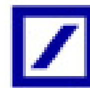
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Data Flash (Euroland)

A possible European framework for Thursday

Economics

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German Chancellor Angela Merkel warned us yesterday: we should not expect a "silver bullet" to come up from tomorrow's ad hoc meeting of the Eurozone's heads of state or government. This means probably two things: First, that the "big one", i.e. a hard restructuring of Greece bringing its public debt back on a sustainable path, is not on the menu. What is currently discussed and should be announced tomorrow revolves around the prolongation in a politically acceptable manner of the liquidity patch for Greece. Second, that no comprehensive reform of EMU, encompassing "Euro bonds", is likely to be discussed at this stage.

The success of failure of any agreement will have to be judged by its ability to limit contagion via (a) offering a framework for private sector participation which will enable the market to bracket the potential exposure, (b) improving the credibility of the EU by finding common ground between the ECB and the partisan of PSIs, (c) ideally creating a framework for pre-emptive action for countries other than Greece, Portugal and Ireland In any event, even if the summit generates a framework, it is unlikely to produce a quick and easy solution, as execution risk is likely to remain and precise details are unlikely to be agreed as yet.

We describe here what in our view would be realistic to expect from tomorrow's summit. In a nutshell, we think that a combination of (i) rollover into longer dated/low coupon Greek bonds with some form of collateralization/guarantee by the EFSF, (ii) earmarking a fraction of the anyway necessary additional lending to Greece for debt buy backs, (iii) pre-emptive recapitalisation of Greek banks would be an acceptable solution for the ECB, thereby ensuring that access to collateral will be maintained and (iv) a reduction in the interest rate and maturity extension for the official loans to Greece. We ascribe a 70% probability to this scenario. In an alternative scenario (30%), the governments would blink at the possibility that the ECB still refuses to refinance Greek banks with post-selective default securities and head for a tax on banks instead.

We expect the Eurozone summit to go "beyond Greece" and also offer some pre-emptive action on the other peripherals. We expect the option to extend support to Portugal to be spelled out, as well as a rebate on the interest rate paid by Ireland on its loans. Ideally, but the Europeans would also agree to make the EFSF even more flexible and allow it to intervene on both the primary and secondary markets, possibly beyond the countries under program (the latter being quite a stretch in terms of political acceptability in the core countries). This – in practice a takeover of the ECB's SMP by the EFSF – would actually boost the chance that the central bank would regard a "Selective Default" event benevolently.

1. The equation for Greece creates a very narrow path:

(i) Under a plausible economic scenario, Greek debt would need to be reduced by about 50% to become sustainable. It is unlikely that the agreement will generate such an outcome. The "Grand bargain" at this stage would be limited to debt coming due. The European decision-makers cannot position themselves in favour of a "hard restructuring" for at least two reasons. First, to borrow from Angela Merkel's own words two weeks ago in the Bundestag' Foreign Affairs committee, Europe does not have "the right tools" to deal with the contagion effects of such decision. Second – and this point was forcefully made in the FAZ on Monday by Ottmar Issing - ex-ECB chief economist and advisor to Merkel – allowing Greece

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to restructure only one year into the adjustment while still enjoying access to ECB liquidity would send a very negative signal on the credibility of fiscal discipline rules in EMU and could trigger similar temptations

(ii) For "political acceptability" reasons in some core countries (Germany, Netherlands, Finland), some substantial Private Sector Involvement (PSI) is required, so that the "European taxpayer" is no longer the sole payer into the rescue system. Short of a roll-over, the participation of the private sector could take the form of a tax on banks, but this proposal probably came a bit too late in the negotiation process to be part of the final deal.

(iii) Any solution must result in significant relief to improve Greece's debt fiscal position. This means inter alia that the interest rate paid by Greece on "new debt" issued as part of a roll-over must be consistent with long term debt sustainability, i.e. lower than the likely post-crisis nominal GDP growth and/or that the debt burden is reduced. This was the main drawback of the "French proposal", with its floor coupon at 5.5% augmented by GDP growth.

(iv) However if the interest rate on new Greek debt is low, its value will be poor relative to the risks incurred. Some form of credit enhancement will be required to secure enough private sector participation and also to contain the potential impact on the banking sector balance sheet.

(v) The rating agencies have made it almost technically impossible to structure a form of roll-over which would not trigger a downgrade to "Selective Default" (SD). Taking Jean-Claude trichet's latest statements literally, this would mean that Greek banks could no longer access ECB's liquidity, which would precipitate a bank run and probably a disorderly default of Greece.

2. A credible and politically acceptable solution to this equation

(i) To assuage market concerns as to the sustainability of Greek debt, we expect the Europeans to make two important decisions. First, the interest rate on the current loans granted in the first program to Greece could be taken down further by reducing the margin (Greece is currently paying an effective average rate of roughly 4.0% on its loans) , and this would also apply to the second package now being discussed. Second, the EFSF could provide loans to Greece to buy back its own debt. This solution – which would only take a change in the Greek MoU, which is anyway needed in view of the second package, and would not necessitate a change in the EFSF terms - can hardly be a silver bullet, as bond prices are likely to rise sharply in response to such an announcement, but that would be a sign that the Europeans are taking the long term debt sustainability issue seriously.

(ii) Rollover into longer dated bonds (20, 30 years) with coupons set at around 3.5/4.0% (likely path for post crisis trend nominal GDP in Greece and consistent with the IMF fourth review which suggested targeting 100bp below the coupon of the existing Greek debt. The "credit enhancement could be brought in two different ways: either – following partly the "French proposal – by diverting a part of the new funding to Greece (via PSI AND official sector loan) to collateralize the new debt, or by making the EFSF guarantee (in full or partly) directly the new Greek debt. The latter is more complicated than the former, as it would entail a change in the terms of the EFSF.

(iii) The key issue would be the acceptability of such a deal by the ECB. Indeed, such a framework would in all likelihood trigger a downgrade to "selective default" ("SD") by the rating agencies. Yesterday ECB Governing Council member Nowotny – often seen as a "dove" - was seemingly opening some room for manoeuvre on this matter, stating "there are some proposals that deal with a very short-lived selective default situation that would not really have major negative consequences". Later in the day he stated that he was in complete agreement with Trichet on the need to avoid a Greek plan which would make it impossible for the ECB to accept Greek bonds as collateral, but the first quote suggests that at least some members of the Governing Council are actually more flexible than it seems on this issue. In practice, the ECB could accept to refinance Greek banks (i) via the ELA or (ii) in

exchange for a guarantee from the EFSF on that fraction of its balance sheet or (iii) if Greek banks are recapitalized using the money already earmarked for that in the troika program .

(iv) The ECB is not formally negotiating with the European partners on the form of PSI, even if it is probably informed of the proposals as they are evolving. The Governing Council will react to the framework. This creates a risk, which adds to the uncertainty of PSI in terms of valuation effects and possible contagion. Levying a tax on financial institutions – which proceeds would fund the EFSF and hence debt buy backs - would then be the fall back plan. Indeed, the main motivation behind PSI was political in the first place (ensuring that the average European taxpayer would not be the only paying agent in the system). A "bank tax" would achieve just that. This proposal – originated in Paris, to lure Berlin away from PSI – probably came a bit late in the process and is likely to remain vague at this juncture. Defining the right perimeter of such a proposal would be a tricky issue. Targeting banks only would probably yield only limited proceeds unless the rate was substantial and potentially counter – productive from a market point of view (and note that European banks own only EUR 36bn of Greek public debt against EUR 150bn for other non residents such as institutional investors. This could fuel ideas for a blanket tax on financial transactions.

3.Not much beyond Greece ?

(i) As part of the discussion we think that market concerns about the other peripherals could be partly assuaged by first reducing the interest rate Ireland pays on its loans. There is probably no valid reason to maintain a higher funding cost for Ireland relative to Greece, if anything Ireland is showing more signs of progress than Greece and should be rewarded. We think there is a fairly high probability that this could happen. Second, the Portuguese program should be extended to improve this country's chances to come back to the market with a sounder macro story. We think that, unfortunately, it may be too early for the Europeans to make that decision.

(ii) The extension of the crisis well beyond the three countries under program would normally entail a re-formatting of the EFSF. At the European Council in June the governments agreed – on top of the extension of the AAA guarantees to the EFSF to EUR440bn from EUR255bn – to allow the EFSF the possibility to intervene in the primary market. However, in view of the speculative attacks which have affected pressure on Italy in the last few days we think that the policy makers would view favourably the possibility for the EFSF to intervene in the secondary bond market, in practice taking over the Securities Market Program set up by the ECB in May 2010 but inactive since April 2011. Note that to effectively take over the SMP, the EFSF should be granted the right to intervene even for countries which are not under program. This could be crucial in particular in the case of Spain, which may need a European backstop to FROB issuance, as part of its much needed bank recapitalisation effort. However, extending the rules of engagement of EFSF beyond the "MoU countries" may be too much in terms of political acceptability for Germany at this stage.

(iii) We reiterate that extending the size of the EFSF beyond the newly agreed EUR 440bn from AAA countries would be a mistake, as it could jeopardize the AAA status of some of the core countries, France in particular, which in term would entail a complete collapse of the rescue system. In any event, it is probably unnecessary as if Italy and/or Spain solvency is genuinely questioned, it is unlikely it will politically feasible for the AAA countries to shoulder the potential costs.

4. What timing for enforceability?

In any case, the above framework would have to be part of a second package for Greece (which is currently not part of the EFSF process), with a new MoU. This would take probably several weeks. Structuring PSI could be done at the same time, as it does not entail a change in the EFSF terms (except for a direct guarantee of new Greek debt by EFSF).Note that parliamentary endorsement of a second package for Greece is not formally necessary in Germany.

However, the change in the rules of engagement of the EFSF would have to be approved by national parliaments. This was due anyway, as a consequence of the extension of the size of the scheme.

All eyes will be on German parliament. The framework described above is in some aspects in contradiction with the non-binding resolution adopted by the Bundestag in February, precluding "jointly financed or guaranteed debt purchase programmes". However, the intensification of the crisis may have mellowed the centre-right majority, given the risks now for global financial stability, while the Chancellor could normally count of the support of the centre-left opposition on such a framework.

Appendix 1

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