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INVESTMENT STRATEGY

Greek debt crisis: overview and lessons

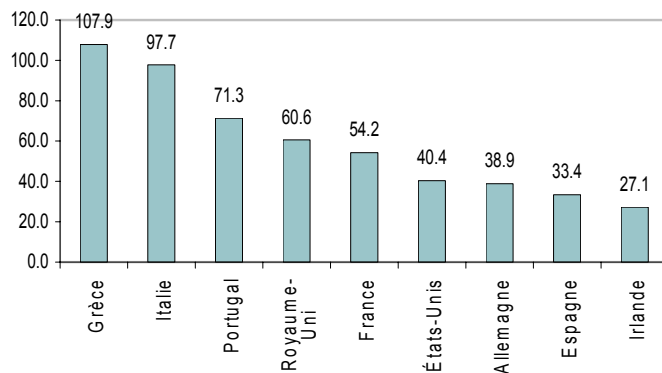
Current situation and outlook

The “Greek debt crisis” is chiefly the result of a particularly acute budget balancing problem, exacerbated by a loss of confidence in the country’s government and statistical tools (elected in October 2009, the government revealed that the deficit was much higher than previously thought – almost 13% of GDP – and there are still doubts about the credibility of its statistics).

While not dire, the situation is very worrisome...

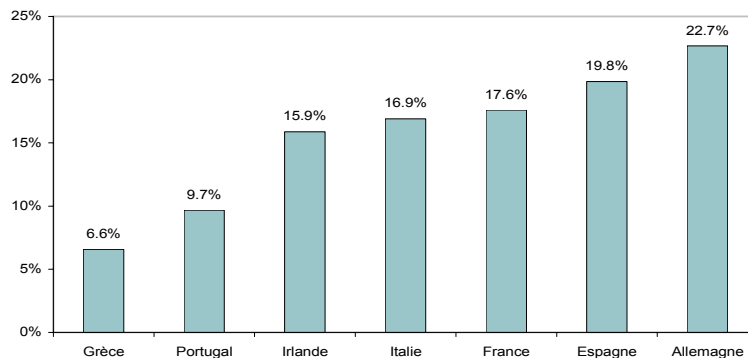
Greece’s public deficit (12.7% of GDP) is the highest in the eurozone. The primary deficit (i.e. before debt servicing) is 8%, and the national debt-to-GDP ratio is quite high as well (107.9% at the end of 2008). Lastly, the country’s current balance deficit is about 10% of GDP, also among the worst scores in the eurozone, while the savings rate is particularly low at 6.6%. All of this makes Greece highly dependent on external financing.

Chart 1: Public debt-to-GDP ratios (end-2008)



Source: OECD – [Greece, Italy, Portugal, UK, France, US, Germany, Spain, Ireland]

Chart 2: Savings rates (% of Gross Disposable Income, average since Q3 2008)



Source: OECD – [Greece, Portugal, Ireland, Italy, France, Spain, Germany]

There is one piece of relatively good news: Greece's total economy debt (private and public) is not too high, at 230% of GDP, compared with 274% in Germany, 298% in Italy, 308% in France, 342% in Spain and 469% in the UK. When the crises began, Ireland showed total debt of 700% of GDP, and Iceland's stood at 1,189% (due in both cases to the weighting of banks).

The highly ambitious plan unveiled by the government calls for the deficit to be reduced to 3% of GDP by 2012, with the primary surplus reaching 2.5%. While not totally unrealistic, the plan will in all likelihood be tough to follow through on:

- It will require follow-up over several years, which might not please public opinion in a country with an extremely high unemployment rate and where social unrest is brewing (cf. riots in Athens).
- Moving from a primary deficit to a surplus would require draining ten GDP points from the economy in just three years, through spending cuts and higher taxes.

In sum, to bring the plan to fruition, Greece will have to accomplish much more than it has been able to do in recent years on the budget front. There is pressure from markets and the rest of Europe for the government to implement the plan as it was presented. While the result would be a substantially lower public deficit, one can legitimately question whether the 2012 target will be met – i.e. whether Greece can become one of the most virtuous countries in the eurozone by that year. That said, the plan was probably deliberately prepared with highly ambitious targets to quell market fears, meaning that it could provide some reassurance even if all objectives are not met in full.

Be that as it may, Greece's economic outlook is dim. The fiscal measures planned, even if not quite as strict as anticipated, can only depress private consumption, and an already low private savings rate will not be able to help absorb the shock. Some GDP growth forecasts for the coming years call for 1% annual growth, some for zero, and some for a recession lasting several years. Based on this outlook, the public debt-to-GDP ratio and uncertainties about whether the recovery plan will be implemented over the long term, there is no reason to believe sovereign spreads will return to normal (i.e. pre-crisis) levels anytime soon.

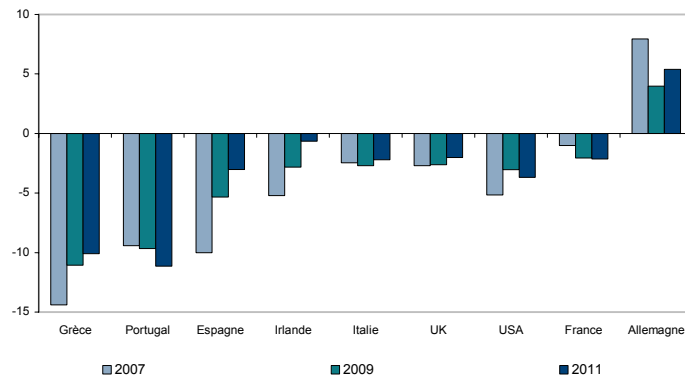
Luckily, there is almost no chance that Greece will be left to fend for itself

Other eurozone states, especially France and Germany, will not risk announcing that they are aiding Greece before this becomes absolutely necessary, as this would undermine the principle of discipline by which each member of the monetary union must abide.

It is also clear, though, that Greece cannot be allowed to stay in a financial impasse or forced to exit the single currency: in that case, other relatively weak EU economies (Portugal, Ireland and Spain) would inevitably face crises of trust in turn. This would be extremely destabilizing for the eurozone and would threaten to cause interest rates to surge in countries that pulled out.

If the crisis continues, Portugal could be next on the list. Indeed, it has two things in common with Greece: a low domestic savings rate and a current account deficit. Its public debt-to-GDP ratio is nonetheless better, as is its sovereign debt rating (Fitch: AA for Portugal and BBB+ for Greece). Spain could follow it (debt-to-GDP still relatively low but rising rapidly).

Chart 3: Current balance (as a % of GDP)



Source: OECD – [Greece, Portugal, Spain, Ireland, Italy, UK, US, France, Germany]

Should the measures proposed by the Greek government fail to reassure (which seems quite possible at this stage), the crisis would likely take on a more political tone with the rest of Europe, backed or not by the IMF, coming onto the scene. In sum, for the relatively near term, Greece's debt would have a "safety net" under it if market and financing conditions continue to worsen. In the meantime, one can expect much more tension and volatility, and swings between hopefulness and wariness. The latest five-year bond issue was four times oversubscribed, but the paper quickly lost ground on the secondary market. The next issue – a 10-year bond – is scheduled for April (see calendar below).

Markets are concerned specifically about Greece's debt because it can be pledged as ECB collateral: through the end of 2010, the ECB will accept bonds rated BBB- and above. Thereafter, this could pose a problem given that the financial system carries large amounts of Greek debt. While the change is more than a year away, and assuming that measures would be extended if necessary, uncertainty about this possibility is clouding the horizon as far as investors are concerned.

It is difficult to assess the current valuation of Greece's bonds because of the crisis, especially as the market is being affected by forced sales (some funds cannot hold onto bonds that have been downgraded), a phenomenon that can distort the relationship between fundamentals and market prices. It is possible to draw a comparison with three countries that also had to call on the IMF: Romania, Hungary and Latvia. Spreads in those countries had reached an average 400bp over Bunds in the six months preceding the IMF's intervention. After this level is reached – and Greece approached it recently – the potential for widening is limited. Assuming that Greece will be able to meet its debt obligations thanks to the recovery plan and any aid it may receive (this is reasonable in our view), and that future volatility will be bearable, the paper could be considered to be attractively valued today.

☞ What the crisis has taught investors

The Greek debt crisis has served as a reminder of some medium- and long-term considerations.

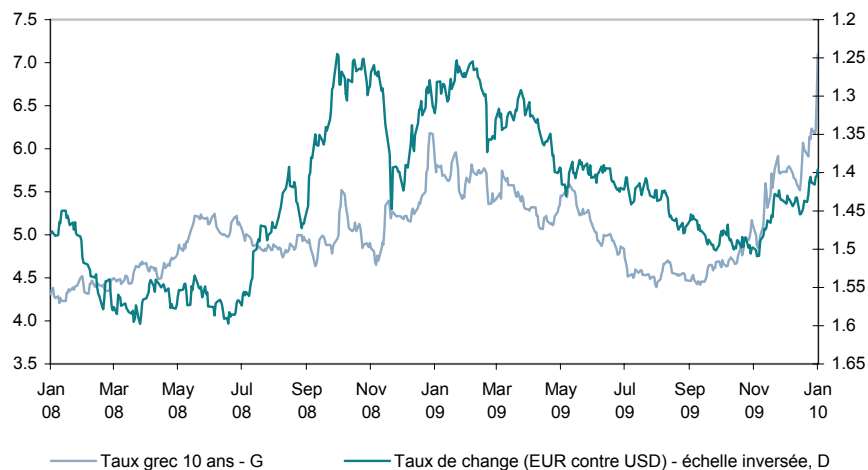
1. Public deficits are surging in Western countries. Situations still vary widely from one country to the next. There is little chance that the sovereign debt ratings of issuers like the US, Germany and France will be downgraded in the near future, while smaller and medium-sized economies like the UK, Italy, Spain, Portugal and Ireland seem more at risk. Be that as it may, public finances are deteriorating across the board, regardless of their starting point or rates of increase. Assuming, as we do, that the economic recovery will be slower than after previous crises (cf. BNPP IP macroeconomic outlook), there does not seem to be any hope of stemming the surge anytime soon. This suggests that there will be more warnings in the years ahead. Looking beyond the market's shorter movements, there is not much incentive to seek out the medium-term yields of issuers in unsure situations (those that, while perhaps not in the same mess as Greece, are somewhere in the middle in terms of public finances), even if spreads are already wide. Moreover, the lower quality of borrowers points to an ongoing steepening of the yield curve for government bonds.

Our overall scenario suggests that there is little chance of a financing shortage over the next two or three years. An increase in private savings, made possible by emerging economy growth and higher savings rates in developed countries, will be able to counteract a rise in public debt that has, since the crisis began, been substituted for private debt. In addition, a large share of government debt issued is monetized either directly (purchased by the Federal Reserve in the US until now, although this will change) or indirectly (use of public debt by banks as collateral for obtaining funds from the Central Bank, this being the European model). However, these mechanisms will only continue to work as long as private sector credit demand is slack and inflationary pressure limited. Beyond the weak, low-inflation recovery we see taking shape over the next two to three years, a return to higher growth or inflation rates, accompanied by an uptick in private sector credit demand, would be a real threat for long rates.

2. The eurozone is plagued by economic imbalances that are threatening the single currency. The euro has tended to be seen in recent years as a "strong" currency (due to the ECB's "orthodox" policy with regard to inflation and the currency's status as an adjustment variable with regard to devaluation strategies elsewhere in the world). Differences between economic performances within the eurozone are undoubtedly the currency's Achilles heel, with some countries using "stowaway" strategies (those that enjoy low rates and stable parities despite high current account deficits), and differences between productivity gains that will be hard to sustain over the long term when devaluations are impossible. Some economies will have to pay a price to converge (or risk seeing imbalances worsen if they do not), and this is also hurting the euro. Of course other factors will also determine the currency's value, but there are good reasons to question strategies based on its appreciation over the medium and long terms.

In the nearer future, one ironic effect of the crisis is that it could trigger a slight increase in European exports thanks to currency weakness (the euro's value has already declined by 5% in two months in real terms). It would obviously be difficult to maintain that the Greek debt crisis is good news for the rest of the eurozone, especially as it had still not been resolved, but the knock-on effect on exchange rates could make the recovery a bit more solid, albeit without making the underlying dynamics any more robust.

Chart 4: Sovereign bond rates (LH scale) and EUR/USD parity (RH scale)



Source: *Datastream* Greek 10-year rate – L Exchange rate (€ vs. \$), reserve scale – R

3. The banking sector’s exposure to sovereign debt risk must be kept under watch. Commercial banks have shown a hearty appetite for sovereign debt (with credit demand low and financing costs still at rock bottom, they are riding the curve), and Greek banks are no exception.

Our scenario suggests that a warning about exposure to government bonds is unlikely in the near future, although it is worth bearing in mind that a sovereign debt crisis in the coming years could turn into a banking crisis if banks continue to show so much appetite for government bonds.

Calendar

February 10: General strike. Its magnitude will give an indication of how well public opinion and the government will be able to tolerate the austerity measures.

February 11: Extraordinary European Council meeting in Brussels.

February 16: Announcement of the European Council’s official position on Greece’s 2010 budget plan.

March: Greek parliament to vote on first tax reforms; more information about public spending reduction program.

April-June: EU to issue statement on implementation of Greek austerity plan. This is when “recommendations” could be made (no “sanctions” at this stage) as part of an Excessive Deficit Procedure. The EU would in this case assess the situation every three to six months. The Greek Treasury could also anticipate key sovereign debt issues (like to peak in April and May) during this time.

March 2011: ECB scheduled to revert to its old rules regarding the eligibility of government bonds for use as collateral. Greece would have to earn a rating of A- or better from at least two agencies for its sovereign bonds to remain admissible. Moody’s rating is still two notches above this critical threshold, but it has kept Greece on “watch negative”.

Source: *Exane BNP Paribas*

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