Economics

June 26, 2015

CARE Ratings
Professional Risk Opinion

Perspective on Greece Default

Greece is once again in the midst of controversy with a default looking likely to the IMF to the extent of € 1.5 bn which looks unlikely to be serviced by 30th June 2015 unless negotiations enable the same. The IMF has stated that it will not allow any more extensions or waivers. The euro zone holds € 7.2 bn of the bailout money for Greece which is not being released unless the government is willing to make credible reforms – which can be read as being expenditure cuts. A default can lead to an exit of Greece from the euro system, but even as it sounds logical, the ramifications are many as European banks have lent heavily to this country. Besides, it will also create a stir in similarly placed countries which are larger in size than Greece. Therefore, the finale of this story as it unwinds towards the end of the month is critical globally. Tuesday the 30th of June will be an important date on our calendar.

Background

Greece one of the member countries of euro zone has been in economic turmoil since 2009. After the biggest restructuring of debt with private sector the country successfully reduced its debt burden from € 355 billion in 2011 to € 280.4 billion in 2012. The country revived its economic growth decline after six years in 2014 with improved economic outlook as well easing unemployment rate. However, it once again has gone into recession in 2015 with higher probability of defaulting on debt with its bailout expiry date approaching at the end of June 2015. The slowdown in growth has been the result of the austerity programme that had to be pursued by the government under the terms of bailout.

The report thus gives a detailed insight into the Greece's current state of the economy and its ongoing debt crisis.

Economy

The economy indicated an improved outlook in 2014 with GDP size of about $238 billion. Its share in GDP of the euro countries is very low at a little less than 2%. However, the economy witnessed a decline of - 0.2% growth in its first quarter of 2015.

- The services sector contributing about 80.6% remains to be the largest contributor followed by industry (15.9%) and agriculture (3.5%).
- Inflation continued to be negative registering -2.1% in May 2015 while its unemployment rate stood at 25.6% in March 2015.
- In terms of trade, exports contracted by -1.3% during 2014 while imports increased by 2.1%.
- The forex reserves stood at $7.52 billion as of March 2014.
- Public debt was 317.09 billion euros in 2014 while budget deficit stood at 3.5% of GDP.

Greece debt crisis and the bailout programme –

Greece signaled the beginning of debt crisis in late 2009 triggered by the turmoil of great recession and the structural weakness in the Greek economy coupled with decade long persistence of high structural deficits. The debt to GDP ratios surged from 109% in 2008 to 146% in 2010 following which the country was downgraded to junk bond status. The present ratio is 173% of GDP.

In an attempt to rescue Greece from sovereign default and cover its financial needs the European countries, European Central Bank (ECB) and International Monetary Fund (IMF) launched bailout loan of a 110 billion euros with subject to certain terms and conditions on 2nd May 2010. These conditions included

- implementations of austerity measures,
- structural reforms and
- Privatization of government assets.

The situation continued to worsen with delayed implementation of the terms agreed upon by the Greek government following which a second bailout amounting to € 130 billion was extended to Greece in February 2012.

- This programme also included a bank recapitalization package of € 45 billion.
- In addition, all the private creditors which held Greek government bonds were directed to accept extended maturities, lower interest rates and a certain percent of loss in face value.

The aggregate bailout package of 240 billion euros was to be transferred in regular tranches from May 2010 to December 2014. However, in December 2012 with conditions deteriorating further and the continuous delay in implementation of the conditions the troika[1] decided to provide a last round with significant debt relief measures along with International Monetary Fund (IMF) extending an additional aid of € 8.2 billion to Greece to be transferred during the period January 2015 to March 2016.

Mr Tsipras' government

In the midst of the bailout programme, in December 2014 the Greek parliament called for premature parliamentary election which subsequently led to formation of Syriza-led government. The government which then came into power refused to accept the terms of the current bailout agreement. The election campaign was run on the stance that Greece should not bend back to the creditors and that the days of austerity would end. With rising political uncertainty, the troika decided to suspend the remaining aid to Greece until it either accepted the original terms of the bailout or mutually reached an agreement with its public creditors. The Euro group then granted a technical extension of its bailout programme for four months with renegotiations before the end of April 2015 in order to complete the last transfer of funds before June 2015. However, the renegotiations continue to remain pending till date in June 2015.

The government on its part has spoken of increasing taxes and increasing the retirement age for government officials. But the tougher issues are:

- cut back on expenditure
- spend less on pensions,
- raise more money from sales taxes,
- Scale back a planned tax increases on business.

Where have the renegotiations reached?

The Greece's bailout is approaching its expiry date with only four days remaining following which a payment to the IMF falls due. However, as indicated by the Euro area finance ministers who continue preparing for lengthy

[1] The parties offering the bailout programme-European countries, European Central Bank and International Monetary fund were nicknamed as troika.

negotiations it appears that more time will be required to make a workable deal for Greece as a breakthrough on the conditions attached to the aid that remained unresolved.

At present, Greece needs additional financial aid to prevent it from defaulting on its € 1.6 bn debt to the IMF. The international creditors have rejected the Greek government's plan to prevent financial crisis and release funds without implementation of additional reforms. Alternatively, they have submitted counter proposals. In the meetings and discussions of Greece's Prime Minster with the heads of European Commission, the IMF, the ECB and euro zone finance misters, there has been no consensus reached so far. The issues that still remain unsettled were the labor laws, collective bargaining, pension reform, and public sector wages, opening up of closed professions, investments as well as VAT and corporate income tax.

Ahead of the Greek bailout expiry on June 30, the European leaders are due to conduct a two day summit in Brussels starting 25th June 2015, which could go to the 27th. In absence of any optimistic views of the European leaders and their lengthy ongoing discussions indicate that default of Greece on its repayments to IMF is likely to go through. In addition, the international creditors have also demanded politically sensitive amendments in tax and reforms proposals which have added more uncertainty in averting a debt default.

The counter view

Greek Prime Minster updating on the latest developments has stated that the non –acceptance of equivalent measures has never happened before neither in Ireland and nor in Portugal. He also pointed out that this strange stance could be hiding one of the two things - either they don't want a deal or they are serving certain interest in Greece.

What could be the Implications if Greece defaults?

- The default could a trigger a bank run, capital controls and an eventual Greek exit from the Euro zone showing that membership of the currency is not irrevocable as its founders intended. Consequently, Greece will have to go back to its old currency Drachma which would be heavily devalued.
- In turn, the devaluation of the currency though would aid in increasing exports the country being import oriented the devaluation of currency will have an adverse impact on its imports.
- In addition, the country could have major internal problems as interest rates would spike on account of growing liquidity constraints which will have an adverse impact on growth and add to a rise in rate of unemployment. Besides, the country is likely to make continued payments towards public pensions and salaries impossible in euro.
- In case of demands of the creditors not being accepted, they are likely to suffer heavy losses.

Contact:

Madan Sabnavis
Chief Economist
madan.sabnavis@careratings.com
91-022-67543489

Jyoti Wadhwani
Associate Economist
jyoti.wadhwani@careratings.com
91-022-6144 3518