BANK FOR INTERNATIONAL SETTLEMENTS

Restricted

Sovereign risk: Why Greece?

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The backdrop

- History of pre-euro competitive currency devaluation

- Joined euro on 1 Jan 2001
  - 2 year late to permit “meeting” Mastricht criteria
  - Competitive devaluation no longer an option
  - Independent monetary policy no longer possible

- The golden years – living beyond their means
  - Credit-based consumption boom fuelled by low rates
  - Little structural reform (job security, bloated public sector, early retirement, etc.) results in low competitiveness

The awakening

- Newly-elected socialist-led government of George Papandreus admits that the previous government had (massively) miss-represented the government's financial position
  - Debt about 120% of GDP (Mastricht target: 60%)
  - Budget deficit about 14% of GDP (Mastricht target: 3%)
- Markets unconvinced that the debt is sustainable
  - Slow growth
  - The needed austerity measures will not be implemented
  - If the market believes you have a problem then you **do** have a problem. The Greek government can no longer borrow – market effectively closed

- Greece's largest deficit is its **credibility deficit** - Papandreus

The rescue

- A belated 110 billion euro IMF/euro-zone support package announced on 2 May 2010
  - WOW! we're talking real money now!
  - Public opinion in other euro-zone countries
  - Package conditional on painful cuts in spending in Greece (deficit to be reduced to 3% GDP over 3 years, debt to peak just below 150% GDP before falling)

- Is this a bail-out of European banks?
  - European bank exposure to GR/PT about 300bn euro (and almost 600 bn exposure to Spain) – BIS statistics

The reaction

- Market unimpressed
  - Greek bonds yield 30% more than equivalent bunds
  - Market anticipates debt restructuring
  - EUR continues to weaken

- Greek workers unimpressed
  - Strikes/protest/riots/deaths

- Greece’s credit rating downgraded to sub-investment grade

The alternative

- Debt restructuring
  - Will this eventually be inevitable, and if so should this have been "plan A"?
  - Fear of a domino effect in which the markets change focus to the next weakest – Portugal, Ireland, Spain, Italy
  - Would such contagion would lead to the next Financial crisis on a scale similar to that following the collapse of Lehman Brothers?

- ECB direct purchases of Greek debt
  - This has not been discussed – Trichet

What next?

- The unthinkable
  - Exit from the euro-zone…
- The hopeful
  - EU/IMF stabilisation programme will succeed

- EUR has taken a big knock as an alternate reserve currency to the USD

- Is this a prelude to something much bigger? Budget deficits are also high outside the euro-zone
  - JP/UK/US
  - Markets are watchful!