



July 22, 2011

## HIGHLIGHTS

- European leaders yesterday agreed on a second bail out program for Greece.
- It includes additional financing and private bondholders' participation.
- If the plan is implemented smoothly, it could bring Greece back to fiscal sustainability.
- However, implementation risks remain large and very few details have been released thus far. Therefore, any assessment is preliminary.
- The European Financial Stability Facility will be allowed to conduct bond operations in secondary markets, and to provide funds to recapitalize banks.
- Despite the progress being made, we do not believe this second bail-out program is a silver bullet to Greece's debt crisis.
- In all likelihood, there will have to be further debt renegotiations down the road. But, for now, Greece looks set to navigate the storm.

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## EUROPEAN SOVEREIGN DEBT: BAILING-IN GREECE

Following the parliamentary approval of a Greek 5-year fiscal plan on June 29th, European leaders were expected to come up with a second bail-out program for Greece. Under the first program approved in May 2010, it was assumed Greece would be able to raise €83 billion in the capital markets during 2012-2014. After the IMF completed its third program review in mid-March, it became evident this was virtually impossible. This led to an additional hurdle. According to IMF internal regulations, it cannot make a disbursement to a country that is not fully funded for the next twelve months. This pressured European leaders to put in place additional funding to close the gap.

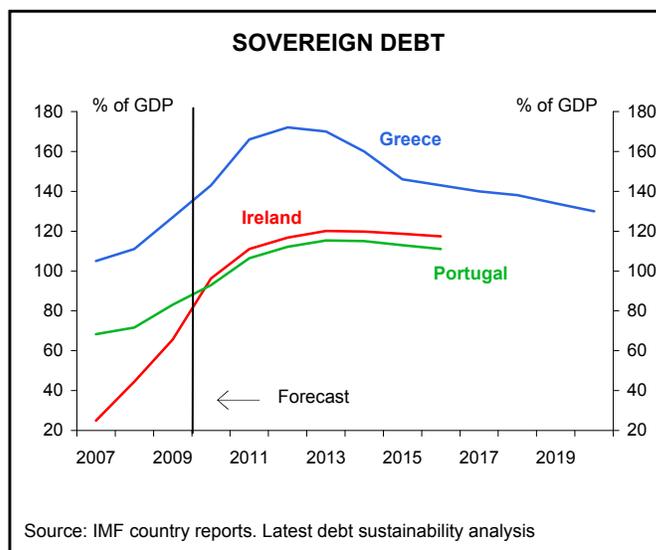
However, their apparent indecisiveness prompted fears of financial contagion in recent weeks, causing a spike in Italian and Spanish sovereign debt yields. Neither country could sustain its current fiscal trajectory if interest rates were to remain above 6%. The issue is that both Italy and Spain are too big to be rescued by the [European Financial Stability Facility](#) (EFSF), the rescue fund European leaders set up last summer in the aftermath of the first Greek bail-out.

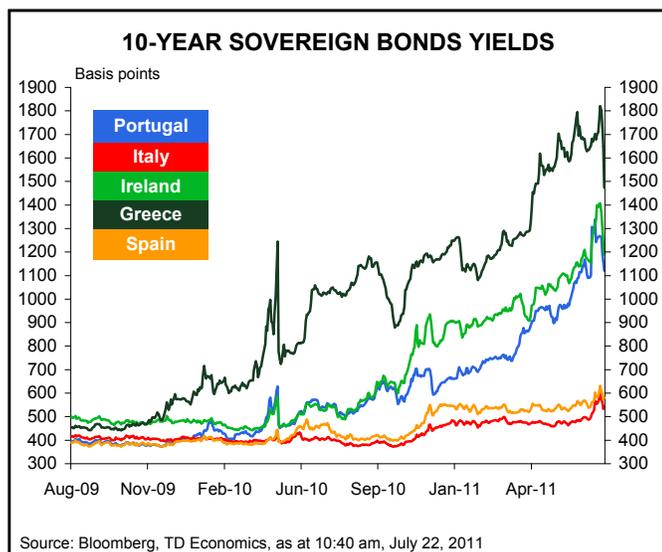
To rein in this situation, European leaders met in Brussels yesterday to finalize the second bail-out program for Greece. They made very important steps to tackle Greece's debt crisis, including a debt swap proposal which would deliver a 20% haircut on Greek debt. However, until details on how these steps will be implemented are released, one can only make very general assessments on their effectiveness to solve the European sovereign debt situation.

Consequently, we remain skeptical of the final reach of these announcements. If implementation goes smoothly on all fronts, then, with continued extraordinary efforts, Greece can reclaim a sustainable debt path. If, on the other hand, implementation is less than ideal, a second debt swap offer may be needed later on. In all likelihood, we do not believe this second bail-out program is a silver bullet that will put the Greek debt crisis to rest.

### The new European response to the debt crisis

The summit yesterday was not only about Greece. Addressing the Greek situation also implied tackling some of the shortcomings of the policy measures Europe





had previously delivered. For instance, the recent escalation in Italian and Spanish yields made it very clear that the EFSF needed to be able to intervene in the secondary debt market in periods of turmoil. So, a broader reaching plan was put in place:

1. Total official financing for Greece will amount to an estimated €109 billion euro. It intends to fully cover Greece's funding gap until 2014.
2. The maturity was lengthened. Future EFSF loans to Greece will be extended from the current 7.5 years to a minimum of 15 years and up to 30 years with a grace period of 10 years.
3. The interest rate on Greek loans will be marginally higher than the EFSF's own funding rate. This could translate into roughly a 200 basis point reduction in lending costs with respect to the first bail-out loans.
4. The EFSF lending rates and maturities agreed upon for Greece will be applied also for Portugal and Ireland.
5. There will be voluntary financial sector support for

Greece. The net contribution (taking into account the cost of credit enhancement for the period 2011-2014) of the private sector is estimated at €37 billion. In addition, a debt buy back program will contribute €12.6 billion, bringing total private sector involvement to €50 billion until 2014.

6. For the period 2011-2019, however, the total net contribution of the private sector involvement is estimated at €106 billion.
7. Additional guarantees will be provided to allow Greek bonds to be used to access European Central Bank (ECB) liquidity lines by Greek banks.
8. Adequate resources will be provided to recapitalise Greek banks if needed.
9. With regards to the EFSF/ESM, there will be increased flexibility linked to appropriate conditionality, which includes the ability to:

- A. Act on the basis of a precautionary program;
- B. Finance recapitalisation of financial institutions through loans to governments including in non-program countries;
- C. Intervene in the secondary markets on the basis of an ECB analysis, and on the basis of a decision by mutual agreement of the EFSF/ESM Member States.

In broad terms, this new plan is addressing some of the more pressing issues regarding Greece's debt sustainability. In relation to the voluntary rollover of Greek bonds, yesterday the Institute for International Finance (an institution representing international banks) released a [communiqué](#) outlining a menu of four bond swap options for Greece. In principle, the new bonds will be priced to deliver a 21% reduction in the net present value of outstanding Greek bonds with maturities up to 2019. A list of 30 banks that

| INDEBTEDNESS AND LEVERAGE IN SELECTED ADVANCED ECONOMIES |      |           |         |        |         |                  |         |       |          |       |
|--|------|-----------|---------|--------|---------|------------------|---------|-------|----------|-------|
| Percent of 2010 GDP, unless noted otherwise              |      |           |         |        |         |                  |         |       |          |       |
|  | U.S. | Euro area | Belgium | France | Germany | Greece           | Ireland | Italy | Portugal | Spain |
| Government gross debt, 2011                              | 100  | 87        | 97      | 88     | 80      | 152 <sup>^</sup> | 114     | 120   | 91       | 64    |
| Government net debt, 2011                                | 72   | 67        | 82      | 78     | 55      | n.a.             | 95      | 101   | 86       | 53    |
| Primary balance  | -9.0 | -1.7      | -0.5    | -3.5   | -0.3    | -0.9             | -7.5    | 0.2   | -1.6     | -4.6  |
| Households' gross debt                                   | 91   | 72        | 55      | 69     | 62      | 68               | 129     | 50    | 103      | 90    |
| Nonfinancial corporates' gross debt                      | 76   | 142       | 161     | 157    | 69      | 71               | 278     | 119   | 154      | 205   |
| Financial institutions' gross debt                       | 97   | 148       | 139     | 148    | 95      | 21               | 664     | 99    | 65       | 113   |
| Bank claims on public sector                             | 8    | n.a.      | 22      | 19     | 25      | 27               | 28      | 32    | 16       | 22    |
| Total economy gross external liabilities                 | 144  | 174       | 417     | 254    | 181     | 194              | 1598    | 153   | 293      | 215   |
| Total economy net external liabilities                   | 19   | 13        | -43     | 11     | -39     | 99               | 102     | 20    | 106      | 90    |
| Government debt held abroad                              | 32   | 29        | 68      | 64     | 53      | 61               | 59      | 47    | 57       | 50    |

Source: IMF, Global Financial Stability Report April 2011. <sup>^</sup> The latest IMF update on Greek debt puts it at 166% of GDP in 2011

have agreed to participate in the bond exchange was included in the IIF communiqué.

Initial estimates suggest that the abovementioned debt-roll over and buyback options could reduce Greek debt by around 12 percentage points of GDP within a year. If we compare this against the IMF projection from the fourth program review, this would put Greek debt at 160% of GDP in 2012. The reprofiling of maturities combined with the lower interest rate payments will bring debt down to 130% of GDP by 2015, equivalent to a 16 percentage points of GDP reduction relative to the latest IMF projection. Again, these are rough estimates based on the very limited information that has been released thus far by European authorities. A more reliable assessment of the impact of these measures on Greek debt sustainability will have to wait until further details are released. Moreover, the final outcome depends critically on actual bank participation in the debt swap.

Another important question arises in relation to the 10-year grace period on new loans for Greece. If the debt swap and buyback options yield the results anticipated by European leaders, the EFSF would still have to provide new loans for around €33 billion in the coming three years to close Greece's funding gap. Now, given the 10-year grace period, the EFSF will have to make the interest and principal payments until Greece takes over this responsibility. Will the other European states provide liquidity to the EFSF to make those payments? If that were to be the case, this would likely be challenged in the German Constitutional Court. A constitutional ban in Germany forbids fiscal transfers to other states.

Furthermore, enabling the EFSF to buy debt in the secondary market will require it to be pre-funded, a significant departure from its current set up. This might imply that guarantors would have to issue guarantees without the backing of a conditionality agreement with a country within a program. An alternative would be for the European Central Bank to buy the debt in the secondary market and then sell it to the EFSF, allowing the latter to come up with its own funding. In any case, the EFSF will have to undergo a significant reconfiguration. The political risks associated with this are not minor. And a final sticky point relates to the size of the EFSF. If it is not augmented from its current €440 billion, it will likely lack the firepower to stem a potential sell-off of Italian or Spanish bonds.

#### Final remarks

It is still too early to tell if yesterday's summit was the beginning of the final chapter of the European sovereign debt crisis. Our initial reaction is that progress was made, but not the sort of game changer that the situation has been demanding. One of our main concerns is that the EFSF will not be endowed with sufficient resources to enable it to perform its prominent new assignments. Furthermore, by looking at some of the key debt metrics of the main EFSF guarantors in the accompanying table, a fundamental question arises: Will the good credit of Germany and France be unaffected when they absorb their shares of the potential EFSF liabilities? This might be the underlying motivation for European leaders to advocate for less reliance on Sovereign credit ratings.