'Greecovery': Is there enough light at the end of the Greek tunnel?

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Executive Summary:

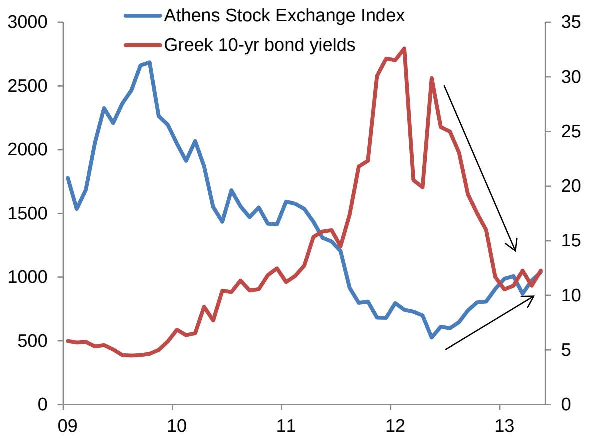
- EH expects GDP in Greece to contract in 2013 (-4.2%) for the sixth consecutive year, but to be closer to stabilization in 2014 (-0.3%).
- Financial pressure has continued to ease since November 2012.
- Business confidence has improved slightly but is still in contractionary territory.
- Ongoing reforms should start to bear fruit in 2014; but public debt sustainability will remain a major concern.
- Renewed social and political instability is still a serious downside risk.
- EH country risk model suggests prolonged crisis in the short-run.
- Risks for businesses remain high as insolvencies soar (+10% in 2013 after +30% in 2012) and a majority of sectors continue to underperform.

Signs of return of confidence since November 2012

2012 ended on a slightly more positive note. First, after the "Troika" (EU/IMF/ECB) agreed to extend the fiscal adjustment path by two years while implementing measures to support the sustainability of Greece's debt (reduction in interest payments on the EU loans and extension of EU loans maturities to 30 years on average). Second, the debt-buy back scheme offered by Greece to the remaining private investors last December facilitated the disbursement of nearly EUR50bn of the total EUR165bn of EFSF/IMF financial support.

Following these decisions, market confidence improved significantly. Since end-2012, bond yields decreased significantly, to 2 year lows, while the stock market recorded increases of nearly 30% y/y (chart 1).

Chart 1: Steady improvement in financial markets developments since end-2012



Sources: Eurostat, Euler Hermes

Some improvement in business confidence, but still suggests activity will contract in the near-term

Business confidence reached a 21-month high in April 2013, but continues to point to activity contracting in the coming months, albeit at a slower pace. At its current levels, both soft and hard indicators give recessionary signals (chart 2). Indeed, economic growth is likely to contract in 2013 (-4.2%) amid fiscal consolidation (6.5% of GDP in 2013 and 2014) and subdued prospects for the Eurozone, but should be closer to stabilisation in 2014 (-0.3%).

Reforms should start to bear fruit progressively in 2014

Greece is the European champion in the number of reforms implemented since 2008 (chart 3), the most important of which targets increased efficiency of the public sector, the labour market and business environment.

Labour market reforms implemented in 2012 – decentralisation of wage bargaining, reduction in minimum wages - have already started to deliver results in terms of wage flexibility and cost competitiveness. The troika estimates that if strengthened, reforms would help Greece to regain its 1995 labour cost competitiveness position (relative to the eurozone) in the coming years. This should support export performance and further reduce the need for external financing.

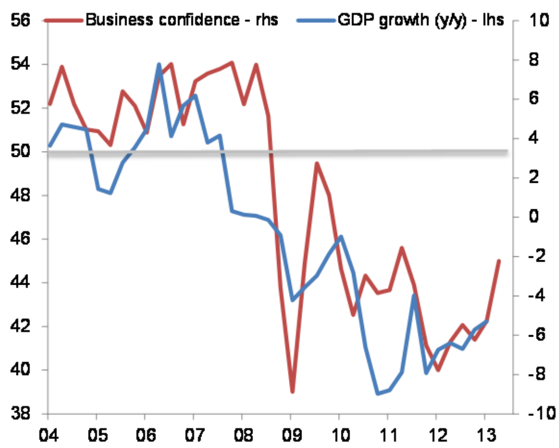
Progress to improve the business environment has been made through measures targeting a reduction of red tape and the time and cost of creating a new business. Also, improving export performance is a key government strategy and reforms to facilitate trade by reducing and simplifying export procedures have been introduced. These measures, together with the increase in competitiveness, the low value of Greek investment assets and projects to improve infrastructure (notably ports) are likely to attract FDI as Greece continues to be European laggard on this front.

Further, ambitious privatisation plans (EUR22bn by 2020), if completed, will help investors' confidence return and support the strengthening of the Greek private sector.

Yet cost pressures on businesses remains high

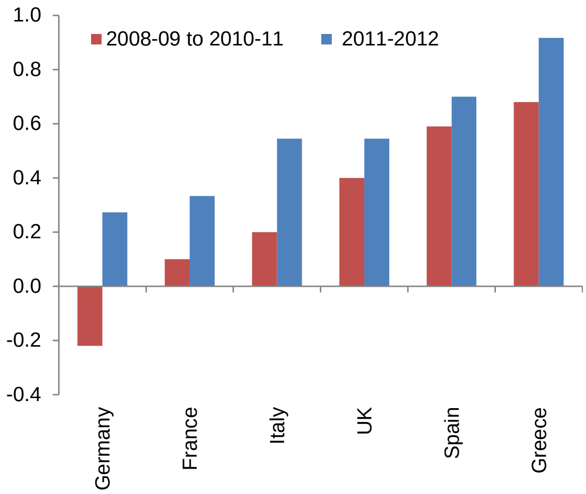
Credit to non-financial corporations continues to contract (-6.5% y/y in April 2013, chart 4) but at a slower pace. This not only reflects contracting private demand and weak activity prospects, but also banks' funding issues and high corporate credit risk – banks' NPL stood at 24% of total loans at end-2012, of which half were corporate loans.

Chart 2 : Business confidence improving, but still in negative terriory



Sources: Eurostat, Euler Hermes

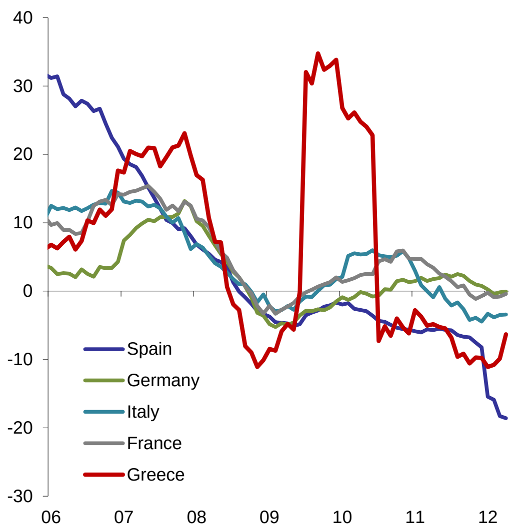
Chart 3: Greece is the leader in reforms since the crisis



Sources: Responsiveness to OECD reform recommendations, Euler Hermes

Chart 4: Lending to non-financial corporations continues to contract, but at slower pace

Lending to NFC, y/y, %



Source: ECB, Euler Hermes

Thus, constraints in access to credit for corporates are highest in Greece than in the rest of the eurozone, particularly for SMEs. Interest rates on loans to non-financial corporations are also significantly higher than in other eurozone countries (at 4.8% compared with less than 3.0% in France and Germany) – chart 5.

However, credit conditions should ease as banks access to funding is set to improve in the coming quarters on the back of (i) returning deposits (chart 6) – since June 2012 total deposits increased by EUR12bn to EUR160bn (ii) decreasing dependency on ECB emergency lines thanks to the European recapitalisation funds (EUR50bn).

Despite good progress on fiscal deficit reduction, public debt sustainability remains a big concern

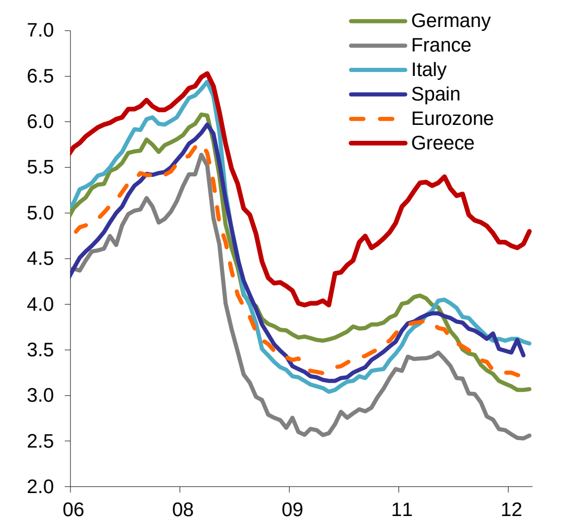
Public debt is likely to reach 180% of GDP in 2013 and to stabilize at that level in 2014. The reduction of interest payments on the EU loans decided last December is a positive step forward for the debt sustainability. However, the return to economic growth is likely to be slow and the 10-year growth trend is unlikely to exceed 3% per year. Moreover, a fiscal primary balance surplus of 4% of GDP is necessary to stabilize the Greek public debt. This means a significant effort over the coming years after already very painful adjustments over the past years: since 2009 the Greek fiscal primary deficit reduced by 10% of GDP (chart 7). All this, together with still high interest rates – above the level needed to stabilize the public debt in the medium run - is likely to slow the reduction of the public debt GDP ratio. Moreover, Greece will start to repay IMF loans in Q3 2013 and disbursements of the current bailout will end in 2014. This raises questions about the future financing sources as the return to the markets (not before 2015) is likely to prove challenging.

Renewed social and political instability – still a downside risk

Unemployment remains very high (23% in February 2013) and austerity remains intense. The 'grand coalition' formed after the June 2012 elections remains fragile given the high number of seats obtained by the extreme-left party SYRIZA (26.9%). However, on the positive side, the government signals that it is a pro-bailout coalition with a firm commitment to the bail-out programme and a popular mandate to remain in the eurozone.

Chart 5: Funding costs for non financial corporations remains significantly higher than in the rest of the EZ

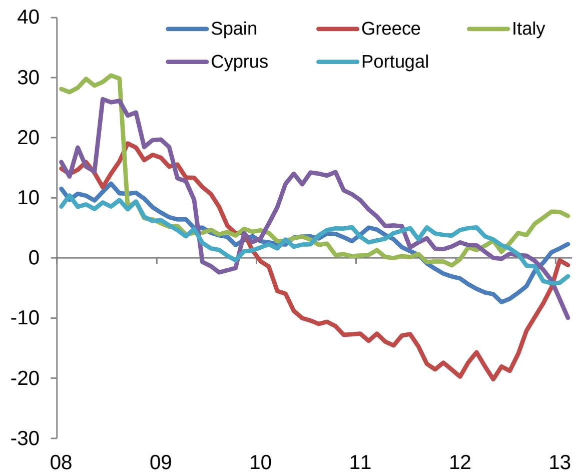
Rates on loans to NFC, %



Sources: ECB, Euler Hermes

Chart 6: Return of deposits in since mid-2012

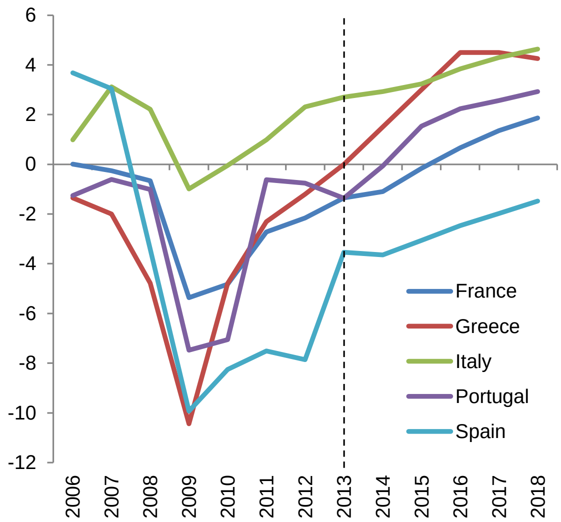
Total deposits, y/y, %



Sources: ECB, Euler Hermes

Chart 7: The adjustment in the Greek primary balance since 2009 has been impressive

Primary fiscal balance, % of GDP



Sources: IMF, Euler Hermes

EH country risk ratings indicate continuing short run weakness

Short term risks remain high as both financing and commercial risks continue to be elevated on the back of contracting activity and weak financial fundamentals (chart 8). However, prospects in the medium run are to the upside given the implementation of structural reforms and the business climate improvement.

Risks for businesses remain high as insolvencies soar

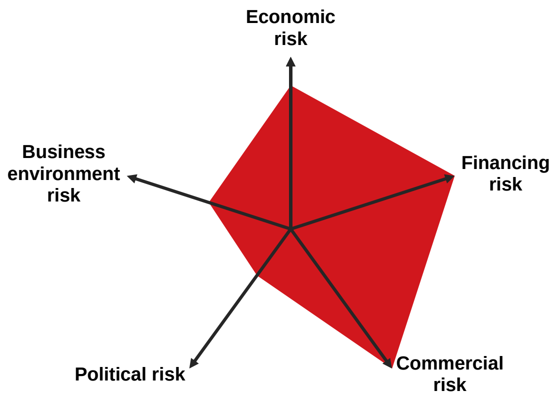
Exacerbated by fiscal consolidation, the fall in domestic demand (25% between 2008 and 2011) has severely hit order books in all sectors, while operating profits measured by national accounts have continued to fall, with a slump of -12.9% since 2008, back to 2006 levels. In this context, the strong rebound of margins shouldn't be misunderstood as it is only a reflection of a sharper fall in value added (-14.7% since 2007). An upturn in exports will not prevent negative growth in 2013 and 2014 or a fresh surge in insolvencies over the same period (respectively +10% and +3%, chart 9).

A majority of sectors continues to underperform

All sectors continue to be in contractionary territory (chart 10) in terms of output with the outlook for main contributors – public administration, food, retail and industry – remaining gloomy. Risk is generalized across all sectors, including ones in which Greece traditionally performed well (e.g. transport and food).

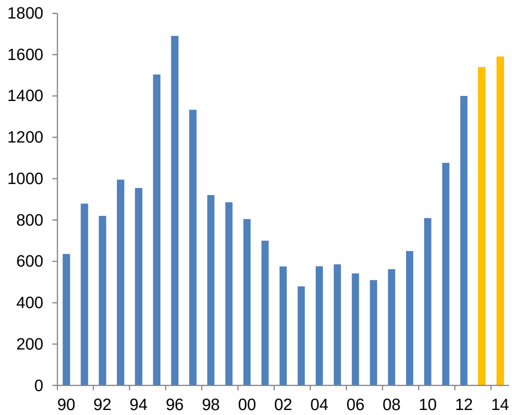
Chart 8: Short-term still a concern

EH risk profile



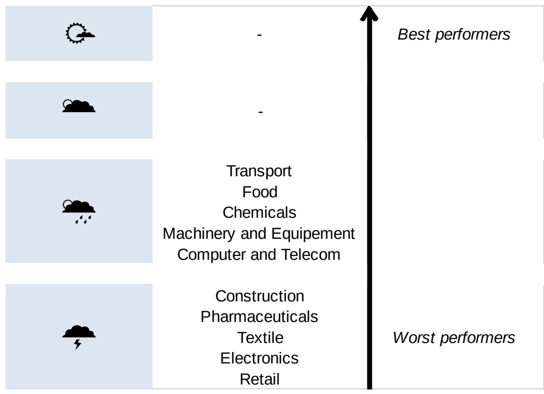
Sources: Euler Hermes as of June 2013

Chart 9: Insolvencies to continue to rise



Sources: Eurostat, Euler Hermes

Chart 10: A majority of sectors continues to underperform



Sources: Euler Hermes, March 2013

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