FFTW OUTLOOK

Our Reaction to the European Rescue Package

Overview

Last Thursday, European policymakers met to decide on an enhanced rescue package for Greece, with the additional aim to bolster the euro-zone's ability to withstand systemic shocks. The measures represent the latest in a series of assistance packages for peripheral euro-zone governments, which to date have failed to stem the crisis of confidence in the soundness of governmental and financial sector balance sheets. With investor skepticism now infecting Italian and Spanish debt markets, the need for resolution is higher than ever.

We believe there are **three main criteria by which to judge the likely success** of this latest rescue package. Namely, does it:

1. improve the debt sustainability of Greece and other program countries (whether through debt relief or measures to enhance growth)?

2. reduce contagion risk?

3. have the ability to be financed and implemented politically?

Summary of New Measures

Before we evaluate the announcements against the three criteria we have outlined above, we will summarize the contents of the rescue package. The package provides the following:

1. Support for Greece

There is €109 billion worth of new assistance, intended to permit Greece to bridge its financing gap and improve fiscal sustainability. The original bilateral program, which has disbursed €65 billion is now closed and the new program will be funded by the EFSF. Thus the total amount of official lending to Greece from 2010 – 2014 will be €174 billion. Final details have yet to be announced, but as we understand it, the package is comprised of the following:

- €34 billion of new loans from European Union (EU) governments, to be disbursed via the European Financial Stability Facility (EFSF).

- Maturities for new and existing loans extended to a minimum of 15 years and up to 30 years with a grace period of 10 years. In addition, interest rates on new and existing loans are lowered to the funding cost of the EFSF, which currently is approximately 3.5%. Both the longer term and the lower rates significantly reduce the net present value of loan repayments.

- Direction of EU structural funds and technical expertise to assist Greece in implementation of structural reforms, as part of a “Marshall Plan” for the Greek economy, estimated at €15bn.

- Additional funds to recapitalize Greek banks, if necessary (€5 billion).

- Private sector involvement, provided through a menu of voluntary debt exchanges, rollovers and buybacks by financial institutions that would result in approximately a 21% loss rate on holdings. Buybacks are set to contribute €12.6 billion of write-downs for Greece. Net private sector involvement from 2011 – 2019 is estimated at €106 billion (using the Institute of International Finance (IIF) assumption of 90% participation).

- Greek bank collateral will be credit-enhanced to make it eligible for European Central Bank (ECB) liquidity financing operations.

Note that existing loans to other program countries (Portugal and Ireland) will also have interest rates lowered and terms lengthened.

In an attempt to reduce contagion fears, the European Heads of State warned that private sector involvement would only be applied to Greece, and would not be repeated for other program countries (though it is not clear how such assurances can be relied upon).

2. A more "flexible" EFSF

The package provides the EFSF with:

- The capability to make loans to any euro-zone government for the purpose of recapitalizing financial institutions.

- Permission to intervene directly in secondary debt markets on a "precautionary" basis, subject to ECB designation of “exceptional" circumstances and unanimous approval by EU governments.

Our Analysis

Now we will evaluate the package against the three main criteria we mentioned above.

Question 1: Do the proposals improve fiscal sustainability for Greece and other program countries?

- The Greek rescue package provides only modest solvency improvement. There is only limited reduction in the debt stock (through €12.6 billion of debt buybacks at prices below par, but not so far below par that investors will not participate). Otherwise, the measures essentially represent a shuffling of debt between EU countries (with Germany and France taking on more debt to assist Greece with paying its current debt). In the short term, the funding gap is bridged, so Greece does not need to return to the market until 2020 (according to Prime Minister Papandreou). In the medium term, the debt burden is admittedly reduced versus the previous trajectory through lower rates and term extensions. But the overall reduction in net present value of Greek debt is modest - Greek fiscal dynamics probably remain unsustainable unless Greece does everything right and European growth avoids another negative shock. Most analysts estimate that in a baseline scenario peak debt to GDP is lowered by around 10 to 20% of GDP, leaving debt to top out well above the 90% threshold considered by many economists as a 'recoverable' state. In sum, the package improves the Greek government’s liquidity (though still with strict conditions), but has only a limited impact on longer-term solvency (by making debt more affordable and delaying repayments), and fails to materially improve it in the near term (given the very low amount of debt relief).

- On the other hand, official loan terms for Ireland and Portugal are substantially improved, and will improve fiscal dynamics for those countries.

Question 2: Do the measures help limit contagion risk?

- On the plus-side, the clear political commitment to support the euro-zone, and the (relative) speed at which policymakers have responded to the latest bout of market stress is encouraging. Furthermore, the measures show the ability of the key parties - the ECB, Germany, the IMF, France and Greece – to compromise.

- Growth is key. The "Marshall Plan" for Greece recognizes that austerity on its own is not enough. But the announcements contain no specific measures to boost growth in countries

outside of Greece. In particular, there is nothing mentioned that would improve growth prospects in Spain and/or Italy. However, it is worth noting the determination that Spain has demonstrated in its reform efforts, while Italy upsized its latest austerity budget in direct response to sharp increases in BTP yields. So we cannot dismiss the possibility that market discipline alone could extract reforms from the 'soft core' countries that will meaningfully enhance the euro-zone's growth prospects. But rebuilding investor confidence is harder than destroying it, and the onus remains on governments to swiftly pass actual reforms.

- German insistence on private sector involvement (to reduce moral hazard) runs the risk of setting a dangerous precedent that could then become priced into Irish and Portuguese debt should budget problems escalate in those countries in the coming months.

- However, the financial stability risk associated with private sector involvement (or a potential Greek default later) has been reduced by mutualization of financial sector risk across the euro-zone (via EFSF loans to governments for recapitalization). This was probably key to obtaining ECB approval for private sector involvement. In our view it is also a key positive, as it weakens the inter-linkage between peripheral governments and their banks. But we will need more information on private sector involvement options, the breadth of participation, and the impact on balance sheets – both to gauge the impact on Greek debt and bank balance sheets.

- While the ECB may have complied on private sector participation (we believe they did not have much choice) in return for indirect EFSF support to troubled banks and credit enhancement on Greek collateral, the ECB is, *per se*, providing no new support for the euro-zone economy. There is no indication that they might participate in additional Securities Market Program purchases or lower policy rates to bolster growth. In essence, the ECB has successfully turned over responsibility for secondary market support to the EFSF, which has a much smaller balance sheet and cannot act as quickly.

- Although we are still a long way from seeing the issuance of Euro-bonds – bonds with joint and unlimited guarantees by euro-zone governments - the EFSF is certainly a step on the long path to fiscal integration, a development that should strengthen the euro-zone over time. But the EFSF lacks credibility as a rescue vehicle in its proposed form. The most recent announcements did not mention growing the size of the facility or the timeframe needed for an enhanced EFSF to become operational. Note that the EFSF is still not fully ratified for its existing proposed €440 billion capacity, and it is unlikely that even this size would provide enough firepower should it need to repel a (renewed) attack on Spanish or Italian government bond markets. Furthermore, the conditionality imposed on EFSF intervention in secondary debt markets (requiring ECB approval and EU government unanimity), as well as the need to pre-fund, are also weaknesses when decisive action is needed.

- Investors hate uncertainty. A point that politicians have under-appreciated is the damage that has already been done to peripheral and 'soft core' bond markets by the volatility of the last two years. Volatility has changed the risk / return characteristics of peripheral debt markets, with many conservative investors abandoning those issuers in response. Those countries that have lost, or are at risk of losing, their investment grade status have already seen their investor bases decimated. But volatility also reduces bond dealers' willingness to warehouse inventory, raise bid-offer spreads and drive up value-at-risk calculations, all of which in turn reduces liquidity further, driving yield spreads wider still. Unwittingly, therefore, the piece-meal approach to crisis resolution that has provided the fuel for volatility has been a destructive influence on investor demand for peripheral debt.

Question 3: Can the politicians deliver?

- The statement was certainly a show of political determination to reinforce the euro. But the package was not particularly generous in terms of resources – direct support to Greece is modest relative to the scale of Greece's liabilities, and the more flexible EFSF 3.0 still looks

under equipped for the task at hand. One has to wonder whether German political leadership, in particular, really has the commitment to see this package through. Germany, after all, keeps writing cheques, and doing so is coming at considerable political cost to the current government. This will probably not be the last call on the German exchequer, and to our mind, there is considerable risk that Germany will at some point refuse to accommodate its European partners, triggering another forest fire that will at that point be too aggressive to contain. France, meanwhile, has every interest to fund a solution, as its banking system looks particularly exposed. But French fiscal capabilities are looking increasingly stretched for a AAA-rated country.

- In addition, the risk that "program countries" will fail to deliver reforms and growth to prevent further deterioration of fiscal standing is non-trivial. With only very limited up-front debt forbearance, and strict conditionality, the challenge facing a (fragile) Greek government remains formidable. And though long-term funding has been made available, the Greek government will need to demonstrate progress on a quarterly basis to qualify for each installment. "Execution risk" therefore remains elevated.

Conclusions

To conclude, the latest announcements contain a number of new and positive elements – namely additional long-term funding for Greece, a large fiscal subsidy for all program countries via reduced interest rates and a longer repayment horizon, and a mechanism for mutualization of financial sector risk and for intervention in secondary debt markets.

But, on the negative side, there is doubt about the ability of the EFSF to meet the challenges ahead given its limited size and reliance on governmental and ECB approval. The amount of debt forbearance provided to Greece is also probably insufficient to alter the conclusion that the country remains insolvent and will at some later point default on its debt. And investors will have noted the insistence on private sector involvement – a measure designed to reduce moral hazard but which also adds to contagion risks. Finally, the negotiations have revealed Germany's conflicted position within Europe, its reluctance to be drawn into a fiscal union to support a currency that most Germans never wanted to adopt.

Unfortunately for bond investors, the result has been a reactive rather than a proactive policy-making approach to Europe's fiscal challenge, which has weakened investor confidence and allowed contagion. Our own view is that the political will is ultimately there to save the European project, and that policy makers will continue to "muddle through". But Europe really needs decisive reform, rather than patchwork repair.

A number of sovereign issuers appear insolvent, or saddled with massive contingent liabilities, structural and cyclical deficits and slow economic growth. With pro-growth reforms and fiscal austerity, the debt can be reduced. But bond investors are losing confidence and have punished weaker sovereign issuers, not just in the periphery, but now also in the semi-core countries of Spain and Italy. With the involvement of these two important markets, the risk that politicians lose control has risen dramatically. So now the question is: "does Europe have a plan B?" Stay tuned.

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