EURO AREA's COHESION AND THE GREEK MULTI-YEAR ADVENTURE

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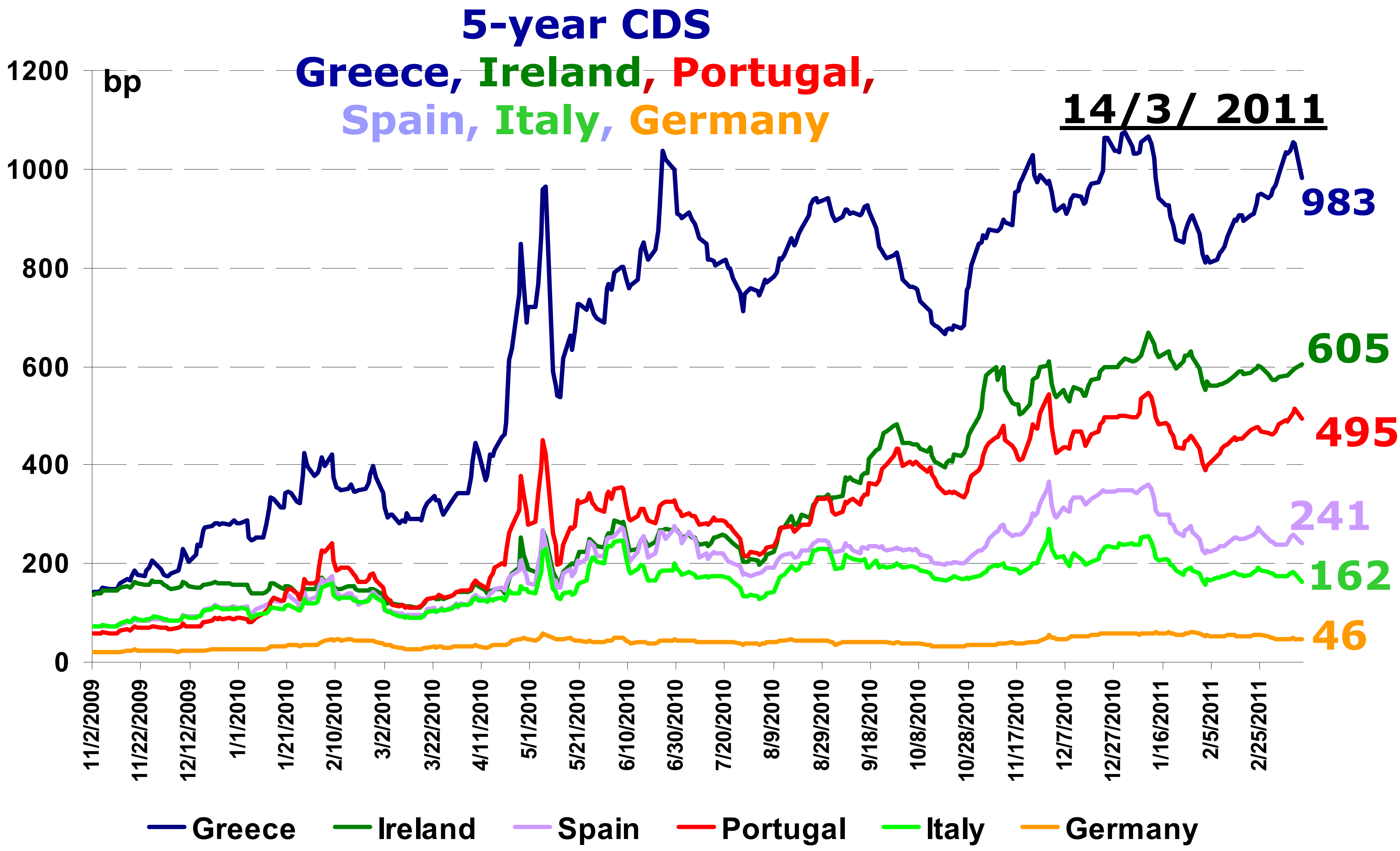
- OFFICIAL FORECASTS UP TO 2020
- ARE RISKS CONTAINABLE?
- DOES THE PROPOSED NEW EURO AREA ARCHITECTURE RESTRICT GREEK CHOICES?

I. THE CRISIS BEGINS AT THE END OF 2009



Πηγή: Bloomberg

I. HAIRCUTS WITH THEIR (RISK-NEUTRAL) PROBABILITIES

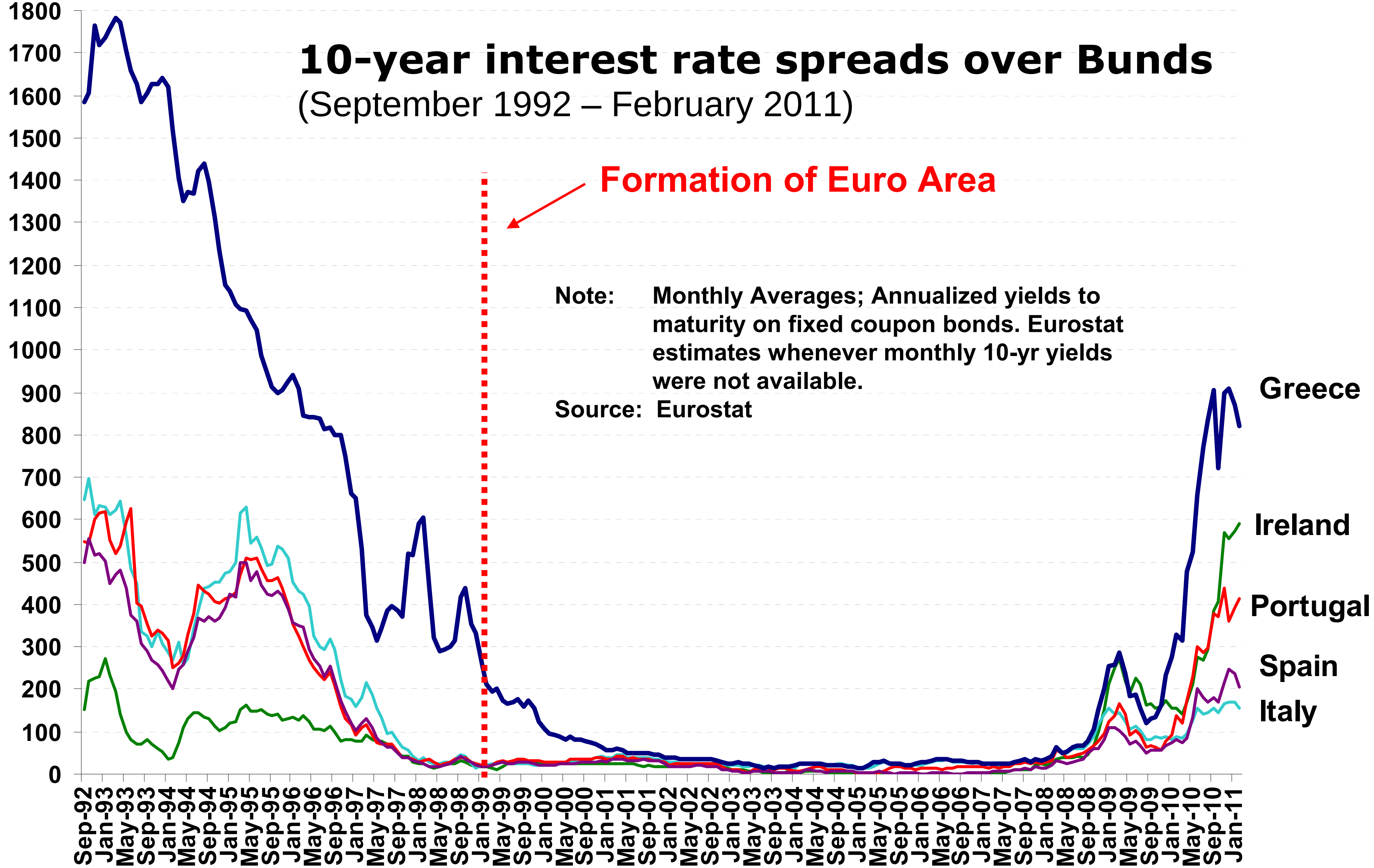
Hair-cut	Greece		Ireland		Spain		Portugal		Italy		Germany	
	MP %	CP %	MP%	CP%	MP%	CP%	MP%	CP%	MP%	CP%	MP%	CP%
100%	9.7	37.3	6.0	24.9	2.4	10.7	4.9	20.9	1.6	7.3	0.5	2.1
90%	10.8	40.6	6.6	27.3	2.6	11.8	5.4	22.9	1.8	8.1	0.5	2.4
80%	12.1	44.4	7.5	30.1	3.0	13.2	6.1	25.4	2.0	9.1	0.6	2.7
70%	13.9	49.0	8.5	33.7	3.4	15.0	7.0	28.5	2.3	10.3	0.6	3.0
60%	16.2	54.5	10.0	38.1	4.0	17.2	8.2	32.4	2.7	12.0	0.8	3.5
50%	19.4	61.4	12.0	43.9	4.8	20.3	9.8	37.6	3.2	14.2	0.9	4.2
40%	24.3	70.0	14.9	51.6	5.9	24.8	12.2	44.6	4.0	17.4	1.1	5.3
30%	32.4	80.7	19.9	62.3	7.9	31.7	16.3	54.8	5.3	22.6	1.5	7.0
20%	48.6	93.0	29.9	77.8	11.9	43.7	24.5	70.3	8.0	31.9	2.3	10.3
10%	88.3	99.9	54.3	95.4	21.6	65.5	44.5	90.7	14.6	50.7	4.1	17.9

Calculations based on 5-yr CDS rates on 14/3/2011 for risk-neutral investors

MP: Marginal Probability for 1-year ahead

CP: Cumulative Probability for 5-years ahead

I. MARKETS WAKE UP TO IMPERFECTIONS AT DIFFERENT EA COUNTRIES



I. ECONOMIC THEORY OF OPTIMUM CURRENCY AREAS WAS IGNORED

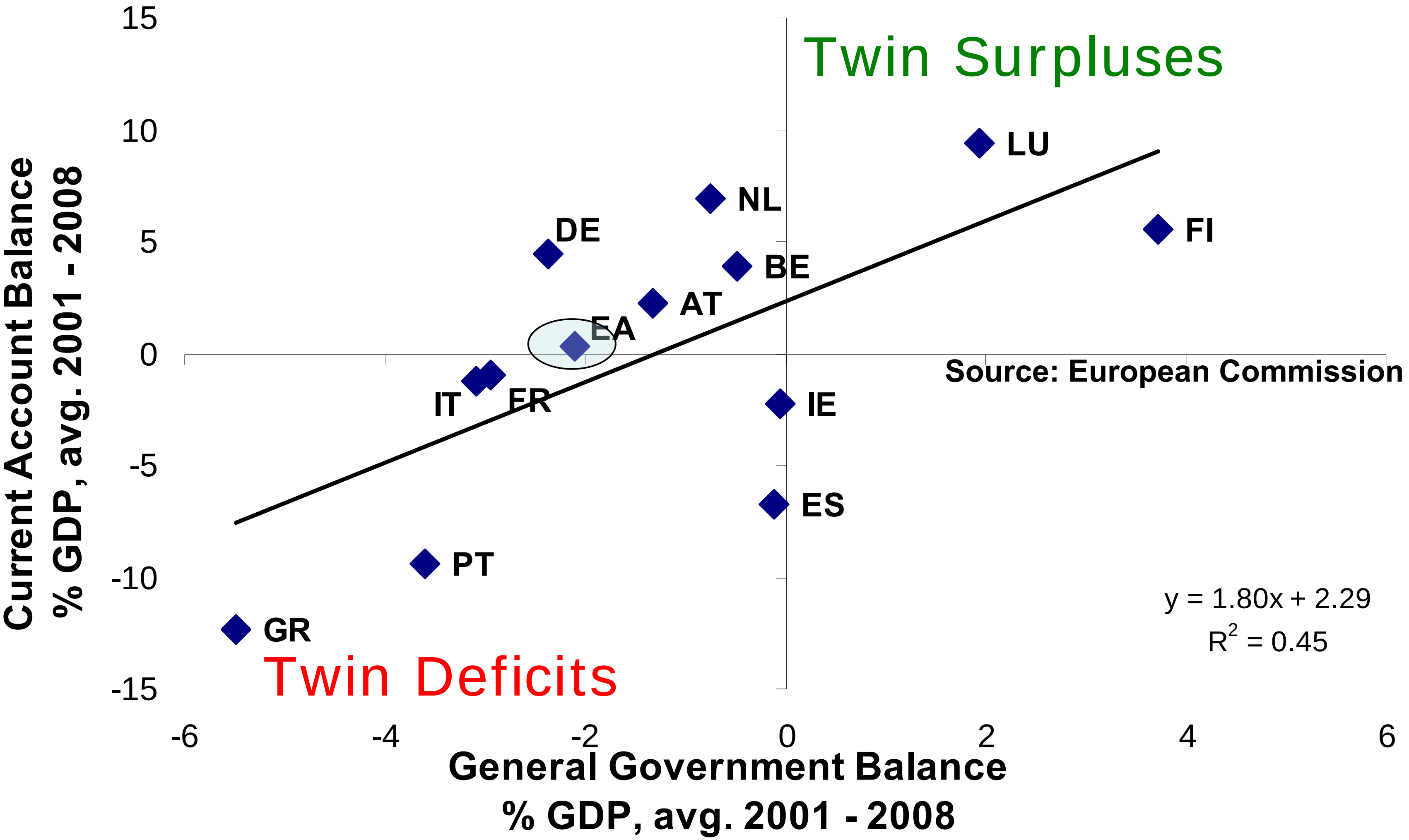
A political project. Academic literature on **Optimum Currency Areas** was ignored. Necessary economic criteria were thought to adjust by themselves and converge once the common currency forms via a political path, i.e. market mechanism would automatically correct deviations from the competitiveness norm. **Criteria for OCA**:

1) **Open economies with highly interconnected external trade sectors**
2) **Liberalized labor, capital and product markets**
3) **Adequate degree of integration / uniformity of:**
   - Macro economic indicators and fiscal policies
   - The structure of the real economy and its development stage e.g. price and labor market flexibility, pension systems, competitiveness rules, uniform degree of state intervention in the private sector
4) **Adequate synchronization of economic cycles**
   - Avoidance of asymmetric shocks in the participating countries (necessary measures include product differentiation, uniform/ integrated product markets (i.e. symmetric shocks in the terms of trade)).
5) **Existence of a fiscal mechanism to smoothen the effects of the asymmetric shocks**

- ✓ The Stability and Growth Pact (SGP) together with the establishment of the independent European Central Bank (ECB) were considered as the **two main pillars for the Euro area stability**
- ✓ It was believed that SGP would be enforced due to the system of penalties and the "**No Bailout Clause**"

I. EXTERNAL AND INTERNAL (FISCAL) IMBALANCES BECAME LARGE

- Uncompetitive South vs. completive North
- Fiscal profligacy almost everywhere



I. DIFFERENT EURO AREA COUNTRIES FACE DIFFERENT PROBLEMS TODAY

✓ **IRELAND**

- ↓ Housing market
- ↓ Banks → public debt ↑
- ↓ High private debt

✓ **PORTUGAL**

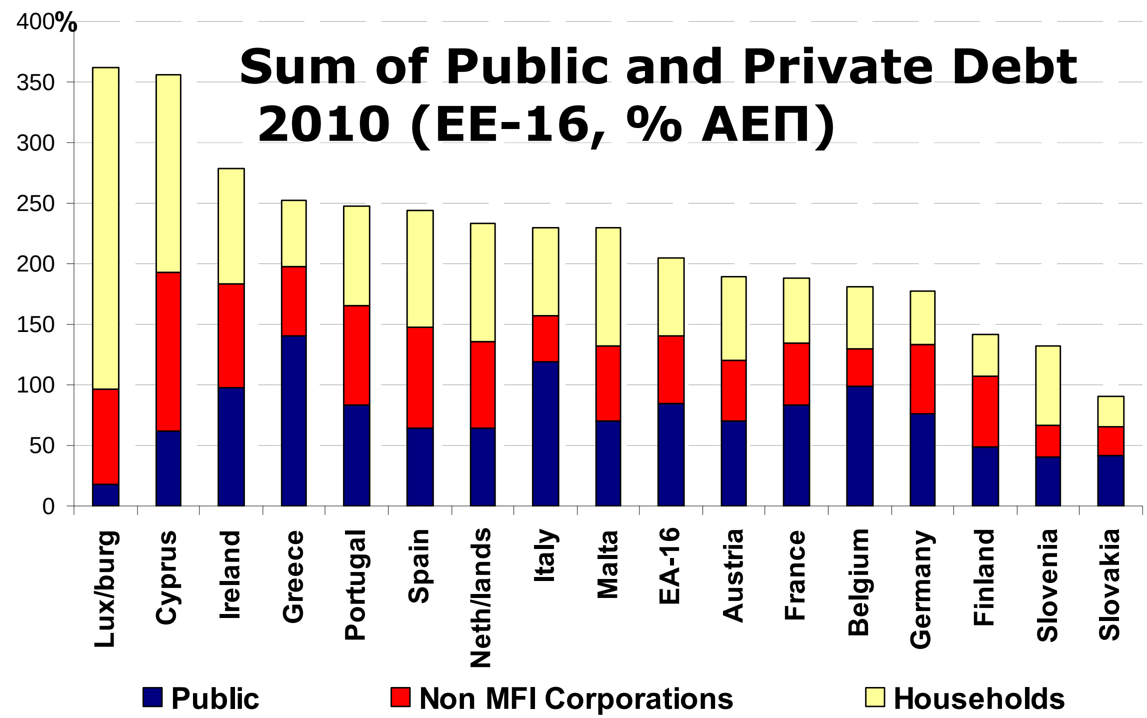
- ↓ Low competitiveness
- ↓ Large fiscal deficits, but not debt
- ↓ High private debt

✓ **SPAIN**

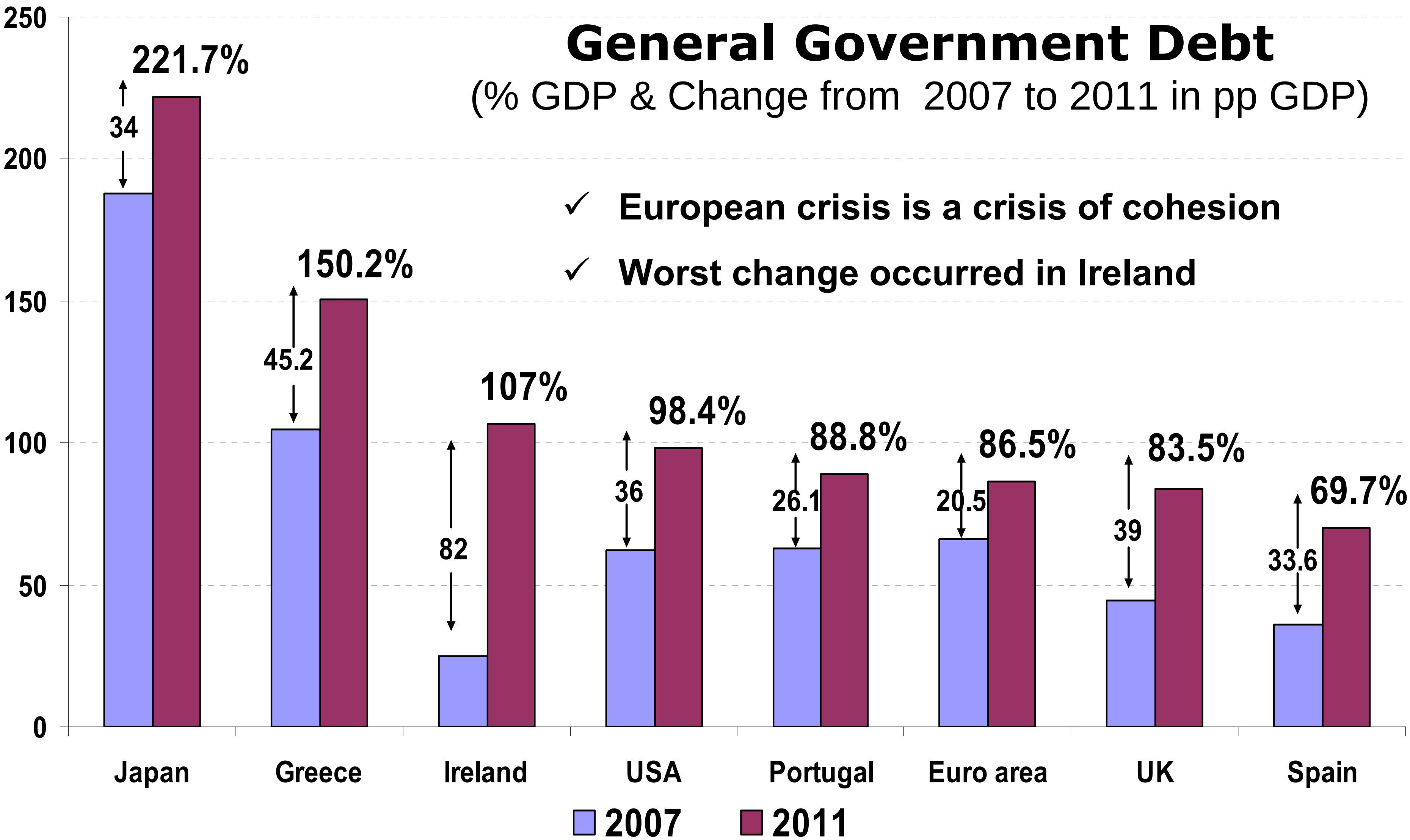
- ↓ Low competitiveness
- ↓ Housing market
- ↓ Small savings banks
- ↓ High private debt

GREECE

- ↓ Low competitiveness
- ↓ High fiscal deficits & debt
- ✓ In Greece Private Debt is low, below EA average, 9th largest



I. THE CHANGE IN EURO AREA DEBT SMALLER THAN IN OTHER REGIONS



- ✓ European crisis is a crisis of cohesion
- ✓ Worst change occurred in Ireland

Source: European Commission

II.

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II. CHARACTERISTICS OF THE NEW ARCHITECTURE

Not politically possible:

- ✓ An annual fiscal transfer mechanism from countries with positive growth to countries with negative growth, as this is perceived as a permanent transfer from the rich North to the more problematic South

The framework is designed along the following lines:

1) Stricter fiscal discipline - ***Van Rompuy proposals*** to be made concrete by June. (reverse majority rule, debt reduction = 5% of excess debt, stricter surveillance, fiscal rules, etc.)
2) Competitiveness Pact or "***Pact for the Euro,***" a follow up to the *Excessive Imbalances Procedure (wages to follow productivity, pension debt matters, corporate tax rates, investment in education and R&D, etc). Unhappy Junker attacked Merkel in mid March 2011.*
3) ***European Stability Mechanism***: No-bailout clause gone, funds boosted, ability to intervene in primary market
4) Stricter supervision of the Financial sector (Basel III: stricter capital requirements, new leverage and liquidity ratios; European Systemic Risk Board plus 3 European Authorities for Banks, Insurance companies and financial markets from January 2011)

- ✓ Eurobonds seem to be out (Objections that they reduce the incentive for compliance; Yet Eurobonds can be issued for European Infrastructure projects; They are created indirectly through the ESM loans)

III.

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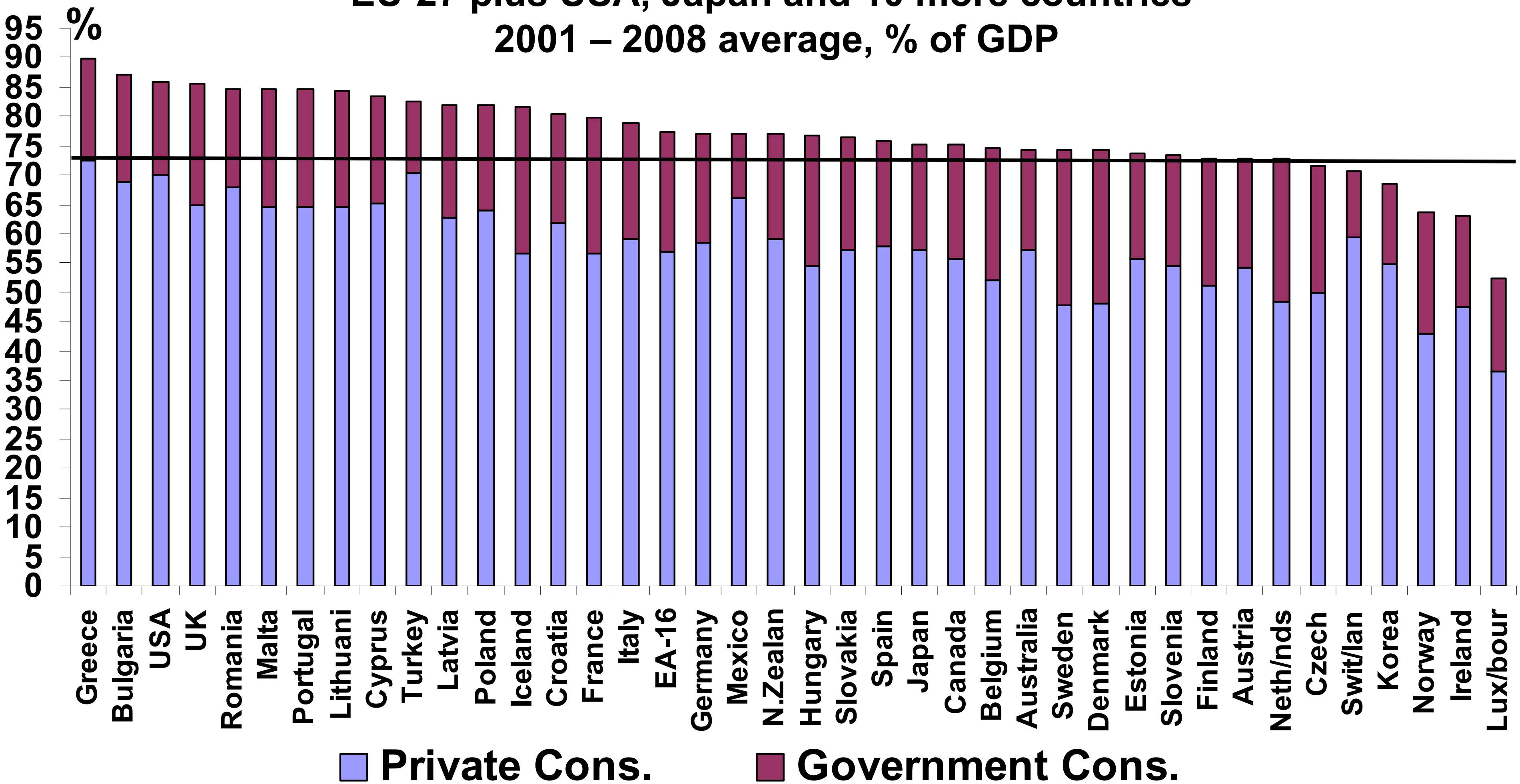
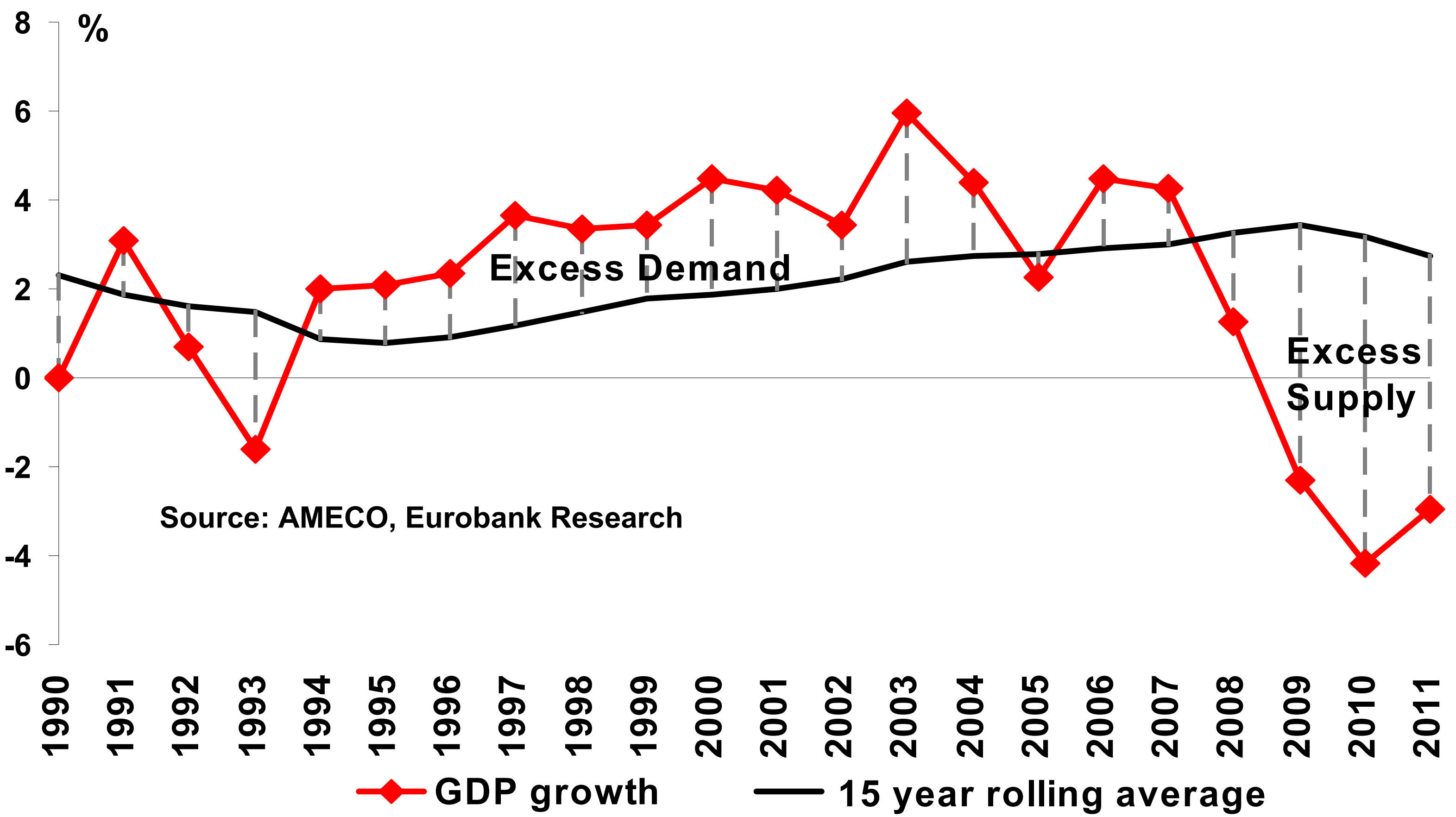
III. GREECE: OVER CONSUMPTION IN THE PAST

Private & Government Consumption
EU-27 plus USA, Japan and 10 more countries
2001 – 2008 average, % of GDP



III. GREECE: NEED TO RETURN TO A BALANCED GROWTH PATH



- ✓ From 1994 to 2008, cumulative real GDP growth rate was 22% higher than the long term average.
- ✓ This gap is expected to close by 2014: the recession restores economic balance

III. EU/IMF/ECB BASELINE SCENARIO

	2009	2010	2011	2012	2013	2014	2015	2020
GDP Growth (%)	-2.0	-4.5	-3.0	1.1	2.1	2.1	2.7	3.0
GDP deflator (%)	1.5	2.3	1.6	0.4	0.8	1.2	0.6	1.8
Nominal GDP (€ bn)	235	229	226	229	236	244	252	315
Current Account (% GDP)	-11.0	-10.5	-8.2	-7.1	-6.6	-5.5	-4.4	----
Interest Rate (%)	4.8	4.9	4.6	5.0	5.4	5.7	5.7	5.9
Bund Rate (bps)		225	275	350	350	350	350	350
Spread over Bund (bps)		550	525	350	300	300	300	250
Interest Expense (€ bn)	12.4	14.6	15.1	17.3	19.7	21.2	21.4	23.7
Interest Expense (% GDP)	5.3	6.4	6.7	7.5	8.3	8.7	8.5	7.5
Primary Expenditure (% GDP)	47.9	43.5	44.0	41.7	38.5	33.2	32.2	30.5
General Gov Revenues (% GDP)	37.8	40.4	43.1	42.8	42.0	39.3	38.5	36.5
Primary Balance (% GDP)	-10.1	-3.2	-0.9	1.0	3.5	6.0	6.3	5.9
General Gov Deficit (% GDP)	-15.4	-9.6	-7.5	-6.5	-4.8	-2.6	-2.1	-1.6
General Gov Deficit (€ bn)	-36.2	-22.0	-16.9	-14.9	-11.3	-6.3	-5.3	-5.0
General Gov Debt (% GDP)	127	143	153	159	158	154	151	130
General Gov Debt (€ bn)	298	327	345	364	373	375	381	409

Source: *IMF Projections of Feb 28, 2011; Eurobank EFG estimates; forecasts do not include March 11 decisions on loan repayment extension and int. rate reduction*

III. MAIN CHARACTERISTICS OF THE PROGRAM

- ✓ Basic scenario assumptions for privatization receipts:
  - ❖ 2011 €2.5bn, 2012 €3bn, 2013 €3bn ⇨ debt in 2015 151%, 2020 130% of GDP ⇨ this scenario is questioned by the markets ⇨ **€50 bn Privatizations**
  - ❖ Alternative scenario with **€50bn** privatizations in 2011–2015 ⇨ **debt** in 2015 134%, **2020 112% GDP**
- ✓ Real GDP growth around **2.8%** from 2015 on, below the 1996-2008 average; Standard of living of 2008 in **2017** ⇨ **a lost decade**
- ✓ Inflation subdued, never above ECB target of 2%: Its necessary to break up oligopolistic market structures
- ✓ Current Account Balance of -4.4% GDP in 2015 (still no external equilibrium)
- ✓ Spread over Bunds 300 b.p. in 2013, 250 b.p. in 2020: a conservative assumption
- ✓ Realistic assumption for a rise in the Bund Rate to 3.5%; Yet, nominal interest rate of 5.7-6.0% is above nominal growth rate of 4.2-4.8%: **Negative snowball effect requires huge primary surpluses** for debt sustainability
- ✓ Interest expense from €**14.6** bn in 2010 to **21.4** in 2015, **23.7** in 2020
- ✓ Primary Balance (-10.1% GDP in 2009) from -3.2% GDP in 2010 to 6.0% in 2014, a huge change of 9.3 b.p. of GDP between 2010 – 2014
- ✓ Primary Expenditure from 47.9% of GDP in 2009 to 30.5% in 2020, meaning a huge reduction in the relevant size of the public sector

III. IS GROWTH POSSIBLE AT TIMES OF FISCAL AUSTERITY?

How can growth be achieved, when the public sector is to shrink?

The assumptions are:

- ❖ Drastic Structural Reforms will have benefits
  - ✓ More flexible labor and product markets
  - ✓ Better institutional environment improvement (less bureaucracy and corruption, no overlaps and delays in the administration's decision process, less waste)
  - ✓ better quality of life (sustainable development, a modern and better organized administration, a new culture of responsibility, accountability and intergenerational solidarity)
- ❖ Crowding-in of the shrinking public sector
- ❖ Production shift to export oriented sectors

III. ARE DERAILMENT RISKS CONTAINABLE?

❖ THE FIVE MAJOR RISKS:

i. *Will the recession end soon?*

Growth may resume through an increase in exports, the stabilization of the economic climate, an increase in investments and a resolution to the EMU crisis

ii. *Will the Greek banking system remain stable and strong?*

Depends on the continuing support from the ECB (€ 97 bn), the opening up of the interbank market for Greek banks

iii. *Will the expected growth benefits from structural reforms materialize;*

Zonzilos (2010), Buis & Duval (2011) estimate an increase in GDP of 17%.

iv. *Will we be able to reduce the huge public debt in other ways?*

A target has already been set to collect €50 bn through privatizations

An extension for repaying IMF and EU loans has been granted (to 7,5 from 3¼ years) and the interest rate has been reduced by 100 b.p.

v. *Will the public sector achieve primary surpluses of around 6% for an extended period of time?*

The new Pact for the Euro helps maintain fiscal discipline for a long time

III. NEW EURO AREA ARCHITECTURE & GREEK CHOICES

- ✓ The new Euro Area architecture aims to improve coherence and overall competitiveness; it is not a zero-sum game
- ✓ The new architecture does not impose additional restrictions on Greece
  - ❖ Those restrictions are already present, triggered by the Greek crisis and the subsequent Economic Adjustment Program.
  - ❖ The discipline enforced by the creditors (EC/ECB/IMF) is more severe than the requirements of the new Euro Area architecture.
- ✓ As a result Greece ought to be in favor of the new Euro Area architecture
- ✓ The new strict Euro Area architecture imposes long term discipline even after a decade, when Greece will hopefully have freed herself from the debt burden
- ✓ As a result, the new Euro Area architecture implies that the current adjustment process of the Greek economy will not derail; it is an one-way road

CONCLUSIONS

- Markets woke up to the Euro Area's inability for fiscal and competitiveness harmonization
- The current Euro Area crisis is the result of a reckless expansion of the financial sector plus an unbalanced growth path in many countries (over-consumption and twin deficits in countries with low external competitiveness)
- The Euro Area is fixing its architecture, strengthening
  - ✓ the regulation and supervision of its financial sector
  - ✓ the unification process through a harmonization of fiscal and competitiveness policies, as necessary complements to the common monetary policy
- The new architecture benefits Greece, as it imposes long-run discipline
- Greece is losing a decade of growth and is in the beginning of a huge transformation of its economy and its culture
- The risks are high but containable