The Squeaky Wheel Gets the Grease

Pessimism pervades discussions of Europe today. Optimists are not to be found. Many warn that the entire economic and monetary union project is likely to falter over the large deficit and debt burden of the Mediterranean members.

We have written much about the sticky wicket Europe finds itself in today: moral hazard and lack of political will on one hand and the risk of a larger sovereign and banking crisis on the other hand. There is no good choice to be made and that is why it is a tragedy.

Muddle Through 2010

On February 25, the yield on the 2-year Greek bond rose by almost 75 bp. That increase alone is nearly the entire annual yield of the US 2-year note (82 bp) and the German 2-year yield (93 bp). Market forces are such that the worst case scenario could be a self-fulfilling prophesy.

Nevertheless there is a case to be made that Greece can muddle though this year. Admittedly it is not a strong case yet, but odds may shift toward the more benign scenario if a couple of near-term hurdles are overcome.

The first hurdle is in the first week of March. Not only must interest rates stabilize, which is arguably beyond the near-term control of Greek officials, but Greece plans on selling 3-5 bln euros of new bonds to fund its deficit. Reports suggest that some German banks have already declined to participate in the syndication. Greece has raised 13 bln euros of the 54 bln projected to be needed this year.

The second hurdle is around the infamous ides of March. It is when Greece is required to report on the implementation of its budget reforms. The Socialist government's fiscal program calls for saving 8-10 bln euros this year through spending cuts and tax increases that will reduce the budget deficit from 12.7% of GDP to around 8.7%.

The measures include freezing civil service wages and cutting some of their benefits, a fuel tax and clamp down on tax evasion. A combined EU, ECB and IMF review argues that Greece's figures are still on the optimistic side to the tune of almost 5 bln euros.

Arguably no matter what Greece proposed, realpolitic would suggest that the EU, the ECB and IMF would need to demand more. The situation is also very fluid. Higher interest rates mean greater debt servicing costs. The protests against the steep cuts may deepen the contraction and also force some extra counter-cyclical spending.

Playing Well with a Weak Hand

This is all part of a macabre political economic dance. The Greek government is already working on some additional measures that could raise another 3.5 bln euros. It is not immediately clear whether Greece will wait until mid-March to announce these new measures or announce them shortly, ahead of its bond offering to help increase the odds of a more favorable (or less worse, if you are inclined to see the glass as half empty) reception.

European officials have to be forceful, but if they overplay their hand, it makes a unilateral request to the IMF, which would most humiliating for the proud bureaucrats in Brussels (arguably more so than for Greece), or even default a less onerous option.

Greek officials know the real score. At 2-3% of the euro zone's GDP, it is not too big to fail. The reason that European officials are hoping Greece does not default is not so much out of sympathy to be sure; rather what is at stake is unadulterated self-interest. Slightly more than half of Greek debt is owned by foreign investors.

The lion's share is in Swiss, French, German and British banks. Some of the exposure may have been offset in the credit default swap market, but the impact on the fragile banking system could be simply overwhelming. All the more so if pressure mounts on other sovereigns. Foreign investors hold around 77% of Portugal's debt and more than 75% of Austria's bonds, for example.

Refunding

The better Greece overcomes these first two hurdles, bond issuance in early March and the mid-March status report, the better positioned it will be in to overcome the third challenge. Bloomberg data indicates that there are roughly 8 bln euros of Greek bonds maturing in both April and May. It will have to replace these funds by issuing new bonds. This is almost a third of the year's anticipated financing needs and about half of the remaining need.

While there is some speculation that an Asian or Middle East sovereign wealth fund may help Greece out, it does not seem particularly likely. Then again, who would have thought they would take stakes in tittering Western banks in the early stage of the crisis?

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In any event, if Greece overcomes these hurdles, the middle of May status report should not be a major issue. This coupled with a bit of luck—factors outside of its control, like no major distresses elsewhere in the world, stronger growth in Europe after what appears to be a weak Q1, and arguably a weaker euro, the second half could be a bit easier.

A Friend in Need is A Friend Indeed

Outside some vultures and carrion eaters no one really wants to see Greece fail, even if primarily motivated by something other than altruism. Even shy of political union, and given the strictures of treaty agreement, there is sufficient institutional capability in Europe, one suspects, to prevent the potential collapse of the EMU or another severe banking crisis

The key is will. To form EMU in 1999 required a certain reading, should we say, of the letter of the law, to allow even some core members to join. If the political will is there, the mechanism to ensure that Greece can raise around 40 bln euros (its remaining funding need) can be found.

One such institution that can be employed is the European Investment Bank. It could help fund some projects in Greece. Last year it provided 79 bln euros in loans, a 36% increase over 2008. The sharp increased was pushed for by the EU to help businesses during the crisis.

Another such institution is the European Union itself. Although apparently not discussed much, almost a year ago the European Council doubled the borrowing authority of the EU to 50 bln euros. Back in December 2008, it had doubled it to 25 bln euros. Surely if this authority can be used to help Hungary, Latvia and Romania, they can figure a way that it can be used to help Greece.

Legalese

There is a compelling argument that contrary to the protestations of some ECB members and German politicians, not only the Lisbon Treaty but also the Maastricht Treaty that created EMU in the first place permits financial assistance to its members.

As others have pointed out, Article 122 of the Lisbon Treaty says that if a member is in trouble, or

> "seriously threatened with severe difficulties caused by natural disasters or exception occurrences beyond its control, the Council [of governments] on a proposal from the Commission may grant, under certain conditions, Union financial assistance to the member state-concerned."

The Greek government that was just elected this past October can argue that this crisis was beyond its control as it was not responsible for the decisions made previously.

The Maastricht Treaty also has an article (119) which allows for assistance under certain conditions, which include balance of payment problems or as a result of "the type of currency at its disposal, and where such difficulties are liable in particular to jeopardize the functioning of the common market or the progressive implementation of the common commercial policy", the European Commission should investigate and should use "all the means at its disposal" to rectify the situation. Reportedly this was the article used to justify assistance to Hungary and Latvia previously.

Lastly, there are also measures that the ECB can take that will help Greece indirectly. It could slow the unwinding of some of its extraordinary measures, such as its liberal collateral rules and unlimited fixed rate repos. It can pre-commit to not raising interest rates this year. The market is still pricing in the likelihood an ECB rate hike in the fourth quarter.

Greece suffers not only from this fiscal crisis, but also from an underlying lack of competitiveness. The muddling through scenario does nothing to address it. It is, as they say, kicking the can down the road a bit. But perhaps the best thing officials can buy now is time.

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