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Greece: Initial Thoughts on What Should Be Done

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Jason, L. Cook, CFA, Head of CEEMEA jcook@gramercy.com +44-779-355-0278
Robert L. Rauch, Director of Research rrauch@gramercy.com +1-203-552-1905

The problems of the "periphery of Europe" and the potential for such problems to lead to the dissolution of the EU and termination of the Euro, have been most sharply scrutinized due to the ongoing and increasing problems in Greece. This discussion has remained largely in the hands of developed market participants who've never confronted the realities of a sovereign default and to our minds remain in denial about the situation; with an emerging markets perspective, the issues and solutions become quite clear.

The situation began in October 2009 when it was revealed the Greece had understated its debt figures when reporting to Eurostat, the official economic statistics bureau of the European Union, and had entered into an off-market cross currency swap that allowed the government to reclassify debt as a contingent liability. (It is worth noting that Italy performed similar accounting magic in its run-up to joining the Euro.) The correction took the Public Debt-to-GDP figure for 2009 from 99.6% of GDP to 115.1% immediately upon discovery; further diligence by Eurostat took the figure to 143% for 2010 and the ratio is now projected at 153% for 2011. The realization of the increased debt load, now around approximately €380 billion, drove market spreads wider for Greek's public debt in light of ongoing fiscal profligacy (government deficits of 9.8% and 15.4% in 2008 and 2009 respectively) and led to a rapid rise in real interest burden for the government as deficits had to be financed.

The EU and IMF rode to Greece's rescue with a €110 billion rescue package, of which €45 billion was disbursed in 2010. The price was a classic austerity prescription from the IMF that targeted a deficit of 8% of GDP in 2010 and primary deficit (before debt service) of 2.4% of GDP. The outcomes were deficits of 10.5% and 4.9% respectively. The market has not been pleased and spreads for Greek debt have remained very high (one year Greek CDS is 18.75% as of this writing). The rescue package contemplated Greece coming back to the public market with long term issuance in 2012 totaling €25 billion; the poor performance relative to the package's targets and weak economic indicators (14.1% unemployment, 4.5% GDP contraction in 2010 and expected contraction of another 3% in 2011) makes that prospect appear unlikely. The private sector is even less likely to provide capital given that the official aid is stated to be structurally senior in payment priority. To emphasize the point, Greece is facing a problem well known to participants in Emerging Markets and high yield debt; distress costs have set in and financing might only be available as prices that will bankrupt the issuer.

Brady Plan or Argentina 2001?

From the perspective of an EM investor, Greece shares a lot of similarities to Argentina in the years prior to the 2001 default: a currency regime that doesn't permit monetary policy, too much debt, structural budget deficits and a populace that won't accept the necessary reduction in its living standards to correct the problem.

One important difference, one that is a threat to creditors, is that only €18.6 billion of the total Greek government debt outstanding is issued under international law. The remainder is subject to Greek jurisdiction and a potential legislatively-mandated restructuring.

A deeper look reveals an even more important difference: whereas Argentina confronted a pool of disparate foreign bondholders, Greece today faces creditors including central banks (an estimated €75 billion) including the ECB with €40 billion; the EU and IMF (€56 billion), Euro area banks ex-Greece (€48 billion) and €90 billion held domestically (of which roughly €48 billion is with seven banks and €29 billion is held by social security and pension funds). The main Greek banks have a total capital €29 billion; a material haircut could wipe that out. Altogether, it is estimated that 30 investors hold roughly 70% of Greece's total €380 billion of debt.

Given the backdrop of EU political influence and legal mechanisms, it appears to us that this situation is closer to the 1980s LDC debt crisis in the US -- where major money-center banks held the bulk of the debt and had the influence to engineer a US Treasury led restructuring plan -- than to Argentina in 2001. The prevalence of government institutions and multi-laterals as creditors and political damage that would be done to the Eurozone and EU from a unilateral restructuring by legal fiat (the Greek government legislating the terms of a restructuring) are the main reasons why we don't believe such a unilateral resolution will be instituted. Moreover, the irreparable damage that would be done to the Greek banking system weighs against precipitous action by the Greek government.

The way forward

When surveying market commentary on the subject, a preponderance of opinion seems to lean towards a continuation of official support for some indefinite period until Greece can make its domestic adjustment and no longer need support. We see this as optimistic, as the implicit assumption is that the issues are of a liquidity nature and not solvency. At this level of indebtedness, Greece is insolvent and the straight-jacket of the Euro deprives it of most of the adjustment tools it could use to address the problem, leaving only austerity and a real reduction in living standards of its populace. This didn't work in Argentina and we believe it won't work in Greece. This is not only because of domestic political pressures and an expected populist backlash, but, as shown by the True Finns Party victory in Finland, the taxpayers of the rest of the EU have limited patience to fund official support for what they see as a, unrepentant profligate nation.

The 2010 rescue plan would have been an appropriate response for a liquidity crisis. This band-aid approach of pushing out maturities and hoping private sectors come back is unrealistic, as it would only work if Greece could grow its way out of its problems. A debt-to-GDP ratio in 2011 of 153% increases as GDP contracts as it will with austerity measures, and as more rescue funds are used. By "kicking the can down the road," Greece need not default in 2011, but the situation is likely to even be more difficult in 2012 or 2013, as debt levels grow higher, the population grows even more restless, and as the official sector replaces the private sector in no small part due to its claim of payment superiority.

Our view is that this leaves two clear paths for the EU and Greece. The first is to try something preemptive and dramatic, such as the Brady plan which provided a real solution for the LDC debt crisis of the 1980s, as it achieved an effective reduction of the burden of debt stock and debt service requirements. In the case of Greece, creditors would be asked to exchange their current debt instruments for a new instrument with a long (say 30 year) maturity. As an inducement to participate in such an exchange, the EU would provide collateral in the form of 30 year (no-interest) strips to fully cover the principal repayment of the bonds. The EU would provide the bonds in lieu of having to put in cash today under the rescue package. Creditors could be given a choice between taking (a) a "par bond" with a concessionary coupon (creating a net present value haircut) or (b) accepting a nominal haircut and receiving a market rate coupon. This will allow banks and the official sector to take par bonds to avoid write-downs on assets held in non-mark to market accounts and for other investors who mark-to-market to have a more tradable instrument that should trade around par. Standing in the way of this solution is bureaucratic inertia (which may not be overcome until there is an actual default) and the inevitable question of whether other periphery countries would be offered the same deal. On the other hand, the outgoing President of the European Central Bank, Jean Claude Trichet, headed the Paris Club during the days of the Brady Plans and has the experience to use that play book for a solution.

If bold action along these lines were not to be embraced, our expectation is that Greece may muddle through for another 6-24 months. Additional debt would continue to pile up, Greek GDP would continue to decline, the local banks would continue to be decapitalized, and the local population would get increasingly restless. Down this path, default is inevitable, but the situation will be much worse. Assistance through the rescue package will have already been utilized such that further support will be even more expensive. Local appetite for further austerity will be non-existent. Official sector assistance will have further subordinated the current private sector debt stock. Accordingly, the "haircut" or discount required on the future debt stock will be even greater and more onerous, resulting in a messy, multi-year process unsatisfactory to all. Such a disorderly process will endanger not only Greek's status as a member of the Eurozone and EU, but the viability of each of those projects. Further, as the realization of a disorderly default in Greece shifted market focus to the rest of "submerging Europe," the contagion pressures on Ireland, Portugal, Belgium, and other highly indebted countries could lead to another widespread LDC-type crisis. It is in everyone's interest -- including the government of Greece, its creditors, the Greek people, German taxpayers, and the politicians of Brussels -- to avoid such an outcome.

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