PUBLIC INTERVENTIONS AND INSTITUTIONAL ACTIONS TO SAFEGUARD FINANCIAL STABILITY AND OVERCOME THE CRISIS

THE CHRONICLE OF THE GREAT CRISIS

THE BANK OF GREECE 2008-2013

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EUROSYSTEM

CENTRE FOR CULTURE
RESEARCH AND DOCUMENTATION

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RESEARCH AND DOCUMENTATION

Overall coordination of the publication: Centre for Culture, Research and Documentation
Digital layout, printing and binding: Bank of Greece Printing Works, Commercial and Value Document Printing Section
Translation: Yorgos Seferlis, Katerina Lagaria, Sophia Mariatou, Isaac Sampethai

The photo section of the book includes photographs from the archive of the Bank's Administration. We would like to thank Vangelis Frangoulis, Elias Anagnostopoulos and "Anagnostopoulos Bros and Co" for granting permission to include some of the photos.

Printed in September 2014

BANK OF GREECE
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ISBN: 978-960-7032-65-2

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FOREWORD BY THE GOVERNOR

In 2001, when Greece joined Economic and Monetary Union and adopted the single currency, the omens were auspicious and expectations were great. The impression at the time was that Greece's inclusion in the core of European economies would act as a catalyst to accelerate its real convergence with the advanced European countries at both the economic and social level.

Unfortunately, these expectations did not materialise. In the years that followed, the economy grew, but not on the basis of a growth model that could ensure sustainable progress. The Greek society showed a clear preference for consumption over saving and investment, while it strongly reacted to attempts to change established structures. The political system assigned a big weight to political costs and hesitated to undertake decisive reform initiatives. The country enjoyed the benefits of the single currency, but did not try to meet the obligations arising from its adoption.

In the economy in particular, growth was strong, but was led by domestic demand, which was fuelled by borrowing, both public and private. The production base did not adjust accordingly and competitiveness declined rapidly, resulting in a deterioration of the external deficit. Public spending kept increasing, while revenue lagged behind, leading to large deficits and historically high levels of public debt.

These problems were repeatedly highlighted by the Bank of Greece, the European Commission and international organisations. The warnings however were not heeded, and the country continued on its carefree path, borrowing in order to consume more and more goods and services that it did not itself produce. With the onset of the global financial crisis in 2007-2008, the international environment changed drastically. In the new conditions that emerged, countries with large structural imbalances were hit the most severely. In Greece, the international financial crisis soon evolved into a sovereign debt crisis. The markets, in a context of reassessment of credit risk that did not preclude a Greek default, imposed new, more onerous lending conditions, which gradually became prohibitive.

As early as in 2008, it became evident that the economy's survival required the implementation of a multiannual programme for reducing the fiscal deficit, con-

trolling debt dynamics and carrying out extensive structural reforms. In early 2010 it became clear that it was no longer possible to cover deficits with financing from the markets. Against this background, in April 2010 the Greek government requested financial support from the euro area countries and the IMF, and in the following month the Memorandum of Economic and Financial Policies was signed. This triggered a process of sharp economic adjustment to avoid default and lay the groundwork for rebalancing the economy.

This process, currently at an advanced stage, has not been linear or painless. It had not been clear from the outset that an orderly adjustment could indeed be achieved, while an exit from the euro area often loomed and was sometimes seen as unavoidable. Moreover, the conduct of economic policy during that period was subject to critical swings between the consistent implementation of measures and —due to political cost considerations— hesitation, which peaked in mid-2011 and resurged in the period of the two election rounds in mid-2012. Finally, significant modifications were made to the original agreements with our partners, to make up for delays in the implementation of the programme or errors in initial forecasts.

Eventually, collapse and exit from the euro area, which appeared as very likely, were prevented thanks to the continued support from our partners and the efforts of successive governments. Thus, today we can look forward to the future with greater confidence, as we can expect that the economy will recover and, under certain conditions, will enter into a new, virtuous circle of growth.

The economic and social costs of the adjustment have been and remain heavy. The citizens' sacrifices have been very painful. However, the problems of recent years and the losses in terms of output, employment and incomes have been the price that was paid to prevent a collapse of the economy, towards which the country was heading due to erroneous choices of the past.

This basic position, which pervades all the analyses and interventions of the Bank of Greece, can be seen clearly in the first part of this publication, which briefly reviews the period from 2000 to 2009. As early as in late 2008, the Bank was warning that the imminent crisis would be deep and of a structural nature, adding that overcoming that crisis would require a long, systematic and painstaking effort, given that problems accumulated over several years had to be urgently addressed.

The second part of *The Chronicle of the great crisis* reviews developments during the critical four-year period from 2010 to 2013. The year 2013 was a milestone, marking the completion of major changes and a halt to the deep recession. Of course, the economy's adjustment was not completed in 2013. It still has to continue, in order to consolidate what has been achieved so far and create the conditions for growth, lower unemployment and improved incomes. However, today —in early

2014— as a cycle is closing, it would be appropriate to take stock of the progress made, evaluate actions and omissions and, most importantly, draw lessons for the future; indeed, this is the main objective of this publication.

The *Chronicle* covers developments in Greece and the international environment, and records in detail the public interventions and institutional actions of the Bank of Greece aimed to safeguard financial stability and contribute to an exit from the crisis, in response to a rapidly changing and, therefore, fluid environment. In the same period, the Bank, through its active participation in the Governing Council of the European Central Bank, contributed to decisions that were crucial to addressing the crisis in the euro area.

I believe that the *Chronicle* can prove particularly useful, since it gathers in a single volume the views and assessments of the Bank of Greece on the critical issues of the period, its institutional actions to safeguard monetary and financial stability and its contribution to the creation of a new European environment.

Whether, and to what extent, these interventions have contributed to overcoming the crisis is up to future historians to judge. But what can be safely said today is that during the crisis, as has been the case throughout its history, the Bank of Greece was a firm point of reference, an anchor of stability in an environment of tumultuous changes and heightened uncertainty. The Bank's positions, as described in detail in the chapters of the *Chronicle*, were expressed clearly and according to the following constant policy orientations:

• Greece should make every effort to remain in the euro area and steer clear of default, which would have incalculable economic and social consequences.

• The adjustment programme and the agreements with our partners ensure the financing of the Greek economy. Without them, default would have been inevitable. This is why they must be implemented with determination and consistency. Moreover, to a very large extent the programme's terms relate to changes that should have been implemented long ago.

• In order to return to growth, securing its European perspective, the country should eliminate its fiscal imbalances, improve its competitiveness and enhance the export orientation of its economy, modernise the state, restore competitive conditions in markets and reduce the burden of public debt. Greece needs a new growth model. A return to the past is not an option.

• Fiscal adjustment should rely primarily on expenditure cuts. An increase in government revenues must be sought by reducing tax evasion and broadening the tax base to make possible the necessary lowering of tax rates in the future.

• The implementation of bold structural reforms will mitigate the severity of the recession and will subsequently support and accelerate the recovery.

• The historical challenge that the country is facing necessitates the greatest possible alignment of political and social forces, an understanding at the national level and convergence of views.

• The adjustment programmes are a necessary but not sufficient condition for exiting the crisis. A radical reorientation of the economy towards a new model requires a comprehensive National Plan for Growth, which will have far-reaching goals and will be implemented consistently.

Adhering to these policy orientations, the Bank of Greece performed its institutional functions with the primary aim of protecting financial stability and bank deposits. Its contribution in this field can be judged by results. Banks have continued to operate smoothly, even in periods of acute uncertainty. Thus a banking crisis —which would also have had a direct impact on the country's future within the euro area— was prevented. At the same time, the banking system, assisted by appropriate planning on the part of the state and the Bank of Greece and despite the heavy losses it has suffered, has managed to effectively deal with the problems and has been restructured on solid foundations. By end-2013, bank recapitalisation had been well under way, 12 banks had been placed into liquidation or resolved, while any risk of contagion from the Cyprus crisis had been averted. These processes were completed without any depositor suffering the slightest loss. Today, the structure of the Greek banking sector is entirely different from the one at the beginning of the crisis. Excess capacity has largely been eliminated, with fewer but stronger banks in operation. In this regard, let me point out the enormous efforts made by the Bank to cope with unprecedented conditions that required swift decision-making and difficult and delicate handling. The Bank responded to these challenges, often outstretching its capacities, thanks to the hard work and dedication of its staff.

The *Chronicle of the great crisis* tells the story of the efforts —successful or not— setbacks, risks, achievements and delays that marked this turbulent and eventful period of recent Greek history. This narrative, in my view, can help towards an informed assessment of the path that we as a country have followed and indicate appropriate orientations for the future.

Today, nearly four years on from the first Memorandum and after five years of deep recession, we have evidently entered a new phase and the economy seems poised to recover, having come a long way in terms of adjustment. The efforts made in the preceding period have prevented developments that would have been catastrophic and have removed visible risks. But the endeavour is yet to be completed, and the remaining problems, particularly in the structural field, need to be effectively addressed. The big challenge that lies ahead of us now is how to turn the ongoing stabilisation into dynamic growth on solid foundations. This is today the top

item on the national policy agenda, the only way that can ensure that the sacrifices of the past years will not have been in vain.

April 2014

George Provopoulos
Governor of the Bank of Greece

Abbreviations

BoG	Bank of Greece
CDLF	Consignment Deposits & Loans Fund
EBA	European Banking Authority
ECB	European Central Bank
ECOFIN	(EU) Council (of Ministers) of Economy and Finance
EDP	Excessive Deficit Procedure
EEA	European Economic Area
EFSF	European Financial Stability Facility
EIOPA	European Insurance and Occupational Pensions Authority
ELSTAT	Hellenic Statistical Authority
EMU	Economic and Monetary Union
ESAs	European Supervisory Authorities
ESCB	European System of Central Banks
ESFS	European System of Financial Supervisors
ESM	European Stability Mechanism
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
EU	European Union
GDP	Gross Domestic Product
HFSF	Hellenic Financial Stability Fund
IMF	International Monetary Fund
MTFS	Medium-Term Framework of Fiscal Strategy
OMT	Outright Monetary Transactions
n.a.	not available
PSI	Private Sector Involvement
SMEs	Small- and Medium-sized Enterprises
SMP	Securities Markets Programme
SSM	Single Supervisory Mechanism

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INTRODUCTION

The purpose of this publication

The present publication aims at recording the activity of the Bank of Greece (BoG) in the 2008-2013 period, with a particular focus on its contribution towards addressing and overcoming the crisis. For that purpose, it discusses on the one hand the economic developments, the policies pursued and the climate prevailing at the time, and on the other hand the actions of the BoG in those particular circumstances.

As the events discussed are too recent to allow a properly distanced historical inquiry, the account provided here is only limited to information released by economic policy makers in Greece and abroad, most notably to the BoG's decisions, acts and other public interventions at the time.

The period examined was in many ways exceptional and will certainly mark a watershed in the history of modern Greece, dividing it into a "before" and an "after". In times which are critical and characterised by high risks, such as the ones in question, decision and policy making also tend to be critical and characterised by high risk. Throughout that period the BoG was actively involved in decision making, directly or indirectly, playing an important role domestically as well as internationally, as a member of the Eurosystem.

The role of the Bank of Greece

The BoG has primarily an institutional role, as detailed in its Statute. At the same time, however, it also has a role of advisor to economic policy makers as well as to the society at large. A few months after officially taking up duties as Governor of the BoG in June 2008, George Provopoulos summed up this dual nature of the BoG's activity, in what can be seen as a 'statement of intention', as follows:

> *"My aspiration is to ensure that the Bank of Greece can continue to effectively function as an advisor not only to the government, but to society as a whole. This approach provides me with a better understanding of our role, one that I believe we will carry on playing. We are committed to openness, keeping abreast of social developments, while always fulfilling our institutional role as precisely defined in the Treaty on European Union. At the same time, however, we pay attention to issues of income distribution, we stress the need to protect the vulnerable groups of the population and we are in favour of sustainable growth that can lead to a lasting improvement of living standards. I believe this would be inconceivable in the absence of environmental protection or without addressing social inequalities, i.e. conditions we consider essential for ensuring that society can always prosper and enjoy wealth that should grow year after year".*[1]

With a view to accurately recording the events of the period in question, the role of the BoG is examined here adopting a dual approach:

The Bank of Greece as a public institution with specific tasks and responsibilities, such as:

- to participate in the Eurosystem and contribute to ECB decisions, being entrusted with monetary policy implementation in Greece; and
- to supervise the banking system and the private insurance sector, being responsible for safeguarding financial stability and empowered to implement resolution measures for banks.

With specific regard to safeguarding financial stability, the BoG faced enormous challenges. The banking system, hit by the financial crisis and the sovereign debt crisis, had suffered heavy losses. Against this background, the prevailing conditions of —at times extremely high— uncertainty could at any moment evolve into a major crisis of confidence in the banking system, triggering developments that would most likely lead to the country's exit from the euro area. To avert such an eventuality, the BoG stepped up its action for safeguarding financial stability, aiming in particular at:

- a stricter and more effective supervision of banks;
- ensuring adequate supply of liquidity at a time when Greece and its banks were cut off from international markets;

1 Hellenic Parliament, Meeting of the Permanent Committee on Economic Affairs, 21 October 2008, Minutes.

- meeting the general public's increased demand for cash;
- safeguarding all bank deposits; and
- helping shape the conditions for restoring the soundness of the banking system and restructuring it.

The Bank of Greece as a potential advisor to the government on general economic policy issues and as a source of public information:

The Bank fulfils this role mainly through its regular and extraordinary publications and/or public interventions, including:

- the Governor's *Annual Report* on the state of the economy;
- the biannual *Monetary Policy Report,* submitted to the Greek Parliament and the Cabinet;
- occasional *Financial Stability Reports* (two in 2009 and one in 2010);
- testimonies by the Governor before the Greek Parliament;
- articles, speeches, statements and interviews of the Governor;
- periodical publications (such as the *Bulletin of Conjunctural Indicators* and the *Economic Bulletin*);
- studies on economic policy-relevant issues (authored or co-authored by BoG staff or commissioned to other researchers); and
- press releases, which provide information and communicate the Bank's official stance.

In the context of the crisis, the BoG —as a review of its communication activities would show— saw a need to enhance its public discourse and increase the frequency of its interventions, with a view to:

— warning about major risks which, although clearly looming, had not been realised by the general public; and

— raising awareness of the complexity of the problems and the need to change the course of the economy, thus contributing to the formulation of policies for an effective management of the crisis.

The BoG's public discourse has been enriched with new elements during the crisis, since the Bank has sought to strengthen its role as an advisor to society, communicating directly with the public, which in that period was inundated with conflicting and inaccurate information and signals that often resulted in confusion and higher uncertainty. Through its statements and its participation in the public debate, the BoG has aimed to present the true facts in a comprehensible manner, dispel misconceptions and misunderstandings, and provide to all citizens reliable and timely information on the available options and implications thereof. The same lines have been followed in the respective communication policies of all central banks,

which —in response to the conditions of the crisis— have shifted away from the traditional communication model whereby their public discourse was addressed to a closed circle of experts and was often cryptic.

The main reasons why central banks were led to broaden the scope of their communication have been the following:

First, the crisis brought to the fore several issues and terms related to the economy and the financial system (e.g. spreads, liquidity, credit risk, debt restructuring and sustainability, etc.) that previously concerned economists and experts alone. But when such matters started monopolising the interest of television programmes and public debate participants, central banks shifted their focus onto informing the citizens directly, so as to avoid any inaccuracies and/or misunderstandings as much as possible.

Second, the lively public debate during the crisis has often led to the adoption of simplistic approaches to complex problems, and from there on to an unnecessary overstatement of certain aspects of the situation. Expressing their own reasoned assessments and well-founded views, and explaining all aspects of the problems discussed, central banks tried to contribute to a more balanced and lucid exchange of ideas, based on correct information.

Third, in the course of the crisis, central banks have adopted extraordinary measures and have taken unprecedented action; as a result, they have come under much criticism, while the Eurosystem as a whole has often been accused of having exceeded its mandate. All this criticism could not go unanswered.[2]

Structure and contents of the study

The present study is structured in two parts, separated by the milestone of Greece's recourse to the support mechanism in late April 2010.

The *first part* (Chapters 1-3), covering the period from 2000, when it was decided that Greece would join the EMU, to the peak of the crisis in late 2009 and early 2010, seeks to demonstrate that the crisis was primarily a result of long-term domestic processes, which led to an accumulation of macroeconomic imbalances and structural problems. The global financial turmoil brought to the fore and accentuated these problems, which thus necessitated immediate and radical response.

2 For more details on the communication practices of the central banks and the European Central Bank (ECB) in the crisis period, see "Building trust in a world of unknown unknowns: central bank communication between markets and politics in the crisis", speech by Jörg Asmussen, member of the ECB Executive Board, at the European Communication Summit 2012, Brussels, 6 July 2012.

The BoG insistently warned about the seriousness of the situation, the first signs of which had already been detected in 2007, while the imbalances and problems had been repeatedly identified since the early years of that decade.

The *second part* covers the BoG's activities during the turbulent period which started with the first Memorandum of May 2010 and lasts to this day. After a positive start in terms of meeting the targets set, this period has tested the limits of the Greek economy, culminating in the open threat of a default and exit from the euro area between late 2011 and mid-2012. The greatest risk looming in this environment of extreme uncertainty was a sudden and generalised crisis of confidence in the banking system, which would lead to a collapse of the economy. This is why, since the beginning of the crisis and especially in 2011-2012, the BoG's main concern has been to avert this risk and ensure full protection of deposits, something that was indeed achieved through a series of actions that safeguarded financial stability and crucially supported the credibility, restoration of soundness and restructuring of the banking system. The second part of the study describes these actions in detail and also discusses all other interventions by the BoG, all converging on a key choice: to maintain the country's euro area membership and to work with its partners in order to ensure it.

Specifically, in the first part:

Chapter 1 begins with a brief overview of the new environment created by EMU participation. Although more favourable for the Greek economy, this environment involved serious medium-term constraints that should be taken into account in economic policy-making and implementation. Furthermore, entry into the euro area entailed a change in the institutional role of the BoG, which became an integral part of the Eurosystem and thus shared responsibility for the formulation of the single monetary policy in the euro area. The same chapter also provides an account of developments between euro area entry in 2001 and 2007, and highlights the factors that gradually led to the huge twin deficits (fiscal and external) which, in the BoG's view, constituted the main causes of the crisis. As pointed out in this chapter, fiscal policy did not take advantage of the favourable conditions offered by EMU participation and the resulting growth momentum so as to address the chronic structural causes of deficit and debt creation. In this period, the BoG highlighted several key aspects of critical issues for the economy, proposing concrete solutions for overcoming macroeconomic imbalances and structural weaknesses.

Chapter 2 focuses on the global crisis and the drastic changes it brought about to the economic environment. It discusses the swings in sentiment that strongly affected the Greek economy, as well as the efforts made at EU level to tackle the cri-

sis. These first efforts marked the initial steps taken towards an exploration of ways to rearrange the set-up and functioning of the EU and the euro area on new terms, which would not only help address the immediate problems that had emerged but also prevent the recurrence of similar problems in the future. These efforts included the decisions to support the Greek, Irish, Portuguese, and (later) Cypriot economies in cooperation with the ECB and the IMF, as well as (on different conditions) the Spanish banking system; the initiatives taken by the Eurosystem in this respect are also discussed. Meanwhile, in Greece, although developments in 2008 and 2009 had clearly shown that the global financial crisis posed a direct threat to the domestic economy as well, social and political forces had not adequately realised the magnitude of the problem.

Chapter 3 discusses the BoG's public interventions in 2008-2009. During that two-year period the BoG kept warning, indeed at a high tone, about the risks ahead and the need to drastically reorient economic policy, stressing that the international crisis was bound to have a much stronger impact on countries with structural weaknesses, such as Greece. This chapter describes in detail the Bank's warnings on all the critical issues that the situation was bringing to the fore, one after the other, namely:

— the risk of a derailment of the fiscal deficit and the liquidity problems the crisis was creating in the banking system;

— the risk to the country's creditworthiness in international markets;

— the adverse debt dynamics, which tended to become uncontrollable; and

— the threat of a protracted crisis and the difficulties it entailed.

The same chapter also reviews the policy recommendations made by the BoG – all based on its fundamental position that no measure would be sufficient unless it formed part of long-term planning for changing the growth model that had led to the crisis. Moreover, it also presents the institutional action taken by the BoG and the Eurosystem in order to shield the banking system from the impact of the sovereign debt crisis, which was leading to successive credit rating downgrades of the country and its banks.

Then, in part two of the study:

Chapter 4 describes the specific initiatives undertaken by the EU and the euro area over the four years from 2010 to 2013, concerning:

— First, the establishment of an EU framework for providing financial support to Member States, in order to address problems that, if left uncontrolled, could become systemic at the European level.

— Second, a reform of the architecture of the EU and the completion of EMU, marked by new rules and arrangements for the coordination of fiscal policies and the

convergence of macroeconomic policies, as well as by effective progress towards a banking union (particularly in 2013).

Chapter 5 describes the important initiatives taken by the Eurosystem between 2010 and 2013 in order to tackle the crisis, including both its interest rate policy and the implementation of non-standard monetary policy measures specifically designed to:

— restore the effectiveness and proper functioning of the monetary policy transmission mechanism and address the fragmentation of the credit market;

— ensure the supply of sufficient liquidity to European banks; and

— restore normal conditions in bond markets across Europe.

Chapter 6 provides a compact narrative of developments in Greece during the crisis, with most notable milestones:

— the country's request for financial support in April and the first Memorandum of Economic and Financial Policies in early May 2010;

— its promising initial performance in meeting the targets during 2010;

— the errors and delays that led it to the brink of default in the summer of 2011;

— the formation of a coalition government in November 2011;

— the conclusion of the new loan agreement and the adoption of the 2nd Adjustment Programme in February 2012;

— the peaking of uncertainty in spring 2012;

— the gradual improvement of confidence and certain economic aggregates after the elections of June 2012;

— the important statement of the Eurogroup in November 2012 on support to Greece; and

— the economy starting on a track of stabilisation in 2013, in parallel with the achievement of a primary budget surplus, the elimination of the current account deficit, negative inflation, and the first upgrading of Greece's sovereign credit rating.

Chapter 7 details the BoG's public interventions in the four years from 2010 to 2013 aimed at helping overcome the crisis. Specifically, in 2010 the BoG considered that, under the circumstances prevailing at the time, coming under the support mechanism was not only inevitable but also necessary for Greece, and outlined the preconditions for the programme's success. In 2011 it called attention to the serious delays observed in the programme's implementation, which eventually necessitated a restructuring of the debt. In 2012 it clearly argued in favour of an affirmative response to the country's historic dilemma on whether to stay in the euro area or not. In 2013 it highlighted that the main aim of economic policy should be to accelerate recovery and create the conditions for a transition to a new growth model by making best use of opportunities actually existing, and also emphasised that, against the

background of uncertainties and risks that still remained, it was imperative to ensure that all social and political forces would come together, in support of a national policy for exiting the crisis and returning to growth. At the same time, it also focused on the question of financing the economy and the role of banks.

Chapter 8 provides a detailed account of the BoG's institutional activities with a view to safeguarding financial stability. Thanks to such action by the BoG, the support provided through some critically important decisions made by the Eurosystem and the measures taken by the State, financial stability was not disrupted and all deposits were fully protected to the last euro, despite the occasional upsurges of economic uncertainty. A long list of important actions not only contributed to financial stability, but also led to the restructuring of the banking sector in Greece; these include:

— strengthening and expanding the supervisory powers of the BoG;

— clearly efficient management of banknotes (ensuring the smooth supply of credit institutions across the country with the necessary quantities of euro banknotes) and provision of liquidity (through Eurosystem operations and/or Emergency Liquidity Assistance);

— establishing an innovative institutional framework for the resolution of credit institutions and applying its rules in particular cases;

— the participation of Greek banks in EU-wide stress tests;

— conducting a diagnostic study on the loan portfolios of Greek banks;

— preparing a banking sector strategic assessment study; and

— adopting in the spring of 2013 the necessary measures to nip in the bud any risk of contagion from Cypriot to Greek banks.

PART ONE: 2000-2009

1 FROM ENTRY INTO EMU TO THE CRISIS: 2000-2007

1.1 2000: Decision to join EMU 2001: A new environment for the economy

In June 2000 the European Council decided that Greece, on the basis of macroeconomic and fiscal data for 1999, had met the criteria of the Maastricht Treaty and, as a result, was accepted as the 12th member of EMU. Thus, from 1.1.2001, Greece joined the single currency,[1] which the first 11 countries of the euro area had already adopted since 1999. This decision came after a six-year period (1994-1999) in which the pursued economic policy had managed to gradually advance nominal convergence, although neither macroeconomic imbalances had been lifted on a sustainable basis nor structural problems had been radically addressed.

The factors contributing to this development were:

(a) A large fiscal adjustment achieved through a reduction of the general government deficit from 13.6% of GDP in 1993 to 3.1% in 1999,[2] while a primary surplus first recorded in 1994 gradually increased from 2.7% of GDP in 1994 to 4.3% in 1999.

(b) A strong recovery in economic activity from 1994 onwards, as GDP growth —then at a rate of 2%— gradually accelerated to 3.4% in 1999.

(c) A fall of inflation from double-digit rates in the period up to 1993 to an annual average of 6.8% in 1994-1999 and to 2.1% in 1999, in parallel with a significant decline in interest rates.

1 Back then, the euro existed only in scriptural form, i.e. it was only used for accounting purposes. The cash changeover took place simultaneously in all twelve countries on 1.1.2002.

2 The initial deficit figure for 1999 was 1.8% of GDP, subsequently revised to 3.4% after the "fiscal audit" in 2004 and finally, with the latest data revision, to 3.1% of GDP.

(d) A weakening of debt dynamics, as a result of faster growth rates combined with the achievement of primary surpluses and lower interest rates on government borrowing. After reaching 110.1% of GDP in 1993, public debt first stabilised and then declined[3] to 105.5% in 1998 and 104.6% in 1999, thereby satisfying the second fiscal criterion of the Maastricht Treaty.

In 1994-1999, it was on monetary policy that the main responsibility fell for meeting three of the five criteria, namely those related to interest rate convergence, low inflation and exchange rate stability. Throughout that period, the monetary policy stance of the Bank of Greece was restrictive, thus curbing inflationary expectations. At the same time, the Bank also pursued a cautious exchange rate policy, in order to help meet the other criteria of the Treaty. The liquidity effect of foreign capital inflows (due to the high —albeit gradually falling— domestic interest rates) was continuously sterilised by liquidity-absorbing open market operations and mainly through the deposit facility.

Finally, in this same period (1994-1999) Greece also saw significant structural changes, mainly in the financial system, including the establishment of the secondary bond market; the end of government financing by the Bank of Greece as of 1.1.1994 under Regulation (EC) No 3604/93; and the completion of the processes for banking system and consumer credit deregulation and capital movement liberalisation.

With the entry of Greece into the euro area, the Bank of Greece became part of the Eurosystem,[4] having participated, along with all the other national central banks of the EU Member States, in the European System of Central Banks (ESCB) since the latter's inception in June 1998, as was provided for in Article 2 paragraph 3 of Law 2548/1997. The primary objective of the Bank of Greece, and of all the other central banks of the Eurosystem, is to ensure price stability in the medium term.[5] The Governing Council of the European Central Bank (ECB) formulates monetary policy for the euro area, which includes decisions on the key interest rates of the Eurosystem and on other monetary policy issues. The Governor of the Bank of Greece is a member of the ECB Governing Council and has one vote, as do all other members of the Council. In the context of the Eurosystem, the Bank of Greece carries out a variety of tasks,[6] the most important being

3 According to the information available in early 2001. Debt data were revised repeatedly thereafter. Based on the latest revision, the debt ratio was 94.5% of GDP in 1998 and 100.3% in 1999 (see Table 2).

4 The Eurosystem comprises the European Central Bank and the 18 (as of January 2014) national central banks of the euro area countries.

5 Article 127 of the Treaty on the Functioning of the European Union.

6 The Bank's other major tasks, such as the supervision of the banking system and of private insurance, were mentioned earlier in the Introduction.

its participation in the formulation of the single monetary policy of the euro area, as well as in its implementation in accordance with the guidelines and instructions of the Eurosystem.[7]

The adoption of the single currency provided the Greek economy with a stable macroeconomic environment, unprecedented by Greek standards, which ensured the conditions for long-term economic growth.

Firstly, foreign exchange risk and the associated uncertainty in cross-border trade and financial transactions was eliminated. This was even more important given the Greek economy's long history of currency crises and —often ineffective— devaluations of the drachma.

Secondly, inflation, which hovered at double-digit rates from 1973 to 1994, fell to an annual average of 3.3% in the period 2001-2007.

Thirdly, the interest rates on government, business and household borrowing[8] progressively declined to historically low levels. Indicatively, the average rate on three-year Greek government bonds,[9] which stood at 22% in 1990-1994, fell to 12% in 1995-1999. As regards ten-year bonds, their yield at issue fell from 8.60% in 1998 to 5.35% by end-2001, and their yield spread over the corresponding German bond narrowed from 65 basis points in early 2002 to 10 basis points by January 2005. A crucial factor that helped maintain a low level of nominal interest rates in Greece after the adoption of the euro was the decline in the foreign exchange risk premia incorporated in domestic interest rates. Moreover, lower interest rates on government bonds reduced public debt service costs.

Finally, the access of businesses and consumers to low-interest bank lending became much easier compared to any other period since World War II, as indicated by the high rates of credit expansion (although from a relatively low base).

In brief, EMU participation resulted in a removal of significant short-term constraints on the financing of chronic current account deficits and on government foreign borrowing.

7 The Bank of Greece conducts liquidity-providing monetary policy operations (main and longer-term refinancing operations), offers two standing facilities, i.e. the marginal lending facility and the deposit facility, and applies a minimum reserve system whereby credit institutions operating in Greece are required to hold reserves in accounts with the central bank. Other tasks of the Bank refer to the compilation of banking statistics, putting euro banknotes into circulation, and the operation of payment systems. For a more detailed description of all Bank of Greece activities, see http://www.bankofgreece.gr/Pages/el/Bank/responsibilities.aspx.

8 For the evolution of interest rates on business and household loans, see http://www.bankofgreece.gr/Pages/el/Statistics/rates_markets/deposits.aspx, Tables 3 and 4.

9 Until 1992 the Greek government bonds were issued with a maximum maturity of three years. Subsequently, bonds with maturities of four, five and seven years were gradually introduced, while the first bonds with maturities of ten or more years were launched in 1998.

The euro created the objective conditions for an overall restructuring of the Greek economy on sound foundations, as it facilitated the implementation of reforms for a gradual adjustment to a new production model that would ensure sustainable and competitive growth.

Nevertheless, the adoption of the euro came with specific requirements. The removal of short-term constraints was accompanied by the introduction of strict medium- to long-term constraints. By participating in EMU, Greece on the one hand acquired unhindered access to international money and capital markets at historically low interest rates, but on the other hand it lost the option of conducting monetary policy and exchange rate policy at the national level. Against this new background, to address any loss of competitiveness, member countries would have to correct/adjust their domestic prices and labour costs and try to improve productivity in order to prevent unemployment from rising in the medium term. Also, it was no longer possible to reduce domestic debt via inflation (debt monetisation),[10] which made prudent fiscal management all the more important. In precisely this light, the Stability and Growth Pact (SGP) was adopted in 1997 to ensure fiscal discipline in the euro area.

Participation in the euro therefore entailed risks for countries that would pursue economic policies with a short-term horizon, without taking into account the strict medium-term constraints. These risks, however, could be avoided by means of increased fiscal discipline, a moderate incomes policy, and continuous improvement of an economy's international competitiveness. Greece lagged behind substantially in all these three areas – as some other countries also did, albeit less.

1.2 2000-2007: Strong growth driven by domestic demand

The new environment created by EMU entry had a major positive effect on expectations and economic activity.

In the next seven years (2001-2007)[11] the Greek economy grew at an average annual rate of 4.2%, which moderated to 3.6% for the eight years from 2001 to 2008 (due to the recession recorded in 2008). But this growth was based on domestic demand, which was growing at a rate of 4.5%, driven mainly by private consumption,

10 It should be noted that such a practice leads to considerable macroeconomic imbalances, and is thus considered unsustainable.

11 As the Hellenic Statistical Authority (ELSTAT) has not released revised data for 1999, all revised series start from 2000 and growth rates can only be calculated on a comparable basis for the years from 2001 onwards.

Table 1 Annual percentage changes in key macroeconomic aggregates, 2001-2008

Year	GDP	Private consumption	Public consumption	Gross capital formation	Average earnings in total economy (nominal)	Inflation	Unemployment (% of labour force)
2001	4.2	5.0	0.7	4.8	4.7	3.4	10.8
2002	3.4	4.7	7.2	9.5	6.6	3.6	10.3
2003	5.9	3.3	-0.9	11.8	5.6	3.5	9.7
2004	4.4	3.8	3.5	0.4	7.2	2.9	10.5
2005	2.3	4.5	1.1	-6.3	4.4	3.5	9.9
2006	5.5	4.4	3.1	14.9	5.7	3.2	8.9
2007	3.5	3.6	7.1	22.8	5.2	2.9	7.3
2008	-0.2	4.3	-2.6	-14.3	6.2	4.2	7.6
Average annual rate of change:							
2001-2007	4.2	4.2	3.1	7.9	5.6	3.3	9.8
2001-2008	3.6	4.2	2.4	4.8	5.7	3.4	9.5

Sources: ELSTAT and Bank of Greece.

which —fuelled by rising incomes and consumer credit expansion— was increasing at a rate of 4.2%, i.e. as fast as GDP. Fixed capital formation, with an average annual rate of 7.9%, outpaced GDP growth, but largely stemmed from housing investment, which benefited from low mortgage rates and expectations of rising incomes and rose at an average annual rate of 9.7% during those seven years. Nevertheless, non-residential fixed capital formation also increased at a high rate (6.5%) (see Table 1).

Inflation remained low by Greek standards, averaging 3.3% per annum, but was consistently higher —by nearly 1.5 percentage points— than the euro area average, resulting in continuous losses in competitiveness. It is estimated that between EMU entry and 2007 the Greek economy's international competitiveness declined by 14% based on relative consumer prices and by 19.3% based on relative labour costs, while exports of goods and services (at constant prices) grew at a relatively low average annual rate of 3.4% in the seven years from 2001 to 2007.

From the above it is clear that private consumption, boosted by rising incomes and credit expansion, and residential investment were essentially the drivers of the rapid rise in economic activity during 2000-2007, while the —also strong— growth of other investment contributed comparatively less. Nevertheless, as domestic output failed to respond —in terms of both quality and quantity— to developments in

Table 2 Competitiveness – fiscal aggregates

All aggregates as percentages (%) of GDP, unless otherwise indicated

Year	Annual percentage changes in real effective exchange rate (on the basis of relative consumer prices/on the basis of relative unit labour costs)	Current account balance	Trade balance	Credit to households by domestic MFIs (consumer credit)	Credit to non-financial corporations by domestic MFIs	General government revenue	General government expenditure	General government net borrowing (deficit)	Public debt
2001	1.1 / 0.7	-7.2	-14.8	5.4	34.3	40.9	45.4	-4.4	103.7
2002	2.6 / 4.0	-6.5	-14.5	6.2	35.1	40.3	45.1	-4.8	101.7
2003	5.5 / 4.0	-6.5	-13.1	7.2	35.4	39.0	44.7	-5.7	97.4
2004	1.9 / 4.3	-5.8	-13.7	9.2	38.6	38.1	45.5	-7.4	98.6
2005	-0.1 / 0.5	-7.6	-14.3	11.3	42.0	39.0	44.6	-5.6	100.0
2006	0.8 / 0.8	-11.4	-16.9	12.7	44.9	39.2	45.3	-6.0	106.1
2007	1.6 / 1.6	-14.6	-18.6	14.3	49.9	40.7	47.5	-6.8	107.4
2008	2.5 / 7.1	-14.9	-18.9	15.6	56.8	40.7	50.6	-9.9	112.9
Average annual percentage of GDP (or rate of change):									
2001-2007	1.9* / 2.5*	9.1	-15.5	10.1	41.2	39.6	45.5	-5.8	102.2
2001-2008	2.0* / 3.1*	-9.8	-15.9	10.8	43.2	39.7	46.1	-6.3	103.5

* Cumulative change in the 8-year period 2001-2008: 16.9% (on the basis of relative consumer prices), 27.7% (on the basis of relative unit labour costs).
Sources: ELSTAT, Eurostat and Bank of Greece.

domestic demand, the gap was filled by imports of goods and services (which at constant prices grew at an average annual rate of 4.5% in the seven years from 2001 to 2007), causing the current account deficit to gradually rise to unsustainable levels – from 3% of GDP per annum on average in 1994-1999 to 8.5% in 2000-2007. In 2007, the current account deficit exceeded 10% of GDP, rising further to 14.9% in 2008. If Greece had not adopted the euro, it would have been unable to finance an external deficit of this magnitude and would have experienced a devaluation of the national currency and high inflation. Imports were financed by low-interest rate foreign borrowing by both the private and the public sectors of the economy. At the same time, Greek exports of goods and services as a percentage of GDP lagged behind those of other peripheral euro area countries (23.8% in 2007, compared with 26.9% for Spain, 32.2% for Portugal, and 28.9% for Italy).[12]

12 See European Commission, *Statistical Annex to European Economy – Spring 2013*.

Moreover, high private consumption led to a significant increase of the share of the trade sector in total value added, from 14.1% in 2000 to 17.4% in 2007,[13] largely concentrated on imported non-durable and durable consumer goods, reflecting a shift in consumption patterns. Indicatively, the annual average number of new registrations of private passenger cars (by definition imported) in Greece rose from 148,100 in 1990-1998 to 270,200 in 1999-2008, i.e. almost doubled.[14]

1.3 Widening of the general government deficit: Initiation of the Excessive Deficit Procedure

The policies pursued after EMU entry failed to effectively address the Greek economy's structural problems through reforms that would have allowed it to converge to the production models/patterns of other European countries.

Especially as regards public finances, following EMU entry the fiscal policy stance should have remained restrictive, with a view to limiting the risk of unbalanced growth, reducing the high public debt and meeting the country's obligations under the Stability and Growth Pact. In fact, the exact opposite happened: the fiscal stance became expansive and remained so until the end of 2004, despite the fact that virtually from May 2004 Greece was subject to an Excessive Deficit Procedure (EDP).[15] Owing to the EDP, there was a slight tightening in the fiscal stance (the so-called "mild adjustment" policy) between 2005 and the third quarter of 2007, but the stance was reversed thereafter.

In more detail, in the first period after joining the euro area the Greek general government deficit continued to rise until 2004 (to 7.4% of GDP, from 3.1% in 1999). Correspondingly, the primary surplus, that in 1999 amounted to 4.3% of GDP, started to gradually decrease after 2000, and in 2003 switched to a primary deficit of 0.8% of GDP. For a decade afterwards, the general government sector continuously recorded primary deficits. The uninterrupted widening of the headline deficit up to end-2004 was due both to revenue shortfalls (recorded repeatedly from 2001 onwards) and continuous primary expenditure overruns.

Once the deficit had surpassed the reference value of the Treaty (3% of GDP), an excessive deficit procedure was initiated against Greece in July 2004. By an

13 Including retail and wholesale trade as well as vehicle trade, according to ELSTAT detailed national accounts data.

14 ELSTAT data.

15 The official decision was made on 5.7.2004.

ECOFIN decision on 17.2.2005, Greece was invited to adopt new structural measures. In this context, fiscal policy was tightened, resulting in a reduction of the deficit to 2.6% of GDP in 2006, according to data available at that time.[16] However, the achieved adjustment had relied on one-off measures[17] and was thus unsustainable.

Nevertheless, based on estimates made at the time, implying a deficit of less than 3% of GDP for 2006, the ECOFIN Council decided on 6.6.2007 to terminate the EDP. This was followed by a relaxation of the fiscal policy stance in the second half of 2007, and fiscal aggregates deteriorated anew.[18]

A serious problem that arose during that period, destined to take large proportions in the next few years, was the doubt cast on the reliability of Greek fiscal data due to the repeated revisions. A first considerable revision took place in June 2002, when the European Commission finalised a new and stricter set of guidelines on public finance statistics, under which the 2000 and 2001 deficits were revised upwards by 1.0% and 1.5% of GDP respectively, while debt data were revised even more, as all new financial products were recorded.

Yet, the major revision of Greek budgetary data came two years later, with the so-called "fiscal audit". On 31.8.2004 the Greek authorities notified Eurostat of an upward revision of the deficit for all the years from 2000 to 2004 (see Table 3).[19]

Undoubtedly, the correctness of fiscal data had to be restored. The 2004 audit, however, was given an unwarranted wide publicity, thus overstepping the limits of a purely technical or methodological issue to be sorted out by experts. This had a negative impact on the credibility of Greek fiscal data as a whole — with two immediate adverse effects, accompanied by long-term implications:

16 The data were repeatedly revised. Reported here are those available in late 2006 and early 2007. Subsequently the deficit was revised to 7.5% of GDP for 2004, 5.5% for 2005 and 5.7% for 2006.

17 According to the official data notified to the European Commission in spring 2007, the deficit reduction over the previous two years (2005-2006) had been around 4.5% of GDP and had been achieved by means of: (i) extraordinary tax measures (generating one-off revenue) amounting to 1.7% of GDP; (ii) public investment cuts in the order of 1.2% of GDP; (iii) a marginal containment of expenditure; (iv) an automatic drop of expenditure, due to the completion of projects associated with the Olympic Games; and (v) an automatic reduction of interest payments and defence expenditure, due to a change in the relevant statistical methodology in the context of the fiscal audit.

18 Drivers of this development were the early elections held in September and the devastating fires in the western Peloponnese. Moreover, since the beginning of 2007, pensions paid by OGA (Agricultural Insurance Agency), the EKAS (Pensioners' social solidarity benefit) and unemployment benefits were raised by 21.7%, 21.9% and 18.1%, respectively, thus contributing significantly to the rise in higher primary expenditure.

19 The revision was due to factors such as a change in the methodology for recording expenditure for defence equipment purchases, the revised surpluses of social security funds, the changes as regards the timing of revenue recording, and the revised amount of (non-defence) expenditure included in the Budget. The effect of these factors varied across years.

Table 3 Revised general government deficit*

% of GDP

	1997*	1998*	1999*	2000	2001	2002	2003	2004
Notification of 27.2.2004	4.0	2.5	1.8	2.0	1.4	1.4	1.7	1.2
Notification of 31.8.2004	6.0	4.3	3.4	4.1	3.7	3.7	4.6	5.3
Current estimates	5.9	3.9	3.1	3.7	4.5	4.8	5.7	7.6

* Data for the years 1997-1999 were revised unilaterally by Eurostat.
Source: (a) for the notifications of 27.2-31.8.2004: data notified under the Excessive Deficit Procedure; (b) for current estimates: European Commission, *Statistical Annex to European Economy-Spring 2013*.

— First, the unilateral revision by Eurostat of the data for the three-year period 1997-1999, based on which Greece's participation in the EMU had been decided.[20] It should be noted that, on the basis of these revised figures, the budget deficit criterion of the Treaty (below 3% of GDP) now appeared not to have been met by Greece in 1999 – as was also the case with other countries for the corresponding period, e.g. Portugal for 1997.

— Second, the association of the fiscal audit with the change of government, a fact that suggested a lack of continuity of the state.

1.4 2007:The Greek economy stands vulnerable to the crisis

The first decade of the 21st century had quite auspicious beginnings. The adoption of the single currency, bringing along significant positive effects on the functioning of the economy but also appearing to upgrade the country's standing within the global community, created expectations that Greece would start orienting itself towards a substantial modernisation of its overall structures, at all levels — economic, social and political. Regrettably, such expectations did not materialise. The decision to join the EMU was not accompanied by a far-sighted policy that would

20 Eurostat, *Report by Eurostat on the Revision of the Greek Government Deficit and Debt Figures*, 22.11.2004.

facilitate the economy's adjustment to the new environment. The key challenges facing Greece at the time referred to steadily and permanently gearing fiscal policy towards the requirements of the Stability and Growth Pact and implementing structural reforms to the functioning of the public sector, the economy and the markets, so as to foster a growth-friendly environment within the new context of EMU participation and thus achieve the goal of real convergence (following nominal convergence that had been achieved in the run-up to euro area entry). In both of these key areas results were poor, while any efforts initiated in this direction were often abandoned soon afterwards under pressure from powerful and organised interest groups.

While Greece embraced and enjoyed the benefits of the single currency, it did not comply with the requirements entailed by euro area participation, namely to reduce its budget deficit below 3% of GDP and, over a period of ten years, bring its government debt below 60% of GDP.[21] As a result, Greece was subject to an EDP in July 2004 (as mentioned above) and once again in April 2009 (as discussed below in Chapter 2.4).

But even after coming under an EDP, Greece failed to make a coordinated effort to ensure a lasting improvement of its public finances, in other words to achieve a sustainable fiscal position. Revenue shortfalls against the targets were constant and were typically addressed by extraordinary measures yielding temporary results. On the primary expenditure side, rather than an effort of rational containment, there were new handouts.

Crucially, Greece lacked the institutional fiscal framework necessary to control budget deficits. The European Commission had also promoted the creation of such an institutional framework at EU level, while the report on the Stability and Growth Pact reform (March 2005) stated that "...national budgetary rules should be complementary to the Member States' commitments under the Stability and Growth Pact...".

These economic policy shortcomings led to a continuous rise in public debt, which in the eight years up to 2007 surged by €112.9 billion. In fact, it is characteristic that the government debt ratio persisted around 100% of GDP, de-

21 An apt comment in this respect was made by J.-C. Trichet in an interview to the German magazine *Focus* on 19.1.2010, i.e. after the onset of the Greek crisis. Asked whether France and Germany should help Greece, the ECB President said: "…We — the 330 million citizens of the euro area — share a common destiny. In a monetary union the ties between the individual member countries are indeed extremely close. The external surpluses of some member countries (in the balance of payments) finance the external deficits of some others; and the constellation can change over time. We all share a credible currency, which is an immense advantage. At the same time, all countries owe it to their partners in the euro area to behave responsibly and correct their imbalances".

spite the extremely favourable conditions for its reduction that prevailed at the time: (i) average annual GDP growth of over 4% in real terms and 8% in nominal terms; (ii) very low interest rates on government borrowing, falling until end-2005 when they averaged 3.2%; (iii) primary surpluses up to 2002; and (iv) privatisation proceeds for several years. The fact that all the determinants of the debt ratio were improving but the ratio itself remained virtually unchanged pointed to the existence of fundamental fiscal imbalances. This fact alone should have been enough to sound the alarm that the country's fiscal position was unsustainable.

For some time, these problems were concealed by strong GDP growth. Still, risks to the economy from the high public debt[22] remained and were growing. In April 2007, the Bank of Greece, referring to debt developments, noted that:

> *"...The considerable rise in interest rates over the past 15 months and their potential further increase —underscoring the risks and uncertainty related to the high public debt— will effectively contain the positive impact of low interest rates. Finally, the robust rates of economic activity seen in the past decade cannot be maintained for ever. (...) The above show that it is imperative to create large primary surpluses and accelerate the efforts to reduce the debt below 60% of GDP, if possible, within the next ten years."*[23]

At the social level, steadily improving incomes and easier access to borrowing had a decisive impact on consumer patterns. Strong private consumption had a positive effect on GDP growth, but limited domestic savings and overburdened the country's external balance. At the same time, society continued to pin hopes and expectations on the state. A commonly held perception that the state should be taking care of everything persisted even after the adoption of the euro, thus limiting self-motivation, initiative and responsibility. In parallel, equally problematic was society's relationship with institutions, which were not seen as the obvious basis for guiding practices and behaviour. As a consequence, phenomena such as the underground economy, tax evasion, non-compliance with building and land use regulations and corruption, rather than being curbed, perhaps even intensified, thus decisively contributing to the adverse developments.

So, by the end of 2007 it had become clear that the economy was extremely vulnerable to potential negative developments, such as a rise in interest rates on government borrowing or difficulties in public debt refinancing. It was also clear that the

22 For a comprehensive analysis of the implications of high public debt, see *Monetary Policy - Interim Report 2009*, October 2009, pp. 111-117.

23 Bank of Greece, *Annual Report 2006*, April 2007, p. 226.

economy lacked both the resilience and the institutional apparatus that would make possible appropriate policy responses to a sudden macroeconomic deterioration.

1.5 2000-2007: The Bank of Greece calls attention to key economic policy issues

The major problems identified in the previous section were visible during the entire period that began in 2000 with the decision on Greece's entry into EMU, despite strong growth performance. Throughout that period, the Bank of Greece, in its public communications, never ceased to highlight and analyse the relevant macroeconomic imbalances and structural problems or indicate the appropriate medium-term economic policy orientations.

As early as in December 2000, i.e. on the eve of EMU participation, the Bank organised jointly with the Brookings Institution a particularly important conference on Greece's economic performance and prospects, bringing together eminent foreign and Greek economists. The participants' presentations covered in depth all the crucial medium- to long-term aspects of the Greek economy, convincingly documenting the need for fiscal consolidation and for structural reforms in the product and labour markets and the public sector.[24]

In April 2002, i.e. 16 months after euro area entry, the Bank's *Annual Report for 2001* explored the economy's medium-term prospects and challenges. In particular, it noted that the favourable effect of certain important factors on long-term growth prospects would be gradually and perhaps substantially reduced after the next five years. At the same time, it clearly formulated recommendations on the policy orientations that were deemed necessary given this prospect. These included an effective utilisation of the available resources at the time (particularly EU funds), a continuation of the fiscal consolidation efforts and an acceleration and expansion of reforms in various sectors so as to ensure strong and sustainable growth. In this context, it made detailed references to the "key problem of social security", the necessary tax reform, the modernisation of public administration, a more efficient operation of the labour market, the importance of privatisations and of opening up critical markets, the need to continue the liberalisation of the energy market, and the further enhancement of the banking system's efficiency.[25]

24 The papers presented at the two-day conference were published by the Bank in February 2002 in English, followed by a Greek translation in February 2003.

25 See Bank of Greece, *Annual Report 2001*, April 2002, Chapter II, Sections 7.2-7.3, pp. 45-57.

In November 2002, in response to a then recently enacted law on social security, in its *Monetary Policy – Interim Report 2002* the Bank discussed in detail the social security reform and stressed the importance of developing the second and the third "pillars" of the social security system – an issue that remains topical even today and has been highlighted in recent reports of the Bank, in November 2012 and May 2013.

Regarding fiscal policy in general, the Bank has published analyses of the budgeting process, numerical fiscal rules (that set limits on the deficit or on public spending) and independent fiscal councils (April 2007), as well as of the budget deficit calculation methods and the available data (October 2003).

Assessing the structural reforms promoted in product and labour markets, and highlighting their importance were constant preoccupations of the Bank in its various reports over the period 2000-2007.[26] Meanwhile, the reports also analysed a series of other key issues.[27]

Inflation determinants, the role of unit labour cost developments, the persistently positive differential between Greek and euro area inflation rates, productivity growth, and loss of cost/price competitiveness, also represented permanent focal points of the Bank's reports in that same period.[28] The issue of wage increases was examined in depth in March 2004.[29]

In parallel, these reports also highlighted economic topics of a broader social relevance, such as poverty, inequality and the effectiveness of social expenditure (October 2005; April 2007), the effects of immigration (April 2007), as well as regional policy and its prospects (April 2006; April 2007). Similar issues were also discussed in the studies published in the Bank's *Economic Bulletin*.[30]

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26 In particular, it discussed matters such as liberalisation of the electricity market (April 2001); market penetration of ICT (April 2004); competition in the product markets (February 2005); competitiveness-boosting reforms and regulatory interventions in economic sectors (February 2006), and administrative burdens on business activity (April 2007).

27 Including the inflows from EU Funds and their prospects under EU enlargement conditions (April 2002, April 2003, April 2004, April 2005, April 2006); the importance of shipping and tourism for the Greek economy (April 2003, April 2004, April 2007); the international investment activity of Greek enterprises (April 2006), as well as the emergence of new players, such as China and India, in the world economic arena and their economic relations with Greece (April 2004, April 2005, April 2006).

28 Reports of April and November 2000, April 2001, April 2002, April 2003, February 2007, and October 2007.

29 *Monetary Policy 2003-2004,* March 2004, Appendix to Chapter V, "The impact of wage increases on economic performance".

30 *Inter alia*, the effect of education on wage inequalities (July 2004, February 2007); the redistributive effects of indirect taxation and inflation (July 2003, January 2005); wage differentials between the public and the private sector, as well as gender wage differentials (July 2003, July 2004), youth and female labour market participation (January 2006, October 2007); the duration of unemployment (July 2006); and the *per capita* income and productivity developments (August 2005).

Finally, it goes without saying that the Bank's reports paid special attention to developments in the financial system,[31] while numerous studies on banking and financial issues were published in the *Economic Bulletin*.[32]

1.6 Addendum: the main characteristics of the period and the assessments of the Bank of Greece

In light of all the above, it becomes evident that fiscal policy in the period 2000-2007 failed to take advantage of the favourable conditions created by EMU participation and strong growth in order to address the country's chronic structural problems regarding deficits and debt. In contrast, continuously rising public and private debt fuelled consumption, which up to end-2007 was increasing faster than in the rest of the EU. On the other hand, strong GDP and productivity growth were not accompanied by an expansion and diversification of the production base, which remained inward-looking, while competitiveness kept declining and the deficit of external transactions grew to unprecedented levels. In sum, all the above added up to a distorted/unbalanced growth model, which was unsustainable, as was insistently pointed out by the Bank of Greece as well as by international organisations.

During that period, the Bank of Greece called attention to many aspects of the Greek economy's critical issues, recommending specific solutions for addressing macroeconomic imbalances and structural weaknesses. Ever since the country's entry into EMU, the Bank constantly expressed the view that the factors driving rapid growth were only conjunctural and thus destined to lose much of their strength over the coming years. This was why chronic weaknesses had to be urgently addressed. The foregoing references represent a selective array of public statements, analyses and studies of the Bank of Greece focusing on critical questions such as the need for

31 In addition to analyses of the data collected through its surveys of the Greek households' borrowing and indebtedness (March 2003, April 2006), the Bank of Greece also published studies on the change in the value of Greek household assets in dwellings, equities and Greek government paper (November 2002, April 2003), on the household savings ratio (April 2002, April 2003), on the evolution of Greece's financial system over the period 1993-2003 (October 2003), and on the availability of funding for SMEs and new businesses (October 2007).

32 Including those on financial deregulation and private consumption (December 2000); on the monetary policy transmission mechanism (December 2001); on competition in the Greek banking system (July 2002); on private savings (July 2002); an extensive special study of the monetary policy in Greece in 1990-2000 through the publications of the Bank of Greece (January 2003); on the effect of bank mergers and acquisitions (January 2004 and January 2005); on bank profitability (January 2005); on household debt (August 2005 and February 2007); on the Greek enterprises' external financing and capital structure (January 2006); as well as on the determinants of bank deposit and lending rates (February 2007).

fiscal consolidation, reforms, the effective functioning of markets, etc. – i.e. problems that eventually had to be dealt with a few years later, through emergency measures and at a great cost.

2 THE ONSET OF THE CRISIS: 2008–2009

2.1 The international dimension

The financial crisis, which originally broke out in the US in August 2007, and then rapidly deteriorated in autumn 2008 with the collapse of the Lehman Brothers investment bank, evolved into a global economic crisis within the environment of closely interlinked economies, causing the greatest recession since the 1930s and a serious deterioration of public finances in most countries. There was an adverse impact on all the economies of the world.

In 2009 the world economy recorded negative growth for the first time in the post-war period, as most advanced economies went into deep recession and economic activity in emerging economies slowed down considerably. All euro area countries recorded negative rates of change in GDP, while the recession was greater in the more open economies, which suffered particularly due to the rapid decline of world trade (by 10.7%) that year. Of course, these more open economies were also the first to benefit from the recovery of the world economy and international trade that started in 2010.

By contrast, countries with serious external and domestic macroeconomic imbalances and structural weaknesses lacked the resilience and flexibility required to independently cope with the impact of the financial and economic crisis and to benefit from the recovery of world economy and trade that followed the great recession of 2009.

Thus, although countries with sound key economic aggregates managed to get back on a growth track within a relatively short time, countries with large macroeconomic imbalances and structural weaknesses faced great difficulties and in some cases had to resort to external financial assistance. Equally large was the divergence in the area of employment as well, since economies with sound fundamentals and a satisfactory degree of flexibility were able to maintain low unemployment rates, whereas unemployment in economies with serious structural weaknesses rose rapidly.

Fiscal aggregates deteriorated considerably due to the crisis, as a result of both the various measures adopted by governments for strengthening economic activity and supporting the financial sector, heavily struck by the crisis, and the operation of the automatic fiscal stabilisers. In the advanced economies, the government deficit as a percentage of GDP rose from 3.5% in 2008 to 8.8% in 2009, before declining to 5.9% in 2012 (in the US it widened from 6.5% in 2008 to 12.9% in 2009, but then fell to 8.3% in 2012; in the euro area it rose from 2.1% in 2008 to 6.4% in 2009 and then narrowed to 3.7% in 2012). Public debt as a percentage of GDP followed a similar path: in the US it rose from 73.3% in 2008 to 86.3% in 2009 and then to 102.7% in 2012; in the euro area it rose from 70.3% in 2008 to 80.1% in 2009 and then to 93.0% in 2012.

2.2 Policies for coping with the world financial crisis

The crisis demonstrated the need to improve the institutional regulatory and supervisory framework of the global financial system and led to the support of the financial sector and to its restructuring in many countries. In Europe, the financial crisis and —later on— the sovereign debt crisis expedited the implementation of extensive reforms in the governance of EMU.

In October 2008 the euro area countries agreed on taking coordinated action to stabilise the banking system. The Paris Declaration, signed by the euro area country leaders on 12 October 2008 and then adopted by the European Council on 15-16 October, provided for coordinated measures to restore confidence and improve financing conditions. These measures included granting government guarantees for bank-issued debt securities as well as bank recapitalisation.

In December 2008 the European Council approved the European Economic Recovery Plan, which aimed at supporting economic activity by stimulating aggregate demand and at intensifying efforts for the implementation of structural reforms.

Moreover, in December 2008 the ECOFIN Council set the broad orientation concerning a draft Directive for raising the maximum coverage level of deposit guarantee schemes from €20,000 to €50,000 in June 2009, and its harmonisation at €100,000 as of 31.12.2011, so as to enhance confidence in the banking sector. In the same month, the ECOFIN Council decided to increase the total financing provided through the mechanism for the medium-term economic support of the balance of payments of non-euro area EU Member States from €12 billion to €25 billion. Three EU member states (Hungary, Latvia and Romania) made use of this mechanism in the period 2008-2009 (see Box 2.1).

Table 4 Key decisions of EU institutions and bodies (euro area summits, European Council, ECOFIN) on the financial system in the EU and on the Greek economy, 2008-2009

Date	Decision
12.10 and 15-16.10.2008	Informal summit of the euro area countries "Declaration on a concerted European action plan of the euro area countries" on the financial system. European Council Endorsement of the above plan.
7.11.2008	Informal meeting of Heads of State or Government of the EU Common principles upon which to build a new international financial system ahead of the G20 Summit on 15 November.
10.3.2009	ECOFIN Council Opinion on the updated Stability Programme of Greece, calling on the country to strengthen the fiscal consolidation path in 2009, improve long-term fiscal sustainability and implement a package of structural reforms.
19-20.3.2009	European Council Agreement that the de Larosière report will be the basis for strengthening financial sector regulation and supervision.
3-4.4.2009	Informal ECOFIN Council decision on the existence of an excessive deficit in Greece and recommendation on measures to correct the excessive deficit by 2010 (both issued formally on 27.4.2009).
18-19.6.2009	European Council Agreement on the creation of a European Systemic Risk Board and a European System of Financial Supervision.
23.9.2009	European Commission New legislative proposals on the establishment of the European Systemic Risk Board (macro-prudential supervision) and the European System of Financial Supervision (micro-prudential supervision) for approval, so that the new structures start functioning in 2010.
20.10.2009	ECOFIN Adoption of a road map on strengthening EU financial stability arrangements.
10.11.2009	ECOFIN The Greek government is asked to urgently take measures to restore the confidence of the European Union in Greek statistical information, following renewed problems with Greek fiscal statistics; the Commission is also invited to propose the appropriate measures for this situation.
2.12.2009	ECOFIN Council decision establishing that Greece's response to the recommendation issued in April 2009 on measures to correct its excessive deficit has been insufficient.
10-11.12.2009	European Council The Council welcomes the entry into force of the Treaty of Lisbon on 1 December. Emphasis is given on the implementation of the Stability and Growth Pact and on the importance of the ECOFIN decisions of 2 December (concerning the fiscal policies of Greece and other Member States).

Source: Bank of Greece.

The interventions aimed at coping with the financial crisis at EU level culminated in 2009 with specific proposals for strengthening the financial stability framework. These proposals were based on the report by the Group presided by Jacques de Larosière,[1] which was published in February 2009 and included recommendations for a new institutional framework of supervision in the EU. Following up on these recommendations, the European Commission submitted to the Council of the EU and the European Parliament legislative proposals for the establishment (i) of the European Systemic Risk Board (ESRB), entrusted with macroprudential supervision, and (ii) of the European System of Financial Supervisors (ESFS), responsible for microprudential supervision and consisting of a network that would comprise three European Supervisory Authorities (ESAs) and the respective national supervisory authorities (see Box 2.2).

At global level, a major landmark was the G20 Summit in London in April 2009, which adopted a resolution on the establishment of the Financial Stability Board (FSB) as successor to the Financial Stability Forum, with a broader composition and enhanced powers as regards maintaining financial stability. The G20 Summit decisions gave rise to a large-scale reform of the supervisory framework, the implementation of which was entrusted to global standard-setting bodies and the European Commission.

1 Report of the High-Level Group on Financial Supervision in the EU, chaired by Jacques de Larosière, 25.2.2009.

Box 2.1

Interventions for supporting non-euro area EU countries

Already since 2008 and early 2009, Hungary, Latvia and Romania (non-euro area EU countries facing serious macroeconomic imbalances and structural weaknesses) were forced, under combined pressures from the global economic crisis and recession and their own financing difficulties, to resort to the financial support mechanisms of the European Union and the International Monetary Fund. These three countries applied to receive external financial assistance undertaking at the same time a commitment to implement a programme of economic adjustment and reforms.

The above countries' recourse to the EU/IMF financial support mechanisms considerably helped them stabilise their economies, as it ensured their funding and put on track a transition to a sustainable growth model, while it also averted a wider contagion of the crisis.

Box 2.2

The proposals in the report of the de Larosière group and their implementation

In response to the global economic crisis, the European Commission asked a High-Level Group presided by Jacques de Larosière to investigate how the EU framework of regulatory and supervisory rules could be enhanced, so as to better protect its citizens and restore confidence in the financial system.

Implementation of the proposals of the de Larosière report

On the basis of this report, submitted on 25.2.2009, the European Commission presented in May 2009 legislative proposals on the creation of the new institutional framework of financial supervision in the EU, consisting of the following two pillars:

1. European Systemic Risk Board (ESRB)

The European Systemic Risk Board (ESRB) exercises macroprudential supervision. The relevant legislation came into force[1] on 16 December 2010 and the ESRB entered into operation on 20 January 2011.

Among other things, the de Larosière report had recommended the establishment of a European body —to be called European Systemic Risk Council (ESRC)— entrusted with monitoring risks to the entire financial system at EU level.

2. European System of Financial Supervisors (ESFS)

The European System of Financial Supervisors (ESFS) was created as a decentralised, multilayered system of microprudential and macroprudential supervision authorities. This system of supervisors is currently undergoing major changes due to the process towards the Banking Union and will be reviewed in 2014.

The pillar of microprudential supervision at EU level is comprised by the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA), which cooperate in the framework of the Joint Committee of European Supervisory Authorities (ESAs). The respective national supervisory authorities of the individual Member States

1 Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macroprudential oversight of the financial system and establishing a European Systemic Risk Board (ESRB Regulation); Council Regulation (EU) No 1096/2010 of 17 November 2010 conferring specific tasks upon the European Central Bank concerning the functioning of the European Systemic Risk Board.

also form part of the ESFS, which aims at forging a common supervisory mentality and contributing to the creation of a single European financial market.

Among other things, the de Larosière report had recommended the establishment of a new European System of Financial Supervision, consisting of three EU authorities (the European Banking Authority, the European Securities Authority and the European Insurance Authority).

2.3 The policy of the Eurosystem in the 2008-2009 period

In parallel to the EU decisions made in response to the crisis, the ECB also intervened, taking both standard and non-standard monetary policy measures.[2] The non-standard measures aimed at supporting financing conditions and credit flow to the real economy, to an extent beyond that achievable by interest rate policy alone, given that, on account of money market dysfunctioning, the transmission of the effects of decisions on the key ECB rates to the wider euro area economy had become ineffective (see Box 2.3, as well as Table 6 in Chapter 5.2).

2 A more thorough analysis and further details on Eurosystem initiatives can be found in the Reports of the Bank of Greece and of the Eurosystem.

Box 2.3

ECB monetary policy and Eurosystem interventions: 2008-2009

1. ECB Governing Council decisions on rates

The intensified global financial turmoil in the wake of the collapse of Lehman Brothers in September 2008 and the resulting higher uncertainty contributed to a considerable slowdown of economic activity in the euro area. In view of the less favourable macroeconomic outlook and the stronger downward risks for price stability in the medium term, the ECB lowered its interest rate on the main refinancing operations three times in the last quarter of 2008, and another four times in a row until May 2009, when this key Eurosystem rate came to 1%. Subsequently the rate on the main refinancing operations remained unchanged at this level for approximately two years, until April 2011, when it was reduced further.

2. Eurosystem interventions: non-standard monetary policy measures

Owing to the turmoil in international money and capital markets, liquidity shortages were already observed since early August 2007 in the euro area as well. In addition, several credit institutions were quite reluctant to extend interbank loans, considering that counterparty risks were heightened. Amidst general uncertainty, credit institutions preferred to retain their cash assets rather than lending them to other banks through the interbank money market. Liquidity shortage in the interbank market resulted in considerable upward pressures on interbank rates.

In order to normalise interbank market conditions, already since August 2007 the Eurosystem diversified and broadened its methods for providing liquidity to credit institutions (see Table 6 in Chapter 5.2). On 9 August 2007 the Eurosystem proceeded to an extraordinary provision of liquidity. Thereafter, it conducted supplementary refinancing operations, in addition to those programmed. Also, as from December 2007 it provided to the euro area credit institutions, in cooperation with the US Federal Reserve (Fed), liquidity in US dollars with a maturity of about one month. Its cooperation with central banks soon expanded to include the Bank of England, the Bank of Japan, the Swiss National Bank and other national central banks (with adjustments and/or interruptions as appropriate).

The intensification of the financial turmoil worldwide following the bankruptcy of the Lehman Brothers investment bank in the US in mid-September 2008 triggered the manifestation of serious problems in the banking system of many countries. Owing to disruptions in the money market, short-term rates rose to particularly high levels, both within and outside the euro area. The heightened tensions and disruptions in the interbank market impaired the Eurosystem monetary policy transmission mechanism.

Against this background, a very important measure adopted by the ECB in October 2008 was the provision of liquidity through fixed-rate tenders with full allotment. In other words, euro area banks could receive from the Eurosystem unlimited liquidity at the key ECB rate, provided that they could offer adequate collateral in the form of eligible assets, which means that the Eurosystem enhanced its intermediating role, largely replacing the operations which were conducted in money markets until then. This development was reflected in the considerable increase of Eurosystem assets (see Chart 11 in Chapter 8.3.4 further below).

Other measures taken by the ECB Governing Council after October 2008 include increasing the frequency of longer-term refinancing operations, widening the set of eligible assets (collateral) against which the Eurosystem provides liquidity to credit

institutions, and lowering the spread between the marginal lending facility rate and the deposit facility rate (i.e. narrowing the standing facilities corridor).[1]

As a whole, the non-standard monetary policy measures adopted by the ECB from October 2008 onwards have been termed "enhanced credit support policy". These measures targeted the banking sector, due to its pivotal role in the transmission of monetary policy and the financing of the economy in the euro area,[2] and helped normalise interbank market conditions, contributing to financial stability. Specifically, since the last quarter of 2008 —with the exception of a few short intervals— interbank rates have fallen to low levels. The containment of counterparty risk in the interbank market also contributed to this development.[3]

In 2009 the Eurosystem continued to implement non-standard monetary policy measures. In more detail, it conducted three longer-term refinancing operations with a maturity of one year, which ensured for banks broad and favourable access to liquidity over a longer horizon, and thus facilitated the financing of the euro area economy. Moreover, as of July 2009 the Eurosystem started carrying out purchases of covered bonds issued by banks, with a view to supporting the covered bonds market, which represents a very important segment of the financial market in the euro area and a primary source of funding for banks. By end-June 2010, when this programme was terminated, the Eurosystem had acquired covered bonds of a total value of about €60 billion.

Since early 2009, money market rates, money market interest rate spreads and bank lending rates have fallen considerably. The lower interbank market rates and the developments in government bond yields compared to 2008 set the stage for a gradual (and cumulatively substantial) reduction of bank rates in all deposit and loan categories in 2009 (and in early 2010) in the euro area. In parallel, lower bank lending costs and debt financing had a favourable effect on economic activity.

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1 This lowering aimed at limiting fluctuations in the interbank overnight market rate (euro overnight index rate – EONIA), as this rate can neither exceed the marginal lending facility rate nor fall short of the deposit facility rate. In other words, this corridor represents a band within which the overnight rate fluctuates, and thus in essence delineates the highest and lowest interbank market rates on overnight deposits/loans. Its narrowing, on the one hand limits the volatility of the EONIA rate, and on the other hand lessens the credit institutions' incentives for raising funds through the interbank market. Correspondingly, its widening helps generate sufficient incentives for banks to channel their excess liquidity into the interbank market, instead of depositing it with the Eurosystem under the standing deposit facility. The width of the corridor has fluctuated several times during the crisis. Since November 2013 it stands at 75 basis points.

2 As opposed to raising funds through capital markets, which is more widespread in other economies.

3 In addition to the enhanced credit support measures taken by the Eurosystem, the financial system support measures that EU Member State governments adopted from October 2008 onwards also helped to limit this risk.

Given the normalisation of conditions in the financial markets, the ECB Governing Council decided in December 2009 to initiate a gradual phasing out of some non-standard monetary policy measures it had adopted. Certain non-standard measures were maintained for a while longer, so as to allow the continuation of the Eurosystem's enhanced credit support policy that involved the supply of liquidity to the euro area banking system under favourable terms, whereas others were discontinued.

2.4 2008-2009: The crisis in Greece

Especially since its dramatic deterioration in October 2008, the global financial crisis started to negatively affect the Greek economy as well, leading to a considerable weakening of expectations.

As regards public finances, in 2008 the (then recorded) general government deficit exceeded 4% of GDP, resulting in the initiation of an Excessive Deficit Procedure (EDP) against Greece in April 2009, while public debt as a percentage of GDP rose to almost 97%.[3]

Developments in 2008 already, clearly indicated that the condition of the economy was bound to deteriorate, a fact confirmed dramatically the following year. Besides, throughout 2008, there had been constant "warnings" from abroad.[4] The previous long period of strong growth supported the "naive forecast"[5] that this would continue in the coming years as well, while there were also *specific reasons* which delayed a full manifestation of the impact of the global crisis (discussed further below).

The overall tone of the estimates regarding the Greek economy's state in late 2008[6] and early 2009 is reflected in the Updated Stability and Growth Programme

3 Eventually, the deficit and debt figures for 2008 have been respectively revised to 9.8% and 112.9% of GDP.

4 Indicatively, already in early March 2008, the President of the ECB, Jean-Claude Trichet, responding to a question on the widening of the spreads between Italian and German bonds, as well as the high yields of the Portuguese, Spanish and Greek bonds, stated that this was a "wake-up call" on the need for policy makers to be very cautious as regards fiscal policy (see press conference held on 6.3.2008). Two months later, answering a question on the economies that for several years had recorded large current account deficits, he stressed that these economies, "including Greece", should monitor closely the cost competitiveness and relative competitiveness indices, particularly if their competitive position had deteriorated and their level of employment was unsatisfactory (see press conference held on 8.5.2008).

5 A naive forecast is one that projects no change in an existing situation in the future. See Theil, H., *Economic Forecasts and Policy*, Amsterdam, The Netherlands: North Holland, (1958) 1961.

6 It is characteristic that "concerns" were already being expressed in Europe about Italy or Greece exiting the Monetary Union: in an interview to *Frankfurter Allgemeine Zeitung* on 17.12.2008, the President of the ECB, Jean-Claude Trichet, asked about his thoughts on this matter, replied: "I don't envisage such fantasies for one second!".

2008-2011, submitted to the European Commission on 30.1.2009 with forecasts that —against that background— were extremely optimistic.[7]

The conclusion drawn from the above has to be that in that period there was no realisation of the severity of the situation and the risk of the global banking crisis turning into a sovereign debt crisis for countries with high deficits and debts such

7 Among other things, the programme stated the following: In 2009, growth would continue at a rate of 1.1%, which would pick up to 1.6% in 2010 and to 1.9% in 2011. The government deficit as a percentage of GDP, which stood at 3.7% in 2008, would remain at the same level in 2009 and fall to 3.6% of GDP in 2010 and even further in 2011 (to 2.6%). See the press release of the Ministry of Economy and Finance dated 30.1.2009.

Table 5 Timeline – Main economic developments in Greece and Europe and actions of the Bank of Greece, 2008-2009

	2008
20.2.2008	Bank of Greece *Monetary Policy Report 2007-2008*: Recommendations for fiscal consolidation, the contribution of social partners in ensuring price stability and improving international competitiveness, as well as decisive structural reforms across economic sectors.
22.4.2008	Bank of Greece *Annual Report for 2007*: The current growth model has exhausted its limits. It is imperative to press ahead with structural reforms, aimed at improving the productivity and structural competiveness of the Greek economy.
20.6.2008	George Provopoulos and Eleni Dendrinou-Louri sworn in as Governor and Deputy Governor, respectively, of the Bank of Greece before the President of the Hellenic Republic Karolos Papoulias and in the presence of the Greek Minister of Economy and Finance George Alogoskoufis.
15.9.2008	Collapse of Lehman Brothers. Merrill Lynch sold to Bank of America for USD 50 billion. On the following day, the bailout plan for AIG is announced.
22.9.2008	Prime Minister Costas Caramanlis and Minister of Economy and Finance George Alogoskoufis visit the Bank of Greece.
30.9.2008	The Governor of the Bank of Greece and the Leader of the Opposition George Papandreou meet for a second time in a month.
3.10.2008	Greece is the second euro area country to declare that it will guarantee bank deposits.
8.10.2008	Bank of Greece *Monetary Policy Interim Report 2008*: The Greek economy exhibits serious structural weaknesses and chronic imbalances that have remained unaddressed for a protracted period. As the international economic conditions deteriorate, the macroeconomic imbalances and structural problems will become all the more severe and difficult to address.
9.10.2008	Coordinated cut in interest rates by the ECB, the Federal Reserve and five other central banks. The ECB lowers its key rates by 50 basis points.
25.11.2008	Enactment of a law on enhancing liquidity in the economy to address the impact of the international financial crisis.
6.12.2008	The killing of a young student by the police triggers widespread rioting that lasts for several weeks in Athens and other Greek cities.

Continued➛

Table 5 Timeline – Main economic developments in Greece and Europe and actions taken by the Bank of Greece, 2008-2009 *(continued)*

2009	
8.1.2009	Cabinet reshuffle. Yannis Papathanasiou is the new Minister of Economy and Finance.
16.2.2009	Bank of Greece *Monetary Policy Report 2008-2009*: The widening yield spread will entail a higher future burden on taxpayers. A multi-annual plan must be adopted, which will include all necessary reforms that were not implemented in the past 15 years, with fiscal consolidation and the implementation of a wide range of structural reforms in the public sector and in the product, services and factor markets being top priorities.
3.3.2009	Ioannis Papadakis sworn in as Deputy Governor of the Bank of Greece.
15.4.2009	Bank of Greece *Annual Report for 2008*: First of all, Greece must break with the growth model of the past that eventually led to an impasse, i.e. a model of overconsumption, sizeable imports, and lasting twin deficits and debts.
23.6.2009	*Financial Stability Report* of the Bank of Greece.
28.7.2009	Bank of Greece *Bulletin of Conjunctural Indicators* for June-July 2009: Central government deficit in the first half of the year exceeds expectations on the total deficit for the entire year 2008, coming to 7.2% of GDP (€17.9 billion).
2.9.2009	Prime Minister Costas Caramanlis meets with the Governor of the Bank of Greece, George Provopoulos.
2.9.2009	Addressing the Greek people, Prime Minister Costas Caramanlis calls early parliamentary elections on 4 October. Beginning of the pre-electioral period.
8.9.2009	The Governor of the Bank of Greece briefs PASOK President George Papandreou and Ministers George Papakonstantinou and Louka Katseli on the state of the economy.
4.10.2009	Parliamentary elections are held: PASOK comes out as the leading party and forms a majority government.
9.10.2009	The Governor of the Bank of Greece meets with the new Finance Minister George Papakonstantinou. In his statement after the meeting, George Provopoulos reports that the deficit for the first nine months is in the order of 10% and looks set to rise to, if not exceed, 12% by the end of the year .
19.10.2009	The European Commission opens an investigation into the reliability of Greek data. Jean-Claude Juncker: "The game is over".
20.10.2009	Bank of Greece *Monetary Policy Interim Report 2009*: It is necessary to halt the twin deficits and speed up structural reforms. It is of vital importance to send a clear message to the markets that Greece is determined to implement a multi-annual plan of fiscal consolidation and structural reforms.
22.10.2009	The Greek authorities announce that the 2009 budget deficit is more than double its projection. The 2008 deficit is also revised significantly upwards, compared with previous estimates.
22.10.2009	Fitch downgrades Greece's credit rating from A to A-.
1.12.2009	The Monetary Policy Council of the Bank of Greece decides to cut by 20% the salaries of its members, including the Bank's Governor and Deputy Governors, thus setting an example for the country's overall cost reduction effort.

Source: Bank of Greece.

as Greece. On the contrary, the international crisis, galloping at rapid rates all over the world, was treated as a distant phenomenon, irrelevant for Greece.

2009 was a particularly crucial year as it saw the aggressive emergence of problems that, albeit pre-existing, had been ignored within the generalised climate of complacency that had been fuelled by growth in the previous period. But, with the onset of the global crisis, these problems were no longer controllable; addressing them required taking immediate extraordinary measures and making long-term coordinated efforts. However, it seems that it was hard, politically and socially, to exert such efforts.

A second decisive fact was the heavy impact of the political cycle on the efforts to address these problems in a timely manner. Two elections were held in the course of 2009, for the European Parliament in spring and for the Greek Parliament in October. This not only led to the typical fiscal result of the political cycle, namely higher public expenditure and relaxation of the tax collection mechanism, but also prevented the political system as a whole from converging on a minimum base of mutual understanding in order to cope with the extraordinary conditions that were patently in the offing.

2.4.1 The climate deteriorates, confidence is shaken

Adverse developments in 2009 were characterised by a **derailing of fiscal aggregates**, with the deficit reaching 15.7% of GDP and public debt 129.7% of GDP.[8]

After fifteen years (1994-2008)[9] of continuous growth, GDP fell in 2009 by 3.2%,[10] despite the vast fiscal stimulus. Specifically, the general government deficit came to 15.7% and the primary deficit to 10.5% of GDP. Compared with 2008, the deficit widened by 5.8 percentage points and the primary deficit by 5.5 percentage points of GDP. This widening was due to poor revenue performance (2008: 40.7% of GDP, 2009: 38.3% of GDP) and increased general government expenditure (2008: 50.6% of GDP, 2009: 54.0% of GDP). Nevertheless, affected by lower investment and private consumption, GDP fell and the economy officially entered into recession.[11] Moreover, in the 2001-2008 period the cumulative loss of international competitiveness reached 16.9% based on relative consumer prices and 27.7% based on relative labour costs.

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8 Revised, final data. In April 2010 the deficit had been estimated at 13.6% of GDP and the debt at 115.1% of GDP.

9 A later revision of GDP showed a small decrease of 0.2% in 2008.

10 The initial estimate regarding the recession was 2.0%.

11 Later estimates put the beginning of the recession in 2008.

These developments dramatically heightened uncertainty about the economy's future, strongly affected expectations, and brought about a confidence deficit, which in turn led to a downgrading of the economy's credit rating and a considerable widening of the yield spreads between Greek and German bonds.

The banking system started facing serious liquidity problems, as the country's lower credit ratings restricted the banks' access to the international interbank market and later on to other funding sources as well.

Already in January 2009, Standard & Poor's downgraded the country's credit rating from A to A-, due to the "Greek economy's deteriorating loss of competitiveness", keeping it nevertheless in the investment grade category. On account of this downgrading, the spreads between Greek and German government bonds rose to 300 basis points in January and remained at this level until March 2009. Over the next months the spreads stood somewhat lower, between 150 and 200 basis points, but moved further upwards in the last months of 2009.

A turning point concerning the *further deterioration in confidence*[12] was the announcement by the Greek authorities on 22 October 2009 that the government deficit in 2009 was more than double the projection and that the 2008 deficit was also considerably higher than estimates up to that time.

This large *official* revision of the deficit confirmed market, rating agency and international media estimates that the fiscal problem of Greece was much graver than what was suggested by the data available by then. This fact was drawing the markets' attention to two crucial questions: First, whether the Greek authorities had the will and the determination to implement a consolidation programme able to address deficits of this magnitude and, second, whether the statistical data reliably recorded the country's fiscal situation.

At the end of 2009, the markets' answer to both questions was negative, corroborated by the December ECOFIN decision, according to which Greece had failed to sufficiently respond to the Council's recommendation of April 2009, when the EDP had been initiated. Specifically, by 27 October when the deadline expired, no measures had been taken. In addition, the decision stated that "new measures of the 2009 budget consist mainly of revenue-enhancing measures, partly temporary, and not permanent measures on the expenditure side, as called for by the Council". It is

12 In an interview published by the Dutch newspaper *Het Financieele Dagblad* on 25.11.2009, the President of the ECB, Jean-Claude Trichet, was asked about the fiscal problems that Greece faced ever since its entry into the euro area and whether this meant that the Stability and Growth Pact sanctions were ineffective. Quite characteristically, J.-C. Trichet replied that, first of all, the Eurogroup, the European Commission and the Greek authorities must improve the way fiscal data are produced, so that they can be reliable, and moreover, that the Pact must be strictly implemented in full by all euro area countries.

characteristic that the largest downgradings of Greece's credit rating in the course of 2009, by all three major rating agencies, took place in December,[13] following the aforementioned ECOFIN decision.[14]

Various reports in the international media, questioning Greece's ability to achieve the required fiscal consolidation and align itself with the other euro area countries, aggravated the adverse climate. In the first months of 2010 such reports multiplied, focusing on the country's public debt and possible bankruptcy and exit from the euro area. Furthermore, as both the implementation of effective fiscal consolidation measures in Greece and the adoption of EU decisions for a support framework conditional on the implementation of an economic adjustment policy were taking time,[15] media reports about a risk of contagion of the crisis to other euro area countries, or even of a breakup of the euro area itself, proliferated. The Greek crisis had thus become the potential catalyst of developments in the world economy.

2.4.2 Questioning of the statistical data

The doubts cast on the reliability of Greek statistical data turned out to be one of the major factors that contributed to the loss of confidence. This questioning had a long history, which was reflected in Eurostat reports. But, by the end of 2009, the issue had grown out of proportion, both in Greece and, mainly, abroad.

In 2009, the persistence with relatively optimistic deficit forecasts, although the data during most of the year pointed to the opposite direction along with successive revisions within a short period of time, dealt a decisive blow to the reliability of Greek statistical data and contributed to the overall questioning of the country's credibility.

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13 Fitch, Standard & Poor's and Moody's downgraded Greece's credit rating respectively on 8 December (from 'A-' to 'BBB+'), on 16 December (from 'A-' to 'BBB+'), and on 22 December (from 'A1' to 'A2').

14 In an interview to the Belgian newspapers *De Tijd* and *L'Echo* on 10.12.2009, the President of the ECB, Jean-Claude Trichet, when asked about the large widening of the spreads of Greek (and Irish) bonds, reiterated his statement on Greece made before the Committee on Economic and Monetary Affairs of the European Parliament on 7.12.2009: "Given the seriousness of the situation, I am sure that the Greek government will soon take the necessary bold measures". A few days earlier, on 3.12.2009, during a press conference, he had stated even more emphatically: "Taking into consideration the *extreme gravity* of the situation, I am sure that the government of Greece will make the appropriate and *absolutely necessary* decisions".

15 The EU had no available mechanism for providing financial support to euro area countries (although it did have one for non-euro area EU countries) and had to create one from scratch: many analysts consider that the relevant EU decisions took a long time until the Member States reached final agreement on 25.3.2010 (discussed in Section 4.5.2 further below). It should be noted, however, that the President of the European Council, Herman Van Rompuy, denies that there was any delay on the part of the EU, as the request for financial assistance was submitted by the Greek government in late April, while the decision to support Greece was made by the Eurogroup on 2 May 2010 and confirmed by the euro area summit on 7 May 2010 (see Report of the European Council for 2010).

In October 2009, Eurostat explicitly expressed reservations regarding the reliability of the fiscal data and did not confirm the deficit of 12.5% of GDP as revised by Greece.[16] Moreover, in January 2010, the European Commission reprimanded and publicly criticised Greece for providing unreliable fiscal data. This referred both to data reported in the past (in the 1997-2003 period, examined in a Eurostat report of 2004, as well as reservations expressed by Eurostat on five occasions after 2004), and, mainly, to the data reported in April and October 2009. Indicatively, the Commission report ascertains that:

> *"Even if the existing governance framework for fiscal statistics at EU level functions satisfactorily and enables improvements of a statistical and methodological nature, it cannot prevent deliberate misreporting of data".*[17]

It was only in April 2010 that Eurostat announced revised data on the fiscal deficit of Greece in 2009, which was now estimated at 13.6% of GDP, a percentage further revised upwards (to 15.4%) later. Thus, for several months and in a particularly crucial period, uncertainty regarding the final level of the deficit persisted, a fact that kept fuelling all sorts of conjectures about the country's future and worsening its relationship with its European partners.

2.4.3 The deterioration of the situation is not dealt with adequately

The economic policy pursued, both before the elections held on 4 October 2009 and for a few months afterwards, was timid and the measures taken proved inadequate to halt the downward course of the economy. Indicatively, the new government, although it released its estimate of the 2009 deficit (12.5% of GDP, against an initial forecast of 3.7%) a few days after the elections, at the same time stated they meant to implement the measures announced before the elections, which were clearly expansionary in nature.

In early 2009, economic policy planning had relied on the forecasts included in the Updated Stability and Growth Programme, about a government deficit in the

16 This was because the data were communicated to Eurostat on 21 October and released on 22 October (according to the schedule for all countries), so there was no time for them to be checked.

17 See European Commission, *Report on Greek Government Deficit and Debt Statistics*, 8.1.2010, COM(2010) 1 final. Moreover, in an interview to the German magazine *Focus* on 19.1.2010, the President of the ECB, Jean-Claude Trichet, emphatically stated that "we shall never again accept fiscal data that do not reflect reality" and that "proper auditing of the data must always be possible", adding that in February (2010) the European Commission would submit proposals that would "dramatically improve" the relevant framework – something that was absolutely crucial.

order of 3.7% of GDP in 2009. Soon enough, however, it became clear that this initial forecast was not compatible with the actual facts, and that the deficit would finally stand much higher. As mentioned earlier, the forecast regarding the 2009 deficit was then (22.10.2009) set at 12.5%, and subsequently at 12.7%, while the estimate for 2008 was 7.7%. Despite the drastic revision of the 2010 Budget, passed in December 2009, the impression continued to prevail that the crisis could be overcome by means of a relatively mild —compared to the size of the problem— fiscal adjustment programme.

Thus, in late 2009 and early 2010, the economy's fundamentals were out of track, with vast public revenue shortfalls and increases in public expenditure, deficit and debt, whereas the balance of payments deficit remained at historically high levels, although the economy was now already in recession.

3 THE BANK OF GREECE WARNS ABOUT THE SEVERITY OF THE IMMINENT CRISIS: 2008–2009

3.1 Public interventions, warnings and policy proposals

The Bank of Greece (BoG) monitored closely the unfolding of the global financial crisis, voicing concerns about its possible impact on the Greek economy, particularly in terms of GDP growth, fiscal deficit and external debt. Of course, there were reasons that delayed a full manifestation of the impact of the global crisis. The Governor of the BoG, in a speech in late 2008, had referred to the factors which, in the early phase, had limited the impact of the crisis on the Greek economy. These factors were the economy's weak export orientation, the fall in oil prices on the world market combined with the domestic economy's high oil dependence, as well as the low mobility of the labour force and the rigidity of wages with respect to real economic conditions. Nevertheless, as he noted,[1] it was a paradox that "…the Greek economy may even stand to be 'protected' in the short run by some of its chronic structural weaknesses". The Governor emphasised that such phenomena "…should not be misinterpreted or lead to complacency", and summarised the views of the BoG as follows:

> "*The only safe way to shield our economy […] is to courageously tackle its imbalances and structural weaknesses, so as to set into motion a far-reaching, more outward-looking, stronger and sustainable growth dynamic. Such a dynamic can only rely primarily on: enhancing the productive base through investment; constantly strengthening and qualitatively upgrading competition in all markets; and, above all, implementing a wide range of structural reforms, particularly in the broader public sector.*

1 Speech at an event held by the Foundation for Economic and Industrial Research (IOBE) on 15.12.2008.

Especially this last issue must be highlighted and prioritised. Without extensive and groundbreaking changes in the structure of the broader public sector, the deficits and debts that today represent a major source of problems cannot be reined in. And the slower the progress made in the structural component of our public finances, the harder it will be to restore investor and market confidence in our economy's prospects".

Two months earlier, in October 2008, in its *Monetary Policy Interim Report*, the BoG had presented in detail its basic reasoning, which can be summarised as follows:

The negative implications of the international crisis on national economies vary depending on their respective structural features. These features define the ability of each to absorb exogenous shocks without facing major problems as regards domestic production, fiscal management and the balance of payments.

In the case of Greece, the implications of the crisis can be particularly adverse because, despite its strong growth in recent years, the economy exhibits serious structural weaknesses and chronic imbalances, which have not been adequately addressed for many years. Therefore, unlike the situation in other countries, for Greece the risks today do not stem from the credit system, which is fundamentally sound and stable. The main problem of our economy is its chronic macroeconomic imbalances, which limit its ability to adjust accordingly and deal with the impact of the crisis. Such imbalances include:

- *The fact that the strong growth in domestic demand did not contribute to a corresponding and adequate strengthening of the productive base and potential output, as well as of the international competitiveness of the Greek economy. The insufficiency of domestic supply relative to domestic demand is reflected in the alarmingly large widening of the current account deficit and the accumulation of a high external debt, developments that, if not reversed, will have an adverse impact on our country's growth prospects and standard of living.*
- *The large fiscal deficits created by the fast growth of primary expenditure and delays in limiting tax evasion and broadening the tax base.*
- *The substantial competitiveness losses, which for the period from 2000 to 2008 cumulatively exceed 25% and feed into the large widening of the current account deficit.*
- *The high public debt, which is one of the most serious structural problems and a source of macroeconomic imbalance. The structural nature of this problem is clearly evidenced by the fact that in the last fifteen years, despite the extremely favourable conditions for its reduction, the debt-to-GDP ratio has remained prac-*

tically unchanged —at 99% on average— while debt as an absolute figure continued to increase.

Based on the above reasoning, the BoG argued that economic policy should give higher emphasis and priority to the more permanent factors and the long-term outlook, and made the assessment that sustained higher growth rates without inflation could only be achieved if the required bold structural changes are advanced and completed with determination.

The BoG called particular attention to the need to continue and strengthen fiscal consolidation. This view was expressed at a time when influential voices called for a more expansionary policy to stimulate demand, according to the then common practice of other European countries that had provided fiscal incentives to boost demand. The BoG argued that there was no room for a traditional type of expansionary policy, due to three reasons: the large fiscal deficit, the high level of public debt and the large current account deficit. Fiscal consolidation, according to the BoG, had to be achieved by reducing primary expenditure, improving the quality of public expenditure, and limiting tax evasion.[2]

Finally, to shield the economy against the adverse international conjuncture and the imminent crisis, the BoG kept reiterating, time and again, the need for structural reforms that would improve the operation of the markets, the business environment and the functioning of the broader public sector.

In general, by contrast to the then widespread illusion that the crisis could be dealt with through *ad hoc* interventions only concerning the symptoms, the BoG was sending out early warning signals, being very clear as regards the severity of the situation and the need for a radical reorientation of economic policy. In its reports published in April[3] and October 2008, as well as in February, April and October 2009, it stressed that the country's macroeconomic imbalances and structural problems would become much larger and more severe as the global economic situation worsened – and thus more difficult to address. It also voiced concerns about the eventuality of increasingly higher borrowing costs and mentioned that a widening of the spread between Greek and German government bonds would entail a higher burden on taxpayers in the future. At the same time it underlined the urgent need to send a clear message to the markets that Greece is determined to implement a multi-annual plan of fiscal consolidation and structural reforms.

2 *Monetary Policy Interim Report 2008*, October 2008, pp. 23-25.

3 In April 2008 (*Annual Report 2007*, pp. 112-113) the Bank was warning: "More recently, the conditions favouring debt reduction have weakened. Specifically, the rise in the average rate on new government borrowing (from 3.2% in 2005 to 3.8% in 2006 and 4.4% in 2007), coupled with the anticipated slowdown in economic growth, strengthens the debt ratio dynamics and makes it more difficult to achieve fast debt reduction".

Particular mention is due to the BoG's clear warnings with reference to the derailing of the central government deficit in 2009, long before it became evident that the deficit would turn out to be much higher than what was initially estimated. The BoG, in the context of the information it provides on a monthly basis through its *Bulletin of Conjunctural Indicators*, in the course of 2009 regularly published the data on the constantly worsening situation as regards the cash deficit of central government, which in the seven months from January to July 2009 had reached 7.2% of GDP, while in the first eight months of the year had already surpassed 8%. Given such cash deficit developments, it was obvious that the official estimate of the central government deficit had to be drastically revised[4] and urgent measures were needed to halt its rapid widening. The BoG reports and publications regarding the fiscal deficit, reproduced across all types of media, sent clear messages that provided an early warning about the difficulties that lay ahead.

The Governor of the BoG, in order to stress even further the importance of these messages for the economic policy required, had meetings, before the elections, with the then Prime Minister and the Leader of the Opposition (on 2 and 8 September 2009, respectively). In both these meetings the Governor expressed the view that the data already published by the BoG were pointing to a 2009 deficit bordering on a double-digit percentage of GDP, possibly higher than 10%. On 4.10.2009, during the annual meeting of the International Monetary Fund in Istanbul, the Governor of the BoG publicly stated that the cash deficit for the nine months stood at 10%. A few days later, on 8.10.2009, right after a meeting with the Finance Minister, he publicly expressed the view that "given the current trend and the fact that there still remain three more months for the year to end, the deficit will exceed 12%".

On 24 November 2009, when the large overshooting of the deficit compared with the initial forecasts had already been announced, the Governor of the BoG, speaking before the Greek Parliament, noted:

> *"I would like to recall that in its recent Reports the BoG had systematically and monotonously called attention to the pressing need to rein in the extremely high fiscal deficit and the debt, which were steadily deteriorating. As you know, the BoG monitors (and publishes on a monthly basis) the central government cash deficit. The relevant data were showing that in every month of this year the deficit was almost double year-on-year. For example, before the elections (specifically, on 18 September), we published figures for the cash deficit in the first eight months, which reached 8% of GDP. Based on these*

4 The deficit was first revised on 2.10.2009, with the announcement of a forecast of 6%, and then again later in the same month, when the forecast became 12.5%.

> *data, it could be estimated that the twelve months would end with a double-digit percentage, unless bold corrective measures were to be taken in the remainder of the year".*

Previously, in an interview on 1 November 2009,[5] the Governor of the BoG had been even clearer:

> *"Before the elections, it was apparent that the course of fiscal developments was steadily worsening, a fact recorded in the BoG's Reports. Those who read them are quite familiar with our 'cry of agony' in view of the risks from the deteriorating public finances. Even the recent elections, were they not proclaimed on account of the severity of the fiscal problem? It is therefore certain that all citizens were aware of the negative fiscal situation and I believe that the BoG has played an important role in pointing it out. Consequently, those who today claim not to have been properly informed by us on how bad the course of our country's public finances was, must not be living in Greece".*

The large and repeated revisions of the fiscal data in the course of 2009 led, as already mentioned (see Chapter 2), to a stern questioning of the Greek statistical data and an intervention by Eurostat. On 15 March 2012, speaking before the Parliamentary Committee of Inquiry concerning the 2009 deficit, the Governor of the BoG underlined that the country's statistical problems did not regard only the year 2009 but a long period of wrong administrative choices. The Governor referred specifically to a Report by Eurostat,[6] stressing that it depicted in full the situation existing for a series of years, not just 2009. It should be noted that the Eurostat report was particularly critical of Greece as regards the state of fiscal statistics. In more detail, with respect to the revisions of fiscal data, it stated:

> *"Revisions of this magnitude in the estimated past government deficit ratios have been extremely rare in other EU Member States, but have taken place for Greece on several occasions. These most recent revisions are an illustration of the lack of quality of the Greek fiscal statistics (and of macroeconomic statistics in general) and show that the progress in the compilation of fiscal statistics in Greece, and the intense scrutiny of the Greek fiscal data by Eurostat since 2004 (including 10 EDP visits and 5 reservations on the notified data), have not sufficed to bring the quality of Greek fiscal data to the level reached by other EU Member States".*

Equally clear were the Bank's warnings regarding the debt. In its *Monetary Policy Interim Report*, in October 2009, the BoG was pointing out that the dynamics of

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5 Newspaper *Kathimerini*, 1.11.2009.

6 Eurostat, *Report on Greek government deficit and debt statistics*, 8.1.2010.

public debt developments was adverse, as markets could possibly deem the announced fiscal consolidation inadequate. In such a case, the BoG estimated that government borrowing rates would rise anew, a fact that would hamper fiscal consolidation. This in turn would heighten market concerns about the sustainability of fiscal consolidation and trigger a vicious circle of increasing debt and worsening expectations.

The same BoG Report included a study summarising the impact of high public debt[7] and analysing the problems this creates in all sectors of the economy, as well as the ensuing distortions and risks. As this study states:

> *"In order for the effort to reduce high public debt to bear fruit, expedited fiscal consolidation will be required in the forthcoming years. Because of the economic crisis and the possibility of a slow or delayed recovery, a substantial reduction in the debt levels cannot stem from the favourable relationship between real interest rates and real GDP growth this time. Therefore, a substantial reduction in public debt can only come from the achievement of high primary surpluses".*

The Governor, speaking at the annual meeting of the IMF held on 4-5.10.2009 in Istanbul, summarised the economic policy proposals of the BoG as follows:

> *"To achieve a robust growth rate in the future, Greece will need to address the challenges of the persistently very large current-account imbalances, the big fiscal deficits, and the worrisome high debt levels. These imbalances are the result of structural rigidities, which have undermined competitiveness over time. To restore competitiveness and remove the imbalances, a dual agenda needs to be concurrently implemented: first, a multi-annual programme of fiscal consolidation, which can reduce risk premia and crowd-in private investment, raising the growth potential of the economy; second, bold and wide-ranging institutional reforms in the public sector and structural reforms in product and labour markets, which can enhance productivity and raise the employment rate. Only by undertaking these reforms will the Greek economy be able to become more competitive and increase its growth potential and the prosperity of its citizens".*

It is worth mentioning that these proposals by the BoG placed emphasis on a comprehensive approach to the notion of growth and on the importance of engaging in a genuine social dialogue under the crisis conditions that prevailed. A fuller account of these proposals can be found in the Bank's *Monetary Policy Interim Report* of October 2009:

7 *Monetary Policy Interim Report 2009*, pp. 111-117.

> *"We should reorient ourselves towards a multi-dimensional concept of development that would also encompass environmental protection and improved income distribution. […] The crisis in the Greek economy should [therefore] be seen as both a challenge and an opportunity for the comprehensive reorientation of economic policy and for the promotion of new growth dynamics […].*
>
> *At the present juncture and for the first time in years, the Greek society is becoming aware of the big and chronic problems that could lead to disastrous developments in the future, if not addressed in a timely manner. It is also becoming all the more apparent that there is no leeway for delay or half-measures, if Greece is to find a way out of the current deadlock and if confidence in the prospects of the economy is to be restored. The global crisis and the critical economic situation can act as a catalyst for an open and meaningful dialogue with the social partners on the reforms of the public sector (public administration, fiscal management, social security, education) and of product and labour markets; such reforms are a prerequisite for attaining the above-mentioned objectives. A dialogue that gets to the heart of the matter would be a first step towards making up for our past failures to communicate effectively, while also strengthening civil society and enhancing respect for institutions, which has been insufficient until now".*

As regards the *banking system*, the main assessment by the BoG in 2009 was that, in contrast to what was the case in other countries where the crisis originated in banks and then dragged the economy along, the course in Greece was the opposite: the crisis in the public sector and the downgrading of the credit rating of the Greek sovereign debt had weighed heavily upon banks, which thus suffered corresponding downgrades and liquidity shortages. The main message that the BoG kept sending throughout that year was the reassurance that, despite the negative effects of the macroeconomic environment, the Greek banking system remained fundamentally sound.

In June 2009, the BoG published the results of the stress tests conducted on the basis of hypothetical scenarios agreed with the IMF. The purpose of these tests was to assess the resilience of the Greek banking system to unexpected and strong exogenous shocks, and the banks' ability to cope with them. The BoG estimated at the time that the test results were encouraging.

In its *Financial Stability Report* published in June 2009, the BoG stated that, according to the stress test results, the banking sector was in a position to cope even with particularly strong shocks, the likelihood of which was extremely low. In fact, in the concluding statement of the IMF mission (May 2009) it pointed out that "the

authorities' response to the financial crisis has been appropriately pro-active...", and that "the banking system appears to have enough buffers to weather the expected slowdown".[8]

Referring to the banking system in general, the Governor of the BoG pointed out at the time that:

> *"In matters relating to banking supervision and financial stability there is no room for even the slightest complacency. My main priority, since the first day I took up my duties, has been to protect financial stability. In view of the increased risks resulting from the weakening economic activity, high market volatility and the prevailing liquidity conditions, I have asked banks to implement the kind of policies that ensure financial resilience, stability and health.*
>
> *I have also urged them to make use of the government plan [for the support of liquidity – see Section 3.2.2 in this chapter], so as to enhance liquidity in the economy. I have asked them not to distribute any dividends, to substantially increase their provisions for bad debts, and to reduce bonuses to their executives. All these measures create additional 'cushions' that shield banks in the difficult times we are experiencing. Nevertheless, continued vigilance is required".*[9]

8 IMF, "Greece: 2009 Article IV Consultation, Concluding Statement of the Mission", Athens, 25.5.2009.

9 Speech by the Governor of the BoG in a conference on "The role of the banking system for the exit from the crisis and for long-term economic and social development", organised by the Economic and Social Committee of Greece on 25.6.2009.

Box 3.1

2008-2009: Studies, publications and analyses – decisions and initiatives aimed at better informing the public

As mentioned previously, in 2008-2009, while the crisis was already intensifying in other countries, the BoG increased the number of its analyses and recommendations as regards the economic policy orientations Greece needed to urgently adopt. These very clear warnings and policy proposals voiced by the BoG were documented through analyses and studies on specific topics, published mainly in the Annual Reports of 2008 and 2009 in the form of boxes or appendices to specific chapters. These interventions, as

well as the decisions and initiatives mentioned below, were aimed at better informing the Greek public on pivotal issues of the economy – which was deemed necessary.

Moreover, as of early 2009 the BoG strengthened its relations with the central banks and supervisory authorities of South East European countries, focusing on matters of surveillance and financial and economic crisis management; already since 2008 the Bank had been closely monitoring developments in the economies of SE Europe.[1]

Meanwhile, in the summer of 2008 a new specialised 'Real Estate Market Analysis Section' was set up in the BoG's Economic Research Department, in order to improve the amount and quality of information on the property market, which is of great importance for the economy in general and the banking system in particular.[2]

Also, in May 2009, on the initiative of the Bank's Administration, the Economic Research Department launched a Working Group on Social Policy and Labour Market Issues, bringing together BoG researchers and university professors (in the context of the programme of cooperation with academia it had initiated).

On 16 June 2009 it was announced that, on the initiative of the Governor of the BoG, a Committee of prominent scientists was set up to prepare a study on the economic, social and environmental impacts of climate change in Greece. The 'EMEKA' (Greek acronym for Climate Change Impacts Study Committee) was entrusted with assessing the cost of climate change for the Greek economy, the respective cost in case of inaction, as well as the cost of the measures to be adopted under the relevant European Union policy for mitigating the impacts of climate change. The study began in March 2009, scheduled to be completed in two years.[3]

On 27 May 2009, in cooperation with the Hellenic Observatory of the London School of Economics, the BoG organised a conference on the costs of the financial crisis and the design of exit strategies.

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1 Already in March 2008 the 3rd annual meeting of the South-Eastern European Monetary History Network had taken place in Athens, while in the summer of 2008 the new 'Analysis of Economic Developments in Eastern European and Mediterranean Countries Section' had been set up in the BoG's Economic Research Department. On 16.10.2009, the BoG, in cooperation with SEESOX (South East European Studies at Oxford), held a conference on the 'Challenges and prospects of South East European economies in the wake of the financial crisis'. Furthermore, in the context of cooperation between the central banks of SEE countries, on 19-21.11.2009 the BoG and the Bank of Albania jointly organised in Athens a workshop on issues of economic research in the region.

2 To support the work of the new unit, credit institutions were required to report relevant data, and a digital database was created. On 29.4.2009, the Section organised a conference on the latest developments and prospects of the real estate market (the proceedings of which were published in December 2009).

3 In connection with this, the *Annual Report 2008* (April 2009) inaugurated the inclusion of a special chapter reporting on international and Greek policies for climate change management, environmental protection issues and developments in the energy sector.

Finally, in November 2009, a brief study by the Bank's staff was published (*The 1929 crisis, the Greek economy and the annual reports of the Bank of Greece for the years 1928-1940*, in Greek) and was presented during a related event organised by the Foundation of the Hellenic Parliament (a research institute).

3.2 2008-2009: Government, BoG and Eurosystem actions to support the banking system

During the first phase of the global crisis (2008-2009) the financial sector was particularly hit — especially bank liquidity, which was extremely squeezed.

All over the world, in order to cope with the new conditions, central banks were forced to give their monetary policies a new direction, abandoning practices of the past and adopting new orientations.[10]

In Greece, during the first two years of the crisis the banking system did not suffer the immediate losses recorded in other countries. However, it progressively came to face the impact of the fiscal crisis, which resulted in a downgrading of the country's credit rating and led to a corresponding downgrading of the banking system. The ensuing restriction of sources of bank funding exacerbated the problem as of early 2009, and Greek banks increasingly resorted to the Eurosystem to secure liquidity.

In that period the BoG sought to support the banking system, on the one hand by ensuring its effective operation through the establishment of new rules, and on the other hand by strengthening its liquidity. In parallel, Greek banks were also effectively supported by the new interventions of the Eurosystem. In more detail:

3.2.1 Intensified micro-prudential supervision of credit institutions

In 2008, the already enhanced supervision of banks became even stricter, pursuant to the new banking law 3601/2007 (to the formulation of which the BoG had contributed greatly) and the Governor's Acts associated with the banking law, as well as due to the adoption of guidelines issued by the Committee of European

10 "The experience of the first five years following the crisis shows that all central banks have adjusted their monetary policies along hitherto unexplored lines: some certainties have been abandoned and no new paradigm has yet been formulated. The wish is to put an end to the emergency and return to normality where the rules are based on a well-established discipline of long standing, but it is not known with any certainty what reality will emerge in the long term", Mario Draghi, "The euro, monetary policy and reforms", speech at the LUISS Guido Carli University, Rome, 6.5.2013.

Banking Supervisors (CEBS). The most important new elements of the supervisory framework are presented in Box 3.2.

On the basis of the new directions and rules, and in view of the increased risks associated with the weak economic environment, the high uncertainty in money and capital markets and the prevailing conditions of low liquidity and reduced profitability, the BoG kept calling upon banks to pursue appropriate policies for promoting financial stability. In this context, the BoG emphasised the need to raise loan-loss provisioning, cut costs and diversify sources of funding. At the same time, given that during that period the South East European economies came up against increasing risks, the BoG recommended to Greek banks active in these countries to carefully assess the local economic conditions, as well as the eventuality of finding themselves exposed not only to credit risk, but to exchange rate risks as well.

Following the recommendations of the BoG, banks adopted a more conservative provisioning policy, based not only on static indicators of portfolio quality, but also on the dynamics of economic and credit conditions in the current circumstances and addressing the adequacy of core capital buffers for covering unexpected losses. In parallel, the BoG tightened its supervisory framework, slashing the expansion plans of banks with identified inadequacies in their internal control systems and increasing, as per case, the minimum capital requirements of banks.

Box 3.2

New elements introduced in the banking supervision framework in 2008

- Modernisation of the provisions on credit institutions' capital increases, as well as on transparency and eligibility of their shareholders that can be very influential in case of wide dispersal of shares.
- Introduction of a totally new risk-based methodology for calculating capital requirements, based on distinct individual risk parameters, including operational risk parameters.
- Reform of the inspections based on a risk-based approach.
- Introduction of requirements on credit institutions to disclose information mainly on: (i) the companies in the group of a credit institution; (ii) the credit institution's own funds and the method of calculating its capital adequacy; and (iii) its exposure to each and every category of risk.

- Establishment of alternative methods for calculating banks' capital requirements for their exposures connected with securitisation.
- Introduction of: (i) qualitative criteria for calculating each credit institution's capital adequacy, in addition to quantitative ones; and (ii) a procedure for the assessment by the BoG of each credit institution's overall compliance with its supervisory obligations.
- Amendments to, and codification of, the applicable provisions on the control of large exposures.
- Codification of the provisions on credit institutions' supervisory reporting obligations to the BoG and identification of the related parties and hence their transactions therewith come under specific supervisory provisions.

In 2008, the BoG set up a specialised Financial Stability Department, with a view to strengthening *macro-prudential supervision*. This Department monitors the stability of the Greek financial sector, analysing developments and prospects at *system level*. At the same time, it supervises the means of payment used and the payment clearing and settlement systems operating in the country, so as to ensure their effectiveness and reliability and, particularly, help limit systemic risk. This development was part of a broader trend towards enhancing the role of macro-prudential supervision, at both European and global level, after the financial crisis had demonstrated the importance of the notion of systemic risk.[11]

3.2.2 Law 3723/2008 on strengthening liquidity

The collapse of Lehman Brothers in September 2008 caused serious shocks in the global financial system. Governments, central banks and other competent authorities proceeded to coordinated actions so as to restore confidence and smooth operation of the financial markets. In summary, in their core these actions involved —directly or indirectly (through government guarantees)— enhancing the liquidity of national economies and strengthening the banks' capital base, so as to mitigate the impact on the real economy and minimise the likelihood of a credit crunch.

Against this background, and in implementation of the key principles agreed during the informal euro area summit on 12 October 2008 (and adopted by the Eu-

11 It should be recalled that the EU has set up the *European Systemic Risk Board*, while bodies with similar powers and responsibilities have also been set up in the US, the United Kingdom and other countries.

ropean Council on 15-16 October 2008), the Greek Parliament passed Law 3723/2008 *on the enhancement of liquidity in the economy* so as to deal with the impact of the international financial crisis. The law aimed at shielding the Greek economy by strengthening liquidity, so as to mitigate pressures on lending rates and facilitate credit institutions in extending loans to households and enterprises.[12]

The BoG, owing to the importance of boosting liquidity and financing the economy, contributed substantially to the drafting of the law. It also provided the necessary technical support during the law's implementation period, having recommended that the financial support should be allocated to banks based on each one's capital adequacy and liquidity needs. In parallel, as banks initially appeared reluctant to take advantage of the measures in fear of a potential negative market response (stigma effect), the BoG urged them to have recourse to the provisions of the law in order to strengthen their capital base and alleviate the tight credit conditions. Indeed, banks improved their capital adequacy and the contraction of credit growth turned out to be considerably smaller than what was anticipated given the depth and the duration of the recession.

3.2.3 Stress tests

In addition, the BoG started conducting stress tests, which constitute an important risk management tool. These tests, on the one hand, detect the major risks undertaken by banks and, on the other hand, explore the potential impact on their financial position in the event of extreme and low-probability situations, which are projected under hypothetical scenarios, so that for purposes of precaution and readiness their risk management policy may be adapted accordingly.

In a period during which the international financial turmoil was causing chain negative reactions across various markets or regions, resulting in an inability to accurately estimate the systemic implications and the impact on the real economy, the liquidity stress tests conducted were an important tool for assessing the banking system's ability to cope with such situations. In fact, the test results helped both the supervisory authority and the banks to adapt in time to the imminent challenges and

12 The law provided for: (i) a recapitalisation scheme, whereby up to €5 billion would be injected to eligible banks in exchange for preference shares acquired by the Greek State; (ii) a government guarantee scheme, covering securities (up to €15 billion) that would be issued by credit institutions with a 3-month to 5-year maturity (which was later extended); and (iii) a securities scheme, i.e. the issuance of special government bonds (up to €8 billion) with a maturity of up to 3 years, provided to eligible credit institutions so as to be used as collateral that would enable them to enhance their access to liquidity, in particular through financing from the ECB or from other banks in the interbank market.

successfully address the impact of the crisis manifest by then. At that particular point in time, the possibility of a "haircut" (restructuring) of public debt could not have been envisaged even as a remote eventuality, and thus could not have been included in the scenarios. The stress test results were showing that banks, though not without some difficulty, were able to cope with the impact of the financial crisis.

3.2.4 The Greek banks and the importance of the decisions of the Eurosystem

The Greek economy was affected by the global financial crisis with some lag. In the course of 2009 it recorded a considerable slowdown in credit expansion to the private sector (households and enterprises). Owing to the restriction of funding sources, from early 2009 onwards the Greek banks started relying heavily on the Eurosystem for raising liquidity (see Charts 11 and 12 in Part Two). In this context, the decision made by the ECB in May 2009, i.e. to maintain the low level of minimum credit threshold for assets in the Eurosystem collateral framework for the provision of liquidity, was particularly important.

Moreover, the worsening macroeconomic environment inevitably affected the quality of the Greek banks' loan portfolio as well. The last months of 2009 (and, mainly, the first quarter of 2010) saw a considerable rise in the liquidity risk Greek banks were facing, as their funding sources were restricted further and deposit outflows started being recorded (see Table 14 and Chart 4 in Chapter 6, Section 3). At the same time, the successive downgradings of the Greek government's credit rating by international rating agencies limited the banks' access to the markets for raising funds and increased their borrowing costs, while in parallel the value of the bonds Greek credit institutions held in their portfolios —and therefore the value of the available collateral— decreased.

Nevertheless, the most important challenge for banks in the euro area (including Greece) had to do with carrying out the necessary adjustments to the size and structure of their balance sheets, without however limiting the availability of credit to the non-financial sector of the euro area, given that numerous businesses lacked access to capital markets for raising funds. In this respect, banks in the euro area proceeded to further strengthen their capital base, also taking advantage of the recapitalisation possibilities offered in the context of measures for supporting the financial sector established by Member State governments.

PART TWO: 2010-2013

4 A NEW EUROPEAN ENVIRONMENT IS BEING BUILT FROM 2010 ONWARDS

In 2010 the financial crisis evolved into a sovereign debt crisis in some euro area countries, posing a direct threat to the stability of the economic and monetary union. Greece found itself at the epicentre of the crisis, as the weakest euro area economy with large (fiscal and current account) deficits and serious structural problems. By early May 2010, it had become clear that one country's problem had turned into a problem for the euro area as a whole. The European leaders came to important decisions for coping with the crisis and averting its future re-emergence; these decisions represent the beginning of the most significant effort to reform the EMU since its inception.

At this time, the European Union was looking into the experience of the crisis, in search of new governance orientations, ones that would define a new operational framework for EMU and the Member States' economies, a new institutional setup. For the countries of the euro area, the environment thus shaped required greater consistency in abiding by fiscal obligations and introducing new rules for all economic policies, in addition to fiscal policy. The crisis appeared to set the EU and the euro area on a new course, having as a main objective the convergence of the Member States' economic policies. This entailed long-term commitments to achieve fiscal balance, improve competitiveness, and harmonise rules on the operation of markets and the banking system.

The crisis resulted not only in the adoption of longer-term objectives for changing the existing structures, but also in a key decision – the one regarding financial support of countries facing problems. This choice was neither easy, nor self-evident; this is why it met with some serious resistance. In the end, however, the choice prevailed, as it was based on European criteria – i.e. the view that the default of one Member State would have very serious side-effects for the entire euro area.

All of the above delineated the objective reality within which the Greek economy had to function in the years of the crisis, and will be required to function in the future:

- In the medium term, meeting the terms of the support programmes was, and still is, a primary condition for European solidarity to continue.

- In the long term, the Greek economy must work towards a new growth model, one that will be in line with the new reality as it is being shaped at European level.

4.1 2010: Decisions for supporting the Member States – in search of systemic solutions

On 11 February 2010, the euro area Heads of State or Government declared that they support the efforts of the Greek government and its commitment to take any action required in order to ensure the achievement of the ambitious targets set in the stability programme for 2010 and the following years, and called upon the Greek government to promote with determination all the necessary measures so as to reduce the fiscal deficit by 4% of GDP in 2010. *Their statement emphasised that euro area countries would take decisive and coordinated action*, if necessary, to safeguard financial stability in the entire euro area, and also clarified that the Greek government had not requested any financial assistance.

On 25 March, the Heads of State or Government of the euro area countries, after reconfirming their statement made on 11 February, reached an agreement which specified that "*as part of a package involving substantial International Monetary Fund financing and a majority of European financing, euro area member states, are ready to contribute to coordinated bilateral loans*". They also agreed on the need to improve and complement the framework for ensuring sustainable public finances in the euro area, and to enhance its ability to act in crisis periods (see Box 4.1.).

On the basis of the aforementioned decision, a mechanism for the support of the Greek economy by the euro area countries and the IMF was activated in early May 2010, after the Greek authorities had drawn up an economic policy programme that was accepted —as a condition for the provision of financial support— by the Commission in cooperation with the ECB and by the IMF.[1]

1 Following a request made by the Greek government on 23.4.2010, the Finance Ministers of the euro area countries reached on 2.5.2010 an agreement on the support package for Greece, which was officially announced by the euro area Heads of State or Government on 7.5.2010. The official IMF decision to grant a 3-year loan of €30 billion to Greece was made on 9.5.2010.

The decisions of the euro area countries to provide a financial assistance package, with IMF participation, to Greece and —a few months later (on 7 December 2010)— to Ireland took into consideration the fact that market pressures had rendered prohibitively high the cost of borrowing for both the public and the private sectors, as well as the risk of an uncontrollable systemic spread of the crisis, initially to the European South and thereafter to the core of the euro area. The financial assistance, which consisted in bilateral loans at special interest rates and with specific maturities, was accompanied by strong binding terms (conditionality), reflecting on the one hand the common interest of the euro area and solidarity within it, and on the other hand the responsibility of each Member State vis-à-vis its partners.

Box 4.1

EU decisions on the support mechanism for Greece and other Member States, March-April 2010

1. Statement by the euro area Heads of State or Government, Brussels, 25 March 2010: main points

"We reaffirm that all euro area members must conduct sound national policies in line with the agreed rules and should be aware of their shared responsibility for the economic and financial stability in the area.

[…] The consolidation measures taken by Greece are an important contribution to enhancing fiscal sustainability and market confidence. The Greek government has not requested any financial support. Consequently, today no decision has been taken to activate the below mentioned mechanism.

In this context, euro area member states reaffirm their willingness to take determined and coordinated action, if needed, to safeguard financial stability in the euro area as a whole, as decided the 11th of February.

As part of a package involving substantial International Monetary Fund financing and a majority of European financing, euro area member states, are ready to contribute to coordinated bilateral loans.

This mechanism, complementing International Monetary Fund financing, has to be considered ultima ratio, meaning in particular that market financing is insufficient. Any disbursement on the bilateral loans would be decided by the euro area member states by unanimity subject to strong conditionality and based on an assessment by the European

Commission and the European Central Bank. We expect Euro-Member states to participate on the basis of their respective ECB capital key.

The objective of this mechanism will not be to provide financing at average euro area interest rates, but to set incentives to return to market financing as soon as possible by risk adequate pricing. Interest rates will be non-concessional, i.e. not contain any subsidy element. Decisions under this mechanism will be taken in full consistency with the Treaty framework and national laws."

2. Statement on the support to Greece by euro area Member States, Brussels, 11 April 2010

"Following the statement by the Heads of State and Government of the euro area on 25 March, Euro area Member States have agreed upon the terms of the financial support that will be given to Greece, when needed, to safeguard financial stability in the euro area as a whole.

Euro area Member States are ready to provide financing via bilateral loans centrally pooled by the European Commission as part of a package including International Monetary Fund financing.

The Commission, in liaison with the ECB, will start working on Monday April 12th, with the International Monetary Fund and the Greek authorities on a joint programme (including amounts and conditionality, building on the recommendations adopted by the ECOFIN Council in February).

In parallel, euro area Member States will engage the necessary steps, at national level, in order to be able to deliver a swift assistance to Greece.

Euro area Member States will decide the activation of the support when needed and disbursements will be decided by participating Member States.

The programme will cover a three-year period. The euro area Member States are ready to contribute for their part up to € 30 billion in the first year to cover financing needs in a joint programme to be designed with and co-financed by the IMF. Financial support for the following years will be decided upon the agreement of the joint programme.

In order to set incentives for Greece to return to market financing, Euro area Member States loans will be granted on non-concessional interest rates. The pricing formula used by the IMF is an appropriate benchmark for setting euro area Member States bilateral loan conditions, albeit with some adjustments. Variable-rate loans will be based on 3-month Euribor. Fixed-rate loans will be based upon the rates corresponding to Euribor swap rates for the relevant maturities. A charge of 300 basis points will be applied. A further 100 basis points are charged for amounts outstanding for more than 3 years. In conformity with IMF charges, a one-off service fee of maximum 50 basis points will be charged to cover operational costs.

For instance, as of April 9th, for a three-year fixed-rate loan granted to Greece, the rate would be around 5%.

The Eurogroup is confident that the determined efforts of the Greek authorities and of its European Partners will allow to overcome the fiscal and structural challenges of the Greek economy. In this context, the Eurogroup welcomes the budget execution in the first months of the year, which shows that the measures taken so far are bearing fruit."

In parallel (on 8-9.5.2010), the euro area summit and the euro area Finance Ministers decided to establish a provisional European Financial Stability Facility (EFSF), accessible only to euro area countries. This Facility was provided with guarantees amounting to €440 billion following a decision on June 17 (in addition to the amounts granted for the support of Greece and a further amount of €60 billion available at EU level),[2] in order to prevent the recurrence of similar debt and confidence crises in the future, and to protect stability in the euro area.

The ECB's monetary policy stance remained accommodative in 2010, while the Eurosystem kept resorting to the use of non-standard monetary policy measures, with a view to improving the financing conditions and boosting the flow of bank credit to the real economy. The ECB activated an additional non-standard measure, the Securities Markets Programme, and intervened in the secondary market by purchasing government bonds issued by some countries,[3] in order to address dysfunctioning in financial markets that jeopardised the smooth operation of the mechanism for the transmission of monetary policy effects to the real economy (see also Chapter 5.2).

These decisions, combined with the better-than-anticipated results of the EU-wide stress tests of banks in July 2010 and the positive performance of adjustment programmes in the first months of their implementation, led to a partial restoration of investor confidence, but only in the short run. Markets continued to treat the provisional support mechanism with scepticism, deeming the size of its available funds insufficient to cope with a broader debt crisis in Europe. The yield spreads of government bonds issued by relatively weaker countries vis-à-vis corresponding German bonds remained at high levels, while new reports in the international me-

2 See the interview of J.-C. Trichet in *Libération* on 8.7.2010.

3 The specific ECB actions are detailed in Chapter 5.2, along with the national breakdown of the bonds purchased by the Eurosystem. See also Chapter 8.3.5.

dia were discussing an increased probability of euro area breakup, at the same time questioning the future effectiveness of the bailout mechanisms and the European leaders' determination to jointly resolve the debt crisis in Europe.

Thus, a few months later, in October 2010, the European leaders decided to alleviate pressures by creating a permanent crisis-resolution mechanism, the European Stability Mechanism, thereby confirming their will to take all necessary actions in order to safeguard the stability of the financial sector and of the euro area in general.

Developments were now making obvious the strong interdependence of EU Member States and the need for closer coordination of their fiscal and economic policies. So, for the first time in 2010, the issue of a "European economic governance in the EU-27" was raised, with a view to developing a common economic agenda and a strong, comprehensive monitoring framework at EU level. The new framework would require all Member States to make long-term commitments, particularly as regards fiscal discipline and the focus of their economic policy on improving competitiveness – i.e. precisely the two major challenges Greece had to face, one way or another.

Specifically, in May 2010 the Commission proposed a strategy for strengthening economic governance in the EU, by introducing the idea of the "European Semester", synchronising the assessment of the Member States' fiscal and structural policies and seeking to enhance the Member States' compliance with the rules and principles of the Treaty and the Stability and Growth Pact. For the euro area it was additionally proposed to enhance macroeconomic surveillance, by establishing official procedures, in order to identify and correct macroeconomic imbalances in a timely manner. This strategy was laid down in September 2010 in six specific legislative proposals (known as the "six-pack"). The new elements of these proposals consisted in: (i) the fact that fiscal discipline and sanctions took both fiscal deficit and public debt into account; (ii) a simplified decision-making process through the introduction of the reverse qualified majority voting rule (meaning that the Commission's proposal is adopted unless rejected by the Member States' special majority); and (iii) the creation of a list of economic indicators (scoreboard) for the quantitatively monitoring of macroeconomic imbalances.

One month later, in June 2010, the European Council approved the EU's "Europe 2020" strategy, a 10-year growth strategy that focused on long-term structural reforms to address the challenges emerging from globalisation, demographic developments and climate change, aiming towards a more competitive EU in terms of production and innovation. In parallel, in October 2010 the European Council approved the report by the Task Force headed by Mr. Van Rompuy, which pointed to the same direction.

In combination with the decisions to strengthen economic governance and safeguard stability in the euro area, the European leaders and the EU institutions implemented in the course of 2010 a series of decisions that had been taken in 2009 for the reform of the financial sector. Specifically, the European Systemic Risk Board (ESRB) was set up, with the active involvement of the ECB. Its responsibilities include monitoring and assessing the risks to the stability of the financial system as a whole ("macroprudential supervision") and providing early warnings and recommendations to the Member States. This Board was complemented by the European System of Financial Supervisors (ESFS) for the supervision of the individual financial institutions ("microprudential supervision"), composed of three new European Supervisory Authorities, according to the recommendations of the de Larosière report (see Chapter 2.2). Also, in June 2010, it was agreed to introduce a system of taxes and levies on financial institutions, in order to ensure fair participation in the systemic risk limitation costs of the financial sector. Finally, in order to increase transparency, it was decided that banks' stress test results would be published.

With Greece returning as a main item of discussion in the G7 meeting (in October 2010), the issue of restructuring the debts of euro area countries was voiced for the first time during the German chancellor's meeting with the French President in Deauville, resulting in an upward surge in the interest rates on government bonds of the euro area periphery, and primarily on those of Greece. Proposals for the issuance of euro bonds were rejected, on the grounds that a mutualisation of the debt would weaken the fiscal and reform efforts of the countries with deficits, whilst creating at the same time moral hazard problems in the rest of the countries.

4.2 2011: Developments in Greece heighten uncertainty about the future of the euro

In 2011, the public debt crisis in the euro area intensified. In April 2011, Portugal became the third country to request financial assistance; its economic adjustment programme was adopted by the Eurogroup on 17 May 2011. At the same time, in the second half of the year there were heightened fears of a possible exit of Greece from the euro, which worsened confidence both at home and abroad.

In the first half of 2011 the situation remained under control. In January, the new economic and fiscal coordination framework, the European Semester, started being implemented, while the new financial sector supervision system was launched. Moreover, in March 2011 the provisional financial stability mechanism

was further improved, as the European Financial Stability Facility was granted the possibility to intervene in exceptional circumstances in the primary market for government bonds, and the terms of the permanent European Stability Mechanism were agreed, with a real lending capacity of up to €500 billion and a nominal capital of €700 billion. In addition, it was decided to change the terms of the bilateral loans extended to Greece, by lengthening their maturity to 7.5 years and lowering their interest rate by 100 basis points, thus allowing some relief as regards the servicing of the debt.

However, economic and financial conditions deteriorated in the second half of 2011, mainly in the more exposed and vulnerable economies, such as Greece. The international community, particularly the US, expressed deep concern that a possible default of Greece would produce chain reactions in the euro area, thereby negatively affecting the global economy. From every direction, euro area leaders were increasingly urged to take determined and coordinated action, so as to avoid a transmission of the peripheral countries' problems to the core of the euro area. The challenge for the European leaders was dual: on the one hand, direct and urgent action had to be immediately taken to protect financial stability in the euro area and prevent any defaults of Member States; on the other hand, the credibility of the euro had to be restored. Thus, the European leaders deemed it necessary to arrive at even bolder and substantial decisions, in order to avert the likelihood of a systemic collapse. In July 2011, under strong market pressures, discussions began on a second support package for Greece, while controversy peaked concerning the way to handle the Greek fiscal crisis – particularly as regards "private sector involvement" (PSI) in a possible haircut of the Greek public debt. Germany insisted in a cut involving the private sector, to which France was opposed, deeming that such a haircut would contribute to a contagion of other euro area countries with the Greek problem. The ECB as well, was not in favour of the idea of cutting the Greek debt, due to its potential significant impact on the financial stability of the euro area.[4] The ECB had repeatedly expressed its opposition to any debt-haircutting forms that would not be purely voluntary but would involve elements of compulsion, while it also wanted to prevent any "credit event", "default" or "selective default".

In the end, an agreement was reached to grant a new, second assistance package to Greece, amounting to €109 billion, as well as to proceed with a cut of the debt on

4 See, *inter alia*, ECB, *Monthly Bulletin*, Box 5 "Private sector involvement and its financial stability implications", October 2011, p. 43, and Lorenzo Bini Smaghi (member of the ECB's Executive Board), "Private sector involvement: From (good) theory to (bad) practice", speech before the Reinventing Bretton Woods Committee, Berlin, 6.6.2011.

the basis of a voluntary involvement of the private sector. Although it was made clear that Greece constituted a special / unique case,[5] markets and investors deemed that the new agreement was setting a precedent for the involvement of the private sector in the haircuts of the public debts of other countries experiencing difficulties as well.

The results of the annual EU-wide bank stress testing exercise conducted in July 2011 confirmed the feeling that the banking sector of the EU was still facing serious challenges. In August and in the fall of 2011, the interest rates on the government securities of some of the larger euro area countries rose dramatically.

The governments of the euro area countries now had to deal with the markets' strong doubts regarding the sustainability of EMU in its existing institutional form. The euro, this "material and symbolic heart of the Union" (in the words of Herman Van Rompuy), was facing the greatest confidence crisis since its introduction, in an environment of increasing financial uncertainty, economic recession and unemployment.

In November 2011, the Commission launched a consultation on its proposals for a joint debt issuance in the euro area, examining the possible benefits as well as the risks of issuing "Stability Bonds". In December 2011, the European Council clarified its approach to the private sector's involvement in public debt write-offs. Specifically, it explained that the Treaty for the establishment of the European Stability Mechanism would explicitly require abidance by the principles and practices of the IMF. This meant that the terms and conditions for all new bonds would include standardised and identical Collective Action Clauses, in such a way as to ensure market liquidity. It was agreed to review the adequacy of the European Stability Mechanism funds in March 2012. Moreover, it was decided to provide the IMF with additional funds amounting to up to €200 billion, in the form of bilateral loans, so that it would have adequate resources at its disposal for dealing with crises.

Finally, the European Council adopted a new Fiscal Compact that would be ratified by the euro area countries and other EU Member States on a voluntary basis. Ratification of this compact would reflect the countries' strong political commitment to a closer and irrevocable fiscal and economic integration, so as to substantially improve the outlook for fiscal sustainability and public debt in the euro area. In the same period, the Commission proposed two new Regulations for enhancing

5 This fact was also stressed by the President of the ECB, who added that a credit event as well as a default were averted (as the ECB had asked), while for the eventuality of selective default it was provided that governments would proceed to a recapitalisation of the banks concerned and would provide credit support so that banks could secure collateral to offer to the ECB in order to obtain liquidity (see J.-C. Trichet's statement on 21.7.2011 and interviews in *Süddeutsche Zeitung* on 23.7.2011 and *Le Point* on 27.7.2011).

fiscal supervision in the euro area (the "two-pack"), while the "six-pack" for promptly identifying and correcting macroeconomic imbalances entered in force in December 2011.

With respect to Greece, on 26 October 2011, the EU Summit approved the new financing package, as well as the debt reduction (PSI). The new agreement revised a previous one reached on 21 July 2011, mainly as regards the part referring to the voluntary involvement of the private sector in the bond exchange, with a 50% nominal discount on the notional Greek debt held by private investors.

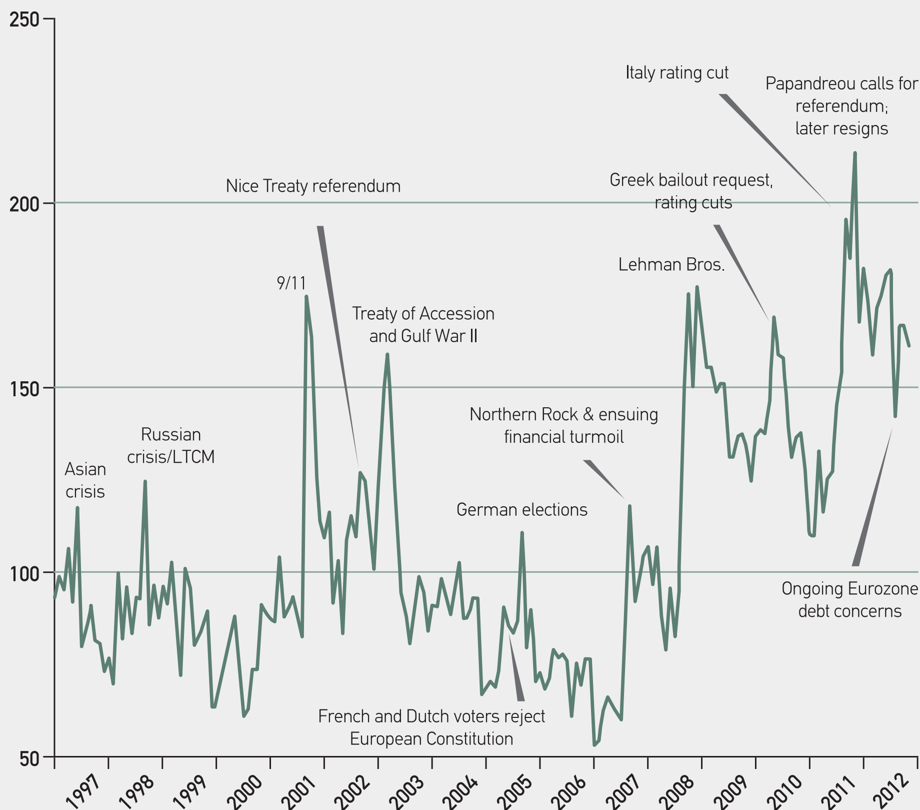
Based on the agreement's provisions at the time, the debt would fall to 120% of GDP by 2020. Despite the positive effects of the PSI on public debt reduction, growing political and social reactions in Greece —which led to a proposal by the Prime Minister, George A. Papandreou, to carry out a referendum on the new loan agreement (which, in the eyes of the European leaders, would be equivalent to a referendum on whether to exit the euro area or not)— sharply increased uncertainty in the country, leading to a massive outflow of deposits, acute liquidity and private-sector financing problems, and a major deviation of the adjustment programme from its implementation course. Developments in Greece were now largely driving international economic sentiment, especially in Europe. Twice in the period 2008-2012, measurements of uncertainty regarding economic policies in Europe recorded peaks attributed to developments in Greece. The first time, in 2010, coincided with the country's recourse to the support mechanism. The second time, at end-2011, coincided with the announcement of plans for a referendum (see Chart 1). It is worth mentioning that in the second case the relevant European Policy Uncertainty Indicator reached its highest level recorded throughout the entire global crisis period (2007-2012).

4.3 2012: Speeding up the efforts to institutionally restructure the EU – sentiment gradually improves

The year 2012 was a turning point for the EU and a resilience test for the euro area. In June 2012, Cyprus became the fourth[6] euro area country to submit a request for assistance. Fears of a euro area breakup, heightened in the first half of the year, gradually subsided, while efforts towards a genuine completion of EMU intensified. Restoring confidence in fiscal prospects and the banking sector, boosting liquidity and getting back on a growth track became cornerstones of the European

6 The fifth, if also taking into account Spain's request for assistance to its banking sector.

Chart 1 European policy uncertainty index
Jan. 1997 – Nov. 2012



Note: Index composed of a News-Based Index (0.5 weight), and country-level components measuring forecaster disagreement about inflation rates and federal government budget balance (each 0.25 weight). News-Based component composed of the monthly number of news articles containing uncertain or uncertainty, economic or economy, as well as policy relevant terms (scaled by the smoothed number of articles containing "today"). Policy-relevant terms include: "policy", "tax", "spending", "regulation", "central bank", "budget", and "deficit". Series is normalised to mean 100 from 1997-2010. Index covers Jan. 1997-Nov. 2012. Papers include *El Pais, El Mundo, Corriere della Sera, La Repubblica, Le Monde, Le Figaro, Financial Times, The Times, Handelsblatt, FAZ*. All searches done in the native language of the paper in question. Over the reviewed period, the index peaked in November 2011 (217.3).
Source: Baker, S.R., N. Bloom and S.J. Davis, "Measuring Economic Policy Uncertainty", Chicago Booth Research Paper No. 1302, 29 April 2013;
see http://www.stanford.edu/group/SITE/SITE_2013/2013_segment_2_papers/baker.pdf.

endeavour. The decisions made resulted in an institutional and legislative reinforcement of the principles of responsibility and reciprocity between euro area countries. However, recession and rising unemployment, particularly in the economies of the European South, rendered the achievement of these targets difficult.

European policy in the course of 2012 focused on the implementation of the fiscal rules, the correction and monitoring of macroeconomic imbalances, and the stability of the financial system. In March 2012, the leaders of the 25 EU Member States signed the "Treaty on Stability, Coordination and Governance" of EMU (also known as the "Fiscal Compact"), which finally came into force in January 2013. The contracting parties were required to introduce in their national legislation a fiscal rule for a budgetary position in balance or in surplus, as well as a corrective mechanism that would be automatically triggered in cases of considerable deviation from the medium-term target or from the adjustment course leading to it.

At the same time, amid strong concerns with regard to the Italian, Spanish and Portuguese bond spreads, the ECB continued to use non-standard monetary policy measures to provide liquidity to banks.

But fiscal consolidation and the confidence crisis made the conditions of economic recession and high unemployment worse, with serious social repercussions in several European countries. Austerity policies were questioned and it was argued that it was imperative to support demand and strengthen the growth potential of European economies. Recognising the need to accompany fiscal consolidation with measures that foster growth and employment, the European Council adopted in June 2012 the "Compact for Growth and Jobs".[7]

In parallel, the euro area came by a more credible and clear proposition regarding its long-term outlook and strategy, through the publication on 26 June 2012 of a report by the four Presidents (of the European Council, the Eurogroup, the Commission, and the ECB) titled "*Towards a genuine EMU*", along with a commitment to prepare a specific roadmap by the end of the year. The final report, presented at the European Council of December 2012, along with the Commission's "*Blueprint for a deep and genuine Economic and Monetary Union*", describe in detail the next steps to be taken for the creation of a robust and stable structural design in the fi-

7 This Compact was mainly aimed at: (i) encouraging job creation, labour mobility and investment for skills acquisition; (ii) maintaining drivers of growth such as investment in energy, innovation and education; (iii) further deepening the Single Market, particularly in the digital industry; (iv) supporting innovation, research and industrial competitiveness; and (v) strengthening the role of trade as a driver of growth. The Compact also included a commitment to finance the EU economy through the mobilisation of €120 billion for investment, including €55 billion from the EU Structural Funds, €5 billion from the pilot initiative for "project bonds", and another €60 billion from the European Investment Bank (after the increase of its capital by €10 billion).

nancial, fiscal, economic, and political sectors, in order to support the stability of the euro and of the EU as a whole. All key choices related to the Member States' economic and fiscal policies would be subject to coordination, endorsement and surveillance at EU level.

These decisions made it even clearer that participation in the monetary union entailed close interdependence and shared responsibility. Crisis prevention, management and resolution tools improved and, on 3 October 2012, the Treaty for the establishment of the European Stability Mechanism (ESM) came into effect, following its ratification by the national parliaments of all the euro area countries. Enabling in principle the recapitalisation of financial institutions directly by the mechanism, this Treaty made the ESM "the world's most capitalised international financial institution and the world's biggest regional firewall".[8]

Pressed by the issue of the Spanish banks' recapitalisation, the Summit of June 2012 turned the financial climate in Europe to a more positive direction. The European leaders decided to create a Single Supervisory Mechanism (SSM) for all euro area banks, something that would have been unimaginable only a few months earlier. The general guidelines of the legal framework for the SSM (which will have become fully operational by end-2014) were agreed during an extraordinary ECOFIN meeting in December 2012. Under these guidelines the ECB will be directly responsible for supervising the largest financial institutions of the euro area and for the overall operation of the SSM, which will pave the way towards the use of the European Stability Mechanism to directly recapitalise banks in the future.

As banking supervision is essentially transferred to a single supervisory mechanism, safeguarding financial stability also necessitates a single resolution mechanism to ensure an effective bank resolution framework able to adequately protect depositors and, above all, taxpayers in cases of crises in the banking sector. The European Commission was called upon to submit a relevant proposal by end-2013. It did so on 10 July 2013, aiming for the proposal to be adopted in the course of 2014, thereby allowing the single resolution mechanism to start operations as of 1 January 2015. The ECOFIN has already adopted these proposals. Under these new arrangements the negative feedback loop between fiscal and banking crises is markedly weakened (see also Section 4.4 of this Chapter and Box 4.2 further below).

The markets' confidence in the euro area was further improved thanks to series of other events, such as the new Greek government's reaffirmation of its commitment (in June 2012) to meet the targets of the economic adjustment programme, the

8 See European Commission, "A blueprint for a deep and genuine EMU", COM(2012) 777 final, 30.11.2012, p. 7.

election of a new government in the Netherlands (in September 2012), the positive ruling of the Federal Court of Justice of Germany (Bundesgerichtshof) regarding the permanent European Support Mechanism (in September 2012), Ireland's "partial" return to the markets (in July 2012), and the new agreement on the sustainability of the Greek debt (in November 2012). Another fact that acted as a catalyst in regaining much of the confidence lost and in diminishing the risk of a euro area breakup was the ECB's decision to activate a new programme for the purchase of government bonds (on 6 September 2012), i.e. to undertake Outright Monetary Transactions (OMTs) which allow for unlimited purchases of government bonds under strict conditionality, so as to address fragmentation in the financial markets. (See also Chapter 5.2 "The financial crisis and the interventions of the Eurosystem").

4.4 2013: Towards a new institutional European setup

The main developments in this respect in the course of 2013 were the following:

- European leaders reached an agreement on the Community Budget for the seven-year period 2014-2020 (in February 2013). The agreement provided for an expenditure ceiling of €960 billion, an amount lower by 3% compared to the previous Budget (for 2007-2013) for the first time in the history of the EU. Special provisions were made for Greece. On 27.6.2013, the Presidents of the European Parliament, the European Commission and the European Council arrived at a political agreement for more flexibility in expenditure, without prejudice to the above ceiling.
- The Fiscal Compact came into effect as of 1.1.2013, following its adoption by Finland as well.
- In February 2013, the European Parliament, the European Commission and the European Council came to a political agreement on the "two-pack" regulations for strengthening the fiscal surveillance mechanisms in the euro area.
- In 2013, in parallel with the completion of the above institutional and legislative interventions, emphasis was placed on the social dimension of EMU (through the adoption —at the Spring and Winter meetings of the European Council— of initiatives for youth employment), as well as on enabling the conclusion of contracts between EU Member States and the EU institutions, with a view to strengthening competitiveness and growth. At the same time, it was made clear that a further enhancement of economic governance should be accompanied by mechanisms that ensure the highest degree of democratic legitimacy and accountability.

- With respect to the integrated financial framework, in 2013 considerable progress was made towards the creation of a Banking Union in the euro area (see Box 4.2).

Box 4.2

Progress towards the establishment of banking union in 2013 and the involvement of the Bank of Greece

1. The four pillars of the banking union

The establishment of a European banking union is a major step towards a genuine economic and monetary union in Europe. As agreed by the Heads of State or Government of euro area Member States and announced by the European Commission in June 2012, the banking union, building on a common rulebook for banks, comprises four additional, inextricably interconnected, pillars: (a) a single supervisory mechanism for banks, (b) a single resolution mechanism, (c) a single deposit protection scheme, and (d) a single mechanism for direct bank recapitalisation. With regard to the latter two pillars, the roadmap towards Banking Union includes[1] harmonised national deposit guarantee schemes, as well as a common backstop arrangement, similar to the Hellenic Financial Stability Fund and the European Stability Mechanism, which will ensure the necessary funds for a direct recapitalisation of banks without the involvement (burdening) of sovereigns. The European banking union, coupled with the single monetary policy, will entail manifold benefits for Europe. First of all, it will contribute to ensuring financial stability and a more efficient functioning of EU banks – and therefore a more effective financing of firms and households. Furthermore, it will contribute considerably: (a) to the economic union of Europe, by increasing the degree of convergence between Member States as regards the operational framework of the financial services sector and its supervision, and at the same time (b) to breaking the vicious circle between the problems facing banks and the fiscal imbalances of European countries. This is particularly of relevance for Greece, given that, unlike other European countries, the Greek crisis did not originate from the banking system, which suffered the consequences of the fiscal crisis.

After its adoption by the European Parliament (September 2013) and its final approval by the ECOFIN Council, a Council regulation conferring specific tasks on the

1 See Herman Van Rompuy, "Towards a genuine Economic and Monetary Union", December 2012.

ECB concerning policies relating to the prudential supervision of credit institutions (i.e. the creation of a Single Supervisory Mechanism for the euro area) was published in the *Official Journal* of the European Union and entered into force. This means that the ECB will assume its banking supervision responsibilities in November 2014.

The Bank of Greece has played an active role in many ways in the whole process of the creation of the Single Supervisory Mechanism.

First of all, the Bank participates in the supreme decision-making body of the ECB, as its Governor is a member of the ECB's Governing Council. Besides, it represents the country in several fora and has taken part in the consultation on the SSM legislative package in the context of the SSM Working Group of the European Council and the European Commission. Lastly, the Bank has been actively involved in the SSM preparatory works through its representatives in the High-Level Expert Group, the Working Group and in other related sub-groups.

2. Proposals on a resolution framework

The creation and operation of a single supervisory mechanism is an important step towards European banking union. However, in order to ensure effective supervision, the mechanism must be accompanied by a credible solution for dealing with ailing banks whose situation cannot be remedied. Towards this end, a further decline in uncertainty, a strengthening of market discipline concerning credit institutions' business choices, and a restoration of confidence both in the banking system and in its ability to finance economic growth will be achieved by pre-determining the procedures to be followed for recovery and resolution of credit institutions which encounter difficulties or are not viable. Two relevant legislative proposals were prepared and submitted to competent EU institutions for approval.

Proposal for a Directive: The Directive establishing a framework for the recovery and resolution of credit institutions and investment firms was endorsed by the ECOFIN Council (June 2013), while on 18 December 2013 an agreement was reached between the Council and the European Parliament. The Directive was expected to be adopted by the plenary session of the European Parliament in April 2014. The Directive aims, apart from preserving financial stability, at ensuring that the competent authorities are equipped with all necessary and effective means to tackle bank crises pre-emptively and implement resolution measures when needed. In the event that a bank's financial condition has deteriorated to such an extent that it cannot be remedied, the Directive shall maintain continuity of the bank's critical economic functions, by ensuring that resolution costs are borne primarily by shareholders and creditors and not by taxpayers. The Directive provides for, among other things, the bail-in tool, which should be applied in a way that re-

spects the preferential treatment of creditors with uninsured deposits (who are private individuals or SMEs) over the remaining creditors and the shareholders of a failing bank. It should be noted that, in any event, deposits of up to €100,000 are fully guaranteed, as they are protected by national Deposit Guarantee Schemes.

Proposal for a Regulation: Furthermore, the European Commission presented (July 2013) a legislative proposal for a Single Resolution Mechanism, with a view to setting up a Single Resolution Board for banks in the euro area and a Single Bank Resolution Fund. This mechanism should complement the Single Supervisory Mechanism (SSM) and ensure that if, notwithstanding stronger supervision, a bank subject to the SSM faced serious difficulties, its resolution could be managed efficiently with minimal costs to taxpayers. More specifically, the Regulation aims at breaking the vicious circle between banks and sovereigns, as well as at effectively shielding the European financial system, by restoring depositor and investor confidence. The Single Bank Resolution Fund will be funded by annual contributions paid by credit institutions in Member States participating in the Single Resolution Fund, thereby ensuring a relative adequacy of resources. In the event that additional funds are required, the Regulation envisages extraordinary *ex-post* contributions from credit institutions or the Single Resolution Fund's borrowing from third parties (such as national governments, financial institutions, etc.). According to the proposals that were submitted until early 2014, the target is that the Fund's resources should correspond to €55 billion by 2025. Under the Greek Presidency, following a political agreement reached at the Council level on the Single Resolution Mechanism, in January 2014 the trilogue discussions between the European Council, the European Parliament and the European Commission started and led to an agreement on 20 March.

The Bank of Greece participated in the Council's Working Groups regarding the proposals for a Bank Recovery and Resolution Directive and Regulation, while it prepared comprehensive strategy proposals, comments and memos, in order to provide its expertise to the Greek Ministry of Finance. It should be noted that under the Greek Presidency of the EU, which started in January 2014, the Bank of Greece set up a working group in close cooperation with the Ministry of Finance to handle the relevant dossier; negotiations with the European Parliament were chaired by Bank of Greece officials on behalf of the Council. Finally, the Bank of Greece, as a resolution authority, is expected to play a key part as soon as the Single Resolution Mechanism becomes operational.

- Moreover, for 2013 and the coming years the time-frame presented in the Commission's "*Blueprint for a deep and genuine Economic and Monetary Union*" (in December 2012) envisaged the following:

In the short term (within 6 to 18 months)

– Implementation of the "six-pack" and the "two-pack" legislation; establishment of a Single Resolution Mechanism for banks in difficulty, following the adoption of the Single Supervisory Mechanism.

– Establishment of a "convergence and competitiveness instrument" within the EU budget, separate from the Multiannual Fiscal Framework, to support the timely implementation of structural reforms. Such support will be based on commitments included in "contractual arrangements" to be agreed between individual Member States and the Commission.

In the medium term (within 18 months to 5 years)

– Further strengthening of the collective exercise of fiscal and economic policies —including tax and employment policies— alongside the creation of a proper fiscal capacity. A special fiscal capacity for the euro area should rely on own resources and provide adequate support to important structural reforms in large economies under distress. This "capacity" could be developed on the basis of the "convergence and competitiveness instrument", but it would best be founded on new and specific provisions in the context of amendments to the Treaties.

– A debt redemption fund subject to strict conditionality and the common issuance of euro "treasury bills" could also be examined as additional means for the reduction of public debt and the stabilisation of financial markets.

– The monitoring and management of the fiscal capacity and other instruments should be entrusted to an EMU Fund, operating within the European Commission.

In the long term (beyond 5 years)

– Provided there is an adequate degree of integration in terms of sovereignty, responsibility and solidarity at EU level, it would become possible to establish an autonomous euro area budget that would provide a fiscal capacity for the EMU to support Member States facing economic shocks.

– An integrated framework of economic and fiscal governance would allow the common issuance of public debt, which would strengthen market functioning and monetary policy implementation. This would be the final stage of EMU.

5 THE EUROSYSTEM TAKES NEW ACTION TO SUPPORT FINANCIAL STABILITY: 2010-2013

From 2010 onwards, the Eurosystem was again faced with a challenging environment, with renewed tensions in financial markets. These included the strong tensions observed in some bond markets, particularly since May 2010, reflecting the debt crisis; the period of the debt crisis was characterised by serious disruptions in the monetary policy transmission mechanism. During that phase as well, the ECB's response was immediate, combining both standard and non-standard monetary policy measures.

5.1 2010-2013: The decisions of the ECB's Governing Council on interest rates

Throughout 2010 and in the first quarter of 2011 the ECB maintained its accommodative monetary policy stance, as inflationary pressures in the euro area remained moderate. The ECB's Governing Council decided to keep the Eurosystem key interest rates unchanged at historically low levels. The rate on the main refinancing operations remained at 1%. But in April and July 2011 the Governing Council decided to raise the Eurosystem's key interest rates, by 25 basis points each time, as there were signs of accelerating inflation in the euro area.

However, since November 2011 the ECB key interest rates followed a steady downward course, mainly due to subsiding inflationary pressures. Following five successive reductions in November 2013 the rate on the main refinancing operations stood at 0.25%. By maintaining extremely low interest rates and supplying ample liquidity to the banking system, the Eurosystem's monetary policy will assist in the gradual recovery of the euro area economy.

In July 2013 the ECB's Governing Council communicated that it expected the ECB key interest rates to remain at present (then) or lower levels for an extended period of time. This expectation was based on the overall subdued medium-term outlook for inflation, given the broad-based weakness of the economy and the subdued monetary dynamics.

By providing forward guidance (indications of the future stance of monetary policy), the Eurosystem aimed at anchoring monetary policy stance expectations. The adoption of this policy exerted downward pressures on expectations regarding money market interest rates and developments in these rates in the euro area were decoupled from corresponding developments in other countries. Following up on the initial announcement made in July, the Governing Council's commitment was reaffirmed in its original wording throughout the second half of 2013.

5.2 2010-2013: The financial crisis and the interventions of the Eurosystem

Between January and April 2010, some non-standard measures employed in previous years were phased out, given the gradual normalisation of conditions in the financial markets in late 2009 (see Table 6).

However, new tensions were observed in the financial markets in the spring of 2010, amid concerns about the fiscal situation in some Member States (and particularly Greece). In countries whose public finances were a cause of concern, credit institutions with liquidity shortages were having trouble attracting interbank deposits from credit institutions with liquidity surpluses in other Member States, when they had no assets to offer as collateral or when they offered only domestic government bonds. Hence, those countries' credit institutions were forced to resort mainly to the Eurosystem's refinancing operations to raise the necessary funds. The ECB's Governing Council deemed that such tensions, which peaked in May 2010, could possibly hamper the effective conduct of monetary policy. For that purpose, in April and May 2010 some non-standard monetary policy measures were reactivated[1] and new, additional ones were adopted.

1 These Eurosystem measures included conducting 3-month and 6-month liquidity-providing open market operations as fixed rate tenders with full allotment, as well as standard open market operations providing liquidity in US dollars to euro area credit institutions. Also, in April 2010 the ECB's Governing Council decided that the reduced credit rating threshold required for an asset to be eligible as Eurosystem collateral would continue to apply. This last measure had been adopted in October 2008.

Table 6 Eurosystem's main non-standard monetary policy measures

	Implementation period	
	Start	**End**
Liquidity-providing operations as fixed-rate tenders with full allotment		
– main refinancing operations (MROs)	15 October 2008	At least until 7 July 2015
– longer-term refinancing operations (LTROs)	15 October 2008	At least until 7 July 2015
Provision of liquidity with a maturity of one maintenance period	30 September 2008	Continued through early 2014
*Additional LTROs**		
*– with a maturity of six months***	2 April 2008	1 March 2012
– with a maturity of one year	24 June 2009	23 December 2010
– with a maturity of three years	21 December 2011	26 February 2015
Securities Markets Programme (SMP)	10 May 2010	6 September 2012
Fine-tuning liquidity absorbing operations – sterilisation of the SMP effect	17 May 2010	Continued through early 2014
Covered bond purchase programme	July 2009	June 2010
New covered bond purchase programme	November 2011	October 2012
Outright Monetary Transactions	OMTs were announced in August 2012, but had not yet been activated by early 2014.	
Extending the list of eligible collateral	Since the end of 2008 and during the financial crisis, several measures have been put in place to broaden the list of eligible collateral, with a view to facilitating banks' access to the Eurosystem credit operations. The expansion of eligible assets was accompanied by appropriate risk control measures.	
Liquidity-providing operations in foreign currency	From December 2007 onwards, the Eurosystem, in cooperation with the Federal Reserve, provided liquidity in US dollars. These operations were soon extended to include the Bank of England, the Bank of Japan, the Swiss National Bank and other national central banks and are still underway (albeit with some necessary adjustments and interruptions).	
Lowering the reserve ratio from 2% to 1%	18 January 2012	Continued through early 2014
Standing facilities corridor	Changes in key interest rates were often accompanied by changes in the standing facilities corridor (see footnote 1 in Box 2.3 above: "The monetary policy of the ECB and the Eurosystem's interventions: 2008-2009").	

* The implementation period starts on the settlement date of the first operation and ends on the maturity (repayment) day of the last operation.
** Discontinued between November 2010 and July 2011.
Source: Bank of Greece.

On 3 May 2010 the ECB's Governing Council made a decision —particularly important for Greece— which allowed the Eurosystem to provide liquidity to banks against collateral of debt securities issued or guaranteed by the Greek government, regardless of the rating assigned to them by credit rating agencies.[2]

Practically at the same time, on 10 May 2010, the Eurosystem announced the launch of the Securities Markets Programme. This programme provided for interventions in government bond markets in order to help eliminate dysfunctioning of financial markets. Such disruptions were deemed to pose risks to the normal operation of the mechanism for the transmission of monetary policy effects to the real economy.

The implementation of these measures by the Eurosystem, in parallel with the introduction by the ECOFIN and the Member States (on 9 May 2010) of a package of measures for safeguarding financial stability in Europe, paved the way for a partial easing of tensions in the second half of 2010.

A period of abatement of the crisis followed in the first few months of 2011. Yet, in the second half of 2011, considerable deterioration was recorded in various segments of the euro area financial market, with surging yields and shrinking transaction volumes.[3] Particularly high pressure was observed in Portugal, which came under an EU/IMF support programme in May 2011. Tension in government bond markets, which was initially limited to Greece, Ireland and Portugal, gradually spread to Italy and Spain, and then across other euro area countries. These developments led the ECB's Governing Council to reactivate in early August —after an interruption of more than four months— the Securities Markets Programme. The Securities Markets Programme became inactive after the first quarter of 2012, and finally on 6 September 2012 the ECB announced its termination.[4]

In December 2011, owing to the serious market tensions that threatened the functioning of the money market and the flow of credit from banks to enterprises, it was decided for the first time to conduct two 36-month liquidity-providing open

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2 The Eurosystem typically sets a minimum credit rating threshold and assets rated lower than the minimum threshold are ineligible as collateral.

3 To alleviate these tensions, in November 2011 the Eurosystem launched its second Covered Bond Purchase Programme, under which it bought covered bonds in euro, issued in the euro area, with a total nominal value intended to reach €40 billion. Purchases took place between November 2011 and end-October 2012, and their total nominal value came to €16.4 billion.

4 On 31.12.2012 the Eurosystem (Press Release of 21.2.2013) held in its portfolio outstanding securities with a total *nominal* value of €218 billion, acquired under the Securities Markets Programme until the latter's termination on 6.9.2012. Their breakdown by issuing country was: Greece €33.9 billion, Ireland €14.2 billion, Spain €44.3 billion, Italy €102.8 billion, Portugal €22.8 billion (see also Chapter 8.3.5).

market operations, in December 2011 and in March 2012.[5] Through these two operations, liquidity amounting to a total of €1,020 billion was provided to the euro area credit institutions. In parallel, it was decided to broaden anew the list of eligible assets accepted as collateral in Eurosystem liquidity-providing operations.

Throughout 2012 the Eurosystem continued to provide liquidity through longer-term refinancing operations and to conduct all its refinancing operations as fixed rate tenders with full allotment. This procedure will continue to be applied for as long as it is deemed necessary, and at least until 7 July 2015.

In late July 2012, distortions in the bond markets of some Member States became more acute and drove bond yields to extremely high levels, since the latter included a premium against the risk of euro reversibility (reintroduction of national currencies). This inclusion of excessive premia in the yields had to be tackled in an effective manner. Addressing this phenomenon was imperative as some investors' fears of an imminent changeover to national currencies were fuelling market fragmentation, hampering the effectiveness of monetary policy.

With a view to safeguarding the singleness of the monetary policy, the ECB's Governing Council announced in September 2012 that it would undertake outright purchases of sovereign bonds (Outright Monetary Transactions) up to an amount sufficient to normalise conditions in financial markets and ensure the proper transmission of the ECB's policy stance to the real economy throughout the area. OMT interventions would be *ex-ante* "unlimited" in size.

On its own, the announcement of the OMTs programme (rather than its activation, which had not taken place until April 2014 —when the Greek version of this publication went to press— as the conditions for it have not arisen) helped reduce tensions in government bond markets. Furthermore, capital flows back to the peripheral euro area countries and a corresponding increase in the balance of bank deposits in these Member States were observed, while considerable capital inflows from third countries were also recorded with respect to the euro area as a whole.

As of 30 January 2013, euro area credit institutions made quite extensive use of the option of early repayment (after one year) of the funds they had raised in late 2011 with an initial maturity of 36 months. Overall, by end-2013 approximately €446 billion out of a total of €1,018.7 billion had been redeemed. This development reflects a reduction of the needs to obtain liquid assets from the central bank, as a result of normalised conditions in financial markets.

5 In addition, credit institutions were given the possibility of early repayment of part or all of the funds they would raise through these operations, after one year.

In summary, over the 2010-2013 period, the Eurosystem continued to play an active intermediating role, substituting for interbank transactions to a great extent, also in view of the inability and/or reluctance observed as regards dealing with the crisis at the political level in the euro area. The Eurosystem almost doubled its assets in 2012 compared with the autumn of 2008, and it should be noted that in March 2012 these assets exceeded 30% of the euro area GDP. Thus, the Eurosystem provided considerable support to the recovery of the euro area economy and the safeguarding of financial stability, contributing to the normalisation of conditions in the interbank market, so as to facilitate the flow of bank credit to euro area enterprises and households.

6 THE CRISIS IN GREECE: 2010–2013

6.1 2010: The Memorandum of Economic and Financial Policies

The negative developments of 2009 (see Chapter 2.4.1) continued and intensified in the first months of 2010. The period was mainly characterised by escalating pressures in the bond market and a dramatic increase in the cost of borrowing. To prevent a further decline in confidence, the Greek government proceeded to considerable fiscal target revisions, and the new targets were included in the Updated Stability and Growth Programme 2010-2013 of January 2010. Compared with the already adopted Budget, this was a more drastic and frontloaded fiscal consolidation. Nevertheless, despite positive statements by heads of EU bodies and institutions, the markets and the international media continued to maintain a strongly negative stance vis-à-vis Greece. By 28 January, the spread of the Greek 10-year bonds over the corresponding German bonds had reached 369 basis points (see Table 7). Markets were reacting intensely to a multitude of unfavourable reports in the international media.

Despite the announcement of additional measures in February and March (also welcomed by heads of EU bodies and institutions),[1] the cost of borrowing for Greece continued to rise. In April 2010, the yield spread on 10-year bonds climbed to 430 basis points.

1 On 3.3.2010 the Governing Council of the ECB welcomed the "convincing additional and permanent fiscal consolidation measures" announced that same day by the Greek government. Before that, the tone of all references to Greece made by the President of the ECB, Jean-Claude Trichet, during press conferences on 14.1.2010 and 4.2.2010 and in his statement following the euro area summit on 11.2.2010, had been positive but strict. Moreover, in an interview to *Le Point* (on 15.3.2010) J.-C. Trichet mentioned that Greece, as all other Member States, has benefited from participation in the euro area, but in exchange should fully respect the rules of the Stability and Growth Pact.

Table 7 Yield spread between 10-year Greek and German government bonds

In basis points

Date	Yield spread
31.12.2009	229
29.1.2010	377
26.2.2010	351
31.3.2010	331
27.4.2010	654
31.5.2010	508
30.6.2010	789
30.7.2010	756
31.8.2010	937
30.9.2010	824
29.10.2010	820
30.11.2010	930
31.12.2010	960

Source: Bank of Greece.

This continuing rise in the cost of borrowing did not permit any new bond issues, while increased uncertainty surrounding fiscal and macroeconomic developments led to successive downgradings of the country's credit rating. In April alone, all three major credit rating agencies (Fitch, Standard & Poor's, and Moody's) announced considerable downgradings (see Chart 10 in Chapter 8.3.4).

Thus, on 23 April 2010 the Greek government submitted to the euro area countries and the IMF a request for financial assistance (based on the framework decision made by the European Council of March 25 and on the elaboration of its terms by the Eurogroup on 11 April – see the full texts in Box 4.1).[2] The *Memorandum of Economic and Financial Policies* and its accompanying provisions were incorporated in Law 3845/2010 ("Measures for the implementation of the support mechanism for the Greek economy by the euro area Member States and the International Mon-

2 In a speech to the 9th Munich Economic Summit on 29.4.2010 (a few days after Greece's request for support), the President of the ECB, J.-C. Trichet, explained that "loans are not transfers, and loans come at a cost. They come not only at a financial cost; they also come with a strict conditionality" that "needs to give assurance to lenders, not only that they will be repaid but also that the borrower will be able to stand on its own feet over a multi-year horizon".

etary Fund"), and provided the guidelines for the economic policy that had to be followed throughout the duration of the loan agreement.[3]

6.1.1 Provisions and directions of the Memorandum

In essence the Memorandum provided for a loan of €110 billion to be extended by the euro area Member States and the IMF to Greece, intended to cover the economy's financing needs and support the banking system. Moreover, the measures, which constituted an integral part of the Memorandum, reoriented economic policy to three main directions:

First, towards a frontloaded fiscal consolidation, effected mainly through across-the-board measures that would bring the deficit below 3% by 2014 and achieve a balanced primary budget in two years. In the immediately next phase, from 2011 onwards, the Memorandum provided for structural reforms in the functioning of the State, aimed at the long-term sustainability of the adjustment effort and the generation of large primary surpluses to reduce the debt.

Second, towards structural reforms in the functioning of markets, aimed at improving competitiveness and creating a business environment able to attract investment.

Third, towards safeguarding the stability of the financial sector.

The first of these three objectives, i.e. fiscal consolidation, was considered to be the programme's cornerstone. As mentioned earlier, fiscal consolidation efforts were heavily frontloaded. Over and above the fiscal measures already adopted in January, February and March, the programme provided for additional measures amounting to 2.5% of GDP for 2010, so as to finally reduce the general government deficit by 5.5% of GDP. In the four-year period 2011-2014, the deficit was to be further reduced, so as to stand at 2.6% of GDP by end-2014.

With respect to the recouping of lost competitiveness, it was projected that the current account deficit (which had risen above 14% of GDP in 2008) would drop from 11.2% in 2009 to 8.4% of GDP in 2010. The two main tools for regaining competitiveness were incomes policy and extensive structural changes, which would

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3 During the press conference of 6.5.2010, the President of the ECB, J.-C. Trichet, explained the reasons behind the ECB's endorsement of the decision to support Greece, while on 13.5.2010 he stated to *Spiegel* that "the Greek government took too long to acknowledge the extent of the problem and take the necessary measures", whereas "we at the ECB were loud and clear in our warnings" about the need for decisive action. In parallel, however, J.-C. Trichet never failed to recall that back in 2004-2005, when Germany and France were asking for a less strict Stability and Growth Pact, the ECB had defended it at the time, averting its "*de jure* dismantling" (see interviews to *Frankfurter Allgemeine Zeitung* on 19.5.2010, *Le Monde* on 31.5.2010, and *Aachener Zeitung* on 27.5.2011).

Table 8 Timeline – Main economic developments in Greece and Europe, and actions of the Bank of Greece, 2010

	2010
11.2.2010	Euro area Member States pledge determined and coordinated action, if needed, to safeguard stability in the euro area as a whole.
22.3.2010	Bank of Greece *Monetary Policy Report 2009-2010*. What is required is a sustainable, ongoing and convincing fiscal adjustment with a concurrent policy of structural reforms that will improve the functioning of markets and enhance competitiveness. Most importantly, Greece must break with the patterns of behaviour, attitudes and policies that have brought us to the present situation.
22.3.2010	Eurostat announces that the 2009 deficit in Greece is revised to 13.6% of GDP.
25.3.2010	Euro area Member States agree to establish a support mechanism for Greece, if the country is shut out of markets. The IMF will participate in the Mechanism.
23.4.2010	From the island of Kastellorizo Prime Minister G. Papandreou announces that Greece has officially requested the activation of the support mechanism. On 2 May, Greek negotiations with the EU and the IMF lead to an agreement on a three-year aid package worth €110 billion.
27.4.2010	Bank of Greece *Annual Report 2009*: The crisis that the Greek economy is facing today is deep, structural and multifaceted. A break with the past is a prerequisite for overcoming the crisis.
3.5.2010	The ECB announces that it will accept Greek government bonds as collateral for its credit operations, regardless of their credit rating.
8.5.2010	In an extraordinary EU summit, the creation of a European Stability Mechanism is decided. The decision to provide bilateral loans to Greece is corroborated with the signing of a Memorandum. The establishment of the European Financial Stability Facility (EFSF) is endorsed.
10.5.2010	The ECB decides to conduct interventions in the euro area public and private debt securities markets (Securities Markets Programme) to ensure depth and liquidity in those market segments which are dysfunctional.
18.5.2010	Disbursement of the first instalment to Greece, worth €14.5 billion.
23.7.2010	Publication of the results of the EU-wide stress testing exercise for banks.
5.8.2010	The first review of the Economic Adjustment Programme is completed by the European Commission/ECB/IMF (hereinafter the "Troika"). The second instalment amounts to €9 billion (of which €2.5 billion from the IMF).
19.8.2010	The European Commission approves the second instalment of the loan to Greece.
10.9.2010	The IMF also approves its €2.57 billion-worth contribution to the second instalment of the financial assistance to Greece, albeit with some reservations.
18.10.2010	French President Sarkozy and German Chancellor Merkel meet in Deauville, France. The participation of private creditors in the bailout of distressed euro area countries is suggested for the first time.
26.10.2010	Bank of Greece *Monetary Policy Interim Report 2010*. The Economic Adjustment Programme is a consistent medium-term plan of economic adjustment that includes a specific timetable for its implementation and compresses into a three-year period changes and reforms which should have been carried out when conditions were more favourable and the associated costs would have been lower.
7.11.2010	Local government elections. On the following day the Troika representatives arrive in Athens.
21.11.2010	Ireland officially requests financial assistance from the EU and the euro area. Negotiations lead to an agreement on 7.12.2010. The IMF will participate in the programme.
23.11.2010	The Troika green-lights the disbursement of the third instalment (€9 billion) to Greece.
16.12.2010	EU Summit. EU Heads of State or Government endorse the establishment of the European Stability Mechanism (ESM).

Source: Bank of Greece.

lead to higher productivity, lower production costs, stronger competition and hence lower prices, and improved competitiveness.

The most significant structural changes included: (i) reforms in the labour market; (ii) the opening up of 'closed' professions; (iii) privatisations; (iv) liberalisation of product markets; (v) merging and/or eliminating public sector entities whose existence was not justified; (vi) reforms in the social security system, etc. All these were highly important structural reforms that could largely transform the Greek economy, help minimise the negative impact of fiscal consolidation on GDP, and accelerate economic recovery.

As regards safeguarding financial stability, the programme provided for the establishment of a Hellenic Financial Stability Fund (established indeed in early 2011) and its endowment with an amount of €10 billion (out of the available €110 billion), which would then be provided to banks with capital adequacy problems.

With respect to the public debt, the programme envisaged no immediate action. Its top priority —"to restore the sustainability of public finances…"— indirectly entailed a stabilisation (from 2013 onwards) and a subsequent reduction in the debt-to-GDP ratio; however, this would only come as a result of the reduction in the deficit and the achievement of a primary surplus.[4]

6.1.2 The implementation of the Programme

In the first months of the programme's implementation, developments were encouraging. According to the first review by the Commission, the ECB and the IMF, published in August 2010, the programme had got off to an impressive start: on the one hand, all (but one) fiscal targets ("performance criteria") set for end-June had been met, and on the other hand, the implementation of some reforms was progressing ahead of the programme's schedule.[5]

Still, despite this generally positive account, the second review, carried out on the basis of data for the first nine months of the year and published on 6 December 2010, fully confirmed the chronic weaknesses of the Greek public sector. At the same time, it pointed out that structural issues had to be addressed for the adjustment to be sustainable.[6] At the macroeconomic level it mentioned that the recession was deeper than initially anticipated, while inflation in October (5.2%) had only slightly

4 IMF, *Greece: Request for Stand-By Arrangement*, 5.5.2010, pp. 4, 8, 10.

5 Joint statement by the European Commission, the ECB and the IMF on 5.8.2010, as well as IMF, *Greece: First Review Under the Stand-By Arrangement*, 26.8.2010, pp. 3-4.

6 Joint statement by the European Commission, the ECB and the IMF on 23.11.2010.

declined compared to July (5.5%). Finally, unemployment had reached 12.2% in August. In contrast to the first review, it was now recognised that liquidity in the economy (and the banking system) was tight, non-performing loans were increasing, and the profitability of the banking system remained weak.[7]

The overall assessment during that period was that, although the programme's implementation remained broadly on track, it had reached a critical crossroads. At that particular point in time, economic recovery relied heavily on dynamically promoting the structural reforms, mainly by opening up closed professions, liberalising retail trade, and strengthening the tourism industry. This would require a clash with vested interests, putting the government's resolve to carry out these reforms to the test.[8]

These remarks reflected concerns caused by the relaxation in the programme's implementation and the discrepancies already apparent since the autumn of 2010. Particularly as regards structural reforms, such as the opening up of closed professions or the deregulation of product and services markets, etc., right from the start there had been hesitation, doubts, cop-outs and procrastination.

6.1.3 Results and consequences

Assessing in brief the results of the implementation of the Memorandum in 2010, the following should be noted:

- The implementation of the financial support agreement allowed the country's financing by its euro area partners and the IMF to continue, averting the eventuality of default that had emerged in April.
- The general government deficit (on a national accounts basis) for 2010 stood at 10.6% of GDP.[9] The deficit fell by almost 5 percentage points compared to 2009 – roughly in line with the programme's projections. This was a very big adjustment, all the more so in a period of recession, even if account is taken of the fact that —due to considerable overruns in 2009— some expenditure cuts were relatively easy. Nevertheless, the revision of the 2009 deficit from 13.6% to 15.4% of GDP negated any possibility of meeting the target set for a reduction of the deficit to 8.1% of GDP in 2010.

7 IMF, *Greece: Second Review Under the Stand-By Arrangement*, 6.12.2010, pp. 5-6.

8 Ibid., pp. 20-21.

9 At end-2010 it was estimated at 9.7%, but on 25.4.2011 it was revised to 10.5% of GDP. Due to the latest GDP revision, the 2010 deficit stands at 10.7% of GDP (see Table 9 and Chart 2).

Table 9 General government fiscal data, 2008-2013 (on a national accounts basis)

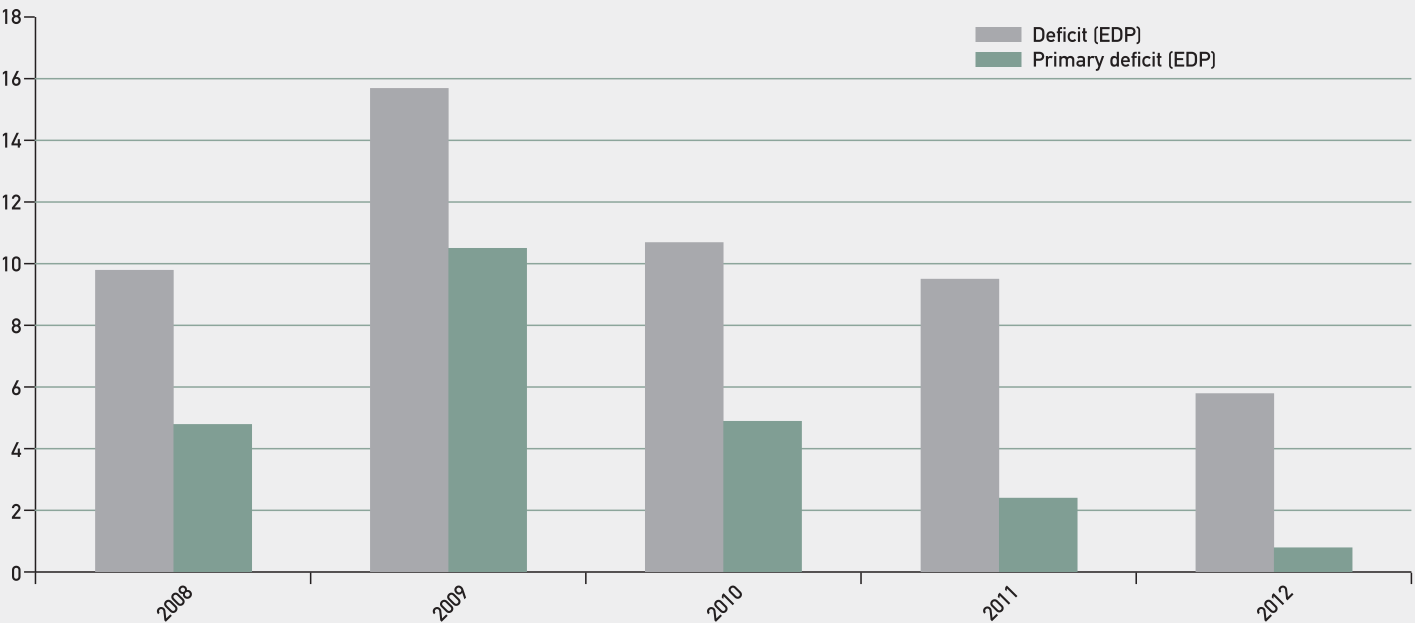
Current prices; million euro

	2008	2009	2010	2011	2012*	2013
Revenue	94,847	88,628	90,197	88,439	86,380	n.a.
Expenditure	117,730	124,794	113,912	108,308	97,584	n.a.
of which:						
Interest payments (EDP)	11,673	11,976	12,855	14,888	9,643	n.a.
Deficit	22,883	36,166	23,715	19,869	11,204	n.a.
Primary deficit (EDP)	11,210	24,190	10,860	4,981	1,561	n.a.
Public debt	263,287	299,690	329,514	355,141	303,928	n.a.
GDP	233,198	231,081	222,151	208,532	193,749	n.a.
(% of GDP)						
Revenue	40.7	38.4	40.6	42.4	44.6	n.a.
Expenditure	50.5	54.0	51.3	51.9	50.4	n.a.
of which:						
Interest payments (EDP)	5.0	5.2	5.8	7.1	5.0	n.a.
Deficit (EDP)	9.8	15.7	10.7	9.5	5.8	n.a.
Primary deficit (EDP)	4.8	10.5	4.9	2.4	0.8	n.a.
Public debt	112.9	129.7	148.3	170.3	156.9	n.a.

* Excluding government support to financial institutions, amounting to €6,210 million (or 3.2% of GDP) in 2012. Including revenue from the 2008 liquidity support scheme for banks.
Sources: Eurostat News Release 21.10.2013 and ELSTAT Press Release 11.10.2013. Eurostat data for 2013 (1st EDP notification) were expected to be released on 23.4.2014.

- The recession deepened: GDP declined (4.5%) for a third consecutive year, affected mainly by lower domestic demand.
- As 180,000 jobs were lost, unemployment exceeded 12% of the labour force.
- Average nominal earnings of employees in the economy as a whole fell by 5%.
- Despite the recession, high inflation persisted (4.7%), partly due to increased indirect taxes.
- The current account deficit narrowed slightly (from 11% of GDP in 2009 to 10.4%).
- The annual rate of credit expansion to the domestic private sector, which had been decelerating considerably since 2008, was nil at end-2010.

Chart 2 Deficit and primary deficit according to the Excessive Deficit Procedure (EDP) methodology
% of GDP, 2008-2012



Note: Excluding government support to financial institutions, amounting to €6,210 million (3.3% of GDP) in 2012. Including revenue stemming from the 2008 liquidity support scheme for banks.
Sources: Eurostat News Release 21.10.2013 and ELSTAT Press Release 11.10.2013.

Table 10 Key decisions of EU institutions and bodies (euro area summits, European Council, ECOFIN) on the Greek economy in 2010

Date	Decision
19.1.2010	ECOFIN Conclusions adopted by the Council on government deficit and debt statistics in Greece, following a report from the European Commission on issues to be addressed as a matter of priority.
11.2.2010	EU Summit Statement by the Heads of State or Government of the European Union supporting the efforts of the Greek authorities to ensure that the targets set in the stability programme are met and calling on the Greek government to implement the necessary measures to effectively reduce the budgetary deficit by 4% in 2010.
16.2.2010	ECOFIN – Council Opinion on the updated Stability Programme of Greece. – Council Decision giving notice to Greece to correct its excessive deficit by 2012, setting out budgetary consolidation measures according to a specific timetable. – Council Recommendation to Greece with a view to bringing its economic policies into line with the EU's broad economic policy guidelines.
25.3.2010	Euro area summit Statement in which (a) euro area Member States acknowledge that the additional measures announced by the Greek government are sufficient to safeguard the 2010 budgetary targets, and (b) reaffirm their readiness to take coordinated action to safeguard financial stability in the euro area as a whole and to contribute to bilateral loans, subject to strong conditionality, with the participation of the IMF.
11.4.2010	Eurogroup Following the statement by the Heads of State or Government of the euro area on 25 March, euro area Member States agree upon the terms of the financial support that will be given to Greece, when needed, in the context of an economic adjustment programme covering a three-year period, through the contributions of euro area Member States and with the participation of the IMF. The Commission, in liaison with the ECB, will start working on 12 April with the IMF and the Greek authorities on the conditionality of a joint programme.
2.5.2010	Eurogroup Agreement on the provision of €80 billion to Greece (totalling €110 billion with the IMF participation) and approval of the economic adjustment programme agreed by the Greek authorities, the European Commission, in liaison with the ECB, and the IMF.
7.5.2010	Euro area summit Reaffirmation of the Eurogroup agreement on the provision of a loan to Greece under a three-year economic adjustment programme.
10.5.2010	ECOFIN Council Decision which revises previous recommendations addressed to Greece, outlines the policy measures of the economic adjustment programme and their implementation calendar, and extends the deadline for the correction of the excessive deficit to 2014.
7.9.2010	ECOFIN Council Decision which revises the measures and the implementation calendar outlined in the decision of May on the correction of the excessive deficit, according to the updated economic adjustment programme of Greece.*
28-29.10.2010	European Council In its Conclusions, the issue of the "private sector involvement" is raised for the first time after its discussion by Chancellor Merkel and President Sarkozy during their meeting in Deauville on 18 October.
16.11.2010	Eurogroup Statement in which the recent revision of the 2009 deficit is noted and the adoption of the required additional measures to confirm the deficit target for 2011 is welcomed.
17.11.2010	ECOFIN Council Conclusions in which the Council welcomes the efforts of the Greek authorities to correct the deficiencies in the statistical system.

* The measures and the implementation calendar of the programme were repeatedly revised, in line with the successive updates to the economic adjustment programme, through new Council Decisions on 20.12.2010, 7.3.2011, 12.7.2011, 8.11.2011, 13.3.2012 and 4.12.2012.
Source: Bank of Greece.

- A major characteristic of the way the crisis was handled is that since the beginning, before the programme's preparation, fiscal adjustment policy had focused clearly on increasing taxes rather than on curtailing unnecessary expenditure and the squandering of public funds. This was a missed opportunity to learn from international experience and studies showing that fiscal consolidation is sustainable and leads to faster economic recovery when based mainly on expenditure cuts. The continuous increase of tax burdens generated right from the start negative expectations that led to disproportionately large declines in private consumption and investment, resulting in a deeper and more prolonged recession.

In summary, although the programme's implementation produced a visible fiscal consolidation result, the means to its implementation amplified the contractionary impact of the reduction of expenditure. One should not overlook, however, that the negative outcomes as regards economic activity and employment would have been much worse in the absence of the adjustment programme and the financial support of the country's EU partners and the IMF.

6.2 2011: Missed targets or delays bring the country to the verge of default

After a brief initial period in which the programme was implemented rather consistently and produced visible results, signs of fatigue and relaxation started to appear. Fiscal adjustment slowed down considerably, while structural reforms fell behind in practically all areas.

Already since February 2011, the review report by the EU, the ECB and the IMF had identified revenue shortfalls and expenditure overruns in entities outside central government and had pointed out the need for additional cuts in central government outlays in order for the "performance criteria" to be met.[10]

The Troika's joint statement following completion of the third review[11] stressed that major reforms need to be planned and implemented, so as to build up the necessary critical mass that would ensure the sustainability of public finances and economic recovery.

Nevertheless, fiscal adjudstment, remained problematic, with large revenue shortfalls and expenditure overruns. Already by mid-2011 it was obvious that with-

10 IMF, *Greece: Third Review Under the Stand-By Arrangement*, 28.2.2011, p. 6.

11 Joint statement by the European Commission, the ECB and the IMF on 11.2.2011.

Table 11 Timeline – Main economic developments in Greece and Europe, and actions of the Bank of Greece, 2011

2011	
1.1.2011	Beginning of operation for the European System of Financial Supervision, which consists of the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA).
24.2.2011	Completion of the third review of the financial assistance programme by the Troika. Next step the agreement on the fourth instalment amounting to €15 billion.
15.2.2011	Bank of Greece *Monetary Policy Report 2010-2011*. So far, changes have been carried out that would have been unthinkable just a few months ago. This goes to show that a radical overhaul of the Greek economy is feasible and that this effort can produce results. On the other hand, several of the reforms are coming up against rigidities and reactions that undermine the overall effort. 2011 will be a year of major and complex challenges for the banking system.
11.3.2011	The Heads of State or Government of the euro area approve the Pact for the Euro, which will be presented to the forthcoming European Council for approval. Relief in Greece following improved borrowing terms and conditions through a reduction of 100 b.p. in interest rates and an increase of the loan maturity to 7.5 years.
6.4.2011	Portugal is the third euro area country to seek financial aid. Its request is approved by the European Council on 17.6.2011.
18.4.2011	Bank of Greece *Annual Report 2010*. The adjustment process of the Greek economy at a decisive juncture. The financial support agreement averted bankruptcy and imposed a reorientation of economic policy. The interventions of the ECB and the liquidity support measures averted a credit crunch. Delays, but also objective difficulties, continue to feed market uncertainty.
3.6.2011	Completion of the fourth review by the Troika.
17.6.2011	Cabinet reshuffle. Evangelos Venizelos is appointed Minister of Finance.
20.6.2011	The Eurogroup agrees to define by early July a new financial support package, calling for voluntary private sector involvement.
29.6.2011	The Medium-Term Fiscal Strategy Framework is voted into a law by the Greek Parliament.
2.7.2011	The Eurogroup approves the disbursement of the fifth instalment.
15.7.2011	Results of the EU-wide stress testing exercise.
21.7.2011	The Heads of State or Government of the euro area agree to support a new programme for Greece, amounting to €109 billion, with the voluntary contribution of the private sector. The EFSF will be the main financing vehicle. Borrowing terms and conditions become more lax with lower interest rates and longer maturities of future loans. The creation of a Commission Task Force is announced.
19.8.2011	The Bank of Greece appoints a liquidator at Proton Bank.
29.8.2011	Alpha Bank and Eurobank announce plans to merge. (The attempted merger falls through, as announced on 14.3.2012).

Continued ➛

Table 11 Timeline – Main economic developments in Greece and Europe, and actions of the Bank of Greece, 2011 *(continued)*

	2011
2.9.2011	The negotiations between the Greek government and the Troika reach a deadlock, with the Troika representatives leaving Athens.
11.9.2011	New package of measures adopted by the Greek government, including the introduction of a special property tax collected through electricity bills (EETHDE).
27.9.2011	Enactment of Law 4021/2011 on the resolution of credit institutions.
2.10.2011	Presentation of the draft Budget.
10.10.2011	Establishment of New Proton Bank (as a good bank) with the Hellenic Financial Stability Fund as its sole shareholder in implementation of Law 4021/2011 on the resolution of credit institutions.
11.10.2011	Completion of the fifth review by the Troika. The PSI is deemed necessary to fully cover the financing gap. On 20.10.2011 the disbursement of the sixth tranche, worth €8 billion, is endorsed by the euro area finance ministers, in the presence of the IMF Managing Director Christine Lagarde.
26.10.2011	The euro area summit approves a new loan to Greece, amounting to €130 billion, as well as a haircut in Greek debt with private sector involvement (PSI).
31.10.2011	Greek Prime Minister G. Papandreou announces plan for a referendum on the new aid agreement during a meeting of the PASOK parliamentary group and raises discussions for a vote of confidence in the government. Following his meeting with German Chancellor Merkel and French President Sarkozy in Cannes on 2 November, he calls off the referendum.
1.11.2011	Mario Draghi is the new President of the European Central Bank.
8.11.2011	The Council adopts the "six-pack" aimed at strengthening economic governance in the EU.
9.11.2011	Long talks on forming a new government continue. In a statement to *Financial Times*, the Governor of the Bank of Greece G. Provopoulos considers it imperative that a new government be formed immediately and the new government and the major political parties commit to the full implementation of the agreement of the Heads of State or Government of October 27.
11.11.2011	An interim coalition government is formed under Lucas Papademos.
23.11.2011	Bank of Greece *Monetary Policy Interim Report 2011*. The Greek economy has entered a new, extremely critical phase. Last chance for an economic restructuring. The implementation of the required policy calls for a strong and effective government. The Bank stresses the need for a comprehensive and binding action plan for growth, a road map for exiting the crisis, and sets forth its main lines.
8.12.1011	Intervention of the ECB to support European banks for a period of three years.
17.12.2011	Transfer of deposits, personnel and banking activities of T Bank to the Hellenic Postbank, in implementation of Law 4021/2011.

Source: Bank of Greece.

out additional interventions the programme was heading to a derailment. The Troika's joint statement (on 3.6.2011) declared that the mission had reached an understanding with the Greek authorities on a package of economic and financial policy measures required to meet the programme's targets. These interventions were included in the Medium-Term Fiscal Strategy Framework (MTFS), having as main objectives the achievement of primary surpluses, an acceleration of privatisations and the development of the state's assets, to control debt dynamics.

The measures, covering the period 2011-2015, were passed by the Greek Parliament in June (Law 3985/1.7.2011) along with the first "implementation" legislation (Law 3986/1.7.2011). It is worth recalling that the governing majority voted in favour of the MTFS as a whole, but the opposition also voted in favour of 22 out of its 55 articles. This probably represents the first indication that the severity of the situation had started to reorient the political forces towards the notion of convergence, which materialised in the form of a coalition government a few months later.

Yet the adoption of the MTFS, despite the big package of fiscal measures it included, failed to convince the markets, which – making the assessment that a debt restructuring was imminent – reacted negatively: the spreads of Greek government bonds over the corresponding German bonds soared to new all-time highs and the three credit rating agencies downgraded the country's credit rating almost to the level of bankruptcy.

6.2.1 October 2011: a new EU/ECB/IMF support programme

From mid-2011 onwards, and despite the adoption of the MTFS, economic developments deteriorated considerably. Fiscal consolidation was already obviously reversing (on the basis of data for the first seven months), with both the total state budget deficit and the primary deficit widening. Moreover, a considerable increase was also recorded in public debt, which had already exceeded 150% of GDP in March.

The sizeable increase of the debt, the large primary deficit and the deepening of the recession (from -3.8% to -5.5% or more) largely offset the positive effects on debt dynamics attributable to the decisions made during the Summit of 21 July 2011, which included a commitment to support —with the involvement of the private sector— a new programme for covering the Greek financing gap and provided for lowering the interest rate and lengthening the maturity of the loans.

On 11 October 2011, the Troika stated that an understanding had been reached with the Greek authorities (at the level of representatives) on the policies required "*in order to get the government's adjustment programme back on track*".

Table 12 Key decisions of EU institutions and bodies (euro area summits, European Council, ECOFIN) on the Greek economy in 2011

11.3.2011	Euro area summit Agreement by the euro area Member States to reduce the interest rate on the Greek loan by 100 b.p. and to lengthen by 7.5 years the maturities of the loans that Greece was granted under the economic adjustment programme.
20.6.2011	Eurogroup Agreement on the finalisation of a second financial support programme to Greece, by early July 2011, with a voluntary private sector involvement.
24.6.201	European Council European Council Conclusions, according to which the main parameters of the new programme should be set up by early July 2011, in line with the Eurogroup agreement of 20 June.
2.7.2011	Eurogroup Statement taking note of the progress made by the Greek authorities in implementing the policy understandings reached with the Troika, which allows for the disbursement of the fifth instalment of the Geek loan facility. The new multi-year adjustment programme for Greece will revolve around the commitment of the Greek authorities to implementing fiscal consolidation measures, as well as structural reform and privatisation plans, and will be supplemented by technical assistance, provided by the European Commission and Member States.
21.7.2011	Euro area summit Agreement on a new EU-IMF programme with a voluntary private sector involvement (PSI).
21.10.2011	Eurogroup Communiqué on the fifth review and update of the economic adjustment programme: the substantial fiscal consolidation efforts undertaken by the Greek government are welcomed, as they will allow it to meet the targets for 2012.
26.10.2011	Euro area summit Agreement on the conclusion of a new EU-IMF economic adjustment programme for Greece, by the end of 2011.

Source: Bank of Greece.

The EU came to realise that a more generalised approach was required for the entire euro area. Thus, the Summit of 26 October 2011 arrived at decisions regarding both a further assistance to Greece and a broader arrangement to support the euro. The new assistance programme for Greece provided for a new package of support measures amounting to €130 billion,[12] as well as for a voluntary exchange of privately held Greek bonds with new ones, the nominal value of which was discounted by roughly 50%.[13] According to estimates of the time, this was expected to lower the Greek debt by approximately €100 billion.

12 In effect, the €109 billion assistance of July would increase to €130 billion.

13 Details were to be determined at a later date.

In parallel with developments in the EU, in Greece it became imperative to take new measures in addition to those of June 2011, in order to limit deviations from the MTFS targets as much as possible. So, in October 2011, Law 4021/2011 imposed an extraordinary special levy on all power-supplied buildings.

In the end, despite all these measures, the general government deficit (on a national accounts basis) in 2011 fell only by 1.3 percentage points of GDP and stood at 9.4%, a level well above the target set (7.4% of GDP). The primary deficit declined more (by 2.6 percentage points), coming down to 2.3% of GDP.

6.2.2 Soaring uncertainty – formation of a coalition government

Perhaps the most important development in 2011 was the large decline in economic activity, much larger than what was originally projected, and the explosion of unemployment.

The deep recession was predominantly due to the decline in domestic demand, although it appears that uncertainty about the outcome of the stabilisation attempt also played an important part.

Such high uncertainty originated to a considerable extent in the way stabilisation was sought after, at least during the second year of the original programme's implementation. Instead of continuing the frontloaded policy decided, a more hesitant approach was favoured, in the hope that perhaps part of the costs could be avoided after all, or, in a worst-case scenario, be paid later on. Postponements and delays each time led to revised agreements with the lending partners and to new measures, resulting in adjustment costs higher than those that would have been incurred by prompt adoption of the measures at the time originally agreed, and in a further forward shift of the expected emergence of positive results. This entrenched a perception that the adjustment programme had failed, and that what was going on was merely a series of painful measures with no visible result. This fact had very grave consequences:

- It strengthened expectations of increasingly adverse future developments, resulting in a constant postponement of consumer and – principally – investment decisions. This resulted in a recession deeper than that warranted by the restrictive policies, a fact that undermined fiscal adjustment and intensified the vicious circle.
- It undermined the credibility of the financial support agreement, which a large part of the population viewed negatively, considering it to be the main cause of all evils, thereby obfuscating the real reasons that had led to the crisis.

- It intensified social unrest for a long period of time, with public debate focusing again and again on the cost of the discussed measures, while their implementation was continuously postponed.
- It threatened the cohesion of the government and undermined political stability.

All of the above widened the credibility gap; as a result, in the negotiations with the country's lending partners increasingly stronger assurances were required that Greece would abide by what it agreed upon. This loss of trust stemmed from the assessment that the political will for the implementation of the programme was subsiding, given that the minimum of consensus necessary to carry out the changes that Greece had committed to implement had not been achieved by the political forces. This assessment led to doubting the country's ability to ensure continuity of the programme's implementation and fuelled all sorts of conjectures and forecasts on possible scenarios.

Uncertainty rose after September 2011 and references to the country's possible exit from the euro area proliferated, a fact that paralysed the economy, causing deposit outflows and further instability in the political system. On 31 October, the then Prime Minister, G.A. Papandreou, announced his intention to hold a referendum on the new loan agreement. This led to a peaking of political turmoil and eventually to the government's resignation. During that period, as already mentioned, the international sentiment on Greece had reached its lowest point and projections about the country's exit from the euro area and its default held sway across all media and experts' analyses.

On 11 November, a new coalition government was formed, headed by Lucas Papademos, with the participation of the New Democracy, PASOK and LAOS parties and with the mandate to ensure the conditions for the implementation of the decisions made on 26 October and then to hold parliamentary elections. The cooperation of political forces, as regards both voting in favour of the new loan agreement and taking part in the Papademos government, represented a first encouraging element that started to have a positive effect on sentiment. Yet, at the end of 2011 uncertainty remained high and the country's future in the euro area was questioned more than ever.

An interesting measure of uncertainty is the evolution of sales of gold sovereigns by the BoG (i.e. of private demand for gold sovereigns), as well as the evolution of the relevant purchases/sales ratio. It is indicative that, in the course of the crisis, sales (after a previous high in October 2008) peaked in May and June 2010 when the country resorted to its euro area partners and the IMF and climbed again to a very high level in December 2011, i.e. the period of negotiations on the second adjust-

Table 13 Purchases and sales of gold sovereigns by the BoG

Monthly data, Jan. 2008-Dec. 2013

Period	Purchases (number of pieces) (1)	Sales (number of pieces) (2)	Purchases/ sales (3)=(1):(2)	Period	Purchases (number of pieces) (1)	Sales (number of pieces) (2)	Purchases/ sales (3)=(1):(2)
	2008				2009		
Jan.	54,287	13,141	4.13	*Jan.*	19,077	13,518	1.41
Feb.	30,829	6,554	4.70	*Feb.*	31,091	17,656	1.76
March	0	0	0	*March*	20,390	15,389	1.32
Apr.	23,848	13,094	1.82	*Apr.*	21,589	9,991	2.16
May	33,433	6,973	4.79	*May*	12,090	6,063	1.99
June	25,061	10,890	2.30	*June*	11,189	5,647	1.98
July	29,235	7,955	3.68	*July*	14,725	6,840	2.15
Aug.	29,587	8,488	3.49	*Aug.*	24,621	4,915	5.01
Sept.	30,549	18,255	1.67	*Sept.*	25,441	5,815	4.38
Oct.	17,530	61,866	0.28	*Oct.*	20,445	5,135	3.98
Nov.	26,320	22,388	1.18	*Nov.*	19,170	8,685	2.21
Dec.	15,464	10,889	1.42	*Dec.*	27,406	11,986	2.29
Total	**316,143**	**180,493**	**1.75**	Total	**247,234**	**111,640**	**2.21**
	2010				2011		
Jan.	15,519	9,617	1.61	*Jan.*	9,190	13,278	0.69
Feb.	16,114	11,901	1.35	*Feb.*	11,021	5,748	1.92
March	19,863	18,985	1.05	*March*	12,335	9,491	1.30
Apr.	18,240	21,506	0.85	*Apr.*	9,296	7,586	1.23
May	9,442	33,051	0.29	*May*	11,331	6,743	1.68
June	15,008	35,045	0.43	*June*	9,461	6,718	1.41
July	15,175	12,514	1.21	*July*	8,621	9,560	0.90
Aug.	16,832	6,686	2.52	*Aug.*	10,689	8,581	1.25
Sept.	13,598	7,745	1.76	*Sept.*	12,307	10,757	1.14
Oct.	12,907	5,954	2.17	*Oct.*	7,906	14,823	0.53
Nov.	24,449	13,686	1.79	*Nov.*	10,239	20,819	0.49
Dec.	18,236	17,785	1.03	*Dec.*	10,290	32,763	0.31
Total	**195,383**	**194,475**	**1.00**	Total	**122,686**	**146,867**	**0.84**
	2012				2013		
Jan.	6,672	24,066	0.28	*Jan.*	11,273	2,653	4.25
Feb.	6,740	11,505	0.59	*Feb.*	10,652	2,029	5.25
March	9,154	4,070	2.25	*March*	11,503	5,096	2.26
Apr.	6,676	3,803	1.76	*Apr.*	9,024	15,927	0.57
May	7,872	11,051	0.71	*May*	7,583	4,194	1.81
June	6,587	13,620	0.48	*June*	8,642	4,865	1.78
July	8,799	2,833	3.11	*July*	7,975	5,524	1.44
Aug.	8,938	4,495	1.99	*Aug.*	6,775	3,429	1.98
Sept.	10,133	2,642	3.84	*Sept.*	7,682	2,825	2.72
Oct.	10,244	3,795	2.70	*Oct.*	9,525	4,432	2.15
Nov.	10,069	2,649	3.80	*Nov.*	7,329	4,112	1.78
Dec.	9,691	2,360	4.11	*Dec.*	7,300	5,933	1.23
Total	**101,575**	**86,889**	**1.17**	Total	**105,263**	**61,019**	**1.73**

Note: Data on the number of gold sovereigns purchased or sold by the Bank of Greece are relevant mainly because they signal the direction of changes (increase-decrease) in each period.
Source: Bank of Greece, Cash Department. See also: http://www.bankofgreece.gr/Pages/en/ Markets/ LIRA/goldlira.aspx.

ment programme (see Table 13). A similar path is observed for the purchases/sales ratio, which implies excess private demand for gold sovereigns when it takes values lower than one (e.g. May 2010: 0.29; December 2011: 0.31; January 2012: 0.28).

6.3 2012: Greece faces historic choices

6.3.1 Political developments heighten uncertainty

The first two months of 2012 saw the completion of negotiations on the restructuring of public debt, according to which the private sector's involvement was greater than what was originally envisaged.

It is estimated that the level of old loans to private investors was reduced in February by approximately €106 billion. Also, with the debt buyback in December 2012, the debt was further reduced by €31.9 billion, i.e. by €137.9 billion in total. But the net gain from the debt restructuring was considerably smaller, mainly due to: (i) the need to recapitalise the Greek banks by issuing new debt (amounting to €41 billion during 2012); (ii) borrowing amounting to €11.3 billion required for the debt buyback operation (in December); (iii) the fact that the reduction of the value of bonds held by Greek insurance funds or other entities (amounting to €16.2 billion) led to no debt reduction since it involved intra-government debt; (iv) borrowing amounting to €4.5 billion in order to provide EFSF bonds to insurance funds as an offset for the reduction in their assets; (v) the need to borrow €11.9 billion to cover the 2012 deficit (including the payment of accrued interest in February but not the effect of supporting credit institutions); and (vi) other government liabilities (payments to the ESM, payment of old debts, etc.) totalling €1.9 billion. The final net result of all transactions was a debt reduction of only €51.2 billion. A precondition for the completion of the debt restructuring was a new agreement on the necessary interventions in the economy. The new arrangements were reflected in the Memorandum of Economic and Financial Policies and the *Memorandum of Understanding on Specific Economic Policy Conditionality*, adopted by Parliament on 12 February 2012 (Law 4046/2012).

The new agreement was accompanied by a new financial support package amounting to €130 billion. Together with the *remainder* of the first programme, total undisbursed assistance at the time was close to €167 billion.[14]

14 European Commission, *The second Economic Adjustment Programme for Greece*, March 2012, p. 4.

The debt restructuring and the new financial support agreement put a halt to the course towards collapse that the Greek economy was on in late 2011. But a condition for the completion of these first positive steps was to proceed without delay to the implementation of everything that had been agreed so far.

This did not happen, however. The elections announced on 11 April were held on 6 May and then repeated on 17 June, creating new long delays and once more heightening uncertainty both in Greece and abroad.

In Greece, the Economic Sentiment Indicator recorded in June one of its lowest levels in the three years up to that time (comparable to those observed in May 2010 and November 2011), standing at 77.3, against an average of 78.5 in the first quarter of 2012 and an annual average of 80.6 points in 2011 (see Chart 3).

The loss of confidence and uncertainty about future developments weighed heavily on banks, which faced considerable deposit outflows: between end-December 2011 and end-June 2012 private sector deposits with the Greek banking system fell by €26.3 billion. Indicatively, in May alone this reduction reached €9 billion. It is clear that this large decline was directly associated with political uncertainty, given that after the formation of the new government (from end-June onwards) and until the end of the year this downward course came to a stop and part of these deposits (€12.2 billion) returned[15] (see Chart 4 and Table 14). Of course, lower deposits were not due exclusively to outflows abroad or to hoarding, but they also partly reflected debt repayments by depositors, including debts to banks. Such behaviour led to lower levels of money in circulation.

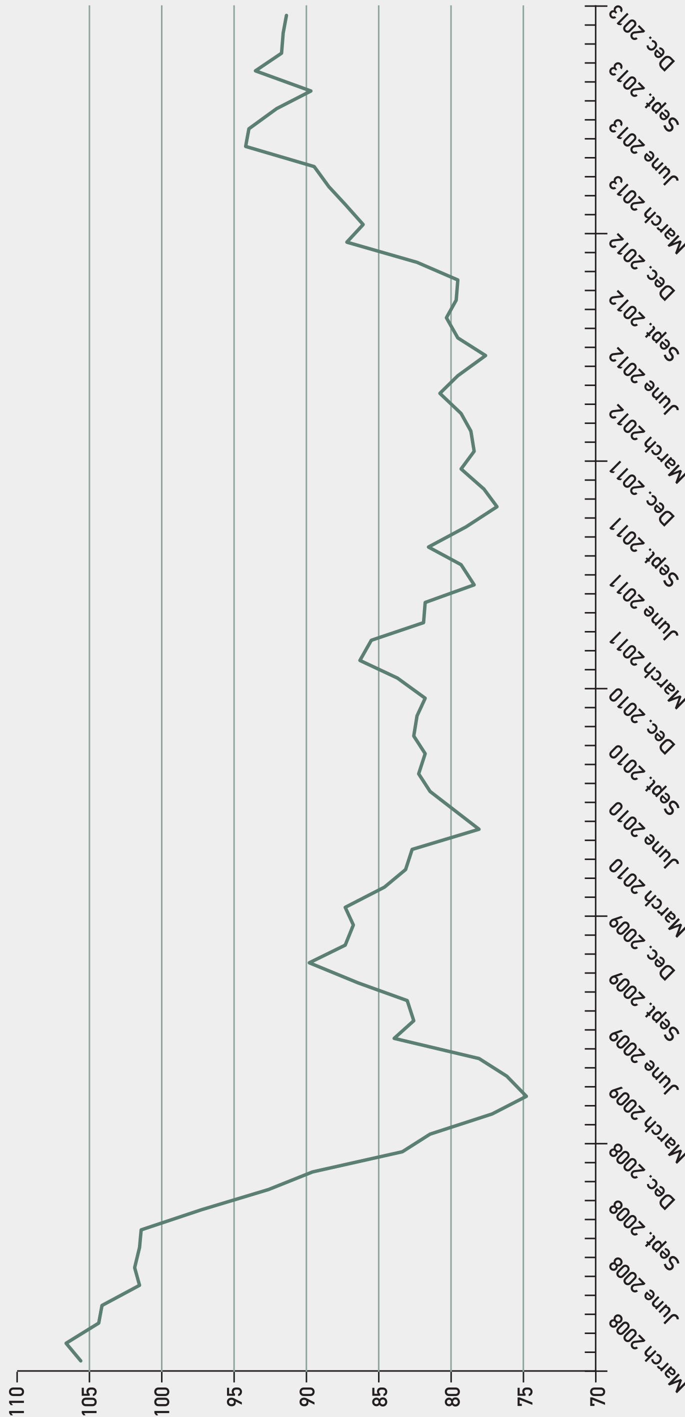
Abroad, the loss of confidence was reflected in media reports, most of which argued that the Greek programme had derailed and considered that the country's exit from the euro area was now very likely. Similar views were also voiced by research institutes, while the likelihood of a Greek default had started to also find its way into statements by European politicians.

It can safely be argued that this upsurge in uncertainty was due to the long delays observed in the implementation of the programme, but the effect of the large increase in political risk was also strong. Indicatively, the Political Risk Index compiled by the Economist Intelligence Unit rose to its historical peak at end-May 2012 and thereafter declined (*for another indicator*, see Chart 1 in Chapter 4.2).

In a similar fashion, this upsurge in uncertainty was also reflected in the BoG gold sovereign purchases/sales ratio (see Table 13), which indicated excess private demand for gold sovereigns, as it fell to 0.48 in June 2012 (its lowest level since February of the same year).

15 See www.bankofgreece.gr, Statistical data, Credit institution deposits.

Chart 3 Economic sentiment indicator
Jan. 2008-Dec. 2013; index 1990-Jan.2014=100



Source: European Commission.

Chart 4 Evolution of deposits by non-financial corporations and households in Greece

In million euro; end-of-period data; Jan. 2007-Dec. 2013

Source: Banks' consolidated financial statements, statistical data from the BoG site.

Table 14 Outstanding deposits by non-financial corporations and households

Million euro

End of period	Non-financial corporations	Households	Total	End of period	Non-financial corporations	Households	Total
Jan. 2007	32,697	140,716	173,414	*July 2010*	34,996	177,395	212,391
Feb. 2007	32,195	141,368	173,564	*Aug. 2010*	35,661	177,470	213,131
March 2007	33,501	143,811	177,312	*Sept. 2010*	36,514	176,500	213,013
Apr. 2007	33,316	145,042	178,358	*Oct. 2010*	35,214	176,414	211,628
May 2007	33,697	145,027	178,724	*Nov. 2010*	35,802	173,433	209,235
June 2007	35,702	149,774	185,476	*Dec. 2010*	36,094	173,510	209,604
July 2007	39,861	149,287	189,148	*Jan. 2011*	34,894	170,627	205,521
Aug. 2007	38,654	150,292	188,945	*Feb. 2011*	33,887	169,030	202,918
Sept. 2007	38,128	151,153	189,282	*March 2011*	33,680	165,505	199,185
Oct. 2007	37,153	151,228	188,381	*Apr. 2011*	32,935	163,821	196,756
Nov. 2007	38,960	152,303	191,263	*May 2011*	32,612	159,321	191,933
Dec. 2007	39,515	158,414	197,929	*June 2011*	32,064	156,116	188,179
Jan. 2008	38,055	158,615	196,671	*July 2011*	30,951	156,265	187,217
Feb. 2008	37,981	159,998	197,980	*Aug. 2011*	31,528	157,135	188,663
March 2008	39,710	161,316	201,026	*Sept. 2011*	30,657	152,549	183,206
Apr. 2008	38,289	164,817	203,106	*Oct. 2011*	29,523	146,898	176,420
May 2008	39,265	166,250	205,515	*Nov. 2011*	28,757	144,142	172,898
June 2008	41,137	168,570	209,707	*Dec. 2011*	28,857	145,370	174,227
July 2008	39,323	170,954	210,276	*Jan. 2012*	26,771	142,186	168,957
Aug. 2008	40,604	173,242	213,846	*Feb. 2012*	25,833	138,548	164,381
Sept. 2008	42,904	175,337	218,241	*March 2012*	25,773	139,583	165,356
Oct. 2008	43,173	179,909	223,083	*Apr. 2012*	25,676	140,276	165,952
Nov. 2008	42,589	181,434	224,024	*May 2012*	24,245	133,193	157,438
Dec. 2008	42,196	185,424	227,620	*June 2012*	23,174	127,414	150,587
Jan. 2009	40,668	188,181	228,849	*July 2012*	23,540	130,357	153,897
Feb. 2009	39,891	189,528	229,418	*Aug. 2012*	23,241	130,157	153,398
March 2009	40,168	190,140	230,308	*Sept. 2012*	23,398	130,932	154,329
Apr. 2009	41,097	193,017	234,114	*Oct. 2012*	24,251	130,995	155,246
May 2009	39,283	193,022	232,305	*Nov. 2012*	24,770	131,120	155,889
June 2009	42,172	195,346	237,518	*Dec. 2012*	26,388	135,063	161,451
July 2009	39,974	194,578	234,552	*Jan. 2013*	25,172	135,796	160,968
Aug. 2009	41,169	195,228	236,397	*Feb. 2013*	25,980	138,037	164,017
Sept. 2009	42,652	195,171	237,824	*March 2013*	25,888	138,253	164,141
Oct. 2009	40,618	194,881	235,499	*Apr. 2013*	25,551	136,784	162,335
Nov. 2009	41,091	193,354	234,445	*May 2013*	26,543	136,870	163,413
Dec. 2009	40,670	196,860	237,531	*June 2013*	26,083	136,591	162,674
Jan. 2010	38,097	194,968	233,064	*July 2013*	25,970	136,416	162,386
Feb. 2010	37,040	192,797	229,836	*Aug. 2013*	25,908	136,300	162,208
March 2010	36,329	191,464	227,792	*Sept. 2013*	26,106	135,241	161,347
Apr. 2010	36,413	186,299	222,712	*Oct. 2013*	25,582	134,802	160,384
May 2010	36,732	183,499	220,230	*Nov. 2013*	26,168	134,874	161,042
June 2010	37,969	178,905	216,874	*Dec. 2013*	28,257	134,994	163,251

Source: Banks' consolidated financial statements, statistical data from the Bank of Greece site.

6.3.2 Towards restoration of balance in late 2012 – the Eurogroup decision of 26-27 November 2012

The formation of a new coalition government in June 2012 put an end to the confidence climate deterioration and all the qualitative indicators mentioned above gradually started to improve. But, following the long delays, the programme was moving off targets, mainly as regards government revenues. Very long delays were also recorded in the implementation of reforms and privatisations. High uncertainty, non-implementation of the programme and deposit outflows (until end-June) deepened economic recession, aggravating the shortfall in government revenue as well as the problem of unemployment.

Between August and October 2012 the Greek authorities had frequent consultations with the Troika,[16] as the implementation of agreed items had been delayed due to the two rounds of parliamentary elections. In parallel, macroeconomic conditions were also deteriorating. Nevertheless, by end-September all quantitative "performance criteria" had been met, except two: the non-accumulation of arrears and the extension of government guarantees.

Moreover, according to the IMF review published in December 2012, very serious delays had been observed in the fields of promoting privatisations, improving the tax collection mechanism, controlling public spending and the build-up of arrears, speeding up court proceedings and reducing court case backlogs, lifting barriers to competition, liberalising the goods and services markets, improving the business environment, and opening up closed professions.[17] Hence, it was decided to revise the targets of the second economic adjustment programme of February 2012.

From end-October onwards, developments were rapid. On 31 October 2012 the 2013 Budget as well as the updated MTFS 2013-2016[18] were submitted to Parliament, which on 7 November 2012 passed Law 4093/2012 ("Approval of the Medium Term Fiscal Strategy Plan 2013-2016 – Urgent implementation measures of Law 4046/2012 and the Medium Term Fiscal Strategy Framework 2013-2016"). In other words, some of the arrangements for the implementation of the measures provided

16 See the joint statements by the Commission, the ECB and the IMF on 5.8.2012 and 17.10.2012. The latter stated that the staff teams and the Greek authorities had agreed on most of the core measures needed to restore the momentum of reform and pave the way for the completion of the review over the next few days.

17 IMF, *Greece: First and second reviews under the extended arrangement under the extended fund facility*, January 2013, pp. 7, 9-10 and 15-17.

18 Which should have been revised in May 2012.

Table 15 Timeline – Main economic developments in Greece and Europe, and actions of the Bank of Greece, 2012

2012	
2.2.2012	Establishment of the European Stability Mechanism (ESM).
12.2.2012	The Greek Parliament ratifies the new loan agreement with a large majority.
21.2.2012	The Eurogroup endorses a second bailout package for Greece, worth over €130 billion.
23.2.2012	The Greek Parliament approves the debt restructuring plan under the PSI.
1.3.2012	The Eurogroup decision makes reference to a backstop facility for the recapitalisation of Greek banks.
2.3.2012	Signing of the EU Fiscal Compact.
9.3.2012	The restructuring of the Greek sovereign debt under the PSI is successfully completed.
14.3.2012	Euro area countries approve the second economic adjustment programme. The first tranche amounts to €39.4 billion.
19.3.2012	Bank of Greece *Monetary Policy Report 2011-2012*. The Eurogroup decision of 21 February shapes a new economic framework that fosters growth. Despite the progress made since 2010, confidence has not yet been restored. A rigorous implementation of the Programme is warranted. The restructuring of the banking system is a prerequisite for boosting liquidity.
19.3.2012	Resolution of the cooperative banks of Achaia, Lamia and Lesvos-Limnos under Law 3601/2007.
24.4.2012	Bank of Greece *Annual Report 2011*. The objective circumstances are currently more favourable, but the exit from the crisis depends solely on the country's will and ability to face this historical challenge.
6.5.2012	Legislative election. New Democracy (ND) comes first with 18.85% of the vote, followed by Syriza-United Social Front (SYRIZA) with 16.78%, the Panhellenic Socialist Movement (PASOK) with 13.18%, Independent Greeks (ANEL) with 10.60%, the Communist Party of Greece (KKE) with 8.48%, Golden Dawn (XA) with 6.97% and Democratic Left (DIMAR) with 6.11%. All attempts to form a new government fail.
17.6.2012	New legislative election. ND comes first with 29.66% of the votes, followed by SYRIZA with 26.9%, and PASOK with 12.3%. A coalition government is formed by ND, PASOK and DIMAR under Antonios Samaras.
25.6.2012	Cyprus applies for financial assistance under the EU Support Mechanism.
25.6.2012	Spain requests financial assistance from euro area Member States for the recapitalisation of its banking sector.
29.12.2012	Euro area summit decision on the establishment of a Single Supervisory Mechanism for banks, with a view to creating a banking union in the euro area.

Continued ➛

Table 15 Timeline – Main economic developments in Greece and in Europe, and actions of the Bank of Greece, 2012 *(continued)*

2012	
26.7.2012	President Draghi states that the ECB is ready to do whatever it takes to preserve the euro.
27.7.2012	Absorption of the sound part of the Agricultural Bank of Greece by Piraeus Bank.
6.9.2012	The ECB decides on the modalities for undertaking Outright Monetary Transactions (OMTs) in secondary markets for the purchase of short-term sovereign bonds in the euro area.
18.9.2012	Bank of Greece Governor G. Provopoulos informs ECB President M. Draghi in a letter of the ongoing process of cost rationalisation at the Bank, namely of his decision to reduce his salary and the Deputy Governors' salaries by an additional 30%, bringing the cumulative decline to 50% since 2009. In this letter, it is stressed that, through its continued hard efforts to contain operating costs and wages, the Bank of Greece leads the way towards an overall national effort.
7.11.2012	The Medium-Term Fiscal Strategy Framework (MTFS) 2013-2016 is passed by Parliament with 153 votes in favour. DIMAR abstains from the vote.
12.11.2012	The Eurogroup meeting focuses on Greek debt sustainability and financing needs. These issues will be discussed at an extraordinary meeting on 20 November.
27.11.2012	The Eurogroup decides to extend the fiscal adjustment programme for Greece by two years, to improve lending terms and conditions and to support a debt buyback operation, with a view to reducing Greek debt to 120% by 2020, provided that Greece reaches a primary surplus by the end of 2013.
03.12.2012	Bank of Greece *Monetary Policy Interim Report 2012*. After serious delays and uncertainty, new conditions have emerged for Greece which under certain conditions create plausible expectations of a recovery of the Greek economy. What is warranted is a consistent implementation of the policies already legislated, coupled with measures that speed up the recovery, as well as a broader structural reform package. The completion of the recapitalisation process and the restructuring of the banking system are reforms of vital importance, as an increase in banks' own funds will enhance confidence among both domestic savers and international financial markets.
13-14.12.2012	Agreement of the European Council on the establishment of a Single Supervisory Mechanism for banks.
13.12.2012	Eurogroup decision on the disbursement of the next instalment exceeding €49 billion.
18.12.2012	Market sentiment on Greece starts to gradually improve. Greece's credit rating raised by S&P to B- "outlook stable".
27.12.2012	The Bank of Greece publishes the *Report on the recapitalisation and restructuring of the Greek banking sector*.

Source: Bank of Greece.

for in the agreement of February 2012 (i.e. Law 4046) were finally passed into law with an *eight-month delay*.[19]

The 2013 Budget was adopted on 11 November 2012, incorporating a large part of the arrangements included in the MTFS 2013-2016. The Introductory Report projected that a primary surplus at the general government level would be achieved in 2013 (for the first time since 2002), amounting to 0.4% of GDP, compared with a primary deficit estimated at 1.2% in 2012. Moreover, the MTFS targeted the general government primary surplus to gradually rise to 4.5% of GDP by 2016 and mentioned that this would require additional interventions amounting to €4.64 billion in 2015-2016, which would be specified later.

On 12 November 2012 the Eurogroup acknowledged the considerable steps taken to get the programme back on track, approved the revision of the fiscal targets and called upon Greece to speed up the implementation of some pending issues.

On 20 November, in an extraordinary meeting, the Eurogroup endorsed the updated programme terms, expressed satisfaction as regards the implementation of prior actions and generally found that initiatives and measures were being taken to ensure sustainability of the country's public debt.

On 26-27 November 2012 the Eurogroup met anew and reiterated its findings regarding the progress made in Greece. Subsequently it was decided that, on a quarterly basis, Greece would transfer to the segregated account for servicing its debt all privatisation proceeds and all primary surpluses achieved in line with the targets set, as well as 30% of the excess amounts in case of higher than targeted primary surpluses (see Box 6.1).

In addition, the Eurogroup took into account that the necessary revision of fiscal targets and the ensuing deferral of the 4.5% of GDP target for the primary surplus from 2014 to 2016 called for a broader review of debt sustainability, which had not improved according to expectations, due to the deep recession. Against this background, there was discussion concerning a reduction of the debt in the near future through a public offering procedure for the repurchase of Greek government bonds, which was completed in December 2012 with a debt buyback amounting to a nominal value of €31.9 billion, bought back at 33.8% of its nominal value.

Following the Greek authorities' assurances that fiscal consolidation and structural reform efforts would continue, and subject to a positive outcome of the bond buyback operation, the country's euro area partners made the commitment that

19 As regards the delay, it is revealing that the "first and second reviews" of the February 2012 programme by the IMF relied on discussions completed in October 2012, were dated "21.12.2012" and were published in January 2013. The corresponding "first review" by the Commission was published in mid-December 2012.

Table 16 Key decisions of EU institutions and bodies (euro area summits, European Council, ECOFIN) on the Greek economy in 2012

21.2.2012	Eurogroup Statement that the conditions are in place for launching the PSI exchange offer and agreement that NCBs will pass on to Greece the SMP profits and the income generated by their holdings of Greek government bonds until 2020 and that the interest rates of the Greek Loan Facility will be retroactively lowered by 150 b.p.
1.3.2012	Eurogroup Statement that the European Financial Stability Facility (EFSF) is authorised to take all necessary action to implement the PSI bond exchange.
9.3.2012	Eurogroup Statement taking note of the high private sector participation in Greece's debt exchange offer and the extension of the offer period until 23 March, and agreement to launch the relevant procedures for the final approval of the second economic adjustment programme.
14.3.2012	Eurogroup Approval of the second economic adjustment programme for Greece.
30.3.2012	Eurogroup Statement acknowledging the extension of the PSI operation until 4 April given by the Greek authorities. Holders of eligible foreign-law Greek bonds are encouraged to participate in the exchange.
17.6.2012	Eurogroup The Eurogroup reiterates its commitment to assist Greece in its adjustment effort and looks forward to the swift formation of a new Greek government that will take ownership of the adjustment programme.
18.10.2012	Euro area summit Statement on the progress made by Greece and the Troika towards reaching an agreement on the policies underpinning the adjustment programme. The determination of the Greek government is welcomed and the remarkable efforts by the Greek people are commended.
12.11.2012	Eurogroup Statement, in which (a) the resolve of the Greek authorities to bring the adjustment programme back on track is welcomed, (b) the revised fiscal targets, as requested by the Greek government and supported by the Troika, are endorsed and (c) the intention to discuss measures for improving Greek debt sustainability on 20 November is expressed.
20.11.2012	Eurogroup Statement noting that Greece has implemented all agreed prior actions required ahead of the Eurogroup meeting in a satisfactory manner and that progress has been made in identifying a consistent package of credible initiatives aimed at making a further substantial contribution to the sustainability of Greek government debt. This issue will be further discussed on 26 November.
27.11.2012	Eurogroup Agreement on the adoption of Greek debt sustainability measures, which include a lowering by 100 b.p. of the interest rate charged to Greece on the loans provided in the context of the Greek Loan Facility, a lowering by 10 b.p. of the guarantee fee costs paid by Greece on the EFSF loans, an extension of the maturities of the bilateral and EFSF loans by 15 years and a deferral of interest payments of Greece on EFSF loans by 10 years, as well as a commitment by Member States to pass on to Greece's segregated account, an amount equivalent to the income on the SMP portfolio accruing to their national central bank as from budget year 2013. Commitment to take additional measures to contain debt dynamics once Greece achieves a primary surplus and provided all programme terms are implemented.
4.12.2012	ECOFIN Council decision to adjust, in line with the updated economic adjustment programme, the fiscal consolidation measures and the implementation calendar required of Greece by the decision of May under the EU's excessive deficit procedure, granting it an extension to correct its excessive budget deficit by 2016.
13.12.2012	Eurogroup Formal approval of the second disbursement under the second economic adjustment programme for Greece, following the review of the outcome of the debt buyback operation conducted by Greece. The debt buyback operation is expected to lead to a substantial reduction of the Greek debt-to-GDP ratio.

Source: Bank of Greece.

additional specific favourable measures would gradually be taken to contain its debt dynamics, and that further measures would be examined as soon as Greece would attain a primary surplus, provided that the country would have implemented all programme milestones. Finally, the Eurogroup concluded that all necessary elements were in place in order for Member States to initiate procedures at the national level for the approval of the payment of the next tranche under the EFSF, amounting to €43.7 billion. The Eurogroup meeting of 13 December 2012 set the timeline for the disbursement of the financing tranches to follow. The new target set was a reduction of the Greek debt to 175% of GDP in 2016, 124% in 2020 and well below 110% in 2022.

Box 6.1

Eurogroup statement on Greece, 27 November 2012: main points

"[…] The Eurogroup noted that the outlook for the sustainability of Greek government debt has worsened compared to March 2012 when the second programme was concluded, mainly on account of a deteriorated macro-economic situation and delays in programme implementation.

The Eurogroup considered that the necessary revision in the fiscal targets and the implied postponement of a primary surplus target of 4.5% of GDP from 2014 to 2016 calls for a broader concept of debt sustainability encompassing lower debt levels in the medium term, smoothing of the current financing hump after 2020 and easing of its financing.

The Eurogroup was informed that Greece is considering certain debt reduction measures in the near future, which may involve public debt tender purchases of the various categories of sovereign obligations. If this is the route chosen, any tender or exchange prices are expected to be no higher than those at the close on Friday, 23 November 2012.

The Eurogroup considers that, in recapitalising Greek banks, liability management exercises should be conducted in respect of remaining subordinated debt holders so as to ensure a fair burden sharing.

Against this background and after having been reassured of the authorities' resolve to carry the fiscal and structural reform momentum forward and with a positive outcome of the possible debt buyback operation, the euro area Member States would be prepared to consider the following initiatives:

- A lowering by 100 bps of the interest rate charged to Greece on the loans provided in the context of the Greek Loan Facility. Member States under a full financial assistance programme are not required to participate in the lowering of the GLF interest rates for the period in which they receive themselves financial assistance.
- A lowering by 10 bps of the guarantee fee costs paid by Greece on the EFSF loans.
- An extension of the maturities of the bilateral and EFSF loans by 15 years and a deferral of interest payments of Greece on EFSF loans by 10 years. These measures will not affect the creditworthiness of EFSF, which is fully backed by the guarantees from Member States.
- A commitment by Member States to pass on to Greece's segregated account, an amount equivalent to the income on the SMP portfolio accruing to their national central bank as from budget year 2013. Member States under a full financial assistance programme are not required to participate in this scheme for the period in which they receive themselves financial assistance.

The Eurogroup stresses, however, that the above-mentioned benefits of initiatives by euro area Member States would accrue to Greece in a phased manner and conditional upon a strong implementation by the country of the agreed reform measures in the programme period as well as in the post-programme surveillance period.

The Eurogroup is confident that, jointly, the above-mentioned initiatives by Greece and the other euro area Member States would bring Greece's public debt back on a sustainable path throughout this and the next decade and will facilitate a gradual return to market financing. Euro area Member States will consider further measures and assistance, including, *inter alia*, lower co-financing in structural funds and/or further interest rate reduction of the Greek Loan Facility, if necessary, for achieving a further credible and sustainable reduction of Greek debt-to-GDP ratio, when Greece reaches an annual primary surplus, as envisaged in the current MoU, conditional on full implementation of all conditions contained in the programme, in order to ensure that by the end of the IMF programme in 2016, Greece can reach a debt-to-GDP ratio in that year of 175% and in 2020 of 124% of GDP, and in 2022 a debt-to-GDP ratio substantially lower than 110%.

As was stated by the Eurogroup on 21 February 2012, we are committed to providing adequate support to Greece during the life of the programme and beyond until it has regained market access, provided that Greece fully complies with the requirements and objectives of the adjustment programme. […]"

These developments contributed to a stabilisation of the situation in late 2012. Indicatively, the economic sentiment indicator for Greece recorded a sharp rise in December 2012 and, following a small decline in January, improved further in February 2013.

Improvement was also indicated by the fiscal data for 2012, despite the deep recession that continued in that year (-6.4%), the two election rounds, and the delay of at least six months as regards the adoption of certain measures. More specifically, the general government deficit narrowed to 5.8% of GDP, while the primary deficit fell to 0.8% (excluding the impact of the support to financial institutions amounting to 3.2% of GDP), and debt declined to 156.9% of GDP.

6.4 2013: The economy on a track of stabilisation

6.4.1 Easing of the recession – marked weakening of macroeconomic imbalances

In early 2014, there were clearer indications that the situation in 2013 had improved compared with 2012 – mainly that the economy had entered a track of stabilisation and that the preconditions were in place for the recession to end and recovery to start in 2014. There was indeed an improvement in 2013, although early in the year the crisis in Cyprus rekindled concerns and uncertainties about the Greek banking system and the Greek economy in general. The risks, which were indeed extremely high, were finally averted, following the swift, coordinated and effective intervention by the government and the BoG (see Chapter 8.6.6).

The more favourable conditions in late 2013 can be summarised as follows:

- Fiscal consolidation made impressive progress and a primary surplus was recorded in 2013 after a long period of sizeable deficits.
- For the first time, the current account balance showed a surplus in 2013. This development was largely due to a decline in imports, but the buoyant recovery of tourism receipts and higher receipts from exports of goods also played a role.
- The pace of recession was estimated to drop to roughly 4% in 2013; the final outturn was slightly lower (-3.85%), i.e. the recession was milder compared with both 2012 and the initial projection for 2013.
- Expectations improved both in Greece and abroad, and confidence was gradually taking hold again. Indicatively, the BoG gold sovereign purchases/sales ratio (see Table 13) stood considerably higher than one —indicating *excess* private *supply* of gold sovereigns— throughout the period from July 2012 to December 2013, with a single exception in April 2013 when it briefly fell to 0.57 (indicat-

ing excess demand), evidently due to the uncertainty caused at the time by the banking crisis in Cyprus and the way it was addressed. Favourable developments started to appear in the real economy as well, in certain production and labour market indicators. In parallel, the spreads of Greek government bonds vis-à-vis the corresponding German bonds fell back to 2010 levels, while on 30 November 2013 a rating agency (Moody's) proceeded to the first upgrading of the Greek government's credit rating after the onset of the crisis, by two notches (from C to Caa3). As regards investment prospects, a most encouraging development was the decision on the Trans Atlantic Pipeline for the transfer of natural gas from Azerbaijan through Greece to Italy and the rest of Western Europe. In parallel, the privatisation programme was now progressing after considerable delays in previous years, and 2013 saw the conclusion of some important privatisation deals (concerning the state-controlled gaming operator OPAP, the state gas network operator DESFA, etc.) that attracted foreign capital as well.

- For the first time in over 45 years, the inflation rate turned negative in 2013. This development indicates that prices have started to respond to lower demand and labour costs and to support real disposable income. However, a prolonged continuation of this phenomenon at the same pace would be undesirable, as negative inflation intensifies uncertainty in the economy and in business expectations and worsens public debt dynamics.
- The restructuring of the economy on the supply side moved ahead, albeit slowly. Nevertheless, developments in relative prices provided an incentive for a shift of resources from the sector of internationally non-tradable goods to the tradables sector, in which productivity is much higher. The assessment was made that the continuation and strengthening of this trend would lead to higher total productivity, improve competitiveness and support job creation, over the medium term.
- The recapitalisation of credit institutions was promoted and the structure of the banking sector changed radically, with the creation of more resilient banks that are better positioned to exploit economies of scale. The restructuring and consolidation of the banking system has been smooth, without a single depositor having incurred a loss on their savings; in other words, without any disruption of financial stability.[20]

20 For a summary of these factors see also the Introductory Statement by the Governor of the BoG before the Greek Parliament's Standing Committee on Economic Affairs discussing the Bank of Greece *Interim Report on Monetary Policy 2013*, 16.1.2014.

Table 17 Timeline – Main economic developments in Greece and Europe, and actions of the Bank of Greece, 2013

2013	
1.1.2013	Last-minute agreement reached by US legislative bodies to avert the fiscal cliff.
18.1.2013	Establishment of the New Hellenic Postbank ("good bank") with the Hellenic Financial Stability Fund as its sole shareholder in implementation of Law 3601/2007.
21.1.2013	J.C. Juncker stepped down from the Eurogroup presidency. He is succeeded by Dutch Finance Minister J. Dijsselbloem.
21.1.2013	The economic adjustment programme for Greece is on a positive track, according to the Eurogroup. A further amount of €7.2 billion to cover bank recapitalisation and resolution costs is also decided to be paid out to Greece.
25.2.2013	Bank of Greece *Annual Report 2012*. The risk of a collapse was eliminated, the likelihood of a Greek exit from the euro area was averted and confidence is gradually being restored. However, these encouraging developments leave no room for complacency. Considerable progress has been made so far in the restructuring of the banking system, while the recapitalisation of banks is well under way.
28.2.2013	The Bank of Greece publishes a report conducted by Bain & Company.
15.3.2013	Cyprus is hit by the crisis. The Eurogroup decides to provide financial assistance of €10 billion to Cyprus. As part of the bailout deal, a one-off levy is imposed on all depositors with Cypriot banks.
19.3.2013	The Cypriot parliament rejects bailout conditions.
25.3.2013	The Eurogroup reaches a new agreement with Cyprus, which includes an agreement between Cyprus and Greece on the transfer of Greek branches of the Cypriot banks, with a view to protecting the stability of both the Greek and the Cypriot banking systems.
15.4.2013	An agreement is reached following the conclusion of the third review of the Greek economic programme by the Troika. The disbursement of a loan tranche worth €2.8 billion by the EFSF, which has been pending since the previous review, is announced.
3.5.2013	Positive assessment of the Greek programme by the IMF.
11.5.2013	Transfer of assets and liabilities of First Business Bank to the National Bank of Greece in implementation of Law 3601/2007. A liquidator is appointed at Probank for the conclusion of the capital increase.
13.5.2013	Eurogroup agreement on the disbursement of two sub-tranches, amounting to €7.5 billion.

Continued ➛

Table 17 Timeline – Main economic developments in Greece and Europe, and actions of the Bank of Greece, 2013 *(continued)*

	2013
17.5.2013	The EFSF disburses €4.2 billion to Greece, following a Eurogroup decision. Greece has now received €120 billion of financial assistance from the EFSF out of the total committed amount of €144.6 billion.
29.5.2013	Bank of Greece *Monetary Policy Report 2012-2013*. Positive indications that the Greek economy is rebalancing. Nevertheless, output continues to decline and unemployment is rising. The banking system is undergoing a process of restructuring on new, healthy foundations.
30.5.2013	The European Commission grants an extension of two years for the reduction of fiscal deficits of France, Spain, Slovenia and Poland, as well as an extension of one year for the Netherlands, Belgium and Portugal.
11.6.2013	The Greek government shuts down the public broadcaster ERT by a legislative act.
25.6.2013	The new government is sworn in, consisting only of ND and PASOK members, after DIMAR has left the coalition government refusing to back ERT's closure.
8.7.2013	The Eurogroup approves the disbursement of €6.8 billion in tranches under the European Support Mechanism.
2.9.2013	Completion of the process of transfer of shares of New TT Hellenic Postbank S.A. and New Proton Bank S.A. to Eurobank.
12.9.2013	The European Parliament approves the establishment of a Single Supervisory Mechanism, conferring supervisory tasks on the ECB.
23.10.2013	The ECB starts the comprehensive assessment of banks in advance of its supervisory role.
10.11.2013	A motion of no confidence filed by opposition party SYRIZA is rejected by Greek Parliament with 153 votes.
8.12.2013	Withdrawal of authorisation of the cooperative banks of Western Macedonia, Dodecanese and Evia and transfer of all of their deposits to Alpha Bank.
8.12.2013	The Greek Parliament passes the State Budget with 153 votes for and 142 votes against.
17.12.2013	Bank of Greece *Monetary Policy Interim Report 2013.*
18.12.2013	The ECOFIN reaches an agreement on the banking union – by adopting a draft regulation on the Single Resolution Mechanism and a decision by euro area member states committing them to negotiate, by 1 March 2014, an intergovernmental agreement on the functioning of the Single Resolution Fund.

Source: Bank of Greece.

6.4.2 The year 2013 is a landmark for fiscal consolidation

The year 2013 was a landmark for fiscal consolidation in Greece, as, for the first time since 2002, a primary surplus was achieved at general government level. According to the Eurogroup decisions of 27 November and 13 December 2012, the achievement of a primary surplus in 2013 was a precondition for the country's euro area partners to take action that will ensure sustainability of its public debt.

Even more important is the fact that the *structural* primary balance is estimated by the BoG to have improved by 19 percentage points of potential GDP over the period 2010-2013, yielding a surplus of around 4.4% of potential GDP by end-2013. This improvement is not only a major accomplishment, but also represents one of the biggest fiscal consolidations ever achieved worldwide, although it should be noted that it has relied more than it should have on tax increases; this put a considerable burden on taxpayers and squeezed disposable income.

In the course of 2013, several measures aimed at increasing tax revenue have been adopted, such as the tax system reform and the new Unified Property Tax. In addition, better expenditure control was ensured through a strengthening of fiscal rules and mechanisms for monitoring the proper execution of the approved budgets across all levels of general government (including public utilities and enterprises). Also, efforts to restructure public entities and enterprises —such as the Hellenic Broadcasting Corporation (ERT), the Hellenic Vehicle Industry (ELVO), Hellenic Defence Systems (EAS), the Mining and Metallurgical Company (LARCO)— progressed, whereas considerable delays were recorded in the course of the year with respect to the implementation of a number of actions necessary for reforming the central government as required by the Economic Adjustment Programme, concerning, for instance, the preparation of updated organisation charts in public administration, the placing of employees in a labour reserve/mobility scheme and an assessment of staff qualifications and performance.

The progress made as regards meeting the fiscal targets of the adjustment programme, as well as the need to speed up public administration reforms, are also pointed out in the joint statement by the European Commission, the ECB and the IMF published in the course of 2013,[21] while on 17 December the President of the Eurogroup confirmed that Greece had met the four preconditions ("milestones") agreed with the Troika during the third review.[22]

21 See "Statement by the European Commission, ECB and IMF on Greece" on 15.4.2013, 8.7.2013, 29.9.2013, and 21.11.2013.

22 See "Statement by the President of the Eurogroup on Greece" on 17.12.2013.

Table 18 Key decisions of EU institutions and bodies (euro area summits, European Council, ECOFIN) on the Greek economy in 2013

Date	Decision
21.1.2013	Eurogroup Statement noting with satisfaction that the MoU milestones for the disbursement of the January sub-tranche, agreed between Greece and the Troika, have been achieved.
4.3.2013	Eurogroup Statement noting with satisfaction that the MoU milestone for February has been achieved and that Greece has adopted measures beyond those required.
13.5.2013	Eurogroup Statement on the outcome of the second review mission under the updated second macroeconomic adjustment programme for Greece, noting with satisfaction that Greece has made further substantial progress in implementing the required fiscal and structural reforms.
8.7.2013	Eurogroup Statement on the outcome of the third review mission under the second macroeconomic adjustment programme for Greece, noting that the programme is broadly on track with the agreed policy conditionality.
17.12.2013	Eurogroup Statement by the President noting that Greece has achieved the four milestones agreed with the Troika in the context of the third review. The EFSF disburses the second sub-tranche of the fifth instalment (€0.5 billion), as well as the remaining amount related to the income that accrued on the SMP portfolio of euro area NCBs in 2012 (€0.5 billion).

Source: Bank of Greece.

6.4.3 Restructuring of the banking system and prospects of normalisation in credit conditions

In 2013, recapitalisation and restructuring in the banking system shaped a new banking landscape in Greece, comprising fewer but stronger banks; it was estimated that in the medium term they would have a greater capacity to supply credit to the economy. In the short term, however, new lending remains very limited, as banks' lending capacity continues to be constrained by several factors. On the supply side, a major constraint has been the accumulation of non-performing loans, which deprives banks of resources while also posing a risk of potential future impairment of their capital base, thereby forcing them to tie up more capital for loan-loss provisions. At the same time, demand for credit has remained weak, due to the adverse macroeconomic environment.

According to the assessment of the BoG, the ongoing improvement in economic conditions together with growing confidence in Greece and its banking system are

expected to lead to a normalisation of credit expansion in the medium term, as they will:

– enable Greek banks to gradually regain access to the international interbank market;
– encourage the flow of retail deposits back to banks;
– generate demand for credit; and
– help to reduce credit risk, broadening the scope for financing viable business projects.

Credit supply conditions would also benefit from improved management of non-performing loans and from proactive measures to prevent further non-performing loans from being accumulated. In this regard, there is considerable room for improvement in current bank policies on this matter (for the views expressed in 2013 by the BoG on the financing of the economy, see Chapter 7.4 further below).

7 PUBLIC INTERVENTIONS OF THE BANK OF GREECE REGARDING ECONOMIC POLICY AND AN EXIT FROM THE CRISIS: 2010–2013

Greece's recourse to the support mechanism marked the end of a mode of conducting economic policy that had long exhausted its limits and the start of a new era that required a radical reorientation of economic policy, as well as of collective and individual behaviour. A large-scale adjustment had to be made at all levels and necessitated a realisation of the size of the problem and a coordinated effort. The Bank of Greece actively supported this effort by raising awareness of key economic policy issues, through publications, statements by its Governor and analyses of particular aspects which concerned the implementation of a new economic policy. What emerges from all these public communications and interventions is a comprehensive proposal for an exit from the crisis, as well as the Bank's key assessments on the priorities of economic policy in response to the changing circumstances.

In 2010, the Bank of Greece argued that recourse to the support mechanism was necessary under the circumstances prevailing at the time and set out the preconditions for success.

In 2011, it underscored the serious delays in the implementation of the Economic Adjustment Programme, which rendered necessary a restructuring of Greek sovereign debt.

In 2012, it pointed out that an affirmative answer should be given to the historic dilemma concerning Greece's continued participation in the euro area.

In 2013, it identified speeding up the recovery and creating the conditions for a transition to a new growth model as the key desideratum of economic policy.

7.1 2010: Recourse to the support mechanism is deemed necessary

Already since 2008, the Bank of Greece had taken a different view regarding the extent and gravity of the crisis relative to the then prevailing perceptions that the cri-

sis would be short-lived and could be addressed with extraordinary, *ad hoc* action. Instead, the Bank of Greece pointed out that the crisis —given that it had brought to the fore the economy's chronic macroeconomic imbalances and structural weaknesses— necessitated fundamental changes across all areas.

The BoG report on *Monetary Policy 2009-2010*, i.e. before Greece was placed under the support mechanism, pointed out the following:

> *"The crisis that the Greek economy is facing today is an all-encompassing and multi-faceted one, and therefore calls for a similar response: sustainable, ongoing and convincing fiscal adjustment, coupled with a policy of structural reforms aimed at improving market functioning and competitiveness. But most importantly: an eradication of the behaviours, attitudes and policies that have brought us to the situation we are in today."*

According to the Bank of Greece, crucial to the success of the effort would be the role of the political system, which was called upon to spearhead the effort, i.e. to lead, convince and inspire the Greek public. As the Bank's Governor stated:

> *"…the government is called upon today, acting with perseverance and resolve, to overcome obstacles, break up the rigidities of the past, open up new pathways and demonstrate in a convincing manner that the gains to be reaped at the end of the long effort outweigh the costs that we will have to bear along the way."*[1]

Based on assessments regarding the nature of the Greek crisis and developments in international markets which rendered borrowing practically impossible, the Bank of Greece considered that recourse to the support mechanism was necessary. However, it stressed from the very outset that success would solely depend on the effective implementation of the economic policy which would accompany this support. In the Governor's Report published in April 2010 and in his speech at the Annual Meeting of the Bank's Shareholders on 27 April 2010, Governor Provopoulos outlined the necessary conditions for the success of the endeavour:

> *"The support mechanism could serve as an additional policy instrument, provided that it is used not as a partial substitute for the national economic policy needed to correct the macroeconomic imbalances and to address the structural weaknesses, but as a tool for bolstering this policy, by giving it time to bear its fruit, while fostering its more effective implementation."*
>
> *"The brunt of the task falls to the Greek State, which holds full responsibility for convincing that the economy is irrevocably engaged on a new tra-*

1 *Annual Report 2009*, April 2010, p. 20, and Speech by the Governor George A. Provopoulos at the Annual Meeting of Shareholders of the Bank of Greece, 27.4.2010.

jectory. In order for this to happen, the economic policy measures announced must be implemented promptly and rigorously, according to strict time schedules for concrete measures and interventions, without any faltering, procrastinating and wavering, and using all available tools, including the financial support mechanism, if and when needed."

Furthermore, early in the year, amid increasing speculation in international and domestic media about Greece's exit from the euro area and a return to the drachma, the Bank of Greece intervened through an article of its Governor in the *Financial Times*,[2] which analysed the negative impact of such a development and argued that the country should make every effort in order to remain within the euro area.

As Governor George Provopoulos pointed out:

"The problems faced by the Greek economy are extremely serious. However, the key question is whether it will be easier to solve them from inside or outside the euro area. My answer is that it will be unequivocally easier to solve these problems from within the euro area."

And he concluded:

"The Greek economy currently stands at a crossroads. The fact of the matter is that it will be immensely less costly for Greece to eradicate its problems from within the euro area. Rather than a Greek tragedy, a more appropriate analogy for the Greek economy stems from Homer's Odyssey. In that epic, the enchanting sounds of the sirens enticed sailors to jump to their deaths in the sea. Those who suggest Greece might leave the euro area are like Homer's sirens. Greece will not be tempted by these short-term options, but will undertake the necessary, bold adjustments. The future of its economy is unwaveringly tied to the mast provided by the euro."

The main positions of the Bank of Greece with regard to the adjustment programme can be outlined as follows:

1st The programme must be implemented rigorously and without delays, in order to succeed.

2nd The programme's cost of implementation is indeed high, but much lower than the cost of its non-implementation.

3rd The effort for the reduction of fiscal deficits should be spearheaded by cuts in public spending, rather than increasing the tax burden for enterprises and individuals. Two thirds of the deficit reduction should stem from spending cuts and one third from revenue increases (mainly through broadening the tax base by curbing tax evasion, rather than by increasing tax rates or eliminating justified tax exemptions).

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2 "Greece will fix itself from inside the eurozone", *Financial Times*, 22.1.2010.

4th The programme is a necessary, albeit not sufficient condition for the Greek economy's exit from the crisis. Efforts are needed from all parties involved, along with a comprehensive plan for the economy's restructuring that will overcome the structural weaknesses of the past and lay the groundwork for sound economic growth. In its *Monetary Policy Interim Report* of October 2010, the Bank of Greece proposed the elaboration of a binding, coherent and broadly acceptable Action Plan for Growth, which would go hand in hand with fiscal adjustment, complement and specify the policies under way and put forward new policies to bolster growth without jeopardising the fiscal targets. The main reasoning behind this proposal was that such an Action Plan, along with the planned reforms and unhampered progress with fiscal adjustment, would send a strong message to the markets that the Greek economy is reorienting itself dynamically, becoming outward-looking, opening up to business initiatives and efficiently taking advantage of the opportunity provided by the support mechanism in order to recover soon. More specifically, the abovementioned Report stressed that:

> "*…the Action Plan should lead the economy away from the old, distorted growth model —based mainly on increasing demand (in particular, consumer demand) and lending to the public and the private sector— towards an outward-looking growth model relying on a strong productive base, supported by investment and structural reforms. At the same time, the new model must encompass environmental protection and reinforce social cohesion. This means that structural reforms must be designed on the basis of a multi-faceted, 'holistic' approach.*"

It also described the intermediate goals for strengthening potential growth and improving the economy's international competitiveness, as well as the key measures for achieving these goals. In one of his speeches delivered in that period,[3] the Governor of the Bank of Greece presented detailed recommendations for upgrading tourism under the new circumstances and underscored the sector's contribution to growth.

To sum up, in 2010 the Bank of Greece pointed out that if the above conditions were met, the adjustment programme would bring positive results. At the same time, the Bank insisted that fiscal adjustment should be accompanied by policies to mitigate the extent of the recession, i.e. structural policies to boost growth, and stressed that the programme's success was subject to considerable uncertainty and risks, such as:

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3 Speech at a conference of the Association of Greek Tourism Enterprises (SETE), 18.10.2010.

- a lack of determination as regards implementation; the latter would require a break with practices of the past;
- a deeper-than-expected recession, which would hinder fiscal adjustment;
- uncertainty about Greece's ability to return to the markets soon;
- a deterioration in conditions in the financial sector, as a result of heightened uncertainty;
- a credibility deficit with regard to Greek statistics; continuous revisions of GDP figures compromised the credibility of estimates and assumptions underlying the programme.

In late 2010, the Bank of Greece pointed out that the discussion on debt restructuring was inopportune and harmful, as it could accentuate market uncertainty and trigger expectations that would undermine fiscal adjustment. The Bank of Greece's position at the time was clear: *debt restructuring is not necessary, if the targets set are steadfastly adhered to*.

Box 7.1

2010: Bank of Greece analyses and studies on economic policy issues

The main policy positions and recommendations of the Bank of Greece were accompanied by analyses and assessments on more specific issues of direct relevance to the economic conjuncture and of particular importance for the effective implementation of the economic adjustment that the new conditions necessitated.

It is indicative that the two reports published in the first four months of 2010, i.e. before the first Memorandum of Understanding was signed, placed particular emphasis on fiscal and structural issues.

The March 2010 report (*Monetary Policy 2009-2010*) included three special features.[1]

1 The first Special Feature ("Fiscal adjustment issues") focused on key aspects such as the size of the public sector, the structure of public expenditure and revenue (in comparison with other EU countries), the evolution of wages and salaries in central government over time and the reforms still pending —relating to budgeting procedures, numerical fiscal rules and independent fiscal councils— which the Bank had recommended as early as in April 2007. The second Special Feature ("Data on and policies for the competitiveness of the Greek economy and future sources of growth") discussed issues such as the potential growth rate, price and cost competitiveness and of structural competitiveness indicators, growth-enhancing structural reforms in product and labour markets, the impact of EU transfers, the contribution of tourism and merchant shipping to growth, as well as the potential of green growth. Finally, the third Special Feature reviewed the European and global economic adjustment. It should also be mentioned that from early 2010 the Bank of Greece started to publish monthly press releases regarding the central government net borrowing requirement on a cash basis, in order to provide more complete and timely information to the public.

The April 2010 report (*Annual Report 2009*), apart from a detailed argumentation in favour of Greece's (then) upcoming recourse to the EU/IMF financial support mechanism, included analyses of the dynamics of public debt, national saving and saving by sector, the negative impact of the economic crisis on youth labour market participation, as well as the prospects of the Common Agricultural Policy after 2013. Furthermore, for the second consecutive year, the report included a special chapter on the European policy for climate change, Greece's environmental performance and the (then) recent policy measures.

The first report published after the MoU (*Monetary Policy – Interim Report 2010*, October 2010) contained an extensive chapter focusing on a more effective implementation of the fiscal adjustment programme and of structural reforms,[2] as well as a box that provided an overview of the (then) recent legislative reforms in the labour market.

The May 2010 issue of the Bank's *Economic Bulletin* featured a study on independent fiscal councils and their possible role in Greece.

A significant contribution to policy-relevant economic research was the publication in September 2010 of a volume entitled: *Greece's current account balance: sources of imbalances and policy recommendations*, which included sixteen studies by the Bank's economists.[3]

2 This chapter indicated possible lines of action for further reducing primary public expenditure and upgrading the tax collection mechanism, analysed opportunities for the utilisation of public real estate property, structural reforms in health care and 'green' tax policy, and also provided an overview of privatisations during 1996-2009 and on loss-making public enterprises.

3 In the course of 2010, the Bank held a number of conferences and events on such topics as the medium-term prospects for EU funding, the labour market, the economies of South-Eastern Europe and climate change.

7.2 2011: Serious delays in the programme's implementation make debt restructuring inevitable

In early 2011, in a first assessment of the adjustment programme's implementation, the Bank of Greece considered that what had been accomplished was important, stressing the positive results in the area of fiscal adjustment.

At the same time, however, the Bank pointed out that there were signs of a relaxation of efforts and that "a strong re-launch" was needed at the time, *"to make up for the delays and give fresh impetus to reform policies."*[4] Progress had been significant,

4 Speech by the Governor George A. Provopoulos at the Annual Meeting of Shareholders of the Bank of Greece, 18.4.2011.

but it was still too slow considering the debt dynamics, and a strategy was needed to reduce the debt-to-GDP ratio over a reasonable period of time. Such a policy should aim simultaneously at: (a) reducing the level of debt, by creating fiscal conditions that would steadily generate primary surpluses over a number of years; and (b) increasing GDP, by ensuring initially economic recovery and subsequently fast-paced growth.

As described in the previous chapter, that period (end-2010 to early 2011) saw a surge in speculation on Greek debt restructuring. The Bank's view, shared by the ECB and the IMF,[5] was that restructuring was neither necessary nor desirable. It was not necessary because debt targets were feasible, if the adjustment programme was consistently implemented. It was not desirable because it would have serious negative impacts on the assets of social security funds, banks and private individuals who had invested in Greek government securities (for more details on the ECB's position regarding private sector involvement and its proposals for a debt write-down, see section 4.2 above).

For these reasons, the Bank of Greece insisted that the adjustment programme should be implemented rigorously and without delays. It also expressed concerns about the fiscal relaxation that had already been visible. These concerns mainly focused on the following:

First, in spite of the progress made, substantial improvement had yet to be made in the areas where deficits are initially generated, i.e. public administration, numerous government agencies and local government. Progress had also been insufficient as regards improving the effectiveness of the tax collection mechanism, which would help broaden the tax base and increase tax revenues, without an additional tax burden on those who already paid taxes.

Second, delays in the implementation of structural reforms, despite important steps taken towards reform of the social insurance and healthcare systems, closed professions, and the labour market. In many cases, as the Bank of Greece pointed out, *"the reforms do not go deep enough and their implementation is often delayed, either because of administrative inefficiencies or because of a reluctance to push ahead, in the face of opposition."*

Third, the recession which had already obviously developed faster than initially predicted, precisely because of delays in the reforms that had been mentioned.

The fourth and particularly decisive factor, which had been underscored by the Bank of Greece since the start of the programme's implementation and brought up

5 See Cottarelli, Forni, Gottschalk and Mauro, "Default in Today's Advanced Economies: Unnecessary, Undesirable and Unlikely", IMF Staff Position Paper SPN/10/12, 1.9.2010.

again emphatically in early 2011, was the stance of society and the political management of the crisis. The Bank of Greece's reasoning on this critical issue, which would turn out to be pivotal in the near future, can be summed up as follows: there was no social ownership of the restructuring effort. On the contrary, the MoU was quite often considered to be the cause of the symptoms of the crisis, rather than an inevitable intervention to tackle it. As a result, cases of behaviour consisting in sterile opposition and denial were frequent and were accompanied by a single key demand, i.e. that nothing should change. More generally, a large section of public opinion treated with reservation each and every measure that called into question certainties long considered unchallengeable. Public debate focused almost exclusively on the cost and impact of such measures, without their necessity or their expected positive effects in the medium term being explained. At the same time, illusions were cultivated as to what was feasible and an impression was given that a way out of the unpleasant reality was possible through a return to the past. The systematic preservation of these illusions has kept social forces from actively joining together in support of the effort.

The public's stance largely reflects long-standing practices and mentalities, which had previously cancelled every single reform effort. These mentalities have two core elements:

First, the public's myopic attitude towards change, a bias for the present versus the future, which had led to a steady rise in consumption and, correspondingly, a steady decline in savings, a continuous burdening of the insurance system and an explosion of public debt. This myopic choice had as its corollary the logic of easy personal enrichment, the spreading of corruption across all levels of public life, a multiplication of illegal activities, the prime example of which is tax evasion, as well as a perception of the European Union as a mere source of money.[6]

Second, a Greek-centred approach to problems, i.e. the society's steady failure to correctly assess the objective circumstances shaped by international reality and the environment to which it had to adjust.

Such mentalities existed before the crisis and could not be eradicated automatically. But they could have started to change, if the extent and gravity of the crisis had been understood, i.e. if public opinion had been informed in an honest, detailed manner and without political expediencies about the real state of the economy, the need for such a policy and, most of all, the ultimate objectives pursued. On this issue, there was a serious deficit on the part of the political system: on the one hand,

6 Speeches by the Bank of Greece Governor at the Annual Meetings of Shareholders of the Bank of Greece on 27.4.2010 and 18.4.2011.

in the conduct of economic policy, there was a lack of determination, serious ambivalence and hesitation, as well as open disputes within the government, which gave the impression that there was no compact political will to implement the programme. The measures taken were often presented by the government itself as imposed by the lenders and not as necessary steps for the restructuring of the economy. On the other hand, the opposition rejected, with an increasing emphasis, the programme as a whole, using as their main argument the truly important negative effects on incomes and standards of living in the short and medium term, rather than looking at the effectiveness of the measures as regards the final objective.

In conclusion, the adjustment programme was not owned by society and by the political system.

Based on these assessments and predictions of upcoming risks, the Bank of Greece stressed since April 2011 that the key prerequisites for the reform policy to acquire momentum were the following:

- The government must actively demonstrate its firm commitment to moving forward, without ambivalence or hesitation, on the difficult path that it has mapped out.
- The public must be regularly informed about where the economy stands, which policy goals are being pursued, what difficulties and risks are present, how much ground still needs to be covered, what the ultimate goal is and what the consequences of failure would be.
- The positive aspect of the reforms, which are not only necessary, but also morally right, must be clearly highlighted as they abolish privileges and aim for equal and better opportunities for all.
- A minimum of consensus must be reached among the political and social forces so as to ensure the continuation of the adjustment effort, given that its duration will extend well beyond any one government's term.

These positions were particularly emphasised in a statement of the Governor of the Bank of Greece published on the front page of the *Financial Times* on Wednesday, 29 June 2011, the day of a crucial vote at the Hellenic Parliament on the approval or rejection of the Medium-Term Fiscal Strategy Framework 2012-2015:

> *"We have never really had a debate in this country about what went wrong. In Portugal the new government has come in and said that there will be a difficult two years ahead. We have not had that kind of talk here. (…) For parliament to vote against this package [the bill on the MTFS] would be a crime – the country would be voting for its suicide."*

More specifically, the call for a consensus between political forces was a permanent motto in many public interventions of the Bank of Greece. This call was re-

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'Enjoy your slump'
Austerity alone risks disaster. Martin Wolf, Page 11

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Henny Sender, Page 30

News Briefing

Rank investors turn fire on takeover rules
Rank Group investors claim they have been let down by the takeover rules after conceding that the gaming company, whose two top executives have resigned, is very likely to be taken private by Guoco, its majority shareholder. **Page 15**

Cameron in strike plea
Prime minister David Cameron made a last-ditch plea for unions to cancel Thursday's one-day strike, describing the action as "wrong" given the urgent need for reform of public sector pensions. **Page 2**

Back-tax blow for 1m
More than 1m people will soon learn they owe the government an average of £900-£800 each because insufficient tax was collected last year by the pay-as-you-earn system. **Page 3**

Axa injury claims move
The French insurer Axa said it would no longer accept referral fees in personal injury claims and called on the government to reform the growing "compensation culture". **Page 4**

Telecoms group turmoil
Shareholders vented their fury after the third profit warning in less than a year at Cable & Wireless WorldWide prompted the telecoms company's chief executive Jim Marsh to resign. **Page 15; Strategy and pay, Page 17; www.ft.com/plutharo**

East European resilience
Central and east Europeans report little overall decline in life satisfaction and remain more optimistic than west Europeans, despite being much harder hit by the global crisis, a survey has found. **Page 5**

Post-Gaddafi warning
The Libyan opposition and its international allies must not repeat mistakes made by the US in the Iraq war once Colonel Muammer Gaddafi has fallen from power, British government officials said. **Page 6; Letters, Page 10; www.ft.com/libya**

Afghan banker accused
Afghan prosecutors say they will charge the former head of the central bank with involvement in the country's biggest financial scandal, a day after he said he had quit his post in fear of his life. **Page 7**

Aubry stakes claim
Martine Aubry, the leader of France's opposition Socialist party, has declared her ambition to challenge Nicolas Sarkozy in next year's presidential election. **Page 8**

California budget cuts
California is preparing for cuts in public spending – including reduced support for the state's universities – to close a $9.6bn (£6bn) budget deficit in the second half of the year. **Page 7**

Egypt disbands councils
An Egyptian court has ordered the dissolution of 1,750 local councils elected under former president Hosni Mubarak, who was toppled by a popular uprising in February. **Page 6**

Spread bet turns sour
Many traders and hedge funds are nursing deep losses after a whiplash-like reversal in one of the biggest commodity trading trends of the year – a bet on a widening spread between types of crude oil. **Page 15; Lex, Page 34; www.ft.com/lexvideo**

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● Central bank warns on austerity package ● EU economic chief turns up heat

Greece faces 'suicide' vote

Times, Mr Provopoulos expressed concern that Greece's economic crisis had been downplayed by politicians over the past 18 months as the country lurched towards a possible default.

"We have never really had a debate in this country about what went wrong. In Portugal the new government has come in and said that there will be a difficult two years ahead. We have not had that kind of talk here," he said.

He added: "For parliament to vote against this package would be a crime – the country would be voting for its suicide."

Turning up the heat, the EU's top

Regulators press UK banks to build up capital

By Brooke Masters, Chief Regulation Correspondent

UK banks are facing increased pressure from regulators to use strong earnings to build up capital ahead of official requirements rather than paying out most of it to staff and investors.

The Financial Services Authority is requiring banks to outline a "flight path" that will put them in compliance with new global Basel III capital requirements, taking into account dividends, bonuses and the potential for another economic downturn.

The Financial Policy Committee, a new arm of the Bank of England, used its first press conference to highlight the need for "opportunistic capital building" last week. Paul Tucker, deputy Bank governor, is expected to hammer home the message today in a speech to the British Bankers' Association.

Sir Mervyn King, Bank governor, had urged banks to build capital buffers above the regulatory minimum. "There will be times when times aren't so good. And you will then want to be able to run down that buffer in order to maintain lending."

Although the FPC "advised" UK banks to build up capital, supervisors are being blunter in private. The FSA can veto bank bonus plans if it believes that the pay-outs are hindering efforts to build up capital.

The public message about retaining earnings to amass capital is intended to give management cover in the face of investor pressure to return cash.

Industry groups warned against piling conflicting demands on banks. "As at least some banks become more utility-like, there will be an investor expectation of a steady flow of dividends which cuts across the FPC's exhortation that banks should build capital," said Simon Hills of the BBA.

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ALWAYS LEARNING PEARSON

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peated in the most unequivocal manner in November 2011, at the peak of political instability, after the resignation of the Papandreou government.

> *"To safeguard financial stability in this very challenging environment, it is essential that a strong coalition government pursues the necessary policies that will ensure Greece's future within the euro area."*[7]

In light of the above, the Bank of Greece argued from the outset that the political management of the programme and the stance of society towards reforms were the most important factors that would ultimately determine success or failure. This view has indirectly or even explicitly permeated most of the Bank of Greece's public interventions from 2008 to this day.

As described in detail in a previous chapter, the decision of the 26 October 2011 euro area summit lightened the burden of government debt and its debt servicing costs, and provided for an increased involvement of the private sector compared with the previous decision of 21 July. The Bank of Greece pointed out that this involvement proved inevitable, following a significant deterioration in crucial areas of the economy, and pointed out the following delays:

- a slowing down of fiscal adjustment, following an encouraging start in 2010;
- no progress on the implementation of privatisations;
- a widening of the confidence deficit, given that there had been no tangible proof of a strong political will to implement reforms in the public sector and the operation of markets;
- a sharper and longer than expected recession, as a result of fiscal adjustment and, to a great extent, of the confidence deficit, as well as an imperfect implementation of the programme.

According to the Bank of Greece, the decision of 26 October represented a milestone on the adjustment path of the Greek economy since 2010, as the debt level was reduced and its dynamics could be put under control, under certain conditions. The Bank went on to stress:

> *"It should be recalled, however, that also in the past (after the Memorandum was entered into, in May 2010) there has been a series of favourable arrangements for the debt, which did not produce the expected results, as the response from the Greek side has not been appropriate. Hesitation in undertaking the necessary actions did not allow to put the facilities provided by these favourable arrangements into good use, thus multiplying the economic and social cost of efforts made and drained confidence in the future of the economy.*

7 *Financial Times*, 9.11.2011.

The new opportunity provided to Greece under the agreement of 26 October may well be the last. The country must avoid all further delays or deviations from the targets agreed upon at all costs; every possible effort needs to focus on overshooting the targets. The present juncture is the most critical period in Greece's post-war history. What is at stake is whether the country is to remain within the euro area in the future."[8]

Following the summit decision and the new measures that had to be included in the MTFS, many —political parties and media alike— held the view that the MoU had failed. The question as to whether this was true or whether the MoU had been implemented poorly and in a piecemeal manner was answered unequivocally by the Governor of the Bank of Greece:

"First of all, the Memorandum averted a Greek default, which in April 2010 seemed inevitable. On the other hand, key requirements were not fulfilled, which seriously weakened the overall result. How can one therefore say that something has failed when it has been implemented only partly? Without wishing to ignore or underestimate the positive steps made, let me recall that the state has not been sufficiently downsized, privatisation has not even started, useless and costly public organisations remain in operation, legislative initiatives have not been implemented and remain inoperative [...]. Delays and omissions hit again the credibility of the country, resulting in a surge in uncertainty and distrust from markets and our creditors. We are now running out of time. So we need to react quickly and dynamically. The adoption of the fiscal adjustment framework is an initial step, but it is not enough. As I stressed in early April, a strong re-launch of the reform effort is needed, in order to make up for the delays as soon as possible and provide new reform impetus. Now we have to convince with actions, not just with words, that Greece does not want to self-destruct. We should move on from reform rhetoric to reform action."[9]

After the Papademos government was formed, the Bank of Greece returned to the crucial issues of consensus and of informing the public, pointing out the following:

"In order to consolidate confidence in the prospects of the economy, the convergence of political forces reflected in the formation of the new government must become more substantive and last beyond the planned election.

8 *Monetary Policy – Interim Report 2011*, November 2011, pp. 17-18.

9 Interview with the Athens daily *Kathimerini*, 26.6.2011. See also Bank of Greece, *Monetary Policy – Interim Report 2011*, November 2011, pp. 19-20.

The upcoming period should be a time of reflection, realistic assessment of the potential of the economy and search for the optimal long-term choices. It would be useful if political debate was carried out in the terms of the future instead of the terms of the past, as this is what led us to the current distressing situation. There is one condition for the government to succeed and for the will of the citizens to be expressed authentically in the next election: the true state of the economy and the international context must be described with utmost candour, possible solutions must be clearly analysed, while the costs and benefits of each option must be explained cogently."[10]

The main issue of economic policy that the Bank of Greece underscored in late 2011 was a need to elaborate the country's medium-term strategy and restore trust in the Greek economy's prospects. This is why it brought back its older proposal for a detailed, binding Action Plan for Growth.

10 *Monetary Policy – Interim Report 2011*, November 2011, p. 21.

Box 7.2

2011: Bank of Greece analyses and studies on economic policy issues

The Bank of Greece's most important intervention was made in a special chapter of its November 2011 report (*Monetary Policy – Interim Report 2011*) concerning the means and conditions for reversing the economic climate and supporting investment and exports.[1] A crucial contribution to the public debate was made by means of a box entitled: "Fiscal consolidation: an inhibitory factor for growth?", contained in the first chapter of the report. Furthermore, the *Annual Report 2010* (April 2011) analysed the objectives and implementation of reforms in labour legislation and introduced a special section on income inequality and poverty, thereafter featuring permanently in the report. The report once again included a special chapter on developments as regards energy policy in the EU and Greece, and also reviewed climate change and environmental issues.

The June 2011 issue of the Bank's *Economic Bulletin* featured studies on, *inter alia*, tax evasion in Greece and numerical fiscal rules in practice. Of course, the most important publication was a study of the Climate Change Impacts Study Committee (EMEKA or CCISC) entitled: *The Environmental, Economic and Social Impacts of Climate Change in*

1 This chapter included policy recommendations for measures on shipping and tourism, as well as an analysis of the "new landscape" as regards the inflow of EU funds to Greece.

Greece, which was published on 1 June 2011 (its English translation was published online in March 2013).[2]

2 Other publications were a study by Professor M. Psalidopoulos entitled *Monetary Management and Crisis: the Policy of the Bank of Greece 1929-1941* (July 2011) and a volume entitled *From Crisis to Recovery – Sustainable Growth in South East Europe* (a joint project of SEESOX and the Bank of Greece, February 2011). The Bank continued to organise research and policy conferences in 2011; the main ones concerned social policy and social cohesion in times of crisis, the real estate property market and the economies of South-Eastern Europe.

7.3 2012: The historical stake – whether the country will remain within the euro area

The main events in 2012 were the approval of a new loan agreement in February, the two parliamentary elections held in May and June and the formation of a new coalition government, a strong test on the banking system as a result of the outflow of deposits and heightened uncertainty, as well as the lifting of a deadlock in negotiations with the EU, ECB and the IMF which resulted by end-2012 in the disbursement of an instalment of more than €49 billion.

The Bank of Greece expressed its views on these events with clear reports, publications and proposals.

The causes of the derailment of the initial adjustment programme

In January 2012, amidst negotiations on the new Economic Adjustment Programme, the Governor of the Bank of Greece expressed his view publicly, in an article published in the *Financial Times*,[11] on why the initial programme went off track. In more detail, he pointed out:

(i) the "slow and inefficient" implementation of many of the measures included in the programme;

(ii) the fact that fiscal consolidation in 2011 consisted in "a mix of 60 per cent revenue (largely tax) increases and 40 per cent spending cuts", despite previous experience showing that spending cuts lead to a *smaller economic contraction* than tax increases;

(iii) the "large magnitude of the fiscal consolidation", which —coupled with "difficulties in implementing structural reforms, privatisation and measures to improve

11 George Provopoulos, "Timely Greek lessons on the eurozone crisis", *Financial Times*, 24.1.2012.

the efficiency of tax collection"— "led to a greater economic contraction than initially projected;" and

(iv) the role of *fiscal multipliers* – more specifically, "per percentage point of consolidation, the [Greek] economy has contracted more" [than in other countries], mainly because "Greece is a relatively closed economy". As a result, "any decline in demand hits domestically produced goods more than imports."

The program can succeed, under certain conditions

In the spring of 2012,[12] the Bank of Greece pointed out that the Eurogroup decision of 21 February on a new financial support agreement laid more favourable ground for the continuation of efforts to find a way out of the crisis and provided "tangible proof of our partners' determination to avert a Greek default." The positive elements highlighted at the time were: a reduced loan burden as a result of the debt write-down, large reduction of the fiscal deficit and a projected achievement of a primary surplus by 2013, expected restructuring of the banking sector and a broader realisation that radical reforms are needed in order for the country to remain within the euro area.

These elements led to the Bank's assessment that the goals are feasible if commitments are implemented to the letter and without procrastination and if the gaps resulting from delays over previous years are covered. According to the Bank, the key prerequisites[13] for the programme's success were:

Continuity, which had to be ensured at all costs. The programme had to be implemented rigorously without deviation throughout its duration. An element which could support the required continuity was broad consensus across the majority of the political spectrum on the objectives of the programme.

Administrative efficiency of the mechanisms called upon to carry out the programme, i.e. the state and the public administration. The implementation of the adjustment programme would fail if the distortions and rigidities caused by statist approaches and clientelism were not overcome.

Restoring confidence. There was only one way to restore the shattered confidence in the Greek economy: to implement the commitments of the loan agreement to the letter, without compromising their content, whilst strictly observing the deadlines.

The Bank of Greece's position on the new support agreement can be briefly summed up[14] in the following:

---

12 *Monetary Policy 2011-2012*, Chapter 1, March 2012.

13 *Ibid*.

14 *Ibid*.

"In the light of the Agreement of 21 February 2012, the new framework in which the Greek economy will operate in the years ahead could suffice to turn the climate and expectations around and, thereby, speed up the recovery process. However, distrust as to the ability and resolve of governments and society at large to carry the necessary reforms decisively forward remains widespread. This distrust is justified. Reform initiatives in the past had more than once come up against the illusion that a system which produced prosperity by running up deficits and debt could be maintained forever. There is no room for such illusions anymore. The truly harsh and painful losses that Greek citizens have had to endure cannot be recouped by returning to the ways of the past. Under the present circumstances, such a return would result in social cohesion disintegrating and incomes plummeting. In order to improve expectations and confidence in the future of the Greek economy, what is needed is adjustment to the new situation, implementation to the letter of all that has been agreed and a correction of past imbalances, so as to lay the foundations for the way forward. Euro-area membership and the support of our partners provide Greece with the opportunity to move forward on this path in an orderly fashion, contain the losses and shorten the difficult period of deep recession. It is up to the country, however, to assume the historic responsibility of elaborating and, more importantly, implementing a new strategy which will convincingly show that the Greek economy can be reconstructed in a way that will bring it back onto a sustainable growth path."

Political developments are decisive for the economy's future

The main position of the Bank of Greece, which runs through its public interventions for more than a decade, is a need for political forces to converge on a consensual approach to the economy's major problems. This position was repeated with much greater emphasis throughout the crisis, which necessitated the "broadest possible consensus", according to the Bank of Greece. Based on this long-standing reasoning, the Bank of Greece considered that the formation of the Papademos government "opened up a window of opportunity", which brought to a halt the ruinous course towards which the country had started to slide.

Then in April 2012, as elections were announced amidst a highly conflictual environment with a sharp distinction between political forces in favour of or against the MoU, the Bank of Greece considered that what was actually at stake was the country's position within the euro area, pointing out that if, after the elec-

tions, there were any question about the will of the new government and of society to implement the programme, the country would risk being in a particularly difficult position.

The Governor of the Bank of Greece reiterated in his speech at the Annual Meeting of Shareholders in April 2012 that:

> *"What is at stake in Greece is the choice between:*
>
> *an orderly, albeit painstaking, effort to reconstruct the economy within the euro area, with the support of our partners;*
>
> *or*
>
> *a disorderly economic and social regression, taking the country several decades back, and eventually driving it out of the euro area and the European Union."*

At about the same time, the Governor gave two interviews,[15] painting a grim picture of the eventuality of an exit from the euro area, which he considered as a "national disaster" which would "open the gates of hell", pointing out, *inter alia*, that:

> *"A return to the drachma would mean that, during a transitional period, i.e, until the new banknotes circulate in physical form, there will practically be no drachmas other than in book-entry form. In other words, it will be possible to carry out transactions in drachmas only through bank accounts. […] As a result, we will inevitably resort to bartering, i.e. exchange one kilo of oil for three kilos of flour.*
>
> *Given that our country relies to a large extent on imports, for which foreign currency —not drachmas— would be needed, there would be significant shortages. These shortages would include fuel, raw materials and even agricultural products, because the weak competitiveness of the country's economy means that even foodstuffs are to a great extent imported. So there will be serious shortages in several key commodities. Schools, hospitals and public services would face difficulties in their operation. There would be fuel shortages so that the police and army would not be able to use their vehicles.*
>
> *Of course, after a certain lapse of time, things will come back to a somewhat better balance, but during the initial transitional period we will experience a nightmare scenario. This is precisely why I am describing some grim situations, in order for people to understand what could happen. And I am not referring here to possible social explosions, which may be expected in such an environment. Some people —well-intentioned at that— naively believe*

15 *Kathimerini*, 31.12.2011 (pre-published excerpts of an interview to SKAI TV station) and *To Vima*, 18.3.2012.

that a return to the drachma would mean that we will go back to the period around 2000, that is, at the point in time before our entry into the euro area. And they remember that at the time, they were doing rather well, so they believe that a return to the drachma would not be a problem.

But things are not like that. For the reasons I already mentioned, a return to the drachma would bring the country decades back. […] In such 'anomalous' situations, the losers are the majority and the disadvantaged. The winners are the cunning few– which is in fact what also happened in the past in extraordinary situations. Certainly, the country as a whole will suffer losses, heavy ones for that matter. […] Economic and social conditions will become unbearable. Living standards will plunge. The new currency would be substantially devalued, possibly by up to 60-70 percent. There will of course be some rebalancing afterwards, but the economic and social cost of the transitional period will be enormous. But even what I called 'rebalancing' will come after repeated devaluations, a period of hyperinflation and high interest rates and major adjustment difficulties. Progress achieved over many decades will go to waste."

The restructuring of the banking system

The Bank of Greece's specific institutional actions for the restructuring of the banking system are described in more detail in the following chapter. It should be pointed out, however, that along with institutional actions there were public interventions by the Bank of Greece throughout 2012 with regard to the banking system. The aim of these interventions was to safeguard the confidence of the public and to avert reactions which would place the entire banking system in jeopardy.

These interventions highlighted, first of all, the issues at hand, but, at the same time, stressed that the foundations for the creation of a sound, strong and competitive banking system had been laid. As a result, following the completion of the agreement on debt restructuring in March 2012, the Bank of Greece considered that if a sense of trust in the economy's prospects was consolidated, deposits could start to flow in. This along with progress in recapitalisation procedures would significantly improve the climate and strengthen trust in the banking system.

In a newspaper interview,[16] Governor G. Provopoulos summed up the Bank of Greece's assessment for the prospects of the Greek banking system as follows:

16 *To Vima*, 25.11.2012.

"Today, solid foundations have been laid to strengthen and restructure banks. Following the disbursement of the next instalment, we will proceed with the full recapitalisation of 'core' banks. [...] The new banking landscape will comprise robust units with satisfactory capital ratios that will be trusted by depositors and regain access to capital markets. [...]"

And he concluded:

"At the Bank of Greece, we feel satisfied that we designed, together with the Greek government and the Troika, and we implemented an integrated plan which safeguarded financial stability under difficult circumstances. We are now turning the page."

In order for the major significance of these developments to be understood, the Bank of Greece clearly mentioned the serious risks that had threatened financial stability over previous months, when uncertainty had reached its peak and the banking system faced a large outflow of deposits and incurred significant losses in the context of the PSI:

"Under these circumstances, it became apparent that not only the stability of the Greek banking system was at stake, but also that any false moves could trigger a banking crisis, with negative consequences that could extend beyond Greece."[17]

A new beginning is possible

In late 2012, the Bank of Greece assessed positively the developments of the second half of the year, pointing out the reduced uncertainty, the halt in the outflow of deposits and the gradually improving climate.

The facts which corroborated this assessment were:

- the reduction of fiscal deficits;
- the recouping of a significant part of the losses in international cost competitiveness registered in the 2001-2009 period;
- progress on reforms, which had been generally slow, though important in some sectors;
- the markedly reduced uncertainty following the formation of the coalition government which undertook the responsibility to complete fiscal consolidation and push ahead with structural reforms; and
- the unblocking of financing flows.

17 *Monetary Policy – Interim Report 2012*, November 2011, p. 8.

Box 7.3

2012: Bank of Greece analyses and studies on economic policy issues

The Bank of Greece's key intervention was made in a special chapter of its November 2012 report (*Monetary Policy – Interim Report 2012*) entitled: "Structural reforms increase potential output and improve debt sustainability prospects". This chapter also included a special analysis of the fiscal impact and prospects of the social security reform.[1] Another analysis regarding reforms in labour legislation (introduced between June 2010 and February 2012) was included earlier in the *Annual Report 2011* (April 2012). The Report also contained: (a) a section on income inequality and poverty and (b) a chapter regarding international policies for addressing climate change, Greek performance in terms of greenhouse gas emissions and reduction of air pollution, environmental policy and the development of renewable energy sources in Greece.[2]

Of particular significance was the presentation of the main findings of the study "Assessment of the past and future impact on the Greek economy from policies funded by the EU budget", commissioned by the Bank to ELIAMEP, at a public event held on 29 October 2012. Concurrently, the Climate Change Impacts Study Committee (CCISC) launched a new round of work, ultimately aiming at the elaboration of a national strategy of adaptation to climate change.[3]

1 This report also provided analyses of public debt dynamics, the effects of structural reforms, EU policy developments as regards fiscal adjustment and growth (including the Fiscal Compact), as well as of the banking union, while it presented an indicator on financial conditions in Greece and the euro area.

2 The April 2012 issue of the Bank's *Economic Bulletin* featured studies on employment flows during the financial crisis, the bank capital adequacy framework, as well as on EMU sustainability and the prospects of peripheral economies. In December 2012, the Bank of Greece published a book by Professor Margarita Dritsa entitled: *Emmanouil Tsouderos 1882-1956 – Central Banker and Politician*.

3 Also in the course of 2012, events on research and policy held at the Bank of Greece dealt with various topics including the financial crisis, the Greek labour market, and the economies of South-Eastern Europe.

7.4 2013: Priority to growth, focus on financing the economy

Already since February 2013,[18] the Bank of Greece highlighted and explained the new situation that the Greek economy tended to find itself in:

18 Bank of Greece, *Annual Report 2012*, February 2013, Chapter II.

"The turnaround in sentiment, the dissipation of pessimistic expectations and the gradual restoration of confidence have been due to a number of factors, which helped the Greek economy avoid the serious impending risks and get back onto a track of rebalancing and stabilisation. First among these factors was the affirmative answer of the Greek people to the historic dilemma concerning Greece's continued participation in the euro area. [...] The second factor which has contributed to this improvement is the progress made in the implementation of the adjustment programme, particularly in addressing the twin deficits – fiscal and external. This progress is a sign of incipient rebalancing and restructuring in the economy. […] Third was the success in safeguarding financial stability and confidence in the banking system in a period marked by record levels of uncertainty. […] Fourth, the continued financial support from our official lenders, which gives Greece both the chance to restructure its banking system and the time to carry forward the structural transformation of its economy. […] Fifth, the steps being taken towards supplementing the institutional architecture of both the European Union and the euro area. […]

[…] It must be understood that we are now at a turning point. There is no doubt that 2013 will be a difficult year, mainly due to the implementation of fiscal measures and to high unemployment. But today we can expect recessionary forces to weaken gradually by end-2013 and the Greek economy to return to positive growth rates in the course of 2014. This forecast is supported not only by the factors mentioned above, but also by tangible signs that improvement is filtering through to the real economy."

These findings resulted in a new hierarchy of priorities as regards economic policy, with an emphasis on speeding up the recovery and creating the conditions for sustainable growth:

"As has been repeatedly stressed, the economic crisis has brought about not only acute problems, but also significant opportunities. The two most important opportunities, which also constitute challenges for Greece today, are: First, to restructure the economy towards high-productivity and high-value added sectors that would produce internationally tradable goods and services that can prove competitive both in the external and in the domestic market. Second, to modernise public administration and streamline the public sector, while making it more citizen- and business-friendly. The ability to rise to these major challenges hinges on building and strengthening social consensus as regards the implementation of the Economic Adjustment Programme, so as to bring the recovery forward and create the conditions for sustainable growth.

Comparing the current situation with the one prevailing just a few months ago, it is clear that much has changed for the better. Most importantly, the risk of default and exit from the euro area is now remote. Thus the main factor that had fuelled uncertainty in the markets and among Greek citizens is weakening."

Still, three months later, in May 2013,[19] it was deemed necessary to point out once again the risks and uncertainty that lurked and stress the need to address them.

"These encouraging developments, however, leave no room for complacency, as risks and uncertainties still remain which could jeopardise stabilisation and undermine the prospects of economic recovery:

– Despite progress in several areas, the functioning of public administration remains weak. This weakness leads to shortfalls as regards the implementation of measures previously passed by the Greek Parliament and effectively delays reforms that could mitigate the intensity of the recession.

– The protracted and deep recession, combined with the lack of liquidity, could increase the number of —essentially viable— businesses that are forced to shut down.

– Finally, the political and public debate remains confrontational and often prevents the forming of a minimum consensus that would ensure the continuity of adjustment and rapid recovery.

The climate is favourable today for the speedier pursuit of policies aimed at translating the improvement in expectations into real economic activity."

This message was restated even more emphatically in late 2013,[20] along with the conclusion that the improvement in macroeconomic aggregates could not be doubted:

"Whether the above-mentioned favourable prospects for 2014 will actually materialise and how the future course of the economy will play out are still subject to considerable uncertainty. A major factor of uncertainty is the political climate, often marked by polarisation and open confrontation, at a time when what is needed is the exact opposite: the coming together of social and political forces for a national policy for exiting the crisis and returning to growth. There is, therefore, some cause for concern that in 2014, an election year, political confrontation could be aggravated and polarisation could peak, making compromise, a prerequisite for a national policy, even more difficult to achieve. Such an outcome would lead to heightened uncertainty

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19 Bank of Greece, *Monetary Policy 2012-2013*, May 2013, Foreword.

20 Bank of Greece, *Monetary Policy – Interim Report 2013*, December 2013, Chapter I.

and once again undermine the elements currently underpinning the favourable forecasts for 2014. Against this background, it is crucial, at the current phase, that economic policy remains focused on the implementation of structural reforms [with] the long-term benefits. […]"

The Bank of Greece's December 2013 *Report on Monetary Policy* placed particular emphasis on exploring ways to finance economic recovery and growth, taking into account that, in the conditions of the crisis, the capacity of private savings and of bank credit was still limited. Alternative sources of financing were explored:

"The forecast recovery of the economy will need to be driven by business investment focused on export-oriented sectors of activity. However, as long as the household saving rate remains negative, putting pressure on the banking system's deposit base, banks' capacity to finance such investments will, at least in the short term, remain limited. Thus, in order to support recovery, alternative sources of financing investment and economic recovery will need to be found,"

such as:

"First, debt financing from the corporate bond markets. […] Second, equity financing. […] Third, resources available from the EU Structural Funds. […] Fourth, resources available from the European Investment Bank (EIB). Overall, resources from EU Structural Funds, bond markets, the stock exchange and the EIB can cover a significant part of the economy's financing gap. Part of this financing (National Strategic Reference Framework and EIB support) will be channelled through banks and will underpin bank lending, especially to small- and medium-sized enterprises. […] Foreign direct investment (FDI) will serve as an additional source of financing."

The report also explored ways to strengthen the role of banks in financing a rebound in the Greek economy:

"As a next crucial step, the Greek banking system will have to develop a sustainable business model. It is clear that each bank has a different starting point. However, the key elements of the model will need to be the same for all banks and focus on:

(i) the rationalisation of operating costs and, more generally, higher internal capital generation via operating profits;

(ii) shedding non-core business;

(iii) redesigning foreign business;

(iv) active management of troubled assets; and

(v) sound pricing policies for banking services.

Action along the lines described above will enable the banking system to play an enhanced role in establishing and supporting the new growth model

of the economy. This calls for a new pattern of credit supply and risk management, in order to avoid the distortions of the previous decade, when credit was largely used for residential investment and consumption. Instead, new credit should be allocated to dynamic and export-oriented enterprises with strong growth potential (e.g. in the sectors of infrastructure, food, energy, technology, health and tourism). In the same vein, a strengthening of businesses through mergers and acquisitions should be encouraged, where possible with support from the banks involved."

Emphasis on growth did not of course mean that the Bank of Greece thought that the fiscal consolidation and restructuring of the public sector had lost their significance – quite the contrary:

"The fiscal consolidation effort will have to be pursued with the same determination in 2014. This will boost confidence in the prospects of the Greek economy and help stabilise and then gradually reduce the debt-to-GDP ratio. Meanwhile, the economic recovery is expected to help in achieving the primary surpluses and, more generally, to facilitate sustainable fiscal adjustment. Meeting the fiscal targets crucially hinges upon further expanding the tax base. However, this must be achieved by curbing tax evasion rather than by imposing new taxes or by continuously increasing the tax burden on those who already pay taxes. Improving the efficiency of the tax administration and the tax collection mechanism, through the establishment and empowerment of an independent General Secretariat for Revenue, will prove key to curbing tax evasion and fostering a climate of social equity, where everyone contributes to the fiscal consolidation effort according to their tax-paying capacity. Progress in this direction would make it possible to ease the tax burden on those who already pay taxes, as this burden has increased substantially in the last few years. […] Efforts will need to be stepped up in 2014 to restructure and consolidate the public sector. This will require merging or eliminating public enterprises and organisations, stamping out corruption, as well as re-staffing public services with a new qualified workforce in replacement of employees exiting or retiring. A more effective and efficient public administration would help to speed up the implementation of structural reforms."

Another notable intervention of the Bank of Greece during the course of 2013[21] concerned the presence of Greek banks in South-Eastern Europe, in conditions

21 Speech by Bank of Greece Governor George A. Provopoulos at an international symposium on 'Growth Challenges and Economic Integration in South-Eastern Europe' organised by the Bank of Greece and the European Bank for Reconstruction and Development (EBRD), 13.12.2013.

characterised by the crisis and by the ongoing completion of the Greek banking system's restructuring:

> *"Let me now turn to the financial sector. The supply of sufficient financing to enterprises is essential for growth. Efficient financial intermediation is crucial for channelling savings to investment. However, post-crisis vulnerabilities leave limited room for traditional bank intermediation – credit expansion has been very low or negative in most countries.*
>
> *The impairment of the bank lending channel has been a stumbling block for the economic recovery. The over-indebtedness of households and, to some extent, businesses, a legacy of the earlier credit expansion, has led to large and rising non-performing loans. At the same time, deleveraging of European banks has led to a significant deterioration in funding conditions. Banks have responded by tightening credit eligibility standards.*
>
> *European bank deleveraging has not only contributed to a tightening of credit conditions but has also forced local subsidiaries to compete for a limited pool of domestic deposits. As a result, there has been a return to more traditional types of banking – those where banks fund loans mainly through deposits, rather than through extensive reliance on the interbank market.*
>
> *Today, a move toward bank consolidation may be essential to enhance efficiency and encourage financial deepening. Obviously, such a process must take place in an orderly and well-structured way, and is likely to require the involvement of International Financial Institutions, in a manner similar to the monitoring of European bank deleveraging in SEE (Vienna Initiative).*
>
> *Greek banks play an important part in the region's banking system. Based on data for June 2013, they hold on average more than 15% of total banking sector assets in the countries in which they have a presence. They are well-capitalized, mainly self-funded and play a vital role in the region's economy.*
>
> *However, not all Greek banks managed to achieve, on an individual basis, a substantial market share and size, which are critical factors for efficiency and profitability. Thus, there is a clear need for consolidation, which can be seen as a follow-up to the successful experience of recapitalisation and restructuring of the Greek banking system."*

Furthermore, in an interview in late 2013,[22] the Governor of the Bank of Greece especially highlighted three issues.

- First of all, the importance of averting polarisation, in view of crucial negotiations on debt:

22 Interview with the Athens daily *Proto Thema*, 29.12.2013.

"[…] The sociopolitical climate presents elements of polarisation at a difficult and crucial juncture when the opposite is needed: a convergence of social and political forces on a national plan for a way out of the crisis. Given that 2014 is a year of elections [regional elections and elections for the European Parliament], I fear that confrontation may become more intense and polarisation may surge. In this case, uncertainty will increase and the elements that currently underpin a positive outlook for 2014 will be undercut, if not eliminated. […] In the first half of the coming year we will negotiate with our partners the issue of public debt, on the basis of the Eurogroup's decision of 26 November 2012. It goes without saying that the more united the country is in the relevant negotiations, the better the outcome it will achieve."

– Secondly, the safety of bank deposits:

"Given that Greek banks are sufficiently capitalised, any speculation about deposit haircuts is due to lack of information, irresponsibility or malicious intent. As I said, very serious work has been done in the banking system. We carried out the most reliable diagnostic exercise on bank portfolios by using the expertise of an internationally renowned consultant. We used part of the €50 billion to recapitalise and restructure the banking system. We have managed to build a sound and robust banking system. We have come a long way. But even in the most crucial moments, one thing was non-negotiable for us: the full protection of depositors. We have completed 12 bank resolutions without any depositors losing even a single euro. I can thus state in full responsibility: no, there will not be a haircut of deposits in Greece."

– Thirdly, the need to restructure other sectors of the economy too, apart from the banking sector, and provide alternative sources of financing to enterprises:

"[…] I stressed the responsibility that [banks] have in terms of a targeted channelling of credit to healthy enterprises in order to bolster their competitiveness and support a new, export-oriented production model for the economy. […] I think that it is inconceivable in an economy that has experienced a crisis of such an extent that the only sector to have been restructured so far is the banking sector. I should also point out that bank credit, even in good times, did not account for more than 40% of total financing to the private sector. In other words, there also exist other methods of financing. […] If the problem is an insufficiency of corporate funds —something which is quite common these days— it is up to the enterprises themselves to solve it. The shareholders have to invest new capital. At the same time, it is up to the entrepreneurs to take initiatives to modernise their businesses through organisational restructuring, beneficial partnerships, controlling costs and adopting

an export orientation. A positive development, in my view, is that lately, big enterprises were able to raise sizeable funds from foreign corporate bond markets. Greek businesses will have broader access to international markets as confidence in the Greek economy's outlook improves. Besides, institutional reforms are also needed to enable the creation of a domestic market for corporate financing to small- and medium-sized enterprises and to speed up privatisations that will attract foreign investment. Concurrently, programmes already under way regarding co-financing and credit guarantees with the use of resources from EU Structural Funds and the EIB must be utilised at a more intensive pace."

The role of banks in the financing of the economy was analysed in more detail in a speech given by the Governor of the Bank of Greece at the beginning of 2014.[23] The starting point was the finding that, despite the recapitalisation and restructuring of the banking system and the creation of necessary conditions to bolster the supply of credit to the economy in the medium term, new lending remained limited, mainly as a result of the following factors:

"First of all, deposit inflows are still low.

Secondly, the loan-to-deposit ratio has to be maintained at a conservative level. This ratio had been disrupted by the shrinking of deposits.

Thirdly, compared to other countries, Eurosystem liquidity support to domestic banks remains high and should be gradually limited to more "reasonable" levels.

Fourthly, the boost to confidence as a result of recapitalisation is mitigated by concerns related to the accumulation of non-performing loans. This development is, first of all, tangible proof that credit risk is quite heightened, thus discouraging the supply of new credit, secondly, deprives banks from funds that could be recycled into new loans and, thirdly, gives rise to an eventuality of future write-downs on bank capital and maintains the need to tie up funds for provisions."

For this reason, short-run scarcity of bank credit can be offset by raising funds from other sources:

"Once the recovery begins, enterprises, initially, utilise the excess output capacity which resulted from the recession. Also, the restart of economic growth after a period of recession is primarily based on internal financing. It

23 "Financing and economic growth: the role of banks", speech by the Governor of the Bank of Greece at a conference of the Hellenic Federation of Enterprises (SEV) entitled: "Corporate financing: which solutions - which outlook?", 15.1.2014.

has indeed been observed that upon the first signs of a recovery, healthy enterprises start to finance the expansion of their operations on their own, by distributing smaller dividends to their shareholders in exchange for expected future capital gains.

Particularly with regard to exporters with long-term and steady trade partnerships, an alternative source of financing is additional trade credit from the foreign companies they have transactions with.

The capital markets are also a significant source of alternative financing. Already in 2013, large Greek enterprises raised significant funds through the issuance of corporate bonds. Such sources of financing will become more important as domestic and foreign expectations improve and confidence in the prospects of our economy gradually takes hold.

Finally, another way out is the use of programmes for loan co-financing and credit guarantees with the use of resources from EU Structural Funds and the European Investment Bank (EIB). It is estimated that, overall, resources from EU Structural Funds, bond markets, the stock exchange and the EIB can cover a significant part of the economy's financing gap."

In the same speech, it was stressed —even more emphatically than in the interview on 29 December 2013— that banks need to avoid their pre-crisis credit practices and contribute to the restructuring of the economy's productive fabric:

"The banking system can become a significant lever for the transition to a new growth model of the economy. Of course, the conditions of ample, and sometimes lax, bank financing cannot and should not be repeated. But the banking system may now take substantial initiatives to restructure enterprises and sectors. […]

The new banking system is now based on more solid foundations. No other sector has experienced a restructuring of such (or even a smaller) magnitude, despite the fact that the unprecedented economic crisis conditions rendered it necessary. The experience of banks may prove invaluable also to enterprises in other sectors and industries of the Greek economy.

Thus, banks are called upon today to contribute substantially to an effort to reshape the productive fabric. Steps need to be taken immediately and follow a specific orientation. Banks' policies should e.g. be founded on a new framework for credit supply and risk management. In this context, the tendencies observed in the decade before the crisis, i.e. when credit was largely used for residential investment and consumption, should be avoided.

New credit should be allocated to dynamic and export-oriented enterprises with strong growth potential. It goes without saying, of course, that in

the context of such an orientation of the banking system it would be pointless and dangerous to let weak, undercapitalised and over-indebted enterprises continue their operation.

In the event of serious undercapitalisation problems, action must be taken, first of all, by shareholders to increase their equity. All enterprises must also take restructuring and reorganisation initiatives, seek partnerships or mergers and use networks and synergies that facilitate cost controlling and export orientation.

In short, I believe that today we need qualitative and targeted action on the part of banks, through specific initiatives aimed at:

- *strengthening genuinely viable enterprises, both old and new;*
- *encouraging business initiatives towards bold restructuring of sectors.*

Such a policy may effectively promote a transition to the new growth model, that is, a restructuring of productive sectors through a restructuring of business units."

Box 7.4

2013: Bank of Greece analyses and studies on economic policy issues

The analyses published in 2013 mainly concerned factors that could bolster the expected recovery, as well as the interplay of economic activity and financing. In more detail, in February 2013 an analysis of the Greek economy's export orientation and competitiveness was provided in a chapter's annex of the *Annual Report for 2012*.[1] A report published in May 2013 (*Monetary Policy 2012-2013*) featured analyses of key issues such as the crisis in Cyprus, the impact of confidence in the Greek economy on private-sector deposits, the interplay of bank financing and economic activity before and during the crisis, EIB actions and the use of EU funds to enhance liquidity, the relationship between indirect taxes and economic activity, the prospects for taking advantage of private insurance (development of the second and third pillars of the pensions system), the contribution of structural reforms (in areas such as road freight transport and retail trade) to boosting productivity and bolstering investment, etc. The most important analysis

1 This report included analyses of the current and medium-term outlook of the absorption and effective use of EU funds and recent institutional changes in the Greek labour market, as well as standard sections on: (a) income inequality and poverty and (b) the environment, energy and climate change.

was published in December 2013 (*Monetary Policy – Interim Report 2013*) and reviewed sources of financing and private sector investment in the economy over the 2000-2013 period. The same report also featured other topical analyses concerning, *inter alia*, creditless recoveries (lessons from international experience) and how to increase the flow of financing to small and medium-sized enterprises.

The January[2] and November 2013 issues of the Bank's *Economic Bulletin* featured, *inter alia*, studies on the size and structure of uninsured employment, the adjustment of retail gasoline prices to crude oil price changes, the impact of indirect tax rises on inflation over the 2010-2012 period, as well as structural reform in road freight transport.[3]

2 The date of publication indicated on this issue is December 2012.

3 In the course of 2013, the Bank also organised research and policy conferences regarding, *inter alia*, the crisis in the euro area, the relationship between climate change and tourism and the redistributive effects of the crisis.

8 ACTIONS AIMED AT SAFEGUARDING FINANCIAL STABILITY: 2010–2013

Since the onset of the crisis in 2009, the institutional responsibility of the Bank of Greece, in accordance with its Statute, for safeguarding financial stability has taken on new, much bigger dimensions. In response to the new, adverse conditions, the Bank stepped up its decision-making and regulatory interventions and greatly broadened the scope of its activities. Its primary objectives were to:

- strengthen the supervision of credit institutions and impose new stricter rules,
- ensure liquidity for the banking system,
- meet increased demand for banknotes in full and without delays,
- develop an institutional framework for the resolution of credit institutions,
- assess banks' viability and determine their capital needs,
- secure the necessary funds for the recapitalisation of the banking sector through the Support Programme, and
- overhaul the banking system.

8.1 Enhanced and broader supervisory tasks for the Bank of Greece

As a result of the intensity, duration and complexity of the crisis, the Bank of Greece has intensified supervision, by expanding the *scope of data* requested from credit institutions and increasing their *reporting frequency*, as well as by carrying out more frequent and more targeted on-site inspections.

In particular, collection of data concerning the liquidity of credit institutions commenced on a daily basis, while of data concerning portfolio quality and capital adequacy on a monthly basis. Furthermore, credit institutions were asked to submit a wide range of new data and supervisory reports, as well as to cooperate in the diagnostic assessments of their loan portfolios and in the recapitalisation exercise. At

the same time, credit institutions drew up medium-term funding plans, business plans, recapitalisation plans, etc.

Moreover, in the context of enhanced system-wide financial supervision, since December 2010 the Bank of Greece has assumed the supervision of private insurance, through the Department of Private Insurance Supervision. This Department has been entrusted with the supervision and monitoring of: (a) Greek-based insurance and reinsurance firms and their branches abroad, (b) insurance and reinsurance firms based in other countries (in the EU or the EEA) and active in Greece under the right of establishment or under the freedom to provide services, (c) insurance firms based in third countries (outside the EU and the EEA) and active in Greece, and (d) insurance intermediaries.

The Bank of Greece has also intensified the supervision of insurance undertakings, by conducting more frequent and more thorough on-site inspections, by establishing reporting requirements for the regular submission of supervisory and financial data and by urging firms to take the appropriate measures towards improving their efficiency. In order to preserve stability in the insurance market, the Bank of Greece had to withdraw the authorisation of several insurance firms. In parallel, the Bank, taking into account the adverse macroeconomic environment, took measures for the smooth absorption of the effects of PSI+ on insurance firms and extended the deadlines for the full recapitalisation of some of them. The Bank has been working closely with the competent Ministries and the Hellenic Association of Insurance Companies and has been constantly updating the institutional framework for private insurance, thereby contributing to the restoration of soundness of the sector as well as of consumer confidence. In view of the preparations for the adoption of the Solvency II Directive, the Bank of Greece has actively participated in the design and implementation of EU-wide Quantitative Impact Studies, as well as in the necessary prior actions for the implementation of the Directive in the Greek market.

8.2 Participation of Greek banks in the EU-wide stress testing exercises of the European Banking Authority

In 2010 and 2011, the Bank of Greece played a decisive role in both EU-wide stress testing exercises that were conducted by the European Banking Authority (EBA). These exercises were aimed at assessing the impact on banks' capital adequacy under adverse scenarios reflecting unfavourable assumptions for credit, market and sovereign risks and, in the case of the 2011 stress test, for the cost of

financing. Taking into account the fiscal crisis, which worsened the operating conditions of the Greek banking system, and with a view to enhancing transparency, the Bank of Greece decided to include in the exercises six Greek banks, which accounted for 85% of the domestic system's assets, against the 50% threshold that had been determined by EBA. The aim of the Greek participation was to improve transparency and strengthen the confidence of international markets and depositors in Greek banks. Furthermore, in order to ensure a level playing field between Greek and European banks, as well as to better understand the internal parameters of the exercise, the Bank was actively involved in all phases of the stress tests.

At the same time, the Bank was responsible for monitoring the correct application of the methodology and for the validation of Greek banks' results. In this context, it developed the appropriate tools to test the reliability of banks' results (such as checks on the proper application of the methodology, cross-checks with other data submitted to the Bank, as well as logical checks). Under this procedure, the Bank asked the participating banks to make corrections to their results before sending them to the EBA, a fact that increased the EBA's trust in the proper execution of the exercise by the Greek part.

8.3 Cash management and provision of liquidity to the banking system amidst uncertainty

Negative developments in macroeconomic aggregates, the prevailing uncertainty concerning the domestic banking system and the risk of a Greek exit from the euro area triggered an increased demand for euro banknotes that the Bank of Greece was called upon to meet.

Ensuring that the public's demand for cash is fully met —which constitutes a central bank's primary obligation— is of vital importance in times of crisis, mainly for two reasons:

1. In times of uncertainty, the public shows a preference for cash as a means of hoarding, or for precautionary purposes. Thus, if demand is fully met, the currency's credibility increases and the public's sense of insecurity declines.

2. Conversely, if the supply of cash by banks is disrupted or hindered, the public's trust in the banking system may be severely hurt, a development that must be promptly dealt with by the central bank.

Contrary to developments in most euro area countries, the global financial crisis, which was triggered by the collapse of Lehman Brothers, had not been markedly reflected in the Greek data concerning demand for banknotes in 2008 and 2009.

The public had reacted only with a short-lived increase in demand for banknotes of high denominations.

8.3.1 Increased demand for cash

Sizeable increases in cash demand were first observed in Greece in February 2010, as the Greek debt crisis unfolded. From that point onwards, a reversal in the long-term trend prevailing until then and in the seasonality of demand, as well as strong movements in euro banknote flows were recorded; these developments implied greater responsibilities for the Bank of Greece.

Notably, from the announcement of the first "package of measures" for the public sector (9 February 2010) until the general elections of 17 June 2012, the value of euro banknotes in circulation more than doubled and came to €47.7 billion, compared with €20.0 billion (+138%), exceeding by far the average increase of previous years (around 7.5% on an annual basis[1]), as well as the respective average of the Eurosystem (see Tables 19-20 and Charts 5-6 below).

As shown in Chart 6, in the period January 2006-December 2009, the average growth rate of euro banknotes in circulation in value terms was somewhat lower in Greece than the respective euro area rate (8.7% against 9.3%). After December 2009, the value of euro banknotes in circulation in Greece grew at an average rate of over 20%.

8.3.2 Surges in the demand for banknotes

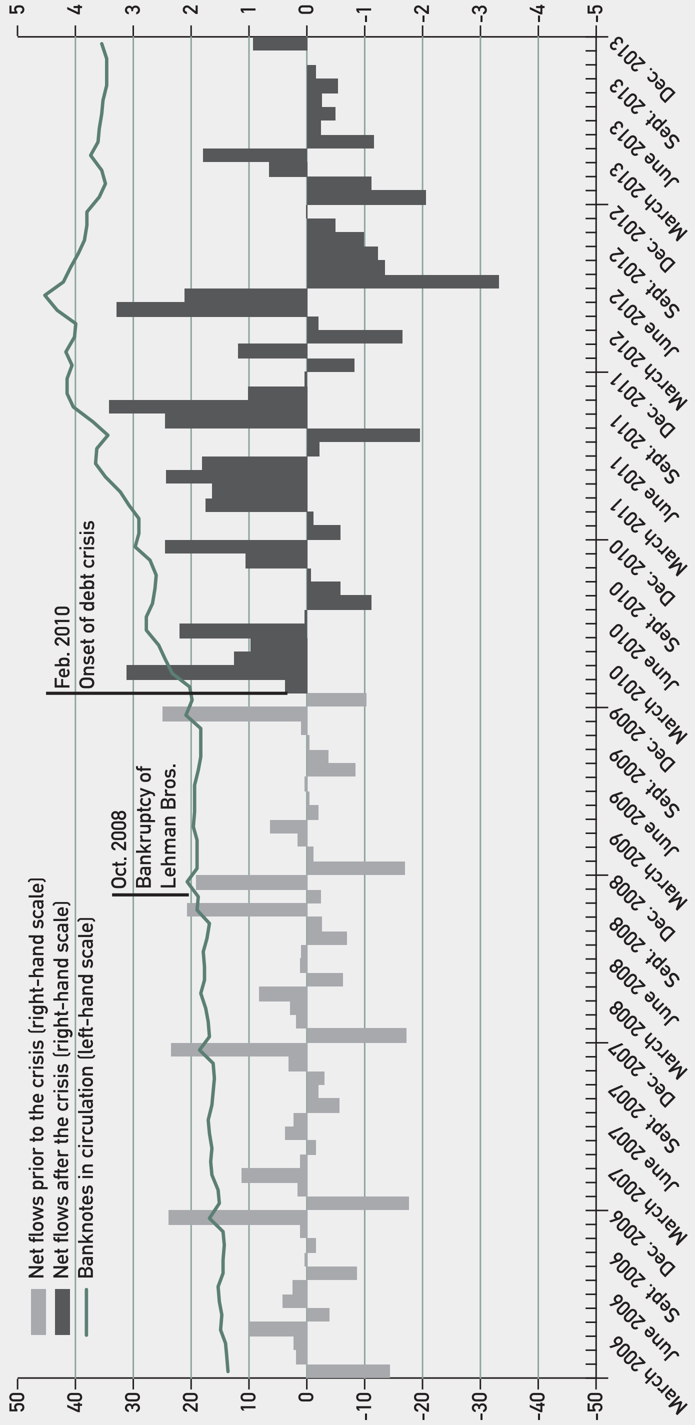
Furthermore, the growth rate of demand was not smooth. Over the period February 2010-June 2012, the Bank of Greece had to deal with successive incidents of sizeable cash outflows, which were attributable to unfavourable media reports and heightened uncertainty among the public (see Chart 9 in Section 8.3.3 below).

According to the breakdown of demand on a weekly basis, 11 weeks with cash outflows of over €1 billion were recorded – with the highest outflows being observed during the week before the election rerun of June 2012 (outflows of €3 billion), the week of 22-26 March 2010 amid growing rumours of a Greek default on 25 March (outflows of €2 billion) and the week when it was announced that Greece would seek support and sign the Memorandum, in April 2010 (outflows of €1.5 billion).

1 Increase 2007: 10.42%; 2008: 11.29%; 2009: 0.94%.

Chart 5 Euro banknotes put into circulation by the BoG: net flows and stocks

Jan 2006-Dec. 2013; billion euro



Source: Bank of Greece.

Table 19 Euro banknotes put into circulation by the Bank of Greece: net flows and stocks

Value in billion euro

Period	Net flow	Circulation	Period	Net flow	Circulation
Jan. 2007	-1.76	15.15	*July 2010*	0.05	27.88
Feb. 2007	0.17	15.32	*Aug. 2010*	-1.11	26.77
March 2007	1.14	16.46	*Sept. 2010*	-0.57	26.20
Apr. 2007	0.12	16.58	*Oct. 2010*	-0.06	26.14
May 2007	-0.16	16.42	*Nov. 2010*	1.07	27.21
June 2007	0.39	16.82	*Dec. 2010*	2.46	29.67
July 2007	0.23	17.05	*Jan. 2011*	-0.58	29.09
Aug. 2007	-0.55	16.49	*Feb. 2011*	-0.12	28.98
Sept. 2007	-0.19	16.30	*March 2011*	1.75	30.73
Oct. 2007	-0.29	16.01	*Apr. 2011*	1.64	32.36
Nov. 2007	0.32	16.33	*May 2011*	2.45	34.81
Dec. 2007	2.35	18.68	*June 2011*	1.82	36.63
Jan. 2008	-1.71	16.97	*July 2011*	-0.22	36.42
Feb. 2008	0.20	17.17	*Aug. 2011*	-1.95	34.48
March 2008	0.29	17.47	*Sept. 2011*	2.45	36.93
Apr. 2008	0.84	18.31	*Oct. 2011*	3.41	40.34
May 2008	-0.63	17.68	*Nov. 2011*	1.02	41.36
June 2008	0.12	17.80	*Dec. 2011*	0.04	41.40
July 2008	0.10	17.91	*Jan. 2012*	-0.82	40.57
Aug. 2008	-0.67	17.23	*Feb. 2012*	1.20	41.77
Sept. 2008	-0.26	16.97	*March 2012*	-1.64	40.13
Oct. 2008	2.07	19.04	*Apr. 2012*	-0.20	39.98
Nov. 2008	-0.23	18.81	*May 2012*	3.29	43.27
Dec. 2008	1.91	20.72	*June 2012*	2.11	45.37
Jan. 2009	-1.70	19.03	*July 2012*	-3.31	42.06
Feb. 2009	-0.10	18.92	*Aug. 2012*	-1.35	40.71
March 2009	0.17	19.09	*Sept. 2012*	-1.23	39.49
Apr. 2009	0.64	19.74	*Oct. 2012*	-0.97	38.52
May 2009	-0.20	19.54	*Nov. 2012*	-0.50	38.02
June 2009	-0.03	19.50	*Dec. 2012*	0.02	38.04
July 2009	0.04	19.55	*Jan. 2013*	-2.05	36.64
Aug. 2009	-0.83	18.72	*Feb. 2013*	-1.11	34.87
Sept. 2009	-0.37	18.35	*March 2013*	0.67	35.57
Oct. 2009	-0.05	18.30	*Apr. 2013*	1.79	37.37
Nov. 2009	0.10	18.40	*May 2013*	-1.16	36.20
Dec. 2009	2.49	20.90	*June 2013*	-0.24	35.97
Jan. 2010	-1.03	19.87	*July 2013*	-0.48	35.48
Feb. 2010	0.39	20.26	*Aug. 2013*	-0.25	35.23
March 2010	3.12	23.38	*Sept. 2013*	-0.53	34.70
Apr. 2010	1.26	24.65	*Oct. 2013*	-0.15	34.54
May 2010	0.98	25.62	*Nov. 2013*	0.003	34.55
June 2010	2.20	27.82	*Dec. 2013*	0.93	35.48

Source: Bank of Greece.

Chart 6 Value of euro banknotes in circulation in Greece and in the Eurosystem
% of GDP; Jan. 2007-Dec. 2013

Sources: Bank of Greece and ECB.

Table 20 Value of euro banknotes in circulation: Greece and Eurosystem

In billion euro

Period	Greece	Eurosystem	Period	Greece	Eurosystem
Jan. 2007	15.15	602.28	*July 2010*	27.88	820.58
Feb. 2007	15.32	604.22	*Aug. 2010*	26.77	813.93
March 2007	16.46	613.56	*Sept. 2010*	26.20	813.35
Apr. 2007	16.58	621.22	*Oct. 2010*	26.14	815.02
May 2007	16.42	625.39	*Nov. 2010*	27.21	816.77
June 2007	16.82	633.04	*Dec. 2010*	29.67	839.70
July 2007	17.05	640.25	*Jan. 2011*	29.09	821.36
Aug. 2007	16.49	637.14	*Feb. 2011*	28.98	820.24
Sept. 2007	16.30	637.25	*March 2011*	30.73	824.15
Oct. 2007	15.99	641.79	*Apr. 2011*	32.36	834.36
Nov. 2007	16.31	645.66	*May 2011*	34.81	837.97
Dec. 2007	18.67	676.62	*June 2011*	36.63	846.96
Jan. 2008	16.96	650.37	*July 2011*	36.42	855.68
Feb. 2008	17.16	653.94	*Aug. 2011*	34.48	849.78
March 2008	17.54	661.18	*Sept. 2011*	36.93	857.32
Apr. 2008	18.37	669.63	*Oct. 2011*	40.34	864.37
May 2008	17.74	671.82	*Nov. 2011*	41.36	867.79
June 2008	17.87	678.55	*Dec. 2011*	41.39	888.63
July 2008	17.96	686.54	*Jan. 2012*	40.57	868.85
Aug. 2008	17.29	683.37	*Feb. 2012*	41.77	867.32
Sept. 2008	17.03	683.89	*March 2012*	40.13	869.92
Oct. 2008	19.10	727.55	*Apr. 2012*	39.98	873.86
Nov. 2008	18.86	731.30	*May 2012*	43.27	883.00
Dec. 2008	20.78	762.77	*June 2012*	45.37	893.72
Jan. 2009	19.08	739.78	*July 2012*	42.06	897.86
Feb. 2009	18.98	741.90	*Aug. 2012*	40.71	896.41
March 2009	19.15	747.04	*Sept. 2012*	39.49	892.48
Apr. 2009	19.81	759.00	*Oct. 2012*	38.52	891.39
May 2009	19.61	761.27	*Nov. 2012*	38.02	889.70
June 2009	19.58	763.72	*Dec. 2012*	38.04	912.59
July 2009	19.62	772.67	*Jan. 2013*	35.98	882.54
Aug. 2009	18.79	767.51	*Feb. 2013*	34.88	879.98
Sept. 2009	18.42	767.18	*March 2013*	35.57	896.36
Oct. 2009	18.37	771.49	*Apr. 2013*	37.37	901.52
Nov. 2009	18.48	776.10	*May 2013*	36.20	905.22
Dec. 2009	20.97	806.41	*June 2013*	35.97	911.01
Jan. 2010	19.87	783.54	*July 2013*	35.48	918.36
Feb. 2010	20.26	784.29	*Aug. 2013*	35.23	919.36
March 2010	23.38	797.06	*Sept. 2013*	34.70	918.59
Apr. 2010	24.65	798.15	*Oct. 2013*	34.54	924.23
May 2010	25.62	805.28	*Nov. 2013*	34.55	927.47
June 2010	27.82	812.06	*Dec. 2013*	35.48	956.19

Sources: Bank of Greece and ECB.

Prior to the crisis, monthly net outflows averaged €112 million,[2] while even during the typical peak months (e.g. in December, because of the pre-Christmas rush) they would not exceed €2.5 billion.

8.3.3 Meeting increased demand for cash

Surging demand for cash affected the volume of activities of the Bank of Greece's Cash Department, as evidenced by data on flows of banknotes in volume terms. In ten months of the period under review (February 2010-June 2012), the volume of euro banknotes that were supplied to the market ranged between 101,000 and 134,000 bundles,[3] up by 120%-158% relative to average outflows in 2009 (84,555 bundles).

On 51 business days of the reviewed period, the volume of euro banknotes that were supplied to the market by the competent Services of the Bank of Greece was higher by more than 120% compared with the daily average outflows of 2009, while on 21 out of those 51 business days the volume of outflows was well above 150% (151%-179%) of the daily average observed in 2009 (see Chart 7 and Table 21).

It goes without saying that the strong movements in demand for banknotes called for skilful and timely action by the Bank of Greece, as well as an intensification of the efforts of the Bank's cash management services, with a view to meeting demand in full and ensuring the smooth distribution of cash to banks, in order to preserve a sense of normalcy.

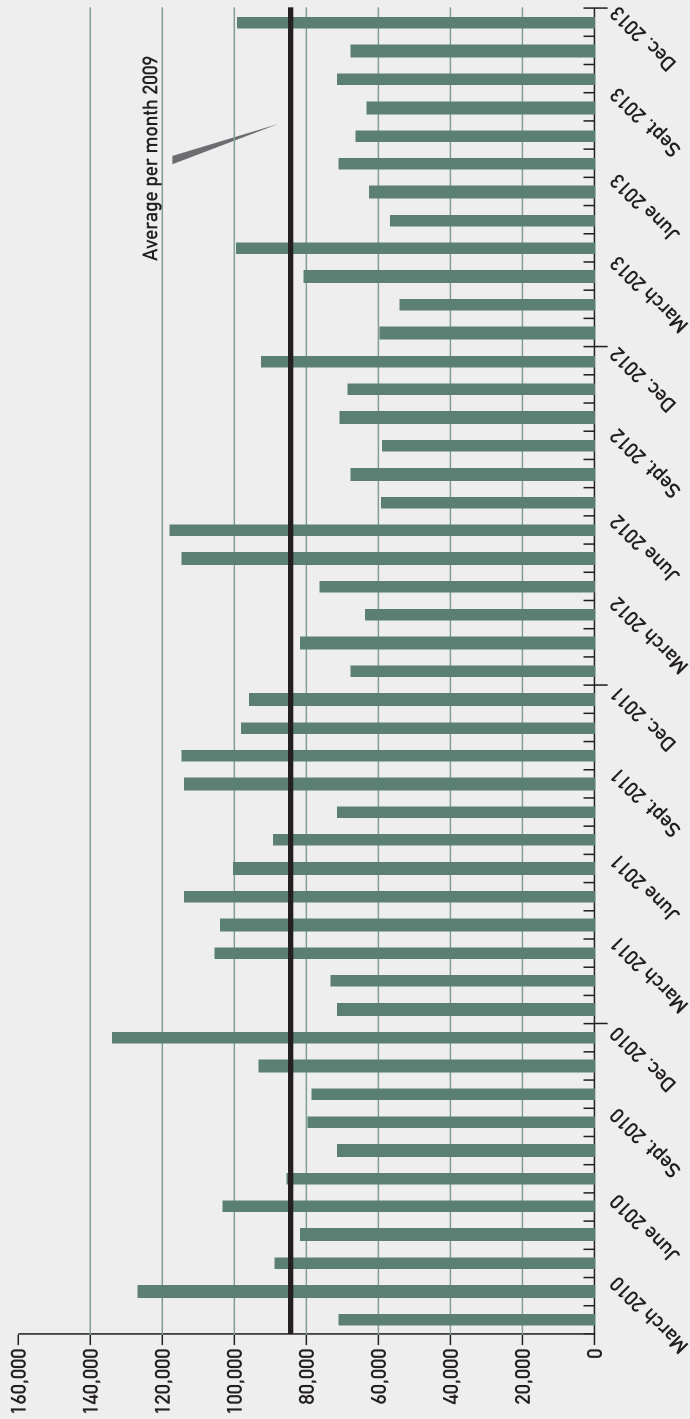
With regard to cash management, the Bank of Greece dealt with the crisis through the following decisive actions:

- It sped up its operations related with the supply and distribution of banknotes. Indicatively, on 14 and 15 June 2012 the Cash Processing and Distribution Centre in Halandri served 76 and 71 cash-carrier vehicles, respectively, for the delivery of cash to credit institutions, against a daily average of 20 vehicles for cash dispatches and receipts. In spite of an increase in the volume of operations, the programme for the rationalisation of cash shipments was strictly observed, thus leading to a reduction of distribution costs over the reviewed period. On that matter, it should be noted that, although cash shipments more than tripled, there were no untoward incidents, despite the increased risks stemming from higher crime rates.
- It adopted a systematic, daily monitoring of demand (on the basis of inflows and outflows recorded by tellers), by analysing the figures on the circulation

2 Monthly average of net outflows for the 2007-2009 period.

3 A bundle comprises 1,000 banknotes of the same denomination, divided in 10 packs of 100 banknotes each.

Chart 7 Euro banknotes put into circulation by the BoG (number of bundles)
Feb. 2010-Dec. 2013



Source: Bank of Greece.

Table 21 Euro banknotes put into circulation by the BoG

In thousand bundles

Period	Circulation	Period	Circulation
		Jan. 2012	67.75
Feb. 2010	71.15	*Feb. 2012*	81.59
March 2010	126.66	*March 2012*	63.51
Apr. 2010	88.47	*Apr. 2012*	76.04
May 2010	81.64	*May 2012*	114.34
June 2010	102.84	*June 2012*	117.72
July 2010	85.16	*July 2012*	59.07
Aug. 2010	71.27	*Aug. 2012*	67.62
Sept. 2010	79.34	*Sept. 2012*	58.96
Oct. 2010	78.29	*Oct. 2012*	70.63
Nov. 2010	93.04	*Nov. 2012*	68.29
Dec. 2010	133.62	*Dec. 2012*	92.40
Jan. 2011	71.19	*Jan. 2013*	59.48
Feb. 2011	73.38	*Feb. 2013*	54.05
March 2011	105.04	*March 2013*	80.55
Apr. 2011	103.85	*Apr. 2013*	99.29
May 2011	113.74	*May 2013*	56.56
June 2011	100.12	*June 2013*	62.63
July 2011	89.14	*July 2013*	71.17
Aug. 2011	71.49	*Aug. 2013*	66.28
Sept. 2011	113.72	*Sept. 2013*	63.26
Oct. 2011	114.23	*Oct. 2013*	71.31
Nov. 2011	97.85	*Nov. 2013*	67.63
Dec. 2011	95.65	*Dec. 2013*	98.80

Note: A bundle is made up of 1,000 banknotes of the same denomination.
Source: Bank of Greece.

and sufficiency of its cash stock, both centrally and at the regional/branch level. In parallel, for precautionary purposes, assessments were carried out to evaluate the sufficiency of the cash stock under adverse scenarios of outflows.

- Thanks to daily monitoring and proper management, the Bank of Greece managed to maintain sufficient stocks of euro banknotes. Further, as early as in 2004 the Bank's Cash Department had kept its "benchmark" stocks for the denominations of 500, 200 and 100 euro at much higher levels than those indicated by the ECB, so as to be able to meet, to some extent on its own, any extraordinary surge in demand.

Over the January 2011-June 2012 period, the stocks of euro banknotes of all denominations held by the Bank of Greece accounted, on average, for 13.8% of deposits with credit institutions, while the respective rate of coverage in the euro area was only 6.8% (see Chart 8).

- In cooperation with the ECB and in order to meet extraordinary demand, the Bank of Greece requested and conducted in a timely manner three extraordinary cash receipts from other national central banks (one from the Italian NCB and two from the Austrian NCB) over the reviewed period (February 2010-June 2012), for a total amount of €5.26 billion. Furthermore, the Bank of Greece minimised the required time for the processing of inflowing banknotes, with a view to putting them again into circulation faster.[4]
- The competent services of the Bank of Greece's Cash Department monitor, on a weekly and monthly basis, both at the Cash Processing and Distribution Centre and in the rest of the network, the non-processed stocks of euro banknotes, as well as the required time for processing the banknotes that flow back from circulation. Anyhow, the timely processing and efficient management of the stocks of euro banknotes by the Bank of Greece are among its primary tasks as member of the Eurosystem and among its obligations to the other NCBs.

As a result of the actions taken by the Bank of Greece, demand for euro banknotes was fully met in all denominations, without the occurrence of bottlenecks in the competent Services, which would have had negative effects on commercial banks.

Therefore, the contribution of the Bank of Greece in tackling increased demand for euro banknotes —which was a crucial issue— is deemed unequivocally successful.

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4 The workload of the Bank of Greece which is due to the higher inflow of banknotes increases to the extent that the overall conditions are improving, given that the banknotes that were supplied to the public flow back (from circulation or from hoarding) to credit institutions and subsequently to the Bank for checking and processing.

Chart 8 Percentage ratio of euro banknote logistical stocks (held by the Eurosystem or the BoG) to non-MFI deposits

Jan. 2006-Dec. 2013

Sources: Bank of Greece and ECB.

Table 22 Extraordinary shipments of euro banknotes

Number of banknotes	Denomination	Date	Country of origin	Value (in euro)
15,000,000	100	10.6.2010	Italy	1,500,000,000
38,400,000	50	16.6.2011	Austria	1,920,000,000
36,800,000	50	24.11.2011	Austria	1,840,000,000
Total				5,260,000,000

Source: Bank of Greece.

After the elections of 17 June 2012, demand for euro banknotes weakened and a larger number of banknotes, mainly of middle and higher denominations, started to flow back to the Bank of Greece.

Between 17 June 2012 and 31 December 2012, a total of €9.7 billion was returned, while inflows continued throughout 2013 when another €2.2 billion were returned.

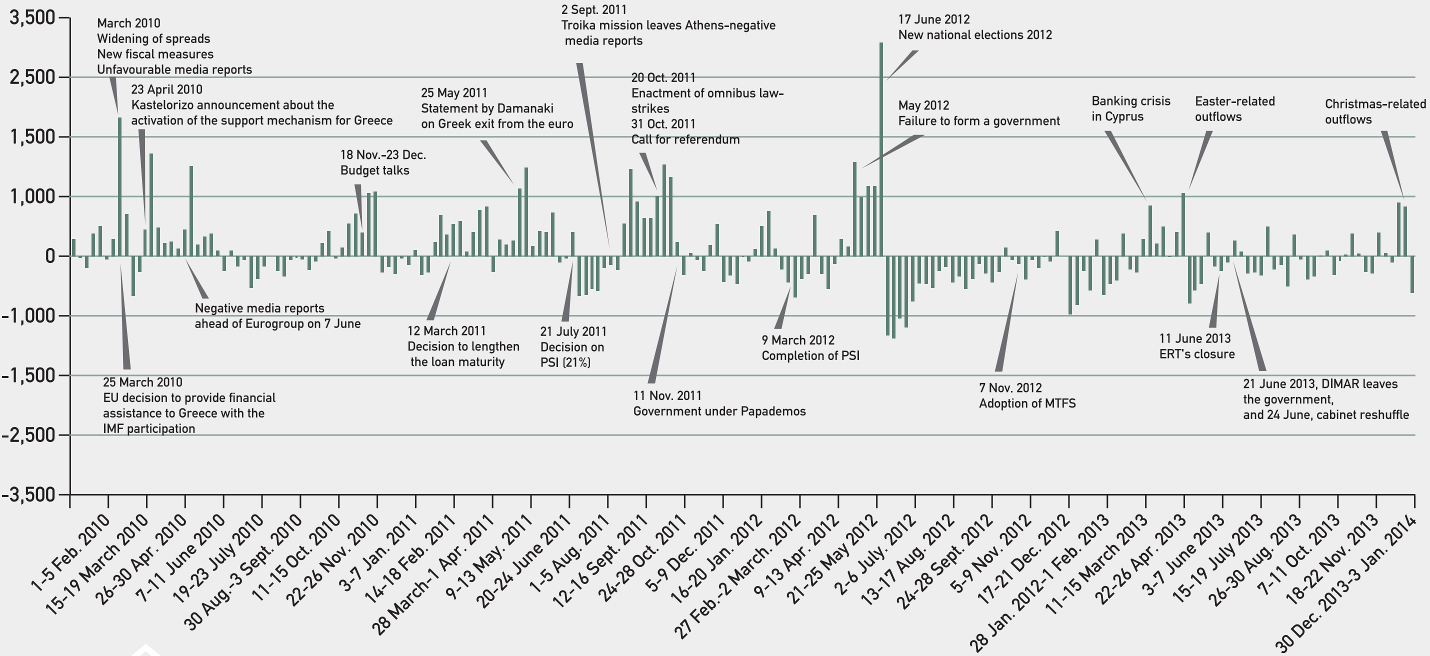
8.3.4 2010-2013: Provision of liquidity to the Greek banking system by the Eurosystem and the Bank of Greece

The Eurosystem's decisions over the 2010-2013 period, which were discussed in Chapter 5, covered the euro area financial sector and were aimed at restoring normalcy in markets and supporting the single currency. These decisions were of relevance to Greece, as the country was faced with severe problems.

The main problem that needed to be addressed was the lack of liquidity faced by credit institutions, particularly in Greece, Ireland and Portugal, as well as in other countries, as they had been cut off from the interbank market and were forced to resort to the Eurosystem's refinancing operations.

The Eurosystem's main refinancing operations at full allotment, which constitute the key non-standard monetary policy measure in the euro area, considerably facilitated Greek banks' liquidity. However, the amount of financing that Greek banks could raise through the Eurosystem's monetary policy operations was limited, as the value of their eligible collateral was constantly decreasing. Furthermore, the most common marketable assets in Greek banks' portfolios (Greek government bonds) at times ceased to be accepted as collateral by the Eurosystem. Similar problems were also encountered by credit institutions in other Member States; so, the Eurosystem took care to expand the range of assets that were eligible for collateral.

Chart 9 Crisis timeline (weekly) - net flow of euro banknotes in value terms
In million euro



Note: The presentation of events is not exhaustive and is limited to those that are considered to have influenced demand for euro banknotes.
Source: Bank of Greece.

Additionally, since August 2011 the Bank of Greece has been providing liquidity to credit institutions through the Emergency Liquidity Assistance (ELA). This emergency funding is provided by the Eurosystem's national central banks to credit institutions that face liquidity constraints; this is done against adequate collateral and with the approval of the Governing Council of the ECB,[5] in accordance with the Eurosystem's guidelines and within a strict timeframe (see Chart 12 below).

This funding was aimed at counterbalancing the decrease in and the withdrawal of deposits by the private and public sectors, as well as the decrease in the value of eligible collateral for monetary policy operations, against a background of the banks' inability to resort to the markets for funding. The fact that the central bank extensively supported the provision of liquidity contributed to safeguarding financial stability and dampening the decline in bank lending to enterprises and households which was much milder than the decline in the banks' deposit base. Thus, the Bank of Greece contributed to the mitigation of the negative effects that the debt crisis and fiscal adjustment had had on economic activity.

The total provision of liquidity to domestic banks through the Bank of Greece increased sharply from €8.8 billion at end-2007 to €40.5 billion at end-2008, had tripled by the end of 2011 and continued to rise in 2012 before declining gradually after July 2012. At the end of 2013, the total provision of liquidity to domestic banks amounted to €73 billion (see Chart 12 below). This increase in central bank funding led to a sharp rise in the financial and operational risks assumed by the Bank of Greece.[6] Especially, the ELA operations carried out by the Bank of Greece for domestic credit institutions entailed risks, which in line with the Eurosystem's rules are borne by the national central bank. Therefore, the Bank of Greece increased its risk provisioning and intensified its efforts to contain these risks – through a swift adjustment of procedures, an upgrading of the existing operational systems and the establishment of new ones. Nevertheless, it would not have been possible to address all those challenges without the strenuous efforts of the Bank's staff, which has seen its numbers fall sharply in recent years.

The following measures were of particular relevance for the provision of liquidity to the Greek banking system:

- The decision of the Governing Council of the ECB on 3 May 2010 to provide financing to banks against debt securities issued or guaranteed by the Greek

5 See ECB, *Monthly Bulletin*, February 2007, "The EU arrangements for financial crisis management", p. 81 ff. and "ELA procedures" on the website of the ECB (https://www.ecb.europa.eu/pub/pdf/other/201402_elaprocedures.en.pdf).

6 Overall, between 2008 and 2013, the Bank of Greece conducted about 2,800 liquidity-providing operations for credit institutions, with a wide spectrum of maturities ranging from one day to 36 months.

government, irrespective of their credit rating. This decision was based on the fact that the Governing Council of the ECB assessed the economic adjustment programme for the Greek economy as appropriate. This measure contributed importantly to the continued refinancing of Greek banks from the Eurosystem, under conditions of successive downgrades of Greece' s credit rating by international rating agencies, which affected the eligibility of debt securities put forward by Greek banks as collateral in the Eurosystem's liquidity-providing operations (see Chart 10).

- The Securities Markets Programme (SMP), which was launched on 10 May 2010 and remained active —with some interruptions— until 6 September 2012, when the ECB announced its termination. The SMP comprised Greek, Irish, Italian, Spanish and Portuguese bonds. The support provided by the SMP to financial markets that were dysfunctional —mainly the Greek market— is reflected in the figures on securities holdings per country of issuer that the ECB published after the termination of the programme.[7] According to these figures, the nominal value of the ECB's holdings of Greek government bonds acquired under the SMP amounted to €33.9 billion at 31 December 2012, while the total nominal value of the debt securities of all countries that were included in the SMP came to €218 billion.
- The framework for additional credit claims (ACC), proposed by the Bank of Greece and approved by the Governing Council of the ECB on 5 July 2012. Under this framework, further to the decision of 8 December 2011 of the ECB's Governing Council, the Bank of Greece may accept as collateral additional performing loan claims that satisfy specific eligibility criteria.
- The decision of the Governing Council of the ECB on 19 December 2012, according to which the marketable debt instruments of the Hellenic Republic shall again constitute eligible collateral for the purposes of Eurosystem monetary policy operations (after long interruptions during that year, mainly as a result of the PSI), subject to a special scale of haircuts. In this decision the Governing Council took into consideration the positive assessment by the European Commission, the ECB and the IMF of the progress of the Greek economy in the context of the Second Economic Adjustment Programme, as well as the adoption of measures by the Greek government (after the delays that were due to the dual election) in the areas of fiscal consolidation, structural reforms and financial sector stability.

7 ECB press release of 21 February 2013, "Details on securities holdings acquired under the Securities Markets Programme", http://www.ecb.europa.eu/press. For the exact amounts, see footnote 4 in Chapter 5.

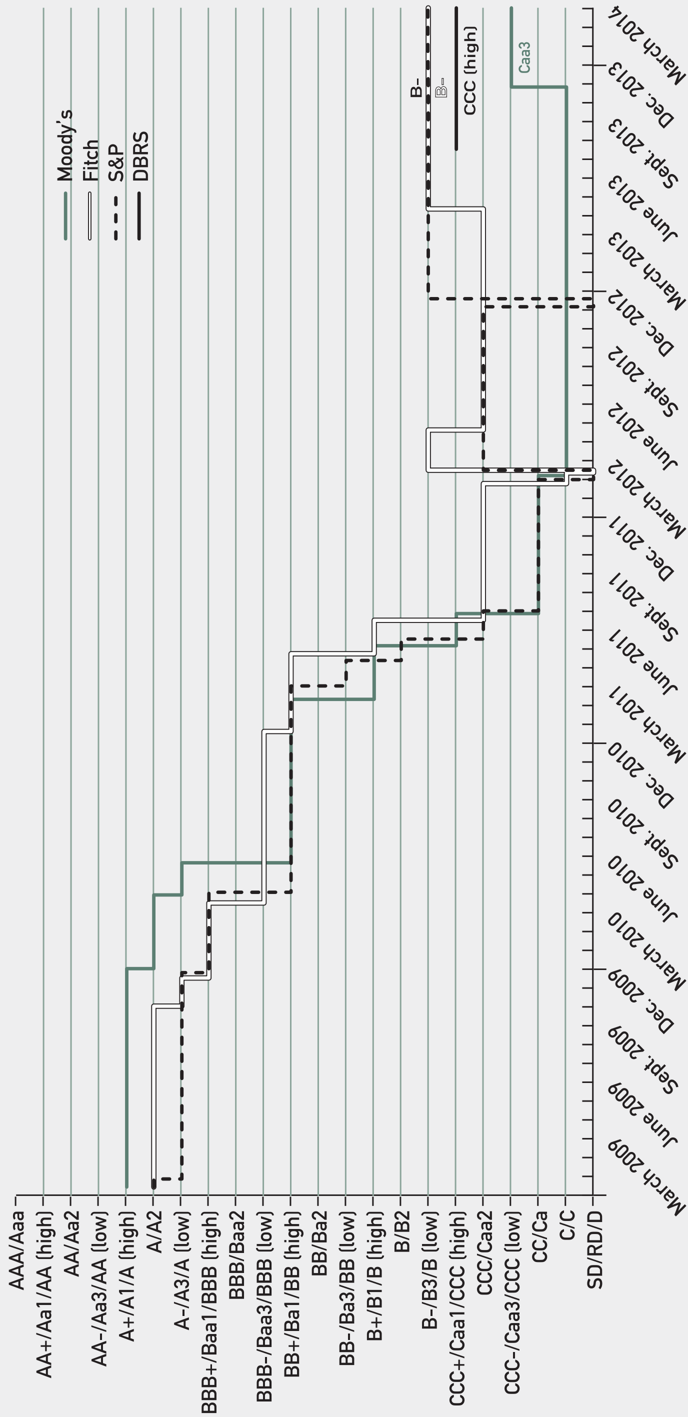
In November 2012 the Eurogroup decided to further ease Greece's public debt through the debt buyback operation by the Hellenic Republic of its new government bonds in exchange for EFSF notes. At the same time, a reversal in the economic sentiment, an abatement of unfavourable forecasts and a gradual restoration of confidence led to an increase in deposits with Greek banks. Between July and December 2012, there was an inflow of approximately €11 billion (by households and non-financial corporations) into the domestic banking system. In 2013 deposits stabilised,[8] although some relatively moderate outflows were recorded in most months of the year. This stabilisation reflected the continuous improvement of the economic climate and contributed to a reduction in the Greek banking system's refinancing needs.

The important contribution to the financing of the Greek banking system by the Eurosystem and the Bank of Greece over the 2007-2013 period is evidenced by the large increase in the Bank's assets. More specifically, during this period, the Bank's assets more than quadrupled and in February 2012, against a backdrop of heightened tensions, they were equivalent to approximately 100% of the Greek GDP. This suggests that the role of the Bank in ensuring liquidity in the Greek economy was crucial and unprecedented by domestic and international standards (see Chart 11 below).

In this way, liquidity risk was averted; this risk posed the most serious challenge for Greek banks, which not only remained shut out of international money and capital markets, but also had to face sizeable deposit outflows as well as haircuts on the collateral they put forward to obtain funding from the Eurosystem. The continuation of the Eurosystem's liquidity-providing operations and the liquidity support measures for the Greek economy helped to avert phenomena of credit crunch. In the absence of such measures, banks would not have been able to renew, even profitable, loans, with negative consequences for profitability and subsequently capital adequacy. Furthermore, a rapid contraction in banks' assets would have led to a strong decline in the financing of the economy, thereby creating conditions that would have brought about an even deeper recession than the one actually recorded. Besides, deleveraging would have had a further negative impact on deposits, given that a decrease in lending, as a result of the interlinkage between bank loans and deposits, adversely affects deposits by enterprises and households. Thus, these developments, compounded by the negative feedback loop between deposits and loans, would have further hampered the already limited financing of the economy, as banks' liquidity would have continued to worsen.

8 In 2013 deposits increased by a total of €1.2 billion.

Chart 10 Evolution of Greece's credit rating



Source: Bank of Greece.

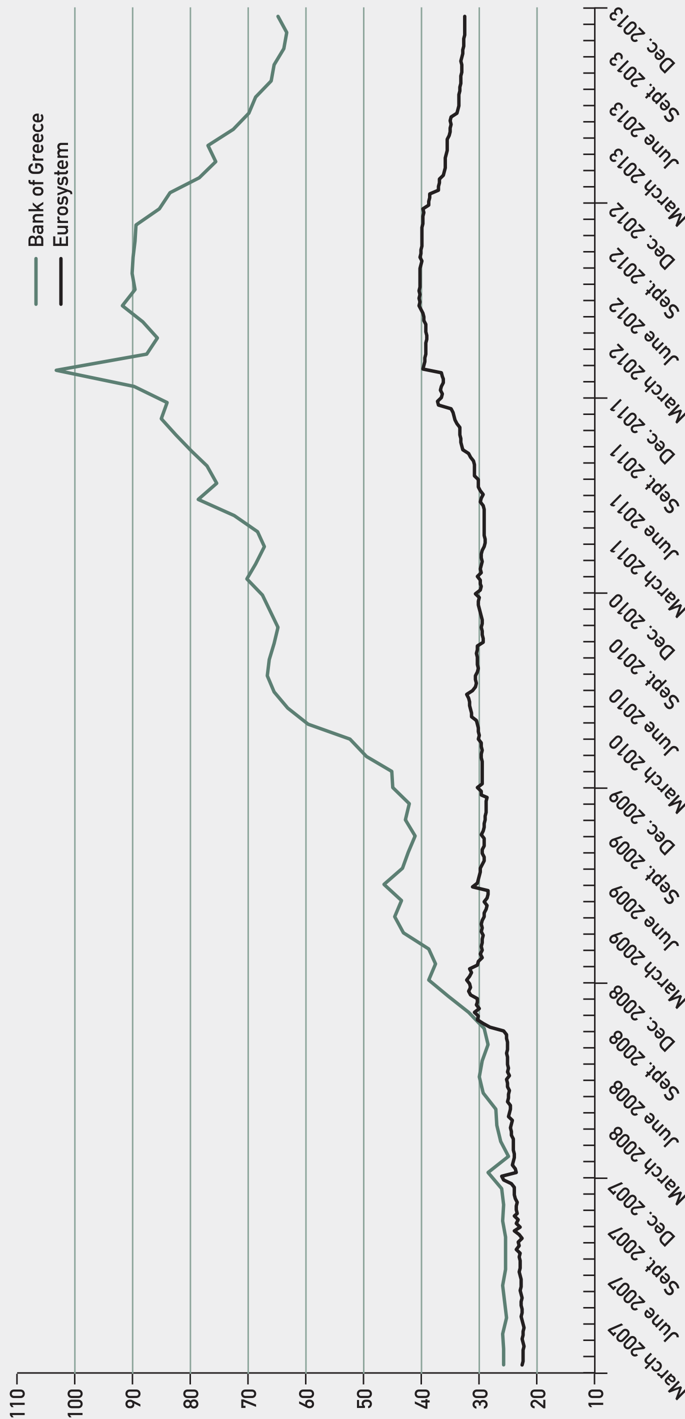


Chart 11 Central bank total assets

% of respective nominal GDP; Jan. 2007-Dec. 2013

Sources: Bank of Greece and ECB.

Box 8.1

Provision of Emergency Liquidity Assistance from the Bank of Greece

Through Emergency Liquidity Assistance (ELA), the Bank of Greece may provide funding (in the form of either central bank money or any other assistance that may lead to an increase in central bank money) to a solvent financial institution, or group of solvent financial institutions, that is facing temporary liquidity problems, without such operation being part of the single monetary policy. Responsibility for the provision of ELA in Greece lies with the Bank of Greece, which incurs any costs of, and the risks arising from, the provision of ELA. However, the Governing Council of the ECB is assigned the responsibility for restricting ELA operations if it considers that these operations interfere with the objectives and tasks of the Eurosystem. To enable the Governing Council to adequately assess whether such interference is given, the Governing Council has to be informed in a timely manner of such operations and of their details (*inter alia*: volume, counterparty, value and maturity date, collateral/guarantees against which the ELA is provided). These procedures are binding for all NCBs.[1]

The Financial Stability Committee of the Bank of Greece played a decisive role in dampening pressures on liquidity. In the light of the new circumstances, its work mainly focused on the evaluation of the required emergency central bank funding for each bank. Thanks to the Committee's decisions and the ECB's contribution, the provision of emergency financing was secured and, as a result, the smooth functioning of the banking system was safeguarded. In other words, a Greek bank run was averted and the rate of decline in bank credit was dampened.

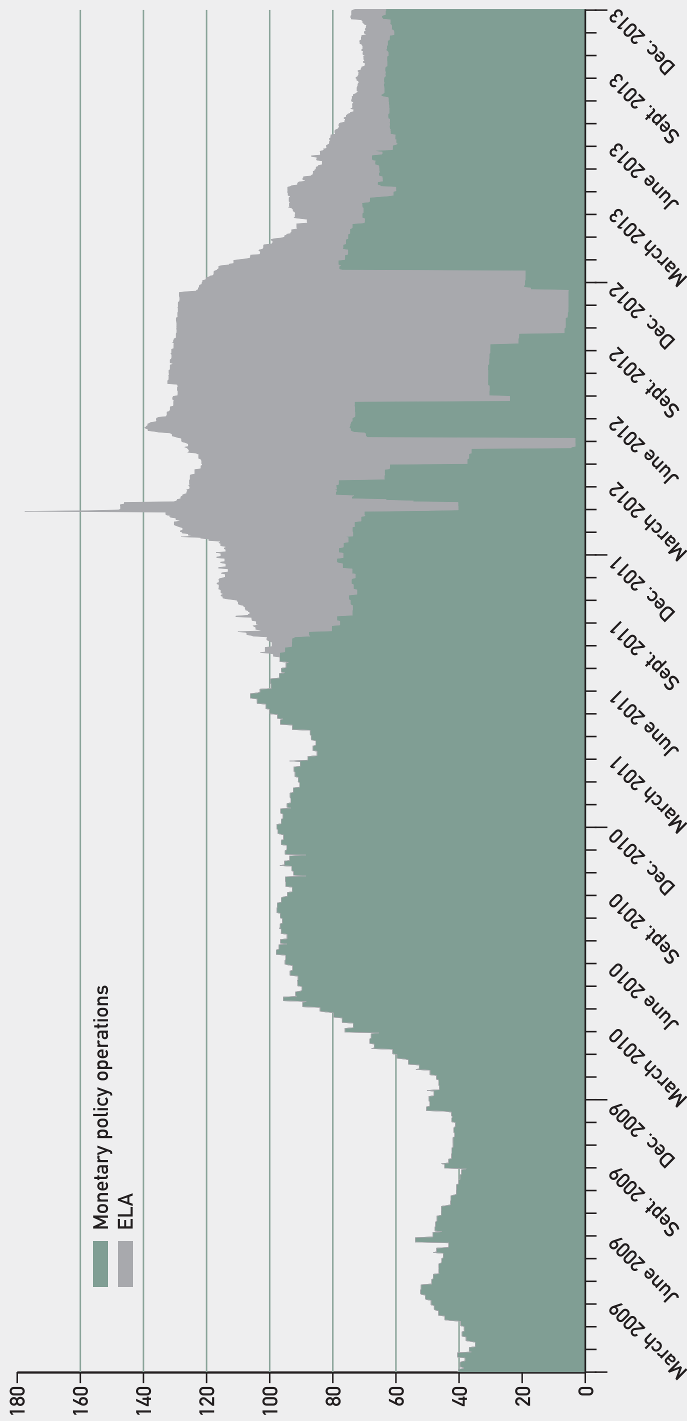
1 See "ELA procedures" on the ECB's website (http://www.ecb.europa.eu/pub/pdf/other/elaprocedures.en.pdf).

8.4 Establishment and operation of the Hellenic Financial Stability Fund

The Hellenic Financial Stability Fund (HFSF) was founded in July 2010 (under Law 3864/2010) as a private-law legal entity. It has administrative and economic independence, operates exclusively under the rules of the private economy and is governed by the provisions of the law establishing the HFSF, as applicable.

Chart 12 Greek banks' recourse to Eurosystem monetary policy operations and Emergency Liquidity Assistance (ELA)

In billion euro; Jan. 2009-Dec. 2013



Source: Bank of Greece.

The objective of the Fund is to maintain the stability of the Greek banking system by strengthening the capital adequacy of credit institutions, including subsidiary credit institutions abroad, and by providing capital support to interim credit institutions (bridge banks).

The Bank of Greece played a significant role in the elaboration of the Fund's institutional framework, as well as during the initial steps for setting up its organisational structure, as it took part in the evaluation process for the Fund's staffing. The Bank also takes part in the Fund's decision-making bodies by appointing a representative as a member of the HFSF's Board of Directors. Furthermore, the Bank of Greece signed a Memorandum of Understanding with the HFSF, concerning the exchange of information in order to maintain the stability of the financial system.

8.5 Institutional framework and bodies for the resolution of credit institutions

8.5.1 Law 4021/2011

The Bank of Greece elaborated an institutional framework for the resolution of credit institutions in cooperation with the Greek government (Law 4021/2011), based on the model of an EU Directive, which was under discussion at the time. This Law allows competent authorities to manage and successfully tackle financial crises, ensuring, to the extent possible, the smooth continuation of business, as well as safeguarding deposits and a sufficient flow of bank credit to the real economy.

8.5.2 Resolution Scheme of the HDIGF

During the first phase of implementation of Law 4021/2011, a separate Resolution Scheme was set up within the Hellenic Deposit and Investment Guarantee Fund (HDIGF), which relied on contributions paid by credit institutions in order to finance resolution measures before the HDIGF compensation procedure is activated, with a view to ensuring continuity of critical banking operations and, hence, financial stability. The establishment of a Resolution Scheme within the HDIGF was preferred over other options because of the synergies resulting from the operation of a Deposit Guarantee Scheme and a Resolution Fund within a single institution, given that resolution serves as an alternative to depositor compensation, ensuring by law the protection of guaranteed deposits. Furthermore, when the Resolution Scheme

was established, the HDIGF was the only institution with available funds which could be used to finance resolution measures without putting a burden on taxpayers.

Immediately following the adoption of Law 4021/2011, the Resolution Scheme was activated in order to finance the resolution of Proton Bank (€862 million) and, shortly thereafter, of T Bank (€450 million), using funds borrowed from the Deposit Guarantee Scheme of the HDIGF.[9]

8.5.3 Provisions improving the law on resolution

In 2012, the institutional framework for the resolution of credit institutions was further strengthened,[10] offering alternative resolution tools and providing for the financing of resolution measures through the HDIGF and the Hellenic Financial Stability Fund.

As regards resolution measures, the Bank of Greece is allowed to select assets and liabilities of a credit institution meeting the conditions of Article 63B of Law 3601/2007, as applicable, and following an informal and confidential tendering procedure, transfer these assets and liabilities to a *transferee credit institution*. Alternatively, the Bank of Greece may recommend to the Minister of Finance the establishment of a *new interim credit institution (bridge bank)*, to which the credit institution's assets and liabilities selected by the Bank of Greece may be transferred. The shareholder of this new credit institution will be the Hellenic Financial Stability Fund, the object of which is to restructure the credit institution and sell it within a two-year period (which may be extended by two more years) to a prospective buyer.

8.5.4 Resolution Unit

By decision of the General Council of the Bank of Greece, a Resolution Unit was established within the Bank on 20 February 2012. The Unit's tasks include:

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9 Funding was possible because increased funds were available to the HDIGF and, more specifically, the Deposit Cover Scheme following a hike in the contributions paid by credit institutions, as a result of a raise in the level of deposit coverage from €20,000 to €100,000. However, increased needs for the implementation of resolution measures and the fact that the Resolution Scheme did not have own assets resulted in the suspension of its use in February 2012 and its replacement by the Hellenic Financial Stability Fund by end-2013.

10 In more detail, Articles 9-11 of Law 4051/2012, amending the provisions of Law 3864/2010 establishing the Hellenic Financial Stability Fund (HFSF), Law 3601/2007 on capital adequacy of credit institutions and Law 3746/2009 on the Hellenic Deposit and Investment Guarantee Fund (HDIGF), along with the provisions of Law 4021/2011 on enhanced measures for the supervision and resolution of credit institutions.

- evaluating the alternative resolution tools to be applied,
- valuating the assets and liabilities of the credit institution being resolved,
- developing the relevant legislative and institutional framework for a more efficient resolution of credit institutions, to address practical issues that may arise from the implementation of measures and to adapt this framework to future developments, as well as elaborate proposals for its modification.

Since its establishment, the Resolution Unit has focused on preparing the resolution of various credit institutions. Bearing in mind that bank closure is an undesirable solution in terms of both stability and cost, given the need to compensate depositors, the available resolution tools are mainly the following:

(a) a transfer order, i.e. an order to transfer assets and liabilities to a transferee credit institution, which is selected on the basis of an informal and confidential procedure inititated by the Bank of Greece. It was decided that this procedure will be confidential, not in order to circumvent transparency, but because an open tendering procedure would include announcing that a bank is facing serious problems and thus resolution measures need to be implemented. Such an announcement would be unthinkable, because it would cause a bank run, i.e. precisely what resolution measures seek to avert. This is why the law provides for a fine of up to €300,000 in the event of violation of the procedure's confidentiality;

(b) the establishment of a bridge bank, pursuant to a ministerial decision, following a relevant recommendation of the Bank of Greece.

By setting up the Unit, the Bank of Greece put in place yet another mechanism for safeguarding the stability of the financial system and the interests of depositors. The reason is that the depth and duration of the crisis, along with heightened uncertainty, put banks' financial aggregates under serious strain. Several banks were not able to meet the challenges, and the Bank of Greece had to intervene. It did so very successfully, given that in all resolution cases, even large banks had to be resolved, there were no disruptions in the operation of the banking system and not one depositor lost a single euro.

8.6 Banking system reform

Taking into account that the recession led to a continuous increase in non-performing loans and that the liquidity crisis had hardened into a solvency crisis, the Bank of Greece had to redraw the banking map and prepare banks for the day after. Given the economic circumstances and the ensuing needs, the Greek banking system had to be strengthened and recapitalised, become more compact and

efficient, eliminate spare capacity and take advantage of synergies and economies of scale. The objective is to make the Greek banking system stronger and thus capable of financing the country's recovery.

The first step was the calculation of the recapitalisation needs of the banking system. The calculation of losses on banks' sovereign bond holdings was quite straightforward. It was much more difficult to conservatively estimate all the potential losses on Greek banks' loan portfolios for the years ahead. This task was assigned by the Bank of Greece to BlackRock Solutions.

The second part of the strategy included evaluating which banks were eligible for recapitalisation by the HFSF and assessing the total recapitalisation and resolution needs of the banking system. At the same time, any banks that would fail to bolster their capital base and ensure their standalone viability (thus placing in jeopardy the stability of the financial system) would be resolved.

More specifically:

8.6.1 Diagnostic study of banks' loan portfolios

In August 2011, the Bank of Greece commissioned BlackRock Solutions (hereinafter BlackRock) to conduct a diagnostic study of Greek commercial banks' loan portfolios. This diagnostic study was required under the June 2011 Memorandum of Economic and Financial Policies.

BlackRock had to conduct an independent estimate of expected losses on banks' loan portfolios as of 30 June 2011 both over a three-year and a loan-lifetime horizon on the basis of two scenarios, the Baseline and the Adverse Scenario. The diagnostic study covered all loans carrying Greek risk, as the quality of such portfolios was closely related to developments in domestic macroeconomic aggregates. In the context of the study, BlackRock collected loan-level information from banks, without any interventions from the Bank of Greece or the Troika. The estimates of expected losses by an independent expert of recognised standing ensured transparency regarding loan portfolio quality and a Loan Loss Reserves Review concerning the adequacy of accumulated provisions for credit risk. Furthermore, expected losses were included in the parameters taken into account in the context of the recapitalisation exercise, which was completed in 2012 (see below).

8.6.2 Strategic assessment

The Bank of Greece carried out a strategic assessment (viability study) of the banking sector in March 2012. This analysis assessed the viability prospects of each bank on a standalone basis using a much broader range of criteria (both regulatory and business criteria), as envisaged in the March 2012 MoU.

The criteria (based on the MoU) had to include, *inter alia*, notably:

- *"shareholders' soundness and willingness to inject new capital;*
- *quality of management and risk management systems;*
- *capital, liquidity, and profitability metrics (both forward- and backward-looking);*
- *the Bank of Greece's assigned ratings to bank risks; and*
- *a sustainable business model".*

8.6.3 Assessment criteria

The assessment of each bank was conducted on the basis of two sets of criteria: regulatory and business. Their combination resulted in each bank's final assessment.

Using *regulatory criteria,* an assessment was made of capital adequacy, liquidity, asset quality indicators, as well as the shareholding structure and the adequacy of management.

Business criteria concern indicators regarding market shares, synergies and cross-sales indicators, stability of the deposit base, adequacy of risk management systems, efficiency, operating costs and estimated future profitability.

In the context of the viability study, which was completed in cooperation with the Troika, historical and current aggregates were indeed taken into account, along with future profit estimates. Future estimates were those included in the business plan submitted by each bank.

This analysis showed banks' estimated future profitability and implied capacity to repay capital injections within a reasonable period of time. This capacity actually explains the notion of viability. The assessment found that the four "core" banks (National Bank of Greece, Alpha Bank, Eurobank and Piraeus Bank) are viable.

8.6.4 Bank recapitalisation exercise

The effects of the prolonged and intensifying recession on the aggregates of Greek commercial banks and, most importantly, the banks' participation in the Greek public debt restructuring (private sector involvement – PSI) resulted in an erosion of their capital base and necessitated the elaboration of a recapitalisation plan.

The first phase of the recapitalisation plan for Greek banks involved an assessment of the minimum necessary additional funds for each bank. The assessment of capital needs was based on two macroeconomic scenarios,[11] which reflected the expected development of key economic indicators over the 2012-2014 period (e.g. real GDP growth, unemployment rate, inflation, house and other property prices):

- a Baseline Scenario, according to the assumptions of the Memorandum, with a Core Tier 1 ratio target of 9% for 2012 and 10% for 2013 and 2014;[12]
- an Adverse Scenario, according to assumptions developed by the Bank of Greece, with a Core Tier 1 ratio target of 7% for the 2012-2014 period.

As a starting point, the exercise used the reference Core Tier 1 capital in December 2011, as submitted by banks[13] and then estimated the evolution of Core Tier 1 capital over the respective period, taking into account the following elements:

- Losses on Greek government bond holdings due to the PSI net of existing PSI provisions. Credit loss projections (CLPs) on banks' loan portfolios, carrying: (i) Greek risk, based on the estimates of BlackRock Solutions, which, as mentioned above, conducted a diagnostic study on the domestic loan portfolios of Greek banks,[14] (ii) foreign risk, based on an extension by the Bank of Greece of the European Banking Authority (EBA) methodology used in the June 2011 EU-wide stress testing, and (iii) state-related risk, based on the estimates of BlackRock or the Bank of Greece. In all three cases, expected losses were net of existing loan loss reserves.
- Banks' internal capital generation over the 2012-2014 period based on a conservative downward adjustment of key drivers of pre-provision profitability from banks' three-year Business Plans and including only those capital-augmenting actions that had already materialised at the time of the exercise.

Finally, the Bank of Greece estimated the target for the required level of Core Tier 1 capital at the end of each year until 2014, based on the target Core Tier 1 ratio set for each scenario and the projected Risk-Weighted Assets (RWAs). More

11 For a more detailed overview of scenarios, see the report of BlackRock Solutions entitled "Diagnostic Assessment of Greek Banks."

12 The updated Memorandum of December 2012 provides for a minimum Core Tier 1 ratio of 9% for the entire 2012-2014 period. The effect of this change on banks' capital needs is very limited, as the binding scenario for almost all banks is the adverse one.

13 Submitted in January 2012 in banks' three-year Business Plans; calculated without taking into account the impact of the modified PSI.

14 Commissioning an international consulting firm to conduct a diagnostic study was included in the terms and conditions of the June 2011 Memorandum.

specifically, to ensure that banks do not underestimate their risk exposure, RWAs were adjusted on the basis of a conservative Bank of Greece methodology.

The capital needs for each bank were then calculated as the difference between: (a) the target set for the required level of Core Tier 1 capital and (b) the estimated level of Core Tier 1 capital at the end of each year until 2014. This assessment was performed both for the Baseline and the Adverse Scenario; for each bank, the scenario that resulted in the highest capital needs was considered binding.

To ensure objectivity and robustness of the capital assessment exercise, the results were cross-checked against a top-down approach. Specifically, full year 2011 financial results of each bank were taken as a starting point, with forward projections based on a quantitative model which took into account macroeconomic forecasts, independently of the submitted Business Plans.

The resulting capital needs for all Greek commercial banks were estimated in May 2012 at €40.5 billion, of which €27.5 billion were earmarked for the four core banks.

8.6.5 Implementation of bank recapitalisation

The HFSF, in cooperation with the Troika, signed in late May 2012 pre-subscription agreements with the four largest Greek commercial banks on the upcoming capital increases and injected a total of €18 billion in the form of EFSF notes. Their capital adequacy was thus restored and liquidity improved.

In October 2012, the Bank of Greece updated its assessment of capital needs on the basis of preliminary financial results for the first half of 2012. This update confirmed the level of capital needs, which had already been estimated conservatively.

In December 2012, the Bank of Greece also updated its assessment on the adequacy of the Financial Envelope, i.e. the amount of public resources required to cover both the recapitalisation needs and the restructuring costs of the Greek banking sector over the 2012-2014 period. Under reasonable levels of economic uncertainty, it was estimated that the amount of €50 billion was enough to cover the recapitalisation and restructuring costs of the Greek banking system. It should be noted that this amount also included a capital buffer for addressing any developments that might increase capital needs. Over the same month, the HFSF moved ahead with the second injection of EFSF bonds to the four core banks, amounting to €6 billion.

Bank recapitalisation procedures were completed during the first half of 2013, with private sector participation coming to at least 10% of the capital increase. The HFSF covered the remainder, thus becoming majority shareholder in the four core banks.

8.7 The implementation of resolution measures and the restructuring of the banking system

In parallel with the bank recapitalisation process, the restructuring of the Greek banking system was also in progress – primarily through the implementation of the provisions of the Resolution Law and secondarily through the transfer of Cypriot banks' branches to Piraeus Bank.

Resolution measures were implemented for the first time in the case of Proton Bank. Subsequently, at end-2011, the Bank of Greece decided to withdraw the authorisation of T Bank, while in March 2012 the resolution of the cooperative banks of Achaia, Lamia and Lesvos-Limnos was also deemed necessary. ATEbank and, in 2013, TT Hellenic Postbank, FBB, Probank and the Cooperative Banks of Western Macedonia, Dodecanese and Evia followed suit.

8.7.1 Proton Bank

The problem

The provisions of the law concerning the resolution of credit institutions were first implemented in the case of Proton Bank.

This bank was characterised by chronic weaknesses, due to its high-risk business model, as it was mainly an investment bank with a large bond portfolio, as well as on account of its imprudent lending policy over the past few years. The problems facing the bank had been identified in a timely manner by the Bank of Greece, which for a number of years —especially after the onset of the global financial crisis and the ensuing liquidity constraints for Proton Bank— had tightened its supervision. Against this background, the Bank of Greece focused on several weaknesses and persistently pressed Proton Bank and its main shareholder to increase the bank's capital, cut down lending to companies with close links to the main shareholder, which could constitute a single risk, rationalise its business operations, improve its systems and explore the appropriate long-term strategic options.

The Bank of Greece, in particular as regards Proton's latest main shareholder, after thoroughly assessing his suitability, exhausted all available possibilities under the applicable institutional framework. The Bank of Greece imposed additional requirements (e.g. by prohibiting the main shareholder from assuming executive tasks or by imposing requirements to increase the bank's capital and observe ceilings for large credit exposures).

As soon as a sharp increase (by 40%) in the bank's exposures was detected on the basis of the submitted supervisory data for June 2010, the Bank of Greece immedi-

ately sent a mission of inspectors to conduct on-site examinations and imposed, for prudential purposes, increased capital requirements on Proton Bank for the coverage of the estimated credit risk.

Furthermore, although Proton's capital adequacy ratio was above the regulatory minimum, the Bank of Greece, considering the nature of Proton's activities (mainly investment banking, which is a high-risk activity), urgently called for an increase in the bank's own funds, as per the main shareholder's commitment.

The examination of the loan portfolio and the interconnected firms revealed unusual transactions, deviations from appropriate lending policy and many oversights and overruns, while evidence of possible manipulation in the share prices of the main shareholder's firm was also detected. The Hellenic Capital Market Commission was duly notified both in writing and orally. Moreover, the audit of the financial statements of the firm Alapis showed several irregularities, which were reported to the Committee for Accounting Standardisation and Auditing.

The thorough examination of Proton's loan portfolio, on the basis of data as of 31.3.2011, was concluded in the beginning of summer 2011 and 66% of the bank's loan portfolio was examined; this included all the loans that had been granted to firms with close links to the main shareholder. The examined percentage was particularly high compared with standard international practice (only one third of total loans is typically examined).

The results of the examination demonstrated the poor quality of Proton's loan portfolio, while almost 50% of loans in the sample were channeled into firms with close links to the main shareholder. In many cases, loans were not backed by eligible collateral, whereas, in case where collateral did exist, its value was very low and mainly consisted in borrowing firms' own shares.

The liquidity problems, which the bank had faced since the start of the crisis, became more severe when the verdict of the Anti-Money Laundering Authority was reached against the bank's main shareholder and senior officers. A sizeable outflow of deposits (over €150 million in the first days) was recorded and continued through 7 October 2011, albeit at a slower pace. Over the same period, the bank faced a shortage of eligible collateral and was excluded from the list of credit institutions which are characterised as eligible counterparties in monetary policy operations. As a consequence, under an ECB decision, Proton would not be allowed to receive any type of financing by the Eurosystem from mid-October 2011 onwards. Therefore, a solution had to be found.

The solution

Given the objective of avoiding a disruption of financial stability and the need to protect depositors, there were two available options: (a) the transfer (sale) of as-

sets to another bank and (b) the establishment of an interim credit institution. Initially, the feasibility of the first option was explored, as in theory it could contribute to increasing the public's trust in the resolution process. However, no credit institution was interested in acquiring Proton's assets. As it was imperative to find a remedy, the establishment of an interim credit institution was the only option. Through the establishment of a "good" bank, the transition process would be smooth, while averting a "fire sale" of the institution was more likely to attract a higher selling price.

The situation was so critical that —compounded by the continuing deferral of a capital increase by the bank itself— it would make withdrawing the bank's authorisation a natural development. Nevertheless, the fragile psychology of depositors due to the negative economic climate necessitated the search for an alternative. In the economic environment of the time, withdrawing the authorisation of even a small bank such as Proton entailed a systemic risk.

For systemic stability reasons, the Bank of Greece was in constant consultation with the Greek Ministry of Finance, the Hellenic Financial Stability Fund (HFSF) and the Hellenic Deposit and Investment Guarantee Fund (HDIGF) to come up with a solution. The adoption of Law 4021/2011 on the resolution of credit institutions provided a possible option, which was thoroughly examined. Taking into account all relevant factors, the Bank of Greece put forward a resolution scheme for Proton Bank (in implementation of Law 4021/2011) and the establishment of a "good" bank (which would continue its operations) and a "bad" bank (which would be wound up and its assets liquidated).

The top priority for the Bank of Greece was to safeguard financial stability and protect deposits with the entire domestic banking system. Therefore, it was decided, as already mentioned, that, given the lack of interest in the acquisition of Proton Bank from another bank, its shutdown would have adverse systemic consequences at that critical juncture of heightened economic uncertainty. Besides, at the European level, systemic stability issues are deemed as matters of top priority (cf. the case of Dexia, which was rescued using a mechanism similar to that selected for Proton).

The resolution of Proton Bank through the establishment of a bridge bank was implemented on 9.10.2011. This option entailed not only the lowest possible cost on the State and the Greek economy but also the largest benefit for employees, depositors and the stability of the banking system as a whole, while at the same time all deposits with Proton Bank were secured.

8.7.2 The case of T Bank

The problem

At end-2011, the Bank of Greece decided to withdraw the authorisation of T Bank.

A withdrawal of authorisation was inevitable, as the bank's capital adequacy ratio, which was well below the regulatory threshold under Law 3601/2007, was beyond restoration. This was due to the fact that, while TT Hellenic Postbank had initiated its merging with T Bank according to the released plan, had applied to the Bank of Greece for approval and had started the required pre-merger procedures for the reorganisation of T Bank, no decision on the finalisation of the merger was made at the 2nd, adjourned, General Meeting of TT Hellenic Postbank on 22 November 2011; this led to an unexpected twist of events. T Bank was no longer viable. This development brought about a rapid deterioration in the financial condition of T Bank and a high risk of its defaulting on depositors.

The solution

In the light of the above, the immediate intervention of the Bank of Greece was required. The establishment of an interim credit institution, as had happened in the case of Proton Bank, would require more time (at least one month), since under Law 3601/2007, as amended by Law 4021/2011, the fair value of the bank's assets would have to be estimated by an auditing firm. With a view to safeguarding depositors' interest and averting the bank's collapse with unforeseen consequences for financial stability, the solution chosen was the transfer of deposits to another credit institution. Law 3601/2007, as amended by Law 4021/2011, stipulates that the transfer of the selected assets and liabilities is conducted through a submission of bids (auction process). The Bank of Greece invited those banks, which, in its opinion, were in a position to respond immediately, to submit a sealed bid. The bank with the most competitive bid was selected, i.e. the bid which would least burden the HDIGF and would ensure the quickest possible completion of the transfer of deposits. This bank was TT Hellenic Postbank, which, as mentioned above, had already initiated the procedures for the absorption of T Bank.

8.7.3 Cooperative banks of Achaia, Lamia and Lesvos-Limnos

In March 2012 the Bank of Greece considered it necessary to apply resolution measures on the cooperative banks of Achaia, Lamia and Lesvos-Limnos.

The problem

All three cooperative banks faced weaknesses, such as capital shortage and inability of recapitalisation, a loan portfolio of bad quality (non-performing loans

were close to 1/3 of total loans in one of the banks and to 3/5 in the other two banks) and severe liquidity constraints. Moreover, several phenomena of mismanagement and serious organisational deficiencies were observed, mostly as regards procedures and risk management. These problems had been long identified by the Bank of Greece, but none of the banks managed to take the appropriate measures to restore its viability. Besides the fact that all three banks were considerably undercapitalised, they faced, as a result of deposit outflows, a severe liquidity problem and an increased risk of defaulting on their depositors.

The solution

Given the global financial turmoil and the adverse fiscal and economic conditions in Greece, the public's trust in the stability and smooth operation of the financial system would be considerably impaired in the event of deposit losses. Therefore, the Bank of Greece sought, through a tender procedure, a transferee for the total of deposits of the three cooperative banks and not just for the guaranteed part. Upon completion of the procedure, the authorisations of the three cooperative banks were withdrawn, the banks were put under special liquidation status, deposits were transferred to the National Bank of Greece and thus depositors' trust in the financial system and its stability was secured.

8.7.4 Implementation of resolution measures on ATEbank

In July 2012 resolution measures were implemented on the Agricultural Bank of Greece (ATEbank). This occurred in the context of the Memorandum of Understanding (which forms part of Greek legislation following its ratification by Law 4046/2012), and ahead of the deadline set by the European Central Bank regarding the cutting-off of liquidity provision to ATEbank.[15]

The problem

ATEbank suffered from several chronic problems, which were exacerbated by the intensification of the crisis. In particular:

- the bank was significantly undercapitalised;
- there was no prospect of a recapitalisation by its main shareholder; and
- the bank was non-viable, as, due to its close entanglement with the State, it exhibited a weak risk management system, chronic structural problems, low productivity, deficiencies in its organisational and operational structure, as well as

15 For details, see the Appendix: "Testimony of the Governor before the Hellenic Parliament's Standing Committee on Economic Affairs", 3 August 2012.

assets of poor quality, while, most importantly, despite repeated capital injections from the State, it still did not meet the capital requirements.

Proof of its vulnerabilities was the fact that in the latest EU-wide stress testing exercise conducted in 2011 it had ranked last among 91 banks at the European level. It should be noted that the capital injections in ATEbank, which reached a cumulative total of €4 billion over the 1997-2011 period, and a considerably higher amount in today's prices, weighed on the State with cumulative losses of €4.7 billion. An immediate recapitalisation would require €5 billion to cover these losses and keep the bank in business. In other words, the total burden for Greek taxpayers would come to about €10 billion.

The surge in non-performing loans in recent years and the negative impact of the PSI weighed further on the bank's financial position. In 2011, its capital adequacy ratio fell short of the minimum 8% threshold. Following the PSI, this ratio dropped to -26% at the end of 2011, as the bank's own funds turned out negative (-€3 billion). If a recapitalisation of ATEbank were feasible, it would require €5 billion, an amount which, as already mentioned, the Greek State —its main shareholder— was not willing to contribute.

Therefore, if the resolution measures were not implemented, the European Central Bank would call in the already extended liquidity amounting to €6.3 billion. On the other hand, the cutting-off of liquidity provision from the ECB would mean the immediate shutdown of ATEbank. Over 5,000 people would lose their jobs, while an amount of €14 billion would have to be found to compensate depositors and another €6.3 billion to return liquidity obtained from the Eurosystem, making a total of over €20 billion.

As a result of all these weaknesses and its long-standing poor performance, some representatives of the Troika were of the view that ATEbank should be closed. The view of the Bank of Greece (and of the Greek government as well) was that a shutdown had to be avoided by all means, mostly due to systemic stability and cost considerations.

The solution

The Bank of Greece, on its part, pressed for a viable solution. This was anyway provided for in the latest Memorandum. Indeed, a commitment was undertaken to conduct a special study on ATEbank. In this context, the following four alternative scenarios were considered by the Greek government, the Bank of Greece and the Troika:

First: Shutdown and liquidation of the bank.

Second: Recapitalisation and radical overhaul of the bank, i.e. a restructuring going far beyond the plan being implemented until recently.

Third: Re-establishing the bank as an interim credit institution, with a view to selling it within a short time-frame.

Fourth: Transfer of the bank's sound part to another bank.

It is clear that the shutdown of the bank was an extreme and undesirable solution. This would translate into thousands of jobs lost and would also imply the closing of its branch network and thus the bank's inability to serve its customers. Lastly, the financial costs would be huge, as an amount of over €20 billion would be required on the spot. Also, a recapitalisation of ATEbank was not a feasible option.

Thus, only two options remained. Namely:

- either the transfer of the bank's sound part to another credit institution, if a prospective acquirer could be found;
- or re-establishing the bank as an interim credit institution and selling it within a short time-frame.

It should also be noted that two independent studies showed that the preferable option should clearly be the transfer of the bank's sound assets and liabilities. These studies were conducted by the international consulting firms Oliver Wyman on behalf of the ECB, and Alvarez & Marsal on behalf of the Greek government (HRADF – Hellenic Republic Asset Development Fund).

As a matter of fact, the latter study mentions that the pair of banks that ensured the highest synergies would be that of Piraeus Bank and ATEbank.

Furthermore, a special study, conducted by the Bank of Greece in collaboration with Bain & Company and thoroughly discussed with the Troika, also concluded that the option of the transfer of sound assets was the best, for the following reasons:

First, it was a sustainable solution compared with the establishment of a bridge bank, for which a private buyer would have to be found soon.

Second, unlike the bridge bank option, it would not necessarily require a drastic downsizing of its staff and branch network.

Third, it would speed up the adjustment of corporate culture and upgrade the efficiency of the transferred sound part.

Fourth, it entailed the lowest possible final costs, taking also into account the gains in future profits as a result of synergies.

Fifth, it reduced the risk of additional recapitalisation being needed in the future; such a need would arise sooner or later under the bridge bank option, if a prospective buyer could not be found early enough.

Finally, while the financial cost appeared, *prima facie*, to be the same under both options, the actual final cost was estimated to be lower under the transfer option. This was so because the benefits from the synergies to be achieved would be reaped

primarily by Piraeus Bank's main shareholder, which is no other than the Greek government, through the HFSF.

The Bank of Greece followed all the procedures provided for in the legal framework. More specifically, under Article 63D of Law 3601/2007 concerning the execution of an order of transfer, the Bank of Greece applied an informal and confidential tender procedure, as stipulated by law.

As regards the procedure followed, in early May 2012 the Bank of Greece invited the four largest Greek banks (National Bank of Greece, Alpha Bank, Eurobank and Piraeus Bank), which were considered to be systemically important and were recapitalised by the HFSF, to consider acquiring ATEbank's sound assets and liabilities. Meanwhile, the Bank assigned two international investment banks to explore any interest from foreign investors. Those investment banks informed the Bank of Greece that no such interest was expressed from abroad, while the four domestic initially expressed interest in examining their options further and, after signing a non-disclosure agreement, received all necessary information from the Bank of Greece.

Any of the four banks which intended to submit a binding proposal to acquire ATEbank's transferred assets had to notify in advance the HFSF of its intention in order to receive its approval. This obligation stemmed from the terms and conditions of the presubscription agreement, which all of the above banks had signed with the HFSF. Finally, on 9 July 2012 only two Greek banks, Eurobank and Piraeus Bank, submitted their proposals to the HFSF for approval. On 24 July 2012 Eurobank stated it was no longer interested, thereby leaving only one interested party.

The HFSF evaluated Piraeus Bank's proposal, examining the synergies achieved and the transferee credit institution's ability to integrate ATEbank's assets, personnel and branch network. Following the evaluation, the HFSF determined that all criteria were met and forwarded the proposal to the European Commission's GD Competition for approval. Once the latter's approval was obtained, the HFSF greenlighted Piraeus Bank to submit a binding bid to the Bank of Greece to acquire ATEbank's sound assets.

8.7.5 Implementation of measures on TT Hellenic Postbank

In January 2013, measures were put into effect for the resolution of TT Hellenic Postbank through the establishment of an interim credit institution.[16]

16 See the Appendix: "Testimony of the Governor of the Bank of Greece during a meeting of the Hellenic Parliament's Standing Committee on Economic Affairs", 16 January 2014.

The problem

TT Hellenic Postbank had long been dependent on the Greek state; as a result, among other things, its management lacked continuity and the state influenced its business operation and strategy. It is indicative that over the 2006-2010 period, i.e. when operating as a bank (it previously operated as a specialised credit institution), TT Hellenic Postbank showed particularly low profitability and continuously rising operating expenses, thus making it highly unlikely that its profits in the coming years could more than offset its operating expenses and losses on its investment and loan portfolios. By way of indication, it is pointed out that the ratio of operating expenses (excluding provisions) to operating income was on average roughly 14 percentage points higher (i.e. worse) than the sector's average, while the NPL ratio had come close to the sector's average already since end-2011 and half of NPLs were past due over a year and were thus considered highly unlikely to be recovered. This was so despite the fact that TT Hellenic Postbank had been operating as a credit institution for just a few years, its ratio of loans-to-assets was low and the bank was in a privileged position in terms of recovering some of its claims, since instalments on mortgage loans to civil servants were recovered directly from borrowers' monthly salaries. According to recent data, a significant number of the bank's borrowers were calling for the contractual term on withholding mortgage loan instalments from monthly salaries to be removed, whatever this might entail in terms of loan servicing delays. As regards capital adequacy, TT Hellenic Postbank recorded a high capital adequacy ratio in the pre-PSI conjuncture thanks to aid from the Greek State, as it received capital injections of roughly €750 million in 2009 (through a €526 million share capital increase and a €225 million issuance of preferred shares). The failure to generate internal capital, the deterioration in the quality of its loan portfolio and the impact of the PSI resulted in capital needs of €3.74 billion at end-2011 and a capital adequacy ratio of -32%. The Bank of Greece had repeatedly requested information from TT Hellenic Postbank's management on the way in which it would meet its capital needs, but it was evident that the shareholders were completely unable to meet the above capital needs. Indeed, even if the above capital needs were met, TT Hellenic Postbank would soon need a new capital injection as a result of its failure to generate internal capital.

The solution

In line with past experience from bank resolutions, including most recently the case of ATEbank, all the alternative options were considered and, in the end, the solution opted for was the one which would prioritise minimum cost and maximum synergies and concurrently safeguard financial stability and all deposits. As it was impossible for the major shareholders to recapitalise TT Hellenic Postbank

and the HFSF was prohibited from recapitalising it because the bank was considered non-viable, the options of transferring assets/liabilities to another bank and establishing a bridge bank were examined. It should be pointed out that profitability had been estimated as part of the assessment of TT Hellenic Postbank's viability, without factoring in PSI-related losses. This was done in order to sterilise the impact from the PSI, as such extraordinary and one-off losses were not associated with individual banks' internal operational structure and structural efficiency. In fact, this methodology favoured banks —such as TT Hellenic Postbank— with government bond holdings representing a large part of their total assets.

Given that neither domestic nor foreign credit institutions showed any interest in purchasing TT Hellenic Postbank's assets, the establishment of an interim credit institution was the only option. The alternative would be the liquidation of TT Hellenic Postbank, but this would have been disastrous for Greece's financial stability and for Greek depositors.

8.7.6 The elimination of the risk of contagion from the Cypriot to the Greek financial system – other cases of bank resolution

Following Eurogroup's decision of 15 March 2013 on Cyprus, the Bank of Greece played a decisive role in safeguarding financial stability in Greece. In concert with the Greek authorities, the Cyprus government, the Central Bank of Cyprus and Greek credit institutions, it ensured the smooth transfer of the assets and liabilities of Cypriot banks' branches in Greece to a Greek bank through a tendering process.

The highly complex task of spinning off the Greek branches of distressed Cypriot banks and transferring their assets and liabilities to a domestic bank was successfully completed in no time, thereby ensuring that:

(a) deposits with Greek branches of Cypriot banks were fully excluded from the bail-in of depositors in Cyprus;

(b) the former Cypriot bank branches operating in Greece continue to serve their customers smoothly; and, above all,

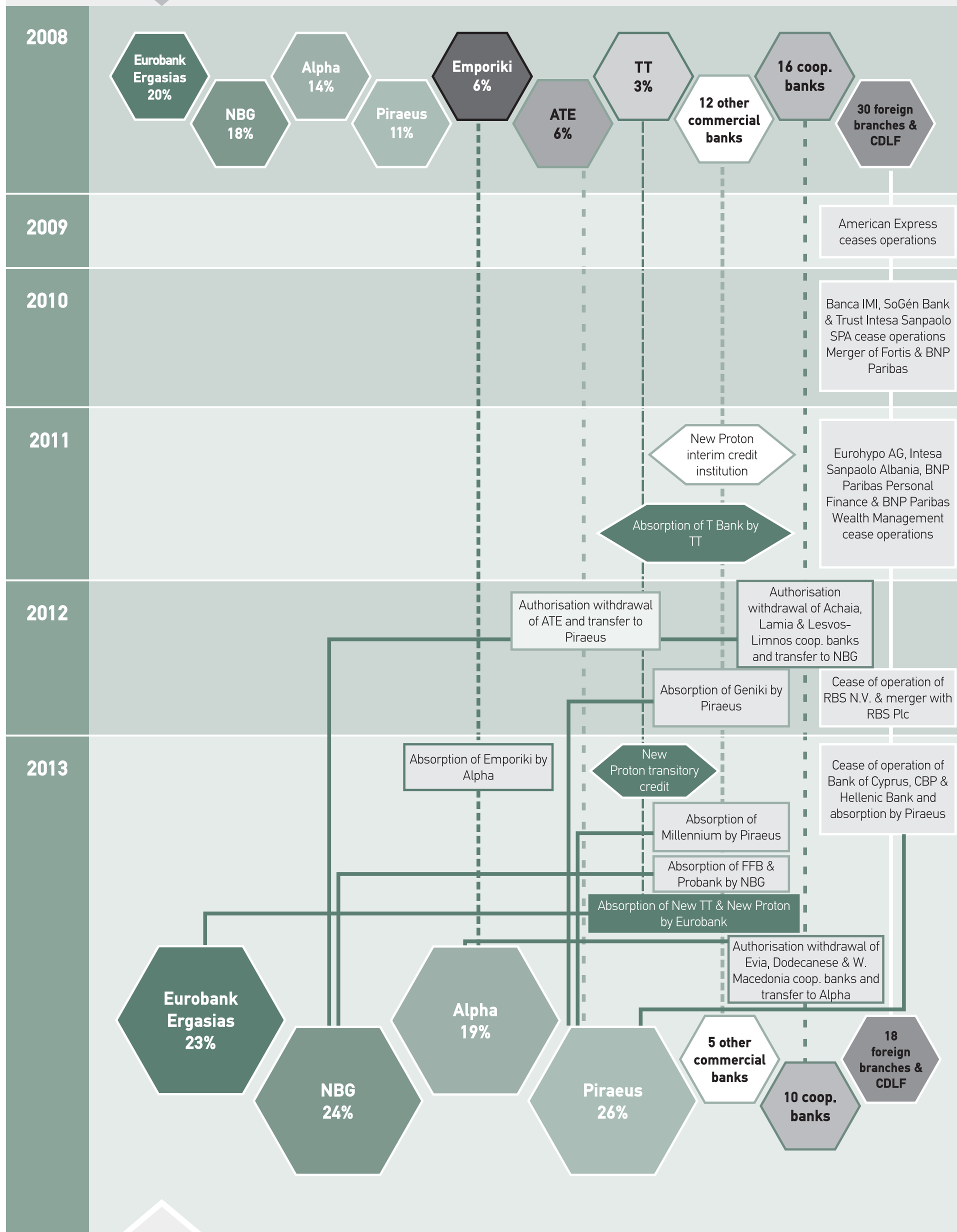
(c) the risk of contagion from the Cypriot to the Greek banking system was nipped in the bud.

* * *

As regards *other changes in the banking landscape* which took place in the course of 2013, two banks —FBB and Probank— were not in a position to raise the capital they needed from the market and were thus resolved. Their sound assets were acquired by the National Bank of Greece following a tendering procedure. Also, the

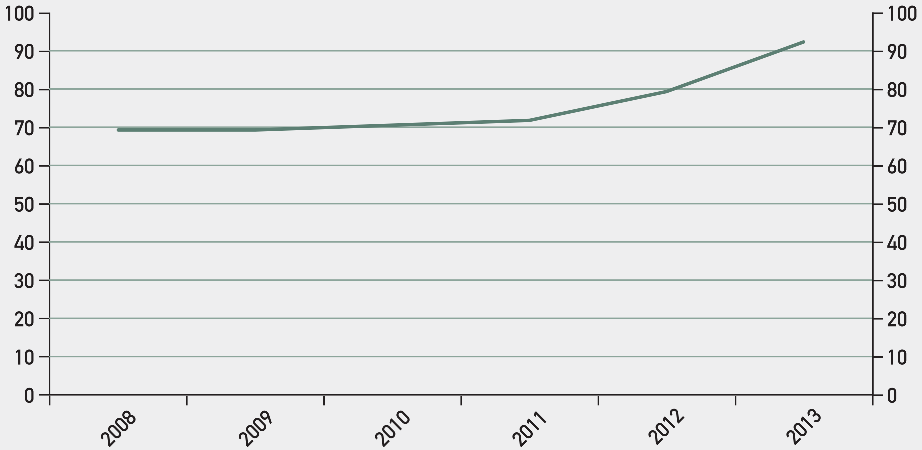
Chart 13 Evolution of the Greek banking system

Percentages refer to market shares on a solo basis



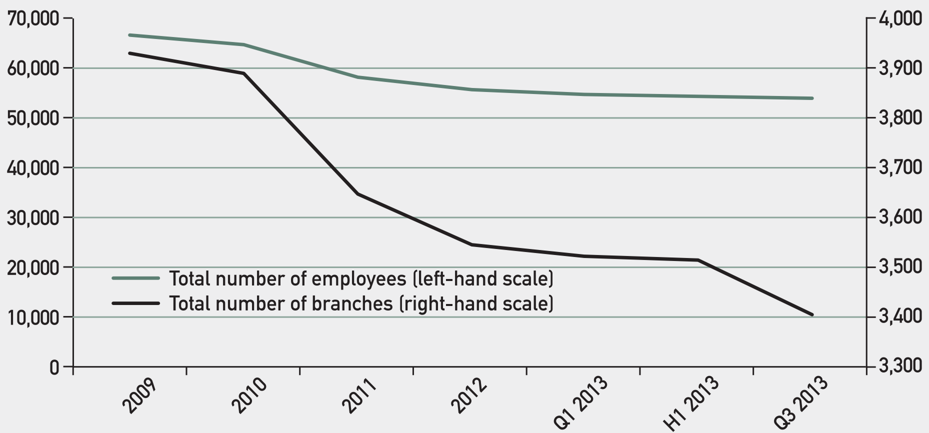
Source: Bank of Greece.

Chart 14 Concentration in the Greek banking system
Market shares of the five largest banks, percentages, 2008-2013



Source: Bank of Greece.

Chart 15 Employees and branches of commercial and cooperative banks
2009-2013



Source: Bank of Greece.

two interim credit institutions (New TT Hellenic Postbank and New Proton Bank) were acquired by Eurobank following a tendering procedure. Furthermore, at end-2013, after the three deadlines for the recapitalisation of the Cooperative Banks of Western Macedonia, Dodecanese and Evia had lapsed, the Bank of Greece, bearing in mind the protection of depositors, deemed it necessary to withdraw their authorisations and transfer all deposits to Alpha Bank. It should be noted that the three cooperative banks were not only faced with capital shortfall, but also with bad-quality loan portfolios and liquidity shortage, at a time when the overall liquidity conditions had improved.

As a result of the processes analysed above (and outlined in Chart 13), a new banking landscape emerged, with fewer and stronger banks.

Inevitably, the degree of concentration increased (see Chart 14), but the presence of another five commercial banks, cooperative banks and branches of foreign banks (see Chart 13) guaranteed the necessary level of competition.

Of course, the benefits from the consolidation of the banking sector in terms of economies of scale had started to become visible (see Chart 15).

Overall, the total cost of resolution and recapitalisation of credit institutions in Greece over the 2011-2013 period came to roughly €42 billion (see Table 23).

8.8 The day after for the banking system – designing a sustainable long-term business model

8.8.1 Key priorities for action

Bolstering banks' capital adequacy was the first substantial step towards restoring confidence in the banking system, which is a prerequisite for improving liquidity conditions and freeing up resources. These resources could then be targeted to activities that will strengthen export orientation, on the basis of the new production model, towards which the Greek economy must turn. By way of illustration, the progress made and the state-of-play in early April 2014 were presented by Danièle Nouy, Chair of the Supervisory Board of the Single Supervisory Mechanism, as follows: *"Incredible progress has been achieved in terms of restructuring and consolidating Greek banks. My colleagues at the Bank of Greece have done a great job in challenging times and I am certain that the situation of Greek banks has improved significantly.*

Greece's four systemic banks will be subject to the ECB's comprehensive assessment, just like all other large European banks. It is important to note that Greek banks are

Table 23 Bank resolution and recapitalisation costs in Greece, 2011-2013, in euro

		No.	Credit institution	Resolution date	Transferee/ acquirer	Funds injected by the HFSF: Funding gap[1]	Funds injected by the HFSF: To the transferee/ acquirer to meet capital needs	Funds injected by the HFSF: Capital injections	Funds injected by the HFSF: Total resolution costs
Non-core banks	*Interim credit institutions*[4]	1	Proton Bank[2]	9.10.2011		1,121,621,860		910,000,000	2,031,621,860
		2	T Bank[3]	17.12.2011	Hellenic Postbank	676,956,514			676,956,514
		3	Hellenic Postbank	18.01.2013		3,732,554,000		500,000,000	4,232,554,000
	Order of transfer	4	Coop. Bank of Lesvos-Limnos	23.03.2012	National Bank of Greece	55,516,733			55,516,733
		5	Coop. Bank of Achaia	23.03.2012	National Bank of Greece	209,473,992			209,473,992
		6	Coop. Bank of Lamia	23.03.2012	National Bank of Greece	55,493,756			55,493,756
		7	ATEBank	27.07.2012	Piraeus Bank	7,470,717,000	570,000,000		8,040,717,000
		8	Greek branches of Cypriot banks	22.03.2013	Piraeus Bank		524,000,000		524,000,000
		9	First Business Bank[5]	10.05.2013	National Bank of Greece	456,970,455	95,000,000		551,970,455
		10	Probank[5]	26.07.2013	National Bank of Greece	562,733,502	233,000,000		795,733,502
		11	Coop. Bank of W. Macedonia	8.12.2013	Alpha Bank	PENDING			PENDING
		12	Coop. Bank of Evia	8.12.2013	Alpha Bank	PENDING			PENDING
		13	Coop. Bank of Dodecanese	8.12.2013	Alpha Bank	PENDING			PENDING
Total costs for the resolution of non-core banks[6]						14,768,981,753	1,422,000,000	1,410,000,000	**17,600,981,753**
Core banks		*No.*	*Credit institution*	*Recapitalisation date*			*Capital needs according to BoG*	*Private investment*	*HFSF*
		1	National Bank of Greece	28.05.2012			9,756,000,000	1,079,000,000	8,677,000,000
		2	Piraeus Bank	28.05.2012			7,335,000,000	1,444,000,000	5,891,000,000
		3	Alpha Bank	28.05.2012			4,571,000,000	550,000,000	4,021,000,000
		4	Eurobank	28.05.2012			5,839,000,000	0	5,839,000,000
Total costs for the recapitalisation of core banks							27,501,000,000	3,073,000,000	**24,428,000,000**
Total costs for the resolution and recapitalisation of the banking sector[7]									**42,028,981,753**

1 The differential between the transferred assets and the transferred liabilities of banks under resolution.
2 The HFSF injected at first €250 million to the bank's initial capital. Subsequently, it provided €265 million for its share capital increase and, lastly, it contributed €395 million for its sale to Eurobank. The Hellenic Deposit and Investment Guarantee Fund (HDIGF) contributed €862 million to cover part of the initial funding gap.
3 The Hellenic Deposit and Investment Guarantee Fund (HDIGF) contributed €450 million to cover part of the initial funding gap.
4 On 2.7.2013 the acquisition of Proton Bank and TT Hellenic Postbank by Eurobank was announced. On 17.12.2011 the absorption of T Bank by TT Hellenic Postbank had taken place following an order of transfer.
5 Data concerning the necessary funds to meet capital requirements are provisional.
6 Costs include a provisional valuation from the resolution of the cooperative banks of Western Macedonia, Evia and Dodecanese, as well as provisional data from FBB's and Proton Bank's capital requirements.
7 Total costs include an amount of €1,312 million contributed by HDIGF to meet the funding gap in implementation of resolution measures at Proton Bank and T Bank. As a result, the HFSF has contributed an amount of €40,176 million for resolution and recapitalisation purposes over the 2011-2013 period.
Source: Bank of Greece, Resolution Unit.

now finding equity on the markets. I believe that all the efforts that have been undertaken until now are moving things in the right direction."[17]

The next crucial step was to design a sustainable business model in the long-term, by gradually reducing banks' reliance on central bank funding and creating the conditions for recurring and sound profitability. In this context, the Bank of Greece determined the key priorities for action, focusing on: (a) the rationalisation of operating costs and, more generally, higher internal capital generation via operating profits; (b) shedding of non-core business; (c) redesigning foreign business; (d) active management of troubled assets.

Particularly as regards the process of active loan portfolio management, the improved management of non-performing loans and proactive measures to prevent further non-performing loans from being accumulated are prerequisites for enhancing the supply of credit to the economy. In this regard, there is considerable room for improvement in current bank policies.

The Bank of Greece contributed by making proposals to banks on indicative actions in this direction, which could include:

- Procedures for the detection of loans in pre-arrears, so that pre-emptive action concerning potential loan servicing problems could be taken;
- A thorough assessment of the financial condition and repayment capacity of distressed borrowers, with a view to working out long-term viable forbearance options and minimising moral hazard;
- Better coordination with other lenders on the joint restructuring of loans extended to the same borrower;
- Qualitative as well as quantitative upgrading of NPL management units.

8.8.2 Updated diagnostic study on domestic banks' loan portfolios and stress test

In July 2013, the Bank of Greece commissioned the internationally reputed consulting firm BlackRock Solutions to carry out a diagnostic study of the loan portfolios of all Greek commercial banks as of 30 June 2013. This study included the following work streams:

– Asset quality review (AQR) of loan portfolio: Its aim was to assess the lending and credit monitoring policy and processes of each bank. The assessment was based, on the one hand, on interviews with bank officials and, on the other hand, a thorough analysis of representative and cross-sectional samples of loans. Furthermore,

17 Interview with Danièle Nouy, Chair of the Supervisory Board of the Single Supervisory Mechanism, published on Sunday, 6 April 2014, in the Greek newspaper *To Vima*.

for a sample of large corporate borrowers, BlackRock conducted a full appraisal of expected losses on each particular loan.

– Troubled asset review (TAR): The TAR work stream was aimed at examining the adequacy and appropriateness of systemic banks' lending policies and procedures to deal with troubled assets and, on the other hand, at developing monitoring tools for troubled assets and submitting proposals on improvement of the above policies and procedures.

– Credit loss projections (CLPs): The CLPs work stream was aimed at estimating CLPs on banks' loan portfolio, over a 3-year and loan-lifetime horizon, on the basis of two macroeconomic scenarios: a Baseline and an Adverse Scenario. The assessment was based on proprietary econometric models applied on loan-level data and took account of the findings of the QAR work stream. CLP is defined as the non-discounted loss of principal due to the (total or partial) non-repayment of loans, taking into account any amounts recovered from the sale of any relevant collateral. CLPs were estimated on a "when realised basis", net of existing PSI provisions.

– Foreign Loan Books (FLB) review: The FLB work stream consisted in a review of lending policies and processes of each bank's largest foreign subsidiaries and a reasonableness assessment of risk parameters (such as probability of default) per category of loans.

In comparison with the 2011 exercise, the 2013 diagnostic study had:

- a broader scope;
- a more complete dataset, which factored in historical ratings data on borrower behaviour patterns over a five-year period coinciding with the deepest economic recession in Greece, and
- an improved methodology, which resulted in a stricter credit risk measurement.

The new stress test was completed at end-2013. Following consultations with the Troika and given the need to integrate assumptions associated with the EU-wide stress testing exercise, which would be conducted by EBA in the course of 2014, its results were made public on 6 March 2014.[18] The stress test consisted of two components, based on which the assessment of banks' capital needs on a consolidated basis was updated:

- a diagnostic study of banks' loan portfolios, independently conducted by BlackRock, and

18 See http://www.bankofgreece.gr/Pages/en/Bank/News/PressReleases/DispItem.aspx?Item_ID=4547&List_ID=1af869f3-57fb-4de6-b9ae-bdfd83c66c95&Filter_by=DT; http://www.bankofgreece.gr/BogEkdoseis/2013%20Stress%20test%20of%20the%20Greek%20banking%20sector.pdf; http://www.bankofgreece.gr/BoGAttachments/Asset%20Quality%20Review%20and%20Credit%20Loss%20Projection%20Methodology%20-%20Prepared%20for%20the%20Bank%20of%20Greece%20-%20BlackRock%20Solutions.pdf.

- a conservative downward adjustment of the banks' internal capital generation which was projected by the banks' adjusted Business Plans.

As in the previous exercise of 2011, two scenarios were used, on the basis of assumptions regarding the evolution of key macroeconomic variables developed in association with the European Commission, European Central Bank and the International Monetary Fund. The aim of this exercise was to conduct a conservative assessment of the capital needs of all Greek commercial banks on a consolidated basis, in order to meet minimum Core Tier 1 target ratios for the June 2013-December 2016 period, i.e.:

- a Core Tier 1 ratio (CT1 ratio) target of 8% under the Baseline Scenario;
- a Core Tier 1 ratio (CT1 ratio) target of 5.5% under the Adverse Scenario;

These targets are in line with those of the EU-wide stress testing exercise to be conducted by EBA in 2014. More generally, the Bank of Greece's methodology was brought in line as much as possible with the approach of the two above-mentioned exercises based on publicly available information in February 2014.

Moreover, adopting a conservative stance, the Bank of Greece required banks to have sufficient provisions by the end of 2016 to cover:

- at least 95% of loan-lifetime losses as estimated by BlackRock under the Baseline Scenario and 85% under the Adverse Scenario, and
- at least 52% of the NPLs as estimated by BlackRock for the end of 2016 in the Baseline Scenario only.

The Bank of Greece methodology incorporated the three-and-a-half-year CLPs on a "when realised basis". In combination with the aforementioned requirements, this resulted in frontloaded coverage in three-and-a-half years of the lifetime expected loan losses.

In addition, the Bank of Greece conservatively adjusted the key drivers of pre-provision profitability associated with internal capital generation and imposed floors on the evolution of Risk Weighted Assets (RWA) to ensure that banks' Restructuring Plans do not underestimate their risk exposure. The Bank of Greece also took into account potential capital needs stemming from the recent stress test of banks' insurance subsidiaries.

The Baseline Scenario was used to determine the capital needs of each bank in alignment with what would happen in the EBA 2014 EU-wide stress test. The resulting capital needs for all Greek commercial banks were estimated under the Baseline Scenario at €6.4 billion. The Bank of Greece officially requested banks to submit their capital plans by mid-April 2014 to cover the identified capital needs in the Baseline Scenario.

APPENDIX

1 Testimony of Governor George Provopoulos before the Hellenic Parliament's Standing Committee on Economic Affairs regarding the resolution of ATEbank

3 August 2012

Ladies and gentlemen Members of Parliament,

Last Friday, the Bank of Greece implemented resolution measures in the Agricultural Bank of Greece (ATEbank), as provided for by legislation (Laws 3601/2007 and 4021/2011).

This occurred in the framework of the Memorandum of Understanding (which forms part of Greek legislation following its ratification by Law 4046/2012), and earlier than the deadline set by the European Central Bank.

The sound part of ATEbank was transferred to Piraeus Bank. The other assets and liabilities remain with the so-called "bad bank", to be liquidated or developed by the Greek government, as appropriate.

These actions were fully in line with the provisions of the law, and the prescribed procedures were followed to the letter.

I would like to point out that the Governing Council of the European Central Bank had decided that after the end of July it would no longer be able to provide liquidity to ATEbank, because the bank was:

- substantially undercapitalised;
- non-viable; and
- without a prospect of a recapitalisation by its main shareholder.

Therefore, if the resolution measures were not implemented, the European Central Bank would call in already provided liquidity amounting to €6.3 billion.

However, the cutting-off of liquidity provision from the ECB would mean the immediate shutdown of ATEbank. Over 5,000 people would lose their jobs, while an amount of €14 billion would have to be found to compensate depositors and another €6.3 billion to return liquidity obtained from the Eurosystem, making a total of over €20 billion.

What were the alternatives?

ATEbank was not viable. This is clear, as:

- it suffered from chronic structural problems;
- it manifested low productivity and deficiencies in its organisational and operational structure;
- its assets were of poor quality, as a result of its close entanglement with the State and weaknesses in its risk management framework. This often led to lending policies that overlooked banking business criteria; and
- more importantly, despite repeated capital injections from the State, ATEbank still faced undercapitalisation.

A proof of its major weaknesses was the fact that it ranked last among 91 large banks in the EU-wide stress testing exercise conducted by the European Banking Authority in 2011.

Indeed, in view of all these weaknesses and the bank's long-standing poor performance, some representatives of the Troika were of the view that ATEbank should be closed.

The view of the Bank of Greece (and of the Greek government as well) was that such a solution should be avoided by all means, particularly because of systemic stability and cost considerations.

For this reason, the BoG insisted convincingly in favour of exploring a more appropriate line of action. Thus, for some time, ATEbank was allowed to implement a restructuring plan which was, in any event, necessary as part of the bank's obligations stemming from its financing under the provisions of Law 3723/2008.

Thereafter, economic conditions deteriorated dramatically. The surge in non-performing loans and the impact of the PSI weighed further on the bank's financial position. In the course of 2011, its capital adequacy ratio fell short of the minimum 8% threshold. Following the PSI, this ratio dropped to -26% at the end of 2011, as the bank's own funds turned out negative (-€3 billion).

Assuming that a recapitalisation of ATEbank was feasible, it would require €5 billion. It is important to note that a large part of those capital needs did not arise from the PSI, as some argue, but from the bank's loan portfolio.

During the last fifteen years, ATEbank received repeated capital injections, cumulatively totalling €4 billion. At today's prices, this amount actually exceeds €5 billion. Over the same period, the bank's weak performance brought about losses totalling €4.9 billion, which means that Greek taxpayers were not only faced with negative returns on their money, but also that they would have to pay another €5 billion to cover the losses and keep the bank in business. The total burden for Greek taxpayers would thus come to about €10 billion.

Today, when the country, through painful sacrifices, is struggling to secure €11.5 billion, one can realize the significance of a loss of a comparable size in the case of the Agricultural Bank of Greece.

This bank, by the way, has ceased being "agricultural", as only 13% of its lending goes to farmers and agricultural cooperatives.

Let me also add that, even excluding financial year 2011, which was marked by the exceptional, non-recurrent impact of the PSI, ATEbank's cumulative profits over the 1997-2010 period barely reached €190 million. That is, in "good times" and with all the generous capital injections of €4 billion thereafter, the bank's financial results were still marginally positive, virtually nil.

Over the same period, the National Bank of Greece made profits of €5.3 billion, Alpha Bank €4 billion, Eurobank €3.5 billion and Piraeus Bank €1.7 billion. This also shows ATEbank's enormous profitability gap versus those four other banks.

Against this background, could ATEbank still be considered a "source of prosperity for the Greek people"?

Let me provide some more examples to illustrate my point:

- ATEbank had invested €1.2 billion in its subsidiaries; today, after repeated write-downs and write-offs, these subsidiaries make up a total net worth of a mere €156 million. That is, the bank lost over €1 billion, or 85% of the total value of its subsidiaries.
- Despite the obvious weaknesses of its risk management framework, ATEbank invested massively in high-risk financial products, with losses from transactions in derivatives amounting to €285 million over the 2009-2011 period.
- As a result of its lax lending policy, ATEbank wrote off non-performing loans totalling €2.5 billion over the past ten years.

The First Review Under the Stand-By Arrangement of September 2010 explicitly states that "ATEbank has an established history of extending loans that are not repaid and are eventually written-off". All these funds that vanished into thin air were tax-

payers' money. And everyone understands that, in the present adverse circumstances, these funds could have been used much more efficiently from a social point of view.

What were the feasible options?

The Bank of Greece, on its part, pressed for a viable solution. This was anyway provided for in the latest Memorandum. Indeed, a commitment was undertaken to conduct a special study on ATEbank. In this context, the following four alternative scenarios were assessed by the Greek government, the Bank of Greece and the Troika:

First: Shutdown and liquidation of the bank.

Second: Recapitalisation and radical overhaul of the bank, i.e. a restructuring going far beyond the plan that was being implemented until recently.

Third: Re-establishing the bank as an interim credit institution, with a view to selling it within a short time-frame.

Fourth: Transfer of the bank's sound part to another bank.

It is clear that the shutdown of the bank was an extreme and undesirable solution. This would translate into thousands of jobs lost and would also imply the closing of its branch network and thus the bank's inability to serve its customers. Lastly, the financial costs would be huge, as an amount of over €20 billion would be required right away.

A recapitalisation of ATEbank was not a feasible option. Since the bank was not viable, it was, under the Memorandum, ineligible for recapitalisation by the Hellenic Financial Stability Fund.

This left us with only two options. Namely:

- either the transfer of the bank's sound part to another credit institution, if a prospective acquirer could be found;
- or re-establishing the bank as an interim credit institution and selling it within a short time-frame.

Before moving on to discuss how the Bank of Greece evaluated the two options, I would like to point out that two independent studies showed that the preferable option should clearly be the transfer of the bank's sound assets and liabilities. These studies were conducted by the international consulting firms:

- Oliver Wyman on behalf of the ECB, and
- Alvarez & Marsal on behalf of the Greek government (HRADF – Hellenic Republic Asset Development Fund).

As a matter of fact, the latter study mentions that the pair of banks that ensured the highest synergies would be that of Piraeus Bank and ATEbank.

The special study conducted by the Bank of Greece in collaboration with Bain & Company and thoroughly discussed with the Troika also concluded that the option of the transfer of sound assets was the best, for the following reasons:

First, it is a permanent/sustainable solution, compared with the establishment of a bridge bank, for which a private buyer would have to be found very soon.

Second, unlike the bridge bank option, it does not necessarily require a drastic downsizing of its staff and branch network.

Third, it speeds up the adjustment of corporate culture and upgrades the efficiency of the transferred sound part.

Fourth, it entails the lowest final cost, taking also into account that future profitability will be bolstered by synergies.

Fifth, it entails a lower risk of additional recapitalisation being needed in the future; such need would arise sooner or later under the bridge bank option, if a prospective buyer could not be found early enough.

Sixth, while the financial cost appears, *prima facie*, to be the same under both options, the true final cost will be lower under the transfer option. This is so because the benefits from the synergies to be achieved would be reaped primarily by Piraeus Bank's main shareholder, which is no other than the Greek government, through the HFSF.

The transfer procedures were implemented in full compliance with the law and in a transparent manner.

The transfer of the bank's sound part took place on the basis of a provisional valuation, as stipulated by law.

To ensure maximum transparency, the Bank of Greece used the study that it had commissioned to two international auditing firms: Ernst & Young and Grant Thornton, while also taking into account the findings of the diagnostic study conducted by BlackRock.

On the basis of the provisional valuation, the funding gap (i.e. the difference between assets and liabilities) was estimated at €6.67 billion. Covering this amount fully protects the deposits transferred to the acquiring bank; indeed, this gap is covered by the HFSF and will be eventually reduced by about €2.5 billion, i.e. by the expected proceeds from the liquidation of the bank's unsound assets.

The sound part of ATEbank consists primarily of:

- performing loans;
- participating interests in financial institutions (excluding leasing companies);
- the securities portfolio;

- customer deposits and liabilities to the Eurosystem.

Certain holdings of ATEbank, such as the Hellenic Sugar Industry, SEKAP Greek Cooperative Cigarette Manufacturing Company, Dodoni S.A., etc. were designated as non-transferred assets; these will be developed by the Greek government. Besides, the government will work towards a solution for the non-performing loans that are collateralised with farmland.

Let me point out that similar resolution measures have been envisaged in other European countries as well (e.g. in the UK, Spain, Germany, Denmark). Furthermore, the European Commission released a couple of months ago a proposal for a Directive in the same vein. The proposed Directive will come into force by the end of this year and will be binding for all Member States of the European Union.

In Greece, the government (which has the legislative initiative) deemed necessary to put a bank resolution framework in place ahead of the adoption of the Directive, so that it can be applied to deal with problems in the domestic banking sector.

Taking note of all the above, in early May the Bank of Greece invited the four largest Greek banks (National Bank of Greece, Alpha Bank, Eurobank and Piraeus Bank) to consider acquiring ATEbank's sound assets and liabilities. Meanwhile, the Bank assigned two international investment firms to explore any interest from foreign investors.

No such interest was expressed from abroad. The four domestic banks requested to examine the dossier. On 9 July two of them submitted their proposals to the HFSF for approval. On 24 July one of them stated it was no longer interested. Piraeus Bank submitted a binding proposal on 27 July.

The HFSF evaluated Piraeus Bank's proposal and determined that all criteria were met. Once the approval of the European Commission's DG Competition was obtained, the HFSF greenlighted Piraeus Bank to submit a binding bid to the Bank of Greece. The price quoted in Piraeus Bank's bid was €95 million, which would accrue to the "bad bank".

Evaluation of the bid

The evaluation of the only bid took into account the potential synergies and the medium-term viability of the new entity.

On the basis of a study conducted on behalf of Piraeus Bank, synergies were estimated at €155 million after taxes for the first three years and at €155 million for each subsequent year.

This means that, since there are considerable synergies for Piraeus Bank, the Greek government, i.e. its main shareholder, will be able to recover the funds it has injected through the HFSF much sooner.

I would like to address certain comments that have been made on the transparency of the procedure followed. By definition, the transfer of an ailing bank should take place in confidentiality conditions, in order to avoid panic among depositors which would have negative repercussions on the economy and society as a whole. It was precisely this panic that we sought to avert by an early implementation of resolution measures. Besides, the law is perfectly clear on that matter and establishes the secrecy of the procedure, providing for high financial penalties in case of non-compliance.

To summarise:

First, ATEbank was not viable based on a number of supervisory and business criteria. This is corroborated by its poor track record.

Second, we strictly complied with the applicable legislation.

Third, closing ATEbank would add thousands to the number of jobless, further raising the rate of unemployment. Over €20 billion would be needed for the compensation of depositors and the return of Eurosystem financing. Systemic stability, which we have so far succeeded in safeguarding, would be shaken.

Fourth, the option that was preferred was the best, for depositors, for the bank's staff, for the Greek government due to the resulting synergies, for the stability and soundness of the banking system.

Therefore, we had no other choice than this option, which is the least costly for taxpayers. It is the only truly viable solution. Moreover, it contributes to the restructuring and strengthening of the country's banking system, which is currently under way.

Thank you for your attention.

2 Statement of Governor George Provopoulos regarding TT Hellenic Postbank during a meeting of the Hellenic Parliament's Standing Committee on Economic Affairs discussing the Bank of Greece's *Monetary Policy Interim Report 2013*

16 January 2014

I will describe the Bank of Greece's supervisory actions on the issue of TT Hellenic Postbank, starting from 2006, when TT Hellenic Postbank was licensed as a credit institution, in view of its listing on the Athens Exchange. The license was granted on the basis of a specific business plan, according to which the bank would engage in retail banking operations only. The BoG specified that, if TT Hellenic Postbank intended to expand its operations beyond retail credit, it would be required to notify the Bank of Greece in advance, enabling it to assess the need for any additional special terms.

Given that TT Hellenic Postbank operated as a public agency until 2006 and its sole banking products were deposit accounts and low-risk mortgage loans to civil servants, its Internal Audit System was not adapted to deal with more specialised activities of wholesale or corporate banking. In 2006, the BoG conducted two on-site inspections, which identified shortcomings in TT Hellenic Postbank's IT systems and corporate governance. As a result, the BoG raised the bank's minimum capital adequacy ratio to 10%, compared with the standard 8% ratio applicable to all other banks.

In 2007 and 2008 new on-site inspections were carried out.

When I assumed my duties as Governor of the Bank of Greece in 2008, we required the Postbank to assign a higher risk weight to its placements in complex investment products (which it had effected in the meantime). We also required the bank to increase its capital.

By early 2009, we found out that TT Hellenic Postbank had engaged in corporate financing without prior notification of the BoG on such change in its business plan. In April 2009 (by our letter 868/13.4.2009), we prohibited TT Hellenic Postbank from extending any further corporate credit until it put appropriate IT and risk management systems in place. In July 2009, TT Hellenic Postbank informed the BoG of the corrective measures it would take and of its intention to expand into corporate banking. In October 2009 (letter 5200/21.10.2009), we indicated that the planned expansion would be conditional on an on-site inspection by the BoG to ascertain the effectiveness of the corrective measures. The subsequent inspection identified deficiencies and shortcomings.

In 2010, as a follow-up to the inspection, a restriction was imposed (letter 5107/14.4.2010) on the bank's lending policy, whereby business loans could only be extended to corporations with a high credit rating or as part of syndicated loans.

In 2011, BlackRock Solutions conducted a diagnostic exercise, which assessed banks' lending practices and loan portfolio quality and estimated expected credit losses.

The exercise showed that the Credit Loss Projection (CLP) on TT Hellenic Postbank's total loan portfolio was 7%. At first glance, this figure may appear low. However, it can be explained by the fact that, first, TT Hellenic Postbank had a sizeable portfolio of mortgage loans to civil servants, which were recovered by regular deductions from the borrowers' monthly salaries and, second, a large number of loans carried a guarantee of the Greek State. Regarding the corporate loan portfolio, however, the Credit Loss Projection (CLP) was estimated at 33.2%. This figure was considered particularly elevated, not only because it was much higher than the corresponding percentage for core (i.e. systemic) banks, but also because it had increased to such a level in a short time, as it reflected loans that TT Hellenic Postbank had started to grant only in late 2008 and which had not matured. Indeed, BlackRock confirmed the findings of the on-site inspections conducted by the BoG, by characterising TT Hellenic Postbank's corporate lending policy as "aggressive". It is clear that credit losses on corporate loans would have grown further, had the BoG not imposed the abovementioned restrictions.

In late 2012 the BoG conducted another inspection, as a result of which questions arose concerning certain loans. As we ought to, we advised the Anti-Money Laundering Authority on the matter.

The AML Authority, based on our report, but possibly also on information collected in the context of its own independent investigation, forwarded its findings to the Public Prosecutor of the Athens Court of First Instance. We know the developments that followed.

Therefore, the BoG did what it had to do. Having placed TT Hellenic Postbank under close monitoring, it notified the competent authorities as soon as it detected unusual movements and made all its findings available to them. The evaluation of these findings is now up to the judicial authorities.

Let me take this opportunity to counter an assertion that is, or rather was, often made, i.e. that TT Hellenic Postbank was an exemplary bank and only started to face problems following the PSI. This assertion is refuted by the facts.

TT Hellenic Postbank had not shown any notable profits before the PSI either. For instance, in its five years of operation as a bank between 2006 and 2010, its profits were marginally positive and its return on equity (ROE) was lower than one half of the average for the sector. It is worth noting that this occurred in a period when the

Greek State had made significant capital injections to TT Hellenic Postbank. This was actually the only reason why TT Hellenic Postbank showed a high capital adequacy ratio before the PSI, i.e. the support it received from the Greek State.

Given the low return on its loan portfolio and the continuously rising operating expenses, it was highly unlikely that its future profits could more than offset its operating expenses and losses on its loan and investment portfolios.

Let me also recall TT Hellenic Postbank's investments in complex derivatives. As a result of these exposures, TT Hellenic Postbank incurred substantial losses in the 2007-2008 period, rendering necessary a capital injection from the Greek State in 2009.

In light of all this, I imagine that there will be no questions as to why TT Hellenic Postbank was considered non-viable. Indeed, it was considered non-viable in the long term, in the sense that it could not continue to operate on a stand-alone basis and repay any state support it received within a reasonable stretch of time.

What I have summarily described shows that the BoG kept TT Hellenic Postbank under continuous and close monitoring and exhausted all the possibilities available under the institutional framework, in order to "push" this credit institution towards a positive direction.

The BoG cooperated with the judicial authorities and assisted their work in every way, as it had done in several similar cases in the past. Of course, the BoG cannot and should not substitute for judicial authorities, which will shed full light on the case and assess any remaining questions.

At this point, I should also clarify that the internationally applied regulatory requirements and standards for lending are not designed to ensure that banks assume zero risk when granting loans, given that the provision of credit inherently entails risk. Rather, they are aimed at ensuring that banks hold adequate funds and establish provisions to cover the risks they assume.

In any event, the BoG is not involved in banks' lending decisions as an informal pre-approving authority, as some seem to believe. The approval process is the exclusive responsibility of each bank's internal services and competent loan approval committees. Our job is to find out, through sample *ex post* checks, whether banks comply with the regulatory framework – which is essentially European!

* * *

In closing, I would like to point out that individual cases of bank loans, which have been brought before the courts, must not be used as an excuse for generalisations, which give the false impression of an unsound banking system. Such generalisations are not only unfounded, but also —and most importantly— dangerous. This is so because they undermine depositor confidence and cancel the potential

for financing the real economy. Particularly today when, due to the current economic circumstances, loan restructurings are on the daily agenda, the eventuality that a climate of fear might prevail among bank officials would have extremely detrimental effects. The truth is that the high NPL ratio is essentially the result of the deep recession, which caused a contraction of 25% in GDP and a soaring of the unemployment rate to unprecedented levels. Still, in this particularly adverse environment, the progress made so far with the banking system's recovery, restructuring and recapitalisation has been remarkable. And this is recognised internationally. It would be a crime to undermine financial stability with unfounded generalisations inspired by sensationalism.

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George Provopoulos, Governor of the BoG, and Jean-Claude Trichet, President of the ECB, during the visit of Prime Minister Costas Caramanlis and Foreign Minister Dora Bakoyannis at the ECB, Frankfurt, 17 October 2008

ECOFIN meeting, Nice – France, 12-13 September 2008

Governing Council of the ECB, Luxembourg, 1-2 July 2009

On the occasion of the Annual Shareholders' Meeting of the Bank of Greece, Athens, 15 April 2009

The Governor submits the Monetary Policy Interim Report to Dimitris Sioufas,
Speaker of the Hellenic Parliament, Athens, 8 October 2008

Prime Minister Costas Caramanlis and Economy and Finance Minister George Alogoskoufis
at the Bank of Greece, Athens, 22 September 2008

The Governor visits Prime Minister Costas Caramanlis at the Maximos Mansion, Athens, 2 December 2008

During a London School of Economics conference at the Bank of Greece, with Lucas Papademos, Vice-President of the ECB, and Ewald Nowotny, Governor of the National Bank of Austria, Athens, 27 May 2009

The Governor visits the President of the Hellenic Republic Karolos Papoulias at the Presidential Mansion, Athens, 22 December 2009

The Governor with Antonis Samaras, Chairman of the New Democracy party and –later on– Prime Minister, at the BoG, 21 December 2009

At the Annual Shareholders' Meeting of the Bank of Greece, with George Papakonstantinou, Finance Minister, and Filippos Sachinidis, Deputy Finance Minister, Athens, 27 April 2010

The Governor at the Presidential Mansion with the President of the Hellenic Republic Karolos Papoulias, Athens, 1 March 2010

The Governor at the Maximos Mansion with Prime Minister George Papandreou,
Athens, 30 March 2010

The Governor with Louka Katseli, Minister of Economy, Competitiveness and Shipping,
Athens, 19 February 2010

Olli Rehn, European Commissioner for Economic and Monetary Affairs and the Euro,
visits the BoG, Athens, 9 December 2010

The Governor at the Maximos Mansion with Prime Minister Lucas Papademos,
Athens, 2 December 2011

The Governor at the Maximos Mansion with Deputy Premier and Finance Minister Evangelos Venizelos, Athens, 27 January 2012

The Governor submits the Monetary Policy Interim Report to Vangelis Meimarakis, Speaker of the Hellenic Parliament, Athens, 17 December 2013

Michel Barnier, European Commissioner for Internal Market and Services,
visits the BoG, Athens, 28 November 2013

At the ECOFIN meeting with Vitor Constâncio, Vice-President of the ECB,
and Yannis Stournaras, Minister of Finance, Vilnius – Lithuania, 13 September 2013

At the Annual Shareholders' Meeting of the BoG, Athens, 25 February 2013

Informal ECOFIN meeting, Athens, 1-2 April 2014

The Chronicle of the Great Crisis is made up of two parts. Part One covers the period 2000-2009 and highlights the warnings of the Bank of Greece concerning the crisis that was coming. Part Two is about the critical four-year period from 2010 to 2013. This is where developments in Greece and in the international environment are analysed; also, the Bank's public interventions and institutional actions aimed to safeguard financial stability and contribute to an exit from the crisis are recorded, together with its contribution to the creation of a new European environment.

ISBN: 978-960-7032-65-2