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"Developments in the Hellenic and European Economy"

I feel awkward to speak on European economic developments before such a learned audience. Your sources of information – commercial banks with their corporate clients, in-house statistics on the credit and default rates, the growth of deposits, etc.– are more differentiated than that of central bankers. However, there is a short-termism bias in the approach of commercial banks, which is natural since a major concern (and it will be even more felt after the adoption of the international accounting standards) is profitability over the current and immediately following quarters. In contrast, central bankers focus on fundamentals, which gives us an advantage in better assessing medium-term developments. However, I have to admit that our economists are not better that your economists in predicting the turning points; they both are more often wrong than right.

Every quarter since 2001 forecasters worldwide have tended to revise downwards their projections for GDP growth and the expected recovery was delayed by up to 12 months. Personally, being influenced by my early studies, I was more cautious, and since mid-2000 I believed that the world and European economies would remain on a slow growth path for a much longer period. In the late 1950s, we were still studying prewar bubbles and investment cycles which, in a period of growing economic interdependence and globalization, also of market psychology, have an almost contemporaneous effect on the major economies. This is also becoming evident from the increasing tendency for a relative synchronization of the economic cycles in the USA and in Europe.

Looking ahead, there are reasons to be cautiously optimistic. First, I want to remind you that if the EU growth rate lagged behind the USA growth rate in the past 10 years this was neither the case in the 1980s (0.4% differential over that of the USA) nor in the 1970s (1.5% differential). But most importantly, during the past ten years, the faster GDP growth in the US (by about 1½%) was mainly the result of a faster growing population, so that per capita GDP growth in the USA was not significantly different from that of the EU. Likewise, before 1996 overall productivity growth in the USA lagged behind that of the EU and hourly productivity growth continued to be lower in the USA even after 1996. But since Americans increasingly work longer hours, whereas Europeans have adopted a leisurely way of life and they have much longer holidays, overall productivity levels are higher than the European levels. I mention these developments to remind you that Europe is not performing as bad as crude statistics indicate and there is great potential for faster growth, but the right policies have to be adopted, especially to encourage a higher employment rate so as to also alleviate the future pension burden.

Looking now at more recent trends, the downward phase of economic cycles usually last about 3 years, so that we could expect a turning point sometime around mid-2003. However, the Iraqi war has increased the downward risks, and, even if the war is quickly resolved, the uneasiness will continue to lurk at least during the remainder of the year. The bottom of the cycle will probably be reached sometime in the 2nd or 3rd quarter of 2003 but, unfortunately, we don't know how deep the bottom is and surprises cannot be excluded. Nonetheless, a weak, by past standards, recovery towards the end of the year seems likely, and the EU GDP may increase in 2003 by about 0.5-1%.

The recovery could be stronger and its sustainability could be better assured if our politicians, together with financiers and business leaders, take the initiative to limit the political damage and the spillover effects on the economic sphere from the disagreements over Iraq. It is important that the unleashed passions on both sides of the Atlantic be contained and that no permanent fissures develop between traditional allies.

The outlook for 2004 is much brighter, but it is too early to predict whether the EU growth rate will reach its potential, which is estimated at about 2½% per annum. There is a number of favorable factors that should underpin a sustainable recovery in the years ahead. Interest rates and credit conditions should continue to be supportive factors. Present nominal and real short and long-term interest rates are close to, if not below, historical low levels and they will most likely remain relatively low even in the first half of 2004. Low interest rates combined with improved economic prospects, the need for replacement and modernization of aging equipment together with the fruits of the ongoing company restructuring should lead in 2004 to a turnaround from a falling to a rising business investment cycle, which should gather pace in 2005.

On the fiscal side, the decision of EU governments to let the automatic stabilizers play their full role, especially in this downward phase of the cycle, together with the extensive social security net, has helped to curtail the slowdown in GDP growth rate. The overall deficit of the euro area increased to about 2.3 percent of GDP in 2002 and, given weak growth in 2003, no improvement is expected this year. However, the deficit in three euro area countries has already exceeded the 3 percent reference value required by the Treaty on the European Union. This, together with some unfortunate public pronouncements, risks undermining private sector's confidence in the commitment of the governments to the Stability and Growth Pact. What is even more worrying is that at least one country is not planning to bring its deficit within the Maastricht criteria in 2003. It is a dangerous precedent for a relatively new institutional set-up to allow the members to break the rules on their own initiative. Fiscal “laxness” should not be allowed and it is up to our governments to re-establish confidence, by lowering expenditure and not raising taxes. On the fiscal side a much needed pension reform, which will assure the viability of the system over the next 30-50 years, would also help achieving a fiscal balance and maintaining long-term interest rates at relatively low levels.

This reaffirmation of fiscal prudence should be coupled with renewed efforts for structural reforms in Europe. In particular, market liberalization should continue, and emphasis should be placed on the labor market. In Germany, where rigidities are pronounced and which have contributed to keeping the economy almost stagnant over the past 3 years, new initiatives to ease the constraints on redundancies and discourage unemployment constitute important steps in the right direction, and should be followed by other reforms as well. Without a revitalized Germany, the EU will continue to grow over the long term at the unsatisfactory average of about 2% p.a., as was the case in the past 10 years. But reforms are needed also in most EU countries and the Lisbon goals will not be achieved if the pace of reforms does not accelerate.

Finally, with regard to inflation, which is the main policy target of the Eurosystem, I want to mention that, contrary to criticisms, the ECB has shown sufficient flexibility to accommodate an inflation of 2-2,5% for over 3 years. And this because the excess of inflation over its target of below 2% was modest and was mainly the result of external and one-off shocks (e.g. higher oil and seasonal food prices). Furthermore, as the economy has been operating below capacity, underlying inflation pressures do not pose serious risks over the medium term.

Turning now to my home country, Greece, I can report that the overall picture is much rosier. We have jettisoned the ideological shackles of the past that stifled private initiative and entrepreneurship. There is an almost unanimous acceptance now that the role of the state has to be reduced and that the growth will come mainly from the efforts and the innovative spirit of private entrepreneurs. Before highlighting a number of positive developments, I don't want to hide the challenges we still face. In particular, I would like to mention three areas of concern, namely the high debt burden, the pension system and the persistent inflation, which has ranged between 3.5-4.3% in the last couple of years.

The public debt, which ballooned in the eighties and early nineties, and after reaching over 111% of GDP, has started falling. Unfortunately, the pace of its reduction is inadequate as progress has been hindered by military expenditure (almost 5% of GDP compared with less than 2% in the EU) and the assumption of debt guaranteed by the state in the past. We hope that this sorry legacy is coming to an end. Small surplus or, at worst, a broad fiscal balance together with the projected high growth rate, will allow the debt burden to be reduced to less than 100% of GDP by 2004, but we hope that it will fall at a faster pace thereafter, and reach the level of 60 percent by 2012 at the latest. This is all the more important as Greece is bound to face additional burden from pensions as from 2015-2020.

Some steps have already been taken in the direction of restoring the pension system's long-term viability, but I am afraid that further interventions are required, and they may have to be painful if they are to be effective. On the positive side, I sense that there is now a wide consensus that a problem exists and measures needed, although reaching an agreement on the intergenerational distribution of the burden of the pension system will be a difficult and protracted process.

Turning to inflation, it has to be said that part of our differential of about 1¾% above the euro area average can be explained by the so-called Balassa-Samuelson effect. The high productivity gains we enjoy, mainly in the tradable sector, allow high wage increases also in sheltered sectors (with low productivity gains) that are passed on in the form of "excessive" price rises in service sectors. Unfortunately, productivity is not the only explanation. It seems that many agents have not understood the discipline imposed by euro area membership. In many cases, public enterprises and the government itself have used their privileged status to offer unwarranted pay increases to their employees. But also in the private sector, owing to the good corporate results, companies were not as firm in the wage rounds as they should have been. However, more recently the climate is changing, also reflecting the pressure of the public which feels that inflation is squeezing its purchasing power. There are signs of moderation in unions' claims, so that private sector wage growth, which was about 6½% in the past few years, is expected to fall to just above 5% in 2003. Similarly the Government, sensing the budgetary tightness in 2003, is holding back wage growth to more moderate rates. However, unless wage moderation is complemented by further structural reforms, inflation will continue to be higher in Greece than in the EU. In particular, the government has to simplify bureaucratic procedures, which raise business costs and discourage the set up of new companies, thus impeding competition.

Turning now to the positive factors. A substantial fiscal adjustment was achieved in the past decade, although much remains to be done in this area. The fiscal deficit was brought down from over 13% of GDP ten years ago to almost 1 per cent in 2002/2003 and it is expected to turn into a surplus once the works for the 2004 Olympics have been paid for. Significant progress has also been made toward privatizing some hitherto untouchable state monopolies.

Investment rising at about 7½% per annum since 1997 has undoubtedly been the engine of Greece's strong growth performance (in the six years to 2002 GDP grew at 3.8% p.a.). In addition to entrepreneurial dynamism, investment has been underpinned by the flow of the EU structural funds, the outlays for the preparation of the 2004 Olympics and the substantial decrease in interest rates.

Interest rates (at over 20% in the mid-1990s) fell fast, as they converged (before Greece's entry into the euro area) towards the euro area level, and (since the participation of Greece in the euro area in 2001) they fell further as the ECB reduced its interest rates over the last two years. At present good corporate clients pay close to zero real interest rates.

Falling interest rates contributed to lowering company's financial burden from over 20% of total sales up to the mid-1990s to around 10% in 2001-2. Corporate sectors' outstanding credit is only 60% of GDP, about one-half below the EU average, thus providing an important security cushion in the case of crises. Falling interest rates have also led to an explosion of consumer credit, thus sustaining strong consumer demand.

However, the positive effects from the decline in interest rates and EU structural funds are gradually diminishing. The EU structural funds have been falling as a percent of GDP in the past five years and due to enlargement they are likely to drop further after 2007-8. However, this should not affect the sustainability of the high growth rate after 2008. Because of the good use of these funds, Greece has succeeded in considerably enhancing its infrastructure and growth potential in general. An illustration of this is that between 1959 and 1992 less than 200 km of highways were built in total, whereas since then around 80 km are being built per year. The benefits from these infrastructure works and other investments will be fully felt after the completion of a number of major projects in 2004/2005, which are expected to maintain the annual productivity growth rate at about 3.5% in the years ahead. This should more than compensate for the decline of the EU funds.

The fall of interest rates is coming to an end, and may be reversed. However, euro area membership, by providing a stable monetary policy and foreign exchange framework, has allowed Greek economic agents to plan ahead without the risk of disruptive abrupt changes in economic conditions, as was often the case in the past. Indeed, lower interest rates and the elimination of the exchange rate risk have also allowed the Greek corporate sector to borrow more easily and to a greater degree. Euro area membership has permitted Greek firms to have access to cheap sources of capital, thus lifting a major constraint to Greek economic growth.

In the meantime, the dynamism of some Greek firms, together with the easier access to financing, has allowed them to attempt their first forays abroad. Far from worrying that outward direct investments are a drain on the availability of funds for domestic investment, we should see them as a sign of the dynamism of the Greek corporate sector. Greek firms have managed to secure footholds in the areas of banking, mining, manufacturing and distribution in practically all Balkan countries and even further away (some Greek companies have acquired small to medium sized companies in the EU and the USA). In many Balkan countries Greek banks represent a major share (sometimes more than 50%) of the domestic market, providing a much needed stability for these countries and a source of high profits for the banking sector, while promoting intra-regional transactions and investment.

Many foreign companies are using Greece as a stepping-stone and are expanding in the Balkans, often with the cooperation with Greek firms. The sons and daughters of the tens of thousands of Greeks communists who remained in our neighbour countries after the civil war and those who were expelled by the communist regimes of these countries and are familiar with the language and culture of the these countries are again becoming the vehicle for closer ties among all nations in the region. Greece's orientation towards the transition economies of the Balkans and Eastern Europe gives us a significant advantage. These economies are growing at a fast pace and assets are still low priced. The accession of some of them in the EU and the close links forged with the others in the context of the European Agreements already bring an expansion of trade and investment opportunities for Greek firms. Greek firms can outsource some of their production activities to neighbouring low-wage countries, and at the same time expand their high-value added activities in Greece. Flourishing Thessaloniki, the second largest city in Greece, with over 1 million people and with its port facilities, located less then 300km from landlocked Sofia, Skopje, Nicj (the second largest city in Serbia) and Tirana, is gradually being reinstated in its historic role (as in the Roman, Byzantine and Ottoman empires) as the metropolis of the Balkans. For the first time in living memory, Greece's location confers us a comparative advantage.

Less visible, but very important, is also the qualitative change taking place within Greek firms. Management is passing from members of the founding families to professional and well-educated managers. Greece now has a large pool of young people, many educated abroad, who feel at ease when working with people from other countries and eager to compete in a globalized world using modern management techniques. They represent a new generation of entrepreneurial managers, some with successful careers in international firms before being lured back home.

Their international approach is reflected in the growing stock of Greek investment abroad that I mentioned before, but also in the large number of joint ventures developed with foreign firms both in the Balkans and in Greece itself. Out of the 100 biggest non-financial firms in Greece, more than one-half are fully or partly owned or have strategic alliances with foreign companies. In the banking sector, foreign participation remains limited, as is the case in many EU countries.

At the other end, the substantial influx of immigrants is also having its beneficial effects on the labour market. Greece is now home to almost one million immigrants (around 1/3 of which are of Greek origin) who all came the last 10 years. Foreign workers represent about 17% of total employment, and have contributed in many ways to the Greek economy also by introducing a certain degree of flexibility that is not always captured by official measures. Moreover, recognizing the shortcomings in high-tech expertise, the number of computers in Greek schools has increased from less that 5000 in 1998 to 60.000 at present and further increases are underway. In two to three years time, when this generation reaches the labour market, it will be able to satisfy the advanced I.T. requirements of a modern economy.

Turning now to the banking sector, I would like to emphasize its strong position. Taking advantage of their high profitability during 1998-2000, banks increased their capital base through retained earnings and new capital issues. At the same time, in line with the Bank of Greece's directives, banks increased provisions for non-performing loans, upgraded their internal control systems and enhanced their risk management systems.

The above developments bolstered the resilience of the Greek banking system and, despite the recent sharp falls in share prices in 2001 and 2002 the average capital adequacy ratio, though below the 15% figure of 2000, is still about 12% and compares favorably with the European Union average. The soundness of the Greek banking system is all the more noticeable allowing for the rapid credit expansion to the private sector (18% average annual rate 1998-2002), sizeable investments in foreign banks, intense internal competition and falling interest rates.

More recently, in view of the prolonged world economic slowdown and reflecting the likely impact of the Iraqi crisis, the Bank of Greece, in line with its prudent tradition, called for increased provisions. The banking system, as was the case during the strong speculative attacks of 1997-8, should easily overcome any difficulty that might arise, while maintaining its role as the lubricant of the sustained rapid economic growth.

Having covered the main underlying dynamic forces of the Greek economy, as well as the black spots, I would like to finish with a note of optimism by a reputable international organization. The OECD last year, after weighing the pros and the cons, projected an average growth rate of Greece's GDP of around 3.5% p.a. up to 2007-2008, i.e. nearly, one-half faster than the euro area average.