OBSERVATION
TD Economics

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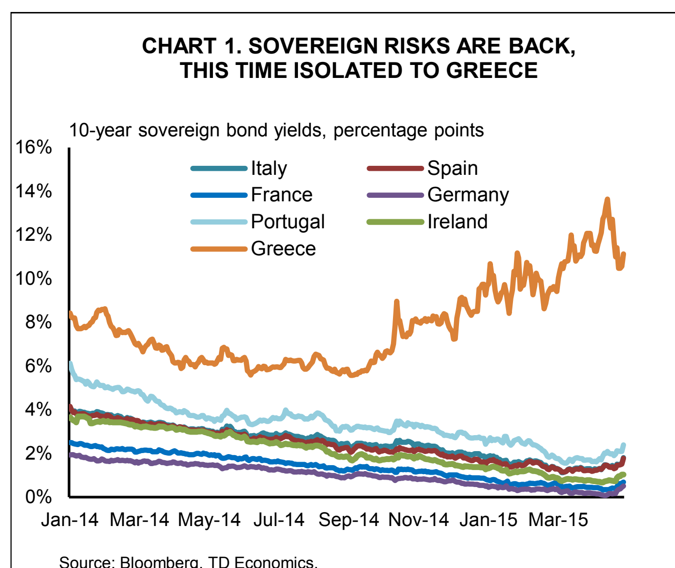
THE GREEK BAILOUT SAGA CONTINUES

Highlights

- The Greek bailout saga has continued to make headlines over the past few weeks, contributing to heightened market volatility. Greece has several upcoming debt payments, including very significant ones to the ECB in July and August, suggesting that the window for negotiation is rapidly narrowing.
- While slashing spending and raising revenue at all costs has allowed Greece to continue servicing its debt, including a €200mn payment to the IMF this week, operating a budget in this manner can only go on for so long. As a result, there is an increased probability that without access to the remaining bailout funds, Greece is running out of runway to pay its upcoming debt obligations.
- A missed payment on an obligation to the IMF or ECB is unlikely to trigger an immediate exit from the euro area. However, the ECB could begin to restrict liquidity funding to Greek banks, suggesting only a short period thereafter in which an agreement could be reached.
- Ultimately, TD Economics continues to believe that an agreement will be reached between euro area creditors and the Greek government. Although there are ups and downs, recent overtures by the Greek government point to the desire for an agreement with its European creditors, an outcome supported by polls of the Greek population.

The Greek bailout saga has continued to lead to periodic bouts of volatility over the past few weeks. Lately, the Greek central government has resorted to increasingly desperate measures to raise funds, such as collecting cash from state-owned corporations, withholding funding for hospital supplies and forcing local governments to hand over all non-immediately required cash. While slashing spending and raising revenue at all costs has allowed Greece to continue servicing its debt payments, including a €200mn payment to the IMF this week, operating a budget in this manner can only go on for so long. As a result, there is increased speculation that without access to the remaining bailout funds, Greece will be unable to meet its upcoming debt obligations. With little progress seemingly being made in negotiations with EU creditors, we are now in a new period of acute brinkmanship.



Overall, TD Economics continues to believe that an agreement will be reached between euro area creditors and the Greek government. Prime Minister Tsipras recently reshuffled his bailout negotiation team with a new individual to handle day-to-day negotiations in Brussels instead of the contentious finance minister, Varoufakis. This suggests a desire on Greece's

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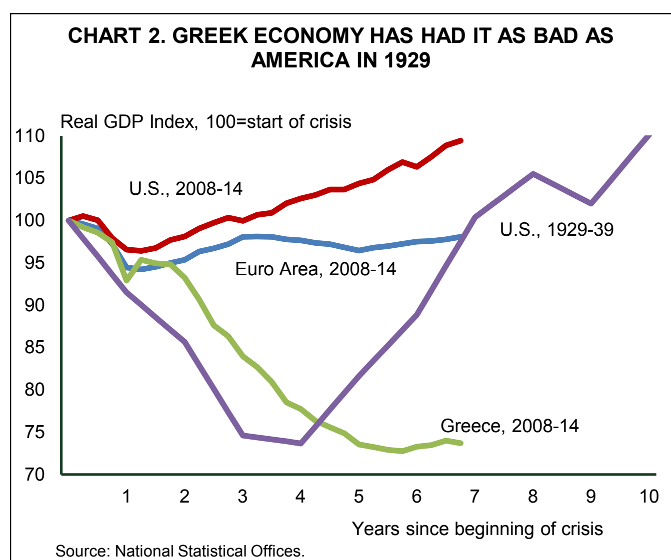


part for an amicable resolution. Moreover, polls continue to show a large majority of Greeks want to stay in the euro area and see a deal with creditors as benefitting Greece. This puts pressure on the government to strike a deal and it also provides some political cover for doing so.

Nonetheless, the negotiations are likely to be bumpy and the risks of Greece missing a debt payment and imposing capital controls remain elevated. Here we examine how Greece got here, what lies ahead, and some of the possible risks.

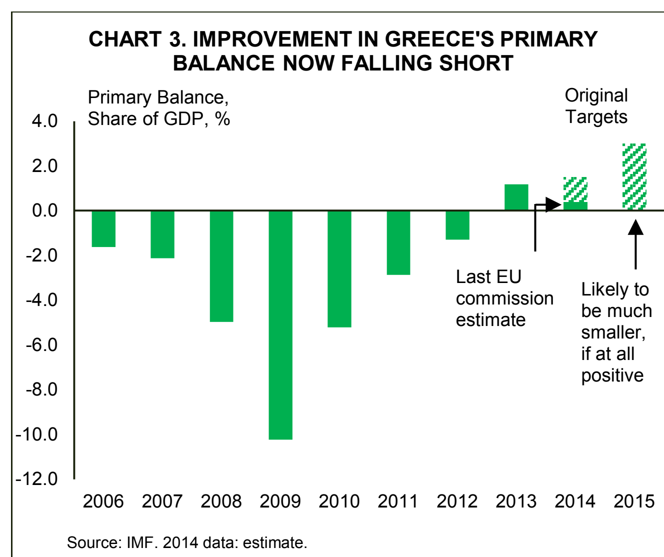
How did we get here?

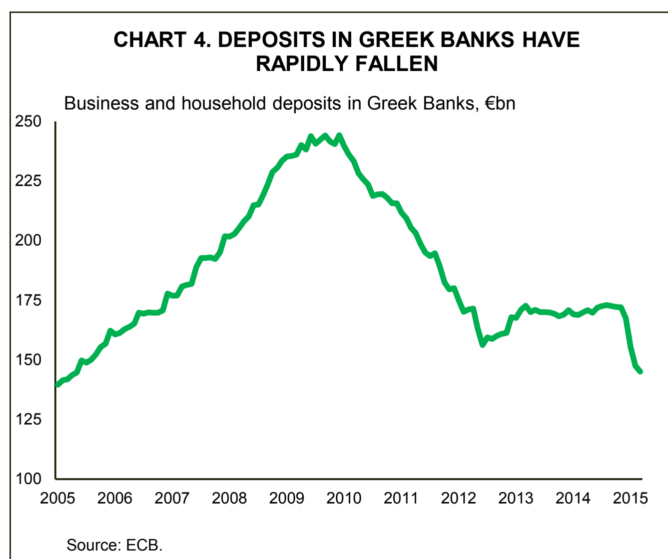
Even before the financial crisis, Greek government finances were shaky, marked by elevated debt, and a large structural deficit. The financial crisis led to even greater deficits and sent the economy into a seemingly perpetual recession. The sustainability of Greece's debt quickly came under question by the market, with Greece dependent on the IMF and its euro area partners for financing. Greece received two financial aid packages in 2010 and 2012, with the government forced to implement numerous rounds of austerity measures. By 2014, it appeared that Greece's economic ship had finally righted itself. Economic growth averaged 2.3% in the first three quarters of the year, while the government's primary balance had gone from a large deficit of -10.3% in 2009 to an estimated surplus of 1.2% in 2013 (and was heading higher prior to the political uncertainty).

However, getting to this stage has been painful. Greece's economic performance since 2008 has been similar to America's during the Great Depression (see chart). Gross disposable income per capita fell from over €15,000 in 2008 to roughly €11,000 in 2014, while the unemployment rate remained at a frustratingly high 26.0% in the fourth quarter of 2014.

On January 25th, running on an anti-austerity platform with a desire to seek debt relief from Greece's creditors, the Coalition of the Radical Left (Syriza) received the largest number of votes of any party in Greek elections. The following day, it agreed to form a coalition government with the Independent Greeks, a right-wing anti-bailout party.

Since then, negotiations between creditors and the Greek government have left the economy in a state of limbo. The uncertainty surrounding negotiations and the threat of a Greek exit has been a major headwind to economic growth and has reversed part of the progress that Greece had made. Growth has already slowed markedly and taxpayers are delaying payments due to the uncertainty. As such, government tax receipts have fallen below target. Making things worse, on February 4th, the European Central Bank removed a waiver allowing Greek debt to be used as collateral by banks in order to secure liquidity from the ECB. As a result, Greek banks have had to rely on emergency liquidity assistance (ELA) from the Greek central bank, subject to ECB approval and reviewed biweekly. Deposit outflows from Greek banks has resumed after a period of steadiness (see chart) and the ECB has had to continuously increase the ELA limit for Greek banks. At the end of February, the eurogroup of finance ministers agreed to extend the current bailout agreement until the end of June. Upon successful review of the bailout program, 7.2bn euros could be disbursed to Greece[1]. Should the eurogroup deem the review as unsuccessful, and if no subsequent agreement is





reached by the end of June, these funds would be forfeited and Greece would be left without financial support from its partners. Even before they reach the end of June, Greece could run out of cash to meet its debt obligations.

Rocky road forward from here

Beyond standard government operating expenditures, such as payments for pensions and wages, and T-bill redemptions, a majority of which Greece should be able to rollover, Greece has several upcoming payments to its creditors (see table). Most of its larger near-term debt obligations are due to the IMF; however, it has large payments to make to the ECB in July and August. While Prime Minister Tsipras ruled out defaulting on its roughly €760mn IMF loan repayment due on May 12th, the risk of a missed payment on a debt obligation rises the longer it takes for an agreement to be reached. Here we examine several scenarios and outcomes:

1) Goldilocks scenario: Agreement is reached over the next several weeks with no missed debt payment.

The scenario where brinkmanship ends and an agreement is struck by euro area partners is the ideal outcome. However, given how far apart both sides still appear in negotiations, this scenario does not seem the most likely at the moment. An agreement would unlock the €7.2bn in bailout funds remaining, which should allow Greece to meet its obligations up until August. The ECB would also likely reinstitute its waiver on Greek collateral, which would allow Greek banks to resume regular liquidity operations with the ECB, rather than through the ELA with the Greek National Bank.

Even under this scenario, a follow-up agreement will be necessary. This could take the form of a precautionary line of credit (with strings attached), which could help Greece tap financial markets. However, it would also likely need to address some of Greece's outstanding debt. While Greece desires some form of debt forgiveness, European partners do not appear inclined to acquiesce. They are more likely to agree to further extending maturities on loans and perhaps swapping debt owed to the ECB by loans from the European Stability Mechanism spread further out into the future.

2) Negotiate in good faith scenario: Greece is unable to come to an agreement in time to meet its obligations and misses a payment on one or more of its obligations, but continues to negotiate in good faith, ultimately coming to an agreement

In our view, this appears to be the most likely scenario at this point. If Greece misses a payment to the IMF, it would not be the first country to owe the IMF a late payment, nor would it be considered a sovereign rating default . If Greece fails to pay the IMF within a month of the payment date, then the IMF will consider it as officially overdue. At this point, there is a section in Greece's bailout agreement that states that Greece could be considered in default of the loans from the European Financial Stability Facility (EFSF). Therefore, it would be up to euro area partners to determine whether Greece is in default of these loans or not.

Importantly, an overdue payment to the IMF would not trigger cross-default clauses in Greece's private sector bonds. Although more subjective, it also appears that as of now, at least three of the top four ratings agencies would not view a missed payment on a bond owned by the ECB as a default[2], with Moody's view still unclear[3].

Overall, a missed payment to the IMF or the ECB would not necessarily precipitate an immediate crisis, but it would place significantly more pressure on Greece, as it would not be viewed favorably by its creditors (neither the IMF nor other euro area countries). It would also likely lead to a response by the ECB with respect to the ELA. The ELA is meant to provide liquidity to solvent financial institutions dealing with temporary liquidity problems. It can be restricted provided that a two-thirds majority of the ECB governing council deem it to be at odds with the objectives and tasks of the Eurosystem (the ECB + 19 euro area members' National Central Banks)[4]. A missed payment by Greece could lead the ECB to apply a larger haircut on Greek government securities posted by Greek banks as collateral for liquidity from the ELA. Ultimately, this would reduce

the total liquidity that could be accessed by Greek banks; leaving less of a margin should deposit outflows accelerate.

Severely limiting the amount that Greek banks can access from the ELA could rapidly precipitate events in Greece and dramatically increase the likelihood of an exit from the euro area. It is unclear that unelected central bankers would want to take this step. Nonetheless, should deposit outflows accelerate materially or the ECB cap the amount that Greek banks can receive from the ELA, Greece may be forced into adopting capital controls. Adopting capital controls and declaring a bank holiday would provide additional time in which an agreement could be reached with Greece's European creditors. Cyprus adopted capital controls in 2013, so the precedent has been set. However, this is likely to be particularly unpopular with the Greek public, while also being detrimental to economic growth.

Besides skipping a payment to its official creditors, another option for Greece to conserve cash would be to issue IOU's as payments to its citizens , thereby saving its euros to pay its creditors. There are precedents for a state issuing IOU's, such as California during the financial crisis , and these can generally be used for a time. However, it is only a short-term solution and operationally, the mechanics would likely become unfeasible in a matter of weeks or months. Paying official creditors with euros and its citizens in IOU's would also be viewed quite unpopularly, and contrary to what the party stood for in the election.

One variant of this scenario that has been mulled by Prime Minister Tsipras is the possibility of holding a referendum on an agreement with its creditors. This would provide the government with legitimacy in agreeing to difficult reforms, somewhat contrary to its election mandate. Holding a referendum would likely require several weeks, during which the economy would be in limbo, and in which it may be difficult to service its debt obligations. In this case, the uncertainty could lead to greater deposit outflows, forcing Greece into adopting capital controls, and also pushing it into missing one or more debt payments. Given the results of Greek polls, the ultimate outcome of a Greek referendum would likely be for an agreement with its creditors.

Overall, Greece missing a payment to the IMF or ECB, or issuing IOU's to pay domestic residents would only be a very temporary solution; however, it would not necessarily imply a Greek exit.

3) Default scenario: Greece chooses to default on its creditors, with little intent of returning to the negotiation table

Of the three scenario, this is the one we view as the least likely, although its odds are slowly rising. A default by Greece on its external obligations would not necessarily force Greece into exiting the euro area. However, with no intent on returning to the negotiating table, it is hard to see the ECB continue funding Greek banks. And, without euro funding, it is difficult to see how the Greek government could as well. In this case, Greece would likely need to call a bank holiday and reintroduce the drachma, and in the end, exit the euro area.

The short term uncertainty associated with a Grexit would be particularly detrimental to Greece's near-term economic prospects. Argentina's experience suggests that a country can remain shut out of global financial markets for a long time following a calamitous default, although in other more limited default cases, it can be much shorter – Ivory Coast defaulted on a bond in 2011 and returned to markets in 2014. It should be noted that at present there is no formal legal mechanism for exiting the euro area without also exiting the European Union[5]. Therefore, even beyond the financial implications which would be severe, the exit is unlikely to proceed smoothly.

For the euro area, the near-term implications may not appear to be that significant, with markets currently viewing the contagion risks as low. However, there are a number of near-term unknowns and medium-term risks (see box: the perils of a Grexit).

Major Upcoming Debt Payments

Date	EUR, mn	Cumulative	Owed to
May-12	763	763	IMF
Jun-05	305	1,068	IMF
Jun-12	343	1,411	IMF
Jun-16	572	1,983	IMF
Jun-19	343	2,327	IMF
Jul-13	458	2,784	IMF
Jul-14	92	2,876	Private
Jul-20	3,491	6,368	ECB
Aug-01	178	6,546	IMF
Aug-20	3,188	9,734	ECB
Total Sep.-Dec.	3,581	--	--

Source: Bloomberg, IMF. Note: Omits T-bill redemptions, as these can generally be rolled over. Sums estimated are based on current exchange rates and are subject to currency fluctuation.

Textbox: The Perils of a Greek Exit

A Grexit would have a number of implications for the euro area, the first of which are potential losses on exposure to Greek debt. Exposure to Greek government debt from euro area sovereigns is equal to roughly €222bn - €142 in loans from the ESFS, just under €53bn in bilateral loans from other euro area members, and €27bn in bonds owned by the ECB. The euro area would also be exposed to losses on Greece's net liabilities to the Target2, the euro area interbank payment system, to the tune of €96bn as of end March[6]. While not insignificant, this would add up to €318bn euros, or 3.1% of ex-Greece euro area GDP[7].

For the banking system, euro area BIS-reporting banks have reduced their claims on the Greek public sector to €677mn in the fourth quarter of 2014 (from €3.5bn in Q1 2012). Total bank exposure to the Greek economy, including derivatives and guarantees, was down to €24bn in Q4 2014, from €73bn in Q1 2012).

Other potential linkages could include select asset managers owning a portion of Greek debt or European companies with operations in Greece. The Greek non-public sector (ex-government, ex-central bank) had external debt of $124bn as of the fourth quarter of 2014, however it was not possible to break this sum into regional/country exposures.

While the sums are relatively large, they generally appear to be manageable. Most of the debt is owned by other European sovereigns, who's banking systems are less exposed to Greece relative to 2012. The ECB's QE would also likely help temper contagion risks.

Nonetheless, a Grexit would represent a near-term unknown, and would present greater risks in the medium-term. The euro area may no longer be seen as a unified, irreversible monetary union, but rather as a group of individual countries with a dysfunctional currency peg. Greece is not the only country to have substantially elevated debt levels. Portugal's general government debt-to-GDP ratio was 130% last year, with a general government deficit of -4.5% of GDP. Of greater concern, Italy's economy has grown very little– annual real GDP growth has averaged -0.1% since 2001 – with general government debt equal to 132% of GDP, or €2.1trillion last year. Elevated debt levels are not currently a major issue as bond yields remain low, partly as a result of European QE. However, once the door is opened to a euro-exit, markets would then speculate on who might be next, particularly in future recessionary or crisis period. This would naturally introduce investor uncertainty and increased volatility, particularly among the more distressed economies. This would be unchartered territory.

While the European Stability Mechanism and the ECB's Outright Monetary Transactions are meant to deal with such a situation, their use remains untested[8]. Nor is it clear what the appetite would be if these tools had to be used to support a country of Italy's size, or multiple bailouts at once.

Bottom Line

Overall, we continue to view an agreement between Greece and its creditors as the most likely outcome. While the adjustment has been remarkably difficult, an exit from the euro area at this point would simply inflict more hardship on the Greek population, which has been shown to support remaining in the euro area. Likewise, creditors of their debt have an incentive to enter into another round of negotiations that would make future payments more feasible.

Meanwhile, for the euro area, a Grexit would imply realizing losses on its ownership of Greek debt, while ramping up short-term uncertainty and diminishing the long-term integrity of the monetary union. This would come at a time when the euro area economy finally appears to be gaining traction following two consecutive crises in 2008-09 and 2011-12. No one has an interest in seeing this outcome.

As mentioned, even if another short-term agreement is reached, Greece will likely need additional support to prevent further turbulence beyond the summer. While euro area governments have shown the debt burden to be extremely fungible, through the creative use of grace periods and lower interest rates, some further debt restructuring is likely to be needed.

Renewed turbulence from Greece would likely have an impact on financial markets. Both bund yields and the Euro-USD exchange rate have recently reversed what had previously been steady downward moves. Should crisis risks escalate, flight to safety moves could easily see the euro sell-off and bund yields tumble anew, as well as see a decline in European equities. However, QE from the ECB is likely to help blunt near-term contagion risks to other peripheral economies.

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End Notes

1. Note that the €7.2bn need not be released as a whole. The eurogroup could decide to disburse its portion of the funds (€3.6), while the IMF retains its own share (€3.6).
2. Source: Reuters. http://www.reuters.com/article/2015/05/01/us-greece-default-ratings-idUSKBN0NM3N420150501
3. Based on April 15th, 2015 report by Moody's on its downgrade of Greek debt.
4. Source: ECB. https://www.ecb.europa.eu/pub/pdf/other/201402_elaprocedures.en.pdf
5. Source: Athanassiou, Phoebus, Withdrawal and Expulsion from the EU and EMU: Some Reflections (December 18, 2009). ECB Legal Working Paper No. 10. https://www.ecb.europa.eu/pub/pdf/scplps/ecblwp10.pdf
6. Source: Institute of Empirical Economic Research of Osnabrück University. Euro Crisis Monitor. http://www.eurocrisismonitor.com/
7. There could also be losses on euro area ownership of IMF loans to Greece, although these were omitted here.
8. The ESM has been used, but the combination of the ESM and the OMT being used in a crisis has not.

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