Greece – How did it come to this?

by NAB Group Economics

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National Australia Bank

How Greece and other Euro periphery economies got into trouble and how Greece failed to get out of it

- Following the creation of the Euro-zone, private capital flowed into the periphery economies – boosting activity and allowing much higher rates of price and cost inflation than the core. Once the flow stopped, these economies had lost competitiveness, and since they couldn't devalue the Euro, the only response was cuts in nominal prices and wages as well as efforts to lift productivity.

- The unwillingness of private investors to put money into Greece also meant that the Greek Government faced problems in funding its big budget deficit and rolling over its massive stock of debt as existing maturities expired. This led to austerity measures, which drove the Greek economy into depression.

- The IMF and Euro-group severely under-estimated the scale of the downturn that the austerity program would have on the Greek economy, and were slow to realise the scale of their error. Too much austerity was delivered too quickly, leading to an implosion in activity – meaning debt to GDP is higher today than before austerity commenced.

- The July 12 agreement came with very harsh terms – implementing more austerity, further reforms in sensitive areas and intrusion into Greek sovereignty. That the Greek government accepted the deal reflects its weak bargaining position.

- A Greek default poses much less risk to the Euro-zone banking system than in 2010. Greek debt is primarily held by European institutions and the IMF, with private investors far less exposed than in 2009 – reducing the contagion risk to other periphery economies.

- The handling of the Greek financial crisis has been a major political and presentational failure for the Euro-zone and its institutions. It has provided more ammunition for critics of the Euro-project – which up until now has been supported by most voters, but that may now be less assured.

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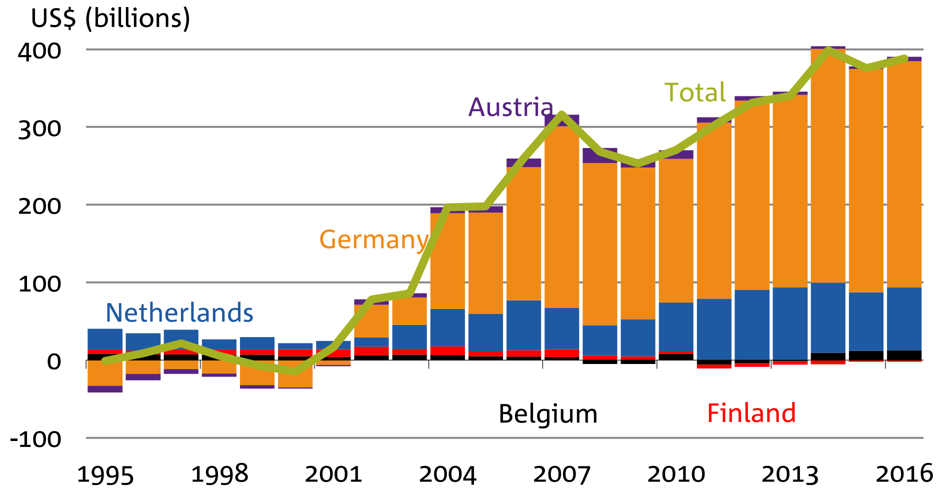
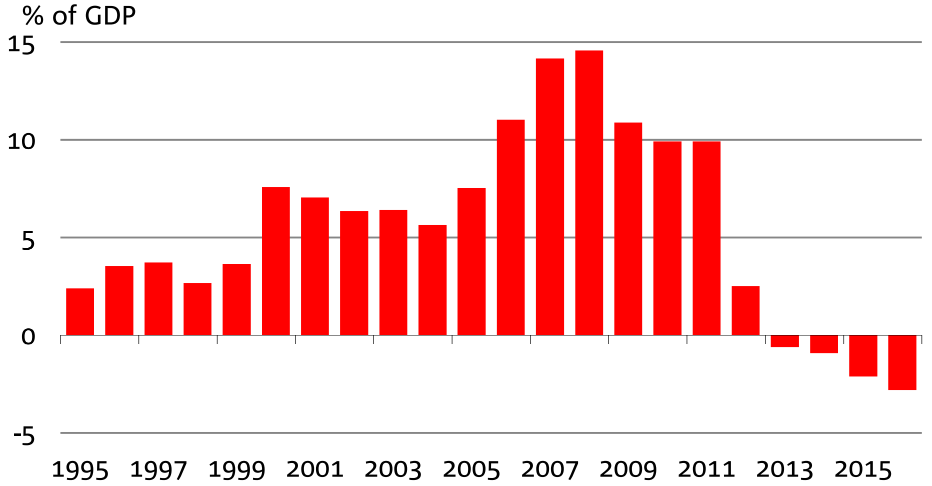
How the Greek crisis unfolded – problem number 1: the sudden stop of capital flows

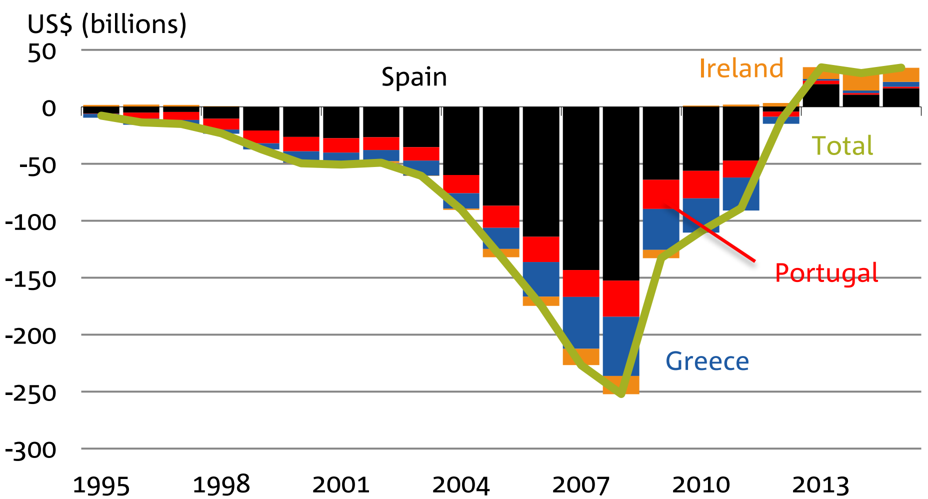
Net capital flows – Eurozone Core



Greece - Net inflow of foreign capital



Net capital flows – Eurozone Periphery



- Following the creation of the Euro-zone, private capital flowed out of the core countries of Northern Europe into the periphery, seeking better returns in Ireland, Spain, Portugal and Greece. Investors under-estimated the risks to their funds – although currency risk had gone, many of the funds were not used effectively in the periphery.
- Once Euro-zone core investors realised this, there was a "sudden stop" to capital flowing into the Euro periphery. Such economic shocks tend to have a severe impact on activity in capital importing economies. While foreign capital flowed in, these countries could spend more than they produced – running very large current account deficits. Once the inflow of capital stopped they could no longer fund these deficits and had to either get financial support from bodies like the IMF or cut their spending back into line with their income. In the case of Greece, national spending exceeded output by almost 15% so the cuts would have to be large.

As capital poured in, costs climb in periphery. Crisis hits, inflows end, need to lift competitiveness

- The inflow of capital boosted activity in the peripheral economies and allowed them to run much higher rates of price and cost inflation than the Euro-zone core. The charts opposite show how consumer price inflation and wage growth in the peripheral economies exceeded that in Germany.

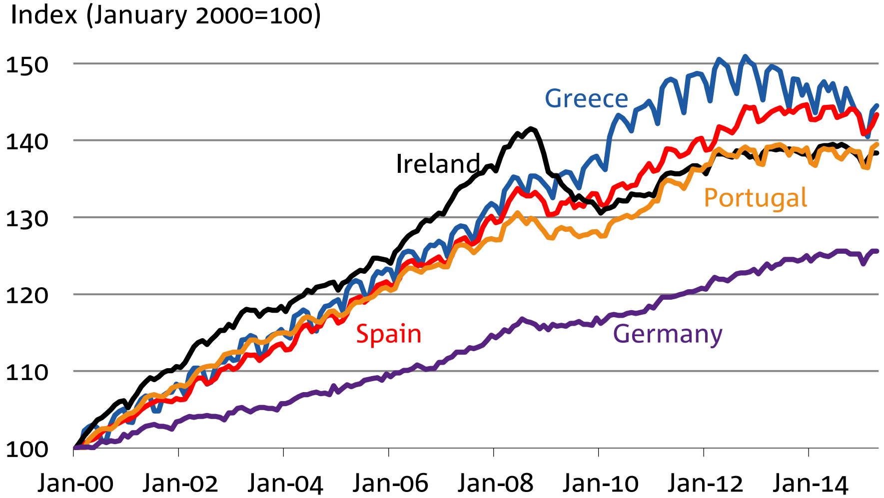
- In effect, firms in the Euro periphery were steadily losing competitiveness against their rivals in core countries like Germany, Belgium or the Netherlands. Both the core and peripheral economies now shared the same money, preventing high inflation peripheral economies from using the time-honoured response of currency devaluation to regain lost competitiveness.

- Once the peripheral economies were unable to attract foreign private sector capital, they had to drastically improve their trade balance – requiring a combination of improvements in their competitiveness and cuts in domestic spending. As currency devaluation was no longer possible and Euro-zone core inflation was minimal, the only response was cuts in nominal prices and wages as well as efforts to lift productivity (see over).

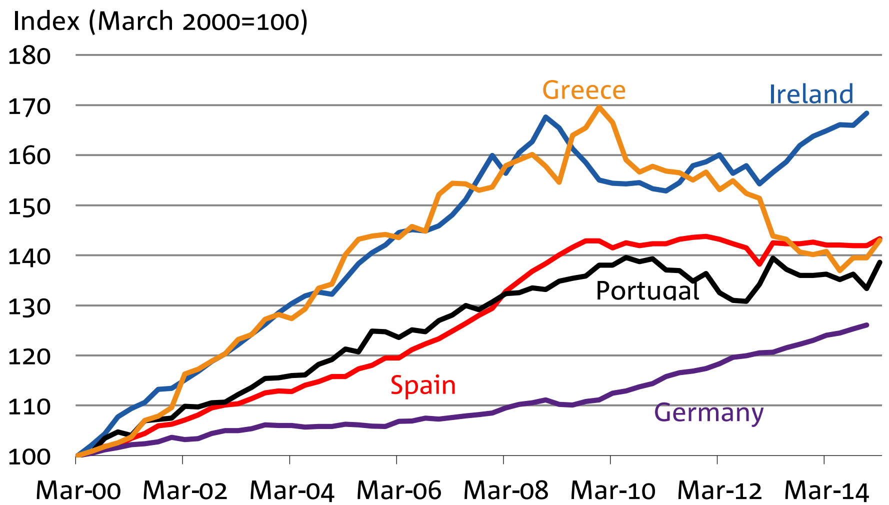
- Significant cuts in economy-wide nominal wages and prices have seldom been seen in recent decades. They are generally secured by creating such a wide margin of unemployment and idle capacity that firms and labour lose so much of their pricing power that they are forced to accept lower returns. This usually entails a very deep recession.

- Greece has seen the biggest falls in prices and (particularly) wages of any peripheral economy since the Euro-zone crisis began – reflecting the unequalled severity of its economic downturn. Unfortunately, this has not led to the surge in exports that was the anticipated result of these cuts in wages and prices.

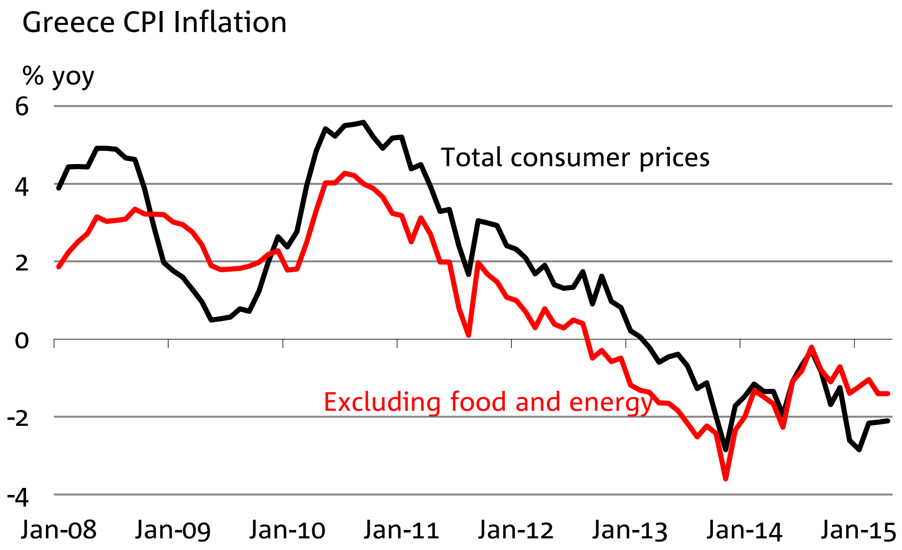
Consumer prices

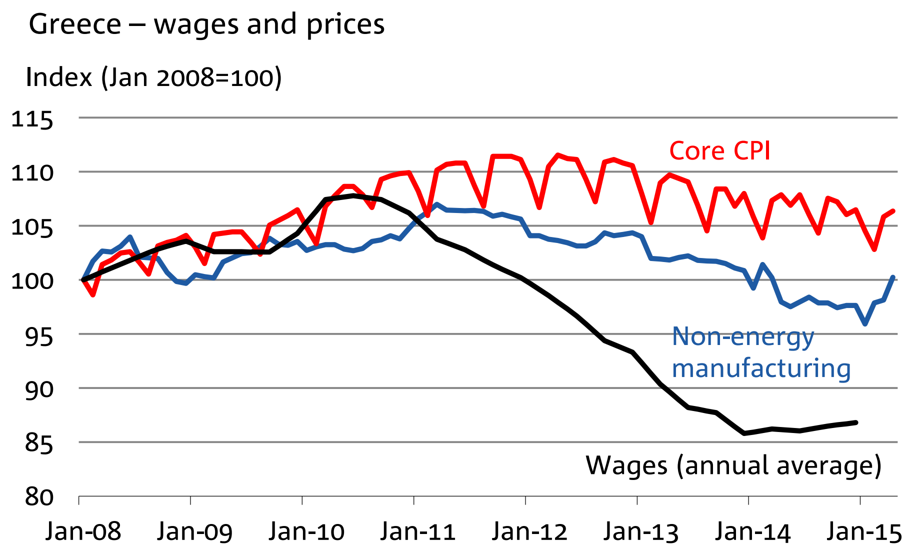


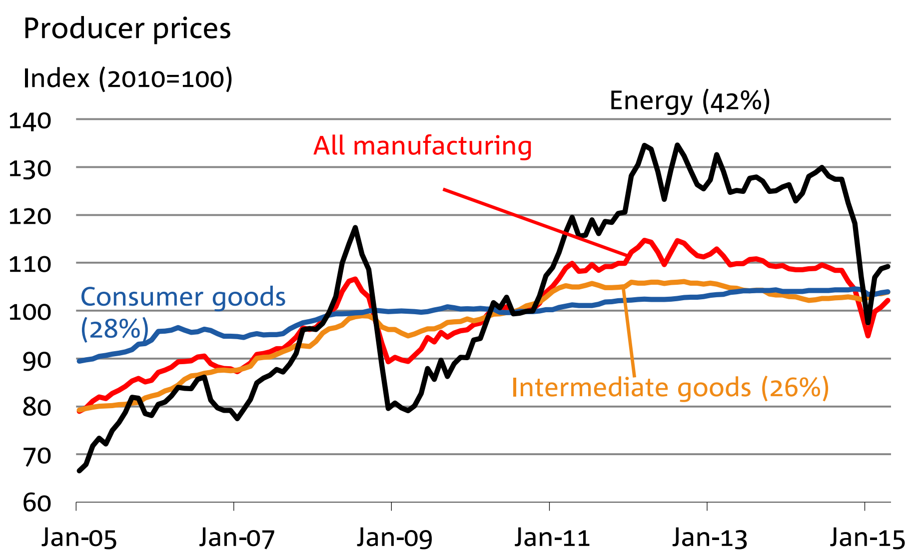
Average earnings indices

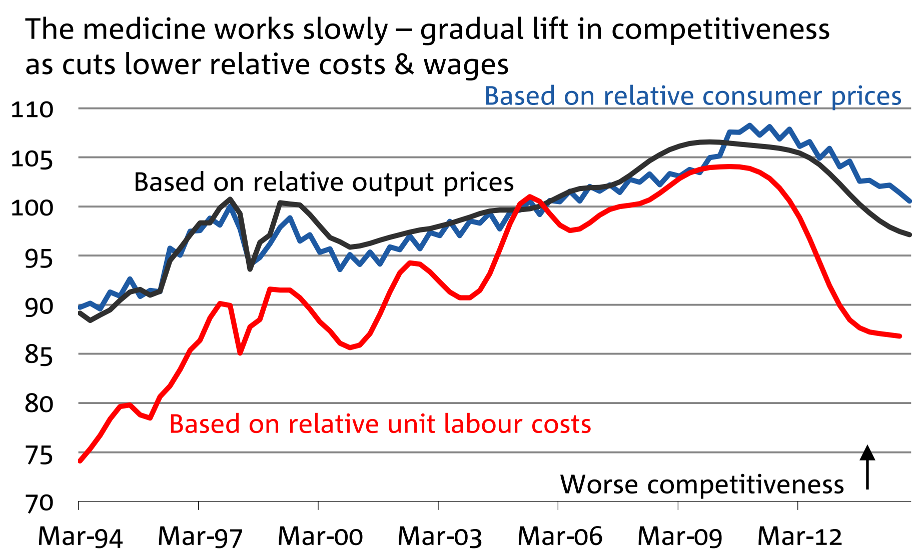


Greece has Euro - can't devalue currency to boost competitiveness, must deflate via wage/price cuts



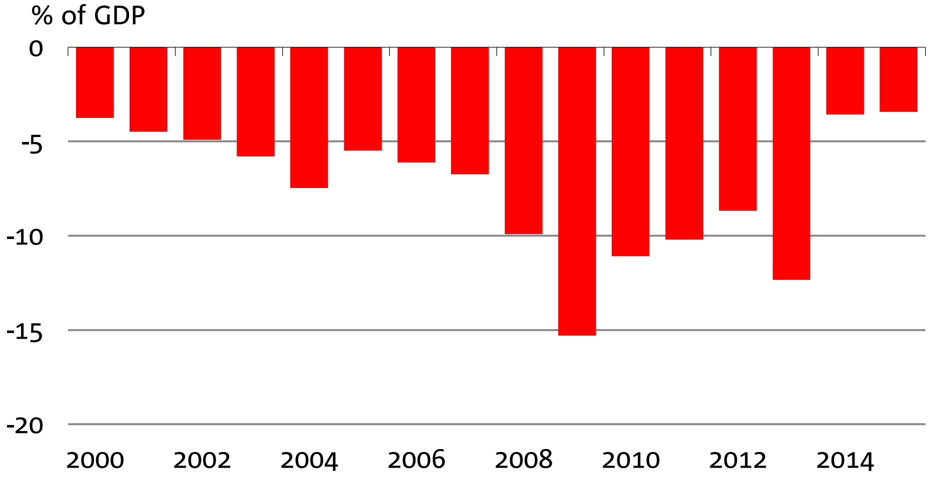






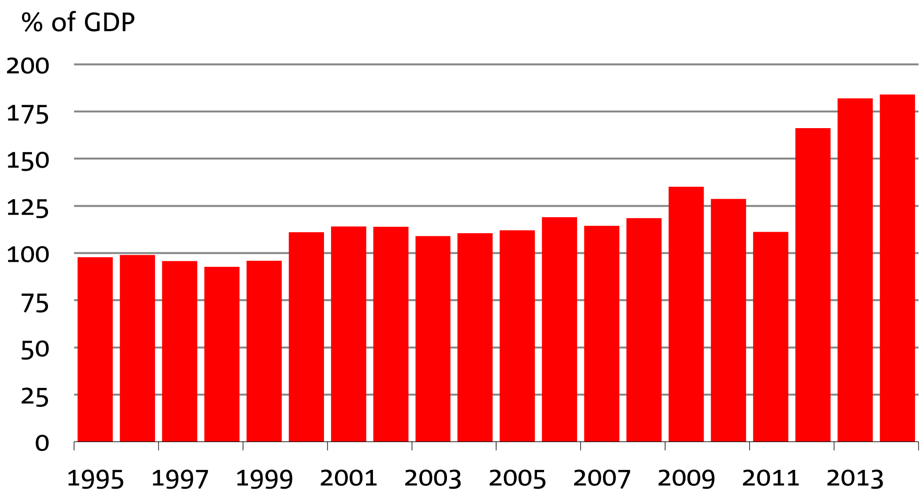
Problem number 2 – Austerity to shrink budget deficits and control public debt

Greek budget deficit – considerable progress in cutting deficit

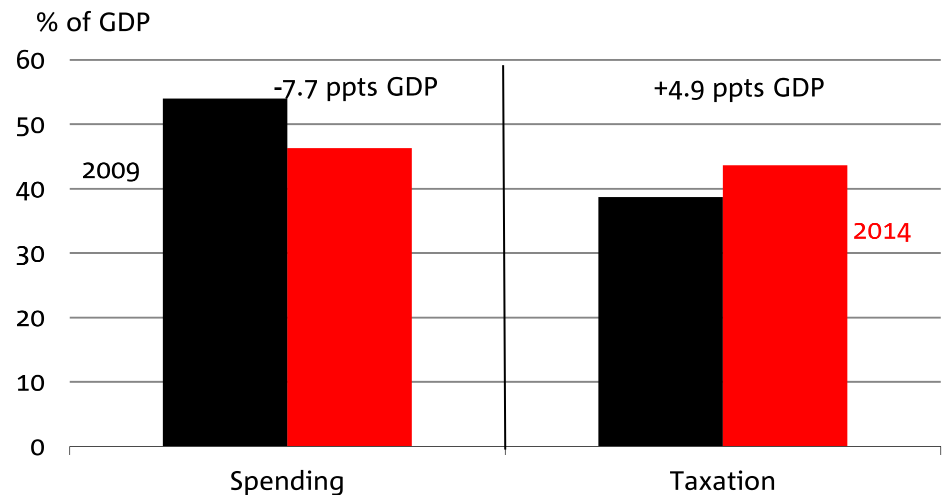


- The unwillingness of private investors to put money into Greece also meant that the Greek Government faced problems in funding its big budget deficit and rolling over its stock of debt as existing maturities expired.
- With a budget deficit equal to around 15% of GDP in 2009, this sudden lack of access to new funds required a drastic program of austerity – increases in taxes and cuts in public spending.
- The Greek Government has made considerable progress in cutting its deficit – cutting the headline deficit to 3.5% last year and securing a surplus on its non-interest budget balance.
- Austerity programs lost some momentum in the last year and the size of the non-interest budget surplus that will be demanded in the latest financial support package is still unclear. The large prolonged surpluses seen in the last program appear unrealistic.

Greek gross government debt (OECD)

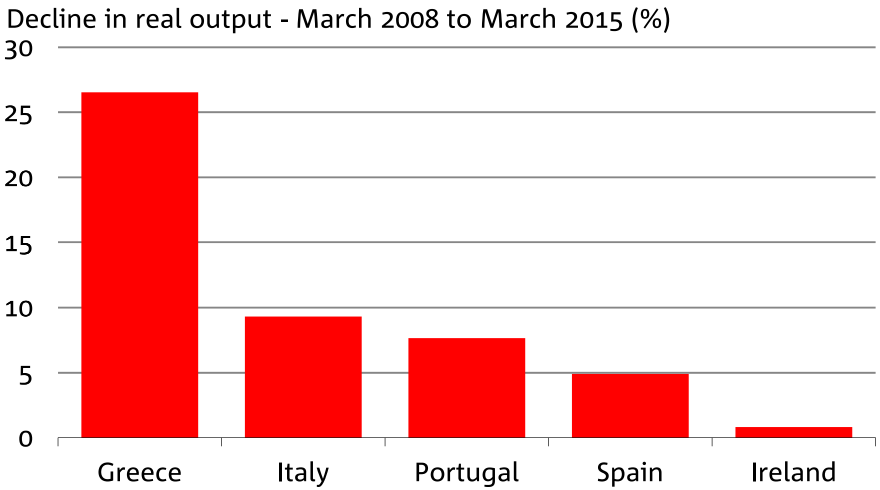


Greek government spending and taxation

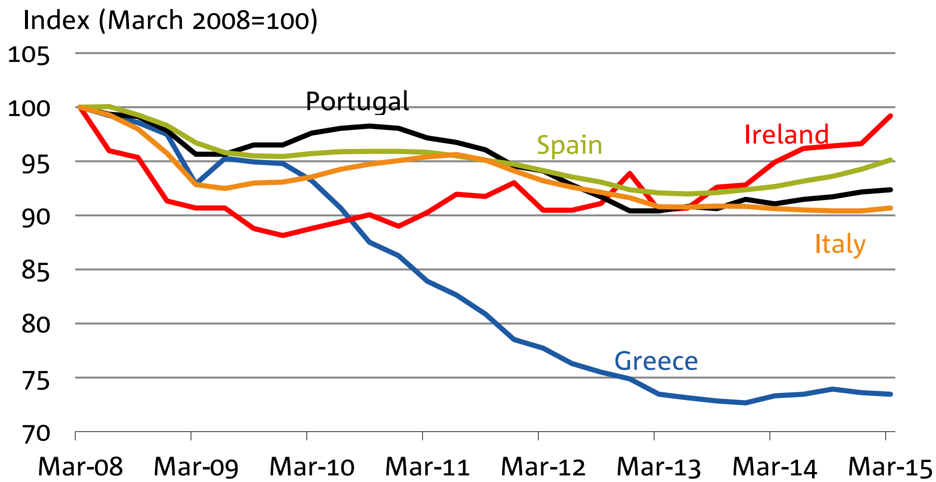


Outcome of austerity – an economic depression, not just a recession

Eurozone periphery economies smaller than early 2008

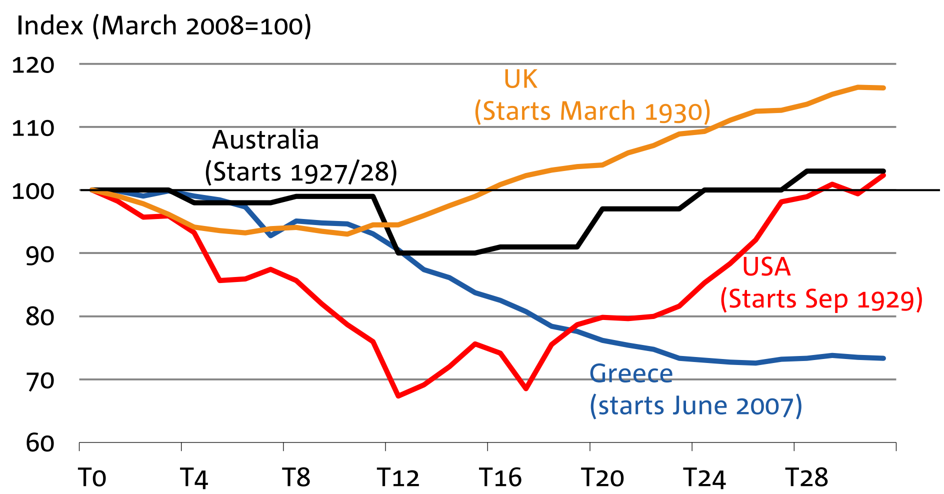


Eurozone periphery indices of GDP



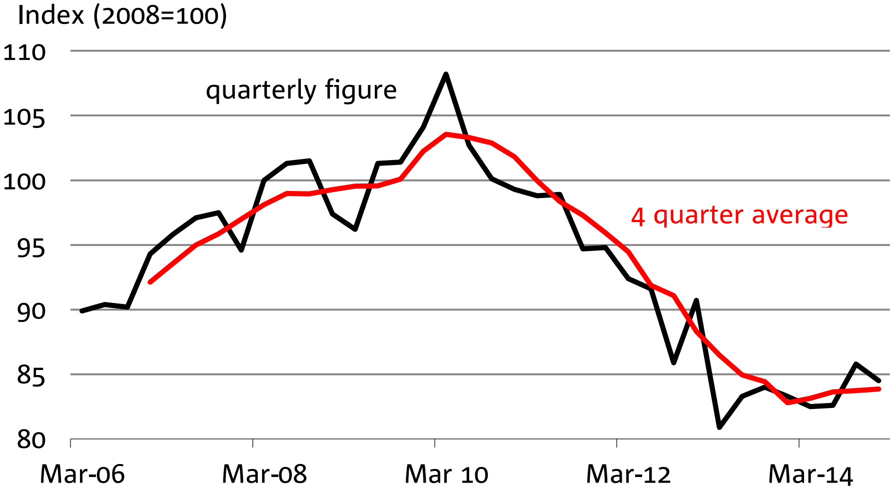
- The austerity programs have had a far worse impact on economic activity in Greece than was initially expected or than in other Euro-zone peripheral economies. GDP in Ireland, Spain and Portugal has started to recover but Greek output has stayed flat.
- The volume of output in Greece has fallen by around 25% from its pre-global financial crisis level and the cumulative loss in output in this Greek GDP downturn will easily exceed what was experienced in the Great Depression in the US, UK or Australia.
- Even worse, there does not seem to be an end in sight for the Greek Depression. Business surveys, loan demand, labour market indicators and some hard data on sales and output did show a few positive signs through late 2014 and early 2015 (whether due to less fiscal austerity or improved competitiveness is unclear) but conditions had already started turning down before the bank shutdowns.

Real output during depressions

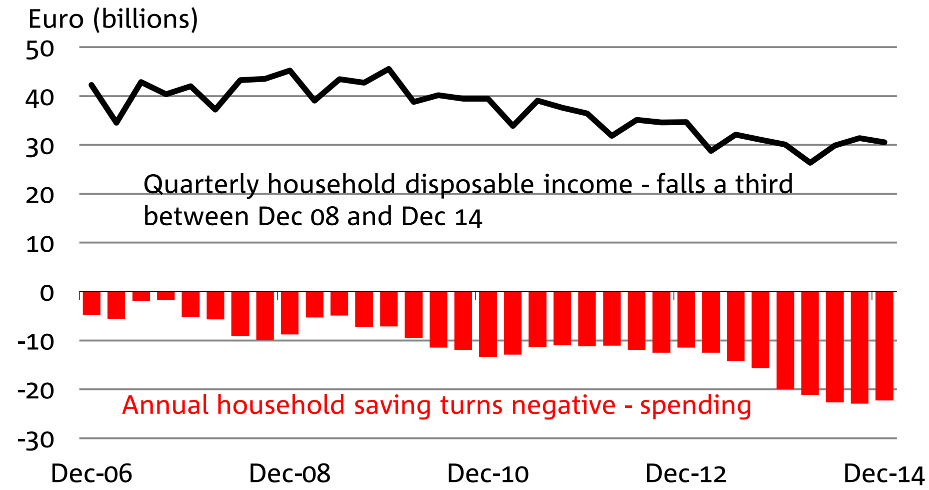


Austerity crunches incomes

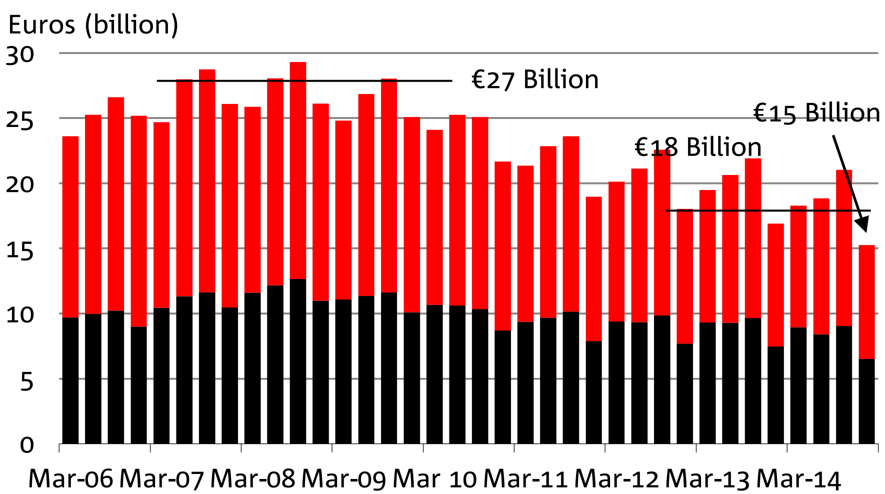
Quarterly wage index (seasonally adjusted)



Household disposable income and savings



Quarterly profits for Greek business



- Besides their intended target of lowering nominal wages, austerity programs have depressed all incomes (nominal or real). Nominal wages have declined by around 20% since early 2010 and the impact on household incomes has been exacerbated by big falls in employment.
- Household disposable income has fallen by over a third and households have been forced to deplete their wealth by large scale dis-saving (consumption spending being well above household disposable income).
- Business has borne the brunt of the collapse in output with profits virtually halving between early 2008 and early 2015. Both corporate and small business profits have fallen heavily and many businesses have been forced to close.

Vicious circle of falling incomes and spending is set in motion

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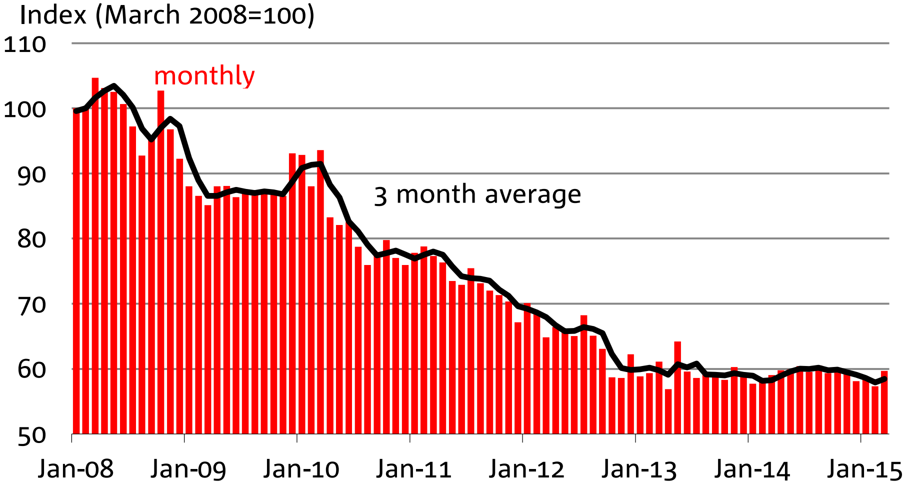
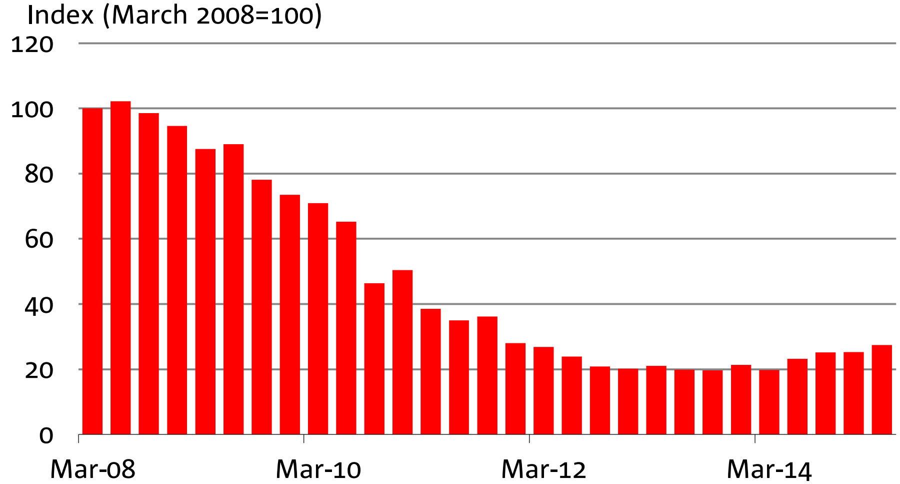
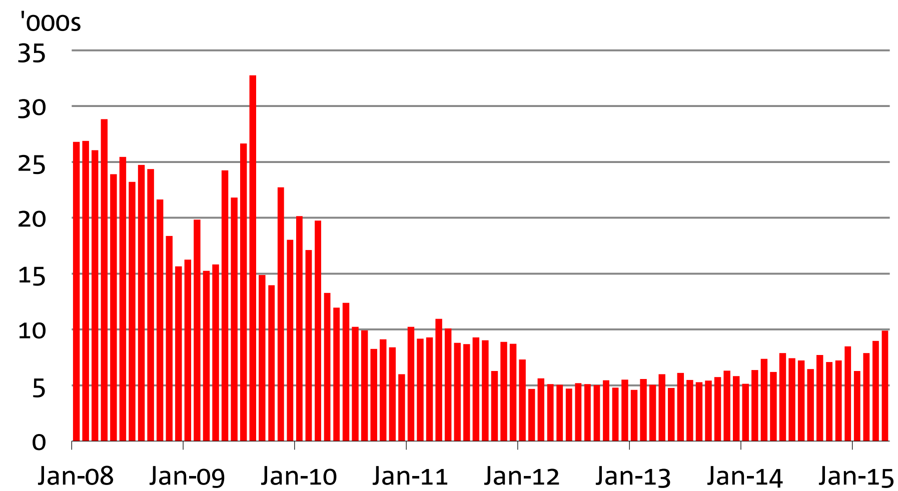
Volume of retail trade – down almost 50%



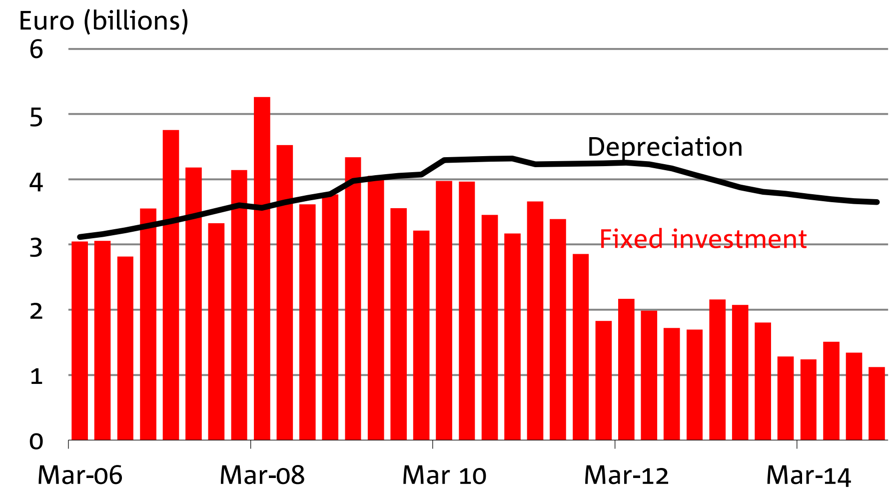
Construction sector activity – down by three quarters



Passenger vehicle registrations – down by three quarters

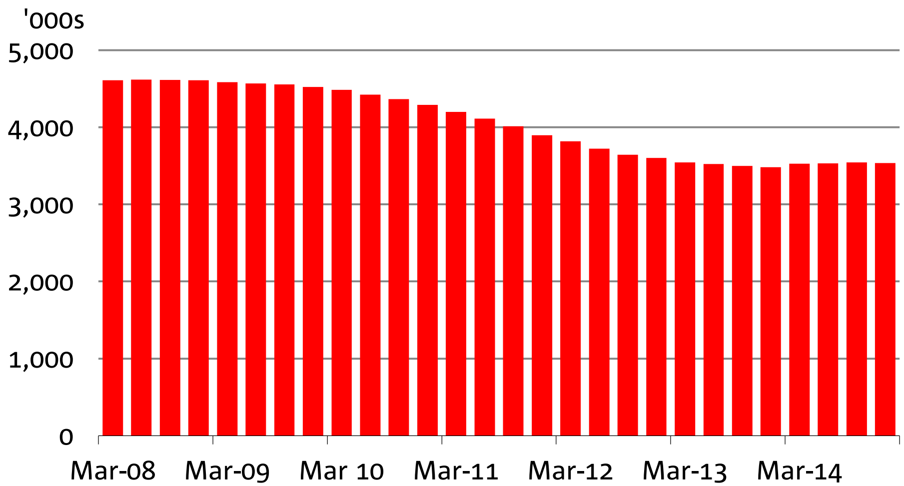


Corporate capital stock falling as depreciation exceeds investment

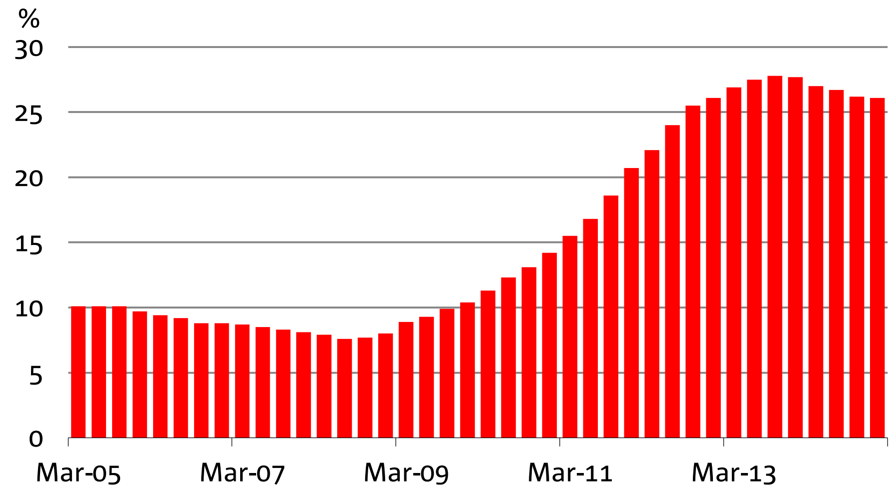


Jobs down 25%, jobless rate over 25%, only 15k job vacancies for 1.2 million jobless, 200k leave workforce, unemployment everywhere

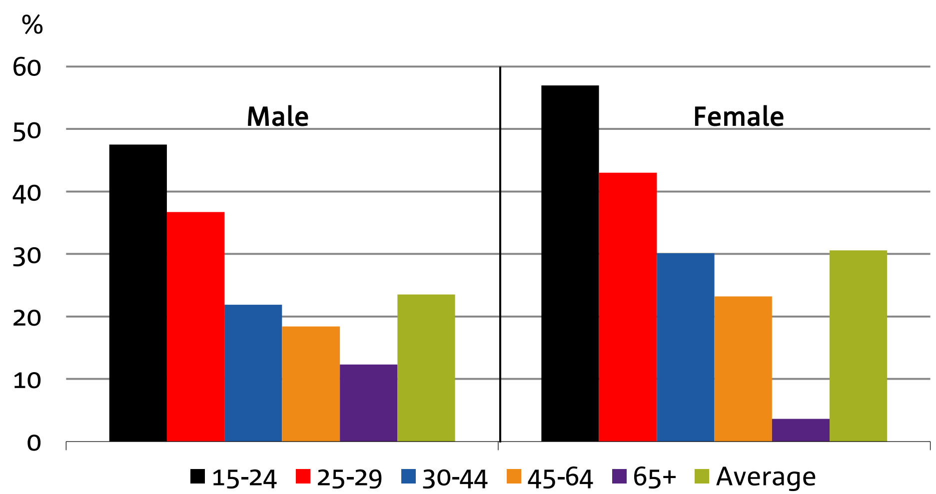
Greek quarterly employment levels



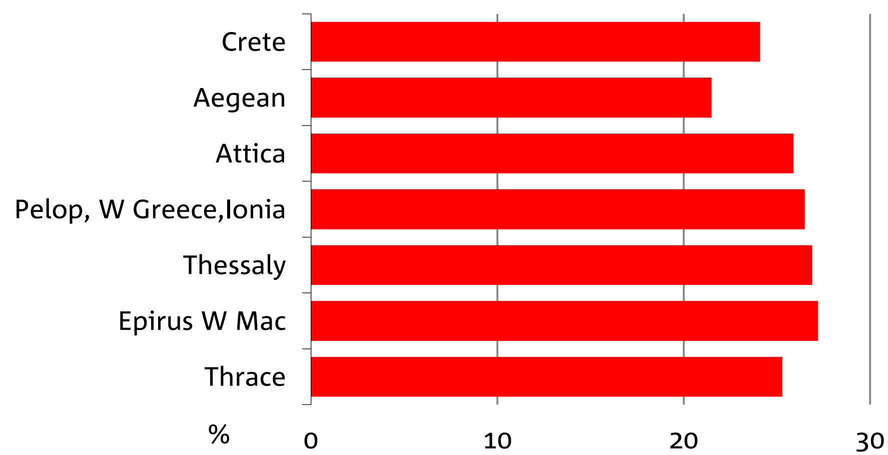
Greek unemployment rate



Unemployment rate by age group – March 2015



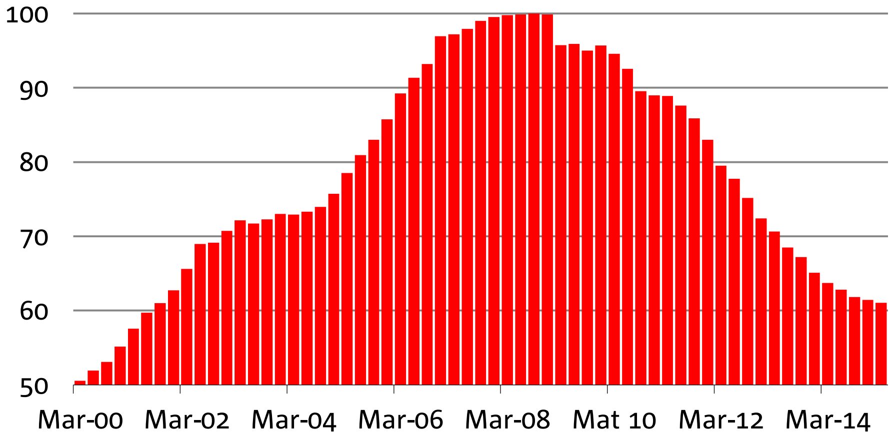
Unemployment rate by region – March 2015



Asset markets turn down heavily - steep falls in property prices and rents

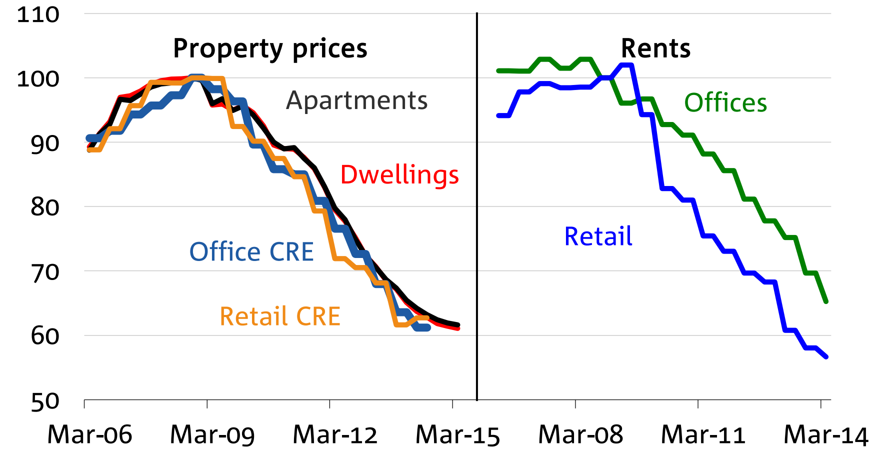
Greek dwelling prices – urban areas

Index (September 2008=100)



Greek property prices and rents

Index (September 2008=100)



- The decline in activity and prices as well as the surge in unemployment to very high levels have undermined most areas of the property market. Greek house prices have fallen by around 40% from their pre-crisis peak and buyers have shifted toward smaller, older and more affordable homes. Falls in commercial real estate (CRE) values have also been around 40%. Rents have declined sharply with Athens retail rents almost halving and office rentals declining by over 30%.

- This decline in collateral values has put pressure on a banking system already struggling with a jump in the level of overdue loans to around 40% of all bank credit. Almost 30% of mortgage loans are non-performing as are a third of business loans. The legal system makes creditor repossession and resale a long process – and this has been one of the areas targeted for reform by Greece's Euro-zone creditors.

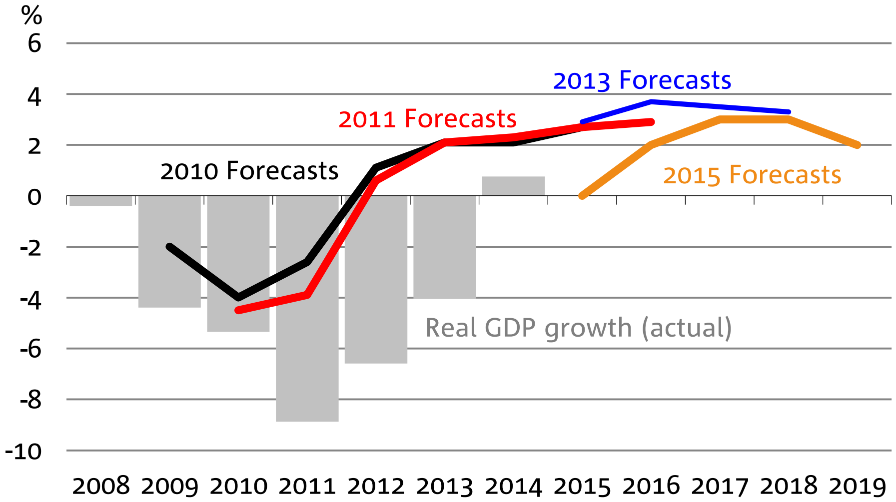
Why did economic activity collapse so fast and fail to recover?

- The IMF and Euro-group severely under-estimated the scale of the downturn that the austerity program would have on the Greek economy. 2010 calculations suggested primary budget cuts worth 12% of GDP would trigger a 3-year recession worth 8.6% of GDP. In event, these fiscal cuts eventually saw output collapse by around 25% – far worse than expected.

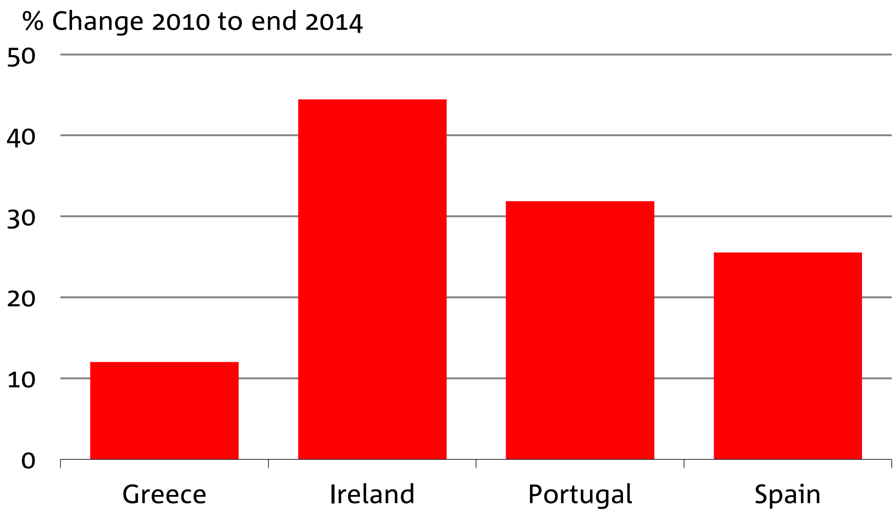
- The IMF and Euro-group were slow to realise the scale of their error, although similar policies of austerity applied in Europe in the 1930s and Argentina in the 1990s had also led to collapsing output and eventually proved politically impossible to sell to the population. Consequently, the high risk of producing an economic depression should have been recognised.

- Part of the problem facing the IMF was that Greece could not devalue its currency and get a boost to its trade. Greek export performance has been disappointing – partly reflecting the shipping, oil and tourism focus of Greek trade which have responded less strongly to cost cutting than in cases like Ireland's multinational high tech export industries.

Greek Real GDP fell further than expected



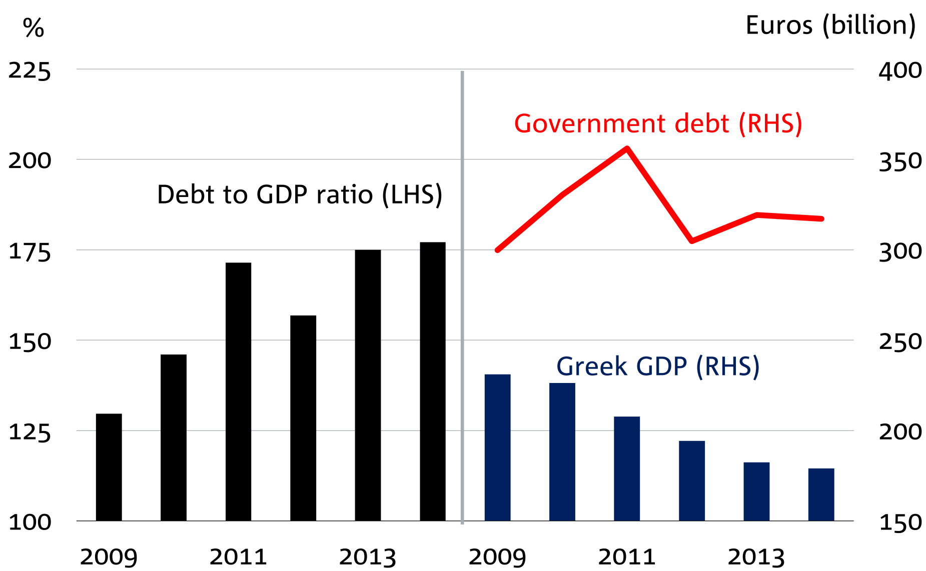
Export volume growth in Eurozone Periphery



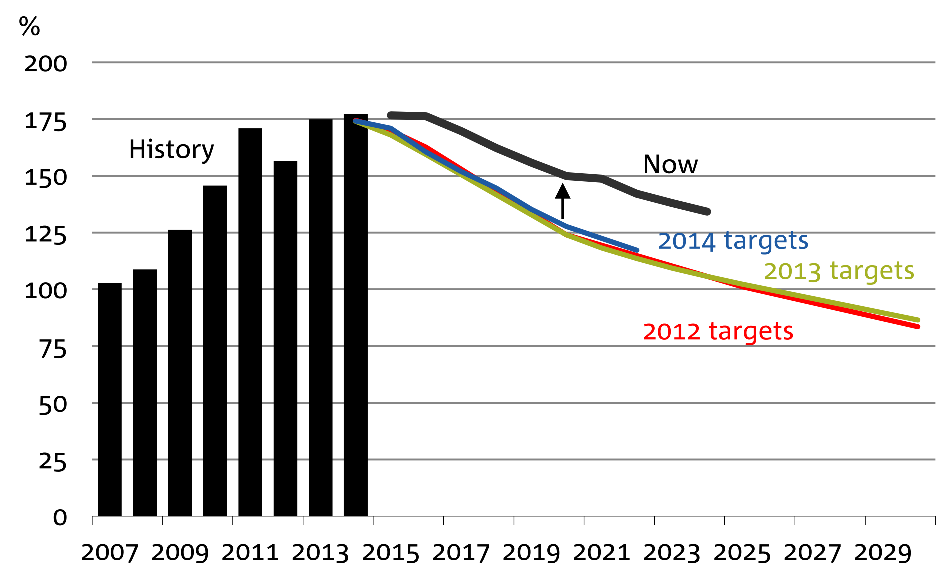
After all the pain, the IMF says Greek debt is still unsustainable

- Despite all the efforts that have been made to improve the budget balance and the creation of a depression, key headline indicators like the government debt/GDP ratio show that the debt situation remains worse than before. The 2014 debt/GDP figure of 177% was higher than before the austerity programs began.
- Even worse, this poor outcome comes after private sector lenders to Greece accepted large write-downs on their loans worth around €100 billion. Officially, Greece's Euro-zone partners have not written down any of their lending but this is an accounting fiction, in reality they have by providing finance on very concessional terms.
- The IMF has concluded that Greek debt is simply unsustainable. Even before any third Euro financial program, the IMF had sharply revised upwards its debt forecasts and was hinting that further Euro concessions in the financing of Greek debt would be required. Since the third program was announced, the IMF has revised the debt/GDP track higher to 200% in the next few years with a still very high ratio of 170% in 2022.
- The failure of all programs to date reflects the lenders initial inability to see that too much austerity delivered too quickly to an economy as weak as Greece would produce an implosion in activity. The debt/GDP ratio has been driven up by a collapse in output, the social consequences of which have sapped public support for the plan.

Greek debt to GDP higher now than pre-austerity



Greek government debt to GDP ratio



Euro partners and IMF have provided sizeable support – and lost patience

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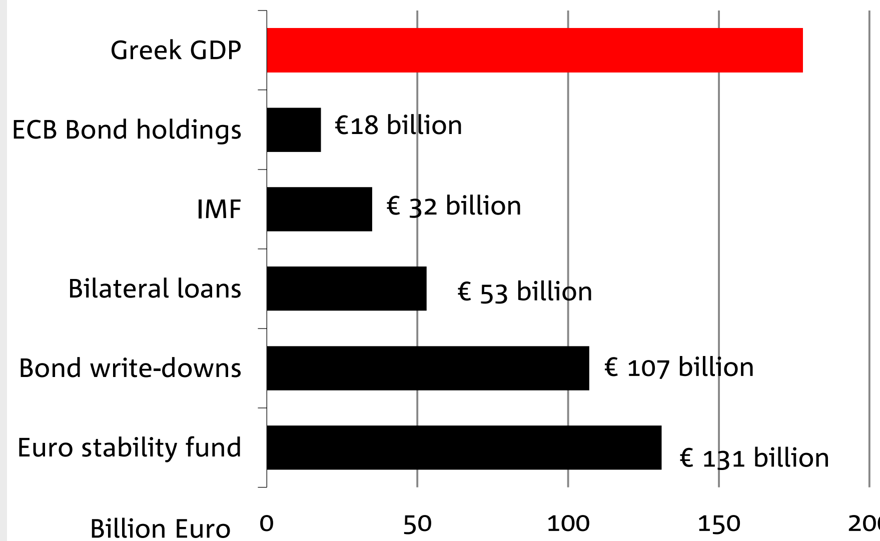
- In total, European partners have already provided Greece almost €200 billion in funding, while the IMF have provided another €32 billion. These programs have come close to breaking the rules surrounding the provision of support funding for both the IMF and Euro area.
- Funding has come at low interest rates (50 bps on $53 bill on bilateral loans; sub 2% on €131 billion EFSF), along with long loan maturities (30+ years). In addition, there were long grace periods – 10 years before repayment plus 10 years interest free on most EFSF loans.
- Eurozone funding provided on very concessional terms – cutting the value of Greek debt to Euro partners by around €90 billion- but this has not been stressed to avoid angering public opinion in creditor countries.
- There is political anger in Germany, Finland and Eastern Europe at the Greek program, based on a belief in some quarters (IMF, Germany) that the Greeks not met some support conditions in past (e.g. on privatization) while low income countries and others who have finished painful austerity programs are also critical of Greece.

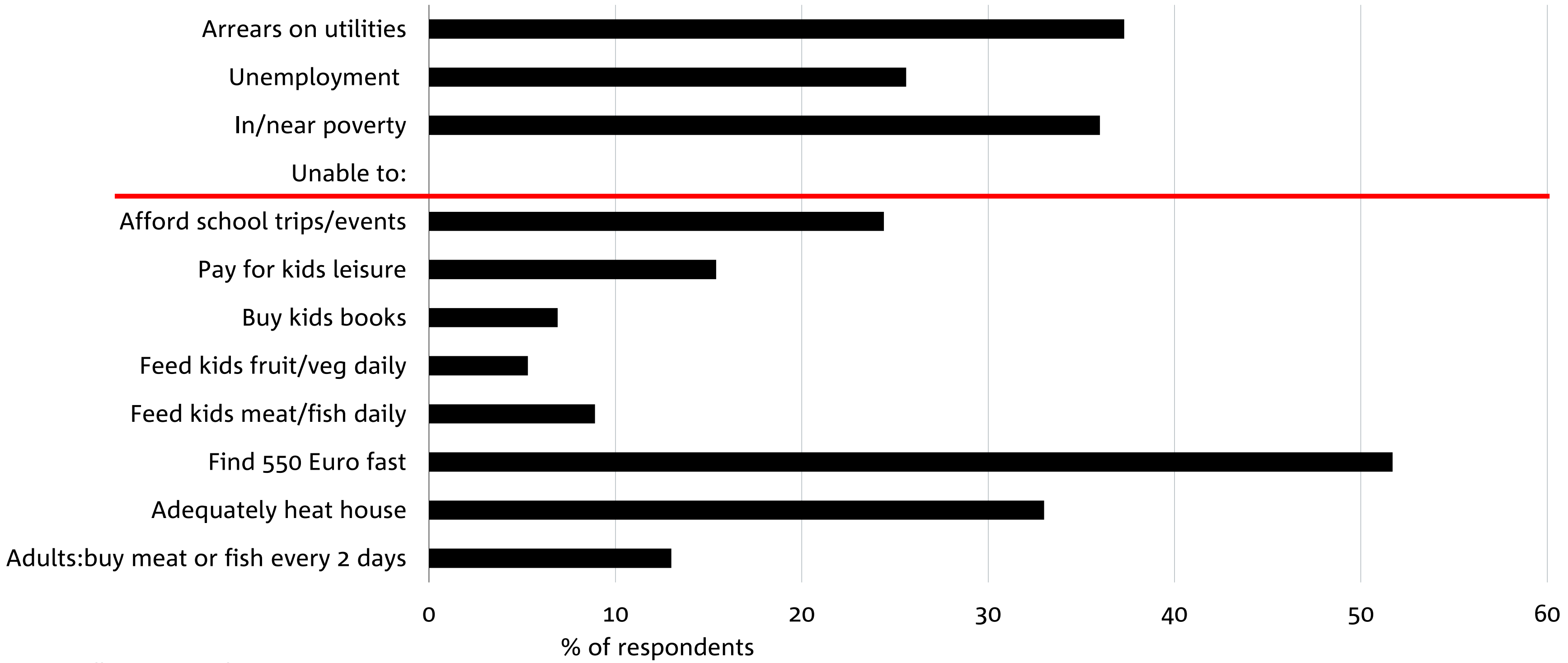
Greek GDP and financial programs



Greek governments have taken many unpopular measures at high social cost

- European financial support came at a heavy price. The Greek government was forced to lift taxes and cut spending (resulting in the budget deficit being cut from 15% to 3.5% between 2009 and 2015). It was also forced to introduce a range of reforms – resulting in pay cuts and sackings of government workers.
- These measures were successful in achieving the goal of a primary budget surplus and European partners had indicated in November 2012 that this could mean further concessions on the funding of Greek debt (although these concessions did not occur).
- This fiscal progress came at a huge social cost – as reflected in the results of the 2014 survey of income and living conditions.

2014 Survey of Income and Living Conditions - % of households surveyed



Source: Hellenic Statistical Agency , NAB Economics

Greece and Euro partners agreement on July 12 2015 – very harsh terms

The 12 July agreement between Greece and its creditors in the Euro-group is a remarkable document which:

(1) Implements yet more austerity – with increases in indirect taxes, cutbacks in pensions and a promise by the Greek government to "re-examine" the changes it implemented that its creditors feel were counter to earlier agreements (some of which involved extra spending).

(2) An extensive array of reforms in sensitive areas – Sunday trading, privatisation of electricity transmission, pharmacy ownership, "milk and bakeries", the reform of collective bargaining and industrial dispute laws in line with "best practice".

(3) Significantly intrudes into Greek sovereignty:

- The Greek Government has to "consult and agree" with the Euro institutions "on all draft legislation in relevant areas" before submitting it for public consultation or to Parliament.
- Greece has to create an independent fund into which "valuable Greek assets" worth €50 billion will be transferred. The proceeds from privatising those assets are to be used in defined ways and, although the Greek authorities will manage this fund, it will be "under the supervision" of European institutions. There is real doubt that the Greek government has assets worth €50 billion that investors would want to buy.
- Greek Governments will have to introduce "quasi-automatic spending cuts" if their budget balance deviates from "ambitious" targets set in talks with its Euro-partners and (probably) the IMF. Again, the prior approval of the Euro-institutions will be required.
- Critics have long focussed on the alleged politicisation, cronyism and inefficiency of Greek Governmental bodies and the July 12 Agreement lists modernising, de-politicising, streamlining and "building the capacity" of public sector agencies.

(4) In return for these changes, the Euro-group costs a third Greek assistance program at €82-86 billion.

This agreement goes well beyond what has been seen in previous Euro-group financial programs, testimony to the "crucial need to rebuild trust with the Greek authorities" that the Euro-group statement mentions twice. Greek economic history shows many examples of sudden policy changes that over-turned key existing monetary arrangements, a lack of consistency and credibility that reflects deep social and political problems.

Greek commentators are bound to notice the obvious parallels between the latest Euro-group statement and the 1898 agreement that a bankrupt Greek state signed with its foreign creditors, following pressure from German bondholders who had lost money in a previous Greek default. This established a creditors committee that had the power for decades to receive and control key tax revenues that were then used to pay interest on the defaulted debt. However, it was also the work of this very creditor committee that enabled Greece to rebuild its financial position, pass much needed monetary and financial reforms, resume foreign borrowing and credibly re-join the Gold Standard in 1910 after a 12 year period of austerity and debt rescheduling.

Why did Greece accept? Because Euro-exit and default is likely alternative

- Having won a General Election by promising to soften austerity, argued for months in the Euro-group against the deal on offer, called and won a referendum that opposed accepting those terms, why would the Greek Government agree to the even tougher terms offered on July 12th?
- Greece entered these negotiations in a far weaker bargaining position than it previously held:
- (a) its Euro-zone partners were far less exposed to a Greek default or exit of the Euro than had been the case before – Governments had used the last few years to build defences to limit contagion to other Euro-zone bond markets and banks had sharply lowered their exposure to Greece. This time the consequences of a Greek exit and default were seen to be more manageable for the rest of the Euro-zone.
- (b) several Euro-zone members were even willing to argue in support of Greece leaving the Euro-zone, their lawyers having found a clause in the European Union Treaty that could (very arguably) have been stretched to permit such an outcome.
- (c) there was real political pressure in several Northern European countries. Any third Greek financial support deal had to be passed by parliaments in capitals like Berlin and Helsinki, where a deal seen as “too soft” on Greece would raise opposition.
- (d) the Greek banking system was weak and reliant on Greek central bank liquidity support to stay open. Greece’s Euro-zone partners could stop the flow of central bank liquidity support by voting against it at the Governing Council of the European Central Bank. The ECB gradually tightened the screws, then stopped the net inflow of new liquidity into the Greek banks and they had to shut their doors.
- (e) political uncertainty, the banking shutdown, Greek default on payments to key official creditors and a renewed decline in Greek business confidence were rapidly undermining the already weak Greek economy – pressuring the Greeks to settle quickly.

Euro-partners' stronger bargaining position - less risk of contagion

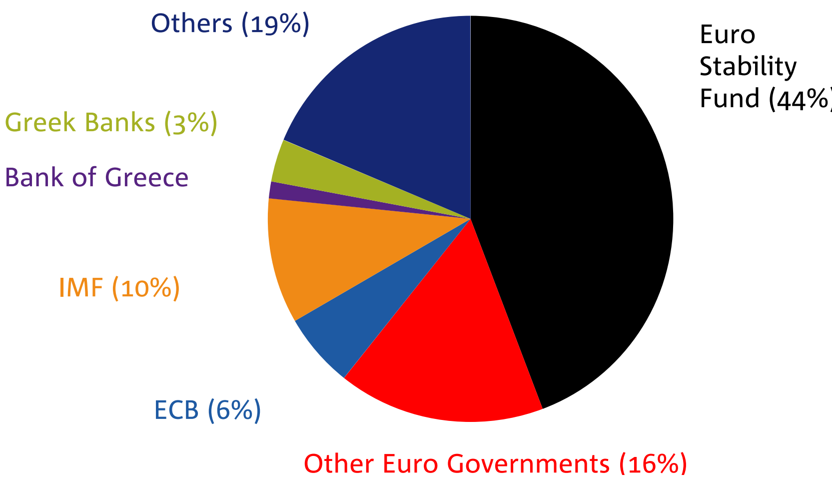
- There has been a significant change in the composition of Greek debt holdings. European institutions now hold two-thirds of the debt, with the IMF holding a further 10%. In contrast, Greek institutions hold 5% and private investors hold less than 20%. This is very different from 2011, when the private sector held the bulk of debt (see over). This means that a Greek default would no longer endanger the balance sheets of European banks – the cost would now mainly fall on other European Governments – so there is much less risk to Euro financial stability than previously.

- The Euro-institutions and their backing governments could probably absorb the cost of a Greek default. It would be expensive (for instance, it could cost France alone €42 billion for loans and another €24 billion to bail out the ECB), embarrassing and politically difficult – but feasible. That said, a Greek default would provide ammunition to political opponents of European integration, who have increasingly argued for populist nationalist approaches in response to the Greek crisis.

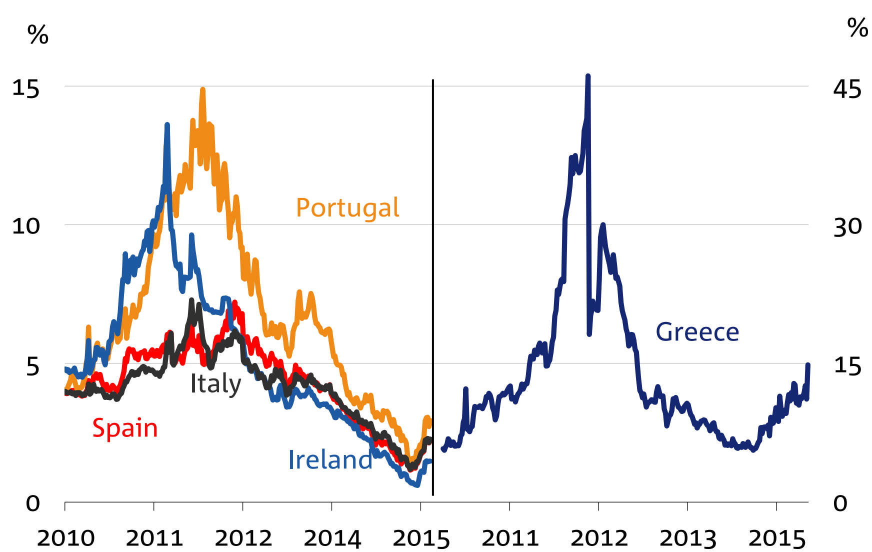
- Euro-zone financial defences against a member's default have been strengthened in other ways. Previously there was little scope for the massive central bank "buyer of last resort" operations needed when markets panicked over a Euro sovereign's credit standing and sent its bond yields sharply higher, threatening a self-fulfilling debt default. The European Central Bank commenced its plans to buy sovereign bonds earlier this year and the European Court of Justice has given the plan the legal green light – so there is now a buyer of last resort for government debt, limiting the risk of self fulfilling debt spirals and the contagion from Greek problems to other Euro peripheral bond markets has been muted.

- Besides these ECB bond support operations, there are now Euro-zone funds created to help cash-strapped governments. The European Stability Fund raises money to lend to Euro governments and raises the money to on-lend at very low interest rates.

Holders of Greek Sovereign Debt 2015



Eurozone periphery 10 year bond yields

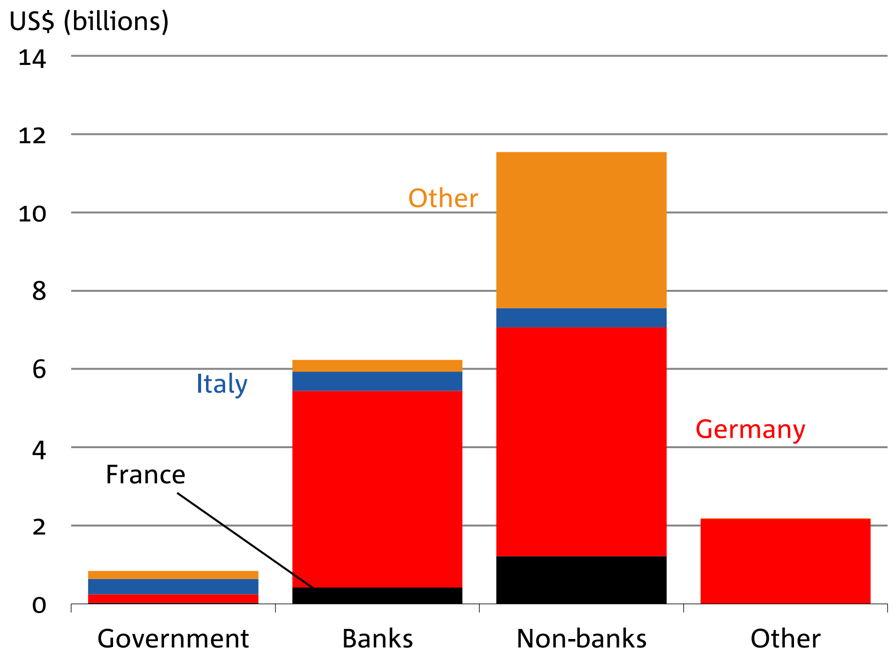


Greek default poses much less threat to Euro-zone banking system

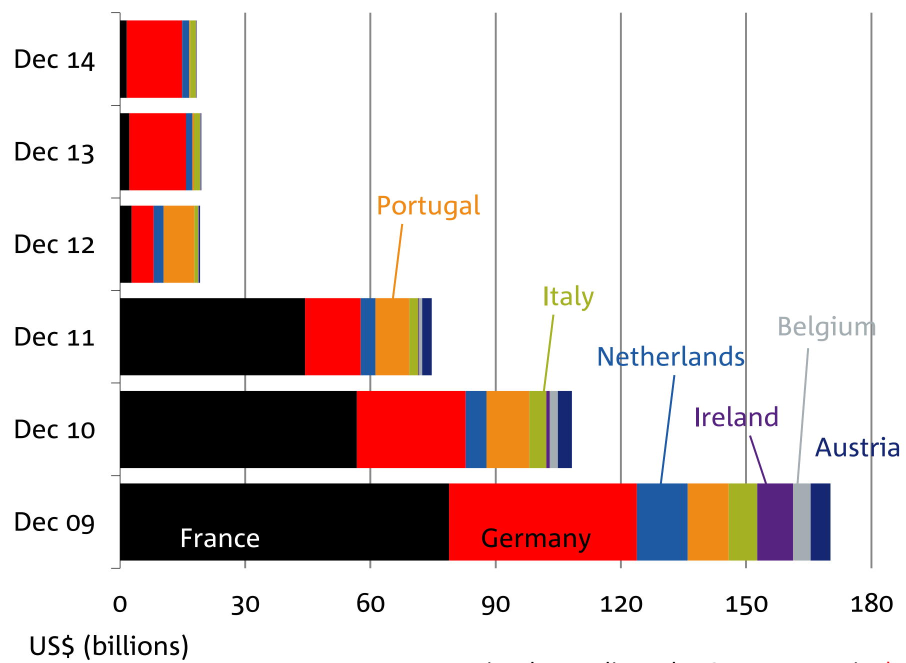
- European banks are much less exposed to Greece than was the case in 2009 and could easily survive the direct consequences of either a Greek default or exit from the Euro-zone. This was not the case in 2010 when a far weaker Euro-zone banking sector also faced the risk of Greek default and Euro exit. The exposure of continental European banks has been cut from around US$170 billion in late 2009 to around US$20 billion now and lending to the Greek Government is only around US$1 billion of that. Even the Cypriot banks, which were very vulnerable at the time of the first Greek crisis, have sharply cut their exposure while the big French banks (which had exposures of almost US$80 billion in 2009) have wound back this sum by disposing of their Greek subsidiaries and taking a write-down on their holdings of Greek bonds when these were restructured. The German banks have the biggest exposure to Greece but again it looks manageable compared to the situation in 2010.

- The UK and US have sizeable banking system exposures to Greece (around US$12 billion and US$13 billion respectively at end 2014, out of a total of US$ 47 billion). The bulk of that exposure is to Greek banks – US$8 billion and US$12 billion of the total is for interbank lending.

Continental Europe Bank Exposure to Greece December 2014



Exposure of Euro-zone Banks to Greece

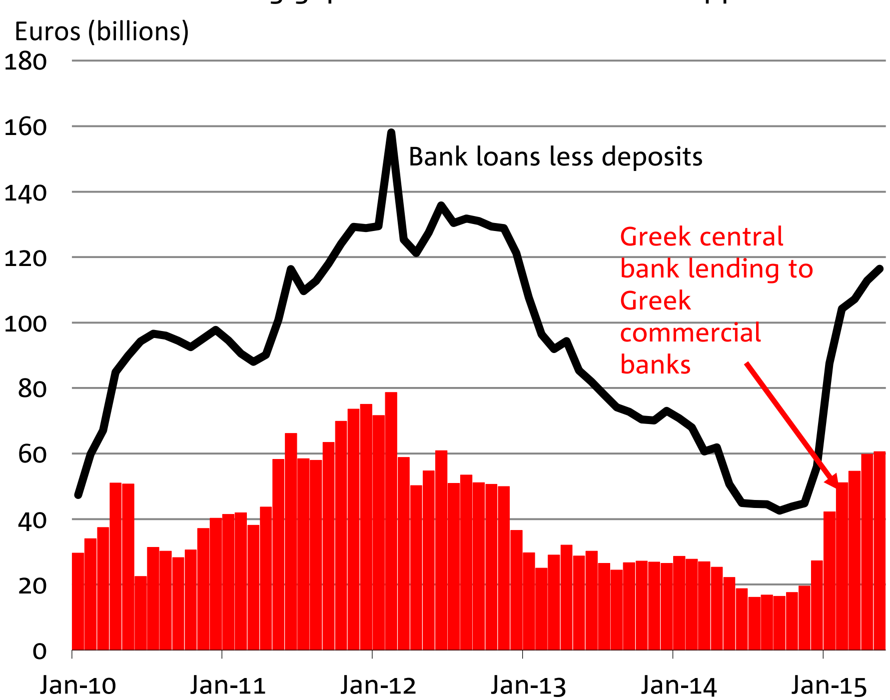


Greek bank reliance on central bank liquidity gives leverage to Euro-partners

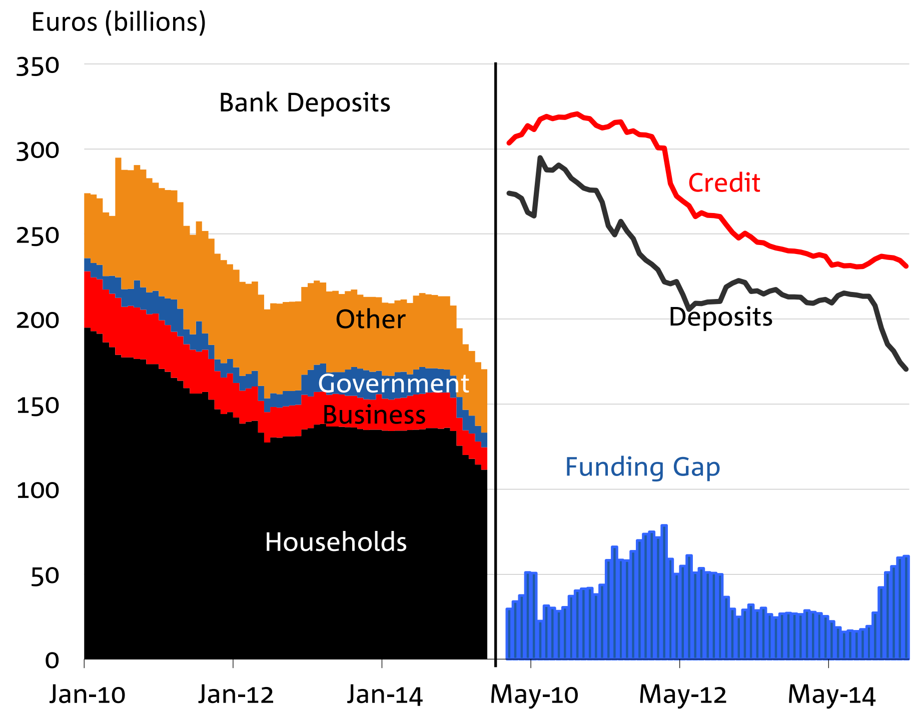
- Financial markets and the Greek public have been concerned that Greece could be forced to leave the Euro-zone and reintroduce a new currency that would probably depreciate heavily against the Euro. If that happened, there is every chance that existing euro-denominated deposits in Greek banks located in Greece would be converted into the new currency and the depositors would see the value of their holdings shrink considerably in Euro terms. This situation had occurred in Argentina after its IMF supported currency peg ended.

- Seeing growing risks, domestic depositor holdings in Greek banks fell from €175 billion in late 2014 to €139 billion in May 2015 with householders running down around €20 billion and non-financial corporates another €7 billion. Greek banks have been shrinking their stock of loans but the loss of deposits easily outstripped the decline in lending – leaving a growing hole in bank balance sheets as the slowly falling stock of existing loans had to funded. To fill the gap, the banks turned to the central banks and once the ECB stopped directly accepting Greek government bonds, only the Greek central bank was left to provide the emergency liquidity. The ECB has the power to limit or prevent the Greek central bank from doing this and tightened the screws before finally capping the funds at €90 billion, at which point the Greek banks had to close and limit depositor withdrawals. The ECB has recently increased the allowed stock of emergency lending.

Greek bank funding gap and Greek central bank support



Greek Banking System Credit and Funding (monthly)



Implications for Eurozone – Euro Finance Ministers pyrrhic victory over Greece

- Despite the creation and use of financial support mechanisms that have delivered considerable financial assistance to Greece and were intended to smooth out the inevitably harsh adjustment that had to follow private investors loss of confidence in the Greek authorities, the handling of the Greek financial crisis has been a major political and presentational failure for the Euro-zone and its institutions.
- The major problems are political and institutional rather than financial. The Euro-group has failed to stabilise the economic situation in one of its smaller economies (despite the considerable assistance provided) as its financial programs were too tough and led to a collapse in activity. The Greek debt to income ratio is higher today than before the funds were provided and the only reason Greece is solvent is because Euro-zone funding is supplied by Governments on concessional terms. This has cut the interest bill on Greek debt but it is not the lasting solution that restoring market confidence and private finance represents. There has also been a write-down of Greek private debt but the ECB and Euro-group resolutely oppose any write-down of the face value of their lending to Greece – despite IMF support for such a move and given its extraordinarily concessional terms, Euro funding to Greece has already been effectively been written down. This episode has to call for a reassessment of the design and execution of both IMF and Euro-group assistance programs in future.
- Key Euro-zone institutions also come out of the Greek crisis with diminished status. In the past, the ECB has threatened to cut-off emergency liquidity assistance from national central banks to cash strapped commercial banks – assistance which comes at the financial risk of the national authorities – to encourage Ireland and Cyprus to sign up to European assistance programs. It has also written letters to previous Spanish and Italian Prime Ministers setting out the reforms it felt necessary to regain investor confidence. These covered changes to local public services, pension systems, collective bargaining and hiring and firing laws, some distance from the ECB's mandate of targeting inflation and helping financial stability. Now the ECB has effectively shut down the Greek banking system and, although it is within its mandate to insist that emergency liquidity only be provided to solvent banks with good collateral, it will be involved in negotiating a new Greek package that again requires reforms a long way from its monetary mandate. Critics of the Euro-project have been quick in the past to accuse the unelected ECB of overstepping its authority and interfering in areas that should be the province of elected governments, now they have even more ammunition.
- Euro-zone leaders and finance Ministers come out of the process facing attacks from their political left and right who say that the entire Euro project is fundamentally undemocratic. It is not just a question of ensuring that a Euro Government – elected with a mandate to oppose austerity and which won a popular referendum opposing such policies – duly implements them against its and its voters wishes on pain of bankruptcy and expulsion from the Euro. That was the price Greece had to pay to stay in the Euro, reopen its banks and have some chance of getting a third European support program – albeit one which prolongs what has already been tried and failed and will probably fail again. The most likely result is eventual Greek insolvency, Euro exit and a replay of the experiences of the 1930s European Gold Block and 1990s Argentina. The wider Euro political problem lies in the encouragement that the way the process was conducted gives to nationalist opponents of the entire European project on both left and right. They will now say it proves that the fundamental design flaws of the Euro-zone are accompanied by its espousal of an ideology based on German principles that is not representative of majority European voter opinion. These critics will add that while this rigid rules based system may now be Euro orthodoxy, it has never faced the test of voter opinion and it is apparently to be enforced ruthlessly by the European institutions. The Euro project has been supported by most voters, but that may begin to change and public opinion shift to see it as potentially damaging to national welfare.

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