Greece
Facing an Uncertain Future

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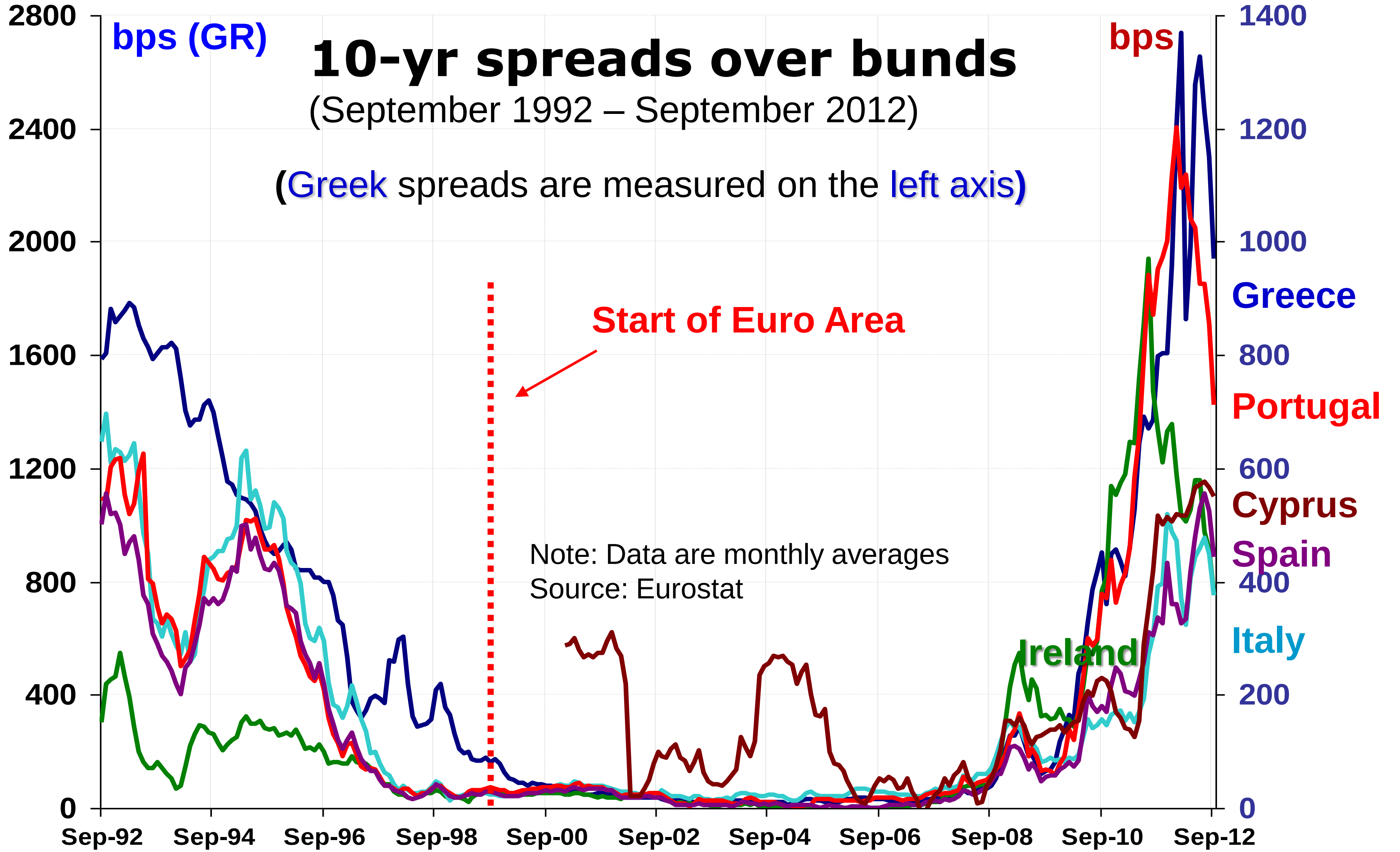
CREDIT RISK MANAGEMENT FOR BANKING AND BUSINESS: FINDING LIQUIDITY
ATHENAEUM INTERCONTINENTALHOTEL, ATHENS, GREECE

MARKET VIEW OF THE CRISIS:
BACK TO THE FUTURE BUT DRESSED UP IN EXIT RISK



Greek spreads on the left axis, twice as large

THE UNHOLY TRINITY: THREE INTERELATED LEGS OF THE EMU CRISIS

Sovereign Debt Crisis

Austerity measures due to sovereign stress weaken economies

Weak growth makes certain indebted sovereigns insolvent

Real Economy Imbalanced & under Stress

Too many bank failures bankrupt sovereigns as they try to support banks

Sovereign defaults bankrupt banks with sizable sovereign debt holdings

Weak banks will slow growth through reduced lending

Weak economy & falling asset prices damage banks' balance sheets

Banking Crisis

- Crisis is deeper as EMU never adjusted endogenously to an Optimum Currency Area, as it was hoped back in 1999

Source: BPEA (2012)

POLICIES FOR THE SUSTAIBABILITY OF EMU

EMU leaders seem to follow rather than lead markets. Yet, for EMU to survive it cannot stay still. It needs bold policies that turn EMU closer to an Optimum Currency Area, implying closer unification

i. **Proceed with banking union policies beyond a common regulatory framework to also a common resolution scheme with a fiscal backstop**

ii. **Proceed with deeper fiscal integration through Eurobonds in the form of e-bonds and blue-red bonds, through a common unemployment insurance framework, through an increase in the central EMU budget. Fiscal Compact is not enough.**

iii. **Establish policies that improve labor mobility across the Euro Area, e.g. common pension policies, common tax policies, etc.**

IN ADDITION,

i. **Follow expansionary fiscal policy in the EMU North (politically difficult) in order to generate demand in the South and resolve the imbalances within EMU**

ii. **Help heavily indebted countries in their debt sustainability efforts**

   a) **Allow crisis countries to enjoy positive inflation despite their internal devaluation, hence let ECB interpret price stability as a target inflation of larger than the current 2% , so that Northerners can have inflation > 2%**

   b) **Capitalize problematic banks directly from the ESM without raising national debts**

GREECE: TWO LEGS OF THE UNHOLY TRINITY ARE PARTICULARLY PROBLEMATIC

- ❖ Growth is the # 1 concern as recession deepens, the fiscal multiplier is bigger than forecasted in the MoUs, threatening the sustainability of debt
- ❖ Political risk is high as new measures are voted by a narrow margin of 153/300 on Nov 7, with no substantial debate, revealing an appalling lack of maturity in the Greek political system
- ❖ Forecasts of the 2013-2016 Fiscal Adjustment Program are based on a success scenario, yet danger of a major implosion is always present
- ❖ The third leg, the banking crisis, although serious, can be solved endogenously by an economic recovery

THE CHALLENGE TODAY: REBALANCE COMPOSITION OF GDP WITHOUT PROLONGING THE RECESSION

- Greek society over-consumes and under-produces, as evidenced by the large share of private consumption in output and the large gap between exports & imports
- The reduction in the share of consumption in output is necessary, yet it has to proceed smoothly to avoid an economic crash

(2011, % of total GDP)	Greece	EA-17
Private Consumption	74.6%	57.4%
Public Consumption	17.4%	21.6%
Private Investment	11.3%	17.1%
Public Investment	2.9%	1.7%
Exports	25.1%	44.0%
Imports	33.1%	42.6%
GDP (€ bn) - 2011	208.5	9420.6

- The investment share is dangerously small, around 14% of GDP from 25% a decade ago. In 2011, depreciation was larger than new investment, resulting in negative net investment and a destruction of capital stock
- Public investment declined instead of going up to counter the recession
- Exports ought to continue their rise but liquidity constraints bite

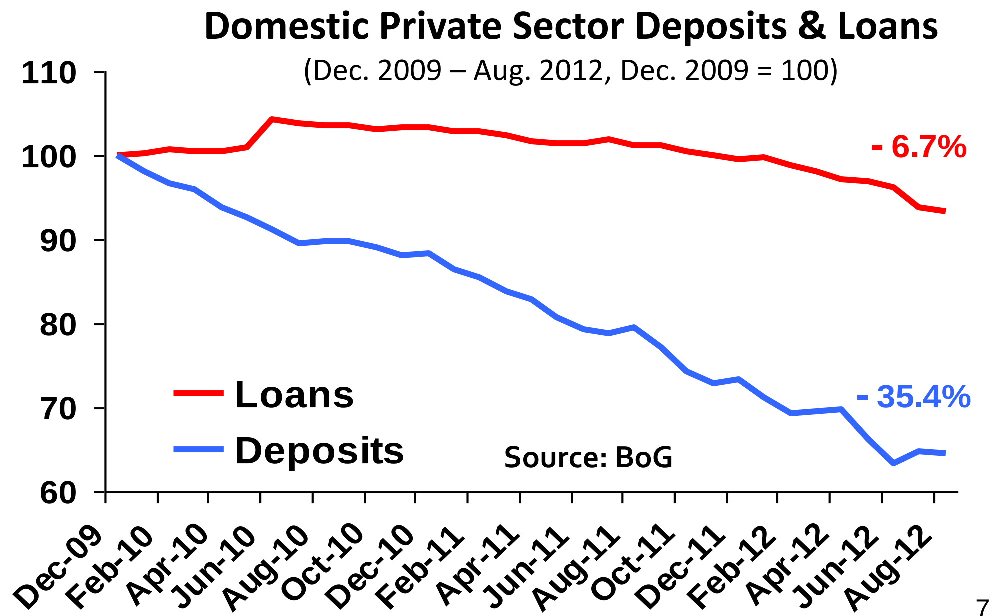
HUGE CRISIS
YET BANKS CONTINUE TO PROVIDE INTERMEDIATION

- Loans fell by <u>less</u> than deposits as banks continue to **restructure loans,** keeping low the NPL increase
- **Deposit withdrawal** stopped after June 2012 elections
- **Bank liquidity support from the State**

  around **€150bn**, mostly in the form of State guarantees (not a cost for the State Budget), utilized (along with other bank assets) for obtaining **ca €130bn** in Eurosystem liquidity (ECB & ELA facility), so as to cover
  - deposit withdrawals (> €80bn since 2009)
  - buy Greek government bonds & bills

Domestic Private Sector

(€ bn)	Loans	Deposits		Loans	Deposits
2007	215.1	197.9	Jan. 2012	248.7	169.0
2008	249.3	227.6	Feb. 2012	246.5	164.4
2009	249.3	237.5	Mar. 2012	244.7	165.4
2010	257.5	209.6	Apr. 2012	242.3	166.0
2011	248.1	174.2	May 2012	241.7	157.4
			Jun. 2012	239.8	150.6
			Jul. 2012	233.9	153.9
Source: BoG			Aug. 2012	232.6	153.4



EUROSYSTEM PROVIDES LIQUIDITY SUPPORT … BUT NOT A LENDER OF LAST RESORT

- ECB intervened to provide liquidity to the banking system, thus averted the typical ***Sudden Stop*** in financing imports to Greece, which usually accompanies a country crisis
- Yet ECB does not act as proper lender of last resort as the ELA mechanism is more costly (extra 2pps). **Periphery suffers from restrictive monetary policy at a time of restrictive fiscal policy**!

Bank Borrowing from the ECB

	EA			Greece		
	a	b	c	a*	b	c
Jun-07	464.6	28,026	1.7	4.3	353.4	1.2
Jun-08	483.0	30,839	1.6	11.6	424.7	2.7
Jun-09	896.8	31,804	2.8	54.0	491.2	11.0
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
Jun-12	1,260.9	34,181	3.7	135.8	437.6	31.0
Aug-12	1,209.8	34,158	3.5	131.8	438.5	30.1
			CY	13.3	134.7	9.9

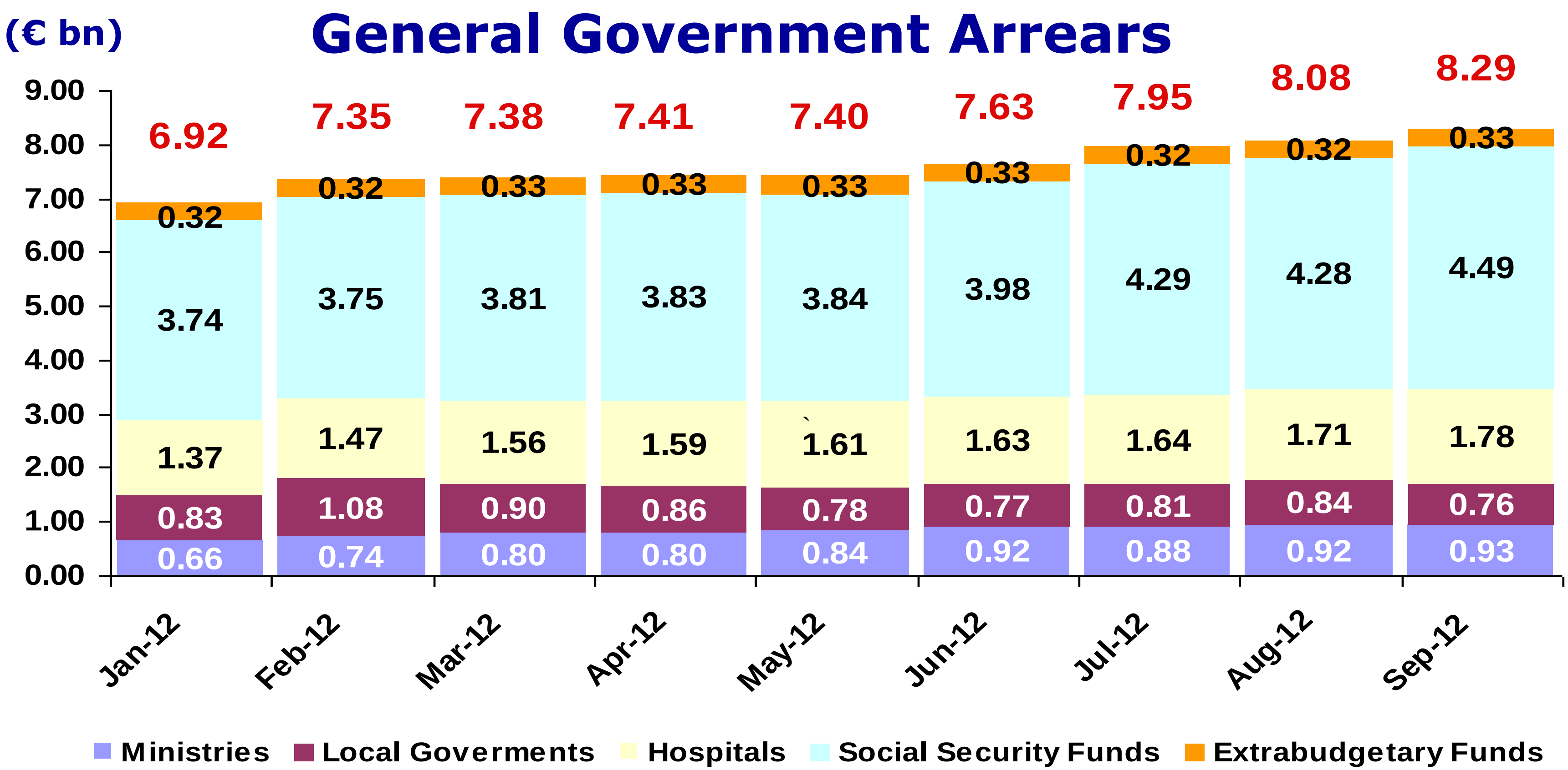
(a) Total Lending from the ECB (€bn)

(b) Total Banks Assets (€bn)

(c) % ratio a/b

* plus lending from the BoG through ELA

LIQUIDITY DEVELOPMENTS ARE NOT ENCOURAGING

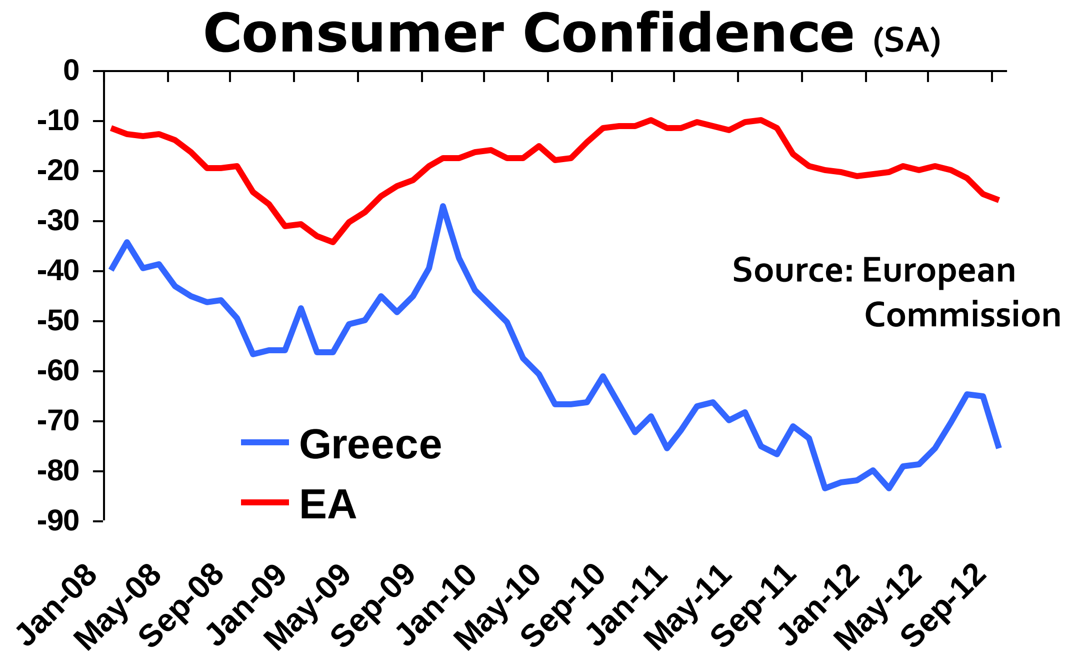


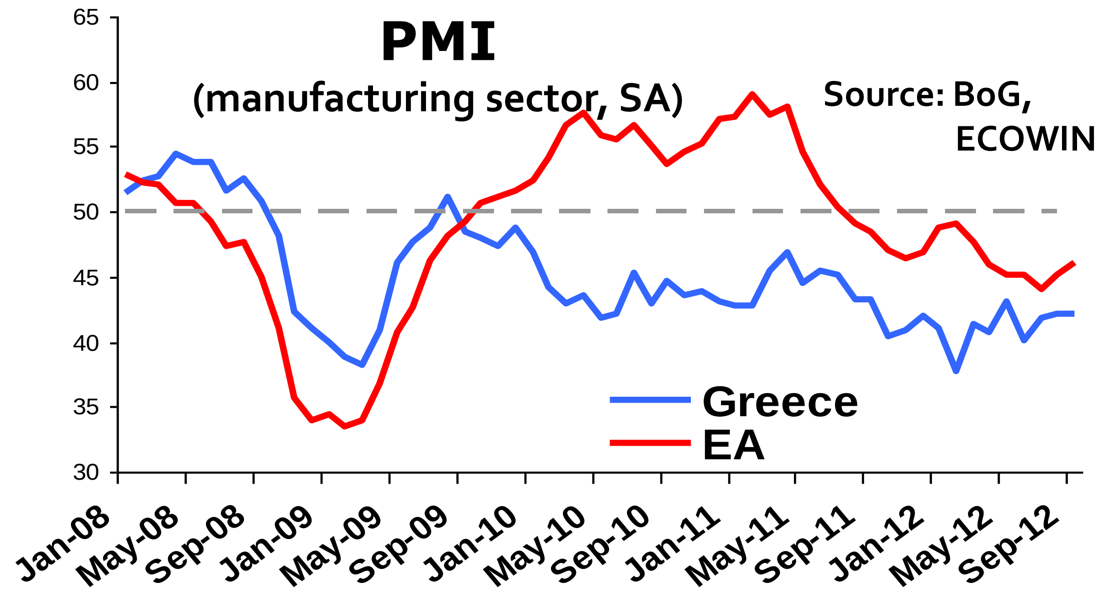
Items that affect liquidity negatively:

1. General Government Arrears
2. Postponement of the deal with Europeans
3. Foreign companies worried about credit risk and also taking advantage of the weakness of the Greek corporate sector
4. Problems ahead for the banking sector as populist politicians try to strangle it

AT TIMES OF AUSTERITY, FOR THE RECESSION TO STOP, A NUMBER OF PREREQUISITES EXIST

- Political stability & Credibility, which would improve if,
  - Troika gives green signal
  - Reforms proceed at a faster pace, particularly the taxation of self-employed
- Liquidity, which is a suffocating constraint even for exports, thus front-loading the economy with cash rather than fiscal measures ought to have been a top European policy in the bargaining process
- Reversal of Sentiment and investment pessimism
- Increase in Public Investment
- Restructuring of the State sector





SUMMARY: GREAT DANGER, BUT IF THERE IS A WILL, THERE IS A WAY

- **The EMU crisis has three interrelated legs: (a) sovereign, (b) competitiveness & (c) banking**
- Greece was originally affected only by the sovereign and the competitiveness crises, yet the Greek **PSI and the prolonged recession** created a domestic banking crisis as well
- From the three legs of the crisis, Growth is the # one priority in Greece, which requires a **push of the reform effort** in order to restructure the economy **but <u>not in a abrupt manner</u>**, in order not to prolong the recession
- **Stopping the vicious cycle of austerity & recession**
  - Requires credibility, liquidity, improved sentiment : Investment & Exports have to fill in the gap in Aggregate Demand as consumption adjusts downward
  - Europeans have to act smartly and front-load the economy with cash, not expenditure cuts (yet seems most likely)
- Among the structural measures, priority to **revamp tax collection mechanism** and **jump start privatizations, free up product & service markets** and **re-organize State sector**
- Improved cost competitiveness, a new export-led economic paradigm, a re-capiltalized financial sector and structural reforms imply that once recovery starts**, growth can take off**

Thank you
for your attention

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I wish to thank my colleagues at Eurobank for their comments