

16 February 2012

## **The second Greek bailout: Ten unanswered questions**

### **1) Will the Greek centre hold?**

Although the EU/IMF/ECB troika has finally managed to pressure former Greek Prime Minister George Papandreou and the leader of centre-right New Democracy party Antonis Samaras into providing written commitments to uphold the austerity plans should either win April's general election, doubts remain over the strength and the actual relevance of the commitment sought by Greece's public lenders.<sup>1</sup>

Firstly, Samaras has long held ideological objections to the austerity approach and said in his letter that he will seek "policy modifications" in the future – suggesting he may well still try to renegotiate the plan after the elections.

Secondly, and more importantly, are the Commission, ECB and others really liaising with the right people in Greece? Recent polls have suggested that the three hard-left parties would garner a combined 42.5% of support – i.e. potentially more than New Democracy and PASOK together that currently poll at 31% and 8% respectively. In other words even if these two parties entered a coalition, they would still not have a majority in parliament. The Greek electorate is moving towards the extremes of the political spectrum – presumably because Greek voters increasingly see the two mainstream parties as mere executors of the demands of the Troika, Germany, France and others.<sup>2</sup>

***Will it be resolved?*** No. The other parties will never provide a written commitment to austerity, while even if New Democracy manages to lead the next coalition government, Samaras will likely try to renegotiate the plan at some point.

### **2) Are Greek government commitments credible? Can Greece fill the €325m budget gap this year?**

The rise in support for the extreme parties also raises pertinent questions over how much more austerity Greek society can take – and therefore how credible any government commitments to impose further budget cuts are. Greek Public Order Minister Christos Papoutsis said recently:

*"Greece has made all the efforts that it needed to do, and the people cannot take any more... The government is making superhuman efforts and we have reached the limits of the social and economic system. From now on, Europe has to take the responsibility."*<sup>3</sup>

This is unlikely to change and will probably only get worse. The latest programme commits Greece to 150,000 public sector job cuts over the next three years. Proportionately, as a share of population, that is the same as cutting over 800,000 jobs from the UK public sector, more than current UK plans and at a faster rate. Greek public workers and unions have no intention of giving in without a fight. Meanwhile, the increasing exasperation of the eurozone with the Greek proposals for cutting the deficit will probably lead to an increasing demand for oversight and eurozone control in Greece – a politically undesirable development likely only

to inflame the issues mentioned above.

The fine line that the eurozone is treading was further highlighted when Greek President Karolos Papoulias responded angrily to eurozone criticisms of Greece, saying, "We are all obliged to work hard to get through this crisis, but we cannot accept insults from [German Finance Minister Wolfgang] Schäuble. Who is Mr Schäuble to insult Greece? Who are these Dutchmen, who are these Finns?"<sup>4</sup>

The niggling €325m gap in the bailout deal, which the eurozone still isn't convinced Greece can fill, is another indication of how long the road ahead will be. In comparison to the overall package, this is a small amount. However, it marks a clear sign that the eurozone, and in particular Germany, no longer sees Greek government policies as credible.

***Will it be resolved?*** *No.* Questions over how much austerity the Greek population can bear and corresponding questions over government credibility will linger as long as Greece is in trouble – or even as long as it remains inside the eurozone. The government will commit to the austerity on paper but full and effective implementation seems unlikely.

### **3) How will the eurozone fund the €94bn needed to get the voluntary restructuring underway?**

Over the past week a document on the private sector involvement (PSI) in the second Greek bailout has been circulated.<sup>5</sup> According to the draft the following funds needed for the PSI to go ahead are:

Bond sweeteners - €30bn  
Funds to buy back bonds from the Eurosystem - €35bn  
Funds to pay off interest - €5.7bn  
Bank recapitalisation - €23bn  
Total - €93.7bn (out of the €130bn bailout)

This is money needed to make the PSI successful and allow the voluntary restructuring to be completed. Firstly, this highlights that the claims by the eurozone leaders that they could simply push ahead with the PSI without fully approving the second bailout seem to be incredibly misleading. Without this money in place there would be a huge amount of uncertainty on the part of bondholders, particularly Greek banks who would need new capital injections to survive. However, to disperse this substantial amount of money would need full approval from the eurozone and some national parliaments (see below). Given that it is widely accepted that the PSI needs to be put into motion by next week if Greece is to avoid a disorderly default on 20 March, getting this money released could be a huge stumbling block.

Secondly, where would this money come from? The draft stipulates that the EFSF will issue debt to raise these funds (since it currently only has guarantees). However, the EFSF has not pre-funded any of these commitments, meaning that it would have to suddenly flood a subdued market with over €90bn in (possibly non-triple-A) EFSF bonds, with it remaining unclear at what cost the EFSF will be able to borrow. Once markets pick up on this fundamental gap, it could raise doubts about the PSI more generally and trigger even more uncertainty. Taken together, it could be catastrophic for Greece.<sup>6</sup>

Lastly, with new provisions such as €35bn for bond buy backs, will €130bn be enough to fund Greece for three years? We have long questioned whether this was even enough under the original estimates. Now it seems even more unlikely.<sup>7</sup>

***Will it be resolved?*** *Probably not.* This is a very tricky situation. The chance of getting

approval for and raising this amount of funds in the time necessary (a week or two max) seems unrealistic. But it's also unlikely that eurozone finance ministers will delay the PSI further, simply because they cannot afford to. We would expect the eurozone to push ahead regardless and just try to manage the uncertainty with the hope that the second ECB Long Term Refinancing Operation (LTRO) at the end of February will help smooth the way and boost the demand for EFSF bonds.

#### **4) Will the ECB participate in the restructuring? If it does, will that be enough to fill the €15bn budget gap?**

One of the longest running sagas in this debate is the role of the ECB and its holdings of Greek debt. Recent comments by Jens Weidmann, Benoit Couere and Luc Coene, all members of the ECB Governing Council, suggest that the ECB is now willing to forego the potential profits on its holdings of Greek debt (around €15bn). This will likely be done using the €35bn in buy back funding given under the bailout, although the draft document on the PSI suggests the money could be used to purchase Greek bonds currently held as collateral in the Eurosystem, possibly opening up greater savings.

**Will it be resolved?** *Probably.* It seems almost certain that Greece will be able to access some savings from the Eurosystem although where, specifically, they will come from is yet to be decided. But whether this will be enough to fill the reported €15bn gap in the Greek budget under the latest debt sustainability analysis, is far from clear.<sup>8</sup>

#### **5) How many private bondholders are still holding out?**

Another big question over the PSI is what percentage of private sector bondholders will be involved. This was a huge unknown a few weeks ago which has been overlooked in recent days but without a definite answer ever being provided. Due to the opacity and confusion with the whole process it is hard to predict exactly where some private creditors, in particular hedge funds, currently stand.

**Will it be resolved?** *Probably.* The ECB and EFSF participation and huge political pressure may, in the end, sway enough private creditors to take part, in turn allowing Greece's debt to be written down to the level required for the Troika to deem it "sustainable". In addition, the recent threat by the Greek government to retroactively introduce collective action clauses – meaning enforced losses on bondholders – is an incentive to accept voluntary losses.<sup>9</sup>

#### **6) Can Greece really achieve its growth and deficit targets?**

With the latest austerity programme still hot off the press Greece already finds itself on the back foot. Figures released on 14 February show that the Greek economy contracted at an annualised rate of 7% in the fourth quarter of 2011, worse than expected, after a slowing of contraction in the third quarter. This bodes ill for the already unrealistic projections that Greece will return to growth at the start of next year.

Meanwhile, provisional data for January 2012 suggest that budget revenues were over €1bn short of expectations. Compared to January 2011, revenues were meant to have increased by 8.9%, instead they declined by 7%.<sup>10</sup> Taken together, this massively undermines the credibility of the second bailout package, which in turn will make it difficult to convince politicians from across Europe to continue to support the package, as well as increasing the risk of more market uncertainty.

**Will it be resolved?** *No.* These are just examples in a long list of missed targets. We expect this to continue under the latest austerity package and find the hopes that Greece will return to growth next year despite even further cuts hopelessly optimistic.

## **7) Will Greek debt ever become sustainable under this plan?**

As we have consistently highlighted, Greece will still have a debt to GDP ratio of 120% in 2020 – where Italy is today. That is not sustainable. Furthermore, even after the restructuring, Greece's debt burden will still be around 150% this year. Market suspicions over its sustainability will not disappear with the restructuring and the intense speculation of a Greek disorderly default will continue. Greece will continue to live from one tranche of bailout funds to the next, with questions being asked over the implementation of the latest bailout plan every time there is a review ahead of the release of funding. This is far from a stable or functioning economy.

**Will it be resolved?** *No*, this cannot be resolved with the current policy approach.

## **8) When will the issue of Finnish collateral be resolved?**

This agreement has been a mess from the start. Originally agreed on the side-lines of the 21 July 2011 summit, the deal involved the Finnish government – under pressure from its parliament – requiring collateral from Greece in exchange for contributing to the second Greek bailout. This prompted much dispute but eventually got the green light from eurozone finance ministers. The latest plan suggests that the four largest Greek banks will provide €880m in collateral to Finland.<sup>11</sup>

Ultimately though, the structure of the deal was never finalised, mostly due to uncertainty regarding the size of the Finnish commitments to the bailout, and is now creating a circular problem: Finland cannot sign off on the collateral deal until it knows exactly how much it will be committing to the bailout. The bailout and the PSI cannot be finalised without Finnish agreement, but it needs to be agreed before Finland can sign off the second bailout.

**Will it be resolved?** *Probably* but given the months of disputes this issue spawned last year it should not be taken for granted.<sup>12</sup> A particular point of contention could be that, since Greek banks are getting a huge capital injection from the eurozone, some of the bailout money (guaranteed by all eurozone states) could actually be indirectly funding the Finnish collateral deal.

## **9) How much money can the privatisation plan actually raise?**

The Greek government owns a huge number of sellable assets – it was expected to raise €50bn by 2015 by selling some of these off under the original plan for a second Greek bailout. This has now been reduced to €15bn, although there are rumours that, internally, the Greek privatisation agency is uncertain that even this lower target can be met. The failure of the programme is an unfortunate mix of many of the problems facing Greece: massive uncertainty over future Greek default, huge implementation and administration problems as well as limited eurozone and global demand due to slowing economic growth and lack of credit.

**Will it be resolved?** *Most likely not*. In turn, this is likely to further dent the Greek debt sustainability analysis, making targets harder to achieve.

## **10) Will the German, Dutch and Finnish parliaments approve the bailout?**

The timetable for parliamentary approvals of the second Greek bailout remains unclear, but here is the status of the key countries – the approval will depend on whether a number of the key issues we flag up in this note will be solved:

Germany: The German Bundestag will vote to approve the second Greek bailout on 27 February, according to the Speaker of the Bundestag, Norbert Lammert, though it may ask for more time to consider the proposal – given the numerous delays in finalising the details of the deal – meaning that the vote could be moved. Whether or not German MPs will approve the deal very much depends on the credibility of the guarantees Greece can provide over the implementation of the additional measures. Regardless, expect many dissatisfied MPs from across the political spectrum.

Finland: It's unclear when the Finnish Parliament will vote on the deal, though the Finnish Finance Minister Jutta Urpilainen has indicated that it may take place at some point next week (the week of 20 February). The opposition Finns Party and the Centre Party could both vote against but they only hold 74 out of 200 seats in the parliament and would therefore not have a majority. Regardless, the Finnish government needs to reach a final agreement on the collateral issue before it can sign off on the bailout.

Netherlands: The Dutch Lower House needs to approve the second Greek bailout package. The Dutch Finance Minister, Jan Kees De Jager, initially said that the Dutch Lower House would vote on 16 February. However, given the absence of a final agreement that will now have to be postponed until a future date, which is yet to be decided. Despite some confusion it is likely that the vote will be binding.

**Will it be resolved?** *Probably.* We expect all the necessary parliaments to approve the deal, once it is finalised, although not without raising a political furore and precious time being lost. However, there is still a risk that one of these parliaments does not approve the deal should Greece be perceived as failing to deliver on some additional points. The delays and complexities of getting approval in these countries could further damage the very tight schedule on which this plan is being run.

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<sup>1</sup> See here for the full letter sent by Antonis Samaras: <http://www.forexlive.com/blog/2012/02/15/samaras-letter-text-supports-plan-recovery-a-priority/>

<sup>2</sup> Cited by *Kathimerini*, 'Poll points to shift in voting intentions', 7 February 2012: [http://www.ekathimerini.com/4dcgi/w\\_articles\\_wsite1\\_1\\_07/02/2012\\_426628](http://www.ekathimerini.com/4dcgi/w_articles_wsite1_1_07/02/2012_426628) Results are supported by a poll cited by *Bloomberg*, see here: <http://www.bloomberg.com/news/2012-01-26/greek-support-for-papandreou-s-pasok-drops-to-12-poll-shows.html>

<sup>3</sup> Cited by *BBC*, 'Greece can't take any more cuts', 15 February 2012: <http://www.bbc.co.uk/news/world-europe-17037267>

<sup>4</sup> Cited by the FT, 'Greek rhetoric turns into a battle of wills', 16 February 2012: <http://www.ft.com/cms/s/0/78f9f072-5808-11e1-bf61-00144feabdc0.html#axzz1mSTTPX9w>

<sup>5</sup> Document published by *La Stampa* on 13 February 2012, see here: <http://www.lastampa.it/web/tmplframe/default.asp?indirizz=http://www.lastampa.it/web/download/pdf/grecia2.pdf>

<sup>6</sup> The draft talks about paying the money out in tranches but to us that just doesn't seem realistic given the situation in Greece post restructuring. Some of the funds could be paid out using EFSF bonds rather than cash, this would speed up the process but would require negotiations with private bondholders and could throw up more disagreements.

<sup>7</sup> *Open Europe*, 'Abandon ship: Time to stop bailing out Greece', June 2011: <http://www.openeurope.org.uk/Content/documents/Pdfs/greece2ndbailout.pdf>

<sup>8</sup> It's worth keeping in mind that, given the interaction between this point and other points we raise, the budget gap could likely be even bigger than €15bn. Also some of these funds may go towards providing Greek banks with new collateral, since much of their current collateral takes the form of Greek bonds or bonds guaranteed by the Greek state – all of which will be in default after the restructuring. Therefore, to allow Greek banks to continue borrowing from the ECB, they will need to be provided with some new collateral to hold them over.

<sup>9</sup> That said, since private bondholders would already face 70% net present value write downs, it is not clear how much worse off they would really be under a disorderly default (although the European economy as a whole would suffer more). They would also definitely get paid out on the credit default swaps they were holding as insurance against Greek default.

<sup>10</sup> Cited by *Kathimerini*, 'Dramatic drop in budget revenues', 7 February 2012: [http://www.ekathimerini.com/4dcgi/w\\_articles\\_wsite2\\_25206\\_07/02/2012\\_426623](http://www.ekathimerini.com/4dcgi/w_articles_wsite2_25206_07/02/2012_426623)

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<sup>11</sup> Cited by *Reuters*, 'Greek banks to satisfy Finnish bailout collateral', 15 February 2012:  
<http://www.reuters.com/article/2012/02/15/greece-banks-bailout-idUSL5E8DF2FA20120215>

<sup>12</sup> Open Europe blog, 'Collateral thinking', 24 August 2011:  
<http://openeuropeblog.blogspot.com/2011/08/collateral-thinking.html>