The Greek/EMU crisis and the need for further unification

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I. KEY ECONOMIC PREREQUISITES FOR THE FORMATION OF AN OPTIMUM CURRENCY AREA WERE PUSHED ASIDE

Some key economic characteristics for an Optimum Currency Area were **expected to adjust endogenously** and conform to the needs of EMU, once the common currency were established. Was this a **POLITICAL HYBRIS**?

- Many economists would say YES,
- while most politicians would say NO, even today after the crisis' wake up call

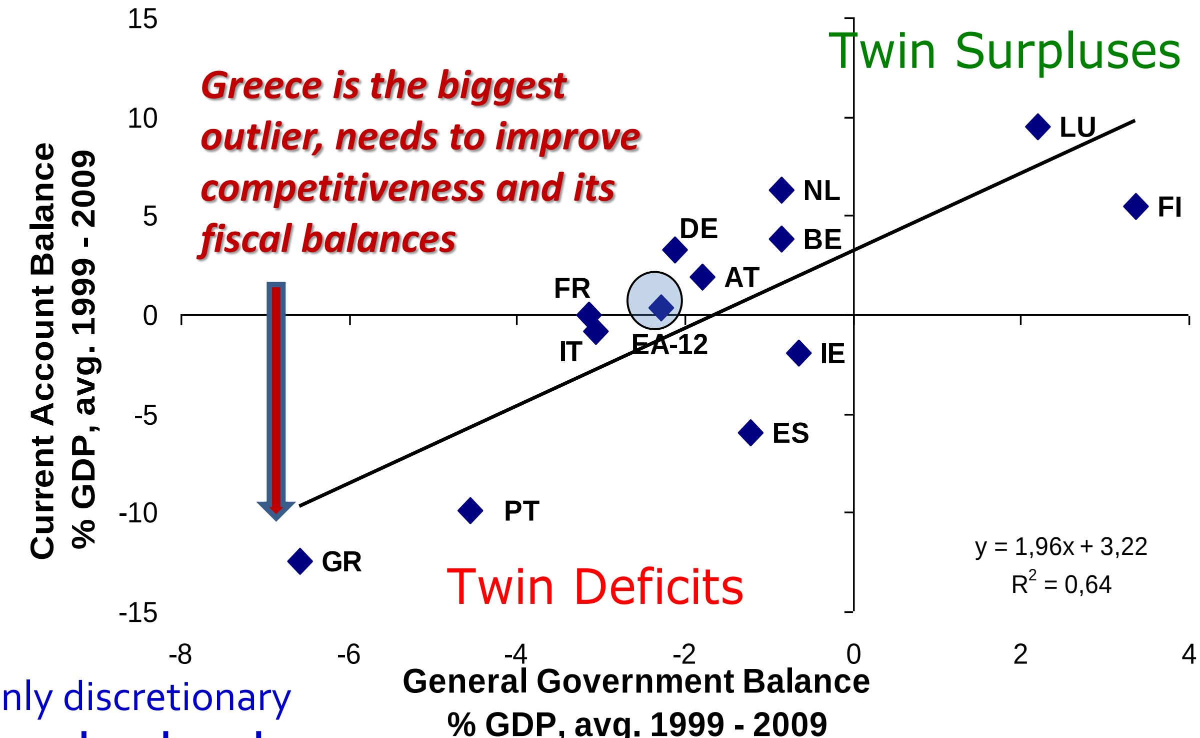
OCA criteria for the participating countries included:

1) **Highly interconnected external trade sectors**
2) **Free cross-country mobility of capital, labor, and products & services**
3) **Adequate degree of uniformity across domestic economic structures and policies**
    a. Common economic policy criteria, synchronization in fiscal policies
    b. Similarity in the structure of the real economy ,e.g. price and labor market flexibility, pension system rules, competitiveness rules, uniform degree of state intervention in the private sector, etc.
    c. Common bank regulation and supervision
4) **Existence of a fiscal mechanism to smoothen the effects of asymmetric shocks**, e.g. on the terms of trade, on size of foreign demand, on asynchronous domestic business cycle developments

I. LARGE EXTERNAL AND INTERNAL IMBALANCES WITHIN EMU FOLLOWING EMU CREATION

- Hope of **endogenous** adjustment towards OCA was proven **wrong**
- 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
  - Real estate bubbles formed
  - Public Deficits went over the 3% GDP limit and **fiscal discipline was abandoned** as early as 2003, first by France & Germany

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



Source: European Commission

- **Structural reforms** became the only discretionary policy tool post-EMU, yet they **were abandoned**, exactly at the moment they needed the most
- Hence, a **competitive Euro Area North** and an **uncompetitive Euro Area South** emerged.
  - Nominal wages proved sticky, did not allow proper adjustment to external asymmetric shocks
  - Pension systems remained unreformed

II

I. **Euro Area, not an Optimum Currency Area**

II. **Crisis reveals need for further unification in EMU**

III. **Greek accomplishments & the risk of Grexit**

IV. **Conclusion**

II. CRISIS MUSHROOMED AS MORAL HAZARD WORRIES DOMINATED THE RESPONSE TO THE CRISIS

- The crisis revealed **two needs, not necessarily complementary**:
  1) **Need for actions to contain the crisis**
  2) **Need for a better long-run framework, consistent with OCA, which would ensure long-term stability of the euro**
- Academics of all political persuasions agree: **Solve the crisis first and then worry about long-run architecture and adverse incentive problems**
- Yet, **Euro Area politicians chose to focus on redesigning its framework and ignored the need to contain the crisis**
  - When the crisis hit Greece, the country seemed too small to impact the rest of EMU. **Moral hazard reasons and austerity prescriptions dominated the discussions**
  - Markets were particularly irked after the Deauville German-French meeting in October 2010 and its **message that the private sector would pay**, hence interest rate spreads shot up. This message **came 15 years too late, at the wrong moment**
  - **Politicians catered to their domestic constituencies and the domestic populist press**, which pained the Greeks as lazy and corrupt, who are taking their money. They confused the EMU imbalances with moral arguments about the Greeks. They **never took decisive actions**, and were thus continuously "**behind the curve**" in their responses
  - The austerity prescription caused even more stress in the South, politics diverged inside the countries, thus driving the countries further apart politically
- At the same time, most **Greek politicians did not understand that this was a regime shift** and not a typical recession. They thought that "*in a a year it will be business as usual,*" hence refrained form pushing the reform effort.
- **It takes two to tango** and in this crisis both counterparties, Europeans & Greeks, failed

II. EUROSYSTEM: PROVIDED LIQUIDITY SUPPORT … BUT PROVED NOT TO BE A LENDER OF LAST RESORT

- ECB intervened to provide liquidity to the banking system, thus **averted** the typical ***Sudden Stop*** in financing, which accompanies a crisis
- Yet, ECB not as aggressive as the Fed, deeply concerned about its independence and of implicit financing of fiscal policy, especially Bundesbank. It intervened massively with **LTROs** only after Italy was hit by the crisis in the summer of 2011
- **SMP** and the recently announced **OMT** are important innovations
- ECB does not act as proper lender of last resort as the ELA mechanism is more costly. **Periphery suffers from restrictive monetary policy**!

Bank Borrowing from the ECB

	EA			Greece		
	a	b	c	a*	b	c
Jun-07	464.6	28,026	1.7	4.3	353.4	1.2
Jun-08	483.0	30,839	1.6	11.6	424.7	2.7
Jun-09	896.8	31,804	2.8	54.0	491.2	11.0
Jun-10	870.4	32,578	2.7	94.3	544.7	17.3
Jun-11	497.5	31,736	1.6	103.1	502.5	20.5
Jun-12	1,260.9	34,177	3.7	135.8	437.6	31.0

(a) Total Lending from the ECB (€bn)

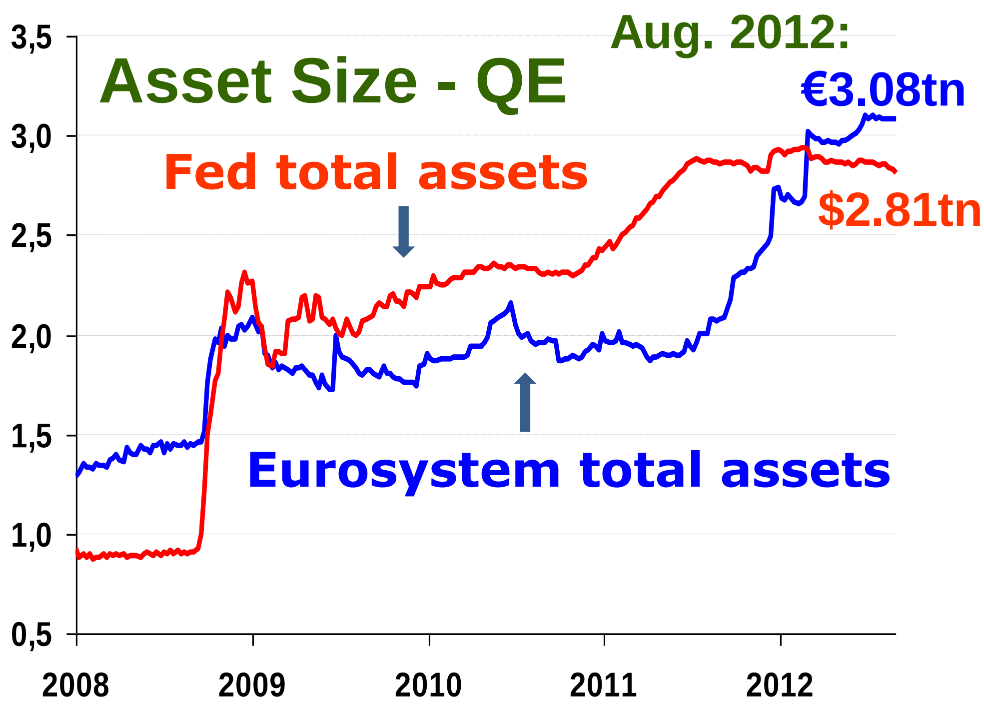
(b) Total Banks Assets (€bn)

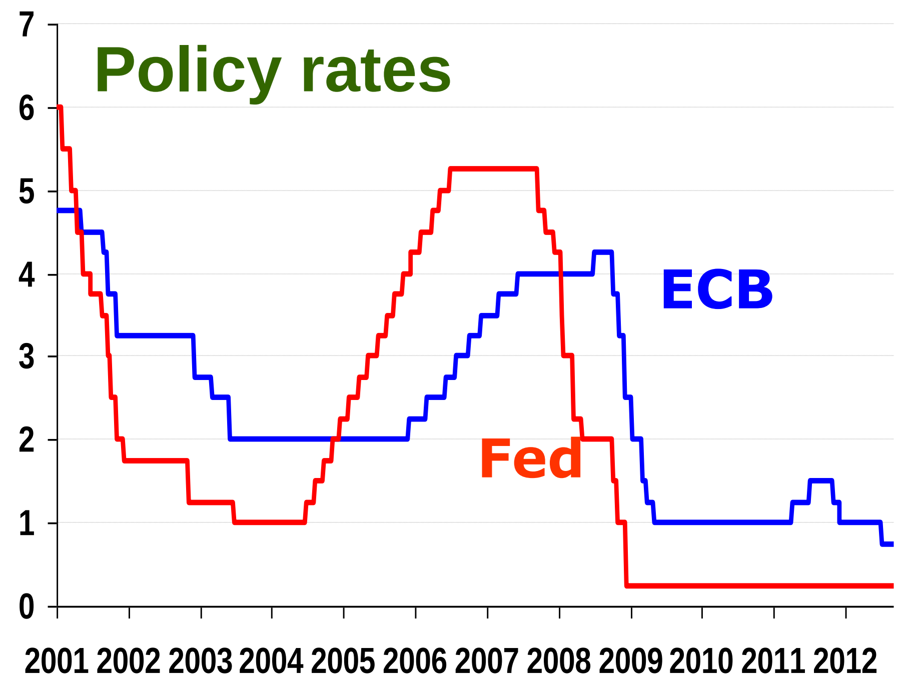
(c) % ratio a/b

* plus lending from the BoG through ELA

II. IN THE PAST, ECB NOT AS AGGRESSIVE AS THE FED, NOW MORE ACTIVE

- The sluggishness of ECB compared to the Fed is visible both in their interest rate setting behavior and in their QE behavior
- September 2012 announcement of OMT signals radical shift, "will do whatever it takes" by Draghi, yet Bundesbank casts negative vote. Two key features:
  - Intervention of unlimited amounts (after official request to EFSF/ESM)
  - Same priority status with private investors





II. NEED FOR TIGHTER UNIFICATION

- **TOWARDS SIMILARITY OF ECONOMIC STRUCTURES**

  Pact for the Euro (or **Euro**+) addresses issues of competitiveness, employment, financial stability and sustainability of public finances: Monitoring and adjusting unit labour costs (ULC); Removing unjustified restrictions on professional services and the retail sector; Improving education systems and promote R&D, innovation and infrastructure; Removing red tape and improving the regulatory framework (e.g. bankruptcy laws, commercial code); Labour market reforms to promote "flexicurity"; Tax reforms, such as lowering taxes on labour; Aligning the pension system to the national demographic situation; Putting in place national legislation for banking resolution; Developing a common corporate tax base.

- **EU BUDGET NOT ALTERED, YET TIGHTER FISCAL RULES**

  Fiscal Compact: GG budgets shall be balanced or in surplus; Annual structural deficit must not exceed 0.5% or 1.0% of GDP depending on the debt-to-GDP ratio; If debt exceeds the 60% reference level, government shall reduce it at an average rate of one twentieth per year as a benchmark; **Six-pack**, existing fiscal rules running in parallel with fiscal compact

- **STONGER BACK-STOPS**

  EFSF (ESM), currently endowed with €440bn, can issue debt instruments to raise funds for a member country, which has signed an MoU with EC & IMF, in order to: Provide loans to distressed eurozone countries; Recapitalize banks; Buy sovereign debt even in primary bond market

- **SSM (Single Supervision Mechanism) for Banks** (EC proposal on 12/9/2012)

  To begin on Jan 1, 2013 and be fully ready on Jan 1, 2014) by ECB with tasks of: authorizing credit institutions compliance with capital leverage and liquidity requirements; conducting supervision of financial conglomerates**. No common resolution mechanism yet**.

III

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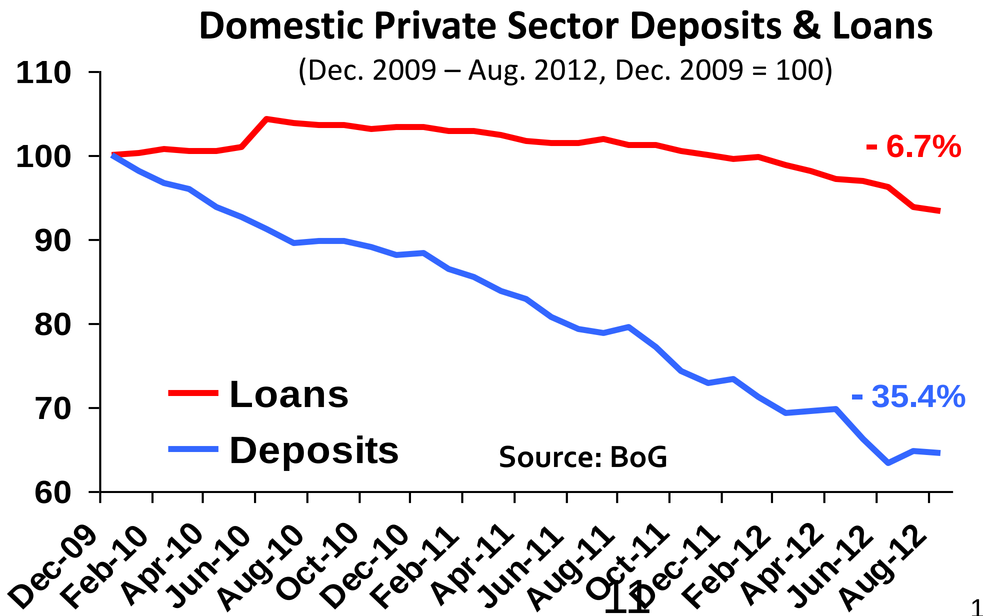
III. ACCOMPLISHMENT: BANKS CONTINUE TO PROVIDE INTERMEDIATION

- Loans fell by less than deposits as banks continue to **restructure loans,** keeping low the NPL increase
- **Deposit withdrawal** stopped after June 2012 elections
- Greek Banks gradually regain **market access**, as International Banks offer:
  - Funding with collateral EFSF bonds
  - REPO agreements on non-correlated assets (i.e. international bonds)
  - Short-term derivative contracts, including FX swaps
- **Bank liquidity support from the State** around **€150bn**, mostly in the form of State guarantees (not a cost for the State Budget), utilized (along with other bank assets) for obtaining **ca €130bn** in Eurosystem liquidity (ECB & ELA facility), so as to cover
  - deposit withdrawals (> €80bn since 2009)
  - buy Greek government bonds & bills
- **Bank recapitalization program** €50bn EFSF funding (€25bn already disbursed) for restructuring & boosting core tier 1 capital ratio of viable banks

Domestic Private Sector

(€ bn)	Loans	Deposits		Loans	Deposits
2007	215.1	197.9	Jan. 2012	248.7	169.0
2008	249.3	227.6	Feb. 2012	246.5	164.4
2009	249.3	237.5	Mar. 2012	244.7	165.4
2010	257.5	209.6	Apr. 2012	242.3	166.0
2011	248.1	174.2	May 2012	241.7	157.4
			Jun. 2012	239.8	150.6
			Jul. 2012	233.9	153.9
Source: BoG			Aug. 2012	232.6	153.4



III. ACCOMPLISHMENT: SOME SUCCESSFUL REFORMS

LABOR MARKET REFORMS

- **Adjustment / Reduction of wage floors:**
  - 22% reduction in the minimum wage
  - 32% reduction in the minimum wage for employees under the age of 25
- **Structural measures to level the playing field in collective bargaining**
  - Shortening the length of collective contracts and reduction of their 'after effects' time.
  - Removal of 'tenure' (contracts with definite duration defined as expiring upon age limit or retirement) in all existing legacy contracts in all companies.
  - A freeze of 'maturity' (referring to all automatic increases in wages dependent on time) until unemployment falls below 10 percent.
  - Elimination of unilateral recourse to arbitration
- **Adjustment to non-wage labor costs:**
  - Close earmarked funds engaged in social expenditures (OEK, OEE)

PENSION & (initial) HEALTH CARE REFORMS

- Future rise in public pension expenditure not to exceed 2.5 % of GDP or the EU-wide average of 14% - (5/2010)
- Retirement age in line with life expectancy; benefits linked to lifetime contribution; disincentives for early retirement
- Health expenditure not to exceed 6% of GDP (2nd MoU)
- Social security funds merged into one (EOPYY), equalizing benefits and contributions
- Overhaul of the list of difficult and hazardous occupations, Disability criteria and rules revised (since Sep. 2011)
- Pharmaceutical expense reduction (2nd MoU)

PUBLIC SECTOR REFORMS

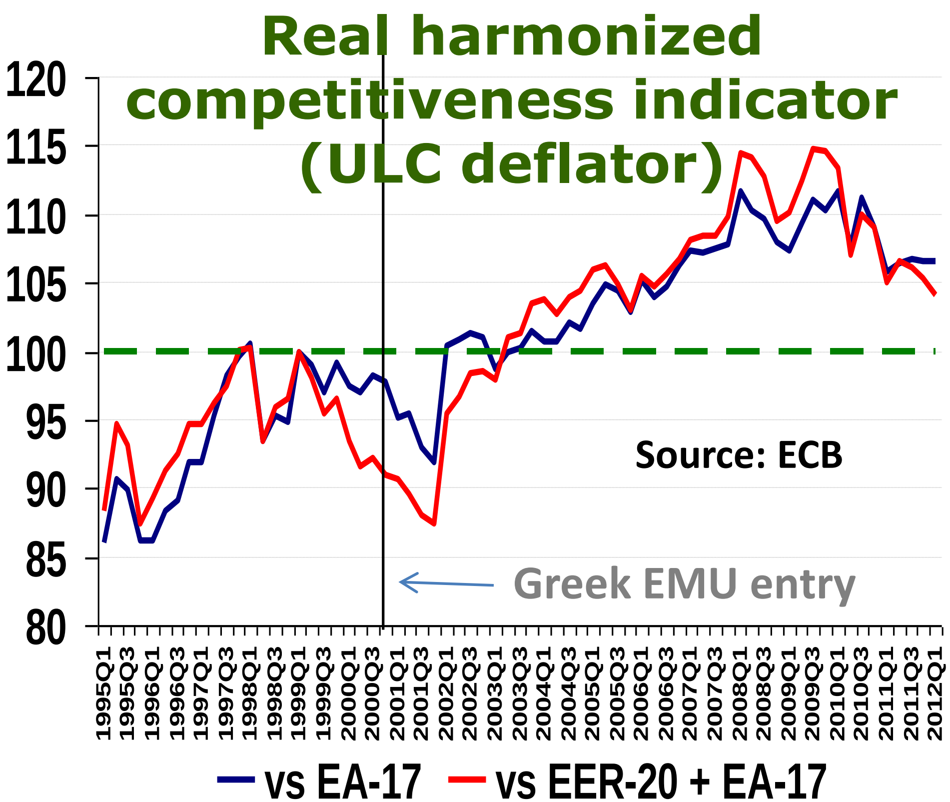
- **Single Payment Authority** established
- **Wage grid** adopted aimed at creating simplified uniformed remuneration system
- **Census of civil servants** (717,792 employees on public payroll)
- **Local government reform**
  - Municipalities reduced from 1034 to 325
  - Local authority entities reduced from 6,000 to 1,160
  - Decrease of elected officials from 30,795 to 16,657

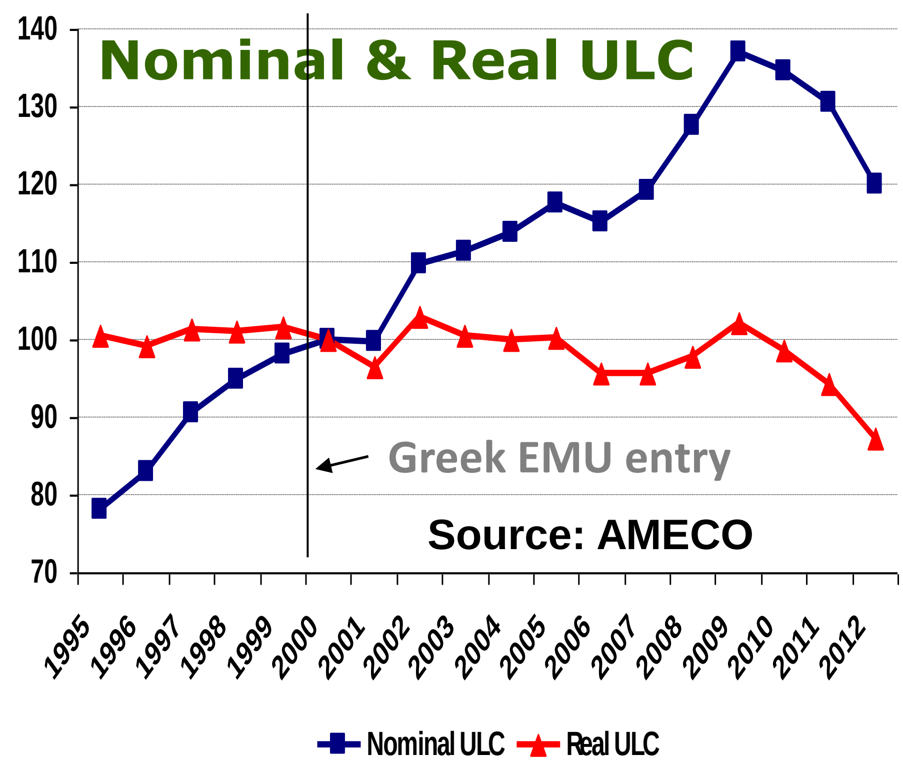
III. ACCOMPLISHMENT: A GRADUAL IMPROVEMENT IN GREEK COST COMPETITIVENESS HAS BEGUN

Nominal ULCs in European countries

% change	Greece	Germany	France	Italy	Spain	Ireland	Portugal	EA17	EU27
2000 - 2009	36.9	5.5	21.8	31.4	32.6	38.2	26.8	20.8	23.2
2009 - 2012	-12.3	3.2	4.6	2.4	-6.2	-12.4	-5.4	1.5	2.3

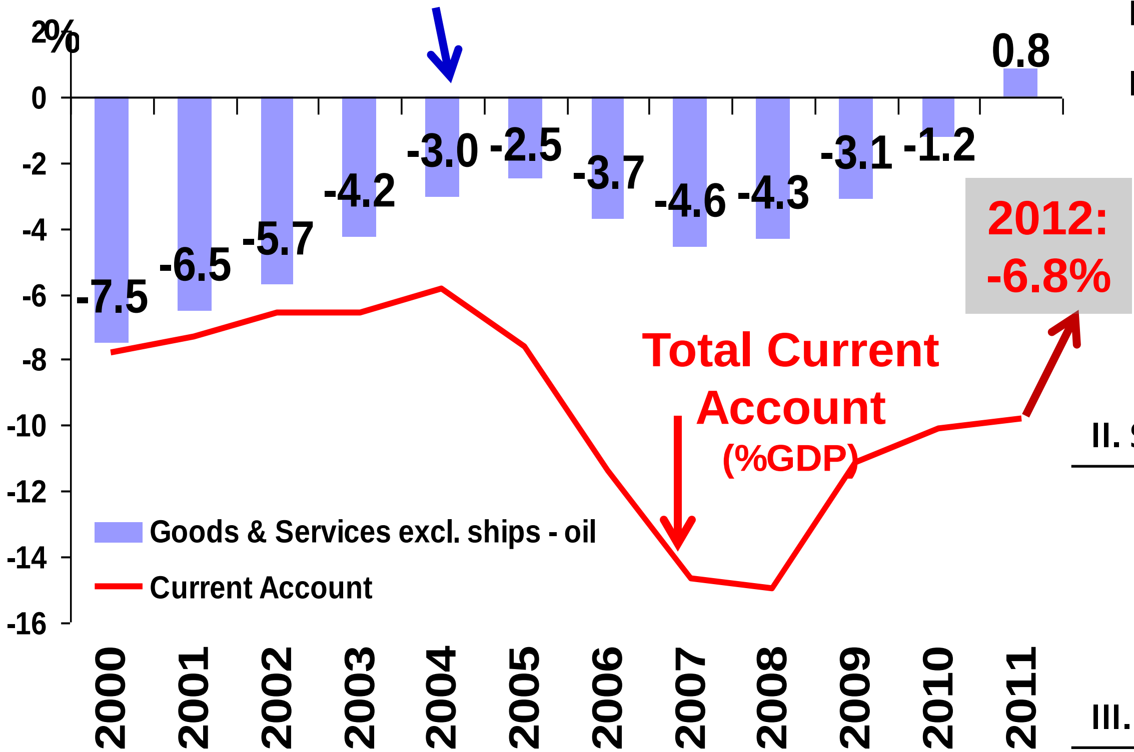
Source: AMECO





III. ACCOMPLISHMENT: EXTERNAL SECTOR ADJUSTMENT

Balance of Goods & Services excl. Ships and oil (% of GDP)

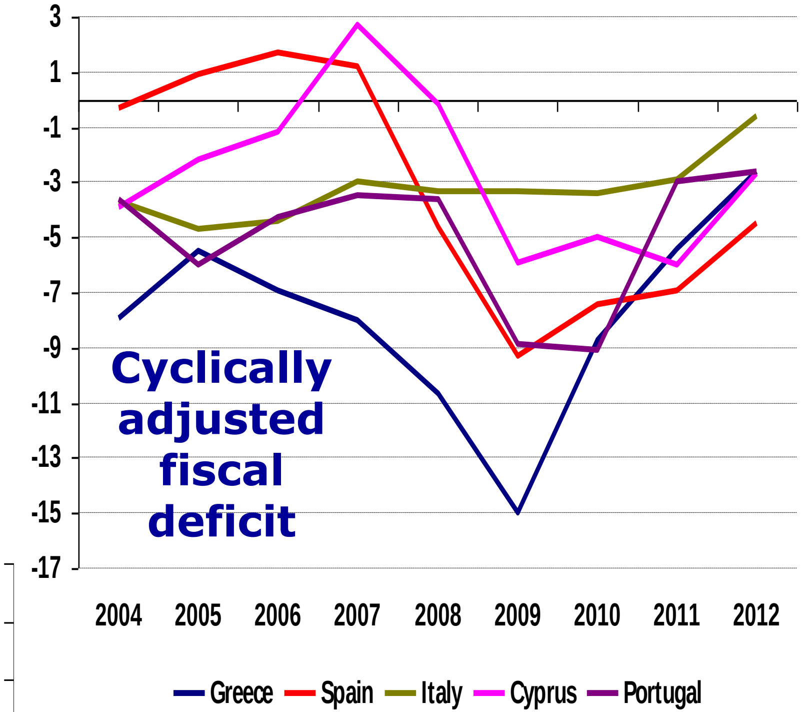


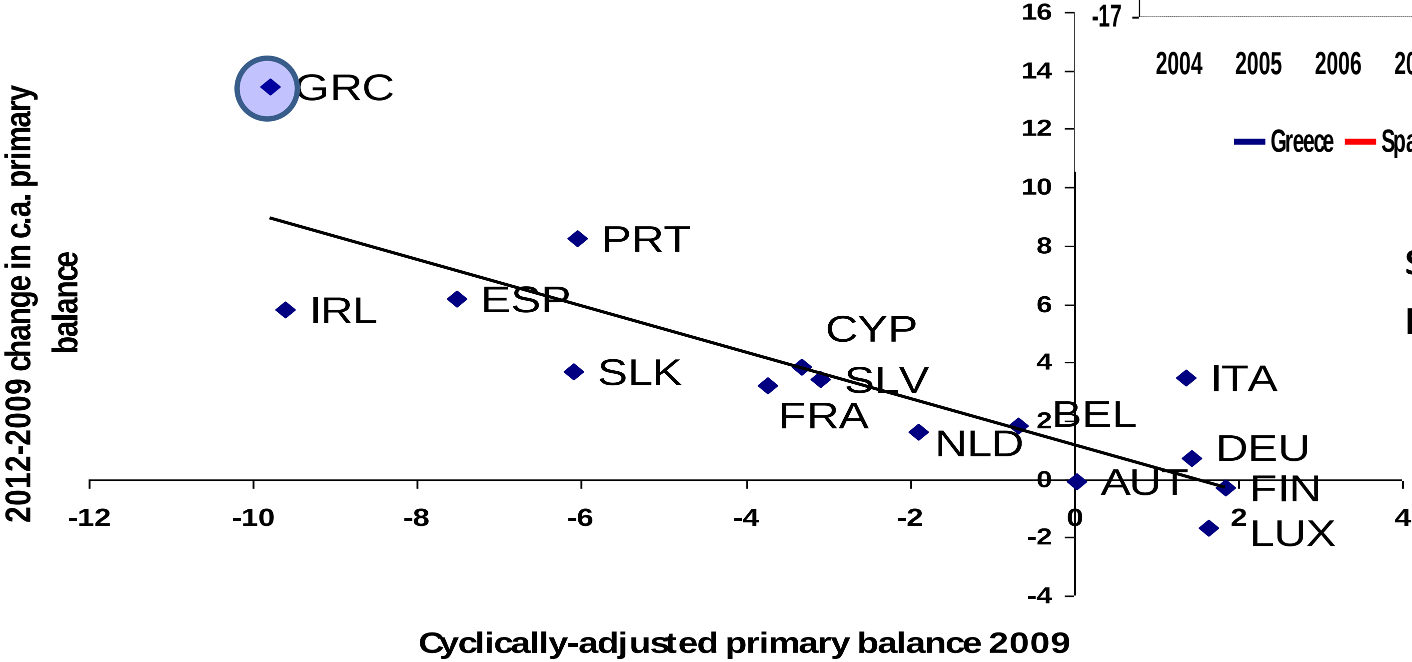
2011	**€ bn**	**% GDP**
Current Account (I+II+III+IV)	-21,1	-9,8
I. Goods	-27,2	-12,7
Exports	20,2	9,4
Imports	47,5	22,1
Oil Balance	-11,1	-5,2
Trade Balance excluding oil	-16,1	-7,5
Ships' Balance	-3,3	-1,5
Trade Balance excl. oil - ships	-12,8	-6,0
II. Services	14,6	6,8
Travel	8,2	3,8
Transportation	6,9	3,2
Other services	-0,5	-0,2
III. Income	-9,1	-4,2
Compensation of employees	-0,3	-0,1
Investment income	-8,8	-4,1
IV. Current Transfers	0,6	0,3

Source: BoG

III. ACCOMPLISHMENT: DRASTIC FISCAL CONSOLIDATION, 2010-12

- Greece shows the largest adjustment in cyclically adjusted fiscal deficit after 2009
- Greece also showed the largest progress in the primary deficit





Source: AMECO

Note: The 2012 figures are AMECO forecasts

III. YET MORE CUTS TO COME … GENERATING RISKS: WILL THE RECESSION END?

- Over 2009-2011, the primary deficit declined by 8.2pp GDP despite the recession, which is an unprecedented achievement
- Program requires another 5.5 pp GDP reduction in primary deficit until 2014. The size of government is forecast to shrink from 1/2 to 1/3 of GDP
- This type of fiscal contraction risks prolonging the recession beyond 2013-14

	2009	2010	2011	2012	2013	2014	2015	2020
GDP Growth (%)	-3.3	-3.5	-6.8	-6.7	-4.0	2.5	3.1	2.2
Nominal GDP (€ bn)	232	227	215	201	195	200	208	255

Source: Eurobank Research

Primary Expenditure (% GDP).	48.7	44.4	43.4	43.2	40.4	37.6	35.6	35.8
Primary Balance (% GDP)	-10.6	-5.0	-2.4	-1.0	1.8	4.5	4.5	4.3

Source: IMF Country Report No. 12/57 (March 2012)

General Gov Debt (% GDP)	129.0	144.5	165.2	167.2	176.3	169.6	162.0	125.1
General Gov Debt (€ bn)	299	328	356	336	344	339	337	319

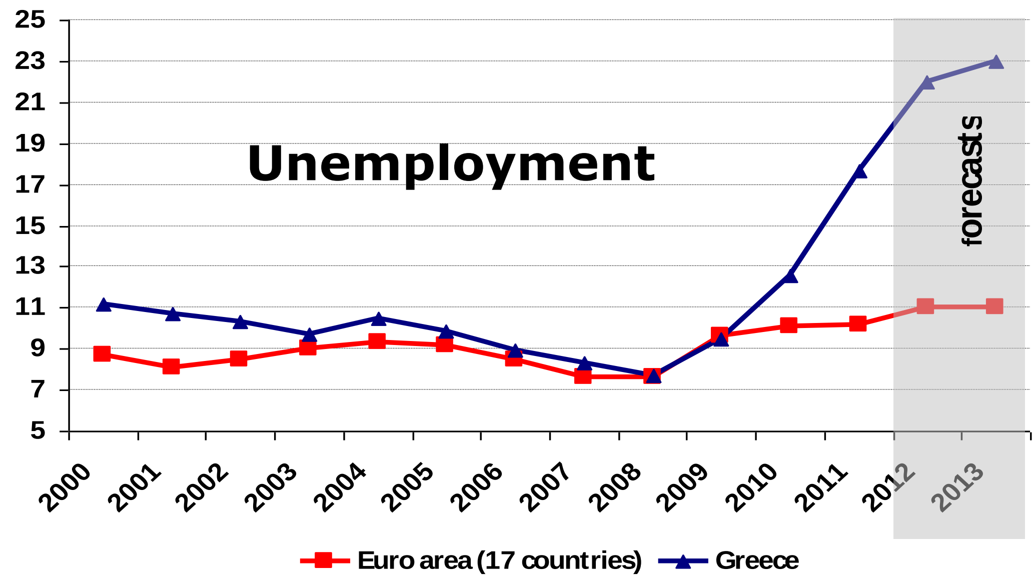
Source: Eurobank Research

- In the optimistic scenario that the 9.6% output gap will be eliminated gradually, growth rebounds more strongly from 2014 on, and Debt/GDP in 2020 becomes 109%

III. IMPLEMENTATION RISKS AS UNEMPLOYMENT RISES

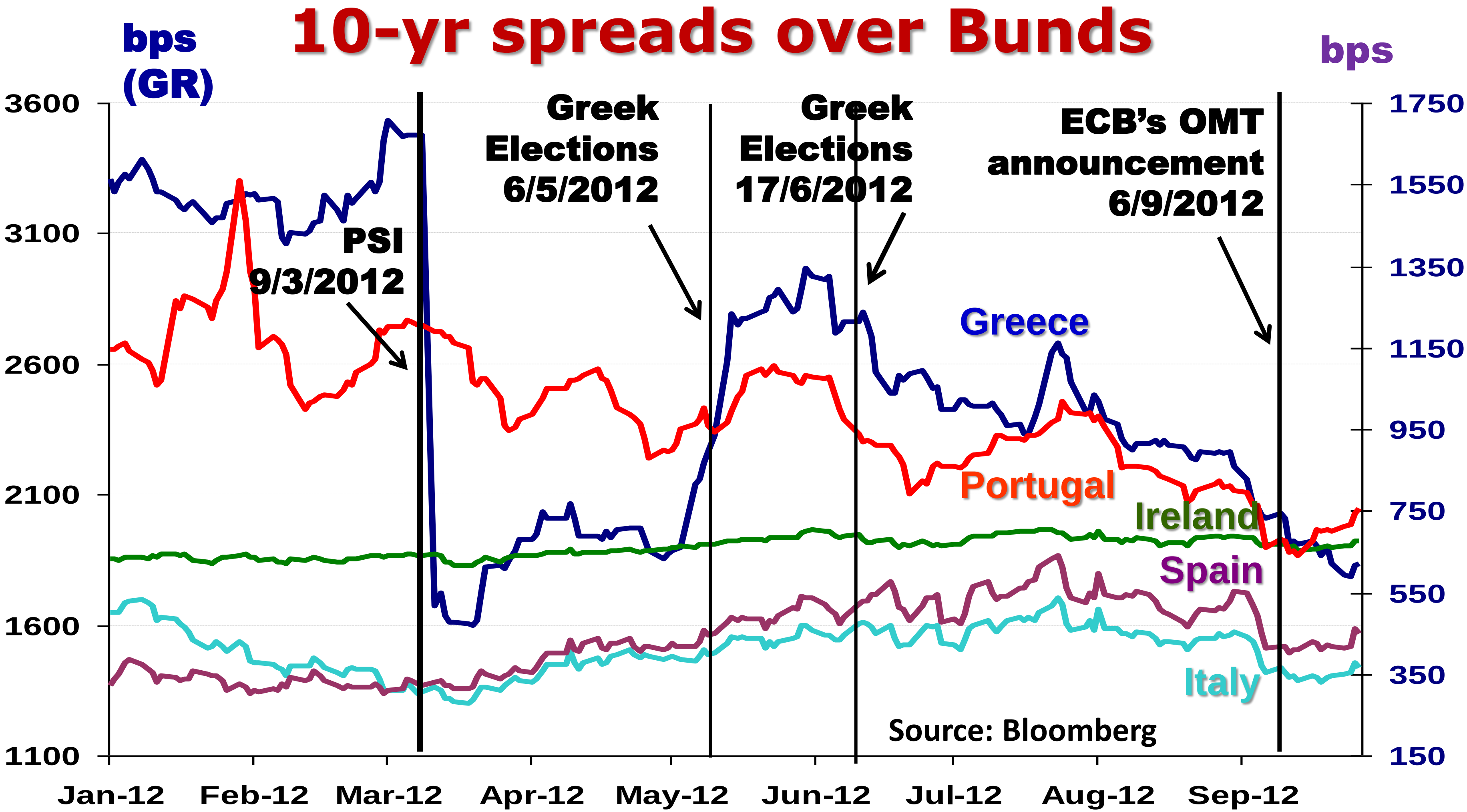
	Greece		Euro Area	
	Unemployment	Youth Unemployment	Unemployment	Youth Unemployment
2007	7.6	22.9	9.6	15.5
2009	8.3	25.8	9.5	20.3
Jun-12	23.9	55.7	10.9	21.7

- The private sector is paying the price of adjustment
- Social response to austerity subdued up to now, e.g., in 2010, the weak response to the drastic pension reform contrasts sharply with the massive demonstrations in 2001 for a much less ambitious pension reform
- Yet, anger is building up



Source: Eurostat, AMECO

III. GREXIT REMAINS A REAL POSSIBILITY IN MARKETS' VIEW



Note: Greek spreads are measured on the left axis

III. GREXIT: POOR SOLUTION TO THE EZ CRISIS

Greece

- **Benefits**
  - Independence of monetary & FX policy
  - Possible ability for countercyclical policies
- **Costs**
  - Chance to reform the State and the institutional structure gone
  - EZ fiscal discipline mechanism lost
  - Political gains from EU/EMU membership lost
  - Mafia – type relations will likely prevail
  - Devaluation and inflation with no serious competitiveness gains
  - Default on State debt obligations
  - Likely default on private debt contracts
  - Capital controls and possible exit from EU
  - Significant contraction of GDP and lowering of living standards & a downward momentum, in contrast to CEE countries
  - No financing from EU Structural & Agricultural funds
  - Short-term need for ca financing with IMF as the only provider
  - Introduction of new currency costly, unlike a fixed FX regime or currency board

EZ

- **Benefits**
  - Swift implementation of unification measures (fiscal, financial, political) by remaining EZ countries
  - Minimization of moral hazard issues through tighter controls
- **Costs**
  - Risk of an EZ break up due to contagion
  - Irreversibility of MU destroyed and possibility of future breakup, as EZ resembles a fixed exchange regime
  - Rest of EZ would write-off exposure to Greece's sovereign & banks
  - EZ break up will cause appreciation of the new German currency (i.e. GDP contraction for Germany via the export channel).
  - Political gains from the EU unification will be lost in the case of a euro break-up

III. CONTAGION CAN SPREAD THROUGH NON-TRADITIONAL CHANNELS

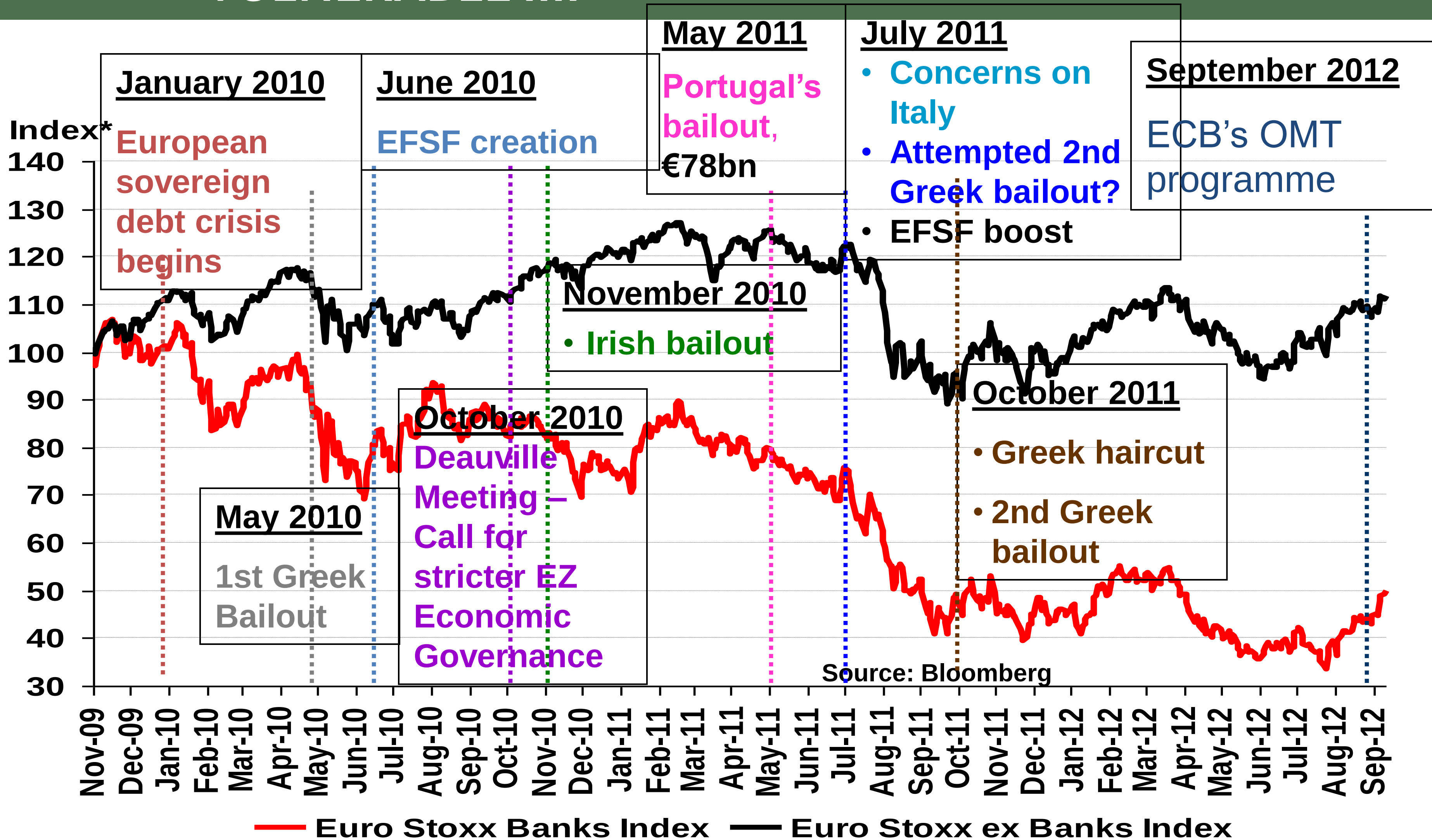
- Contagion can happen through: (a) trade, (b) portfolio investors, (c) cross holdings of financial institutions, (d) official lending, (e) fear, a non-traditional channel
  - Channel (a) is small as EMU exports to Greece represent 0.18% of total EMU exports
  - Channel (b) was never a large component in international wealth portfolios
  - Channel (c), exposure of FIs is reduced and small (**Table A**)
  - Channel (d) is small, especially since Target 2 is central bank money (**Table B**)
  - Channel (e) is important as **fear can spread** no matter what the exposure is the most important also small,

Table A	European banks	France	Germany	Italy	Spain	Sw/land	UK	US
Foreign claims	90473	44353	13355	2186	969	1940	10537	4455
Other potential exposures	29032	6901	3779	1790	417	1406	11825	46231

Source: BIS

Table B	Member states		Eurosystem		Total	
	Bilateral loans	EFSF	SMP	Target 2	€ bn	% GDP
Total	52.9	73.0	34.9	130.0	291.1	3.0

III. … ESPECIALLY WHEN EURO AREA BANKS ARE VULNERABLE ….

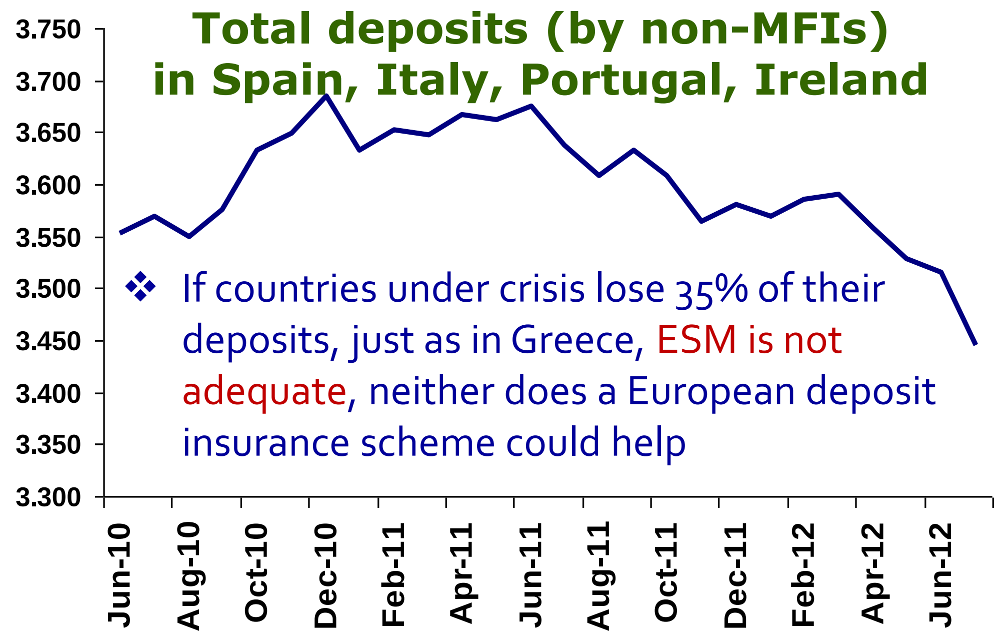


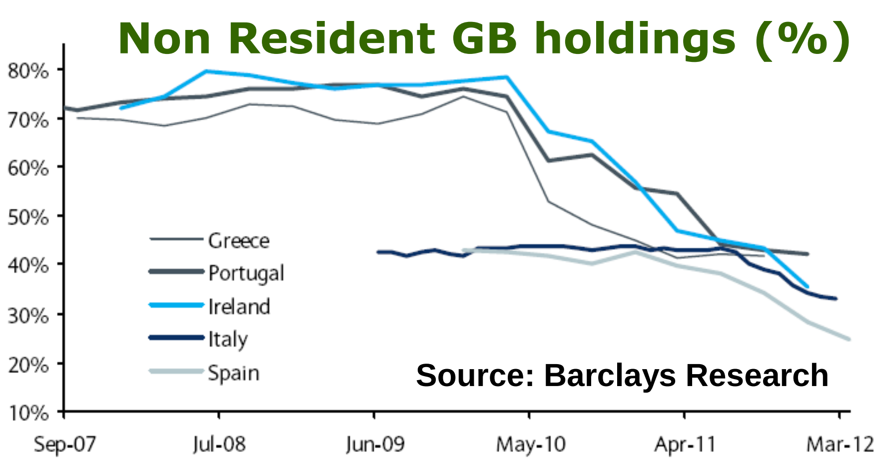
* October 30, 2009=100, first observation: Beginning of November 2009

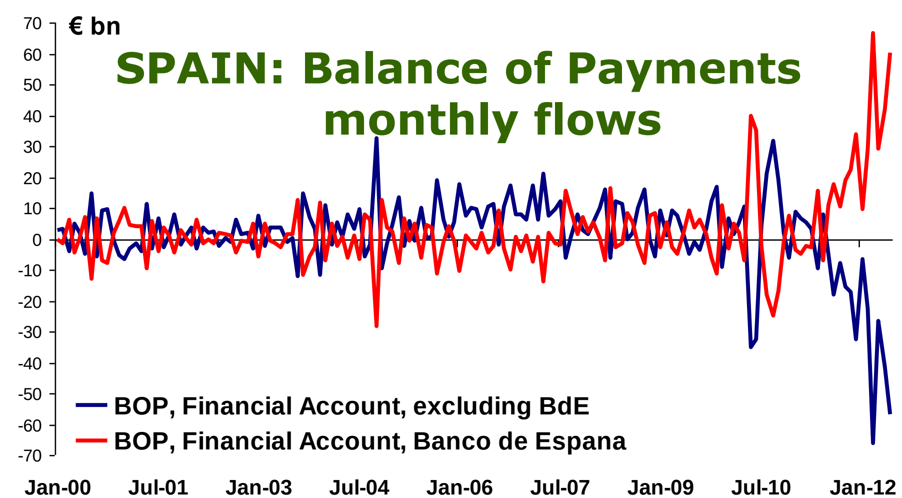
Capital deficiency € 114.7 bn from (a) stress tests that mark-to-market sovereign bonds, and (b) increase in Core Tier I ratio to 9% from 7%

III. IF FEAR SPREADS, IT COULD LEAD TO HUGE BANK WITHDRAWALS IN THE PERIPHERY

- **Smart money is leaving the Periphery, depositors are the last to go**
- **Fear spreads: In Greek June elections, Spaniards stuck into their TVs**
- **A Greek exit devastating, but ECB will intervene to avoid a bank run**
- **Yet, the IRREVERSABILITY PRINCIPLE would be destroyed and EMU would become another fixed exchange rate regime**







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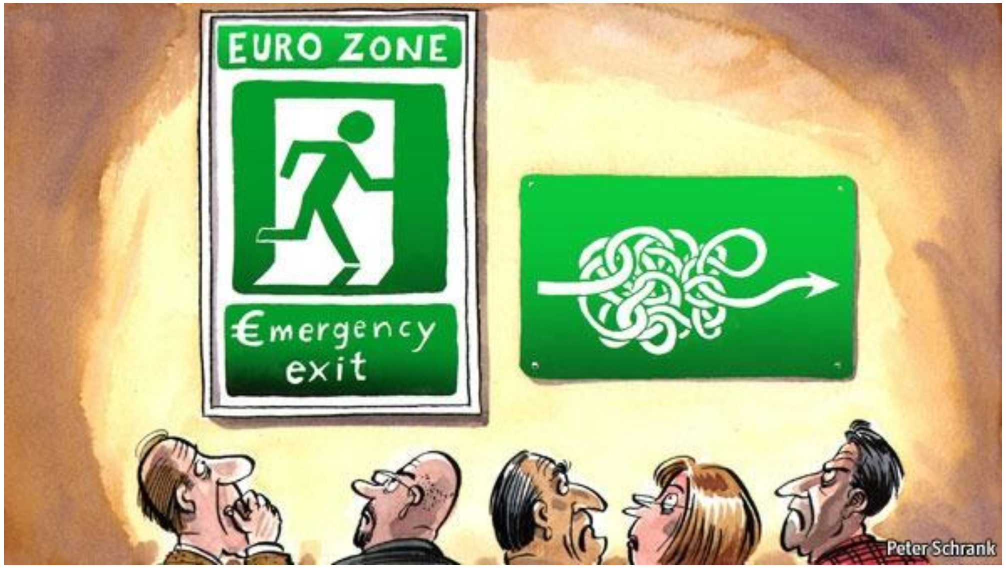

IV. CONCLUSION: IF THERE IS A WILL, THERE IS A WAY

- In the 1990s, it had been hoped that EMU would speed up the economic and political integration of Europe; it did the opposite as the low interest rates and the market euphoria that followed monetary integration, shielded EMU countries from performing the required structural reforms or reducing their debt, leading to important divergences within EMU
- For EMU to survive, prerequisites are not only debt sustainability and structural reforms in individual economies, but also deeper EMU integration: in fiscal policy, in financial market policy and in politics
- The crisis was triggered by fiscal concerns, a subset of the divergences
- Greece has accomplished substantial fiscal austerity and has begun major reform projects, yet its recession continues, undermining the will of the population
- A Greek exit would easily trigger contagion, which would then require massive ECB interventions to avoid the destruction of the European financial system
- A Greek exit destroys the IRREVERSABILITY principle of joining EMU, thus would herald EMU's prospective unraveling
- Recent Greek achievements in a hostile macroeconomic environment show that Greece can re-invent its economic paradigm and return to balanced growth: If there is a will there is a way

Thank you
for your attention

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