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Gikas Hardouvelis: Five major reforms to jump start the economy and the role of banks

Interview: Gikas Hardouvelis

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Greece attracts significant interest among international investors and its economy is expected to grow at a rate of 5% in the following years. However, the big question is whether the earlier pessimistic IMF forecasts of a long-term growth of 1% can be disproved.

"To achieve high growth, the country needs to go through major reforms," explains Professor Hardouvelis, "*in particular, he points to: digitization of the public sector, major transformation in the energy sector, radical changes in the labor market and the social security system, faster delivery of justice, and a substantial upgrading of the educational system, which lags far behind in international comparisons."*

The Professor of the University of Piraeus and Independent Non-Executive Member of the Board of Directors of National Bank of Greece highlights that "*any obstruction or loss of trust can put us in a difficult position, exposing the wounds of the ten-year crisis and the pandemic*."

Despite the many challenges banks face, he expects them to reduce non-performing exposures to below 5% or even 3% of their total loans by the end of 2022. It will thus be easier for banks to finance the economy.

The interview was conducted by George Fidikakis of Liberal.gr

- **Greece is turning the page as shown by many economic indicators and by the forecasts of domestic and foreign analysts for a growth rate of more than 5% in the next five years, while the Bank of Greece states that if radical reforms were made, there would be a positive impact of 7% on economic growth. Do you support these estimates? Is this optimistic scenario possible?**

Indeed, lately Greece is again in the antennas of international investors. The Resilience and Recovery Fund (RRF) is expected to lead to high growth rates for quite some time in the medium term, most likely over 5% for some of those years. RRF is expected to completely cover the loss of -8.2% in economic activity that the pandemic created last year, and could eventually boost future GDP to a level, which would be permanently higher by 7%, as the Bank of Greece stated recently.

In the long run, the most important question centers on the RRF impact on the dynamic trend of the economy. Will we manage to reach a trend rate of growth of close to 2% or higher? Before the pandemic, the annual long-term growth forecasts for the next fifty years of the IMF and the EU, were in the neighborhood of 1%. To abandon those earlier pessimistic forecasts, it is necessary to see the presence of specific economic catalysts in the economy, such as the quality of investment activity plus a major restructuring of the economy through reforms.

- **I have my questions on growth because although we constantly hear about reforms, we never seem them in practice, or the ones we see may not be brave enough. Can you name five important reforms that would transform the country for the better?**

Over the last decade and under the constant pressure of its creditors and the "Troika," Greece went through a series of significant reforms, especially on the fiscal side of the General Government. The current administration continues the reform agenda on its own initiative as part of the National Recovery and Resilience Plan, and without the Damocles sword of the "Troika." Many reforms are accelerated and are visible, while others require a longer period of normality to bear fruit.

The first reform, which is ongoing at an accelerating pace, is the comprehensive digital transformation of both the public and the private sector. This reform became visible to citizens exactly because of their intimate experience with the vaccination appointment process and the online booking platform. The digital transformation is expected to have a strong impact on business planning across different sectors, on economic and social policy, as well as on domestic and foreign investment. It is important the government provides incentives for the deepening of the digital transformation, which would influence the core of the production process and the provision of services and would not only remain at the level of sales, consumer behavior and customer contact.

A second reform, also in progress, is the energy transformation. Greece is not doing badly in adopting green energy production technologies. However, the country is lagging in energy efficiency and cost minimization, which tend to hinder other sectors of the economy that utilize energy as an input. The wave of investments in green energy must be properly designed to mobilize sustainable investments as well as investments that ensure a reliable and competitive energy mix for the economy. Special incentives should be provided to those entrepreneurs investing to produce intermediate goods within the country, which would replace imported intermediate goods that are required for the digital and green transformation.

A third reform, which is also accelerating but seems to be facing hurdles is in the labor market and social security. Labor market issues can be resolved more easily, since the relevant counterparties, namely, employees and employers, are currently present and can easily sit on the negotiating table. In fact, a relevant labor market bill is expected to become Law soon.

Social security, on the other hand, is a major sticking point. It raises funding issues for the State as it taxes current workers to pay for the pensions of retired workers or employees. In addition, the reform would regulate a relationship between different generations, namely, between current retirees and the younger population who will retire in the distant future. The latter do not have the same political maturity and power as current retirees do, nor do they have the same interest in this issue and, consequently, they are constantly the losers in the bargaining. This is evident from the fact that in Greece we have failed so far to fully establish the so called “third pillar” of social insurance, a system that exists in all European countries. The relevant discussion started in Greece in year 2001 but very little was accomplished since. The third pillar essentially allows current employees to save their own (before-income tax) money throughout their working life for their retirement, plus it allows them to freely manage this pool of own funds, without any interference from the State. Currently, there is discussion for only a small amount from the employee supplementary pension to be treated in this manner, plus it is unclear whether employees will have the ability to manage those funds themselves.

A fourth reform refers to the judicial system and the quick delivery of justice. Over the past years, the judicial system has increasingly penetrated the core of economic relations and now it affects economic outcomes directly, as for example, in the recovery and pricing of bank collaterals. Today, there is a need to reduce the judges' excessive workload and to activate extrajudicial solutions. There is also need for investment in the infrastructure, in technology and in the education of the judicial system. New legislation that would deter judicial delaying tactics that extend the time for final court decisions is also welcome.

A fifth necessary and longer-term reform is the transformation of the educational system to make it more conducive to the changing needs of an extrovert economy. Over time, the educational system has suffered a dramatic deterioration in its quality, as is evident in almost all international comparisons. This deterioration can be traced to anachronistic and conservative ideologies that have captured the Greek political system. The Recovery Fund and the challenges posed by the pandemic today, provide an opportunity to prioritize again the needs and orientation of the educational system. We can reverse part of the brain drain of the last ten years, pursue vocational training and lifelong learning policies, and emphasize the development of critical thinking among our young people.

- What will happen if inaction and second thoughts eventually prevail, pushing back those long-term reforms? Are you worried about that?

For reforms to thrive without a risk of reversion, society itself has to “own” them. If society is in favor of them, political parties - even the most regressive ones - will follow. The ten-year crisis brought a wide range of political parties to power, challenging them to face and manage reality, often against their previous ideology. This experience made the Greek society more mature and ready to shake out many of the old and rusty beliefs of the past decades. Citizens became motivated for hard work and personal advancement and are more ready to accept rational policies that would bring growth, equal opportunities and social justice.

Today we have a unique opportunity to restart the economy, administer reforms and attract investments within a supportive European environment of mutual trust. Any setback or breach of trust can put us in a difficult position and would easily resurface the wounds of the ten-year crisis and the recent pandemic.

- **Considering the good scenario, could Greece play a leading role in Europe in specific areas? In other words, is Greece able to become "a model student," as was recently stated in the Economist, which quoted the vaccination certificate idea and the Recovery Fund? In the coming years, can Greece become a model country instead of being a pariah?**

I would not call Greece a pariah, not even during its most difficult moments. Greece cannot be written off easily. During the crisis years many of its sectors continued to have a strong comparative advantage. There were many islands of excellence and attracted investors' interest.

The challenge today is to multiply those islands of excellence and have them spread all over the economy. The big challenge is to increase overall productivity, which can be achieved if our economy were gradually to become internationally competitive in many different products and services, which are in high international demand.

- **Turning to the banking sector, we are constantly told the banks are improving their balance sheets and their non-performing loans and that they will soon start financing the real economy. Will we see a big comeback by the Greek banks in 2022?**

Bank lending did improve substantially in 2020. And as the economy improves, so do the banks' balance sheets. By the end of 2022 most of them will have reduced their non-performing loans to below 5% or even 3% of total loans. Therefore, they will be able to finance the economy more easily.

Nevertheless, a comeback of Greek banks would also depend on what will happen internationally to the banking sector. Many Greek bank challenges are like European bank challenges. The low international interest-rate environment, the intense competition from technology companies that are gradually entering the retail banking, and the constant tightening of the bank supervisory framework, are putting enormous pressure on bank profitability in Europe.

In Greece there are additional difficulties. Banks are being transformed rapidly with fewer branches, more digital platforms, fewer employees, more work from a distance, and executives who are constantly being trained in new technologies. The economy is changing, being digitized, and the bank challenges are multiplying, making the increase in profitability a strategic one-way street.

- **Of course, the big problem for the economy is private debt. Although the volume of non-performing loans is being reduced for banks, these loans continue to burden economic agents. They are not written off but simply restructured. Will the banking system continue to lend to those previous borrowers, who restructured their loans? For otherwise, it looks as if every effort up to date were a waste of time.**

Private debt as a percent of GDP is not the main problem of the Greek economy, even after the ten-year crisis and the sharp decline in GDP itself. This becomes evident when we compare it with the private debt ratio in other European countries. For instance, less than 1/4 of the private sector has some type of leverage, a percentage that is among the lowest in the EU, according to ECB data. On the other hand, it makes sense to provide some long-term relief to those who are burdened by the crisis and owe money to the public sector, the banks, and the non-banking private sector.

Of course, in the end, for the healthy development of the financial sector in Greece, it is important to observe an increase in the percentage of businesses and households, which have the desire and the ability to access credit in the banking system.

- **In your recent study on the banking system, you rang a warning bell for the Deferred Tax Credit (DTC). Can this problem be solved through the Bank of Greece proposal for the establishment of a "Bad Bank"? If not, is there another way?**

The DTC Law was established during my tenure as Minister of Finance and went against the Troika agenda of the time. Its success is attested by the fact that even today Deferred Tax Credit still represents more than two thirds of the Tier I regulatory capital of the systemic banks. When the relevant law was passed in September 2014, despite its importance and enormous impact, the Government did not advertise its accomplishment because the DTC accounting structure is complex and could easily be misunderstood by citizens as a sign of bank weakness.

Please keep in mind that over time, DTC is gradually being retired and its withdrawal is covered by new capital, which is generated from the annual bank profitability. So, where exactly is the problem that you alluded to in your question?

One problem stems from the need of banks to quickly reduce non-performing loans. When a large amount of non-performing loans is securitized and sold within the same year, the bank typically shows negative profitability. Then, according to the DTC Law, the negative profitability forces the State to cover it with cash and acquire new bank shares. This capitalization increases the State's percentage ownership and automatically leads to dilution of private shareholders, something they do not like. Dilution has been avoided up to date through a “hive down” accounting methodology. Three of the systemic banks used the hive down methodology. National Bank was the exception. Its huge positive profitability was more than enough to cover the loss in its securitizations and did not need it. The hive down methodology is not a panacea, however. It can be applied only once by a bank. Thus if a large residual volume of non-performing loans continues to remain on its balance sheets, it could easily force dilution the second time the bank attempts a large securitization.

A second problem stems from the supervisors themselves, who would like to see the DTC turn into a more "powerful" capital in the form of immediate cash. This can be achieved either through the "Bad Bank," as suggested by the Bank of Greece, or, alternatively, if the four systemic banks were to negotiate directly with the Greek State for a DTC swap for cash, which ought to be slightly beneficial for the State so that it has the incentive to do it. It seems there has been no attempt for such a swap yet. There is no urgent need for it, but we will probably have to deal with the issue in the following years if the supervisors were to request it.

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