Euler Hermes Economic Research

Economic Insight

Greece and Europe: The sequel
Political will, Time and Value-at-Risk

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Executive summary

- In the aftermath of the Greek elections, solving the debt issue (to avoid a default) is the priority. However, more options seem to be on the table this time. We expect: first, an extension of the current bailout; then, a new precautionary credit line should follow by end-2015, accompanied by further debt relief in the form of frozen interest payments on EU and IMF loans for a limited period of time and longer loan maturities.
- For now, our baseline scenario for Greece remains unchanged: GDP growth of +1.4% in 2015 (+1.8% in 2016); business insolvencies to fall by -4% (-8% in 2016). However, time and policies will be critical to keep this momentum. Lasting uncertainty and harming competitiveness too fast could lower GDP growth by as much as 0.5pp this year.
- Europe can afford to be (more) patient with Greece. Though the Greek Value-at-Risk has shrunk by 40% for corporates to 70% for financials, the impact of a Grexit (5% likelihood) will still be unprecedented and systemic.

New political scene: Checked. Next step: Solve the debt issue

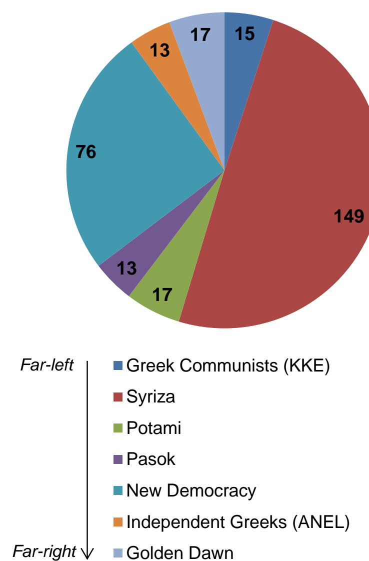
As expected, Syriza emerged as the winner of this Sunday's legislative elections obtaining 149 seats out of 300 and formed a coalition with right-wing Independent Greeks (ANEL) - see Figure 1. This brings a majority of 162 seats out of 300 for the governing coalition, led by Syriza's Alexis Tsipras.

The next critical step is progress in negotiations between the new government and the Troika on how Greece could obtain the funds to cover their financing needs, ,avoid a default and a Grexit - in that order. Over the whole year, the funding gap is estimated at EUR18bn, circa 10% of GDP (Figure 2). However, the biggest deadline is mid-July by when Greece will have to reimburse around EUR7bn of bonds.

A menu of options is on the table, political will is necessary

Action 1: We think that a **new extension of the current bailout is likely as an intermediate solution by mid-2015** in order to avoid default on

Figure 1: Results of the Greek legislative elections, number of seats



Sources: Macropolis, Euler Hermes

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the debt that is still held on the market (two bond issuances mature mid-July), which is neither in the interest of the Eurozone nor the Greek government. Indeed, it is impossible that Greece covers the funding gap through external financing as the agreement with the Troika states that bills issuance cannot excess EUR15bn and this limit has been already reached, while we doubt that Greece will obtain the required market confidence to issue new bonds.

Action 2a: Independently of the intermediate solution, we believe that negotiations between the Syriza-led coalition and the Troika **will lead to a new precautionary credit line (ECCL) by end-2015** that will ultimately help Greece to progressively return to the bond market.

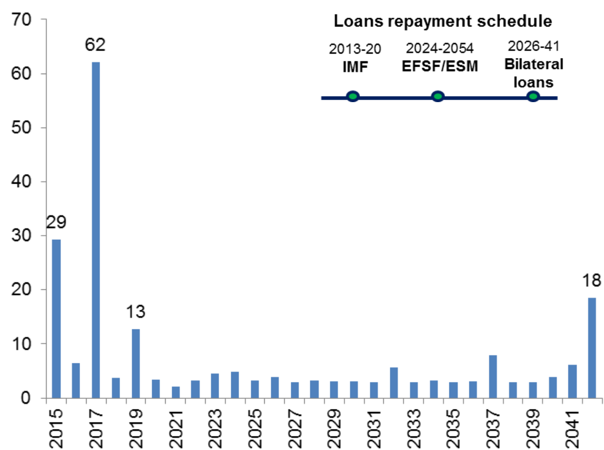
Action 2b: To incentivize structural reforms, this must be combined with **a new round of debt relief will be agreed with the Troika.** Crucially the unsustainability of the Greek debt (circa 175% of GDP) and the fact that more than 80% of that Greek debt is held by the EU, the ECB and the IMF (see Figure 3) with an average maturity of around 20 years – more than twice as long as Italian or French debt –, makes us believe that further debt relief will be agreed by the Troika in the form of one or a combination of the 3 following options: **(i) 0% interest rates on the EU loans for some years; (ii) 0% interest rates on the IMF loans; and (iii) further extension of EU loan maturities** – see Figure 3. We see this as politically acceptable as the Member States would only give up profits on the Greek bailout for a limited period of time (and not register losses as many believe) while a temporary postponement in interest payments has previously been approved for Mexico in the '80s and for Brazil in the '90s. This is important as it would allow Greece breathing space to improve its primary fiscal surplus (to above 4% of GDP).

What to expect for the Greek economy? No major drawback but the clock is ticking

At this stage, despite the expected short-term uncertainty, we maintain our cautiously optimistic scenario unchanged: **GDP growth of +1.4% in 2015 (+1.8% in 2016); business insolvencies to fall by -4% (-8% in 2016); and financing conditions to improve,** albeit from a very low base, on the back of improving banks' balance sheets and positive spillovers from the ECB's Quantitative Easing. Greece has managed to return to growth and the momentum should be kept.

Syriza's economic program is very laconic at this stage. It is a vision; the implementation of which may prove difficult in the short-term, especially as the large fiscal stimulus (EUR12bn) is yet to be financed. Tax justice takes the lion's share of the first-aid kit: (i) restituting the employment protection system and collective agreements to avoid layoffs; (ii) restoring of the minimum wage to EUR751/month (iii) immediately increasing public investment by at least EUR4bn;

Figure 2: Greek debt maturing, EURbn



Sources: Euler Hermes

Figure 3: What kind of debt relief could be agreed with the Troika?

Most likely	Likely if negotiations are too tough and financial stress is very high
EU loans: Lower interest rates to 0 for some years. This would only imply that Members States give up the profits on the Greek bailout.	Write-off the part of the Greek debt on the **bilateral loans from the EU (20% of total debt).**
IMF loans: Lower interest rates to 0 for some years. A temporary postponement in the interest payments has been approved for Mexico in the '80s and for Brazil in the '90s.	**EFSF and IMF loans**: Cut interest rates to a low and fixed rate on EFSF/ESM loans and lower interest rates to 0 for IMF loans.
EU and EFSF loans: Extend further the loans maturities.	**EU and EFSF loans:** extend further the loans maturities.

Source: Euler Hermes

(iv) providing SMEs with incentives for employment (target 300K new jobs); and (v) rebuilding the welfare state and restoring the rule of law. There is a fine line between more tax justice and harming competitiveness. The latter has been restored at a high price and was starting to pay off (lower euro, cheaper energy bill, higher growth).

The upcoming period of uncertainty could negatively impact Greek companies (reputation effect). Should things escalate (high policy volatility, increased cost burden on companies e.g.), **we expect the negative impact to be limited to below 0.5pp of GDP growth**, but the magnitude of impact will depend on the time it takes to reach an agreement. A total lack of agreement by mid-2015 will indeed threaten the Greek economic recovery.

Europe can afford to be (more) patient with Greece as the Greek Value-at-Risk – in other words the face value of a *Grexit* – has shrunk by 40% for corporates to 70% for financiers

The scarring effect of the crisis is notable when looking at Greece in 2012, and Greece today in numbers. In Figure 5 we put together a scorecard of why peer pressure is less on than in 2011-12. In a nutshell, by major aggregate:

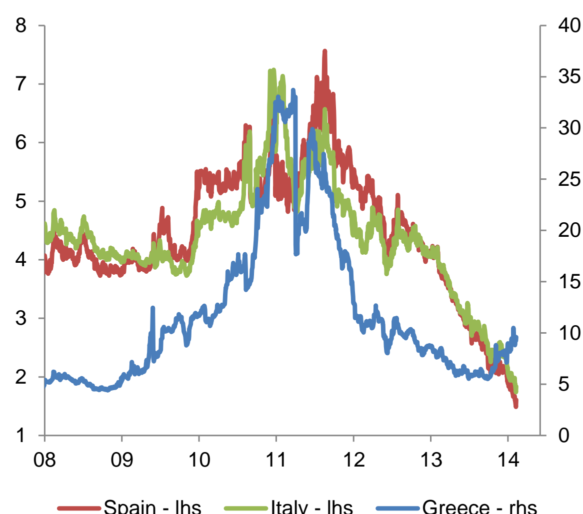
1/ The size of the Greek economy (including in the Eurozone) has significantly reduced. Nominal GDP has dropped almost -30% since 2008 and value added declined more than EUR60bn. The domestic economy has suffered the most with private consumption down by more than -20% (in nominal terms) and total investment by -65%.

2/ The European markets are less exposed to Greece. Since the debt write-off in 2012 (Private sector involvement - PSI), the amount of the Greek government debt (bills and bonds) held by the private sector has fallen by more than 60% from EUR224bn in 2012 to EUR80bn. Further, the CDS market is much smaller (1/3) and the correlation between the Greek yields and the other Southern European countries is much lower (see Figure 4).

3/ European banks' exposure has significantly reduced. Exposure in terms of lending to the Greek economy has collapsed. In 2012 European banks held around than EUR120bn of exposure in terms of lending, mainly French and German banks, which it is estimated to have fallen to EUR35bn.

4/ European corporates are much less dependent on business with Greece. Total Greek imports have fallen by as much as -30% since 2008, the equivalent of EUR25bn less interaction with the rest of the world. In 2008, Greek imports were equivalent to only 2% of total Eurozone exports, whereas now they stand at a

Figure 4: 10-year sovereign bond yields, %



Sources: Bloomberg, Euler Hermes

Figure 5: The Greek Value-at-Risk for Europe

	Prior to 2012	Today	
	EURbn		% change
Greek economy			
GDP	242	179	-26%
Private consumption	164	129	-21%
Total investment	57	20	-65%
Greek sovereign bond market held by the private sector	224	80	-64%
Greek CDS market	60	2	-98%
European banks exposure to Greece (through lending)	120	35	-71%
Exports of non-Greek corporates to Greece	87	62	-29%
Exports of European corporates to Greece	32	19	-41%
of which			
Germany	9	2	-79%
France	4	1	-81%
Italy	9	3	-71%
Spain	3	1	-76%

Sources: BIS, IHS, Bloomberg, Euler Hermes

mere 1%. When looking at the biggest eurozone countries, Germany, France, Italy and Spain, total exports to Greece have fallen by more than -70% since 2008.

If all goes wrong, the impact will still be systemic for the eurozone

A lack of agreement with the Troika would send a very negative signal to the market and cripple the real economy – a scenario for which we give only 5% of probability.

In the adverse scenario of a Greek exit (Grexit) from the Eurozone, the economic consequences will be considerable and should be avoided at all cost. In Greece, GDP growth would decline by -15% followed by another -10% drop in 2016. Business insolvencies would increase by circa +50% in 2015 (+30% in 2016). 2017 would likely be the first year of improvement as the economic finally re-orientates itself and the New Greek Drachma is slowly accepted by financial markets.

The spillover effect to the rest of the Eurozone would be unprecedented. Although the European institutions are more complete and efforts multiplied - on paper for now: banking union, ESM, QE; Junker plan to name a few - the uncertainty related to the economic consequences of a Greek Eurozone exit remains high and the political damage could be irreversible. It could send a signal to the other Eurozone countries in terms of relevance of their membership. Financial stress would increase considerably (Southern Eurozone sovereign bond yields would rise again), and fragile financing channels in many European countries would be immediately impacted. Capital outflows would accelerate and the euro will be once again deemed a problematic settlement currency. Timid growth in the Eurozone would be paused and Southern European economies will have a hard time avoiding yet another headwind. Once the genie is let out of the bottle, it is hard to get it back in.

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