



Time to Let Go? Greek Debt and the Eurozone

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*See disclosure on page 3.

Executive Summary

Newton’s Paul Brain looks at the options remaining to European policymakers in dealing with Greece’s sovereign debt problems and points out the hurdles involved with each of them. Instead, he argues it might be time to consider the possibility of letting Greece leave the eurozone and put an end to the uncertainty and volatility created by continued prevaricating among policymakers.

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Human resources departments tend to prefer the “let you go” phrase to the harder “you’re fired” or “we’re making you redundant” alternatives, all of which imply a rather one-sided discussion. “Let you go” could even, at a pinch, hint that it is in an employee’s interests to leave.

We are now three years into economic recovery, and yet employment conditions still remain subdued in western economies. As we work through this deleveraging phase, a lack of investment and sluggish consumer spending are restricting economic growth to a speed so slow it is dangerously close to stalling, and employment growth is almost non-existent. As a result, cash interest rates are likely to stay low for the foreseeable future.

While bond yield curves are still steep (short-dated bond yields are much lower than long-dated yields), we believe there are rich pickings for investors who are willing to move up the yield curve. Previously, the fear of inflation inhibited investors from reaping the benefits of these pickings. However, many non-western central banks — and even the European Central Bank (ECB) — have recently raised interest rates to choke off the threat of inflation, and they may have succeeded in their effort to dampen inflation expectations. We think the strategy of buying long-dated US bonds as a reaction to the Chinese rise in interest rates is a particularly interesting development.

We believe that, realistically, the current idea of a modest “haircut” for Greek debt holders is not sufficient to bring Greece back onto a more sustainable budget path. A more drastic approach appears necessary, which we believe would necessitate Greece leaving the euro.

Searching the globe for markets that had priced in higher short-term interest rates was a positive strategy over the summer, and we feel there may be further scope to do so. Elsewhere, there could potentially be attractive opportunities in markets where authorities have begun to reverse interest rate rises; Turkey and Brazil are among countries to have done so already.

Meanwhile, we believe the eurozone remains the biggest risk to the global economy. The sovereign debt crisis remains unresolved and, if anything, we believe some aspects of it have worsened. While fiscal austerity is prevalent throughout the region, economic growth is not. As we return to that September “back-to-school” feeling of fresh enthusiasm, we also start to realise that nothing has changed. So far, the authorities have tried to put off the inevitable, but as the economic numbers from the north of Europe start to deteriorate, there is a groaning realisation that events are reaching a boiling point. The southern states are unable to reduce their deficits through fiscal austerity because their economies are not growing, as confirmed by recent data from Greece. There appear to be three potential solutions remaining, none of which is appealing:

- The “monetisation” of debt, i.e., the ECB printing money and buying European bonds, which has been fiercely argued against by the German Bundesbank
- Fiscal union, and the issue of a common “Eurobond,” which would involve changes to the European Union treaties; most of the northern European states’ populations would likely vote against such a motion
- Debt default, which could possibly bring about a major collapse of the European banking system

This third option may have to be attempted. In our view, it would be a dangerous road to follow, and controlling any resultant contagion could be beyond the scope of the authorities. However, let’s explore the possibility of a fourth option: **letting Greece go.**

We believe that, realistically, the current idea of a modest “haircut” for Greek debt holders is not sufficient to bring Greece back onto a more sustainable budget path. A more drastic approach appears necessary, which we believe would necessitate Greece leaving the euro. We have argued for some time that this is inevitable, and that all the other plans have simply been about building enough time for the European financial system to prepare for this eventuality. Unfortunately, we believe time has now run out and we are not sure that the system is ready for a Greek default.

We believe that the current plan of delay and fiscal austerity will not work and, as new bond issues build through September and October, events seem to be coming to a head. We think it is time to “let go.”

A default with a 40% “recovery rate” (return of capital) would reduce the Greek deficit to a more sustainable level. Introduction of a new drachma currency and support from the IMF would be essential, we believe, through what is likely to be a very difficult period. The hit to the Greek banking system and the economy would be huge, but would it be any worse than the present situation of depression and growing deficits? Current Greek bond prices almost reflect this scenario, so it should not come as a surprise.

Would the European banking system survive and would contagion be manageable? These questions are unanswerable at this stage, but one could argue that, given the prevailing pricing of bonds, the markets have had time to prepare. We believe that the current plan of delay and fiscal austerity will not work and, as new bond issues build through September and October, events seem to be coming to a head. We think it is time to “let go.”

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