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Economics Group

WELLS FARGO SECURITIES

Special Commentary

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Will Greece Actually Default?

Executive Summary

Greece is back in the news because the government is running out of cash and is close to default. We believe Greece and its creditors will eventually reach agreement, because default would probably be in nobody's interest. That said, the probability of Greek default and potential exit from the Eurozone, although less than 50 percent, is probably higher now than it has ever been.

There are some backstops now, which did not exist a few years ago, that should prevent contagion from spreading to other European economies. That said, nobody really knows what would happen if indeed the Hellenic Republic defaulted and exited the Eurozone. Although the probability of a "train wreck" in Europe appears to be low, it is probably more than just an insignificant tail risk that investors can blithely ignore. In our view, readers should keep a close eye on near-term developments in Europe.

Will the Greek Government and the Eurogroup Reach Agreement?

The cash balances of the Greek government are dwindling.

Greece has been in and out of the headlines ever since its government and the Eurogroup agreed on February 20 to a four-month extension of the country's current (i.e., its second) bailout program.[1] Thus far, the Greek government and the Eurogroup have failed to come to terms on the conditions under which the Eurogroup will release the next tranche, which is worth €7.2 billion, of the €165 billion bailout program that has been in place since 2012. Consequently, the cash balances of the Greek government are dwindling. Although the government probably has enough cash on hand to make a scheduled €768 million loan repayment to the International Monetary Fund (IMF) in May, it likely will not be able to come up with the €1.6 billion it needs to repay the IMF in June without a fresh infusion of cash (Figure 1). If not, the government of the Hellenic Republic would then be in default.

Nobody has an interest in default.

We believe the Greek government and the Eurogroup will eventually reach agreement, thereby precluding default. In our view, the Greek government will ultimately come up with enough concrete reforms to convince the Eurogroup to release the next tranche of the bailout program and to begin negotiations on the terms of a third agreement. Neither the Greek government nor the Eurogroup has an interest in a default in our view. Default, which likely would be followed by Greek exit from the Eurozone, would most likely cause the Greek economy to weaken even further. In short, in our opinion, default and exit from the Eurozone clearly is not in the interest of the Hellenic Republic.[2]

We believe a Greek default is also not in the interests of other European countries for a number of reasons. First, officials from other countries would be in the uncomfortable position of explaining

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[1] The Eurogroup refers to the meetings of the 19 finance ministers of the Eurozone countries.

[2] Exit from the Eurozone does not necessarily need to follow default. However, default would mean that Greek banks would have limited eligible collateral to post for ECB liquidity operations. The possibility of banking system collapse could induce individuals to pull their deposits from Greek banks, which could hasten the collapse of the banking system. The Greek government could try to prevent capital flight by imposing capital controls, but it may judge instead that exit from the Eurozone would give the country the ability to export its way back to some semblance of prosperity via currency depreciation.

to their voters why more than €300 billion worth of debt that Greece owes collectively to the other 18 members of the euro area could now be essentially worthless.[3] Second, Greek exit from the Eurozone, should it occur, would represent the most significant setback in the process of European integration that has been in place for about 60 years. Third, an implosion of the Greek economy would likely lead to heightened social instability in Greece, a country that sits on Europe's southern flank.

Figure 1

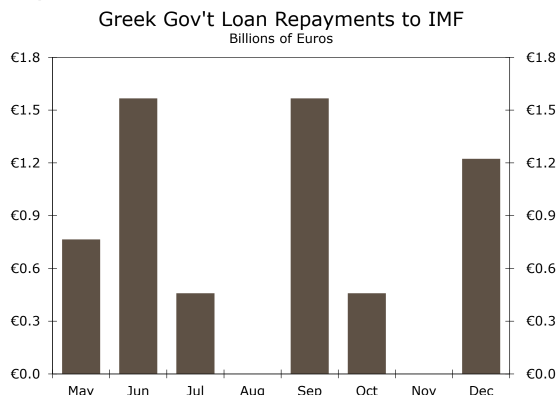
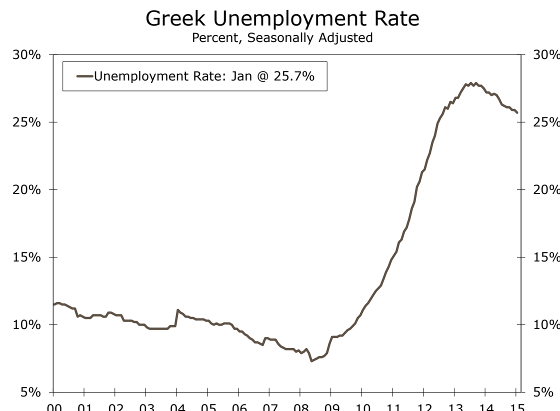


Figure 2



Source: Bloomberg LP, IHS Global Insight and Wells Fargo Securities, LLC

There are political constraints on both sides that could preclude a deal.

That said, there are political constraints on both sides that could preclude a deal. The Greek economy is roughly 25 percent smaller today than it was at its peak in 2007, and the unemployment rate has climbed to more than 25 percent (Figure 2). Greek politicians have blamed many of the economy's woes on the austerity measures that have been in place for five years. The government of Prime Minister Alexis Tsipras was elected in January with the mandate to roll back some of these austerity measures, and the government may feel limited in its ability to make concessions to the Eurogroup.

Politicians in other European economies have their own political constraints as well, because many Europeans do not believe their governments should extend more aid to the Hellenic Republic. Voters could subsequently cause headaches for governments that are seen as being "soft" on Greece. A poll conducted in March found that 52 percent of Germans thought that Greece should leave the Eurozone, with only 40 percent responding that the country should remain in the euro area. As we discuss below, some officials are willing to contemplate Greek default and exit from the Eurozone because, in their view, other European economies are now largely insulated from the negative financial market effects that those events would previously have caused.

In our view, the risk that the parties fail to reach agreement is not insignificant. The probability of a Greek default and exit from the euro area, although in our view not more than 50 percent, seems to be higher today than at any time during the 16 years that the Eurozone has been in existence.

Backstops Impart More Stability to the Eurozone

Financial market tension related to the European sovereign crisis has waxed and waned for more than five years. Between 2010 and 2012, government bond yields in Italy and Spain moved higher when investors feared Greek default and a Eurozone exit at that time (Figure 3). Stock markets in Italy and Spain also moved lower with their Hellenic counterpart during those years as well (Figure 4). Asset prices in the so-called "peripheral" European economies (i.e., Greece, Ireland,

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[3] **The exposure that other European countries have to Greece takes the form of bilateral loans, and lending via the European Financial Stability Facility (EFSF) and the European Central Bank (ECB).**

Italy, Portugal and Spain) moved higher starting in July 2012 when European Central Bank President Draghi said "the ECB is ready to do whatever it takes to preserve the euro."

Figure 3

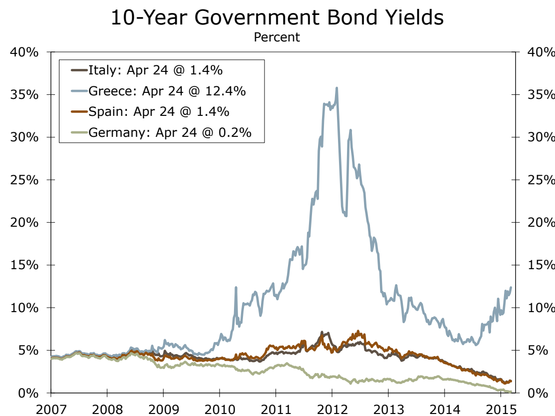
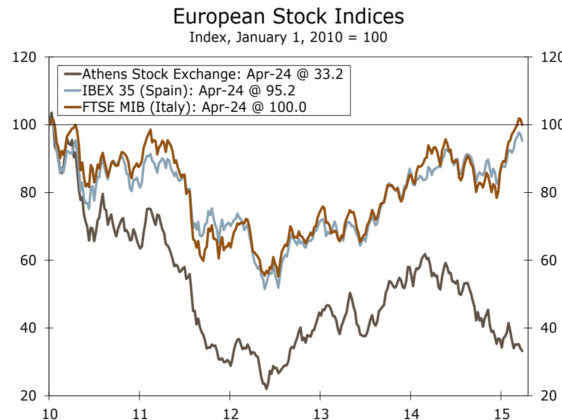


Figure 4



Source: IHS Global Insight, Bloomberg LP and Wells Fargo Securities, LLC

However, as the probability of Greek default and exit from the Eurozone has risen over the past year or so, the correlation between asset prices in Greece and the other peripheral European economies has broken down. Although the yield on the 10-year Greek government bond has risen about 600 bps since September, yields on comparable securities in the other peripheral European economies have continued to move lower. The Greek stock market has dropped more than 30 percent since September, but the equity markets in Italy and Spain have registered strong gains over that period.

The Eurozone now has some backstops in place to minimize contagion to other countries.

A few years ago Europe did not have many backstops in place to help prevent contagion from spreading from Greece to other countries in the European periphery. Today, however, the €500 billion European Stability Mechanism (ESM), which was established in 2012 to provide financial assistance to euro area member states, is capitalized and operational. European peripheral economies could seek support from the ESM if a Greek default would make it onerously expensive for them to issue their own securities in sovereign bond markets. In March 2015, the ECB started a program of sovereign bond buying as part of its monetary policy. Presumably, the ECB would ramp up its purchases of Italian and Spanish government bonds if their yields were to shoot higher in the event of a default by Greece. In other words, the Eurozone now has some backstops in place to minimize contagion to other countries. These backstops have given some European officials the incentive to pursue a hard line in their negotiations with the Greek government because they believe the Eurozone could withstand a Greek default and exit.

Would Financial Market Fallout Be Limited to Greece?

Greek default and exit from the Eurozone, should it occur, would establish a precedent.

But is the Eurozone really immune to contagion from Greece? Nobody really knows for sure. A Greek default and exit from the Eurozone, should it occur, would establish a precedent: Eurozone membership would no longer be irrevocable. Recognizing that highly indebted governments in Italy, Portugal and Spain could also default and exit the Eurozone at some point, owners of long-dated sovereign bonds of these countries may require higher yields to compensate them for the higher risk that could be perceived to be embedded in these securities. As we showed in an earlier report, debt sustainability can be adversely affected by an increase in borrowing costs.[4] A vicious circle of higher borrowing costs, deterioration in debt sustainability dynamics, further increase in borrowing costs, etc. could be put into train.

[4] **See *"Is the European Sovereign Debt Crisis 'Solved'?"* (January 27, 2014), which is available upon request.**

The private sector has significant exposure to the Spanish and Italian governments.

Most of the financial obligations of the Greek government are held by multilateral institutions such as the ECB, the EFSF and the IMF. Private sector investors, especially foreign investors, own very little Greek government debt today. However, the private sector has significant exposure to the Spanish and Italian governments. For example, Spanish financial institutions have €640 billion worth of exposure to the general government in Spain while Italian financial institutions own nearly €500 billion worth of Italian government bonds.[5] Default by the Spanish and/or Italian governments would lead to significant financial losses in their respective banking sectors that could have depressing effects on European economic activity.[6] In that event, financial markets outside of Europe could experience significant volatility.

We think that the probability of a general financial crisis sweeping through Europe in the foreseeable future is low.

We think that the probability of a general financial crisis sweeping through Europe in the foreseeable future is low. First, Greece would need to default, which as we discuss above, is not the most likely outcome, in our view. Then, contagion would need to spread to other peripheral European countries. Moreover, the ESM and ECB backstops would need to be overwhelmed by investor fears about the debt dynamics of the Spanish, Italian and Portuguese governments. Although the probability of a "train wreck" in Europe appears to be low, it is probably more than just an insignificant tail risk that investors can blithely ignore. In our view, readers should keep a close eye on near-term developments in Europe.

Conclusion

Greece is back in the spotlight because the government is getting dangerously close to running out of cash. Unlike the previous two Greek crises, there has been very little reaction thus far in financial markets in other peripheral European economies. European Monetary Union (EMU) is more stable today than it was a few years ago because European policymakers have put some backstops in place that, in theory, should keep contagion from spreading from one country to others. Although the probability of Greek default and exit from the Eurozone seems higher today than it was during the previous two crises, the probability that "Grexit" causes widespread financial market turbulence in other European economies appears to be lower than previously.

However, Greek default and exit from the Eurozone, should it occur, would be a watershed moment for EMU. Sovereign bond yields in other peripheral economies likely would rise in a kneejerk reaction, but the ESM backstop, not to mention the likely reaction of the ECB, probably would prevent the crisis from spreading in a sustainable fashion. That said, it is impossible to know exactly how investors will react. In our view, developments in Europe over the next few weeks warrant attention by most investors.

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[5] **The Spanish figure includes bonds and loans to the central government in Madrid as well as to provincial governments. Although data on the amount of Spanish government bonds on the books of Spanish financial institutions are not readily available, these holdings are likely sizeable.**

[6] **See *"Potential Financial Fallout from 'Grexit'"* (February 12, 2015) for a discussion of foreign exposure to peripheral European economies. This report is available upon request.**

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