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MACROCOSM

# Whatever It Takes

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**Lorcan Roche Kelly**

**It's default for Greece, yet the Euro authorities have successfully arrested contagion.**

It has happened, as we expected (see "Greece: Suicide, Not Murder" June 7, 2011) -- the decisions taken by European leadership yesterday will put Greece in default. It is an orderly default to be sure -- more orderly than we had hoped for, with the voluntary rollover of privately held bonds at a net present value loss of 21%. Because it is voluntary, it appears the International Swap Dealers Association (ISDA) won't see it as triggering credit default swaps. But make no mistake about it, it's a default. Already Fitch has said the rollover would constitute a "restrictive default" event.

The fear has been that surely a default within the Euro area would lead to contagion -- a massive sell off of Euro area bonds, banks and the euro itself. The exact opposite has occurred. With the exception of the currency's strength, this too has been just as we expected (again, see "Greece: Suicide, Not Murder"). Perverse as it seems, what contagion there has been *occurred two weeks prior*, with the speculative attack on Italy (see "The Sack of Rome", July 13, 2011). This brief episode of worst-case contagion drove Euro area leaders to do exactly what we said they'd do -- find a solution that would allow Greece to default -- yet at the same time, reassure markets that Greece is unique, and that they will do whatever it takes to prevent contagion -- including steps toward *de facto* federalism that would have been unthinkable just a year ago.

They have not let us down. The Greek default has been managed so well that markets have rallied strongly on the news. If anything, our bullish stance on the Euro area's ability to survive a Greek default was not bullish enough.

To be clear, this does not change our long-term caution on Europe (see "Europe Gropes toward Stress-Tests" July 12, 2010). Until Europe fashions true federalism -- that is, fiscal union -- it will be in the interests of selfish markets to continue to foment financial crises in weaker nations' debt in order to trigger the increasingly generous guarantees on offer. Each crisis gives the European political elites another opportunity to come a little closer to fulfilling what they see as their destiny -- to truly unify Europe as the world's largest economy. Selfish markets and selfish politicians are thus perfectly aligned.

**Update to strategic view**

**EUROPE MACRO, EUROPE BONDS:** It has happened, finally -- Greece is committed to default. Yet the Euro area's commitment to pick up the pieces is so robust, it would seem that short-term Greek debt is a strong buy. And there is no contagion. Quite the opposite -- the contagion to Italy that began two weeks ago has been turned back. Once again the European authorities have demonstrated clearly their enduring commitment to do whatever it takes preserve the Euro area.

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At the press conference after yesterday's Euro area leaders' summit, Herman Van Rompuy, president of the European Council, reaffirmed that Euro area leaders would do "everything what [sic] is required to save the Eurozone." At the same time, the statement released after the summit declares, "we would like to make it clear that Greece requires an exceptional and unique solution." Taken together, these mean that Greece must default, but that there will be no contagion.

The summit produced concrete proposals -- very nearly commitments at this point -- very much along the lines we have been expecting. Greek debt will be reduced, via an orderly and voluntary partial default; the bailout terms for Greece, Ireland and Portugal will be made less onerous; the scope of the European Financial Stability Facility (EFSF) will be expanded to provide a firewall for "non-program countries" -- read Italy and Spain -- and to increase European economic governance -- read *de facto* fiscal union.

There were two important documents produced following the conference. The first is the statement from the Council of the European Union, which outlines the measures that will be taken to help Greece, and to protect the wider Euro area. The second is the statement from the Institute of International Finance (IFF) which outlines the mechanism for private sector involvement (PSI, and Eurospeak for default) via a Greek debt rollover.

The main points from the statement from the council are:

- Greece will receive a further €109 billion, with funding coming from the EFSF -- which has not been used for Greece before -- and the International Monetary Fund.
- Loan maturities will be up to 30 years, with interest rates on those loans reduced to 3.5%. This covers future, and current loans to Greece, Ireland and Portugal. This pre-empts Ireland and Portugal from roiling markets by threatening default in order to win terms *pari pasu* with Greece.
- A "Marshall Plan" for Greece will be created, involving a European Commission task force and investment from the European Investment Bank (EIB), to rebuild the Greek economy.
- The full extent of the solution for Greece applies to Greece alone -- neither Ireland nor Portugal need all the measures that Greece needs. We note that while this may be correct at the moment, it is unlikely that we have seen the last bailouts for those countries.
- The EFSF, and its successor European Stability Mechanism (ESM), will be allowed to intervene in markets on a "precautionary" basis, and provide financing to countries to recapitalize their banking systems. Notably these measures extend to "non program countries," meaning that the ESFS can provide funding, via national governments, to any bank anywhere in the Euro area.
- There is an attempt to start reforming the structure of the Euro area, with a call for a legislative package to strengthen the Stability and Growth Pact and introduce macroeconomic surveillance across the Euro area.

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- Finally, the reliance on external ratings agencies is to be reduced. The Euro area is being hypocritical here, choosing to ignore the ratings when they are below investment grade, while at the same time lauding the AAA rating of the EFSF.

A document from the IFF outlines the plan for PSI -- that is, orderly default. It is structurally similar to the earlier plan put forth by the Fédération Bancaire Française (see "Dependence Day" July 5 2011), but less generous -- it entails actual bondholder losses, the first since the European debt crisis began more than a year and a half ago.

- The basic idea is an exchange of existing bonds into a package of structured instruments of various maturities, expected to lengthen the average maturity of Greece's debt from six years to eleven.
- All the new instruments will be priced to produce a net present value loss of 21% -- this is the extent of the default.
- The interest rates on the new instruments will be stepped up through the life of the bonds, with lower rates in the first ten years.
- New bonds will be collateralized with AAA-rated zero coupon bonds -- as per the original French plan.
- The exchange is voluntary. There is long list of financial institutions in support of the measure -- with some notable absences, including Credit Agricole and its Greek bank Emporiki. The IFF statement explains the absences saying that it expects support to build for the plan as the offer is more widely disseminated.

Initial market reaction to the plan has been positive, with sovereign debt yields across the periphery tightening and CDS coming in very strongly. The move in CDS is probably fueled by comments from David Geen, general counsel for ISDA saying a "voluntary exchange" would be unlikely to trigger CDS, as this is not covered under the ISDA definition of a default for CDS purposes.

Greek two year debt is at 27%, in from nearly 40% two days ago. ECB president Jean Claude Trichet expressed confidence at yesterday's press conference that the ECB's Securities Market Programme (SMP) would be paid in full and on time for its holdings of Greek debt, as it is a public body and therefore not subject to the PSI agreement. If his confidence is well founded, it hard to see short term Greek debt as anything other than a screaming buy.

What might go wrong in the short term? Simply, the program put forth yesterday must be actually implemented, and that is not without risk. The banks signed up for voluntary loss-taking on Greek bonds now must follow through. And changes to the EFSF will need to be voted on in several national parliaments -- not least the German Parliament -- and it may require changes to European Treaties. The original EFSF package is still under a challenge at the German Constitutional Court -- and while we believe this challenge will be defeated, there is still a risk there. Further challenges are possible in other Euro area states. The package outlined can be construed to violate article 125 of the Treaty on the Functioning of the European Union (see "Confidence Game in Greece" June 23, 2011) and is open to challenge under this, unless the Treaty is changed.

Longer term, we think the latest package from Euro area leadership is strong enough to allow Europe to fall from the headlines for a while -- but the structural problems of the Euro area itself, especially within overindebted slow-growth countries like Spain, Italy and Belgium -- are not fixed in the slightest by yesterday's announcements. To repeat our long-standing articulation of the governing dynamic: it remains in the market's self-interest to cause the deployment of the rescue mechanisms whenever they are available -- and this plays into the self-interest of politicians looking for opportunities to solidify and formalize a European empire.

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**Bottom line**

It has happened, finally -- Greece is committed to default. Yet the Euro area's commitment to pick up the pieces is so robust, it would seem that short-term Greek debt is a strong buy. And there is no contagion. Quite the opposite -- the contagion to Italy that began two weeks ago has been turned back. Once again the European authorities have demonstrated clearly their enduring commitment to do whatever it takes preserve the Euro area.