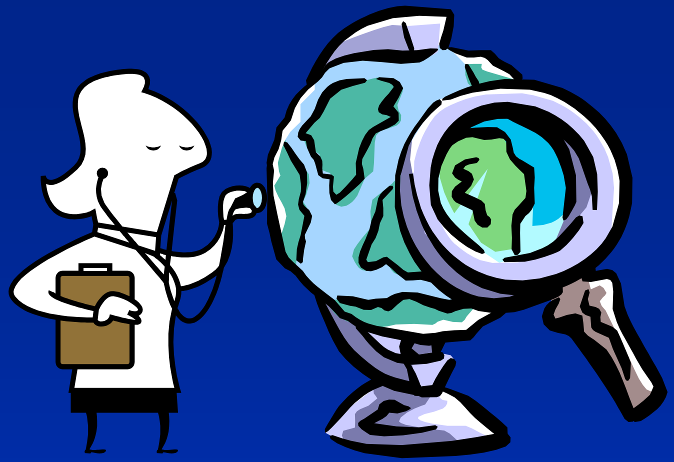

Euro area crisis: The case of Greece and the role of the IMF

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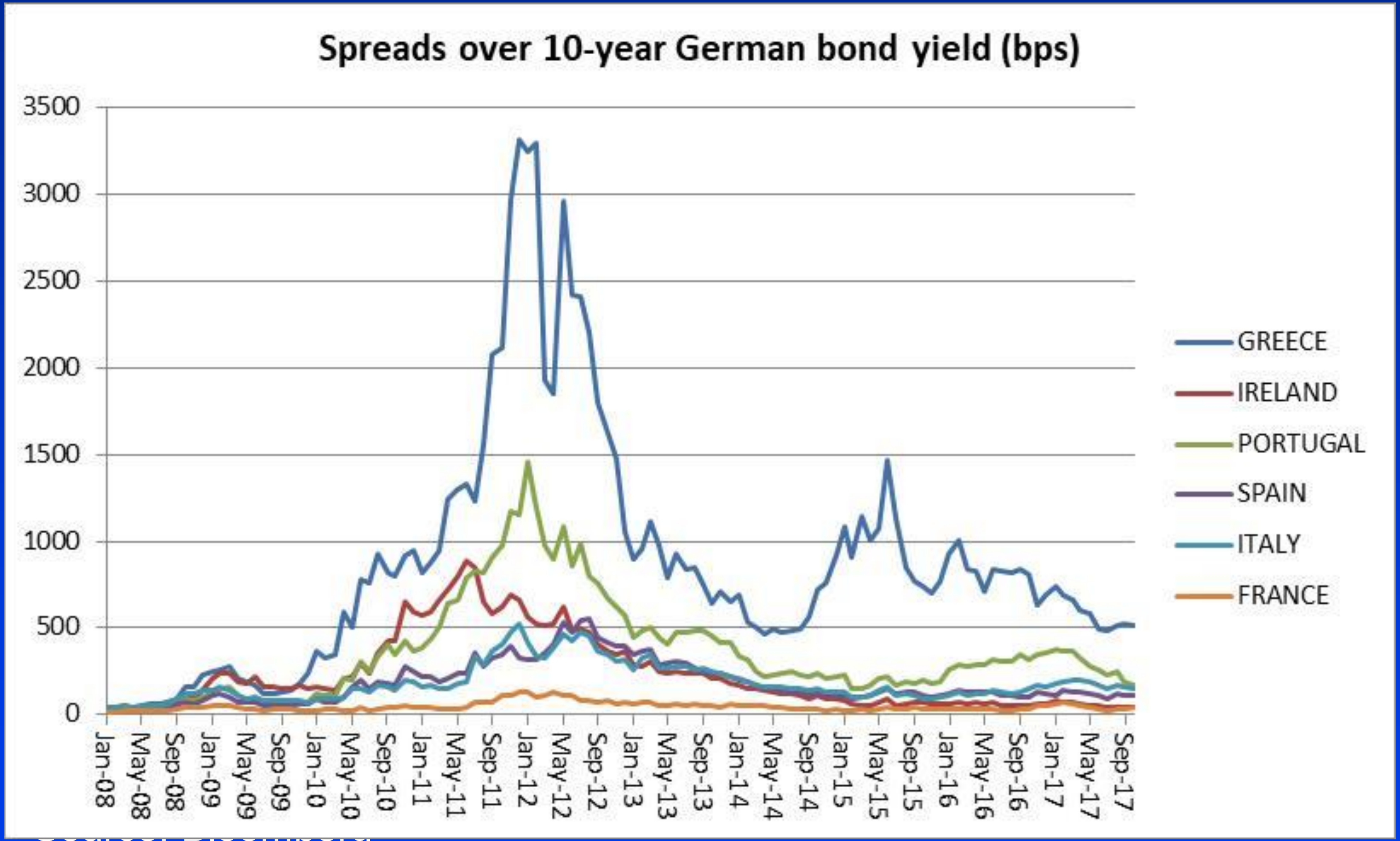
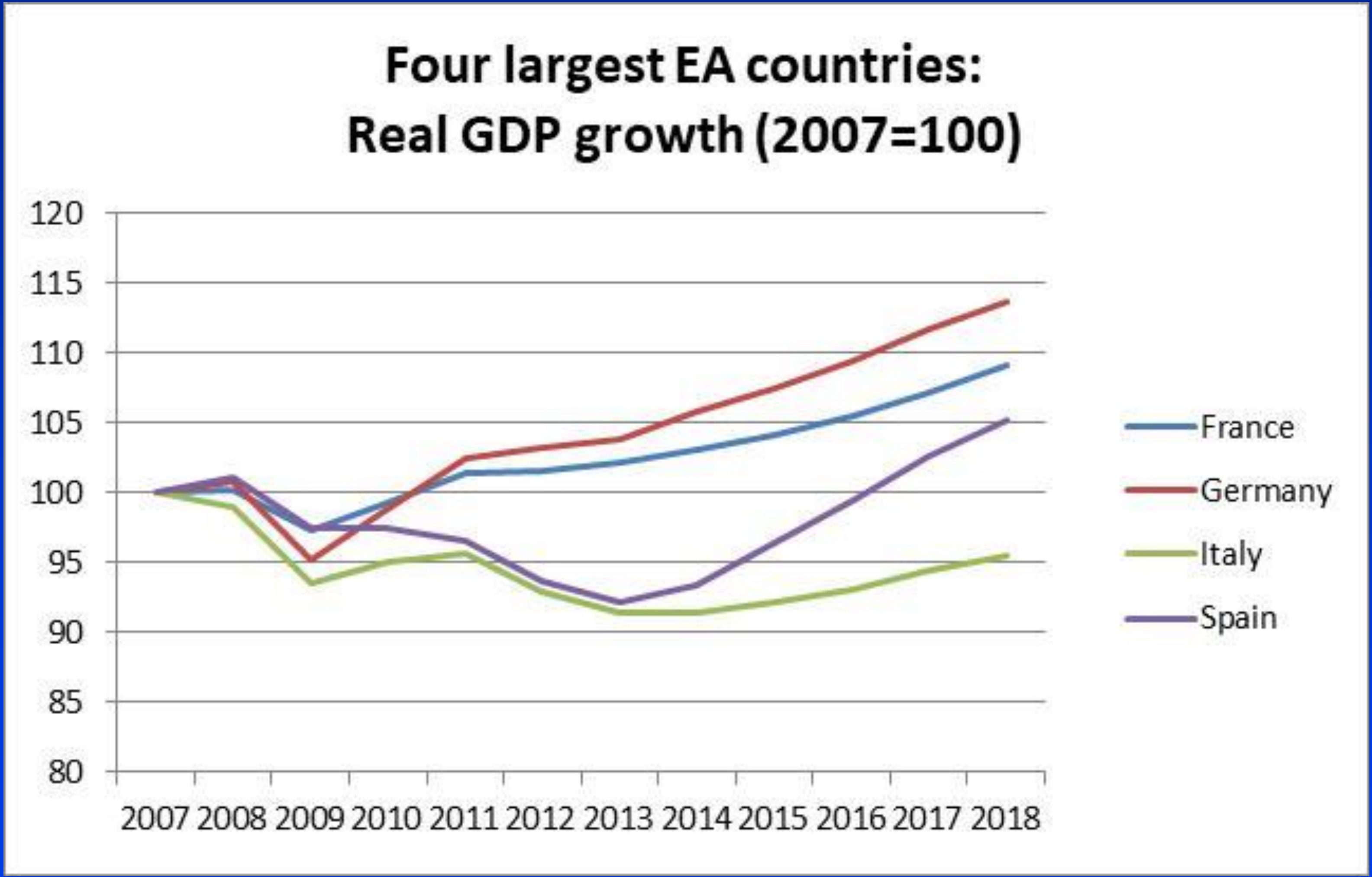
Financial divergence



Source: Bloomberg

Real divergence



Source: WEO database

Global financial crisis morphed into sovereign debt crisis

This was the result of:

- Monumental market failure: market participants believed that there is no credit risk in the EA
- Regulatory failure: all EA sovereign bonds shared the same zero-risk weight in bank balance sheets
- Institutional failure: Stability Pact failed to impose fiscal discipline.

Impossible Trinity restated

Original version

- Fixed exchange rates
- Capital mobility
- National autonomy for monetary policy

Monetary union version

- Monetary union
- Integrated capital markets
- National autonomy for fiscal policy

Negative feedback loop

- Uncertainly leads to closing of market positions and flight to quality, depressing asset prices.
- Banks reduce new lending to preserve capital adequacy despite losses.
- Recession leads to NPLs, further lowering bank asset quality.

Policy paralysis compounded the crisis

- Policymakers behind the curve
- Inability to reach agreement on "comprehensive solution" proposed by IMF contributed to uncertainty
- Implementation delays (Greek PSI, EU bank recapitalization, increase in EFSF resources, all agreed in Oct 2011)
- <u>June 2012</u>: EU leaders recognized crisis was systemic, agreed to time-bound road map toward genuine EMU (banking union, closer macro coordination, tighter fiscal rules).
- Crisis became self-fulfilling because it was not dealt with promptly; the Euro area's breakdown was at stake.

Credibility problem

- May 2010: Greek rescue package agreed; Eurogroup declares there will be no debt restructuring in the EA
- Oct 2010: Deauville Franco-German summit - Merkel & Sarkozy declare that burden sharing with bondholders in rescue packages not ruled out
- March 2011: ESM agreed; Eurogroup declares there will be no debt restructuring before 2013
- October 2011: Greek PSI agreed; Eurogroup declares there will be no debt restructurings except in Greece, but the statement lacked credibility

Euro area: Weaknesses in three areas

- <u>Banking sector</u>: large cross-border exposures but national regulation; gaps in EU-wide regulation and supervision (deposit insurance, bank resolution); a common safety net for the financial system would help mitigate pro-cyclical elements of fiscal policy. Heavily indebted countries faced sharp correction because fiscal and credit tightening compounded the recession.

- <u>Public finances</u>: Fiscal deficits in nearly all EA countries exceeded the Stability Pact 3% limit.

- <u>Growth model</u>: wide divergence in competitiveness indicators of member countries; balanced external position of EA as a whole masked huge internal imbalances.

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Initial policy response was case-by-case

- May 2010: Greece gets the biggest loan in history (€110bl), co-financed by EA countries and IMF
- June 2010: As contagion spread, the European Financial Stability Facility (EFSF) is created, with a mandate to borrow up to €440bn in the markets to rescue member-states at risk of default. To avoid Treaty changes, the EFSF was set up as a Luxembourg-based, AAA-rated SPV. EFSF was a temporary facility set to expire in mid-2013.
- Nov 2010: Ireland receives emergency financing of €85bn co-financed by EFSF/IMF
- May 2011: Portugal receives emergency financing of €78bn, co-financed by EFSF/IMF

Response to crisis-cont'd

- March 2011: EU Summit; leaders agree to set up a permanent crisis resolution framework, the European Stability Mechanism (ESM), to replace the temporary EFSF when it expired in mid-2013. Existing facilities under the EFSF would be merged into the ESM.
- The ESM supposed to function as an orderly default procedure, in which bondholders would suffer losses if a country's debt were judged to be unsustainable. In effect, EU leaders deferred for the future the judgment on whether this was a liquidity or solvency crisis that would require debt reduction.

The IMF was closely involved in the reform of the EA's architecture

- After an initial phase of hesitation, the Europeans determined that Fund involvement was a necessary component of crisis management and resolution.
- The Fund contributed actively to European discussions, both through direct and active involvement of the MD in Eurogroup meetings and EU summits, and through staff contributions to the design of mechanisms and procedures.

IMF advice during crisis

- The IMF was among the first institutions to understand the severity of the crisis and to call for a strong policy response.
- IMF advised EA to adopt a "comprehensive solution" to the crisis to restore confidence in its viability. Specifically:
  - -Set up firewalls to prevent contagion (ESM, OMT, QE)
  - -Break negative feedback loop between bank and sovereign stress (Single resolution fund)
  - -Impose effective fiscal discipline (stricter SGP enforcement)

Criticism of IMF advice

- Eagerness to play a role in the complex European policy process reduced the IMF‘s effectiveness as an independent “truth-teller” on the EA crisis (Pisani-Ferry J., A. Sapir, and G. Wolff “TSR External Study—An Evaluation of IMF Surveillance of the Euro Area” July 2011; also Paul Blustein “Laid Low: Inside the Crisis That Overwhelmed Europe and the IMF”, 2016).
- The ECB criticized the IMF’s decision to publish in 2009 estimates of potential write-downs (losses) in EU banks. However, the IMF contributed to increasing public awareness of the underlying problem.

Road map to completing the monetary union

Mid-2012: EU Council maps out a road to:

- Banking union
  - Common supervisory framework (SSM)
  - Bank resolution authority that would act as pan-European FDIC (SRM)
  - Deposit insurance (still pending)
- Fiscal union
  - balanced-budget amendments
  - ex ante approval of budget plans

Each issue is being addressed

- Crisis management mechanism (ESM): Took effect Oct 2012, with a capital of €700bn – was a missing element from EA architecture; possibility of default is necessary to impose market discipline!
- Common supervision (SSM) and resolution (SRM): ECB took over pan-European supervision of systemic banks in Nov 2014; SRM up and running; EA banks will contribute €55bn to SRF over 8 yrs; SRF gradually mutualized, with 40% of the funds available to all participating countries from year one.
- Fiscal compact: Intergovernmental Treaty to foster budgetary discipline took effect in January 2013.

Banking union needed to:

- <u>Break the link between banks and sovereigns</u>: The bank-funded Single Resolution Fund (SRF) helps break the vicious circle by avoiding taxpayer-funded bailouts.
- <u>Establish clear pecking order on bank losses</u>: Bail-in rules to deal with failing banks without burdening taxpayers (Cyprus).
- <u>Reverse fragmentation</u>: “Balkanization” of EU financial system stems from perception that stressed sovereigns lack the fiscal backstop needed to address potential capital needs.

But negative feedback loop between bank and sovereign stress remains

- In contrast to Anglo-Saxon world, European banks hold large exposures to their sovereign (up to a third of the sovereign debt outstanding).
- Large sovereign exposures raise concerns about bank solvency when their sovereigns are struggling to balance their budgets, potentially driving risk premiums to new records.
- Also, bank capital includes DTAs and DTCs in Greece and Italy, linking bank capital to sovereign stress.

Capital Markets Union initiative launched in 2015

- Financial union is a necessary complement to EMU, to transmit monetary policy signals uniformly across the union and to diversify risks in order to reduce the impact of country-specific shocks and the need for fiscal risk sharing.
- Together with banking union, CMU is a fundamental step towards completing the EMU architecture.
- EC is pursuing an Action Plan aimed at identifying and removing obstacles to cross-border capital flows.
- The Brexit vote in mid-2016 was a clear setback, as key elements of the Action Plan were delayed to avoid pre-empting the Brexit negotiations. But the movement of big parts of UK banks' operations to continental Europe will expedite the process.

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ECB is playing key role in resolving the crisis

- The ECB is the only institution that can act quickly, with unlimited resources at its disposal.
- It can put pressure on governments to take measures to cut public spending:

  - SMP program ended in Nov 2011

  - OMT program, announced in Sep 2012, is subject to conditionality under an ESM/IMF-supported program

  - QE program, started in March 2015, will end in 2018

Strengthening the European firewall to limit contagion

- Draghi promise to do "whatever it takes" to save the euro in June 2012 saved the euro.
- High borrowing costs in Italy & Spain (≥6% in 2012) risked causing their liquidity problem to morph into a solvency problem.
- <u>March 30, 2012 Eurogroup</u>: Combined lending ceiling of EFSF & ESM raised from €500 to €700bn.
- <u>BUT</u>: (a) €200bn was already committed to Greece, Portugal & Ireland; (b) additional capital would only be contributed gradually by mid-2014.
- Uncommitted resources of €500bn are barely sufficient to backstop Italy and Spain for a year

ECB launched Outright Monetary Transactions (OTM) in Sep 2012

- OTM is a way of leveraging ESM with near-infinite resources.
- Precondition for OMT is strict conditionality attached to an EFSF/ESM program. Can be full macro adjustment or precautionary program.
- OMT requires IMF involvement to be sought for the design of the country-specific conditionality and program monitoring.

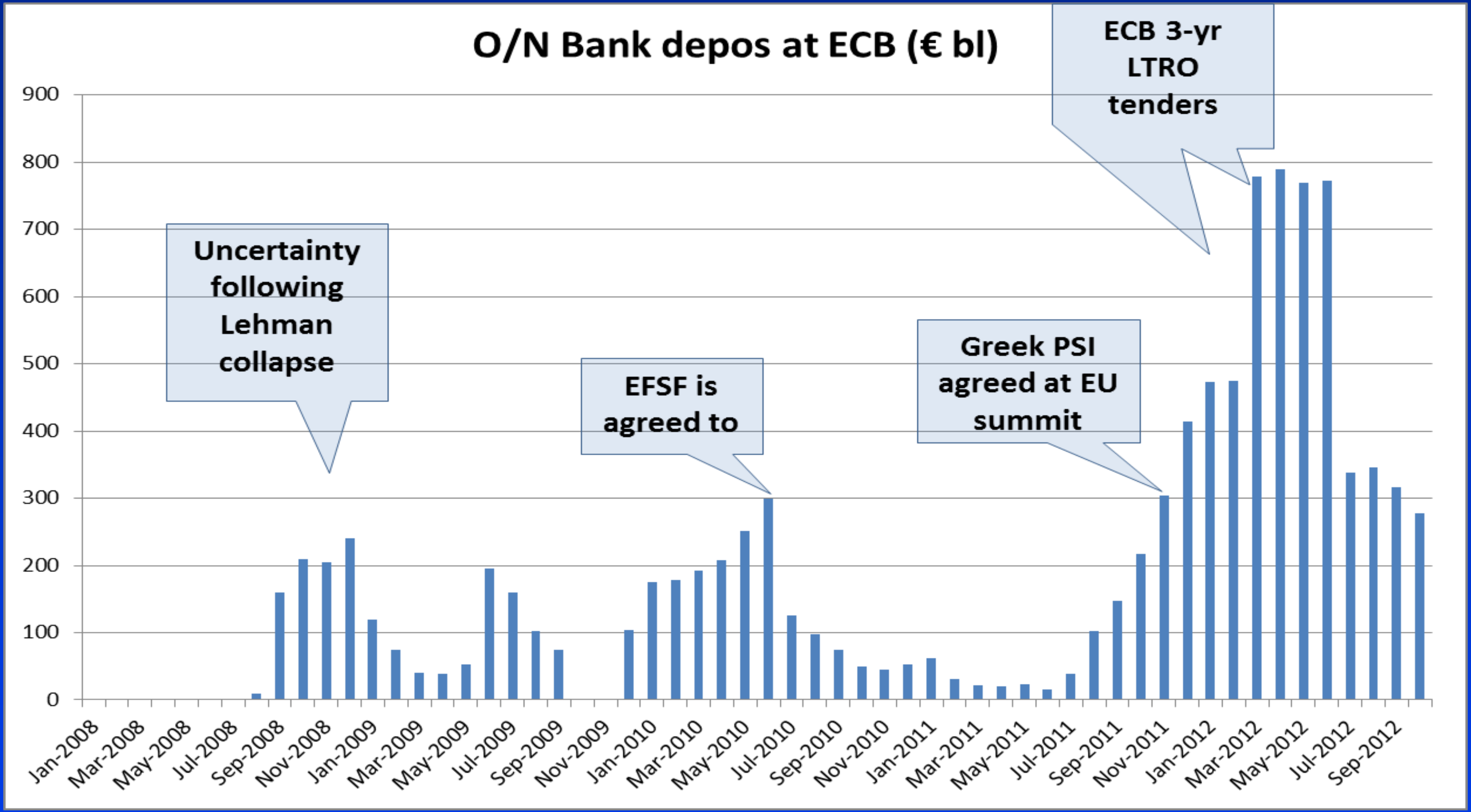
Two big differences between SMP and OMT

- OMT involves conditionality, whereas SMP did not.
- The ECB accepts the same (pari passu) treatment as private creditors with respect to EA bonds purchased by the ECB under OMT (addresses subordination concerns).
- By contrast, SMP purchases were a double-edged sword because they made private creditors junior to the ECB.

ECB launches 3-yr Longer-Term Repo Operation in Dec 2011

- ECB provided an unprecedented €489bl at a first-ever 3-yr LTRO tender on 21-Dec-2011, and an additional €530bl on 28-Feb-2012.
- Powerful tool to pump cheap liquidity into banks to help cover their refinancing needs at a time when funding markets had shut down due to counterparty risk.
- ECB expanded eligible collateral several times, opening up the possibility of additional liquidity provision even to junk-rated EA countries.

Spillover from sovereign debt crisis to banks' funding markets



Source: ECB

Systemic risk peaked in Nov 2011

- Spreads peaked in Nov 2011 due to lack of agreement on leveraging EFSF/ESM resources, fear of contagion.
- A good chunk of systemic risk was removed with 2^{nd} LTRO (Feb 2012), 2^{nd} rescue package for Greece (Mar 2012), and OMT announcement (Sep 2012).
- But still considerable headwinds ahead; fears that Greece might exit the EA receded, but concerns that austerity can lead to downward spiral remained.

EA going through a balance sheet recession

- A balance sheet recession emerges after the bursting of a nationwide asset bubble (real estate, tech) that leaves private-sector balance sheets with more liabilities than assets.

- To repair its balance sheets, the private sector starts deleveraging even at zero interest rates. Savings and profits are used to repay debt, while asset sales depress prices.

The ECB launched QE in March 2015, expanding its balance sheet by €60bn/mo

- The ECB embarks on a QE program similar in scale to those undertaken by JA, US, UK.
- About €3tr of liquidity provided so far.
- Interventions by the ECB can buy time, but the final solution to debt problems must come from governments (balanced budgets, growth-oriented reforms).

QE would not add to inflation

- When the private sector is deleveraging despite ultra-low interest rates, the money multiplier for the private sector turns negative at the margin.
- This means the money supply will not increase no matter how much QE the central bank engages in.
- Without growth in the money supply, there can be no inflation.

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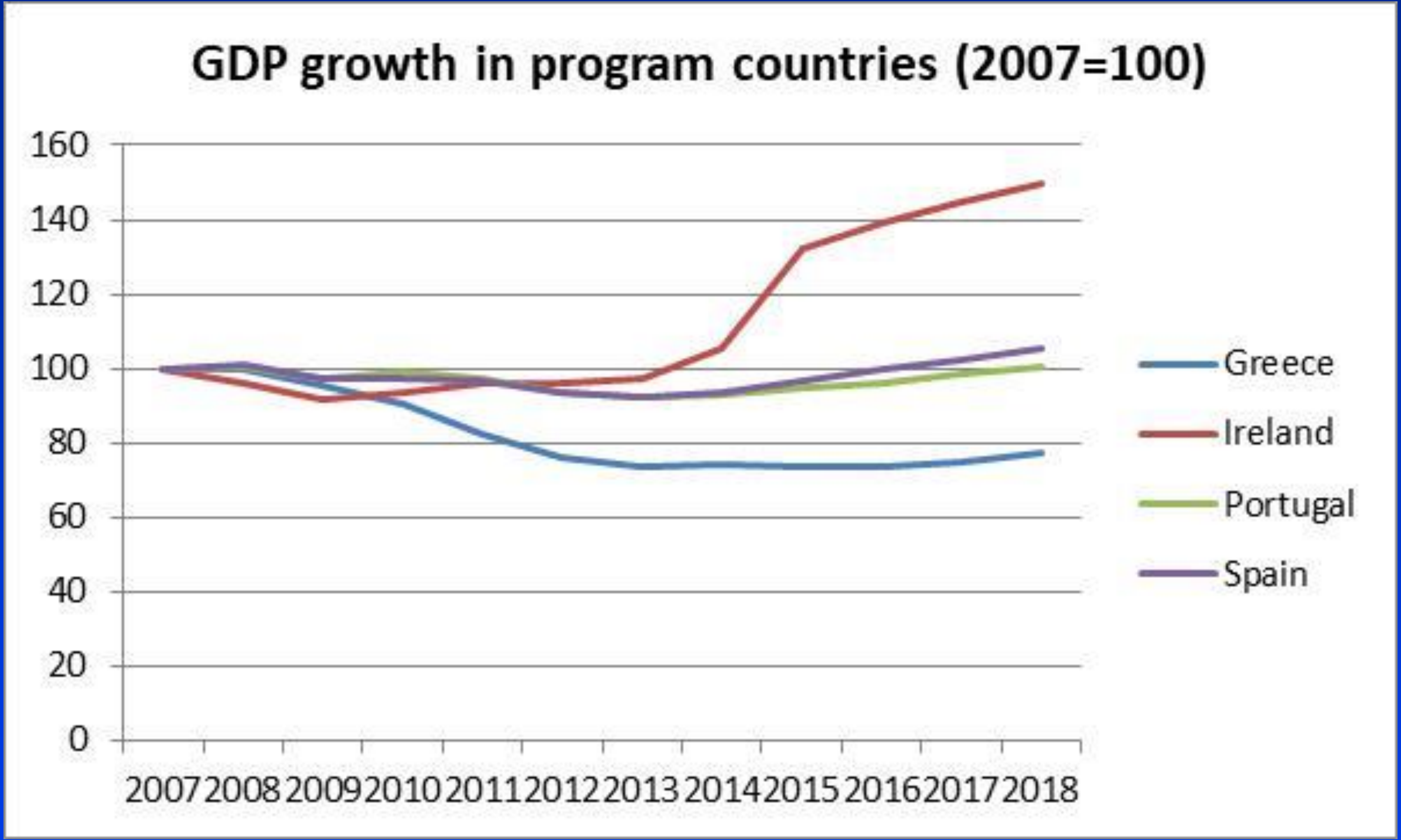
Program countries: Country-specific remedies proved insufficient

- Greece rescue package agreed in May 2010 (€110bn);
  - 2nd rescue package agreed in March 2012 (€130bn)
  - 3rd rescue package agreed in July 2015 (€86bn)
- Ireland rescue package agreed in Nov 2010 (€85bn)
- Portugal rescue package agreed in May 2011 (€78bn)
- Spanish banks' rescue package agreed July 2012 (€41bn)

Origins of crises very different:

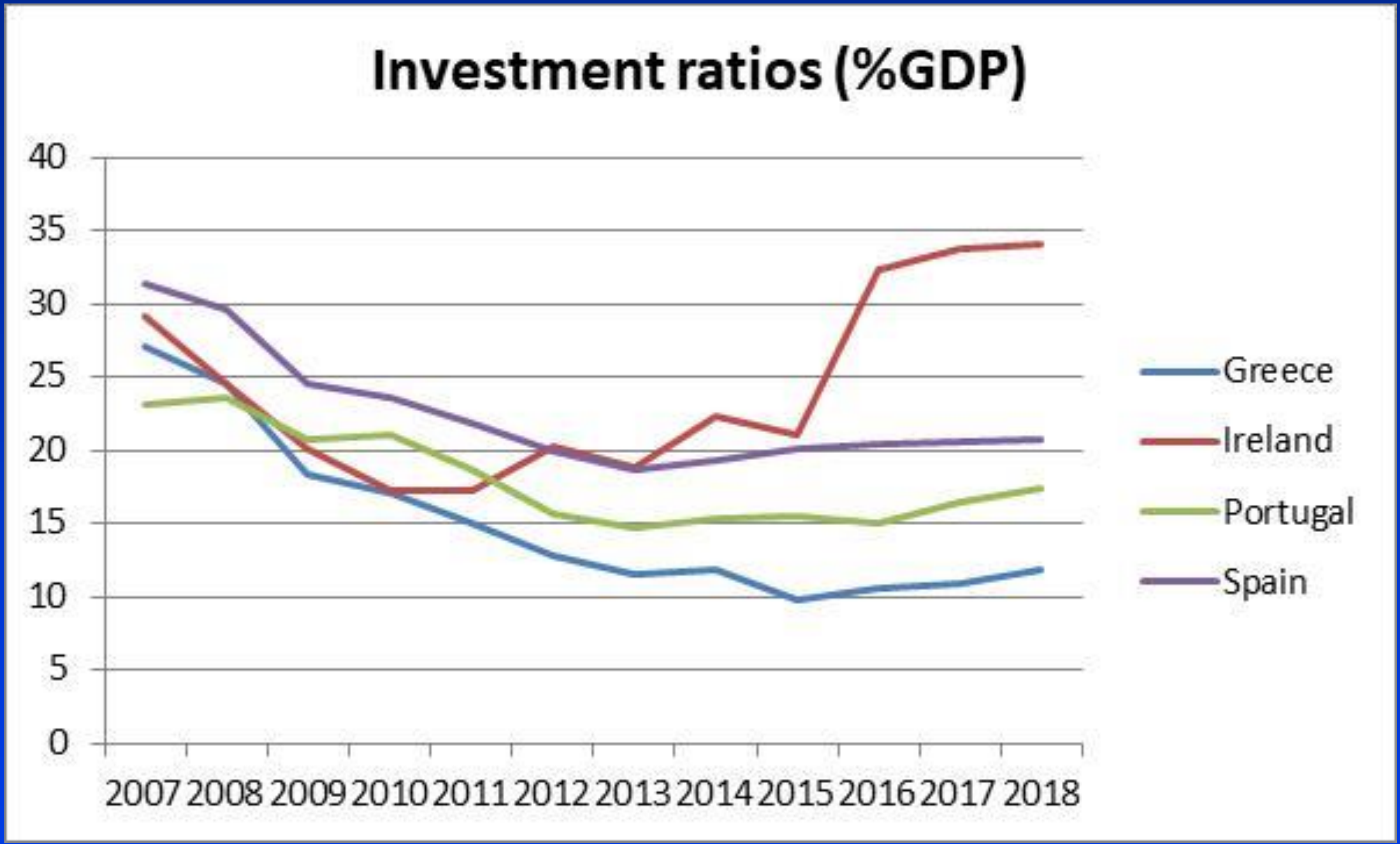
- IR, SP: legacy costs of the real estate boom-bust
- GR, PO: competitiveness and public finances

GDP in the periphery now above pre-crisis level (except in Greece)



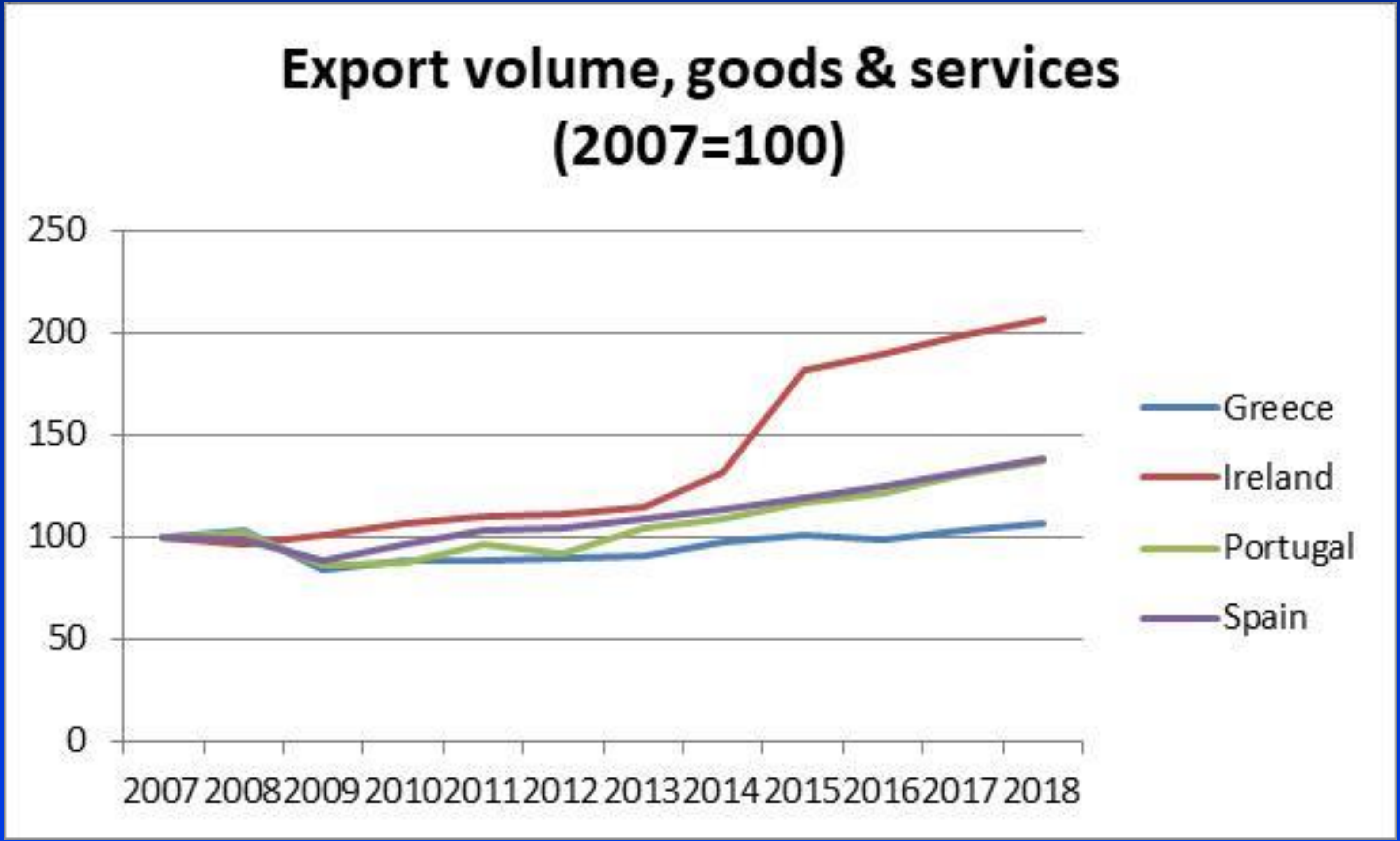
Source: IMF WEO database

Investment ratios have dropped sharply (except in Ireland)…



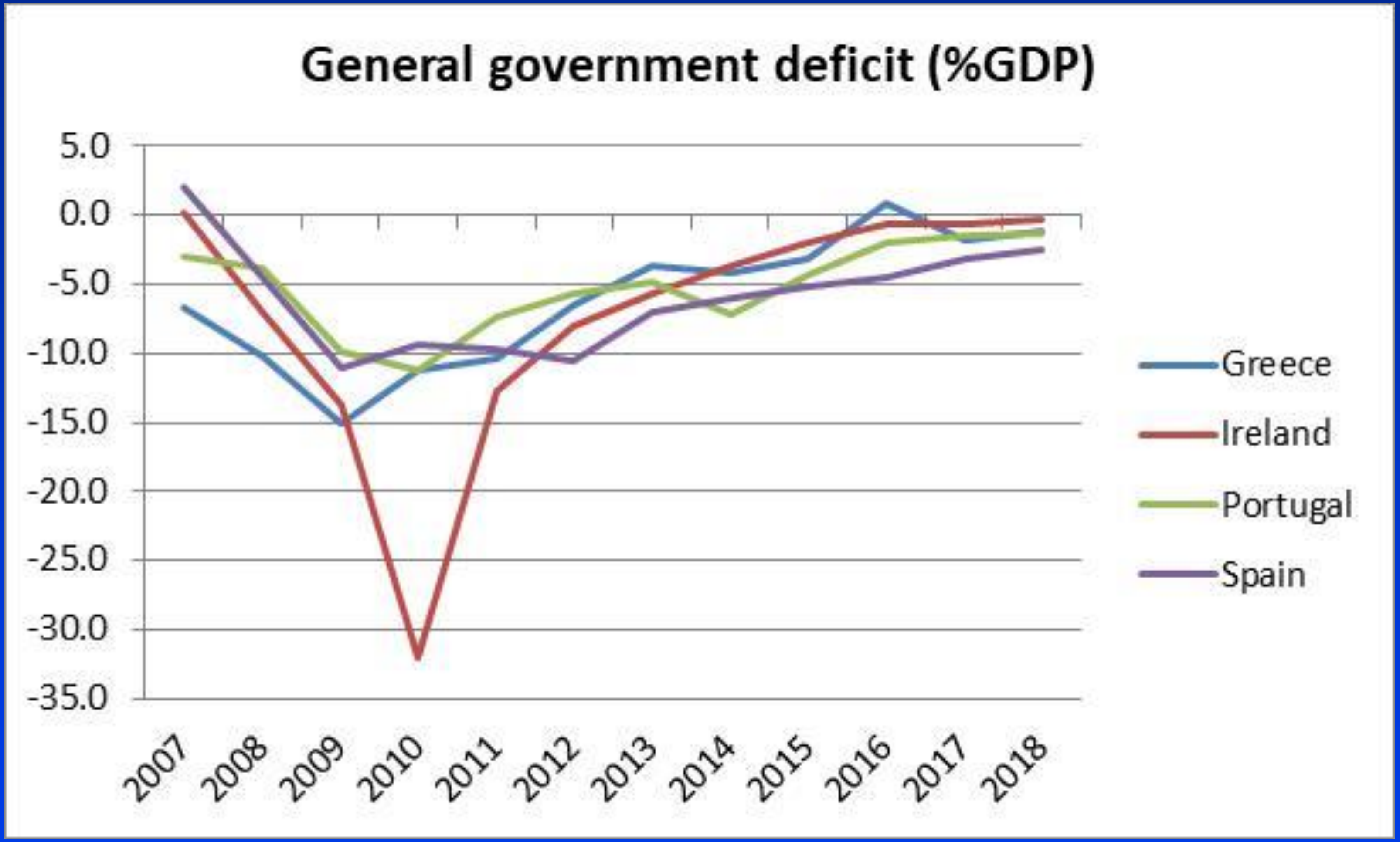
Source: IMF WEO database

…but exports are picking up part of the slack



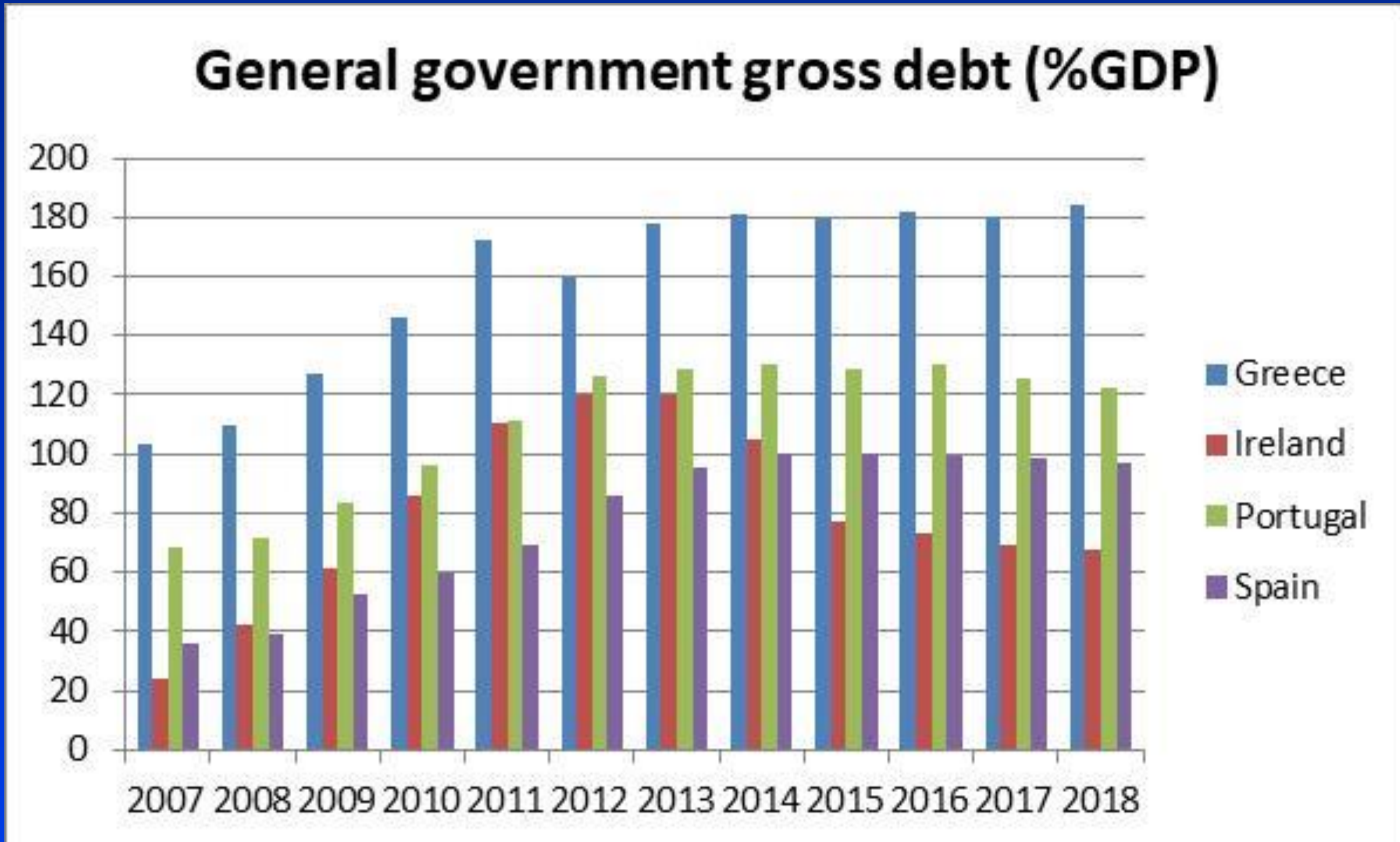
Source: IMF WEO database

Fiscal deficits converging to balance…



Source: IMF WEO database

…stabilizing the debt burden



Source: IMF WEO database

Austerity is not a choice

- Countries that have lost market access (Greece) or face high risk premia (Spain, Italy in 2011-12) have no choice: they must bring their budget deficits to a sustainable fiscal path to receive official funding.
- Lenders will not fund spending at the level that got the country into trouble.
- In the EA periphery, austerity is not a matter of fine-tuning demand, but of ensuring the government's solvency.
- Solvency, in turn, depends on growth prospects and debt service obligations.

World Bank – 2018 Doing Business Report

- Global rank (190 countries):
  - Ireland 17th
  - Portugal 28th
  - Spain 29th
  - Italy 46th
  - Greece 67th (downgraded 6 places,18th out of 19 EA countries)
- Greece still ranks very low in the areas of
  - registering property (145th)
  - enforcing contracts (131st)

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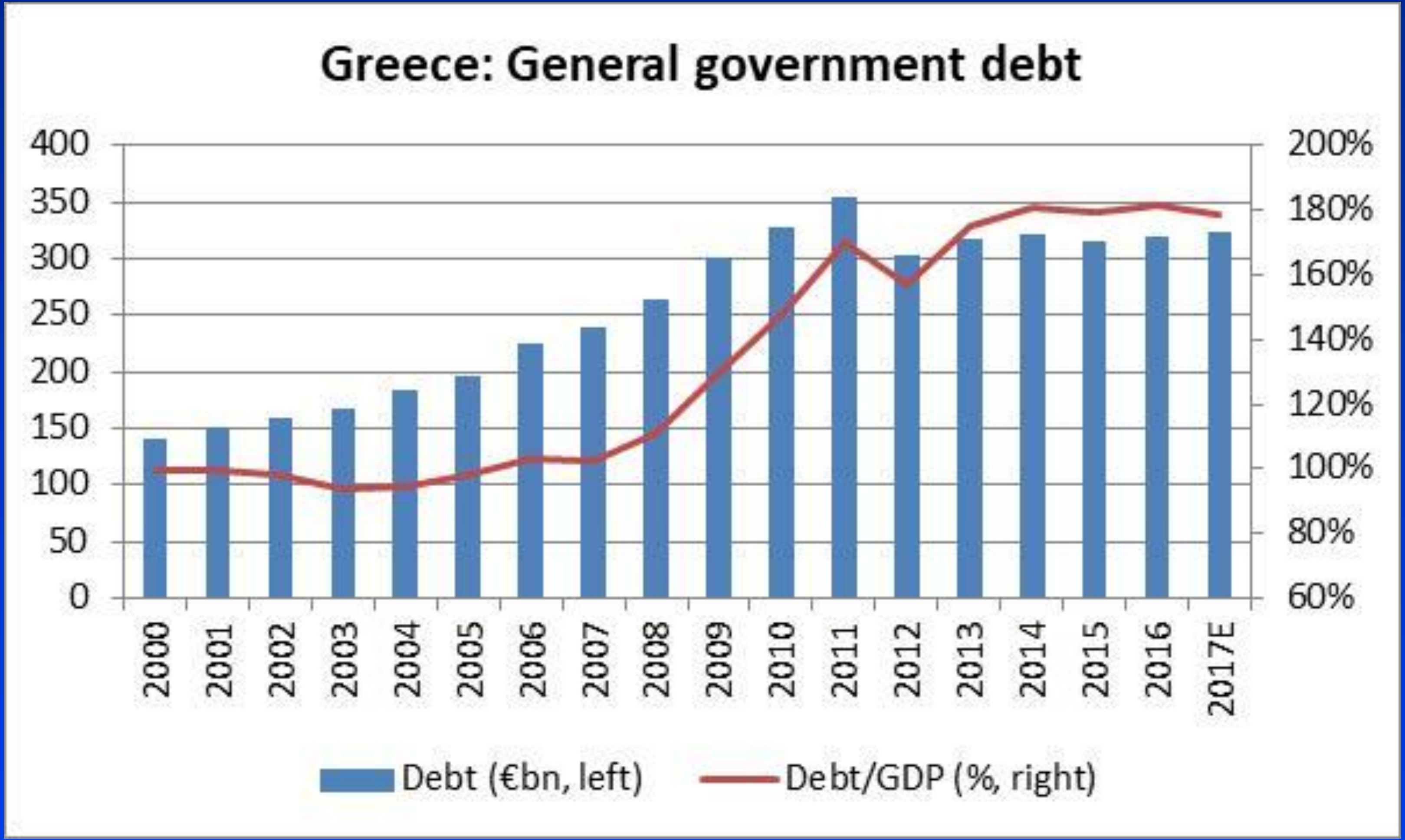
The 2012 Greek debt restructuring

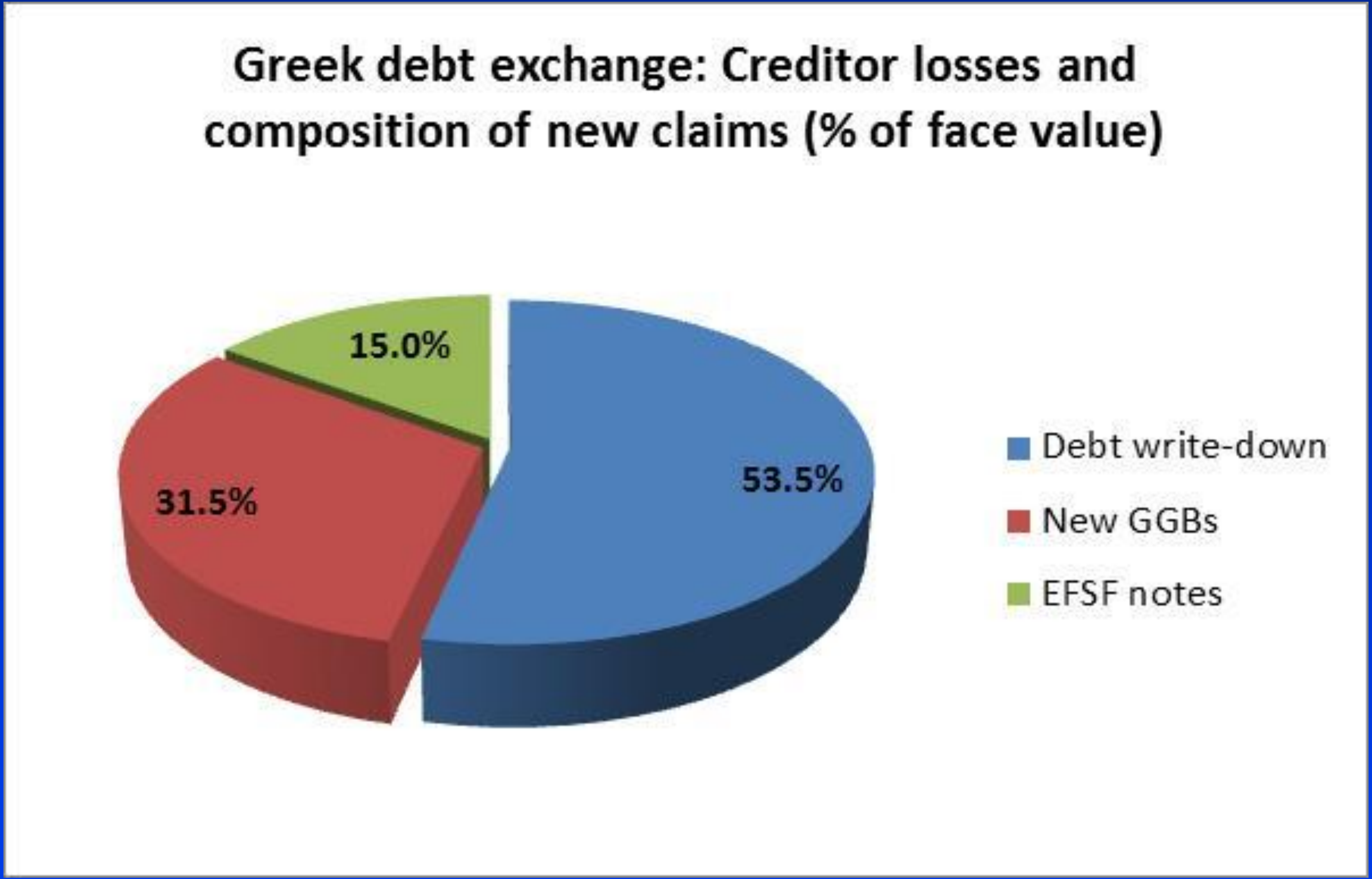
- Key episode in Eurozone crisis
- Largest debt restructuring in the history of sovereign defaults (€206bn).
- Though it achieved unprecedented debt relief of €106bn (55% of GDP), “too little, too late” to restore debt sustainability.

Greece's debt ratio is now 178% of GDP, higher than before the debt restructuring



Source: IMF WEO database

The 2012 debt exchange involved a 53.5% haircut on eligible debt



Mega-swap of 20 PSI bonds underway

- The government has invited investors to swap the 20 PSI bonds issued in 2012 maturing over 2023-42 with 5 new bonds maturing over the same period at 5-year intervals (2023, 2028, 2033, 2038, 2043).

  Coupons: 3.5%, 3.75%, 3.90%, 4.0% και 4.2%

  Settlement date: December 5
- The objective is to increase liquidity by quadrupling the size of each bond, and thus facilitate Greece's return to international capital markets.
- More in Kopf & Xafa (2013) "A proper yield curve for Greece to start financial intermediation", CEPS https://www.ceps.eu/publications/proper-yield-curve-greece-kick-start-financial-intermediation

Drawing the lessons

- Two features make Greece unique in history of sovereign debt:

(1) By virtue of EA membership: Greece was bankrupt in its own currency but could not inflate its debts away.

(2) Unlike emerging markets: The bulk of public debt was issued under domestic law without CACs.

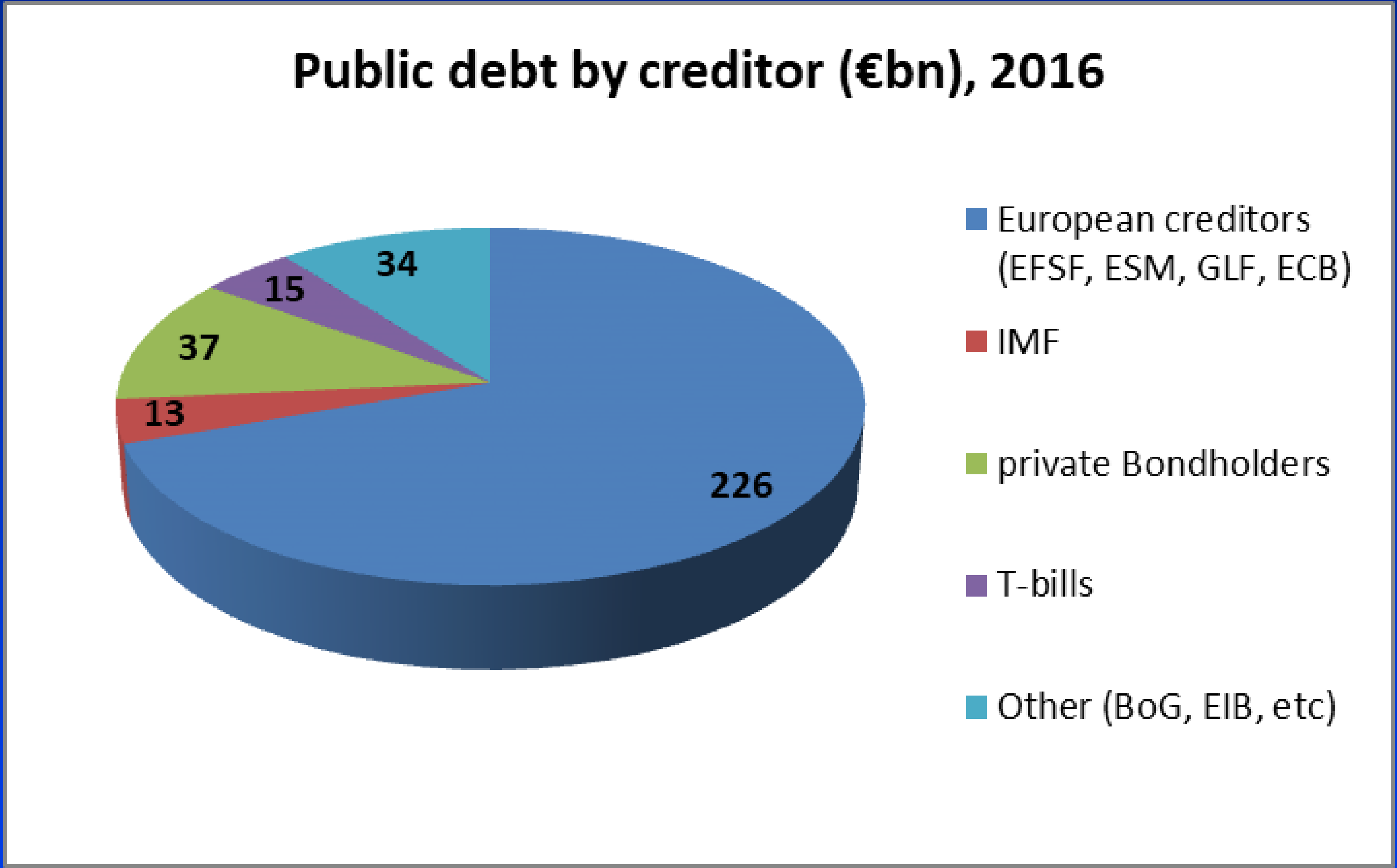
Greek debt issued under domestic law

- Greek debt issued under domestic law, with few creditor protections, gave Greece enormous power to change bond terms; but Greece chose to just retrofit CACs by an act of parliament.
- There was thus no coercive restructuring, no disorderly default (unlike Argentina 2001).
- But the CDS were triggered by ISDA; a non-event, as it turned out.

Timing

- Heated debate on whether debt restructuring could have taken place earlier, to avoid paying maturing debt with official loans.
- Deep haircut up front (May 2010) would be seen as unnecessary and deeply coercive.
- But delaying the restructuring beyond the spring of 2011, when debt was clearly unsustainable, was unjustified.

The official sector is by far Greece's largest creditor (81% of total)



Source: PDMA

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The crisis is not over

- Private sector borrowing costs remain high in the periphery, particularly for SMEs, and ailing banks continue to restrict the flow of credit
- Sovereign credit spreads converging, but wide discrepancies persist
- GDP in the EA periphery only just returned to pre-crisis level in Portugal and Spain, but far below in Greece
- Public debt ratios are still high
- ECB's stress tests could reveal additional capital needs for some EA countries
- Banking union and capital markets union still incomplete

Thank you!