GREECE AND THE EURO DEBT CRISIS: WHERE DO WE STAND? WHERE ARE WE HEADING?

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Roundtable Discussion
McGill Faculty Club
Montreal AHEPA Family
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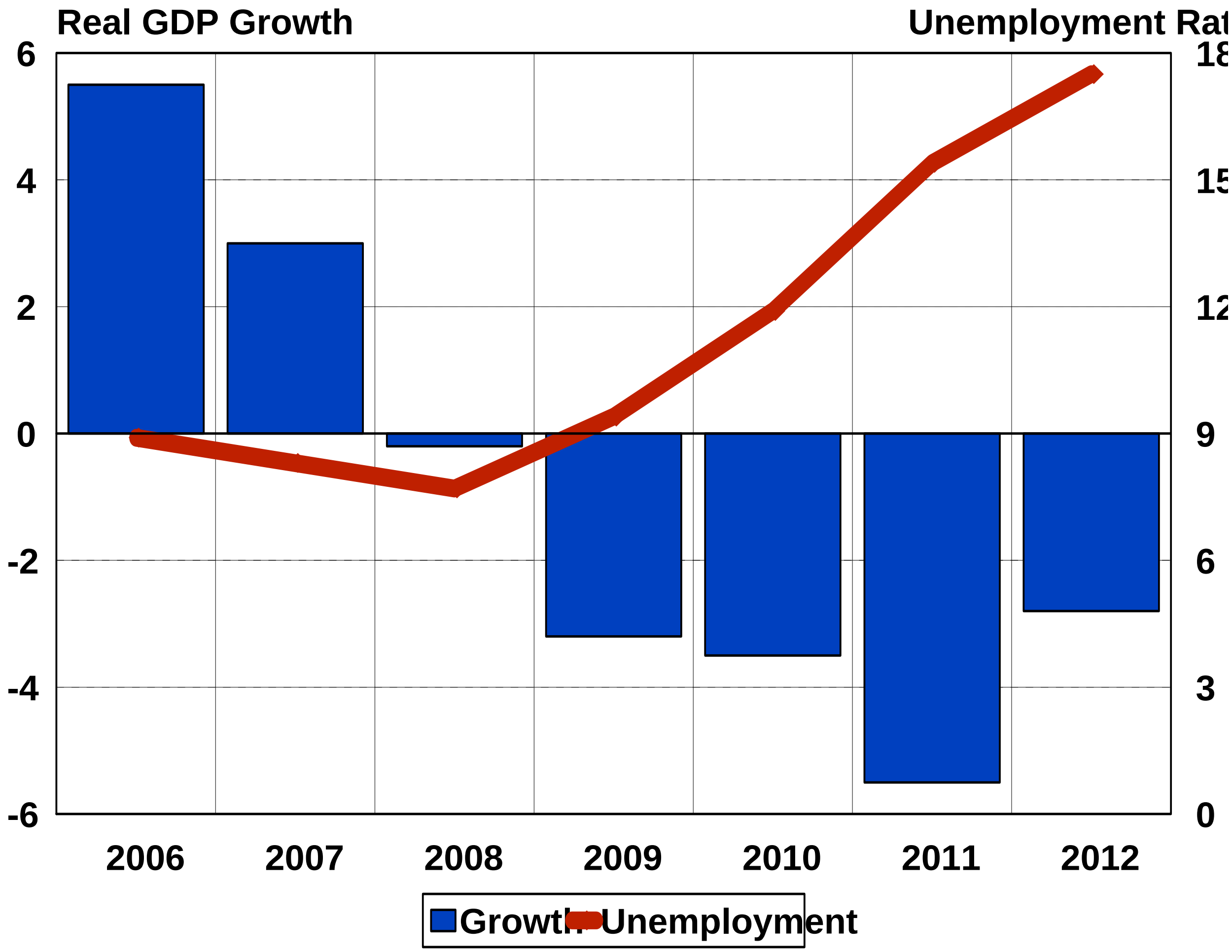
A Hard Economic Landing for Greece

A cumulative decline exceeding 12% and a doubling of the unemployment rate

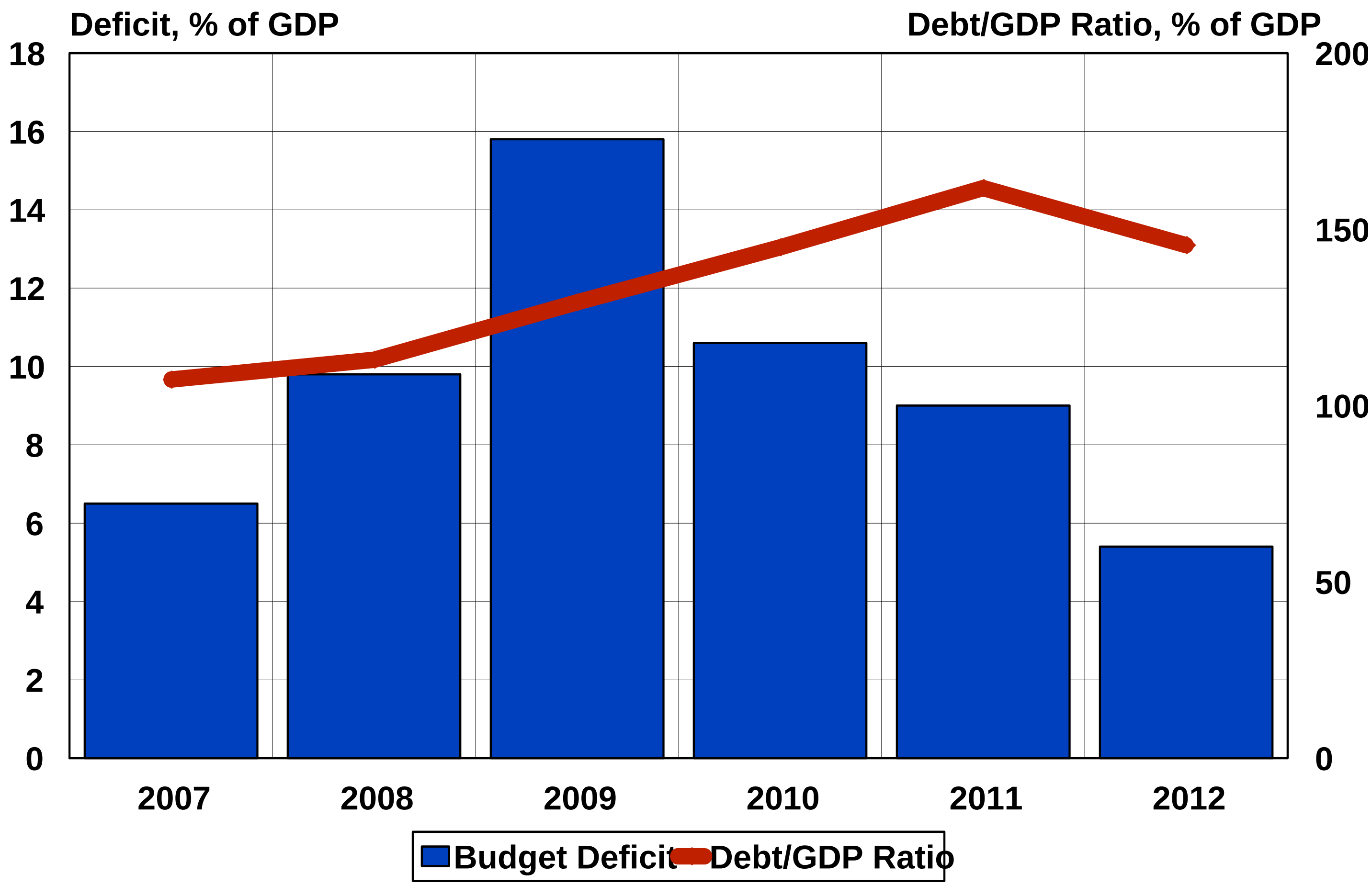


BASIC MACROECONOMIC INDICATORS, GREECE

	2006	2007	2008	2009	2010	2011	2012
GDP (Euros)	208,893	222,771	232,920	231,642	227,318	217,771	212,544
Private Consumption	4.3	3.7	4.0	-1.3	-3.6	-6.2	-4.1
Public Consumption	2.3	7.6	-2.1	4.8	-7.1	-8.0	-7.5
Capital Investment	19.2	10.1	-8.0	-26.6	-13.3	-12.9	-4.0
Exportts	3.1	6.9	3.0	-19.5	4.2	4.5	6.4
Imports	8.2	14.6	3.3	-20.2	-7.2	-5.9	-2.8
Growth Rate (%)	5.5	3.0	-0.2	-3.2	-3.5	-5.5	-2.8
GDP Price Deflator	2.5	3.5	4.7	2.8	1.7	1.4	0.4
Consumer Inflation	3.3	3.0	4.3	1.3	4.7	2.8	0.6
Unemployment Rate	8.9	8.3	7.7	9.4	11.9	15.4	17.1

Source: Hellenic Statistical Service (ELSTAT) and Ministry of Finance, 2012 Budget

Surging Budget Deficits and Upward Revisions to Public Debt



Latest and More Accurate Figures on Greek Economy

- The figures presented here on Greece's GDP and public finances are the latest figures available: October 5, 2011 Revised Greek Annual Accounts for period 2005-2010 and October 17, 2011 Revised Fiscal Accounts published by the Hellenic Statistical Authority (ELSTAT) as well as the 2012 Budget submitted to Parliament on November 17, 2011 by National Economy Minister Evangelos Venizelos
- Fiscal Projections for 2011 and 2012 are based on the 2012 budget and assume the implementation of the Private Sector Initiative (PSI) reduction of 50% in the privately held debt of the Greek state

PUBLIC FINANCES, GREECE

		2007	2008	2009	2010	2011	2012
GDP	Bil Euros	222,771	232,920	231,642	227,318	217,771	212,544
Receipts		90915	94764	88070	89750	85027	89583
Outlays		106066	117850	124636	114213	105483	100190
Budget Deficit	Bil Euros	**-14475**	**-22822**	**-36624**	**-24125**	**-19683**	**-11427**
	% of GDP	**-6.5**	**-9.8**	**-15.8**	**-10.6**	**-9**	**-5.4**
Interest Costs	Bil Euros	10684	11937	11915	13205	15873	12787
Public Debt	Bil Euros	239300	263131	299537	329351	352050	309300
	% of GDP	**107.4**	**113**	**129.3**	**144.9**	**161.7**	**145.5**
Primary Balance		-3791	-10885	-24709	-10920	-3810	1360
			232920	232920	232920	232920	232920
Income Effect			113%	129%	141%	151%	133%
Interest/GDP Ratio		**4.8%**	**5.1%**	**5.1%**	**5.8%**	**7.3%**	**6.0%**
Aver Interest Rate		4.5%	4.5%	4.0%	4.0%	4.5%	4.1%

Source: Hellenic Statistical Service (ELSTAT) and Ministry of Finance, 2012 Budget

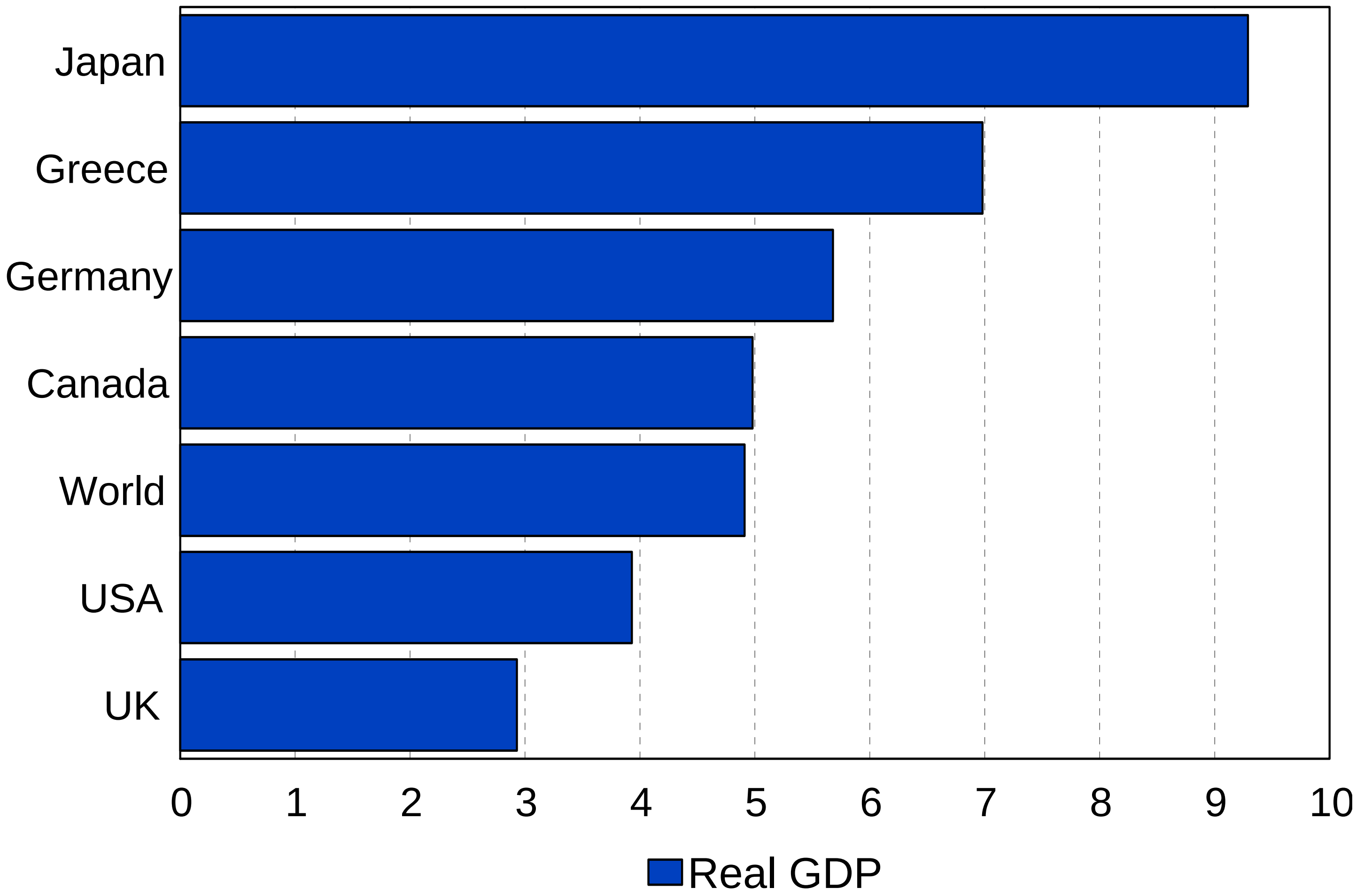
INDEBTEDNESS AND LEVERAGE

Gross Levels, % of GDP	USA	UK	EURO	GREECE
Government Debt	100	83	87	150
Household Debt	91	107	72	68
Corporate Debt	76	128	142	71
Financial Debt	97	735	148	21
Gross Debt/GDP	**364**	**1053**	**449**	**310**
Bank Leverage	13	24	26	17
Debt/Equity Ratio	105	89	72	218
External Govern Debt	32	27	29	61
Net Int Invest Pos. NIIP	19	14	13	99

Source: IMF, Financial Stability Report, April, 2011

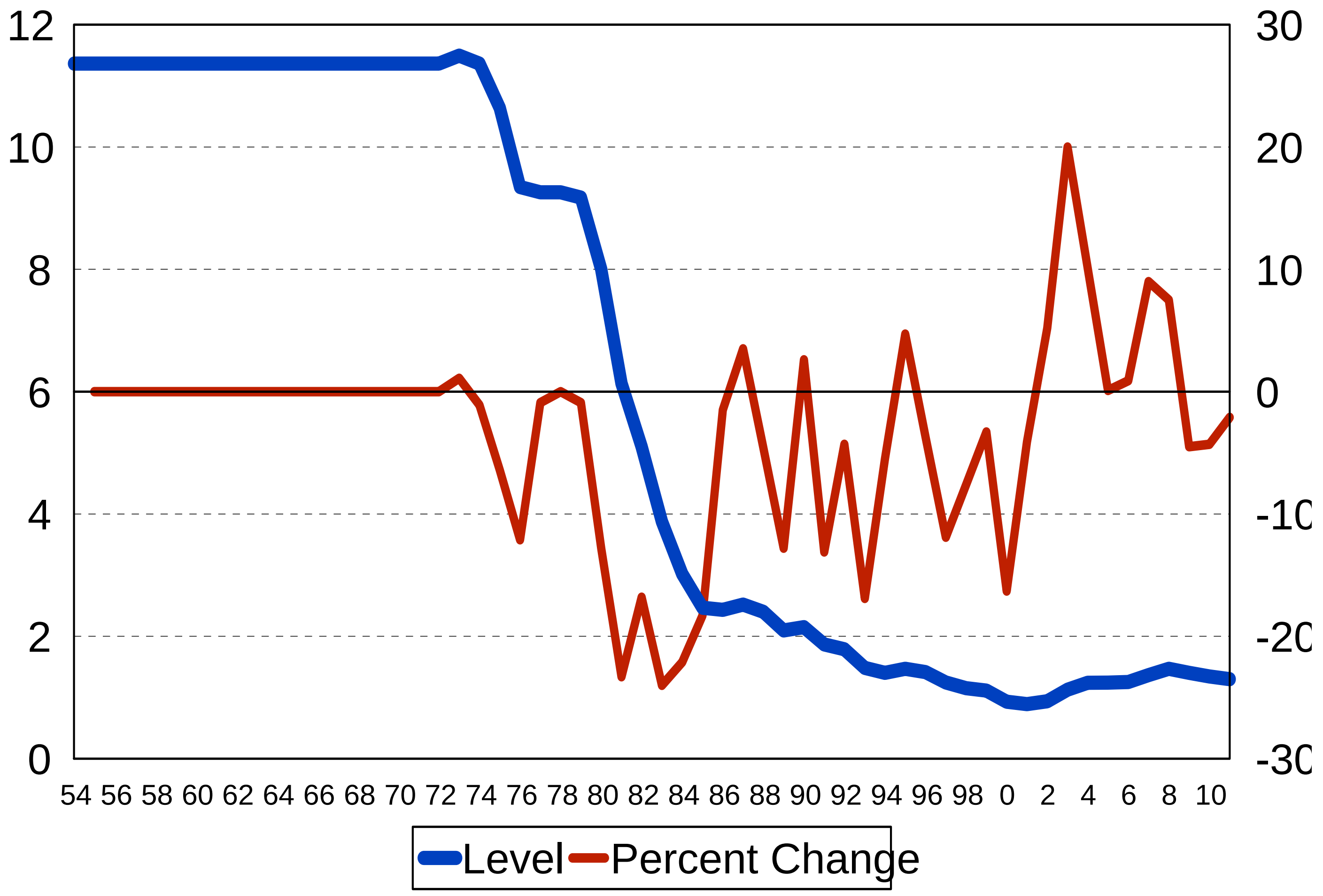
GDP Growth Rates, 1950-1973

OECD, The World Economy: A Millennial Perspective, Angus Maddison, 2001

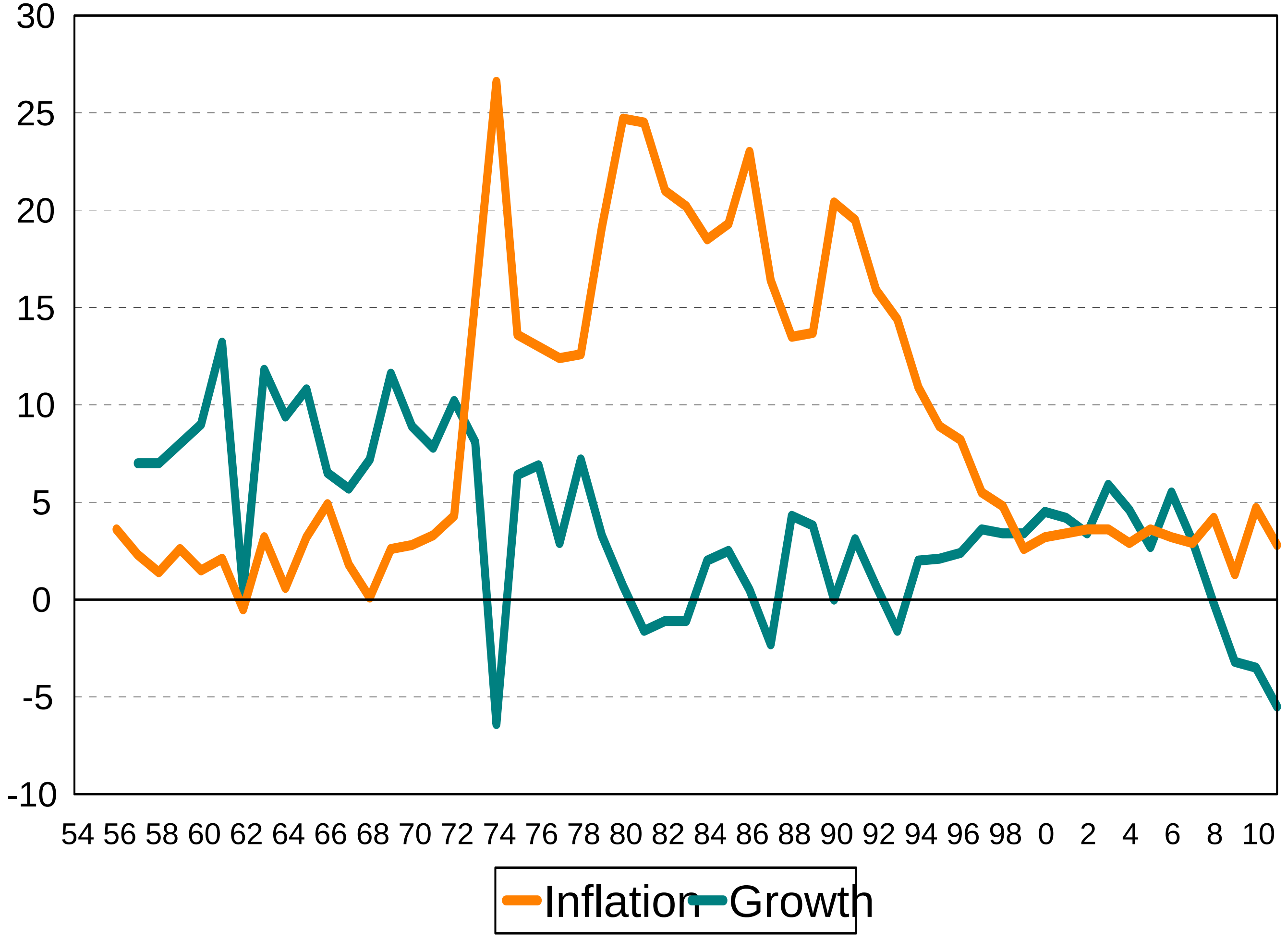


Greek Drachma USD Exchange Rate: 1954-2011

Euro since 2001

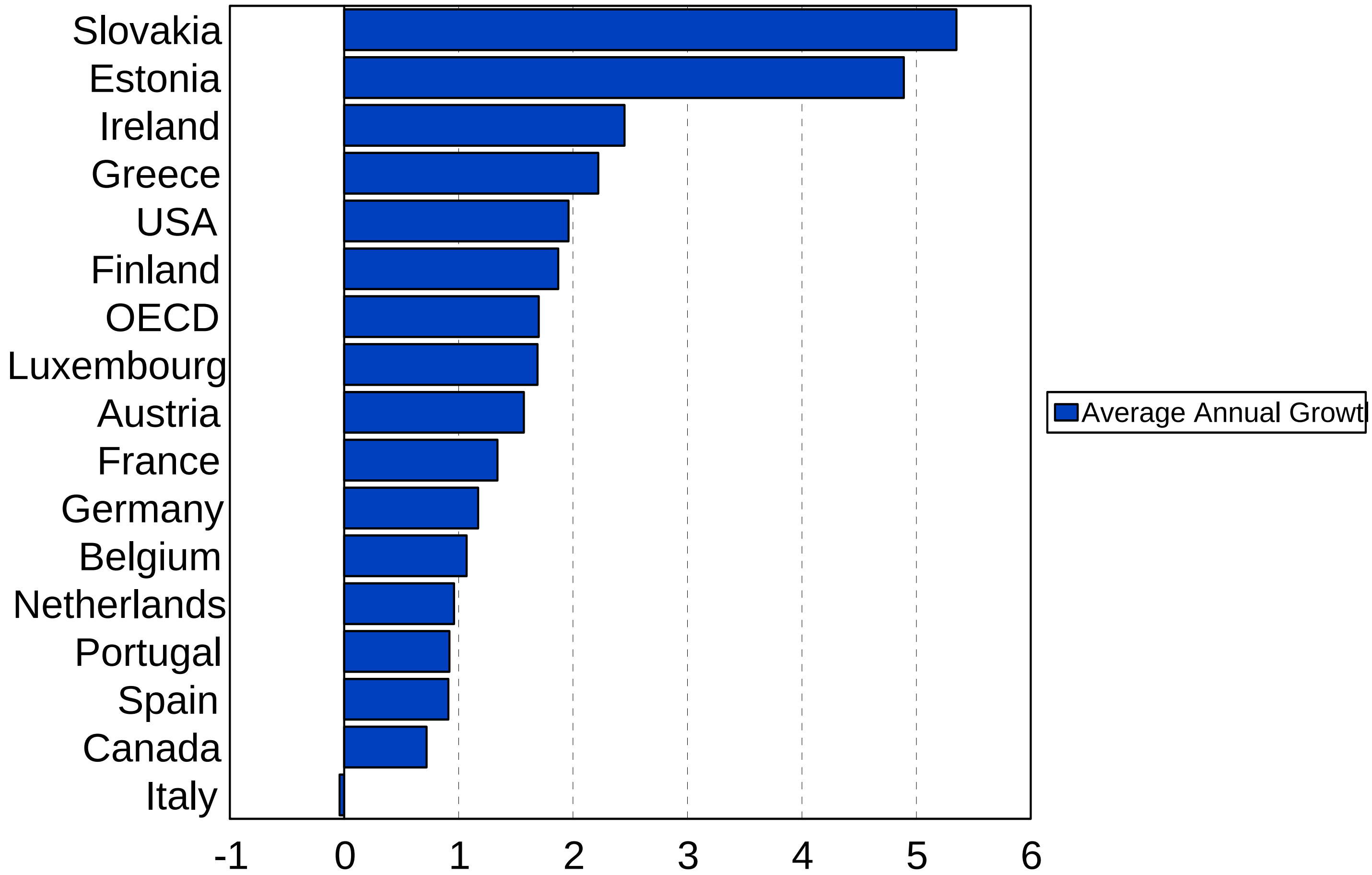


Inflation & Growth Rates Greece: 1956-2010



Labour Productivity Growth: 2001-2008

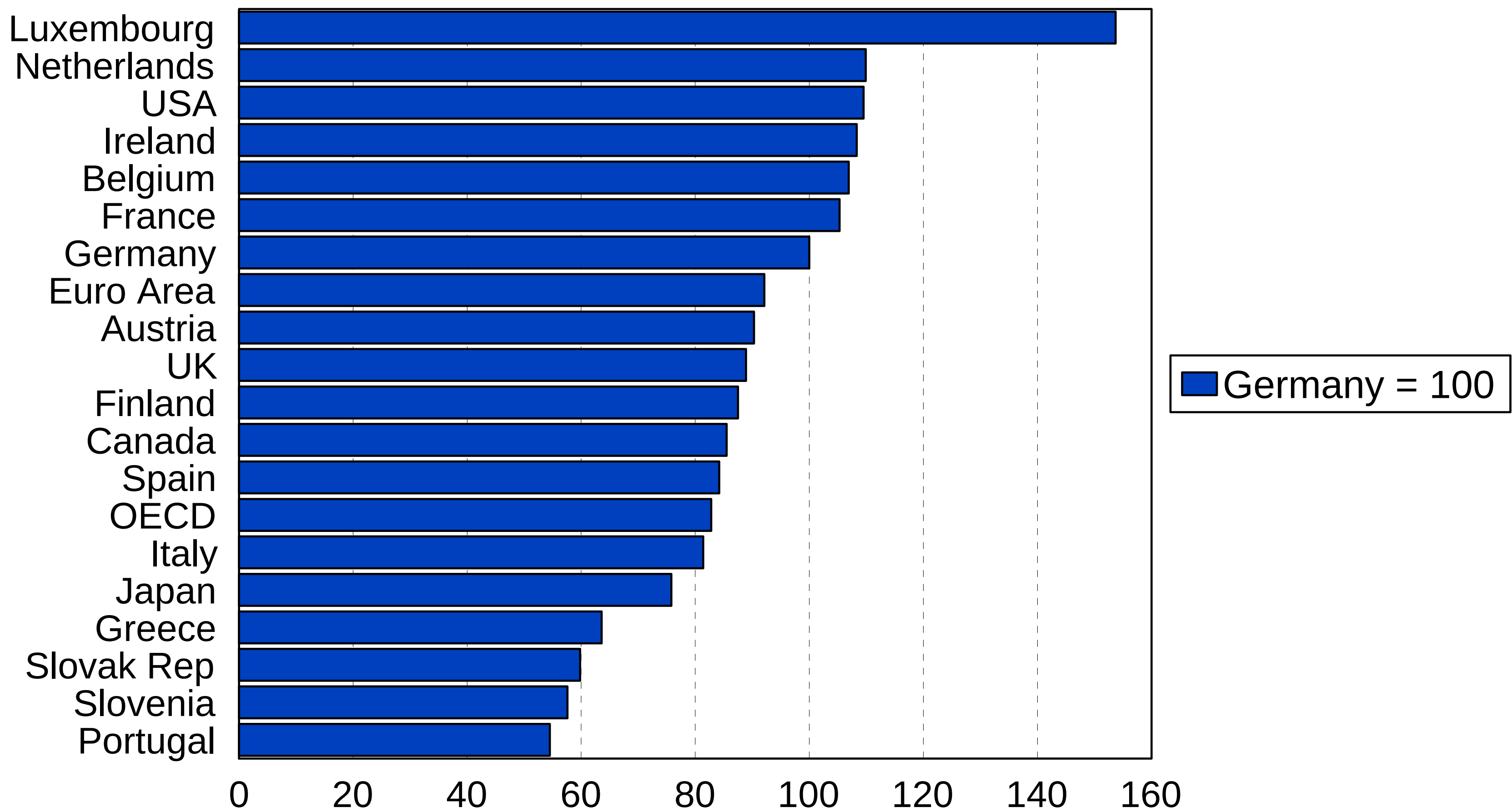
Greece recorded one of the highest rates of growth in labour productivity (2.2%) within the Euro Zone



Labour Productivity, 2008

GDP per hour worked, current prices & PPPs

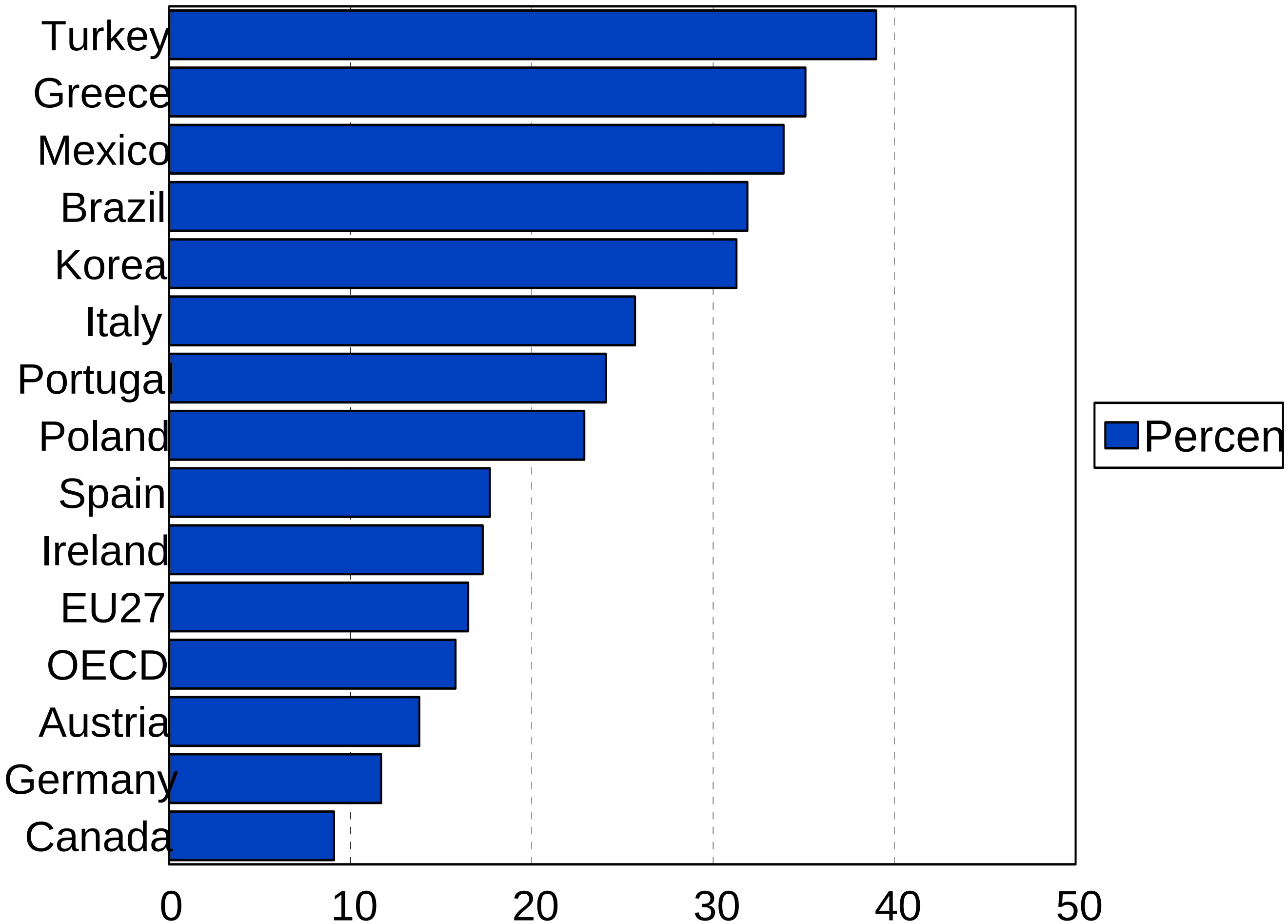
Yet, Greece's productivity was 63.6% of that of Germany



Self Employment Rates

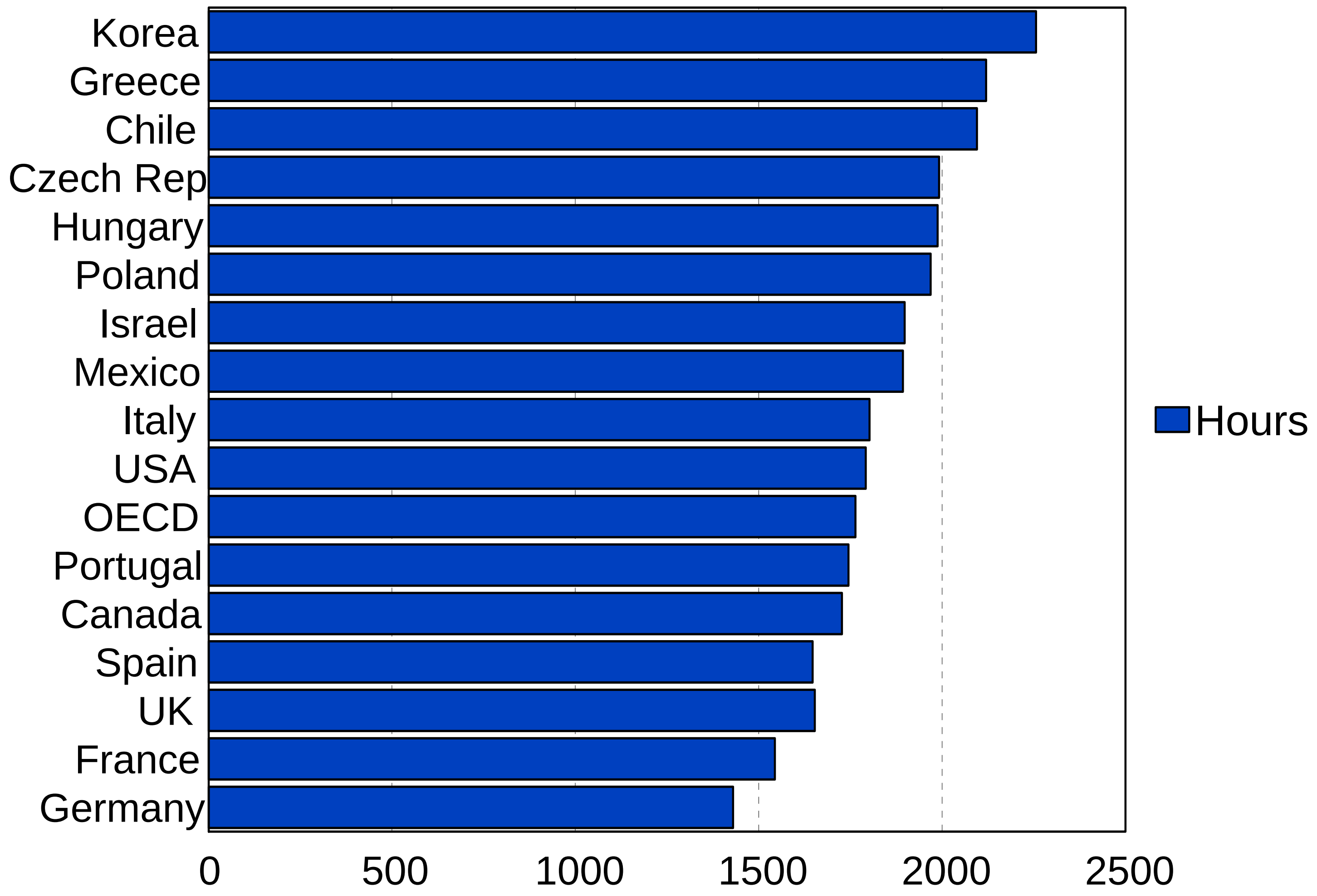
As a percentage of total employment, OECD

This explains why it is harder for Greece to collect taxes



Average Hours Actually Worked, 2008, OECD

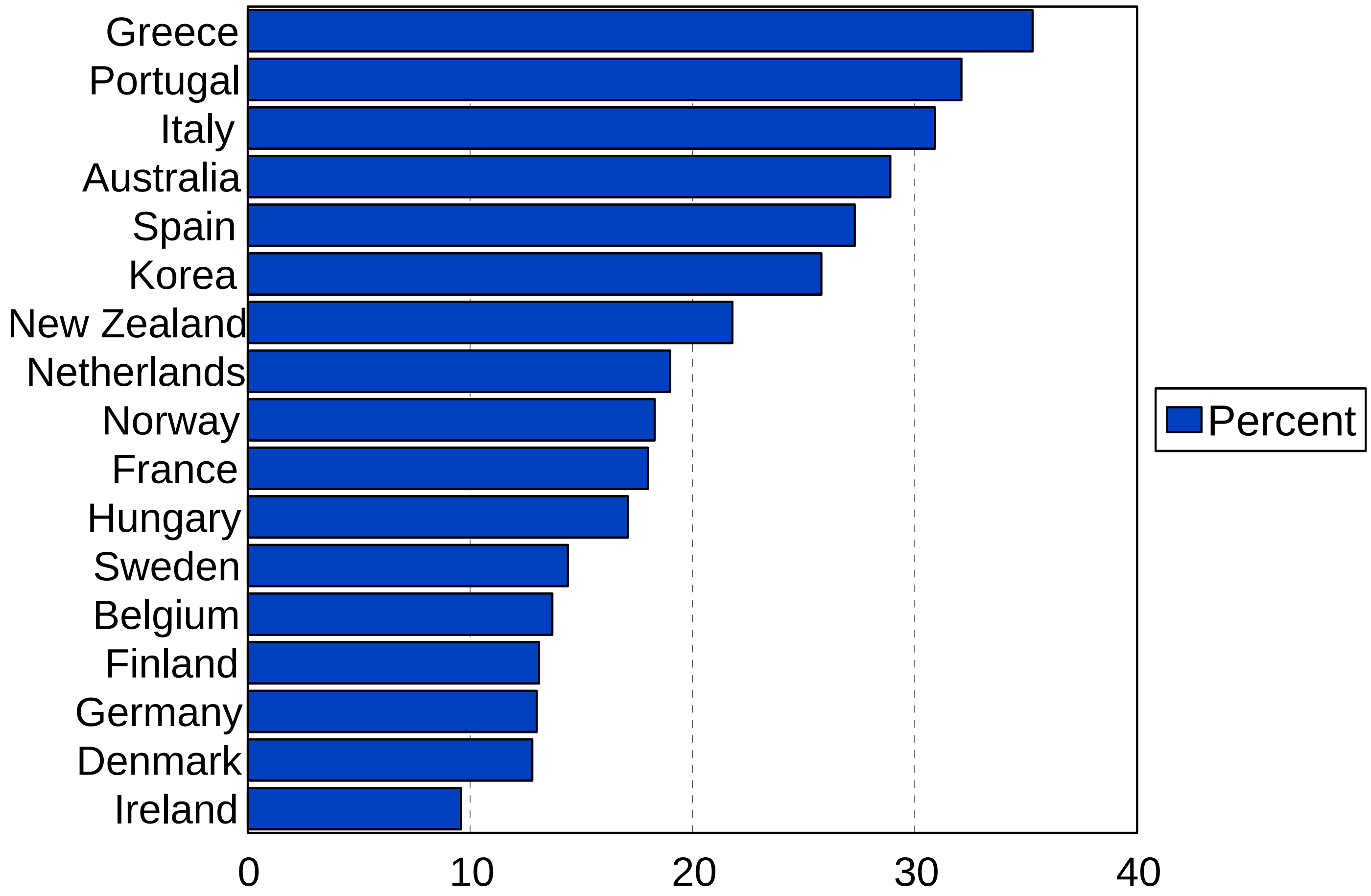
To make up for lower productivity Greeks work more hours than the Germans (Germans work 67.5% of the amount of time Greeks do)



STRUCTURE OF MANUFACTURING SECTOR, 2006

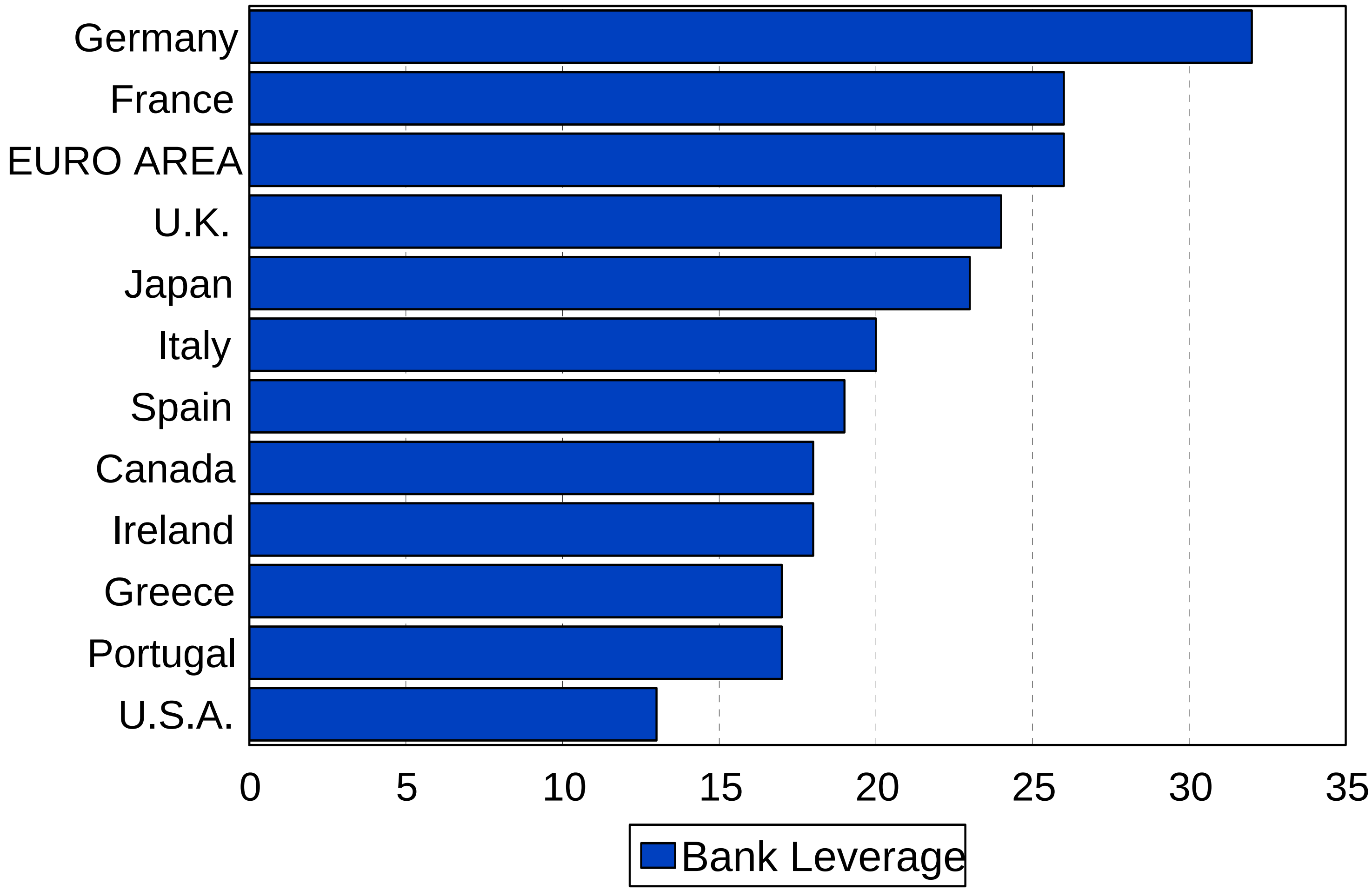
Number of Employees in Manufacturing in Enterprises With Less than 20 Employees

Percentage of total number in manufacturing



Bank Leverage Multiples of European Banks

Euro Area banks are as heavily leveraged as Wall Street Investment Houses were in 2008



Government Support to Financial Industry

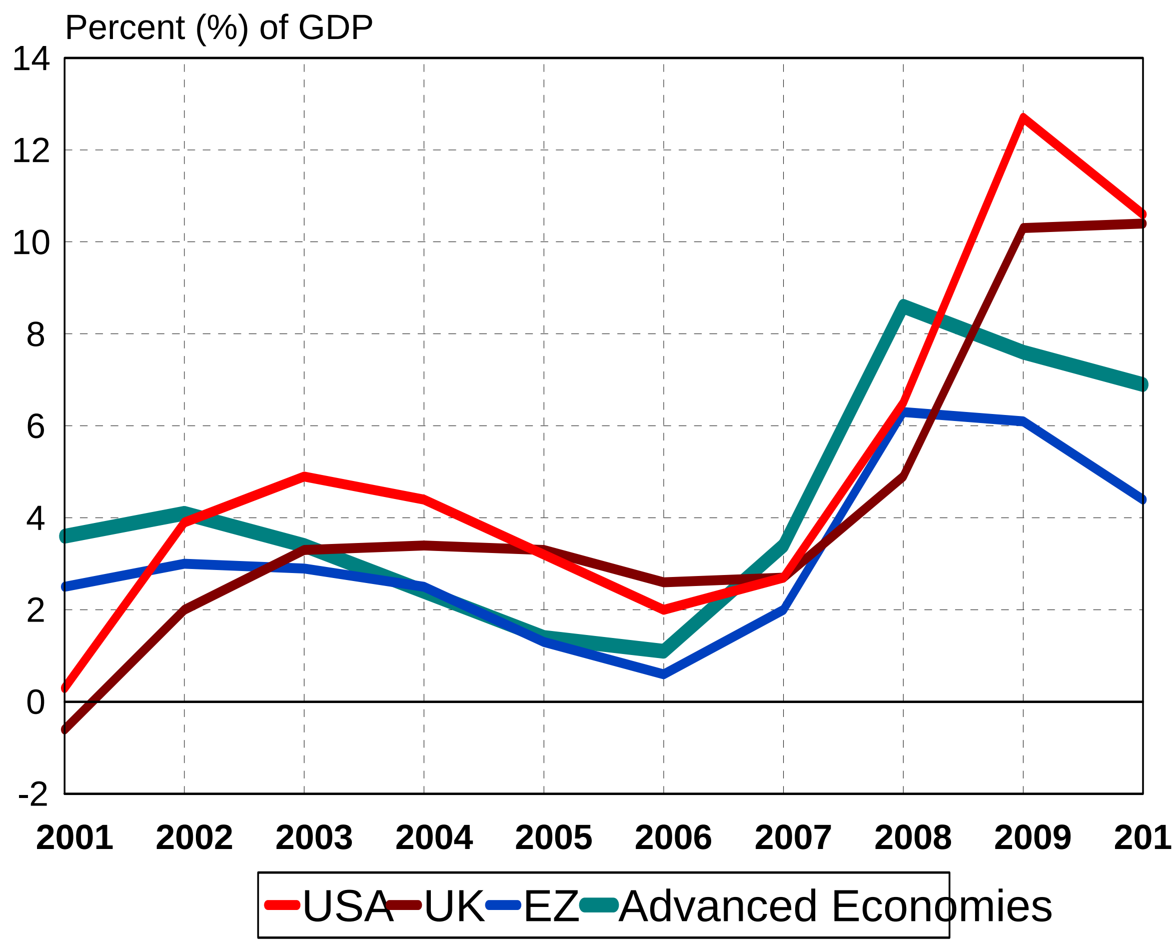
The EZ failed to provide sufficient liquidity into the EZ to stabilize the market and the crisis flared up again

Government Support Packages to Financial Sector United States, United Kingdom and Eurozone				
Trillions of US $	**UK**	**USA**	**EURO**	**Total**
Central Bank				
- "Money creatio	**0.32**	**3.76**	**0.98**	**5.06**
- Collateral swa	**0.30**	**0.20**	**0.00**	**0.50**
Government				
- Guarantees	**0.64**	**2.08**	**1.68**	**4.40**
- Insurance	**0.33**	**3.74**	**0.00**	**4.07**
- Capital	**0.12**	**0.70**	**0.31**	**1.13**
Total (% of GDP)	**74%**	**73%**	**18%**	**15.16**

Source: Alessandri & Haldane, Table 1, Banking on the State, Bank of Englan 2009

Fiscal Impact of Global Downturn on Major Economies

The fiscal response of EZ governments was far less than those of the rest of the world



Greece’s problems stem from internal and external factors

- The structure of its economy and the public governance institutions cannot support generous social entitlements
- The problem is centered mainly in the public sector of the economy, in 2009 public spending accounted for **54% of GDP** whereas public revenues accounted for **38%**
- It needs to reduce the size of the public sector and make it more efficient
- It needs to liberalize markets and allow the private sector to regain control of the economy
- Structural reforms will allow for a more efficient use of limited resources that will contribute **15-20%** to country’s GDP over a 5-year horizon
- Greece’s problem is the public sector and a populist political environment, not its economy.

Was Joining the Euro a Mistake?

- Not in my opinion.
- As during the Bretton Woods period of stable monetary environment, Greece needed to return to such an environment, membership in a stable currency area would encourage structural reform and promote growth in its economy
- What went wrong?

Structural Reforms & Fiscal Discipline Were Sideswiped by Credit Bubble

- Greece’s entry in the EZ in 2001 coincided with the start of easy money and the credit bubble fostered by the expansionary monetary policy of the US Fed

- The shift toward record low interest rates along with financial deregulation, liberalization of international capital flows (Washington Consensus), and financial innovation created the largest credit bubble the world had ever seen (George Soros, Super-Bubble)

- In Europe the banking system is based on the unitary banking model where there is no separation between retail and investment banking as existed in America with Glass-Steagall Act between 1932 and 1999 and as exists to this day in Canada

Risk-Free Lending to Euro Sovereigns

- Entry of Greece in the EZ meant that Greek government bonds (GGB) became risk-free according to the Basel II capital adequacy standards as interpreted by EU Banking regulations.
- French, Belgian and German banks could buy Greek and other EZ member state bonds as if they were risk-free

- They borrowed in the inter-bank market huge loads of cash at rock-bottom rates and reinvested them in higher yielding Greek and other EZ periphery nations inducing a credit bubble that financed the housing bubbles in Ireland and Spain and public spending in Greece

- Euro core and British banks made a fortune on these loans without having to set up capital or provisions.

- By 2007, the yield differential between GGB and German bunds had narrowed to only 29 basis points

- Whose mistake was to lend to Greeks at the same rate as the Germans? Greece’s fault or the bankers’ fault?

The Curse of Easy Money

- With lenders eager to lend and borrowers willing to borrow it resulted in a monster debt bubble that manifested itself in different forms in different countries

- Unlike Ireland and Spain where the banks lent and fuelled the housing bubble in Greece the state borrowed to finance a massive investment program of infrastructure development and social spending

- Unlike Ireland, Spain and the UK where the banks bankrupted the state, in Greece it was the state that has bankrupted the banks and its economy

- In the face of low borrowing rates and easy money it became easier to borrow than to make the tough decisions of reforming and restructuring its economy

Greece is a Victim, but Not the Only One, With More to Follow

- When the credit bubble finally burst in 2008 and resulted in the global recession of 2009, we entered a period of financial deleveraging and the credit bubble has morphed into a debt bubble

- Having placed itself on the financial edge, Greece has become one of the first celebrity victims of this process, but is not the only one and more will follow

Where does Greece Go From Here?

- It can default on its bonds and stay in the EZ

- It can exit the EZ, reintroduce the Drachma, devalue it against the Euro and pay with devalued Drachmas

- It can accept the Oct 27th Euro package that includes the PSI initiative of a 50% ‘voluntary’ haircut on privately held debt and complete its restructuring program

Unilateral Default is an Act of War on its EZ and EU Partners

- Defaulting unilaterally on its debt to its EZ partners is financially the least costly to Greece, but it is the most politically damaging to Greece. It is tantamount to a declaration of war against its own partners.

- It irreparably harms Greece's reputation in the EU and risks 1) Greece's continued membership in the EZ and 2) can cause the demise of the EZ itself, for which Greece will be permanently branded as a villain.

- This is a non-starter

Exit from the EZ and Return to Drachma is Economic & Geopolitical Harakiri

- Voluntary exit from the EZ and reintroducing the Drachma is the most damaging financially option for Greece. It will still be seen as default, an admission of failure but will not be as politically as damaging because it will not be perceived as an opportunistic move.

- It also undermines the financial stability and credibility of the EZ and risks its collapse

- The cost to Greece is catastrophic, also a non starter

The Costs of EZ Exit Far Out Way the Benefits of Staying the Course

- It will result in a steep devaluation of the Greek Drachma and a massive rise in inflation that will dramatically reduce living standards over night
- It will bankrupt its banking system and induce massive capital flight
- It will lead to a steep rise in interest rates
- It will decimate the private business sector as much of its debt will still be denominated in euros
- It will not induce a sufficiently high rise in exports and even as volumes rise terms of trade will deteriorate
- It will result in years of negotiations and uncertainty to unscramble the scrambled egg
- It will undermine incentives to reform the economy and will lead to social unrest and political instability

Bite the Bullet and Reform its Economy

- It involves hard work and persistence, but it is the only road that will lead to lasting and sustainable benefits
- It is less financially costly than the other alternatives
- If it succeeds, it salvages Greece’s reputation and influence within the EU and geopolitically
- It involves the lowest risks to Greece and the EZ
- It assures the structural reforms that will make Greece a more prosperous and a stronger country
- It will restore confidence and instil pride in the nation

Once the Deleveraging Storm is Passed, Greece will be the Better for it

- Greeks need to understand that the problem they are experiencing is part of a bigger and wider economic problem affecting all countries in the EZ and the advanced industrial world

- The solution to the problem will be found at the systemic level and once found it will benefit Greece as well

- What Greece needs to do is balance its budget, reduce the size of its public sector and reform its economy

- Eventually better times will return and Greece will be the better for it

Some Possible Solutions?

- Fiscal union, pooling of debts and the issuance of jointly-backed euro bonds
- Creation of European government bond (EGB) market
- Greater economic integration
- Expansion of the mandate of the ECB to allow for the purchase of large quantities of EZ sovereign bonds
- Allow some inflation to take place to reduce debt burdens, better than seeing the total collapse of the euro zone and depression

For further inquiries, contact the author:

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