GREXIT:

A possibility that carries significant costs

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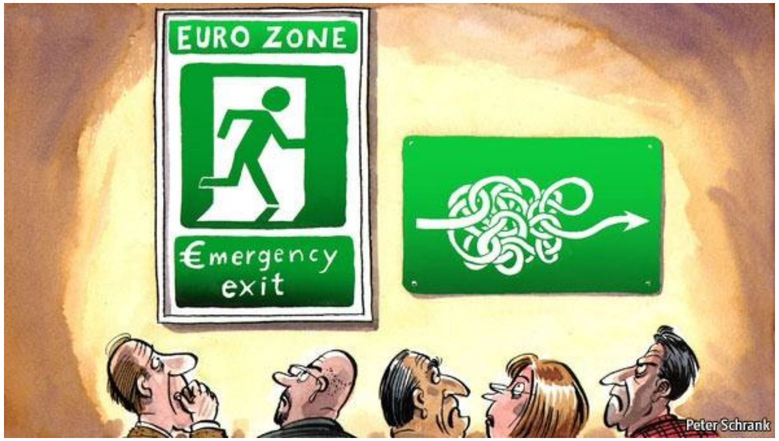
GREXIT

CONTENTS

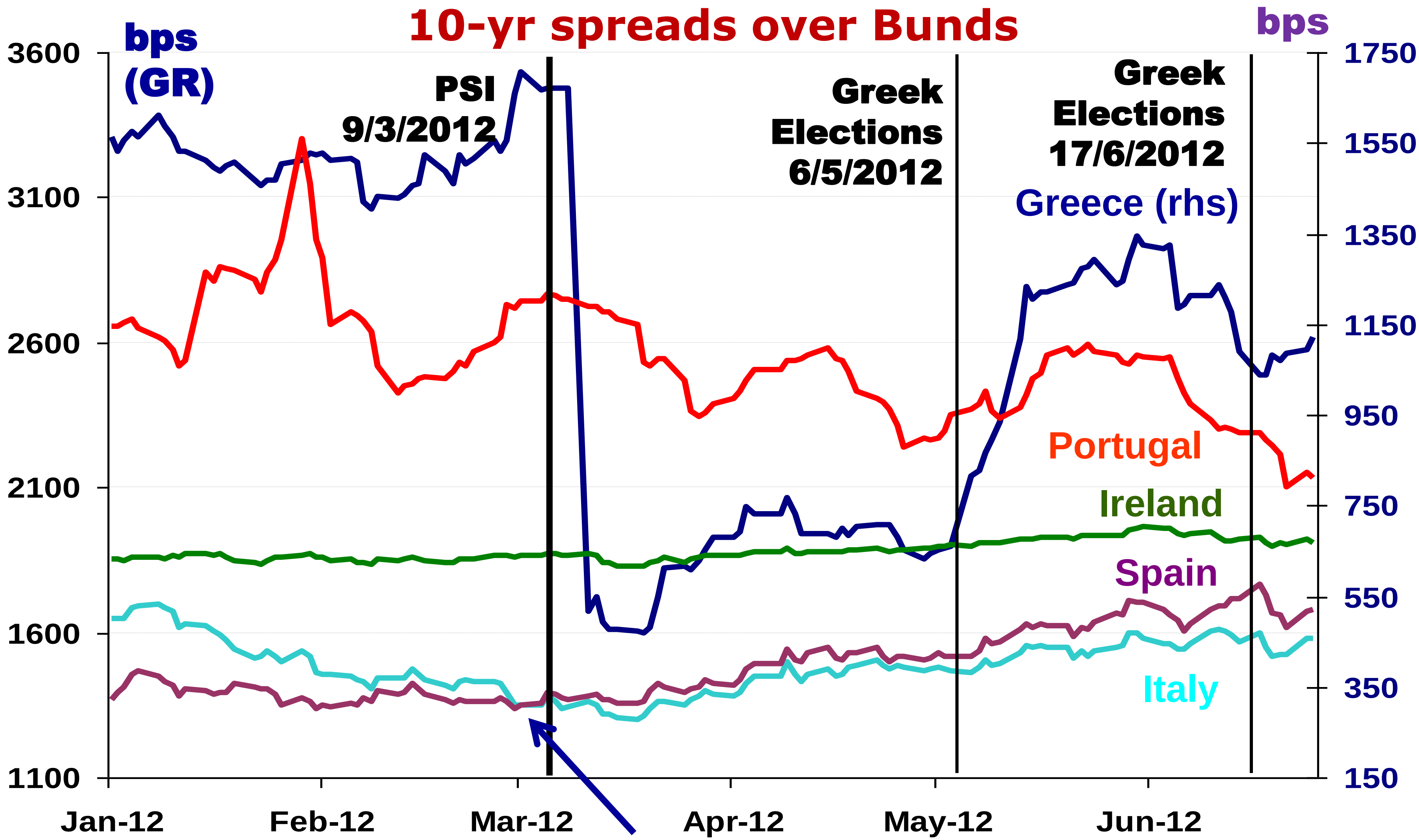
I. A disorderly Greek exit cannot be ruled out

II. High costs of exit

III. Conclusion



I. Market odds of Greece remaining in the Euro Area: Improved after PSI but declined after May elections



✓ Worries about Spain outpaced those for Italy in early March 2012

Source: Bloomberg

I. Greek vulnerabilities can lead to an involuntary exit

1. **Public finances still out of equilibrium and government cash needs urgent**

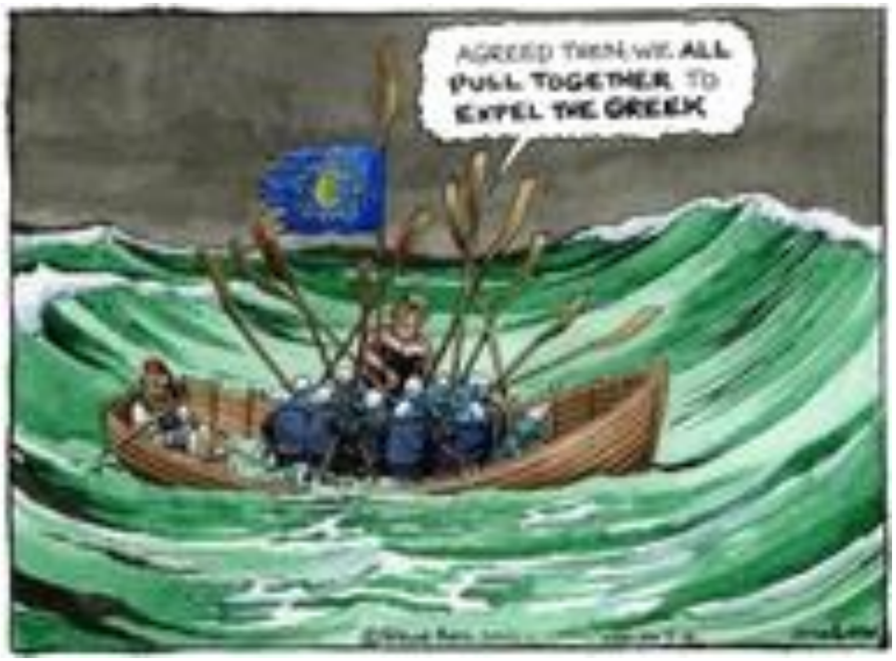
2. **Banks are under severe stress with liquidity shrinking**

3. **Debt overhang persists**

4. **Unemployment rising, companies shutting down, possible social upheaval**

5. **Sentiment low**

6. **Adjustment of current account is slow**



I.1 Drastic fiscal consolidation over 2009-2011 but more cuts in primary expenditure to come

- ✓ Over 2009-2011, the primary deficit declined by **8.2pp GDP** despite the recession, which is an unprecedented achievement
- ✓ Program requires another **5.5 pp GDP** reduction in primary deficit until 2014. **The size of government is forecast to shrink from 1/2 to 1/3**
- ✓ This type of fiscal contraction risks prolonging the recession beyond 2013

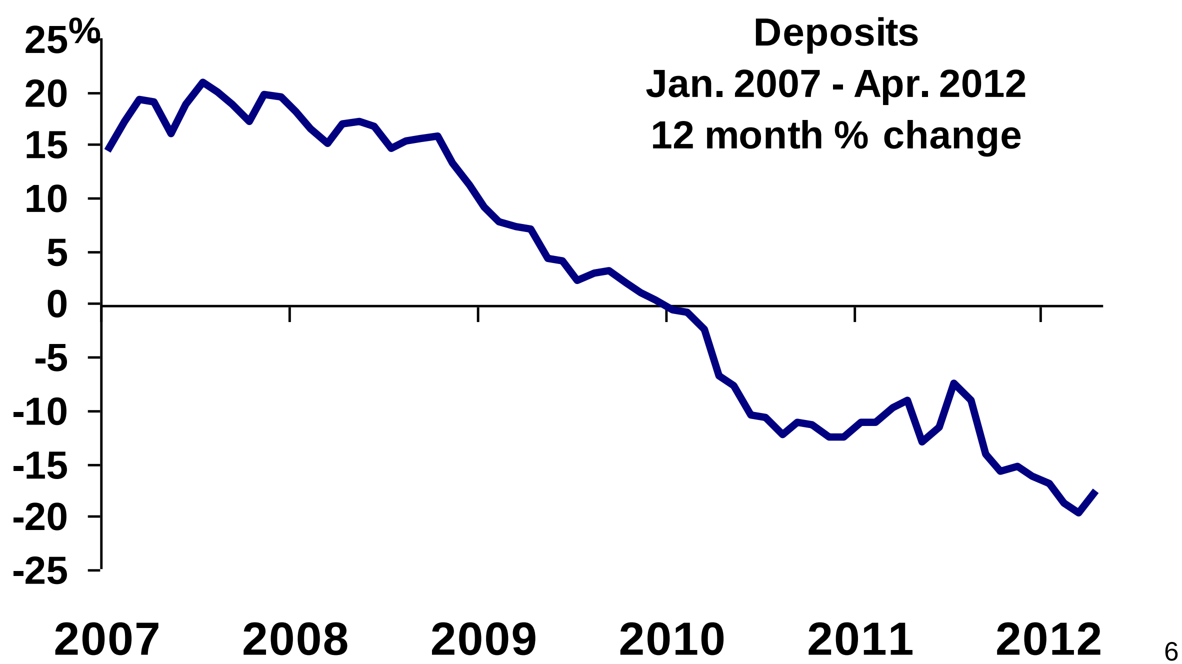
	2009	2010	2011	2012	2013	2014	2015	2020	2030
GDP Growth (%)	-3.3	-3.5	-6.9	-4.8	0.0	2.5	3.1	2.2	1.4
Nominal GDP (€ bn)	232	227	215	204	203	208	216	265	---
Interest Expense (€ bn)	11.9	13.2	14.9	12.8	13.0	13.8	13.3	---	---
Interest Expense (% GDP)	5.1	5.8	6.9	6.3	6.4	6.6	6.1	6.4	---
Primary Expenditure (% GDP)	48.7	44.4	43.4	43.2	40.4	37.6	35.6	35.8	36.6
General Gov Revenues (% GDP)	38.0	39.5	41.0	42.2	42.2	42.1	40.1	40.1	40.1
Primary Balance (% GDP)	-10.6	-5.0	-2.4	-1.0	1.8	4.5	4.5	4.3	3.5
General Gov Deficit (% GDP)	-15.8	-10.8	-9.3	-7.3	-4.6	-2.1	-1.6	---	---
General Gov Deficit (€ bn)	-36.6	-24.5	-20.0	-14.8	-9.4	-4.4	-3.6	---	---
General Gov Debt (% GDP)	129	145	165	163	167	161	153	116	88
General Gov Debt (€ bn)	299	329	356	332	339	334	331	309	---

Source: IMF Country Report No. 12/57, March 2012

I.2 Lack of liquidity at center stage

- International markets closed to Greek banks following global crisis
- After Greek crisis began, persistent deposit outflow, cumulative reduction of 30%
- Hence, increased dependence on ECB funding
- Successful PSI calmed markets and stabilized bank deposits, yet May elections reignited fears
- Significant arrears , €6.3 bn, by the State further reduce liquidity

	Bank Assets (€ bn)	Bank Assets (% of GDP)	ECB + ELA liquidity (€ bn)	ECB + ELA liquidity (% of Assets)
2007	391.5	175.7	8.8	2.2
2008	464.7	199.5	40.6	8.7
2009	492.6	212.7	49.7	10.1
2010	515.0	226.5	97.8	19.0
2011	476.9	221.7	129.6	27.2
Apr. 2012	429.4	210.8	121.3	28.2



I.3 Debt overhang despite PSI

PSI details

- ✓ Voluntary debt exchange with Private Sector. Affected bonds of €206bn FV, forgave ca €110bn with ↓in interest rates.
- ✓ Old debt of FV = €100 swapped for
  - ❖ €15 "cash" and FV = €31.5
  - ❖ with coupon = €2 until 2015, €3 in 2016-2020, €3.65 in 2021, €4.3 in 2022-2032
  - ❖ GDP-linked detachable securities of €1
- ✓ Redirection of the Eurosystem's profits from Greek bonds bought in the secondary market, to the reduction of the Greek debt.
- ✓ 150 bp reduction of the interest rate on bilateral loans provided to Greece under the May 2010 EC/ECB/IMF agreement.
- ✓ New funding of €173bn from the Official Sector to address the country's funding needs related to the PSI+, Greek banks' recapitalisation, budget deficits and overdue invoices of the public sector's suppliers

	Before PSI	After PSI (end-2012)
IMF loans	20	28
EU loan package 1	53	74
EU loan package 2	0	88
ECB SMP+Investment portfolio	55	46
T-bills	15	15
Banks (Greek banks)	70(40)	22(13)
Insurance	10	3
Central banks/official institutions	38	12
Other investors	70	22
Greek Social Security Funds	18	6
Total Greek debt	349	316

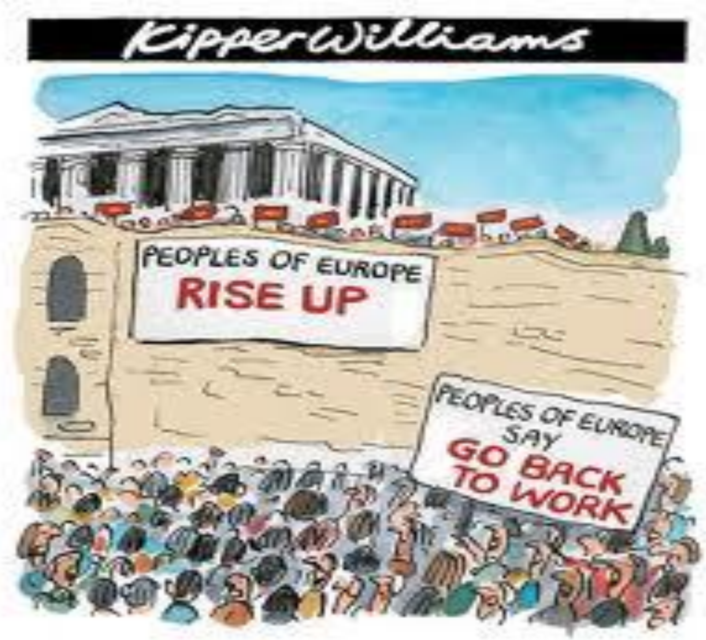
Source: European Commission

✓**Debt remains huge despite the haircut**

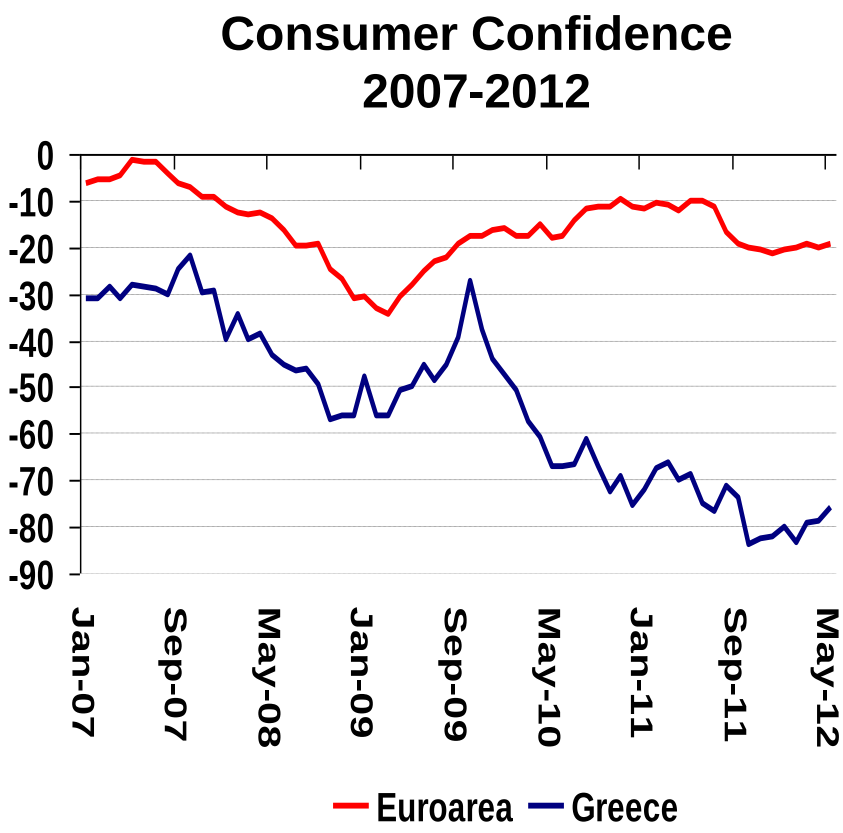
I.4 Economy affects jobs

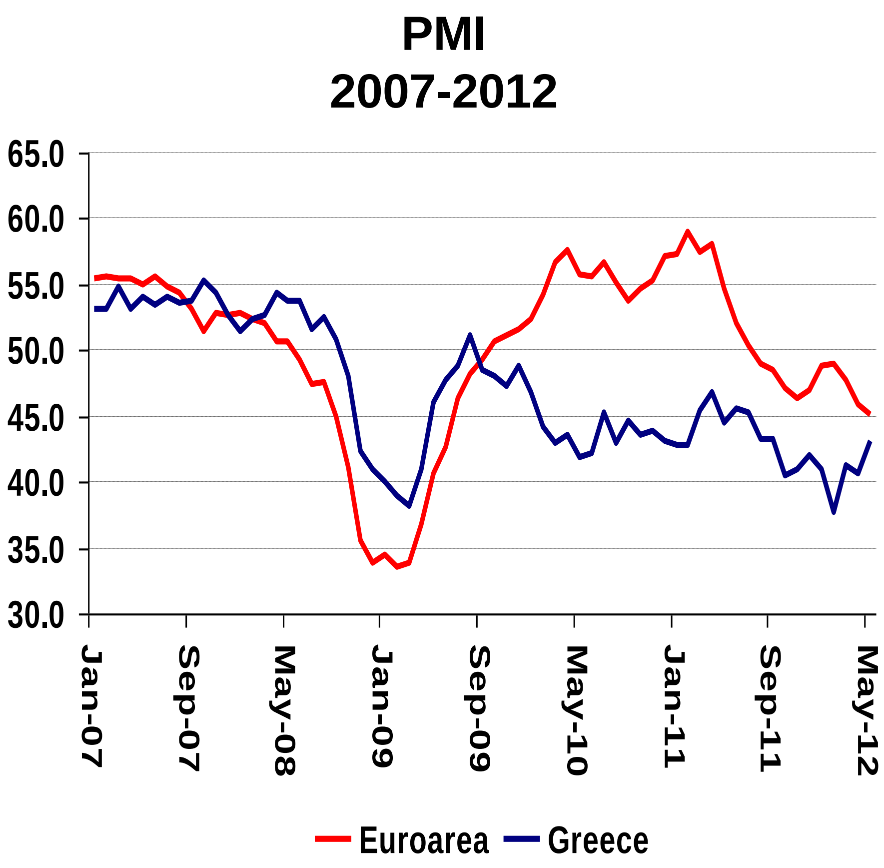
	Unemployment (April 2012)		Employment (2011)	
	Greece	**EU-17**	**Greece**	**EU-17**
Total	**21.9%**	**11.0%**	**61.4%**	**66.9%**
Male	**18.9%**	**10.8%**	**74.9%**	**74.2%**
Female	**25.8%**	**11.1%**	**47.9%**	**59.7%**
Young	**52.1%**	**22.2%**	**24.0%**	**40.8%**

Σκίτσο του Ηλία Μακρή



I.5 Sentiment is down

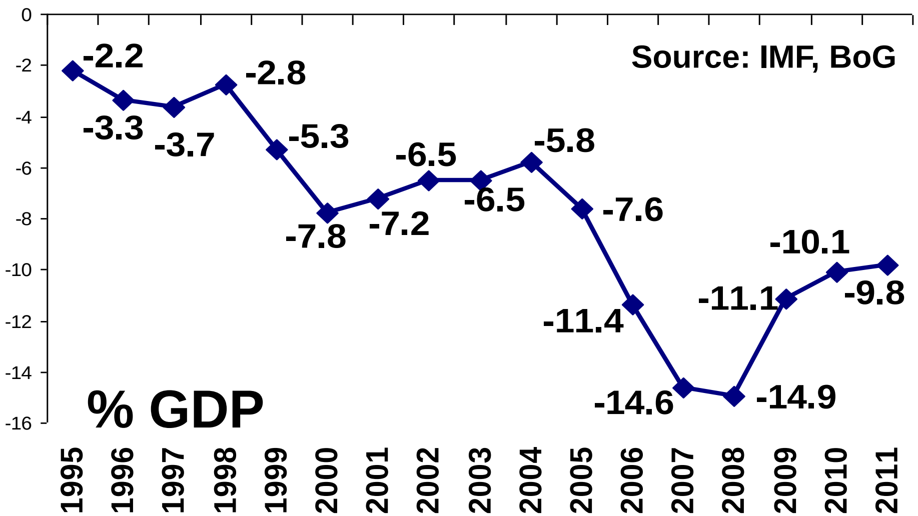




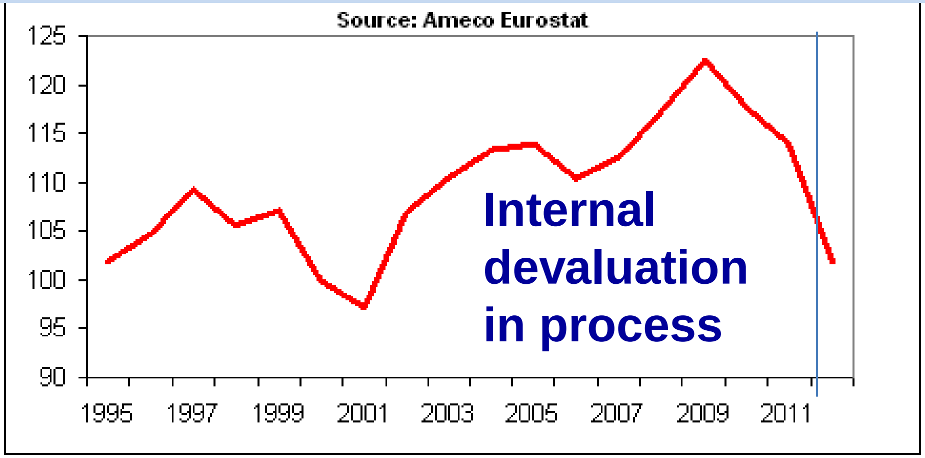
- ✓ **Political uncertainty has to decline before confidence can come back, which is a necessary condition for a reversal in the exodus of deposits and for consumption and investment expenditure**

I.6 Current account slow to adjust despite competitiveness improvement from internal devaluation

Current Account Balance



Nominal Unit Labor Costs
relative to 35 Industrialized Countries



- ✓ No sudden stop thanks to ECB funding, thus current account remains negative
- ✓ Wage reductions improve ULCs back to 1995 levels by 2012, yet cannot erase the current account deficit
- ✓ Price of oil also helped keep current account deficit high

2011	**€ mill.**	**% GDP**
Current Account	**-21.096,1**	**-9.8**
Goods	**-27,221.2**	**-12.7**
Services	**14,630.8**	**6.8**
Income	**-9,066.5**	**-4.2**
Current Transfers	**560.8**	**0.3**

I. A disorderly exit could be avoided …

To avoid a disorderly exit, the MoU **renegotiation** outcome should come to a **quick closure**. **Time is essential** as the recession mushrooms.

- ❖ The renegotiation outcome is **supply-constrained** , i.e. lenders call the shots. The idea that Greece carries "nuclear weapons" that could damage the rest of Euro Area is over played domestically and destroys credibility internationally. We discuss it in the next section.
- ❖ **An extra year already exists in the current 2nd MoU**
- ❖ **Possibly, one more year** would be given to allow the economy to stabilize. The Greek political establishment has erroneously discounted the lengthening of the time of the Program as a done-deal. This is wrong.
- ❖ The **financing** of the extra years may require another €25 bn (of which €13 bn are present even without the lengthening) . It may be possible **through ESM** as Spanish case shows the way. Otherwise having to go back to 16 European Parliaments may be difficult
- ❖ **The Greek side needs credibility** in order to gain even the lengthening of the adjustment period, which can only come from **enforcing the structural reforms with increased vigor.**
- ❖ The parameters in the bank recapitalization methodology likely to be a prior action before the next disbursement

I. A disorderly exit could be avoided, yet it remains a serious possibility

Can the new Coalition Government claim **victory** in the renegotiations quickly enough without further alienating Europe?

- Yes, if Europeans are willing to go along a reasonable subset of the Greek concerns
- But Greeks have to work hard on it as building alliances within the Euro Area takes time and previous history of Hellenic inadequacies (prior to the Papademos government) leaves a lot to be desired

If, instead, Europeans **turn off the tap of cash:**

- Liquidity shortages will soon get worse with arrears increasing, imports becoming more difficult to secure, blackouts, poor public services, etc
- A default on a foreign payment is possible
- Issuance of IOUs would then signal the birth of a new currency
- Fear may generate a quick bank run, which would lead to capital controls and an exit from both EMU and EU

II.

I. A disorderly Greek exit cannot be ruled out

II. High costs of exit

III. Conclusion

- *"Angela dearest, I can take you down with me, as we both carry nuclear weapons"*
- *"Alexis my dear, your so-called nuclear bazooka is nothing more than a toy gun. I will stop funding you baby"*

II. Domestic costs of exit are extremely high

- Greece will lose its chance to become a **modern European state** and reform its State sector
- The main **reforms left in the 2nd MoU are desirable** as they tackle oligopolistic structures in product and service markets and reorganize the general government, improve transparency, etc.
- Expect a **run on the banks**
- The major constraint on economic policy is not the primary fiscal deficit of, say, €2bn, which politicians like to erroneously focus on, but the **huge trade imbalance**. Paying for the trade deficit requires around €13 bn. The absence of those funds implies (NBG):
  - ✓ **a 65% devaluation** or 40% real devaluation as inflation picks up
  - ✓ **A bigger recession of 20% on top of the 14.3% cumulative current one**, implying unemployment at 34% and NPLs at 1/3
  - ✓ **A rise in Debt/GDP to 370% GDP** → a default (NBG assumes 80% default)

	GDP per capita (€, 2011)
Greece	19400.0
Croacia	10385.0
Poland	9726.0
Latvia	9102.0
Greece (devaluation included)	8700.0
Turkey	7177.0
Romania	7173.0
Bulgaria	5225.0

Source: IMF, NBG

- Not clear what the full negative domestic consequences will be as it will take time to re-introduce a new currency. We have no experience on such a shock.
- EMU exit will also be accompanied by an analogous kicking out from the EU due to the imposition of capital controls

II. Direct costs to the rest of Europe are small but a contagion could happen

- ✓ Trade is small (EMU exports to Greece is 0.2% of its GDP)
- ✓ Official lending exposure is small, especially if Target 2 were excluded

	Member states		Eurosystem		Total	
	Bilateral loans	EFSF	SMP	Target 2	€ bn	% GDP
Total	52.9	73.0	34.9	130.0	291.1	3.0

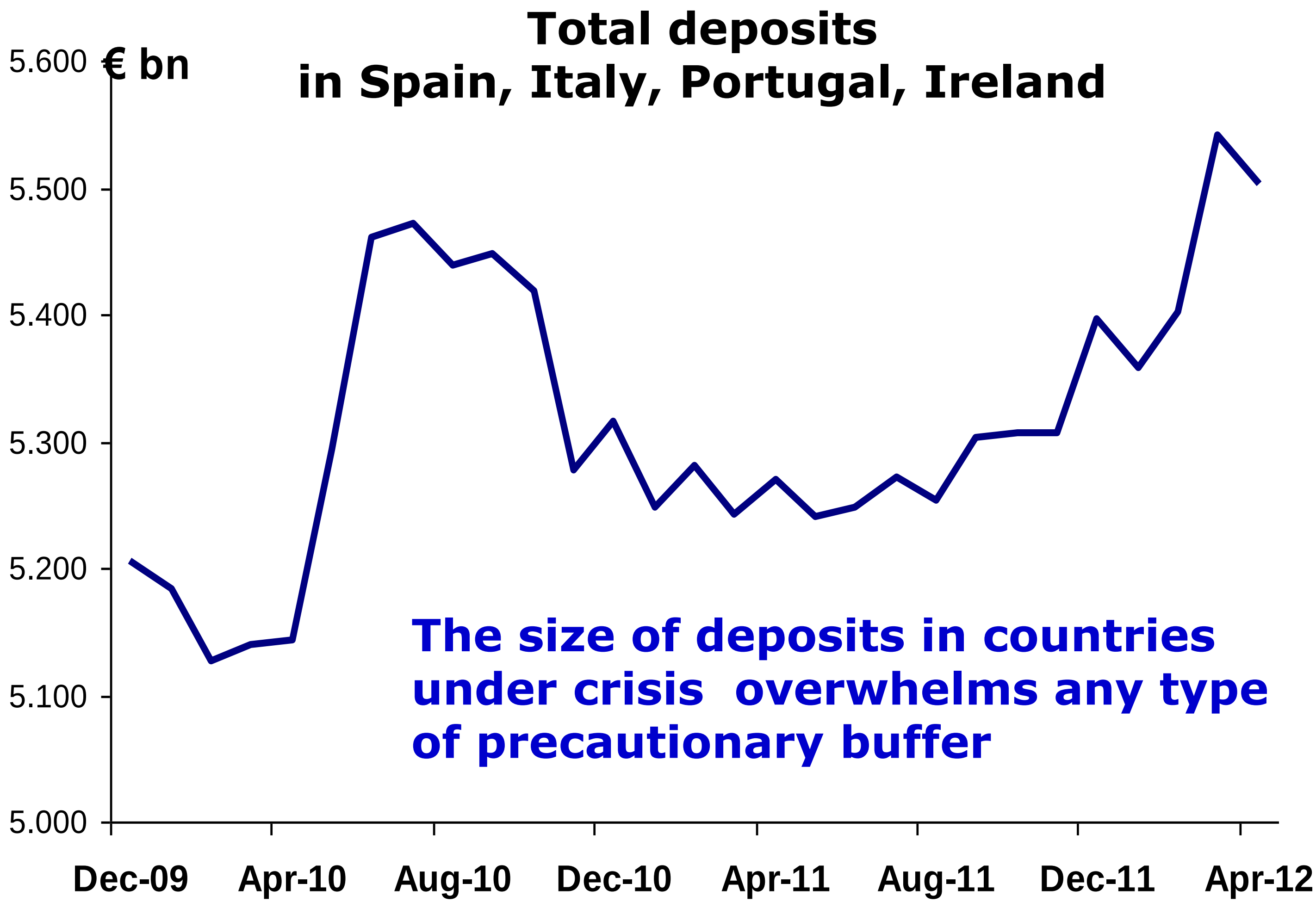
- ✓ Bank exposure to Greek banks is also small, according to the BIS data

	European banks	France	Germany	Italy	Spain	Sw/land	UK	US
Foreign claims	90473	44353	13355	2186	969	1940	10537	4455
Other potential exposures	29032	6901	3779	1790	417	1406	11825	46231

- ✓ Yet contagion is in the minds of market participants since the Greek crisis started, as GIIP 10-year bond yields moved up and down together with the higher Greek 10-year bond yields
- ✓ What is the major channel through which contagion can take place in the short-run? In our view, the channel is a bank run

II. The Periphery cannot easily withstand a deposit withdrawal similar to Greece's

✓ Pray a bank run will not happen: If depositors withdraw 30% of their money, i.e. as much as Greeks have slowly done thus far, this would be a loss of EUR 1.7 tn, a shock that cannot be absorbed even by today's EFSF

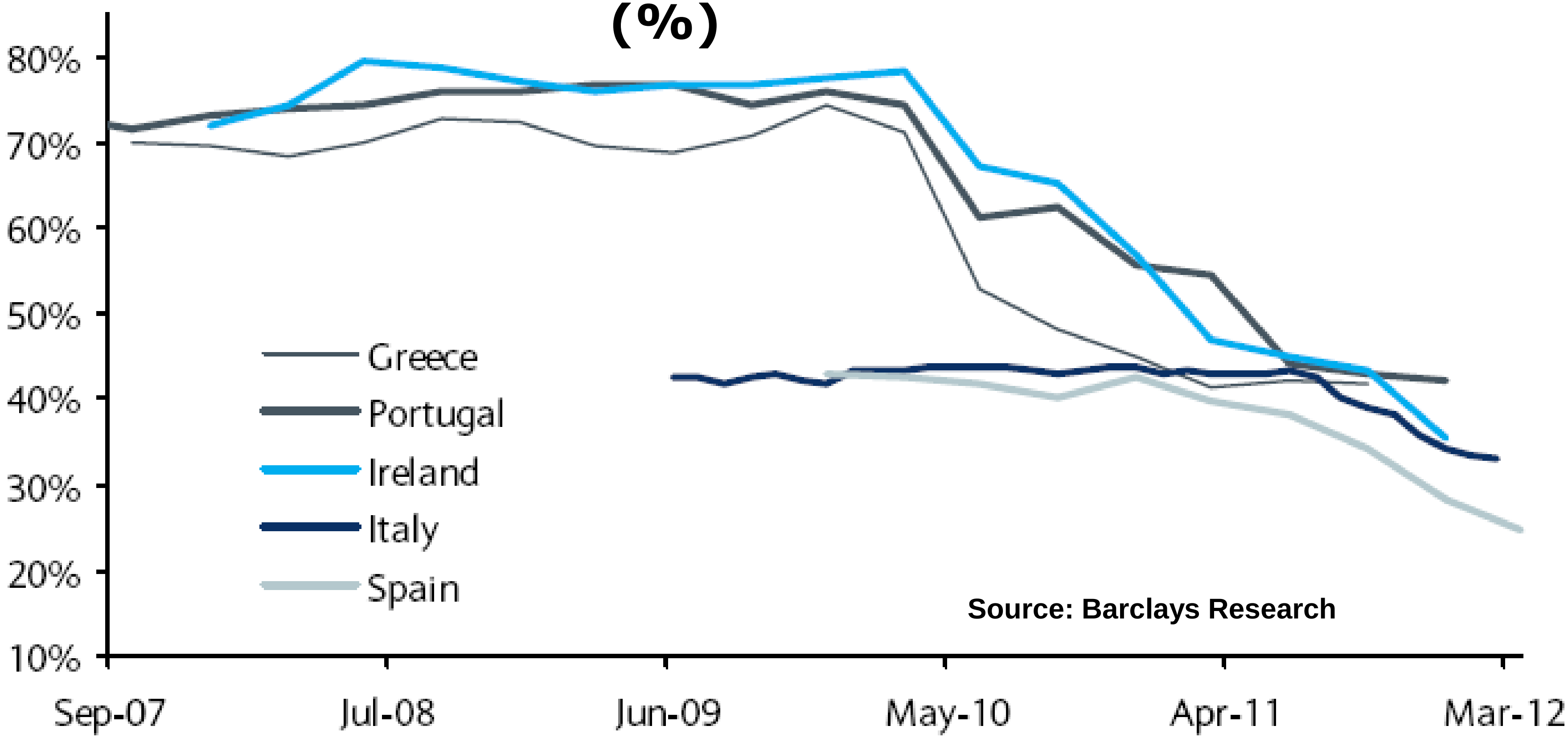


✓ A pan-European deposit insurance is not adequate to absorb such a shock. Deposit insurance is designed to handle individual bank insolvencies, not a systemic crisis.

II. Smart money is leaving the Periphery

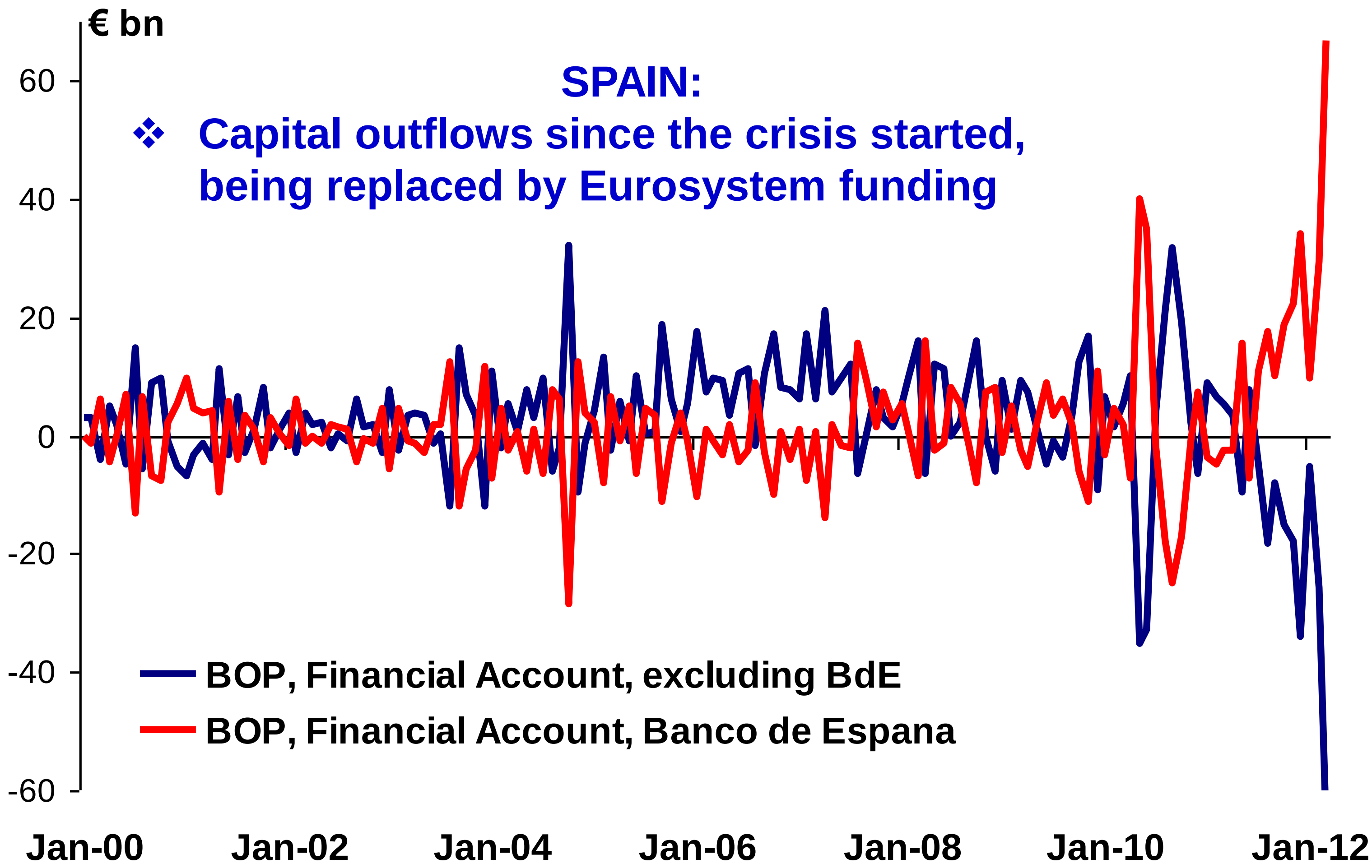
✓ **Smart money usually moves out first, hence notice that foreign investors have abandoned the government bond market of the European Periphery**

EGB holdings by non residents (%)

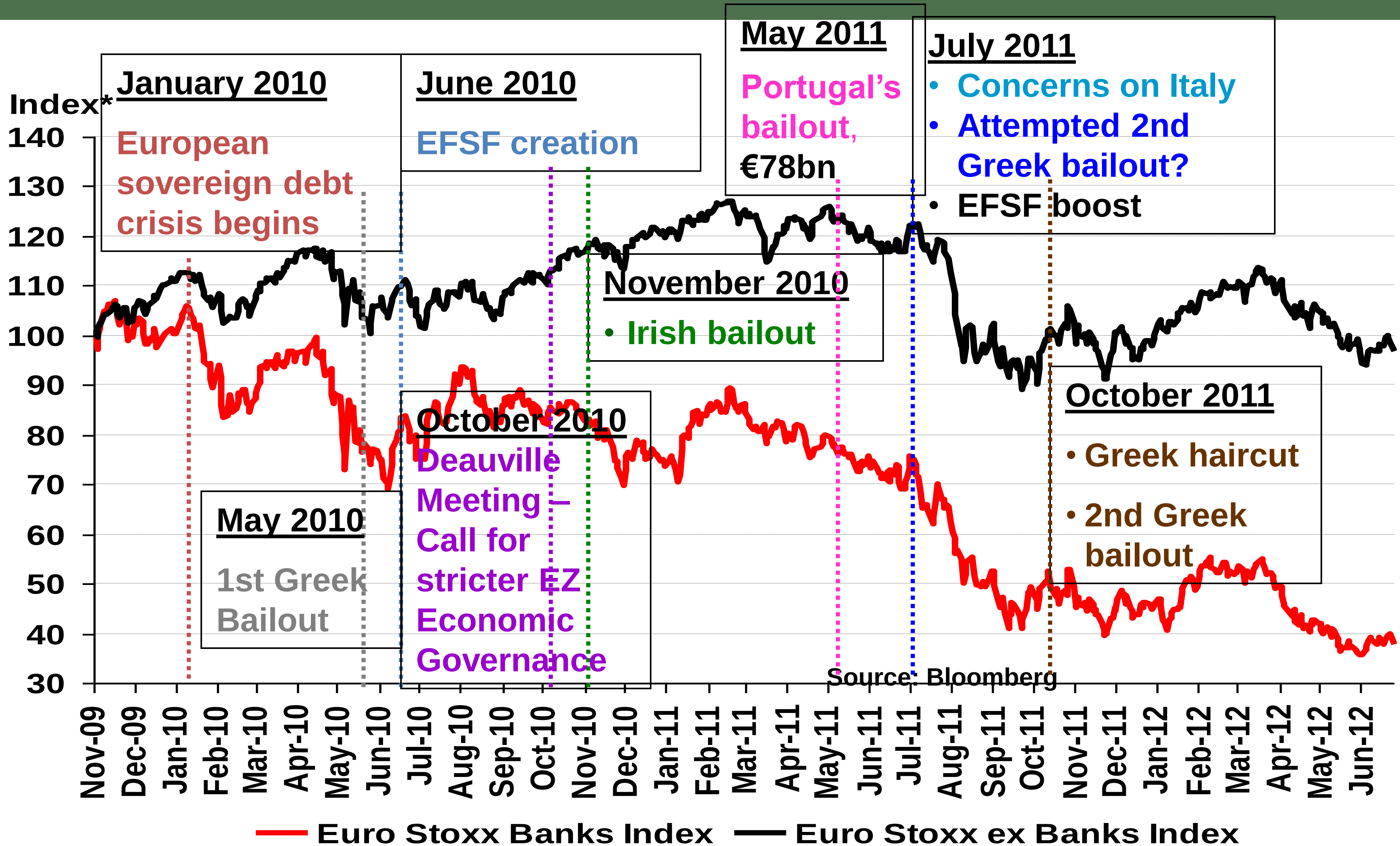


II. Can a bank run really happen in GIIPS?

- ✓ **Capital outflows are the first warning signals of a possible bank run**
- ✓ **Spaniards are already nervous**



III. Euro Area banks are vulnerable …



* October 30, 2009=100, first observation: Beginning of November 2009

Capital deficiency € 114.7 bn from (a) stress tests that mark-to-market sovereign bonds, and (b) increase in Core Tier I ratio to 9% from 7%

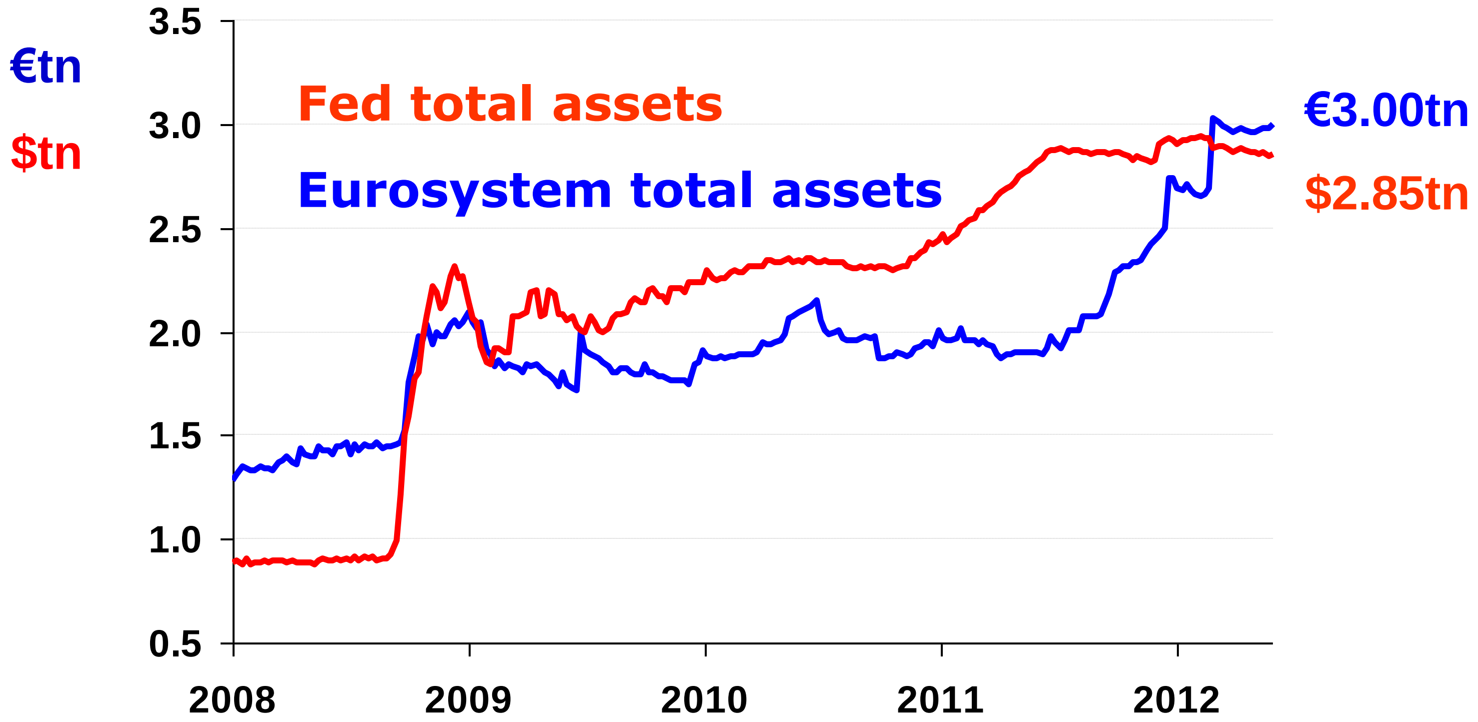
II. … hence a bank run could occur

Euro Area banks & sovereigns are already suffering a confidence crisis. Hence,

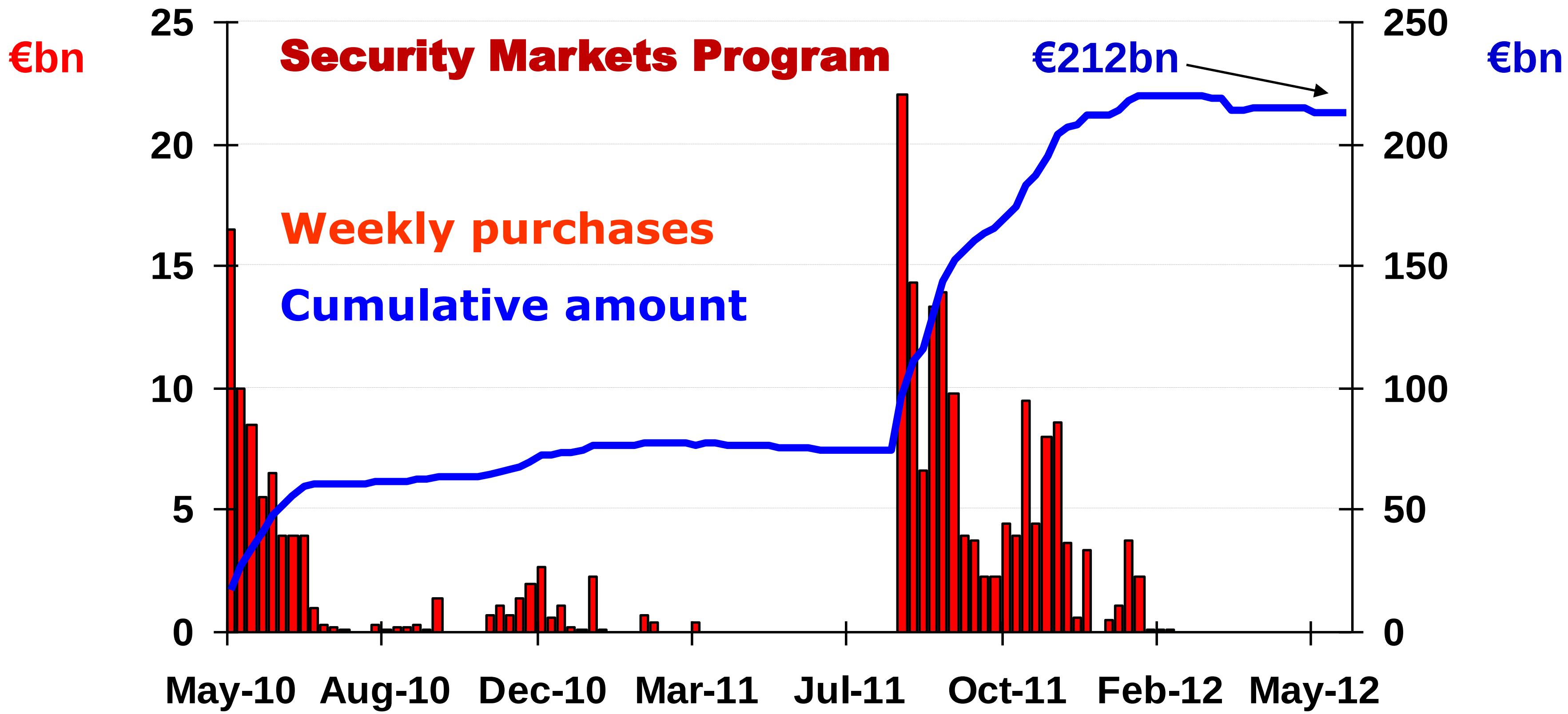
- In the **<u>short-run</u>**, given the vulnerability of European banks:
  1. A banking collapse in Greece can lead to a similar bank run in GIIPS, while Greece still remains in the Euro Area and is struggling. GIIPS depositors may fear a **corralito,** similar to Argentina's or, possibly, to Greece's.
  2. ECB is the (only) institution able to control a bank run. Thus far capital outflows in the Periphery have been accommodated by liquidity support from the ECB
- In the **<u>intermediate run</u>**, if Greece were to depart from EMU:
  1. Once the **exit template** is established, individuals and markets will likely ask: "***Which country is next in line?***" A bank run can easily form then. This is perhaps the biggest threat that Greece poses to EMU, namely the **destruction of the irreversibility principle** of EMU membership
  2. **Debt default** (or new restructuring) and **EMU Exit** are <u>two distinct phenomena</u>.
     - ✓ The latter is more serious. Thus Greece cannot be compared to Argentina, whose default did not affect peripheral markets then
     - ✓ Also do not confuse the future reaction to EMU exit with the March 2012 reaction to PSI closure. In March, markets did not respond negatively to the PSI because it was expected and was already priced-in . A Greek EMU exit is not fully priced -in and its consequences are not easily predictable.

II. Can Quantitative Easing avert a bank run?

- ✓ The ECB has the power to provide ample liquidity and avoid the size constraints, which even a European Deposit Insurance system cannot surpass
- ✓ The Fed was more aggressive early on in using Quantitative Easing, yet the ECB also expanded aggressively in the second half of 2011 after the Italian crisis revealed a great danger to the Euro Area



II. Time for Euro-Area's own version of Operation Twist?



- ✓ The so-called ECB's "nuclear option" or SMP began in May 2010
- ✓ Markets could stop their pressure on the Periphery if the ECB were to buy bonds of the Periphery and sell equal value bonds of the Center
  - ❖ This operation twist would be a special case of the SMP program
  - ❖ Yet, watch out for the subordination status of private bondholders following the Greek PSI and possible strange price effects

II. Spain’s Financing Needs

- ✓ State financing needs alone over the next 3 years are large and can easily overwhelm the funds of ESM
- ✓ A similar Spanish problem in Italy would subsequently undermine the stability of the Euro Area

	2012	2013	2014	2015
	Amounts in billions of euro			
Primary Balance	-23.5	2.2	11.2	23.2
Interest Payments	-33.0	-34.8	-35.8	-35.9
Bond Redemptions	-86.8*	-112.7	-86.5	-69.4
Total Financing needs	-143.3	-145.3	-111.1	-82.1

* Remainder of 2012

Source: Spanish Stability Program, Bloomberg

III.

I. A disorderly Greek exit cannot be ruled out

II. High costs of exit

III. Conclusion

III. GREXIT is not inevitable

- GREXIT can occur
  - ✓ either because Greece is incapable of getting out of its current recession mess by completing the structural reforms, balancing its budget and adopting a new equilibrium and export-led growth strategy
  - ✓ or because EMU dissolves on its own for other reasons, since the EMU crisis is not just a Greek crisis but runs deeper into a lack of adequate fiscal integration
- The vulnerabilities that can lead to a Greek EMU and EU exodus are many: A tighter than needed fiscal program that protracts the recession, a persisting debt overhang that upsets markets, a deposit flight and a liquidity drain that threaten the banking system and the corporate sector, bankruptcies and unemployment that ignite possible social upheaval and political fragmentation, uncertainty and low sentiment that prohibit new investment
- GREXIT would cost Greece a lot more than its European partners as it threatens its institutional fabric , its financial and macroeconomic stability and leads to declining living standards
- GREXIT could cause a contagion , yet the ECB could come to the rescue
- GREXIT is not a tool to be used in renegotiating the MoU as it destroys credibility
- The recent Greek achievements in competitiveness and fiscal discipline in a hostile environment show that GREXIT can be avoided: If there is a will there is a way, and the previous Papademos government demonstrated it very clearly

Thank you
for your attention

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