Eurobank
GREECE MACRO MONITOR
October 16, 2014

Greece: making sense out of the latest market upheaval

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Key points:

Greek asset markets declined sharply amid heightened uncertainty over global growth prospects, domestic political jitters and expectations for Greece's early exit from the IMF program

Such an exit would require the maintenance of market access by the Greek State, so as to facilitate the coverage of the country's projected funding gap on a multi-year basis. However, recent market action suggests that international investors still need strong assurances as to the country's commitment to fiscal discipline and the agreed structural reforms agenda.

A swift clarification of the terms of a new mechanism (with or without the Fund's participation) to replace the credibility premium enjoyed by the Greek program due to the IMF involvement could go a long way towards soothing prevailing market worries, especially given persisting domestic political jitters ahead of the presidential election in early 2015.

As per a number of market sources, that mechanism could potentially take the form of a precautionary credit line (*e.g.* an ESM-supported Enhanced Conditions Credit Line) coming with some underlying conditionality.

Drivers of the latest bout of increased investor uncertainty over Greece

In a backdrop of heightened investor uncertainty over global growth prospects and the short-term outlook of the euro area, domestic political developments and the government's stated aim to opt for an early exit from the IMF program exerted immense pressure on Greek asset markets over the last few sessions. Since the beginning of the week, the benchmark index of the Athens Stock Exchange (ASE) has lost around 13%, to c. 875 at the time of writing (12.30 GMT on Thursday), from 1,004.88 at last week's market close. In a similar vein, the benchmark 10-year Greek government bond yield spiked to a one-year high above 8.9% in mid-day trade on Thursday, from c. 7.65% at the market close a day earlier and levels around 6.60% at last Friday's settlement.

In a move to soothe Greece-related market fears, European Commission Vice President Jyrki Katainen said in a statement earlier today that the country has already made "immense progress" in creating a basis for a sustainable growth model based on sound public finances, a more competitive economy and a robust domestic financial sector. Katainen said that "Europe will continue to assist Greece in whatever way is necessary to ensure reasonable financing conditions for Greek State and to smooth the path back to full and sustainable market access". He also added that EU partners will support the country in reassuring financial markets of its ongoing firm commitment to reform and to maintain fiscal discipline via the maintenance of strong and adequate fiscal buffers. Markets' initial reaction to Katainen's comments was rather limited, with downward pressures on Greek financial assets persisting in early afternoon trading hours.

As a reminder, the Hellenic Republic has managed to access international markets earlier this year, raising €4.5bn of short- and medium-term government notes (€3bn of 5-year paper in April and €1.5bn of 3-year bonds in July). More recently, it successfully swapped €1.5bn worth of T-bills with 3- and 5-year government securities, further increasing the average maturity of outstanding market debt and boosting the liquidity of the recent bond issues. Furthermore, the government has recently signaled its intention to proceed with additional debt issuance before year end, including a 7-year bond and 18-month T-bills. In a similar vein, the 2015 draft budget that was unveiled in early October envisages issuance of additional market debt next year, in the form of 7- and 10-year government securities of a total notional amount of €9bn. Finally, we note that the latest bout of heightened market uncertainty over Greece is taking place against a backdrop of improving domestic macro fundamentals, with the economy having stabilized further in recent months and real GDP growth estimated to have returned to a positive territory in Q3 for the first time since the third quarter of 2008. According to our *GDP Nowcasting* model, Greek real GDP recorded positive growth of c. 1% YoY in the third quarter of this year.

The section below attempts to shed additional light on the main causes of the latest market upheaval and discusses what should be expected in the days and weeks ahead.

Revisiting the feasibility of an early exit from the IMF funding program

In our *Greece Macro Monitor* of September 24, 2014, we examined the feasibility of an early exit from the IMF program from a pure funding-requirement standpoint.[2] In that report we presented a detailed analysis of the evolution of the general government borrowing requirement up to year 2020, based on the troika's present baseline macro scenario for Greece and assuming the potential utilization of a number of additional funding sources, i.e., over and above those committed in the context of the present bailout program. Overall, the arithmetics pertaining to the controversial period (2015-2016) are as follows:

Projected funding gap in 2015-2016

According to the latest IMF assessment of Greece's adjustment program (June 2014), a funding gap will arise in the second half of next year, amounting to c. €12.5bn over the period 2015-2016. This gross figure assumes a buildup of a Treasury cash buffer of €2bn and also incorporates market financing (i.e., via the issuance of government notes & bonds) of only €3bn in 2014. The above projections imply that an early exit from the IMF funding program would add to the aforementioned shortfall another €12.5bn, boosting the total general government funding gap in 2015-2016 to c. €25bn. Note that the latest calculation assumes that Greece will receive a final disbursement of €3.5bn from the IMF upon completion of the current review, leaving unutilized remaining IMF commitments of €12.5bn (scheduled over the period Q1 2015-Q1 2016).

Sources of funding (over and above these assumed in the troika baseline scenario)

A number of available funding sources could potentially be used to facilitate coverage of the projected funding gap in 2015-2016 (€12.5bn plus another €12.5bn if the country exits the IMF program ahead of schedule). These include, among others:

- Any remaining funds earmarked for the domestic bank recapitalization program post the upcoming EU stress test results (current HFSF buffer estimated at c. €11.4bn). This possibility has recently been signaled by a number of high-level EU officials and our understanding is that it will require the approval of some EU parliaments, thought this would not likely create any major complications since it constitutes program financing, which has already been accounted for in the country's gross public debt.
- Use of idle resources available in other parts of general government for liquidity purposes and intra-general government borrowing through repo operations. According to certain estimates, the total amount of liquidity raised by these sources could reach or exceed €6bn.
- Purchase of preference shares from the State by domestic banks. These were issued in April 2009 so as to increase the share capital of domestic credit institutions in response to the international financial crisis. €1.7bn of these have been bought back earlier this year by two Greek systemic banks, with the remaining shares outstanding amounting to c. €2bn.

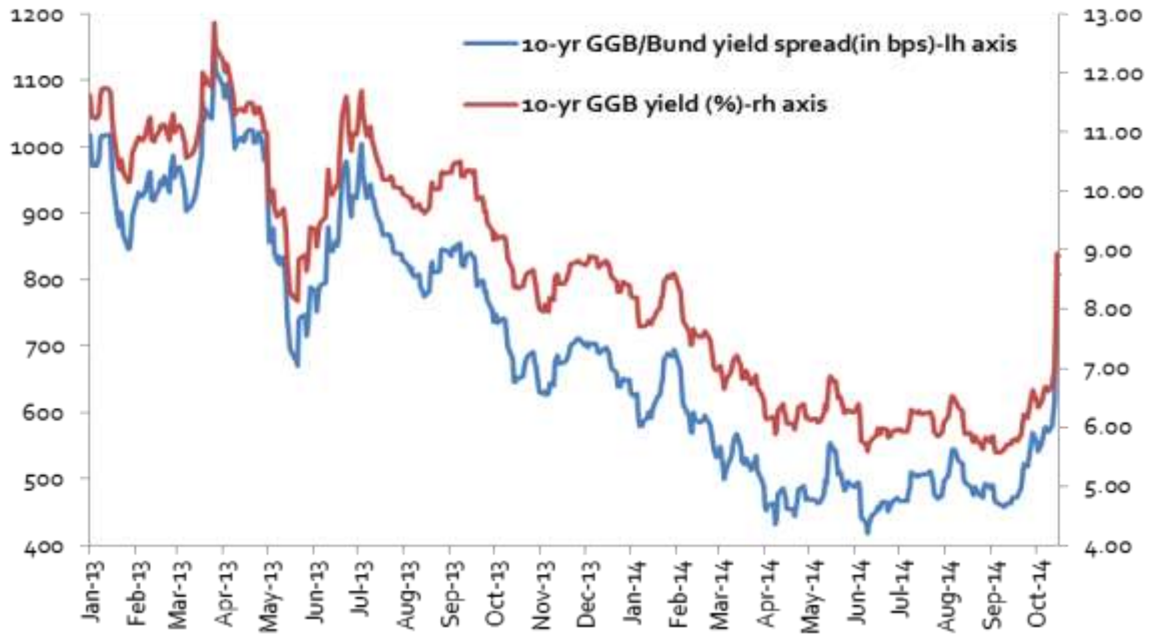
[2] "Greece: how feasible is an early exit from the IMF lending program", Greece Macro Monitor September 24, 2014.
http://www.eurobank.gr/Uploads/Reports/GREECE_MACRO_FOCUS_Sept24_2014.pdf

- Any additional cash flow respite provided by a new debt relief package (OSI) to be agreed with official lenders. In a recent study on the latter subject we estimated such cash relief to amount to c. €2.5bn in 2015-2016, assuming a 20 year extension of GLF loan maturities, along with a further reduction of respective interest rates to 0.6% fixed (from 3m euribor + 50bps, currently) and a 10-year grace on interest payments.
- Additional market funding through the issuance of government notes and bonds. In our Sept 24 Greece Macro Monitor we estimated net bond issuance amounting to ca €6-7bn/annum would be needed in 2014-2016 to provide full coverage of the projected borrowing gap over that period, assuming that the country would be able to utilize all of the aforementioned funding sources.

Bottom line

In the current trajectory, an early exit from the IMF program would require the maintenance of market access by the Greek State. Under certain conditions, new government bond issuance could be used, in combination with a number of other available financing sources, to facilitate the coverage of the projected funding gap on a multi-year basis. However, recent market action suggests that international investors still need strong assurances as to the country's commitment to fiscal discipline and the agreed structural reforms agenda. In view of the credibility premium that has so far been enjoyed by the Greek program due to the IMF involvement, a swift clarification of the terms of a new mechanism (with or without the Fund's participation) to replace that credibility premium could go a long way towards soothing prevailing market worries, especially given persisting domestic political jitters ahead of the key presidential election in early 2015. That is of course, provided that Greece sticks to its stated plan to opt for an early exit from the IMF program. As per a number of market sources, that mechanism could take the form of a precautionary credit line (e.g. an ESM-supported Enhanced Conditions Credit Line) coming with some underlying conditionality.

Graph- Evolution of 10-yr GGB yield and spread vs. Bund



Source: Bloomberg, Eurobank Global Markets Research

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