

2014 ANNUAL REPORT

EUROPEAN STABILITY MECHANISM



European Stability Mechanism



Programme country experiences



GREECE

Greece's economic adjustment programme was designed to restore the sustainability of public finances, restructure and stabilise the financial system, and support long-term growth through an ambitious structural reform agenda. By autumn 2014, the economy had stabilised, growing again after six years of recession and a successful adjustment of the external and fiscal balance. However, Greece then lost the cautious recognition it was getting from market participants on its achievements. The conclusion of its programme with the EFSF and the IMF was postponed due to a lack of progress since summer 2014. Greece needs to provide a clear and credible way forward to restore market trust and return to a sustainable growth path.

The latest successful programme review was completed in April 2014 and the last tranche of the agreed EFSF disbursement took place in August 2014, after the completion of agreed milestones. Due to delays in concluding the final programme review, the Facility has been extended twice since December 2014 and it is now set to expire at the end of June 2015.

The economy stabilised in 2014 after six years of recession, with real GDP growing by a seasonally adjusted 0.7%. The economic growth registered in 2014 was mainly driven by a recovery in domestic demand, supported by considerable gains in the tourism sector. The external sector continued to contribute positively to growth, with exports outpacing imports. But the decline in public consumption persisted in 2014, albeit at a lower rate than in previous years. On the supply side, wholesale and retail trade contributed the most to growth.

Preliminary data suggest that in 2014 the government missed the primary surplus programme target of 1.5% of GDP. This fiscal underperformance stemmed primarily from tax revenue slippages, given that overall political uncertainty ahead of the January 2015 parliamentary elections influenced taxpayer behaviour during the last months of 2014.

The external adjustment continued in 2014, with Greece recording a current account surplus (0.9% of GDP) for a second consecutive year. The improvement reflects a substantial increase in the services surplus, which more than offset an increase in the goods deficit. Price competitiveness has improved notably from 2012 onwards due to labour cost adjustment and

the implementation of competition-enhancing reforms, which facilitated price and wage flexibility. Ambitious labour market reforms yielded results, with Greece more than recovering the cumulative loss in labour cost competitiveness observed between 2000 and 2009.

Greece's improving economic performance, policy reforms and the broadly favourable market conditions gained investors' recognition during the first half of 2014. Greece managed to come back to the markets by placing new 5-year and 3-year bonds at relatively favourable yields. By mid-October 2014, however, the confidence Greece was building in financial markets was rapidly undone, due to weaker programme implementation. Market participants made clear that the perception of regained market access was premature, triggering a sell-off.

Despite the clear progress achieved in fiscal adjustment and competitiveness so far, the continuous delays in programme implementation, accompanied by political uncertainty, have taken their toll on the Greek economy and budget. The liquidity and funding conditions for the economy and the financial sector grew very strained during the first quarter of 2015 as a result of the ongoing dialogue between the Greek government and its official sector creditors. For Greece to regain market confidence and reap the benefits of the substantial adjustments made to date, the authorities will need to demonstrate their determination to continue improving fiscal sustainability, preserve financial sector health, and boost growth and employment through robust implementation of structural reforms. These elements would be crucial for Greece's long-term outlook and gradual return to accessing market financing.

HOW GREECE BENEFITTED FROM EUROPEAN DEBT RELIEF

Euro area Member States have taken several steps to ease the lending terms for Greece to support its ability to service its debt burden, principally through lower financing costs and longer maturities.

The first European assistance instrument, known as the Greek Loan Facility (GLF), was amended in June 2011, when the maturity was extended by five years to a total of 10 years, the grace period was lengthened to 4.5 from three years, and the margin was lowered by 100 basis points, to 2% in the first three years and 3% thereafter. This change was superseded by the second amendment in March 2012 where maturities were extended to 15 years, the grace period raised to 10 years, and the margin reduced further to 150 basis points over the entire period.

In November 2012, the second Greek financial assistance programme included additional debt alleviation measures. Worse-than-expected macroeconomic developments, missed targets and incomplete programme implementation meant additional measures needed to be taken to reduce financing needs and to support the sustainability of Greek government debt. Therefore, the Eurogroup approved a broader set of measures on the GLF and EFSF loans:

- reduction of the GLF interest rate margin by 100 basis points;
- cancellation of the EFSF guarantee commitment fee;
- deferral of EFSF interest payments on loans under the Greek Master Financial Assistance Facility Agreement by 10 years;³
- return of the Securities Markets Programme (SMP) profits (when the ECB bought Greek government bonds with a discount in the secondary market and made a profit at maturity);
- extension of the GLF to 30 years and EFSF weighted average maturities to 32.5 from 17.5 years.

³ Not applied to Private Sector Involvement (PSI) and bond interest facilities, which correspond to roughly 25% of the overall EFSF loan to Greece.

The low financing costs of the European facilities reduced Greece's debt servicing burden, thereby providing authorities with greater fiscal flexibility. The GLF and EFSF rates remain well below market rates. Due to the relief measures and market conditions for EFSF funding, the EFSF lending rate for Greece, which reflects the market situation, currently stands at around 1.35%. The EFSF rate compares favourably with the current IMF lending rate of 3.6%. It also remains far below the roughly 5% rates that Greece has had to pay for corresponding maturities over the past decade and current market rates. Financing at EFSF and GLF rates therefore entails an important support component, because they are alternatives to other, more costly sources of financing.

The measures correspond to substantial economic debt relief, with effects that transcend the enhanced fiscal room for manoeuvre provided to Greece. Considering these maturity extensions and interest rate deferrals over the entire debt servicing profile from a net present value (NPV) perspective shows a reduction in the overall debt burden and reveals implicit savings. The NPV approach consists of discounting the difference between the future cash flows of the loans benefitting from lower financing costs and debt relief measures and the cash flows of the same loans had they not benefitted from the relief measures.⁴ Stretching out principal repayment schedules over such an extended period of time, along with interest payment deferral, imply that these payments account for substantially less in NPV terms when assessed from the Greek side taking into account the financial market perspective.⁵

⁴ For the calculation of the interest Greece would have paid in the markets, the historical 10-year German bund rate plus a theoretical market spread of Greece at the starting date of each EFSF loan tranche is used. For the calculation of the interest applicable to the EFSF loans to Greece, projections of the EFSF cost of funding are based on the estimate of the funding volumes that the EFSF has to achieve in the future. The NPV gain is derived from the difference between these two flows of interest payments. The discount curve is derived from the German bund plus the theoretical market spread for Greece as of calculation date.

⁵ It should be noted that this does not entail any financial loss or write-down from an EFSF perspective. The EFSF is fully repaid; Greece has to cover any financing costs related to the agreed interest rate deferral in line with the amendment of the Master Financial Assistance Facility Agreement.

The economic reduction of the debt burden and implicit savings from the various relief measures described above leads to NPV savings equivalent to 49% of Greece's 2013 GDP. The overall figure comprises an NPV reduction for the EFSF facilities of 34% of GDP, of which 7% of GDP can be attributed to the extension of maturities and interest rate deferral, and 27% of GDP can be attributed to the savings from the financing at EFSF rates compared to market rates for Greece. To this number, one can add the impact of the extension of maturities and the lowering of the margin for the GLF. This adds another 10% of GDP in NPV reduction. Finally, the return of SMP profits adds up to 5% of GDP. This overall NPV savings figure as a percentage of GDP and its breakdown is based on theoretical assumptions of the interests Greece would

have paid in the markets, compared to estimates of the future EFSF cost of funding.

From a Greek perspective, the debt relief measures taken by its European creditors provide a substantive benefit in fiscal space and overall payment profile. It cannot be argued that the debt level is unsustainable by merely looking at the aggregate nominal debt to GDP ratio. A proper sustainability analysis must consider the structure of Greek debt. Payment obligations over the years until 2023 are minimal. Thereafter, the repayment is stretched out over several decades which, combined with favourable lending rates, results in an overall high but sustainable debt – provided that Greece continues its reform agenda.

