The financial crisis and Greece

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Outline

- The on-going crisis: vulnerabilities
- The current account deficit
- Policy reactions

1. The on-going crisis: vulnerabilities

Threats to growth and employment

- No country will be spared
  - Financial crisis contagion
  - World demand down
  - Only one good news: falling oil and commodity prices

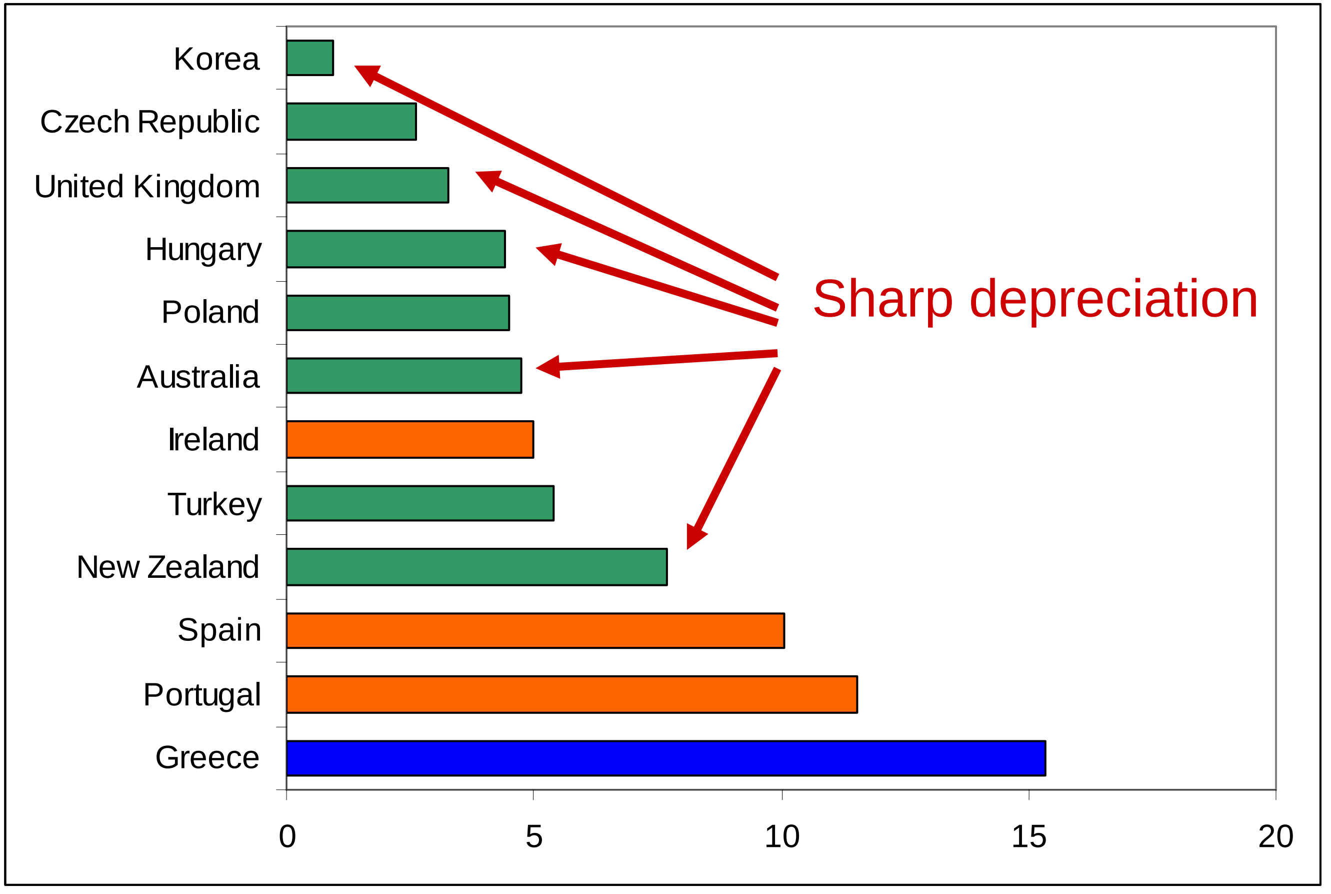
Threats to growth and employment

- No country will be spared
- Some countries have aggravating factors
  - Financial systems
  - Structure of trade
  - High public debts and deficits

Threats to growth and employment

- No country will be spared
- Some countries have aggravating factors
- As markets panic, they try to identify vulnerabilities
  - Banks exposure (Iceland)
  - Currency/maturity mismatches (Korea)
  - Current account deficits (Hungary)

Large current account deficits in the OECD countries (2008)



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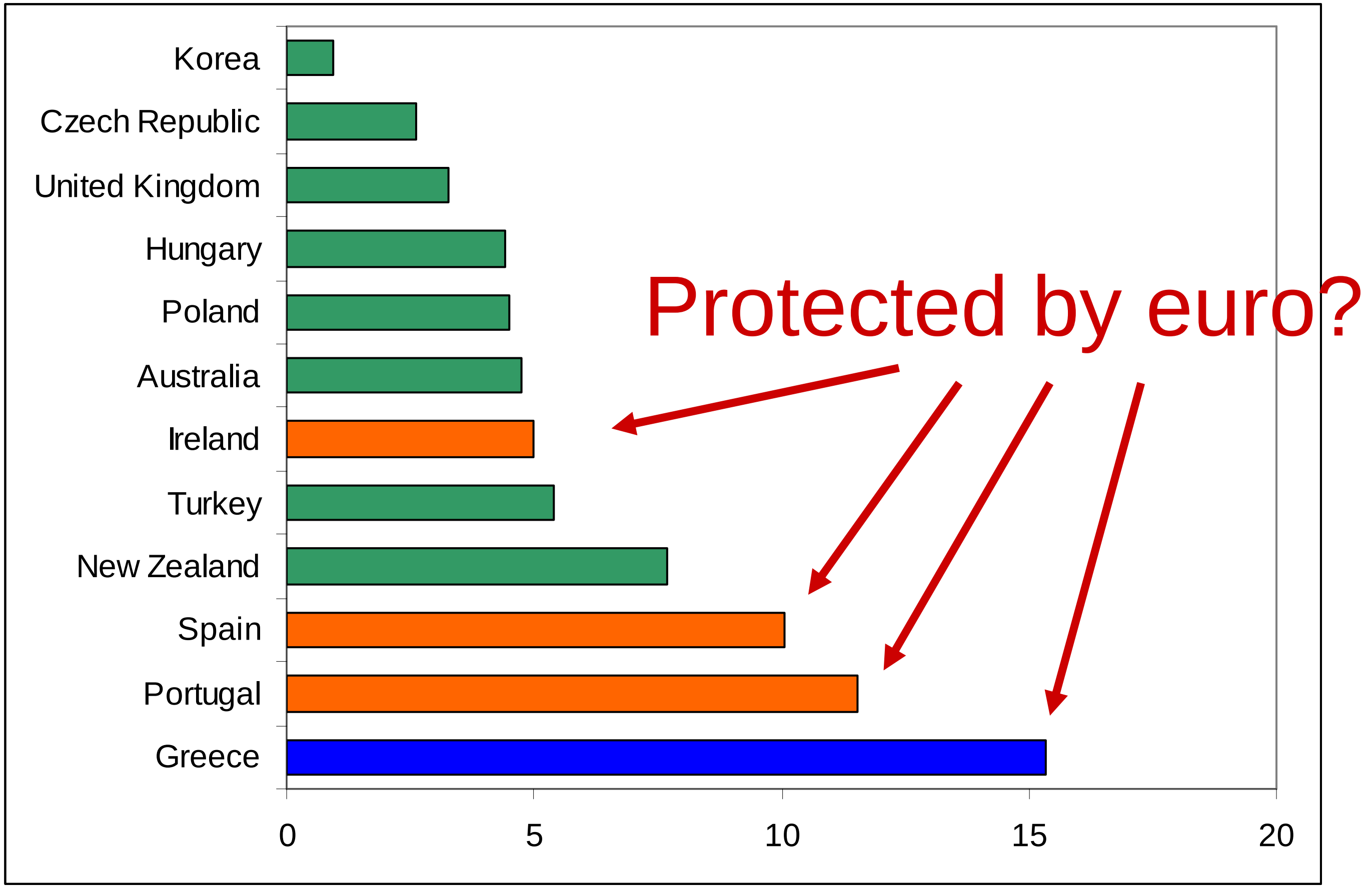
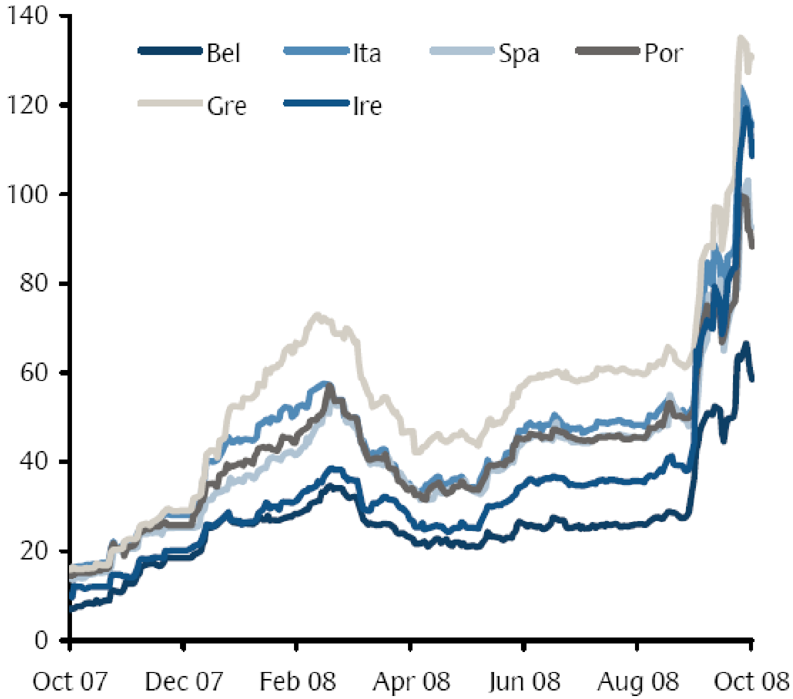


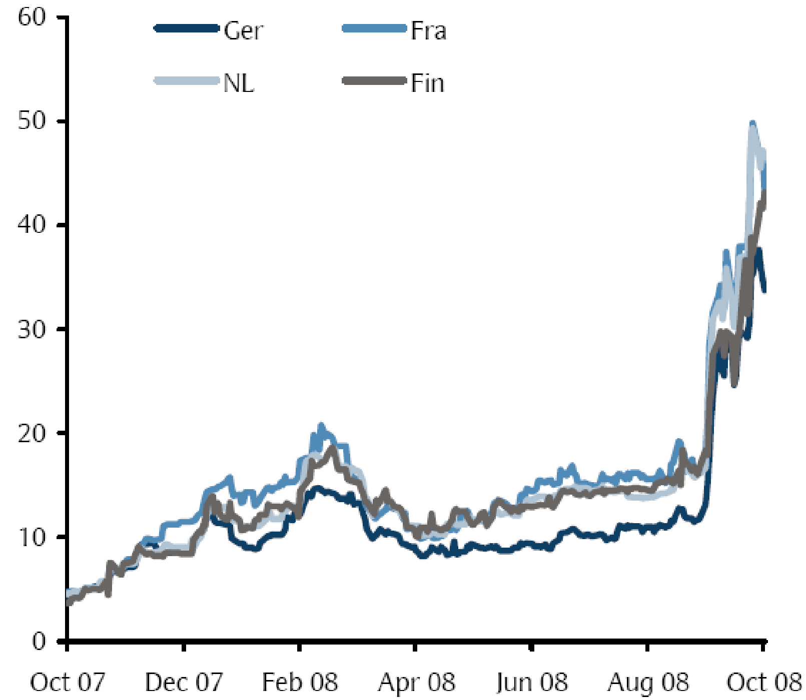
A different pressure path

Figure 37: Selected euro area 10yr CDS rates



Source: Barclays Capital

Figure 38: 10yr CDS rates – core euro area

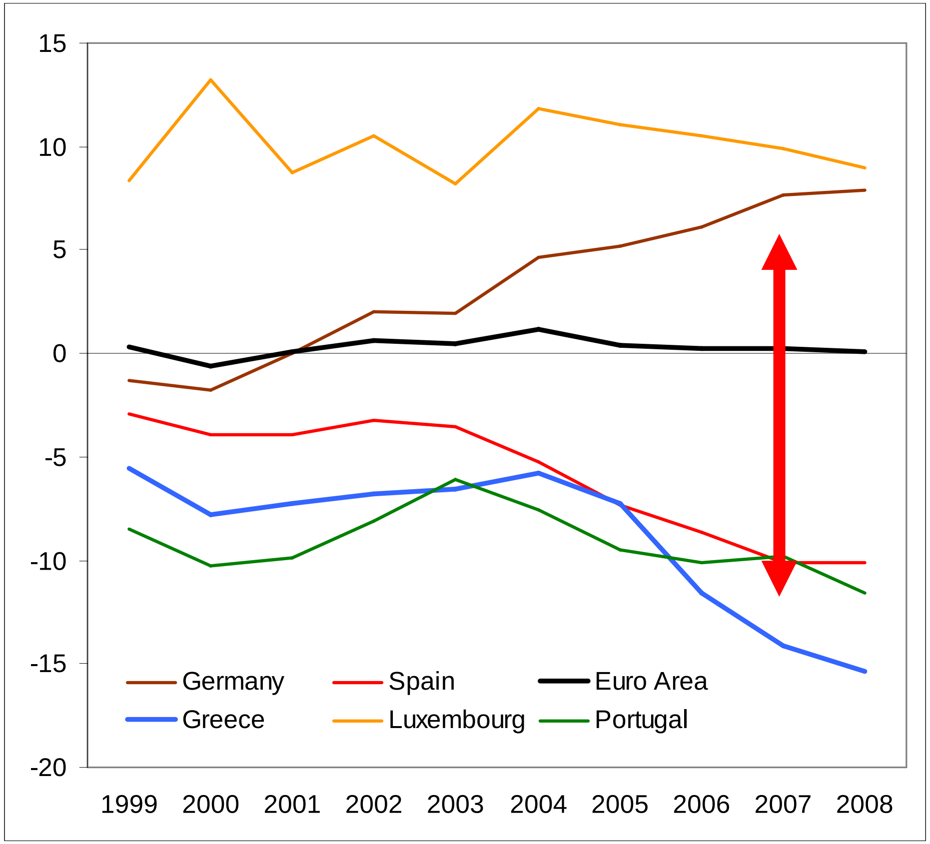


Source: Barclays Capital

Interest rates and credit distribution

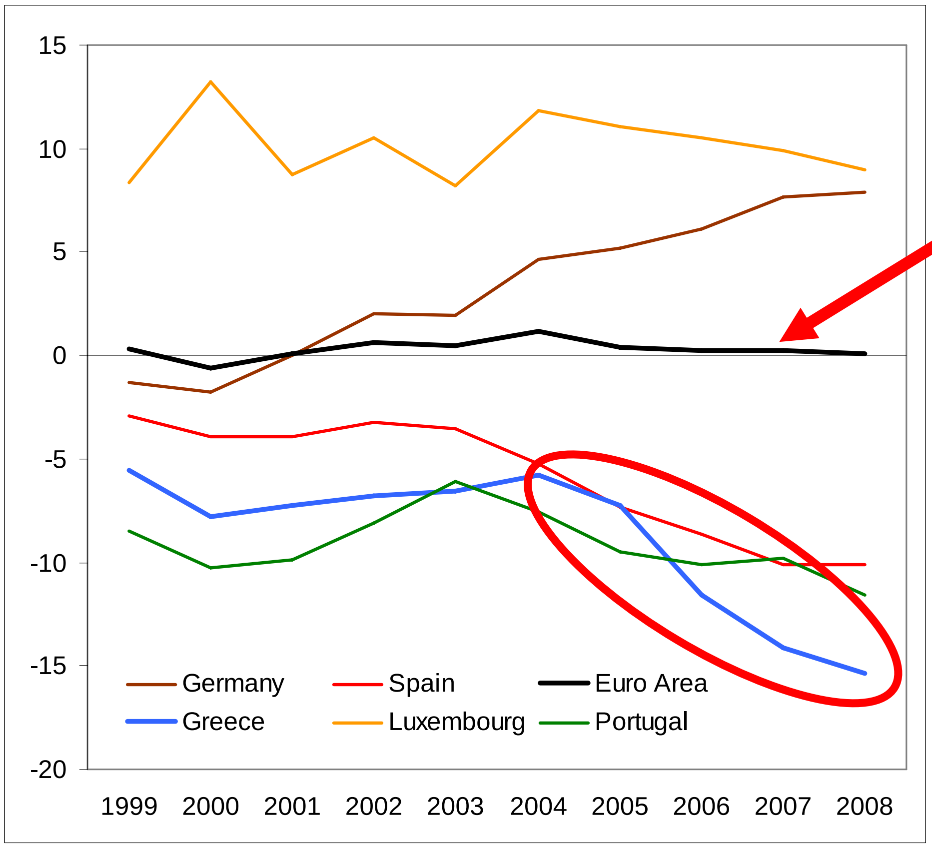
2. The current account deficit

Rising current account deficits



An unexpected feature of the Euro area

Rising current account deficits



Euro area
as a whole

Greece

Why deficits? Five possible reasons

- Adverse demand shocks
- Loss of competitiveness
- Excessive private demand
- Budget deficits
- Indirect impact of Walters critique

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Adverse demand shocks

- Years of strong world expansion

Adverse demand shocks

- Years of strong world expansion
- Look at export performance
    - Share of world trade (including EU)

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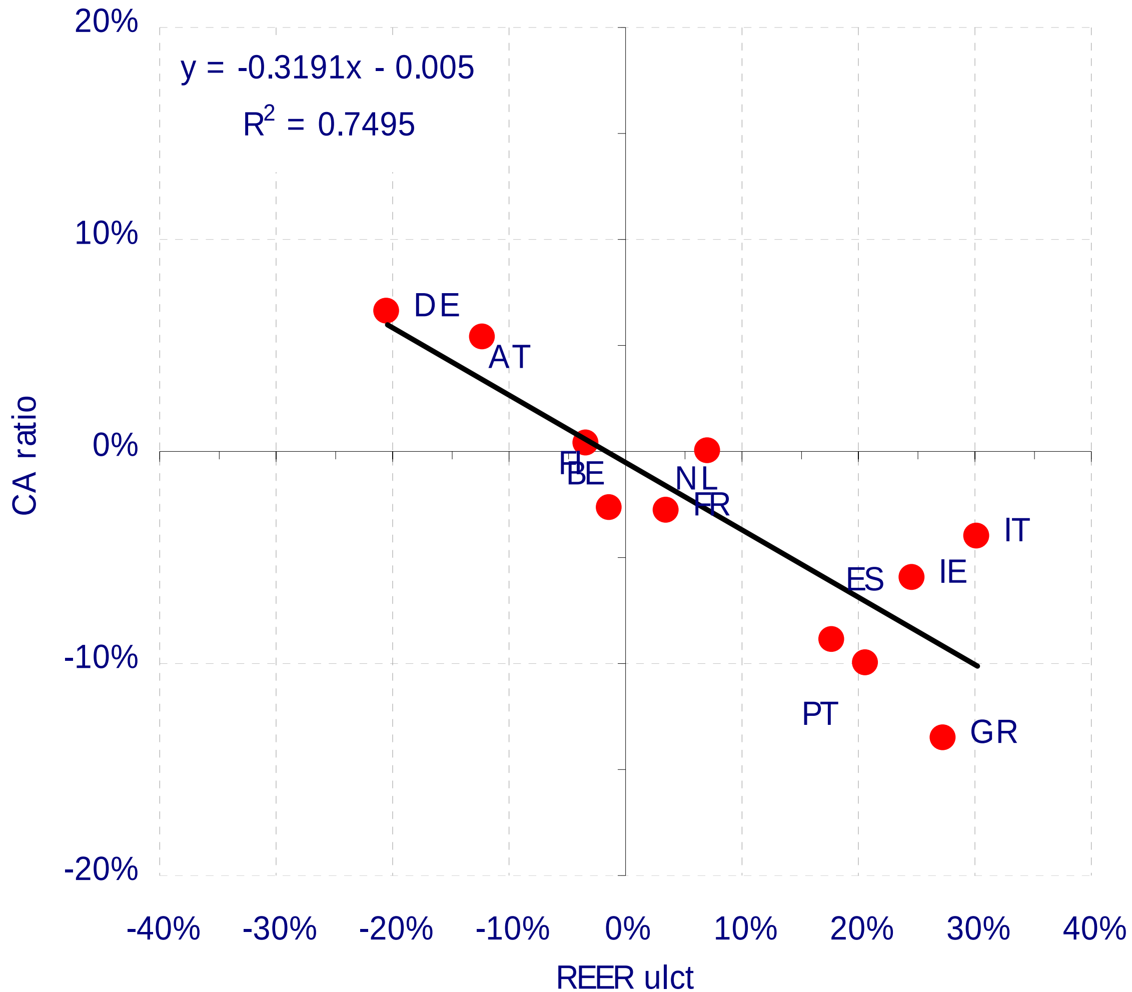
Loss of competitiveness



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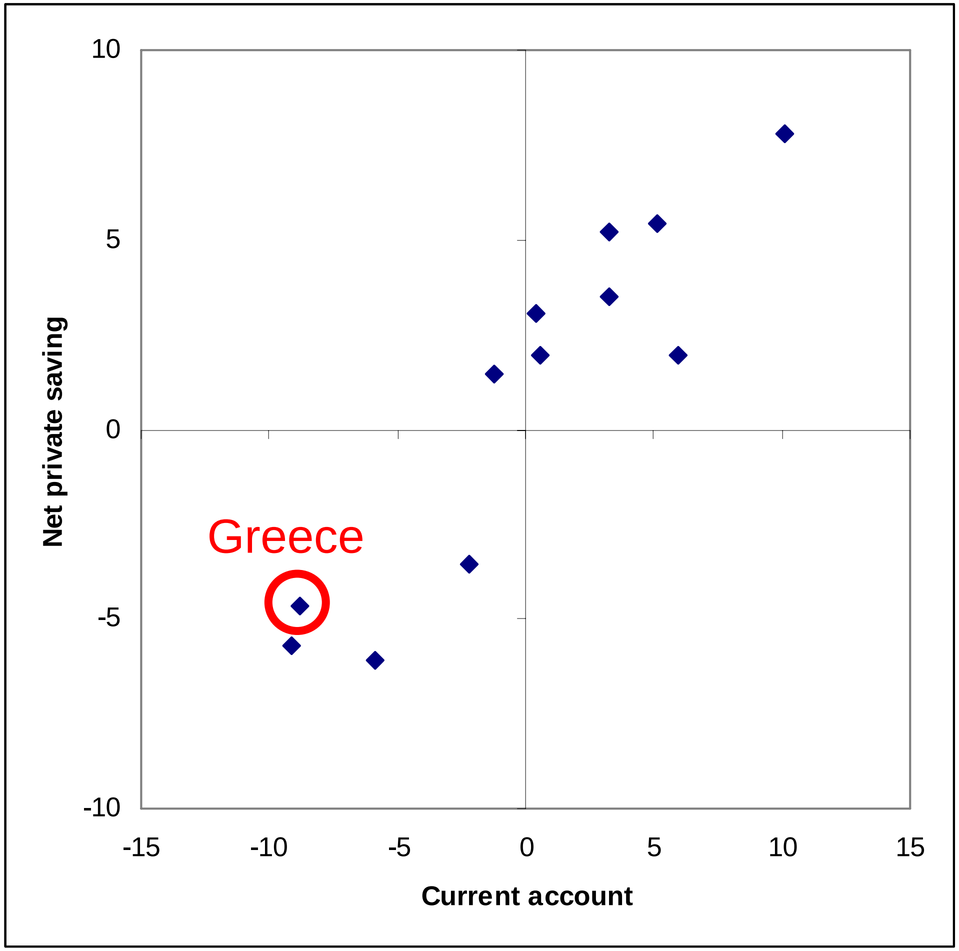
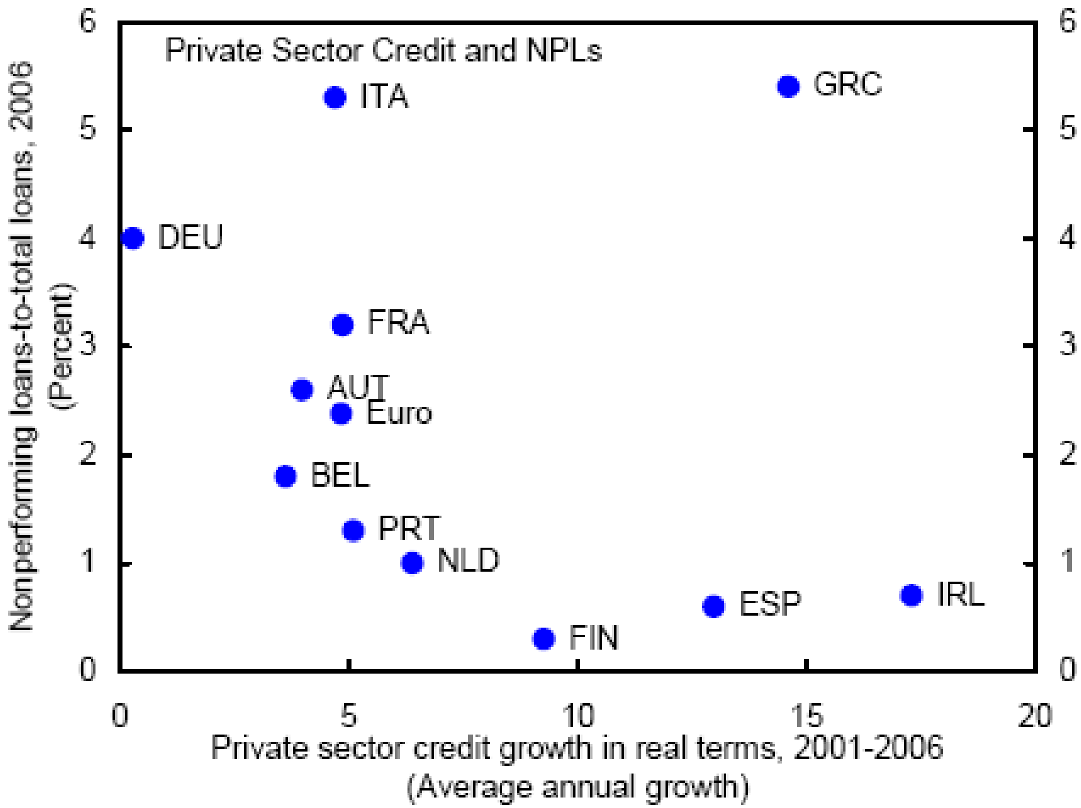
Excessive private demand



Excessive private demand



Sources: IMF, *Global Financial Stability Report*; Bank of Greece; and ECB.

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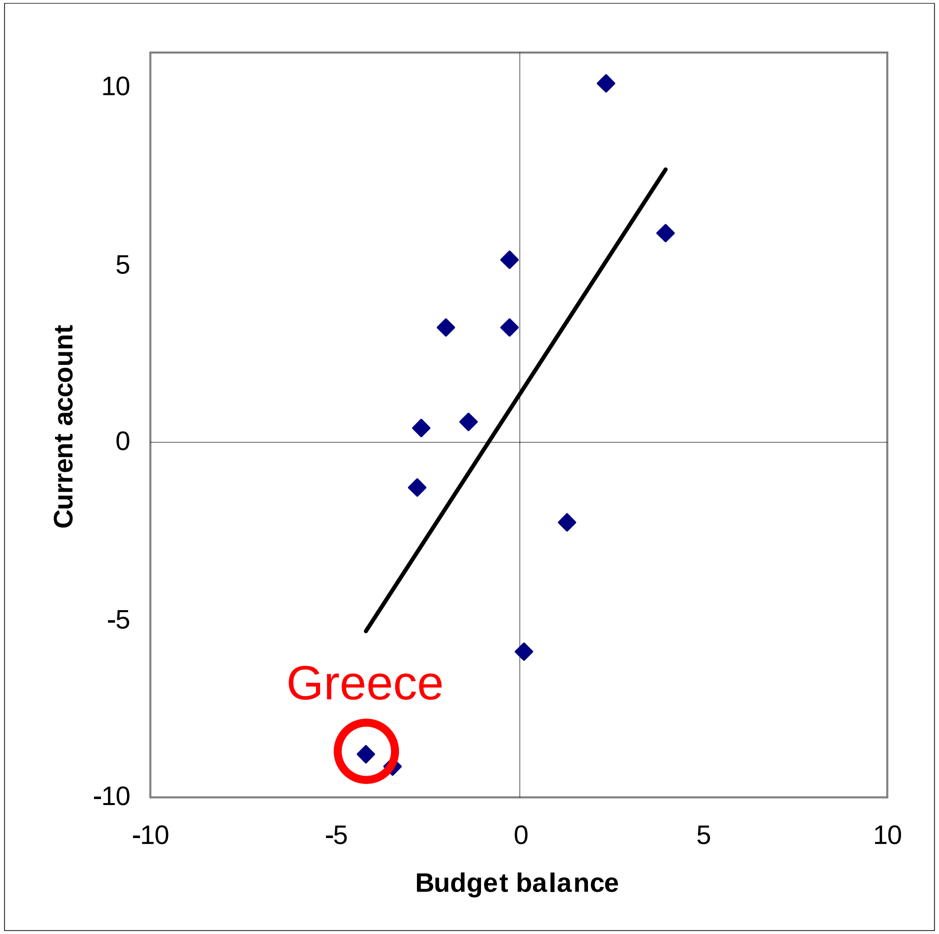
Budget deficits



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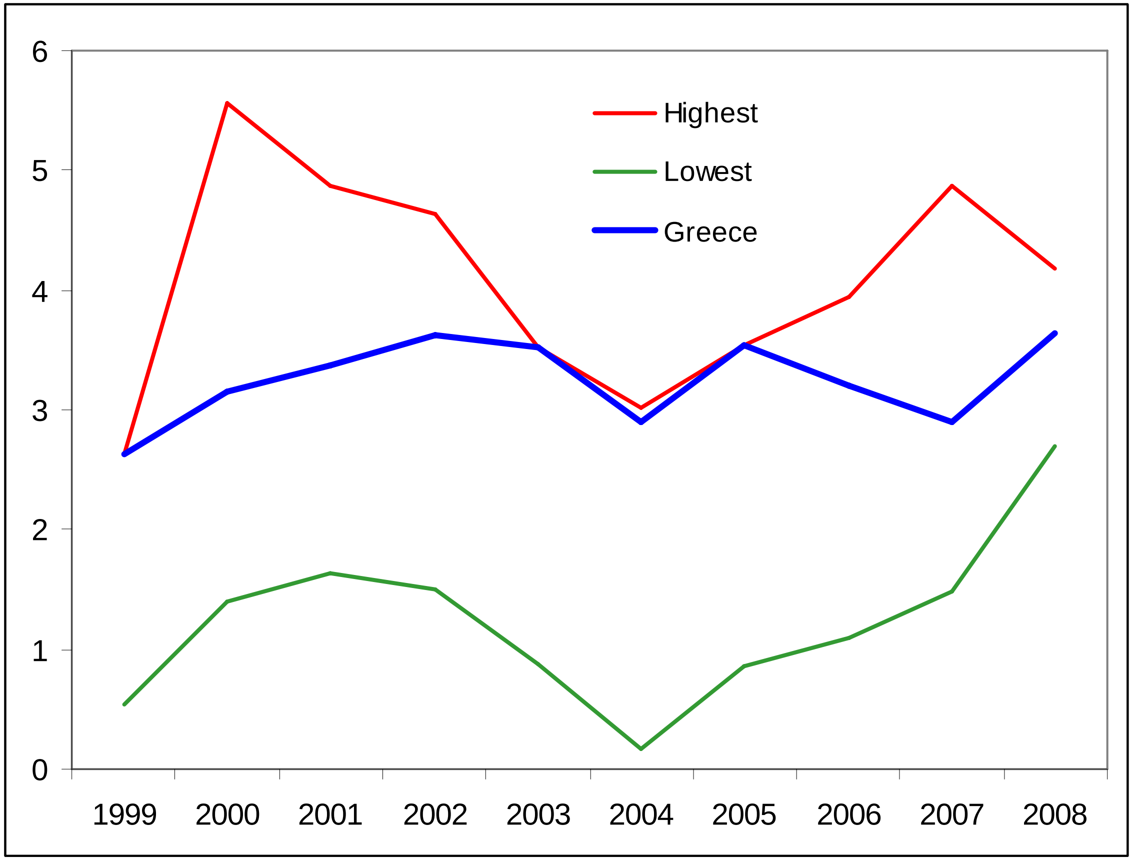
The Walters critique

- Start membership with higher inflation than average
- Real interest is lower
  - Common monetary policy is more expansionary
- Inflation even higher
- And so on...
  - Explosive process

The Walters critique

- Did not happen!



The Walters critique

- Did not happen!
- But, maybe, another channel
- Inflation higher → loss of competitiveness
  - Real appreciation
  - Current account deficit
  - Restraint on inflation
  - Boosts domestic demand (wealth effect)

Why deficits? Five possible reasons

• Adverse demand shocks	No
• Loss of competitiveness	Yes
• Excessive private demand	Yes
• Budget deficits	Yes
• Indirect impact of Walters critique	Yes

BUT....

Why deficits? Five possible reasons

- Adverse demand shocks
- Loss of competitiveness — that
- Excessive private demand — and that
- Budget deficits — but not that
- Indirect impact of Walters critique

This could explain

3. The crisis channels and policy responses

Transmission of crisis: potential channels

- Bank exposure to toxic assets
- Borrowing/lending in foreign currencies
- Huge increase in risk perception
  - Frozen interbank market
  - Highly selective bank lending
  - Highly prudent asset management

Policy reactions

- Absolute priority: end the banking crisis
- Next step: limit the slowdown
- Longer run: clean up the mess

Ending the banking crisis

- One year of arm-flexing
  - The banks won
- The Gordon Brown formula
  - Recapitalize banks — € 5 bn.
    - Where losses big, capital has been depleted
  - Guarantee bank borrowing — € 15 bn.
    - To restart interbank market
- The Fed formula
  - Lend directly to the “needy” — € 8 bn.

Avoiding the slowdown

- Monetary policy will not be sufficient
  - ECB: slow and half-hearted
  - Banking transmission badly impaired
    - Direct lending dangerous
- Fiscal policy: the only game in town
  - Tax cuts or public spending?
  - A few principles
    - Must be explicitly temporary
    - Must be efficient
    - Must be **very** fair

Even if deficit
is already high?

Even if current
Account deficit
is a vulnerability?

Cleaning up the mess

- Banks
  - Governments have been taken as hostages
  - Will need better regulation
- Inflation
  - Immediate risk: deflation
  - Longer term: no new credit boom-and-bust
- Deficits and debts
  - Debts too high
  - Avoid “discipline is for tomorrow”