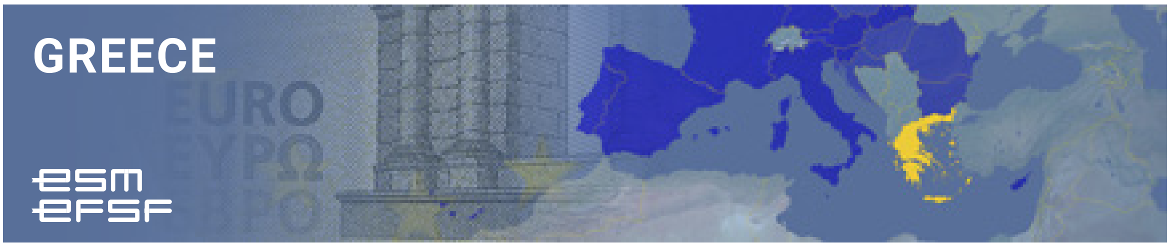


Greece returned to financial markets in 2017, supported by economic growth and successful reform implementation under the second and third reviews of the ESM programme. Despite strengthened market confidence, the Greek economy faces a difficult economic and financial environment. Greece must address remaining challenges before the programme concludes to ensure that it can build upon its significant programme achievements in the post-programme period.

In 2017, Greece made substantial progress in implementing reforms under the ESM programme, which aims at restoring fiscal sustainability, safeguarding financial stability, boosting growth, competitiveness, and investment, as well as fostering a modern state and public administration. The government also continued clearing arrears using ESM funds and its own resources, and thereby provided direct support to the real economy. The officially recorded stock of arrears, including tax refunds, stood at €3.3 billion at the end of 2017, the lowest level since December 2014.

Following successful policy implementation in the second and third reviews, the ESM governing bodies approved financial assistance of €15.2 billion between July 2017 and March 2018, of which €3.1 billion was allocated to arrears clearance. As a result, €45.9 billion[3] of the up-to-€86 billion programme envelope was disbursed since the initiation of the programme, with, however, just €43.9 billion currently outstanding as Greece prepaid €2 billion in February 2017 related to the redemption of contingent convertible bonds (CoCos) from a bank recapitalisation in which it used ESM funding. Up to €39.1 billion is available until the programme ends in August 2018. Part of this amount should be disbursed in the final programme review, while the rest might be used as part of possible debt measures to be decided by the end of the programme.

For the first time since 2006, the Greek economy grew for four consecutive quarters in 2017, supported by the completion of the second review in June, which helped stem uncertainty and ease market conditions. Economic activity rose by 1.4% in 2017, as increasing investment compensated for declining net exports and government consumption, while private consumption remained largely stable. The European Commission's spring forecast predicts that GDP will increase by 1.9% in 2018 and 2.3% in 2019, and that the current account deficit will narrow to 0.4% and 0.5% of GDP, respectively, from 0.9% of GDP in 2017.

Greece outperformed the ESM programme fiscal targets by a wide margin for the third successive year. According to Eurostat, the primary surplus reached 4.0% of GDP in 2017. This translates into a surplus of 4.2% in programme terms, which exceeds the 1.75% target by 2½% of GDP. The 2015 and 2016 fiscal reforms supported revenue growth, although lower-than-envisaged public investment also boosted the surplus. The authorities legislated additional fiscal measures for the post-programme period as part of the second review to provide further safeguards that the 3.5% of GDP medium-term primary surplus target will be reached. These measures complement existing reform packages by, most notably, adjusting pensions to the new rules as of 2019 and by broadening the personal income tax base as of 2020 if not pulled forward. Additionally, but contingent on the achievement of the medium-term primary surplus target, tax reductions and targeted spending for labour market policies, investment, and welfare will underpin growth. Greece has already implemented some welfare measures in 2017, including the roll-out of the social solidarity income scheme.

Government debt remained elevated at 178.6% of GDP in 2017. To address concerns regarding the sustainability of Greece's public debt, the ESM has successfully implemented the short-term debt relief measures agreed by the Eurogroup at the end of 2016 (Please see page 28). The ESM estimates that by 2060, these measures will reduce Greece's debt-to-GDP ratio by around 25 percentage points and gross financing needs by almost six percentage points. According to the Eurogroup, a second set of debt measures could be implemented after the successful completion of the ESM programme, if needed, to restore debt sustainability. This could include, among other measures, an EFSF re-profiling with an extension

[3] This amount does not include the €1 billion that was approved in the third review for arrears clearance and which is expected to be disbursed by mid-June.

of the weighted average maturity and a further deferral of EFSF interest and amortisation payments between zero and 15 years, which should respect the EFSF's maximum programme authorised amount. To take into account possible differences between growth assumptions and actual growth developments over the post-programme period, the EFSF re-profiling would be recalibrated according to an operational growth-adjustment mechanism to be agreed.

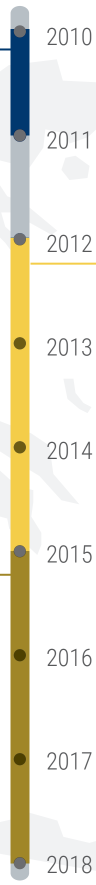
In its first international bond sale since 2014, Greece issued a 5-year bond in July 2017, followed by a liability management operation involving €25.5 billion in November 2017 and a 7-year bond issue in February 2018. The two bond issues raised a total of €4.4 billion at overall favourable rates, helping to build a cash buffer before the programme exit.

The year 2017 also saw the full operationalisation of the Hellenic Corporation of Assets and Participations. This company manages key Greek assets to maximise their financial returns as well as the quality of services that state-owned enterprises and real estate provide to the Greek public. The company's proceeds will assist Greece with debt reduction, as well as support investment and growth.

Greek banks remained stressed due to a very high NPL level of 43.1% of gross loans at the end of 2017. Although banks were meeting targets to reduce the stock, they must step up efforts to meet more ambitious targets over the next two years. In 2017, the government introduced important legislation to assist banks in reducing NPLs to 35.3% by the end of 2019 through an out-of-court workout law and the establishment of an electronic auction platform for the sale of assets. Initial results are, however, below expectations. NPL reduction is a key input into the supervisory stress tests, which determine whether the banks have sufficient capital to absorb losses under different scenarios.

Greece has made significant progress in stabilising its economy. Continuing on this path is decisive for the sovereign to regain stable market access. Timely implementation of outstanding reform commitments will be important to further strengthen the economy and solidify market confidence.

The three financial assistance programmes for Greece



FIRST PROGRAMME (I)
agreed in 2010

Initial programme amount: €110 billion

Total amount disbursed: €73 billion

Lenders: Euro area countries (except Slovakia) under Greek Loan Facility (GLF) managed by the European Commission: €52.9 billion; IMF: €20.1 billion

Grace period and maturity on GLF loans extended in 2012 to 10 and 30 years from 3 and 5 years, respectively

Interest rate: priced with Euribor 3-month with a margin lowered to 50 basis points from 300 basis points for GLF; IMF – around 3.96%

Key areas of legislated reforms: Pension system, healthcare system, public financial management, state budget, public sector benefits, labour market, closed professions

SECOND PROGRAMME (II)
agreed in 2012

Initial programme amount: €164.5 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 was not used by the Hellenic Financial Stability Fund (HFSF) and was returned to the EFSF; IMF: €12 billion

Maximum weighted average maturity on EFSF loans extended in 2012 to a maximum 32.5 years from 17.5

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

Key areas of legislated reforms: Labour market, income tax, public administration, social protection, health system, public financial management, business environment

THIRD PROGRAMME (III)
agreed in 2015

Total amount committed: up to €86 billion

Total amount disbursed: €45.9 billion

Lenders: ESM: up to €86 billion (including up to €25 billion for bank recapitalisation); IMF: €1.6 billion if the precautionary stand-by arrangement becomes effective

Maximum weighted average maturity: 32.5 years

Interest rate for cash disbursements: 0.95% (early March 2018)

Key areas of legislated reforms: VAT, personal income tax, pension system, corporate and household insolvency law, out-of-court debt workout, sales and servicing of loans (NPLs), establishment of independent public revenue agency and independent fund for management, investment and monetisation of state assets, public administration, social protection

> Working in the ESM mission team to Greece is exceptionally challenging, as we operate under intense pressure and very tight deadlines. There is an immense team effort and commitment by all colleagues to ensure that we achieve success for Greece, which makes this time one of the most rewarding of my professional career.
>
> MIKE HESKETH
> **Principal Banking Expert**

ESM cuts interest rate risk for Greece on loans, measures also reduce long-term debt burden

ESM's short-term measures cut the interest rate risk for Greece on its outstanding ESM and EFSF loans.

The ESM projects the measures will decrease Greece's debt burden.

The ESM reduced the interest rate risk on Greece's outstanding ESM and EFSF loans by successfully conducting the short-term debt relief measures for Greece in 2017.

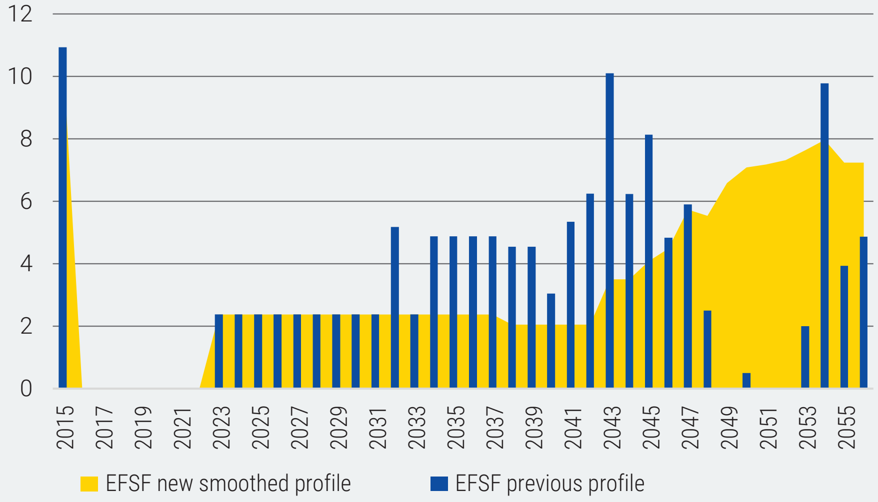
Specifically, the ESM estimates that by 2060 the total package will lower the country's debt-to-GDP ratio by about 25 percentage points and the gross financing needs-to-GDP ratio by around six percentage points. The three short-term measures designed and carried out by the ESM consist of: smoothing Greece's repayment profile; reducing interest rate risk; and waiving the step-up interest rate margin for 2017. The euro area finance ministers mandated the ESM to elaborate these measures in May 2016, endorsing the ESM's proposals the following December. Both the ESM and EFSF Board of Directors adopted them the following month. In their May 2016 statement, the finance ministers also mentioned a possible second set of measures, known as medium-term measures, as well as a contingency mechanism to ensure long-run debt sustainability if an adverse economic situation arises.

Short-term measures

Measure 1: Smoothing the EFSF repayment profile under the current weighted average maturity

The maximum weighted average maturity under the EFSF master agreement was set at 32.5 years. But it dropped to about 28 years after Greece returned bonds to the EFSF in February 2015. The maturity has now been brought back to the maximum of 32.5 years, and the repayment schedule has been re-profiled, to avoid a number of repayment humps in the 2030s and 2040s (Figure 15).

Figure 15
EFSF loans: previous profile vs. new smoothed profile
(in € billion)



Source: ESM

Measure 2: Using the EFSF/ESM funding strategy to reduce interest rate risk without incurring any additional costs for former programme countries

There are three different schemes for the second measure, which focus on locking in the current low interest rates. These bring the largest beneficial effects to Greece in the long term without incurring any additional costs for former programme countries. However, these long-term gains carry some short-term costs.

- **Scheme 1: Bond exchange.** To recapitalise banks, the EFSF/ESM provided loans to Greece worth €42.7 billion during 2012 and 2015. These loans were not disbursed in cash but in the form of floating rate notes. The ESM has now exchanged those notes for cash, funded through long-term fixed-rate funding instruments. This exchange was neutral for Greek banks and needed their consent for implementation. This scheme significantly reduces the interest rate risk that Greece bears.
- **Scheme 2: Swap operations.** The variability of interest rates associated with an ESM loan can be reduced by swapping floating for fixed interest rates. Fixing the interest rate for part of the ESM loan will provide more certainty and predictability on the future stream of interest rates that Greece will pay to the ESM. The ESM put the swap programme in place, and will continue to be active in the derivatives markets to maintain it.
- **Scheme 3: Matched funding.** The ESM can internally allocate the proceeds of long-term issues exclusively to future loan disbursements to Greece. The ESM may continue to use this scheme in 2018, subject to market conditions.

Measure 3: Waiving the step-up interest rate margin related to the debt buy-back tranche of the second Greek programme for the year 2017

In December 2012, the EFSF provided €11.3 billion for financing Greece's debt buy-back operations. A margin of 2% had originally been foreseen from 2017 onwards but was not charged for 2017. This constitutes a relief for Greece of around €220 million.

Impact of the short-term measures

The bond exchange and the interest rate swaps are providing Greece with the most relief.

The short-term debt measures improve Greece's debt sustainability. When implemented in full, these measures should lead to a reduction of Greece's debt-to-GDP ratio of around 25 percentage points until 2060, according to ESM estimates. It is also expected that Greece's gross financing needs will fall by around six percentage points over the same time horizon. The bond exchange and the interest rate swaps make up the largest part of this reduction. Second-round effects on Greece's refinancing rates would be an additional benefit. However, caution is warranted. The impact of some of the measures hinges on several factors beyond the ESM's control. These include the interest rate environment and the availability of other market participants to conclude some transactions.

The short-term measures are seen reducing the overall debt burden by around 10% of GDP.

From a net present value (NPV) perspective, the short-term measures reduce the overall debt burden by around 10% of GDP. The NPV approach consists of discounting the difference between the future cash flows of EFSF and ESM loans before and after the short-term measures. The discount factor reflects the weighted average cost of financing total Greek debt. The NPV gains increase if the second-round effect of lower market refinancing rates for Greece due to the short-term measures is taken into consideration. The eventual aggregate impact of these measures depends, however, on the size and timing of market transactions and the combination of schemes.