



July 2011 Global Strategy Update

>> The second bailout of Greece, worth €159bn, was agreed at the EU summit on 21st July 2011. As part of the measures, loans from the European Financial Stability Facility (EFSF) will come at a lower interest rate and can be paid back over 15 years instead of 7 and a half. This applies to Ireland and Portugal as well, so is positive news for them.

Following pressure from core European governments, particularly Germany, the private sector will be involved in sharing some of the cost of the bailout. Holders of Greek debt can 'voluntarily' roll over their bonds into longer maturities, although there is a range of options of how to do this. Essentially, this will reduce the net present value of holdings as the coupons on the new bonds are lower and the money gets paid back over a longer period. However, the 'haircut' is only about 20% which is not that substantial given where market values are. This is good news for European banks.

The measures discussed above means there will be a 'selective default' on certain Greek bonds but it is unlikely to trigger a credit-default swap payout due to the voluntary nature of the rollover. Also, the European Central Bank (ECB) will continue to accept Greek bonds as collateral when lending

to Greek banks despite the default, partly due to credit guarantees from the EFSF. This is crucial because otherwise the Greek banking system would collapse.

In an effort to limit contagion to other countries, the powers of the EFSF have been boosted. It can now buy Eurozone government bonds in the secondary market to ward off speculators. However, this comes with strings attached: the ECB and all Eurozone countries need to approve the purchases in advance. The EFSF can also help to recapitalise banks in any country through loans to governments.

Finally, a 'Marshall Plan' for Greece was mentioned, i.e. funds will be allocated to boost growth and competitiveness. This is welcome as it recognises the fact that austerity alone will not return Greece to solvency.



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A few concerns...

One of the major drawbacks of the deal is that the EFSF has not been increased beyond its current €440bn size. That sounds a lot but it wouldn't be enough to cope with a crisis in Italy and Spain for long. The approval process for allowing it to buy bonds in the secondary market also sounds cumbersome.

Furthermore, the changes to the EFSF that have been made are likely to need parliamentary approval in Eurozone countries, raising the prospect of some political concerns, especially in Germany where Angela Merkel faces a battle to keep her coalition partners supportive.

As a result of the agreement, the debt service burdens of peripheral countries are being reduced but not by enough. Debt to GDP ratios in Greece, Ireland and Portugal look set to remain comfortably above 100%. That raises the risk of another default and more hits to the private sector.

At the summit, policymakers promised that private sector involvement would only occur in Greece but not any other country, like Ireland and Portugal. There is no guarantee that this promise will be kept and markets will be sceptical.

Overall, European policymakers did deliver more than expected and have taken steps to ease the burden faced by the periphery. This should calm risk markets in the short-term (or allow them to focus on the US debt ceiling), particularly with the extent of private sector involvement reasonably limited. This is not the endgame though and slow growth in the peripheral economies and/or a sluggish implementation of reforms will probably lead to yet more volatility and additional steps towards a fiscal union.

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