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Greece's Banking Sector Options

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Emergency Economic Summit for Greece

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Introduction

When the financial crisis originating in the U.S. struck in late 2008, Greece’s current account deficit—the counter part to its large capital inflows—was a staggering 15% of its GDP. The sudden stop of these capital inflows required the elimination of Greece’s current account deficit, which within the common Euro currency area would require a fall in the prices of its exports and increase in the relative cost of its imports sufficient for that purpose (internal devaluation). In a world of perfectly flexible wages and prices in which the needed adjustments would occur frictionlessly, there would be no loss of output or employment, though Greeks would be poorer unless the increase in their external competitiveness came from improved productivity. Such a world does not exist. Wage and price adjustments and certainly improvements in productivity take time. Given the sever rigidities and inefficiencies in the Greek economy, these adjustment are taking a very long time indeed forcing the adjustment (the fall in the demand for imports) initially through a large and painful fall in output and employment.

Greece has the right to build whatever sort of society it is capable of and can pay for. Its people may prefer a more leisurely environment with lots of sun time and slow or no growth in income or a more competitive environment in which hard work is rewarded with more rapid growth in income. It is their lives and their choice. What Greece cannot do is live on other people’s money forever. It has done so for a surprisingly long period of time, but that time is over. It became obvious to the Greek government and a substantial part of its citizens in 2010 that it had no choice but to adjust it’s spending to its income. Whether it chose to default on its debt and leave the Euro and the EU or to stay, it could not avoid a large and painful fiscal adjustment. In my opinion, it chose wisely to keep the Euro and accept the financial support of the IMF and others that would enable its unavoidable adjustment to occur more gradually than if it defaulted. Without external financial assistance, Greece’s fiscal adjustment (austerity) would have had to be more severe than with it. The key policy question has been and should continue to be what form and pace of adjustment would minimize the pain of adjustment while maximizing long economic growth.

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1 Warren Coats, Ph.D., Bethesda, MD, retired from the International Monetary Fund
Within its financial means, Greece can chose whether it is rich or poor or something in between. This depends on its productivity. Productivity—the average output per worker—depends on the legal, institutional, and cultural incentives to invest and work. Can enterprises be established and operated with minimal legal and regulatory costs? Are unsuccessful enterprises able to exit with minimal cost? Are investments attracted to the best and most productive uses of the country's resources or do complicated and burdensome taxes and regulations distort the allocation of resources toward less productive uses? Does the government provide important public services on which families and firms depend, efficiently at minimum cost? My comments will focus on the central role of the banking sector.

**Background**

Greece’s entry into the EU and replacement of its drachma with the Euro unleashed a flood of funds into Greece. Much of the inflow took the form of loans at interest rates only modestly above German borrowing rates. Within the single currency area this put upward pressure on Greek wages and prices in order to produce the trade deficit that was the necessary counterpart of the capital inflow. However, Greece proved to be a less attractive place to invest than initially expected and too much of the inflow financed consumption, which did not increase Greece’s productive capacity and hence its ability to repay these loans.

According to the World Bank Ease of Doing Business Index, Greece ranks 61 in the world not far below Italy at 56, way below, for example, Georgia at 15 and Denmark at 4. For decades Greek political parties have attracted votes by offering favors. Its tax laws are riddled with special exemptions for all kinds of special interests. Many industries and most professions are protected from competition. Government employees are often unqualified, well paid and able to retire earlier than most any other European country, and difficult to fire.

Greece’s long tradition of clientelism has severely stifled its economy’s **productivity**. In addition to the rent seeking opportunities and behavior indicated above, Greece’s public services are lacking in many other ways that also undermine its productivity. For example, establishing and proving ownership of property is almost impossible. It is estimated that less than 7% of the country has been properly mapped. The New York Times reported that: “If you calculated the total deeds that are registered,” said Dimitris Kaloudiotis, an engineer who took over as president of the national land registry authority last month, “the country would be twice as big as it is.” (May 26, 2013) This is a huge impediment to investment and productivity.

Political patronage and other inefficiencies in government contribute significantly to high government spending but low quality of government service, thus reducing the Greek economy’s productivity. Government employees enjoy high wages and generous pensions with early retirement. These wasteful expenditures were not
sustainable. The key policy issue is which expenditures to reduce. Sadly for the Greek public such cuts often came from useful services rather than patronage, rent seeking related expenditures. As with the poor land registration service, the administration of government services in Greece are often simply inefficient and wasteful, benefiting no one other than bureaucrats.

With the onset of the financial crisis originating in the U.S. in late 2008 the flow of capital into Greece and many other countries dried up. Interest rates on ten-year Greek government bonds moved up modestly from around 5% at the end of that year to around 5.5% at the end of 2009. An election in late 2009 won by the Panhellenic Socialist Movement elevated George Papandreou to the Prime Ministership on October 6. Then came the shocking announcement by the new government that the government deficit for 2009 had been grossly underestimated. It is now estimated to have been around 10% of GDP. Though the Greek economy had made some progress during its first decade with the Euro it had entered that period with a public sector debt of around 100% of GDP, well above the EU average of 70%. Following Papandreou’s deficit revelation, markets began to lose faith in Greece’s ability to service and repay its debts and by the end of 2010 the interest rate on the government’s ten-year bonds doubled to 12% despite an agreement with the IMF, EU and ECB in May for substantial financial assistance.

An IMF review of Greece’s performance under this agreement concluded that: “There were notable successes during the SBA-supported program (May 2010–March 2012). Strong fiscal consolidation was achieved and the pension system was put on a viable footing. Greece remained in the euro area, which was its stated political preference…. However, there were also notable failures. Market confidence was not restored, the banking system lost 30 percent of its deposits, and the economy encountered a much-deeper-than-expected recession with exceptionally high unemployment. Public debt remained too high and eventually had to be restructured, with collateral damage for bank balance sheets that were also weakened by the recession. Competitiveness improved somewhat on the back of falling wages, but structural reforms stalled and productivity gains proved elusive.”

Prior to the 70% plus write off of privately held government debt in February 2012, interest rates continued to rise, reaching over 21% by the end of 2011 and peaking at almost 30% in February 2012. The government clearly could not refinance and service its debt much less increase it at these rates.

On March 9, 2012 Greece and its official creditors agreed to a new program and additional financial assistance. The goals of the program agreed to by the Greek government with the IMF, EU, and ECB were to bring it’s spending in line with its income, strengthen the quality and targeting of public services, strengthen its

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financial sector to support economic growth, and improve the economy’s productivity. Limiting spending to income requires **balanced trade**—paying for imports with exports and **balanced government budgets**. The first requires lowering the cost of Greek exportables until they are competitive on the world market. In 2010 Greece’s unit labor costs were estimated to exceed those of its trading partners by 15%. According to Bank of Greece Governor, Yannis Stournaras, earlier this year: “Cost competitiveness has improved by more than 25 per cent since 2009”

Restoring competitiveness within the single currency Euro area required Greece’s painful internal devaluation—price and wage reductions and improved productive efficiency. Greece has achieved current account balance since 2013; however, this reflects reduced imports from the dramatic fall in Greek income more than improvements in external competitiveness. In order to preserve external balance it is likely that wages and prices will need to fall further as the economy recovers. More over this external balance of payments needs to include sufficient surplus to gradually repay Greece’s debt to the rest of Europe and the world. The IMF’s assessment that Greece should be able to service its existing and prospective debt depended on optimistic assumptions about its prospective economic growth.

Earlier this month the EC sharply reduced these growth forecasts for this year from 2.5% to 0.5% (while modestly increasing growth forecasts for the EU as a whole. Greece had also achieved a primary fiscal balance with a small surplus by the end of 2014, though not sufficient to cover its debt service obligations much less to reduce its outstanding debt. By the end of September 2014 the rate on ten-year government debt had fallen to 5.89%. By the end of last month (April, 2015) this rate had risen again to 12.06%.

**Achieving fiscal balance** has required both reductions in spending and increases in revenue. While improving tax administration in the interests of tax efficiency and fairness can increase revenue available for government services and programs, a large share of government expenditures is wasteful or directed to lower priority expenditures. The previous government achieved primary fiscal balance (i.e., before taking into account debt service) in 2013. This was an impressive but painful achievement. But much remains to be done to strengthen Greece’s tax administration and the efficiency with which it delivers government services. These badly needed reforms will take many years to complete even with a government that cares to undertake them.

**Banks** play a critical role in providing credit to the domestic economy and executing domestic and cross borderer payments in Euro. Their ability to lend rests on their ability to attract and hold deposits. If cross borderer payments don’t balance, what

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4 Speech at the Hellenic Observatory of the London School of Economics on March 25, 2015.
above was referred to as the balance of payments, deposits in Greek banks will increase or decrease depending on whether there is a net inflow or a net outflow of funds. The mechanics of how this is done are important.

When a Greek importer pay’s for its purchase, it instructs its bank to transfer balances in its account to the credit of the foreign seller in the seller’s bank. A critical issue is what asset the seller’s bank receives in order to credit the seller’s account. Let’s call the seller Mercedes Benz in Stuttgart and the seller’s bank Deutsche Bank (DB). The asset transferred to DB could be a loan from DB to the importer’s bank, say, Alpha Bank. In this case DB would gain a “Claim on Alpha Bank” on the asset side of its books and a deposit balance owed to Mercedes Benz on the liability side of its books. But generally DB will receive an increased balance with the European Central Bank (ECB) either directly or through its national central bank, the Bundesbank. That balance comes by transferring the equivalent amount from Alpha Bank’s deposit balance with the ECB. But how does Alpha Bank maintain sufficient balances with the ECB if its customers keep paying out more than they receive from other Euro area banks? Alpha Bank can fund its ECB account by selling other assets on its own books to customers in other Euro area countries or by borrowing Euro abroad or from the ECB itself.

Cross border payments in Europe are made through TARGET2 (Trans-European Automated Real-time Gross settlement Express Transfer system 2). The ECB (actually the national central banks on behalf of the ECB) provides Emergency Liquidity Assistance (ELA) to its member credit institutions if they do not have sufficient balances to transfer to another bank through TARGET2 if they are solvent and pledge qualified collateral. A country’s current account deficit can only continue as long as loans and investments flow in to finance it. If such capital inflows finance productive investments, the economy’s growth can finance their repayment in the future. But as Greece’s foreign creditors are belatedly discovering, if such loans are largely financing consumption, Greeks will eventually be unable to repay them.

In a well functioning economy in a currency union the outflow of funds that finance a balance of payments deficit in the absence of sufficient capital inflows will drain money from the deficit economy bringing downward pressure on wages and prices until external payment flows balance. Wage and price rigidities in Greece made these adjustments difficult and slow thus plunging it into a deeper recession than would otherwise have occurred. At the end of March this year the ECU had a €110 billion exposure to Greece banks through ELA loans extended to finance the currency outflow, the largest in Europe relative to GDP. Much of the collateral for these loans consists of Greek government debt, which remains eligible as long as such debt is backed by a program with the IMF/EU/ECB. This cannot and will not go on much longer without a new program.

5 A country’s current account balance consists largely of its trade balance plus interest earned on foreign investments less interest paid on foreign debt.
The soundness of Greek banks is critical to their ability to continue extending credit in Greece and thus to support economic recovery and growth. This soundness has been threatened by the economic collapse in Greece for several reasons. First, the sharp drop in external financing of Greece’s balance of payments deficit ended that source of Alpha Bank’s balances with the ECB and thus its ability to transfer its customer’s payments to Mercedes Benz at DB. Secondly, the recent fall in domestic prices (internal devaluation) has increased the real value of debt and when combined with the sharp fall in economic activity in Greece has increased the amount of non-performing loans (from around 10% of total loans in 2010 to over a shocking 30% in 2013), reducing Greek banks’ capital. On top of that the very large write off of privately held Greek sovereign debt in February 2012 (over 70%) fell heavily on Greek banks, which held large amounts of such debt. The newly established Single Supervisory Mechanism of the EU Banking Union has capped the exposure of Greek banks to the Greek government thus providing them with important protection against any efforts by the Greek government to push its debt onto its banks. Third, though all deposits at Greek banks are now guaranteed by the Greek government, the government’s ability to honor that guarantee is questionable to say the least causing the size of deposits in Greek banks to fall from around €260 billion in 2009 to a bit under €200 billion in 2013 and 2014 as depositors move their deposits to safer banks. Over the first quarter of this year the declined resumed with a further €27 billion outflow.

An important component of Greece’s agreement with its creditors concerns addressing the weakness and undercapitalization of Greek banks discussed above.

The reforms Greece has agreed to with its creditors also aim to improve Greece’s productivity. This requires structural adjustments to reduce waste and promote the more efficient allocation of Greek resources. But what structural reforms should Greece undertake, consistent with its life style preferences, not only to become competitive and thus to pay for its imports with its exports, but to become as efficient and productive as possible within its life style preferences? Are the reforms agreed to by the previous government the most appropriate in the eyes of the new government?

What is needed?

Fiscal Balance

Whether or not to achieve fiscal balance is no longer an option though the size of the government’s surplus and how quickly to get there (over and above debt service) can be debated. The new government has made many promises, but it cannot deliver them all within the resources it has or is likely to get. The new government should establish priorities for government spending that best serve the national interest rather than the special political interests of selected groups, which the
pattern of previous governments for many decades. This seems fully consistent with the new government’s stated goals at the most general level. It is not yet clear that its more specific goals satisfy this objective. Government programs underway to improve government administration and efficiency and tax fairness, efficiency and compliance should continue. Given its political base, the Syriza government would seem to be well placed to dissolve the special privileges of Greece’s powerful economic tycoons who have rules and stifled Greece’s economy for generations. They should do so.

As of a week ago Greek negotiators were refusing to implement pension cuts and labor market deregulations agreed to under the existing program with the IMF/EU/ECB. Greece still spends about 17% of its GDP on pensions, one of the most generous in the EU. Failure to reduce these expenditures will require cutting other expenditures, which have not been identified. Failure to reduce special treatment and protection of favored professions and occupations will undermine efforts to improve labor productivity. The government has hard choices to make with or without the benefit of a support program. Its choices will reveal whether it is promoting the public interest or continues the long tradition of protecting special interests.

Banking sector

Much has been done since 2010 to restore the soundness of Greece’s banking sector so that it can contribute to Greece’s economic recovery and growth. It’s Letter of Intent to the IMF of May 14, 2014, stated that “The overriding objectives were to strengthen the bank’s capital base as soon as possible, attract in a competitive process anchor investors that would play an active role in the bank’s management and balance sheet repair, and achieve a strong private sector participation in the transaction, marking the return of our banking sector to capital markets as a sign of its nascent recovery.”

Again quoting Governor Stournaras: “Over the past few years, the landscape of the banking system has changed significantly with the number of banks being reduced through mergers, takeovers and resolutions. Today the system comprises four core banks and a number of smaller banks. The four core banks, following recapitalization and the implementation of restructuring plans, are well-placed to meet the new challenges that the banking system faces going forward.”

In addition, banking supervision and related laws and regulations have been significantly strengthened, especially with regard to bank restructuring and resolution and the management of non-performing loans. These include strengthening legal and organizational measures to reduce conflicts of interest between supervisors and the supervised, always a challenge but especially so in Greece. Nonetheless, bank credit

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to the private sector continues to decline (the annual rates of decline in each of the first three months of this year were -2.9%, -2.5%, and -2.5%).

Two major weaknesses in Greece’s banking sector need attention. The first is the need to progress more rapidly in resolving the still high level of non-performing loans. According to Governor Stournaras: “Greek banks must now adopt an active management of distressed loans, in a manner that not only eases the burden on cooperating borrowers facing temporary difficulties in servicing their debt, but also enables banks to unlock funds tied up in troubled loans that are unlikely to be repaid. The banking sector must be assisted in this effort through improvements in the legal framework that would lift restrictions on, for instance, (pre-) bankruptcy procedures, out-of-court settlements or, as already mentioned, a speeding up of the judicial procedure.”

The second weakness is the shortage of acceptable collateral for additional ECB liquidity support under the ELA should current deposit withdrawals continue. The potential need for additional collateral is wholly the result of the Syriza government’s failure to conclude an agreement with its creditors on policy benchmarks and structural reforms and/or to implement them. Should it fail to do so very soon (perhaps before this presentation is made), it will have little choice but to impose capital controls on the withdrawal or transfer of bank deposits.

Structure reforms

According to Poland’s former central bank Governor: “regardless of who governs Greece, we believe these steps should be taken: First, be absolutely determined on structural reforms. They are essential for the Greece’s economic growth, and they are not painful for the society at large but to some statist vested interests in this country.” Greece has agreed with its creditors on a long list of reforms to labor, service, and product markets intended to make them more competitive and efficient. The government should continue these reforms.

Underlying most of Greece’s economic problems is a long existing culture of corruption. This extends well beyond the well known vote buying with state favors and employment. One example is the massive bribery connected with Greece’s bloated military budget.

In the most recent issue of the Cayman Financial Review, L. Burke Files and Mike J Masoud nail Greece’s biggest problem—corruption—with a fascinating suggestion:

Following the disastrous losses from staging the Olympic Games in 2004, the largest losses in the history of the games by a large margin, “the Greek government was the third largest arms importer after China and India. As part of an earlier rescue

8 Ibid.
program, Greece agreed to cut its defense spending from over 7 percent of GDP to 4 percent of GDP, which is still twice the euro-zone average....

“During 2010, the very first year of austerity, Greece increased military spending to €7.1 billion, a 13 percent increase over the year before accompanied by a €1.8 decrease in social spending. It has been claimed by many that the 2010 bailout was linked to buying six stealth frigates and 15 search and rescue helicopters from France, 223 Howitzers from Germany, as well as two “remanufactured” German submarines....

“The Greek government has purchased billions of dollars of military equipment based upon contracts greased with bribes. All of those agreements are voidable, as there was material unlawful consideration as part of entering into the agreements. Return the merchandise and demand a triple refund as a penalty for the fraud and corruption involved. Go back 15 years or more and unwind all transactions involving bribes.

“Demand immediate cooperation from all Greek government officials who took bribes. Demand they come forward and disclosure the nature of the bribes. Pursue all domestic and foreign companies who have been paying bribes. Fine them, fine them heavily or seek criminal prosecution of the management for those companies, in particular the arms dealers. Fine the corrupt fraud feasons until Greece is solvent.

“If Greece officials can stop taking bribes to buy over-priced expensive weapons that are not needed, Greece could save 7 percent to 8 percent of its GDP.”

**Conclusion**

The economic recovery that got underway last year has, hopefully temporarily, stopped and capital flight resumed. These are the results of the failure of the Syriza government to specify the adjustments in the existing program with its creditors that it is prepared to implement in order to live within its means. It is understandable that the new government has different priorities. More rapidly removing costly favors to the oligarchs and strengthening the safety net for the poorest would be welcomed. Greece's creditors are prepared to consider adjustments within the general ceilings and targets of the existing agreement, but the Syriza government needs to conclude its negotiations urgently and move forward with its reforms without further delay.

I am in full agreement with Governor Stournaras’ recommendations:

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“Policy actions that promote long term growth

In the long term, the growth outlook of the Greek economy is expected to improve following the rebalancing of fundamentals such as the twin deficits and competitiveness, provided reforms continue and emphasis is placed on the following priorities:

• **Speeding up structural reforms in the product and services markets** in order to enhance competition and innovation, increase price flexibility and improve competitiveness.

• **Consolidating fiscal achievements**. Efforts must focus on structural measures to strengthen the independence and efficiency of tax administration, with the aim to tackle tax and social contribution evasion. The application of modern, risk-based tax audit methods and the activation of a nationwide asset registry are fundamental in the fight against tax evasion.

• **Reviewing tax exemptions and other favourable tax treatment**. Tax exemptions and favourable tax treatment, including reduced VAT rates, need to be reviewed and streamlined.

• **Lowering tax rates and reviewing the efficiency of public spending**. To the extent that fiscal achievements are safeguarded, a lowering of the direct and indirect tax rates will become possible. On the expenditure side, efforts to better target social benefits must continue, while the existing exemptions from the general pension system provisions must be re-examined.

• **Increasing public sector efficiency**. Completing the national cadastre and eliminating the chronic obstacles to the efficient and speedy delivery of justice are fundamental prerequisites for a well-functioning state, as are the efficient deployment of human resources and a transparent staff appraisal framework that rewards productivity and work ethic.

• **Strengthening active labour market policies with particular emphasis on education and training**, as a way to improve the job-finding chances of people on the sidelines of the labour market, such as the long-term unemployed and young people, who have borne the burden of unemployment.”

And the Governor’s closing remarks:

“The new Greek government has a unique opportunity to implement bold structural reforms, which would be backed by a large majority of political forces in the country. This is in my view a historical opportunity which should not be missed.”

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