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# The Greek Economy and Banking System: Recent Developments and the Way Forward ☆

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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.


## 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.

☆ George A. 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.

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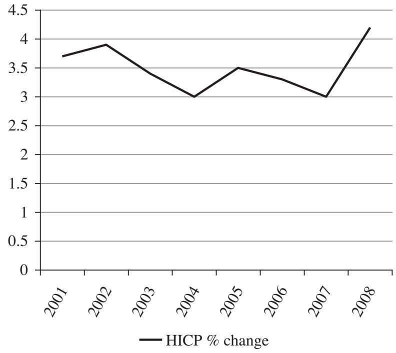


**Fig. 1a.** Greece: Inflation rate. *Source*: ECB Statistical Data Warehouse.

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 (Figs. 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 (Fig. 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 (Fig. 3).
- The ratio of government debt to GDP rose from 103.7 per cent in 2001 to 129.7 per cent in 2009 (Fig. 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 (Fig. 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 (Fig. 6).[1]

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

[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.

[2] As shown by Gibson et al. (2013), the markets did not price the fundamental economic variables into Greek sovereigns until 2008–9.