Yannis Stournaras: What lies in store for the eurozone? An assessment of the Greek bailout programmes: has EU become wiser?

Speech by Mr Yannis Stournaras, Governor of the Bank of Greece, at The Economist: Southeast Europe-Germany Business and Investment Summit "Reassessing Europe's priorities", Berlin, 3 December 2018.

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Over the past eight years, Greece has implemented a bold economic reform and adjustment programme that has eliminated flow macroeconomic imbalances, namely the large twin deficits, and has improved sharply wage and price competitiveness. In addition, it consolidated and recapitalized the banking system. Still, stock imbalances remain, such as high public debt and a high non-performing loans ratio. Also, despite the successful conclusion of the third adjustment programme in August, Greek government bonds are still below investment grade and bond spreads remain close to 400 basis points. Moreover, the cost of the adjustment programme in terms of output and unemployment losses has been much higher than in the other euro area Member States that also implemented adjustment programmes.

I will start today by providing a brief overview of the progress achieved so far. I will then discuss the current economic conditions and prospects, as well as the challenges ahead. Next, I will highlight what, in my opinion, went wrong during the programme implementation in spite of overall success, and I will also refer to certain weaknesses of the EMU architecture. Before concluding, I will present a number of proposals for enhancing the functioning of the EMU.

1. Progress since 2010

Over the past eight years, Greece has implemented a bold economic reform and adjustment programme that has eliminated fiscal and external deficits and improved competitiveness. However, some crisis legacies remain unaddressed, as I will explain later. In more detail:

• The general government balance recorded a small surplus for a second consecutive year in 2017 (0.8% of GDP) from a deficit of 15.1% of GDP in 2009. The primary fiscal balance as a percentage of GDP has improved by about 14 percentage points since the beginning of the sovereign debt crisis outperforming the ESM programme's fiscal target for three years in a row. The 2017 primary fiscal outcome (according to ESM programme definition) recorded a surplus of 4.1% of GDP, well above the target of 1.75% of GDP.

• The current account deficit has fallen by 13 percentage points of GDP since the beginning of the crisis.

• Labour cost competitiveness has been fully restored and price competitiveness has recorded substantial gains since 2009. This outcome was mainly driven by labour market reforms, which liberalised employment protection legislation and facilitated a more flexible and decentralised wage bargaining system.

• A bold programme of structural reforms and privatisations has also been implemented. Reforms cover various areas, such as the pension system, the health system, goods and services markets, the business environment, the tax system, the budgetary framework and public sector transparency.

As a consequence of the above, 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 34.2% in 2017. Exports of goods and services excluding the shipping sector have increased by 54% in real terms since their trough in 2009, outperforming euro area exports as a whole. The share of tradable goods and services in the economy has increased by 10% relative to non-tradables in terms of real gross value added since 2010. On account of improving economic conditions and the reforms implemented, the unemployment rate, although still quite elevated, declined to 19.0% in the second quarter of 2018from 27.8% at the end of 2013.

The banking system has been restructured and recapitalised and its corporate governance has been enhanced. Following three rounds of recapitalisation, Greek banks have capital ratios above the euro area average and maintain buffers sufficient to absorb additional credit losses, as the recently completed pan-European stress test indicated. They have also markedly improved their liquidity position, regaining access to the interbank market and issuing covered bonds; as a consequence, they have reduced their reliance on central bank funding. However, non-performing exposures (NPEs), one of the most important legacies of the crisis, remain banks' most significant challenge. A number of important reforms have been implemented, aiming to provide banks with a variety of tools to meet this challenge. These reforms include, among other things, the establishment of a secondary market for non-performing loans (NPLs) and the subsequent licensing of fourteen credit servicing firms, the operation of an electronic platform for out-of-court settlement, and electronic auctions of real estate collateral.

These efforts have started to bear fruit: According to end-September 2018 data[1], there is continued progress in the pace of NPE reduction - the stock of NPEs decreased by 4.7% compared to end-June 2018, reaching €84.7 billion or 46.7% of total exposures. Despite the fact that this is a very high ratio the reduction amounts to 21% or €22.5 billion compared to March 2016, when the stock of NPEs reached its peak.

The key driver of NPE reduction so far has been write-offs. Going forward, NPL sales (incl. securitisations) will play a more important role, coupled with collections, collateral liquidation and curing of loans. The pace of NPE reduction is anticipated to accelerate based on the revised and more ambitious NPE targets submitted by banks and covering the period up to 2021.

2. The current state and the outlook of the economy have both improved

Following the stagnation of 2015-2016, GDP growth turned positive in 2017 (1.5%) and accelerated to 2.2% (y-o-y) in the first half of 2018. GDP growth in the first half of 2018 was driven, primarily, by exports of goods and services and, secondarily, by private consumption.

The continued economic expansion is reflected not only in GDP figures, but also in the performance of several key indicators of economic activity, such as: industrial production, retail sales and dependent employment flows in the private sector as well as in several soft data indicators such as manufacturing PMI, economic sentiment and consumer confidence[2].

The Eurogroup decision of 21 June 2018 had a positive effect on confidence as it ensured the sustainability of Greek public debt, at least in the medium term. Moreover, the improved outlook for the economy boosted economic sentiment leading to an increase in bank deposits by the non-financial private sector, improved Greece's credit rating and led to a reduction in banks' dependence on central bank financing.

Despite these positive developments, several other banking and financial indicators provide a mixed picture. For example, the annual change of bank credit to the non-financial private sector remains negative and bank lending rates edged up in September. Moreover, government bond yields have been volatile and rose further, amid broader investor concerns related to political risks in Italy and increased volatility in emerging markets, as well as concerns about possible reversal of legislated measures in Greece after the end of the programme. Thus, Greek businesses and households still face overly high borrowing costs, suggesting that the Greek economy has still not fully overcome the crisis.

Looking forward, the Bank of Greece expects economic activity to pick up in the medium term. Growth will be driven by robust export performance, benefiting from continued global expansion and competitiveness gains; solid private consumption growth, supported by rising employment and gradually rising compensation per employee; and increased investment spending, reflecting the realisation of new investment projects, thanks to the gradual improvement in both confidence and financing conditions.

The outlook is subject to downside risks relating to delays in reform implementation and privatisations and a possible backtracking from previous commitments, including, in particular, court decisions on previous pension reforms. There are also external risks related to the increased volatility and tensions in international financial markets, an increase in global interest rates due to monetary policy normalisation, spillover effects from Italy, a slowdown of the global economy due to the rise in trade protectionism worldwide, geopolitical developments and a possible resurgence of refugee flows.

3. Crisis legacies and challenges ahead

Despite the progress of the Greek economy since 2010 and the debt relief measures decided by the Eurogroup, there are still important crisis-related legacies, such as high public debt, the high stock of non-performing loans, high unemployment, a brain drain, a large investment gap, and relatively high poverty rates in the population. Moreover, non-price or structural competitiveness is still low compared with our European peers and has receded over the past two years, according to the Doing Business report of the World Bank and the Global Competitiveness index of the World Economic Forum[3].

Domestic saving is insufficient to meet the investment needs of the Greek economy; hence, it is crucial to attract foreign direct investment by cutting red tape and accelerating the privatisation programme.

In the long term, the projected demographic decline (due to population ageing and outward migration) will exert downward pressure on potential growth, which could, however, be offset by high investment and total factor productivity growth, as well as by raising labour force participation (especially female) and reducing structural unemployment. It is therefore crucial to continue implementing the necessary structural reforms to boost TFP growth.

Nonetheless, the main challenge for the Greek economy in the immediate future is the sustainable return to financial markets. Despite the successful conclusion of the ESM programme last August and the Eurogroup debt relief measures, Greek government bonds have still not obtained investment grade status and yields remain elevated and volatile, affected by the recent turbulence in international financial markets and in Italy in particular.

4. Missteps and delays

Greece had to remain in an adjustment programme for eight years, unlike Cyprus, Ireland and Portugal, that completed their respective programmes much earlier, despite having entered these programmes later than Greece. Moreover, despite the implementation of three economic adjustment programmes over the past eight years, Greece has still not managed to return to international financial markets on sustainable terms.

In addition, the economic cost of the adjustment effort is unprecedented during peacetime. Between 2008 and 2016, Greece lost over one fourth of its GDP at constant prices, and the unemployment rate rose by nearly 16 percentage points. Furthermore, GDP per capita at purchasing power parity declined to 68% of the EU average in 2016, down from 93% in 2008. A number of Greek-specific and European factors account for this large economic cost and the lagging behind other euro area countries:

First, the size and speed of the fiscal consolidation were unprecedented, explaining why the recession was so deep compared with other programme countries. This primarily had to do with the fact that the initial macro imbalances were much higher in Greece than in those other countries.

Second, the fiscal multipliers turned out to be higher than initially anticipated, implying that the reduction in primary deficits had a larger recessionary impact on the economy. As a result, the economy soon became trapped in a vicious circle of austerity and recession.

Third, there were certain mismatches in the design of the economic adjustment programmes. Given the size of the fiscal imbalances back in May 2010, when the first economic adjustment programme was initiated, more emphasis was placed on tax rate increases, pension reform, streamlining budgetary procedures, increasing fiscal transparency, as well as on financial sector restructuring. Less emphasis was placed on growth-enhancing reforms, tax collection and tax evasion, and on reorganising the public sector.

Fourth, the idiosyncratic sequencing of structural reforms led to real wages declining more than initially planned, deepening the recession. In particular, more emphasis was placed on labour market than on goods and services market reforms. Hence, prices declined both at a slower pace and by a smaller degree than nominal wage costs did. As a result, households experienced a massive drop in purchasing power, which had not been foreseen. This, in turn, constrained personal consumption and deepened the recession.

Fifth, the non-performing loans (NPL) problem proved more difficult that initially anticipated. It was mainly the outcome of economic contraction, but it was also propagated by legislative changes such as the blanket moratorium on auctions and the abuse of protection law 3869/2010. Several other legal and judicial impediments exacerbated the NPL problem[4]. A more forceful reaction during the first years of the crisis by implementing the required legislative changes much earlier and introducing a centralised asset management framework for NPEs as other Member States had done could have reduced the problem we are facing today. The Bank of Greece believes that there is still ample scope for introducing such a systemic solution now and has recently presented a scheme to deal with the high volume of NPEs, in addition to banks' endogenous efforts, in order to achieve a rapid convergence of the Greek NPE ratios to the European average.

Sixth, certain reforms fell behind the agreed time schedule due to several factors, including: insufficient ownership of the necessary reforms; populist rhetoric, rivalry and failure to reach an understanding among political parties; and the various – small and large – vested interests that resist reform.

Seventh, at the same time, political economy deliberations in the euro area have played their part in delaying the recovery of the Greek economy. The Eurogroup decision of November 2012 to grant further debt relief was put off for several years and was actually implemented only in June 2018. This was partly due to delays and to mixed signals occasionally received from Greek political parties on the commitment to reform. However, and rather more importantly, it also reflects forthcoming elections and populist voices in a number of euro area Member States. Overall, this development undermined the growth prospects of the Greek economy and extended the duration of the crisis.

Eighth, at the start of the Greek sovereign debt crisis in 2010 the euro area authorities objected to any type of intervention to contain the rapidly rising Greek government debt. Instead, emphasis was placed on drastically correcting fiscal imbalances. Hence, on account of all this, the much larger than initially anticipated recession over the programme years and the rather unorthodox negotiations of the first half of 2015 that led to the third economic adjustment programme, the Greek debt rose to 176.1% of GDP at the end of 2017 from 126.7% of GDP in 2009, thus requiring further debt relief, which was actually provided in June 2018. If, for instance, this kind of debt relief was given in the beginning of the first adjustment programme, it would have had a more positive impact on the economy, possibly limiting output and employment losses.

Last, but not least, the Stability and Growth Path (SGP) failed to avert the soaring public debt in the pre-crisis period. Furthermore, there was no monitoring and control over macroeconomic imbalances, such as the evolution of the current account and the private debt.

When the Greek crisis broke out in 2010, euro area crisis management and resolution tools were rather non-existent on account of moral hazard concerns and in the absence of the appropriate institutional setting. Moreover, there was no provision for risk-sharing in the initial EMU architecture. Instead, the ECB stepped in to contain the spill over risk to the rest of the euro area.

5. EMU: past reforms and some proposals for improving the euro area architecture

A lot has been done in recent years following the Greek crisis to improve the functioning of EMU. Key initiatives were the provision of intergovernmental loans to Greece, the establishment of the EFSF, and its successor the ESM, the creation of the (still incomplete) Banking Union and the application of stricter rules on banking regulation and supervision, the establishment of the European Systemic Risk Board and the development of appropriate macro-prudential instruments which allowed greater emphasis on identifying and addressing system-wide risks. The ECB developed new monetary policy instruments to deal with the very low inflation and growth, and the SSM assumed responsibility for all systemic banks, thus addressing the home bias issue in supervision.

More recently, the European Commission, in view of the Multiannual Financial Framework for the period 2021-2027, tabled proposals to establish a Reform Support Programme and a European Investment Stabilisation Function. The new EU budgetary tools aim at supporting stability in times of stress through investment continuity and providing incentives for domestic structural reforms.

Nonetheless, the architecture of EMU is still incomplete in many respects and euro area policy makers cannot rely solely on ECB interventions. It is essential to ensure that the economic rebalancing mechanism (i.e. the Macroeconomic Imbalances Procedure) operates more symmetrically, i.e. both for member-states with external deficits and for those with external surpluses. Up to now, the burden of adjustment has fallen, to a very large degree, on Member States with current account and budget deficits (like Greece on the eve of the crisis), while Member States with high (compared to the Macroeconomic Imbalances procedure limits) current account surpluses could have responded more appropriately.

After the crisis, we have seen a home bias in investment and a flow of euro area excess savings towards the rest of the world rather than within the EU (from higher to lower GDP per capita countries). This has also led to a reversal of the degree of financial integration and income convergence among the euro area Member States. Therefore, there is a priority to complete the Banking Union with a European Deposit Insurance Scheme and the Capital Markets Union in order to restore intra-European financial flows, to improve stability in the banking sector and to promote private risk-sharing in the EU. In this context, the role of the ESM could be further enhanced, and among other things, to support Banking Union with a backstop facility.

EMU should also enhance public sector risk-sharing by creating a centralised fiscal stabilisation tool. The European Investment Stabilisation Function, once fully and efficiently operative, could be transformed into such a tool. Other proposals involve a European unemployment insurance scheme and the issuance of European “safe” bonds. These proposals deserve our attention.

As regards Member States, national ownership and credible implementation of country-specific recommendations is crucial both for promoting economic policy coordination and for risk reduction. Therefore, national policies should focus on: a) structural reforms aimed to improve the flexibility of domestic markets and to reduce vulnerabilities in the financial sector in order to facilitate the adjustment of the economies to future shocks; and b) sound pro-growth fiscal policies that allow for stabilisation over the business cycle and, at the same time, ensure debt sustainability.

6. Conclusions and policy lessons

In conclusion, the main policy messages from the Greek crisis are the following:

• Delaying the needed adjustment only magnifies the problem, which will then have to be addressed later on less favourable terms.

• The proper sequencing of the reform programme as well as ownership mainly by the government but also the main opposition parties, is key to its success.

• Greater risk-sharing in the euro area to address large asymmetric shocks and political solidarity in the EU to help countries in difficulty rather than pointing the finger at them (which in fact propagates populist voices in both camps) are of utmost importance in order to ensure the success of our common European endeavour.

• In this regard, private and public risk-sharing should be enhanced by moving forward with the Banking and the Capital Markets Union, and by creating a centralised fiscal stabilisation tool. To avoid moral hazard, risk-sharing should go hand-in-hand with risk reduction and close economic policy coordination. Moreover, we need to improve income convergence and to ensure that economic rebalancing operates symmetrically.

• Last but not least, a final point on Greece: in order to bolster investors’ confidence in the prospects of the Greek economy and to be able to refinance maturing debt on sustainable terms, Greek governments must continue the implementation of reforms and avoid reneging on programme-related commitments.

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1 *Greek commercial and cooperative banks on a solo basis.*

2 *The Greek manufacturing PMI has been in expansionary territory over the past seventeen months, by far the longest period since 2007. Economic sentiment has been on an upward trend since mid-2015, reaching a 3-year high in 2017, and it now stands close to pre-crisis levels. Consumer confidence has been increasing since early 2017, reaching in October 2018 its highest level since March 2015.*

3 *According to the latest Doing Business Report of The World Bank (31 October 2018) Greece ranked 72nd among 190 countries, down from 67th in 2017 and 61st in 2016. According to the latest Global Competitiveness Index of World Economic Forum (17 October 2018), Greece ranked 57th among 140 countries down 4 positions from the previous year.*

4 *Legal and judicial obstacles relate to the lengthy legal procedures, issues related to the legal liability of bankers, the preferential claims of the State, the absence of specialised courts, the lack of adequate corporate insolvency procedures.*