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MACROCOSM

Greece: Down to the Wire

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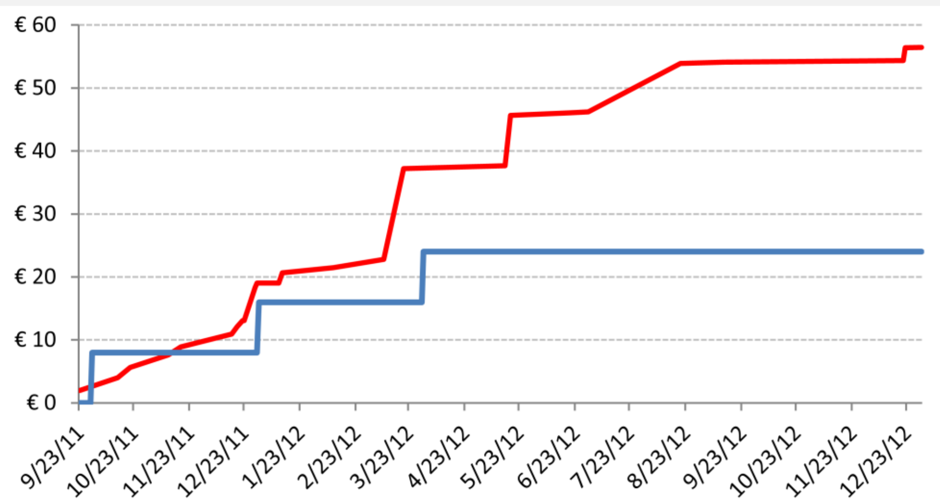
Lorcan Roche Kelly

It's hard bargaining as usual, but default will be deferred until the new EFSF is ready to go.

Last weekend's Eurogroup (the finance ministers of the Euro area) meeting did nothing to relieve market unease with the sovereign debt crisis. In fact, the meeting achieved the exact opposite. Euro area finance ministers have decided to push back until early October the decision on the next €8 billion tranche of bailout money for Greece. Disbursement of what is quite literally a touch-and-go lifeline for Greece is now impossible until mid-October -- if agreement can be reached at all. Without it, Greece will be in disorderly default in a matter of weeks.

Officials at the Greek finance ministry have pointed to the middle of October as the end of their current cash reserves, with a relentless schedule of bond maturities ahead (see the chart below). The "troika" of the Eurogroup, the European Central Bank and the International Monetary Fund is making Greece sweat. At the same time, Greece is making the troika sweat, with the usual round of excuses for unfulfilled promises of austerity and more promises for the future. If this sounds familiar, it's because we went through this three months ago before the previous disbursement (see "Confidence Game in Greece" June 23, 2011). As usual in Europe, it is down to the wire, with all parties seeking to maximize

Greek sovereign bond maturities **Bailout payments** €bn, cumulative



Source: Bloomberg, TrendMacro calculations

Update to strategic view

EUROPE MACRO, EUROPE BONDS, EUROPE FINANCIAL STOCKS: Greece and the "troika" are back to playing chicken, with both sides knowing that the current bailout tranche must be paid to avoid imminent disorderly default. The key issue is buying time for the enlargement and expansion of the EFSF. With the new EFSF in place, a Greek default could be a difficult but welcome catalyst to restoration of confidence in Europe. In the meantime, bank depositors are fleeing European banks, finding work-arounds to keep their deposits safe as they tire of promises without action.

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their negotiating leverage.

We think Greece will get the €8 billion required to stave off default. But it is not uncertainty over Greek solvency that will ensure payment of the latest tranche -- it is *certain* that Greece *will* default at some point, probably by year-end. It is uncertainty over the timing of the availability of the expanded European Financial Stability Facility (see "From the Vacation to the Frying Pan" August 30, 2011) that will ensure Greece gets the payment.

- The expanded EFSF needs to be in place before Greece will be allowed to default, as the safety net it will provide will be needed to alleviate contagion effects in the rest of the Euro area.
- Once approved by Euro area parliaments, the new EFSF will be 75% larger than it is today, with almost €400 billion in available bailout capacity.
- It will be empowered to make *ad hoc* interventions in markets, including buying distressed sovereign bonds and bank securities for its own account, relieving the reluctant ECB of the duty of being lender of last resort.
- So far, five Euro area states -- France, Spain, Italy, Belgium and Luxembourg -- have approved the expanded powers of the EFSF. With twelve countries still to vote, it is unlikely that all the legislative hurdles can be passed in time for a Greek default in mid-October -- Malta's parliament does not reconvene until October 3, and Slovakia is not planning to vote until mid-October.
- It is counterintuitive, but we think that once the new EFSF is in place, a Greek default could be just the catalyst that is needed to restore confidence. Today its potential systemic consequences are terrifying "unknown unknowns." Once it finally happens, and once the EFSF and other safety nets in Europe succeed in preventing contagion, then -- at last! -- a rigorous stress-test will have been passed.

This does not preclude Greece from taking unilateral action that leads to default. On Monday, a Greek paper carried a story claiming that Greece is considering holding a referendum on Euro area membership -- a report which has since been rejected by a Greek government spokesman. The timing of the report was certainly unhelpful -- Greece is in the middle of two days of conference calls with the troika, with agreement on the details of a new round of austerity expected later today.

As though to underscore how critical it is that a Greek default be deferred, Standard and Poor's downgraded Italy one notch to A (from A+) late on Monday. While markets have mostly shrugged off the not unexpected downgrade, it leaves Italy with misaligned ratings. Moody's -- who recently extended its review of Italy -- now rates Italy three notches above S&P. With Fitch's ratings one below Moody's and two above S&P, it is reasonable to expect further downgrades in the coming months.

At the same time, the Euro area banking sector continues to show signs of reduced access to market funding.

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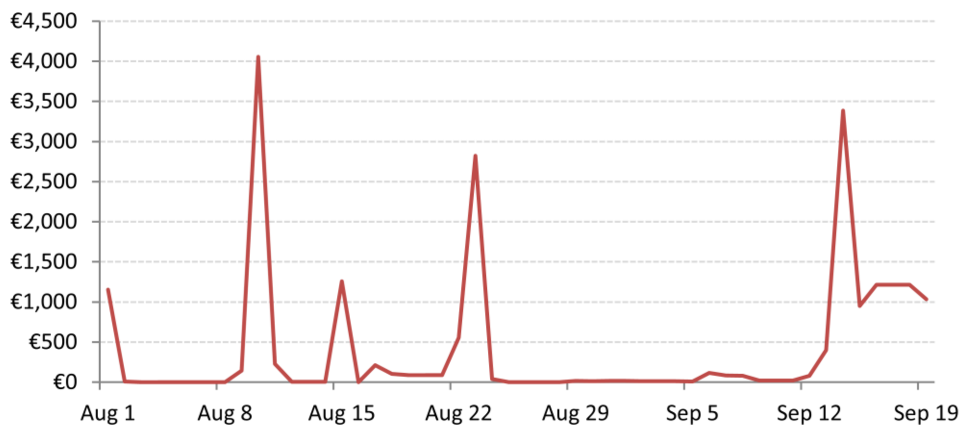
- Use of the ECB's marginal lending facility (MLF) -- the overnight facility akin to the Fed's discount window, which charges a penalty interest rate -- has remained elevated in the past week (see the chart below).

ECB Marginal Lending Facility borrowing €millions



Source: ECB

- Today's main refinancing operation (MRO) -- the weekly liquidity operation -- attracted bids of €201 billion, the highest since February 2011. We expect that today's MRO will allow the MLF to drop back to close to zero -- as the banks using the MLF moves their borrowing to the less costly MRO. But the increased use of ECB liquidity does mean that funding conditions for Euro area banks are a long way from returning to "normal."
- But this does not mean that Euro area banks are likely to suffer a liquidity crisis. The ECB "fixed rate, full allotment" liquidity operations -- including the longer term dollar operations announced last week in coordination with the world's major central banks -- mean that the availability of ample liquidity is a certainty. Whatever is wrong with Europe's banks, liquidity isn't it.

However, in order to unwind the addiction of certain banks to ECB liquidity, access to market funding and deposits has to return. A report in the *Financial Times* about the German industrial conglomerate Siemens having up to €6 billion of deposits with the ECB adds an unwelcome new wrinkle. It means that in the fight for deposits, the commercial banks now have an unwelcome competitor in the ECB, the very institution that wants to reduce bank reliance on central bank liquidity. It is worth noting that the only reason Siemens can do this is because the company is one of a few that has a banking license -- most of the rest are car manufacturers with large finance arms.

The geologically slow progress in permanently resolving -- rather than just ameliorating -- the crisis that began three years ago means that the Euro area banking sector risks losing access to the depositors they will have to rely on to return to growth. While most other bank depositors will not have access to the ECB facilities that Siemens does, the longer the crisis grinds on, the more likely they are to seek other places to deposit their money. This has already been seen in Ireland, where lost deposits have been replaced by emergency liquidity assistance (ELA) (see "Understanding ELA: Emergency Liquidity Assistance" July 15, 2011). If the deposits lost do not return, then use of such liquidity operations will become permanent.

Bottom line

Greece and the "troika" are back to playing chicken, with both sides knowing that the current bailout tranche must be paid to avoid imminent disorderly default. The key issue is buying time for the enlargement and expansion of the EFSF. With the new EFSF in place, a Greek default could be a difficult but welcome catalyst to restoration of confidence in Europe. In the meantime, bank depositors are fleeing European banks, finding work-arounds to keep their deposits safe as they tire of promises without action.