The Bank of Greece Report on Monetary Policy 2014-2015

(June 17, 2015)

Today, in accordance with its Statute, the Bank of Greece submitted its Report on Monetary Policy 2014-2015 to the Speaker of the Greek Parliament and the Cabinet.

At the time of writing of the present report, news kept unfolding, especially as regards the negotiation of a financial support agreement. As of today, the negotiations are still ongoing. As the Bank of Greece had assessed in its Governor's Report for the year 2014, the conclusion of a new agreement with our partners is of the utmost importance to fend off the immediate risks to the economy, reduce uncertainty and ensure a sustainable growth outlook for Greece.

Failure to reach an agreement would, on the contrary, mark the beginning of a painful course that would lead initially to a Greek default and ultimately to the country's exit from the euro area and – most likely – from the European Union. A manageable debt crisis, as the one that we are currently addressing with the help of our partners, would snowball into an uncontrollable crisis, with great risks for the banking system and financial stability. An exit from the euro would only compound the already adverse environment, as the ensuing acute exchange rate crisis would send inflation soaring.

All this would imply deep recession, a dramatic decline in income levels, an exponential rise in unemployment and a collapse of all that the Greek economy has achieved over the years of its EU, and especially its euro area, membership. From its position as a core member of Europe, Greece would see itself relegated to the rank of a poor country in the European South.

This is why the Bank of Greece firmly believes that striking an agreement with our partners is a historical imperative that we cannot afford to ignore. From all the evidence available so far, it seems that a compromise has been reached on the main conditions attached to this agreement and that little ground remains to be covered. Besides, the lowering of the primary surplus targets is a decision of paramount importance that significantly extends the time needed for fiscal adjustment and allows for additional degrees of freedom in the conduct of fiscal policy. Equally important will be the reaffirmation and articulation in more specific terms of our partners' willingness to provide debt relief, as initially stated at the Eurogroup meeting of 27 November 2012. What we need today is a viable debt deal which will spare future generations burdens that we have no right to saddle them with.

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In late 2014, there were serious indications that the Greek economy had overcome the recession and was returning to positive growth. At the time, the Bank of Greece, as well as all the international organisations, were projecting positive GDP growth in 2015 and a further pick-up in 2016.

These projections have since been revised downwards, as the latest GDP data point to a sharp slowdown in annual growth and to quarterly contractions of GDP in two consecutive quarters. The deterioration of economic sentiment indicators and financing conditions in the private sector suggest that the slowdown of the economy is likely to accelerate in the second quarter of 2015, putting the economy at risk for a renewed bout of recession.

The most serious and direct impact of the prevailing uncertainty in recent months has undoubtedly been the loss of confidence.

This was reflected in rising Greek bond yields and the exclusion of Greek businesses from financing on the capital markets. Meanwhile, impaired confidence has hampered negotiations, strengthening the arguments of those who want Greece out of the euro area.

On the domestic front, heightened uncertainty was reflected in the deterioration of economic sentiment and confidence indicators and in bank deposit withdrawals by businesses and households. Indicative of the overall climate was the fact that the outflow of deposits (amounting to some 30 billion euro in the period October 2014-April 2015) has largely taken the form of cash withdrawals and hoarding, while flight of capital has also been recorded.

The outflow of deposits significantly squeezed the lending capacity of the banking system, forcing banks to resort to emergency liquidity assistance (ELA) from the Bank of Greece. Recourse to ELA also became necessary as a significant category of assets in banks' portfolios (debt instruments issued or guaranteed by the Hellenic Republic) became ineligible, as from February 2015, for Eurosystem monetary policy operations.

A factor that further aggravated the liquidity situation was the postponement of payments mainly to the suppliers of general government entities and the tapping into the reserves of General Government entities through short-term borrowing. Thus, the primary balance of general government, on a cash basis, was still in surplus in the first four months of 2015, but has worsened relative to last year.

The adverse developments described above can for the most part be attributed to the uncertainty prevailing since the last months of 2014. Initially, this uncertainty was associated with the political standoff that ultimately led to a snap election. The Bank of Greece, in a public intervention by its Governor on 15 December 2014, had warned of the serious risks for the economy and liquidity. In 2015, uncertainty heightened on account of the difficulty to predict the outcome of negotiations on a new agreement with our partners. The decision of the Eurogroup on 20 February 2015 provided the framework for such an agreement, which produced a positive impact on the overall climate. However, the dragging-on of negotiations on the details of the framework dissipated the initial optimism and refuelled uncertainty. Against this background, all sorts of scenarios once again came to the fore, both in Greece and abroad, about the future course of the country, the possibility of default and Greece's exit from the euro area.

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As detailed in the present Report, it is not possible at present to make any safe projections about the future course of the economy. Given that the greatest problems for the Greek economy today stem from uncertainty and the loss of confidence, it is reasonable to assume that, once the climate improves, the economy will get back on track and resume an upward trajectory. For this to happen, however, the risk of a credit event must be averted once and for all and the country must remain in the euro area. And this can only be achieved if, first, a realistic agreement is concluded soon and, thereafter, if the terms of this agreement are adhered to without any wavering or delay, in conditions of political stability.

An agreement would generate positive prospects and help to make up for the ground lost in the first half of 2015. In particular, an agreement with our partners would:

• avert the risk of very adverse developments and ensure that the sacrifices made so far by Greek citizens will not have been in vain;

• restore trust between the Greek authorities and our partners;

• secure financial support for the Greek economy from our partners and the IMF;

• provide tangible proof of our commitment to continue and deepen the necessary structural reforms and to consolidate the fiscal achievements;

• allow for milder fiscal consolidation, based on lower and more realistic targets for the general government primary surplus, while boosting growth prospects;

• create the conditions for a transition to a new medium- to long-term agreement with our partners, geared towards Greece's smooth return to the international markets and accompanied by the Eurogroup's delivery on its commitment of 27 November 2012 to provide debt relief, so as to ensure a definite exit from the crisis and a path of sustainable growth.

• In addition, an agreement would allow Greece to benefit from the favourable global environment and the ECB's quantitative easing programme.

As soon as the uncertainty dissipates, focus must then be turned to the development of a growth policy capable of ensuring a definitive exit from the crisis and a shift of the Greek economy to a new export-oriented and sustainable growth model. Such a policy would require:

(a) the continuation of structural reforms in the products and services markets, as these reforms would facilitate the market entry of new enterprises, enhance competition and foster innovation;

(b) a strengthening of active labour market policies geared towards tackling the high rate of unemployment;

(c) development and implementation of a coherent and targeted social safety net to provide lasting, rather than piecemeal, support to those truly in need;

(d) a streamlining of the functioning of the State, improvements in the institutional and legislative framework, adoption of a stable fiscal framework and, more generally, of a business-friendly environment;

(e) ensuring fiscal discipline and the achievement of primary surpluses through interventions of a more structural nature rather than merely through revenue-raising measures. Emphasis should be placed on ensuring the viability of social security funds by eliminating the numerous exemptions from the general provisions. The various exemptions from direct and indirect taxes also need to be reviewed and should only remain in place if warranted by growth-enhancing and social considerations;

(f) addressing the challenge posed by the management of non-performing loans, so as to enhance the banking system's ability to play its part in the recovery effort of the Greek economy. Changes must also be made to the institutional framework, for instance in the fields of (pre)bankruptcy law, the Civil Procedure Code and out-of-court settlement arrangements, in order to assist banks in their effort to better manage non-performing loans.

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Today, five years after the first loan agreement of 2010, Greece is once again seeking financial support from its partners, as it remains excluded from financial markets. The indications from the negotiations so far are that the conclusion of an agreement would allow for a slower pace of fiscal consolidation by way of lower primary surplus requirements, in exchange for the implementation of necessary reforms. A large part of these reforms has already been carried out, while the fiscal and the current account deficits have been eliminated.

Therefore, if the overdue reforms can be completed and if all other reforms under the new agreement can be implemented and fiscal balance is maintained, providing space for growth-enhancing initiatives, then the positive outlook should prove true. Our top priority right now should be to create, as soon as possible, those conditions that would enable the Greek economy to benefit from the favourable global economic environment and the highly accommodative monetary policy at the euro area level and would speed up a sustainable return to global capital markets. Such a return to markets could be accelerated provided that, first, financial support from our partners is secured. Equally important, however, is the need for the new financing agreement to be based among other things on our European partners' delivery on their commitments in November 2012 to Greek debt relief, which now need to be specified in greater detail.

http://www.bankofgreece.gr/Pages/en/Bank/News/PressReleases/DispItem.aspx?Item_ID=4988&List_ID=1af869f3-57fb-4de6-b9ae-bdfd83c66c95&Filter_by=DT