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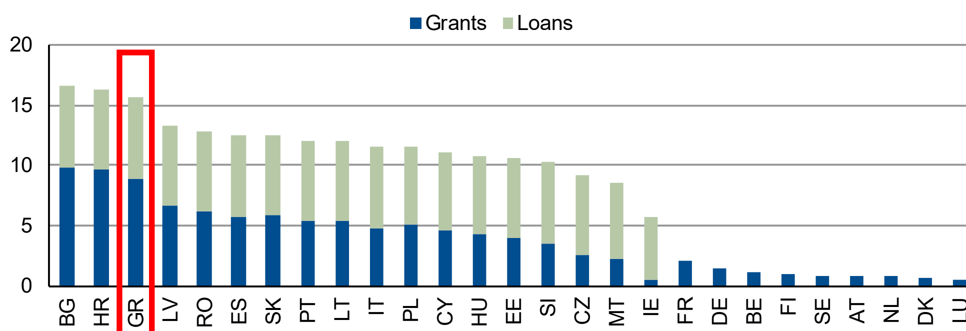
Greece's Covid-19 recovery: short-term risks contrast with longer-term growth potential

Greece's economic recovery has ground to a halt with the outbreak of Covid-19 and measures to combat the pandemic. However, the forceful response from the EU, the ECB and the government have improved Greece's longer-term growth outlook and debt sustainability. The country's economic growth hinges on effective absorption of EU recovery funds, continued reforms to increase the economy's growth potential, and an acceleration in the reduction of non-performing loans (NPLs) of Greek banks.

Greece **(BB/Positive)** is particularly exposed to the economic impact of the pandemic through its dependence on tourism, hard hit by lockdowns and travel restrictions, and the high proportion of its workforce made up of the self-employed. In the second quarter of 2020, Greek real GDP declined by 15.2% year-on-year, and we expect a rebound from Q3 on, provided the second wave of the pandemic does not require a new lockdown with adverse effects on Greece's growth prospects and public debt trajectory. In addition, the poor core profitability of Greek banks, burdened by still elevated levels of NPLs, limits their capacities to support the real economy. We project Greece's real GDP to decline by 7.8% this year.

However, the economy benefits from effective government measures to contain the public health crisis and fiscal action to support the economy. In addition, emergency action by the ECB and the EU are of particular benefit to Greece. The European Commission's *Next Generation EU* proposal should deliver an estimated maximum allocation of grants and loans of almost 16% of 2019 GDP (see **Figure 1**). The combined impact should be to limit the drop-off in activity in 2020 and contribute to a strong recovery in 2021 (projected 5.2% real growth).

Figure 1: Proposed allocation of Next Generation EU funds
% of 2019 GDP



N.B. For loan allocations, we assume 6.8% of 2019 GNI in take-up by sovereigns with a higher financing rate than the EU. Source: European Commission, Bruegel, Eurostat, Scope Ratings GmbH

For the short-term, we identify these policy challenges for the Greek government:

- maintaining liquidity for the real economy, supported by EU measures; and
- stabilising the economy during the crisis with adequate fiscal policies to help prevent layoffs, particularly in a scenario of a much more sluggish recovery.

Past structural reforms have improved Greece's long-term growth outlook though Greece faces several economic challenges over the medium term, including:

- reducing the high stock of NPLs, which impair banks' lending capacities;
- narrowing the large investment gap by attracting enough foreign direct investment (FDI), as domestic savings are insufficient to provide necessary funds; and
- making effective use of available EU funds for investment projects, such as green and digital projects, alongside the continued opening of the Greek economy.

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Economic outlook: short-term risks vs long-term growth potential

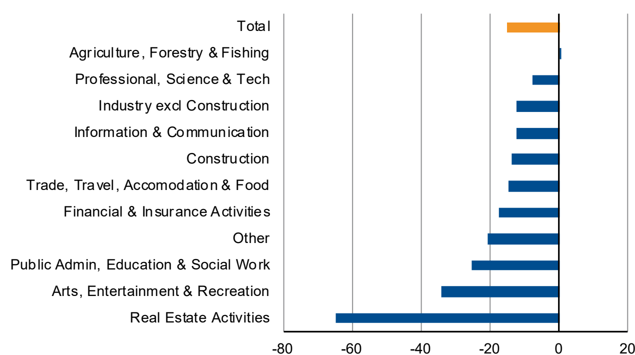
In the first half of 2020, output was reduced significantly due to lockdown measures

Greece experienced a 15% decline in output across all sectors on aggregate in the first half of 2020 compared with the same period last year (see **Figure 2**), one of the sharpest declines in the euro area. The third quarter will be crucial for determining how quickly the economy can rebound and whether a wave of insolvencies, should furlough schemes and moratoria end, can be avoided, given the period is typically responsible for 55% of tourism receipts. Under our baseline scenario, we expect a 7.8% contraction of real GDP in 2020 before a 5.2% rebound in 2021, with the crisis disproportionately hitting services sectors related to tourism and real estate (**Figure 2**). For more details on our economic forecast, see **Annex I**.

Government measures have supported employment and liquidity to businesses

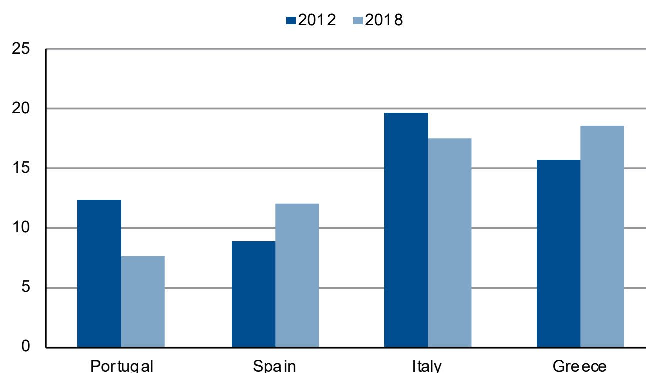
Government measures in the form of furlough schemes have prevented higher unemployment, which stood at 17% in May (vs. 17.2% a year before). Part of this trend was also due to people leaving the labour force after losing employment in the first months of the crisis, thus not counting towards unemployment statistics. Government support for small and medium-sized enterprises (SMEs) has included comprehensive financial aid, including the deferral of company tax and social insurance payments, and a loan-guarantee programme. High-frequency indicators like tourism arrivals and business confidence point to a rebound since June, albeit with economic activity still at weakened levels. The shape of the recovery will depend on the trajectory of the pandemic, both domestically and internationally.

Figure 2: Output of Greek businesses in H1 2020
% change vs H1 2019



Source: ELSTAT, Scope Ratings GmbH

Figure 3: Time to resolve civil and commercial court cases
Months on average



Source: EU Justice Scoreboard, Scope Ratings GmbH

After the crisis containment phase, reform progress is key for sustained economic growth

Looking beyond the crisis, it is crucial for the Greek government to progress on its reform agenda in support of economic growth over the medium to long term. The European Commission (EC)'s latest Enhanced Surveillance report on Greece included a favourable assessment of economic reform progress, such as improvements in digitalisation and in the efficiency of public administration.

Structural reforms would significantly lift growth trajectory

In a recent study[1], the OECD found that, if proposed reforms were to be implemented, output could be 5.2% higher in 2030 than otherwise. These reforms include reducing the tax wedge and increasing family benefits, and streamlining judicial and administrative processes to improve the investment climate and attract foreign direct investment, as, for example, the time for legal enforcement is the longest of any country in the euro area periphery (see **Figure 3**). Another key element is boosting public investment, while making more efficient use of EU funds. Historically, Greece's absorption rates of EU structural funds have been below average, so it is key to improve the administrative capacity and

[1] OECD (2020), Economic Survey of Greece 2020.

governance to effectively use the significant funds made available under the EU's forthcoming recovery fund.

Pandemic creates NPLs; speed of NPL reduction contingent on market participants' sentiment and speed of economic rebound

Declining trend in NPL stock strengthened before the pandemic

Greek banks' aggregate domestic stock of NPLs fell 16% in 2019 compared with the previous year, representing a 36% decline from a March 2016 peak. However, the NPL ratio remains high at 37.3% of gross loans (see **Figure 4**). Evidence of the improved resilience of Greek banks was visible at the end of 2019, driven by improved profitability and enhanced capital adequacy: the capital adequacy ratio stood at 16.2% of risk-weighted assets at end-March. However, deferred tax credits (DTCs) accounted for 54% of total prudential own funds, signalling a strong linkage with the Greek sovereign and a more limited ability to use own funds to improve asset quality (see **Figure 5**).

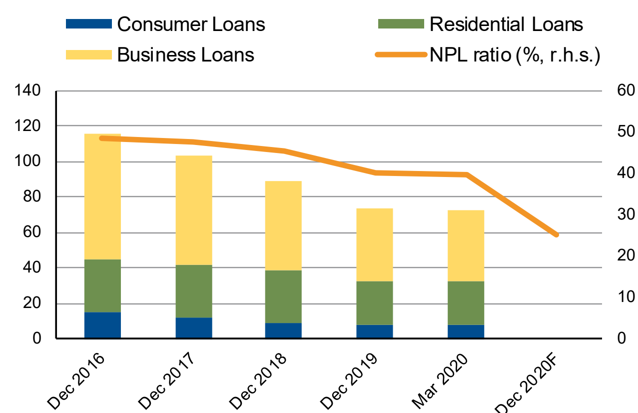
Impact of Covid-19 crisis expected to be material for Greek banks

The unprecedented lockdown measures in Greece have adversely affected the domestic financial system by: i) weakening asset quality given the expected boost to NPLs over a longer period of time as forbearance measures are exited; ii) squeezing profitability, still under pressure from the high stock of NPLs before the crisis, with the cost of credit risk set to rise as NPL volumes grow, further constraining banks' capacities to generate fresh capital; and iii) heightening risk aversion in securitisation markets, due to the debt moratoria applicable only until year-end, in which the precise impact on NPLs in these markets has yet to truly materialise.

National and EU-wide monetary, fiscal and regulatory measures soften the impact

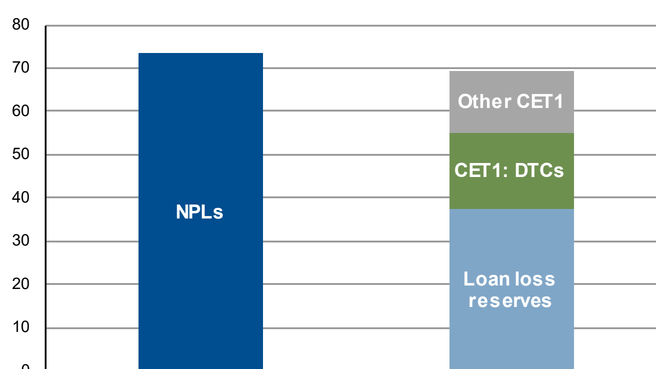
We expect, at the same time, that monetary, fiscal and regulatory measures put in place both at national and at the euro area level will considerably soften the impact of the pandemic on Greek banks while the completion of NPL securitisations transactions with recourse to the Hellenic Asset Protection Scheme (HAPS) will support further reductions of the existing NPL stock in 2020. The Bank of Greece estimates that the NPL ratio will reach around 25% at year-end, while remaining the highest ratio in the EU (see **Figure 4**).

Figure 4: NPLs by category and the NPL ratio
EUR bn (l.h.s.) and % of gross loans (r.h.s.)



Source: Bank of Greece, Scope Ratings GmbH

Figure 5: NPLs, loan loss reserves and own funds
EUR bn



Source: SNL Financial, Scope Ratings GmbH

Reform progress in the private debt resolution framework will accelerate NPL reductions

We believe that further progress in the reform of the private debt resolution framework, via streamlining legal procedures, could materially reduce the time to collect collateral and settle debt resolution, supporting a faster reduction in the NPL stock. With planned HAPS transactions experiencing delays, the Bank of Greece is developing a complementary proposal via an Asset Management Company, which could accelerate the reduction of NPLs and provide capital relief to Greek banks. While potential losses related to the existing legacy NPL stock should be covered by the private sector, up to the level of the minimum

capital adequacy requirement – and therefore not by the Greek tax payer, recent proposals aim at conducting transactions on market terms with the participation of private investors.

ECB crisis response has notably eased financing conditions, signalling low rates for longer

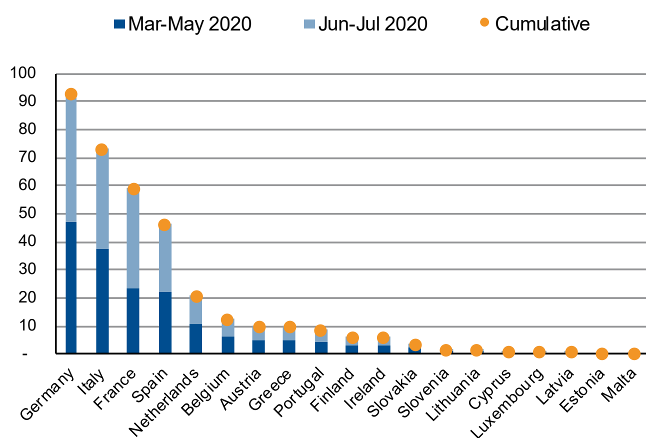
ECB and EU actions have broadened market access at favourable rates

Forceful European and euro area level support since the onset of the Covid-19 crisis has markedly improved Greece's access to capital markets. The inclusion of Greek government securities in the ECB's Pandemic Purchase Programme (PEPP) has allowed the ECB to purchase around EUR 10bn in Greek bonds on a net basis from March to July (see **Figure 6**). As a consequence, secondary market trading volumes for Greek government securities increased to EUR 1.8bn in July 2020 from EUR 0.8bn in July 2019 and Greece's 10-year yield declined to 1.2% at the time of writing.

Various sources of funding have ensured accommodative financing of the crisis response…

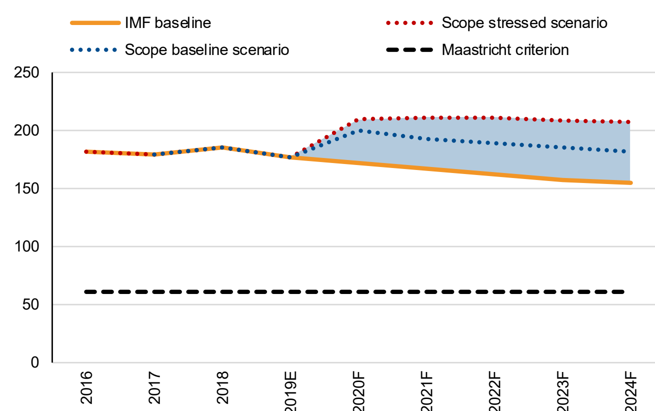
Greece tapped markets for a new 10-year bond for EUR 2.5bn at a coupon of 1.5% on 2 September, significantly down from a 3.875% coupon for a 2019 issuance of the same maturity, having already fulfilled 2020's funding objectives. In addition, the European Commission's SURE proposal would extend to Greece a loan of EUR 2.7bn on favourable terms to be used for the country's unemployment protection scheme. This, along with a modest reduction in the country's cash buffer of EUR 3bn between end-2019 and the end of March 2020, the third tranche of contingent debt relief of EUR 700m and the use of EU structural funds, has enabled Greece to finance its very sizeable fiscal response to the Covid-19 crisis of around EUR 14bn. Flows from the EU's recovery fund are scheduled to start in 2021 in a front-loaded fashion, further easing the future supply of financing.

Figure 6: ECB PEPP net purchases
EUR bn



Source: ECB, Scope Ratings GmbH

Figure 7: Gross public debt
% of GDP



Source: IMF, Scope Ratings GmbH

… leading to improved debt sustainability.

Greece's improved market access strengthens the country's medium-term debt sustainability. Our updated assumptions include i) the growth-boosting effects of EU grants and loans to be used for future investment, ii) a lower-for-longer financing rate environment and iii) slightly improved fiscal balances from 2021 onward as part of government spending can be assumed to be financed with EU grants or cheap loans. On this basis, in our baseline scenario, we expect Greece's debt-to-GDP ratio to decline from a 2020 peak of 199% to around 181% in 2024 (see **Figure 7**). In a stressed scenario, we only see a very gradual reduction in the debt ratio, from a 2020-peak of 209% to 207% in 2024, based on lower growth assumptions, higher structural unemployment assumptions, a weaker absorption of EU funds assumed that leads to less investment and worse fiscal performance. For further details on our assumptions for Greece's debt sustainability analysis, please see **Annex II**.

Annex I: Economic growth forecasting assumptions

For 2020, we use a model based on a gross value-added (GVA) calculation of GDP and run two scenarios (baseline and stressed), defined by the timing and shape of economic recovery in the activities of various industry sectors. We classify industry sectors as operating during the crisis at either at i) near-full capacity; ii) medium capacity; or iii) low capacity. This assessment is based on the severity of the synchronised demand and supply shocks on sectors in 2020.

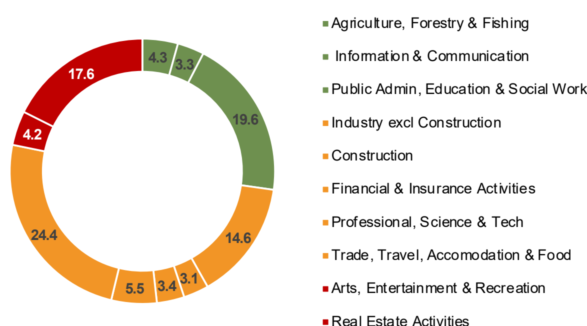
Impact of demand/supply shock		
Low	**Medium**	**High**
• Agriculture, forestry and fishing • Information and communication • Public administration, education and social work	• Industry • Construction • Financial and insurance • Professional services, science and technology	• Trade, travel, accommodation and food • Arts, entertainment and recreation • Real estate

We assume monthly recovery rates in output compared with pre-crisis levels for each of the above three broad classifications of sectors. In addition, we explicitly model the growth-positive effects of fiscal countermeasures announced by the government to date.

Our baseline scenario entails a gradual recovery into 2021 after containment measures were relaxed starting in H1 2020. Through 2020, we assume declines in monthly productive capacities of around 0-20% for low-hit (near-full capacity) sectors, 10-25% for medium-hit (medium-capacity) sectors, and 10-50% for the hard-hit (low-capacity) sectors in the case of Greece. We then adjust for the impact of announced fiscal stimulus measures, acknowledging varying fiscal multipliers between various types of government spending and government liquidity assistance.

Figure 8: Sectors' share in total GVA, by capacity

% of total

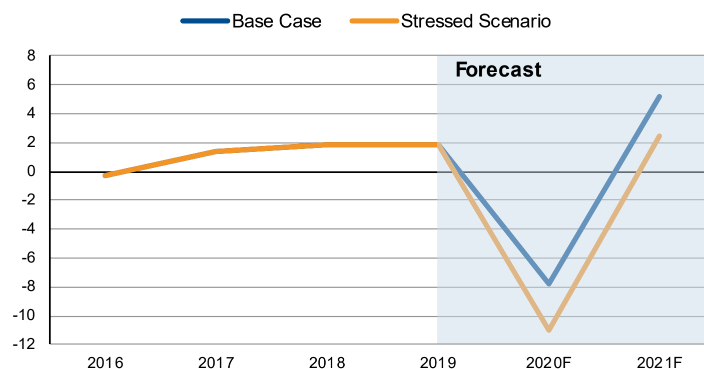


N.B. Green colour indicates low-hit, orange: medium-hit and red: hard-hit.

Source: Eurostat, Scope Ratings GmbH

Figure 9: Scope forecasts for real GDP growth

%



Source: Eurostat, Scope Ratings GmbH

We also estimate a central downside economic scenario, which considers the case that a second wave of coronavirus contagion in H2 2020 results in the re-introduction of strict containment measures by the fourth quarter, which also causes a much slower recovery in 2021. The results for real GDP growth in 2020-21 under baseline and (the outlined) stressed scenarios are as follows:

Scenario	2020	2021
Baseline	-7.8	5.2
Stressed	-10.8	2.5

Annex II: Debt sustainability assumptions

Our **baseline** debt projections derive from the following assumptions:

Factor	2015-19	2020	2021	2022	2023	2024
Real GDP, %YoY	1.0	-7.8	5.2	1.6	1.1	1.2
GDP deflator, %YoY	0.3	-0.4	0.4	0.8	1.5	1.8
Primary balance, % GDP	3.2	-3.9	-0.5	1.0	1.3	1.5
Interest payments, % GDP	3.3	3.6	3.8	3.8	3.8	3.8
General government debt, % GDP	176.6	199.2	192.6	189.1	185.0	181.4

- Continued recovery in economic growth into 2021 absent another strict round of lockdown measures and broad travel restrictions as seen in H1 2020; better than previously observed absorption rates of EU funds, amounting to a maximum 15.8% of 2019 GDP, estimated to boost real growth by 0.5pp between 2021-2024;
- Weaker annual inflation in the GDP deflator in 2020 to reflect weak economic conditions; and
- 50bp lower financing rates vis-à-vis IMF pre-crisis implicit assumptions, reflecting central bank interventions.

Our **stressed** debt projections derive from the following assumptions:

Factor	2015-19	2020	2021	2022	2023	2024
Real GDP, %YoY	1.0	-10.8	2.5	1.1	0.6	0.7
GDP deflator, %YoY	0.3	-0.9	0.2	0.6	1.3	1.5
Primary balance, % GDP	3.2	-5.9	-3.5	-0.5	0.8	1.0
Interest payments, % GDP	3.3	3.7	4.1	4.3	4.4	4.4
General government debt, % GDP	176.6	209.0	211.2	210.9	208.8	207.1

- Additional economic weakness by Q4 2020 and significantly slower recovery in 2021 due to prolonged pandemic alongside lesser growth-boosting effects from funds from the Next Generation EU fund;
- Weaker annual increases in the GDP deflator, especially over 2020 and 2021, reflecting weak economic conditions;
- 50bp higher financing rates vis-à-vis IMF pre-crisis implicit assumptions, reflecting higher risk premia in from 2022; and
- Crystallisation onto the sovereign balance sheet of contingent liabilities from government guarantees: 0.2% of GDP per year until 2022 vis-à-vis IMF pre-crisis implicit assumptions.

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