Photograph Courtesy: Ed Yourdon

GREECE IMPASSE:

Can Europe Bear Greece's Future?

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IMF, ECB and European Commissions' cautionary stance and G7 Summit's uncertainty spell trouble for Greece.

Greece is still in trouble. It had been progressing well on its fiscal and labor fronts, until now. Recent risks emerging in its banking system and the impending payments in June have made the country seek extensions through a debt relief program with its Eurozone creditors.

The bigger concern is that if the Greek economic conditions had been deteriorating when repayments are due, why the concerned parties failed to reach a deal with time on hand?

IMF, ECB and European Commission did not recognize reforms implemented by Greece so far. Moreover, the country has been unstable in committing itself to the reforms suggested by its Eurozone creditors. Some of such creditors, thus, have ignored whatever headway made by Greece and have been fixated at its current ability to repay. These factors, we believe, have led to the impasse.

If both sides continue to take a tough, myopic stance by grossly underestimating the full intensity of a default and exit, regional as well as global stability could potentially be at risk.

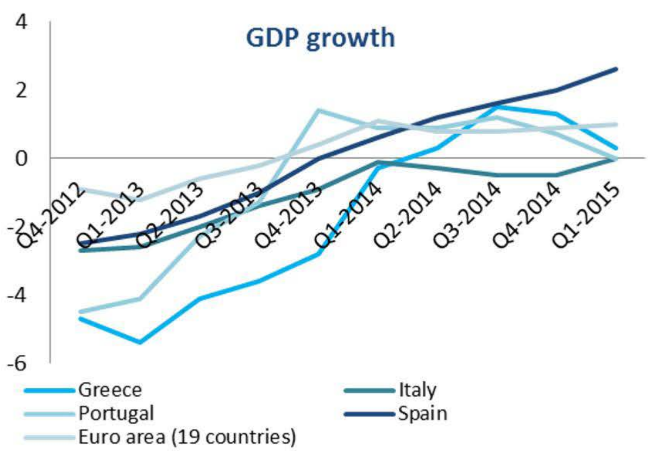
To break the gridlock, we believe that Eurozone creditors must acknowledge the adjustments made by Greece and focus on arriving at an extension, conditionally, which would allow Greece to continue its slow, sustainable recovery.

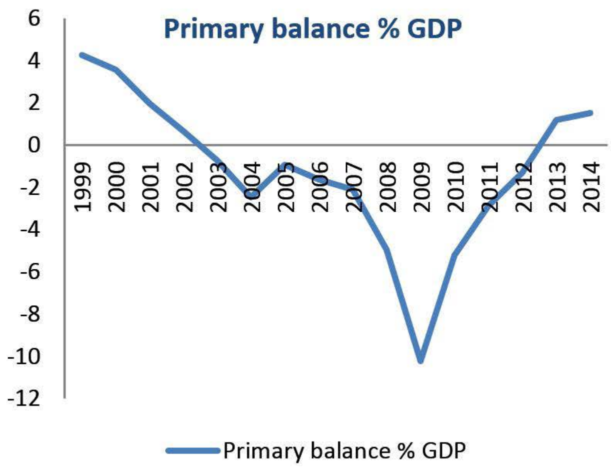
While the G7 finance summit resulted in no concrete deal with creditors, the fresh proposal submitted in Brussels G7 summit with the heads of state could lead to a breakthrough. This would prevent Greece from defaulting, while buying time to reach a stage where investors will be willing to lend afresh to the ailing economy.

Encouraging Greek performance in 2014

In its 2014 interim report on monetary policy the Bank of Greece declared that its economy grew for the first time in six years. The last three quarters of 2014 were particularly encouraging, with Greece and the Eurozone growing an average 0.8% and 0.9%, respectively (Eurostat). Some austerity measures that Greece adopted in return for assistance from creditors were bearing fruit. For example, unit labor costs fell substantially in 2014, increasing the economy's cost competitiveness by 20%. Moreover, following intense deliberations, Eurozone finance ministers agreed on another extension of the current debt-relief program by four months, which will expire on June 30.

Commendable Greek recovery in 2014; continued drive to achieve a surplus





Source: Eurostat, IMF

Yet, IMF is concerned

In May, the IMF highlighted its disagreement with the government on several issues. This includes the fiscal deficit target of 3%, which the IMF finds unrealistic. However the concern may not be entirely justifiable, given that Greece reduced its fiscal deficit from 12.3% in 2013 to 3.5% last year, mainly through severe expenditure cuts. The IMF expressed its apprehensions over Greece's ability to continue with structural reforms in the labor market and pension system.

Both these areas of reforms are politically sensitive and have been seen as "Red Lines" the Greek government would not want to cross. But adjustments in the labor market have indeed been made; and taking into consideration the long term, not just imminent repayments, the adjustments in the labor market cannot be disregarded. The same goes with fiscal consolidation; expenditure cuts may work now, but in the interest of sustainable, long-term recovery, reforms need to focus on rebuilding a solid revenue base. Greece's finance minister recently stated that the primary reason for an extended delay in reaching an agreement is the focus on attaching strings to the next liquidity injection rather than the country's sustainable recovery.

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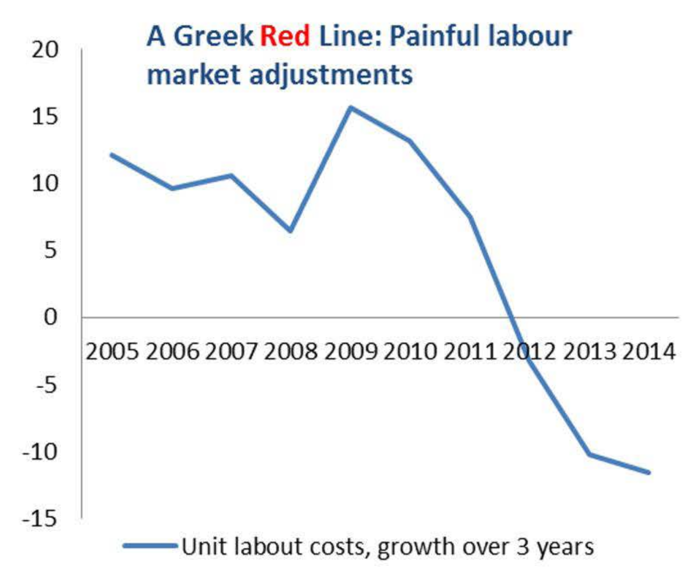

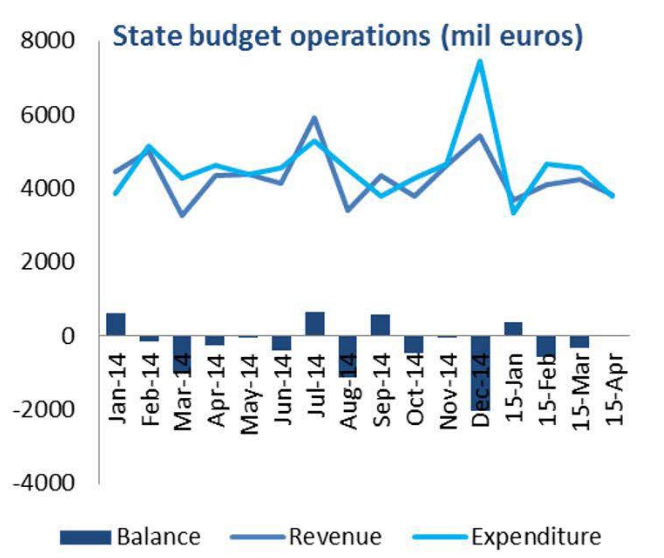

Source: Eurostat, Ministry of Finance, Greece

ECB lifts waiver for Greek banks, creates run-like situation on Greek banks

In February, the ECB unexpectedly lifted the waiver on Greek banks' ability to access ECB's cheap liquidity through the use of Greek government bonds as collateral, even though they did not meet minimum credit rating requirements. While liquidity would now flow to the banks through the Bank of Greece's emergency liquidity assistance (ELA), it is going to reflect substantially higher costs for these banks. The interest on ELA is 1.55%, while ECB's facility carried a rate of 0.05%.

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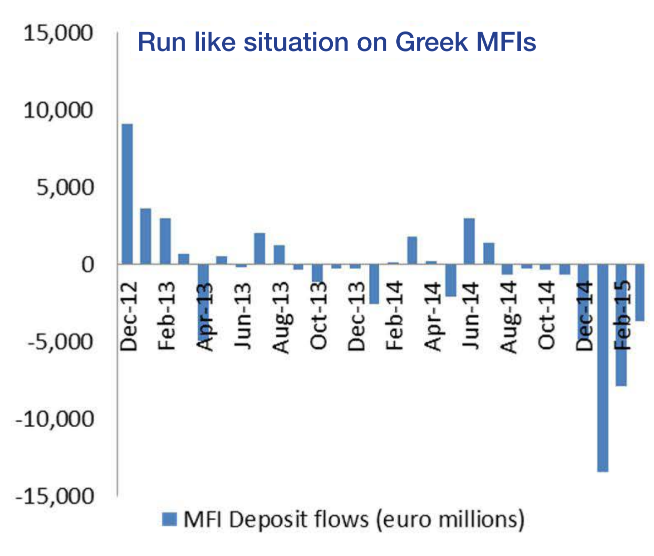
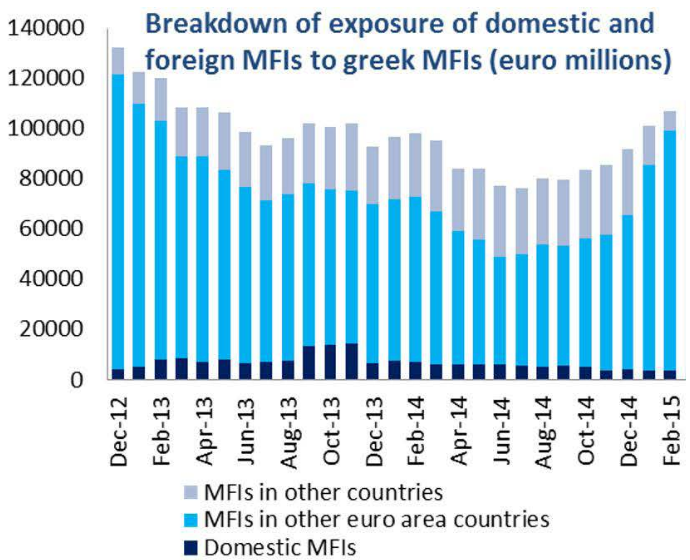
Greek banks were already battling deposit flight and high NPLs; this move has exacerbated the situation, creating run-like scenarios to deepen. The IMF noted a deposit flight of around €40 billion since December 2014.

There is however a growing view that holds the inaction by Greece with regard to capital controls as a tool that Greece used to boost its negotiating powers with creditors. Either way weakness in the banking system can create a whole new fragility to deal with, no side really benefitting in the end.

Run-like situation and exposure of Eurozone creditors to Greek monetary financial institutions (MFIs)





Source: Bank of Greece

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Repayments due in June; dire need for decision on extension

Between June 5 and June 19, Greece is supposed to have paid the IMF about €1.5 billion and 1.23 billion SDR. Amid dissent within the ruling left-wing party, where support for default and exit is growing, it had become increasingly important for authorities to express confidence in being able to reach an agreement on debt relief before end–of June. However, no deal being in sight the only course of action left was to delay these payments. The four payments due in June will be paid in lump-sum at the end of June. Most of the efforts now are being directed towards convincing creditors that debt relief is very crucial, and that the €7.2 billion that form the last tranche of the current program should be unlocked.

Greece's counter to the troika's proposals

Greece presented in Brussels its debt restructuring proposal which states that achieving the 3% deficit target is well within reach, provided the focus is on achieving positive nominal growth which it seeks to achieve through measures that facilitate financing of private sector investment spending. Even at the current 175% debt-to-GDP, if a medium term nominal growth of 3% is assumed, the benchmark deficit beyond which debt becomes unsustainable is 5.25%. Hence according to Greece's proposal the 3% target is not unreasonable. Also, keeping in mind the interest payments it owes, the effective primary surplus must be maintained at around 2.5%.

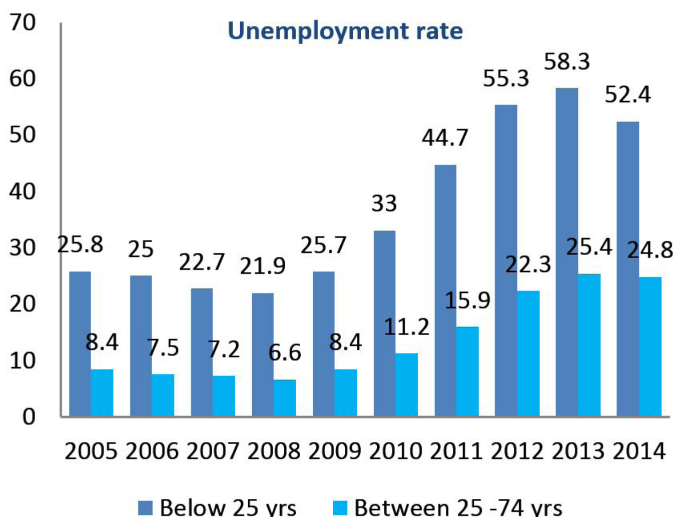
The proposal also states that to bring the debt ratio down to more sustainable levels, interest rates will have to come down significantly. This is at the heart of the restructuring proposal, and an important reason for the current deadlock. The use of debt swaps is suggested that can help creditors lock in the current low rates into much longer maturities. To this end, transforming the debt under the Greek Loan Facility program into perpetual bonds and linking interest payments to nominal growth have been put forward.

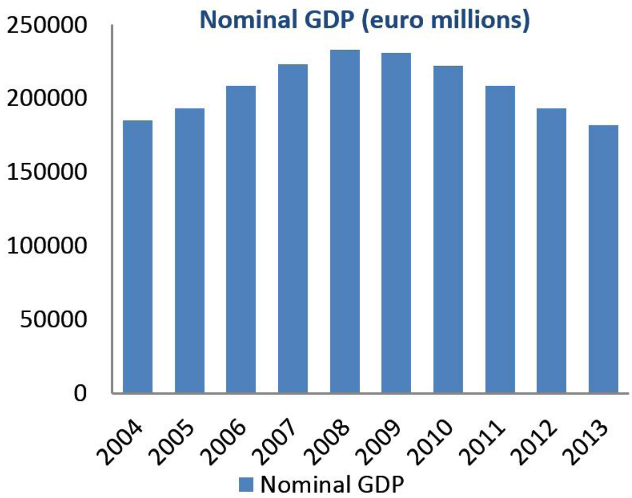
We believe debt relief is extremely critical to buying of time for Greece so that it can focus on stimulating private sector growth and investment. At the same time since Greece is to a limited extent willing to address issues related to reforms in return, it would be imperative for both sides to scrutinize the impact so far, before mistakes are repeated in the name of reforms.

It is crucial for creditors to recognize how painful it is to maintain a surplus when nominal GDP has been shrinking in order to stabilize the debt ratio.

In particular it is crucial for creditors to recognize how painful it is to maintain a surplus when nominal GDP has been shrinking in order to stabilize the debt ratio. If positive growth is achieved, a deficit is feasible while maintaining the debt ratio at sustainable levels.

Scrutinizing the impact of reforms, did they make things worse?





Source: Eurostat

Possibility of default and exit looms over the global economy

Grexit (Greece's Exit) could have considerable global ramifications, but the extent or intensity is uncertain. The financial stability review released by ECB in May 2015 notes that market reactions to developments in Greece have been muted thus far. However, the report warns that a failure to reach a quick agreement can increase risk premiums for other vulnerable Eurozone sovereigns. In the past few days, the US also seems to have expressed its worry over Euro creditors' apparent overconfidence on the limited impact a Greek default or exit could have. The Federal Reserve's decision to raise rates this year will factor this in, magnifying global interconnections and making uncertainty surrounding rising of rates in the US more pronounced.

If an agreement is not reached and Grexit does become a reality, it would derail, at least in the short term, the whole region's attempts to escape low inflation and sluggish growth. Some believe that a Grexit and eventual devaluation of drachma may be in favor of Greece, creating exports as the growth engine in the long run. But if this hypothesis were truly what the two sides subscribed to, there would be no impasse.

We stress on the significance of immediate debt relief, as well as the dire need to avoid making past mistakes with reforms. But given the history Greece has had with its debt levels, we do believe that unless the underlying system of benefits that the Greek citizens have been accustomed to changes drastically, little else will, whether Greece is going on the path to reform as a member state or going it alone with a devalued currency.

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