Cologne, November 30, 2012

Flash Update

Greece: Restructuring avoided – at least for now

Generali Investments Europe Research

The compromise between the Eurogroup, the ECB, and the IMF about the disbursement of the next tranche on November 26 prevented a threatening default of Greece. Although the measures did not come as a surprise, financial markets breathed a sign of relief. The IMF was not able to enforce a haircut of Greek debt as European politicians balked at a second restructuring.

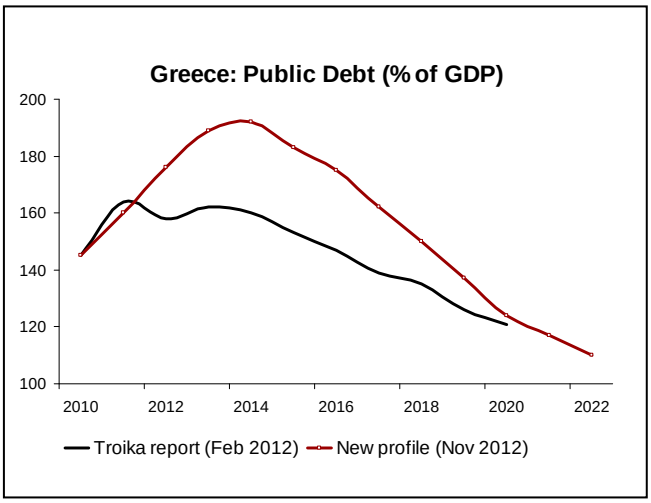
The long-term sustainability of the Greek debt situation was not tackled adequately. Hence, in light of too optimistic assumptions we expect the financing of the Greek program to come up again further down the road. However, the commitment by European politicians shows that the threshold of an EMU exit of Greece could be higher than currently assessed by financial markets.

Indeed, while the agreement gives Greece some time, negative headlines could even occur as soon as in the first months of 2013. The implementation of reform steps as well as negative headlines with respect to the economic and political situation have the potential to keep markets on their toes.

At a third attempt an agreement on Greece was reached last Monday and opened the way for the disbursement of a € 43.7 bn tranche. The first part of around € 34 bn will be paid out in December and the final part in three sub-tranches during the first quarter of 2013 linked to the implementation of the Memorandum of Understanding (MoU). Hence, our expectation of an avoidance of a Greek default in the near term materialized. However, the financing gap of up to € 40 bn until 2016 which emerged due to the deeper than expected recession, the postponement of the deficit reduction target by two years and lower privatization revenues is not completely closed.

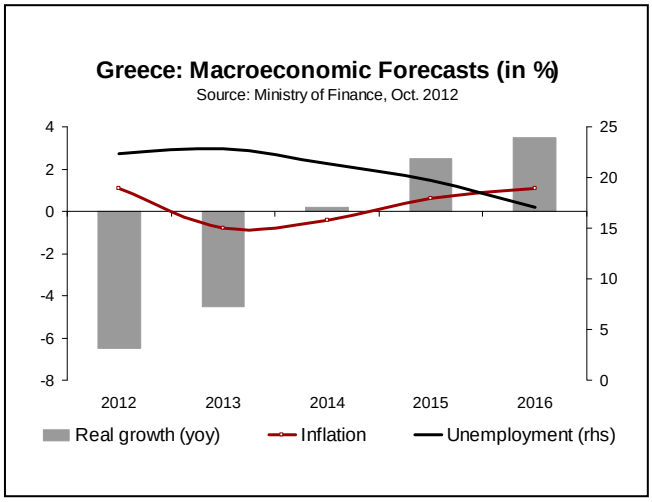
Features of the agreement

The statement released after the meeting outlined the main elements of the compromise between the Eurogroup, the ECB, and the IMF. All measures were discussed beforehand and did not surprise market participants. First, interest rates will be reduced and maturities will be extended. The rate on loans provided in the Greek Loan Facility (bilateral loans) will be lowered by 100 bps. Guarantee fee costs on the EFSF loans will be lowered by 10 bps. Moreover, the maturity of bilateral and EFSF loans will be extended by 15 years and interest payments on EFSF loans will be deferred by 10 years. In particular the deferral on EFSF loans is meaningful. All in, these elements sum up to around € 16 bn until 2016. Second, the profits on Greek SMP holdings will be transferred to Greece via governments. While the ECB is not forced to a restructuring of its bonds, the additional revenues of around € 11 bn due to purchases below face value will be passed in the years to come. Third, a possible implementation of a debt buy-back program was welcomed. While it is not clear which institution will provide the necessary funds (probably the EFSF), it is reported that around € 10 bn will be spent to buy back Greek sovereign debt at discounted market prices. Assuming an average price of around 35% - which is well above the current price - Greece can purchase a face value of up to € 30 bn. If carried out successfully, this implies a reduction of the debt-to-GDP ratio of nearly 10 pp and an annual financing relief of around € 0.6 bn.



The compromise does not include a restructuring of public debt as demanded by the IMF. The core countries (in particular

Germany) successfully resisted a haircut at this point in time. However, this decision was not mainly an economic issue as a haircut in the future was not excluded but driven by political considerations (a new parliament will be elected in Germany in September 2013 and the ruling coalition wanted to avoid the impression of too much resilience). It is said that once Greece will reach an annual primary surplus further measures will be considered (possibly as early as 2013). This already indicates the willingness to seriously discuss a restructuring of public debt further down the road.



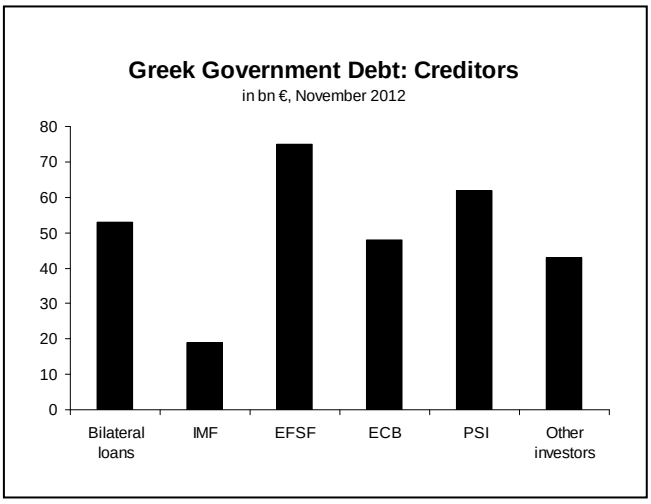
According to the statement released by the Eurogroup these measures should reduce the debt ratio to 124% by 2020. This is a little above the ratio agreed on in March and above the threshold the IMF called for. To meet the IMF's demands it was stressed that the aim is to reduce the ratio further to a level below 110% until 2022.

Calmer waters for now, but …

The agreement reduces pressure on Greece significantly and means a major step forward. The government will use the tranche to normalize its cash flow and recapitalize its banking sector. What is more, the agreement shows that European politicians still want to avoid a Greek exit. To secure this, they even exceeded red lines. For the first time, this agreement is not just granting guarantees for Greece, but it implies giving up claims on interest. This should not be seen as a selfless behavior but as the fear of a precedent for an EMU exit and the potential negative economic and financial consequences. Anyway, the compromise offers an opportunity to implement the reform steps to achieve a more sustainable growth path and to continue on the path of consolidation. In this respect, it should be noted that there are some encouraging signs. For the first time since 2004, the 3-month moving average of the current account moved in positive territory (around € 1 bn/mth). However, the undeniable improvement is mainly due to a drop in imports and is only to a small extent triggered by higher exports. This shows that Greece still has a long way to go to restore its competitiveness. In addition, Greece achieved a significant deficit reduction. While the government budget deficit until October was at € 21.1 bn in 2011, this has come down to € 12.3 bn this year. Although there are some unpaid arrears, the reduction is noticeable. Going forward, the budget deficit will take center stage even more as before as a primary surplus is seen as a precondition for further assistance (including a debt restructuring).

… more trouble ahead

Nevertheless, it is clearly too early to sound all clear. First of all, as usual there remain implementation risks. National procedures (e.g. parliamentary approval) will have to be completed before the formal decision on the disbursement can be taken. Moreover, the financing of the debt buy-back is not secured yet and the success is not guaranteed either. Prices have already rallied to an average of just below 30% which is above the base the Eurogroup indicated. The Eurogroup intends to base the tender on November 23 bond prices. Indeed, even at 35% Greece can still reduce its debt ratio by nearly 10 pp. However, the participation of Greek banks implies further write downs and, hence, an even higher recapitalization need for Greek banks. Finally, the IMF stressed that its participation in the continuation of the program is conditional to a successful implementation of the buy-back.



Moreover, the disbursement of the subtranches in the first quarter 2013 is linked to the implementation of the MoU. Given the recent experience, an incomplete implementation cannot be ruled out and, hence, tough negotiations will keep financial markets on their toes. While we expect that the tranches will ultimately be disbursed, negative headline risks will most likely continue to burden markets in the months to come.

The most important reservation is the too optimistic economic assumptions underlying the forecast decrease of the debt-to-GDP ratio until 2022. A return to positive growth rates in 2014 and a peak in the unemployment rate already in 2013 appear unrealistic. So far, the expected bottoming out of the Greek economy is just wishful thinking. All leading indicators still point to a continuation of the recession. Hence, the currently estimated resources can quickly turn out as too low and loopholes will have to be filled again. By that date at the latest, a second restructuring will be on the table again. In view of the fact that official creditors hold the majority of Greek debt (currently more than 60%, to increase further in the future) an involvement of the public sector appears unavoidable.

Conclusion

The compromise paved the way to the disbursement of the next tranche, thereby preventing a default of Greece in the weeks to come. This buys time for Greece and is positive news for financial markets – although all measures were discussed beforehand and the prevention of a default was expected. What is more, the agreement can be seen as a strong commitment by European politicians to keep Greece in the EMU. Hence, a Greek exit in the years to come is more unlikely now.

However, this should not be confounded with a lasting stabilization of the crisis. The underlying problems of Greece are still unresolved and the long-term sustainability of the Greek debt situation remains highly questionable. Hence, a default or another haircut should be off the table for now but market participants should prepare for further negative headlines with respect to the economic situation of Greece, lagging implementation of reform measures, and social unrest.

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Issued by:
Generali Investments Europe Research Department
Cologne, Germany · Trieste, Italy
Tunisstraße 19-23, D-50667 Cologne
Version completed on:
November 30th, 2012
Sources for charts and tables:
Thomson Reuters Datastream, own calculations

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