Greece: Taking Stock

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Economic and financial changes since the onset of the global and euro area crises

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With the introduction of the euro and the mispricing of sovereign (Greek) risk, a flux of funding inundated Greece and helped fuel an impressive growth rate (averaging 4%) in 2000-2008. Growth, combined with low inflation since monetary policy was managed by the European Central Bank (ECB), produced a flattering picture of an economy suffering from serious reform resistance. Growing fiscal and external imbalances were thus left unaddressed. In 2009 the fiscal deficit reached 15%, while Greece's competitiveness loss against its trading partners in 2000-2008 was 30%, leading to a current account deficit exceeding 15%. The government sector was crowding-out the tradeables sector.

The increase in sovereign risk that followed the outbreak of the global financial crisis and the realization of the flawed fundamentals led to Greece being cut off from the markets. Hence the need of an adjustment programme combined with a loan from IMF and European partners in 2010, subject to strict conditionality. The programme consisted of four pillars: fiscal adjustment, structural reforms of labour and product markets, measures to combat tax evasion and privatization. With the emphasis placed on the first pillar and a preference for tax increases instead of spending cuts, the recession took unprecedented dimensions, indicating a much higher multiplier than initially estimated.

The cumulative reduction in GDP in 2008-2013 reached 25%, while unemployment surpassed 27%. On the side of the fundamentals though, fiscal consolidation was striking, since a primary surplus (close to 2%, excluding? banks) was achieved in 2013 and the current account showed a surplus for the first time since WWII. Fiscal and structural reforms led to a re-balancing of the economy with the non-tradeables sector shrinking and leaving space for the tradeables sector to develop. Positive growth is expected in 2014 based on: the decline in fiscal drag, competitiveness gains affecting export performance, loosening liquidity constraints and supply-side effects of structural reforms.

Before the crisis, the Greek banking system was sound (capital adequacy ratio 12% and loans/deposits 104%) with a large presence in South Eastern Europe and no toxic assets related to the US subprime crisis. In 2008 private debt/GDP was 97% (vs 220% in Ireland, 202% in Spain and 173% in Portugal). With the outbreak of the sovereign crisis Greek banks were hit by a series of downgrades (following the sovereign), experienced substantial deposit withdrawals (lost €88bn, or one third of deposits, between June 2009-June 2012) and were cut off from money and capital markets (while having to pay back maturing debt).

The Bank of Greece (BoG) had to intervene in order to provide Greek banks with access to eurosystem funding and even extend (expensive) emergency liquidity assistance since August 2011. Greek banks experienced serious losses as a result of the deep restructuring of sovereign debt (PSI losses of €38bn), the fast rise in Non-Performing Loans (5% in 2008 vs 25% in 2012) and the deterioration in interest expense. Banks responded with deleveraging (until September 2014 cumulative bank credit was reduced by 14% vs 31% deposit reduction) which contributed to economic contraction creating a vicious circle. In this fragile environment the stability of the banking system could have been at risk, with possible implications extending beyond Greece. But careful cash management, continuous liquidity provision and tight supervision exercised by the BoG avoided an immediate problem, while a long-term strategy was implemented to create a viable and well capitalised banking system post crisis. Capital needs and viability assessment exercises were performed twice: in 2011-2012 with the help of Blackrock and Bain, and in

2013-2014 with Blackrock and Rothchild.

Four (core) banks were deemed eligible for public support while the rest had either to be privately recapitalised or be resolved. A financial envelope of €50bn was secured for bank recapitalisation and resolution. A new legal framework was introduced to guide the resolution process. A serious restructuring of the banking system followed leaving 39 financial institutions (10 commercial, 19 foreign and 10 coop banks,) in 2013 out of 65 (19 commercial, 30 foreign and 16 coop banks in 2009). The four core banks control 92% of total bank assets today. The cost (due to private capital injections) reached €42bn with the rest of the financial envelope being kept as a backup.

The political stabilisation post June 2012 and the implementation of the banking strategy led to a return of private sector deposits and a decline of dependence on eurosystem funding (€14bn and over €100bn respectively until August 2014). Also, the four core banks regained access to the international unsecured debt markets. At the same time the creation of the Banking Union with the undertaking of the supervision of the core Greek banks by the Single Supervisory Mechanism of the ECB (starting November 2014) will help to improve transparency and credibility. The comprehensive assessment carried out by the ECB (results publicised on 26 October 2014) will identify capital shortfalls. Corrective actions submitted by the supervised banks will be assessed and monitored.

The resulting strengthening of the banks' balance sheets and the effective NPL management will help restore positive financing flows to the real economy. Furthermore, alternative non-bank funding sources are activated including corporate bond markets, EIB funding initiatives, foreign direct investment (gross inflow of €7.1bn in 2009-2014) and efficient absorption of EU structural funds.

In a nutshell, the Greek banking system, as well as the Greek economy, have undergone profound (and long overdue) structural changes. Reform of the euro area financial architecture is also building confidence. Growth can resume, provided that major local or international political, geopolitical and economic risks are evaded.

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Professor Louri-Dendrinou *gave a seminar on the topic on October 14. To listen to the podcast, please visit the event's page.*