

The Greek crisis, why bankruptcy is a bad option, and why leaving the euro is the worst option

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Nicholas Economides

Stern School of Business, New York University

<http://www.stern.nyu.edu/networks/>

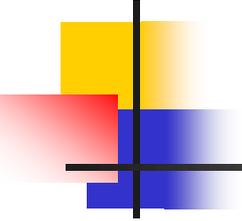
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<mailto:economides@stern.nyu.edu>

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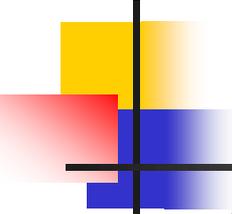






Greece has three big economic problems

- Huge accumulated debt it cannot service
- Significant public sector deficits
 - Tax evasion; need new tax enforcement
 - Very inefficient public sector; corruption in procurement
- Lack of competitiveness caused by
 - Union power increasing wages and salaries
 - “Closed” sectors, including trucks, taxis, pharmacies, engineers, lawyers, notaries
 - Fixed exchange rate (locked in the Euro)



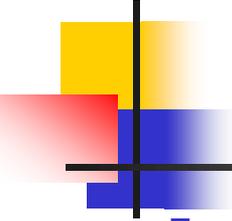
Three options available to Greece (voted Feb. 12, 2012)

A. Accept lenders' demands, do loan restructuring, and receive €130 billion additional loans [approved by Greek parliament on 2/12/12]

B. Reject lenders' demands and declare bankruptcy (hard, uncontrolled default) within the Euro

C. Reject lenders' demands, declare bankruptcy, and leave the Euro

In my opinion, "A" is by far the best



The EU & IMF provided Greece with loans of €110b asking for reduction of public deficit and liberalization of “closed” sectors (May 2010)

- Things did not work smoothly because
 - The EU, the IMF, and Greece focused on a short run perspective, essentially postponing the full acceptance of the problem
 - Serious disagreements arose among the EU members, and between the EU and the ECB
 - Some of the imposed requirements were unfeasible
 - The Greek gov. proved inept in implementing the agreements
- The Greek gov. has essentially given its power to the EU/IMF/ECB lenders; did not distinguish between feasible and unfeasible demands
 - Every economic measure adopted so far was dictated by the EU/IMF/ECB lenders
- This, combined with a deep recession and high unemployment has created a very negative mood in Greece that equates the present crisis with the Nazi occupation of 1941-1944 that was devastating for Greece causing over a million deaths and the extermination of the Greek Jews of Thessaloniki

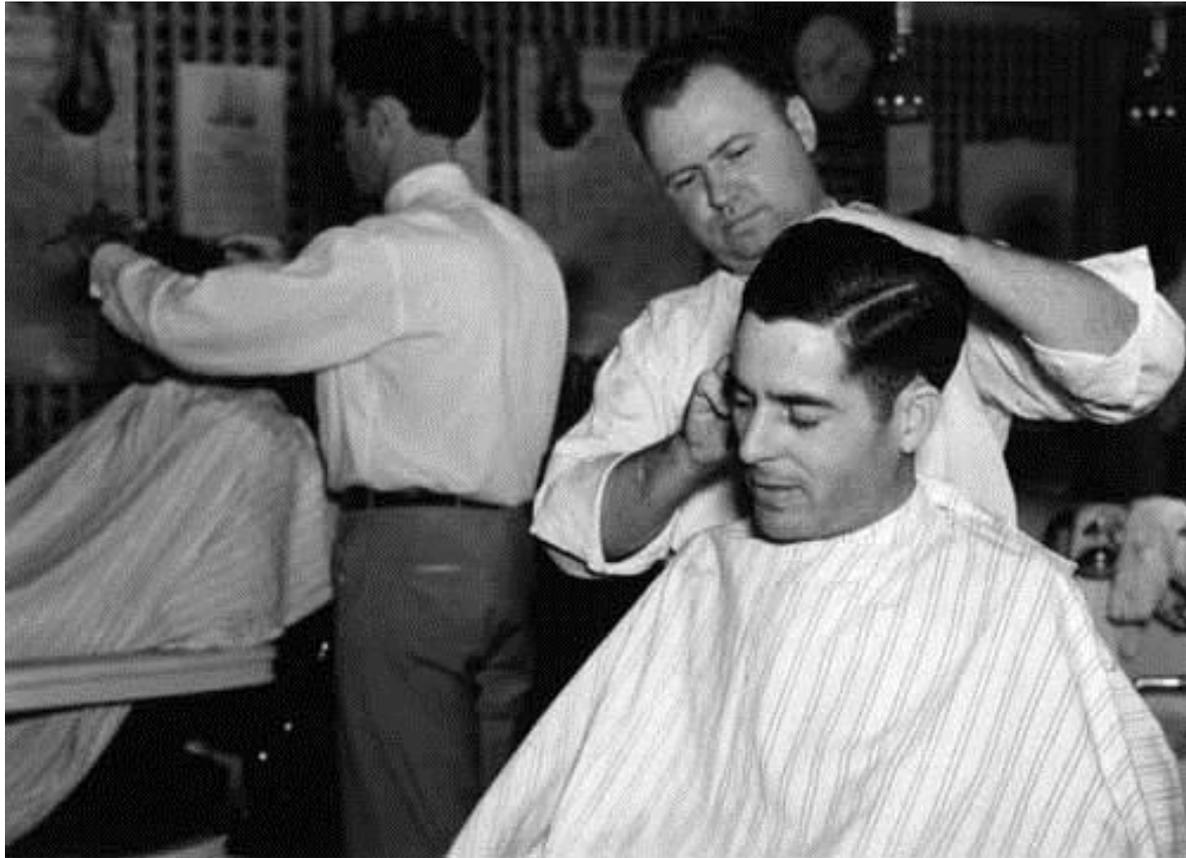
Greek sovereign debt is very large and growing

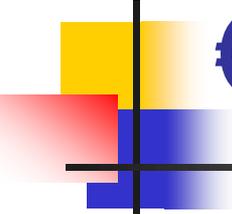
- Greek sovereign debt: €329 billion at end of 2010, €368 billion at end of 2011
- In May 2010, EU & IMF promised Greece a €110 billion loan (EU €80b; IMF €30b)
- Greek debt held by private parties: €210 billion
 - Unclear if €55b held by the ECB will be subject to a haircut
- Greek GDP was €230 billion in 2010; €215 in 2011
- Greek sovereign debt was 145% of GDP at the end of 2010; 169% of GDP at end of 2011
- Greek debt is growing because:
 - Despite cuts in public sector expenses, the Greek public sector had a budget deficit of 10% in 2010, which increased debt
 - Severe recession in Greece reduces the GDP and therefore increases Greek sovereign debt as a percentage of GDP

Greece cannot pay back the full amount of its debt

- Even if Greece had public sector surpluses (but it has an over 10% deficit instead), debt reaching 150% or more of GDP cannot be fully financed from the surplus, even at a relatively low interest rate of 4-5%
- At 5% interest rate
 - yearly interest on Greek sovereign debt is €17.5 billion
 - or about 21% of public revenue
- This is unsustainable, and fin. markets understand that
- Present interest rates of Greek bonds (in secondary market)
 - 1-year: 497%, 2-year: 197%, 5-year: 52%,
 - 10-year: 33%, 30-year: 21%
- Greece cannot impose reductions on EU and IMF bilateral loans
 - Needs to reduce its privately-held debt
- "Haircut" of the private debt imminent (next week)

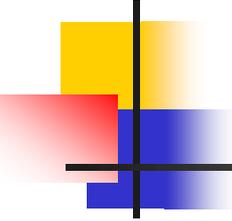
“Private Sector Involvement” (PSI) Will Cut Greek Debt Not Held by the EU and IMF by 50-70%: Debt Haircut





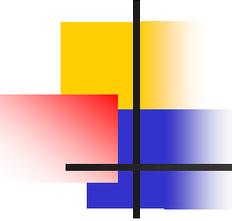
Voluntary Restructuring of €200-250billion of Greek debt

- Voluntary exchange of old debt with new (Brady method, as proposed by Economides and Smith (2010))
 - At the bond exchange, impose a market-implied haircut (50-70%)
 - New debt will have long maturities (30-50 years)
 - 15% of the principal will be paid by the EFSF
 - 35% of the principal will be paid by Greece
 - In July 2011, the EU proposed restructuring with a 21% haircut; not implemented
 - In Oct. 2011, the EU increased the restructuring target haircut to 50% (to be implemented next week)
- Not uncontrolled bankruptcy
- Not considered “default”
- Not a “credit event”
- No triggering of Credit Default Swaps (CDS)



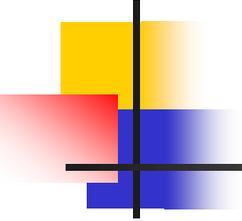
Problems for Greek banks after a voluntary restructuring?

- Greek banks have about €40 billion exposure to Greek bonds and less than €5 billion total market value
- They will take an accounting hit of €20 billion
- These losses have already occurred, but, using an accounting trick, banks do not show the losses in their books
- Restructuring will imply an accounting recognition of the existing losses
- Greek banks need to recapitalize
- Greece will give banks €30-35b ECB money and get common shares (non-voting for 5 years, voting later)
- In contrast, the US financed Citibank when it was bankrupt in 2008 with preferred non-voting shares

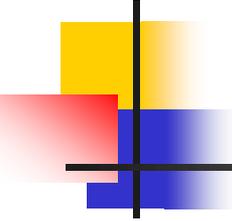


Impact of the PSI on EU banks

- Largest non-institutional holders
 - French banks € 56.9b
 - German banks € 28.3b
 - UK banks € 14.7b
- Except for BNP and Societe Generale, Greek holdings are widespread
- Minimal exposure of US banks

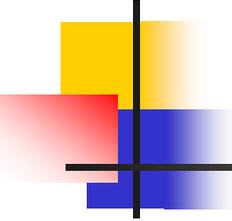


OPTIONS FOR GREECE



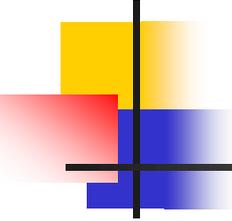
Option A: Accept the PSI and additional lenders' demands, and receive €130 billion of new loans from the EU and IMF

- Cut private sector minimum wage by 22%
- Lay off quickly 15,000 out of about 800,000 civil servants
- Over 5 years reduce civil servants by 150,000
- Open the "closed" professions
- Reduce (presently rampant) tax evasion
- Reduce supplementary pensions that were supported by investments in Greek bonds
- Receive € 100b loan + € 30b for banks' recapitalization



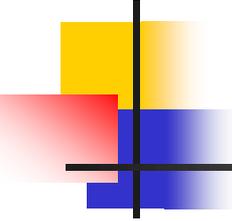
Option B:

- Reject lenders' demands and declare bankruptcy (hard default) within the Euro



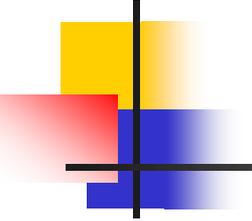
Should Greece do a hard default / uncontrolled bankruptcy?

- Lehman-like (2008) event with adverse effects for world financial markets
- Bad for Greece, the EU, and the US
- Under a hard default, Greece will
 - have to balance its public sector immediately
 - have to cut public sector procurement and lay off about 20% of civil servants immediately
 - Greek importers will have to pay cash
 - Huge disruption of trade; will be difficult to find imported goods, even necessities like drugs and fuel
 - Exclusion of Greece from capital markets for years
- Greek banks may collapse
- EU banks will face additional large losses
- “Credit event” will trigger CDS and have repercussions in many markets, including in the US



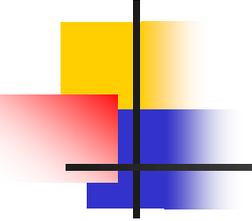
Option C:

- Reject lenders' demands, declare bankruptcy, and leave the Euro



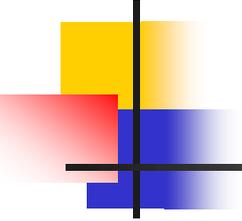
Greece leaving the euro is a very bad for debt

- If Greece leaves the euro, its “new drachma” will be devalued significantly compared to the old drachma
 - Old drachma to euro approx. 340 dr = 1 €
 - New drachma to euro approx. 1000 Ndr = 1 €
- Debt is in euros, suddenly gets multiplied by 3 in new drachmas
- Outside the euro, Greece will be forced to borrow at very high interest rates
- Present interest rates of Greek bonds
 - 1-year: 497%, 2-year: 197%, 5-year: 52%, 10-year: 33%
 - 30-year: 21%
- Debt will be unsustainable (again)
- It will be hard to cut the debt because most of it will be to EU countries and the IMF



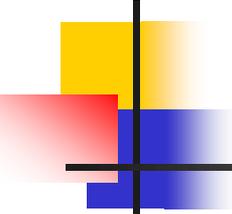
Greece leaving the euro will create very high inflation

- Will result in huge inflation in Greece where practically everything is imported
 - Prices in Greece will be multiplied by 3, wages and pensions cannot adjust quickly, and Greeks will become much poorer
- To pay public servants salaries and pensions, Greece will print too many new drachmas, thereby creating an inflationary spiral
- Greek politicians (who have already proved to be irresponsible) will have an “easy way out” by printing drachmas
- Will create hyperinflation



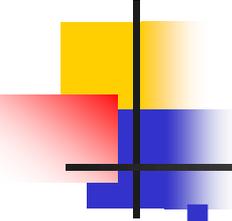
Greece leaving the euro will lead to bank collapse

- As leaving the euro is anticipated, Greek banks will collapse because
 - Depositors will withdraw their euros (what little is left in banks) because they will not trust the government to convert them to new drachmas at the “right” exchange rate
 - The ECB will withdraw its lifeline of about € 116 billion cash to Greek banks



In summary, Greece leaving the euro will result in

- Greek banks collapsing even before the new drachma is introduced
- Extreme poverty as goods become three times more expensive
- Hyperinflation as Greek politicians will now be able to print currency
- Likely social unrest – already parties on the left of PASOK have 36-40% in polls
- Greece has significant national and political reasons besides the economic reasons to stay in the Eurozone at the core of the EU
 - Danger of isolation in a neighborhood of a very aggressive enemy which can easily overpower Greece militarily
 - Greece needs support of the EU and the US to counterbalance



Is there hope? Yes!

- Two largest political parties accepted Dr. Papademos as Prime Minister, former head of Bank of Greece and Vice Chairman of ECB
- But
 - there is a need for tremendous amount of work to be done while parties push for elections in April or May
 - many Greeks think that they have sacrificed enough and want to give up
 - many Greeks have no idea how bad things can be if Greece declares bankruptcy and leaves the euro
- The fate of Greece is very uncertain
- Most likely scenario
 - Greece accepts option "A" [approved 2/12/12]
 - Implementation will be limited, as usual
 - EU and IMF consider another package for Greece in June 2012



See “Greek economists for reform” at <http://greekeconomistsforreform.com/> for a discussion by prominent Greek academic economists on the crisis