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Latest macro & market developments

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Part I

Troika unveils new fiscal sustainability assessment on Greece; *A significant worsening in debt dynamics since the fourth programme review*

A *strictly confidential* analysis on Greece's debt sustainability prepared by the EC/IMF/ECB troika of official lenders was reportedly discussed at the October 21-22 Eurogroup/Ecofin meetings. The new analysis will *purportedly* form the basis for talks with private investors on what losses they should accept on their Greek government bond (GGB) portfolios in a new bailout package for Greece expected to be announced at the October 26 EU Council. The report was *apparently* leaked to the press, with a number of international papers and newswires commenting over the last couple of days on its main findings and revised projections.

The new sustainability report shows a significant worsening in Greek debt dynamics, with a *revised* baseline scenario forecasting a debt ratio trajectory that is subject to a range of adverse shocks. Presumably, the revised troika projections highlight the need for an ambitious combination of official support and private sector involvement (PSI) for an extended period so as to facilitate a return to a more sustainable fiscal position. The forecast horizon of the troika's revised baseline scenario is extended through 2030 to better capture long-term growth dynamics and possible financing implications. It shows that Greece's public debt ratio remains elevated for the entire horizon, reflecting the interplay of a number of factors highlighted below (see also Table 1 at the last page of this report).

Slower domestic economic recovery than envisaged earlier

The revised baseline scenario assumes a more downbeat domestic macro environment than envisaged in the fourth programme review. Besides the deeper-than-expected domestic recession in 2011-2012, it is also assumed that it will take longer to implement growth-enhancing structural reforms, among other reasons because of administrative capacity limitations in the broader public sector. The *revised* scenario forecasts real output contracting by 5.5% in 2011 and by 2.9% in 2012. A gradual return to positive economic growth is expected thereafter, with real GDP growth averaging around 1.25% in 2013-2014 and 2.75% in 2015-2020. The new sustainability report does not provide detailed forecasts for the subsequent period, but it assumes output growth averaging around 1.75% in the next decade, with GDP growth decelerating from 2.4% in 2020 to 1.5% in 2030. **Comment:** The latter appears to be broadly in line with a number of studies by international organizations, which assume that future productivity growth eventually converges to the average historical productivity growth of a technological leader (e.g. the US). These studies usually assume long-term equilibrium labor productivity growth of 1.50%-1.75%. In the case of Greece, the latter assumption along with a broadly constant population structure would yield a long-term real GDP growth forecast of 1.50%-1.75%. This is not much different from the EC projections presented in earlier Sustainability Reports.

More gradual fiscal adjustment

The revised sustainability report assumes that nominal targets for the general government deficit are maintained throughout the program (mid-2013). However, forecasts for annual primary surpluses in the period after 2012 are significantly lower (and, *arguably*, more realistic) relative to those envisaged in the July 2011 IMF baseline scenario. **Comment:** The new medium-term troika assumptions regarding the evolution of the primary balance appear to be broadly in line with the more recent IMF projections (see e.g. Sept. 2011 Fiscal Monitor). Specifically, the primary surplus is now seen stabilizing between 4.3%-of-GDP and 4.5%-of-GDP in the period 2014-2020, before easing gradually towards 3.5%-of-GDP in 2030. These forecasts are more in line with the primary fiscal balances Greece was able to sustain for a number of years in the past (e.g. during the second half of the 90s) and compare with projected surpluses of 6.4%-of-GDP or higher in the July 2011 IMF baseline.

Lower privatization revenue

Annual privatization proceeds are forecast to be lower than envisaged in both the government's initial medium-term fiscal plan (MTFS) and the IMF's July 2011 baseline scenario. They are now expected to rise from 1.5%-of-GDP in 2012 to ca 2%-of-GDP in the subsequent two-year period. Through 2020, total privatization proceeds are expected to amount to €46bn vs. €66bn assumed in the program. **Comment:** the latter figure corresponds to the sum of the original €50bn target for the period 2011-15 and an additional amount from the expected disposal of assets linked to domestic bank recapitalizations.

Delayed access to market funding

The revised sustainability report assumes that Greece's access to market financing will not be restored before 2021. **Comment:** This compares with earlier official-sector forecasts for a gradual return to sovereign debt markets from 2014 onwards (see *e.g.* 4th MF program review, July 2011). Note that the new troika report assumes a *rather arbitrary* rule for resumed market access. The rule assumes that new market financing can become available only after Greece has achieved a consecutive 3-year period of positive output growth and primary surpluses above the debt stabilizing level in conjunction with a debt-to-GDP ratio below 150%.

Additional official funding needs

Even assuming full implementation of the July 21st PSI deal, the *revised* baseline scenario envisions additional official financing for Greece as a result of delayed market access relative to earlier forecasts. Projected official financing in the period 2011-2020 rises to ca €252.3bn (€163.7bn in 2011-14 and €88.6bn in 2015-20), from €109bn envisaged in the July 21 EU Council agreement. Under a stress scenario, which assumes a much stronger "internal devaluation" as a result of a deeper domestic recession the overall funding needs for the period 2011-20 rise to as much as €444bn. **Comment:** In view of the aforementioned trends, the revised debt sustainability report calls for an ambitious combination of official support and private sector involvement. On the latter issue, the new report encompasses two alternative scenarios, envisaging larger private sector contributions than in the July 21 bailout deal. These take the form of NPV losses for bondholders of 50% and 60%, respectively. Under the 50% PSI scenario, the public debt ratio is projected to reach 120%-of-GDP in 2020 (vs. 152%-of-GDP in the baseline scenario, which assumes full implementation of the July 21 PSI deal). Under the 60% PSI scenario, the public debt ratio falls to 110%-of-GDP in 2020 (vs. 152%-of-GDP in the revised baseline).

Part II

October 23 EU Council: Some progress towards a comprehensive plan to address the lingering crisis

Sunday's EU Summit did not exactly yield a breakthrough towards resolving the lingering debt crisis. That was broadly expected after German Chancellor Angela Merkel and French President Nicolas Sarkozy signaled mid last week that final decisions were to be postponed for an emergency Summit scheduled on October 26. Reportedly, a number of political and technical hurdles are yet to be overcome before a more comprehensive solution to the euro area crisis is presented. According to a number of reports, the decision to hold a second Council meeting this week was the result of the German Chancellor's request to allow sufficient time to get the necessary mandate from the German lower house of parliament. According to a recent Constitutional Court ruling, the federal government has to get approval by the Bundestag's budgetary committee before handing over guarantees for bailout deals and, in general, before taking decisions affecting government expenditure. Despite the lack of concrete decisions at y-day's Summit, EU leaders reportedly made some progress towards a final plan expected to be unveiled on October 26. More specifically, progress was presumably made on bank recapitalizations and the method to increase the EFSF's firepower. Yet, the official statement issued after the conclusion of the Summit was largely vague on the aforementioned issues, concentrating mostly on to the progress made so far to strengthen budget discipline among member states and address underlying weakness in the economic governance. Based on number of press reports, the most important developments stemming from the October 23 EU Summit can be summarized as follows:

EU-wide bank recapitalization

EU leaders reportedly agreed in principal on a €108bn bank recapitalization plan. EBA head Andrea Enria who attended the October 22 Ecofin, informed EU finance ministers that, based on the results of an emergency stress test run earlier this month, European banks' capital requirement was estimated at between €100bn and €110bn if banks' core tier-1 capital ratio was raised to 9% by June 30, 2012. The new minimum required capital ratio is higher than the 5% used in the summer tests and is based on banks' capital position at the end of June 2011. That is, after marking down to market their EMU-periphery sovereign bond holdings. The EBA head specified that 38% of the overall capital shortfall is reckoned to be at banks in program countries (Greece, Ireland and Portugal), with the rest being spread among Europe's biggest banks, largely in Italy, France and Spain. While there was a tentative agreement over the size of bank recapitalization, other key elements of the plan remain unclear. Press reports suggested that the European Commission has proposed a three-step process, which appears to be backed by the German government. First, banks will be asked to carry out the capital injection via the private sector. Second, any remaining shortfalls have to be met by national governments (based on the US experience with the Term Asset-Backed Securities Loan Facility adopted at the height of the crisis in 2008, bank recapitalization could be instrumented via the use of preferred shares). Third, the EFSF would be used only as a last resort.

Scaling up the EFSF's lending capacity

Reportedly, EU finance ministers considered mainly two proposals for leveraging the EFSF. The first involves allowing the mechanism to act as a bond insurer. Specifically, rather than issuing bonds and then lending to sovereigns and banks, the EFSF would instead be allowed to guarantee the "first-loss" of newly issued European sovereign debt in the event of a default or a debt restructuring. According to press wires, the insurance would cover the first 20-30% of any losses, implying that the EFSF could *correspondingly* be leveraged up by between three to five times. Although there appeared to be merits in the aforementioned proposal, certain objections were raised. Among others, these relate to worries of creating a two-tier bond market (guaranteed bonds trading at a premium over old bonds), potentially making market conditions even more challenging than they currently are. Moreover, a successful implementation of such a scheme would potentially require an explicit commitment from the ECB to stick to its Securities Markets Program (SMP) to halt the rising trend in the borrowing costs of Italy and Spain. Another proposal which, according to unnamed EU officials, gained most traction involved the combination of using the EFSF as a bond issuer that would provide partial guarantees for newly issued European sovereign debt and the creation of a special purpose vehicle (SPV) with an EFSF subordinated loan to guarantee bonds in the secondary bond market. Reportedly, France appears to have dropped its proposal to turn the EFSF into a bank which could then be allowed to leverage its capital via the ECB. Under such a plan, the EFSF could buy bonds of countries under financial stress on the secondary market and then use these bonds as collateral to borrow funds from the central bank. Germany, the Netherlands and Finland as well as the ECB have strongly opposed the latter proposal on the basis that it risks undermining the credibility of the central bank and because it also violates the article 123 of the Lisbon Treaty, which restricts the central bank from funding member states.

Tighter economic governance in the euro area

In an effort to prevent a future economic crisis, EU leaders considered steps towards tighter economic governance. Among the options under discussion, European Union deficit and debt rules should be embedded in national legislation, preferably at constitutional level by the end of next year with sanctions imposed on member states consistently breaching the Treaty's deficit and debt limits. The European Council could also get more powers in monitoring closely national budgets to better coordinate macroeconomic policies across the euro area. No final decisions were reached on the aforementioned issues, but press reports suggested that Germany and France are pushing for limited Treaty revisions which would speed up the process of moving towards closer economic governance, particularly on fiscal issues. Specifically, there is speculation over the likelihood of euro area states losing part of their fiscal sovereignty by *e.g.* allowing the European Commission or the European Council to veto national budgets.

A new bailout package for Greece

Speaking on the sidelines of the October 22 Ecofin meeting, IIF managing director Charles Dallara said that some limited progress was made regarding a potentially larger private sector contribution to a new bailout plan for Greece. The IIF official added that private holders of Greek sovereign bonds "… remain open to explore options on a voluntary approach built on a realistic outlook for the Greek economy and restoration of Greece's market access". Reportedly, private institutions have offered to *voluntarily* take NPV losses of up to 40%, but several EU governments demanded even larger contributions i.e., NPV losses of 50% or more. Negotiations between private investors and the official sector on this important issue continued at the time of writing.

Table 1 - Evolution of Greece's public debt ratio and underlying macroeconomic & fiscal variables (troika's revised sustainability analysis of general government debt net of debt for collateral vs. earlier IMF forecasts for the gross public debt ratio)

		2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2030
Real GDP growth (%)	Revised troika baseline (Oct 21, 2011)	-5.5	-2.9	0.5	2.1	2.7	2.9	2.8	2.8	2.7	2.4	1.5
	IMF Fiscal Monitor (Sept. 2011)	-5.0	-2.0	1.5	2.3	3.0	3.3	n.a.	n.a.	n.a.	n.a.	n.a.
	IMF 4th review (July 2011)	-3.8	0.6	2.1	2.3	2.7	2.9	3.0	3.0	3.0	3.0	n.a.
GDP deflator (%)	Revised troika baseline (Oct 21, 2011)	1.4	0.2	0.3	0.4	0.6	0.8	1.0	1.2	1.5	1.7	1.8
	IMF Fiscal Monitor (Sept. 2011)	1.0	0.3	0.3	0.3	0.4	0.6	n.a.	n.a.	n.a.	n.a.	n.a.
	IMF 4th review (July 2011)	1.5	0.7	1.0	1.0	0.9	1.1	1.3	1.4	1.7	1.8	n.a.
General gvtn primary balance (% of GDP)	Revised troika baseline (Oct 21, 2011)	-2.3	1.4	2.5	4.5	4.5	4.5	4.3	4.3	4.3	4.3	3.5
	IMF Fiscal Monitor (Sept. 2011)	-1.3	0.8	3.3	5.7	5.1	4.4	n.a.	n.a.	n.a.	n.a.	n.a.
	IMF 4th review (July 2011)	-0.8	1.5	3.5	6.4	7.7	6.4	6.4	6.4	6.4	6.4	n.a.
Average nominal interest rate on public debt (%)	Revised troika baseline (Oct 21, 2011)	4.5	5.1	4.3	4.5	4.5	4.5	4.6	4.7	4.7	4.7	5.1
	IMF Fiscal Monitor (Sept. 2011)	4.5	4.6	4.5	4.6	4.6	4.5	n.a.	n.a.	n.a.	n.a.	n.a.
	IMF 4th review (July 2011)	4.6	4.9	5.0	5.5	5.9	6.1	6.4	6.9	6.7	6.7	n.a.
Gross public debt (% of GDP)	Revised troika baseline (Oct 21, 2011)	162	183	186	184	179	173	168	163	157	152	130
	IMF Fiscal Monitor (Sept. 2011)	166	189	188	179	165	163	n.a.	n.a.	n.a.	n.a.	n.a.
	IMF 4th review (July 2011)	166	172	170	160	146	143	140	138	134	130	n.a.

Source: Eurobank EFG Research based on EC/IMF/ECB revised debt sustainability report (Oct 21, 2011)

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