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# The Greek economy and banking system: recent developments and the way forward

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# Editorial

On 23-24 May 2013, the Bank of Greece organised a conference on "The Crisis in the Euro Area", in Athens.

The papers and commentaries presented at the conference addressed many important issues related to the functioning of the euro area. Our hope is that these contributions will help improve understanding of the nature of Europe's monetary union, the underpinnings of its crisis, and the changes that are needed so that crises will be prevented in the future.

The papers examined two main sets of issues. One group of papers, adopting a union-wide perspective, assessed the aspects of the euro area's institutional architecture that, with the benefit of hindsight, may have contributed to the crisis, and the policy responses to the crisis at the union level. A second group of papers focused on developments in three crisis countries -- Greece, Ireland, and Portugal.

The papers presented at the conference, with their discussions, will be published in the *Journal of Macroeconomics.*

Here we present the paper by George Provopoulos, the Governor of the Bank of Greece.

# THE GREEK ECONOMY AND BANKING SYSTEM: RECENT DEVELOPMENTS AND THE WAY FORWARD[1]

George Provopoulos
Bank of Greece

**ABSTRACT**

This paper describes the origins of the Greek financial crisis and discusses the progress that Greece has made in adjusting its economy. The main causes of the crisis were the large and growing external and fiscal imbalances. The primary factors accounting for the growing current-account deficit were declines in competitiveness and in public-sector saving. Moreover, prior to the outbreak of the crisis, the Greek banking sector had sound fundamentals. Also, in contrast to the situation in other countries, in Greece the sovereign crisis led to a banking crisis. The paper then (i) takes stock of the considerable progress that Greece has made in addressing its external and fiscal imbalances, and (ii) describes the strategy developed by Bank of Greece to transform the banking system. It is shown that implementation of the Bank's strategy has led to a major restructuring of the banking system, allowing it to become efficient and competitive. These improvements are leading to a positive assessment of the future prospects of the Greek economy by the financial markets.

*JEL classifications*: E4, E58, F3, G15

*Keywords*: Greek sovereign debt crisis, fiscal adjustment, external adjustment, banking sector reform

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[1] George Provopoulos is the Governor of the Bank of Greece and a Member of the Governing Council of the European Central Bank. This is a revised version of the paper presented at the Bank of Greece conference "The Crisis in the Euro Area", held on May 23-24, 2013. The revisions were made to update the information that became available between the dates of the conference and end-July 2013.

## 1. Introduction

The Greek economy is in its fifth year of contraction, the unemployment rate has reached a post-World War II high, and Greek borrowers remain shut-out of the international financial markets. The country has undertaken painful adjustments in order to set the stage for sustainable growth that will put people back to work and increase living standards. How far away is Greece from achieving that objective?

In what follows I will provide an assessment of recent developments in Greece, especially with regard to the banking system. Before do so, however, let me provide a brief preview of my main conclusions.

The Greek economy has turned the corner. The situation has turned brighter for the following reasons. First, fiscal and external adjustment, and a strengthened, well-capitalized banking system, are making the economy competitive. Second, during the past year, the pace of implementation of the adjustment program has been stepped up. Third, recent political developments have resulted in a government that shares a strong commitment to the program. My expectation is that we will see enhanced ownership and implementation of the program. Fourth, the official lenders will continue to provide strong support so long as the government remains committed to the adjustment program. This support is helping the country carry-out the essentials reforms of its economy, including the banking system. Fifth, policy makers in the euro area are addressing the flaws in the monetary union's original institutional design, decreasing the likelihood of future crises and providing the framework to allow them to manage crises better, should they occur.

The remainder of my presentation will be structured as follows. First, I will describe the origins of the Greek financial crisis. Next, I will take stock of the progress that Greece has made in addressing its macroeconomic imbalances and in restructuring its banking system. I will then conclude with my assessment about the prospects of the Greek economy.

## 2. Origins of the crisis

During the 1980s and 1990s the performance of the Greek economy was characterized by double-digit inflation rates and interest rates, anemic real growth rates, large fiscal and external imbalances, and several balance-of-payments crises. The entry of Greece into the euro area in 2001, however, seemed to mark a transformation in the country's economic performance. Between 2001 and 2008, real growth averaged almost 4 per cent a year and, with the European Central Bank anchoring inflation expectations, inflation fell to the low single digits and interest-rate spreads between 10-year Greek and German sovereigns dropped to between 10 and 50 basis points, from over 600 basis points in the late 1990s (Figures 1 and 2).

Yet, in the years leading up to the eruption of the Greek sovereign-debt crisis in 2009, unsustainable fiscal and external imbalances were building. Consider the following developments.

- Greece's fiscal deficit increased from 4.4 per cent of GDP in 2001 to 15.6 per cent of GDP in 2009 (Figure 3).
- The widening of the fiscal deficit was mainly expenditure driven. The share of government spending in GDP rose about 9 percentage points, to 54 per cent (Figure 3).
- The ratio of government debt to GDP rose from 103.7 per cent in 2001 to 129.7 per cent in 2009 (Figure 4).
- Greece's competitiveness, measured in terms of the country's unit labor costs against those of its main trading partners, deteriorated by about 30 per cent over the period 2001 to 2009 (Figure 5).
- The current account deficit rose from 11.5 per cent of GDP in 2001 to a peak of 18.0 per cent of GDP in 2008, before declining to 14.4 per cent in 2009 (Figure 6)[1].

[1] There are several series on the Greek current-account. They differ according to the methodology used. The series for the current account balance used in this paper is based on the national-accounts methodology.

Effectively, these large and rising imbalances meant that the Greek crisis was an accident waiting to happen. Indeed, as early as 2008 the Bank of Greece began warning of the dangers posed by the country's macroeconomic imbalances and competitive weaknesses. Consider, for example, the following statement that I made in the Bank's *Monetary Policy Report,* published in October 2008.

> In this difficult global economic conjuncture, the Greek economy's macroeconomic imbalances and structural weaknesses become all the more apparent, as the combination of factors that had supported rapid and uninterrupted growth over the past thirteen years is gradually losing strength. Among the factors that had underpinned the robust growth of demand were: the improved macroeconomic environment ensuing from Greece's EMU entry, the drop in interest rates, the deregulation of the credit system and the substantial inflows from the EU Structural Funds. It is therefore of the utmost urgency to decisively address the macroeconomic imbalances and the structural weaknesses of the Greek economy (Provopoulos, 2008, p. 4).

The large and growing imbalances should have sounded loud warning alarms to the financial markets, but they did not do so for some time.[2] The dangers inherent in these imbalances became evident -- belatedly -- to the financial markets in the fall of 2009. Specifically, in October of 2009 a newly-elected Greek government surprised the markets with the news that the 2009 fiscal deficit would be much higher than had been projected.[3] The news set interest-rate spreads on a relentless upward climb. The Greek financial crisis was underway.

Two distinctive characteristics set the Greek financial crisis apart from the crises that were to erupt in other euro-area countries, including Ireland, Portugal, Spain, and Cyprus. First, in the case of Greece it was the build-up of *public*-sector imbalances, as reflected in the large and growing fiscal and current-account deficits that caused the crises. In most other euro-area countries, *private*-sector imbalances were mainly

[2] As shown by Gibson, Hall and Tavlas (2013), the markets did not price the fundamental economic variables into Greek sovereigns until 2008-9.

[3] The outgoing government had projected that the 2009 fiscal deficit would be 6 per cent of GDP. In October of 2009, the incoming government announced that the deficit would be more than double the earlier projection made by the outgoing government. As noted above, the final figure for the 2009 fiscal deficit was 15.6 per cent of GDP. In early September 2009 (ahead of the Greek general election in October), I alerted the leaders of the two main political parties to the deteriorating fiscal situation and the need of strong corrective actions. See Ziras (2009).

responsible for the crises. Second, in the case of Greece, the sovereign debt crisis spilled over to the banking system, creating a second storm front. In contrast, in most of the other euro-area countries, the crises originated in the banking sector and spilled over to the sovereign sector. Since the origins of the Greek financial crisis are sometimes comingled with those in the other euro-area crisis countries, it is important to explain in some detail the characteristics that differentiated the Greek crisis from the crises that occurred in other euro-area countries.

*Sources of imbalances.* In a recent paper, Holinski, Kool and Muysken (2012) argued that the origin of the crises in the southern countries was the growing divergences between current-account balances in northern and southern euro-area countries during the period from 1992 until 2007. To document these divergences, those authors compared the aggregate current-account positions of a group of countries comprised of Austria, Finland, Germany and the Netherlands, which the authors called the "North", with the aggregate current-account positions of a group of countries comprised of Greece, Ireland, Portugal and Spain, which they called the "South"[4]. The authors split their sample period into two sub-periods, 1992 to 1998, and 1998 to 2007. With regard to the South, Holinski, Kool and Muysken, concluded the following. First, between the two sub-periods, the average current-account deficit in the South widened by 6.1 percentage points of GDP, that is, from -0.7 per cent of GDP during 1992-1998, to -6.8 per cent of GDP during 1997-2007. Second, net public saving rose by 3.6 percentage points of GDP between the two periods, that is from -5.7 per cent of GDP during 1992-1998, to -2.1 per cent of GDP during 1999-2007. Consequently, the behavior of the public sector contributed to a *narrowing* of the current-account deficit of the South. Third, net *private* saving declined by 9.2 percentage points of GDP, that is from 5 per cent of GDP during 1992-1998 to -4.7 per cent of GDP during 1999-2007. On the basis of these figures, Holinski, Kool, and Muysken (2012, p.18) concluded that, "For [the] South, the decline in private-sector saving in terms of GDP by about 10 percentage points between 1992 and 2007 is the major driver of the considerable growth of the current-account deficit, dominating the effect of higher net public saving".

[4] Holinski, Kool and Muysken (2012) used unweighted averages of current account balances for the North and South groupings to avoid German dominance in the North and Spanish dominance in the South.

While the foregoing assessment may be valid for the four crisis countries considered by Holinski, Kool and Muysken as a *group*, it is not valid for Greece. In the case of Greece, it was the decline in *public*-sector saving that was the driver for the widening of the current-account deficit after Greece joined the euro area.

To demonstrate, consider the data presented in Table 1 on net public saving, net private saving, and the current-account balance for Greece over the period from 2001, the year in which Greece joined the euro, through 2008, the year prior to the outbreak of the Greek crisis. As reported in the table, during the period considered Greece's current-account deficit (as a per cent of GDP) widened by 6.5 percentage points. During the same period, net private saving increased by 0.7 percentage point of GDP, which, with all other factors held fixed, worked to reduce the current-account deficit. However, net public saving declined by 6.5 percentage points of GDP, accounting for all of the widening of the current-account deficit.[5]

*The twin crises.* As reported in Table 2, prior to the outbreak of the sovereign crisis, the Greek banking sector had sound fundamentals -- with high capital-adequacy ratios, low loan-to-deposit ratios, and essentially no toxic assets of the kind that set-off the 2007 global financial crisis. As also reported in Table 2, the size of the banking sector (relative to GDP) in Greece at the outset of the crisis was considerably smaller than in some other euro-area countries that experienced crises. For example, in 2008 the assets of the Greek banking system amounted to 193 per cent of GDP, compared with 777 per cent for Ireland, 232 per cent for Italy, 280 per cent for Portugal, 311 per cent for Spain, and 685 per cent for Cyprus. As I mentioned earlier, in Greece it was the sovereign crisis that led to a banking crisis -- in contrast to the situation in some other countries. How did that happen?

A series of sovereign downgrades, beginning in late 2009, led to what initially was a liquidity problem for the banks. The sovereign downgrades generated increased uncertainty, leading to deposit withdrawals and deleveraging, which fed on each other,

[5] Note that the sum of the change in net private savings (+0.7 percentage point of GDP) and in net public savings (-6.5 percentage points of GDP) does not equal the change in the current account (-6.4 percentage points of GDP). This circumstance reflects a change in the methodology used to calculate the Greek national accounts that took place beginning with the 2005 national-accounts statistics.

compounding the problems faced by the banking sector, exacerbating the economic contraction, and contributing to a rise in non-performing loans. A contracting GDP, however, shrank the denominator in the debt-to-GDP ratio. As a result, the debt dynamics became more severe, and the crisis became self-reinforcing.

The deteriorating situation led to downgrades of Greek banks, forcing the banks out of the global financial markets, and further affecting their capacity to provide liquidity to the economy. The self-generating process reached a peak in early 2012 as Greek banks, which held large amounts of Greek sovereigns in their portfolios, took huge one-off looses on their bond portfolios following the voluntary restructuring of Greek sovereign debt in the early spring of 2012. As a result, banks had to rely increasingly on central-bank funding. At its peak, central-bank funding of Greek banks amounted to about 140 billion euros. At first, this funding took place through Eurosystem monetary-policy operations, but gradually, because of a lack of eligible collateral, banks relied increasingly on emergency liquidity assistance (ELA) from the Bank of Greece. Borrowing through ELA came at a higher price than borrowing through monetary-policy operations. Consequently, what started as a liquidity problem threatened to turn into a solvency problem. In 2012, Greece was said to be on the road to the unthinkable -- an exit from the euro! The markets even had a name for it; they called it a GREXIT.

*The May 2010 adjustment program.* By the spring of 2010, spreads between 10-year Greek and German sovereigns reached 1,000 basis points. Following several months of negotiations, on May, 9, 2010 the Greek government reached agreement with the European Commission, the European Central Bank, and the International Monetary Fund on a 110-billion-euro adjustment program. Initially, the program contributed to increased market confidence that Greece's debt dynamics would be sustainable, and, as a result, spreads began to fall; by October 2010 the 10-year spread had fallen to 550 basis points.

The improvement in market confidence, however, turned out to be short-lived as the adjustment program went off-track. In late 2010 spreads began an upward climb, which continued for more than a year, with the 10-year spread peaking at 4,000 basis points in early 2012 prior to Greece's debt restructuring. What happened? Why did the adjustment program go off-track?

The adjustment program was built on two main pillars -- fiscal adjustment and structural reforms. In both of these areas, implementation was slow and inefficient.

*Fiscal adjustment and structural reforms.* Experience shows that fiscal consolidations based mainly on spending cuts typically lead to smaller economic contractions than those based primarily on tax increases. For this reason, beginning in 2010 the Bank of Greece advised that Greece's fiscal adjustment should comprise two-thirds expenditure cuts, so that the share of government spending in national output would be reduced, allowing a competitive exports sector to flourish[6].

In 2010 and 2011, however, fiscal measures involved a mix of 60 per cent revenue (largely tax) increases and 40 percent spending cuts. This mix had several consequences. First, it has reduced the incentive for companies to invest by reducing the after-tax return on investment. Second, to the extent that some of the tax increases were intended to be temporary, they created policy unpredictability, holding back spending. Third, the tax increases reduced after-tax income, restraining private consumption. Moreover, with regard to expenditure reduction, one of the areas in which government spending was most-sharply scaled back was public-sector investment, a key contributor to future economic growth.

Apart from a major reform of the pension system, difficulties in implementing structural reforms, including privatization and measures to improve the efficiency of tax collection, exacerbated the economic contraction. As a result of these difficulties, fiscal adjustment led to a greater economic contraction than projected because, for an adjustment program to be effective, all the interconnected parts must be in place.

One other point about Greece's fiscal consolidation needs to be mentioned. The effect on economic activity of a *given* fiscal consolidation is likely to be higher for Greece than in such economies as those of Ireland, Portugal and Spain. This circumstance stems from the fact that Greece is a relatively-closed economy. Any decline in demand hits domestically produced goods more than it does imports. The decline in demand for domestic production, therefore, affects output more than if the economy were more open.

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[6] See, Bank of Greece (2010).

Consequently, Greece has a larger fiscal multiplier than the other crises countries, which are more open than the Greek economy[7].

## 3. Fiscal and external adjustment

So much for past developments. Is there light at the end of the tunnel? During the past few years, throughout the economic contraction, Greece has made important progress in addressing its fiscal and external imbalances. The country is also in the process of creating a viable and well-capitalized banking system.

Consider, first, fiscal adjustment (Figure 7).

- Excluding the one-off cost of the support to the banking system, from 2009 to 2012 the fiscal deficit was reduced by some 10 percentage points of GDP.
- The structural fiscal deficit -- that is, the deficit corrected for the business cycle and for one-off measures -- has shrunk by almost 16 percentage points of GDP.
- The primary fiscal deficit -- that is, the deficit excluding interest payments -- was 10½ per cent of GDP in 2009. It is projected to swing into a small surplus this year.

What makes these achievements especially impressive is that they have taken place despite a contracting economy, which creates moving targets for fiscal consolidation. Greece's fiscal consolidation is one of the largest ever achieved by any country at any time. In gross terms, fiscal-adjustment measures amounting to more than 20 per cent of GDP were implemented between 2010 and 2012. Additional fiscal measures, amounting to 11 per cent of GDP, are being implemented in 2013 and 2014. These measures will increase the primary fiscal surplus to 1.5 per cent of GDP in 2014. The new measures place emphasis on expenditure cuts to reduce the size of the government sector and to stimulate the tradables sector, so that net exports can contribute to growth.

[7] This argument was made in Provopoulos (2012). Subsequently, Blanchard and Leigh (2013) found that the IMF had initially underestimated the size of the fiscal multipliers for a group of 27 European countries, including Greece. Those authors also found that the fiscal multipliers for Greece and Germany were the highest of all the countries considered.

Moreover, the decisions of the Eurogroup in November 2012 -- including the debt buyback, reduction in interest rates, and lengthening of maturities on official sector loans -- are improving the country's debt dynamics. As a result, the debt-to-GDP ratio is on a path that will bring it close to 110 per cent of GDP in 2022. The major reform of the pension system -- which I mentioned earlier -- will also contribute to an improvement in the debt dynamics. Further debt-reducing measures, also announced last November by the Eurogroup could be implemented, subject to Greece's fulfilling certain conditions. These measures could include further interest rate reductions, once Greece reaches an annual primary surplus, which, as I mentioned, the government expects to achieve this year.

Consider, next, external adjustment. As noted above, between 2001 through 2009, Greece lost about 30 per cent in terms of cost competitiveness against its major trading partners. In just three years, 2010 through 2012, 80 per cent of that loss was recovered (Figure 8). By the end of this year, the entire loss --and more -- will have been recovered.

Two circumstances make this improvement in competitiveness stand out. First, it has taken place without the benefit of a nominal exchange-rate devaluation. Greece's competitiveness gain has been produced entirely by an internal devaluation, meaning, it has been produced by reductions in domestic wages and prices relative to those in Greece's trading partners. Second, the gain and competitiveness has taken place against a backdrop of low global (including euro-area) inflation. In this connection, Shambaugh (2012) showed that, with the decline in global inflation beginning in 1991, internal devaluations have become much more difficult to achieve[8]. Specifically, using a sample of 26 (mostly) developed economies, that author found that there were 68 episodes of internal devaluations between 1964 and 2010. However, nearly all these episodes occurred before 1991; between 1991 and 2010 only three economies -- Japan in the late 1990s and the early 2000s, Hong Kong in the 1990s, and Ireland during 2009-2010 -- were able to implement internal devaluations. An update of Shambaugh's sample period

[8] Shambaugh defined an internal devaluation as a fall in a country's overall price level relative to world prices that is not accompanied by a nominal depreciation of that country's currency. He used the following criteria to determine if an internal devaluation had taken place -- a change in a country's real exchange rate, without a similar move in the nominal exchange rate, of at least 3 per cent in one year, at least 5 per cent over three years, or 7 per cent over five years.

through 2012 would have resulted in the inclusion of Greece in the author's internal - devaluation group.

Competitiveness is also being promoted through structural reforms, which have increased the flexibility of labour and product markets. As a result of these improvements in competitiveness, a rebalancing of the Greek economy is taking place. The share of exports of goods and services in GDP rose from 19 per cent in 2009 to 27 per cent in 2012. It will continue to rise. The current account deficit, which reached 18 per cent of GDP in 2008, fell to less than 5 ½ per cent last year. It will continue to fall (Figure 9).

## 4. Banking sector strategy

I now turn to the banking sector. As I mentioned, what had started out as a liquidity problem in the banking sector threatened to turn into a solvency problem. The Bank of Greece had to step-in to preserve banking system stability. To do so, we developed a strategy comprised of several essential elements.

The first part of our strategy was to calculate the amount of funds needed to recapitalize the banking system. Such a calculation involved determining the losses on banks' bond and loan portfolios. The determination of the losses on bond portfolios was pretty straightforward. It was dependent of the value at which old government bonds were exchanged for new bonds under the voluntary debt restructuring. What was challenging was to calculate, in a conservative manner, all possible losses on the loan portfolios of Greek banks in the coming years. For this purpose, the Bank of Greece used BlackRock. Once BlackRock finished its work on loan portfolios, most pieces were in place for the calculation of the capital needs of banks.

The overall needs of the banking system were determined as the sum of: (1) the amounts needed for the recapitalization of core-banks (€28 billion); (2) the amounts needed for the resolution of non-core banks (€17 billion); and (3) a buffer of €5 billion to cover any unexpected adverse developments. Thus, we came up with a total amount of €50 billion. We believe that this amount will be more than adequate to cover any further deterioration of the loan portfolio, beyond the very conservative estimates by BlackRock, or a further reduction of pre-provision profitability. In fact, the Bank of Greece will be re-running a diagnostic exercise in the second half of this year to verify the adequacy of this amount. By doing so, we will dispel any remaining doubt that the banking system will be well-capitalized looking forward.

The second part of our strategy was to assess which banks were good candidates for recapitalization by the Hellenic Financial Stability Fund. The Bank of Greece, in association with Bain, conducted a “viability assessment.” As a result of the “viability assessment”, the four largest banks, now called “core banks”, were recapitalised with public-sector funds. These banks were assessed as the most likely to repay such funds within a reasonable timeframe. One non-core bank was able to be recapitalized through private capital.

When our exercise started there were 17 banks in operation: four core banks and 13 non-core banks[9]. So far, the resolution framework has been used to resolve nine banks: six commercial banks (two of which were large and state-owned) and three cooperative banks. Consolidation is progressing. A core bank -- Piraeus -- absorbed three banks (two foreign subsidiaries and the state-owned Agricultural Bank). During the recent turmoil in Cyprus, that bank also absorbed the branches of three Cypriot banks (Bank of Cyprus, Laiki Bank and Hellenic Bank) in Greece. Those purchases helped stem any contagion from the Cypriot banking system to the Greek financial system. Alpha bank, the third largest core bank, absorbed Emporiki bank, a fairly large subsidiary of Credit Agricole. Finally, Eurobank acquired the two bridge banks (New Proton and New Postal Bank), while the National Bank of Greece acquired two small banks (FBB and Probank).

Our financial sector strategy is nearing the completion of its first stage, in which the key objectives were the consolidation of the banking system and the strengthening of its capital base. Three core banks have now concluded the processes needed to increase their capital by the amounts required -- a private-sector threshold of at least 10 per cent for private sector participation -- set by the Bank of Greece. NBG, Alpha and Piraeus have raised the minimum 10 per cent of their capital needs through the market and will remain

9 There were also 16 cooperative banks, the combined market share of which was only 1 per cent of the banking system.

under private control. The remainder of these banks' capital is fully subscribed by the Hellenic Financial Stability Fund (HFSF). The fourth core bank -- Eurobank -- has been recapitalized directly -- and solely -- by the HFSF. The authorities committed to sell a stake back to the private sector March 2014, so that the bank regains quickly its private character. We will end up with four well-capitalized core banks and a few non-core banks.

I am extremely satisfied that, having survived such an enormous economic and financial storm, the Greek banking system is becoming more compact, strong and well-capitalized. The second stage of our strategy is only just beginning. This stage will be characterized by the efforts of the banking system to implement a new business model. For Greek banks such a model will entail eliminating excess capacity, exploiting synergies and economies of scale to become more efficient and gradually disentangling themselves from state aid and central bank funding. These are the challenges that lie ahead.

## 5. The euro area's response to its crisis

What about the euro area as a whole? Here, there are two important factors at work that will make the euro area a stronger monetary union. First, just as the Greek economy is undergoing a major restructuring to make it a stronger, competitive economy, similar things are occurring in other peripheral economies, including Ireland, Portugal, Spain, and Cyprus. Second, work to make the euro area a more complete monetary union is also under way, with:

- stronger economic governance;
- procedures to prevent macroeconomic imbalances from emerging, and
- strong backstops and initiatives -- including the ESM and Outright Monetary Transactions by the ECB -- to prevent future crises.

Moreover, concrete steps are being taken to create a cohesive banking union. These steps include the following.

- The Single Supervisory Mechanism (SSM) will become operational in 2014.

- Although the ECB will be ultimately responsible for the conduct of the supervisory function, it will be assisted by national supervisory authorities.
- The four largest Greek banks will be among those that will be supervised by the SSM.
- The SSM will be a key component of the banking union.
- Work is also progressing on another key component --the Single Resolution Mechanism.

## 6. The future

What, then, about the future prospects of the Greek economy? And what are the major risks that lie ahead? I think that it is fair to say that we are already seeing the results of the changes that have been taking place. These results are especially evident in the soft economic data, which are leading indicators of real activity, and in financial-market developments. Consider the following.

- The Greek PMI has been rising steadily from 37.7 early last year to 45.3 in May.
- The Commission's economic sentiment indicator for Greece is at a 5-year high.
- Consumer confidence is at its highest level since August 2010.
- Tourist arrivals are projected to rise by 10 per cent this year over last year.

What about the risks facing the Greek economy? One risk is domestic risk. Especially in light of recent developments, it is crucial that the government remains committed to seeing through the reforms in the adjustment programme. It is essential that people start to see the benefits of the government's reforms. Importantly, these benefits are beginning to appear. A second risk is at the euro-level. Euro-area authorities have committed to undertaking reforms that will make the euro area a more-effective monetary union. It is important that these reforms, including the move to a banking union, proceed without delays.

I do not believe that we will see these risks materialize. Indeed, financial markets apparently share my view about a positive future for the Greek economy.

- Since the peak of the crisis last June,
    - Equity prices have doubled.
    - 10-year bond spreads against German sovereigns have fallen by 2,200 basis points.
    - Prices for Greek CDS have started being posted again – and they are several thousands of basis points lower than at the time of the PSI.
    - Deposits of the private sector have increased by about 11 per cent.
    - Hoarded banknotes -- a key sign of uncertainty -- are returning to the banking system. Some €12 billion has been returned so far, and we expect another €10 - €15 billion to return as the situation continues to normalize.
    - Reliance of Greek banks on Eurosystem financing is down by about 44 per cent.

After undergoing a succession of rating downgrades, beginning in late 2009, recent months have seen several rating upgrades of Greek sovereigns. Although a full-fledged recovery has not yet started, the hard data -- including retail sales, industrial production, and new passenger car registrations -- show signs that they are approaching a turning point. Moreover, export growth is picking up. Receipts from exports increased by about 11 per cent (year-on-year) in real terms in the first quarter.

In addition to this evidence, there are other important reasons that the future looks brighter.

- Reducing uncertainty is key to economic stabilization and successful reform. In this connection, GREXIT fears have largely disappeared.
- Fiscal policy is likely to be less contractionary going forward.

- I expect the credit crunch, a key factor retarding growth in the wake of the crisis, to ease progressively. With the completion of the restructuring of the banking system, Greek banks will resume their role as a supplier of credit to the economy.

For all those reasons, I expect growth to return next year, led by exports and investment, and supported by the marked improvement in confidence. Financial markets apparently share my view about a positive future for the Greek economy. Increasingly, the markets are viewing the Greek economy as a source of profit opportunities. In this connection, the markets have recently replaced the term GREXIT with a new term-- GRECOVERY -- that is, a recovery of the Greek economy.

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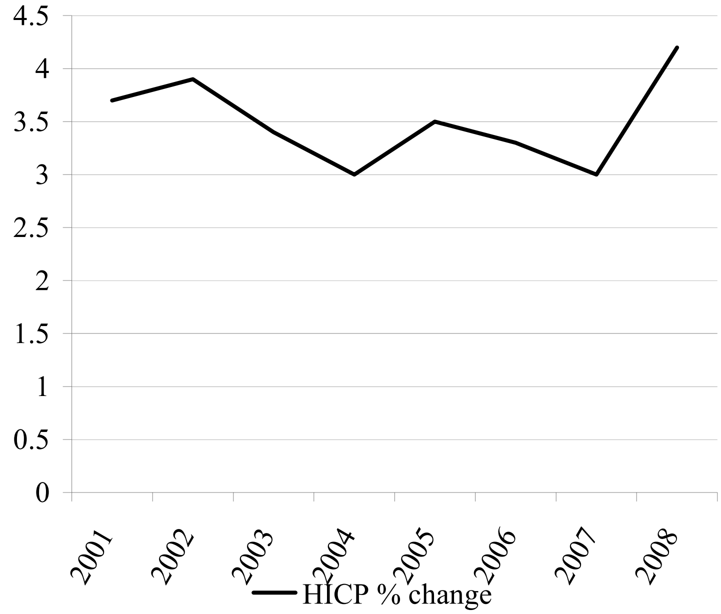
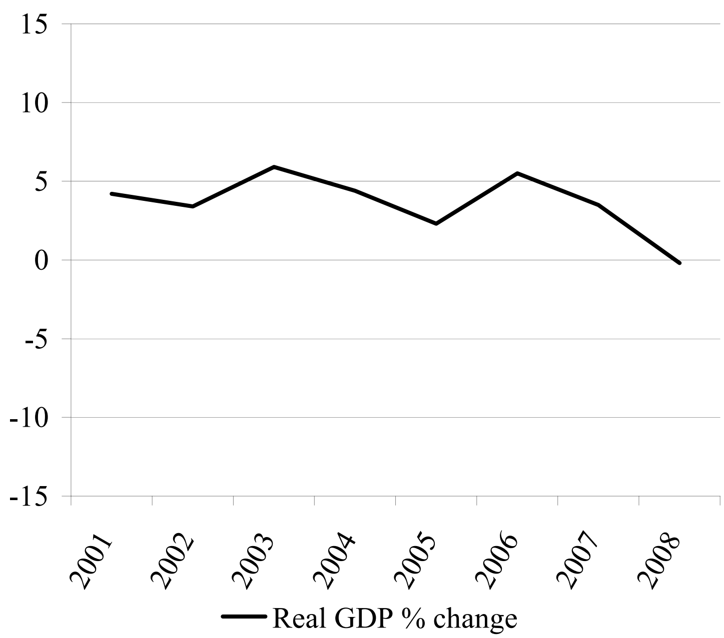
**Figure 1a.**
**Greece: Inflation Rate**



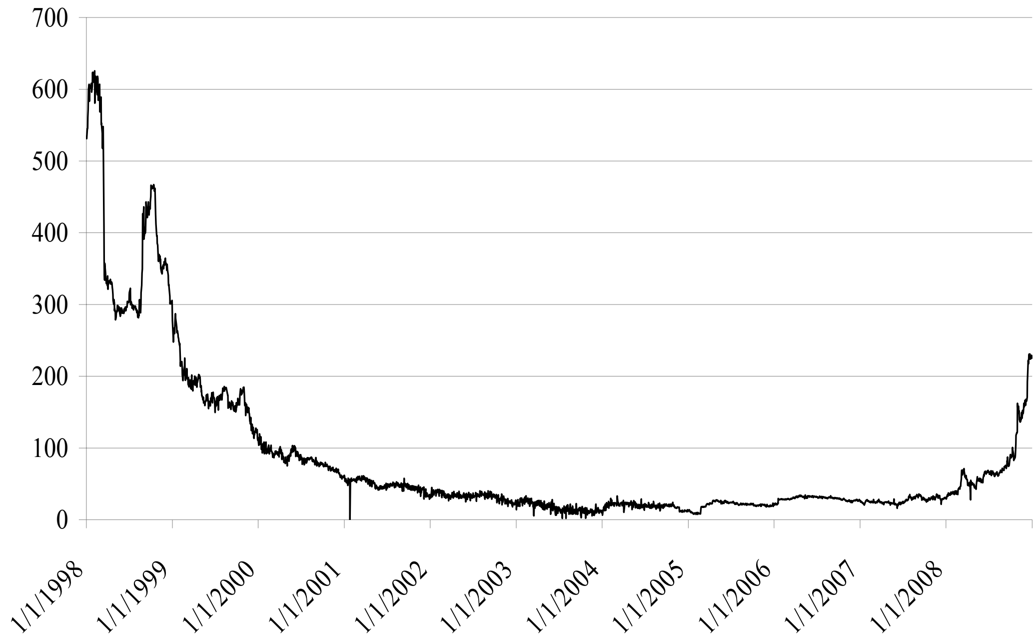

SOURCE: ECB Statistical Data Warehouse

**Figure 1b.**
**Greece: Real Growth Rate**



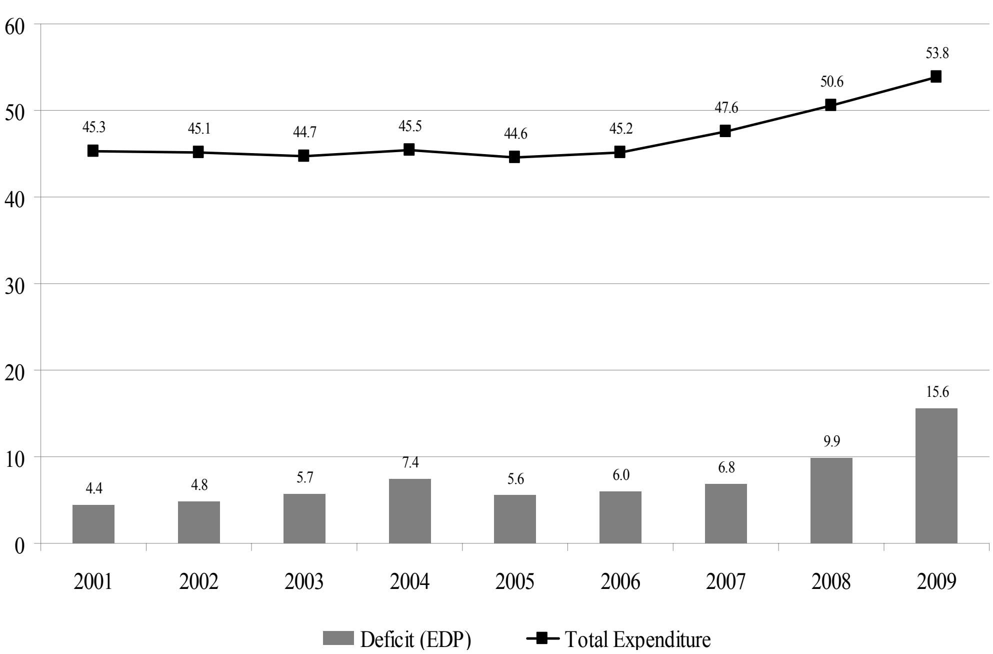

SOURCE: IMF Statistics

**Figure 2.**
**Interest rate spreads: Greece relative to Germany.**



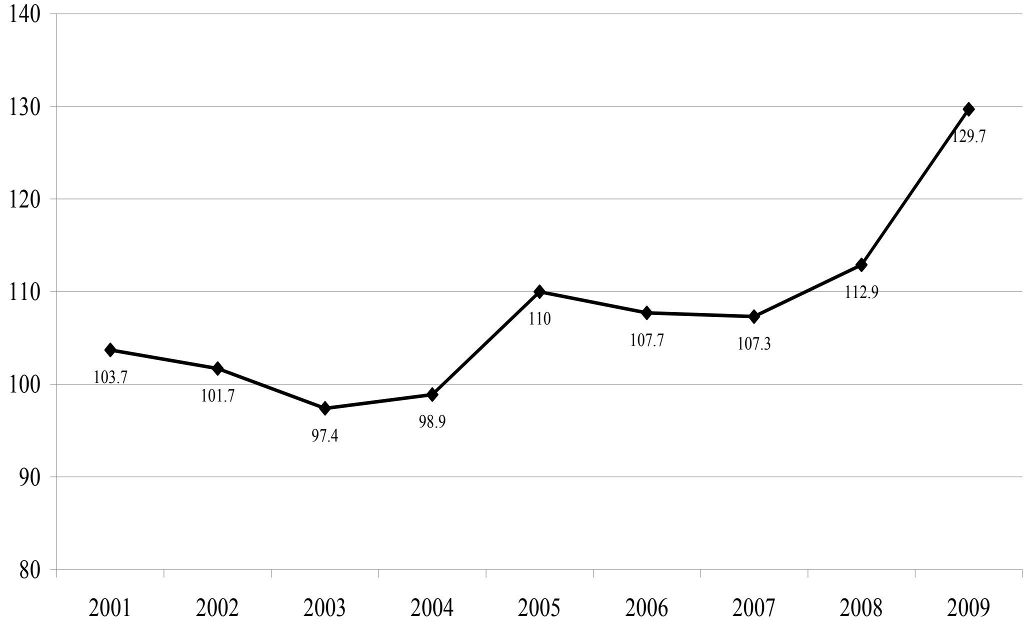

SOURCE: ECB Statistical Data Warehouse

**Figure 3.**
**Greece: Total Expenditure and Deficit (% of GDP)**



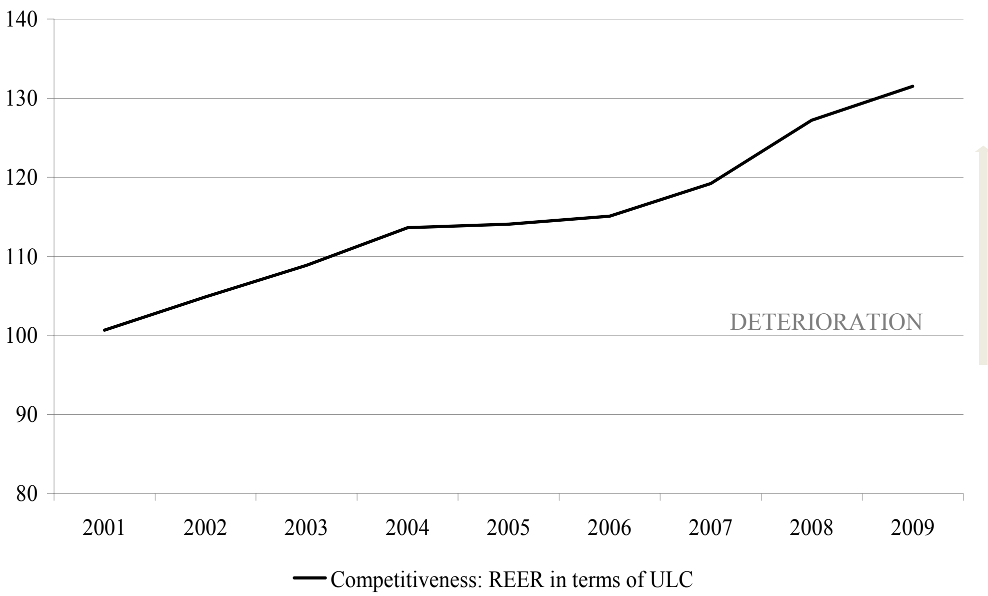

SOURCE: ELSTAT (Hellenic Statistical Authority)

**Figure 4.**
**Greece: Government Debt (% GDP)**



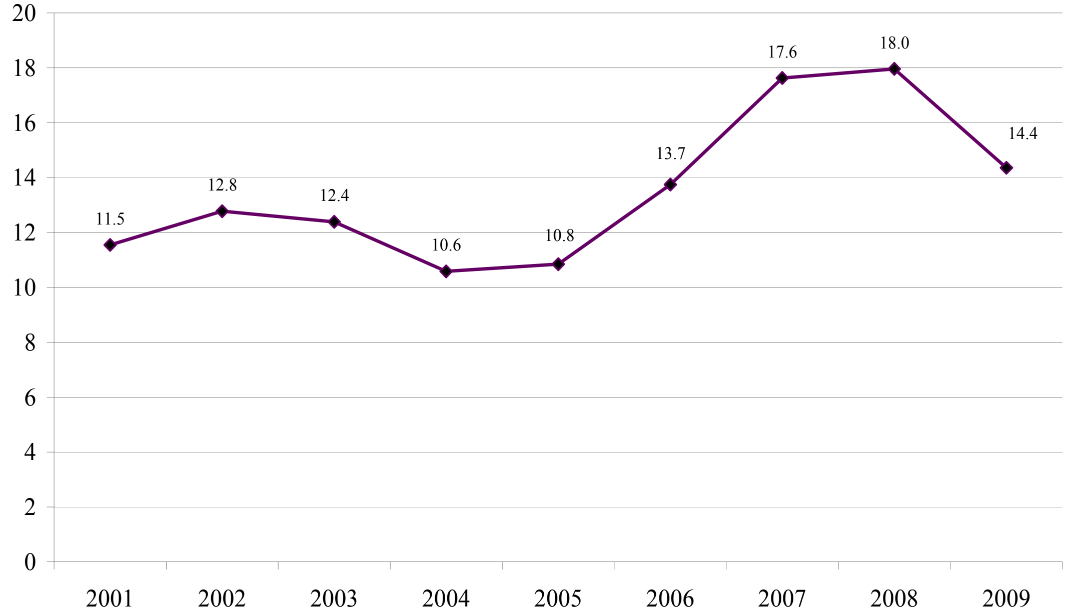

SOURCE: ELSTAT (Hellenic Statistical Authority)

**Figure 5.**
**Greece: Competitiveness, 2001-2009**



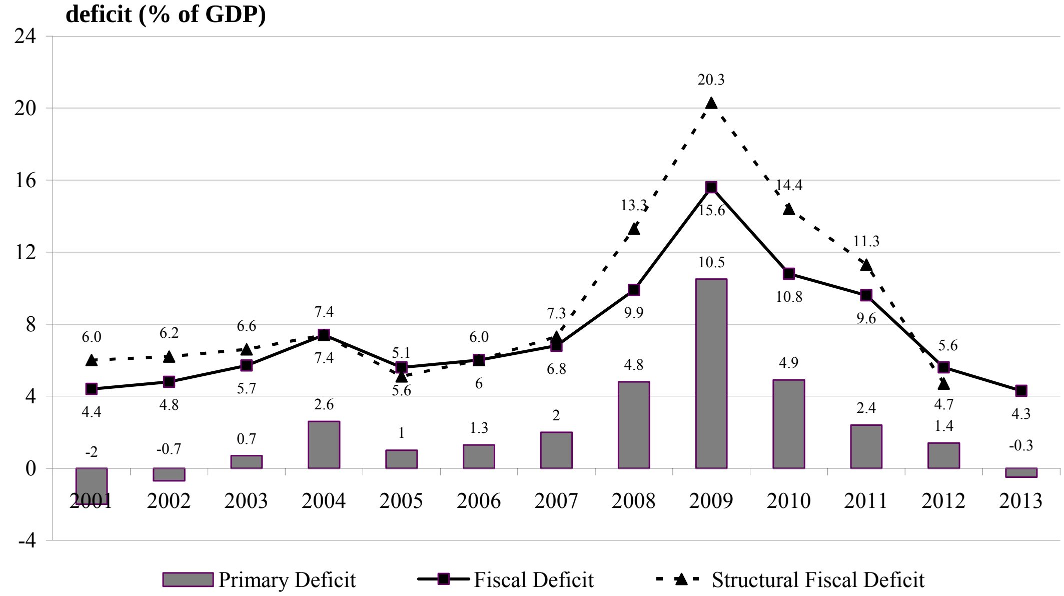

SOURCE: Bank of Greece

**Figure 6.**
**Greece: Current Account Deficit (%GDP)**



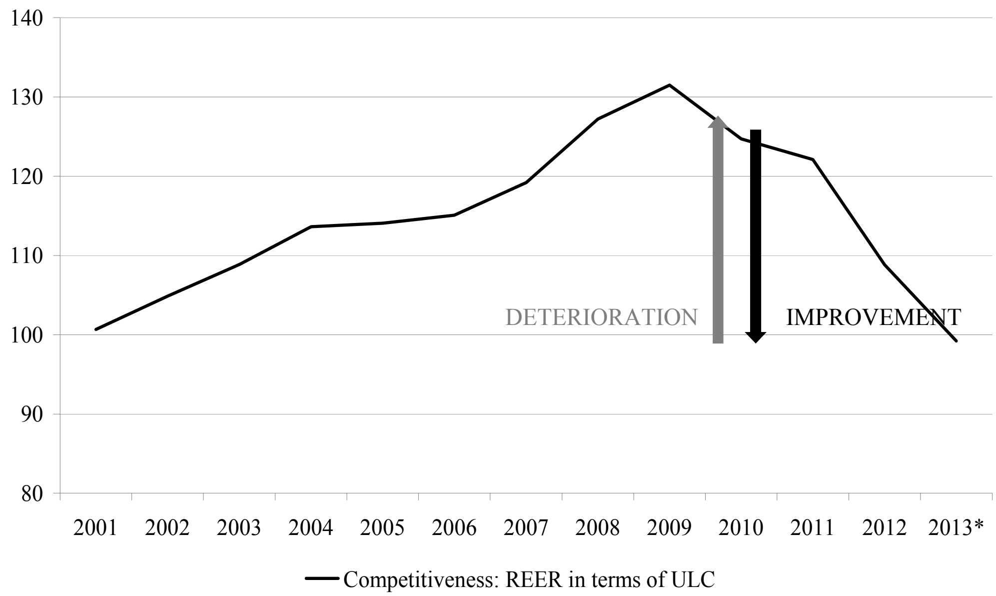

SOURCE: European Commision Annual Macroeconomic Database

**Figure 7.**
**Greece: Evolution of General Government deficit, structural deficit and primary deficit (% of GDP)**



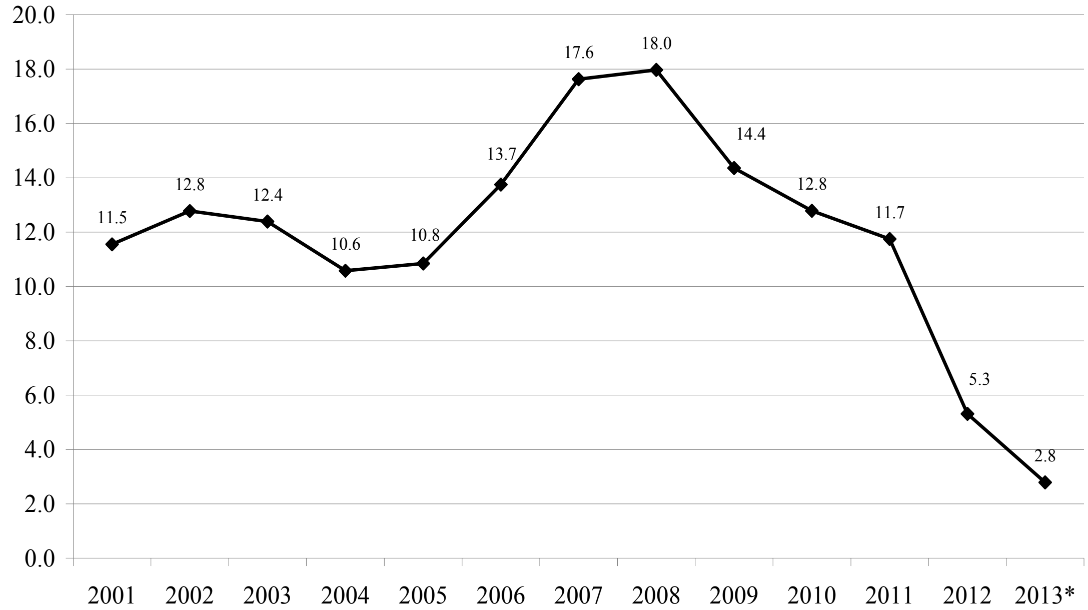

SOURCES: ELSTAT (Hellenic Statistical Authority) and Bank of Greece

**Figure 8.**
**Greece: Competitiveness, 2001-2013**




SOURCE: Bank of Greece

**Figure 9.**
**Greece: Current Account Deficit (%GDP)**




SOURCE: European Commision Annual Macroeconomic Database

## Table 1. Current account breakdown

(Greece, % GDP)

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|---|---|---|
| **Current Account Balance** | -11.5 | -12.8 | -12.4 | -10.6 | -10.8 | -13.7 | -17.6 | -18.0 |
| Net Public Saving | -3.7 | -4.1 | -5.4 | -6.6 | -5.7 | -7.2 | -7.7 | -10.2 |
| Net Private Saving *(including changes in inventories)* | -8.5 | -9.3 | -7.7 | -4.7 | -5.1 | -6.5 | -9.9 | -7.8 |

SOURCE: European Commision Annual Macroeconomic Database

## Table 2. Banking sector

| | Loan to Deposit Ratio | | Capital Adequacy Ratio | | Assets to GDP | |
|---|---|---|---|---|---|---|
| | **2008** | **2009** | **2008** | **2009** | **2008** | **2009** |
| Ireland | 1.57 | 1.52 | 10.80 | 10.90 | 7.77 | 8.09 |
| **Greece** | **0.78** | **0.77** | **9.90** | **11.90** | **1.93** | **2.06** |
| Spain | 1.14 | 1.10 | 11.30 | 12.20 | 3.11 | 3.27 |
| Italy | 1.52 | 1.46 | 10.40 | 11.80 | 2.32 | 2.43 |
| Cyprus | 0.97 | 1.00 | 11.00 | 12.10 | 6.85 | 8.22 |
| Portugal | 1.33 | 1.30 | 9.10 | 10.30 | 2.80 | 3.10 |

SOURCES: EU Banking Structures (ECB, 2010), and EU Banking Sector Stability (ECB, 2010)

## Special Conference Papers

### The Crisis in the Euro Area, May 23-24, 2013

14. Provopoulos George, “The Greek Economy and Banking System: Recent Developments and the Way Forward”, July 2013.
15. Constâncio Vítor, “The European Crisis and the Role of the Financial System”, July 2013.
16. Honkapohja Seppo, “The Euro Area Crisis: a View from the North”, including discussion by Dimitris Malliaropulos, July 2013.
17. Goodhart C.A.E., “Lessons for Monetary Policy from the Euro-Area Crisis”, including discussion by Gikas A. Hardouvelis, July 2013.
18. Bordo Michael and Harold James “The European Crisis in The Context of the History of Previous Financial Crises”, including discussion by Nicos Christodoulakis, July 2013.
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28. Gibson D. Heather, Palivos Theodore, and Tavlas S. George., “The Crisis in the Euro Area: an Analytic Overview”, July 2013.