

VAKIFBANK GLOBAL ECONOMY WEEKLY

**Will the new aid package for Greece
be solution for Eurozone problems?**




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Concerns about PIIGS's (Portugal, Ireland, Italy, Greece, Spain) high levels of debt have put pressure on the markets since 2010...

	Country's Share of Total Eurozone GDP(%)	Gross Government Debt/GDP (%)	Budget Balance/ GDP (%)
France	21	84.3	-7.7
Germany	26.9	80	-3.3
Greece	2.4	142	-9.6
Ireland	1.6	96.1	-32.2
Italy	16.1	119	-4.6
Portugal	1.8	83.3	-7.3
Spain	11.5	60.1	-9.2
Other Country's	18.7		
Euro Zone	100		
Source: Bloomberg			

 PIIGS's economies represents 33.4% and Italy's economy represents 16.1% of the total Euro Zone GDP. This reflects the magnitude of the debt problems of periphery countries.

Details of the Last Aid Package For Greece...

The new aid package includes €109 billion and aims to fulfill Greece's funding needs until 2014 through private and public sector's repurchasing Greek bonds. For the first time private sector has involved in debt financing.

New loans' maturity has raised up 15 to 30 years from 7.5 years and the interest rate has reduced to 3.5% from 4.5%.

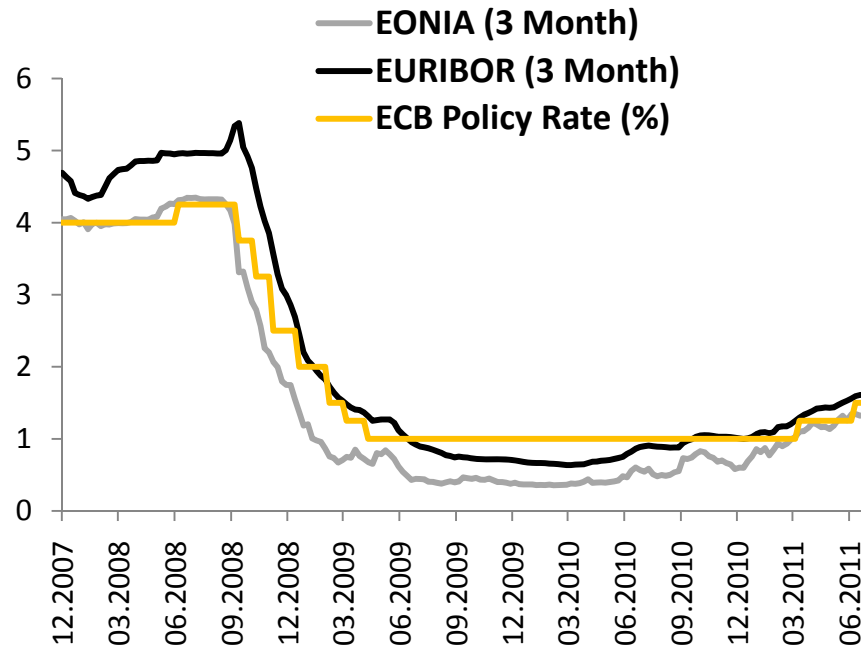
€35 bln would be given to Greece to help eligibility of Greek bonds in ECB liquidity operations.

EFSF has gained new importance. EFSF could intervene on the secondary market operations, could recapitalize financial institutions through loans and could extend credit to countries when needed.

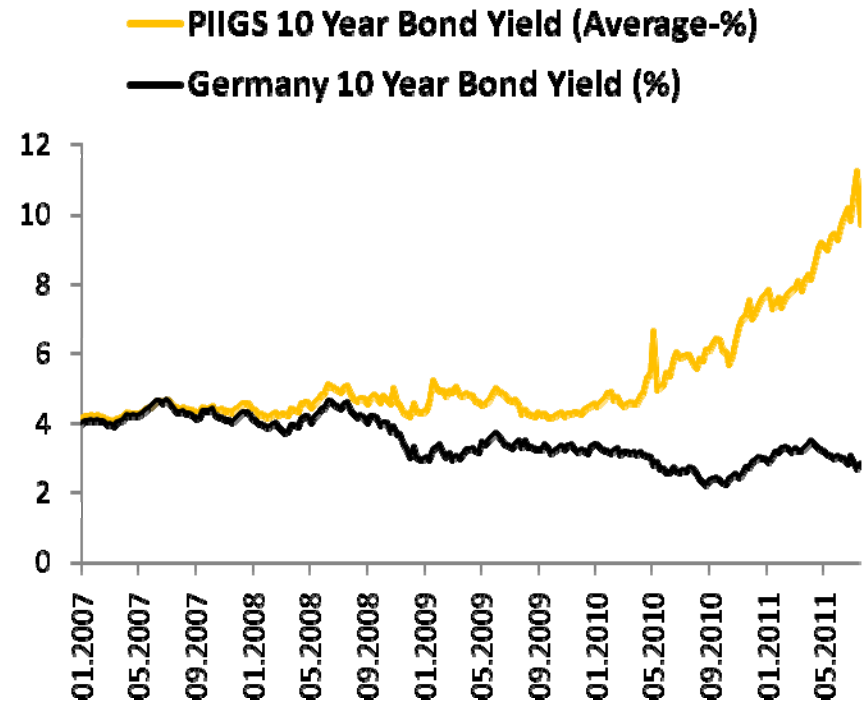
Greece has high budget deficit and public debt which amounts to 143% of GDP. So EU countries agreed to reduce Greece debt in two ways.

Firstly, private sector contribution would combine €12.6 bn of buybacks, €37 bn voluntary support, €50bn in total. Secondly Greek government would buyback its own bonds and would help to reduce the debt.


Despite the new aid package for Greece, market interest rates have maintained high levels...



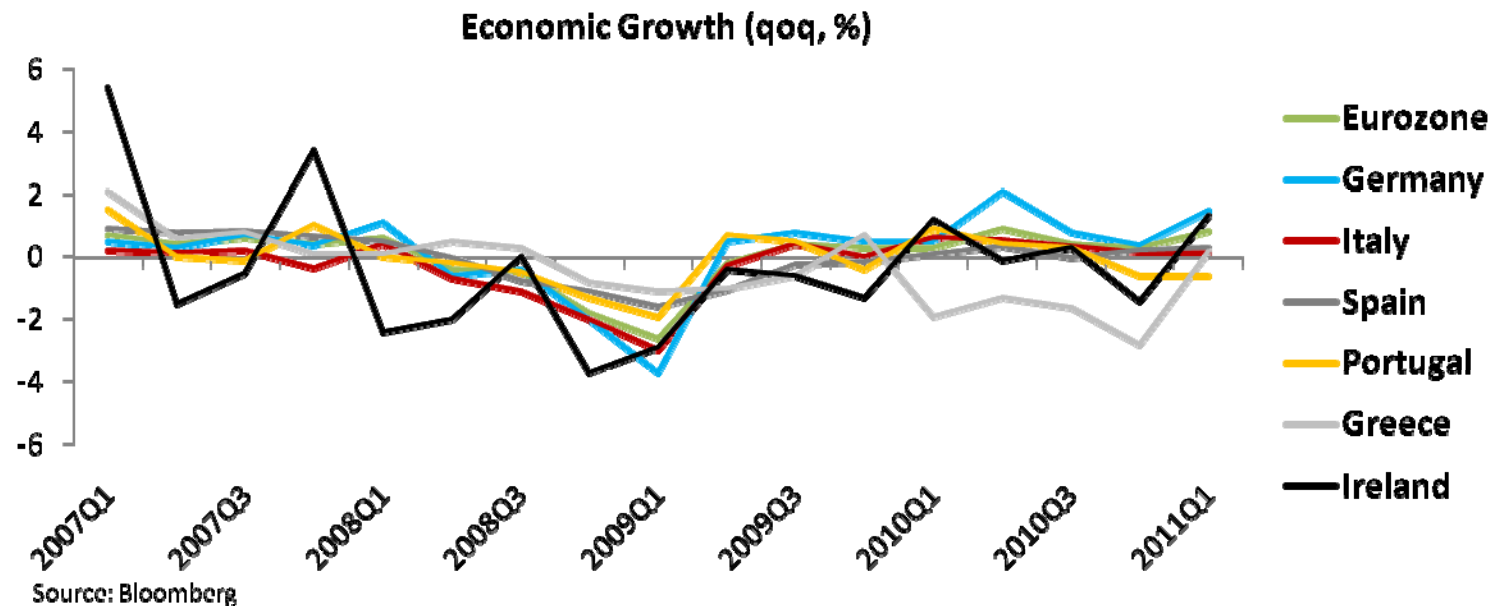
Source: Bloomberg



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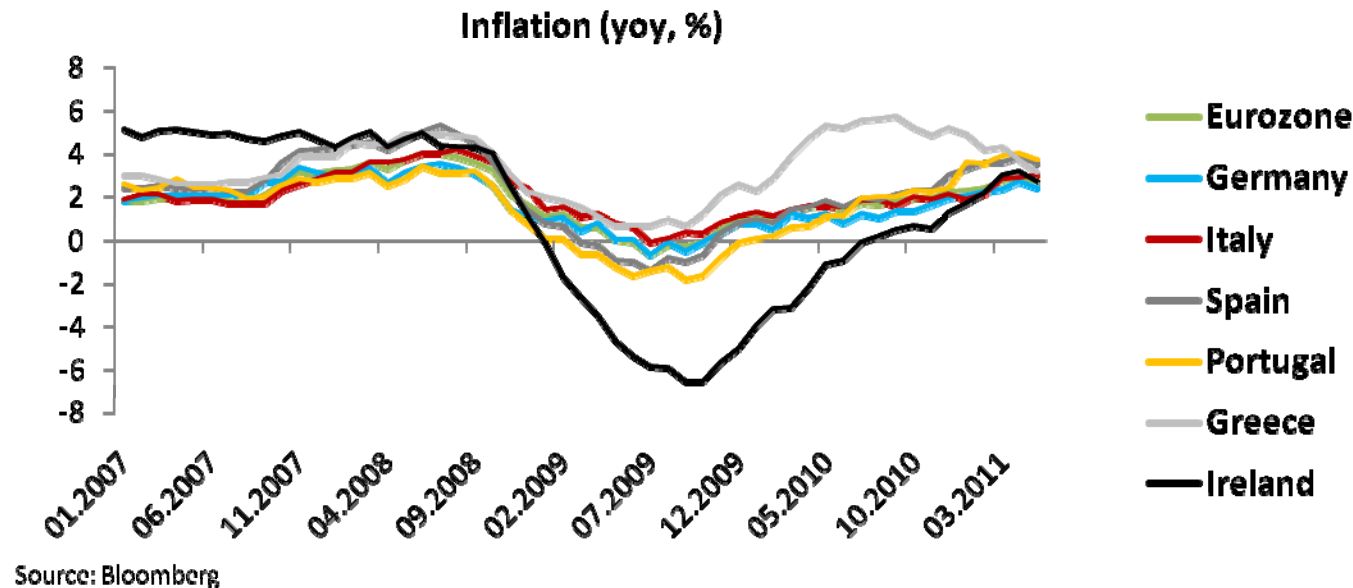
 10-year average bond yield in PIIGS countries has maintained high levels and the spread between these countries' and Germany 's 10 year bond yield has widened.

The difference between the countries' economic outlooks are noteworthy...



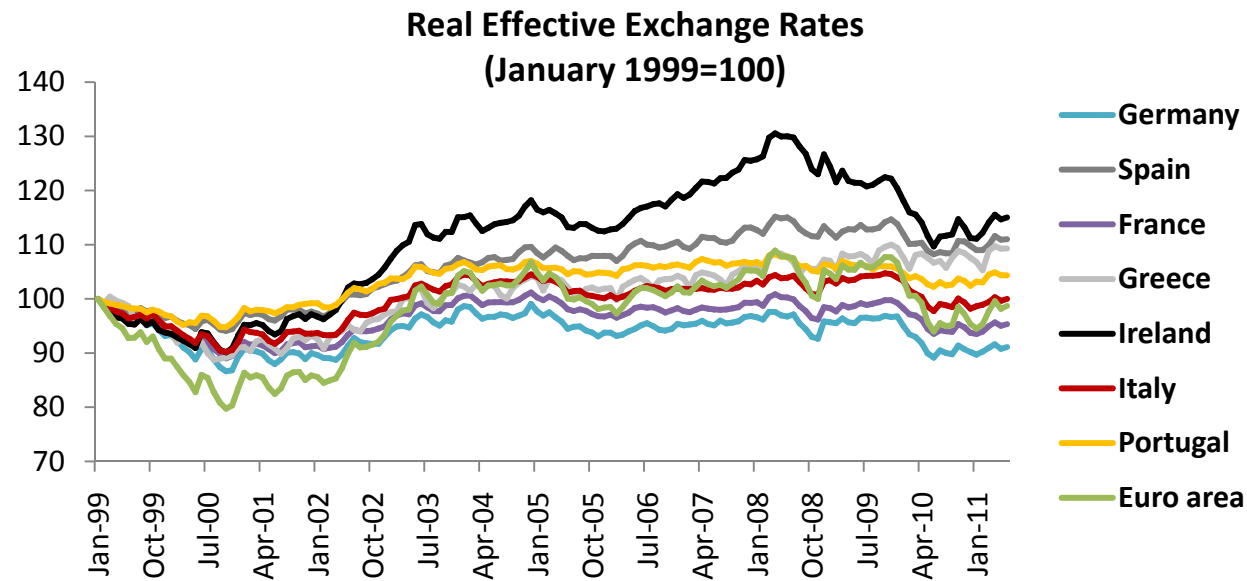
- ✔ The GDP of the Eurozone increased by 0.8% in the first quarter of 2011. The growth rate of Germany and Ireland mainly affected the capture of Eurozone GDP level.
- ✔ The economic uncertainties and increasing imbalances in countries like Italy and Portugal have been the main factors that restrict the upward trend in the growth rate.
- ✔ PIIGS' countries growth is not sustainable due to low consumption and strict fiscal policies.
- ✔ In contrast to PIIGS's countries Germany's growth performance mostly based on private consumption. So growth rate differentiate between countries and this increases concerns about Euro Zone.

Euro Zone inflation exceeds ECB target...



- ✔ The inflation rates which decreased after the crisis period have started to increase since the end of 2010. The margin between the periphery and central countries' inflation rate is gradually decreasing in the recent period.
- ✔ Euro Zone inflation rate has been above the ECB 2% target since 2010. Upward movement of inflation has an influence over the ECB policy interest rate decisions.
- ✔ European countries with different economical problems and fiscal policies implementing same monetary policy limit their capabilities of search for the solutions.
- ✔ This supports the concerns for the measures adopted to be insufficient and debt crisis would be spread over Euro Zone.

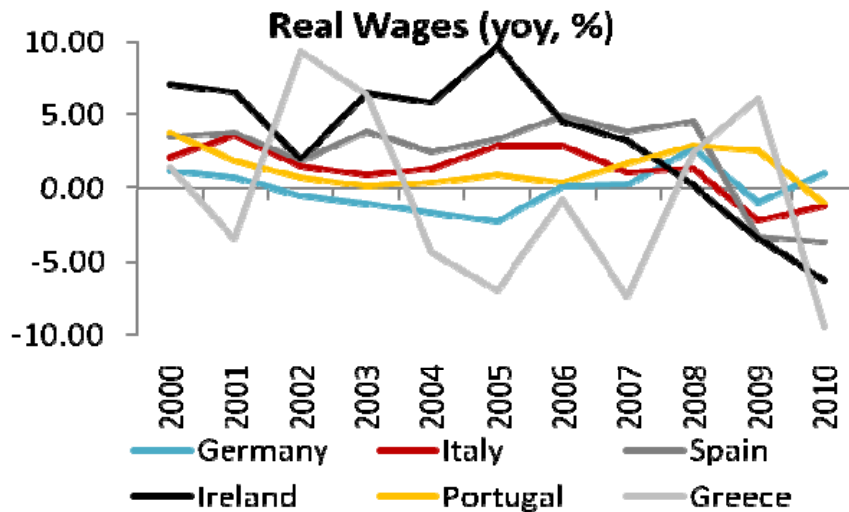
The periphery countries lost their exchange rate flexibility after transition to the monetary union...



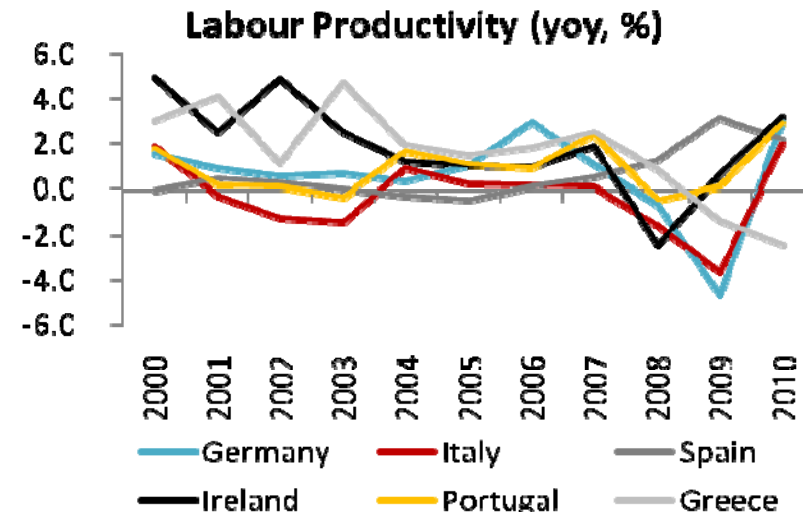
Source: BIS

- ✔ When the real effective exchange rates are analyzed historically, it is seen that periphery countries have lost their competitiveness and exchange rate flexibility after transition to monetary union.
- ✔ The real effective exchange rates that affect inflation rates indexed as January 1999 = 100. When figures are analyzed, Germany and France are the most highly competitive countries whereas Italy, Ireland, Portugal and Greece are the weakest countries in terms of competition.
- ✔ This is the main factor behind the distinctness among the Euro Zone economies. Therefore, common policies implemented in Euro Zone are not effective and decisive.


There are profound differences between Eurozone countries in terms of real wages and productivity in the labor market...





Source: Bloomberg, VakifBank




Source: OECD

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 In the most problematic countries of Euro Zone -Greece, Ireland and Portugal- real wages sharply declined in 2010. In the coming period, more decline may be seen in real wages in these countries because of tightening fiscal policies applied to struggle crisis.

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 While labour productivity decreased, real wages increased in Spain which has the highest unemployment rate among Euro Zone countries. However, decreasing productivity may affect the real wages downwardly in the coming period.

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 In Germany both productivity and real wages increased but rise in real wages is not as high as the rise in productivity. This improves the competitive advantage of Germany and increases the chance to keep the inflation under control .

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 PIIGS countries don't have an advantage like Gemany. This situation profounds the differences among the Euro Zone countries.

Advantages and Disadvantages of the New Package...



New aid package shows EU countries commitment to support Euro Zone.

Official loan terms for countries like Greece, Portugal and Ireland are improved.

Time frame is needed for the cahanges to the EFSF to be operational.

Private and public sector contribution to debt buyback are not explained in detail.

Private sector contribution may result in bigger problems.

- ✔ New package would support Greece's short term financing needs. Whereas it would make a small contribution in terms of reducing its high debt. Net effect of the new package would be redistribution of Greek debt around Euro Zone countries.
- ✔ Euro Zone countries which implement common monetary policy but different fiscal policies should take strict measures aganist crisis. However strict measures would affect employment markets negatively. In this respect countries which implement common monetary policies should implement common fiscal policies. Thus economic problems would not be solved until all Euro Zone countries pass to common eurobond. Moreover EFSF is not large enough to support Italy and Spain aid packages. After the announcement of Greece's aid package Greece's spread decreased whereas Italy's and Spain's spreads increased due to these concerns. In this respect the new aid package would not be a solution for Euro Zone debt problems and its contagion effect.

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