What follows Greek Crisis Phase II ?

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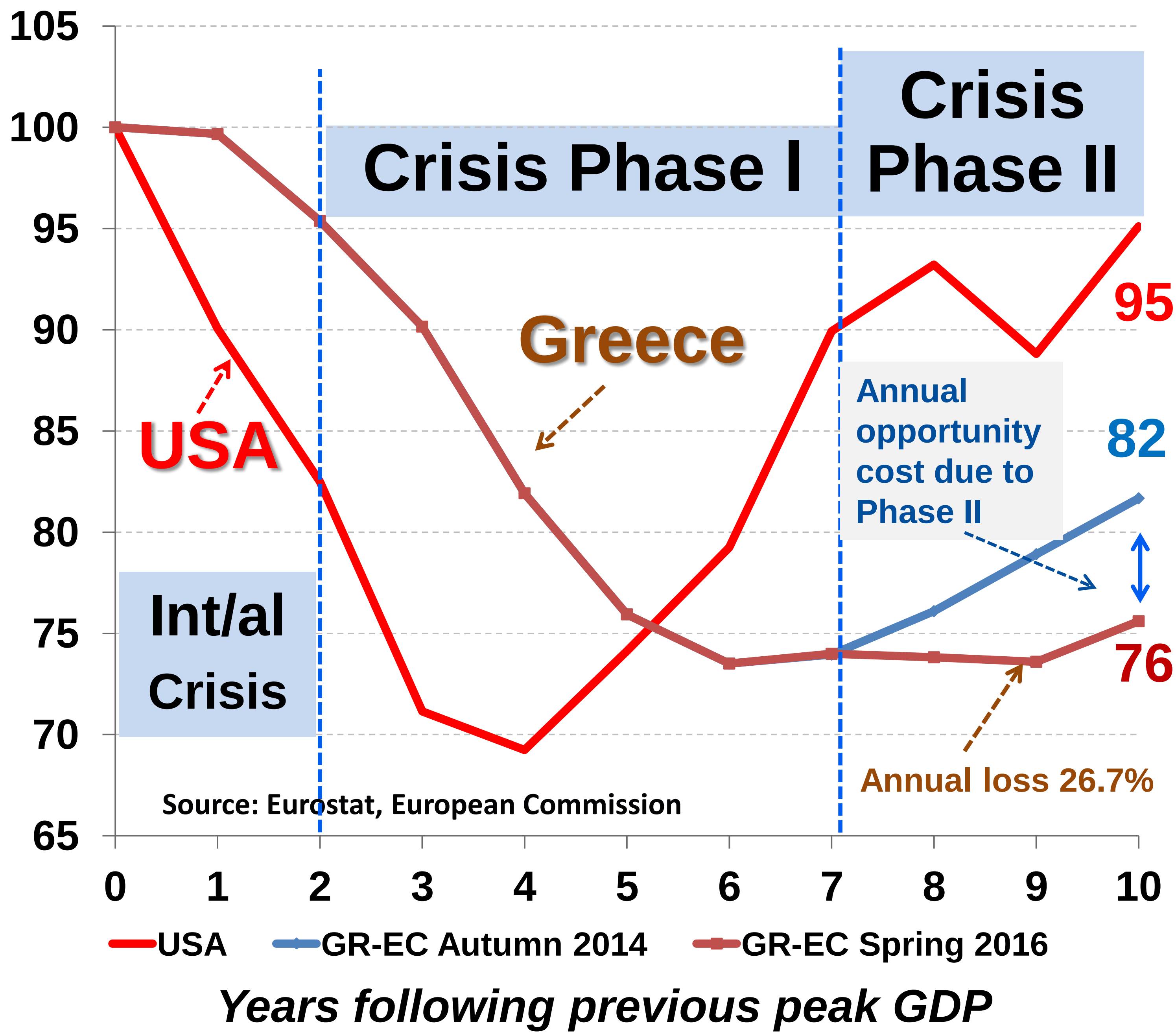
Overview

1. **Why Phase II of the crisis?**
   - A disastrous confrontation with the lenders in early 2015 ➡ Crisis Phase II

2. **The future: Will growth come back and how?**
   - Key challenges
   - The short-term
   - The long-term: Three scenarios

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

- Date 0 is 1929 for the US and 2007 for Greece: Real GDP is set at 100
- The Greek recovery of year 10, 2017, is a forecast
- After 10 years, the US was at 95 in 1939 but Greece (at best) at 76 in 2017
- Fall 2014: Greece was forecasted to be above 82
- At minimum, Phase II costs annually 6.1 ppts or €14bn



1. Recent History: State of Play at end-2014

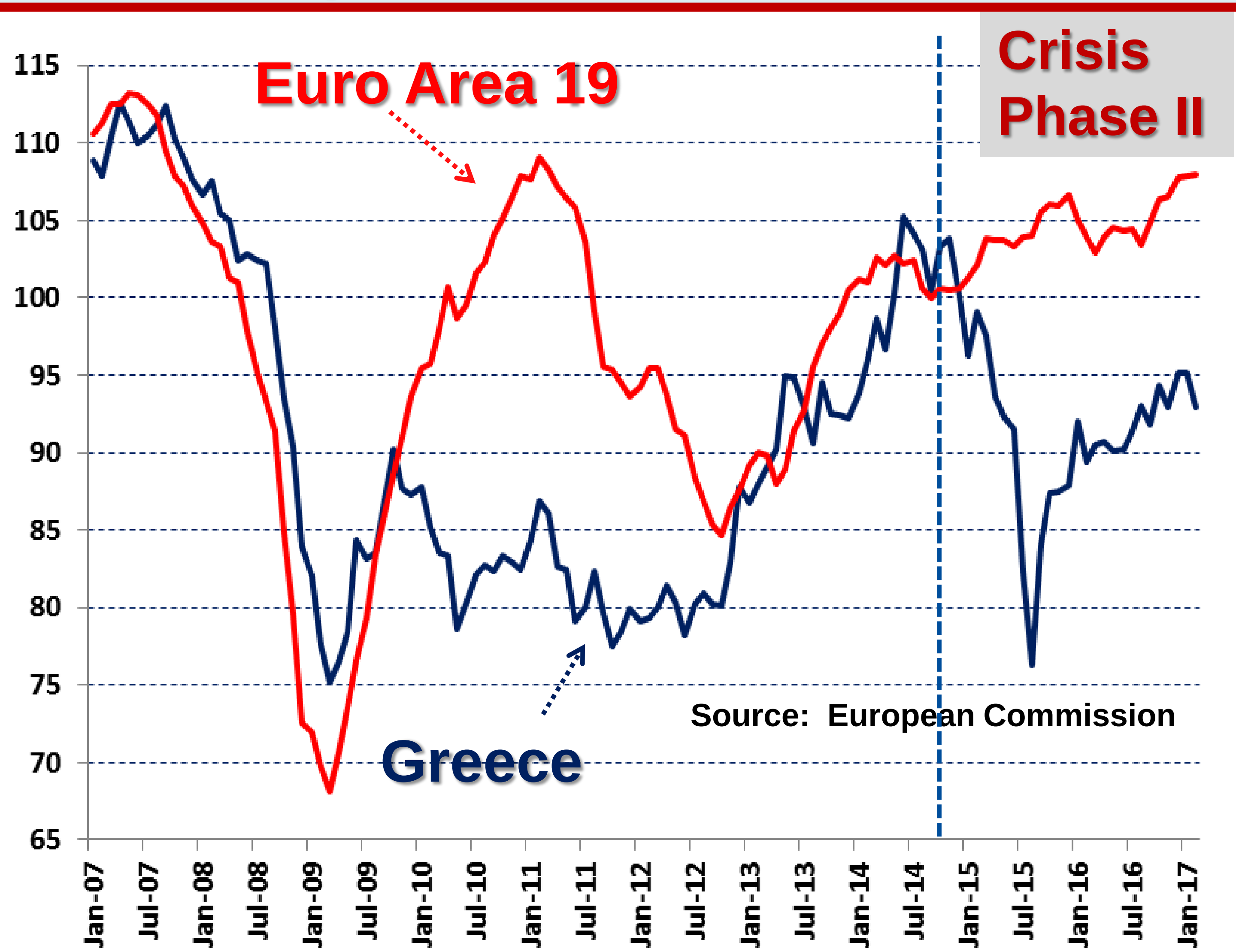
- Imbalances were almost cured (fiscal, competitiveness)
- Many reforms in the public sector, tax administration, product markets, labor markets, pension system, etc. placed Greece as #1 in OECD's reform indicator for three consecutive years
- The banking system had passed the October 2014 European-wide AQR and stress tests without needing additional capital, partly due to DTC and an earlier capital increase in 2014Q1
- Privatizations began taking off, large private firms were able to issue debt in the international market, even the Government was able to issue bonds twice in the capital markets
- Economic growth resumed (+0.4% in 2014), with sentiment rising, investment turning positive and unemployment declining. 2015 growth was expected 2.9%. The submitted 2015 budget was balanced.
- Greece was ready to 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 unused funds. €13bn IMF money was going to be added to that.
- Debt was on a sustainable path, plus further debt relief measures were already under discussion according to the November 2012 agreement.
- Yet, last Review of 2nd Adjustment Program did not conclude due to IMF 's effort to hold all cash disbursements for after the expected upcoming elections

1. From a Great Depression to a Great Stagnation? What went wrong in 2015 H1?

- A new coalition government of left-wing (SYRIZA) and right-wing (ANEL) populists took over in January 2015, which ignored the supply side of the economy, and instead made nominal debt haircut central issue, attempting to bring back the clock to 2010
- Did not attempt to close the Review, hence was deprived of cash → arrears went up to €9bn, 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 pulled €45bn from banks or 25% of 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 (20 times the measures), raising taxes and cutting wages and pensions. So he called a referendum. The referendum had a very ambiguous question.
- Announcement of referendum → bank panic → bank holiday and capital controls
- July 5th referendum → decisive NO to austerity, yet PM, within a few days, did the opposite of the referendum result → avoided the sure Grexit
- 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.

1. Crisis Phase II shows up in Economic Sentiment

- The sentiment index in Greece was moving together with sentiment in EA until late 2009, both declining
- **Decoupling during the Greek crisis until November 2012**
- From late 2012 until late 2014, **re-coupling**: Greek sentiment moved upward and in line with EA sentiment

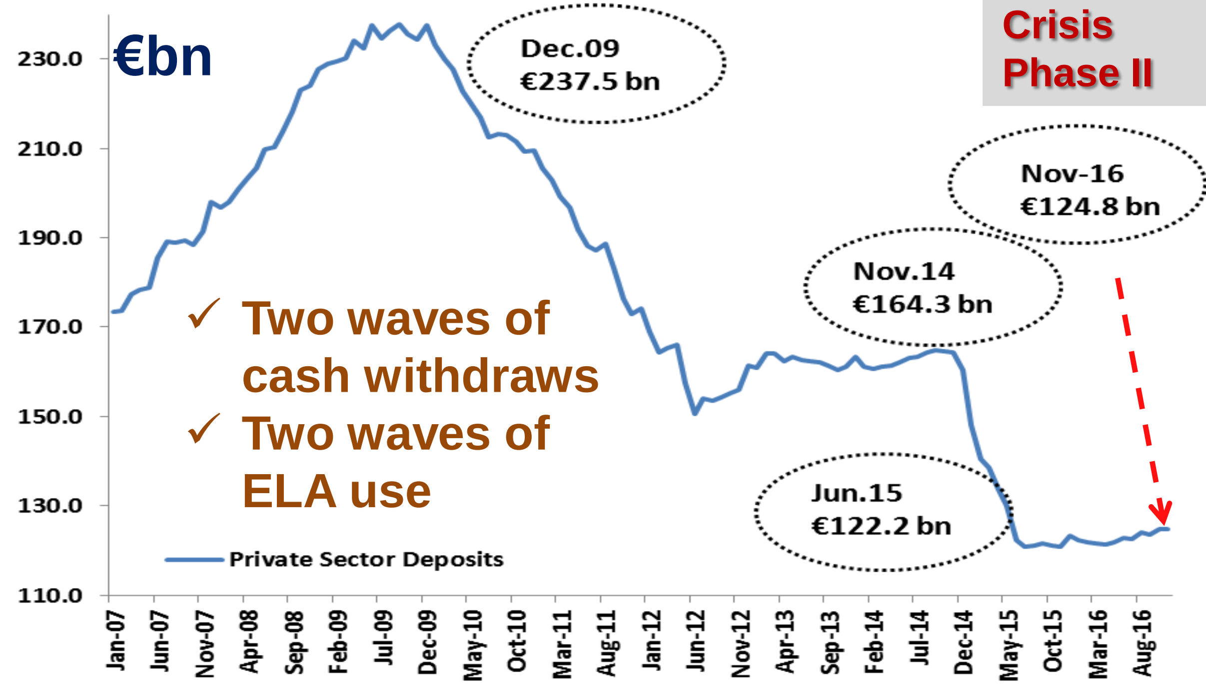


- Greek sentiment peaked in the period June 2014 - November 2014, but subsequently began a fast downward slide as the political landscape deteriorated and generated new uncertainty, thus <u>decoupling a second time</u> from the rest of EA. **Phase II of the crisis was creating anxiety in sentiment.**

1. Crisis-Phase II shows up in the Financial sector

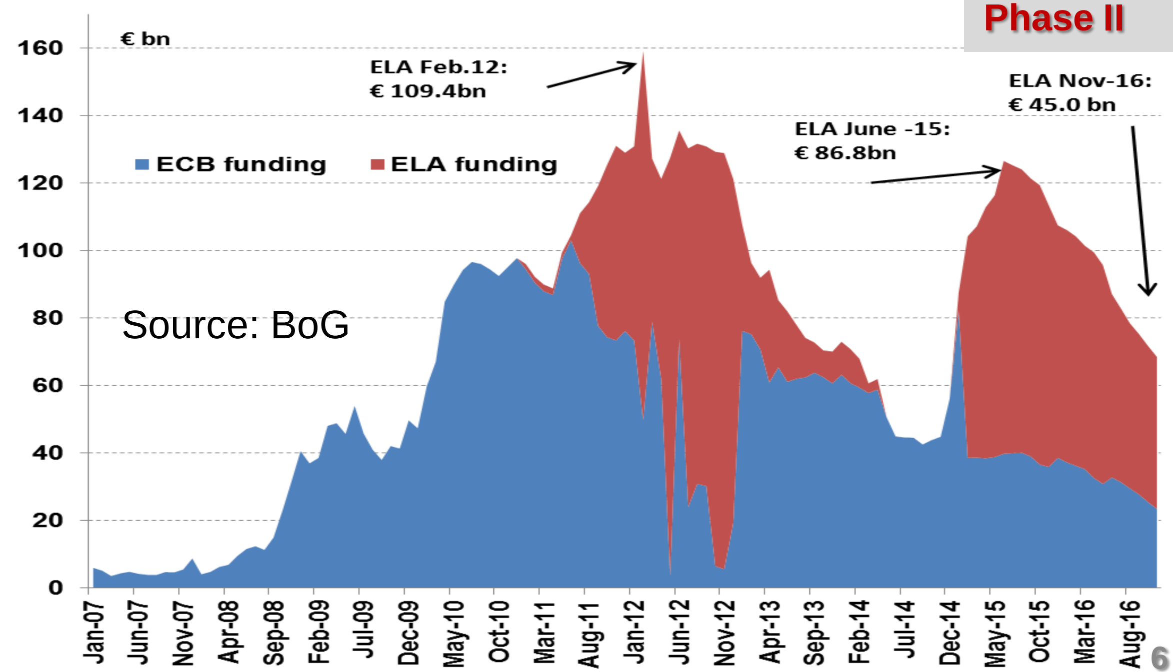
- A <u>second wave of cash withdrawals</u> in 2015 plus a disappearing inter-bank market <u>leads banks to ELA</u>:
  - ELA was zero at the end of 2014, yet it peaked again in 2015
  - It remains at €45bn today
  - Capital controls still imposed
  - Unless credibility returns, cash will stay outside the banks
  - After re-introduction of ECB waiver in July 2016, gradual improvement in ELA dependence
- <u>Bank stock prices collapsed</u> in 2015H1, State lost over €25bn in value, and a necessary 3rd recapitalization in Nov 2015
- State owner-ship of systemic banks shrank: NBG (40.4%), Piraeus (26.4%), Alpha (11.0%), Eurobank (2.4%)
- **Capital (**excl. CoCos & Prefs**) strong,** yet **depends on DTA**, 49% of €8.92bn in Alpha, 64% of €7.89bn in Piraeus 66% of €7.74bn in NBG, 78% of €6.25bn in Eurobank

Crisis Phase II

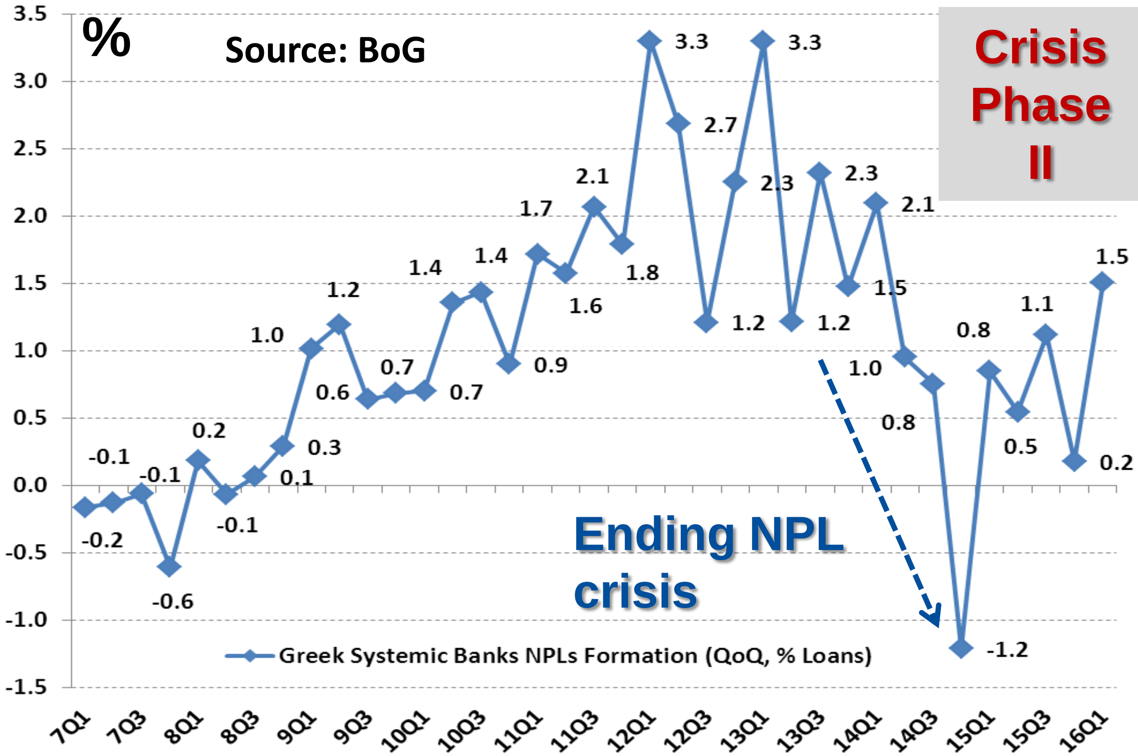


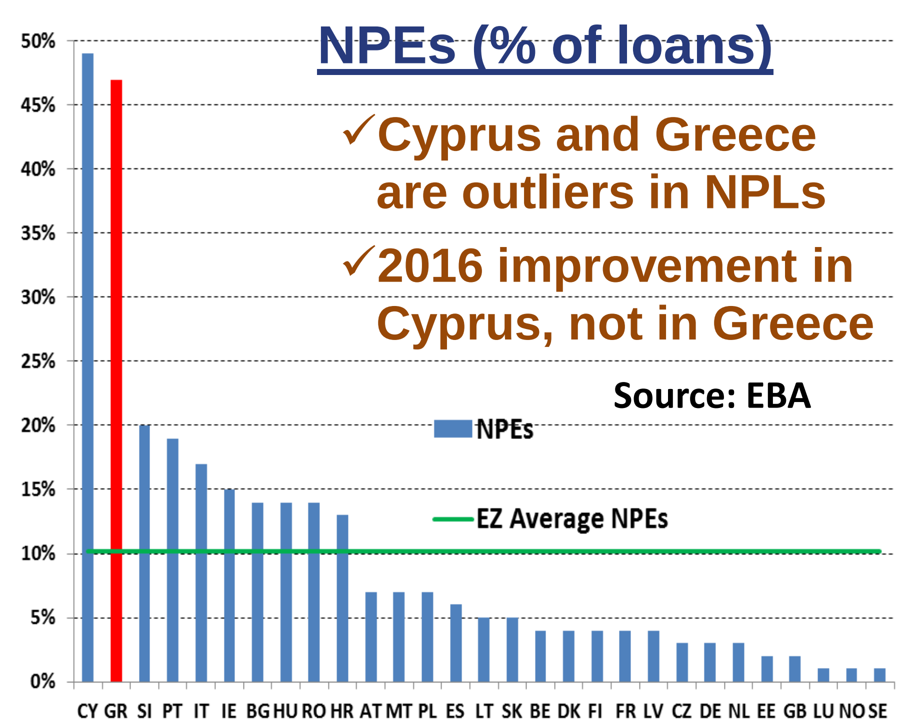
Source: BoG

Crisis Phase II



1. Banks remain vulnerable on both sides of their balance sheet





- ❑ A second major problem is NPLs, which keep rising. Target reduction of 40% until 2019
- ❑ The NPL improvement of late 2014 was reversed due to Phase-II of the crisis
- ❑ Unless economy picks up and NPL problem is gradually resolved, banks
  - Would stay zombies, unable to provide new credit to healthy companies
  - May need additional capital infusion, with no foreigners willing to come in this time
- ❑ Since Jan 2016, bearish world market has taken a toll on Greek bank stocks, which are down 42% on average, relative to the recent recapitalization of November 2015.

2.

1. Why Phase II of the crisis?

- A disastrous confrontation with the lenders in early 2015 ➡ Crisis Phase II

2. The future: Will growth come back and how?

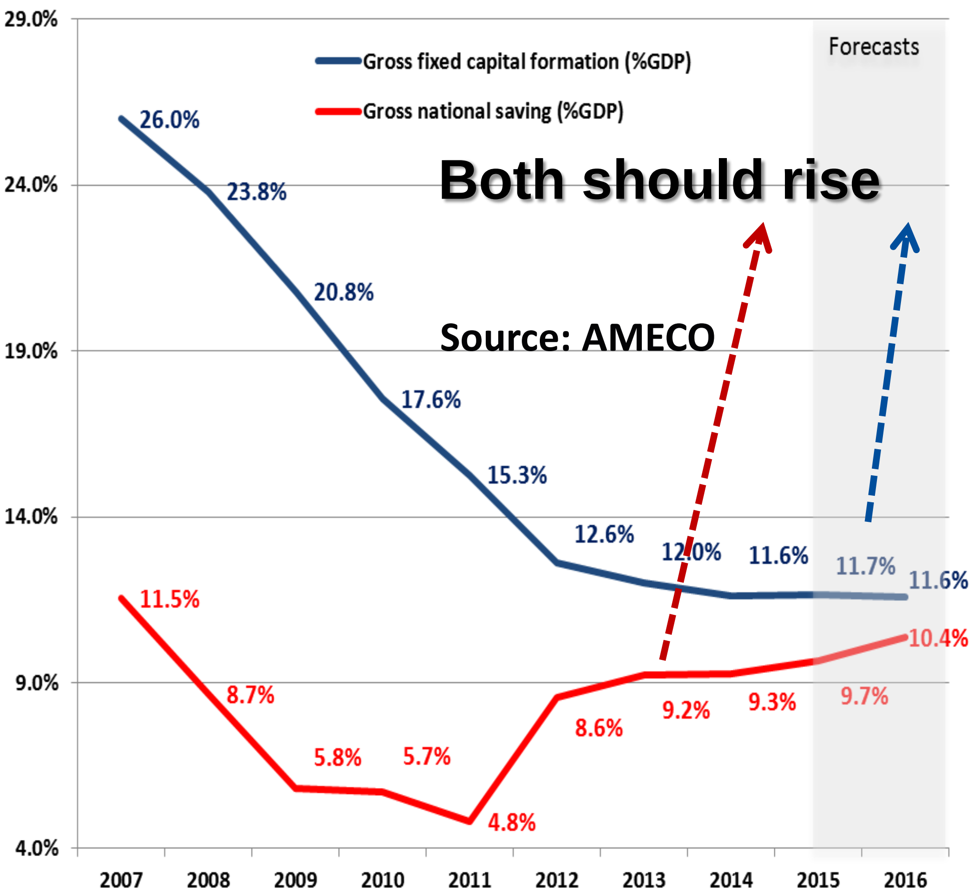
- Key challenges
- The short-term
- The long-term: Three scenarios

2. Key Challenges for the Medium Term

- Rebalance the economy away from consumption (<u>new growth model</u>)
  - *Consumption: 90% vs. 76% in EA*
  - *Investment: 11.5% vs. 20% in EA*
  - *Exports: 30% vs. 46% in EA*
- Safeguard medium-term fiscal stability (<u>return to growth, fiscal discipline</u>)
  - *Deficit of pension system: 11% of GDP vs. 2½ % in EA*
- Improve competitiveness (<u>structural reforms required</u>)
  - *Reverse the current over-taxation, Minimize bureaucracy, Improve efficiency of public sector, Continue on OECD toolkits*
  - ✓ *Between 2009-2014 GR climbed ca 40 positions in the WB's Doing Business Index. However, in 2015 and 2016 GR fell by ca 5 notches (currently in the 61th position from the ca. the 56th in 2014). <u>The OECD average currently is at 26</u>.*
- Attract sizeable foreign investments (<u>process interrupted in early 2015)</u>
  - *Gross national saving: c. 10% of GDP vs. 23% of GDP in EA*
- Restore sustainability of public debt (<u>decision in 2018)</u>
  - *Explosive path post-2020 in the absence of significant debt relief - OSI*
- Strengthen social net & confront unemployment (<u>GMI delayed</u>)
  - *Unemployment at 23.15% in Sept.2016 from 27.90% in Sept. 2013 with long-term unemployment in Q2:2016 at 72.2% of the unemployed.*

2. Key challenge: Foreign Direct Investment

Total Investment vs.
Gross National Savings
(% GDP)



- ❑ 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: €21.5bn in 2015 from €35.4bn 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 passed into Law (1st review). Fund expected to be fully operational in 2017 Q1.
- ❑ Slow progress on various projects (Regional airports, Hellinikon, Port of Piraeus, etc.)
- ❑ Another source is EU funds *available* for Greece (from Structural Cohesion funds, ca. €4bn for 2007-2013 & €20bnfor 2014-2020, ca. €15bn from Agricultural Funds) plus funds from the European Fund for Strategic Investments (Juncker plan).

- ❑ Low domestic savings is the flip side of high domestic consumption. Growth requires the share of savings to rise and consumption to decline

2. Short-term dominated by 3RD MoU

- A package of over €86 bn, €31.7 disbursed already & €19.6 unused from bank recap
- Implementation Period: 2015-2018,Conditionality will be updated on a quarterly basis
- About **241 actions**, about half would be over by March 2017

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*:

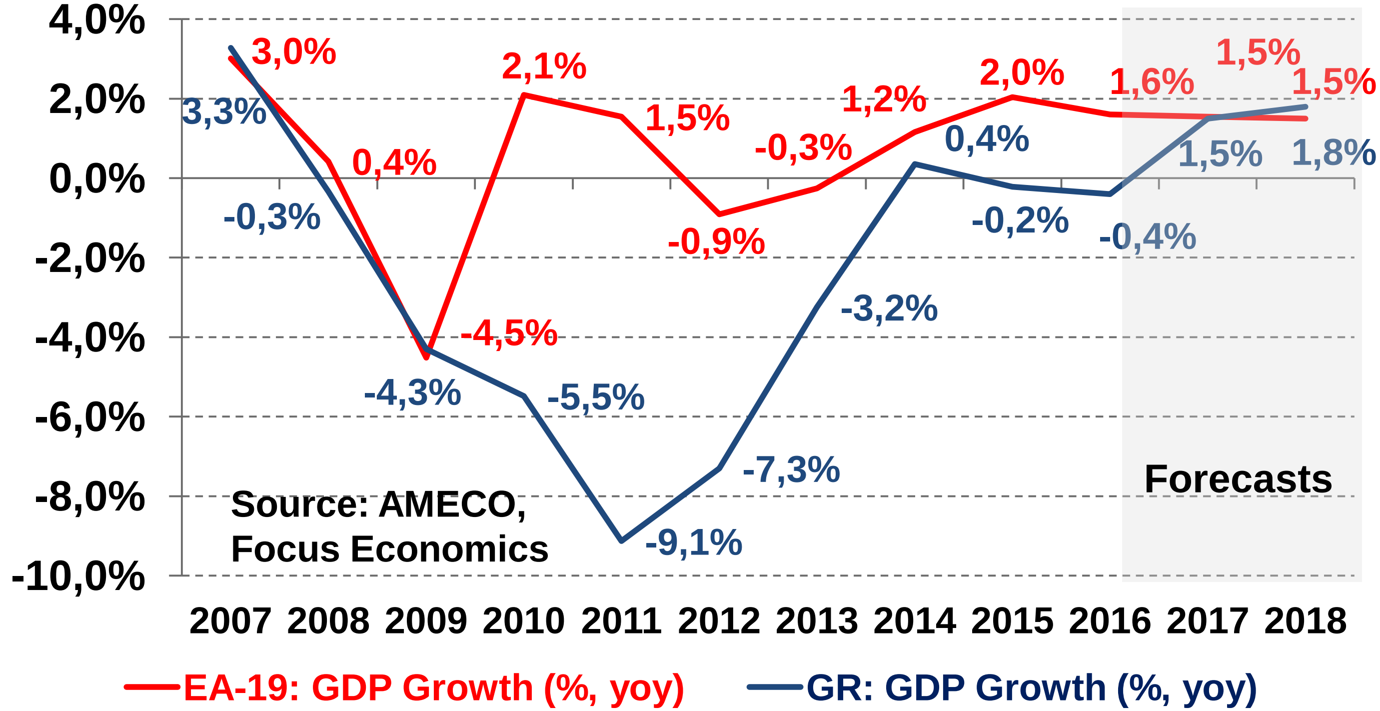
- Reforms in labor markets & product markets (including energy) via business environment and competition policies
- Ambitious privatization Programme

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

2. The short-term: Signs of stabilization

- Second leg of W-shaped recession less severe than expected, helped by
  - Less than expected liquidity constraints
  - decrease in oil prices
  - Euro depreciation
  - pre-cautionary consumption in 2015
- After conclusion of the 1st review of the 3rd Ec. Adjustment Program,
  - re-introduction of collateral waiver →cheaper funding for banks and reduced dependence of Euro-system



2. The short-term: Signs of stabilization

- Following the conclusion of the 1st Review, ESM loan disbursements: €7.5bn in June 2016, €2.8bn in October 2016
  - Partial clearance of public sector arrears, remaining stock of €5.6bn (Nov. 2016).
  - From €85.5bn, €31.7 disbursed, €53.8 remaining (incl. €19.6 from bank recap).
- Strengthened budgetary surveillance (contingency mechanism to correct deviations from fiscal targets).
- Agreement for short-term debt relief measures
  - Penalty of 200bps on €11bn buyback, delayed for a year
  - Peaks in maturities up to 2059 ironed out by extensions (4-yr, 2%, €96bn = €8bn)
  - EFSF bonds of €30bn held by banks to be swapped for cash
  - ESM would Issue fixed-rate bonds
- Conclusion of 2nd Review
  - Would release €6.1bn
  - 50% of reforms in the 3rd Economic Adjustment Program would be completed
  - Main issues: Labor reform, privatization fund, medium term fiscal framework (Primary surplus of 3.5%GDP for 2018 & the medium term)
- Delays in framework for NPL management & resolution:
  - OCW stuck in the nature of a common haircut across creditors,
  - No common data base on delinquent borrowers across banks, tax offices & social security funds
  - Accounting treatment of losses from loan haircuts
  - No protection for bank managers from overzealous prosecutors

2. 2017 Programme Disbursements & Debt Financing Needs

2017 Amortization, maturing debt and interest payments			
	Amortization & Maturing Debt (2017, €bn)	Interest payments (2017, €bn)	Total
Jan-17	0.00	0.13	0.13
Feb-17	0.01	1.51	1.52
Mar-17	0.67	0.71	1.39
Apr-17	1.61	0.43	2.04
May-17	0.00	0.19	0.19
Jun-17	0.62	0.43	1.04
Jul-17	6.61	0.83	7.44
Aug-17	0.01	0.39	0.40
Sep-17	0.22	0.04	0.26
Oct-17	0.00	0.31	0.31
Nov-17	0.00	0.18	0.18
Dec-17	0.32	0.18	0.50
Total	**10.07**	**5.33**	**15.40**

Source: PDMA

Programme Disbursements (2017, €bn)	
January (*)	6.1
Q1	1.5
Q2	9.6
Q3	2
Q4	5.1
Total:	**24.3**

Source: Greece - ESM Compliance Report, June 2016

Note: (*) Initially planned for Q4 2016 (Conclusion of 2nd Review)

2. The short-term: Consensus forecasts for 2017

Source: ELSTAT, EC, Focus Economics

	2015, €bn (nominal)	2015 Real YoY%	2016 Real YoY%	2017 Real YoY%
GDP	176.0	-0.2	0.1	1.5
Private Consumption	123.8	-0.2	0.2	0.9
Government Consumption	35.2	0.0	-1.1	0.1
Gross Fix. Capital Formation	20.5	-0.2	3.2	5.1
Exports	53.0	3.4	-1.8	3.7
Imports	53.3	0.3	0.3	2.1
GDP deflator		-1.1	0.0	0.9
Unemployment Rate (avg %)		25.0	23.5	22.4
Priv. Sector Deposits (yoy%)		-23.0	2.0	4.0
Private Sector Credit (yoy%)		-3.6	-3.0	0.0

- If the forecasts of the domestic Greek banks are excluded, the consensus GDP growth for 2017 made by private sector participants falls well below 1.5%
- Official growth forecasts for 2017 are more optimistic, at 2.7% but assume:
  - Ownership of the reform agenda implementation, elimination of political uncertainty
  - No more delays of 2nd review, substantial debt relief and QE participation, no negative shock from migration issue, BREXIT, EZ elections

2. The long-term: Can growth come back beyond simply a cyclical recovery?

- ❑ **Can the country push exports and investment?**
- ❑ **<u>POSITIVES</u> are mostly of cyclical nature**
  1. Arrears are now lower, at €5.6bn, and are gradually being paid back.
  2. ECB reestablished the waiver on Greek banks, plus (long shot) it may include Greek bonds in its QE program, which would drastically reduce bond yields.
  3. Implementation of S-T debt relief measures expected to start soon.
- ❑ **<u>NEGATIVES:</u>**
  1. Economic policy remains unfocused: There is no clear growth strategy, no commitment for reforms and credibility is still wanted → **dismal Long-run prospects**
  2. Fiscal mix provides wrong incentive for growth, as Greeks are <u>overtaxed</u> → **dismal Long-run prospects**. Also, fiscal multiplier implies a drop of GDP by 3%
  3. The youth is immigrating and companies are registering abroad → **dismal Long-run prospects**
  4. **Financial sector cannot help**, this time the economy ought to improve on its own
  5. M-T Debt relief too far away, expected in the end of 2018, after German elections, while L-T measures unspecified
  6. Risk of further automatic restrictive fiscal measures in 2018 if targets not met
  7. Government **delays** in implementing the MoU → postpones growth come-back

2. Are there sectors with promise?

- Greece does have comparative advantages
  - Many sectors show promise
  - Its labor force continues to be well educated and works hard (OECD comparisons)
- But <u>policy ought to focus on the supply side</u>, something completely off the antennas of the administration today
  - In areas not touched by the Troika, reforms are even being reversed and criticism is suppressed, e.g., in education, in independent agencies, in justice

Tourism (focus on promising sub-sectors: home-porting for cruises, health tourism, etc.)
Transportation & Logistics (positive externalities to other important sectors)
Agriculture (branded products)
Energy (renewables)
Public Infrastructure (positive externalities to other sectors)
Shipping (development of long-delayed shipping-services hub)

2. The long-term: Three scenarios

i. Super-Growth, i.e., growth ~ 3%,

- Carries low probability. Not just a function of completion of 2nd Review.
- Requires a) ownership of reforms and vigilance on implementing them, b) policy credibility and consistency, c) reversal of current tax policies, d) FDI, e) quick resolution of NPLs, f) possible attention to sectoral comparative advantages, …..
- For 2017-18 cyclical recovery, requirements: a) Program on track, b) QE participation so that yields decline, c) Debt sustainability in 2017 and later access to markets

ii. Stagnation, i.e. growth ~ (0% - 1%)

- Carries high probability. The dominant scenario is a muddle-through one, it assumes continuation of the status quo

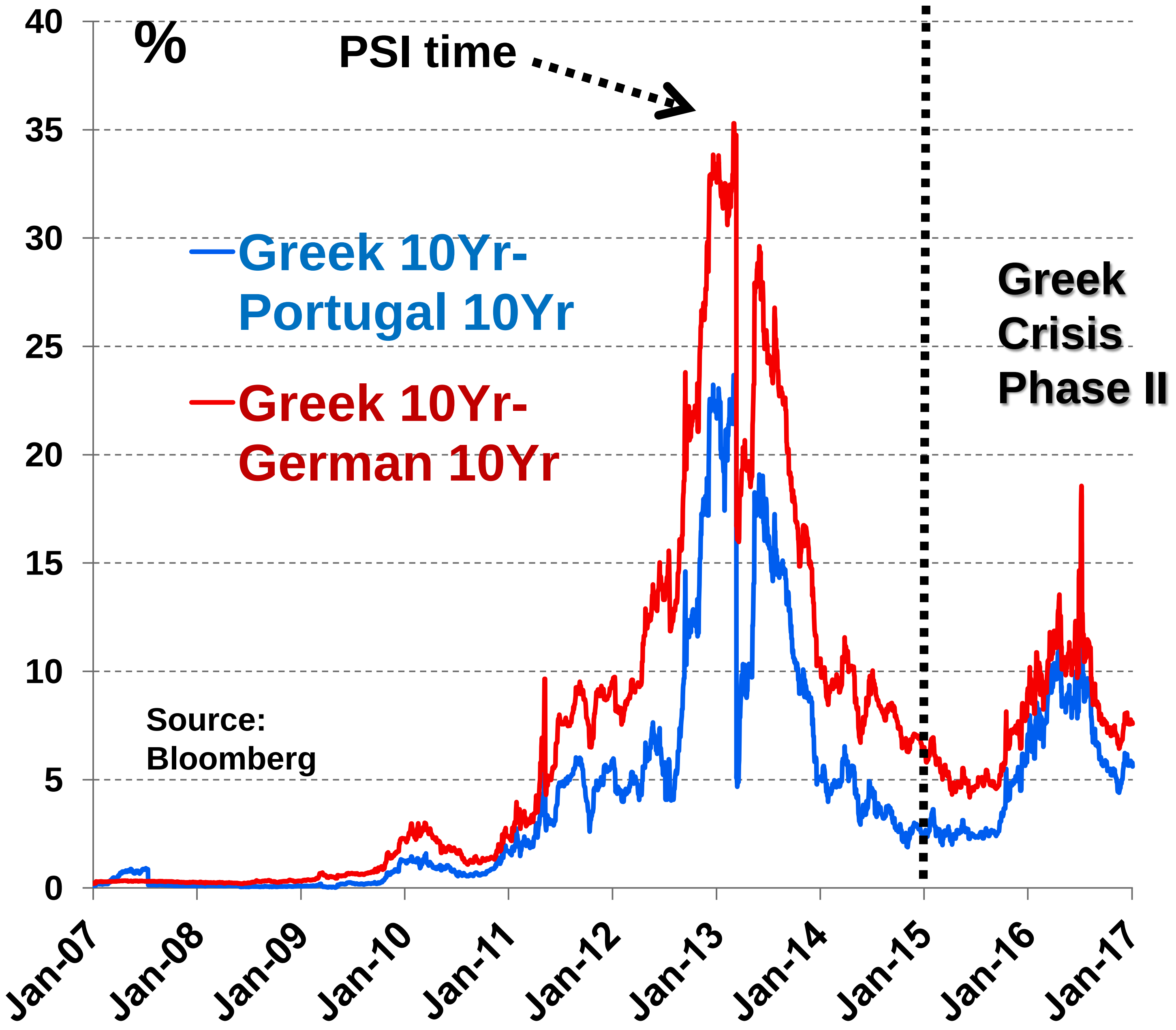
iii. Further Deterioration, growth ~ -3% for a while and GREXIT

- Carries very low probability ~ 10%, European politics is against it
- Bond yield spreads remain high as markets have not extinguished the probability of GREXIT from their perceptions
- No external force exists to counteract a potential downward economic slide: Europeans have stopped paying attention to Greek growth prospects as contagion risk has diminished, hence their pressure for reforms in Greece has subsided (*example: They have allowed a fiscal consolidation based on taxation alone*)

2. Markets do worry about GREXIT

Which conditions enacted together, could lead to GREXIT?

1. **Economic stagnation continues for a long time or even a new drastic recession takes hold as automatic fiscal cuts are enacted**
2. **No QE for Greece in 2017 perhaps due to a negative IMF DSA**
3. **Parliament dissolves and new more extreme political parties come to power which call for GREXIT**



Concluding remarks

Greece faces major challenges

- ❑ **Cyclical recovery at the doorstep but growth likely to be slow**
  - **Will Greece be part of ECB's QE?**
  - **Will the IMF be a lender in the 3rd Program and if yes, will it insist on resolving the pension imbalance right away?**
  - **How long would Primary Surpluses of 3.5% GDP last without serious pension reform and / or significant debt relief measures?**
- ❑ **Medium-term imbalances**
  - **Major fiscal imbalance in pension expenditure, 8.5% GDP above EA average**
  - **Excessive domestic Aggregate demand: Over-consumption, low savings rate (hence need for FDI)**
  - **Weak supply side: Low competitiveness, over-taxation (hence immigration of people and companies), under-investment, low exports**
  - **Public debt currently unsustainable**
  - **Social safety net in need of improvement**
- ❑ **Three scenarios of the future, with stagnation being the dominant one. Why? Because there is no focus on long-term growth policy, with the European lenders staying indifferent on the sidelines. This increases the probability of GREXIT, which continues to be priced in bonds**

What follows
Greek Crisis Phase II ?

Thank you
for your attention!

Gikas A. Hardouvelis