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Greece: An Arctic winter with no end or an end with a winter

Summary

Greece's bluff was called by the EU in terms of either "comply with the old agreement and get funding in July 2015, or find money on your own". Finding money on their own, and at extremely short notice, was clearly impossible, except by breaking all the rules of the EU and ECB, such as issuing TBs without permission from the ECB, issuing their own "quasi currency" or, ultimately, leaving the EUR but still staying in the EU, legally possible but a nightmare. We expect no Grexit or unilateral decisions, but a U-turn in Greece's policies and a few more years of hard labor as the economy reforms.

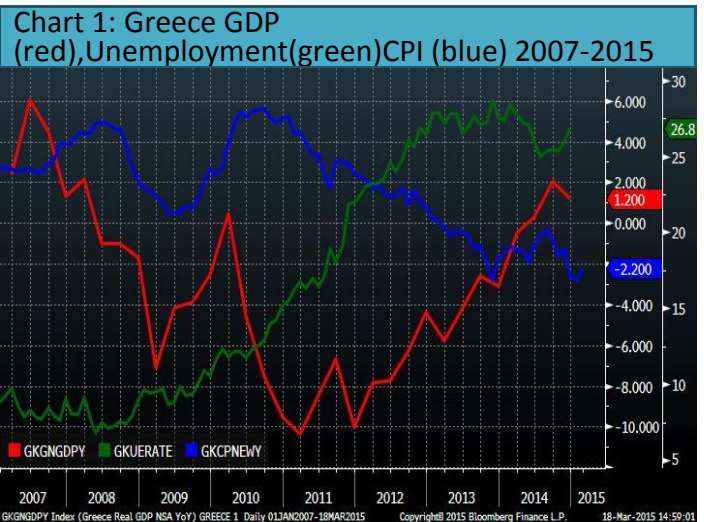
Investment Conclusions

Greece is not cheap to buy now, and till July, Greek bonds will remain volatile and risky. Better buy late than have a few very uneasy weeks. Even after a resolution in July 2015 over the rescue plan and funding, the equity market may not be cheap as the recession could deepen, albeit temporarily, before it bottoms out. If Greece was to apply vigorously the deregulation plans, which actually do not imply salary and pension cuts, then some sectors, especially services, will become far more attractive.

Scenarios (hate them but no choice !)

A typical economist's scenario will involve a price going up, down or staying the same, thereby offering nil value added as this covers all eventualities. Mercifully the Greek scenarios involve nearly purely technical issues rather than pure "choices" and, hence, manage to avoid this conundrum. Let us start by saying that we do not expect Greece to leave the EUR let alone the EU or to default or to introduce unilateral measures. As Chart 1 shows the steep shrinkage of GDP could be ending, although unemployment remains high and inflation low. We do expect that the state will do mostly the troika's bidding, but with focusing on the liberalization of the economy and of the services sectors in particular. Other areas will involve elimination of "islands" of state pension privileges as well as the acceleration of the privatization of state assets. We expect that "charity" measures will be introduced to help the low-paid and some pensioners who have been hit disproportionately by the austerity. Further emphasis will be given to collecting taxes due rather than raising more taxes. And to get one issue clear, Greek ship-owners have their overseas earnings protected by legislation, some of which is even in the Constitution.

The Greek government has been given till July to produce a program of action which, if it satisfies the EU, will then trigger the release of EUR 7.2 bl due under the existing rescue plan. So far the measures suggested have not been accepted by the EU and thus the Greek state is rapidly running out of money to pay salaries and pensions. One solution has been to raid other non-state pension funds!



Source: Bloomberg

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Suppose the Greeks go on their own

After a few more days of haggling with the EU, the Greek state declares that it will issue TBs to the local banks, despite directives forbidding this by the ECB. The ECB cuts off all emergency funding to the Greek banks which have been bleeding deposits for weeks now. Deposits withdrawals become a panic and the government closes the banks indefinitely. Measures to provide substitute credit are implemented, including I.O.U.s issued by the state, which are made legal tender, and used to pay all state debts and obligations especially pensions. This is the first step to issuing drachmas, the old Greek currency. The I.O.U.s are universally rejected and trade at a huge discount to EUR notes- still in circulation. Shortage appear everywhere as

FACT BOX: Has it been done before?

Well yes, sort of ..As there has not been a currency union which broke up or whose members left, the nearest case is that of countries breaking off pegged forex and substituting the USD with a local unit. Argentina in Dec 2001-Jan 2002 is a good example involving the break of the peg to the USD, default on the public debt, freezing of all bank deposits and the compulsory exchange of USD deposits to pesos at the official exchange rate (corralito). Asia in 1997 is NOT example as no country, except Hong Kong was pegged to the USD. Argentina did face a mini-Artic winter, high inflation, deep recession and 3 presidents within 12 months. Enough said. (The author was actually in Argentina at the time. Not fun.)

importers cannot get the forex. The government does not dare to open the banks as deposits will be withdrawn. To pave the way to the issuing of drachmas, all the deposits in EUR are compulsorily converted to government I.O.U.s at EUR parity as to assuage fears that the deposits are “devalued.” No one buys this, as the moment the banks will open, a huge black market for I.O.U.s in EUR or USD will develop. So next stage will be to freeze these converted deposits and limit severely their use. All the while prices are rising, the financial system has collapsed and, inevitably, the government defaults on all its debt as its I.O.U.s will not be accepted outside Greece and because it has no access to EUR. Chart 2 shows current market reaction.

Chart 2: 10Y,Greece (red),Spain(green),Port(blue)



Source : Bloomberg

Continuing the woes

Drachmas are printed and shipped to Greece. Banks are opened and permit limited cash withdrawals of the frozen deposits now denominated in drachmas on a parity to the EUR. No one wants drachmas and the black market will trade it massively below the official parity. The drachma cannot be pegged to the EUR and devalues. Inflation accelerates and forces the government to issue more drachmas to fund its activities. Accelerating inflation caused by shortages causes the drachma to depreciate even further. To help importers, the state introduces special rates for special transactions only to find out that the EUR is siphoned off by phony deals. Greece becomes cheap for those with EUR and the tourist sector may boom, assuming that planes fly, cars run and food is available as all of the above are mostly imported in Greece and now imports, with the devalued drachma, are very expensive, thus driving domestic prices even higher up. Pensioners and civil servants are worse off than ever. The poster stickers in Athens who had mounted posters declaring “ Bring back our little, old, lovely drachma” are hunted down and are forced to accept it, or even worse. The Greek state has to accept all it had declared it would not if elected.

Andrew Freris (18/3/2015)