prospects for sustainable access of the Greek sovereign to international capital markets after the end of the programme in August 2018.

Moreover, there are significant external risks associated with a stronger euro and a possible slowdown in the euro area economy. A further rise in the euro exchange rate from its current levels could negatively affect goods exports as well as tourism receipts, dampening the economic growth outlook and slowing the pace of the exit from the crisis. There are also significant geopolitical risks that could increase the risk aversion of international investors. Other geopolitical risks relate to a possible exacerbation of the refugee crisis.

4.1 Medium- to long-term challenges

In addition to the above domestic and external risks to the recovery, there are also some medium- to long-term challenges that need to be addressed in order to strengthen the positive outlook. In particular:

- Unemployment remains very high, while the new jobs created largely involve low-pay, part-time or intermittent employment. At the same time, the tax burden on dependent and independent employment has increased and social benefits continue to decline. As a result, household consumption is likely to weaken or remain subdued for a long time.
- Despite the progress made so far, banks continue to be burdened with the management of a high stock of non-performing loans, affecting their ability to adequately support economic activity with new lending.
- Investment remains at a very low level, and this is not only due to delays in financing the Public Investment Programme or the lack of bank lending, but also to the fact that the investment climate in the country is still perceived as unfriendly to private investment.
- Government debt remains very high and its servicing requires the commitment of significant public resources on a long-term basis. This can be achieved either by curtailing spending and downsizing the public sector or by increasing revenue. However, raising revenue by maintaining the existing high tax rates is a drag on growth and ultimately can have a negative impact on public finances and the manageability of public debt. This is because high tax rates discourage investment insofar as businesses know that part of their profits will, on a permanent basis, have to be spent for servicing the public debt. Moreover, high tax rates are a disincentive to work, while in the case of both businesses and households they create incentives to tax evasion and the strengthening of the shadow economy. Also, high taxes and social security contributions provide an incentive for businesses to relocate to European

countries with a more favourable tax regime and, accordingly, contribute to brain drain. The lack of investment and the loss of human capital hamper total factor productivity and potential output growth.

5. Strengthening the growth potential

5.1 Boosting investment

Economic adjustment and structural changes over the last seven years have 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. Consequently, the great challenge today is to stimulate investment. And the only way to close the large investment gap is by attracting foreign direct investment, focusing on the most productive sectors of the economy.

This requires, first, the rigorous implementation of the structural reforms outlined in the European Stability Mechanism (ESM) programme. At the same time, the Bank of Greece has repeatedly proposed changing the fiscal policy mix to make it more business- and growth-friendly. This can be achieved with more emphasis on reducing non-productive expenditure. This would, for example, entail an assessment of the structures of general government and the system of incentivisation for its various entities (e.g. local authorities) through a review of the manner in which they are subsidised by central government, as well as the expansion of Public-Private Partnerships (PPPs) in areas that are seen as taboo, such as education, health, social security. Together with a more efficient management of public property, notably real estate, through appropriate land-use legislation and by further enhancing the efficiency of the public sector and the tax collection mechanism in particular, a further reduction of non-productive public sector expenditure will enable the lowering of high tax rates, thereby supporting the growth process.

In addition to the above, it is also necessary to decisively and definitively address the obstacles posed by various small or large vested interests and groups, which weigh on the business climate and hamper investment and the implementation of reforms and privatisations, even those already approved. Unless these barriers which in practice discourage investment are addressed, then the prospect of dynamic growth of the economy and its shift towards an extrovert growth model may not materialise, given that one of the key drivers of economic growth over the coming years is the expected rise in investment and the resulting impetus to the export base.

5.2. Pushing ahead with reforms and privatisations

Despite the progress made so far, there is still a lot to be done in the areas of privatisations, efficient use of public property and structural reforms. For example, we need even greater ownership of privatisations; more public-private partnerships, even in areas that, as already mentioned, have so far been considered as taboo; several other reforms, e.g. in the energy market, the product market, the services market and in certain professions, in order to increase productivity and reduce the cost to consumers; measures to cut red tape across public administration; measures for the rapid delivery of justice; full respect for the independence of institutions; encouraging and incentivising private sector cooperation with universities and research institutes in order to promote innovation and the transition to a knowledge-based economy.

5.3 Reducing non-performing loans

In the banking sector, a priority is to address the large volume of non-performing loans, in particular the problem of “strategic defaulters”, which is detrimental not only to the soundness of the banking system but also to the growth of the Greek economy. It is worth noting that all the necessary measures have now been legislated and that the regulatory framework has been put in place to tackle the problem of NPLs in an efficient and fast manner. Banks also possess adequate loan loss provisions, collateral and capital, which more than cover the outstanding amount of these loans, while the economy is recovering. Banks' efforts are therefore expected to, and must, be stepped up, so as to accelerate the pace of NPL reduction, also taking into account that the targets for 2018 and 2019 are more ambitious than those for 2017. Particular emphasis should be placed on business restructuring, on providing liquidity support to viable businesses but also on the liquidation of non-viable ones. This will unlock resources that can support new or existing sound investment and business initiatives necessary to consolidate the growth dynamics. In general, banks have achieved significant improvements in their corporate governance and liquidity and solvency ratios in recent years and there is absolutely no reason for concern about their performance.

5.4 Tackling the high public debt

Concrete actions are necessary to ensure the sustainability of public debt, as well as a more realistic adjustment of medium-term fiscal targets. The Eurogroup of 15 June 2017 reiterated in a clearer manner the lines along which further debt relief measures could be adopted, if deemed necessary, after the end of the programme. The Bank of Greece has already made specific proposals for a mild debt restructuring, for example by lengthening the weighted average maturity of interest payments on EFSF loans by at least 8.5 years. The calculations show that this could make a significant contribution to debt sustainability, even if primary government surpluses were to remain at 3.5% of GDP until 2020 only (rather than 2022 as envisaged in the agreement) and fall to 2.0% afterwards. These two proposals, if adopted, will certainly support both the recovery of the economy and the country's creditworthiness.

The growth impact of debt restructuring and the resulting reduction in its servicing costs will be higher if the fiscal space created by the lowering of fiscal targets, amounting to 1.5% of GDP, is used to reduce labour and capital taxation and is accompanied by appropriate policies to increase potential output and bring about a reversal of the brain drain, i.e. a repatriation of young graduates and professionals who left the country during the crisis.

This mild debt reprofiling proposal is vital for Greece and entails only a negligible cost for its partners. This will pave the way to the inclusion of Greek government bonds in the ECB's quantitative easing programme, which in turn will facilitate sustainable market access and further support the economic recovery. This will set in motion a new virtuous circle that will signal investor confidence in Greece's economic prospects while encouraging the return of deposits to banks, a return to financial markets after the end of the current programme and, eventually, the full abolition of capital controls.

6. Conclusions

The Greek economy is on a steady upward trajectory. However, despite the encouraging signs coming from the positive GDP growth figures for the first half of 2017, there is no room for complacency or a relaxation of efforts. We still have a way to go before the positive prospects of the Greek economy for the period 2017–2019 can be confirmed and before Greece can gain the full confidence of markets after the end of the programme in August 2018. This will be achieved if the country obtains a credit rating enabling it to refinance its debt at rates that are in line with its sustainability and if banks have sufficient collateral to be fully funded from the ECB's refinancing mechanism and not only from the costlier Emergency Liquidity Assistance (ELA).

Consequently, a sustained exit to markets requires: First, adhering to the objectives of the programme and accelerating the pace of implementation of reforms, both those decided as part of the programme and discretionary reforms to strengthen economic growth. The fast completion of the third review of the programme is absolutely necessary. Second, sufficient and timely specification of medium-term debt relief measures in line with Eurogroup decisions. Third, constructive cooperation between the Greek government and the institutions on the type and conditionality of support to the Greek economy after the end of the programme in August 2018, in order to ensure its return to financial normality after seven years of significant sacrifices of the Greek people.