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 on the occasion of Accenture's 25th anniversary in Greece "Greece and the global economy - prospects and main challenges ahead", Athens, 28 March 2018.

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Ladies and Gentlemen,

It is a great pleasure for me to be here tonight and share my thoughts on the prospects of the Greek economy against a backdrop of brighter prospects for the global and euro area economy but also against the headwind of higher uncertainty due to a rise in protectionism worldwide.

1. The international environment

The **global economy continues to strengthen**, underpinned by the investment and international trade recovery, on account of favorable financial conditions, supporting monetary policy, improving confidence and low international commodity prices. This favorable momentum is expected to continue in 2018. [1]

World trade in goods and services has **recovered** and its volume is now estimated to have increased by 4.7% in 2017, compared with 2.5% in the previous year. The upward revision of growth rate of international trade is not only due to a faster recovery in world GDP but also to an increase in income elasticity that has fallen in recent years due to the sluggishness in fixed capital investments which are to a large extent "trade-intensive".

Regarding the **euro area**, economic expansion **is strong and broad-based**.[2] The recovery is accompanied by solid employment gains, reflecting also past labour market reforms. The unemployment rate continues to decline despite an increase in labour force participation. Private consumption is supported by rising employment and growing household wealth. The investment outlook is positive, on account of rising corporate profitability, easing financing conditions and solid demand, as well as the need for capital stock replacement after several years of underinvestment. The broad-based global expansion is providing impetus to euro area exports.

Overall, in the **euro area**, GDP in 2017 grew by 2.3% – the highest post-crisis growth rate – and is expected to increase by 2.4% in 2018 and 1.9% in 2019. Positive consumption and investment developments have been fostered and reinforced by the pass-through of the ECB's monetary policy measures, that eased funding conditions for households and firms[3]. The contribution of the ECB easing measures to annual euro area GDP growth was estimated at half a percentage point in 2017 and still is expected to be around one-third of a percentage point in 2018.[4]

Inflation in the euro area reached 1.5% in 2017 and is expected to decline slightly to 1.4% in 2018, largely a reflection of developments in international oil prices. Inflation is expected to move gradually up thereafter to 1.7% in 2020, reinforced by the ECB's accommodative monetary policy, robust economic activity and projected labor cost increases, as the level of underemployment of the workforce will decrease.[5]

The Governing Council of the ECB is more confident that inflation will reach a level of below, but close to, 2% over the medium term. At the meeting of March 8, the Governing Council of the ECB introduced a further gradual adjustment to the monetary policy stance, removing from the official communication the so-called APP easing bias[6]. However, the Governing Council still needs to see further evidence that inflation dynamics are moving in the right direction. So monetary policy, as President Draghi and other members of the Executive Board of the ECB have put it, will remain patient, persistent and prudent.

The **risks** surrounding the forecasts for the global and European economies appear to be **balanced in the short term**, under the positive effect of accommodative monetary policy in advanced economies and the recovery of international trade. However, they **are tilted to the downside in the medium term** as interest rate hikes as a result of the normalization of monetary policy in advanced economies (which is under way) are expected to burden the service of high total public and private debt and to dampen growth dynamics.

Downside risks relate to:

- Rising protectionism and in particular the possible spillovers of the **new trade measures announced by the US administration**. An escalation of trade tensions, the intensity of retaliation and their potential negative confidence effects, would weigh on world trade. These measures already affect stock markets.

- The possibility of **tighter global financial conditions** as well as potential sharp correction in financial markets, triggered by a faster than expected tightening of US monetary policy and/or a reassessment of investors' risk appetite. In this context, **talking down currencies** exacerbates exchange rate volatility which is harmful for global and euro area growth.

- The outcome of Brexit negotiations.

- Geopolitical tensions in the Middle East, the Korean peninsula and Iran, as well as a possible resurgence of the refugee crisis.

- The possibility of anti-euro attitude by populist governments in Eurozone Member States.

Moreover, there are **several medium-term challenges for the global economy**.

- **Productivity growth has slowed** across advanced, emerging market and low-income countries at a time of significant innovation and technological change. This is expected to negatively affect the long-term potential output.
- The generally **low level of global inflation and wage growth**, especially in advanced economies despite the fact that the output gap is closing, **is a puzzle for monetary policy makers**.

  – This development could be linked to globalization and the increasing role of China in the global economy, labour market slack and labour's weakened bargaining position on account of labour market reforms, increases in labour supply and more work of a temporary and part-time nature, the opening up to competition of product and services markets coupled with the growing importance of services, as well as e-commerce which dampens price inflation.

- These changes – **some of which are here to stay for long – have affected the position and the slope of the Phillips curve** (the relationship between labour market slack and inflation) in these economies, and pose a number of **dilemmas for central banks** regarding the continuation of the accommodative monetary policy stance.

2. The future of the Economic and Monetary Union (EMU)

A Euro Area specific challenge relates to the fact that, despite the robust recovery and the policy changes taken in recent years, **the EMU architecture remains incomplete**, making the region vulnerable to future financial crises. Euro area policy makers cannot rely solely on the ECB and expect that it will keep monetary policy loose indefinitely. A well-functioning monetary union requires: **flexible markets for goods, services, labour and capital** to facilitate adjustment and reduce both the likelihood and the impact of any future shock[7]. At the same time, **national fiscal positions should be sound** to cater the stabilization needs over the business cycle and create fiscal space that could be used in a recession. Notwithstanding the above actions which are based on **national responsibility, euro area wide policy instruments** are necessary to **provide risk-sharing and enhance solidarity** in order to cope with large shocks.

Building on the Five Presidents' Report and the European Commission[8] proposal, the key institutional reforms for the new EMU architecture should be the following:

o The **completion of the Banking Union** through the establishment of a European Deposit Insurance Scheme and a common fiscal backstop for the Single Resolution Mechanism to stop the still strong bank-sovereign links.

o The creation of a true **Capital Markets** Union to increase harmonization towards best practices in securitisation, accounting, insolvency law, company law, as well as property rights and to enhance **private risk-sharing**.

- The creation of a **centralised fiscal stabilisation tool** in order to **enhance public sector risk-sharing**. This tool will provide effective protection against asymmetric shocks triggered by regional disturbances. Various proposals have been put forward, i.e., a **common investment fund of EU resources** to finance investment projects conditional on reform implementation, the establishment of a **European unemployment insurance scheme**, the issuance of **European "safe" bonds (ESBies)** and, later on, **Eurobonds** by the European Stability Mechanism.
- The transformation of the European Stability Mechanism into a fully-fledged **European Monetary Fund** that would act as lender of last resort for Member States.
- The **appointment of a Euro Area Finance Minister**, accountable to the European Parliament.
- **Increasing accountability** of all European institutions to the European Parliament, and
- **Reinforcing the macroeconomic rebalancing mechanisms** (i.e. the Macroeconomic Imbalance Procedure), which must operate **symmetrically**. Up to now, the burden of adjustment falls on Member States with current account and budget deficits, while Member States with current account surpluses continue to augment even higher surpluses. This creates a "recessionary" bias in the Eurozone.

Moving forward in this direction would safeguard the monetary union's resilience, its viability and the long-term prosperity of its citizens. **These changes will also reinvigorate real convergence in the euro area**. Recent IMF work has shown that since 2010 there is real divergence among the original euro area countries[9], while in-house work by the Bank of Greece has shown that the real divergence persists even if Greece is excluded from the sample.[10]

3. Greek economy: 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**. As a consequence, openness has improved substantially and the economy has started to rebalance towards tradable, export-oriented sectors.[11]

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.[12]

The **ratio of Non-Performing Exposures to total Exposures remains quite elevated** (44.6% of total exposures or €100.4 billion in September 2017). But banks have set operational targets to reduce the stock of non-performing exposures (NPEs) by 37% by end-2019. And they have accumulated provisions covering about half of their total NPEs, while the other half is covered by the underlying collateral. According to December 2017 provisional data, there was a substantial improvement in the pace of NPE reduction in the fourth quarter of 2017 (with the NPE stock amounting to roughly €95 billion).

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

4. Short and medium-term outlook

Progress in the implementation of the adjustment programme is having a beneficial impact on confidence, liquidity and the real economy. **Real GDP in 2017 increased by 1.4%** on account of the positive contribution of exports of goods and services and gross fixed capital formation. By contrast, private consumption remained flat, while public consumption contributed negatively to growth. Positive developments are not only reflected in economic activity indicators, but also in soft data such as the manufacturing PMI and the economic sentiment indicator which have reached and at times surpassed previous peaks pointing to continuing economic expansion.

Improvements are also visible in the financial sector: bank deposits of the non-financial private sector have increased by about 10 billion euro since mid-2016 and bank credit to non-financial corporations has stabilized. Capital controls have been relaxed and banks' dependence on central bank financing has declined significantly. Nevertheless, financial conditions remain tight and bank lending rates are high compared to other euro area countries.

Yields of Greek government bonds have declined to pre-crisis levels, despite recent turbulence in financial markets, and the yield curve has largely normalised. **The Greek government returned to international bond markets,** for the first time since 2014.

- A five-year bond was issued in July,
- an exchange operation of PSI bonds was conducted towards the end of 2017, in order to enhance the liquidity of the market for Greek debt,
- in early February 2018 (and despite market turbulence) the Greek government raised €3 billion from a new seven-year bond, at a yield of 3.5 percent.
- **Fitch and Moody's recently upgraded the Greek sovereign.** However**, GGBs are still five notches below investment grade.**

Looking forward, the **Bank of Greece expects economic activity to pick up in the medium term, with GDP growing above 2.0% in 2018 and 2019**. Growth will be driven by robust export performance, benefiting from the global expansion and competitiveness gains, solid private consumption growth, supported by rising employment, and robust investment spending, reflecting the realization of new investment projects, benefiting from the gradual improvement in both confidence and funding conditions. These forecasts are based on the assumption that the reform and privatization programme will be implemented smoothly and according to the agreed time schedule.

- **Domestic downside risks** are related to **reform implementation**, as well as the impact of excessive taxation on economic activity.
- There are also **external risks to the forecast**, which are linked, among others, to a slowdown in global economic activity, an increase in investors' risk aversion due to disturbances in international financial markets, tensions in foreign exchange markets, and the rise in protectionism worldwide, as well as a possible resurgence of the refugee crisis.
- Finally, there are **upside risks** too. The most significant one is related to the announcement of further debt relief measures.

5. The return to financial markets on sustainable terms

The **key issue** in the coming months is 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. This requires strengthening the confidence of international investors in the prospects of the Greek economy. This, in turn, can be achieved by implementing the following actions:

- First, economic policy should focus on the preparation for the **timely conclusion of the fourth and final review**, which will mark the end of the programme;
- Second, our European partners should **specify in more detail the medium-term debt re-profiling measures**. This 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, **capital controls should be lifted** after the end of the current ESM programme.
- Fourth, **build up a cash buffer** using new bond issuances coupled with ESM disbursements. 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, and if volatility in financial markets remains elevated.

Nevertheless, in order to **fully resolve uncertainty** over the medium term prospects of the economy the Greek authorities alongside with our European partners **should clarify** both the **type of post-programme surveillance** and **whether any post-programme support arrangement** would be available after the completion of this programme in August 2018. 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).

According to the Bank of Greece, **the decision to establish a post-programme support arrangement** should reflect the need to **ensure smooth financing of Greek banks** (including the continuation of the waiver) and the **Greek economy** in the event that Greece's credit rating remains lower than investment grade and especially if international financial market conditions deteriorate.

6. The transition to a new outward–oriented growth model

As the 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 outward-oriented growth model. 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. In order to address the abovementioned challenges and to ensure that the economy will move towards a sustainable export led growth model, **the focus of economic policy** should be on the following:

- **Implementing the remaining reforms, improving the quality of and safeguarding the independence of institutions**, because institutional quality is a key determinant of long-term growth.
- **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.
- **Adopting a growth-friendly fiscal policy mix**. High tax rates and the over-reliance on taxes are a disincentive on the willingness to invest and to work. Moreover, high tax rates encourage the shift of activities towards the shadow economy and provide incentives for tax evasion.
- **Tackling the problem of non-performing exposures (NPEs)** which constrains the banking system's ability to finance economic growth. Banks need to step up their efforts to attain their operational targets for reducing their NPEs. In this context, banks should facilitate the restructuring of viable businesses, the identification of strategic defaulters and the liquidation of non-viable businesses. Due attention should be paid on 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.
- **Promoting innovation, education and knowledge-based capital** in order to raise TFP and long-term growth.
- **Attracting FDI to close the investment gap and to increase the openness of the Greek economy**, because FDI promotes greater trade ties with countries and companies with cutting edge-technologies.
- **Supporting the unemployed** by using employment and training programmes and targeted social transfers.

7. Final remarks

Over the past eight years, Greece has gone a long way in adjusting its major macroeconomic imbalances, reforming its economy and restoring competitiveness. The economy is now recovering.

Overall, I believe that 2018 is a landmark year for Greece's return to normality. I am convinced that the actions I have just described will lead to a sustainable return to the financial markets. This will mark the final exit from the crisis and the transition to a sustainable export led growth model after many years of painful adjustment, social tensions, recession and economic stagnation.

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1 Global GDP growth is estimated by the IMF (2018) to have accelerated to 3.7% in 2017 from 3.2% in 2016 and is expected to reach 3.9% in 2018.

2 See Draghi, Mario (2018) Introductory Statement, 8 March 2018. www.ecb.europa.eu/press/pressconf/2018/html/ecb.is180308.en.html

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11 The share of total exports in GDP increased from 19.0% in 2009 to nearly 32% in 2017. Exports of goods and services, excluding the shipping sector, have increased by 50% 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.

[12] Based on September 2017 data the CET1 ratio came to 17.1% (December 2016: 16.9%) and the CAR to 17.2% (December 2016: 17%).