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The financial services industry after the PSI

The banking sector and the real economy are closely interdependent: for the time being, the real economy and the PSI are pulling down the banking sector. Non-performing loans (NPLs) are on the rise, banks proceed with restructuring of loans that have a big probability of being repaid, so that fundamentally healthy companies and small businesses that are suffering from the recession do not close down. And this is a great service to the economy that few acknowledge. Banks, admittedly with some delay, have been reacting appropriately to the crisis. All banks have been engaged in a soul-searching exercise and have presented business plans, much ahead of the supposed restructuring in the wider public sector. Branches are being reduced, personnel is being reduced (in many of them by 10-20% – e.g. Agricultural Bank, New Proton Bank), wages are being cut dramatically to the tune of almost 15-20% [much more for senior personnel (35% in real terms) and significantly more for the top management], units are being merged with other units to improve cost efficiency. However, for the time being the firing costs (severance pay is equal up to18 months' salaries) do not allow this cost-cutting to be reflected in the profit and loss accounts of the banks. However, these transformations will be fully reflected in the accounts in about a year's time, when the efficiency gains will be effective and non-core activities will be disposed off and administrative costs reduced. Of course, this will not be reflected immediately in a big improvement in the cost/income ratio because income is still being squeezed, but once the situation is stabilized and even more when recovery is underway, cost/income ratios will be reduced drastically.

At the same time, banks seeing a rise in their NPLs are quickly building up provisions. Some banks built more provisions last year than the accumulated provisions of the previous ten years. Their accounts, therefore, also after Black Rock's findings, will not be questioned as was the case in the beginning of the crisis.

These actions that each bank pursues with rigor will be complemented by the economies of scale that will develop once mergers between banks start. For some banks, especially the smaller ones (but not only), it will be difficult to stand alone in a very competitive European environment, especially given the unprecedented long and deep recession. Since he took office in 2008, the Governor of the Bank of Greece, Mr.

Provopoulos, urged banks to go ahead and create bigger banks, which will be more competitive in the European scenery. Mergers and the associated synergies, including mergers of their subsidiaries in the other South-Eastern European countries, will further reduce their costs and make them more attractive to potential investors when in 4-5 years' time the HFSF exits these banks. Already Greek banks, after the funding by the HFSF, which has raised their Core Tier 1 Ratio to about 8%, are better capitalized than many European banks, whose common shares capital ratio is around 5%. I am sure that all these positive developments will convince many foreign banks, which have drastically reduced their transactions and commercial relations with Greek banks, to reconsider their policies vis-à-vis the stronger Greek banks that will develop in 2 to 3 years' time.

The HFSF, with its €50 billion firepower and its competence, will play a pivotal role in the remaking of the Greek banking sector. The HFSF considers that the managements of the banks are not responsible for the banking crisis; they are, as most other companies and simple civilians, the victims of the fiscal debacle. In the beginning of the crisis, banks were slow to understand that the international crisis would also soon hit Greece and even as late as 2009 showed exuberance-optimism, and this despite the warnings by Mr. Provopoulos and myself, when I was still Deputy Governor of the Bank of Greece. The banks' managements now know very well the problems of their banks, and they are psychologically committed to doing their outmost to make their banks profitable again. However, this will be done in close cooperation with the HFSF, which will also oversee the implementation of the restructuring plans, which should also be approved by the European Commission. Many of the bankers, who all these years had full control of their banks and ran them successfully, as underlined by the successes of Greek banks in South-Eastern Europe, are changing management practices in order to conform with the new reality.

We all live in a situation where we have lost our independence. There is an overseeing/control chain at all levels of the EU. I would dare to say that the first who lost their independence in the financial area were the big countries, including Germany, which had a paramount influence in the monetary and foreign exchange fields and many other countries were dancing to its tune. Now decisions are reached in close cooperation with the euro area partners within the ECB framework.

As far as it concerns us, the chain of control/overseeing starts with the Troika at the top, the EFSF, the Bank of Greece and the HFSF next, and finally the banks down the chain. The HFSF has to make regular reports to the Ministry of Finance, the Bank of Greece, the European Commission, the IMF and the ECB, and inform the European Financial Stability Facility (EFSF) etc.

The Services of the HFSF have acted promptly whenever our engagement was necessary, but the law and the agreements require in many cases prior consent from the European Commission, the ECB, the EFSF, the Bank of Greece etc. This procedure might take somewhat longer than if the HFSF had no constrains in the decision-making process but, on the other hand, it safeguards the interests of all stakeholders and especially taxpayer money. I would like to remind you that the Bank of Greece has the initiative to start the procedure for the recapitalization by the HFSF. The Bank of Greece decides which banks need to be recapitalized, by how much and when, and whether they are a going concern (viable) or belong to the category of resolution banks (i.e. there should be a split between bad and good bank, a transfer order – Purchase and Assumption – for good assets should be issued, with very risky assets to be disposed off by a liquidator, or a very thorough restructuring should be undertaken so that a new, smaller bank becomes viable again).

After this phase the HFSF takes over and has the initiative, but always in close cooperation with the Troika and the European Financial Stability Facility, which provides the €50 billion recapitalization bonds.

As soon as we engage in a bank, the aim is to implement a sound restructuring plan so that the bank can return to profitability and be sold to the private sector as required by the European Commission state aid rules. The recapitalization of the four big banks, as well as the HFSF involvement in Proton Bank and the three cooperative banks, have been going on smoothly and were organized in cooperation with the Bank of Greece. This paves the way for all future recapitalizations and I believe that after a couple of years a new and more dynamic banking sector will emerge, which would be able to help the real economy to rebound.

I may sound too optimistic regarding the Greek banking sector, but this optimism rests on past experience because, as the economic situation improves, banks will automatically benefit and today's vicious spiral will be transformed into a virtuous self-reinforcing cycle. Of course, this will happen only if we move at full speed to implement the reform agenda and I am optimistic that finally we are moving towards this direction.

I shall give you some historical examples, hoping to persuade analysts that whenever they considered Greece a basket case, it suddenly demonstrated a dynamism that caught most people by surprise.

- In the second half of the 1920s, for a country with a population of just over 4 million, Greece had (at considerable cost) to absorb almost 2 million of destitute refugees from Asia Minor, while at the same time the economy was hit by the 1929 world crisis. The 1930s started with bad omens and 1931 saw a further steep decline in activity. The then Governor of the Bank of Greece, as today Mr. Provopoulos, in his annual speech of 1931 asked all Greeks to accept the inevitable belt tightening, but at the same time to work hard to reform the country in order to bring Greece out of the misery. With the help of foreign advisors and funds, the turnaround was spectacular: as the then Governor said in his 1935 annual speech, not only was the pre-1931 loss of output reversed, but GDP was about 15% above the previous peak.
- After the terrible losses of human and physical capital during World War II and the Civil War, Greece's situation was desperate when peace was restored in 1950. Nonetheless, Greece's record in the 1950s was impressive: the second fastest growing economy in the OECD area (after Japan), which transformed a rural economy into an urban economy and lay the foundations for an industrial economy, which unfortunately regressed in the 1980s.
- After the first oil shock, despite the high dependency on imported energy and the huge expenses for re-armament because of the Turkish invasion of Cyprus, Greece achieved one of the highest growth rates in the OECD area: 3.7%

between 1973 and 1979 (i.e. Greece was growing 50% faster than the average of the OECD and OECD Europe).

- In 1995 nobody believed that Greece would satisfy the Maastricht criteria, and despite all accusations, with the exception of an ex-post correction of the fiscal deficit to 3.1%, all the other criteria were satisfied in full. I would like to remind that some other countries' fiscal deficits were also ex-post revised upwards, and some countries had even higher deficits than Greece. However, Greece's record was particularly impressive given that, when it started in 1994 its convergence process, its fiscal deficit was 13% of GDP, government interest payments 14% of GDP and inflation around 16%, so the distance Greece had to cover to get into the euro area was immensely greater than that of the other euro area candidates. Greek citizens and the political establishment espoused the euro area cause and participated in the necessary effort so that Greece joined the euro area only with 2 years' delay.
- In the period 1996-2004 Greece's growth rate exceeded 4%, with productive investment (excluding housing) rising twice as fast, almost 8% annually and finally the debt-to-GDP ratio falling by almost 10 percentage points to around 105%. Unfortunately, after the Olympic Games things went astray, as many Greeks, including the elite, thought that euro area membership provided only benefits and no obligations.

I am referring to these historical experiences because I believe that there is dynamism in the Greek economy, especially when the rich Greek communities operating abroad, particularly shipowners, are convinced that there is a genuine effort to redress the economy, and the Greek intelligentsia and professionals working abroad take the road back home, bringing along much needed capital and skills.

Now this dynamism is being suppressed by bureaucracy, the long, very long court procedures that sometimes make court judgments effectively irrelevant, corruption, labour market practices which are not conducive to employment creation or preservation, virtual cartel conditions in certain key areas (e.g. road haulage etc.). Reforms in these areas have begun, although at a slow pace, but I expect that the reform agenda will, with the guidance of foreign experts and a new political drive, gather momentum over the next couple of years. As is often the case, it is difficult to quantify the positive impact of each of the reforms, but we know that individual reforms are mutually reinforcing. Accordingly, after some time, there will be a strong cumulative impact, which is much greater than the sum of the impacts of each reform. Official projections, I believe, tend to underestimate the big impact that a comprehensive reform agenda has on growth. In addition, the way the European political and economic agenda is moving gives us great hopes that the present uncertainty which keeps the European economy down will be lifted and the Greek economy will benefit greatly. All the more so when a sizeable improvement in unit labour cost is underway, so that by 2014-15, Greece will have recovered the loss of competitiveness which occurred between 2000 and 2008. For all these reasons, I think that in the second half of this decade the rate of growth will approach or even exceed 3%, i.e. higher than the official projections. A high rate of growth will have multiple benefits on the banking sector and on all ratios which now entertain uncertainty and give food to speculation.