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MACROCOSM

Six Days to What?

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A resolution to the Greek crisis is a key coming catalyst, but Europe's woes will remain.

Markets world-wide have experienced a stunning rally the last two weeks, largely on hopes that Europe is close to a definitive resolution of its debt crisis. It's as though investors were hearing "Sixty Seconds to What?" -- Ennio Morricones' dramatic music leading up to the climactic shoot-out at the end of the 1965 spaghetti western classic, *For a Few Dollars More*. A summit of the European Council is coming on October 23, possibly the climactic shoot-out that will finally bring resolution to the drama. But will it? And what form would resolution take? For investors, it's now "Six Days to What?"

The communiqué released following the meeting of G20 finance ministers over the weekend seemed to support the idea that resolution is coming:

> We look forward to further work to maximize the impact of the EFSF in order to avoid contagion, and to the outcome of the European Council on October 23 to decisively address the current challenges through a comprehensive plan.

But markets today -- with US stocks dropping away from the top of the trading range established over the last three months -- are keying off statements by both German Finance Minister Wolfgang Schäuble and Merkel spokesman Steffen Seibert, that quickly poured cold water on the idea that the summit would bring resolution. And outgoing ECB executive member Jurgen Stark bemoaned today the lack of the "quantum leap" in economic governance that the ECB has been calling for.

So the reality is that this isn't really like a 1960's-era movie where all the loose ends get neatly tied up. This is a more modern movie -- *For a Few Euros More* -- in which the climax will only resolve a few minor plot-points. That's all to the good, as far as it goes. But the fact is that *this* movie has been designed to make you want to see the sequel.

- It is extremely unlikely that a plan could possibly emerge from the October 23 meeting that is comprehensive enough to end all problems in the Euro area. In fact it is doubtful if such a plan can exist at all under current arrangements within the monetarily united but fiscally disparate bloc.

Update to strategic view

EUROPE MACRO, EUROPE FINANCIALS: Greek default in some form is inevitable and imminent, perhaps to be announced at the European Council meeting on October 23. If it is, we expect it will be wrapped in programs for intervention in markets that could undergo speculative attack, and plans for bank recapitalization. A default "pre-packaged" in this way, keeping Greece in the euro and in NATO, would be a powerful positive catalyst. But Europe's larger debt problems won't be solved so quickly, leaving it a depressant to global growth for years.

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- The only sustainable endgame for the Euro area -- the fiscal and political union we have envisioned forming around a Franco-German "axis" (see "Two-Tier Europe is Born" August 17, 2011) -- is still years away.
- That very long-term endgame requires political buy-in from sovereign nations -- especially Italy and Spain -- who will not easily submit to a Franco-German agenda. So for Germany and France, the game consists of keeping financial pressure in place to drive other nations into their hegemonic embrace. *The means there won't be a true resolution anytime soon, because Germany and France don't want one yet.*
- In the meantime, shorter term solutions must be found to flash-point issues such as Greece, and shoring up Europe's banks in the wake of an inevitable Greek default. *Those* solutions may well emerge in the coming weeks, if not precisely at the October 23 summit. That may well be enough to restore market confidence for quite a while -- at least until the next flashpoint.

With all that in mind, let's look to the summit on October 23 and outline what we expect to hear from it, what we don't expect to hear, and how it might move markets in the coming weeks.

A blueprint for the October 23 meeting was published by the European Commission on October 12 as "A roadmap for stability and growth." This roadmap outlines five policy areas where coordinated response needs to happen. Two of them are boilerplate Eurocratic babble -- but the other three deserve a closer look.

First is decisive action on Greece. The roadmap calls for removal of all doubts about Greece's economic stability and calls for adequate financing through public and private sector involvement -- that is, loss-taking.

- The July 21 summit introduced the idea of private sector involvement (PSI) (see "Whatever It Takes" July 22, 2011) -- which was a selective Greek default by voluntary agreement.
- Private investors would have to take a 21% writedown on NPV of their Greek sovereign holdings maturing before 2020.
- It is has become abundantly clear that a 21% default is not enough, with estimates now suggesting that the haircut will be increased to something in the region of 50%. It is also likely that there will be moves to include post-2020 debt in the haircut.
- European banks have already been taking writedowns on their Greek sovereign holdings (please see the chart on the following page) -- larger haircuts will lead to larger writedowns, which in turn, will lead to larger capital needs for European banks. Happily, the amounts are not catastrophic in any case.
- It is unclear what the roadmap means by "public sector involvement." The ECB has been adamant that it will not take a writedown on its Greek sovereign holdings, so this may refer to increased structural funds for Greece from the European Union.

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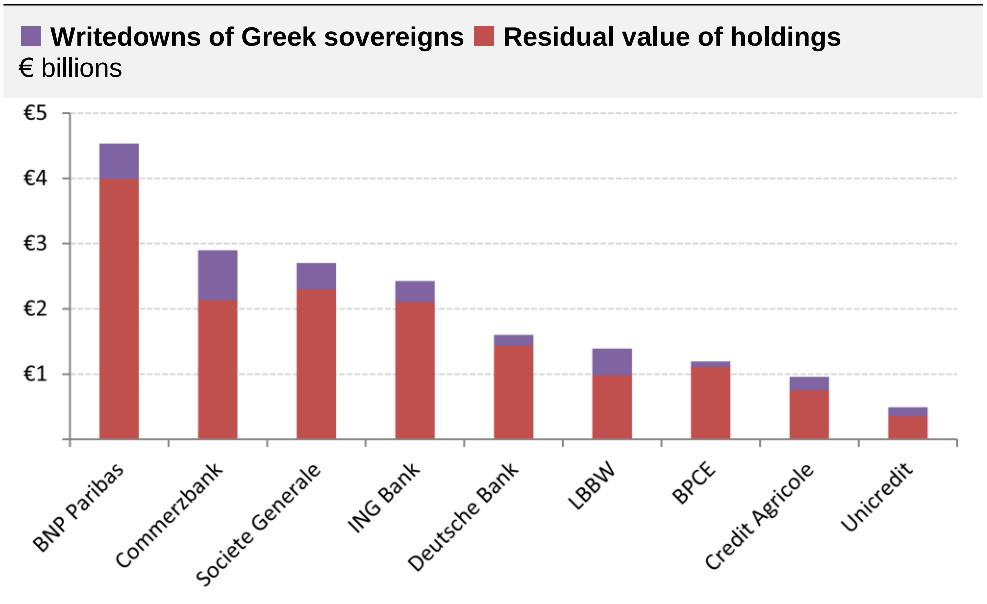

Source: Bank filings, UBS, Fitch, TrendMacro calculations

- This would be a step toward what we see as the stable long-term status of Greece within Europe -- that of a protectorate. Europe would subsidize Greece on an ongoing basis to keep it in the euro -- and just as important given its strategic geographic position, keep it in NATO. But Greece would have to pay a price in sovereignty, ceding to the EU many economic decisions.
- It is clear that a bigger default will not be enough for Greece. Greece still runs a large primary deficit -- which means that even total debt forgiveness would not solve its structural problems as its GDP continues to shrink at an alarming rate.

The second area of coordinated response envisioned in the roadmap is the completion of Euro area intervention. This is broken into three parts:

- Maximizing the effectiveness of the European Financial Stability Facility (EFSF), which has now completed its ratification process as expected (see "Stress Test for Europe's Banks, and Its Politics" October 11, 2011).
- Accelerating to mid-2012 the launch of the European Stability Mechanism (ESM), the permanent replacement for the temporary EFSF. Previously it was not expected until mid-2013 at the earliest.
- Ensuring the ECB continues to provide sufficient liquidity to Euro area banks.

The EFSF waited until after Thursday's ratification by Slovakia to issue a press release that outlines how it actually intends to operate. Gone are the cash buffers that existed in the old EFSF -- money set aside from each issuance to assure repayment to bondholders. The new EFSF fully relies on over-guarantees by Euro area nations to achieve triple-A rating for its bonds. We think the October 23 summit will change this structure again -- just as TARP morphed many times during the US banking crisis in 2008 and 2009. And as with TARP, there is still no clarity on how the EFSF, however it may be structured financially, will be used. Having it guarantee sovereign bond issuance is currently a favorite.

The ECB, for its part, is certainly doing the hard work on the liquidity provision side. At the last monetary policy meeting (see "On ECB and BOE October Rate Decisions" October 6, 2011) the ECB announced 12-month Longer Term Refinancing Operations (LTRO) which, added to its recent relaxation of collateral rules and the introduction of longer-term USD operations means that ECB liquidity should be adequate for European banks.

The third area of coordinated response envisioned in the roadmap is bank recapitalization. What the ECB cannot do is provide *capital* for the banks. While resistance mounts to another stress test -- a more honest one that would result in higher capital ratio requirements -- it is clear that recapitalization of European banks is necessary.

The summit roadmap states that capital raising will have to go through a three-step process:

- First port of call for the banks will be private sources of capital. While it is easy to scoff at the idea of a European bank being able to raise capital in the markets at the moment, there have been some recent successes -- notably, the sale by the Irish government of an equity position in Bank of Ireland to private buyers in July.
- If the private capital route fails, then a bank must seek capital from its national government. Banks will likely be keen to avoid this outcome as such funds come with many strings attached.
- The third route for banks, if national funds are not available will be the EFSF. It is unclear how this will work, as it was unclear at the outset how TARP would work under similar circumstances. The presumption is that national governments will borrow from the EFSF to fund banks, but it is unclear who will be the actual shareholder in the bank. It is safe to assume that banks will try to avoid this outcome, too. Nevertheless, it is a critical backstop, as TARP was.

If banks cannot raise capital in the market and are unwilling to do so with national or EFSF funds, then the only option open to those banks is to shrink their balance sheets. So it is possible that an unintended consequence of any bank recapitalization plan would be increased zombification of the European banking system. To avoid this outcome, the Euro area summit may have to agree some mechanism for forced recapitalization of banks.

The three roadmap elements we've discussed -- Greece, intervention, and bank recapitalization -- are only small parts of an overall solution to Europe's pressing issues. But they are the parts that make up the present flashpoint, and offering a comprehensive solution that embraces all three would be very salutary for markets.

- Greece is running on fumes. It virtually *must* default in some way in a matter of days or weeks. Admitting that reality at long last, and embracing it as part of an overall intervention and bank capital strategy, could be a powerful upside catalyst for markets.
- The critical element is that any Greek default be "pre-packaged" like a corporate strategic bankruptcy filing -- with the objective to keep Greece using the euro, and keep it a member of NATO.
- If that can be done, we don't see why a Greek default *per se* ought to have enduring systemic consequences.
- But it's not a permanent or truly comprehensive solution. While we think a well-managed Greek default will end up being a positive catalyst, we believe that the larger issues facing Europe will cloud global growth prospects -- at least at the margin -- for years to come.

Bottom line

Greek default in some form is inevitable and imminent, perhaps to be announced at the European Council meeting on October 23. If it is, we expect it will be wrapped in programs for intervention in markets that could undergo speculative attack, and plans for bank recapitalization. A default "pre-packaged" in this way, keeping Greece in the euro and in NATO, would be a powerful positive catalyst. But Europe's larger debt problems won't be solved so quickly, leaving it a depressant to global growth for years.