“GREECE IN A TRAP”

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“At the end of 2014 we were so … close … yet so far … from a major economic take-off !”

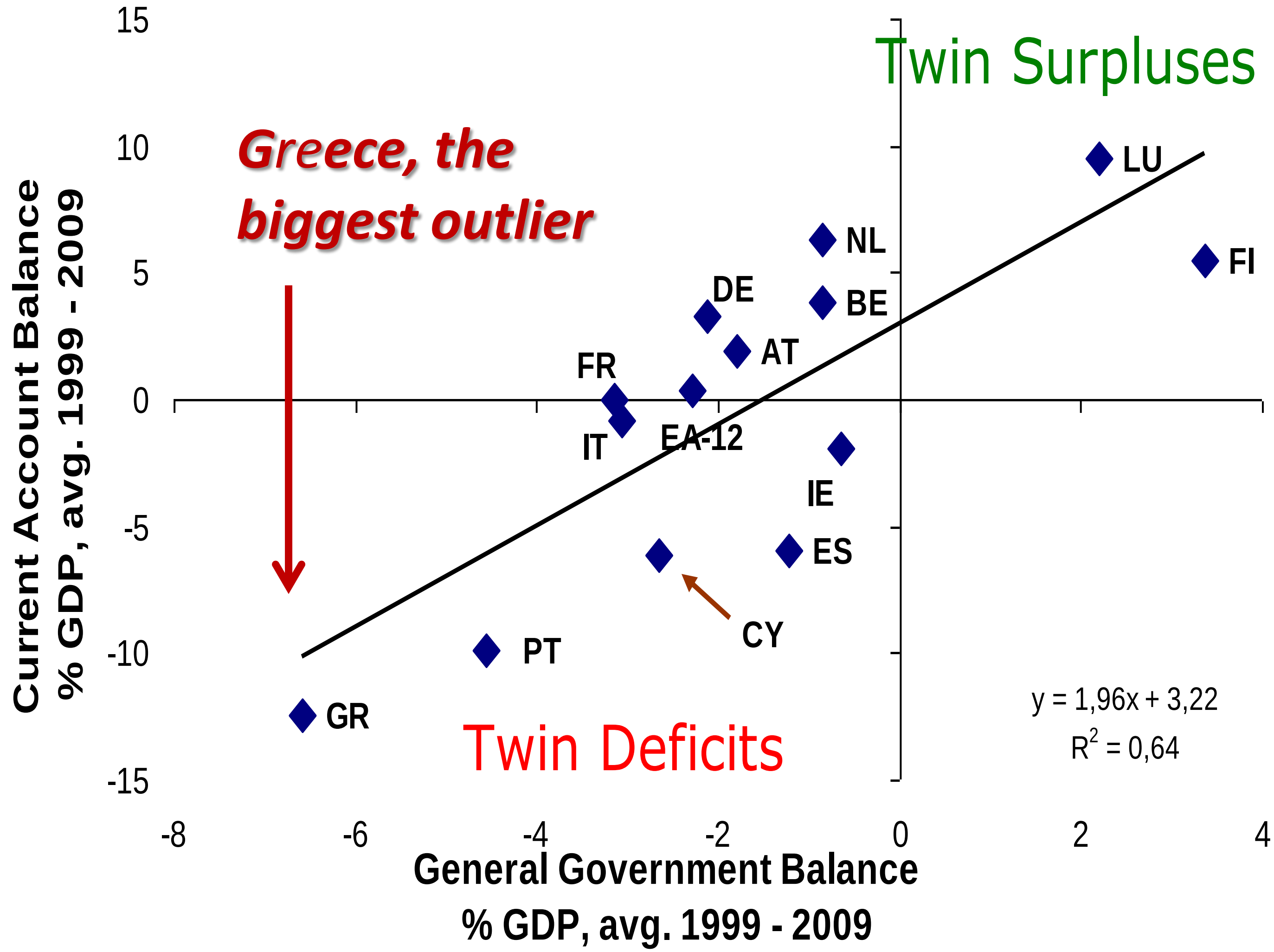
Summary: We were close … yet so far

- The Greek economy **stabilized in 2014**, with its major imbalances gone. Productivity-enhancing reforms were set at center stage, ECCL agreed & the country was ready for a major take-off in 2015
- Yet, it took just **5 months of inaction, confusion** about the European point of view, attempts to reverse reforms, and a lot of cheap domestic bravado talk to generate uncertainty, fear of the future and instability → Policy was like a random walk → Causing **new recession, threatening EA exit and a rapid further drop in living standards**
- Now, the Greek side is **trapped** with limited options and few friends, having to take recessionary fiscal measures → **desperate choice of referendum** in an attempt to throw the blame elsewhere → **CAPITAL CONTROLS** → If they stay, further **negative effects on the economy**
- And this happens at a time of European positive growth, as lower oil prices, a weakening euro and QE are pushing Europe forward
- Recession next year, even in an optimistic scenario of no GREXIT
- Key issue of **productivity-enhancing reforms** has taken the back stage

The Past: Serious macroeconomic imbalances

- Besides the fiscal & external imbalances, there is a serious pension system imbalance
- On the other hand, private debt not as serious as in other EA countries
- The current account imbalance reflects deeper competitiveness problems, not yet fully cured

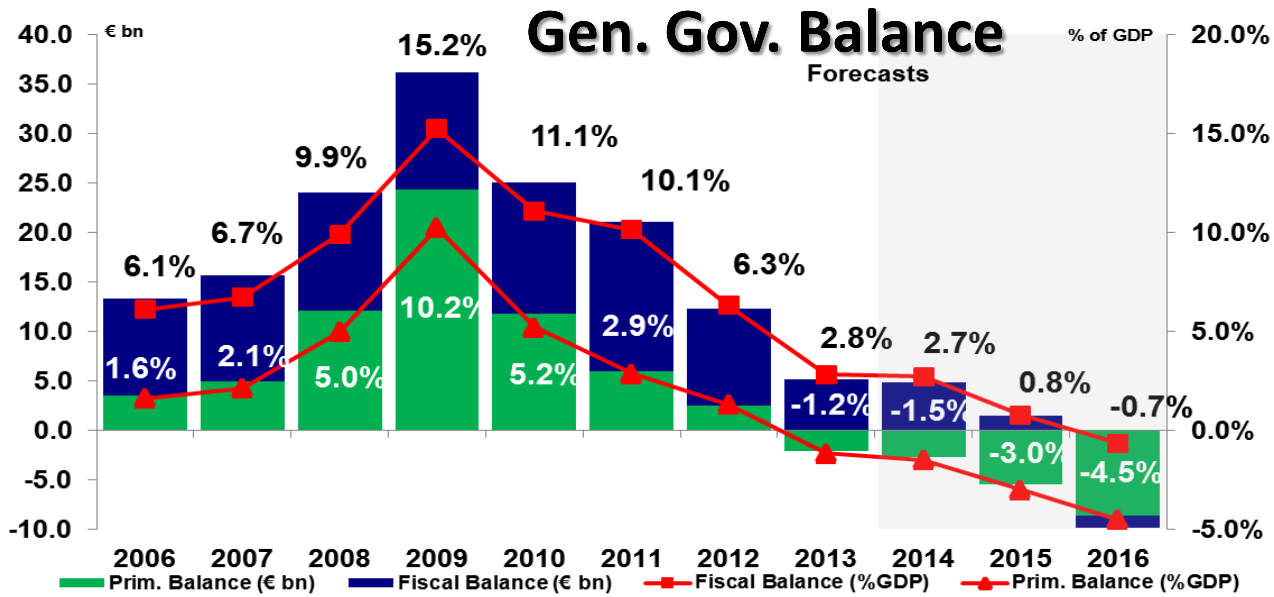
Eurozone Years up to the Greek Crisis

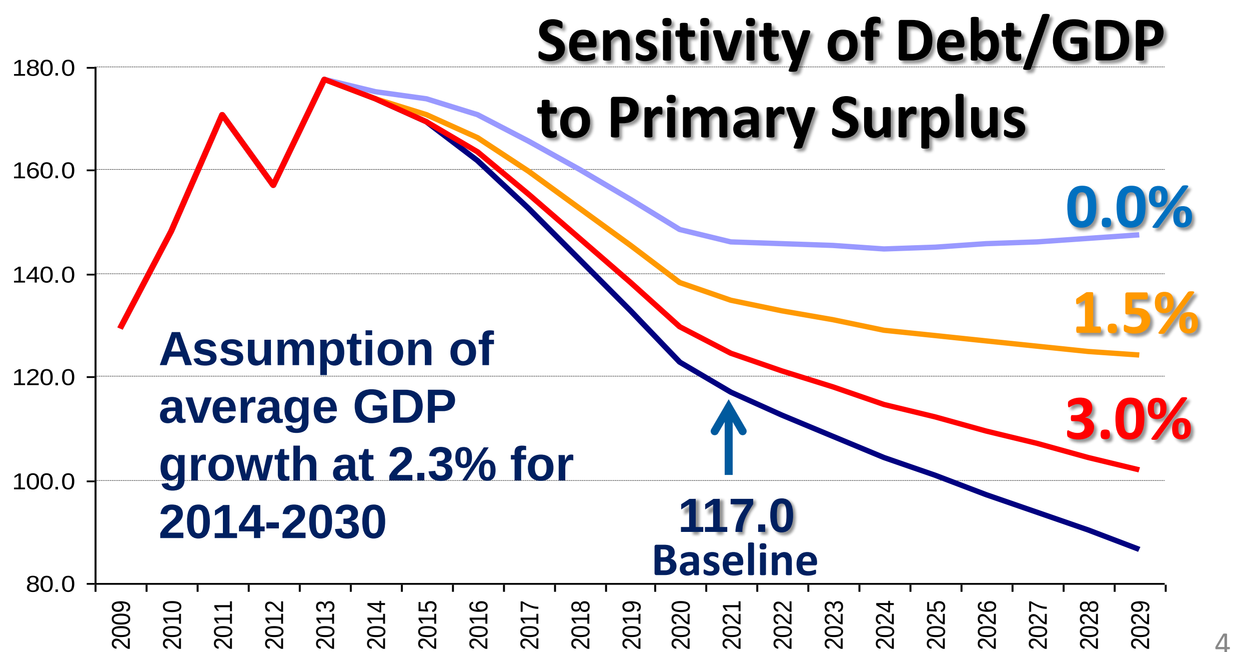


Source: European Commission

State of Play prior to January 2015 elections

- **Enormous fiscal consolidation since 2009** when Gen. government expenses were **€128.2** bn and Gen. government revenues **€91.9** bn. In the budget of 2015, the corresponding expenses and revenues were both projected at **≈€80bn.**
- **Debt sustainability on track**, Average Maturity from 6 years to 17 years, interest rates low
- Soon out of the MoU, into ECCL with Euro Area, and a precautionary agreement with the IMF





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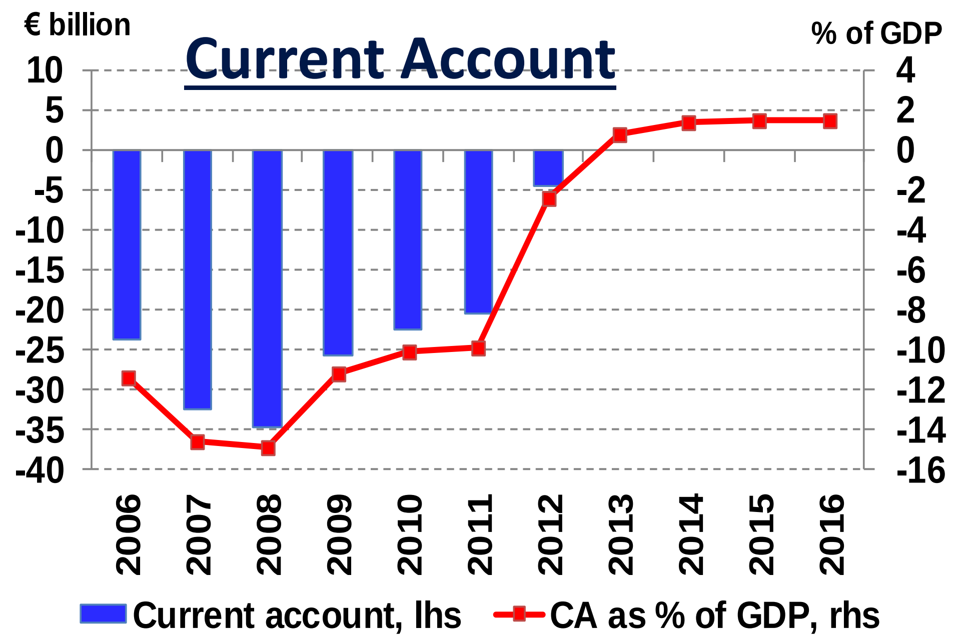
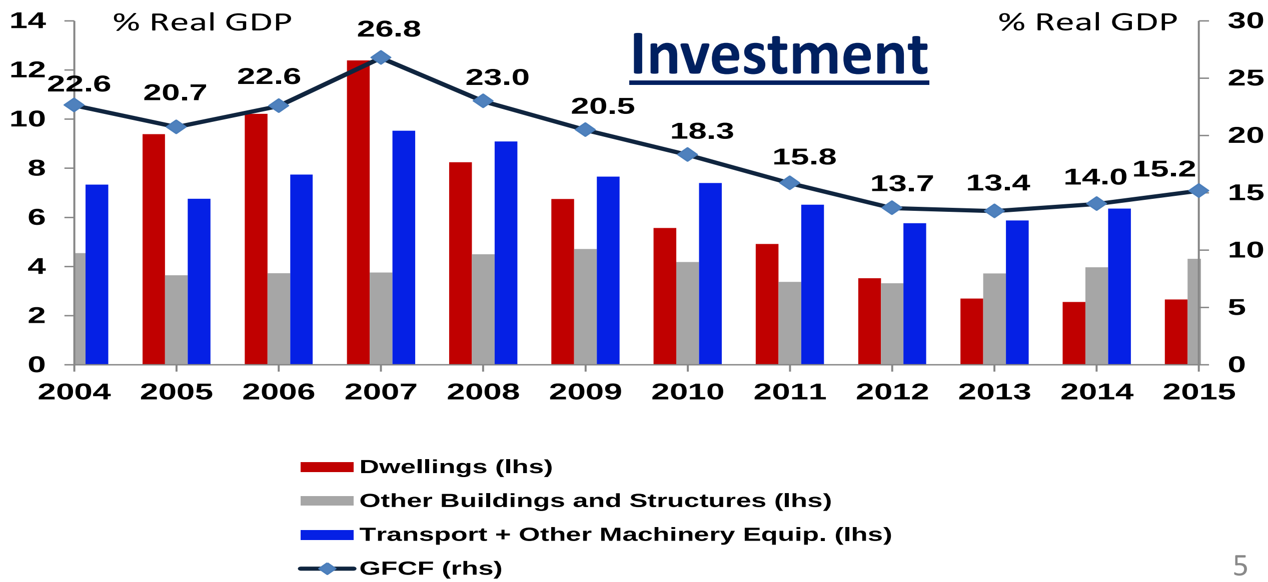
Optimistic State of Play at the End of 2014

- **Foundations of an extrovert and competitive economy via reforms:**
  - ✓Competitiveness rankings↑
  - ✓Current account in surplus after years of deficits, yet <u>exports still anemic</u>
  - ✓2014 growth of 0.7%, after a cumulative drop of ca 26%, yet now in a new recession
  - ✓FDI in 2013 and 2014 exceeded 2007 level
  - ✓Privatizations picked up momentum
  - ✓Investment in machinery & equipment up
- **A new Growth strategy based on 3 pillars: institutions, education, competitiveness**

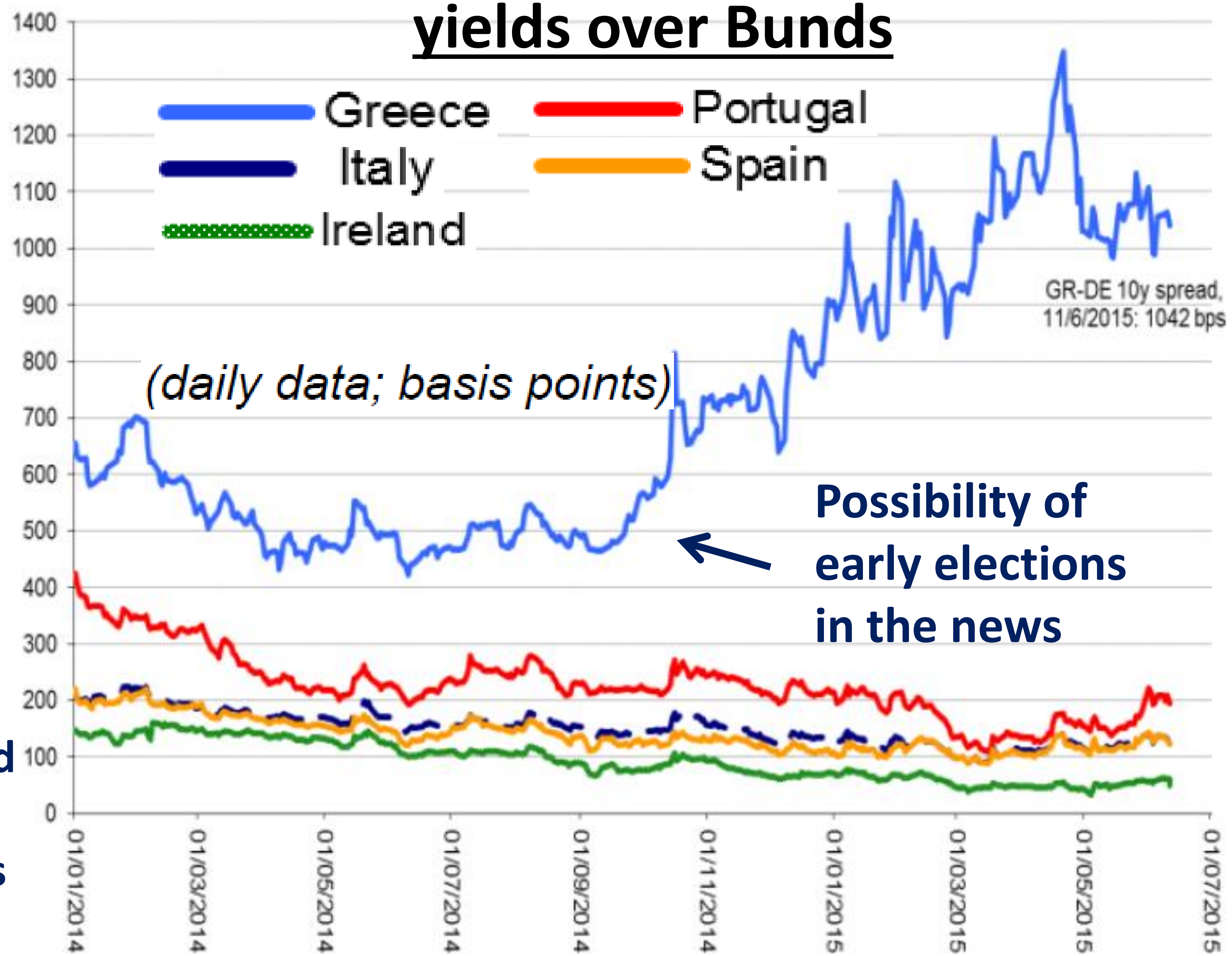




Yet decoupling since early October 2014

- Prospective presidential elections in 2015 Q1 gave power to the opposition parties to force governmental elections a year & a half early
- Since October, markets worried about it, with bond yields de-coupling from the rest of European yields
- De-coupling reduced consequences of GREXIT in the minds of hardliners

Spreads of 10-yr government bond yields over Bunds



Source: Thomson Reuters, Datastream

A brief look at the Adjustment Programme

- Programme had three major policy areas and was on its last leg in 2014Q4:
  - I. <u>Fiscal structural policies</u> (REMAINING REFORMS ON: tax, revenue administration, public spending, social security reform, public administration)
  - II. <u>Financial Stability</u> (REMAINING REFORMS ON: installment schemes, Non-Performing loans)
  - III. <u>Policies that Promote Growth</u> (REMAINING REFORMS ON: Privatizations, Labor market reforms, product market reforms, better business environment, reform of the judiciary, statistics)
- On February 24, 2015, the new Greek government begrudgingly applied for an extension of the adjustment program (received 4 months) and committed to specifically finish the above remaining reforms
  - IV. Government added "<u>Humanitarian crisis</u>" for domestic political product differentiation, yet was obliged to raise funds by own means

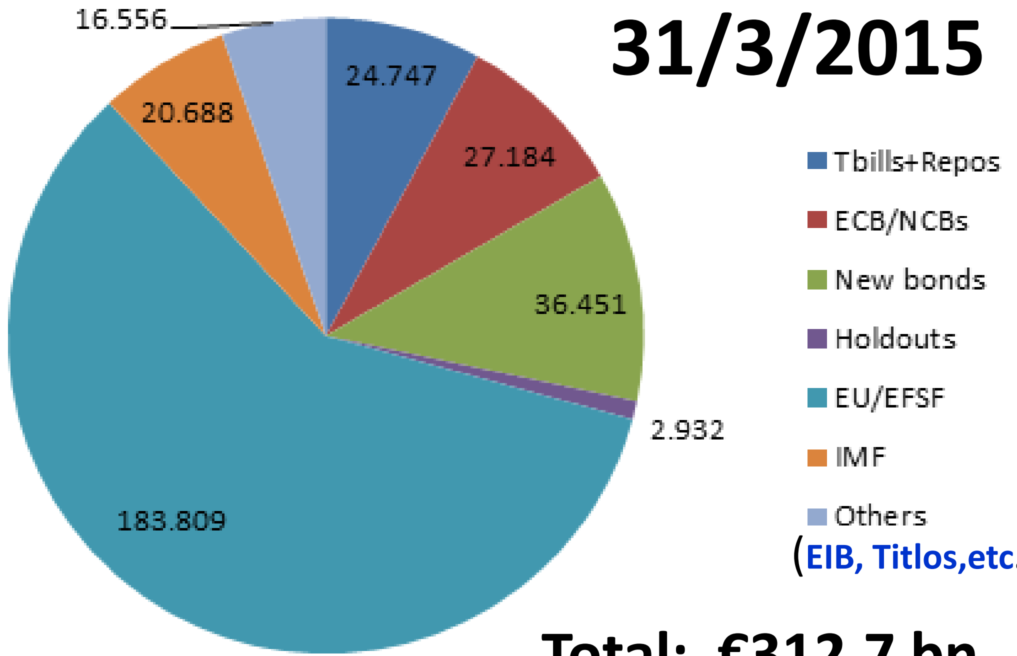
The recent five months: An enigmatic & procrastinating strategy

- New government's top priority at end -January 2015 was to reduce the size of **public debt**, instead of worrying about the foundations on which the economy is built - Yet size of debt is not of immediate concern
- Other enigmas:
  1) Did not understand that **loss of credibility and time** in closing the Review had immediate negative repercussions on the economy: Indifference?
  2) Disregarded the **need to bring cash** into the economy; "we do not need it" was the original statement of MinFin → **Arrears building** instead
  3) Did not behave **cooperatively** with the other Europeans, rather … insulting
  4) Abandoned the **European way of bargaining**, described as "working to earn gains without appearing of having broken any major rules or signatures"
  5) Treated the European side as if Europeans mainly worry about **CONTAGION**, as opposed to **Moral Hazard** , while the latter is thought by many hardliners to be more damaging to the long-run stability of EMU
  6) **Hesitancy** to address the issues and inaction were translated into the domestic political scenery as an act of **tough bargaining** → **further inaction**

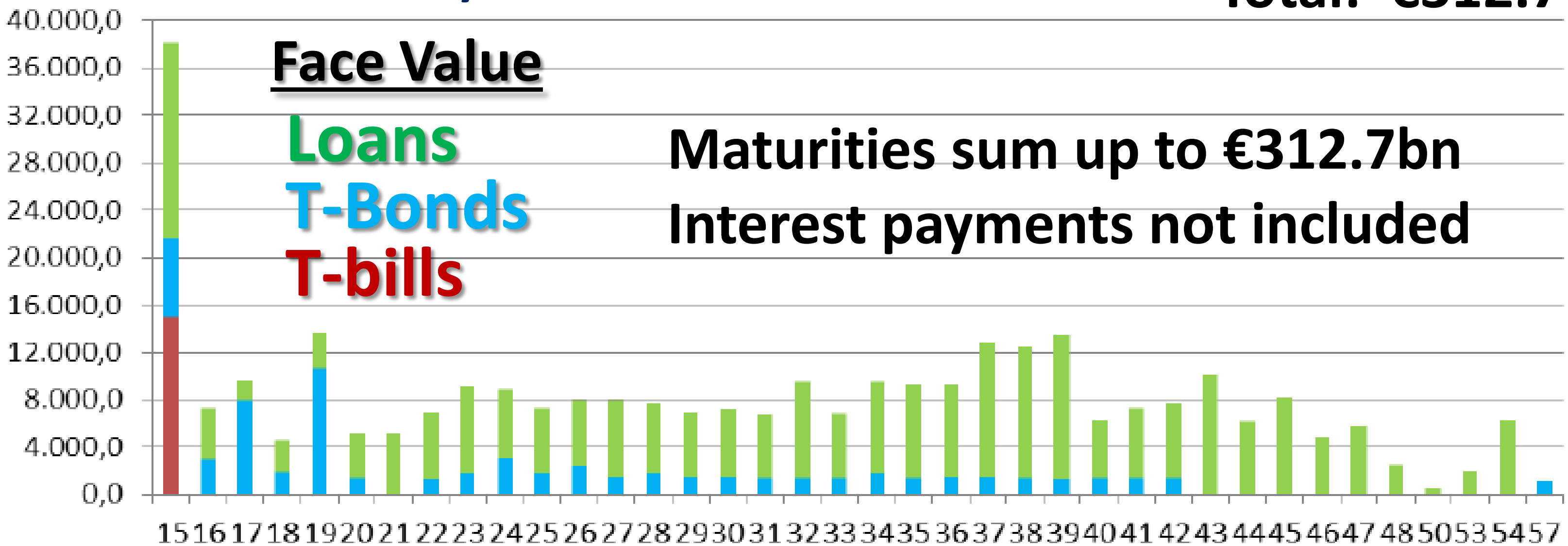
Greek Central Gov. Debt Composition

- EFSF loans worth €130.9bn or 42% of the total debt stock: Interest rate of 1.6%
- Greek Loan Facility (GLF) worth €52.9bn or 17% of the total stock: Interest rate of 0.7%
- Annual interest payments of ca. €5.5bn until 2022 with an extra ca. €1.5bn deferred
- Gen. Gov. debt smaller by ca. €8bn

31/3/2015



Total: €312.7 bn



Revised Debt Evolution as proposed by lenders' side on June 25

- Deterioration due to lower economic growth, lower fiscal surpluses, lower privatization revenues
- All Scenarios assume a new 3-year Programme with concessional financing
- Debt ratio would be higher if additional bank recapitalization required
- Scenario A assumes full implementation of reforms
- Scenario B has lower growth (0.5%) and privatization revenues
- Scenario C is the IMF baseline, the most pessimistic on privatizations

			2015	2020	2022	2030
	Debt to GDP ratio (%)	Scenario A	172.8	137.5	124.0	85.0
		Scenario B	174.3	146.5	135.0	100.9
		Scenario C	176.7	149.9	142.2	118.0
Assumptions*	Primary surplus (%GDP)	Scenario A	1.0	3.5	3.5	3.5
		Scenario B	1.0	3.5	3.5	3.5
		Scenario C	1.0	3.5	3.5	3.5
	Privatisation proceeds (€bn), cumulative	Scenario A	1.4	15.2	22.0	26.8
		Scenario B	0.4	9.2	16.0	20.8
		Scenario C	0.5	3.0	4.0	4.0
	Nominal GDP growth	Scenario A	-0.6	4.1	4.1	4.0
		Scenario B	-1.2	3.5	3.5	3.5
		Scenario C	-1.2	3.7	3.5	3.5
	Re-financing rates (%)	Scenario A	1.4	5.1	4.9	4.1
		Scenario B	1.4	5.4	5.2	4.7
		Scenario C	1.4	6.3	6.3	6.3

Ways to reduce the Present Value of Debt

Eurogroup statement (November 27th 2012):

*"Euro area Member States will consider further measures and assistance, including inter alia **lower co-financing in structural funds and/or further interest rate reduction of the Greek Loan Facility**, if necessary, for achieving a further credible and sustainable reduction of Greek debt-to-GDP ratio, when Greece reaches an annual primary surplus, as envisaged in the current MoU, conditional on full implementation of all conditions contained in the programme, rin order to ensure that by the end of the IMF programme in 2016, Greece can reach a debt-to-GDP ratio in that year of 175% and in 2020 of 124% of GDP, and in 2022 a debt-to-GDP ratio substantially lower than 110%."*

Suggestions

- ***Fixing interest rates***: The EFSF interest rate cost, currently at 1.6%, could be fixed for a period of 30-50 years (10 year EFSF rate currently close to 1%). The GLF interest rate should be fixed for a period of 10-15 years at current levels (0.7%+hedging cost) between 2015-2030.
- ***Maturity extensions*** EFSF and GLF loans can be extended to 50 years.
- ***Extension of the grace period for the EFSF interest deferral*** to, say, 2030 so that debt/GDP is below 80% - ***Forgiveness?***
- ***Sweetener Interest Rate Deferral:*** €96.1bn coming from the Master FAFA, €29.7bn from the PSI LM Facility (Sweetener) and €4.9bn from the Accrued Interest Facility → annual savings of €550 mn. - ***Forgiveness?***

The unfortunate June 22-28, 2015 events

- The Greek side managed to secure a lower primary surplus of 1% GDP for 2015, 2% for 2016, 3% for 2017, and 3.5% afterwards
- Despite the lower surplus, the downward revision in growth necessitated additional fiscal restrictions
- As of Monday morning, June 22 the Greek side had offered a proposal of fiscal restrictions worth ca. €8bn over 2015-2016, of which €6bn were for 2016 .
- Yet, 92% of the measures were tax increases, with some badly affecting competitiveness
- Lenders came back on Monday-Tuesday ,reallocating part the fiscal restriction to expenses as well, taking away the increase in SS contributions (1% of GDP) and insisting on reducing pensions instead
- Lenders did not offer any statement on a Debt reduction - in NPV terms, something the Greek PM needed to claim victory in the domestic political front
- On Friday, June 26 the Greek PM proposed a – quite vague - referendum for Sunday, July 5 and then on Saturday, the Greek Parliament ratified it
- On Sunday, June 28, after the ECB did not increase ELA, announcement of capital controls & a bank holiday that would last at least until Sunday, July 5

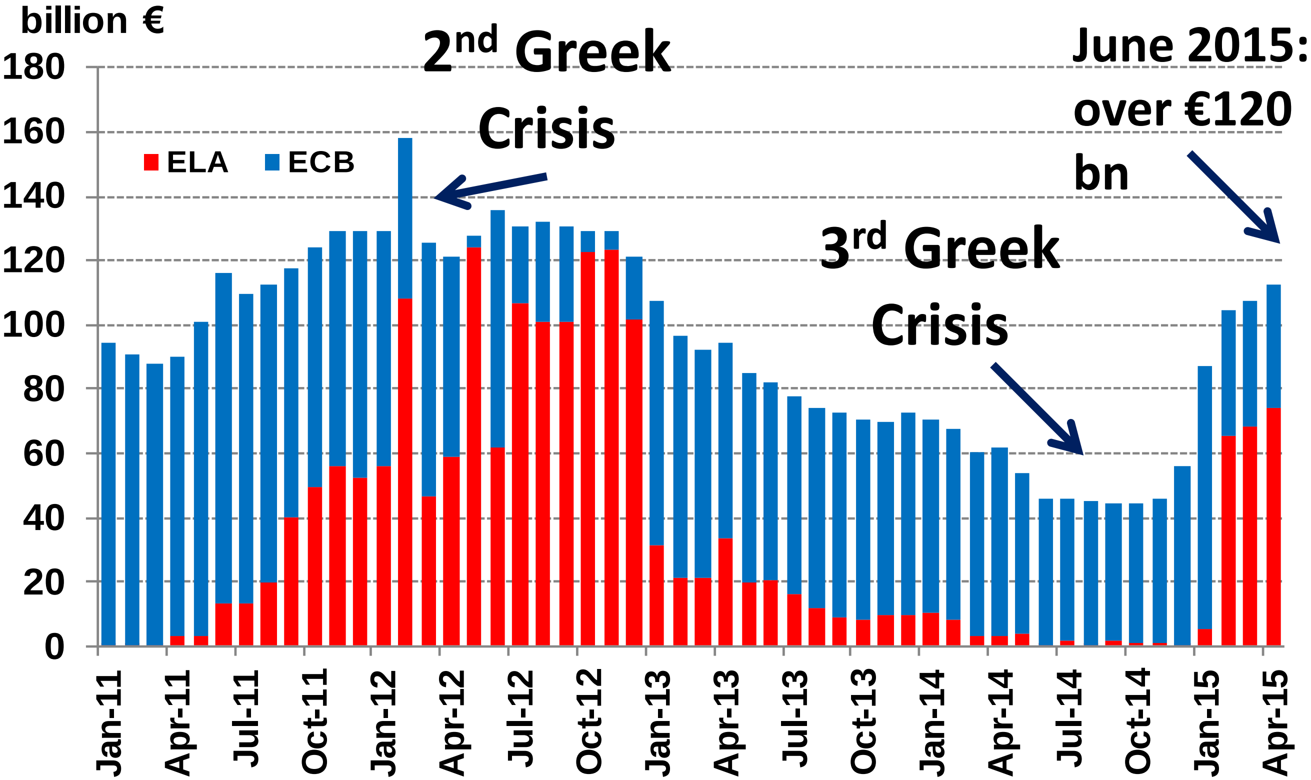
How much would capital controls bite?

1) It depends on how long they last and whom they primarily affect. Households will be less affected than SMEs, tourism, as well as exporters that depend on imported intermediate goods

2) In Cyprus, economy lost 6.5% GDP in 2013, lower than originally expected but estimates were based on the effects of the fiscal restriction and on wealth effects, not on capital controls. Would we witness a repetition of Cyprus? No

- CYPRUS COOPERATED WITH ITS LENDERS AND, DURING THE PERIOD OF CAPITAL CONTROLS, IT RECEIVED NEW LOANS, WHEREAS GREECE IS IN CONFRONTATION
- THE NEGATIVE WEALTH EFFECT IN CYPRUS WAS ABSORBED BY FOREIGNERS
- CYPRUS ISSUE WAS CENTERED AROUND BANKS & WAS UNANTICIPATED, WHEREAS GREEK ISSUE IS CENTERED AROUND SOVEREIGN DEFAULT, WIDELY ANTICIPATED, LEADING HOUSEHOLDS TO HOARD CASH (€45 BN)
  - CYPRUS BANKING IN EARLY 2013 WAS UNDERCAPITALISED, GREEK BANKING SYSTEM IS FULLY CAPITALIZED, HAVONG PASSED THE **AQR& STRESS TESTS** LAST OCTOBER
  - TWO CYPRIOT BANKS INSOLVENT (BoCY & LAIKI) → RESTRICTIONS BETWEEN BANKS
  - CYPRUS OVERSIGHT BY CENTRAL BANK AT THE TIME, GREEK SYSTEM IS NOW UNDER **SSM**
  - IN CYPRUS, PROVISIONS FOR CORPORATE TRANSACTIONS (A COMMITTEE WAS ESTABLISHED WITHIN THE CENTRAL BANK TO ADDRESS THE REQUESTS OF CORPORATES AND INDIVIDUALS TO SEND MONEY ABROAD)

Major Challenges in the Banking Sector



- Fear of GREXIT led to massive exodus of bank deposits& disappearance of inter-bank market, with costly borrowing from ELA and no access to QE. Today more than **half of bank lending financed by the Eurosystem**
- **Restriction of ELA** funding, which will happen without a Program, as quality of collateral deteriorates
- **NPLs** have <u>not</u> stabilized, likely to **<u>increase</u>** if capital controls persist
- SSM thinks of disallowing **DTA**, which is ca. half of Core Tier I capital

What does the future look like?

- **Recession/Depression underway,**
  - If review closes soon, in the order of **-1%** or larger for 2015 perhaps continuing with less force into 2016
  - If review closes in 2 months, easily at **-4%**
  - **If review never closes, a depression of immense proportions**
  - No longer sure that Net Exports of goods & services would increase in 2015, that would have provided a cushion to the recession, as they are constrained by capital controls, by lack of cheap bank financing and an unflattering Greek image abroad
  - Forget Investment, likely to start declining again as sentiment deteriorates, public investment collapses, and uncertainty continues
- Yet is there a chance for a **reversal in economic growth** in the **intermediate & long-run**?
  - Will Greece stay in the Euro Area?
  - Will productivity-enhancing reforms continue or reverse?