



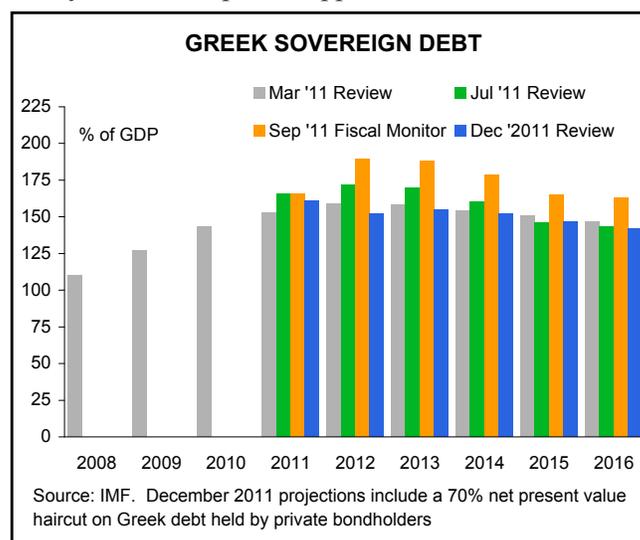
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GREEK SOVEREIGN DEBT CRISIS: SORTING THE PIECES OF THE BAIL-OUT PUZZLE

Highlights

- Greece is struggling to meet the demands of its euro zone peers and secure a second bail-out program
- At the same time, euro zone leaders, the IMF, and the European Central Bank are struggling to find the means to finance Greece over the next three years and bring it back from the brink of default
- Timing is not on their side, even if a deal is signed off on Monday, any implementation misstep could push Greece into default on March 20th.

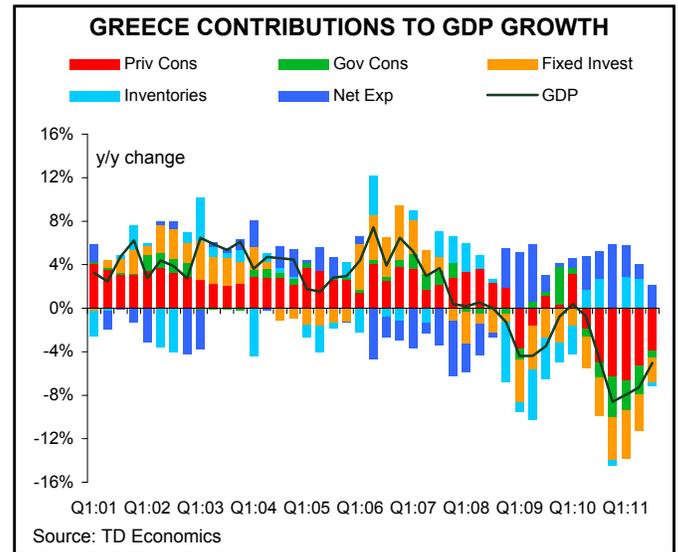
Last Sunday, against the backdrop of burning buildings and rioting on the streets of Athens, the Greek parliament passed further austerity measures required to close a €3.3 billion funding gap on its second bail-out program. A meeting of euro zone finance ministers had been scheduled for Wednesday. The objective was to ratify the latest austerity measures and give the green light for Greece to present a formal debt swap offer to its private bondholders. However, after the measures cleared the Greek parliament, euro zone finance ministers demanded specific details on how those spending cuts would be implemented. They also sought written confirmation by the leaders of the two main Greek political parties that whoever wins the April elections will carry through with the fiscal tightening efforts. As a result, the euro FinMin meeting was postponed until Monday February 20. If the plan is approved, Greece should be in a position to proceed with the debt swap offer – a.k.a. private sector involvement or PSI – on Wednesday. The offer will be open for a period of ten days. Then, there will be another week to complete the formal proceedings of the exchange, leaving a buffer of around a week prior to the €14.4 billion debt payment Greece has to make on March 20th. However, even if there is agreement this Monday, Greece would still have to meet 24 “prior actions” – a set of prerequisites set by the IMF/EU/ECB – before the second bail-out is finalized. Moreover, media reports signaled this program will exert much closer oversight over fiscal spending. Some European officials have called for the creation of an escrow account that would have enough funds to cover up to a year of Greece’s debt payments. In addition, the bail-out would include a permanent envoy of international monitors following government spending decisions on a daily basis.



The bottom line is that implementation will remain a sizeable risk in the run up to the March 20th deadline, not only because of the large number of administrative and formal procedures that need to be completed, but also because the funding gap will remain a moving target until the debt swap has been completed. Depending on the level of PSI participation, the IMF and the EU will have to decide whether they will provide additional official funds to cover the shortfall. So far, the IMF has been avoiding headlines on this topic. However, Gerry Rice, Director at the IMF's External Relations Department, was asked at a press conference on February 9th whether the IMF would foot a third of the bill for the second bail-out program as it had done in the past with Ireland and Portugal. Mr. Rice answered "we have to wait and see what the overall financing package is going to look like,...then there will be a discussion, an assessment by the IMF of what's required, and of course a discussion with our Executive Board where a decision will be made on the level of participation of the IMF and its level of financing". That is not a very reassuring answer, especially in light of the latest Greek debt sustainability analysis conducted by the IMF/EU/ECB.

Reuters reported yesterday that, based on the latest Greek fiscal data, as well as the new assumptions regarding the debt swap, the troika report shows Greek debt would only decline to 129% of GDP by 2020 instead of the 120% target. Part of the deviation is explained by Greece's deepening recession: fourth-quarter GDP data showed the economy contracted 6.8% last year, which is more than what the December debt sustainability analysis had assumed. This economic performance, and the repeated failure of Greek officials to implement the agreed-upon reforms has raised skepticism in some euro zone countries on the viability of the second bail-out program. This presumption is reinforced by the fact that under the current design, Greece's gross external financing needs would still exceed 60% of GDP in 2020. It would require a dramatic economic transformation for Greece to able to secure such a high level of funding through private capital markets, and eight years go fast.

As a result, government officials in Germany, Finland, and the Netherlands have considered, instead of signing off for the full program right now, they could provide a bridge loan to get Greece pass the March 20th hurdle. Completion of the second bailout program could then wait until a new Greek government takes office after the April elections. Their hesitation might also be exacerbated by the significant



amount of frontloaded funding that is required to implement the debt swap. First, European Financial Stability Facility (EFSF) bonds with a €30 billion face value would be provided as "sweeteners" to entice bondholders to participate in the exchange. Second, there is the issue of recapitalization funds for Greek banks associated with the losses they will sustain due to the swap – the estimated figure is €23 billion. Third, the debt swap would require Greek banks to replace the sovereign Greek bonds they have pledged as collateral with the ECB. Although a portion of that collateral could be replaced once the swap is executed, Greek banks would initially need to replace the defaulted bonds, or risk losing the liquidity that is being provided to them by the ECB.

Lastly, the bail-out program will also require parliamentary approval in some of the euro zone creditor countries. The vote on the German parliament is scheduled for February 27th; however, the final PSI outcome will be still unknown by then, meaning German MPs will be voting without knowing the final tab Germany might need to pick up if they are still willing to support Greece. The program would also have to clear the Finnish and Dutch parliaments, where resistance towards the Greek bail-out has been mounting.

It is very clear that there are several elements that could prevent the second Greek bailout from coming into place. So, the question that comes to mind is whether Greece is in a better position now to handle a default than it was two years ago, should the negotiations fail?

Greece has made some progress, but a default would still be devastating

Greece ended 2009 with a fiscal deficit of 15.8% of GDP and a level of gross government debt equivalent to 129.3% of GDP. This caused the country to lose access to capital markets, and it had to be bailed-out by the EU and the IMF in May 2010. In September 2011, eighteen months into its IMF/EU program, Greek authorities had managed to narrow the fiscal gap to around 10.6% of GDP, not a minor achievement if one considers the Greek economy has been contracting since the third quarter of 2008. Nevertheless, sustained high fiscal deficits drove gross government debt to 159% of GDP.

Perhaps more relevant at this juncture is the fact that Greece has reduced its primary fiscal deficit to 3.8% of GDP, and on the external front, its current account deficit excluding interest payments on public debt stands at a still high 5% of GDP. These two gaps are important because if Greece repudiated all of its debts, including those with official creditors, they would become Greece's immediate funding constraints. How would Greece address those funding constraints? The go-alone option would be to leave the euro zone, reestablish its local currency and nationalize / recapitalize its banks by issuing domestic bonds. If, on the other hand, Greece's euro zone partners wanted to keep the country within the monetary union, they would have to provide the means to jumpstart the Greek economy by recapitalizing Greek banks. The latter seems to be the less likely alternative, because it would deprive the Greek economy from the boost of a devaluated currency. Moreover, that help would still have to come with strong conditionality attached. It is hard to imagine politicians and policymakers, either in Greece or abroad, would be willing to commit to that process again. Neither does it seem plausible that public opinion in creditor countries would favor more lending to

a country that has just imposed losses on them. In all, there are no palatable options for Greece, it will have to choose between very bad and worse alternatives. A lot of painful adjustment is unavoidable, regardless of whether it occurs with or without the help of its euro zone partners.

Final Remarks

There are plenty of risks for the second Greek bail-out program to become a reality. However, the consequences of a disorderly default are also plentiful and daunting. Fear to the latter may once again be the major incentive for Greek policymakers and their euro zone peers to carry forward and extend a second program, even if there is close to universal consensus that it will not suffice. But, securing high private sector participation on the debt swap may prove even more elusive than in the first attempt conducted last year, which, in principle, had only achieved 76% acceptance. There is a key element that undermines the success of the exchange.

A debt sustainability analysis forecasting Greek debt at 129% of GDP in 2020, in combination with the likely exclusion of the ECB as a potential bearer of losses on its holdings of Greek bonds, means that there is a very high probability that the new 30-year Greek bonds being offered in the exchange would have to be renegotiated down the road. Under that assumption, the mark-to-market of those bonds on the days following the exchange will almost surely translate into an ex-post net present value haircut far larger than the 70% loss that has been the working assumption throughout the negotiation process. There could be some bondholders that might not be in a position to absorb such a loss.

To sum up, the stakes are still very high, and the risk of a Greek default is still a material threat, even if Monday's meeting ends on a positive note. There is still a lot of work to do before all the pieces of the bail-out puzzle fall into place.

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