MACROECONOMIC ADJUSTMENT AND ECONOMIC CHANGE

REDESIGNING GREECE?

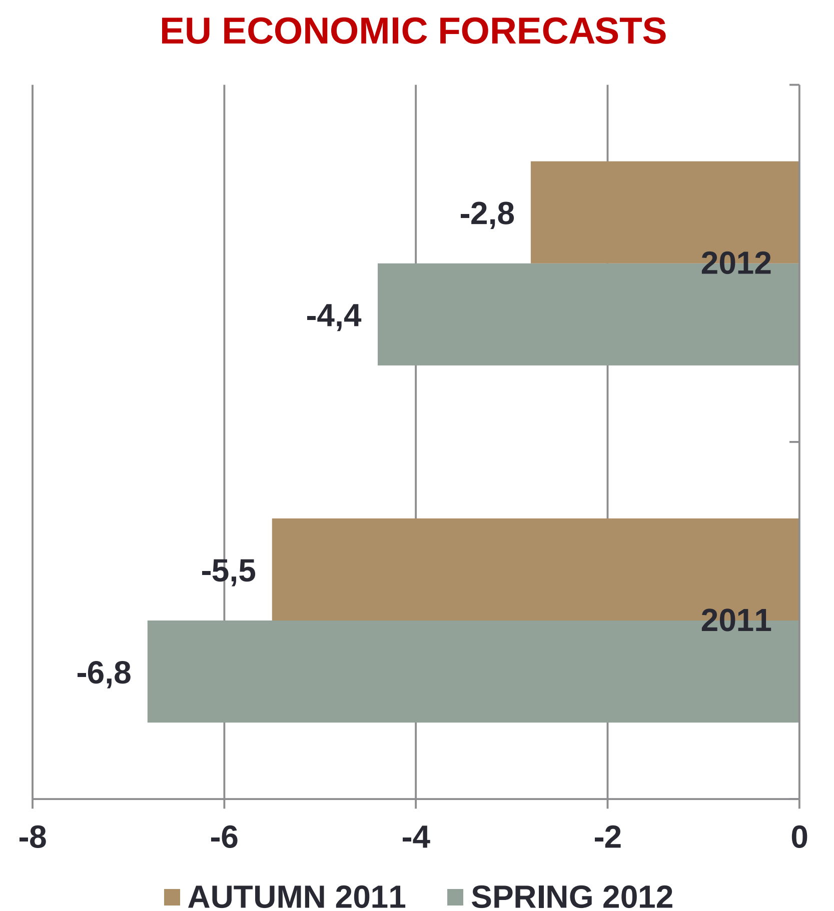
S. TRAVLOS APRIL 2012

A DIFFICULT MACROECONOMIC ENVIRONMENT

2012: STRUCTURAL REFORM OR NEED FOR THIRD RESCUE PACKAGE AND POSSIBLE GREXIT

MACROECONOMIC ENVIRONMENT

- The economy continues to shrink at an increasing pace.
- EU forecasts revised downwards for 2012 to -4,4%.
- Unofficial forecasts suggest that GDP may contract in 2012 by as much as 7% if no compensatory measures are taken.
- In the five year period 2008-12, **26.6** billion euro of GDP in constant prices have been lost.



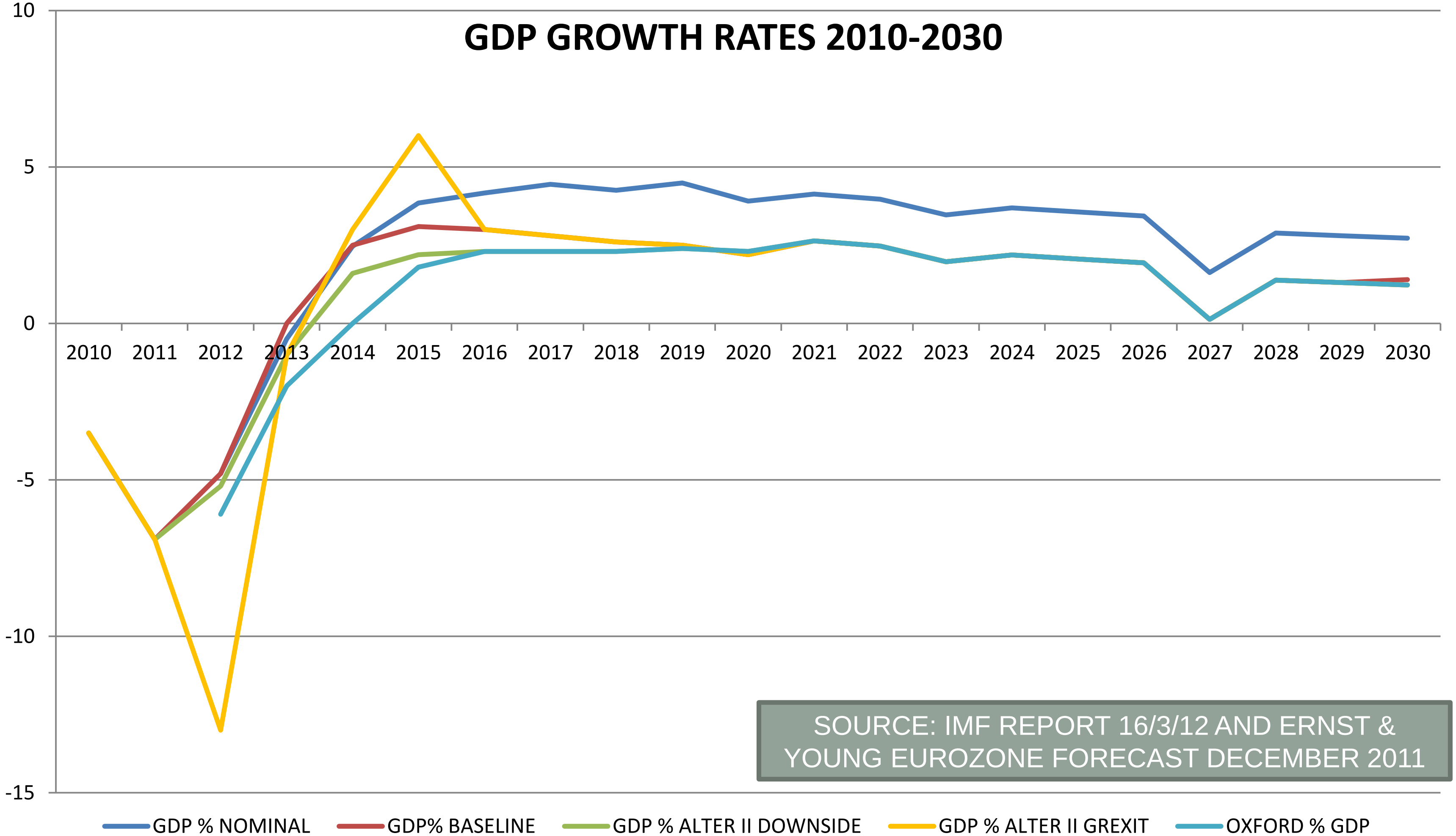
PSI AND NEW LOAN AGREEMENT

- Greece has agreed with EU-ECB-IMF the new loan arrangement.
- The agreement on the part of the creditors involves:
  - PSI with private creditors taking a nominal haircut of 53.5% or about 75% in present value terms.
  - New official loans
  - Increased monitoring on implementation
- And on the part of Greece:
  - Further fiscal consolidation with cuts of 3 billion euro for fiscal 2012 and more measures for 2013 and 2014 to be agreed in June 2012.
  - Spending review of pensions, health, local authorities and defense will be completed by June 2012.
  - More structural reforms mainly in the labor market reducing minimum wages and in the opening up of product markets.
  - A revised more realistic privatization program
- Greece is under increasing pressure to show results. Speed of implementation is of paramount importance with specific deadlines set for results.

NOT THE END OF THE MATTER?

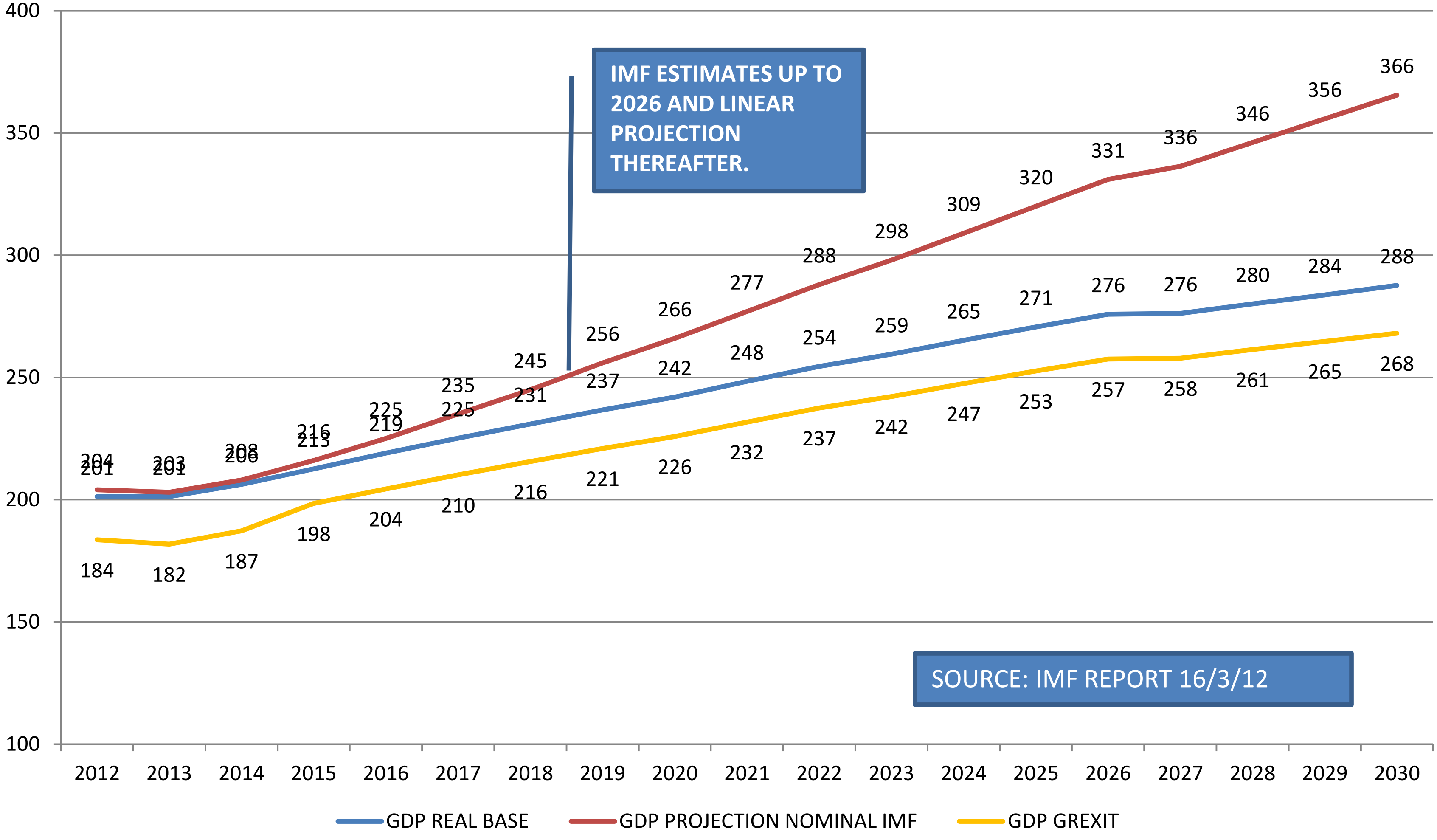
- The current loan agreement and the PSI may not represent the final solution for Greece.
- Debt dynamics are highly sensitive to the policy mix that Greece is implementing. As depression sets in and growth is postponed fiscal stabilisation becomes elusive: tax receipts fall spending is increased to cover unemployment benefits and pensions.
- Official calculations indicate that another 50 billion of aid may be required after 2015 if the current economic trends continue unhanged.
- A return to growth is of paramount importance for the next 12 to 18 months in order to avoid default and/or the need for additional aid package.
- The crucial events to watch are:
  - Greek Elections by the end of April or early May,
  - French elections in May and,
  - The establishment of the permanent rescue mechanism or European Stability Mechanism in July.
- By July 2012 the new program will have enough time to prove whether there is a possibility for reversing decline and improving sentiment in the markets. If not, with the mechanism in place, Europeans will be increasingly confident about being able to confront contagion from a Greek default. There is also a downside risk of failing to prevent an accident as Europeans continue to be conservative on the level of funding of the ESM and as other countries fail to recover contagion may be difficult to prevent.
- **A third support package for Greece in the next 8 to 12 months remains still a more likely possibility than GREXIT**.

RETURN TO GROWTH IN 2013 OR 2014?

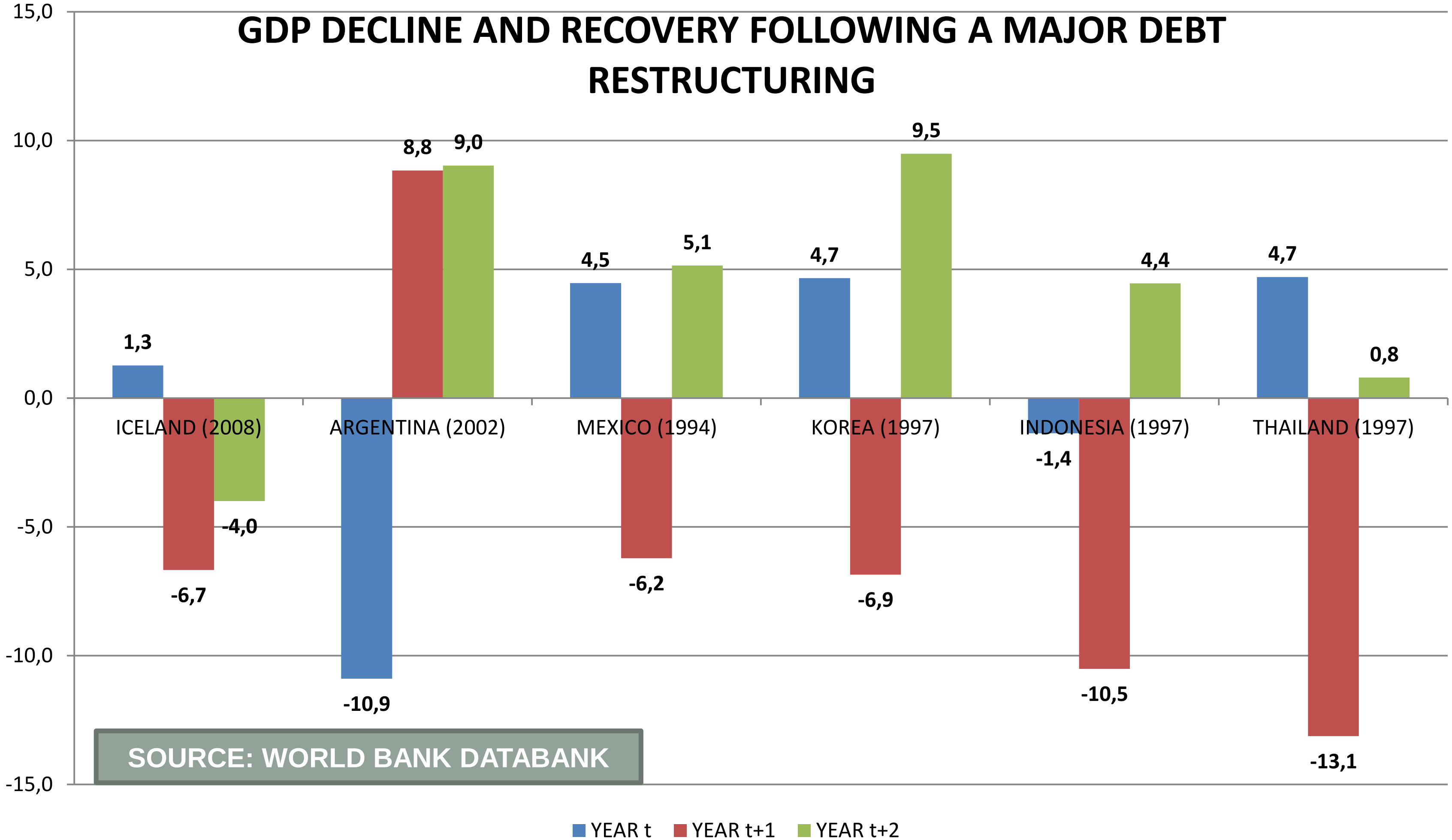


SOURCE: IMF REPORT 16/3/12 AND ERNST & YOUNG EUROZONE FORECAST DECEMBER 2011

GDP EVOLUTION UP TO 2030

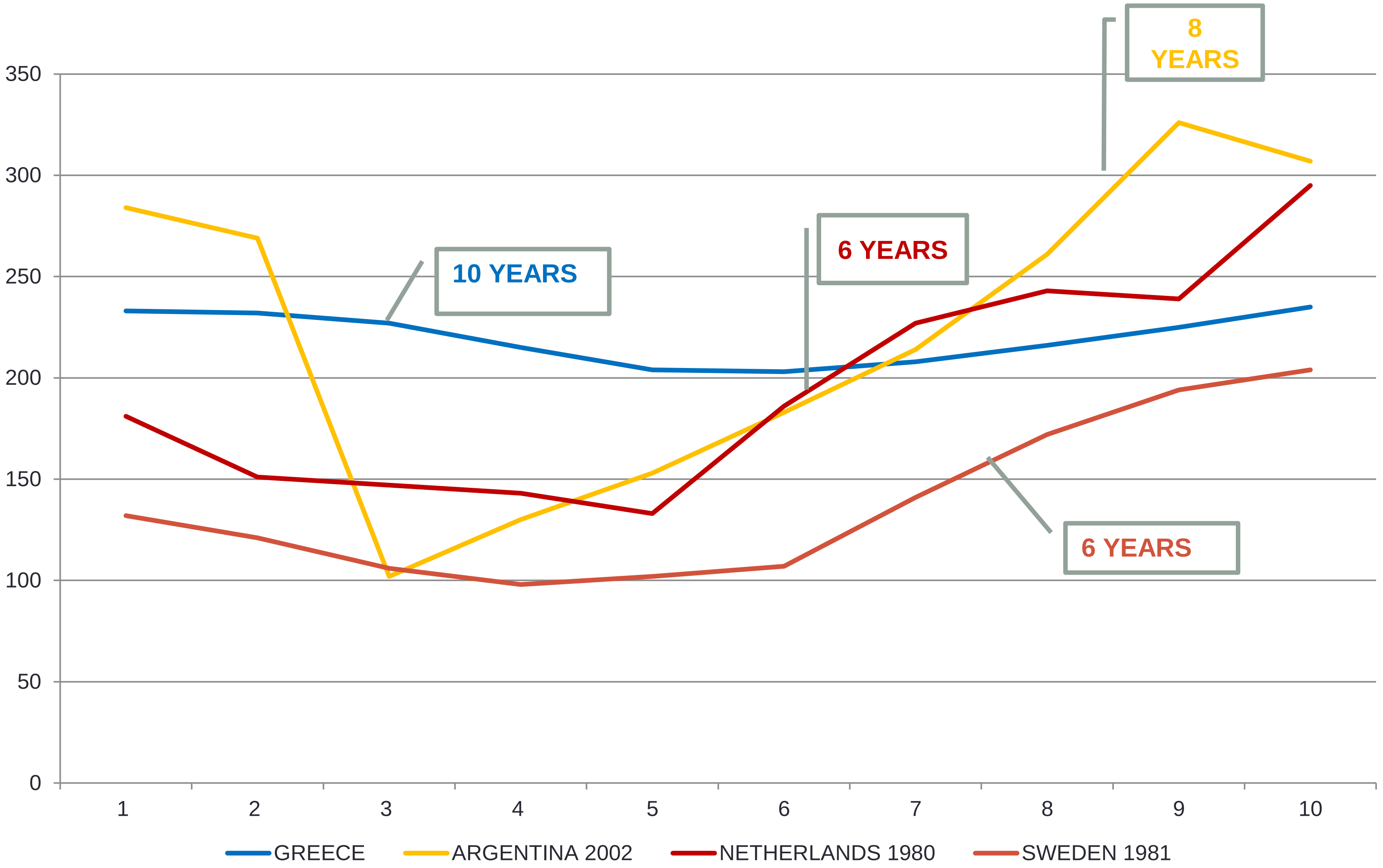


WHAT HAPPENS IF GREXIT OCCURS?

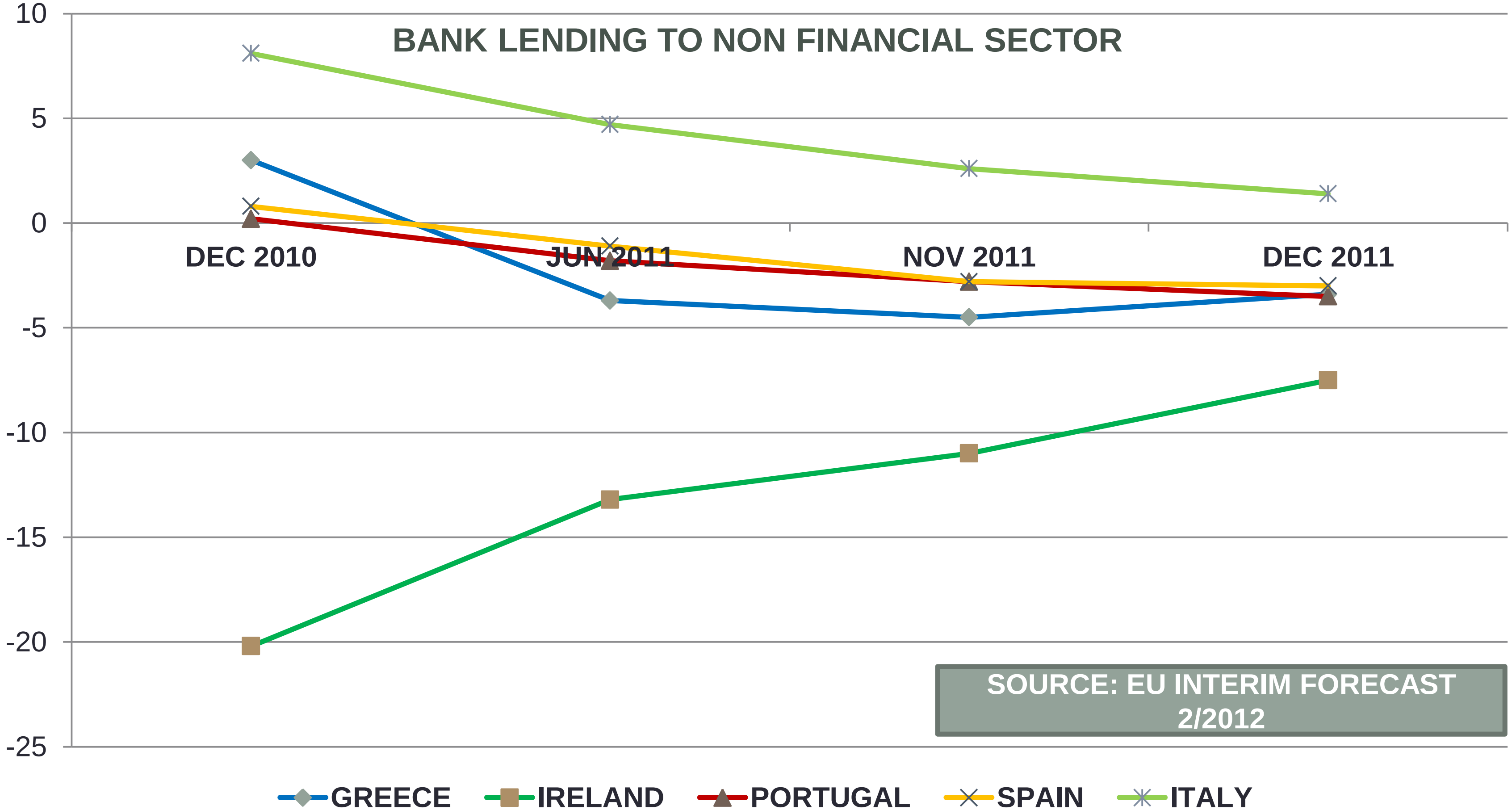


SOURCE: WORLD BANK DATABANK

LONG WAY TO RECOVERY

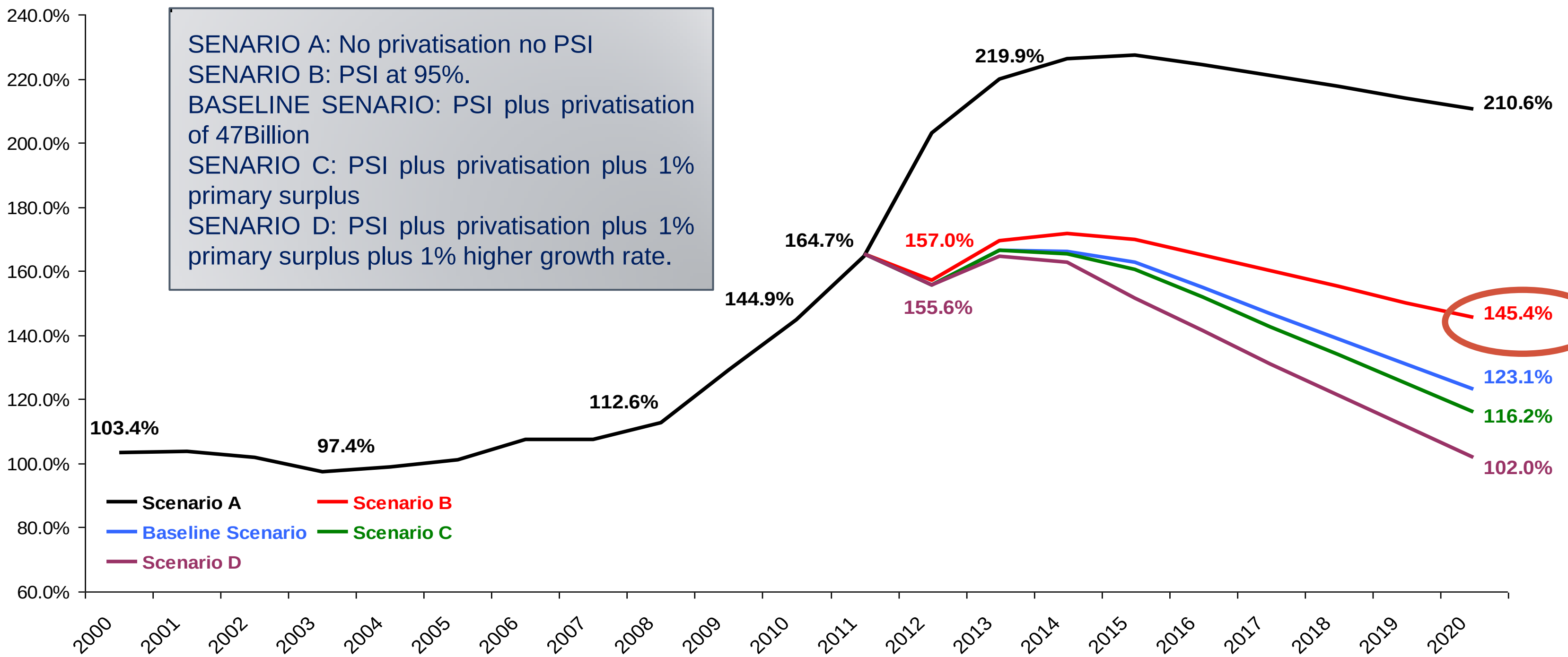


CONTRACTION IN LIQUIDITY CONTINUES



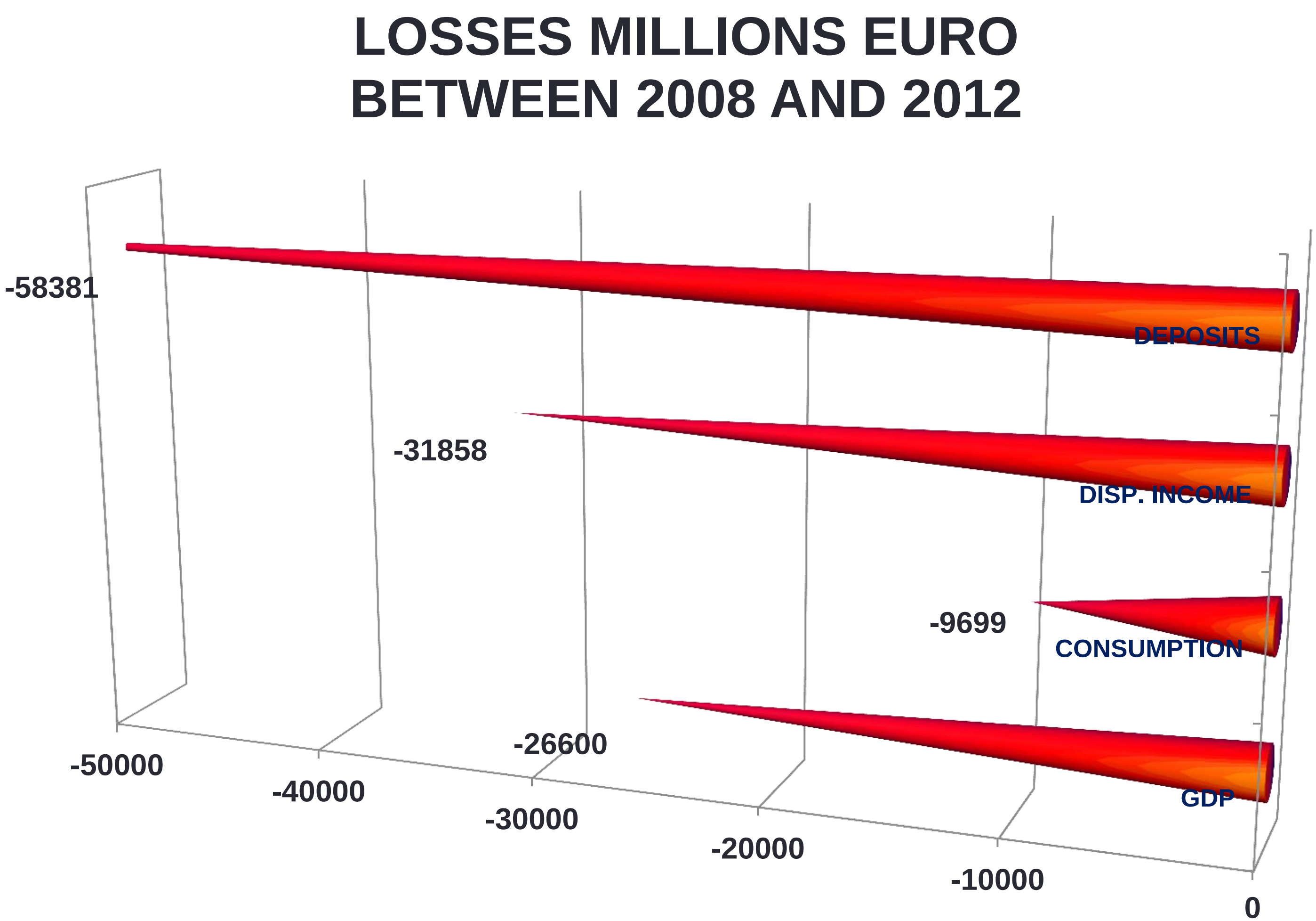
UNPREDICTABLE DEBT DYNAMICS

Debt dynamics highly sensitive to future growth rates and privatisation receipts.

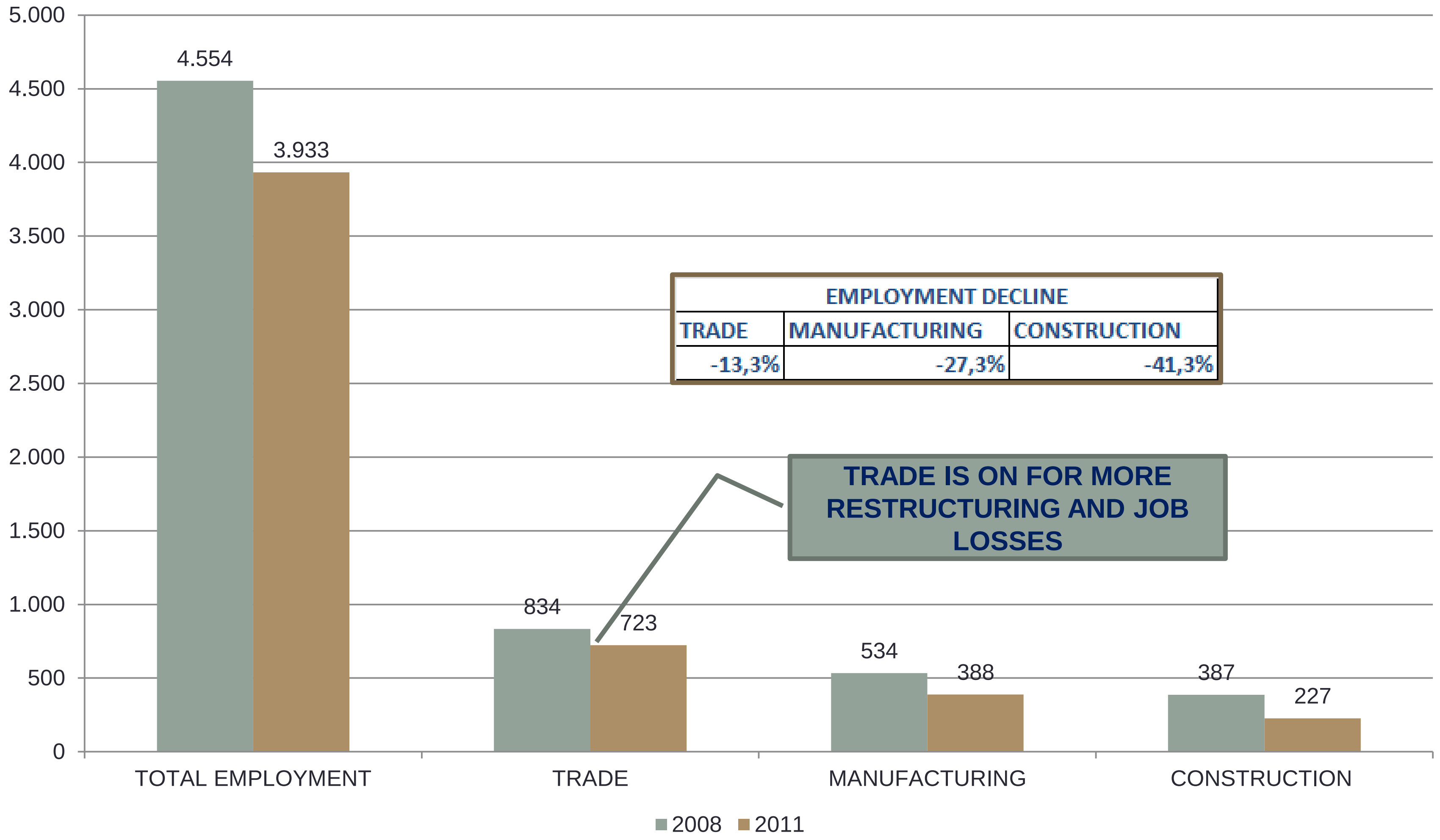


SOURCE: IMF and IOBE (2012)

WHAT WE HAVE LOST SINCE THE OUTSET OF THE CRISIS?



WE HAVE LOST 621 THOUSAND JOBS IN 2008/2011



POLICY PRIORITIES

GREECE REQUIRES A NEW PLAN

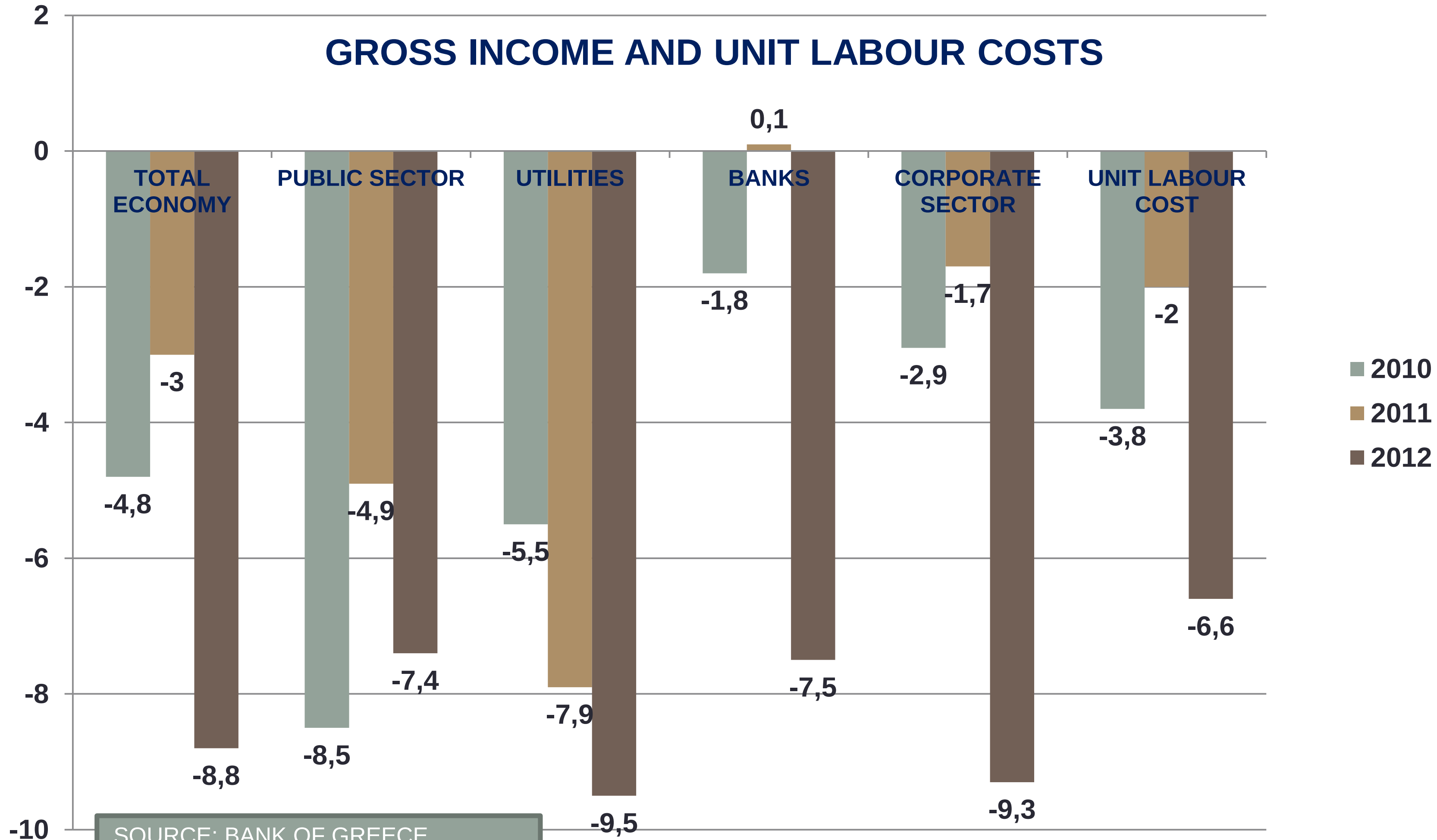
GREECE PRIORITIES

- Greece must return as soon as possible to a growth path for the debt reduction to be sustainable.
- A growth dynamic will be created by:
  - Structural reforms improving non price competitiveness
  - Wage reduction restoring price competitiveness
  - Improved liquidity of the financial system
  - Inflow of investment through privatizations
  - New investment in certain sectors especially raw materials extraction
  - Development of innovation
- European and Asian countries are encouraging their corporations to invest in Greece with Germany Russia and China taking the lead.
- However, the business environment requires a major overhaul in order to attract serious foreign investors.

STRUCTURAL REFORMS HAVE BEEN SET OUT CLEARLY IN THE SECOND MOU

- Overregulated goods, services & labor markets, and more than 250 restrictions on private investment and entrepreneurship undermine competitiveness.
- The average profit margin in the non-tradable goods & services sector is 15% higher than the relevant eurozone margin, while in the labor market the margin is 10% higher (vs. Eurozone).
- Serious Investment Impediments include Environmental licensing and Land Use legislation.
- The second MOU sets specific targets for speeding up private land development and reducing bureaucratic obstacles to business development.

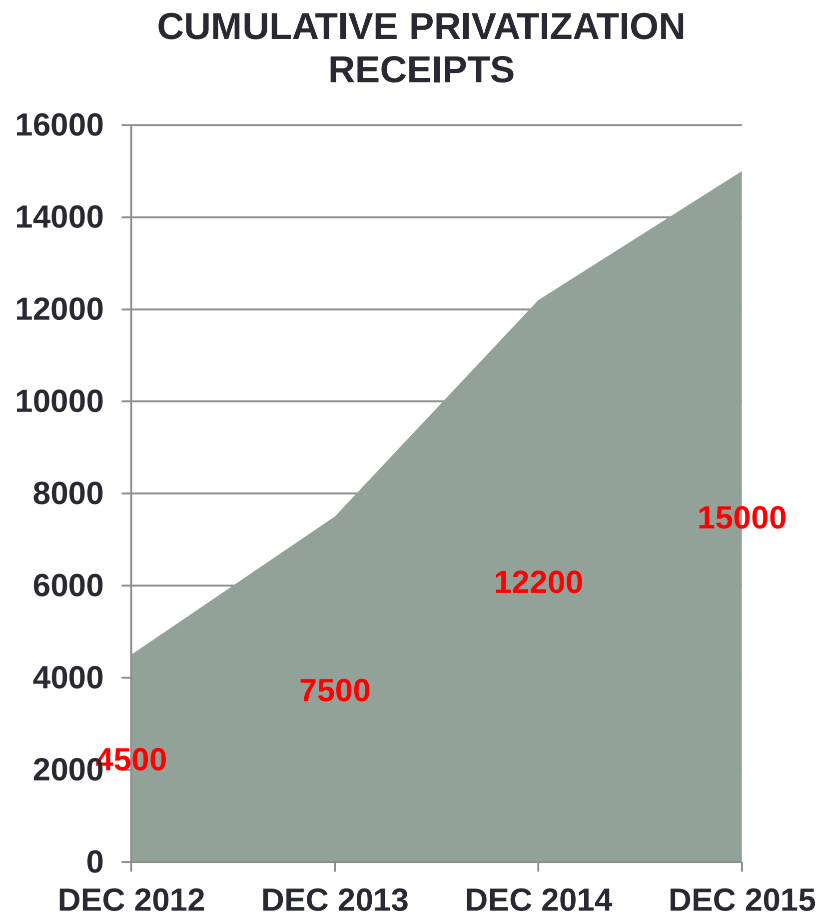
A FASTER ADJUSTMENT IN LABOUR MARKETS WILL OCCUR IN 2012.



SOURCE: BANK OF GREECE MONETARY POLICY REPORT 2012

PRIVATISATIONS ONCE MORE DOWNSIZED

- Greece must raise 15 billion euro from asset sales until 2015 a modest target compared to the initial estimates.
- But the Fund is now better prepared.
- About 3 billion euro of assets will have to be sold by the year end of 2012.
- Top priorities in 2012 include:
  - Public Gas Corporation
  - Hellenic Gas Transmission System Operator
  - Hellenic Petroleum
  - Hellinikon real estate
  - Athens international Airport



ASSETS STRUCTURE AND QUALITY NOT UNIFORM

- Greek state assets are not uniform:
  1. Listed corporations: Well managed with transparent accounts but with some rigidities of the past remaining in labor relations and concessions to customers (Public Power Corporation, Athens Water Company, Organization of Football Prognostics. Pireas Port Authority, Hellenic Petroleum).
  2. Non listed profitable and dominant in the market: Relatively well managed possibly lacking the resources for future growth (Athens International Airport, Public Gas Corporation, Hellenic Gas Transmission Corporation, PPC Power Stations).
  3. Prime land for world level development projects: Planning framework clarified huge potential but requiring major investment (Hellinikon, Rodos Afantou Golf, Heraklion Gournes Base)
  4. Mining and extraction rights: straight forward process but requires more research (Gold, Gas and Oil licenses)
  5. Non listed loss making of strategic nature: Utilities and other corporations that have limited potential (TRAINOSE, Hellenic Aerospace Industry).
  6. Non listed loss making: Limited potential and major restructuring required(Hellenic Defence Systems, Hellenic Vehicle Company).
  7. Land with a long term development potential: Planning framework requiring clarification and business case not clear.
- Assets 1 to 3 are likely to be sold first, most of them within 2012 and 2013.
- Assets 4-5 will need considerable preparation before being sold and carry a significant risk.
- Assets 6-7 will take longer to prepare for privatization they require major restructuring and they are less attractive for investing unless they are combined with other business activities.

RECAPITALISATION OF BANKS

- Recapitalisation will take place between April 2012 and October 2012.
- Banks may opt to seek private funding before asking for official support.
- The MOU dictates that: “The Government will ensure that Greek banks have business autonomy both *de jure* and *de facto*”. The voting rights of HFSF shares will be restricted to limited strategic decisions for as long as the private shareholders participate with more than 10% in the capital increase.
- Private shareholders will be given incentives to purchase HFSF-held shares.
- The recapitalisation of banks creates an opportunity for increased liquidity if a more strategic approach is taken by authorities and regulators.
- The HFSF is restructured and a new board is expected to take over soon with the Chairman and CEO being persons with international experience.
- However, we should expect more deleveraging in the economy and as a result the corporate sector will further contract with bankruptcies increasing and restructuring taking a more violent form in the latter part of 2012.

FIVE MAIN FLOWS/RISKS IN GROWTH STRATEGY

GREECE IS DIVIDED INTO SPHERES OF INFLUENCE AS FOREIGN INVESTORS PEAK AND BUY STRATEGIC ASSETS LEADING TO FRAGMENTATION OF INTERESTS

A DUAL REAL ESTATE MARKET IS LIKELY TO EMERGE WITH EASY TO DEVELOP PROTECTED AND INCENTIVISED PUBLIC LAND AND HIGHLY RISKY PRIVATE LAND

RECAPITALISATION OF BANKS SERVING ONLY BANKING INTERESTS AND NOT THE REAL ECONOMY

EUROPEAN UNION FINANCING CHANNELED AGAIN TO TRADITIONAL PUBLIC WORKS PROGRAMS REVIVING THE OLD CONSUMPTION BASED MODEL

NO OVERALL PLAN BY THE GOVERNMENT AND THE SOCIAL PARTNERS AS LACK OF LONG TERM STRATEGY AND FAILURE TO ASSESS IMPACT OF SPECIFIC STABILISATION AND REFORM MEASURES UNDERMINES POLICY COHERENCE

AND ONE MAJOR WEAKNESS

- "Greece's innovation system displays serious weaknesses. In Greece, high- and medium-high-tech industrial sectors and knowledge-intensive service sectors carry very little weight in the overall economy. There is little potential to leverage the development of fast-growing industries with high productivity levels". (EU Monitor, Deutsche Bank 27.1.2012).
- Successive governments have failed to initiate a consistent drive towards innovation despite the existence of some positive elements. The absence of a stable and coherent institutional framework has hindered efforts by researchers and start up entrepreneurs.
- Innovation infrastructure should be further supported and spin off companies with potential should be targeted for further assistance. Management of innovation should be upgraded with external assistance if required.

THE OUTLOOK IS NOT PROMISING FOR THE IMF

A 3rd PACKAGE?

"In the event of slower progress in policy implementation, or failure of the economy to respond rapidly enough to reforms, completion of reviews may require additional support from Greece's European partners on yet more concessional terms than currently envisaged, and/or another restructuring of bonded debt "(page 43).

THE POLITICAL SYSTEM AGAIN?

Debt is projected to remain at extreme levels and "considerable risks remain about the Greek political system's ability to reinvigorate reforms and deliver the structural changes needed for Greece to become competitive inside the Eurozone" (page 44).

THE WAY OF ARGENTINA?

The experience of Argentina in 1998–2002 shows that an economy can get trapped in a downward spiral in which adjustment through internal devaluation eventually proves impossible, and the only way to an eventual recovery remains default and the abandoning of the exchange rate peg (page 49).

SOURCE: IMF Country Report No. 12/57
MARCH 2012

BUT A REVERSAL IS STILL POSSIBLE

- There is a possibility for a higher than the IMF base line scenario under certain circumstances mainly based on building confidence.

SURPISE THE MARKETS

MORE RADICAL CONSOLIDATION OF THE PUBLIC SECTOR	ACCELERATED PRIVATIZATION PROGRAM	FASTER ABSORPTION OF EU FUNDS AND MORE SUPPORT FOR INNOVATION	REGAIN PRICE COMPETITIVENESS IN 2012

WE NEED A STRONG EFFICIENT AND PROFESSIONAL GOVERNMENT

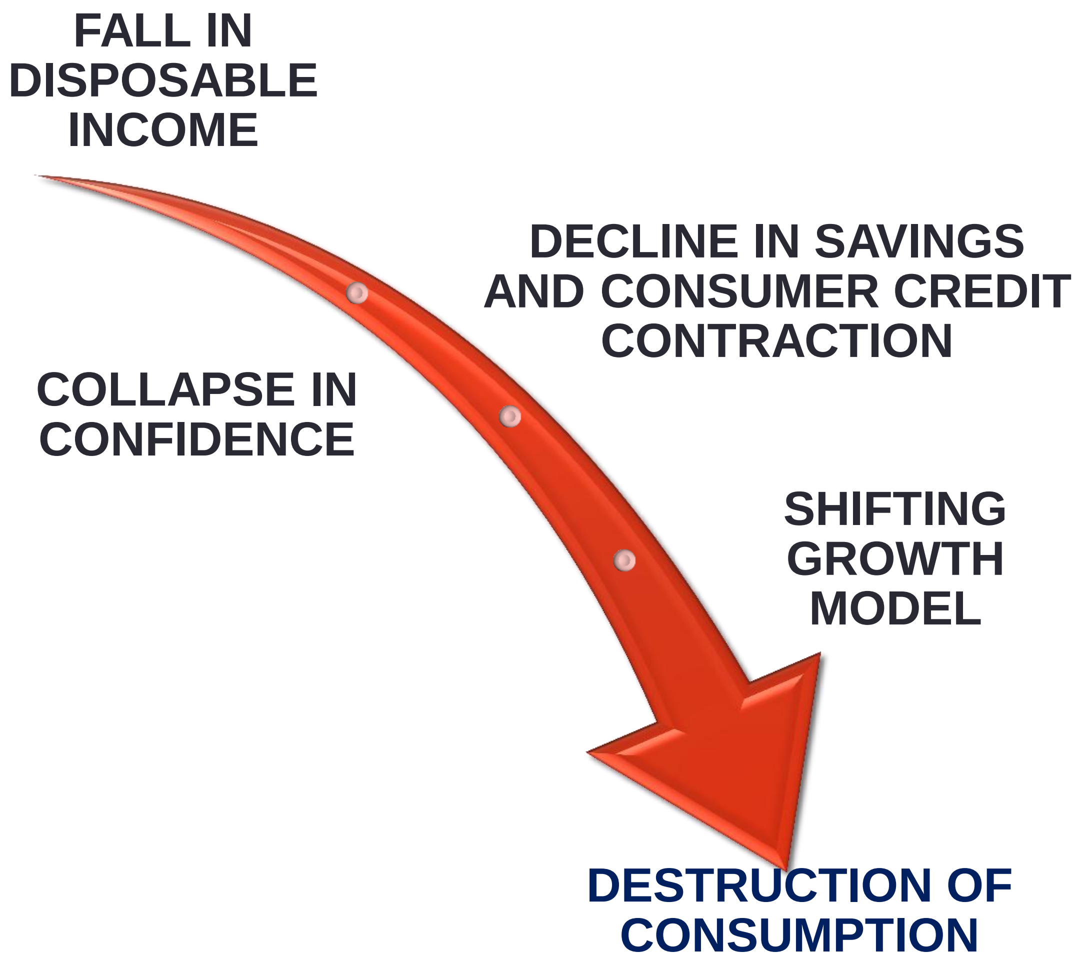
CONSUMPTION PATTERNS HAVE CHANGED

IMF/EU/ECB POLICIES FOR INTERNAL DEVALUATION AND BREAK DOWN IN CONFIDENCE ARE MAKING THE DIFFERENCE

CHANGING CONSUMPTION PATTERNS

- The current policy mix imposed by the official lenders is leading to a **permanent break** in long established growth patterns. The consumption and lax credit based growth has come to an abrupt end in 2009.
- First, private consumption is expected to continue to decline until 2013 recovering slowly thereafter and not exceeding 0.9% percentage change at any year up to 2020 ending up at a low of just 0.2%. The main driver of consumption decline is the fall in incomes (complete loss in case of unemployment, severe losses for the public sector employees and the new entrants in the private sector, e.t.c.).
- Second, the IMF forecasts on consumption are continuously revised downwards from one review to another indicating a deterioration in outlook.
- Third, credit expansion has become negative and liquidity conditions are deteriorating. Deleveraging is set to continue for at least two years.

UNDERMINING CONSUMPTION

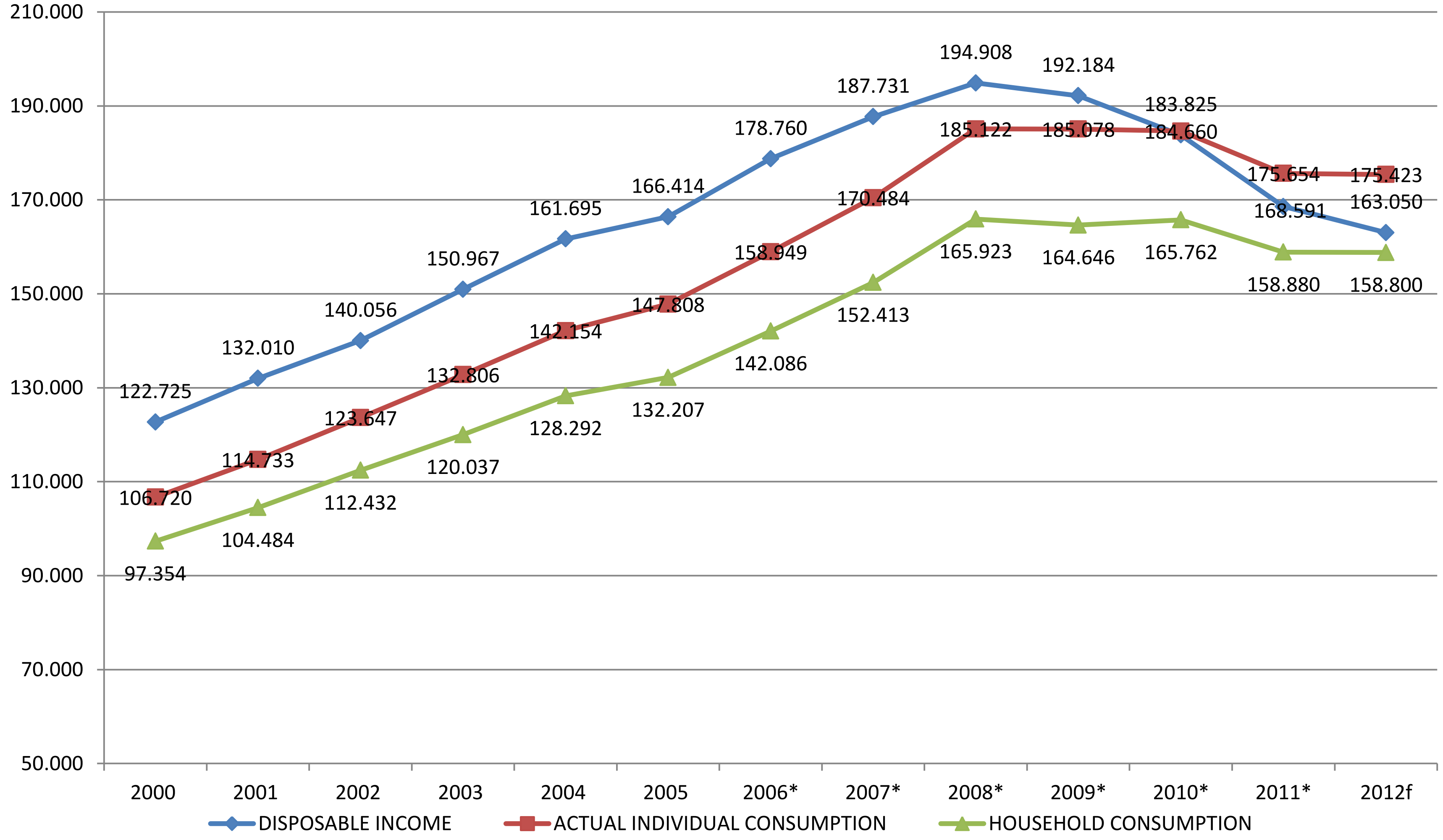


THE IMF IS CREATING AN ANTI-CONSUMPTION CLIMATE

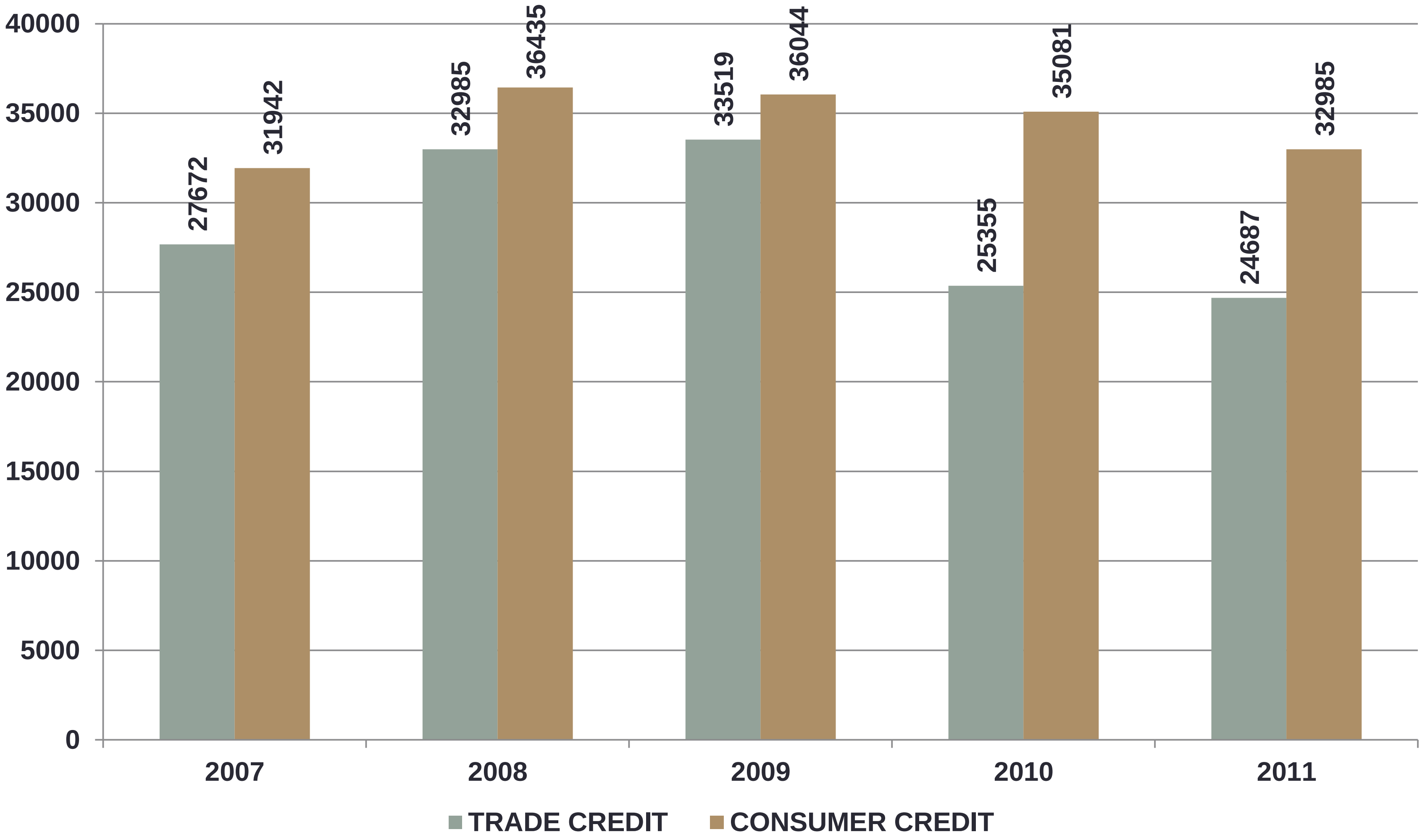
- **The IMF believes that:**
  - Resolving Greece's balance of payments problem within the euro will require a shift in the structural reform strategy to directly prioritize **internal devaluation**.
  - Given program policy settings, domestic consumption is expected to be suppressed for some time: **this is the main channel through which the Greek economy needs to adjust**.

SOURCE: IMF Country Report No. 12/57 MARCH 2012

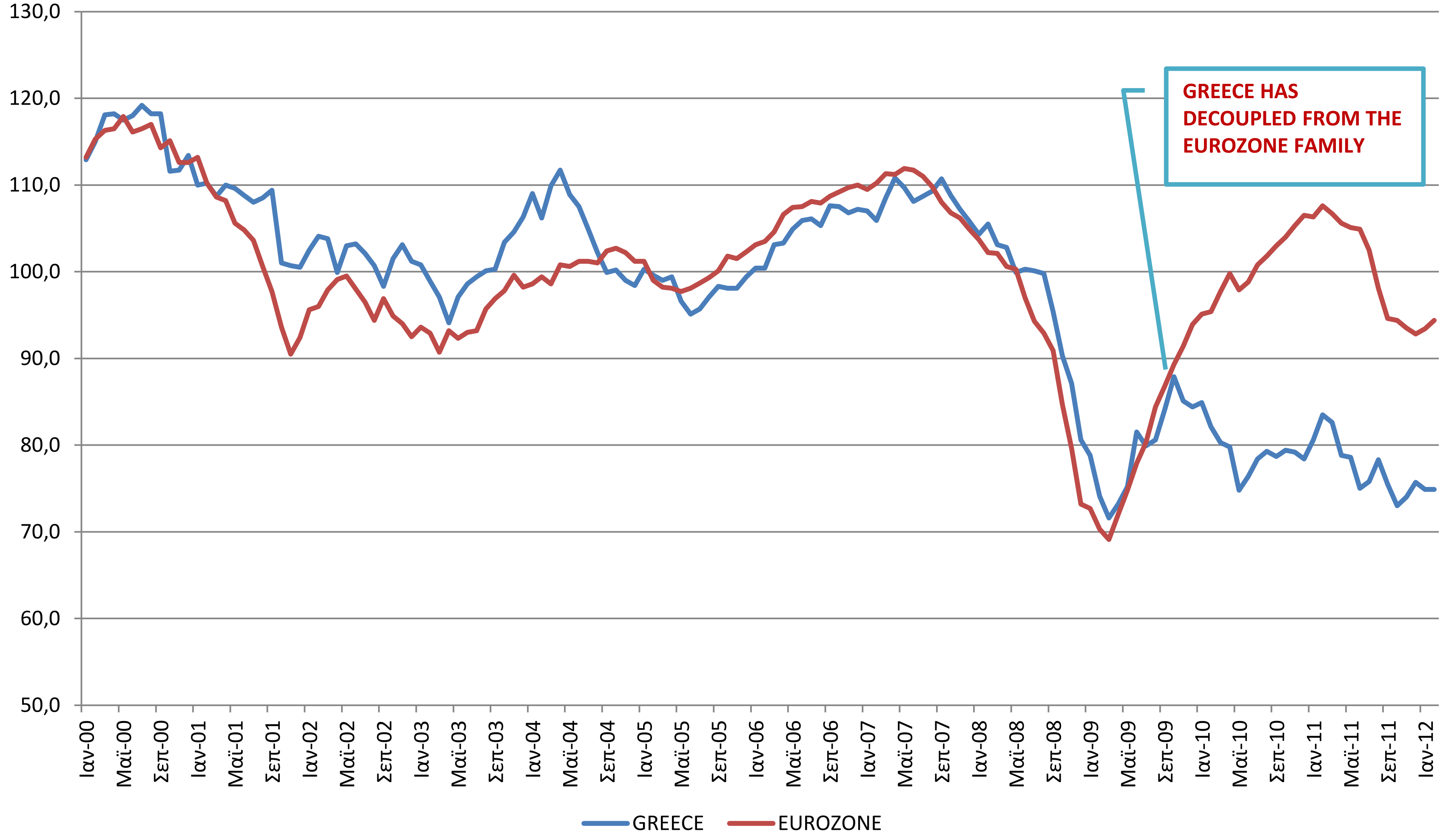
DISPOSABLE INCOME: BACK TO 2004



CONSUMER CREDIT AND FINANCING OF TRADE HAVE CONTRACTED



CONFIDENCE HAS COLLAPSED



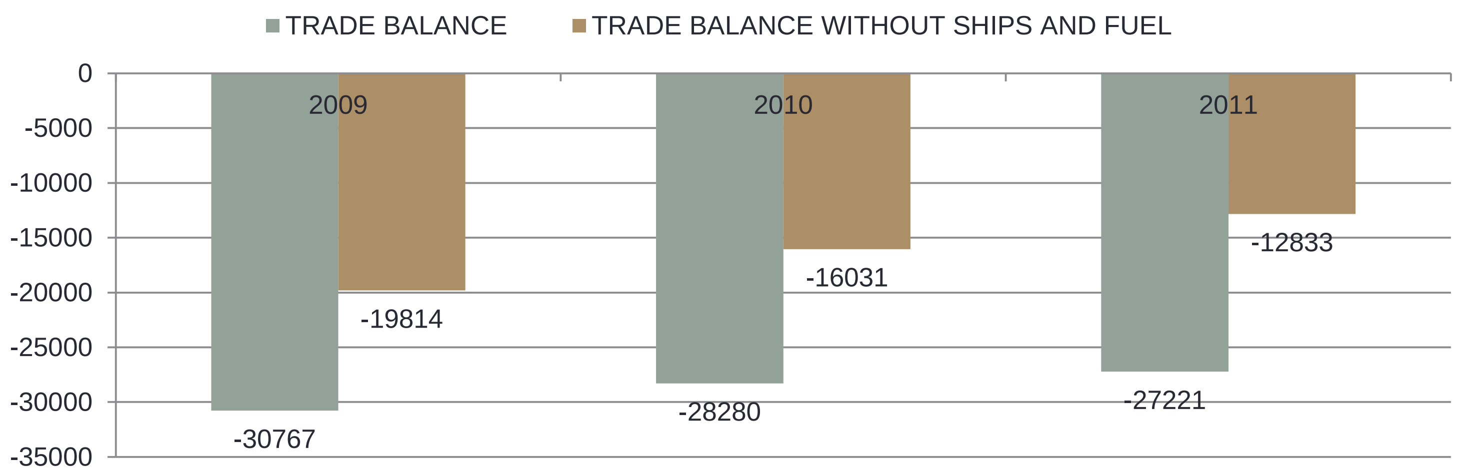
ANOTHER IMF PROMOTED GROWTH MODEL

THE OLD MODEL HAS TO DIE AS SOON AS POSSIBLE

- Greece's recession is considered as mainly structural.
- The pattern of production that emerged during Greece's decade in the euro—built on unsustainably high domestic demand—cannot be maintained.
- Consumption will pay the price for as long as it takes.

BUT THE NEW MODEL HAS A DIFFICULT BIRTH

- Improved competitiveness is expected to promote exports and investment in the tradable-sector capacity.
- Investment and export led growth will underpin the new model but sluggish international demand in 2012 and the lack of appropriate productive capacity will delay the shift.



THE IMF PATH TO EXPORT LED GROWTH

HIGHER EXTERNAL DEMAND WILL DRIVE INVESTMENT IN TRADABLES AS FOREIGN SALES WILL PROVIDE FUNDING FOR NEW PROJECTS

+

LABOUR MARKET REFORMS WILL DEPRESS WAGE INCOME AND INFLATE THE PROFIT SHARE IN INCOME

→

IMPROVED MARKET SENTIMENT

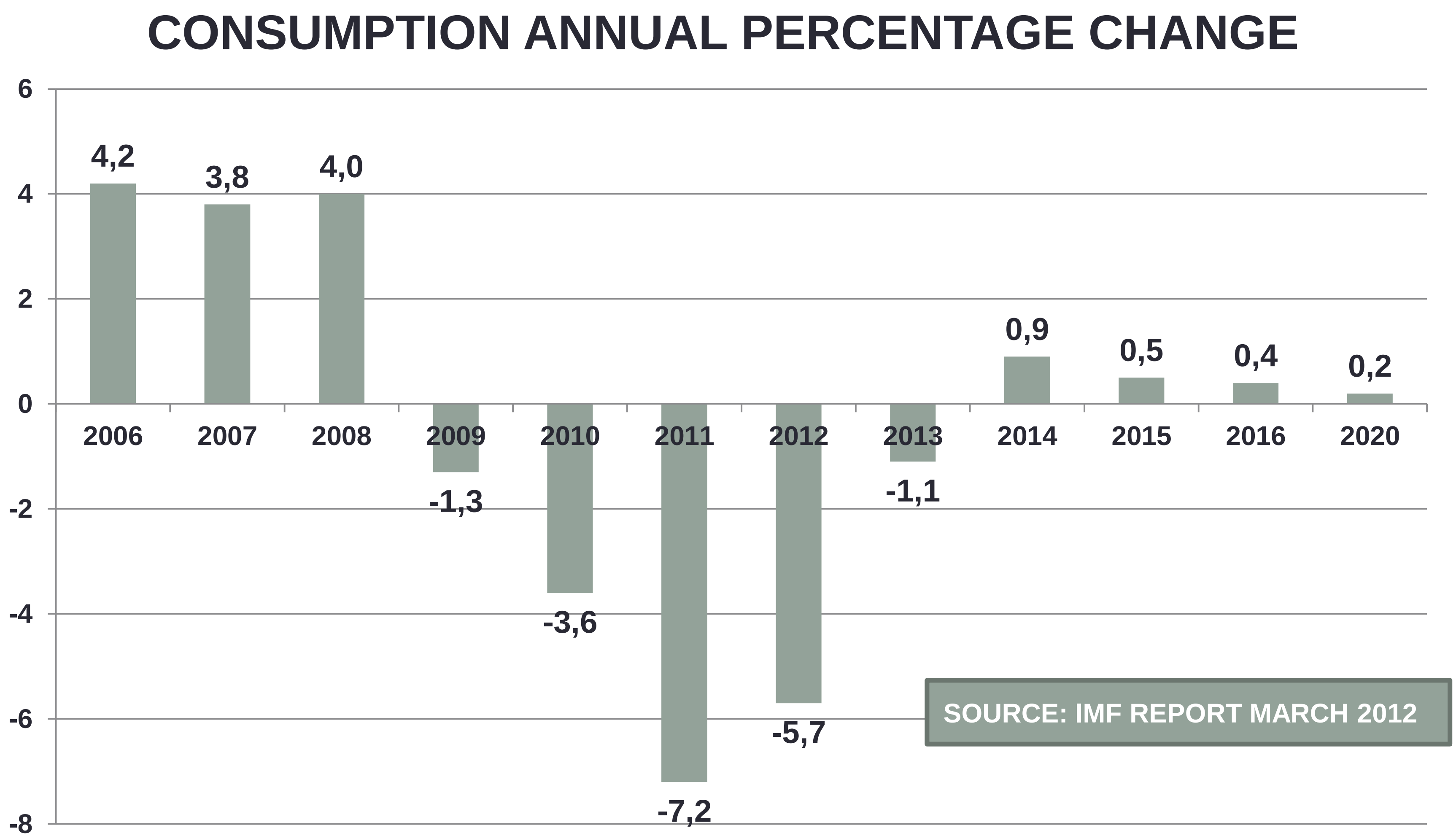
+

IMPROVED CONDITIONS IN BUSINESS PROFITABILITY WILL ENCOURAGE REPATRIATION OF CAPITAL AND FDI AND MORE GROWTH

−

PROFITS REMAIN ABROAD
LUXURY CONSUMPTION INCREASES

CONSUMPTION SUBDUED



HOW CONSUMERS REACT TO CRISIS?

- During the economic crisis, there are several changes in consumer behavior, many of which will persist even when the economy recovers.
- Consumer behaviour in a crisis is characterized by consumption smoothing at various levels:
  - inter-temporal,
  - inter-category and
  - intra-category.
- Behavioural adjustments result in significant reallocation of consumption expenditures.
- The smoothing decisions due to a crisis are distinct and independent of the impact of changes in income and prices that accompany a crisis.
- In developed countries, consumption smoothing benefits the services sector at the expense of durables.

THE EVIDENCE IS CLEAR

- If we examine the fall in expenditures in the year of the crisis across countries, we find on average:
  - 20% decline for Durables,
  - 14.6% decline in Services,
  - 9.5% decline in Semi-durables and
  - 7% decline in Non-durables.
- “A careful understanding of wallet-share movements will reveal the classification of durables as a discretionary good and that wallet allocation to this category has been shrunk drastically by consumers. Price reductions are not going to re-channel those expenditures back into that category”.

SOURCE: Pushan Dutt and V. Padmanabhan (2010) CRISIS AND CONSUMPTION SMOOTHING, INSEAD SINGAPORE.

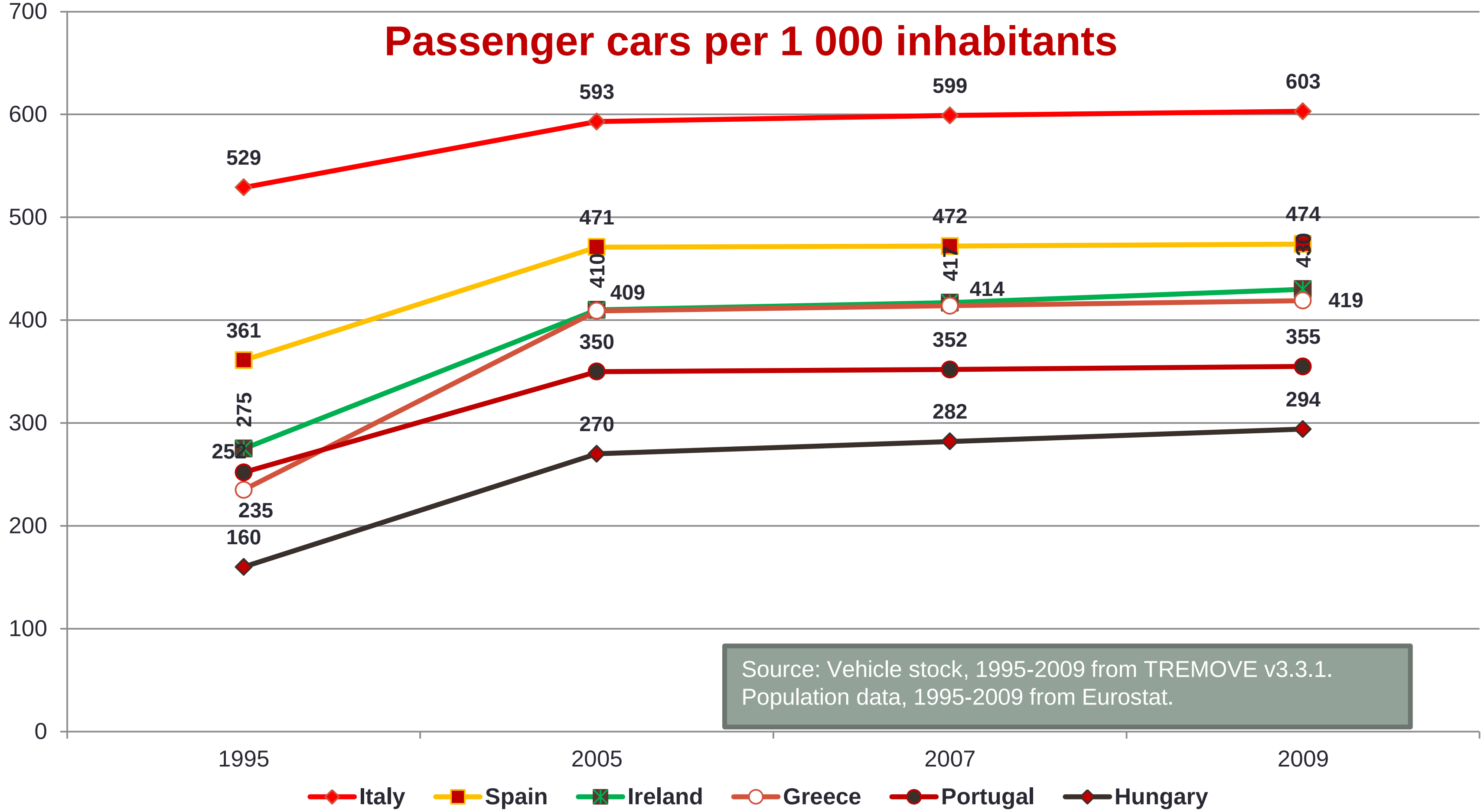
THE CAR MARKET IN DEEP FREEZE

CONFIDENCE IS THE KEY DRIVER

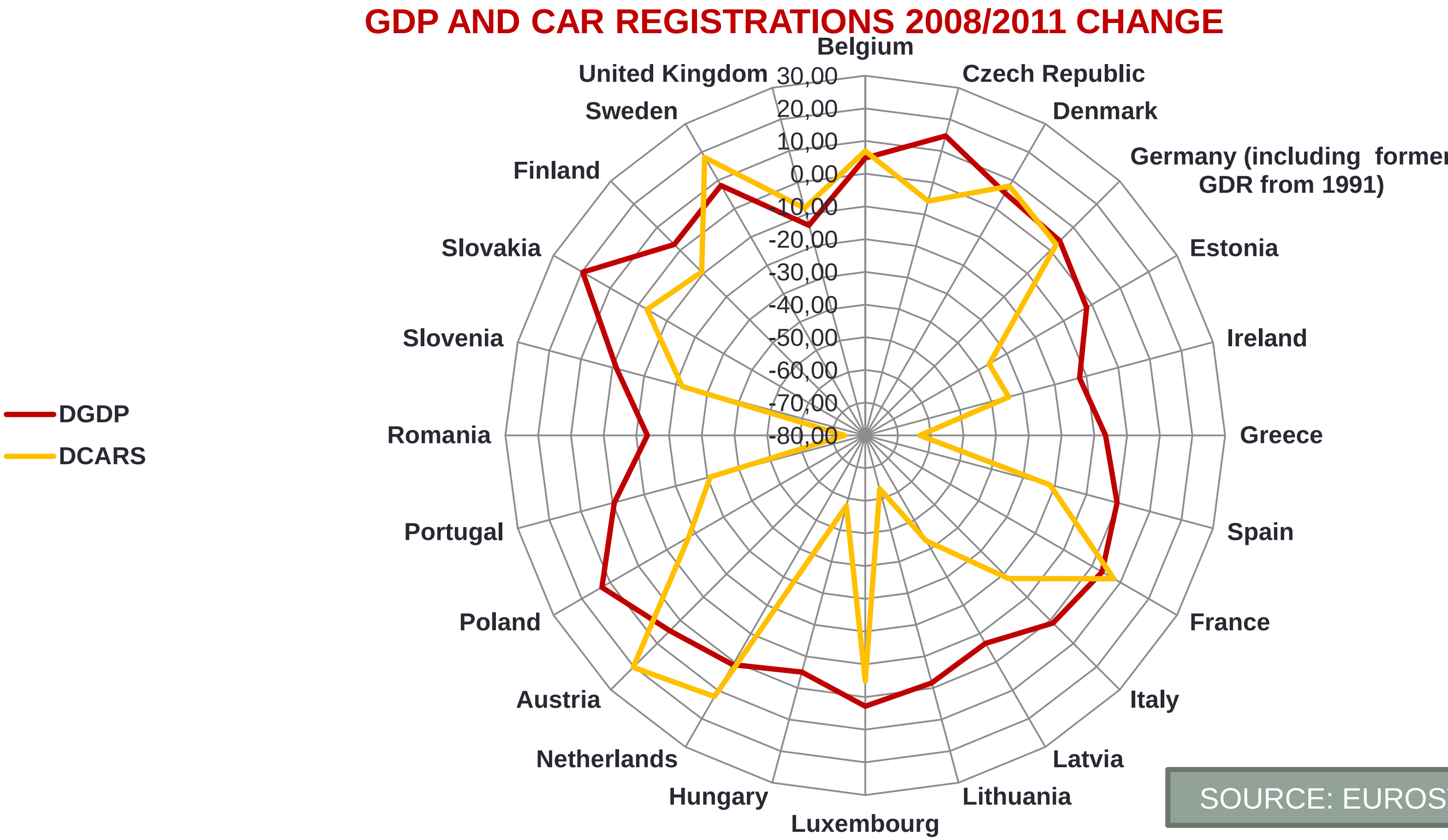
THE CAR MARKET

- Car ownership has exploded between 1995 and 2005 as in most European countries. Since then it has stabilised.
- At the eve of the crisis in 2009 car ownership was standing at 419 cars per 1000 inhabitants just below Ireland.
- The decline in the market broadly in line with GDP trends but overshooting by a wide margin. The confidence factor is more important than the income factor.
- The R^2 of the regression of new car registrations to GDP is 0,3556 indicating a significant correlation.
- The car market in Greece is likely to consolidate further as trends in Hungary Ireland and more appropriately Iceland indicate.
- A recovery in GDP will not automatically lead to a recovery in the car market as regaining confidence will take time. A stable tax framework is urgently required to restore stability in the market.

CAR OWNERSHIP



CAR MARKET DECLINE OVERSHOOTING



SOURCE: EUROSTAT

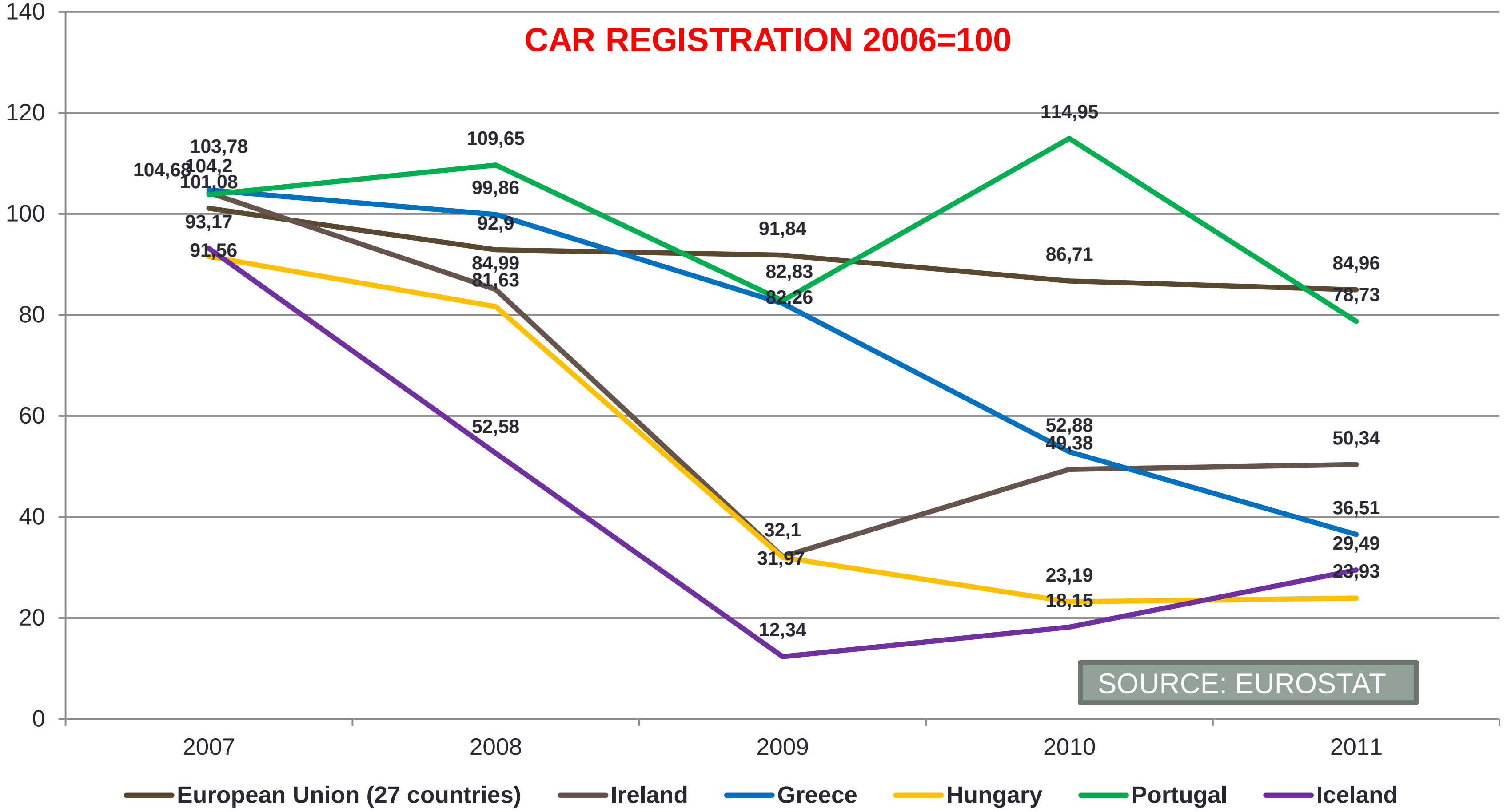
GDP AND CAR MARKET TRENDS

- A group of countries exhibit both large fall in GDP and large fall in car registrations: Ireland, Romania, Greece, Hungary, Latvia.
- In another group of countries large declines in car registrations are decoupled from GDP falls: Lithuania, Slovenia, Portugal, Poland.

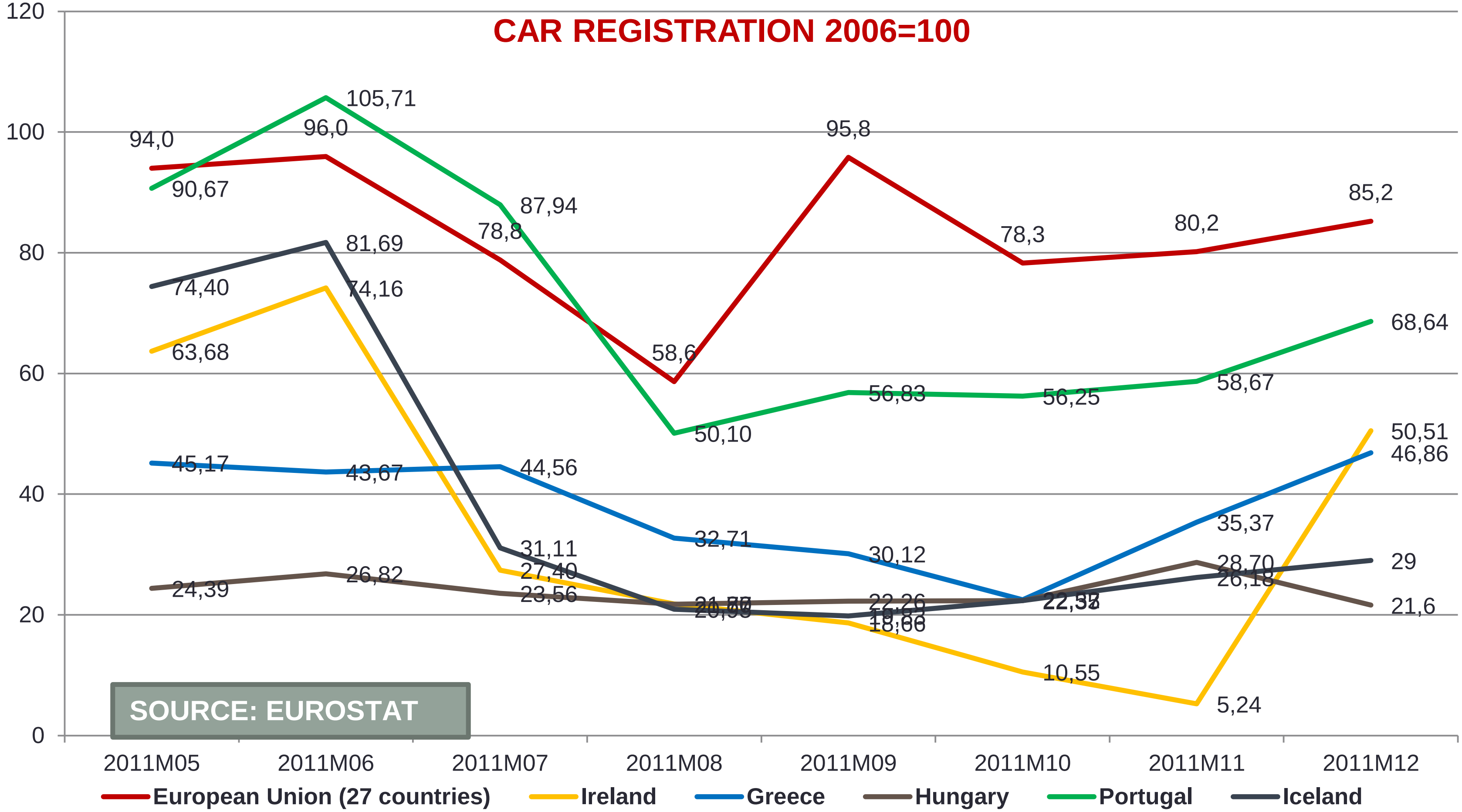
GEO/TIME (EURO AT MARKET PRICES)	CHANGE IN GDP 2008-2011	CHANGE IN CAR REGISTRATION 2008-2011
Belgium	4,85	6,99
Czech Republic	14,81	-5,83
Denmark	5,55	7,99
Germany	4,02	2,51
Estonia	-1,84	-36,26
Ireland	-12,23	-34,65
Greece	-6,57	-63,35
Spain	-0,37	-21,54
France	3,51	7,69
Italy	1,13	-18,12
Latvia	-6,53	-42,84
Lithuania	-1,60	-63,07
Luxembourg	2,88	-4,86
Hungary	-5,06	-57,70
Netherlands	1,01	12,19
Austria	4,49	20,32
Poland	12,95	-17,68
Portugal	-0,63	-30,92
Romania	-13,43	-73,71
Slovenia	-1,35	-22,08
Slovakia	19,70	-3,04
Finland	2,57	-9,29
Sweden	8,24	18,18
United Kingdom	-13,48	-8,07

NON EURO COUNTRIES ARE AFFECTED BY THE CONVERSION ESPECIALLY UK

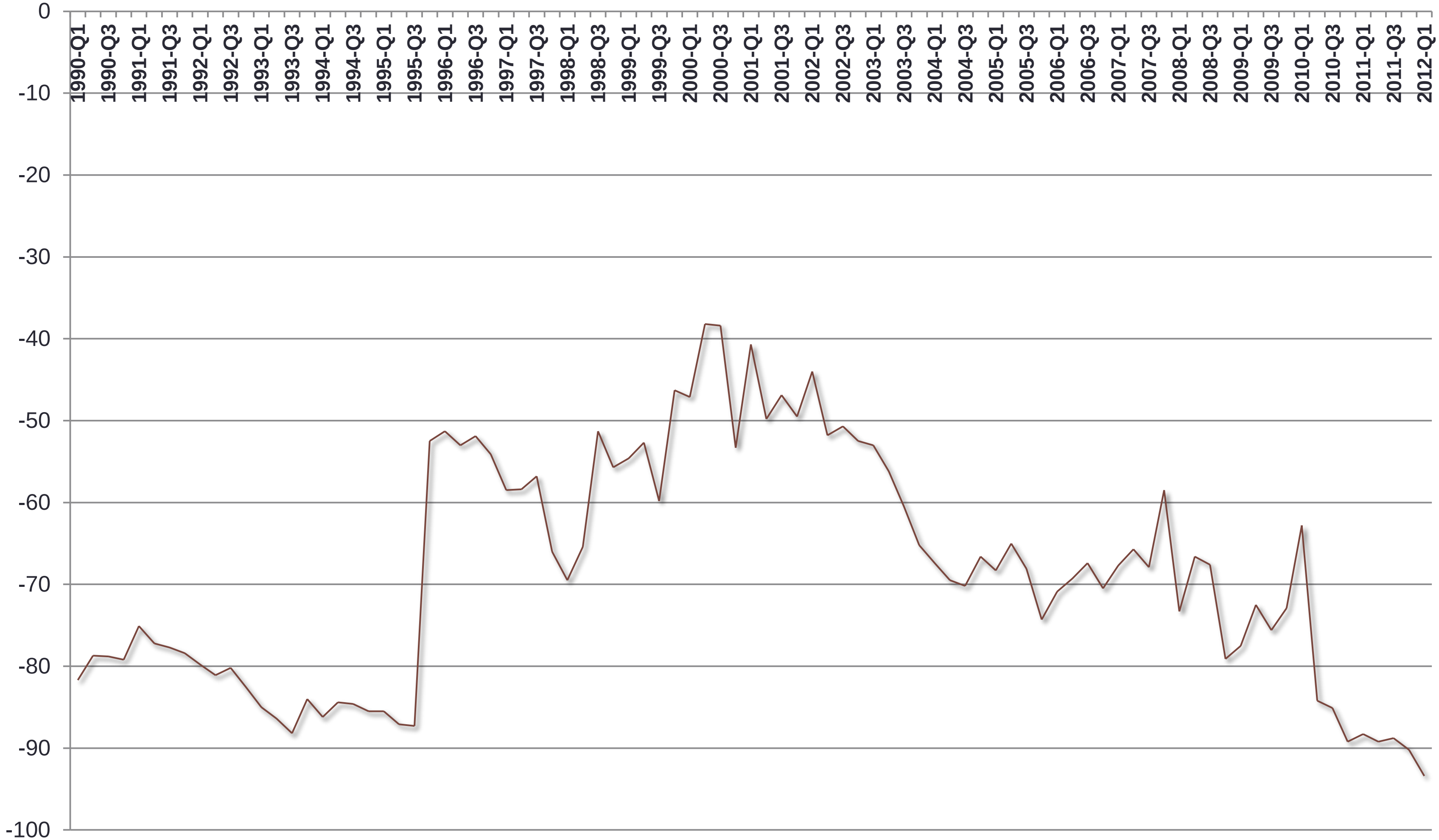
FIVE YEARS OF DECLINE IN THE DEBT LADEN COUNTRIES



2011: ANOTHER BAD YEAR



INTENTION TO BUY A CAR GREECE: BACK TO THE EARLY 1990s



IS A RECOVERY POSSIBLE?

- The car market is likely to contract further as consumer confidence declines and the depression deepens throughout 2012.
- However, the recapitalisation of banks may marginally improve liquidity and new credit may help the already observable shift towards smaller and less expensive cars.
- The eventual recovery will create a polarized market with incomes diverging. Businessmen and management in the export oriented sectors will accumulate wealth earlier and faster than the rest of the economy and luxury consumption may resume affecting also the car market.
- The main driver on the demand side will be coming from heavy vehicles and construction equipment when the infrastructure and real estate projects get started again. Existing overcapacity may result in a very slow recovery of the subsector but the re-building of networks is necessary.

SYNOPSIS

- The macroeconomic environment still unstable.
- Public finances fragile.
- Depression deepening with recovery continuously postponed.
- Sudden death for the economy has been avoided and postponed but not for good.
- Structural reforms legislated but slowly implemented.
- Bank recapitalisation positive factor for stability but it will not guarantee increased liquidity for the economy.
- Labour cost reductions improve competitiveness but further undermine recovery.
- Privatisations key to attract foreign investment but there is a lack of an overall plan for the economy.
- A reversal is possible but requires major readjustment of priorities in the stabilisation program and faster implementation.