Greece in the Euro Area: Opportunities & risks ahead

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Σύνδεσμος Επιστημόνων Χρηματοοικονομικής και Λογιστικής Ελλάδος

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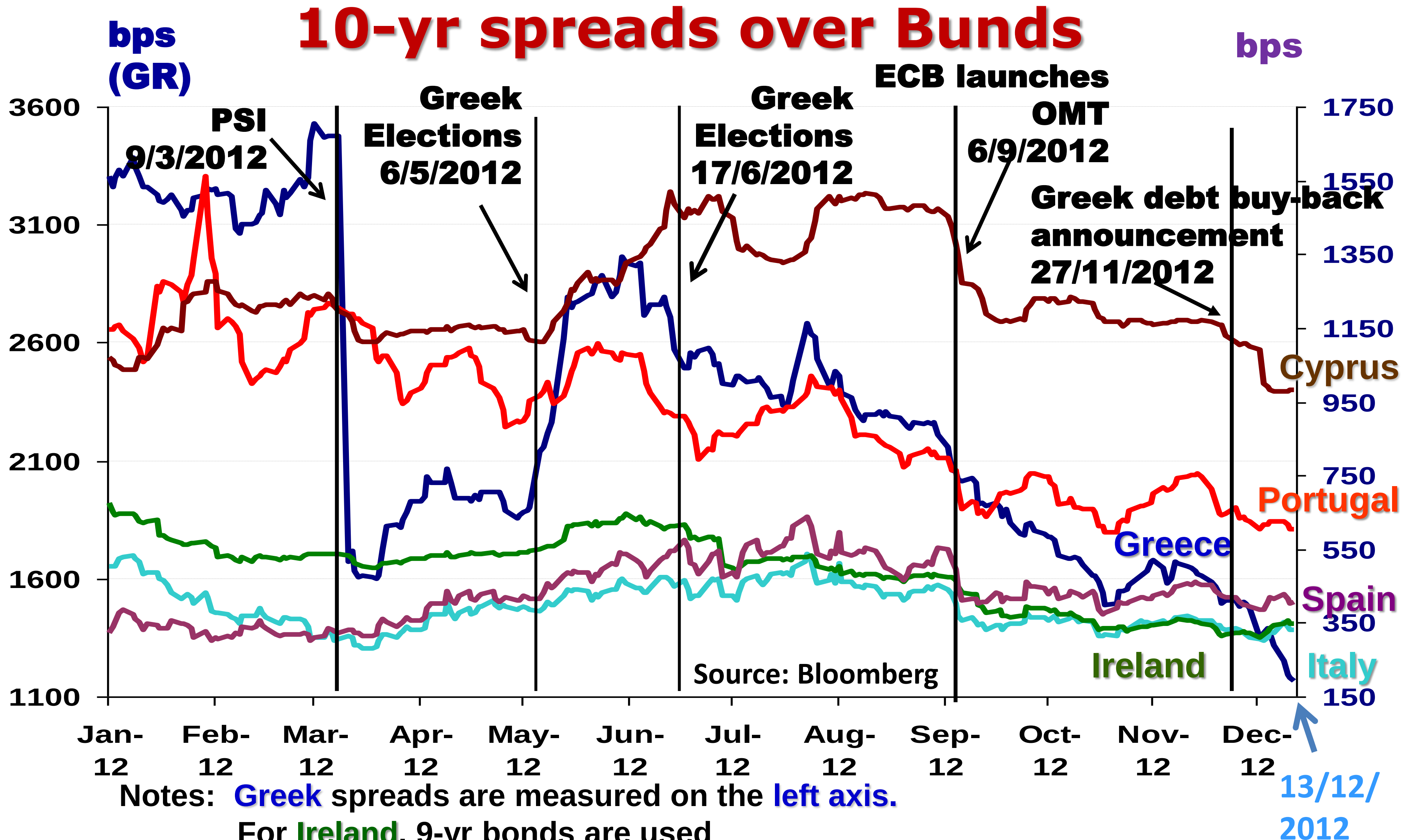
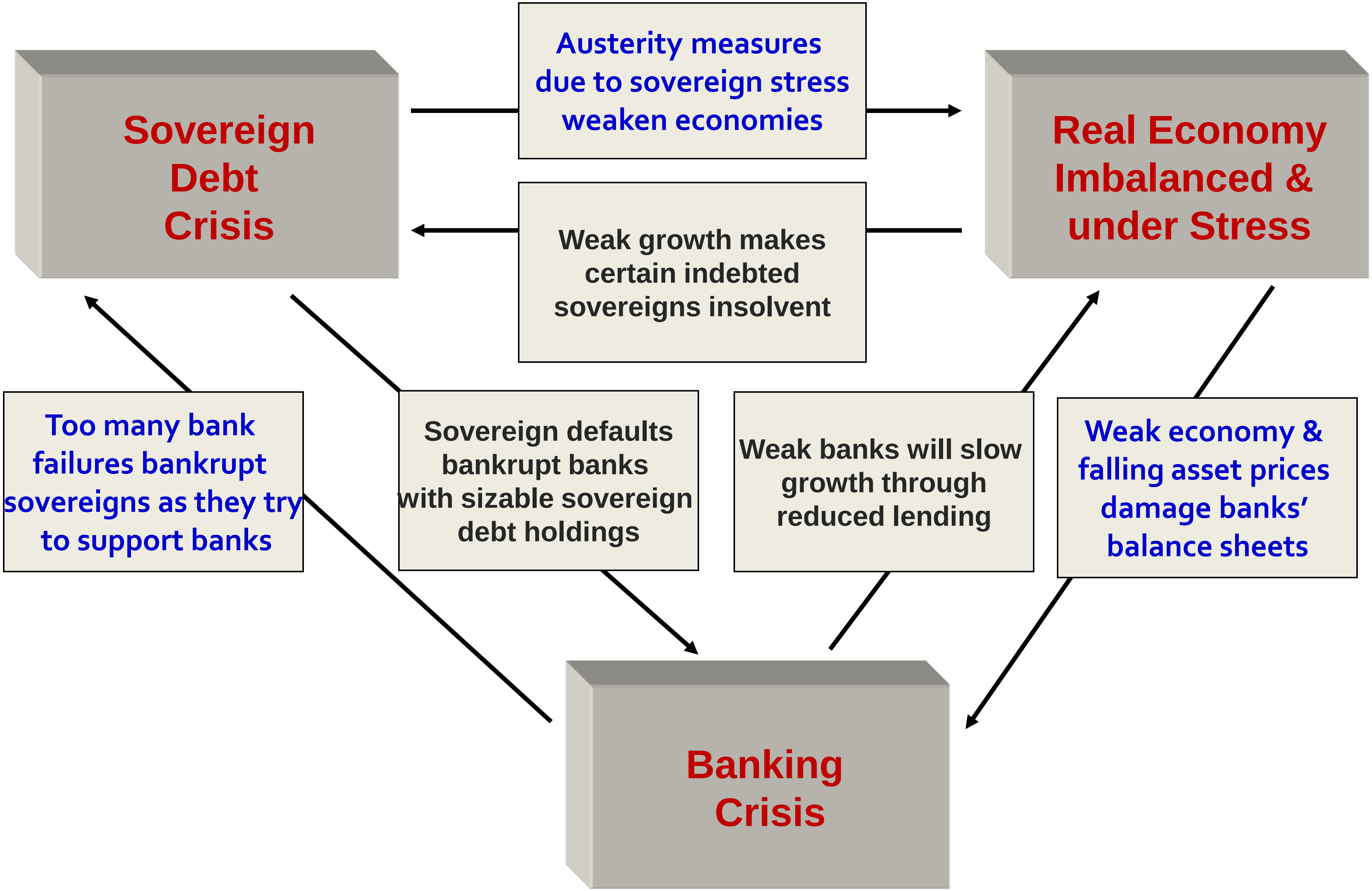


Notes: Greek spreads are measured on the left axis.
For Ireland, 9-yr bonds are used
For Cyprus, the bond had a 10-yr maturity in Aug 2011

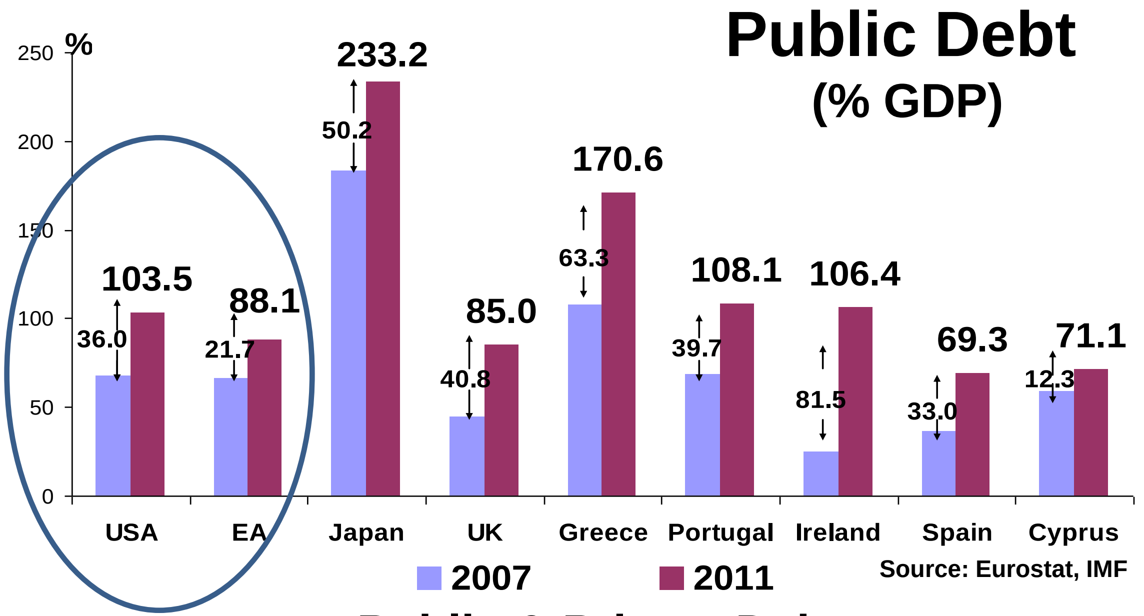
I. THE UNHOLY TRINITY: THREE INTERELATED LEGS OF THE EMU CRISIS



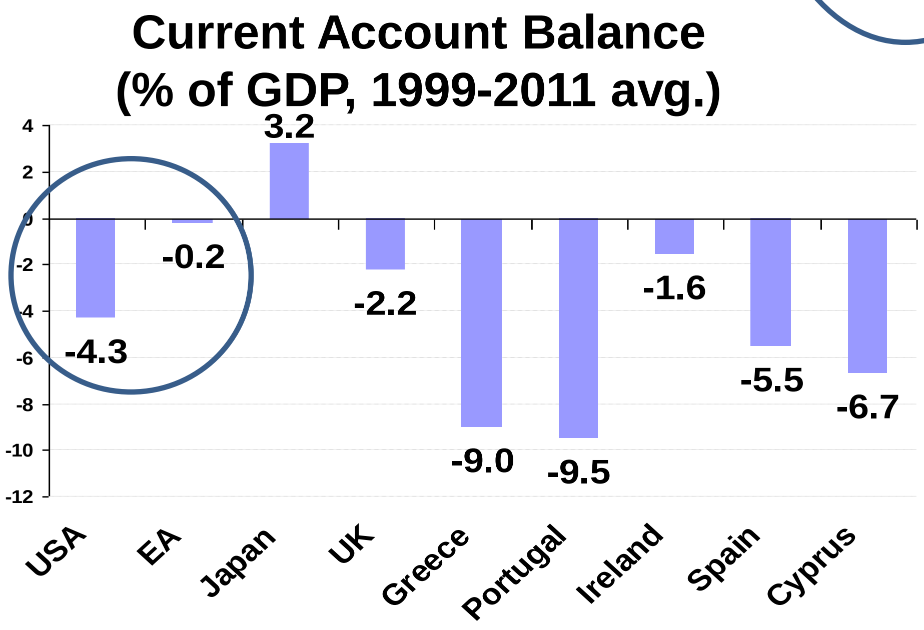
Source: BPEA (2012)

I. AGGREGATE EMU STATISTICS NOT NECESSARILY WORSE THAN THOSE IN USA, YET CRISIS IN EMU

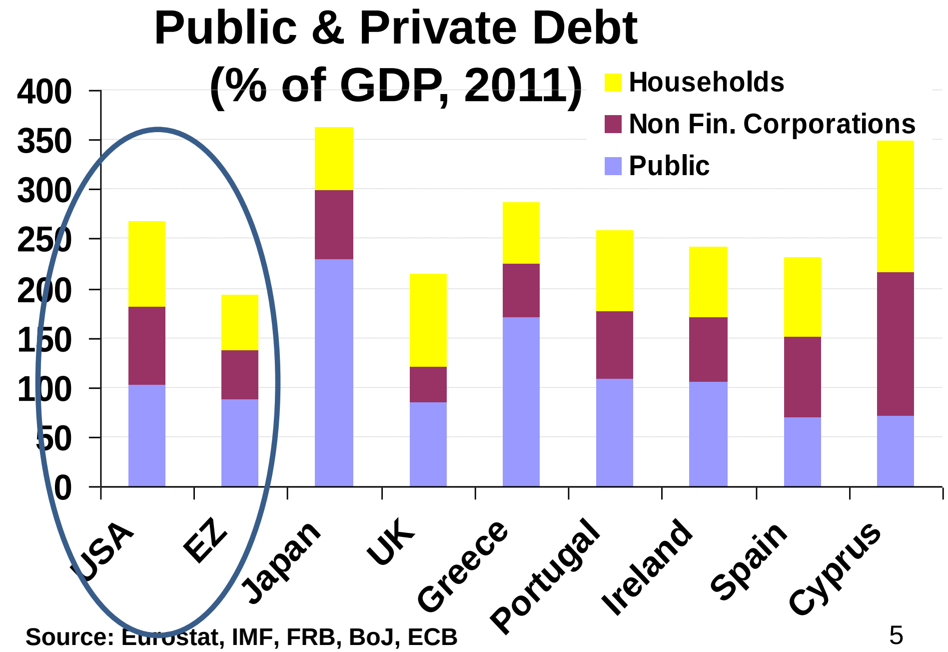
- **Euro Area as a whole in better shape than USA**
  1. US Public Debt/GDP worse
  2. US current account balance negative
  3. International banking crisis started in the US, but US policy makers managed it better than Europeans



Source: Eurostat, IMF



Source: Eurostat, IMF

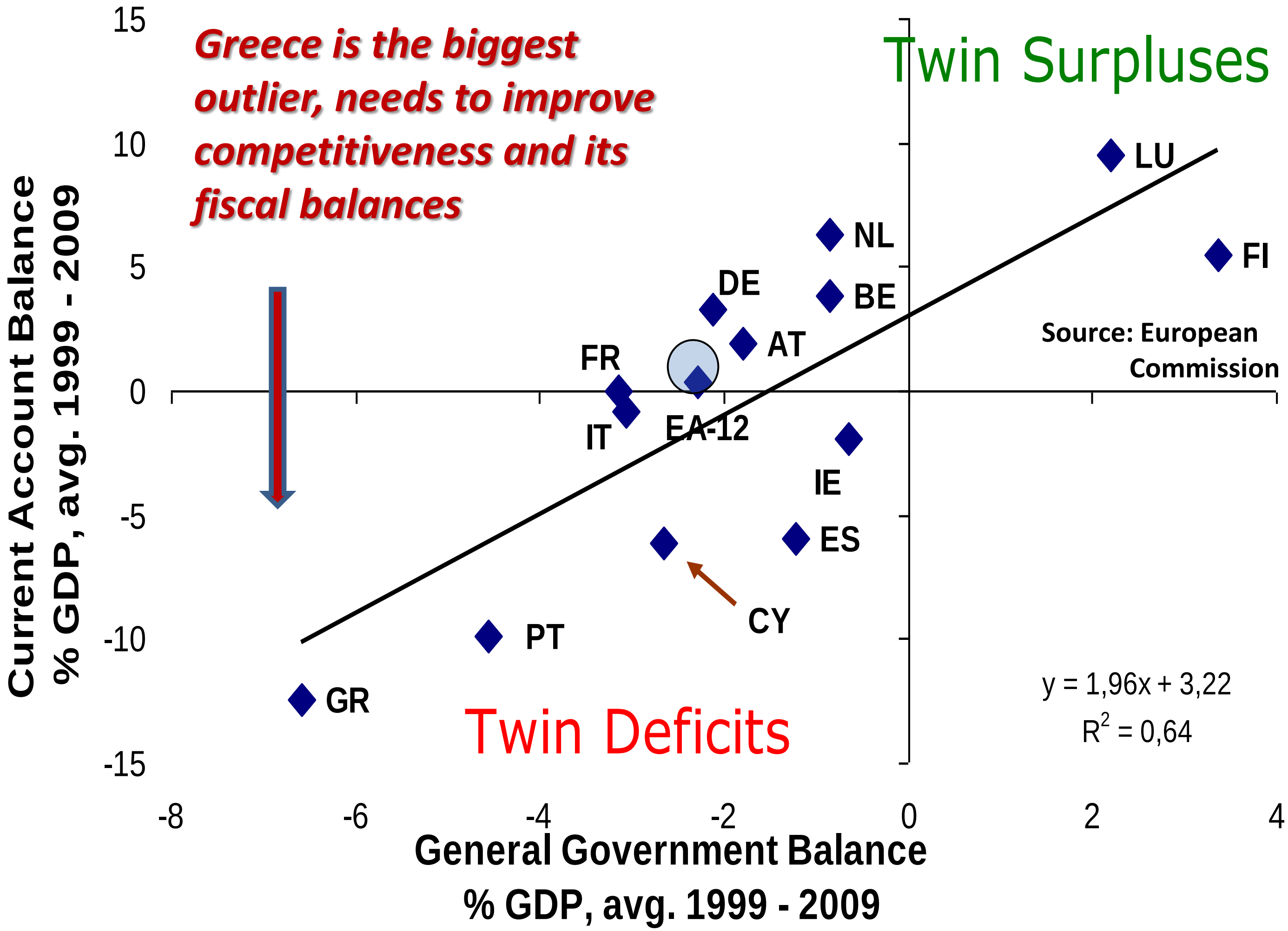


Source: Eurostat, IMF, FRB, BoJ, ECB

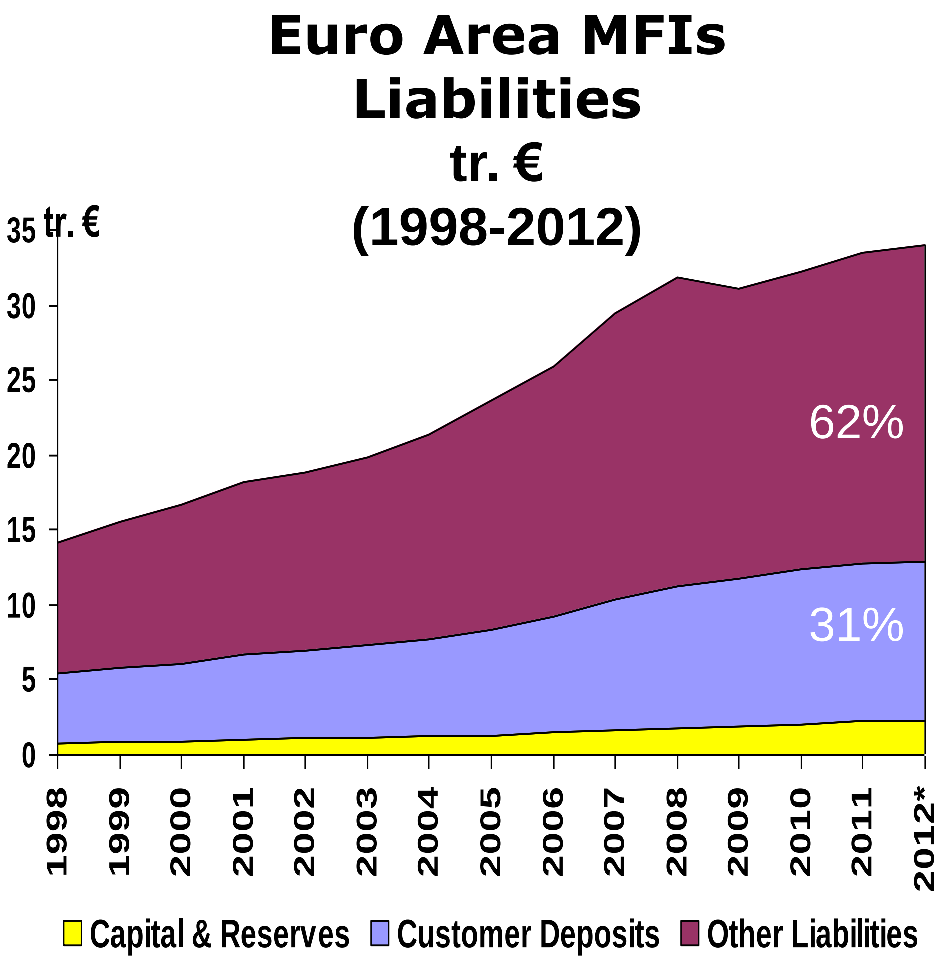
I. THIS IS A CRISIS OF EMU COHESION

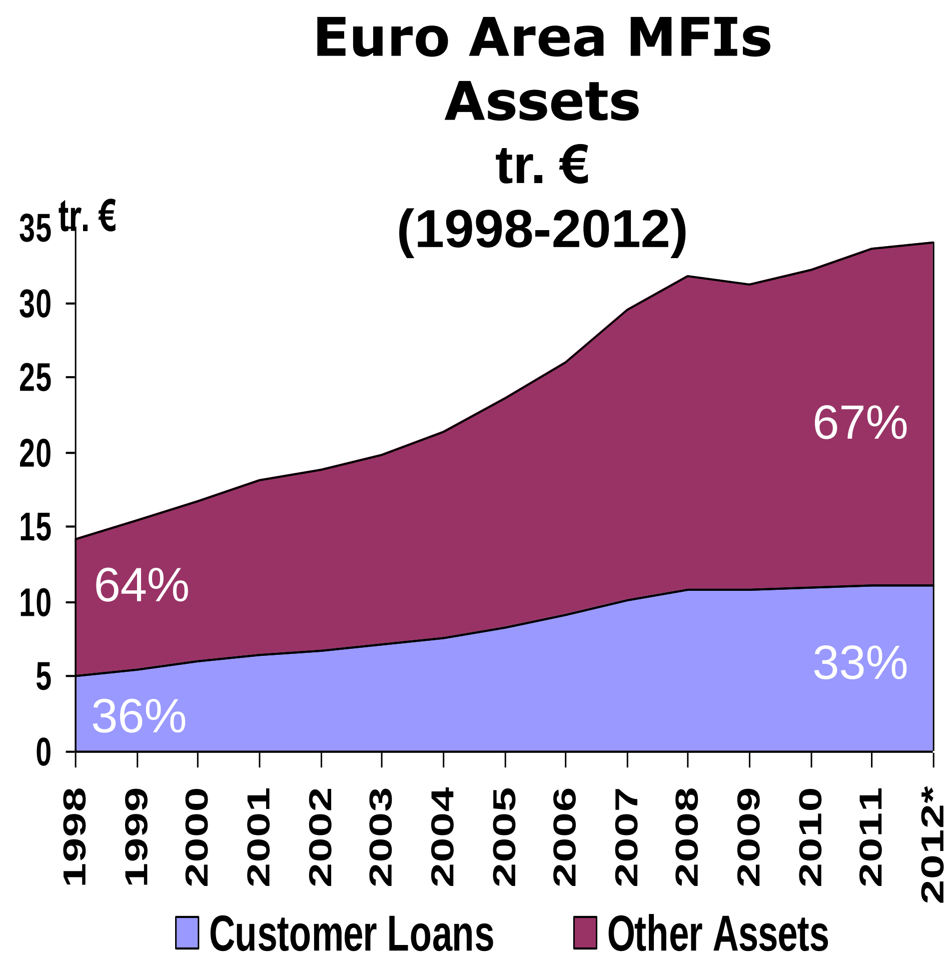
- **EMU never adjusted endogenously to an Optimum Currency Area, as it was hoped back in 1999**
- Post-EMU, a **competitive North** and an **uncompetitive South** emerged
- Spain & Ireland were in better fiscal shape than Germany, yet they suffered from a crisis of market confidence

Average annual external and fiscal balance in EA-12 before the Greek/EMU crisis hit in early 2010



I. THE LARGE SHARE OF NON-TRADITIONAL BANKING PEAKED IN 2008, BUT NOT MUCH DELEGERAGING SINCE THEN





❖ **Growth in assets & liabilities exceeds inflation**

Notes: *Oct. 2012 data
Customer Deposits and Loans refer to Non-MFIs excl. General Government
Source: ECB

I. FUTURE POLICIES FOR THE SUSTAINABILITY OF EMU

EMU leaders seem to follow rather than lead markets. Yet, for EMU to survive it cannot stay still. It needs bold policies that turn EMU closer to an Optimum Currency Area, implying closer unification BUT increased friction between ins &outs

i. **Proceed with banking union policies beyond a common regulatory framework to also a common resolution scheme and a common deposit insurance scheme with a fiscal backstop**
ii. **Proceed with deeper fiscal integration through Eurobonds in the form of e-bonds and blue-red bonds, through a common unemployment insurance framework, through an increase in the central EMU budget. Fiscal Compact is not enough.**
iii. **Establish policies that improve labor mobility across the Euro Area, e.g. common pension policies, common tax policies, etc.**

IN ADDITION,

i. **Follow expansionary fiscal policy in the EMU North (politically difficult) in order to generate demand in the South and resolve the imbalances within EMU**
ii. **Help heavily indebted countries in their debt sustainability efforts**
    a) **Allow crisis countries to enjoy positive inflation despite their internal devaluation, hence let ECB interpret price stability as a target inflation of larger than the current 2% , so that Northerners can have inflation > 2%**
    b) **Capitalize problematic banks directly from the ESM**

II.

I. The cohesion crisis in EMU and its three legs

II. Growth is the risky key leg in the current stage of the Greek crisis

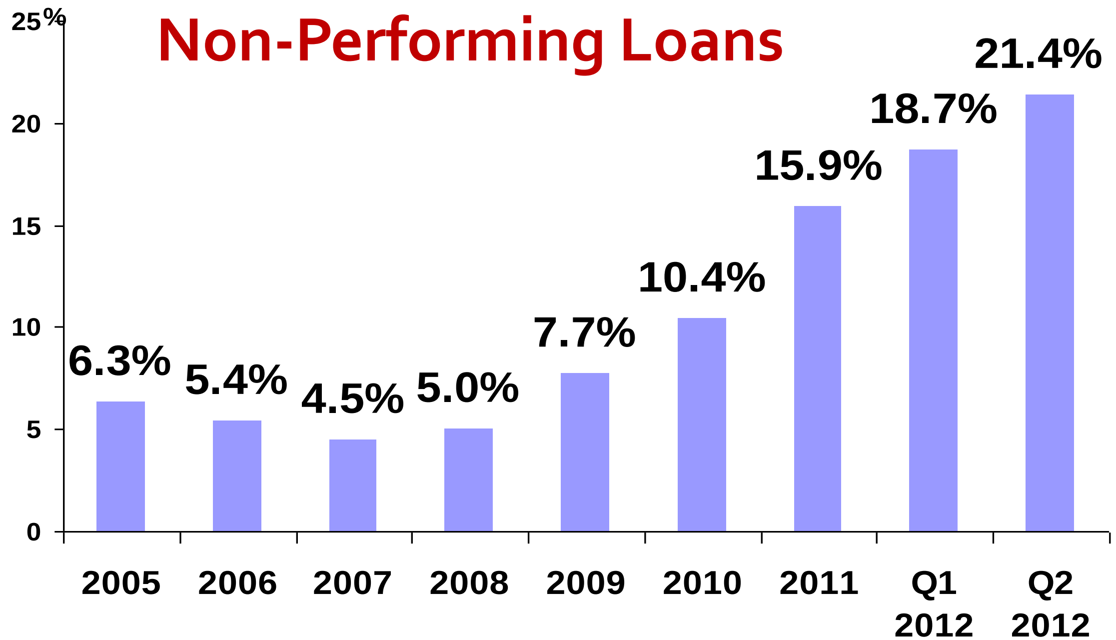
II.A The supply side

II.B The demand side

II. WHY GROWTH IS THE KEY LEG IN THE GREEK UNHOLY TRINITY

- **The <u>first</u> leg**, the Debt crisis, can be resolved only if growth comes back
  - **The reduction in interest rates and the maturity extension of official loans provide financing relief for a decade**
  - **Each point increase in real GDP growth implies a reduction of Debt/GDP of 20% in 2022**

- **The <u>third</u> leg,** the Banking crisis, is an outcome of the sovereign crisis through the PSI and now through the increased NPLs as the recession continues.
  - **It will be solved through growth as NPLs decline a year after the recession stops**
  - **Getting of the ECB lending (20% of Greek bank assets) will be tough**
  - **Simultaneous deleveraging through a forced separation of trading activities? See Liinkanen Report (2012)**



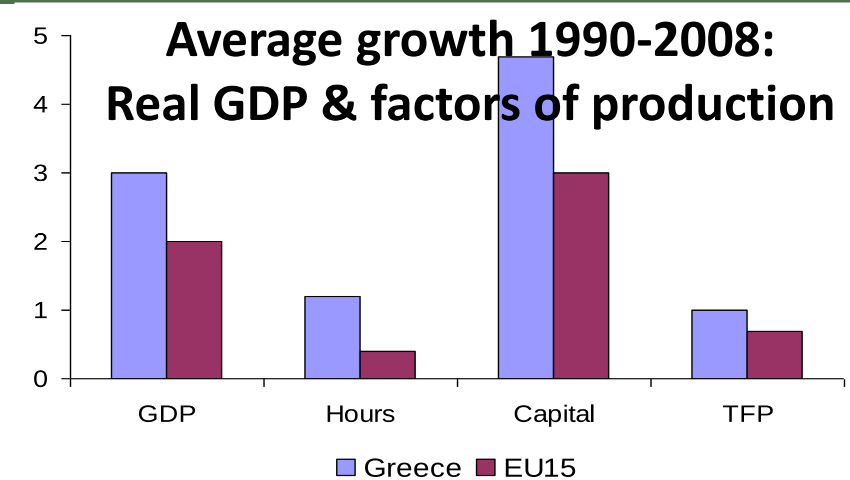
II. PAST OCTOBER OFFICIAL GREEK FORECASTS UNTIL 2016

	2007	2009	2010	2011	2012	2013	2014	2015	2016
Debt (€ bn)	239.3	299.7	329.5	355.7	340.6	346.2	350.1	357.7	363.4
GDP (€ bn)	223.2	231.1	222.2	208.5	194.0	183.0	182.7	187.7	196.5
Revenues (€ bn)	90.9	88.6	90.2	88.2	82.4	77.5	78.4	78.1	81.5
Expend. (€ bn)	106.0	124.7	114.3	108.0	95.9	87.5	85.3	86.3	87.9
Deficit (€ bn)	15.1	23.1	36.1	24.1	13.5	10.1	6.9	8.2	6.3
Interest (€ bn)	10.7	11.9	13.2	15.0	10.4	10.1	11.0	12.1	12.7
Debt (%GDP)	107.2	129.7	148.3	170.6	175.6	189.1	191.6	190.6	184.9
Revenues (%GDP)	40.7	38.3	40.6	42.3	42.5	42.3	42.9	41.6	41.5
Expend. (%GDP)	47.5	54.0	51.4	51.8	49.4	47.8	46.7	46.0	44.7
Deficit (%GDP)	6.8	9.9	15.6	10.8	7.0	5.5	3.8	4.4	3.2
Interest (%GDP)	4.8	5.1	5.9	7.2	5.4	5.5	6.0	6.4	6.5
Debt (%Rev)	263.3	338.3	365.3	403.3	413.5	446.8	446.7	457.8	445.7
Interest (%Rev)	11.8	13.4	14.6	17.0	12.6	13.0	14.0	15.5	15.6
Real Growth (%)	3.5	-3.1	-4.9	-7.1	-6.5	-4.5	0.2	2.5	3.5
GDP deflator (%)	3.3	2.3	1.1	1.0	-0.5	-1.2	-0.4	0.3	1.1

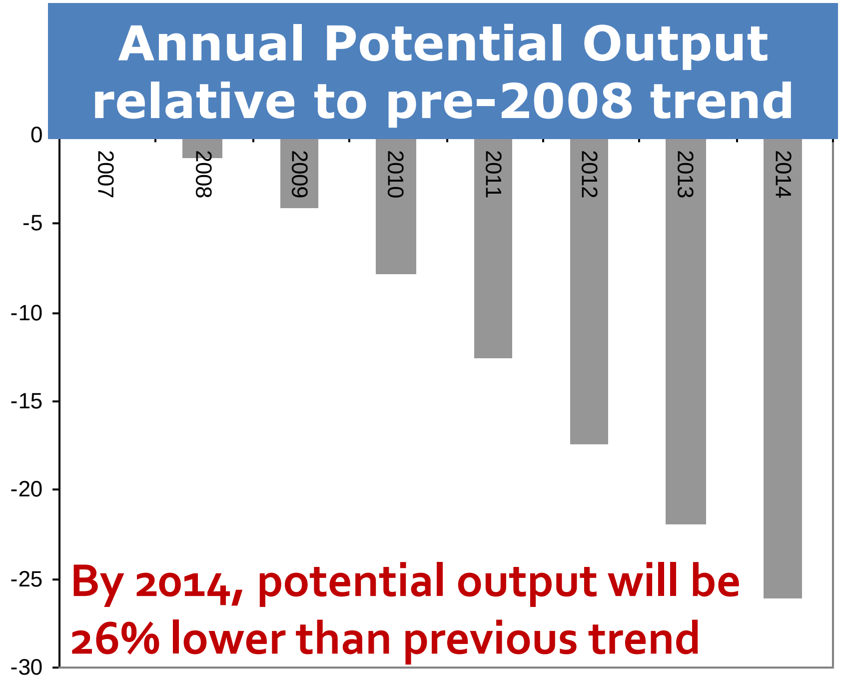
Source: AMECO for 2007-2011, MTFS 2013-16 for 2012-2016

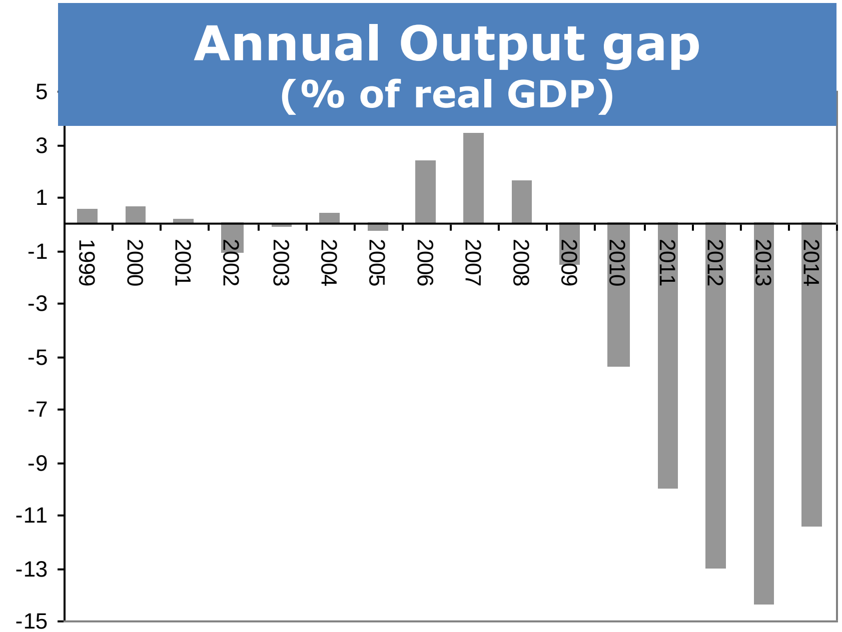
II.A THE SUPPLY SIDE COLLAPSED DURING THE CRISIS

- ***Will factors of production grow again?***
- **Up until 2008, GDP growth supported by employment, capital and TFP growth with labor share at 76.6%**
- **Potential GDP growth of 3.0% due to**
  - **Capital (1.10 pp.)**
  - **Labor hours (0.90 pp.)**
  - **TFP (1.00 pp.)**



- **Potential is now falling, but real output is falling faster, generating a large output gap**





Source: GGDC, AMECO, Eurobank Research

II.A HYSTERESIS: A NEW LOWER STARTING POINT

- Two shocking numbers emerge from the earlier graphs:
  1. By end 2014, decline in potential output relative to pre-2008 trend will be 26%
  2. Cumulative loss in output relative to potential is expected to be 61%.

- By the end of 2014, relative living standards compared to the old EU-15, back to the 1980s

Relative Living Standards
EE-15=100 in PPS

1991	75.6
1995	71.7
1999	71.0
2003	80.7
2007	80.9
2014	65.5

- HYSTERESIS:
  - Current depression destroys human capital, increases long-term unemployment and reduces labor forcer participation
  - Current depression destroys capital stock
  - Both channels decrease the level of potential GDP, hence the new much lower equilibrium starting point of the economy
- Hardouvelis – Malliaropulos estimate of hysteresis parameter η =0.4
  - That is, for every 1% of recession, potential GDP declines by 0.4%
- We need to start all over again, but before we can start, the recession has to stop. Will the recession stop? This is the demand side of the problem

II.A ANOTHER LOOK AT THE SUPPLY SIDE CHALLENGE: REBALANCING PRODUCTION

- Rebalance production to satisfy a new composition of GDP
- Greek society over-consumes and under-produces, as evidenced by the large share of private consumption in output and the large gap between exports & imports
- The reduction in the share of consumption in output is necessary, yet it has to proceed smoothly to avoid an economic crash

(2011, % of total GDP)	Greece	EA-17
Private Consumption	74.6%	57.4%
Public Consumption	17.4%	21.6%
Private Investment	11.3%	17.1%
Public Investment	2.9%	1.7%
Exports	25.1%	44.0%
Imports	33.1%	42.6%
GDP (€ bn) - 2011	208.5	9420.6

- The investment share is dangerously small, around 14% of GDP from 25% a decade ago. In 2011, depreciation was larger than new investment, resulting in negative net investment and a destruction of capital stock
- Public investment declined instead of going up to counter the recession
- Exports ought to continue their rise but liquidity constraints bite

II.A SUCCESSFUL REFORMS TO FIX THE SUPPLY SIDE

LABOR MARKET REFORMS

- **Adjustment / Reduction of wage floors:**
  - 22% reduction in the minimum wage
  - 32% reduction in the minimum wage for employees under the age of 25
  - Reduction of severance payments
  - Abolition of automatic (3-year) wage increases
  - Annulment of the marriage allowance
- **Structural measures to level the playing field in collective bargaining**
  - Shortening length of collective contracts and reduction of their ‘after effects’ time
  - Removal of ‘tenure’ (contracts with definite duration defined as expiring upon age limit or retirement) in all existing legacy contracts in all companies.
  - A freeze of ‘maturity’ (referring to all automatic increases in wages dependent on time) until unemployment falls below 10%.
  - Elimination of unilateral recourse to arbitration
- **Adjustment to non-wage labor costs:**
  - Close earmarked funds engaged in social expenditures (OEK, OEE)
  - Decrease by 1.1% in employer contributions to social security funds as of Nov 1, 2012
- **Alterations in other restrictions**
  - Reduction of minimum time between shifts / worker at 11h a day
  - Increase maximum workdays per week from 5 to 6 in retail establishments

II.A SUCCESSFUL REFORMS TO FIX THE SUPPLY SIDE

PENSION & HEALTH CARE REFORMS

- Future rise in public pension expenditure not to exceed 2.5 % of GDP or the EU-wide average of 14% - (5/2010)
- Retirement age in line with life expectancy, already 67 from 65 previously; benefits linked to lifetime contribution; disincentives for early retirement
- Health expenditure not to exceed 6% of GDP (2nd MoU)
- Social security funds merged into one (EOPYY), equalizing benefits and contributions
- Overhaul of the list of difficult and hazardous occupations, Disability criteria and rules revised (since Sep. 2011)
- Pharmaceutical expense reduction (2nd MoU)
- Increased contribution of insured

PUBLIC SECTOR REFORMS

- **Single Payment Authority** established
- **Wage grid** adopted aimed at creating simplified uniformed remuneration system
- **Census of civil servants** (717,792 employees on public payroll)
- **Local government reform**
  - Municipalities reduced from 1034 to 325
  - Local authority entities reduced from 6,000 to 1,160
  - Decrease of elected officials from 30,795 to 16,657

II.A INCOMPLETE REFORMS THAT HAVE PRIORITY

1. **Structural fiscal reforms**
   - Tax reform bill that aims at simplifying the tax system, eliminating exemptions and special treatment regimes, broadening the tax base, etc. (to be submitted by December 14 2012)
   - Anti-corruption plan (to be submitted by February 2013)
   - Audits of large-scale tax payers, high-wealth individuals and self-employed, resolution of tax arrears, etc. seriously lag behind targets.
   - Expenditure commitment registries not fully operational for all GG entities yet
2. **Energy sector reform**
   - Plan for the PPC (ΔEH) privatization and its implementation
3. **Health sector reform**
   - Prescription budget for each doctor & a target on the average cost of prescription per patient
   - Restrict promotional activities through code of good conduct between pharmaceutical industry, doctors, patients, pharmacies and other stakeholders to
   - Fees for medical services outsourced to private providers to be reviewed so as to reduce related costs by 15% since Q1-12. (Instead, the expenditure to private clinics and diagnostic services has gone out of control in H2-12).
4. **Judicial sector reform**
   - Study of the backlog of non-tax cases in courts not published yet
   - Action plan with measures to reduce non-tax cases backlog of at least 50% by end-July 2013
5. **Implementation of the privatization agenda after legal clearances**

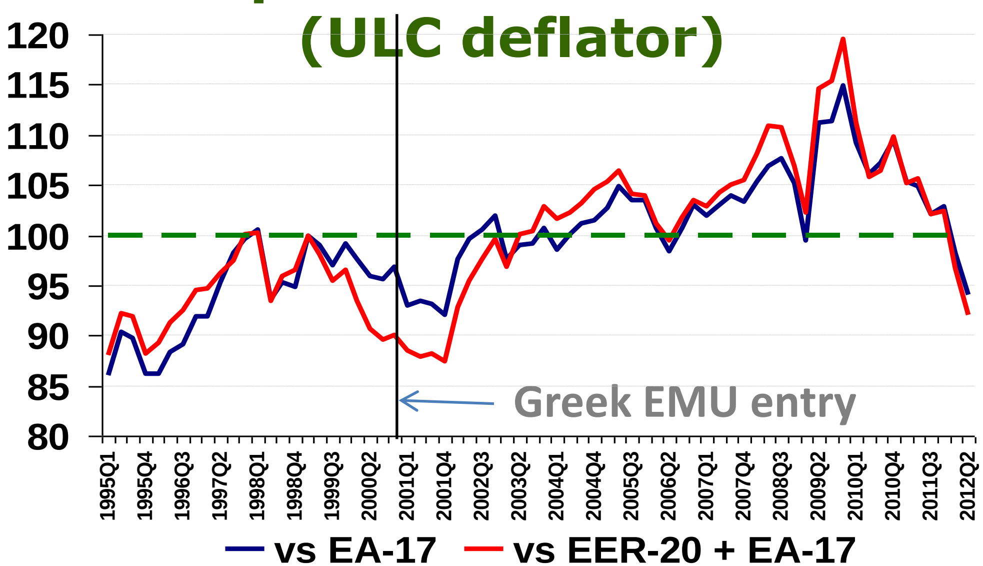
II.A A GRADUAL IMPROVEMENT IN GREEK COST COMPETITIVENESS HAS BEGUN

NOMINAL UNIT LABOR COSTS

% Δ	GR	CY	DE	FR	IT	ES	IE	PT	US	EA17	EU27
2000 - 2009	33.2	31.0	5.6	22.4	31.4	33.8	34.6	26.8	18.2	21.0	23.2
2009 - 2012	-10.5	2.0	3.1	3.9	2.7	-6.0	-10.3	-6.1	3.3	1.5	2.4

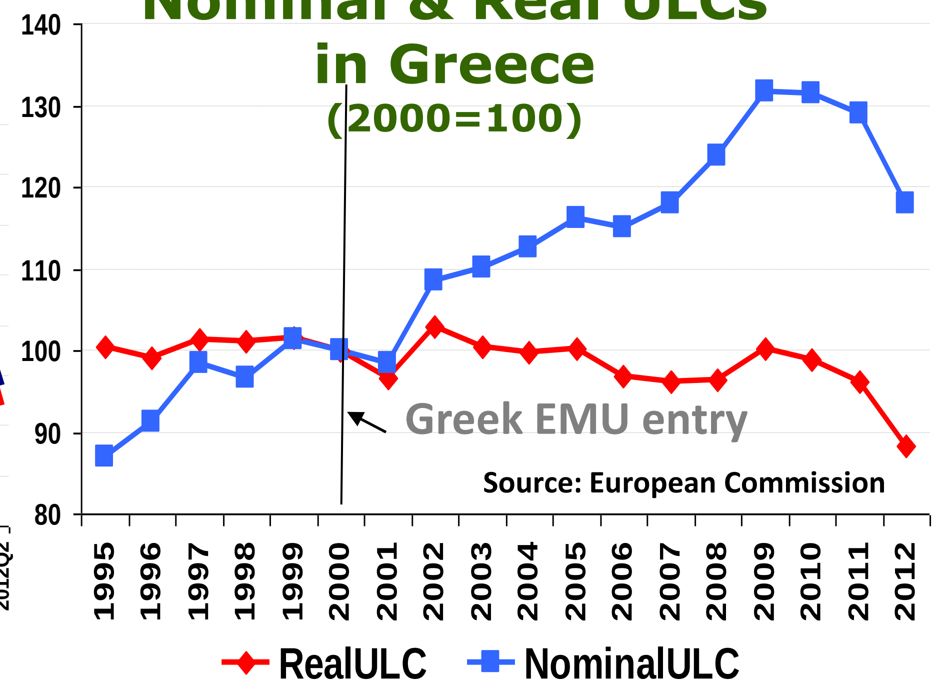
Source: European Commission

Real harmonized competitiveness indicator (ULC deflator)



Source: ECB

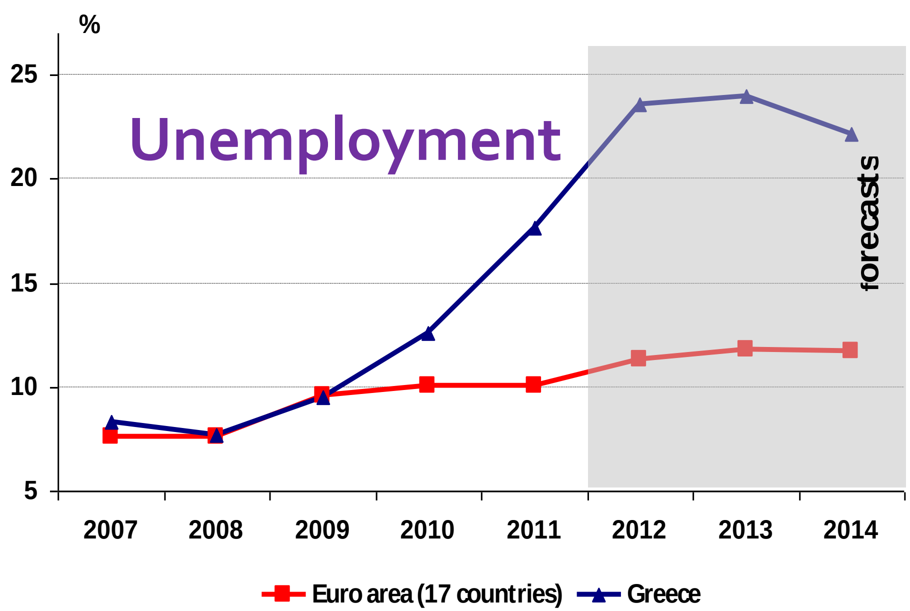
Nominal & Real ULCs in Greece (2000=100)



Source: European Commission

II.B GREECE SUFFERS FROM LACK OF DEMAND AS CUMULATIVE RECESSION REACHES RECORD LEVELS

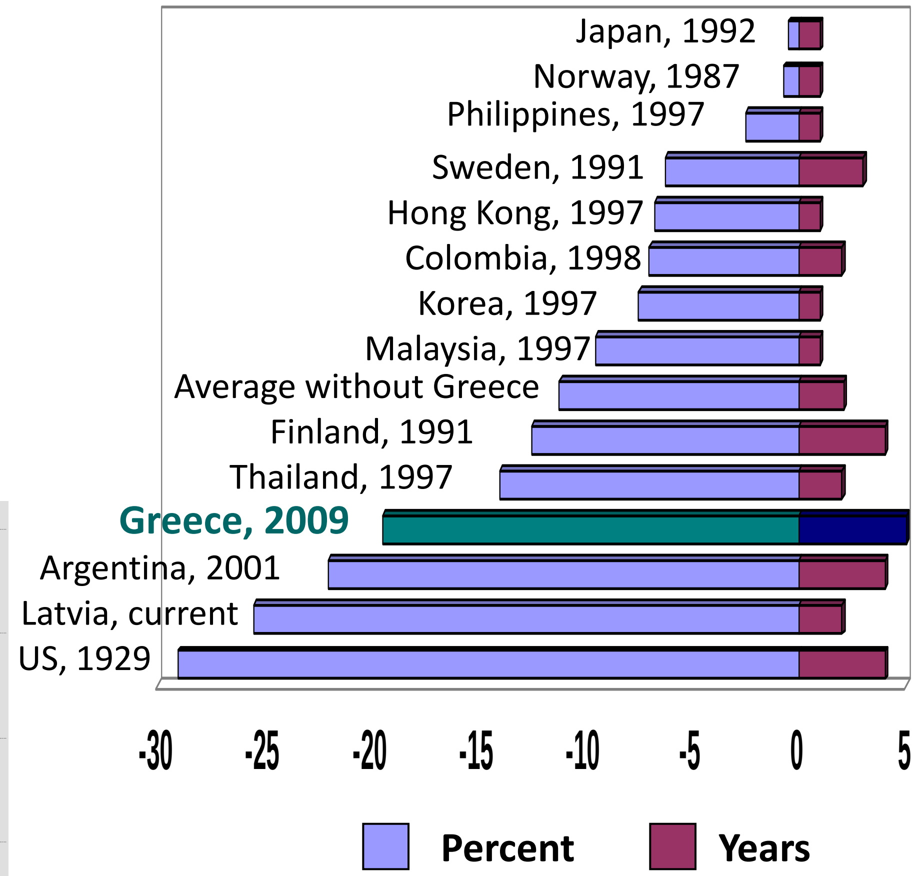
- The cumulative recession will continue into 2013 and is one of the worst in global history over the last 80 years
- Risk of social upheaval rises as incomes collapse and unemployment worsens
- The most important policy task is to stop the recession



Source: Eurostat, Draft 2013 Budget

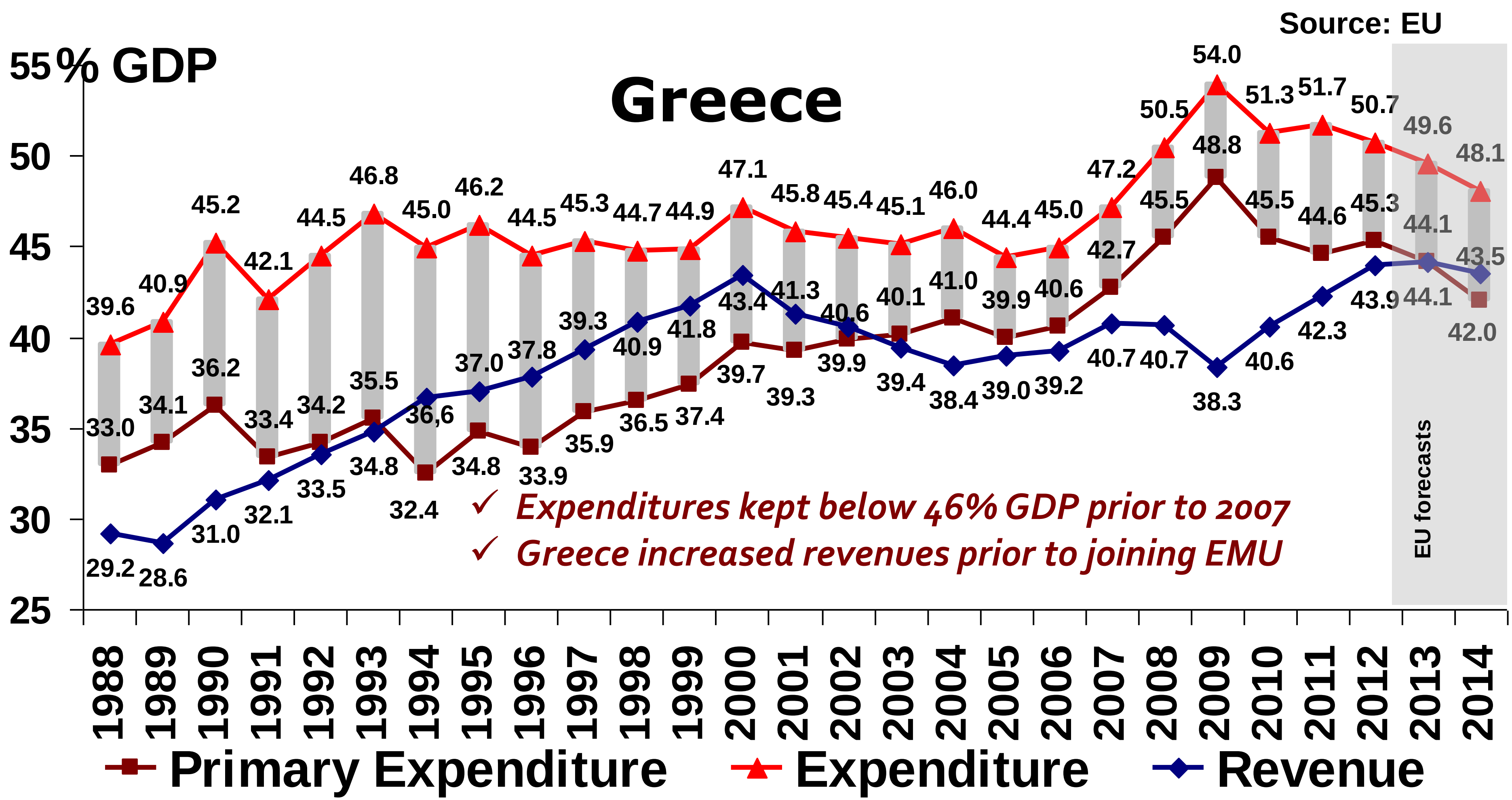
Historical Crises:

% Cumulative loss in Output & Duration



Source: IMF (2010), Reinhart & Rogoff (2009)

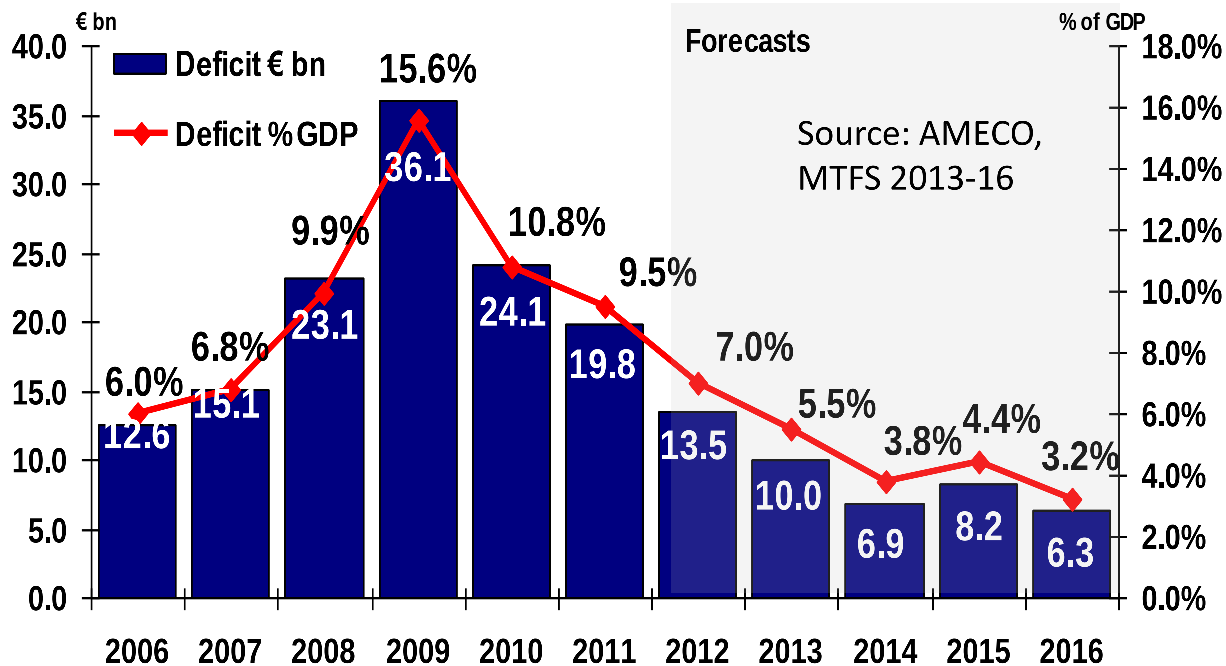
II.B THE DEMAND SIDE: BALANCING THE BUDGET IS A MUST

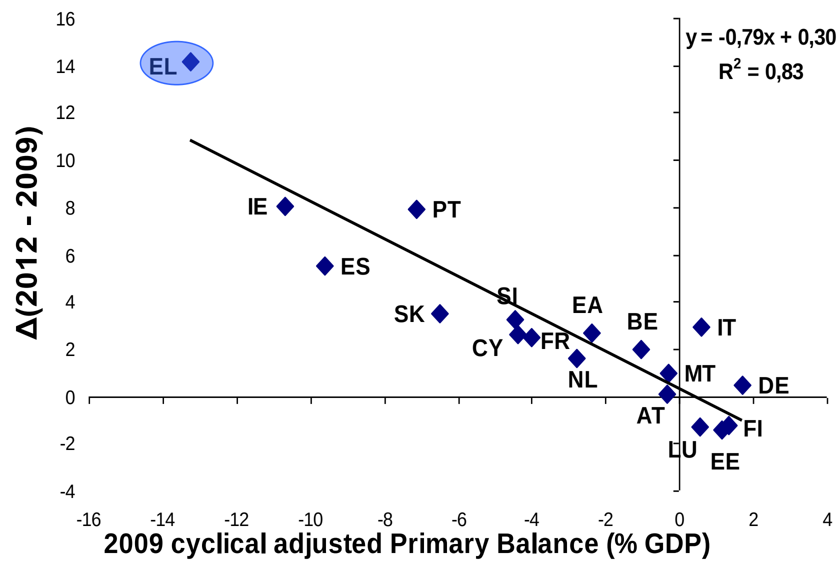


- ✓ Greece was almost always in fiscal trouble, but the fiscal mess grew way prior to the onset of the 2008 recession, during 2006
- ✓ The period of primary surpluses was from 1993 to 2003, and hopefully from 2013 on

II.B BUT WATCH OUT NOT TO DO IT VERY FAST

- From 2009 to 2012, Fiscal balance improved from -15.6% to -7.0% GDP
- Primary balance improved more, by 9.1 pp of GDP
- On a cyclically adjusted basis, consolidation even more impressive as cumulative recession reached 20%

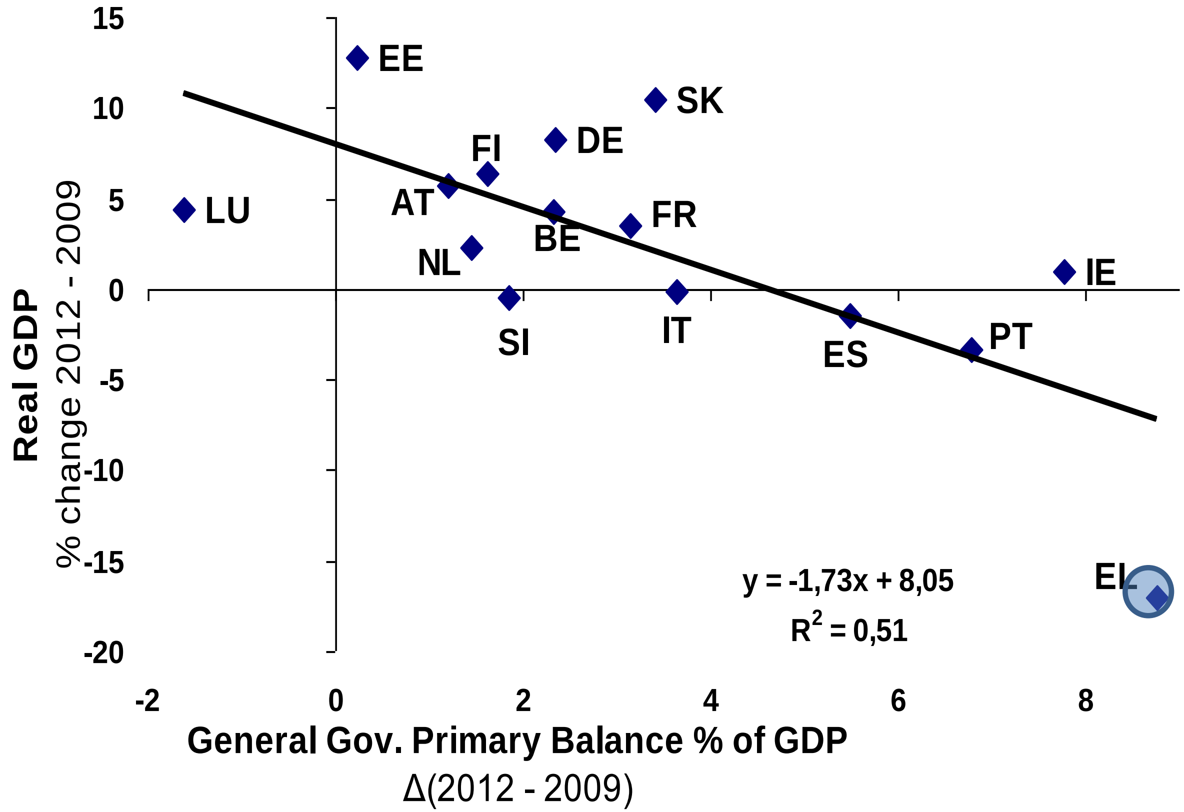




II.B FISCAL AUSTERITY PROLONGS THE RECESSION

- Recent IMF and Eurobank studies confirm that the fiscal multiplier is larger during recessions
- From 2009 to 2012, a reduction in primary deficit of 9% GDP was associated with a drop of 17% in real GDP
- A vicious cycle is in progress, with more fiscal austerity causing a deeper recession
- Hence, a further reduction in the primary balance of 6% GDP could possibly add another cumulative contraction of over 10%

Greek MoUs underestimated the size of the fiscal multiplier



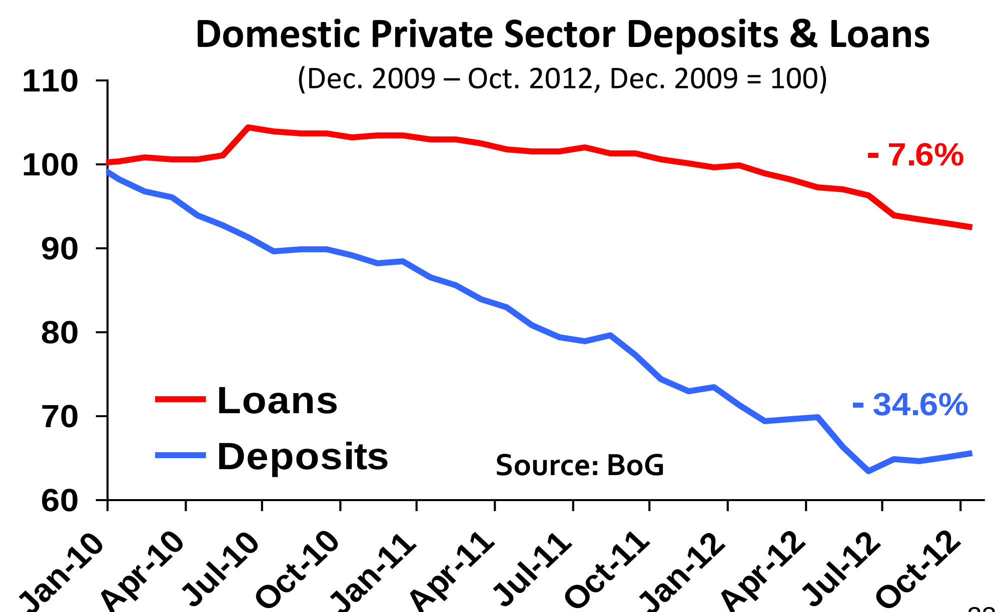
II.B BANKS CONTINUE TO PROVIDE INTERMEDIATION

- Loans fell by less than deposits as banks continue to **restructure loans,** keeping low the NPL increase
- **Deposit withdrawal** stopped after June 2012 elections
- Greek banks in need of over €40bn in January 2012. Since then, the rising NPLs and the new higher CAR of 9% imply additional capital needs
- NPLs rose by 5.5ppts in H1-2012 or ~ €13bn and they keep rising, representing the major risk to the pool of existing rescue money
- If economy turns more sour than expected , then more NPLs may turn into defaults plus the Loss given Default rate may rise
- New injected capital does not necessarily translate into new liquidity to the private sector

Domestic Private Sector

(€ bn)	Credit	Deposits		Credit	Deposits
2007	215.4	197.9	Jan. 2012	249.1	169.0
2008	249.7	227.6	Mar. 2012	245.1	165.4
2009	249.7	237.5	Jun. 2012	240.1	150.6
2010	257.9	209.6	Jul. 2012	234.3	153.9
2011	248.5	174.2	Aug. 2012	233.0	153.4
			Sep. 2012	231.8	154.3
			Oct. 2012	230.7	155.2

Source: BoG



II. GDP OUTLOOK IN 2012 AND 2013

	2011 €bn, Nominal	Share in 2011 GDP	2012 %yoy Real	2013 %yoy Real
Private Consumption	162.3	75.5%	-9.6%	-8,5%
Government Consumption	37.5	17.5%	-7.8%	-7%
Total Consumption	199.9	92.9%	-9.2%	-8,4%
GFCF	31.3	14.5%	-18%	-4%
Domestic Demand	231.1	107.5%	-10.4%	-8%
Exports	67.7	24.0%	2.5 %	5,7%
Imports	51.7	31.5%	-12,9%	-9,4%
Real GDP	215.1		**-6.7%**	**-3,8%**
GDP deflator			-0.5%	-1%
Unemployment			24%	27%

II. UPSIDE POTENTIAL TO THE NEGATIVE 2013 GDP OUTLOOK

- The **fiscal drag** from fiscal consolidation measures (**€2.185bn** from the carry-over of previous measures and **€9.374bn** from measures agreed in October 2012) can be **counterbalanced** by the following **Liquidity Boosts**:
  - ✓ Improved absorption of **EU Structural Funds**: gov budget accounts for **€5.7bn** or **3.1% of G**DP of net inflows from the EU (comparable to previous non-recessionary years)
  - ✓ Planned **reduction of gov arrears** of **€7bn** or **3.6% of GDP**, €3.5bn to be disbursed in Dec 2012 (hence impacting in 2013) and €3.5bn throughout 2013
  - ✓ **Recapitalization of Greek banks** and its impact on banks' cost of funding, as well as by a possible return of deposits (this factor is mitigated by the need to reduce exposure to the Eurosystem for liquidity- no assumed impact)
  - ✓ Better outlook of investment and consumption due to **resolve of uncertainty regarding Euro participation** (no assumed impact)
  - ✓ **€1bn** of **EIB funding** agreed for 2013 for SMEs (this will probably be larger due to leveraging/co-financing of projects by banks)
- **Net liquidity injection is positive**
- On the baseline scenario, the injection of arrears, €1bn of EU funds or EIB funding is not incorporated. Assuming an average multiplier of unity & only €3bn out of €7bn arrears clearance staying in the domestic economy, the above could theoretically mediate recession by 2.5 ppts, i.e. a ceteris paribus real growth rate of **-1.3%.**

II. DOWNSIDE RISKS TO THE 2013 GDP OUTLOOK

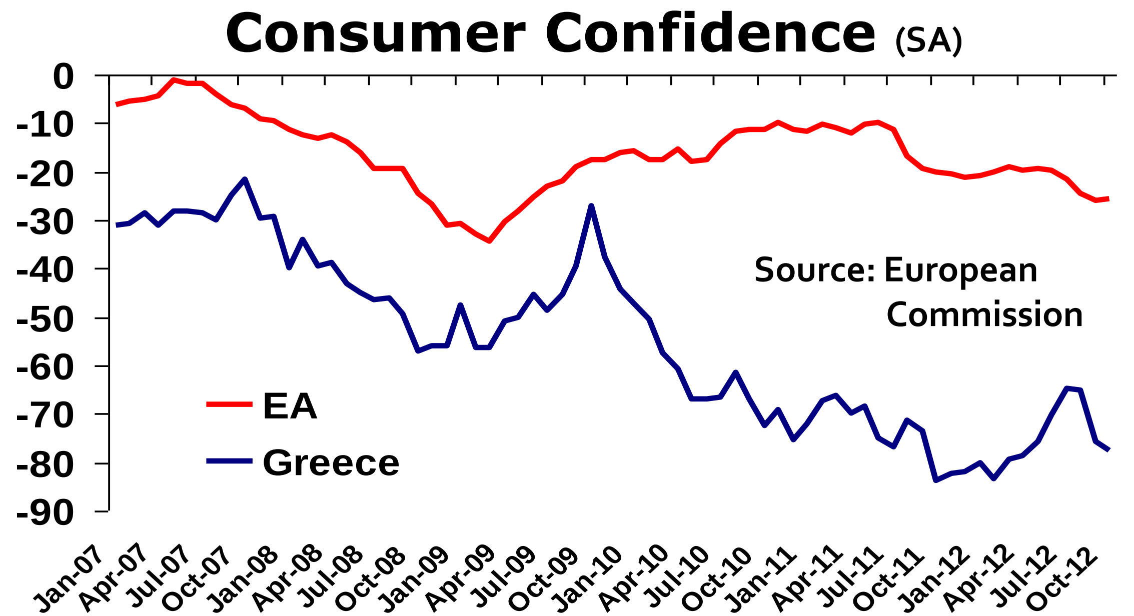
- **If private sector liquidity squeeze persists**, it could lead to a **non-linear** increase in the number of –otherwise healthy- firms closing down with severe repercussions on unemployment and GDP
- **Liquidity constraints** for households which consume > 100% of their disposable incomes and a **negative wealth effect** (falling house prices and stock prices, bond haircuts) could increase pass through on consumption
  - Estimations above implied a 0.9 elasticity of consumption w.r.t. disposable incomes; if e.g. elasticity is increased to 1.3, private consumption could be reduced by -12.2% and the subsequent GDP fall would enlarge to **-6.4%.**
  - If, in addition, investment falls by -20%, instead of -4%, due to firms' closing down, GDP fall would enlarge to **-8.5%.**

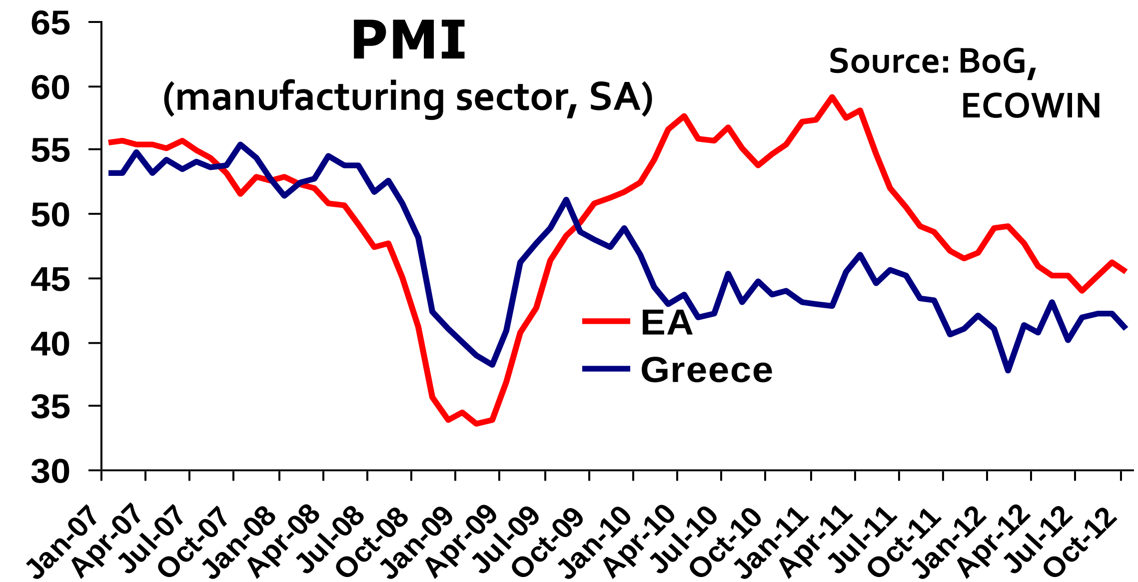
Other Downside Risks:

- Social turmoil
- Euro accident
- Slippages in budget execution that have to be dealt by extra measures, thereby enlarging the fiscal drag

II. AT TIMES OF AUSTERITY, FOR THE RECESSION TO STOP, A NUMBER OF PREREQUISITES EXIST

- Political stability & Credibility, which would improve if,
  - Reforms proceed at a faster pace, particularly the taxation of self-employed
  - Government re-invents itself
- Liquidity, which is a suffocating constraint even for exports, thus front-load the economy with cash
- Reversal of Sentiment and investment pessimism
- Increase in Public Investment
- Restructuring of the State sector





SUMMARY

- ❖ The current **crisis in EMU** is a crisis of cohesion and is manifested in a triple form: Competitiveness, sovereign and banking.
- ❖ In 2009, **Greece** suffered from **two legs** of the crisis only, the sovereign leg and the competitiveness leg. Yet the length of the recession and the PSI have caused a banking crisis as well
- ❖ **The key risk for Greece is growth.** If growth comes back, both the sovereign and the banking crises would subside
- ❖ **The growth task is dual on a) Supply and on b) Demand**
- ❖ For supply to reach a new balance, structural reforms need to be completed. The 3.0% annual growth of the earlier two decades requires a major boost to both physical and human capital and a transparent economy with no bureaucratic restrictions
- ❖ **Hysteresis** implies a new starting point for potential output, well below the 2008 level. Living standards are expected to fall to 65% of the old EU-15 by the end of 2014
- ❖ **Demand** needs restructuring **away from consumption**, towards investment & exports
- ❖ Stopping the vicious cycle of austerity & recession is thus a major challenge
  - Requires **credibility, liquidity, improved sentiment** . Deposits have to come back to banks and Investment & Exports need to fill in the gap in Aggregate Demand as consumption adjusts downward
  - Greeks need to **revamp tax collection mechanism** and **jump start privatizations, free up product & service markets** and **re-organize State sector**

Thank you
for your attention

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I wish to thank my colleagues at Eurobank for their comments