Yannis Stournaras: Recent economic and financial developments in Greece

Speech by Mr Yannis Stournaras, Governor of the Bank of Greece, at the 86th Annual Meeting of Shareholders, Athens, 1 April 2019.

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GREECE IN THE POST-PROGRAMME PERIOD: CHALLENGES AND PROSPECTS TOWARDS A SUSTAINABLE GROWTH MODEL

2019 marks the beginning of new course for the Greek economy. Following the successful completion of the last economic adjustment programme in August 2018, the activation of the enhanced surveillance framework and with Greece now subject to the improved institutional framework for economic governance in the European Union and the euro area, the Greek economy is called upon to operate in a new economic policy context. It is our duty, as individuals, businesses, political and institutional stakeholders, to prove that we have taken ownership of the lessons of the crisis.

2018 saw the recovery of the Greek economy gain traction, with a GDP growth rate of 1.9%. The key drivers of growth were a rise in exports of goods and services, reflecting a greater extroversion of the economy, and a pick-up in private consumption supported by employment growth and an increase in households' disposable income.

The smooth execution and completion of the economic adjustment programme, improvements in confidence and the ensuing strengthening of growth led to a return of deposits to banks. This, in turn, enabled an increase in bank liquidity, a significant reduction and almost elimination of emergency liquidity assistance (ELA) from the Bank of Greece, a small recovery of bank credit, as well as a further relaxation of capital controls.

All of the above led to upgrades of the credit rating of the Greek sovereign and enabled Greece to return to international financial markets a year later, in February 2019, when, taking advantage and of the favourable global investment climate, the Greek government successfully issued a five-year bond. The successful issue of a five-year government bond was the first positive step on the way back to normality.

Moreover, the successful 10-year bond issue in March 2019, for the first time since the start of the public debt crisis in 2010, marked a more decisive step in the same direction, i.e. towards reconnecting Greece with the markets. The legal provision recently passed by Parliament on primary residence protection also contributes in this direction, as it reforms the relevant legislative framework, incorporating specific eligibility criteria and safeguards.

The debt relief measures agreed in June 2018, together with the increased disbursements from the European Stability Mechanism (ESM) for the creation of a cash buffer, have significantly improved the sustainability of public debt in the medium term. However, given that Greek government bonds are still rated at below investment grade and in the absence of access to a precautionary credit line, Greek bonds remained ineligible for the ECB's quantitative easing programme (QE) that would have helped strengthen economic activity and further improve the credit standing of Greek bonds. Greek government bond yields are still high and volatile. They are sensitive to potential disturbances in international financial markets and are influenced by increased uncertainty regarding the maintenance of reform momentum. In fact, the yield spread of Greek 10-year government bonds remains elevated, at just under 400 basis points, despite the recent decline in yields. This persistent phenomenon is a matter that needs our serious attention.

2019 will be another challenging year for the Greek economy. In the **external**

environment, the slowdown of world trade amid rising protectionism could dampen export growth.

On the **domestic front**, increased uncertainty about the continuation of reforms coupled with credit constraints are weighing on investment. High taxation in recent years has taken a toll on the growth dynamics of the economy, the competitiveness of Greek enterprises and confidence, and has caused tax fatigue leading to a contraction of the tax base and an exhaustion of the taxpaying capacity.

In 2019, the growth momentum of the Greek economy is expected to continue at the same pace as in 2018, despite a further slowdown of growth rates worldwide and, especially, in the euro area. However, this forecast is conditional upon the resolute pursuit of structural reforms, the implementation of the privatisation programme without delays and the strengthening of productive investment. These conditions are essential to completing a successful transition to a sustainable and extroverted growth model.

More specifically, according to Bank of Greece forecasts, GDP at constant prices is expected to grow by 1.9% in 2019, driven mainly by exports and private consumption. However, in order to make up for the huge losses suffered by the Greek economy in terms of output and employment during the long period of recession, higher growth rates are needed.

The low level of investment, insufficient domestic savings, the high – albeit declining – stock of non-performing loans, the large loss of physical and human capital during the recession, as well as the apparently low expectations regarding medium-to-long term potential output growth as a result of adverse demographic trends and the sluggish adoption of new technologies in production processes, all weaken the growth dynamics. Meanwhile, the outlook for the economy still depends largely on foreign investor confidence and on foreign capital inflows.

Turning to the domestic environment, and the fiscal front in particular, the possible implementation of Council of State Plenum rulings that earlier pensions cuts and the abolition of pensioners' bonuses were unconstitutional, poses the greatest fiscal risk in the immediate future.

Furthermore, the fact that Greece is entering an electoral cycle increases the risk of a slowdown of the reform effort and of fiscal relaxation, compounding economic uncertainty. Thus, backtracking on agreed policies would undermine the significant progress achieved so far.

DEVELOPMENTS AND PROSPECTS OF THE GREEK ECONOMY IN 2019

Actual GDP developments in 2018 and the outlook for 2019 indicate that the Greek economy is back on a track of positive growth. The challenge now is to preserve and reinforce the growth momentum so as to enable strong growth rates over a long period.

The reason for this is that growth has yet to gain sufficient traction, as reflected in a negative rate of change in investment, a negative household saving rate and a still high – albeit decreasing – rate of unemployment. The continued underexecution of the Public Investment Programme is also dampening growth.

The growth prospects for 2019 will, to a large extent, remain conditional on the course of the global economy and of the euro area economy in particular, as well as on the continuation of the reform effort.

Economic expansion in the euro area is projected to continue in 2019, but at a significantly more moderate pace (1.1%), as recent data point to a considerable weakening relative to the strong growth rates of previous years. In order to avert the risk of a further economic slowdown in the euro area and to ensure the continued sustained convergence of inflation to levels that are below, but close to, 2% over the medium term, the Governing Council of the European Central Bank

(ECB) decided in March 2019 to maintain accommodative monetary policy by keeping the key ECB interest rates unchanged until the end of the year and by launching a new series of quarterly targeted longer-term refinancing operations (TLTRO-III) with a maturity of two years. This decision should improve financial conditions in Greece and support the growth effort. The ECB Governing Council additionally stressed, as it has been doing for some time now, that fiscal policy in euro area member states with adequate fiscal space should be supportive of economic growth.

The Greek economy in the current year is forecast to be driven mainly by export growth, albeit at a slower pace, and a rise in private consumption. Private consumption will be supported by the continued robust performance of the tourism sector, the ongoing recovery of the labour market and the improved disposable income of households, while investment will benefit mainly from a stabilisation of the real estate market.

HICP inflation fell to 0.8% in 2018, from 1.1% in 2017. The absence of significant further increases in indirect taxation during 2018, the sharp drop in international crude oil prices as from October 2018 and strong base effects were among the main factors behind weaker inflation developments. Looking forward, HICP inflation in 2019 is expected to fall to lower levels, as a result of low international crude oil prices, a slowdown in global activity and trade, as well as strong competition in the domestic retail food market.

FISCAL POLICY

In 2017, for the third consecutive year, the general government primary balance exceeded the programme target. An overperformance is also expected for 2018, according both to the Introductory Report on the 2019 Budget and to Bank of Greece forecasts.

However, the Public Investment Programme was once again underexecuted in 2018. Moreover, considerable delays were observed in the clearance of general government arrears to suppliers, despite targeted disbursements under the loan agreement. These developments, which have been observed repeatedly in recent years, tighten credit supply constraints, thereby depriving the real economy of much-needed financing resources and weighing on long-term growth, as also pointed out by the European Commission in its Enhanced Surveillance Report.

For 2019, an expansionary fiscal package amounting to roughly 0.6% of GDP is envisaged, partly offset by a curtailment of 0.3% of GDP in Public Investment Programme expenditure.

More importantly, possible further fiscal expansion in the run-up to the elections could put public finances at risk.

THE BANKING SYSTEM

Developments in the Greek banking system during 2018 were marked by an accelerating return of bank deposits, banks' improved liquidity situation and diversification of funding sources through access to the interbank market and away from emergency liquidity assistance (ELA) of the Bank of Greece, a small recovery of bank credit and the maintenance of capital adequacy ratios at satisfactory levels. However, bank profitability remained weak.

In early 2018, an EU-wide stress test exercise was conducted, including Greece's four systemic banks, in order to assess bank resilience to hypothetical shocks over the period 2018–2020. The stress test exercise identified no capital shortfall in any of the participating Greek banks.

Non-performing loans

The high stock of non-performing loans (NPLs) on banks' balance sheets remains the major challenge for Greek banks and a serious constraint on their lending capacity. Banks are using the options provided by the improved legal and regulatory framework, which has removed significant institutional and administrative impediments to NPL reduction. These important reforms have begun to bear fruit, as indicated by the reduction of the stock of NPLs to €81.8 billion at end-December 2018 (or 45.4% of total loans), down from a peak of €107.2 billion in March 2016. However, the NPL stock is still excessively high.

At the end of March 2019, Greek banks submitted to the ECB and the Bank of Greece their revised operational targets for NPL reduction, incorporating any recent changes in their strategies since September 2018 and any revised macroeconomic assumptions. According to the previous submission in September 2018, the banks aimed to reduce the aggregate stock of NPLs to €34.1 billion by end-2021, bringing the NPL ratio down to 21.2% of total loans. With the new submission, the Banks aim to reduce the NPL ratio even further, to slightly below 20%. Despite the significant reduction, this ratio is still roughly six times the EU28 average, meaning that the NPL reduction needs to be further accelerated.

The successful resolution of the NPL problem is one of the major challenges facing the Greek economy in its effort to achieve sustainable growth, given that bank lending is the main source of financing for non-financial corporations (NFCs), owing to their structure and size, and for households. Freeing the banks of the NPL burden would help reduce the financial risks and funding costs faced by banks, thereby improving their internal capital generation capacity on a sustainable basis and enabling them to resume their intermediation role. In addition, alleviating the NPL burden would strengthen banks' resilience and shock-absorbing capacity against potential future shocks; support operating profitability and put the conditions in place for a gradual increase in loan supply and a decrease in lending rates to enterprises and households, thereby enabling the smooth financing of the real economy.

The Greek authorities will soon need to decide on new, more systemic tools that would complement the banks' own efforts. The Bank of Greece has for quite some time now proposed a systemic solution, which provides for the transfer to Special Purpose Vehicles (SPVs) of a significant part of NPLs along with part of the deferred tax credits (DTCs) on banks' balance sheets. This solution has the advantage of addressing two very serious problems at the same time: NPLs and DTCs. The government and the Bank of Greece are working together towards the submission for approval of such systemic solutions by the competent European authorities and their ultimate adoption with a view to successfully tackling the NPL problem.

Furthermore, as mentioned previously, the new legislation on primary residence protection is a first step towards an overhaul of the personal insolvency framework in pursuit of a holistic solution to the problem. The implementation of the new framework, which incorporates specific eligibility criteria and safeguards, aims to protect the more vulnerable social groups, to avoid creating moral hazard at the expense of non-delinquent borrowers and to ensure that the impact on bank capital is manageable.

PRIVATE INSURANCE UNDERTAKINGS

As a consequence of Solvency II, the Greek private insurance market matured further in 2018, with improvements in governance structures and human resources. Risk and solvency assessment capabilities were also improved, with a view to better capital and risk management and more effective protection of policy-holders. In 2018, insurers continued their efforts to reduce the long-term guarantees embedded in their products. In this context, the time horizon of coverages has been reduced, and the financial guarantees offered reflect more accurately the prevailing economic conditions. These practices have had a positive impact on the undertakings themselves, by enhancing their solvency position, and on policy-holders, by ensuring lower insurance costs and better quality of insurance products. Nevertheless, insurance undertakings must take care not to lose their long-term perspective.

In the life insurance sector, insurance undertakings are increasingly designing and providing insurance-based investment products. This business strategy supports the financial strength of insurance undertakings, while also enabling them to offer higher returns to policy-holders, although exposing them to higher investment risks. Against this background, it is of crucial importance that insurers provide accurate and relevant information to prospective customers, enabling them to understand the risks involved and avoid losses. In addition, with Law 4583/2018, Directive (EU) 2016/97 on Insurance Distribution was transposed into national legislation, and the Bank of Greece was entrusted with the supervision of insurance intermediaries and distributors.

The outlook for the domestic insurance market is promising. In particular, based on the recent proposal for an EU regulation on a Pan-European Personal Pension Product (PEPP), Greek insurance undertakings could assume a new role and offer personal pension products to customers seeking to supplement their pension entitlements. Likewise, insurance undertakings could be part of a broader scheme providing protection against natural disasters, climate change-related and environmental risks in general.

Moreover, insurance undertakings can take advantage of new technologies, such as big data analytics, artificial intelligence and machine learning, to improve risk assessment and pricing.

RISKS AND SOURCES OF UNCERTAINTY

Despite the progress made so far, as shown by key economic aggregates, risks remain, both domestic and external.

On the **external front**, risks could arise from a possible further slowdown of global economic activity in 2019 amid increasing trade protectionism, geopolitical risks and vulnerabilities in emerging market economies. The slowdown of the European economy is also a significant source of concern, which together with heightened uncertainty over the outcome of the Brexit process, could negatively affect the growth of Greek exports and tourism.

Turning to the **domestic front**, the possible implementation of Council of State Plenum rulings that earlier pensions cuts and the abolition of pensioners' bonuses were unconstitutional, poses the greatest fiscal risk in the medium term. The associated additional expenditure would weigh negatively on the public debt sustainability analysis and would feed uncertainty about the fiscal policy and the financial sustainability of the pension system.

Other domestic risks include the potential implications of high taxation and the overall fiscal policy mix, as well as the backtracking on reforms or delays in their implementation. In addition, in the labour market, the increase in the minimum wage, legislated last January, though expected to bring about short-term gains by supporting disposable income and thereby private consumption, is expected in the medium term to hurt employment, mainly of youth, and competitiveness. In any event, any raise of the average wage must be consistent with labour productivity growth, so as to preserve the gains in competitiveness and employment achieved through a painstaking reform effort since 2010.

CHALLENGES FOR GROWTH

Greece is confronted with a dual challenge: on the one hand, to achieve strong and sustainable growth rates and, on the other, to ensure high primary surpluses in order to meet its fiscal commitments, as defined in the Eurogroup decision of June 2018 and by the broader framework of European fiscal rules.

During the long period of adjustment, the Greek economy succeeded in correcting several macroeconomic imbalances. However, Greece continues to face vulnerabilities which can, to a large extent, be considered a legacy of the crisis, although the multiple and interrelated nature of these vulnerabilities reveals chronic weaknesses.

In greater detail:

– **The permanent return of the Greek State to international financial markets on sustainable terms** is the greatest challenge ahead. The existence of a cash buffer, though useful, is only a temporary means for refinancing State borrowing requirements, and would prove rather ineffective in the event of future shocks in international markets. By no means, therefore, can the cash buffer substitute for a return to the markets at regular intervals and on sustainable terms.

– **The high public debt-to-GDP ratio** increases public and private sector borrowing costs and puts a drag on growth. Although Greece's debt sustainability improved markedly with the measures adopted by the Eurogroup since 2012 and up, most recently, to June 2018, debt reduction ultimately hinges upon both achieving the fiscal targets and remaining committed to the reform effort so as to ensure robust GDP growth.

– **The maintenance of large primary surpluses over an extended period of time** (3.5% of GDP annually until 2022 and 2.2% of GDP on average over the period 2023–2060), especially when accompanied by high taxation, weighs on growth and consequently on debt sustainability.

– **The high stock of non-performing loans (NPLs)** on banks' balance sheets hampers the financing of growth, as it ties up bank capital and financing resources in non-productive activities. The successful resolution of this problem is absolutely necessary in order to improve the quality of bank assets. This, in turn, would enhance the access of healthy entrepreneurship to bank credit.

– **The rate of unemployment remains not only high**, but the highest across the European Union. High unemployment, in particular youth and long-term unemployment, gives rise to inequalities that threaten social cohesion, devalues human capital, saps away any motivation for better education and work, and feeds the brain drain.

– **Low structural competitiveness**, with in fact a trend towards deteriorating.

– **The still negative rate of change in investment**, considering the need to replenish Greece's capital stock, especially in the wake of a protracted period of disinvestment. Moreover, continued underexecution of the Public Investment Programme holds back growth, as it reduces aggregate demand, leads to a deterioration of public infrastructure and increases businesses' operating costs.

– **Insufficient domestic savings**. The rise in nominal disposable income per capita, in particular in the lower income brackets, supported by employment growth especially among youth and workers with part-time and intermittent employment contracts, was chiefly channelled into consumption. Thus, the household saving rate has remained in negative territory.

– **Delays in the delivery of justice**. According to the Enforcing Contracts Indicator used in the World Bank's Doing Business report for 2019, compared to the OECD average, the time for trial and to enforce the judgment is three times longer in Greece, while the time for resolving insolvency is twice as long. Therefore, the rapid and fair settlement of legal disputes in a transparent and stable legal framework is crucial to strengthening the rule of law, thereby also improving investor confidence.

– **The quality of institutions and respect for independent authorities**. Countries with weak institutions lack in flexibility and adaptability, making potential economic disturbances more likely to occur and more difficult to address.

– **Adverse demographic developments**. Over the past decade, Greece's demographics have deteriorated dramatically, as evidenced by the decline and rapid ageing of the population and a very low fertility rate. This trend in demographic data was further exacerbated by the recent wave of migration of part of the population of reproductive age. The demographic crisis is one of the most serious challenges that Greece's society and economy will need to address in the immediate future, as the rapid contraction and ageing of the population adversely impacts potential output and the pace of economic growth in the medium-to-long term.

– **The slow digital transformation of the economy**. According to the Digital Economy and Society Index (DESI), Greece ranked second to last among the EU28 in 2018, meaning that the digital transformation of the Greek economy remains slow. As a result, Greece is still considered 'digitally immature'. Consequently, policy action must be taken to eliminate this technological lag and reduce digital illiteracy.

– **Climate Change and the challenge of sustainable development**. Redefining the concept of growth in a sustainability context and embracing the principles of a circular economy will be crucial to our future. According to the World Economic Forum's Global Risks Report for 2019, three of the top five risks for the world economy are environmental and all three relate to climate change.

PREREQUISITES FOR SUSTAINABLE GROWTH

Addressing the above challenges effectively will require, as a minimum, the following set of policy actions:

First, a **continuation and completion of structural reforms**, so as to safeguard the achievements made so far, reinforce the credibility of economic policy and further improve Greece's credit standing, paving the way to a **permanent return to international financial markets on sustainable terms**. In this context, top priority must be given to reforms that enhance public administration efficiency, legal certainty, especially in land use, and the faster delivery of justice.

Second, **reducing the high stock of non-performing loans**, so as to free up funds for viable businesses, facilitate the restructuring of the business sector and strengthen healthy competition. Meanwhile, the legal framework reforms currently under way should improve payment morale.

Third, **a change to the fiscal policy mix** geared towards lowering the excessively high tax rates, further rationalising public expenditure and enhancing the Public Investment Programme. Ideally, this change should be combined with more realistic primary surplus targets, considering that, with public debt close to 170% of GDP, one additional percentage point increase in GDP contributes 1.7 times more towards reducing the public debt ratio than does one percentage point of primary surplus.

Fourth, **greater focus on attracting foreign direct investment of high value added**, which would accelerate technology integration, strengthen Greece's export performance, utilise inactive human resources, thereby increasing total factor productivity. This presupposes a continuation of privatisations, along with an encouragement of public-private partnerships and a removal of disincentives to investors.

Fifth, **strengthening the "knowledge triangle"** (education, research, innovation). As shown by the latest global trends, in modern efforts to reconcile the functioning of a market economy, i.e. capitalism, with democracy, investing in knowledge and the access opportunities to knowledge for all are a crucial catalyst both for economic growth and for social justice. The Greek education system, despite producing a pool of highly-qualified individuals, fails to equip them with the skills required in today's digital world. The new technologies can generate employment opportunities, provided that labour can rapidly adjust to a human-centred working environment, in which knowledge, skills, personal initiative, mobility, flexibility and cooperation will play a key role. Investing in human capital and fostering entrepreneurship are strategies crucial to the successful adjustment of the labour market. All levels of the education system must therefore be redesigned in order to cultivate the skills required by the modern labour market. Closer links between education and the production process will contribute towards this goal.

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2019 will be a challenging year, as domestic and external risks remain. Therefore, there is no room for complacency. Greece’s successful course in new, post-crisis, European normality calls for strict commitment to uphold the very important achievements made so far, conduct a prudent economic policy aimed at eliminating the remaining imbalances and pursue reforms. The ultimate objective is to complete the Greek economy’s safe transition to a sustainable growth model based on extroversion, entrepreneurship, investment, knowledge and social cohesion, with social sensitivity and respect for the natural environment. The benefits to be reaped are substantial: a rapid decrease in the unemployment rate, a reversal of the brain drain, higher total productivity, higher wages and incomes.