Greece and the COVID-19 outbreak: Five factors to watch in 2020 and beyond

While the inclusion of Greek government bonds in the European Central Bank's Pandemic Emergency Purchase Programme is credit-positive, the success of government measures in major economies to slow the COVID-19 pandemic will set the stage for the country's ratings trajectory in 2020. Amid an uncertain outlook, Greece's economic policy challenges include the reduction of the large stock of non-performing loans (NPLs) and the stepping up of privatisations and reforms, which would support the resilience of Greece's economic recovery and long-term public debt sustainability.

While the COVID-19 pandemic will set the stage for Greece (BB/Positive)'s rating outlook in 2020, five key factors will determine Greece's ratings path over the next 12 to 18 months:

i) the *resilience of the economic environment* with the COVID-19 pandemic posing a serious risk to macroeconomic conditions;

ii) the realised *reduction in still-high NPLs*, which weigh on the banking system's performance and capacity to finance growth;

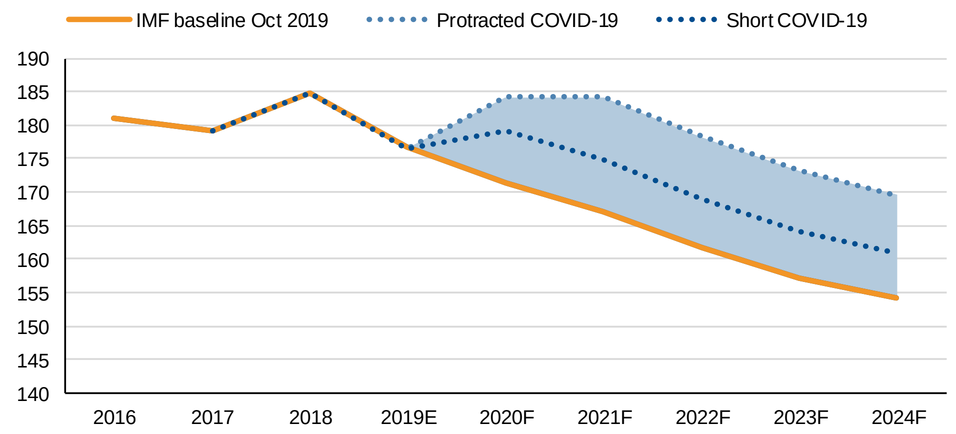
iii) the *broadening of the country's capital market access* amid rising risk aversion;

iv) the *appropriateness of the fiscal policy mix* and possible budgetary measures for extraordinary spending on healthcare; and

v) *continued reform momentum* to close the country's investment gap by creating productive possibilities for new lending and attracting foreign direct investment.

Each of these factors, or a combination thereof, could materially improve the real economy's access to required liquidity and Greece's macroeconomic stability, thus ultimately strengthening the sovereign's long-term public debt sustainability and creditworthiness.

Figure 1: Public debt/GDP under different scenarios, %



Source: IMF, Scope Ratings GmbH

We have considered different scenarios over the period 2020-2024 in our debt sustainability analysis (see **Figure 1**). For reference, we include the latest IMF *baseline scenario* from October 2019 with a projected decline of Greece's debt-to-GDP ratio to ca. 154% by 2024.

The *protracted COVID-19 scenario* stresses the IMF forecast by capturing materialisation of economic risks related to a severe COVID-19 pandemic with an extended lockdown of the economy, which would lead to a debt reduction to just around 170% of GDP by 2024. The *short COVID-19 scenario* assumes that the COVID-19 outbreak is relatively contained by end-H1 2020 with a more modest impact on growth and the primary balance (see **Appendix**). On this more favourable basis, public debt would decline to 161% of GDP by 2024.

Analysts
Jakob Suwalski
+49 69 6677389-45
j.suwalski@scoperatings.com

Julian Zimmermann
+49 69 6677389-89
j.zimmermann@scoperatings.com

Team leader
Dr Giacomo Barisone
+49 69 6677389-22
g.barisone@scoperatings.com

Media
André Fischer
+49 30 27891-147
a.fischer@scopegroup.com

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Scope Ratings GmbH
Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

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Key factor # 1: Resilience of the economic recovery

Sustaining robust growth is crucial for the long-term outlook for public finances

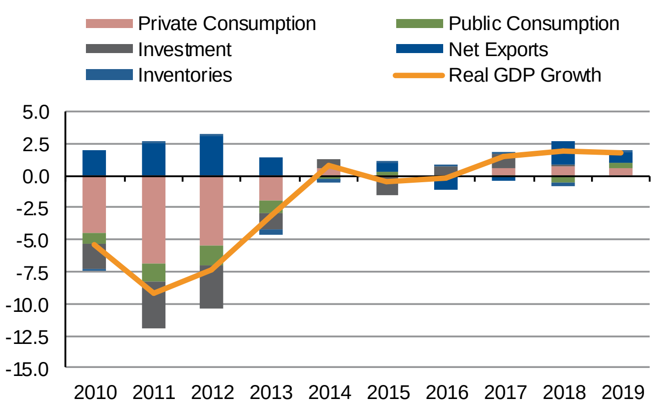
Economic growth ultimately holds the key for Greece's public debt sustainability. After returning to growth in 2017, the growth rate has recently stabilised at around 2% (see **Figure 2**), driven by exports on the back of cost competitiveness gains, rising tourism and shipping receipts and consumer spending supported by improving real disposable income.

We expect a significant cyclical slowdown of growth in 2020

We expect real GDP growth of around -1% this year, subject to substantial uncertainty given the dynamic nature of the COVID-19 pandemic and government countermeasures. This baseline scenario assumes a COVID-19 outbreak that is momentarily contained by the summer 2020, although with the risk of an additional "wave" in the fall or winter. Our growth forecast is based on:

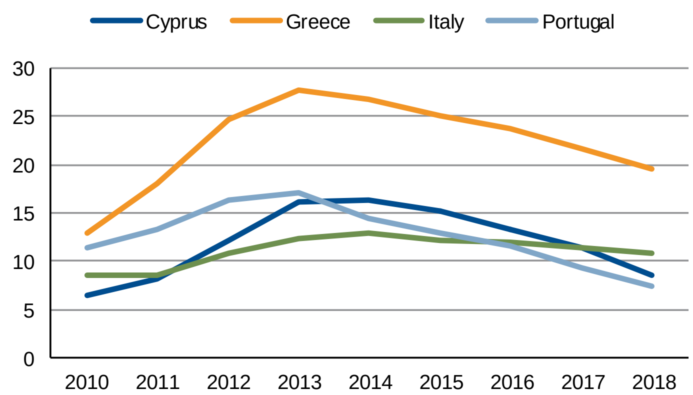
- *weakened private consumption*, supported by tax measures adopted in 2019, which lower the tax wedge on earnings at lower income levels;
- *moderate investment, weakened over the first half of the year but recovering in the second half of this year*, supported by the 2020 tax package, which aims to reduce the tax burden on capital, which should support the reduction of Greece's large investment gap; and
- *a tentative and gradual recovery in exports in the second half of this year with risks of further interruptions in the case of additional external shocks*, while imports are set to weaken as well (balancing moderate domestic demand growth as well as lower costs for oil imports), leading overall to a deterioration in the trade balance in the year ahead.

Figure 2: Real GDP growth contributions, pps of GDP



Source: Haver Analytics, Eurostat, Scope Ratings GmbH

Figure 3: Unemployment rate, %



Source: Haver Analytics, Scope Ratings GmbH

The Greek economy is vulnerable to the COVID-19 pandemic in view of a high reliance on tourism

The Greek economy is vulnerable to the COVID-19 pandemic in view of: i) still moderate consumption growth, mirroring relatively high household debt and the low debt-servicing capacity of households with negative gross savings rates since 2012, implying that savings must fund consumption; and ii) unemployment at 16.3% of the active labour force as of December 2019 (see **Figure 3**), which we expect to remain high due to the significance of vulnerable industries such as tourism and trade (21% of GDP in 2018); and iii) a high share of self-employed workers (34% of total employment vs. euro area average of 15%) that are particularly vulnerable in view of weakened cash flows due to sickness coverage and low availability of liquid savings or collateral.

Recovery is subject to the impact on financial markets and broader economy of the spread of the coronavirus

Key risks to our growth forecast in 2020 include:

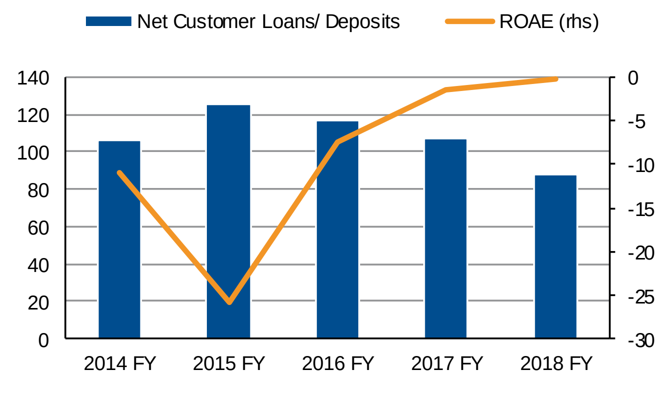
- scenarios such as that in Italy playing out in Greece, in which economic activity is brought to a near-halt to slow the pandemic, thus weighing on private consumption and resulting in lower-than-expected receipts from the tourism and transportation sectors;
- an exacerbation of the refugee crisis or escalation of political conflicts with neighbouring Turkey, which could damage tourism and trade; and
- failure to attract (foreign) investment due to increasing risk aversion rooted in the pandemic, thus furthering the burden on the banking system's performance and further limiting the latter's capacity to support the real economy via liquidity provision.

Key factor # 2: Increasing robustness of the banking system

NPL reduction accelerated in 2019 but levels to remain high

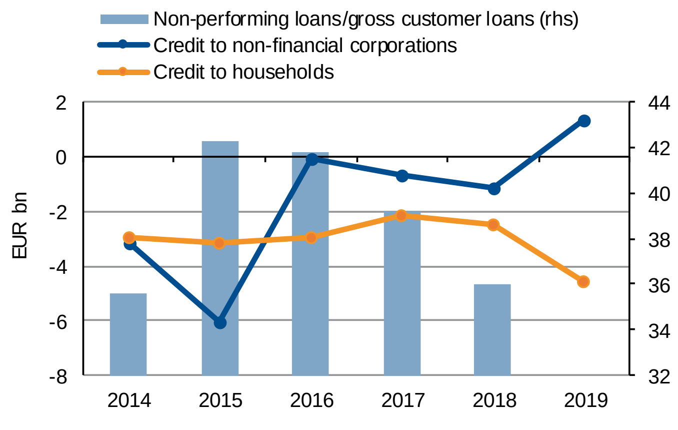
Greece's restructured banking sector is set to become another important supporting factor for the economy. While there has been significant progress made in reducing the nominal amount of NPLs on Greek banks' balance sheets (from EUR 100bn in 2015 to around EUR 70bn at the end of 2018), the NPL ratio remains high compared to that of euro area peers at 36% of gross customer loans at end-2018.

Figure 4: Loan-to-deposit ratio and return on average equity, %



Source: SNL, Scope Ratings GmbH

Figure 5: Lending to the private sector (flows, EUR bn) **and NPL ratio** (%)



Source: ECB, SNL, Scope Ratings GmbH

Greek banks' profitability has improved but is constrained by poor asset quality

A high share of NPLs weighs on banks' profitability and inhibits new lending to the economy by tying up provisions and binding a high share of capital due to high risk weights. The return on average equity (ROAE) of Greek banks has been negative in past years (see **Figure 4**), further putting pressure on the capital stocks of banks, which, coupled with the very low interest rate environment, constrains new lending. While the latest available financial results (Q3 2019) still show profitability supported by one-off items, core profitability remains weak reflecting low net interest income. Due to domestic banks' large structural shares of net interest income in total earnings together with the weakening of the macroeconomic outlook, we expect Greek banks' profitability to remain constrained over the medium-term.

NPLs require high provisioning, which constrains banks' lending capacity

As the reduction of legacy NPLs frees up capacity, capital is a key driver to support economic growth via new lending. Due to the prolonged nature of the earlier recession, the weight on balance sheets of NPLs and other structural factors, Greek banks continued to deleverage loan books to non-financial businesses and households in past years. The recent recovery of economic sentiment and the success in reducing NPLs have led to a recovery in lending to non-financial businesses in 2019 (see **Figure 5**, previous page), which shows a positive annual flow for the first time since 2010, albeit concentrated in favour of large firms. The Greek secondary market for NPL portfolios continued to pick up pace in 2019 as the "Hercules" scheme was approved by the European Commission (EC) in October 2019. The associated capital relief could strengthen the financing capacity of the banking sector and help tackle crisis-induced investment-gaps that weigh on Greece's economic potential.

Two key risks to ambitious NPL reductions: implementation and regulatory treatment of state guarantees

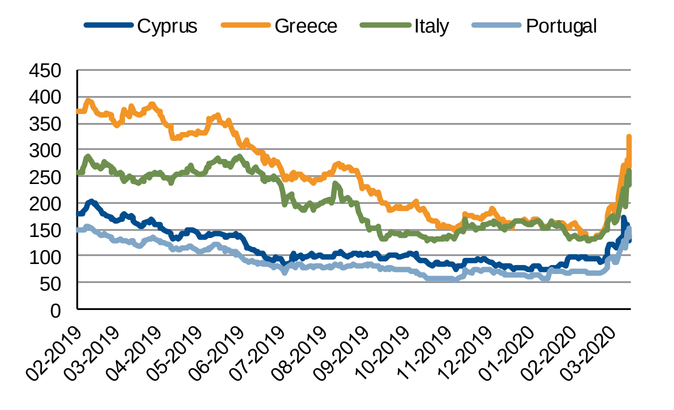
Greek banks have set ambitious NPL reduction targets to hit single-digit NPL ratios by 2023. Two key risks stand out: first, risk aversion and a drying up of liquidity in securitisation markets due to the coronavirus pandemic may result in a material slowdown in anticipated NPL reductions. Second, the Single Supervisory Mechanism does not consider the guarantees provided by the Greek state for senior tranches of Hercules securitisations to be sufficient to assign a zero risk-weighting to the guaranteed tranche of the transaction. This could lead to required provisions for additional collateral.

Key factor # 3: The country's and its banking system's capital market access

The declining trend in sovereign yields was reversed by COVID-19 risk aversion but the ECB's emergency purchase programme has alleviated pressure

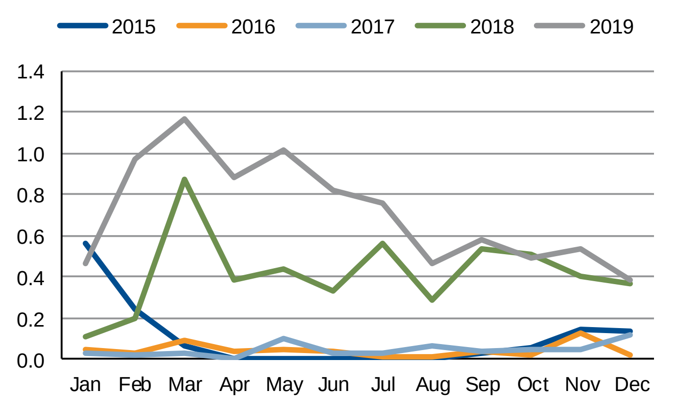
Greece's risk premia and refinancing rates had declined significantly until mid-February, with the 10-year government bond yield reaching 0.9%, close to Italy's level, with the spread to the 10-year German Bund at 136bp, before COVID19-induced financial sector volatility and risk aversion led to higher spread levels (**Figure 6**). The ECB announced on 18 March its Pandemic Emergency Purchase Programme in response to the distress in financial markets caused by the pandemic with a volume of EUR 750bn until at least the end of 2020. The purchase programme includes a waiver for the eligibility of Greek government securities, allowing ECB purchases of Greek government securities for the first time since the Securities Markets Programme of the early 2010s. This has helped to reverse the recent jump in Greek spreads to German Bunds.

Figure 6: 10-year bond yields over comparable Bunds, bps



Source: Haver Analytics, Scope Ratings GmbH

Figure 7: Monthly turnover of Greek government bonds, EUR bn



Source: Bank of Greece, Scope Ratings GmbH

Greece strengthened its presence on the sovereign bond market in 2019 and 2020

Before the pandemic outbreak, Greece proved its ability to issue debt with maturities beyond 2032, the year the grace period for existing EFSF loans ends, at low cost by issuing a 15-year bond (EUR 2.5bn) on 4 February 2020 with a 1.875% coupon and a final order book of EUR 19bn. In addition, several liquidity operations have reduced refinancing rates without increasing the debt stock[1]. However, secondary market trade volumes remain at a fraction of pre-crisis levels (average monthly turnover of EUR 0.7bn in 2019 vs. EUR 7bn in 2010 and EUR 47bn in 2006) but were steadily increasing since 2018 (**Figure 7**).

[1] In 2020, Greece's Public Debt Management Agency (PDMA) conducted liquidity operations via a bond swap agreement on three bonds with maturities between 2023-26 (held by the National Bank of Greece) with a new government bond that has a 30-year maturity, with equal market value and nominal amounts of the bonds exchanged.

Favourable debt and liquidity profile

Greece's debt and liquidity profile benefits from three key factors, which shield the economy to an extent against current heightened capital markets volatility:

- a substantial cash balance, with government reserves standing at EUR 23.5bn at the end of 2019, fully covering government debt maturities through 2022 and a credible backstop against refinancing risks over the rating-relevant time horizon;
- a favourable amortisation profile, characterised by i) a long weighted average debt maturity of 21 years as of end-2019, ii) a low effective weighted average interest rate of 1.7% (January 2020), and iii) a high share of fixed-rated debt (>90% of total debt as of end-2019), limiting risks from rising borrowing rates; and
- continued contingent official sector support, tied to ongoing enhanced post-bailout surveillance through mid-2022, and subject to Greece's compliance with reform commitments.

Further normalisation of the liquidity situation of the financial sector is a key ingredient for sustained growth

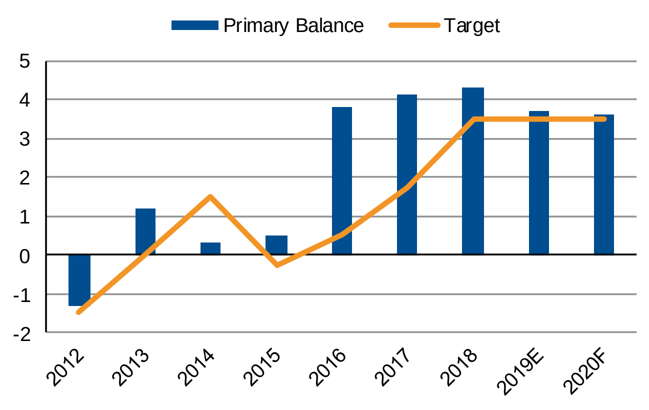
Along with the sovereign, Greek banks also experienced easing liquidity conditions over the past three years. Customer deposits in Greek banks have been increasing since 2017 on average by 13% per year and, in 2019 and 2020, and for the first time since 2015, all major Greek banks were able to place unsecured long-term tier 2 bonds on the market, albeit at relatively high though declining rates, paving the way for future capital market issuance.

Key factor # 4: Fiscal policy mix and budgetary measures

We expect Greece to have met its primary surplus target in 2019

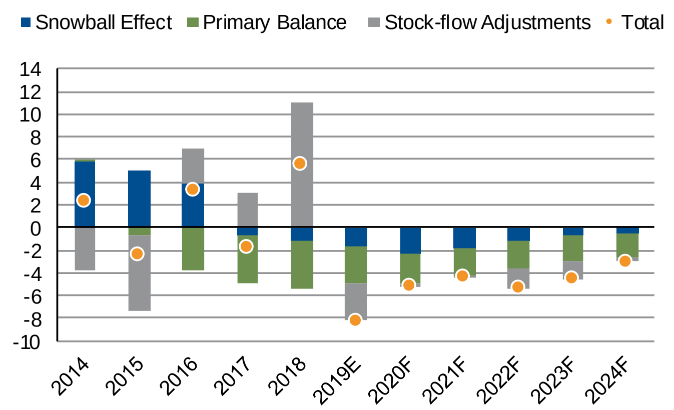
The primary fiscal surplus is projected to have been at around 4% of GDP in 2019 (enhanced surveillance definition[2]), well above the target of 3.5%. This would mark the fifth year in a row in which Greece would have exceeded its budget target (**Figure 8**, next page), helped by stronger value-added tax collections due in part to buoyant tourism spending. These factors offset expenditures related to measures adopted by the former Alexis Tsipras government in May 2019, as well as retroactive payments to public sector employees and pension outlays.

Figure 8: Primary Budget Balance under the programme definition, % of GDP



Source: Greek Ministry of Finance, Scope Ratings GmbH

Figure 9: Annual change in Public Debt to GDP and decomposition, % of GDP



Source: IMF, Scope Ratings GmbH

Greece has exceeded its fiscal targets in recent years due to underspending of the investment budget

Over past years, Greece has established a rules-based fiscal governance framework and extended the budgetary scope from the state to the general government, which has strengthened top-down budgeting and supported meeting fiscal targets and maintaining

[2] The definition of the primary budget balance under the programme deviates from that under the Excessive Deficit Procedure. The former excludes the cost of banking sector support, Securities Markets Programme (SMP)/Agreement on Net Financial Assets (ANFA) profits-related transfers from member states and some privatisation revenues.

market confidence. Striking the right balance between growth-enhancing measures such as greater public investment – the low level of which in part drives the large primary surpluses[3], fiscal discipline and policies to address social pressures have required the government to revisit agreed primary surplus target for 2020, as provided for by the EU's Stability and Growth Pact, which allows fiscal flexibility in cases of exceptional incidents such as this pandemic that is beyond the control of governments (see Scope's related research). The Greek government will now have greater leeway to expand public spending as the EU relaxes budgetary limits and ECB action supports lower borrowing rates.

Lowering of future primary surplus targets will likely support debt sustainability

Lower primary surpluses are also supported by the still low borrowing rates under historical standards. Under this context, we note that Greece's borrowing terms for new issuances in 2019 and 2020 remained significantly below the baseline scenario considered in the debt sustainability analysis underpinning the completion of Greece's former European Stability Mechanism programme.

Key factor # 5: Continued reform momentum

Greece progresses well in implementing reform commitments in 2019

According to the EC's fifth Enhanced Surveillance Report issued in February, Greece has progressed well in implementing its reform commitments for end-2019. While growth in output ultimately holds the key for Greek debt sustainability, we are reassured by recent government successes in facilitating a shift in the country's economic structure towards tradeable products and luring back foreign investors. Reforms include:

- the resumption of the stalled privatisation process that Prime Minister Kyriakos Mitsotakis's government is pursuing to lift growth potential;
- tax benefits for foreign investors, coupled with the expected full implementation of the investment licensing reform (by mid-2020) and the completion of the cadastral and forest mapping (by mid-2021) to strengthen currently low levels of investment, which was in 2018 still less than half of its pre-crisis average level of 11.1% of GDP (euro area average: 20.6%), mirroring constrained access to finance;
- the envisaged reduction of red tape via implementation of the three-year action plan on justice (incl. e-Justice, by mid-2020) to reduce still high regulatory burdens and material inefficiencies in the justice system alongside reforms of the Greek legislative process (by mid-2022) to streamline public administration; and
- structural reforms in the labour market with wage bargaining becoming more flexible, which has improved cost competitiveness and facilitated a shift in the economic structure towards tradeable products, with the economy remaining relatively closed (exports at 37% of GDP in 2019 vs. a euro area average of 48%).

Greece needs to attract foreign capital and open its economy

Making up for years of underinvestment over the last decade would improve the attenuated capital stock, attract skilled workers and increase productivity and is thus of vital importance for future economic growth – hence the need for further privatisation and labour-market and tax reforms. While fast realisations of flagship privatisation projects are crucial for attracting higher investment via foreign direct investment in the short-term, higher investment would support sustaining higher and more stable growth rates over the longer-run. Greece's improved price competitiveness has provided incentives for producers to move into tradeable sectors, which should support the reduction of skills mismatches in the labour market going forward.

The Hellenic Corporation

A keystone for the privatisation strategy is the 'Hellenic Corporation of Assets and Participations', which was established in 2016 to manage Greek state assets in several

[3] On average, Greece spent 61% of public investment budget ceilings allocated to ministries over 2017-18.

public corporations and maximise their value through privatisations and other means. Recent measures (per the Asset Development Plan in September 2019) include:

- the 20-year extension of the concession agreement of the Athens International Airport (AIA);
- nine finalised privatisation projects (Piraeus Port Authority, Thessaloniki Port Authority, Hellenic Gas Transmission System Operator, etc.);
- 23 ongoing projects, with some of them at an advanced stage (e.g. sale of 30% of stakes in Athens International Airport (AIA)); and
- the initiation of a process for many real estate assets, most of which are expected to be completed in 2020.

The faster implementation of privatisation projects is reflected in the Greek state budgets: the forecast for public revenues from privatisations for 2020 is EUR 2.4bn (mainly due to the sale of a 30% stake in AIA and the sale of a 65% stake in the Public Gas Company), following sales in 2019 of EUR 1.3bn (mainly due to the extension of the concessional agreement of the AIA) and around EUR 1bn in 2018.

Appendix

Table 1: Assumptions and debt/GDP results under different scenarios

Scenario	Time Period	Real GDP growth (%)	Primary bal. (% of GDP)	Effective int. rate (%)	Debt, end period (% of GDP)
History	2014-2018	0.7	2.5	2.2	185
IMF Baseline	2019-2024	1.5	2.5	2.2	154
Short COVID-19: Modest shock to economic growth and primary balance contained to 2020	2019-2024	1.0	2.3	2.2	161
Protracted COVID-19: Severe and extended shock to economic growth, primary surplus and refinancing rates	2019-2024	0.4	1.8	2.2	170

Source: IMF, Scope Ratings GmbH

We have considered different scenarios over the period 2019-2024 in our debt sustainability analysis (see **Figure 1**), including:

- an *IMF baseline scenario* based on October 2019 forecasts, with i) annual real GDP growth averaging 1.5% over the reference period, ii) primary surpluses averaging 2.5% of GDP and iii) an increasing cost of debt, with an average effective interest rate of 2.2%;
- a *short COVID-19 scenario*, with i) real GDP growth averaging 1.0% as a result of an impact from the SARS-CoV-2 virus contained predominantly to H1 2020 with a potential lockdown of the economy of up to one month and a modest rebound thereafter, as well as ii) lower primary surpluses averaging 2.3% GDP as a result of higher healthcare costs, which will be partially funded by Greece's cash balance in 2020 and iii) slightly higher financing costs compared to the IMF baseline;
- a *protracted COVID-19 scenario*, with i) real GDP growth averaging 0.4% per annum, i.e. 1.1% lower than the IMF baseline, which would be driven mostly by the adverse growth impact into 2021 from a prolonged and significant global shock related to the COVID-19 pandemic including a lockdown of the Greek economy for up to three months in 2020 and primary surpluses below the IMF baseline scenario in the context of lower growth, and thus reduced revenues, high healthcare spending and higher spending on support measures for the economy.

Outcome:

- According to the IMF baseline scenario, Greece's debt-to-GDP ratio is expected to decline to around 154% of GDP by 2024.
- The *short COVID-19 scenario* would see a less favourable outcome, with public debt-to-GDP declining to 161% of GDP in 2024, while the *protracted COVID-19 scenario* would lead to a flatter path of decline for public debt, to just 170% of GDP by 2024.

Scope Ratings GmbH

Headquarters Berlin
Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main
Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris
1 Cour du Havre
F-75009 Paris

Phone +33 1 82 88 55 57

London
Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 20 3457 0444

Madrid
Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

Milan
Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo
Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com