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“Lessons from the Greek Crisis: Past, present, future”

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Ladies and gentlemen,

It gives me great pleasure to be here today to share my thoughts on the lessons from the Greek crisis. First, I would like to give you an overview of the Greek crisis and a recap of the progress made since 2010, and outline the challenges that Greece still faces. I will then discuss the prospects of the Greek economy and the pre-conditions that need to be met to achieve sustainable growth. Finally, I will put forward some proposals for enhancing the EMU architecture.

1. Brief overview and lessons from the Greek crisis

At the onset of the crisis, a deterioration in the macroeconomic environment, the downgrades of sovereign debt and rising sovereign spreads on account of large macroeconomic and fiscal imbalances cut off the Greek sovereign and Greek banks from international capital and money markets. Extremely tight liquidity conditions ensued, and pressure on the banking sector grew, amid substantial deposit withdrawals. An unprecedented fiscal consolidation was undertaken to correct the fiscal imbalance.

The crisis has taken a heavy toll on output, incomes and wealth. 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 67% of the EU average in 2017, down from 93% in 2008. Meanwhile, there was a large brain drain, depriving Greece's society and economy of a highly productive segment of its population, with immeasurable demographic, economic and social consequences.

The deterioration in the macroeconomic environment and the slide of the GDP growth rate into negative territory raised the debt-to-GDP ratio to unsustainable levels despite the fiscal consolidation and caused debt-servicing problems for households and businesses. As a result, non-performing loans (NPLs) rose substantially, weakening the banks' asset quality, thus making it difficult for banks to finance the real economy. Resolving the Greek crisis took eight years, three economic adjustment programmes, one major debt restructuring and three rounds of banks recapitalisation.

Several factors can explain the length and depth of the Greek crisis:

First, the size and speed of fiscal consolidation were unprecedented. This primarily had to do with the fact that the initial macroeconomic imbalances were much higher in Greece than in other countries.

Second, the fiscal multipliers turned out to be higher than initially anticipated (see Blanchard and Leigh, 2013, 2014). Furthermore, the focus of fiscal policy on higher taxes led to an increase in the informal sector of the economy, a loss of tax revenue due to tax evasion and additional measures in order to meet the fiscal targets (Dellas et al., 2017). As a result, the economy was soon caught in a vicious circle of austerity and recession.

Third, there were certain flaws in the design of the economic adjustment programmes. Given the size of the initial fiscal imbalances, more emphasis was placed on fiscal consolidation, streamlining budgetary procedures and increasing fiscal transparency, at the expense of growth-enhancing reforms, tackling tax evasion and reorganising the public sector.[1]

[1] For example, according to Alesina (2015a,b), revenue-based consolidations are more harmful for output dynamics than expenditure-based consolidations. The more benign effect of the latter type of consolidations works through their positive impact on business confidence and private investment. Moreover, Kasselaki and Tagkalakis (2016), using Greek data, have found that a government spending-based fiscal consolidation improves financial markets and boosts economic sentiment. This, in turn, mitigates the direct negative impact of fiscal consolidation on private investment and output, leading to a more rapid recovery.

Fourth, the idiosyncratic sequencing of structural reforms led to real wages declining more than initially planned, deepening the recession. The reform effort focused more on the labour market than on goods and services markets (see Berti and Meyerman, 2017, on the 'sequencing' and 'packaging' of reforms). Hence, nominal wages declined faster and more strongly than prices. Households experienced a massive drop in purchasing power, which, in turn, constrained personal consumption and deepened the recession.

Fifth, the non-performing loans (NPL) problem proved more difficult to manage than initially anticipated. Mainly the result of economic contraction, it was further exacerbated by legislative changes such as the blanket moratorium on primary residence auctions and the abuse of foreclosure protection under Law 3869/2010, as well as several other legal and judicial impediments. A more dynamic response during the first years of the crisis, by implementing the necessary legislative changes much earlier and introducing a centralised asset management framework for NPLs as other Member States have done could have reduced the problem we face today.

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 of the political parties to reach an understanding; and the resistance of various – small and large – vested interests to reform. The biggest manifestation of this political rivalry and polarisation was the failure to elect a President of the Republic at the end of 2014, which led to early elections in 2015 and to the unfortunate negotiations of the first half of 2015. These, in turn, led to the signing of the third adjustment programme, capital controls, another bank recapitalisation round and two years of economic stagnation.

Seventh, political economy deliberations in the euro area also 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 implemented only in

June 2018. This undermined the growth prospects of the Greek economy and prolonged the duration of the crisis.

Last, but not least, when the Greek crisis broke out, the EMU lacked the tools to avert and contain the crisis (see Katsimi and Moutos, 2010). The EU fiscal rules (Stability and Growth Pact – SGP) failed to avert the soaring public debt, and there was no monitoring and control over macroeconomic imbalances. Moreover, euro area crisis management and resolution tools were practically non-existent due to moral hazard concerns. Instead, the ECB stepped in to contain the spillover risk to the rest of the euro area.

2. Significant progress had been made since the beginning of the debt crisis

Despite the missteps and delays, significant progress has been made since the beginning of the sovereign debt crisis in 2010. The implementation of a bold economic adjustment programme has eliminated the root causes of the Greek crisis (see Stournaras, 2019a, 2018a,b and Malliaropulos, 2019). It is particularly worth noting that:

- The fiscal adjustment was unprecedented, turning a primary deficit of 10.1% of GDP in 2009 into a primary surplus of 3.9% of GDP in 2017.
- The current account deficit has been reduced by more than 12 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.
- A bold programme of structural reforms was implemented, covering various areas, such as the pension and healthcare systems, goods and services markets, the business environment, the tax system, the budgetary framework and public sector transparency.

Meanwhile, the role of the Bank of Greece was pivotal in the restructuring and the recapitalization of the banking system as well as in the enhancement of its corporate governance. Today, banks' capital adequacy ratios stand at satisfactory levels, and their loan-loss provisions are sufficient to address potential credit risks.

However, the banking system still faces a very high stock of non-performing loans (NPLs). A number of important reforms have been implemented in this regard, aiming to provide banks with an array of tools to tackle this challenge, including a strengthening of the supervisory framework by setting operational targets for NPL reduction, the creation of a secondary NPL market and the removal of various legal, judicial and administrative barriers to the management of NPLs (see Bank of Greece, 2018).

These actions have started to bear fruit, as shown by the continued reduction of the NPL stock in line with the targets set. Non-performing loans amounted to EUR 81.8 billion at the end of

December 2018, down by EUR 25.4 billion from their peak in March 2016. However, the NPL ratio remained high, at 45.4% in December 2018.

On account of the reforms implemented since the beginning of the crisis and the effort of enterprises to make up for declining domestic demand by exporting to new markets, 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 37.7% in 2018. Exports of goods and services, excluding the shipping sector, have increased in real terms by 53% since their trough in 2009, outperforming euro area exports as a whole.
- The volume of tradable goods and services in the economy increased cumulatively between 2010 and 2017 by 14% relative to non-tradables in terms of gross value added. The rebalancing of the economy towards the internationally

tradable sectors was facilitated by increases in the relative prices and net profit margins of tradable goods and services. It is worth underlining the fact that, in 2017, the estimated net profit margins of tradables were three times higher than those of non-tradables.

Thanks to improved economic conditions and to the reforms implemented, the unemployment rate, though still high, fell to 18.7% in the fourth quarter of 2018, from 27.8% at the end of 2013.

3. The Greek economy continues to face major challenges

Despite the progress made so far, the Greek economy continues to face major challenges and crisis-related legacies. The European Commission, in its report for the European Semester of 2019 (see European Commission, 2019), points out that Greece faces excessive macroeconomic imbalances. Particular mention is made of the following challenges:

- the high public debt (whose sustainability has improved significantly in the medium term with the measures adopted by the Eurogroup in June 2018);
- the high stock of non-performing loans (NPLs), which impairs banks' lending capacity and delays the recovery of investment and economic activity (see Abiad et al., 2011);
- Greece's negative net international investment position and still negative current account balance;
- high unemployment, which generates inequalities that threaten social cohesion and increases the risk of depreciation of human capital (see Blanchard and Summers, 1986, and Moller, 1990); and
- the low potential growth rate, due to the loss of human and physical capital during the crisis (see Bhagwati and Hamada, 1974, on the effect of brain drain), coupled with population ageing and a very low investment rate.

Without ignoring the effect of still relatively weak domestic demand and the funding constraints hampering new investment, the business environment can still not be considered investment friendly and discourages investment with high tax rates, extensive bureaucracy, limited access to bank financing and delays in court proceedings and rulings. In this context, it should be noted that non-price or structural competitiveness is not only low compared with our European peers but it has in fact receded over the past two years, according to the Doing Business report of the World Bank (2018) and the Global Competitiveness Index of the World Economic Forum (2018).

On top of all this, maintaining large primary surpluses over a prolonged period (e.g. 3.5% of GDP until 2022) impacts negatively on GDP growth. The restrictive effect of large primary surpluses is even more pronounced when accompanied by very high taxation which increases the informal sector of the economy (see Dellas et al., 2017).

4. The pre-conditions for sustainable growth

To address the challenges facing the Greek economy, speed up the recovery and strengthen investor confidence in Greece's long-term economic prospects, the following ten policy actions should be considered:

1st Reducing the high stock of NPLs with the timely implementation of the two systemic solutions proposed by the Bank of Greece and the Ministry of Finance, which will supplement the banks' own efforts.

2nd Reducing the primary surplus target for the period up to 2022 to 2.0% of GDP compared with the current target of 3.5%.

3rd Changing the fiscal policy mix, with an emphasis on lower tax rates and higher public investment, so as to boost the growth impact of fiscal policy.

4rd Implementing more structural reforms (including those agreed as part of the enhanced post-programme surveillance) to safeguard the fiscal achievements made so far and to enhance policy credibility. This would have a positive impact on Greece's attempt to return to international financial markets on a sustainable basis.

5th Broadening the scope for public-private cooperation, in line with best international practices, for example, by strengthening public-private partnerships in investment, social security and healthcare.

6th Improving the quality and safeguarding the independence of public institutions. Independent and properly functioning institutions enhance long-term economic growth (see Acemoglu and Robinson, 2012). In this context, a speedier delivery of justice, legal certainty and a clear and stable legal framework are essential conditions for strengthening the public sense of fairness and justice, for improving the investment climate and for accelerating economic growth.

7th Implementing a more focused policy for attracting foreign direct investment (FDI), by reducing the tax burden, improving public administration efficiency and removing major disincentives, such as bureaucracy, legislative and regulatory ambiguity, especially land use, delays in litigation, and remaining restrictions on capital movements. FDI is crucial as domestic savings are insufficient to cover the investment needs of the Greek economy. In addition to helping to reduce the investment gap, FDI promotes closer trade links with countries and companies with state-of-the-art technologies and facilitates participation in global value chains. This would increase extroversion and improve both the quantity and quality of Greek exports (see Kinoshita, 2011). This, in turn, would accelerate a reallocation of production resources towards exports and increase Greece's long-term potential output (see Olosfdotter, 1998, and Reisen and Soto, 2001).

8th Maintaining labour market flexibility and supporting the long-term unemployed, so as to avoid losing the gains in competitiveness and employment growth from the painstaking reform effort of the period 2010-2017.

9th Enhancing the so-called 'knowledge triangle', i.e. education, research and innovation, and the digitalisation of the economy by adopting policies and reforms that support research, technology diffusion, entrepreneurship and foster closer ties between businesses, research centres and universities. This would contribute to further increasing R&D spending and the ICT sector's share in GDP.[2] However, exploitation of ICT calls for continuous development and training in new technologies, the adoption of innovative products and the enhancement of start-up entrepreneurship. Overall, serious efforts are required to foster innovation and R&D spending in order to boost Greece's digital transformation.

[2] R&D spending in 2017 rose to 1.14% of GDP from 0.67% of GDP in 2011, but still lags behind the euro area average of 2.13% in 2016. The ICT share in GDP in Greece was 3.1% in 2015 and lags behind the EU average of slightly above 4%. Indicatively, Ireland recorded an ICT sector share in GDP of 11.6% in 2014 (see European Commission, 2018a).

10th Targeting policy efforts on providing incentives for cluster development, so as to help SMEs overcome their small size and exploit economies of scale, given the very significant role of SMEs in the Greek economy. Incentives should also be provided to improve the technology and knowledge content of their output, while emphasis should be placed on facilitating their access to foreign markets through export promotion strategies and the establishment of common distribution channels. It is well documented that financial development boosts the growth of small firms more than it does large firms and hence fosters aggregate economic growth (see Beck et al., 2004). Furthermore, policy action is needed to provide funding via the banking sector, the capital markets as well as through various EU funds, while financial technology (FinTech) could offer alternative finance options to SMEs.

The Bank of Greece has an active interest in FinTech and has, in fact, recently set up a FinTech Innovation Hub (see Bank of Greece, 2019) aiming to offer support and information to firms and individuals who are introducing or considering the adoption of innovative, technology-driven financial products, services or business models.

6. The EMU dimension

A lot has been done in recent years to improve the functioning of EMU. Nonetheless, the architecture of EMU is still incomplete in many respects, and euro area policy makers cannot rely solely on ECB interventions (see European Commission, 2018d; Stournaras, 2019b). The following improvements are considered necessary:

First, it is essential to ensure that the economic rebalancing mechanism (i.e. the Macroeconomic Imbalance 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 deficits. Member States with high current account surpluses could have responded more appropriately.

Second, it 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, improve stability in the banking sector and promote private risk-sharing in the EU.

Third, the ESM could be transformed into a European Monetary Fund to act as a lender of last resort for Member States, when they cannot access financial markets on sustainable terms.

Fourth, the EMU should also enhance public sector risk-sharing by creating a centralised fiscal stabilisation tool (based on investment and/or unemployment insurance) and by allowing for the issuance of European "safe" bonds.

Fifth, it is crucial to improve the accountability of European institutions to the European Parliament, for European citizens to have their say (through their European MPs) on euro area developments as a way of combatting populist and anti-European voices.

7. Conclusions

Despite some missteps and delays and political resistance to the implementation of the required reforms, Greece has made notable progress since the start of the crisis in 2010. The implementation of a bold economic adjustment programme has eliminated several macroeconomic imbalances. Moreover, the economy is now recovering and has started to rebalance towards the tradable, export-oriented sectors. Nevertheless, significant challenges and crisis-related legacies remain (e.g. a high public debt ratio, a high NPL ratio, and high long-term unemployment), while the brain drain and underinvestment weigh on the long-term growth potential. To address these challenges, emphasis must now be placed on implementing the reforms described above. These reforms would facilitate the sustainable return of the Greek State to the international government bond markets and the rebalancing of the economy towards a knowledge-based and export-led growth model.

Finally, it is high time to take bold steps towards the completion of EMU, promoting greater political solidarity and fostering private and public risk-sharing. The next crisis should not find us unprepared and we should not rely solely on the ECB's monetary policy to deal with it.

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