EURO AREA's NEW ARCHITECTURE AND THE GREEK MULTI-YEAR ADVENTURE

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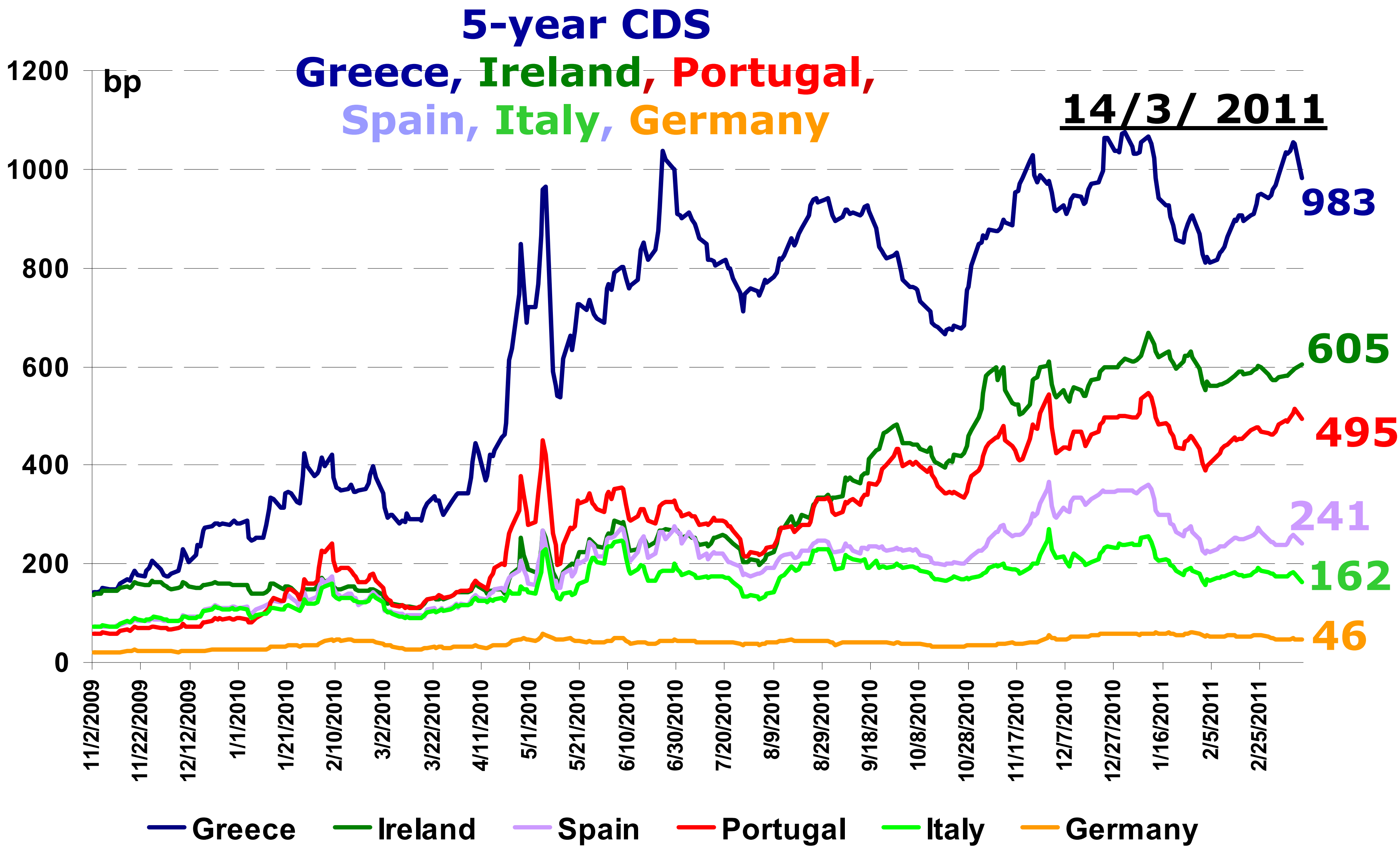
I. THE CRISIS BEGINS AT THE END OF 2009



Πηγή: Bloomberg

I. HAIRCUTS WITH THEIR (RISK-NEUTRAL) PROBABILITIES

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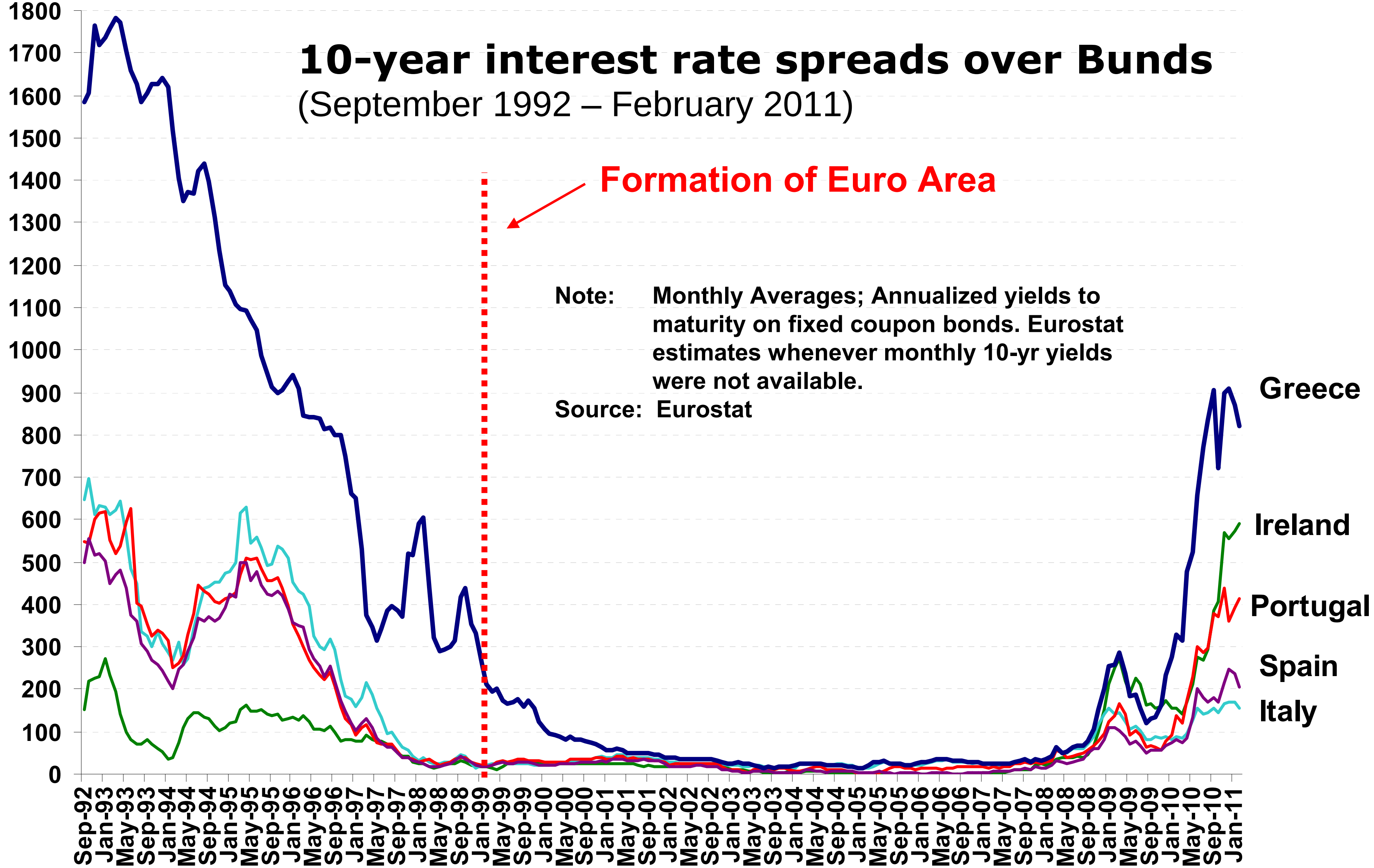
Hair-cut	Greece		Ireland		Spain		Portugal		Italy		Germany	
	MP %	CP %	MP%	CP%	MP%	CP%	MP%	CP%	MP%	CP%	MP%	CP%
100%	9.7	37.3	6.0	24.9	2.4	10.7	4.9	20.9	1.6	7.3	0.5	2.1
90%	10.8	40.6	6.6	27.3	2.6	11.8	5.4	22.9	1.8	8.1	0.5	2.4
80%	12.1	44.4	7.5	30.1	3.0	13.2	6.1	25.4	2.0	9.1	0.6	2.7
70%	13.9	49.0	8.5	33.7	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. THE FORMATION OF THE EURO AREA

- ✓ A political project and a natural culmination of the efforts to build a common market (Hardouvelis & Sachinidis (1999))
  - European Coal & Steel Community (1951),
  - European Economic Community (EEC), (1957, France, Germany, Italy, Belgium, Netherlands, Luxemburg),
  - Single European Act (1986): Free movement of goods, services and capital (from 1990) & labour (from 1992)
  - ERM, 1979-1998
  - Delors Report (1989): A 3-stage plan for a European Economic & Monetary Union
  - European Union Treaty - Maastricht Treaty (1992): 2nd stage 1994, 3rd stage in 1999

- ✓ The creation of the Euro Area was based in the nominal convergence of its member states – the Maastricht criteria:
  - **Inflation rates**: < **1.5** pp than the average of the three best performing member states of the EU in the 12 months before entry
  - **General Government Deficit**: the ratio of the annual government deficit to GDP must not exceed **3%** at the end of the preceding fiscal year .
  - **General Government Debt:** the ratio of gross government debt to GDP must not exceed **60%** at the end of the preceding fiscal year. Alternatively, the ratio must have sufficiently diminished and must be approaching the reference value at a satisfactory pace.
  - **Exchange rate:** Member of ERM II for two consecutive years with no devaluation.
  - **Long-term interest rates**: Nominal yield of fixed-coupon 10-year gov. bonds **< 2** pps than the average yield in the three lowest inflation member states in the 12 months before entry

I. ECONOMIC THEORY OF OPTIMUM CURRENCY AREAS WAS IGNORED

The academic literature on **Optimum Currency Areas** was disregarded. The necessary economic criteria were thought to adjust by themselves and converge once the common currency forms via a political path. These criteria included:

- ✓ **Open economies with highly interconnected external trade sectors**
- ✓ **Liberalized labor, capital and product markets among participating countries**
- ☒ **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
- ☒ **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)).
- ☒ **Existence of a fiscal mechanism to smoothen the effects of the asymmetric shocks**

I. THE GLARING EMU IMPERFECTIONS

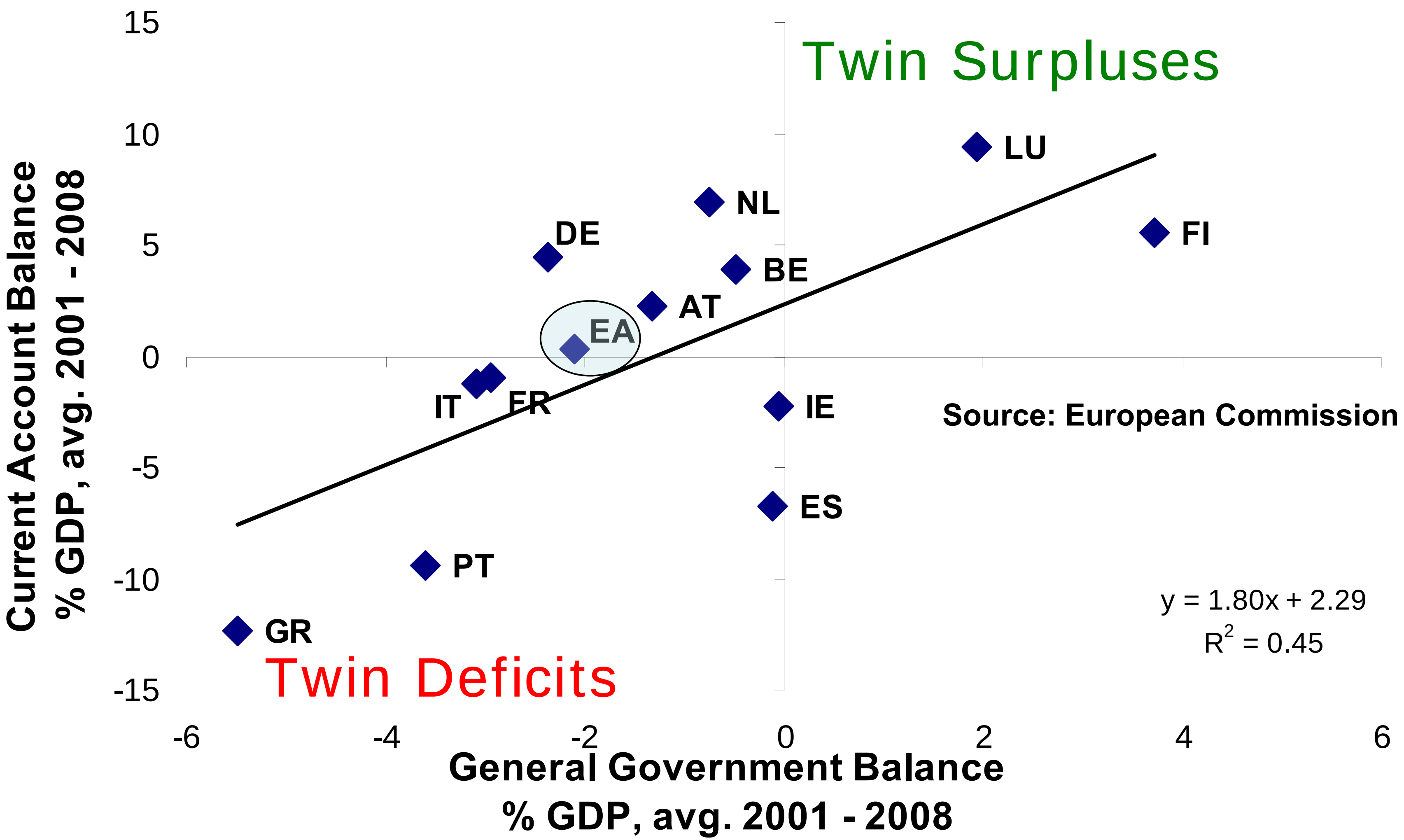
- ✓ The Stability and Growth Pact (SGP) together with the establishment of the independent European Central Bank (ECB) were considered as the **two main pillars for the Euro area stability**
- ✓ It was believed that SGP would be enforced due to the system of penalties and the "**No Bailout Clause**"
- ☒ A fiscal transfer mechanism was never installed as it required deeper political integration
- ☒ Further uniformity in economic structures was avoided due to domestic political reasons
- ☒ The Lisbon Agenda aiming to improve competitiveness was based on the method of "open coordination," which posed no constraints on Member States

- ❖ Yet, the Maastricht Treaty had mentioned the significance of economic variables like the balance of payments, unit labor costs, etc.
  - No mechanism was created to control systematic imbalances between Member States
  - No importance was given to **a)** the uniformity of pension systems, **b)** the competitiveness of labor markets, and **c)** the uniformity of tax rates

I. DESIGN IMPERFECTIONS LED TO EVEN LARGER CROSS COUNTRY DIVERGENCES

- ✓ There was a latent assumption that the market mechanism would automatically correct deviations from the competitiveness norm
- ☒ The assumption turned out plain wrong as real economies diverged: A competitive Euro Area North and an uncompetitive Euro Area South
  - Nominal wages were sticky and an imperfect substitute of the flexibility that an independent domestic monetary and exchange rate policy have as tools to counteract asymmetric shocks (e.g. on the terms of trade)
  - Difficult to generate the required internal devaluation or over-valuation
- ☒ In addition, the 12-year Euro Area experience showed that the independent ECB worked, but this was not the case for the SGP, the second pillar
  - The SGP’s system of embedded penalties for excessive deficits were relaxed after Germany and France faced the first difficulties
  - Eurostat auditing of fiscal data proved far from perfect (Greek statistical data constitute a typical example).
  - The «No Bailout Clause” was circumvented because of the contagion effect that a Member State’s default might cause

I. EXTERNAL AND INTERNAL (FISCAL) IMBALANCES BECAME LARGE



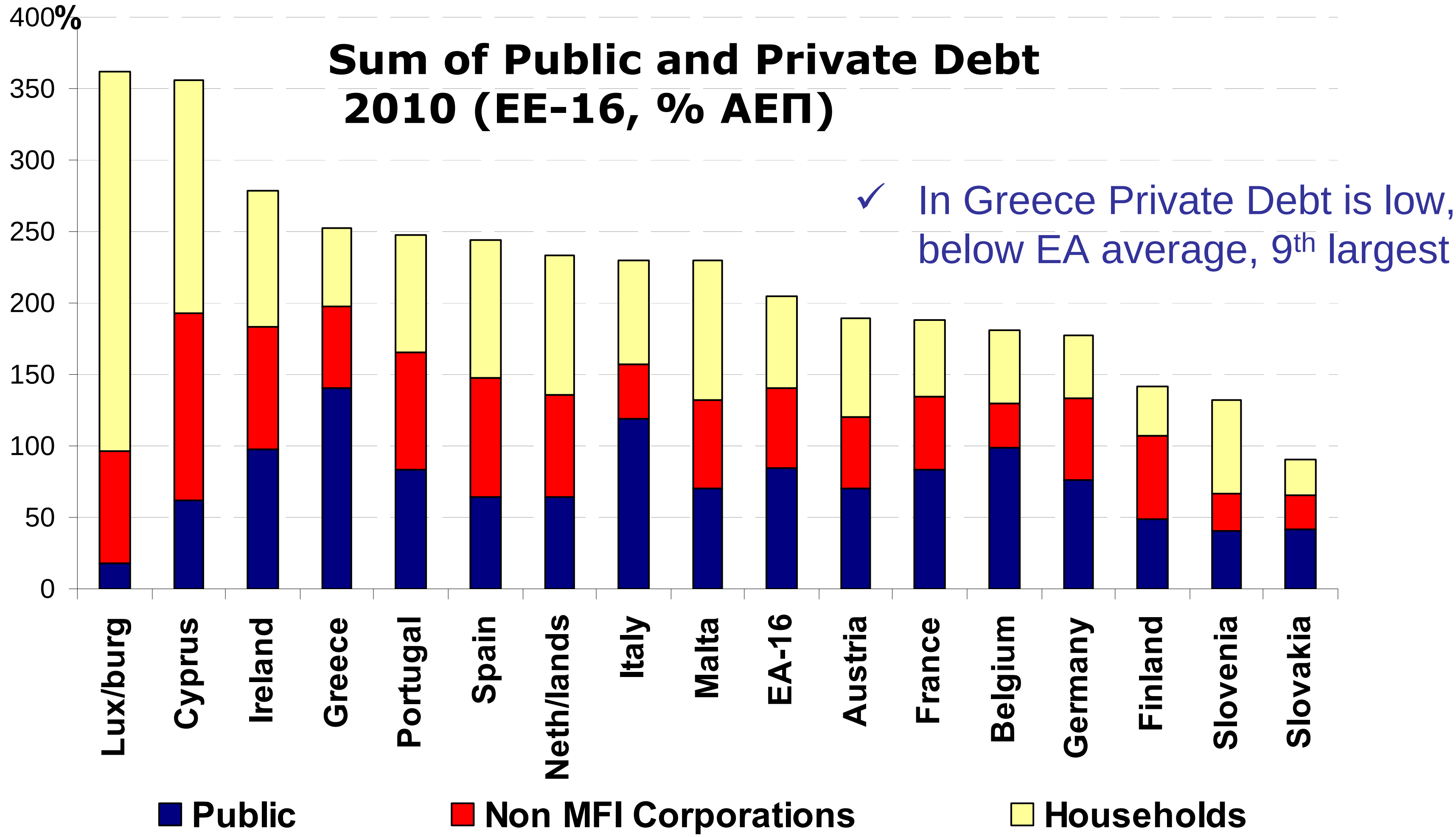
I. DIFFERENT EURO AREA COUNTRIES FACE DIFFERENT PROBLEMS TODAY

- ✓ **IRELAND**
  - ➔ Housing market
  - ➔ Banks ➔ rise of 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

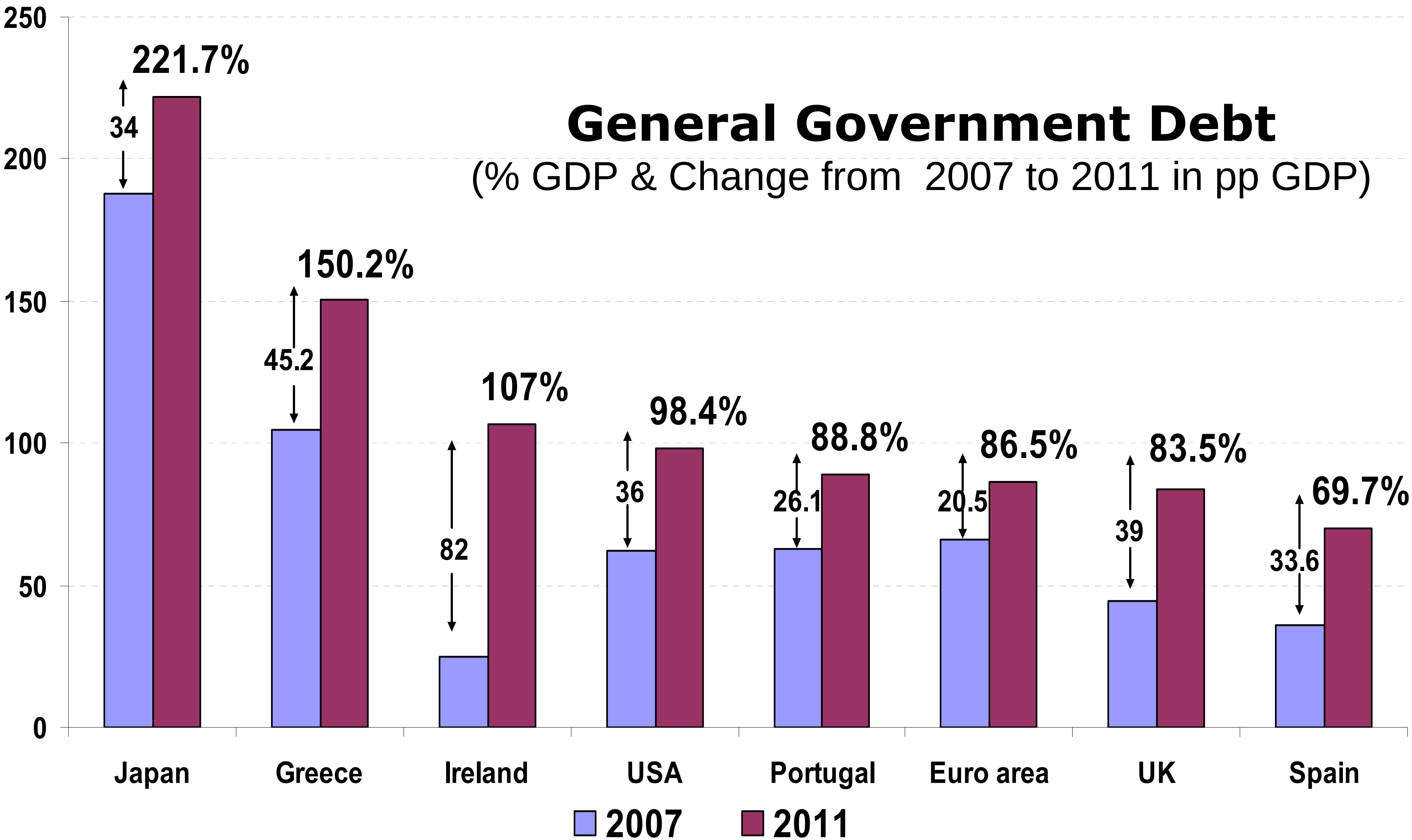
I. PUBLIC AND PRIVATE DEBT



Source: European Commission, ECB

Note: ECB data for private debt are Loans; Neither seasonally nor working day adjusted; MFIs excluding Eurosystem. All currencies combined. Private sector is composed of: Other financial institutions, Insurance corporations and pension funds, Non-Financial corporations, Households and non-profit institutions serving households.

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



Source: European Commission

II.

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II. NEED FOR A NEW EMU ARCHITECTURE

- ✓ EMU crisis is the final symptom of
  - ❖ Imbalanced growth (over-consumption and twin deficits (external and fiscal) in countries with low competitiveness
  - ❖ Over-aggressive financial sector
- ✓ The Euro Area is working on three fronts:
  - ❖ Fiscal
  - ❖ Competitiveness
  - ❖ Financial stability
- ✓ Euro Area countries understand EMU dissolution is not an option: Implies huge costs in financing, in trade, in politics and the average European living standards
- ✓ Hence, the only available option is to strengthen the regulation and supervision of the financial sector and work towards closer unification through the harmonization of fiscal and competitiveness policies, as necessary complements to the common monetary policy

II. CHARACTERISTICS OF THE NEW ARCHITECTURE

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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.
2) Competitiveness Pact or "***Pact for the Euro,***" a follow up to the *Excessive Imbalances Procedure*
3) ***European Stability Mechanism***: No-bailout clause gone, funds boosted, ability to intervene in primary market

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

II. VAN ROMPUY PROPOSALS

Approved in October 2010, to be made concrete by June 2011. They boost the existing Stability & Growth Pact.

- ✓ Adoption of fiscal rules by all EU countries
- ✓ Larger debt or implicit debt => faster adjustment path (1/20 of existing debt according to March 11 Council)
- ✓ Excessive Deficit Procedure can be triggered even with deficit below the 3%.
- ✓ Stricter Sanctions, particularly a higher degree of automaticity – using a **reverse majority rule**.
- ✓ A new surveillance mechanism to address macroeconomic imbalances and divergences in competitiveness, plus an enforcement framework: “Excessive imbalances procedure”
- ✓ Deeper and broader coordination - the "European semester“ – budget planning surveillance and coordination at a European level.
- ✓ Introduction of a permanent crisis resolution mechanism for the euro area aiming to address financial distress and contagion.

II. COMPETITIVENESS PACT OR PACT FOR THE EURO

- ✓ Based on German - French proposal of February 2011. Will be presented to the European Council of 24/25 March 2011 with a view for Non-Euro Area Member States to indicate whether they intend to participate

- ✓ According to the March 11, 2011 Council decision:
  - ❖ Common objectives, but flexibility in methods within Member States
  - ❖ Commission to monitor the implementation. Indicators cover:

    i) **competitiveness**: wages to evolve in line with productivity, ii) **employment**: long term and youth unemployment rates, and labour participation rates iii) **fiscal sustainability**: Debt levels also depend on pensions schemes, health care and benefit systems, demographic factors. iv) **financial stability**: bank stress tests
  - ❖ Actions to correct problems: review the wage setting arrangements, opening of sheltered sectors, improve education systems and promote R&D, innovation and infrastructure, improve the business environment (bankruptcy laws, commercial code), “flexicurity”, reduce undeclared work and increase labour participation, lower taxes on labour to make work pay, align pension system to the demographic situation, limit early retirement schemes, use targeted incentives to employ older workers, translate EU fiscal rules into national legislation, (e.g. a "debt brake", rule related to the primary balance or an expenditure rule)
  - ❖ Commission to propose a common consolidated corporate tax base

II. EUROPEAN STABILITY MECHANISM

- ✓ Council agreed on Mach 11, 2011 to include the EFSF €440 bn plus the EFSM €60 bn as maximum final size of loans, independent of collateral requirements. The size of the loans of the future ESM will not exceed the €500 bn threshold.
- ✓ **Mechanism endorsement procedure:** European Council, Modification of the Lisbon Treaty is a prerequisite (approval of member states parliaments and not referendums)
- ✓ **Activation date:** Permanent Mechanism to be activated by 1/1/2013. The ESM will replace the two existing mechanisms.
- ✓ **Source of funding/ guarantees:** Not specified yet (expected to be a mix of paid-in capital, callable capital and guarantees.
- ✓ **To whom it applies:** All Euro Area members.
- ✓ **Activation procedure**: Unanimous decision of the Euro Area countries on the basis of a debt sustainability analysis of the Member State concerned conducted by the Commission, the IMF and the ECB.
- ✓ **Form of financial assistance:** loans and intervention in the debt primary market in a context of a programme with strict conditionality .

II. STRICTER SUPERVISION OF FINANCIAL SECTOR

- ✓ Key elements of new proposals, coordination by the G-20:
  - ❖ Raise the quality (e.g. loss absorbency of regulatory capital), consistency and transparency of capital base
  - ❖ Strengthen (counterparty) risk coverage of capital framework
  - ❖ Restrict shadow banking system and over-the-counter markets
  - ❖ Macro-prudential supervision and inter-connectedness
  - ❖ Closer monitoring and supervision of MFIs of systemic importance
  - ❖ Control leverage and liquidity through simple indicators

- ✓ The Basel Committee on Banking Supervision (BCBS) has formulated a comprehensive set of proposals (so called “Basel III”), which follow up on the previous G-20 proposals

II. STRICTER SUPERVISION OF FINANCIAL SECTOR

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In the **EU**, a new supervision and regulatory framework from January 2011:

- European Systemic Risk Board (ESRB), macro prudential supervision
- European Banking Authority (EBA)
- European Insurance and Occupational Pensions Authority (EIOPA)
- European Securities and Markets Authority (ESMA), also supervising Credit Rating Agencies

In **USA**, the **Dodd–Frank Wall Street Reform and Consumer Protection** Act (July 2010):

- Increases the supervision and regulation of the “shadow” banking system;
- Financial Stability Oversight Council in the Treasury Department, to monitor systemic risk;
- Office of Financial Research in the Treasury Department, tasked with providing administrative, technical, budget analysis and other support services to the FSOC and its affiliated agencies;
- Orderly Liquidation Authority is to be an FDIC-managed fund, to be used in the event of a financial company's liquidation that is not covered by FDIC or SIPC;
- Federal Insurance Office within the Treasury Department for the supervision of insurance companies
- Bureau of Consumer Financial Protection in the Fed;
- Office of Credit Ratings for the supervision of credit rating agencies
- Volcker Rule (Glass-Steagall) with the aim of reducing the amount of speculative investments on large MFI' balance sheets
- Regulation of over-the-counter derivatives markets (e.g. CDS)

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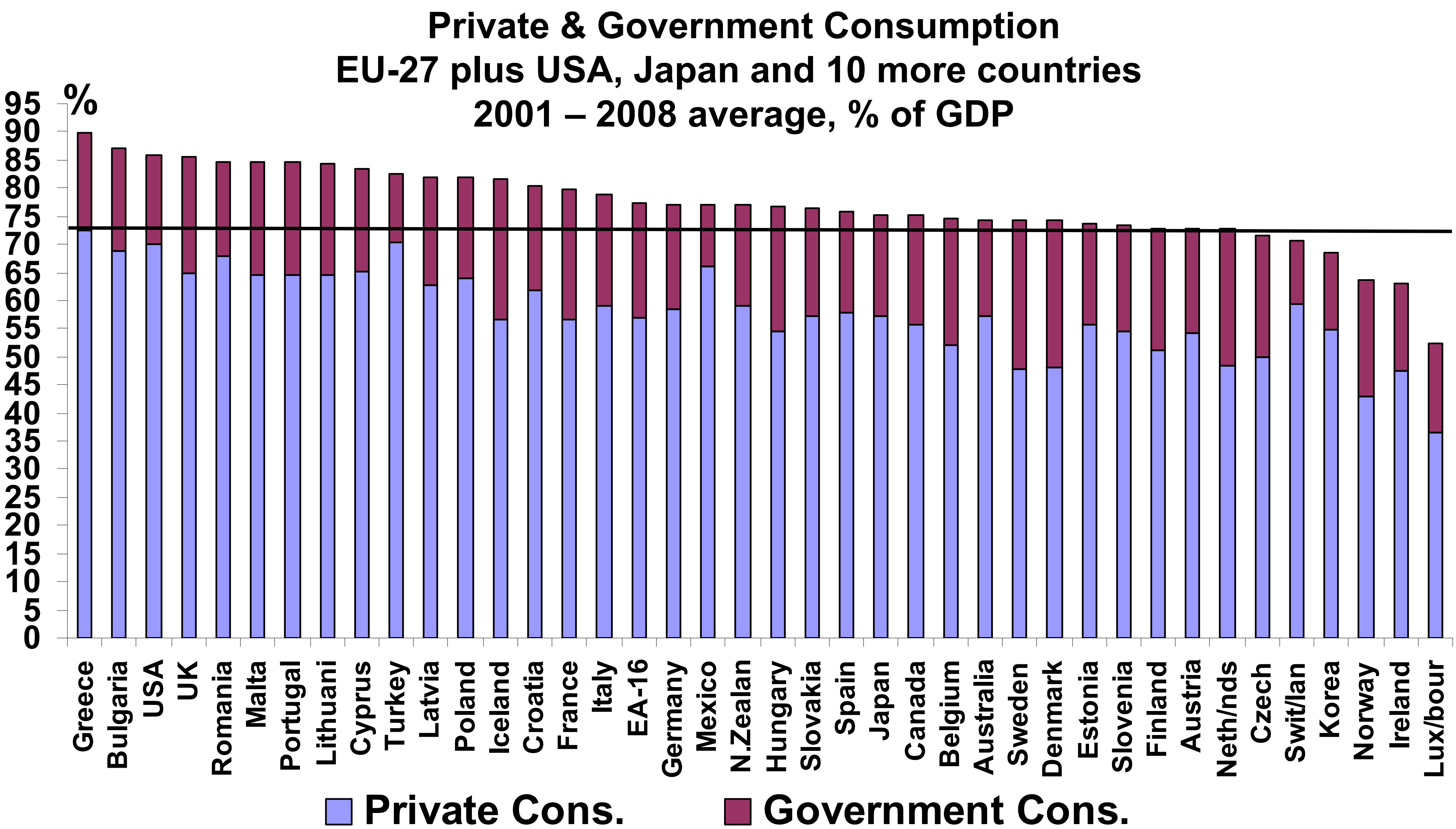
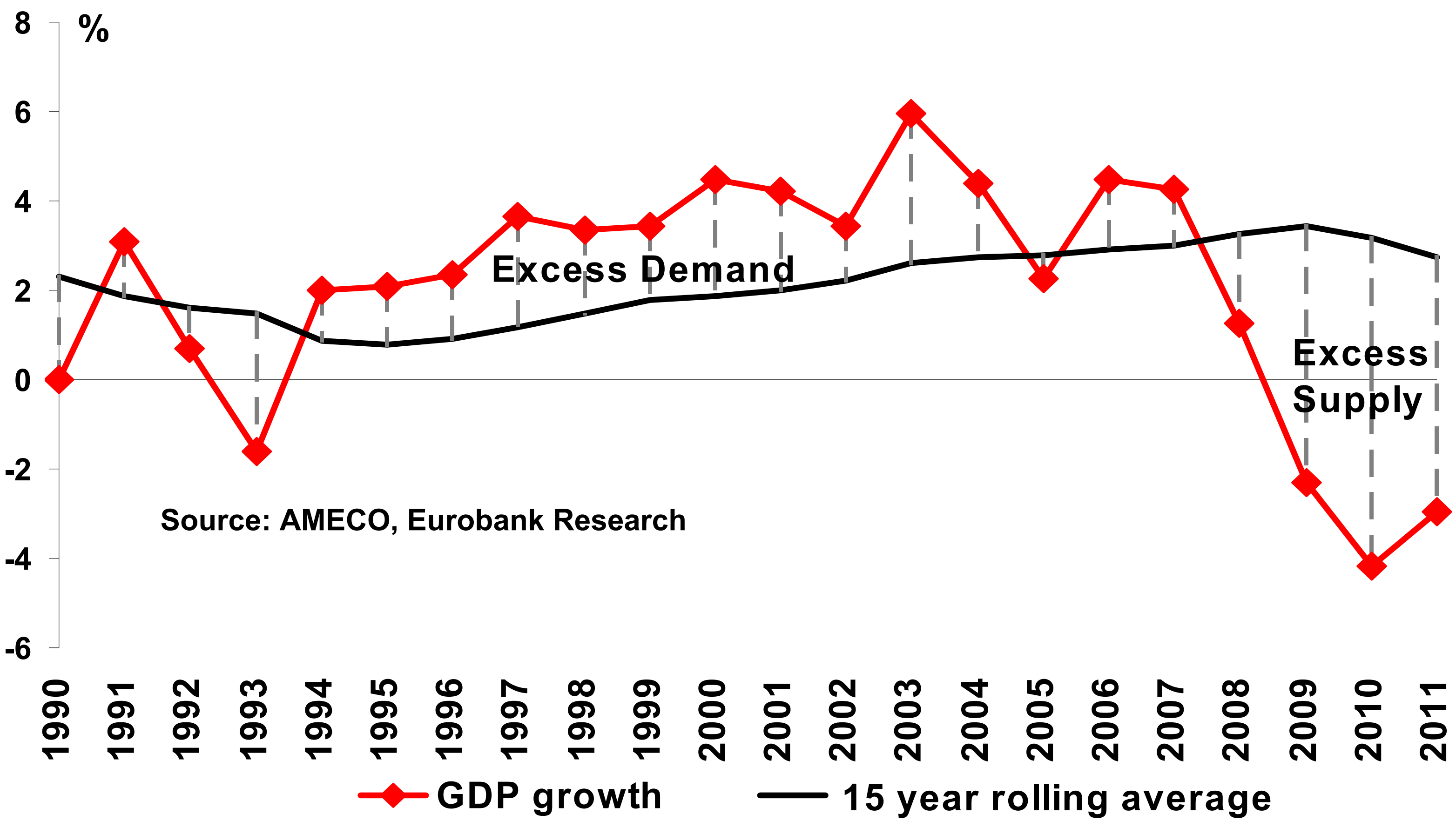
III. GREECE: OVER CONSUMPTION IN THE PAST



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	2.7
GDP deflator (%)	1.3	2.2	1.5	0.4	0.8	1.2	1.3	1.8
Nominal GDP (€ bn)	235	229	227	230	237	244	254	311
Current Account (% GDP)	-11.1	-10.4	-7.1	-6.1	-5.2	-4.3	-3.3	----
Interest Rate (%)	4.8	4.9	4.6	5.0	5.4	5.7	5.7	5.7
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	14.9	17.2	19.6	21.3	21.4	23.1
Interest Expense (% GDP)	5.3	6.4	6.6	7.5	8.3	8.7	8.4	7.4
Primary Expenditure (% GDP)	47.9	43.1	43.2	42.2	40.7	37.3	36.1	34.4
General Government Revenue (% GDP)	37.8	39.8	42.4	43.2	44.2	43.4	42.0	40.3
Primary Balance (% GDP)	-10.1	-3.3	-0.8	1.1	3.5	6.0	6.0	6.0
General Government Deficit (% GDP)	-15.4	-9.6	-7.4	-6.4	-4.8	-2.7	-2.4	-1.4
General Government Deficit (€ bn)	-36.1	-22.2	-16.7	-14.7	-11.3	-6.6	-6.2	-4.4
General Government Debt (% GDP)	127	141	152	158	158	154	150	131
General Government Debt (€ bn)	298	324	344	363	374	376	381	408

Eurobank EFG estimates

III. MAIN CHARACTERISTICS OF THE PROGRAM

- ✓ Real GDP growth around **2.7%** 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 -3.3% 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 6% is above nominal growth rate of 4.5%: **Negative snowball effect requires huge primary surpluses** for debt sustainability
- ✓ Interest expense from €**14.6** bn in 2010 to **21.3** in 2014, **23.1** in 2020.
- ✓ Primary Balance (-10.1% GDP in 2009) from -3.3% 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 34.4% in 2020, meaning a reduction in the relevant size of the public sector.
- ✓ Debt to GDP ratio from 141% in 2010 to 158% in 2012 and 131% in 2020 ⇨ this scenario is questioned by the markets ⇨ **€50 bn Privatizations**

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?

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❖ 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

❖ *Will the expected growth benefits from structural reforms materialize;*

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

❖ *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.

❖ *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

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- ✓ 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