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EUROPEAN MARKET COMMENTARY

A Note on the Greek Drama

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Current events in Greece are unlikely to lead to a breakup of the European Monetary Union, but underline concerns over sovereign indebtedness and associated risks to global currency, credit, and equity markets.

"No one can pretend that in all possible circumstances a Greek default is—for those outside Greece—economically preferable to 'determined and co-ordinated action'."
—Tommaso Padoa-Schioppa, President of Notre Europe, *Financial Times*, February 18, 2010.

The resolution of the unfolding Greek financial drama remains far from clear. However, in our view events are playing out largely along the lines discussed in our April 2009 Market Commentary on the euro, *Breaking Up Is Hard to Do*. Put simply, we believe the likelihood of Greece leaving the Eurozone is small, and even under such an eventuality, we would not expect the euro to break up, although the currency could certainly continue to weaken. The Greek situation may turn out to have far-reaching implications (e.g., by setting a precedent for a euro-member bailout); however, in our opinion, such an event is not predictable. We feel we can say two things with some confidence. First, we fully expect Greece to receive some sort of bailout rather than go into default, and second, we expect the issue of sovereign defaults to get significantly worse before it gets better.

Our Views on the Euro

As noted, our views have changed little since we published our report on the euro last April. At that time, we characterized the options available to a country in Greece's situation as follows:

1. The country in question could attempt to issue more debt, albeit at punitive rates. Such an outcome might or might not be viable, depending on the specifics of the situation, although it would also be possible for the European Central Bank to purchase the debt if private buyers did not emerge (essentially the "quantitative easing" currently employed by the Federal Reserve, Bank of England, and Bank of Japan).
2. Other countries (likely France or Germany) could bail out the country and/or its banking system. While neither country has given any indication it is even considering such a step, and would likely face strong internal resistance to the idea, we cannot rule out this possibility.*
3. The International Monetary Fund (IMF) or some other international organization could bail out the country. Indeed, the recent G20 decision to triple the organization's lending capacity to US$750 billion makes it much more likely such a bailout could become reality.
4. The country could opt out of the euro.

* While EU rules technically prohibit countries from bailing each other out, few expect this to be an insurmountable hurdle. As EU Economic and Monetary Affairs Commissioner Joaquín Almunia said in March, "If a crisis emerges in one euro area country, there is a solution…Before visiting the IMF, you can be sure there is a solution and you can be sure that it is not clever to talk in public about this solution."

Option 1 has thus far remained viable, due largely to recent austerity measures. However, Greece's ability to borrow in the public markets has also been aided by investor confidence that a bailout (option 2) will occur if necessary. *Whatever the exact mechanics of the bailout, the bottom line is that one will surface if required, and as a result, we do not believe this crisis poses any short-term threat to the existence of the euro.* As we noted last year, "benefits outweigh costs for the vast majority of participants; in other words, it is in everyone's interest to maintain the EMU [European Monetary Union]. The question thus becomes whether a euro breakup could happen *in spite of this*. While such an outcome is certainly possible, it seems unlikely to occur anytime soon." This remains our view today.

While the Greek situation has highlighted some of the problems inherent in the euro structure (e.g., inflexible interest rates for countries with widely disparate economies), the fact is that the euro remains a net benefit for virtually all participants. For example, while some have noted that Greece could devalue its currency were it not part of the euro, such an option is almost certainly less palatable than current discussions of a bailout, which would not take place were Greece on its own. (Not to mention that interest rates for Greek debt would be significantly higher, if the country was even able to issue debt.) It is also worth mentioning that Greece has some specific characteristics—e.g., a low-wage/low-productivity workforce that gained fairly sudden access to easy credit thanks to the euro's fixed exchange rates—that contributed to its plight (and which it shares to a large degree with fellow euro members Portugal and Spain).

Countries such as France and Germany, meanwhile, rightly see the euro as smoothing trade flows and providing some sort of economic cohesion to the region, and are likely more inclined to support a bailout (as unpopular as this may be with citizens) than to allow Greece to fracture the Eurozone and wreak havoc on the region. From a broader perspective, there simply seems no political appetite for allowing any sort of substantive default after the Lehman Brothers experience, and as a result, we fully expect policymakers to pull whatever levers are necessary to prevent a breakup, both now and for the foreseeable future.

Recent Events and Context

Greek financial difficulties are not new—according to several published reports, the country has been in default for 105 of the past 200 years. In 2004, the country admitted that it had fudged financial data prior to joining the EMU in 2001 (without which admission would likely have been denied), and since joining has managed to stay within the Stability and Growth Pact limits on deficits for only one year (2006). While Greece is far from unique in flouting these requirements, its dodgy data and external financing problems set the country apart. Greece has among the largest budget deficits (2009 estimate: 12.7%) and debt/GDP ratios in the Eurozone (Exhibits 1 and 2). Such problems have been building for a number of years, due in large part to a bloated and inefficient public sector (government spending accounts for roughly 40% of the country's GDP) as well as lax fiscal controls.

Greece also has a credibility problem with the market, which has been exacerbated by recent events. Government officials, for example, said in March that the country's 2009 budget deficit would be 4% of GDP; in October, the new government admitted the true figure was more than 12%, which led to downgrades from all three major ratings agencies in December. This in turn brought Greek government debt perilously close to being ineligible for use as collateral with the European Central Bank, which put pressure on bond prices and sparked concerns about Greek banks (as large holders of the country's debt).

Then, in January, a poorly executed bond deal precipitated the current crisis, as investors became concerned that Greece—which has a funding need of approximately €60 billion in 2010,[1] equivalent to roughly 20% of its

[1] BofA Merrill Lynch, "Greece: What If?," January 27, 2010.

outstanding debts—might not be able to meet its financing needs. Indeed, in the weeks since the crisis erupted, spreads on Greek sovereign bonds and credit default swaps have widened dramatically (Exhibit 3), which raises the question of whether the country will be able to roll over approximately €17 billion of government debt that matures in April and May.

On January 15, Greece submitted to the European Commission its annual stability program for the period 2010-13, which outlined a series of proposed measures to reduce deficits. This plan was accepted by the commission on February 3, with the caveat that additional monitoring and updates would be required to ensure full compliance. While this initially calmed markets, spreads on Greek debt subsequently drifted wider, prompting a February 11 announcement that European Union (EU) Heads of State and Government "fully support the efforts of the Greek government" in achieving their targets. Finally, to put additional pressure on Greece and build on the European Commission monitoring requirement, European finance ministers (Eurogroup) released a statement on February 15 telling Greece to propose and make new deficit reduction measures by March 16; otherwise, the Eurogroup will start telling Greece what to do.

Most recently, consensus has appeared to be forming around a bailout, with reports in the European press discussing a rescue package that involves both loans and guarantees. One possibility would be using state-owned banks such as KfW and CDC to help provide this facility. Concerns about moral hazard, meanwhile, could be reduced by both demanding further austerity measures, and charging a sufficiently high fee for the money to discourage Greece from tapping it unless absolutely necessary. This would be a shift from the subsidized rates attached to emergency lending facilities offered during the crisis and more accurately reflect Walter Bagehot's famous declaration that during times of crisis central banks should "lend freely," but only against good collateral and at a "penalty rate" of interest.

Conclusion

Obviously, the significance of this crisis stretches beyond Greece and its bondholders. Greece accounts for just 2.7% of Eurozone GDP and 3.9% of its public debt; outstanding Greek government and government-sponsored debt is approximately €300 billion. While a worst-case scenario (default) would have a significant effect on certain European banks and pension funds, it is the wider contagion effect that has policymakers (and investors) running scared. In short, Greece is far from the only heavily indebted sovereign (in Europe and elsewhere)—the finances of countries such as Italy, Portugal, and Spain are in similar shape. Italy's debt/GDP is already more than 100%, and Spain's deficit is more than 11% of GDP (similar, we would add, to the current U.S. deficit). In a nutshell, the recent crisis has brought attention to the perilous financial state of many European sovereigns, and the realization that their options may also be quite limited.

This realization has forced investors to re-evaluate the euro (Exhibit 4), which has dropped 5.3% versus the U.S. dollar since the beginning of 2010, although some of this may be due to the fact that the euro had become overvalued on several metrics[2]. (Indeed, European Central Bank President Jean-Claude Trichet has said a lower euro would be beneficial for the Eurozone recovery.) While initially the Eurozone was seen as a candidate for early interest rate hikes, it is increasingly clear the region will be facing large

[2] We will cover this issue in more depth in a forthcoming market commentary.

reductions in government spending as well as tax hikes, both of which will place a larger damper on growth than initially realized. The crisis has also poured cold water on the euro's usefulness as a reserve currency, causing foreign exchange forecasts to be readjusted across the globe.

Given what is at stake, it seems a virtual certainty the EU will blink if the bond market stands firm (i.e., refuses to supply Greece with necessary funds). While talk of implied support and monitoring is well and good, investors would certainly be justified to conclude that there is no rationale for buying additional Greek debt without some type of explicit support. In this instance, the EU might provide some type of credit guarantee or back-stop facility (act as a lender of last resort), or arrange a loan from an official institution such as the European Investment Bank. While involvement by the IMF has also been discussed, this would most likely be in a monitoring capacity given the inability of Greece to manage its monetary policy as a member of the Eurozone. Such support would undoubtedly be politically unpopular in many of the core countries, but would be widely supported by peripheral countries such as Spain and Italy that have their own potential bailouts to consider. It would, to be sure, also cause consternation among those who believe the EU is effectively encouraging moral hazard, and kicking the can down the road with respect to creating true fiscal reform. However, given the realities of the post–Lehman Brothers world, we feel confident such concerns—whatever their merits—will not pose an insurmountable obstacle to a bailout.

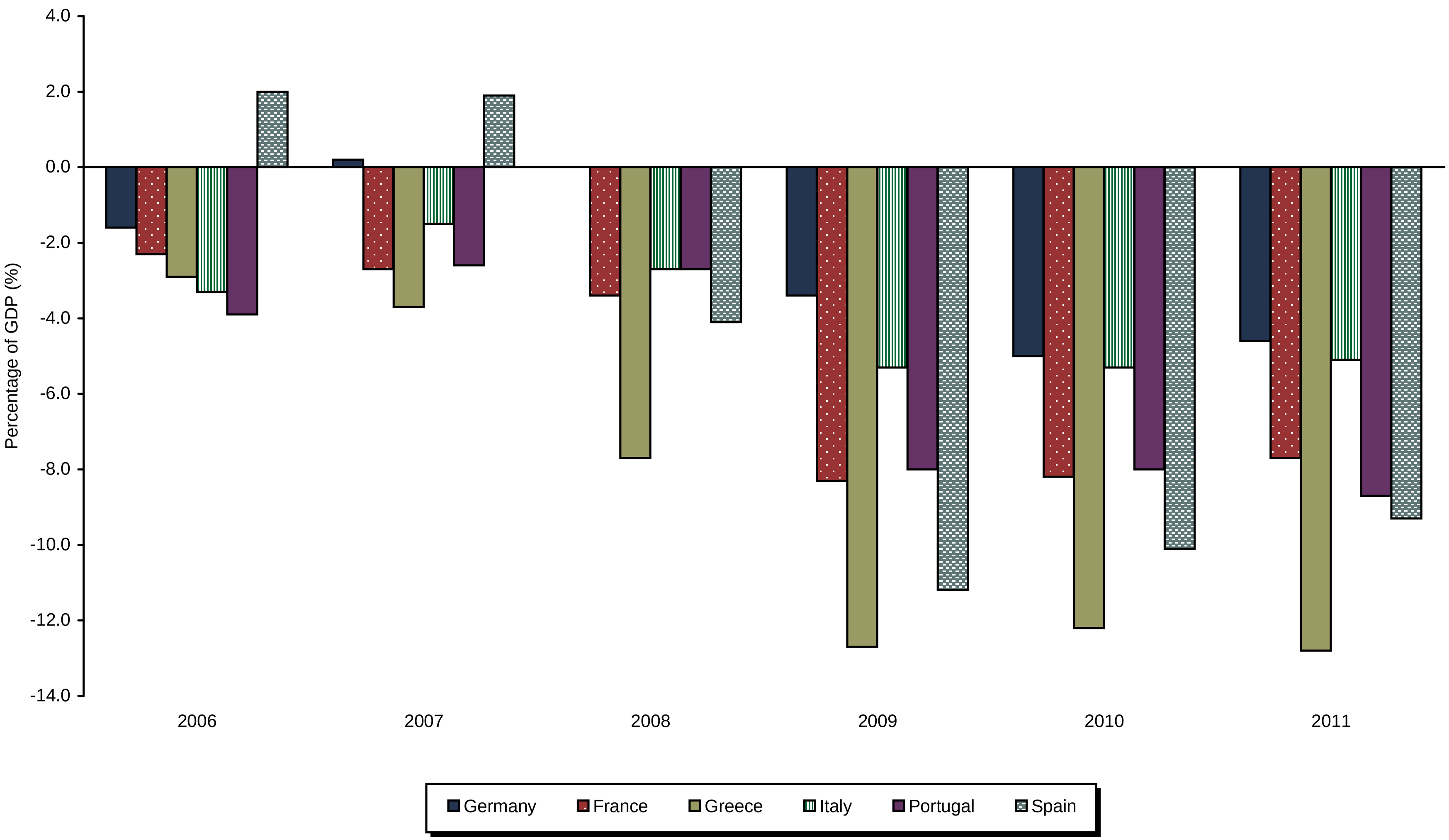
The bottom line is that events in Greece appear to be following the script we laid out last April—not due to particular prescience on our part, but rather because the mechanics of such debt crises are fairly straightforward, particularly with default having been effectively taken off the table as an option. Thus, we believe the Greek crisis will be "resolved" in much the way other crises have been handled of late, with governments and/or government-backed institutions coming to the rescue for the moment, but likely only delaying the ultimate day of reckoning until some indeterminate date in the future.

From a practical standpoint, most clients need not "do" anything as a result of these events. As noted, the euro was overvalued prior to the crisis, and thus one could simply view its decline as serving to remove some price risk (i.e., despite rising concerns about the euro, the common currency is a good deal *less* risky now than it was a few months ago). While we do believe there are structural issues with the euro that have yet to be resolved (most notably the lack of capital flows and migration between member countries), these are longer-term problems that are unlikely to manifest anytime soon; further, the breakup of the euro would of course have large and unpredictable impacts on asset classes broadly, and neither we nor anyone else can accurately handicap the effects of such an eventuality. ■

Exhibit 1

Deficit/Surplus as a Percentage of GDP

2006–11

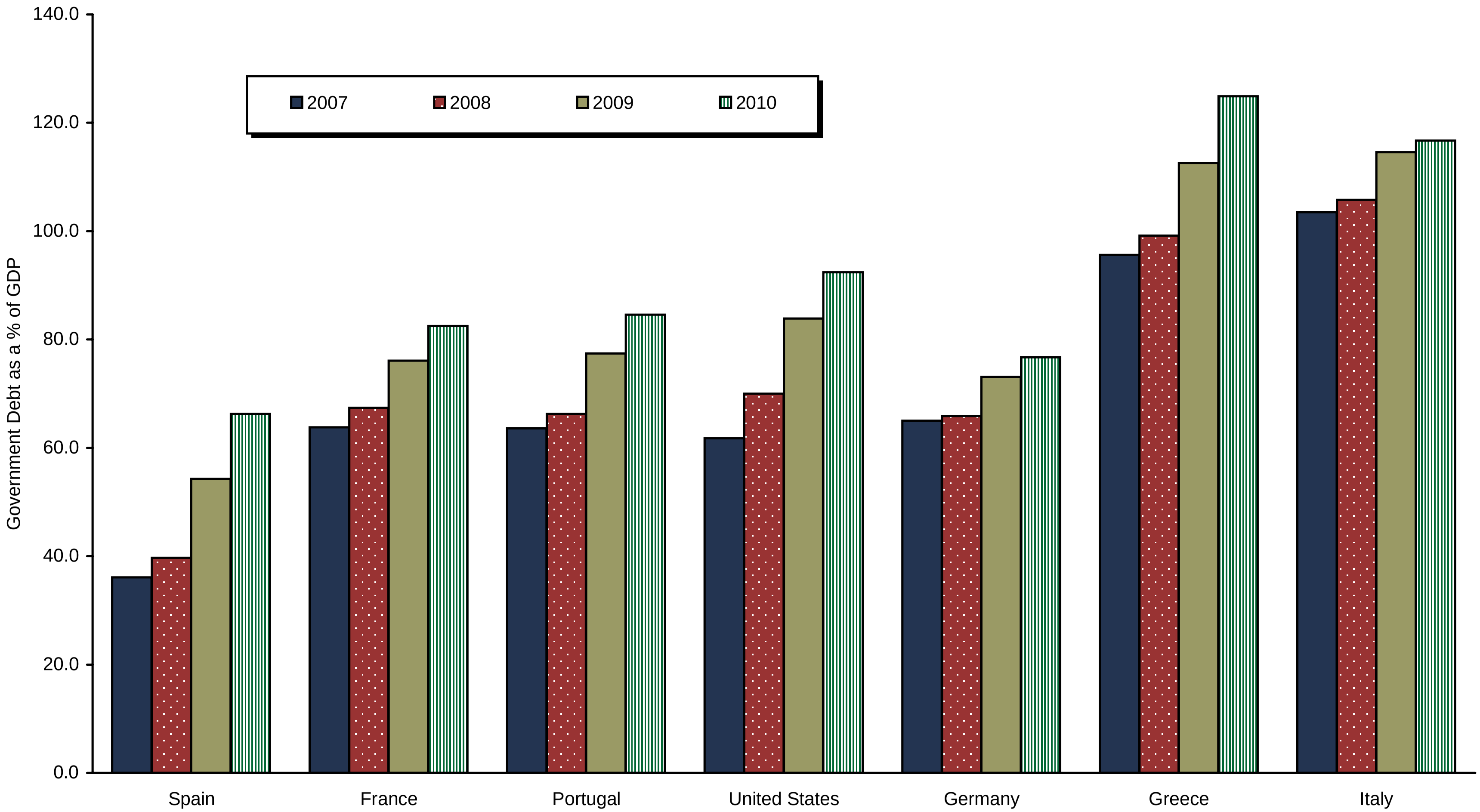


Source: European Commission.
Note: Data for 2009, 2010, and 2011 are forecasts.

Exhibit 2

Debt as a Percentage of GDP

2007–10

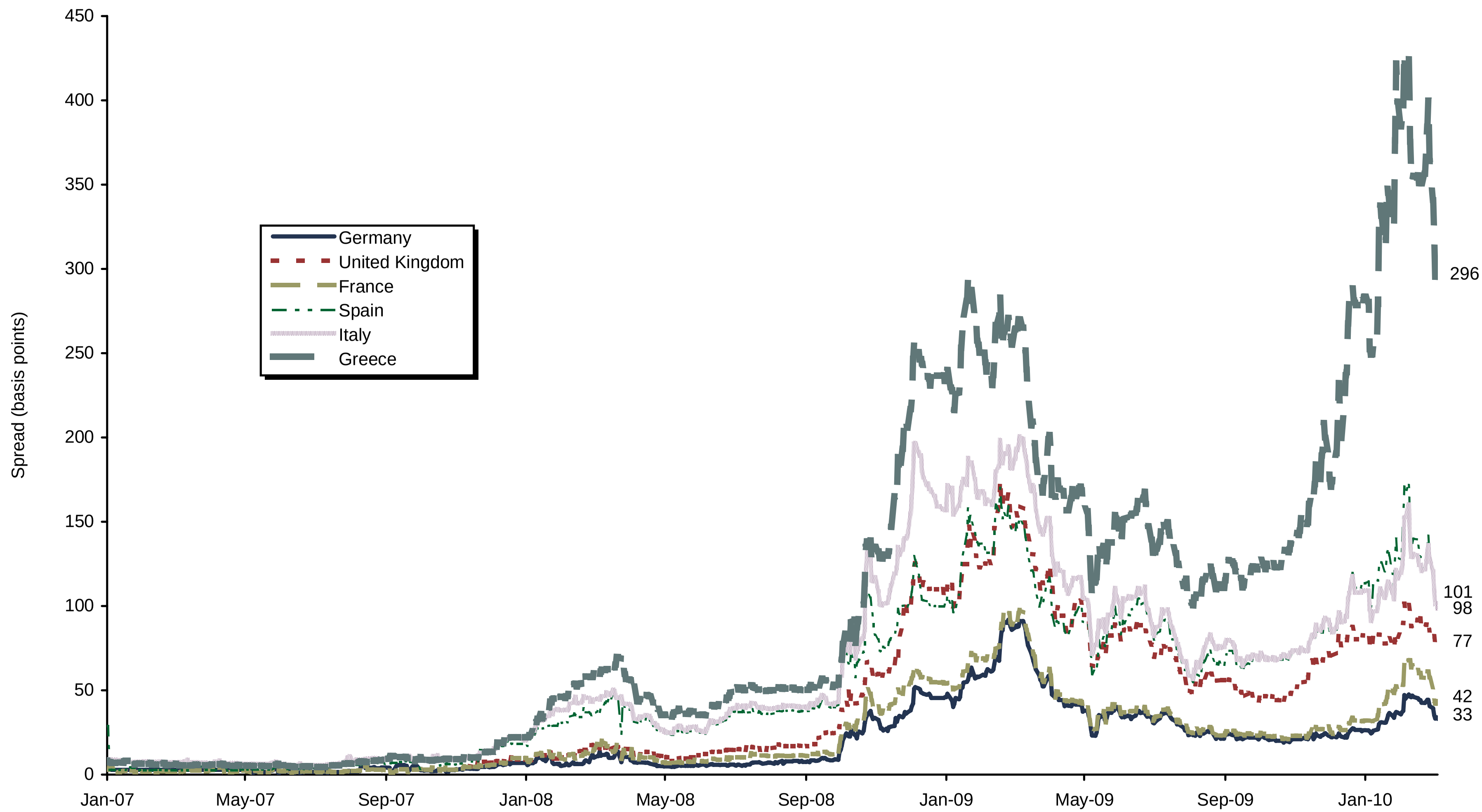


Sources: European Commission, OECD, and Thomson Datastream.
Notes: Data are as of October 2009. Data for 2009 and 2010 are forecasts. All forecasts are from the European Commission, with the exception of the U.S. forecast, which is from OECD.

Exhibit 3

Five-Year Credit Default Swap Spreads

January 1, 2007 – March 5, 2010

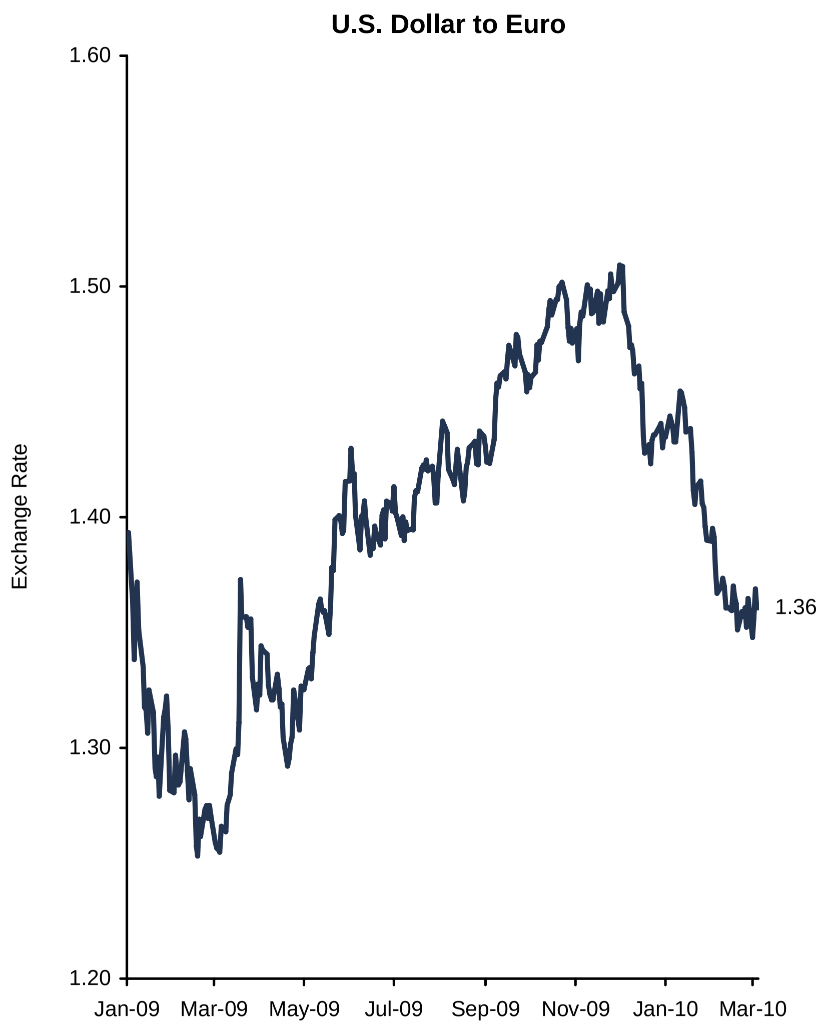


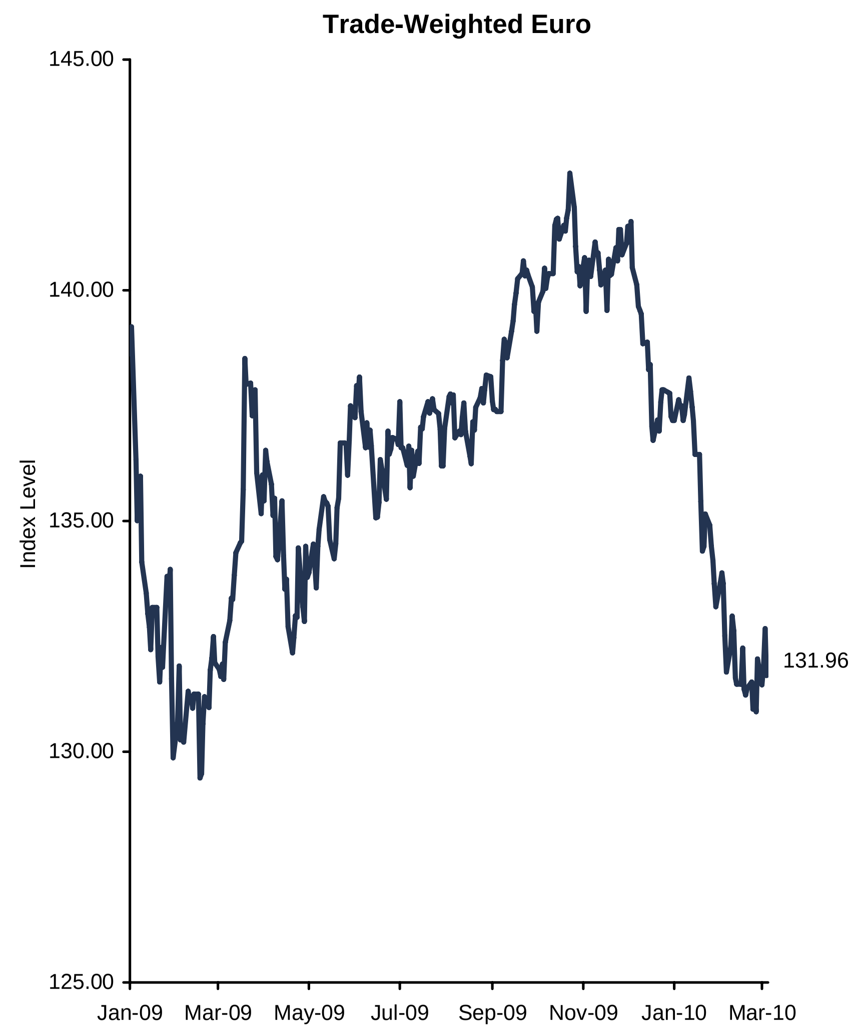
Source: Thomson Datastream.

Exhibit 4

Exchange Rates

January 1, 2009 – March 5, 2010





Source: Thomson Datastream.