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Economy and Markets

The price of uncertainty

Summary

Eurobank's Economic Analysis and Financial Markets Research published today a special analysis titled "The price of uncertainty". Authors of this publication were Mr. N. Karamouzis, Chairman Eurobank Ergasias, Chairman Hellenic Bank Association and Mr. A. Kouleimanis Group Strategy, Transformation Sector, Eurobank Ergasias.

For almost a decade, Greece has experienced an unprecedented crisis, both in terms of duration and intensity, following eight years of economic adjustment programs that have come at an extremely high social and economic cost. However, with the completion of the second review of the third economic adjustment program it appears, for the first time since the first half of 2014, that both international markets and ordinary citizens are gradually regaining confidence in Greece's growth outlook and the prospect of finally exiting from the crisis. The country's recent, successful issuance of a 5-year government bond, after three years exclusion from the debt markets, confirms this sentiment.

Despite the unprecedented social and economic cost, the country, for several years now, has remained mired in economic stagnation and uncertainty, and under strict oversight of its adjustment programs. This is regardless of the fact that there has been a significant macroeconomic convergence – that the major macro imbalances that led to the crisis have been eliminated – and that dozens of reforms have been implemented, as affirmed by major international indicators.

The rapid downgrading of Greece's sovereign credit rating by the international rating agencies, mainly due to the large macro imbalances in the early stages of the crisis, had abruptly interrupted the country's access to international markets. As a result, the yield on the Greek benchmark, 10yr sovereign bond skyrocketed, especially during periods of increased uncertainty and risk.

Given the above circumstances, a number of poignant questions arise: why does Greece remain in this unfavorable position? Why has the necessary macroeconomic adjustment carried such a large social and economic cost? Why do international markets, the business community, investors and Greek citizens alike remain skeptical about the ability of Greece to exit the crisis after so many years and despite the macroeconomic and structural progress that has already taken place? Why do the markets demand a significant risk premium in order to lend to the country? Finally, why have other countries exited the adjustment programs and are now on a rising growth trajectory, whereas Greece is only slowly moving in this direction?

Thus, if we accept the hypothesis that the sustainability of the public debt is not the only, or even the main, explanation for the still low credibility of Greek economic policy and similarly limited market confidence and trust in the country's prospects of exiting the crisis, then the question arises: what accounts for such a poor outcome? In our view in the case of Greece, credibility and trust were critically influenced by a number of other important and interacting factors which fueled uncertainty and undermined political instability leading to the confidence of the markets in Greece and its prospects.

Credibility of economic policy and trust of the markets fluctuated at low levels throughout the crisis mainly because of:

1. high political uncertainty and risk,

2. serious inconsistencies and delays in delivering reforms which undermined market confidence in the commitment of the Greek government to implement the agreed measures (program ownership),
3. wrong policy mix in certain areas,
4. absence of a convincing and credible Greek national plan for exiting the crisis that would enjoy wide political and social acceptance and support. The adjustment program was constantly disputed and challenged by the political system but we never presented our own program to restore fiscal sustainability, financial stability and growth prospects.

Especially, the comparison between Greece and Portugal (a country of roughly similar size) is extremely problematic for the former. Despite the fact that, in recent years, Greece has implemented a much greater fiscal and macroeconomic adjustment compared to Portugal, the yield on the Greek 10yr government bond remains roughly 260bps higher than that of Portugal. Also, Portugal, as opposed to Greece, has normal access to international markets, while the credit default swap (CDS) on Portuguese debt is 266bps lower than the Greek equivalent and its credit rating (S&P) is five notches higher.

The cost of Greece's low credit rating, which reflects the views of the rating agencies on the country's macroeconomic, political and social prospects, can be seen by comparing the ten-year bond yields and credit ratings of different countries with those of Greece.

Indicatively because this relation is not linear comparing 10yr bond yields, current data shows that a one-notch decline in credit ratings roughly corresponds to a 40 bps increase in borrowing costs. Currently, Greece's credit rating stands six notches below "investment grade". It should be noted that the yield on the Greek 10yr government bond remains significantly higher than that of other European countries, despite the notable improvement in conditions and expectations.

In the case of Greece (as opposed to the recent experience in the U.S., as well as other countries of the euro area) the crisis was not triggered by excess in the domestic banking industry. The Greek crisis was a result of Greece's fiscal derailment and loss of competitiveness after the country joined the European and Monetary Union.

The long duration of the crisis and the deep recession, in tandem with high interest rates, losses stemming from the PSI debt swap, tight liquidity, large scale deposit outflows, the ongoing uncertainty caused by the ineffectiveness of the applied economic policy, and finally, the risk of Grexit, have significantly damaged the banking system. Damage has also been done by the prevailing attitude of a large number of debtors to shirk their obligations. Combined, these factors have forced the banks to seek several major capital increases and led to the formation of substantial higher provision levels for bad debts.

In particular, the banking system was forced into successive capital increases totaling €64bn, partly covered by private money, has lost deposits amounting cumulatively to €125bn, and relied heavily on the Eurosystem for liquidity to survive (at the height of the crisis Eurosystem borrowing exceeded €130bn). Non-performing exposures have spiked to more than €100bn, which has led to €57bn of accumulated provisions. As a result, Banks received substantial state aid and have to implement significant restructuring plans. Bank shareholders, including the Greek state, lost twice their total investment in the banks amounting to tens of billions of euros. In addition, capital controls were imposed and banks were forced to implement restructuring programs and shrink their activities, while a number of them were pushed to non-viability and eventually bankruptcy.

For Greek companies, whereas in September 2008 were borrowing at less than 100bps (1%) above the European Union average, that difference increased to more than 300bps when the second economic adjustment program was officially adopted. On average, the difference in borrowing costs between Greek and European companies almost tripled compared with pre-Lehman level, with significant negative repercussions on the companies' cash flows. Currently, though borrowing costs have declined moderately, they still remain significantly higher than in other Eurozone members that requested financial support from international lenders through an economic adjustment program. Undoubtedly, high borrowing costs and economic uncertainty negatively affected not only credit demand, but also Greek entrepreneurs' appetite for investment. It is indicative that net lending flows (new disbursements less repayments) from 2011 to 2015 were strongly negative, while in 2016 they shifted into positive territory with just €120m, reflecting limited demand, tight liquidity conditions and more conservative bank lending policies.

The recent decline of uncertainty and risks, as well as Greece's improved economic growth prospects, confirmed by a string of encouraging data, market expectations and the issuance of a new 5yr sovereign bond, undoubtedly constitute positive developments. However, the country is still far from securing full coverage of its financing needs through the markets at competitively low rates without having to depend on the positive progress reports of official creditors overseeing the 3rd adjustment program. It is crucial for the future of Greece to bridge, in a timely and decisive manner and with appropriate policies, the credibility and trust gaps that continue to exist so the country can continue on its path towards economic normality at lower cost and with greater economic benefit. To this end, it is of vital importance that Greece strictly implements the agreed policy conditionalities attached to the bailout program, and create a greater political and social consensus on the adoption and implementation of a national reform program. Without further delay, the country must undertake growth initiatives focused on rebuilding the country's productive base, relying on private investment and an outward orientation of the economy, with emphasis on international tradable goods and services, as well as Greek manufacturing and agricultural production.

Likewise, it is critical that Greece create an inviting institutional and economic environment for business, private investment, innovation, exports, and attracting significant foreign capital. The latter is of overriding importance, given the collapse of domestic savings, private sector deposits and the liquidity squeeze in the banking system, to secure the quick return of the country to a strong growth trajectory.

Economic growth will help address the major problems the country faces in terms of unemployment, poverty, high public debt and the large stock of non-performing loans in the Greek banking system.
Lastly, the key prerequisite for realizing all of the above is political stability and the unwavering adoption – by the greatest possible economic, political and social majority – of all the necessary reforms. Only then will the country return to normal economic and social conditions, regain access to financial markets, and restore Greece as an equal partner within the European Union free of capital controls and economic supervision. A country with strong growth prospects, capable of taking the future in its own hands, relying on its significant comparative advantages, the private sector and competitive markets, the untapped potential of its productive forces and the skills and abilities of its human resources. Greece has the ability, but also the opportunity, to turn the next ten years into a period of strong economic recovery for the country, establish a modern, competitive, open and productive economy for the benefit of the many, and with effective social policy and protection for the most socially vulnerable groups.