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Focus notes: Greece

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Latest on Greece and the euro area crisis

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Part I - July 9 Eurogroup: What's on the agenda?

The Eurogroup is bound to hold on July 9 its last scheduled gathering before the summer break. During the meeting, euro zone Finance Ministers are expected to exchange views on a number of important issues that need to be clarified regarding the crisis-fighting measures EU leaders decided at the June 28-29 Summit. As a reminder, the decisions reached at the last EU Summit centered on the following areas: **(i)** development by the end of this year of a *time-bound* roadmap towards closer financial, budgetary and economic policy integration. A related interim report is expected to be presented in October 2012, developing further an initial draft published ahead of the June EU Summit; **(ii)** direct bank recapitalization from the *permanent* European Stability Mechanism (ESM) once a single supervisory mechanism for euro area banks, involving the ECB, is established; **(iii)** increased flexibility in the usage of the existing EFSF/ESM instruments to stabilize debt markets of euro area sovereigns that strictly comply with EU fiscal rules; and **(iv)** adoption of a growth-stimulus package to accompany the *Fiscal Pact*. Important aspects of the aforementioned matters will be discussed at the July 9 Eurogroup, but it is unlikely that concrete decisions will be announced. It is clear now that more time will be needed for euro zone Finance Ministers to bridge their differences and overcome important political and legal hurdles, with a number of high-level EU officials suggesting last week that another Eurogroup may take place before the summer break, probably on July 20th. Regarding tomorrow´s meeting, the agenda is expected to include, among others:

i) Conditionality and technical details for direct bank recapitalization by the ESM

EU leaders agreed at the June 28-29 Summit that, once a single supervisory mechanism is established, the European Stability Mechanism (ESM) would be authorized to recapitalize banks directly, bypassing the respective sovereign borrower. The measure aims to break the *vicious cycle* between euro area banks and sovereign governments that has been a pernicious feature of the lingering debt crisis. That is because direct bank recapitalization through the ESM would not raise the respective

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sovereign debt burden and thus, it would remove some pressure from sovereign credit ratings, as Fitch suggested in an official statement released soon after the conclusion of the June EU Summit. Yet, a crucial related issue that needs to be clarified relates to the conditionality attached to direct bank recapitalization through the ESM. As per the Summit statement, direct bank recapitalization will be accompanied by a *Memorandum of Understanding*, with no specific details being provided as to its potential content. The statement merely said that bank recapitalization directly from the ESM will rely on "appropriate conditionality, including compliance with state aid rules, which will be institution-specific, sector-specific or economy-wide". Furthermore, with the European Stability Mechanism not currently having the legal authority to recapitalize banks directly, another issue that is it expected to be discussed at tomorrow's Eurogroup is whether this would require certain alteration in the ESM Treaty and/or renewed endorsement by national parliaments. Note that Article 15 of the ESM Treaty states that the mechanism may grant "*financial assistance through loans to an ESM Member for the specific purpose of re-capitalizing the financial institutions of that ESM Member*". Other important related modalities including, among other, the scale of recapitalization, the seniority status of capital injected and the implementation timeline, will be reportedly included in the agenda of discussions.

ii) Support program for Spanish banks

The recapitalization program for Spanish banks will be a central issue at tomorrow's Eurogroup. In an emergency teleconference held on June 9, euro area Finance Ministers decided to commit up to €100bn to help Spain shore up its ailing banking system. As per the official statement released after that teleconference, the required recapitalization funds will be transferred to viable domestic banks through the Spanish Fund for Orderly Bank Restructuring (FROB). The operation is initially expected to increase Spain's public debt–to–GDP ratio by an equiproportional amount. However, once the single supervisory mechanism for euro area banks is in place, the said amount will be removed from the sovereign balance sheet. That is, provided that the June 28-29 EU Summit decisions will indeed apply to Spain. As per the last EU Summit statement, the financial assistance to Spanish banks will be provided by the EFSF until the ESM becomes operational, and that it will then be transferred to the ESM. Importantly, EU leaders agreed that, exceptionally for Spain, the loans provided to recapitalize the country's banking sector will not enjoy seniority status over existing bondholders. The signature of a Memorandum of Understanding (MoU) for financial aid up to €100bn for Spanish banks was originally scheduled for July 9. However, a final agreement on the issue may not be reached at tomorrow's Eurogroup as the auditing of the country's four biggest banks is not yet finalized. In any case, investors will be closely scrutinizing any new information regarding the specific terms and modalities of the recapitalization package *e.g.* loan amounts, respective maturities and interest rates. Finland's request for collateral in return for its participation in the EU loan to Spain is also expected to be a point of discussion.

iii) Treatment of Irish bailout package

Regarding the issue of direct bank recapitalization by the ESM, the June 28-29 EU Summit statement read that "the Eurogroup will examine the situation of the Irish financial sector with the view of further improving the sustainability of the well-performing adjustment programme". Interestingly, these comments coincided with market talk that Ireland may be forced to request additional EU/IMF funding due to rising loan losses in its banking system. According to a number of reports circulating in the international press and newswires in recent weeks, domestic banks may need €4-5bn of additional capital to cover non-performing commercial property loans, relative to what was assumed in last year's stress tests. Since 2009, the government has pumped €63bn into its ailing domestic banking system. Out of this amount, €18bn has come from the bank recapitalization package envisaged in the EU/IMF 3-year bailout plan (€85bn) agreed in November 2010. While it remains to be seen whether the upcoming Eurogroup will take any decisions on Ireland, a direct recapitalization of the domestic banking system through the ESM would, undoubtedly, improve sovereign debt sustainability. According to the sixth review of the Irish economic adjustment programme released last month, the debt-to-GDP ratio is projected to peak at 121.2% in 2013 from an estimated 117.5% this year and its 65.1% level at the end of 2009.

iv) Conditions for using existing rescue mechanisms to stabilize sovereign debt markets

As per the June Summit statement, existing EFSF/ESM instruments should be used "in a flexible and efficient manner" so as to stabilize sovereign debt markets for member states respecting the "Country-specific Recommendations and their other commitments including their respective timelines under the European Semester, the Stability and Growth Pact and Macroeconomic Imbalances Procedure". The associated conditionality, to be laid out in a Memorandum of Understanding, will presumably be a much *softer* one compared to that applying to existing programme countries i.e., Greece, Ireland and Portugal. The EU Summit statement clarified that the ECB will serve as an agent to the EFSF/ESM in conducting such market operations. In view of the aforementioned, market participants will be closely monitoring tomorrow's Eurogroup for any hints regarding the lending capacity of the existing mechanisms, especially in view of the increased challenges lying ahead. ***Comment:*** EFSF's overall lending capacity is €440bn, with *uncommitted* resources is currently standing at €247bn *i.e.,* after incorporating commitments already made for the Greek, Irish and

Portuguese bailout programs. In addition, there will be new claims for financing the Spanish and Cypriot bank recapitalization schemes (up to €100bn and €10bn, respectively). With respect to the permanent rescue mechanism, ESM, its total subscribed capital stands at €700bn (€620bn in callable capital + €80bn paid-in capital), while its overall lending capacity is set at €500bn. Note that the mechanism's callable capital will be ready for use immediately, but its paid–in capital will reach its full amount only in June 2014. The paid-in capital is planned to be covered in five equal installments of €16 each; with the first two to be paid in July and October 2012, the next two by mid–2013 and the fifth by mid–2014. For the transitional period mid-2012 to mid-2013, whereby the EFSF will be allowed to run alongside the ESM, the total maximum amount of combined lending capacity for *new* lending programmes will be capped at €500bn. As per Article 10, paragraph 1 of the ESM Treaty, the Board of Governors will review on a regular basis whether the maximum ESM lending volume is still appropriate, given that its paid–in capital can not fall below 15% of the outstanding amount of ESM debt issuance. However, any required adjustments could prove time consuming as they might require the approval of national parliaments, including in Germany. Other important issues regarding sovereign debt purchases by the EFSF/ESM mechanisms still remain unanswered. For instance: Who will monitor compliance with underlying conditionality? Will the volume of EFSF/ESM interventions (say, per sovereign entity or intervention round) be capped at particular levels? Will there be any particular bond yield levels targeted? Will the ESM be allowed to conduct primary bond market purchases along with secondary market purchases? Another potential obstacle to a more flexible use of the existing anti-crisis mechanisms to stabilize euro area sovereign debt markets is opposition to EFSF/ESM bond purchases expressed by Finland and the Netherlands. Note that according to the existing ESM Treaty, financial assistance to member states in need normally requires unanimous approval by the mechanism's Board of Governors *i.e.,* the euro area Finance Ministers. However, following the amendment of the ESM's voting framework last December, in case the EU Commission and the ECB conclude that the financial and economic sustainability of the euro area is threatened, an emergency procedure may be followed, requiring a qualified majority of 85% of member votes rather than a unanimous consent.

v) Greece

According to a European Commission press release on the July 9 Eurogroup agenda, the Greek Finance Minister is expected to present the policy priorities of the new government. Moreover, euro area Finance Ministers will hold a first discussion on the results of a recent troika fact–finding mission in Greece.

vi) Other issues

Eurogroup Finance Ministers will also discuss the appointment of the new Eurogroup President, a vacancy on the ECB Board, the selection of a Managing Director for the ESM as well as the Chairman of the ESM Board of Governors. EFSF chief Klaus Regling will reportedly be appointed as the managing director of the ESM, but it is entirely open whether a compromise will be reached at the July 9 Eurogroup regarding the other placements. Spain has claimed a seat at the ECB Board while Jean–Claude Juncker reportedly intends to retain his post as Eurogroup President only if Yves Mersch, Governor of the Central Bank of Luxembourg, is appointed to the ECB Board.

Part II – Focus Greece: Latest domestic macro and political developments

Troika fact-finding mission arrived in Athens earlier this week; negotiations with domestic authorities on the completion of 1st programme review, potential changes to the existing MoU will reportedly begin in the last week of July

A technical team of the EC/IMF/ECB troika of official lenders began earlier this week a series of meetings with domestic authorities in an effort to evaluate of the current state of the Greek economy and assess whether and to what extent the prolonged pre-election period has caused deviations from the agreed programme targets. The heads of the troika mission also held a number of meetings with high-level government officials and the leaders of the ruling tripartite coalition. Reportedly, they departed from Athens yesterday and they will return in the week starting July 24th to complete the 1st review of the existing stabilization programme.

Greek Prime Minister presents programmatic commitments of the new government

Opening up a 3-day parliamentary debate on the programmatic commitments of the new government on Friday July 4, Greek Prime Minister Antonis Samaras outlined nine policy priorities aiming to facilitate a return to sustainable economic recovery and secure social cohesion:

i) Swift implementation of the agreed privatization program, even through legislative intervention when required.

ii) Privatization of the National Railway Company (OSE) and liberalization of the domestic energy market. Energy

networks will remain under State control, while exploratory concession contracts will be granted to mines. The privatization program's objective should not be solely to increase state revenues but also to attract new investments and create new jobs. The government will also seek to privatize water utilities, applying an enhanced regulatory control framework for water resources.

iii) Concessions to operate regional ports and airports.

iv) The government will also seek to better exploit real estate assets other than the old Athens airport property at Hellenikon, which is already in the privatization pipeline. The intention is to set up a Special Purpose Investment Vehicle to take over the State's coastal property in the southern Athens region, targeting a rise in values and proceeds. Any ensuing legal issues (e.g. ownership titles) will be cleared up and similar schemes will be launched in other parts of Greece.

v) The government intends to make faster use of remaining funds (~€12.5bn) under the National Strategic Reference Framework (NSR) for Greece, especially for major projects run under the auspices of the development ministry.

vi) Over the next five months, dozens of state entities and organizations will be merged or shut down.

vii) Adoption of special legislation for the repatriation of unregistered funds to boost liquidity in the economy.

viii) Measures to strengthen e–governance, combat bureaucracy and contain spending on State supplies through the use of electronic tools.

ix) Settlement of State arrears to various suppliers and other parties within the next 12–18 months. Special scheme to offset debts to and from the State.

The Parliamentary debate on the government´s programmatic commitments is scheduled to be concluded with a vote of confidence late on Sunday, July 8. According to the Constitution of Greece (Article 84, paragraph 6), the confidence vote requires an absolute majority of the Members of Parliament attending the vote, which can not be less than 120 MPs (i.e. 2/5 of the total number of parliamentary deputies). Understandably, the new government, which currently controls 179 parliamentary seats, is expected to comfortably win the confidence vote.

Greece receives remaining amount of 1st EU loan tranche under new bailout programme

As we have repeatedly noted, the completion of the 1st programme review is a key prerequisite for the disbursement of additional EU-IMF financing to Greece under the existing bailout agreement. According to the new rescue programme, the next loan tranche amounts to ca €31.25bn and consists of: (i) €29.6bn in EFSF financing, inclusive of the second *and final* installment for the domestic bank recapitalization scheme (€23.5bn); and (ii) €1.65bn in IMF funding under the new 4-year Extended Arrangement for Greece. The release of the said tranche was originally scheduled for June 2012. However, the prolonged pre-election period following the inconclusive outcome of the May 6 national ballot delayed the timely completion of the 1st programme review, creating subsequent delays in the agreed timeline of official financing. These developments raised worries about an imminent depletion of the government's cash reserves, with a recent number of press reports suggesting that in the absence of new financial assistance from official lenders State coffers would risk running out of cash by the end of the current month. That would, in turn, force the government to temporarily utilize a number of alternative funding sources to cover its imminent budgetary needs including, among others, higher T-bill issuance in July (i.e., beyond the €4.0bn expected to be rolled over that month) contingent on the troika's approval and/or the temporary tapping of the Hellenic Financial Stability Fund for €2-3bn.

Latest loan disbursement provides some short-term relief to State coffers

Fortunately, the June 21th Eurogroup gave the green light for the disbursement of a remaining amount of €1bn that was unexpectedly withheld from the last EFSF loan disbursement to Greece (May 2012). The said amount was received earlier this week, with €450mn of that being utilized to pay for the country's contribution to the ESM's paid-in capital. Greece's overall contribution to the ESM paid-in capital is estimated €2.25bn. The first payment was due in early July, but the government has reportedly reached an agreement with euro area authorities to pay that amount in two equal installments; the 1st has already been contributed to the mechanism and the second will be paid in October 2012. Following the disbursement of the latest EU loan instalment, a government official was quoted in the media as saying that State cash reserves are now standing at "satisfactory levels". Greece's first major sovereign liability settlement comes on August 20, when two old GGBs mature (€3.1bn cumulatively). The biggest chunk of these two issues (ca €3bn) is currently held by the ECB and, understandably, the full payment of the corresponding notional amounts could not be possible without the disbursement of new EU-IMF financing. According to some reports, the July 9 Eurogroup may discuss the possibility of granting Greece a 1-month extension in settling these payments, though several euro area Finance Ministers may voice objections to such a concession.

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