

Greece: Will the ‘tail’ wag the dog?

Events over the past two weeks have increased the risk of a serious ‘tail event,’ whereby problems in Greece spill over to the rest of the euro-zone through the bond markets and via banking-sector linkages. Contagion in bond markets is already taking place. In an extreme scenario, substantial capital flight from euro-zone periphery banking systems to the euro-zone core is also possible.

Following a further revision in the government’s budget deficit last week and downgrades to its credit ratings by Moody’s and Standard & Poor’s, Greek bonds are pricing in a likely debt restructuring or default. On 22 April, Greece’s 2009 deficit was revised up to 13.6% of GDP, from a previous estimate of 12.9%. The same day Moody’s downgraded Greece to A3 from A2 and yesterday S&P dropped its rating from BBB- to BB+ (i.e. below investment grade, or junk). Difficulties coordinating between the IMF, EU, ECB and individual countries, coupled with public opposition in Greece, have added to the uncertainty.

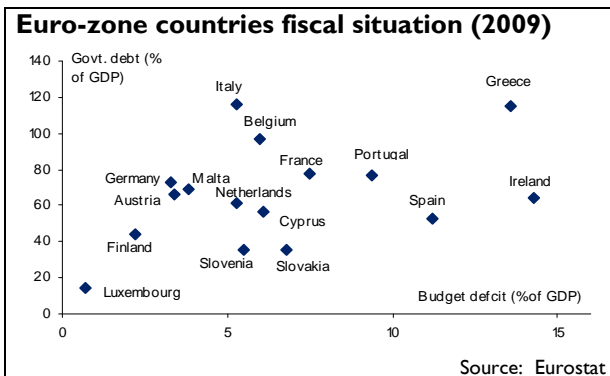
Two-year Greek bond yields have risen by more than 1000 basis points (bp) since 12 April. We estimate that in the next three years Greece would have to raise about €150 bn, more than 50% of its GDP, to pay debt redemptions and interest. With debt markets effectively closed, this makes the stand-by facility of €30 bn from the euro-zone plus €15 bn from the IMF inadequate. Either the bailout funds will have to be substantially increased, which is already under discussion, or Greek debt ‘restructured.’ A restructuring could involve, for example, a forced extension of maturity of bonds due to be redeemed in the next few years – effectively a soft form of default. Or more drastically, investors could be forced to take a significant reduction on their interest and principal payments.

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Linkages to other euro-zone countries

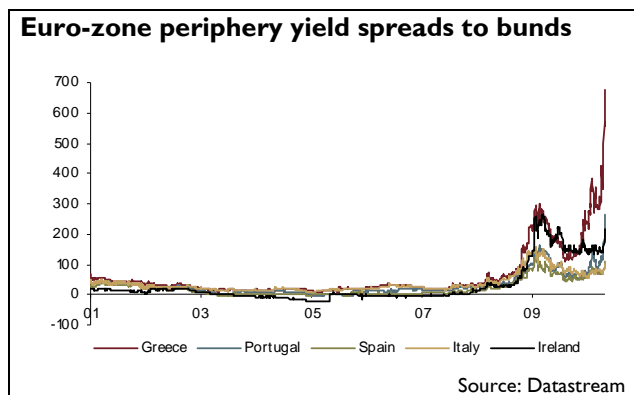
By itself Greece is a relatively small economy, representing only 2.7% of euro-zone GDP. However, the risk is one of contagion. This could happen in at least two ways, via the bond markets and via the banking sector. In an extreme scenario, we could also see a flight of capital out of peripheral euro-zone countries.

1. Bond market spreads could widen further

Contagion in bond markets is already taking place. Bond yields for other peripheral euro-zone countries with high debt burdens have already increased sharply in the past few days. A restructuring of Greek debt would see investors questioning which euro-zone country will be next and hence lead to even higher yields for Portugal, Italy, Spain and Ireland, widening further the premium over German bunds.

Portugal is already being singled out as the next most likely candidate. 10-year bond yields have increased by more than 150 bp since early April. Its fiscal situation is not as bad as Greece, nor has its deficit had to be restated, as Greece’s has. Nonetheless, once investors start to lose confidence

and financing costs rise, a default/bailout can become a self-fulfilling prophecy.



2. Contagion via the banking system

Low savings rates and large current account deficits mean that a significant proportion of peripheral euro-zone debt is owned by non-domestic investors. In particular, France and Germany have significant exposure to the periphery via their banks, much larger than UK banks for example. A restructuring of Greek or Portuguese government debt would require some of these assets to be marked down, leading to losses for German and French financial institutions. Spain has very little direct exposure to Greece, but has a large exposure to its neighbour Portugal - roughly \$86 bn at the end of 2009.

Estimated exposure by country					
	French banks	German banks	Italian banks	Spanish banks	UK banks
Greece	75	45	7	1	15
Portugal	45	47	7	86	24
Spain	220	238	31	-	114
Italy	511	190	-	47	77
Ireland	60	184	18	16	188

Source: BIS, Coutts (\$ bn, assets include govt debt, end 2009).

3. Capital flight

In an extreme scenario there would be a danger of huge capital flight from weaker euro-zone country banking systems. Greek banks have already reported a loss of around €10 bn of deposits, equal to about 4.5% of the total in the banking system, in the first two months of the year. In response, on 7 April Greece's four largest banks asked to borrow €17 billion left over from a €28 billion support program launched in 2008 by the Greek government. Further capital flight would place additional strain on peripheral euro-zone countries' public finances, and

eventually could require ECB intervention in the form of guarantees for national banking systems.

The Greek banking system would come under additional stress if further credit downgrades, especially by Moody's, led to Greek debt no longer being accepted by the ECB as collateral against Greek banks' cash borrowings. The minimum threshold for assets the ECB will accept as collateral is currently BBB-, i.e. the lowest investment grade. The S&P rating is now already below this, though the Moody's rating for Greece at A3 is currently still three notches away from this minimum requirement.

Investment Implications

For bond markets, a restructuring of Greek debt would see the required yield on other peripheral euro-zone countries increase too. More generally, we are likely to see much more discrimination in bond markets between those countries deemed fiscally responsible versus those with fiscal problems. The example of bond markets punishing Greece (and possibly Portugal) will increase pressure on other countries with precarious fiscal situations to accelerate financial consolidation (including the UK), suggesting slower growth overall. Against this, looser monetary policy will probably provide an offset.

In foreign-exchange markets, the increased uncertainty surrounding restructuring and divergence in bond yields will continue to weigh heavily on the euro. Even if a restructuring can be avoided (i.e. further money for a bailout is put forward instead), the euro is likely to continue to weaken over the medium term.

In equity markets, we expect the peripheral euro-zone markets to continue to underperform the core euro-zone, with the exception of German and French banks, which are also likely to show weakness given their exposure to the periphery.

On a more positive note, current euro-zone activity indicators for the big three economies (Germany, France and Italy) indicate a recovery in their economies, if not over taken by a financial crisis. Indeed, a weaker euro would give a boost to these countries' exporters, many of which are already extremely competitive in world markets.

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