ALLIANCEBERNSTEIN

ECONOMICS: EUROPEAN PERSPECTIVES—APRIL 11, 2014

Can Greece Exit Its Bailout?

- **Dennis Shen**
  Economic Associate—Global Economic Research, + 44 (020) 7173 9270
- **Darren Williams**
  Senior European Economist—Global Economic Research, + 44 (020) 7959 4543

With a successful bond auction this week, Greece's ambitions to exit its bailout late this year have taken an important step forward. We believe such a bailout exit is now more likely. However, with debt still at very elevated levels, many of the country's fundamental problems remain unresolved.

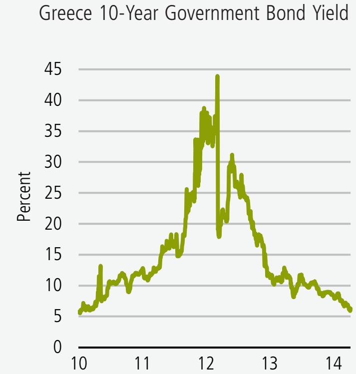
Greece marked its comeback to international bond markets on Thursday—with the issuance of a new €3 billion, five-year bond. It was the first bond issue since the country was shut out of the markets when the debt crisis erupted in early 2010. This remarkable return has come sooner than anyone anticipated—just two years after the largest default in sovereign history.

Thursday's issuance symbolizes the sharp turnaround in the market environment towards peripheral issuers. Over the past two years, Greece's 10-year yield has tumbled from more than 30% after the 2012 Greek Private Sector Involvement (PSI) to just above 6% **(Display 1)**.

This return to markets has been motivated by domestic political circumstances—in particular the tenuous position of the current coalition government and strong domestic pressure to leave the bailout behind and break the "drama"[1] of the Troika reviews and unpopular austerity measures. If all goes well, the government hopes that a successful test issuance, within the current decidedly favorable market conditions, would lead to an exit without any additional assistance and/or intervention when Greece's second bailout from the European Union (EU) expires at the end of this year.[2] The government hopes, in turn, that steps to exit the bailout could foster greater political and social stability.

Until very recently, a Greek bailout exit in late 2014 would have appeared close to unthinkable. However, rapid improvements in market conditions and this week's successful auction make it more likely now that Greece will be able to meet its limited funding needs for 2014 and 2015 via private sources. This increases the chances of a bailout exit later this year, in our view.

Display 1
Tumble in Greek Yields



As of April 11, 2014
Source: Financial Times

However, this would not solve Greece's many fundamental dilemmas and may reduce momentum in the drive for critical reforms.

Opposition to Third Bailout

Late last month, the Greek parliament passed a package of reforms mandated by the latest Troika review. This paved the way for last week's approval of the latest loan disbursement from the EU worth €8.3 billion. The conclusion of this latest review, which ended seven months of contentious debates with the Troika, served as a stark

[1] Infrastructure minister Michalis Chrisochoides recently said that Greece would "return to markets, with a slightly high interest rate, which will fall after and Greece won´t remain in this drama of quarterly troika reviews".

[2] Note that while the second bailout facility for Greece from the EU concludes at the end of 2014, the assistance from the International Monetary Fund's (IMF) Extended Fund Facility continues into 2016.

reminder to Greece of the difficult relationship it has with its international creditors and the political consequences that the administration would face domestically were the country to request a third bailout.

The Troika reforms passed on March 31 concentrated on a liberalization of domestic product markets and an overhaul of bank recapitalization laws. In the parliamentary vote, there was an additional dismissal from the government´s ranks, which cut its majority in parliament to a tenuous two seats. Since the coalition government was elected in June 2012, internal conflict over unpopular reforms has reduced its hold on power from 179 seats (a majority of 29) to the current 152 seats (the two-seat majority).

It's clear to the government that in order to complete its term through 2016 (the next scheduled parliamentary election), it must weather the Troika reviews and demands yet to come. Domestic opposition to the austerity reforms and a keen desire to minimize the political risk of early parliamentary elections will continue to be powerful forces behind the administration´s opposition to a third bailout, as such. In the current tense political climate, we expect Greece to advance its return to the capital markets in order to prevent the need for additional assistance.

Return to Markets

But does Greece have the capacity to go without additional loans? EU officials have not ruled out a third bailout—but with the improvements in peripheral bond markets, have delayed a decision until later in 2014. German Finance Minister Wolfgang Schäuble recently noted that "if there is a need [for a third bailout], one will help; if there is no need, then it's also fine."

Whether Greece is able to exit its bailout without additional EU loans will depend critically on whether it can raise a limited amount—estimated by the IMF at €11 billion for 2014 and 2015 (highlighted by the financing gap in **Display 2**)—from private sources. In Display 2, the sharp decline in Greece's annual funding needs since 2012 is the product of the PSI, benefits from official sector relief efforts and the country's fiscal adjustment.

This week's return to international bond markets represents an important step towards a bailout exit. The €3 billion, five-year issuance made a significant impression on the country's €11 billion in estimated needs for 2014 and 2015. Moreover, the issuance was oversubscribed, receiving about €20 billion in orders, with a yield of 4.95%, well below most analyst estimates. However, to meet Greece's funding needs without additional loans still requires a continuation of current favorable market conditions—at least until several additional issuances are complete. Given the recent volatility in Greek yields and ongoing risk of political instability, this is still not a certainty.

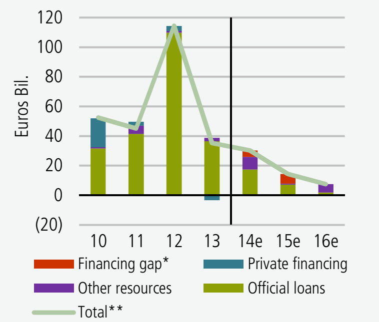
What of the Fundamentals?

Despite Greece's return to markets and the increased chance of a bailout exit, domestic fundamentals still warrant caution. Even after the PSI, public debt stands at a record 177% of gross domestic product (GDP). And, while the economy is now showing early signs of recovery, it will require high nominal growth over the medium term to materially reduce Greece's debt level.

At present, Greece's debt reduction is being supported by the very low interest rate on its debt, currently at a weighted average of about 2.7% due to the private and official sector restructurings. But even with this advantage, it may be difficult to stabilize/reduce debt ratios in the short

Display 2
Fall in Funding Needs

Financing Requirements by Source of Financing



*Financing gap shown is prior to this week's issuance.
**The funding requirements for 2012 are elevated owing to the PSI sweetener and bank recapitalizations.
Source: European Commission, IMF and AllianceBernstein

term owing to present deflation risks—Greece's inflation rate stood at –1.5% in March. With Greece's debt still at elevated levels, we believe additional relief will be required—however, with about 80% of Greek government debt held by the EU, European Central Bank and the IMF, this is likely to involve the official sector rather than private investors.

It is also important to consider what the policy framework in a post-bailout Greece would look like. In the latest Troika review, with its bargaining position strengthened by a reduced dependency on the bailout loans, Greece visibly opposed the EU and IMF's demands for new austerity and/or structural reforms. With this in mind, we are concerned that a bailout exit would adversely affect Greece's commitment to needed reforms. As the adjustment to a primary surplus worth 4.5% of GDP by 2016 (from a small primary surplus last year) is a core pillar of Greece's debt reduction strategy, any backtracking would represent a risk to longer-term debt sustainability. ■