LBS Conference on May 18-19, 2015

"GREECE: SEEKING A WAY FORWARD"

Session 1: **Setting the Agenda: Lessons, Successes and Mistakes; Macroeconomic Considerations**

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Discussion:

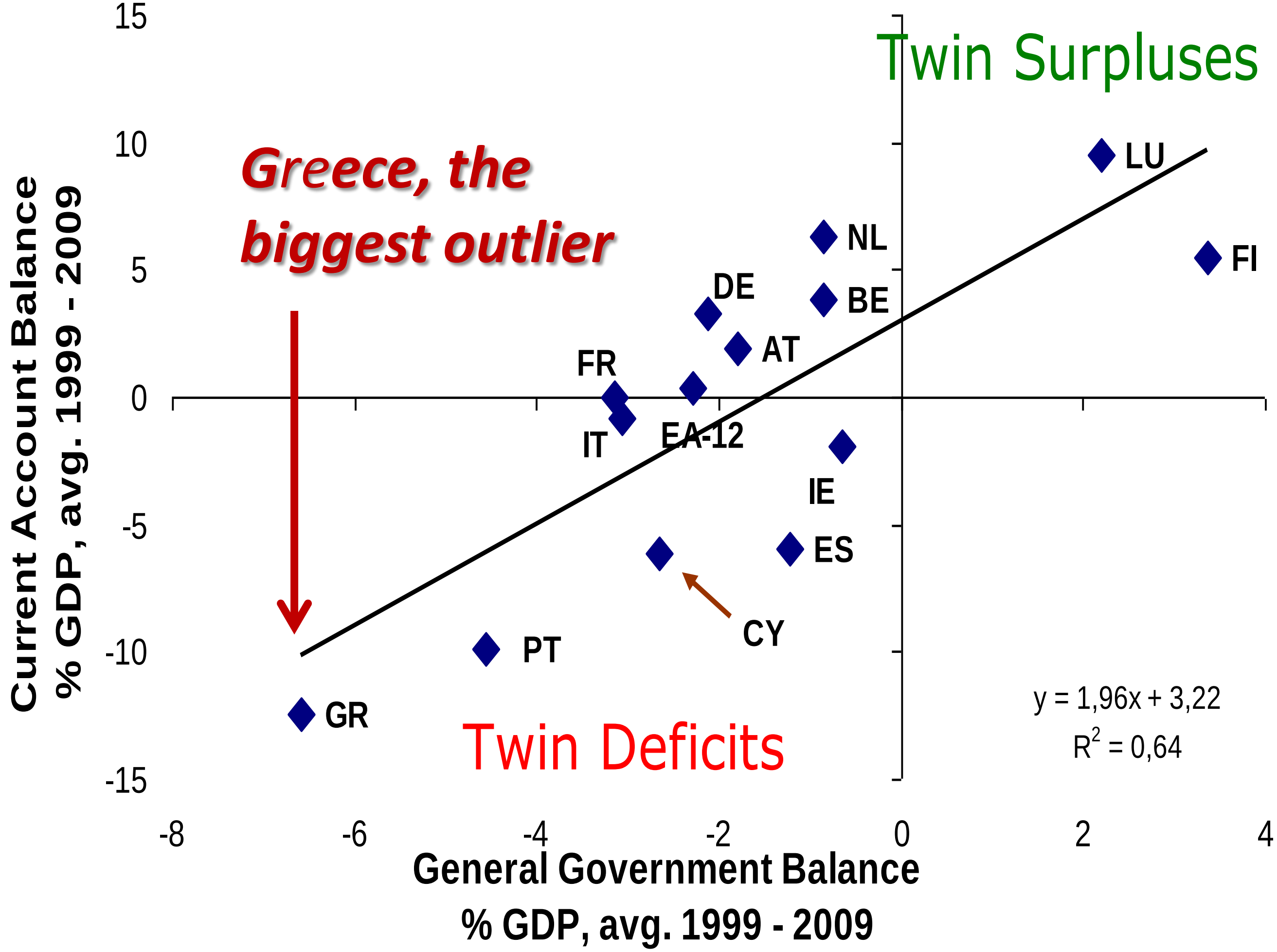
"Yet we were so close … for a major economic take-off!"

Why such a huge recession until 2014?

1) Initial macroeconomic imbalances worse than elsewhere in EA
2) Structure of economy substantially different:
   a. More closed economy than in other EA countries, with consumption a very large fraction of GDP
   b. Activity dominated by small firms and self-employed labor with a big underground economy – oligarchs do play a role
   c. Inefficient public administration, legacy of unstable tax policies, major bureaucratic hurdles in doing business, lack of level-playing field, closed professions, lack of flexibility
3) Hence fiscal multiplier was underestimated, particularly in an environment of a simultaneous drastic contraction in credit supply
4) Lack of political consensus led to lack of Ownership of the Program
5) Ability of public administration to implement reforms overestimated
6) Export performance disappointed
7) Wrong sequencing of reforms, initial inexperience in handling similar crises plus negative external macroeconomic environment

Serious macroeconomic imbalances prior to the crisis

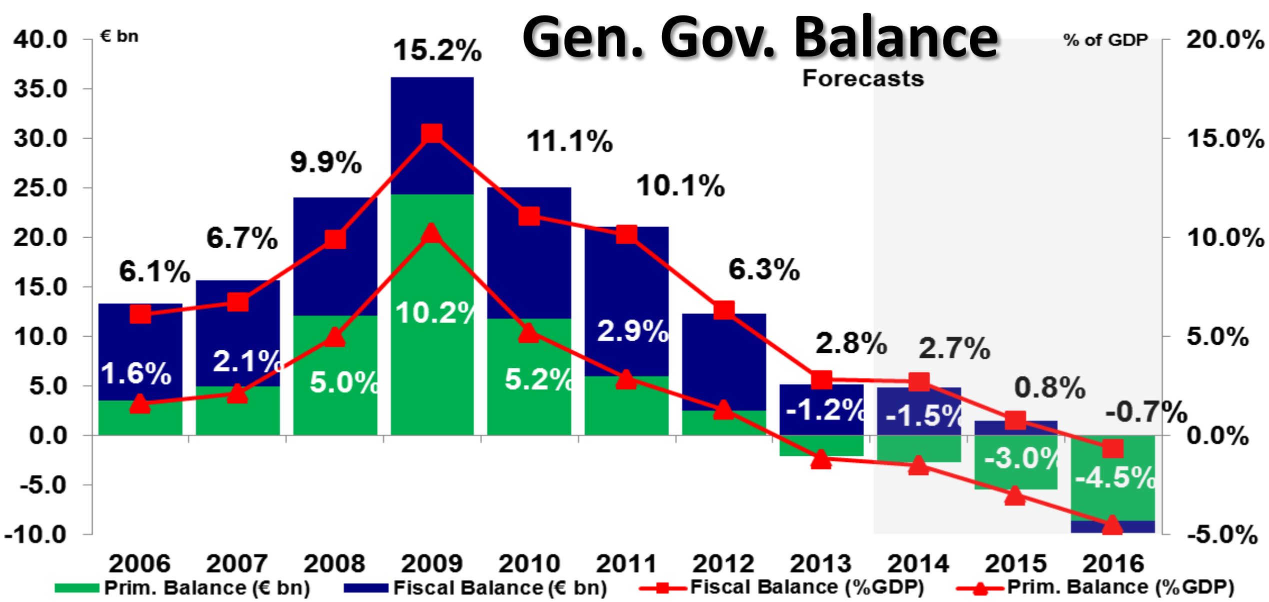
- ***Besides the fiscal & external imbalances, there is a serious pension system imbalance***
- ***On the other hand, private debt not as serious as in other EA countries***
- ***The current account imbalance reflects deeper competitiveness problems, not yet cured***

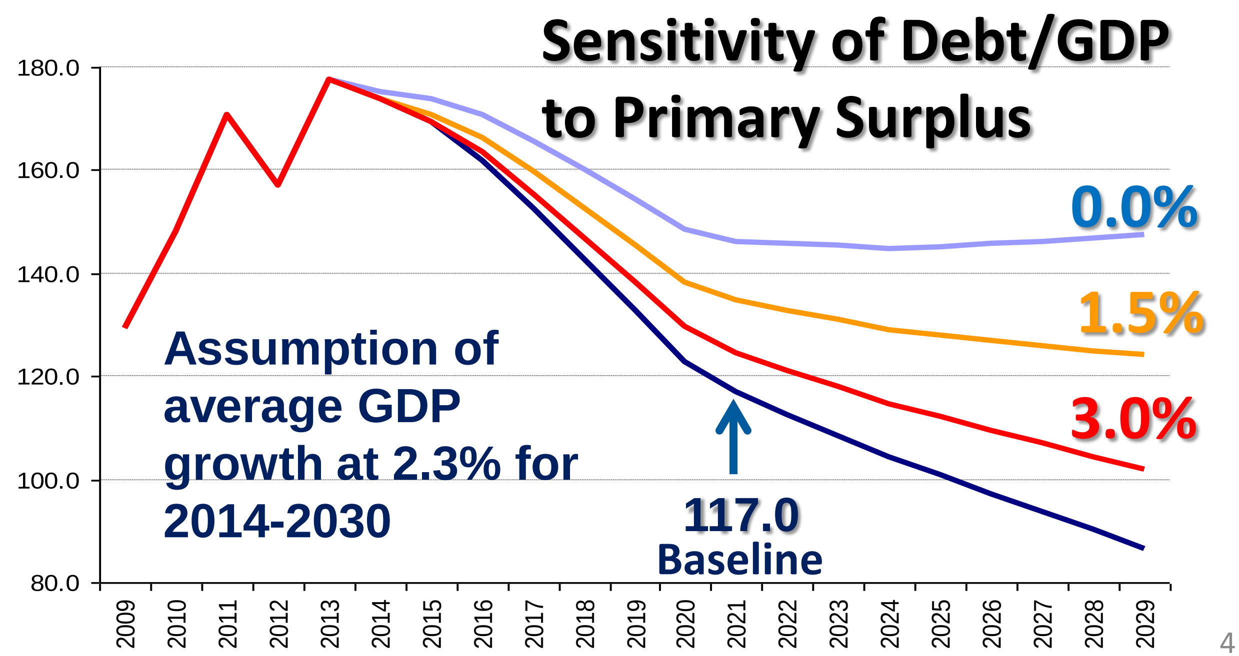


Source: European Commission

State of Play prior to January elections

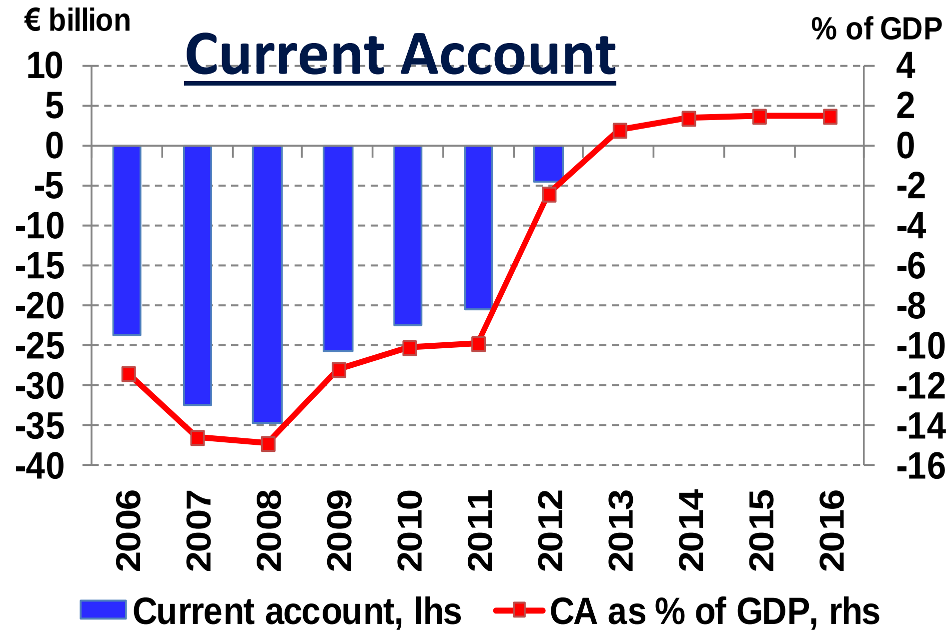
- **Enormous fiscal consolidation since 2009** when Gen. government expenses were **€128.2 bn** and Gen. government revenues **€91.9 bn**. In the budget of 2015, the corresponding expenses and revenues were both projected at **≈€80bn.**
- **Debt sustainability on track**, Average Maturity from 6 years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

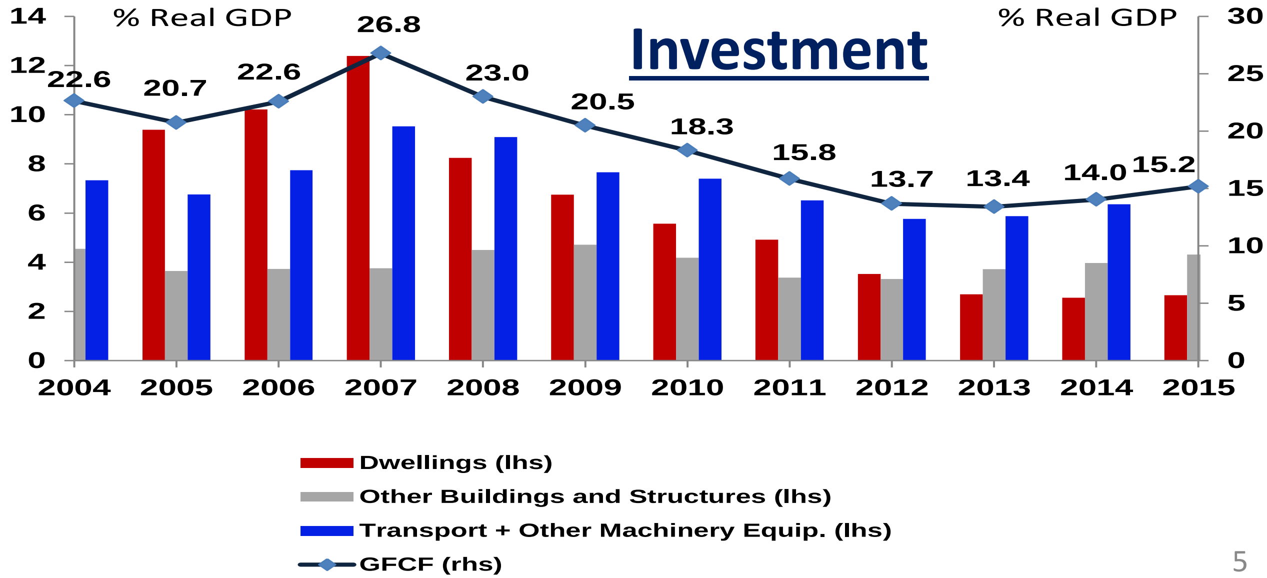




State of Play at the End of 2014

- **Foundations of an extrovert and competitive economy via reforms:**
  - ✓Competitiveness rankings↑
  - ✓Current account in surplus after years of deficits, yet exports still anemic
  - ✓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**





We were close, yet far

- The Greek economy stabilized in 2014 , with its major imbalances gone. Productivity-enhancing reforms we set at center stage.   And the country was ready for a major take-off in 2015.
- Yet, it took just 4 months of inaction, confusion, attempts to reverse reforms , and a lot of cheap bravado talk to generate uncertainty and fear of the future. The new current recession is self induced.
- An this happens at a time of European positive growth, as lower oil prices, a weakening euro and QE are pushing Europe forward.
- There is a pessimistic and an optimistic reading of the immediate future:
    A. The pessimistic envisages capital controls, a further drop in economic activity and even a possible separation from the EU with a drastic fall in living standards
    B. The optimistic envisages a muddle through and economic stagnation for a while, yet a subsequent new beginning free of illusions and ideology with productivity -enhancing reforms being a top priority.

APPENDIX

The Adjustment Programme and remaining reforms

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

Economics & politics since January: An enigmatic 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 debt is not of immediate concern
- Other enigmas:
  1) Disregard of the need to bring cash into the economy; "we do not need it" was the original statement of MinFin. Arrears building.
  2) Did not behave cooperatively with the other Europeans
  3) Brushed away issues of moral hazard. Should have tried to gain perks without appearing of having broken any major rules or signatures
  4) Treated the European side as if Europeans worry about CONTAGION, which they do not necessarily. Yet GREXIT may be caused by accident even if other European countries think that a Greek departure is not beneficial to the long-run stability of EMU
  5) Overall strategy confused . Refusal to address the issues was sold to the domestic clientele as being tough bargainers . Inactivity for a long time and now the cash is running out

Challenges as of May 2015

Huge challenges before the Review can come to a close:

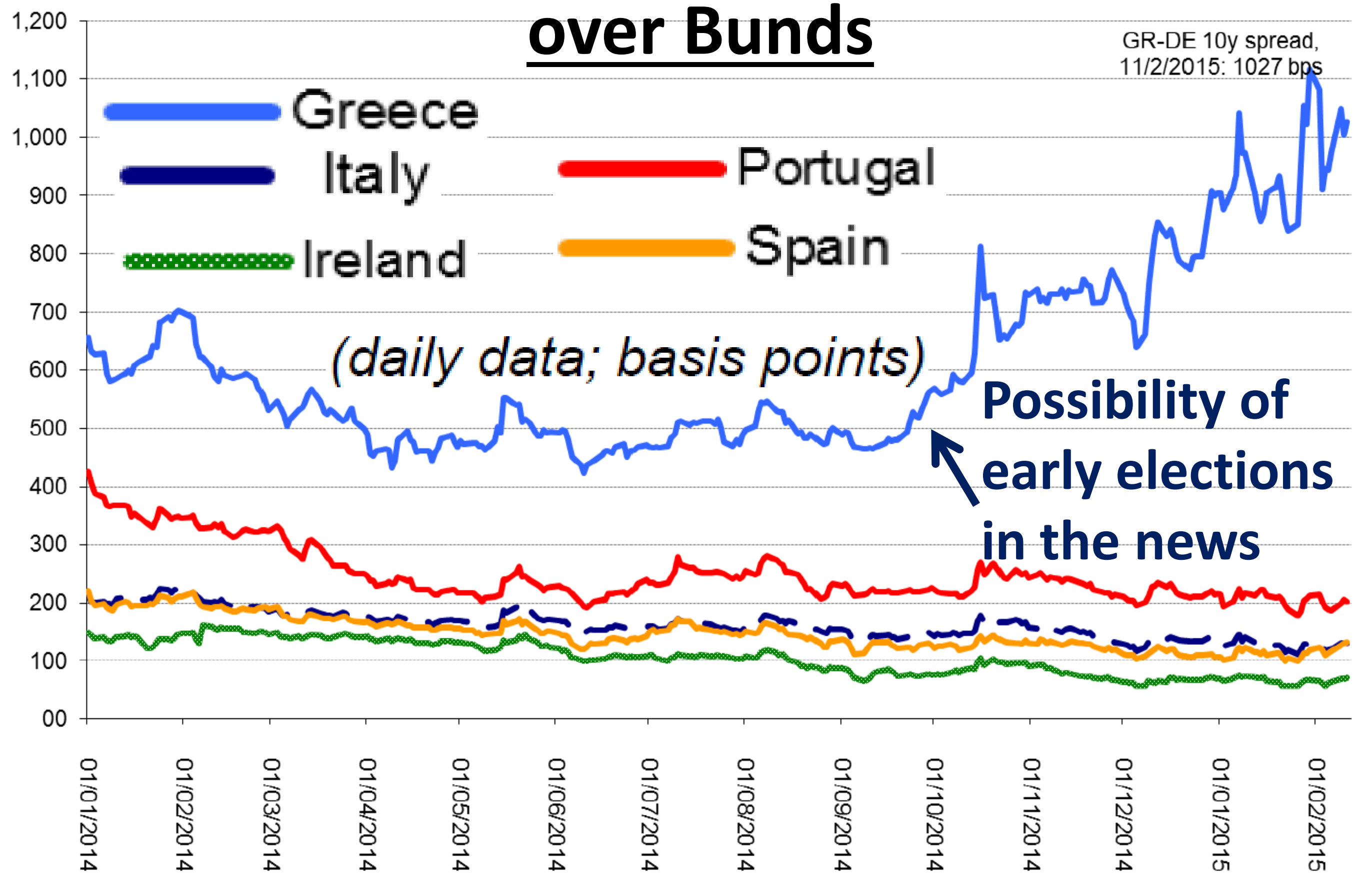
- ❑ **Liquidity squeeze** on the public sector is onerous. Even T-bill issuance is difficult as no foreigner shows up to roll-over their past T-bills. Inability to pay foreigners in July & August, and perhaps earlier.
- ❑ **Banking sector fragile**
  - as fear of GREXIT led to massive exodus of bank deposits and disappearance of interbank market, with costly borrowing from ELA and no access to QE. E.g. half of bank lending financed by the Eurosystem
  - NPLs have not stabilized and Government lost control of €11.4bn of EFSF
- ❑ **Recession underway**, makes primary surplus target extremely difficult to attain even if it comes down to 1.5% of GDP from 3%. Already, in November 2014, the lenders claimed there was a €2.6bn fiscal gap in 2015 even under the assumption of 2.9% growth
- ❑ **Obstacles in Exports** & Private sector companies are on the verge of collapse, with a weak banking sector unable to help
- ❑ **Economic sentiment** declines

LONG-RUN CHALLENGE: WILL PRODUCTIVITY-ENHANCING REFORMS CONTINUE OR REVERSE?

Economics & politics today: Decoupling since early October 2014

- Prospective presi-dential 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

Spreads of 10-yr government bond yields over Bunds



Source: Thomson Reuters, Datastream