June 2015

EFG Market Comment

An update on Greece

The worsening situation in Greece has been a dominant item in global news for most of the past few months. After protracted and difficult negotiations it finally looked as if some progress was being made last week and hopes were still high that a deal could be reached before the end of June, at which point Greece needs to repay about €1.6 billion to the IMF. However, events took a turn for the worse over the weekend; some capital controls have already been imposed. To summarise recent developments:

- On 22nd June, the Greek government presented a draft proposal to the three main creditors - the IMF, the ECB and the EU - in which some concessions were made, notably in terms of extending the retirement age, limiting the ability of certain groups to retire early and raising additional revenues mostly from the corporate sector. The Greek government agreed to target primary surpluses (the budget surplus before servicing government debt) of 1%, 2% and 3% of GDP over the next three years.
- This was felt to be much closer to the terms required by the creditors. However, the IMF in particular expressed discomfort with the emphasis on tax hikes, feeling this would be a headwind to economic growth and preferring instead to place a greater share of the adjustment on reduced government spending. The proposal was rejected by the creditors.
- On 25th June, the creditors offered to extend the amount available to Greece by €15.5bn subject to the Greek government signing up to the creditors' adjustment programme. The creditors also intimated that further debt relief would be forthcoming should the Greek government comply. The Greek authorities rejected this deal.
- In spite of the failure to reach a deal, the rhetoric emanating from both camps remained relatively upbeat. It was believed that the two parties were not that far apart in terms of what remained to be negotiated and that a deal could be reached over the weekend.
- In a move that took the creditors by surprise, Greek Prime Minister Alexis Tsipras announced on 27th June that a referendum will take place on 5th July. Voters will be asked to decide whether or not to accept the creditors' terms. If rejected, this would imply non-compliance with the adjustment programme and serve as the likely first step in Greece exiting the single currency and possibly the Eurozone.
- The Greek government requested that the creditors extend the 30th June deadline to permit the referendum to take place. The creditors have rejected this request.
- Throughout the negotiations, the ECB has permitted liquidity to be provided to the Greek banking system via its Emergency Liquidity Assistance (ELA) programme. This has been necessary to offset the large deposit withdrawals that have taken place as depositors have become nervous about the possibility of capital controls being imposed. The amount of ELA funding currently extended to Greek banks is about €89 billion.
- On Sunday 28th June, the ECB indicated that it will not extend any further money via the ELA to Greek banks. The Greek government declared a bank holiday on Monday to protect the Greek banking system and imposed certain limitations on the movement of capital. The ECB has said it "is determined to use all the instruments available within its mandate" to contain the crisis.

What next?

It is not entirely clear what happens next. The creditors have indicated that, since the referendum takes place after the programme officially ends, the deal to extend the programme will have expired so the outcome of the referendum will be irrelevant. Greece will still technically and legally be part of the single currency and the EU so the ECB will remain responsible for oversight of the Greek banking system. However, the ECB is only allowed to sanction ELA if it believes the banks receiving it are solvent. Should Greece default on its payment to the IMF, that then brings into doubt the ability and willingness of the Greek authorities to service and repay other government debt. Given that ELA loans to Greek banks are collateralised with Greek government debt, a default by the Greek authorities against the IMF in turn raises questions

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over the solvency of the Greek banking system[1]. Media footage over the weekend showed people queuing up at banks to take money out. Greek banks will need to replace lost deposits with funding from other sources. Without access to the ELA programme, funding options are limited.

Against this difficult background, it seems likely that the ECB will apply more stimulus. This could take a number of different forms. The ECB has already indicated that it will front load asset purchases over the summer. The extent of this front loading could be magnified or the ECB could announce a more permanent increase in the scale of monthly asset purchases, to be reviewed at a later date as and when the Greek crisis subsides. The ECB could also choose to extend the date of its asset purchase programme beyond the current expected end date of September 2016, although this would largely be symbolic since it would not have an immediate effect. Finally the ECB could invoke Outright Monetary Transactions (OMTs). These have not been used before but the establishment of the OMT programme was instrumental in calming markets in August 2012 when fears were also running high regarding a potential Greek default and exit from the euro. OMTs would allow the ECB to purchase unlimited quantities of sovereign bonds with a maturity of between one and three years from those Eurozone governments that have signed up and agreed to some form of fiscal adjustment under the EFSF / ESM.

What will be the fall out?

If Greece defaults on its IMF loan repayment, as seems highly likely, this would be the first step in exit from the euro, although exit would not be guaranteed. Should exit occur, it would require full blown capital controls to be imposed on Greece, severely limiting the ability of Greek households and businesses to take money abroad or indeed engage in transactions denominated in foreign currencies. (As noted above, some capital controls have already been imposed though these would have to be tightened further should the situation deteriorate.) This would severely limit the ability of the Greek economy to import goods and services[2]

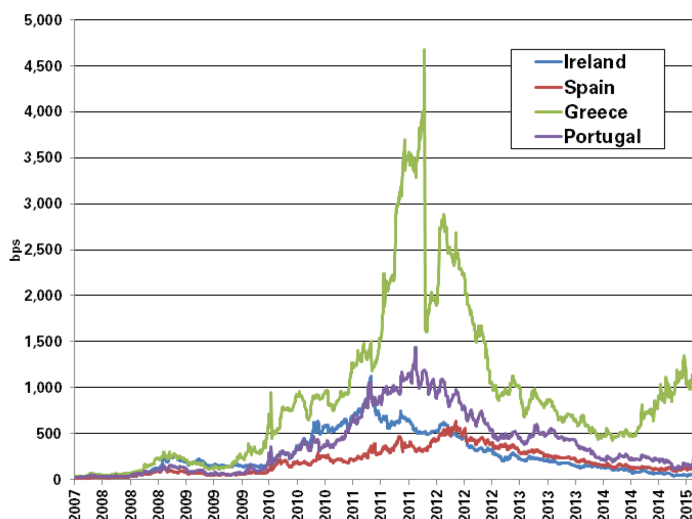
Furthermore, the Greek government and businesses would be unlikely to have access to capital markets, hampering their ability to raise funds. The effect would be most profound for the Greek government who would struggle to fund public expenditures, particularly in an environment where tax revenues were collapsing. The Greek government would then find that decisions over whether or not to increase pensions for this group of people funded by an increase in taxes on that group become irrelevant.

I think it is safe to say that the outcome for Greece would be unequivocally bad. Economic activity would collapse, the banks would struggle to stay afloat, the government would find itself powerless to intervene and it seems probable that some sort of humanitarian crisis would ensue.

What of the impact on the rest of the world?

Thankfully such events occur very rarely. As such we do not have many data points available against which to compare the current situation in Greece. With this in mind and as was the case when Cyprus experienced its financial crisis two years ago, we do not envisage wide scale negative repercussions from a Greek default and possible euro exit. Household, business and investor confidence will almost certainly be hit in the short term, not least because of the uncertainty associated with the situation. So it would be natural to expect an increase in market volatility. However, we believe that the rest of the Eurozone remains well placed to withstand a Greek Eurozone exit. It is notable how over the past few months credit spreads of debt issued by peripheral Eurozone nations over German government debt have remained well behaved - see Chart 1. This is telling us that, even though the market has been rightly concerned about events in Greece, fears of contagion have been contained.

Chart 1. European 10 Year Sovereign Spreads (bps) to Bunds



Source: Datastream, EFG calculations

We should remember that the Greek economy is small, at less than 2% of Eurozone GDP, so the direct impact on other Eurozone nations is unlikely to be very great. It is also true that some of the other peripheral nations that had previously experienced difficulties and required bail outs are now in much stronger positions. For example, Table 1

[1] The rating agencies have indicated that missing a payment to the IMF would not result in downgrade to a default rating (http://www.reuters.com/article/2015/05/01/us-greece-default-ratings-idUSKBN0NM3N420150501). However, it is unclear how the ECB would respond.

[2] At the time of writing, foreign transactions have to be sanctioned by a special committee to allow importation of essential items such as pharmaceuticals (http://in.reuters.com/article/2015/06/29/eurozone-greece-banks-idINKCN0P905G20150629).

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shows current account balances and budget balances as a % of GDP for Ireland, Italy, Portugal and Spain. These countries have moved from deficit to surplus in their current accounts and have meaningfully improved their fiscal deficits:

Table 1. Eurozone Current Account and Budget Balances

	Current Account (%) of GDP		Government Primary Net Lending / Borrowing (% of GDP)	
	2008	latest	Peak (crisis period)	Latest
Ireland	-5.7	6.2	-30.0	-0.3
Italy	-2.8	1.8	-0.2	1.8
Portugal	-12.1	0.6	-9.1	0.1
Spain	-9.3	1.4	-9.6	-3.0

Source: IMF WEO Database (April 2015)

So the rest of Europe is in a relatively strong position to withstand any second round effects of a Greek default and exit. When the first Greek bailout was arranged in 2010, a major concern was the impact Greek default would have on global banks, particularly those banks located in Europe. This is because a lot of European banks had bought significant amounts of Greek debt, attracted by the higher yields on offer. With hindsight, those higher yields reflected the higher risk inherent in Greek paper. Table 2 shows exposure to Greece across the banking systems of France, Germany, the UK and the US:

Table 2. Global Bank Exposure to Greece **(US millions)**

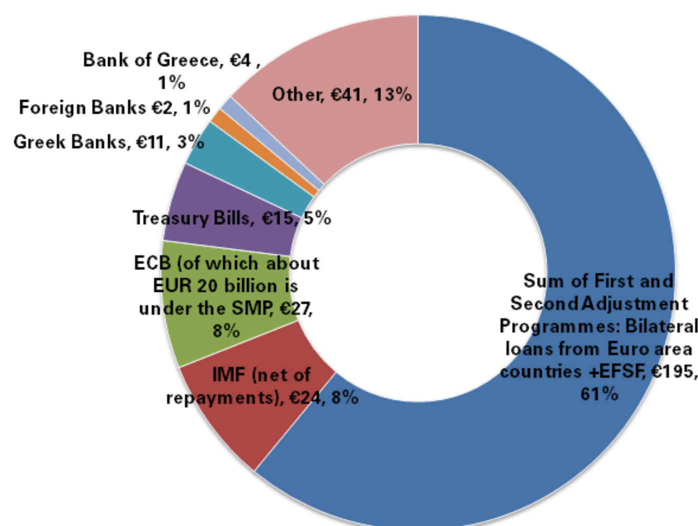
	Exposure by Country to Greek Sector					
	Germany	France	US	UK	Others	Total
Banks	5,028	413	11,798	8,425	938	**26,602**
Public Sector	219	20	278	290	610	**1,417**
Private (Non-Financial)	5,849	1,214	622	3,442	5,449	**16,576**
Other	2,168	0	0	0	21	**2,189**
Total	**13,264**	**1,647**	**12,698**	**12,157**	**7,018**	**46,784**

Source: BIS Quarterly Review June 2015, EFG calculations

Total exposure to Greek debt is now only $47 billion, significantly less than the $138 billion exposure as of the end of 2010. Direct exposure to Greek government debt is now only $1.4 billion, a fraction of the $46 billion exposure in December 2010.

In terms of who the Greek government owes money to, this is shown in the pie chart below. The chart illustrates how the bulk of the money is owed to other European nations either directly via the bilateral loans arranged via the first adjustment programme or indirectly via EFSF loans. This then represents the greatest risk to the rest of Europe:

Chart 2. Greek Creditors



Source: IMF, European Union, ECB, Bloomberg, CNN, EFGAM Calculations

The amounts involved are not insignificant but nor are they trivial. If Greece were to default much of the debt would be written off. The countries that lent the money would have to subsume the debt onto their own balance sheets. Aside from the obvious humanitarian tragedy in Greece, this is probably the least palatable aspect of a Greek default. By itself, however, it does not appear to be of sufficient size to destabilise the rest of Europe, especially given the potential increase in ECB intervention.

For reference, 2014 Eurozone GDP was €10.1 trillion, so even if the full amounts of the first and second adjustment programs were to be written off, it would only amount to under 2% of the Eurozone's annual output.

Conclusion

The situation may be summarised as one of intense uncertainty, at least for Greece. The announcement of the referendum has created a strange situation where we do

not know if the outcome will come too late to bear any influence, even if it is in support of the creditors' demands. In the meantime, default against the IMF looks hard to avoid and, absent a sharp U-turn by the Greek government, full blown capital controls look highly likely to be imposed. We anticipate a general increase in investor nervousness and uncertainty though the contagion effects should be well contained. This is partly because the size of the Greek economy is small relative to the rest of Europe, partly because the rest of Europe is in a much stronger position than it was when the first and second Greek adjustment programmes were arranged and also partly because the ECB stands ready to act. For certain Eurozone countries, the negativity associated with the Greek negotiations and its aftermath could act as a deterrent to political extremism, encouraging a shift closer to the political centre. This is potentially a positive side-effect; Greece will become an example to other anti-austerity leaning parties making the Eurozone more robust over the longer term. From an equity market perspective, the uncertainly and volatility associated with Greece will create some opportunities. Long term valuations are attractive, the ECB is providing plenty of support in terms of asset purchases plus whatever else it does to alleviate short term concerns and the weaker euro will help export oriented corporates. Of course if Greece does not exit, we could see an improvement in financial markets anyway.

It would be a tragedy if Greece were to go down the route of default and Eurozone exit. It is not too late to reach a solution though time is rapidly running out. While the impact on the rest of Europe can, we believe, be contained, the impact on Greece will be devastating. Let us hope that the grown ups regain control of the situation.

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