Greece

October 27, 2011

A significant move in the right direction

Eurozone leaders took significant steps today by announcing a series of measures intending to tackle the region's debt and banking crisis. The package of policies includes the leveraging of the EFSF, to help ring-fence credit deterioration in Spain and Italy, as well as a 50% 'haircut' on the private holders of Greek government debt.

The decisions taken by the Eurozone were bolder than the market's (low) expectations, especially in terms of the compromise struck with private debt holders over the 'voluntary' Greek 'haircut.' Despite the positive step forward, the plan lacks details and ambiguities need to be addressed in the coming days and weeks.

Although we believe the plan improves Greece's debt sustainability, we would have liked a lower debt-to-GDP profile resulting from the negotiations. Nevertheless, we have to take into account the increasing efforts by the government (and eventually by EC-IMF-ECB) on the fiscal front that should improve the country's debt dynamics. For the Greek banking sector the agreement (the 'haircut') posses a huge challenge that should lead most of the local banks to be nationalized for a short period of time.

With respect to broader Europe, the deal helps address the concerns over Spanish and Italian debt sustainability, while providing support to the European banking sector.

The focus now is on the specifics of the plan (leveraging the EFSF, the details of the haircut) and also on the ability of the Greek government to approve the new Memorandum of Understanding. To the latter we note that the government has 153 seats and it needs 151 votes to pass the new MoU with simple majority. The Greek government has shown signs of fatigue but given the absence of any other real alternative we believe the MoU should eventually get the necessary votes for passage.

Specifically Eurozone leaders agreed to:

1) Secure the decline of the Greek debt to GDP ratio with an objective of reaching 120% by 2020. The nominal discount will be 50% on notional Greek debt held by private investors. On that basis, the official sector stands ready to provide additional programme financing of up to EUR100bn euro until 2014, including the required recapitalisation of Greek banks. Eurozone will offer 'credit enhancements' to the PSI package of an additional EUR30bn. The new programme should be agreed by the end of 2011 and the exchange of bonds should be implemented at the beginning of 2012. The IMF was invited to continue contributing to the financing of the new Greek programme.

2) Leverage the EFSF. The EFSF will be leveraged in two ways, either by offering insurance, or first-loss guarantees, to purchasers of euro zone debt in the primary market, or via a special purpose investment vehicle that will be set up in the coming weeks aimed at attracting investment from other countries. The leverage effect of both options will vary, but could be up to 4 or 5 times, which is expected to yield around EUR1.0trillion.

3) Take a comprehensive set of measures to raise confidence in the banking sector. These will include facilitating access to term-funding through a coordinated approach at EU level and the increase in the capital position of banks to 9% of Core Tier 1 by the end of June 2012. Banks should first use private sources of capital, including through restructuring and conversion of debt to equity instruments. There will be constraints regarding the distribution of dividends and bonus payments until the target has been attained. If necessary, national governments should also provide support , and if this support is not available, recapitalisation should be funded via a loan from the EFSF in the case of Eurozone countries.

4) Commit to ensure fiscal discipline and accelerate structural reforms for growth and employment.

5) Go ahead with a significant strengthening of economic and fiscal coordination and surveillance. A set of very specific measures, going beyond and above the recently adopted package on economic governance, will be put in place.

The merits of the decisions

Eurozone took a more realistic view of the region's debt issue (compared to the July 21st resolution) trying to come up with a 'comprehensive' solution that addresses both Greece's and the Eurozone's problems.

The Eurozone is now set to address and fix remaining issues as there are less political issues / hurdles ahead (as it was the case with the enlargement of the EFSF that had to be approved by all member-States).

The EFSF's firepower will increase to cEUR1.0trillion through leveraging. The leverage options will allow other countries to participate in the effort.

The leveraged EFSF should help ring-fence Spain and Italy from speculation and should help reduce their funding costs. The EFSF will participate in primary and secondary market interventions as well as precautionary arrangements and bank recapitalizations.

The decisions will help to bring the Greek debt levels close to 120% by 2020. Note that the 2012 draft budget forecasts that the Greek debt-to-GDP should reach 173% in 2012. It is true that the debt levels were close to the targeted level of 120% when Greece got into trouble but the deficit had different dynamics back then. For 2012 the deficit is forecasted by the government to settle at 6.8% of GDP (from expectations for a 8.5% - 9% deficit in 2011) but it also aims at a primary surplus of c1.5% for the year.
At the same time we note that the monitoring of the implementation of the Greek program by the troika (EC-IMF-ECB) will be strengthened.

The questions / uncertainties

There is lack of detail on the efforts to leverage the EFSF especially in regards to the SPV that will be set up with the intention of attracting investment from other countries. The market will need to see commitments from other countries and/or the IMF to invest in this SPV as soon as the upcoming G20 meeting.

More details are needed with respect to the EUR30bn credit enhancement to bondholders that will be part of the PSI. It has to be clarified if this credit enhancement is related of the upfront cash element private investors could be paid to participate in the PSI (a potential option that leaked to the press as an option).

The level of the PSI participation to the new program is still in question.

There is still uncertainty whether the 50% 'haircut' will be viewed as a credit event or if any decision by ISDA will be challenged.

There are questions of the role of the ECB in the debt crisis given the enhanced formation of the EFSF. Will ECB bond buying program continue in light of German objections?

Specifically for the Greek banks there is uncertainty over the sector's capital requirements. The Eurozone is targeting a 9% Core Tier I to be reached by June 2012. It is unclear if this will apply to the Greek banks' as well or if the target of the Bank of Greece for a Core Tier I 10% by 2012 will be maintained. In any case, most small Greece banks (as expected) will be nationalized, at least for the short-term.

Overall

The Eurozone took a significant step in the right direction today. The decisions taken do not resolve all the problems of the region (not immediately and certainly not simultaneously) but for the first time they aim towards a 'comprehensive' solution to the issue. There are a number of questions / details that need to be addressed but we would expect Europeans to move quickly to resolve the issues.

For Greece, the resolutions are significant as they address the country's 'debt sustainability' concerns. The onus now is on the government to push fiscal consolidation, implement structural reforms and commence the privatization program. Lower debt levels and increased government efforts, along with the support and the monitoring of the troika, brings more optimism about the country's ability to tackle its debt problems and reform its economy.

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