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Adjusting Course: A Strategy for Greece and Europe to Emerge from the Crisis

Speech to the Hellenic Bank Association

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Thank you, George, for those kind words. I am delighted to be back in Athens today, and pleased to see so many old friends, many fellow warriors in the cause of battling Greece's economic and debt problems. I would like to thank the Hellenic Bank Association for giving me an opportunity to address this distinguished audience on a subject close to the heart of everyone here and in the streets of Athens, and of Europe generally – how to formulate a strategy that will enable Greece and Europe to emerge from this crisis. Outside, the people of Athens are protesting against the austerity that they are living through. If my words today have any lasting effect, I hope that the need for such demonstrations will begin to diminish, as despondency is replaced by hope and new opportunity.

As I stand here today I think some of you may feel a sense of déjà vu. Greece has recently passed legislation authorizing a new round of difficult austerity measures, despite widespread popular discontent. Eurozone officials profess their support, but fail to release urgently needed funding. The economy contracts at a pace greater than anticipated, raising questions once again about debt sustainability. Banks are short of liquidity and borrowers are short of credit. Observers and even some officials raise questions about the future of Greece as part of the Eurozone, while the Eurozone itself struggles to deal with fundamental flaws at the heart of its architecture.

These seem to be features of an all too familiar landscape, stretching back over three painful years. But if we step back from these realities we can see a bigger picture that suggests that both Greece and Europe may be approaching a new set of opportunities.

In Greece, we see for the first time since the crisis erupted, a popularly elected coalition government with broad representation across a wide political spectrum and with a significant parliamentary majority. This government has passed two sets of legislation that present a comprehensive framework for deeper reform and further adjustment of the economy. Greece now has the benefit of an unprecedentedly large reduction of its debt, roughly €107 billion, almost one third of total. And slowly, as stability and confidence return, deposit outflows have begun to reverse. There are also faint indications that the economy may be approaching a bottom, and the value of Greek debt has also shown signs of life since mid-year.

At the European level, there are also new developments of note: a Euro Area funding mechanism, the European Stability Mechanism (ESM), is now up and running, with prospective firepower of €500 billion. Important steps are being taken to create a Eurozone-wide approach to banking, including a single supervisor and direct recapitalization of banks by the ESM. And the ECB has shown real leadership by launching an innovative instrument, Outright Monetary Transactions, with powerful potential to begin breaking the stranglehold that uncertainty has had over Eurozone sovereign bond markets.

These relatively new additions to the landscape give us reason to hope that Europe and Greece may be finally heading clear of the rocks, towards safer waters, and eventually, smoother sailing.

However, for this potential to be realized, Europe and Greece need to steer a new course to find a better balance between austerity and growth, between short-term fiscal discipline and long-term expansions of output and employment opportunities. A return to real, sustainable economic growth, I will argue here today, can be the only genuine solution to Europe's crisis. It is time to recognize that austerity alone condemns not just Greece but the whole of Europe to the probability of a painful and protracted era of little or no economic growth. This would be a tragedy not just for Greece, and for Europe, but for the world.

Let me begin by making some key points.

- The conventional wisdom, often reinforced by the media and random comments of disparate officials and market commentators, is that Greece has not performed under its program. There are, of course, elements of truth here. Revenue collection has lagged, privatization is just barely underway, and other structural reforms have been caught in the crosswinds of political change. But this is not the whole story. Greece's progress in reducing its fiscal deficit is, in fact, of historic proportions. Adjusted for cyclical effects, Greece's adjustment from 2009 to 2011 was virtually unprecedented in recorded economic history, amounting to 12.6% of GDP. Moreover, this happened while the Greek economy has contracted to an extent rarely seen since the Great Depression, accumulating to a huge 20% of GDP by the end of this year. This is testimony to the resilience and fortitude of the Greek people, who have made considerable sacrifices and, despite fatigue, have shown resolute determination to rebuild their country. They have demonstrated an impressive willingness to bear short-term pain for the long-term gain that will come from the structural adjustment of the economy.
- I would also pay tribute to the governments which have guided Greece through these last three tumultuous years. I had the privilege of living in Greece in the early 1970s. As all of you know, this was a dark period for democracy in Greece, but the Greek economy functioned and at the heart of it was a wide sense of entrepreneurialism among the Greek people. In the intervening years, a clientelist, paternalistic state developed that eroded the efficiency of the Greek economy. The successive governments of Prime Ministers Papandreou and Papademos were very different in their political texture, but they both set Greece on a path of facing a grim reality and tackling imbalances that had accumulated over many years. Both governments made progress in the face of huge adversity and deep skepticism.
- Greece has now more than fully reversed a 27% loss in external competitiveness since it adopted the Euro in 2001, up to mid-2009. Much of this has been due to the intensity of the fiscal adjustment effort and its effects on labor demand and wages, which have helped lower unit labor costs by more than 15%. Some has been due to structural reforms, on which

Greece has made a good start. Some have reflected the depreciation of the Euro. If Greece perseveres with the structural reforms embedded in the revised program, there is no reason to believe that Greece cannot become one of Europe's most competitive economies.

- With unemployment above 25% and output having fallen 20% (and still declining), the adjustment Greece has endured has been nothing short of brutal. This has brought tremendous stress to Greek society, as has the need to hold two difficult elections and repeated pressure to enact painful legislation. While I question whether these measures have always had the correct balance, they do point to a nation which recognizes the need to rebuild credibility, to take the long view, a view of the future that remains firmly within the framework of the Euro.
- In contrast to some other countries in the Eurozone, the banks here did not bring down the sovereign. In fact, it is a tribute to their underlying strength, their position leading into the crisis and their resilience throughout the crisis, that the sovereign has not, in fact, brought down the banks in Greece. It may seem like a distant memory to some in this room, but Greek banks registered impressive levels of capital adequacy before the crisis, with core Tier 1 ratios of 10% or more, well above those for banks in the U.S. and the rest of Europe. Performance was also strong: return on equity before the crisis ran near 15%, compared with only about 10% on average in the U.S. and the rest of Europe. But Greek banks now face capital shortfalls, liquidity pressures and increases in nonperforming loans, after incurring heavy losses earlier this year due to the restructuring of Greek sovereign debt. Nevertheless, they are still alive and poised for a comeback following recapitalization.
- Greece now urgently needs a greater emphasis on growth, and less emphasis on austerity. Europe needs the same. Despite the key decisions taken since June, Europe's future will hang in the balance so long as doubts remain over whether Greece will stay inside the Euro. Until the Greek economy returns to growth, those doubts will persist, fuelling contagion elsewhere in the Euro Area.

This new strategy should revolve around the following five key ingredients.

1. More gradual fiscal adjustment

2. Additional financing and liquidity to support this adjustment
3. Accelerated public investment
4. Intensified structural reforms, including
 - Improved tax collection
 - Streamlining the size and scope of government, social spending and entitlements
 - Product and labor market liberalization, and
 - Determined moves on privatization
5. Recapitalization and adequate provision of liquidity to banks to enable them to provide the credit expansion needed to stabilize and grow the economy.

Allow me to make the case for each of these. First, more gradual fiscal adjustment.

Greece's unprecedented fiscal effort, which was more than planned, has triggered much larger contractions of economic activity and the tax base than the original program had assumed.

For example:

- Real GDP fell by 11.7% over the two years, rather than the 6.5% assumed in the original program
- Domestic demand fell by 15%, rather than 12%
- Real wage incomes fell by 15%, rather than 7% and
- Unemployment rose to 25%, rather than 15%

This weaker performance caused revenue to fall far short of projections. Non-interest government spending, as a result, ended up having to be cut by €20 billion from 2009 to 2011, more than five times what was originally targeted. This was because financing was limited and only so much deficit could be financed. The harshly negative effects of these cuts on domestic incomes and spending were a major reason that the economy has weakened so much more than expected, undercutting revenues so severely in the process. This became a vicious cycle in which revenue shortfalls prompted spending cuts that weakened revenues and triggered the need for still more spending cuts. Then came revisions of debt to GDP projections, delays in program disbursements, growing frustrations both in Greece and among key creditors and a broad sense that Greece simply could not perform. The fiscal data we have cited demonstrates otherwise – rather convincingly.

As we sit here today, the official creditors anticipate a further contraction in Greece's economy of 4-5% in 2013. Everything must be done to avoid this becoming reality.

The first step in this direction has been taken with the extension of the fiscal targets by two years, which has now been approved by the Eurozone ministers. But this will not be enough. This new program, in fact, assumes the decline of 4-5% percent in 2013, in part because two thirds of the further fiscal adjustment required in 2013-2014 is frontloaded to next year. What is needed instead is to ease the pace of the remaining fiscal adjustment to something closer to that of Ireland, which has been moving steadily with annual reductions of 1.5% per annum. This is just one third of what is programmed in 2013 for Greece. More moderate targets are more achievable, will have less negative effects on unemployment, and as demonstrated by Ireland, can have positive effects on market confidence, on the perception of performance, and put Greece on a more plausible path to an early restoration of market access. In the short run, creditors may feel this leaves an additional burden on their shoulders. And after all, other Eurozone countries along with the IMF have shouldered a substantial burden already, in amounts approaching €150 billion. We should appreciate how difficult this has been, requiring the creation of new lending instruments and institutions that violated, in the eyes of some, EU principles and treaties.

Of course, it is true that much of the lending by the EFSF has been earmarked to finance principal repayments to the IMF and ECB that will total €39 billion through 2014 and to recapitalize banks hit by losses from the bond exchange and rising volumes of nonperforming loans and to encourage private participation in the bond exchange. Including funds available from the IMF, the amounts left over for Greece's deficit financing are limited to only about €22bn over 2012-2014. This is not even sufficient to cover Greece's interest payments to these same official creditors.

I've seen this movie before: it was called the Latin debt crisis before the Brady plan. Very difficult debt negotiations took place over reform programs guided by the IMF. After months of debate, bank creditors often agreed to extend new credits to Latin debtors. The amounts at first looked impressive, but it soon became evident that the new funds were not even enough to cover repayments to the banks plus interest. Economies contracted, austerity set in, and social and political strains grew. It took the Brady plan to change the dynamics of the Latin debt picture. I do not

suggest for a moment that this approach is needed for the Eurozone. Clearly, here in Greece, Europe needs to find its own way to change the dynamics. Cutting interest rates on existing and prospective EU and IMF lending to funding costs would be a good place to start. This would not increase the burden on Eurozone taxpayers, but would give meaningful debt service relief to Greece. Recognizing that the ECB is a monetary, and not a lending institution, there is nevertheless both scope and need for the Eurogroup governments to commit to transfer back to Greece their full share of ECB profits on holdings of Greek bonds. The ECB should also consider steps to avoid substantial net repayments.

These changes would go a long way to allowing the adjustment of the Greek fiscal path that I have outlined. Some additional financing could be needed, perhaps €10 billion for the next two years, but the upside potential of an earlier revival of revenues, credit and growth in the Greek economy holds the best hope for finding the new balance between growth and austerity that is so direly needed. By generating interest savings of as much as €7 billion a year, equivalent to 3½% of GDP, these changes would also improve debt sustainability.

Now let us turn to the case for more public investment. Utilizing the additional fiscal space afforded by this more moderate adjustment path, in conjunction with accelerated drawings on unused EU structural funds, economic growth would be better supported. Public investment, in turn, would add significantly to supply, and support demand via labor-intensive construction. Revenue shortfalls, actual and prospective, must not be allowed to snuff out investment spending – otherwise growth will be difficult to restart.

Increased flexibility by the EIB, intense efforts by both the Eurozone and the Greeks, and prompt restructuring of project finance deals designed for a more robust economy could lead to a substantial number of new jobs before the end of 2013. Highways still need building, metros need to be completed and ports need expanding, but the structure of these deals needs an overhaul, and this can be done.

The resulting stimulus would make recovery more likely after mid-2013. It would add perhaps more than 2% to GDP after next year.

Turning next to Greece's structural reform efforts, this is something on which I believe we can all agree. Greece has made strides in some areas, especially pension reform and labor market liberalization. The passage one week ago of a wide-ranging package of new reform commitments has now set the stage for meaningful breakthroughs on long-standing structural problems. Areas such as tax collection, liberalization of product and service markets and privatization should be at the top of the list for full implementation this time around. If Greece is to expect serious consideration by the Eurozone, the IMF and the ECB of some of these ideas, then both the Greek people and Greece's creditors have every reason to expect a more determined effort in these efforts during the year ahead. The Greek people deserve an economy that is not burdened forever by a heavy bureaucracy and a bloated public sector.

Key ingredient number five is bank recapitalization, the importance of which I do not need to stress to this audience. Recapitalization soon, with renewed commitment by both the Greek government and its official creditors, is needed to enable Greek banks to renew credit expansion and to attract private capital. At the same time, as implementation proceeds, we believe there will be a case for early reflection by the ECB of its current liquidity policies toward Greek banks, which involves today an extra charge of more than 200 basis points at a time when the Greek economy can ill afford it.

What course corrections are needed in Europe, alongside those we have been discussing for Greece? The policy decisions so far taken by Euro Area leaders certainly provide firmer fiscal foundations to Europe's monetary union. Full fiscal mutualization, including full-blown Eurobonds, would be seen as lastingly resolving the crisis. However, with 12 of 17 Euro Area countries in the EU's Excessive Deficit Procedure, and only 4 with government debt below the 60% of GDP Maastricht limit, mutualization is a long way off. Stronger fiscal rules are a necessary precursor to the ultimate aim of fiscal union. It is also vital that ratification of the Fiscal Compact be completed and that work is completed on banking union, including the establishment of a single supervisor and agreement on both a common deposit insurance framework and a Eurozone resolution policy. These changes will be extremely difficult, because they are economic, financial and political in nature. Markets should not expect near-term agreements, but they have every right to expect a clear roadmap and timetable that can frame positive expectations as negotiations proceed.

In the meantime, however, partial mutualization, limited to bank recapitalization costs, should be helpful, sooner. European leaders need to resolve differences about timetables, which institutions would be covered, and how to deal with legacy losses incurred prior to the establishment of an effective single supervisor. The June 2012 EU summit made what looked initially like important progress, affirming the need to break the other vicious cycle that has emerged, that between banks and sovereigns. Agreeing to give the ESM the ability to recapitalize banks directly, rather than via sovereign balance sheets (with accordingly negative effects on government debt) is helpful.

Many of the suggestions we have made today regarding the program with Greece have relevance for other sovereigns under stress. Moderated paths of fiscal adjustment, supported temporarily as needed by additional financing, augmented by accelerated investment funds and structural reforms, could hold the keys in more than just this capital to replacing despair with hope. The current paths of ambitious deficit targets needing frequent modification, accompanied by collapsing private investment and a dearth of private credit, are not recipes for success. Just as in Greece, discipline and steady progress in reining in fiscal deficits are essential, but cannot alone do the job. Growth must be restored sooner rather than later if Europe is to resume its rightful place as one of the world's leading economic powers. A better balance within Europe between growth and austerity, indeed, could turn what threatens to become a vicious spiral of stagnant decline more generally into a virtuous circle of stronger growth and improved government revenues, feeding in turn into better job prospects and stronger profits for corporation and banks, the world over. Achieving this balance and making this turn will require vision, courage, and determination. Europe's leaders now need to demonstrate that they have plenty of each.

This new course requires not only revised financial calculations and economic reforms, but also two ingredients that have been sorely missing in recent experience: greater trust and mutual respect. Experience tells us that trust must be earned. But if we step back and reflect upon the last three years, Greece and its creditors, both public and private, have gone quite some distance down a road together. It is now time to recognize, perhaps somewhat begrudgingly, that each side has done enough to earn a meaningful degree of trust. What is now needed is to build on that trust to create a true partnership which can overcome the challenges that remain.

It can be argued that in the end, the problems facing Greece must be solved primarily by the Greek people. But in reflecting upon that sentiment, I am reminded of words by the English Romantic poet, Percy Shelley. As many of you know, Shelley was a man who revered all things to do with classical Greece, its values, and in particular, its democracy and sense of independence. Of course, we live in a very different era today, two centuries after Shelley. However, many citizens of Europe and indeed the world, have made strenuous efforts to contribute to the solutions of Greece's economic problems, have helped Greece build a stronger future. Indeed, I know that I speak for many when I say that those who have taken part in this effort fully associate themselves with Shelley's statement, that "We are all Greeks."