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PSI expectation is rather excessive

After the haircut, the debt-to-GDP ratio will only be 2-3 percentage points lower in 2012 than last year

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ANALYSIS

Greece's tender offer for the biggest-ever bond exchange enters the final stretch and even though a few bankers have expressed concerns about its outcome, we have no doubt Greece will be able to achieve a high participation rate at the end of the day, partly thanks to the activation of CACs (Collective Action Clauses).

However, it is rather worrisome that PSI (Private Sector Involvement) may not do away with the drachma specter, undermining efforts to stabilize the economy and making it more difficult for the main pro-euro political parties to broaden their appeal as the country heads into the next general elections.

This means that the end result of the Greek crisis may have more to do with politics and institutions and less with economics.

In its latest Greek debt sustainability analysis, the International Monetary Fund assumes that investor participation in the PSI will be at 95 percent. It is hard to imagine that participation will end up even somewhat under 95 percent, given the political and financing repercussions and therefore expect Greece to activate CAC to make the PSI terms binding for all bondholders.

However, CAC activation will likely be deemed a credit event by the relevant ISDA commission and trigger CDS (Credit Default Swap) contracts, meaning the buyers will be compensated by the writers, most likely banks and insurers. This may be a welcome development after all since it will not undermine the sovereign CDS market used by bondholders in other EU markets to hedge their risk.

Some market participants always thought a large scale "voluntary" Greek debt restructuring with no CDS triggering would have had adverse effects on Italian and Spanish bonds since buyers could not hedge their exposure via the CDS market. It is quite a change since politicians like German Chancellor Angela Merkel, French President Nicolas Sarkozy and former Greek premier George Papandreou used to blame the CDS for fostering the debt crisis.


ICON PRESS

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Coming back to PSI, an important step for Greece to secure the second financing package from the EU and the IMF, calculations show the debt relief may not be as big as thought at the beginning for specific reasons. Crude estimates put the debt reduction tied to PSI at around 105 billion euros. This is so if one takes into account the 53.5 percent haircut on the nominal amount of Greek bonds outstanding equal to around 206 billion euros.

However, the actual debt reduction appears to be smaller as Nomura analysts recently pointed out. Greece's debt-to-GDP ratio will only be 2-3 percentage points lower in 2012 than in 2011, which stood at 164 percent at the end of last year.

This is so because the general government debt-to-GDP ratio excludes intergovernmental holdings such as bonds held by social security funds put at more than 23 billion euros while the debt is burdened by the extra recapitalization needs of the banks to 50 billion euros from 40 billion, the clearing of arrears in excess of 6 billion euros to the private sector, the primary budget deficit and others.

In the Greek domestic political debate, the leaders of the mainstream parties have stressed the significance of PSI in getting debt relief and cutting the annual interest expenses to lower the budget deficit to rally support for the second financing package. Antonis Samaras, the head of the conservative New Democracy party leading in the polls, has also used it as the main argument to justify his backing of the new economic program after coming out against the first one.

Opponents of PSI have so far focused their criticism of the deal on the fact the new Greek bonds to be exchanged for the tendered ones will be subject to English law. They claim this amounts to a loss of national sovereignty and deprives the country of a powerful negotiating tool in the event of a future Greek debt restructuring. It will be a surprise if they fail to capitalize on the smaller-than-thought debt relief once they get hold of them.

Therefore, the smaller initial debt relief from PSI will make life harder for political parties championing Greece's position in the eurozone, increasing the country's political risk. The latter make some market participants more skeptical of whether PSI and the second financing package constitute the endgame in the Greek debt saga.

All of them combined with a tumbling economy, which shows no sign of stabilization and recovery, do little to chase away the specter of the drachma, in turn undermining efforts to revive private investment spending and further boost exports.

In a situation like this, enlightened political leadership plays an important role in drumming up support among the country's business community and elsewhere to get the country out of the slump and provide a clear vision for the future to the masses.

We would be lying though if we were saying the odds are good, knowing the institutional inefficiencies of the Greek state, the quality of the majority of local politicians and even the opportunistic character of many businessmen.

However, hope dies last. Even though the assumed successful completion of PSI may not provide Greece with the economic impetus many like us thought of a few weeks ago, there are competent people in politics who can go against the tide, including the public administration, to steer the economy ship into calm waters and exorcize the specter of the drachma.