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"Greece & Europe: Beyond the Financial Crisis"

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Ladies and gentlemen,

It is my pleasure to be back to my Alma Mater and its Center for European Studies and share with you my thoughts on Europe and Greece. I will concentrate on two main questions:

1) **Will the Euro Area survive the next economic crisis?**
2) **Will Greece be a member of the Euro Area over the next decade?**

The two questions, although they refer to the future, are intimately related. Some claim that if Greece were forced to abandon the Monetary Union, the irreversibility principle of a country joining EMU would be broken and subsequently the Union would begin unraveling. In the next crisis, markets would naturally ask the question: "Which country is next to go?" and would pick on the most vulnerable EMU member by dumping its stocks, stop lending it, etc., thus forcing it to quit EMU.

Others, however, insist that letting Greece exit would stabilize EMU. EMU cannot be a stable union without incorporating into its bylaws the risk of departure. The fear of departure would incentivize renegade members to behave constructively and avoid exit. Without such a fear, the case of Greece will soon find many copycats. For example, some countries would never reform or never obey the deficit limits of the Stability and Growth pact, and if rules are not obeyed, EMU would naturally dissolve.

The Greek drama of the last 8 months brought this point to the surface. For a number of months, the Greek left wing party of SYRIZA behaved as if Europe were scared of the country's possible departure from EMU and would thus bend to its demands. In the end, SYRIZA failed in its strategy of bullying the rest of EMU, but it nevertheless taught the rest of Europe an important lesson: The Monetary Union should not again be in a position of being blackmailed by one of its members, who does not wish to obey the rules of EMU. So in my view, the risk of exit may soon be incorporated into the architecture of EMU.

A. WILL THE EURO AREA SURVIVE?

Going over the first question on the viability of EMU, I have an optimistic view that the Euro Area will survive. The average US perspective on EMU viability may be different. Back in the late 1980s, when the discussion of the creation of the monetary union had entered center stage, in academic conferences and seminars, I frequently encountered the view by leading economists that "*The EMU will never happen*." Interestingly, in the late 1990s, as the EMU was being formed, in similar US conferences, the same people would say: "*The EMU will dissolve soon.*"

Why do many economists in the US have such a negative point of view on EMU? Well, they claim the European Monetary Union is not an Optimum Currency Area. The straight jacket of a common monetary policy inside the Union creates enormous pressures on individual countries, when those countries are hit by asymmetric shocks but are not united in other ways. The countries ought to have open borders, i.e., free mobility of goods, capital and labor, a unified financial system plus they need a fiscal transfer mechanism inside the Union to counteract the different calamities that may hit some countries but not others. A lot of these elements were missing from EMU and are still missing today.

A.1 Early happy days

In the 1990s Europeans ignored the economic arguments that it was premature to create a monetary union before their economies united more tightly. They believed the monetary union would force a faster unification in labor markets, in banking services, in fiscal policies, and in politics. They saw the monetary union as a catalyst for the desired economic and political unification, not as a source of frictions.

In the late 1990s financial markets became enthusiastic about the monetary union. In order to join EMU, countries had to reduce their fiscal deficits and domestic inflation. Hence, the effort to join imposed discipline on macroeconomic policies and this was appreciated and discounted in market prices. 10-year bond spreads shrunk to almost zero. After all, it no longer mattered which EMU country issued a ten year bond. It would be redeemed in euro. And the value of the euro in 10 years time would be a function of the overall inflation in EMU and the euro exchange rate, not the economics of the country that issued the bond. The possibility that the country may not be able to pay the bond was unimaginable. Country risk was not priced.

Not only country risk but also issues of competitiveness and debt sustainability were ignored at the time. The enthusiasm and the supply of easy money covered up all other issues. Yet, the low interest rates led to unwarranted credit expansion in both the public and private sector. The absence of an exchange rate between countries also led to mispricing. Southern countries lost competitiveness. There was no market pressure to reform. Imbalances built up.

By 2007, two major imbalances between Core countries and Periphery appeared: (a) in competitiveness, and (b) in fiscal deficits. Greece was the outlier in both, followed by Portugal. Spain and Ireland were fiscally prudent, more prudent than Germany, but their private sector borrowing created banking problems, which ended up affecting the State sector and its debt.

A.2 The crisis as a wake-up call for the architecture of the Monetary Union

When the international crisis hit in 2007-8, the European policy system was largely unprepared. Euro Area did not have mechanisms to respond to the crisis. Europe simply followed the coordinated action of the G-20.

The USA proved to be a lot more aggressive in its response to the crisis, both the government and the central bank. Recall the ECB had even raised interest rates early on in the crisis.

Europeans continued to be sluggish in their response, even after the Greek crisis broke out in late 2009. In addressing the crisis, EMU policies were continuously behind the curve. This is because Europeans were awakened to the faults in the design of the Euro zone. And instead of addressing the crisis by an expansionary fiscal policy and a generous debt write-off policy, they worried about moral hazard. They realized they could not follow an expansionary policy because they would create copy cats. Creditor countries became preoccupied with issues of moral hazard and one-way transfers.

Thus Europe followed a strategy to contain the crisis, not extinguish it, and buy time in order to put in place a more stable architecture. This strategy caused delays and often backfired. Recall the Deauville Merkel-Sarkozi statement on the participation of the private sector in sovereign defaults (October 2010). It created turmoil in the markets and worsened the crisis. I recall Greeks banks were shut once again from the wholesale market.

A.3 Were Europeans successful in the end?

When looking at the macroeconomic results and we compare them to the US, the answer is no. The crisis response has not delivered: (a) GDP has not grown since 2008 (b) Unemployment from 7.5% in 2007 to 11.6% in 2014 (c) Inflation declined and became negative in late 2014. In fact, from 2011 to 2013 fiscal policy was procyclical.

Some internal adjustment inside EMU did proceed. Current account deficits in Periphery countries were erased. However, current account surpluses continued in Germany and the Netherlands. The adjustment was not symmetric.

Also relative wage and price adjustment between the three large countries (Germany, France, and Italy) has marginally changed. No mechanism exists yet to address the divergences.

What about the EMU architecture? Has it proceeded in a satisfactory fashion? Was the sacrifice of abandoning prudent countercyclical macroeconomic policy worth it?

A lot took place in strengthening the EU surveillance mechanisms (6-pack, two-pack, euro+, fiscal compact, ESM) and lot is to come. A summary of what Europeans think ought to be done in the future is contained in the Five Presidents Report on "*Completing Europe's Economic and Monetary Union.*"

The report was released on June 22, this year, and tackles four aspects of EMU: (a) Economic Union (b) Financial Union (c) Fiscal Union (d) Democratic legitimacy. The ultimate aim is to achieve similar resilient economic structures until year 2025.

This is not the place to go through a detailed analysis of the report. I will only go over the elements that make me optimistic.

- First, there is discussion of an EMU <u>fiscal stance</u>. This is important as an EMU-wide fiscal policy is needed. If one compares EMU with the US, the absence of a common or coordinated fiscal policy is obvious. Moreover, unlike the Fed, the ECB only targets inflation, not unemployment. There is absence of institutionalized countercyclical policy altogether in EMU. While many economists may disagree about the effectiveness of countercyclical fiscal policy, my point here is that we need to agree amongst us in Europe about the stance of policy before we decide to take action or not.
- Second, there is discussion of a <u>deeper integration of labor markets</u>. This is a must for the long-term viability of EMU. A European citizen ought to have to ability to relocate from country to country and not worry about different labor laws, pension benefits or health benefits. I would like to see a more common tax framework as well. And the requirement that school children learn three additional European languages besides their native language. Europe will be united only when economic and cultural structures unite. A bottom up unification is the most powerful one.
- Third, there is an effort to make the Macroeconomic Imbalances procedure more binding by proposing a system of country Competitiveness Authorities.

- Finally, the financial union is being expedited. This is already a successful example of the effects of the crisis. A capital markets union is launched. The banking union is being completed. We already have a common financial supervisor. A common deposit insurance system is proposed using the concept of re-insurance. And a bridge financing for the Singe Resolution Mechanism is proposed.

On the negatives, it seems the earlier push for a more drastic fiscal unification has lost steam as the crisis is over. In the report there is no discussion of a common unemployment insurance system, neither a discussion of common debt issuance.

A.4 So will the Euro Area survive in the long-term?

My hunch is it will as long as it adapts. The Great recession was not easy to overcome and the Greek crisis was even more difficult. Yet, EMU became a stronger union as a result of those crises and now aims to become even better. If individual EMU countries are vigilant in reforming their economies, we may eventually observe a convergence in their economic structures. Similar economic structures imply similar political processes. At that point, the topic of fiscal transfers may be more acceptable than is today.

As we speak today, there is a refugee crisis that threatens to open more cracks among the countries of the European Union. But this is a topic beyond the scope of my analysis today.

B. WILL GREECE'S EMU MEMBERSHIP SURVIVE?

Now I want to come to the second question I posed in the beginning. Will Greece be an EMU member 10 years down the line? My answer tends to be an optimistic one, yet I still have serious concerns. Since February 2015, Greece has caught international media attention thanks to the haphazard and confrontational behavior of its new leaders. This confrontation was five years too late and was thus doomed to fail from the beginning. But the government was new and ignorant of European realities and experimented. It came very close to GREXIT but eventually chose the path of staying inside the Euro Area.

From 2009 to 2014 Greece cured most of its economic imbalances. Yet the anger and stress of the population found release in voting for the far left. The SYRIZA party was new in the government, untested, unprepared to govern, yet assured of its ideological correctness.

Year 2015 is the year that brought Greece back to recession, yet it is also the year that may have taken most of the immediate political risk of Grexit away. The political risk was always there, i.e., that a novice government may push the country outside EMU. Fortunately, it did not happen. Furthermore, the very radical leftists within SYRIZA split off and were marginalized. The party they formed did not even make it to the Greek Parliament in the recent elections of September 20.

While Grexit was avoided, its risk has not been wiped out. The third MoU seems to be the very last offer of the lenders. Will the new government change course and deliver on what it signed it would deliver and on time? It is a prerequisite for long-term growth and thus for being able to remain in the Euro Area. We will know better in a few months.

B.1 Misperceptions about Greece

Before I give you my more detailed interpretation of the events of the last year, I want to dispel some myths about Greece and its relation to EMU.

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

This statement is not true. There was an accounting change that took place in 2004, well after Greece joined EMU, in the way military expenses are recorded. This accounting change affected expenses going back to 1998. The ex post accounting change boosted the deficit for year 1999, the year Greece had been examined on whether or not it satisfied the deficit criterion, from 2.2 to 3.1% of GDP. This is all. To make the analogy with everyday life, imagine the top marginal tax rate in the US is raised to 60% not only for 2015 and beyond, but retroactively from 2011 on. Then the IRS audits you and finds you have not paid your taxes in 2011. You are then put in prison for your crime. This is exactly what happened to Greece. It is being "put in prison" for an ex-post accounting change beyond its control.

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

This accusation was popularized by a well circulated book. Yet, the swap took place in 2001, well after Greece had already joined EMU. Moreover, these types of swaps were common practice back then by many countries. There was no devious intent involved.

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

Greece violated the 3% deficit rule in 2005, but was preceded by Portugal in 2002 and soon after, France and Germany. In particular, the French and German governments had to run public deficits during 2002 and 2003, which would break the rules of the Stability and Growth Pact. They would have faced sanctions for running large deficits. However, in November 2003, France and Germany persuaded enough other Member States to "*suspend the excessive deficits procedure*." The European Commission took the case to the European Court of Justice. The latter ruled in support of the two governments.

Thus while on paper the EDP was not violated by the two core EMU countries, in practice it was. This created a serious negative example for the rest of the Euro Area. It installed the impression that the "the rules are for the small and weak, not the large and strong countries."

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

The progress made until the end of 2014 on the structural reforms implementation front was remarkable by international standards. Greece recorded a big improvement in the World Bank Doing Business competitiveness index. It was ranked in the 61st position in 2014 from ca. the 100th position in 2009. No other similar example of such improvement exists in the records of the World Bank so far, especially for a Western democracy. At the same time, Greece was ranked first among Euro zone countries on the OECD responsiveness on structural reforms for every year in 2010-2013 (November 2014) and also in the Adjustment Progress Indicator of the Lisbon Council (Spring 2014).

However, the reforms implemented so far failed to create the necessary mass that would permit the return of the country to a sustainable growth path. Also Greek politicians proved reluctant to expedite the reforms and go against many clientele groups, thus generating anxiety. Neither did they attempt to explain to the public the usefulness of reforms. Reforms were carried under the continuous threat that the inflow of loans will be interrupted. Ownership of reforms is still missing.

The recent new ESM programme (the 3rd MoU) aims to complete the missing or delayed structural reforms. The new programme includes approximately 220 structural reform actions for the 2015-2018 period. It is frontloaded, as 96 out of the 220 actions have to be implemented until the end of 2015. The next three months are critical for the implementation of structural reforms.

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

This is not necessarily a myth, but nevertheless the enormous progress escapes the attention of many observers. Fiscal consolidation was fully achieved at the end of 2014.

- The General Government Budget balance was at -3.5% at the end of 2014 from **-** 15.3**%** of GDP at the end of 2009.
- The primary budget deficit turned positive at 1.2% of GDP in 2013, one year earlier than expected in the 2nd Bailout. This over-performance continued in 2014 with a primary surplus at 0.4% of GDP (AMECO/European Commission Data).
- However, this changed during 2015. The primary balance for 2015 is expected again on the negative side at -0.25% of GDP. The respective figures for 2016, 2017 and 2018 are expected at 0.5%, 1.75% and 3.5% of GDP.

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

At the end of 2014 public debt was sustainable, as the economy had stabilized and was expected to grow by 2.9% in 2015 and continue this way into the future. There was little additional borrowing to be made. Relative to 2011, the outlook for debt sustainability at the end of 2014 had become optimistic.

- The Greek public debt was at 175.1% GDP in 2013 and was expected to become lower than 110% GDP in 2022, conditional on the final agreement regarding debt relief measures. These measures included the extension of maturities and the transformation of the current variable interest rate to a fixed one. Those measures had been proposed by the 2014 Greek government.
- At the same time, the average maturity of debt from 6 years at the end of 2011 increased to almost 17 years at the end of 2014. Interest expenses fell from 6.9% in 2011 to 3.3% and 3.2% of GDP in 2013 and 2014 and are expected to remain at this level in 2015 also.
- A recent IMF DSA report acknowledged the fact that debt was sustainable at the end of 2014 conditional on the debt relief measures.
- However, this changed during 2015. After the imposition of capital controls in late June, the IMF expects that public debt would peak around 200% of GDP for 2016 and 2017 and will reach 170% of GDP in 2022.
- Clearly, such debt levels are unsustainable and we now expect that a discussion over debt relief measures will start after the successful conclusion of the 1st Review of the new ESM programme. The Europeans may not give present value relief too easily, however. They are likely to condition that relief on the continuation of reforms.

MYTH #7: There was no investment interest for Greece

True, at the end of 2013 investments were at ca. 12.1% of GDP, at their lowest level since 1960. Recall Investments were at 17.7% of GDP in 1997 and increased at 26.6% of GDP in 2007.
However, new foreign investors showed up in 2014, buying bank stocks and other real assets. The change in investment was positive after six years of continuous quarterly declines. There was a change of mood. Credibility had come back to the country.

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

A Grexit and the reintroduction of a new national currency is not among the viable options for the return of the Greek economy to a sustainable growth path even if we abstain from the enormous transaction costs that such an action will have in the short run:

- The internal devaluation has already taken place. The external devaluation will only bring inflation. There will be no gain from the new Currency for Greek exports.
  - The successive devaluations of the drachma in the 1980s only brought inflation. They had only temporary results on exports performance.
  - Recent studies showed that the implementation of the structural reform agenda will be the main factor for the improvement of exports in the upcoming period. The under-performance of the Greek export sector was mainly due to the institutional environment of the Greek economy and not to the participation of the country in EMU.
- There is no gain from the new currency for public debt. Most of the post PSI public debt is under foreign law and so a re-denomination of public debt to the new currency is not possible.
- A Grexit would create a precedent for exit by others.

MYTH #9: Greeks are lazy

This is very far from the truth. Working hours are way above Euro Area average. OECD statistics show Greeks working the largest number of hours among the EU 28. The problem of low productivity is due to the organization of the economy and the public administration, not the lack of working hours per employee.

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

The ratio of taxes to GDP is lower than the corresponding Euro Area average but this is only due to the high percentage of self-employed in the workforce, which is 36% of labor force as opposed to 15% in Euro Area. Wage earners pay a lot of taxes. Also Greeks own real estate but are not rich because of that. Real estate values have declined by more the 45% since the crisis began.

MYTH #11: Greeks are in a constant turmoil

Observers seem tired of hearing about Greece and its problems. Yet, given the unprecedented for peacetime size of recession, which was bigger than the Great Depression in the US, the population's reactions were controlled. The latest GREXIT fiasco, which occupied Europe and caught world-wide media attention, is at odds with the amazing maturity of the Greek population. The fiasco only reflects the inexperience and unpreparedness of its new leaders.

B.2 Why such a huge recession until 2013?

Misperceptions about the Greek economy are plenty. I only listed a few. But why did the country go through such a huge recession? No other European country had a similar fate. The Greek depression is not a myth. It is a harsh reality. After all, output fell by 26% from 2008 to 2013 and unemployment has skyrocketed. What was so special in Greece that six years after the crisis erupted, the country is still in a mess? The reasons are many:

1) The main reason is that the initial macroeconomic imbalances were a lot worse than elsewhere in the Euro Area. For example, there was no way but to cut the fiscal deficit by a huge amount, if equilibrium were to be restored in the economy. Naturally, fiscal policy was extremely restrictive, a lot more than any other Program country. This restrictive fiscal policy in an environment of tight credit made the negative fiscal multiplier a lot worse than expected.
2) A second reason relates to the structure of the Greek economy, which is substantially different from the rest of the Euro Area economies:
    a. It is a more closed economy than in other EA countries, with consumption representing a very large fraction of GDP. Exports were only 1/5 of GDP and could not carry enough counter-weight to the reduction of domestic aggregate demand.
    b. Economic activity is dominated by small firms and self-employed labor. There is a big underground economy – oligarchs do play a role. All these are obstacles to an immediate export oriented growth strategy.

c. We suffer from inefficient public administration, a legacy of unstable tax policies, major bureaucratic hurdles in doing business, a lack of level-playing field, a structure of closed professions, and a general lack of flexibility in economic relations.

3) A third, and more frequently quoted reason, is the presence of serious Program errors. They were made mostly by domestic politicians, but also originated on the side of lenders.
   - On the domestic front, there was lack of political consensus on the need to cure the imbalances and move quickly to implement reforms. Governing political parties were hesitant, while parties in the opposition were completely irresponsible. This led to lack of Ownership of the Program, hence to a lack of implementation drive for reforms. Politicians ended up delivering mostly horizontal tax increases and expenditure cuts.
   - Another major error is the wrong sequencing of reforms. This mistake is due to the lenders. I had written about it back in 2007 before even the international crisis had hit, as the imbalances were obvious by then. I fought it when I advised the Prime Minister in 2011-2012. Yet the lenders had the money and carried the day. The correct sequencing is first to reform the product markets and the public sector and then reform the labor market. The lenders insisted on the easier target of tackling the labor market first. Hence, they brought down wages before product prices had a chance to decline, thus they forced a cut in real incomes and made the recession worse. The negative fiscal multiplier became larger.

4) Finally, Greece turned out to be special because although its economy stabilized and began growing in 2014, it was hit by an independent "political shock" in 2015 that has resulted in a W-shaped recession. I will speak about the events of 2015 soon.

B.3 <u>State of Play at the end of 2014</u>

At the end of 2014 the worst seemed to be over. The economy had stabilized and was close to a major take-off.

- Imbalances were almost cured (fiscal, competitiveness)
- Economic growth resumed (+0.7% in 2014), with investment turning positive and with 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 at 2.9%. The proposed and voted 2015 budget was balanced like in Germany
- Greece was ready to almost leave the lenders' bailout PROGRAM, like Ireland and Portugal had done before. We 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.

In November 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, on the other hand, wanted all 2015 reforms (e.g. pension) front-loaded before the possible elections. The ECB sided with the IMF position during the Eurogroup meeting of December 8. The review was not concluded. We only received an extension until the end of February 2015. In my view, this was a major IMF blunder. They acted politically watching the polls that showed SYRIZA would come to power and thus wanted to keep their money. Yet they could have concluded the review and begun delivering the money after the elections and after certain prior actions would be completed. SYRIZA would have behaved rationally much earlier than they eventually did. The recession could have been avoided.

B.4 What went wrong since January 2015?

So if optimism had come back in 2014, how come we are not there yet? How come we face another recession? What went wrong again?

The January 2015 elections brought a new government, which was very sluggish and wasted precious time, thus bringing the economy back to stagnation, if not recession due both to its inaction and its actions.

- The new government was inexperienced, with many of its members lacking – I would dare say - work ethic. They kept promising more after the elections than before the elections! Ministers spent more time on TV stations than their ministries.
- The new government was full of illusions about how the economy operates, with no sense of how value added gets created, and with an apparent genuine dislike of the private sector. So they ignored the supply side of the economy, thinking it has a momentum of its own and their own behavior does not affect it.
- They claimed the previous MoUs were responsible for the economy's fate and they would negotiate to alter it. This was a battle five years too late. For example, the new government made a policy of a nominal debt haircut central to its campaign, claiming they would hold an international conference on debt, and ignoring the wishes of other European voters. Why would a poorer Euro Area country resident accept a haircut?

- The government adopted an aggressive strategy vis-a-vis the Europeans based on the perception that Euro Area instability gets generated from Grexit alone, not from moral hazard. The government did not understand that Europeans equally disliked being lenient to Greece, as this could set the stage of all rules unraveling in EMU. Thus instead of maximizing the flexibility of the European side to their benefit, they chose to ignore the other side's maximization problem! Well, this is Game Theory at its worst.
- The government's erratic behavior, comprised of a lot of bravado talk and little action, and became obvious to many in the population. The Greek finance minister called it "constructive ambiguity," yet it was only a misnomer for lack of strategy & action. Households became very worried of Grexit and capital controls. Hence they gradually pulled more than €40bn from the banks or 25% of their deposits.
- In the end, after insulting just about every potential friend in Europe, the June 30 deadline of the previous Program passed with no agreement. The Europeans insisted that the country had to deliver what it signed. And in February SYRIZA had already signed – although it viciously objected it in the domestic media - to deliver many unpopular actions in order to close the review of the 2nd adjustment program.
- By June, the Prime Minister had trapped himself into a corner with no friends. He was about to close a deal with €9bn worth of measures he had proposed (9 times worse that the measures the previous government had agreed in November). 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, but I will not analyze it here.
- The announcement of the referendum created a bank panic, which immediately led to a bank holiday and capital controls. Yet, Greeks were semi prepared for it. For example, many households had already pulled their money out, as they feared this possibility early on. This has cushioned a bit the recessionary impact of capital controls.
- At that point, the economy had been cornered to a slow death. In the previous months not only arrears had gone up to €7bn, drying up the liquidity of the private sector, but €7.6bn were squeezed out of the state entities' cash buffers, leaving the general government sector dry of liquidity as well. Soon the payment of wages and pensions to public sector employees would have to be postponed. Naturally, payments to the ECB would be out of the question, as it would have created an immediate banking collapse.
- The July 5th referendum delivered a decisive NO to austerity, yet subsequently the Prime Minister, within a few days, did the opposite of the referendum result. And he signed a deal, worse than the deal he was offered three weeks earlier. This way he avoided the sure Grexit, as the country was desperate for cash.

- This abrupt political summersault created an upheaval within SYRIZA. The leftist opposition of SYRIZA split off and formed a separate political party. They did not vote the government's laws in Parliament. The laws of a 3rd MoU passed because the center right and the centrist opposition parties decided to act constructively and vote YES to the laws, thus avoiding Grexit.
- 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.

B.5 Current state of affairs

Today we face the following circumstances:

- ✓ Economic activity was resilient in H1 2O15 due to earlier momentum; full-year GDP contraction is expected to originate from a contraction in the second semester.
- ✓ We expect an expansion, at the earliest in 2016 Q3.
- ✓ Debt is no longer sustainable.
- ✓ Economic sentiment is very low. The well known PMI index is below 40, which is a post war negative record, when it ought to be above 50 to reveal optimism.
- ✓ The new program envisages full coverage of State borrowing needs for the next 3 years plus a new OSI would be likely after completion of the 1st review.
- ✓ The 3rd MoU is further burdening the existing debt by approximately €45bn or 25% of GDP. This is more than zero, under the previous government's targets, yet it is smaller than the total package of €86bn, as a big chunk of the money will go to refinance existing debt. Of course, this is not the only cost to the economy. Just the loss in value from the State holding of bank shares is over 20 billion euro. And the loss in GDP is enormous.
- ✓ The major immediate challenges are:
  1) The timely completion of bank recapitalization in order to facilitate improvement of domestic financial conditions. Also a swift removal of capital controls is a must together with a resumption of positive growth in deposits. Capital controls are not likely to be lifted soon, however.
  2) As mentioned earlier, the new programme includes ca. 220 actions of structural reforms for the 2015-2018 period, which are frontloaded, as 96 out of the 220 actions have to be implemented until the end of 2015, with 29 of them being key deliverables.

Now the penultimate question:

B.6 Can growth come back after a simple two-year delay? Or we are heading for Grexit and a further drastic reduction in living standards?

It is difficult to be fully sure of the answer. A lot depends on what the government is capable of delivering.

- ✓ The first three months will reveal whether the government has changed for the better or not. There was little reshuffling of the government after the September 20 elections and this is worrisome.
- ✓ Structural reforms have to be implemented on pensions, labor market, public administration, etc., all of which touch on the SYRIZA voter-clientele groups. SYRIZA promised almost the opposite of what it signed it would do. Hence there is a serious risk of not delivering on time.
- ✓ A renewed focus on structural reforms could significantly boost medium-term growth performance, assuming ownership of reforms. Will the government understand that the overwhelming majority of reforms empower the people and the economy? Will it try to persuade the population about their necessity? We do not know yet. This is also worrisome.
- ✓ For growth to come back more is needed. A necessary ingredient is credibility, which the government itself in the recent past did more than ever imagined to destroy. Credibility gets reestablished slowly with time. Investors have to see the "proof in the pudding." Is the government up to the task? We do not know yet.
- ✓ Liquidity sources do exist to re-engineer domestic growth (EU structural funds & the Junker plan, new cash for bank recap). Again, the government has to show efficiency in their utilization.
- ✓ Finally, it must be understood that higher private investment and exports are key for a quick transposition of the Greek economy to a new growth paradigm. We have not seen a concrete growth plan in that direction yet. Hopefully it will be fleshed out soon. In addition, the government seems reluctant to tackle waste and keeps raising taxes in order to attain its fiscal targets. This is not the way growth will come back. And growth is a must, for otherwise the Grexit fears will resurface soon.

Today in Greece the economics of the country and its EMU fate are in the hands of politicians more than ever before in its post war history. Let us hope for the best.

Thank you for your attention.