International Political Economy

Analyzing the effects of politics on business and markets.

Special Report

August 13, 2013

THE MEDITERRANEAN RIM IN TURMOIL: OBSERVATIONS FROM A FORTNIGHT IN CYPRUS, GREECE, SPAIN AND PORTUGAL

by Kenneth Courtis

A startling report on Cyprus, Greece, Portugal and Spain by a veteran economic and political observer.

THE MEDITERRANEAN RIM IN TURMOIL: OBSERVATIONS FROM A FORTNIGHT IN CYPRUS, GREECE, SPAIN AND PORTUGAL

by Kenneth Courtis

I have just spent a fortnight trying to get a better understanding of what is really happening on the ground in Greece, Cyprus, Spain and Portugal. I arranged for meetings with central banks, ministries of finance, in three cases, the very top echelons of government, unions, political parties in both government and opposition, academics, journalists, the local teams or international financial organizations, businesses, aid organizations, NGOs, and in Greece and Spain also with local governments.

The crisis in its form, its dynamic, in its details is particular to each country. But what struck me were the number of common factors among the four.

I have tried to summarize two weeks of meetings and observations into these twelve points.

1. Unemployment and Under-employment. Crushing is not a strong enough word. It is one thing to see the numbers, it is another to see the reality on the streets.

For youth unemployment, the numbers are acute – 34% and rising quickly in Cyprus, 43% in Portugal, 57% in Spain, 63% in Greece. (In comparison, it is 40% for Italy, 31% for Ireland, 26% for France, 21% for the UK, 9% for Austria, 8% for Germany.) So in raw data terms, Spain and Greece are running youth unemployment 7-8 times that of Germany, and Cyprus and Portugal at 5 times.

Importantly, note that the official unemployment statistics include only those who have been looking for a job in the last four weeks, so the reality is surely even more extreme than these numbers.

Across the four countries, the average of youth unemployment is 49%, the average unemployment rate of the 25-35 age cohort is 39%, and still rising. Again, the statistics under-count the reality. Among the unemployed in the 25-35 age cohort, some 45% have tertiary education degrees (technical college or university)! An example of the labor market imbalance is that while I was in Spain 18,500 people applied for 11 summer jobs at the Prado!

Among unemployed over 45, there appears to be virtually no hope that most will ever again be employed.

This employment situation is simply staggering, and has to be the number one issue, as it is central to the surge of poverty, social and political stability, and the still more fundamental question of human dignity.

2. A Credit Shock Which Is Virtually Total For Small And Mid-Sized Companies And Extreme For Larger Firms. Can there be recovery without credit? In theory,

there could be a recovery driven by investment from abroad (FDI – private equity, international companies establishing local operations or acquiring assets – official sector investment from say the EBRD...), corporate loan guarantees or credit insurance from the EU, eventual access to capital markets of the strongest local companies, at prices which allow them to invest profitably.

With rare exceptions (e.g., the long-term lease of half of the port of Piraeus by China headquartered COSCO), and a handful of very expensive bond issues of some local international companies with international scale (e.g., Greek cement co. Titan has managed to issue 5 year paper at 8.5%), there is yet no flow of investment into these countries in any way that could make a difference.

One thing is sure, there is a vast output gap, such that any new investment would have an immediate multiplier effect.

3. Non-Performing Loans Continue To Surge In All Four Countries, And The Fall In Prices Of Labor, Real Estate, And Company Assets Continues. As NPLs climb, the day when the banking system starts effectively to function becomes still more distant. That in turn means that foreign investment becomes still more important. Yet foreign firms on a net basis are still withdrawing capital from all four countries. The banking crisis is in my view far from over.

4. Six Years Into The Crisis, Official Forecasts -IMF, ECB, EU, National Governments - Continue To Under-Estimate Virtually Everything! The drop in demand, the scale of non-performing loans, unemployment, government deficits, and overly optimistic forecasts of government revenues in all forms (taxes, fees, duties, privatizations, etc.), foreign inflows (investment, tourism, remittances), credit creation, the pace of recovery of the banking system, as well as the overall trend for the economy, everything on which 'sustainable' programs are, based is inadequate.

I discussed this ad nauseum with everyone, and I still do not understand why this is the case. Surely much of the analysis is 'political,' but even in private, the people who are at the center of things, even now, seem to be living in a land of hopes, rather than in a world of realities.

5. Much Discussed Privatizations Have Been To Date But A Modicum Of Expectations. Why? There are multiple reasons – incompetence, unrealistic price expectations, inability to resolve related finance issues (e.g., governments incapable, unwilling or forbidden by the Troika to provide guarantees for payments in arrears due to assets to be privatized), intractable legal entanglements, unclear regulatory regimes, meddling from the EU and other countries (e.g., the failed sale of Greek gas company DEPA. It is said that both Germany and the US intervened to block Russian and Chinese bidders).

6. Large Scale Migration Among The Most Dynamic, Entrepreneurial, Best Educated Young People And Among The Most Experienced And Best Trained People Between 25-40 Years Of Age. Much of this emigration is benefiting Germanic Europe (Switzerland, Austria, Denmark, Germany...) and an increasing portion of emigrants are heading to North and South America.

As one politician said to me in Portugal, "Think of it, first the Germans get free access to our markets, then they get that which is over-valued for us, and under-valued for them, then they squeeze us to the bone to pay for the bad decisions of their banks and now they suck out the best talent from our society. At some point, these all means big political trouble for Europe, because it is not happening only here."

7. Social Welfare Systems Are Contracting Dramatically, And This Is The Case Even For The Medical And Hospital Systems. The Result Is Everywhere A Very Real And Deep Social Crisis.

One of the key issues at stake in the European crisis is the future of the welfare state. The proponents and largest beneficiaries of the welfare state are today losing, and losing big time, as the welfare state literally shrivels.

8. Coalition Governments In Each Of The Four Countries Have An Increasingly Precarious Hold On Power. None would survive elections. It is not clear, however, if the opposition is prepared to govern, anywhere in Europe, including Greece, nor even that they want elections. So I expect governments to continue stumbling from one crisis to another, as we have seen recently.

Governments in the four countries have Troika imposed budget plans, fiscal targets, government debt-to-GDP targets, revenue targets, deregulation targets, all based on assumptions which frequently make little sense. At the same time there is permanent improvisation.

A case in point is the sudden closing of the national Greek TV network. For 2013, the Athens government has committed to reducing the civil service by a further 6,000 people a quarter. By early June, they had only cut 4,000 for Q2. In negotiations to prepare for the late June meetings in Athens with the Troika, when it would be decided to release a new tranche of financing, the Greek government was told that one categorical condition for the release of the funds was meeting the job cut target. Coalition negotiations were stalled.

So at the last moment, the prime minister's office issued a late night decree mandating the closing of the national TV network, which conveniently had just over 2,000 employees, largely members of left wing unions, which had been a thorn in the side of the government. The Troika had their 6,000 public servant scalps. The government had an additional 1.8 billion euros released by the Troika, while it thought it had killed off an important center of opposition. The imbroglio, in turn, led to one political party leaving the coalition, so in the end the government is today even more fragile than before the TV network was 'closed.' But the TV network has refused to die; most of the network is today occupied, and operates on a wildcat basis. The courts have mandated that the employees be paid until it can decide on the legality of the closing of the TV network. Not surprisingly, the television programming today is even more opposed to the government than previously.

9. In All Four Countries, A Parallel, Informal, Cash-Based Economy And A Parallel Barter Economy Have Emerged. Cyprus is a special case in this regard, where people not only are doing everything possible to keep cash, but also to

make their daily maximum withdrawal from the local banks.

In all four countries, most daily transactions are discounted for cash – restaurants, hotel rooms, clothing, food, etc. Checks are suspect. Letters of credits issued by local banks are virtually nonexistent. Credit cards are accepted with much reluctance. People try to keep as much cash as they can out of the banking system, and to do transactions in cash. Barter markets are common.

Interestingly, in all four countries, Chinese merchants are active in the barter markets. The Chinese traders import cheap goods – garments, everyday household goods, do-it-yourself tools – and they are everywhere trying to create business. They work on a basis of clans, and so can operate very effectively in these conditions. After all, as one of Chinese traders told me, "We survived in China, so this is easy!"

10. Despite How The Crisis Of The Last Six Years Has Been Handled, There Is Still The Sense Everywhere That Staying In The Euro Makes More Sense Than Anything Else. There are lots of reasons for that, but importantly, the case for euro exit has not been made in ways that are convincing to people who are crushed by fear and extreme economic crisis. I was surprised about this, as I had anticipated much more hostility to the EU, for what these countries are living through today is equivalent to the depression of the 1930s. There is hostility but it is directed to local governments and to Germany to some extent. But the frustration has not yet been political organized in any clear way, and so tends to be dispersed in many directions. It may not remain that way.

The initial priorities of the EU, its biggest member countries, the ECB, and the IMF were to stop the real prospect in 2009 - 2012 that the northern European banking system would implode, that the euro would fail, and all the while and importantly, being able to sell what was being done to domestic voters in Germanic Europe. The immediate consequences for the countries on the Mediterranean Rim were a secondary consideration.

At the same time, forecasts for growth, deficits, debt, unemployment, investment, and hence of stabilization have been systematically and wildly optimistic. The IMF and others have been committed to and continue to commit to targets, which in reality only make sense through a collective "suspension of disbelief." This fantasy world continues.

11. Cyprus Is Being Forced Into A Contraction That Later Will Be Seen To Be The Equivalent Of That Of Iceland, If Not Worse.

There is a very significant probability of a hard default. The IMF is forecasting inflation at 18% but the figure has since headed sharply higher. The IMF is forecasting an 8.7% contraction of the Cypriot economy this year, and a return to growth by late 2014. People analyzing things on the ground are looking for a 15-18% contraction this year, and a possible return to growth in 2017-2018. The IMF is forecasting public sector debt-to-GDP at 105% by 2020, an impossible number in the context. Think in terms of 150%. None of the IMF numbers, on which the Troika bail-in program is based, make any sense.

The haircut for depositors in the two main Greek banks are now likely to be in the order of 60-80% vs. the 30-40% forecast by the IMF at the time of the deal with the Troika. Government debt is no longer sustainable. The default of local bonds, which appears inevitable, will in turn bankrupt the Cooperative banks, the largest holders of these bonds. The Co-op banks hold the deposits of 4 out of 5 families.

So Cyprus is an economic and financial calamity in the making. In effect, the Troika has adopted a scorched earth approach to the Cypriot financial sector. All that is holding it together now is the Bank of Cyprus, which stamps its chop on virtually any paper as being 'acceptable' collateral. In turn, the Bank of Cyprus then hands off this 'acceptable collateral' to the ECB in the hopes that the mandarins in Frankfurt release some liquidity. The ECB is keeping the BOC on a very short leash, as it releases liquidity in a drip fashion, and in this way the ECB continues to drive the process, reinforced by the IMF and the EU. This ECB liquidity drip is the club that the Troika is wielding to force Cyprus to execute its admonitions, most of which are working to transform a catastrophe into a calamity.

In these conditions it is impossible to lift the "temporary" capital controls. Yet the longer the controls stay in place, the greater the incentive to get money out as soon as possible and the higher is the likelihood that the country will have to declare default, in one form or another. In the end, this will all come back to the balance sheet of the ECB.

The result is that depositors and bondholders will run instantly for the exit the next time any EU bank anywhere gets in to trouble.

Countries from Japan to Canada, and in much of Europe have added bail-in resolutions to bank regulator legislation in the last few months. None of them should take Cyprus as a case for best practice!

Some are hoping that the blind luck of having recently made discoveries of what appear to be large quantities of natural gas in Cypriot territorial waters may be the piggy bank that saves the country from default. The problem is that the gas will not come on stream, at the earliest until late decade and Cyprus so far has refused offers from both Russia and German companies to take over the gas fields. The irony of this crisis would be that the country is forced to give up its best card for the future in order to finance a crisis that was largely imposed on it.

12. Where Are The Green Shoots? It May Be Greece That Will See The Up-Turn First, If Only Because It Has Been Driven Down So Far And The Purge Has Been So Brutal.

In Spain there is enormous reluctance to come clean about the banks. Real estate is still falling, NPLs are still increasing, the SME sector continues to be torn to shreds. There are zombie banks, zombie consumers, zombie regional governments, zombie companies, zombie co-ops, zombie everything, everywhere. It is hard to see how all of this works, but clearly there are vast efforts below the surface to provide support, to push to later the realization of losses. This is what we saw in Japan, and we know where that leads.

Spain and Portugal are now both generating current account surpluses, not because exports have increased, but because imports have crashed. Remittances are increasing for Greece, Spain and Portugal, as so many people have left to work abroad in the last three years.

Both the Greek government and the IMF are forecasting a primary surplus for 2014. Actually they were forecasting such a surplus for 2013, but given the obvious, a few weeks back they slipped it to 2014. Portugal claims it is headed to primary surplus for 2014 as well. Very unlikely is my view, given how far they are already behind on their targets for this year.

Portugal has recently adopted a series of laws to attract foreign investment – particularly targeting Russians and Chinese. In exchange for investing 500,000 euros or more in Portuguese real estate or 2 million euros or more in Portuguese government bonds, and in spending but 12 days a year in the country, a foreign investor can acquire residency. After 5 years, the investor can apply for permanent residency. Spain is in the process of putting in place similar legislation; Greece and Cyrus are also putting in place similar programs. Over time, this could make some difference, because in effect it is a way for non-EU members to get permanent residency anywhere in the EU, for once a resident in one country, one can travel and reside anywhere in the Schengen area. They can also get some real estate in the sun at prices incomparably lower than in Beijing, Shanghai, Hong Kong, Singapore, or Moscow.

Portugal has recently adopted another law, which offers retirees from the private sector from any where in the EU a ten year tax holiday if they settle in Portugal and buy a residence.

So green shoots, yes a few, but the spring is still far off.

My best conclusion for Spain, Portugal and Greece is that the pace of decline is slowing while for Cyprus the decline is just beginning. The very profound social crisis ripping these societies apart is nowhere near being over. Indeed so deep and damaging is the crisis that its social and political consequences will last for decades.

Kenneth Courtis is Managing Partner of Starfort Investments. He is former Vice-Chairman of Goldman Sachs Asia and previous to that, Strategist and Chief Economist of Deutsche Bank Asia. He is co-founder of private equity firm Themes Investment Management and Chairman of Asia Frontier Capital. He is a member of the board or advisory board of listed companies in Asia, Europe and the Americas. This piece was written on July 28, 2013.