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Investment Publications Highlights

Fasten Your Greek Belts

Christel Aranda-Hassel et al., Credit Suisse, February 2, 2015

The rise of Syriza in Greece has turned the market's attention once again to the possibility of the country leaving the Eurozone. The European economics team at Credit Suisse contends that it is in the best interest of both Greece and Europe for the two sides to strike a new compromise and does not see a Greek exit from the Eurozone as an event that will happen suddenly.

After a decisive win in the latest Greek elections, the Syriza party has rattled markets with promises of anti-austerity reforms and pledges to restore growth. Greek leaders are now seeking to renegotiate the terms of the existing EU/IMF bailout or to leave the Eurozone altogether. The European Economics team at Credit Suisse believes that there is both willingness and strong incentives for the two sides to reach a mutually beneficial compromise.

Under the current conditions of support, the Greek government can stay afloat until June, but then needs new agreements from official creditors. For the year, Credit Suisse estimates that the country's borrowing needs are around €22 billion and financing sources around €8 billion, leaving a funding gap of around €14 billion. March will be a test for repayment with a substantial amount of debt coming due; the Greek government can likely reach a temporary agreement with the EU/IMF to provide the necessary liquidity to fund the government until a broader deal is reached by mid-year when €6.7 billion of debt is set to mature.

With EU policymakers taking a hardline stance against a nominal haircut to the loans provided to Greece, any conversation of compromise will center on the speed and amount of repayment to official creditors. One plausible route toward a deal is to render the final repayment of the debt conditional on Greece reaching some level of GDP growth at a future date. Another possible scenario would see debt repayment linked to a certain amount of agreed reforms. However, these possibilities will only provide limited, short-term relief to the Greek government. A maturity extension of existing debt is possible, and likely in Credit Suisse's view, but it will not change the government's short-term funding position.

The authors believe that some delay in the pace of fiscal adjustments could be offered to Greece in exchange for a commitment on reforms. For example, the new Greek finance minister would like to lower the target for the country's primary surplus from 4.5% of GDP to 1% to free up capital for the new government to fund its social programs and other growth supporting policies. Greece can probably obtain some reduction (not to the level it is seeking) given the need to encourage domestic demand. The European Central Bank's (ECB's) new, relaxed guidance for all members on how to apply the Stability and Growth Pact supports this notion. Further, the ECB's new QE measures and growth supportive policies provide further incentive for Greek officials to strike a deal with their creditors. To negotiate for access to additional funding, however, Greek government officials will have to present a comprehensive plan for deep structural reforms, likely in the areas where previous governments have failed.

While a "mutually beneficial" deal appears to be the most likely scenario, a "Grexit" from the Eurozone cannot be ruled out. The authors contend that the first signs of a failure to reach agreement would see an acceleration of capital flight, leading to capital controls and possibly a new round of elections to confirm that Greek citizens are in favor of leaving

the Eurozone. For these reasons, the authors do not see a Greek exit as an event that will happen suddenly, but rather an outcome that will be the result of mistakes and failures over time. The uncertainty of how this situation plays out will likely keep markets volatile.

Exit Risk on the Rise

Francois Cabau et al., Barclays Euro Weekly, February 2, 2015

A team at Barclays argues that it is a close call whether the base case is Greece staying in the Eurozone. The positions of the new Greek government and other European governments are far apart, and a Greek exit would be somewhat less traumatic now than it would have been in the 2010–12 period. Risks of Greece exiting are much higher now than they were then.

Syriza's hardening position (including announcements of plans to increase the minimum wage to €750 per month, rehire 10,000 civil servants, and cancel privatization) bodes poorly for negotiations with the troika. Several Eurozone countries, including Germany and Spain, have clearly signaled that additional financial support is contingent on structural reforms, fiscal prudence, and no unilateral debt restructuring. Losses on EU loans to Greece could be difficult—even though some mechanisms in place now, like quantitative easing, should serve as firewalls to reduce contagion—because political parties in countries such as Germany and the Netherlands have claimed that these loans are not simply transfers. The IMF's position that no country shall receive "special treatment" (such as debt relief) increases the divisions between the two sides. Barclays sees little support for revising the conditions already in place for Greece and thinks most Eurozone countries would have "zero tolerance" for a reversal of structural reforms.

Greece staying in the European Monetary Union is possibly still the baseline scenario, but is a closer call than in 2010–12. In the short term, the immediate adjustment costs for Greece defaulting on some part of its debt are much less than in the earlier period. Certainly the long-term adjustment costs for Greek society would be incalculably large, including high inflation and a drop in purchasing power for the less wealthy, and the majority of Greeks want to remain part of the monetary union. The initial reaction to a Greek exit would likely be increased volatility of risky assets, although the ECB's QE program may limit how much peripheral sovereign bonds are impacted. If Greece did exit, the initial costs to both Greece and Europe might send support for far-right parties plummeting. This would particularly impact Spain, where Podemos's radical platform has been gaining support that could decrease if voters actually see the impact of a euro exit.

Danger Zone

Dario Perkins, Lombard Street Research, January 29, 2015

The situation with Greece is a symptom of a larger problem for the Eurozone—rising dissatisfaction with the euro—which is compounded by faltering economic growth and falling consumer prices. However, not all the news has been negative. Lombard Street Research argues that modest GDP growth in 2015 will be supported by the ECB's aggressive quantitative easing policy, lower energy prices, and a depreciating currency; however, a strong, sustained recovery requires structural reforms, fiscal easing, and targeted debt forgiveness that reduces political risks.

The Greece situation is a reminder of "the unhappy state of euro politics," says Lombard Street Research. However, the ECB's recent shift in strategy should address a number of challenges the Eurozone faces, among them sentiment about being a part of the region. The market has so far had a muted response to Syriza's victory

in the Greek elections, some of which may be accounted for by hope that the ECB has taken the right path.

Beyond some members' dissatisfaction with the euro, lower GDP growth across the Eurozone and the looming specter of deflation create challenges. The ECB has been behind the curve on monetary policy, but has finally announced its own program of quantitative easing. The ECB plans to buy €60 billion in public and private assets through at least September 2016—this implies at a minimum €1.1 trillion of purchases, perhaps €900 billion of which will be sovereign bonds. These planned purchases represent about 10% of Eurozone GDP, which compares favorably to the start of the Federal Reserve and Bank of England (BOE) programs. Given that the ECB's QE program is open-ended, it could ultimately reach the size of the Fed's and BOE's programs at completion (25%–30% of GDP).

QE can lower interest rates, raise asset prices, increase money supply, lower exchange rates, and put a floor under inflation expectations. However, the Eurozone's unique features mean the first three of these transmission mechanisms may not work as well as they did in the United Kingdom and the United States. The most likely impact of the ECB's QE will be on the currency. The euro has already fallen sharply, but may have more to go. Currency depreciation should provide a boost to exports and improve the Eurozone's competitiveness versus non-euro trading partners, especially, LSR notes, because Eurozone exports tend to have a higher price-elasticity than other major economies. Finally, the ECB's program should help counter the deflation narrative by showing that the bank is seeking to restore inflation to the region.

LSR considers a Greece exit of the Eurozone a low probability risk, but one that is not unthinkable. Syriza is demanding a large nominal reduction in debt, which sets up some difficult negotiations for the Eurozone to navigate. The situation in Greece is just the most extreme example of rising populism and growing dissatisfaction with the euro within the European periphery. The oil-price collapse and the ECB's QE should help the Eurozone economy improve in the short term, but for a strong, sustained recovery to take hold, LSR argues that more is needed. The ECB must complement monetary policy with structural reforms, fiscal easing, and debt forgiveness for all indebted countries, not just Greece. Not taking these steps could lead to further political risks and an unfavorable medium-term economic outlook in the Eurozone. The situation in Greece highlights the risk facing the region if a broader policy response is not forthcoming. ■

At press time, the Eurozone had agreed to a four-month extension on Greece's bailout, on condition that Greece submit a list of proposed measures on Monday, February 23, that the European Commission, the ECB, and the IMF will evaluate.

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