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GREECE MACRO MONITOR

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June 15 Eurogroup on Greece
What has been achieved; what remains unclear

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This report attempts a preliminary assessment of the outcome of yesterday's Eurogroup meeting as regards the outlook of Greece's stabilization programme and the prospect of the additional debt relief that is required to restore the medium- and long-term sustainability of the country's fiscal position.

On the positive side, the following can be said regarding yesterday's decisions:

Firstly, Euro area Finance Ministers positively assessed the fulfilment of the 2nd review conditionality and approved the release of the next ESM loan tranche. The tranche will amount to €8.5 billion, from which €7.7 billion will be released by early July and €0.8 billion after the summer. Out of the €7.7 billion, €0.8 billion are earmarked for state arrears clearance, while €6.9 billion will be used to cover Greece's interest and debt redemptions falling due in July. The disbursement effectively secures adequate financing of the government's gross financing needs for the remainder of the current year, especially taking into account the state's existing cash reserves[1] and the relative light debt service calendar over the said period (figures 1 & 2).

Secondly, the agreement specifies the fiscal trajectory beyond 2018 setting the primary surplus target at 3.5% of GDP from 2018 to 2022 and equal to or above but close to 2% of GDP from 2023 to 2060. This is a positive development because the original fiscal trajectory envisioned the primary surplus target at 3.5% for ten years (up to 2027) and because it provides additional clarity which will facilitate the debt sustainability analyses of the IMF and the ECB.

Thirdly, as regards the medium-term debt relief framework, it was agreed that a set of measures will be implemented "*to the extent necessary*" versus "*if necessary*" as was the wording in the Eurogroup statement of May 25th 2016. To the extent that this could be interpreted as tacitly assuming that debt relief will in fact be needed and the Eurogroup stands ready to provide it (within the framework agreed at the May 25th 2016 Eurogroup), it can also be counted in the positive elements of yesterday's decisions.

Fourthly, it was specified that the average maturities and the deferral of EFSF interest and amortisation will be extended by 0 to 15 years. The potential size of the extension was undefined in the May 25th 2016 Eurogroup statement, which was limited to the wording that some targeted EFSF re-profiling would be implemented *to the extent needed*.

Fifth, in reference to the medium-term debt relief framework, the agreement contains a provision that aims at bridging potential differences between growth assumptions in the DSA and actual growth developments over the post-programme period through the recalibration of the EFSF re-profiling according to an operational growth-adjustment mechanism. Such a provision was absent from the May 25th 2016 Eurogroup agreement, which merely mentioned the possibility of flexibility in the debt measures to accommodate uncertain GDP growth and interest rate developments in the future.

Sixth, the Eurogroup explicitly committed yesterday to provide support for Greece's return to the financial markets through future disbursements that will not only cover debt repayments and

[1] According to the latest available data (May 2017), the General Government's cash reserves deposited at the Greek Central Bank (BoG) stood at €4.5 bn.

arrears clearance but will help Greece to build up cash buffers in order to boost investors' confidence and facilitate market access.

Finally, the agreement reached yesterday opened the way for an Approval in Principal of a Stand-by Arrangement with the IMF. This development came as a result of the acknowledgement by the Fund that there has been significant progress both with respect to the policy reforms by the Greek government and the debt relief by the European creditors.

Notwithstanding the aforementioned progress, the following can be cited as regards the unresolved issues and the challenges Greece will be facing in the period ahead

First, even after yesterday's decisions/clarifications on the existing medium- and long-term relief framework, the IMF maintains its reservations on the sustainability of Greek public debt, clarifying that *"no resources become available until there are satisfactory assurances received from creditors on financing or (Greece's) debt relief".* Effectively, the AIP Stand-By Arrangement for Greece that Ms. Christine Lagarde intends to propose to the IMF's Executive Board will aim to allow additional time for such assurances to be provided by the European creditors. Once this is done, the IMF's Executive Board will take a second decision, at which point the country can draw resources under the arrangement.

Secondly, the level of clarity provided by yesterday's Eurogroup on the existing medium- & long-term debt relief framework and the absence of a positive assessment on the part of the IMF on the issue of debt sustainability makes it rather difficult for the ECB to initiate purchases of Greek eligible debt under its extended asset purchase programme, at least for the intermediate period leading to the inception of the third programme review (late September to mid-October, 2017).

Thirdly, it seems that the two main players on the issue of Greek public debt i.e., IMF and EU institutions still have divergent views as regards the underlying macro assumptions of their respective DSAs and, by implications, the debt relief needed to restore Greece's debt sustainability (see paragraph below).

Official creditors maintain divergent views on Greek public debt

In a few special research pieces we published recently, we analyzed in detail the elements and the extent of the diversion of views between the IMF and the EU institutions on Greek public debt and the size of additional debt relief that is required to restore the medium- and long-term sustainability of the country's fiscal position. In our view, the following points which constitute an excerpt from our research piece "How far apart are the official creditors in their positions towards Greek public debt?" published in late May[2] provide a good summary on the aforementioned issues.

The views of the two sides on a) the baseline macroeconomic assumptions underlying their respective Greece DSA; and/or b) the scope of the medium- and long-term debt relief that is required to restore Greece's debt sustainability should converge more substantially, to arguably facilitate the Fund's financial participation in the present programme.

Importantly, the scope and modalities of the existing debt relief framework (agreed at the Eurogroup of May 2016) may not be adequate to fully restore the sustainability of Greek public debt under significantly more downbeat macroeconomic assumptions, such as those currently assumed by the IMF; that is, unless the aforementioned framework is potentially implemented in its most radical and far-reaching form.

In support of the aforementioned, we note that a significant part of debt relief implied by the existing medium- and long-term framework is projected to come from the targeted reprofiling (maturity & grace period extensions of, as well as lower interest rates on) the EFSF loans disbursed to Greece in the context of the 2nd bailout; and this, without incurring any additional costs for former programme countries or to the EFSF.

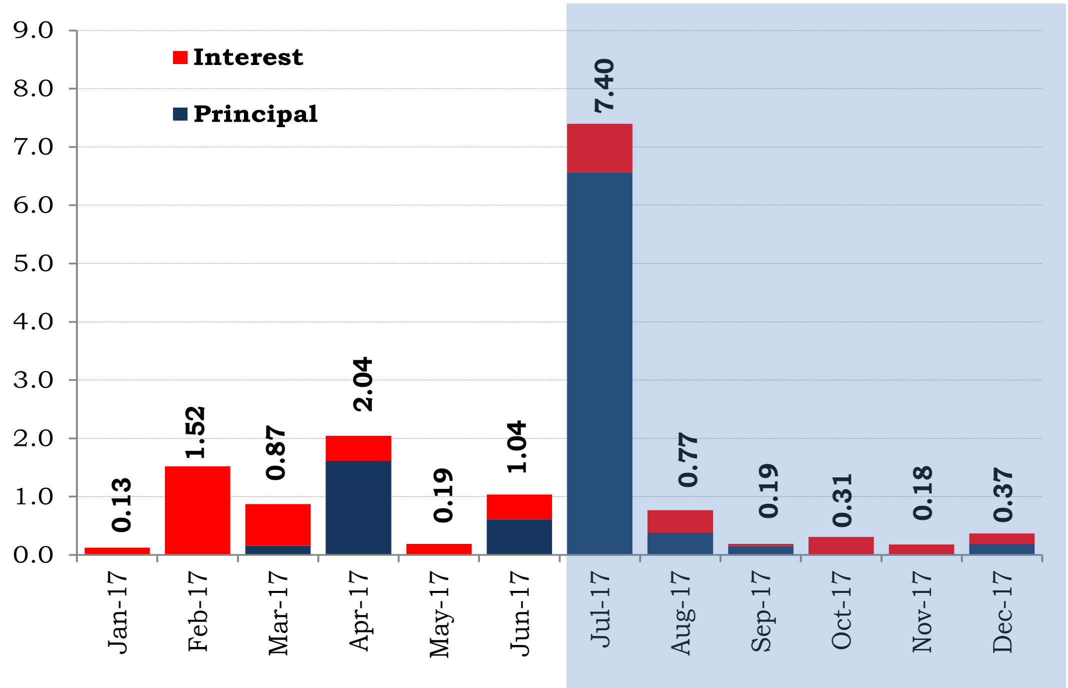
On the other hand, the existing framework does not envisage any interventions in/reprofiling of the remaining package of EU loans to Greece (GLF facility & ESM) However, the package of outstanding EFSF loans to Greece constitute c. 60% of all EU loans

[2] https://www.eurobank.gr/Uploads/Reports/GR%20MACRO%20MONITOR_How%20much%20relief%20is%20actually%20needed%20to%20restore%20public%20debt%20sustainability_May%202017.pdf

disbursed thus far and just c. 50% of all EU loans that are expected to be disbursed until the completion of the present programme (all in notional terms)

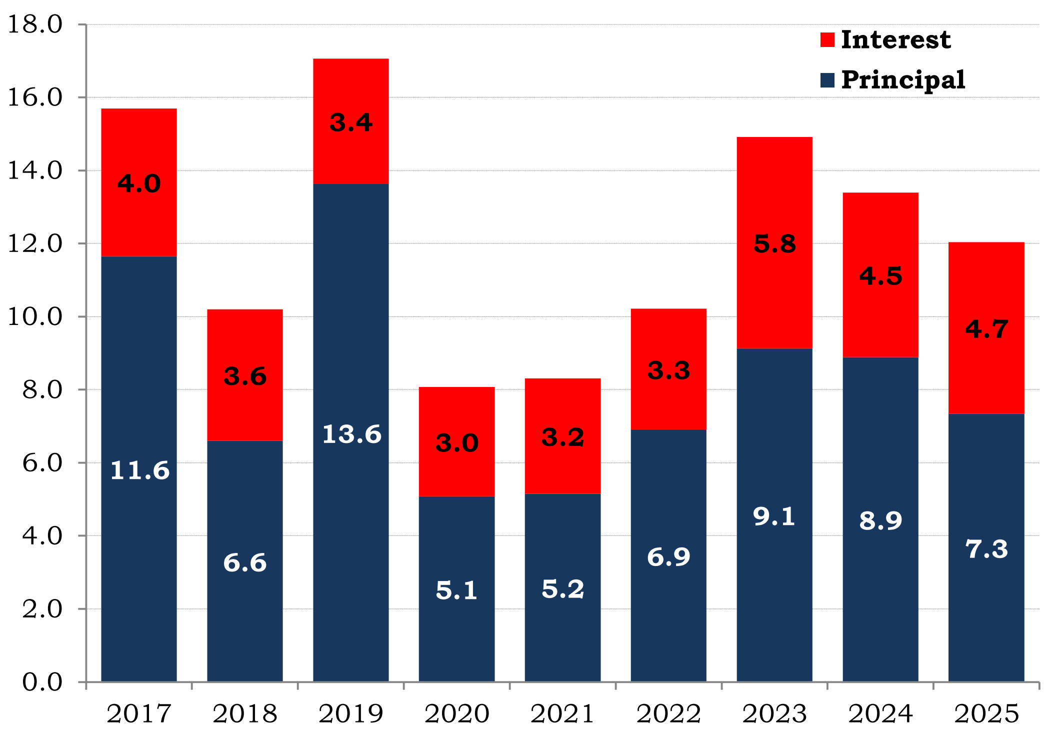
As a conclusion, the baseline is that the scope of the existing medium- and long-term debt relief framework would probably need to be further extended (by e.g. envisaging a significant reprofiling of all EU loans disbursed to Greece) if debt sustainability were to be accommodated under significantly more adverse macroeconomic scenarios, such as the one currently assumed by the IMF.

Figure 1 – Greece: realized & projected monthly interest and principal payments on Greek public debt in €bn (Jan-Dec 2017)



Source: EC, IMF, Eurobank Economic Research

Figure 2 – Greece: projected annual interest & principal payments on Greek public debt as of January 2017 (period 2017-2025 in €bn)



Source: EC, IMF, Eurobank Economic Research

Greek assets react positively to the better than expected June 15 Eurogroup outcome

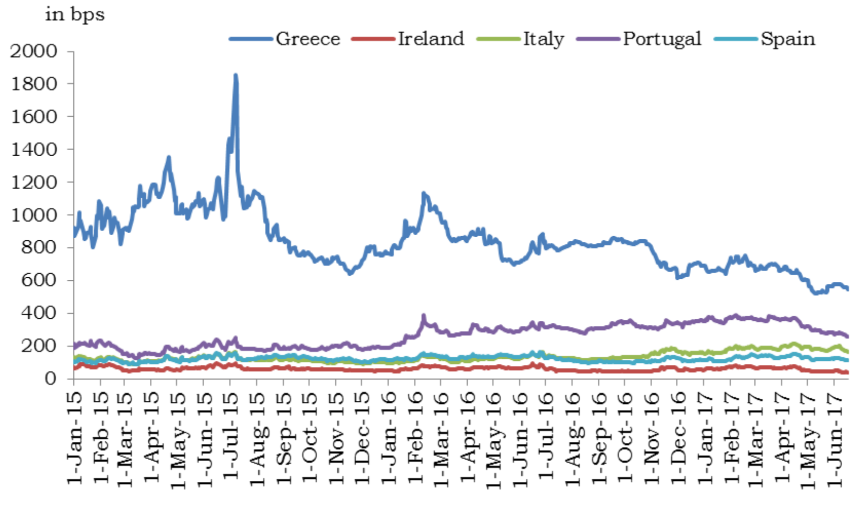
The outcome of the June 15th Eurogroup yielded a number of positive surprises for market participants. Euro area finance ministers undertook an explicit commitment to support investors' confidence so as to facilitate Greece's return to financial markets and provided some further clarity on the existing medium- and long-term relief framework. Furthermore, they committed to adopt an "operational growth adjustment mechanism" as part of the medium-term relief framework and they set out a clearer fiscal trajectory for the post-programme period, IMF Managing Director Christine Laggard announced her intention to shortly recommend to the Fund's Executive Board to approve in principle a Stand-by-Agreement while there was a clear reference in the accompanying statement to certain proposals for the development and support of a holistic growth enhancing strategy. All things considered, based on the news flows circulated over the last few days ahead of the meeting, the Eurogroup outcome was perceived as better than expected driving Greek assets higher across the board.

In a knee-jerk reaction, GGBs firmed extending gains recorded over the last few sessions amid expectations for a successful completion of the 2nd programme review that would open the way for the disbursement of official funding enabling Greece to meet interest and debt redemptions falling due in July. Following a short-lived bounce to levels slightly above 6.0% earlier this month, the 10-yr GGB yield remained in a downward trend for the sixth session in a row hitting a three-week intraday low close to 5.6% in early European trade (13:00GMT, Friday, June 16) marking a 22bps drop on a daily basis, the biggest in more than a month. The 2-yr paper outperformed with the yield falling to a new year-to-date low of 4.6% pushing the 2-10 year yield curve steeper. Reflecting the overall improved sentiment towards Greek sovereign paper, the GGB strip bounced to 79, some 130 cents higher on the day, approaching the 79.7 recent peak (May 2017).

Partially assisted by a renewed up-move of the 10-yr Bund yield to multi-week highs as market participants adjust their positioning to the more hawkish than expected tone adopted by both the Fed and the BoE at their June monetary policy meeting, the 10-yr GGB/Bund yield spread stood close to 540bps at the time of writing, some 40bps narrower from last week's multi-session peak, approaching the two-year low of 520bps marked in early-May. It is worth mentioning that the Greek sovereign bond market has been the star performer in the EMU sovereign space so far this year with the 10-yr GGB/Bund spread having narrowed by some 150bps cumulatively. The technical picture for the 10-yr GGB/ Bund yield suggests that strong support stands at 500bps (mid-Sep. 2014) with 455bps seen containing any further narrowing on market anxiety ahead of the release of the IMF's updated DSA, expected in late July. On the flipside, strong resistance stands at 582bps (early Jan. 2017) ahead of 751bps (Feb. 2017).

In a similar positive tone, Greece's equity market firmed with the Athens Stock Exchange General Index (ASE) surpassing the 800 level for the first time in two years, recording cumulative gains c. 26% so far this year. Bank shares were among the main outperformers on Friday's session with the respective equity index recording an intraday session peak of 1,085, the highest in a year.

Table- EMU 10-yr yield spreads vs. their German counterpart



Source: Bloomberg, Eurobank Economic Research