



# SHAPING UP GREECE

In May 2010, the eurozone countries and the IMF provided Greece with €110bn in funding over 3 years contingent on the implementation of a strict austerity plan. This will hopefully lead to long-term benefits through reductions to pensions, flexibility in the labour market and a degree of dissolution of some intrinsic monopolies. The short-term outlook, however, does not appear as promising. GDP, forecast to fall by 4% in 2010 and 2.5% in 2011, fell instead by 4.5% in 2010 and is now forecast to fall by 3.2% this year. The unemployment rate now stands at around 14.2%, up from 9%, and is expected to rise to 15.5% this year. The level of public debt stands at 145% of GDP, up from 126% late in 2010.

**THE MARKETS APPEAR TO BE PRICING IN A RESTRUCTURING.** The credit rating agencies recently downgraded Greece's sovereign debt to junk status. The yield on two-year sovereign debt is around 24.36%, a spread of 22.6 percentage points over Germany's equivalent. Five-year credit default swaps, a risk measure of default, climbed to 1356 bps which signals a 66% probability of default within the next 5 years.

A turnaround scheme to tackle this problematic situation needs to be formulated. A restructuring of the bailout loan has already

been implemented with a haircut of the financing rate from 5.2% to 4.2% and an extension of the maturity of the loans from 3 to 7.5 years. The Greek Prime Minister has noted that this will lead to a saving of around €6bn. The government has also promised to raise €50bn (about 22% of GDP) by selling Greek assets to gain better terms for European loans. The offer, however, is complicated and land sales, a predominant factor of this privatization, will be hard to attain given the lack of a reliable land registry.

**OTHER OPTIONS INCLUDE RESTRUCTURING** the remaining (non-bailout) debt either by an extension of the maturities, a haircut of the principal owed or by slashing the financing rate. The first was adopted by Uruguay in 2003 following its banking crisis whereby it extended the maturity of its loans by 5 years to successfully decrease its debt burden by 15%. However, Uruguay's debt burden was only half of Greece's and as a commodity producer, the country benefited from the respective boom cycle which resulted in stellar annual GDP growth of 6%. The contingent view is that Greece needs to cut its debt burden by half and a bolder restructuring is required such as a considerable principal cut. In 1982 Mexico restructured by lengthening its debt maturities to buy time but then had to follow this with the more stringent and

compelling move of a principal cut. Greek and Cyprus banks are the top holders of Greek sovereign debt (representing 60% of total Greek debt outstanding with Cyprus constituting 8% of this share) followed by Germany (18%) and France (9%). A study by Goldman Sachs estimates that the repercussions of a 20%-60% haircut of principal would correspond to an aggregate European bank capital hit of €13-41bn, representing a mere 1%-3% of total Tier 1 capital. To the Greek banks, however, the impact is unfortunately much more pronounced. A 20%-60% principal haircut would wipe out €8-25bn or 26%-80% of total Greek bank capital. The Greek banks, not themselves a cause of the country's difficulties, would thus need substantial additional capital to recover from the consequences of such a restructuring.

**THE DESIGNATED ROUTE** of restructuring is yet to be decided. Nonetheless, it is evident that a derivative of corrective measures needs to be unraveled and implemented. Timing also seems in tune. The economic environment in Europe has much improved from when the Greek crisis first erupted, as has market psychology and investor sentiment. As a result, an imminent and bolder decision by the governing authorities may be advisable for a speedier and more effective Greek economic recovery.

**info:** **PERSELLA IOANNIDES** heads Meritkapital Ltd, a CySEC licensed investment firm. She has an MBA from Columbia University and worked at Morgan Stanley's institutional equity derivative desk, New York.