GREECE'S ECONOMIC COMMENCEMENT

I. MARKETS DISCOUNT A HIGH PROBABILITY OF FAILURE

II. YET, EU/IMF STABILIZATION PLAN HAS HIGH CHANCES TO SUCCEED

III. SUMMARY

Gikas A. Hardouvelis *

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* *Professor, Department of Banking and Financial Management, Un. of Piraeus*
Chief Economist, Eurobank EFG Group, www.hardouvelis.gr

Eurobank EFG

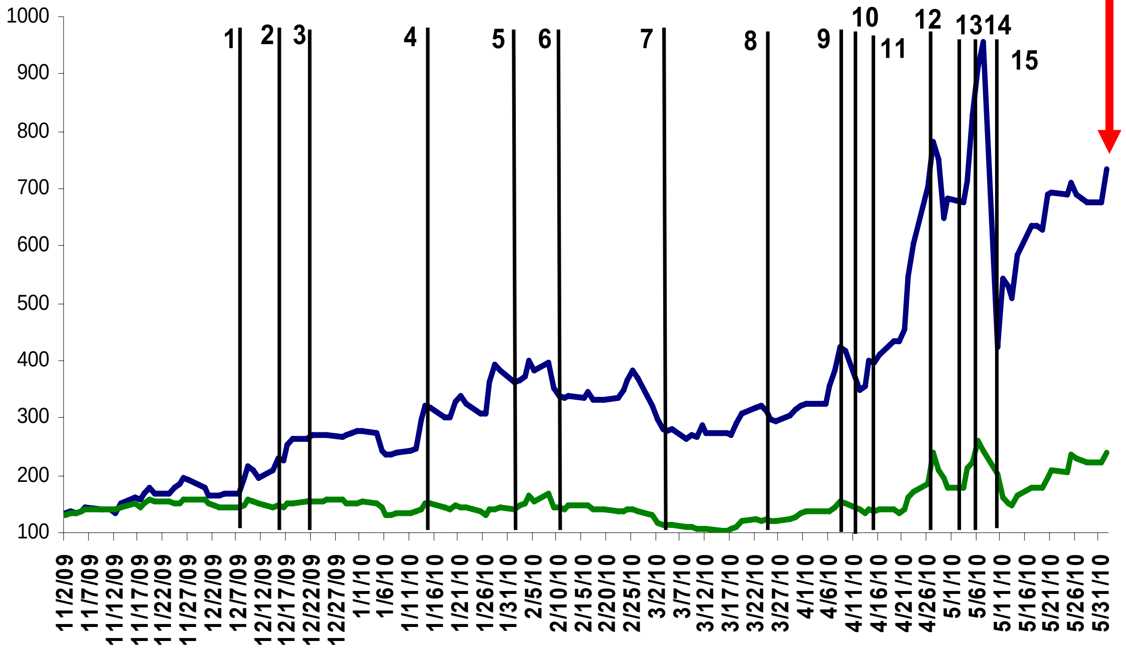
I. Two major imbalances led to the crisis

1) **Greece faces two major idiosyncratic risks**
   i. **Lack of Competitiveness**
   ii. **Fiscal laxity**
2) **The rating agencies alter their view on Greek debt sustainability in December 2009 and unnerve markets**

I. Credit Default Swap spreads widened since December 2009

7.35%

bp. **5-yr CDS – Greece vs. Ireland**



Source: Bloomberg — Greece — Ireland

1.	8/12/09	FITCH downgrading (A- to BBB+)
2.	16/12/09	S&P downgrading (A- to BBB+)
3.	22/12/09	Moody's downgrading (A1 to A2)
4.	15/1/10	SGP announcement
5.	2/2/10	PM announces first package of measures
6.	11/2/10	Eurogroup leaders approve SGP
7.	3/3/10	Second package of measures
8.	25/3/10	EU decides on fiscal aid plan for Greece
9.	8/4/10	ECB announcement on accepted collateral after 1/1/11
10.	12/4/10	Details of EU/IMF fiscal aid plan
11.	15/4/10	Finance Minister's letter to EU, IMF, ECB
12.	27/4/10	S&P downgrading (BBB- to BB+)
13.	3/5/10	Eurozone approves € 110 bn for GR, ECB suspends GR minimum credit rating
14.	6/5/10	Parliament approves IMF deal
15.	10/5/10	€750 bn to save the euro

- ✓ On June, 1st 2010 the required premium against a partial default by the Greek State was **$735,515** annually for 5 years (based on 5-yr GGB with face value **€ 10 ml.**)

II. Market pricing incorporates the possibility of a significant haircut in Greek debt obligations

A haircut is the % loss of the promised total payment by the government

5 yr CDS premium (June 1st, 2010)	735.52	
Haircut	**Marginal 1-yr Risk-neutral Probability**	**Cumulative 5-yr Risk-Neutral Probability**
100%	7.1%	30.6%
90%	7.8%	33.4%
80%	8.8%	36.7%
70%	10.1%	40.8%
60%	11.8%	45.9%
50%	14.1%	52.3%
40%	17.6%	60.6%
30%	23.5%	71.6%
20%	35.3%	86.0%
10%	70.5%	99.5%

II. EU/IMF/ECB adjustment program: Key characteristics

- ✓ A well-balanced program, which draws on IMF's experience
- ✓ Key characteristics:
  - ❖ Real growth resuming in 2012 but staying well below the 1996-2007 historical norm
  - ❖ Inflation subdued, even turning negative in 2011
  - ❖ Front-loaded reforms and drastic first-year fiscal tightening with a large subsequent fiscal cushion, with only €1 bn revenues from privatizations and with no zeal to ever zero the deficit
  - ❖ EU/IMF/ECB detailed conditionalities with quarterly targets as a strong disciplinary device
  - ❖ Effort to minimize the burden on the poor
  - ❖ Real pension solution sought which controls hidden future liabilities
  - ❖ Benign future interest rate environment, with Greek spreads over 10-yr Bunds eventually declining to 100 basis points in 2013
- ✓ Debt-to-GDP ratio declines to **119% by year 2020** in the baseline scenario
- ✓ Yet, assuming real growth of 1% higher/year, which is closer to historical norm, EU/IMF shows that it would lead to a **Debt-to-GDP** ratio in 2020 of **80%**

II. An EU/IMF/ECB adjustment program: Assumptions

	2009	2010	2011	2012	2013	2014	2015	2020
GDP deflator (%)	0.7	1.2	-0.5	1.0	0.7	1.0	1.1	1.5
GDP Growth (%)	-2.0	-4.0	-2.6	1.1	2.1	2.1	2.7	2.7
Nom. GDP (€ bn)	237	231	224	228	235	242	251	308
Int. Rate (%)	5.0	4.8	4.8	5.3	5.6	5.8	5.8	5.9
Interest Rate on new debt		5.0	5.3	5.3	5.4	5.5	5.6	5.8
Spreads over Bund		250	200	150	100	100	100	100
Bund rate		175	275	350	350	350	350	350

II. The EU/IMF/ECB program forecasts

	2009	2010	2011	2012	2013	2014	2015	2020
Current Account (%GDP)	-11.2	-8.4	-7.1	-5.6	-4.0	-2.8	-1.9	---
Gen Gov Deficit (%GDP)	-13.6	-8.1	-7.6	-6.5	-4.8	-2.6	-2.0	-1.0
(€ bn)	-32.3	-18.6	-17.0	-14.7	-11.5	-6.2	-5.0	-3.1
Gen Gov Debt (%GDP)	115.1	133.3	145.1	148.6	149.1	144.3	138.8	119.2
(€ bn)	273.4	307.5	324.7	339.7	350.4	353.8	348.4	367.5
Interest Payment (%GDP)	5.1	5.6	6.5	7.5	8.1	8.4	8.1	7.0
(€ bn)	11.9	13.0	14.9	17.1	18.9	20.4	20.3	21.5
Primary Surplus (%GDP)	-8.6	-2.4	-0.9	1.0	3.1	5.9	6.0	6.0
(€ bn)	-20.4	-5.5	-2.0	2.3	7.3	14.3	15.1	18.5

❖ Debt numbers do not include €26 bn or 11% of GDP of government guarantees, but neither do they include the reducing effect of privatizations

II. Risks

a) **High market interest rates** may persist, especially if rest of Europe screws up and continues being the center of market attention, which could prohibit Greece from tapping the bond market in a year or so

b) **Implementation risks** originating from possible lack of political will in individual ministries (e.g. attempts to fake reforms) – and/or from a lack of expertise or incentives in the public bureaucracy to support the reforms

c) **High unemployment may cause a civilian backlash in a year or so,** especially if government does not deliver the promised reforms on time, leading to a vicious cycle of mistrust, incriminations, lack of appetitive for zeroing the deficit on an going basis, even lower growth, a further explosion in debt-to-GDP

d) Apparent **delays and/or budget overruns** in some ministries already raise concerns

e) As European belt-tightening is currently taking place, a **low European economic growth** may cause Greek growth to stall for longer than the Program anticipates

II. Big pluses exist

1) EU/IMF/ECB conditionalities are a strong disciplinary device
2) Fresh popular vote, strong parliamentary majority, government commitment so far, public support so far
3) An equitable distribution of burdens is likely to occur
4) Real pension solution in sight
5) Front-loaded Program with a significant fiscal cushion
6) Debt-to GDP ratio may not explode to 150% of GDP, as EU/IMF predicts, due to stronger growth, higher inflation, an upward revision in GDP, significant privatizations and, gradually, a stronger commitment to minimize deficits
7) Economic growth may surprise on the upside as productivity is historically high, capital utilization is low, lots of mature projects exist to activate, available EU funds, real wage decline, consecutive structural reforms that may raise potential output and bring a new export-driven growth model
8) Government is poor but citizens are rich: Lots of wealthy people look for investment opportunities, assuming the government switches taxation gears in 2-3 years' time
9) Private leverage is small compared to EU South
10) Unlike in the rest of Western Europe, a well capitalized, prudent & extrovert Greek banking sector

II. So .... is a haircut probable?

1) Euro Area intact, <u>Program succeeds</u>, then Greece has a choice to voluntarily take or not take a haircut

   i. Greece <u>would choose not take a haircut</u> since a cost-benefit analysis would show that the cost – especially the political one - is way too high. Also, success implies conformity with the established EU rules.

   ii. A rescheduling of the EU/IMF €110 bn loan is possible

2) Euro Area intact, <u>Program fails</u> as Greeks prove incapable of handling belt-tightening ⇨ severe repercussions:

   i. <u>Either</u> a new austerity program with stricter conditionalities ⇨ a worse recession and significant lowering of living standards but <u>no haircut or a small one</u>

   ii. <u>Or</u> a forced exit from EU ⇨ all hell breaks loose ⇨ no reversal in sight, with additional loss of political power in Europe, <u>default</u>

3) Euro Area collapses ⇨ turmoil in Greece and a severe lowering of living standards ⇨ <u>default</u> is likely as foreigners own most of the debt ⇨ vicious cycle of banking collapse and societal upheaval ⇨ but a reversal of fortunes in sight as every other EMU country suffers as well. This is the Argentinean case.

✓ **Current credit default swap rates over-penalize lenders to the Greek government. I do not think a haircut is probable because case #1 would prevail**

III. Summary

- ✓ The international crisis uncovered the **two major imbalances** of the Greek economy: the lack of competitiveness and the lack of fiscal discipline – two related problems
- ✓ Since December 2009, increased **market pressure** eventually led to a bailout by the EU/IMF/ECB: € 110 bn with quarterly conditionalities
- ✓ **Markets presently discount a significant haircut** in Greek government bonds, which is an overreaction
- ✓ The **EU/ECB/IMF Program has a high chance to succeed** as **Pros** outweigh the **Cons** by a significant margin
- ✓ There will be no haircut in Greek government debt obligations
- ✓ This is **commencement time** for the Greek economy, Greek society and the spoiled generation of baby boomers, who learned they have rights but no obligations towards the state
- ✓ Yet, a new beginning can be built on consensus and the mature recognition that we, Greeks – ourselves alone and nobody else – are responsible for bringing the country to a near-bankruptcy state