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
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
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

<table>
<thead>
<tr>
<th>% GDP (official estimates)</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP Growth</td>
<td>2,0%</td>
<td>-1,1%</td>
<td>-0,3%</td>
<td>0,7%</td>
</tr>
<tr>
<td>Budget Balance</td>
<td>-7,7%</td>
<td>-12,7%</td>
<td>-12,2%</td>
<td>-12,8%</td>
</tr>
<tr>
<td>Primary Budget Balance</td>
<td>-3,2%</td>
<td>-7,7%</td>
<td>-6,6%</td>
<td>-6,7%</td>
</tr>
<tr>
<td>Gross Public Debt</td>
<td>99%</td>
<td>113%</td>
<td>126%</td>
<td>135%</td>
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</tbody>
</table>

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
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

![Primary Budget Balance Graph](image-url)

![Debt-to-GDP Graph](image-url)
Turkey vs. Greece: What Made the Difference?

GDP

- Turkey
- Greece

CDS Spreads

- Turkey, BB+
- Greece, BBB+

DenizBank
FINANCIAL SERVICES GROUP
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?
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
Why Should the EU Stand by Greece?

### Bank Exposure

<table>
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<tr>
<th>USD bn</th>
<th>Exposure in (BIS, 2009H1)</th>
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<tr>
<td>Banks</td>
<td>Portugal</td>
</tr>
<tr>
<td>Germany</td>
<td>45</td>
</tr>
<tr>
<td>France</td>
<td>34</td>
</tr>
<tr>
<td>UK</td>
<td>24</td>
</tr>
<tr>
<td>Switzerland</td>
<td>4</td>
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<tr>
<td>Europe</td>
<td>227</td>
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<table>
<thead>
<tr>
<th>% in Total</th>
<th>Portugal</th>
<th>Ireland</th>
<th>Italy</th>
<th>Greece</th>
<th>Spain</th>
<th>PIGS</th>
<th>PIIGS</th>
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</thead>
<tbody>
<tr>
<td>Germany</td>
<td>1%</td>
<td>5%</td>
<td>6%</td>
<td>1%</td>
<td>7%</td>
<td>15%</td>
<td>20%</td>
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<tr>
<td>France</td>
<td>1%</td>
<td>2%</td>
<td>14%</td>
<td>2%</td>
<td>5%</td>
<td>10%</td>
<td>24%</td>
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<tr>
<td>UK</td>
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<td>5%</td>
<td>2%</td>
<td>0%</td>
<td>1%</td>
<td>7%</td>
<td>9%</td>
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<tr>
<td>Switzerland</td>
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<td>1%</td>
<td>3%</td>
<td>1%</td>
<td>5%</td>
<td>6%</td>
</tr>
<tr>
<td>Europe</td>
<td>1%</td>
<td>3%</td>
<td>5%</td>
<td>1%</td>
<td>4%</td>
<td>10%</td>
<td>15%</td>
</tr>
</tbody>
</table>

### 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 monitoring and institutional arrangements needed to save Euro