Greek Crisis Phase II: More Pain in Sight?

Gikas Hardouvelis
Professor of Finance & Economics
University of Piraeus

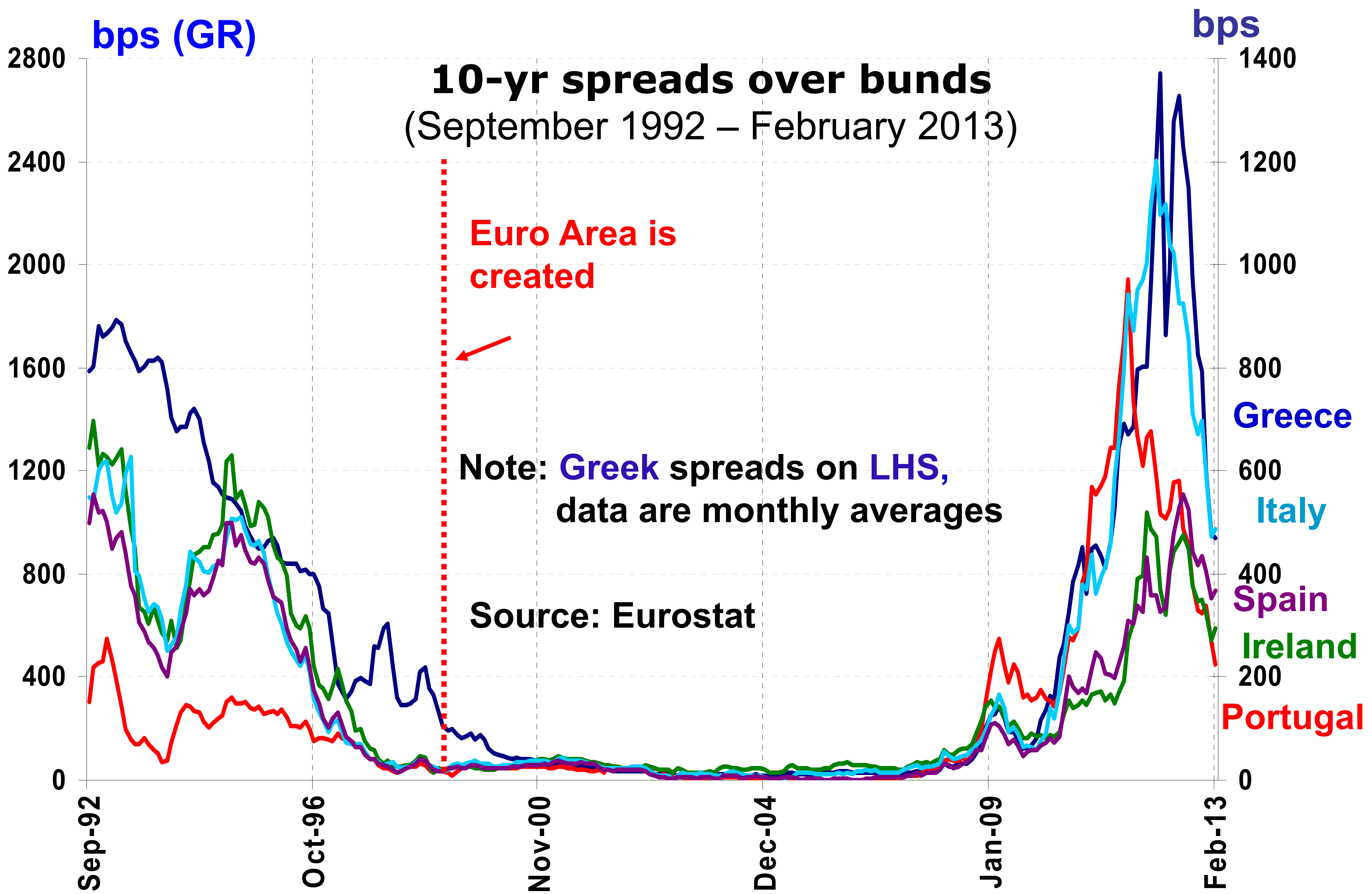
April 26, 2016

ICMB, Geneva

Overview

1. EMU Crisis & Greek Imbalances
2. Phase I of the Greek Crisis (2008-2013):
   - Remarkable adjustment of earlier disequilibria
   - Huge loss in output and incomes, increase in unemployment
3. The 2014 beginning of a new economic take-off vs. Popular Myths
4. Phase II of the Greek Crisis (Jan 2015 - ?):
   - A new political reality, confrontation with the lenders, stalling and declining output, capital controls
   - 3rd Adjustment Programme 2015-2018
   - 3rd recapitalization, sluggish economic policy, NPLs rising again
5. Short-Term Outlook & Longer-term Challenges
6. Conclusion

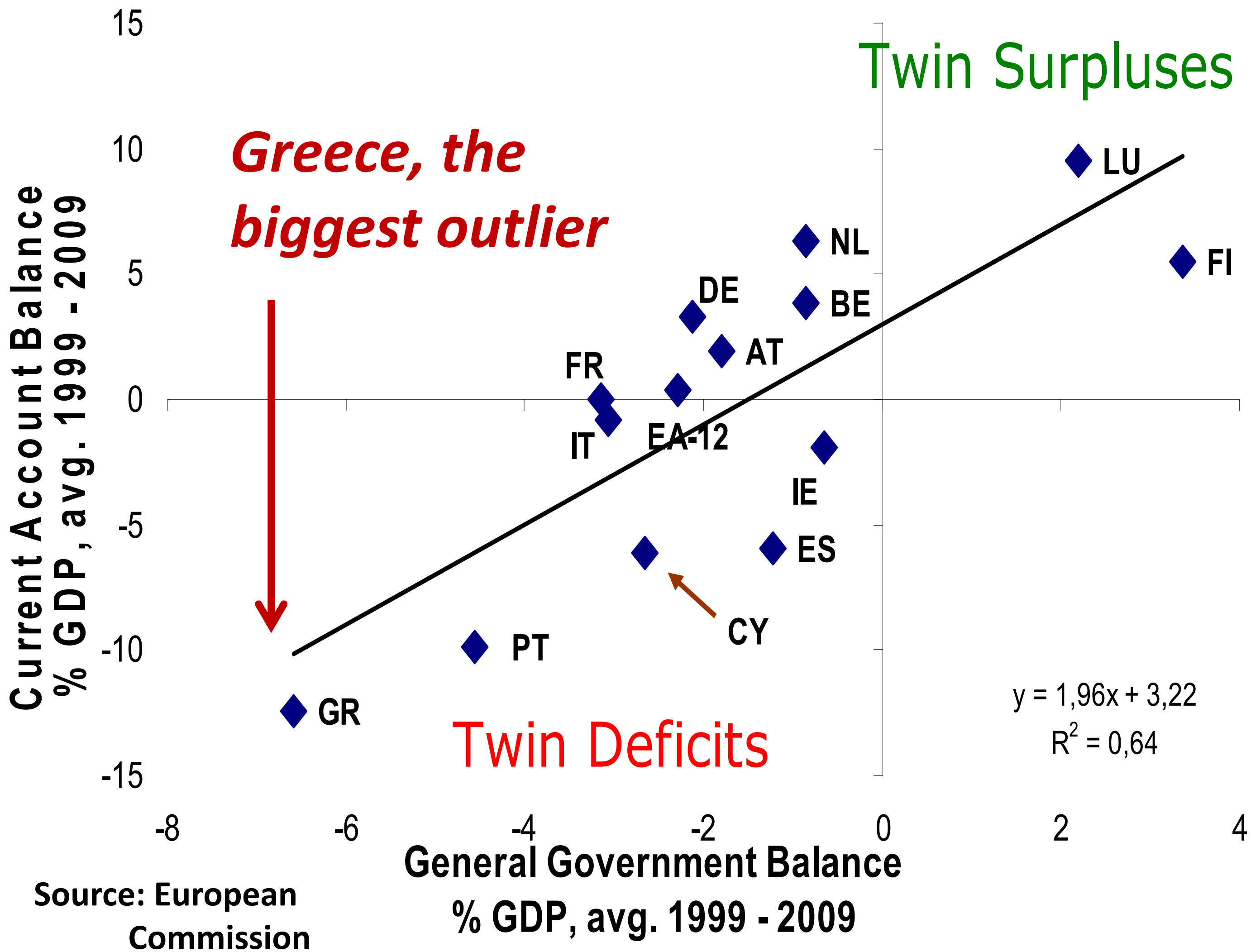
1. The Market View of EMU



1. EMU sad story: Instead of real convergence, serious imbalances

- **Market failure**: Markets ignored the differences between countries and lent easily to both private & public sector
- Two major imbalances , fiscal & external competitiveness
- Greece was an outlier in the Euro Area
- Other imbalances: Private sector credit

Eurozone Years up to the Greek Crisis



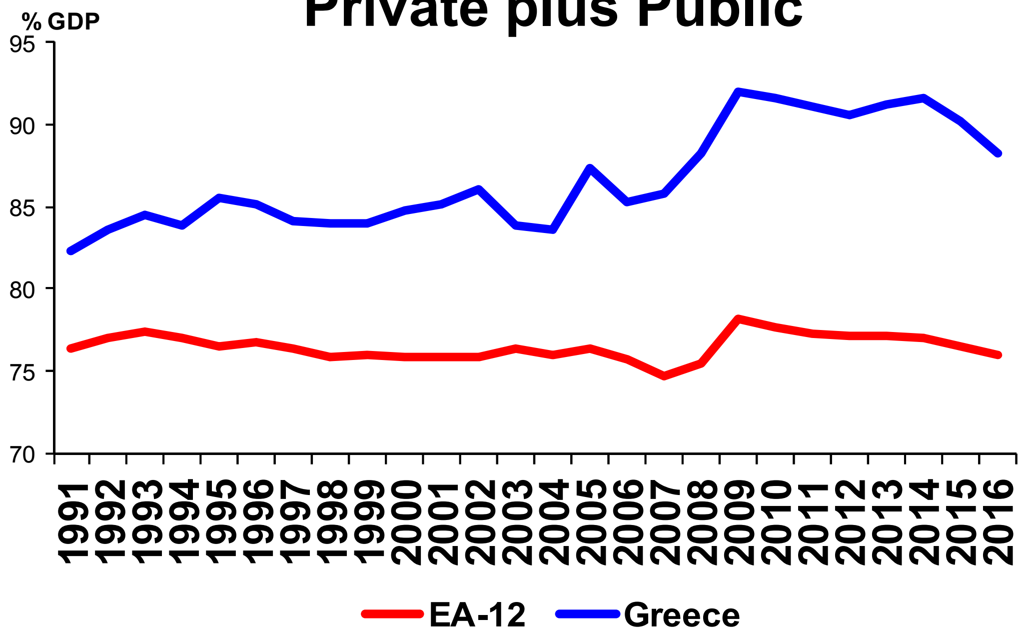
Source: European Commission

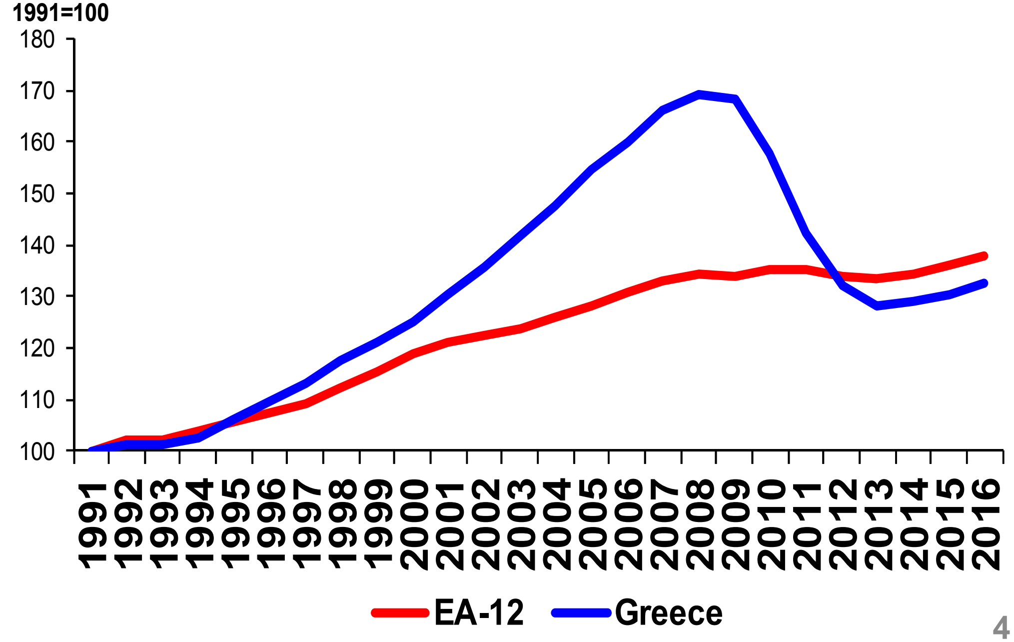
1. Greek Imbalances: Another Comparison

- Our society over-consumes and under-produces
- The gap in consumption with EA-12 is over 15 percentage points of GDP
- Before the crisis, exports were a very small share of GDP
- Investment has become a very small share of GDP (10.4% in 2015) since the beginning of the international crisis (26% in 2007)

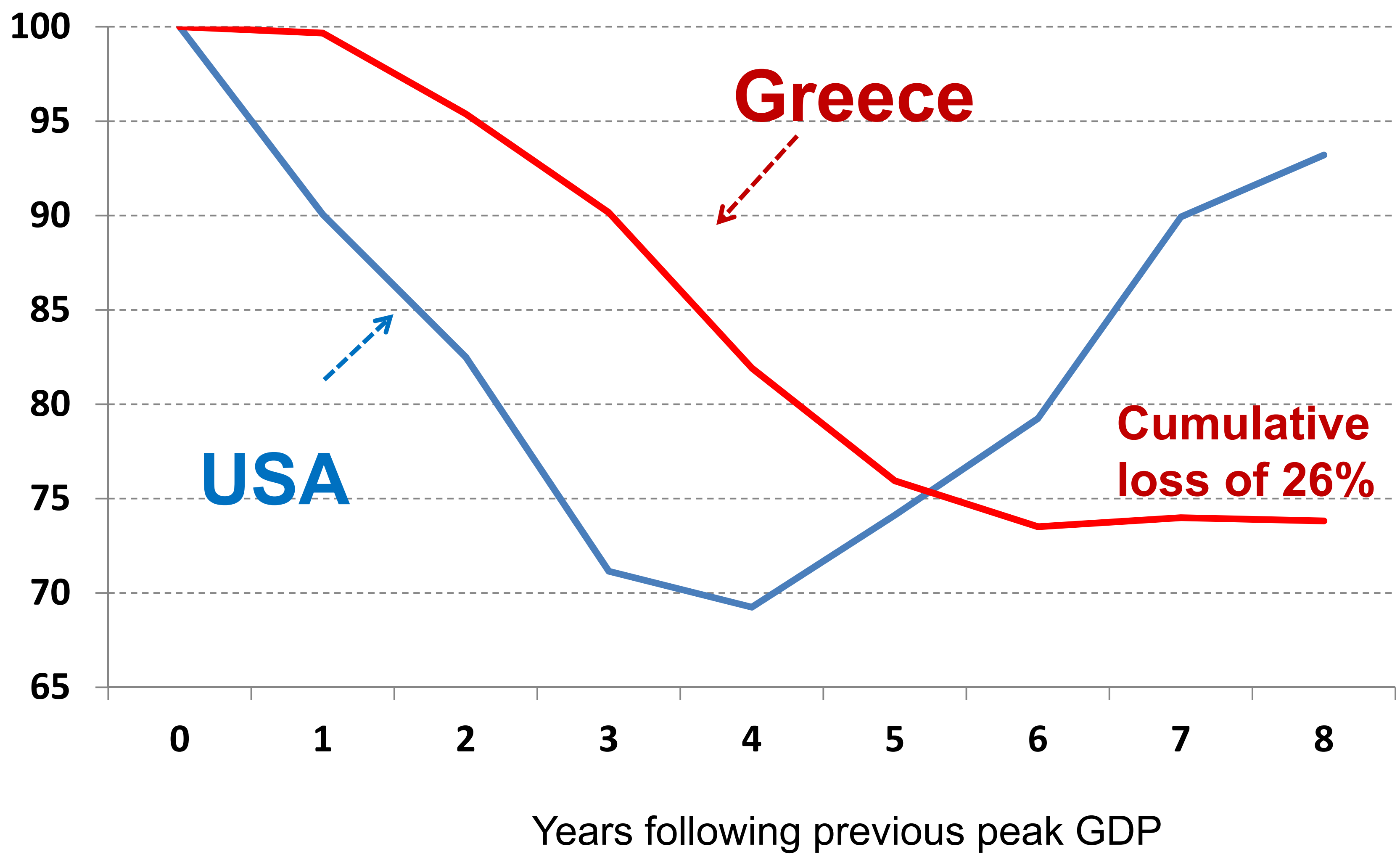
(2011, % of total GDP)	Greece	EA-17
Private Consumption	74.6%	57.4%
Public Consumption	17.4%	21.6%
Private Investment	11.3%	17.1%
Public Investment	2.9%	1.7%
Exports	25.1%	44.0%
Imports	33.1%	42.6%
GDP (€ bn) - 2011	208.5	9420.6

Real Consumption
Private plus Public





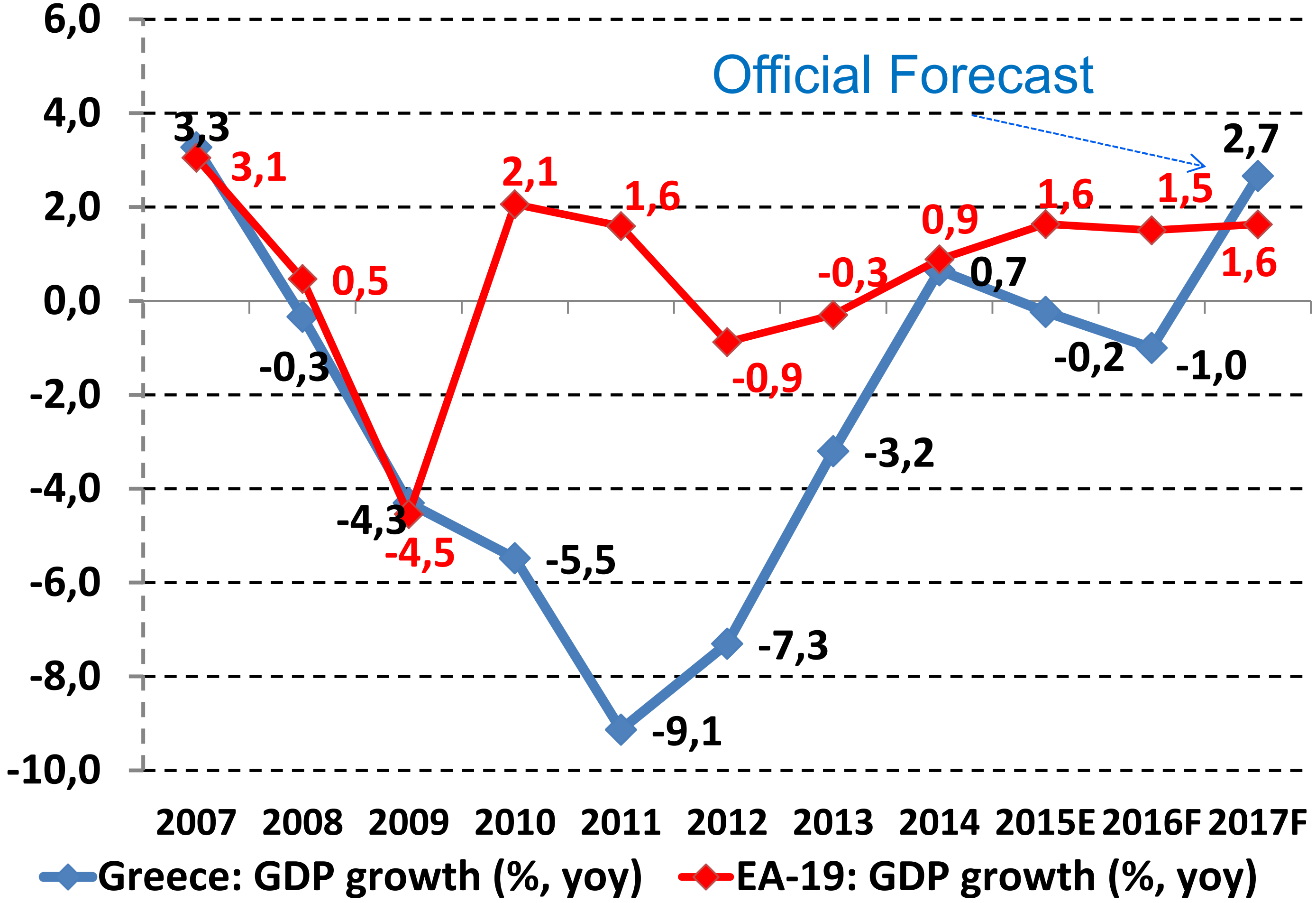
2. Greek crisis brought a worse recession than the Great Depression in the United States



- ❑ **Real GDP is indexed at 100 on date 0**
- ❑ **Date 0 is 1929 for the US and 2007 for Greece**

2. Greece: Why such a huge recession until 2013?

1. **Macroeconomic imbalances worse than anywhere else in the Euro Area**
2. **Closed economy, dominated by small firms, with inefficient public administration, unstable tax policies, lack of confidence, etc.**
3. **Liquidity crunch**
4. **Serious program errors by domestic politicians and lenders**

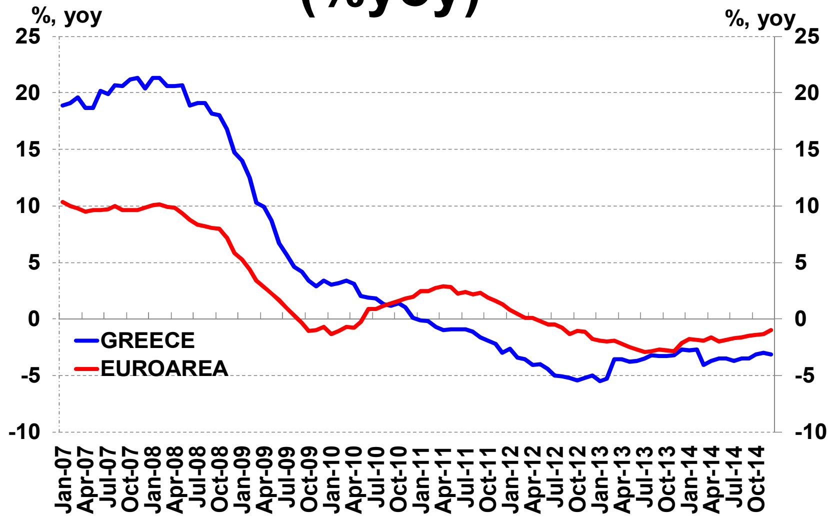


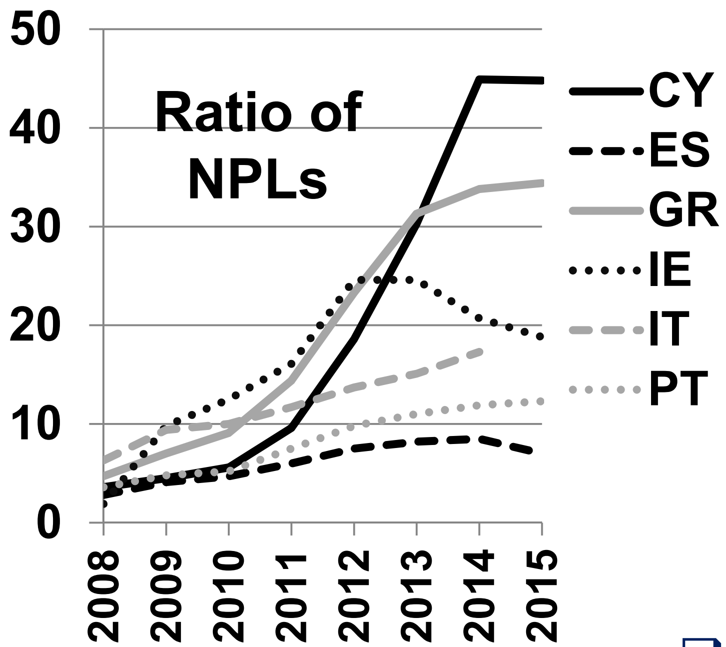
- **Parties in opposition consistently took extreme positions against "MoU," unlike in other programs countries. Hence, no ownership of reforms**
- **Lenders insisted on the wrong sequencing of reforms**

❑ **Then a "political shock" in 2015, brought a W-shaped recession**

2. Bank funding problems, NPLs and credit contraction

Credit to the private Sector (%yoy)

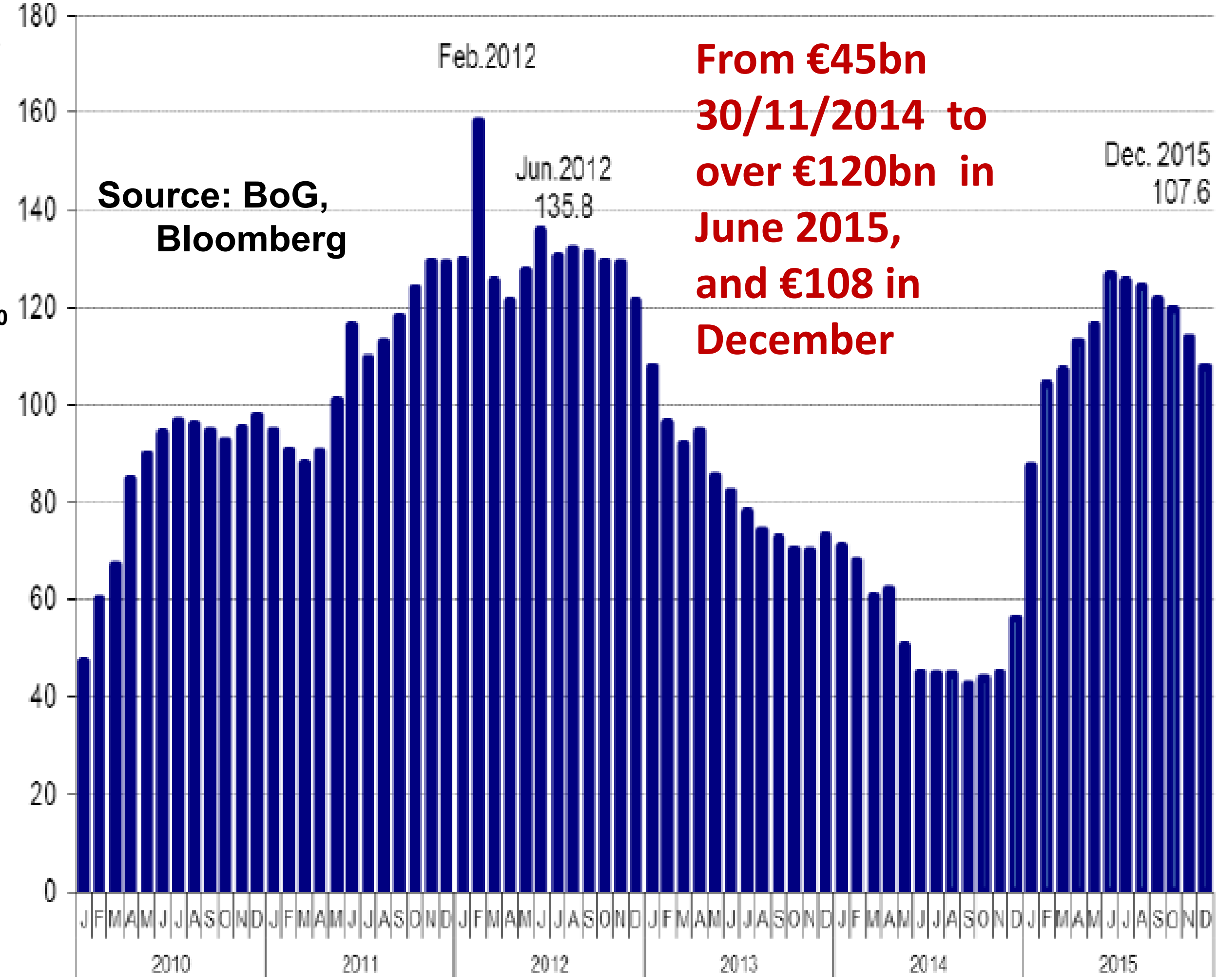




Central bank financing

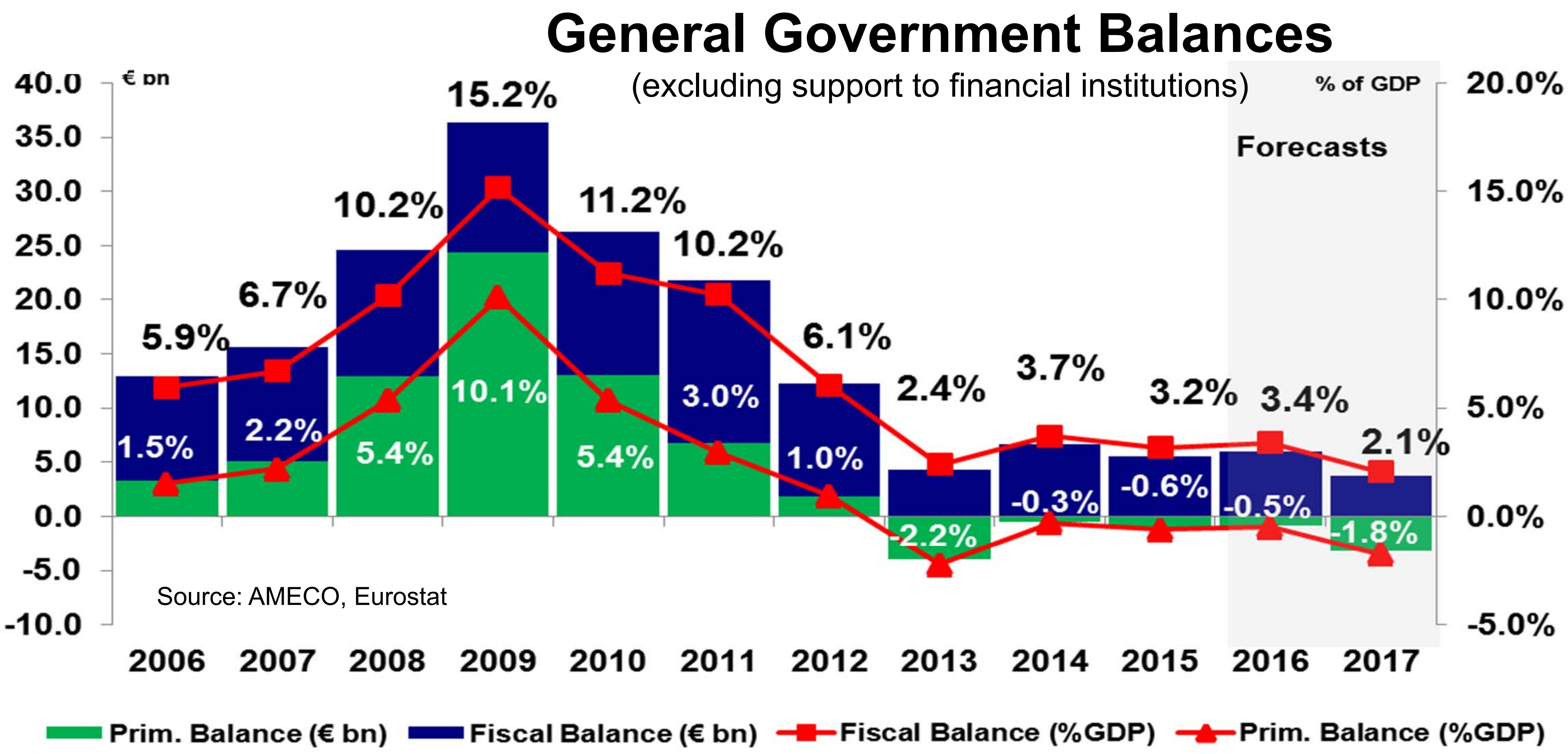
to Greek commercial banks

(in EUR billion, end of month)



- Banking sector affected by the PSI and NPLs
- Most of Eurosystem funding is through ELA

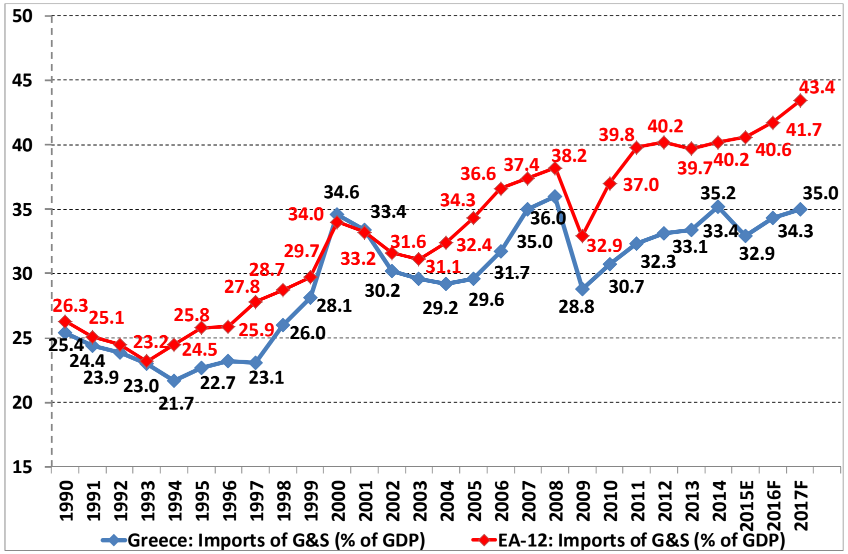
2. Unprecedented fiscal adjustment

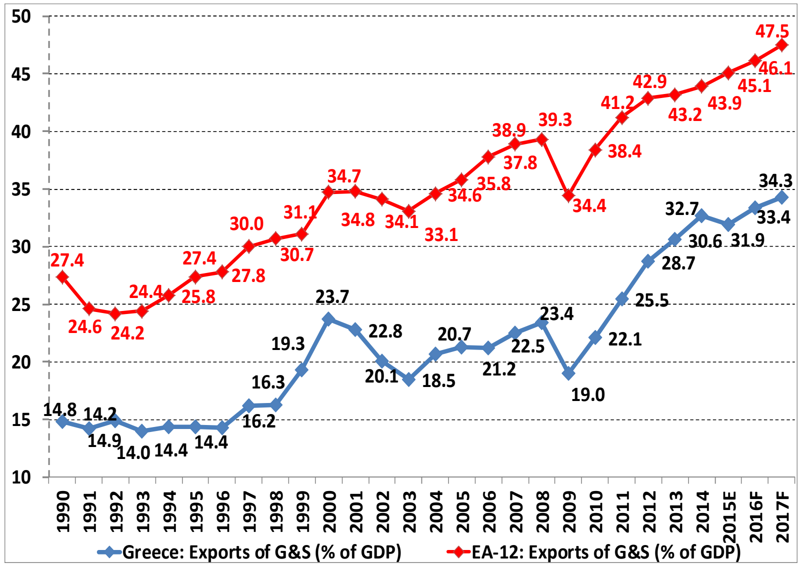


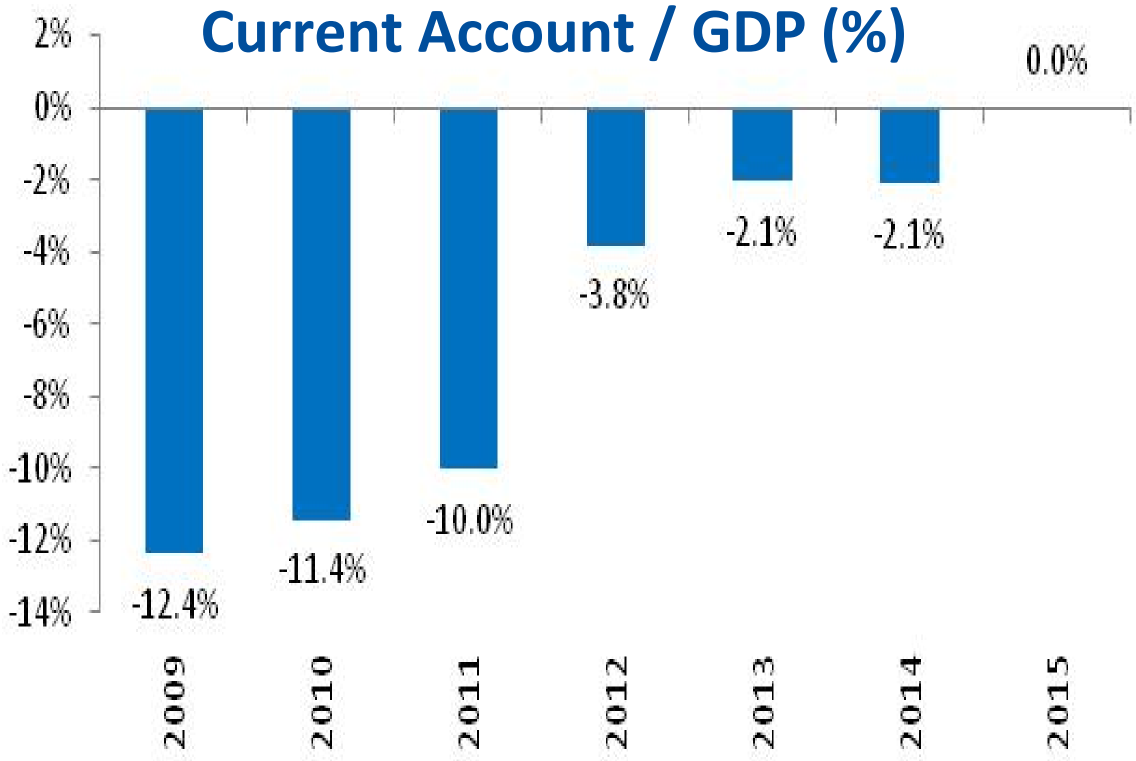
- Enormous fiscal consolidation since 2009,
  - When Gen. government expenses were €128.4bn and General Government revenues €92.4 bn.
  - In the original budget of 2015, the corresponding expenses and revenues were both projected at ≈€80bn.
- **Primary balance currently expected at 0.50%, 1.75%, 3.5% of GDP for 2016, 2017, 2018 and above 3.0% of GDP for a number of years afterwards.**

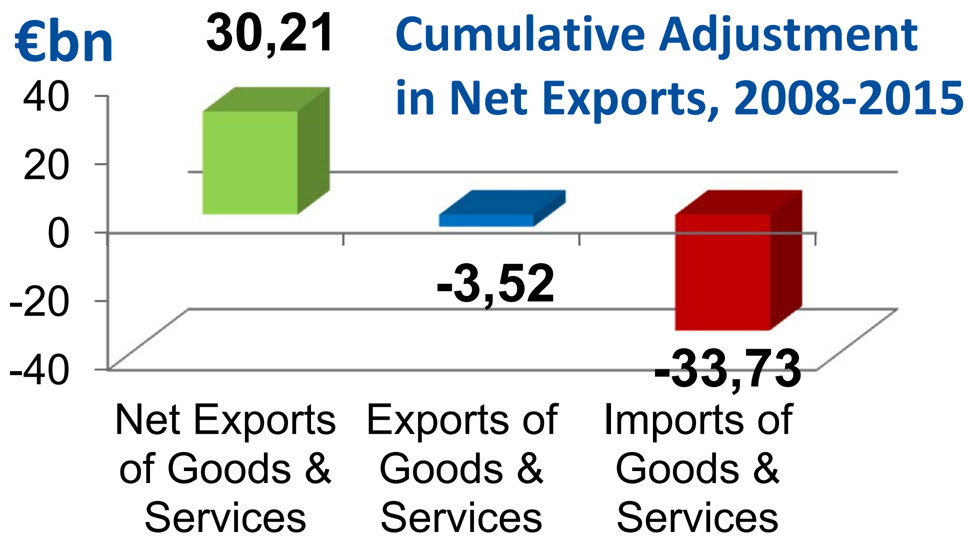
2. Current Account improvement

- **Improvement in current account balance mainly due to lower imports and improved revenues from tourism.**





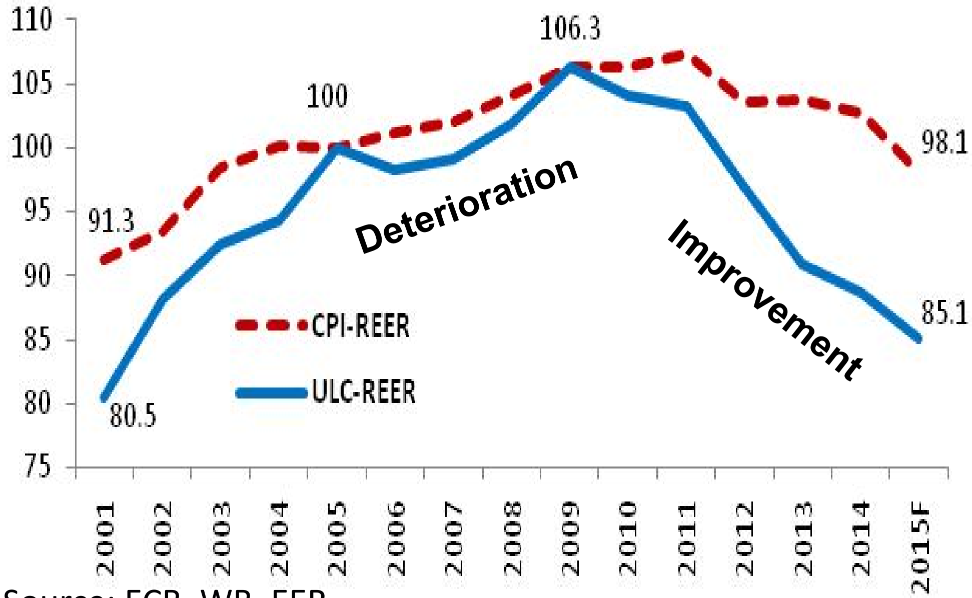




Source: ELSTAT, BOG, AMECO, EER

2. Competitiveness improved , yet still wanting

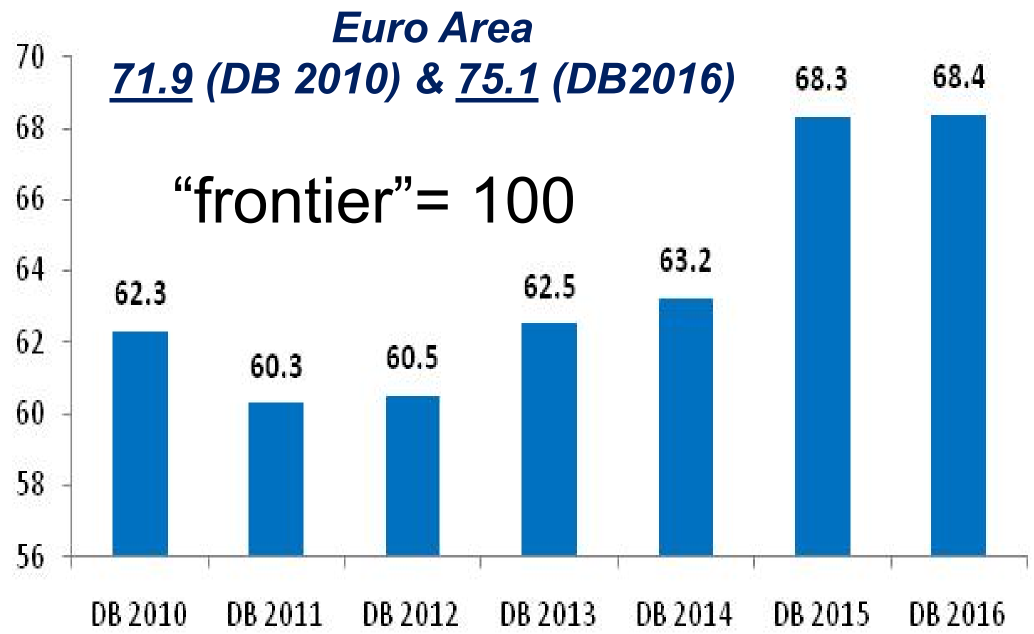
Near-Elimination of Post Euro-entry Wage Competitiveness Losses



Source: ECB, WB, EER

CPI & ULC – REER vs. Trading Partners Including EA Countries

Regulatory Environment



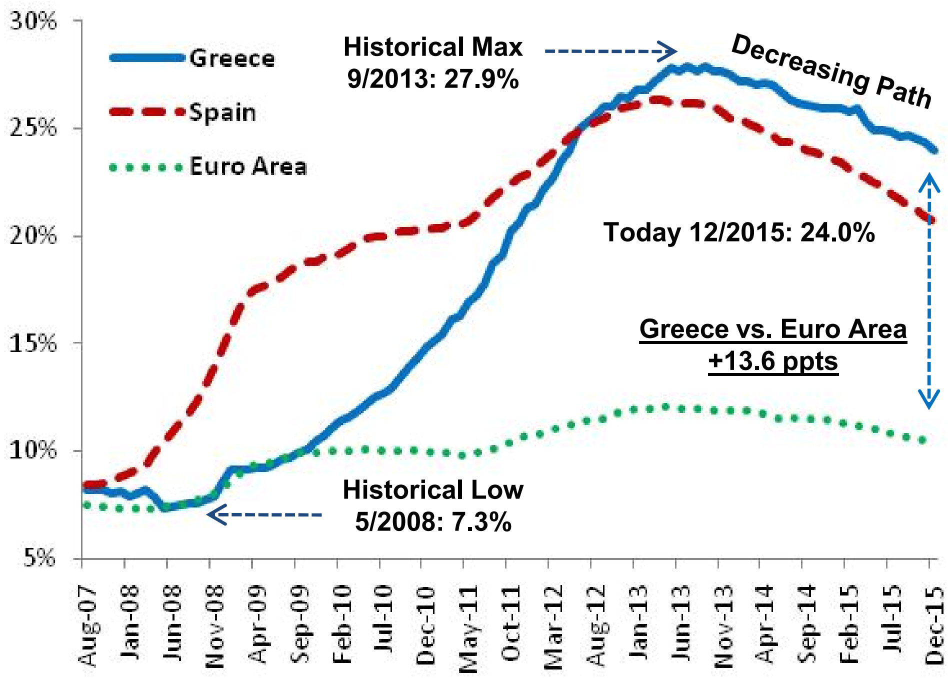
World Bank's Doing Business Indicator
Distance to Frontier (DTF) Ranking

- **CPI adjustment lagged behind (2012-2015 Cumulative Change at -3,92%) due to VAT hikes and rigidities**
- **Greece between 2009 and 2014 improved by ca. 40 positions in the Word Bank's Doing Business rankings (or 6.1 pp in the WB DB DTF rankings) but still ranks 60 in DB 2016 vs an average ranking of the OECD countries of 25.**
- **Significant effort needed in order to form the critical mass of reforms that will boost the Greek economy towards the OECD average. This is required for a sustained increase in exports & investment and for a turn towards a more export oriented growth model**

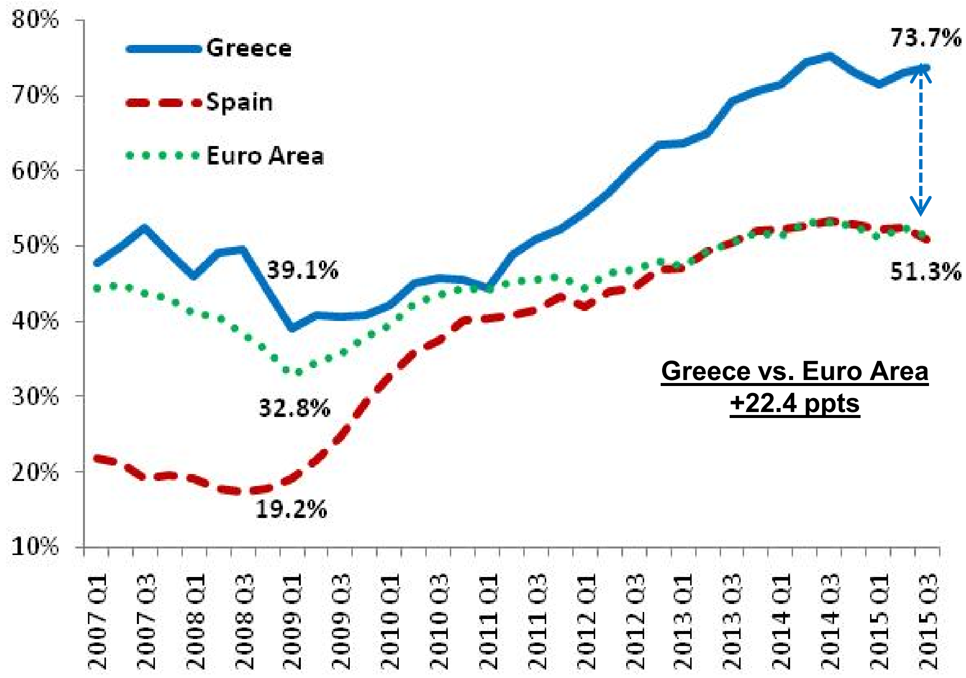
2. Very high unemployment rate

- Rise of unemployment rate by 20ppts between 2007-2013
- On a declining path over the last couple of years but still unacceptably high (and with a deceleration of improvement lately). It rose again in January 2016 to 24.4% from 24.3% in December
- Low labour productivity remains a major obstacle to growth
  - Persistently high long-term unemployment (>12 months) due to a shift of paradigm and collapse of non-tradable sectors; could lead to a further deterioration in labor productivity and an increase in the natural rate of unemployment

Unemployment Rate, %



Long - Term Unemployment, %



Source: ELSTAT, EUROSTAT

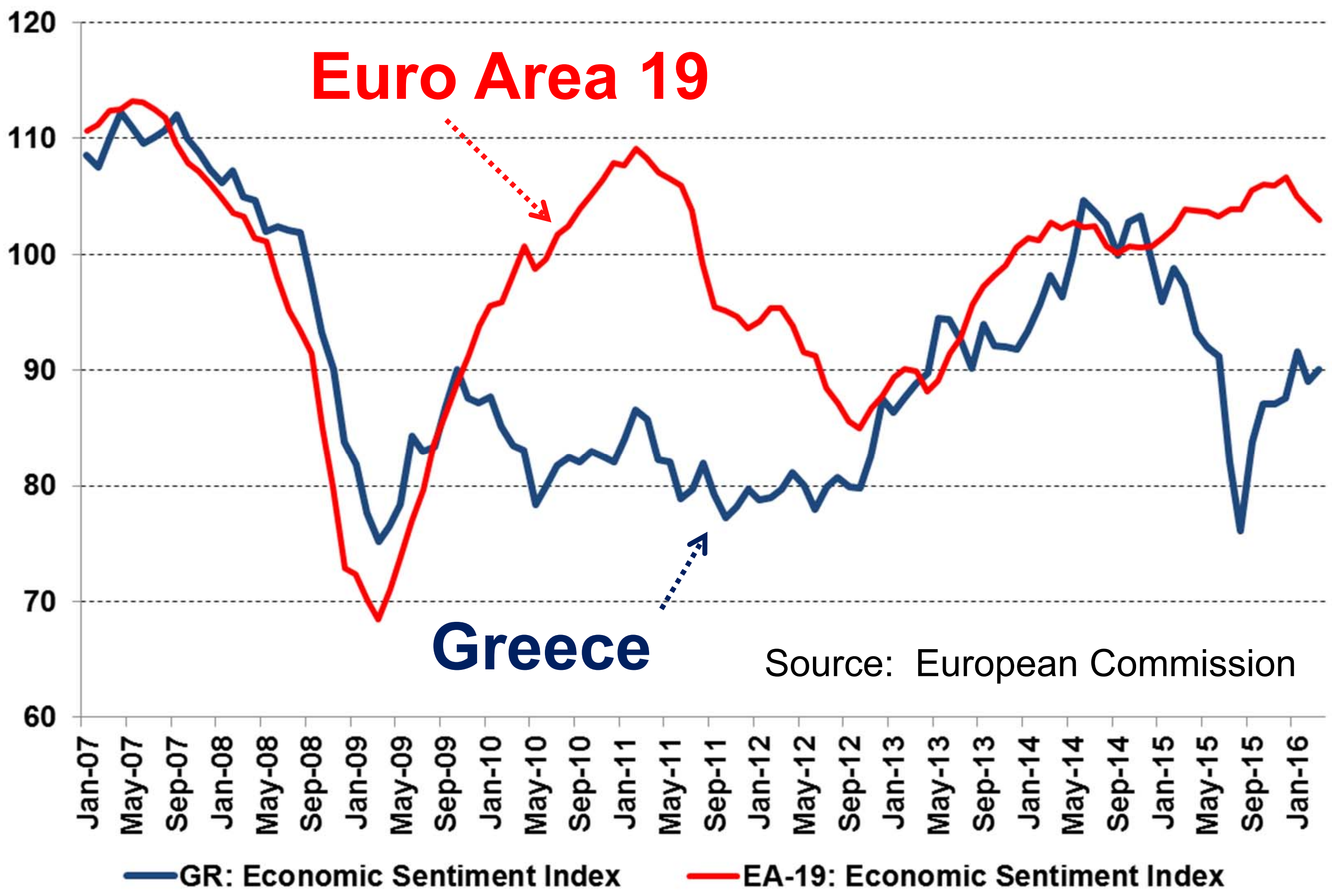
3. State of Play at end-2014

- Imbalances were almost cured (fiscal, competitiveness), with Greece improving in many competitiveness indices.
- Economic growth resumed (+0.7% in 2014), with sentiment rising, investment turning positive and unemployment declining.
- Investors had come back to buy domestic firms, privatizations began taking off, large private firms were able to issue debt in the international market
- 2015 growth was expected higher than 2.5%. The 2015 budget was balanced like in Germany.
- Greece was ready to almost leave the lenders' bailout PROGRAM, like Ireland and Portugal had done before. Government had secured a credit line from the Europeans (ECCL) with €11bn HFSF pre-existing funds. The IMF money was going to be added to that pool.
- Debt was on a sustainable path, assuming growth would continue, yet further debt relief measures were already under discussion according to the November 2012 agreement.

- In Nov 2014, little remained to close the final review of the 2nd Program:
  - At the Eurogroup meeting of December 8, 2014, EU Commissioner Pierre Moscovisi stated: "*Greece has done more than enough to close the review and a lot more than any other Program country.*"
  - The IMF and the ECB did not agree

3. Economic Sentiment on a rising trend until end-2014

- The sentiment index in Greece moved together with sentiment in EA until late 2009, both declining
- Decoupling during the Greek crisis
- From late 2012 on, Greek sentiment moves upward and again together with EA sentiment



- Greek sentiment peaked in the period June 2014 - November 2014, but subsequently began a fast downward slide as the political landscape deteriorated and generated new uncertainty, thus decoupling a second time from the rest of EA

3. Important Reforms up to 2014

- The corrections of the twin imbalances are important reforms by themselves
- Large privatizations (Port of Piraeus-container terminal, small PPC, Regional airports-1, Hellenicon)
- Restructuring of ministries, employee evaluation procedure, unified wage framework, wage grid
- Improved flexibility in labor markets (no carry-over of past privileges (μετενέργεια), part-time employment, consensus arbitration
- Improved sustainability of pension system (unification of funds, new IT systems, increase in pension age limit, abolishment of many premature pensions, abolishment of third party fees, “no deficit clause” in supplementary pensions, new rules in calculating future pensions in alignment with SSCs)
- Opening up of closed professions, energy auctions, separation of ADMIE, simplification of permits to do business
- Progress in land registry
- Organic Budget Law-I with registries, automatic expenditure cuts, Parliament Budget Office, Fiscal Council, Tax policy unit
- Independence of Tax administration (ΓΓΔΕ)
- Observatory for monitoring local authorities and their expenses

3. Popular myths about Greece

MYTH #1: Greece used faulty statistical data to enter EMU

MYTH #2: The Goldman Sachs interest rate swap reduced the size of debt, helping Greece enter EMU with lower than the real Debt-to-GDP ratio

MYTH #3: Greece was the first country to violate the Stability and Growth pact

MYTH #4: Greece did not achieve much regarding structural reforms implementation under the 1st and the 2nd bailout program

MYTH #5: Greece did not achieve much in fiscal consolidation

MYTH #6: Public Debt was unsustainable at end-2014

MYTH #7: There was no investment interest for Greece

MYTH #8: A Grexit will improve the prospects of the Greek economy in the medium term

MYTH #9: Greeks are lazy

MYTH #10: Greeks are wealthy because they do not pay their taxes

MYTH #11: Greeks are in a natural constant turmoil

MYTH #12: The excessive behavior of Greek banks caused the country to suffer

4. Crisis Phase II: What went wrong in 2015 H1?

- Inexperienced government, MPs kept promising more after the elections!
- Ignored the supply side of the economy, instead made nominal debt haircut central issue
- Misjudged the European side's maximization problem
- Did not attempt to close the Review, hence were deprived of cash. Thus arrears went up to €6.1bn, drying up the liquidity of the private sector, plus €7.6bn were squeezed out of the state entities' cash buffers
- Created anxiety among the population, who gradually pulled more than €40bn from the banks or 25% of their deposits.
- By June, PM was about to close a deal with €9bn worth of measures he had proposed But he had an internal problem within SYRIZA. Not only would he fail to deliver on his pre-election promises of €10bn more in expenditure, but he was about to sign a much worse deal than the previous government, raising taxes and cutting wages and pensions. So he called a referendum. The referendum had a very ambiguous question.
- The announcement of the referendum created a bank panic, which immediately led to a bank holiday and capital controls
- July 5th referendum delivered a decisive NO to austerity, yet subsequently the PM, within a few days, did the opposite of the referendum result. This way he avoided the sure Grexit, as the country was desperate for cash.
- Leftist opposition of SYRIZA split off and formed a separate political party.
- SYRIZA did not want to govern as a minority government. Elections were thus called for September 20th. SYRIZA won again with 35.5% of the vote. A new SYRIZA –ANEL coalition runs the country.

4. The August 2015 3^RD MoU with its 4 pillars

- Implementation Period: 2015-2018,Conditionality will be updated on a quarterly basis
- About 241 actions, with 110 front-loaded until January 2016 according to original plan

I. *Restoring fiscal sustainability*:

- More gradual fiscal path due to objective weakness: Primary surplus balance targets of -¼, 0.5, 1¾, and 3.5 % of GDP in 2015, 2016, 2017 and 2018 and beyond, respectively
- Tax policy reforms (Income tax revamp, eliminate exemptions, VAT, tax on farmers), minimize Arrears, central procurement, more savings from Pension expenses, reinstate reforms in Health Care, Roll-out GMI

II. *Safeguarding financial stability*:

- Recapitalization of banks before the end of 2015, tackle strategic defaulters, sell NPLs, new governance structure of HFSF & banks

III. *Growth, competitiveness and investment*:

- Reforms in labor markets & product markets (including energy) via business environment and competition policies
- Ambitious privatization Programme

IV. *A modern State and public administration*

- Efficiency of judicial system, (Code of Civil Procedure, fight fraud & corruption)
- Institutional & operational independence of key institutions such as Revenue Administration & ELSTAT
- Pension reforms to remove exemptions, end early retirement
- Fiscally-neutral Wage Grid, Better recruitment process for Managers
- Rationalization of SOEs

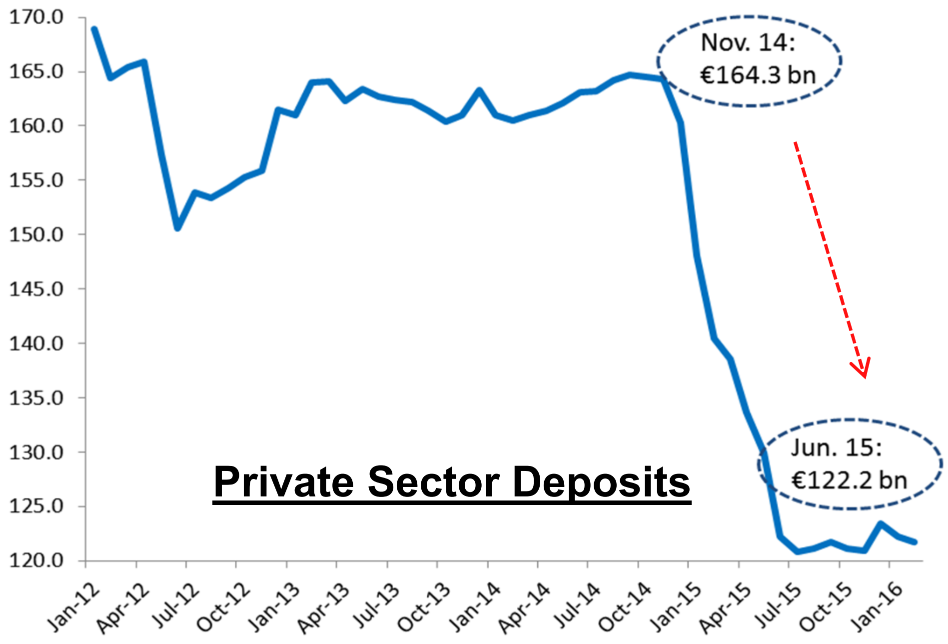
4. Why a Crisis - Phase II ?

- Lack of will to carry the reforms and install the agreed fiscal measures of the 3rd MoU has delayed the approval of the first Review way past the October 2015 deadline. Many of the 110 actions due in January 2016 are way overdue.
- Despite relaxation of fiscal targets, measures worth 9 times worse are required
- Economic policy resembles the economists' random walk model.
- This behavior further destroys credibility, while keeping the uncertainty in the economy and thwarting investment, pushing companies to register abroad and the youth to seek employment elsewhere.
- Bad news on growth:
  - Full year 2015 contraction of -0.2% instead of the original 2.9% thanks to precautionary consumption , postponement of tax payments, drop in oil prices (2015 Budget). And a growth of -1.0% for 2016 is optimistic at this stage. Hence, at a minimum the loss in GDP over 2015-16 is cumulative at ca. 7.0% GDP compared with the 2015 Budget targets for growth (2.9% and 3.5% for 2015 and 2016 respectively).
  - But growth is unlikely to resume easily given the fiscal measures to be taken, which are ca. 5% of GDP, (mainly based on raising taxes and less on expenditure cuts). Assuming a fiscal multiplier of unity, this implies a further reduction of GDP by another 5%.
  - Assuming growth resumes in 2017, the pre-Phase II end-2016 GDP earlier forecasted GDP level is likely to be reached with at least a four-year delay, way into 2020s.
  - There is silence about the government's growth policy, if there is one.

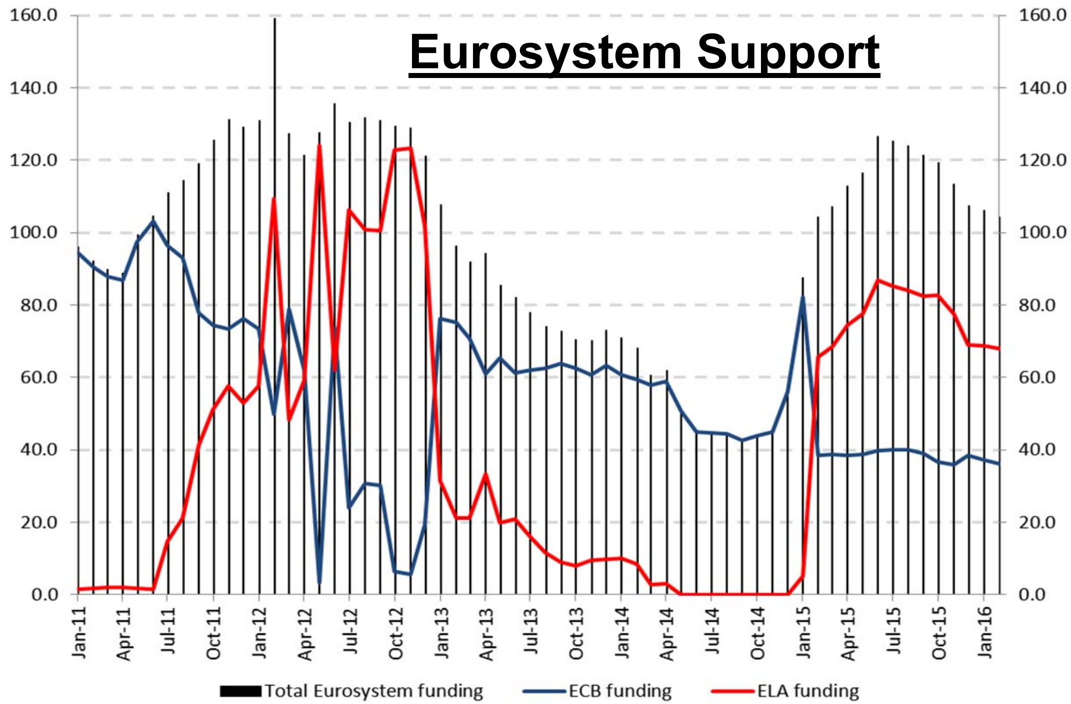
4. Why a Crisis Phase II ?

- Bad news on Nominal Debt, which will ceteris paribus deteriorate by approximately €50bn or 30% of GDP:
  - By 7.75% of GDP or €13.5bn from the lower primary surplus targets up to year 2018
  - By 14% of GDP or €25bn from the loss in bank stock value under State ownership since the summer of 2014
  - By another 4% of GDP or €7.1bn of the required new capital infusion into domestic banks since November 2015 just in order to keep the new much lower stock participation intact. This number came out lower than the anticipated 25bn, hence the Program may require €64.5bn instead of €86bn until end-2018.
  - By possibly another 3% of GDP or €5bn from the collapse in asset prices and the reduced value of privatization receipts
- All the above together with a much lower growth trajectory past 2018 than earlier anticipated (i.e. a growth rate of 2% instead of 3.0%-3.5%) make the Debt-to-GDP ratio clearly unsustainable
- Debt relief is now a must. This is the IMF view. It is thus puzzling the Greek government chose to make the IMF its "enemy." Perhaps due to their insistence on reforms.
- The possibility of future social unrest is no longer unthinkable

4. Tight domestic Financial Conditions

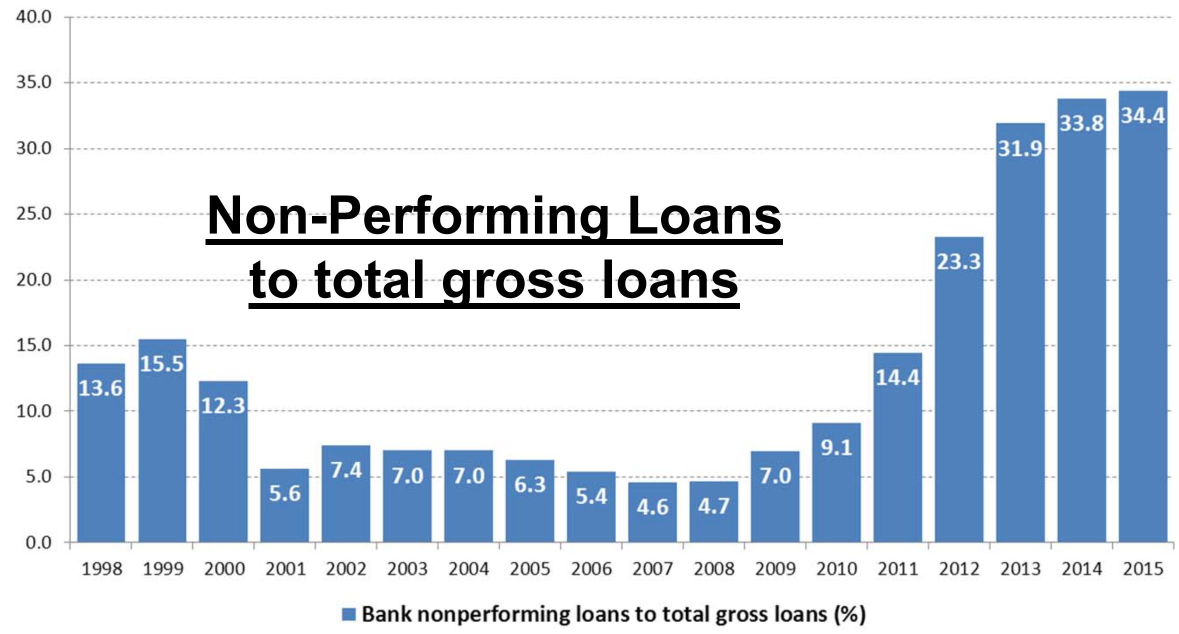


Source: Bank of Greece



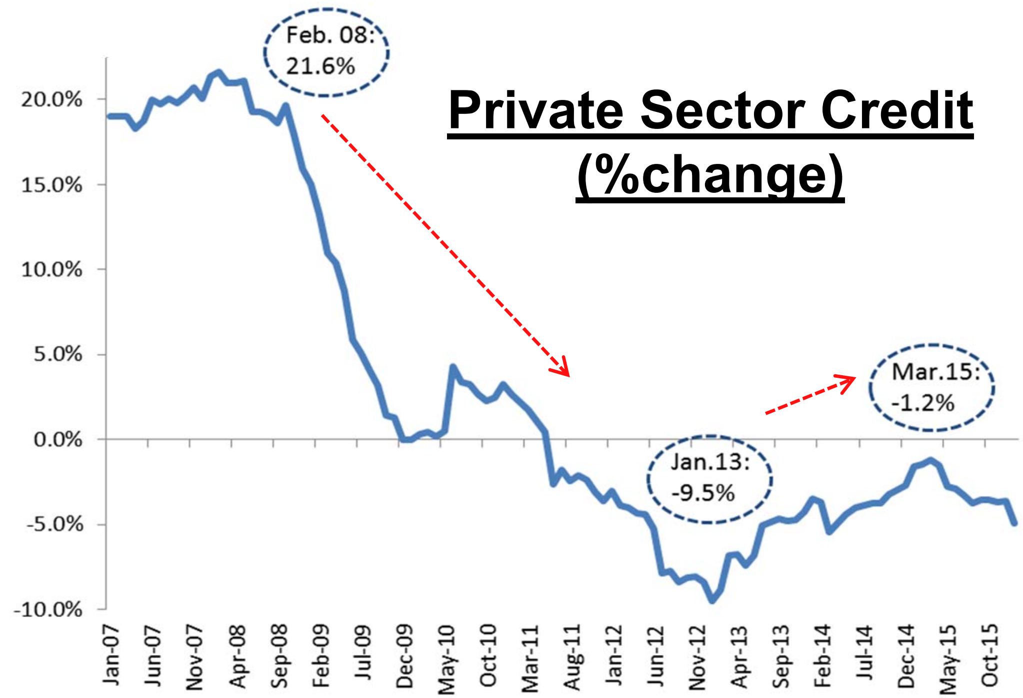
- **Private Sector Deposits decreased by ca €42.1 bn between November 2014 and June 2015 just before the imposition of capital controls (June 28 2015).**
- **Private Sector Deposits at €121.7 bn at the end of February 2016 recorded a -0.4% mom & a -13.4% yoy decrease amid uncertainty over the conclusion of the 1st Review of the Third Economic Adjustment Programme for Greece**
- **Emergency Liquidity Assistance (ELA) increased from 0 (zero) in November 2014 to €86.8bn at the end of June 2015 mainly due to the 2015 turmoil over the conclusion of the Second Programme, the Grexit fears, etc. The most recent ELA reading (March 2016) was at €66.2bn.**

4. Tight domestic Financial Conditions



- Non Performing Loans increased from 4.6% of total gross loans at the end of 2007 to 34.4% at the end of 2015 due to the ongoing recession
- SSM adopted a stricter measure, NPEs

- Private Sector's Credit Growth decreased from 21.6% yoy at the end of February 2008 to -9.5% yoy in January 2013. Currently (February 2016) it stands at -4.8% yoy due to the ongoing deleveraging of the Greek banking system but also to a lack of demand.

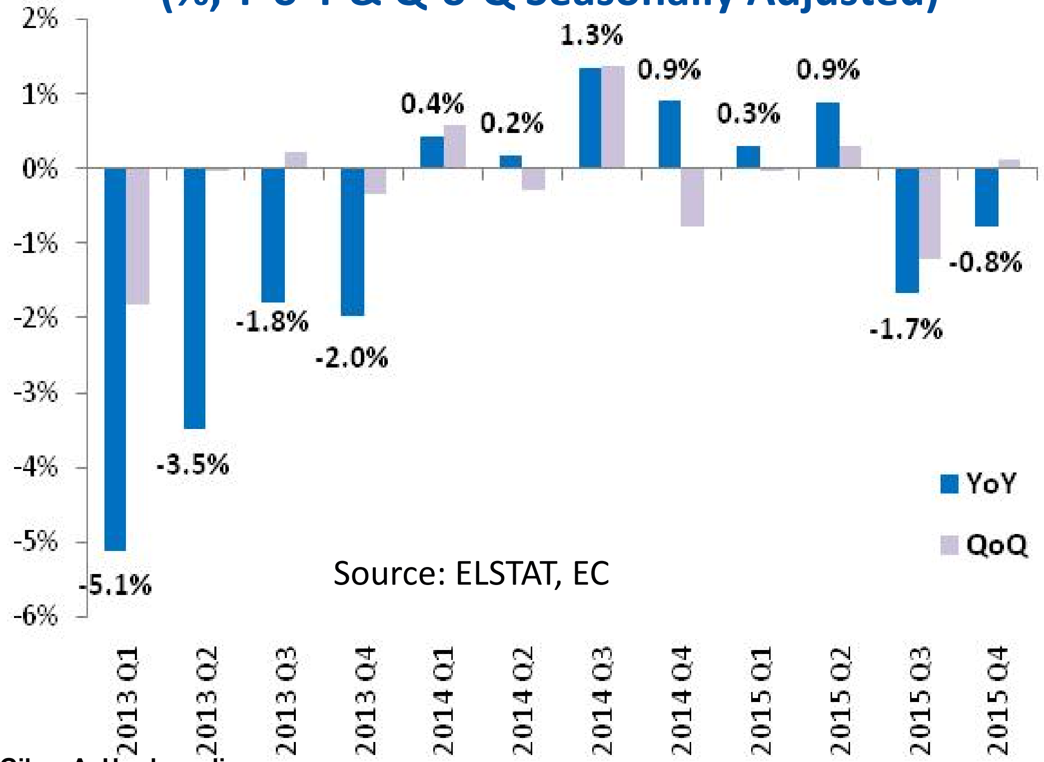


Source: World Bank, Bank of Greece

4. Over the Short-run: Capital controls aborted growth take-off, yet impact milder than feared

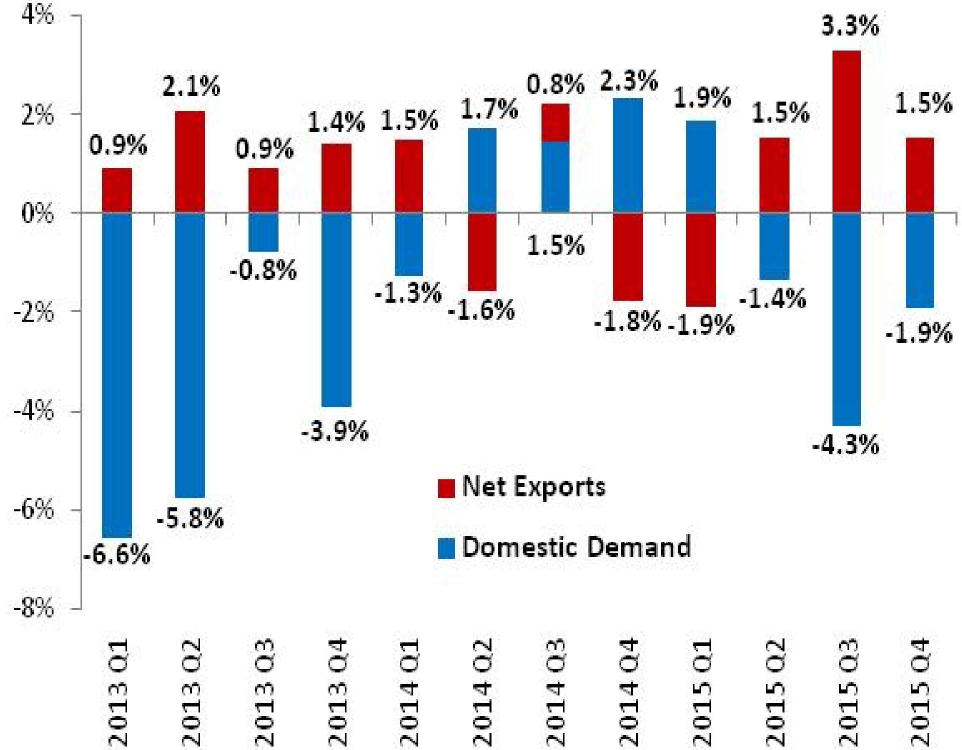
- Liquidity squeeze & heightened uncertainty in negotiations with official creditors affected sentiment, SMEs, and aborted the anticipated growth take-off
- Some resilience due to positive consumption dynamics (lower oil prices, delayed tax payments, declining unemployment & precautionary spending vis-a-vis negotiation uncertainty) and a decline in imports
- Resilience weakens in H2 and investment falls, real GDP growth turns negative (fiscal austerity measures & capital controls) with CPI at -0,5% in Jan 2016, HICP at 0.1%

Greek real GDP growth
(%, Y-o-Y & Q-o-Q Seasonally Adjusted)

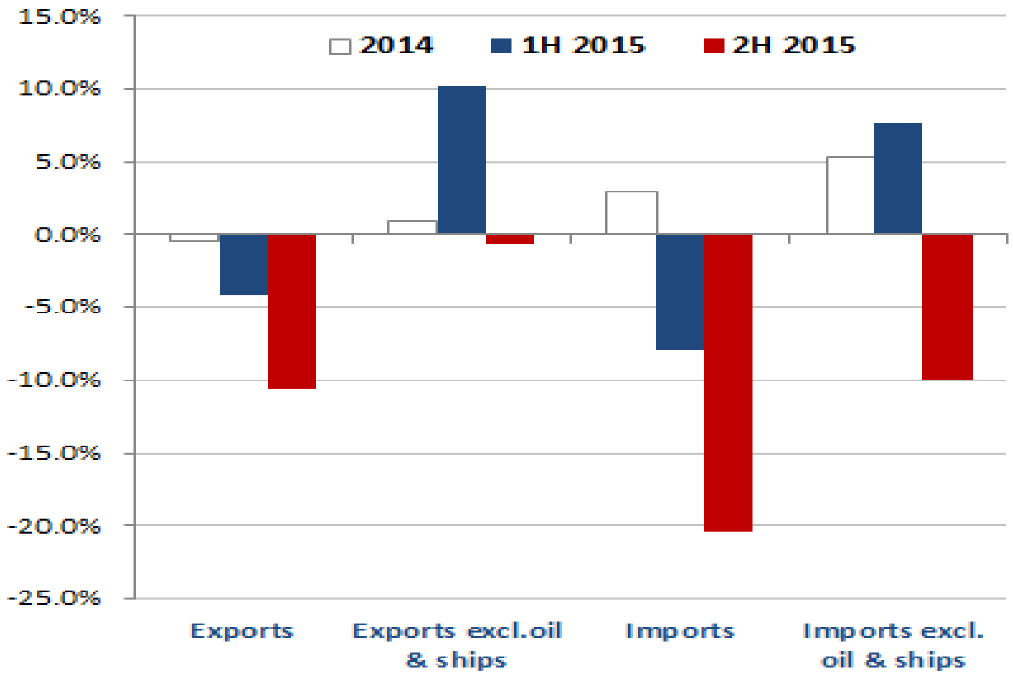


Source: ELSTAT, EC

Contributions to real GDP growth

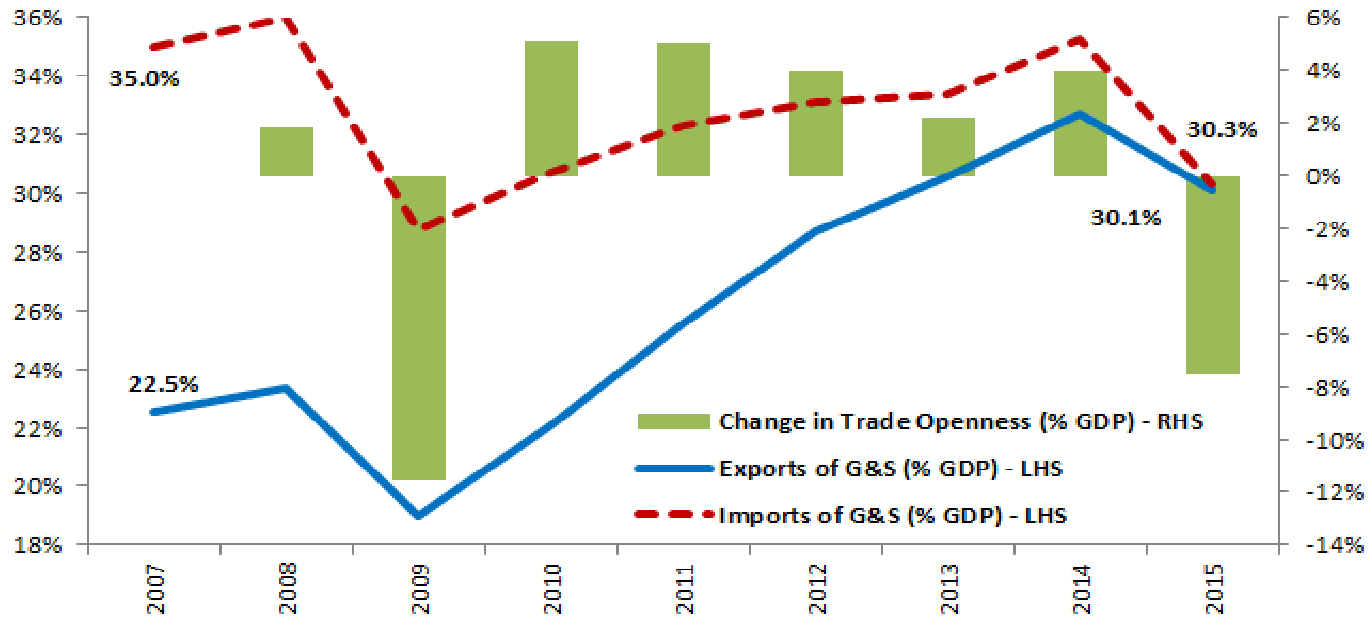


4. Capital Controls Hurt Extroversion



Goods exports & imports (YoY, %)

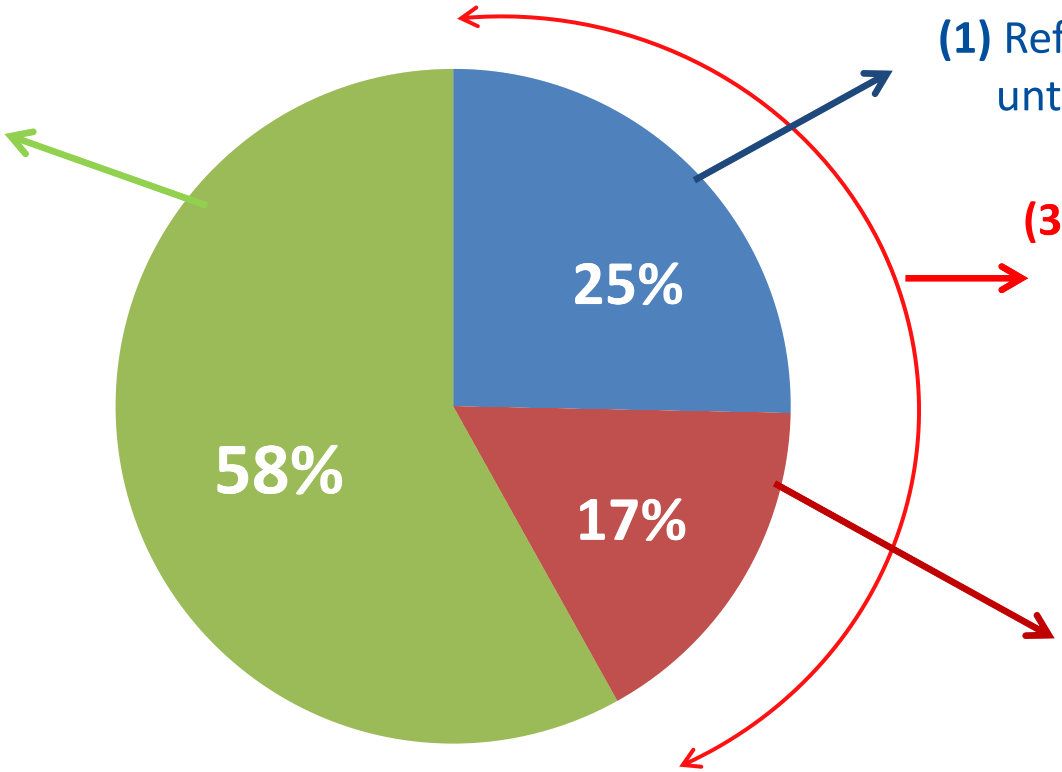
- Goods balance: sizeable decline in imports after imposition of capital controls ; Exports of goods excl. oil & ships and tourism resilient in H2 in 2015, shipping revenue and oil exports fell



- Capital Controls already in place for 9 months, hurting exports – imports and internal trade
- The uncertainty over the successful conclusion of the 1st Review delays the abolition of CCs; relaxation already in progress but <u>full abolition not expected before end of 2016 at the earliest</u>, conditional on positive developments in upcoming reviews
- Convincing structural reform plan essential in reinstating confidence and thus avoid deposits flights upon abolishment

Source: ELSTAT, BoG, AMECO.

4. New bailout Programme frontloads reforms

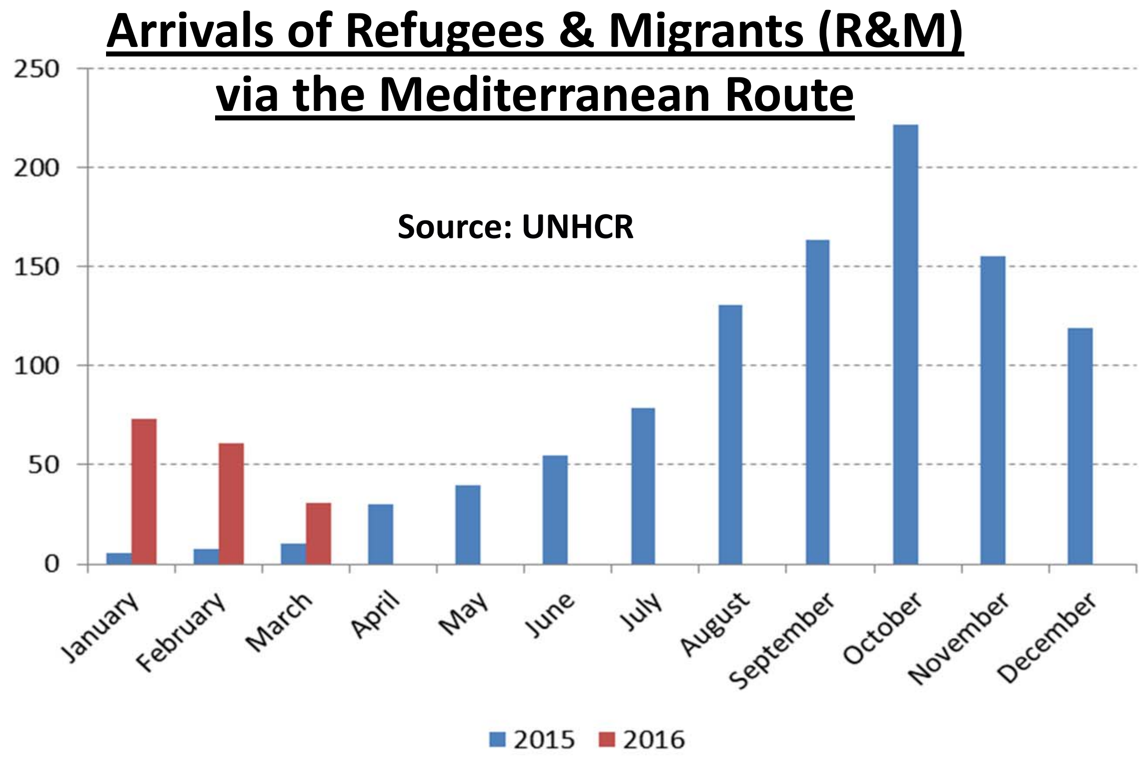


# Reforms	
(1)	61
(2)	40
(3)=(1)+(2)	101
(4)	140
Total (3)+(4)	241

Source: 3rd Economic Adjustment Programme

- **1st program review: key items on the agenda**
  - Social security & income tax reform
  - New Medium-Term Fiscal Strategy (2016-2019) & identification of measures to cover projected fiscal gaps
  - New Privatization Fund
  - Outstanding issues on NPL resolution framework (first residence and SMEs)
  - Modernization of public administration & completion of the energy-electricity sector reform (*e.g.*, NOME auctions)

4. Geopolitical risks: Refugee crisis



R&M that remained stranded within the Greek border reach ca 51.00 thousands at the end of March 2016. Continuation of the current situation constitutes a significant risk for:

- **The Greek tourism sector.**
- **The Greek exports / logistics sector since all the major export ways (railways) pass via the now closed north borders of the country.**
- **The Schengen Treaty membership of the country.**

1. Out of a total of 164.7 thousands of R&M arrivals from the Mediterranean Route in the first 3-months of 2016:
   - 90.8% arrived via GR
   - 8.8% via IT
   - 0.4% via ES
2. Clearly a too heavy burden for GR to carry alone. BoG estimated *immediate* fiscal cost at €600bn; EU resources of €470mn but bureaucratic difficulties
3. Domestic and EU delays; EU-TK agreement finally stricken in late March 2016 but questions remain over the ability of various parties to implement it.

4. An Optimistic Macroeconomic Outlook for 2016

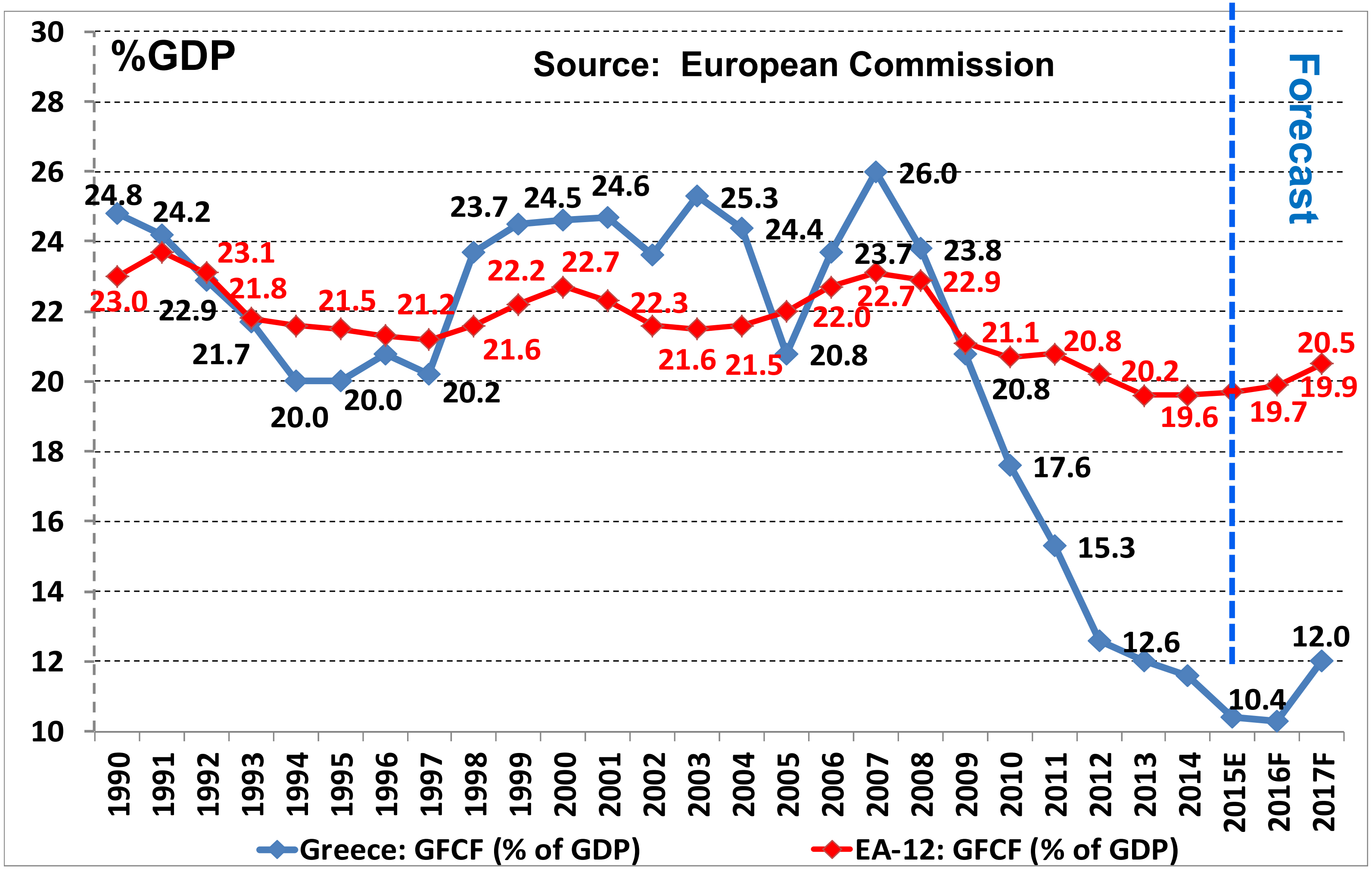
- Key assumptions
  - Global economy evolves in line with the latest official sector forecasts
  - Successful completion of 1st programme review
  - Containment of geopolitical risks, refugee crisis
  - Political ownership of the reform agenda implementation

	2014, €bn (nominal)	2015 yoy% Real Growth	Shares in 2015 GDP	2016 yoy% Real Growth
Private Consumption	125.0	0.3	70.3	-2.9
Government Consumption	35.4	0.0	20.3	-0.8
Total Consumption	160.4	0.2	90.3	-2.4
Gross Capital Formation	21.7	-13.1	9.8	-1.5
Domestic Demand	182.1	-1.4	100.2	-2.3
Imports	62.6	-6.8	30.3	-2.1
Exports	58.0	-3.8	30.1	2.4
GDP	177.6	**-0.2**	100.0	**-1.0**
	2014	**2015**		**2016**
GDP Deflator (yoy%)	-2.2	-0.6		0.2
Unemployment Rate (%)	26.5	25.1		25.5
Pr Sector Deposits (yoy%)	-1.8	-23.0		6.3
Pr Sector Credit (yoy%)	-2.7	-3.6		-1.0

Source: ELSTAT, EC

5. Over the long-term: Investment is a binding constraint on growth

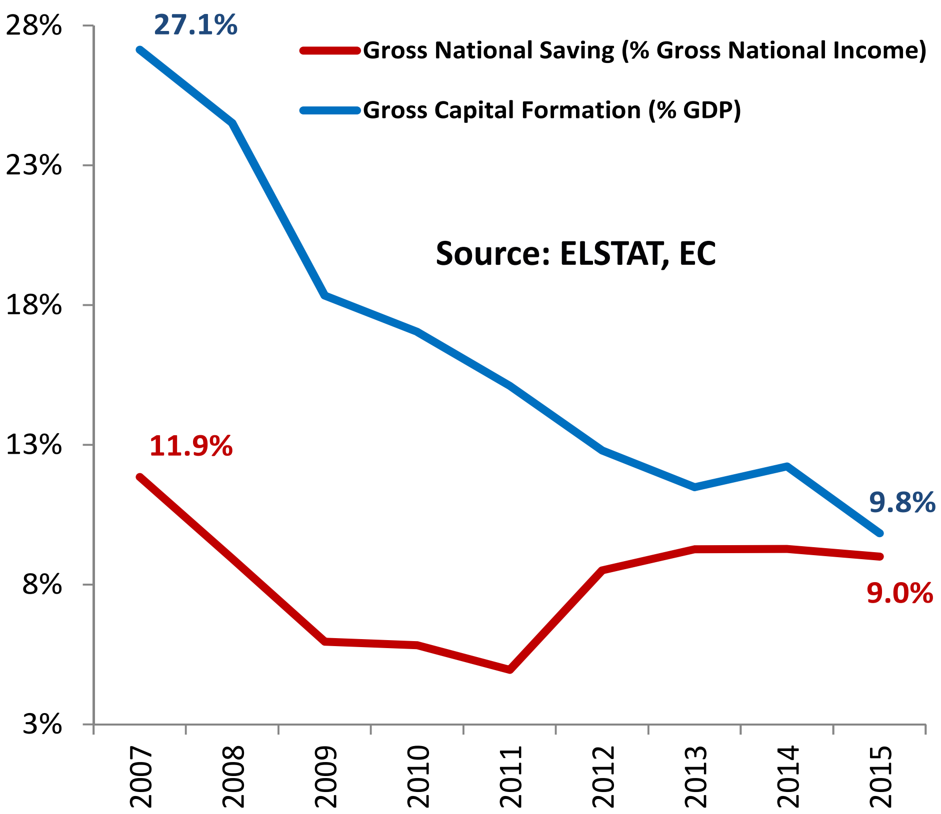
- Assuming the economy manages to stabilize, the challenges are many, including Investment
- Investment needs funding, FDI, EU funds, the Junker plan



- It will be difficult for Investment to reach the pre-crisis shares of GDP, as real estate investment will take time to recover
- What is needed for growth today is Investment in machinery & equipment

5. Foreign Direct Investment needed

Total investment vs. gross national savings (% GDP)



- ❑ Greece's investment spending (% GDP) lowest since 1960
- ❑ Investment Ratio needs to converge to EA average and remain there for a number of years so as to lead to a sustainable recovery
- ❑ Domestic savings inadequate to finance a sustainable future expansion, FDI urgently needed
- ❑ Stock of FDI: €18.6bn in 2015 from €35.8bn in 2007
- ❑ Major source for the attraction of FDIs in the medium term is the implementation of the privatization agenda
- ❑ Creation of a new privatization fund with a longer maturity
- ❑ Progress on various projects (Regional airports, Hellinikon, etc.)
- ❑ Another source is EU funds *available* for Greece (ca €4bn and €20bn from Structural Cohesion funds for 2007-2013 & 2014-2020 respectively, ca €15bn from Agricultural Funds)

- ❑ Repayment of Gen. Gov. Arrears & tax refund arrears is another potential source of liquidity
- ❑ Arrears at €5.4bn in Jan 2016 (€6.1bn in Oct 2015), from €3.8bn in December 2014, a 42.8% rise
- ❑ Circa 5.5 bn have been earmarked for arrears payment according to the 2016 Budget. No payments observed yet

5. Summing up: Can growth come back beyond simply a cyclical recovery?

Is Phase II of the Greek Crisis just a 2-year delay to a growth take-off which began in 2014?

- Economic policy remains unfocused
  - There is no clear growth strategy, no commitment for reforms
  - The first Review of the 3rd program was supposed to have been concluded last October. Yet, there is doubt it would conclude even before the Greek Easter. An issue of contention is the design of the pension system. The IMF insists on its long-term sustainability.
  - Meanwhile the Greeks are been overtaxed and began resisting, from white-collar processionals to farmers
  - The youth is immigrating and companies are registering abroad
  - And the government keeps hiring new public employees!
- Meanwhile, since January 2016 the bearish world market has taken a toll on Greek bank stocks, which are down 60% relative to the recent recapitalization of November 2015. Their NPLs keep rising.
- And there is a refugee crisis

6. Conclusion: An uncertain future ahead of us

- Europe faces major challenges
- Greece faces even bigger ones
  - The risks today are bigger than last summer as their resolution requires hard work by many, not just political will by some
  - Greeks may have reached their limit in absorbing tax increases: Immigration of people and companies
  - Avoiding persistent stagnation becomes increasingly more difficult

Greek Crisis Phase II: More Pain in Sight?

Thank you
for your attention!

Gikas A. Hardouvelis