Yannis Stournaras: The Greek economy - prospects and main challenges

Speech by Mr Yannis Stournaras, Governor of the Bank of Greece, at the 2nd EU-Arab World Summit on "The Greek economy: Prospects and main challenges", Athens, 10 November 2017.

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Ladies and Gentlemen,

It is a great pleasure for me to be with you today. The EU-Arab Summit is a forum that improves communication and fosters cooperation between Europe and the Arab World. Regular dialogue between the two parties improves understanding, builds trust, addresses concerns and challenges, and removes barriers. These positive effects are reflected in improved cooperation at both regional and global level, in the context of multilateral institutions and international fora. This promotes cross-border trade and investment flows, which, in turn, raise economic growth and prosperity in both areas. In the last two days in Frankfurt I had the benefit of participation in the High-Level Policy Dialogue between the Eurosystem and Gulf Countries' central banks and monetary agencies.

In my intervention today I will focus on the Greek economy: First, I will present the progress that has been made in Greece since the start of the crisis. Second, I will discuss the outlook for the economy and the main risks and remaining challenges that must be addressed. Third, I will underline the preconditions for a sustainable recovery of the Greek economy. Finally, I will point out the advantages of investing in Greece.

1. Progress since the start of the crisis

Despite past mistakes, occasional delays and even serious backtracking, economic adjustment in Greece has been one of the largest ever undertaken by any country. Since the beginning of the sovereign debt crisis in 2010, Greece has implemented a bold programme of economic adjustment that has fully eliminated fiscal and external deficits and improved competitiveness.

- The **general government balance** turned into a surplus of 0.5 percent of GDP in 2016 from a deficit of 15.1 percent of GDP in 2009. The primary surplus (that is, the general government balance net of interest payments) was 3.7 percent of GDP in 2016, from a 10.1 percent of GDP deficit in 2009. This represents one of the largest, if not the largest, fiscal adjustments ever undertaken in economic history. Based on this progress, on 25 September 2017, the European Council repealed its 2009 decision on the existence of an excessive deficit.
- **The current account deficit** has fallen by 15 percentage points of GDP 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 the year 2000. It is worth noting that this has been achieved mainly through the painful process of internal devaluation, that is, through reductions in nominal wages and salaries.
- A bold programme of **structural reforms** and privatizations has been implemented. Reforms cover the pension system, the health system, labour markets, product markets, the business environment, public administration, the tax system, and the budgetary framework. According to a recent Lisbon Council report (EuroPlus Monitor, September 2017 Update), **Greece is ranked first** among the 28 countries of the European Union on the basis of the **Adjustment Progress Indicator**.

- As a result of these efforts, **openness has improved substantially** and the economy has started to **rebalance towards tradable, export-oriented sectors**. For example, the share of total exports in GDP increased from 19.0% in 2009 to 30.2% in 2016. Exports of goods and services, excluding the shipping sector, have increased by 41% in real terms since their trough in 2009.
- 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, play a catalytic role in allowing banks to address the pressing issue of reducing significantly 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. According to incoming data, 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 NPEs (including off balance sheet items) was 3.2% lower than at end-December 2016.

2. 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 performance of several short-term indicators of economic activity, such as: industrial production, retail sales, dependent employment flows in the private sector, and real exports of goods, tourist arrivals and receipts.

The improved outlook for the economy boosted economic sentiment, increased bank deposits, improved Greece's credit rating and led to successive declines in the banks' dependence on central bank financing: for example, Emergency Liquidity Assistance (ELA) for Greek banks now stands at €26.9 billion, down from its peak of €90 billion in July 2015. In addition, yields of Greek government bonds declined to late-2009 levels, which allowed the Greek government to return to international markets, after a period of three years, 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. Meanwhile, Greek banks have made their way back to international financial markets by selling covered bonds.

Looking forward recent soft data, such as the manufacturing PMI and the economic sentiment indicator, point to a sustained recovery in the coming months. **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**. These projections are mainly based on the assumption that the reform programme will be implemented smoothly and according to the existing timetable.

3. 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.

In the short-term, the main risk is **a delay in the completion of the third review of the programme,** which will fuel a new cycle of uncertainty. In such a case economic recovery and the return to international financial markets will prove to be short-lived.

In addition, there are **external risks** associated with developments in global financial markets and **geopolitical factors**.

There are also some medium-term challenges that need to be addressed in order to strengthen the positive outlook. In particular:

- The currently high and persistent **long-term unemployment** raises inequality, posing a risk for social cohesion and increases the risk that human capital is destroyed, affecting long-term potential growth.
- 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.
- **Investment** remains at a very low level, due also to the fact that, despite considerable progress, the business environment is not yet considered as friendly as it should be towards private investment. For example, according to the **Global Competitiveness Index** of the World Economic Forum, competitiveness **slightly deteriorated in 2017–2018**. According to this Index, the most problematic factors for doing business in Greece are considered to be high tax rates, inefficient government bureaucracy, tax regulations, policy and government instability, access to finance and corruption.
- The **general government debt-to-GDP ratio** has risen to unsustainable levels.

4. Preconditions for a sustainable recovery

To address the existing risks and challenges and to remain on a sustainable recovery path, economic policy must focus on the following eight issues:

i. Attract FDI and increase openness

As already mentioned, the economic adjustment and the structural improvements in Greece during the past seven years have been one of the largest ever undertaken by any country. Among other benefits, this has minimized the various risks, has rendered Greece more business friendly and created significant investment opportunities. However, domestic savings are insufficient to meet investment needs which, after a long period of very low investment rates, are significant even though capacity utilization remains low in some sectors. Thus, besides **restoring access of companies to capital markets and to bank funding, conditions should be encouraged that will attract foreign capital, notably Foreign Direct Investment (FDI)**.

FDI, besides closing the investment gap, promotes greater trade ties with countries and companies with cutting edge-technologies. This facilitates **the participation in global value chains** (GVCs). FDI and participation in GVC improve both physical and human capital, spur innovation and contribute to the development of new products and services in high value added sectors, thus boosting productivity.

Domestic and foreign investment and the integration in GVC will increase openness and improve both the quantity and quality of Greek exports. This, in turn, will accelerate the reallocation of productive resources towards exports and will raise the long-term potential output. At the same time, the production of high technology goods and the provision of high technology knowledge-intensive services will improve the capacity of the country to retain and attract talents.

ii. Pursue privatizations, reforms and improve institutions

Despite the progress achieved so far, there is still a lot to be done in the areas of **privatizations, structural reforms and the quality of institutions**. Privatizations, which are at a mature stage, need to be completed quickly. In order to attract both domestic and foreign investment, further emphasis should be put on reforms that foster competition in product and services markets, which in turn raises productivity and employment.

At this point I want to emphasize that well-functioning institutions matter for economic growth and enable countries to address significant challenges, because they affect incentives for people and businesses to invest in physical and human capital, technology and the organization of production. As pointed out in the seminal work of Acemoglu and Robinson (2012), institutions can increase both aggregate economic growth and improveincome distribution, because they guarantee property rights and enforce contract law, providing incentives for people and businesses to invest and innovate, while at the same time the State provides adequate education and a sufficient level and quality of public infrastructure, allowing people and businesses to thrive.

Hence, good institutions enable growth and poverty reduction. At the same time economic and social progress also facilitates better institutions. Well-functioning institutions improve non-price competitiveness, enhance business confidence and reduce the country risk, leading to more domestic and foreign investment. Therefore, **besides macroeconomic and fiscal adjustment, more economic flexibility via the adoption of structural reforms and sound institutions lead to more resilience, faster recovery after an adverse shock and higher long-term growth**.

Institutions have improved in a number of cases over the course of the years. For example, the independence of the Hellenic Statistical Authority (EL.STAT) and the new Tax Revenue Authority has been established by law. In addition, over the course of the crisis, new institutions and regulatory authorities have been established. For example, the creation of the Parliamentary Budget Office and the Fiscal Council improves oversight on public finances. However, much more needs to be done in a number of areas.

According to the Global Competitiveness Index 2017–2018 of the World Economic Forum, Greece ranks in the 87th position out of 137 countries in terms of institutions. Greece ranks quite low in terms of the efficiency of government spending, the burden of government regulation, and the efficiency of the legal framework in settling disputes and in challenging regulations. Moreover, according to the World Bank's "Ease of Doing Business" ranking on the conditions for setting up a business, Greece's position has improved significantly in 2011–2017 (from 148 in 2011 to 37 in 2017), but remains low relative to its European peers.

Therefore, particular emphasis should now be placed on upgrading the education system, improving public administration, cutting red tape, lowering the regulatory burden and ensuring the predictability and stability of legislation, reducing entry barriers into network industries, retail trade and professional services as well as in enhancing judicial efficiency. With regard to independent authorities, it is important to strengthen the role and administrative and financial autonomy, as well as accountability towards the Parliament, of the authorities responsible for regulating, supervising and maintaining a level playing field in the markets.

It should be taken into account that most of the reforms to be implemented entail fewer short-term costs relative to those implemented earlier on in the programme (i.e. labour and pension reforms). However, taking into account the synergies with the already implemented reforms, upcoming reforms are expected to yield immediate net gains in terms of faster economic recovery.

Moreover, flexible economic structures and better institutions not only lead to higher long-term growth but also reduce the probability of severe recessions.

iii. Tackle the NPL problem

In the banking sector, **the large volume of non-performing loans and the problem of the 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.

As I mentioned earlier, incoming data point to a reduction in NPEs and this is mainly driven by loan write-offs. However, banks should utilize all the available toolbox to reduce troubled assets, and in particular speed up the sale of NPLs. To accelerate the reduction of the NPL stock, the new electronic auctions platform should become fully operational as soon as possible. Particular emphasis should also be placed on the restructuring of viable companies and the liquidation of non-viable ones. This will release resources to support new and existing sound investment and business initiatives, thereby supporting the economic recovery. The recent modernisation of the institutional framework allows the co-operation of banks with loan servicers and various non-bank entities and private investors, such as private equity funds, in order to restructure the underlying business.

iv. Adopt a growth friendly fiscal policy mix

The Bank of Greece has proposed the adoption of **a more growth friendly fiscal policy mix**. More emphasis has to be placed on cutting non-productive expenditures and increasing the public sector efficiency, including the management of state property. 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 and the improvement in tax administration will lead to a fairer distribution of the fiscal burden and will facilitate the reduction of the excessively high tax rates. According to the Global Competitiveness Index 2017–2018, Greece ranks last and second to last as regards the adequacy of the tax system to provide incentives to invest (137th out 137 countries) and to work (136th out of 137 countries).

v. Support Small and Medium Enterprises (SMEs)

SMEs[1] are the backbone of the Greek economy in terms of employment and gross value added (GVA). In 2015, they accounted for 75.1% of total GVA and for 87.3% of employment in non-financial corporations. Very small or micro SMEs (employing less than 10 people) accounted for 59.1% of total employment and for 35.9% of GVA in the non-financial corporate sector. The larger share of SMEs in total employment relative to their share in GVA suggests that there is a problem of low productivity, which is more pronounced for very small SMEs. Given the prevalence of SMEs in the Greek economy, policy efforts should also be targeted towards providing incentives for cluster development, alongside with measures to provide affordable funding via the banking sector, the capital markets and the official sector through various EU initiatives. These concerted efforts will allow SMEs to adopt new technologies and benefit from economies of scale as they will gain access to international distribution channels and to foreign markets.

vi. Remove various barriers to investment

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

The **removal of capital controls** as a result of the gradual improvement of the economy and the return of full confidence will improve the investment climate and help attract foreign direct investment.

vii. Promote innovation and a more effective use of human capital

Innovation-driven growth, supported by knowledge-based capital (or intangible assets), is critical to improving living standards.

The efforts of previous years, mainly through the use of resources from the European Structural Funds, have led to a partial improvement in the country's performance in many areas, with the expenditure in research and development (R&D) being on an upward trend over the period 2011–2016. R&D expenditure reached €1,733 billion or 0.99% of GDP in 2016 from €1,391 billion or 0.67% of GDP in 2011. Despite the continuing rise, Greece records one of the lowest R&D intensities compared to its euro area peers (2.0% of GDP).

However, innovation-based growth is based on a much wider range of elements than just R&D spending, such as employee skills and training, investment in information and communication technologies (ICT), organizational know-how, databases, design, brands and various forms of intellectual property.

A more effective use of domestic high-skilled human capital requires the **adoption of policies and reforms that encourage research, facilitate the diffusion of technology and boost entrepreneurship**. Companies should be incentivized to increase investment in R&D in order to improve their capacity to innovate. Universities and research institutes should be encouraged to cooperate with the private sector to commercially exploit research results and ideas. These initiatives will promote innovation, increase productivity and facilitate the transition to a knowledge-based economy.

The improvement in institutions and the implementation of the reform and privatization program will provide incentives for the initiation of new investment projects. New investment goes hand-in-hand with job creation and is, thus, expected to facilitate the reduction of the unacceptably high unemployment rate. However, certain aspects of structural reforms and the stabilisation of the economy might have negative distributional effects. Hence, it is essential to **provide immediate support to the unemployed and those marginally attached to the labour** market by employing active labour market policies and targeted social transfers to counter the temporary income loss and to shorten job-transitions. In the medium-term, emphasis should be placed on **skill upgrading and retraining policies** to get people back to work as well as **improvements in education**, given that investment in human capital is a prerequisite to an inclusive and sustainable growth model.

viii. Address the public debt overhang

Decisive and concrete actions are needed to **ensure the sustainability of Greek public debt**. The Eurogroup reaffirmed last 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 of at least 8.5 years. If adopted, such a proposal would support both the recovery of the economy and the country's creditworthiness. This is more so if it is combined with a lower fiscal target, that is a primary surplus of 2.0 percent of GDP instead of 3.5 percent, and more privatisations.

This mild debt reprofiling proposal is vital for debt sustainability in Greece, while it involves only a negligible cost for its partners. It would also 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, the return of more deposits to the Greek banks and, ultimately, the **full abolition of capital controls**.

5. Greece has the potential to become an attractive investment destination

I will now briefly refer to some factors and structural features that make Greece an attractive place to invest. First, the **policy changes that have taken place** over the past seven years, coupled with the decisive implementation of the **remaining reforms**, improve confidence, enhance business climate and generate positive growth prospects providing incentives for the initiation of new domestic and foreign direct investment.

Second, **economic policy is and will remain prudent**. The most crucial factor that ensures the implementation of the reforms required for the Greek economy to prosper in the context of the Economic and Monetary Union is the emergence of a **strong political consensus** in Parliament and society in favour of keeping Greece in the euro area. In addition, **adherence to the EU macroeconomic and fiscal rules** and the strict monitoring by the EU as part of **post-programme surveillance** which is already envisaged for programme member-states with relatively high public debt, precludes the emergence of new imbalances.

Third, Greece benefits from a **large amount of EU funds** which aim at boosting growth and jobs. In particular, the EU funds programmed to be disbursed to Greece for the period 2014 to 2020 amount to €35.9 billion, or 20% of Greece's 2016 GDP.

Fourth, Greece is both a **European Union and a euro area member state**. Hence, enterprises located in Greece enjoy the benefits of **currency and price stability** and have access to the **EU Single Market**. They face a stable institutional environment, enjoy investor protection, and have access to a **sound banking system** which is under the oversight of the **European Central Bank**.

Fifth, there are several **non-price competitiveness** features that make Greece an attractive **place to invest**. Greece has a **highly skilled human capital** by international standards. According to the 2017–2018 Global Competitiveness Report of the World Economic Forum, Greece ranks relatively high in **higher education and training** (44th out of 137 countries) and, in particular, in the tertiary and the secondary education enrollment rates. Moreover, Greece also receives a relatively good ranking in **technological readiness** (50nd) and in some **innovation and business sophistication factors** like the application for patents (PCT patents: 37th), and particularly in the availability of scientists and engineers (10th). In addition, Greece receives a relatively good ranking in terms of the **strength of investor protection** (41th) and in terms of its **infrastructure** (38th) as well as the number of procedures to start a business (36th) and the degree of customer orientation (48th).

Sixth, one of Greece's most important advantages is its **geographical location** in Southeastern Europe. Being **at the crossroads of three continents** and in close proximity with the Middle-East and the Arab world, Greece provides significant investment opportunities as a **transport and energy hub**. Given that Greece is a major tourist destination country, there are significant investment opportunities in tourism conditional on expanding the capacity and quality of tourism infrastructure. Investment opportunities also exist in sectors such as **logistics, networks, shipping, trade, pharmaceutical, manufacturing, and mining and quarrying**. Since many Arab countries seek to diversify their investment base, these sectors in Greece provide a mutually beneficial opportunity for doing so.

Seventh, it has already been mentioned that Greece has a sizeable state **real estate property** that is available for utilization by private investors under the privatization programme. Both the **current privatization programme** and the private investment needs generate profitable investment opportunities for foreign investors. Despite some missteps, there is already encouraging evidence. **FDI inflows** reached almost €2.8 billion in 2016 (1.6% of GDP). It is the biggest FDI inflow recorded since 2010 and was mainly directed to services sectors (i.e. hotels and restaurants, transportation, financial intermediation and real estate activities). In the **first eight months of 2017** the total inflow has already reached €2.7 billion. **The increased FDI flow and the continuation of the privatization programme** (e.g. the recent sale of the train operator Trainose S.A. to Trenitalia, the extension of the Athens International Airport Development Agreement for 20 additional years) **indicate that major foreign investors see positive prospects on the future of the Greek economy**.

Last but not least, Greece, being a **member of the EU, NATO and other international multilateral organizations**, enjoys peace, security and enhanced cooperation with its partners.

6. Conclusions

The ongoing reform and fiscal adjustment effort is bearing fruits. The fiscal and current account imbalances have now been corrected, important and long-needed reforms have been implemented, competitiveness has improved and the banking sector is adequately capitalized. The economy is now recovering and growth is gathering pace.

However, more needs to be done. Greece is now facing three stock imbalances, namely a high rate of unemployment, a high public debt and a high stock of NPLs in bank portfolios. These three crisis legacies, coupled with the significant investment requirements in order to improve the economy and modernize its public and private infrastructure, will remain the major challenges for Greece over the coming years.

In addition, we still have some way to go in order for Greece to tap the financial market on sustainable terms after the end of the current programme in August 2018. To this end, the Greek authorities must pursue the remaining reforms forcefully and close the 3rd review before the end of the year, in order to improve the credit rating of the country. At the same time our European partners should specify in more detail the medium-term debt reprofiling measures according to the Eurogroup agreement and, in close cooperation with the Greek authorities, provide more clarity on the post-programme support for the Greek economy.

These actions will improve the investment climate and attract foreign direct investment. This, in turn, will facilitate the return to financial normality after seven years of significant sacrifices by the Greek people. More flexible economic structures coupled with sound institutions and macroeconomic fundamentals will accelerate the reallocation of productive resources towards tradable and exportable goods and services, making the economy more resilient to future shocks and raising long-term potential growth.

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[1] Employing less than 250 people.