Eurobank

# Overcoming the Crisis in Greece


Gikas A. Hardouvelis

Un. of Piraeus, Eurobank and CEPR


ΕΙΠ
ελληνικό ινστιτούτο πληροφορικής & επικοινωνιών

εεδε
ελληνική εταιρία διοικήσεως επιχειρήσεων

KEYNOTE PRESENTATION

5ο Risk Management & Compliance Forum

Athens, November 4, 2013

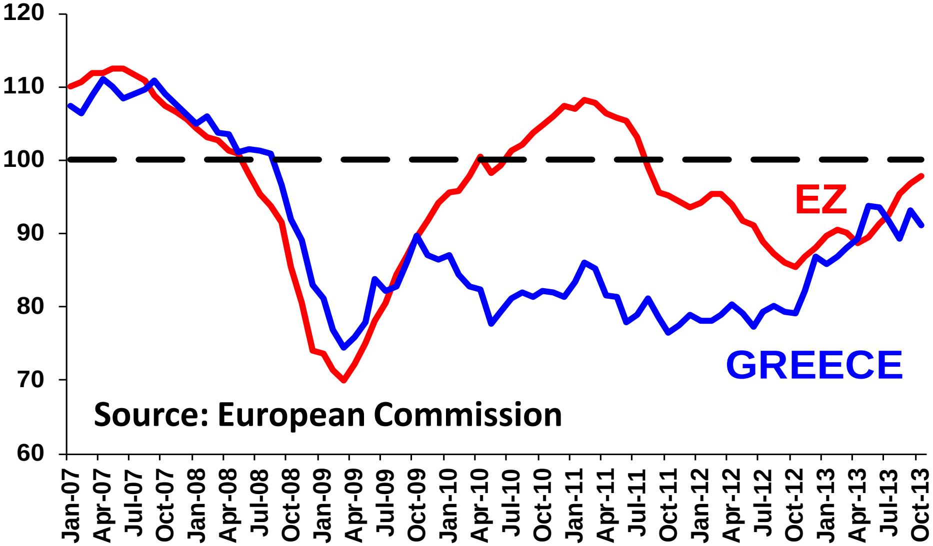
I. WILL THE RECESSION BE OVER SOON?

II. CAN SOLID EQUILIBRIUM GROWTH COME BACK?

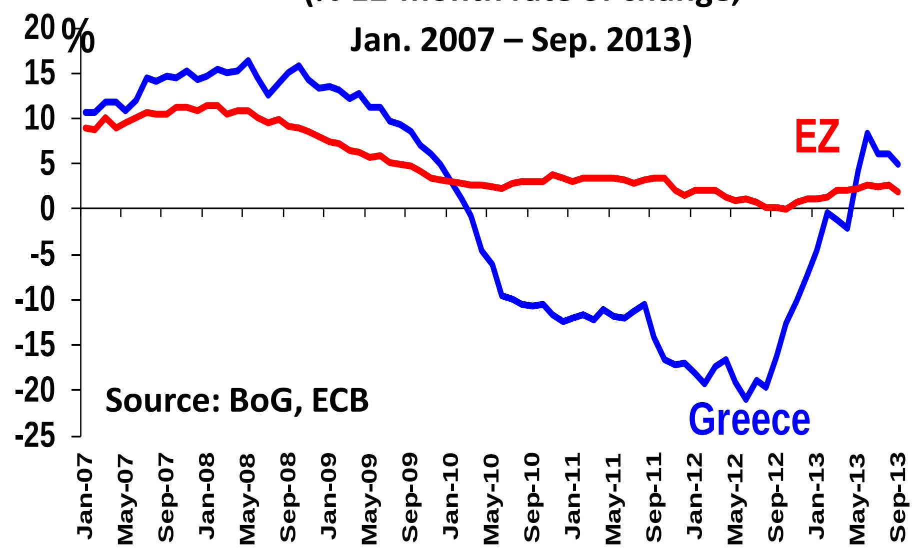
# I. CLUES THAT OPTIMISM IS COMING BACK

Eurobank

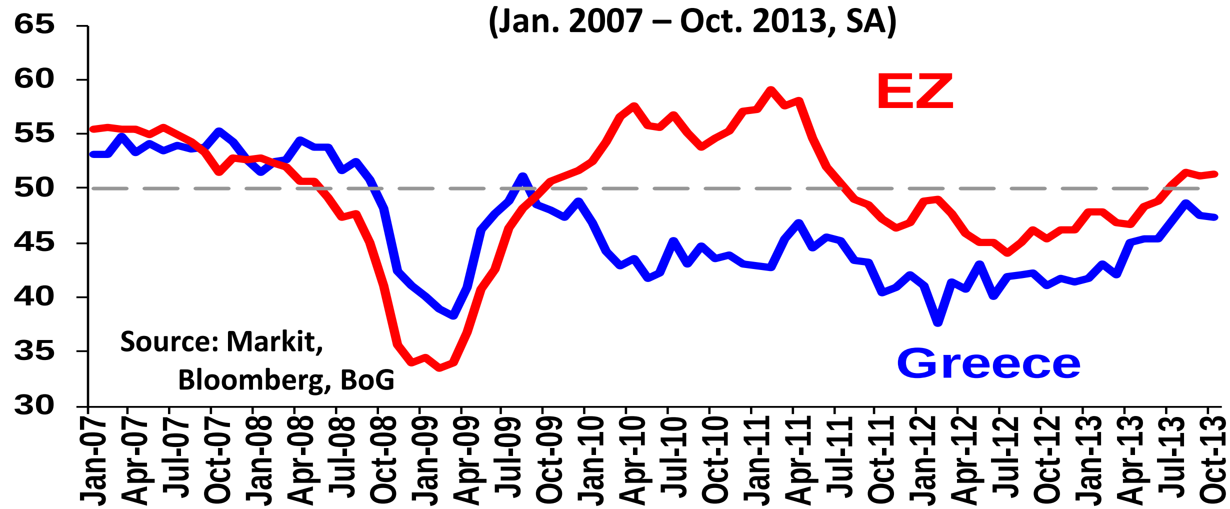
## Economic Sentiment Indicator
(1/2007 – 10/2013, 1990-2012=100, SA)




## Private Sector Deposits
(% 12-month rate of change, Jan. 2007 – Sep. 2013)




## Manufacturing Purchasing Managers' Index (PMI)
(Jan. 2007 – Oct. 2013, SA)




- ✓ **Hard economic data also show an improvement as 2013Q2 GDP and tourism receipts higher than expected**

# I. SIGNIFICANT IMPROVEMENT IN "EASE OF DOING BUSINESS"

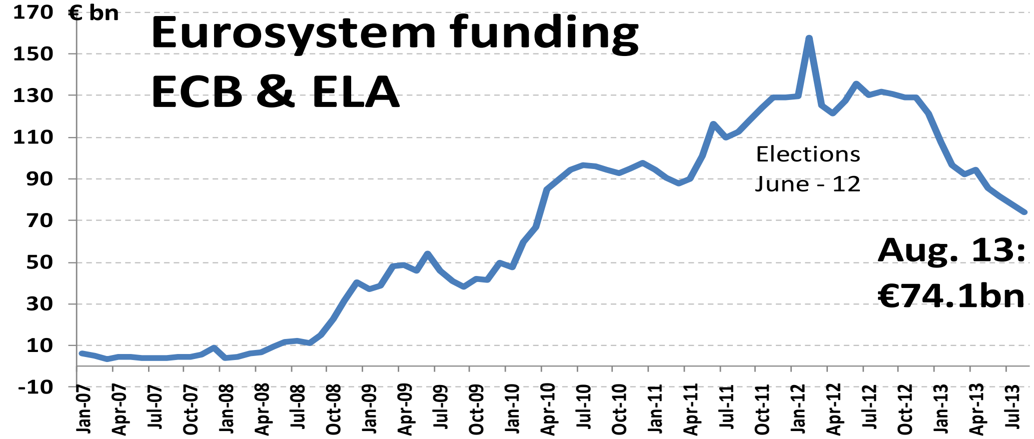
Eurobank

| | RANK DB2014 | Δ(2013 -2012) | Starting a business | | Protecting investors | | Trading across borders | | Resolving insolvency | | Paying taxes | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | 2013 | 2012 | 2013 | 2012 | 2013 | 2012 | 2013 | 2012 | 2013 | 2012 |
| OECD | 29 | -1 | 60 | 60 | 56 | 56 | 31 | 32 | 27 | 26 | 55 | 53 |
| US | 4 | 0 | 20 | 11 | 6 | 6 | 22 | 21 | 17 | 16 | 64 | 69 |
| GR | 72 | 17 | 36 | 147 | 80 | 113 | 52 | 60 | 87 | 63 | 53 | 56 |
| CY | 39 | -1 | 44 | 35 | 34 | 32 | 27 | 27 | 24 | 25 | 33 | 34 |
| DN | 5 | 0 | 40 | 32 | 34 | 32 | 8 | 7 | 10 | 10 | 12 | 13 |
| IT | 65 | 2 | 90 | 84 | 52 | 51 | 56 | 58 | 33 | 30 | 138 | 135 |
| ES | 52 | -6 | 142 | 136 | 98 | 95 | 32 | 35 | 22 | 20 | 67 | 33 |
| IE | 15 | 0 | 12 | 9 | 6 | 6 | 20 | 20 | 8 | 9 | 6 | 6 |
| PT | 31 | -2 | 32 | 25 | 52 | 51 | 25 | 17 | 23 | 22 | 81 | 81 |

- **The DB 2014 covers 189 countries and describes the regulatory environment of each country measured from June 2012 through May 2013**
- **Second year of significant improvement: Greece ranked 72th in 2013 from 89th in 2012**
  - **Starting a business: ranked 36th in 2013 from 147th in 2012 (implementation of a new form of legal entity and streamlining of the business start-up process)**
- **Distance to best performance frontier at 37.5% (OECD avg. 23.5%), improves from 38.5% in 2012, 40.3% in 2011, and 40.9% in 2010**

# I. RETURN OF CONFIDENCE IN THE BANKING SYSTEM

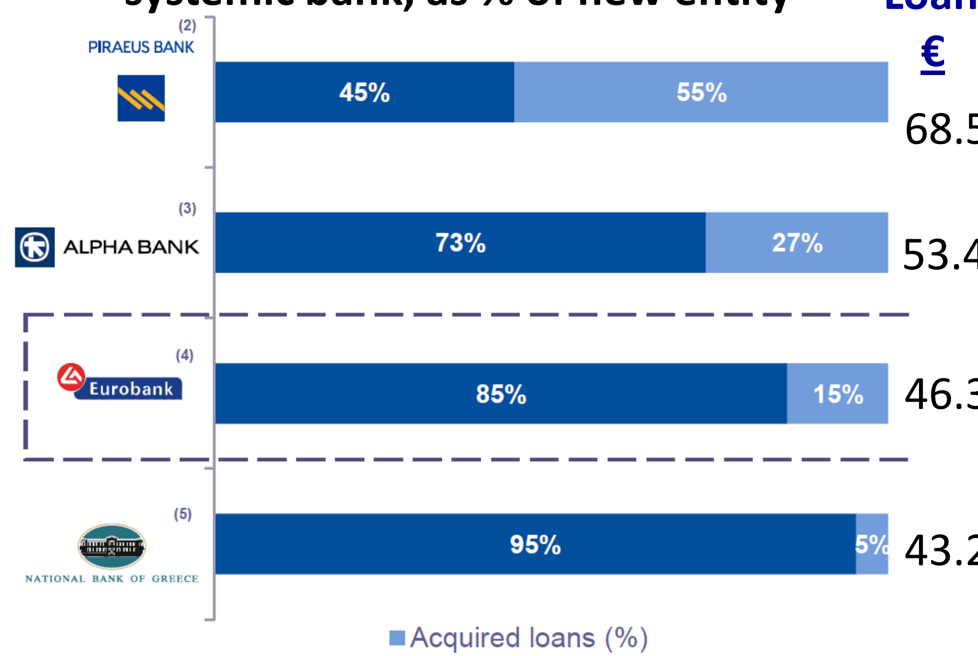
- Deposits flow back after June 2012 elections & there is room for more inflows
- Eurosystem funding declines, and so does the costly ELA funding
- Cost of deposits begins declining from unusually high levels
- Deceleration in new NPLs
- Provisions (i.e. cost of risk) are reaching their maximum in 2013
- Consolidation in the sector, as four systemic banks now own 91% of total gross loans
- Banks are fully capitalized: €42 bn of new capital injected via HFSF (€38.9) and private investors (€3.1)
- Pre-provision income improves



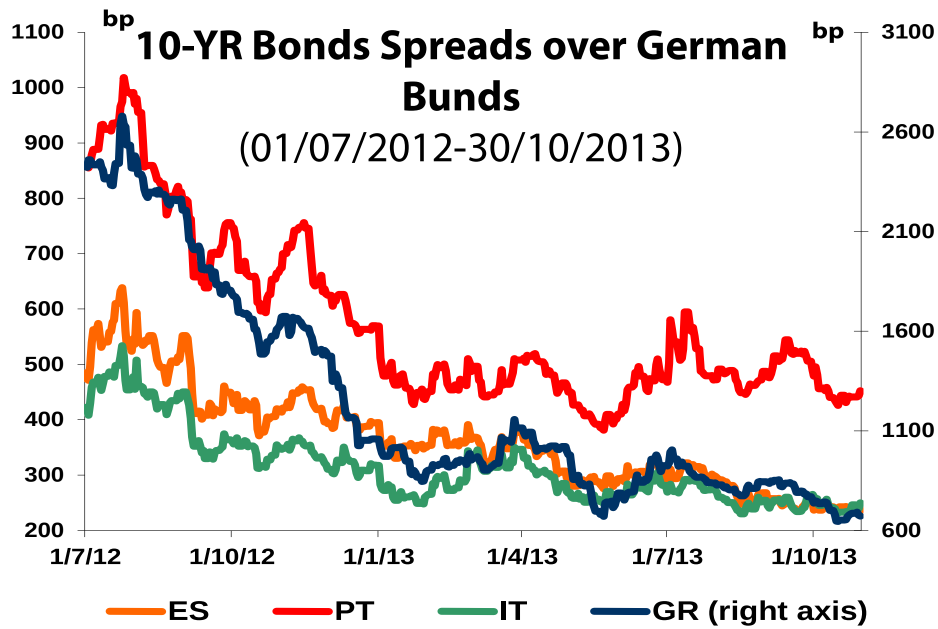

Loan portfolio expansion per systemic bank, as % of new entity

New size of Loans

€



# I. MARKET CONFIDENCE IMPROVES





| GREECE: CREDIT RATINGS | | | | | |
|---|---|---|---|---|---|
| | end-of-2008 | end-of-2009 | PSI (March 2012) | end-of-2012 | NOW |
| S&P | A | BBB+ | SD | B- | B-<br>18/12/2012 |
| Moody's | A | A3 | Caa1 | Caa1 | C<br>02/03/2012 |
| Fitch | A | BBB+ | CCC | CCC | B-<br>14/05/2013 |

# I. MACROECONOMIC PROJECTIONS POINT TOWARDS AN END OF THE RECESSION

| | 2012 Nominal €bn | 2012 growth Real | Shares in 2012 Nom. GDP | 2013 growth Real | 2014 growth Real |
|---|---|---|---|---|---|
| Private Consumption | 142.756 | -9.1% | 73.7% | -7.1% | 0.5% |
| Government Consumption | 34.398 | -4.2% | 17.8% | -7.2% | -3.1% |
| Tot. Consumption | 177.154 | -8.1% | 91.4% | -7.1% | -0.2% |
| GFCF | 26.339 | -17.6% | 13.6% | -9.9% | 1.5% |
| Domestic Demand | 203.493 | -9.4% | 105.0% | -7.5% | 0.0% |
| Imports | 62.053 | -13.8% | 32.0% | -9.8% | 0.6% |
| Exports | 52.309 | -2.4% | 27.0% | 2.9% | 2.1% |
| GDP (nominal) | 193.748 | | | | |
| Real GDP | | -6.4% | | -3.9% | 0.4% |
| GDP deflator | | -0.9% | | -1.5% | -0.5% |
| Unemployment (avg) | | 24.2% | | 27.6% | 28.5% |

Source: Eurobank Research

# I. WHY SUCH MACROECONOMIC PROJECTIONS?

- **What is so different in 2014, which was not present in previous years that can justify the optimism?**
- **Answer: Besides the positive clues already mentioned earlier, no additional anticipated restrictive measures, hence stability in disposable income and improvement in sentiment**

1. **Consumption stops declining as fast as before**
   - **Tax rates do not rise further, hence do not decrease disposable income**
   - **Level of permanent income stops declining, as exports & investment-driven growth generates a recovery**
2. **Exports continue expanding with the help of the freshly capitalized banking system and with the enforcement of structural reforms that minimize bureaucracy and help improve price & quality competitiveness**
3. **Gross investment stabilizes and takes off soon, that is,**
   - **Sentiment improves and Greeks begin believing in future stability**
   - **Privatizations continue as planned and bring in additional fresh capital & jobs**
   - **Highway projects begin, TAP pipeline gets off the ground**
   - **Liquidity improves as Government arrears are paid, EIB loans accelerate**
   - **A solution to the sustainability of the Debt-to-GDP ratio is brokered with the official lenders, minimizing the threat for possible future over-taxation**
   - **The banking system stabilizes and regains some of its deposits back**
   - **Interest rates on bank loans decline**
   - **Political stability prevails**

# I. DOWNSIDE RISKS IN THE SHORT RUN

## 1. European hardliners prevail

- Hardliners emboldened by the Cypriot Solution and the balancing of the Greek current account, which minimizes contagion
- Hardliners insist on new fiscal contractionary measures, e.g. possible new cuts in primary and secondary pensions in order to address expected fiscal shortfall (Gov: €0.5-1.0bn, Troika: €2.0-2.5bn)
- Solution to Debt sustainability delays as OSI is politically difficult, hence investment does not pick up momentum on time

## 2. Government keeps raising taxes

- Thus disposable income continues its earlier decline

## 3. Political instability before May 2014 European Parliament elections

- Population does not see the greenshoots, hence climate can turn sour for investment and consumption
- Reforms can stall due to elections, resulting in a toughening European stance

## 4. Other risks:

- No solution to lack of ANFA funding, Liquidity does not improve, Political pressures to loosen the program, Structural reform fatigue, Delays in the privatizations program

# I. THE 2014 CENTRAL NEGOTIATING FEATURE: DSA – CONTINUOUS PRIMARY SURPLUS MATTERS

Eurobank

| DSA – Sensitivity to primary surplus | | | |
|---|---|---|---|
| | 2012 | 2021 | 2030 |
| Debt Baseline (€ bn) | 304.6 | 292.3 | 301.3 |
| Nominal GDP - Baseline (€ bn) | 194.1 | 247.3 | 348.3 |
| Debt Baseline (%GDP) | 156.9 | 118.2 | 86.5 |
| PS at 3% after 2015 (%GDP) | 157.5 | 124.4 | 98.5 |
| PS at 1.5% after 2014 (%GDP) | 157.5 | 134.6 | 120.5 |
| PS at 0% after 2013 (%GDP) | 157.5 | 146.2 | 143.9 |

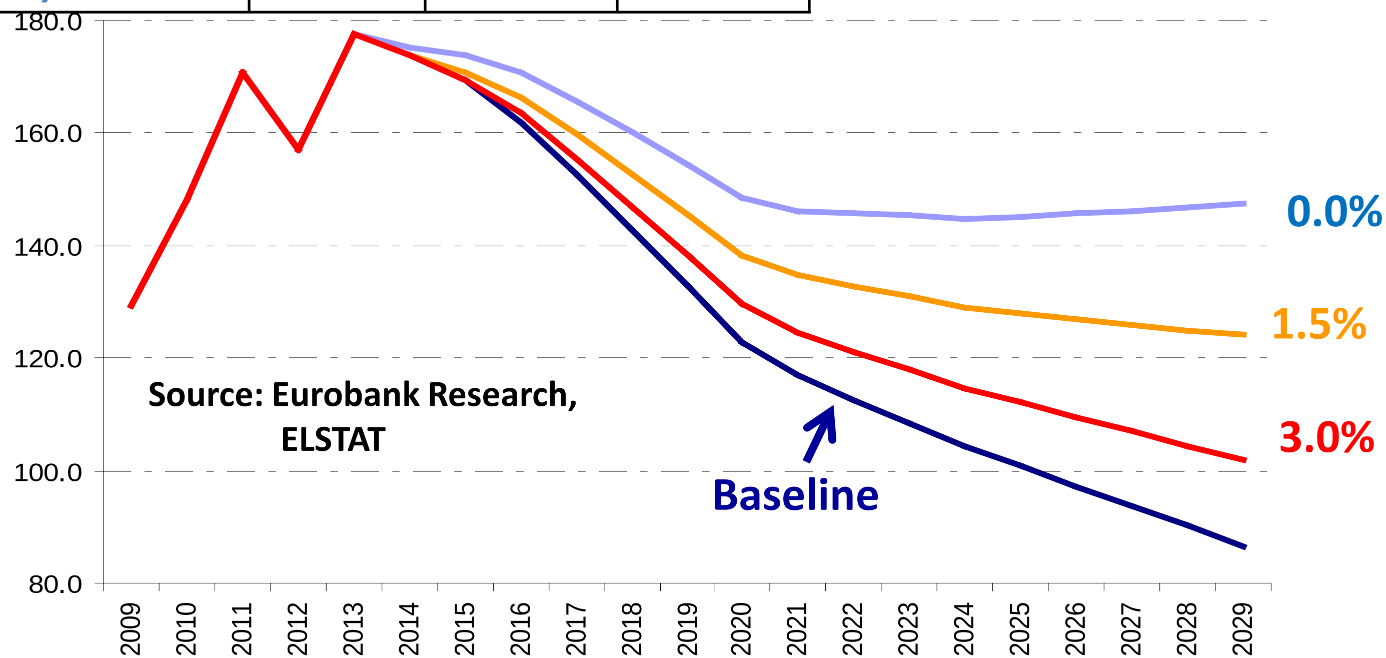
**BASELINE ASSUMPTIONS**

- **Positive Growth from 2013 onwards with average growth at 2.3% of GDP for 2014-2030**
- **Primary Balance at 0.0% in 2013, 1.5% at 2014 3.0% at 2015 and on average 4.1% of GDP for 2016-2030**

✓ **Not only growth, but also primary surplus matters for debt sustainability**

✓ **Attaining a large primary surplus is <u>not easy</u> politically**

✓ **OSI could help as official holders, excluding the ECB, own €217bn**



# II.

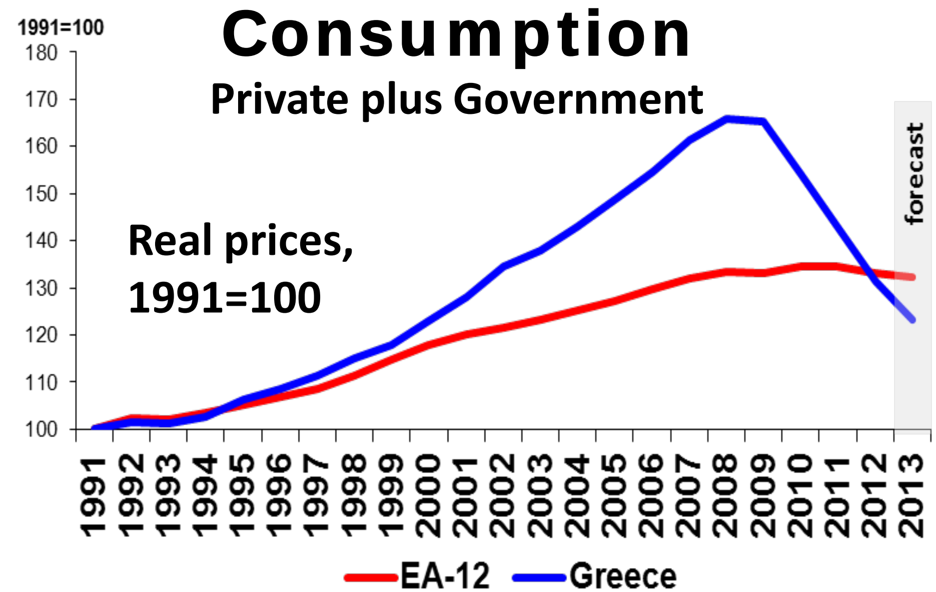
I. WILL THE RECESSION BE OVER SOON?

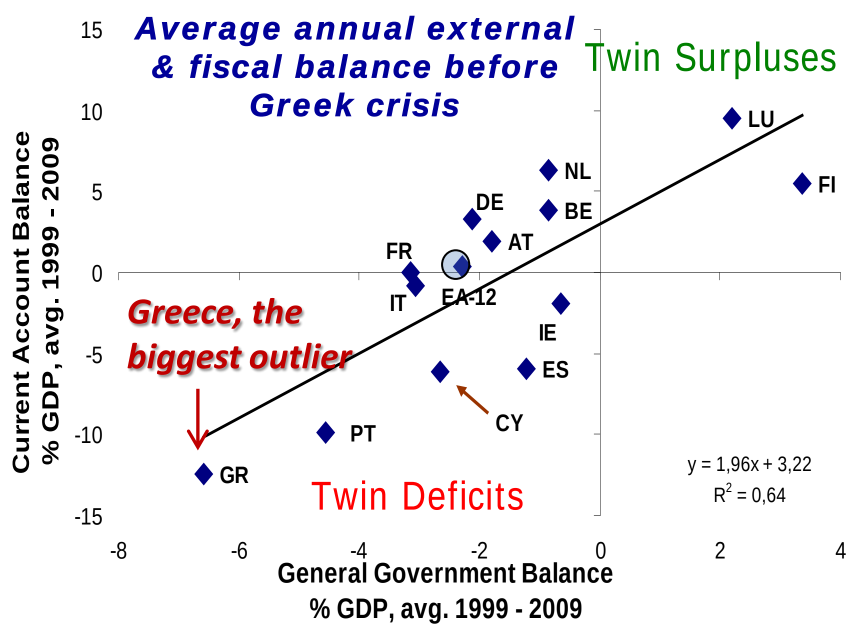
II. CAN SOLID EQUILIBRIUM GROWTH COME BACK?

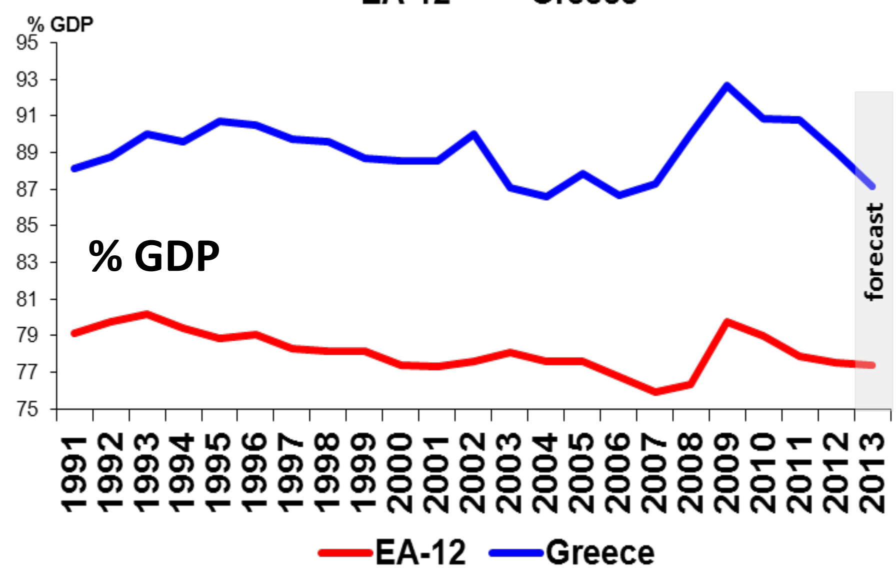
# II. FUTURE GROWTH MODEL HAS TO EMPHASIZE INVESTMENT & EXPORTS

| 2012 SHARE in nom. GDP | Greece | EA17 |
|---|---|---|
| Private consumption | 73.7% | 57.5% |
| Public consumption | 17.8% | 21.5% |
| Total investment | 13.6% | 18.3% |
| Exports | 27.0% | 45.7% |
| Imports | 32.1% | 43.0% |

Oil Exports in 2012 were € 10.4bn or 5.4% GDP
Oil Imports in 2012 were € 17.9bn or 7.2% GDP




Source: European Commission

Source: European Commission

# II. CONSUMPTION SHOULD GROW TOO, BUT AT A LOWER RATE

- ✓ Equilibrium growth implies that the share of consumption in GDP has to decline
  - ❖ **Puzzle**: But if consumption is such a huge percentage of GDP and, therefore, its momentum drives GDP growth, how can this be done without a long recession/stagnation?
  - ❖ **Answer**: By ensuring the other components of GDP rise a lot faster, namely exports and investment.
  - ❖ This way consumption can still increase, yet at a lower rate than GDP, with a declining share in GDP and simultaneously without dragging down aggregate demand
- ✓ Hence, the **new growth model should place an emphasis on exports and investment.** This points to the importance of competitiveness and a friendly business environment.
- ✓ This balance between consumption and investment & exports is also present in the Troika projections over the next decade
- ✓ Thus far only exports have picked up. Investment has shrank and there is no help form public investment either

# II. CAN WE SAY MORE ABOUT THE GROWTH MODEL?

- ✓ **There is a tendency,** especially among consultants who are pressed to give concrete advice, **to pick certain sectors of the economy on arguments of:**
  - comparative advantage (which is usually assumed to be obvious)
  - or large multipliers (without concrete estimation results)
  - or export importance of domestic value added,

  and claim those sectors ought to provide the basis for growth, e.g. tourism, agri-business, information technology, large infrastructure projects, energy, etc.
- ✓ **In choosing the sectors, one has to remember:**
  - The sector recipe advice tends to be <u>similar for many countries</u>, yet, no one says why is Greece different than, say, Croatia. (Answer: institutional & business environment)
  - <u>Past sector performance</u> does not guarantee <u>future</u> results, as world demand may shift in the future
  - Tourism is everyone's favorable sector in Greece and may indeed prove the counter-example: While it has <u>silently</u> shrank in importance over the last fifteen years, there is a <u>loud</u> anticipation that world demand for its services would rise over time
- ✓ **Supporting policies ought to shy away from subsidies and, instead, reward risk taking**
- ✓ **Another feature is the small size of enterprises across all sectors in Greece ⇨**
  - Need for policies that support <u>consolidation</u> and do not keep marginal enterprises artificially afloat
  - A large fraction of micro-enterprises in Greece survive because they cheat on taxes

# II. DETERMINANTS OF LONG-TERM GROWTH

Eurobank

**Economists shy away from the sectoral approach**

- According to the traditional model, in Greece, during 1990-2008, average growth was 3%, caused by three determinants: **Capital (1.10 pp.), Labor hours (0.90 pp.), Total Factor Productivity (1.00 pp.)**
  - **Current recession destroys the factors of production**, i.e. capital becomes obsolete, labor skills destroyed, the youth immigrating, childbearing diminishing, etc.
- In the 1990s, economists emphasize **investment in technology** to boost productivity
- Then in the 2000s, **institutional characteristics** like corruption, rule of law, efficient organization of the State sector, etc. were thought to be the deeper causes of growth
- The empirical literature makes cross-country comparisons over decade-long time intervals. Variables found important:

**I. (+) Investment as a % of GDP (affecting size of physical capital)**
**II. (+) Rate of human capital increase, ~ by % population in sec. education**
**III. (-) Initial income, capturing convergence**
**IV. (-) Government consumption, thought not to be productive (e.g. military exp.)**
**V. (-) Inflation, which destroys the price mechanism**
**VI. (-) Real effective exchange rate, showing the competitiveness effect**
**VII. (+) Openness**
**VIII. (+) Quality of institutions**

----------------------------------

**IX. (-) FX risk premium in countries that have flexible exchange rates**



Gikas A. Hardouvelis

# II. ADDRESSING THE LONG-TERM: PROGRESS IN CERTAIN SOURCES OF GROWTH

Eurobank

- The country is addressing some of those factors with success, see Table in RHS:
- A more specific growth path is hard to pin point with precision as it depends on the evolution of both demand and supply factors (potential GDP). Nevertheless, we know:
  - **The procrastination of recession destroys labor skills and capital** and constrains growth over the next decade
  - **Lack of population growth or immigration abroad also reduces growth**

1. **Competitiveness improving**
2. **Openness is improving: (Exports + Imports)/GDP from the 57.7% average over 2001-2009 is 59.0% in 2012**
3. **Inflation is improving: From 3.3% in 2001-2009 to 1.0% in 2012 (expected at -0.8% for 2013)**
4. **The size of government consumption is declining, from 18.4% in 2001-2009 to 17.8% in 2012**
5. **The initial condition will be lower at the end of 2014, which makes convergence easier**

**Relative Living Standards**

**EE-15=100 in PPS**

| | | | |
|---|---|---|---|
| 1991 | 75.5 | 2003 | 80.7 |
| 1995 | 71.7 | 2007 | 80.9 |
| 1999 | 71.0 | 2014 | 65.4 |

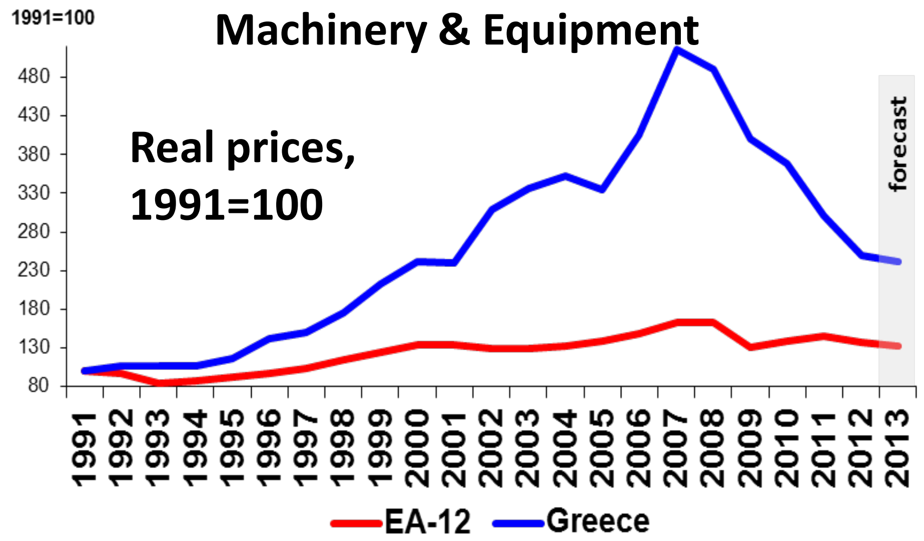
# II. LAGGING BEHIND IN OTHER SOURCES OF GROWTH

| | Greece | EA-12 |
|---|---|---|
| **1. Investment** (% GDP) | | |
| 2001-2009 | 22.8 | 20.6 |
| 2012 | 13.1 | 18.4 |
| **2. Corruption Perceptions Index** 2012 (0-100) | 36.0 | 70.6 |
| **3. Rule of Law** 2011 (score -2,5 to 2,5) | 0.57 | 1.41 |
| **4. Government Effectiveness** 2011 (score -2,5 to 2,5) | 0.48 | 1.36 |

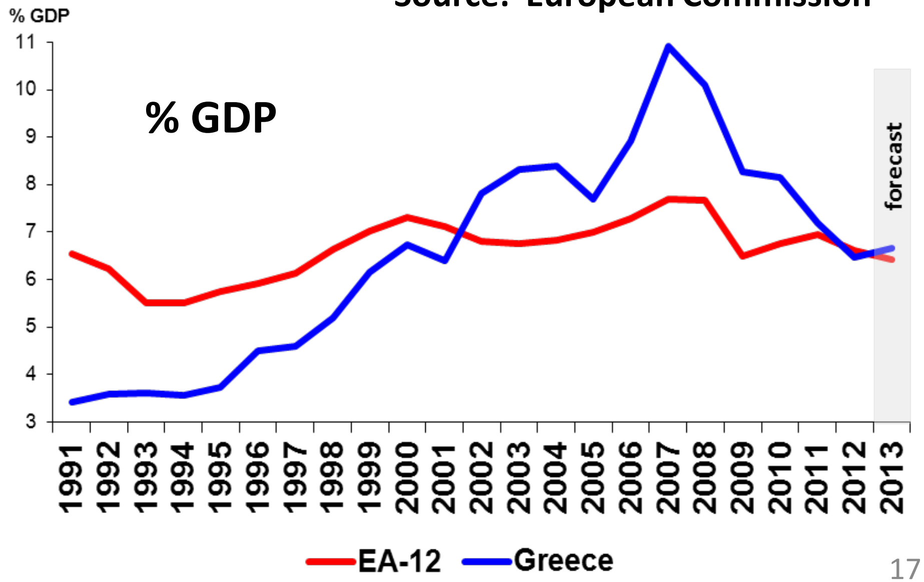
Source: EUROSTAT, Transparency International, World Bank

**5. Labor force participation and quality of education are also factors that lag behind**

## Investment




Source: European Commission



# SUMMARY: OVERCOMING THE CRISIS IN GREECE

- ✓ The neglected imbalances of past decades, particularly aggravated by the creation of EMU, brought the prolonged Greek crisis today
- ✓ Yet, the crisis presents an opportunity for Greece to reform its economic structure and for Europe to prove EMU can adjust and thrive: Over the last four years,
  - EMU members with the IMF invested a huge sum in rescuing Greece
  - Greece accomplished unprecedented fiscal consolidation, huge internal devaluation and initiated major structural reforms, which are still on-going
- ✓ THE NEW GREEK GROWTH MODEL requires a delicate balance between (i) a strong emphasis on exports & investment, and (ii) the requirement that consumption increases more modestly, i.e. at a lower rate than GDP, so that its share declines gradually to more normal levels without being a drag on domestic aggregate demand
- ✓ Policy-wise, there is still a lot to be done, nevertheless two are the critical questions:
  1. When will the economy stop shrinking?
  2. How will long-term equilibrium come back?
- ✓ The two questions are inter-linked because the sooner the recession/depression is over, the better the long-term prospects become, as
  - we need to reverse the trend of destruction in the factors of production, i.e. capital becoming obsolete, labor skills being destroyed, the youth immigrating, childbearing diminishing, etc.

# SUMMARY: OVERCOMING THE CRISIS IN GREECE

Eurobank

1. WHEN will the economy stop shrinking? **This is the current priority.** When:
   - Aggregate demand stabilizes; we are almost there as long as no additional restrictive fiscal measures are imposed; Greeks are over-taxed and their savings have dwindled; the fiscal gap needs external financing
   - Sentiment continues improving, so that Greeks and foreigners believe in the growth scenario, which can reverse the vicious cycle into a virtuous one
   - Pro-growth policies and public investment are re-ignited
   - Political stability prevails and lenders do not impose additional fiscal measures

2. HOW will long-term equilibrium growth come back?
   - By addressing via reforms the factors which drive long-term growth: (i) **Investment/GDP,** (ii) **quantity** plus **quality** of **human capital** (iii) reduction in the size of government, (iv) inflation (v) cost competitiveness, (vi) openness, (vii) **quality of institutions** like Government functioning & effectiveness, rule of law and corruption
   - Reforms have now touched the **DEEP STATE** and test government's willingness to proceed: OWNERSHIP OF REFOMRS NEEDED
   - The reform recipe ought to go ahead even if recession continues

**LET US NOT FORGET: Fixing our country is our problem and no one else's**



Gikas A. Hardouvelis

# Thank you
# for your attention

www.hardouvelis.gr

www.eurobank.gr/research

I wish to thank my colleagues at Eurobank for their comments