Economic Research

Eurobank EFG

Athens, April 12 2010

Focus
Eurogroup details sizeable aid mechanism for Greece

In this report, we present an analysis on Greece's sovereign debt crisis, focusing, primarily, on the likely characteristics of a Euro Area / IMF rescue package, provided that the country will apply for such aid. We also provide specific examples of effective borrowing costs for various maturity loans
Our analysis is based on

I. **what has become publically known following a Eurogroup teleconference held on April 11**
II. **the modalities and cost structure of existing IMF lending instruments, particularly those applied to the Stand-By Arrangement (SBA), which currently appears the most suitable lending facility for Greece and**
III. **various comments made so far on the issue by high-level EU and IMF officials.**

I - Eurogroup details aid mechanism to Greece

On the basis of what has become publically know so far, the proposed rescue package will have the following characteristics:

- Will involve loans extended by both **Euro Area member states** (on a bilateral basis) and the **IMF**
- According to the European Commissioner for Economic and Financial Affairs Olli Rehn, bilateral **loans by Euro Area members states** would account for ca **two-thirds** of a rescue package for Greece, with the **rest of the money** provided by the IMF
- Euro Area could contribute **up to €30bn in the *first* year** to Greece, with the exact IMF contribution still remaining unclear. A meeting between officials from the Eurogroup and the International Monetary Fund will take on April 12 and thus, we expect the IMF´s stance on the issue to be clarified over the next few days

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- Based on the Euro Area-IMF contribution ratios suggested above, we surmise that the **total size of a rescue package for Greece could be as high as €45bn**, with the potential for additional money to be put on the table by Euro Area partners if needed in the following years. Notably, a Greek Finance Ministry official told Reuters that **€80bn** would constitute a **''logical amount''** of aid to Greece **over the next three years!** The statement was later amended to ''a logical amount for the three-year period would be significantly higher than €40bn, but this has not yet been determined''. Whatever the case may be, the total loan amount quoted is sizeable and significantly higher relative to what financial markets were expecting.
- In our view, the tenor of any Euro Area bilateral loans will likely be ***at least*** 3 years
- More importantly, the interest rate applied to Euro Area bilateral loans to Greece would be calculated by a formula very similar to that used by the IMF, albeit with certain modification, purportedly aiming to maintain the non-concessional character of such loans *(in conformity with the EU Council statement on March 25, 2010)*

- Specifically, the following **pricing formula on Euro Area bilateral loans** will be used: **Variable-rate loans** will be based on 3-month Euribor. **Fixed-rate loans** will be based upon the rates corresponding to Euribor swap rates for the relevant maturities. A charge of 300 basis points will be applied. A further 100 basis points are charged for amounts outstanding for more than 3 years. In conformity with IMF charges, a one-off service fee of maximum 50 basis points will be charged for operational costs

Example 1
A three-year variable-rate loan would be priced as follows:

Annual *effective* cost of 3YR variable-rate loan = 3-month EURIBOR + 300bps + (50bps ÷ 3)

Note also the following:

- The 3-month EURIBOR rate currently stands at around 0.64% (64bps) and this variable part of the loan will need to be marked-to-market every three months

- 50bps represents a (one-off) service fee for operational costs. This will needs to be divided by 3 in the above formula to derive the annual *effective* cost of the variable-rate loan

- **300bps is the spread charged, which will rise to 400bps for any amounts outstanding over 3-years**

In line with the above, the *annual* effective rate applied to a 3YR variable-rate loan becomes:

Annual *effective* cost of 3YR variable-rate loan = 64bps + 300bps + 16.7bps = 381bps or 3.81%. *(That is for the first 3-months of the loan i.e., before the mark-to-market of the variable component)*

Example 2
A three-year fixed-rate loan would be priced as follows:

Annual *effective* cost of 3YR fixed-rate loan = 3YR fixed swap rate + 300bps + (50bps ÷ 3)

For a current the 3YR fixed-swap rate of ca 1.90% the above formula becomes:

Annual *effective* cost of 3YR fixed-rate loan = 190bps + 300bps + (50bps ÷ 3) = ca 500bps or 5.0%

Example 3
A 5-year fixed-rate loan would be priced as follows:

Annual *effective* cost of 5YR fixed-rate loan = 5YR fixed swap rate + 300bps + (50bps ÷ 5) = 250bps + 300bps + 10bps = around 560bps or 5.60%

To the above formula, one needs to add a further 100bps charge for any loan amounts outstanding beyond 3 years

Example 4
A 10-year fixed-rate loan would be priced as follows:

Annual *effective* cost of 10YR fixed-rate loan = 10YR fixed swap rate + 300bps + (50bps ÷ 10) = 355bps + 300bps + 5bps = around 660bps or 6.60%

To the above formula, one needs to add a further 100bps charge for any loan amounts outstanding beyond 3 years

- Our own calculations show that the effective cost of Euro Area bilateral loans to Greece could be **higher by 100bps or more** relative to that of an IMF Stand-By Agreement. However, in addition to any internal-politics considerations, one could claim that there is a certain rationale behind such a higher cost *e.g.,* in view of the higher (overall) size of Euro Area bilateral loans and the incentive to minimize moral hazard *(and/or any other agency-type problems)*

- In a press conference given shortly after the Eurogroup detailed the proposed aid plan, Greek Finance Minister George Papaconstantinou said that Greece has not asked for the activation of an EU/IMF aid mechanism and hopes to be able to continue to borrow smoothly from markets. Separately, an unnamed official source from the Greek finance ministry told Reuters "We will monitor the markets in the coming days and, depending on how the spreads move, we will decide whether to request the aid mechanism."

- In case that that Greece makes an official request for the activation of the lending mechanism, the ECB and the European Commission will need to assess whether there a real need for the country to get bilateral loans and then a unanimous decision of euro zone finance ministers will give the final go-ahead.

Our assessment

We have long held the view that any rescue package for Greece would:

a) **be sizeable enough to stabilize market sentiment and deter further speculative attacks on Greece *(and the* euro area as a whole) and**
b) **involve an effective cost that is considerably lower than recently prevailed market interest rates *(e.g., considerably higher than 7.00% across the full spectrum of maturities as of mid-day on Friday April 9)***

On the basis of what we have heard so far, we believe the proposed mechanism satisfies both conditions.

Te first condition above is easily understood. We therefore elaborate further on condition b). The condition of lower-than-market interest rates is also satisfied due to a number of reasons. First, Greek spreads underwent a further sharp widening over the past two weeks, partly because markets were not sure that EU help would actually arrive. Market needed reassurance on the modalities, structure and operational characteristics of the rescue mechanism, especially regarding bi-lateral loans by other EMU member states. This uncertainty has now evaporated and GGB spreads are now expected to decline on a consistent basis *(The table below shows the current market interest rates on Greek debt relative to their closing levels on Friday April 9)*

GGB nominal yields as of Monday, April 12 (08:30GMT)

	2YR	5YR	7YR	10YR	30YR
Last	5.34	6.27	6.49	6.52	6.55
change (in bps)	-200	-60	-84	-60	-45

Source: Bloomberg

Second, it is the existence of funding at "normal" rates, which is particularly helpful at this juncture. An effective lending rate for Greece close to recently-prevailed market rates (7.00% or higher) would not have provided much help for the country to sustainably tackle its fiscal problems and promote the promised reduction in general government budget deficit over the forecasting horizon of the stability and growth programme (2010-2013). That is easily understood in view of the country's present public debt burden (€300bn and rising), the current interest rate costs (more that 5ppts-of-GDP per annum) and the mere fact that for every 100bps rise in the average borrowing rate, the Greek budget incurs an additional cost of more than €400mn or more that 0.17ppts-of-GDP per annum for a multi-year period, depending on the average maturity of new borrowing.

In our view, the main priority of fiscal policy in Greece at this juncture should be to sustainably stabilize (if not reduce) the public-debt-to-GDP ratio within the time frame of the stability and growth programme. To attain that aim the country needs:

a) fast GDP growth (highly unlikely in 2010 and over the next few years
b) lower primary deficits (and eventually primary surpluses)
c) lower borrowing costs and
d) lower stock-flow adjustments.

With domestic GDP growth expected to remain well-below trend throughout the period 2010-2013, it becomes obvious that the effective borrowing cost for the state needs to move significantly lower from current market levels so as to allow the de-escalation of primary deficits and, eventually, a shift to primary surpluses. That is assuming that the government will implement its fiscal consolidation program vigorously and without deviations.

Bottom line

In view of the latest developments with respect to the EU-IMF aid mechanism and judging from current market dynamics, we believe that there is a high probability of the government applying for the mechanism over the next few weeks, if not days. Certainly, the results of an announced auction of 6- and 12-month T-bills on April 13 will be crucial to such a decision *(the country needs to roll-over some €3.85bn of maturing bills along with €8.2bn of five-year notes this month).* We believe that the proposed mechanism is strong enough to promote a sustainable de-escalation of market interest rates and allow some valuable breathing room to the Greek government to implement uninterrupted the announced program of fiscal consolidation and structural reforms. Needless to say here, that a great amount of vigilance needs to be exercised to such implementation as the country's fiscal problems do not allow *any room* for complacency.

II- Structure of IMF lending instruments: The case of Greece

IMF involvement in a possible rescue package for Greece

IMFs present Stand-By Arrangement (SBA)[1], which constitutes the Fund's workhorse lending instrument for the resolution of crises and the smooth adjustment to various shocks *(triggered by e.g. severe balance-of-payments-problems and increased risks of sovereign default)* has the following characteristics:

a) allows **frontloaded and rapid access**[2] to funds and provides **flexibility with respect to the frequency of reviews** depending on the strength of the member's policies and the nature of balance of payments problem faced by the member.

b) encompasses **a simplified Fund lending toolkit,** which eliminates certain rigid facilities that were rarely used in the past as they used to cater to narrow balance of payments problems

c) the **access limit** for a member wishing to take advantage of the mechanism is **up to 200%** of its quota (with the Fund) on an annual basis and to **a 600% of quota cumulative limit**. There continues to be scope for access above these limits, for example though the Flexible Credit Line facility (unlikely to apply to the Greek case, in our view), or following intensified scrutiny under the Exceptional Access framework. Note here that exceptions of counties borrowing well beyond the official SBA 600% are rare, including *e.g.* Turkey, Korea during the Asian crisis (2.000% of quota) and Latvia in 2008 (1.200% of quota). Latvia could be seen as the closest parallel to the Greek case. Back in 2008, Latvia was already an ERM II member and has a currency peg to the euro *(with a -1/+1% allowed fluctuation band).* Moreover, the IMF´s lending to the county was only 25% of the total package, with more than 40% coming from the EU´s balance-of-payments support mechanism (only for EU and non-EMU members) and ca 30% from the Nordic countries in the form of bilateral loans.

d) **the length of a SBA is flexible**, and typically **covers a period of 12–24 months**, but **no more than 36 months**, consistent with addressing short-term balance of payments problems.

e) **repayment of borrowed resources** under the SBA are due **within 3¼-5 years** of disbursement, which means each disbursement is repaid in eight equal quarterly installments beginning 3¼ years after the date of each disbursement.

f) **with respect to IMF program conditionality**, the SBA framework regularly involves fiscal and other quantitative criteria but the progress in implementing structural reforms is assessed in a holistic way in the context of program reviews. According to reports, the IMF is presently satisfied with the measures announced by the Greek government thus far. Yet, the possibility of the Fund asking Greece additional consolidation measures (especially for the period 2011 onwards) and/or an acceleration of structural reforms should not be ruled out, in our view.

[1] IMF Public Information Notice (PIN) No. 09/40, April 3, 2009

[2] Fund support under the SBA can be accelerated under the Fund's Emergency Financing Mechanism, which enables rapid approval of IMF lending. This mechanism was utilized in several instances during the recent crisis.

g) **the lending terms** of a regular SBA arrangement are as follows: The lending rate is tied to the IMF's market-related interest rate, known as the *basic rate* of charge, which is itself linked to the *Special Drawing Rights* (SDR) interest rate. The IMF regularly announces its basic rate of charge, which stood at 1.26% in the week April 5-April 11, 2010. For loans higher 300% of a country's quota a surcharge of 200bps is applied. If credit remains above 300 percent of quota after three years, this surcharge rises to 300bps. To these costs, one should also add a certain *commitment fee* levied at the beginning of each 12 month period on amounts that could be drawn in the period as well as a *service charge* of 50bps for any amount borrowed. The commitment fee is 15 basis points for committed amounts up to 200 percent of quota, 30 basis points on committed amounts above 200 percent and up to 1,000 percent of quota and 60 basis points on amounts exceeding 1,000 percent of quota. These fees are **fully refunded** if the entire amount committed under an SBA is borrowed during the course of the relevant period. On the other hand, no refund is made under a precautionary SBA under which countries do not draw.

Based on the above, we provide below **a hypothetical scenario**, under which Greece borrows from the IMF around €9.25bn for a 3-year period (or ca 1000% of its quota, estimated under current EUR exchange rates). Under this scenario, and assuming that commitment fees will be fully refunded by the IMF, the effective cost to Greece would be 2.66% (=1.26% * 0.3 + 3.26% * 0.7) plus 0.5% for the flat service fee. Of course the maximum marginal rate on the amount above 300% of quota would rise to 4.26% after three years, but the effective rate would still remain below 4.00% and thus, significantly lower than that financial markets are presently willing to lend Greece.

III - Latest market developments

Greek sovereign bonds, stocks stage relief rally on reports that terms of rescue mechanism agreed
Greek government bond prices bounced strongly in late European trade on Friday and the domestic stock market staged a late-hour rally on median reports suggesting that EU-16 deputy finance ministers and central bankers reached an agreement over the terms of a possible financial rescue package for Greece. The news followed a barrage of statements by high-level EU policymakers earlier in the day, aiming to reassure markets of the Greek government´s commitment to fiscal consolidation and the readiness of the Euro Area countries to extent bilateral loans to Greece or any other member state facing severe difficulties in accessing credit markets. French President Nicola Sarkozy said at a joint news conference with Italian Prime Minister Silvio Berlusconi that "Greek authorities have taken courageous measures to restore their public finances''. He added that "We are ready to take action at any moment to come to the aid of Greece". On his part Mr. Berlusconi noted said it was in Europe's interest to help Greece, "otherwise there will be very negative consequences for our common currency and our economy." In a separate statement, a German Finance Ministry spokesman said that no one should doubt that the Euro Area and the IMF would help Athens if needed, adding that "We still believe that Greece can reach its goals on its own." Furthermore, EU President Herman Van Rompuy told a French newspaper on Friday that the European Union is prepared to intervene over Greece should it be required to.

Markets broadly shrugged off Fitch downgrade news
News that rating agency Fitch cut Greek sovereign debt by two notches to *BBB-; Outlook Negative* were broadly shrugged off by a market that had lately come under severe pressure on lingering uncertainty over the structure and operational aspects of a Euro Area/IMF rescue plan decided by the Eurogroup in late March. The benchmark 10-year Greek government bond (GGB) to Bund yield differential tightened by ca 30bps shortly after the loan terms news broke out, temporarily testing levels below 400bps. The corresponding spread recorded a fresh post-EMU entry high of 461bps a day earlier. In a similar vain, Greece's 5-year CDS spread tightened to ca 425bps

from Thursday's closing levels around 443bps, while bank stocks gained more than 7%, recouping some of their recent heavy casualties.

Why the announcement of a Euro Area/ IMF rescue plan on March 25 failed to stabilize sentiment
In our view, the significant escalation of the Greek sovereign credit crisis over the past two weeks should be mainly attributed to lingering market uncertainty over the structure and operational aspects of the proposed Euro Area/IMF rescue mechanism. Several other domestic developments also played a role, including:

a) a lukewarm market reception of a 7-year syndicate GGB issue on March 29
b) a news report quoting an unnamed official source as suggesting that the Greek government wants to renegotiate the terms of the recently announced Euro Area/IMF safety-net programme for member states facing restricted access to funding markets
c) rumors about a sizeable revision to the Greek general government budget deficit in 2009 *(to as high as 14.2%-of-GDP from 12.7%-of-GDP reported initially)*. On the latter, Greek Finance Minister George Papaconstantinou said earlier last week that the 2009 deficit figure will be revised to ''at least'' 12.9%-of-GDP, purely as a result of a greater GDP contraction last year (-2.0% YoY) relative to that expected earlier (-1.2% YoY). Note also that Eurostat has yet to finalize the Greek fiscal data for the period after 2004. As such, further revisions to past fiscal accounts can not be ruled out, though we believe that any new revisions would rather be small ones, especially for the years before 2009
d) News early last week that Greece's four largest commercial banks have asked for access to a *(still unused)* €17bn part of a €28bn government package that was put together during the 2008 global credit crunch *(see also analysis below)*. These developments conspired with market rumors of foreign banks continuing to cut credit lines to Greece to further aggravate worries over the sustainability and health of the domestic banking system and
e) BoG data showing a significant decline in domestic deposits in January-February 2010 and some domestic rumors *(largely unfounded, in our view)* suggesting savers withdrawing large-denomination notes such as €200 and €500 to put in safe-deposit boxes or hold in cash as "mattress money".

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