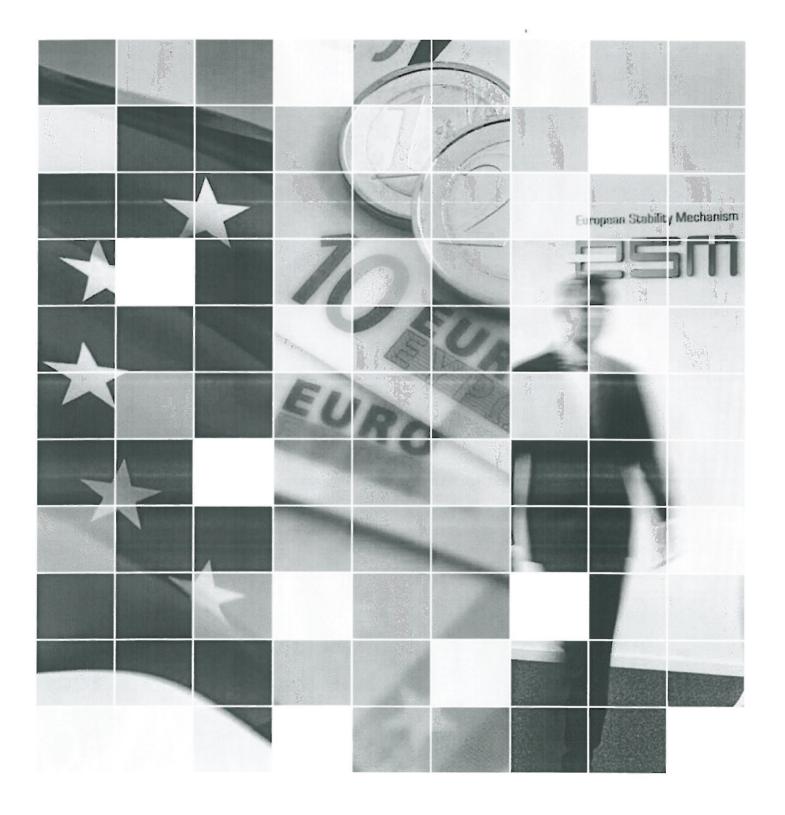
ETTP4407

European Stability Mechanism



2015

ANNUAL REPORT



Greece

In the first half of 2015, significant political uncertainty linked in part to a reversal of previously implemented reforms and to protracted negotiations between the newly elected Greek government and its official lenders severely undermined market sentiment and the banking sector. In June 2015, after having gone into arrears with the International Monetary Fund (IMF), the Greek government implemented a bank holiday and capital controls. In the end, Greece and its official sector creditors agreed on a three-year ESM economic adjustment programme of up to €86 billion. The new programme aims to safeguard previous programme achievements, strengthen the country's financial stability, and return it to a sustainable growth path based on sound public finances and enhanced competitiveness. By the end of the year, the economy had stabilised, proving more resilient than expected. Programme implementation, most notably the completion of the bank recapitalisation in December 2015, helped steady the economy. Looking ahead. Greece needs to take full ownership of the programme and put forward credible and effective policies to reach agreed programme targets, regain market access, and put the economy on a firm and sustainable footing.

In the first half of 2015, the Greek government was heading for a political standoff with its official lenders, exacerbating liquidity distress and reversing the growth momentum that had emerged in 2014. Funding stress in the banking sector intensified as political uncertainty induced massive deposit outflows and the stock of NPLs increased. The Bank of Greece started providing emergency liquidity assistance as Greek banks were not eligible for normal monetary operations. In response, all rating agencies took negative credit rating decisions on Greece. Yields on Greek government bonds climbed, in contrast to the declining bond yields for other euro area sovereigns.

The EFSF lending facility expired at the end of June 2015. In the absence of official financing and without market access, Greece faced severe liquidity constraints that eventually led to failure in servicing external debt obligations with the IMF and the Bank of Greece. This constituted a default event under EFSF lending agreements. On 3 July 2015, the EFSF decided to reserve its right to accelerate the repayment of its facilities.

The political tensions culminated in a referendum on 5 July 2015 which resulted in the rejection of potential programme conditions. To protect the

banking sector from a bank run, the government imposed bank holidays and capital controls on 29 June 2015 and the Athens stock exchange was closed on 27 June. The economic and financial situation became increasingly untenable and on 8 July 2015, Greece made an official request for stability support – in the form of a loan facility – to the ESM. The acute liquidity shortage was temporarily addressed with a bridge loan on 20 July 2015, under the European Financial Stabilisation Mechanism (EFSM), clearing arrears with the IMF.

After the political agreement in the Euro summit in July, the Greek authorities passed several sets of required reform legislation, so-called prior actions. in July and August 2015. The ESM approved the new programme on 19 August 2015, with available financing of up to €86 billion over three years. This amount could be reduced, given that earmarked amounts for bank recapitalisation were not fully needed. Such a reduction would also depend on IMF participation and on Greece's success in implementing policy reforms that would enable it to resume market financing before 2018. Under the programme, the Greek government committed to several reforms. including: restoring fiscal sustainability; safeguarding financial stability; boosting growth, competitiveness and investment; and reforming the public administration. The first disbursement was made in August 2015, in part to repay the short-term bridge loan disbursed under the EFSM, while earmarking €10 billion for bank recapitalisation and resolution. The recapitalisation of systemically relevant banks was successfully completed in December 2015 and only required €5.4 billion. By December 2015, the entire amount of the first tranche to be released in cash, €16 billion, had been disbursed. Given that the Greek government had cleared its arrears with the IMF and the new ESM financial assistance programme was in place, the EFSF decided to waive its rights with respect to the events of default tied to Greece's obligations towards the IMF and the Bank of Greece.

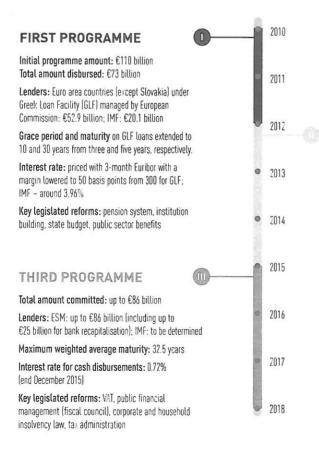
The economy stabilised at the end of 2015 and proved more resilient than expected, benefitting from successful programme implementation. Capital controls, in particular, exerted a less detrimental influence than predicted. According to the Greek statistical agency's first estimate, real GDP declined by 0.2% in 2015, as private consumption and net exports almost fully offset the negative impact of investment, while public consumption remained broadly stable. In 2015, the external adjustment continued and the current account neared zero following a deficit of 2.1% of GDP in the previous year.

Eurostat data confirm that in 2015 the government achieved a primary surplus of around 0.7% of GDP according to the programme definition against a target of -0.25% of GDP. The general government debt ratio declined by 3.2 percentage points to 176.9% in 2015, but may increase again in the coming years. Despite these developments, concerns remain regarding the sustainability of Greece's public debt. These concerns should be addressed through strong programme implementation. Euro area partners stand ready to consider, if necessary, possible additional measures aiming at ensuring that Greece's gross financing needs remain at a sustainable level. These measures will be conditional upon full implementation of the measures agreed in the ESM programme and will be considered after the first positive completion of a programme review.

But important challenges still lie ahead. Mediumterm fiscal stability necessitates, among other measures, an income tax overhaul and a pension reform to ensure the sustainability of the social security system. For the banking sector to remain viable, the elevated stock of NPLs must be reduced, thereby supporting credit growth and relaunching investment in the private sector. Reforms to modernise the banking sector are also critical to restoring its soundness. The privatisation programme should be pursued without undue political interference. Only timely and successful programme implementation will unlock programme funds for arrears clearance to inject liquidity into the business sector.

Despite earlier programme achievements and a stabilising economy, conditions for the real economy and the financial sector remain challenging. Greece cannot afford delays in programme implementation or a new phase of excessive political uncertainty if the economy is to benefit fully from the improvements already achieved under the third adjustment programme. The Greek government and official sector creditors must keep building a trusting relationship and the Greek government needs to take full ownership of the programme and act in its spirit.

The three financial assistance programmes for Greece



SECOND PROGRAMME

Initial programme amount: €165.4 billion Total amount disbursed: €153.8 billion

Lenders: EFSF: €141.8 billion (including €48.2 billion for bank recapitalisation, €34.6 billion for private sector involvement and bond interest facilities) of which €10.9 billion for bank recapitalisation were not used by the HFSF and were returned to the EFSF

Maximum weighted average maturity on EFSF loans extended to a maximum 32.5 years from 7.5

Interest rate: guarantee fee cancelled on EFSF loans and some interest payments deferred by 10 years; IMF – between 2.85% and 3.78%

Key legislated reforms: labour market, income tax, public administration, structural reforms

EUROPEAN DEBT RELIEF BENEFITS GREECE

Euro area countries have taken many steps to ease Greece's overall repayment burden 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 a longer repayment period. Nominal haircuts on the debt have not been undertaken.

First Greek programme (no EFSF or ESM involvement)

In the first programme, euro area countries cut borrowing rates, and put off and extended the repayment period. When Greece first asked for financial assistance from the EU, there was no lender of last resort for governments yet. Under that programme, known as the Greek Loan Facility (GLF), euro area countries lent Greece €52.9 billion on a bilateral basis, and the IMF another €20.1 billion.

Begun in April 2010, the programme was amended in June 2011:

- the maturity was extended by five to 10 years,
- the grace period was lengthened to 4.5 from three years,
- the margin was lowered by 100 basis points, to 2% in the first three years and 3% thereafter.

This change was replaced by the second amendment in March 2012:

- maturities were extended to 15 years,
- the grace period raised to 10 years,
- the margin was further reduced to 150 basis points over the entire period.

Second Greek programme (EFSF involvement)

In the second, they adopt another similar set of measures.

The EFSF, Europe's temporary rescue fund, had already been in operation for nearly two years when the second Greek assistance programme began in March 2012. In November of that year, this second programme introduced additional debt alleviation measures. Worse-than-expected macroeconomic developments, missed targets, and prolonged policy uncertainty 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.

Third Greek programme (ESM programme)

In August 2015, Europe's permanent rescue fund, the ESM, launched the third programme for Greece. As of 31 December 2015, it had disbursed €21.4 billion to Greece under this programme of up to €86 billion total agreed financial assistance. This programme was needed to help Greece tackle worsening macroeconomic conditions and a serious deterioration in the banking sector. The weighted average maturity of the loans to Greece was fixed at 32.5 years and lending rates were, as in all programmes, based on the ESM's low cost of funding.

In 2015, the ESM took on the third programme for Greece.

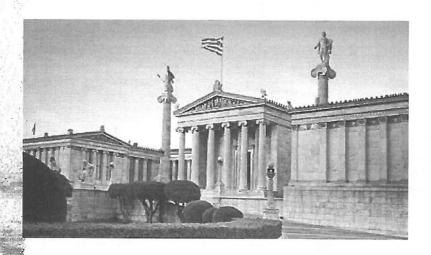
Low financing costs

The low financing costs of the European facilities reduced Greece's debt servicing burden, thereby providing authorities with greater fiscal flexibility. The GLF, the EFSF, and ESM rates are well below market rates for Greece. The EFSF and ESM lending rates (excluding fees) stood at 1.57% and 0.72%, respectively, as of end-December 2015. The EFSF and ESM rates compare favourably with the 2015 IMF lending rate of around 3.8%.(4) They also remain far below the roughly 5% rates that Greece had to pay for corresponding maturities before the crisis and its current market rates. Financing at the EFSF, ESM, and GLF rates therefore entails an important support component compared to other sources of financing.

The low financing costs of the European facilities create fiscal space.

As far as EFSF/ESM financial assistance is concerned, the simplest way to estimate the savings achieved over the past years is to compare the effective interest rate payments on EFSF/ESM loans with the interest rate that these countries would have paid had they been able to cover their financing needs in the market in the absence of disruption. The proposed approach values every single disbursement in the past at the average market 10-year bond yield in a year.^[5]

^[9] The market interest rate is capped at a maximum of 6.4%, which represents the highest rate at which euro area countries issued a bond over the past eight years. This cap is imposed because secondary bond markets do not provide reliable pricing information at times of distress given very high rates.



⁽⁴⁾ For 2016, the implicit interest rate is projected to reach 3.10% by end-December 2016, assuming no new disbursements.

6 5.0 5.1 5 4.1 6 0.4 3.7 3 1.9 2 0.4 0.6 0.7 0.7 0.1 0.3 0.3 0.4 0.3 0.2 0.2 0.2 0.2 0.0 n 2012 2012 2013 2014 2015 2012 2014 2012 2012 2013 2014 2016 2018 2012 2012 2013 2014 201 Greece - EFSF Ireland Greece - ESM Spain Cyprus Portugal Source: ESM

Figure 20: Potential budgetary savings from EFSF/ESM low cost of financing (in % GDP)

The EFSF and ESM pass on their low financing costs to the borrowing country.

Figure 20 shows the savings for Greece and the other countries benefitting from EFSF/ESM financial assistance. Savings are presented as a percentage of GDP. The deferral of interest payments granted to Greece on EFSF loans is depicted in light colour. The figure shows that all countries benefitted from low interest rates, though the financial advantage is by far the largest for Greece given the massive size of the financial support. Benefits increased in all cases with the disbursement of the programme. They have slightly decreased recently for Ireland in view of its improved financing conditions. However this effect is expected to be temporary, when the more expensive loans provided initially under EFSF mature. (4) The deferral of interest rates, which was only granted to Greece in view of its special debt challenges, provides an additional advantage in current budgetary savings, representing a total 5.1% of GDP in 2015. The deferred payments will, however, become due after 2022.

Effective reduction of the debt burden

Greece benefits in the long run through a more sustainable debt burden The measures correspond to substantial economic debt relief. Considering the 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. The NPV approach consists of discounting the difference between the future cash flows of the loans with lower financing costs and debt relief measures and the cash flows of such loans had they not benefitted from the relief measures. 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 for Greece from a financial market perspective.[7]

The reduction of the debt burden in NPV terms and savings from the various relief measures described above leads to NPV savings equivalent to 51% of Greece's 2015 GDP. Excluding ANFA and SMP profits, the debt relief for Greece in NPV terms rep-

^[6] See also the section on lending in Chapter 2.

^[7] It should be noted that this does not entail any financial loss or writedown 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.

resents 40% of outstanding debt to European official creditors; this, however, implies no reduction in nominal debt and therefore no cost for the European taxpayer.

The overall savings figure comprises first an NPV reduction for the EFSF facilities of 32% of GDP, of which 3% of GDP can be attributed to the extension of maturities and interest rate deferral, and 29% of GDP can be attributed to the savings from the low financing rate. The ESM disbursed facilities as of end of 2015 created another NPV reduction of 5% of GDP thanks to favourable financing rates. To these numbers, one can add the impact of the extension of maturities and the lowering of the margin for the GLF. This generated another 9% NPV savings of GDP. Finally, the return of SMP profits added up to 5% of GDP.

This overall NPV savings figure and its breakdown is based on assumptions of the interest Greece would have to pay on the market, compared to estimates of the future EFSF cost of funding.(8) Figure 21 summarises the breakdown of overall savings.

The ESM calculates those NPV gains at 51% of Greek 2015 GDP.

Debt repayment

The debt relief measures taken by its European creditors represent a substantial benefit in fiscal space and overall payment profile for Greece. Payment obligations are minimal until 2023. Thereafter, the repayments stretch out over several decades. The favourable lending rates and the lengthy repayment periods were considered adequate at the time to safeguard the sustainability of Greek debt provided that Greece continued its reform agenda.

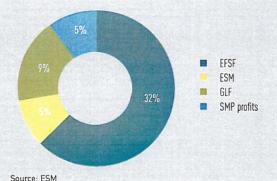
Views on how to best assess debt sustainability are evolving. There is a growing consensus in line with the EFSF/ESM view that debt sustainability depends not only on the overall amount of liabilities, but also on the underlying debt structure, in particular its maturity. On this score, key to debt sustainability are:

One must consensus

- a downward sloping path for the overall debt stock, and
- a sufficiently modest level of annual gross financing needs, a metric which reflects the fiscal stance and debt service flows.

To assess the sustainability of debt, one must consider more than its overall amount

Figure 21: Long-run net present value savings for Greece from European financial support (in % gross domestic product)



^[8] Estimates of future EFSF and ESM cost of funding are based on expected interest rates (forward rates) derived from market data which are applied to future EFSF and ESM funding volumes. The rates Greece would have to pay on the market are based on the EFSF and ESM cost of funding plus estimates of spreads.