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MACROCOSM

Black Wednesday in Greece

Thursday, June 16, 2011

Lorcan Roche Kelly

With government in chaos, the next step is a bank run -- then default.

Wednesday, September 16, 1992 will forever be remembered as "Black Wednesday,'" as the British Chancellor of the Exchequer was forced to withdraw the pound from the European exchange rate mechanism. It seems that Wednesday, June 15, 2011 may go down as Greece's Black Wednesday, as the government of George Papandreou finally faced reality and realized it neither has the political legitimacy nor the power to deliver the austerity package demanded by the so-called "troika" (the European Union, the European Central Bank, and the International Monetary Fund) as a *quid pro quo* for another bailout package. It's exactly what we predicted last week (see "Greece: Suicide, Not Murder" June 7, 2011). Now increasingly panicky global markets await the denouement, and the potentially systemic consequences.

- There was a national strike in Greece yesterday that, as expected, led to large protests in front of the Parliament buildings.
- Prime Minister George Papandreou met with the Greek President at lunchtime and then set about trying to form a government of national unity with opposition parties.
- These talks failed, with the main opposition leader, the New Democracy Party's Antonis Samaras, demanding that Papandreou resign as Prime Minister and that the austerity package agreed with the troika be renegotiated before his party would enter a national government.
- In a TV address, Papandreou blamed opposition politicking for the failure to agree to a national unity government. He plans to form a new government today -- or more accurately, a cabinet reshuffle -- and call for a vote of confidence, which is due to be held at midnight next Tuesday. If his new government does not win the vote in parliament, expect a snap election.
- Samaras, in a later TV address, said that the Papandreou government is untenable and called for immediate elections.

Yesterday was about a lot more than just Greek political difficulties. Standard &Poor's downgraded all the Greek banks it follows -- Alpha Bank, National Bank of Greece, EFG Eurobank and Piraeus Bank -- from B to CCC.

Update to strategic view

EUROPE MACRO, EUROPE BONDS: Greece's political structure imploded yesterday, likely rendering any bailout impossible. The next step will be a bank run, which will challenge the ECB and the Bank of Greece to keep the Greek banking system from imploding, too. Even before a formal Greek default, the European core will have to move to assure markets that it intends to ringfence Greece and protect Ireland, Portugal and Spain from systemic contagion. Our bet is that after a bit of a panic, it will succeed.

US STOCKS: We've been waiting for the correction to turn from a "slow-motion drip-down" into at least a bit of a panic. That started yesterday as the turmoil in Greece fed exaggerated fears of contagion to other European nations. We move closer to an entry point.

[Strategy Dashboard home]

- The assets of these banks accounted for 65% of all Greek bank assets at year-end.
- Moody's placed three French banks on review for possible ratings downgrade. Credit Agricole and SocGen both have Greek subsidiaries. Credit Agricole's Emporiki Bank has a customer loan book of €22.6 billion with SocGen's Geniki bank much smaller at €3.5 billion. Moody's also placed BNP Paribas on review due to its €5 billion holding of Greek sovereign debt. These explain the majority of the French banking system's exposure to Greece (please see the chart below).
- In a rare moment of comedy in a dark day, French minister for Europe Laurent Wauquiez reacted to the Moody's action saying "We need to stay calm and serene on these issues."
- In other ratings action, Moody's placed the Brazilian subsidiaries of Banco Espirito Santo and Banif Portugal -- both Portuguese -- on review for possible downgrade following placing the Portuguese parents on review last week.

Ireland's Finance Minister Michael Noonan, perhaps feeling he needed to get in on the action, said that his government will seek to impose losses on senior bondholders in Anglo Irish Bank and Irish Nationwide Building Society.

- The move would impose losses on the €3.5 billion of outstanding unguaranteed, unsecured senior debt at the two institutions.

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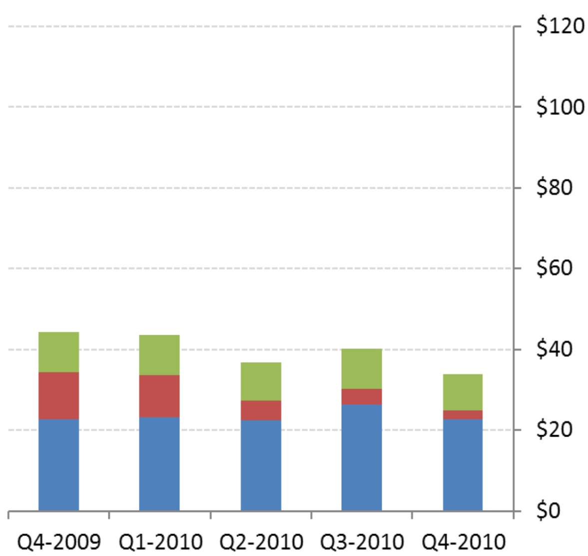
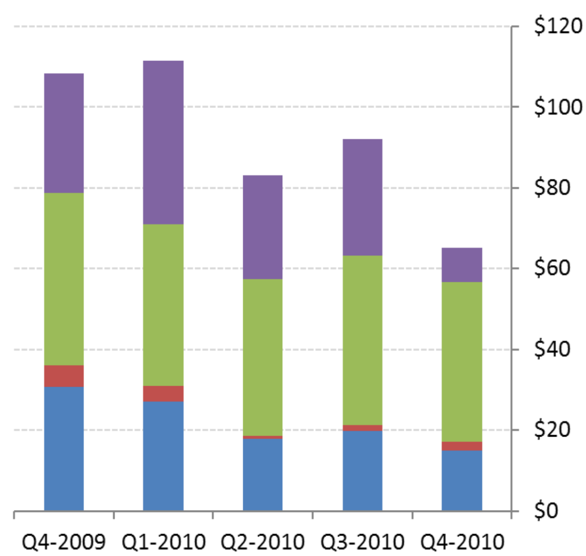
[About us]

Exposure of German banks to Greece
Sovereign Bank Private Other
USD billions, year-end 2010



Exposure of French banks to Greece
Sovereign Banks Private Other



Source: Bank for International Settlements

- Noonan said that the institutions could no longer be considered to be banks -- the Irish government transferred all deposits from them in February of this year to other Irish banks -- and instead should be viewed as warehouses for bad debt.
- Noonan's assertion that the institutions can no longer be considered banks may put the Central Bank of Ireland in a difficult position. Currently it provides Anglo and Irish Nationwide with more that €30 billion of liquidity via its controversial Emergency Liquidity Assistance -- if the institutions are no longer banks, then the Irish central bank cannot provide this anymore. But this only reflects the perverse circularity of a situation in which, ultimately, the banks and the central bank are both liabilities of the sovereign anyway.
- Noonan said that he has support from the IMF for the idea.
- In a clarification of earlier reports on the issue, this would not be a unilateral move by Ireland, as Noonan said he would seek the permission of the EU and ECB to take this course of action.
- Dramatic timing perhaps, but this shouldn't be a surprise. Noonan's Fine Gael party ran for election in January under a manifesto calling for this (see "The Libyan Connection" February 22, 2011).

With the stench of panic spreading in global markets, it seems that the political center of Europe is not going to be rushed to action. Tuesday evening's meeting of Euro area finance ministers failed to produce any results other than an agreement to meet again next Sunday evening before the full ministerial meeting planned for Monday. Ollie Rehn's statement this morning expresses confidence that the meeting will decide favorably on the disbursement of the fifth tranche of the existing loan package for Greece in early July. They will also discuss conditions for a second bailout for Greece, with an eye to making decisions on this at the July 11 meeting. The important caveat that Rehn makes is that he expects the Greek Parliament to pass the austerity package by the end of June, before decisions are made at the July meeting.

The current political situation in Greece may make meeting that caveat very difficult. With the confidence vote in Papandreou's new government delayed until Tuesday evening -- after the Eurogroup meeting will have already finished -- and rumors in Greece that Papandreou might lose leadership of the ruling PASOK party, with a meeting called for this afternoon -- there effectively isn't a government in Greece for Europe to talk to over the weekend, and if a snap election is called, there may not be a government in place able to vote on an austerity package until July. In this game, it remains Greece's move.

- The next likely step is a run on Greek banks, accelerating the "walk" we highlighted last week (again, see "Greece: Suicide. Not Murder"), which would quickly make the entire Greek banking system insolvent.

- S&P cited this risk among its rationales for its Greek bank downgrades.
- The FT's Brussels blog published excerpts from a briefing document that the finance ministers received at the Tuesday meeting, also highlighting this risk.
- Some banks should be able to rely on foreign parent companies for support, but most of the Greek banking system would be looking to either the ECB or the Bank of Greece for support.
- The ECB's longstanding stance on not supporting insolvent banks would mean that the Bank of Greece would have to engage in Extraordinary Liquidity Assistance -- much as the Irish Central Bank has (again, see "The Libyan Connection") -- to support its banks.
- So the first systemic consequence of Greece's accelerating troubles will be felt in Romania and Bulgaria, where Greek bank subsidiaries control a major share of the banking market.

This intensifying bank run, coupled with a possible political vacuum, puts Greece on the brink of becoming a "failed state." The troika has clearly laid plans for Greece which must be followed for Greece to maintain access to funding -- the IMF has very clear rules on disbursements of funds, and Greek inaction on austerity might jeopardize disbursement of those funds. Reports in the *Financial Times* this morning suggest that the EU may have to provide guarantees to the IMF for the next round of funds to be disbursed. But if the political situation in Greek continues its rapid deterioration and an election is called in the coming days -- an outcome seeming more likely by the hour -- then there will be no one for the troika to negotiate with, so there will be little they can do.

Already, Olli Rehn, European Commissioner for Economic and Financial Affairs is talking about July 11 as a likely date for decision to be taken on a program for Greece. This is quite an extension on an agreement that was supposed to be reached this weekend.

A banking panic clarifies the mind -- so perhaps there remains a small chance that Greece will pull itself together and come around to meet to troika's terms. But the likely scenario is that Greece will default, in which case it will be up to the troika to assure markets that it still intends to stand behind Ireland and Portugal or any other nation in distress that is reasonably willing to pay the price to remain integrated in the modern global economy -- all the more so, since it no longer has to throw good money after bad in Greece.

- Nout Wellink, outgoing Dutch central bank president and ECB executive board member, took up this theme this morning. He said that the Euro area bailout fund will have to double to €1.5 trillion, and that the fund must have increased flexibility in how it can spend that money. He hinted that the fund should be prepared to buy sovereign debt in the secondary market, as the ECB did with its €75 billion Securities Markets Programme in 2010, saying "people should be prepared to do things the ECB has previously done."

- The euro briefly fell following publication of his comments. This reflects the reality that official assurances, however generous, are inevitably also somewhat alarming -- they reveal the unpleasant fact that assurances have to be made in the first place. But better that there be assurances than not, if the reality demands them.
- In the end, official assurances will have to be strong and credible, as the global market's first reaction will be to assume -- perhaps in the manner of a self-fulfilling prophecy -- that Greece's failure will swiftly lead to failures throughout the periphery. We're mindful of the risks here, but our bet for now is that, after an initial panic, Greece will be correctly understood as the Enron of Europe, not the Lehman.

Bottom line

Greece's political structure imploded yesterday, likely rendering any bailout impossible. The next step will be a bank run, which will challenge the ECB and the Bank of Greece to keep the Greek banking system from imploding, too. Even before a formal Greek default, the European core will have to move to assure markets that it intends to ringfence Greece and protect Ireland, Portugal and Spain from systemic contagion. Our bet is that after a bit of a panic, it will succeed. We've been waiting for the correction in US stocks to turn from a "slow-motion drip-down" into at least a bit of a panic. That started yesterday as the turmoil in Greece fed exaggerated fears of contagion to other European nations. We move closer to an entry point.