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THE IMPACT ON EU GOVERNMENTS' DEFICIT AND DEBT OF THE DECISIONS TAKEN IN THE 2011-2012 EUROPEAN SUMMITS

In the successive EU summits since July 2011 up to 30 March 2012, major decisions have been taken as regards the financial rescue of Greece, and the reinforced European financial rescue mechanisms for EU Member States (MSs). This note explains the implications of these decisions on the measurement of EDP deficit and debt for MSs, not only for Greece, Portugal and Ireland, but also for the other Euro area MSs participating in the EFSF, as, following Eurostat's decision of January 2010[1], the accounts of the EFSF are partially consolidated with the accounts of the MSs which guarantee the EFSF.

In summary, the note confirms that all EFSF interventions, except a very specific and transitional one relating to ESCB collateral, will increase both the Maastricht debt of the benefitting MSs and of the guarantor MSs. It confirms that the so-called "PSI exchange" in Greece will reduce the Maastricht debt of Greece, to the extent of the decrease in the nominal value of the bonds. It recalls the possible impact on the EDP deficit of MSs due to bank recapitalisations. It also covers specific technical features such as the new potential leveraging tools of the EFSF and interest rate agreements (step up bonds, reduction of interest, GDP growth linked bonds). At this stage, some issues still remain open, as this note refers to information received by Eurostat up to 11 April 2012.

While reading this note, it is important to keep in mind three elements. First, the measures discussed in the present note will not affect the EDP deficit and debt of MSs for 2011.[2] Thus the data included in the notification that will be published by Eurostat on 23 April 2012 and covering the period 2008-2011, will not be affected. Only future deficits and debt, starting in Q1 2012 onwards, will be affected. This is true in particular for the Greek Maastricht debt. Second, the EDP debt is measured at nominal (face) value. This entails that any change in the market (or net present) value of issued debt instruments is not reflected in the level of the EDP debt. Only changes in the nominal (face) value of debt have an impact on the amount of EDP debt.[3] Third, the ESA 95 sequence of accounts reflects any change in the market value of debt in the so-called "revaluation account", which is "below the line" of EDP deficit/surplus. As a result, EDP deficit/surplus is not impacted by any change in the market (or net present) value of debt.

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[1] See Eurostat decision of 27 January 2011: http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-27012011-AP/EN/2-27012011-AP-EN.PDF

[2] Except for the implemented reduction of interest rates for Portugal and Ireland. See section 3 below.

[3] For the experts: the change in the market value of debt is recorded in the so-called "financial accounts", but not in Maastricht debt.

1. Extension of the EFSF range of interventions.

The summits extended the range of types of interventions by the EFSF (and the ESM), such as directly financing MSs for them to recapitalise financial institutions, to purchase bonds at the time of their issuance on the primary market and, under specific conditions, to directly intervene on secondary markets in order to purchase sovereign MS debt. The EFSF can also grant precautionary credit lines to requesting countries. This extension of the coverage of EFSF support is reflected in the "Financial Assistance Facility Agreements" to be signed between the EFSF, the government and the authorities of a Beneficiary Member State.

Eurostat does not consider that the change in the range of types of intervention modifies the nature of the EFSF, which remains an accounting and treasury tool created by MSs to enable the same conditions for access to borrowing for members of the euro area, acting exclusively on behalf of them and under their total control. Because of the above, the EFSF is not an institutional unit as defined in national accounts, and therefore its lending will continue to be partially "rerouted" ("consolidated") in national accounts within the accounts of the governments of euro area MSs, as explained in Eurostat's decision of January 2011.

As a result, all new loans, in particular to Greece, made by the EFSF, are rerouted to the 14 euro area guarantor MSs participating in the operation, according to their contribution key.[4] This recording does not depend on the nature of the counterpart of the loan, whether in cash (if the EFSF borrows on the market) or whether in EFSF bonds (without the need for the EFSF to borrow on the market). As regards the financial rescue for Greece, this should amount globally to a rerouting of up to 144.6 billion euro over the coming years, according to EFSF estimates.[5] When adding the financial rescue to Portugal and Ireland, this could reach up to 188.3 billion euro over the coming years. Eurostat will show these rerouted elements, when they will occur, in the line "Intergovernmental lending" in its quarterly and bi-annual publications on deficit and debt in the euro zone and the EU.

As regards possible direct purchases by the EFSF on primary or secondary markets, if any, Eurostat will reroute these operations to the guarantor MSs in the same way as loans.[6]

2. ESM

The ESM will become operational in July 2012, and will run in parallel with EFSF operations. Contrarily to the EFSF, the ESM will be classified by Eurostat as an international

[4] In the context of its diversified funding strategy, adopted in November 2011 and based on a liquidity buffer, the funds raised on the market by the EFSF are no longer back-to-back attributed to a specific Euro Area country as all resources are now pooled. Therefore, a minor part of the EFSF debt, at the end of each month, has no counterpart as loan to a borrowing country. This liquidity buffer is not rerouted by Eurostat to the guarantor Member States.

[5] This maximum amount does not include 35 billion of notes issued by the EFSF as referred to in the section on the ECB collateral. As explained in this section, part of this loan could be rerouted but only under very specific circumstances. For a global view, see EFSF note: http://www.efsf.europa.eu/about/operations/index.htm

[6] The EFSF could use a technique so-called "variable balance loan" for these interventions. In this system, EFSF will have recourse on the issuing country, which statistically can be considered a form of guarantee to the EFSF, that would compensate the EFSF if the bond would fall under its purchase price by the EFSF. Eurostat will not record this specific guarantee as debt, but consider it as a contingent liability.

organisation and its future loans will not be rerouted to the participating MSs.[7] This is based, in particular, but not exclusively, on the significant amount of paid-in capital invested by MSs in the ESM (80 billion euro, compared to 30 million for the EFSF). Thus, the statistical recording of the EFSF and the ESM will be different during the period of parallel functioning.

3. New features of loans and possible interventions

The summits decided an extension of maturities, compared to the present situation, for the existing Greek facility and for future EFSF loans. In the beginning, the maximum maturity for EFSF loans was 10 years and it has now been extended up to 30 years. Such a change in maturity has no impact, as such, on EDP deficit and debt.

The summit of July 2011 decided a reduction, including retroactively for the past, in the interest rate in the case of the bilateral loans to Greece and also in the case of the first loans granted by the EFSF and EFSM to Ireland and Portugal. Any reduction of interest rates means a reduction of the interest expenditures of the debtor recorded in the national accounts and, thus, a reduction in its EDP deficit.

However, a particular issue concerns the retroactive reduction of interest. In statistics, the a reduction of the deficit of the borrowing countries is to be recorded at the time the retroactive measure is implemented, which is the time of the signature of the formal agreement confirming the decision of July 2011. This formal agreement was signed in late March 2012 for the bilateral loan for Greece, and, as regards EFSM loans, in October 2011 for Ireland and Portugal. The impact of the retroactive reduction of interest will be therefore shown in 2012 for Greece and 2011 for Ireland and Portugal. However, for the first loans granted by the EFSF, the exact amount of the retroactive reduction of interest will be known with certainty only at maturity of the loans and thus the rebate will have an impact only at maturity.

In addition to normal loans, the EFSF now has the possibility to leverage its loan capacity. This could be implemented in two ways. First, a Special Purpose Vehicle (SPV) could grant, at the request of the issuers Member States, partial protection (likely to be around 20% or 30%[8]) to bond holders, by way of “Sovereign protection certificates” (issued by a limited liability company which has been registered in Luxembourg as "European Sovereign Bond Protection Facility"). These certificates, provided at the same time of issuance of bonds by an Euroarea MS, would represent the right of their holders to be paid in cash in case of credit events related to the issuer of bonds. At that time, the EFSF would record a loan to the defaulting country. From a statistical point of view, there would be no impact on the debt of the guarantor MSs as long as the protection is not activated, i.e. it does not give rise to a loan from the EFSF. The certificates will be classified as financial derivatives (not included in the Maastricht debt).

Second, the EFSF has set up a “Co-Investment Fund” (CIF) as a Luxembourg-based securitisation vehicle investing in bonds (purchased on secondary market). The EFSF would partly (up to 30%) fund the CIF (structured by compartments related to a beneficiary country) in a specific tranche (“First loss”) which will provide a protection, for the strict limit of the tranche, to other investors in the Fund (“participating tranche” and, possibly “senior

[7] See Eurostat opinion of 7 April 2011: http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/documents/Eurostats_preliminary_view_on_the_recording_of_the_futu.pdf
[8] Erratum: In a previous version of this note, these numbers were, wrongly, mentioned as 30%/40%.

tranche"). If the CIF is activated, Eurostat will reroute to the guarantor MSs the amounts provided by EFSF for the "First Loss" tranche.

4. Bank recapitalisation by Greece or other MSs

Some EFSF loans (possibly under the form of its own bonds or notes in a first stage) will be granted to Member States, and in particular to Greece, which will use the funds, directly or through specific government bodies, for capital injections into their banks. Such bank recapitalisations have already taken place in Greece, Ireland and Portugal.

Existing accounting rules consider two possibilities as regards recapitalisation: either record them as a financial transaction (the government obtains equity in exchange to cash or equivalent) or as expenditure (the transaction is then recorded as a capital transfer from government to the benefitting entity). In the latter case, this impacts the government deficit.

This impact will be assessed on the basis of the existing rules stated by Eurostat. Notably, as mentioned in the Guidance note of July 2009 in the context of the financial crisis[9], the nature of the form of the recapitalisation (ordinary or preferred shares where EU State Aid rules on rates of return) are considered. More generally, as usual, several criteria are to be considered in order to decide on the treatment of these operations, which may impact the government deficit: price of the equity instruments, possible participation of private shareholders, past losses of the bank and long term profitability of each bank benefiting from the operation (whether a market rate of return will be achieved or not). Recapitalisations of Greek banks, Irish banks or Portuguese banks by their respective governments are therefore to be considered on a case by case basis.[10]

It is to be noted that the programme deficit ceilings for Greece, Ireland and Portugal are calculated excluding any impact of bank recapitalisations.

5. Private Sector Involvement for Greece: exchange of bonds at discount (PSI)

At the beginning of March 2012, the private sector supported Greece on a voluntary basis by participating in an exchange of existing Greek Government bonds – maturing in the next few years - against new Greek Government bonds with longer maturity (from 11 to 30 years). In terms of net present value, taking into account all time-discounted flows (interest and principal) related to the bonds, the private sector has realised a loss close to 73%. For its part, the reduction in nominal value (which is the relevant valuation for Maastricht debt) is equal to 53.5%.

In terms of principal amount, the bond holders received for each 100 of old Greek bonds, 31.5 of new bonds and 15 of EFSF one-year and two-year notes, in equal proportions. The latter corresponds to a loan made to Greece by the EFSF (for an amount of up to EUR 30 billion, of which 26.6 was already disbursed at the end of March 2012). This loan is treated in statistics similarly to other loans granted by the EFSF and, thus, will increase Greece's debt and will be rerouted to the guarantor Member States, as part of their own Maastricht debt. The loan will

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[9] http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/documents/Eurostat_guidance_note_FT_-_10_September_2009.pdf

[10] In Greece, the Hellenic Financial Stability Fund (HFSF) will be significantly involved in bank recapitalisation. HFSF is classified inside the general government. The maximum involvement of the Greek general government in future bank recapitalisation is estimated at up to around 50 billion euro.

be reimbursed by Greece to the EFSF, which will use it, in parallel, to reimburse the private bond holders.

The PSI exchange is treated in national accounts as a market operation, similar to buybacks by issuers of bonds on the market. The Collective Action Clauses, recently set up for the existing Greek Government Bonds issued under Greek Law (which covers about 95% of the exchangeable Greek Government bonds), has been activated, but the exchange is considered as voluntary because the condition of a minimum majority has been reached through the participating rate to the exchange before the activation. Overall, Greek Maastricht debt towards the vast majority of private bond holders should be reduced to around 60 billion, from around 200 billion. There will be no impact on the Greek EDP deficit.

As regards the very small minority of bonds which were not exchanged by some holders after the final settlement date of 25 April 2012, they will be recorded in statistics until their maturity (interest still being accrued with an impact on the deficit) at their nominal value in Greece's Maastricht debt, as, in national accounts, any unilateral decision by a debtor as regards its repayment obligations are not taken into account ("no debt repudiation"). They will remain as part of the Greek debt until maturity.

In addition, the agreement includes a clause by which the interest accrued and not yet paid on existing Greek bonds is provided to private bond holders in the form of EFSF 6-month bills (for a total amount of up to EUR 5.5 bn, of which 4.6 was disbursed at the end of March 2012). A corresponding additional loan is made by EFSF to Greece, thus increasing Greek Maastricht debt (and the Maastricht debt of guarantor MS).

The new Greek Government Bonds are issued with a "step-up" coupon system. Under such an arrangement, the interest applied to the principal outstanding amount progressively increases by periods (2% from 2012 to 2015; 3% from 2015 to 2020; 4.3% from 2020 to 2042). In national accounts, interest must be accrued according to the market rate (yield-to-maturity) observed at issuance, which is consistent with the "debtor approach" of national accounts. This rate, an average of the stepped rates, will be between the lower early rate (2%) and the higher latest rate (4.3%). Thus the impact on the Greek deficit will be larger than the coupon actually paid during the early years, and smaller in the later years.

In addition, the holders of the new Government Greek Bonds receive a right to a supplementary remuneration linked to the real growth performance of Greece under some conditions and capped at 1%. Such a right takes the form of a specific security (with a notional amount equal to the face value of the new bond) which is to be recorded as a financial derivative. These certificates are not included in the Greek Government debt. In accordance with specific rules for EDP purposes (recording of interest on financial derivatives), and ESA rules related to indexed instruments, the supplementary remuneration, if any, will be recorded as interest expenditure of the Greek government, with an impact on its deficit.

6. ESCB involvement for Greece

Part of the Greek bonds are used as collateral, mainly by Greek banks, in the context of repos with the ECB and transferred to National Central Banks in the context of the practical arrangements for monetary policy. As Greece was considered in temporary selective default by rating agencies when the PSI started, a specific facility of 35 Billion euro from the EFSF has been set up at the same time, for the buy-back by Greece of the Greek Government bonds that the Eurosystem national central banks hold as collateral, in order to back these collateral operation during the temporary selective default period. This facility took the form of bonds issued by the EFSF and transferred to Greece, to be used exclusively as specific collateral for a short period.

This operation is neutral on the level of the Maastricht debt of Greece. It is foreseen that the facility will be cancelled when the selective default ends, so that the Greek Government Bonds would again be eligible as collateral for monetary policy purposes. However, if a National Central Bank would exceptionally need to draw on the collateral during the selective default period, the Greek Government would not be in a position to give back the corresponding amount of EFSF bonds and thus would be committed to repay in cash this amount to the EFSF over a longer period (25 years). Only in this case, these bonds will be part of Greek Maastricht debt and also rerouted to the guarantor MS. The period during which this could happen will expire very soon.

The conclusions of the February 21 2012 Eurogroup also mentions transactions linked to bonds held by the ECB and National Central Banks (NCBs) for purposes other than collateralisation, but under the "Securities Market Programme", or purchased using own resources. These bonds have been exchanged with new bonds, without a haircut, and the corresponding profit will be redistributed, via the NCBs, to government shareholders of NCBs. These transactions should be classified in statistics as pure financial transactions with no impact on deficit/surplus of Member states.

The conclusions also mention a commitment by Member States to "pass on to Greece" any future income accruing to their national central bank, stemming from their portfolio of Greek Government Bonds until 2020. The term "pass on to Greece" needs to be clarified before reaching a conclusion on the statistical treatment of this future transaction. However, if the passing of future income is not linked to any obligation for Greece to return the income, this should be recorded as an expenditure of MSs and a revenue to Greece (capital transfer). The recent Compliance report on Greece notes that these amounts will, in any case, be neutralised in the programme deficit ceilings.

7. IMF transactions

IMF loans related to the programmes are included in the Maastricht debt of beneficiary countries.

Independently of this, in the November 2011 Summit, the reinforcement of the IMF in the support operations to the benefit of some Euro Area Member States has been evoked. In this context, the resources of the IMF could be increased under the form of loans from some Member States. However, there is still uncertainty on the practical modalities of the operation. The loans could be granted by Member States through their national Central Banks. A procedure of “General Agreements of Borrowing", in force since 1983, and of "New AB", since 1998, with a significant increase in 2011, already exists. Such arrangements normally have no impact on government debt, both at time of their signature (contingent commitment) and when activated (provision of cash to the IMF). However, it has not been confirmed at this stage whether the above-mentioned specific financing for EA support by the IMF would fully fall under such arrangements. If this is not the case, Eurostat will closely consider the possible impact on government finance of the lender Member States.