Yannis Stournaras: Recent economic and financial developments in Greece

Speech by Mr Yannis Stournaras, Governor of the Bank of Greece, at the 85th Annual Meeting of Shareholders, Athens, 26 February 2018.

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TOWARDS THE COMPLETION OF THE THIRD PROGRAMME AND A RETURN TO THE MARKETS

The successful completion of the third programme in August 2018 will signal the end of a long period of economic adjustment, allow a return to normality and could, under the right conditions, prove to be a starting point for strong and sustainable growth.

The crucial issues which, from now on, will have a decisive impact on the course and prospects of the Greek economy are the following four:

(a) Public debt sustainability

The high level of public debt feeds uncertainty, undermines confidence in the prospects of the economy, weighs on Greece's credit rating and hinders the smooth exit from the current programme.

The debt sustainability report by the institutions and the adoption of the medium-term debt restructuring measures by the Eurogroup need to be made as soon and as clearly as possible, so as to further strengthen financial markets' confidence and ensure a smooth exit from the programme.

(b) Consolidating confidence

In order to ensure its return to the markets on favourable terms, Greece must consolidate investor confidence in the continuation of reforms and convince that fiscal policy will not relapse once again in the wrong direction. The commitments made must be kept and decisive steps must be taken to continue reforms and privatisations, starting with the removal of obstacles to large investment projects that have already been agreed to, but are lagging. Land-use legislation should play an important role in this area.

The formulation of a national strategy integrating the fiscal and structural targets already agreed for the post-programme period, will boost confidence. It will have a positive impact on the terms of Greece's return to the markets, improve market sentiment and help attract investment. It will also facilitate the return of deposits to banks and will enhance their lending capacity. The above will set in motion a virtuous circle for the economy and the banking system and will create the necessary conditions for a full lifting of capital controls.

(c) A smooth return to the markets

After the end of the programme, Greece will have to secure the funds required to cover its financing needs by resorting to international financial markets on sustainable terms. As already mentioned, the consolidation of confidence is a sine qua non. At the same time however, a financial safety net will need to be put in place to assure that Greece is able to weather adverse developments that could temporarily drive borrowing costs up to unsustainable levels.

The envisaged "cash buffer" is one such safety net, that would enable Greece to avoid a recourse to the markets at times of heightened volatility and high refinancing costs. This cash buffer is currently being built up with the trial bond issues before the end of the programme, as well as with disbursements from the European Stability Mechanism (ESM). At the current stage, the first trial return to the markets took place in July 2017 with a five-year bond issue, while in November 2017 a bond exchange was conducted for an amount of €25.8 billion. Subsequently, after the completion of the third review, a seven-year bond issue was launched, as part of the government's plan for Greece's return to international markets before the end of the programme. This issue, which took place amid turbulence in international financial markets, was successful.

However, episodes of turmoil such as the recent ones appear to have a greater impact on countries with poor credit ratings and a weaker economy. These countries saw the yields on their government bonds rise considerably. This suggests that, in the present uncertain conditions, the Greek State's return to the markets, as necessary as it may be for a return to normality, must proceed with caution.

International experience has shown that trial bond issues for the purpose of creating a sound cash buffer prior to the expiry of a programme helps bolster confidence and paves the way to the exit from the programme. Nevertheless, the need for a complementary precautionary assistance programme must also be considered. The possibility of a recourse to a precautionary support programme, especially if financial market conditions call for one, must not be overdramatised, as the European mechanisms are there to be used if needed. Such a precautionary assistance framework can be expected to support the Greek economy, by helping to reduce borrowing costs, since it will provide assurance of the Greek government's and banks' access to funding beyond the end of the current programme in August 2018. Under an ESM precautionary credit line, funds would become available, without necessarily having to be raised beforehand, whereas the build-up of a cash buffer necessarily entails additional borrowing, which would increase the annual debt service costs. Moreover, this precautionary financial assistance framework would ensure that the waiver on Greek government bonds stays in place, so that the latter remain eligible as collateral in Eurosystem monetary policy operations until Greece regains an investment grade credit rating. Furthermore, in such case, the buffer for systemic banks should remain available beyond August 2018. Finally, the maintenance of the waiver, along with the debt sustainability measures, would enable the purchase of Greek government bonds by the European Central Bank under its public sector purchase programme either in its regular duration or during the reinvestment period, thereby exerting a downward effect on the borrowing costs of Greek government.

(d) The post-programme surveillance framework

According to the European institutional framework, the end of the Greek programme in August 2018 does not relieve Greece of its obligations vis-à-vis its lenders. What changes is the form of the surveillance framework for Greece, which must conform to the general surveillance terms and regulations in force in the European Union.

Regulation (EU) No. 472/2013 of the European Parliament and of the Council provides for automatic post-programme surveillance until the country repays 75% of the loans it has obtained from other Member States, the European Financial Stability Fund (EFSF) and the European Stability Mechanism (ESM). Furthermore, the European Commission reserves the right to subject a Member State to enhanced surveillance, if it judges that this is warranted by the circumstances.

Apart from these provisions, already in force, the European Commission has proposed changes to the economic governance of the euro area, some of which could be relevant for the type of post-programme surveillance that the Greek economy would be subject to, and will be discussed by the European Council within the first half of 2018. The aspects of potential relevance to Greece concern the enhanced role of the ESM and the possible support to Member States for the implementation of structural reforms.

Therefore, it is clear that Greece's smooth exit from the programme and its successful course in new post-crisis European normality entail a commitment to safeguard the achievements made so far, to pursue sound economic policies and to continue and complete the structural reforms.

Rebalancing and adjustment of the economy from 2009 to 2017

The positive indications of a sustainable return to growth are the result of a long-standing and painful economic adjustment effort. The progress made since the beginning of the debt crisis in 2009 is remarkable and unprecedented by international standards. More specifically, Greece achieved:

- The full elimination of the twin deficits, i.e. the very high fiscal deficit and the large current account deficit.
- The full recouping of competitiveness in terms of labour costs and its considerable improvement in terms of prices. It is worth noting that this was achieved through a painful process of internal devaluation, involving significant reductions in nominal wages and salaries, mainly in the private sector.
- At the same time, a bold reform, privatisation and economic modernisation programme is being implemented in areas such as the labour and product markets, the healthcare and social security systems, the fiscal framework, the tax system and public administration.
- As a result of all these major reforms during the eight years of the crisis, the economy has become more extrovert and the production model has begun to rebalance towards export-oriented sectors.
- Finally, the restructuring and consolidation of the banking system, characterised first and foremost by significant recapitalisation, following stringent stress tests and in-depth asset quality reviews, ensure high capital adequacy ratios (Common Equity Tier 1-CET1), higher than the European average, which, along with a satisfactory NPE coverage ratio, enable Greek banks to effectively manage their high stock of NPEs.

It should however be noted that, despite the progress made, the crisis has had significant costs in terms of output and employment losses and a marked decline in household wealth. Between 2008 and 2016, Greece lost over one fourth of its GDP at constant prices, and unemployment rose by nearly 16 percentage points. Furthermore, per capita GDP in purchasing power parity in 2016 came to merely 68% of the EU average, down from 93% in 2008. Meanwhile, a large brain drain has taken place, depriving Greece's society and economy of one of its productive parts, with devastating demographic, economic and social consequences.

DEVELOPMENTS AND PROSPECTS OF THE GREEK ECONOMY IN 2018

2017 marked the return of the Greek economy to positive growth after several years of recession, with the exception of 2014. GDP growth is expected to come to 1.6% in 2017 and to pick up further to 2.4% and 2.5%, respectively, in 2018 and 2019. Therefore, there are reasonable grounds to anticipate that, after a protracted and very painful economic adjustment, growth is now taking hold, on the back of favourable domestic developments and a positive European context.

The improved prospects for the domestic economy have bolstered the economic climate and led to an increase in bank deposits, to upgrades of the credit ratings of the Greek sovereign and to successive reductions in Greek banks' dependence on Emergency Liquidity Assistance (ELA). These better prospects also resulted in sovereign bond yields falling to January 2016 levels, thereby allowing the Greek government to return to the markets in July 2017 for the first time in three years. Corporate bond yields also fell and Greek banks returned to international financial markets with covered bond issues.

Against this background, it is reasonable to anticipate a pick-up in growth for 2018, with GDP growing by 2.4%, driven by: (a) the solid performance of tourism; (b) stronger manufacturing output, reflecting the improved business environment and heralding a rise in business investment; (c) increased exports; and (d) favourable global economic conditions.

HICP inflation returned to positive territory in 2017, posting an average annual rate of 1.1%, compared with 0% in 2016. The weakening of deflationary pressures is mainly attributed to the sharp upswing of international oil prices, particularly in the first five months of the year, and to the inflationary impact of new indirect taxes, effective from early 2017. In 2018, domestic inflation is expected to be determined largely by base effects, which will keep inflation in positive territory, but lower than in 2017.

It is, however, worth noting that the favourable projections rely crucially on the assumption that the fourth and last review of the current economic adjustment programme will be completed smoothly and according to schedule, without delays or setbacks, and that the implementation of reforms will continue unabated in the post-programme period.

FISCAL POLICY

In 2016, Greece's general government primary balance – as defined in the Economic Adjustment Programme – overshot the target set in the programme, for the second consecutive year. More specifically, the general government primary balance, according to the programme definition, turned out at a surplus of 3.8% of GDP in 2016, against a target of 0.5% of GDP. This overachievement reflected the better-than-expected performance of direct and indirect tax revenue, as well as the containment of social expenditure and of public investment. In the course of 2017 and in the context of the second review of the programme, a number of fiscal measures were adopted aimed at bolstering tax revenue, curbing tax evasion and, in the medium term, rebalancing the current fiscal policy mix. Legislation of fiscal measures continued into 2018 with the enactment in January of Law 4512/2018 in the context of the completion of the programme's third review.

According to the Introductory Report to the 2018 Budget, the primary surplus for 2017 is projected to reach 2.44% of GDP, against a target of 1.75%. However, based on the available fiscal data, it is estimated that the 2017 primary budget balance will exceed this forecast. Nevertheless, budget execution data for 2017 indicate that the overachievement of the fiscal target for 2017 is mainly driven by increased revenue from tax arrears (forced collection, additional taxes from the voluntary disclosure of income, tax arrears settlement), which are in large part conjunctural, but also by public expenditure cuts. On the other hand, the increase in direct and indirect tax revenue is marginal, despite higher tax rates and the introduction of new taxes. This confirms the view that the tax-paying capacity of the country's productive forces has been exhausted and points to a need for change in the fiscal policy mix.

THE BANKING SYSTEM AND PRIVATE INSURANCE UNDERTAKINGS

The main developments in the domestic banking sector in 2017 were a gradual recovery of operating profitability; the maintenance of capital adequacy at satisfactory levels; a diversification of banks' funding sources; and a small decline in the stock of non-performing exposures (NPEs) in line with the targets set, although this stock remains high (€100.4 billion in September 2017). It is worth noting that, according to December 2017 provisional data, there was a substantial pick-up in the pace of NPE reduction in the fourth quarter of 2017 (with the NPE stock amounting to roughly €95 billion).

Bank deposits by non-financial corporations and households increased in 2017, as a result of the economic upturn and the gradual recovery of public confidence in the banking system. Furthermore, the slowdown in credit growth observed during the crisis years now seems to have abated. Bank deposit rates continued to fall, albeit at a slower pace, and lending rates to non-financial corporations continued to decline.

Non-performing exposures

The effective management of NPEs is the most crucial legacy problem that banks now have to tackle, if they are to fully consolidate their loan portfolios and become capable of increasing their lending. To this end, the legal and regulatory framework has been strengthened, and banks have taken important action. Specifically, electronic platforms for out-of-court settlement of debts and e-auctions of real estate were launched; the authorisation framework for credit servicing firms was simplified; and the first sales of loan portfolios were conducted. Moreover, new legislation now protects bank officers involved in bad loan restructuring against criminal prosecution, and the rights of secured creditors have been enhanced. The progress achieved in removing the obstacles to the management of NPEs and, in particular, the impact on strategic defaulters' behaviour from the launch of e-auctions was a main factor behind the favourable picture in the fourth quarter.

Banks are complying with a specified time schedule to gradually reduce the stock of NPEs, with a view to driving down the total outstanding stock of NPEs by about 37% from June 2017 to December 2019. Furthermore, the coverage ratio of NPEs by accumulated provisions is satisfactory, and the Common Equity Tier 1 (CET1) ratio was 17.1% in September 2017, higher than the EU average of 15%.

In the period immediately ahead, banks must step up their efforts to attain their NPE operational targets. The targets for the next two years are high and ambitious, yet feasible, now that the economy has returned to positive growth. Banks must, as soon as possible, broaden the scope of workouts offered to borrowers and move towards more drastic decisions, in particular with respect to the restructuring of viable businesses, the conclusion of multi-creditor workouts, the identification of strategic defaulters and the implementation of definitive solutions in the case of non-viable businesses. After the publication of relevant guidelines by the European Commission, the possibility of transferring NPEs to one or more central entities to be set up for this purpose could be considered. Moreover, banks should revise their business plans with an emphasis on developing new operations and further cost-cutting.

However, there is no room for complacency. The domestic financial system remains vulnerable to macroeconomic and financial shocks. Banks will be facing new challenges in 2018, most notably the implementation of International Financial Reporting Standard 9 (IFRS 9), the stricter treatment of loan-loss provisions for new NPEs, as well as the EU-wide stress test to be conducted by the ECB. Against this background, it is important that a cash buffer be available under the third support programme, to ensure financial stability by supporting the banking sector if need be.

Insurance undertakings

According to the new framework of Solvency II for insurance undertakings and with a view to increased transparency and consumer protection, as from 2017 Greek insurance undertakings publish an annual report on their solvency and financial condition. The industry's key financial indicators for 2017 remained stable, whereas solvency ratios are expected to improve. With a view, however, to mitigating the risks stemming from the low interest rate environment and the resulting search for yield, insurance undertakings have adjusted their investment strategies and modified their traditional life products by offering reduced interest rate guarantees and by focusing on promoting mostly unit-linked products.

RISKS AND SOURCES OF UNCERTAINTY

Despite the progress made so far, as reflected in key economic indicators, domestic and external risks remain, which could jeopardise the course of the Greek economy.

In the short term, the main **risks** relate to a delayed implementation of the measures agreed in the third review, which would in turn delay the completion of the fourth and last review of the current programme, as well as to an underachievement of the fiscal targets. In addition, the absence of a timely specification of the debt relief measures could rekindle uncertainties.

Equally significant is the risk of a reversal of the so far downward trend of Greek government bond yields. The recent upgrading of the country's credit rating is a positive development towards a restoration of investment grade ratings for Greek bonds; also, 2017 saw a significant decline in the high yields of Greek government bonds. The fact, however, that Greece still has the lowest credit rating in the euro area, five notches below investment grade, means that, as soon as Greece exits the programme, Greek bonds will no longer be eligible as collateral for access to low-cost refinancing from the ECB. Considering that the yield on the 10-year Greek government bond currently exceeds 4%, compared with 2% for the Portuguese and Italian counterparts, the risk to the debt dynamics is all too clear. This problem could be further exacerbated, as the factors behind the favourable conditions of 2017 appear to be reversing.

There are also **external risks**, which give rise to concerns about the preservation of the very favourable global economic conjuncture and global stability. More specifically, some of the matters pending at the EU level that could hinder the smooth development of the EU economy are: the Brexit preparations after the agreement of 15 December 2017 for an orderly exit, and the need to reach a mutually acceptable agreement on how to address the refugee crisis ahead of the revision of the Dublin Regulation in June 2018. Furthermore, at the euro area level, significant changes to its architecture are expected to be carried out this year, such as the setting up of the European Monetary Fund and the completion of the banking union. Any delays to the scheduled changes could stoke uncertainties. Turning to the global level, the deterioration of relations between the United States and both North Korea and Iran has given rise to turmoil. Finally, the surge of populism in several countries across the globe erodes public trust in democratic institutions and the rule of law.

A STRATEGY FOR SUSTAINABLE GROWTH: THE NEW PRODUCTION MODEL

Today, Greece faces the historic challenge of returning to normality and to a path of convergence with its European partners. A return to strong economic growth calls for maintaining and implementing the structural reforms already legislated, as well as further crucial reforms in areas still lagging behind, such as the tax system, public administration, the judicial system and the goods and services markets. For all of the above to materialise and for Greece to once again become a friendly place for doing business and an attractive destination for productive investment, the end of the current adjustment programme will have to mark the launch of a comprehensive national plan of economic restructuring, whose authorship and ownership will lie with the Greek government. Economic policy planning for the 'day after' Greece's exit from the economic adjustment programmes will have to focus not only on actions to smooth out cyclical shocks, but also, and more importantly, on a medium-to-long-term growth policy geared towards the dual goal of fully utilising the economy's productive potential and safeguarding fiscal stability.

This plan must aim for high and sustainable growth rates by encouraging private initiative, extroversion and broader social engagement. The success of such a plan will require radical changes in the fabric of the economy. The implementation of these changes requires effective and broader consensus and consultation across all social groups as well as across European-oriented political forces in the country. Today, at this critical juncture for the Greek economy, it is important to avoid a halt of the positive momentum or, worse yet, a situation where the lack of social consensus or a polarised political climate could jeopardise what has been achieved after nine years of great sacrifices. More specifically, what is needed is:

First, a drastic overhaul of public administration with clear delimitation of state intervention in private initiative. The state's role should be to regulate the institutional framework governing the private economy and provide oversight of performance and monitoring capacity rather than acting as an entrepreneur-producer. Furthermore, the use of public-private partnerships in a wide range of administrative procedures and in the delivery of public services would shift costs from taxpayers onto users, while at the same time enabling care to be taken to support the weaker groups of the population.

Second, speeding up the privatisation programme and the development of public property. With government intervention under the new productive model being limited to the role of overseer-regulator, privatisations will increase public revenue, while also strengthening competition to the benefit of the consumer.

Third, changes in the tax system with a view to creating a clear and stable tax regime with lower tax rates for households and businesses and to broadening the tax base.

Fourth, expanding the use of electronic transactions to all types of economic activity, so as to effectively reduce the informal economy and increase public revenue with a fairer distribution of the tax burden. The success of this endeavour will crucially hinge upon citizens' familiarisation with digital technology applications, as well as upon building a taxpaying culture.

Fifth, emphasis on the "knowledge triangle" (education-research-innovation), with evaluation of higher education and linking research to funding and to the production process. This is so because linking higher education with the production process promotes innovation and the country's competitive advantages.

Sixth, and most important, strengthening the operational independence of key institutions and the rule of law. For this to become possible, society and the political forces must understand that strong and sound inclusive institutions, which do not serve the interests of specific groups at the expense of others, promote the welfare of society as a whole. For the restart of the economy to be a success, the status of institutions – which is synonymous of confidence –needs to be elevated in future. Weak and closed institutions generate uncertainty and disorientation, whereas strong, open and socially accepted institutions are necessary for a return to normality.

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Today, the Greek economy is close to an exit from the crisis and a return to normality. The economic fundamentals, as recorded, so far, in the evolution of economic indicators, are encouraging. However, making the most of these favourable conditions calls for a comprehensive plan for the future, within a climate of social consensus and normality, capable of convincing the productive forces and the international markets that Greece has broken once and for all with past practices and is back on track to its convergence with Europe.

Related link: Annual Report of the Bank of Greece (in Greek).