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Greece – Key Issues

[March 25, 2010]

Greece needs a multiyear adjustment program with large financial backstopping. *It needs more time than provided under present SGP limits to adjust the fiscal balance, get the debt under control, and implement structural reforms to restore competitiveness. During this transition period, the financing needs will be large, the economy will be very sensitive to negative shocks and the stress for Greek society will be high as well. Capital markets need strong confidence that funding assurances are in place for the long duration of these efforts, otherwise interest rates for Greek bonds will not come down and make the debt dynamics quickly unsustainable. The challenge goes much beyond overcoming the short-term problems resulting from a bunching of amortization payments in April-May of this year.*

- **The economy is uncompetitive.** Few reforms have been implemented, the economy remains relatively closed, and competitiveness has dropped by some 25 percent since euro adoption as domestic prices have continuously exceeded the euro average. The current account balance, even in the recession, still stands at 11 percent of GDP.

- **Fiscal policy has been poor.** Reflecting higher spending on wages and entitlements, and tax cuts, non-interest spending jumped by 8 percent of GDP between 2000-09 and revenue fell by 3 percentage points, thus worsening the primary fiscal balance by 11 percent of GDP since 2000. Public debt increased to 115 percent of GDP.

- **Deflation and low growth will make this debt burden difficult to manage.** With no recourse to exchange rate changes, Greece faces the dual challenge of restoring competitiveness through internal devaluation—always a long and arduous process— while undertaking a large fiscal adjustment. This will compel Greece to go through a period of nominal wage and benefit cuts—a disinflation scenario under which it will likely see several years of declining *nominal* GDP. Domestic spending, the base for fiscal revenues, is bound to be weak. Thus, deficits and debt relative to GDP will be under upward pressure even with significant fiscal adjustment: despite ambitious measures yielding 4 percent of GDP this year, the deficit is set to rise to 11½% percent of GDP next year. Strong and prolonged fiscal adjustment is needed to break and reverse the upward trend in the debt ratio under the conditions facing Greece.

- **But the fiscal adjustment also needs to be realistic.** Even with additional fiscal measures of 2-214 percent of GDP each year for some 5 years, debt to GDP would rise to about 150 percent of GDP by 2013, before stabilizing and beginning to slowly decline. Much faster adjustment—as implied by the SGP deficit target of 3 percent of GDP by 2012—will be very risky: Greece is a relatively closed economy, and the fiscal contraction implied by this adjustment path will cause a sharp contraction in domestic demand and an attendant deep recession, severely stretching the social fabric. This is also unlikely to be technically feasible as durable spending cuts require reforms and changes in entitlement program that will take time to implement and yield results.

• **The banking system poses an important further risk**. With the downgrading of the sovereign, banks have come under funding pressures, been cut off from interbank credit lines and wholesale funding, and—recently-—lost deposits. Banks are using recourse to the ECB to tie themselves over, but this is not a durable solution. Moreover, the long downturn that lies ahead will significantly increase nonperforming loans, and it is possible, even likely, that the government will have to provide capital injections to stabilize the banking system and safeguard deposits. This would add further to the Government's already large financing requirements.

• **Financing needs to remain big**. Because deficit reduction takes time while amortizations on the growing stock of debt roll in, the public sector gross borrowing need will average about €50 billion in 2010-12, even with fiscal measures of 2-2½ percent of GDP every year, as discussed above. And this does not make allowance for the potential need for public support of the banking system,

• **Therefore, capital markets are scared**. Financial markets look ahead and perceive the difficult period that is beginning to unfold. The continuous rise in the debt ratio threatens sovereign ratings and pushes up spreads on Greek bonds. Markets need to be assured that a default is off the table before committing more funds.