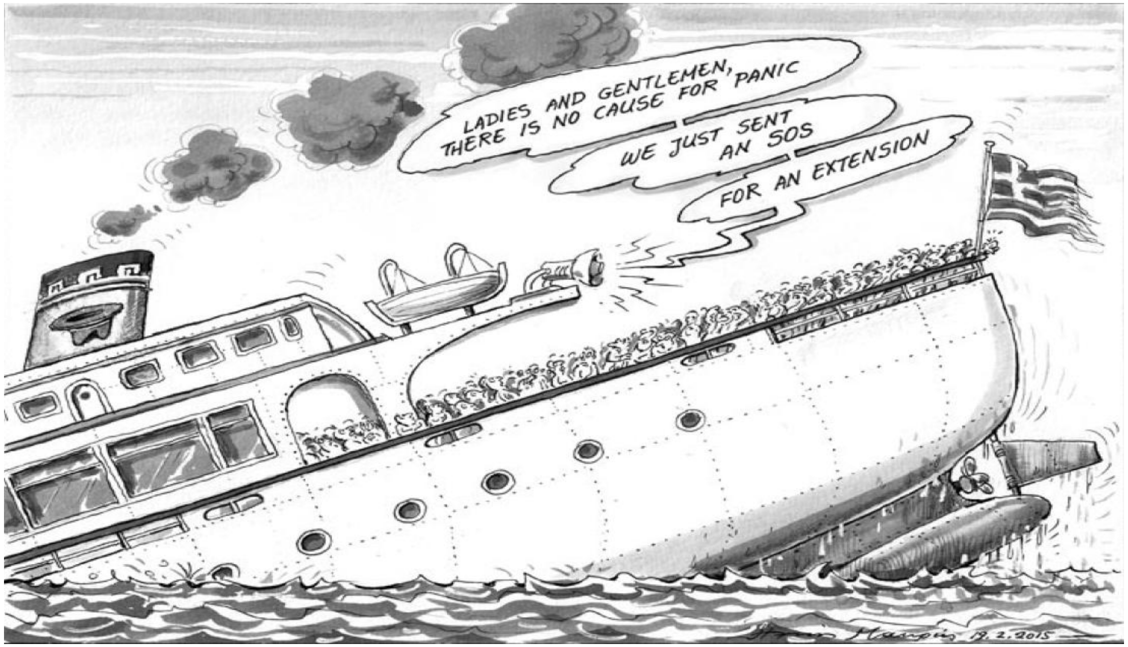
# ECONOMIC DISTRESS INSIDE THE MONETARY UNION:

## Post-election risks of the Greek economy

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Larnaca, MFS Spring Conference,
April 18, 2015

# ECONOMIC DISTRESS INSIDE THE MONETARY UNION: Post-election risks of the Greek economy

I. Introduction

II. The state of play at the end of 2014

III. An enigmatic policy strategy following the January 2015 elections

IV. Will the Review of the 2$^{nd}$ Economic Adjustment Program close on time?

V. Conclusion

# I. Introduction

- Greece at the epicenter of world media attention
- Possibility of default has a negative effect on economy: business prospects, exports, FDI, privatizations, investment, economic sentiment, bond yields, stock prices, bank deposits
- Few months ago, a positive 2015 growth forecast of 2.9%; Yet now most analysts worry of a recession, e.g. S&P forecasts -1.5% growth in 2015
- Current disarray is self induced: Pre-election promises are counter to the reform agenda the country signed up to follow
- This created long delays, hence anticipated funds of 7.2bn euros are missing from the economy
- The longer the delay, the faster credibility is lost, the faster the economy slides into recession

# II. State of Play at the End of 2014

- Enormous fiscal consolidation since 2009
- Debt sustainability on track
- Foundations of an extrovert and competitive economy via a set of reforms
  - ✓ Evidenced by all types of country rankings
  - ✓ Current account in surplus after years of deficits
  - ✓ 2014 growth of 0.7%, after a cumulative drop of ca 26% since 2008
  - ✓ FDI in 2013 and 2014 exceeded the 2007 level
  - ✓ Privatizations picked up momentum
  - ✓ Investment in machinery & equipment positive
- A new Growth strategy was designed based on three pillars
- Out of the MoU, into ECCL with Euro Area and a pre-cautionary agreement with the IMF

# III. An enigmatic Strategy

- New government took office having as a top priority 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
  2) Slow response in decision making and lots of cheap talk. The lack of cash caused the creation of arrears and a crowding out of the private sector. Hence economic stagnation
  3) Overall strategy unclear and confused. Did not behave cooperatively, but rather insulting to the other Europeans
  4) Brushed away issues of moral hazard. Should have tried to gain perks without appearing of having broken any major rules or signatures
  5) Treated the European side as if Europeans worry about CONTAGION, which they do not. 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

# IV. Will the Review close on Time?

- On February 24, 2015 the Government signed a 4-month extension of the 2nd Adjustment Program (the earlier MoU) & double promised explicitly actions on a number of policy areas:
  I. Fiscal structural policies (tax, revenue administration, public spending, social security reform, public administration)
  II. Financial Stability (installment schemes, Non-Performing loans)
  III. Policies that Promote Growth (Privatizations, Labor market reforms, product market reforms, better business environment, reform of the judiciary, statistics)
  IV. Humanitarian Crisis (Guaranteed Minimum Income Scheme, policies to deal with absolute poverty that have no negative fiscal impact)
- A stalemate followed, with a jump-start occurring after PM visit to Brussels & Berlin
- Meanwhile Budget execution becomes more difficult and Lenders are pushing on pension reform, on VAT reform, on collective dismissals, on privatizations, etc.

# IV. Will the Review close on Time?

**Huge challenges before the Review can close:**

1) Drop in growth makes primary surplus target extremely difficult to attain even if it comes down to 1.5% of GDP from 3%. In November the lenders claimed there was a €2.6bn fiscal gap under the assumption of 2.9% growth.
2) 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
3) NPLs have not stabilized and Government lost control of €11.4bn of EFSF
4) Exports are difficult to materialize as demand shrinks and obstacles rise
5) Private sector companies are on the verge of collapse, with a weak banking sector unable to help
6) Economic sentiment declines drastically
7) 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.

# V. Conclusion

- **Lower oil prices, a weakening euro and QE are pushing Europe into strong growth trajectory in 2015. Also, prudent policies have helped Ireland, Portugal and soon Cyprus to get out of the strict EU surveillance.**
- **Yet, only one country follows its own lonely negative trajectory: Greece. Because of its inability to face reality. It took just 3 months of contradictory statements, ambiguity, bravado statements, media manipulation, ideological stereotypes, and lack of action, to almost destroy the efforts and pain of five years.**
- **There is a pessimistic and an optimistic reading of the future:**
  - **A. The pessimistic envisages capital controls, a further drop in economic activity and even a possible separation from the EU**
  - **B. <u>The optimistic is my baseline scenario</u>. It envisages a muddle through and economic stagnation for a while, yet a subsequent new beginning free of illusions and ideology. It assumes a new maturity among the full spectrum of Greek political parties, which is enforced on the politicians by the citizens, who are more rational than is assumed.**

# THANK YOU FOR YOUR ATTENTION

# APPENDIX

APP.

# A BIRD EYE VIEW ON GREECE

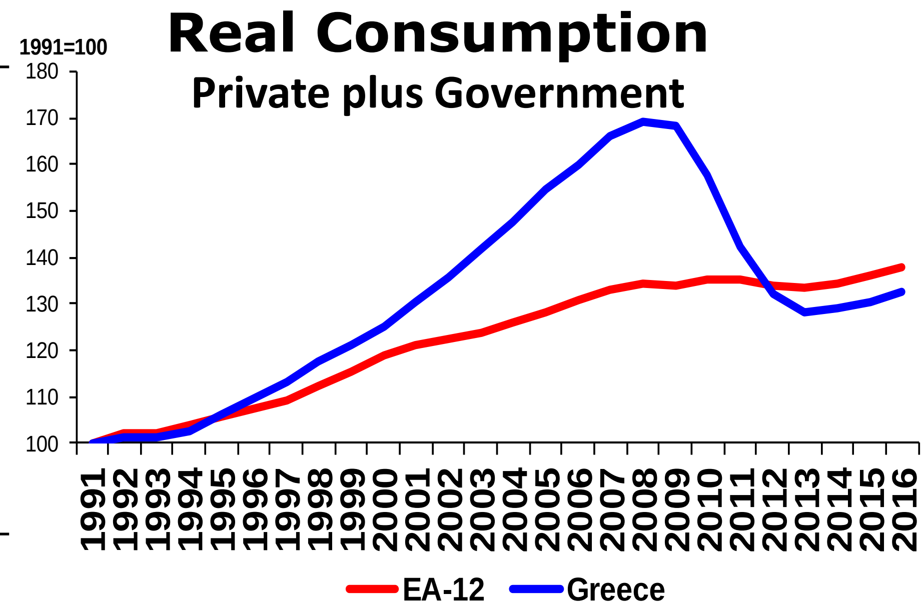
| 2012 | Greece | EA17 | World |
|---|---|---|---|
| Population (mil.) | 11.3 | 333.5 | 7,056.7 |
| Geographical Area (thousand $km^2$) | 132.0 | 2,624.0 | 148,940 |
| GDP per capita (€) | 17,146 | 28,460 | 9,729.1 |
| Human Development Index (2011 UN ranking among 194 countries) | 29 | | |
| Life expectancy (years) | 80.0 | 79.8 (EU-27) | 71.2 |
| Motor vehicles per 1000 inhabitants (2010) | 624 | 593 | 175 |
| Suicides / 100 thousand inhabitants (2010) | 2.9 | 9.1 | |
| Primary Sector (% GDP) | 3.4 | 1.8 | 4.3 |
| Secondary Sector (% GDP) | 16.4 | 25.2 | 29.3 |
| Tertiary Sector (% GDP) | 80.2 | 73.1 | 66.4 |
| Tourism (Total contribution, % GDP) | 16.4 | 8.3 (EU-27) | 9.2 |
| Construction (% GDP) | 2.1 | 5.9 | |
| Public Sector (Prim. Gen. Gov. Exp. % GDP) | 45.4 | 46.7 | |
| Exports (% GDP) | 27.2 | 45.8 | |
| Imports (% GDP) | 32.1 | 43.1 | |
| Private Consumption (% GDP) | 74.6 | 57.5 | |
| Gen. Gov. Debt (% GDP) | 161.6 | 93.1 | |

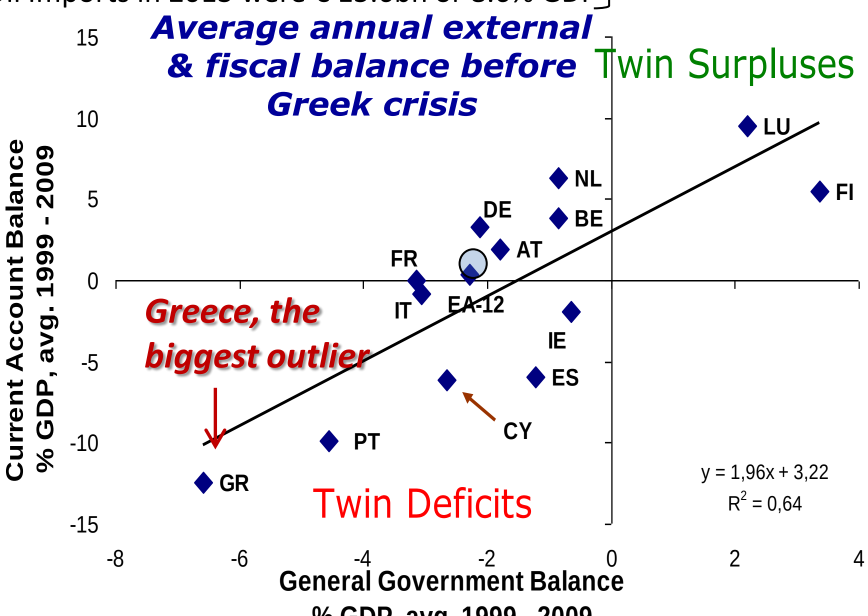
# APP. GREEK GROWTH MODEL, REQUIREMENT #1: NEED TO CORRECT THE DISEQULIBRIA

| 2013 SHARE in nom. GDP | Greece | EA18 |
|---|---|---|
| Private consumption | 71.2% | 56.0% |
| Public consumption | 20.0% | 21.1% |
| Gross Fixed Capital Formation | 11.2% | 17.7% |
| Exports | 30.2% | 43.8% |
| Imports | 33.2% | 40.4% |

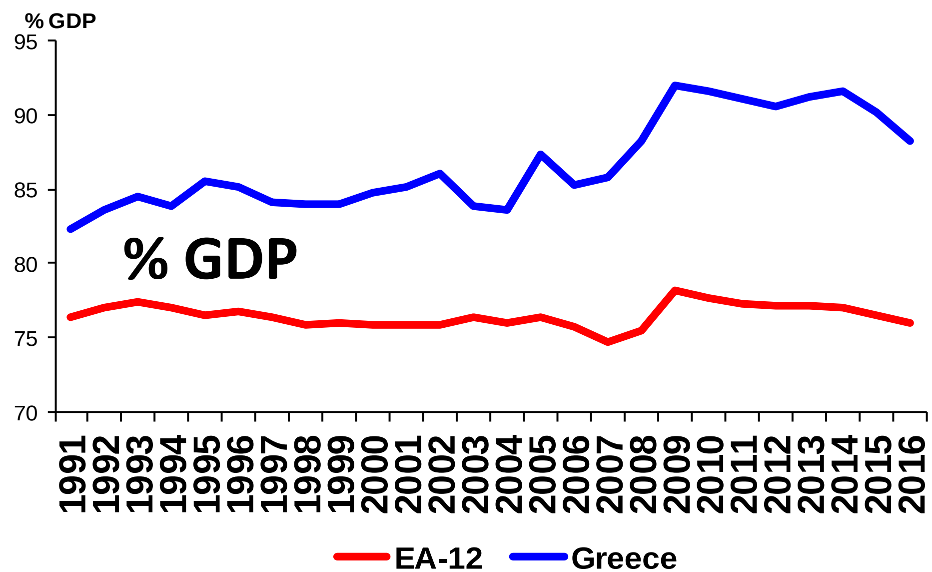
Source: European Commission

Oil Exports in 2013 were € 7.9bn or 4.3% GDP
Oil Imports in 2013 were € 15.6bn or 8.6% GDP
BoG data




Source: European Commission




Source: European Commission

# APP. GREEK GROWTH MODEL, REQUIREMENT #2: CONSUMPTION SHOULD GROW TOO, BUT AT A LOWER RATE

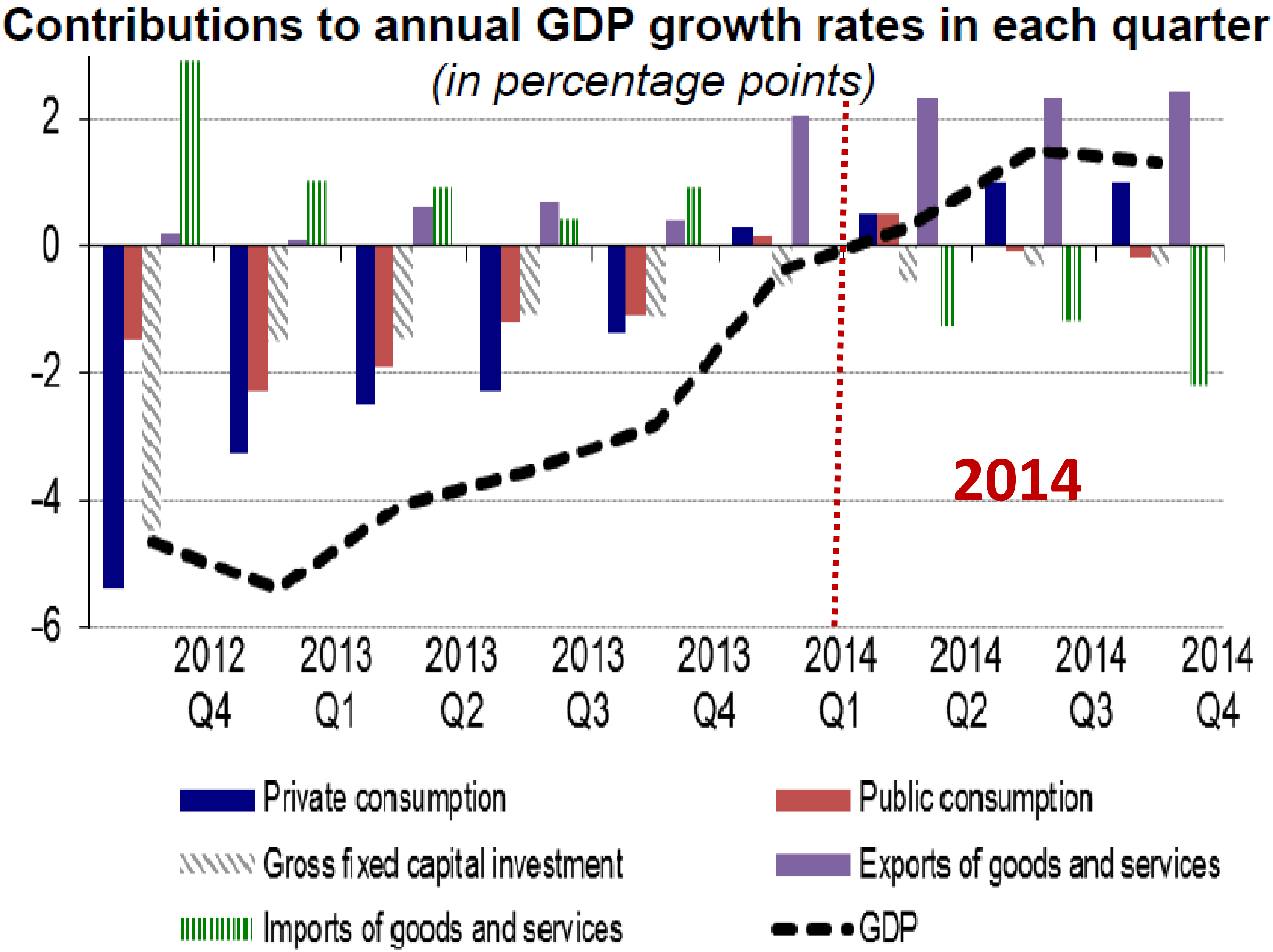
- ✓ **THE GROWTH MODEL**: In the future, consumption should grow at rates lower than investment & exports
- ✓ In 2014, model requirement #2 began taking hold: Consumption improved, investment stabilized & exports picked up momentum
- ✓ **The short and long-term growth paths are inter-linked**: If expansion gains momentum, capital & labor inputs improve, raising potential growth

Old Forecasts

| | 2013 Share in Nom. GDP | 2014 growth Real | 2015 growth Real |
|---|---|---|---|
| Private Consumption | 71.2% | +1.4% | +1.7% |
| Government Consumption | 20.0% | -1.1% | -0.9% |
| Tot. Consumption | 91.2% | +0.8% | +1.1% |
| GFCF | 11.2% | +0.8% | +8.4% |
| Domestic Demand | 102.4% | +0.8% | +1.9% |
| Imports | 33.2% | +4.7% | +4.0% |
| Exports | 30.2% | +8.0% | +5.6% |
| GDP (nominal, € bn) | 182.4 | | |
| Real GDP | | +1.0% | +2.5% |
| GDP deflator | | -2.2% | -0.2% |
| Unemployment (avg) | | 26.6% | 25.0% |

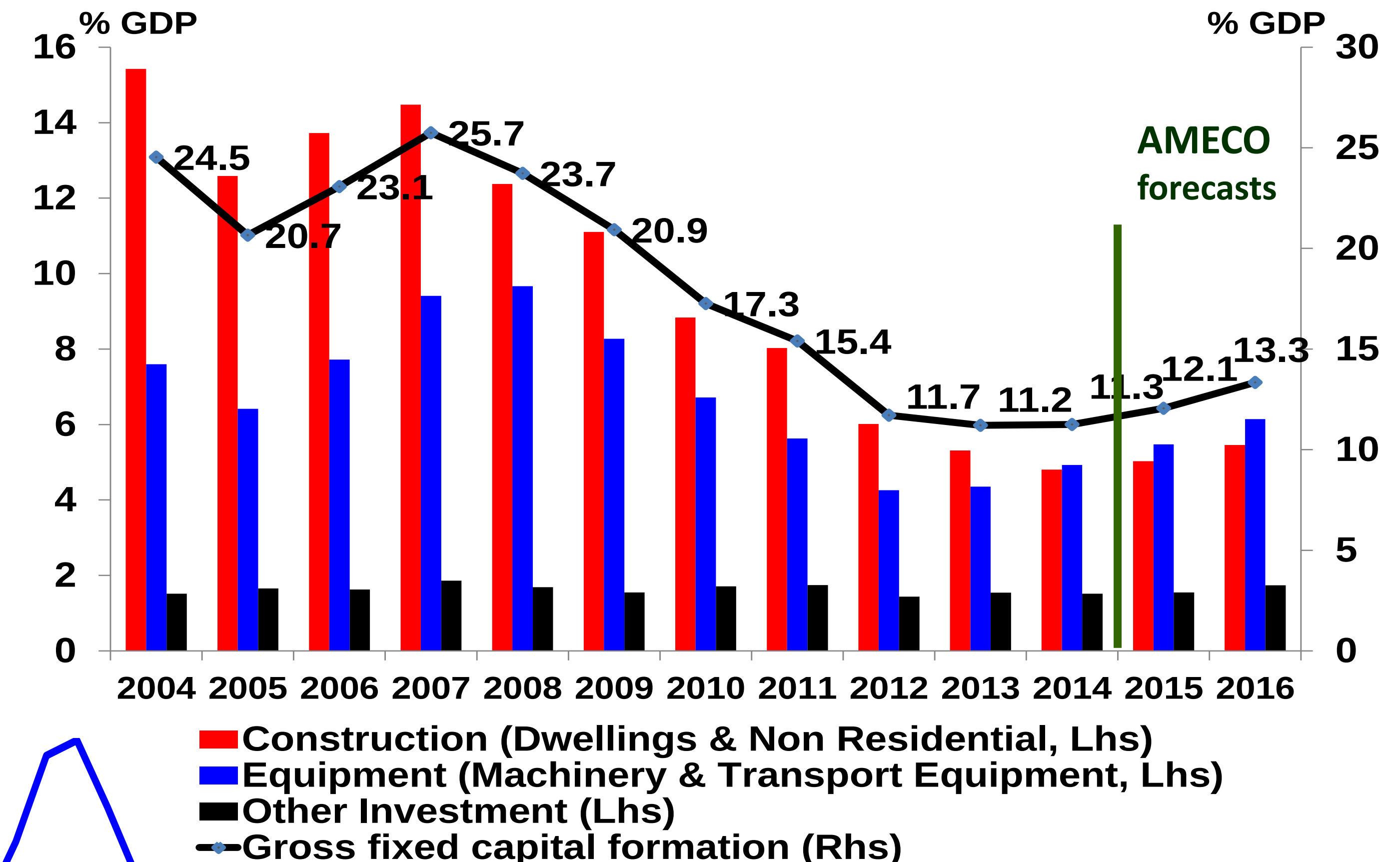
Source: European Commission

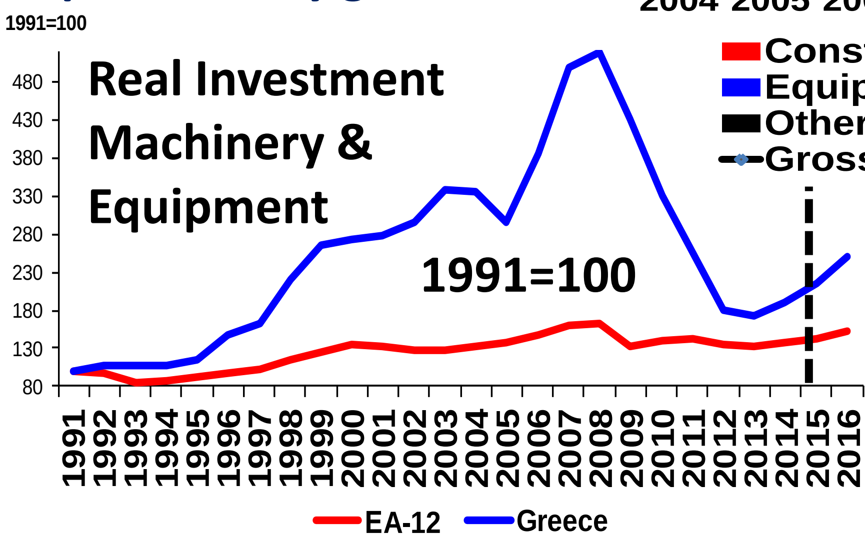
# APP. RECESSION STOPS IN 2014



# APP. GREEK ECONOMY – EARLIER GOOD NEWS

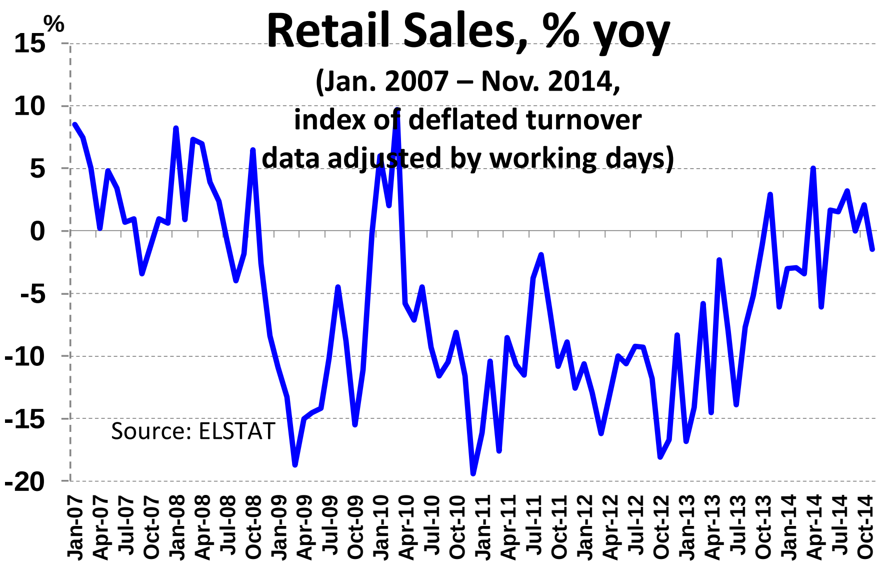
- ✓ In 2013 & 2014, investment in machinery & equipment improved
- ✓ Machinery & equipment embody technological change, preserve potential for productivity growth

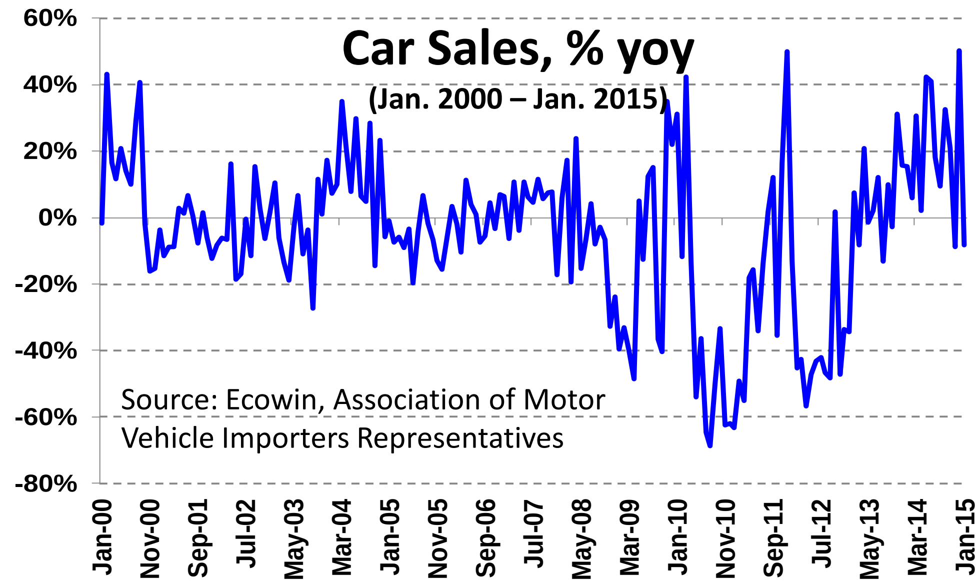


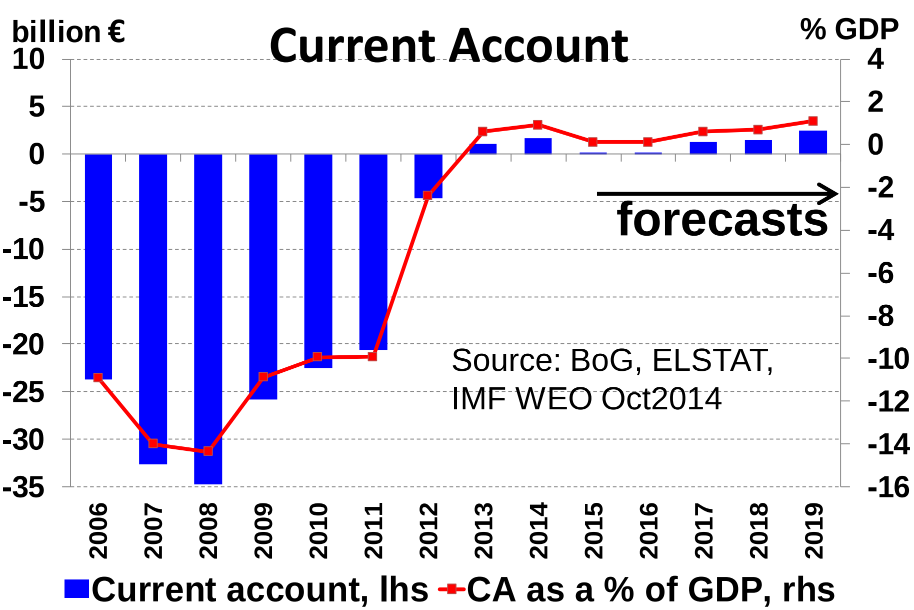



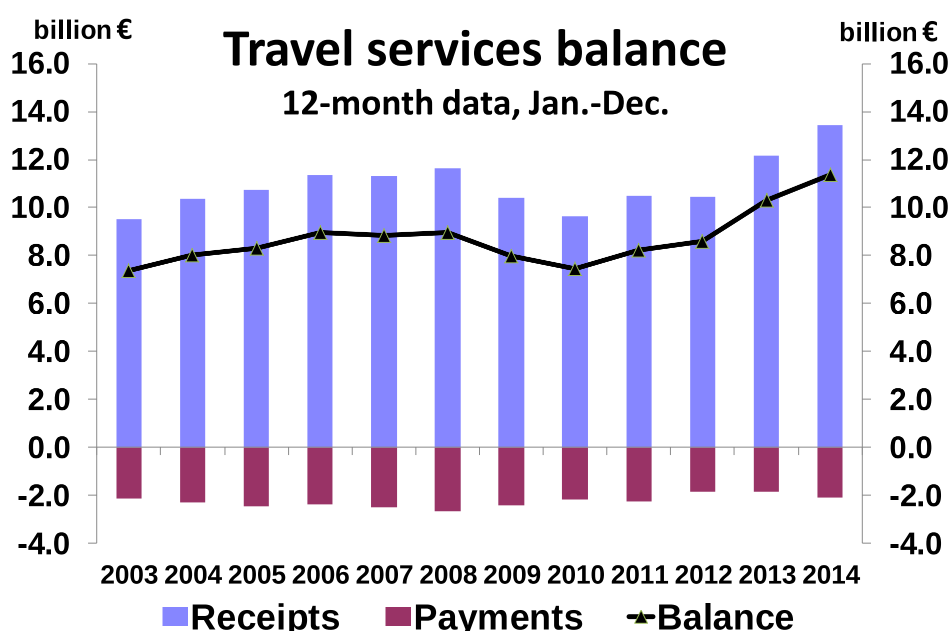

Source: European Commission,
AMECO Database

# APP. GREEK ECONOMY – EARLIER GOOD NEWS



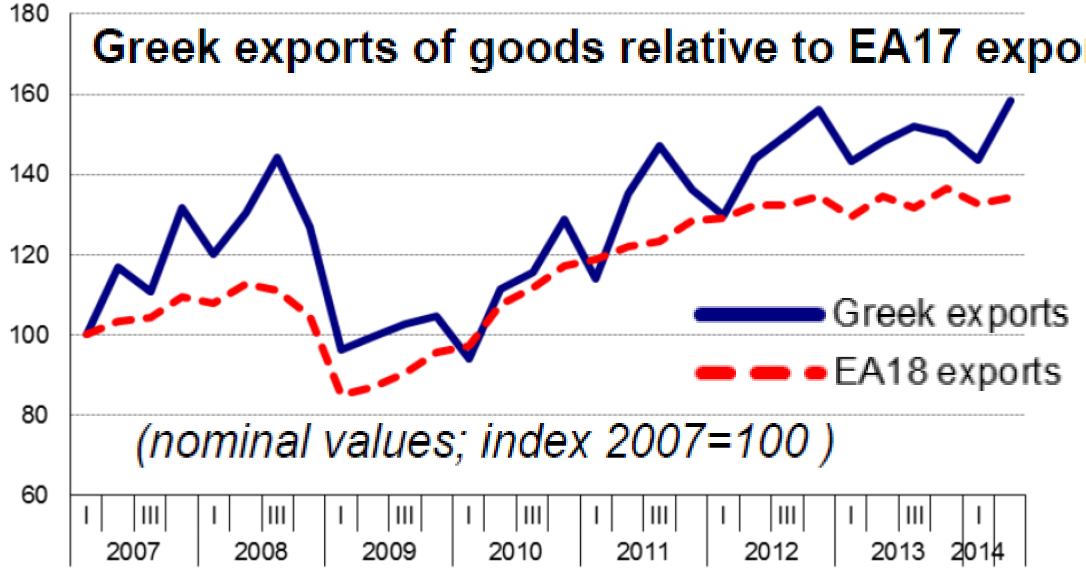




Source: Bank of Greece

# APP. EARLIER FORECASTS OF POSITIVE GROWTH




✓Exports of goods are the weakest component of GDP growth, but ok

**Source:** Bank of Greece (BoP statistics) ECB (BoP statistics for the euro area)

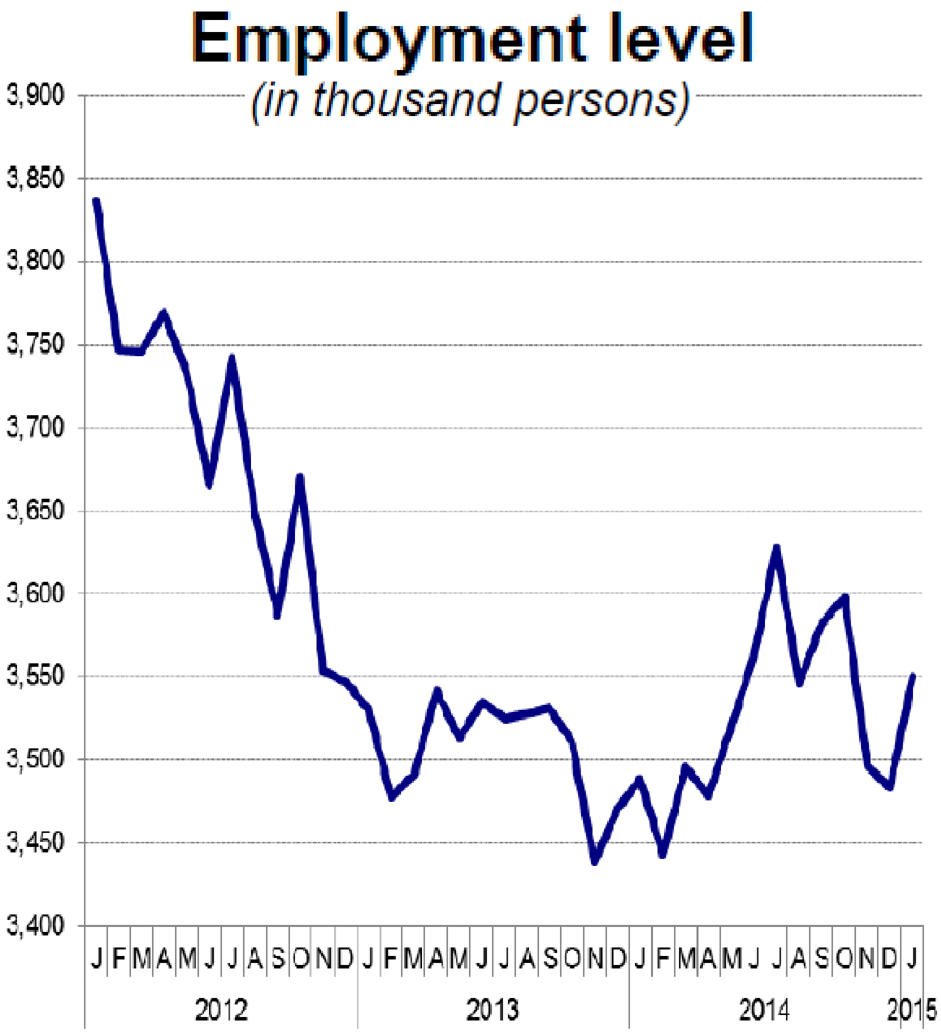
✓ **2015 GDP growth forecasts are old, hence over-estimates**

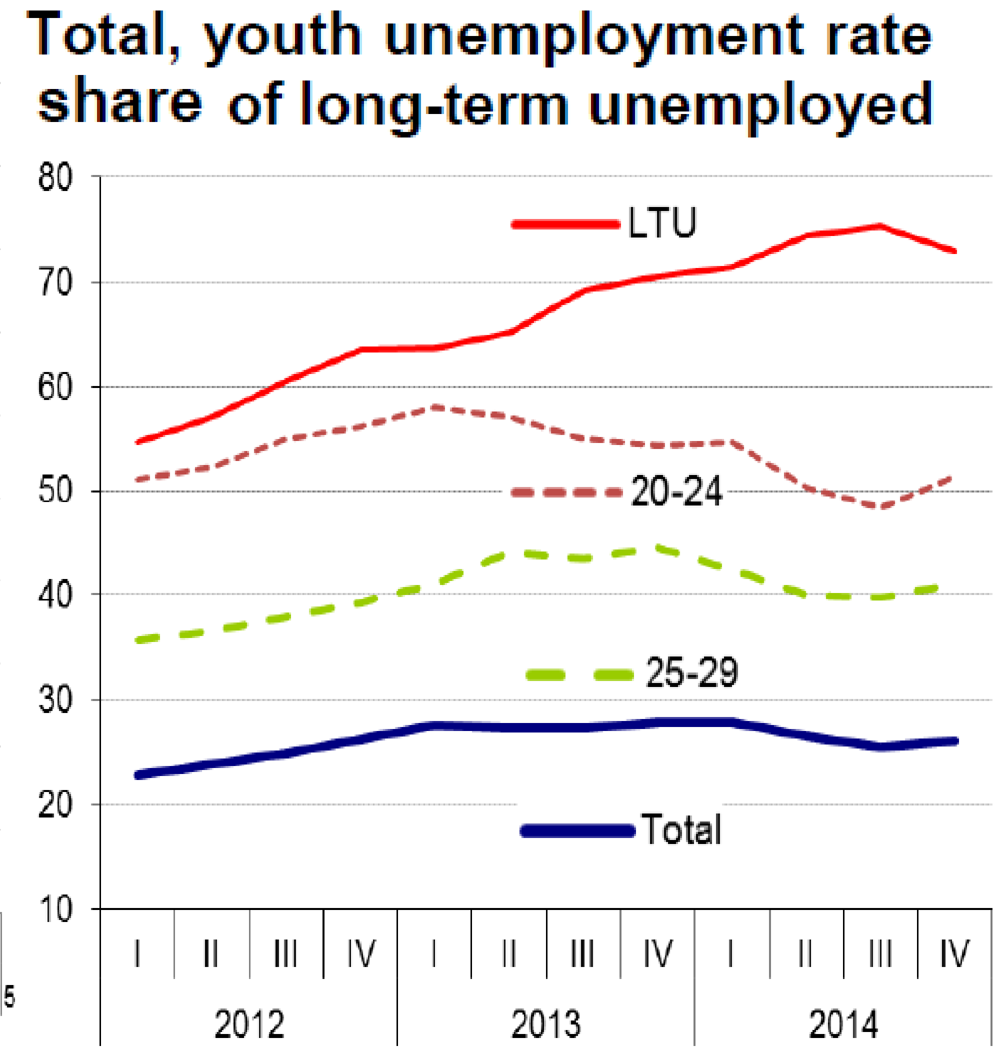
**Projections for Greek GDP by international organizations and the BoG**

| *Percentage changes on a year earlier* | **Release date** | **2013** | **2014** | **2015** |
|---|---|---|---|---|
| OECD | Nov-14 | -3.9 | 0.8 | 2.3 |
| European Commission | Apr-14 | -3.9 | 0.6 | 2.9 |
| IMF | Oct-14 | -3.9 | 0.6 | 2.9 |
| Consensus | Oct-14 | -3.9 | 0.2 | 1.9 |
| NIESR* | Nov-14 | -3.9 | 0.3 | 1.8 |
| BoG | Dec-14 | -3.9 | 0.7 | 2.1 |

* Britain's National Institute of Economic and Social Research

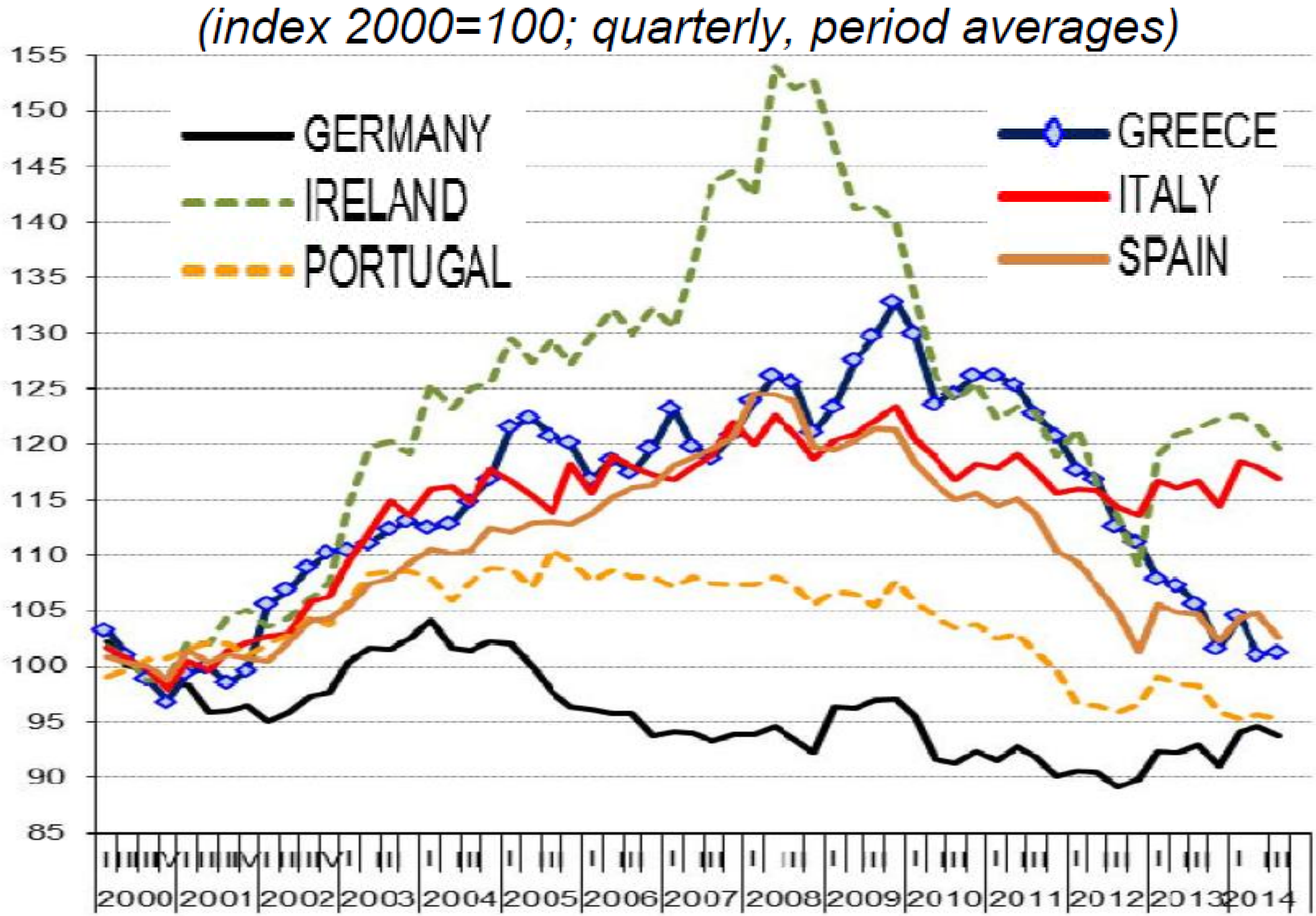
APP. **LABOR MARKET SUFFERED**



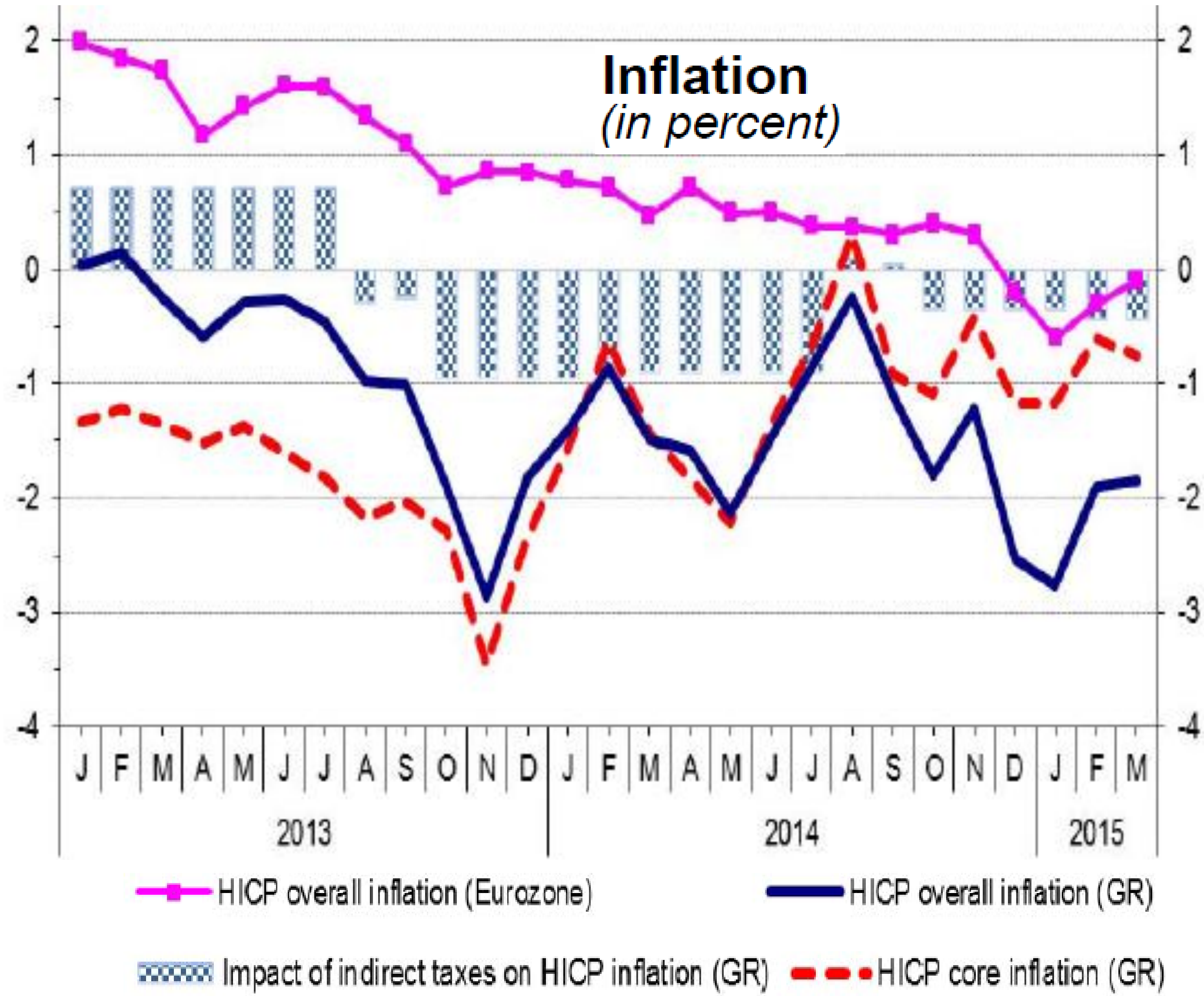

**Source:** EL.STAT, Labour Force Survey

# APP. LABOR COST COMPETITIVENESS IMPROVED



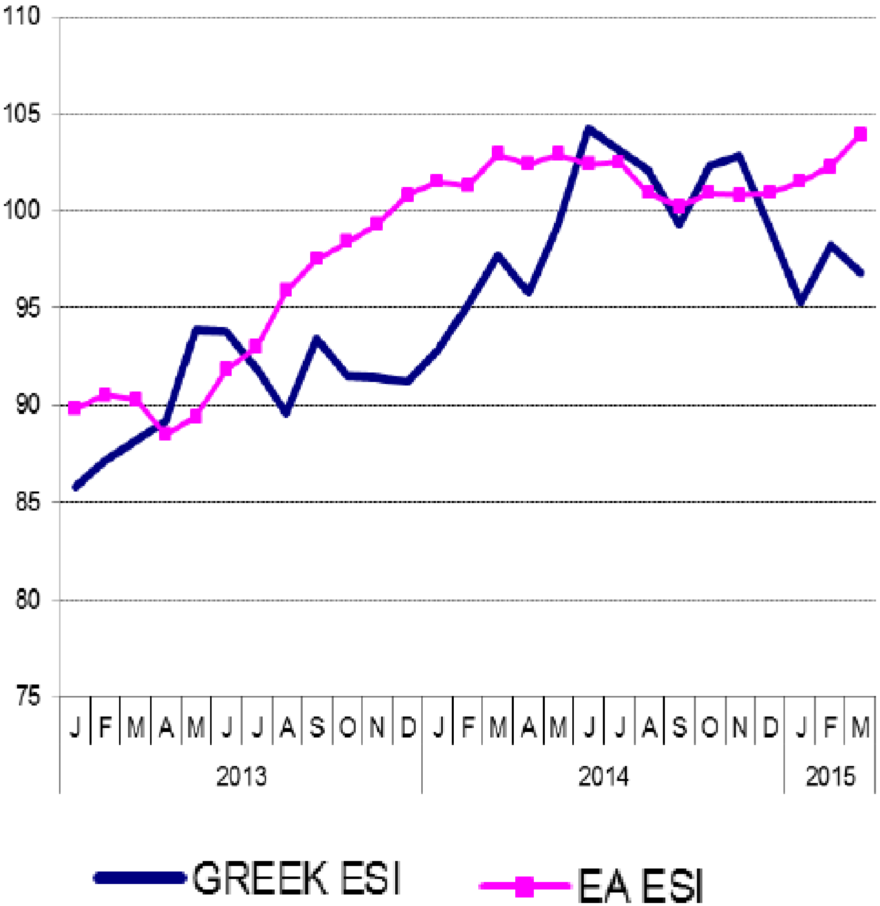
APP. DEFLATION SINCE 2013

- ✓Deflation arrived much earlier in Greece, by 2013 Q1
- ✓Deflation is mainly due to non-tradables, a much needed adjustment



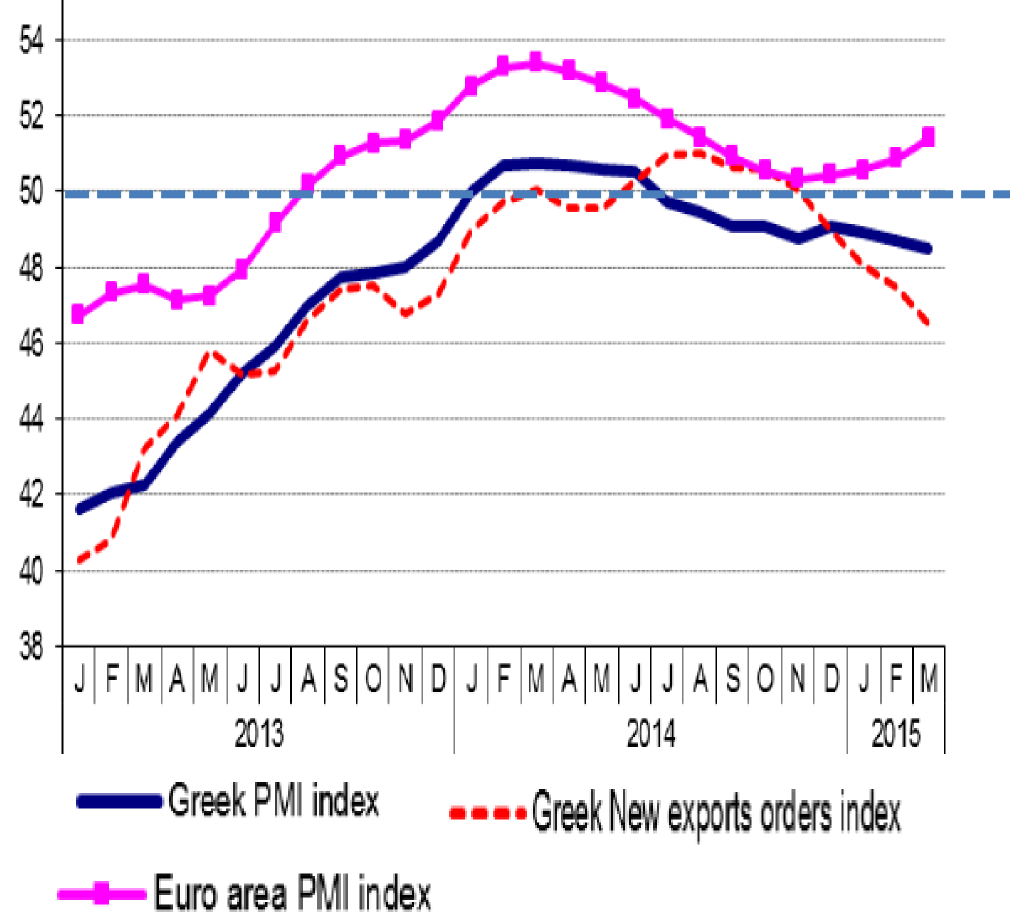
# APP. RECENT SOFT DATA SHOW ECONOMY HAS STALLED

**Greek and Euro Area Economic Sentiment Indicator** *(balance)*



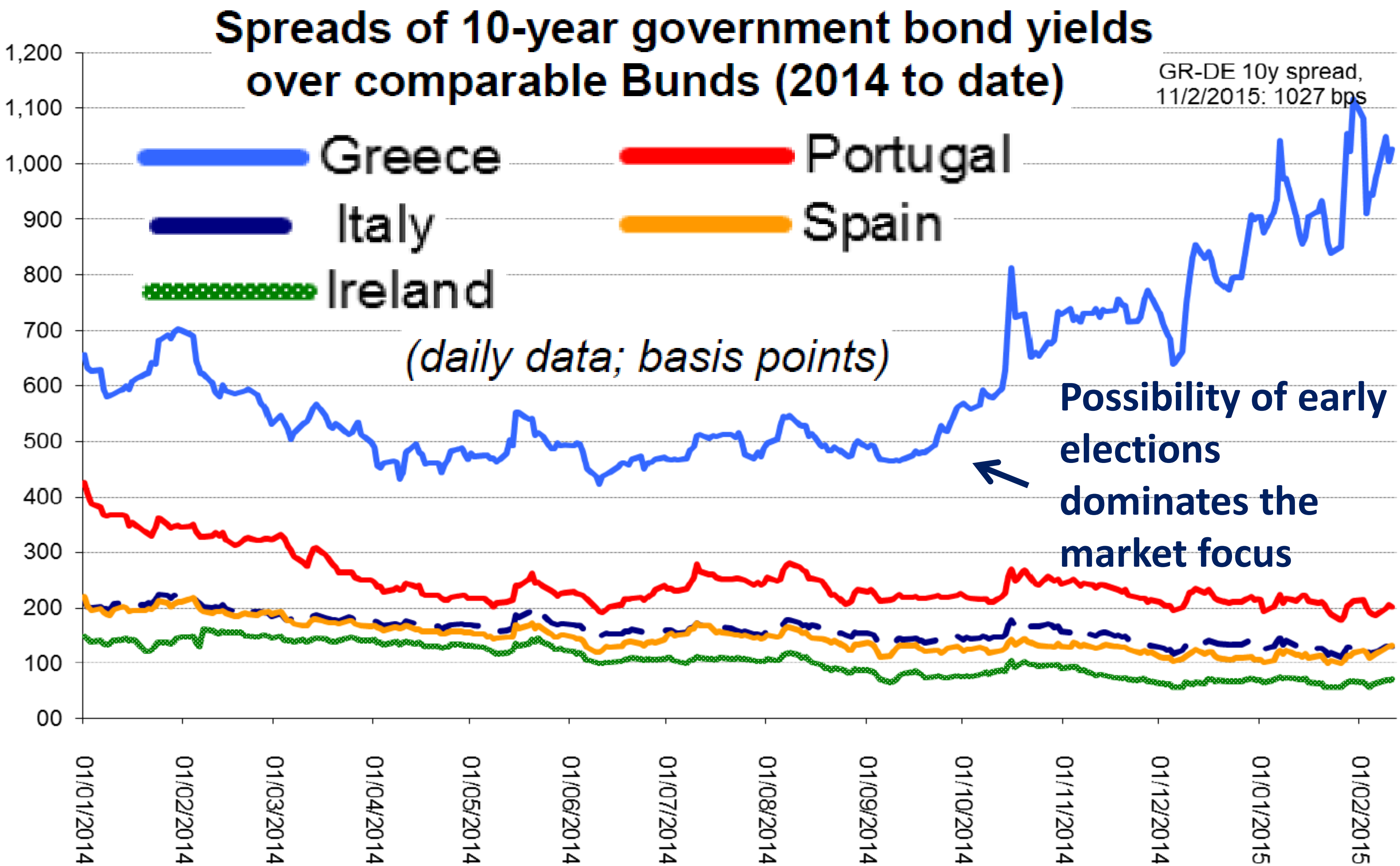

**Source:** European Commission.

**PMI overall index**
**& new Export orders component**
**(**3month moving average**)**




**Source:** Markit

# APP. BOND MARKETS UNSETTLED SINCE EARLY NOVEMBER




**Possibility of early elections dominates the market focus**

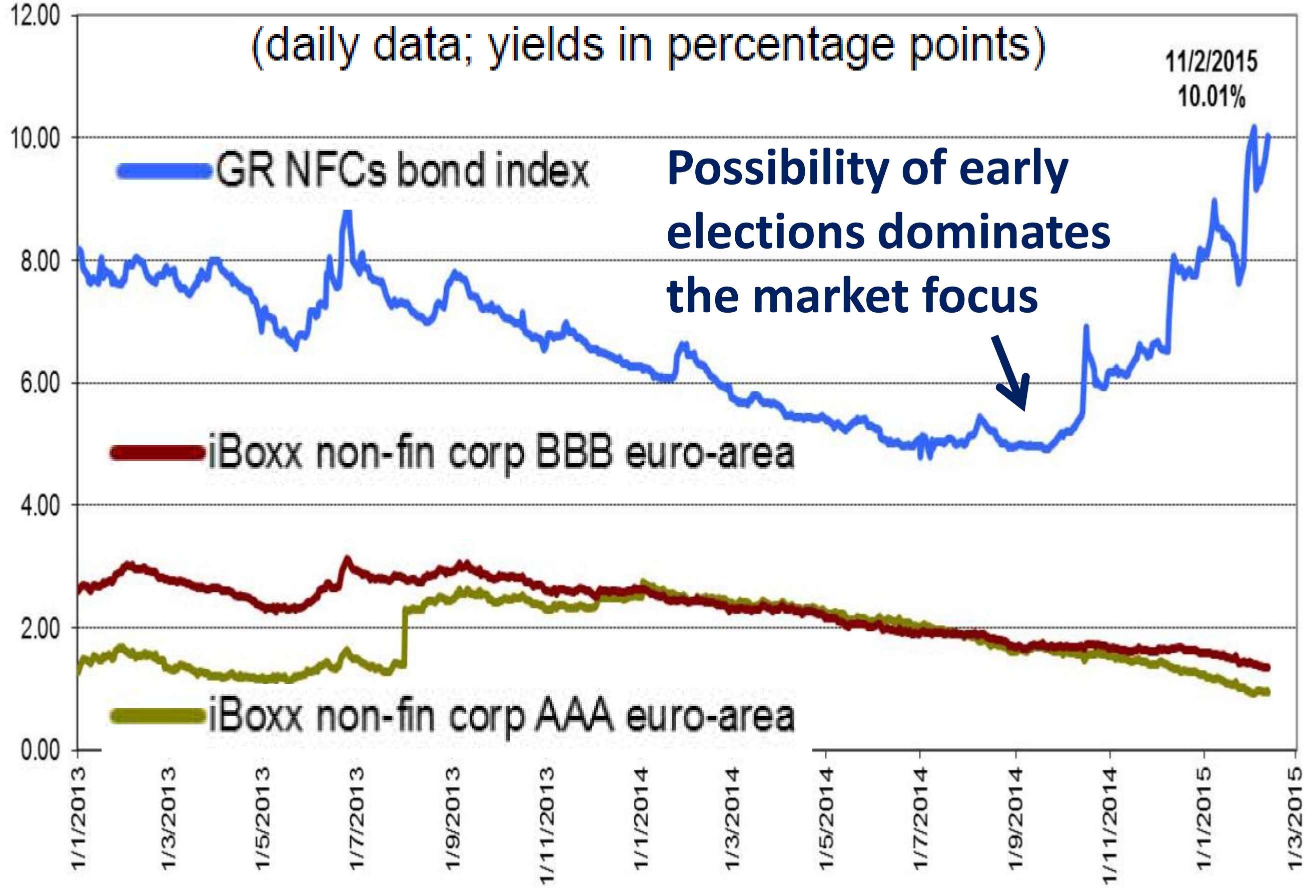
**Source:** Thomson Reuters, Datastream

# APP. DECOUPLING FROM THE REST OF EURO AREA SINCE EARLY NOVEMBER

- ✓ Decoupling not only in sovereign bond spreads but in corporate bonds as well
- ✓ Markets became worried of the possibility of elections and a SYRIZA win
- ✓ Markets have a short-term view on the conse-quences of GREXIT

## GR NFCs bond index

### & iBoxx indices for EA non-financial corporates

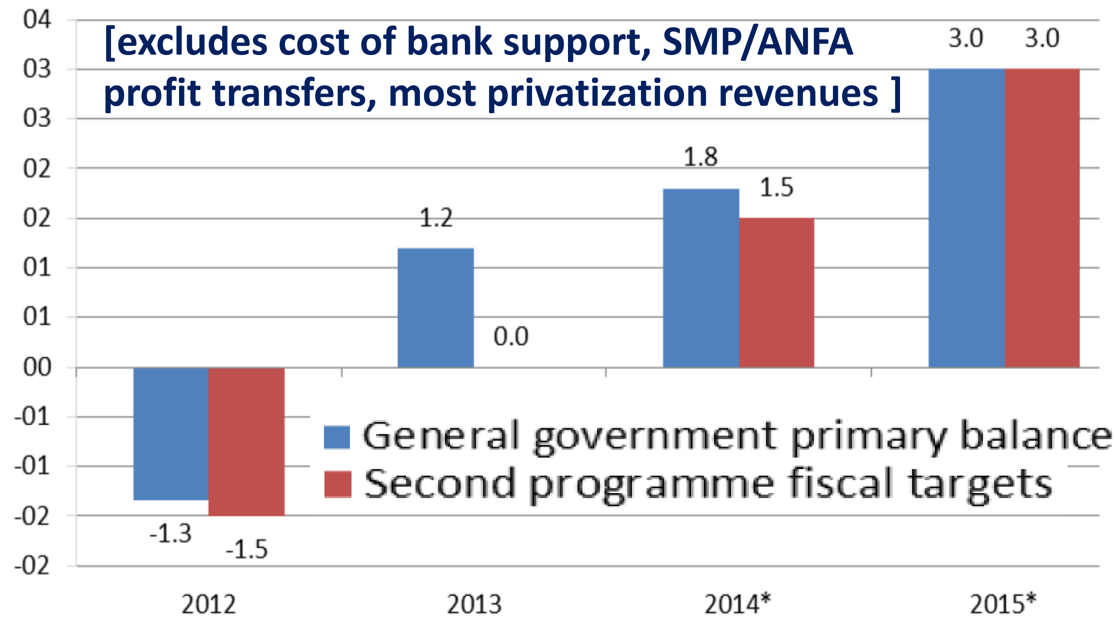



**Source:** (GR index) Bank of Greece; (iBoxx indices) Thomson Reuters, Datastream

# APP. FISCAL SPACE IS LIMITED

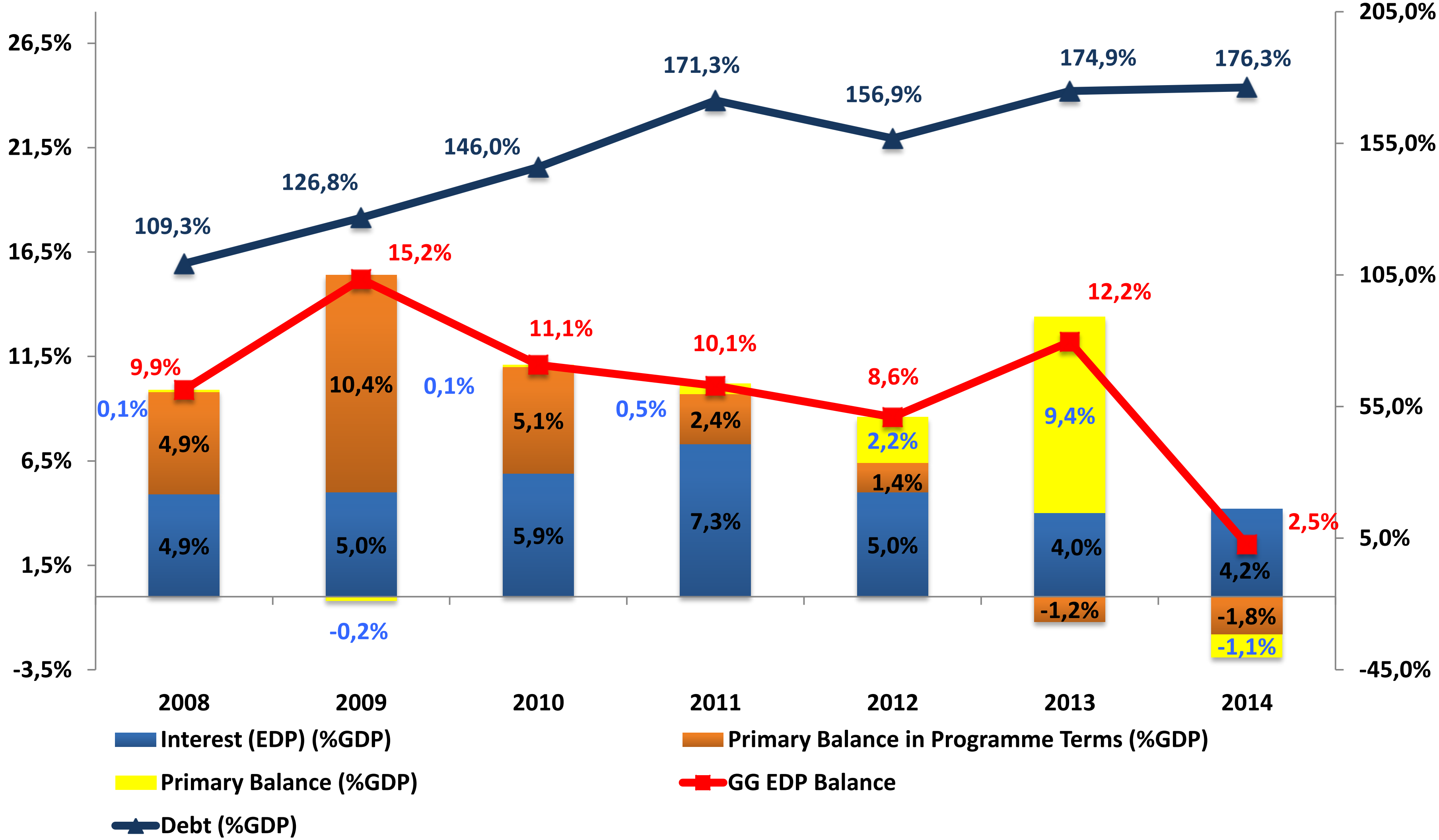
- ✓ Huge fiscal consolidation, from a deficit of 15.2% DGP in 2009 to probably around 3.5% in 2014
- ✓ For 2015, the previous government was forecasting a primary surplus of 3% GDP, yet Troika insisted on a fiscal gap of €2.6bn
- ✓ The new elections have caused the economy to stall since November and revenues to lag behind
- ✓ Without closure of the 5th Review, €7.2 bn would be missing at least until May
- ✓ Gov has topped up its sources of short-term funding and is shut out of the market

**General Government Primary Budget Balance under the programme definition (% of GDP)**




- ✓ April and May obligations will squeeze the State even further
- ✓ This implies growth will lose its momentum and earlier forecasts become optimistic

# APP. HUGE FISCAL CONSOLIDATION SINCE 2009



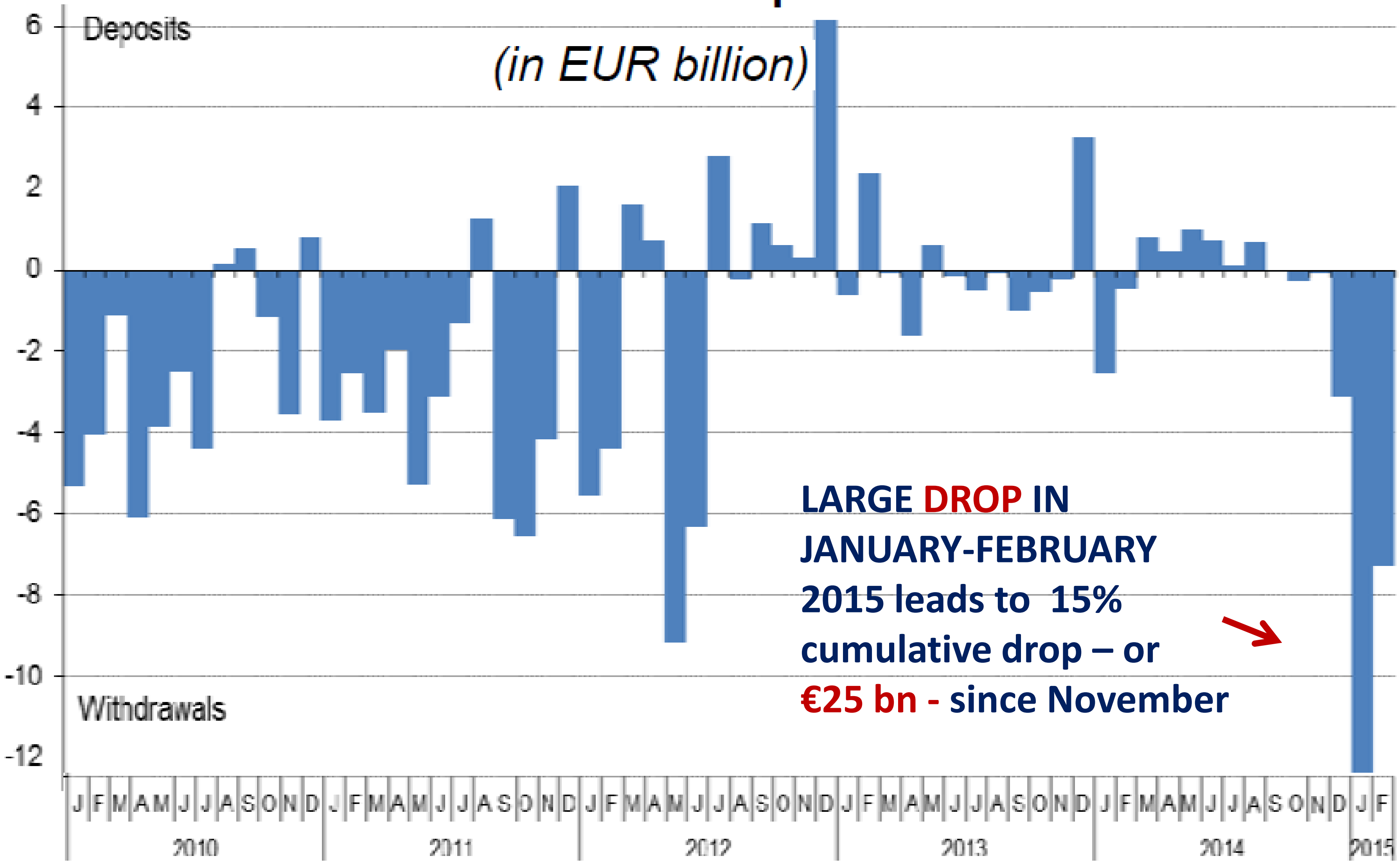

Source: European Commission, ELSTAT, 2015 Budget

*2015 Budget Projections for 2014

# A NEW ROUND OF DEPOSIT OUTFLOWS

## Monthly flows of deposits

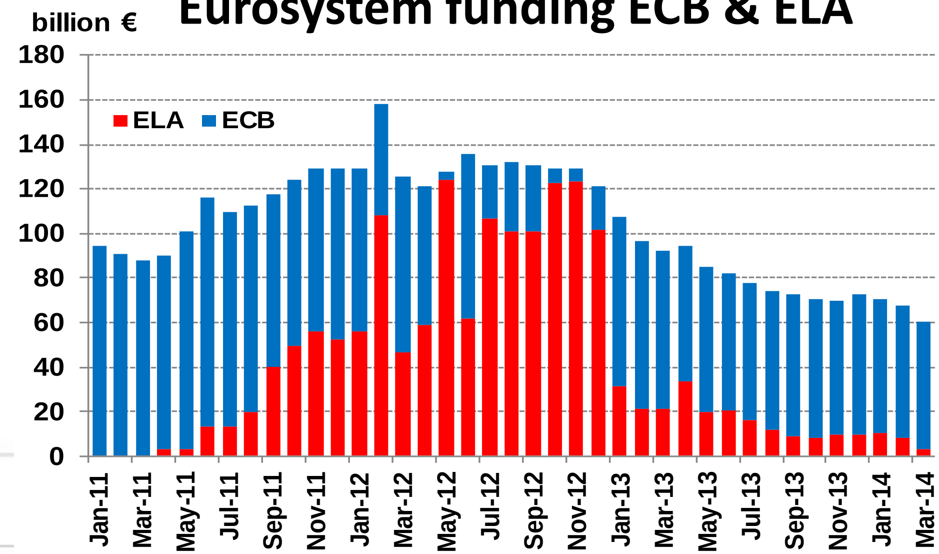
### from non-financial corporations and households



# APP. BANK FUNDING FROM THE EUROSYSTEM RISES

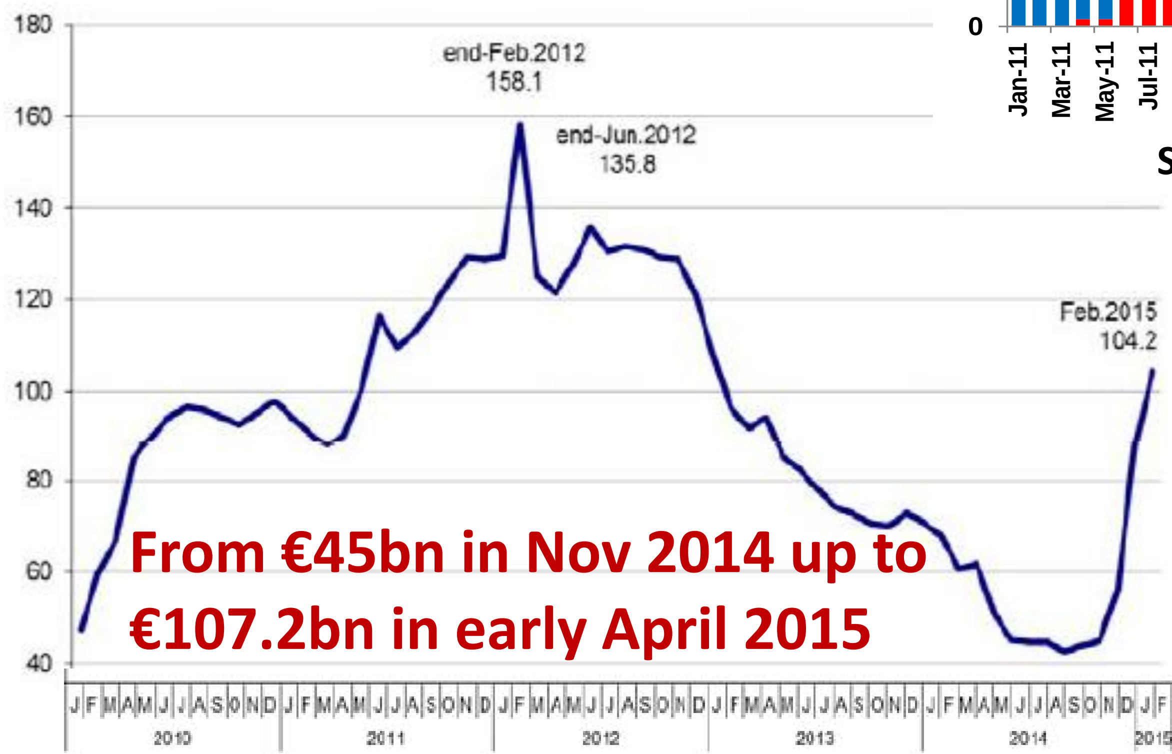
(a) DEPOSIT OUTFLOWS PLUS
(b) SHUTING DOWN OF INTERBANK MARKET
LED TO A DOUBLING OF EUROSYSTEM DEPENDENCE SINCE NOVEMBER

**Eurosystem funding ECB & ELA**




Source: BoG, Bloomberg

**Central bank financing to Greek commercial banks**
*(in EUR billion, end of month)*



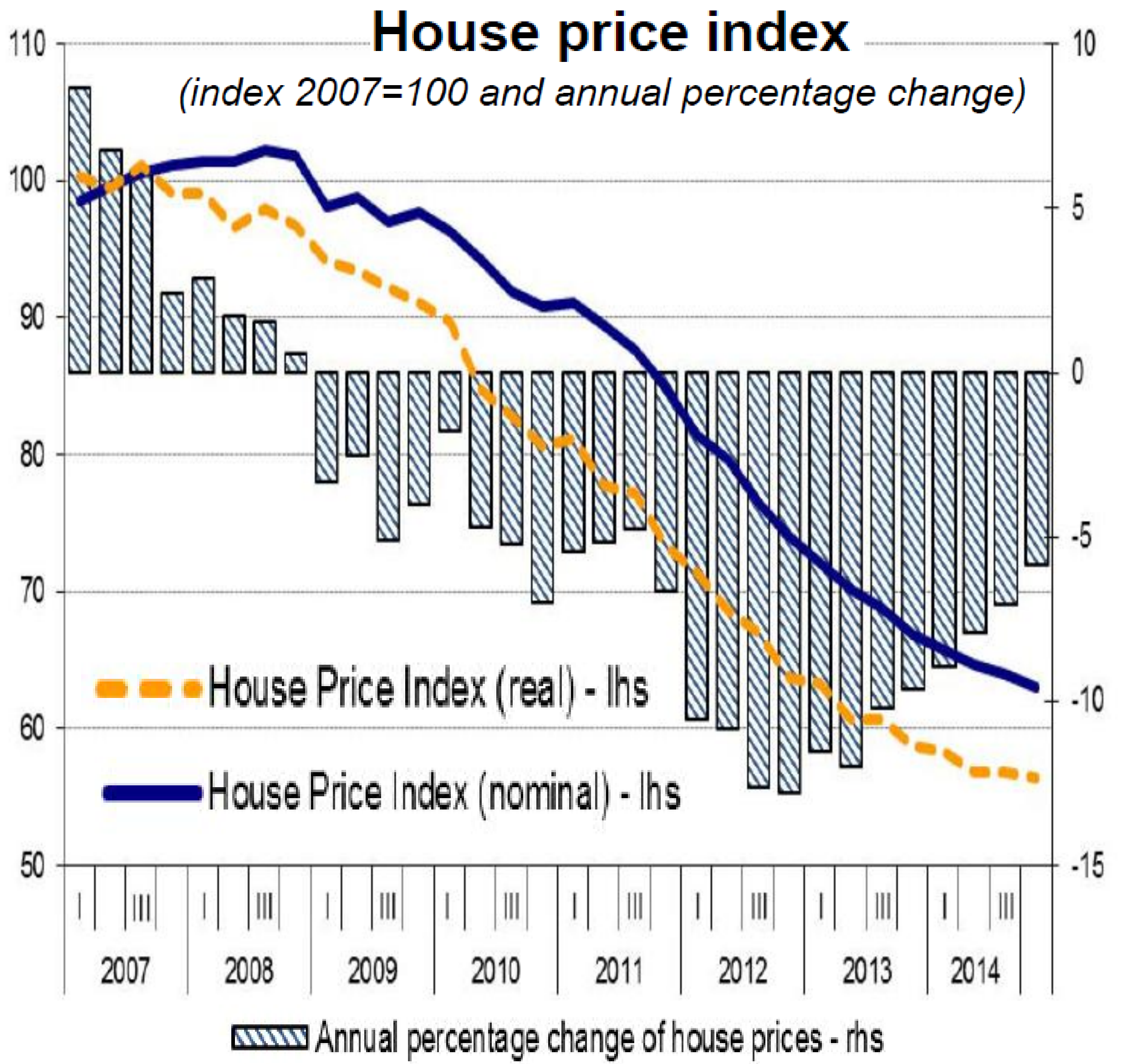

- ✓ The persistent drop in Eurosystem borrowing that began after the June 2012 elections stopped in November 2014, as new elections were now been forecasted with a SYRIZA win

# APP. BANK COLLATERAL VALUES DECLINE

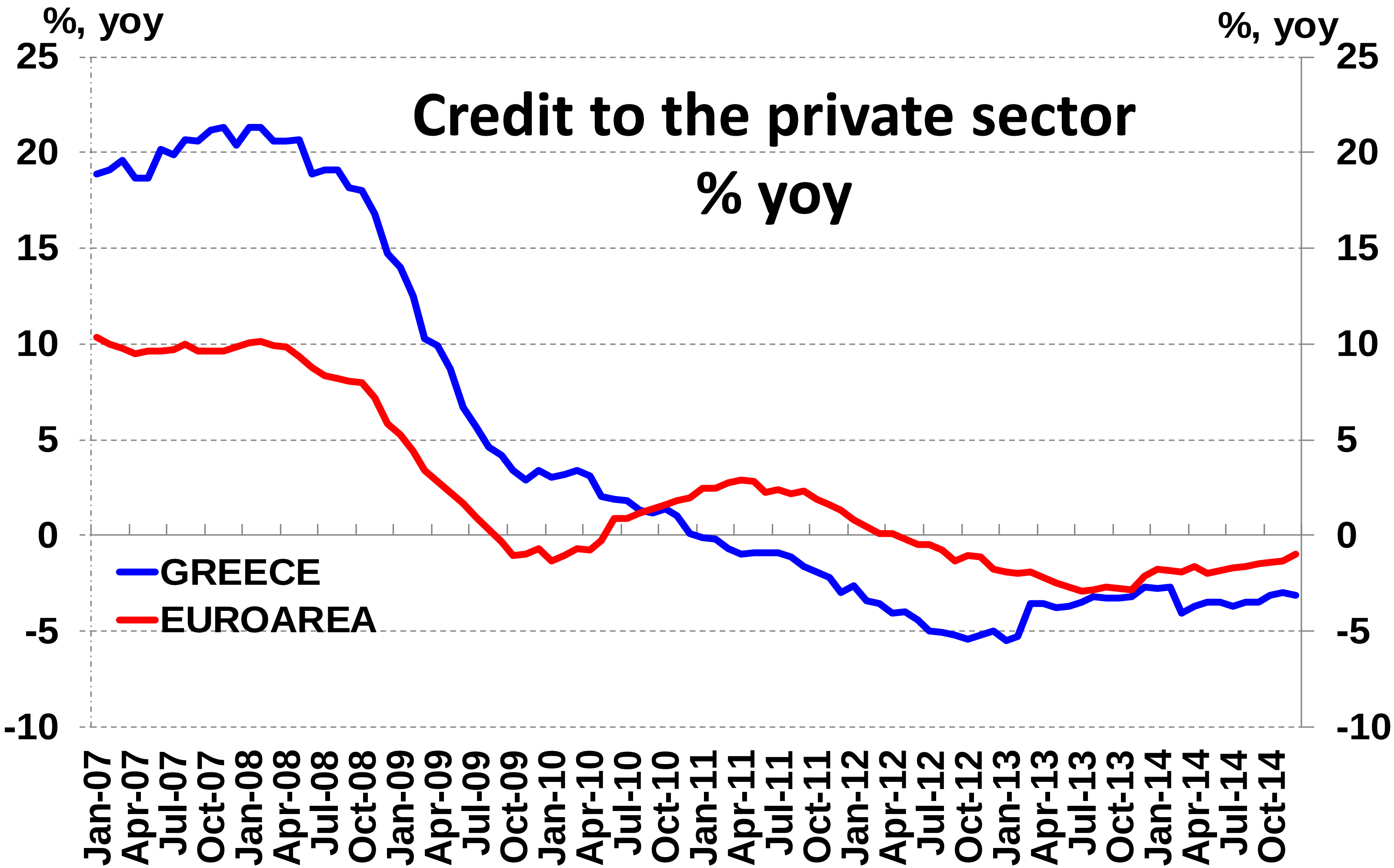
Value of Bank Collateral affected by

1) Country's worsening outlook and credibility, as ratings decline
2) Decline in home values, affecting particularly credit to households
3) Rising Non-Performing Loans

February last minute Extension of the Program by 4 months avoids further deterioration



# APP. CREDIT TIGHTER THAN IN EURO AREA




Source: ECB, Ecowin

# APP. NON PERFORMING LOANS MAY HAVE PEAKED

Explanatory variables with explanatory power of 90%:

1) Change in GDP (-), Works throughout the period
2) Change in unemployment (+), Works during crisis period
3) Loan-deposit rate spread (+), works before the crisis

Additional explanatory power by bank efficiency ratio and paying culture