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ISSUER COMMENT

Finland-Greek Collateral Agreement Illustrates Euro Area Divisions

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Analyst Contacts:

NEW YORK	1.212.553.1653
Kristin Lindow *Senior Vice President* Kristin.Lindow@moodys.com	1.212.553.3896

On 18 August, Finland (Aaa stable) and Greece (Ca developing) reached preliminary agreement on a side-accord to Greece's latest bailout via the euro area's European Financial Stability Facility (EFSF). The bilateral agreement partially cash-collateralizes Finland's contribution to Greece's second round of support financing, which the European Union and International Monetary Fund agreed to in July. After Finland's announcement, several other euro-area members participating in the financial support package, such as Netherlands, Austria, Slovenia and Slovakia, expressed an interest in pursuing similar bilateral agreements with Greece.

If generalized, these bilateral agreements would be credit negative for Greece and other countries now receiving or potentially in line for bailouts, since it illustrates continued differences among euro area states over the provision of support to their fellow members. The pursuit of such agreements could delay the next tranche of financial support for Greece and so precipitate a payment default.

Finland's contribution to the overall support package for Greece is only about 2% of the total, although the other countries now likely to seek their own collateral agreements with Greece have a larger share in the program. A proliferation of collateral agreements would limit the availability of funds for future programs, as well as the value of the package that the bailout recipients actually receive. It would also imply that the some euro area countries would bear disproportionately large shares of the risk associated with the provision of financial support to other members. Therefore, the agreement between Greece and Finland, which is small by itself, assumes much greater significance. The deep fissures among the ostensibly united euro area nations evidenced by such demands, even in the context of new German and French proposals intended to strengthen European institutions, create additional concerns over the conditional and evolving nature of current financial support mechanisms.

The background to Finland's agreement was the contentious formation of its new coalition government, with the EFSF bailout of Portugal then taking place the main point of controversy. The Social Democratic Party agreed to join the coalition only on the condition that, going forward, the government negotiate bilateral accords with each country receiving European support to assure a skeptical Finnish electorate that the country would get its money back.

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The other countries now likely to seek their own bilateral accords are challenged by equally reluctant voters and concerns about their own credit quality, should they have to provide support to more countries on an ongoing basis.

We expect other euro-area members to ultimately reject the Finland-Greece deal because of the above considerations, but the message sent by the calls for such agreements confirms that Europe is conflicted over the very decision to provide financial support to its members, not just the amount of support.

In this context, the tentative Finnish-Greek collateral accord raises concerns about the willingness and ability of some euro-area policymakers to implement measures that may prove necessary to preserve the stability of the European Monetary Union. This reticence places greater pressure on Germany and France to stake out a strongly supportive stance toward the euro area, with more concrete and immediate effect than the proposals the two countries made last week, in order to shore up the single-currency project.

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Author
Kristin Lindow

Senior Production Associate
Shubhra Bhatnagar