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Russell Market Pulse

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by John Velis

Is Greece set for failure? What does the future hold for other European economies? Here, John Velis, Head of Capital Markets Research, EMEA, explains the shape of things right now – and provides his thoughts about where the Eurozone economies might be heading.

WHAT IS THE CURRENT STATUS IN GREECE?

The Greek government continues to implement deeper and deeper austerity measures as it tries to get control of its fiscal situation. Over the weekend, Athens passed a 2012 budget plan that includes deeper cuts in government spending and new taxes. However, Greece also admitted that it will likely fall short of the target that had been agreed with the Troika (European Central Bank, International Monetary Fund, European Commission) for the 2011 budget deficit - and data also suggest that this year will see negative economic growth for the fourth year in a row. While this underscores the difficulty with extended austerity alone as a means to reduce fiscal shortfalls, it seems that the Troika will look favourably on the 2012 budget and recommend – possibly at the last minute – that the next tranche of aid (approximately €8 billion) be released to Greece in mid-October. If there is a surprise, and the aid is withheld, we would then face the real probability that Greece would run out of money and be forced into insolvency. It is precisely because of that that we expect the aid to be granted this time around; a Greek bankruptcy this soon would find European governments and banks still unprepared for the subsequent fallout and therefore forced to face a "messy outcome" that could descend into even further market panic and contagion. Since Europe is currently unprepared for this we suspect the aid will be released and that the rest of the year will see European governments grappling with creating mechanisms to deal with an eventual Greek default later in the year.

SO DO YOU THINK GREECE WILL BE FORCED TO DEFAULT?

We think the arithmetic is undeniable. Austerity alone is not enough. Enforcement of previous measures has fallen short, and targets continue to be missed. Meanwhile growth in Greece continues to fall, the debt-to-GDP ratio continues to rise, and political and social will to maintain austerity ebbs by the day. We suspect that by the time the next Troika review of Greece's programme takes place (in December of this year) a "managed default" will occur - assuming European-wide measures are in place and if Greece looks like it will have trouble meeting its goals. The trick is that the EU needs to have adequate capital buffers for banks which are exposed to Greek debt - and credit derivatives based on this debt. In addition, they need a strategy in place to prevent this event from spiralling into a contagion that could engulf the much larger Italian and Spanish bond markets, banks and their counterparties. We suspect that the rest of the year will see leaders occupied with the development of this strategy.

MARKETS CONTINUE TO REMAIN VOLATILE. DO WE EXPECT THIS TO CONTINUE?

In a word, yes. In a few more words, yes as long as concrete proposals and mechanisms to deal with short term issues remain out of reach. An eventual Greek default and banking sector capitalisation needs are among the two main worries, but proposals also need to cover structural flaws in the Euro and, until they do, we expect markets to react with every piece of news, albeit in a general downward direction. We take the view that policymakers in Europe continue to be timid and restrained in their responses and that this lack of an holistic solution means that fundamentals and market sentiment will continue to deteriorate. It may come to an eleventh hour situation in which policy-makers' backs are squarely against the wall before solutions are seen.

For example, over the weekend of 24th-25th September at the IMF meetings, it seemed that there was some movement – unofficially, of course – towards consensus that bigger more ambitious measures needed to be enacted. This was seen as a positive by the markets; the realisation that more needed to be done. Markets reacted positively on the Monday after the IMF meetings, but the lack of concrete steps being announced in subsequent days saw a gradual erosion in the prices of risky assets over the rest of the week. On Tuesday night this week the market seemed to think that the Franco-Belgian steps to deal with Dexia Bank's problems are a positive admission that a state role in banking sector capitalisation is finally being acknowledged. If we see no larger and broader follow-up however, the gains of Tuesday afternoon could be given back.

WHAT IS THE STATUS OF THE EFSF?

There are still four countries scheduled to vote on ratification of the July 21st agreement to expand the European Financial Stability Facility's (EFSF) powers. The German ratification last week was seen as a positive development; not because the Bundestag agreed to the measure, but because Chancellor Merkel, embattled at home politically, managed to secure passage by garnering sufficient affirmative votes from the members of her government. There was some fear that she would not get sufficient support from her CDU/FDP coalition members, and would need support from the opposition, thus weakening her position further. She avoided that problem, in what was seen as a positive outcome. It is well known that Chancellor Merkel has been facing a dilemma in Germany, where support for additional bailout measures is wavering at best. Any uncertainty in her domestic political position would have only added to uncertainty in the broader Eurozone.

THERE HAS BEEN TALK ABOUT "LEVERING UP" THE EFSF TO INCREASE FUNDS AVAILABLE FOR OPERATIONS. WHAT IS THE STATUS?

We have long said that the €440 billion available in EFSF lending – even if and when the July 21st agreement gets ratified by all Eurozone members – was insufficient to capitalise banks that would need assistance in the inevitable (in our opinion) case of a Greek default, support Spanish and Italian bond markets, and continue to fund Irish and Portuguese bailout programmes. Since additional direct contributions from Eurozone members have been effectively ruled out at the moment, and since Eurobonds remain a concept with no formal backing at the moment, the next ideas involved levering the EFSF. This would have taken place by either allowing the ECB to lend to the EFSF in return for

some of the already committed €440 billion as collateral, or turning it into a structured entity so that it could use the €440 billion to guarantee a less risky tranche of new bonds, with subsequently riskier tranches as one goes down the capital structure. Both of these ideas remain conceptual only; there has been no consensus, and in some cases even outright rejection of these and similar proposals. It is important to remember that the EFSF gets its funding from Eurozone sovereign states, and any increase in the size of the EFSF or the inherent riskiness of the already committed funds would reflect poorly on the credit-worthiness of the donor countries, even risking credit watches or downgrades from ratings agencies for AAA countries like France of even Germany, as they would be seen as “on the hook” for any increase.

YOU MENTIONED DEXIA BANK ABOVE. WHAT HAPPENED THERE?

Dexia, a medium sized Franco-Belgian bank with exposure to Greek and Italian bonds, ran into serious financing trouble over the last few weeks. One of its largest business lines is local, regional, and national government finance. As credit-worthiness across the Eurozone deteriorated over the summer (either real or perceived), Dexia found itself further and further shut out of interbank financing. This liquidity crisis got so bad that over the last few days, the French and Belgian governments had to step in and orchestrate a break up of the bank into three entities, one of which is a “bad-bank” with access to state guarantees from Brussels and Paris. This episode was an example of a “reactive recapitalising”; by which governments responded once things in the market got so bad there was no choice. It was initially seen as welcome in the sense that the precedent for addressing banking sector vulnerabilities to the sovereign debt crisis has been set (and markets last night in the US rallied on the news). Nevertheless, a more systematic, front-loaded rather reactive mechanism still needs to be set up; we do not think that lurching from one brush fire to another will prove itself to be ultimately sustainable throughout the rest of this year.

SO, IS THE SITUATION IN EUROPEAN BANKS STILL UNSOLVED?

Yes it is. And this, to us will be the biggest single issue that will dominate the policy-making argument in the Eurozone crisis in the coming months. With all ideas to increase the size of the EFSF so far not even on the drawing board, there remains a vacuum of concrete ideas to deal with the fact that if and when Greece defaults, the European banking sector will find itself in grave, possibly Lehman-like, danger - unless a plan can be put in place beforehand to backstop the sector. In the meantime liquidity gets harder and harder to obtain and markets continue to eschew banking shares. This is why credit spreads continue to widen, and equity prices continue to weaken. Essentially, a sovereign debt crisis has become a banking crisis in Europe, and even previously “strong” economies in the EU like Germany and the other “northern core” countries are now facing a serious growth crisis; the financial channel is getting tighter and tighter in Europe, and consumer, investor and industrial sentiment weakens progressively as solutions still don’t seem to be forthcoming.

WHAT IS THE ECB’S ROLE IN THE EUROZONE CRISIS?

This remains the big mystery and the big hope. Elected politicians in Europe have demonstrated insufficient resolve. In those countries which face fiscal difficulty, they have shown themselves either unwilling and/or unable to act with assuredness, and at the EU-level, there has been a lack of consensus and

concrete measures to deal with the crisis for over 18 months. Thus, the ECB has been the only entity with the flexibility and muscle to deal with the crisis.

Thus far the ECB has used its ability to expand its balance sheet by supporting secondary bond markets in Italy and Spain as well as provide nearly open-ended liquidity to European banks in need of support. It is unclear how comfortable the ECB has been with this role, or how long it would continue to fill it. Some governments have even questioned the legality of the ECB's moves. Nevertheless, it is clear that in the absence of leadership by political leaders the ECB's role has been indispensible so far.

More recently, as discussed above, it has been suggested that the ECB could provide loans to the EFSF in return for some of the €440 billion the latter has in direct funding as collateral, thus increasing the total firepower of the EFSF. However, this remains wishful thinking, as no agreement or even concrete proposal on this suggestion has come forward, and some observers think it will be politically impossible as well as financially dubious.

So, we have been left with the ECB as the only rampart between contagion and potential chaos and the current muddle through, yet we do not know if Frankfurt is comfortable with this role, or whether it will continue to perform it with open-ended, unlimited, support.

SO WHAT IS THE SOLUTION?

We have long argued that a Greek (or that of another peripheral state) or German (or that of a combination of "core countries") exit from the Eurozone, would be nearly technically and legally impossible, and economically and financially so costly, that it would not happen unless all other options were exhausted. The only sufficient solution, then, in the short- to medium-run, was in our opinion a form of three-legged stool which included firstly, a larger support package than the €440 billion already committed to the EFSF; secondly, the recognition that some countries' fiscal positions were unsustainable and therefore required some form of restructuring and/or write-downs for bondholders, and thirdly, the ongoing convergence of the real economies, structurally and fiscally, of the peripheral countries. In the longer run, this would probably need to be supported by much further centralisation of fiscal and economic governance across the Eurozone with some surrender – either de-facto or de-jure – of economic sovereignty by nations. Without this, a monetary union cannot be sustained in the long run.

We still think those three legs will need to be constructed, but the difference is that the first leg, an increase in the size and scope of the "pot" of money almost certainly will need to be aimed at both the peripheral sovereign states as well as European banks, who would suffer enormous capital losses when the second leg eventually (as we believe is all but inevitable) is constructed. It is reckoned by the IMF and others that a 50% haircut on outstanding Greek debt would lead to undercapitalisation of the European banking sector of something between €300 and €500 billion. Thus, leg two cannot be built with out leg one at the same time.

HOW IS IT GOING TO END?

No one has a crystal ball, and we find it something of a surprise that we are nearly two years along in this crisis and still very far away from an overall solution - even though the elements of the solution seem to be clear for all to

see. Nevertheless, ruling out a collapse (by the exit or ejection of one or more members of the single currency) of the Eurozone, we still think the solution will be created and will resemble some form of the three legged stool outlined above and long-described by Russell.

In terms of how things will play out, we suspect that the next tranche of Greek aid will be disbursed, even if the Troika's targets are not achieved down to the letter. The Eurozone is simply not prepared for a Greek default at the moment. Then, in subsequent months this autumn, we should see movement – probably in fits and starts and with the same degree of clumsiness that European leaders have displayed – towards erecting the architecture required to deal with an eventual Greek default at the end of 2011 or early 2012.

In the meantime, the markets will remain volatile, and we will be running the risk that while the three legs are being built, something could go wrong before Europe is "ready". A bank failure or a sharp deterioration in sentiment that leads to a bond or banking crisis. Such an unforeseen event may even be a "Lehman" type moment, after which European leadership's minds become sufficiently focussed to finally erect a mechanism to stem an episode of contagion.

WHAT IS THE TIMELINE LIKE?

From Reuters, these are the important dates for scheduled events in the Eurozone through the end of the year.

- **October 7th and 8th** – the Troika is likely to conclude its review of Greek austerity measures.
- **October 13th** – A special meeting of the Eurogroup (finance ministers of the Eurozone), most likely to discuss the disbursement of an €8 billion tranche of aide from the Troika to Greece. It is estimated that without this aide, the Greek government will be insolvent by the 15th of October.
- **October 14th and 15th** – meeting of G20 finance ministers in Paris.
- **October 17th and 18th** – EU summit for heads of state or government. On the 18th, the summit will include only those members of the Eurozone itself.
- **October 31st and November 1st** – Current ECB President Trichet to step down, replaced the next day by Maria Draghi. We do not have great insight as to how much, if at all, Draghi's approach to the ECB's role in the crisis will differ from that of Trichet.
- **November** – Thus far there are two meetings each of the Eurogroup and the finance ministers of the larger European Union.
- **November 3rd and 4th** – G20 annual summit in France.
- **December 9th** – EU summit meeting for heads of state or government.

We suspect that the hard work of finally building the three legs will take place in November, hopefully with some public understanding of the size and scope of any solution to be achieved in December, after which some end-game moves will seem likely.

GLOSSARY

Core Countries: Those countries in the Eurozone which are not embroiled in both market and official concerns about their fiscal sustainability.

ECB: European Central Bank.

EFSF: European Financial Stability Facility. A special purpose vehicle set up by the Eurozone in May 2010 to fund assistance to the HYPES countries. At present it has a lending capacity €440 billion, made up of contributions from European Union countries.

HYPES: High Yielding Peripheral European States. This refers to Greece, Ireland, Portugal, Spain, and Italy, those countries of the European Monetary Union which have significant fiscal difficulties and have come under severe market pressure, driving their bond yields and borrowing costs much higher than the "core" countries of the Eurozone.

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