Eurobank

# GREECE MACRO MONITOR

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## May 24th Eurogroup

## Key highlights and a preliminary analysis of debt relief measures

After a marathon session in Brussels yesterday, euro area finance ministers acknowledged that a staff level agreement on the prior actions for the 1st programme review has been reached. This development is expected to have a number of positive implications, such as the lifting of short-term uncertainty surrounding the outlook of the Greek economy, the re-instatement of a Greek collateral waiver and the eventual inclusion of the country in ECB's QE programme[1]. With regard to public debt, in line with the agreement of the May 9 Eurogroup and upon the full implementation of the conditionality underlying the new programme, euro area finance ministers agreed to implement a three-layer roadmap of relief measures .

The main elements of yesterday's Eurogroup outcome are highlighted below.

**Pending items with regard to prior actions for the 1st review**

The Eurogroup welcomed the endorsement by the Hellenic Parliament of the relevant legislation required for the implementation of most of the 18 key deliverables, notably: (i) a package of fiscal parametric measures amounting to 3%-of-GDP to facilitate fulfillment of the primary surplus target of 3.5%-of-GDP in 2018;[2] (ii) the fiscal contingency mechanism that will be activated if annual government accounts released by Eurostat in mid-April show a deviation from the agreed primary surplus target of the previous year;[3] (iii) the establishment of the new Privatization Fund dubbed Hellenic Company of Assets and Participations; [4] (iv) finalization of the NPL resolution framework; and (v) full independence of the General Secretariat of Public Revenues.[5] Nevertheless, the Euroworking Group has been mandated to verify in the next few days the full implementation of the outstanding prior actions including the corrections to the legislation pertaining to the opening up of the market for the sale of loans and the pension system reform as

[1] According to BoG Governor Yannis Stournaras, the reinstatement of sovereign debt waiver and the inclusion in the ECB's QE program could have a positive impact of €400- €500mn on Greek bank results in 2017.

[2] The package of parametric measures includes three items projected to secure savings/revenue of €5.4bn cumulatively in the period 2016-2018 (€1.8bn each); (i) social security pension reform; (ii) overhaul of the pension income tax; and (iii) additional parametric measures incorporating, inter alia, an increase in the top VAT rate to 24% from 23% and an increase in the special consumption tax on gas, unleaded petrol, diesel, cigarettes & tobacco products.

[3] The contingency mechanism that come in force in 2014 and will remain active at least until the end of May 2019.If annual general government accounts released by Eurostat show a deviation from the agreed primary surplus target of the previous year, then a package of measures aimed at general government expenditure, including non-discretionary measures, will automatically be implemented following the issuance of a relevant Presidential Decree by Greece's Minister of Finance. The said decree will have to be issued by May 31st and the relevant measures, including pensions and public sector wages, should be implemented by June 1st. In case the required decree is not issued, the mechanism will be activated automatically and will be applied horizontally on all areas of general government expenditure. The primary surplus targets according to the programme are as follows: 0.5%-of-GDP in 2016, 1.75%-of-GDP in 2017, 3.5% -of-GDP in 2018.

[4] Greek state assets including 70k real estate properties will be reportedly transferred to the new Fund with a lifespan of at least 99 years. The Supervisory Board will comprise five members while both the Greek government and official creditors will have veto rights on the appointment of the Board members. 50% of privatization proceeds will be channeled towards investment and the remaining 50% will be used for decreasing Greece's debt to GDP ratio.

[5] As of 2017, the General Secretariat of Public Revenues will be replaced by the Independent Authority for Public Revenue that will be fully autonomous, i.e. it will have operational independence, administrative and economic autonomy and will not be monitored by any government or state entity or other administrative authority.

well as any government pending actions pertaining to privatisations (e.g. the approval by the Hellenic Parliament of the privatisation plan for Ellinikon). According to the May 24th Eurogroup statement, upon full implementation of the remaining prior actions for the completion of the review and subject to the completion of national procedures, the ESM Board of Governors stands ready to endorse the supplemental MoU and approve the release of the next ESM loan tranche to Greece.

**Next ESM loan disbursement to be released in sub-tranches**

Upon verification by the Euroworking Group in the next few days that all outstanding prior actions attached to the 1st review have been met, the ESM Board of Governors is expected to approve the release of the 2nd programme disbursement to Greece, amounting to €10.3bn. The said amount will be released in several sub-tranches. The first one scheduled for June 2016 and amounting to €7.5bn, will cover debt servicing needs and clear an initial part of arrears as a means to support the real economy. Further disbursements will be made after the summer. The disbursements for arrears clearance will be subject to a positive reporting by the European Institutions on the clearance of net arrears. The disbursements intended for debt servicing will be released conditional on milestones related to the privatization programme (e.g. the Supervisory Board of the new Privatisation and Investment Fund must be appointed by June 2016 and the Fund must be fully operational by September 2016), bank governance, the General Secretariat of Public Revenues and the energy sector.

**IMF financial participation in the current programme**

The IMF, represented at the May 24 Eurogroup by its European Department Director Poul Thomsen, has made a significant concession by agreeing to the implementation of the bigger part of debt relief at a later stage – namely, upon completion of the programme in July 2018 – contrary to its original demand for a generous debt-relief upfront. According to the Eurogroup official statement as well as its President's remarks, the IMF management expressed its intention to recommend to the Fund's Executive Board to approve a financial arrangement before the end of 2016. Before going to the Board, the IMF management will, among others, carry out a new DSA analysis taking into consideration the agreement between Greece and the European institutions and assess the possible debt relief measures agreed at the May 24 Eurogroup. Nevertheless, Mr. Thomsen reportedly stated that whether the IMF management will indeed make a positive recommendation to the Fund's Executive Board or not, will be dependent on the specification and quantification of the debt relief measures by the European institutions.

**A preliminary analysis on the debt relief measures**

On debt relief, the Eurogroup elaborated further on the general guidelines agreed on 9 May.[6] In more detail, an agreement has been reached on a package of measures that will be subject to the pre-defined conditionality of the ESM programme and be phased in progressively so as to ensure that Greek public debt remains sustainable under the new definition of sustainability (annual government gross financing need < 15% of GDP during the post-programme period for the medium-term and < 20% of GDP thereafter). The table below includes the list of these relief measures, while a preliminary analysis on their potential impact on the government's borrowing requirement and the nominal debt stock follows.

[6] These guidelines include: (i) facilitating market access in order to replace over time public financed debt with privately financed debt; (ii) smoothening the repayment profile; (iii) incentivising the country's adjustment process even after the programme ends; (iv) flexibility to accommodate uncertain GDP growth and interest rate developments in the future; and (v) exclusion of any nominal haircuts on outstanding public debt.

**Table – Debt relief measures agreed at the May 24 Eurogroup**

| Time horizon | Measures |
|---|---|
| **Short term** (From completion of 1st review to the expiration of the current programme in Aug 2018) | Smoothening the EFSF repayment profile under the current weighted average maturity |
| | Use EFSF/ESM diversified funding strategy to reduce interest rate risk without incurring any additional costs for former programme countries |
| | Waiver of the step-up interest rate margin related to the debt buy-back tranche of the 2nd Greek programme for the year 2017 |
| **Medium term** (Upon succesful completion of ESM programme) | Abolish the step-up interest rate margin related to the debt buy-back tranche of the 2nd Greek programme as of 2018 |
| | Use of 2014 SMP profits from the ESM segregated account and the restoration of the transfer of ANFA and SMP profits to Greece (as of budget year 2017) to the ESM segregated account as an ESM internal buffer to reduce future gross financing needs. |
| | Liability management - early partial repayment of existing official loans to Greece by utilizing unused resources within the ESM programme to reduce interest rate costs and to extend maturities. Due account will be taken of exceptionally high burden of some Member States. |
| | If necessary, some targeted EFSF reprofiling (e.g. extension of the weighted average maturities, re-profiling of the EFSF amortization as well as capping and deferral of interest payments) to the extent needed to keep GFN under the agreed benchmark in order to give comfort to the IMF and without incurring any additional costs for former programme countries or to the EFSF. |
| **Long term** (After finalization of the ESM programme) | Activation of a contingency debt relief mechanism after the finalization of the ESM programme so as to ensure debt sustainability in the long run in case that a more adverse scenario were to materialize. |

The debt relief package announced yesterday may not have a significant impact on the evolution of the government's gross borrowing needs in the short-term (i.e., over the duration of the current programme). This is because Greece already enjoys a 10-year grace period for both principal and interest payments on EFSF loans, with the exception of a €34.5bn loan tranche released for financing the PSI operation in early 2012. The latter loan *does* carry a 10 year grace on principal, but it regularly pays an annual interest of around EFSF funding cost + 12bps. However, the impact of the aforementioned measures could be material longer-term. On the first item, which relates to the "smoothening" of the EFSF repayment profile, our take is that yesterday's agreement points to a potential for extending the weighted average maturity of EFSF loans (currently c. 28 years) by, say, 1-2 years, so as to lighten up the debt service profile when needed. As regards the second item i.e., the use of EFSF/ESM diversified funding strategy to reduce interest rate risk, the official statement suggests the potential to swap part of the EFSF facility (say, the €37.3bn loan provided for the first bank recap.) with new ESM loans of a longer maturity and lower interest cost. Finally, a waiver of the step-up interest rate margin related to the debt buy-back tranche (€11.3bn) could reduce the 2017 debt service burden by c. €226mn (=2% X €11.3bn).

For the medium term, the Eurogroup committed to implementing a possible second set of relief measures, contingent on: a) successful implementation of the ESM programme; and b) the release by the institutions at the end of the programme of an updated DSA showing that such measures are needed to meet the agreed GFN benchmark. As per the earlier analysis, the potential impact of the first of these measures (i.e., the abolishment of the step-up interest rate margin related to the debt buy-back tranche) would secure an annual saving of c. 226mn over the period 2018-2022 along with additional, though gradually declining, relief in the outer years (until 2040/41). On the second item i.e., the use of SMP and ANFA profits for the creation of an internal buffer to reduce future gross financing needs, the estimated amounts to be accrued to the relevant ESM segregated account are: €5.96bn over the period 2017-2020 and €1.2-1.5bn between 2021 and 2026. This buffer could potential be used to reduce future gross financing needs. In addition, any remaining resources within the ESM programme (say, a significant part of the c. €20bn bank recapitalization commitments that remain unutilized) could be used to swap outstanding official funding (say, from the IMF) with longer duration and/or lower interest bearing loans. Finally, some targeted EFSF reprofiling (e.g. extension of weighted average maturities, re-profiling of amortization payments and caps/deferrals of interest payments) could be used to keep government gross financing needs under the agreed benchmark (<15% of GDP / annum in the medium-term and < 20% of GDP in the long-term). The latest measure would clearly have a significant impact on the long-term evolution of borrowing needs. Note that the overall outstanding notional amount of EFSF loans provided to Greece in the context of the 2nd programme is currently €130.9bn.

For the long-run (and after the finalization of the ESM programme), the agreement envisages the activation of a contingency debt relief mechanism to safeguard debt sustainability in case that a more adverse scenario were to materialize. This contingency mechanism could incorporate a whole range of strategies to ensure observance of the annual GFN benchmark target. The Eurogroup statement explicitly mentions the possibility of further EFSF reprofiling along with caps and deferrals of interest payments. We would add the possibility of extending this kind of reprofiling to the GLF facility (EU bilateral loans under the first programme – €52.9bn in outstanding notional) and/or the ESM loans in the context of the current programme. For a relevant quantitative analysis see https://www.eurobank.gr/Uploads/Reports/GreeceMacroFocus_21122015.pdf

The big picture is that the new debt relief package presented yesterday includes all necessary components to ensure that Greece's debt servicing profile remains broadly manageable in the long term. However, it involves strengthened conditionality. Although this may sound inferior to upfront (and unconditional) debt relief, it does seem to provide a "carrot and stick" approach to ensure that the agreed targets are met and Greece maintains fiscal prudence well beyond the expiration of the current programme.

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