

Understanding the Greek Crisis

Unlocking the puzzle of Greek banks' deteriorating performance

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Introduction

Since the mid-1990s, Greece's economy has enjoyed an average growth rate of 4%, allowing the country to converge, more or less, with Eurozone standards of living. This followed as a result of a number of reforms that were passed, mainly in the financial and telecommunications sector, and that were paired with the benefits of EU and EMU membership as described in Mitsopoulos and Pelagidis (2009a). But at the same time many structural weaknesses continued to prevail and, in many cases, even deteriorated. As a result, Greece managed to substantially improve the 'private standard of living' of its citizens, although at the same time it failed to progress in terms of matters like the organisation of its society and its economic institutions, or the provision of public goods. So, when the global economic crisis hit, all the deficiencies behind the impressive but superficial 'nominal growth' that was not based on a matching increase in the competitiveness of the economy, was unmasked.

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To find a way out of the current difficult situation, we need first to understand the Greek economy's basic flaws, the distortions, the injustices and the bad incentives built in to the institutions of the country. Next we need to explore the crucial link that could initiate a mutually enhancing and accelerating sequence of progressive structural reforms.

In this context, this paper focuses on the distortions that the Greek public debt has imposed on the Greek banking system, as it forms a crucial

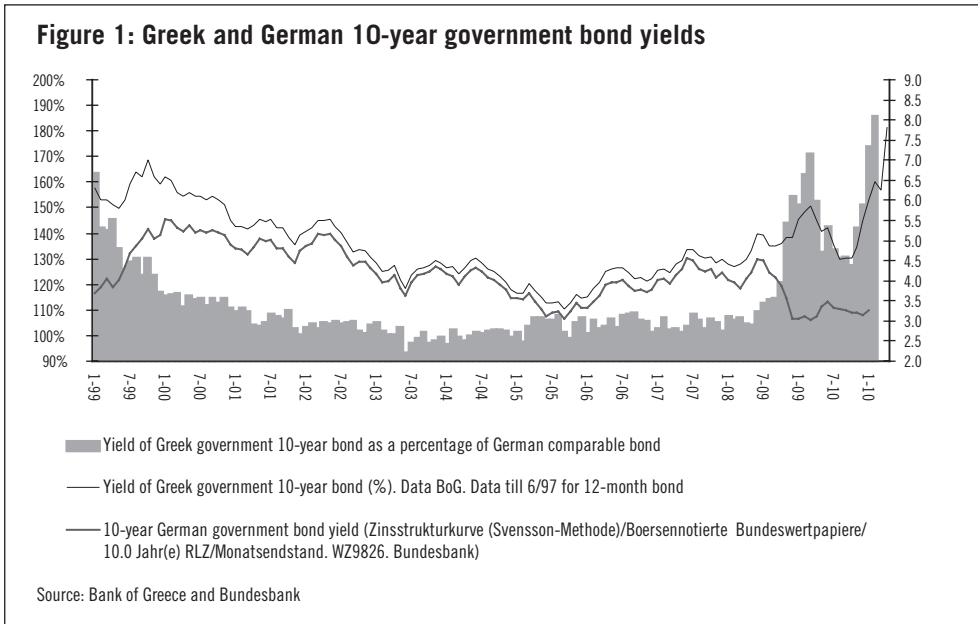
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link both for the challenges the country faces and for the only feasible solution to deal with them. To better understand this link we need to analyse the relationship between Greek banks and government debt, and show the process of banks' infection by the huge government debt.

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The current crisis and the Greek financial system

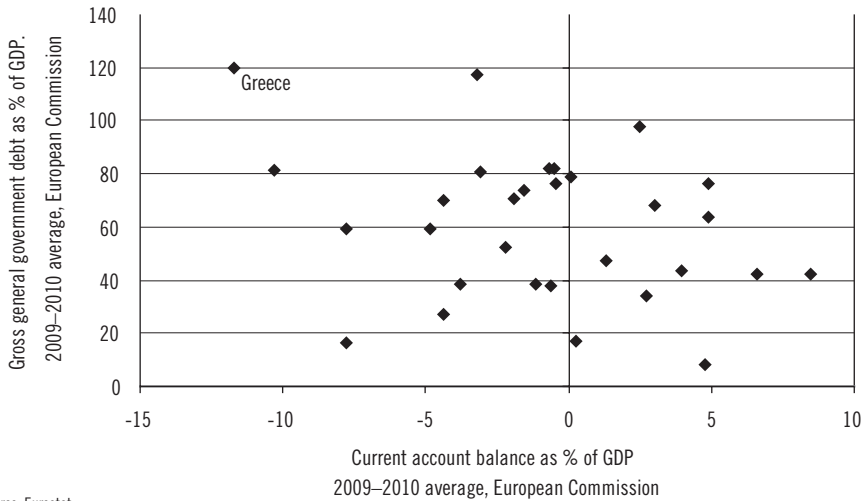
During the last year the documented weaknesses of the Greek economy have been shown up in the spotlight of the attention of international markets. This is justified given the analysis of Haugh, Ollivaud and Turner (2009), who investigate the factors that affect sovereign debt risk premiums. The unfavourable focus on Greek debt happened in spite of the achievements of the past decades, which had attracted the buying interest of international markets from the EMU accession of the country until the emergence of the current crisis. This followed as the strong growth of previous years, which had highlighted the successes rather than the failings of the country, seemed to peter out at the same time as the creditworthiness of the Greek government came under scrutiny and doubt. Furthermore, this happened at a time after global solvency risks had been transferred from the private sector to the public sector as a result of the rescues of the global banking sector crisis. As a result sovereign risk was being reassessed by markets along with private sector risk. All these factors are reflected,



for example, as Figure 1 shows, in a significant increase in the spread of the Greek ten-year government bond with respect to the German ten-year government bond, after several years of convergence between these yields.

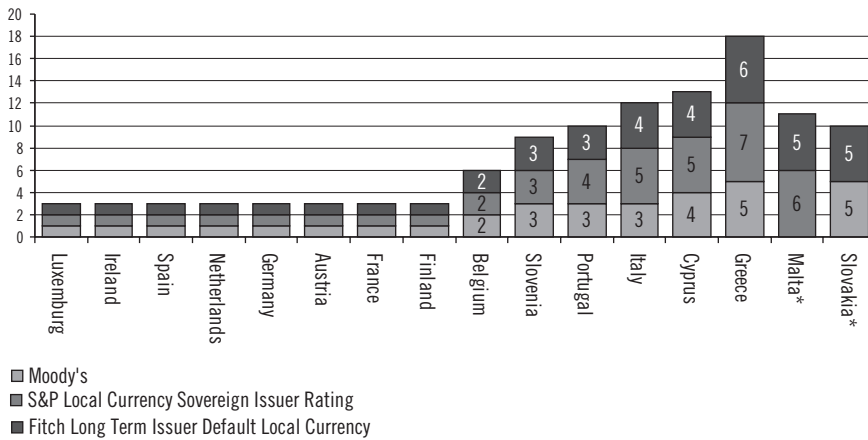
The concerns were basically fuelled by the coincidence of the high debt of the Greek government and the low competitiveness of the economy, rather than the occurrence of either of these problems in isolation. Indeed, as Figure 2 shows, Greece is not alone regarding either the stock of the government debt or the balance of payments deficit, which can be used as a broad approximation of the ‘competitiveness deficit’ of the economy. But it stands alone among its European peers once one looks at the size of both these attributes together. The accumulation of these concerns to such a large extent in one single country is the factor that leads to the increased concerns of international markets regarding the ability of the country to generate in future the taxable income that will make it possible to service its public debt. The combined concerns regarding, first, the size of the debt stock and the current deficits of the government budget, as well as the reduced competitiveness of the economy, which generates the taxable income that has to service this debt, existed even before the current crisis. Indicatively, this fact was reflected by the credit rating of Greek government debt by the three rating agencies before the emergence of the

Figure 2: Government debt and balance of payment as a % of GDP, European countries



Source: Eurostat

Figure 3: Sovereign debt ratings, January 2009, Eurozone member countries



Rating for sovereign debt, January 2009
 AAA = Aaa = 1, AA+ = Aa1 = 2, AA = Aa2 = 3, AA- = Aa3 = 4, A+ = A1 = 5, A = A2 = 6, A- = A3 = 7,
 BBB+ = Baa1 = 8. * not rated by all 3.

Source: Rating agencies

current debate regarding Greece in January 2009. At the time, as Figure 3 shows, Greek bonds were rated lower than the bonds of all other Eurozone member countries, even though this lower rating was not reflected correspondingly in the pricing of Greek government debt as the markets were at the time pricing risk, and in particular the risk of sovereign debt, much lower than they do now.

The challenging situation of public debt and Greek government finances is in sharp contrast with the situation of the Greek banking system at the beginning of the global banking crisis compared with the situation in the other major European countries. While in those countries the banks were severely challenged by significant losses that put their capital base at such a risk that the intervention of governments, with generally sound finances, was needed, in Greece the banks did not incur potentially crippling losses from their exposure to unwise or excessively risky investments and positions. At the same time, the situation of government finances in Greece was significantly worse than in the other European countries. Yet, the Greek commercial banks were the intermediaries that financed the excessive current account deficit of the past years, as well as a significant part of the public debt, both directly and indirectly. This was the case, especially in recent years, when the inflows for the purchase of stocks and government bonds that dominated after the EMU accession of the country gradually became less prominent. As these inflows abated, Greek banks secured the liquidity required to finance the expansion of the economy and the sustenance of the current account deficit with the tapping of the liquidity pool that was provided by the European interbank money market as well as the European capital markets. These markets willingly financed Greek banks – for example, with the purchase of covered bond issues. This mechanism ceased to operate once the interbank money market seized up as the financial crisis hit important international banking institutions. But even as the global financial markets started to recover, increased concerns over Greece in particular kept them largely shut to Greek banks and the Greek government. These concerns were further exacerbated by the demonstrable lack of a political will to deal with the twin issue of deteriorating public finances and the reduced competitiveness of the economy by successive Greek governments. During the time that ranged from the outset of the global crisis until the beginning of 2010, Greek banks were able to avoid these problems as they

had the option to use the measures installed by the ECB, which allowed them to draw about €30–40 billion of liquidity from the ECB by offering as collateral mainly Greek government bonds. This happened in spite of the creditworthiness rating downgrades these sustained in the meantime, and which were accommodated by the ECB, allowing Greek government bonds to be used as collateral even after they lost their investment grade rating.

In a nutshell, even though Greek banks did not have any direct exposure to the risks that led to the current global financial crisis, they were placed in the middle of the stream of international money that financed the unsustainable growth of the uncompetitive Greek economy and the runaway Greek government budget deficit, and as a result of the mechanism that ensured a growth of government tax revenue that could match the ever increasing public expenditure. They were simply placed in the middle of the chain of events through which the international crisis was first imported into the Greek economy. During 2009 the liquidity provided by the ECB was largely handed over to the Greek government. This happened, first, through the ‘support measures’ that were devised by the government to shore up the capital base of the banks with the issuance of about €10 billion of special government bonds that the banks were strongly encouraged by the then government to accept and then turn into cash at the ECB in order to finance further government bond purchases; and, second, through the direct purchase of new government bond issues. Even though, according to Morgan Stanley (2010), the exposure of Greek banks to Greek government bonds has fallen, it remains at levels that are well above the European average, and it can be assumed that these holdings consist mainly of Greek government bonds. So 2009 passed with the banks remaining at the middle of a process that financed the uncompetitive Greek economy and the, by now rapidly faltering, finances of the Greek government, only this time the source of money that was tapped into was the ECB. During 2009 the capital base of the Greek banks was supported by the healthy fundamentals of 2008, which were not harmed by the fallout of the sub-prime crisis and, furthermore, it was enhanced by the above-mentioned special Greek government bonds issued to them in 2009 as a capital increase. As argued for by researchers like Hardouvelis (2008) the Greek banks remained in good health throughout this time, and were largely able to bypass the liquidity constraints posed by the drying

up of global money markets on the one hand, and the need of the Greek economy – and the Greek government in particular – for sizeable capital inflows on the other hand.

However, 2010 brought increased challenges for the Greek banks, even though the uncertainties related to the prospect of the retraction of the special measures taken by the ECB have been postponed thanks to the decisive initiatives taken by the ECB. Such a retraction would have required the Greek banks to refinance the Greek government bonds that have been deposited as guarantees with the ECB at a time that the creditworthiness of these bonds is severely diminished. Still, they face significant losses from the Greek government bonds directly owned by them, and they also face an increasing number of non-performing loans as the recession of the Greek economy proves to be deeper than the initial over-optimistic estimates of successive Greek governments. Finally, they face the need to refinance a series of covered bond issues at a time that they also are sustaining downgrades of their creditworthiness, while at the same time facing a barrage of hostile legislative initiatives by the Greek government (Massourakis 2010). These legislative initiatives either seem to: blatantly ignore the advice and opinion of the ECB, at a time when the ECB has taken unprecedented initiatives to support the Greek financial system; or aim to enhance the rights, as perceived by successive Greek governments, of the consumers of bank products during this challenging conjuncture; or, simply, aim to increase the taxes, tax advances or other burdens that successive governments impose on them (Massourakis 2010).

It appears therefore that the Greek banks at this point face significant challenges that are largely a reflection of the weaknesses of the successive Greek governments and their policy choices, which have determined the competitiveness of the Greek economy. The faltering creditworthiness of the Greek government and prospects for the Greek economy seem, for now, to shut out commercial banks from the international money and capital markets, or at least seem to lead to an increase in the cost of money offered to them to such a degree that renders it prohibitive. The reduced creditworthiness of Greek government bonds puts a large portion of their assets at risk, threatening significant capital losses unless the situation is turned around within a reasonable window of opportunity. These investments in Greek government bonds, it has to be stressed, were traditionally actively invited by successive Greek governments. Finally, the reduced

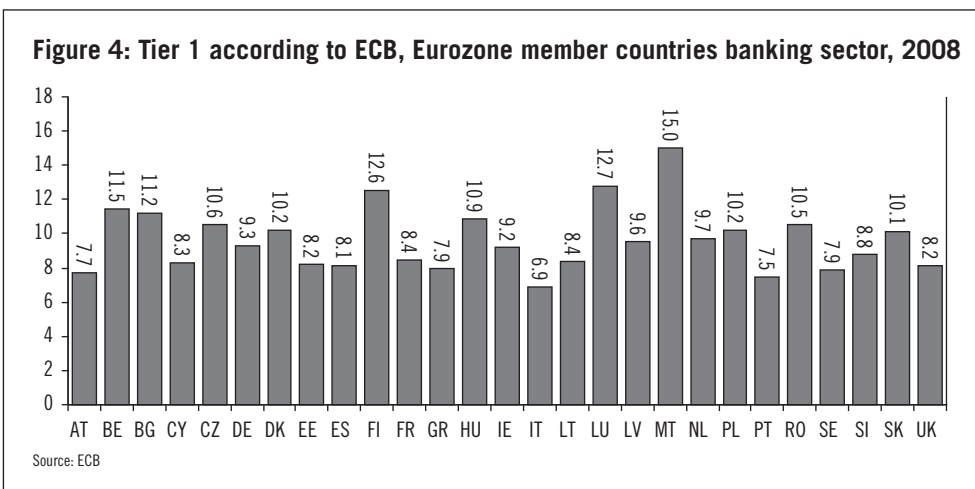
competitiveness of the economy poses a long-term risk for the incomes of Greek households and companies. It also puts at risk the health of the domestic private and corporate loan portfolios that the banks hold. This reduced competitiveness follows the insistence of the government to keep product and services markets closed to competition, to maintain such an excessive administrative burden on the economy and to actually legislate new laws that have exacerbated these problems, testing the resistance of the financial system. These have been described by Mitsopoulos and Pelagidis (2009a, 2011) and Massourakis (2010) in this journal. The particular issue of labour market regulation is less clear-cut, as argued by Mitsopoulos and Pelagidis (2009b), and in any case the measures taken in the context of the conditionality attached to the financial support package accepted by the Greek government have probably removed the most harmful labour market regulations. But the relatively slow progress regarding product market reforms and improvements in the public administration, which will reduce the excessive administrative burden and the corruption it invites, increases risks that strain the confidence of international markets. Investors are increasingly sceptical about the prospects of the Greek economy if these issues cannot be fully addressed in the window of opportunity that the financial support package and the resilience of the Greek banks still provide.

An assessment of the current situation requires a realisation that banks are particular organisations that redistribute funds in an economy from those that have them but do not know how to, or want to, put them into productive use to those that don't have them but that have productive ideas or needs that require financing. The term 'financial intermediation' thus accurately describes their role in redistributing funds from depositors towards households and enterprises with financing needs. This process is inevitably undertaken with a relatively thin capital base. It is this ability to redistribute the funds of others with this thin capital base that is, on the one hand, the contribution of the banking system towards the enhancement of the efficiency and competitiveness of an economy, as idle funds are redirected towards productive employment. On the other hand, this also means that banks are at particular risk if their loan or investment portfolio sustains significant losses, as their capital base is relatively small when compared to the total size of their assets. Of course, an excessive increase of their capital base could eliminate almost completely these risks. But then

they would cease to operate as financial intermediaries, and would rather resemble private equity companies, something that would undermine their productivity-enhancing role of redirecting existing funds that are not owned by them towards more efficient and productive employment at a reasonable cost to the users of this flow of redirected capital. These concerns – regarding the striking of a fine balance between ensuring adequate capital to shore up the resilience of banks to shocks on the one hand and to sustain their efficiency-enhancing role on the other hand – are at the core of the current debate regarding the reshaping of the regulation of the financial sector. The debate is complex as a result of issues that relate not only to the quantity but also, mainly, to the qualitative aspects of supervision and of the capital base that is needed to secure an adequate resilience of the financial system to severe and rare adverse shocks.

Greek banks are operating within an economy whose total indebtedness, if one adds public debt to private debt, is about average with respect to the other Eurozone countries.

If one were to disregard for a moment the reduced competitiveness of the Greek economy, one could argue that the Greek banks entered the crisis with an adequate capital base of high resilience during the unfolding of the sub-prime crisis, if compared to the banks of other countries. This is illustrated in Figure 4. Also, during the current period Greek banks are operating within an economy whose total indebtedness, if one adds public



debt to private debt, is about average with respect to the other Eurozone countries (Arestis & Pelagidis 2010a, 2010b). This happens as the total loans issued to Greek households and non-financial corporations, as a percentage of GDP, are well below the Eurozone average (ECB 2010). This is despite the fact that, at the same time, the respective indebtedness of the Greek government exceeds the Eurozone average.

This shows that the current concerns regarding the indebtedness of the Greek government, and their implications for the whole of the economy, are not founded on concerns regarding the total indebtedness of the economy; rather they regard the allocation of this debt predominantly in the hands of the Greek government and the competitiveness of the economy. This observation also suggests that if the government were to decide on the decisive deregulation of product and services markets, the reduction of the administrative burden and the exercise of economic policy that honestly and truthfully conforms with the goals of the economic and monetary union, then the increased economic activity of the private sector may be able to take up, within a reasonable period of time, a significant portion of this public debt. This will happen as the new private-sector activities will be financed with debt and at the same time they will create taxable profits and personal incomes that will lead to tax revenue and demand growth that will ensure the reduction of government budget deficits and the erosion of the government debt to GDP ratio. At the same time, the rise in private-sector activity will reflect the improved competitiveness of the economy, thus removing related concerns. Such positive prospects would, of course, be immediately reflected in the cost of servicing the public debt. This has been argued by Professor G. Stournaras, the director of IOBE, a Greek economic think-tank. Such a development would also amount, of course, to the adoption of the reform agenda that will allow Greece to take the next step towards the completion of its transition from the set of developing countries into the club of developed countries, despite its membership of the OECD. Besides the implementation of an aggressive reform agenda in product markets and the rationalisation of government finances, which will largely coincide with the content of the conditions set by the European Commission, the European Central Bank and the International Monetary Fund, such a step will also require the improvement of governance and the development of first-class institutions besides the regulation of markets. Such a development will at the same time reduce the risk that the

Table 1: Profitability of the banking sector in OECD countries

Profit after tax to average total assets (%)													
	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Greece	0.7	0.9	0.9	0.5	0.7	0.8	2.4	1.4	1.0	0.5	0.6	0.3	0.9
France	0.0	-0.1	0.1	0.1	0.2	0.3	0.3	0.5	0.5	0.5	0.5	0.5	0.5
Germany	0.3	0.3	0.3	0.3	0.2	0.4	0.2	0.2	0.2	0.1	-0.1	0.0	0.4
Portugal	0.8	0.6	0.5	0.6	0.7	0.7	0.7	0.9	0.7	0.6	0.6	0.5	0.6
Netherlands	0.5	0.5	0.5	0.6	0.5	0.4	0.6	0.5	0.5	0.3	0.5	0.5	0.5
Italy	0.3	0.1	0.1	0.2	0.1	0.5	0.6	0.8	0.6	0.5	0.5	0.6	0.6
Spain	0.1	0.6	0.6	0.7	0.7	0.8	0.8	0.8	0.8	0.7	0.7	0.7	0.7
UK	0.5	0.8	0.8	0.8	0.8	0.8	0.9	0.9	0.7	0.6	0.7	0.7	0.6
Belgium	0.3	0.2	0.2	0.3	0.3	0.3	0.4	0.5	0.5	0.3	0.5	0.4	0.5
Denmark	0.4	0.0	1.2	1.0	1.0	0.8	0.7	0.8	0.8	0.7	0.7	0.9	1.0
Finland	-1.4	-1.2	-0.4	0.3	0.6	0.6	0.9	1.0	2.8	0.8	1.6	0.7	0.9
Poland		0.1	2.2	2.6	2.0	0.6	0.9	1.0	0.9	0.5	0.5	1.3	1.6
Sweden	0.0	0.8	1.1	1.0	0.3	0.7	0.4	0.5	0.8	0.4	0.5	1.5	0.7
Turkey	3.2	2.4	4.2	4.4	3.4	2.5	-1.0	-4.0	-7.8	1.3	2.3	2.3	1.5
Weighted average	0.2	0.3	0.4	0.5	0.4	0.5	0.5	0.5	0.5	0.4	0.4	0.7	0.6
Average	0.4	0.4	0.9	0.9	0.8	0.7	0.6	0.4	0.2	0.6	0.7	0.8	0.8

Source: OECD banking profitability data

strength of the Greek banking system is tested in a severe and protracted contraction of an uncompetitive economy, in which the government will seek to increase its tax revenue from its fast-shrinking position while at the same time it seems to resort increasingly to microeconomic policies that are not aligned with the goals of economic and monetary union. Such a development, finally, might make it possible to reduce the debt burden of the general government towards the levels foreseen by the Maastricht Treaty, without the need to reduce the total debt burden of the economy. In other words, shifting the debt burden from the general government to the new activities of the private sector may make it possible to improve the creditworthiness of the whole economy without the need to severely reduce the total debt burden of the economy.

To assess the prospects of Greek banks during the current period one has also to take into account that in the existing environment of the uncompetitive but fast-growing Greek economy, as described in Mitsopoulos and Pelagidis (2011), Greek banks posted during the past decade significant increases in their profitability, which in turn allowed them to both strengthen their capital base and expand in the markets of neighbouring countries. Yet with the exception of the years 1999 and 2000, during which the impact of Eurozone accession was most forcefully reflected in their balance sheets but also in the balance sheets of non-financial corporations, as documented by evidence presented in Mitsopoulos and Pelagidis (2011), the increase of the absolute magnitude of banking assets, along with the rapid expansion of private credit, implied that their profitability as a percentage of their assets remained close to the average observed in other OECD countries, as shown in Table 1.

Both the OECD data up to 2005 and the ECB data for 2008 (see Figure 7) show that not only is the profitability of the Greek banks on a par with that of the OECD and Eurozone average, when taken in proportion to total banking assets, but they also verify that this average profitability is a result of above average general, administrative and staff expenses paired with higher than average operating income, as shown in Figures 5 and 6. It emerges, therefore, that Greek banks have indeed been more profitable than other non-financial Greek enterprises, but this is only because the non-financial Greek enterprises have posted, in an environment of high growth, below-average profitability with respect to their European peers, as illustrated by data presented in Mitsopoulos and Pelagidis (2011), while

Figure 5: Expenditure of Eurozone member countries banking sector as percentage of total assets in 2008

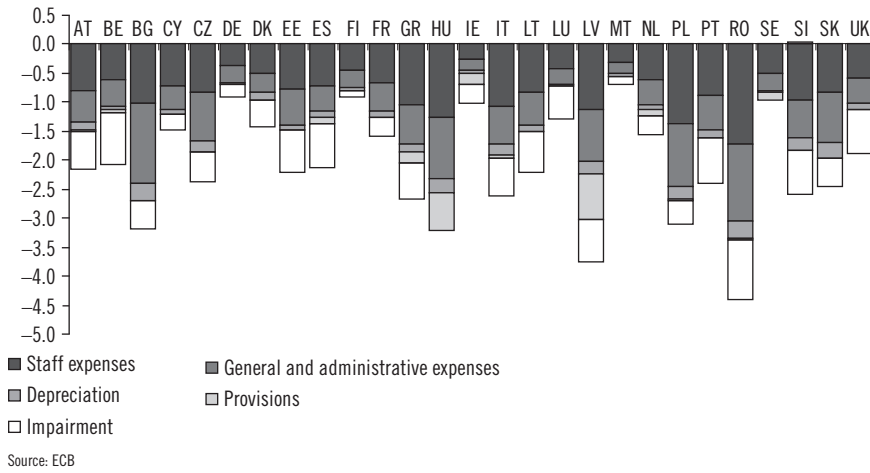
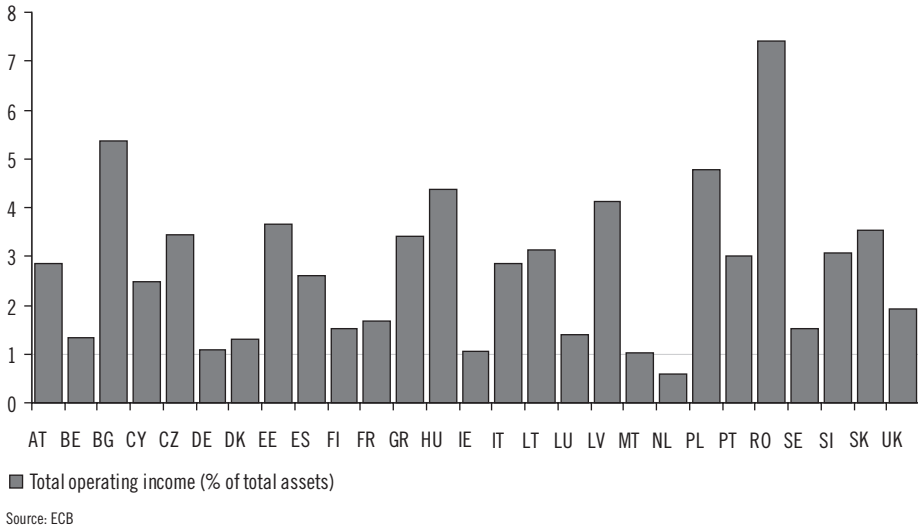
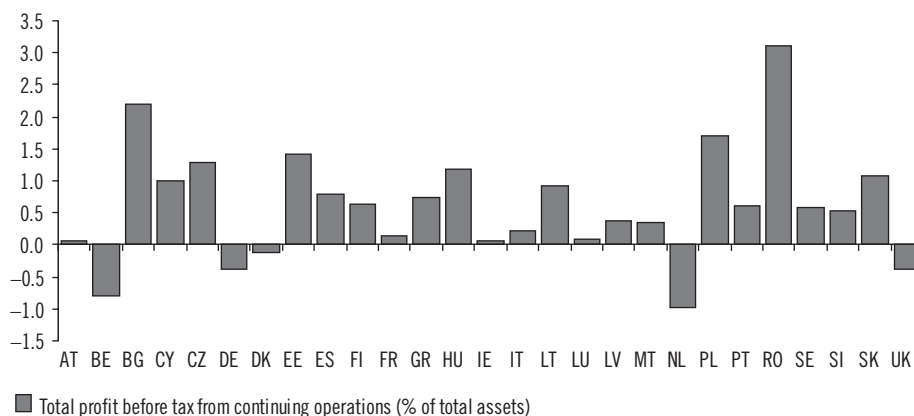


Figure 6: Total operating income of Eurozone member countries banking sector as percentage of total assets in 2008



the Greek banks posted, in the same environment of high growth, average profitability. It has to be stressed at this point that Greek non-financial companies operate largely in a legislative environment of uncompetitive product markets and unusually high administrative burden, while banks benefited from operating in a largely competitive and deregulated finan-

Figure 7: Total profits before tax of Eurozone member countries banking sector as percentage of total assets in 2008



cial services market that followed from the proper implementation of the relevant EU directives during the 1990s. Under these circumstances, and given the current state of the Greek economy, government policy initiatives to tax the supposedly excessive profits of banks and to actively undermine them seem largely misplaced and untimely, especially as their profitability is set to decrease while their excess costs will most probably persist. The latter will be the case as long as the structural rigidities that are imposed by specific Greek legislation keep Greek banks from reducing their costs and from increasing their efficiency. Such legislation, for example, relates to the ability to rationalise operations in the case of merger, which is now nearly impossible, thus depriving mergers of their potential efficiency-enhancing benefits.

On the other hand, the healthy profitability of the Greek banks so far implies that the Greek banks may not only contribute towards the unwinding of the current challenges faced by the economy but they may also enjoy a renewed period of prosperity. For this to happen though, a large part of the indebtedness of the economy has to be shifted from the public sector to the private sector through a process that requires as a prerequisite that product market reforms are advanced decisively and wholeheartedly. If this prospect seems appealing, one should beware the danger of underestimating the significance and difficulties of implementing the initiatives necessary to get there.

Conclusions

According to Azariadis and de la Croix (2006), when financial deregulation takes place in an uncompetitive economy that cannot generate the income needed to service its debt, the long-term growth rate of the economy can be reduced. This will happen once the debt has been accumulated after the expansion that follows the deregulation. This warning is directly related to the reality of the Greek economy as it currently has an average level, for an advanced economy, of total indebtedness, but its competitiveness is still comparable to that of a developing economy. This warning takes the place of a grave and serious counter-argument to those who declare that the Greek economy will return to the growth rates of the past automatically, as long as it secures access to new loans and funds. If it does not address the severe structural deficiencies that still prevail today, such an approach risks to invite severe negative repercussions to the welfare and coherence of the Greek society. Anastasatos (2008) argues that either the Greek economy will face a significant reduction in its welfare, as incomes adjust to the respectively lower competitiveness of the economy, or the competitiveness of the economy will have to be increased to match the welfare currently enjoyed by Greek society. The choice is between allowing the positive contribution of the banking sector or the potential of a systemic meltdown in the Greek economy, as long as Greek governments keep insisting on perpetrating policies that are not aligned truthfully and honestly with the goals of economic and monetary union.

Furthermore, the downward adjustment of economic activity to match the reduced competitiveness of the economy, be it within the Eurozone or outside it as some advocate, will leave the Greek economy with a low level of economic activity, which will match its reduced competitiveness, even though its total indebtedness will still remain at the levels of a developed and competitive nation. The daunting challenges posed in such an event to the ability of the country to service its debt leave as the only reasonable option the choice to remain in the Eurozone and to implement an aggressive reform agenda, as in the conditionality of the support package. Such a strategy, if applied within a rapidly shrinking window of opportunity, can secure both the future prosperity of Greece and its ability to honour the obligations it has already taken on.

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