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Greece & Europe – what's the risk of a disorderly default & euro break-up?

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Key points

> Logic argues against a Eurozone break-up given the costs to countries that exit. Nevertheless, a disorderly Greek default is a high risk, but at least Europe is becoming better at being able to deal with it, particularly if it occurs after new bailout funds are in place from mid-year.

> So while Greek issues are unlikely to go away any time soon and remain a source of volatility, they are unlikely to pose as big a threat to the global economy and investment markets as was feared last year.

Introduction

It would be nice to have a year without Europe's debt woes constantly in the news. Sadly that's still not the case, with Greece back in the headlines again lately as it seeks yet another bailout package. With its economy in tatters and social unrest on the rise, it's natural to wonder if at some point Greece and maybe Portugal and Ireland will opt to default and leave the euro. Or alternatively, given it's impossible to expel countries from the euro, a group of strong countries might decide to leave.

What is the current situation with Greece?

The Greek (and hence European) debt crisis has been raging since late 2009. Greece first received a bailout in May 2010. Last year it was recognised that Greece's public debt, at 165% of gross domestic product (GDP) and rising, was unsustainable and private investors 'agreed' to accept a write-down. Over the last month or so, Greece has been negotiating with private investors on the size of the write-down, and more recently with the so-called troika - the European Union (EU), the International Monetary Fund (IMF) and the European Central Bank (ECB) - on additional austerity measures and reforms to boost its competitiveness in order to receive a second bailout package. This is necessary to make a €14.5 billion bond payment due on 20 March this year.

Greece has since agreed to troika demands and its parliament has approved an austerity package. The key elements of the deal are a 1.5% cut in public spending, the loss of 150,000 public sector jobs over four years, a 22% reduction in the minimum wage, pension cuts and a debt swap that would cut €100 billion off more than €200 billion of privately-held Greek public debt.

However, the end to this Greek tragedy is a long way off. While Greece appears to have met all of the conditions set by the troika, Eurozone finance ministers are yet to approve the deal amidst talk it may be delayed further given the coming Greek election, some European parliaments are to vote on the package including the German Bundestag, and it's unclear whether private bond investors will be forced to participate in the 70% debt write-down. Finally, to meet the objective that Greece's debt falls to 120% of GDP by 2020 it's likely the ECB will need to forego profits on Greek bonds it bought at a discount. More fundamentally though, even if Greece gets its second bailout it will likely still struggle to meet its deficit reduction targets as austerity continues to bear down on its economy.

The Greek economy has fallen around 20% since 2008 and is likely to shrink 5% more this year. Unemployment is 21% and is set to rise to 25% over the year ahead. With depression setting in and unrest escalating, an obvious issue is at what point the Greek people say enough is enough and decide to default and leave the euro. Or alternatively the rest of the EU decides it won't provide further assistance given Greece's constant failure to deliver on commitments.

What if Greece defaulted and left the euro?

If Greece (and other peripheral countries) were not part of the euro, the way to work through current problems would have been to allow monetary easing via an exchange rate collapse in order to offset fiscal austerity. This would allow it to trade out of its problems, much as the Asian crisis countries did in the late 1990s or Iceland is doing now. However, tempting as such an approach is, getting to it is problematic once a country is already in a currency union like Greece is with the euro.

If Greece or any other troubled country opted to formerly default and leave the Eurozone, the following would likely occur: The countries new exchange rate would plunge, possibly by 50% to 70%; austerity would become more severe as no one would be prepared to fund the existing budget deficit; there would be a risk of a collapse in the banking system as local citizens would seek to withdraw their euro-denominated deposits ahead of the switch to the new currency; the plunge in the currency would likely result in severe inflation initially; and remaining Eurozone countries might seek to impose trade barriers on exports from countries that left on perceptions they have an unfair currency advantage. In short, the pain for Greece and other leavers could actually get a lot worse initially outside the euro than within.

For the countries that remain in the euro, it wouldn't be smooth sailing either. Banks would have to completely write off their sovereign debt investments in the departing countries. Bond yields in remaining troubled countries, such as Portugal (if it doesn't leave with Greece), Spain and Italy might come under renewed pressure as they might be assumed to be next. The euro would probably fall initially but maybe not by much as it might be seen as stronger once Greece and one or two others exit. The loss of export markets and ultimately a stronger euro could make life tougher for the remaining euro countries.

What if strong countries left the euro?

An alternative scenario would be where strong countries such as Germany, the Netherlands and Finland decide they have had enough and leave the euro. The outcome for such countries would be similar to that described in the last paragraph. The stronger countries new currency (or currencies) would likely surge in value. Interest rates would likely move higher. Lenders in such countries would face losses on their loans to euro countries given currency appreciation. Exports would suffer thanks to exchange rate appreciation and a departure from the euro would also mean a departure from the EU trade bloc.

Finally it should be noted that the process of any country leaving the Eurozone is likely to be long involving referendums and treaty changes and may take a year or so.

What's the risk of this occurring?

Both of these scenarios would be very disruptive with a Eurozone break-up potentially weighing heavily on risk markets globally. But what is the chance of it occurring? Our assessment is that the risk of a Eurozone break-up is low.

Firstly, as is apparent above, the transition out of the euro for both strong and weak countries would be quite painful, particularly for weaker countries like Greece. As such it is in neither side's interest. Greece (and any other weak euro leavers) would face an incredible disruption as the lengthy adjustment occurred – its banks would potentially collapse and it would have to undergo even more austerity to bring its budget straight to balance as there would be no one to fund its budget deficit. On the other hand, stronger northern European countries would be reluctant to go down that path as its still not known whether the firewall to protect other larger countries such as Spain and Italy, and banks, from renewed contagion is strong enough yet, and more fundamentally because they would suffer from lost export markets and a stronger currency.

Secondly, polls indicate 75% or so of the Greek population want to stay in the Eurozone. A majority of the population in Eurozone countries, including in Portugal, Ireland, Spain and Italy also want to stay in the Eurozone. And in Germany, the main opposition is more pro-euro and Europe than is the ruling coalition led by Chancellor Merkel.

Finally, European countries have immense political capital invested in the 60-year project of which the euro is a key part and their actions to date (e.g. setting up a permanent bailout facility and the fiscal compact) are all about strengthening it.

Of course none of this is of any relevance if Greece descends into some sort of political chaos and effectively stumbles into a disorderly default or euro exit.

How strong is the European firewall?

Much of what has gone on in Europe over the last two years has been about kicking the can down the road until the rest of Europe is stronger and a firewall can be built so as to withstand a Greek default. While it's doubtful we are at that point yet, there are some positive signs.

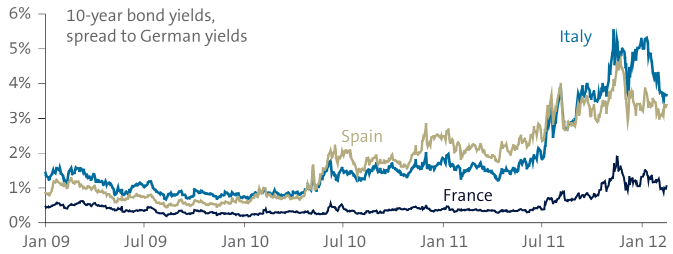
Firstly, the move by the ECB to provide banks with dirt cheap three-year funding under its Long-Term Refinancing Operation (LTRO) has removed concerns about the ability of European banks to finance themselves. As such the risk of a re-run of the global financial crisis, during which bank funding problems were at the core, has been greatly reduced. While banks may not be using cheap LTRO funds to buy bonds in troubled countries, at least they are less likely to be selling them.

Secondly, the fire power of bailout funds that may be used in Europe is growing. By mid-year the European Stability Mechanism (ESM) will be running with at least €500 billion of its own funding and China and other key emerging countries seem to be moving closer to adding to rescue funds.

Also, while many fret about Portugal going the same way as Greece and requiring its own debt write-down, there are signs Europe is feeling more comfortable with Portugal and is unlikely to let it go the same way as Greece. EU policy makers have backed away from forcing private sector investors to take write-downs (as it only adds to the panic). Portugal is seen as delivering on its agreed reforms (unlike Greece), Germany has signalled a willingness to provide extra assistance and the amount of money required to fully fund Portugal for the next three years is low.

Further, bond yields in Italy, Spain and France have stayed calm through the latest bout of worries, suggesting greater investor confidence that Greek worries will be contained.

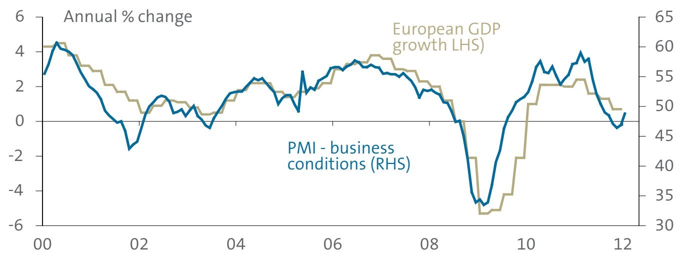
Italian, Spanish and French bond yields have been stabilising relative to German bonds



Source: Bloomberg, AMP Capital

Finally, Europe as a whole does not seem to be plunging into the deep recession feared several months ago. Sure, growth went negative in the December quarter, but by less than feared and business conditions indicators have since stabilised and hooked up.

European growth is slowing but not collapsing



Source: Bloomberg, AMP Capital

Ideally, if Greece is going to have a disorderly default the EU would probably prefer it to occur after the ESM is set up mid-year. This is another reason why a deal on a second bailout or at least bridging finance is more likely than not by the 20 March bond payment. But the key point is there are several reasons to be confident that over time the impact of a disorderly Greek default on the rest of Europe, and hence globally, will be more in line with its modest size, i.e. just 2% of Eurozone GDP and less than 0.5% of world GDP.

Concluding comments

The European debt crisis is still alive and well. Logic argues against a Eurozone break-up, but a disorderly Greek default is a high risk. However, at least Europe is showing signs of being better able to deal with it were it to occur, particularly if it is after new bailout funds are in place from mid-year. So while European debt issues are likely to remain a source of volatility, they are unlikely to pose the threat seen last year.

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