

Playing cat and mouse with Greece

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For professional investors



Key points

- ◆ No rescue plan from other European countries
- ◆ Finance ministers talk tough on Greece
- ◆ Growth will be slow in the PIGS

European leaders did not come up with any clear rescue plan for Greece last week, other than stating that they have a common responsibility for economic stability in the eurozone. In this flash we provide a short update on recent developments and give our views on what is going on.

No rescue plan

On Thursday 11 February European leaders met, officially to discuss the European Union's long-term growth strategy, although in practice the meeting was dominated by developments in Greece. Markets had hoped that the meeting would result in an outline rescue plan, but they were disappointed. The group only pledged to take coordinated action to protect the stability of the eurozone. The euro, which had been trading as high as USD 1.51 in early December, continued its downward trend and ended last week at just USD 1.36. Risk spreads on Greek government bonds fell slightly as bond markets were reassured by the vague pledge of a European solution for Greece's problems.

Early this week the European Commission, the European Central Bank and the finance ministers of the sixteen eurozone countries all talked tough on Greece. The basic message was that Greece should solve its fiscal mess by itself. In fact, they urged Greece to be even more ambitious in its deficit reduction plan. As markets had again hoped for at least an outline of a solution, risk spreads widened once more.

The cat and mouse game

The Greek finance minister has blamed the European Commission for failing to act when previous Greek governments ran unsustainable deficits and falsified statistics. Although this may be part of the problem, it will only have angered other member states. Those other member states must now navigate the severe implications of a possible Greek default as well as the moral considerations that a rescue plan would involve.

A default by Greece would have very serious implications. According to the Bank of International Settlements, French banks own USD 73 billion of Greek government bonds, German banks USD 38 billion and Dutch banks USD 11 billion. Write-downs of these bonds in the event of a default would weaken a sector that is already reluctant to borrow. Default would also trigger payments on Credit Default Swaps – essentially insurance contracts on bonds. These contracts are not traded on exchanges, so it is impossible to assess how big those payments would be and who holds the contracts.

Nevertheless, the biggest risk of a Greek default (let alone expulsion from the eurozone) would be that markets would focus their attention on the other PIGS countries: Portugal, Ireland and Spain. In such an event these other relatively-weak EU economies would inevitably also face crises of trust. This would be extremely destabilising for the eurozone and there would be the threat of interest rates surging in countries that pulled out of the eurozone.

The other side of the problem is the moral implications. If Greece is rescued, that would mean it had not been punished for its reckless behaviour. There would therefore be no impetus for the country to change its future behaviour or indeed for other countries to avoid replicating it (although we doubt whether any other countries envy Greece's predicament at the moment).



Greece's financial needs are not far over the horizon. It needs to sell EUR 53 billion of debt this year and faces bond redemptions of about EUR 8 billion on 20 April and 19 May. A buyers' strike in the bond markets would immediately lead to a crisis.

The game plan of the European Union and its member states appears to us to be an attempt to address all the issues. Vague statements about a European rescue plan (which is a step further away after the Dutch parliament voted against any taxpayer-supported bail-out of Greece on 16 February) should appease the bond markets. Demanding extremely tough austerity measures will make the Greeks pay for their lax policies in the past and should also convince bond markets that this time is different. However, whether this will work remains to be seen. It is encouraging that Greece successfully sold EUR 8 billion of government bonds in January, and the next auction of Greek bonds will be an event to keep an eye on.

Recession continues

It looks inevitable that the PIGS will struggle economically, at least this year. Spain reported that its economy shrank by 0.1% quarter-on-quarter in the final quarter of last year, the seventh straight quarter of declining economic activity. Portugal's economy was flat, while activity in Greece fell by 0.8%. These countries no longer have the luxury of being able to postpone fiscal adjustments until when the economic recovery has fully taken hold. Turning around double-digit deficits would be extremely difficult in prosperous economic times, let alone during a recession.

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