“The Fundamentals of the Greek Economy in View of the International Financial Crisis”

Gikas A. Hardouvelis*

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Czech Embassy

* *Chief Economist, Eurobank EFG Group*
Professor, Department of Banking and Financial Management, Un. of Piraeus

TABLE OF CONTENTS

I.
THE FINANCIAL CRISIS NINETEEN MONTHS LATER

a. THE TWO FUNDAMENTAL PROBLEMS THAT PROLONG THE CRISIS:
   i. Insolvency
   ii. Counterparty risk

b. GREEK BANKS

I.a Two major problems behind the continuation of the current crisis

The crisis spread internationally due to high degrees of leverage. Today, de-leveraging occurs due to two major problems:

1) The loss in asset values generates write-downs, which cannot be replenished by new capital increases, thus forcing banks to reduce asset size by a multiple amount
   - The intervention of governments smoothens but does not solve the insolvency problem
   - Bad bank is a bad idea, simply postpones the date of nationalization for many banks
   - Recent announced bank losses show banks can no longer hide losses from their income statement through capital declines
2) The inter-bank market still effectively shut beyond the weekly horizon
   - Liquidity has particularly dried up post-Lehman
   - Signs of semi-revival in Jan 2009, particularly in the US

✓ The lack of capital and liquidity force Financial Institutions to de-leverage by a multiple amount, restricting new lending and causing a slowdown in economic activity

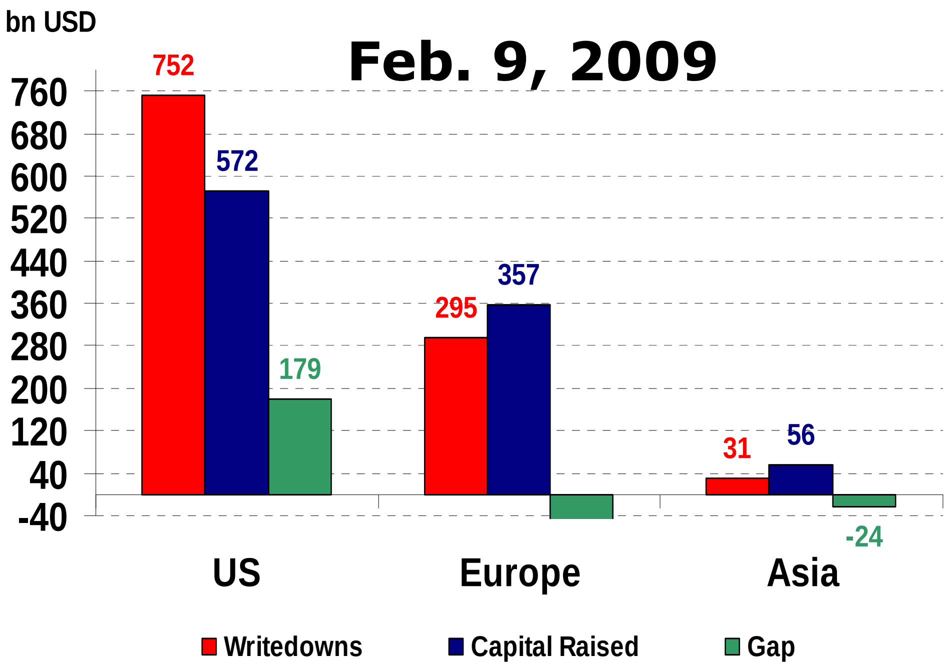
✓ ***As long as the insolvency & illiquidity problems remain unresolved, the crisis is far from over***

I.a Insolvency: The number one problem again

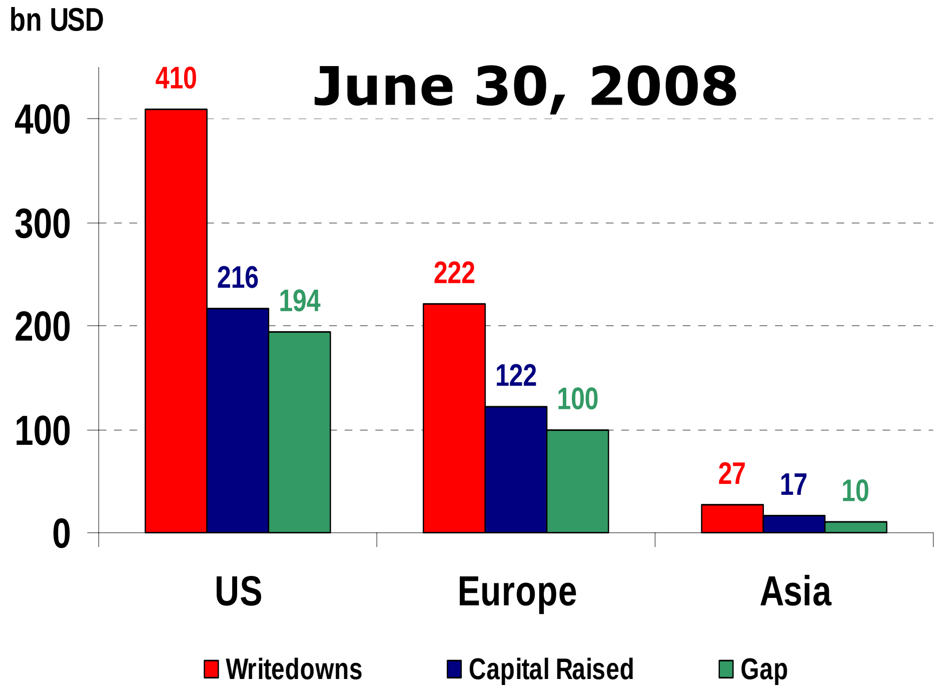
- ✓ The gap between total write-downs and capital increases has declined sharply due to governments' recapitalizations
- ✓ Yet, more write-downs to come: IMF raised its estimate for total write-downs to $2.2 trillion in January 2009 from $1.4 in October 2008

All Financials*

Total Write-downs: $ 1077.8
Total Capital Raised: $ 985.1
Total Gap: $ 92.7



Total Writedowns: $ 658.5
Total Capital Raised: $ 355.3
Total Gap: $ 303.2

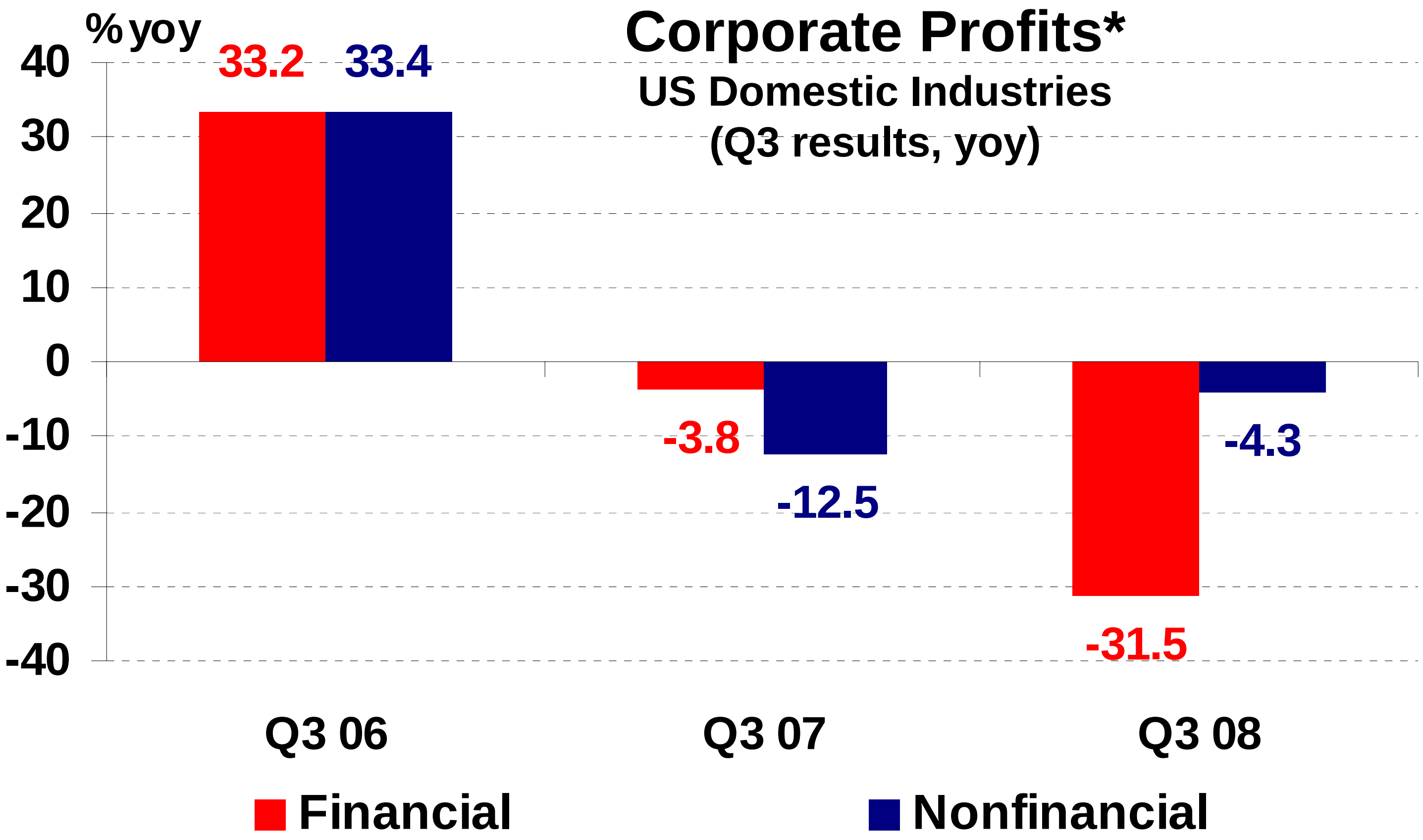


Source: Bloomberg

* Banks/Brokers, Insurers, GSEs

I.a More insolvencies to come

Expect a further deterioration in profitability from 2008-Q4 and on …



* Corporate profits with inventory valuation and capital consumption adjustments

Source: US Department of Commerce, Bureau of Economic Analysis, National Economic Accounts

I.a Liquidity:
US & European banks are hoarding cash

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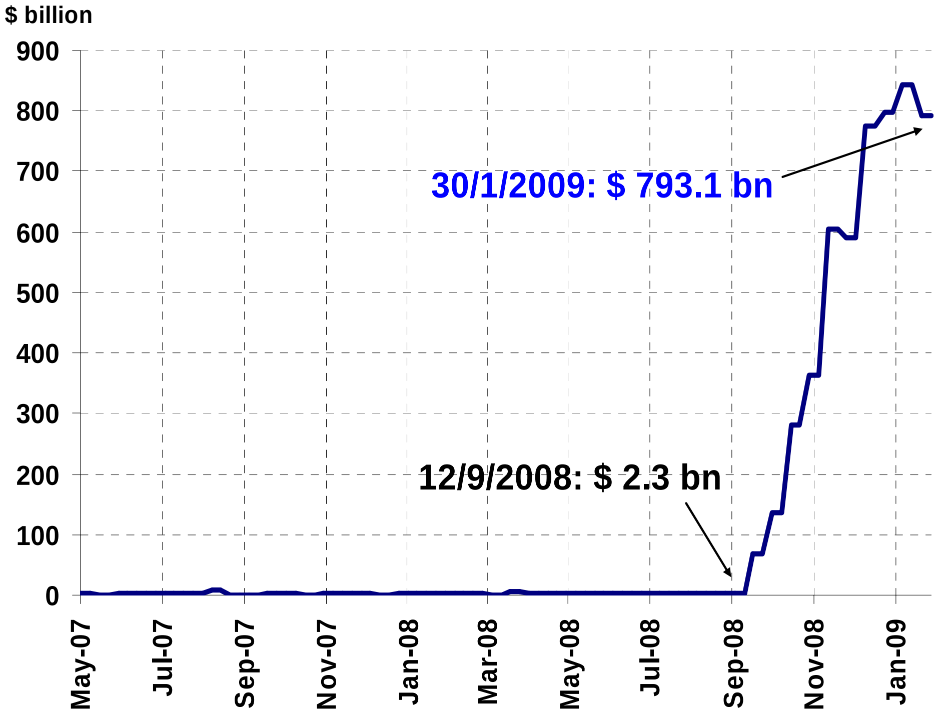
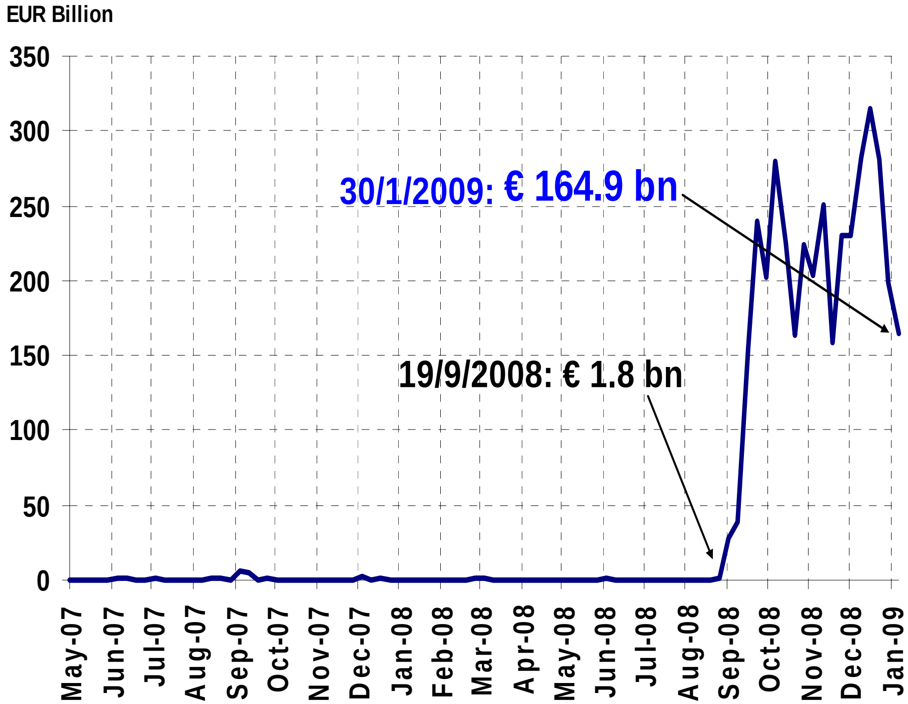
USA: Excess Reserves



Europe: Deposit Facility



Source: Federal Reserve, ECB

I.a Liquidity: Still problematic

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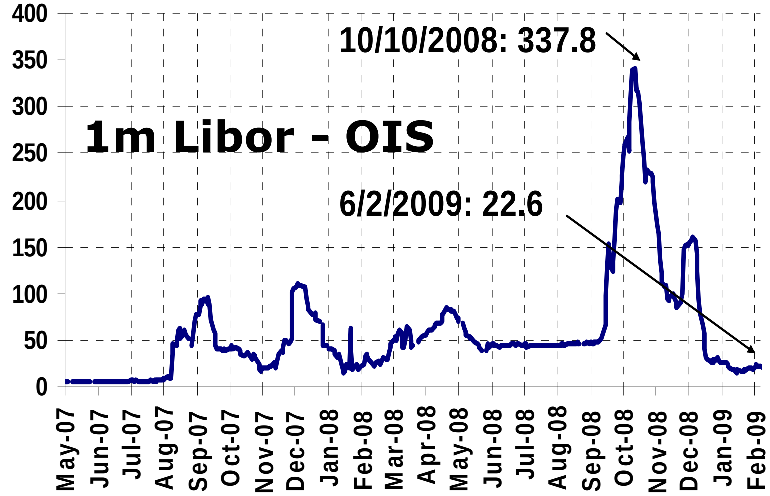
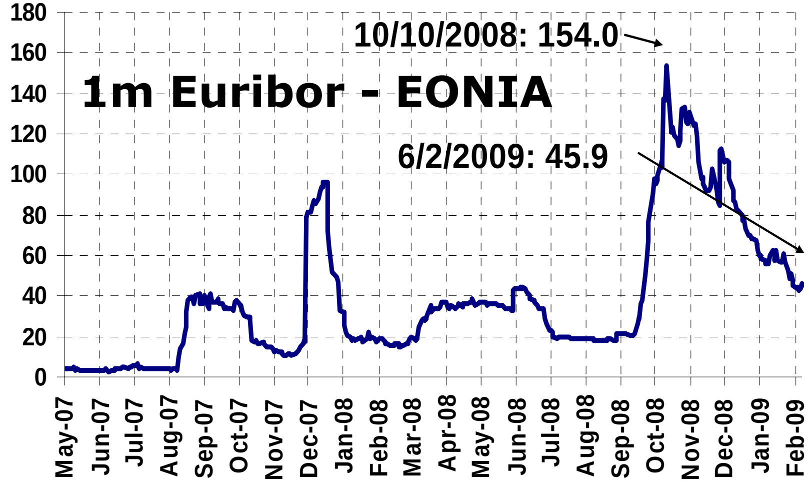
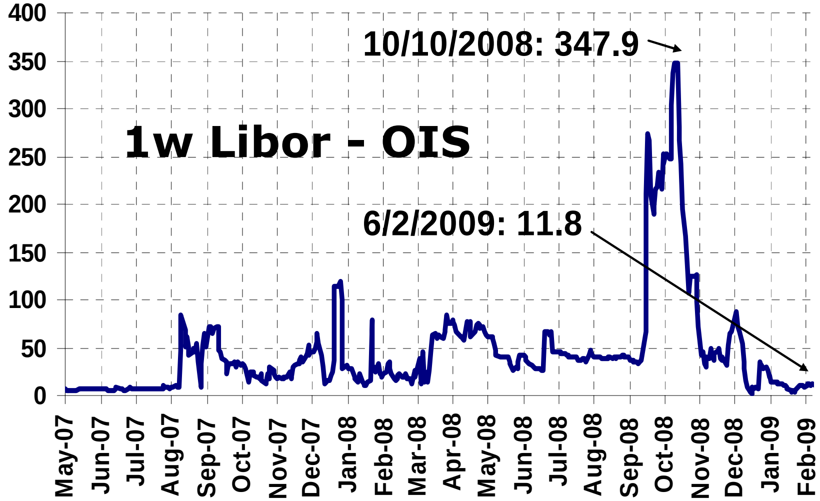
U.S.A. Euro Area

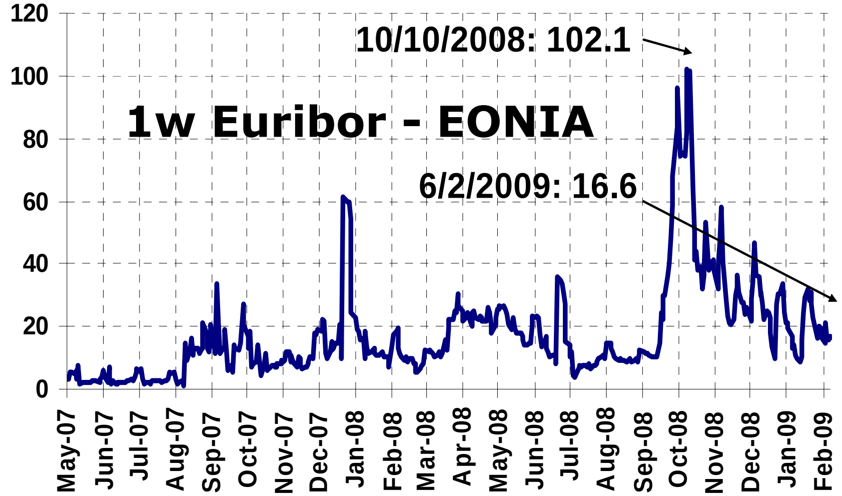
Uncovered minus covered 1-month inter-bank rates





Uncovered minus covered 1-week inter-bank rates





I.a Illiquidity & Insolvency -> deleveraging
Significant tightening of credit standards

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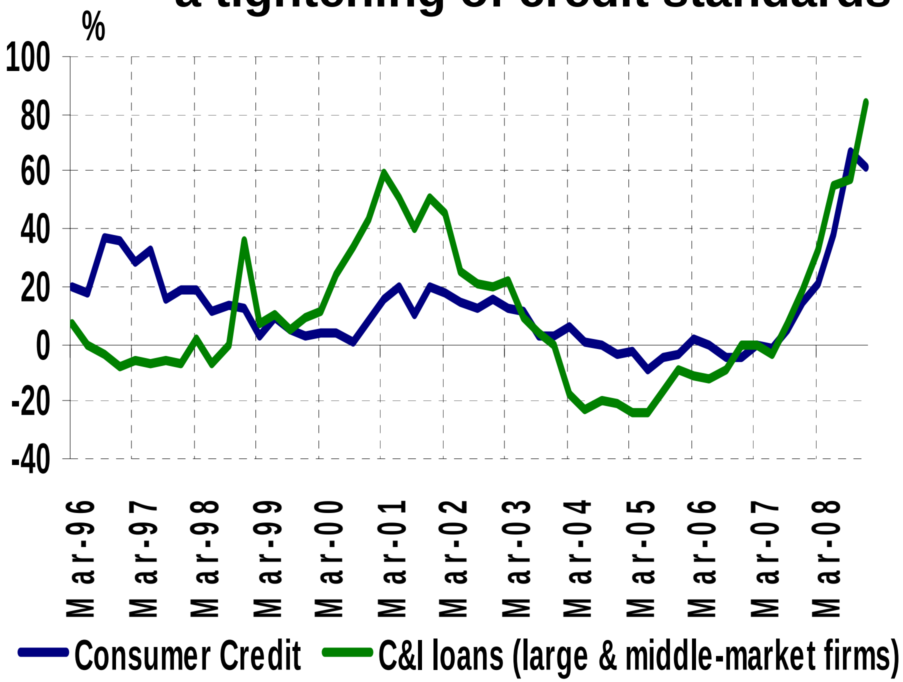
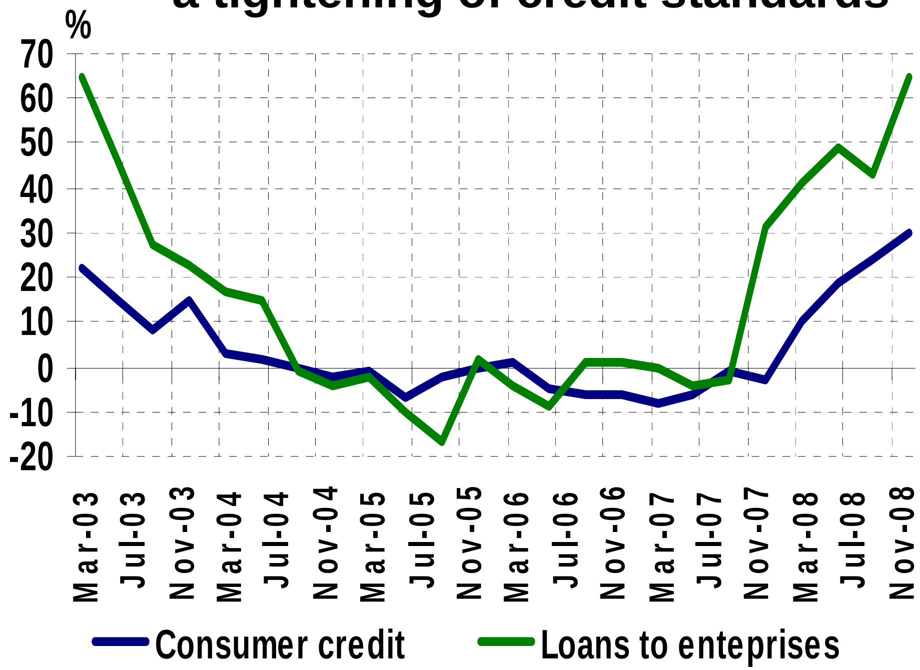
USA
Net percentage of banks reporting a tightening of credit standards



Source: Federal Reserve, The Senior Loan Officer Opinion Survey on Bank Lending Practices, October 2008

Euro area
Net percentage of banks reporting a tightening of credit standards

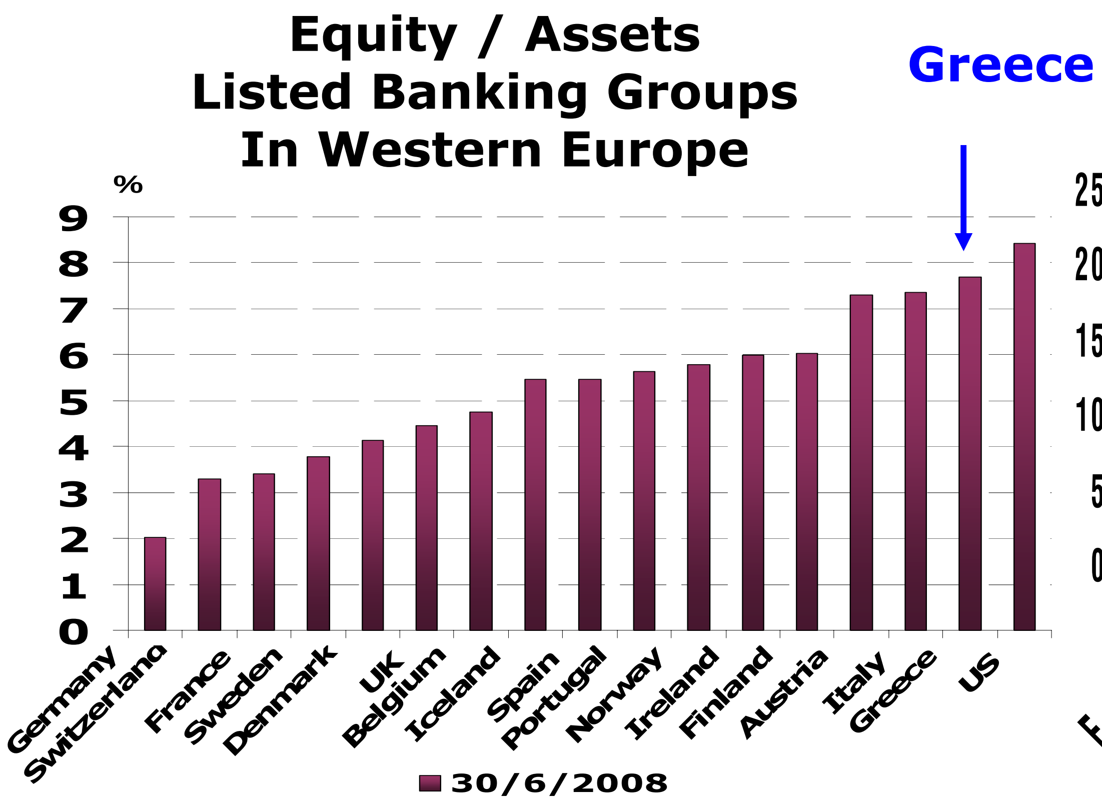


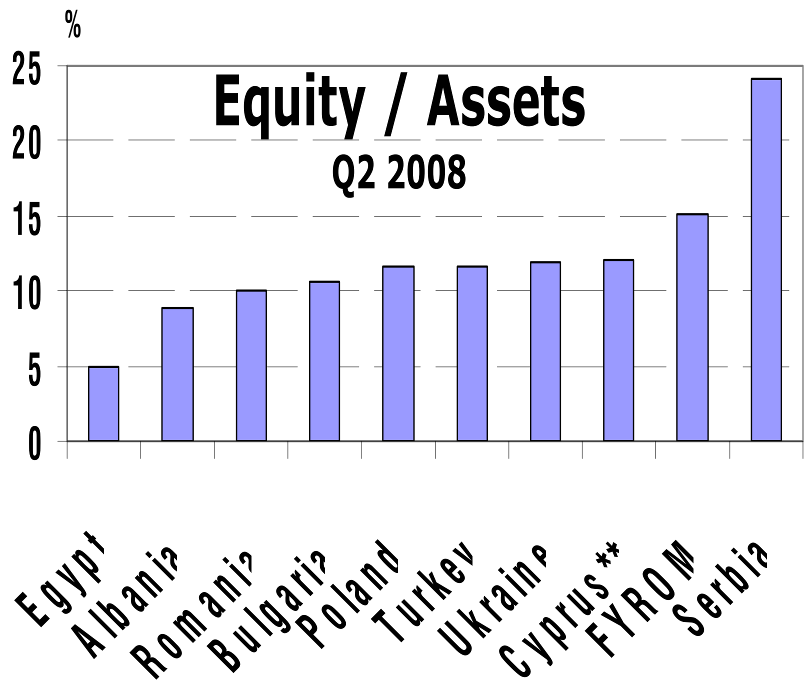
Source: ECB, The Euro Area Bank Lending Survey, October 2008

✓ *The results of the October 2008 bank lending surveys in the US and the EA indicate a significant increase in the net tightening of credit standards for loans to enterprises in Q3 08.*

I.b Capitalization:

Greek banks in good shape - Banks in New Europe better capitalized than in Western Europe





* Albania, data as of Dec 07

** Cyprus, data refer to Tier I Capital

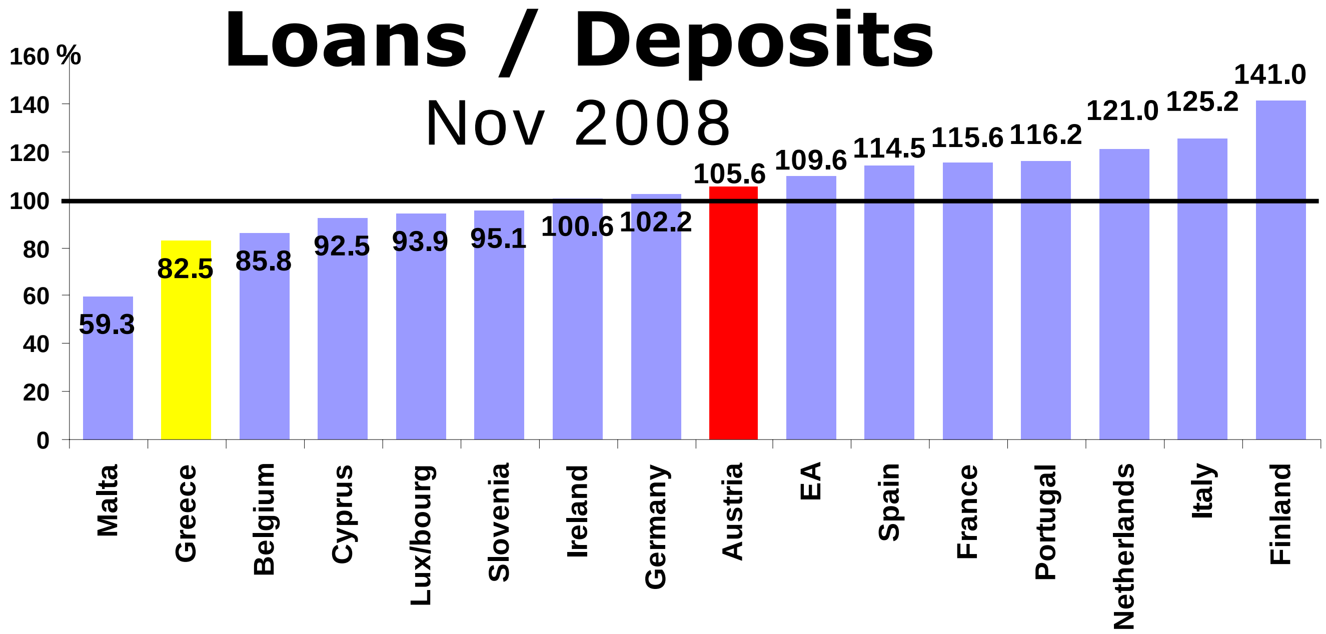
Best:

EFG Intern/al **13.52%** in Switzerland

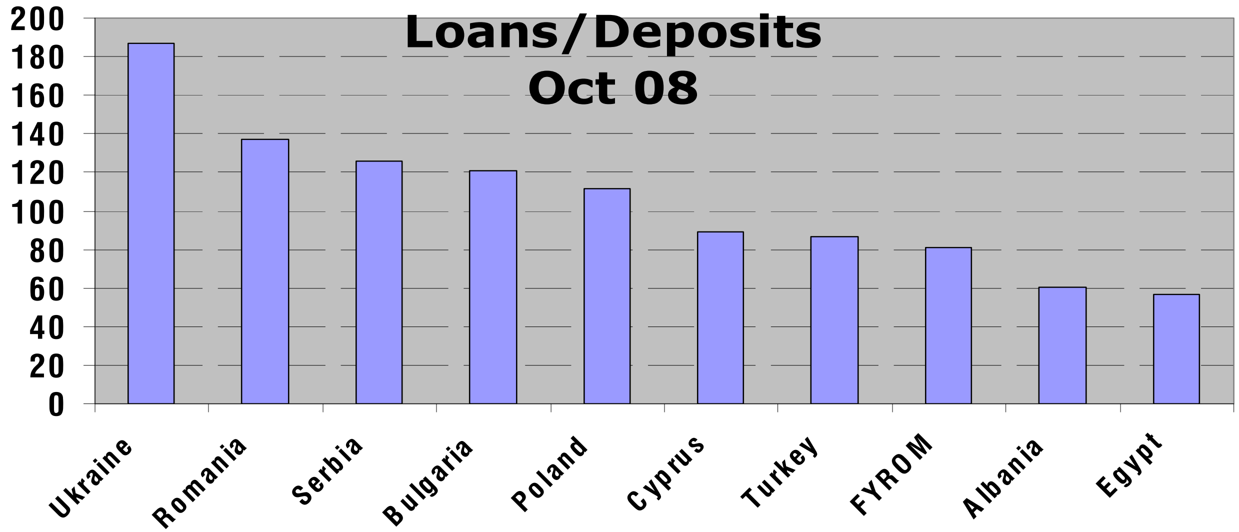
Worst:

DEXIA **1.67%** in Belgium

I.b Liquidity: Abundant in Greece, lacking in some New Europe countries



Source: ECB, Balance Sheet Items data
(Total Loans / Total Deposits, MFIs excluding Eurosystem)



*Cyprus as of Sep 08, FYROM as of Jun 08

II.
Effects on the Greek economy

1) Greek schizophrenia: The short-run vs. the long-run
2) Greece in a better short-run position relative to its Euro Area peers
3) Yet vulnerable to prolonged economic stagnation

II. Greek schizophrenia

A. In the **short-run**, Greece **can withstand** the crisis **better** than its European counterparts, thanks to

1) Strong real wage growth that boosts consumption, which has the largest share in output within the EU
2) A strong banking system that weathers the external financial storm
3) A relatively more closed economy within the EU
4) Horizontal diversification of business activity, i.e. absence of vertical integration
5) Continuation of looseness in fiscal policy

B. Yet, in the **intermediate-run**, economy's vulnerabilities are deep (competitiveness, fiscal imbalances) and are now exposed by the crisis. Hence, a **nightmare scenario** of negative growth and subsequent prolonged stagnation if

1) officials remain sluggish to the **elevated demands for active policy** and the need to **prioritize its policies in a credible manner**, such as (i) Re-adjusting public expenditure, (ii) Improving the tax collection mechanism, (iii) Pushing the needed structural reforms
2) Credit expansion does not resume soon
3) Markets' negative focus on the financing of the Greek external debt does not go away

II. Gloomy EU projections

	2007	2008e	2009f	2010f
Germany	2.5	1.3	**-2.3**	0.7
France	2.2	0.7	**-1.8**	0.4
Spain	3.7	1.2	**-2.0**	-0.2
Italy	1.5	-0.6	**-2.0**	0.3
Ireland	6.0	-2.0	**-5.0**	0.0
Portugal	1.9	0.2	**-1.6**	-0.2
Greece	4.0	2.9	**0.2**	0.7
EuroArea	2.7	0.9	**-1.9**	0.4
EU-27	2.9	1.0	**-1.8**	0.5
Japan	2.4	-0.1	**-2.4**	-0.2
USA	2.0	1.2	**-1.6**	1.7

European Commission projections, January 2009

	2007	2008e	2009f	2010f
Slovakia	10.4	7.1	**2.7**	3.1
Poland	6.7	5.0	**2.0**	2.4
Bulgaria	6.2	6.4	**1.8**	2.5
Romania	6.2	7.8	**1.8**	2.5
Czech Rep.	6.0	4.2	**1.7**	2.3
Cyprus	4.4	3.6	**1.1**	2.0
Malta	3.9	2.1	**0.7**	1.3
Slovenia	6.8	4.0	**0.6**	2.3

- ✓ **Yet, Greece in better shape in 2009**
- ✓ **EU countries with Greek investments in better shape too**

II. Greece in comparison to Euro Area

GREECE	2008	2009	2010
GDP growth (%)	**2.9**	**0.2**	**0.7**
Δ Unemployment rate	**0**	**0.7**	**0.4**
Inflation (HICP)	**4.2**	**2.5**	**2.7**
Current Account Balance (% GDP)	**-13.4**	**-12.8**	**-13.2**
General Government Deficit (% GDP)	**-3.4**	**-3.7**	**-4.2**
General Government Debt (% GDP)	**94.0**	**96.2**	**98.4**

EURO AREA	2008	2009	2010
GDP growth (%)	**0.9**	**-1.9**	**0.4**
Δ Unemployment rate	**0**	**1.8**	**0.9**
Inflation (HICP)	**3.3**	**1.0**	**1.8**
Current Account Balance (% GDP)	**-0.4**	**-0.6**	**-0.6**
General Government Deficit (% GDP)	**-1.7**	**-4.0**	**-4.4**
General Government Debt (% GDP)	**68.7**	**72.7**	**75.8**

European Commission projections, January 2009

II. Greece: Channels of negative influence

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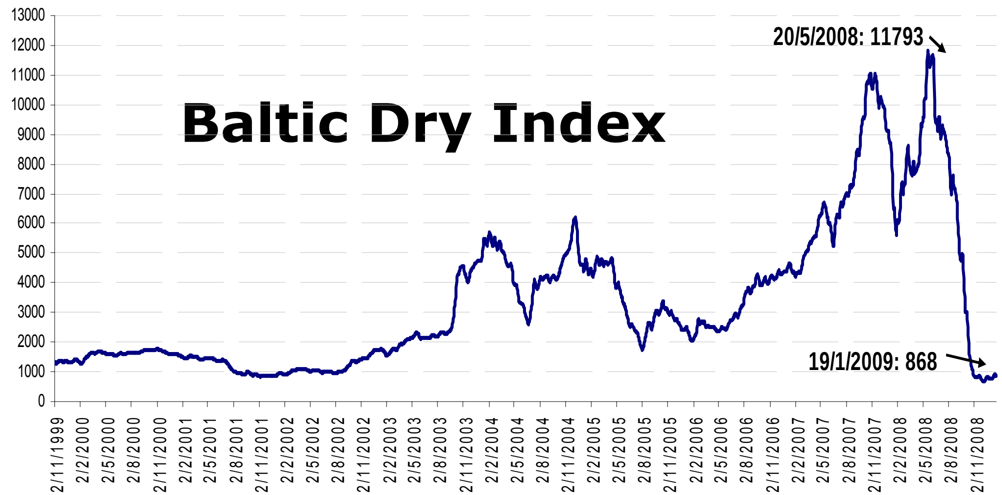
1) Real contagion: Lower economic activity abroad → less exports, lower tourist receipts, less foreign buying of property, lower shipping rates
2) Credit contagion: Less credit expansion (both supply & demand driven), lower consumption & investment
3) Market contagion: Asset values ⇩ , i ↑ more difficult debt financing

Greece will avoid:

✓ Large bank failures and abrupt restriction of credit due to solvency reasons to the same degree observed abroad



II. Fiscal ability limited

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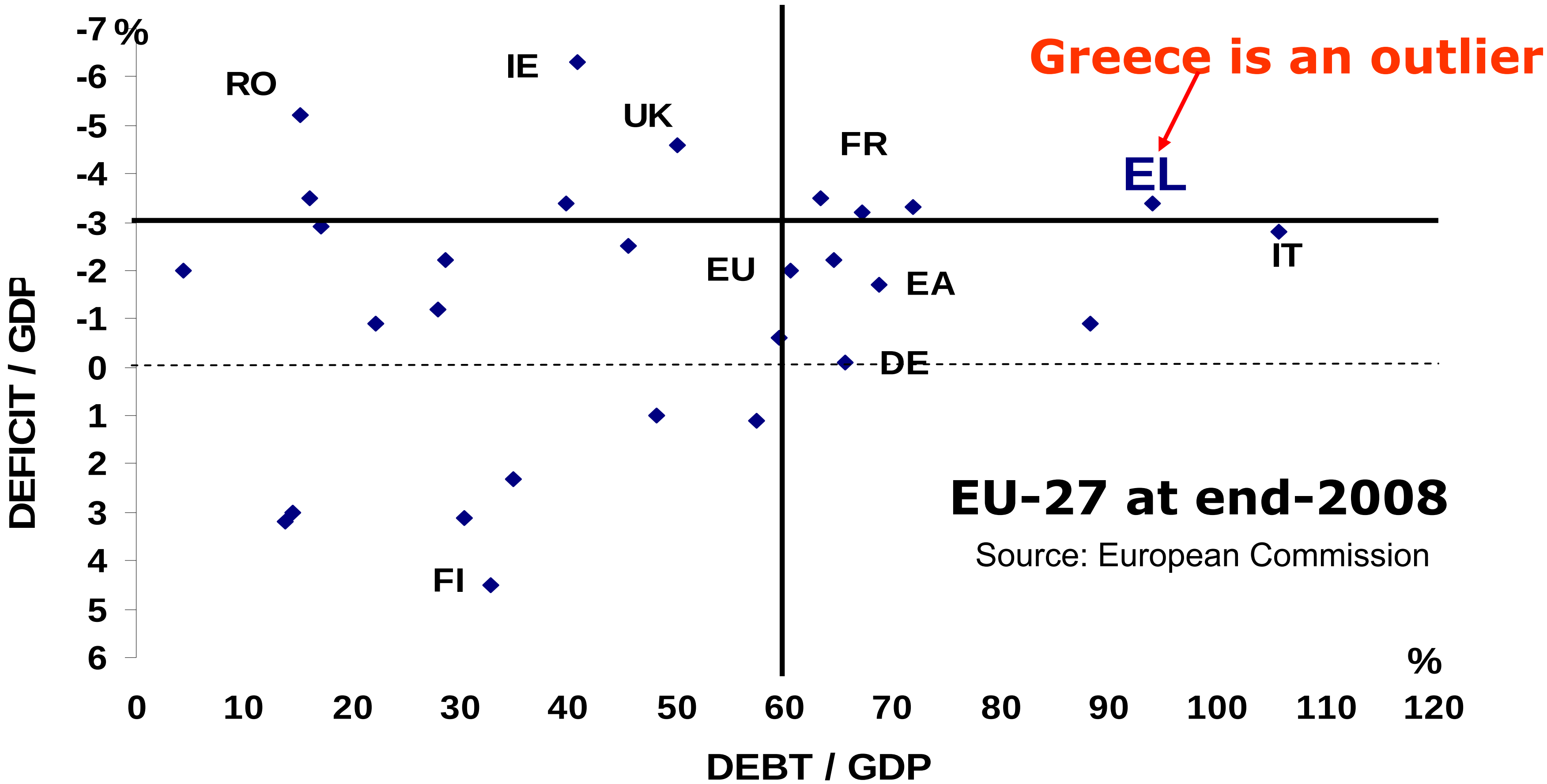


Inability to follow an expansionary policy vivid in the 2009 budget

- ✓ **The Public Investment Budget outlays are <u>reduced</u> by 8.8% !!**
- ✓ Surprisingly lower EU inflows in 2009
- ✓ A possible relaxation of the SGP by the EU might allow some fiscal expansion
- ✓ Eventual 2009 deficit expected to be larger than the one predicted by the EU

II. Relatively optimistic projections for Greece by the European Commission

	% GDP	2008	2009	2010
GDP at constant prices	100.0	2.9	0.2	0.7
Private consumption	71.2	2.4	0.7	0.7
Public consumption	16.7	2.8	2.4	2.3
Gross fixed capital formation	22.5	-0.5	-2.8	-0.1
of which : equipment	8.7	4.3	-1.4	0.5
Exports (goods and services	23.0	3.7	-1.5	0.8
Imports (goods and services	33.5	-0.2	-0.9	1.1
GNI at constant prices	97.1	2.6	0.0	0.6

- ✓ **Will the above baseline scenario prevail or nasty surprises are waiting on the sidelines?**
- ✓ **Will policies that support short-run growth avoid sacrificing long-term stability and economic dynamism?**

II. Greek government's projections even more optimistic

	Baseline scenario				Alternative scenario			
	2008	2009	2010	2011	2008	2009	2010	2011
GDP growth rate	3.0	1.1	1.6	2.3	3.0	0.5	1.3	1.8
Private consumption deflator	4.2	2.6	2.5	2.4	4.2	2.2	2.1	2.0
Unemployment rate	7.5	8.0	8.0	7.9	7.5	8.1	8.2	8.2
General government deficit, % GDP	3.7	3.7	3.2	2.6	3.7	3.7	3.2	2.6
General government debt, % GDP	94.6	96.3	96.1	94.7	94.6	97.2	97.6	96.9
Current account deficit, % GDP	14.6	13.1	12.5	11.7	14.6	13.4	13.0	12.4

Source: Hellenic Stability & Growth Programme 2008 - 2011

Measures to be taken in order to safeguard public finances projections:

- Close monitoring of tax offices' performance – Setting up an early warning system
- Pushing forward with privatizations
- New hires < Retirements (except in health and education sectors)
- Wage increases covering inflation
- Close monitoring of the wider public sector's expenses
- Adoption of program budgeting

II. The history of recessions has not been kind to Greece

Recessions 1960-2007

Summary Statistics

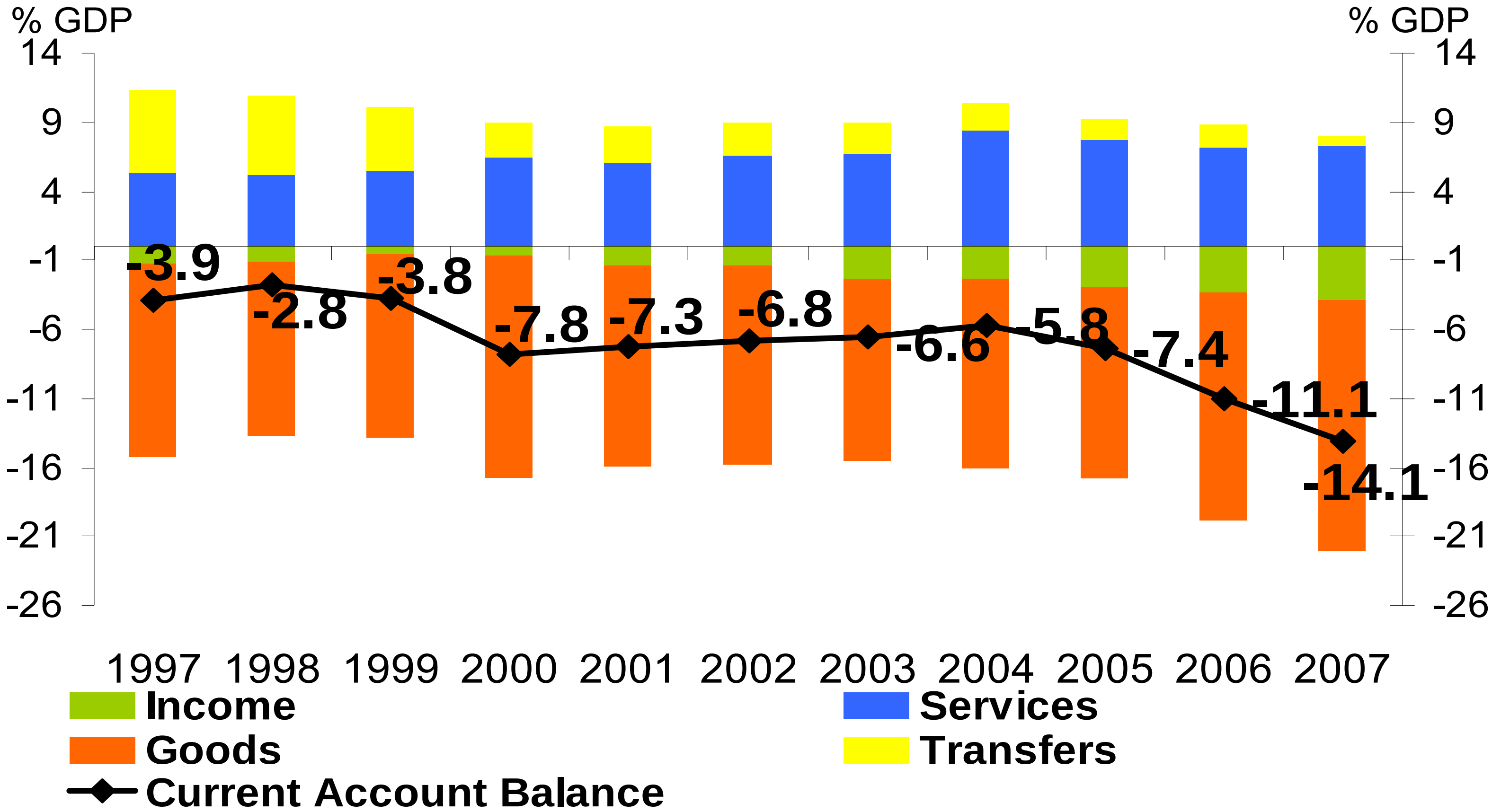
	# of Recessions	Duration (quarters)	Amplitude	Cumulative Output Loss
Greece	**8**	**3.50**	**-6.45%**	**-11.8%**
OECD (Median)	**5**	**3.00**	**-1.87%**	**-3.0%**

Source: Stijn Claessens, M. Ayhan Kose & Marco E. Terrones, IMF 8/2008, "What Happens During Recessions, Crunches and Busts?"

Notes: **Duration** is the number of quarters between a peak and the next trough. **Amplitude** is the percent change in output from a peak to the next trough. The **cumulative loss** combines information about the duration and amplitude to measure the overall cost of a recession and is expressed in percent. Country-specific data are means. Country-group data are means/medians.

II. Greece's deteriorating current account …

- ✓ **CA deficit** has **tripled** relative to the pre-EMU period, while the growth in aggregate demand is the same as before
- ✓ **CA deficit** can lead to an abrupt **future recession**
- ✓ **EU projections:** CA deficit 13.4% in 2008 and 12.8% in 2009



Source: Bank of Greece

II. … keeps pushing up the external debt

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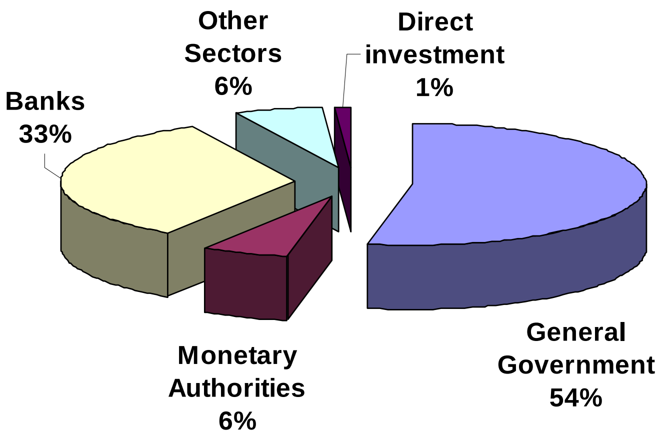
Greek Gross External Debt increased by **52.4 p.p.** of GDP, or 220% in 5 years

2Q 2008 : $ 531.7 bn : 138.2% of GDP
2Q 2003 : $ 166.2 bn : 85.8% of GDP

Accumulated Current Account Deficits 2Q 2003 – 2Q 2008 : **49 p.p. of GDP**

Greek Gross External Debt Composition

(2Q 2008, Total: $531.7 bn)



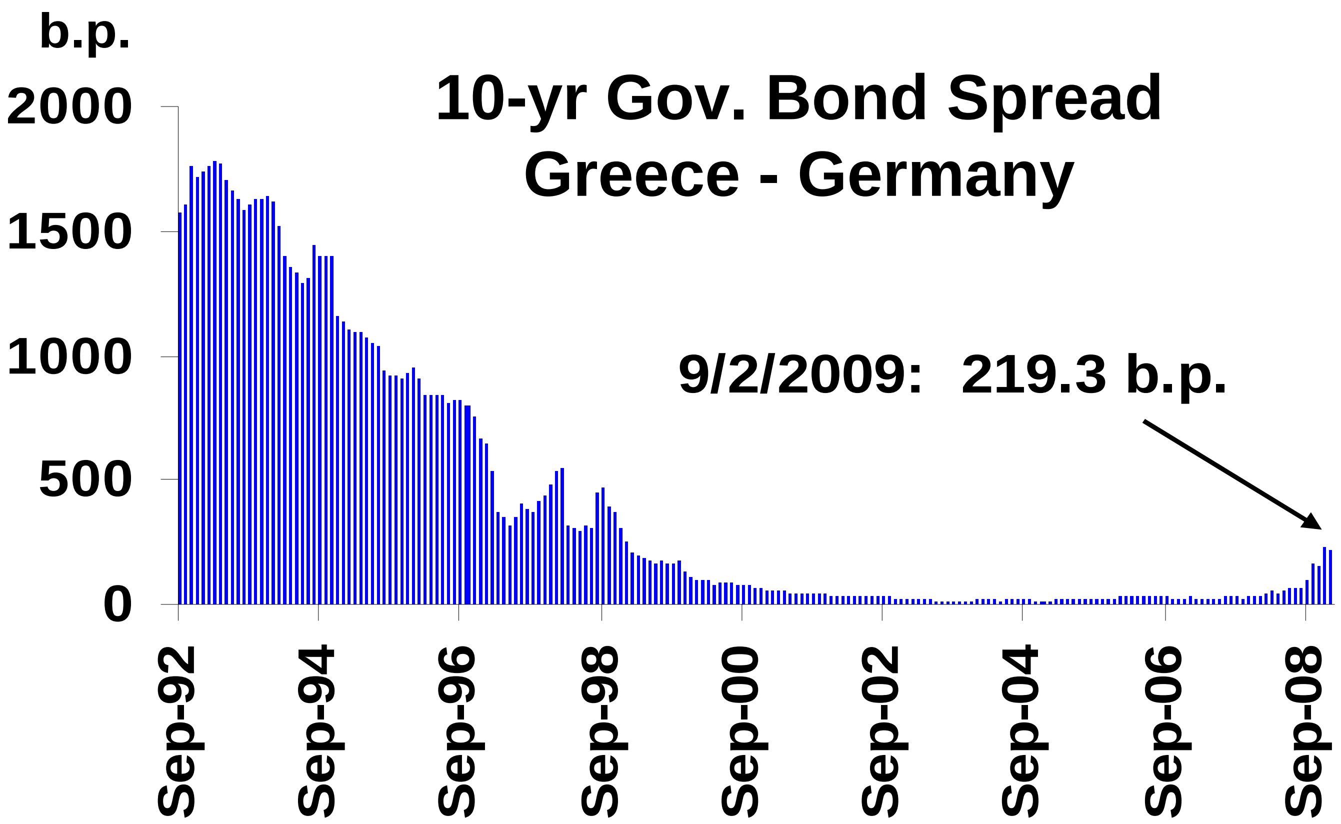
Source: IMF, OECD, BIS, WORLD BANK Joint External Debt Database

✓ Banks' ownership of 1/3 of external debt may prolong the current liquidity problem if crisis continues

% of GDP	2000	2007	2020	2040	2050
Pension Expenditure	10.82	11.7	13.2	21.4	24.0

Source: Hellenic Stability & Growth programme 2008 - 2011

II. Could the rise of external debt lead to a nightmare of high spreads as in the early 90s?



- ✓ Spreads have risen but are unlikely to reach the levels of the early 90s
- ✓ Most of the rise in spreads due to global risk aversion, not local factors

II. The Need for Structural Reforms in Greece

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- ✓ **We desperately need reforms**

  a) Our policy tools are restricted in EMU

  b) Yet, the awareness of reforms is missing as market discipline within EMU disappeared

- ✓ **Crisis and economic imbalances in Greece**

  a) The three major imbalances:

  Competitiveness, Public Debt, Inequalities

  b) The global financial crisis as a stress test scenario:
  If economy goes into recession, it is likely to **stagnate** for a long time as it would be difficult to reverse the downward momentum

- ✓ **Structural reforms**

  a) Product Markets

  b) Public Sector

  c) Labor Market (perhaps over-emphasized)

III.

Policy Priorities

III. Immediate policy priorities to avoid a deep recession

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1) Expenditure reallocation
    i. Allocate funds according to an announced plan based on a cost-benefit analysis with an explicit list of priorities and do not succumb to interest groups via handouts and cheap talk
    ii. Safeguard the public sector's credibility in its monetary obligations to citizens during today's difficult times
    iii. Expedite investment projects through use of EU money & PPPs
    iv. Improve incomes of citizens with high marginal propensity to consume, i.e. the low-income groups
2) Revamping the system of tax collection
    i. Improve transparency further through carrots and stick and the use of technology and fight corruption
3) Allow for budget overruns in 2009 but ensure they are of temporary nature and a return to fiscal discipline is possible once the crisis is over
4) Ensure the continued expansion of loans to households and enterprises, say at 10% -15% in 2009

III. Additional policy priorities to ensure long-term growth

5) Restructure the health care system as competition with the private sector is accelerating

6) Expedite the restructuring of many public sector companies

7) Tackle the oligopolistic practices in trade & commerce that create a huge wedge between producer and consumer prices

8) Reconnect the educational system with the needs of contemporary society

Conclusions

- ✓ Greece is facing fewer short-run problems than its Euro Area partners thanks to the strength of its financial sector, its relatively closed economy, lack of vertical integration in production and real wage growth that boosts consumption
- ✓ In the short-run trade-off between a deep recession and fiscal overruns, policy should try to avoid a recession but without sacrificing long-term stability
- ✓ The open question: Will fiscal pressures lead to rational decisions and an explicit ranking of policy priorities or are we facing a period of weak governing and economic stagnation?
- ✓ Economists claim that during tough times, no serious structural reforms are undertaken
- ✓ Yet Greece is different: The crisis may awaken citizens and policy makers from a period of sleep-walking due to EMU

THANK YOU FOR YOUR ATTENTION!

My thanks to the Research Department of Eurobank EFG for able research assistance and support