



## What about Greece and Goldman Sachs?



Greece is a small country (around 10.7 million inhabitants); it is 70 % mountainous, which makes it impossible to develop agriculture. It has only two major economic sectors: tourism and shipping. The shipping sector pays very little taxes because its main revenue and profits are booked in offshore centers. Greece has also a long history of fiscal trouble. When it became the 12th country to join the Euro in 2001, its public debt was more than 100 % of GDP. Many thought its chronic budgetary mismanagement might harm the Euro currency. For Greece, membership was a boon. Bond markets no longer had to worry about high inflation or devaluation. Lower interest rates allowed the government to refinance debt on

more favorable terms: the ratio of net interest costs to GDP fell by 6.5 % in the decade after 1995. The underestimation of default risk during the credit boom gave Greece easy access to longer-term borrowing. Lower interest rates also spurred a spending splurge. The economy grew by a yearly average of 4 % until 2008. But this strong GDP growth masked the underlying weakness of public finances. The public debt ratio fell, but only because GDP in cash terms grew more quickly than debt. Large budget deficits continued because once inside the eurozone Greece relaxed its fiscal grip, the primary balance was in surplus in the run-up to membership but has been in deficit since 2003. That did little to cool the economy. Greece's inflation rate stayed above the euro-area average, hurting its competitiveness. The economy relied increasingly on foreign borrowing. The current-account deficit widened to 14.6% of GDP in 2008.

The father of the present Prime minister, Mr. Andreas Papandreou, was a spendthrift PASOK Premier who presided over the origins of Greece's crisis with a borrowing spree in the 1980s. In 1985, under the older Mr. Papandreou, Greece was bailed out by an emergency loan from Brussels. But the tighter fiscal policies imposed by the Commission were soon ignored. The younger Mr. Papandreou must now act quickly to curb the Greek "triple deficit" – huge budget and current account deficits plus a soaring public debt of 272 billion€ which is superior to its GDP. The racking up of crushing debts is in part due to the fact that they bought too many Mercedes cars and other imports from Germany and elsewhere without producing enough of their own export goods. Greece goods are no longer competitive on world markets because in the past decade Greece has let wages rise faster than productivity and has become too expensive even in the tourist sector when compared to Turkey for example. The trade

balance is negative by 28.3 Billions€, just before Spain (-51.8bn€), France (-4.6bn€) and Britain (-92.6bn€). In a study made by Carmen Reinhart and Kenneth Rogoff over eight centuries Greece is the number one country in terms of bankruptcy and payment defaults with an average of 50.6 years. Hiding debt has been going on for decades by the Greek Ministry of Finance.

On the darker side, Greece is known to have a mismanaged and profligate economy. It is a country of tax dodgers, graft, waste, with small firms operating below their efficient scale being bigger would attract the tax authorities. The black economy in Greece is estimated between 25 and 30 %. Half of Greek taxpayers reportedly declare annual income under 12,000€ and pay no tax. Greece's higher inflation is partly explained by a lack of competition in parts of the economy, wages are set centrally with too little regard for differences in productivity across industries and companies. It has low saving rates, a low birthrate, a rapidly graying population, a poor education and training scheme. It does not really implement the European Services Directive in order to improve competition and create new firms; it has no real R&D, innovation and corporate investment. Around 30 % of the Greek employed are government employees. A total of 51 % of the budget goes to public sector wages and pensions. Greece has one of the most generous and therefore expensive state pension system among the 30 mostly rich OECD countries; workers look forward to a pension of 96 % of pre-retirement earnings. Athens, the most polluted European city, accounts for half of the Greek population. And most importantly it has a great deal of corruption; at a conference with Nobel Price Professor Stiglitz, who advises Greece, one businessman drew applause for telling Mr. Papandreou that the entire tax administration was corrupt and needed to be replaced and that most government contracts are allotted after bribing civil servants. According to Transparency International, Greece has one of the highest levels of corruption in the OECD countries.

### The discovery of the manipulation of Greek official figures



The trigger was Greece's admitting in late 2009 that its government deficit would be 12.7 % of its GDP, not the 3.7 % the previous government had forecasted earlier. Investors were stunned. In early 2010, the fears grew into a full-fledged financial panic, as investors questioned whether Greece's Socialist government could push through the tough measures it has promised in order to reduce its budget deficit. Moreover, Greece has to refinance 17 billions€ of bonds maturing in April and May 2010. As the fear spread to Portugal and Spain, Germany and France worried about the lasting damage to the Euro, stepped in with a pledge to defend the currency but stopped short of an outright bailout for Greece. French and German banks alone carry 37 % of the Greek debt. On the 7th of December 2009, Standard & Poor's announced having placed Greece debt under surveillance with negative implication. Fitch indicated that Greece debt would reach 130 % of its GDP in the coming years. It is presently 107.3 %.

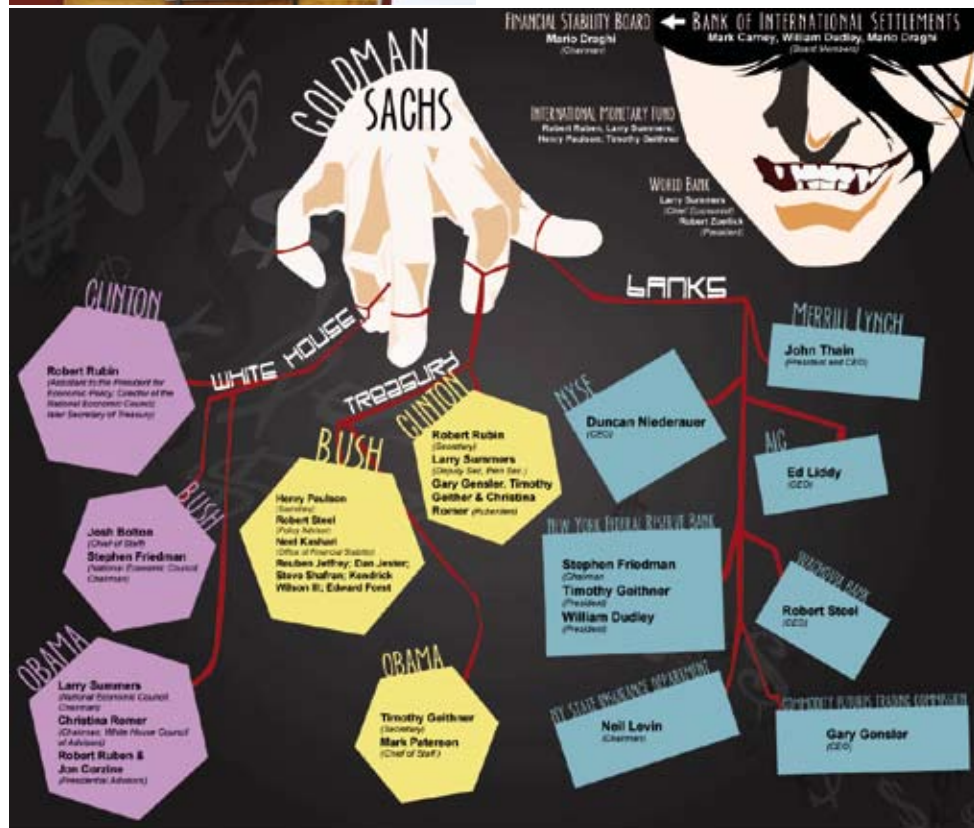
Meanwhile questions were widely raised about the role played by banks, including Goldman Sachs, in constructing elaborate financial deals that helped the previous government hide the extent of its deficit. At the same time, some of those same banks were using credit default swaps (CDS) to bet on the likelihood of a default that had the effect of making it harder for Greece to borrow, thereby pushing it closer to a financial cliff. On the 24th of February, Fitch downgraded the ratings of the four largest banks in Greece to BBB – just two notches above junk. Funding from the wholesale market has been curtailed, while repo funding has been limited to relatively short periods.

Slowly, information filtered about the extent of barely legal transactions between Greece and Goldman Sachs over the last decade. The truth will only be known early March when Greece has to provide to the European Commission with its use of complex financial deals and currency swaps and how it might have affected debt and deficit figures statistics which have been falsified for years. Greece has until the end of March to prove that its drastic budgets cuts go far enough to reassure the markets and EU governments who are reluctant to bail out Athens if they

can't pay their bills. At the same time the Federal Reserve and the SEC in the USA are starting an enquiry about the financial transactions between Greece and Goldman Sachs.

### What do we know about Greece financial manipulation and Goldman Sachs?

Greece economy was unready to join the European Union when it was too hastily admitted in 1981, nor was Greece ready to join the Euro zone. Following Greece's decision to join the Euro zone reducing the size of foreign denominated debt became a priority for Greece. According to EU accounting framework, unhedged foreign denominated debt was required to be translated into Euro using the year-end exchange rate. The strengthening of the dollar and the yen against the € in 1999 and 2000 created an unfavorable increase in Greece reported Euro debt levels. Greece entered into a series of hedging agreements designed to transform foreign debt in Euro. By the end of 2000, Goldman Sachs had a portfolio of swaps hedging USD and JPY debt issued by Greece. In December 2000 and in June 2001, Greece entered into new cross-currency swaps and restructured its portfolio with Goldman Sachs at a historical implied foreign exchange rate. These transactions reduced Greece foreign debt by 2.367bn€ and in turn decreased Greece debt as a percentage of GDP by 1.6 %, from 105.3 % to 103.7 %. The bank was paid about 300 millions \$ from the swaps, the New York Times reported on February 14, 2010. Moreover it appears that the cross-currency swaps transactions were "off-market" – the spot exchange rate was not used for re-nominating the notional of the foreign currency debt. Instead, an artificial or fictional or "off market" lower level of Euro versus dollar and yen was used in the contracts and resulted in a mismatch between the domestic and foreign currency swaps notional. The effect of this was to create an upfront payment by Goldman to Greece at inception, and an increased stream of interest payments to Greece during the lifetime of the swap. In total, the currency and interest rate hedges reduced Greece's debt by a total of 2.3bn€.





Goldman would recoup these non-standard cash flows at maturity, receiving a “large” balloon” cash payment from Greece. As of the 1st of March, neither Goldman nor Greece will comment on the deal, much of the details in fact are remaining vague. The total currency swap notional was approximately 10bn \$, with tenors ranging from 15 to 20 years. Goldman Sachs immediately placed the risk with Frankfurt based Deutsche Pfandbriefe Bank (Depfa). According to the New York Times, Depfa entered into a credit default swap with Goldman, selling 1bn \$ of protection on Greece for up to 20 years. Goldman Sachs sold the swaps to the National Bank of Greece in 2005. Goldman Sachs claims that it consulted European Union regulators when it arranged the swaps in 2000 and 2001. Eurostat official said this year on February 17 they only recently became aware of the contracts. According to Eurostat, the deal was hidden from public view because it was treated as a currency trade rather than a loan and buyers of Greek debt and that they were misled about the country’s true fiscal position. The rather twisted transaction also induced Standard & Poor’s to upgrade Greece’s long term debt from A to A+ in June 2003. The existence of these cross-currency swaps is fueling questions about whether Greece used the contracts to mask the fact it was struggling to comply with the Euro zone membership criteria from the early days of its entry into the Euro zone.

### Securitizations set sight on Greek markets

Goldman Sachs was also involved in a series of securitizations deals like:

- a Special Purpose Vehicle (SPV) named Aeolos raised 355m€ in 2001. The issue was backed by revenues owed to the Greek State by international airlines using Greece airspace;
- another SPV named Ariadne was backed by revenues from OPAP, the State lottery organizations;
- a SPV named Atlas took place in 2001 when it raised 2bn€ backed by grants the Finance ministry expected to receive from European Union structural funds;
- the last SPV Atlas Securitization was made in 2005 and backed by about 5bn€ of tax arrears owed to the Greek government.

Greece claims that it is impossible that Eurostat did not know about these transactions. Investment banks are very keen to do these deals because they bring high fees.

### The 2009 proposal of Goldman Sachs

In early November 2009, according to the New York Times, a team of Goldman Sachs bankers led by Goldman President Gary D. Cohn arrived in Athens to meet the Greek President and Minister of Finance. They held out a financing instrument that would have pushed debt from Greece’s health care system far in the future much as when strapped homeowners take second mortgages to pay off their credit cards. Athens did not pursue the latest Goldman proposal, but with Greece groaning under the weight of its debts and with its richer neighbors wowing to come to its aid, the deals over the last decade are raising questions about Goldman Sachs role in the latest financial drama.

### Are Goldman Sachs and John Paulson attacking Greece and the Euro?

John Paulson, the hedge fund manager, after having made 3.7bn \$ by betting on the US subprime market has been cited as a partner of Goldman Sachs in the Greek market. According to Kevin Connor on February 6, co-Director of the think tank The Public Accountability Initiative, Greece was victim of speculative attacks on the part of an important US Investment bank and hedge funds betting on a default in payment of Greece. The vehicle to be used is Sovereign Credit Default Swaps. The Greek Government has itself accuses Goldman Sachs and John Paulson openly.

But potentially more damaging is the assertion by Mr. Kevin Connor that Goldman Sachs is taking advantage of its advisory role with Greece. On 25th of January 2010, Greece managed to place 8bn€ in 5-years paper. Goldman was certainly among the syndicate that placed this Greek paper. After this success everyone thought that the markets had calmed down; but then starting on the 27th of January another storm hit. An article from the Financial Times had just confirmed news to the effect that China had refused to buy 25bn€ of Greek debt – a private placement engineered by Goldman Sachs. ■