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TRIP NOTES

Greece—Near-Term Tailwinds, Medium-Term Headwinds

December 2019

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Following last year's substantial official sector debt relief, Greek government bonds have strongly outperformed in 2019, and we recently returned to Athens for some first-hand perspective on Greece's recovery and bond market prospects going forward.

We found that Greece's near-term outlook remains positive with a current cyclical upswing reinforced by reform measures implemented by the newly elected center-right government of Prime Minister Mitsotakis. Although moderate slippages from the proposed fiscal targets for 2020 may occur, corporate and personal income tax cuts should boost demand, while offsetting measures will likely maintain a tight fiscal stance overall.

Progress on privatization continues and risks to financial stability are beginning to recede. Despite the banking system's precarious undercapitalization, non-performing loans have started to roll off banks' balance sheets.

However, current conditions mask deep-rooted structural bottlenecks that continue to stifle the country's productivity and competitiveness. Unless the authorities address these structural impediments in a comprehensive manner, a marked widening of the current account deficit is possible and would likely serve as a harbinger of renewed, broader macro imbalances over the medium term.

The Near-Term Outlook—Supportive for Bonds

A moderate economic recovery is underway. The economy is on track to grow about 2% this year, and growth will likely accelerate somewhat more in 2020. There are differences in the degree of optimism on next year's growth outlook: both the IMF (2.3%) and the EU Commission (2.2%) expect growth to be less buoyant than the government (2.8%). The recovery has so far been largely driven by exports and, to a lesser extent, government consumption, while household consumption and investments have remained relatively muted.

Going forward, the central bank expects a recovery in investment expenditures—since the crisis, investments have been trailing depreciation and, as a result, the capital stock has been shrinking. At this stage, however, there are signs that this negative trend is finally reversing, and the capital stock is starting to grow again (net of depreciation). Moreover, the central bank also expects modest consumption growth given that disposable income is on track to rise about 5% this year amidst much improved political stability.

As the sources for this cyclical recovery increasingly shift to domestic demand, it is also becoming less dependent on developments in the euro area, which is a clear positive considering the risks to eurozone growth that lie ahead.

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Fiscal Policy and the 2020 Budget—Tight For Now

Greece's fiscal policy, particularly its 2020 draft budget, aims to bolster growth. Finance Minister Staikouras stressed that the government is making good on its electoral promises to alleviate the tax burden, and the draft budget cuts personal income tax rates, corporates tax rates as well as the much-loathed real estate tax, referred to as the ENFIA tax. The sum of these cuts is estimated to cost €1.18 billion, or 0.6% of GDP. Moreover, the Minister suggested that the government would use any additional fiscal space to pay down more debt, in contrast to the repeated social handouts that were funded with "spare cash" during the Tsipras government. As observed in Figure 1, measures offsetting the revenue loss from tax cuts primarily rely on the tightening of the electronic transfer tax (€557 million) and the alignment of assessed property values towards market values (€142 million).

Figure 1: 2020 Draft Budget—Revenue and Expenditure Measures

Initiative	Amount (€s in millions)
Total cost of revenue and expenditure measures	1,181
Corporate income tax cut	541
Personal income tax cut	281
Allowance for newborns	123
Social security contribution cut	123
Dividend tax cut	75
VAT suspension on new buildings	26
VAT reduction select items	12
Offsetting Measures	1,189
Increased electronic transfer tax	557
Real estate tax measures	142
Revenue administration	134
Spending reductions general government entities	184
Other	172
Increased electronic transfer tax	557
Real estate tax measures	142
Revenue administration	134

Source: PGIM Fixed Income, Greek authorities.

The IMF views the authorities' projected revenue yield from the electronic transfer tax as overly optimistic. But even the IMF—much criticized on this trip for its budget pessimism—sees next year's primary surplus at a respectable 3.1% of GDP. In contrast, the European Commission deems that the GDP primary surplus target of 3.5% of GDP is realistic and continues to praise the government's swift and successful 2020 budget negotiations. The reaction of the EU Commission is somewhat surprising given that its 2020 growth forecast trails that of the Greek authorities by 0.6 percentage points. Either way, based on current policies, Greece's primary surplus is likely reach about 3% of GDP next year, which seems more than sufficient to maintain near-term budget optimism.

Further boosting the EU Commission's budget optimism is the authorities' decision to maintain their emphasis on debt reduction, at least for now. In particular, amid pushback from creditors, the Mitsotakis government decided to continue to fully allocate its receipts from the SMP/ANFA profits (€1.2 billion or 0.6% of GDP) towards debt reduction.[1] These profits refer to the gains that accrue to Eurosystem central banks on their Greek bond holdings under the SMP/ANFA programs; by political agreement, these profits are "returned" to the Greek fiscal authorities. That said, for the budgets in 2021 and beyond, the authorities are seeking an agreement that would allow them to shift the SMP/ANFA resources from debt reduction to public investment with a view to further boosting growth.

[1] *SMP refers to the Securities Market Programme and ANFA refers to Agreements on Net Financial Assets under which the Eurosystem purchased Greek government bonds.*

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However, not all of the new government's fiscal initiatives seem prudent. Most notably, the authorities decided to maintain the 13th pension payment introduced by the Tsipras government in violation of its 2016 reforms undertaken as part of the EU-IMF bailout program. Despite several earlier cuts, the costs of Greek pensions remain high both by international standards and relative to contributions.

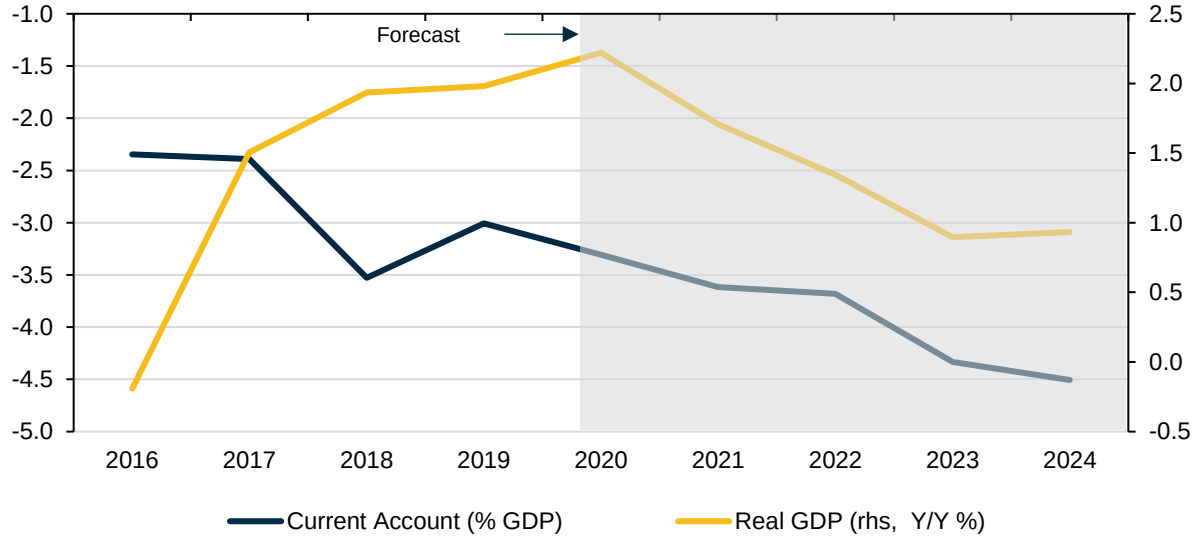
Moreover, Greece's tax base is too small and remains riddled with gaping exemptions. At €8,600, the tax-free threshold for personal income tax is too high—at this level, 52% of income earners are exempt from taxation. The IMF recommends lowering the threshold substantially to €5,600 and thereby broadening the tax base. At this lower level, the additional revenues would yield an additional 1% of GDP, according to IMF estimates. These revenues could be reallocated to fund much-needed, means-tested social programs to alleviate poverty—the Greek population remains the legacy of the country's previous abject policy failure as about one-third still lives in poverty almost a decade after the onset of the crisis.

The Medium-Term Outlook—Risk of Renewed Imbalances

Beyond Greece's cyclical recovery, its medium-term outlook remains subdued, largely given aging-related headwinds and hitherto sluggish productivity growth. The central bank estimates potential growth at 1.5%, while the IMF sees it at an even lower 0.9%. Both estimates are disappointing considering that per-capita income remains more than one fifth below its pre-crisis peak.

Regardless of which estimate will prove correct, subdued potential growth is likely to result in external imbalances. As the compression in Greek imports gives way to renewed import demand, both the Bank of Greece and the IMF see the current account deficit widening above 4% of GDP over the medium-term horizon (see Figure 2); furthermore, the IMF see a distinct risk that the deficit could rise further to 6% of GDP over the long run. In the absence of meaningful productivity-boosting reform, Greece's macro fundamentals and external financing requirements risk deteriorating anew.

Figure 2: Greece's Real GDP and Current Account Balance (% of GDP)



Source: Haver Analytics as of October 2019

The Banking System—Critical Improvements Underway, But a Long Road Ahead

The banking system remains the Achilles' heel of the Greek economy. A few data points make it abundantly clear that investing in the Greek banking system is not for the faint of heart. Non-performing loans (NPLs) remain at about €75 billion (end of June 2019), comprising nearly 44% of the sector's loan book and tantamount to a whopping 38% of GDP (see Figure 3). By now, provisions cover €40 billion of the NPLs, and while this level is vastly improved, when excluding provisions, NPLs still exceed core equity capital of €22 billion by nearly a factor of two.

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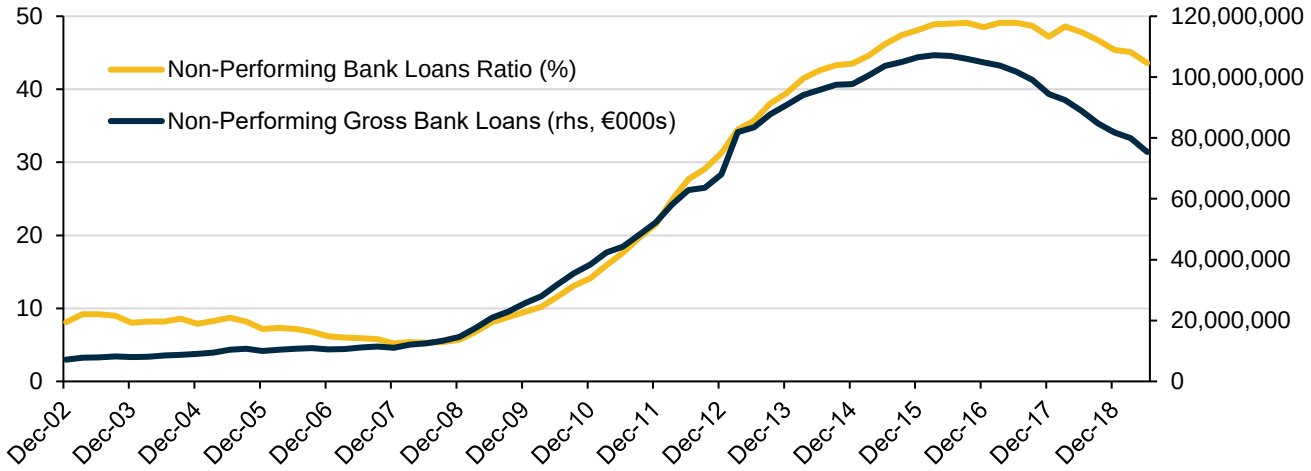
Figure 3: Greece's Non-Performing Bank Loans



Source: Haver Analytics as of June 2019.

Upon further inspection, the financial state of the Greek banking system appears even more brittle. Some four-fifths of the sector's capital is comprised of deferred tax credits (DTCs). In other words, the banking system would need to regain its footing and return to profitability for a prolonged period of time in order to "cash in" on these tax credits in order to replace the accounting capital with real cash and other high-quality assets. In the meantime, any setbacks to the sector risk crystalizing the sector's weak capital base—largely propped up by regulatory forbearance.

In the absence of such forbearance, the authorities' choices on the banking sector were between burdening the tax-payer, further adding into the government's debt overhang, or letting the system collapse, none of which were deemed palatable.

That said, the past is hindsight and progress is finally underway. The new government is finalizing its Hercules SPV scheme that is designed to remove €30 billion of NPLs from banks' balance sheets (see the accompanying box). The scheme closely resembles the GACS scheme initiated by Italy in 2016.[2] Given the close similarities, the authorities expect the EU commission to approve the plan shortly, followed by Parliamentary approval by the end of November.

If all goes well, after full implementation of the Hercules scheme, the system would still be left with a non-trivial €50 billion in NPLs. Although these magnitudes are still daunting, the banking system has so far managed to reduce its NPL burden without government intervention. From their peak level of €107 billion in early 2016, NPLs have declined by €32 billion thanks to several, smaller market-driven transactions.

This organic trend is likely to continue with or without government assistance, at least over the near term. The Greek regulator sees the economic recovery providing tailwinds to the banking system as the real estate market is rising from the ashes and improving valuations boost the collateral value (to the extent that it was not already inflated). At the same time, banking sector liquidity has vastly improved, and if banks meet the targets agreed with the ECB, the banking system-wide NPL ratio is deemed on track to decline to 20% by end-2021. A tangible improvement, yet ongoing context is required—the NPL ratio across the euro area is about 3.2%. This stark differential clearly illustrates Greece's need for consistent reform progress.

The Hercules SPV Scheme

In essence, the Hercules scheme allows banks to transfer NPLs to securitization vehicles that fund the acquired NPLs through the issuance of notes issued in tranches of different seniority.

Banks need to appoint independent servicers to optimize loan recovery and mitigate conflicts of interest. The Greek government is expected to provide a €9 billion guarantee to the senior tranche of €15 billion.

The regulator, the ECB's Single Supervisory Mechanism (SSM), still needs to assign a risk weight to this tranche, but the hope is that the government guarantee will facilitate a zero weight, although the sovereign remains at a sub-investment grade rating. In exchange for this guarantee, the banks will need to pay a fee, which is believed to be about 160 bps. Moreover, at least half of the non-guaranteed junior and mezzanine tranches will need to be placed for the government guarantee to be activated.

[2] *GACS refers to guarantee on securitization of bank non-performing loans.*

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Conclusion

With a tumultuous decade behind it, Greece's outlook presents two distinct sides. In the near term, there are numerous developments that support a positive outlook for the Greek economy as well as for holders of Greek government bonds. The economy is finally growing at a moderate pace, and the expansion will likely accelerate somewhat in 2020 on improved investment expenditures and household consumption. Furthermore, the Mitsotakis' government draft 2020 budget implements broad-based tax cuts while also maintaining a high primary surplus target, facilitating much needed debt reduction.

Yet, these achievements need to be viewed in the context of ongoing cyclical strength, as structural impediments continue to cloud Greece's medium-term outlook. In particular, subdued potential growth threatens the renewed deterioration in external balances and risks exacerbating the fragilities of the banking system that remains burdened by the legacy of the crisis and extraordinarily high NPLs. Although a continued reduction of NPLs seems probable, the magnitudes remain daunting and the risk of financial instability—and, by implication, to the taxpayer and bondholders alike—will likely remain high for years to come.

While this two-sided outlook presents near-term opportunities for investors, Greece's recovery will require ongoing monitoring given its deep fragilities.

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2019-5862

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