CORONATION FUND MANAGERS

Greece

The gloomy shadow of the Acropolis

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There is no shortage of things to say about the crisis in Greece; after all, the situation remains so fluid that every day something new comes up. The Donald Rumsfelds amongst us could identify many 'known unknowns', speculate on a few 'unknown unknowns', but agree on very few 'known knowns'. The crux of the matter is that so far, there appears to be a lot of liquidity support but very little concrete action in terms of solving the underlying Greek problems which led to the crisis in the first place.

From what we know, the scenario at the time of writing is that:

- The first €110 billion bailout package agreed to in May 2010 by the European Union (EU) and International Monetary Fund (IMF) for the period 2011-2014 is now deemed insufficient for Greece's needs. A second bailout package estimated at €90 billion is on the cards, with the popular view being that some of this money should come through private sector involvement and the balance from the EU and IMF.

- As part of the agreed austerity package Greece is required to respond by contributing a further €30 billion through state asset sales (privatisation), bringing the total to €50 billion.

- The European Central Bank (ECB) has taken an active role in stabilising the banking system since the early days of the financial crisis and continued to do so as the sovereign debt crisis unfolded. The ECB stated in May this year that it would reject Greek bonds as collateral should any forced 'burden sharing' by private investors result in the bonds being rated as in default. But the ECB now finds itself between Scylla and Charybdis (having to choose between two evils): it has lent Greek banks €98 billion secured against Greek government bonds. Removing its support would cause the collapse of the Greek banking system and risk spreading contagion.

European policymakers have been working on a solution, but with the probability of default now estimated by credit default swaps to be in excess of 90%, some 'fancy footwork' will be required. The rating agencies, often criticised for not being proactive, find themselves under immense pressure to delay judgement. ECB officials concede that discussions with the rating agencies are difficult and it looks increasingly likely that some form of compromise will be necessary. The ECB has, after all, already changed its collateral requirements to accommodate Greece (and Ireland and Portugal). In all likelihood it may also have to ultimately accept bonds that are in selective default, with the compromise being that they take a larger 'haircut' (more security is required for a given amount of cash provided).

With the largest private holders being the German and French banks, a 'voluntary debt rollover agreement' was initially sought. This appears increasingly unlikely, with the probability now swinging towards a buyback of debt at market prices through a central European vehicle, most likely the European Financial Stability Fund (EFSF). This vehicle, initially set up to issue bonds to pay for loans to Greece and Ireland, is not currently permitted under its terms of agreement to participate in the secondary market. In order to be used in a buyback programme all 16 member states would be required to ratify the mandate changes at a parliamentary level – something that could take several months. Even then the realistic size of any such buyback programme would be questionable given the EFSF's need to maintain a AAA rating, meaning even if it gets authority to buy back bonds it may not be able to buy enough. In any case, to reiterate – this is more of a band-aid solution, when in fact Greece needs surgery.

Thus we are left depending on Greece to deliver on its obligations; their past record does not inspire confidence.

We look to Greece's history and identify the messages that can be drawn for long-term investors. Bear in mind that government defaults are not uncommon, with defaults occurring on external debt in most geographical regions as recently as the 1980s and 90s. Since 1941, Europe has fared slightly better than other regions with only defaults from Romania (1981 and 1986) and Poland (1981). Greece, however, has defaulted or rescheduled its debt five times since gaining independence in 1829, and has spent 50% of the years since then in a state of default or debt rescheduling[1] . All too often governments have attempted to inflate their debt problems away by boosting money supply or devaluing their currency.

As a result of being locked into the euro, Greece does not have the ability to devalue its currency in order to boost competitiveness. This means it needs to accept real wage cuts to do so – and in conjunction with the austerity measures being implemented to reduce the budget deficit and debt, it is no surprise that citizen anger has swelled into protests.

Investors need to appreciate that the EU and its single currency, the euro, are as much – if not more – about politics as economics. Since the end of World War II, Europe has steadily moved towards greater forms of integration, in part to avoid the rise of extreme forms of nationalism. The EU came into being alongside the Maastricht Treaty in 1993, replacing the previous European Community (1967) and the European Economic Community (1957). The Maastricht Treaty also gave rise to the creation of the euro and a set of convergence criteria which members of a single European currency had to meet. Unfortunately the criteria were never truly adhered to and were all too easily disregarded once entry was gained. In fact, Finland is the only country that currently meets both the 60% gross debt to GDP ratio and the annual debt to GDP deficit limit of 3%.

All too often policy is only made amid a crisis and arguably the events in Greece should not have been allowed to get to this stage. Greece, regarded by many as the birthplace of mathematics, has long struggled to make its numbers add up and there is a history of 'fudging':

- Eurostat publicly expressed doubts about the official figures which led to revised debt figures as early as 2002.
- In 2003, Greece was advised of flaws in the manner in which it estimated revenue collection.
- In 2004, an audit by the then incoming New Democracy government revealed that the 3% hurdle used for euro entry had in fact not been achieved[2].

- Following the election of the Socialist government in October 2009, the 2009 budget deficit was revised from 6% to 8% to 12.7% and then to 15.4% of GDP. In fact, Eurostat has had more issues with how Greece calculates its debt statistics than any other EU member state.

Perhaps most controversial was the revelation that it had entered into swaps with Goldman Sachs in 2000 and 2001 in order to reduce its recorded debt by a total of €2.376 billion. This first came to light in 2003 as did the revelation in 2001 that Italy had made similar trades with JP Morgan dating back as far as 1996. The real issue here is that despite the fact that this was brought to the attention of the ECB and Eurostat, nothing changed until 2008 when several other member states lobbied for a change in the way these transactions were accounted for. So what about the excessive debt procedure and fines for those that failed to adhere to the Maastricht criteria? It seems these were effectively abandoned when the pact was reformed in 2005. So Europe really only has itself to blame for this mess.

Greece should be seen as Europe's canary in the coal mine. At only 3% of eurozone GDP, Greece is ultimately manageable, but both Spain and Italy are regarded as too big to bail and too big to fail. The EU needs to address its structural issues and somehow establish a firebreak in the event that Greece fails to deliver on its austerity and asset sale programme. Greece today looks very similar to Argentina a decade ago. In the IMF post-mortem[3] of that crisis it concluded that the most viable option would appear to have been an early debt restructuring and abandonment of the currency peg. They also went on to say that the provision of new financing only postponed the inevitable and meant the eventual cost of collapse was all the greater. There are thus worrying implications for the eventual Greece endgame from this analysis.

In the aftermath of the financial crisis governments have been very quick to point fingers and impose new rules on banks requiring them to boost their capital adequacy. They need to heed their own advice: Europe may be in the spotlight, but is far from being the main culprit. Despite the peripheral outliers its total debt burden is lower than both Japan and the US. Both these nations are living on borrowed time. For the current demographics, this means that their debt burdens will deteriorate significantly if nothing is done. Governments may argue that their debt dynamics were compromised by the financial crisis and the transfer of bad debts from the corporate sector. But that merely reflects the consequences of their laissez-faire attitude – an attitude that can be ill afforded at the current juncture. In the past, poor discipline on the part of borrowers would have seen them excluded from markets for a protracted period of time. However, in recent years the fragmentation of the investment community has seen the rise of hedge funds and short-term investors fill vacuums, and even junk-rated borrowers have been able to raisefunds at relatively low interest rates. Issuers of debt should nevertheless be wary of relying on the finite resources of these investors. If the number of distressed entities continues to increase, long-term investors are going to demand a lot more certainty before they get involved.

As we go to print US politicians continue to pontificate on the debt ceiling debate. If Europe has one message for the US surely it is 'do not ignore the bond vigilantes'.

1. This time is different Reinhart &Rogoff 2009
2. http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/GREECE/EN/GREECE-EN.PDF
3. www.imf.org/external/np/pdr/lessons/100803.pdf