DOC. N.º 44

The Baseline Scenario

What happened to the global economy and what we can do about it

Greece, The IMF, And What Comes Next

Posted on April 23, 2010 by Simon Johnson | 85 Comments

By Peter Boone and Simon Johnson

The latest developments from Europe – including Greece appealing for an IMF program today – may well be a watershed, but if so, it is not a good one. The key event yesterday was that the yield on all the debt of weak eurozone governments widened while German yields fell. The spreads show all you need to know: a very clear and large contagion risk.

The five year Portuguese yields rose from 3.84% to 4.26%. The five year Spanish bonds rose from 2.89% to 3.03%, and the five year Irish bonds rose from 3.74% to 3.97%. These are not minor moves for investment grade sovereign bond funds. This kind of change means, for example (and roughly), you lose 0.5% on the value of a bond in one day. These are bonds that just pay 3% per year – and one such day may be enough to cause "investment grade investors" to decide not to stay involved and not to come back for a long while.

If these bonds transition towards being held by "emerging market investors" (usually quite different people), and stronger European commercial banks decide to limit their exposure to the weaker government's bonds, we could be in for quite a major increase in yields across the spectrum.

Emerging market investors look at these weaker eurozone bonds – compared to say Argentina with 10% yields – and think they represent unappealing reward for the risk. Greek 5 year bonds rose to 9.4% yesterday from 8.1% the previous day. This is still low for a country on the verge of default.

These higher government bond yields are also hitting banks. No doubt there is a bank run on in Greece to some extent at the wholesale level. This will spread to other banks in the region. Since their marginal funding costs are tied to the creditworthiness of the sovereign, and since the collateral for these banks' portfolios is tied to local property values and assets, these changes in sovereign yields will have a negative impact on banks' balance sheets.

Irrespective of the next move – which lies this weekend with the International Monetary Fund and the ministers of finance meeting in Washington for the Fund's spring meetings – this looks like the moment when the Greek problems really start to generate contagion across the eurozone region. We'll see rates on government debt trending higher, asset prices (such as real estate) falling even more, and renewed concern about banks on the European "periphery".

What can the authorities do? The only path is a new package of "liquidity assistance" for countries under pressure but not yet ready to call in the IMF. The liquidity is available from the ECB – it can provide emergency loans to all the banks in the region to prevent bank runs from toppling them. But there is also a solvency problem for the weaker countries now under pressure.

To return to solvency, the struggling eurozone countries will need funding for budget deficits and debt rollover for several years. Governments will need to recapitalize their banks with new government-backed debt. The best solution would be for the government to then sell their stakes to larger European banks with more creditworthy sovereigns. SocGen Greece (with all its issues) would be a lot more attractive to Greek businessmen and depositors than National Bank of Greece at the end of all this.

And this is the heart of the problem: Will Germany and other European nations be prepared to provide the large sums needed to refinance several peripheral nations? Will these nations then take the painful austerity measures needed in the midst of recessions in order to get out of this?

When the problem was just Greece, the numbers were already large. In our view, the Greek government needs 150bn euros over three years to be sure it can refinance itself through a recession. The Portuguese will roughly need 100bn euros. If those amounts were made available – will that support the confidence needed to buy Irish and Spanish bonds, or would it scare investors because the protests from Germany would be so large that it would be clear no more funds would be available in bailout mechanisms?

There is no easy answer to this question, but yesterday's action suggested that markets are not at all confident policy makers are going to stop this crisis soon. They are surely right: Greek strikes, a weak Portuguese government deeply in denial, and German hatred for bailouts, all make a path to restore confidence very difficult.

Yesterday was also a wake-up call for the United States. It is no longer reasonable or responsible to say: "US banks have no exposure to Greece". US banks are heavily exposed to Europe, and this is turning into a serious Europe-wide problem. The US badly needs to make sure this does not spread beyond Greece and Portugal/Ireland.

To restore confidence in buying Spanish and other major European nation bonds, it would surely help to have clear signals that President Obama himself, and the Federal Reserve, are taking an active stance now on making sure this does not spread to become another threat to global financial stability. A broader wall of preventive financing must now be put in place – after all, this is exactly why (in principle) the IMF was recapitalized this time last year.

Such a push by the US would be awkward, to be sure, as the French and Germans (and British) are not keen to have more US involvement in their affairs. But the Europeans have handled matters so badly in the past few months, it is time for a much more scaled-up US role.

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85 RESPONSES TO "GREECE, THE IMF, AND WHAT COMES NEXT"

Per Kurowski | April 23, 2010 at 8:05 am |

If the 150bn Euros to Greece and the 100bn to Portugal and the much more to so many others were seen to have a chance to fly, against German opposition, then the Euro might strengthen for a couple of weeks, because some investors would feel reassured... only to really tank some months later when waking up to the bail-out implications.

john | April 23, 2010 at 8:30 am |

Perhaps this is where we test the laws of game theory; is it really to our advantage to support the lowest tier of European countries and prevent default or is it really better for us to stay out entirely?

We have our own weak recovery to worry about do we not? Why start picking sovereign winners and losers? Is there fear of this creating a domino effect in European finance, yes, but where does it effectively stop for the US?

I think if you do assist Greece, you'll have to assist every other EU country that steps up to the plate, an amount that could easily end up costing a half a trillion dollars. Their deficits were run up in good time and in bad, a sign of overconsumption and excessive spending (as opposed to ours which was run up to combat the effects of the recession).

john | April 23, 2010 at 8:34 am |

Let me edit here: Trichet knew of these problems and has had as much time as anyone else to come up with appropriate packages and plans. Obama should take a hands off approach.

Barbyrah | April 23, 2010 at 8:47 am |

If one steps back from everything...and takes a "wholistic" look around...it becomes obvious.

Only no one in "official" capacities dares suggest. Nor do well-known pundits and/or authors of books that offer mere glimpses into the tidalwave about to engulf.

From the top, the very top on down, we are witnessing the beginnings of an unraveling never seen before. Expect more sleight-of-hand, more "fancy" accounting, perhaps even yet another false flag operation meant to divert attention from the reality:

indigenous people mean literally nothing as far as life is concerned,if they get in the way!
Lastly,...take a realistic look back at "911"?
