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MACROCOSM

# Dependence Day

Thursday, July 5, 2011

**Lorcan Roche Kelly**

**Over the weekend, as the US celebrates independence, Greece falls under EU stewardship.**

Following the passing of the austerity bill and its associated implementation bills in the Greek parliament last week, the scheduled two-day Eurogroup (Group of the Euro area finance ministers) meeting was reduced to a conference call on Saturday evening.

- The Eurogroup issued a one-page statement after the conference call, envisioning payment of the fifth tranche of the first bailout agreement by July 15. The disbursement of the fifth tranche will have to be passed by the IMF when it meets on July 8, but with EU approval, this now seems likely to be a formality.
- Worryingly for Greece, the statement says that the agreed multi-year adjustment program "will be supplemented by large-scale technical assistance, provided by the Commission and Member States." While it has become obvious over the past year that Greece is unable to implement meaningful reform of its economy, it is hard to see 'large-scale technical assistance' as anything other than an erosion of Greek sovereignty. Speaking on Sunday, Eurogroup chairman, Jean Claude Juncker echoed this point, saying "The sovereignty of Greece will be massively limited."
- There is a chance that this might give the Greek opposition a cause to rally around, but it is unlikely to mean an election in the short term.
- Next week's meeting of the Eurogroup is due to discuss a second bailout for Greece, but details of this will not be signed until September.
- Contrary to some reports, Greece is not off the political agenda between now and September. The next big Greek parliamentary vote is due on August 15. This vote will be on public sector and social welfare reforms, and is likely to be contentious (report here, in Greek).

Meanwhile, the French plan for voluntary roll-over of Greek sovereign debt seems to be in trouble, with Standard & Poor's being very clear that it would view it as a selective default, and Fitch indicating it would follow suit. Moody's has yet to comment.

**Update to strategic view**

**EUROPE MACRO, EUROPE BONDS**: Greece will receive enough funding from the fifth tranche of the original bailout package to see it through to September. But this does nothing to address Greece's underlying solvency crisis, and will provoke continued political instability by significantly depriving Greece of economic sovereignty. Without a reduction in the level of Greek debt, there is no alternative to a disorderly default.

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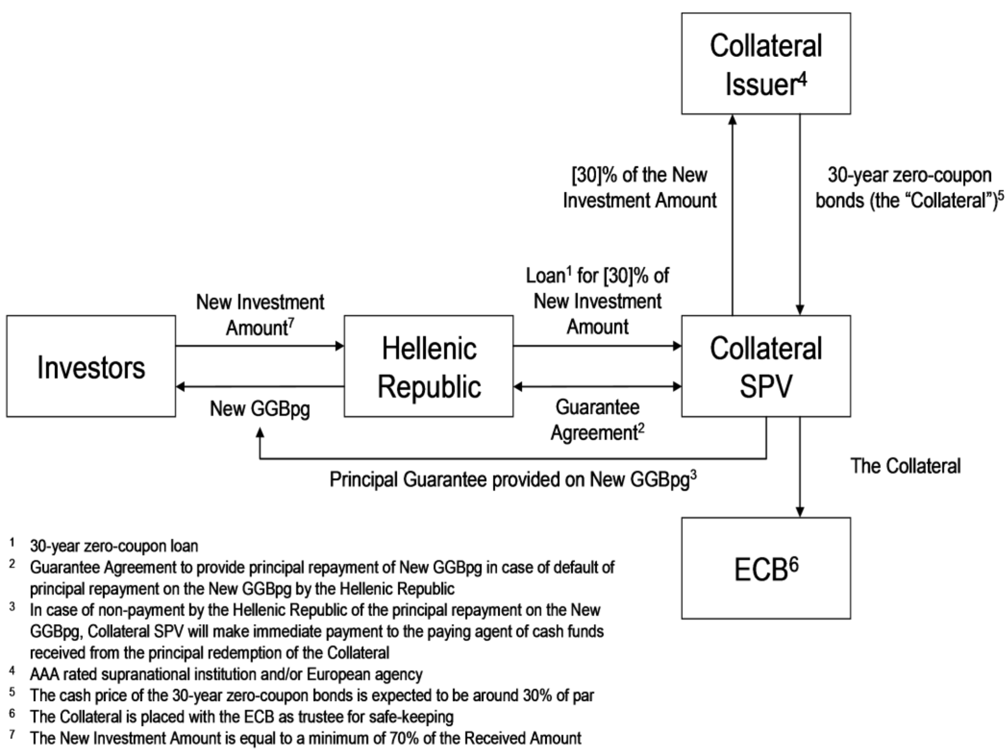
- However, the *Financial Times* is reporting that the ECB would continue to accept Greek debt as collateral unless *all* the ratings agencies declare it to be in default.
- The French plan involves investors receiving payment at par, but only €30 for every €100 in bonds held would be in the form of cash. (please see the chart below, from the plan put forth by the Fédération Bancaire Française). The remaining €70 would be in the form of new 30-year bonds. Greece would deposit €21 of the €70 received for these bonds into a special purpose vehicle (SPV), which would use it to purchase high-quality collateral. This, in turn, would fund the SPV's guarantee of the 30-year debt. The yield on the 30-year debt would be between 5.5% and 8%, based on a formula linked to Greek GDP growth.
- The plan does seem to be very light on specifics -- we do not know what high-quality collateral would be purchased, for example -- but in the absence of any other plan, and with the ECB softening its stance on ratings, it still seems the most likely, at the moment.

A successful voluntary bond rollover -- added to the release of the fifth tranche of the bailout -- does not mean that the medium or long term projection for Greece has improved.

- The level of Greek debt is not reduced by these moves. While they do improve the liquidity situation for Greece, they don't address Greece's underlying solvency problem. Without a reduction in the

**Proposal for rollover of Greek debt**




Source: Fédération Bancaire Française

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*level* of debt, Greek is still on the road to default.

- The austerity plan seeks to reduce the level of debt through privatizations -- a program that requires Greece to sell an asset every ten days. Greece has not been successful in the past at attracting foreign direct investment, (see "Greece: Suicide, Not Murder" June 7, 2011), and the likely failure to do so now would be a conspicuous sign of not adhering to the austerity plan.
- While EU finance ministers may think they have successfully dealt with Greek default risk until September, there is a very real (and rational) risk that the ratings agencies will call any rollover of Greek debt a default.
- Further, it has to be remembered that Greece is living on a financial knife-edge, its funding literally hand to mouth as it draws down each tranche of the bailout. With no room for unanticipated expenses, it is unfortunate that Greece is unusually prone to natural disasters, with wildfires common in the summer and earthquake risk all year. Greece is more seismically active than California, and a large wildfire in the summer of 2009 was a trigger for riots in Athens that led to the fall of the New Democracy government in September that year.

The other possible "black swan" to watch for is the lawsuit at the German constitutional court that is challenging Germany's participation the Greek bailout. While it is extremely unlikely that Merkel's government will lose the case, the stakes are very high. If the court rules against the government's actions to date, the entire bailout process would fail, and the Eurozone would be plunged into crisis.

This week also sees interest rate decisions from the ECB and the Bank of England on Thursday. The Swedish Central Bank kicked off the week's action this morning with a 25 bp hike, bringing the Swedish repo rate to 2% -- the eighth 25 bp hike in a year.

- As we noted before (see "On the June ECB Rate Decision" June 9 2011), predicting ECB rate decisions is a science based on phraseology used by Jean Claude Trichet. The code phrase for an impending rate raise is "strong vigilance." He used this phrase at the June press conference following that month's rate decision and has repeated it since. Anything other than a 25 bp rate hike by the ECB on Thursday would come as a shock to the market.
- Meanwhile, Mervyn King at the Bank of England is unlikely to move rates higher. With mixed data on the UK economy -- June construction output was worse than expected, while services data exceeded expectations -- projections for growth are still not on a sound enough footing for a rate hike.

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**Bottom line**

Greece will receive enough funding from the fifth tranche of the original bailout package to see it through to September. But this does nothing to address Greece's underlying solvency crisis, and will provoke continued political instability by significantly depriving Greece of economic sovereignty. Without a reduction in the level of Greek debt, there is no alternative to a disorderly default.