THE FUTURE OF THE CRISIS

Special Economic Analysis

"In view of the recent dramatic evolution of finances in Europe and the world, RIEAS publishes its own appreciation of the European situation"

The essay analyses present Eurogroup States finances, with emphasis on Greece, explain why present measures to circumvent the crisis do not work and demonstrates why more and more Eurogroup countries collapse financially and how this will evolve.

It addresses further the issue of growth which is just now being accepted as a remedy with its possible formulations and how this will affect the economies of Europe and Greece.

Finally it states what can be expected in Greece for the next twelve months and the lessons of the crisis.

Greece will have a deficit at the end of 2012 of over 8%, which is 26bn Euros at least and a recession of a further 6% or more under the best scenario. The outlook for 2013 is almost equally bleak.

Public debt after the haircut as a percentage of GDP will hover to about 165% hoped to be dropping to about 120% in 2020. That means a 6% average yearly reduction of debt in terms of end of 2012 debt, which is simply unachievable.

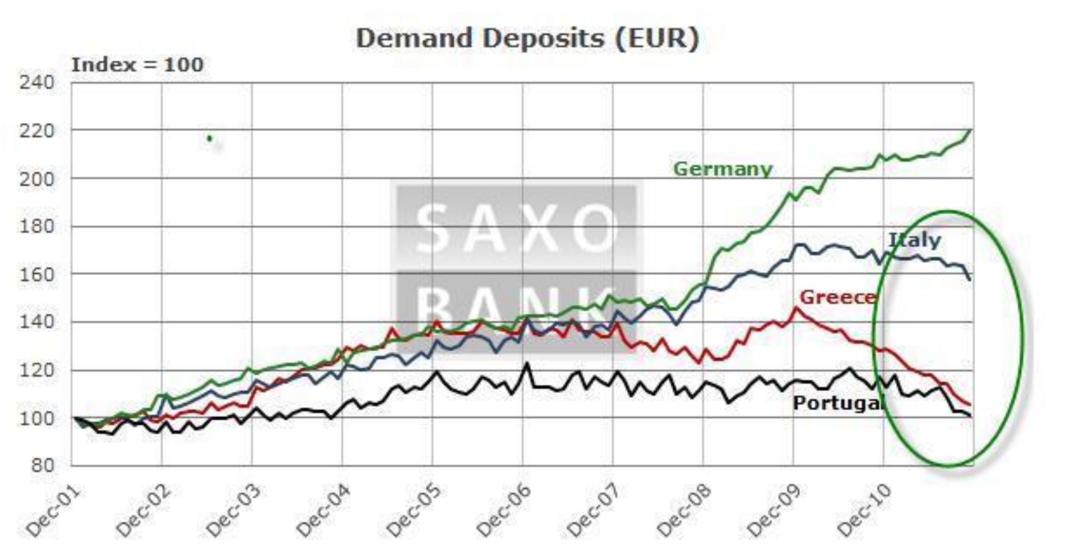
No matter how we manipulate numbers it is highly unlikely that we will achieve 120% debt of GDP by 2020. (Let me remind you that the troubles for Italy started at 120% debt of GDP). The debt in 2020 will be about 150% of GDP because among others the net gain of the debt after the haircut is only 9% of GDP. The conclusion is obvious. Greece will need another “haircut” before 2020 possibly just after 2015 but likely earlier, and another 50 billion loan, when the present program stops. Will it be granted? We hope (?!) What will be our future? Bleak.

Why is this happening? For a very simple reason, Greece as it is today has no growth prospects. The collapsed bubble cannot be blown up again. 75% of our GDP comes from services most of which are inside Greece. Our balance of payments improvements are still a long way to achieve balance and are more due to repression of imports than to increase of exports.

Why is all that? Mainly because the approach adopted throughout Europe at the insistence of Germany is self-defeating. You must understand that German Economists are pillars of Economic Orthodoxy, they are very good to discuss labor costs, production optimization, structure of public finance but they have absolutely no experience in Crisis Economics.

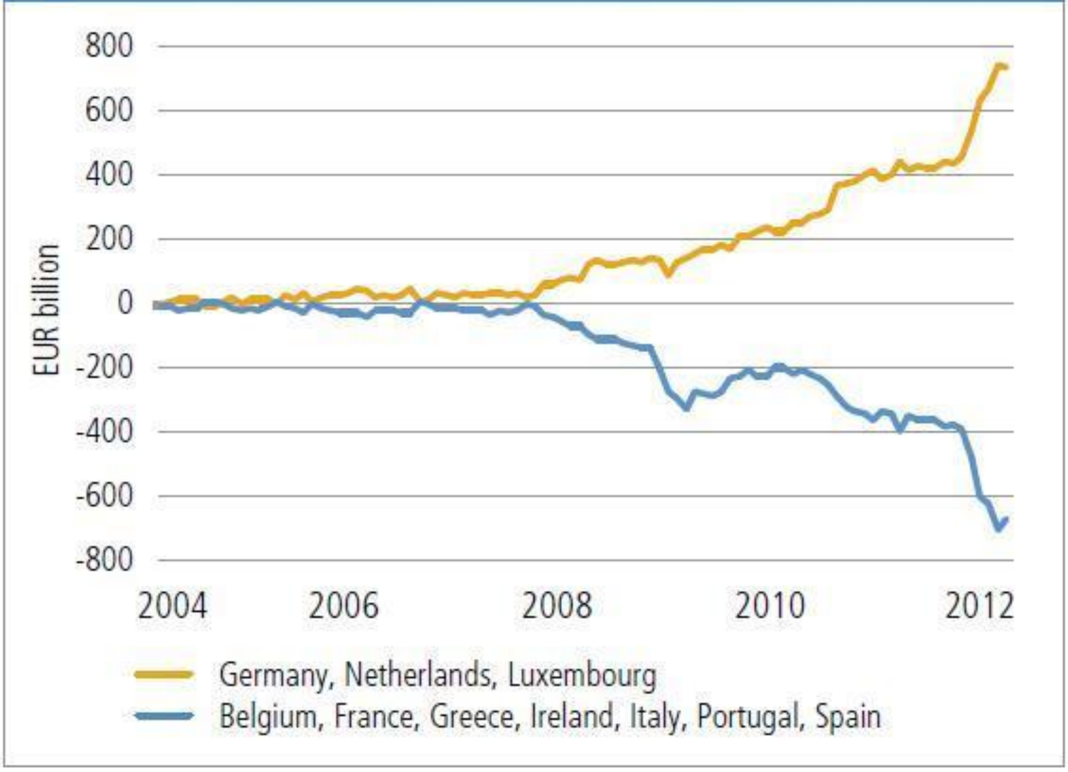
On top of it why should they be alarmed? The following two graphs tell the story of the link between southern lack of capital and hence credit and German excess of capital and hence credit.

GRAPH 1



GRAPH 2

Figure 1: National Central Banks' TARGET2 Net Positions



Source: Bundesbank, Banco de Portugal, Central Bank & Financial Services Authority of Ireland, Banca d'Italia, Bank of Greece, Banco de España, De Nederlandsche Bank, Banque Nationale de Belgique, Banque de France, Banque centrale du Luxembourg, PIMCO

Further to the above the dominant German economic dogma is "expansionary fiscal contraction" which is taught only in German Universities which simplifying means that if you cut salaries and everything else you will return to prosperity!!

That does not mean that Greece did not require a fundamental restructuring of its economy. But it did not need only that and certainly not as it was applied and also obeyed or better disobeyed by us.

If you oblige a fat man to stop eating completely so that he slims he would soon die. That of course would be a good slimming but not in the desired sense.

To put it in economic terms as the Great Dr Richard Koo of Nomura did:

> **"When a debt financed asset bubble bursts a large portion of the private sector is actually minimizing debt instead of maximizing profits. Asset prices collapse while liabilities remain, leaving most private sector balance sheets under water. In order to regain their financial health and credit ratings, households and businesses are forced to repair their balance sheets by increasing savings or paying down debt (if they can).**
>
> **This act of deleveraging reduces aggregate demand and throws the economy into a very special type of recession."**

It is a paradox but therein lies our salvation. We are not alone. This very special type of recession is now spread throughout the South of Europe and is affecting even solid economies as Belgium, Netherlands and even France.

Here are some numbers.

In spite of Mr. Monti's honeymoon with the North European triple AAA is, at the end of 2012 Italy will have a debt ratio of 125% of GDP a recession of at least 2% and a deficit of 4% of GDP at best.

The case of Portugal, Ireland and particularly Spain are worse.

Portugal simply will have 5% or more recession this year and an economy that cannot take off. The total debt of Portugal is 360% of GDP, higher than Greece (= 280% GDP).

Bini-Smaghi the ex member of the executive council of the European Central Bank estimates that Portugal will need a "haircut" in 2013 and an additional 100 bn Euros. Ireland will need another 80 bn Euros.

Spain in spite of its promises will have a deficit over 6% in 2012, recession more than 3% and unemployment over 25%. Spain stated that at the end of 2011 its debt was 87% of GDP. But the numbers say another story:

Spain End of 2011 – Beginning 2012

- Admitted Sovereign Debt €732 billion
- Admitted Regional Debt €183 billion
- Admitted Bank Guaranteed Debt €103 billion
- Admitted Other Guaranteed Debt €72 billion
- Total Admitted Debt €1.09 trillion
- A More Accurate Debt to GDP Ratio is 113.2%

The end of 2012 debt will be near 120% and rising because the main Spanish exports were holiday homes and this bubble is burst without hopes of reinflation. The debt incurred in their construction is a main reason for unpaid loans which increase every year. Thus Spanish Banks that took 260bn recently from the ECB thanks to Mr. Draghi's splash of one trillion, just to save themselves and buy and support Spanish Government Bonds, are chronically dependent from the ECB and are liable to big problems if Spanish bonds take a turn for the worse which is likely. Combined with the real-estate loans losses the Spanish Banks are ready for Brussels injected recapitalization further to that injected by the Spanish Government. The total state, business and household debt in 2011 in Spain was 386% the highest in Europe and the 2012 budget devotes 57% to pensions, unemployment benefits and interest on loans. Now Spain is whispering that the deficit of last year is bigger than the 8.51% of GDP accepted by Brussels. Spain of course now is in the same intensive care as Greece with unknown end in sight.

The situation is such in Europe that no country of Eurogroup, except Luxemburg, covers all Maastricht criteria, not even Germany that has a debt of over 60% of GDP or others that have a deficit of over 3%.

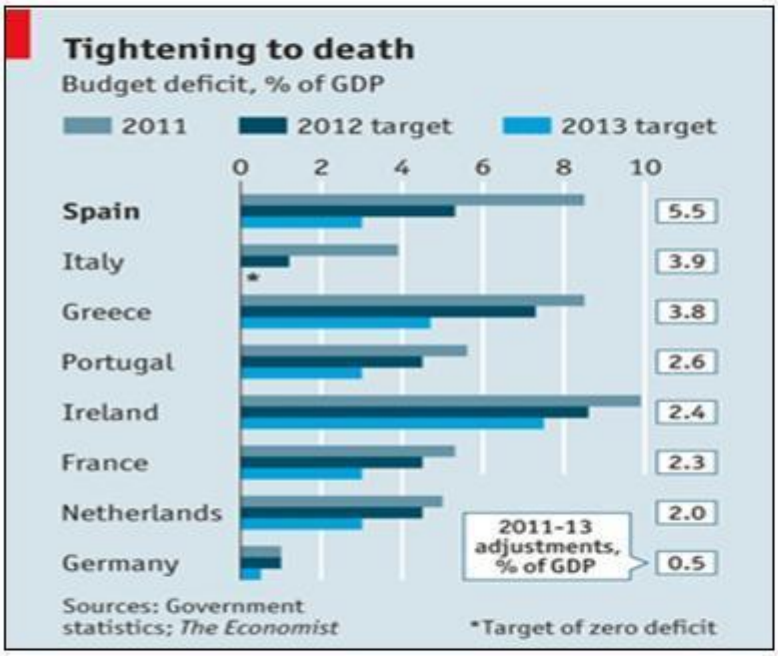
It is obvious that something big must be done in a bigger order of magnitude and in a more professional way that it is done now. A measure of the politico-economic ineptness of the Eurogroup is the following:

The ECB contravening its charter had a balance sheet in February 2012 of over 3 trillion Euros, 30% bigger than the FED. Those are the trillions that Mr. Draghi spread to save Italy and Spain from a collapse of their economies.

So by spending 30% more than the Americans we have in Europe a recession of 1% and the U.S. have a growth of 2% and more.

It is not surprising because 1,5 trillion are deposited by the Banks back to ECB. Thus there is not enough money to finance enterprises and fiscal strangulation is approaching because of the parochialism of the members of Eurogroup.

The situation in Europe can be presented by the following graph:



Most of the above are already out of target.

Clearly the way ahead is full of ugly surprises. We wait for the gentle bankrupsy of U.K. after the Olympics (6% GDP current deficit), which at present has a banking debt of 735% of GDP.

Moody's, S&P and Fitch are active cutting ratings. The whole financial status of the south of Europe is approaching insolvency.

Additionally the social situation with over 20% of the Labour potential of the South in unemployment, is brewing social unrest that we have not seen so far.

The total debt of the Eurogroup is over 10 trillion euros and growing. Can it be paid back ? NO.

Their only two ways that a state debt can be treated if it cannot be serviced. By some form of haircut or inflation.

Keeping the ECB rate at 1% and letting inflation rise from the present 2,7% to 3-4-5% is a way to force the accumulated capital which is very big to exit the Banks and be invested in the active company.

(For example Siemens has deposited to ECB 6 bn Euros).

Is this the right cure? Certainly not. It is maybe the only cure coupled with purchases of debt by EFSF or ESM or any other initials to avoid doing the undesired:

Direct purchase by the ECB. In essence this is a proposal for ECB to become FED.

This is now emerging in proposals for ECB to fund directly the states, for ECB or ESM to guarantee Bank deposits in all Euro area and other proposals aimed at all Eurogroup members benefit.

There is a proposal growing in strength in Europe except Germany. The Eurobond which is to be used to finance big projects throughout Europe and thus hopefully relaunch growth and ensure financing outside the Markets. Now however the Eurobond is looked upon as an instrument to save Spain and subsequently Italy from bankrupt and not to ensure growth. No clear cut way out has been found and agreed yet. It has to be noted that all these proposals are also inflationary, either way.

They will go even further. E.U. , IMF and other organizations are thinking to change the econometric model so that deficit will take under consideration recession and thus corrected for recession will appear less.

Will all this work? We hope but we do not know. It is certainly subject to strong political decisions and the head-on collision that started this year in May and onwards, of France and the South, versus Germany and the North. This will continue at least till October 2012.

Until recently German position was clear:

Eurobonds	Nein
Increase in Funds available for ESM	Nein
Common backing of the Banking System	Nein
Softening of fiscal austerity	Nein
Monetary financing of Governments	Nein
Relaxation of Eurozone monetary policy	Nein
At least, credit boom in Germany	Nein

All these have been discussed in the summit and hopefully will be reconsidered.

Nobody knows the outcome. It is hoped that Germany will shed some of their economic orthodoxy and the South will reform in a more responsible way.

We are in for a lot of storms before reaching port. One thing is certain. Neither Greece not the rest of Europe can carry on as it is now for years to come.

The end of 2012 will not be the beginning of the End of the European Crisis. It will be the End of the beginning.

The question is not whether Greece will stay in the Euro but if there will be a Euro of 17 countries or at all.