

## Greece, the EU and the Euro – The Main Elements of a Greek Tragedy?

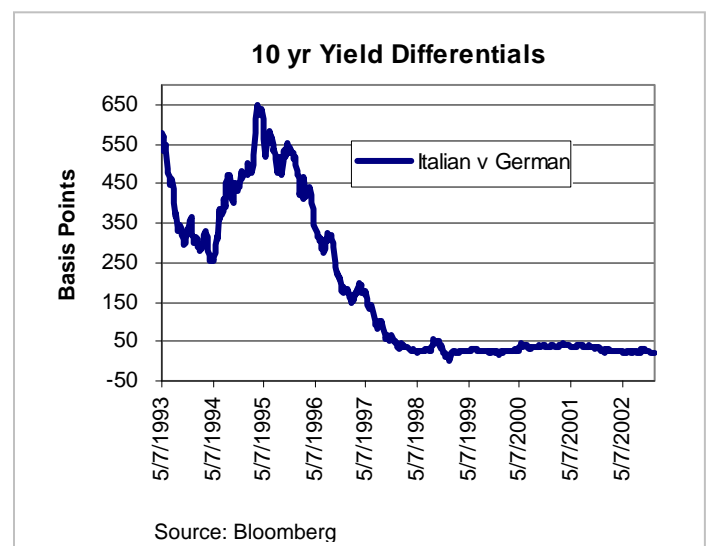
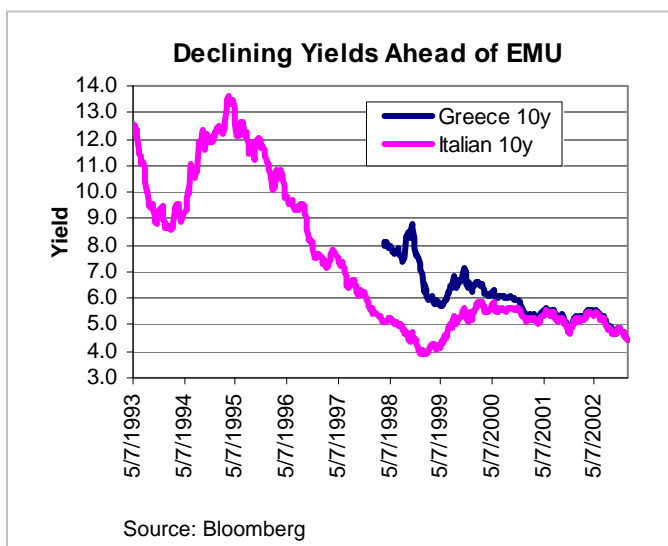
### ELEMENT I – THE STAGE IS SET FOR THE TRAGIC ACT

The idea of creating an economic and monetary union has long existed in Europe and modern attempts began between members of the European Economic Community in 1969. In March 1979, the European Monetary System was created, pegging member national currencies to a notional currency, the ECU. A further major step was taken in February 1992 with the signing of the Maastricht Treaty, which agreed to create a single currency (the Euro) by January 1999, although Denmark and, more notably, the UK opted not to join this new currency.

In 1997, the Stability and Growth Pact was agreed in Amsterdam, along with a new Exchange Rate Mechanism (ERM), to ensure budgetary discipline after the introduction of the Euro. In order to be a founding member of the Euro, countries had to pass two main criteria: (1) Debt / GDP ratio of less than 60%, and (2) a budget deficit of 3% of GDP or lower. Other criteria included having inflation rates no more than 1.5% higher than the three lowest inflation states in the EU, long-term interest rates no more than 2% higher than the three lowest inflation states and countries to have been members of the ERM for at least two years and not to have devalued their currency within that timeframe.

Eleven countries were selected initially to be part of the Euro – ironically, Greece was judged to have failed to meet the criteria and was excluded. But even at this early stage in the new currency’s life, it was evident that political compromise was winning over strict adherence to fiscal criteria – Italy was accepted as an initial member of the Euro despite blatantly having failed to meet the requirements of the Stability and Growth Pact.

Despite scepticism from some quarters that monetary union would never succeed without political union, the new currency was introduced in non-physical form on January 1st 1999 as the existing national currencies of the 11 participating states were fixed against the Euro with all their domestic debt now denominated in Euros. The benefits of being a member of the Euro also became apparent when looking at both short- and long-term interest rates. Instead of converging at some average, interest rates converged to the level of the strongest country, Germany.

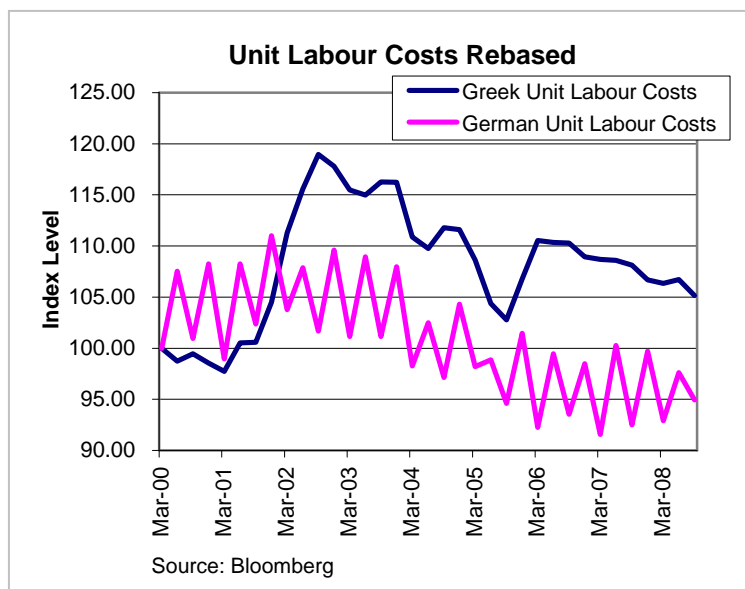


For countries like Ireland and Italy, this meant almost a halving in domestic borrowing rates and mortgages. This massive lowering of the interest rate paid on government debt made deficits easy to finance, made housing tremendously affordable and gave a huge boost to consumer spending in certain European countries. Greece belatedly joined the party (as it turned out to be) in January 2001, having been required to devalue its currency and undertake some fiscal adjustments.

Like Italy before it, Greece was subsequently found to have used some creative accounting measures to meet the entry criteria. Defence expenditure was classified as a state secret and removed from the deficit calculations (Greece has the third largest army in Europe). Outstanding medical bills owed by the government to doctors and hospitals (estimated at €6bn) were also excluded. Certain off-balance sheet derivative transactions marketed by aggressive investment banks were used to temporarily reduce deficits and future government receipts were securitised to achieve once-off gains. However, for political expediency, these concerns were ignored and Greece became the 12th member of the Euro.

## ELEMENT II – ENTER THE PROTAGONIST

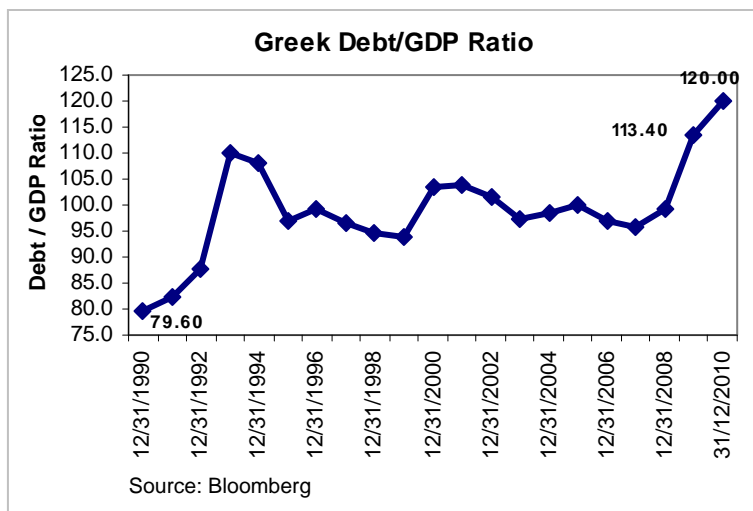
Greece had experienced strong growth prior to the global recession (4% on average from 2003-07), driven by strong global economic conditions and the aforementioned low interest rates within the Euro zone. Despite this growth, Greece has consistently posted wider budget deficits (2000-08 average of -5%) and higher government debt / GDP levels (99% in 2008) than most of its EU peers. These negative indicators, in conjunction with a loss of competitiveness, led to a large current account deficit (2000-08 average of -9%) and high public sector debt. These factors, combined with the relatively small size of the domestic banking sector, led to Greece having a large external funding requirement (72% of total funding / 97% of GDP).



Negative market sentiment towards Greece has been building over the past 12 months due to its perceived position as one of the weaker core EU countries, colloquially known as the PIIGS grouping (Portugal, Italy, Ireland, Greece, Spain). However, the recent upsurge in market concern has been due to the combination of the Greek economy exhibiting most of the unfavourable economic indicators of the European peripherals, as well as a recent loss of credibility due to significant negative revisions to its 2009 budgetary outcome.

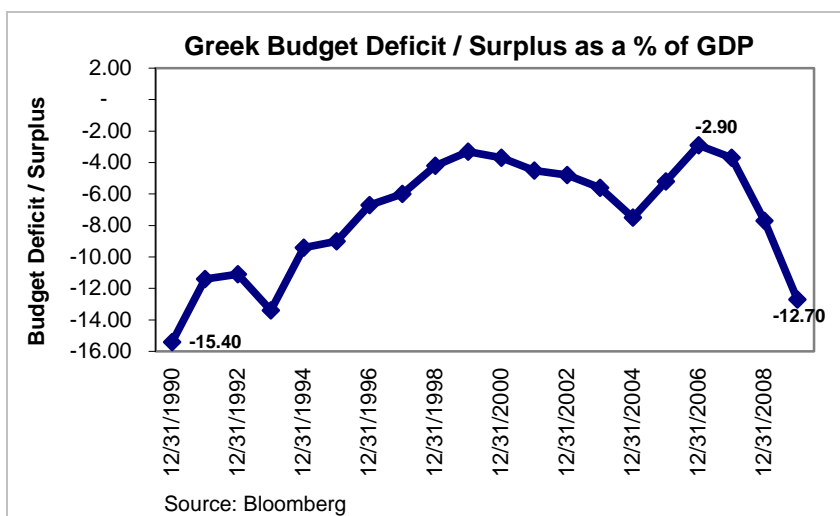
Despite initially holding up relatively well through the recent global recession, the Greek economy deteriorated rapidly in H2 09 largely due to the inability of the new government to implement its planned policies, with issues controlling public spending (which increased 10.5% in 2009). Greece has had to deal with systematic barriers to reforming its fiscal position with low competitiveness, high structural spending and high tax evasion. Public spending is out of control with public-sector wages rising 97% from 2000 to

2008. GDP in 2009 is expected to contract by around 4% with an estimate of -0.3% for 2010 and a return to growth in 2011 through 2013 of +1.5-2.5%. These 2011-2013 forecasts are challenging given the level of fiscal consolidation to be implemented and that medium term growth will not experience the previous benefits of low interest rates and strong domestic credit demand. The debt / GDP ratio, which was already quite high pre-recession at 99% in 2008, is likely to increase to 120% in 2010 and peak around 130% in 2011. This would push the debt / GDP ratio past Italy as the weakest in Europe. Greece had reduced government debt interest / revenue from 12.6% in 2004 to 10.3% in 2007 but, unfortunately, it is likely to accelerate again to 15.1% in 2010, adding a further barrier to addressing debt levels. Its current account deficit peaked at -14.6% in 2008 but should recover to -7.1% in 2009 and improve as global economic conditions improve with domestic credit demand likely to be restrained.



The first draft of the 2010 Greek budget is part of a medium-term stability plan aimed at reducing its deficit (which has deteriorated to -12.7% in 2009) to -2.0% in 2013 through reductions in public spending (public-sector job cuts and wage freezes for all public-sector workers), healthcare and pension reform, and tax increases (fuel and excise as well as longer term tax reform). This plan has the dual aims of short-term fiscal consolidation and longer-term structural reforms. The implementation of this plan will come under severe and on-going scrutiny from the EU.

**ELEMENT III - EU POLITICAL REACTION – THE IMPACT ON OUR TRAGIC FIGURE**



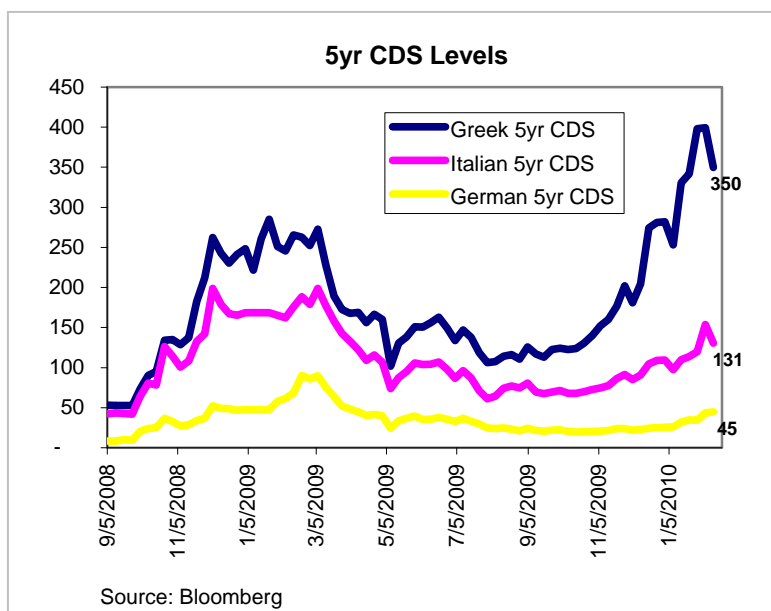
The situation facing Greece has caused problems across the political sphere in Europe as EU procedures in dealing with members in fiscal difficulties have not been stress tested since the advent of EMU. The EU's default path of action requires member states to adhere to the Stability & Growth Pact and maintain annual budget deficit and debt / GDP targets. Countries which fail to meet these targets

must provide medium-term plans as to how to rectify the situation (as Greece has done) or else face sanctions from the European Commission (EC) under the Excessive Deficit Programme (EDP). As things

stand, Greece has triggered the first of the sanctions under the EDP and was required to provide an updated austerity package to reduce its budget deficit. This programme was reviewed by the EC and noted as “ambitious but achievable.” Greece will have to submit a timetable to the EC in mid-March for its 2010 fiscal measures, with a further report to be provided in May and quarterly updates to be provided beyond that. The programme also requires Greece to implement stronger controls of its official statistics office, which was found to be severely wanting and not up to the EU standard. If Greece fails to abide by its stability programme, it will face sanctions from the EC in the form of fines or restriction on EU funding / support.

Given the rise in the cost of financing Greek debt (which we return to below) and the not insubstantial amount of funding that must be done in Q2 of 2010, there has been considerable speculation that the EU will be forced to step in and support Greece in some manner. To date, the EU has made rather vague statements that are long on rhetoric but short on detail, noting that the EU will stand behind Greece, i.e.,

*“We fully support the efforts of the Greek government and their commitment to do whatever is necessary, including adopting additional measures to ensure that the ambitious targets set in the stability programme for 2010 and the coming years are met. Euro area Member states will take determined and coordinated action, if needed, to safeguard financial stability in the euro area as a whole.”*



#### ELEMENT IV – THE PROCESS OF AFFIRMATION

In our opinion, a Greek default is very unlikely given what we have seen communicated around Europe. However, markets remain distinctly unimpressed by the statements emanating from the EU in relation to support for Greece. Market participants wanted all the details immediately, regardless of the difficult circumstances the EU finds itself in. For a start, there are significant legal problems with disbursing aid to a fellow member-EU state. Articles 123 & 125 of the Treaty on European Union prohibit overdraft or credit facilities to fellow member states, the purchase of fellow-member debt instruments and assuming the liabilities of other Euro members. However, as with all good Treaties, there is a general get-out-of-jail clause: Article 122 (2) states

*“Where a Member State is in difficulties or seriously threatened with severe difficulties caused by natural disasters or exceptional circumstances beyond its control, the Council, on a proposal from the Commission, may grant, under certain conditions, Union financial assistance to the Member State concerned.”*

High-level EU sources have been quick to blame “speculators and profiteers” for the current turmoil in European markets – it wouldn’t take a big leap of imagination to note that with Greece having taken some

measures to tackle its budget deficit, an unwillingness by investors to fund the Greek government could be blamed on circumstances beyond the control of the Greek government.

However, from leaks from high-level EU sources, we know that some form of support has been agreed for Greece amongst other European states. Given what we have written above about the Treaty on European Union, it seems likely that such support will come in the form of bilateral loans from other member states, most likely Germany and France. But it will most certainly come with stringent terms and conditions attached. However, it will happen for two main reasons: (1) A default by a member state of the EU would sound the death-knell for the whole monetary union project and too much political capital has been invested over many years for it to now fail, and (2) If Greece were to default, focus would turn on Ireland, Portugal and Spain. Greece on its own only accounts for 2.6% of Euro zone GDP but that number rises to 17% if you include the aforementioned countries. The knock-on effect on German, French and Italian banks would be catastrophic, requiring government support that would far exceed what it would cost to support Greece.

Still, the EU would prefer to use this backstop loan facility as a last resort and would rather see Greece try and sort out its problems itself. In practice, this probably means allowing Greece to implement austerity measures over the next month, regaining market confidence and funding the forthcoming maturities in April and May, albeit at elevated interest rates.

### **MOST LIKELY OUTCOME**

- Bilateral loan arrangements are agreed between Greece and Germany, France and possibly other major EU members to the tune of €20bn - €30bn. These loan arrangements are acknowledged in public but details are not disclosed.
- Greece implements already-agreed austerity measures within the next 30 days to reduce its budget deficit.
- Greece presents its first public finances report to the European Commission in mid-March. EC greets report with verbiage such as “good progress, first step on a long road, etc.” and makes further (tough and non-negotiable) “recommendations” to further cut the deficit.
- Rating agencies reaffirm current Greek ratings (A2 / BBB+), allowing Greek bonds to continue to be used as collateral in ECB operations. This allows Greek banks to fund themselves at lower rates than they would normally pay in the market.
- EU re-affirms its intention to support member states by whatever measures necessary. Markets perceive the likelihood of a Greek default to be shrinking and start to buy Greek bonds, allowing the refinancing of April and May’s maturities to occur.
- Greek spreads remain wide as investors remain sceptical about Greece’s long-term ability to implement the austerity measures. Other peripheral spreads tighten as contagion fears are reduced.

### **WHAT COULD GO WRONG?**

- Populist pressure and strike activity force the Greek government to back down from implementing the austerity measures. Although recent opinion polls show support for the new measures running at

somewhere between 60%-70%, Greece had the most general strikes in Western Europe between 1980 and 2008. Note also that trade union density in Greece was 27% in 2007, higher than the EU average of 25%.

- Political pressure in Germany prohibits the arrangement of a bilateral loan. A vital state election is forthcoming in Germany in early May where the present government is facing a difficult challenge. If it loses this election, a bailout of Greece (already deeply unpopular with the public) becomes less likely.
- Despite EU assurances, markets are not convinced to step up and refinance Greek maturities in April and May. EU backstop facility is rolled out but perceived to be “too little, too late” and contagion spreads to other countries such as Ireland, Portugal and Spain.

### FOR GREECE, THE CURTAIN FALLS FOR MOMENT, BUT ...

The recent problems in Greece are a direct consequence of the massive transfer of leverage from the private sector to the public sector, not just in Greece but worldwide. Markets have suddenly awoken to the fact that, just as in the corporate market, in the sovereign market there also should be greater disparity between credit quality of states and their relative spread levels. We should be prepared to accept that sovereign credit risk is here to stay.

That also means questioning previously accepted assumptions such as the ability of large debtor nations (most notably the UK and the US) to retain “AAA” ratings. The ability of Greece to use derivative transactions to hide the true level of their indebtedness and protect their ratings, whilst not illegal, could be considered unethical and may yet meet with a stern response from EU governments, particularly if it is found that other countries have availed of such instruments. It would be foolish to disregard the possibility that regulatory action could be taken to prevent a repeat of this situation occurring.

Note also that the extreme austerity measures being imposed on the Greek population may be a harbinger of what the rest of the developed world may have to face (either voluntarily or involuntarily) in the future. This means less consumption, higher saving and a general diminution in living standards, which have ramifications for asset prices globally.

The reaction of the Euro to the problems, not just in Greece but other peripheral European countries, leads to the inescapable conclusion that the Euro is not yet ready to challenge the US Dollar for the role of primary reserve currency. What it also highlights is the long-held belief that monetary union without political union is an uneasy compromise.

And finally, as heretical as it sounds, governments (and by implication, central banks) may accept a higher level of inflation going forward as a means of reducing their outstanding levels of debt. And bond yields are most certainly not priced for that outcome.

Greece remains a crucial character in this drama with the conclusion still to be written. It remains to be seen if careful attention and thoughtful action can provide a satisfactory solution to this “tragic” situation. ♦

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