“The International Financial Crisis & Greece”

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THE FINANCIAL CRISIS EIGHTEEN MONTHS LATER

1. **FACTORS BEHIND THE CRISIS**
2. **THE TWO FUNDAMENTAL PROBLEMS THAT PROLONG THE CRISIS:**
   1. **Insolvency**
   2. **Counterparty risk**

I.1 Factors behind the crisis

- ✓ Macro-economists, oblivious to the underlying asset “bubbles” and global imbalances, up until recently were debating the question as to who takes the credit for the great moderation, i.e., the observed low inflation and high global growth
  - The period 2002-2007 records the highest average 5-yr growth of the last 40 years
- ✓ Now, the global party is over: The crisis is already 18 months old, growing worse in the last three months
- ✓ Not a single scapegoat for the crisis but **<u>many underlying causes</u>**:
  - Large global imbalances
  - cheap money or liquidity from surplus countries channeled mainly to US
  - Housing bubble
  - the subprime explosion without adequate bank controls on credit risk
  - Securitization and its new complicated and non-transparent layers
  - “Greed,” i.e. the quest for yield with a simultaneous underestimation of risk, that is, the opposite of the “*Peso Problem*”
  - Lax regulation and regulatory arbitrage, especially cross-border
  - Perverted incentives by Rating Agencies, corporate managers, etc.
  - **Enormous Leverage** based on **short-term** borrowing by FI investing on their own account. This factor is very important in spreading the crisis.

I.2 Two major problems behind the continuation of the current crisis

1) The loss in asset values generates write-downs, which cannot be replenished by new capital increases, thus generating insolvencies
   - The intervention of governments has partly solved the problem
   - Yet new bank losses recently make it the number one problem again

2) The inter-bank market was effectively shut beyond the weekly horizon
   - Liquidity has particularly dried up post-Lehman
   - Signs of a 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***

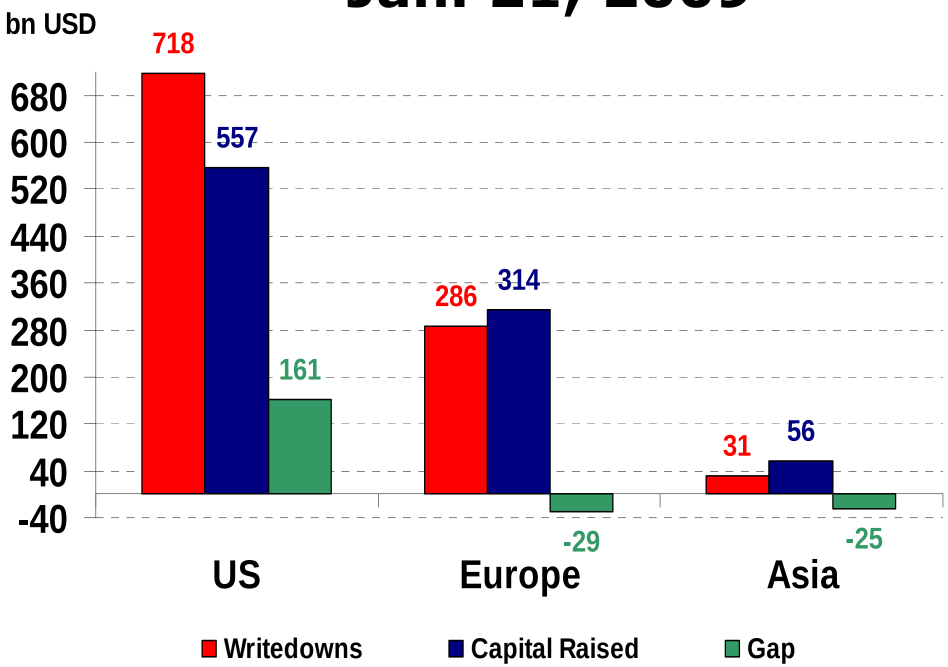
I.2 Insolvency

- ✓ The gap between total write-downs and capital increases declined sharply by the end of Dec 2008, thanks to government recapitalizations
- ✓ New bank losses are being announced
- ✓ Bank of England estimates marking-to-market losses of 2.5 trillion

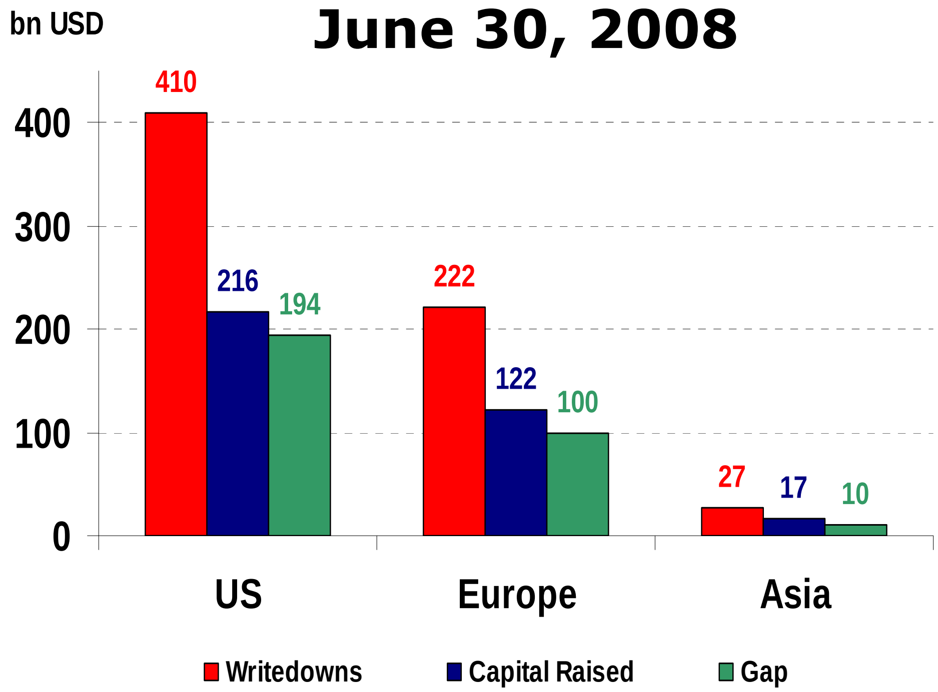
All Financials*

Total Write-downs:	$ 1034.9	Total Writedowns:	$ 658.5
Total Capital Raised:	$ 927.8	Total Capital Raised:	$ 355.3
Total Gap:	$ 107.1	Total Gap:	$ 303.2

Jan. 21, 2009



June 30, 2008



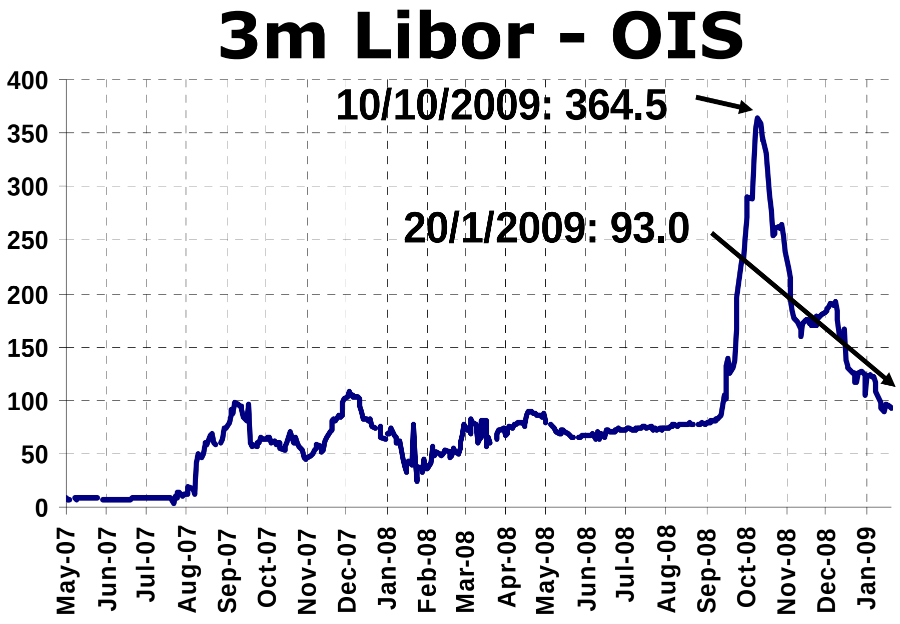
* Banks/Brokers, Insurers, GSEs   Source: Bloomberg

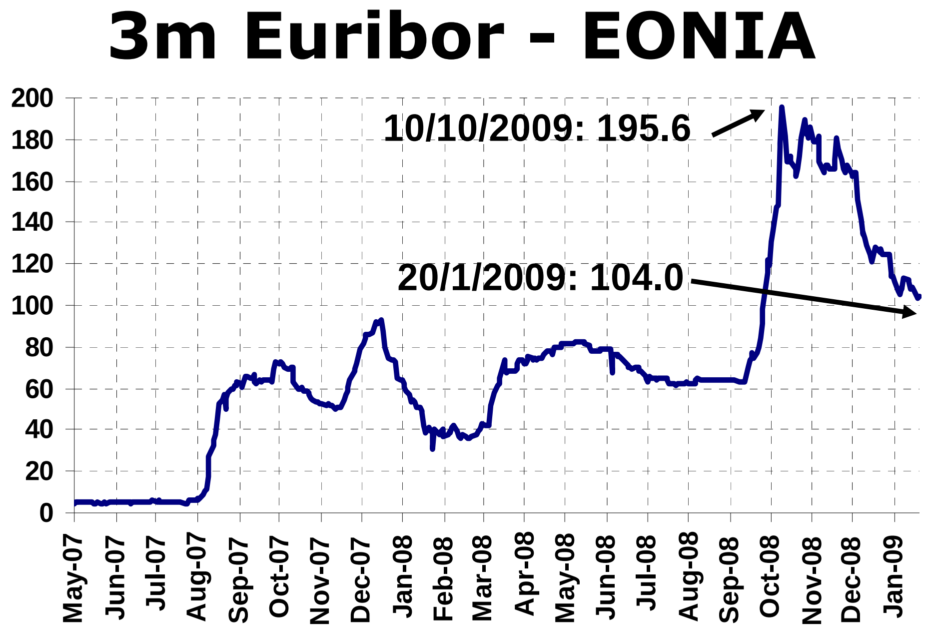
I.2 Liquidity – or counterparty risk - slowly improving to pre-October levels

✓ Europe lags behind the improvement

U.S.A. / Euro Area

Uncovered minus covered <u>3-month</u> inter-bank rates



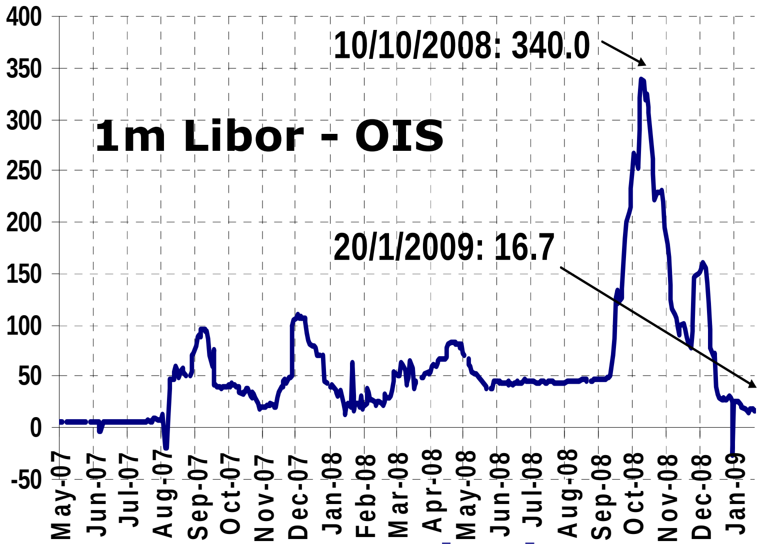


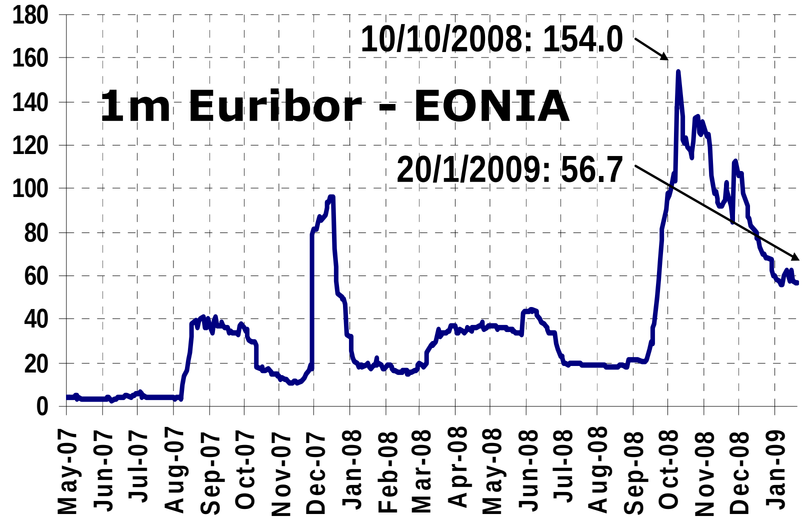
I.2 Liquidity: Europe not yet recovered

Eurobank EFG

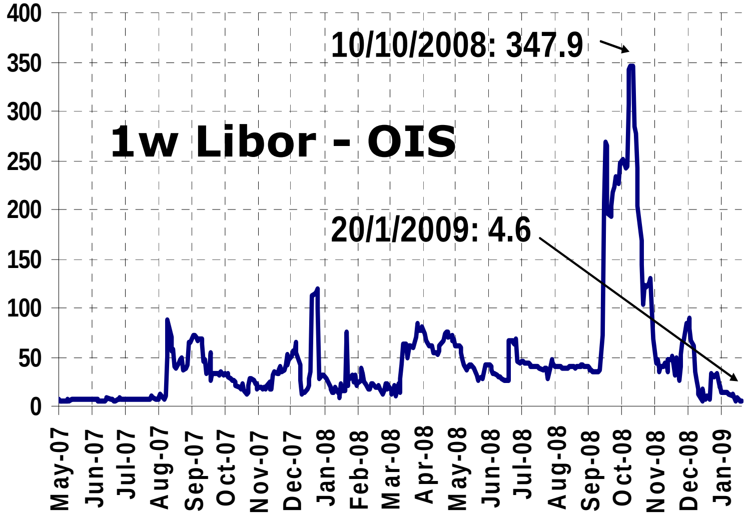
U.S.A. — Euro Area

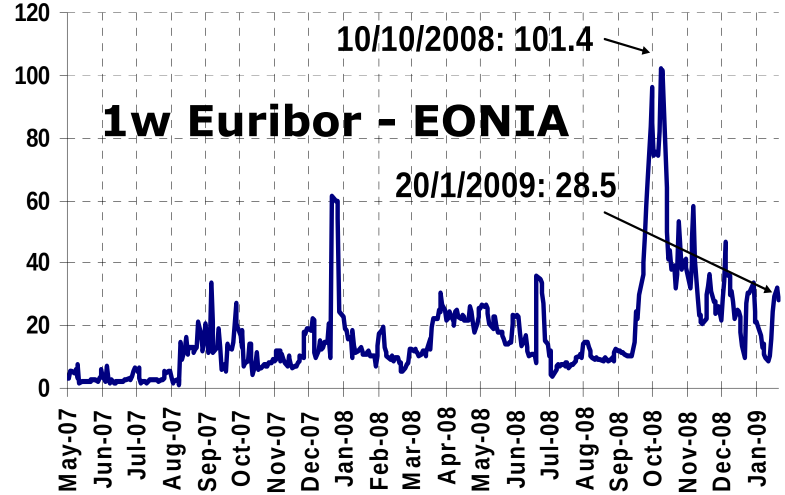
Uncovered minus covered 1-month inter-bank rates





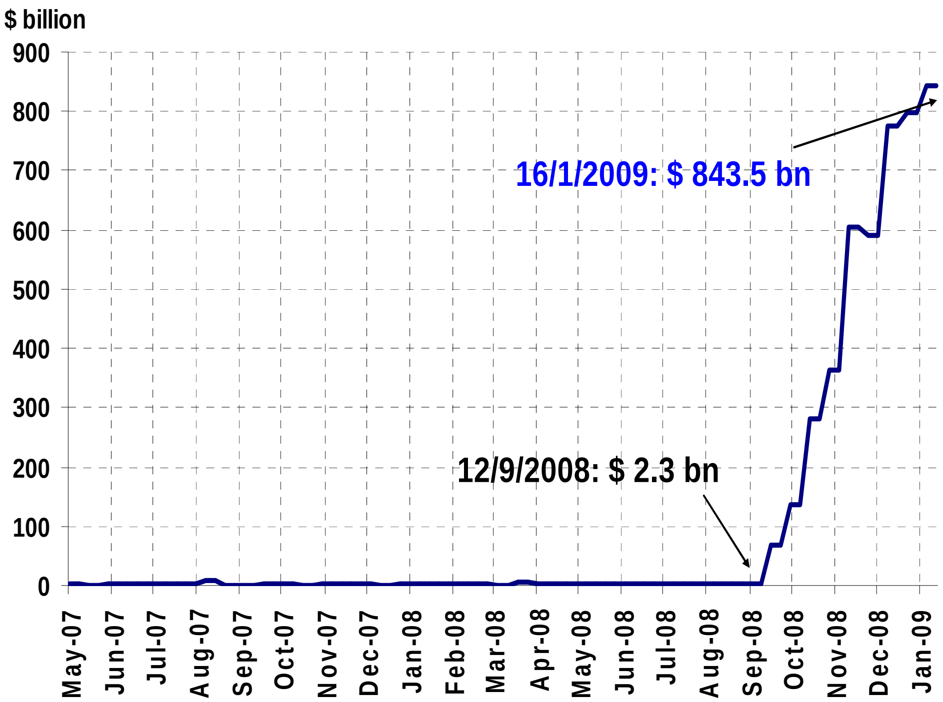
Uncovered minus covered 1-week inter-bank rates



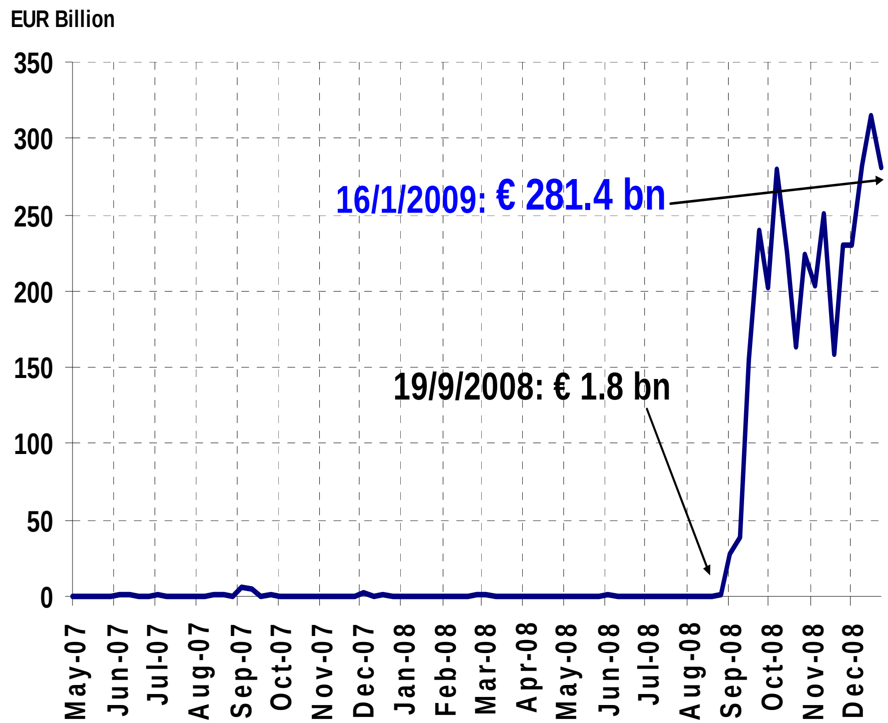


I.2 Liquidity:
US & European banks are hoarding cash

USA: Excess Reserves

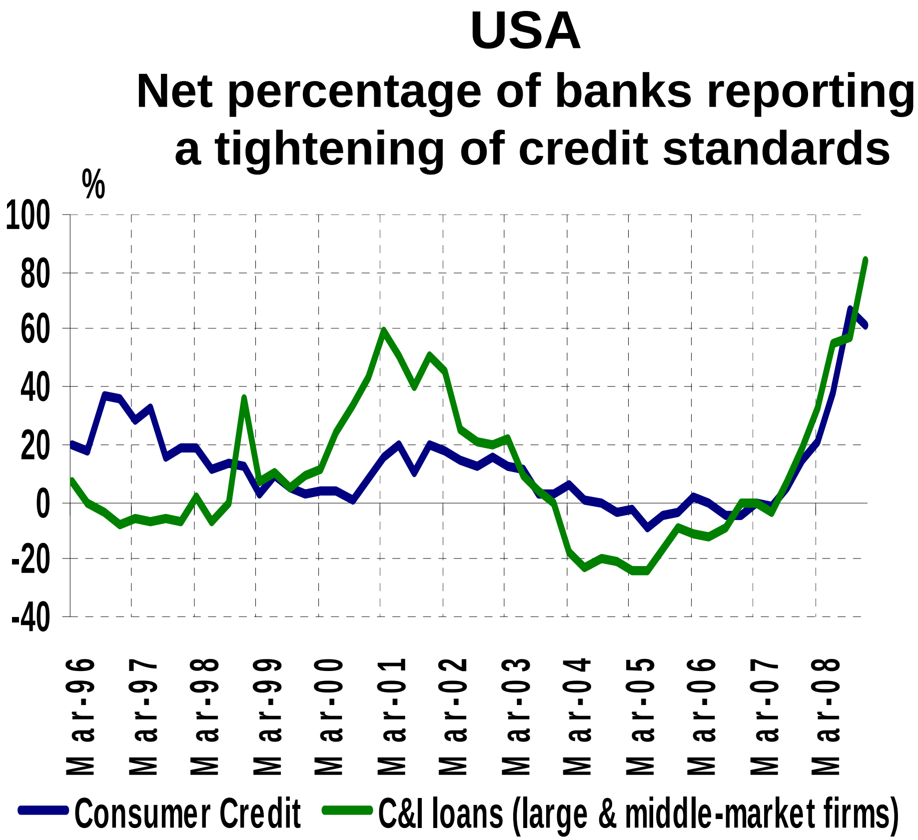


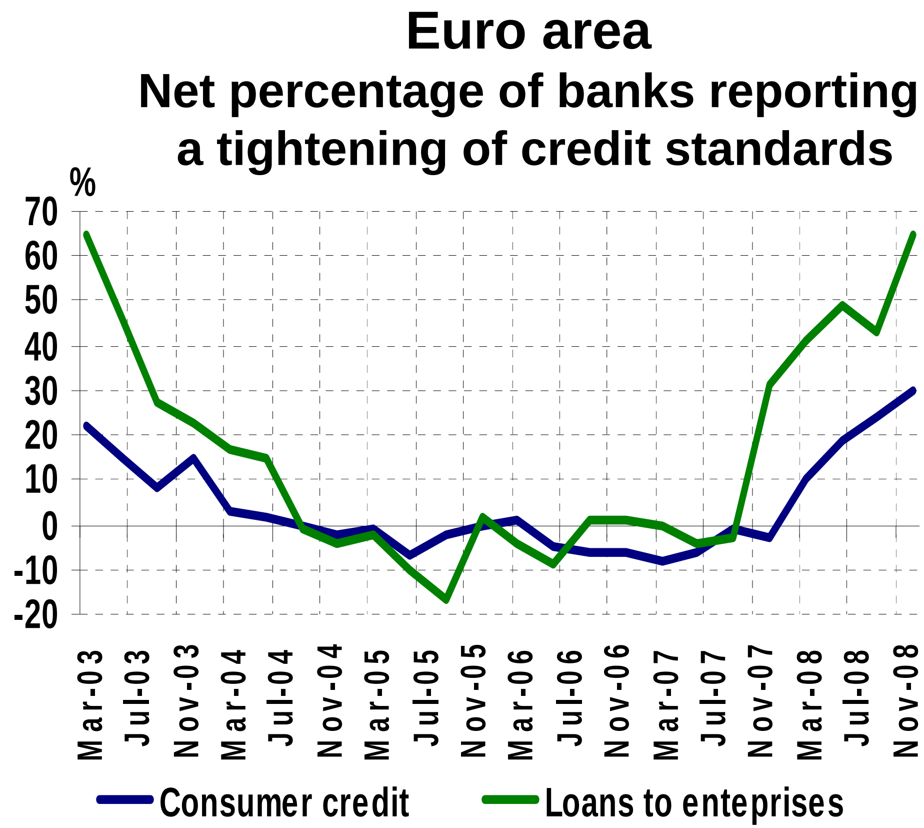
Europe: Deposit Facility



Source: Federal Reserve, ECB

I.2 Illiquidity & Insolvency -> deleveraging
Significant tightening of credit standards





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

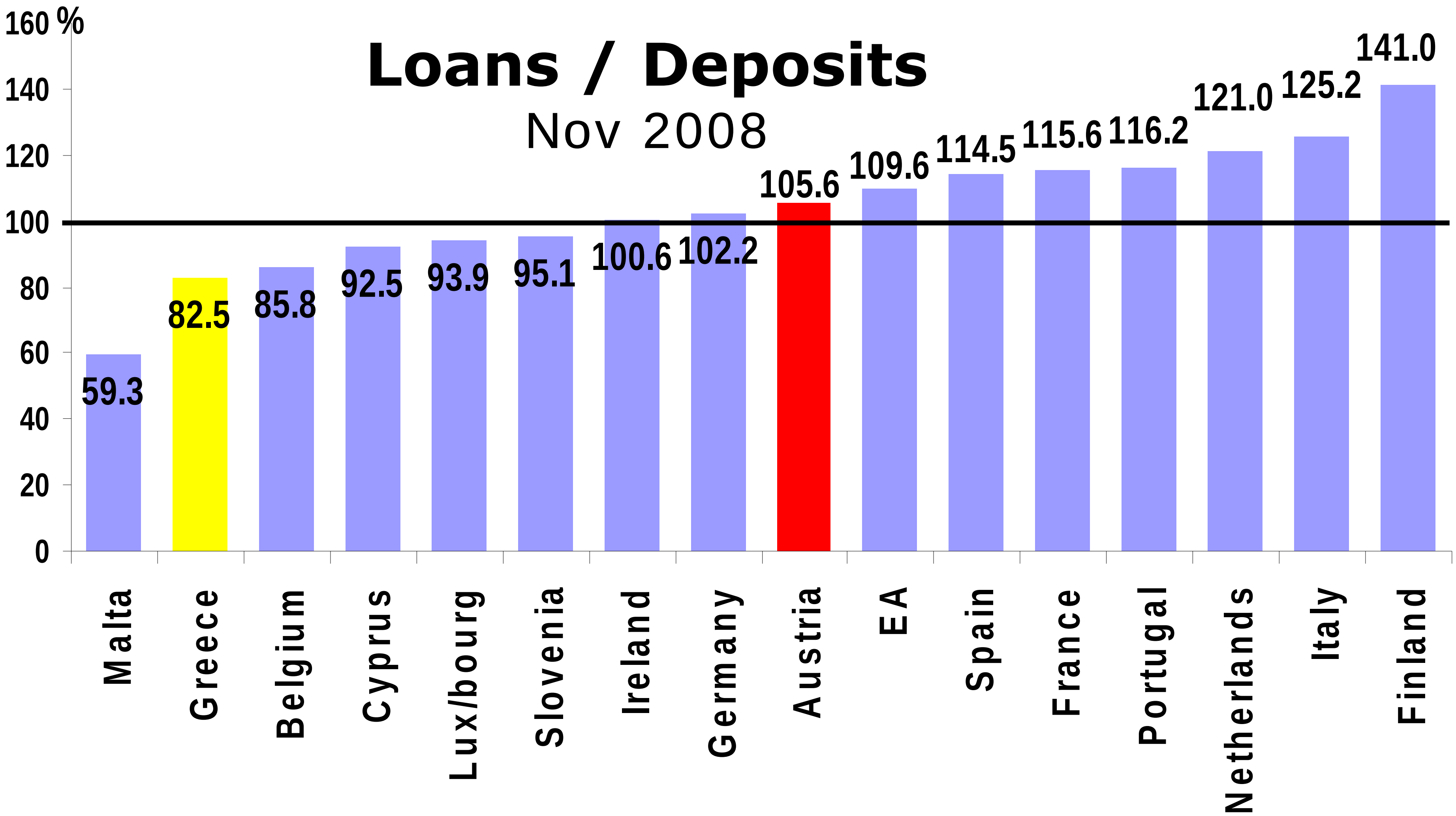
Source: ECB, The Euro Area Bank Lending Survey, October 2008

✓ *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.*

II.
GREEK BANKS

1) LIQUIDITY
2) SOLVENCY

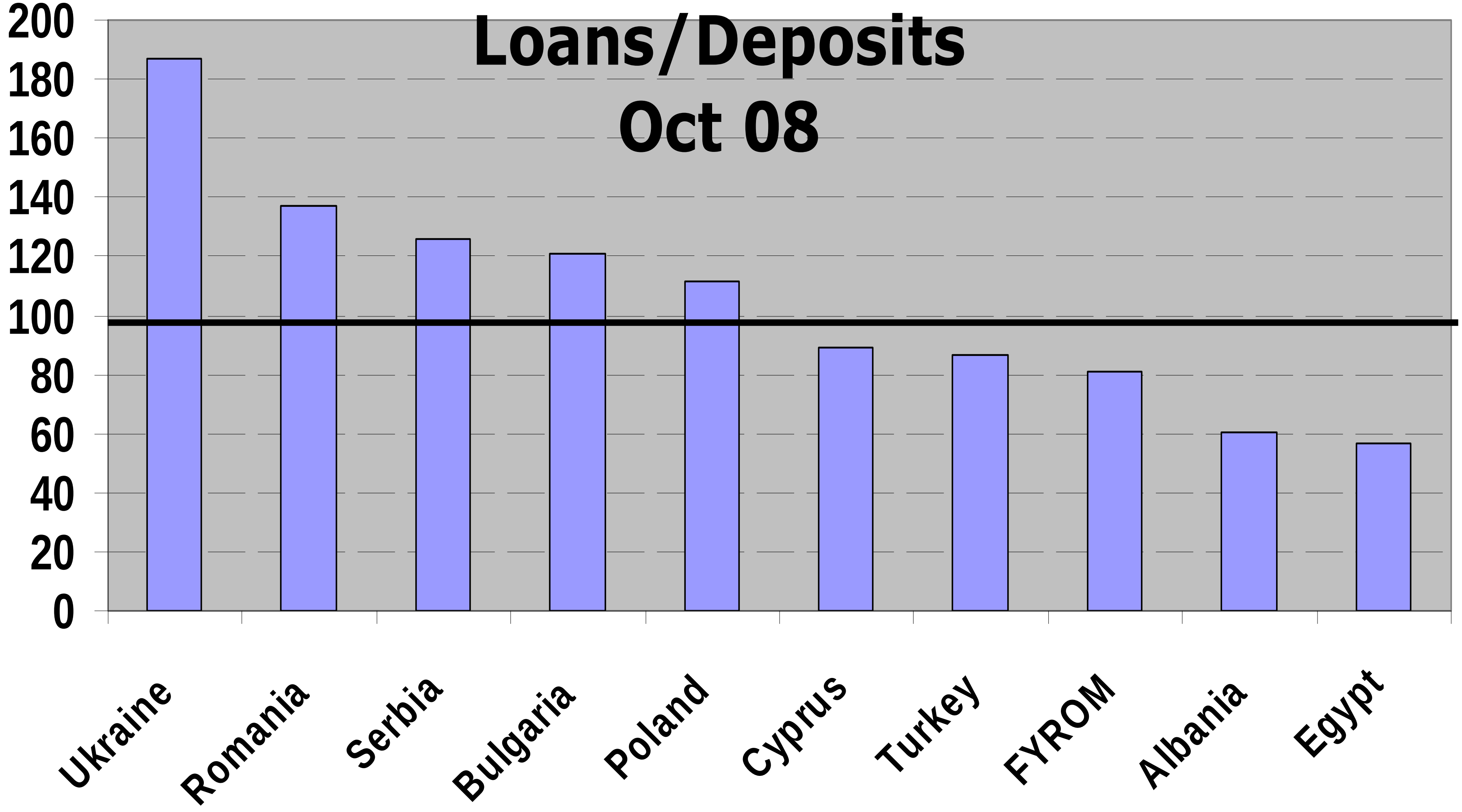
II.1 Liquidity: Abundant in Greece



Source: ECB, Balance Sheet Items data

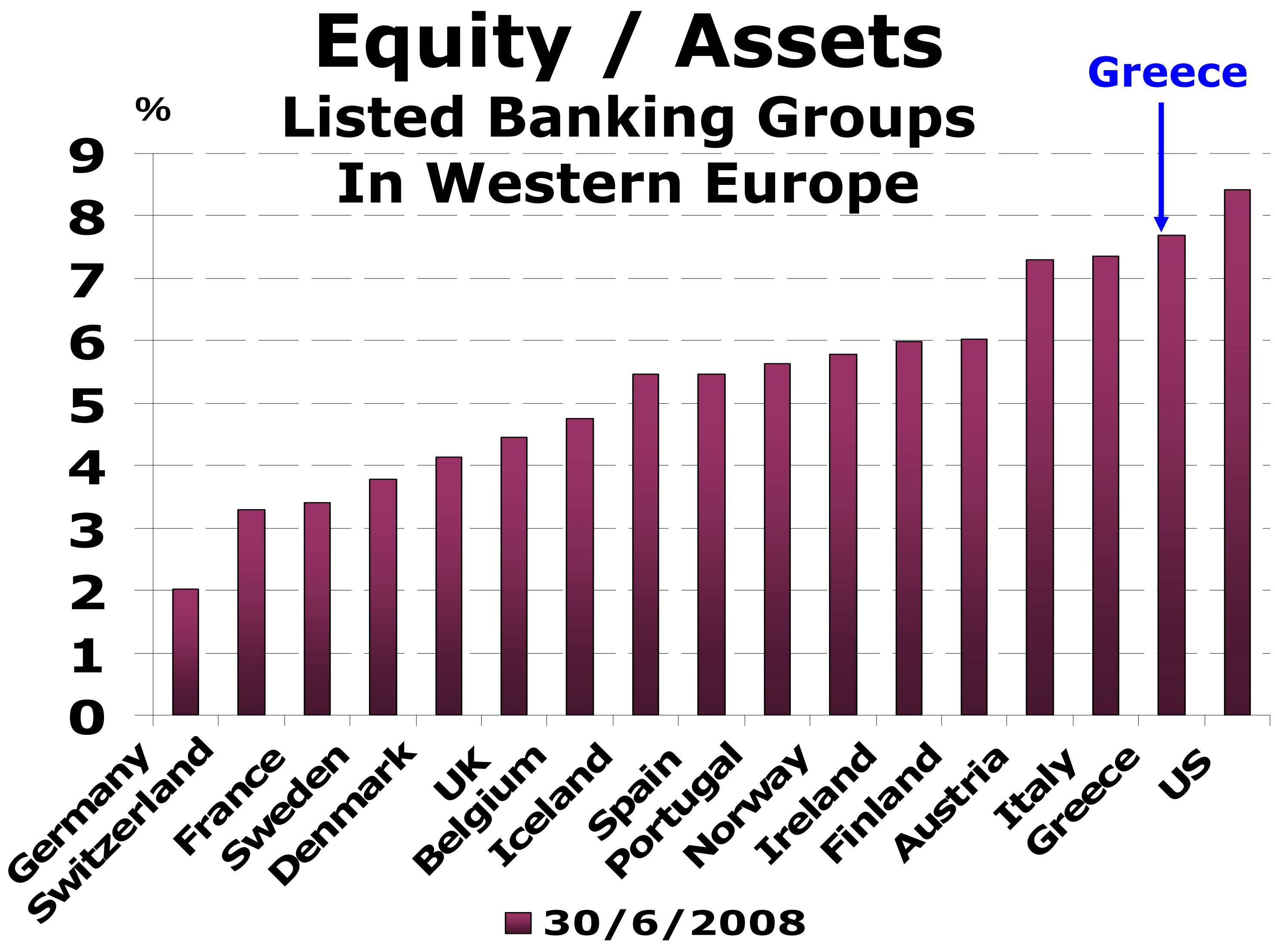
(Total Loans to Total Deposits, MFIs excluding Eurosystem)

II.1 Liquidity: Lacking in some New Europe countries



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

II.2 Capitalization: Greek banks in good shape

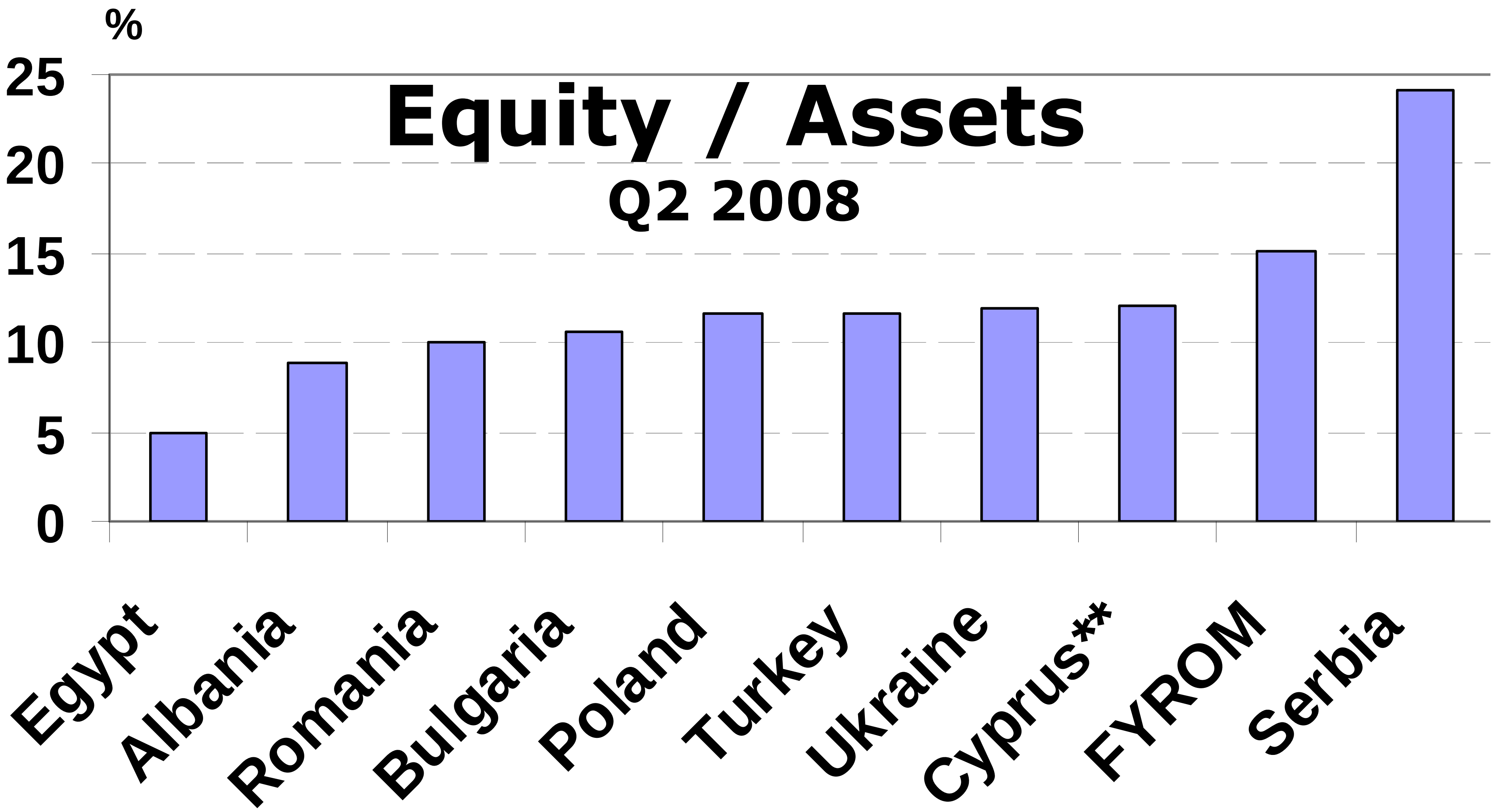


Ranking of individual banks

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

Worst:
DEXIA **1.67%** in Belgium

II.2 Banks in New Europe better capitalized than in Western Europe



* Albania, data as of Dec 07

** Cyprus, data refer to Tier I Capital

III.
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

III. 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

III. Gloomy EU projections

Eurobank EFG

	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

	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

European Commission projections, January 2009

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

III. Greece: Channels of negative influence

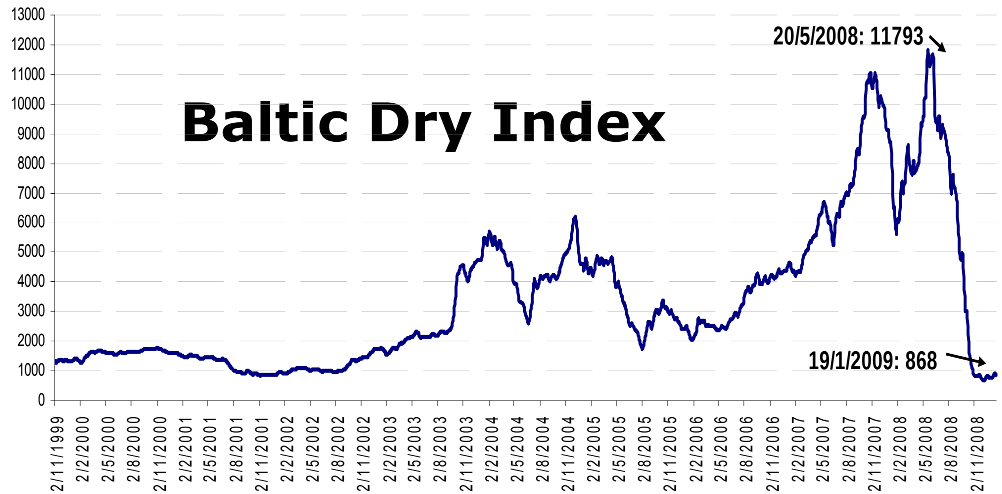
Eurobank EFG

1) Lower economic activity abroad → less exports, lower tourist receipts, less foreign buying of property, lower shipping rates

2) Higher interest rates due to liquidity considerations → less credit expansion, lower consumption & investment

Greece will avoid:

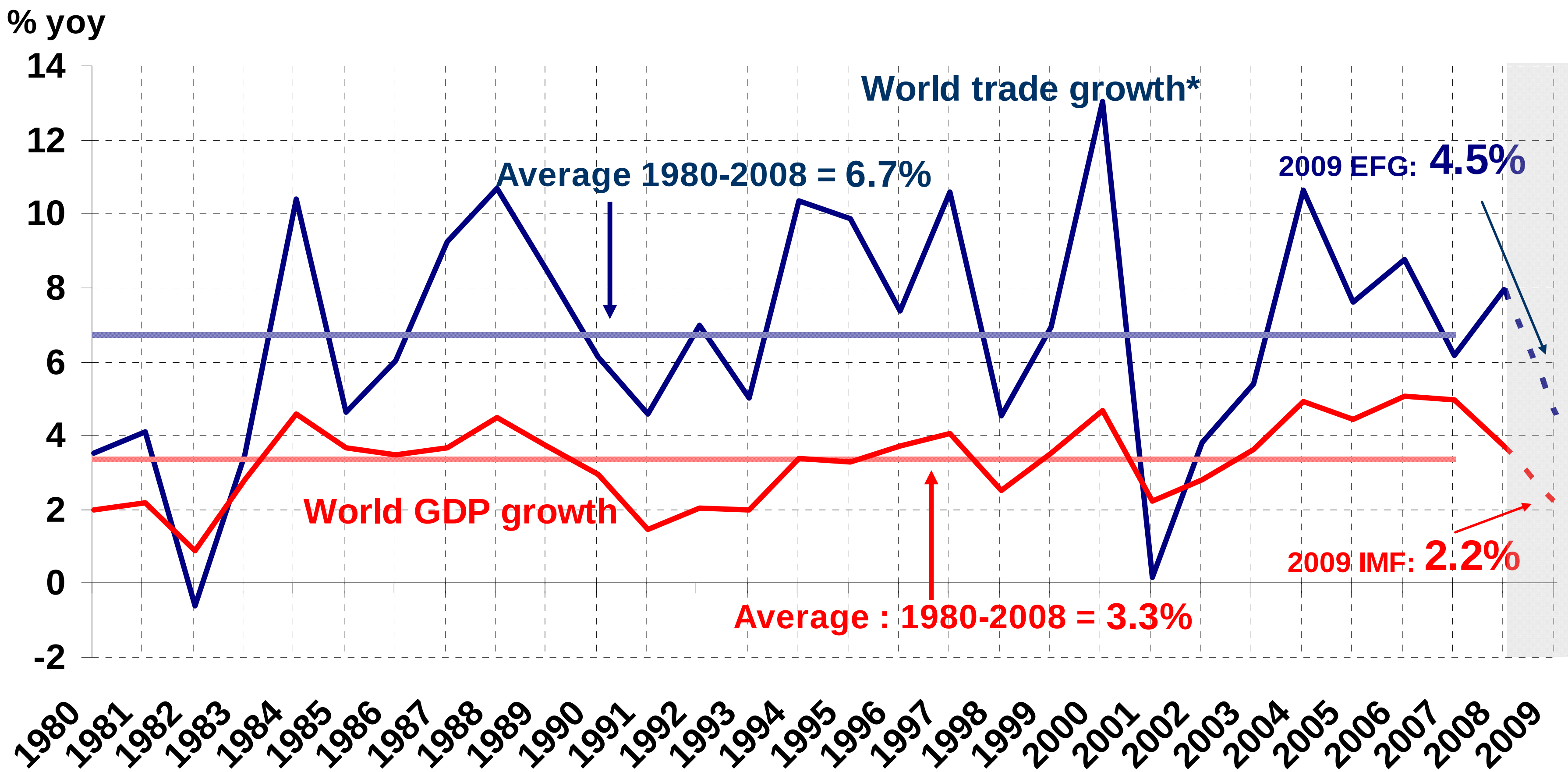
✓ Large bank failures and abrupt restriction of credit due to solvency reasons to the same degree observed abroad



III. International trade

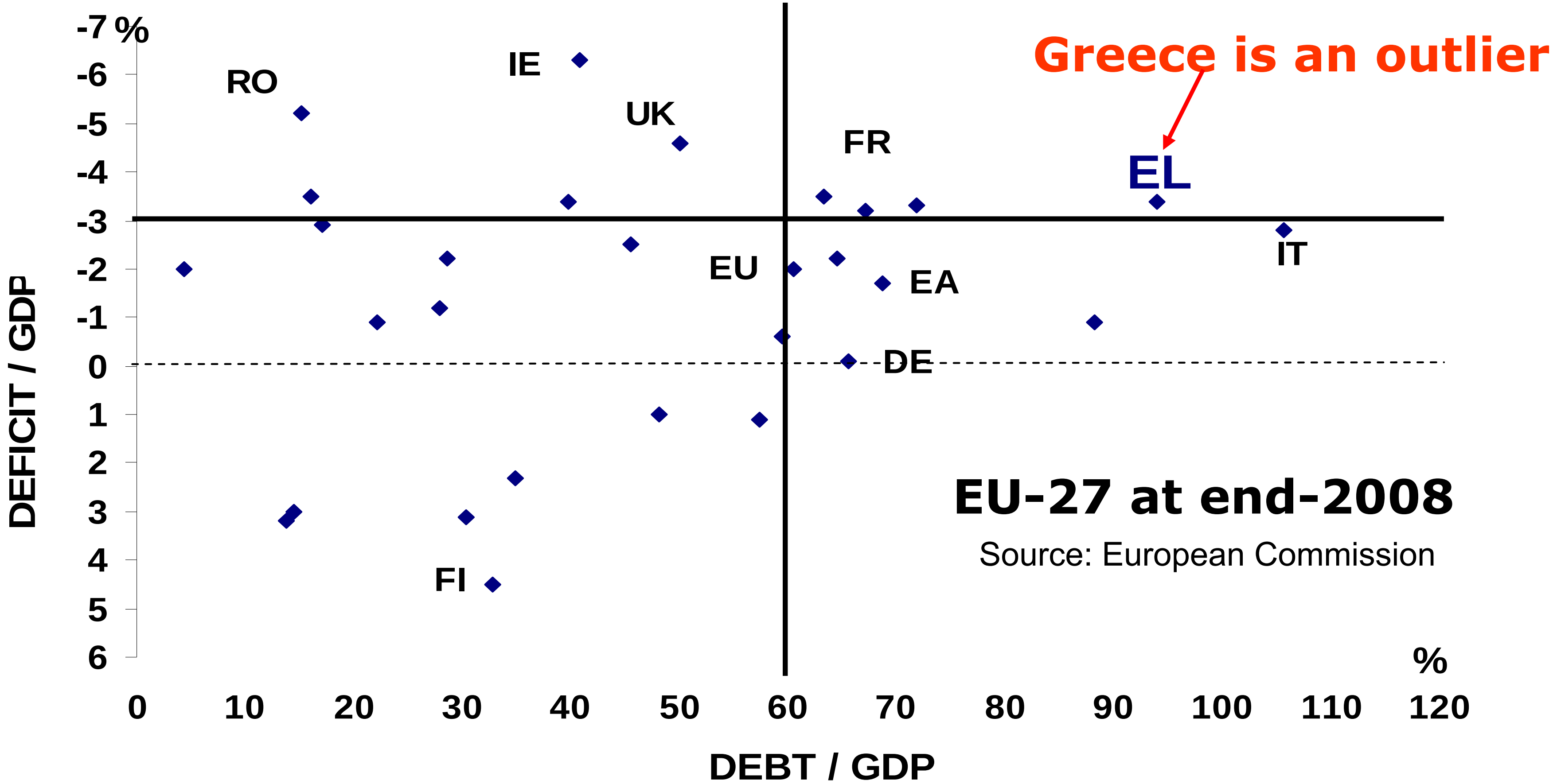
Increase in trade = -0.50 + 2.28* GDP growth, $R^2 = 67\%$
(-0.52) (8.11)

Trade growth will drop to 4.5% in 2009



Source: IMF, OECD, Eurobank Research

III. Fiscal ability limited



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

III. 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?**

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

Eurobank EFG

Recessions 1960-2007

Summary Statistics

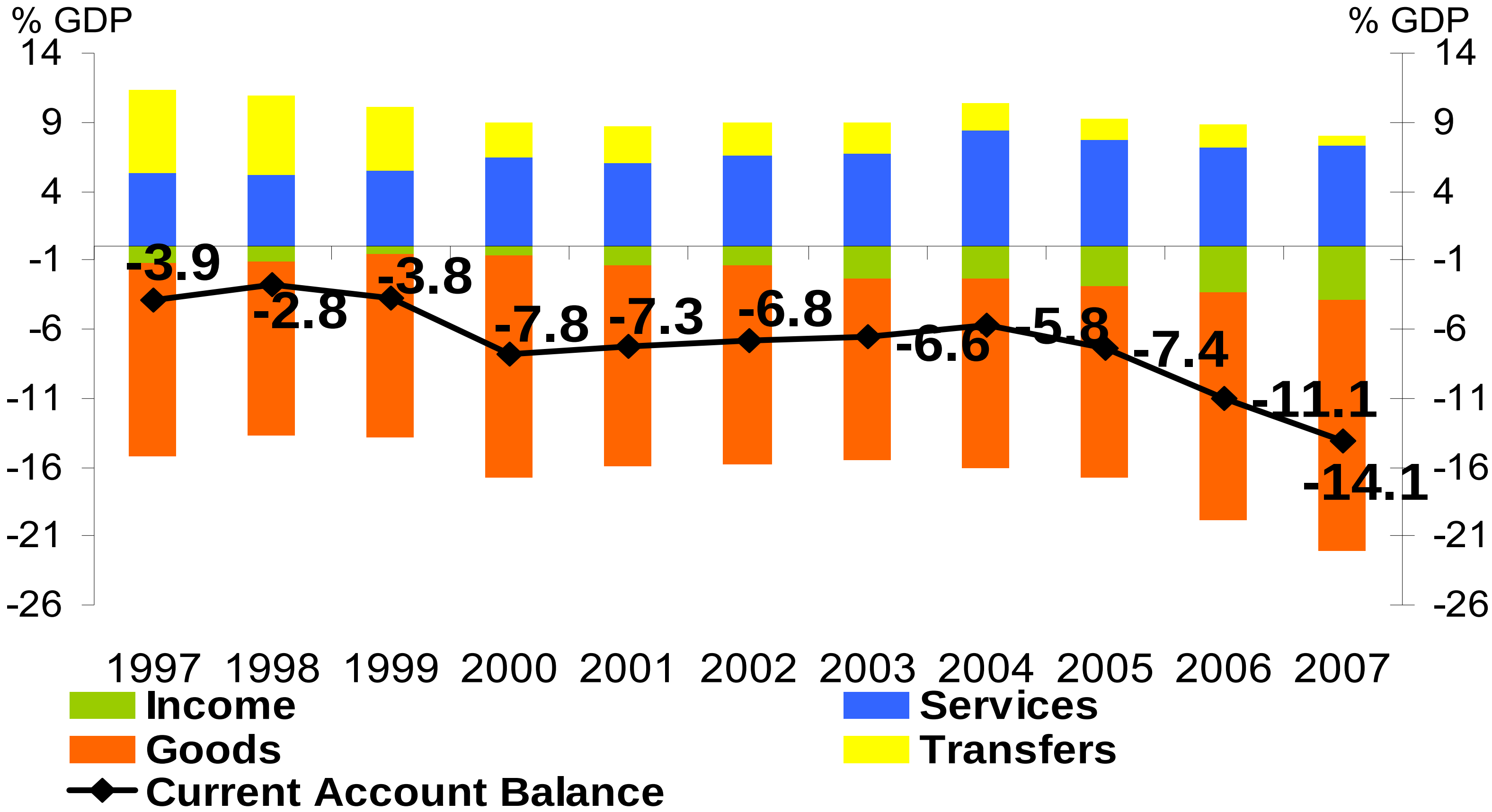
	# of Recessions	Duration (quarters)	Amplitude	Cumulative Output Loss
Greece	**8**	**3.50**	**-6.45%**	**-11.8%**
OECD (Median)	**5**	**3.00**	**-1.87%**	**-3.0%**

Source: CKT, IMF (8/2008)

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.

III. 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

III. … keeps pushing up the external debt

Eurobank EFG

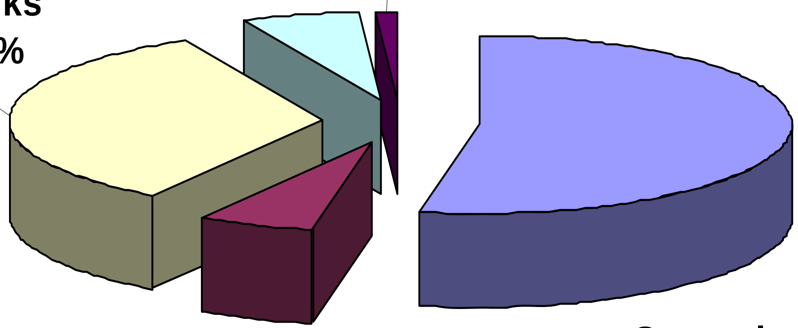
Greek Gross External Debt increased by **52.4 p.p.** of GDP, or 220% in 5 years

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)

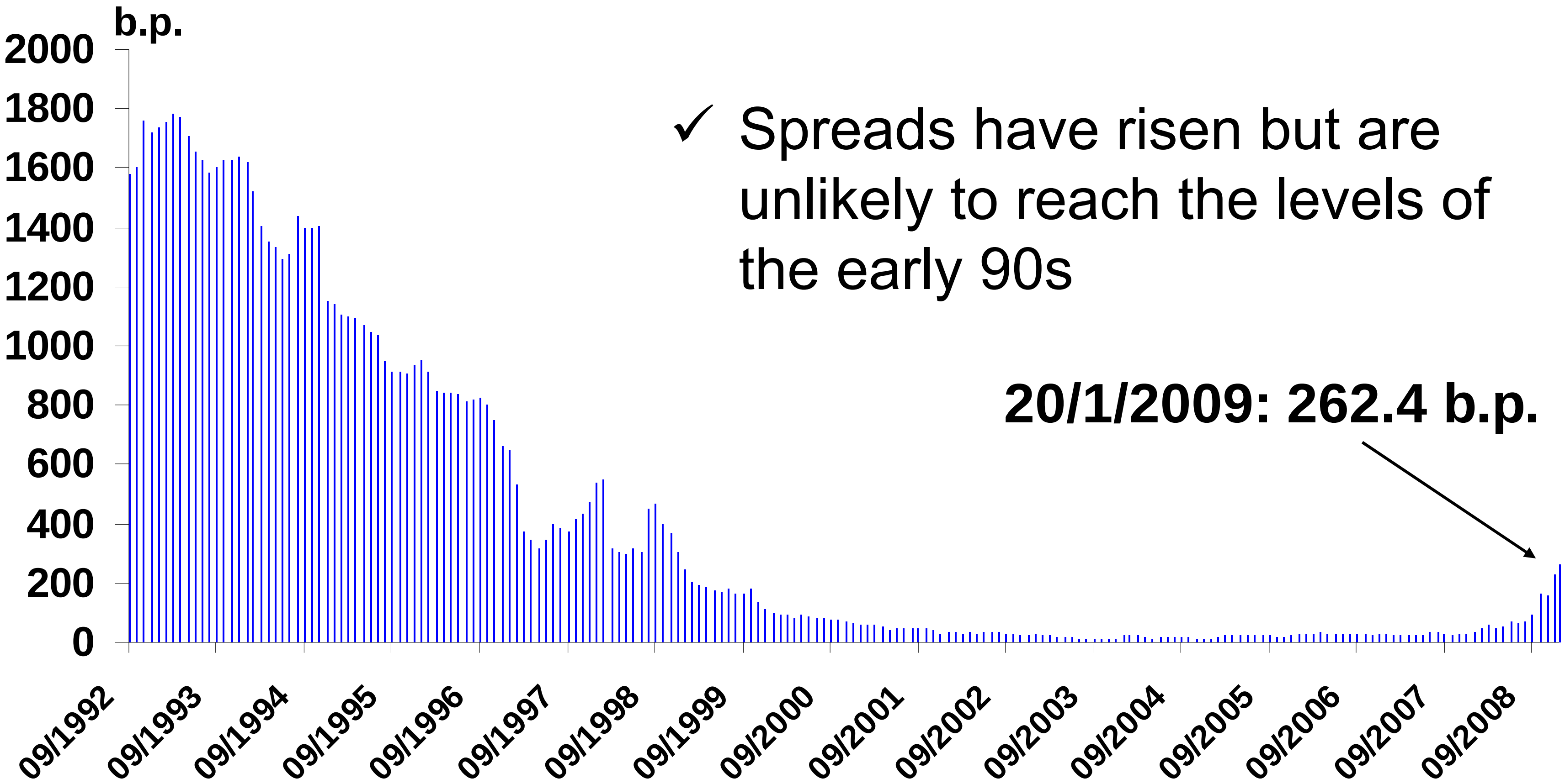


✓Banks' ownership of 1/3 of external debt may prolong the current liquidity problem if crisis continues

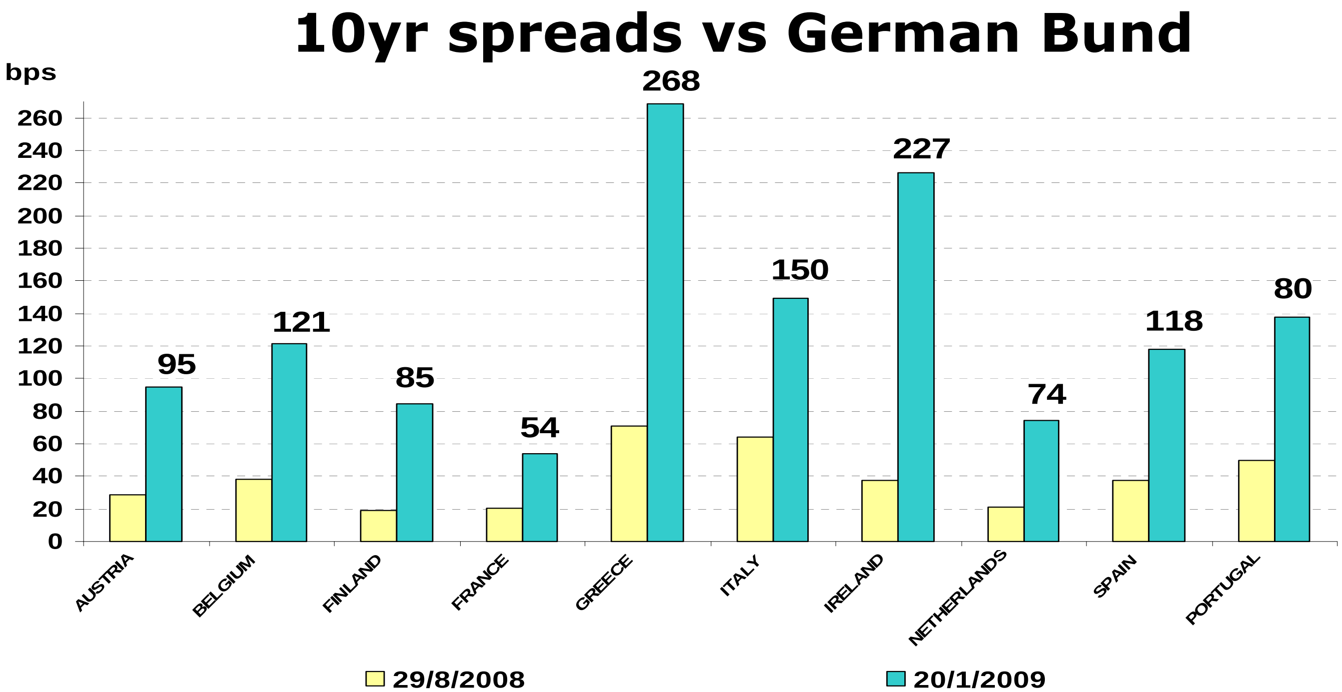
Source: IMF, OECD, BIS, WORLD BANK Joint External Debt Database

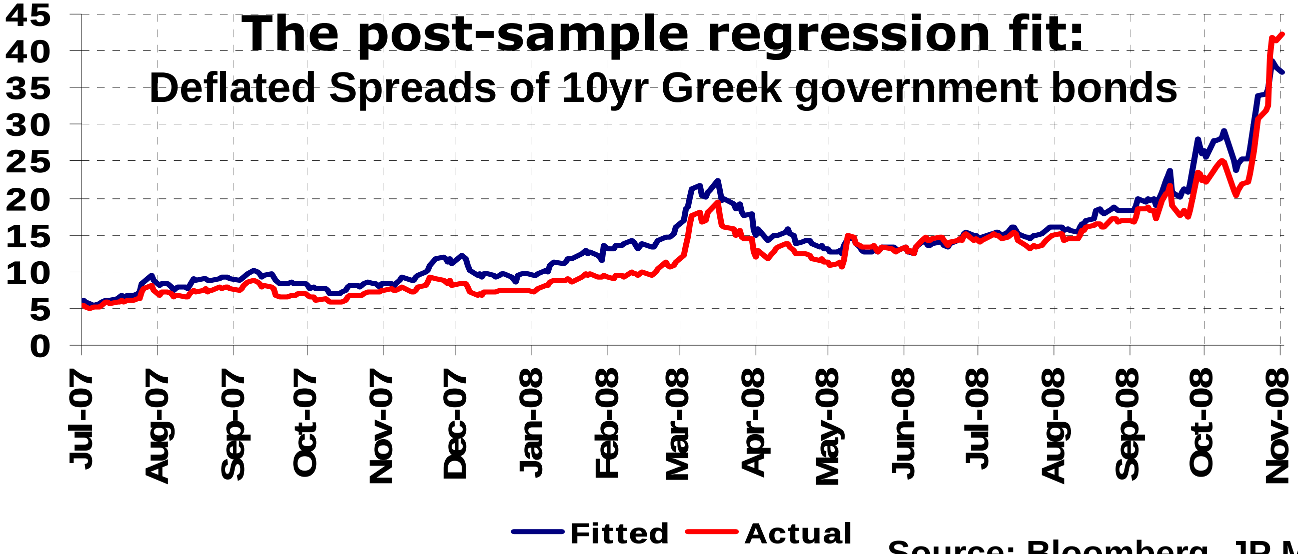
III. Could the rise of external debt lead to a nightmare of high spreads as in the early 90s?

10-yr Gov. Bond Spread: Greece - Germany



III. Rise of spreads: A global phenomenon





- ✓Increase in Greek spreads consistent with increase in all other spreads and the EMBI+
- ✓Behavior similar to pre-crisis period
- ✓Hence, most of the rise in spreads due to global risk aversion, not local factors

Source: Bloomberg, JP Morgan EMBIG, Eurobank EFG

III. The Need for Structural Reforms in Greece

- **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)

IV.

Policy Priorities

IV. Immediate policy priorities to avoid a deep recession

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

IV. 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 and growth
- ✓ 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