# Greek Crisis Phase II

## The Way Forward


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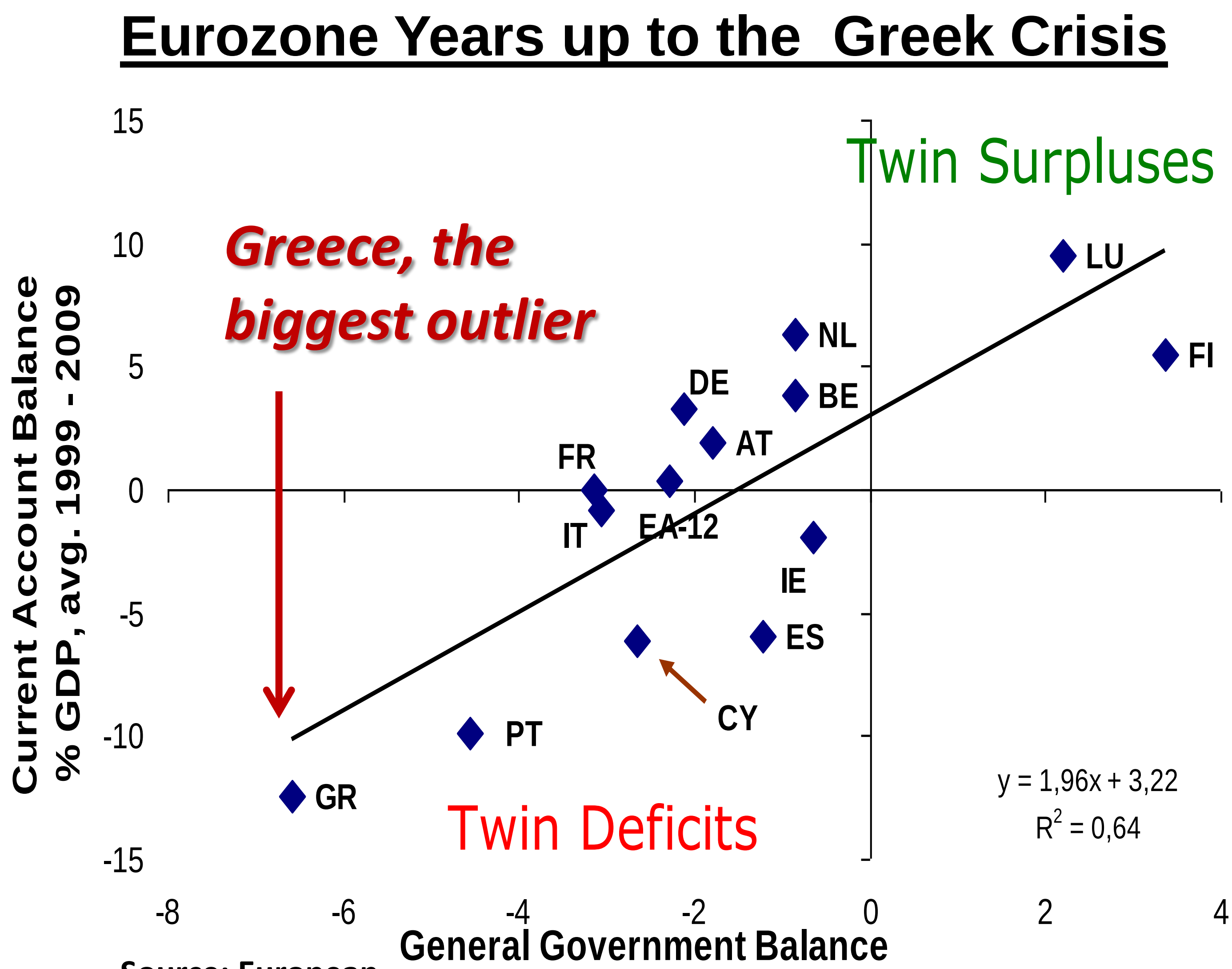
# GREEK CRISIS PHASE II: Overview

1. **The past: Why a Greek crisis?**
   - Unprecedented macroeconomic imbalances
   - The necessary adjustment brings a huge recession
   - Growth resumes in 2014, but …
2. **The present: Why Phase II of the crisis?**
   - A disastrous confrontation with the lenders in early 2015
   - Government is starved of cash, growth stalls, capital controls, GREXIT fears and the referendum gimmick
   - $180^0$ policy turn & a 3rd Rescue for 2015-2018
   - 3rd Bank recapitalization, yet NPLs keep rising
3. **The future: Will growth come back and how?**
   - The short-term
   - The long-term: Three scenarios

# 1. Why a crisis? Serious internal & external imbalances prior to the crisis

- Crisis was triggered by the revelation of a huge fiscal deficit in 2009, which led rating agencies and markets to interrogate the economic fundamentals of Greece
- Greece was an EA **outlier** in both **fiscal & current account deficits**
- The high Greek nominal growth had kept debt-to-GDP in control until 2009
- **EA Era's Market Failure**: Markets ignored the differences between countries and lent easily to both private & public sector

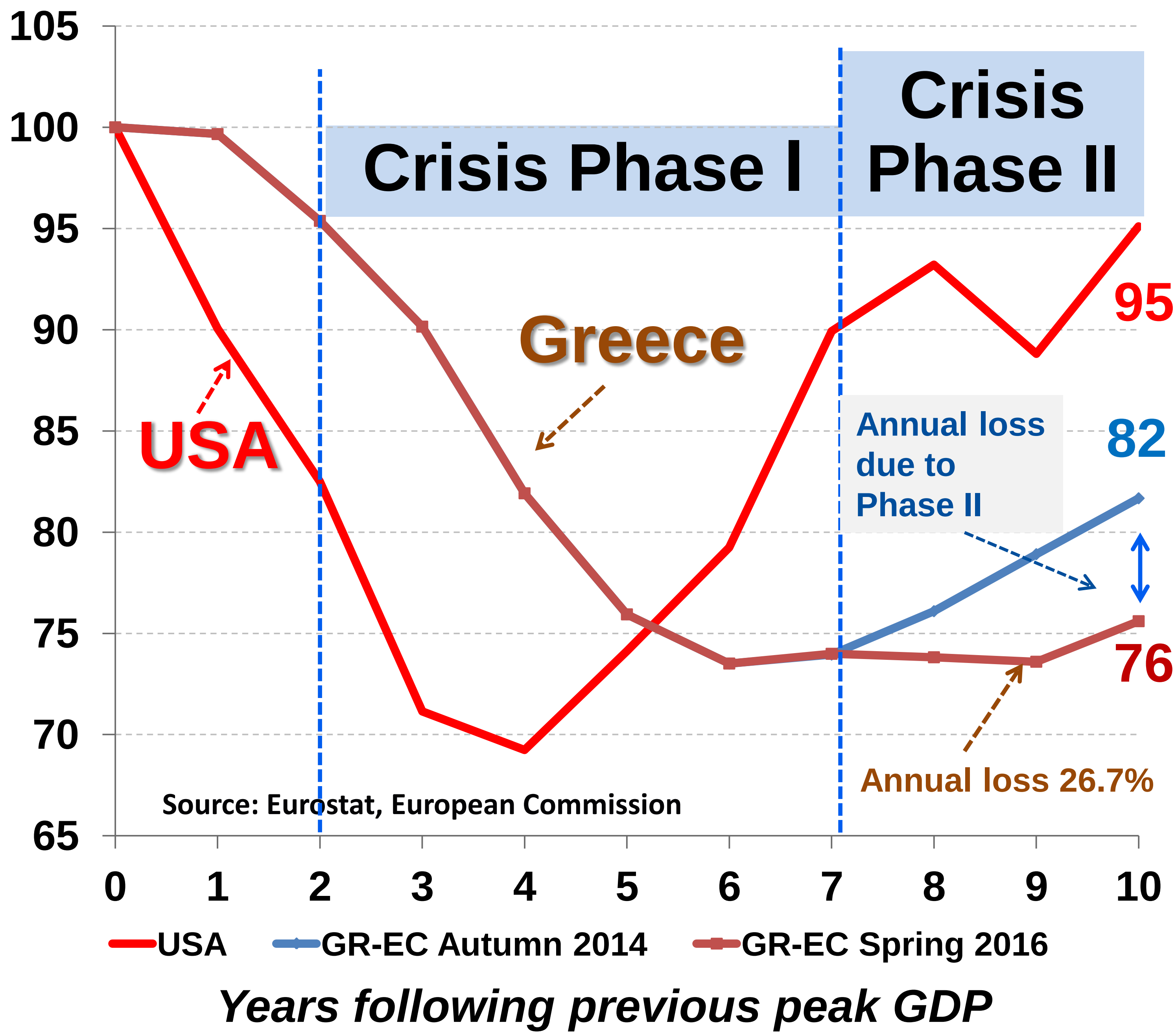



Source: European Commission

- Other EA - but not Greek imbalances: Private sector credit

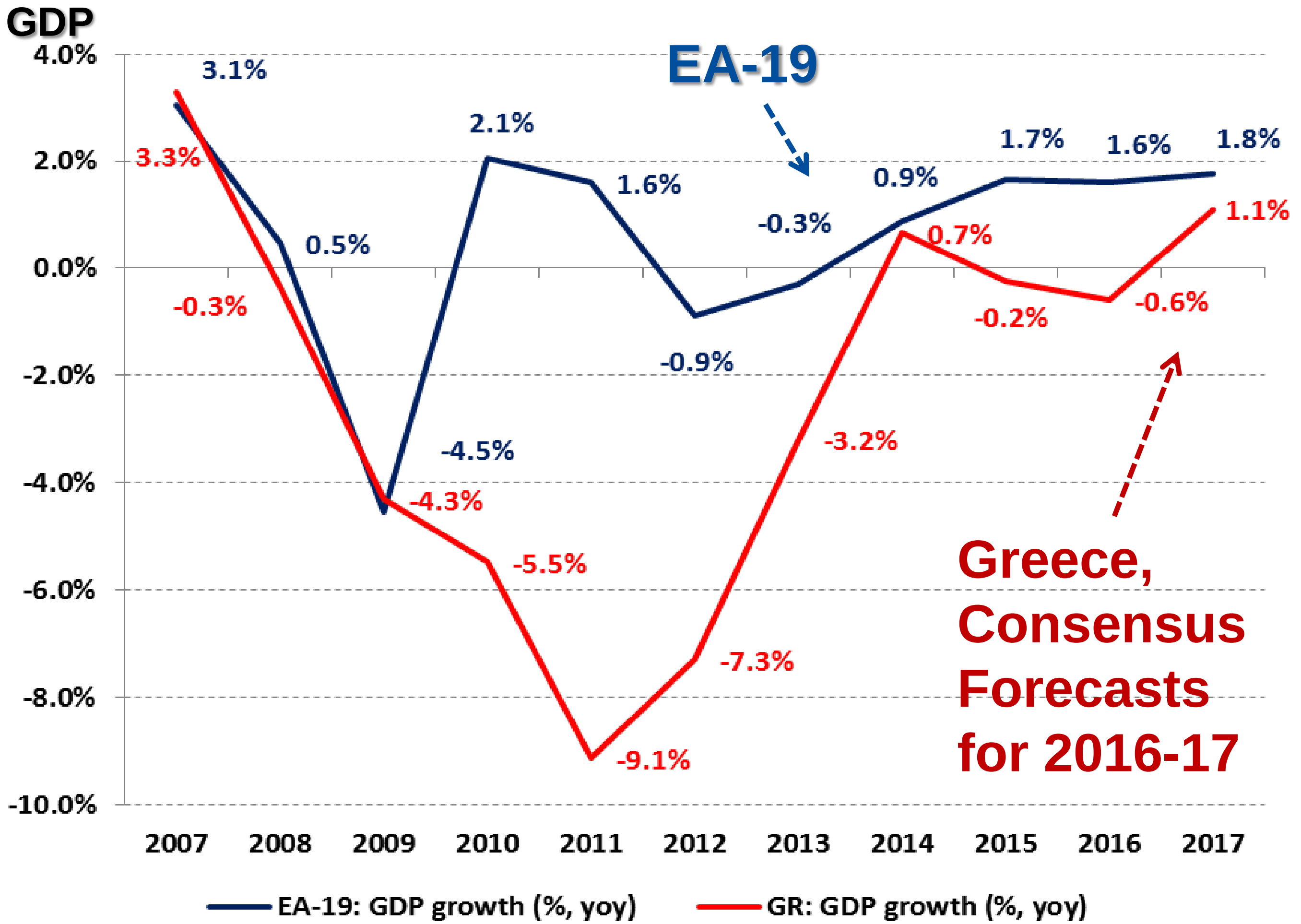
# 2. Greek crisis brought a worse recession than the Great Depression in the United States

- Date 0 is 1929 for the US and 2007 for Greece: Real GDP is set at 100
- The Greek recovery of year 10, 2017, is a forecast
- After 10 years, the US was at 95 in 1939 but Greece (at best) at 76 in 2017
- Fall 2014: Greece was forecasted to be above 82
- At minimum, Phase II costs annually 6.1 ppts or €14bn



# 1. Greece: Why such a huge recession until 2013?

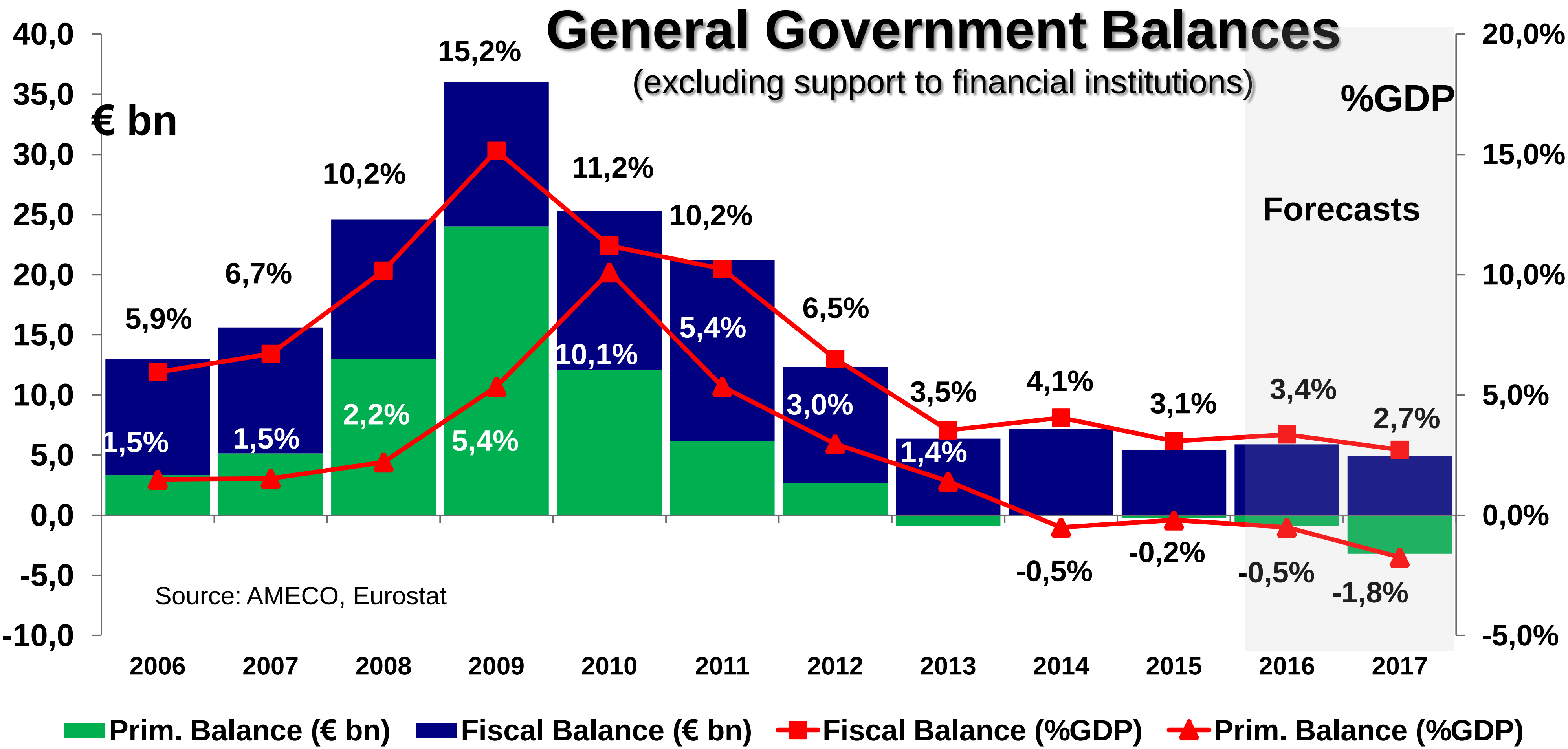
1. Macroeconomic imbalances worse than anywhere else in the Euro Area
2. Closed economy, dominated by small firms, with inefficient public administration, unstable tax policies, lack of confidence, etc.
3. Liquidity crunch
4. Serious program errors by domestic politicians and lenders




- Parties in opposition consistently took extreme positions against "MoU," unlike in other programs countries. Hence, no ownership of reforms
- Lenders insisted on the wrong sequencing of reforms

❑ **Then a "political shock" in 2015, brought a W-shaped recession**

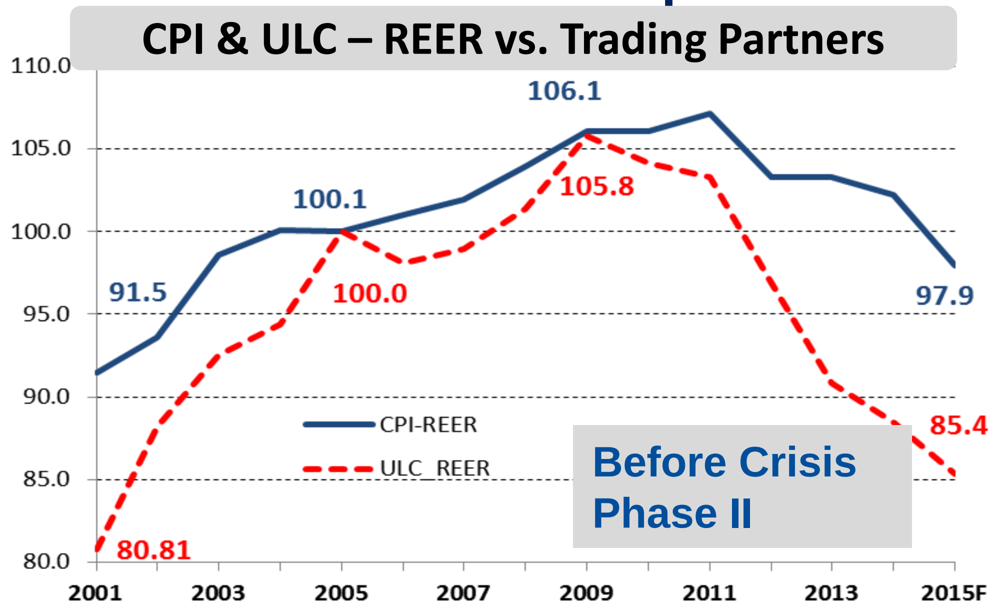
# 1. Fiscal imbalances are corrected today

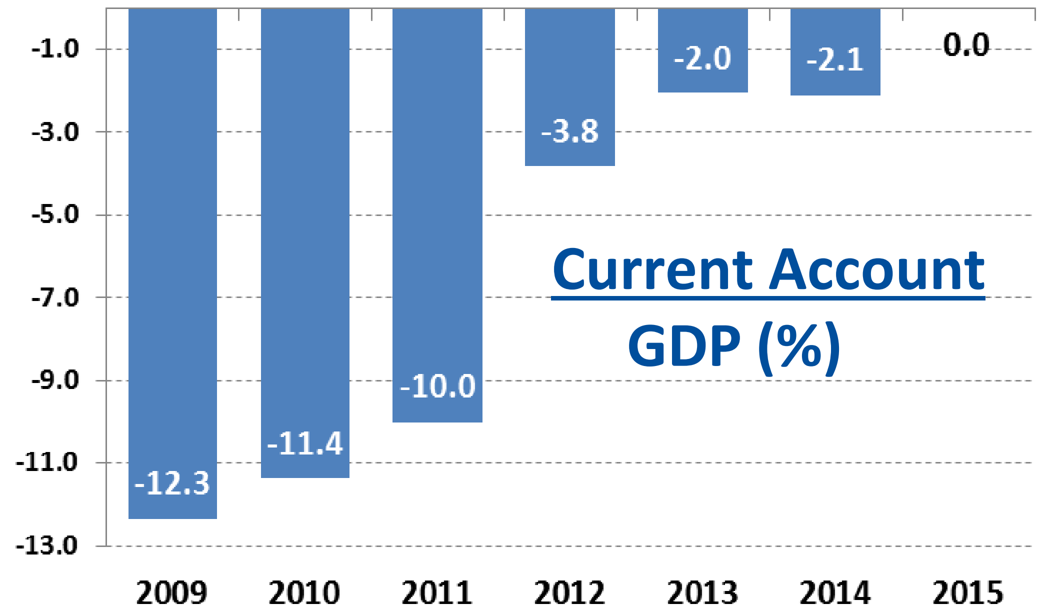


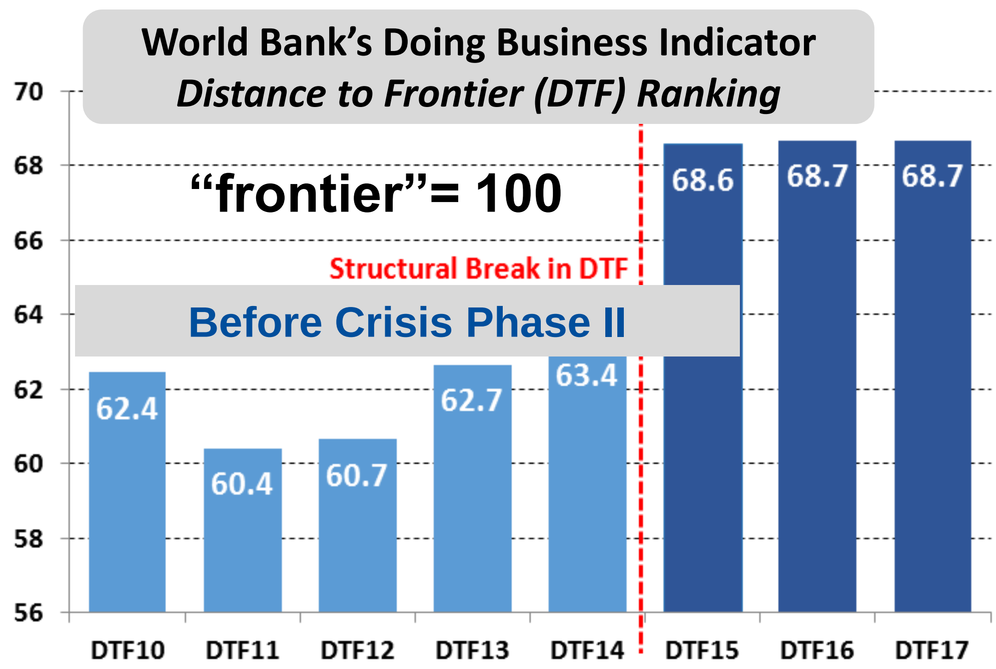

- <u>**Enormous fiscal consolidation**</u> **since 2009,**
  - **When Gen. government expenses were €128.4bn and General Government revenues €92.4 bn.**
  - **In the original budget of 2015, the corresponding expenses and revenues were both projected at ≈€80bn.**
- **Primary balance currently expected at 0.50%, 1.75%, 3.5% of GDP for 2016, 2017, 2018 and above 3.0% of GDP for a number of years afterwards.**

# 1. Partial correction in competitiveness & current account

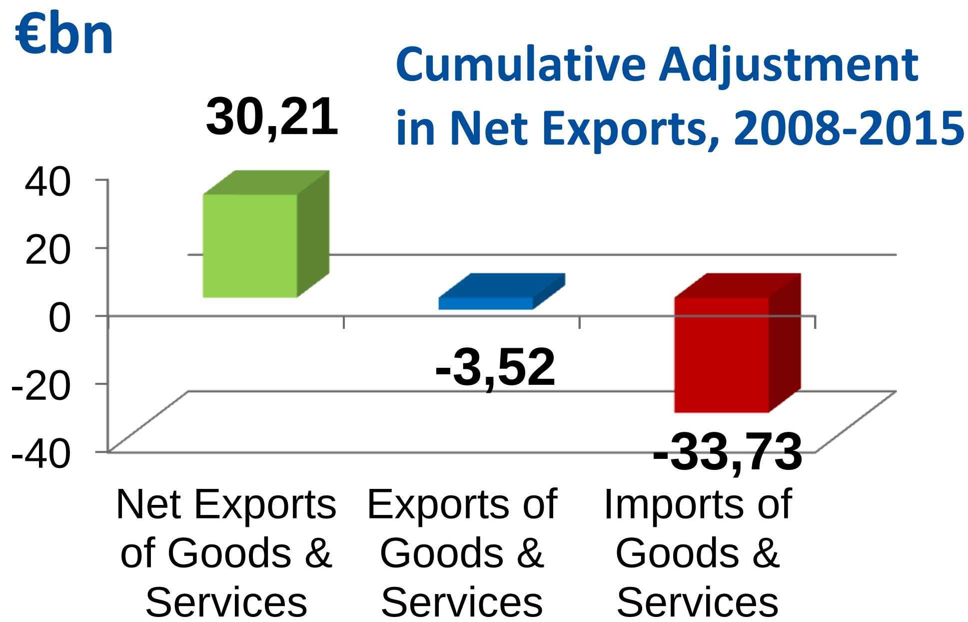
## ❑ Current Account Improvement due to lower imports, not higher exports




*Euro Area 72.5 (DTF10) & 75.6 (DTF16)*

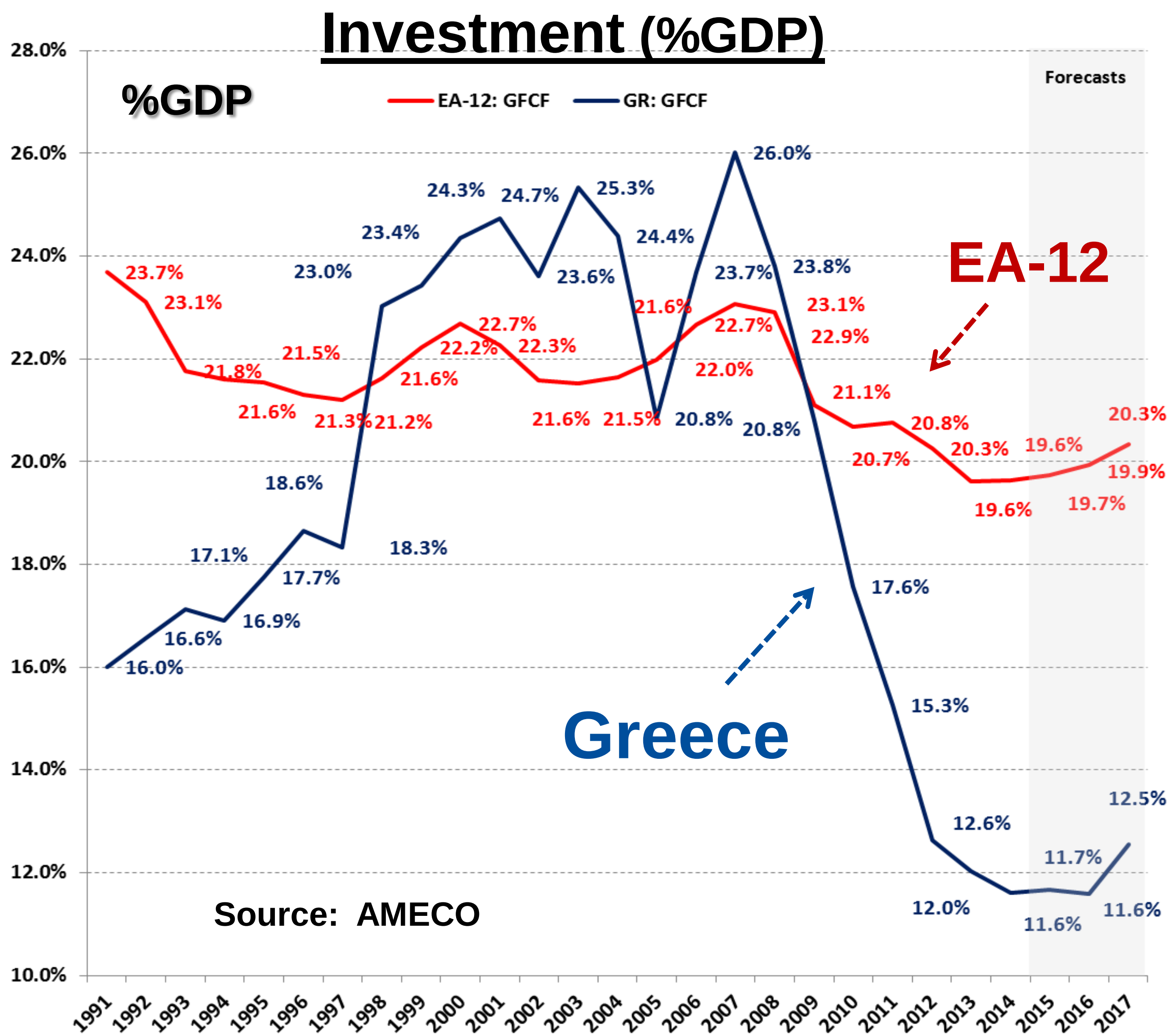



Source: IMF, AMECO

Source: ECB, WB

# 1. Future growth to be based on Exports & Investment

- Future growth model must be based on exports & investment with consumption increasing at a lower rate than real GDP
- Yet so far exports have not picked up & investment is problematic
- Since 2010, full fiscal & partial competitiveness correction
- Yet, these corrections were demand driven
- We need a supply-side recovery, with a substantial rise in machinery & equipment investment



# 1. State of Play at end-2014

- Imbalances were almost cured (fiscal, competitiveness)
- Many reforms in the public sector, tax administration, product markets, labor markets, pension system, etc. placed Greece as #1 in OECD's reform indicator for three consecutive years
- The banking system had passed the October 2014 European-wide AQR and stress tests without needing additional capital, partly due to DTC and an earlier capital increase in 2014Q1
- Privatizations began taking off, large private firms were able to issue debt in the international market, even the Government was able to issue bonds twice in the capital markets
- Economic growth resumed (+0.7% in 2014), with sentiment rising, investment turning positive and unemployment declining. 2015 growth was expected 2.9%. The submitted 2015 budget was balanced.
- Greece was ready to leave the lenders' bailout PROGRAM, like Ireland and Portugal had done before. Government had secured a credit line from the Europeans (ECCL) with €11bn HFSF unused funds. €13bn IMF money was going to be added to that.
- Debt was on a sustainable path, plus further debt relief measures were already under discussion according to the November 2012 agreement.
- Yet, last Review of 2nd Adjustment Program did not conclude due to IMF 's effort to hold all cash disbursements for after the expected upcoming elections

## GREEK CRISIS PHASE II: 2.

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## 2. The present: Why Phase II of the crisis?

- A disastrous confrontation with the lenders in early 2015
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### 3. The future: Will growth come back and how?

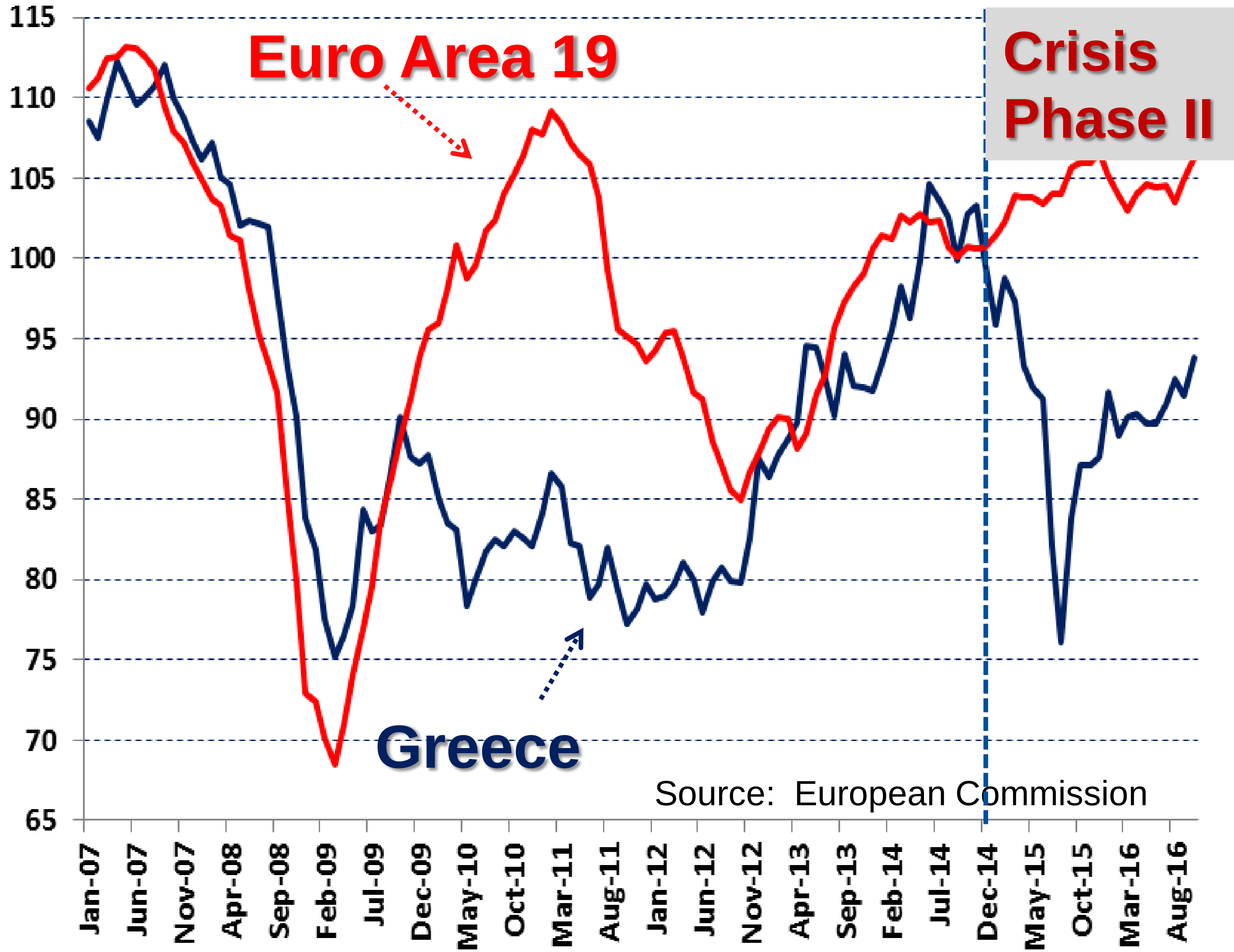
- The short-term
- The long-term: Three scenarios

# 2. What went wrong in 2015 H1?

- A new coalition government took over in January 2015, which ignored the supply side of the economy, and instead made nominal debt haircut central issue, attempting to bring back the clock to 2010
- Misjudged its abilities and leverage, as well as the European side's maximization problem
- Did not attempt to close the Review, hence was deprived of cash → arrears went up to €9bn, drying up the liquidity of the private sector, plus €7.6bn were squeezed out of the state entities' cash buffers
- Created anxiety among the population, who gradually pulled €45bn from the banks or 25% of their deposits.
- By June, PM was about to close a deal with €9bn worth of measures he had proposed But he had an internal problem within SYRIZA. Not only would he fail to deliver on his pre-election promises of €10bn more in expenditure, but he was about to sign a much worse deal than the previous government (20 times the measures), raising taxes and cutting wages and pensions. So he called a referendum. The referendum had a very ambiguous question.
- The announcement of the referendum created a bank panic, which immediately led to a bank holiday and capital controls
- July 5$^{th}$ referendum delivered a decisive NO to austerity, yet subsequently the PM, within a few days, did the opposite of the referendum result. This way he avoided the sure Grexit, as the country was desperate for cash.
- Leftist opposition of SYRIZA split off and formed a separate political party.
- SYRIZA did not want to govern as a minority government. Elections were thus called for September 20th. SYRIZA won again with 35.5% of the vote. A new SYRIZA –ANEL coalition runs the country.

# 2. Crisis Phase II shows up in Economic Sentiment

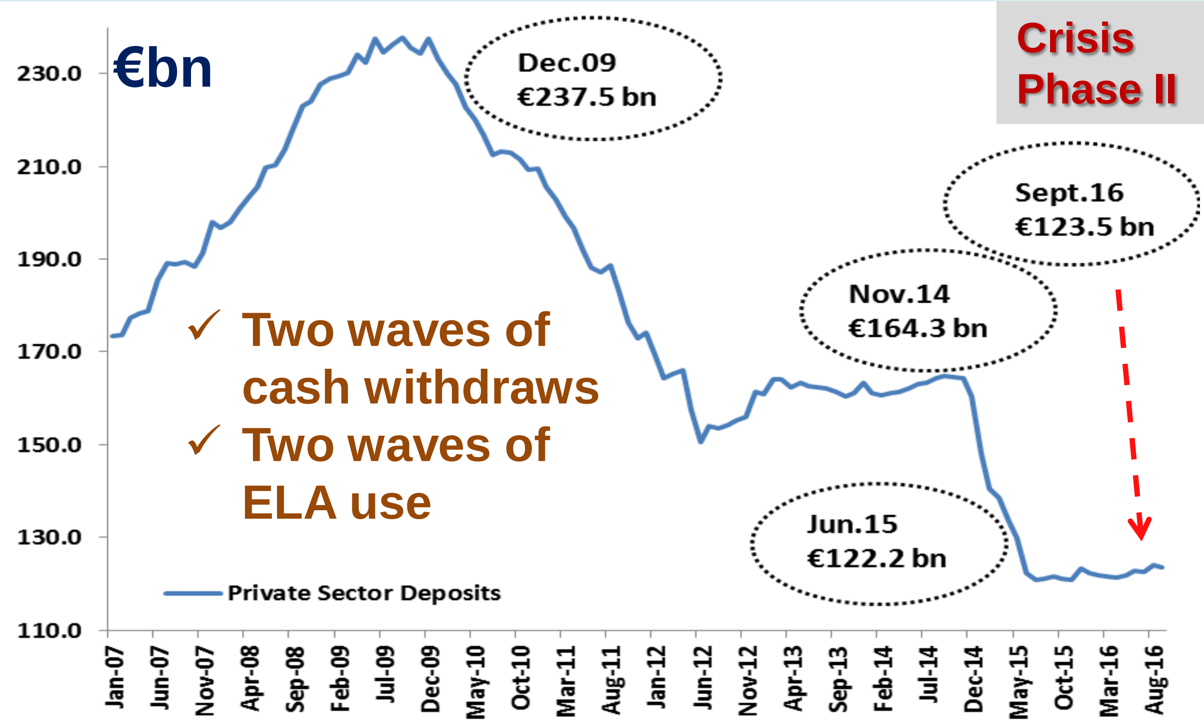
- The sentiment index in Greece moved together with sentiment in EA until late 2009, both declining
- **Decoupling during the Greek crisis until October 2012**
- From late 2012 on, **re-coupling**: Greek sentiment moves upward and again in line with EA sentiment

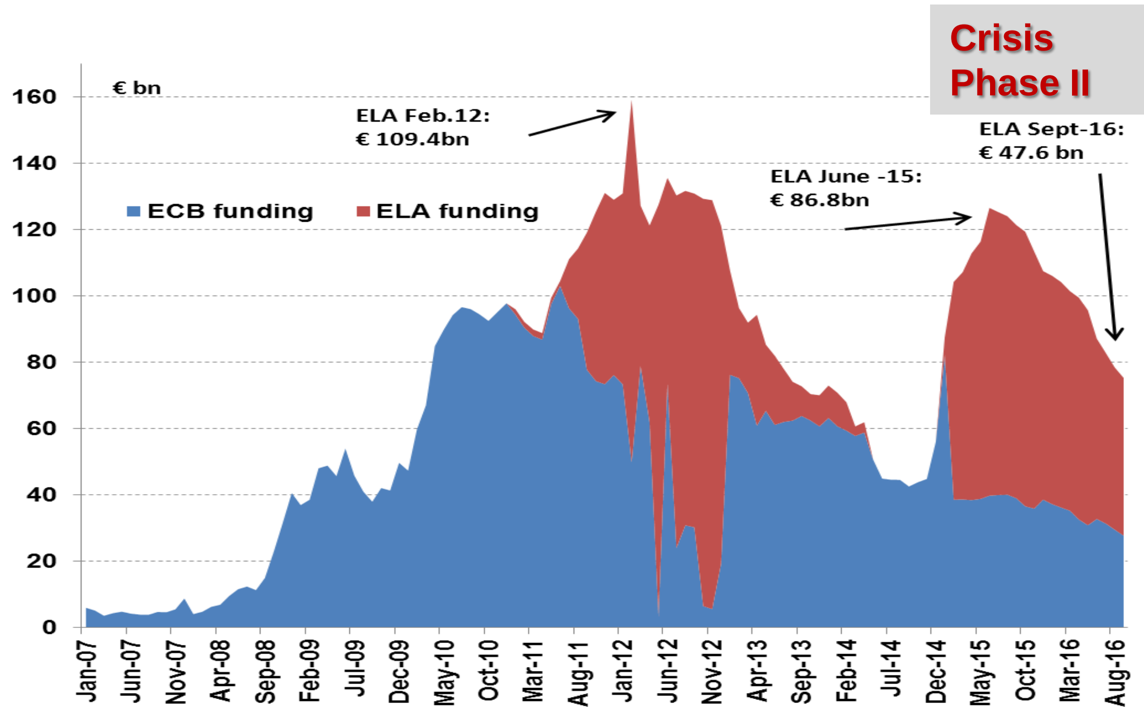



- Greek sentiment peaked in the period June 2014 - November 2014, but subsequently began a fast downward slide as the political landscape deteriorated and generated new uncertainty, thus <u>decoupling a second time</u> from the rest of EA. **Phase II of the crisis was creating anxiety in sentiment.**

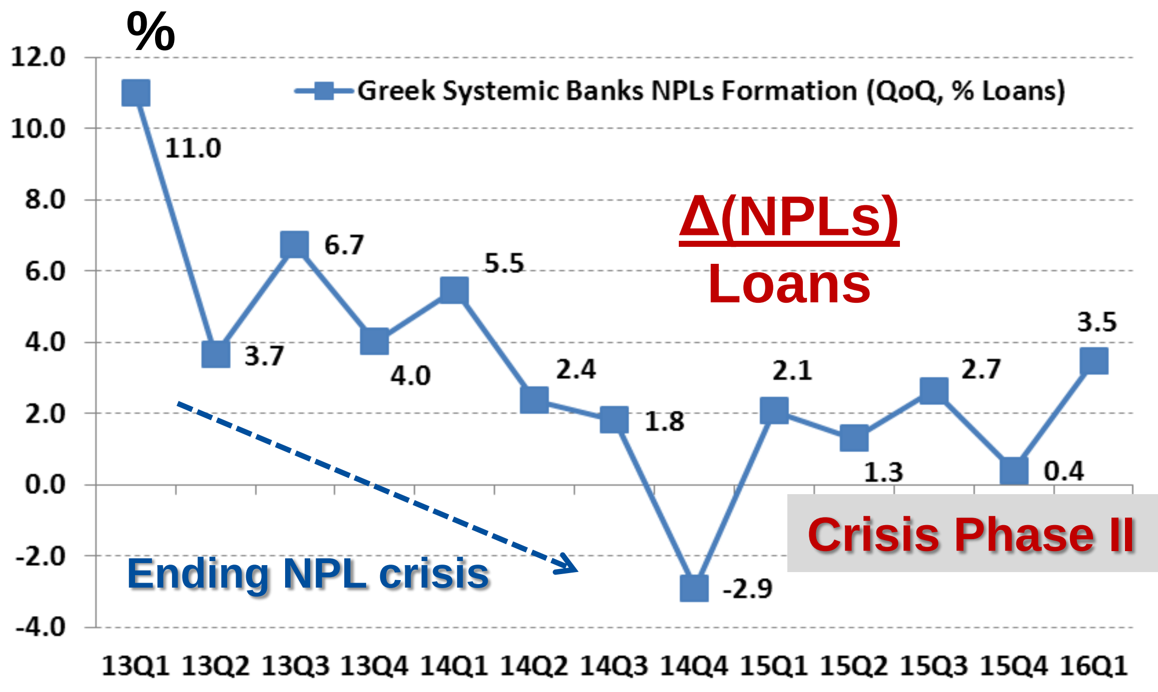
# 2. Crisis-Phase II shows up in the Financial sector

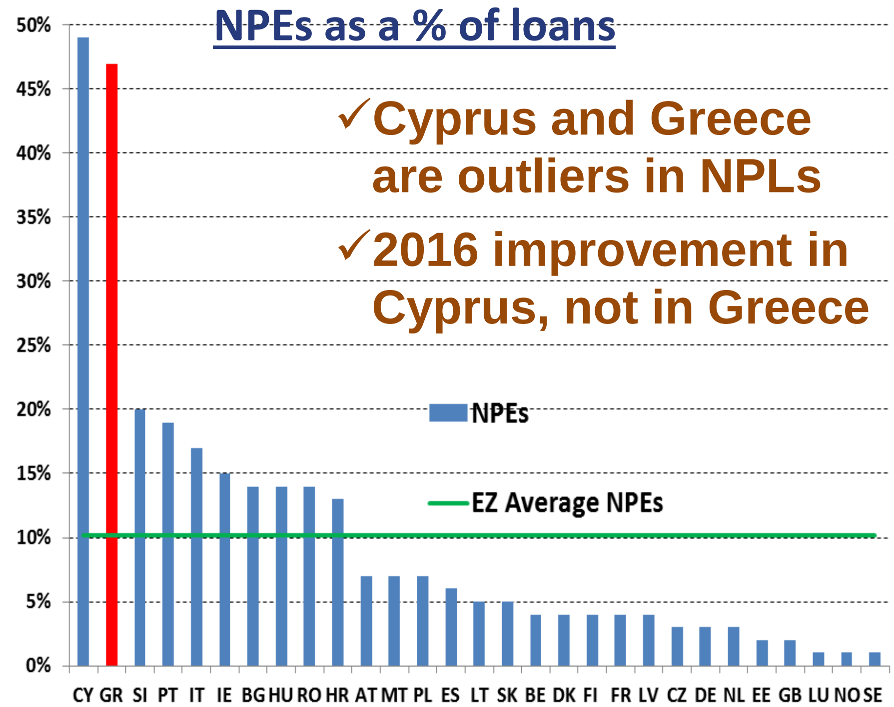
- A second wave of cash withdrawals in 2015 plus a disappearing inter-bank market leads banks to ELA:
  - ELA was zero at the end of 2014, yet it peaked again in 2015
  - After re-introduction of ECB waiver in July 2015, gradual improvement in ELA dependence
  - Yet it remains at €48bn today
  - Capital controls imposed
  - Unless credibility returns, cash will stay outside the banks
- Bank stock prices collapsed in 2015H1, State lost over €20bn in value, and a necessary 3rd recapitalization in Nov 2015
- State owner-ship of systemic banks shrank: NBG (40.4%), Piraeus (26.4%), Alpha (11.0%), Eurobank (2.4%)
- Capital strong, depending on DTA



# 2. Banks remain vulnerable on both sides of their balance sheet




- ❑ A second major problem is NPLs, which keep rising. Target reduction of 40% until 2019
- ❑ The NPL improvement of late 2014 stopped, due to Phase-II of the crisis
- ❑ Today, unless the economy picks up and the NPL problem is gradually resolved, banks
  - Would stay zombies, unable to provide new credit to healthy companies
  - May need additional capital infusion, with no foreigners willing to come in this time
- ❑ Since January 2016 the bearish world market has taken a toll on Greek bank stocks, which are down 50-55% relative to the recent recapitalization of November 2015.

# GREEK CRISIS PHASE II: 3.

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3. **The future: Will growth come back and how?**
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# 3. The short-term: Consensus forecasts for 2016-17

| Source: ELSTAT, EC, Focus Economics | 2015, €bn (nominal) | 2015 Real YoY% | 2016 Real YoY% | 2017 Real YoY% |
|---|---|---|---|---|
| GDP | 176.0 | -0.2 | -0.6 | 1.1 |
| Private Consumption | 123.8 | 0.3 | -1.1 | 0.3 |
| Government Consumption | 35.2 | 0 | -0.5 | -0.1 |
| Gross Fix. Capital Formation | 20.5 | 0.7 | 0.2 | 2.8 |
| Exports | 53.0 | -3.8 | -3.4 | 5.1 |
| Imports | 53.3 | -6.9 | -1.9 | 3.4 |
| HICP (yoy%) | | -0.6 | 0.1 | 1.6 |
| Unemployment Rate (%) | | 25.0 | 24.1 | 23.5 |
| Priv. Sector Deposits (yoy%) | | -23.0 | 6.3 | 7.5 |
| Private Sector Credit (yoy%) | | -3.6 | -1.0 | 2.7 |

- If the forecasts of the domestic Greek banks are excluded, the consensus GDP growth for 2017 made by private sector participants falls below 1%
- Official growth forecasts for 2017 are more optimistic, at 2.7% but assume:
  - Political ownership of the reform agenda implementation
  - Program on track, substantial debt relief and QE participation

# 3. Short-term dominated by 3RD MoU

- A package of over €86 bn, €31.7 disbursed already & €19.6 unused from bank recap
- Implementation Period: 2015-2018,Conditionality will be updated on a quarterly basis
- About **241 actions**, with **110 front-loaded** until January 2016 according to original plan

## I. *Restoring fiscal sustainability*:

- More gradual fiscal path due to objective weakness: Primary surplus balance targets of -¼, 0.5, 1¾, and 3.5 % of GDP in 2015, 2016, 2017 and 2018 and beyond, respectively
- Tax policy reforms (Income tax revamp, eliminate exemptions, VAT, tax on farmers), minimize Arrears, central procurement, more savings from Pension expenses, reinstate reforms in Health Care, Roll-out GMI

## II. *Safeguarding financial stability*:

- Recapitalization of banks before the end of 2015, tackle strategic defaulters, sell NPLs, new governance structure of HFSF & banks

## III. *Growth, competitiveness and investment*:

- Reforms in labor markets & product markets (including energy) via business environment and competition policies
- Ambitious privatization Programme

## IV. *A modern State and public administration*

- Efficiency of judicial system, (Code of Civil Procedure, fight fraud & corruption)
- Institutional & operational independence of key institutions such as Revenue Administration & ELSTAT
- Pension reforms to remove exemptions, end early retirement
- Fiscally-neutral Wage Grid, Better recruitment process for Managers
- Rationalization of SOEs

# 3. The long-term: Three scenarios

## i. Super-Growth, i.e., growth ~ 3%,

- Carries low probability. Not just a function of completion of 2nd Review.
- Requires a) ownership of reforms and vigilance on implementing them, b) policy credibility and consistency, c) reversal of current tax policies, d) FDI, e) quick resolution of NPLs, f) possible attention to sectoral comparative advantages, …..
- For 2017-18 cyclical recovery, requirements: a) Program on track, b) QE participation so that yields decline, c) Debt sustainability in 2017 and later access to markets

## ii. Stagnation, i.e. growth ~ (0% - 1%)

- Carries high probability. The dominant scenario is a muddle-through one, it assumes continuation of the status quo

## iii. Further Deterioration, growth ~ -3% for a while and GREXIT

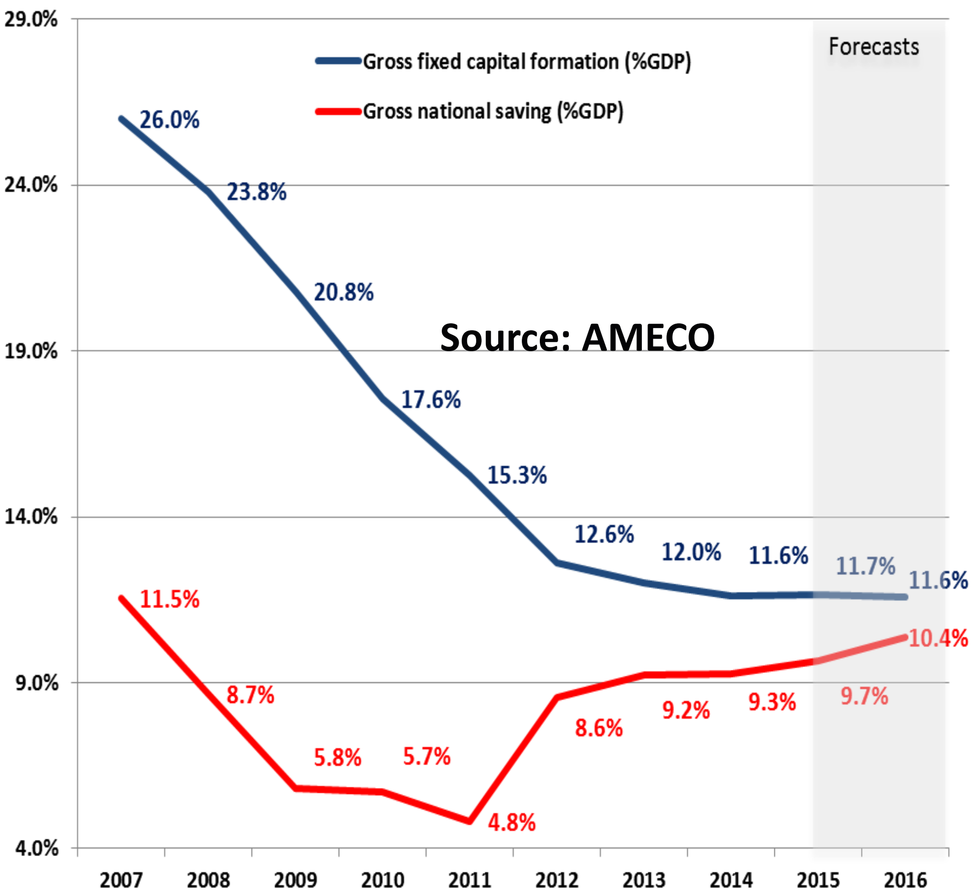
- Carries very low probability ~ 10%, European politics is against it
- Bond yield spreads remain high as markets have not extinguished the probability of GREXIT from their perceptions
- No external force exists to counteract a potential downward economic slide: Europeans have stopped paying attention to Greek growth prospects as contagion risk has diminished, hence their pressure for reforms in Greece has subsided (*example: They have allowed a fiscal consolidation based on taxation alone*)

# 3. The long-term: Can growth come back beyond simply a cyclical recovery?

- Has Phase II of the Greek Crisis caused a permanent damage or it simply represents a 2-year delay to an inevitable growth take-off which began in 2014?
- **Can the country push exports and investment on its own?**
- **NEGATIVES:**
  1. Economic policy remains unfocused: There is no clear growth strategy, no commitment for reforms and credibility is still wanted → **dismal Long-run prospects**
  2. Fiscal mix provides wrong incentive for growth, as Greeks are overtaxed → **dismal Long-run prospects**. Also, fiscal multiplier implies a drop of GDP by 3%
  3. The youth is immigrating and companies are registering abroad → **dismal Long-run prospects**
  4. **Financial sector cannot help**, this time the economy ought to improve on its own
  5. Debt relief is postponed for 2018, after German elections, yet recent noise by the government on the issue with many delays, as the first Review delayed by one year!
  6. Risk of further automatic restrictive fiscal measures in 2017 if targets not met
- **POSITIVES are of cyclical nature only**
  1. Arrears are now lower, at €6.9bn in July, and are gradually being paid back
  2. ECB reestablished the waiver on Greek banks, plus (long shot) it may include Greek bonds in its QE program, which would drastically reduce bond yields

# 3. Foreign Direct Investment needed

**Total Investment vs.**
**Gross National Savings**
**(% GDP)**




- Investment spending (% GDP) lowest since 1960
- Investment Ratio needs to converge to EA average and remain there for a number of years so as to lead to a sustainable recovery.
- Domestic savings inadequate to finance a sustainable future expansion, FDI urgently needed.
- Stock of FDI: €18.6bn in 2015 from €35.8bn in 2007
- Major source for the attraction of FDIs in the medium term is the implementation of the privatization agenda
- Creation of a new privatization fund with a longer maturity passed into Law (1st review)
- Progress on various projects (Regional airports, Hellinikon, Port of Piraeus, etc.)
- Another source is EU funds *available* for Greece (from Structural Cohesion funds, ca. €4bn for 2007-2013 & €20bnfor 2014-2020, ca. €15bn from Agricultural Funds)

- **Low domestic savings is the flip side of high domestic consumption. Growth requires the share of savings to rise and consumption to decline**

# 3. Are there sectors with promise?

- Greece does have comparative advantages
  - Many sectors show promise
  - Its labor force continues to be well educated and works hard (OECD comparisons)
- But policy ought to focus on the supply side, something completely off the antennas of the administration today
  - In areas not touched by the Troika, reforms are even being reversed and criticism is suppressed, e.g., in education, in independent agencies, in justice

**Tourism**
(focus on promising sub-sectors: home-porting for cruises, health tourism, etc.)

**Transportation & Logistics**
(positive externalities to other important sectors)

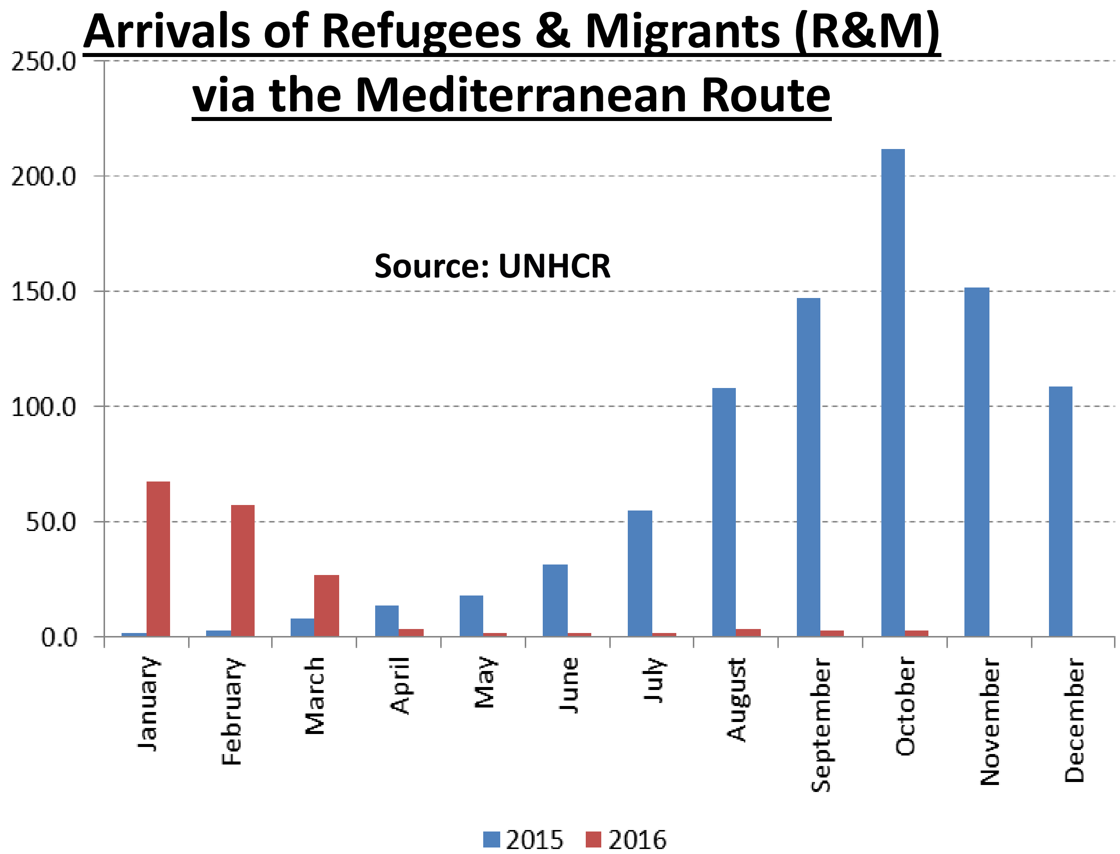
**Agriculture**
(branded products)

**Energy**
(renewables)

**Public Infrastructure**
(positive externalities to other sectors)

**Shipping**
(development of long-delayed shipping-services hub)

# 3. Geopolitical risks: Refugee crisis



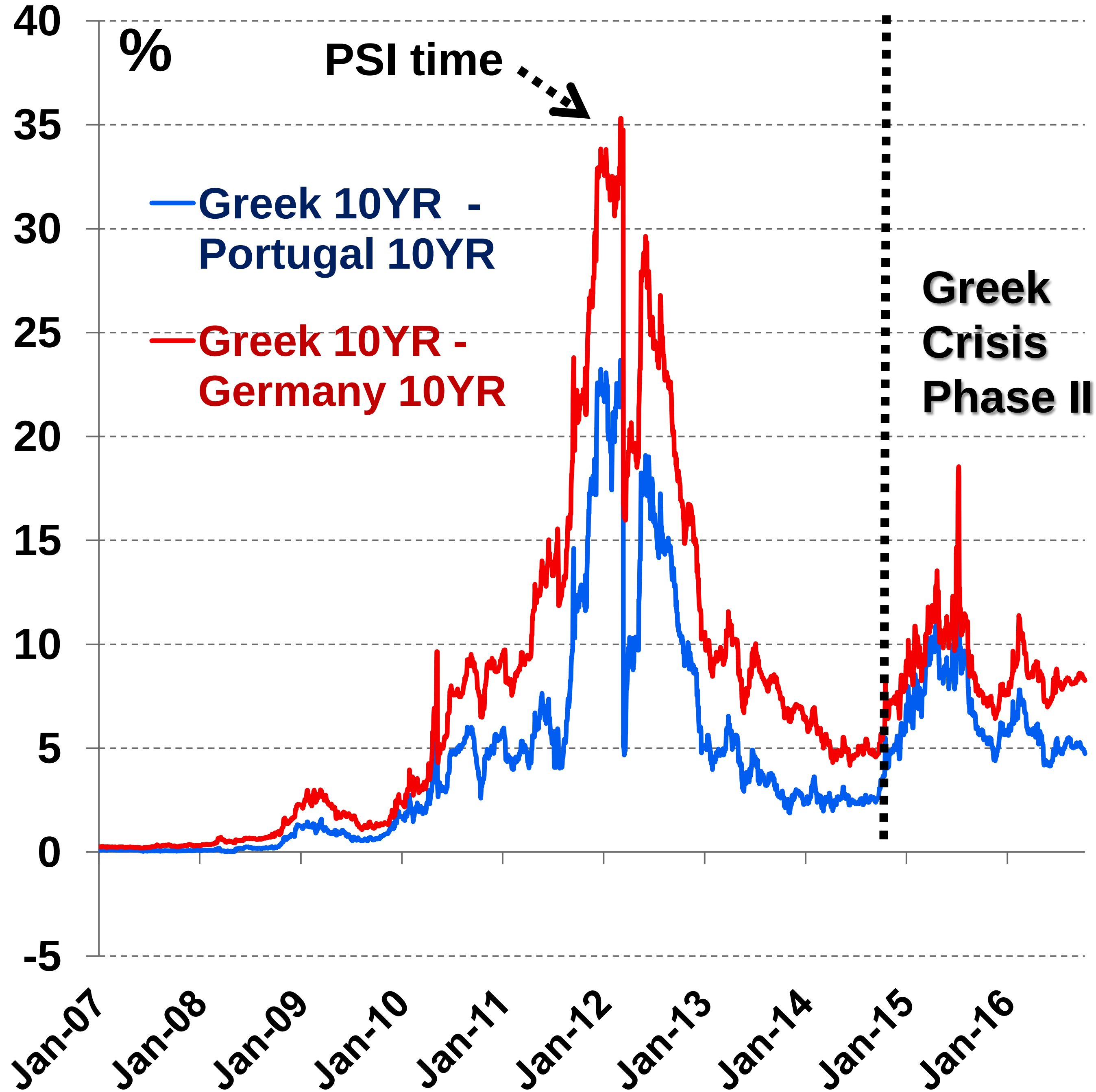

- ❑ R&M stranded within the Greek border reach ca 61.383 in early November 2016
- ❑ Current situation constitutes a significant risk for:
  - The Greek tourism sector.
  - The Greek exports / logistics sector since all the major export ways (railways) pass via the now closed north borders of the country.
  - The Schengen Treaty membership of the country.

- ❑ EU-TR agreement finally stricken in late March 2016 but can easily fall apart, carrying significant risks to Greece
- ❑ Out of a total of 164.7 thousands of R&M arrivals from the Mediterranean Route in the first 3-months of 2016:
  - 90.8% arrived via GR, 8.8% via IT, 0.4% via ES
- ❑ BoG estimated *immediate* fiscal cost at €600bn; EU resources of €470mn but bureaucratic difficulties

# 3. Markets do worry about GREXIT

**Which conditions en-acted together, could lead to GREXIT?**

1. Economic stagnation continues for a long time or even a new drastic recession takes hold as automatic fiscal cuts are enacted
2. No QE for Greece in 2017 perhaps due to a negative IMF DSA
3. Parliament dissolves and new more extreme political parties come to power which call for GREXIT



# 3. Concluding remarks

- Europe faces major challenges that go beyond BREXIT
- Greece faces even bigger ones
  - Greeks may have reached their limit in absorbing tax increases → Immigration of people and companies
  - As the IMF insists, the country needs fiscal breathing space – a reduction in taxation - with a simultaneous willingness to reform (program ownership)
  - Three scenarios of the future, with stagnation being the dominant one. Why? Because not only short-run problems but <u>no focus on long-term growth policy either</u>, with the European lenders staying indifferent on the sidelines. This has not escaped the attention of markets, which continue to incorporate a GREXIT premium in Greek bond yields
- The new growth model requires more domestic savings and less domestic consumption in order to finance investment, i.e. emphasis on production and the supply side with aggregate demand originating from abroad via exports

# Greek Crisis Phase II

## The Way Forward

# Thank you
# for your attention!

Gikas A. Hardouvelis