Europe at a crossroads:

The Greek & Euro Area Sovereign Debt Crisis

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I. Markets woke up from a decade of nirvana: Sovereign risk is now the driver

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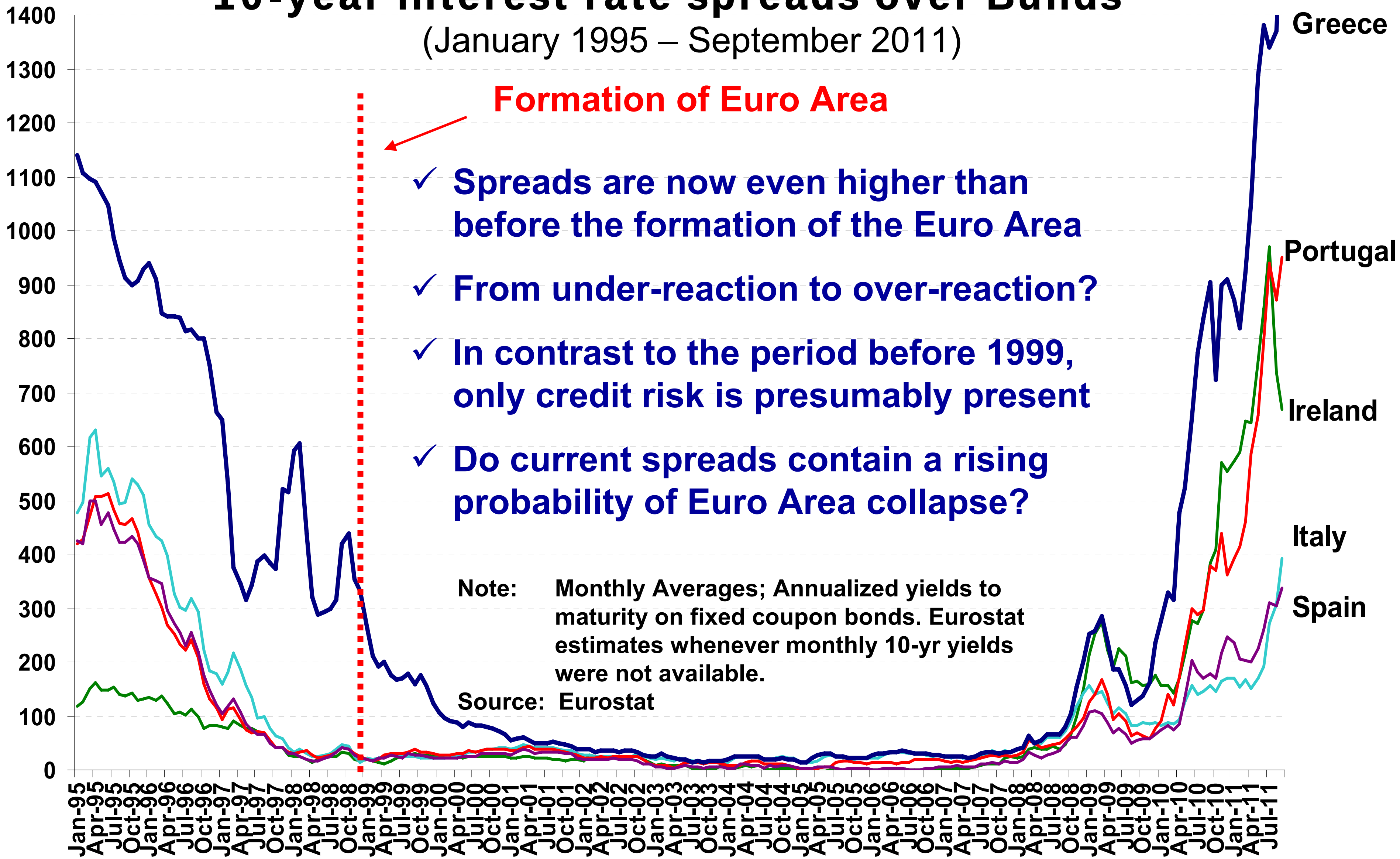
10-year interest rate spreads over Bunds

(January 1995 – September 2011)



- ✓ Spreads are now even higher than before the formation of the Euro Area
- ✓ From under-reaction to over-reaction?
- ✓ In contrast to the period before 1999, only credit risk is presumably present
- ✓ Do current spreads contain a rising probability of Euro Area collapse?

Note: Monthly Averages; Annualized yields to maturity on fixed coupon bonds. Eurostat estimates whenever monthly 10-yr yields were not available.

Source: Eurostat

I. Two years of Greek & Euro Area crisis

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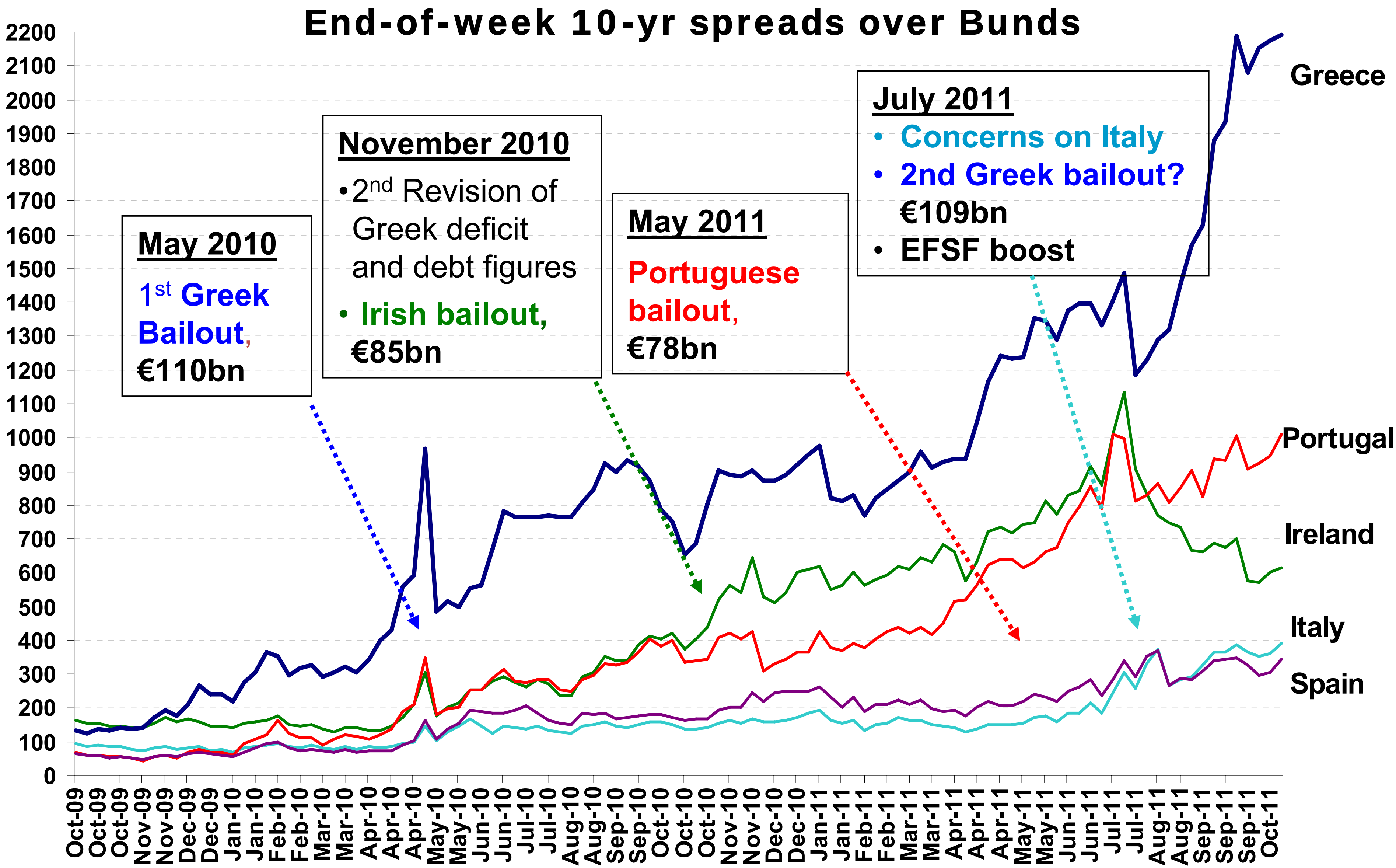
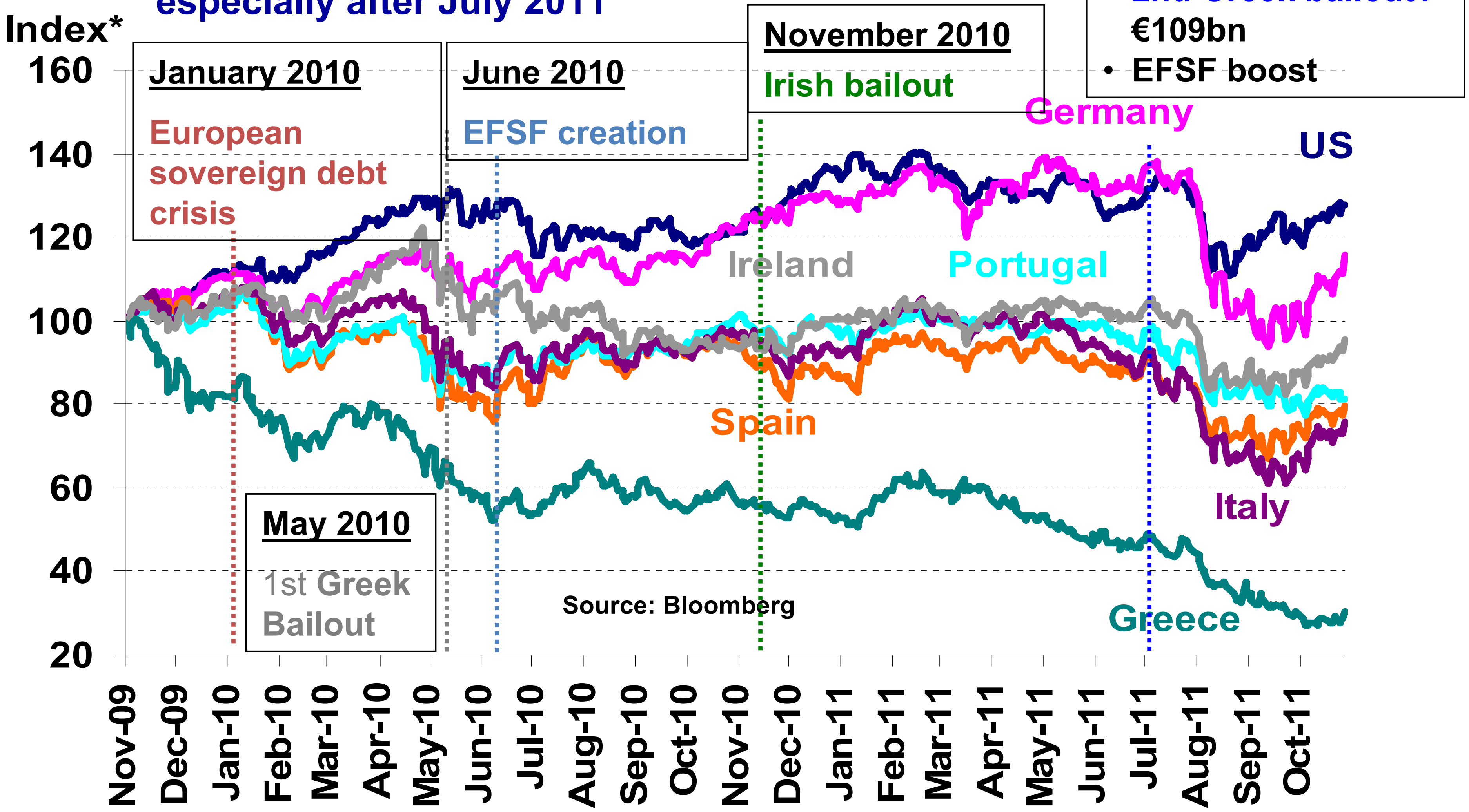


Source: Bloomberg

I. Stock markets in European Periphery underperform

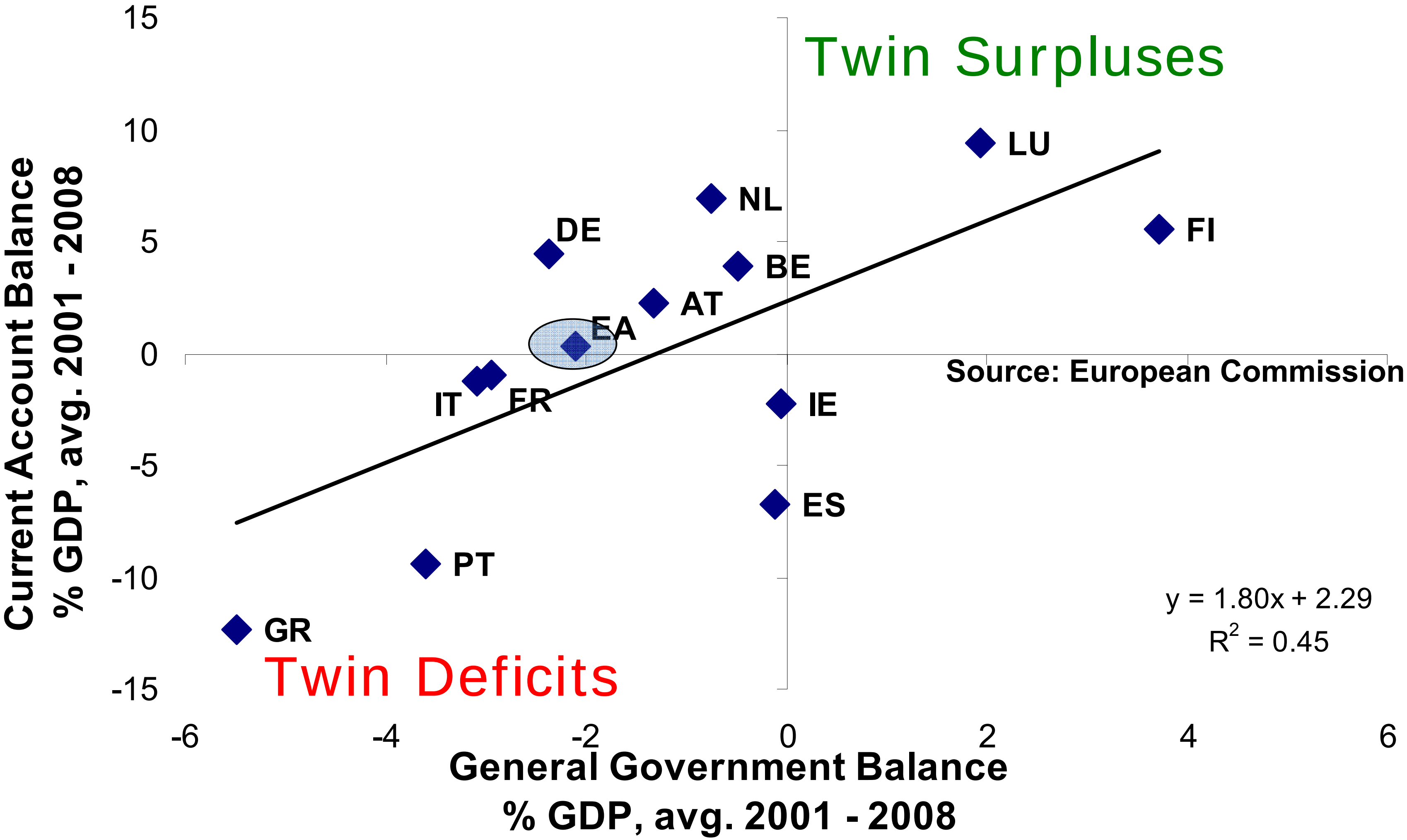
- ✓ Greece stands out as a main looser
- ✓ Portugal, Ireland, Spain & Italy also decoupled, especially after July 2011



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

I. External and internal (fiscal) imbalances in the Euro Area

- ✓ **Uncompetitive South vs. competitive North**
- ✓ **Fiscal profligacy almost everywhere**



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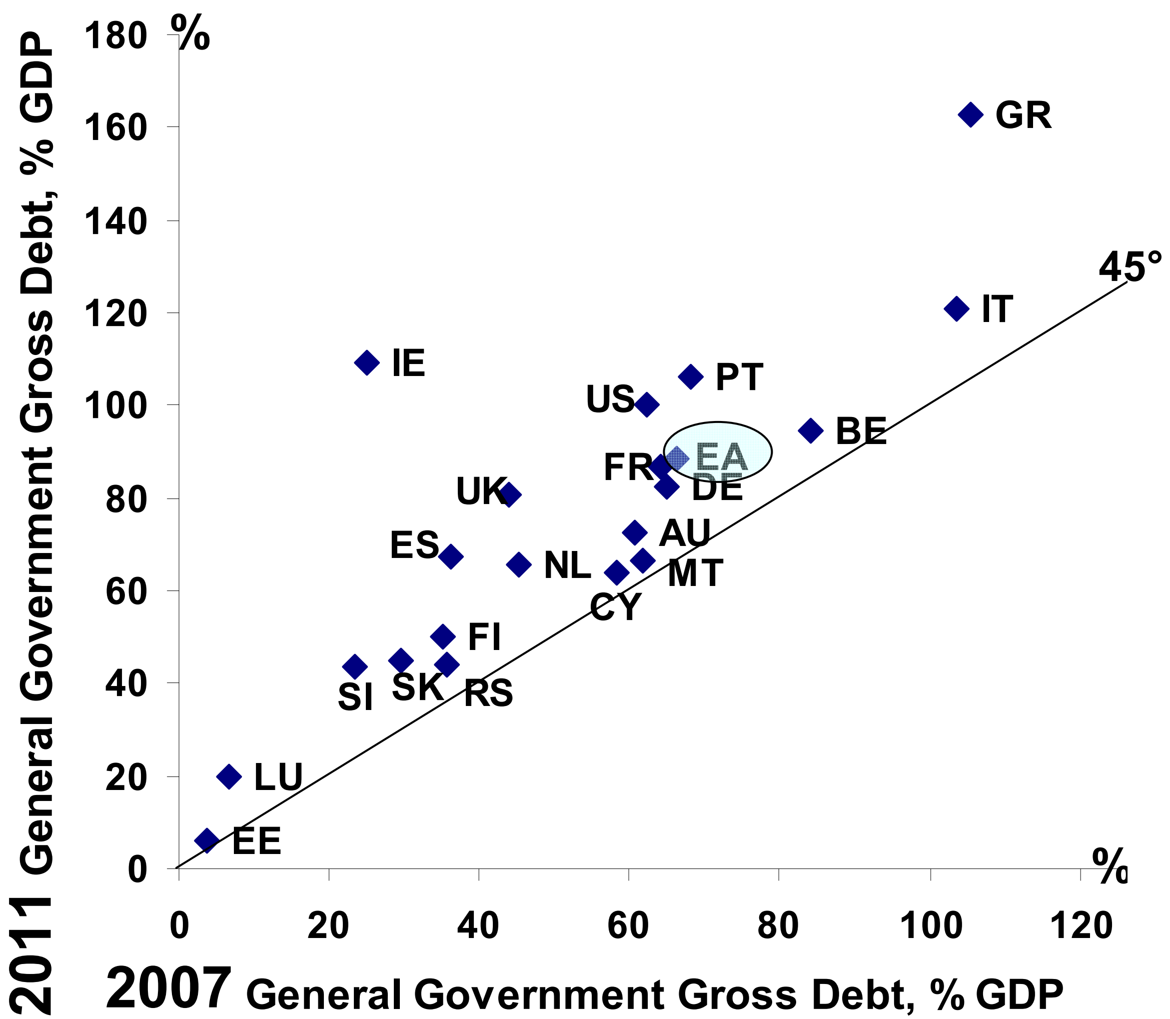
General Government Debt-to-GDP



Source: IMF, EU

2011 GG Debt (€ bn)	
Portugal	181.5
Ireland	171.9
Italy	1,924.2
Greece	357.0
Spain	733.2

- ✓ Debt Deterioration everywhere from 2007 to 2011
- ✓ Largest deterioration in Ireland
- ✓ EA showed smaller deterioration than US or UK

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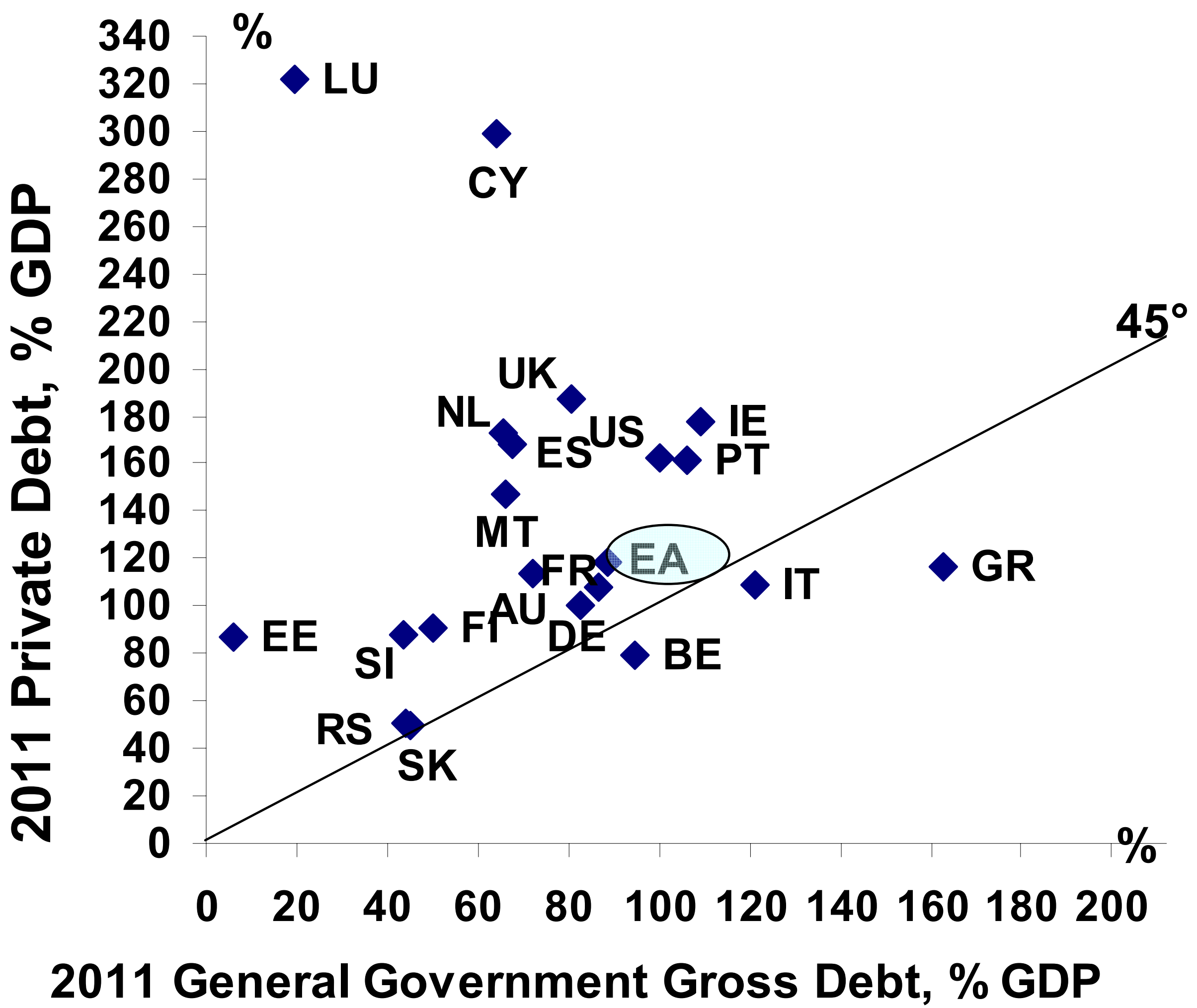
Household & Corporate Debt-to-GDP in 2011



- ✓ EA Private debt higher than Public debt in 2011
- ✓ Most countries above the 45-degree line: Higher private than public debt
- ✓ Exceptions are Belgium, Italy & Greece, where Private debt is smaller than Public Debt

Source: EU, IMF, ECB, Federal Reserve, NBS

I. Different Euro Area countries confronted with different challenges

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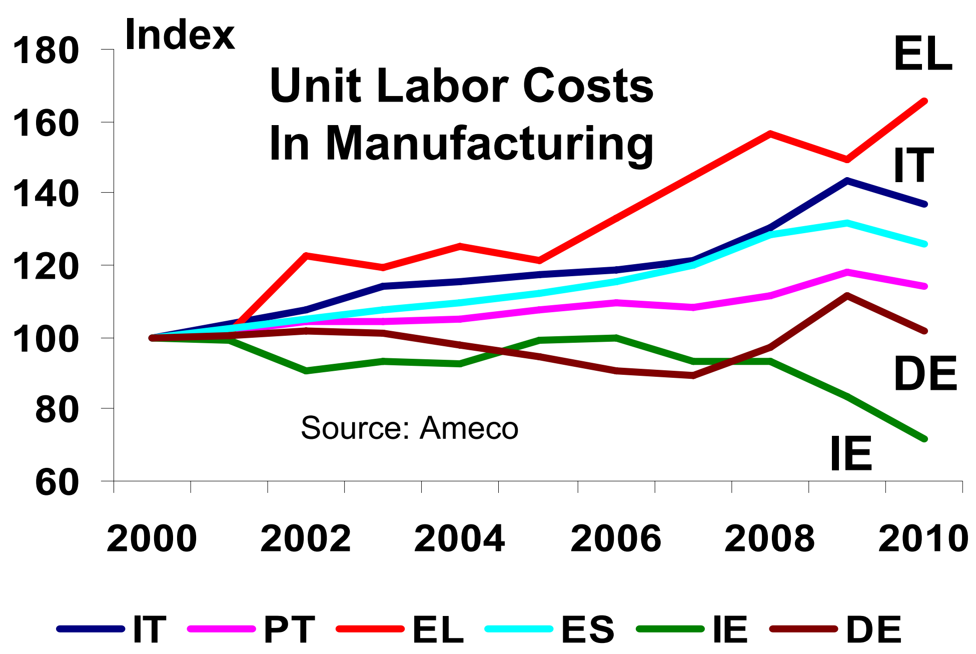
- ✓ **IRELAND**
  - ↓ **Housing market**
  - ↓ **Banks →rise of public debt**
  - ↓ **High private debt**
- ✓ **PORTUGAL**
  - ↓ **Low competitiveness**
  - ↓ **Large fiscal deficits, but not debt**
  - ↓ **High private debt**
- ✓ **SPAIN**
  - ↓ **Low competitiveness**
  - ↓ **Housing market**
  - ↓ **Small savings banks**
  - ↓ **High private debt**

GREECE

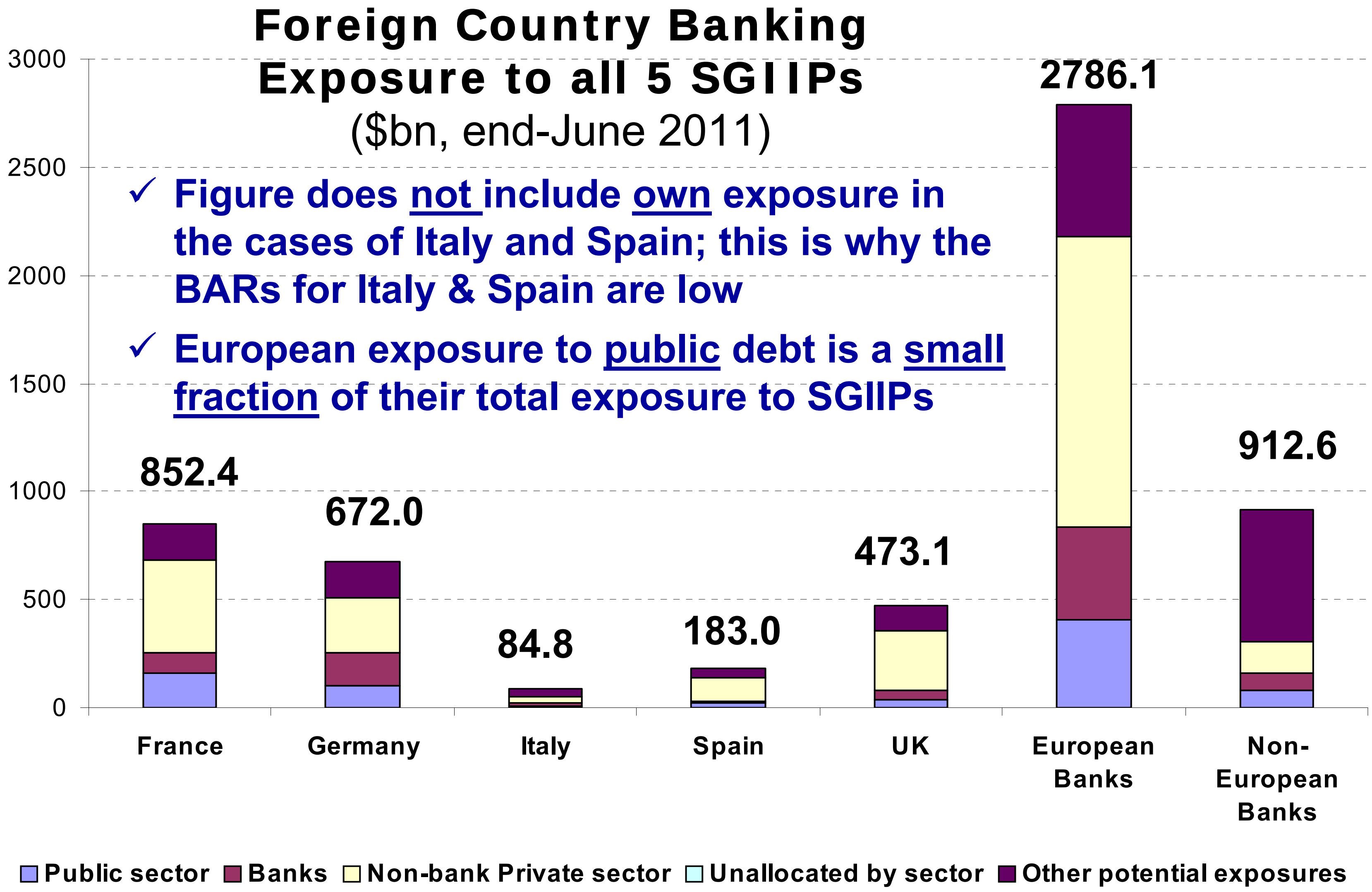
- ↓ **Low competitiveness**
- ↓ **High fiscal deficits & debt**

ITALY

- ↓ **competitiveness**
- ↓ **High debt**



I. Debt crisis can easily turn into a banking crisis



Source: BIS

I. Debt crisis can easily turn into a banking crisis

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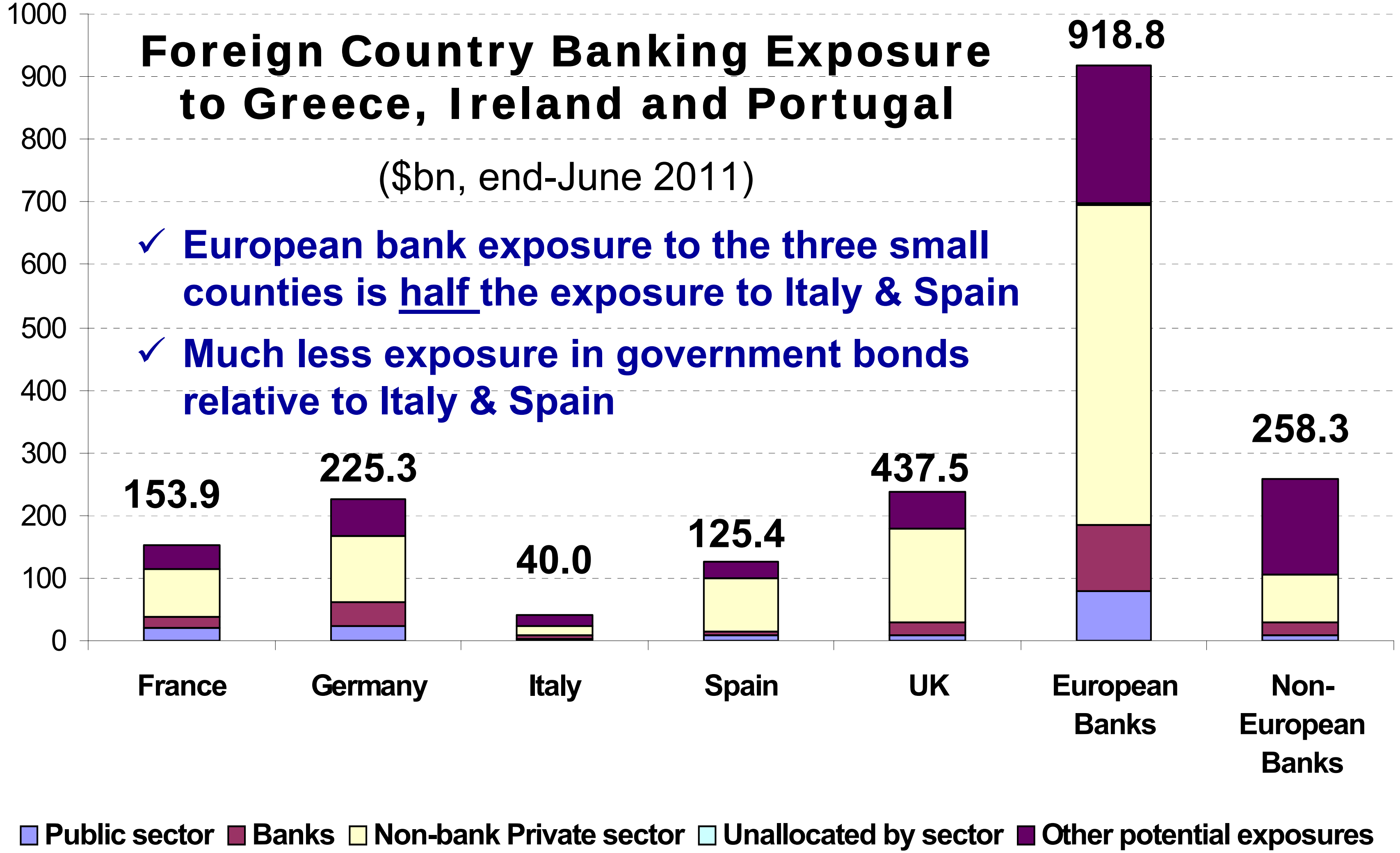
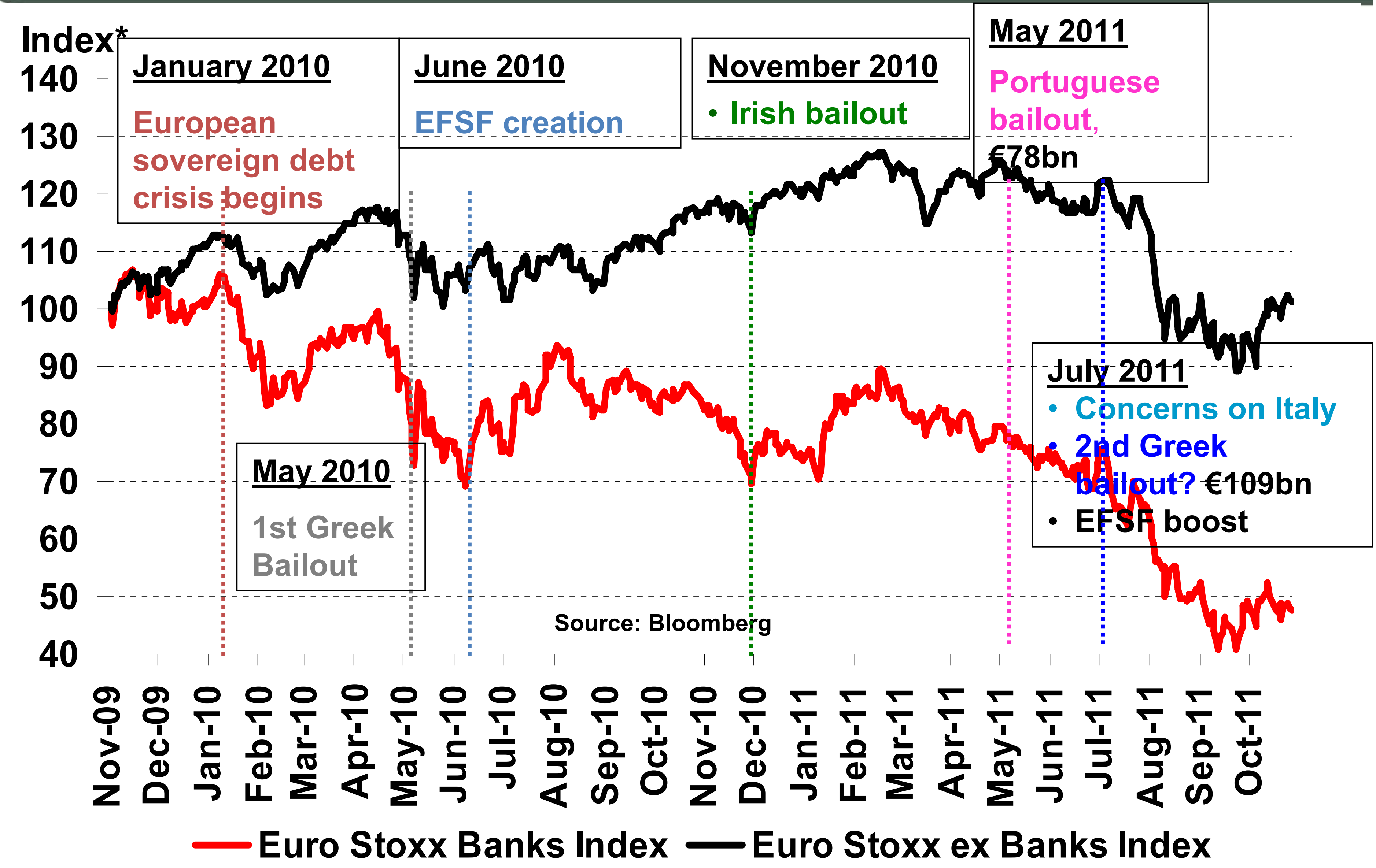


Source: BIS

I. Euro Area bank stocks distressed



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II

I. Economic Imbalances and Markets

II. Is EMU design to blame? How did we get to here?

III. What is the solution for the Euro Area?

IV. Can Greece escape the crisis?

II. Why a crisis? Economic theory of Optimum Currency Areas was ignored

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Politicians advanced the hypothesis that convergence to an **Optimum Currency Area** will naturally take place once EMU is formed in an environment of open borders and free competition. Openness & free competition were legislated prior to the formation of EMU:

- ✓ **Liberalized labor, capital and product markets among participating countries**
- ✓ **Internal market rules that ensure a level-playing field**.

However, the remaining structure of the real economies was left intact. But for OCA to occur in a region with no common central authority that would redistribute the effects of shocks, member countries either have to share similar structures or be flexible enough to absorb shocks quickly.

- ⌦ A **fiscal transfer mechanism was never installed** as it required deeper political integration
- ⌦ Further **uniformity in economic structures was avoided** due to domestic political resistance in various countries. The Maastricht Treaty did mention the significance of economic variables like the balance of payments, unit labor costs, etc.
  - No mechanism was created to control systematic imbalances between Member States
  - No importance was given to **a)** the uniformity of pension systems, **b)** the competitiveness of labor markets, and **c)** the uniformity of tax rates
- ⌦ Even Maastricht Treaty implementation **ignored the debt/GDP criterion** for political reasons: Belgium and Italy had to enter EMU easily
- ⌦ The **Lisbon Agenda** aiming to improve competitiveness addressed EU member states, not EMU states. It was also based on the method of "***open coordination***," which posed no constraints on Member States

II. EMU formation led to additional imperfections

Were European politicians naïve? No, they installed <u>safeguards</u>:

- The **Stability and Growth Pact** (SGP) and the **independence** of the **Eurosystem** were considered the **main pillars for the Euro Area stability**
  - ✓ **Independence of Eurosystem worked**, although questioned today
  - ✓ **SGP did not work**
    - System of embedded penalties for excessive deficits was relaxed after Germany and France faced the first difficulties in 2004
    - Debt criterion continued to be ignored
    - EUROSTAT auditing of fiscal data proved far from perfect, plus it some times played politics with the configuration of statistics (e.g. case of Greek military expenditure)
  - ✓ "No Bailout Clause" was presumed to exist but ceased ex-post, after the crisis hit

- The very existence of the Euro Area resulted in **absence of market discipline**, which allowed **low interest rates** and resulted in the explosion of private and public debt
  - ✓ As money was cheap, banks became over-extended and vulnerable
  - ✓ Real estate bubbles were formed
  - ✓ Public Deficits in certain countries went over the 3% GDP limit
  - ✓ Nominal wages proved sticky and did not allow proper adjustment to external asymmetric shocks
  - ✓ Structural reforms were abandoned, a competitive Euro Area North and an uncompetitive Euro Area South emerged

I. Economic Imbalances and Markets

II. Is EMU design to blame? How did we get to here?

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III. Is there a solution? Europeans in disarray are fixing an architecture with a 15 year lag

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- ✓ Euro Area countries understand EMU dissolution is not an option: Implies huge costs in financing, in trade, in politics and the average European living standards
- ✓ The crisis revealed **two needs**, **not necessarily complementary**:
  1) **Need for actions to contain the crisis**
  2) **Need for a better long-run framework, which would ensure long-term stability of the euro**
- ✓ Euro Area has chosen to focus on redesigning its framework and ignored the need to contain the crisis, which has slowly grown larger and larger. In fact, **the new design, which comes ex-post with a 15-year lag, tends to inhibit actions that can counter the crisis but add to moral hazard**
- ✓ The Euro Area is working on three fronts:
  - ❖ Harmonization of Fiscal policies - ***Van Rompuy proposals,*** final report will be presented on October 2011 EU Council
  - ❖ Harmonization of Competitiveness policies - "***Euro Plus Pact***"
  - ❖ Financial stability – Better regulation & supervision of Financial Institutions plus the European **Stability Mechanism**: No-bailout clause gone, funds boosted, ability to intervene in primary & secondary market
- ✓ A list of ten measures aiming to strengthen economic policy coordination and surveillance was included in the October 26, 2011 Euro Summit results.

III. Is there a recipe for euro survival?

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- Academics of all political persuasions agree: **<u>Solve the crisis first</u> and then worry about long-run architecture and adverse incentive problems**
  - ✓ The visit of US secretary Timothy Geithner at the September 2011 ECOFIN Council was intended to push Europeans for a drastic solution beyond the narrow local country interests; serves to indicate the **EA crisis can easily become global**
  - ✓ **Contagion to Italy** in August **shook up the hardliners in Europe**; Germans worked with the IMF to cut Greek debt and ring-fence Europe from the onslaught of markets
  - ✓ EU Council decisions of October 27 set the stage for the next few months
- **<u>A recipe for euro survival</u> (crisis comes first, design issues later)**:
  1) **Separate insolvent from illiquid countries**; Restructure the debt of insolvent and provide unlimited backing to illiquid ones; Urgent need to create a firewall around solvent governments.
  2) **Shore up the capital base of European banks** to be able to withstand country defaults
     - ✓ IMF's discussion on the need to recapitalize European banks pinpoints the issue
     - ✓ Increasing core Tier I capital requirements to 9% from current 7% <u>is not prudent</u>
  3) **Switch to an agenda of growth** from the current obsession with fiscal discipline
     - ✓ Possible need to follow the US example of handling the crisis; Meets strong German opposition as it increases moral hazard; Greece has no discretionary power
  4) **Redesign the long-term EA framework** in a way that does not allow crises, implying change of treaties
     - ✓ The design effort on the new Euro Area architecture is along those lines

III. What is the role of EMU institutions?

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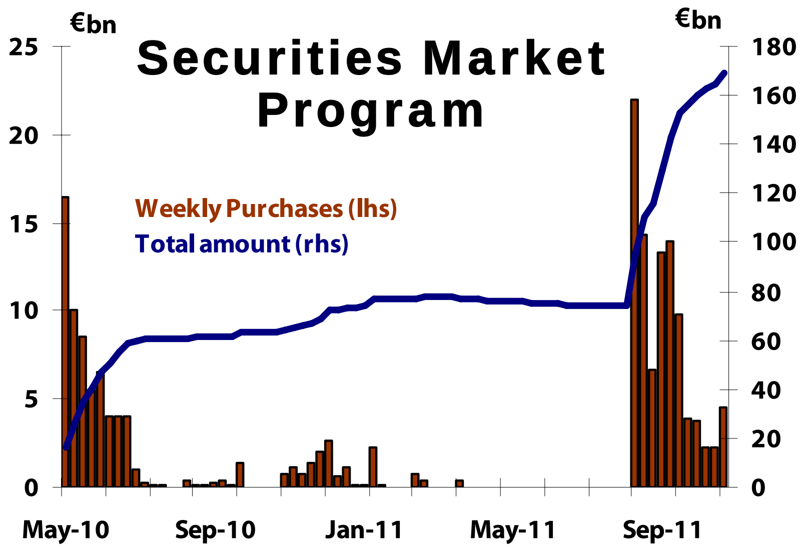
<u>On the ECB role</u> – ECB resists implicit fiscal role, *My View: ECB better be left alone, provided the EFSF is allowed to assume an active role; otherwise ECB ought to be more active*

- ECB intervened to stabilize banking system, hence constrained Sudden Stop in Periphery.
- ECB not as aggressive as the Fed. Bankers complain it does not act as proper lender of last resort as the ELA mechanism is costly and the pressure on them to deleverage huge
- Independence issues:
  - ✓ Calls for ECB to act as lender of last resort for <u>governments as well</u>, or to guarantee gov. debt
  - ✓ Should ECB transfer its SMP to the EFSF to keep its independence?

	EA			Greece		
	a	b	c	a	b	c
Jun-07	464.6	28,026	1.7	4.3	353.0	1.2
Dec-07	637.1	29,494	2.2	8.8	391.3	2.2
Jun-08	483.0	30,839	1.6	11.6	424.5	2.7
Dec-08	843.2	31,831	2.6	40.6	464.5	8.7
Jun-09	896.8	31,804	2.8	54.0	490.6	11.0
Dec-09	728.6	31,144	2.3	49.7	491.9	10.1
Jun-10	870.4	32,578	2.7	94.3	543.2	17.4
Dec-10	546.7	32,200	1.7	97.8	514.1	19.0
Jun-11	497.5	31,743	1.6	103.1	503.2	20.5
Aug-11	524.6	32,782	1.6	93.2	490.0	19.0

Bank Borrowing from the ECB



III. What is the role of EMU institutions?

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On the EFSF (ESM) Role

- ESSF could play a major role, relieving the ECB. Yet it has little money, **€440 bn**
- Leveraging that money is under discussion. According with the results of the October 27 EU Summit, two basic options we decided:
  - ✓ Provision of credit enhancement to new debt issued by Member States in order to reduce the funding cost. The risk insurance will be provided to investors when buying bonds in the primary market – ***Analysts question its effectiveness***
  - ✓ Separate SPV per problematic country, with funds from other sovereigns and private investors in order to enlarge the amount of resources available for bank recapitalization and purchase of bonds in the primary and secondary markets. IMF contribution is considered too. **– Criticism: *If Germany is unwilling to put up the funds, why would anybody else outside EMU trust those structures|?***
- The EFSF could use both options at the same time. The final details of the new EFSF structure will be announced in November 2011 EU Summit.
- Academics and professional economists argue for a more aggressive EFSF:
  - ✓ Transformation of the EFSF from an SPV with capital guarantees to a bank or an SPV with permanent capital. It would then borrow from the market and/or the ECB (Gros & Mayer 2011)
  - ✓ EFSF to be transformed into a fiscal transfer mechanism (Tabellini 2011)

III. What did European leaders decide?

EU Council conclusions on October 27, 2011

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❖ EFSF will be leveraged "up to four or five times"

EFSF's effective lending capacity is **€440 bn**. Out of this, €48.5bn committed for the Irish and Portuguese rescue programs (€22.5bn and €26bn). An additional €100bn earmarked for a second bailout plan for Greece, along with some €30bn in the form of Euro Area member state contributions to a new PSI package. **Leverage will occur via two methods**:

i. **EFSF guarantees "first loss**" of EA sovereign bonds, perhaps up to 20% -30%

ii. **Special purpose investment vehicles** open to potential funding from the IMF as well as public and private financial institutions and investors.

❖ EU-wide bank recapitalization

i. New **Core Tier-1 Capital Ratio of 9%** (vs. 5% in the summer EBA stress tests) after marking down to market their EMU-periphery sovereign bond holdings as per September 30, 2011. Deadline to reach the new core tier 1 threshold is end-June, 2012. To achieve this, banks should first raise capital via the private sector. Any remaining shortfalls to be met by national governments. The EFSF would be used only as a last resort. According to EBA, current short-fall of €106.5 bn.

ii. ensure European banks have **adequate medium-term funding**. No details yet.

❖ Italy commits on strengthened fiscal consolidation

❖ Tighter fiscal & economic governance in the Euro Area (new rules still postponed)

❖ Greek sovereign bond haircut, plus second bailout package

IV

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IV. Tough road ahead for the Greeks: From riches to rags?

- √ **Greece is a small country with a relatively closed economy**
- √ **Greece grew fast from 1994 to 2007 but the growth was imbalanced**
- √ **Greece was the first country to "call the whistle" on the Euro Area imperfections, yet it did enter the Euro Area having satisfied all the criteria**
  - ❖ The current assertions that Greece tricked Europe to enter with false numbers are utterly wrong and are driven by domestic politics in EA countries
- √ **Greek economy is in deep recession with no clear sign of recovery , causing popular anger**
  - ❖ the new recovery date of 2013 in the Troika Program is a guess based on previous experience with many countries in crisis and is conditional on reforms being implemented soon
- √ **In contrast to Ireland and Portugal, no consensus among main political parties on an economic strategy for the next decade**
  - ❖ Citizens' Ownership of the MoU targets was never tried; too late to do it now?
  - ❖ Perhaps, we should not demand too much from politicians who themselves are partly responsible for the current dead-end; they cannot become managers overnight or gain the political legitimacy to carry the required drastic reforms
- √ **Implementation of reforms was delayed for a year, but now auditors by the EU and the IMF creditors will become more aggressive**
- √ **The EU Council decisions of October 26 buy time for Greece, perhaps until 2014 to fix its economic structure or risk being kicked out of the Euro Area**
  - ❖ Yet contagion will always be there to scare European hardliners; Ring-fencing European banks is not enough to eliminate contagion;
  - ❖ Negative events may accelerate if Italy does not take drastic actions

IV. A birds' eye view on Greece: Population and the economy

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2009	Greece	EA16	World
Population (mil.)	11.3	329.1	6,756.0
Geographical Area (km^2)	132.0	2,578.8	510,072
GDP per capita (€)	20,820.9	27,218.9	7,704.9
Living standards (UN ranking among 182 countries)	25	17	
Life expectancy (years)	80	80.5	66.1
Cars per 1000 inhabitants (2006)	407	506	
Suicides / 100 thousand inhabitants	2.8	8.8	
Primary Sector (% GDP)	3.1	1.7	6.0
Secondary Sector (% GDP)	13.3	17.9	30.6
Tertiary Sector (% GDP)	79.1	74.2	63.4
Tourism (% GDP)	15.2	8.1 (EU-27)	9.3
Construction (% GDP)	4.5	6.3	
Public Sector (Gen. Gov. Expenditures % GDP)	52.7	50.8	
Exports (% GDP)	18.8	36.3	
Imports (% GDP)	29.6	35.0	
Private Consumption (% GDP)	73.5	58.2	
Gen. Gov. Debt (% GDP)	127.1	79.3	

IV. High Greek growth rates, yet based on an imbalanced economy

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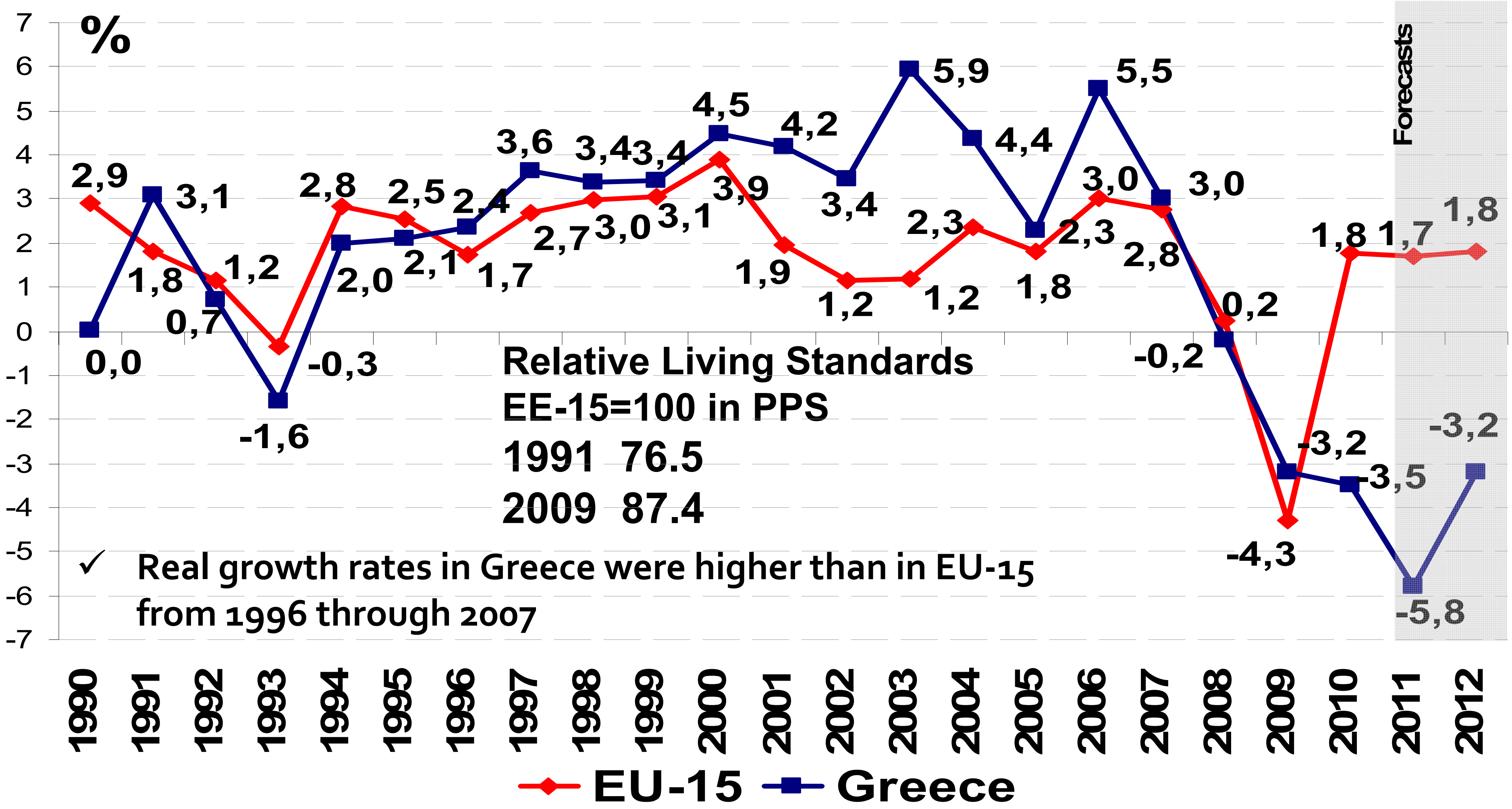
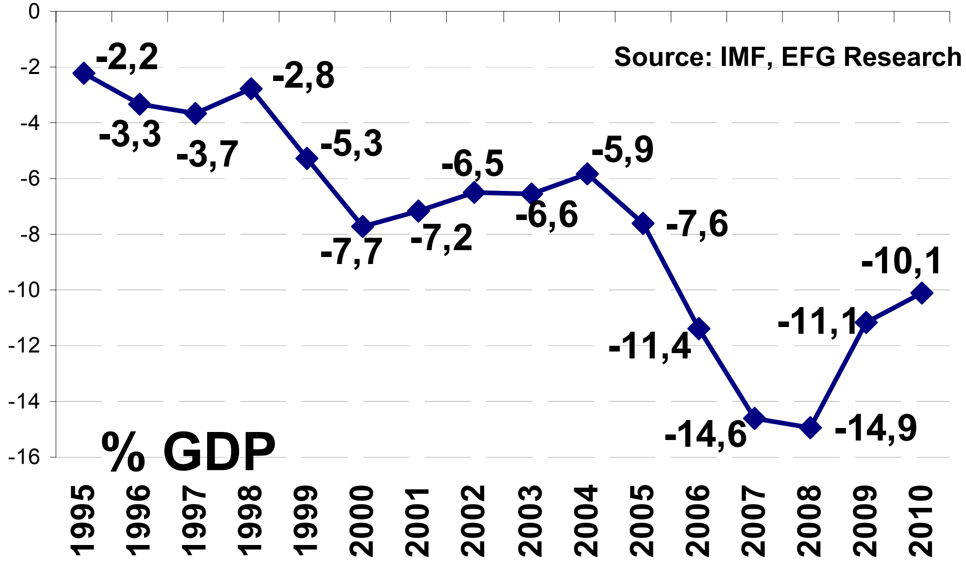
Greece: From boom to bust. How come?

Answer: **Not an equilibrium growth**

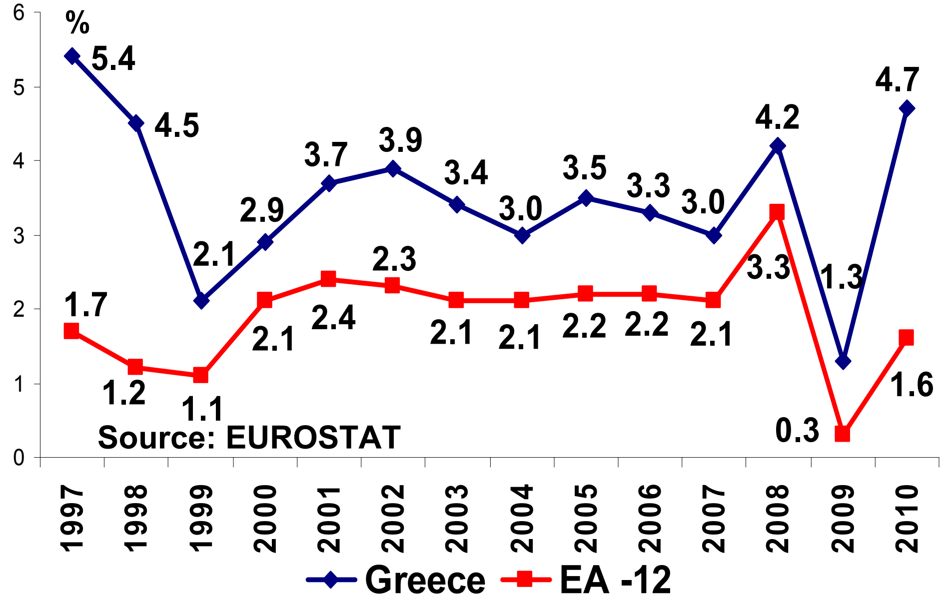


Source: EU, ELSTAT, EFG Forecasts

Current Account Balance



Inflation



2010	€ mill.	% GDP
Current Account	-22,975.6	-10.1
Goods	-28,279.6	-12.4
Services	13,248.5	5.8
Income	-8,143.4	-3.6
Current Transfers	198.9	0.1

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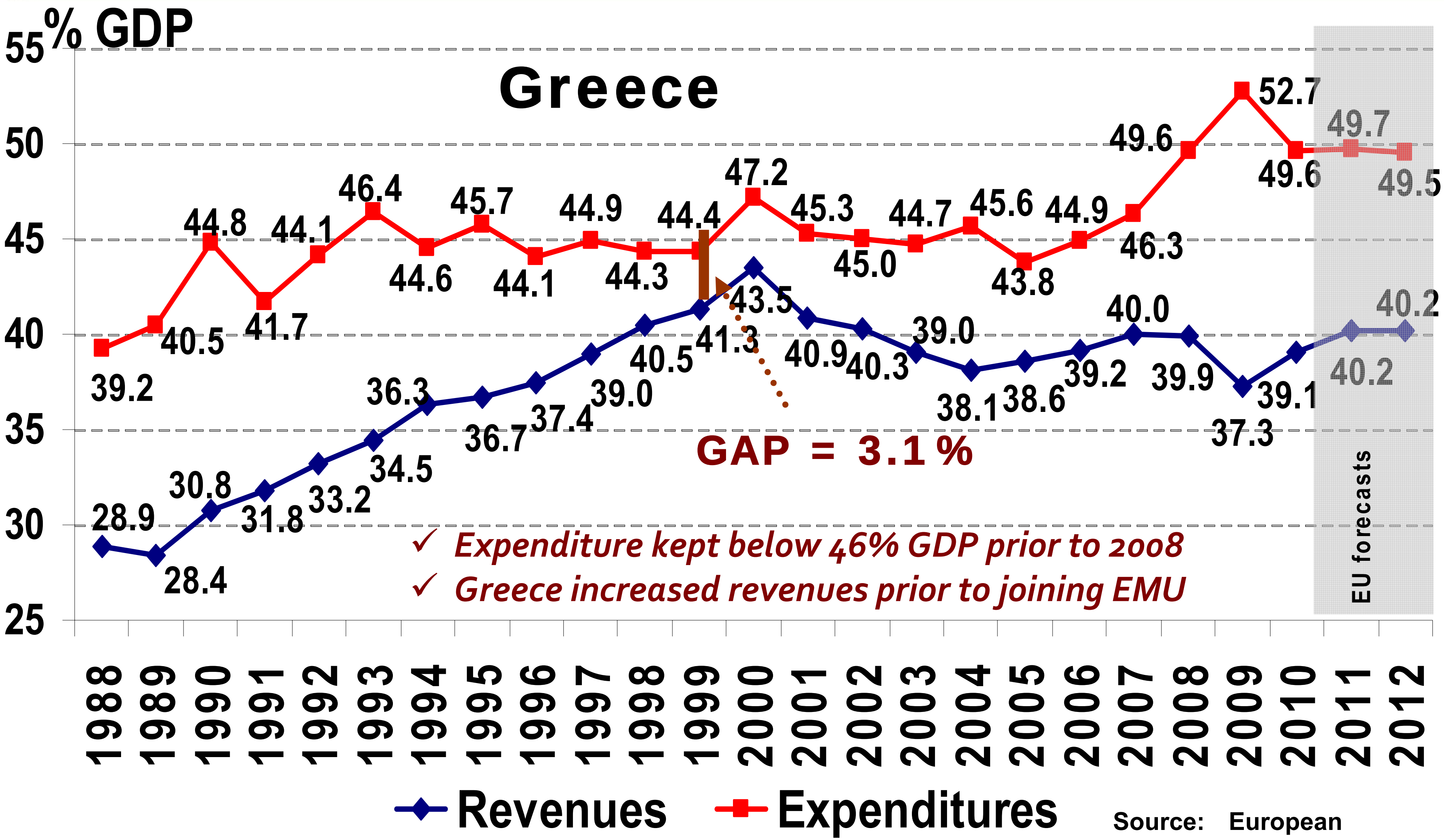
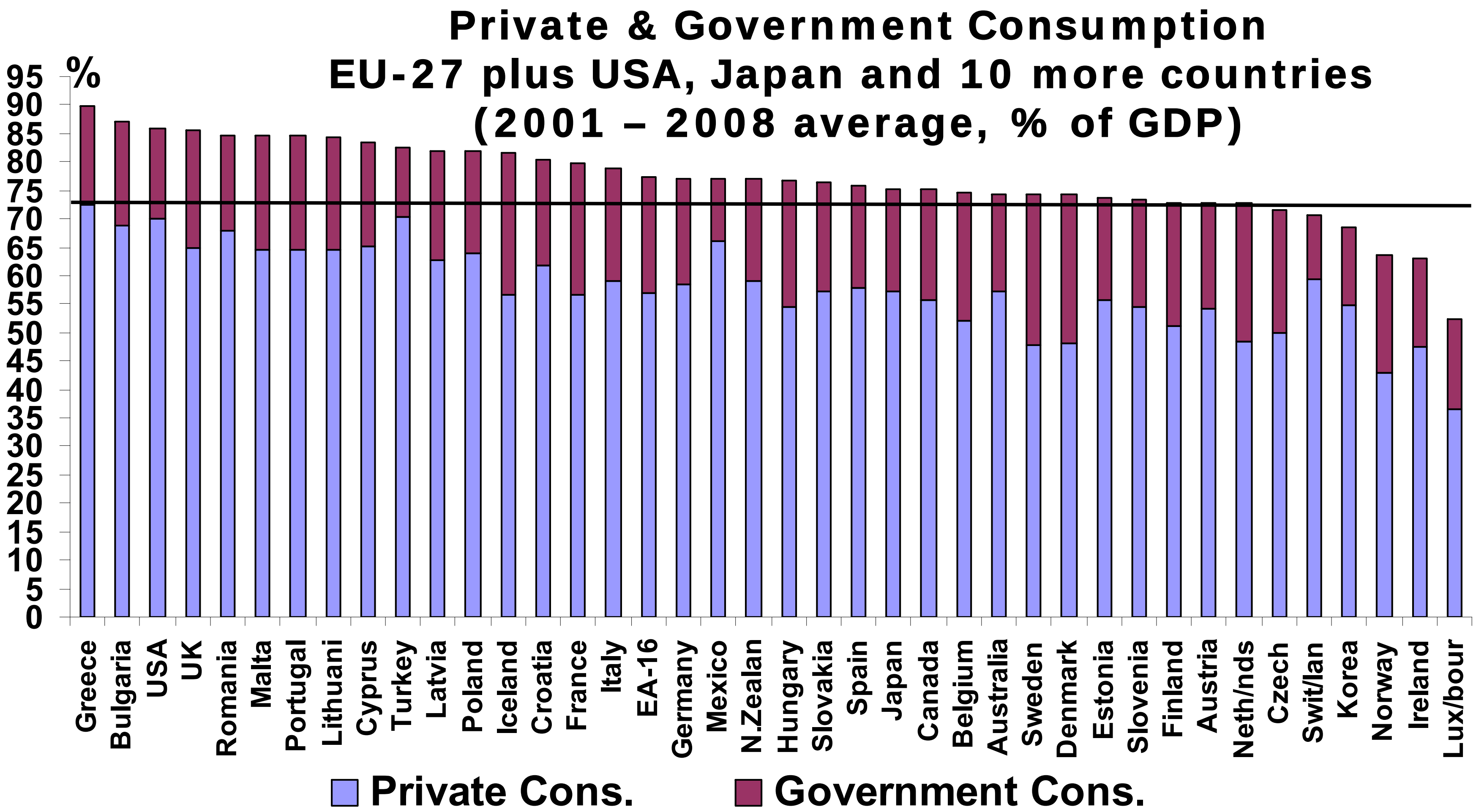


Source: European Commission, Spring 2011 forecasts

✓ Greece was almost always in fiscal trouble, but fiscal mess grew prior to the onset of the 2009 recession

IV. Related disequilibrium: Over consumption

- ✓ Excessively optimistic expectations about future income motivated borrowing (facilitated by low interest rates) and consumption
- ✓ Fiscal laxity is a separate imbalance



IV. Is there a common denominator among the disequilibria after EMU entrance?

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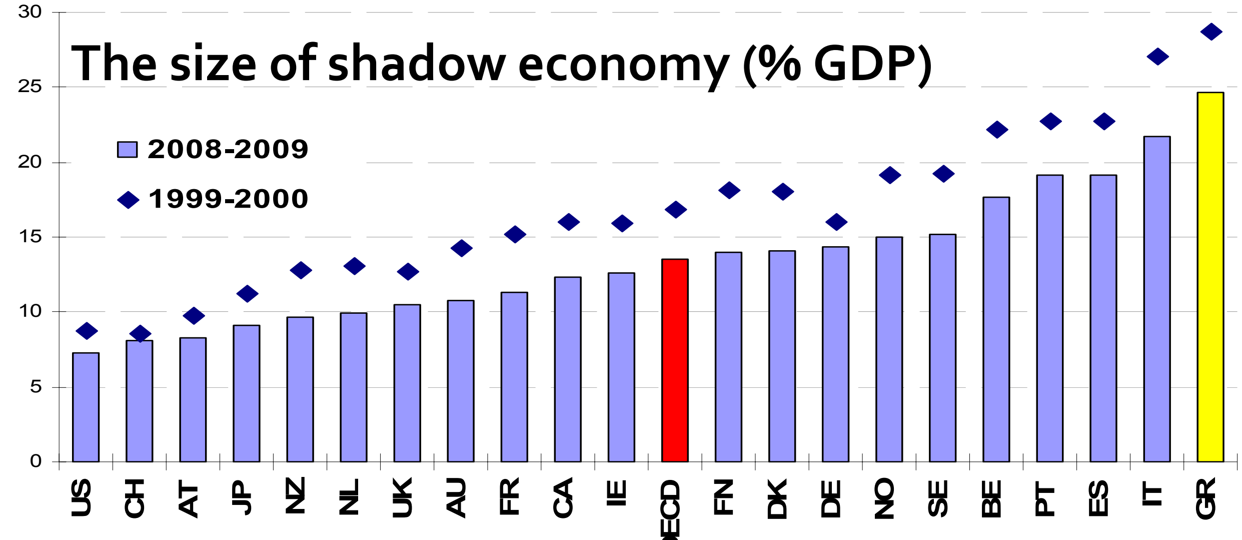
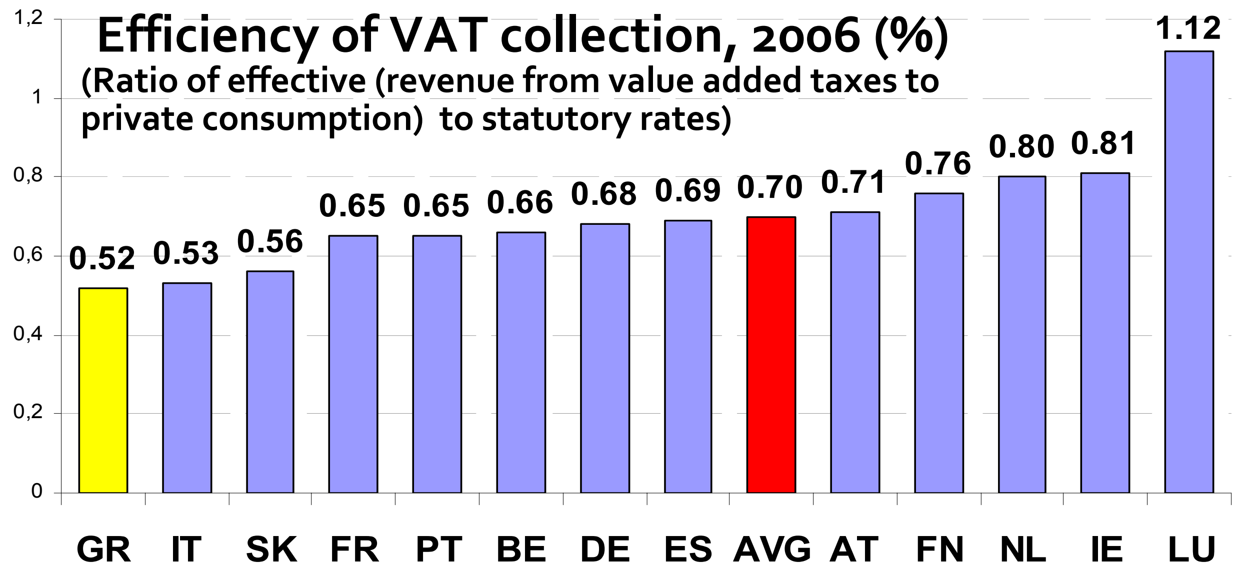
- Yes, lack of structural reforms and in particular, the disorganized & neglected inefficient public sector
- **EMU** acted as a **sleeping pill** not to do the required structural reforms, exactly when most needed
- ✓ The disorganization of the public sector is evident in the size of the underground economy or in the lack of ability to collect taxes



Source: Schneider, F. (2009) "The size of the Shadow Economy in 21 OECD Countries Using the MIMIC and Currency Demand Approach"



Source: OECD Economic Surveys Greece 2009

IV. Related long-run disequilibrium: An imbalanced pension system perhaps solved

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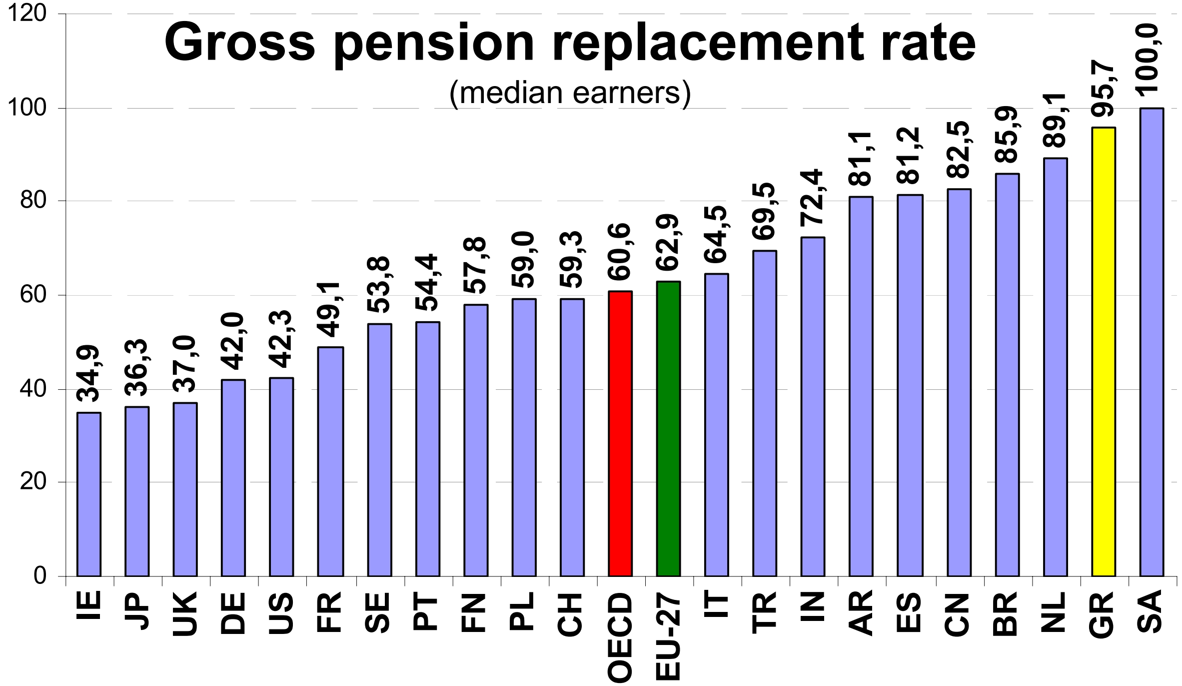
New pension Law adopted in July 2010:

- Fix system's parameters ⇨ reduce the expected <u>increase</u> in future annual state pension liabilities (by 2060) from 12.5% of GDP to 2.5% of GDP.
- Retirement age **for everyone** at 65 by 2015, increasing in line with life expectancy after 2020 with minimum contributory period of 40 years by 2015
- **Early retirement** restricted to the age of **60** by 2015, will be penalized more than before (6% loss per year, including those insured prior to 1993)
- Size of pension linked to **life-time contributions**
- List of heavy and arduous professions to be reduced drastically, under a ceiling of 10% of labor force

Old Regime	2010	2020	2035	2060
Pension Exp. (% GDP) GR	11.6	13.2	19.4	24.1
Dependency*	56	59	78	102
Pension Exp. (% GDP) EA	11.2	11.6	13.2	13.9

Source: European Commission 2009

** Ratio of pensioners to contributors*



Source: OECD Pensions at a glance 2011

III. Greek economic outlook: Recession continues with a fear of imminent social collapse

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		2011	2012
	% GDP	% change	% change
Private final consumption	76.1	-9.4	-6.1
Gen Gov consumption	17.2	-8.5	-9.0
Total consumption	83.3	-9.2	-6.7
Gross fixed capital formation	14.8	-15.0	-5.0
Domestic demand	107.3	-10	-6.5
Imports g&s	27.7	-11.7	-7.6
Exports g&s	20.3	8.7	6.2
Real GDP Growth		**-5.8**	**-3.2**
GDP Deflator		**1.7**	**0.7**

Source: Eurobank EFG Research

Our Assumptions: Real disposable income -11.7% in 2011, -7.6% in 2012, Δ(consumption) = 80% Δ(disposable income) due to intertemporal consumption smoothing, Exports a function of ULCs & unitary elasticity w.r.t. trading partners' growth rates, unitary elasticity of imports w.r.t. net disposable income.

IV. Greek Economic Outlook: Main characteristics of latest IMF forecasts, prior to haircut

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Main characteristics of long-term outlook do not change much relative to July EU/ECB/IMF forecasts

✓ **Greek economy: Conservative future expansion**

- Real GDP growth around **2.7%** from 2015 to 2020, below the 1996-2008 average. Much lower real growth, **1.5%,** after 2020 due to demographics
- Inflation subdued, never above ECB target of 2%: It is necessary to break up oligopolistic market structures
- Current Account Balance of -5.2% GDP in 2015 (July forecasts, still no external equilibrium with Incomes deficit rising)

✓ **Huge downsizing of the public sector:**

- Primary Expenditure **from 48.3%** of GDP in 2009 **to 33.0%** in 2020, meaning a huge reduction in the relevant size of the public sector, especially given the large and inelastic transfer component of those expenditures

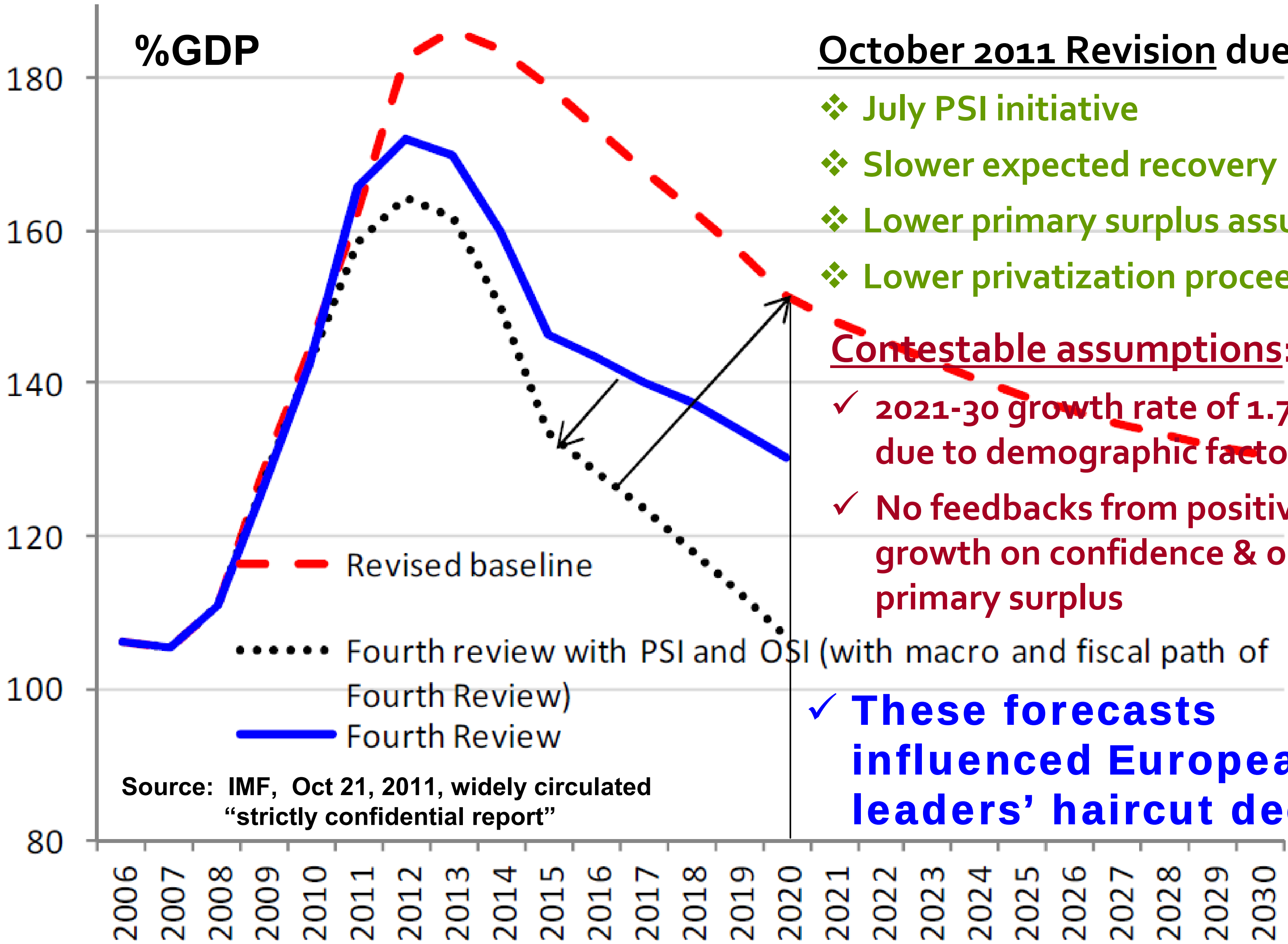
✓ **A negative snowball effect on Debt/GDP:**

- Nominal interest rate always larger than nominal growth: Big primary surpluses needed in order to obtain fiscal sustainability.

✓ **The public debt burden eases gradually as a % of GDP from 2014 onwards**

- New IMF baseline <u>without a haircut</u>, projects a Public debt at **152 %** of GDP in 2020 (from original 120%) and at **130%** only in 2030!

IV. Is Greek public debt sustainable? Revised IMF forecasts prior to October 26 haircut



Source: IMF, Oct 21, 2011, widely circulated "strictly confidential report"

October 2011 Revision due to:

- ❖ July PSI initiative
- ❖ Slower expected recovery
- ❖ Lower primary surplus assumption
- ❖ Lower privatization proceeds

Contestable assumptions:

- ✓ 2021-30 growth rate of 1.7% due to demographic factors
- ✓ No feedbacks from positive growth on confidence & on primary surplus

✓ **These forecasts influenced European leaders' haircut decision**

IV. Is Greek public debt sustainable?
October 2011 Revised IMF estimates

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Prior to October 26 haircut

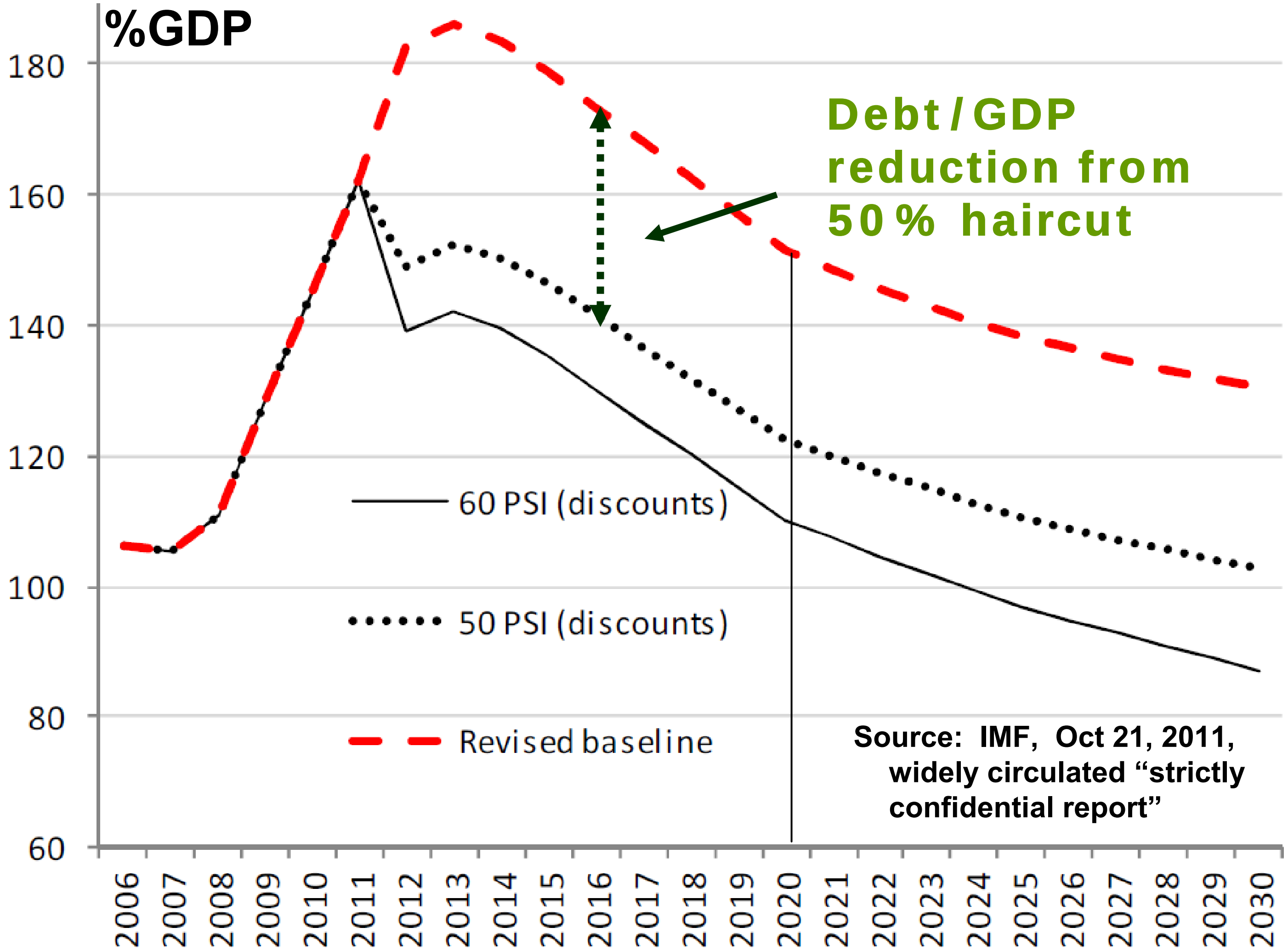
	2009	2010	2011	2012	2013	2014	2015	2020	2030
GDP Growth (%)	-3.3	-3.5	-5.5	-2.9	0.5	2.1	2.7	2.4	1.5
GDP deflator (%)	1.1	1.7	1.4	0.2	0.3	0.4	0.6	1.7	1.8
Nominal GDP (€ bn)	234	230	220	214	216	221	229	278	---
Interest Rate (%)	4.7	4.2	4.5	5.1	4.3	4.5	4.5	4.7	5.1
Bund Rate (bps)	----	225	275	350	350	350	350	350	360
Spread over Bund (bps)	----	1175	1175	1000	800	495	475	250	250
Interest Expense (€ bn)	12.4	12.7	15.0	18.2	16.9	18.1	18.3	19.7	---
Interest Expense (% GDP)	5.3	5.5	6.8	8.5	7.8	8.2	8.0	7.1	---
Primary Expenditure (% GDP)	48.3	44.6	42.4	38.5	38.4	36.5	36.4	33.0	33.9
General Gov Revenues (% GDP)	37.9	39.5	40.2	39.9	40.9	41.0	40.9	37.4	37.4
Primary Balance (% GDP)	-10.4	-5.0	-2.3	1.4	2.5	4.5	4.5	4.3	3.5
General Gov Deficit (% GDP)	-15.8	-10.6	-9.1	-7.1	-5.3	-3.7	-3.5	-2.8	---
General Gov Deficit (€ bn)	-36.6	-24.1	-20.1	-15.2	-11.5	-8.1	-8.0	-7.7	---
General Gov Debt (% GDP)	129	145	162	183	186	184	179	152	130
General Gov Debt (€ bn)	299	329	357	392	402	407	410	422	---

The IMF debt sustainability analysis was contacted using GDP data prior to the recent ELSTAT GDP revision.

IV. IMF: The effect of 50% haircut

Eurobank EFG

- ✓ IMF Simulation shows large benefit from haircut
- ✓ But haircut has costs, even if it is friendly and does not trigger exe-cution of CDSs
- ✓ Banks, pension funds and others lose capital
- ✓ Greek agents exposed to Greek bonds



Besides haircut, Additional official financing needed: **Total: €113.5 bn, of which € 98.6 bn in 2010-14**

IV. Details of Greek haircut decision on October 26, 2011

Eurobank EFG

- ✓ **Voluntary bond exchange** with a nominal **discount of 50%** on notional Greek debt held by private investors (€207 bn).
- ✓ This PSI+ ought to secure a debt-to-GDP ratio of **120%** by 2020.
- ✓ Euro Area Member States to contribute a **sweetener of €30 bn**.
- ✓ Provision of credit enhancements to underpin the quality of collateral so as to allow its continued use for access to Eurosystem liquidity operations by Greek banks
- ✓ New programme to be accompanied by a strengthening of monitoring on the implementation of reforms, though its execution will remain a responsibility of the domestic authorities
- ✓ **New bailout package** to replace the July one. Up to **€172bn** of EU-IMF Programme financing committed so far, beginning with 2012, and consisting of:

  — up **€100bn** in new EFSF - and, potentially, IMF - loans until 2014;

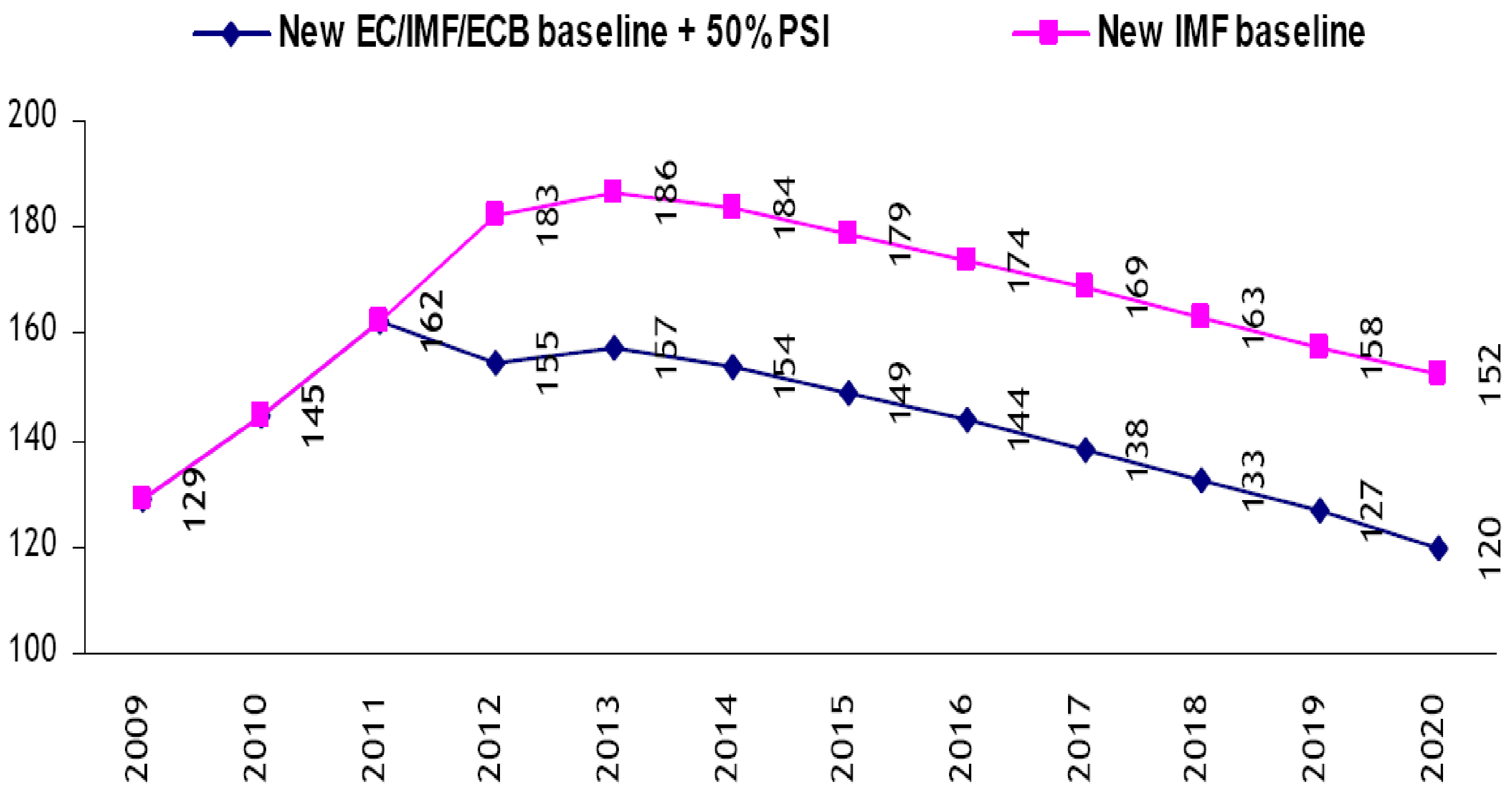
  — up to **€30bn** of EA member state contributions for a new (voluntary) PSI

  — **€42bn** of still undisbursed (by year-end 2011) funds under the existing Greek Loan Facility.

  The July 21st EU Council announcements will apply as regards the improved terms and conditions of the new & existing EA/EFSF loans, related to e.g. interest rate charges, grace periods and loan maturities.

IV. Haircut improves debt sustainability

Eurobank EFG



- ✓ Eligible Debt for a haircut: €207 bn, held by Greek banks (€ 47 bn), Greek pension funds (€ 23 bn), foreign accounts (€137 bn)
- ✓ Non-eligible debt: €153 bn, held by the ECB (€ 55 bn), Troika (€65 bn), in T-bills (€ 16 bn), other (€17 bn)

IV. Elements of a Greek strategy forward

- Political consensus and MoU ownership required on a Long-Term Growth Strategy that builds credibility
- Follow an export-led paradigm of growth (to replace the failed consumption-led one) based on price- and quality-competitiveness, support a switch from non-tradeables to tradeables sectors
- This strategy implies:
  - ✓ Emphasis on capturing tax evasion and increasing revenues without raising marginal tax rates
  - ✓ Switch the allocation of public spending away from consumption and military towards Public Investment and Education
  - ✓ Reduce public consumption expenditure by shrinking redundant agencies
  - ✓ Privatizations should not be viewed exclusively as cash machines, but as a way to improve public sector efficiency and bring FDI
  - ✓ Improve absorption of Cohesion Funds, PPPs, stabilize business sentiment, stabilize tax regime, simplify legislation
  - ✓ Be more aggressive with special interest groups that extract economic rents, reduce bureaucratic cost to business, open-up markets and closed professions, emphasize education and R&D
  - ✓ Avoid ad hoc last minute decisions simply to attain the MoU macro targets, as they can lead to a slow death trap

Concluding remarks

- The Euro Area is busy fixing its architecture for a year and a half, avoiding a fiscal union, but strengthening
  - ✓ the regulation and supervision of its financial sector
  - ✓ the harmonization of fiscal and competitiveness policies
- Yet markets have anything but calmed, with the crisis mushrooming
- Europe delayed because the actions required to resolve the crisis tend to increase moral hazard and contradict the long-term optimal EMU design
- After the crisis hit Italy in August 2011, the hardliners in Europe realized they had to switch priorities. This is evident in the October EU Council decisions, which provide for a 50% Greek haircut, a stronger – more levered - EFSF and a recapitalization of European banks
- Ring- fencing solvent countries may not be adequate; the crisis my continue
- Ireland and Portugal seem to manage the crisis thus far, while Italy is aware of the required austerity actions to take but seems unable to deliver; Italy is currently the main source of risk for the viability of the Euro Area
- Greece is in a graver spot, with the largest debt: After an initial strong reform momentum that lasted five months, the implementation of reforms stalled. "Ownership" of the Reform Program – a necessary condition for success, according to IMF's experience – was never attempted.
- The October 27, 2011 EU Council decisions improve Greek debt sustainability
- Greece's survival is essential for Euro Area survival even if European banks are ring fenced from a Greek default; contagion is always present