25/03/2015 - **Speech by Bank of Greece Governor, Yannis Stournaras at the Hellenic Observatory of the London School of Economics: "Greek economy: current developments, challenges and prospects"**

Speaker: Yannis Stournaras

Ladies and Gentlemen,

It is a great pleasure to be with you tonight. I will share with you my thoughts on the prospects of the Greek economy and I will focus on four issues: **First**, the achievements so far during the difficult years of the economic adjustment. **Second**, current developments in the Greek economy and future challenges and prospects, in view of the 20 February 2015 Eurogroup agreement and the 20 March high level agreement between the Greek government and the EU partners. **Third**, the reasons why Grexit is not an option. **Fourth**, issues related to the sustainability of Greek public debt.

a) Economic adjustment during the past five years

Since the beginning of the crisis, five years ago, Greece has come a long way in adjusting its fiscal and external imbalances and has implemented a bold programme of structural reforms.

First, there has been unprecedented fiscal consolidation. In 2013, Greece returned to a primary surplus in the general government for the first time since 2002. Moreover, by achieving a primary surplus (as defined in the programme) of 1.2% of GDP, it outperformed the programme target of a balanced primary result in the general government. Fiscal consolidation achieved a more than 11 percentage point improvement in the primary budget as a percentage of GDP over the period 2009-2013, despite the deepening recession. Adjusting for the effect of recession, the improvement in the "structural" primary budget balance over the period 2009-2013 reached 18 percentage points of GDP, at least twice as much as the adjustment in other programme member-states.

Second, competitiveness has been restored. Greece has now recovered all of the cost competitiveness it had lost relative to its trading partners since joining the euro area. Cost competitiveness has improved by more than 25 per cent since 2009. According to the ECB's Harmonized Competitiveness Indicators, Greece has been one of the best performers in improving labour cost competitiveness over the period 2000-2014.

This development reflects the effect of structural reforms in the labour market, which have allowed more flexibility in the process of wage bargaining, as well as the impact of the sharp rise in unemployment on labour costs. Structural competitiveness is also showing signs of significant improvement, as suggested by indicators compiled by the OECD, the World Bank and the World Economic Forum.

Third, external adjustment has been significant. The current account in 2014 was in surplus for the second year in a row (0.9% of GDP) with exports of both goods and services increasing at a faster rate than that of the previous year. This development marks a significant turnaround of the current account balance of about 15 percentage points of GDP since 2008. Adjustment came primarily through a decline in imports of goods, particularly in 2009, when world trade collapsed due to the global recession. However, after 2009, adjustment was nearly equally shared between exports and imports.

It is worth highlighting that, during the last four years, exports of goods have rebounded, with growth rates of real exports outpacing those of the euro area average. Moreover, the share of goods exports in extra-EU trade has nearly doubled and the share in world trade has increased by about 30% since 2010. These developments have occurred despite the adverse liquidity and financial conditions faced by Greek exporters.

By contrast, exports of services underperformed until recently largely as a result of uncertainty, which had a negative impact on tourism, and global factors, which affected the performance of the shipping industry. Nevertheless, exports of services rebounded in 2013 and 2014 after years of underperformance, reflecting both a strong tourism season and, more recently, a rebound of the global shipping sector.

Fourth, the policy agenda has included structural reforms. A series of structural reforms have been implemented in labour and product markets as well as in public administration.

In the labour market significant changes were adopted aiming at:
– better aligning wage developments with firm performance; and
– enhancing labour mobility across sectors.
– More specifically, reforms involved measures to decentralise wage bargaining to firm level, reduce minimum wages and increase flexibility.

Progress with structural reforms in product and services markets, by contrast, was markedly slower than in the labour market. Nevertheless, according to the OECD, Greece ranks first in the responsiveness to structural reform recommendations made by the Organisation. Moreover, according to the Euro Plus Monitor 2014, Greece ranks first in the adjustment progress among twenty-one European economies, based on indicators capturing fiscal and external adjustment, labour costs and structural reforms.

This period also witnessed significant institutional changes geared towards streamlining the public administration and downsizing the public sector. In the period 2010-2013, public sector employment fell by more than 20% or 180,000 employees. New institutional reforms were adopted that lay the foundations for ensuring the better control of public spending and improving public financial management. Finally, the Greek authorities have greatly reshaped the taxation system by adopting the Income Tax and Tax Procedures Codes and the new unified Property Tax. Measures have also been adopted to bolster the autonomy of the revenue administration in order to strengthen the collection of current and overdue revenue.

All these reforms will boost the growth potential of the Greek economy in the long term. Bank of Greece staff estimates suggest that structural reforms in labour and product markets are likely to increase potential growth by about 1.6% per annum over a period of ten years, mainly coming from gains in total factor productivity.

Lastly, bank recapitalization and considerable consolidation have taken place.

Over the past few years, the landscape of the banking system has changed significantly with the number of banks being reduced through mergers, takeovers and resolutions. Today the system comprises four core banks and a number of smaller banks. The four core banks, following recapitalization and the implementation of restructuring plans, are well-placed to meet the new challenges that the banking system faces going forward. This was also confirmed by the results of the Asset Quality Review and the EU-wide stress test exercise, conducted by the European Central Bank (ECB) in cooperation with the European Banking Authority (EBA), made public on 26 October 2014.

b) Current developments, challenges and prospects

Recent data suggest that, after six years of deep recession, the economy has started to rebound since the second quarter of 2014. **Real GDP** grew by 0.8% in 2014, positive for the first time since 2007. The increase in GDP is driven by buoyant exports of goods and services, the recovery of private consumption and investment in machinery and transport equipment. The pickup in economic activity also led to a strong rebound of dependent employment and the decline in the unemployment rate, which, however, remains particularly high.

Based on the latest available data, **GDP growth in 2015 is projected to be higher than in 2014** and to pick up even further in 2016. The main elements of uncertainty weighing on the prospects for economic activity in the medium term refer to our ability to fulfil successfully the transitional agreement struck with our partners, a possible deterioration in public finances and reform fatigue.
If these uncertainties can be contained, then the economy will show strong growth in 2015, driven by exports of goods and services and by private consumption and supported also by rising business investment.

Exports of goods and services are expected to remain one of the growth drivers in 2015, with the global economic environment projected to improve as growth rates pick up both in the EU and the other markets and world trade strengthens. A positive impact is also expected from the further improvement in structural competitiveness and possibly in cost competitiveness, combined with restored access to financing for Greek businesses and an improving business climate.

Disposable income developments, the declining general level of prices and reduced uncertainty are expected to affect consumer spending positively in the course of 2015. Private consumption is therefore expected to increase in the year as a whole, supported by the fall in oil prices and the ensuing strengthening of Greek households' real disposable income.

However, although recent hard data show that the economy continues to show signs of stabilizing, **soft data** paint a mixed picture, with PMI and some sentiment indicators softening over the past two months.

Financial indicators (such as Greek sovereign and corporate bond yields and stock prices), which had improved significantly from mid-2012 up until autumn 2014 in line with the improved macroeconomic performance of the country and the consistent implementation of the adjustment programme, **have been deteriorating over the last months**.

The 20 February Eurogroup agreement combined with the 20 March high level agreement alleviated part of the uncertainty

The Eurogroup's decision on 20 February 2015 to grant Greece an extension of the current programme and its approval on 24 February of the Greek government reform measures alleviated part of the uncertainty and gave Greece's government time to complete the reforms still pending and to set its own priorities. As a follow up, on 9 March, the Greek authorities presented to the Eurogroup a more detailed list of reform measures which allowed the commencement of the evaluation process. As reaffirmed by the joint statement by Greece and the EU on 20 March, the Greek authorities are expected to present a full list of specific reforms to be considered by the Eurogroup. These positive developments led to a stabilization of bank deposits, after some outflows during the past three months. However, a large risk premium has been built into Greek financial assets, which still remains at high levels.

The Greek government is now proceeding fast towards agreeing a reform programme with the EU partners and the involved institutions and making progress in the implementation of the agreed policy actions. The 20 March high level agreement in Brussels confirmed the willingness of all parts to respect the rules of the game and the procedures agreed in the Eurogroup of 20 February.

Once the implementation of the current agreement is under way and Greece fulfils its commitments, then financing and liquidity constraints for the Greek state and Greek financial and non- financial corporations will ease and Greek assets should be expected to recover.

Moreover, the decision by the ECB's Governing Council to lift the waiver affecting marketable debt instruments issued or fully guaranteed by the Hellenic Republic will soon be re-examined and should be revoked, as in similar cases in the past, as long as Greece fulfils its current agreement with its EU partners.

The full implementation of the agreed reforms and the conclusion of the evaluation process are prerequisites for the restoration of confidence to the prospects of the Greek economy. Moreover, upon the conclusion of the current evaluation procedure, the Greek government in close cooperation with our EU partners should reach a mutually beneficial agreement on the follow-up arrangement involving a credible reform and medium term fiscal policy programme backed by a reliable credit line paving the way for Greece's return to international financial markets.

These actions will enable Greece to benefit from July 2015 onwards from the recently announced ECB decision on the implementation of Quantitative Easing (QE) at least up until September 2016.
Provided that uncertainty is quickly resolved, the positive momentum of the economy will be maintained and economic recovery will gain speed over the course of the year.

Policy actions that promote long term growth

In the long term, the growth outlook of the Greek economy is expected to improve following the rebalancing of fundamentals such as the twin deficits and competitiveness, provided reforms continue and emphasis is placed on the following priorities:

- **Speeding up structural reforms in the product and services markets** in order to enhance competition and innovation, increase price flexibility and improve competitiveness.
- **Consolidating fiscal achievements**. Efforts must focus on structural measures to strengthen the independence and efficiency of tax administration, with the aim to tackle tax and social contribution evasion. The application of modern, risk-based tax audit methods and the activation of a nationwide asset registry are fundamental in the fight against tax evasion.
- **Reviewing tax exemptions and other favourable tax treatment**. Tax exemptions and favourable tax treatment, including reduced VAT rates, need to be reviewed and streamlined.
- **Lowering tax rates and reviewing the efficiency of public spending**. To the extent that fiscal achievements are safeguarded, a lowering of the direct and indirect tax rates will become possible. On the expenditure side, efforts to better target social benefits must continue, while the existing exemptions from the general pension system provisions must be re-examined.
- **Increasing public sector efficiency**. Completing the national cadastre and eliminating the chronic obstacles to the efficient and speedy delivery of justice are fundamental prerequisites for a well-functioning state, as are the efficient deployment of human resources and a transparent staff appraisal framework that rewards productivity and work ethic.
- **Strengthening active labour market policies with particular emphasis on education and training**, as a way to improve the job-finding chances of people on the sidelines of the labour market, such as the long-term unemployed and young people, who have borne the burden of unemployment.
- **Managing in an effective way non-performing loans (NPLs).** Greek banks must now adopt an active management of distressed loans, in a manner that not only eases the burden on cooperating borrowers facing temporary difficulties in servicing their debt, but also enables banks to unlock funds tied up in troubled loans that are unlikely to be repaid. The banking sector must be assisted in this effort through improvements in the legal framework that would lift restrictions on, for instance, (pre-) bankruptcy procedures, out-of-court settlements or, as already mentioned, a speeding up of the judicial procedure.

c) Grexit is not an option

After six years of severe recession and five years of fiscal adjustment, the economy has stabilized and is showing signs of improvement. If this momentum is maintained, the economy is likely to return to a steady growth path in the next few years.

Grexit is not an option to Greece for the simple reason that the competitiveness of the Greek economy has been restored over the past five years through internal devaluation and bold reforms in the labour market. Hence, Grexit would deliver no benefit but a lot of pain.

In case of Grexit, the Greek economy would enter another deep recession characterized by extremely tight financing and liquidity conditions, on account of massive deposit outflows and a dramatic fall in confidence and living standards. These developments would lead to trade disruption, push unemployment further up and reduce government revenues, generating fiscal and financing gaps and concerns for the stability of the financial system. As a consequence, another round of fiscal consolidation would be required, while capital controls would be imposed and a deposit freeze could also be required. Moreover, the rapid depreciation of the new currency would serve to improve Greece's international price competitiveness, but this would also drive higher inflation as import prices rise. As a result, the gains from depreciation would be only temporary. Finally, de-anchoring of inflation expectations would imply substantially higher inflation, requiring a tightening of monetary policy. Hence, leaving the euro would not allow the country to run an independent monetary policy, as the primary goal of the central bank would be to stabilize the value of the currency.
Grexit would also risk the elimination of EU-budget related inflows to Greece (cohesion and structural funds, agricultural subsidies). Overall, Grexit would imply huge costs for the Greek people, firms and the Greek financial system. IMF and official debt would run in arrears, while foreign law bonds would force Greece into a lengthy litigation process in international courts. In the event of such actions, it is uncertain how long it would take until Greece would regain access to financial markets and would depend on the eventual resolution of official foreign law debt.

On top of all, a Grexit scenario could also have negative contagion effects on weak euro area countries, by introducing a permanent convertibility risk premium into sovereign bond yields and financial asset prices. Last but not least, Grexit might entail very substantial geopolitical risks.

d) Actions to improve debt sustainability

Turning to public debt sustainability, some points are worth-highlighting:

• Nearly 80% of Greece's general government debt is held by the official sector, i.e. bilateral loans by EU countries under the GLF, IMF and EFSF loans, as well as debt securities held by the ECB and NCBs.
• Up until now, Greek debt has benefited from the lowering of the interest rate and the extension of maturities on the GLF loans. The interest rate charged on bilateral loans from euro-area partners is Euribor plus 50 basis points, which is currently about 0.56% per year. GLF loans have an average maturity of about 16 years. In addition, the lending

rate from the European Financial Stability Facility (EFSF) is a mere 1-10 basis points over the average borrowing cost of the EFSF. The average maturity of EFSF loans is over 25 years with the last loan expiring in 2051, while Greece benefits also from the deferral of principal payments on GLF and EFSF loans by 10 years and a 10-year grace period for interest payments on most EFSF loans.

• Moreover, Greece has been receiving the profits made by the ECB and NCBs on their Greek government bond holdings (SMP and ANFA).

As a consequence of these actions, the average maturity of the Greek government debt has increased from 6.3 years in 2011 to about 16.5 years by end 2014 and debt servicing costs have decreased to levels comparable with other southern European countries (i.e. around 4.3% of GDP in 2014), while the actual debt servicing cost is much lower, i.e. about 2.6% of GDP if one takes into account that the interest paid to the ECB and euro-area national central banks (NCBs) is returned to Greece and interest payments on EFSF loans are deferred. Taking into account the fall in interest rates over the past three months, the actual interest expenditures of Greece will be likely about 2% of GDP in 2015.

In view of the existing favourable debt servicing arrangements, it can be argued that the stock of debt, despite amounting to approximately 177% of GDP, need not pose such a big a concern, conditional on there being a credible commitment to the agreed fiscal targets and the implementation of structural reforms which can improve the growth potential of the Greek economy in the long term.

However, in view of the progress achieved so far in terms of reaching primary surpluses and meeting the various conditions incorporated in the adjustment programme, further debt relief should be provided to Greece along the lines of the Eurogroup decision of 27 November 2012. This is necessary for achieving a further credible and sustainable reduction of the Greek debt-to-GDP ratio and in order to smooth out a demanding government borrowing profile post 2022/23, i.e. after the expiration of the 10-year grace period currently applied on GLF interest payments and on EFSF loan principal and interest payments.

There are various ways to do that without losses for euro area creditors.

For example:

• By reducing the lending rate on the Greek Loan Facility by setting the spread over the Euribor -- currently at 50 basis points -- to zero;

• by a further 10-year extension of the maturity profile of EFSF and GLF loans.

The combination of these actions would amount to a net present value benefit of about 17 percent of 2015 GDP for Greece over the next 35 years, thus improving debt sustainability. This will also make possible a relaxation of fiscal targets, making some room for additional investment spending and catering social needs.

In fact, extending maturities and reducing interest rates on the outstanding debt may improve the growth outlook of the Greek economy and, hence, provide further support to public debt sustainability.

Bank of Greece Staff estimates that a permanent reduction of the interest payments –to-GDP ratio by 0.6 percentage points can lead to an increase in real GDP by a total of 4-7% over the next ten years, depending on the fiscal policy mix. This corresponds to a boost in real GDP growth of ½ percentage point per year on average for a ten-year period. The economic rationale that debt relief of this form can provide a "growth dividend" is that reducing the debt servicing costs can free up resources which can be used for investment, job creation and economic growth. The growth dividend is more pronounced if such debt relief is combined with a credible expenditure based fiscal consolidation programme. However, broadening the tax base and fighting tax evasion should not be expected to weigh negatively on growth performance.

Alternative options could also be considered to improve the sustainability of Greece's public debt. However, they might be more contentious as they likely involve some costs for euro area partners.

Concluding remarks

Concluding, the immediate challenges of the government are to:
• consolidate fiscal achievements, further specify and agree with the institutions the full list of specific reforms by the end of April 2015,
• implement the agreed reforms in order to allow for a speedy and successful conclusion of the current evaluation procedure.

This would allow Greek banks to regain full access to the ECB's monetary operations, alleviating liquidity pressures, reducing the funding costs for the Greek financial system and the Greek economy as a whole, and exploiting the accomodating monetary policy applied by the ECB in the Eurozone.

The conclusion of the current evaluation procedure by the end of June 2015 will pave the way for a final agreement on the follow up arrangement between Greece and the EU partners. This should involve a credible medium term fiscal and structural reform programme, backed up by a reliable credit line, as well as further debt relief along the lines of the November 2012 Eurogroup decision. These actions are prerequisites for strengthening both economic growth and employment and for Greece's return to international financial markets, thus, signaling the definitive exit from the crisis.

The new Greek government has a unique opportunity to implement bold structural reforms, which would be backed by a large majority of political forces in the country. This is in my view a historical opportunity which should not be missed.

Thank you very much for your attention.

(http://www.bankofgreece.gr/Pages/en/Bank/News/Speeches/DispItem.aspx?Item_ID=315&List_ID=b2e9402e-db05-4166-9f09-e1b26a1c6f1b)