Eurobank Research
www.eurobank.gr/research
research@eurobank.gr

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GREECE MACRO MONITOR

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Focus notes: Greece

Latest political developments & the prospect of a new bailout package

Written By:

Dr. Platon Monokroussos
Assistant General Manager
Head of Financial Markets Research

Paraskevi Petropoulou
G10 Markets Analyst

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German Chancellor Angela Merkel, French President Nicolas Sarkozy break deadlock over private-sector involvement in a second bailout package for Greece: *Latest developments, potential credit-rating implications and hurdles that still need to be overcome*

In a closely-watched meeting in Berlin on Friday, German Chancellor Angela Merkel and French President Nicolas Sarkozy discussed the form of private-sector involvement in a new financial aid package for Greece. At a joint press following the conclusion of the meeting, the two leaders expressed their firm support for a new bailout deal that would involve a *Vienna-type* rolling-over of Greek sovereign debt exposures. The proposed scheme would be implemented on "voluntary" basis so as to avoid triggering a "credit event", an outcome strongly opposed by the ECB. The two heads of States did not elaborate on how exactly this rollover debt scheme would be conducted in practice, but emphasized that they want a new Greek rescue package to be in place as soon as possible.

As a brief reminder, the so-called Vienna Initiative was launched in January 2009, at the height of the global financial crisis. The initiative was basically a "gentlemen's agreement" between the ECB, the European Bank for Reconstruction and Development, the IMF, regulators and banks with subsidies in Central and Easter Europe. Under the plan, parent bank groups were publicly committed to maintain their CEE exposures constant at pre-crisis levels and to recapitalize their subsidiaries in exchange of securing continued financial aid from official lenders.

With respect to the new proposed Greek bailout deal, Germany appears to have backed away from its earlier demand for a (more radical) "voluntary" debt swap. If implemented, the

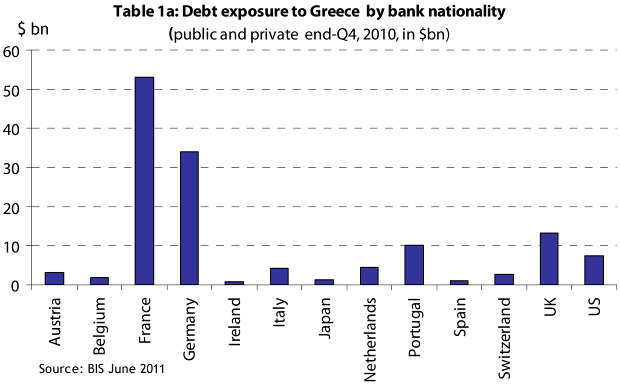
German proposal would risk being perceived by rating agencies as involving elements of coercion, leading to further downgrades of Greece's sovereign debt ratings to selective default/default categories. Note that in a letter sent earlier this month to the EC/ECB/IMF "troika", German Finance Minister Wolfgang Schaeuble insisted on a "quantified and substantial contribution of bondholders" to a new bailout deal for Greece that would endeavor beyond a pure Vienna-type scheme. According to that proposal, private creditors would be allowed to *voluntary* exchange *outstanding* Greek bonds in their portfolios for ones with maturities extended by seven years. Yet, ratings agencies warned that they would view such a scheme as coercive, labeling it as a distressed debt exchange (DDE). The latter would be on the basis that, given current fiscal conditions in Greece, it would be hard to see how a debt swap would be conducted on a *truly* voluntary basis.

According to a number of reports, the German Chancellor and the French President reached a preliminary agreement over a new scheme that would encourage banks, insurance companies, pension funds and other private-sector players to voluntarily rollover -- reportedly, by as much as seven years -- their Greek government debt holdings, maturing between 2012 and 2014. Private holders would only buy the new bonds once the old ones mature, effectively suggesting that a) existing bond contracts would be honored and b) the terms of the new securities offered would not be materially disadvantageous relative to those of the earlier issues.

David Geen, the general counsel of the International Swaps and Derivates Association (ISDA) which has the final say on whether a "credit even" has occurred, said last week that voluntary exchanging bonds for ones with a longer maturity would "typically" not trigger payment of CDSs, provided that the original terms are not amended. This holds under the assumption that the rollover does not postpone the payment terms *i.e.,* the existing bonds would have to be paid back to their holders at the time they mature and before they are exchanged. ***Yet, uncertainty still remains over whether even a Vienna-type scheme to voluntarily rollover maturing exposures would avoid being characterized as a Distressed Debt Exchange (DDE) by rating agencies***. Note that the ECB has already threatened that it would not accept as collateral default-rated government bond securities in its liquidity-providing operations.

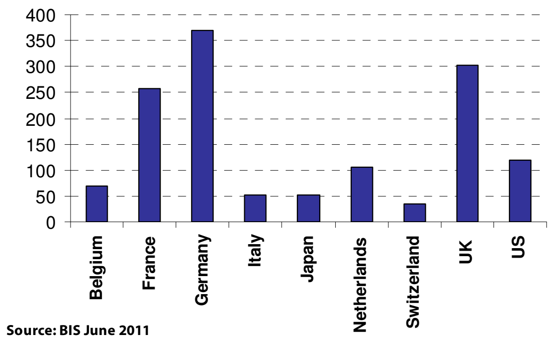
A number of euro zone countries, including France, had already strongly supported a debt roll-over scheme for Greece, on the condition that it would not trigger a credit event. The fear of contagion to other fiscally-vulnerable economies in the euro area is one of the main reasons behind the strong opposition to any *sovereign credit-triggering* arrangement. Note that according to the most recent BIS data (June 2011), French banks are the biggest foreign holders of Greek (public and private) debt (Table 1a). The overall exposure of EU and other foreign banks to the four most fiscally-vulnerable countries of the euro area -- *i.e., Greece , Ireland, Portugal and Spain* -- is also a matter of concern.

Table 1a: Debt exposure to Greece by bank nationality
(public and private end-Q4, 2010, in $bn)



Source: BIS June 2011

Table 1b: Total foreign exposures to Greece, Portugal, Ireland, & Spain by bank nationality
(public and private debt, end-Q4 2010, in $bn)



Source: BIS June 2011

Key hurdles that need to be overcome in the way to a new bailout deal for Greece

The next steps that *purportedly* need to be taken before a final agreement on a new bailout package for Greece is reached include, among others, the following:

i) secure that the proposed debt rollover scheme is not classified as a credit event by the major rating agencies. In line with what the latter have said so far, this could be avoided by ensuring that the proposed scheme meets the following conditions: **a)** it does not feature any element of coercion, **b)** the terms of the new securities offered to private-sector participants in the debt rollover operation are not worse than those of the old instruments and **c)** the risk of sovereign default would not increase if bondholders refuse to participate in the rollover scheme. The aforementioned conditions were underlined by rating agency S&P when it downgraded Greece's sovereign credit rating by three notches to CCC earlier this month.

ii) secure "substantial contribution of bondholders", a key precondition purportedly *imposed* by, among others, Germany, the Netherlands and Finland, countries that strongly oppose a disproportionate shouldering of the burden of a new Greek bailout by tax payers.

iii) Greece needs to attain parliamentary approval of the medium-term fiscal strategy (MTFP) announced last month, involving an ambitious privatization programme worth €50bn, additional austerity measures for 2011 and a significant fiscal adjustment effort in 2012-2015. (For a more in depth analysis on the main ingredients and projected fiscal impact of the MTFP please see our June 11, *Greece Macro Monitor* report). ***A parliamentary vote on the medium term fiscal plan is expected at the end of the month (most probably on June 28) and we now assign a high probability that the plan will get parliamentary approval (please also see analysis in our Greek politics section below).*** In all, the passing of the MTFP in parliament is a key precondition for an agreement over a new bailout package for Greece.

As things stand at this point, more time may be needed before all key technical details of a supplementary aid plan for Greece are hammered out. Thus, a final decision may be delayed until the July 11th Eurogroup meeting. However, unnamed German sources insisted earlier this week that a finalization of the technical modalities of the new rescue plan will probably need to be pushed back to September 2011.

New bailout package for Greece: *Potential size and sources of funding*

Reportedly, the potential size of a new Greek aid package would be around €120-150bn, an amount that is deemed more than adequate to cover Greece's borrowing requirement for the following three years; that is, assuming that the country will likely be unable to access international capital markets by early next year, as envisioned in the March 2011 update of the EU/IMF programme for Greece. Newswires suggest that, almost half of the total sum would come via additional EU/IMF financing. The European portion of the money would probably come in the form of loans from the European Financial Stability Facility (EFSF). Unlike bilateral loans from euro zone economies, EFSF loans do not require parliamentary approval. The latter would probably be difficult to obtain in countries such as the Netherlands, Finland, Germany and Austria, where there is strong opposition for taxpayer-funded sovereign bailouts. The remainder amount would be divided between **i)** private-sector burden sharing and **ii)** proceeds from Greece's privatization and real estate development programme.

Even though the precise details of a Greek package will not likely be known for a few more weeks, the upcoming Eurogroup meeting commencing on June 19 has still the potential to elicit a positive market response towards EMU sovereigns. Following the preliminary agreement between the German Chancellor and the French President over the "basis" of private sector burden-sharing, we expect euro zone policy makers to explicitly pledge additional official funding to Greece, conditional on a parliamentary approval of the announced medium-term fiscal plan by the Greek parliament. A political commitment by EU authorities to secure Greece's funding needs for at least 12-month ahead is expected to allow the IMF Board to approve the release of the Fund's 5th loan trance under the existing bailout programme.

June 19-20 Eurogroup meeting to give green light for release of fifth loan trance to Greece

In view of Greece's severe liquidity strains, there have recently been heightened market worries over whether the country would be able to receive the fifth loan tranche (€12bn) under the existing EU/IMF aid programme. Greece's first major sovereign liability settlement is scheduled for July 15, when €2.4bn in T-bills redemptions is due. This is followed by total coupon payments of €2.85bn by the end of July, with another T-bill redemption of €1.6bn coming on July 22. Further down the road, the next headwind in terms of debt repayments is on August 22, when the 3.9% August 2011 redeems for €6.6bn (see Table 2 below).

Table 2

Greece's sovereign liabilities in July (€bn)		
15-Jul	26-wk T-bills redemption	2.40
19-Jul	Coupon payment	0.93
20-Jul	Coupon payment	1.48
22-Jul	13-wk T-bills redemption	1.63
25-Jul	Coupon payment	0.44

Source: Bloomberg

In view of the above liquidity hurdles, the release of the 5th loan tranche under the existing EU/IMF programme is expected to dominate official discussions. In a statement released late this week, Economic and Monetary Affairs Commissioner Olli Rehn expressed his confidence that the June 19-20 Eurogroup will agree on the disbursement of the 5th loan tranche to Greece, worth €8.7bn.

The IMF's slice on the 5th loan trance amounts to €3.3bn. In compliance with its internal rules, the Fund threatened earlier this month to withhold payment of its share, unless the EU guarantees to meet the country's funding needs for the next 12 months. Yet, the IMF seems to have lately softened its stance on the latter requirement, and it now appears to be leaning towards releasing its 5th loan installment for Greece. FT reported earlier this week that the IMF wants the EU to make a conditional promise to meet Greece's funding needs over a 12-month period rather than make a concrete commitment. This would effectively eliminate the risk of an outright sovereign default, ensuring that the country is fully funded until September, when the next scheduled €8bn aid payment is due. Moreover, it will provide more time to EU officials to reach a compromise on the final form of an additional Greek rescue package. But, another key hurdle will need to be overcome before the 5th EU/IMF loan tranche is released. Namely, a parliamentary baking of the Greek government's medium-term fiscal strategy submitted last week.

Confidence vote, parliamentary approval of the medium-term fiscal plan are the first obstacles faced by the newly-sworn Greek government

Following a dramatic week of heated political debate over the new austerity programme both within the ruling party, PASOK, and between the government the main opposition parties, Prime Minister George Papandreou announced on Friday a broad cabinet reshuffle. Outgoing Finance Minister George Papaconstantinou moved to the Environment Ministry. Mr. Evangelos Venizelos, outgoing Defense Minister and a ruling PASOK party heavyweight, was appointed as new Finance Minister with the extra status of deputy prime minister. Both labour and environment ministers Louka Katseli and Tina Mpirmpili who, according to a number of a reports, resisted some of the EU/IMF-backed reforms were removed from the government.

A couple of sessions earlier, Mr. George Papandreou had reportedly offered his resignation in a move to allow the formation of a national unity (coalition) government between PASOK and New Democracy, the main conservative opposition party. The intension was to purportedly shore up support for the aggressive austerity fiscal measures envisioned in the 2011-2015 medium-term fiscal plan, a key prerequisite for the release of additional EU/IMF official funding to Greece. But a deal could not be reached as, reportedly, the conditions the leader of the conservative New Democracy party requested -- i.e., among others, early elections and a renegotiation of the terms of the EU/IMF bailout package for Greece -- were perceived by the Prime Minister as too demanding.

The first important hurdle the newly-appointed Greek government will need to overcome is a confidence vote in Parliament, which was requested by the Prime Minister earlier this week. The debate will start on Sunday, June 19th and a vote will take place at midnight on Tuesday, June 21st. Should Mr. Papandreou survive the confidence vote- which is our core scenario- we see a very strong probability that he will also be able to push the MTFP through parliament later this month, albeit with thin majority. In our view, the successful conclusion of an emergency meeting of PASOK's parliamentary group last Thursday (reportedly, involving a debate on leadership issues), is almost as good as an informal vote of confidence to Mr. Papandreou provided by his MPs.

Following Mr. Giorgos Lianni's resignation from PASOK parliamentary group earlier this week, the ruling party has now a majority of five MPs in the 300-seat parliament. However, it can only hope for 154 in favour votes from Pasok MPs at best, after MP Alekos Athanasiadis publicly stated earlier this week that he will vote against the government's medium-term fiscal plan. Although main *parliamentary* opposition parties are broadly expected to vote against the plan, the latter may *reportedly* draw some in-favor votes from a number of MPs from a smaller party with parliamentary representation *(e.g., five MPs from "Democratic Alliance" party, formed last year by Mrs. Dora Bakoyannis, an ex Minister and MP of the main opposition party).* Separately, even though the main opposition party has stated that it will not be voting for the MTFP, one of its MPs, Elsa Papadimitriou, has recently indicated that she may vote in favour. This leaves us with a potential best-case scenario of 160 MPs voting in favor. According to parliamentary legislation, the approval of the MTFP requires the simple majority of the attending MPs (50% + 1 vote), but not less than 120 in favour votes (i.e. 2/5 of parliament members). Both the Communist Party of Greece (KKE) and the Radical Left Coalition party (Syriza), controlling a total of 30 seats, announced that they will refrain from all parliamentary procedures concerning the medium-term fiscal plan.

In an adverse, *though low probability,* scenario that the government fails to pass the no-confidence vote, early elections would be called, ultimately leading to a coalition government. On the latter, please note that according to the latest opinion polls, no political party would gather enough support to form a single party government (i.e., higher than 150 seats in the 300-seat parliament). According TO the results of an opinion poll published in local press last Sunday, only 27% would vote for the governing PASOK party (vs. 43% in a poll conducted by the same company in early May and 44% in the October 2009 election). The main opposition party, New Democracy, would win 31% of the votes, leading the ruling PASOK party for the first time since late 2009 elections. Moreover, the poll revealed that seven parties would get over the 3% required threshold to enter parliament.

In the *unlike* scenario of early elections, resulting *e.g.* from the failure of government to win the confidence vote, the vote of the MTFP in parliament will be postponed, as it usually takes around 30days from the date of announcement of snap elections to the actual election day. Moreover, additional time would be required to form a government coalition. In this case, negotiations on additional official financing would probably freeze, putting in doubt the timely disbursement of the next EU/IMF loan tranche to avoid an outright sovereign default. Even under such adverse circumstances, however, some new official financing e.g. in the form of a bridge loan to cover the borrowing needs until a new government is formed should not be entirely excluded; at least as a number of recent reports have suggested (e.g. see June 17, 2011 FT issue).

Greece Events Timeline

Date	Event
19-Jun	Debate on a **confidence vote** in the Greek parliament begins **Eurogroup meeting** commences (in the evening). Finance Ministers are expected to sign off on their €8.7bn portion of Greece's next loan trache
20-Jun	**PM George Papandreou** will meet Eurogroup President Jean-Claude Juncker and President of the European Commission Jose Manuel Barroso **Ecofin meeting** of all 27 EU finance ministers (starts in the evening)
21-Jun	**Parliamentary Vote of confidence** to be concluded (at midnight)
22-June or **24-June**	**Economic Affairs Committee of Parliament to discuss again on the MTFP**
23/24-June	**EU Summit**
28-Jun	Reportedly, the parliament will vote on the **MTFP**
Early July	The fifth EU/IMF l**oan tranche** (€12bn) likely to disbursed
11-Jul	Scheduled **Eurogroup meeting. According to** Economic Affairs Commissioner Olli Reh, a final agreement on a second aid package for Greec will be reached.
15-Jul	Greece has €2.4bn in **T-bills redemption**
22-Jul	Greece has €1.6bn in **T-bills redemption**
20-Aug	Greece has €6.6bn in 5-yr **bond redemption**

Source: Offiical sources, Eurobank Economic Research

Research Team

Editor, Professor **Gikas Hardouvelis**
Chief Economist & Director of Research Eurobank EFG Group

Financial Markets Research Division
Platon Monokroussos, *Head of Financial Markets Research Division*
Paraskevi Petropoulou, *G10 Markets Analyst*
Galatia Phoka, *Emerging Markets Analyst*

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Maria Prandeka, *Economic Analyst*
Theodosios Sampaniotis, *Senior Economic Analyst*
Theodoros Stamatiou, *Research Economist*

Eurobank EFG, 20 Amalias Av & 5 Souri Str, 10557 Athens, tel: +30.210.333 .7365, fax: +30.210.333.7687, contact email: Research@eurobnak.gr