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Focus notes: Greece

Some initial thoughts on the draft EU Council Statement circulated earlier today

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The heads of state and government of the EU-17 meet in Brussels today to address the challenges threatening the stability of the euro area. The meeting started at 11.00GMT and it was still going on at the time of writing this report. In a draft statement circulated ahead of the meeting, Euro zone leaders reaffirmed their strong commitment to the euro and vowed to do whatever is needed to ensure the stability of the euro area as a whole. In what follows, we provide some initial thoughts on the main anti-crisis measures likely to be agreed at today's EU Summit, provided that the official statement will not deviate substantially from the earlier circulated draft report.

On the scope and flexibility of the European Financial Stability Facility (EFSF)

In a broadly anticipated move, Euro zone leaders will likely decide to let the EFSF intervene in the secondary government bond markets, effectively taking over the Securities Market Program (SMP) from the ECB. This would be an important step towards enhancing the flexibility of the mechanism by *e.g.* enabling it to orchestrate future debt-buyback programs. EFSF secondary market purchases could also provide considerable debt relief to heavily indebted euro area countries by allowing them to "capture" existing bond price discounts. The move would also help improve liquidity conditions in the EGB markets. Moreover, EU-17 leaders will likely decide to allow the EFSF to act preemptively, by buying the bonds of (and finance bank recapitalizations in) euro area countries not presently receiving official bailout funds, but still facing increased difficulties in accessing credit markets. Note that Germany has in the past strongly opposed proposals to allow the EFSF conduct sovereign bond purchases from the secondary markets and the scheme may still face some difficulty in passing through a number of national parliaments.

On the EFSF size

With regard to some earlier speculation about a possible enlargement of the EFSF, *no* decision is likely to be taken today to increase the mechanism's effective lending capacity. Note that the June 2011 EU Council decided, among others, to extend EFSF's AAA guarantees to €440bn, from €255bn and to also empower the mechanism to intervene in the primary EGB markets. It appears that a further increase in the effective lending ceiling of the mechanism has been strongly opposed by Germany and a number of other euro area governments, on concerns that such a move would risk endangering the AAA ratings of a number of core EZ countries. Currently, the overall size of the European stabilization mechanism stands at ca €750bn (= €440bn from the EFSF + €60bn from the European Financial Stability Mechanism + €250bn in the form of IMF participation). Taking out from this amount ca €145.5bn for the Irish and Portuguese lending programs (€67.5bn and €78bn, respectively) and €70bn for the EFSF's contribution to the new bailout programme for Greece we are left with a firing power of some €535bn, an amount that is deemed sizeable, but not necessarily adequate to deal with other, higher-profile rescue programs in the euro area (under an admittedly worse-case scenario).

On the new funding programme for Greece

According to a number of press reports , euro area leaders will decide to provide the troubled sovereign borrower a second bailout package worth around €100bn-€115bn, consisting of ca €70bn in EFSF/IMF loans, with the remaining amount being covered by private-sector participation. This along with the official funding provided under the existing EU/IMF support mechanism (€65bn disbursed so far out of a total package of €110bn) should be adequate to cover Greece's funding gap until the end of 2014 (~ €100bn, according to the latest IMF projections).

On EFSF lending rates and loan repayment periods

EFSF lending rates for troubled euro area countries receiving official financial assistance will likely be reduced from between 4.5 and 5.8 percent currently to ca 3.5 percent (but not below the mechanism's funding cost). The average maturity of loans provided by the EFSF will be also extended from 7.5 years to at least 15 years. The interest rate Greece now pays on EU bilateral loans taken under the present EU/IMF adjustment programme is determined as follows: EURIBOR + 250bps (~4.10 percent) for the first 3 years and EURIBOR + 350bps (~5.10 percent) for longer maturity loans. Moreover, the average maturity of these loans is currently 7.5 years. Understandably, the new (reduced) EFSF lending rates will apply to both the existing and new assistance programmes for Greece as well as the current bailout programmes for Ireland and Portugal. The possibility of significantly lower EFSF lending rates was explicitly stated in the July 11 Eurogroup statement and constitutes an important step towards addressing the debt sustainability/solvency issue. On the latter, note that the July 2011 revision of the EU/IMF adjustment programme for Greece forecasted the average (real) interest rate on the overall outstanding public debt stock to exceed (by between 1.3ppts and 3.8ppts per annum) the rate of real GDP growth over the 2011-2020 projection horizon. Understandably, given that debt dynamics are difficult to stabilize solely by generating primary surpluses, lower interest rates (and/or higher GDP growth) are needed to reduce (and preferably neutralize) the "snowball effect" in debt dynamics. According to the IMF baseline macro scenario, Greek real GDP growth is likely to recover towards potential (around 3% YoY) by 2015.

On the form of Private Sector Involvement

With respect to private sector involvement in the new bailout programme for Greece, the EU draft document noted the finance sector's willingness to support Greece on a voluntary basis thought "a menu of options (bond exchange, roll over, and buyback) at lending conditions comparable to public support with credit enhancement". Such schemes would aim to **a)** help reduce Greece's sizeable debt burden (by *e.g.* providing low interest rate loans to the country and allow it to buy back its debt at discount from the secondary market) and **b)** ensure a more equitable shouldering of the new rescue deal costs between the private financial sector and the euro area tax payers. At the time of writing this report, no details were known as to the precise form of terms and conditions of these PSI options.

Tax levy option seems to have been abandoned

As to the idea of a tax levy imposed on the euro area banking sector, that would reportedly take the form of a 0.0025 per cent tax on all assets held by Eurozone banks, aiming to raise as much as €50bn over a five year period. The proceeds from the levy would then be channeled to buy-back as much as 20 percent of the outstanding Greek debt stock. Reportedly, Eurozone officials were of the view that this option was the less likely to be labeled as a Distressed Debt Exchange (DDE) by rating agencies and thus, trigger further sovereign credit downgrades to "selective default" ratings. Yet, the bank levy option seems to have been abandoned for the time being, among other reasons, because it would be difficult to be implemented quickly (due to technical & legal complexities) and also because it has been strongly opposed by the banking industry.

"Marshall Plan" for Greece to help stimulate investment and boost economic growth

Today's EU summit will likely call for a "Marshall plan" for Greece, aiming to spur investment and stimulate domestic economic growth. No more details were revealed in the EU Council draft statement. Presumably, this plan should take the form of reduced Greek participation for co-financed development projects, in the context of the National Strategic Reference Framework (ESPA). It is worth recalling that European Commission President Manuel Barroso announced last month that the EU was prepared to reduce the amount of money Greece has to come up with to co-fund projects under its regional funds to 15% from the usual 50%. The whole amount available to Greece for the 2007-2013 period is €26.232bn, with the country having already absorbed some €5.282bn or 20.14%. The EU Council also called member states and the Commission to mobilize all resources necessary in order to provide exceptional technical assistance to help Greece implement its reforms.

Market reaction: EMU-periphery sovereign debt spreads narrow, euro firms on optimism over a new rescue deal for Greece

Increased optimism that euro zone leaders will soon reach an agreement to address the lingering crisis and help Greece tackle its debt woes fueled a pronounced tightening in EMU sovereign debt spreads over the last couple of sessions. The Greek bond market was the star performer in the EMU sovereign space, with short-dated notes outperforming longer maturity paper. The corresponding 2/10-year GGB spread was hovering around -1,735bps in late European trade on Thursday, some 350bps tighter relative to all-time lows hit a few sessions earlier. Meanwhile, the 10-year Greek government bond yield was standing s at ca 16.48%, down from highs near 18.2% recorded earlier this week. The 10-year GGB/Bund yield spread was hovering around 1,360bps at the time of writing, ca 75bps narrower in a week and off 1,556bps record highs marked a few sessions earlier. With the short-term outlook of the Greek debt market crucially depending on the (soon to be announced) final details of the Euro zone leaders' accord, the technical picture indicates that only a sustainable move below1,205bps (100-day MA) has the potential to open the way for a further significant spread tightening in the sessions ahead. In FX markets, easing EMU contagion fears helped the EUR move higher, recovering some of its recent hefty losses. The EUR/USD hit one-month highs of 1.4400 shortly after the release of EU summit draft proposals, up from levels near 1.4000 tested earlier this week. Elsewhere, global equity markets gained sharply with bank-related shares outperforming. A new string of positive US Q2 corporate earning results also favored market sentiment. The pan-European FTSEurofirst 300 index closed at its highest level in nearly two weeks on Thursday while the Athens bourse's baking index gained 7.4%, outperforming the benchmark general index which was up 2.6%.

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