The Euro Area Crisis and the Role of Greece

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Introduction

- Greek vs. US Great Depression
- Economic Policy Uncertainty in Greece

I. Greek Crisis Phase I

1) Why so deep?
2) Its aftermath: Debt rescheduling and a banking crisis
3) Euro Area moves to correct some of its deficiencies

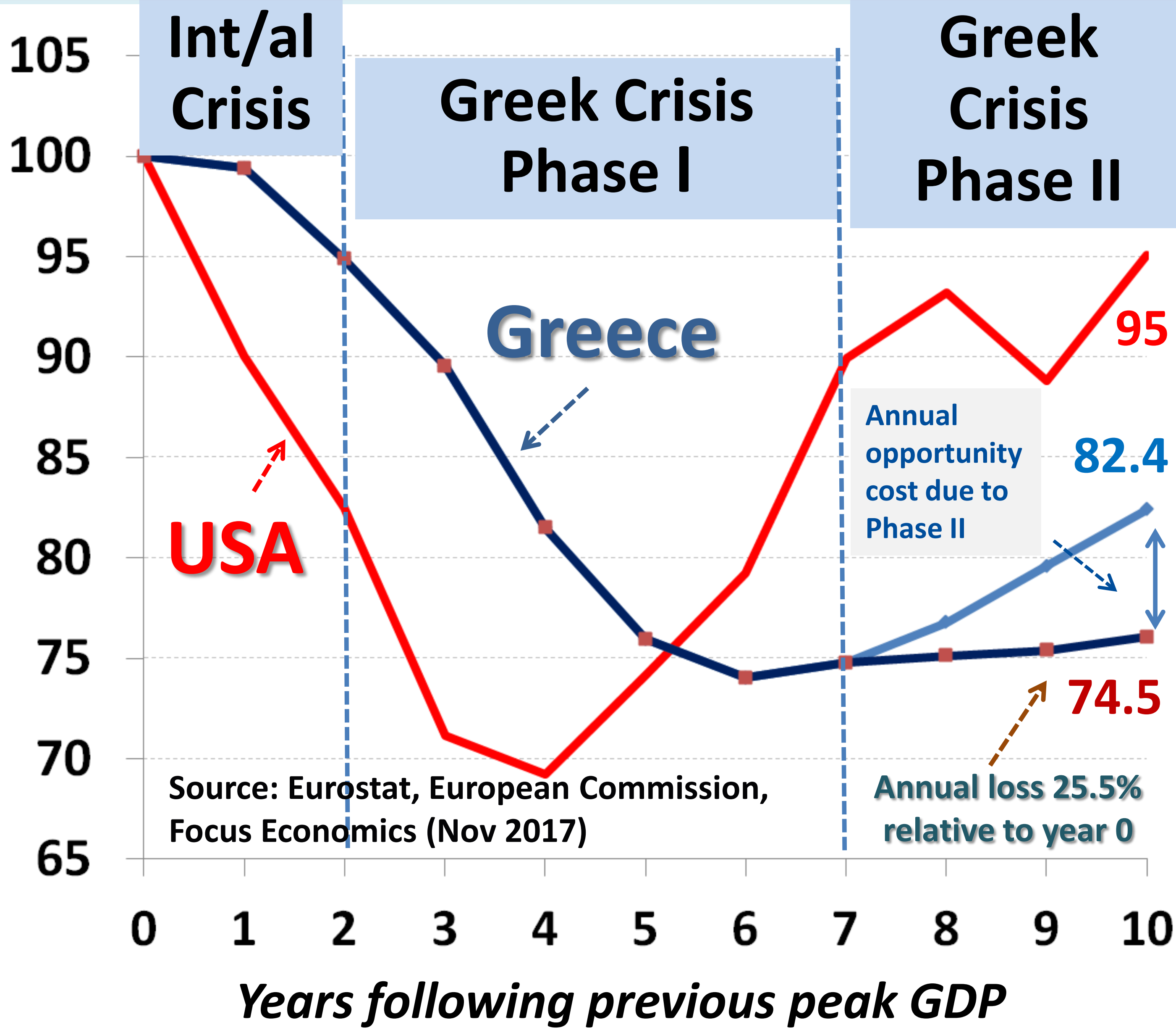
II. Greek Crisis Phase II: Unnecessary?

1) Domestic Politics overcomes economic logic
2) Europeans in search of their future: Will the Euro Area survive ?

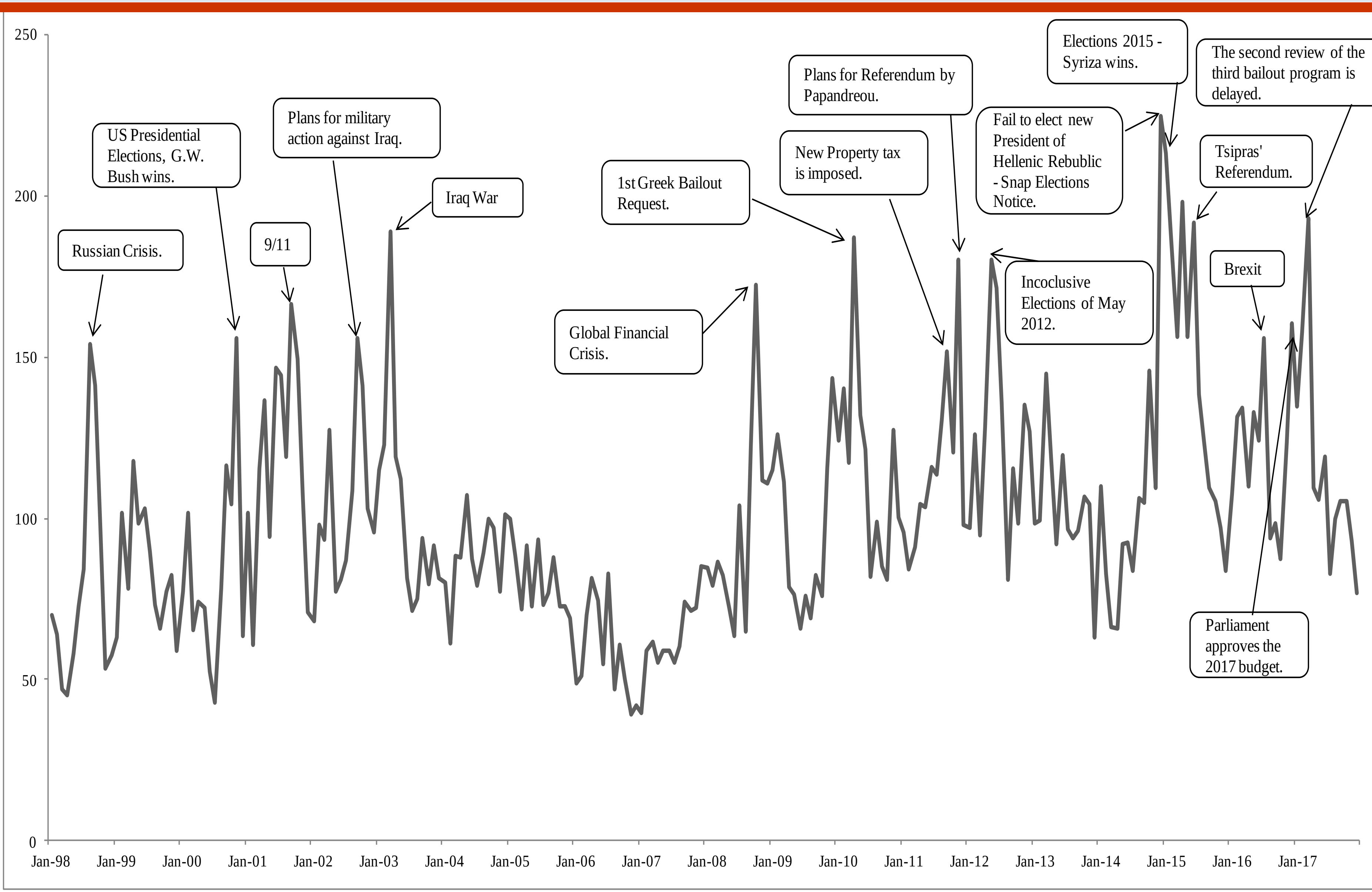
Concluding remarks

Greek Depression worse than US Great Depression

- 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 74.5 in 2017
- Fall 2014: Greece was forecasted to be around 82.4
- At minimum, Phase II costs <u>annually</u> 7.9 ppts or ca. €18bn



Greek Economic Policy Uncertainty over time



Source: Hardouvelis, Karalas, Karanastasis, Samartzis, 2018, "Political, Economic and Economic Policy Uncertainty in Greece"

Greek Economic Policy Uncertainty and its correlations vary across the different crises

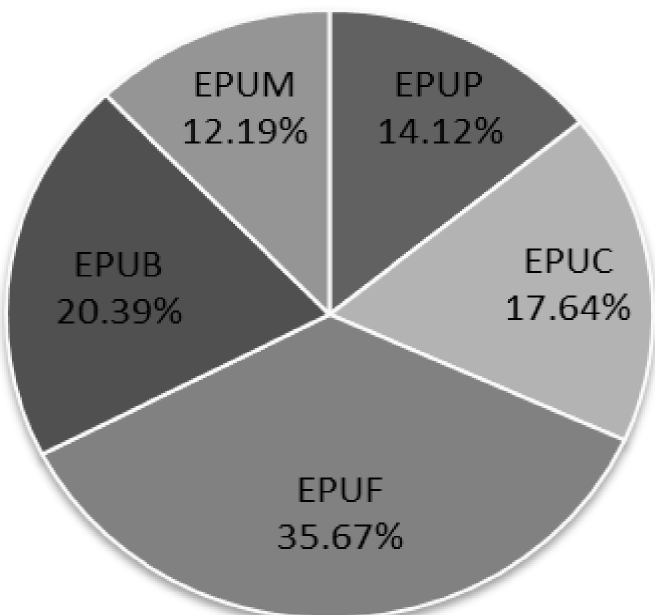
Greek EPU Correlation with EPU of:	Pre-Crisis 1/1998 7/2007	International Crisis 8/2007 9/2009	Greek Crisis Phase I 10/2009 11/2014	Greek Crisis Phase II 12/2014 12/2017
US	64.6%	78.8%	32.4%	7.8%
EU	63.3%	74.3%	50.3%	0.5%
Global	66.4%	90.5%	42.9%	0.5%
France	34.8%	58.0%	35.0%	18.6%
Germany	50.6%	62.2%	44.2%	6.8%
Italy	57.9%	56.6%	27.1%	19.7%
Spain	58.8%	45.1%	53.5%	-3.4%
UK	49.4%	66.7%	40.9%	-18.2%
Average Greek EPU with (st.deviation)	86.55 (29.7)	89.18 (25.7)	111.31 (27.4)	130.47 (38.9)

Source: Hardouvelis, Karalas, Karanastasis, Samartzis, 2018, "Political, Economic and Economic Policy Uncertainty in Greece"

Sources of Greek Economic Policy Uncertainty

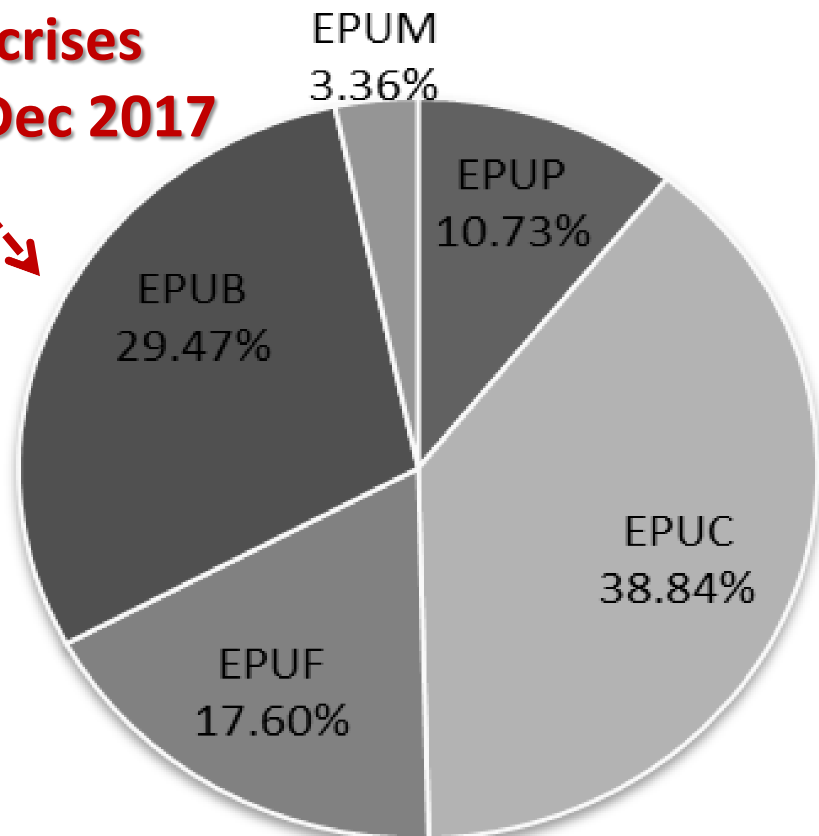
- ❑ Relative contribution of Monetary Policy Uncertainty EPUM is minimal and declines
- ❑ Relative contribution of Currency (or GREXIT) uncertainty EPUC rises during the crisis
- ❑ Relative contribution of Banking Uncertainty EPUB rises during the crisis
- ❑ Relative contribution of Fiscal uncertainty EPUF declines during the crisis

Before the crisis
Jan 1998 – July 2007



EPU
Composition

During the consecutive crises
Aug 2007 – Dec 2017



Source: Hardouvelis, Karalas, Karanastasis, Samartzis, 2018, "Political, Economic and Economic Policy Uncertainty in Greece"

3-year cumulative effect of 30% uncertainty shock

	EPU	EU	POLU	EPUB	EPUP	EPUF	EPUC	EPUM	Actual Change
Ind.Pr	-14.2%	-6.5%	-6.6%	-6.4%	-2.5%	-8.2%	-8.7%	-4.8%	-11.3%
Empl.	-8.0%	-5.2%	-5.7%	-3.4%	-1.5%	-3.9%	-5.3%	-2.3%	-7.4%
Ec.Sent	-19.8%	-17.7%	-11.2%	-16.0%	-11.9%	-6.3%	-10.8%	-4.4%	-14.5%
ASE	-69.6%	-72.1%	-54.1%	-36.8%	-24.6%	-41.3%	-41.1%	-14.9%	-56.3%
10-yr r (bps)	1081	978	1174	302	426	326	736	229	1126
H.Dep.	-21.3%	-24.8%	-27.9%	-8.5%	-6.2%	-0.9%	-14.0%	-4.8%	-30.4%
G.D.P.	-8.2%	-4.7%	-6.4%	-2.5%	-1.5%	-8.2%	-9.3%	1.4%	-26.0%
Invest.	-24.4%	-11.9%	-17.8%	-6.6%	-3.6%	-24.6%	-28.2%	5.5%	-69.0%

- Crisis sample VAR model estimates (Aug2008 – Dec 2017). Eight separate models in 8 columns.
- The actual changes of Industrial Production, Employment, Economic Sentiment, Athens Stock Exchange index and 10-yr yield are the % changes of their average values from the period 1/98-7/07 to the period 8/07-12/17.
- The actual changes of Household Deposits, GDP and Investment are the % changes of their values from July 2007 to December 2017.

Source: Hardouvelis, Karalas, Karanastasis, Samartzis, 2018, "Political, Economic and Economic Policy Uncertainty in Greece"

I.

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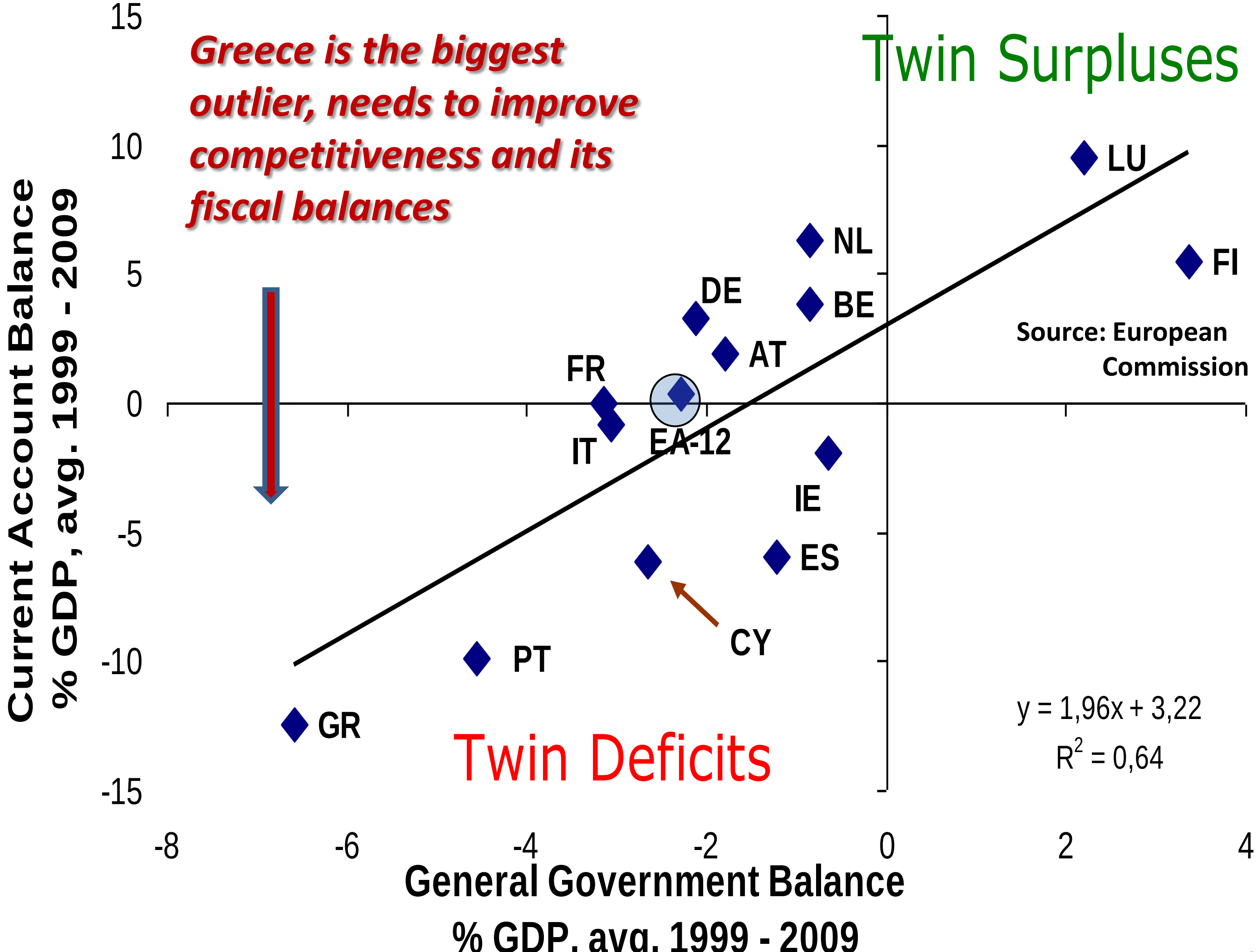
Concluding remarks

I. Severe macroeconomic imbalances bring Greek Crisis Phase I

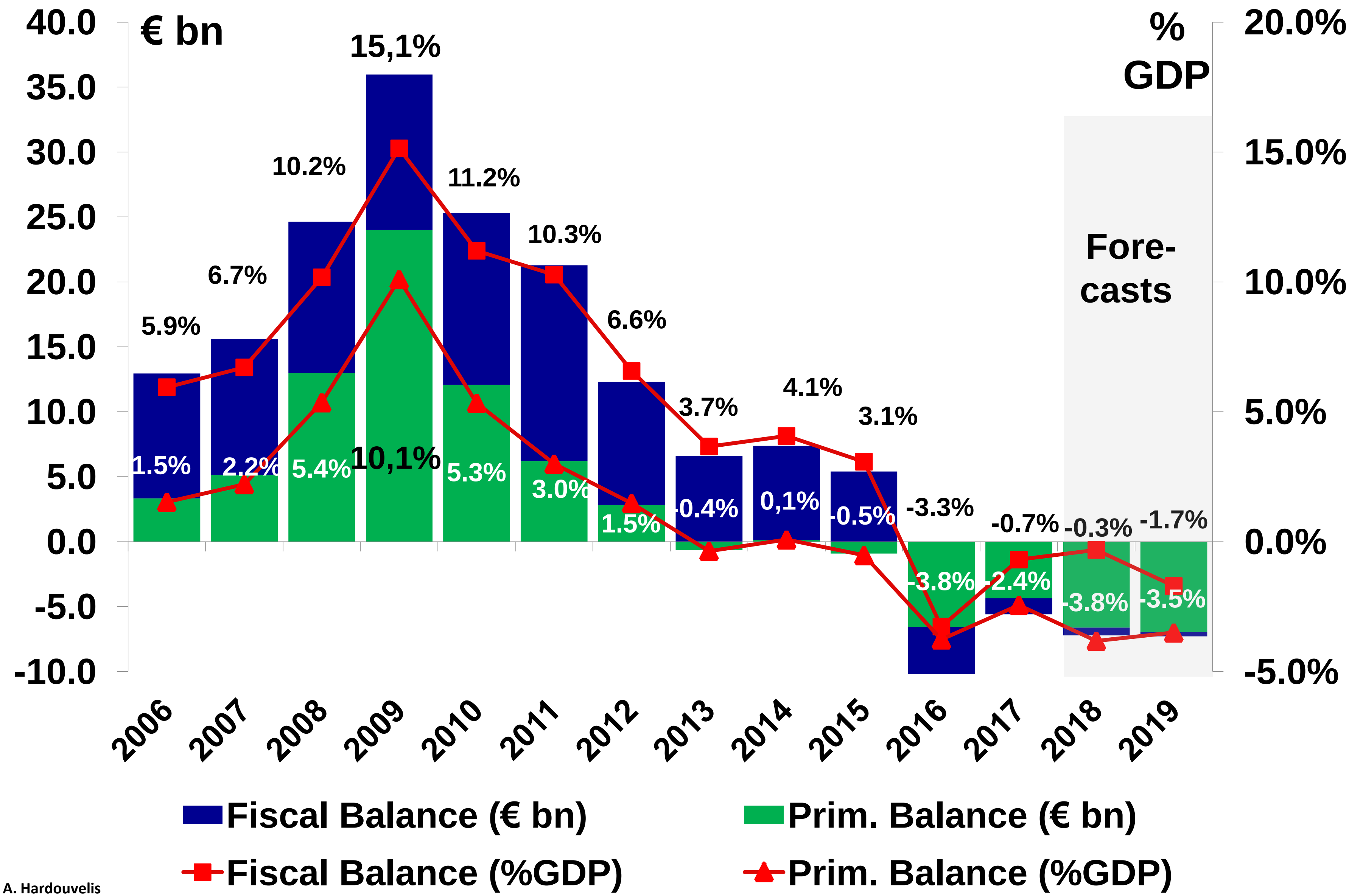
- Greece suffered from **lack of fiscal discipline and lack of competitiveness** as shown in the Figure
- Private sector leverage was not the problem
- Post-EMU, a **competitive North** and an **uncompetitive South** emerged

Average annual external and fiscal balance in EA-12 before the Greek/EMU crisis hit in early 2010



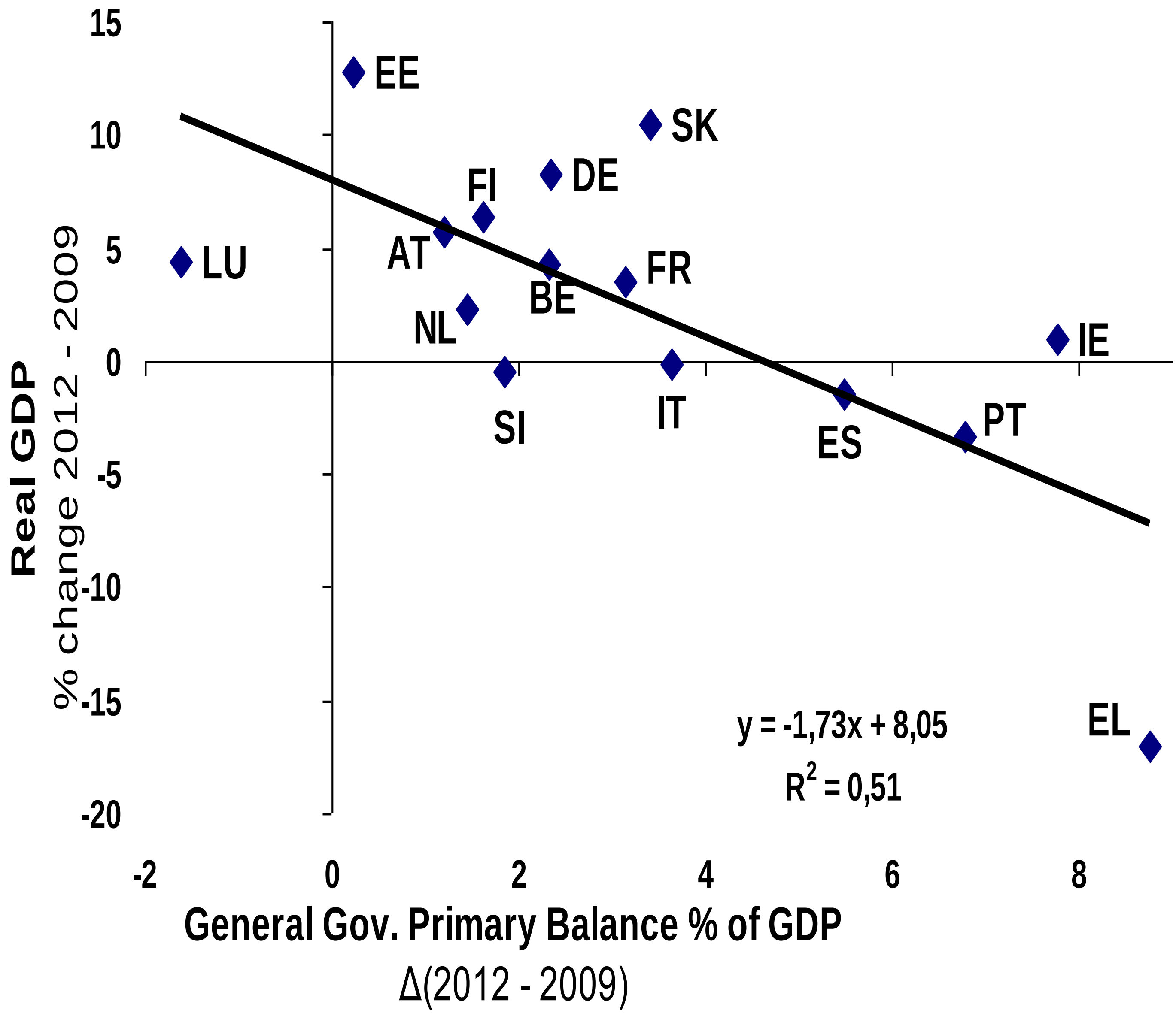
I. Greek Fiscal imbalances over time

- Peek imbalance in 2009
- By 2013 the Primary Balance was back to almost zero



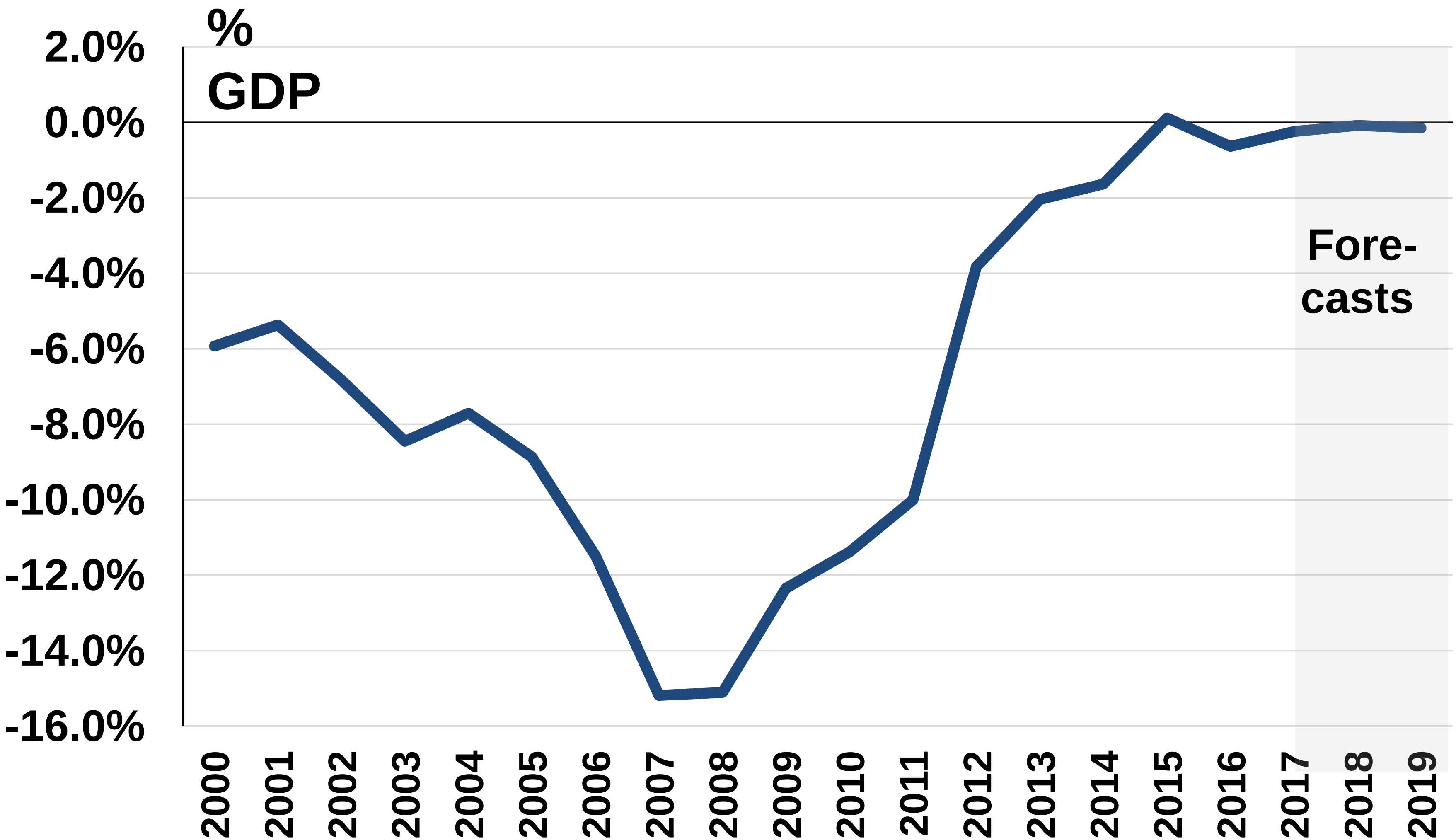
I. Fiscal austerity brings Recession

- A vicious cycle of more fiscal austerity causing a deeper recession
- An apparent fiscal multiplier close to 2 as a reduction in primary deficit of 9% GDP resulted in a drop of 17% in real GDP

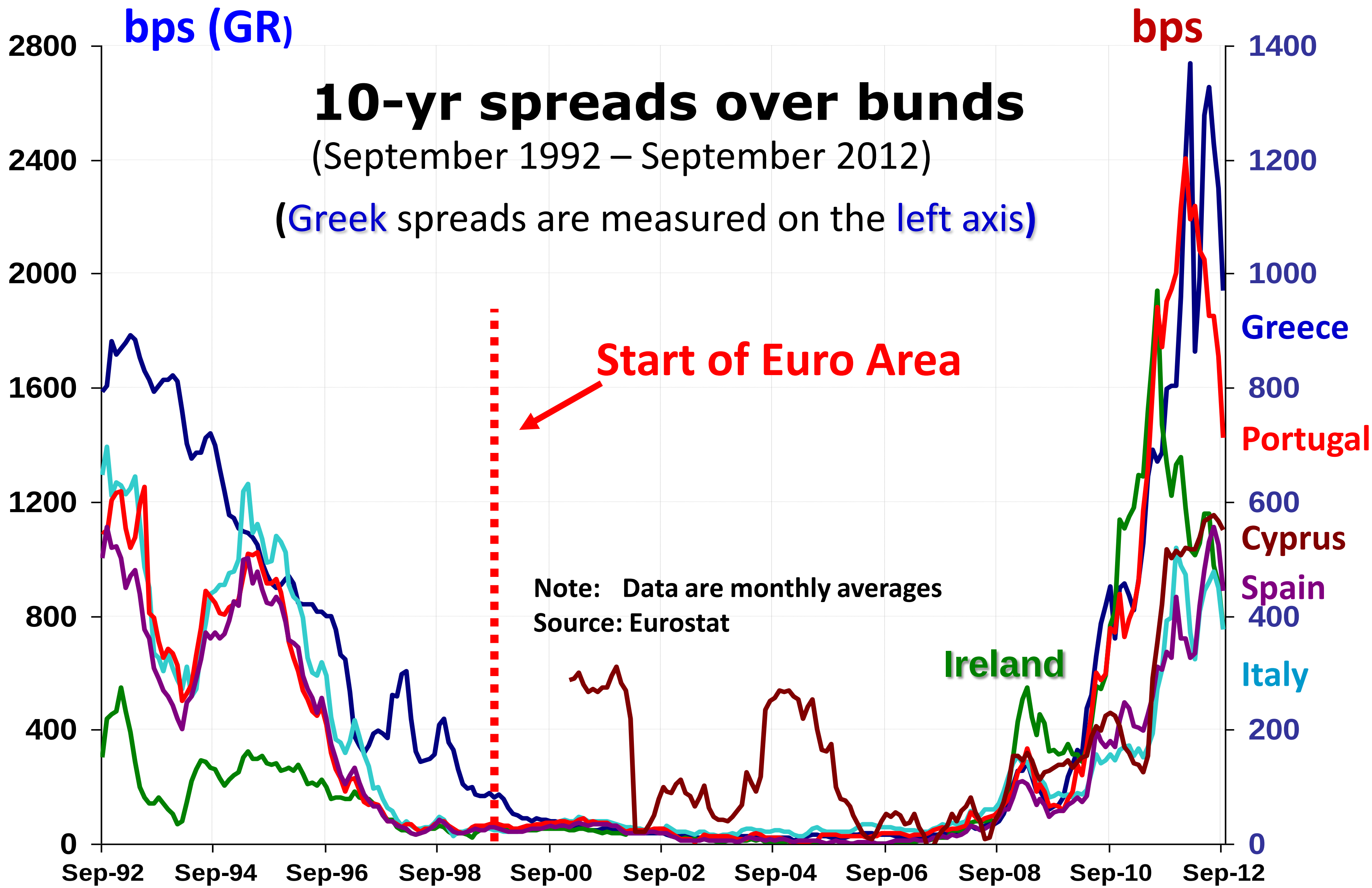


I. Greek Current Account imbalances over time

- Peak imbalance in 2007-2008
- Complete correction by 2015



I. The crisis decouples bond yields in the Euro Area



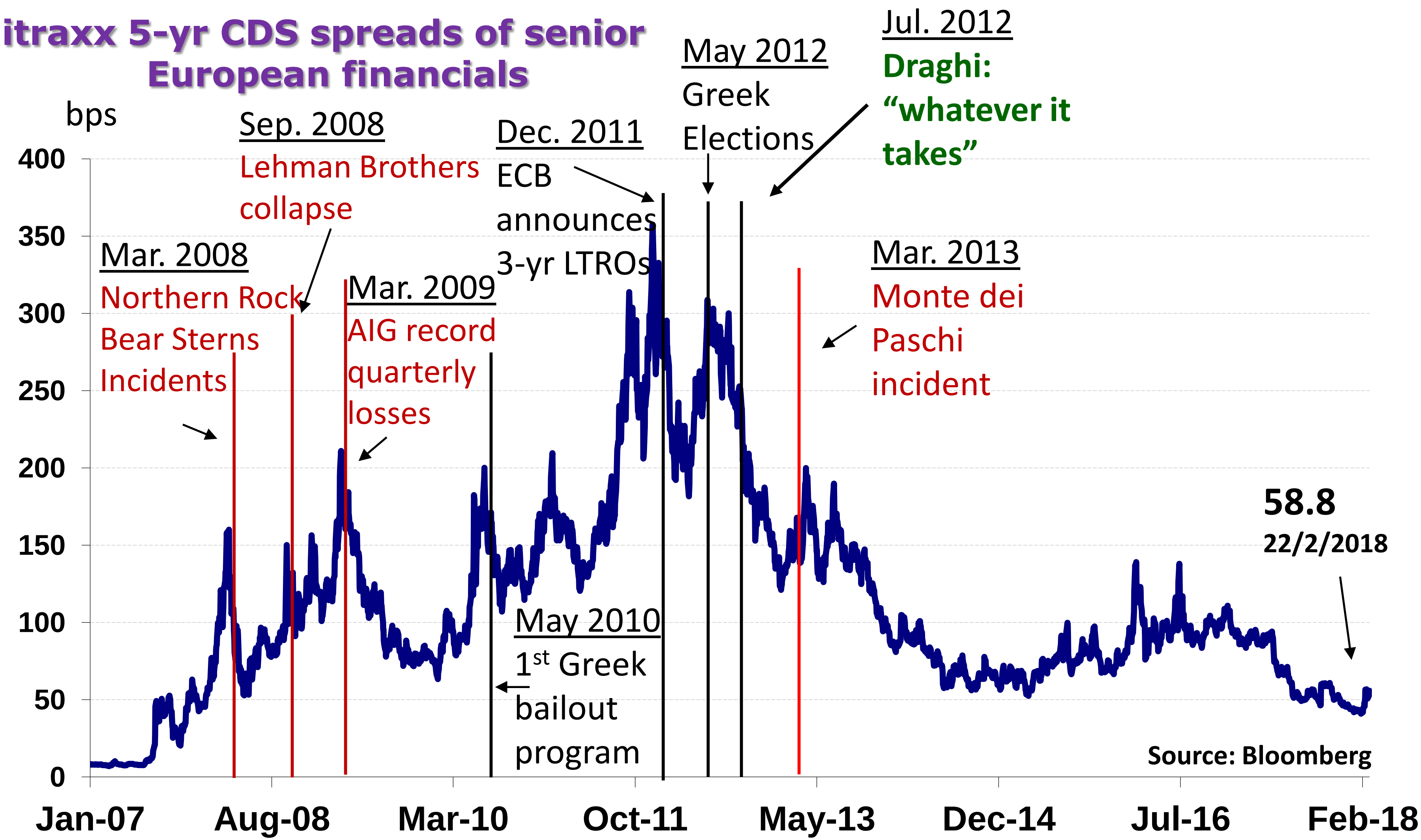
I. Major debt restructuring brings a banking crisis

- The PSI was finalized in February 2012: Largest restructuring in history
- Eligible paper for restructuring : €205.5bn
  - €177.3bn (86,3%) under Greek Law, retroactive CACs were imposed on them
  - €28.2bn (13.7%) mostly under British Law
- About €198.2bn were swapped for new bonds:
  - "Cash" 15% of old FV or €29,7bn
  - New Bonds under British Law with FV = 31.5% old FV (or €62.4bn) with annual maturities from Oct 15, 2023 to Oct 15, 2042 and with coupon 2%, rising to 3.4%
  - Detachable GDP-linked securities (if GDP > forecasts) whose ≤ 1% FV)
- Greek banks lost €38bn or 170% of their capital (equivalent to 10.1% of their assets)
- Four deemed to be systemic and were recapitalized mostly with funds from the second economic adjustment program. Most others were liquidated and sold.
- The banking crisis was equally big in Europe

I. The evolution of stock prices

- Feb 2018: European financial stocks at 80% of Sept 2004 vs US financial stocks at 147% of Sept 2004
- Yet European non-financials at 280% in Feb 2018
- Greek banks at zero at the end of 2011

I. CDSs reveal the European Banking Crisis



I. Euro Area responds to the crisis

During the crisis, the European response seemed to be too little too late as there was a conflict between

- **those who wished to mitigate the crisis and demanded quick action**
- **and those who worried abut moral hazard and preventing a future crisis by copycats**

This conflicts continues to split Europe today

Despite the conflict, some reforms were initiated:

- ❑ **Banking Union**
  - **Single Supervisory Mechanism** (on 130 large banks since November 2014)
  - **Single Resolution Mechanism** (Bail-in feature, Bank Recovery and Resolution Directive, a further backstop proposed in Dec 2017**)**
  - **European Deposit Insurance scheme - still pending**
- ❑ **European Stability Mechanism (**since Sept 2012**)**
- ❑ **Stricter fiscal rules**

The crisis was avoided thanks to an expansionary monetary policy by the ECB , also with unconventional measures (SMP, LTRO, OMT, QE, etc.)

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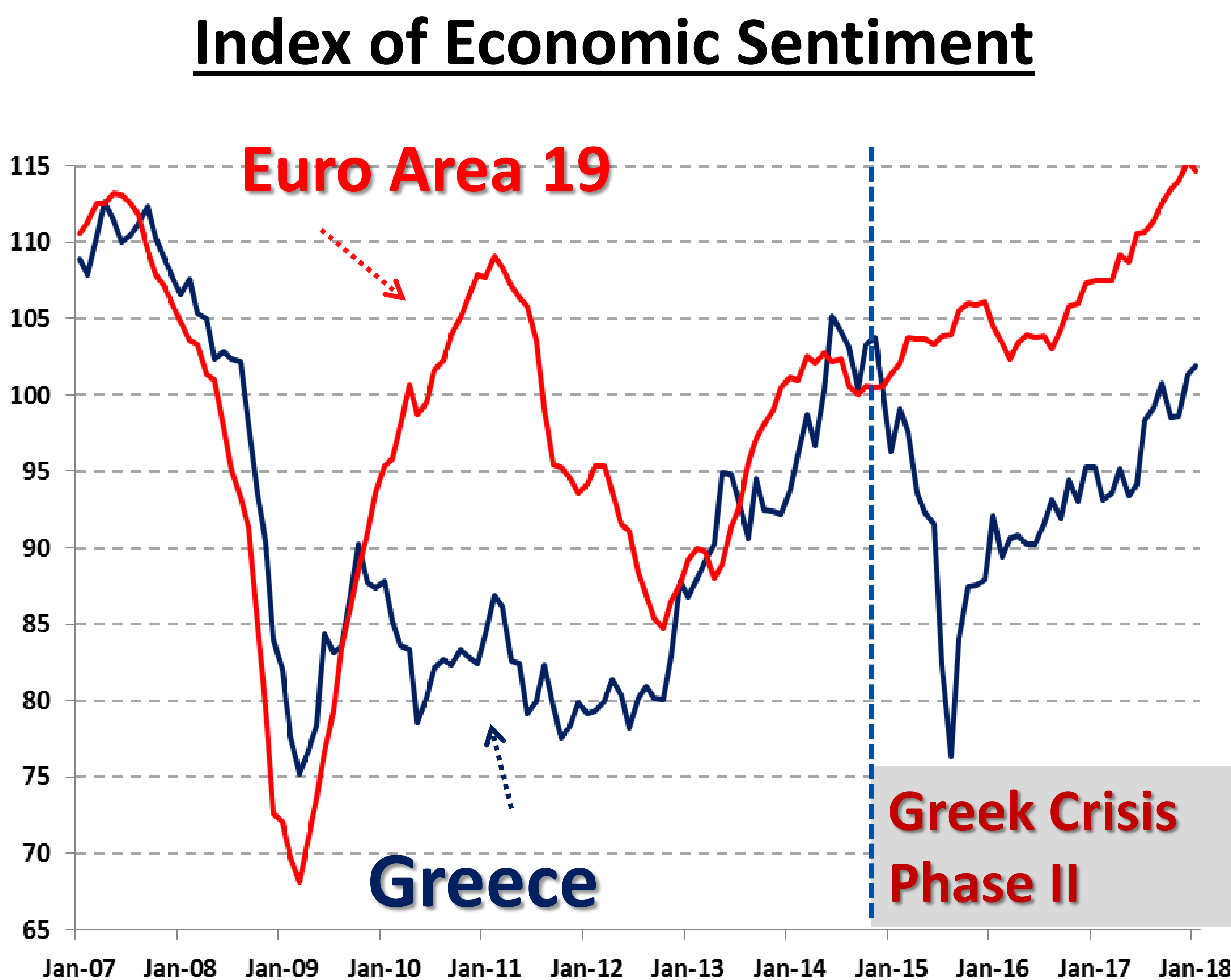
II. Politics brings Greek Crisis Phase II in January 2015

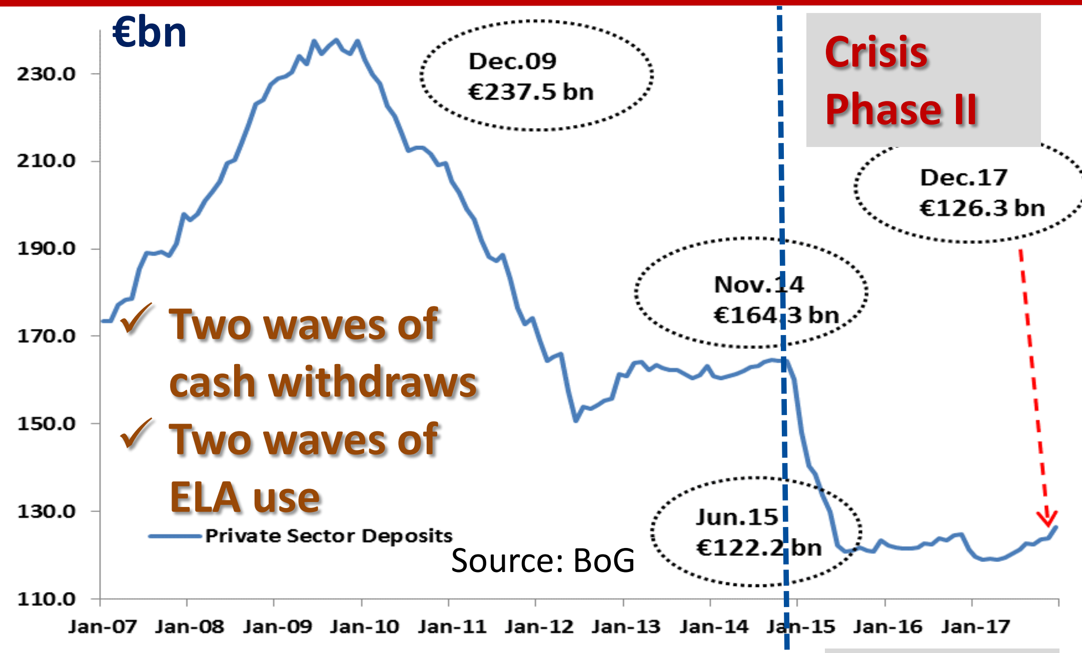
- By 2014 macroeconomic imbalances were cured and the economy was growing again
- Yet a new government of leftist ideology in January 2015 decided to refuse cooperation with the lenders and "to export revolution" to the rest of Europe as well
- Economy stalled
- Pessimism rose again
- New wave of bank deposit withdrawals brings capital controls in June 2015

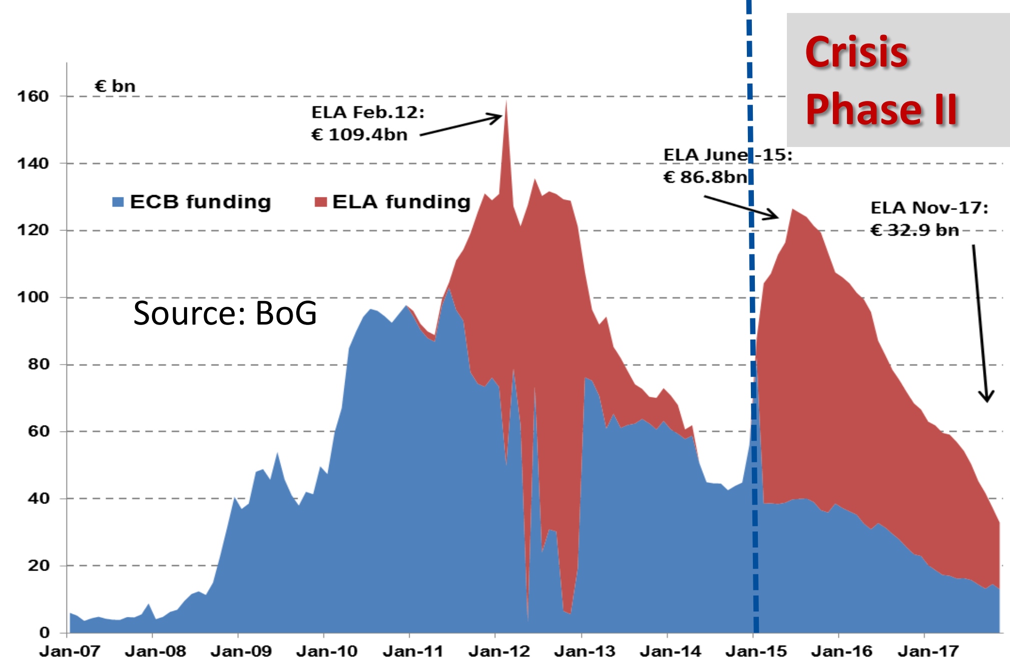


Source: European Commission

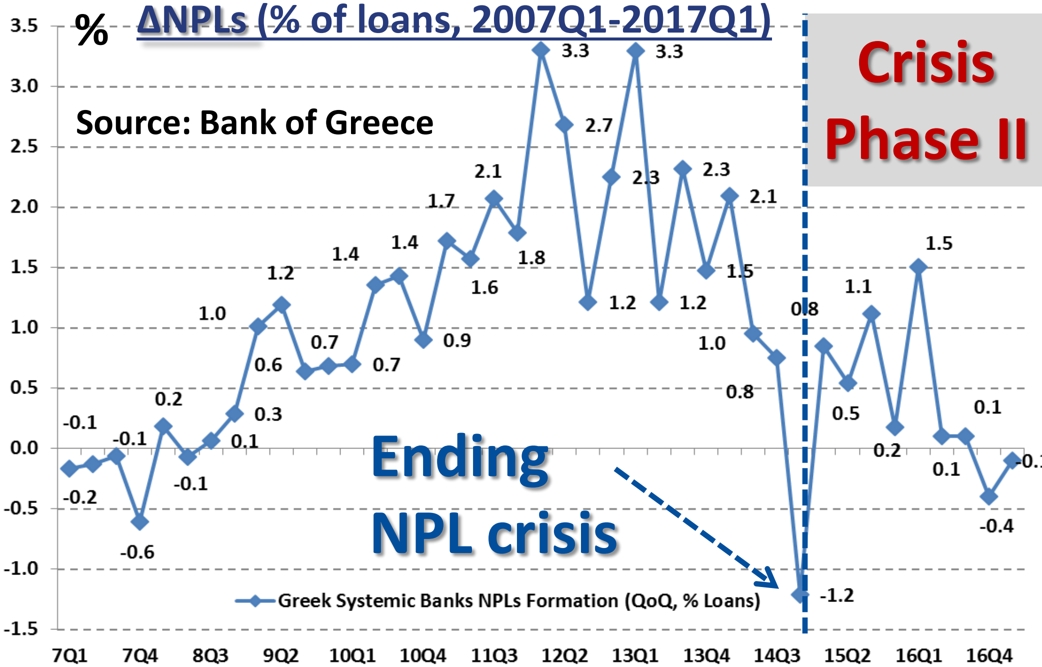
II. A second wave of deposit withdrawals

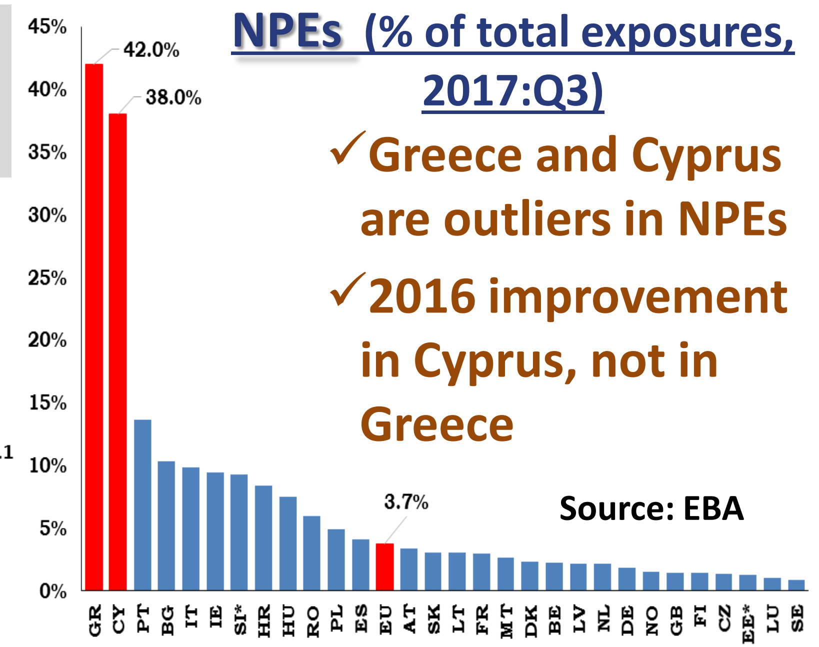
- During the international crisis deposits were rising
- Two waves of cash withdrawals since 2010
- The second comes with phase II of the Greek crisis
- Dependency on the Eurosystem climaxed in 2011-12 and again in 2015





II. Banks remain vulnerable on the Asset side as well as NPLs rise





- The NPL improvement of late 2014 was reversed due to Phase-II of the crisis
- Greek banking sector NPEs the highest in Europe, followed by Cyprus.
- Target volume reduction by 38% by end of 2019
- 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

II. Negative growth in lending since April 2011

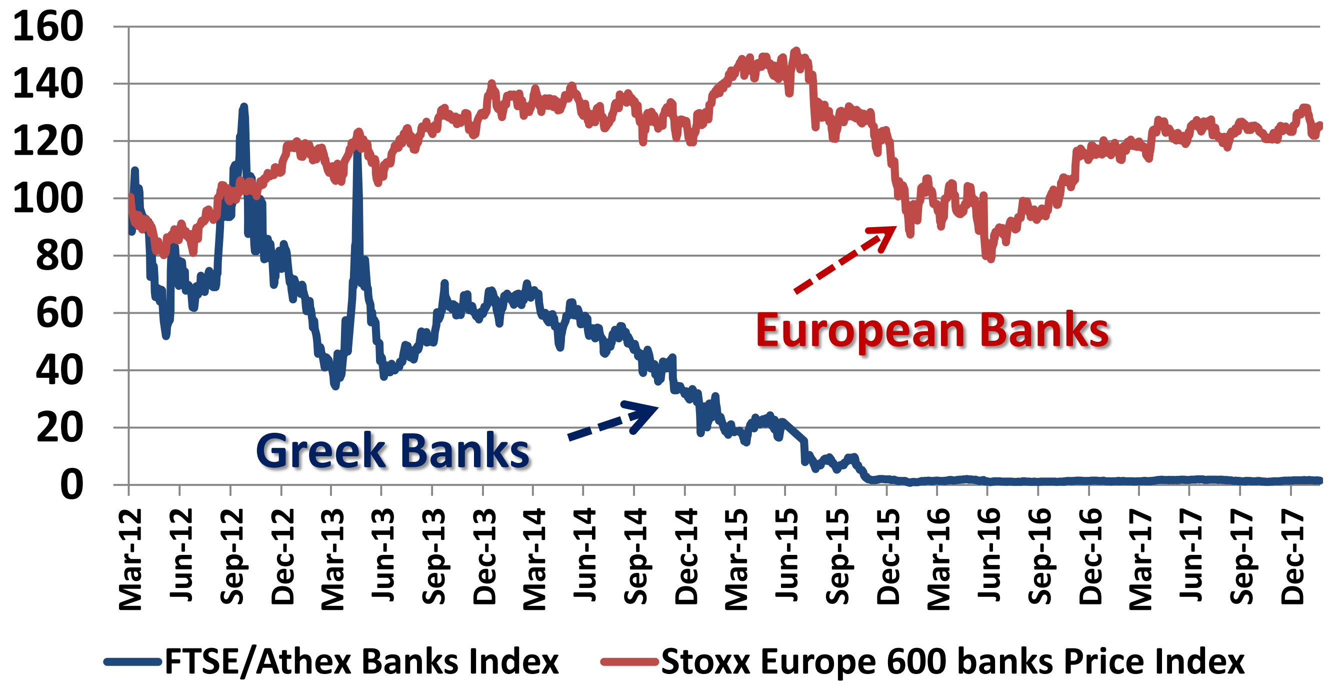
Stock prices for a second time at zero in Nov 2015

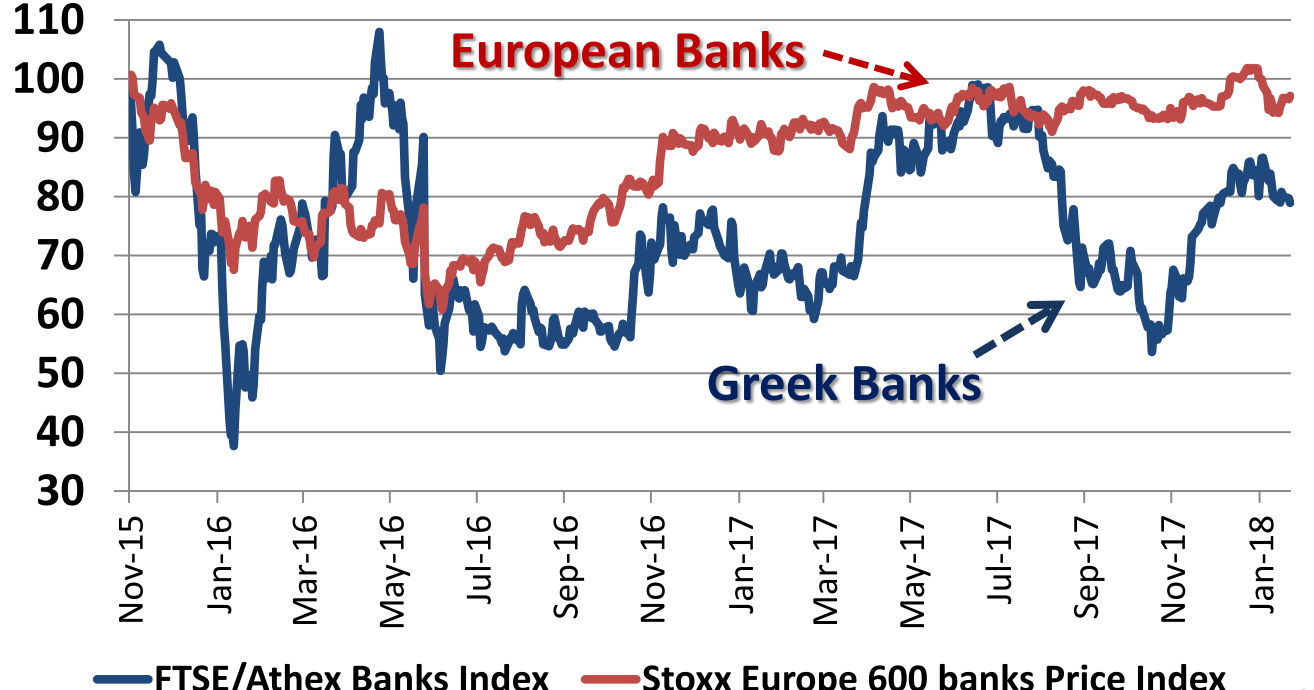
BANK INDICES = 100 at 30/3/2012

- Bank stocks reached zero value for a second time in November 2015

BANK INDICES = 100 at 30/11/2015

- After the third recapitalization, the Greek bank index fluctuated and now is 20% lower, due to the fears of additional capital needs in 2018





II. Euro Area reform has stalled
What is to be done?

- As the economy rebounded in Europe, reform pressure subsided
- The IMF came out in Feb 2018 with a proposal for a tighter fiscal union
- In Jan 2018 , without proposing a fiscal union, a dozen French & German CEPR economists offer ideas on a number of financial, fiscal and institutional reforms that would both improve market discipline (→ lower moral hazard) and risk sharing (→ mitigate a crisis) in the Euro Area:
  1) Break the Bank-Sovereign doom loop via sovereign bond concentration charges for banks and a common deposit insurance
  2) Switch to fiscal targets based on simple expenditure rules and finance possible planned deviations from those targets with subordinated debt
  3) Make the "no-bailout" clause time-consistent by designing orderly debt restructurings through legal and economic means
  4) Create a Euro Area fund to absorb large economic disruptions
  5) Create a synthetic Euro Area safe asset (like a CDO)
  6) Reform the Euro Area institutional architecture by separating the watchdogs from the political decision makers

Concluding remarks

- Challenging times ahead for the European Monetary Union the moment cyclical recovery is over or the moment ECB begins restricting monetary policy
- Yet, EMU will not dissolve as easily as some colleagues of ours tend to think
- The Greek crisis brought many changes in its architecture and more is to come
- Finance, Economics, but also Politics play important roles
- My recent research on Political, Economic and Economic Policy uncertainty suggests the variables are highly correlated, yet political uncertainty seems dominant during the Greek crisis

THANK YOU FOR YOUR ATTENTION!

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