Wither Greece & The Euro ?

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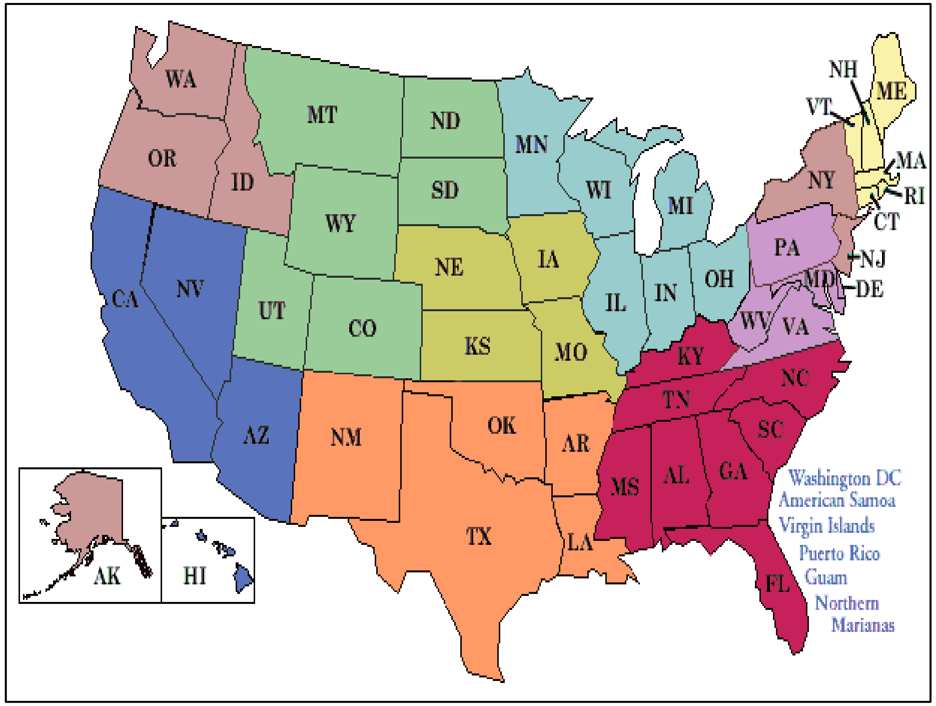
The EU's Problem: Not an Optimal Currency Zone

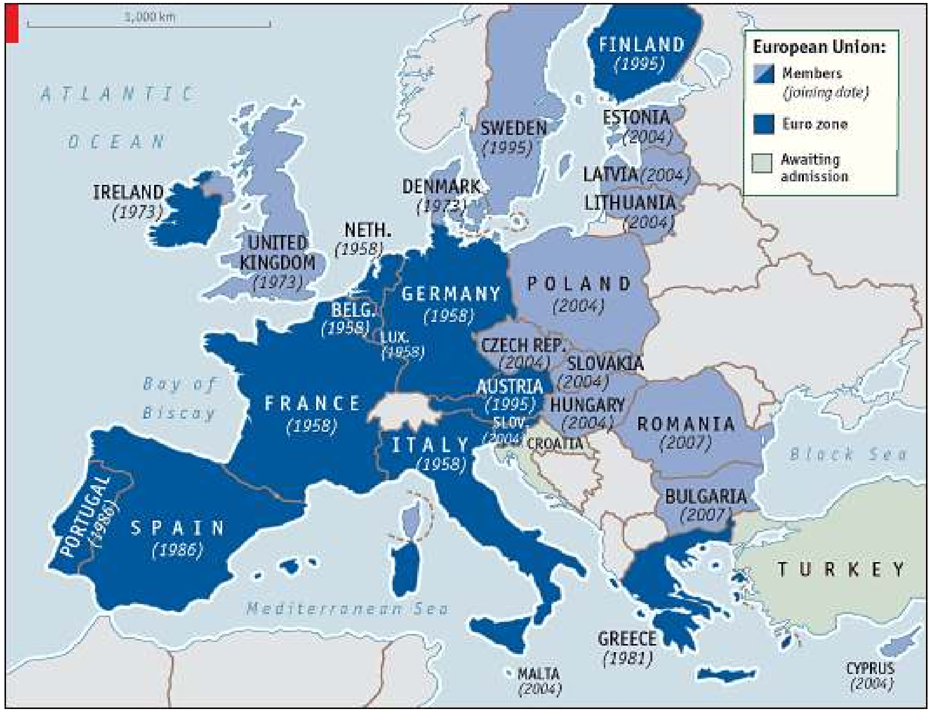
Optimal

- Single Fiscal and Monetary Authority
- Perfect Labor and Capital Mobility
- Cultural and Political Integration

Sub-Optimal

- Single MA but Multiple Fiscal Authorities
- Imperfect Labor and Capital Mobility
- Partial Cultural and Political Integration





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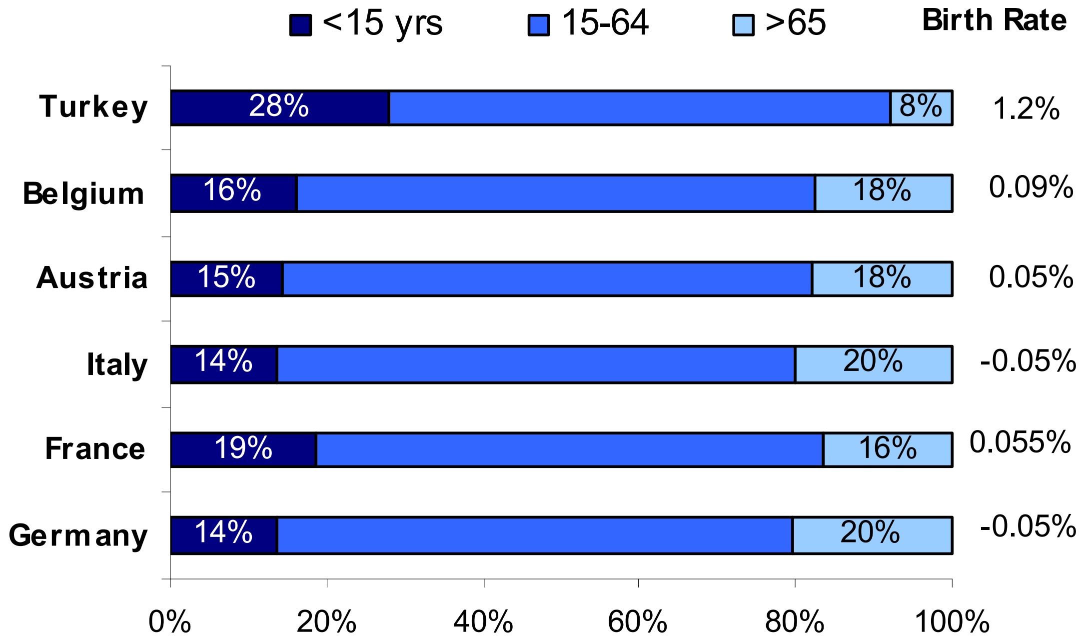
Why Put the Horse Before the Cart ?



- Demographics
  - Old Population
  - Slow Growth

- Relying on Fiscal Rules
  - Budget Deficit -> 3% GDP
  - Public Debt -> 60% GDP

- Paving the Way For Political Union
  - Only a hope

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Greece's Problem: Big Debt and Small Payment Capacity

- Fiscal Profligacy
  - 6.5% Budget Deficit on average (2003-2008)
  - Public debt from 97% (2003) to 125% (2010)

- Lack of Policy Choice
  - One Monetary Policy
  - Strong Euro

- Farce
  - Concealing Fiscal Spending & Massaging Public debt
  - NBG Hiding the Make-up through ECB Funding

Greece's Problem: Big Debt and Small Payment Capacity

- Over-extended Banking System
  - Loan-to-Deposit Ratio for Top 10 = 115%
  - 9% of Liabilities from the ECB On Greek Sovereign Collateral
  - Bleak Rating Outlook

- Weak Demographics
  - Small Population (11 mn)
  - Low Population Growth (0.1%)

Why Betting Against Greece Makes Sense

% GDP (official estimates)	2008	2009	2010	2011
GDP Growth	2,0%	-1,1%	-0,3%	0,7%
Budget Balance	-7,7%	-12,7%	-12,2%	-12,8%
Primary Budget Balance	-3,2%	-7,7%	-6,6%	-6,7%
Gross Public Debt	99%	113%	126%	135%

⇊

Fiscal debt sustainability at Stake...

$$d_t = (r-g)\, d_{t-1} - ps_t$$

where d = public debt-to-gdp

r = real interest rate

g = real economic growth

ps = real primary budget surplus-to-gdp

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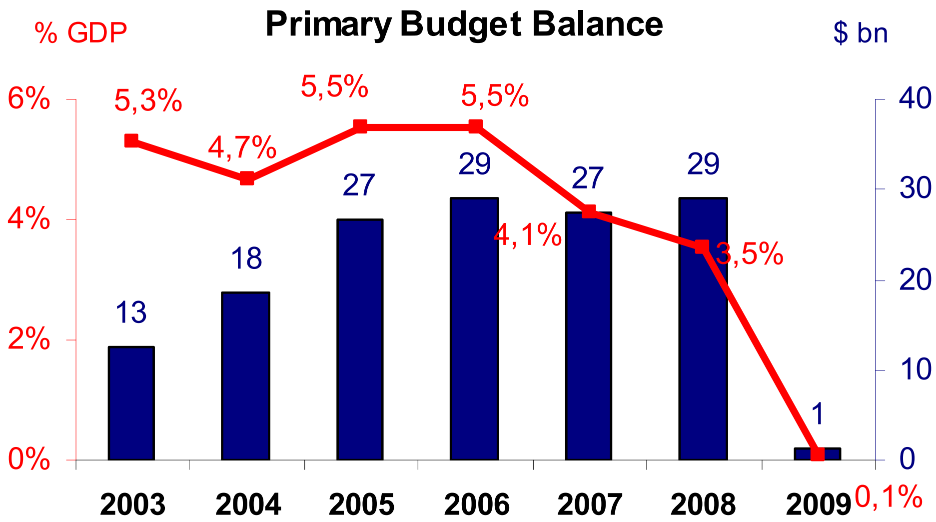
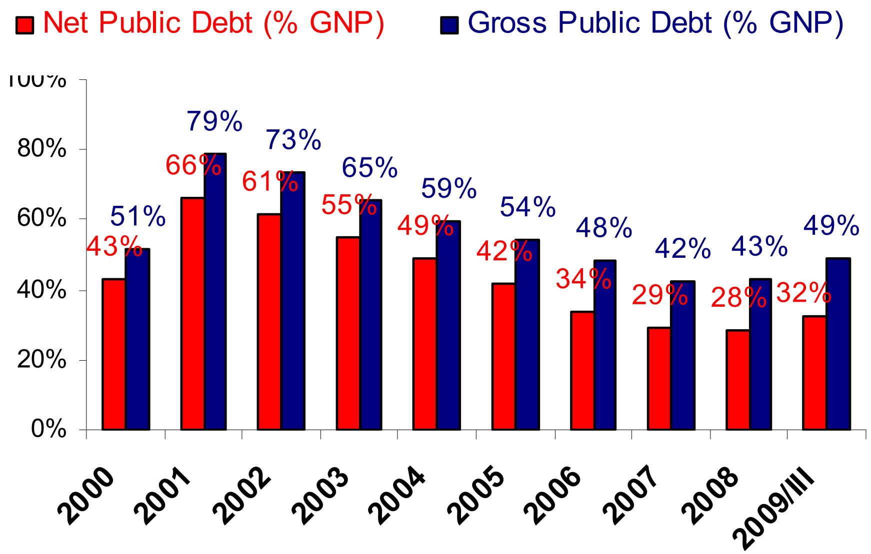
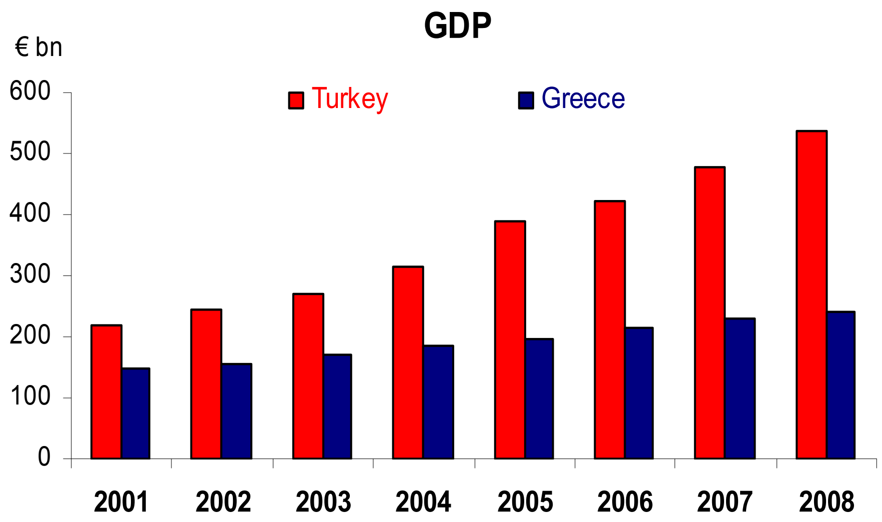
Turkey Did It Before

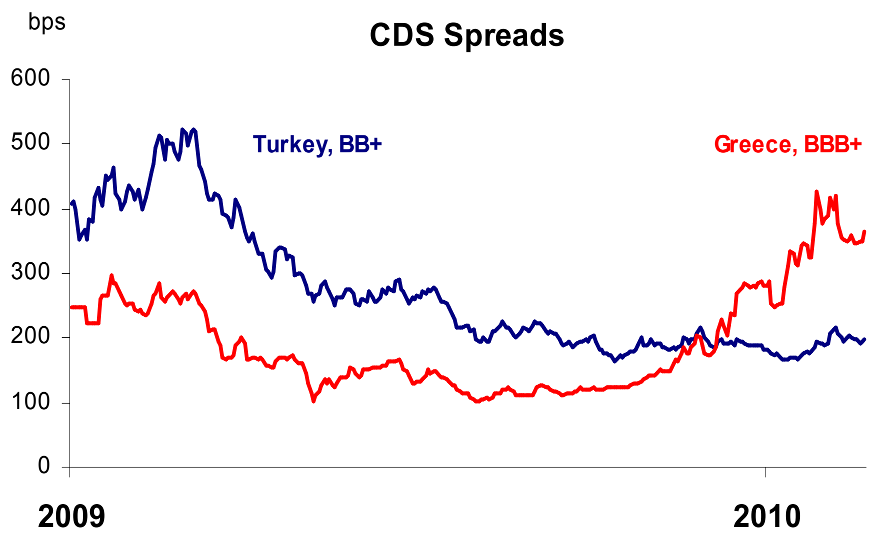
- Brought down Debt-to-GDP to below 50%
  - 7% a year on avg. GDP growth (2003-2007)
  - 5% a year on avg. Primary Budget Surplus (2003-2007)
  - 20% cost of debt financing (real) in 2005 down to 9% in 2010





Turkey vs. Greece: What Made the Difference ?

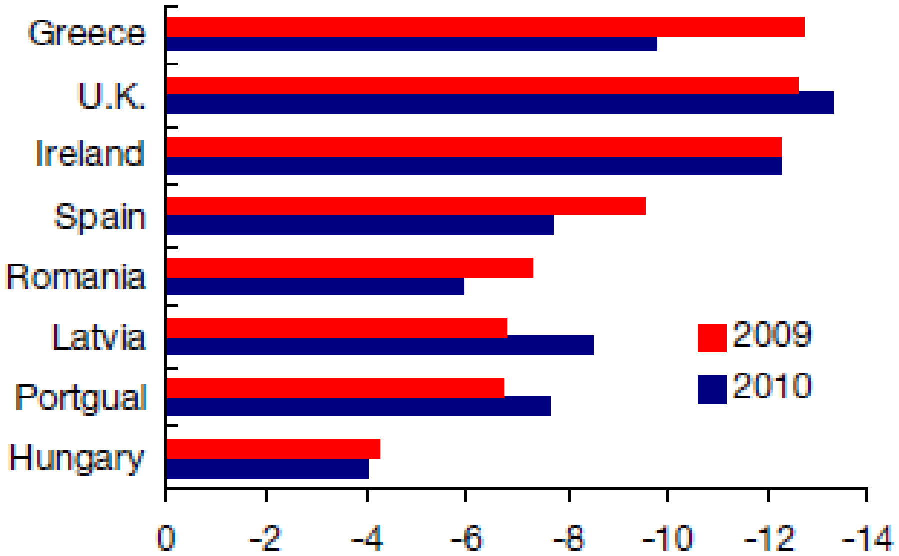




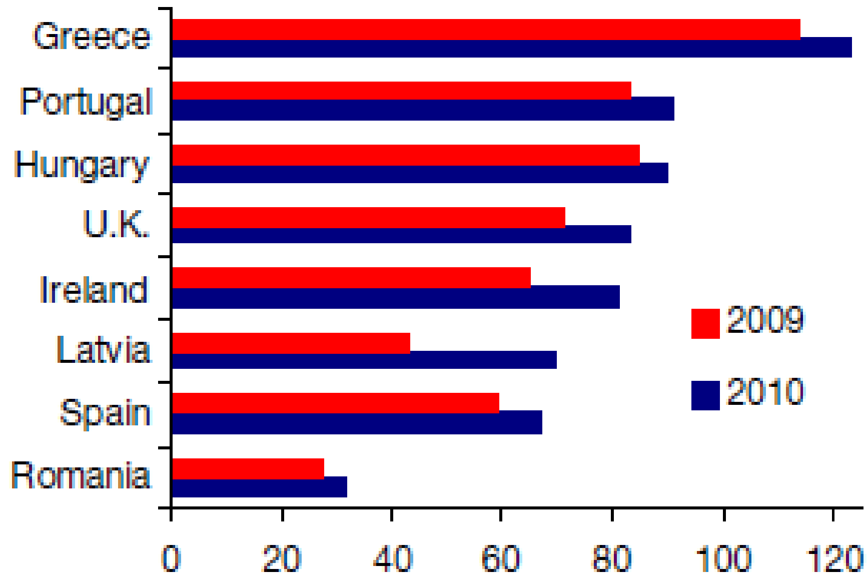
Is Greece the Canary in a Coal Mine ?

- PIIGS (Portugal, Ireland, Italy, Greece, Spain)
  - More high public debt and high budget deficit countries in the zone
  - Could the crisis spill over to the UK and the US ?

Selected European Government Fiscal Deficits
General gov't financial balances, % GDP, OECD est./proj.



Selected European Government Debt Levels
General government debt, % GDP, OECD/IMF est..



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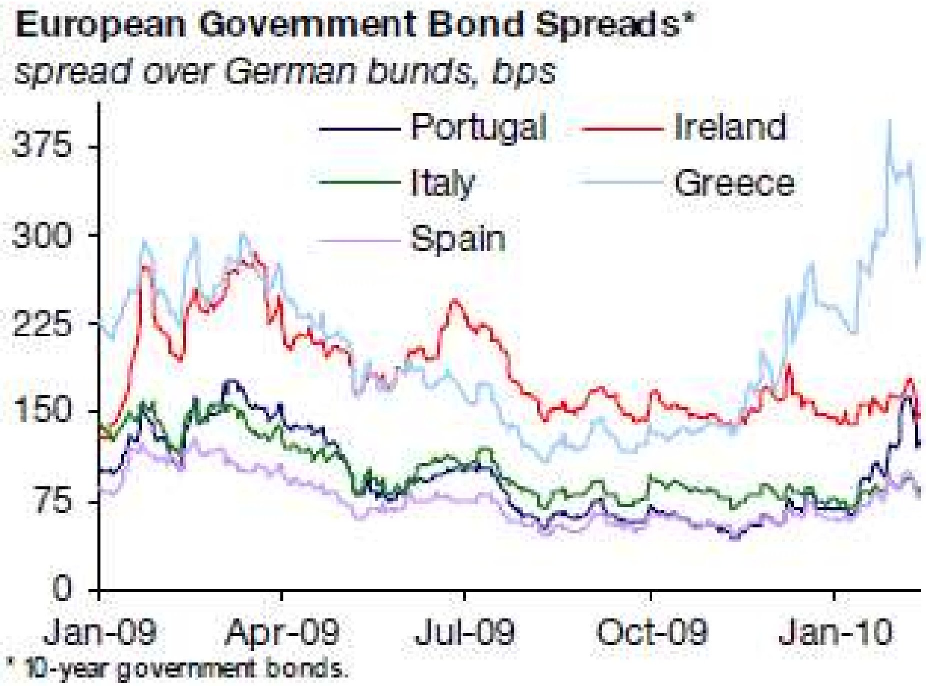
The Markets Think So



Why Should the EU Stand by Greece ?

- Economically Insignificant
  - Greece makes up only 3% Eurozone GDP...
  - Trade ties negligible; Share in German Exports <1%, Italy <2%...
- Domino Effect
  - Worries Spreading to Others, e.g. PIIGS
  - PIIGS Have the Highest Budget Deficit and Public Debt
- Greek Banks’ Exposure in the Periphery
  - $55 bn in the Balkans (TUR, ROM, BUL, MCD, ALB, SER)
  - Further Damage to Eurozone Economic Growth
- Few Alternatives
  - Throwing Greece out has transaction costs

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Why Should the EU Stand by Greece ?

- Bank Exposure

USD bn	Exposure in (BIS, 2009H1)							
Banks	Portugal	Ireland	Italy	Greece	Spain	All Countries	PIGS	PIIGS
Germany	45	184	203	39	238	3462	505	707
France	34	71	483	73	191	3567	370	853
UK	24	184	77	13	50	3689	271	348
Switzerland	4	15	17	59	13	1814	91	108
Europe	227	654	1032	235	857	20018	1974	3006

% in Total	Portugal	Ireland	Italy	Greece	Spain	PIGS	PIIGS
Germany	1%	5%	6%	1%	7%	15%	20%
France	1%	2%	14%	2%	5%	10%	24%
UK	1%	5%	2%	0%	1%	7%	9%
Switzerland	0%	1%	1%	3%	1%	5%	6%
Europe	1%	3%	5%	1%	4%	10%	15%

- Confidence in Euro
  - Macroeconomic Impact of Depreciating Euro

Why it Shouldn’t ?

- **Greek Credibility at Stake**
  - Farce in the Past
  - Democratic Forces at Work

- **Moral Hazard**
  - If Greece Saved, Why Should Others Take Disciplinary Measures ?
  - Germans Paying For Greeks

- **Saving Euro & Eurozone**
  - If Greece can be fixed outside Eurozone, better for Euro
  - See Gideon Rachman piece (FT, Feb 23, 2010, p9: Greece Threatens more than Euro)

What if the Tail Wags the Dog ?

- Eurozone Fiscal Outlook Will Be Questioned
  - German and French Fiscal Outlook Not Tolerant of a Heavy Subsidy
  - Public Debt 77% and 83%, Budget Deficit 5% and 8% in 2010

- Euro Will Depreciate Further
  - Will Force ECB To Exit
  - Will Theraten Eurozone Stability

- Global Recovery Will Be Derailed
  - US, UK and Japan Will Be Questioned
  - Global Confidence Will Weaken

Solutions Offered

- Otmar Issing (former ECB Exec.), Martin Feldstein (Harvard)
  - Greece needed to abide by the rules. Don't tolerate breaching the rules, don't bail-out Greece, ask Greece sort out its own mess.
  - Let Greece take a holiday from the zone until fixing its problems, Drachmi/€=1.3, gain competitiveness and decrease debt.

- Tommaso Padoa-Schioppa (former ECB Exec.), Samuel Brittan (FT)
  - Don't leave Greece alone. Find a mid-way.
  - Use "Exit" as last resort. Internal devaluation (=Reduce wages).

- Daniel Gros (CEPS) & Thomas Mayer (Deutsche Bank)
  - Establish an European Monetary Fund financed by those breaching the rules.
  - Finance back those in times of difficulty if agrees with an adjustment programme.

- George Soros
  - Euro construction is patently flawed. Issue jointly guaranteed eurobonds to finance 75% of the maturing debt. But what if the others ask for the same ?
  - More intrusive mointoring and institutional arrangements needed to save Euro