MACROCOSM

Greece: Suicide, Not Murder

Tuesday, June 7, 2011

Lorcan Roche Kelly

Ironically, a Greek default may strengthen the rest of the Eurozone.

My first report as TrendMacro's Chief Europe Strategist comes at a pivotal moment, when the Greek government of George Papandreou finds itself caught between a rock and a hard place. The rock is the so-called "troika" of the European Union, the European Central Bank and the International Monetary Fund. The hard place is the Greek people. Papandreou now has no room to maneuver, which means that the muddle-through approach to Greece's debt crisis that TrendMacro has described since last year (see, among many others, "Greece Gets TARPed" April 12, 2010) has nearly run its course.

- What has changed is politics, not finance.
- So far political risk throughout the European debt crisis has been mostly with the nations of the center, and their institutions. Financial resources have never been the limiting factor -- it has been political will, and the ability to credibly coordinate.
- Now political risk has shifted to the periphery. There has always been the possibility of a peripheral nation opting to not accept a bailout from the core (see "The Libyan Connection" February 22, 2011, and "If Portugal Fell..." March 24, 2011) -- now that is happening in Greece, in the form of increasingly intense opposition to the austerity required.

Eurozone finance ministers (Eurogroup) are due to meet on June 20 to finalize details of the latest bailout for Greece. Friday's whisper number of €60 billion seems to have grown to €100 billion over the weekend -- the country needs €84 billion (net of current troika funding) in the next two years just to meet interest and redemptions on its debt.

Greece is likely to be offered a new bailout from the troika, but the conditions attached to any such bailout may make acceptance of (or adherence to) those terms impossible for Greece. The original bailout conditions have not been met, and continuing weak Greek economic statistics give little hope for improvement this time around. The inability of Greece to meet the conditions attached to the troika's bailouts is driven by its own problems, both political and structural.

Among Greece's structural problems:

Update to strategic view

EUROPE BONDS, EUROPE MACRO: The political situation in Greece makes it impossible for it to accept further bailouts on terms that the core nations and their institutions will be able to countenance. Default is inevitable. But as this will be Greece's choice, not a sudden withdrawal of the core's safety net, it will likely not have contagious impact in European debt markets. Indeed, it would motivate the core to redouble its efforts to support the other peripheral nations willing to bear austerity.

[Strategy Dashboard home]

Note to clients:
If there are people in your organization who cover Europe, or are especially interested in European issues, and who are not currently receiving TrendMacro's reports, please identify them to Tom Demas so he can add them to our distribution list.

.

- The proposed €50 billion privatization program is likely to hit an early snag due to Greece's lack of a functioning land registry -- basically, the Greek government cannot be sure of exactly what real estate it owns.
- When it comes to the properties it is sure it does own -- utilities and other semi-state companies -- strong union opposition to privatizations is likely to, at best, delay the process.
- Further, Greece has not been particularly successful at attracting foreign direct investment during its decade long membership in the Euro -- the entire stock of existing FDI is only about €25 billion -- which does not bode well for Greece's chances of being able to raise €50 billion during the current fire-sale. The alternative is for the money to be raised from domestic investors, but this solution will do nothing to improve the overall Greek position, as the Greek investors will either have to raise financing from Greek banks, or reduce holdings of other Greek assets to fund the purchases.
- Greek unemployment numbers for March and CPI for May are due to be released on Wednesday, with Q1 provisional GDP out on Thursday. Weak numbers are expected, which will put further pressure on the government to resist the retrenchments that will be required under the bailout round currently under negotiation.

Among Greece's political problems:

- The ruling party and its opposition cannot agree on terms that will put public finances on a sustainable path. But the sticking point goes deeper than partisanship. Polls show that it is not just the ruling party that is unpopular -- there is widespread disenchantment with both parties.
- Since Greece returned to democratic government in 1975, the country has always been ruled by one of the two main parties. Both the current prime minister's father and grandfather served as prime minister, and the opposition leader who was prime minister from 2004 to 2009 is also the son of previous prime minister.
- This dynastic nature of Greek politics, and the continued occupation of the square in front of the Greek parliament by thousands of protestors calling themselves "the indignant" means that reports that surfaced in the Turkish press of a CIA warning of a possible coup are not as far-fetched as they might seem. While we are not factoring a coup into our outlook for Greece as a likely outcome -- there is as yet no organized opposition in place to seize power -- we are highlighting the reports, as they give a sense of the tension in Greece at the moment.
- It is important not to underestimate the level of political protest in Greece against any new austerity measures. The first bailout saw large one-off protests in Athens that only occasionally turned violent. The current round of protests have more in common with "Arab Spring" as Greek citizens have occupied the square in front of the parliament now for two weeks -- shades of the dynamic in the Tahrir Square protests in Cairo.

Contact TrendMacro

On the web at
trendmacro.com

Follow us on Twitter at
twitter.com/TweetMacro

Donald Luskin
Menlo Park CA
650 429 2112
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Lorcan Roche Kelly
Sixmilebridge Ireland
212 537 9067
lorcan@trendmacro.com

[About us]

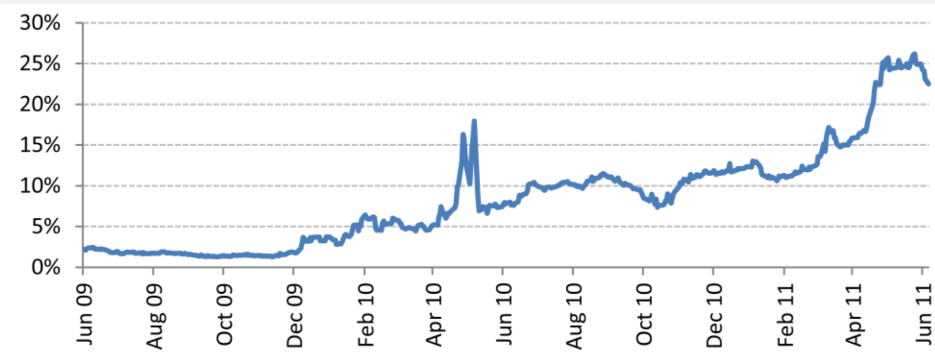
- There are two major strikes coming -- on Wednesday, by workers at companies ear-marked for privatization, and the following Wednesday a national strike.

All of this means that it will be impossible for Greece to implement the conditions that will be attached to any bailout from the troika. If the conditions cannot be met, then the road that Greece is on can only lead to default, and probably eventually exit from the Eurozone.

So, what does all this mean for the Eurozone? The starting point has to be that this would be the least surprising default in the history of international finance.

- It's no secret to bond markets. Yields on Greece's junk-rated 2 year debt permanently passed 10% last October and have been above 20% since the end of April (please see the chart below).

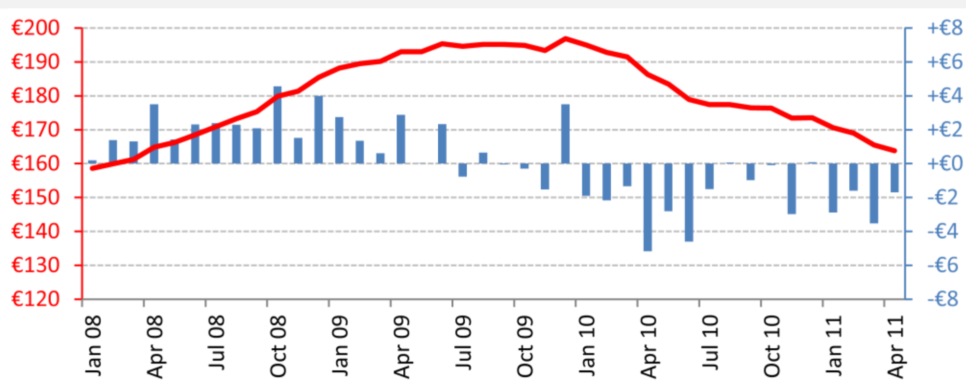
— Yield on Greek 2-yr sovereign debt



Source: Reuters, TrendMacro calculations

- It's no secret to Greek citizens, either. There's not quite a run, but at least a "walk," on Greek banks. Bank of Greece data shows there has been consistent withdrawals from household deposits for the past 16 months (please see the chart below).

Household deposits in Greek banks — Overall ■ Monthly change
€ billions



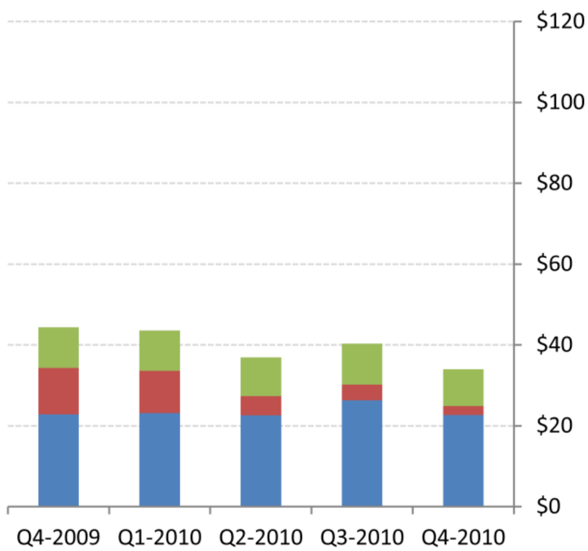
Source: Bank of Greece, TrendMacro calculations

- Some evidence of how well the markets are prepared for a Greek default came on Wednesday when Moodys downgraded Greece three notches further into junk status to Caa1. While the main Euro currencies pairs did take a bit of a dip, they quickly recovered -- and this was *before* Friday's troika's staff level report on Greece, which was more supportive than some might have feared.
- With Greece's difficulties much in the news last week, Spain and Italy had successful bond auctions. Italy sold €3.5 billon of 5-year debt at lower yields than the previous month's sale, and Spain sold €3.95 billion of 3-year and 4-year debt at yields of 4.03% and 4.23% respectively, with demand stronger than previous auction, albeit at a 47 bp premium.

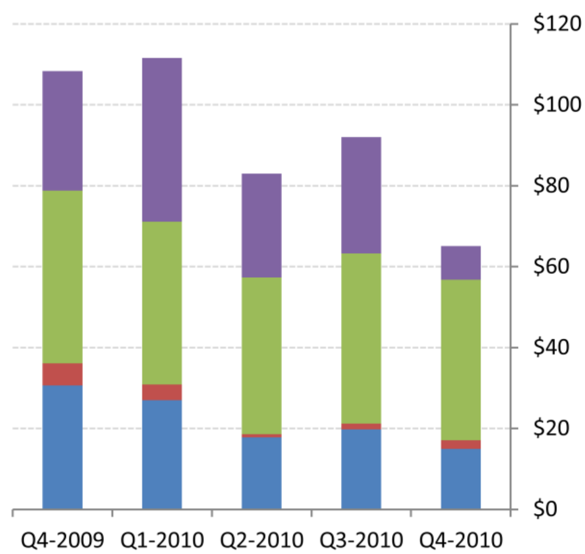
What about the risk of contagion to other peripheral nations in difficulty, and from there to the Eurozone itself?

- First, exposure to Greece by the German and French banking systems is not overwhelmingly large -- especially to sovereign debt -- and has lessened over the last five quarters (please see the charts below).

Exposure of German banks to Greece
Sovereign Bank Private Other
USD billions



Exposure of French banks to Greece
Sovereign Banks Private Other



Source: Bank for International Settlements

- We think the key dynamic here is that a Greek default would not be the result of the core nations and their institutions suddenly withdrawing the safety net the market has come to expect. If that were the case, it would potentially be a systemic catastrophe as it was when the Federal Reserve chose not to bail out Lehman Brothers. Instead, a Greek default under the dynamics we've described would be a situation-specific event, driven by the unique political choices made by Greece itself. It would not be a murder, but a suicide.

- While Ireland and Portugal are also in receipt of EU/ECB/IMF bailouts, they do not share Greece's political dynamic. There is general unanimity in both nations to bear austerity as the cost of participation in modern Europe. There was a general election in Portugal on Sunday, with the outgoing socialist government losing to a center-right coalition of the PPD and CDS parties. It is notable that this election has passed off with little protest, much as the Irish election in February did.
- Greece, in default, would not necessarily leave the Eurozone. There is no mechanism under EU treaties by which a country can be expelled or suspended. This does not mean that Greece cannot choose to leave -- as long as it is a sovereign state, it can do whatever it wants. This is not to understate the difficulties involved in leaving the Euro for Greece itself -- the shock to the economy would be huge -- but there comes a point at which the risk-reward ratio makes sense.
- A Greek default would not bankrupt the ECB, even though it is estimated that it has purchased €45 billion of Greek debt under the Securities Market Programme. If, *in extremis*, the ECB were forced to write down all of this debt, the loss would be greater than the ECB's €5 billion capital. But the SMP is a EuroSystem operation, so any losses on it are borne by the wider ESCB (European System of Central Banks) which has €81.3 billion capital.
- For all that, a Greek default would be -- at least at first -- a terrifying event. We would expect that the core nations and their institutions would visibly redouble their public commitments to supporting other nations under stress. Thus the default of a single peripheral nation would actually strengthen the prospects of all the others.

Bottom line

The political situation in Greece makes it impossible for it to accept further bailouts on terms that the core nations and their institutions will be able to countenance. Default is inevitable. But as this will be Greece's choice, not a sudden withdrawal of the core's safety net, it will likely not have contagious impact in European debt markets. Indeed, it would motivate the core to redouble its efforts to support the other peripheral nations willing to bear austerity.