EUROPEAN ECONOMICS UPDATE
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CAPITAL ECONOMICS

Greece's second bail-out deal far from being concluded

- **The dispute over the provision of collateral by Greece to some euro-zone economies in return for a second bail-out, coupled with the private sector's reluctance to take part in a debt exchange, may not reignite the funding crisis in the near-term. But it supports our long-held view that a major debt restructuring is inevitable and that Greece may eventually have to leave the euro-zone too.**
- Reports last week suggesting that Greece may provide Finland with collateral worth 20% of the value of Finland's loan guarantees as part of the second bail-out package prompted the Netherlands, Austria, Slovakia and Slovenia to suggest that they may demand a similar deal too. It also highlighted the core economies' continued opposition towards a fiscal union. **We estimate that if all five economies demand the same deal as Finland, Greece might have to set aside up to €13bn of its new €109bn loan package as collateral.** Unsurprisingly, this led Greek yields to rise sharply. (See Chart 1.)
- **Of course, the latest spat may not be disastrous.** After all, thanks to the existing rescue package, the Greek Government will have enough funds in place to roll over all its debts until the end of the year. This leaves policymakers with a bit of time to persuade Finland and/or the other economies to back down, or find other ways to ensure that Greece's financing needs for the next three years are met.
- **Nonetheless, this latest development will inevitably raise concerns that the second rescue package may flounder before it is even up and running.** After all, doubts over whether enough private-sector creditors will agree to exchange their bonds for new assets, a key element of the deal, have recently intensified. Reports suggest that a lacklustre response from investors to the deal means that creditors holding bonds maturing after 2020 may now be asked to take part. If some core governments deem private sector involvement to be too limited, they might seek to make other alternations to the package.
- **What's more, there remain doubts over whether Greece will be willing or able to meet the budget deficit goals and other conditions of the rescue deal.** Admittedly, the central government deficit in the seven months to July was below target. (See Chart 2.) But it was still higher than a year earlier. And given that Greece has found it harder to reduce the wider and hence more important general government deficit measure in the past, we continue to think it will fail to meet its fiscal goals.
- Note too that the fiscal targets for 2012 and beyond are based on over-optimistic forecasts for economic growth, suggesting that additional austerity measures may be needed to stand any chance of meeting them, which would, needless to say, be extremely unpopular with voters.
- **Most importantly, though, we think that the Greek bail-out package has not done enough to reduce the Government's outstanding debt burden.** (See our *European Economics Update* "Can the new rescue package solve Greece's problems" 1st August.) Accordingly, Greek politicians and voters may eventually decide that the costs of complying with the bail-out deal outweigh the benefits.
- The upshot is that we expect bond yields to remain high, even if the latest problem regarding loan collateral is quickly resolved. **As it appears increasingly likely that Greece will have to suffer years of painful austerity before the core will countenance further steps towards fiscal union, we still think that Greece may eventually decide to restructure its debts again and leave the euro-zone.**

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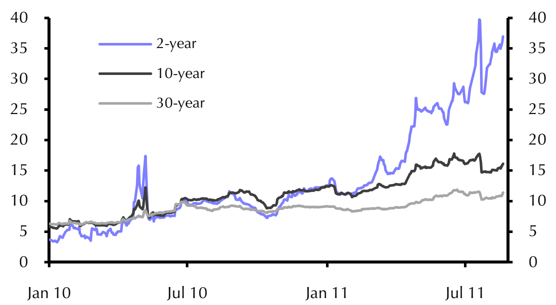
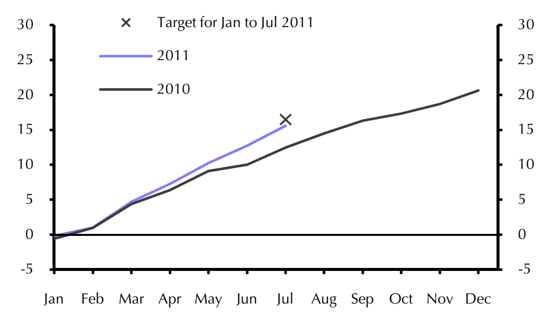
Chart 1: Greek Government Bond Yields (%)



Source – Thomson Datastream

Chart 2: Greek Central Government Deficit (Cumulative €bn)



Sources – Thomson Datastream, Greek Ministry of Finance