Greece: Is Default-Day Approaching?

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Key Points:

- Headlines on Greece have managed to disrupt markets and provide a large source of volatility, not just in Europe.
- If Greece were to default on its obligations, the European Central Bank (ECB) will face a dilemma: continue to provide liquidity to the banking system of a country that has defaulted on its debt (including debt with the ECB); or cut its access to emergency liquidity (ELA).
- The sudden absence of liquidity in the system could likely force Greece out of the Eurozone (EZ). After months of negotiations, the integrity of the EZ is once again in the hands of the central bank.

Financial Fragility

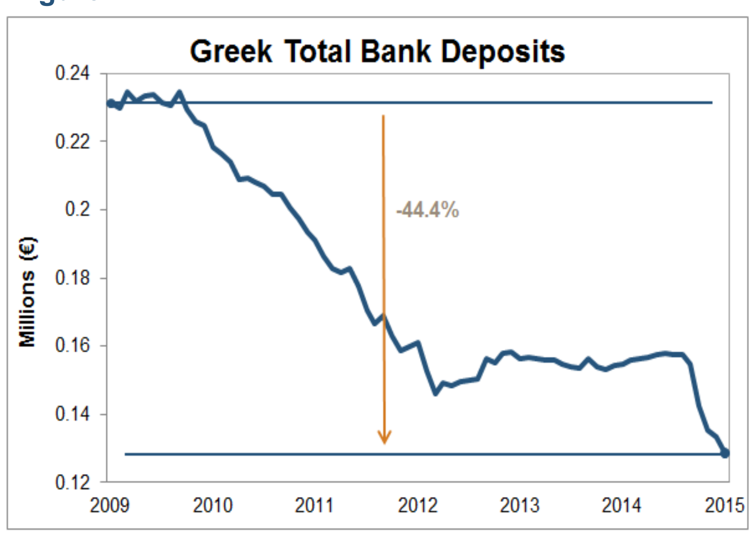
One of the risks that we have been highlighting and monitoring since late 2014 is financial fragility in the EZ, in particular in Greece. Greece is about 2% of EZ GDP[1], its financial sector is largely isolated from the rest of the EZ and the world, and the ECB is aggressively injecting liquidity in the EZ. Nevertheless, headlines on Greece have managed to disrupt markets and provide a large source of volatility, not just in Europe.

In February, Greece and its creditors agreed on a four month extension of the bailout program that would enable Greece to remain current on its obligation while continuing on a program of fiscal adjustment and economic reforms. At that time it looked like concerns around Greece, its solvency and its ability to remain in the EZ were thought to fall onto the backburner for a few months. In a piece that we published in March 2015, we maintained that the “Greek theater” would not disappear and would reopen soon. In reality the theater never closed. Negotiations for the extension of a new bailout started immediately and four months later they have not come to fruition. Greece owes €1.7 billion to the IMF by June 30th 2015 and over €4 billion to IMF and ECB by the end of July[2]; it is believed that Greece will mostly likely not be able to make these payments without a fresh bailout. Moreover, liquidity in Greece’s banking sector is drying up as deposits have been flying out at a rapid pace: down over 44% since 2009 when the crisis started, and down another 18% since November 2014[3]. Greek banks have been relying on the ELA program which the ECB has increased by €23 billion since February, for a total now of over €80 billion[4].

In the Hands of the ECB

Central bankers might not be elected officials, but they can have power over the fiscal and economic faith of democracies all over the world. Conversely, central bank independence from governments appears to be more of a myth than a reality nowadays. Through the EZ crisis, governments have been engaging in austerity measures to rejoin the path of fiscal sustainability, while ECB liquidity and verbal intervention has largely reduced the cost of sovereign debt. Now, we might be at the forefront of a whole new chapter when it comes to the role of the ECB within the EZ’s institutional set up.

Figure 1



Source: Bloomberg as of 4/30/2015

We believe Greece is likely insolvent. The debt restructuring of 2012 and subsequent bailouts and conditions have not been successful in reining in the growth of the country’s liabilities, as shown in figure 2 on the following page by the trajectory of Greek government debt. The Greek economy is back in recession after a short period of positive growth in 2014.

Overall, the Greek government balance remains in deficit; even if the primary fiscal balance (the overall fiscal balance excluding interest payments on the debt) now has a small surplus. The Greek stock market has lost over 40% of its value in the last year as shown in figure 4 on the right.

As we explained in our thematic piece from March ("The Greek Theater Will Reopen Soon"), the fiscal adjustments requested by the Troika (IMF, ECB and European Union Commission) does not appear to be realistically feasible for Greece and will most likely result in a further loss of GDP, keeping the country in contraction without stabilizing its debt.

So, what could be next?

There is a reason why Greece and its creditors have not been able to agree on the terms of a new bailout. Failure to negotiate a reduction in austerity would likely result in the end of the Syriza government, which won the February elections on that premise. On the other side of the table, Greece's creditors are not willing to give in on the austerity and reform commitments and create a precedent knowing that, absent a bailout, Greece will default and will likely be forced to exit the EZ.

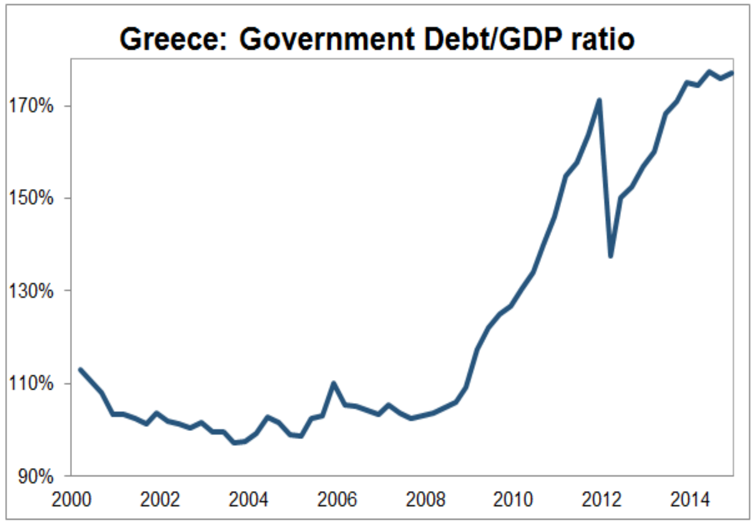
In reality, the step between default and exit is not a small one. Without a bailout Greece could default on its official obligations, official creditors would not be happy, but default is one way to restore fiscal sustainability as it would substantially reduce Greece's debt burden. However, a default could increase fears around the fragility of the Greek financial sector to the point that capital controls (i.e. limiting the outflows of capital) would likely need to be introduced in an attempt to preserve liquidity in the Greek banking system which is not something unseen in the EZ; Cyprus recently lifted capital controls that they implemented during the past two years.

The key to all of this is…the ECB

If Greece were to default on its obligations the ECB will face a dilemma: continue to provide liquidity to the banking system of a country that has defaulted on its debt (including debt with the ECB) or cut its access to ELA. The sudden absence of liquidity in the system, we believe, would likely force Greece out of the EZ.

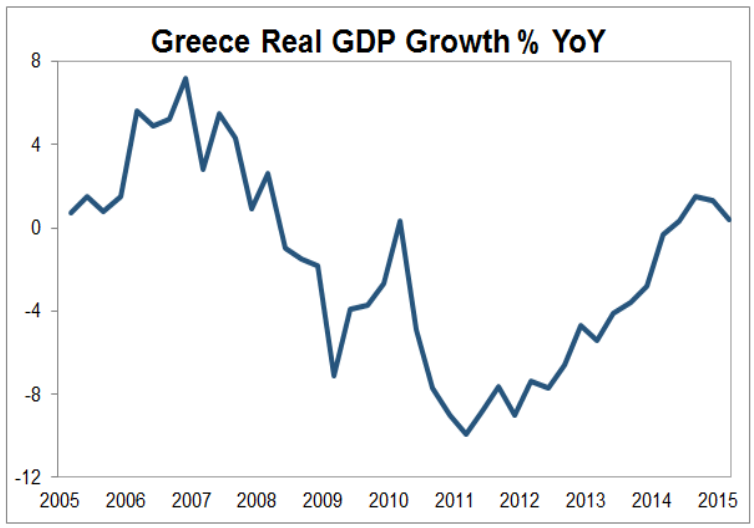
It is difficult to say what would ultimately be the best scenario for the Greek economy in the long run; whether to remain in a debtor prison and a near depression during the fiscal adjustment demanded by the Troika or whether to leave the EZ (which could be painful in the short term) and regain control on its monetary policy and exchange rate.

Figure 2



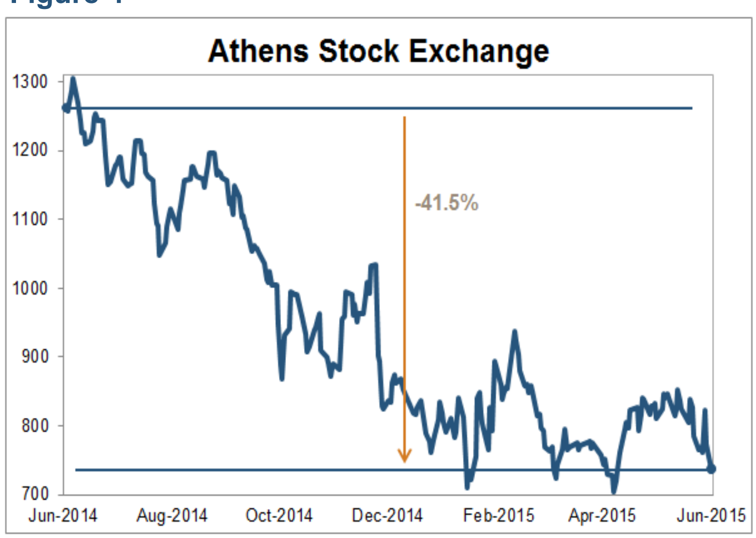
Source: Bloomberg and Eurostat as of 12/31/2014

Figure 3



Source: Bloomberg and National Statistical Service of Greece as of 3/31/2015

Figure 4



Source: Bloomberg as of 6/15/2015

In any case, the prospect of a Greek exit is an event that could lead investors to request a significant premium on Greek and European assets, but not one that we believe is a globally systemic event with high odds of turning into a financial crisis.

Once again, while politicians are running out of time to avoid a default, a central bank, the ECB, might turn out to be yet again the only game in town. The ECB could find itself in the uncomfortable position of having to decide on whether Greece will be able to remain in the EZ or not.

Seizing Global Opportunities, While Navigating Uncertain Markets

At Windhaven we strive to seize opportunities but also to manage risk by attempting to minimize drawdown in the event of negative scenarios such as a Greek exit from the EZ. Our strategies maintain exposure to U.S. fixed income securities at both the short and long end of the maturity spectrum which could help reduce portfolio drawdown and losses in the case of the materialization of a tail risk scenario such as a Greek exit. Moreover, we maintain a position in German equities (partially hedged for currency risk) to capture the potential upside opportunity that a resolution of the Greek saga could open. The ongoing quantitative easing program of the ECB and the cyclical improvement that the EZ has shown in the first half of 2015 constitute further potential tailwinds to our German equity position.

Sources:
[1]European Commission, http://ec.europa.eu/index_en.htm
[2]Bloomberg, http://www.bloomberg.com/news/articles/2015-04-23/greece-s-scary-calendar-of-debt-payments-due
[3]Bloomberg as of 4/30/2015
[4]Bloomberg, http://www.bloomberg.com/news/articles/2015-06-10/ecb-said-to-raise-greece-s-ela-ceiling-by-most-since-february-iaqvvnk1