

How Clean is “Clean”? Greece is Aiming for a “Clean Exit” From Its Third Bailout

HETEROGENOUS ALLIANCE—GREECE AND ITS OFFICIAL CREDITORS

As the third bailout of Greece comes to an end on August 20, 2018, there is a great deal of political will to ensure that Greece achieves a “clean exit” from its adjustment program. Despite years of protracted bickering and deep-rooted mistrust, all parties to the bailout are united in this endeavor, although for starkly different reasons:

- The Tsipras government is intent on capitalizing on the end of the program and, if the political winds are deemed favorable, may call for early elections in the fall.
- The European creditors are more than ready to shift their undivided attention to post-Brexit Europe and somewhat fool-heartedly hope to finally lay to rest the controversy surrounding cross-border bailouts.
- Last but not least, the International Monetary Fund (IMF) is looking to extricate itself from one of its largest and most controversial financial engagements that intermittently teetered on the brink of default.¹

As so many times before, time pressure is building. This time, however, the looming expiration of the program carries particular weight and the August 20th deadline is indeed a hard stop. Unless the next review is completed on time, securing further funds would require the politically difficult approval of European creditors’ Parliaments.² The policy



Jürgen Odenius, PhD
Economic Counsellor
PGIM Fixed Income

*Available for professional and institutional investors only.
Your capital is at risk and the value of investments can go down as well as up.*

¹ In June 2015 Greece became the first developed country that failed to repay the IMF on time.

² A staff-level agreement was reached on May 19, 2018. Indications, however, suggest that many of the 88 prior actions have yet to be taken.

conditionality spans several politically difficult measures, including:

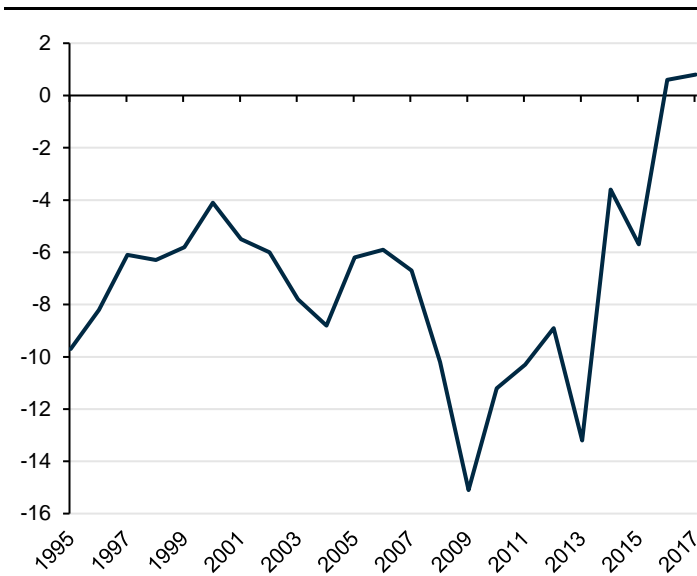
- changes to the “Katseli law” deemed necessary to limit widespread strategic defaults;
- changes to assessed property valuations and underlying unpopular real estate taxes that currently are deemed to favor lower-end properties at the expense of higher-end properties;
- recalibrating pensions and thereby once more effectively lowering benefits in line with the 2016 pension law; and
- progress with much delayed privatization projects.

At stake is a lot more than just one of the many program tranches. This third and final bailout by the European Stability Mechanism (ESM) was endowed with an overall financing envelope of €86 billion. Amidst a political crisis and protracted delays, several disbursements did not take place; as a result, the unutilized funds are a fortuitous €40 billion. The European creditors are willing to employ these funds to endow Greece with a cash buffer, while also helping to fund much needed debt relief.

THE CASH BUFFER—FOR BONDHOLDERS WITH LOVE

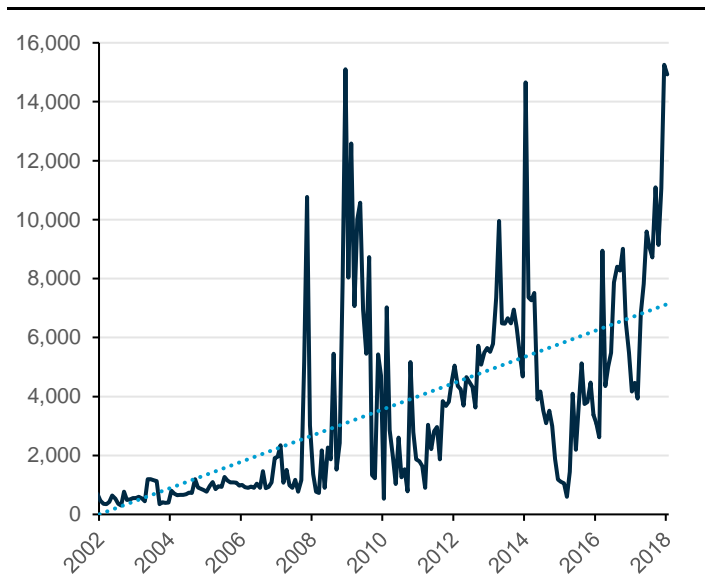
The cash buffer intends to ensure that Greece is endowed with sufficient funds to service its debts in the foreseeable future. As far as private bondholders are concerned, the Greek debt profile remains rather favorable. Leaving T-bills aside, there are no repayments due to private bondholders this year and only about €3 billion in 2019. This favorable profile, however, is just another indication of how dependent Greece has become on its official lenders. For instance, overall amortization due in 2019 is projected at €12.7 billion, of which nearly €7 billion is due to the ECB and another €2 billion is due to the IMF.

FIGURE 1.1: GREECE GENERAL GOVERNMENT DEFICIT (AS OF DECEMBER 2017, AS % OF GDP)



Source: Statistical Office of the European Communities and Haver Analytics.

FIGURE 1.2: GENERAL GOVERNMENT DEPOSITS WITH THE BANK OF GREECE (AS OF APRIL 2018 IN EURO MILLION)



Source: Bank of Greece, Haver Analytics.

Be that as it may, the Greek government is holding cash deposits with the Bank of Greece of a record €15 billion, indicative of the drastic fiscal tightening that led to a small budget surplus in 2016-2017, continued official financing, bond placements and, last but not least, arrears financing. Any “topping up” of this cash cushion by its European creditors would result in a substantial buffer, assuming a continuation of the restrictive fiscal stance. The expectation is for a final disbursement of some €11 billion, thus leaving €29 billion in ESM funds. All indications are that the European creditors are considering using these funds to refinance the ECB’s bond holdings (€13 billion), the IMF (€10 billion), and possibly refinance some of the bilateral debts that funded the initial bailout in 2011.

OFFICIAL SECTOR DEBT RELIEF—MUCH NEEDED BUT STILL CONTENTIOUS

Besides these likely steps to further improve the financing terms, progress on more sweeping debt relief appears bogged down at the highest political level over disagreements about the modalities for debt relief. Some of the creditors—especially Germany and others—feel uneasy about the potential for sudden policy reversals that could undermine the viability of the Greek finances. Those creditors prefer phasing in debt relief and make it conditional on the continued implementation of sound policies.

Regardless of Greece’s debt overhang—government debt now totals €344 billion, almost twice as high as its GDP—the immediate future looks bright for bondholders. Key risks, besides rapid and far reaching policy reversals, are early elections and the potential for political instability. Even if Prime Minister Tsipras refrains from calling early elections to capitalize on the “clean exit” narrative, the Presidential elections in January 2020 are likely to trigger early elections, as they did last time in 2015. Parliament is unlikely to muster a three-fifth majority that is required to elect a President; failure to do so would trigger early Parliamentary elections. Above and beyond these near-term challenges, the most oppressing of all is the need for a comprehensive and sustainable policy platform to boost growth. On current indications, we refrain from optimism.

NOTICE: IMPORTANT INFORMATION

Source(s) of data (unless otherwise noted): PGIM Fixed Income as of June 8, 2018.

PGIM Fixed Income operates primarily through PGIM, Inc., a registered investment adviser under the U.S. Investment Advisers Act of 1940, as amended, and a Prudential Financial, Inc. ("PFI") company. PGIM Fixed Income is headquartered in Newark, New Jersey and also includes the following businesses globally: (i) the public fixed income unit within PGIM Limited, located in London; (ii) PGIM Japan Co., Ltd. ("PGIM Japan"), located in Tokyo; and (iii) the public fixed income unit within PGIM (Singapore) Pte. Ltd., located in Singapore. Prudential Financial, Inc. of the United States is not affiliated with Prudential plc, which is headquartered in the United Kingdom. Prudential, PGIM, their respective logos, and the Rock symbol are service marks of PFI and its related entities, registered in many jurisdictions worldwide.

These materials are for informational or educational purposes only. The information is not intended as investment advice and is not a recommendation about managing or investing assets. In providing these materials, PGIM is not acting as your fiduciary as defined by the Department of Labor. These materials represent the views, opinions and recommendations of the author(s) regarding the economic conditions, asset classes, securities, issuers or financial instruments referenced herein. Distribution of this information to any person other than the person to whom it was originally delivered and to such person's advisers is unauthorized, and any reproduction of these materials, in whole or in part, or the divulgence of any of the contents hereof, without prior consent of PGIM Fixed Income is prohibited. Certain information contained herein has been obtained from sources that PGIM Fixed Income believes to be reliable as of the date presented; however, PGIM Fixed Income cannot guarantee the accuracy of such information, assure its completeness, or warrant such information will not be changed. The information contained herein is current as of the date of issuance (or such earlier date as referenced herein) and is subject to change without notice. PGIM Fixed Income has no obligation to update any or all of such information; nor do we make any express or implied warranties or representations as to the completeness or accuracy or accept responsibility for errors. **Your capital is at risk and the value of investments can go down as well as up. These materials are not intended as an offer or solicitation with respect to the purchase or sale of any security or other financial instrument or any investment management services and should not be used as the basis for any investment decision. No risk management technique can guarantee the mitigation or elimination of risk in any market environment. Past performance is not a guarantee or a reliable indicator of future results and an investment could lose value. No liability whatsoever is accepted for any loss (whether direct, indirect, or consequential) that may arise from any use of the information contained in or derived from this report. PGIM Fixed Income and its affiliates may make investment decisions that are inconsistent with the recommendations or views expressed herein, including for proprietary accounts of PGIM Fixed Income or its affiliates.**

The opinions and recommendations herein do not take into account individual client circumstances, objectives, or needs and are not intended as recommendations of particular securities, financial instruments or strategies to particular clients or prospects. No determination has been made regarding the suitability of any securities, financial instruments or strategies for particular clients or prospects. For any securities or financial instruments mentioned herein, the recipient(s) of this report must make its own independent decisions.

Conflicts of Interest: PGIM Fixed Income and its affiliates may have investment advisory or other business relationships with the issuers of securities referenced herein. PGIM Fixed Income and its affiliates, officers, directors and employees may from time to time have long or short positions in and buy or sell securities or financial instruments referenced herein. PGIM Fixed Income and its affiliates may develop and publish research that is independent of, and different than, the recommendations contained herein. PGIM Fixed Income's personnel other than the author(s), such as sales, marketing and trading personnel, may provide oral or written market commentary or ideas to PGIM Fixed Income's clients or prospects or proprietary investment ideas that differ from the views expressed herein. Additional information regarding actual and potential conflicts of interest is available in Part 2A of PGIM Fixed Income's Form ADV.

In the United Kingdom and various European Economic Area ("EEA") jurisdictions, information is issued by PGIM Limited with registered office: Grand Buildings, 1-3 Strand, Trafalgar Square, London, WC2N 5HR. PGIM Limited is authorised and regulated by the Financial Conduct Authority of the United Kingdom (Firm Reference Number 193418) and duly passported in various jurisdictions in the EEA. These materials are issued by PGIM Limited to persons who are professional clients or eligible counterparties for the purposes of the Financial Conduct Authority's Conduct of Business Sourcebook. In certain countries in Asia, information is presented by PGIM (Singapore) Pte. Ltd., a Singapore investment manager registered with and licensed by the Monetary Authority of Singapore. In Japan, information is presented by PGIM Japan Co., Ltd., registered investment adviser with the Japanese Financial Services Agency. In South Korea, information is presented by PGIM, Inc., which is licensed to provide discretionary investment management services directly to South Korean investors. In Hong Kong, information is presented by representatives of PGIM (Hong Kong) Limited, a regulated entity with the Securities and Futures Commission in Hong Kong to professional investors as defined in Part 1 of Schedule 1 of the Securities and Futures Ordinance. In Australia, this information is presented by PGIM (Australia) Pty Ltd ("PGIM Australia") for the general information of its "wholesale" customers (as defined in the Corporations Act 2001). PGIM Australia is a representative of PGIM Limited, which is exempt from the requirement to hold an Australian Financial Services License under the Australian Corporations Act 2001 in respect of financial services. PGIM Limited is exempt by virtue of its regulation by the Financial Conduct Authority (Reg: 193418) under the laws of the United Kingdom and the application of ASIC Class Order 03/1099. The laws of the United Kingdom differ from Australian laws.

© 2018 PFI and its related entities.

2018-2489