

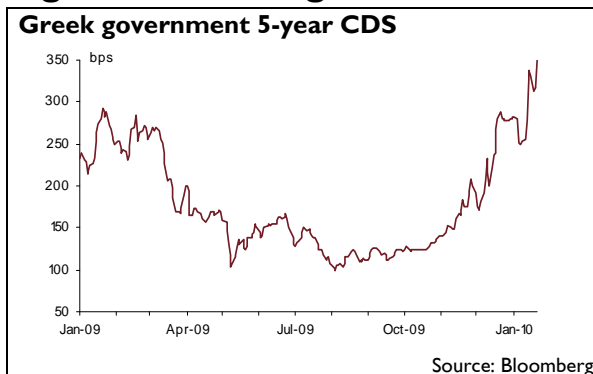
**Greece's crunch time in 2010 could weigh on euro and growth**

**Greece's fiscal problems have figured prominently recently and will continue to plague the eurozone over the course of this year, weighing on the euro. We may see a further spike higher in Greek bond yields, before a way through the crisis is found. Aggressive investors may want to wait for a spike in yields and a crisis event, as an entry point to buy Greek debt.**

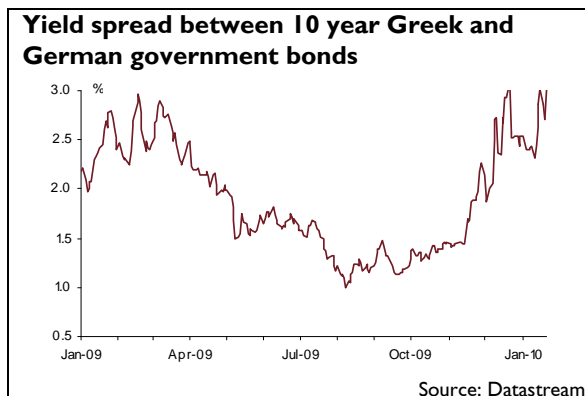
In October last year Greece announced it was revising its budget deficit estimate for 2009 from 3.7% of GDP to 12.7% as well as restating past years, shocking the European Commission and financial markets and leading to downgrades from the ratings agencies.

On the 8<sup>th</sup> January this year, the European Commission revealed that it still had doubts over Greece's revised budget deficit estimate, stating that 'a substantial number of unanswered questions and pending issues still remain in some key areas'. Last week, the rating agency Moody's issued a report on Greece and Portugal warning of a 'slow death' for their economies - suggesting further ratings downgrades are on the cards. Then on 14 January, ECB President Jean-Claude Trichet took a tough line on Greece at the monthly ECB press conference, warning that the ECB would not grant any 'special treatment' to Greece to help it deal with its fiscal problems.

The market reaction, especially following the comments by Trichet and the Moody's report, was strong. Greek five year government bond CDS spreads spiked almost 100 bps. Similarly spreads between German and Greek government debt reached levels seen during the peak of the credit crisis in early 2009.



At the end of last week, the Greek government proposed a 'stability and growth pact programme' with budgetary cuts and revenue raising measures to reduce the deficit to 8.7% of GDP in 2010 and bring the deficit down to below 3% by 2012. This would amount to a reduction in the budget deficit of 10% of GDP in three years, which is incredibly ambitious. These proposals are currently being scrutinised by the European Commission and European Council of Finance Ministers (ECOFIN).



It appears that Greece, is once more being given the benefit of the doubt, with Jean-Claude Juncker (President of the Eurogroup) telling reporters in Brussels on the 18<sup>th</sup> January that "The measures are a step in the right direction. We'll have to see whether they're enough." A final report will be

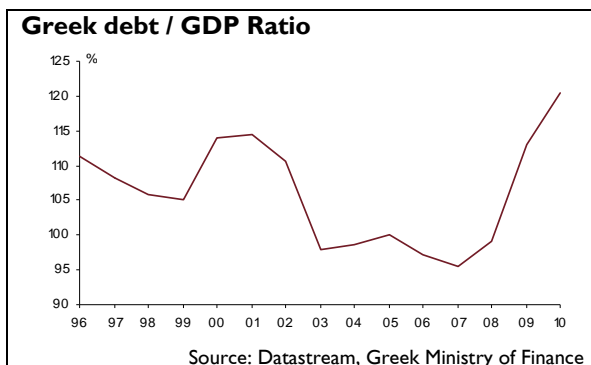
issued in February, with ongoing regular assessments of progress being made thereafter.

### Is it half-past ten or five to midnight?

It is worth emphasising that the market has been aware of the problems facing Greece for some time. Greek bond yields have spiked before on ratings downgrades and increased budget deficit estimates, only to fall back. Given the relatively relaxed comments by the Ecofin council, this could happen again over the next few months. But crunch time for Greece is still likely sometime in 2010 for three reasons: 1. Unfavourable debt dynamics, 2. the danger of further ratings downgrades and 3. the expiry of more relaxed collateral requirements by the ECB at the end of 2010.

#### 1. Unfavourable debt dynamics

Greece's debt dynamics look particularly unfavourable. Even if we accept the Greek government's latest budget deficit forecasts this leaves total debt to GDP at 113% by the end of 2009 and set to hit 120% in 2010. Interest payments on debt currently amount to around 5.5% of GDP, and could rise to 7-8% within a year or two, raising the danger of a snowball effect, where the debt balloons as interest payments are added every year to the outstanding debt.

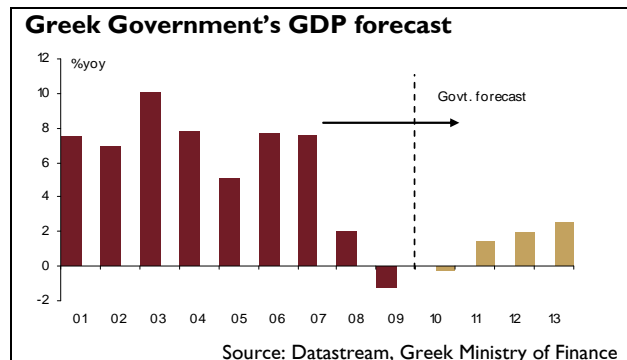


Even these figures may be optimistic. The deficit reduction and growth assumptions made in its latest proposals look heroic. For example, despite an enormous cut in spending, the Greek government is still forecasting only a very modest recession in 2010 and a return to growth in 2011. In addition, a large part of the revenue raising proposals rely on better enforcement and collection of taxes as well as a radical overhaul of

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the system. These proposals are fraught with difficulty.



Furthermore, a proposal for a pay freeze in the public sector is likely to meet with stiff opposition, with unions already calling for strikes. If the measures fail to work, debt and interest payments will grow more quickly.

#### 2. Further debt downgrades likely

There is a strong chance of further downgrades during the course of the year. The main ratings agencies have indicated that they will be monitoring closely implementation of the latest proposals by Greece to reduce its deficit, and that any slippage relative to the targets set out in this programme would be likely to lead to downgrades.

#### 3. ECB collateral policy will hit Greek banks

The ECB, when providing liquidity to the banking sector, stipulates that a government bond must be above a certain rating before the bank will lend out cash against these bonds as collateral. In October 2008, during the peak of the credit crisis, the ECB relaxed its criteria, expanding its list of collateral and adjusting the minimum requirement for credit assessment to BBB- from A-. On May 7<sup>th</sup> 2009 the ECB announced it would extend the new expanded collateral policy until the end of 2010.

More downgrades could lead to Greek government bonds no longer being eligible as collateral with the ECB, especially from January 2011. This would create a liquidity crisis for Greek banks, as well as lead to a spike in Greek bond yields and further losses for Greek banks which hold significant amounts of their government's debt.

Greek government debt is currently rated A2 by Moodys and BBB+ by S&P and Fitch. Only the

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Moody's rating is within the minimum requirement of the pre-crisis framework, and it is only two notches away from ineligibility under these rules.

Therefore, things may come to a head later in the year, either when downgrades resume, the deadline for tightening of ECB collateral policy comes closer, or simply if the budget deficit estimate for 2009 or 2010 is revised higher again.

### **Options for Greece and rest of eurozone**

The options for Greece are stark: 1. Default on its debt 2. And/or leave the eurozone 3. Muddle through 4. Bailout.

1. Default. Greece could temporarily suspend coupon payments on its debt, or pay them at a rate of its choosing. However, this would create massive problems in issuing new debt, eventually reducing government spending and therefore still leading to a big recession.

2. Leaving the eurozone. This has the advantage of allowing Greece to issue its own currency, which it could allow to depreciate, helping to restore competitiveness and thereby boosting the export sector. Whilst superficially attractive, the process of leaving would be very costly. The question would arise over debt denominated in euro and whether it would be converted back to local currency (effectively a default) or still paid in euro (raising government interest-servicing costs).

Departure of Greece from the eurozone would also have a cascading effect, as financial markets and investors focused on which country would be next to leave. Bond yields spreads for other problematic countries would widen massively and we could even see capital flight, with depositors and investors shifting their money out of these countries in anticipation of an eventual eurozone departure and replacement with a weaker domestic currency. The disruption to the financial system would be enormous.

3. Muddle through. Greece could attempt to maintain the status quo, hoping that a gradual economic recovery will help it to grow more quickly and gradually consolidate its finances. However, the window of opportunity for this option is rapidly diminishing given the debt dynamics and other factors mentioned above. Even

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in a best-case scenario, the fiscal consolidation needed to restore health to its public finances would see many years of recession/stagnation. The inability to devalue its currency to boost the export sector makes the necessary adjustment to the domestic economy even more painful and unlikely to materialise.

4. Bail-out. Eventually, some sort of bailout for Greece will be needed. This may involve the IMF as well as the European Union institutions, to get round the 'no-bailout' clause of the Maastricht Treaty. For example, the IMF could provide 'stability loans' to Greece in return for fiscal consolidation and austerity plans. In return, the ECB could extend its easier collateral requirements, or find another way of providing indirect support for Greece.

The European Commission may ask for greater control of the Greek budget and we could see significant changes in the way the EU institutions are set up, with more control over national budgets given to Brussels. The necessary fiscal consolidation for Greece and other eurozone states in a similar position would weigh on the region's growth.

### **Athens and Brussels in 'game of chicken'**

On balance, a combination of 'muddle through' and eventual bailout is the most likely outcome. It is unlikely that the eurozone will allow Greece to go bust. The knock on confidence in the rest of the eurozone financial system and the danger of contagion to other fiscally weak countries would be too great.

However, the tough stance taken by the ECB suggests a degree of brinkmanship, and that the ECB will want to inflict some pressure on the Greek government, possibly through higher bond yields, before a compromise is eventually agreed.

Increased uncertainty around these issues as we progress through 2010 is likely to weigh on the value of the euro and could lead to a further spike higher in Greek bond yields and CDS spread at some point, before a compromise is eventually agreed. This could then see yield spreads narrowing sharply. Aggressive investors may therefore want to look for a crisis event as an entry point to buy Greek government debt.

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