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Investec Economics

Greece still pushing a Sisyphean boulder

- Over the last few weeks concerns over the outlook for Greece have been rising again. These concerns came to a head with the release of the IMF's 2017 Greek Article IV publication, which highlighted 'explosive and highly unsustainable debt', as well as a rare difference of opinion within the IMF's Executive Board. Short dated Greek bonds sold off, pushing the 17th July 2017 bond yield to 13.2% (see chart 1), as investors fretted over the apparent disagreements between the creditors and Greece and the potential risk that July's debt repayments could be missed if no agreement was reached.

State of play

- In August 2015 Greece signed a third (€86bn) bailout programme with the European Stability Mechanism (ESM) (whilst it was assumed the IMF would provide new funds, at the time of writing that had not been agreed). Of the third programme €13bn was initially disbursed and a second €10.3bn tranche approved in May 2016 following the completion of the first review. However, since then the programme has effectively been 'off-track' with the second review, which was meant to have been completed in Q4 2016. As a result a €6.1bn payment to Greece has been delayed due to disagreements between Greece and its creditors and even between the creditors (IMF, European Commission).

- There are a number of issues at the heart of the disagreements:
  - Greece threw a curveball into discussions back in December when it took unilateral action in approving a bonus pension payment and suspended a planned VAT increase on the Aegean islands. The move prompted Greece's euro area creditors to suspend short-term debt relief measures which were agreed early December and talks were halted. Whilst talks have resumed, Greece's unilateral fiscal policy measures, differing views on reforms (most notably in the labour market) and implementation fatigue are all weighing on talks.

  - Primary budget surplus: One major issue that has dogged discussions surrounds Greece's medium term primary surplus targets (deficit minus interest payments). Under the current programme's MoU (Memorandum of Understanding) Greece is expected to meet a primary surplus target of 3.5% of GDP in 2018. However the IMF has a more pessimistic outlook in assuming that under current policy the surplus will stand at only 1.5%. Greece has already legislated for contingency measures, known as 'the cutter', should the 3.5% 2018 target not be met. Not only that, but under the MoU Greece is also expected to achieve a 3.5% surplus for the following 10 years as well, which is where the disagreements between the creditors and accusations of overly bearish IMF forecasts have arisen. Whilst the EC has assumed Greece can meet a 3.5% primary surplus, the IMF in its latest review suggested that such a primary surplus could only be achieved with further fiscal measures.

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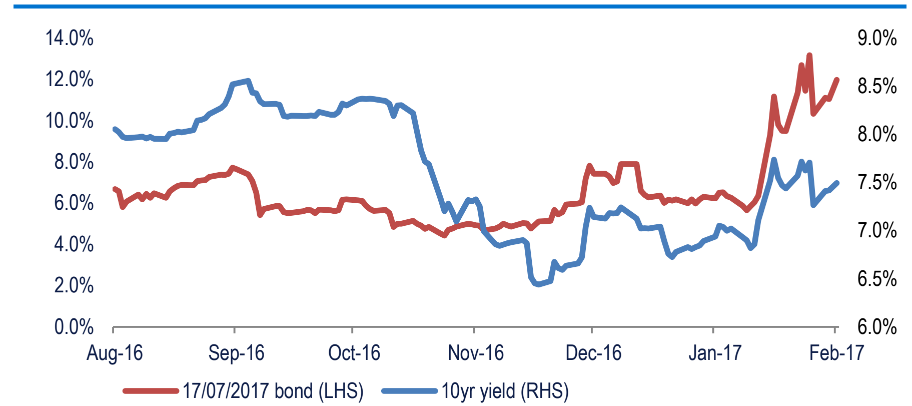
On Friday 10th February there appeared to have been some convergence of views with a common proposal being put forward to Greece suggesting that the impasse could be broken if Greece were to take additional fiscal measures worth 2% of GDP (approx. €4bn); 1% to be legislated for now and a further set of measures worth 1% after 2018, if they were required. But after 7 years of austerity it remains to be seen how politically feasible this proposal would be given PM Tsipras' previous pledge not to legislate for 'a single euro' worth of additional measures.

Chart 1: Programme uncertainty pushes yields higher again



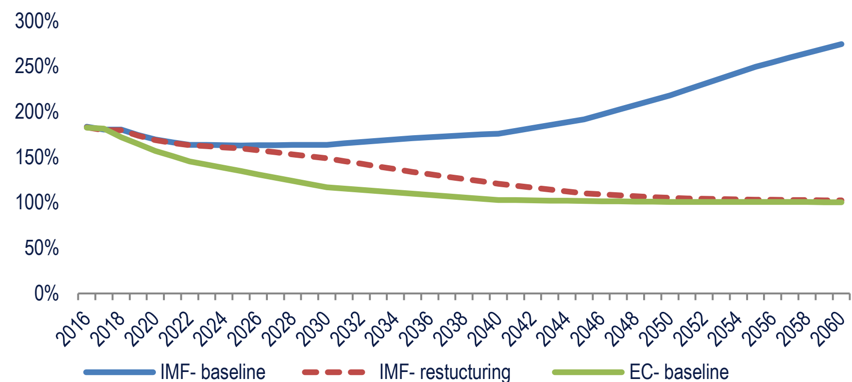
Source: Bloomberg

IMF involvement

- Away from the immediate need to reach an agreement on the second review, a potentially bigger question is the issue of IMF involvement in Greece's programme. Whilst the IMF is not currently a cash contributor to Greece's programme, the original third bailout agreement was ratified on the condition of IMF participation in the German Bundestag. Despite a Greek preference for an IMF free programme, the line from Germany, the Netherlands as well as the ESM, is that IMF involvement is a pre-requisite and that without it, programme disbursements would end.

- Should the obstacles of the 2nd review be overcome, the bigger hurdle to IMF involvement is perhaps the assessment of Greek debt sustainability. Under the IMF's own internal rules, funds can only be lent under an assessment of sustainable debt. However the IMF's latest assessment is one of 'highly unsustainable and explosive' debt, with the IMF's baseline forecast of Greek debt rising to 275% of GDP by 2060, from 2018's estimate of 180%. That assessment surely questions the IMF's ability to participate.

Chart 2: Greek debt % GDP- IMF and European Commission debt sustainability analysis



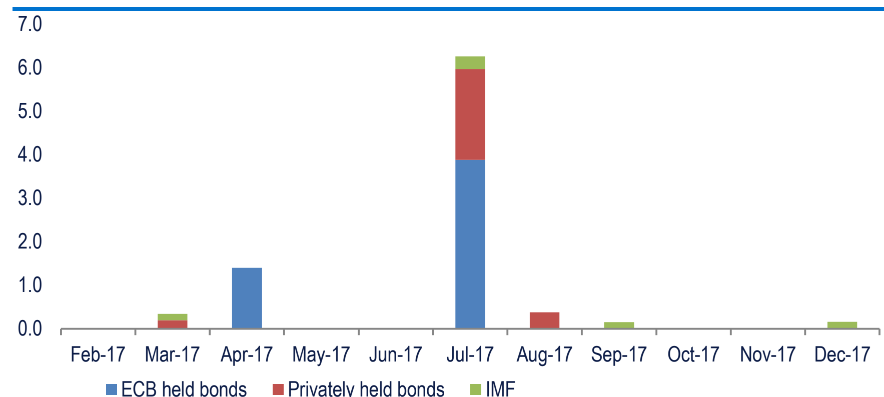
Source: IMF Greece Feb 2017 Article IV, European Commission compliance report June 2016

- One path which could lead to the IMF's involvement is the possibility of debt relief. Indeed the question of debt relief is another major point of contention between the IMF and Greece's European creditors, with each having a very different outlook for Greek debt (see chart 2). Under the EC's baseline assumption Greek debt is expected to stabilise around 100% of GDP between 2040-2060, a 175ppts of GDP difference with the IMF in 2060. The IMF insists the European baseline assumptions are too optimistic, whilst the opposite is levelled at the IMF. However the crux of the issue is that the IMF is suggesting that for debt to be put on a sustainable path by 2060 (100% GDP) and thus for it to participate in Greece's programme, European creditors will need to undertake a significant restructuring of its loans to Greece. Obviously, with major European elections this year, agreeing to such an option is an almost impossible pill to swallow at this point.

Where do we go from here?

- Greece has been given a deadline of the 20th February Eurogroup meeting to clinch a deal, which would in turn allow for ratification in early March. The reason for this timetable is that Dutch elections take place on the 15th March. Whilst this is not necessarily the hard deadline for reaching a deal, it would seem that any agreement after this point would be more difficult, although not impossible to come by given the run of European elections thereafter.

Chart 3: Greek 2017 principal repayments (€bn)



Source: Bloomberg, IMF

- A more formal deadline would be Greece's July repayment hump. On the 17th July Greece has a €2.1bn repayment of privately held bonds due, whilst a further €3.9bn held by the ECB under its Securities Market Programme (SMP) programme redeems three days later on the 20th. Should the €6bn tranche from the second review remain frozen, it would seem unlikely that Greece would have sufficient funds to meet payments which are due in the coming months and July's redemptions, risking the possibility of default.

- To our minds a deal by Monday's Eurogroup (20 February) seems unlikely given the timeframe, outstanding issues and the fact Greece's creditors have yet to even return to Athens for negotiations. That view is seemingly shared by Eurogroup President Jeroen Dijsselbloem. We do however expect a compromise will be reached at some point, possibly just before the Dutch elections. However reaching an agreement will likely require the Greek government's acceptance of further fiscal measures, but may also require Greece's European partners to provide additional clarity on longer-term debt relief measures to help satisfy the IMF's debt sustainability criteria. The 25 May 2016 Eurogroup statement did acknowledge the possibility of medium and longer term debt relief measures for Greece following the successful completion of the ESM programme in 2018. Whilst politically it would seem unfeasible to outline such relief for Greece in a busy election year, a firmer commitment to implement measures in 2018 (after the Dutch, French and German elections) may prove sufficient to bridge the gap to the IMF's involvement. The risk to this view would be a stalemate whereby all parties fail to reach a compromise, the IMF refrains from participating and further ESM disbursements are halted. This effectively raises the prospect of a Greek euro exit, although we see this risk as being pretty small given the effort to keep Greece in over the last seven years.

- With much of the focus fixated on Greece's near-term prospects, even if Greece manages to secure a deal questions abound over its longer term prospects. Under the terms of the current ESM agreement Greece's last aid tranche is scheduled for August 2018, which would mean that Greece would have to re-access capital markets on a regular basis and at something that resembled a sustainable rate. Greek 10yr bonds currently trade at a yield of 7% and even if Greece was able to successfully navigate the remaining 18 months of its programme, it remains to be seen whether the risk premium on Greek bonds (700bps over 10yr bunds) would narrow sufficiently to enable sustainable debt issuance from Greece. It is also worth noting that even if Greece is able to readily access capital markets, it will be at significantly higher interest rates than under its bailout agreements. That is one reason the IMF expects debt to rise rapidly without restructuring. Certainly the prospect of a fourth programme is not zero, suggesting Greek uncertainty will probably exist for a while longer.

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