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## Greece unlikely to escape its worst financial crisis of modern times!



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**Greece, a developed country with a high standard of living and very high Human Development Index; with the largest maritime fleet in the world; a top five tourist destination since at least the 80s; with a GDP growth average since the early 90s higher than that of the EU average; and according to the European Commission, the second best growth outlook in the Eurozone after Cyprus – the only economy in the single currency club projected by the EU Commission (not by Pytheas) to grow this year, is to the point of view of Pytheas unlikely to escape its worst financial crisis of modern times!**

The robust expansion of Greece since its entry into the euro area has slowed significantly under the weight of the international crisis. During the upswing, per-capita incomes approached the euro-area average. This occurred in an unusually benign global environment with ample liquidity and low interest rates. However, with limited reforms, unmanageable corruption and insufficient policy adjustment, competitiveness deteriorated. Consequently, catching up was largely financed by debt, generating large fiscal and external imbalances. The current global crisis has already affected Greece and marks a turning point in economic conditions going forward. Necessary policy adjustments are inevitable to correct the imbalances.

Growth remained positive until the end of 2008 thanks to relatively buoyant exports to the Balkans and large wage increases which supported consumption. The banking sector has benefited from marginal exposure to the toxic assets which were at the root of the international crisis. Even so, the impact of the crisis substantially shook the confidence of households and businesses, which are reining in spending.

**Furthermore, persistent structural imbalances, illustrated by the poor state of public finances and the large current account deficit, limit room for policy maneuver, and Greece's exposure to south-eastern Europe has increased the country's vulnerability to the crisis. In the wake of a general increase in risk aversion, the long-term sovereign interest rate spread vis-à-vis Germany widened sharply in early 2009.** In line with market assessments and as in a number of other European countries, rating agencies downgraded the sovereign debt and credit risks of the leading Greek banks.

**Pytheas projects a decline in output by 1.25% in 2009. Pytheas also estimates that the deficit could fall by more than the 3.6% target.** In the first quarter of 2009, real GDP contracted by an annualized rate of 4.8% over the previous quarter, but grew 0.3% year on year according to the national accounts estimates.

**Exports will be adversely affected this year by the plunge in international trade, including in shipping and tourism. Lower confidence, an expected rise in unemployment, and tighter credit conditions will weigh on domestic demand. Nevertheless, a number of factors should moderate the slump.** The rise in household income is expected to deteriorate despite the generous wage agreements signed in the private sector in 2008. **Greece is less dependent on trade and in particular on manufacturing. It also continues to receive substantial EU financial support, and its growth potential is still high, even if this is likely to be weakened by the crisis.**

This outlook is surrounded by uncertainties which tend to weigh on the downside, and if they materialize, the output projection would probably be weaker. **A greater deterioration of the external environment, especially in the Balkans (which absorb almost a fourth of exports), would cut growth. The impact of the weaker economy on the financial sector could pose another risk to growth. The continuous erosion of international competitiveness, driven by the relatively rapid wage increases and a persistent inflation differential with the euro area, could also hamper the recovery more than expected, especially if the pick-up of activity remains subdued in the south-eastern European markets...**



Unlike other EU countries, Greece has virtually no room for budgetary maneuver to cushion the weakening of activity. Public debt is expected to exceed 100% of GDP, and the fiscal deficit rose from 3.1% to 5% of GDP between 2006 and 2008 despite a buoyant economy. Against the background of the general rise in risk-aversion and declining market liquidity triggered by the financial crisis, repeated fiscal slippages together with the impact of ageing on the long-term budget outlook, largely explain the sharp widening of interest rate spreads with Germany.

Greece is also subject to an EC excessive deficit procedure, and has about three months until October 2009 to undertake corrective measures needed to bring its deficit back to 3% by 2010 from 5% of GDP in 2008 – it is impossible that Greece will manage to meet these targets.

Under these circumstances, the government limited its crisis-related fiscal support to the most vulnerable groups and key economic sectors, such as tourism, construction and small enterprises. It has adopted a consolidation plan which, based on measures announced as of mid-June 2009, aims at reducing the structural budget deficit by 2.5% of GDP by 2010... This plan includes a cut in civil service employment, a freeze in government wages, a 10% cut in “elastic” budget outlays and a one-off levy on high incomes.

Since the government plan was adopted, however, growth prospects have substantially weakened and the 2008 fiscal deficit was revised up. As a result, to bring the deficit below 3% of GDP in 2010, the structural fiscal adjustment would have to exceed 6% of GDP, which is more than double than that envisaged in the government consolidation plan. Given the weak economy, such an adjustment would be impossible. In the short term, the structural deficit should be reduced by at least the 2.5% of GDP already planned by the government over 2009-2010, and automatic stabilizers should be allowed to work beyond this. This would result in a deficit of some 6% and 6.75% of GDP in 2009 and 2010 respectively, and lead to public debt above 100% of GDP in 2010.

**To limit any adverse impact of the higher deficit in 2009 on market confidence and interest rate spreads, the authorities should make a strong commitment to fiscal consolidation, increase credibility of fiscal policy and deal with the long-term threat to budgetary sustainability posed by population ageing.** The authorities should adopt specific and concrete measures to rein in spending and improve tax collection. This policy should be reinforced by a long-term budgetary framework, a legally binding fiscal rule that would monitor expenditure appropriately and prevent structural deficits monitor fiscal policy effectively. To achieve fiscal sustainability, the rules should aim at reducing public debt to less than 60% of GDP by 2020-25, when the budgetary consequences of population ageing start to be fully felt. This in turn requires eliminating the budget deficit by 2014, once economic recovery is underway, to be followed by surpluses of about 1% of GDP as from 2015.

**Greek banks are confronting the crisis after a prolonged high growth in lending upon liberalization of the sector since the millennium, including substantive privatization, and with no experience with recession. Although the crisis initially had little effect on banks beyond reduced liquidity, they remain vulnerable to international volatility through their exposure in the Balkans (especially in Bulgaria, Romania, FYROM, Serbia, and Turkey) and the Gulf (UAE, Qatar, Oman, Bahrain and KSA), if the economic situation in these economies were to worsen substantially.** Bank claims in these countries, whether held by subsidiaries or cross-border, correspond to more than 20% of GDP, which is high compared to most other European countries. In these rapidly growing markets, bank groups have run substantial credit risk, exacerbated in some cases by overvalued real estate prices, and exposure to largely unhedged borrowers since half of local claims are denominated in foreign currencies. On the domestic front, banks face a large exposure to a contracting real estate sector, in which investments have dropped by over 3% of GDP since 2006. In the months ahead, the strains induced by the crisis in this sector are likely to be compounded by the impact of the projected recession on bank portfolios.



A support package was adopted to boost confidence and liquidity in the banking system totaling up to €28 billion (11.5% of GDP) – intended to lessen the risk of a pro-cyclical tightening of bank lending conditions – appears for now to provide enough assistance to ensure financial stability, especially in view of the good initial level of bank profitability and capitalization. It is important to note that **the Greek banking is rather characterized by robustness as its exposure to products that have been developed by banks gone bust or to other problematic high-risk financial products is negligible; characterized also by a strong deposit base and satisfactory capital adequacy.**

Greece needs to reduce its structural imbalances and improve competitiveness with reforms that raise productivity. The sizeable difference in per capita income with the most advanced economies is mostly due to a productivity gap. Low productivity is influenced by rigid product and labor market regulations. Enhancing labor market flexibility would also help prevent the expected rise in unemployment from becoming structural. Further reforms in labor and product markets are needed to deal with these challenges. Minimum wages setting should better take into account the high youth and female unemployment. The government should encourage decentralized wage bargaining by avoiding administrative extensions of collective agreements to firms not directly represented in the negotiation. **Specific areas where there is most scope for improvement include: reducing the number of procedures for business registration and meeting legal obligations; easing regulation of professional services; and making the regulatory framework in retailing more conducive to competition. Establishing effective competition in network industries can be achieved by further progress towards privatizing public enterprises and introducing more modern regulation in the energy, communications and transport sectors. Strong and effective regulators are critical for promoting competition in all newly liberalized sectors.**

The high fiscal deficit and recently rising public debt point to the urgency of improving the financial situation and efficiency of the public sector. **The poor fiscal situation left Greece with a weak fiscal armor in the current recession. The room for fiscal maneuver, the main stabilization tool for countries in the euro area, needs to be restored to deal with economic shocks. The recession will also worsen an already difficult fiscal situation and the cost of sovereign debt. The need for reform is enhanced further by the looming pressures on public finances in the coming decades – the expected drop in the inflow of structural funds from the EU and the fiscal burden from demographic ageing. Efficiency of public services, especially in health and education, is below the EU average.** Renewed efforts at reforms in the public sector are thus needed to bring government finances on a sound basis, and enhance the efficiency of public services. A well-functioning public sector would also play a central role for modernizing the economy and maintaining a high trend growth rate.

**Reducing extensive tax evasion will be key to putting public finances on a strong footing.** While recent steps to improve tax collection through the strengthening of tax administration are welcome, **tax evasion remains widespread, especially among the self-employed. This reflects weak collection procedures, a large informal sector, frequent tax amnesties and a complex tax system.** Collection can be improved by strengthening auditing activities through a better qualified personnel and a more comprehensive exchange of information among agencies. The collection of taxes and social security contributions should be combined in a single authority. This would also reduce the cost of compliance borne by taxpayers and the tax administration, which is among the highest in the EU. Repeated tax amnesties need to be discontinued, as they only discourage compliance. Broadening of the tax base hinges upon a more simplified tax system. Revenue can be boosted by reducing the number of VAT rates and shortening the list of goods and services that are eligible for reduced rates, and by eliminating exemptions in income taxation. Balancing the level of taxation between employees and the self-employed, who currently face a lower burden, would make the tax system fairer.

The repeatedly missed fiscal targets partly reflect difficulty in controlling spending. In particular, personnel outlays have risen rapidly with diverse systems of special benefits, wage



increases beyond productivity gains and overstaffing in many ministries. **Public enterprises, hospitals, social security funds and local authorities, which account for a significant part of recurrent expenditure overruns, lack a hard budget constraint. Overall expenditure management needs to be strengthened. Moderate pay increases in the public sector are indispensable not only to improve public finances but also to contain wage pressures, given the sector's signaling role on private wage bargaining.** The establishment of a central wage payments authority, envisaged by the government, is a positive step towards a better management of public sector wages. The plans to rationalize special employee benefits should also proceed quickly, even though this only concerns new hires. The policy of only partially replacing public sector retirees should be pursued. Improving the performance of public enterprises should remain a priority, including by rapid implementation of the new operational framework that introduces improved governance and the preparation of annual business plans. It is necessary to ensure that the planned move toward a program-based budget and multi-year budgetary framework takes place in line with the authorities' deadline of 2012, and that the implementation of ongoing reforms for the modernization of the public accounting proceeds rapidly.

The public administration should be streamlined and made more transparent. Swift actions are needed to increase the efficiency of the public sector, reduce staffing, and limit "political appointees" to lower costs. Accelerate privatization of public enterprises to limit losses and public indebtedness.

Pension costs are estimated to rise to more than 20% of GDP by 2050. High long-term pension liabilities have contributed to some extent to the increase in the government bond spreads vis-à-vis Germany. While recent reforms are welcome and a necessary step forward, they are not sufficient to stem the sharp rise in costs. The merging of pension funds in 2008 by scaling back their number from 133 to 13 and reductions in some early retirement incentives will help to rationalize the system and improve supervision of the schemes. The efforts to bring uniformity to the operations and parameters of the recently merged funds, standardize their accounting rules and computerize the system should continue. It is absurd that the system is not yet fully computerized and functional.

Product and service markets need to be further liberalized, by rationalizing legislation and accelerating actions cutting administrative burdens to facilitate a more efficient business environment; completing reforms and unbundling of network industries, which provide vital inputs to the entire economy; and ambitiously implementing the EU Services Directive to liberalize professional services, retail trade, and other activities that can significantly lower production costs.

**Opinion: It is Pytheas opinion that Greece cannot avoid recession and it could fall into its worst financial crisis of modern times!**

**As credibility, confidence, tourism and shipping revenue contracted substantially, the financial sector shall be hard hit by the also contracting real estate sector and the Country's exposure to the emerging economies of south-eastern Europe. The tightly restricted room for policy maneuver by the high public debt, the repeated fiscal mistakes, the large external and internal imbalances and corruption give Greece no choice but to change fundamentally or sink!**

**Despite the above, it is also Pytheas opinion that Greece will not default. It is highly unthinkable that an EU member country will default. A bankruptcy in the Eurozone could destroy the common European currency; confidence in the Euro will be shattered...**



### **Sources**

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