MACROCOSM

Greece at the Cliff: Thermopylae Edition

Friday, June 26, 2015

Donald Luskin

We still think Greece will fold, at the last moment or a little after. But what if it doesn't?

For all Greek celebrity finance minister Yanis Varoufakis's claims of expertise in game theory, Greece's leverage in the present debt negotiations all comes down to a suicide threat. Such a thing might work for a terrorist wearing a vest full of C-4 in the Mall of America. *But Greece's suicide -- default, banking collapse, capital controls, leaving the euro currency* de facto *or* de jure *-- may not pose a threat to anyone but itself. The problem is -- can we know for sure?*

- *The reality is that, for Europe, Greek suicide is a portal into a realm of unknown unknowns.*

The problem is that one can never truly grasp all the moving parts in crises that play out within an interconnected global economy. Consider the way the failure of Lehman Brothers unfolded in 2008. When US authorities declined to rescue Lehman over the weekend of September 13 and 14, they thought they'd thought of everything. The markets didn't disagree, with stocks closing higher on the first trading day after the decision, Monday, September 15. But as then-Fed Governor Randall Kroszner recalls,

> *...the major hit was only on Tuesday when…one of the money market mutual funds "broke the buck" due to its exposure to Lehman Brothers paper. The interconnection issue that came from*

Update to strategic view

EUROPE MACRO, EUROPE STOCKS, EUROPE BONDS, ECB, FX: We think Greece will blink at the last moment, when €1.6 billion comes due to the IMF next week -- or perhaps, as is the nature of such "cliff" negotiations -- a little bit after the last moment. Europe will make only token concessions. But if we're wrong and Greece commits suicide by defaulting, we can't rule out wild-card consequences that we can't think of in advance, like the contagion arising from Lehman's commercial paper in 2008. The worst risk is a catastrophic loss of confidence as Europe's indebted and slow-growing nations have to write off Greek debt. Default and "Grexit" could wipe out the ECB's entire capital and reserves, casting doubt on its credibility as Europe's "whatever it takes" institution. Until those things are known not to happen, markets will go risk-off, perhaps producing the first really buyable dip in over three years.

[Strategy Dashboard home]

the money market mutual funds was something that was not foreseen.

- Yes, believe it or not, as obvious as it now seems, no one thought about the commercial paper.
- *Is there anything like that we aren't thinking of with Greece?*
- *By definition, we can't think of what we're not thinking of.*

We know that the precipitating event -- the "cliff" -- occurs next Tuesday, June 30, when a €1.6 billion payment from Greece to the International Monetary Fund comes due. Europe's negotiators are treating this weekend as an effective deadline for completing negotiations ahead of that cliff, as Greece's parliament -- and the legislatures of several other euro area nations, notably Germany -- would have to approve any deal.

- What gives this cliff a surreal quality is that paying the €1.6 billion is a precondition for unlocking €7.2 billion in additional previously committed loans -- in part for the purpose, it seems, of at least appearing to repay some of the previous loans (while borrowing even more in order to do so).
- That such maneuverings are necessary means that the small and dysfunctional Greek economy can't generate the wealth required to pay back its €300 billion in sovereign debt -- even if Greece wanted to, which apparently it doesn't.
- *This puts Greece's suicide threat in a new light. Suicide would reveal that Greece is already dead, and that would be a dangerously illusion-shattering revelation. Europe's nations and*

Contact TrendMacro

On the web at
trendmacro.com

Follow us on Twitter at
twitter.com/TweetMacro

Donald Luskin
Chicago IL
312 273 6766
don@trendmacro.com

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

Michael Warren
Houston TX
713 893 1377
mike@trendmacro.com

[About us]

Recommended Reading

The U.S. Stands Out on Labor Force Participation Rates
David Harrison
WSJ Real Time Economics
June 26, 2015

[Reading home]

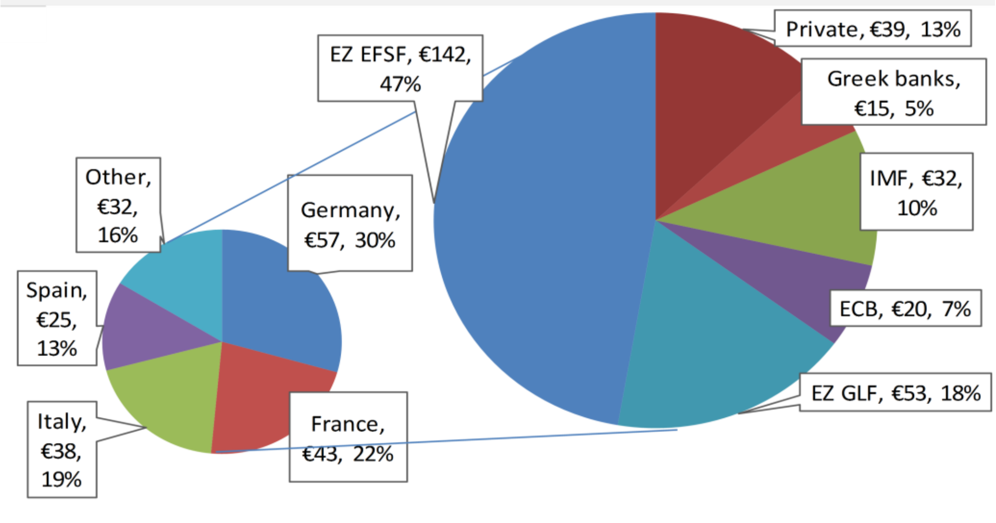
institutions would have to deal with the politically highly unpleasant reality of getting real about €246 billion in losses that have been hiding in plain sight all along.

- *€246 billion isn't a lot of money in the grand scheme of things. The salient question is what finally recognizing the loss would do to confidence.*
- *If we learned anything in 2008 and 2009, it's that any amount of debt is okay if it is supported by confidence -- and no amount of debt is okay if there's no confidence.*

In a crisis of confidence, markets would look hard at any debt about which it could be colorably claimed that no one had dared to ask the obvious question: "why did we pretend this would ever get repaid?" *In extremis*, one could ask that about US Treasury debt (many clients already do, actually). In a Greek default, that question would be asked of the highly indebted and slow-growing nations of Europe, whose large debt burdens would be worsened by having to pony up for their exposure to Greece.

Through the first Greek bailout -- 2010's Greek Loan Facility -- and the second Greek bailout -- 2012's intervention by the European Financial Stability Mechanism -- individual European nations explicitly and derivatively are exposed to €195 billion of Greek debt (please see the chart below).

Greek sovereign debt outstanding Face value



Source: Various, TrendMacro calculations

- Germany is the biggest creditor, owed €57 billion.
- France is owed €43 billion, Italy €38 billion, Spain €25 billion, and the rest €32 billion.
- The GLF component of this debt is a direct bilateral obligation between Greece and each country. The EFSF component devolves upon individual countries through their guarantees of widely held and highly rated EFSF bonds, which in a Greek default they would have to pro-actively honor. For highly indebted Italy and Spain --

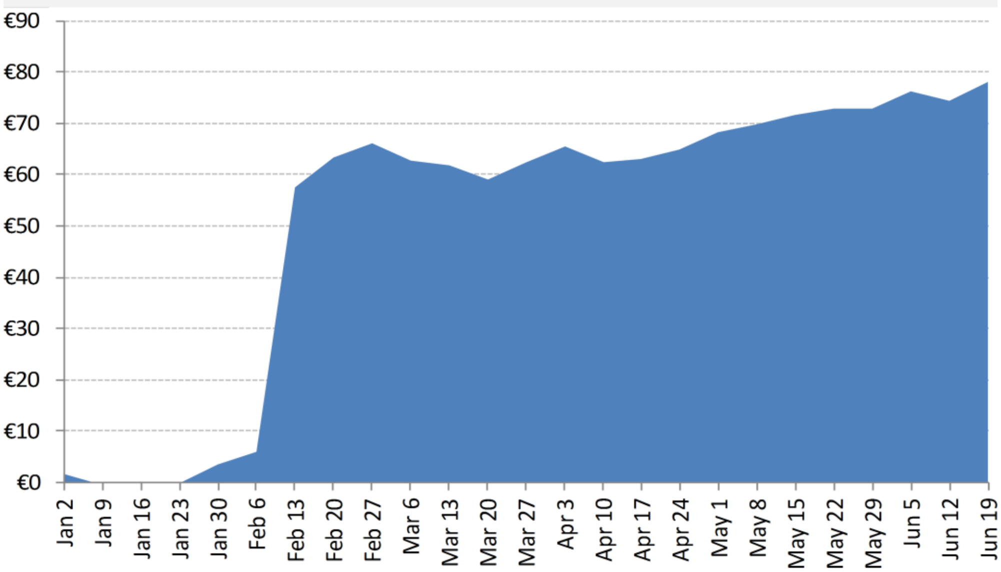
especially Spain, itself the recipient of a bail-out -- this would be a non-trivial act.

- *So it's not confidence in Greece we are concerned about here. It's confidence in Spain and Italy.*

Another vector for potentially catastrophic loss of confidence is the ECB. Directly and through its member national central banks of the Eurosystem, it holds €20 billion of Greek debt, acquired as part of two rounds of the ECB's emergency Securities Markets Programme (SMP). €3.5 billion matures in late July, and another €3.2 in late August. If Greece honors its commitments, the ECB could roll these bonds over as part of its new quantitative easing program.

- If Greece defaults, what would eventually grow to a €20 billion loss would not be a substantive event in the context of the ECB's €2.4 trillion balance sheet.
- *That said, it would be, we believe, an entirely unique circumstance -- a major modern central bank realizing losses on its assets.*
- *Considering the large and growing portfolio of sovereign bonds on the balance sheets of the world's most important central banks -- and considering that those portfolios have been at the center of a gradual restoration of confidence in global financial markets since the depths of the crisis -- a loss of confidence here could be a very big deal.*
- Complicating matters is the ECB's Emergency Liquidity Assistance (ELA) to the Bank of Greece, Greece's national central bank (see "Understanding ELA: Emergency Liquidity Assistance" July 15, 2011). At about €80 billion, this lending is intended to provide Greece's nominally solvent banks liquidity to meet panicked depositor withdrawals during this crisis (please see the chart below).

ECB Emergency Liquidity Assistance to the Bank of Greece EUR billions



Source: ECB, TrendMacro calculations

- On paper, ELA is not a liability of the Eurosystem, but rather the Bank of Greece. But if the banks to whom the liquidity has been supplied cannot return it, and if the collateral they set against it proves inadequate -- or if in a "Grexit" and capital controls regime the Bank of Greece blockades the delivery of collateral to the ECB -- then losses would, in the end, devolve upon the Eurosystem.
- If the ECB must recognize losses of €20 billion in its SMP bonds and €80 billion in ELA, total losses would not quite be covered by the Eurosystem's capital and reserves. If they were depleted, then the remaining 18 nations in the Eurosystem would have to pony up new capital in proportion to their capital keys.
- To avoid this cash-call, the ECB could alternately assign the Greek ELA losses to its "revaluation accounts" of more than €400 billion, reflecting mostly unrealized mark-to-market gains in the ECB's gold position.
- Most likely it would create a deferred asset representing expected retained earnings that it would otherwise have had to pay out. This is the approach suggested by Germany-appointed Governing Council member Jörg Asmussen in testimony before Germany's constitutional court concerning potential losses in the ECB's Outright Monetary Transactions program.
- But these are self-evidently maneuvers designed to disguise an unpleasant truth. The ECB has fought long and hard for its credibility, and its stature as Europe's most effective "federal" institution. Facing Greek losses, the ECB would depend heavily on President Mario Draghi's ability to once again declare "whatever it takes" -- and on the markets' once again believing him.
- If the market does not, then Europe would face a repeat of the crisis of mid-2012, when the social construct underlying the euro currency -- a political reality as much as an economic reality -- was unraveling.
- *It's not "Grexit"* per se *that would threaten the euro currency -- it is the ECB's credibility in facing the crisis.*

Having imagined these very large-scale and somewhat abstract risks, let us come back to earth and talk about what we think is actually going to happen.

- What we've done in these musings is given a structure to Greece's suicide threat, in the attempt to explain why it gives them any bargaining power. Simply, they are betting that Europe won't want to take the chance of invoking a vicious cycle of collapsing confidence.
- A limit on the power of this gambit is Europe's fear of populist politics -- the idea that if it gives in to SYRIZA's demands, then populist parties in Spain and elsewhere will seize power by claiming that they, too, can get debt relief by threating default and currency exit.
- *For all the fears of default and "Grexit," we think this prospect of a populist upsurge is Europe's deeper fear. In Europe's "minimax" approach to this game -- in which it seeks to minimize its maximum*

loss -- then political risk will trump economic risk as the negotiation's governing dynamic (see "From Grexit to Griddance" February 23, 2015).

- Another limit is Greece's own likely costs in the suicide scenario. Default, banking collapse, capital controls, leaving the euro currency *de facto* or *de jure* -- Greece would be right back in an outright depression like it experienced in 2010 and 2011.
- And surely Greece knows that somehow it has to finance itself. As onerous as it claims so-called "austerity" is, at the same time the portfolio of bail-out loans that have already been extended are extremely generous in their extended maturities and far below-market interest rates. They are irreplaceable. Honoring them, or at least most of them, is probably a reasonable price for not having to go it alone in the future.
- *Our point-estimate for the outcome is that Greece will blink at the last possible moment -- or, in the nature of such "cliff" negotiations, a little after it seems officially too late. Europe will give only token concessions. The art of it will be for Greece to claim it bettered its situation a little, while at the same time Europe can claim its concessions were merely cosmetic.*
- If we're wrong, and the negotiations fail, and Greece defaults with no safety net, there will be a risk-off reaction in markets. There is a consensus of sorts that a default or "Grexit" would be a non-event. One investor we spoke with recently felt that this consensus was now so complete and so correct that, if the negotiations break down and Greece defaults, it won't even provide a long-awaited "buy the dip" opportunity in global equities or peripheral euro area bonds (see "The Short of a Lifeline" June 4, 2015).
- *We don't agree. In a default scenario there will have to be a risk-off move lasting long enough to gain assurance that there are no contagion dynamics that no one was thinking of -- no Lehman paper.*
- *If there are not, then that waiting-period would be a buyable dip.*
- *If there are, then the dip will be deeper and longer-lasting, and will be buyable to the extent that the authorities are able to respond effectively to the contagion -- itself a risky process which would take some time to play out.*

Bottom line

We think Greece will blink at the last moment, when €1.6 billion comes due to the IMF next week -- or perhaps, as is the nature of such "cliff" negotiations -- a little bit after the last moment. Europe will make only token concessions. But if we're wrong and Greece commits suicide by defaulting, we can't rule out wild-card consequences that we can't think of in advance, like the contagion arising from Lehman's commercial paper in 2008. The worst risk is a catastrophic loss of confidence as Europe's indebted and slow-growing nations have to write off Greek debt. Default and "Grexit" could wipe out the ECB's entire capital and reserves, casting doubt on its credibility as Europe's "whatever it takes" institution. Until those things are known not to happen, markets will go risk-off, perhaps producing the first really buyable dip in over three years.