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A New Lease for Greece: Part II

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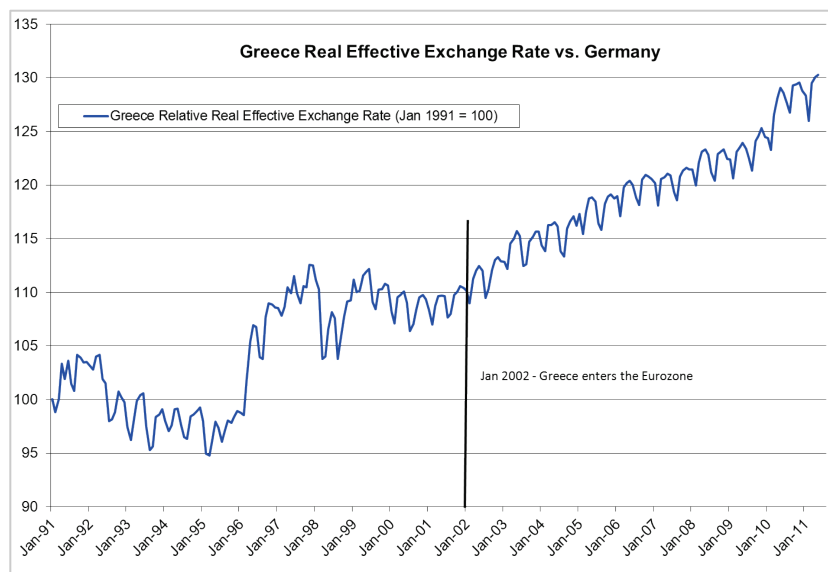
"There goes another beautiful theory about to be murdered by a brutal gang of facts."

- Duc de La Rochefoucauld

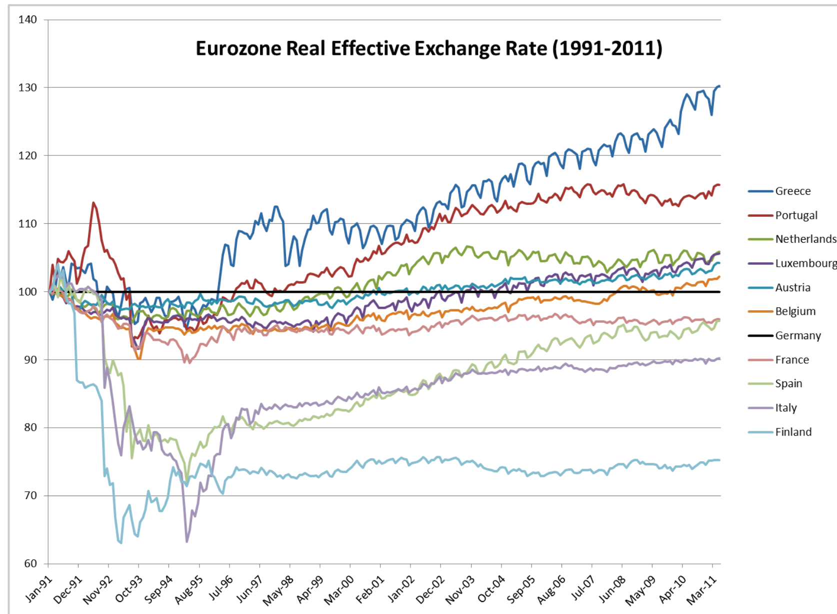
In our recent article entitled "A New Lease for Greece", we suggested that the Europeans are continuing to treat the current crisis as a liquidity issue when, in fact, Greece is insolvent. As part of this *Monthly Client Report*, we would like to provide additional data which supports our contention of insolvency. The comparisons to Argentina 2001 are favorable to … Argentina.

Background

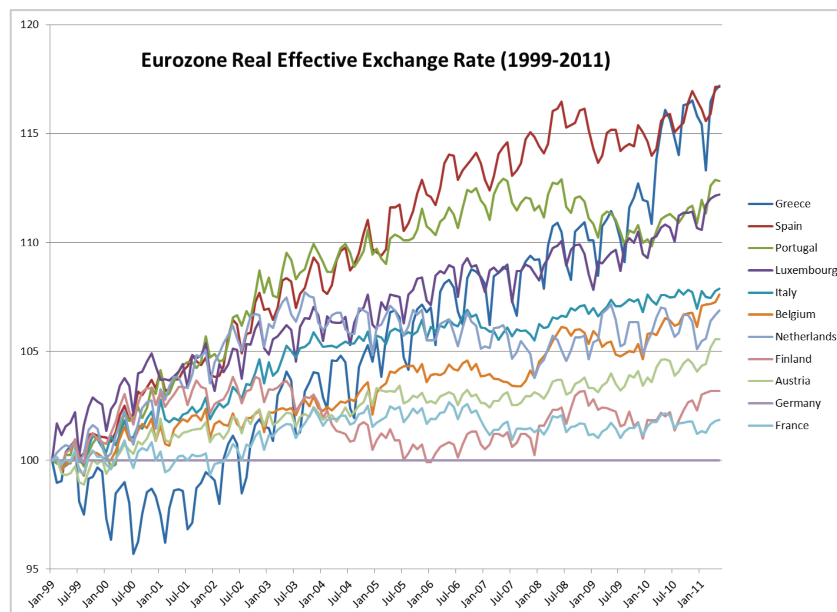
Greece became a member of the Eurozone in January 2002. The nation was rejected from joining at the inception of the euro in January 1999 due to excessive debt and deficit figures. The December 2001 tally now shows that Greece's debt to GDP was 103.7% at the time, compared to the Maastricht Treaty cap set at 60%. The rules were bent to let Greece in; in retrospect we now know the Greek government lied about its debt and deficit levels to gain entry to the Eurozone. Following it's entry into the Eurozone, Greece managed to string together some impressive growth figures, averaging 4.2% in the 2002 to 2007 period. The GDP figures masked a steady drop in Greece's competitiveness. Inflation continued to exceed levels seen in Germany and the historical remedy of currency devaluation was no longer available. After holding in a narrow 95 to 112 band from 1991 to 2002, Greece's Real Effective Exchange Rate (REER) relative to Germany began a steady march higher, reaching 130 in April 2011.



As a comparison, we looked at the other Eurozone nations that have continuous data back to 1991. Greece holds the dubious distinction of 1st place in loss of relative competitiveness to Germany.



Looking at the data since the 1999 introduction of the euro shows that Greece, Spain and Portugal have seen the largest deterioration in competitiveness.

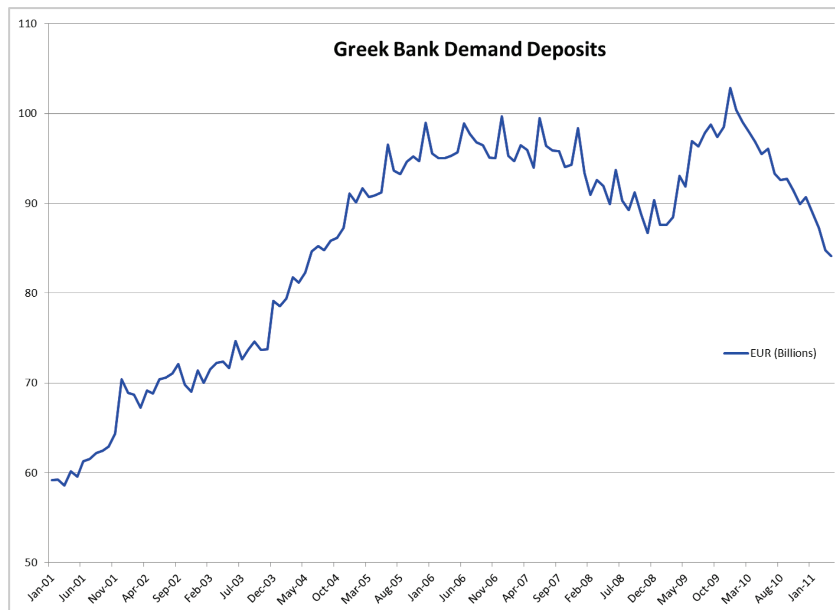


Transition to Crisis

During 2002 to 2007, Greece's decreasing competitiveness was masked by strong global growth. Most nations suffered a severe shock to GDP and production during the crisis. Unlike many nations that quickly bounced back, Greece has never recovered. Industrial production began to drop in the fall of 2008, and has yet to recover. The recent 12 month period saw production that was nearly 20% below the levels seen in September 2008.

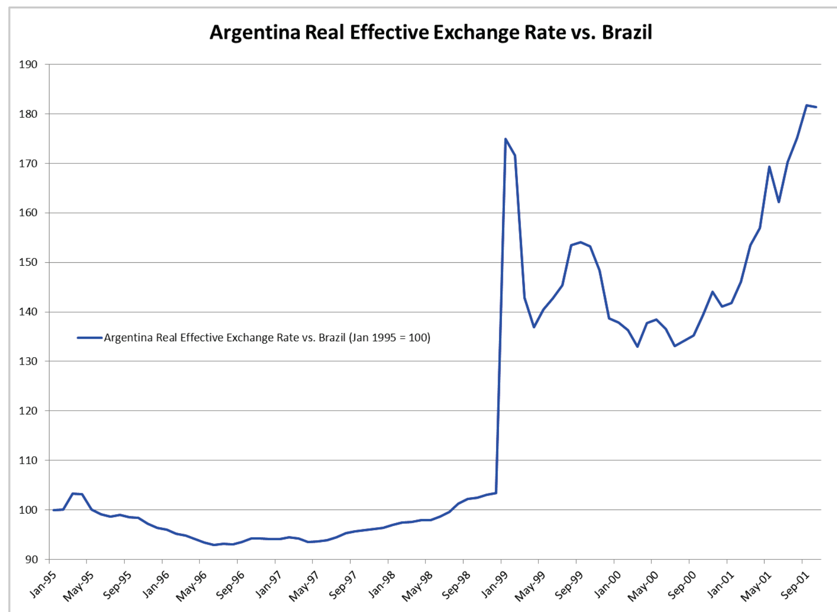
Not surprisingly, Greece has had poor post-crisis GDP performance. During the period from March 2000 until December 2008, real GDP growth averaged +3.9%. Since the 4th quarter of 2008, the average has been -3.6% and Greece has not had a single quarter of positive GDP growth. Nine straight quarters of economic contraction; No wonder they are rioting!

As a result of declining GDP and increasing social transfer payments, Greece's budget deficit began to deteriorate. The deficit clocked in at -6.4% in 2007 and -9.8% in 2008. Poor economic performance was reflected on the political scene, and in September 2009 Prime Minister Karamalis of the New Democracy Party called elections two years before they were required. After spending five years in opposition, the October 2009 elections returned the Socialists (PASOK) to power on a platform of increased social spending. Two weeks later, Greece announced that the 2009 deficit would come in closer to 10%, or maybe 12%, instead of the 3.7% estimated by the previous government. Quipped Eurogroup Chairman Jean-Claude Junker: "I have to say that I am very impressed by the difference between the old and the new figures." The final figures for 2009 showed a deficit of 15.4%, and the market quickly deteriorated to the point where Greece was unable to fund itself in the private markets. Since the spring of 2010, Greece has been a ward of the EU and IMF, which continue to provide bailout loans in exchange for austerity measures and deficit reduction targets by the Greek government, none of which have been met. As we write, Greece has had one bailout, is in the process of securing a second and is also working on a plan to involve the private sector via rollovers of maturing debt. Sadly, the Eurozone has repeatedly missed opportunities to address the issue of insolvency by funding a "Brady Style" plan that reduced Greece's debt burden. Whether the reasons were political or economic, they have only delayed the inevitable and have increase market stress to the point that they will likely precipitate bankruptcies in several other Eurozone sovereigns as well. The Greek government continues to tell the public that austerity is necessary to place Greece on a sustainable path. The Greek population is not buying it. When they are not out in the streets hurling stones and Molotov cocktails at parliament, the Greeks are at the bank withdrawing their savings. Demand deposits peaked in December 2009, shortly after the government revealed the statistical fraud. The Greek public knows that given the large holdings of government bonds, Greek banks are also insolvent and deposits are likely to keep heading south until the government introduces capital controls and/or bank withdrawal restrictions.



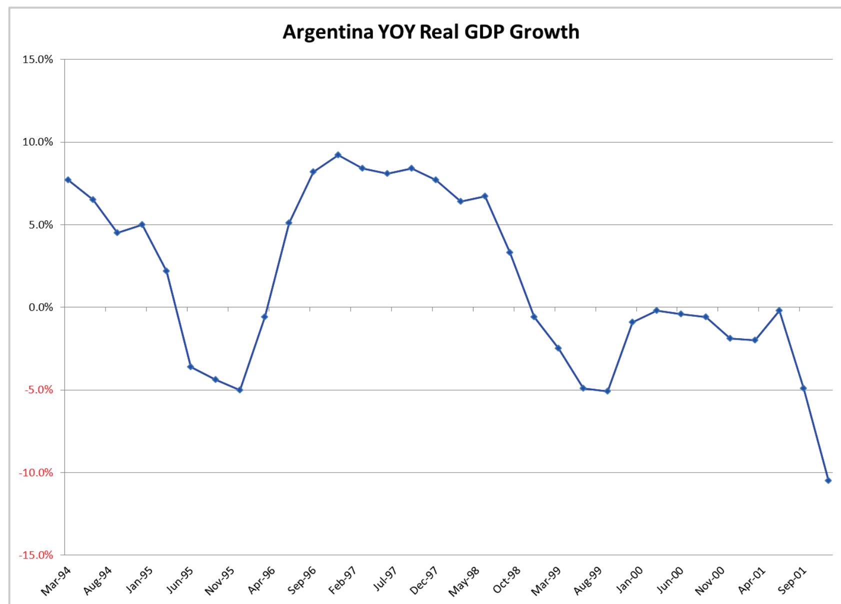
The Comparison to Argentina (ca. 2001)

We have often suggested that Greece is the second slowest train wreck in history, after Argentina. Here we present some of the data in the run-up to the Argentine default of 2001 and show how history is the process of repeating. The first chart shows the relative competitiveness between Argentina and Brazil. Brazil's early 1999 devaluation put a crimp in Argentina's export picture.

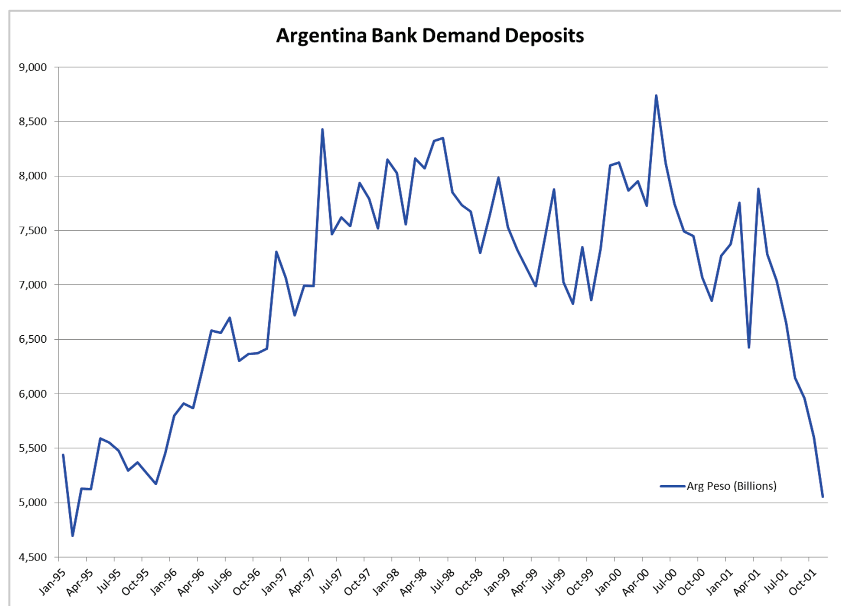


The higher risk aversion in the aftermath of the Asia and Russia/LTCM crises and the devaluation in Brazil sent Argentine industrial production into a downward trajectory. In December 2001, production was 15% lower than levels seen in the summer of 1998. Not surprisingly, Argentina found itself in a lengthy recession.

The Argentine economy continued to suffer. Real growth averaged +4.2% in the 1994 to 1998 period but dropped to -2.7% in the 1999 to 2001 timeframe. By the time of default, the Argentine population had suffered through 13 straight quarters of GDP contraction, much of it exacerbated by repeated austerity drives to reign in budget deficits.



Amid increasing economic distress, the Argentine public began to lose faith in the domestic financial system and demand deposits began a precipitous drop in May 2000.

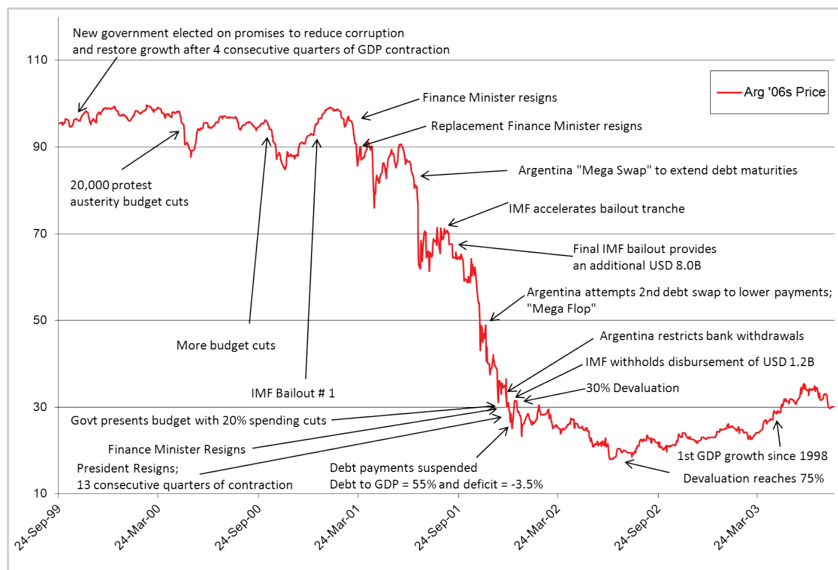


"History Doesn't Repeat Itself, But It Rhymes"

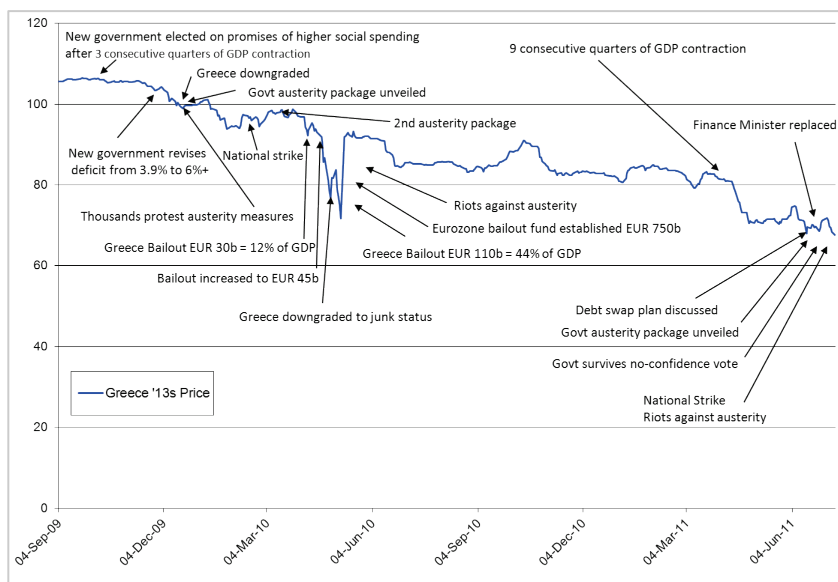
- **Attributed to Mark Twain**

Below we show two annotated charts of government bonds in Argentina and Greece; the parallels in events seem striking to the uninitiated, but the events have been a mainstay of every emerging markets sovereign debt crisis in the past 25 years.

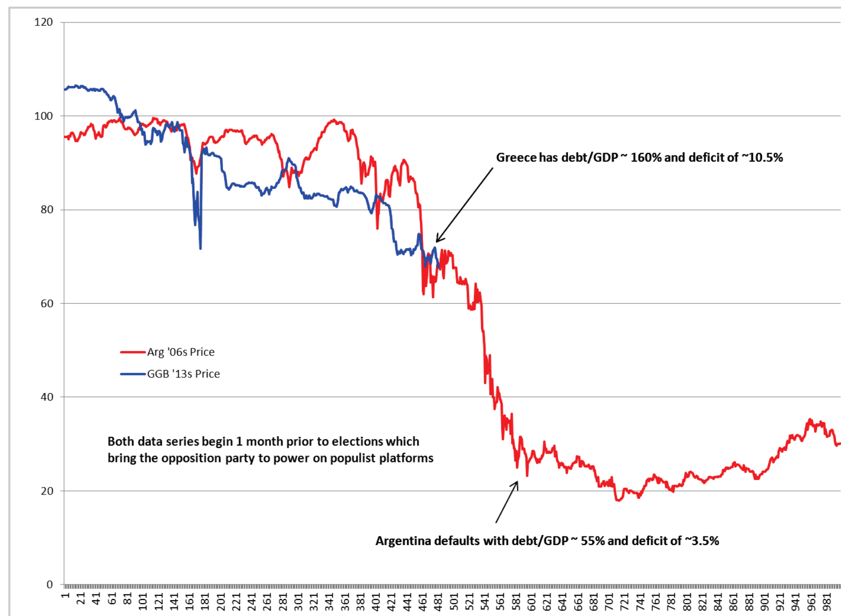
Price of the Argentina 11% due 2006, along with important events during the debt crisis



Price of Greece 4.6% due 2013, along with important events during the debt crisis



Argentina defaulted in December of 2001 with debt/GDP of around 55% and a trailing deficit of 3.5%. The comparable numbers in Greece are 160% and 10.5%. Greece is not like Argentina; it is much, much worse. Those arguing that the issue is liquidity and not solvency are either disingenuous or just haven't been paying attention.



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