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GREECE MACRO MONITOR

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Focus notes: Greece

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Key parameters and conditionality

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After a 12-hour marathon session in Brussels yesterday, euro area finance ministers endorsed a second bailout package for Greece worth €130bn. The deal aims to bring the county's public debt-to-GDP ratio to 120.5% by 2020, close to the 120% target envisioned in the October 26-27 Summit. The formal endorsement of the new bailout package by the Eurogroup offers the green light for the implementation of a market-based restructuring of Greek public debt and, if everything goes as planned, the release of the next EU-IMF loan tranche before March 20 when a 3-year bond redeems for €14.435bn.

The decision came after Greece met a number of key pre-conditions set by its official lenders including: (i) parliamentary approval of an omnibus bill containing all fiscal measures and structural reforms comprising the conditionality of the new rescue package; (ii) written commitments from the leaders of the two political parties supporting Lukas Papademos's government as regards the rigorous implementation of the agreed austerity and structural reform programme after the next national election (to be reportedly held on April 29, 2012); and (iii) the specification of extra consolidation measures worth of €325mn as part of a €3.3bn auxiliary package to help attain the 2012 fiscal target.

In what follows we summarize the main parameters of new rescue package:

PSI terms

— 53.5% reduction in the nominal face value of eligible Greek sovereign bonds held by private investors, with an aim to provide an up-front debt relief of ca €107bn (Eurobank EFG estimate assuming full participation). Note that this is slightly higher than the 50% face-value reduction envisioned in the October 26-27th EU Summit Statement. The overall notional amount of Greek sovereign bonds eligible for exchange is estimated at ca €206bn.

— The coupon rate on the new bonds will vary with maturity: 2% for the period between February 2012 to February 2015; 3% in 2016-2020 and 4.3% thereafter. The weighed average coupon of new bonds over a 30-year period is 3.65%, for maturities up to 2020 the average coupon is 2.63%.

— New bonds to be issued by the Hellenic Republic will have a face amount equal to 31.5% of the face amount of old bonds tendered for exchange. In addition, an investor gets 15% of the face amount of debt exchanged in the form of 24-month EFSF bills.

— Each participation holders will also receive detachable GDP-linked securities issued by the Hellenic Republic with a notional amount equal to the face amount of the new bonds offered to him.

— New bonds will be governed by English law.

Official sector involvement (OSI)

— The ECB will pass on any profits from the Greek bonds it bought over the past two years under its Securities Markets Programme to national euro area central banks- in line with its statutory profit distribution rules. (These profits may then be allocated by Member States "to further improve the sustainability of Greece's public debt"). Presumably, this will involve swapping existing central bank GGB holdings with new bonds issued by the Greek state, carrying the exact financial and legal provisions as the old ones, except for new serial numbers (ISINs) in order to avoid taking forced losses in case that CACs are activated.

— Governments of euro area Member States where central banks currently hold Greek government bonds have committed to pass on to Greece any related future profit accruing to their portfolios until 2020. These flows are expected to help reduce the Greek debt-to-GDP ratio by 1.8ppts by 2020 and are also estimated to lower the financing needs over the programme period by approximately €1.8bn.

— Eurozone member states will lower by 150 basis points the interest rate on bilateral loans already provided to Greece under the first bailout package. This is estimated to cut the debt-to-GDP ratio by 2.8% and lower financing needs by around €1.4bn over the programme period (2012-2015).

Conditionality of new EU-IMF rescue package for Greece

The new rescue package for Greece is comprised of several layers of conditionality including, among others:

Detailed timeline of a set of "prior actions" that needs to be completed before disbursement of first loan tranche under the 2nd bailout package

These "prior actions" were explicitly spelled out in the new Memorandum of Understanding (MoU) endorsed by the Greek parliament on February 13, 2012. Among others, they include: **(i)** additional fiscal measures worth ca €3.2bn (~ 1.5%-of-GDP) to compensate for slippages in the execution of the 2011 budget; **(ii)** measures to enhance wage flexibility with a view to further reduce labor costs and boost competitiveness; **(iii)** actions aiming to downsize the public sector and improve government efficiency; **(iv)** further steps to fully liberalize a range of closed professions; and **(iiv)** the recapitalization of the domestic banking system after the Greek debt swap (PSI). A more detailed list of the so-called "prior actions" is provided on *Table A* at the end of this document. To fully incorporate the package of aforementioned measures into national legislation, the government needs to ensure parliamentary endorsement of all relevant implementation laws as well as the issuance of ministerial decrees, legislative amendments and enactment of new legislation by the end of this month.

The government's battle against time starts today with the submission to Parliament of a new bill including two implementation laws. The first one will be voted on Thursday (February 23, 2012) and encompasses a set of "prior actions" relating to labor market reform, liberalization of closed professions and a supplementary budget for 2012. The latter involves additional structural spending cuts worth €325mn (see Table A). In total, additional austerity measures worth €3.3bn will be applied in 2012. This new package is over and above the measures already incorporated in the 2012 budget. As such, the overall fiscal effort to be applied this year will amount to over €18bn, according to our estimates. The second implementation law, which will be voted in Parliament early next week, involves a set of "prior actions" relating to public spending on pharmaceuticals and the health system as well the unification of auxiliary funds.

Establishment of special segregated account to prioritize debt payments

This account will reportedly collect bailout funding under the new rescue package instead of paying it all directly to the Greek government. More specifically, the amount deposited in this account should be high enough to cover, at any moment, Greece's debt service for the coming quarter. Reportedly, every time the balance of the account goes below the pre-specified limit, all *new* bailout funding and, possibly, part of Greek government revenues would have to be earmarked to replenish the account. Until the account is replenished, all other payments by the Greek government (*e.g.* budgetary expenditure including wage and pensions payments) would have to be delayed. To sum up, the establishment of the segregated account will guarantee that bondholders will be paid on time, thus minimizing the risk of an outright debt default at times when the government's cash reserves are nearing depletion. The idea of prioritizing debt payments was reportedly proposed by the French President and the German Chancellor following talks they held earlier this month. Reportedly, the idea for the establishment of the segregated account has also received significant backing from the European Commission on the basis that it would give official lenders strong control over Greece's use of bailout funds without (de-facto) stripping the country from its budgetary sovereignty. As per today's Eurogroup statement, Greece vowed to introduce in its legal framework over the next two moths a provision ensuring that priority is granted to debt servicing payments. This provision will be enshrined in the Greek constitution at the earliest possible time.

Tighter surveillance of the fiscal austerity program and the implementation of structural reforms

Amid increased skepticism over Greece's ability to deliver on promised reforms and fiscal austerity measures, EU officials called for tighter surveillance of the country's economic policies to ensure reforms agreed under the new rescue program are implemented. According to the Eurogroup statement, increased oversight will take place through a significant strengthening of the European Commission's *Task Force for Greece*, through an "enhanced and permanent" presence on the ground. Reportedly, a monthly review of Greece's progress has to be issued which will be critical on whether official lenders will proceed with the release of the subsequent installments of the loans. During a cabinet meeting on Saturday, Greek Prime Minister Lukas Papademos stressed out that there is no such issue as having a commissioner installed in each ministry as there are other monitoring mechanisms in place for official lenders to ensure the implementation of the agreed measures.

Strict implementation of agreed privatization plan

The Eurogroup statement called the Greek government to "carry out fully the privatization plans". As per the new MoU voted in Parliament last week, "the government anticipates €50bn in proceeds over the lifetime of the asset sale program, including at least €19bn through 2015". Assets offered for sale in the first half of 2012 include DEPA (Public Gas Corporation),DESFA (the Hellenic Gas Transmission System Operator), HELPE (Hellenic Petroleum), OPAP, EYDAP (The Athens Water Supply and Sewerage Company), EYATH (Thessaloniki Water Supply & Sewerage) and IBC (International Business Center). In the second half of the year, tenders for the ports, airports and Egnatia Odos motorway will proceed. According to the agreement, the privatization program will monitor progress towards objectives via quarterly indicative targets.

Table A. Set of "prior actions" included in the new Memorandum of Understanding

i) **Additional structural spending cuts worth €325mn, as part of a recently-agreed €3.3bn package of new austerity measures to be applied this year.** After lengthy talks, the proposal finally agreed with the troika late last week provides for: a) a €100mn reduction in the operating expenses of the National Defense Ministry; b) 10%-20% reductions in special wage regimes to come into effect on July 1st, as opposed to September 1, 2012 planned initially (measures estimated to yield €100mn in savings); c) any pension amounts exceeding €1,300 per month will be lowered by 10%-12%, saving the state about €45mn (exceptionally, pensions provided by the Navy Pension Fund, NAT, will be lowered by 7%); d) abolishment of special allowances for families with four or more children and an annual income of more than €45k (ca €42mn in expected savings); e) the total bill for supplementary pensions will be cut by another €30mn (supplementary pensions between €200 and €250 per month will be cut by 15%, between €251 and €300 by 15% and pensions above €300/month by 20%; and f) operating expenses of public utilities (DEKO) will be slashed by an extra €8mn.

ii) **Additional cuts in supplementary and main pensions** (i.e., on top of those noted above), with the aim of saving at least €300mn.

iii) **Reduction of the Public Investment Program** by €400mn.

iv) **Reductions** in central government **operational expenditure and election-related spending** by at least €270mn.

v) Cuts in budget **grants provided to several public entities** and frontloading cuts in subsides to residents in remote areas by €190mn.

vi) Dismissal of a number of **deputy mayors** and associated staff, saving at least €300mn.
vii) Reduction in **military expenses** by €300mn.
viii) Reduction in overtime pay for **NHS doctors,** with the aim of saving at least €50mn.
ix) Reduction in public spending on **pharmaceuticals** by at least €1.076bn.
x) Ministerial decision for the **application of new "*objective criteria*" in taxing the self-employed.**
xi) Ministerial decision for the full **implementation of the new wage grid** (single salary system) **in all state entities**; legislation for the recovery of wages paid in excess of limits set by the new wage grid (November 2011 afterwards).
xii) Completion of **75 full-scope audits** and **225 VAT audits of large taxpayers**. These targets actually constituted prior actions to the 5th Review under the 1st EU-IMF programme.
xiii) Amendment of regulations for **overdue taxes and social contributions** for individuals and corporations.
xiv) Completion of the **pension reform** with the submission of a framework law envisioning an in-depth overhaul of secondary and supplementary pension funds. The reform will aim to: a) merge all existing funds and eliminate their deficits; b) reduce their operational and payroll costs; and d) ensure long-term sustainability of secondary schemes.
xv) With the support of external consultants, **Bank of Greece** will need to undertake a comprehensive assessment of domestic banks' capital needs.
xvi) Completion of study aiming to address **Agriculture Bank of Greece** (ATE). The study will illustrate the legal, operational and financial aspects of the different solutions and lay out associated costs.
xvii) Government to enact legislation to support the strategy for **bank recapitalization.**
xviii) Government will need to enact legislation to strengthen **governance arrangements in financial oversight agencies.**
xix) A 22% weighed average **reduction in the minimum gross wage** at all levels; an additional 10% cut for young people under 25 years of age.
xx) Suspension of **automatic wage increases**, including those based on seniority.
xxi) Elimination of unilateral recourse to **arbitration** (i.e. to the Organisation for Mediation & Arbitration OMED).
xxii) **Elimination of permanent tenure** in all existing legacy contracts and in all companies.
xxiii) **Closure of organizations providing state-subsidized housing (**OEK and OEE).
xxiv) Full implementation of legislation for **liberalizing 17 closed professions** (*e.g.* accountants, tourist guides, private doctors and dentists' practices, shops for optical use and contact lenses).
xxv) Publication of secondary legislation specifying the **cost of issuing new road transport operator licenses.**
xxvi) **legislation on collective labor agreement to be amended**: a) collective agreements regarding wage and non-wage conditions can only be concluded for a maximum duration of 3 years; b) agreements that have been already in place for 24 months or more shall have a residual duration of 1 year; c) collective agreements which have expired will remain in force for a period of maximum 3 months (vs. six months previously), and c) allowances for seniority, child, education and hazardous professions will continue to apply, until replaced by a new collective agreement or amended individual contracts.

Greece - updated event-risk timeline

In what follows, we present an updated timetable of the key dates and events investors need to closely monitor in the crucial weeks leading to the timely implementation of the Greek debt exchange (PSI) and the disbursement of the new loan tranche under the new EU-IMF rescue program. The timetable below is based on the most recent information we managed to collect from a number of press reports and other sources.

<u>February 20</u>

Eurogroup endorsed 2nd bailout programme for Greece.

<u>February 21</u>

Greek government submits to Parliament two implementation laws incorporating set of "prior actions", including €325mn supplementary budget for 2012.

<u>February 22</u>

Greek government proceeds with retroactive insertion of collective action clauses (CACs) in existing local low bonds (ca 95% of

GGBs outstanding are subject to Greek law). According to local press wires, this will take place via a legislative act, which will have the force of law. In our view, the mere introduction of CACs would not constitute a "credit event". However, their activation would likely trigger CDCs.

Official public offer for the Greek debt swap (PSI). Effectively, the public tender will be launched before national parliaments and governments in the euro area endorse the provision of the necessary EFSF funding for running the PSI (i.e., 2-year EFSF bills offered as *sweetener* to private bondholders participating in the exchange).

February 23

Greek Parliament endorses implementation law encompassing supplementary budget for 2012 and set of prior actions related to labour market reforms.

February 23-24

Finnish parliament debates 2nd rescue package for Greece. Finland and Greece singed a collateral deal in Brussels on Monday. This followed local press reports suggesting that the four biggest Greek banks –National Bank of Greece, Eurobank, Alpha Bank, Piraeus bank- will provide guarantees up to €88omn to Finland in order to fulfill the latter's demand for some form of collateral in exchange for backing Greece's 2nd bailout package. Reportedly, the banks would put up the necessary collateral so as to eliminate the need of having the Greek state doing so, since the latter could raise questions of preferential treatment of some countries funding the new bailout. As a reminder, Finland's coalition government is led by the (pro-European and right-leaning) National Coalition and the Social Democratic Party. The latter, headed by Finance Minister Jutta Urpilainen, agreed to join the government after last April's general elections under the condition that collateral deals would be a key prerequisite for future bailouts.

Feb. 23-24

G20 meeting takes place where finance ministers and central bank governors will discuss the provision of additional funding to the IMF so as to ensure that the Fund has enough resources to help sovereigns in financial need. Reportedly, G20 countries have signaled that they will agree to increase IMF funds if Eurozone countries allow the ESM and the EFSF mechanisms run in parallel with the aim to boost their combined bailout capacity.

February 27

German parliament debates 2nd rescue plan for Greece.

March 1-2

EU Summit - EU leaders will reportedly assess early signs of implementation of the newly-agreed austerity measures before giving the green light for the implementation of the PSI and the disbursement of the first loan tranche under the 2nd bailout. A number of EU officials hinted in recent weeks that no advance payments of bailout funds to Greece will be authorized before implementation of the agreed reforms has begun. EU leaders will also discuss whether to allow the ESM and the EFSF run in parallel so as to increase the combined lending capacity of the two mechanisms.

March 7

Deadline for private bondholders to affirm participation in the debt exchange.

March 8

Deadline for governments and euro area national parliaments to approve EFSF loan for running the PSI. The deal has to be ratified by all eurozone member states. In seven countries (Germany, Finland, Estonia, Italy, Malta, Portugal and Slovenia) the new ESFS loan requires parliamentary approval. In all others, finance ministers have the authority to approve a deal via some kind of "reporting" to national parliaments.

Eurogroup approves first EU/IMF loan tranche, consists of: **i)** up to €30bn in EFSF funds for running the PSI i.e., provide 2-year AAA-rated EFSF paper to bondholders participating in the debt exchange, **ii)** first loan installment of €10bn for bank recapitaltation, **iii)** €5.7bn for debt servicing and **iv)** provision of temporary EFSF credit enhancement (up to €35bn) for ensuring collateral eligibility of Greek sovereign bonds in ECB liquidity operations. The EFSF credit enhancement will remain in place for as long as Greece's sovereign debt rating remains on 'selective default" as a result of the debt swap, **v)** Eurogroup approves the terms of the new loan agreement).

Upon agreement with official lenders, Greece launches voluntary debt exchange (PSI). The bonds to be swapped are estimated to have a total face value of approximately €206bn. If participation in the new debt exchange is not deemed to be adequate, then CACs are likely to be activated, upon agreement by a pre-specified bondholder majority. Reportedly, the whole process is likely to take around a week. Bear in mind that, the respective contract of the €14.5bn 3-year bond maturing on March 20 provides a seven-day grace period for the repayment of the principal and one month for the interest payment.

March 9

Responses from private-sector bondholders concerning the bond swap offer are processed.

March 10-11

Greek government exchanges old bonds for new ones.

Mid-March

IMF convenes to decide its contribution to Greek 2nd bailout package. The Wall Street Journal reported late week that the IMF considers contributing just €13bn, an amount equivalent to no more than 10 percent of the 2nd bailout package for Greece. As a reminder, the IMF committed €30bn to the first Greek bailout programme, an amount equaled to about 27% of the whole package.

March 20

€14.435bn 3-year bond matures.

April 29

Assuming that everything goes according to plan, national elections are likely to be held on April 29, 2012. The publication of results of a public opinion poll conducted by MARC late last week showed an eight-party Parliament with the New Democracy (ND) partly continuing to lead. Specifically, if elections were to be held today, ND would gain 24% of the vote, down from 30.5% in an earlier poll published in January and well short of levels around 40% needed for an outright majority in parliament. The same poll showed that the socialist party PASOK attracted the support of 13.9% of respondents, ranking in the third place. The leftist parties achieved high rates with the Democratic Left, the most moderate of the three leftist parties, gaining 15.2%, up from 13% in an opinion poll conducted last month. The Communist party (KKE) garnered 11.9% and the coalition of the Radical Left (SYRIZA) reached 10.7%. The left-wing LAOS recorded 6.9%.

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