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Editorial: European Stability Mechanism: involvement of private investors essential

During 2009 financial markets became increasingly concerned about the sustainability of Greece's public finances. The mark-up of Greek sovereign bonds relative to the German benchmark grew to historically high levels. Worried about the stability of the Euro area the EU attempted to avoid a sovereign default of Greece by setting up a € 110 bn support package, comprising a € 80 bn facility from EU countries and a € 30 bn stand-by arrangement from the IMF. It soon became clear that this support was not sufficient to calm financial markets. Therefore, in May 2010 the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM) were created. The EFSF is a special purpose vehicle set up to make loans to Euro area countries up to an amount of € 440 bn, supplemented by a € 250 bn IMF commitment. Both the EFSF and the EFSM were set up as temporary measures, terminating in June 2013. The first country to ask for assistance from these facilities was Ireland in October 2010, followed by Portugal in May 2011.

From a temporary to a permanent mechanism

As these temporary measures were regarded as insufficient to secure the long-term fiscal sustainability of the Euro area, a permanent crisis mechanism was set up to safeguard the financial stability of the Euro area as a whole. The granting of any required financial assistance under this mechanism is subject to strict conditionality. In March 2011, the European Council decided upon details of a comprehensive reform agenda, comprising a reform of the Stability and Growth Pact (SGP), the introduction of a procedure aiming at the correction of "excessive" macroeconomic imbalances, the "Euro Plus Pact" and a European Stability Mechanism. The "Euro Plus Pact" intends to improve the international competitiveness, increasing employment, enhancing the sustainability of public finances and financial stability in the EU. While aiming at closer cooperation of national fiscal and structural policies, the formulation of concrete policy measures remains the Member States' competence.

The European Stability Mechanism

The European Stability Mechanism (ESM) ought to be capable of providing financial assistance to Euro area members under strict conditions. The assistance will be granted as loans and, in exceptional cases, by purchases of bonds issued by the respective countries, i.e. bonds that cannot be sold in the markets as they bear a high risk of default. In order to protect taxpayers' money and to send a clear signal to private creditors that their claims are subordinated to those of the official sector, ESM loans will enjoy preferred creditor status, junior only to the IMF loan. Furthermore, all bonds with maturities of more than one year issued by Euro area Member States comprise Collective Action Clauses (CACs) from 2013 onwards to insure that the private sector will bear a part of the solvency risk. However, this involvement of private investors has not yet been clearly formulated.

Further financial assistance may be needed

Granting financial assistance will be conditioned to ambitious and rigorous fiscal consolidation programs as well as to structural reforms. However, it is questionable whether such measures are sufficient to bring fiscal policies on a sustainable path. While reducing interest payments on public debt and restoring confidence of private creditors should bring about lower interest rates on sovereign bonds and thus supports long-term growth, the short-run impact of tax hikes and drastic cuts of public expenditures will affect economic activity and the public fiscal balance negatively. Hence, in the near future public debt in the respective countries will grow further, making access to financial markets more difficult if not impossible for years to come. In addition, public and increasingly also political support for rigorous fiscal adjustment plans will fade in the countries in question, rendering it increasingly questionable whether the consolidation programs will be fully implemented. Hence, the countries once having got financial aid will continue to depend on international assistance for a prolonged period.

What should be done?

By providing financial assistance to Greece in the first instance, the EU ignored fundamental principles of the monetary union, namely the principle of subsidiarity and the no-bail-out clause. Having violated these two fundamental rules once, doubts arise whether these principles will be respected in the future. As a consequence, the credibility of the EU may be impaired. Moreover, the lax attitude towards countries disobeying the rules of the SGP in the past casts doubts whether the EU will insist on the strict conditionality of the financial assistance in the future. On the contrary, it seems realistic that conditions will be relaxed and financial assistance will be granted if countries come under severe pressure. In addition, the attitude of the EU towards the involvement of private investors is ambiguous. Nonetheless, such an involvement seems necessary for at least two reasons: firstly, to reduce incentives for moral hazard, and secondly, to reduce public debt of the respective countries and hence their dependence on financial aid from the international community. However, involving private investors by a “haircut”, i.e. a devaluation of sovereign bonds, will also be associated with risks. Banks holding these bonds will suffer losses which might require further financial assistance to the European banking sector. Therefore, alternatives offering soft versions of a “haircut” are currently also discussed. These include a re-profiling and a rolling over of sovereign debt, implying that the government gets more time to repay the debt.

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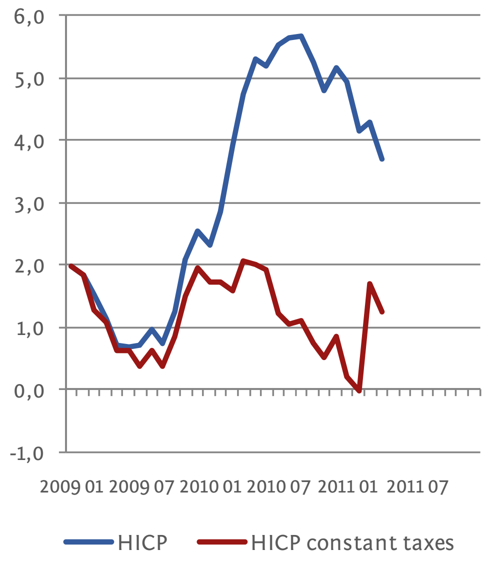
Greece: Macroeconomic developments and prospects - Fiscal adjustment and reforms

The Greek economy continued to contract throughout 2010, with a year-on-year GDP decline of 4.4%. The contraction deepened towards the end of the year, reaching 7.4% year-on-year in the last quarter. Domestic demand fell sharply in 2010, as private consumption and investment continued to trend downwards, while public consumption remained depressed. The 4.5% year-on-year decrease of private consumption mirrored both the worsening of employment and wage developments, which had a negative impact on disposable income, and the restrained credit conditions. The effects of the implemented measures on wages and pensions materialised gradually in the course of 2010, as witnessed by the significant fall of private consumption towards the end of the year. With the deterioration in business sentiment and the tight supply of credit, the contraction of investment deepened in 2010, thus contributing significantly to the decline of domestic demand. Some positive developments were signalled by the external sector, which registered an improvement during 2010, reflected in a significant decline of the current account deficit. Exports gained power due to strengthening external demand and some gains in competitiveness, while imports were compressed as a result of the ongoing contraction of domestic demand.

Graph 1

HICP and HICP at constant taxes

yoy percentage changes



Source: EL.STAT.

Inflation pressures hiked and the unemployment rate climbed up

The increases of VAT rates and excise duties implemented during the course of 2010 under the adjustment programme pushed up inflation, which reached 4.7% in 2010. With the tax component of the inflation rate being particularly high, the effect of indirect taxes on prices was estimated for December 2010 at 102% of the constant taxes' HICP (Graph 1). As the slack in economic activity widened, labour demand weakened further, heavily impacting on employment. The annual unemployment rate reached 12.5% on the back of layoffs and jobs reduction in the private sector, as well as recruitment freezes and cuts in short-term contracts in the public sector.

The financial sector came under stress but retained stability

Amidst the ongoing recession, the state of the financial sector, and more particularly banking sector conditions, remained rather stable. This was achieved despite the tense situation due to the negative sentiment of financial markets and the strains put on the banking system. Losses in terms of confidence and deteriorating perceptions as to the sustainability of the public debt led to unprecedented peaks in Greek government bond spreads vis-à-vis Germany. Despite liquidity support by the ECB, banking sector liquidity remained tight over the course of 2010, while deposit outflows continued and non-performing loans increased. With the demand for loans shrinking, the growth of credit to the private sector declined sharply and turned negative towards the end of 2010.

Positive prospects for a gradual rebound and rebalancing of the economy from 2012

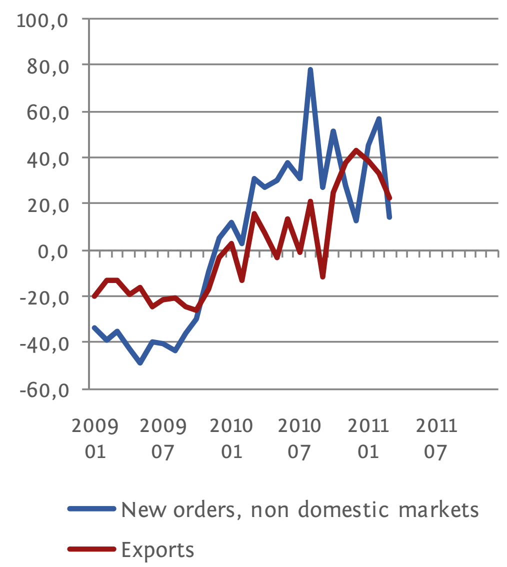
The Greek economy is projected to continue contracting through 2011, as the dampening impact of fiscal retrenchment on economic activity is expected to remain strong. Domestic demand is set to decline against the backdrop of further income losses, increasing tax burden and tax uncertainty, as well as tight credit conditions and, evidently, restrained public demand. Indications provided by high frequency indicators for the first months of 2011, relating to retail trade, private passenger cars and consumer credit, point to a continuing slack in private consumption. Investment is not projected to return to positive territory in the course of 2011, but the implementation of the new investment law, improvements in the absorption of the EU Structural Funds and gains in competitiveness may enhance market sentiment. Imports are projected to continue to shrink during 2011, while the rebound in exports is expected to be strong, with positive indications already provided by accelerating non-domestic industrial orders (Graph 2).

Inflation has been moderating during the first months of 2011, as the impact from indirect tax hikes has been fading out, reinforcing the tendency for the gap between inflation and constant-tax inflation to close gradually. The further easing of inflation will partly depend on the impact of the newly announced tax and excise duty increases. The unemployment rate is projected to climb further in 2011 on the back of the ongoing recession, the measures envisaged for the public sector and their potential spill-over effects to the private sector.

Graph 2

Non-domestic new industrial orders and exports

yoy percentage changes



Source: EL.STAT.

The medium-term prospects, with regard to the return to positive growth rates and the correction of imbalances will heavily depend on the redefinition of the underlying growth model and the adherence to the programme of fiscal adjustment and structural reforms. According to current forecasts, GDP is projected to rise in 2012, with a potential for stronger than expected growth relying on a changed demand composition, shifted from private consumption to investment and net exports. Continuing downward pressure on unit labour costs and labour market adjustments are expected to lead to improvements in competitiveness. An enhanced orientation towards foreign markets, given that external demand will remain supportive, will lead to gains in export market shares, especially in sectors such as tourism and shipping, and will allow the external sector to become a key driver of economic activity. Still, a considerable part of the adjustments necessary lies ahead, while market sentiment remains fragile and the regaining of confidence presupposes a credible resolve to confront imbalances and effectively implement reforms.

Fiscal adjustment is progressing

In 2010, Greece's budget deficit declined by 5 percentage points relative to GDP, amounting to 10.5% versus 15.5% in 2009. This reduction, although being the largest among EU countries in 2010, was still short of the 2011 State Budget's estimates, according to which a 9.4% deficit was expected. While several waves of drastic deficit reducing measures were implemented in the course of the year on both the expenditure and the revenue side of the budget, and efforts were made to under-execute the state's spending plans, there were large shortfalls in tax collection and social security contributions. These shortfalls, which proved critical in hindering the full achievement of the country's 2010 budgetary goals, resulted largely from a deeper than projected recession and from deviations from budgetary targets in specific areas of public administration (e.g. hospitals, local governments).

Deviations from fiscal targets call for further action

Revenue shortfalls persisted in the first four months of 2011, while upward pressures on budget expenditures also intensified, mainly due to increased interest payments and to the settlement of public hospitals' past debts. In view of these developments, the need to guard against further deviations from the budgetary ceilings agreed in the framework of the Economic Adjustment Programme has rendered urgent (i) the immediate adoption of additional fiscal measures to secure the 2011 deficit target, (ii) the finalisation of a medium-term fiscal strategy setting a clear plan for the measures needed to satisfy the annual fiscal targets for 2012-15 and (iii) the acceleration of fiscal and growth enhancing structural reforms, including privatisations and real estate development. Given its commitment to the Economic Adjustment Programme, the Greek government is working hard on all these fronts, with many of the decisions on specific measures for the period 2011-2013 being finalised as these lines are written.

Additional fiscal measures are adopted to secure 2011 targets

The additional fiscal measures aimed at keeping the deficit within target over the short term will amount to a total of € 6.4 billion. According to the information currently available, the measures will include cuts in pensions and public sector wages, a levy on personal income applicable from 2010 onwards, a rise of the VAT rate on food and beverage service activities from 13% to 23%, a reduction of the tax-free threshold on private real estate property and one-off levies on owners of high value real estate property and luxury assets.

A medium-term fiscal strategy is being finalised

Turning to the medium-term fiscal strategy for achieving budgetary targets until 2015, this will define the measures and reforms required to tackle the root causes of Greece's fiscal imbalances, setting annual spending ceilings for individual ministries and specifying fiscal balance targets for all general government entities. The strategy's detailed action plans will cover several areas of government expenditure and revenue, including taxes, public enterprises, extra budgetary funds, public employment and wages, public administration, social spending, public investment and military spending. More specifically, in the strategy's framework, measures will be adopted to (i) simplify the tax system, broaden the tax base and improve tax administration to fight tax evasion, (ii) improve state-owned enterprise efficiency, (iii) merge, restructure, privatise or close public entities with overlapping mandates, (iv) reduce public employment, while also creating a more equitable and orderly system of wages and benefits in the public sector, (v) restructure public administration, (vi) eliminate social programmes overlapping with other initiatives, (vii) prioritise public investment projects, while identifying public savings and (viii) rationalise spending on defence.

Table 1

Medium-term fiscal strategy measures

	Billion €	% of GDP
Rationalisation of wage costs	2.2	0.9
Cuts in operating expenditures	1.2	0.5
Closures/mergers of public entities	1.5	0.6
Restructuring of public enterprises	1.5	0.6
Cuts in military expenditures	1.2	0.5
Cost savings and efficiency improvements in the health sector	0.8	0.3
Rationalisation of expenditures on medical care and medicines	1.1	0.4
Social security expenditure cuts	4.2	1.7
Social security revenue increases	3.1	1.2
Strengthening of tax compliance	3.5	1.4
Reductions of tax exemptions	6.0	2.4
Improvement of local authority results	1.4	0.5
Rationalisation of the expenditures of the public investment programme	0.5	0.2
Total	**28**	**11**

Source: Ministry of Finance

Reforms are again on top of the agenda

Following a wave of radical structural reforms in 2010 - including a far-reaching pension reform, a first leg of labour market reforms and a road freight reform - privatisations, as well as fiscal and growth enhancing structural policies are currently gaining momentum, assuming a key role in the government's efforts towards fiscal consolidation and economic recovery. In a move to substantially scale up Greece's privatisation programme, the aim to collect € 50 billion by 2015 through privatisations and real estate development, has recently been announced. The programme will start with the immediate sale of public shares in OTE telecom, and will continue with the privatisations of the Hellenic Post Bank, the public electricity company DEI, the state gas monopoly DEPA, the Athens and Thessaloniki Water Companies, the Hellenic Post, the monopoly betting firm OPAP and others. The government's privatisation plan is hoped to contribute to the reduction of Greece's debt-to-GDP ratio by almost 20 percentage points by 2015, and will be critical in helping to regain investor confidence.

Concerning fiscal structural reforms, additional measures are planned to further secure the long-term sustainability of the pension system, while a health care reform is in progress, aiming at keeping public health expenditure at or below 6% of GDP, maintaining access to and improving the quality of health care. On the growth enhancing reforms side, the agenda of actions under way is wide, with considerable progress already recorded with respect to the labour market, the deregulation of closed professions and the liberalisation of transport. Several new reforms are being planned towards the liberalisation of the wholesale electricity market, the promotion of R&D and innovation and the improvement of the business environment. These reforms will be of key importance for enhancing supply-side conditions in the economy and improving internal competition and international competitiveness.

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EUREN Inside

COE-Rexecode

Digitization plays an essential role in growth

Coe-Rexecode has analysed in a recent study the impact of the digital economy on growth. It is globally positive but digital economy contributes much more to growth in the United States than in Europe. This calls for a response in the way of an industrial policy and the definition of a real digital economy development strategy for Europe and for France.

More information can be found under:

http://www.coe-rexecode.fr/public/Espace-Presse/Communiques-et-Dossiers-de-presse/Digitization-plays-an-essential-role-in-growth

The EUREN summer forecast 2011/12 will be published in the mid of June

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Impressum

The European Economic Network (EUREN) is a network of European economic research institutes, which was formed in 1999. Members of EUREN are:

- Centre d'Observation Economique et Recherche pour l'Expansion de l'Economie et le Developpement des Entreprises (Coe-Rexecode), Paris, France
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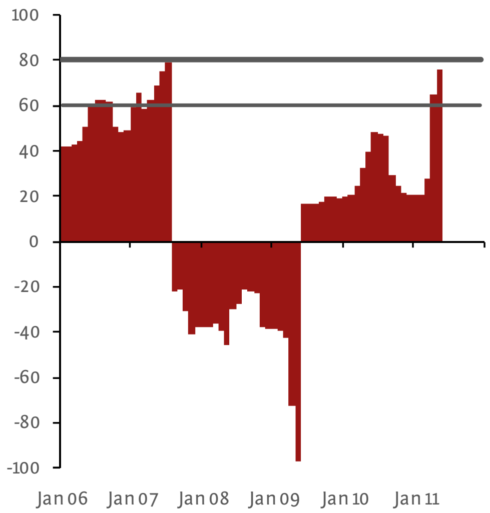
- Ricerche per l'Economia e la Finanza (Ref), Milan, Italy

COE-Rexecode Leading Indicator for the Euro area

The Coe-Rexecode leading indicator is looking for the next peak of the euro area growth cycle. It must overpass in turn the 60 and the 80 thresholds to send a strong signal of an imminent economic downturn. The indicator had receded to a low point of around 20 at the beginning of 2010. Since March, it has started to rise again with a quite strong increase in April from 27.8 to 65, crossing the first threshold of 60, which indicates a possibility of a downturn in the euro area growth cycle in the nine coming months. This message was reinforced with the May index of 75.8, not very far from the 80 threshold which, once over-passed, would indicate, with a strong probability, a downturn in the three coming months. The underlying instantaneous growth rate, at an annual rate, as measured by the Coe-Rexecode indicator, is estimated at 2.1 % in May 2011. The trend growth rate is estimated at 1.2%. A downturn would mean a return of growth towards or below an annualized rate of 1.2% for at least a few quarters.



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Forecast of the EUREN/CEPREDE High Frequency Model

Last update:May 13th, 2011

	09 Q4	10 Q1	10 Q2	10 Q3	10 Q4	11 Q1	11 Q2	11 Q3	2009	2010	2011
Jan 10	-2.1;0.0	0.4;0.0	0.8;0.3						-3.1	1.1	
Feb 10	[-2.1;0.1]	0.0;-0.2	-0.2;-0.9						-2.7	1.1	
Mar 10	[-2.1;0.1]	0.0;0.2	-0.1;-0.8	-0.3;0.2	-0.1;0.2				-3.3	1.4	
Apr-10	[-2.1;0.1]	0.2;0.2	0.5;-0.2	0.6;0.4	0.9;0.4				-3.3	1.4	
May-10	[-2.1;0.1]	[0.6;0.2]	1.3;0.6	1.5;0.6	1.9;0.5				-3.4	1.4	
Jun-10	[-2.1;0.1]	[0.6;0.2]	1.5;0.8	2.0;0.9	2.6;0.7				-3.9	0.8	
Jul-10	[-2.1;0.1]	[0.6;0.2]	1.6;0.9	1.9;0.6	2.3;0.5				-4.0	-0.3	
Sep-10	[-2.0;0.2]	[0.7;0.3]	[1.9;1.0]	2.1;0.6	2.7;0.8				[-4.0]	-0.1	
Oct-10	[-2.0;0.2]	[0.7;0.3]	[1.9;1.0]	2.2;0.1	3.0;1.0	2.9;0.2	2.2;0.3		[-4.0]	0.5	2.1
Nov-10	[-2.0;0.2]	[0.7;0.3]	[1.9;1.0]	[2.1;0.4]	2.8;0.9	2.6;0.1	1.9;0.3		[-4.0]	1.3	1.9
Dec-10	[-2.0;0.2]	[0.7;0.3]	[1.9;1.0]	[2.1;0.4]	2.6;0.7	2.3;0.1	1.6;0.3		[-4.0]	1.7	1.6
Jan-11	[-2.0;0.2]	[0.7;0.3]	[1.9;1.0]	[2.1;0.5]	2.0;0.1	1.5;-0.1	0.9;0.4		[-4.0]	1.7	0.8
Feb-11	[-2.0;0.2]	[0.7;0.3]	[1.9;1.0]	[2.1;0.5]	[2.0;0.1]	1.5;-0.1	0.9;0.4		[-4.0]	1.7	0.9
Mar-11	[-2.0;0.2]	[0.7;0.3]	[1.9;1.0]	[2.1;0.5]	[2.0;0.1]	1.5;-0.1	0.9;0.4	0.5;0.2	[-4.0]	1.7	0.9
Apr-11	[-2.0;0.2]	[0.7;0.3]	[1.9;1.0]	[2.1;0.5]	[2.0;0.1]	1.5;-0.1	0.9;0.3	0.5;0.2	[-4.0]	1.7	0.9
May-11	[-2.0;0.2]	[0.8;0.4]	[2.0;1.0]	[2.1;0.5]	[2.0;0.1]	[2.5;0.8]	2.1;0.5	1.8;0.3	[-4.0]	1.7	2.1

In brackets; GDP-Data published by EUROSTAT. In italics: quarter on quarter rates.

Data published by Eurostat for the first quarter of 2011 were significantly higher than those estimated by the model which has resulted in a significant upward revision of estimate for the whole year. The reason for the deviations between model and actual data probably can be found in the relative weight of expectation indicators. They understated the decline in 2008 and 2009, and in the same way they have not been able to capture the strength of the recovery.

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