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The Price of Uncertainty

The importance of credibility and market trust in economic policy: The case of Greece

For almost a decade, Greece has experienced an unprecedented crisis, both in terms of duration and intensity, following eight years of economic adjustment programs that have come at an extremely high social and economic cost. However, with the completion of the second review of the third economic adjustment program it appears, for the first time since the first half of 2014, that both international markets and ordinary citizens are gradually regaining confidence in Greece's growth outlook and the prospect of finally exiting from the crisis. The country's recent, successful issuance of a 5-year government bond, after three years exclusion from the debt markets, confirms this sentiment.

Despite the unprecedented social and economic cost, the country, for several years now, has remained mired in economic stagnation and uncertainty, and under strict oversight of its adjustment programs. This is regardless of the fact that there has been a significant macroeconomic convergence – that the major macro imbalances that led to the crisis have been eliminated – and that dozens of reforms have been implemented, as affirmed by major international indicators.

The rapid downgrading of Greece's sovereign credit rating by the international rating agencies, mainly due to the large macro imbalances in the early stages of the crisis, had abruptly interrupted the country's access to international markets. As a result, the yield on the Greek benchmark, 10yr sovereign bond skyrocketed, especially during periods of increased uncertainty and risk.

¹ We would like to thank Mr. F. Karavias, Mr. S. Ioannou, Mr. T. Kalantonis, Dr. P. Monokrousos, Dr. A. Anastasatos and Ms. C. Kontonika for their valuable contributions that improved the content of this report.

Currently, Greece has the lowest credit rating in the Eurozone, substantially below “investment grade”. To raise liquidity, the country must pay the highest risk premium on government bonds issued by European peers in the international markets.

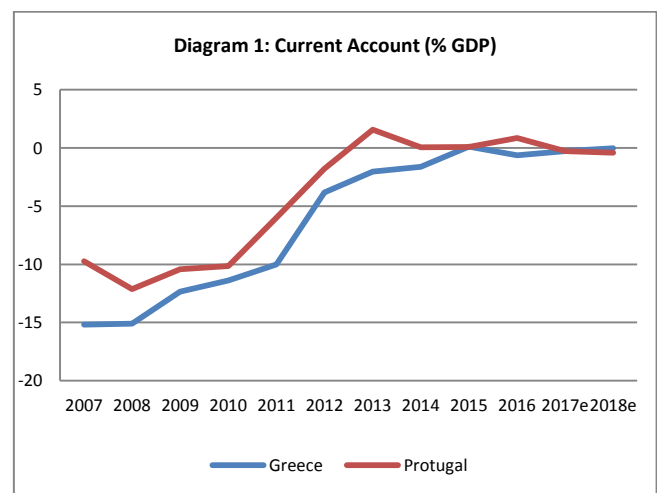
At the same time capital controls remain in place (despite several recent relaxation initiatives), real estate prices have declined substantially, the liquidity squeeze and the lack of deposit growth is ongoing, the levels of the non-performing loans remain very high at record levels and access to international money and capital markets is improving but still remains limited. Furthermore, the payments ethos and culture has deteriorated, with the emergence of a practice of delaying or avoiding obligations altogether. This applies both to the public sector, which has billions of euros in payments that are past due, and in the private sector with the emergence of the phenomenon of strategic defaulters.

It is noteworthy that Greece remains the only country that has yet to exit its economic adjustment program, in stark contrast with other Eurozone countries that were forced to implement similar programs, such as Ireland, Cyprus and Portugal. These countries have managed, not only to exit their programs and economic supervision by the creditors, but also to resume financing from international money and capital markets at competitive rates. Furthermore, they have returned to satisfactory economic growth and to an environment of stable and positive economic prospects.

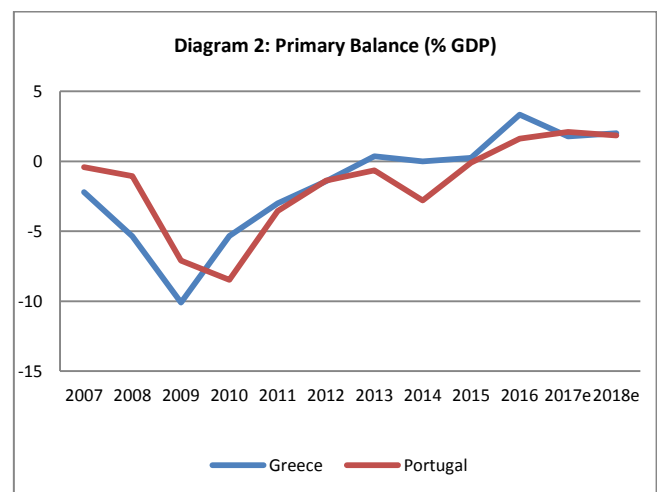
The huge fiscal correction and reforms not fully reflected in Greece’s cost of borrowing

Especially in this area, the comparison between Greece and Portugal (a country of roughly similar

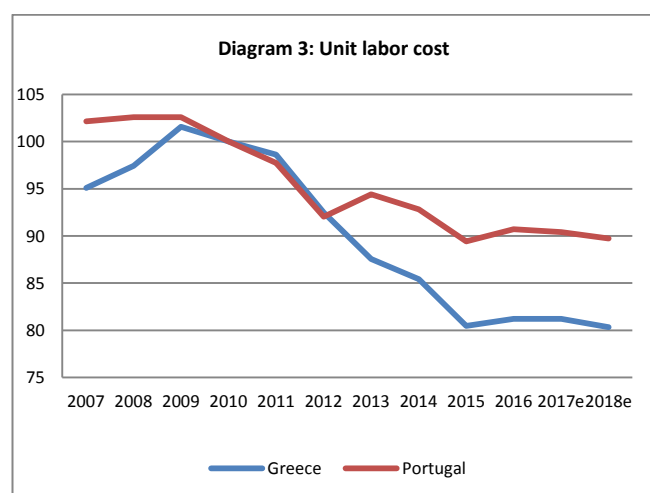
size) is extremely problematic for the former. Despite the fact that, in recent years, Greece has implemented a much greater fiscal and macroeconomic adjustment compared to Portugal (Diagrams 1, 2 and 3), the yield on the Greek 10yr government bond remains roughly 260bps higher than that of Portugal.



Source: Thomson Reuters



Source: Thomson Reuters



Source: Thomson Reuters

Also, Portugal, as opposed to Greece, has normal access to international markets, while the credit default swap (CDS) on Portuguese debt is 266bps lower than the Greek equivalent and its credit rating (S&P) is five notches higher (Table 1).

Table 1: Creditworthiness comparison Greece – Portugal

	Greece	Portugal	Δ
10yr yield	5,46%	2,87%	259 bps.
10yr CDS	4,99%	2,33%	266 bps
Credit rating (S&P)	B-	BB+	5 notches

Source: Thomson Reuters (04 Aug 2017)

The comparison with other countries that have been under an adjustment program underscores further concern about Greece. Namely, its economy remains in worse condition and the important reforms that Greece has undertaken have apparently failed to impress international markets.

According to the OECD, Greece ranks first in implementing structural reforms among the European countries that have adopted an economic adjustment program. Also, according to the Adjustment Progress Indicator² by the

Lisbon Council, and based on four criteria (increase in exports, contraction of fiscal deficit, changes in the labor costs, progress in structural reforms), Greece ranks first, Ireland second, with Portugal fifth and Cyprus seventh.

The reforms have produced tangible results in the competitiveness of the Greek economy. Greece's ranking in the World Bank's Doing Business index (Diagram 4) has improved since the start of the crisis, standing at 61 among 190 countries³ surveyed in 2016. Admittedly, Greece's ranking has historically been low while significant steps have been taken since the start of the crisis, but there is still room to improve the country's position further.



Source: World Bank

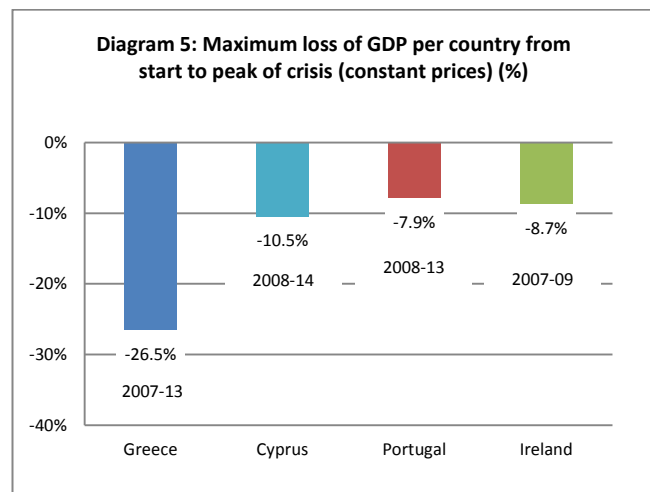
Greece's unprecedented adjustment over the past several years has come at a significantly higher social and economic cost compared with other Eurozone countries that had to implement similar adjustment programs.

Indicatively, Greek GDP contracted by more than 25% compared with its pre-crisis level (Diagram 5), while the unemployment rate reached unprecedented heights, surpassing by a

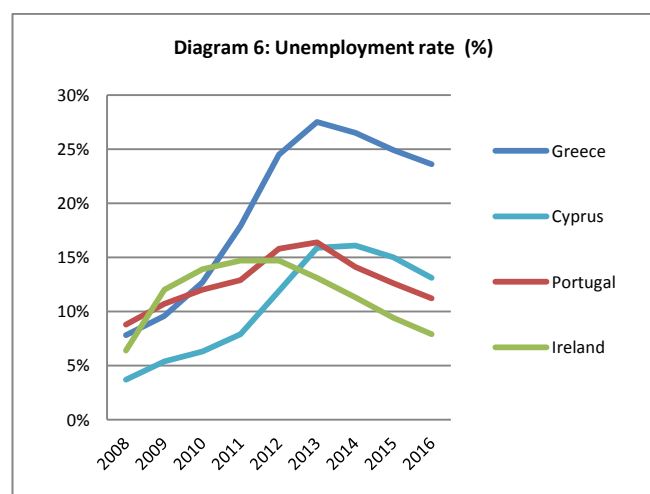
² The 2016 Euro Plus Monitor: [Coping with the Backlash](#), The Lisbon Council

³ Despite this progress, Greece's ranking has remained unchanged over the last three years.

significant amount the levels of other countries that implemented similar programs (Diagram 6).

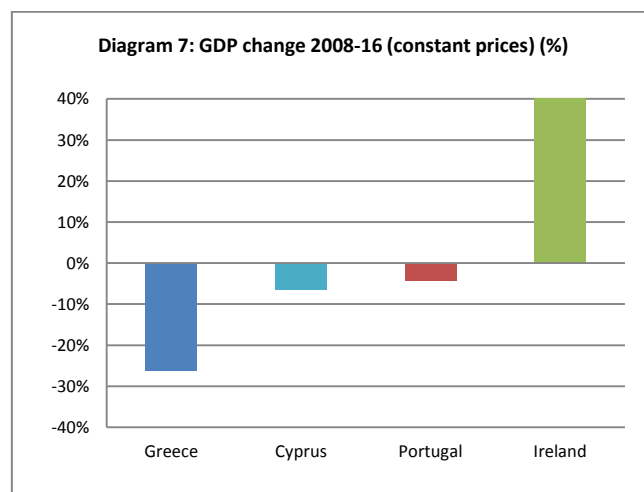


Source: AMECO



Source: AMECO

Significantly, the aforementioned countries have, to a large extent, recovered or even surpassed their pre-crisis GDP levels with Greece remaining the odd one out (Diagram 7), while no other country experienced deposit outflows close to the levels experienced in Greece (Table 2).



Source: AMECO

Table 2: Evolution of private sector deposits Dec. 2010 – June 2017

	Greece	Portugal	Italy	Cyprus	Spain	Ireland
Private sector deposits evolution	-40%	-3%	16%	-21%	-18%	1%

Source: ECB

An important and worrying manifestation of this social and economic cost is the large-scale emigration, primarily for economic and professional reasons, of mostly younger and mostly higher educated people (ca. 450,000 below the age of 45) seeking and finding employment opportunities outside Greece (brain drain). It is estimated⁴ that those emigrants contributed €12.9 billion annually to the GDP of their destination countries in the period between January 2008 and June 2016 and more than €9 billion in tax revenue, while the cost of their education burdened the Greek state to the tune of €8bn. The repatriating this lost human capital must become, without question, a top national priority. However, it also presents a challenge: Greece must be able to offer similar, if not more appealing, professional opportunities and prospects than in the destination countries.

⁴ According to a study of Endeavor Greece: [link](#)

Given the above circumstances, a number of poignant questions arise: why does Greece remain in this unfavorable position? Why has the necessary macroeconomic adjustment carried such a large social and economic cost? Why do international markets, the business community, investors and Greek citizens alike remain skeptical about the ability of Greece to exit the crisis after so many years and despite the macroeconomic and structural progress that has already taken place? Why do the markets demand a significant risk premium in order to lend to the country? Finally, why have other countries exited the adjustment programs and are now on a rising growth trajectory, whereas Greece is only slowly moving in this direction?

The answer to these key questions is complex. Many significant political, economic and social factors play a role in shaping up the outcome and explain the differences among the countries, such as: their different macroeconomic and political circumstances, the size of their imbalances at the start of the crisis, the sustainability of public and private debt, as well as the peculiarities in the production structures of each country and the quality of their institutions and their public administration.

Without attempting too technical an approach, and without ignoring the importance of crucial economic and institutional variables in the economic outcome, it is our intent to show, in the case of Greece, how the low credibility in economic policy, and the low confidence of the markets in those policies, played a critical role. In our view, those two factors are the key determinants in explaining the negative economic result, especially in relation to the depth, duration and intensity of the crisis.

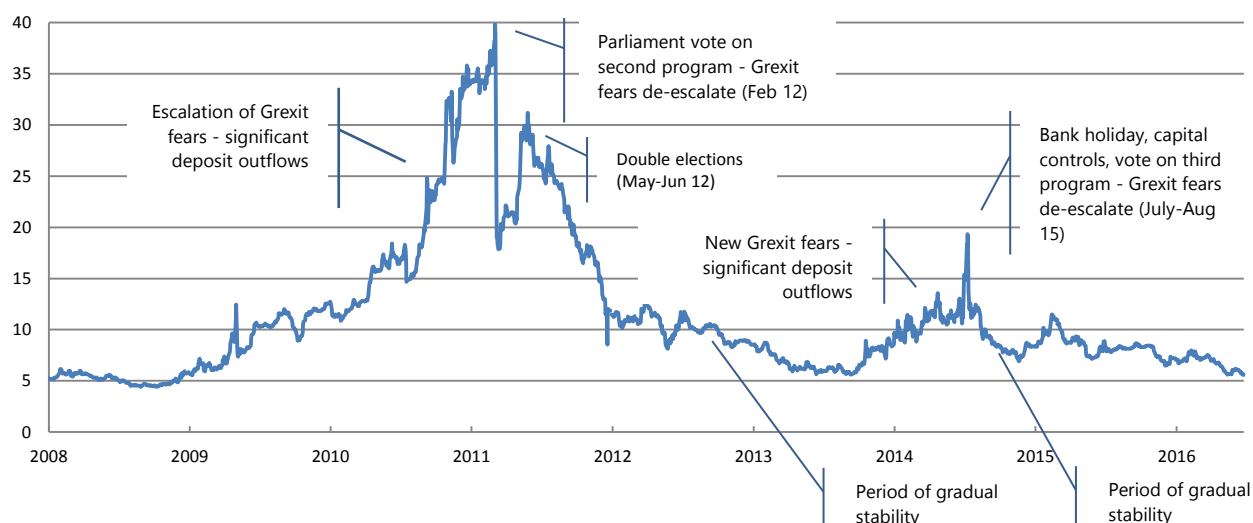
In our opinion, the answer to Greece's sub-optimal performance lies in the chronic lack of

credibility in relation to the implementation of its economic reforms. It also relates to the still limited confidence of the international markets, and of Greek citizens and businesses, in the commitment of Greece's governments and political establishment to implement the necessary reforms to steer the country out of the crisis and to lead it to an environment of economic normality and stable growth prospects. This lack of credibility and trust has kept the risk of Grexit alive and only served to deepen the crisis. Greece is, unfortunately, the only country in the Eurozone – including even those that adopted an adjustment program – whose European prospects and future within the Eurozone was disputed, both by segments of the Greek political system as well as certain European decision-makers.

Credibility and the trust of the markets are interconnected. They are key parameters for the implementation of a successful economic policy while their absence, other things being equal, increases the intensity and duration of the crisis on the one hand and severely delays the economic upturn and the country's return to normality and growth on the other.

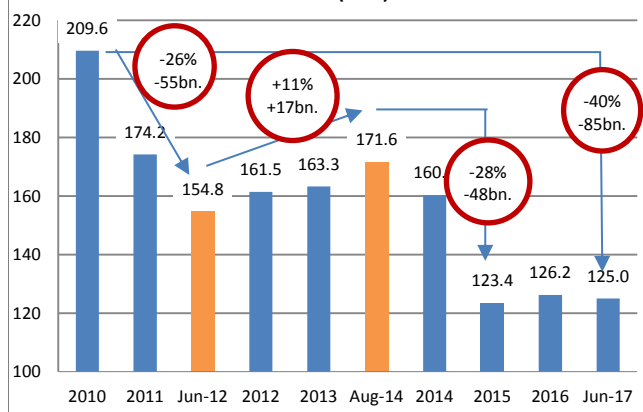
The problem of credibility and trust can be said to be chronic for Greece. The lack of confidence in the country's reform program peaked in the first half of 2012, improved somewhat in 2014 but worsened again in the first half of 2015. This can be demonstrated by three key metrics: the yield on the 10yr Greek government bond (Diagram 8), the trends in private sector deposit outflows from the banking system (Diagram 9), and the change in bank notes in circulation in the economy (Diagram 10). These variables deteriorated during challenging periods of declining credibility and trust as in the first half of 2015.

Diagram 8: Yield of the 10yr GGB benchmark (%)



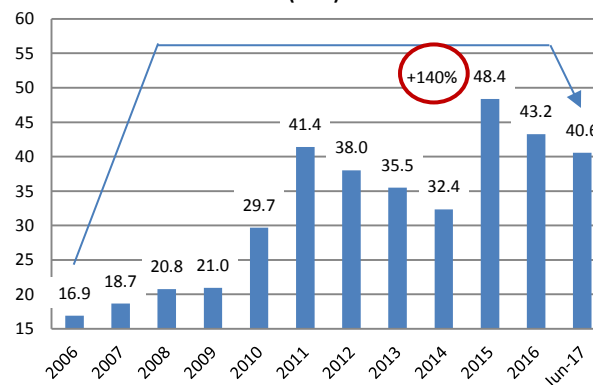
Source: Thomson Reuters

Diagram 9: Evolution of private sector deposits in Greece (€ bn)



Source: Bank of Greece

Diagram 10: Money in circulation in Greece (€ bn)



Source: Bank of Greece

On a theoretical level, credibility and trust in economic policies, institutions and the leadership of a country are crucial elements for the success of broader economic policy. Their strong presence not only improves the effectiveness of policy making, but more importantly, drastically shortens the duration, the depth, and the economic and social cost of the necessary adjustment and hastens an exit from the crisis.

Both theoretically and historical experience show that losing credibility and the regaining of lost trust do not behave in a symmetrical fashion. Indeed, following poor policy choices, the loss of credibility can lead quickly to a rapid deterioration of confidence, compel investors to accelerate divesting, and result in markets entering an intense downward spiral. However, restoring credibility and trust can only be achieved over time, based on tangible results and not on announced plans and promises.

Is the disputed sustainability of the Greek sovereign debt a key factor that justifies the above different performance of the Greek economy compared to other European countries in an adjustment program?

A factor, some international analysts claim, that contributes to the uncertainty and may justify the difference in behavior of the international markets towards Greece and, for example, Portugal (which has a significantly lower public debt-to-GDP ratio compared to Greece) is the concern over the size and dynamics of the Greek public debt. In this context, further contributing to this uncertainty is also the different views held by the International Monetary Fund and

European institutions regarding the required policies for its sustainability.

In short, the IMF assumes a very low economic growth rate for Greece in the medium term (ca. 1% per annum). This also partially reflects a low degree of confidence in Greece's ability and commitment to implement required reforms. The IMF argues that the sustainability of the Greek public debt makes necessary the immediate implementation of generous structural interventions, so that realistic and reasonable assumptions can be made regarding the amount of required fiscal primary surpluses. The proposed restructuring include, among other things, a significant time extension in the maturity of total loans borrowed (and/or that will be borrowed) by Greece in the context of its three consecutive European rescue programs, long grace periods for the repayment of interest and amortization, and even lower fixed interest rates on these loans.

On the other hand, the European Commission assumes Greece will achieve significantly higher annual economic growth rates and primary budget surpluses in the medium term. These assumptions suggest a milder (in size and scope) restructuring of Greek public debt, with the focus on maintaining the ratio of annual gross general government financing needs to GDP within the agreed sustainability limits (i.e. below 15% in the medium term and 20% in the long term).

It should be noted that, of all the European countries that underwent adjustment programs, only in Greece's case has there been such a strong divergence of opinion between the IMF and the European institutions, a fact which particularly affected the credibility of the program.

The theoretical approaches to this question are undoubtedly useful. But regardless of the technical discussions on whether or not sovereign debt sustainability conditions are met, the fact is that both the credibility of Greece's economic policies and its access to international markets are matters that require particular consideration and attention.

Taking into account that Greece's public debt-to-GDP ratio (at almost 180%) is currently the highest in the Eurozone (Table 3), it is not surprising that the international investment community remains cautious, despite the significant restructurings on Greek public debt that have been undertaken until now.

Table 3: Debt/GDP of countries that adopted a program and countries of the European South - 2016

	Greece	Portugal	Italy	Cyprus	Spain	Ireland
Debt/ GDP	179.4%	130.4%	132.6%	107.8%	99.4%	75.4%

Source: Thomson Reuters

However, in our view, the sustainability of the Greek public debt does not constitute the only nor, perhaps, even the main reason why Greece has been unable to restore the confidence of international markets in its economic prospects. That becomes especially clear if three facts are taken into account:

- the largest part of Greek government debt is now owed to official institutions and Greece already enjoys preferential terms with regard to interest rates and maturity,
- the public and institutional commitments of European partners to ensuring the sustainability of Greek debt in the context of existing medium-term relief arrangements, especially after the German elections, seems to limit market uncertainty,

- the recent positive reaction of international markets, which despite the lingering uncertainties and doubts surrounding the sustainability of the public debt, have led Greek government bond yields steadily lower and access to the market improving on the back of better economic performance and government credibility.

Further, we recall that Greece's creditors have already undertaken several measures to restructure the Greek public debt. The Greek government's borrowing requirements in the first five years following the successful completion of the current program namely up to 2023 would be relatively limited (around €7bn to €12bn per year). This is a particularly low amount for a European country and an embarrassment to accept that it cannot be raised from international markets, by applying effective and credible economic policies.

Thus, if we accept the hypothesis that the sustainability of the public debt is not the only, or even the main, explanation for the still low credibility of Greek economic policy and similarly limited market confidence and trust in the country's prospects of exiting the crisis, then the question arises: what accounts for such a poor outcome? In our view in the case of Greece, credibility and trust were critically influenced by a number of other important and interacting factors which fueled uncertainty and undermined political instability leading to the confidence of the markets in Greece and its prospects.

Credibility of economic policy and trust of the markets fluctuated at low levels throughout the crisis mainly because of:

1. high political uncertainty and risk,
2. serious inconsistencies and delays in delivering reforms which undermined market confidence in the commitment of the Greek government to implement the agreed measures (program ownership),
3. wrong policy mix in certain areas,
4. absence of a convincing and credible Greek national plan for exiting the crisis that would enjoy wide political and social acceptance and support. The adjustment program was constantly disputed and challenged by the political system but we never presented our own program to restore fiscal sustainability, financial stability and growth prospects.

In more detail:

Firstly, the intense political uncertainty in the country, which had a negative impact on market expectations, was fueled over recent years by:

- the chronic absence of wider political consensus on an adjustment and reform program to conclusively exit the crisis,
- the never-ending confrontational populist rhetoric between government and opposition,
- a permanent environment of rivalry and confrontation between Greece and its creditors and partners, which increased mistrust,
- rising populism, special interest protection, pointless political maneuvering and tactics,
- denial of reality and ideological fixation on non-realistic solutions,
- the threat of Grexit and a return to the drachma, a strategy that was pursued both

by segments of the Greek political system, as well as by certain European entities,

- continuous changes of government, prime ministers and finance ministers (10 finance ministers over the last eight years), which undermined the continuity of reforms and negotiations,
- the confrontational negotiations between Greece and its creditors in the first half of 2015, which destabilized the markets, ordinary citizens and the economy, resulting in the country facing significant and unprecedented risks, and
- the significant divergence of opinion between the IMF and the European institutions.

Secondly, the lack of credibility in economic policy was also fed by a persistent unwillingness by Greek governments to take ownership of the agreed measures and implement reforms in a timely manner. Program reviews were never completed within the agreed timeframe, while the delays were often significant and detrimental to the economy. On many occasions, instead of implementing the reforms which Greece had accepted and signed, successive Greek governments sought to achieve a more lenient, alternative solution through a tactic of political negotiation with European leaders. This tactic failed utterly and fueled the distrust of partners and international markets about the true intentions of Greece and the country's willingness to forge a modern, competitive economy. Meanwhile, Greek leaders often cultivated the impression that the agreed reforms and measures were imposed by creditors and, rather than embracing them, were only being adopted because we had to, while

sometimes publicly disagreeing about their usefulness.

In fact, with a few exceptions, throughout the crisis successive Greek governments failed to convincingly take ownership of the program and the agreed reforms. At the same time, Greek society vigorously resisted the reforms, convinced in most cases by the political establishment (government and opposition) that there was a milder alternative solution with less cost and pain, a view further reinforced by wrongfully identifying reforms with across-the-board wage and pension cuts.

As a result, Greece is now in its third bailout program and its eighth year of crisis.

Along the way, creditors became rigid, demonstrating an unbending insistence on implementing policies even when some policies were proven to be highly ineffective and counterproductive. The result was a climate of confrontation and where the agreed measures were implemented under the “Sword of Damocles” threat of Grexit. Both sides used that threat to intimidate the other, destabilizing markets in the process. In such an environment, expectations of a rapid exit from the crisis were thoroughly undermined, further raising the economic and social costs of the adjustment.

This is particularly disappointing given that someone actually living in Greece could not, in all honesty and in good faith, reasonably disagree with the need for the proposed reforms or the need to modernize Greek society, its economy and institutions. It is also surprising why, for so many years, Greece did not undertake similar reforms on its own initiative and why there was a delay in realizing their necessity.

We briefly present the headlines of some of the reforms included in Greece's recent agreement

with its creditors to demonstrate why they constitute, in the vast majority of cases, necessary measures for the institutional and financial modernization of the country, and for restoring its international competitiveness.

In more detail, the recent agreement envisions:

- the removal of barriers to competitiveness in the products and services markets,
- the simplification of licensing procedures and the modernization of corporate law for undertaking business activities,
- the opening up of regulated professions to competition,
- the modernization and upgrading of public administration,
- the modernization of the public health system,
- the modernization of tax administration,
- systematically combating tax evasion, improving tax compliance and the tax collection mechanism,
- the central management of social security contributions,
- modernization of the judicial system
- the creation of an independent public revenue authority,
- adopting measures to fight corruption,
- restructuring the energy sector and opening it up to competition,
- restructuring agricultural policy and providing incentives to promote exports,
- strengthening the autonomy and effectiveness of independent authorities, e.g. the national statistical office,

- a review of social policy to improve its effectiveness,
- the development of a new modern land policy and spatial planning,
- developing a modern, credible and transparent public procurement policy and procedures,
- centralizing management of public property with the creation of an independent fund,
- actions to ensure a sustainable pension system,
- the liberalization of the transport sector.

Thirdly, significant delays in the implementation of reforms was not the only problem in the economic policy that was pursued. Implementing in some cases the wrong mix of policies also undermined credibility and effectiveness, a point that has already been acknowledged by creditors, particularly the IMF. This wrong policy mix, coupled with erroneous estimates over the size of fiscal multipliers, had a significant impact on the escalation of the crisis.

For instance, at the beginning of the program, the Greek government failed to integrate the necessary fiscal consolidation and reduction of labor costs, with a front-loaded privatization policy, measures to encourage private investment and foreign capital flows, and the creation of a business friendly environment. As a result, fiscal and labor discipline measures were combined with plummeting investment spending (from 23% of GDP pre-crisis to around 11% in 2016), exacerbating the negative economic impact. Additionally, there was no convincing restructuring of the sizeable Greek public debt early in the program, in order to limit the servicing cost and curtail the uncertainties and the overhung effect in the markets. As a result,

and due to Greece's deep recession, public debt as a percentage of GDP is now higher than it was before the crisis (2009: 127% vs. 2016: 179%).

The low-credibility of economic policy and lack of market confidence further fueled uncertainty and risks that, coupled with the negative impact of the PSI and the deep and protracted recession, led the banking system into a major crisis. A liquidity squeeze and a capital shortfall were created and substantial, successive capital increases were required and the banking sector went from being potentially a growth driver and a mitigator of the crisis, to a factor of destabilization and an accelerator of the crisis.

At the same time, the necessary fiscal adjustment was mainly based on a significant increase in tax rates and not on the widening of the tax base and on curbing tax evasion. In addition, Greece did not rationalize in time the cost, structure and operation of public administration. Above all, however, Greece delayed any decision and implementation on privatizations (in the first two years of the reforms there was not a single privatization) and the liberalization of the markets. Delays in these areas have had a particularly negative influence on the assessment of international markets regarding the credibility and commitment of Greece to implement reforms, liberalize its markets, and open up the economy to competition and foreign investment.

In addition, the significant reduction in labor costs has largely been negated by increases in other costs of production such as higher taxes, energy bills, lending rates and other non-wage costs, significantly reducing the benefits of wage reduction to the country's overall competitiveness.

Fourthly, despite the constant disagreements over the adjustment programs within the political system, which to a large extent were drafted and presented by the creditors, Greece has failed to develop its own convincing and comprehensive national program for exiting the crisis. The long-term absence of such a program, which would enjoy broad political and social acceptance, adds to the problem of credibility. On one hand, there is no clear commitment from the political system to implement the agreed reforms. Nor have Greek leaders, in contrast with, say, Cyprus given a sincere explanation to Greek society about the problems faced and the realistic options available. On the other hand, investors did not have visibility of what a solution to the crisis might look like, given that key parameters determining investment choices were shrouded by uncertainty. Ultimately, Greece did not convince international markets that it had taken ownership of the adjustment program, nor that it had any other credible alternatives.

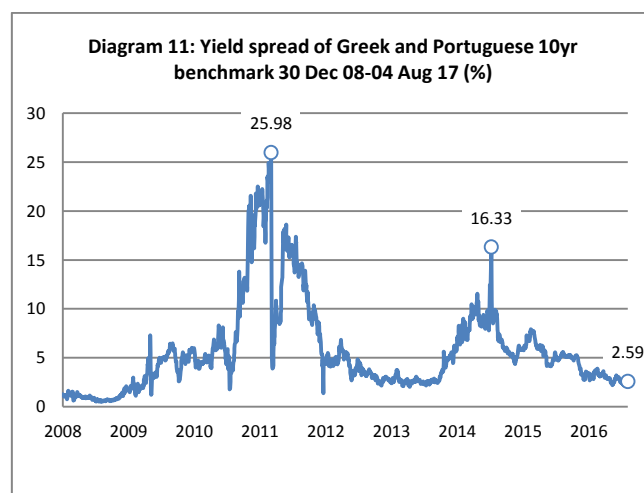
The cost of low credibility of economic policy and lack of market trust has been significant

The cost of low credibility of economic policy and limited market confidence is significant for everyone: the public sector, businesses, households, the society and the economy as a whole. In the present analysis, we are making a first indicative effort to present some of its aspects, without attempting to present a too technical or detailed study.

The Greek government especially was obliged to pay a significantly higher risk premium, or even to have no access to international markets in times when the crisis peaked. As a result, the country was found without alternative financing solutions, social and economic tensions were

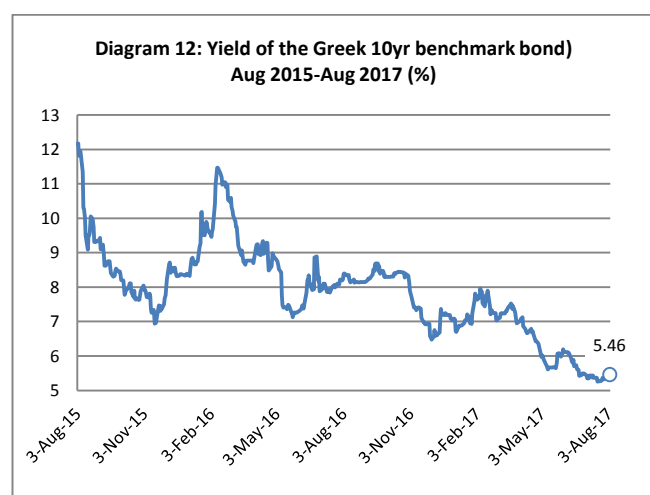
multiplied, the social and economic costs increased, and at the same time the country, with no market access, had little negotiating power in discussions with official creditors. The cost of low credibility finally burdened taxpayers and had a negative impact on the sustainability of public debt.

Despite the differences in the structural characteristics of the two countries, the comparison between Greece and Portugal, and the difference in their cost of borrowing over time (Diagram 11), is indicative of how the limited credibility and trustworthiness of a non-convincing economic policy has cost the country, especially in times of acute crisis.



Source: Thomson Reuters (04 Aug 2017)

Despite the significant decline in Greek government bond yields (Diagram 12) after the successful completion of the second review of the existing program and the visible improvement in economic climate and expectations, Greece has not yet fully convinced international markets of the progress that has been made, or of its commitment to consistently pursue growth oriented restructuring of the economy and the implementation of reforms.



Source: Thomson Reuters (04 Aug 2017)

If Greece wants to regain full access to the markets and policy independence without the explicit reliance on the official creditors (who currently provide financing at low interest rates and long maturities, but who also impose policy reforms), it should, first of all, vigorously and fully implement the agreed reforms and, in addition, to undertake further growth and market liberalization initiatives. At the same time, it must effectively communicate this commitment and the positive results of its policies to international markets. Only in this way, will Greece gradually recover its credibility and convince international markets and its European partners that it is actively taking the necessary initiatives to exit the crisis, to regain uninterrupted access to the capital markets and to return the economy to a stable growth path. Only the front-loaded and consistent implementation of the ambitious reform program will give Greece uninterrupted access to international markets at low, competitive borrowing rates that will not burden fiscal goals, thus making unnecessary the reliance on official funding.

To help achieve this, it would be useful for Greece and its partners to consider a series of credit lines (ECCL) with European institutions, in

the transition period following the successful completion of the current program. Those credit lines would only be used if needed, but would serve to boost market confidence while acting as a buffer in case of possible future exigencies.

It should be noted that, despite the positive market reaction to recent developments, the still unsatisfactory degree of credibility of the implemented economic policy is reflected in Greece's low credit rating by rating agencies. This fact also hampers the issuance of long-term sovereign paper by the country on acceptable terms.

The cost of Greece's low credit rating, which reflects the views of the rating agencies on the country's macroeconomic, political and social prospects, can be seen by comparing the ten-year bond yields and credit ratings of different countries with those of Greece (Table 4).

Table 4: Credit ratings and cost of borrowing

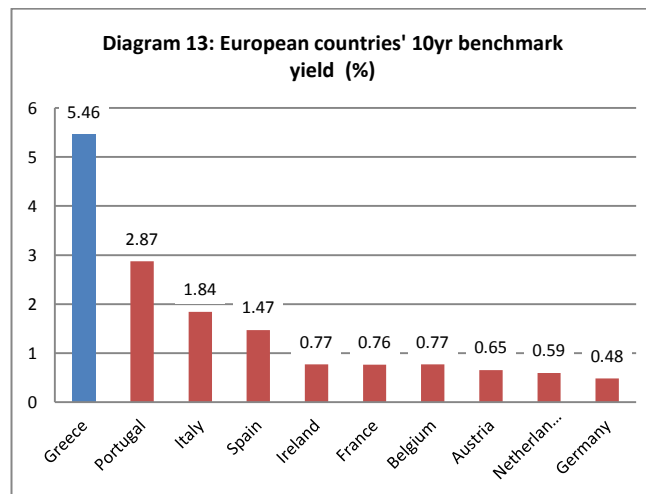
S&P LT issuer rating (Foreign)	Current credit rating	Δ in notches	Yield of 10yr bond (%)	Δ Greece (pps)	pps/notch
Greece	B-	-	5.46		
Portugal	BB+	5	2.87	2.59	0.52
Italy	BBB-	6	1.84	3.62	0.60
Spain	BBB+	8	1.47	3.99	0.50
Ireland	A+	11	0.77	4.69	0.43
France	AA	13	0.76	4.70	0.36
Belgium	AA	13	0.77	4.69	0.36
Austria	AA+	14	0.65	4.81	0.34
Netherlands	AAA	15	0.59	4.87	0.32
Germany	AAA	15	0.48	4.98	0.33
Average					0.42

Source: Thomson Reuters (04 Aug 2017)

Indicatively because this relation is not linear comparing 10yr bond yields, current data shows that a one-notch decline in credit ratings roughly corresponds to a 40 bps increase in borrowing costs. Currently, Greece's credit rating stands six notches below "investment grade".

It should be noted that the yield on the Greek 10yr government bond remains significantly higher than that of other European countries,

despite the notable improvement in conditions and expectations (Diagram 13).



Source: Thomson Reuters (04 Aug 2017)

Accordingly, Greece needs to convince international markets and rating agencies that the reforms will remain in place and will not be reversed after the completion of the third support program.

Once again, the credibility issue comes to the forefront as markets do not constitute a uniform entity but consist of a large number of players who interact to form a consensus on the investment profile of each country or investment product.

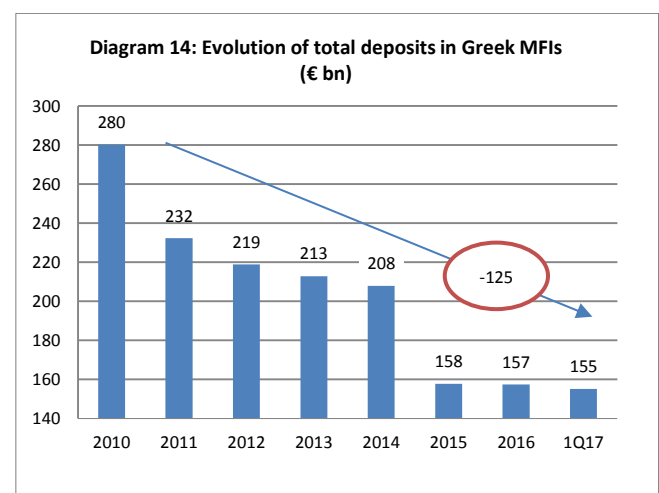
For banks, businesses and households the cost of limited credibility and confidence was also high

In the case of Greece (as opposed to the recent experience in the U.S., as well as other countries of the euro area) the crisis was not triggered by excess in the domestic banking industry. The Greek crisis was a result of Greece's fiscal derailment and loss of competitiveness after the country joined the European and Monetary Union.

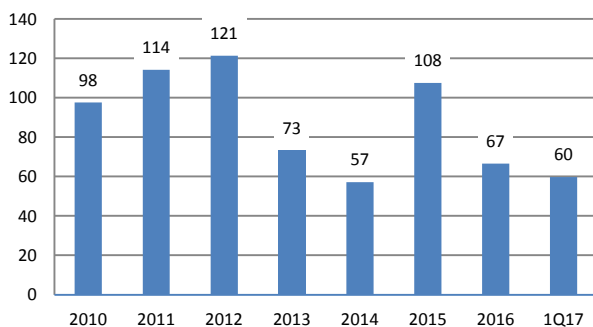
The long duration of the crisis and the deep recession, in tandem with high interest rates, losses stemming from the PSI debt swap, tight

liquidity, large scale deposit outflows, the ongoing uncertainty caused by the ineffectiveness of the applied economic policy, and finally, the risk of Grexit, have significantly damaged the banking system. Damage has also been done by the prevailing attitude of a large number of debtors to shirk their obligations. Combined, these factors have forced the banks to seek several major capital increases and led to the formation of substantial higher provision levels for bad debts.

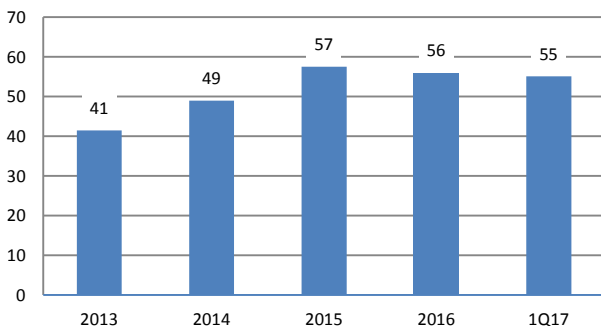
In particular, the banking system was forced into successive capital increases totaling €64bn, partly covered by private money, has lost deposits amounting cumulatively to €125bn, and relied heavily on the Eurosystem for liquidity to survive (at the height of the crisis Eurosystem borrowing exceeded €130bn). Non-performing exposures have spiked to more than €100bn, which has led to €57bn of accumulated provisions (Diagrams 14, 15, 16). As a result, Banks received substantial state aid and have to implement significant restructuring plans.



Source: Bank of Greece

Diagram 15: Exposure of Greek banks to the Eurosystem (€ bn)

Source: Bank of Greece

Diagram 16: Accumulated provisions of systemic banks (€ bn)

Source: Systemic banks' balance sheets (IFRS)

Bank shareholders, including the Greek state, lost twice their total investment in the banks amounting to tens of billions of euros. In addition, capital controls were imposed and banks were forced to implement restructuring programs and shrink their activities, while a number of them were pushed to non-viability and eventually bankruptcy.

Similarly, companies and households experienced an unparalleled financial squeeze in an environment of negative credit growth, elevated interest rates and limited access to financial markets. Deep economic recession, collapsing demand and corporate turnover, significant cuts in wages and pensions, were

accompanied by a massive depreciation in financial and real assets.

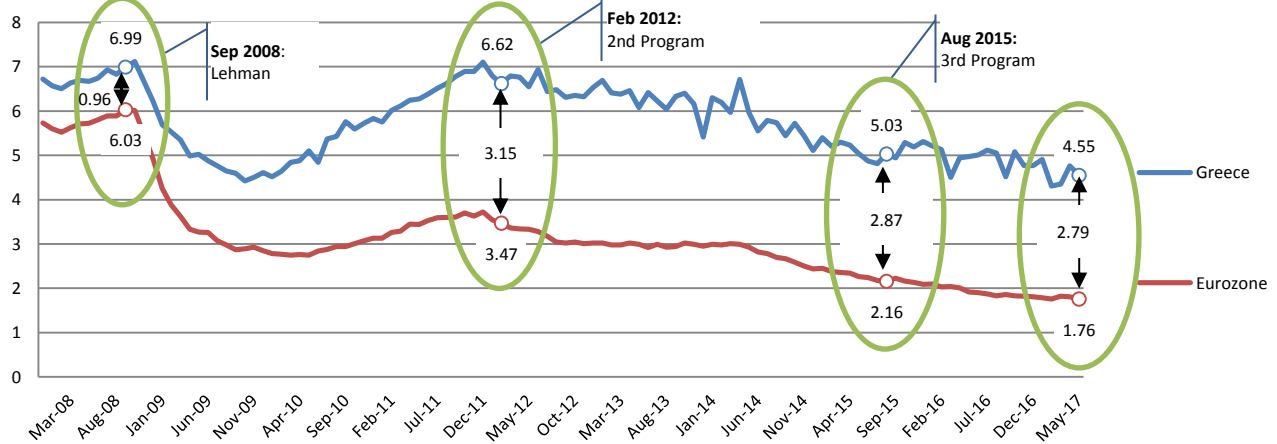
Though households were similarly affected, our analysis will focus on the costs of the prolonged economic recession on corporates.

In order to compare the borrowing costs for companies (excluding those of the financial sector) and households across the Eurozone, the European Central Bank (ECB) established a group of composite borrowing indicators⁵, based on statistical data provided by the commercial banks, for both individual Eurozone countries and the euro area as a whole.

Whereas in September 2008 Greek companies were borrowing at less than 100bps (1%) above the European Union average, that difference increased to more than 300bps when the second economic adjustment program was officially adopted (Diagram 17). On average, the difference in borrowing costs between Greek and European companies almost tripled compared with pre-Lehman levels (Diagram 18), with significant negative repercussions on the companies' cash flows. Currently, though borrowing costs have declined moderately, they still remain significantly higher than in other Eurozone members that requested financial support from international lenders through an economic adjustment program (Diagram 19).

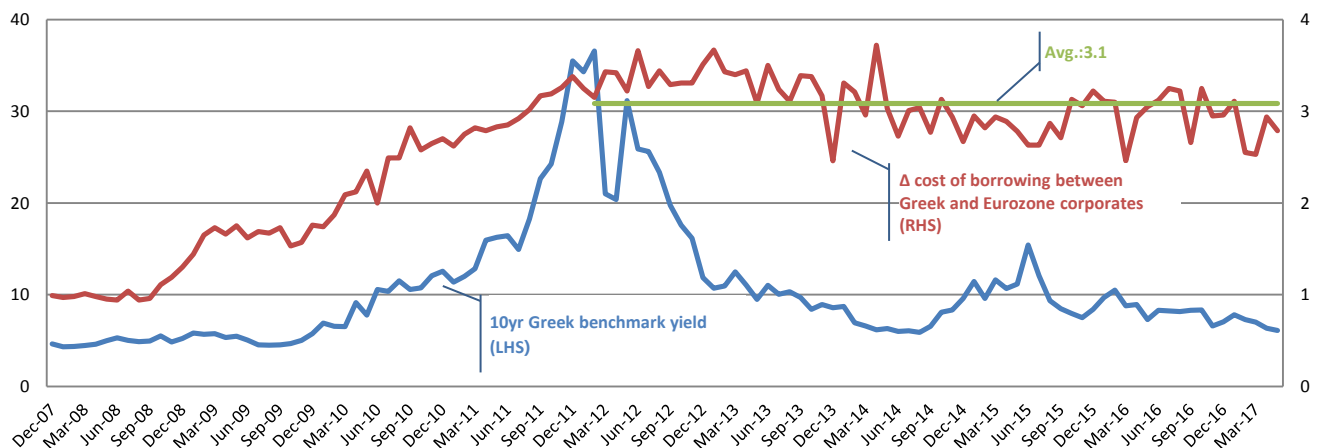
⁵ The calculation methodology can be found here: [link](#)

Diagram 17: Composite cost of borrowing indicator of Greek corporates vs. Eurozone average (%)



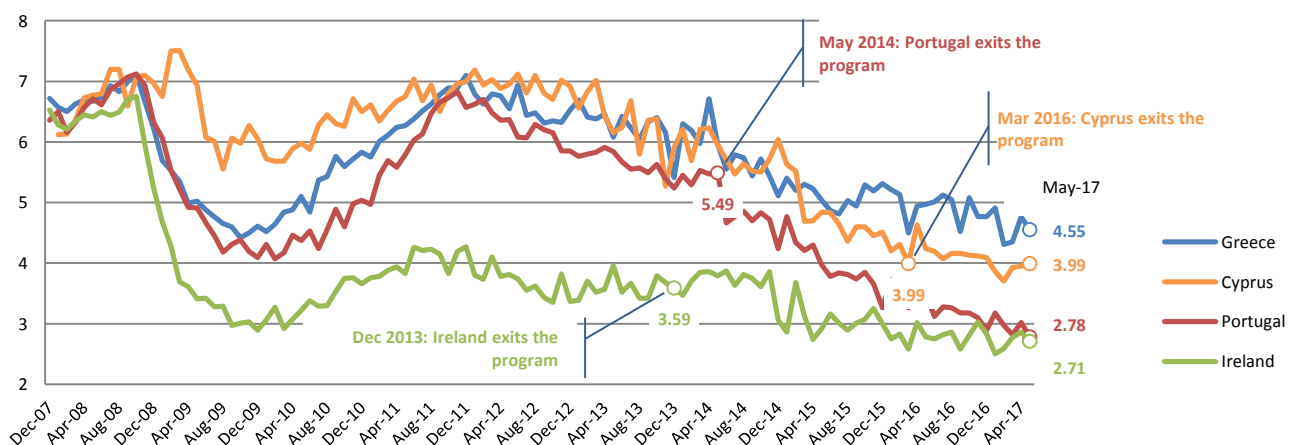
Source: ECB, Eurobank

Diagram 18: Δ cost of borrowing between Greek and Eurozone corporates (%)



Source: ECB, Eurobank

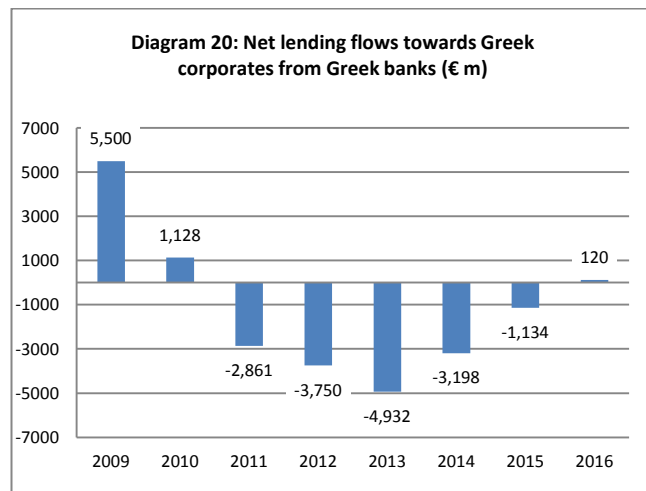
Diagram 19: Cost of borrowing of corporates of countries that adopted a program (%)



Source: ECB, Eurobank

It should be noted that the borrowing cost for Greek companies, compared to the EU average, remains close to the elevated levels of February 2012. This confirms that the level of borrowing costs, especially for small and medium-sized enterprises, lag the improvement in financial indicators, making clear that time is needed and, most significantly, a clear improvement in the liquidity conditions of the banking sector as well as the macroeconomic growth outlook.

Undoubtedly, high borrowing costs and economic uncertainty negatively affected not only credit demand, but also Greek entrepreneurs' appetite for investment. It is indicative that net lending flows (new disbursements less repayments) from 2011 to 2015 were strongly negative, while in 2016 they shifted into positive territory with just €120m (Diagram 20), reflecting limited demand, tight liquidity conditions and more conservative bank lending policies.



Source: ECB, Eurobank

At the same time, the financial crisis undermined the health of hundreds of companies, leading them to bankruptcy and financial asphyxia, destroying a significant part of the country's productive and economic base. Indicatively, Table 5 presents the evolution of the non-

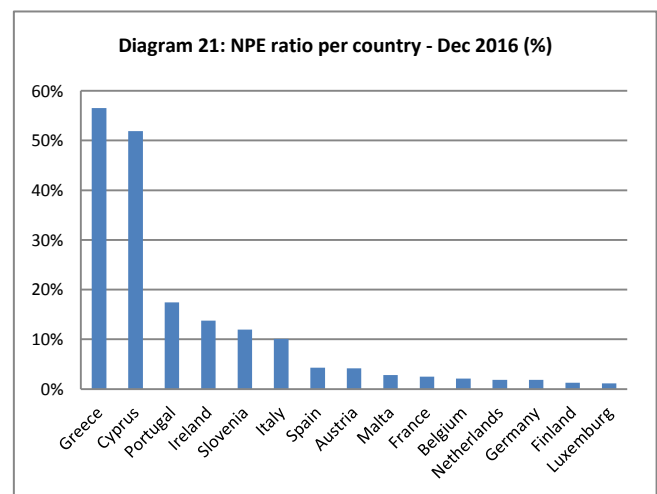
performing exposures (NPEs) ratio for the business portfolio. It is evident that more than half of business loans, totaling €62bn, are not being fully serviced at present.

Table 5: Corporate NPE ratios

	2014	2015	2016	March 2017
NPE ratios	39,8%	43,8%	52,2%	54,2%

Source: ECB

Furthermore, the ability of households to service their loans has decreased significantly, while it is particularly worrying that the residential portfolio, which currently stands at €66bn, has an NPE ratio of 42% (€28bn). It should be noted that, as shown in Diagram 21, Greece's stock of non-performing exposures as a percentage of total exposures, is the highest among Eurozone members.



Source: SSM

Greece's largest international companies have restored their access to funding markets faster

Even though, as we have already emphasized, the vast majority of Greek companies continue to face serious financing constraints, a limited number of large corporations have managed to restore their access to international markets

ahead of the Greek state and the banks, and on relatively satisfactory borrowing terms.

Specifically, throughout the duration of the crisis, from 2011 to 2016, there were 20 bond issues by just nine Greek corporates raising a total of €7.1bn in capital. But even for the large corporates that issued bonds during that period, the cost of issuance fluctuated considerably, in line with domestic (and to a lesser extent international) macroeconomic and political developments.

It is indicative that corporate issuances between 2011 and 2013, a period characterized by elevated economic uncertainty, yielded an average interest rate of around 8.1%.

By contrast, the borrowing cost on corporate issuances during the spring and summer of 2014 fell to around 4.7%, or 340bps lower. Recently, trading in the secondary bond market has shown further improvement, with impressively low yields on Greek corporates (Table 6), lower than or comparable to sovereign debt maturities.

In the first seven months of 2017, an additional five corporate bond issuances have taken place on the Athens Stock Exchange at yields of around 3.3%, or 150bps lower than those issued between 2015 and 2016 (Motor Oil €350mn @ 3.225%, Sunlight €50mn @ 4.25%, OPAP €200mn @ 3.50%, Mytilineos €300mn @ 3.10% and Terna Energy €60mn @ 3.85%).

Table 6: Greek corporate bond issuances during the crisis

S/N	Issuer	Issue date	Coupon	Amount (€ m)	Yield (%) 26 Jul 2017	Maturity
1	OTE '14	Apr-11	7.250%	500.0	-	Apr-14
2	Titan '17	Dec-12	8.750%	200.0	-	Jan-17
3	OTE '18	Jan-13	7.875%	700.0	1.718	Feb-18
4	ELPE '17	Apr-13	8.000%	500.0	-	May-17
5	Frigoglass '18	May-13	8.250%	250.0	122.637	May-18
6	Intralot '18	Oct-13	9.750%	325.0	-	Aug-18
7	Intralot '21	May-14	6.000%	250.0	5.278	May-21
8	DEH '17	Apr-14	4.750%	200.0	-	May-17
9	DEH '19	Apr-14	5.500%	500.0	10.520	May-19
10	ELPE '16	May-14	4.625%	400.0	-	May-16
11	Motoroil '19	May-14	5.125%	350.0	-	May-19
12	FollieFollie '19	Jun-14	1.75% (convertible)	249.5	3.209	Jul-19
13	ELPE '19	Jun-14	5.250%	325.0	3.405	Jul-19
14	OTE '20	Jul-14	3.500%	700.0	2.164	Jul-20
15	Titan '19	Jul-14	4.250%	300.0	1.278	Jul-19
16	OTE '19	Nov-15	4.375%	350.0	1.759	Dec-19
17	Titan '21	Jun-16	3.500%	300.0	1.679	Jun-21
18	Intralot '21	Sep-16	6.750%	250.0	5.187	Sep-21
19	Housemarket (Fourlis)	Oct-16	5.000%	40.0	-	Oct-21
20	ELPE '21	Oct-16	4.875%	375.0	3.578	Oct-21

Source: Eurobank, Thomson Reuters

Conclusion

Greece has experienced an unprecedented sovereign debt crisis in the post-Lehman period and still, after eight years, a return to normality and stable economic growth prospects have yet to be achieved. At various points during the crisis, such as in early 2014, it appeared that there was reason for optimism. However, the political choices and developments post the summer of 2014, as well as the deteriorating macroeconomic environment resulted in heightened the risks and uncertainty, undermined the confidence of international markets, questioned the credibility of economic policies, and delayed the exit from the crisis while increasing the social and economic cost.

The case of Greece underscores how regaining and maintaining the trust of international markets, the formation of a credible economic policy, and continuous access to international funding are key accelerators for exiting the crisis. Such available options also represent a powerful negotiating tool with creditors and are critical to the success of the economic program and the country's growth prospects.

The inconsistent implementation of the adjustment program, the delays in delivering on crucial reforms, the wrong economic policy mix, and the lack of ownership in implementing the reforms, limited the freedom and the negotiating power of Greece with its official creditors. Moreover, these factors fuel the concerns of the markets and increase the economic and social costs, while also delaying the country's return to a sustainable growth path. Unfortunately, without creating an attractive exit plan from the debt crisis, Greece's haphazard approach to its reform program had significant negative effects on the economy, Greek society as a whole, and

particularly on the country's most socially vulnerable groups.

The recent decline of uncertainty and risks, as well as Greece's improved economic growth prospects, confirmed by a string of encouraging data, market expectations and the issuance of a new 5yr sovereign bond, undoubtedly constitute positive developments. However, the country is still far from securing full coverage of its financing needs through the markets at competitively low rates without having to depend on the positive progress reports of official creditors overseeing the 3rd adjustment program. It is crucial for the future of Greece to bridge, in a timely and decisive manner and with appropriate policies, the credibility and trust gaps that continue to exist so the country can continue on its path towards economic normality at lower cost and with greater economic benefit. To this end, it is of vital importance that Greece strictly implements the agreed policy conditionalities attached to the bailout program, and create a greater political and social consensus on the adoption and implementation of a national reform program. Without further delay, the country must undertake growth initiatives focused on rebuilding the country's productive base, relying on private investment and an outward orientation of the economy, with emphasis on international tradable goods and services, as well as Greek manufacturing and agricultural production.

Likewise, it is critical that Greece create an inviting institutional and economic environment for business, private investment, innovation, exports, and attracting significant foreign capital. The latter is of overriding importance, given the collapse of domestic savings, private sector deposits and the liquidity squeeze in the banking

system, to secure the quick return of the country to a strong growth trajectory.

Economic growth will help address the major problems the country faces in terms of unemployment, poverty, high public debt and the large stock of non-performing loans in the Greek banking system.

Lastly, the key prerequisite for realizing all of the above is political stability and the unwavering adoption – by the greatest possible economic, political and social majority – of all the necessary reforms. Only then will the country return to normal economic and social conditions, regain access to financial markets, and restore Greece as an equal partner within the European Union free of capital controls and economic supervision. A country with strong growth prospects, capable of taking the future in its own hands, relying on its significant comparative advantages, the private sector and competitive markets, the untapped potential of its productive forces and the skills and abilities of its human resources. Greece has the ability, but also the opportunity, to turn the next ten years into a period of strong economic recovery for the country, establish a modern, competitive, open and productive economy for the benefit of the many, and with effective social policy and protection for the most socially vulnerable groups.

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