Backsliding is out of the question

Yannis Stournaras, ekathimerini, 4 January 2016

‘A potential failure to complete the review would have a destabilizing effect, bringing back to mind the negative experience of the first half of 2015,’ Yannis Stournaras says.

In terms of financial developments, 2015 can be separated into two periods. The first half of the year was marked by a high level of uncertainty. Protracted negotiations and the constant and sizable outflow of deposits from the banking system (of the total reduction in deposits from 2009 until now, 40 percent was recorded in the first half of 2015) led on June 28 to the temporary closure of banks and the imposition of capital controls in order to safeguard the stability of the banking system and deposits.

The protracted negotiations, the outflow of deposits, the sense of uncertainty and the constantly rising percentage of nonperforming loans, because of the deterioration of the economic climate, made it necessary to recapitalize the Greek banking system anew, despite the recapitalization of 2014.

The adverse and uncertain course of the economy was averted at the July 12 Euro Summit, where Greek authorities committed to a framework of prior actions as a basis for negotiations for a new program with the European Stability Mechanism (ESM). The agreement that was achieved on July 12, 2015, was ratified by the Hellenic Parliament on August 14 with an unprecedented majority in the House’s history.

After the July 12 deal, the bank holiday was lifted almost immediately (on July 20), while there was a gradual relaxation of capital controls, as a result of trust gradually returning. It is telling that since July 20, some 2 billion euros’ worth of deposits have returned to the banking system, the banks were successfully recapitalized using just 5.3 billion euros of public funds compared to an initial Eurogroup estimate of 25 billion euros, while their dependence on emergency liquidity assistance (ELA) declined by about 14.5 billion euros from end-August to the present.

Crucial year

The Greek economy is back at a crucial crossroads at the start of 2016. It faces the first review of the new funding program, which contains two very important and sensitive prior actions: the completion of the reform of the social security system and the alignment of tax on farmers’ incomes. Both of these measures are necessary for fiscal and pension sustainability but also for creating social justice both between the generations and between different groups of taxpayers.

Moreover, they will complete a series of similar fiscal and social security measures that have been implemented over the past few years, which resulted in the reduction of the big “twin” deficits that peaked in 2009 and constituted the main causes of the Greek financial crisis, namely the state budget deficit and the current account deficit.

I will not mention the other measures that will come under review, such as the lifting of the remaining barriers to competition in the goods and services sectors, the overhaul of the public sector or the improvement of the prerequisites and conditions for privatizations, because these raise rather than lessen total disposable income; they have, in other words, a positive income multiplier and can therefore not be defined as sensitive, neither in the political nor the social sense of the word.

In quantitative terms, the fiscal adjustment that has been achieved from 2010 to the present is close to 75 percent of the target required for debt sustainability, which is a primary surplus of 3.5 percent of GDP in 2018. In fact, if the backsliding of the first half of 2015 had not occurred, the adjustment so far would have reached 85 percent of the target. The economic and social cost of the remaining fiscal and social security adjustment is expected to be significantly smaller than the expected benefits. There is, in fact, no comparison. Furthermore, it would even be possible to reduce the final fiscal target.

The successful completion of the first review is certain to have a positive effect on the climate of trust. It is key for the return of deposits to the Greek banking system and the launch of talks with partners on a series of positive actions to benefit the course of funding and, by extension, the pace of the Greek economy’s rate of growth: the further lightening of the debt load that would have as an immediate effect the relaxation of the fiscal targets, the European Central Bank accepting Greek bonds as collateral for the regular (and much cheaper) funding of Greek lenders, the gradual lifting of capital controls and, finally, the inclusion of Greek bonds in the ECB’s quantitative easing program.

Progress in the talks and implementation of these positive actions also, of course, depends on the progress of negotiations with creditors and the level to which confidence in the Greek economy is restored. Indeed, it is reminded that in the two-year period from 2013 to 2014, when the climate of trust had been partially restored, 17 billion euros of deposits withdrawn in 2010, 2011 and 2012 returned to the banking system. The spreads of Greek bonds fell significantly, the state, banks and a number of businesses started to successfully tap capital markets, while the economy started to grow in 2014 after six years of recession.

Failure

In effect, as mentioned previously, there is no comparison between the costs and benefits, because a potential failure to complete the review would have a destabilizing effect, bringing back to mind the negative experience of the first half of 2015. A repeat of that experience would carry grave dangers that the Greek economy may not survive this time around. Problems would appear in the banking system, capital controls would have to be tightened rather than relaxed, a loss of confidence would lead to a new wave of nonperforming loans, the fiscal situation would worsen and the funding needs of the state would lead to a new amassing of outstanding debt to the private sector and, ultimately, to a sharpening of the recession.

The European Union is also more vulnerable now than it was before and in a less favorable position to deal with a new Greek crisis. European players who are very knowledgeable about such matters say that the terrorist attacks in Paris, the asymmetric challenges posed by the refugee crisis, the threat of a British exit from the European Union and the now-openly acknowledged rift between the European Central Bank and the European Commission on the one hand, and certain member-states on the other, make a potential failure of negotiations at the Eurogroup level and this being transferred to the leaders’ summit, extremely risky.

Despite indisputable and significant problems and the cost of the adjustment, despite the mistakes made both by the Greek side and its partners in designing and implementing the program from its start and to the present day, the possibility of success remains very high and depends mainly on us. Since 2010, we have achieved the biggest fiscal deficit adjustment ever recorded in history, and among OECD member-states, the biggest adjustment of the current account deficit and one of the biggest adjustments in competitiveness as measured by unit labor costs.

Furthermore, we are already seeing a significant restructuring of the productive sectors to the benefit of tradable goods and services and an important boost in exports, while Greek banks were recapitalized amid adverse conditions and are now poised to meet the challenge of dealing with the large number of nonperforming loans, thus contributing to the funding of the Greek economy and the implementation of a new growth model that is more conducive to competitive and export-oriented sectors and businesses.

Succeeding

However, in order to succeed we need to overcome our own skepticism. We need to own these successes. We have to move forward and implement the program. We must take advantage of the state's real estate assets, attracting direct foreign investments by updating land usage while respecting the environment. We need to include more privatizations in the program so we can reduce the primary surplus target, which would made the public debt sustainable. We need to move ahead with more reductions to non-targeted and also to specific but inadequately designed social expenditures, instead of choosing to raise taxes.

We need to move ahead with a review and reduction of the some 1,800 legal entities that come under the state's supervision; to implement plans for the mobility of personnel within the public administration; to put an end to the exemptions from general taxation regulations for specific groups of taxpayers that would allow, on a medium-term basis, the reduction of the overall level of taxation; and to put an end to exemptions from pension rules. Finally, we need to end fixed funding for local government, which is full of disincentives, and replace it with targeted spending.

An exit from the crisis, a return to normality and a sustainable level of growth are all within reach. The government needs to implement the agreement it negotiated with the partners and adopt initiatives that will create more trust, taking advantage of the positive development in the recapitalization of the banks, which attracted private funds. The Hellenic Parliament, which from 2010 has supported the adjustment effort and, in effect, the salvation of the Greek economy, must obviously do its part to complete the legislative work outlined in the agreement, particularly since the larger part of the adjustment has already been achieved. Today, a new period of backsliding is out of the question.

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