

European economy

Greek debt and the elections

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- **Outlook:** Polling in Greece suggests that New Democracy may win the largest number of seats in the parliamentary elections on 7 July. However, clarity on who will govern Greece for the next few years may only emerge after the presidential election, which is due by January. The president is elected by parliament, requiring a minimum of 180 votes of a total of 300. Should the winning party fail to muster a coalition with at least this number of seats, the possibility of another snap parliamentary election looms.
- **Markets:** Greek government bonds have performed well this year. We think the political outlook as well as the government's large cash buffer should remain supportive. However, Greek bonds continue to be sensitive to global economic uncertainty and Italian political risks.
- **What we watch:** Polls and European presidential appointments, party leaders' TV debate on 1st of July.

Our view

The Greek economy is showing signs of recovery. We expect this recovery to continue, even if constrained by global trade tensions. Nonetheless, Greece remains challenged by its debt overhang. The fiscal policy stance of the next government will therefore be key. However, we do not expect clarity on business conditions until after the presidential elections (due by January 2020). A minimum of 180 votes in parliament are required to elect the president (in the third round of voting). In 2014, failure to muster 180 votes led to the change in power from New Democracy to Syriza.

We believe that the Greece's medium-term outlook will depend more on the economy. European creditors have set strong incentives for fiscal compliance. We think that in a stable economic recovery, the sovereign debt to GDP to ratio should fall rapidly. Even in the event of a moderate global recession in the early 2020s (with the Eurozone economy contracting by 2%), the debt to GDP ratio should be substantially below today's levels in five years' time. However, in a severe global recession in the early 2020s (with the Eurozone economy contracting by 6%-7%), we expect debt to GDP would be at similar levels in five years as it is today and bond market access would likely dry up, requiring a further ESM program. Nonetheless, the solid popular support for the euro and the goodwill earned with creditors should ensure that European solidarity would be granted, even if it requires a fiscal adjustment in the event of a severe global recession. Accordingly, we expect Greece to remain in the euro.



Note: Greek parliament. Source: Dreamstime

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- Germany: Defying recession fears, 15 January

Source: UBS

Economy: At a crossroads

Greek recovery has broadened

Greece still remains an outlier in the Eurozone when it comes to macroeconomic imbalances (see Fig. 1), mainly due to its sovereign debt overhang. However, the Greek economy has come a long way since the last general election in 2015. The unemployment rate has fallen considerably from almost 28% in 2013 to 18% now (see Fig. 2). Initially, the recovery was driven by the declining fiscal drag on consumption and investments as well as by exports (up about 9% in 2018). The latter development has allowed Greece to expand its market share in global exports. Meanwhile, the improving labor market has supported consumption, which has become a positive contributor to economic growth. To this effect, real GDP printed +1.9% in 2018. We think growth could have been stronger, but surprisingly, a key drag came from the public sector and its under-execution of the budget. The latter has been a big drag on government consumption (down 2.5% in 2018) and in particular on public investment projects (down 29% in 2018). This has helped the government to exceed fiscal targets and to negotiate several debt relief measures with its European creditors.

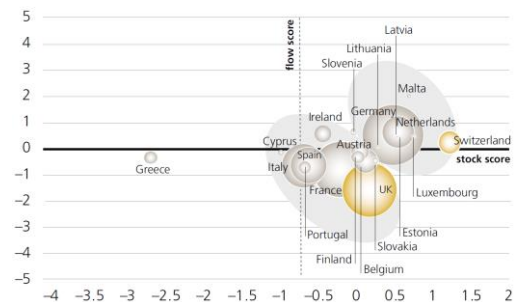
Economic growth expected to remain resilient

Weakening export markets in 2019 pose a challenge for Greek companies. However, we think that exports should hold up due to the low demand elasticity of Greece's key exports. Moreover, domestic demand benefits on several fronts. For example, consumption should gain from the hike in the minimum wage and subdued inflation supporting real disposable incomes. On the investment side, we see encouraging signs that Greek firms are starting to become more inclined to invest as well as to offset the squeeze on profit margins stemming from higher labor costs (see Fig. 3). This should also underpin employment growth, which should rise well over one percent in 2019 as well as in 2020. Accordingly, we think that the Greek economy can continue to grow at around two percent in 2019. Beyond 2019, the government's potentially more pro-business stance after the general election on 7 July could further support investments. Growth should also be supported, if the Bank of Greece terminates capital controls by the end of 2019 (as expected by the central bank).

Risks around the economic outlook

A worse-than-expected evolution of the trade war may prove to be a bigger drag on exports. The European Commission also estimates the fiscal stimulus from the new fiscal measures, including personal income tax cuts and higher social benefits, may trigger a fiscal slippage of one percent of GDP in 2019. This may lead to counterbalancing measures after the general election. At the same time, the stimulus poses economic upside risks. The European Commission will reassess the situation after the election in the fall. In addition, several court cases could lead to reforms being partly reversed, resulting in higher fiscal liabilities. On the positive side, the completion of the general election could lead to the government fully utilizing the budget ceilings agreed. This would support government investments and government consumption significantly, as the underspending observed has been heavy. This will partly also depend on the outcome of the upcoming election, as the fiscal stance on budget reserves could change depending on who will be in government. As such, the election puts the Greek economy at a crossroads now.

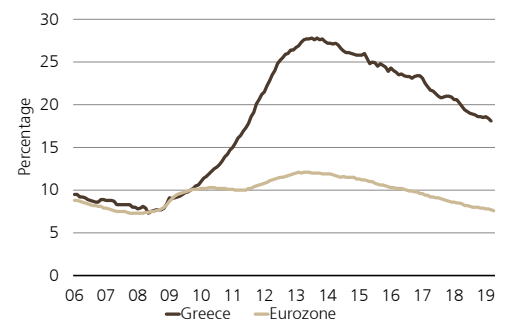
Fig. 1: UBS CIO synthetic imbalance indicator
Greece still the outlier (2017)



Note: Non-Eurozone members are tinted yellow. The stock dimension is based on the debt-to-GDP ratio, the net international investment position (i.e. net foreign financial assets of all residents in a country) and excess unemployment. The flow refers to the change in these variables.

Fig. 2: Unemployment in Greece vs. Eurozone

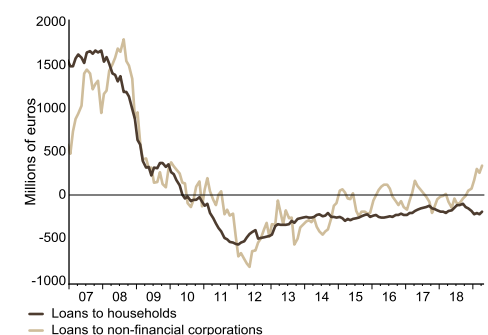
Greece still way above Eurozone



Source: UBS, Haver Analytics, as of 6 June 2019

Fig. 3: Bank loans

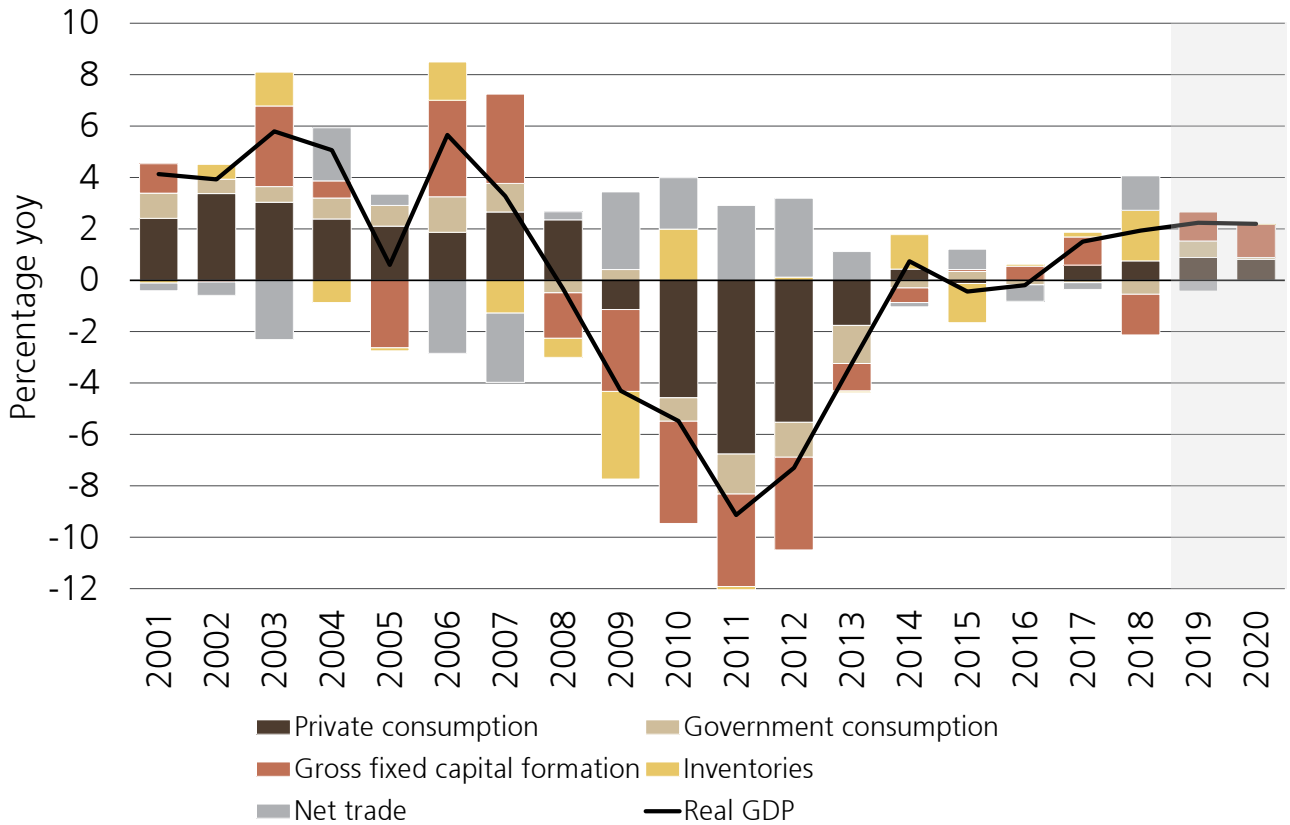
Corporate loan flows at 10-year high



Note: 6-month moving average. Source: Haver Analytics, UBS, as of 5 June 2019

Fig. 4: Economic growth, by component

Contributions to GDP growth – recovery set to broaden



Source: European Commission, UBS, as of June 2019

Election outlook and fiscal implications

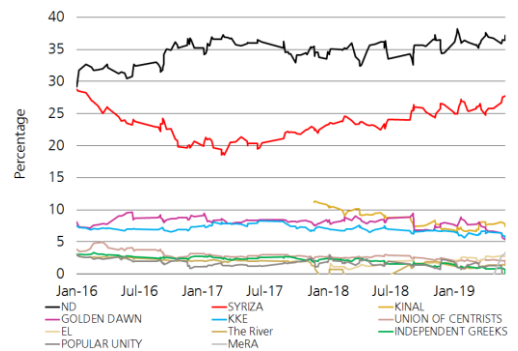
New Democracy on course to take over government

The European, municipal and peripheral elections recently gave a clear message that New Democracy is set to lead the next government after 7 July 2019. Syriza has worked hard for years to improve its performance at the opinion polls after the economic shock of 2015. However, several issues such as the North Macedonia naming debate have slowed down its recovery at the polls, making it difficult to catch up in time. We would therefore allocate a 60–70% probability that New Democracy wins the election on 7 July.

Based on the European election results and recent opinion polls, New Democracy may even get a majority on its own, especially if enough parties fail to match the three percent minimum threshold to parliament. 250 seats will be allocated, with seats being redistributed from parties failing to match the three percent threshold. In addition, the winning party gets 50 additional seats. In the event that New Democracy doesn't command a majority, the main potential coalition partner is KINAL, in our view. A smaller coalition partner would mean less power being given away, but that depends on who makes it above the three percent hurdle on election day. What's more, New Democracy

Fig. 5: Greek political opinion polls

New Democracy clearly in the lead



Source: Polls, UBS, as of 19 June 2019. KINAL = Movement for Change (PASOK, DISI, KIDISO). 5-poll moving average.

will have a big incentive to bring KINAL on board because of the Greek presidential election that must be held by January 2020. According to the Greek constitution (Article 32), at least 180 votes (out of 300) in the third round are needed to elect Greece's president. Failure would trigger a snap general election. To this effect, the parliamentary election on 7 July could potentially lead to different dynamics in opinion polls after a government change, especially if the Eurogroup asks that the fiscal slippage this year is addressed swiftly. If New Democracy fails to muster a majority of at least 180 votes (including other parties) for the presidential election, the government would fall, just as it did in early 2015 when it was overtaken by Syriza. In any event, clarity on who will run the country for the next four years will probably only emerge after the Greek presidential election.

Elections: Fiscal implications

In the event that Syriza wins the 7 July general election, we could possibly see fiscal budget ceilings being utilized more and a continuation of the current government stance. In the more likely event that New Democracy wins the election, we may see a stronger focus on immigration and border controls, more investment in education and a tax reform. The tax reform may encompass a reduction in taxes financed by spending cuts (and a broadening of the international tax base through incentives), which should be growth supportive. A greater utilization of budget ceilings is also likely with New Democracy, which is also growth supportive.

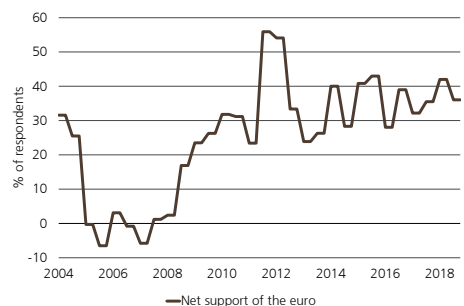
Overall though, we expect continued fiscal discipline during the tenure of the next government, given the incentives set by creditors, even if court rulings on overturning the 2012–2015 pension cuts and public-sector bonuses present important risks (costing up to EUR 9bn). After all, EUR 15.7bn of Greece's cash buffer are sourced from European Stability Mechanism (ESM) disbursements, which will only be fully drawn by the end of 2023. In addition, the ESM intends to disburse central bank profits on Greek bonds (SMP and ANFA profits) worth about EUR 5bn until June 2022 through bi-annual tranches of EUR 640m. Also, interest payments of a further EUR 220m annually are being waved on a semi-annual basis, and permanently after 2022 (waiver of EFSF step-up interest rate margin). Accordingly, we think that the biggest risk to government finances until 2022/2023 are economic shocks, rather than fiscal mismanagement (subject to court rulings on the pension system and public sector bonuses).

Long-term implications

Over the longer term, the outlook will depend on the next Greek general election due by 2023. Also, from 2023, the European fiscal framework will apply (i.e. the Stability and Growth Pact and the Fiscal Compact), as for all other Eurozone member states. What's more, the Eurogroup has agreed to a contingency mechanism on debt in the event of adverse macro-economic shocks, which could for example entail further debt re-profiling and capping and deferral of interest payments to the EFSF to meet the gross financing needs benchmark of 15–20%. However, activation of that contingency mechanism by the Eurogroup is subject to Greece's compliance with the aforementioned European fiscal framework. In addition, potential future debt relief measures at the end of the EFSF grace period in 2032 will be subject to Greece's compliance to the European fiscal framework. Accordingly, it is more likely than not, that due to European incentives, Greece's fiscal policy will move within

Fig. 6: Greek support for the euro

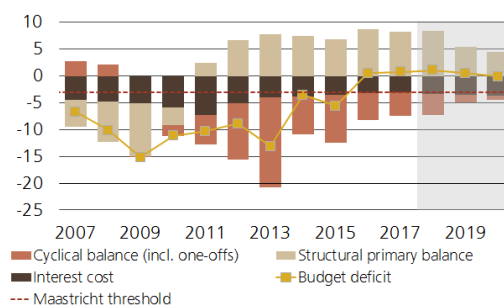
Solid support



Note: Percentage of respondents in support of the euro minus those against it. Quarterly data. Source: Haver Analytics, European Commission, UBS, as of December 2018

Fig. 7: Fiscal position of Greece

Huge improvement this decade



Source: Haver Analytics, European Commission, UBS, as of June 2019. Note: all figures in % of GDP.

the European fiscal framework and any significant deviations will likely remain subject to Eurogroup approval(s). Italy's recent standoff with the European Commission over the debt rule may also have implications for Greece, as it clearly sets a precedent for compliance with the Maastricht debt rule. Italy has a blocking minority in the ESM, which may be used if the country implements a fiscal austerity program during a recession (see our Future of Europe report dated 9 April 2019). This further increases the pressure for fiscal compliance in Greece.

Against this backdrop, we have simulated the impact of three economic scenarios over the 2020–2025 period on Greek sovereign debt. The moderate and severe recession scenarios assume a global recession (see the Future of Europe, 9 April 2019, for further scenario details). For Greece, it will be crucial whether a downturn happens before 2023. Given that creditors have set the fiscal policy targets at the primary surplus level, rather than the structural level until 2022, the requirement is to deliver fiscal discipline independently from the business cycle. Only from 2023 onwards on is the business cycle being taken into account for more appropriately (i.e. through structural budget targets). This means that in the event of a severe recession before 2023, Greece would prima facie be required to enact a fiscal austerity program. However, we think that the government would try to negotiate this with creditors in the spirit of the May 2016 and June 2018 Eurogroup agreement. The success of these negotiations is uncertain and may also depend on the French and German elections in 2021/2022. In a severe downturn, there would also be a high risk of the banking sector needing a recapitalization. In any event though, we don't see the Greek economy falling into a deep deflationary spiral again, given that the fiscal position is now much stronger. Rather, even in our most adverse case, we would expect Greek sovereign debt in five years to be similar to current levels. In more benign economic outlook scenarios, the debt should fall rapidly given the high primary surplus.

Bond markets

(by Thomas Wacker)

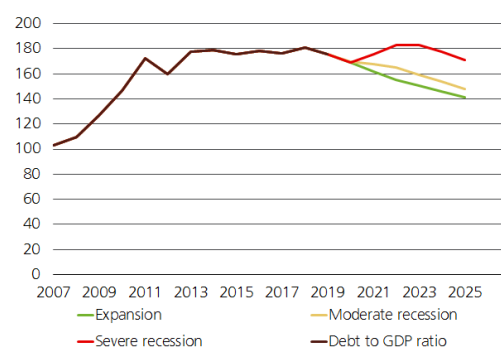
A decent cash buffer provides near-term comfort

Greece exited its third support program in August last year with a EUR 24.1bn cash buffer, largely funded by a EUR 15bn final tranche from the ESM. The total funding support from the ESM and its predecessor, the EFSF, to Greece since 2010 amounts to EUR 204bn, all of which has long tenors and low interest rates. The ESM assumes that its loans save Greece EUR 12bn in terms of interest costs every year compared to funding from bond markets. As another EUR 9.3bn are due to be paid to the IMF, the total amount of loans taken out by the Greek government amounted to EUR 282.6bn as of end March 2019. Compared to this, the remaining EUR 75bn of debt outstanding in the form of bonds is relatively small. It includes EUR 15.3bn in short-term bills and EUR 59.7bn in bonds, of which EUR 10.9bn are due to be paid to the ECB.

As of end March 2019, including all new bond issues this year, Greece reported a total cash deposit of EUR 22.4bn. In addition, it will receive about EUR 1bn of central bank profits resulting from an earlier bond buying program (SMP).

Fig. 8: Greek debt-to-GDP ratio (%)

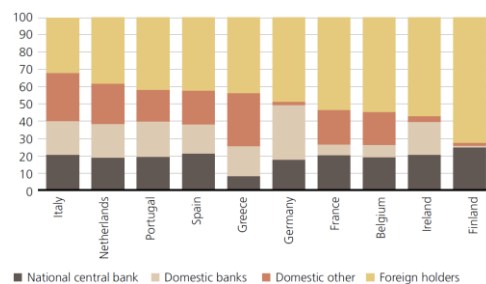
Scenario simulations over 2020–2025



Source: Oxford Economics, Haver Analytics, European Commission, UBS, as of June 2019

Fig. 9: Holders of sovereign debt (in %)

Greece with over 50% domestic ownership rate



Note: Domestic holders deemed as resident in the respective country. Source: Brügel, national central banks, UBS, as of December 2018.

Near-term cash requirements are mainly for interest payments and redemptions of bonds due to the ECB. Last year's fiscal numbers suggest an annual interest cost for the EUR 340bn debt stock of EUR 6.2bn, which reflects an average interest rate of only 1.8%. The outstanding bonds carry a weighted average coupon of 4.2% and IMF loans cost over 5%. To address the latter, Greece recently obtained permission to repay early a total of EUR 3.7bn in IMF loans due this year and next year. The government indicated this would save EUR 150m in interest costs.

We estimate that only servicing bonds and repaying some IMF loans early will require EUR 11.2bn for the remainder of this year, cutting the cash balance by half. However, next year's cash requirements for paying the country's bond market debt will be only EUR 3.4bn, followed by EUR 6bn in 2021. By this time, the cash buffer would – theoretically – be fully used up, unless Greece issues further bonds in the market and/or achieves a significant budget surplus. The latter was EUR 2bn in 2018 and should remain at comparable levels over the next couple of years assuming continued economic expansion and fiscal discipline; privatization efforts could result in further proceeds. In addition, if Greece issues new bonds every year of say around EUR 5bn, the country could maintain its cash buffer at over EUR 10bn.

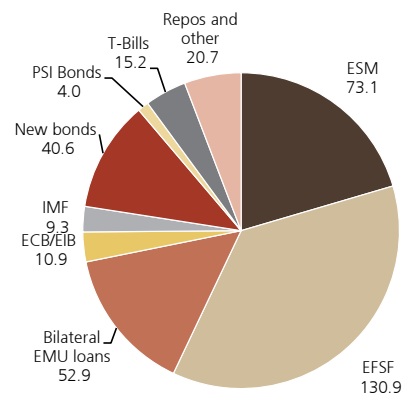
While the cash position clearly provides near-term comfort to bondholders and can continue to do so if managed prudently, renewed political, economic and fiscal uncertainty can cut Greece off from bond market funding again so that existing cash could be depleted by 2021.

Funding costs would be lower under a negative scenario

Under our expansion scenario, Greece would partially pay off debt from its public-sector creditors and roll over remaining maturing loans into newly issued bonds. This would result in the average cost of funding rising as interest rates in a benign economic environment would likely exceed what Greece currently pays on its EFSF/ESM loans. However, the average cost of the debt stock would still decline gradually.

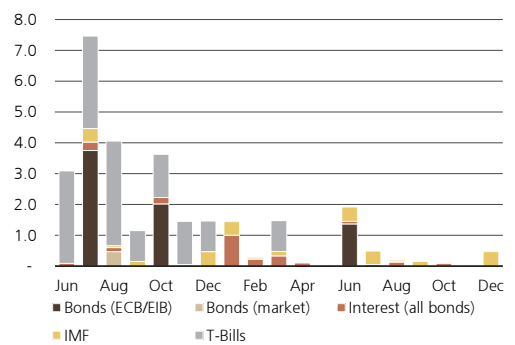
In the event of a moderate recession, the cost of bond market funding would likely rise due to increasing risk premiums. However, unlike most other lower rated countries, the cost of funding for Greece would likely decline under a severe recession scenario. At the point where Greece would be unable to tap bond markets, it may receive a fourth support package, mostly financed by the ESM. This would likely come at a small margin over the ESM's own cost of funding, which we think should remain roughly in line with that of France. ESM bonds have also been eligible under the ECB's public sector bond purchase program and would likely be bought again in a possible future program. This assumption is reflected in our debt path for a severe recession (see Fig. 8).

Fig. 10: Breakdown of Greek debt
In EUR bn



Sources: IMF, ESM, PDMA, Bloomberg, UBS, as of 12 June 2019

Fig. 11: Debt payment schedule
In EUR bn



Source: IMF, Bloomberg, UBS, as of 12 June 2019

Appendix

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