Yannis Stournaras: Greece and the global economy - prospects and main challenges ahead

Speech by Mr Yannis Stournaras, Governor of the Bank of Greece, at an event organized by Credit Suisse, Athens, 11 October 2017.

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Ladies and Gentlemen,

It is a great pleasure for me to be here with you tonight and have the opportunity to share my thoughts on the prospects for the Greek economy against the backdrop of brighter prospects for the global and euro area economy. I will focus on the following issues: First, I will say a few words about the international environment. Second, I will present the progress that has been made in Greece since the start of the crisis. Third, I will discuss the outlook for the economy and outline the main risks and remaining challenges that must be addressed. Fourth, I will discuss the preconditions for a sustainable recovery of the Greek economy. Finally, I will make some remarks about the need to improve the EMU architecture.

1. The international environment

The **global economy is maintaining a solid pace of expansion**. Business and consumer confidence indicators suggest that sentiment remains upbeat, while financial conditions in advanced economies remain supportive, underpinned by accommodative monetary policies. Financial markets in emerging market economies remain resilient and capital flows towards these economies are robust. Looking ahead, global economic activity is expected to accelerate moderately. Improving activity in advanced economies is underpinned by monetary and fiscal policies. In emerging market economies, growth is expected to remain resilient in commodity importers, while activity in commodity exporters will bottom out after deep recessions in these economies. World trade is projected to expand in line with global activity over the medium term.

Nevertheless, there are **several medium to long-term challenges** affecting the prospects of the global economy. First, productivity growth has slowed across advanced, emerging market, and low-income countries at a time of significant innovation and technological change. Second, income inequality has increased in advanced economies, leading to growing dissatisfaction among electorates and a sharp swing in sentiment against globalization. Third, the generally low level of global inflation and wage growth, especially in advanced economies, is linked, inter alia, to globalization, labour market slack and labour's weakened bargaining position, the growing importance of services, increases in labour supply and more work of a temporary and part-time nature. These, difficult to predict, changes have affected the position and the slope of the Phillips curve in these economies, that is the relationship between labour market slack and inflation, and pose a number of dilemmas for monetary policy. These dilemmas would have been lighter if other policies, such as fiscal policy and structural reforms, had been more responsive to the needs of the real economy.

Closer to home, **the economic expansion in the euro area is continuing and becoming increasingly resilient. The euro area economy has enjoyed 17 consecutive quarters of growth, and the latest data indicate continued momentum in the period ahead**. The accommodative monetary policy stance is supporting domestic demand. Employment growth and the slight increase in employee compensation are supporting households' disposable income. These, coupled with increasing household wealth, are benefiting private consumption. The recovery in investment is supported by improvements in corporate profitability and the very favorable financing conditions. Buoyant foreign demand supports euro area exports, though the recent appreciation of the euro represents a source of uncertainty for the overall contribution of net trade to economic growth.

Headline inflation is expected to decline in the short term, driven mainly by base effects in the energy component. Looking further ahead, headline inflation is expected to remain clearly below a level that is consistent with the ECB inflation aim over the next two years, averaging 1.5% in 2019. Furthermore, the recent volatility in the exchange rate represents a source of uncertainty which requires monitoring with regard to its possible implications for the medium-term outlook for price stability. Developments in core inflation still do not show convincing signs of a sustained upward trend. For this reason, the Governing Council of the ECB has recently confirmed the need for monetary accommodation to secure a sustained return of inflation rates towards levels that are below, but close to, 2%.

2. Progress since the start of the crisis

Let me now turn to Greece. 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.

- The general government balance turned into a surplus of 0.7 percent of GDP in 2016 from a deficit of 15.1 percent of GDP in 2009. Between 2009 and 2016, **the primary balance** (according to the programme definition) improved by about 14 percentage points. In 2016 the primary surplus was close to 4.0 percent of GDP outperforming significantly the target of 0.5 percent. This represents one of the largest fiscal adjustments ever undertaken by any country. **Based on this progress, on 25 September 2017, the European Council repealed its 2009 decision on the existence of an excessive deficit**. For 2017 it is projected that the primary balance target of 1.75 percent of GDP will be reached with a safe margin.
- The **current account deficit** as a percentage of GDP has fallen by 15 percentage points since the beginning of the crisis, with the current account effectively being in balance over the last two years.
- **Labour cost competitiveness** has been fully restored and price competitiveness is almost back at its level of 2000 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. It is worth noting that this has been achieved through the painful process of internal devaluation, that is, through outright reductions in nominal wages and salaries.
- At the same time, a **bold programme of structural reforms** has been implemented covering the pension system, the health system, labour markets, product markets, the business environment, public administration, the tax system and the budgetary framework. Its implementation, alongside the privatization and real estate development programme, is on-going.
- Finally, the banking system has been **restructured and consolidated**. **Significant recapitalization**, following stringent stress tests along with in-depth asset quality reviews, now ensures that Greek banks are among the best capitalized in Europe. This fact, along with an NPE coverage ratio of 47 percent and good collateral will play a considerable role in allowing banks to address the pressing issue of the stock of non-performing loans. In addition, significant institutional reforms have been initiated aiming at providing banks with a variety of means of reducing non-performing loans.

As a result of these efforts, the economy has already started to **rebalance towards tradable, export-oriented sectors**. A few numbers are indicative of this trend:

- First, the **share of exports of goods and services in GDP increased** from 19% in 2009 to 30.2% 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.
- Second, between 2010 and 2015, **the relative price of tradables versus non-tradables rose by about 10%. 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%. Whereas both sectors have been hit hard by the recession, tradables have performed better than non-tradables as outward-looking companies increased their exports, taking advantage of the improvement in competitiveness.

Overall, this increased openness implies that Greece is better placed to take advantage of improved global growth prospects.

3. The short and medium term outlook of the Greek economy

The economic recovery continues and growth is gathering pace following the completion of the second review and the positive impact it had on confidence and liquidity. The consolidation of growth dynamics is reflected not only in GDP figures, but also in the improvement in various short-term indicators:

- Following the rebound of economic activity in the first quarter of 2017, **real GDP** increased at a faster rate in the second quarter. Positive drivers of growth were exports of goods and services, government consumption and private consumption, while gross fixed capital formation declined, mainly due to the significant fall in disbursements from the Public Investment Programme.
- **Industrial production** performed exceptionally well in the first eight months of 2017.
- **Retail sales volume** in the first seven months of 2017 increased.
- **Employment** has been growing at healthy rates since mid-2014 despite the stagnation of economic activity. The rebound is largely driven by greater job-market flexibility due to past structural reforms. As a result, the **unemployment rate** has now fallen to just above 21 percent, down from its peak of over 27 percent.

The improved outlook for the economy and the completion of the second review contributed to the decline in Greek government bond yields to late-2009 levels and facilitated the **return to international markets on July 25**. Moreover, the **slope of the yield curve steepened**, implying improved investor perceptions for the outlook of the Greek economy. **Corporate bond yields have also fallen to historically low levels**. Finally, Fitch recently upgraded Greece's credit rating on account of the sustained recovery and the decline in political risk.

On top of the above, the following developments are worth highlighting: **The successive reductions in the ELA ceiling, the increase in deposits, FDI inflows and the rise of soft data indicators like the PMI and economic sentiment.**

At the same time, **there has been progress since the beginning of the year in the area of banks' Non Performing Exposures (NPE).** At end-June 2017, the stock of Non-Performing Exposures (including off balance sheet items) was 3.2% lower than at end-December 2016. Following the pattern of previous quarters, the outflow of NPEs coming from collections, liquidations and sales of loans was rather limited. Instead, the key driver for the reduction in the stock of NPEs over the past quarter has been loan write-offs, especially in the business and consumer portfolios which reached €3.3 billion for the first half of 2017.

Finally, there is progress in reforms despite the recurrent delays in programme implementation. According to a recent Lisbon Council report (EuroPlus Monitor, September 2017 Update), **Greece is still ranked first among the 28 countries of the European Union on the basis of the Adjustment Progress Indicator**. This implies that Greece has put the worst of the first half of 2015 slippage behind it and has started to improve again.

3.1 Growth forecasts for 2017–2019

Overall, in 2017 the Bank of Greece estimates that GDP will increase by approximately 1.7%. For 2018 and 2019, growth is projected to accelerate to 2.4% and 2.7% respectively. Consumption is expected to rebound modestly, driven by robust employment which is recovering faster than output on account of the previously implemented labour market reforms and the active labour market programmes in place. **Investment** is projected to increase as confidence is restored and financial conditions improve. **Exports** are projected to continue their positive trend, benefiting not only from the benign global economic outlook but also past improvements in cost competitiveness.

These projections are based on the assumption that the reform and privatization programme will be **implemented smoothly and according to the set timetable**.

4. Risks and major challenges ahead

Despite the positive signs that are being recorded today and the progress achieved, there are still **downside risks** to the outlook of the Greek economy.

The most significant and immediate risk is a **delay in the completion of the third review of the programme**. This should be avoided as it would fuel a new cycle of uncertainty that would lead to the suspension of investment plans, it would delay the repayment of government arrears and would not facilitate a normalization of financial conditions. In such a case economic recovery and the return to international financial markets will prove to be short-lived.

In addition, there are significant **external risks** associated with the **strengthening of the euro** and the likelihood of economic growth slowing in the euro area. There are also significant **geopolitical risks** that could increase the risk aversion of international investors as well as exacerbate the refugee crisis.

Besides the downside risks, there are also **upside** opportunities related to the inclusion of Greek sovereign debt in the ECB’s quantitative easing programme (QE), which will improve liquidity and confidence and will result in a more benign than currently projected economic outlook.

4.1 Medium and long-term challenges

In addition to these 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,

- The currently high **long-term unemployment** increases the risk that human capital is destroyed, affecting long-term potential growth. Potential growth is also negatively affected by the emigration of young and highly-qualified professionals. Moreover, persistent unemployment has negative effects on life satisfaction and health, undermining trust in public institutions and posing a risk for social cohesion.
- Despite the progress made so far, banks continue to be burdened with the **large stock of non-performing loans** and are, thus, unable to provide sufficient credit to the private sector in order to support economic activity.

- **Investment** remains at a very low level, and this is not only due to delays in the disbursement of the Public Investment Programme and the lack of bank lending, but also to the fact that the business environment is not yet considered as friendly as it should be towards private investment.
- **The general government debt-to-GDP ratio has risen to unsustainable levels**. This implies that for many years to come a significant amount of public resources will have to be directed to the servicing of debt-related obligations. This can be done either by compressing spending and scaling down the public sector or by increasing revenue. However, raising revenue by maintaining the currently exceptionally high tax rates constitutes a drag on long-term growth. **High tax rates are a disincentive for launching new investment plans** because companies know that on a permanent basis a substantial part of their future profits will be transferred to the state. In addition, high tax rates are a disincentive to work and create incentives for tax evasion for both businesses and households, increasing the size of the underground economy. At the limit, high taxes and social contributions force businesses to move their businesses to countries with more favorable tax regimes.
- Despite substantial progress in various areas, qualitative indices reflecting the **business environment** suggest that Greece is still ranked low relative to other European countries. For example, according to the Global Competitiveness Index of the World Economic Forum, competitiveness slightly deteriorated in 2017–2018. The most problematic factors for doing business in Greece are considered by the above Forum to be the following: high tax rates, inefficient government bureaucracy, tax regulations, policy and government instability, access to finance and corruption. The authorities need to continue to put emphasis on improving non-price competitiveness and public sector efficiency.

These challenges must be tackled urgently in order to avoid hampering the strengthening recovery and the long-term prospects of the Greek economy.

5. Preconditions for a sustainable recovery

In the medium to long-term the growth prospects of the Greek economy are positive because the structural reforms implemented raise total factor productivity and consequently potential growth. According to estimates by the OECD, the full implementation of all reforms, both those undertaken and those scheduled as part of the ESM programme, is expected, ceteris paribus, to boost real GDP over a 10-year-horizon by about 13%. And this figure excludes further positive effects from structural reforms which 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 points to similar estimates of the effects of structural reforms. However, in order to reap these potential gains, a number of conditions should be satisfied.

a. Create the conditions to encourage investment

The economic adjustment and the structural improvements during the past seven years have rendered Greece more business friendly and have created significant investment opportunities. However, domestic savings are insufficient to meet the investment needs of the Greek economy which, after a long period of very low investment rates, are significant. Thus, besides restoring access of companies to capital markets, conditions should be encouraged that will attract foreign capital, notably Foreign Direct Investment.

This presupposes the smooth and timely implementation of the agreed reforms and privatization programme in order to further **improve the business environment and cut red-tape**. In addition, the Bank of Greece favours a more **growth friendly fiscal policy mix**. More emphasis has to be placed on cutting non-productive expenditures and managing state property effectively. This is important since, according to OECD estimates, state property in Greece is among the highest as a percent of GDP in OECD member-states. The scaling down of an oversized and inefficient public sector will facilitate the reduction of the excessively high tax rates benefiting the private economy and facilitating the return to growth.

Besides improving the business environment and lowering taxation, it is necessary to **remove decisively and definitively the obstacles** arising from various small or large vested interests and groups, which exacerbate the business climate and **hamper the materialization of new investment and the implementation of reforms and privatizations, even those already approved**.

Last but not least, the **removal of capital controls** would be a manifestation of the improving confidence both in the stability of the banking system and the sustainable recovery of the Greek economy. This will, in turn, facilitate the improvement of the investment climate and help attract foreign direct investment.

b. Speed up the implementation of the privatization and reform programme

Despite the progress achieved so far, there is still a lot to be done in the areas of **privatization and structural reforms**. Privatisations which are at a mature stage need to be completed quickly. Other reforms have to be completed before the end of the programme, including, for example, the liberalization of the energy market and the opening of the remaining professions. In addition, universities and research institutes should be encouraged to cooperate with the private sector, in order to promote innovation and the transition to a knowledge-based economy. These initiatives will increase productivity and reduce costs for consumers.

c. Tackle the NPL problem

In the banking sector, **the large volume of non-performing loans and the problem of strategic defaulters** prevent the banking system from financing economic growth. All the necessary measures have now been legislated and the regulatory framework has been re-formulated in order to be able to address the NPL problem in an efficient and expeditious manner. Banks need to follow faithfully the targets agreed with supervisors. Particular emphasis should be placed on the restructuring of companies and the closure of non-viable businesses. This will release resources to support new and existing sound investment and business initiatives, thereby supporting the economic recovery.

d. Address debt sustainability concerns

Decisive and concrete actions are needed to **ensure the sustainability of Greek public debt, while, according to the Bank of Greece, there is also a strong case for a more realistic adjustment of medium-term fiscal targets**. The Eurogroup reaffirmed in June its commitment to the principles contained in the May 2016 statement and specific mention was made of measures that could be taken, if necessary, regarding public debt reprofiling. The Bank of Greece has put forward a specific proposal for extending 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 surpluses were to fall to 2 percent of GDP from 2021 onwards rather than from 2023 as envisaged in the Eurogroup agreement. If adopted, such a proposal would certainly support both the recovery of the economy and the country's creditworthiness, especially, if the fiscal space created by the reduction of fiscal targets is used to reduce taxes on labour and capital.

This mild debt reprofiling proposal is vital for debt sustainability in Greece, while it involves only a negligible cost for its partners. It would pave the way for the inclusion of Greek government bonds in the ECB's quantitative easing programme, which in turn will facilitate sustainable market access. This will set in motion a **virtuous circle**: greater investor confidence in Greece's economic prospects will encourage the return of more deposits to banks, allow for a smooth exit from the current programme, and, ultimately, the **full abolition of capital controls**.

6. Some remarks about the future of the Economic and Monetary Union (EMU)

Last but not least, given that the recovery is accelerating in the euro area, now is the right time **to consider the future of Europe and in particular possible ways to strengthen the Economic and Monetary Union.**

A lot has been done in recent years to **enhance the functioning of the EMU**. Policy actions have focused on addressing institutional weaknesses, structural fragilities and excessive risk taking that led to the sovereign debt crisis and the negative feedback loop between sovereigns and banks, which in turn undermined euro area stability. Some key initiatives were the provision of intergovernmental loans to Greece, the establishment of the EFSF, and its successor the ESM, the creation of a banking union and the application of stricter rules on banking regulation and supervision, the establishment of the European Systemic Risk Board and the creation of appropriate macro-prudential instruments which allowed greater emphasis on identifying and addressing system-wide risks. Moreover, various monetary policy interventions by the ECB played a pivotal role in supporting the euro area economy and safeguarding price and financial stability.

Despite these changes, the new institutional setting of the EMU is far from being appropriate to address a future crisis. The changes made so far mainly aim at closing loopholes rather than strengthening EMU. Euro area policy makers cannot rely solely on the ECB and expect that it will keep monetary policy loose indefinitely. Efforts should focus on improving the resilience and potential growth of our economies and on reinvigorating real convergence as the way of improving the well-being for all euro area citizens. The time for action is now, because the euro area economy is on a stable footing.

First, the economic rebalancing mechanisms (i.e. the Macroeconomic Imbalance Procedure) should be reinforced and operate symmetrically, i.e. both for countries with external deficits and for countries with external surpluses. Second, the institutional reforms proposed by the Five Presidents' Report and the European Commission are in the right direction because they will improve economic policy coordination, facilitate convergence and allow for risk reduction and greater private and public risk sharing. The key institutional reforms for the new EMU architecture are the following:

- the creation of a framework for **incentivizing structural reforms and aligning national and EMU** priorities by placing more emphasis on the links between financing via European Union (or euro area) instruments and initiatives, on the one hand, and reform implementation, on the other;
- the completion of the **Banking and Capital Markets Union**;
- the creation of a **central fiscal-macroeconomic stabilization function**;
- the adoption of a **European Safe Asset**;
- the transformation of the ESM into a **European Monetary Fund**;
- the creation of a **euro area Treasury**; and
- an increase in the **accountability of European Institutions** to the European Parliament.

Moving forward in this direction would safeguard the monetary union's resilience, its viability and the long-term prosperity of its citizens.

7. Conclusions

Over the past seven years, Greece has gone a long way in adjusting its major macroeconomic imbalances, reforming its economy and restoring competitiveness. The economy is now recovering and growth is gathering pace. An important factor behind this improvement was **the emergence of a strong political consensus** in favour of keeping Greece in the euro area. In their majority, Greek political parties are not only in favour of the euro, but also have supported measures in Parliament, sometimes with heavy political and social cost, to ensure that Greece remains in the euro area. This **new political reality resolves, once and for all, any future uncertainty regarding the course of the country and ensures the implementation of the reforms required for the Greek economy to prosper in the context of a deepened and completed Economic and Monetary Union**. Building on this political consensus, the Greek authorities must pursue the remaining reforms forcefully in order to improve the investment climate, take full advantage of the brighter global prospects and put the economy on a sustainable growth path.

Such policies will address the three stock imbalances that remain (high unemployment, high public debt and a large volume of non-performing loans), attract foreign direct investment and facilitate the reallocation of productive resources towards tradable and exportable goods and services. This, in turn, will boost financial markets' confidence about the prospects for the Greek economy and will signal the exit from the crisis. Nevertheless, despite the progress achieved so far, we still have some way to go in order for Greece to tap the financial markets on sustainable terms after August 2018. This will happen if the country can achieve a credit rating enabling it to refinance its debt at interest rates compatible with debt sustainability and if banks have appropriate and adequate collateral to have full access to the ECB's refinancing operations (and not only to ELA). To this end, the reform effort has to be stepped up to close the third review. Adequate and timely specification of the medium-term debt relief measures in the context of the decisions taken in the Eurogroup is also necessary, as is constructive dialogue between the Greek government and the institutions on the type of support for the Greek economy after the end of the programme in August 2018. In this way, we can ensure a return to financial normality after seven years of significant sacrifices by the Greek people.

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