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Focus notes: Greece

Our take on the July 11 Eurogroup statement & the latest comments by EU officials

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July 11th Eurogroup signals readiness to apply a more holistic approach to the lingering sovereign debt crisis

As expected, the official statement accompanying the July 11 Eurogroup meeting contained no concrete announcements with respect to the main parameters and modalities of a new financing programme for Greece. Yet, the statement included a number of elements that signal an increasing sense of urgency among euro area policy makers over the need for "a broader and more forward-looking" policy response to assist the Greek government improve debt sustainability and, thereby , safeguard financial stability in the euro area.

Specifically, the Eurogroup statement emphasized the Minister's readiness to adopt further measures that would improve the euro area's systemic capacity to resist contagion risk, including enhancing the *flexibility* and the *scope* of the EFSF, lengthening the maturities of the loans and lowering the interest rates, including through collateral arrangements, where appropriate.

With respect to Greece, the EU-17 Ministers discussed the main parameters of a recently legislated fiscal austerity package for the period 2011-2015 and welcomed the reinforced monitoring mechanisms of the country's adjustment programme. On its part, the ECB confirmed its long-standing position that a *sovereign credit event* or *selective default* should be avoided. The statement also revealed that Ministers have tasked the Eurogroup Working Group to propose measures to reinforce the current policy response to the Greek crisis. Potentially, these would include steps to reduce the cost of debt-servicing and other measures aiming to improve the sustainability of public finances.

According to a number of reports, the parameters of the new "multi-annual" financing programme for Greece should be probably clarified by the end of this month, though Germany's Finance Minister indicated earlier this week that a second Greek rescue package could wait until September. Yet, market developments in a number of Euro-periphery economies over the last few sessions leave little doubt that the euro area sovereign debt crisis is increasingly taking (potentially dangerous) systemic proportions, requiring a more *holistic* policy response to deal with the situation as soon as possible. Note that the yield of the Italian benchmark 10-year bond temporarily breached the key 6.00% level y-day, to stand at 5.45% at the time of writing.

Dutch Finance Minister says a selective default of Greek debt "is no longer being excluded as a possibility"

Reflecting a heightened degree of alertness over the deepening debt crisis, a number of EU diplomats indicated earlier this week that European Union leaders are poised to hold an emergency summit on July 15. This followed a series of comments from key EU officials on the issues discussed during the July 11/12 Eurogroup/Ecofin meetings and, importantly, a statement by the Dutch Finance Minister that a selective default of Greek debt "is no longer being excluded as a possibility". This was a rare public admission made by a high-level EU official over the possibility of a selective default for Greece, an option that has been strenuously opposed by the European Central Bank.

This appears to suggest the possibility of a widening rift between the ECB and number of euro area governments -- including, Germany, Austria, Finland and the Netherlands -- on how to deal with the lingering debt crisis. It also reflects an increasing conviction among euro zone policy makers that a more comprehensive response to the crisis would need to encompass measures aiming to deal with the *debt sustainability/solvency* problem of Greece and other fiscally-vulnerable Member States and not merely with shorter-term liquidity issues.

Supporting the latter view, Germany's Finance Minister Wolfgang Schaeuble said yesterday that "extending payment periods and lowering rates for Greek aid will improve its debt sustainability" and added that "all options on how to involve the private sector will be examined without any reservations". Mr. Schaeuble repeated that it was inevitable that the private sector would participate in a new bailout deal for Greece and added that a recent proposal made by Commerzbank's CEO on how to deduce the country's debt burden was "interesting" and would be considered along other proposals.

In a recent piece entitled "Randezvous with reality", Commerzbank CEO Martin Blessing called for creditors to take a 30% haircut on Greek sovereign bonds and exchange them with new 30-year government securities with a 3.5% interest rate and a collective guarantee on the part of the euro area countries. Mr. Blessing's note also read that "If Greece's debt were restructured, it would also be necessary to find a solution for Portugal and Ireland. Spain and Italy also threaten to succumb. No one can tell whether further countries will be affected". The report also stated that the nature of private sector involvement (PSI) in the proposed scheme *would not* be "voluntary", necessitating additional measures to stabilize Greece's financial sector, in the event of ensuing credit rating downgrades to "SD" / "D" categories.

On his part, Greek Finance Minister Evagelos Venizelos said in a news conference on Tuesday that he was told by ECB President Jean-Claude Trichet that on the private sector involvement (PSI) issue there are currently 36 different scenarios being considered. Importantly, on the possibility of selective default for Greece, Mr. Venizelos said "selective default is not a real event, it is an assessment [by rating agencies]", adding that "we must not convert a perception into a reality, into a self-fulfilling prophecy". He also emphasized that a key prerequisite for any final decision on how to involve the private sector in a plan to reduce Greece's debt burden is to ensure the uninterrupted financing of the banking system. (Note that domestic banks remain overly dependent on the ECB for liquidity, with the most recent BoG data showing Greek banks' reliance on ECB liquidity rising by 12.2% mom in May 2011 to ca €97.5bn).

On the latter issue, Mr.Venizelos said that "…there must not and there will not be (a liquidity problem). This is fundamental and this was a basic parameter of our discussions". He added that any final decisions on a new bailout plan for Greece should be reached before mid-September, when the next EU/IMF loan tranche to Greece (under the current rescue package) comes due for release. For some further analysis on the Greek States borrowing requirement & sources of funding in the period leading to the release of the 6th EU/IMF loan trance please refer to our previous Greece Macro Monitor, July 10, 2011.

Our take on the July 11Eurogroup statement and the latest comments by EU officials

The following points summarize our take on the July 11th Eurogroup announcements and the more recent official comments and market developments:

As things stand at this point, it appears that there is an increasing realization among EU politicians and technocrats that the lingering debt crisis is taking systemically dangerous proportions, necessitating a "broader" and more "forward-looking" policy response. Such a response should deal with the debt sustainability / solvency problems of Greece (and other fiscally-vulnerable Member States) in a more convincing way by incorporating steps aiming to *e.g.* lengthen official loan maturities and/or lower interest rate costs, including through appropriate collateral arrangements.

On the latter point, please note that the majority of options proposed so far, at least those than have been publically known -- *e.g. the so-called "French Proposal" on the issue of private-sector involvement (PSI) as well as a number of alternative proposals discussed during last week's IIF meetings in Paris and Rome* -- did not necessarily provide any significant medium-term debt relief to the sovereign borrower. They merely presented a way to deal with the shorter-term liquidity issue, at the expense of broadly *unattractive* interest rate costs, from a debt sustainability/solvency perspective. To deal with the latter issues, the IIF proposed the formation of a Debt Buyback Facility (DBF) that would be begin to lower Greece's outstanding stock of debt, taking advantage of the existing sizeable discounts on Greek bond secondary market prices.
To complicate things further, although the French plan (and a number of other related options) *should not* reportedly trigger the payout of Greece CDS contracts, the likely response of major rating agencies to such a roll-over exercise remains unclear. S&P already warned that the French proposal, if implemented in its original form, would likely amount to a "default" under their criteria. More radical schemes to involve the private sector in a plan aiming to provide a more significant relief to Greek debt problem could also risk "SD" / "D" ratings for Greece, necessitating additional measures to ensure the uninterrupted access of the domestic banking system to ECB liquidity.

In our view, it is clear that any new comprehensive plan to improve Greece's fiscal sustainability/solvency outlook in a more convincing way wound need to secure, among other things, significant lower interest rates for the sovereign borrower than those projected in the present EU/IMF adjustment programme. Note here that in its last programme update for Greece (July 2011), the European Commission forecasts the average interest rate on the outstanding public debt stock to exceed the rate of real GDP growth (by between 1.3ppts and 3.8ppts) for each single year over the 2011-2020 projection horizon. Given that debt dynamics are difficult to stabilize solely by generating primary surpluses, lower interest rates are needed to reduce (and preferably neutralize) the "snowball effect" on the debt ratio. The latter could by easily understood by looking at the basic dynamic equation describing the evolution of the debt ratio[1]. In view of the aforementioned, we deem as particularly encouraging the July 11 Eurogroup statement's reference to the possibility of lower interest rates and/or longer loan maturities for Greece (and/or other fiscally-vulnerable euro area countries).

Original French PIS proposal not drastic enough to address debt sustainability

As an additional note to this report, we provide below a number of calculations regarding the PV loss/gain an investor participating in Option 1 of the original French plan[2] would receive per 100 points of maturing notional under various assumptions for the respective coupons and exit yields (see Table).

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[1] This can be (approximately) written as follows:

$\Delta B_t = (r-g) * B_{t-1} + PRB_t$ + [stock flow adjustments inclusive of privatization revenues]

Where, ΔB_t is the change in the debt ratio in year t; B_{t-1} is the level of the level of the debt ratio in year t-1; PRB_t is the primary balance (in ppt--of-GDP terms) in year t; r is the real interest rate on the overall debt stock, and g is real GDP growth.

[2] French Proposal - **Scenario 1**

Participants reinvest at least 70% of the principal amount of proceeds received from Greek government bonds (GGBs) maturing between July 2011 and June 2014 in a new 30-year bond issued by the Hellenic Republic. The proposed structure results in net debt financing for Greece equivalent to least 50% of maturing notional, with 20% of that being placed with an SPV collateralized by AAA-rated zero coupons. The SPV effectively provides a full principal guarantee for the new 30-year GGBs. The latter, bears a coupon of 5.5% plus an uplift indexed to annual Greek GDP growth, capped at 2.5% and floored at 0% per annum.

Table-French Initial PSI Proposal (Option 1): PV loss/gain of new instrument per 100pts of maturing notional

		Coupon		
		5.5%	7.0%	8.0%
Exit yield	12%	-19.0	-10.5	-4.9
	10%	-13.7	-3.8	2.8
	8%	-6.7	5.2	13.0

Source: French Banking Federation; Eurobank EFG Research

As we have noted earlier, a number of additional structures have been discussed during last week's IIF-run meetings in Paris and Rome, but it appears that none of them gathered adequate support to provide a strong candidate in a new bailout programme for Greece. Although official discussions regarding the nature and modalities of private sector's contribution in a new plan to address the Greek debt sustainability problem continue (and it is difficult at this point to foresee their final outcome), the table above provides additional support to the view that the French plan, at least in its initial form, provided (at best) only limited NPV relief to Greek public finances.

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