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GREECE MACRO MONITOR

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Sovereign solvency outlook post the July 21 Council announcements

Following a positive market reaction in the wake of to the July 21 Council announcements, sentiment towards the euro area periphery has taken a turn for the worse on increased doubts over the outlook of the 5th Greek program review and headwinds to the ratification process of the proposed EFSF reforms in EU-17 national parliaments.

In Greece, the domestic macro and sociopolitical environment is worsening again, driven by a sharper than expected recession and the need to accelerate fiscal adjustment in order to prevent a sudden stop in official financing and to build up a critical mass of growth-enhancing structural reforms.

In this increasingly difficult environment, the latest IMF estimates of possible bank losses due to the lingering debt crisis and, more recently, Italy's downgrade by S&P sent out new warning signals to the markets. To make things worse, the recent weeks have seen increasing voices coming from certain political and market cycles, warning over the possibility of a hard debt restructuring, or even Greece's eventual exit from the common currency area.

The latest piece of news related to the aforementioned issues came earlier today in the form of a number of local press reports (later denied by the government), claiming that Greece's finance minister Evaggelos Venizelos told lawmakers that he sees three main scenarios to resolve the debt crisis. Namely, a "disorderly default", the implementation of the 2nd bailout plan agreed between Greece and its lenders on July 21 and an "orderly default" involving a 50% haircut for bondholders. According to the same sources, Mr. Venizelos claimed that it would be "dangerous" to request the 50% haircut, as it would require "an agreed and coordinated effort by many".

Although we continue to regard a Greek euro area exit scenario as highly improbable and, in addition, we maintain serious reservations over the feasibility of an "orderly" default, we realize that it is getting increasingly difficult to argue against the prevailing market view that the country's public debt remains at unsustainable levels. That is, especially in view of the deepening domestic recession, the presence of still negative *(albeit improving)* primary fiscal balances and earlier significant delays in the government's privatization plan.

More recently, un-sustainability concerns were reinforced by the latest *IMF Fiscal Monitor (September 2011),* which projects a peak in Greece's public debt ratio at higher levels than envisioned earlier. Specifically, under a baseline scenario, the peak in debt ratio is now seen at ca 189%-of-GDP in 2012 (vs. 172%-of-GDP in the July 2011 IMF report), with a gradual de-escalation expected thereafter, to levels around 162%-of-GDP by 2016.

In a special focus report we published in December 2010 (*Eurobank EFG Research, "Assessing fiscal policy with the use of sustainability indicators: The case of Greece",* please click on the following link http://www.eurobank.gr/Uploads/Reports/December%202010_Economy%20and%20Markets%20Fiscal%20Sustainability%20Greece.pdf) we presented a structural approach to address the sustainability and solvency issues of Greece's fiscal position.

More recently we provided a quantitative assessment of the potential implications of the July 21 EU Council announcements for the evolution of the government borrowing needs and public debt ratio up to the year 2020 (see e.g. *Greece Eurobank EFG Research, Greece Macro Monitor, August 2, 2011* http://www.eurobank.gr/Uploads/Reports/Greece%20August%202%202011.pdf).

As we alluded to back then, a second bailout package for Greece worth €109bn, lower interest rates and extended maturities on new EFSF loans as well as the proposed PSI scheme and debt buybacks could provide a sizeable cash flow relief and facilitate an improvement in Greece's solvency outlook. That view depends crucially on a rigorous implementation of the EU/IMF-agreed reforms and, in particular, the fiscal and structural measures envisioned in the government's medium-term fiscal plan.

In the present note, we revisit the Greek fiscal sustainability issue and provide some further analysis on the July 21 agreement with the official lenders. Although the proposed new bailout package for Greece does not *necessarily* constitute a "silver bullet" solution for sovereign solvency, we realize that the market currently refuses to fully price in the (potential) beneficial effects of the agreement for the country's borrowing needs and debt levels. That is, despite increasing signs arguing in favor of a successful completion of Greece's PSI transaction *(intended participation rate already exceeding 80%)*.

To the best of our knowledge, the most recent IMF forecasts for the evolution of the Greek debt ratio *(Fiscal Monitor Sept. 2011)* came as a negative surprise to a number foreign and domestic analysts and commentators. In fact, we had warned much earlier that the likely peak in the gross debt ratio would likely be beyond the levels projected in the July 2011 IMF baseline scenario (~172% in 2012-2013).

In our Greece Macro Monitor report date August 2, 2011 we projected a peak in the *gross* debt ratio at levels around 182%-of-GDP in 2012. That was mainly as a result of the potential impact of financial transactions related to the PSI scheme (e.g. purchase of defeasance assets), an increase in the size of FSF (domestic fund for bank recapitalizations) and the creation of a special government deposit reserve, as per the July 21 EU Council announcements.

If a deeper than-earlier-expected domestic growth trajectory for 2011-2012 is incorporated in the aforementioned forecasts, then one can clearly understand the reasons for the latest IMF revisions. More importantly, though, the beneficial effects of the measures announced on July 21 become more visible in the projected path of the *net* gross debt (i.e., excluding the impact of financial transactions), under various plausible scenarios for the evolution of the macro economy.

In the *PowerPoint* document accompanying this note, we highlight in a more compact format several important points about the July 21 EU Council announcements and their potential impact on Greek public borrowing needs and debt dynamics. The key message stemming from our analysis is the following: The July 21 EU Council decisions can indeed provide a significant cash flow and debt stock relief to Greece, under a range of (broadly realistic) underlying macro & fiscal scenarios. The key prerequisites underlying the latter view include: **(i)** a swift ratification of the July 21 Council announcements by EU-17 parliaments and **(ii)** a rigorous implementation of Greece's stabilization programme.

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