

Focal Point

Greece: A pragmatic deal but only for the short term

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- Greece and its creditors have extensively negotiated on the terms for the release of the next aid tranche, which is vital for Athens to meet the € 3.7 bn debt repayments due in July.
- We expect a solution to emerge at the next Eurogroup meeting on May 24. Pragmatism will prevail: PM Tsipras' popularity has weakened and EU creditors do not want to escalate a crisis just ahead of the Brexit referendum.
- However, the participation of the IMF in the third bailout program will likely remain unclear. The Fund and EU lenders disagree on the extent and modality of debt relief, which will be addressed only at a later stage.
- Despite the uncertainty over the IMF's role, we consider the deal to be enough to prevent Greek-originated systemic woes in the short-term. That said, we remain concerned on a longer term view due to the unsustainable debt burden, the deep-rooted deflationary environment and private sector's inability to self-finance investments and support growth.

Over the recent weeks, the news flow on Greece has focused on the negotiations between PM Tsipras' government and the creditors over the completion of the first review of the third bailout program agreed last summer and the subsequent release of the next aid tranche. As occurred last year, this money is vital for Athens to meet the large debt repayments coming due in July. Given the procrastination of technical talks and reform implementation – the review was planned to be concluded in late 2015 – European politicians have turned increasingly nervous amid the risk of a repetition of last year's drama, which pushed Greece on the brink of exiting the euro area.

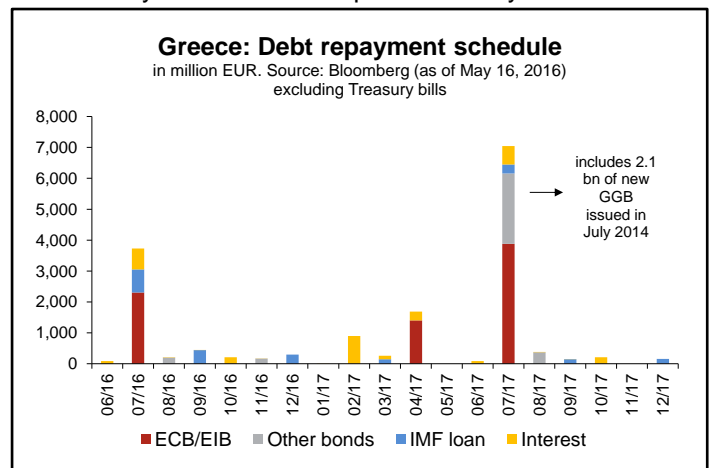
While a few similarities with last year's experience do exist, we will present several arguments suggesting that a far less traumatic conclusion is in sight. Indeed, a deal between Greece and its lenders will likely occur as soon as at the next Eurogroup meeting on May 24.

Large debt redemptions due in July

The calendar for debt repayments represents the main analogy with last year. Excluding the roll-over of Treasury bills, Greece will face total payments of € 3.7 bn in July, of which € 2.3 bn due to the ECB (the bonds purchased under the Securities Markets Programme, SMP, in 2010) maturing on July 20, and around € 0.75 bn as an amortization of the loan from the IMF (Jul 12). This compares to almost € 7 bn of debt repayments in the summer of last year.

The state coffers are at low levels, but the situation is not as dramatic as last year. At the end of March, the latest available data, the central government had € 3.9 bn in its central bank's account. This compares to € 1.1 bn in the

same period of 2015. In addition, the government has already implemented cash management policies, including a tactical increase in state arrears (up to € 5.6 bn in March from € 4.8 bn at end-2015). Finally, the data on budget execution for the first three months of the year showed only a minor slippage in state revenue, more than offset by lower primary expenditure. As a result, the risk of a missed payment in July looks lower compared to last year.

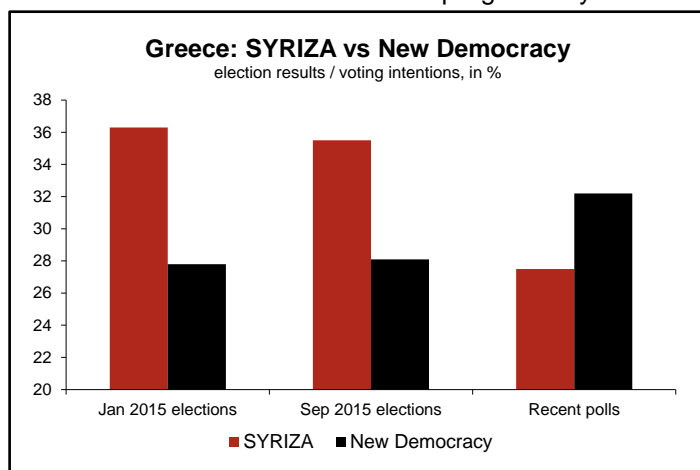


A more pragmatic approach in the negotiations

We do not anticipate the Greek government to exploit the stronger cash position to buy time and extract more concessions from creditors. Under the responsibility of the new Finance Minister Mr Tsakalotos – who replaced Mr Varoufakis in July 2015 – the Greek government has maintained a more constructive attitude in recent months, es-

pecially towards European lenders, and we expect such an approach to continue.

PM Tsipras' bargaining power has diminished markedly hand in hand with the fall in opinion polls. The renewed economic downturn (real GDP fell 1.3% yoy in Q1), the continuation of capital controls and the prospects of additional austerity all contributed to the erosion in popular consensus. Indeed, after the surprisingly large victory in the snap elections in September 2015, the support to SYRIZA, PM Tsipras' party, has declined and the center-right New Democracy has taken the lead. As a result, PM Tsipras will not be able to rally people against the implementation of the terms of the bailout program anymore.



While Greece is left with few alternatives, the position of EU lenders is not that different either. The existential decision whether to keep Greece within the euro area was already addressed last year and will not come back on the table at this stage. The main goal in Brussels is now to avoid adding uncertainty to an already complex political agenda, given the upcoming referendum on the permanence of the UK in the European Union (June 23) and the snap elections in Spain (June 26). It is a widespread conviction that messy negotiations with Greece could affect voters' intention and favor the pro-Brexit camp, possibly leading to a much less predictable and more dangerous outcome than the one resulting from a Greek exit one year ago.

Given the alignment of interests, we believe that Greece and EU lenders will announce the completion of the first review and the release of the so awaited aid tranche at the next Eurogroup meeting on May 24. The Greek parliament already approved a broad set of structural reforms and fiscal measures worth 3% of GDP ahead of the extraordinary Eurogroup meeting on May 9. In coming days, the last few obstacles will be removed. The Greek parliament is expected to approve the framework for the new privatization agency and the sale of non-performing loans, along with a contingent fiscal package that would be activated automatically in case of non-compliance with the primary budget targets agreed in the summer last year (0.5% in 2016, 1.75% in 2017, 3.5% in 2018). According to the Greek press, the aid tranche will range between € 9 and 12 bn, of which € 5.7 bn for debt servicing and up to € 6 bn (in several sub-tranches) to clear state arrears.

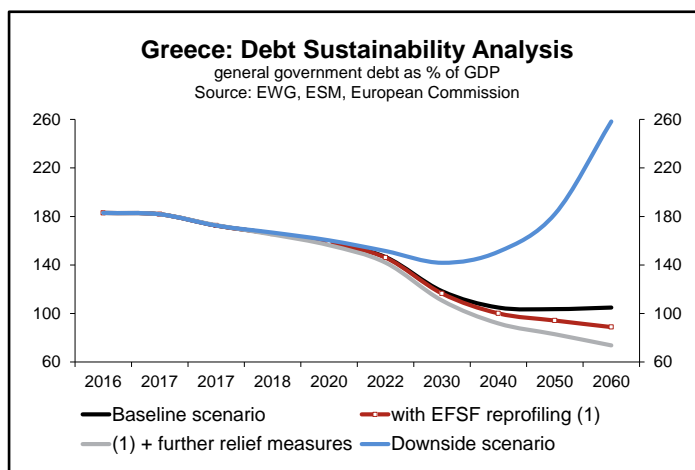
IMF's role in doubt amid debt relief stalemate

The widening rift between the EU lenders and the IMF on a number of key issues has contributed notably to the de-

lay of the first review so far. First of all, the IMF argued that the 2016-2018 budget targets looked unattainable and requested additional structural measures, focusing on the expenditure side (e.g. deeper pension reform). This will be only partly addressed by the upcoming contingent package, given its large reliance on higher taxes.

The second IMF's request is by far more problematic for EU lenders. Indeed, the Fund has incrementally pushed for a substantial debt relief as it considers the assumption of a 3.5% primary surplus over the next decades as unrealistic and therefore the debt trajectory as unsustainable. While no public endorsement for a nominal haircut was made by Fund's officials, the terms of debt relief presented by the IMF look far more ambitious compared to the ones discussed by the European Working Group (EWG), a preparatory body composed by the representatives of euro area member states of the Economic and Financial Committee, the European Commission and the ECB, that provides assistance to the Eurogroup and its President.

In mid-April, Poul Thomsen, director of the IMF's European Department, stated that debt sustainability could be achieved by extending maturities on official loans and by locking in interest rates at the current low levels, a request also supported by the Greek government. The recent Debt Sustainability Analysis (DSA) made by the EWG, however, did not consider this option. In our view, the rationale for this exclusion is similar to the one against nominal debt haircut. Locking in record-low interest rates for the debtor may result in state transfers should EFSF refinancing costs rise above those levels at a later time.



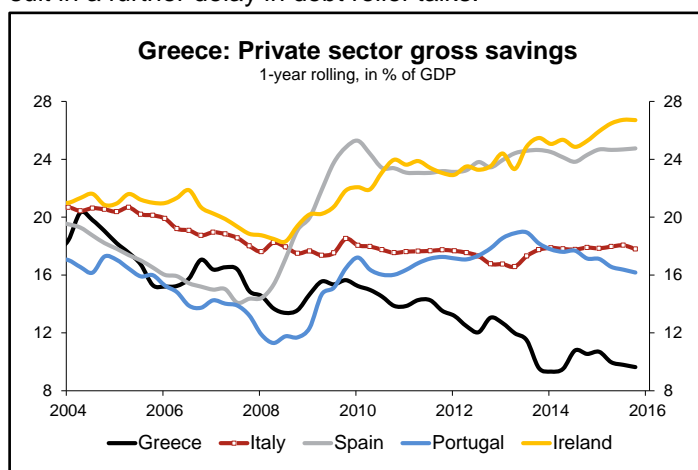
The baseline scenario of the EWG's DSA assumes that the primary surplus is maintained at 3.5% of GDP until 2025 before declining gradually to 1.5% by 2040. The debt-to-GDP ratio would decline from 182.9% at end-2016 to 146.5% in 2022 (well above the 110% target set in November 2012) and 104.9% in 2060. The EWG considered three set of debt relief measures. The first group includes an extension of the weighted average maturity of EFSF loans by 5 years, a re-profiling of the debt amortization scheme by setting a cap to loan repayments (1% of GDP until 2050) and the deferral of interest payments in excess of 2% (to be repaid after 2050). Additional measures include the restoration of the transfer of central banks' profits on Greek government bonds (ANFA and SMP facilities) and the early repayment of the more expensive IMF loan. All these measures combined would lower the debt-to-GDP ratio to 141.9% in 2022 and 73.7% in 2060.

The downside scenario by the EWG is very similar to the one depicted by the IMF. The primary surplus is expected to decline immediately after the end of the bailout program in 2018, albeit at a gradual pace and with a floor of 1.5% of GDP, in line with IMF's assumptions. The growth profile is only slightly more pessimistic than in the baseline scenario. Worryingly, the outcome leads to a debt-to-GDP ratio of 151.5% in 2022 and 258.3% in 2060.

While the evidence of EWG's analysis sounds alarming, EU lenders are not in a rush for defining concrete debt relief measures beyond the ones suggested in the DSA. As a result, a deal involving the IMF on this front looks unlikely. In our view, the most likely outcome consists of a short-term deal to unlock the aid tranche to Greece, with no definitive decision on the debt relief side. This should allow the IMF to wait for the negotiations among European leaders on the latter issue, without declaring its formal exit from the third bailout program for now. In the meanwhile, no financial assistance from the IMF should be expected. The recent statement by the Slovakian Finance Minister, a well-known hardliner, points into this direction. He affirmed that a swift agreement unlocking the aid tranche should be expected with or without the IMF consent, adding that IMF's technical and policy involvement would be more important than its financial participation in the program.

A still bleak long-term outlook

The announcement of a Greek deal at the Eurogroup meeting next week would remove one of the various downside risks from the European agenda. While this represents a positive factor, we do not anticipate a meaningful reaction by financial markets, as the agreement is largely priced in already. Indeed, the 10-year rate on Greek government bonds currently stands at 7.40%, the lowest level since last November and more than 400 bps below the peak seen in February. A less optimistic outcome, for instance, would be represented by an early exit of the IMF from the program. This would raise concerns over the commitment to structural reforms by Greece and could result in a further delay in debt relief talks.



Looking further down the road, we remain concerned about the longer-term recovery prospects for Greece. First, we share the IMF's concerns over the sustainability of the Greek debt and we consider the prospect of Greece being able to meet gross financing needs in excess of 10% of GDP (as depicted in EWG's baseline scenario) via market access as highly unrealistic. Second, we stress the risks emanating from the deflationary environment. Greece has

experienced five and a half years of uninterrupted negative growth in core consumer prices (excluding the impact of higher taxes), with a deepening downward trend in recent months. Third, differently from other peripheral countries, the Greek private sector shows no sign of improvement in terms of gross savings. The latter is a proxy of private sector's ability to self-finance investments, without relying on indebtedness. The current level (9.6% of GDP at end-2015) is less than half compared to the euro area one (21.7%) and it is only barely above the lows seen in Q1 2014 (+0.3 pp), compared to the strong improvement experienced in Spain (+10.7 pp since Q3 2007), Ireland (+8.4 pp since Q3 2008) and Portugal (+4.9 pp since Q2 2008). With the public sector forced to adjust further (mainly via higher taxes on the private sector), the chances for an improvement are at best meager. This jeopardizes Greece's potential growth prospects and makes the country more and more dependent on external financing, which is exactly the opposite of the ultimate goal of any adjustment program.

Imprint

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