Yannis Stournaras: Sources of financing of the Greek economy

Speech by Mr Yannis Stournaras, Governor of the Bank of Greece, at an event organised by the Foundation for Economic and Industrial Research (IOBE) and the Athens Stock Exchange, Athens, 19 March 2018.

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Ladies and gentlemen,

It is a great pleasure for me to be here with you today for the presentation of a very comprehensive IOBE report, which draws on a wealth of information to discuss, among other things, the impact of the distorted growth model of the past and the pressing need to adjust it. I am also glad to see that the findings of IOBE and its proposals on how to achieve this adjustment are in line with the recommendations made by the Bank of Greece in successive reports. It is also encouraging that, even as a forced response to the crisis and with small steps, this adjustment has been underway for a few years now.

The protracted and deep crisis that Greece experienced over the past ten years has brought about **three major changes that are relevant to its growth model**. First, bank lending, which used to be the main source of financing for households and businesses, collapsed. Second, private investment, residential investment in particular, shrank. Third, the production structure became more extrovert against a background of recession in the domestic economy.

Starting with the changes in the real economy, the transition to a new, more extrovert growth model has already begun and can be expected to continue. Businesses, adapting to the new conditions of declining domestic demand, have strengthened their export orientation and, as a result, the percentage of output that is exported has increased in all sectors. Exports of goods and services as a percentage of GDP rose from about 19% in 2009 to 33% in 2017, i.e. by 14 percentage points. This improvement has been driven by goods exports and, to a lesser extent, by services exports. A case in point is the refinery industry, which has become one of the most extrovert among manufacturing sectors.

Developments in productive investment as a driver of growth have been less encouraging. Overall, gross capital formation in the private sector has declined over the last ten years, from 22% of GDP in 2007 to 8% in 2017 at current prices. Of this total 14 percentage point decline, the largest part (11 percentage points) is attributable to a contraction of household investment, chiefly in housing. Business investment, on the other hand, showed a smaller decrease, but remains alarmingly low (4.8% of GDP in 2017, compared with 8% in 2007).

Excluding depreciation, net capital investment by businesses has remained negative since 2009, standing at about €4.3 billion or –2.4% of nominal GDP in the third quarter of 2017. However, in order for the capital stock and potential growth of the Greek economy to increase, positive net capital investment is crucial. For this to happen, private investment must rise by 50% in the coming years. Therefore, the Greek economy needs an **investment shock**, with a focus on productive and extrovert business investment, to avoid output hysteresis and foster a rebalancing of the growth model in favour of tradeable goods and services.

One of the obstacles to the adjustment of the economy is **the scarcity of investment finance**. In recent years, the household saving ratio has been negative. Businesses, on the other hand, have used up part of their own resources in recent years in order to service liabilities, in the absence of profitability and access to market-based financing, also as a result of capital controls. Turning to external financing, i.e. from banks and capital markets, bank credit remains subdued, while alternative market financing sources are still underdeveloped. Businesses' market-based financing virtually collapsed during the crisis years and turned negative from 2011 to 2015. It has since rebounded, but remains well below pre-crisis levels, while it has deteriorated anew since the last quarter of 2016.

In an environment, post-crisis, of bank lending scarcity and tighter credit standards, businesses have sought to cover their financing needs through **alternative types of external financing**, in addition to their own resources. These alternative types included non-bank loans, i.e. loans from domestic financial institutions other than banks, as well as foreign borrowing, mostly intragroup loans and corporate bonds issued on international markets. They also raised unlisted equity financing, while particularly muted was the domestic issuance of corporate bonds (€600 million in 2017) and listed shares. Improved economic conditions helped Greek businesses with positive growth prospects to regain access to international markets, with bond issuance coming to €1.1 billion in 2017, relatively more moderate compared with €6.3 billion in 2012–2014.

Small and medium-sized enterprises, which make up the vast majority of Greek businesses, were disproportionally hit, compared with large businesses with high credit ratings, by the continued contraction in domestic bank lending, given their almost exclusive reliance on bank lending for their external financing.

The supply of bank credit, traditionally a key source of financing for Greek businesses, inevitably decreased during the crisis, as banks faced strong pressures on their liquidity, profitability and capital adequacy from the combined impact of: (a) their inability to access international markets; (b) continuous deposit outflows; (c) the public debt restructuring; (d) the recession, as well as strategic default practices, on the quality of their loan portfolios; and (e) capital controls.

The ECB's interventions were crucial in supporting and restoring smooth monetary policy transmission to the real economy. At the European level, credit growth turned positive long ago, whereas in Greece it would have been far more negative in the absence of these measures.

The improvement in confidence in the Greek banking system and the **tackling of the problem posed by the high stock of non-performing loans** can be expected to further boost bank lending. On a positive note, the annual contraction in credit growth observed during the crisis seems to have eased considerably, in particular with respect to credit to non-financial corporations, which rose in 2017 relative to 2016, as reflected in disbursements of new loans with a defined maturity.

The completion of the two pillars of the Banking Union, i.e. the Single Supervisory Mechanism and the Single Resolution Mechanism, has already contributed significantly to restoring confidence, as the supervisory authorities uniformly and strictly assess banks' soundness and require banks to maintain high capital adequacy ratios and, at the same time, improve the quality of their balance sheets. The completion of the third pillar, the European deposit insurance scheme, will bolster confidence even further.

Reducing **the high stock of non-performing loans** will exert a beneficial effect on economic activity and productivity via two channels: (a) increased supply of bank loans; and (b) the restructuring of the productive sector. According to Bank of Greece estimates and research, a reduction in non-performing loans will help reduce banks' financial risk and drive down their funding costs, while also boosting their capital adequacy.

This will gradually translate into higher l**oan supply and lower lending rates to businesses and households.** Meanwhile, business and household financial risk will decline as the economy recovers, producing valuation gains on their existing assets and higher returns on capital and real estate property. The creditworthiness of households and businesses will therefore increase, enabling further support to investment demand. Finally, the resolution of non-performing loans will free up resources which, if allocated to more productive businesses and sectors, will lead to higher total productivity. Crucial will be the financial support to business start-ups, which have a stronger growth potential than well-established businesses and can prove to be big job creators.

Today, **the domestic banking system is clearly stronger** than at the start of the crisis. Banks' capital adequacy ratios are satisfactory, higher than the EU average; profitability, ROE and ROA indicators have improved; and the actions taken to tackle the problem of non-performing loans seem to be bearing fruit, as the NPL stock is continuously falling in line with the targets set. During 2017, the outstanding balance of banks' non-performing exposures decreased by some €11 billion, but still remains high (about €95 billion as at end-2017).

In addition to the NPL-reducing impact of solid **recovery**, further NPL reduction can also be expected to come from **the acceleration of real estate e-auctions,** which will help improve the pricing of collateral undergoing liquidation that inevitably loses value so long as its sale is delayed. These delays hamper the development of a secondary loan market, as well as the implementation of other measures that would speed up judicial proceedings and facilitate the active management of at least part of non-performing loans under legal protection, in particular those presumably owed by strategic defaulters.

It is worth noting that, even in the cases where banks have agreed on multi-creditor workouts, several months are needed to complete the relevant legal procedures before these workouts can be implemented, obviously depriving the economy of resources. Following the publication of the 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.

However, despite the important role that banks will continue to play in Greece and the EU, in particular for small and medium-sized enterprises, market participants have, for years now, pointed out the pressing **need to expand long-term financing sources**.

Apart from the traditional forms of investment financing, e.g. bank credit and guarantee instruments, more active use could be made of the capital markets or alternative financing instruments such as the following:

(1) **equity funding**, including venture capital, equity crowdfunding and specialised platforms for public listing of SMEs;

(2) **hybrid instruments**, such as convertible bonds and mezzanine finance, typically involving debt instruments that, subject to a trigger, can be converted to equity;

(3) **non-bank debt financing**, such as corporate bonds, securitised debt and covered bonds.

With the exception of corporate bonds, market-based financing is virtually non-existent in Greece for small and medium-sized enterprises, as shown by the present IOBE study, and is also very limited at European level. In the EU, market-based financing of small and medium-sized enterprises accounts for less than 15% of their total financing, and is very costly. A key problem is that investors lack information on small and medium-sized enterprises. In this regard, around 25% of all companies and **around 75% of owner-managed companies** in Europe **do not have a credit score**, according to the European Commission's Green Paper on Building a Capital Markets Union.

The extent of the problem across the EU led the European Commission, in 2015, to draw up and launch an ambitious plan for building a single EU-wide capital market by 2019. The plan aims to improve access to financing for all businesses across Europe, increase and diversify the sources of funding, and make markets work more effectively and efficiently, by removing obstacles that make investor and business access to capital markets harder and costlier.

Well-developed capital markets deliver considerable benefits to market participants and economic activity in general. ***First***, they enable businesses to diversify their financing sources, thereby reducing their reliance on bank credit, and create an environment that is more resilient to shocks. ***Second***, they help to improve the allocation of capital in the economy and risk sharing, by offering investors a broader array of options and enabling them to make their investment decisions in line with their risk appetites and therefore finance even businesses that would have been seen, by banks, as too risky to lend to. ***Third***, equity financing in particular boosts investment without necessarily increasing private debt in the economy.

Progress towards the creation of a Capital Markets Union has been steady, but rather slow. Of the eight legislative proposals submitted by the European Commission before early March 2018, three have been approved so far by the European Parliament and the Council and concern: simple, transparent and standardised securitisation as an additional source of financing in particular for small and medium-sized enterprises and start-ups; the European Venture Capital Fund and European Social Entrepreneurship Fund Regulations, aimed to facilitate investment in innovative companies; and the revision of the Prospectus Directive with a view to facilitating the access of small and medium-sized enterprises' to capital markets. The five remaining proposals are still being negotiated. Meanwhile, during the past two weeks, the European Commission released five new proposals on: an Action Plan on how to harness the opportunities presented by technology-enabled innovation in financial services (FinTech) and crowdfunding; an Action Plan on sustainable finance for a greener and cleaner economy; common rules on covered bonds as a stable and cost-effective source of funding for credit institutions, especially where markets are less developed, which would translate into lower borrowing costs for the economy at large; a proposed Directive aimed to reduce barriers to cross-border distribution of investment funds, making it simpler, faster and less costly; and the clarification of the law applicable to cross-border transactions in claims and securities, promoting cross-border investment.

Once finalised and implemented, this legislative package can be expected to remove barriers to the **geographical diversification of investor portfolios**, which reduce market liquidity and hamper business expansion. Private investors in the EU usually keep their funds in bank deposits with short-term maturities. Moreover, institutional investors, in particular insurance undertakings and pension funds, with traditionally long investment horizons, have reduced their equity investment to 5-10% of their total portfolios. The Capital Markets Union, by facilitating access to attractive investment on competitive and transparent terms, is expected to encourage such investors to invest in equity instruments within the EU. This will help tackle the challenges that population ageing and low interest rates pose to the viability of social security funds, while at the same time opening up financing opportunities for businesses.

Overall, however, as bank credit and the recourse to alternative financing sources are not expected – at least in the short term – to increase enough to bring about the quantum leap in business investment needed for sustainable growth, an **aggressive policy for attracting strategic foreign direct investment** is necessary. This need becomes all the more pressing considering that the saving-to-GDP ratio of the domestic private sector dropped dramatically during the crisis, from 15.3% of GDP in 2007 to 3.8% in the first three quarters of 2017.

If the country is to attract foreign direct investment, **priority must be given to eliminating major counterincentives**, such as red tape, an unclear and shifting legislative and regulatory framework, an unpredictable tax system, inadequate protection of property rights, and delays in contract enforcement. Although foreign direct investment in Greece has been on an upward trend for the past two years, starting, true, from low levels, its share in GDP is still well below that of Greece's South-eastern European trading partners, as well as the EU and euro area averages.

Emphasis should also be placed on promoting co-financed projects and **systematically utilising the resources of European Structural Funds** under the new Strategic Reference Framework 2014–2020, as well as under other programmes such as those of the European Strategic

Investment Fund and the European Investment Bank. The **active utilisation of these innovative financial instruments** and of the advantages they present over traditional grants can maximise the growth impact of EU resources available for investment in the Greek economy.

These financial instruments provide opportunities for: mobilising and blending funds from various EU, public or private sources; revolving funds for the financing of other investment; and leveraging additional public and private resources. In this manner, the final amount of financing can turn out to be much larger than the initially available EU resources, creating a **multiplier effect** for the real economy. According to a European Commission report published in December 2017, Greece has committed 9% of the total resources under the European Regional Development Fund and the Cohesion Fund through financial instruments, compared with 19% for Slovenia, 18% for Portugal and 8% for the EU as a whole. However, several of these financial instruments, despite having been activated, remain untapped.

Bank of Greece research also indicates the important role of **public investment** in boosting business investment. Higher public investment is expected to have a favourable effect on aggregate demand and total productivity in the private sector and to create incentives for investment initiatives.

Most importantly however, what is needed is a continuation of reforms and privatisations, starting with the elimination of obstacles to large investment projects that have already been agreed upon, but are lagging. Greece must consolidate investor confidence in the continuation of reforms and convince that fiscal policy will not relapse once again in the wrong direction, succumbing to clientelism and to a stifling by the State of private initiative. This would have a positive impact on the terms of Greece's return to the markets, improve market sentiment and help attract investment. It would also encourage the return of deposits to banks, thereby enhancing banks' lending capacity. The above would set in motion a virtuous circle for the economy and the banking system and create the necessary conditions for investment financing and a return to sustainable growth.

If consolidating confidence is a sine qua non for the above, i.e. for the increase of both domestic and total investment, **Greece must also take full advantage of the possibilities arising from EU and euro area membership to create a financial safety net** that would convince of its ability to cope with any headwinds that could make its financing costs unsustainable, in particular in an international environment rife with financial and geopolitical challenges.

Ladies and gentlemen,

Today, Greece faces the historic challenge of returning to normality and to a path of convergence with its European partners. A return to strong and sustainable growth calls for maintaining and implementing the structural reforms already legislated, as well as further crucial reforms in areas that are still lagging behind, such as the tax system, public administration, the judicial system, the link between production, research and education, the legislative and regulatory framework, especially as regards the use of land, and the goods and services markets. It is obvious that only on this condition can Greece once again become a friendly place for doing business, effectively support productive investment and make a successful leap in total factor productivity.

In closing, I would like to underline that, in the long run, increasing investment require an increase in private sector saving (by households and non-financial corporations), which, as I pointed out earlier, has declined dramatically, dropping by 11.5 percentage points as a ratio of GDP, in ten years. The fall in saving was particularly sharp in the years 2015–2016, for households and businesses alike. Admittedly, the capital controls combined with higher taxation led households and businesses to tap their savings, in order to meet their current needs.

However, there can be no investment without domestic saving or, alternatively, without continued foreign financing. This is why it is so important in the long run to restore the saving capacity of the private sector. In this context, the development of the second and third pillars of the social security system will not only ensure the system's viability, but will also encourage households to increase their saving and open up a new channel for the financing of business investment. This will enable Greece, in a self-reliant manner, to increase its productive capacity and build the new growth model on sound foundations.