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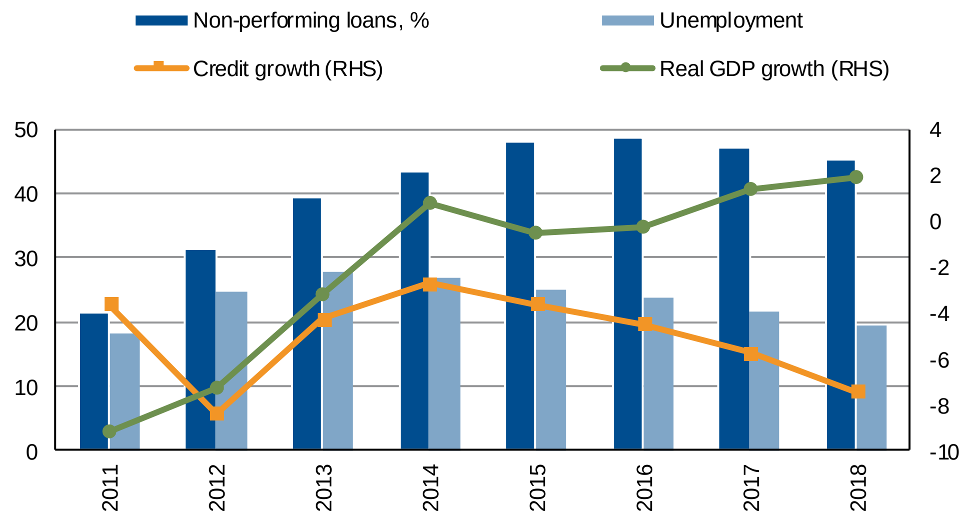
Greece must improve private-sector liquidity, raise investment to tackle economic constraints

Greece has kept public sector deficits in check since exiting its European Stability Mechanism (ESM) programme in August 2018. Ensuring robust growth and access to adequate funding for the real economy are vital in offsetting persisting crisis era-induced constraints, such as high levels of non-performing loans and unemployment.

Greece's economy continues to be challenged by crisis-induced economic constraints, although improvements are occurring at a slow pace. The banking system remains saddled with a strong sovereign-bank-nexus and a substantial stock of non-performing loans (NPLs), which amounted to 45.1% of total loans at the end of first quarter in 2019. This is weighing on credit supply amid an improving liquidity situation and increased depositor confidence.

Real growth and employment creation have been maintained in 2019, but the economic recovery remains fragile in view of the emigration of skilled labour and a high unemployment rate of 17.2% in May 2019 (although down from a peak of 27.8% in 2013; see **Figure 1**).

Figure 1: Real growth and credit growth (both %YoY) vs. NPL ratio and unemployment rate (%)



Source: Scope Ratings GmbH

The Greek government is working on initiatives to address residual legacy constraints head-on, such as high NPL levels, and, in the short term, has announced the full lifting of remaining capital controls, which is credit-positive. Two factors are key for Greece's growth prospects:

- **Financial sector policies that improve liquidity in the real economy**. Greek banks play an important role, first by reducing the high NPL stock and, second, by providing the necessary credit to fund productive investments. Banks will have to move NPLs off their balance sheets to strengthen support for the financing of economic activity.
- **Commitment to more reforms to attract foreign capital.** Higher growth backed by investment would contribute to addressing the crisis-induced investment gap that weighs on Greece's economic potential. Low domestic investment and a still-weak Greek banking sector make the economy reliant on foreign capital. Accelerated reforms would support investor confidence and potentially reverse emigration of skilled labour, by creating more business-friendly conditions and higher-value added employment opportunities.

Lead Analyst

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

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

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

info@scoperatings.com
www.scoperatings.com

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Macroeconomic outlook

Strengthened growth momentum

Following eight years of recession resulting in a 44% loss of per capita GDP between 2008 and 2016, Greece's recovery has gained some momentum. The economy grew by 1.9% in 2018. The European Commission is forecasting real GDP growth of 2.1% in 2019 and 2.2% in 2020[1], which would broadly match figures from the ambitious baseline macroeconomic scenario in Greece's Stability Programme 2019-2022 (real GDP growth of 2.2% per year).

Economic recovery will continue in 2019/2020

Scope expects Greek growth of around 2.5% in 2019, with the pace remaining robust over 2020-2024, helped by the consumption-friendly impact of fiscal measures adopted by the previous government in May 2019 (including an increase in the minimum wage, reductions in selected VAT rates, and introduction of a 13th pension) alongside certainty offered by the new government's commitment to fiscal discipline and structural reforms.

Our 2019 growth expectation is based on six factors:

i) a still-high negative output gap (-6.0% of potential GDP in 2018), meaning there remains significant unused economic capacity;

ii) steady private consumption growth, reflecting the country's recovery process following a protracted crisis (see **Figure 2**);

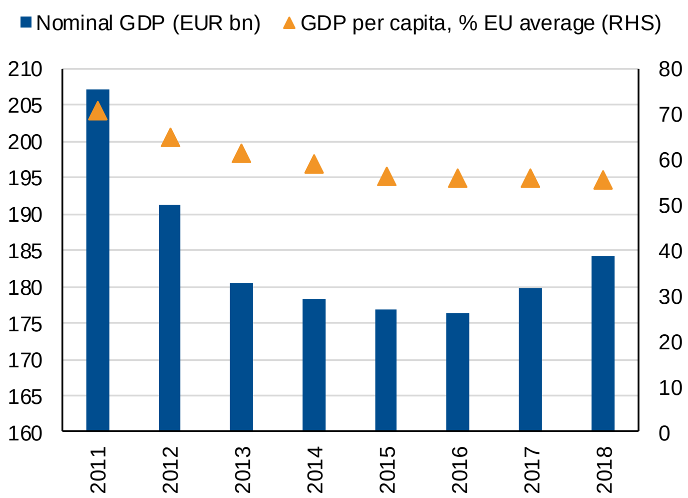
iii) the positive effects of fiscal measures adopted in May 2019, boosting household disposable income;

iv) muted inflationary pressures –with consumer price inflation at 0.4% in July – supporting household purchasing power;

v) accelerating investments, as reflected in the rebound in non-residential construction and equipment investment in the first quarter of this year and indications that the housing market is continuing to recover despite shrinkage in the volume of home loans extended by banks; and

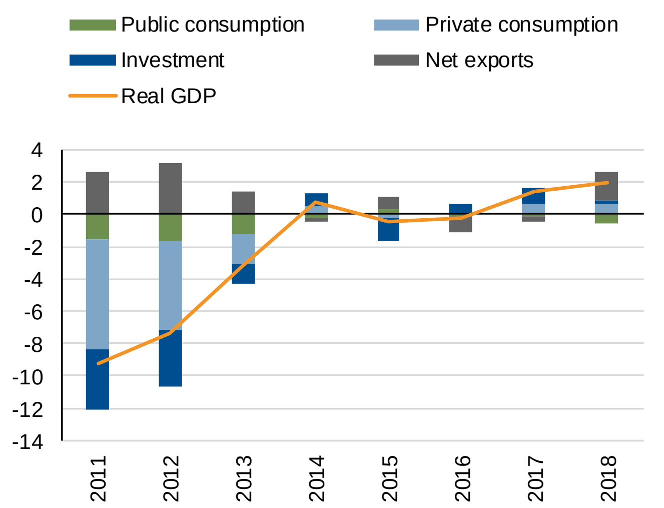
vi) moderation of export performance, reflecting a weakening external environment and Greece's still-narrow export base.

Figure 2: Nominal GDP and GDP per capita



Source: Eurostat, Scope Ratings GmbH

Figure 3: Real GDP growth, % and contributions



Source: IMF, Scope Ratings GmbH.

[1] Source: European Commission, summer 2019 interim forecast

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Crisis-induced constraints weigh on growth potential

Real GDP growth was 1.3% (year-on-year) in the first quarter of 2019, down from 1.5% in the previous quarter, which highlights the still-fragile nature of Greece's recovery. Higher growth backed by higher investment would help tackle the crisis-induced economic constraints that weigh on Greece's economic potential. These legacy issues include high NPLs, resulting in sluggish credit growth and weighing on investor confidence; high long-term unemployment and the emigration of skilled labour; and weak competitiveness, as illustrated by Greece's stagnant performance in the World Bank's Ease of Doing Business ranking.

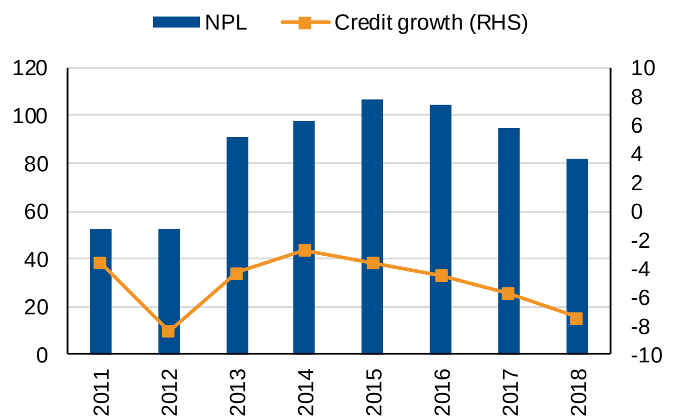
Financial sector policies to reduce substantial NPL stock

Poor asset quality constrains credit supply for investments

Greek banks have a critical role to play in ensuring the country's continued recovery, by reducing the substantial NPL stock and providing the necessary credit to finance productive investments. Greek banks have fully repaid costly Emergency Liquidity Assistance provided by the Bank of Greece. But while the banking sector has benefited from more diversified funding sources, the return of Greek banks to funding normality is impeded by legacy NPLs. NPLs declined from EUR 82bn at the end of 2018 to EUR 80bn at the end of the first quarter of 2019. But they still account for 45.1% of total loans.

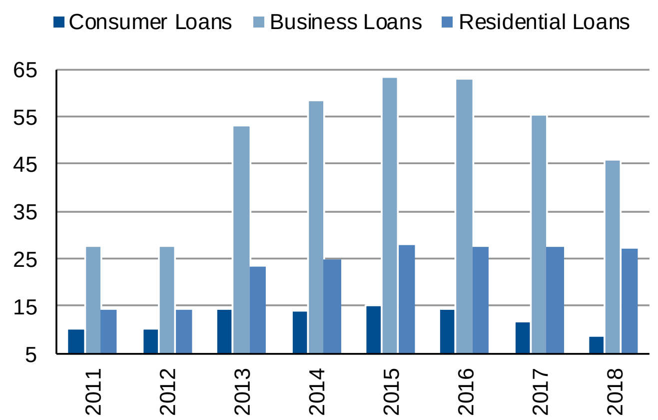
However, the falling level of NPLs is credit-positive, particularly when compared with NPLs of EUR 107bn in March 2016, when the stock of NPLs reached its peak (see **Figure 4**). Greek banks have made substantial progress in reducing NPLs by 21 percentage points in the past four years through write-offs and individual bank loan sales. But they are still struggling to meet rising demand for liquidity as the economy improves. Credit extended to the private sector shrank by around 10% YoY as recently as June 2019.

Figure 4: NPL (EUR bn) and Credit growth (%YoY)



Source: Bank of Greece, Scope Ratings GmbH

Figure 5: NPLs per segment (EUR bn)



Source: Bank of Greece, Scope Ratings GmbH

Recent measures have improved NPL resolution to some extent

At an operational level, Greek banks have finalised the segmentation of NPLs and set up specialised units for the management of NPLs, following the establishment of a comprehensive legislative and regulatory framework for the licensing and servicing of companies for non-performing loans. Several measures improved NPL resolution in Greece over the course of Greece's ESM bail-out programme, including: i) the introduction of an out-of-court debt restructuring framework (though only a few cases were concluded under this procedure); ii) simplification of the rather complex insolvency regime for small businesses; and iii) an acceleration of bank loan sales and the enhancement of enforceability of collateral backing defaulted loans through electronic auctions and loan-servicing agreements.

Reasons for high NPL stock and slow pace of resolution

The persistently-high NPL stock in Greece vis-à-vis other euro area member states is explained by: i) the protracted economic crisis that occurred in Greece and its adverse impact on businesses and households; ii) the wide range of asset types that are non-performing, including the more problematic SME loans (see **Figure 5**); iii) the restructuring of Greek public debt and impact on the banking system; iv) banks' restricted access to international capital markets due to a lack of eligible collateral; v) a substantial sovereign-bank nexus[2] and close relationships between banks and borrowers, which have prevented a more rigorous collection of claims against households and businesses and avoided a further deepening of the crisis; and vi) capital controls that have weighed on investor confidence.

These factors have put some strain on banks' balance-sheet strength and restructuring capacity, which resulted in a lengthy restructuring process versus the process in other euro area countries. As NPLs remain on banks' books, these assets weigh on banks' capacity to lend to the real economy. To achieve additional restructuring capacity in a swift manner and provide a viable long-term solution, the NPL stock will have to be either securitised or sold via large portfolio sales.

Speeding up NPL resolution is a priority for the government

As previous reforms will likely not achieve the targeted sizeable NPL reduction (to a ratio of 20% by 2021), the government intends to strengthen the NPL resolution framework and reduce the sovereign-bank nexus, based on two complementary proposals from the Bank of Greece and the Hellenic Financial Stability Fund (HFSF). The implementation of these systemic NPL resolution measures is assessed under Greece's post-bailout "enhanced surveillance framework" vis-à-vis European creditors as part of Greece's commitment 'to continue to implement reforms aimed at restoring the health of the banking system, including NPL resolution efforts'.

Two complementary NPL carve-out proposals in a nutshell:

Proposal by the HFSF (asset protection scheme)

- Creation of an asset management company that is similar in principle to the Italian GACS scheme, with the most senior tranches to be guaranteed by the government, thereby bridging gaps between the pricing of NPL portfolios between Greek banks and investors.
- Establishment of a series of SPVs by each of the four systemic banks, which would purchase NPL portfolios funded by sales of asset-backed securities to private investors.

Supplementary proposal by Bank of Greece (a common asset management company)

- Supplementary transfers of a significant share of NPLs along with deferred tax credits booked on banks' balance sheets to a special purpose vehicle (SPV).
- The SPV's acquisition of assets from banks would be funded through the issuance of securitised notes backed by the NPL stock.

Scope's view:

- Both proposals – relying on portfolio sales and securitisations – would shift large stocks of NPLs into legally-separate entities, thereby freeing up funds for new lending.
- Both proposals will support the development of a secondary market for the management of NPLs, provided the schemes comply with EU restrictions on State aid.
- Depending on the final implementation, both proposals can be very supportive in reducing the NPL stock in a swift manner, while economic conditions remain favourable.
- The benefits of securitisation schemes in facilitating debt restructuring by bringing more flexibility into NPL reduction plans are strong in a small and inter-linked economy such as Greece's, in which bank lending is the key source of corporate and household financing.

[2] The sovereign-bank nexus remains substantial in Greece. The Greek banking system had a fully loaded common equity tier 1 ratio (CET1) of 12.1% on a consolidated basis in 2018, which is an adequate capital position but below the EU average (of 14.4%). However, deferred tax credits accounted for 60% of the CET1 capital on average for the country's four systemically-important banks at end-2018. The banks' reliance on tax credits underscores how closely linked the health of Greece's public finances remain to that of the country's banking sector. In addition, one characteristic of the Greek financial system is the dominance of only four banks, which has resulted in the creation of systemic NPL servicers.

Measures required to attract foreign capital and address high unemployment

As a result of years of prolonged austerity, Greece is facing a significant investment gap, with domestic investment levels amounting to just 10% of GDP (half of pre-crisis levels). Greece is also confronted by a demographic crisis, reflected in a shrinking population exacerbated by brain drain, resulting in a weak medium-run potential growth rate. In order to achieve stronger, sustainable growth and reduce unemployment, Greece needs to increase investment to foster a rebalancing in the economic growth model. Higher growth backed by higher investment would contribute to tackling the crisis-induced economic constraints holding back Greece's economic potential.

However, as borrowing conditions remain tough owing to the legacy of the debt crisis, Greece has become increasingly reliant on foreign capital to fund investments in order to deliver sustainable growth. Greece needs to further strengthen investor confidence; accelerate privatisation to demonstrate a clear economic vision, with a coherent strategic investment plan; and enhance the competitiveness of the economy.

Capital controls to be fully lifted in 2019

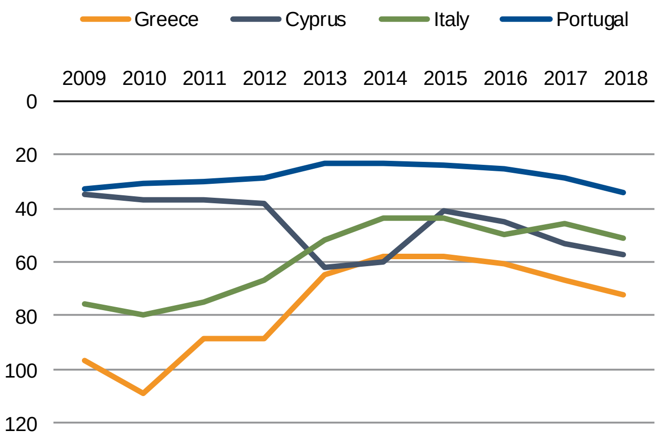
Greece's credit outlook benefits from the full lifting of capital controls, which have been in place since 2015. Prime Minister Kyriakos Mitsotakis announced on 25 August that the government intends to fully lift remaining capital controls in the short term, with the legislation becoming effective on 1 September. As the Greek economy relies predominantly on domestic bank credit (rather than access to international capital markets) for financing economic activity, a return to sustained deposit growth has been a pre-condition for the complete lifting of capital controls.

The timing here is good. In July 2019, deposits placed by the private sector increased by EUR 1.3bn, with the YoY growth rate of private sector deposits standing at 6.4%. Moreover, several European initiatives, including the Capital Markets Union are under way, which could significantly enlarge market-based financing of the real economy.

Accelerated privatisations expected

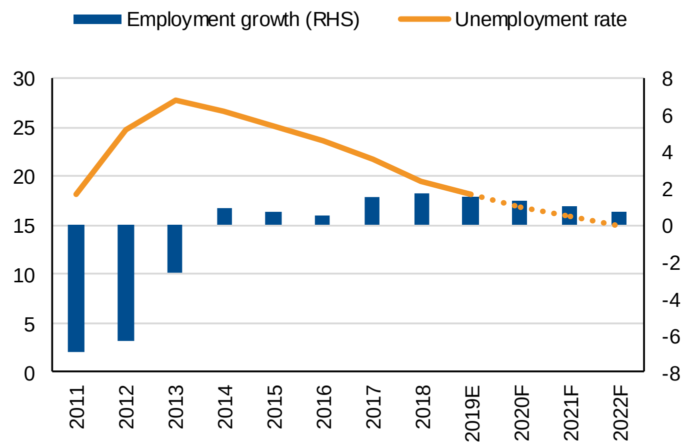
Another pre-condition to attracting higher investment is continued progress on privatisation, which would increase economic efficiencies and provide additional funds to the State. Transactions under the so-called 'Asset Development Plan of the Hellenic Republic Asset Development Fund' (TAIPED) are behind schedule but are expected to be completed this year, following the resolution of challenges related to regional ports.

Figure 6: World Bank's Ease of Doing Business Index, country rank



Source: World Bank, Scope Ratings GmbH

Figure 7: Unemployment rate (%) and Employment growth (%YoY)



Source: Eurostat, Scope Ratings GmbH

Reform progress has positive impact on competition

To strengthen Greece's weak competitiveness, as illustrated in the economy's stagnant performance in the World Bank's Ease of Doing Business rankings (see **Figure 6**), the Greek government intends to reduce bureaucracy, simplify tax incentives for investments and improve the speed and efficiency of public administration to ensure more business-friendly conditions. By removing various procedural impediments to trade, Greece is targeting an ambitious export share of 50% of GDP (vs. 35% in 2018).

Specific policy measures include the further streamlining of customs procedures, for example. While the government continues to focus on improving domestic economic competition, including reforms of pharmacies, over-the-counter drug distribution and Sunday retail trading, further progress will require the engagement of all economic stakeholders.

Labour market keeps improving at a slow pace

Greece's labour market is improving, although major imbalances remain. The unemployment rate is still high (see **Figure 7**). Recent policy decisions will support private household spending, notably the sharp hike in the minimum wage by 11% to EUR 650 per month, sales tax reductions, restoration of bonus payments and renewed collective-bargaining arrangements. One danger, however, is that they will also increase costs and reduce firms' abilities to respond to changing market conditions. However, according to preliminary data, employment growth in the private sector was robust in the months following the increase in the minimum wage.

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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-75008 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

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