Hot Topic

GREEK TRAGEDY, NOW ITALIAN OPERA: THE DRAMA CONTINUES

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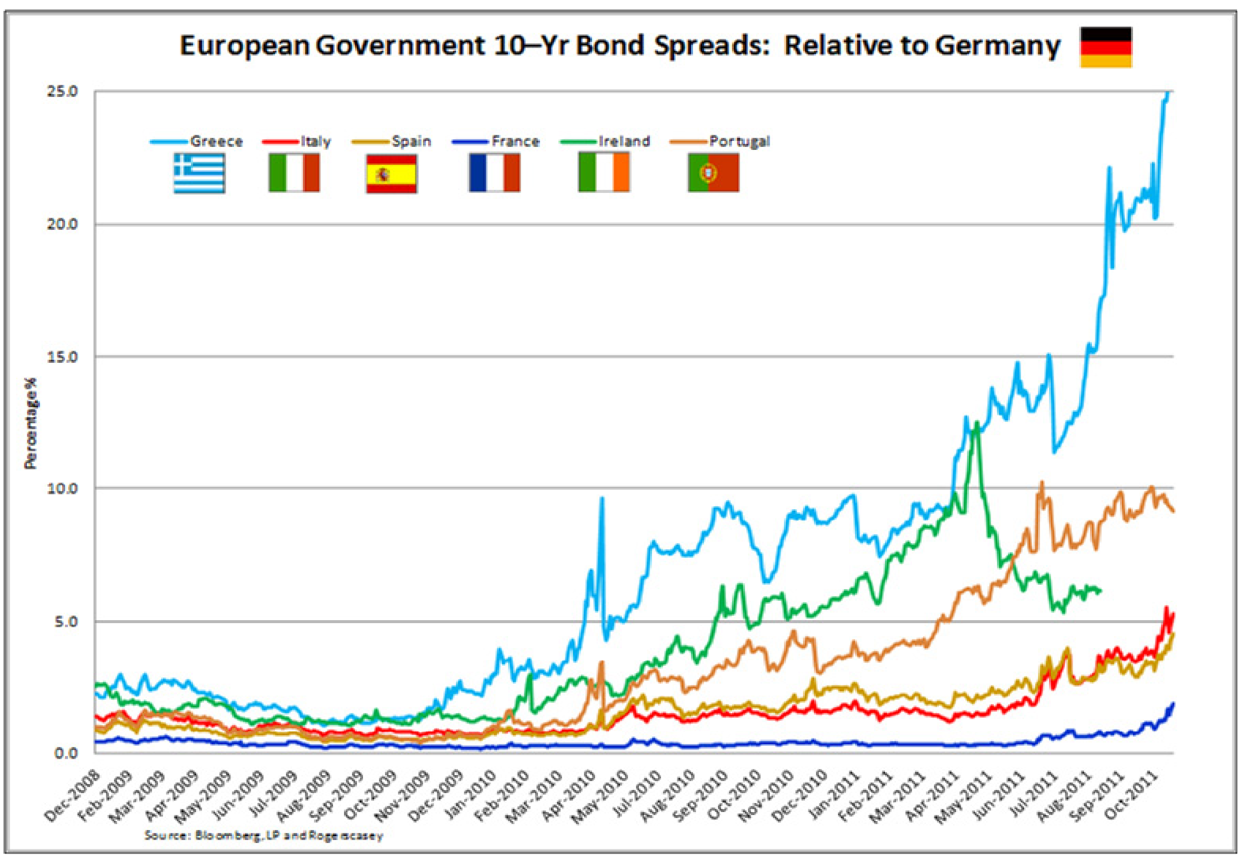
The eurozone debt crisis continues to move markets. Certainly at stake is the European common currency. Perhaps the very existence of the European Union and the global banking system also hang in the balance. So far, the eurozone has been able to avoid disaster; however, the economic, political, and debt troubles have intensified with Greek and Italian bond yields rising to soprano-like levels and political leaders engaging in a game of musical chairs. Global investors are tuned in for breaking news, and are watching the shifting political leadership within these troubled countries. They are looking for any indication that Greece or Italy can successfully implement deficit and spending reforms in order to receive additional bailout euros and capital support. Without such support, defaulting on their respective debt or exiting from the euro currency seems inevitable for at least these two countries, which would likely cause a meltdown in the European banking system.

Figure 1: European Government Bond Spreads



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GREECE

Greece, a nation with a history dating back to 3000 B.C., has caused enough drama over the past three years to keep historians busy for almost that long. The most recent jaw-dropping headline came in early November, as Greece's now-ousted prime minister, George Papandreou, announced plans for a referendum on the unpopular bailout and austerity program that was laboriously hashed out by eurozone leaders weeks before. The very real prospect of Greek voters rejecting the plan—and essentially the euro along with it—sent markets into a panic, wiping out the large gains seen in previous trading sessions that were prompted by the relief that investors felt over the European Financial Stability Fund ("EFSF") having the (now fleeting) appearance of being more or less adequately addressed. Not only did the markets react negatively to this about-face on the part of the Greek leader, so did other European counterparts and fellow Greek politicians. While Papandreou was able to survive a no-confidence vote, he was still forced to step aside, and has been replaced by Lucas Papademos, a former Vice President of the European Central Bank. The referendum was shelved, and, for now, Greece seems to be back on board with the terms it agreed to before this latest twist in a modern Greek tragedy.

One of the most striking aspects of this latest episode is that German chancellor Angela Merkel and French president Nicolas Sarkozy have openly discussed ejecting Greece from from the eurozone, marking the first time a member of the currency union has ever been considered for expulsion. There is little doubt that Greece's departure would have minimal impact on Europe's GDP, as it represents only 2.5% of the eurozone economy; however, Greece's implications are more relevant to the euro currency system and the precedent it establishes from being ejected from the eurozone. Though immediately after the problem's apparent resolution, both leaders were at pains to say that it was in everyone's interest to keep the eurozone intact. Germany would likely see its all-important export machine suffer as the remaining part of the eurozone sees its currency appreciate from the removal of its weakest link.

Greek 10-year interest rates have ascended to about 28% while the spread above German Bunds (1.81%) has ranged above 2,600 basis points (see Figure 1). Greece has customarily run high government deficits and debt-to-GDP ratios in excess of 100%. In terms of debt-to-GDP, Greece's is the world's fourth highest (following Zimbabwe, Japan, St. Kitts and Nevis, respectively), and is projected to reach 163% of GDP in 2011, almost three times the European Commission's limit. It is hoped that the proposed reform policies and bond haircuts (50% Greek debt write-down) will lower debt-to-GDP ratios to 120% by 2020 and sway investor confidence, buying enough time to hold the eurozone together.

Another worrisome development in the eurozone debt crisis is the negative sentiment toward bailout and austerity efforts. If the matter were left up to voters, it's likely the euro monetary system would collapse, as disgust over the debt crisis has made many pine for the old system of individual national currencies.

But for now, Greece seems to have put this most recent twist in the eurozone saga behind it, and the markets have taken comfort in Papademos being named interim prime minister. An MIT-trained economist, Papademos is the head of a unity government that appears to have stronger political support than the previous government led by

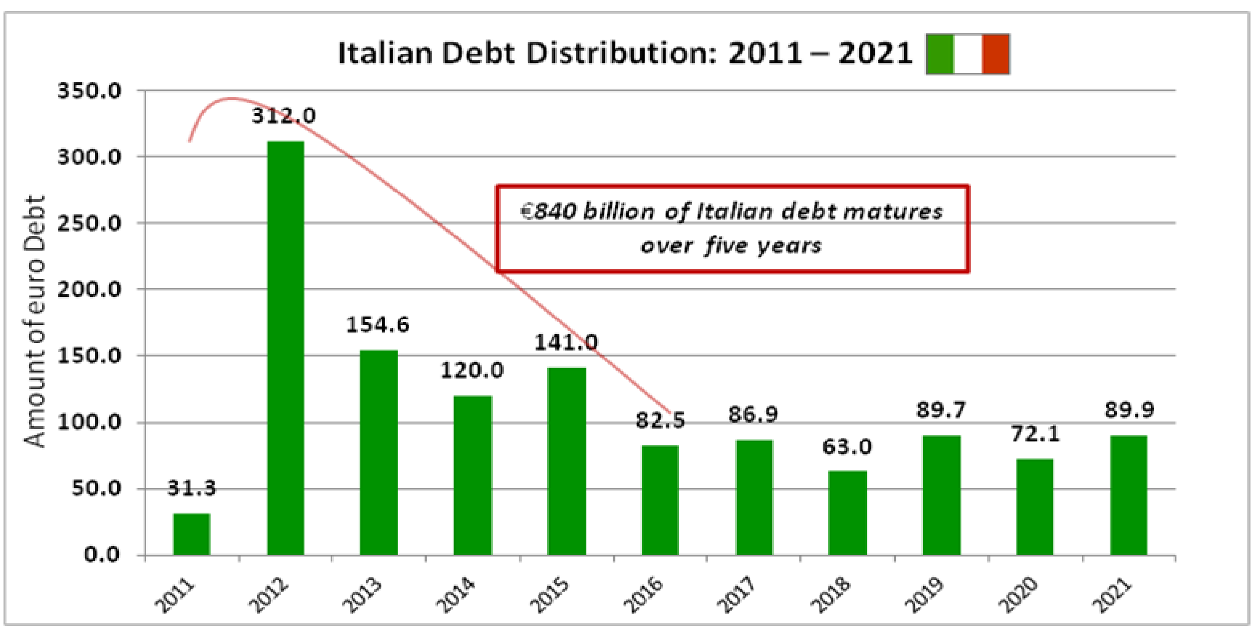
Papandreou; however, he does not have political experience and may yet run afoul of the high emotions on the streets of Athens.

ITALY

Italy has become the latest real battleground within the eurozone. Italian bond yields have reached the critical 7% level that previously drove other distressed European countries with the "PIIGS" moniker to seek international bailouts in order to stave–off a eurozone meltdown. As the third largest bond market in the world, Italy's outstanding debt of €1.9 trillion ($2.6 trillion) exceeds that of Greece, Spain, Portugal, and Ireland combined.

The bond market is clearly targeting Italy, causing its yields to rise. Out of fear that Italy's fiscal problems will turn into a larger Greek–like situation, Italian bond prices have declined, inversely sending the yield on the 10–year bond up to 7.48% on the 9th of November. As Figure 2 indicates, a greater proportion of Italy's debt will mature over the next five years, requiring principal payment or refinancing. If interest rates push above 7% (a spread of 500 bps relative to Germany), it would indicate that bond investors believe Italy is at great risk of default and would therefore demand greater compensation in return for lending to the Italians (purchasing Italian bonds). With Italian debt already exceeding GDP (120%) and a budget deficit unlikely to be offset by economic growth further exacerbating Italy's need to borrow, Italy's credit rating faces the likelihood of being downgraded, which would increase their cost to borrow capital. Higher interest rates could further weaken its credit rating, leading the higher borrowing rates and the debt spiral to continue until Italy could no longer afford to make good on its payments or lenders refuse to support Italian bonds. Since Italy is unable to print its own money, its situation would become unsustainable as markets would discount the spiral to the endgame at hyperspeed.

Figure 2: Italy's 10-Year Debt Distribution



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Failure to restore order in Italy's public finances may cause it to join Greece, Portugal, and Ireland in seeking outside help. It is difficult to envision an external solution to Italy's problems with the limited amount of resources currently available. Under the EFSF, a troubled country can now receive support of up to 10% of its GDP. For Italy, that equates to approximately €160 billion. After spending €170 billion on Greece, Portugal, and Ireland, the EFSF's rescue ability now stands at just €270 billion. The International Monetary Fund's crisis-busting war chest is only $391 billion to assist all of Europe. Even the combination of these resources could not result in sufficient assets to cover the bond maturities Italy is facing over the next three years, as the bonds are estimated to be approximately €650 to €700 billion. Considered too big to fail, Italy may actually be too big to save!

"Attenzione" has now turned to the Italian government and will be focused on former European Union Commissioner Mario Monti in his new role as prime minister of Italy. While the Italian parliament has taken the first step in reducing debt by passing parts of a €45.5 billion austerity deal intended to restore investors' confidence, the pressure on Italy remains heightened as the European Union, International Monetary Fund, and European Central Bank have recently sent inspectors into Italy to monitor and review its austerity and implementation progress.

The Italians clearly hope this first step will boost investor confidence in their government, economy, and debt markets. Whether market concerns subside and the crisis is averted, or contagion spreads further to other countries, will only be determined over the coming weeks and months.

The pressure continues to mount for the Greek and Italian governments to implement the troika's (European Commission, European Central Bank, and International Monetary Fund) policies intended to restore Europe's external competitiveness, confidence, sustainability of public finance, and economic growth. Politically, it's a tall order under the best of conditions, but especially for untested new political leaders Papademos and Monti. All investors will continue to watch the situation unfold with their fingers crossed, if not squarely on triggers, looking for the political signs that a solution can be reached to avert the crisis from worsening.

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