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HIGHLIGHTS

- Debt restructuring in Greece has transitioned from “will likely happen” to “will happen”
- After the restructuring takes place, the Greek economy will still be contracting, fiscal policy will remain excruciatingly tight, and monetary conditions will be even tighter
- As a result, there is a meaningful risk that a debt restructuring announcement would intensify market speculation that Greece would eventually opt out of the euro zone
- Greek bank failures could trigger financial contagion across the European banking system, but the magnitude is difficult to quantify in the absence of data
- Once Greece announces restructuring efforts, this could cause markets to quickly speculate the same outcome for Ireland and Portugal
- If Spanish debt moves into the spotlight and comes under significant market pressure, we are likely to see much bolder efforts by European leaders to prevent further contagion

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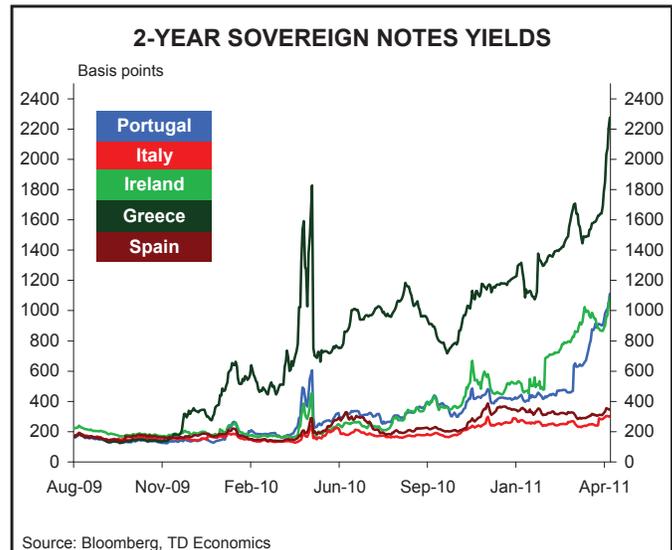
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EUROPEAN SOVEREIGN DEBT: ENTERING THE END-GAME

The European sovereign debt crisis has entered into a new stage this week. Yields on 10-year Greek sovereign bonds reached 14.55% on Monday after speculation rose over the weekend that Greek officials had consulted about a “voluntary” maturity extension at the latest European Finance Ministers meeting. There were also rumors that German government officials are working on the details of a Greek restructuring plan. We have long argued that debt restructuring was a likely event. Despite enormous fiscal tightening efforts being made by Greece amid the financial assistance program it signed last year with the EU and the IMF, its fiscal outlook remains dire.

Indeed, the adjustment program has missed some of its targets and a weaker economic outturn will continue to cast doubts over the ability of the Greek government to meet its program objectives. According to the third IMF review completed in mid-March¹, the 2010 fiscal budget is estimated to have fallen by about 5.7 percentage points of GDP to 9.5% of GDP. However, the economic recession meant that fiscal tightening measures equivalent to 8% of GDP had to be implemented to achieve such a reduction. Fiscal revenues have been weaker than projected, growing by 5.6% rather than the 13.7% originally planned. In addition, there have been expenditure overruns in sub-national entities (such as state-run firms), and at end-November, the general government registered some €4 billion in arrears.

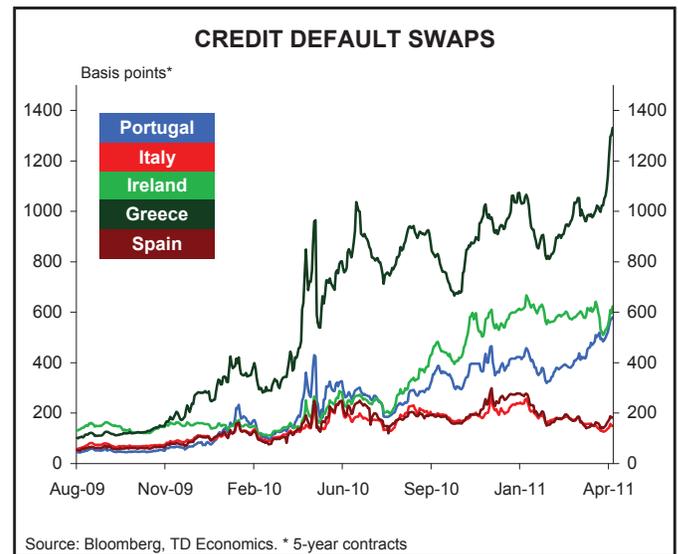
Passing the IMF reviews is critical in order to secure loan disbursements, not only from the IMF, but also from the EU. This year, reviews will be finalized at the end of May, August, and November, with payments of €4.1 billion and €10.9 billion by the IMF and the EU, respectively, planned for the May deadline. On the other hand, the country’s rollover calendar will provide quite a few tests for market confidence. According to data from Bloomberg, Greece faces redemptions to the tune of €9.6 billion in May, €5.5 billion in July, €9.5 billion in August, and €8.2 billion in December. Next year, there is a €16-billion bump in March, and two €10-billion rollovers in May and August, respectively. If Greece fails to meet its targets at a review, prompting a delay in disbursements, it could end up short of the cash needed to make its payments.



In a previous report ([European Sovereign Debt: The Time Has Come for the ECB To Guard The Euro](#)), we highlighted the role domestic politics will play in shaping the response of European countries to the debt crisis, and the risks this posed to borrowers missing their program targets. In line with this, the results of the Finnish elections this weekend were one of the main drivers for the latest spike in sovereign bond yields. Two opposition parties, the True Finns and the Social Democrats received roughly 20% of the votes each. Both of them dislike the idea of providing financial assistance to their debt-laden European neighbors. This might complicate matters at the upcoming revisions on the Greek program, because disbursements have to be approved unanimously at the EU level. This is why markets are so nervous and increasingly pricing in a Greek debt restructuring. Greek two-year yields rose 130 basis points to 22.01% yesterday, and an auction of 13-week bills on Tuesday placed €1.625 billion at a yield of 4.1%, up from 3.85% at a mid-February auction.

Beyond this year and next, there are still a lot of risks related to the implementation of the fiscal tightening and structural reforms under the Greek program. For instance, according to a set of alternative debt scenarios modeled by the IMF, if the Greek government had to honor all the state-guarantees it has offered, including those to Greek banks through its liquidity support program – a potential €85 billion liability – the debt level would reach 199% of GDP by 2020, instead of the 130%-of-GDP baseline level. Under a different alternative scenario that reflects a GDP growth rate that is one percentage point lower in each year relative to the baseline scenario, debt would reach 173% of GDP by 2020. These scenarios become very relevant once we take into account that by mid-2013, the current IMF/EU program will expire, and if by then Greece has not been able to return to the markets, it will have to rely on the European Stability Mechanism, which has bondholders' haircuts as a prerequisite for granting loans to countries with unsustainable debt dynamics (please see [European Sovereign Debt: Still Without Signs of Resolution](#)).

The bottom line is that a debt restructuring in Greece has transitioned from “will likely happen” to “will happen”, but we do not know exactly when it will occur. We have had the view that the most likely scenario was next year. However, recent developments suggest that a Greek debt restructuring is more imminent and likely to be announced sometime this year. To speculate on a potential timeframe, we think a physical restructuring of Greek debt is unlikely to occur before June because of the calendar of both Greek



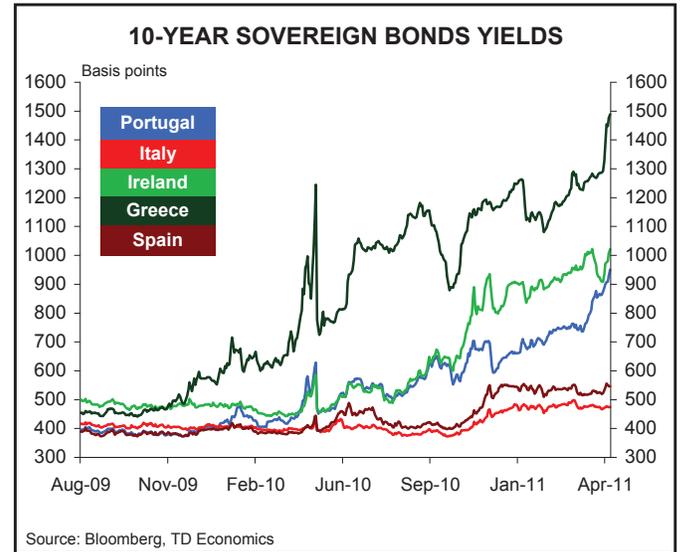
debt rollovers and scheduled IMF/EU revisions, in combination with the fact that there are ongoing discussions on a Portuguese bail-out program. However, an announcement of the intention to restructure can come at any time.

What happens after a Greek restructuring?

From the macro economic perspective, a debt restructuring will not eliminate the need for fiscal and structural adjustment. After the restructuring takes place, the Greek economy will still be contracting and fiscal policy will remain tight. Monetary conditions will be even tighter, because Greek banks will have to deal with both the withdrawal of deposits triggered by the sovereign restructuring and the impact of the latter on their balance sheets. Already, more than €40 billion in deposits have been withdrawn from Greek banks – roughly 14% of their total deposits. We'll likely see that withdrawal pressures intensified in March and April when those statistics become available. These forces immediately translate into a reduced ability to lend. So, for an economy enduring both constrictive fiscal and monetary settings under a fixed exchange rate regime, the only variable left to bare the brunt of the adjustment is domestic prices. In other words, even after restructuring its debt, and until structural reforms elevate potential economic growth, Greece will have to endure deflation. But, as we've repeatedly noted, deflation is both socially unbearable and self defeating: through its impact on profits and wages it reduces tax revenues and exacerbates the need for more fiscal adjustment. Moreover, the symmetry of deflation's impact on both profits and wages means that it has the power to bring together corporations and labor unions to resist such an adjustment.

The Argentinean default experience of the early 2000's offers some insights on these issues. Within the four-year period ending in 2002, the Argentinean economy contracted by 18.4% in real terms, unemployment peaked at 30.5%, and currency in circulation declined by 25%. However, amidst those tremendous recessionary conditions, consumer prices only fell by an accumulated 3.4% from January 1999 to December 2001. By comparison, without the debt default as yet, the Greek economy has contracted by 6.5% over the last two years, the unemployment rate was at 14.1% and climbing in December 2010, and the M3 monetary aggregate had shrunk 10.4% y/y in February 2011. However, annual inflation is still running high at 4.3%. IMF estimates suggest that the real effective exchange rate is overvalued by around 20% to 34%.² As such, it becomes clear that the Mediterranean country would have to endure deflation in order to restore its competitiveness vis-à-vis its euro zone neighbors, while it waits for its structural reforms to yield meaningful productivity gains. With this in mind, there is a sizeable risk that a debt restructuring announcement would intensify market speculation that Greece would eventually opt out of the euro zone.

On the financial front, European banks balance sheets would be immediately impacted by a Greek debt restructuring. In a previous report, we put forward a back-of-the-envelope calculation of the direct impact of a hypothetical case (please see [European Sovereign Debt: Stress Testing](#)



[Banks for “Sovereign Default” Is Key Next Step](#)). Greek banks holding more than €40 billion of Greek government bonds will suffer a massive dent on their capital buffers as a result of the restructuring. The combination of the direct impact from the sovereign restructuring and the potential for Greek bank failures could trigger financial contagion across the European banking system. But, the full ramification of such a crisis is impossible to quantify. For instance, by end-September 2010 – currently the latest available data – Irish and Portuguese banks had exposures to Greek debt

| FOREIGN BANKS CLAIMS ON PIIGS and CORE EUROPE | | | | | | | | | | |
|---|----------|---------|-------|--------|-------|-------------------------|--------|---------|----------------|--------------|
| (% OF LENDER BANKS' HOME COUNTRY BANKING SYSTEM CAPITAL AND RESERVES) | | | | | | | | | | |
| | Portugal | Ireland | Italy | Greece | Spain | Total Exposure to PIIGS | France | Germany | United Kingdom | Total |
| Belgium | 3.0 | 73.3 | 34.0 | 2.9 | 27.3 | 140.5 | 42.5 | 30.7 | 51.0 | 264.7 |
| Germany | 8.3 | 32.0 | 36.8 | 8.3 | 41.7 | 127.1 | 43.2 | | 102.5 | 272.8 |
| France | 6.0 | 8.4 | 72.6 | 9.6 | 29.5 | 126.1 | | 50.4 | 56.6 | 233.1 |
| Netherlands | 4.7 | 17.4 | 37.3 | 3.5 | 60.7 | 123.6 | 73.1 | 129.6 | 122.1 | 448.4 |
| Portugal | | 39.1 | 6.7 | 19.3 | 46.5 | 111.6 | 15.3 | 7.1 | 13.9 | 147.8 |
| Ireland | 5.0 | | 38.6 | 7.4 | 23.8 | 74.8 | 17.8 | 38.0 | 193.2 | 323.8 |
| Switzerland | 2.3 | 12.6 | 12.9 | 2.4 | 9.6 | 39.6 | 44.3 | 57.0 | 142.8 | 283.7 |
| United Kingdom | 2.4 | 17.3 | 6.3 | 1.2 | 11.9 | 39.1 | 26.7 | 19.0 | | 84.9 |
| Spain | 22.8 | 3.5 | 8.7 | 0.3 | | 35.4 | 7.8 | 11.7 | 112.2 | 167.1 |
| Austria | 1.5 | 3.0 | 20.2 | 2.9 | 6.2 | 33.9 | 8.8 | 49.2 | 17.6 | 109.4 |
| Denmark | 0.3 | 22.5 | 0.5 | 0.1 | 2.4 | 25.8 | 3.2 | 17.7 | 51.7 | 98.4 |
| Sweden | 0.5 | 5.9 | 1.8 | 0.7 | 5.3 | 14.3 | 12.2 | 96.0 | 51.4 | 174.0 |
| Italy | 1.0 | 3.3 | | 1.0 | 5.9 | 11.3 | 8.9 | 56.7 | 10.5 | 87.4 |
| Greece | 0.3 | 1.5 | 1.6 | | 0.6 | 4.0 | 4.6 | 12.8 | 37.0 | 58.4 |

Source: BIS, ECB, Swiss National Bank - September 2010, TD Economics

equivalent to 7.4% and 19.3% of their total banking system's capital, respectively. However, which specific institutions would be affected and where their counterparty risks lie is another layer of the onion.

Another contagion influence stems from the fact that a Greek bail-out would show that the levies built by the IMF / EU to contain the debt flood have not worked adequately. This could cause markets to quickly speculate that debt restructuring in Greece raises the potential for the same outcome for Ireland and Portugal. Moreover, social appetite for bail-outs and adjustments programs will run very thin, both in countries besieged by the sovereign debt crisis and in the fiscally stronger neighbors. This will further exacerbate the challenges of managing the political dimension of the crisis resolution.

Final Remarks

It becomes easy to see how one event could become a trigger for others. And, at this juncture, it is difficult to assess the final impact of Greek debt restructuring and the final reach of the chain of events, particularly because it is as yet unknown how the restructuring will be shaped. Imposing a 50%-haircut upfront will carry much more severe

consequences than an initial 10% cut with an extension on the maturity date; even if investors anticipate a second restructuring to impose larger haircuts would take place later on. Sovereign defaults that have taken place in recent years have caused the average investor loss to range from 25% to 35%. The lowest loss corresponded to Uruguay in 2003 with an estimated 13% haircut, and the highest to Argentina's 2005 debt restructuring at 74%.³

In addition, we do not know the risk profile of individual European banking institutions, which makes a systemic risk assessment literally impossible. But one thing is for sure, there will be coordinated efforts by the EU and the IMF to reduce the contagion risks to Ireland and Portugal. And, even though Spain's debt dynamics are superior to many other sovereigns, it too may come into the spotlight. If significant market pressure builds on Spain, we are likely to see coordinated efforts even more broadly and aggressively to prevent the dominoes from falling. In other words, Spain is where a line will be drawn. We can only speculate on what shape this will take, but in all probability it would require a pooling of European debt and concrete efforts towards a European fiscal union.

Endnotes:

- 1) Greece: Third Review Under the Stand-by Arrangement – Staff Report. IMF Country Report No. 11/68. March 16th, 2011.
- 2) Ibid., page 4.
- 3) "Haircuts: Estimating Investor Losses in Sovereign Debt Restructurings, 1998-2005", IMF Working Paper WP/05/137, by Federico Sturzenegger and Jeromin Zettelmeyer.

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