



ECONOMICS: EUROPEAN PERSPECTIVES

GREEK NEGOTIATIONS CONTINUE AMID CASH CRUNCH

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Tense negotiations between Greece and its international creditors continue. We expect an interim deal for bailout funds, but not before late April. While we expect Greece to ultimately meet its debt obligations and remain in the euro, this is likely to be a very uncomfortable period for investors. We also need to recognize that risks of more adverse outcomes are material.

Greece has continued to negotiate a reform package with its international creditors that it hopes will unlock long-delayed bailout funds. The talks have centered on the latest draft of Greece's reform agenda, which outlines revenue-generating initiatives that the government estimates are worth €6.2 billion, or 3.5% of gross domestic product (GDP). These initiatives include tackling tax evasion, higher taxes for the wealthy and €1.5 billion in projected privatization receipts. However, the draft also includes €1.1 billion in estimated new spending—mostly to support low-income pensioners.

After weeks of unclear progress amid an acrimonious war of words, negotiations seemed to have finally made modest ground in the wake of a summit between Prime Minister Alexis Tsipras and European heads of state in late March. The two sides have jointly restated that Greece will have ownership of planned reforms. This represents a concession from the previous structure of financial assistance programs whereby reforms were written by the lending institutions. However, the plan of action will still need to meet previously agreed commitments.

At this point, while Greece has found common ground with its creditors in several areas, like efforts to tackle tax evasion, reform public administration and eliminate early retirement schemes (and postponed many electoral commitments to roll back previous reforms), there is still insufficient detail on the specific measures to be implemented and projections of the likely fiscal impact remain too optimistic. Moreover, there are still core ideological differences on several contentious issues—notably pension policy, labor market reform and the scale of privatizations. In the past, the Coalition of the Radical Left (Syriza) government has stated further reductions in wages and pension payments, labor market liberalization and fire sales of state assets to be “red lines” in what it can concede. The government hopes that by over-delivering on other structural areas, like its revenue-raising proposals, its creditors may grant an amount of flexibility on contentious pension and labor market reforms.

A deal on the reform plan (and probably some implementation of reforms) will be required before part of the remaining €7.2 billion of bailout funds can be disbursed.

Much of the work to reach this deal will need to come from the Greek end, but some flexibility will probably also be required on the part of the creditors. Greece has stated that it intends to reach an agreement at the next scheduled euro-area finance ministers' meeting on April 24. At present, this looks like the earliest potential date for a deal, with the risk that negotiations go on for longer. However, we believe it remains in the shared interest of both parties to conclude an agreement, and avoid the worst-case outcomes of default and/or euro exit.

Liquidity Fears

The Greek government's electoral plans for financial independence (and vows to end the “extend and pretend” of seeking new loans to repay old loans and bonds) rested heavily on securing an orderly debt restructuring. However, owing to the firm opposition of its official creditors to requests for principal write-downs and/or bond swaps, the new government has found itself isolated in a very similar position to that of its predecessor—fighting for new rescue loans to pay old debts and prevent a disorderly credit event (and its attendant implications).

As it struggles to secure new loans, Greece's liquidity status has grown increasingly concerning. With its cash balance now running very low, the government has introduced emergency measures to bridge short-term requirements. These include borrowing from the deposits of public agencies and utilities, and postponing some expenditure—such as payments to suppliers and public investment.

These actions helped ensure the repayment of a €460 million loan tranche due to the International Monetary Fund (IMF) on April 9, quelling speculation that the payment might be missed. For the rest of April, Greece's repayment schedule seems manageable: with the rollover of two Treasury bills worth €1.4 billion and €1.0 billion on April 14 and 17 respectively, and several interest payments due. We note, however, that the rollover of Treasury bills has been made more challenging by a new European Central Bank (ECB) ruling that bars domestic banks from taking on additional Greek Treasury bill exposure—forcing a search for new buyers. Greece's repayment calendar is shown in *Display 1*.

After the April 9 payment to the IMF, the next date in relation to liquidity risk that many analysts will focus on is May 12—when a further €770 million IMF tranche comes due. Now, if things go well and Greece reaches an interim agreement with its creditors before this date, the sub-tranche of bailout funds would cover the payment without issue. However, what might happen in the unexpected scenario that a deal can't be secured by then?

In such an eventuality, Greece's first response would probably be to resort to further emergency initiatives similar to those it's already implemented. There are still funds that probably could be shored up if absolutely required, like borrowing from the social security funds and further postponements in expenditure. If these actions are not enough, Greece might in an

adverse scenario be forced to confront the unwanted dilemma of whether to pay salaries and pensions or the IMF. In this scenario, we do not rule out the chance the government might opt to temporarily prioritize payment to the IMF because of the reputational cost and threat to ongoing negotiations if it falls behind on its international obligations (though a missed IMF payment would not constitute a credit event until at least one month after). If an IMF payment were missed, we note that Greece would fall under intense pressure to reach an agreement for funds that make the loan payment whole.

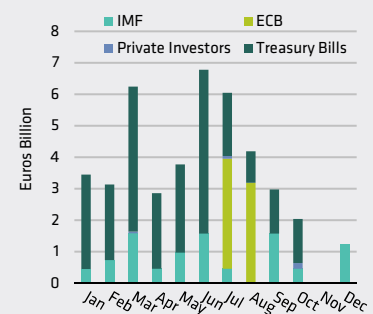
Difficult Period Ahead

Our base case assumes a rocky, drawn-out bailout negotiation during which Greece remains under a constant cash shortage*. This liquidity crunch forms part of a deliberate strategy on the part of Greece's lenders to force compliance with reform commitments. In the coming weeks, we expect a last-minute deal to be agreed that unlocks a partial disbursement of remaining bailout funds. However, if/when Greece comes to such an agreement, this partial tranche would probably cover liquidity for just a short window (perhaps a month). Shortly thereafter, another iteration of tough negotiations (now around implementation of reforms) and tightening liquidity conditions would inevitably be repeated to conclude the bailout review. If the current bailout is successfully concluded (the four-month extension expires at the end of June), Greece would still need to negotiate a new financial assistance arrangement to follow it.

For investors, this means that a very difficult and uncomfortable period lies ahead—including the possibility of political instability in Greece. Our base case assumes that Greece will avoid default and remain in the euro area. But we acknowledge that risks of more adverse outcomes are material and at least as high as at any previous stage of the crisis.

Display 1
Greek Repayment Risk

State Monthly Principal Repayments, 2015



As of April 10, 2015
Source: Bloomberg

*See "Rocky Road Ahead for Greece's New Government", *European Perspectives*, February 6, 2015.

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