



Perspectives by Ruth Lea

Economic Adviser to Arbuthnot Banking Group



A second Greek bailout: nearly there (21/6/11)

Greece's current financial needs

The Greek debt crisis, and the possibility of a Lehman-like shock to the global financial system if Greece defaults, is focusing minds in the capitals of the EU. The urgent matter is the quick resolution of Greece's immediate funding needs. Greece requires an urgent instalment of €12bn from the €110bn emergency loan agreed in May last year¹ to avoid defaulting on its debts due for repayment over the coming months. Even though the €12bn has yet to be signed off by the EU and the IMF, this tranche looks almost certain to be paid as both the EU and the IMF wish to avoid the almost certain financial turmoil following a Greek default.

The EU has already indicated that it will almost certainly provide its share of the funds, though there are some formalities to be surmounted and it is conditional on Greece's passing the new austerity programme.² The IMF has also already said that it is prepared to contribute its share (€3.3bn) on the strength a promise of European funding. The €12bn should see Greece through to September and buy some time for the authorities to agree a second bailout. It is expected the money will be made available to Greece in early July.

As the discussions were going on concerning the €12bn tranche, Standard and Poor's downgraded the rating on Greek sovereign debt to CCC on 13 June, worse than Ecuador and Pakistan. Efforts to bridge the funding gap faced by Athens, they said, were likely to culminate in "one of more" defaults. Under these circumstances it is hardly surprising that many analysts see the successive bailout plans for Greece as merely "kicking the can down the road" or "putting off the day of reckoning". Italy, incidentally, was recently threatened with a debt downgrade by Moody's.³

The need for a second bailout

The slightly less urgent matter, though no less important, concerns the need for a second bailout package for Greece. This has arisen because it is now quite clear that Athens cannot return to the financial markets to issue new bonds to pay off maturing ones in 2012, as planned in the May 2010 rescue plan. Such market access is now considered quite out of the question. The 2010 Greek bailout plan is therefore effectively dead.

This second bailout package now looks likely to be finalised at the 11 July meeting (“mid-July”) of the Eurozone finance ministers and could amount to around €120bn.^{4,5}

The precise details have yet, of course, to be agreed but the package looks likely to include:

- A private sector “contribution” of about €30bn. Before the meeting between German Chancellor Merkel and French President Sarkozy on 17 June 2011, there was a heated dispute between Germany and France (allied with the ECB) relating to the nature of the private sector contribution. Specifically, the German Minister of Finance Wolfgang Schäuble wanted the private holders of Greek debt to be forced to extend the maturities of their debt by 7 years to prevent a Greek bankruptcy. The ECB had adamantly opposed Schäuble’s plan, saying that it would amount to a *de facto* default, which would probably lead to market turmoil. The ECB wanted bondholders whose debt comes due over the next 3 years to voluntarily rollover their debt. Mrs Merkel conceded the point, agreeing to “Vienna initiative” style voluntary rollovers for the private contribution to the new package. The private creditors, of course, must be brought on board. This is likely to take several weeks. The Vienna initiative and other financial terms are discussed in annex table 1.
- Funding from the EU, probably from the Eurozone’s European Financial Stability Facility, though there may be some from the EU’s European Financial Stabilisation Mechanism (EFSM, to which Britain contributes).
- Funding from the IMF (to which Britain contributes, as a shareholder).
- Greek asset sales, through a radical privatisation programme which began in May, variously estimated at €30-50bn. Some estimates are lower than this – nearer to €15-20bn.

A second bailout is conditional on the Greek Parliament passing a new 4-year austerity package worth €28bn (deadline the end of June). In order to increase his chances of getting parliamentary agreement Greek Prime Minister George Papandreou reshuffled his cabinet on 17 June, amid riots, appointing “heavyweight” Evangelos Venizelos as his Minister of Finance. Suffice to say, further austerity packages are deeply unpopular with the Greek electorate. The chances are that Papandreou will get the package through parliament and the second bailout will go ahead.

Costs of the bailout packages

One aspect of the deeply dysfunctional Eurozone is the cumulative costs of the rescue packages, including Britain’s contribution despite not being a member of the Eurozone.

There are now four instruments in place, with different financial volumes and institutional set-ups, for supporting EU members in economic difficulties:⁶

- The euro-area Member States have provided financial support of €80bn to Greece in the form of pooled bilateral loans. This support was organised in an inter-governmental framework.
- The **European Financial Stability Facility (EFSF)**, in the form of a Special Purpose Vehicle (SPV) allowing funding of up to €440bn. This was set up using an inter-governmental approach rather than creating a permanent instrument under the Treaty on the Functioning of the European Union. Since there is no legal basis for a permanent fund, the Treaty will have to be amended for the agreed €500bn European Stability Mechanism (ESM) due to succeed the temporary EFSF and EFSM in mid-2013.⁷ The non-Eurozone members are not involved in the EFSF and should not be involved in the ESM. See table 2 in the annex for further details of the EFSF.
- The **European Financial Stabilisation Mechanism (EFSM)** is a Treaty-based mechanism covering all 27 EU Member States. It allows maximum financing of around €60bn. The EFSM operates under Article 122(2) of the Treaty on the Functioning of the European Union, which allows EU financial assistance to be granted to Member States facing “severe difficulties caused by natural disasters or exceptional occurrences beyond its control”. It arguably contradicts Article 125, the “no bail-out clause”. After the Irish & Portuguese bail-outs there is only €11-12bn left in the EFSM. It should be noted that the UK could not have unilaterally, legally opted out of the EFSM as it was decided by Qualified Majority Voting (QMV) in May 2010.^{8,9}
- Finally, non-euro-area Member States may receive assistance through the Balances of Payments (BoP) Regulation 3. This allows the granting of financial support up to a total of €50bn. €15bn has already been used to provide support to Romania, Latvia and Hungary, leaving an available balance of €35bn.
- In total, this means that the EU and its Member States can provide financial support of up to €630bn.

The IMF has also been involved in the rescue packages for Greece, Portugal and Ireland. The IMF contributed to the first bailout package for Greece in May 2010. May 2010’s €500bn “shock ‘n’ awe” rescue package, which set up the EFSF and the EFSM, was accompanied by up to €250bn from the IMF. IMF members contribute to the rescue packages as shareholders. The UK has a 4.5% share. See annex 3 for key countries’ IMF quotas.

Table 1 shows the details of the 3 rescue packages to date, formally known as Economic Adjustment Programmes in EU-speak, with a speculation about the shape of the second rescue package for Greece.

Table 1 Eurozone bailouts, maximum support

	Eurozone members	EU27 (EFSM) & non-Eurozone members	IMF	Total
Greece (May 2010)	€80bn, bilateral loans	€0bn	€30bn Stand-By Arrangement (SBA)	€110bn, 3-year horizon
Ireland (November 2010)+	€17.7bn (EFSF); €17.5bn (Ireland)	€22.5bn (EFSM) + bilateral loans from the UK (€3.8bn), Denmark (€0.4bn), Sweden (€0.6bn)	€22.5bn Extended Arrangement	€85bn (€67.5bn, external), 3-year horizon
Portugal (May 2011)	€26bn (EFSF)	€26bn (EFSM)	€26bn Extended Arrangement	€78bn, 3-year horizon
Greece (2011)	€30bn (EFSF)	€0bn	€30bn	€60bn++

Sources: European Commission's website, www.ec.europa.eu.

+The Irish package comprised €50bn to cover public finance needs and up to €35bn to cover banking assistance, including a contingency element. Half of the banking support measures (€17.5 billion) were financed by an Irish contribution through its treasury cash buffer and investments by Ireland's National Pension Reserve Fund (NPRF). The Irish package was equally shared between: the EFSM; the EFSF plus non-Eurozone bilateral loans; and the IMF.

++ Assuming a total package of €120bn, with €30bn from the private sector & €30bn from asset sales and no contribution from the EFSM.

UK contributions to the bailout packages

The UK has so far contributed to the bailouts in 3 ways:

- Through the EFSM: the UK faces an indirect contingent liability through its participation in the EFSM, equivalent to its share in the EU Budget. In other words, the cost of default on EFSM loans will be borne by the EU Budget and if this creates a shortfall in revenue, it will be made up by further Budget contributions from Member States. Based on its 2011 Budget share, the UK would contribute 12.5% to these costs if they arose. The maximum liability the UK can incur through the EFSM is thus equal to 12.5% of €60bn, or €7.5bn (£6.6bn). For this to occur, the EFSM ceiling of €60bn would have to be reached, and all borrowing countries would have to default on 100% of their loans. The recent history of sovereign debt restructuring suggests the latter event is extremely unlikely.¹⁰
- €3.8bn bilateral loan to Ireland.
- Through its IMF contributions, with a 4.5% share of IMF loans.¹¹

As can be seen from table 2 below the UK faces maximum liabilities of €13.35bn (£11.8bn) relating to the 3 rescue packages for Greece, Ireland and Portugal. There could be an extra €1.35bn (£1.2bn) for the second bailout for Greece.

Table 2 Eurozone bailouts: possible, maximum UK liabilities

	EFSM	Bilateral loan	IMF	Total
Greece (May 2010)	Na	Na	4.5% of €30bn = €1.35bn	€1.35bn
Ireland (November 2010)+	12.5% of €22.5bn = €2.8bn	€3.8bn	4.5% of €22.5bn = €1.0bn	€7.6bn
Portugal (May 2011)	12.5% of €26bn = €3.25bn	Na	4.5% of €26bn = €1.15bn	€4.4bn
Total				€13.35bn (£11.8bn)
Greece (2011)	Na	Na	4.5% of €30bn = €1.35bn, \$1.9bn	€1.35bn (£1.2bn)

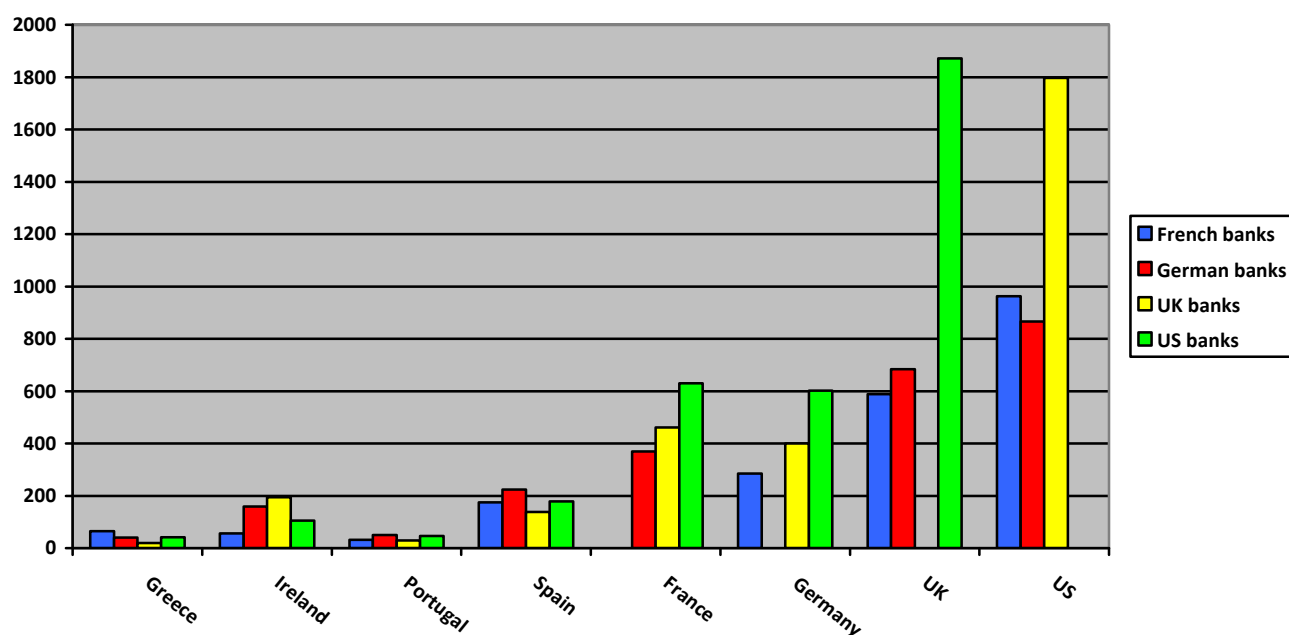
Note: the conversions to sterling use the rate 1£=€1.13.

Fears of a Lehman-like shock on the global financial system

As already indicated the urgency with which the EU and the IMF have *de facto* agreed to the latest €12bn tranche of support for Greece shows how concerned EU and IMF leaders, amongst others, are about the possibility of a Greek default unleashing a Lehman-like shock (“Credit Crisis 2”) to the global financial system.¹² The knock-on impacts on the Eurozone’s other peripheral economies, Ireland, Portugal, maybe Spain, and maybe Italy are very real.¹³

Given the risk of market contagion (as voiced by the ECB when opposing Germany’s plans for restructuring Greece’s debt), the decision to choose voluntary rollovers for the private contribution to the second rescue package, as agreed by Chancellor Merkel and President Sarkozy last week, was probably the right decision. But of course EU leaders are just “kicking the can down the road”, and at some point some hard decisions will have to be made about the future of the Eurozone. We will return to options for the Eurozone in a future Perspective.

Chart 1 Consolidated foreign claims, ultimate risk basis, €bn



Source: BIS Quarterly Review, June 2011, table 9E, www.bis.org. "Other potential exposures" comprise: derivatives contracts, guarantees extended & credit commitments.

Suffice to say at this point, the global financial system is highly interconnected. Chart 1 above and tables 3A and 3B below show the exposure of key banking sectors (French, German, UK and US) to the PIGS countries (table 3A) and to each other's countries (table 3B).¹⁴

Table 3A shows that French banks are significantly more exposed to the fortunes of the Greek economy (\$65bn of claims and other potential exposures) than German (\$39.9bn), UK (\$19.1bn) or US banks (\$41.4bn). But then UK banks are exposed to France, including French banks to the tune of \$135.3bn, as shown in table 3B.

Even the US banks are not immune. Its big banks have sold Credit Default Swaps (CDSs) on Greek debts held by European banks. If Greece defaults European banks facing losses could try and claim substantial billions from US banks. Former Federal Reserve Chairman Alan Greenspan has even spoken of the pressure that could be put on US banks following a Greek default having the potential to push the US into another recession.¹⁵

Table 3A Consolidated foreign claims & other potential exposures of reporting banks, amounts outstanding, to the PIGS, end December 2010, ultimate risk basis, \$bn

Exposures vis-à-vis:	French banks	German banks	UK banks	US banks
Greece				
Foreign claims	56.7	34.0	14.1	7.3
Of which:	15.0	22.7	3.4	1.5
(1) Public sector				
(2) Banks	2.2	2.2	2.6	1.5
Other potential exposures	8.3	5.9	5.0	34.1
Total	65.0	39.9	19.1	41.4
Ireland				
Foreign claims	29.6	118.2	135.2	50.9
Of which:	4.0	3.1	4.5	2.2
(1) Public sector				
(2) Banks	8.1	28.5	18.3	11.6
Other potential exposures	26.4	40.4	59.2	54.0
Total	56.0	158.6	194.4	104.9
Portugal				
Foreign claims	26.9	36.4	24.3	5.3
Of which:	8.2	7.8	2.1	1.1
(1) Public sector				
(2) Banks	6.1	15.7	4.7	2.5
Other potential exposures	5.2	13.8	4.7	41.2
Total	32.1	50.2	29.0	46.5
Spain				
Foreign claims	140.6	181.9	107.2	47.2
Of which:	30.3	28.6	9.6	3.8
(1) Public sector				
(2) Banks	38.8	75.4	21.1	19.5
Other potential exposures	34.9	42.1	30.6	131.7
Total	175.5	224.0	137.8	178.9
Total PIGS	328.6	472.7	380.3	371.7

Table 3B Consolidated foreign claims & other potential exposures of reporting banks, amounts outstanding, to major economies, end December 2010, ultimate risk basis, \$bn

Exposures vis-à-vis:	French banks	German banks	UK banks	US banks
France				
Foreign claims	-	189.4	269.1	256.5
Of which:	-	21.5	44.7	28.8
(1) Public sector				
(2) Banks		98.6	135.3	162.0
Other potential exposures	-	95.2	192.0	373.4
Total	-	284.6	461.1	629.9
Germany				
Foreign claims	261.0	-	174.5	236.2
Of which:	54.75	-	56.5	71.4
(1) Public sector				
(2) Banks	96.1		70.8	119.5
Other potential exposures	108.3	-	226.1	365.2
Total	369.3	-	400.6	601.4
UK				
Foreign claims	281.4	465.7	-	651.1
Of which:	10.6	4.2	-	47.8
(1) Public sector				
(2) Banks	145.6	159.7		185.9
Other potential exposures	306.6	217.8	-	1,220.7
Total	588.0	683.5	-	1,871.8
US				
Foreign claims	529.7	491.1	1,035.1	-
Of which:	65.2	18.2	184.1	-
(1) Public sector				
(2) Banks	111.3	113.1	169.4	
Other potential exposures	433.3	374.4	761.5	-
Total	963.0	865.5	1,796.6	-

Source: BIS Quarterly Review, June 2011, table 9E, www.bis.org. "Other potential exposures" comprise: derivatives contracts, guarantees extended & credit commitments.

References

1. Ruth Lea, "The eurozone's rescue package: buying time and postponing the day of reckoning", Arbuthnot Banking Group, 24 May 2010.
2. The Eurogroup of finance ministers met on 19 June and announced that the €12bn tranche was conditional on Greece's new austerity programme being passed. The European Council will meet on 23-24 June.
3. *FT*, "Disunity deepens Greek crisis", 16 June 2011, reported that Ireland had revived the "haircut" demand on some senior bondholders at Anglo Irish Bank and Irish Nationwide, saying they should be required to take losses to lessen the cost of Ireland's rescue.
4. The second bailout package will also be discussed at the meeting of 23-24 June.
5. *FT*, "EU holds talks to salvage Greek rescue package", 14 June 2011, reported that "of the €172bn Greece is expected to need to the ends of 2014, about €87bn is already accounted for: €57bn from Greece's existing EU-IMF bailout, and another €30bn from a privatisation programme [some estimates are for €50bn]. That leaves another €85bn unaccounted for, which must be made up either through new EU-IMF loans or by persuading private bondholders to delay their redemptions."
6. Source: the European Commission's website, www.ec.europa.eu
7. On 21 March 2011 the Eurozone finance ministers reached an agreement on the creation of the European Stability Mechanism (ESM) as a permanent means of providing assistance to indebted countries. The ESM, due to be set up as of mid-2013, will have €700bn euros (with an overall effective lending capacity of €500bn) including €80bn of capital contributed directly by Member States in order to guarantee the AAA rating of the €620bn of bonds to be issued.
8. "The European Financial Stabilisation Mechanism (EFSM)", House of Commons Library, May 2011.
9. Unlike the IMF, loans under the EFSM (and the EFSF) rank *pari passu* with private creditors; that is, in the event of default, payment of EFSM loans does not take particular precedence over payment of other holders of sovereign debt. The rationale for this is that too many creditors with 'preferred' status (like the IMF) can crowd out private investors wishing to purchase sovereign debt.
10. "The European Financial Stabilisation Mechanism (EFSM)", House of Commons Library, May 2011. This paper estimated that based on borrowing up to 19 May 2011, the UK's liability was €1.2bn (£1.1bn).
11. *CityAM*, "Greek debt woes rattle markets", 17 June 2011 reported that the "Treasury had snuck through another £9.2bn contribution to the IMF".
12. *Sunday Telegraph*, "Battle lines drawn for the European debt war", 18 June 2011, reminded its readers that when Lehman went down, it "only" had debt stock of \$610bn (€425bn).
13. *Times*, "After Greece, markets lose faith in Spain, too", 17 June 2011 reported that "any hopes that Spain had decoupled from the other peripherals had, for now, been buried".
14. Table 4 in the annex gives some equivalent data on "immediate borrower basis".
15. *FT Adviser*, "Greenspan: The 'almost certain' Greece default could cause US double-dip", 17 June 2011.

Annex

Table 1: Lexicon of a debt crisis

Terms connected with debt and the financial markets:
<ul style="list-style-type: none">• Contagion: the impact of events in one country on others. The ECB, for example, claims that the financial & other linkages between the 17 Eurozone countries (and indeed the UK) mean that these impacts would be swift & severe in the case of a default in a member state.• Credit event: any sudden and tangible (negative) change in a borrower's credit standing or decline in credit rating. A credit event brings into question the borrower's ability to repay its debt. It is the defining trigger in a credit derivative contract, or credit default swap (CDS). If the borrower experiences a credit event, then the buyer of the contract must pay the seller an agreed-upon sum to cover the loss.• Default: strictly speaking a default is when a creditor or investor who has agreed to lend to a government by buying bonds (in sovereign debt markets) does not receive money due according to the terms of the contract. That could be the result of a government's failure to meet coupon interest payments; a delay in paying coupon payments (known as grace periods); the failure to pay the principal, or the original amount lent by an investor, which is known as a haircut; or a delay in payment of the principal, which must be paid when a bond matures.• Restructuring can be seen as a softer word for "default". Distinction is made between:<ul style="list-style-type: none">○ "Hard" or forced" restructuring which is likely to lead to big haircuts (losses) for bondholders.○ "Soft restructuring" which is generally seen as a "voluntary" agreement (in the absence of coercion) with investors allowing a government to extend debt maturities without the full consequences of a default. Re-profiling is arguably a more politically acceptable term for soft restructuring – coined, apparently, by Eurozone finance ministers.○ The chief practical difference therefore between soft restructuring (or re-profiling) and the harder type of restructuring is that the former does not require that bondholders take "haircuts". Instead of a reduction in the value of the outstanding debt, the schedule of payments servicing that debt would be stretched out. But the markets might take the view that this was equivalent to debt restructuring.• Rollover of debt refers to the renewal of an existing debt.• Vienna initiative: the collaborative effort of banks to prevent an escalation of the financial crisis in January 2009 by agreeing to maintain (rollover) their exposures to troubled Central European economies.

Table 2 European Financial Stability Facility

EFSF is a company. Its objective is to preserve financial stability of the euro by providing temporary financial assistance to euro area Member States in difficulty.

The EFSF issues bonds backed by guarantees of 16 euro area members (now 17, with Estonia) of up to €440bn on a pro rata basis, in accordance with their share in the paid-up capital of the ECB.

Country	Guarantee commitments (€bn)	% of total
Belgium	15.3	3.5%
Germany	119.4	27.1%
Ireland	7.0	1.6%
Spain	52.4	11.9%
France	89.7	20.4%
Italy	78.8	17.9%
Cyprus	0.9	0.2%
Luxembourg	1.1	0.25%
Malta	0.4	0.1%
Netherlands	25.1	5.7%
Austria	12.2	2.8%
Portugal	11.0	2.5%
Slovenia	2.1	0.5%
Slovakia	4.4	1.0%
Finland	7.9	1.8%
Greece	12.4	2.8%
Total	440.0	100.0%

European Financial Stability Facility, www.efsf.europa.eu

Table 3 IMF members' quotas, main countries

EU		Non-EU	
Country	Quota (%)	Country	Quota (%)
EU, Eurozone	[about 23]	USA	17.7
Germany	6.1	Japan	6.6
France	4.5	China	4.0
Italy	3.3	Saudi Arabia	2.9
Netherlands	2.2	Canada	2.7
Belgium	1.9	Russia	2.5
Spain	1.7	India	2.45
Austria	0.9	Brazil	1.8
Finland	0.5	Mexico	1.5
Ireland	0.5	Switzerland	1.45
Greece	0.45	Korea	1.4
Portugal	0.4	Venezuela	1.1
		Argentina	0.9
EU, non-eurozone		Australia	0.9
UK	4.5	Indonesia	0.9
Sweden	1.0	Norway	0.8
Denmark	0.8	South Africa	0.8
Poland	0.7	Malaysia	0.75
Hungary	0.45	Nigeria	0.7
Czech Republic	0.4	Iran	0.6

Romania	0.4	Singapore	0.6
		Thailand	0.6
		Turkey	0.6
		Ukraine	0.6
		Kuwait	0.6
		Libya	0.5
		Algeria	0.5
		Iraq	0.5
		Egypt	0.4
		New Zealand	0.4
		Pakistan	0.4

Source: www.imf.org

Table 4 Consolidated foreign claims of reporting banks, amounts outstanding, end December 2010 – immediate borrower basis, \$bn

	French banks	German banks	Greek banks	Irish banks	Italian banks	Neths. Banks	Port. banks	Span. banks	UK banks	US banks
Exposure to...										
France	-	189.4	2.0	15.4	39.0	91.4	7.8	26.5	256.9	180.1
Germany	249.4	-	5.2	73.2	251.9	166.9	3.7	41.7	169.7	157.8
Greece	53.0	34.0	-	0.7	4.2	4.5	10.2	1.1	13.1	7.4
Ireland	36.8	118.2	0.5	-	14.2	19.1	22.2	11.1	152.4	65.4
Italy	389.1	162.3	0.5	13.3	-	45.4	2.9	30.7	66.7	36.0
Portugal	27.0	36.4	0.1	2.5	4.1	5.3	-	86.0	24.4	5.4
Spain	141.5	181.9	0.3	13.9	29.9	77.0	25.9	-	112.1	41.1
UK	293.0	465.7	15.9	178.7	47.1	133.0	7.0	420.0	-	506.5
PIGS, external total	258.3	370.5	0.9	17.1	52.4	105.9	58.3	98.2	302.0	119.3

Source: BIS Quarterly Review, June 2011, table 9B, www.bis.org

Ruth Lea, Economic Adviser, Director,
 Arbuthnot Banking Group,
ruthlea@arbuthnot.co.uk,
 Tel: 07800 608 674