

# *Greece at Razor's Edge: Prosperity or Digression?*

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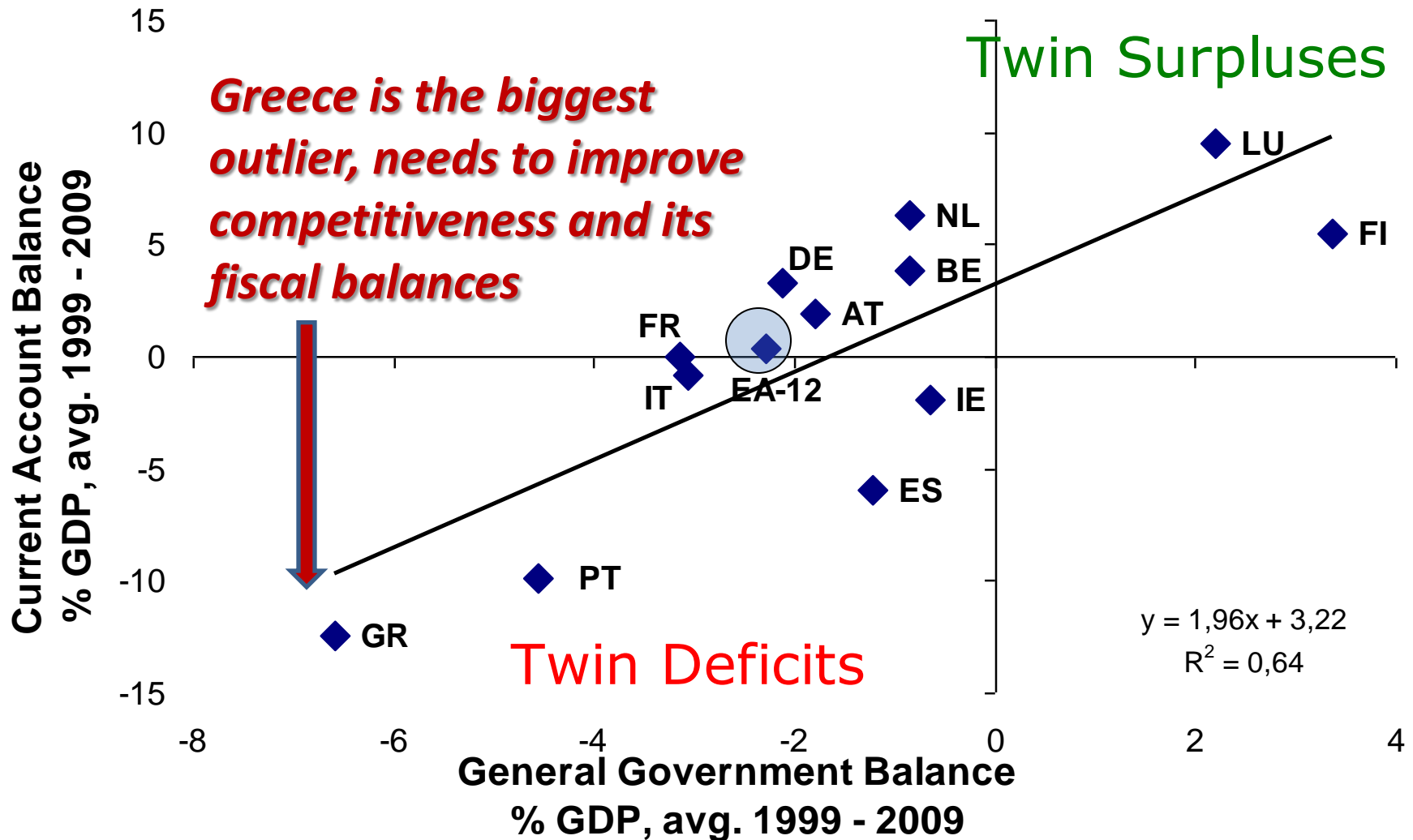
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# LARGE EXTERNAL AND INTERNAL IMBALANCES WITHIN EMU FOLLOWING EMU CREATION

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



# GREECE HAS RESPONDED TO CORRECT THE DISEQUILIBRIA

The MoUs, to which Greece agreed, contained 3 main parts:

- 1) Fiscal consolidation:
  - a) Huge progress thus far but more cuts to come
  - b) Risks of social unrest are big if measures are perceived as inequitable
- 2) Structural reforms:
  - a) Delayed for at least a year and created animosity and distrust among European partners, who in response demanded more fiscal discipline
  - b) Some key competitiveness indicators began improving
  - c) Completion of structural reforms is not an easy task and takes time and collective effort
  - d) Privatizations have to begin soon for Greece to regain credibility
- 3) Stabilization of the financial system, which was not in disequilibrium in early 2010 but the political response to the crisis made it a problem. Hence, urgent need for bank recapitalization, deleveraging and consolidation, as it was hit:
  - a) by the recession, with NPLs rising
  - b) huge PSI losses

# DRASTIC FISCAL CONSOLIDATION OVER 2009-2011 AND MORE CUTS TO COME

- ❖ Over 2009-2011, the primary deficit declined by **8.2pp GDP** despite the recession, which is an unprecedented achievement
- ❖ Program requires another **5.5 pp GDP** reduction in primary deficit until 2014. The **size of government** is forecast to shrink from **1/2 to 1/3 of GDP**
- ❖ This type of fiscal contraction risks prolonging the recession beyond 2013

	2009	2010	2011	2012	2013	2014	2015	2020
GDP Growth (%)	-3.3	-3.5	-6.8	-7.1	-2.4	2.5	3.1	2.2
Nominal GDP (€ bn)	232	227	215	201	195	200	208	255

Source: Eurobank Research

Primary Expenditure (% GDP).	<b>48.7</b>	44.4	43.4	43.2	40.4	37.6	<b>35.6</b>	35.8
Primary Balance (% GDP)	-10.6	-5.0	-2.4	-1.0	1.8	4.5	4.5	4.3

Source: IMF Country Report No. 12/57 (March 2012)

General Gov Debt (% GDP)	129.0	144.5	165.2	167.2	176.3	169.6	162.0	125.1
General Gov Debt (€ bn)	299	328	356	336	344	339	337	319

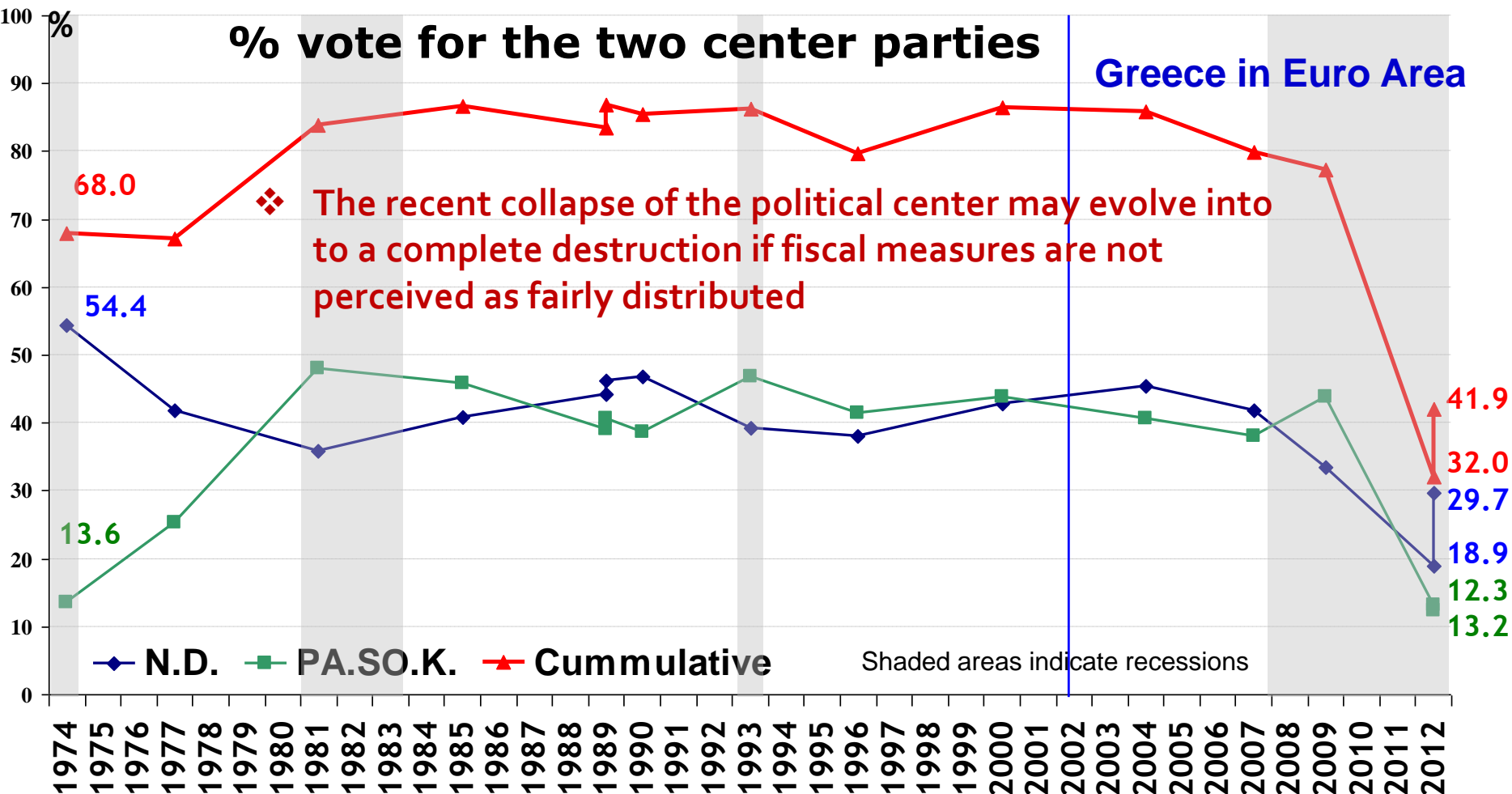
Source: Eurobank Research

- ❖ In an optimistic scenario, in which the 9.6% output gap will be eliminated gradually, growth rebounds more strongly from 2014 on, and Debt/GDP in 2020 becomes 109%

# YET RISKS EXIST AS POPULATION MAY HAVE REACHED ITS LIMITS

## % vote for the two center parties

Greece in Euro Area

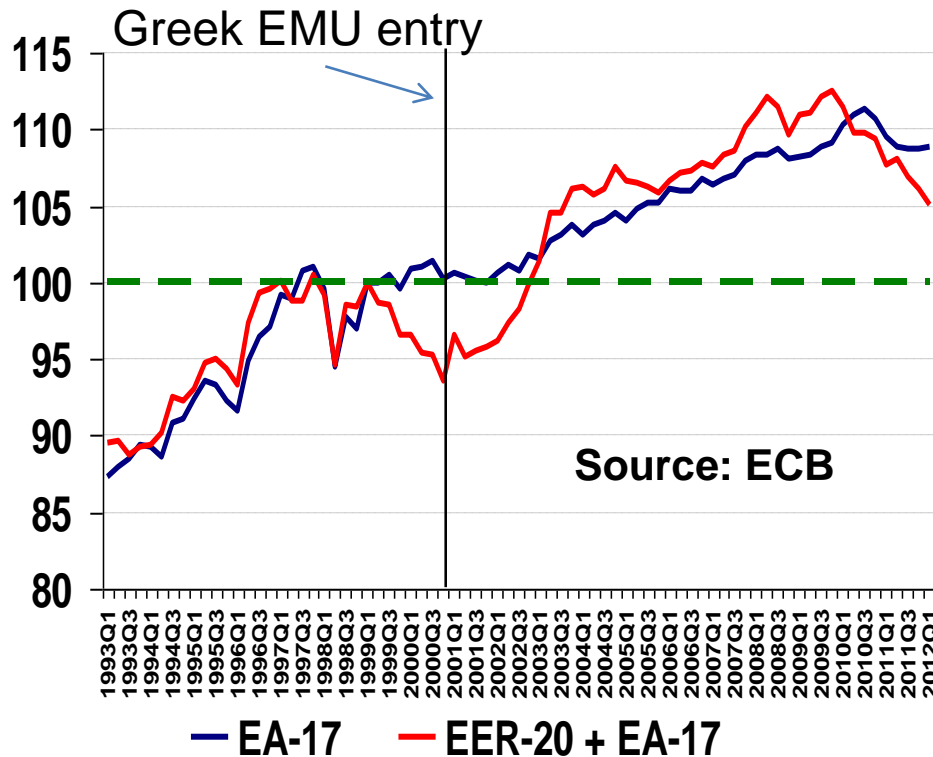


Source: Ministry of Internal Affairs

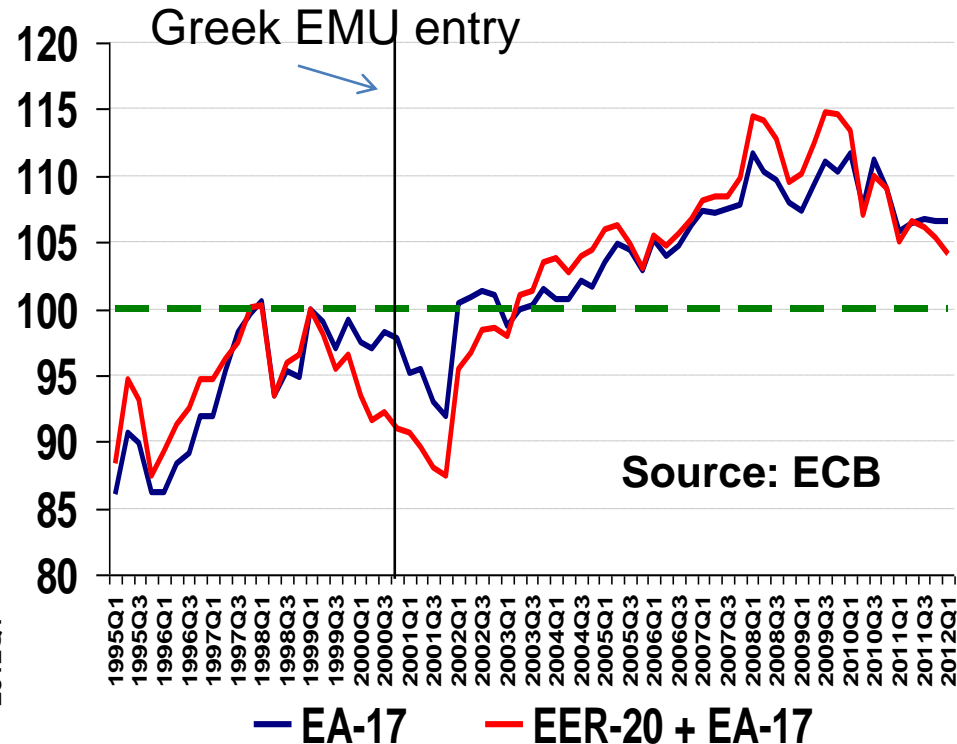
- ❖ Four decades of political dominance destroyed, from 80% down to 40%
- ❖ Both parties supported the 2<sup>nd</sup> Economic Program in the recent elections

# A GRADUAL IMPROVEMENT IN GREEK COMPETITIVENESS HAS BEGUN

## Real harmonized competitiveness indicator (GDP deflator)

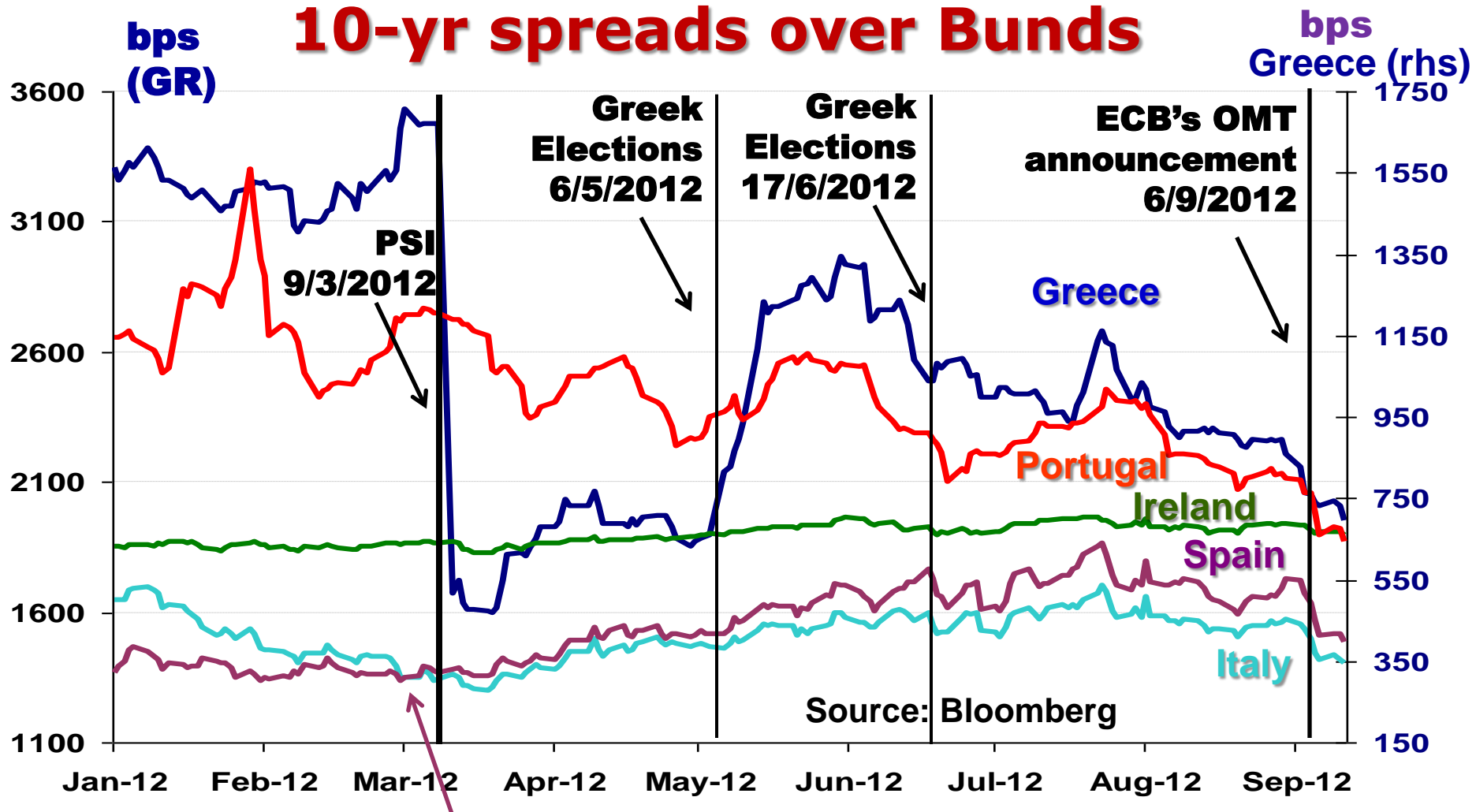


## Real harmonized competitiveness indicator (ULC in total economy deflator)



- ❖ Yet prices are not falling as fast as wages, which indicates *ceteris paribus* that competition in product and service markets remains a challenge

# GREEK ODDS OF EXIT DECLINED AFTER PSI, INCREASED AFTER MAY ELECTIONS, ARE DECLINING SINCE JUNE



- ❖ The larger the spread, the higher the probability of exit
- ❖ Worries about **Spain** outpaced those for **Italy** in early March 2012
- ❖ Watch **Greek** spreads are measured on the **left axis**

# WILL GREECE MAKE IT?

## CREDIBILITY & LIQUIDITY AS MAIN PREREQUISITES

- ❖ Greece needs **GROWTH** to come back, as the economy is falling and even exports may soon be affected. Yet **no growth strategy can work unless both credibility and liquidity are reestablished**
- ❖ Credibility is a necessary condition for the exit premium to decline and thus investment plus deposits to stabilize
- ❖ Hence liquidity is also a function of credibility, not only related to the EU cash disbursements or ECB behavior, which follows a restrictive monetary policy in Greece, penalizing Greek banks to go to ELA

### Bank Borrowing from the ECB

**EA**

**Greece**

	<u>a</u>	<u>b</u>	<u>c</u>	<u>a</u> *	<u>b</u>	<u>c</u>	
Jun-07	464.6	28,026	1.7	4.3	353.4	1.2	(a) Total Lending from the ECB (€bn)
Jun-08	483.0	30,839	1.6	11.6	424.7	2.7	(b) Total Banks Assets (€bn)
Jun-09	896.8	31,804	2.8	54.0	491.2	11.0	(c) % ratio a/b
Jun-10	870.4	32,578	2.7	94.3	544.7	17.3	
Jun-11	497.5	31,736	1.6	103.1	502.5	20.5	* plus lending from the BoG through ELA
Jun-12	1,260.9	34,177	3.7	135.8	437.6	31.0	



# WILL GREECE MAKE IT?

## A CASE OF MULTIPLE EQUILIBRIA

A case of multiple equilibria:

- 1. BAD EQUILIBRIUM:** Greeks do not appear capable of carrying the obligations of the 2<sup>nd</sup> economic programme,
  - ❖ Thus are starved of cash, and are subsequently forced to issue their own IOUs, effectively exiting EMU
  - ❖ Contagion spreads and EMU dissolves
- 2. GOOD EQUILIBRIUM:** Greeks are persuasive and thus Europeans act smartly,
  - ❖ Frontloading Greece with cash, extending the fiscal adjustment period and placing an emphasis on the effective implementation of structural reforms
  - ❖ Banks are recapitalized, exit risk premia decline, liquidity comes back
  - ❖ Thus growth comes back to Greece and the Debt-to-GDP ratio is stabilized

**CAN EUROPEANS CHOOSE THE BAD EQUILIBRIUM IN THE CASE OF A GREEK ERRATIC BEHAVIOR?**

# THE COSTS OF THE BAD EQUILIBRIUM ARE NOT ONLY GREEK

## ❖ Contagion can happen through:

(a) trade, (b) portfolio investors, (c) a wake-up call to re-assess fundamentals, (d) financial institutions, (e) official lending

❖ Channel (a) is small as EMU exports to Greece represent 0.18% of total EMU exports

❖ Channel (b) was never a large component in international wealth portfolios

❖ Channel (c), the wake up call about fundamentals is already present

❖ Channel (e) is also small, especially since Target 2 is central bank money

	Member states		Eurosysteem		Total	
	Bilateral loans	EFSF	SMP	Target 2	€ bn	% GDP
<b>Total</b>	<b>52.9</b>	<b>73.0</b>	<b>34.9</b>	<b>130.0</b>	<b>291.1</b>	<b>3.0</b>

❖ **Channel (d) is important as fear can easily spread.** The bank direct exposure is small not give a sense of the dimensions of possible deposit withdrawals once fear takes over.

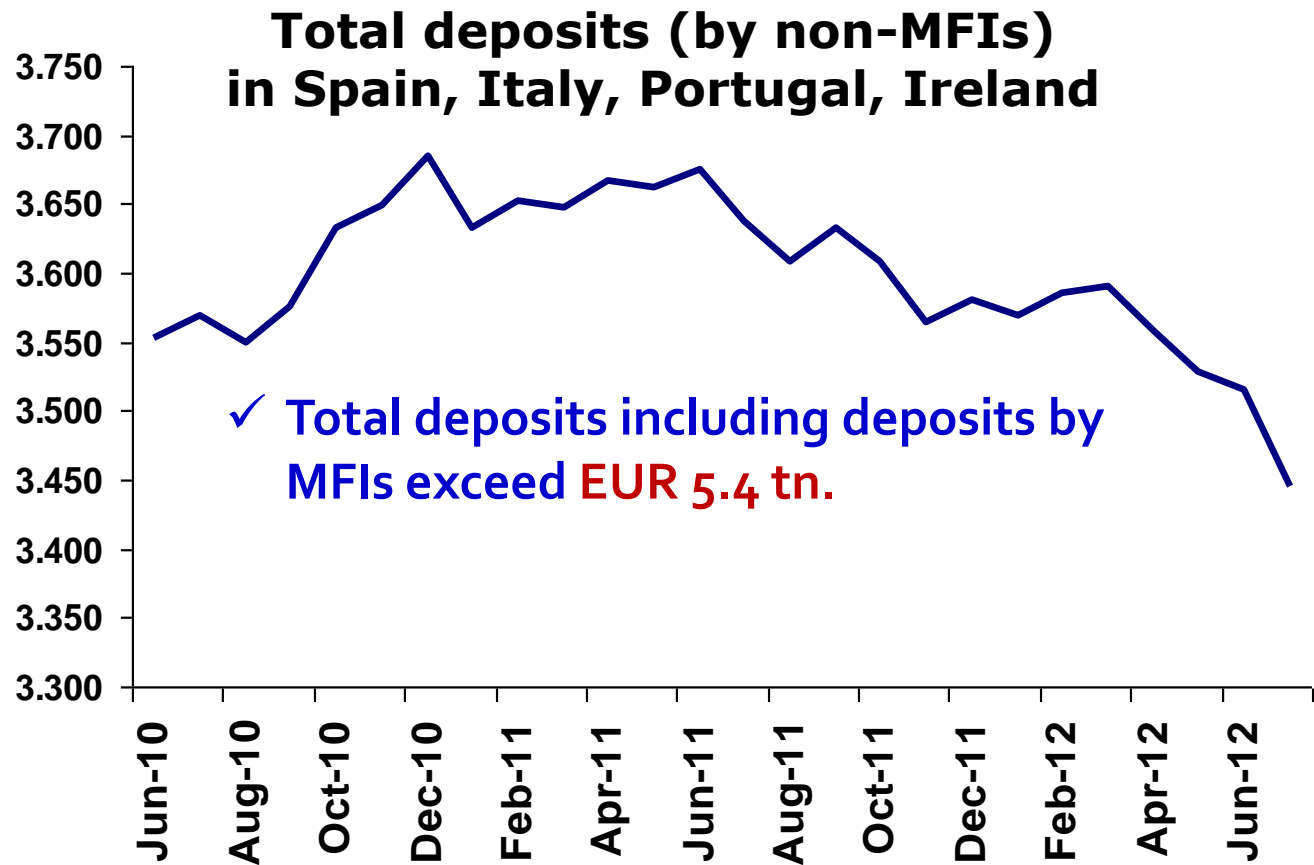
	European banks	France	Germany	Italy	Spain	Sw/land	UK	US
Foreign claims	90473	44353	13355	2186	969	1940	10537	4455
Other potential exposures	29032	6901	3779	1790	417	1406	11825	46231

Source: BIS

# EMU PERIPHERY CANNOT EASILY ACCOMMODATE A DEPOSIT WITHDRAWAL

✓ The size of deposits in countries under crisis overwhelms any type of precautionary buffer.

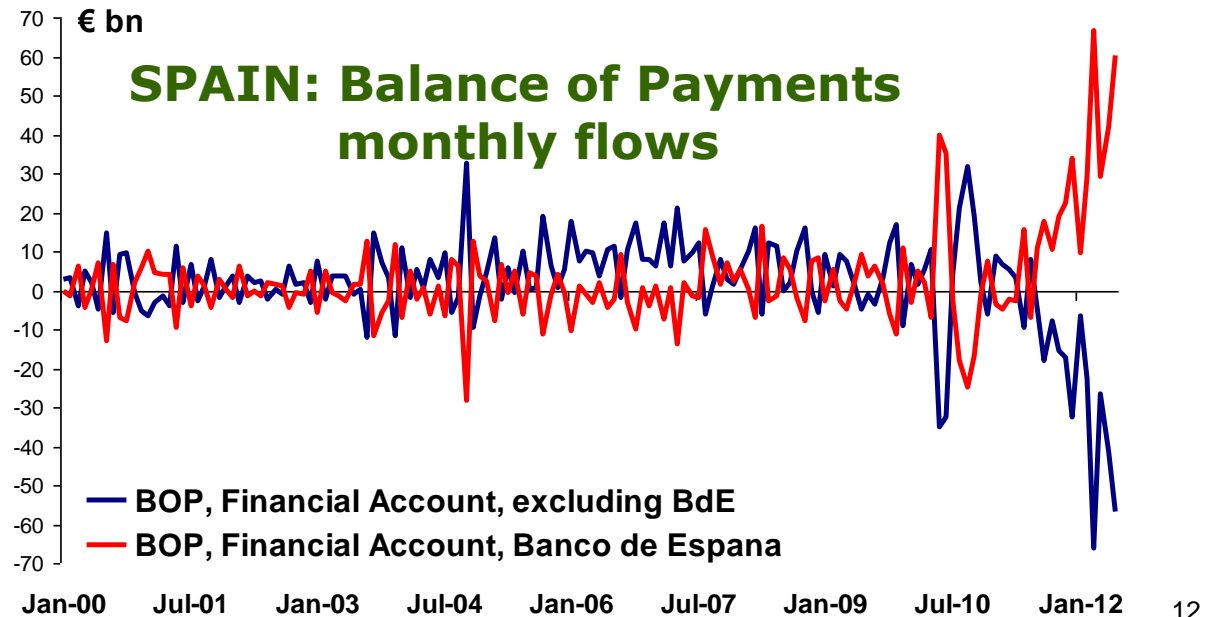
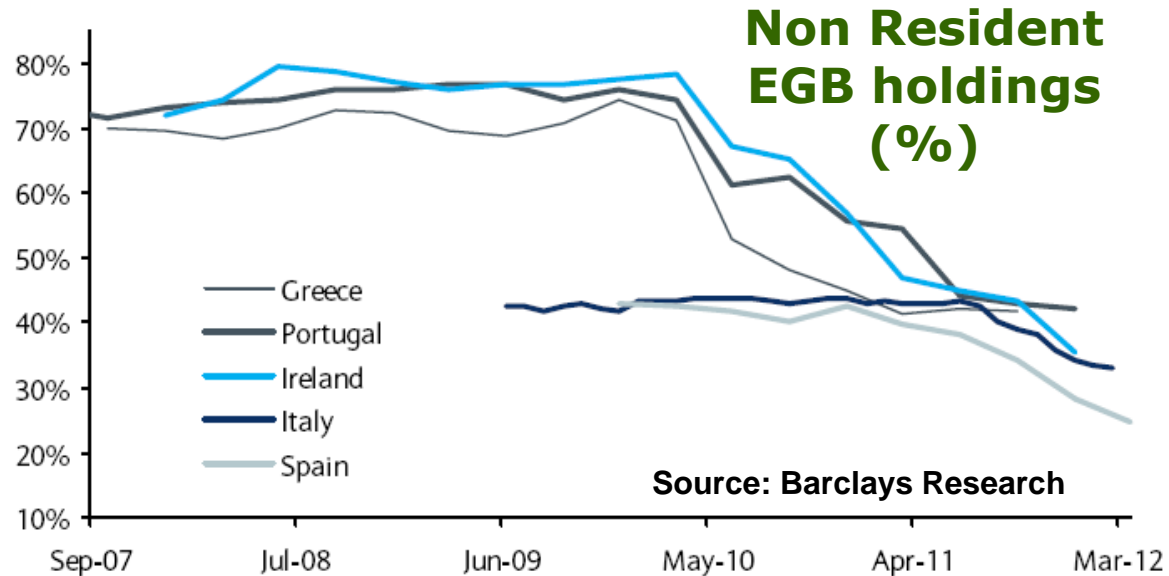
✓ Pray a bank run will not happen: If depositors withdraw 30% of their money, i.e. as much as Greeks have slowly done thus far, this would be a loss of EUR 1.0 tn, a shock that cannot be absorbed even by today's EFSF



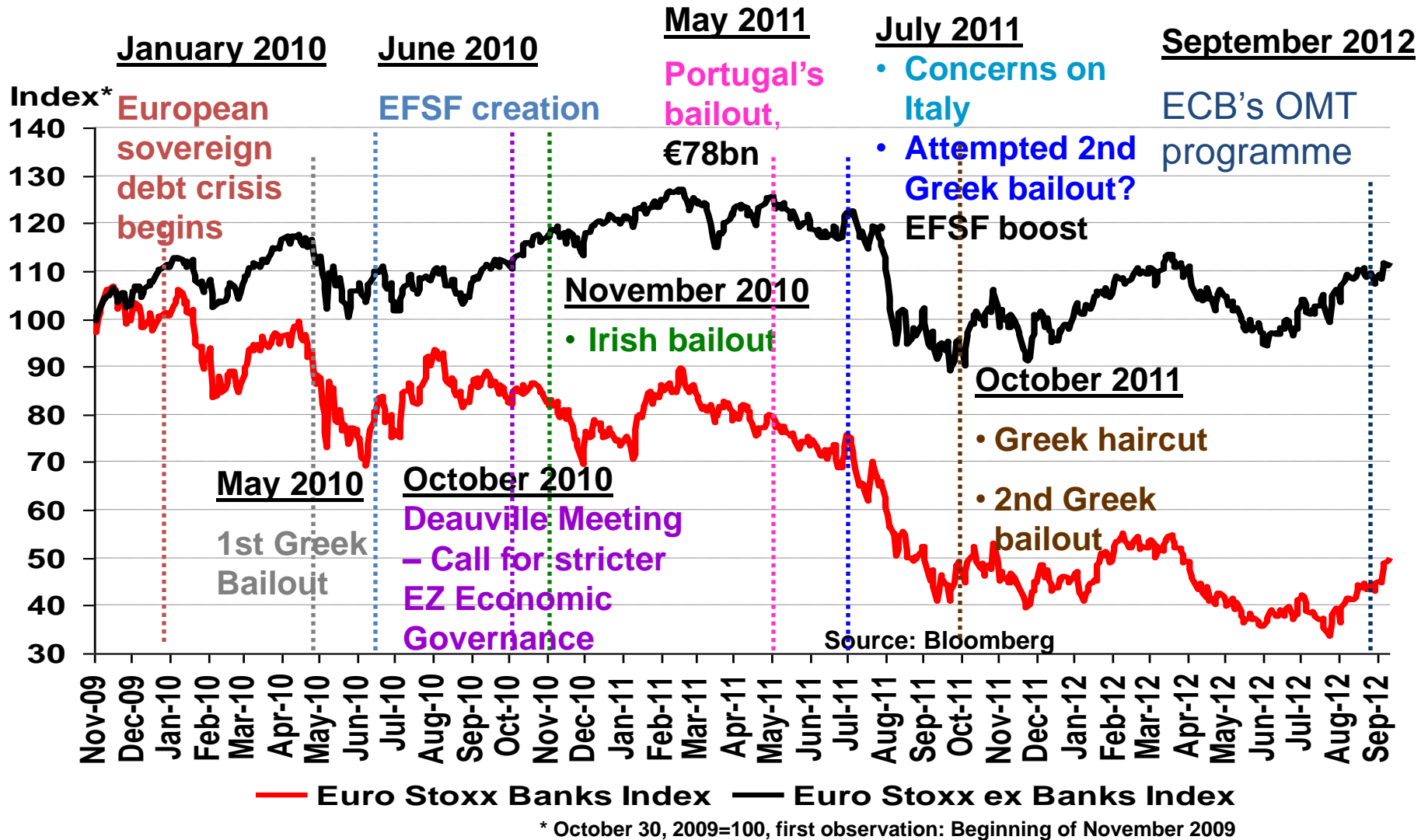
✓ A pan-European deposit insurance is not adequate to absorb such a shock. Deposit insurance is designed to handle individual bank insolvencies, not a systemic crisis.

# SMART MONEY IS LEAVING THE PERIPHERY

- ❖ Smart money usually moves out first, hence notice that **foreign investors have abandoned the government bond market of the European Periphery**
- ❖ **Spanish capital outflows since mid 2011**, being replaced by Eurosystem funding
- ❖ Capital outflows are the first warning signals of a possible bank run



# EURO AREA BANKS ARE VULNERABLE .... HENCE A BANK RUN CAN EASILY SPREAD



- ❖ While the ECB may help avoid a bank run, the irreversibility principle would be destroyed, hence EMU would look like another Fixed Exchange Rate regime

# CONCLUSION: IF THERE IS A WILL, THERE IS A WAY

- ❖ In the 1990s, it had been hoped that EMU would speed up the economic and political integration of Europe as OCA requirements would be satisfied gradually
- ❖ Yet, the low interest rates and the market euphoria that followed monetary integration, shielded EMU countries from performing the required structural reforms and led to important divergences within EMU
- ❖ The crisis was triggered by fiscal concerns, a subset of the divergences
- ❖ The political response to the crisis was myopic, driven by moral hazard and other domestic concerns in lender countries, thus unsettling markets and fuelling a subsequent spread of the crisis beyond the Greek border
- ❖ For EMU to survive, prerequisites are debt sustainability and structural reforms in individual economies, plus deeper EMU integration: in fiscal policy, in financial market policy and in politics
- ❖ **Contagion** would require massive interventions by the ECB and may not be avoidable as the spread of fear cannot be controlled simply by minimizing banking, asset allocation or trading exposures to Greece
- ❖ EMU can easily unravel once the **IRREVERSABILITY** principle of joining EMU gets destroyed
- ❖ Recent **Greek achievements in competitiveness improvement and in fiscal consolidation** in a hostile macroeconomic environment show that Greece can reinvent its economic paradigm: If there is a will, there is a way

**Thank you  
for your attention**

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