Yannis Stournaras: The future of the Greek economy

Speech by Mr Yannis Stournaras, Governor of the Bank of Greece, at an event organized by the Hellenic Spanish Chamber of Commerce, Athens, 12 February 2018.

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Ladies and Gentlemen,

It is a great pleasure for me to be with you today. I will share with you some thoughts on the developments, the risks, the challenges and the future prospects of the Greek economy.

First of all, I would like to emphasize that Greece and Spain are connected by close ties of friendship and constructive cooperation within the European Union and the Eurozone. Existing strong economic ties are reflected in our bilateral trade in goods and services.

1. There is scope for further increasing the Greek-Spanish bilateral trade in goods and services

In more detail, Greece's trade balance with Spain is negative (at about 1 billion euro in January-November 2017) and has been gradually worsening over the last five years. Exports of goods to Spain account for about 2.5% of Greek exports of goods and have increased by 29.4% in nominal terms in 2012–2016. Imports of goods from Spain account for 3.5% of Greece's total imports of goods and have increased by about 20.9% in nominal terms in 2012–2016. The services balance with Spain is positive, albeit too small to cover the trade deficit[1]. The total net inflows for foreign direct investment coming from Spain reached 3.5% of the total in 2016. The figures I have just mentioned are a testimony of our good economic relations, but provide room for further increasing bilateral trade and investment flows, which, in turn, will raise economic growth and prosperity in both countries. On the last point, let me highlight that the **policy changes that have taken place** over the past eight years in Greece, coupled with the decisive implementation of the **remaining reforms and privatizations**, have rendered Greece an attractive place to invest and provide opportunities for expanding the activities of Spanish businesses in Greece in both goods and services sectors.

2. Progress over the past eight years

The Greek crisis was the result of major macroeconomic imbalances which have accumulated over a long period of time, leading to the outbreak of the sovereign debt crisis in 2010. To a large extent, these imbalances have now been addressed, although major challenges remain, as I will explain later. Over the past eight years, Greece has implemented a bold economic reform and adjustment programme that has **fully eliminated fiscal and external deficits and improved competitiveness**. In more detail:

• 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 (i.e., the general government balance net of interest payments) showed a surplus of 3.8 percent of GDP in 2016 (programme definition), from a deficit of 10.0 percent of GDP in 2009.

• 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 three years.

• **Labour cost competitiveness** has been fully restored and price competitiveness has recorded substantial gains since 2009.

• The **reforms** implemented cover the pension system, the health system, labour market, product market, the business environment, public administration, the tax system, and the

budgetary framework.

As a consequence, openness has improved substantially and the economy has started to rebalance **towards tradable, export-oriented sectors.**

• The share of total exports in GDP increased from 19.0% in 2009 to 33.1% in January-September 2017. Exports of goods and services, excluding the shipping sector, have increased by 47% in real terms since their trough in 2009, similar to euro area exports.

• The share of tradables goods and services in the economy has increased by 10% relative to non-tradables in terms of real gross value added since 2010. Also, relative prices and net profit margins of tradables' sectors have increased, facilitating the rebalancing process of the Greek economy towards tradable goods and services.

The **banking system has been restructured, consolidated and recapitalized**, following stringent stress tests along with in-depth asset quality reviews. Greek banks are now among the best capitalized in Europe. In September 2017 the CET1 ratio came to 17.1% (December 2016: 16.9%) and the CAR to 17.2% (December 2016: 17%). Moreover, the accumulated provisions cover half of banks' total NPEs, while the other half is covered by the value of the underlying collateral, resulting in an overall coverage ratio of almost 100%.

Significant **institutional reforms** have been implemented, aiming at providing banks with a variety of means of reducing non-performing loans. These reforms, among other things, include the authorization of credit servicing firms, operation of an electronic platform for out-of-court settlement, and electronic auctions of real estate.

In addition, banks have set operational targets to reduce the stock of non-performing exposures (NPEs) by 37% by end-2019. According to the relevant reports published by the Bank of Greece, **progress towards the achievement of targets is satisfactory**. In September 2017 non-performing exposures stood at €100.4 billion or 44.6% of total exposures, having declined by 7.6% (or €8.2 billion) from the March 2016 peak. The improvement during the period January-September 2017 resulted mainly from sales and loan write-offs.

3. Short and medium-term outlook

Progress in the implementation of the adjustment programme and in particular the completion of the 3rd review is having a beneficial impact on confidence, liquidity and economic activity. **The economy is recovering. This is reflected not only in GDP figures, but also in several key indicators of economic activity**, such as industrial production, private sector employment flows, exports of goods and services, and foreign direct investment, as well as soft data such as the manufacturing PMI and economic sentiment indicators.

Improvements are also visible in the financial sector: bank deposits of the non-financial private sector have increased and bank credit to non-financial corporations has stabilized. Nevertheless, financial conditions remain tight and bank lending rates are high compared to other euro area countries. Since October 2017, all four systemic banks returned to the international capital markets with covered bond issues for the first time since 2014. Banks' dependence on central bank financing has declined significantly. The ELA ceiling stands now at €19.8 billion euro, down from 90 billion euro in July 2015. The reduction reflects an improvement of the liquidity situation of Greek banks, taking into account flows stemming from private sector deposits, banks' liquidations of non-core assets and banks' access to wholesale financial markets.

Yields of Greek government bonds have declined to pre-crisis levels and the yield curve has largely normalised. The Greek government returned to international bond markets, for the first time since 2014, with a new five-year issue in July and, towards the end of 2017, conducted

an exchange operation of PSI bonds in order to enhance the liquidity of the market for Greek debt. Investors' participation in this operation came to 86%. Following the swap of old bonds for new ones, yields have fallen substantially (especially on shorter-term notes). Last week and despite market turbulence Greece issued a seven-year bond through which it borrowed €3 billion at a yield of 3.5%. Moreover, yields on corporate bonds fell, while share prices rose, reflecting a gradual recovery of investor confidence in connection with steady progress in the implementation of the economic adjustment programme.

On the **fiscal front**, in January-November 2017, the general government cash primary surplus improved, reaching 4.0% of GDP, compared to 3.7% of GDP in the same period last year. Based on the above, the incoming ESA-2010 data and the execution of the 2017 state budget, the 2017 primary balance target of 1.75% of GDP is expected to be reached with a significant margin. For 2018 the primary balance target of 3.5% of GDP is considered achievable.

According to Bank of Greece estimates, economic activity is expected to pick up in the medium term, with GDP growing by 1.6%, 2.4% and 2.5% in 2017, 2018 and 2019, respectively.

Growth is projected to accelerate in 2018 and 2019, supported by exports, private consumption and investment. Consumption is expected to recover, primarily on the back of higher household real disposable income as a result of increased employment. The contribution of investment is expected to be positive, mainly due to stronger business investment, reflecting the gradual restoration of confidence and liquidity in the financial system, as well as the acceleration of privatisations. Exports are expected to remain robust, reflecting higher foreign demand and the restoration of international competiveness.

4. Risks and challenges

The above forecasts are based on the assumption that the reform and privatization programme will be implemented smoothly and according to the agreed time schedule. The recovery of the economy remains fragile and subject to risks and vulnerabilities, both internal and external. Delays or backtracking on reforms would weaken the positive outlook and impact negatively on investors' confidence in the future course of the Greek economy. Therefore, economic policy should remain focused on the implementation of the remaining programme measures and the preparation for the timely conclusion of the fourth and final review, which will mark the end of the ESM programme.

There are also external risks to the forecast, which are linked, among other things, to the sudden increase in investors' risk aversion due to disturbances in international financial markets (such as the recent mini-crash in Wall Street), tensions in foreign exchange markets and broader geopolitical factors.

5. Major challenges looking forward: Putting the economy on a sustainable growth path

As a result of the painful economic adjustment over the past eight years, macroeconomic flow disequilibria have now been eliminated and reforms have contributed to a substantial improvement of competitiveness. Hence, this is a good starting point for the Greek economy to embark on a sustainable growth trajectory. However, stock disequilibria — such as the high public debt, the high burden of NPLs and high unemployment — persist or have even increased during the years of the crisis, acting as a drag on long-term growth. Furthermore, a large number of legislated reforms need to be fully implemented and the fiscal policy mix is not supportive of growth.

The high level of public debt reduces long-term growth prospects because it increases the cost of capital and generates expectations that future taxes will remain high in order for the sovereign to service the debt, lowering investment. High NPLs in banks' balance sheets reduce the ability of the banking system to provide credit to healthy firms because capital is trapped in non-viable

firms. High long-term unemployment leads to depletion of human capital whereas the collapse in investment has contributed to a decline in the stock of productive capital with negative consequences for long-term productivity growth.

In order to address the abovementioned challenges the focus of economic policy should be on the following:

1. Addressing the public debt overhang. Decisive and concrete actions are needed to ensure the sustainability of Greek public debt, on the basis of the Eurogroup's decision of June 2017. The Bank of Greece has put forward a mild debt re-profiling proposal, which entails only a negligible cost for our partners and provides for, among other things, extending the weighted average maturity of interest payments on EFSF loans by at least 8.5 years. This, along with a long-term commitment to structural reforms, could bring Greek debt back to a sustainable level in gross financing needs terms, allowing for a smooth return of the country to the international capital markets.

2. Implementing the remaining reforms and improving the quality of institutions. Academic research on the drivers of long-run growth shows that well-functioning institutions, high regulatory quality and good governance matter for economic growth and enable countries to over-perform in the long run[2]. This is because institutions and regulatory quality affect incentives for people and businesses to invest in physical and human capital, technology and the organization of production. Therefore, particular emphasis should now be placed on improving the public administration, implementing the land registry, strengthening institutions, 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 on enhancing judicial efficiency. Moreover, with regard to independent authorities, it is important to strengthen their administrative and financial autonomy and ensure respect for their independence, as well as accountability towards Parliament.

3. Adopting a growth-friendly fiscal policy mix. The over-performance relative to the fiscal policy targets over the past three years strengthened fiscal policy credibility, but it came at a cost, i.e., lower economic growth. This is due to the high reliance of the fiscal policy mix on tax policy measures and tax rate hikes. 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). High tax rates actions encourage the shift of activities towards the shadow economy and provide incentives for tax evasion. Hence, the fiscal mix is not sustainable and must change. More emphasis has to be placed on cutting non-productive expenditures, increasing the public sector efficiency, including the management of state property and improving the tax administration. These actions will lead to a fairer distribution of the fiscal burden and will facilitate the reduction of the excessively high tax rates.

4. Tackling the problem of non-performing exposures/loans (NPEs/NPLs) and strategic defaulters which constrains the banking system's ability to finance economic growth. The NPE reduction targets for the next two years are ambitious compared to last year, implying that banks will need to step up their efforts and make full use of the available toolkit for private debt resolution. Moreover, banks will be facing new challenges in 2018, most notably the implementation of IFRS 9, stricter treatment of loan-loss provisions, as well as **the EU-wide stress test** to be conducted by the ECB. Thus, banks need to step up their efforts to attain their operational targets for reducing their NPLs and, ideally, over-achieve them now that the economy has returned to positive growth. In this context, they need to broaden the scope of the workouts they offer to borrowers and make more drastic decisions, in particular with respect to the restructuring of viable businesses, identification of strategic defaulters and the liquidation of non-viable businesses.

5. Improving further the business environment and the insolvency framework to enable faster reallocation of productive factors to more productive opportunities. Rebalancing of the economy towards tradables heavily relies on the ability to freely and quickly move capital from less profitable to more profitable sectors. An efficient insolvency framework is crucial in restructuring companies that are viable and liquidating companies that are not. Despite streamlining the insolvency framework over the past four years, insolvency proceedings remain slow and asset recovery rates are low. Indicatively, according to the OECD, a typical insolvency process in Greece lasts on average 3.5 years, double the time of the OECD average and the recovery rate is 35%, half the level of the OECD average. According to OECD research, Greece has the highest share of capital (and labour) trapped in non-viable companies among OECD countries (27%). This suggests that there is a high degree of capital misallocation in the economy, which contributes to lower productivity.

6. Promoting innovation, education and knowledge-based capital. A necessary condition for sustainable growth is the achievement of higher TFP growth. In order to foster TFP growth, policy must focus on improving the quality of labour (i.e. skills), attracting investment in new technologies and improving the quality of capital through the creation of an institutional framework that supports innovation. Given the decline in the cost of labour relative to the cost of capital and the tight financing conditions of companies, the major risk looking forward is that investment will be concentrated in labour-intensive, low-productivity sectors. This, however, would trap the economy in a state of low productivity and low growth. Hence, innovation, ICT investment and technological progress are important in order to boost productivity in the long run.

7. Speeding up privatizations to attract FDI. Given the decline in disposable income due to the recession and the increased tax burden due to fiscal consolidation, 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, conditions should be established to attract Foreign Direct Investment (FDI). One way to do that is by completing quickly privatization projects which are at a mature stage, as well as stepping up the pace of the overall privatization and real estate development programme. FDI, besides closing the investment gap, promotes greater trade ties with countries and companies with cutting edge-technologies. This will allow integration of Greek companies into global value chains, increasing openness of the economy and improving both the quantity and quality of Greek exports.

8. Supporting the unemployed and enhancing employment and training programmes. With unemployment at very high levels, it is essential to provide immediate support to the unemployed and those marginally attached to the labour market by using active labour market policies and targeted social transfers to counter temporary income losses and shorten job transitions. In the medium term, emphasis should be placed on skill upgrading and retraining policies to get people back into work.

6. Final remarks

A major issue in the coming months is the consolidation of confidence and the **improvement of the country's creditworthiness**, which will allow the return of the Greek sovereign to financial markets on sustainable terms after the end of the programme in August 2018. The steps that will make an effective contribution in this direction are:

• First, the **implementation of the reform and privatization programme** and the preparation for the **timely conclusion of the fourth and final review**, which will mark the end of the programme;

• Second, the **specification of medium-term debt re-profiling measures**, which will enable Greece's access to bond markets on sustainable terms and will facilitate the inclusion of Greek government bonds in the ECB's quantitative easing programme.

• Third, the **complete lifting of capital controls**, in connection with the improvement of the economic outlook and depositors' confidence in the Greek banking system.

New bond issuances, while still in the ESM programme, coupled with the forthcoming ESM disbursements (in line with the June 2017 Eurogroup commitment) could be used to build up a cash buffer to support investors' confidence and facilitate Greece's market access. Such a cash buffer would be particularly useful in the event that Greece's credit rating has not improved to investment grade by the end of the programme in August 2018 (currently, five notches lower).

However, notwithstanding the existence of a cash buffer to consolidate confidence over the medium term, it is important to **clarify the environment in which the Greek economy will move after the end of the ESM programme**. Under the EU legal framework, Greece will be under surveillance at least until it repays 75% of the official loans received from euro area countries, the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM). Therefore, it remains to be clarified first, **the form of supervision in the conduct of economic policy** and, second, **whether and on what conditions precautionary financial support from the partners will be available after the completion of this program.** According to the Bank of Greece, such a precautionary support framework could assist the Greek economy by further driving down borrowing costs, as it will provide assurance of Greece's access to financing after the end of the programme in August 2018, especially if international financial market conditions deteriorate. It will also allow the ECB to maintain the waiver on Greek government bonds after the end of the programme and eventually include Greek government bonds in its asset purchase programme in the normal or/and in the reinvestment period. Maintaining the waiver is, in the Bank of Greece's view, important for the smooth financing of Greek banks as long as Greece's credit rating remains lower than investment grade, as even repo operations are facilitated by the waiver.

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The ongoing reform and fiscal adjustment effort is bearing fruits. The macroeconomic 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 recovering. However, we still have some way to go in order for Greece to tap the financial markets on sustainable terms after the end of the programme in August 2018.

I am confident that the actions I have just described will improve Greece's creditworthiness, boost the investment and business climate, facilitate the return to financial normality, and will contribute to the sustainable recovery of the economy after many years of recession and stagnation.

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1 It is about 30 million euro in January-November 2017. Services receipts from Spain account for approximately 1.0% of total Greek exports of services (and have declined by 11% in nominal terms in 2012–2016), while payments to Spain account for about 2.2% of total Greek imports of services (and have increased by about 9% in nominal terms in 2012–2016).

2 (2) For an overview of the literature and an empirical analysis of the role of institutional factors in long-term growth in the EU, see Masuch, K., Moshammer, E. and Pierluigi, B. (2016): Institutions and Growth in Europe", CEPS Working Document No 421.