

## Greece: It didn't have to be like this

In our February monthly piece entitled “Greece, birds and bees: Time for some tough love”, we argued that unless the EU demanded significant changes and a rapid move towards Euro monetary compliance, then Greece should not receive unconditional support. Despite the decision to call in both the EU and the IMF, I fear that neither the Greek population wishes to take the medicine, nor does much of the European electorate wish to offer their taxes in support of the Greeks. This is a train wreck in slow motion.

The inevitable result will be that Greece will restructure its outstanding Government debt. Government bond spreads are still lower than where they were before Greece joined the Euro, but this is not going to be the case for much longer. The cost of a rescue, for both Greece and the rest of the Euro zone, is probably not worth it. A debt restructuring, a haircut of the outstanding debt, perhaps a moratorium on interest payments, or the creation of bonds with warrants linked to future privatization proceeds, would be more attractive for all concerned. The trouble with trying to draw a line in the sand is that such lines are impossible to defend, particularly as the whole notion of “confidence” is based not necessarily on fact, but on a combination of fact and perception. The markets perceive that Greece does not have the resolve required to sort out the problem. In pre-Euro times, they would have simply devalued the drachma and inflated the problem away. However, I think that a debt haircut, combined with an IMF facility and even Euro country support may have a better chance of flying. The largest holders of Greek government debt, other than Greek banks and institutions, are other Euro

zone countries, notably Germany and France. So taking a haircut on the notional outstanding debt might end up being less painful than stumping up new cash and then seeing the country default 12 to 15 months later.

The disgracefully wavering behaviour of the German Chancellor, pandering to her domestic electorate and refusing to either back or drop Greece has only made the problem worse. This is a self-inflicted wound because, as I have pointed out earlier, Germany is already one of the single largest creditors of Greece. So the Germans' lack of decisive action, masquerading as a show of force, has in fact had a costly impact on their current Greece exposure. Ironically, both Germany and France were keen to see a significant enlargement of the Euro zone, seeing this not only as a counterbalance to US economic hegemony, but also as an expansion of the European market place (read German goods). When many of the new Euro entrants, and some of the original members as well, blatantly flouted the “rules”, they were not sanctioned or even admonished because, as everyone who has ever played Game Theory rapidly realized, there was no effective punishment for not following the rules, and huge benefits to reap from playing along and exploiting the structural weakness of the programme.

Frankly, as I write these words, the shoddy performance of the Euro zone members as a whole must be raising, in many debating chambers, the inevitable question as to whether a return to the old currency might in fact be preferable. It really did not need to come to this. The inability of the EU/Euro

countries to speak with one voice and to have in place a coherent action plan to avoid these problems before they happened sadly undermines many of the benefits the Euro system has delivered.

It is not too late for the Euro, or indeed for some of the other troubled member states. But if I were the Government of Portugal (or Spain or Ireland), I would be on the phone to the Germans asking them what the hell they thought they were doing with Greece and telling them to either put up or shut up. I would equally be camped out in Washington talking to the IMF to ensure that the Greek disaster does not happen in my country.

Tough decisions need to be made, and right now. Allow me an analogy: the Captain of a ship that has struck an iceberg needs to make a similar decision. All ships are divided into compartments that can be sealed with watertight doors. When there is a hole in the hull, the Captain only has a limited amount of time to decide whether the hole can be repaired or whether he should seal the bulkhead doors, thus containing the water in the flooded compartment but sacrificing any crew stuck there, in order to ensure that the entire ship does not sink. This is exactly the situation faced by the Euro zone. Should the Captain close the bulkhead door in order to keep the rest of the boat afloat? Well, the first problem is rather obvious: Who is the Captain? The second problem is that swift action is required and there are not enough lifeboats for everyone. Forgive the continuation of this analogy, but if I was the commanding officer of a compartment adjacent to the flooded one, I would be screaming for the bulkhead door to be slammed shut – right now – and for additional strengthening

material to be put in place to ensure the bulkhead, once closed, does not break.

Bottom line: Greece will re-structure its debt, because it has no choice. But whether it does this whilst still a Euro member country remains to be seen. The market is currently pricing the recovery value of Greek bonds at 55%, which implies a pretty large haircut. If this is coupled with an IMF programme and ECB credit support from a united Europe, it might just work for Greece, while stopping the rot and otherwise inevitable slide for other “compartment countries”. The macro data is not at all pretty for most of them, especially when you look at old-fashioned emerging market indicators such as external, total debt including bank debt (conditional liability of the state), and finally the Budget Deficit as a percentage of GDP.

In the meantime, what does this imply for the markets? It is clear most participants are already short or under-weight the Euro versus pretty well any other currency... It has even been falling against the British pound in the last few weeks! Smart operators will likely play this via long volatility optional strategies, since it's difficult to determine whether the Euro would fall further or rally on a Greece re-structuring. Finally, I expect that the ECB, which until recently had been hoping to begin to cut back on the liquidity spigot, will have no option but to turn the taps full on. So I expect to see big demand for any 1 Year Bills they offer. And some banks will soon find that the ECB is the only way of funding their liquidity position. This probably also means that bank lending data is going to begin to show a further cut back in credit made available to the real economy.

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