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FOCUS NOTES

May 9 Eurogroup: a step closer to a final agreement

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Euro area finance ministers acknowledged in their extraordinary meeting yesterday (May 9) the progress made so far by the Greek government towards the successful completion of the 1st programme review. The said meeting took place after the government had secured parliamentary approval with the support of all 153 coalition MPs of the social security pension reform and the overhaul of the income tax code, two of the core prior actions for the completion of the review. The contingency mechanism, another prior action for the review, and debt relief were also in the agenda. A final agreement on these issues will be pursued when Euro area finance ministers reconvene on May 24th. The main elements of yesterday's Eurogroup meeting are highlighted below.

Prior actions for the completion of the 1st programme review

— First package of fiscal parametric measures amounting to 3%-of-GDP by 2018, including: (i) social security pension reform; (ii) overhaul of the personal income tax; and (iii) additional parametric measures such as a VAT reform and public sector wage bill measures.

— Finalization of the NPL resolution framework for the immediate opening up of the market for the sale and servicing of performing and non-performing loans, with the temporary exclusion of small loans secured by primary residences.

— Establishment of the Privatization and Investment Fund, including an initial asset transfer. The Supervisory Board will be appointed by June 2016 and the Fund will become fully operational no later than September 2016.

An additional contingency mechanism which will be legislated upfront to ensure that when Greece deviates from the annual primary surplus targets in the programme, based on an objective assessment, a package of measures, including non-discretionary ones, would be automatically activated. Expenditure measures, including non-discretionary ones may be replaced at a later stage, as part of the regular budgetary process, by permanent structural measures agreed with the intuitions, including revenue measures to bring the budget structurally back on track.

Comments

– The social security pension reform, the overhaul of the pension income tax and a package of additional parametric measures are expected to secure savings/revenue of €5.4bn (€1.8bn each) in the period 2016-2018. In a roll-call vote earlier this week (May 8), the Hellenic Parliament endorsed a bill incorporating the relevant legislation of the social security and income tax reform with the support of all 153 coalition MPs, while all opposition parties and independent deputies casted a negative vote. A bill including the legislation for the adoption of a package of additional parametric measures is reportedly expected to be submitted for vote in Parliament in the next couple of weeks. As per the same sources, the said package will incorporate, inter alia, the increase of the top VAT rate to 24% from 23% currently and the implementation of a recruitment rule in the public sector (1-to-5 for 2016, 1-to-4 in 2017 & 1-to-3 in 2018).

– According to press reports, the Greek government and official creditors are close to a final agreement on the NPL resolution framework. As per the same sources, loans collateralized by the debtor's primary residence will be exempt until end-December 2017 from the scope of permitted sales, provided that certain eligibility criteria are met. These reportedly include, inter alia: (i) the objective value of the primary residence should not exceed €140k; and (ii) the debtor's declared annual income should not exceed the agreed tax-free income threshold. Reportedly, the remaining NPL categories will be eligible for sale as units or in groups together with performing loans.

– As regards the operation of the Privatization and Investment Fund, the two sides have reportedly agreed that the Supervisory Board will comprise of five members; three will be appointed by the Greek side and two, including the President, by the official creditors. As per the same sources, decisions will be reached by a qualified majority and both sides will have veto rights on the appointment of the Board members. The new Fund will reportedly comprise of four subsidiaries: (i) the Hellenic Republic Asset Development Fund (HRADF); (ii) state enterprises (DEKO); (iii) the Public Properties Company (PPCo S.A); and (iv) the Hellenic Financial Stability Fund (HFSF). Official creditors have reportedly requested the privatization of 27 public bodies and utilities in total including the seven privatizations currently in progress as well as the privatisation of the 65% stake in Public Gas Corporation (DEPA), the 35% stake in Hellenic Petroleum (ELPE), the 24% stake in the Athens Water Supply and Sewerage Company (EYDAP), the 24% stake in the Thessaloniki Water Supply & Sewerage Company (EYATH) and the 17% stake in the Public Power Corporation (PPC).
– On the grounds that the earlier proposal by official creditors for the legislation of contingency measures is legally unattainable, euro area finance ministers accepted, as a base for talks, a scheme submitted by Finance Minister Euclid Tsakalotos envisioning, instead, the legislation of a contingency mechanism. The said mechanism will reportedly work as follows: If annual general government accounts released by Eurostat once per year (usually in April) show a deviation from the agreed primary surplus target (0.5%-of-GDP in 2016, 1.75%-of-GDP in 2017, 3.5% -of-GDP in 2018), then a package of measures, including non-discretionary measures, would be automatically implemented following the issuance of a relevant Greek Presidential Decree. The said decree will reportedly have to be issued by May 31st and the relevant measures to be implemented by June 1st. According to Greece's finance minister, the said package will not incorporate certain socially-sensitive measures, namely defense spending and unemployment benefits. Should expenditure measures be automatically activated, the Greek government will be authorized to replace them (or part of them) with permanent structural measures, including revenue measures, in the budget law that is submitted in Parliament for vote in the last few months of each year (usually in October/November).

Debt relief

The Eurogroup committed to consider, if necessary, possible additional debt relief measures to ensure Greece's refinancing needs are kept at sustainable levels in the long-term. The guiding principles for debt relief are to: (i) facilitate Greece's return to bond markets; (ii) smoothen the repayment profile in the coming years; (iii) incentivise the country's adjustment process even after the programme ends; and (iv) accommodate uncertain GDP growth and interest rate developments in the future.

The sustainability of the Greek debt will be assessed against a benchmark according to which, under the baseline scenario of a debt sustainability analysis (DSA), Greece's financing needs should remain on a sustainable path. The Eurogroup instructed the Euroworking Group to work on the design of the aforementioned benchmark along with the specifics of the debt relief measures and report back to the May 24th Eurogroup.

It should be emphasized that any debt relief measures will be considered upon full completion of the 1st review and euro area finance ministers will return to the issue when they next meet. Debt relief may be granted in a three stage process. More specifically:

- For the short-term: exploration of possibilities to optimize debt management of the programme, making it more manageable in the future. As was reportedly clarified by Greece's finance minister, the short-term stage will start when both the review has been completed and the next loan installment has been disbursed.
- For the medium term: The Eurogroup mandated the Euroworking Group to explore specific measures such as: (i) longer grace and payment periods which can be implemented, if necessary, at the end of the ESM programme, i.e. no earlier than 2018; and (ii) return of SMP and ANFA profits (estimated according to our own calculations at €7.7bn).
- Long term: at the end of the programme the Eurogroup may consider, if necessary and conditional upon compliance with the primary surplus targets, the need for additional debt measures to ensure that Greece's gross financing needs remain on a sustainable path.

IMF participation to the programme

According to the official statement released after the Eurogroup meeting as well as the statement by the Eurogroup President Jeroen Dijsselbloem, the agreement and implementation of the policy package together with the agreement on debt and adequate financing assurances by the European partners, are expected to allow the participation of the IMF in the programme. However, the

Fund's views were not expressed at the Eurogroup press conference. Having said that, it should be noted that for a number of countries, spearheaded by Germany, the participation of the IMF in the programme constitutes a prerequisite for the disbursement of further loan tranches.

Next steps – sequence of events

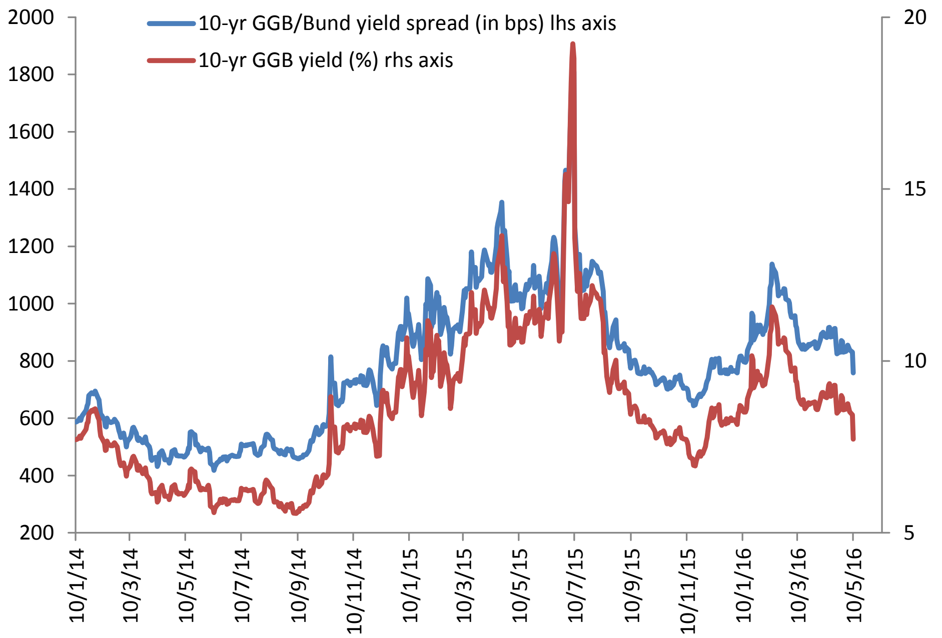
The aim of the Greek government is to reach a staff level agreement with official creditors on the 1st programme review, including the contingency mechanism, within the next couple of weeks in order for the next Eurogroup on May 24th to give the green light for the release of the next loan tranche. The sequence of events towards this goal is as follows:

1. The Eurogroup receives the draft supplemental MoU including the final list of prior actions.
2. Greece takes immediate steps to fulfil the prior actions including the adoption of the relevant legislation.
3. The Eurogroup receives the compliance report for the 1st review.
4. Necessary national procedures for the clearance of the next loan tranche are carried out, where required.
5. The Eurogroup approves the disbursement of the next loan tranche. The amount of the tranche has not yet been specified, but in our view it may exceed €7bn, more than adequate to cover upcoming interest and debt amortization payments as well as a part of State arrears. According to press reports, the Euroworking Group will determine the amount.

Positive reaction of GGBs & the Athens Stock Exchange General Index on May 9 Eurogroup outcome

The Greek government bond (GGB) market was one of the main outperformers in the EMU sovereign space today, reacting positively to the May 9 Eurogroup meeting outcome. Short & medium dated maturities outperformed with the 3-10 year segment of the GGB curve undertaking some bullish steepening. The 3-year GGB cash yield was hovering around 7.75% at the time of writing this report (European trade, May 10), the lowest so far this year and sharply below levels near 11% recorded earlier this month. With the 10-yr Bund yield hovering around multi-session lows of 0.13% favoured by lingering worries over the growth prospects of the world economy, the 10-yr GGB/Bund yield spread moved below 800bps for the first time in the last four months to stand at 760bps compared to levels near 850bps a week earlier. Along similar lines, Greece's ASE benchmark general stock index moved higher standing close to 629 at the time of writing, the highest in near four months, after hitting a multi-year low near 300 in mid-February. The technical picture for the 10-year GGB/German Bund yield spread suggests that strong support lies at 645bps (Nov. 2015) while on the upside, major resistance stands at recent highs ahead of 920bps (Feb. 2016).

Evolution of 10-yr GGB yield and spread vs. Bund



Source: Bloomberg, Eurobank Economic Research

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