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Focus notes: Greece

July 21 EU Council Statement: What it means for Greece and the euro area

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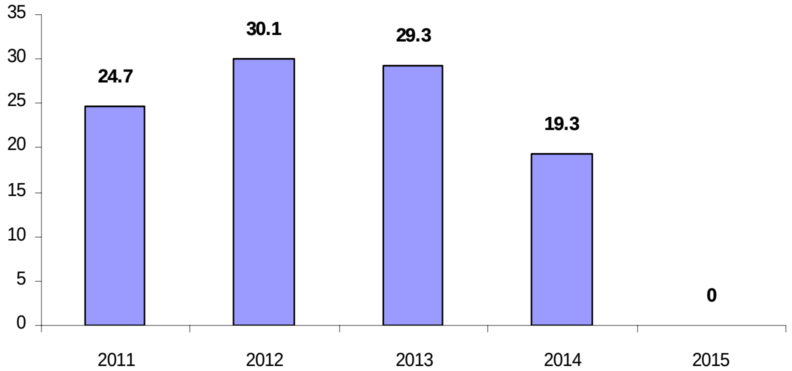
In this note we provide a brief analysis on the July 21 EU Council decisions to address the euro area debt crisis. As an overall assessment, we would agree with the prevailing market view that the decisions made by the EU-17 leaders constitute a major step forward in addressing the euro area debt crisis in a more consistent and comprehensive way. The announcements appear to have been in the optimistic side of expectations, as attested by the positive market action both ahead and after the EU Summit. In what follows we highlight some of the main points in the Council statement and their implication for Greece's fiscal outlook and the stability of the euro area as a whole.

July 21 EU Council Statement: What it means for Greece

- **Full coverage of the government's borrowing requirement until 2014**

A new financing program will be provided to Greece, aiming to broadly cover the country's public borrowing need until 2014. Note that in its July 2011 update of Greece's adjustment programme the IMF projected a net borrowing gap of ca €103.4bn for the corresponding period (see graph below). According to the July 21 EU Council Statement, the new package consists of €109bn in EFSF/IMF funding – covering both the remaining part of the existing program and loans under the new program -- as well as additional contributions from private sector involvement (PSI). The latter will take the form of "Four Instruments" proposed by the IIF (three debt exchanges and one roll over scheme) and a Debt Buyback Facility. According to the final IIF-backed proposal for Greece, net PSI contributions are projected to amount to as much €50bn until mid-2014 (€37bn from private investor participation in the "Four Instruments" and around €13bn from debt buybacks).

Net financing gap of the general government excluding new official funding & PSI contribution (EUR bn)



Source: IMF July 2011

- **Lower interest rates & longer maturities for EFSF loans to help improve debt dynamics**

EFSF lending rates for troubled euro area countries receiving official financial assistance will be reduced from between 4.5 and 5.8 percent currently to ca 3.5 percent (but not below the mechanism's funding cost). Note that the EU Council Statement *did not* mention whether the interest rates on Greece's *existing* EU loans will also be reduced. The interest rate charged to Greece on EU bilateral loans *already received* under the first EU/IMF adjustment programme was determined as follows: EURIBOR + 250bps (~4.10 percent, currently) for the first 3 years and EURIBOR + 350bps (~5.10 percent) for longer maturity loans.

The *average* maturity of loans provided by the EFSF will be extended from 7.5 years to a minimum of 15 years and up to 30 years with a grace period of 10 years. Moreover, according to the PSI schemes proposed by the IIF, the average maturity of privately-held debt is projected to increase to 11 years, from around 6 years, currently. As to the EU bilateral loans already disbursed to Greece, the Council statement did not specify a precise range, but said that their repayment periods will also be extended "substantially". Naturally, the new (reduced) interest rates and extended repayment periods for EFSF loans will also apply to the existing financing programs for Ireland and Portugal.

The possibility of significantly lower EFSF lending rates and longer maturities 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 according to the July 2011 revision of the EU/IMF adjustment programme for Greece, the average effective nominal interest rate on the overall outstanding public debt stock was projected to exceed the rate of nominal GDP growth by ca 2ppts/annum over the period 2013-2020. 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. Luckily, taking into account the agreed reductions in EFSF loan interest rates (as well as the effect of the proposed PSI schemes) the government now reportedly estimates the average nominal interest rate on the overall debt stock to fall towards 4% in the period 2011-2016 (and to be no much higher than 5% over the next 30-40 years). These rates do not deviate substantially from where we see nominal GDP growth settling once the current recession is over, meaning that interest rate costs on public debt are now more consistent with debt sustainability than previously the case.

In addition to the aforementioned, the proposed PSI schemes and debt buybacks are projected to reduce Greece's overall debt stock by as much as €26bn or ca 12%-of-GDP. Note that according to a debt sustainability analysis included in the IMF fourth review of Greece's adjustment progarmme (July 2011), the Fund projected that under a hypothetical debt-exchange operation -- involving a 85 percent participation of private, non-ECB bond holders and a 10-year maturity extension at a coupon of 1 percentage point lower than the existing coupon (ca 5.0%) –- the debt to GDP ratio would fall by 2020 to ca 125% vs. 130% envisioned under its baseline scenario. The latter projects a peak in the debt ratio to levels around 172%-of-GDP in 2012 and a gradual de-escalation thereafter. The IMF baseline scenario is framed around a relatively optimistic backdrop with respect to its underlying macro and fiscal assumptions, envisioning a return to positive GDP growth from 2012 onwards, primary surpluses of 6%-of-GDP or more after 2014 and total privatization revenues of €50bn in the period 2011-2015. It is, however, much more conservative (relative earlier IMF forecasts) with respect to its spread assumptions and the potential impact of contingent liabilities (i.e., it assumes higher stock flow adjustments). Furthermore, it does not incorporate the impact of lower interest rates and longer maturities of official loans to Greece. In the table below we show the results of a preliminary scenario analysis we conducted to assess the potential impact of the July 11 EU Council decisions on the evolution of Greece's public debt ratio.

	2010	2011	2012	2013	2014	2015	2020
IMF Baseline scenario (July 2011)							
Primary balance (% GDP)	-4.9	-0.8	1.5	3.5	6.4	7.7	6.4
Nominal GDP growth (%)	-2.0	-2.4	1.3	3.1	3.3	3.6	4.9
Average interest rate on debt (%)	4.2	4.6	4.9	5.0	5.5	5.9	6.7
Debt-to-GDP projections (%)	143	166	172	170	160	146	130
IMF Baseline scenario adjusted for lower interest rates & PSI contribution							
Debt-to-GDP projections (%)	143	165	169	165	152	134	99
IMF Baseline scenario adjusted for lower interest rates, PSI contribution, lower primary surpluses & nominal GDP growth							
	143	165	169	164	152	137	116

Source: IMF July 2011, Eurobank EFG Reseach

The lines below the *"IMF Baseline scenario (July 2011)"* heading show the underlying assumptions and the evolution of the debt ratio, as projected in the most recent IMF forecasts. The line below the *"IMF Baseline scenario adjusted for lower interest rates & PSI contribution"* heading shows the projected path of the debt ratio under the July 2011 IMF baseline assumptions (i.e., for nominal GDP growth, primary balances and stock-flow adjustments inclusive of privatization revenue) adjusted for lower interest rates and PSI contibutions. Here we assume an average interest rate on the overall debt stock of ca 4.5%/annum after 2011 and PSI contributions in line with the IIF's projections. The effect of these contributions is assumed to be evenly split over the projections horizon. Finally, the last line shows the projected path of the debt ratio under the latter scenario adjusted for more benign (and, in our view, more realistic) assumptions for nominal GDP growth (around 4%/annum after 2014) and primary surpluses (close to 4.0% of GDP) after 2013. The results presented above are strictly preliminary, albeit indicative of the potential improvement in Greece's debt dynamics contingent on the successful execution of the country's stabilization programme..

- **A "comprehensive" strategy to boost domestic growth and investment**

The EU Council called for a comprehensive strategy to spur investment in Greece and stimulate domestic economic growth, in line with the draft version of the statement which made reference to the "Marshall Plan". Presumably, this strategy should take the form of reduced Greek participation in EU 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 as much as 50% currently. The whole amount available to Greece for the period 2007-2013 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.

- **Continuity of Greek banking sector's access to ECB funding secured**

As per the EU Council statement, credit enhancement will be provided to underpin the quality of collateral so as to allow its continued use for access to Euro system liquidity operations by Greek banks. This signals a major softening in ECB's long-stated stance with respect to the eligibility of Greek government bonds in case that PSI triggers "selective default". In a post-EU Summit press conference, ECB President Jean-Claude Trichet said that "the Eurozone promised collateral for Greek debt if necessary" adding that the heads of state and government agreed to commit up to €35bn to help the eligibility of Greek bonds in ECB liquidity operations. Reportedly, the rescue package for Greece might involve direct guarantees from the EFSF on collateral or the use of the so-called Emergency Liquidity Assistance (ELA) facility. Note that the Irish central bank has already made repeatedly use of the ELA facility to fund domestic banks. On the latter, note that the latest (July 2011) IMF review on Greece's adjustment programme read that "…. the authorities have put into place the necessary technical preparations to enable ELA-related lending (which will also help manage any unexpected contingencies)". In addition to the aforementioned, Mr. Trichet also emphasized that Eurozone leaders had committed themselves to provide €20bn to help recapitalize Greece's banks, if needed. This would increase the overall size of the existing FSF (back-stop) facility for potential recapitalizations to €30bn. The facility has been established under the existing EU/IMF rescue program for Greece (initiated in May 2010) and has remained untapped so far.

- **Potential implications of further sovereign downgrades due to PSI minimized; temporary "selective default" should not constitute much more than a mere technicality**

The threat for imminent selective default ratings on Greek sovereign debt, as a result of the terms of the new bailout plan, was raised last Friday, just one day after the conclusion of the July 21 EU Summit. Fitch noted in a statement that the IIF's proposed debt exchange scheme for Greece implies a 20 percent net present value loss for banks and other holders of Greek government debt. The rating agency added that "An exchange that offers new securities with terms that are worse than the original contractual terms of the existing debt and where the sovereign is subject to financial distress constitutes a default event under Fitch's Coercive Debt Exchange Criteria" However, in an interview to Reuters, Fitch head David Riley stated that the "Restricted Default" status for Greece's sovereign debt would likely prove temporary (and last probably only a few days), with the default tag being lifted as soon as the bond swap transaction is completed. Fitch indicated that once the exchange is concluded it would likely issue higher ratings (B or CCC) for the new Greek sovereign bonds as the government's fiscal position would be strengthened by the bailout. Fitch had last cut Greece's sovereign credit rating (to CCC from B+) on July 13, citing the country's weakening macroeconomic outlook and heightened uncertainty surrounding the role of private creditors in any future EU/IMF funding programs.

- **July 21 EU Council decisions: What they mean for the stability of the euro area**

In our view, the latest EU Council announcements constitute a major step forward in addressing the euro area debt crisis in a more consistent and comprehensive way. Among other measures, Euro zone leaders decided 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 decided 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.

With regard to earlier speculation about a possible enlargement of the EFSF, no decision was made by euro area leaders to increase the mechanism's effective lending capacity. Note that the June 2011 EU Council endorsed, 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 €109bn for the EFSF/IMF contribution to the new bailout programme for Greece we are left with a firing power of some €495.5bn, 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).

Focus - The nature of Private Sector involvement (PSI) in the new rescue package

Part of the new bailout package for Greece will be financed by Private Sector Involvement (PSI). This was a key precondition purportedly imposed by a number of creditor countries –Germany most vocally- for additional financial support to Greece, aiming to ensure a more equitable shouldering of the new rescue deal burden between the private financial sector and the euro area tax payers. According to the EU Council statement, PSI would be implemented on a voluntary basis through a "menu of options" Specifically, the Institute of International Finance (IIF) clarified that financial institutions can choose to exchange their debt securities with four different long-term debt instruments. Alternatively, the private sector could opt to participate in a Debt Buyback Facility run through the EFSF. With regard to the four different debt instruments, creditors can opt for: i) a Par Bond Exchange into a 30 year instrument, ii) a Par Bond offer involving rolling-over maturing Greek government bonds into 30 year instruments, iii) a Discount Bond Exchange offered at 80% of par value into a 30 year instrument, and, iv) a Discount Bond Exchange offered at 80% of par value into a 15 year instrument. For the first three instruments, the principal would be fully collateralized by 30-year zero coupon AAA bonds, purchased using EFSF funds. The 15-year discount bond would be partially collateralized through funds held in an escrow account and borrowed by Greece from the EFSF. The coupons of the new bonds will range between 4.0% and 6.8%, depending on the debt instrument. The range of options has purportedly been set in an effort to secure the maximum possible contribution of private bondholders and to limit potential spill over effects into the financial sector on the grounds that different investors have different regulatory and accounting framework in which they operate. Assuming that i) the private participation rate comes in at 90%, ii) private creditors end up taking a lose of about 21% in the Net Present Value (NPV) of their bond holdings (calculated at a 9% discount rate) and ii) each of the four instruments accounts 25% share in the overall scope of the PSI, the IIF estimates that private sector investors will contribute to Greece's financing needs some €54bn from mid-2011 through mid-2014 and a total of €135bn from mid-2011 to end-2020. Moreover, the IIF also expects that four PSI instruments and the Debt Buyback Facility will help reduce Greece's debt burden by some €26bn (ca 12% of GDP). The EU Council statement explicitly said that the private sector involvement scheme is applied solely to Greece, which "requires an exceptional and unique solution". This implies that PSI should not be viewed necessary as a template for Ireland and Portugal or any other country experiencing funding difficulties.

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