

Investment Essentials

22nd February 2012

AXA Investment Managers - Research & Investment Strategy

WEEKLY COMMENT

Greece: exploring end games

Key points

by

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- The 21 February deal will avoid a disorderly default of Greece and buy time for the euro area to strengthen its credibility.
- In the short term, this is positive for risk assets, all the more so in that central banks are flooding markets with liquidity worldwide.
- However, we fear that this is not the last episode of the Greek crisis. In our view, an exit from the euro area and a further default are likely in the medium term.
- Assuming a political plan is launched to 'help' Greece out of the euro so it can balance its macro books, we estimate that the 'new drachma' would fall by 50% against the euro.
- Total losses caused by this event would reach almost €300bn, on top of the losses from the current PSI. 90% of the losses would be borne by euro area tax payers.
- Contagion effects should be limited, while the risk of a political backlash in lender countries could be significant.

Exhibit 1

Losses to foreign investors under the stress scenario of 50% devaluation of the New Greek Drachma versus the euro and a 20% recovery rate following default

Total losses prior to PSI	€348bn
Total losses post PSI	€292bn
of which:	
official sector (ie euro area governments)	€264bn
foreign private investors	€28bn
of which:	
euro area investors	€19bn
non-euro area investors	€9bn

Source: Bank of Greece, IMF, European Council, International Institute of Finance, AXA IM Research

The last minute deal on Greece, reached in the early hours of Tuesday 21st February 2012, should buy enough time for the euro area to sail toward safer waters and continue to restore the badly damaged credibility of its governance. Since the main global systemic risk is rooted in the euro crisis, the Greek deal is therefore positive for global financial markets, and we take it as such. However, we believe that this is not the end of the story. Sooner or later, wage costs and productivity will align one way or another. In this note, we take stock of these fresh developments and elaborate on what we think could be the end game for Greece.

Where do we stand?

The Eurogroup and the Institute of International Finance (IIF) have just agreed on a new bailout and debt relief operation for Greece. The deal was reached after the Eurogroup obtained a strong commitment from the two political parties comprising the current coalition government to stick to strict conditionality objectives on deficit reduction measures and structural reforms.

The euro area has committed new loans to the Greek government of €130bn via the European Financial Stability Facility (EFSF) to cover its financing needs through 2014 and sweeten the debt relief provided by private creditors. The International Monetary Fund (IMF) is expected to shoulder a part of the new loan package to the tune of 10%. Europeans have once again agreed to lower the interest rate paid on the Greek Loan Facility (GLF), Greece's first loan program. Private creditors represented by the IIF have conceded further debt relief efforts, writing off 53.5% of the nominal value of Greek government bonds (GGB) totalling €107bn, and swapping the remainder for EFSF short-term bills and new long-term Greek government securities with step-up coupons. Eurosystem's holdings of GGB will be swapped for EFSF bonds, while the profits made on them will be redeemed by governments via national central banks and on-lent to Greece. All these efforts are expected to achieve a public debt to GDP ratio of 120.5% by 2020, a level that supposedly places public finances on a sustainable path thereafter.

Three very tight terms were attached to the second Greek bailout, to ensure that the Greek government, whatever it is after snap elections at end-April, will deliver on its promises. First, Greece agreed to the creation of an escrow account held at the Bank of Greece (BoG), where internally generated funds designated to service Greece's debt (i.e. privatization receipts) and official borrowing will be deposited. The balance of the escrow account must be equal to the amount of the next quarter's debt service. In other words, Greece cannot default in the next three months. Second, Greece agreed to include a provision in its Constitution that will guarantee priority to debt servicing payments. This provision must be introduced in the next two months. Third, the European Commission will permanently strengthen the presence of its Task Force in Greece in order to bolster its capacity to provide and coordinate technical assistance.

On the positive side, the government bond maturing next March will be included in the debt exchange and a messy default will be avoided. After the debt exchange, most Greek debt will be issued under international and not Greek law, weakening Greece's ability to unilaterally default. Also, Greece will still have a primary deficit that will have to be serviced, and will therefore be more likely to implement the fiscal conditionality attached to the new bailout.

The deal has bought time, but serious doubts remain

Despite this new package, we remain sceptical of Greece's ability to escape its current debt trap. Firstly, the downward path of indebtedness towards 120.5%—a level at the upper end of the sustainable range assumed by the IMF—depends crucially on the economy's exit from its current recessive tailspin, and does not allow for any leeway in the event of external shocks. Secondly, the smooth implementation of the plan assumes strict adherence to fiscal discipline and the implementation of structural reforms, both areas where the track record of the government in the last two years has been extremely poor. Lastly, and most importantly, the political willingness of Greek society to

endure more economic hardship under the adjustment program is dubious. With general elections scheduled for late April, and widespread austerity fatigue, a political U-turn on the part of Greek authorities towards populism could disrupt the entire bailout program, leading to a disorderly default and exit from the euro area. We believe the current deal considerably reduces the probability of this adverse scenario in the next two months, but uncertainties run high after this period. This is why we think it is worth exploring the outcomes of a derailment of the plan, leading to a “hard” default and euro area exit.

We fear that the second bailout announced yesterday has bought more time for Greece and fiscally weak countries in the euro area to implement the necessary fiscal consolidation and structural reforms. However, it has not removed the spectre of a Greek default and does not signal the end game. We see four possible outcomes.

Greece makes it. Post-election, the new cabinet has a mandate from the Greek people to save Greece, and undertakes a crackdown on tax evaders and corrupt civil servants, including judges. Confidence returns, the most visible sign being that German companies start re-investing in Greece. Creditors are happy to soothe the pain by extending the maturity of loans. This sounds like a fairy tale.

Kicking the can down the road and letting Greece leave the euro later. The ‘private sector involvement’ (PSI) works, a new loan is disbursed, EU/ECB/Greek officials work on the technicalities of a euro exit behind closed doors, the condition being to keep Greece within the European Union (EU). At some point, by the end of this year or in 2013, Greece violates one or several covenants and eventually issues the new drachma. We think this is the most likely scenario.

Large-scale default on bonds and loans. The Greek government defaults on all its debt but IMF loans, but Greece remains in the euro as creditors fear contagion spreading to Italy and Spain. The quid pro quo is a large internal devaluation, i.e., large cuts in nominal wages and pensions. Even so, macroeconomic sustainability would not be warranted.

Disorderly default and EU exit. Political and social chaos and tensions with other EU countries result in Greece leaving the EU, defaulting on its debt (but IMF loans) and starting negotiations with the IMF.

We will not explore each scenario in detail in this note. Rather, we will focus on the second one (“kicking the can down the road”), and on the internal factors that are likely to prove decisive for Greece. We will also explore the potential consequences of a default and exit for investors.

Fiscal consolidation approved

The package that passed the Greek parliament on February 13 included €3.3bn (1.5% of GDP) worth of extra cuts for 2012, on top of the fiscal consolidation pencilled in to the 2012 budget (*Exhibit 2*). The government is now targeting a primary deficit of 1% of GDP by the end of this year, versus a primary deficit of 2.5% at end-2011. Given the poor track record of the government on execution, lenders (EU and IMF) have required detailed estimates of the impact on the new budget. The Eurogroup has welcomed the decisions taken by the Greek government on 21 February.

Exhibit 2

Additional fiscal cuts approved on 12/02/03 by the Greek Parliament

Expenditure cut	€billion
Reduction in pharmaceutical expenditure	1.1
Reduction in overtime pay for doctors in hospitals	0.1
Reduction in the procurement of military material	0.3
Reduction in the number of deputy mayors and associated staff	0.03
Reduction in the central government's operational expenditure, and election-related spending	0.3
Frontloading cuts in subsidies to residents in remote areas, and cuts in grants to several entities supervised by several ministries	0.2
Reduction in the public investment budget	0.4
Changes in pension funds (supplementary and main) with high average pensions or which receive high subsidies from the budget	0.3
Additional structural spending cuts	0.3
10% reduction in the so-called 'special wages (ie, for judges, military personnel, security forces etc.)	0.3
Total	3.3

Memorandum item: Greek GDP in current prices = €215bn (2011)

Source: *The Greek Parliament, AXA IM Research*

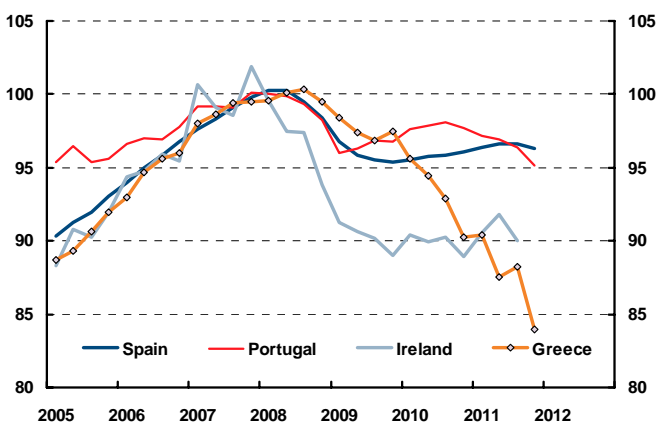
The growing risk of a political vacuum in Greek politics

Reaching a consensus and committing to fiscal consolidation within the ruling coalition is proving difficult. Already, the junior partner has defected, while Antonis Samaras, leader of New Democracy and likely the next prime minister, has floated the idea of renegotiating the terms of any bailout should he be elected in his letter to international creditors. We fear that written commitments by Pasok and New Democracy have limited credibility as long as no other Greek political party supports the fiscal consolidation.

More importantly, a policy vacuum is gradually emerging in Greece. About 40 MPs from Pasok and New Democracy were expelled from their parties because they rejected further fiscal consolidation. Now independent MPs control 61 seats in the 300-seat house, vs. 130 for Pasok and 64 for New Democracy. Therefore, independent MPs can raise non-negligible parliamentary opposition to any bill on fiscal consolidation or structural reform. On top of that, public opinion polls signal a shift towards the far right and left, which are vocally against any fiscal consolidation and euro membership per se. If this tendency finds its way to the voting booth, neither Pasok nor New Democracy – the two political parties traditionally alternating in the government – will be able to form a stable government after elections.

Exhibit 3
The Greek economy is in deep and prolonged recession

Real GDP, indexed
100 = average 3 quarters around peak

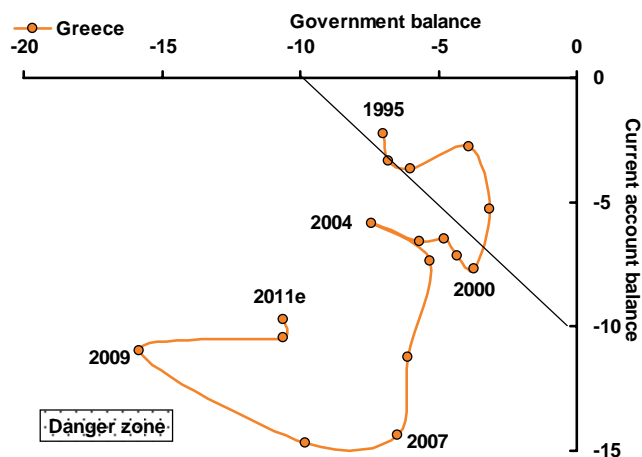


Source: Datastream, AXA IM Research

Macroeconomic imbalances have not been corrected

So far, €73bn has been disbursed to Greece under the original GLF of €110bn, while public debt is snowballing. It stood at 113% of GDP in 2008 and will probably turn out to be around 165% at the end of 2011. Real GDP nose-dived in the 4th quarter of 2011 (-7%yoy), standing 16% below the peak reached in 2008 (*Exhibit 3*), a deeper decline than the Irish economy has experienced, although a smaller one in nominal terms. Despite the depth of the recession, inflation is proving stubbornly rigid, at 2.3%yoy in January. Although almost half of it is attributable to higher taxes, inflation remains abnormally high in a context of falling domestic demand and wage restraint. Yet, the contraction in domestic demand has not run its course, as attested to by a current account deficit still close to 10% of GDP. Behind the external deficit is a public deficit that stood at 10.6% of GDP in November 2011, overshooting both the original and the revised full-year forecasts.

Exhibit 4
Greek macroeconomic imbalances are looming large



Source: Datastream, AXA IM Research

A very tight timetable lies ahead

The voluntary debt reduction deal negotiated with private creditors (PSI) should lead to a debt exchange, which will have to be concluded in the next two weeks. In the meantime, the Greek Parliament will have to vote for retroactive Collective Action Clauses (CACs) that will be attached to the old debt before the PSI exchange in order to increase

participation in the exchange. According to the press release from the meeting of the Steering Committee of the Private Creditor-Investor Committee for Greece (PCIC), which followed the Eurogroup meeting, successful implementation of the debt exchange will result in a reduction in the overall debt stock of approximately €107bn. In our books this assumes a 97% participation rate, which can be met only thanks to CACs.

CDS will be triggered

This will, we think, put Greece in selective default until the exchange is completed and trigger CDSs on current bonds. After the successful completion of the debt exchange, the sovereign Greek rating should be upgraded to investment status as the new debt will include credit enhancements and will be of better quality.

Exhibit 5
Breakdown in Greek Public debt by sector (2011Q3)

Sectors	€billion
Debt subject to PSI, of which:	206
Banks	70
Insurance	10
Central banks	38
Other investors	70
Greek social security fund	18
IMF loans	20
EU loans	53
Eurosystem including ECB	55
T-bills	15
Other	11
Total	360

Memorandum item: Greek GDP in current prices = € 215bn (2011)

Source: Barclays Capital, AXA IM Research

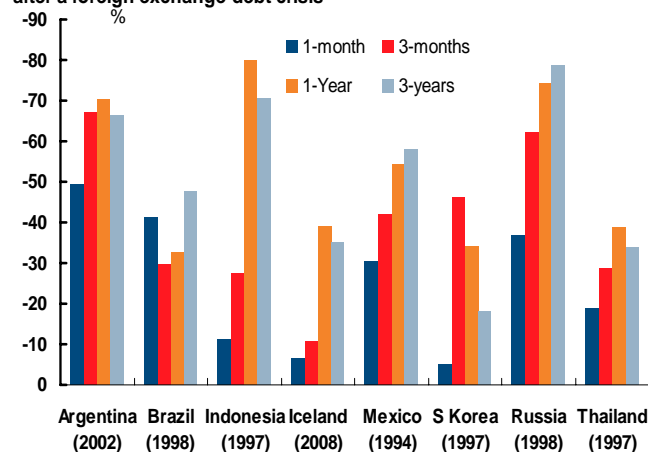
The Argentina lesson

If Greece becomes blatantly non-compliant with the fiscal conditionality attached to the new bailout, or if Greek politicians attempt to renegotiate the agreement, we think that lenders will decide to pull the plug on Greece and “help” the country out of the euro area, an event which EU Treaties are not even considering and which will require some creating thinking on the part of EU

officials. If not voluntary, leaving the euro could be triggered by shutting down ECB funding to Greek banks and prohibiting the Bank of Greece from lending to Greek banks through the ELA window. Greece would thus introduce the New Greek Drachma (NGRD) at a formal initial conversion rate and then let the new currency float. All old debt, public and private, issued under Greek law, and all deposits, would be restated in the new currency. Capital controls would be imposed to stop the draining of deposits. Capital controls would include freezing all bank accounts initially for about a quarter and subsequently allowing weekly withdrawals from NGRD accounts, not to exceed a pre-specified ceiling. Operations using credit and debit cards and cheques would continue to be conducted normally. This is the Argentinean version of capital controls known as “*corralito*”, which was implemented in the first days following Argentina’s default in 2002. Contrary to Argentina, a “*corralito*” type of capital control could work in Greece, since many Greeks have a personal bank account, many businesses are equipped to accept credit cards, and Greeks are accustomed to using them. Should the drainage of deposits continue, capital controls will have to be strengthened and most deposits irrespective of the currency will be exchanged for NGRD bonds.

Exhibit 6
Currency depreciation following past foreign exchange and sovereign crises

Foreign exchange % change in different horizons after a foreign exchange-debt crisis



Source: Datastream, AXA IM Research

The New Drachma would depreciate by around 50% against the euro

We anticipate that the NGRD would depreciate against the EUR immediately after its launch. In order to get a view on the possible depreciation, we draw lessons from the past, examining the behaviour of bilateral exchange rates versus the US dollar following foreign exchange crisis or sovereign defaults. Specifically, we focus on the Argentinean default in 2002, the Asian foreign exchange crisis in 2007, the foreign exchange crisis in Mexico and Brazil in 1994 and 1998, the Russian default in 1998, and the banking crisis in Iceland in 2008.

We compare the percentage depreciation of the bilateral exchange rate of the domestic currency *vis-à-vis* the USD under four different horizons after the crisis event, 1-month; 3-month; 1-year, and 3-year. *Exhibit 6* shows that, on average, the domestic currency depreciated by 25% 1 month after the event; by 40% 3 months after; and by 50% in 1- and 3-year horizons. In Argentina, for example, the peso depreciated by 50% in the month after the default and by 67% after three months, then climaxed at 70% a year after.

In the case of Greece, a 50% devaluation over a 12-month time horizon seems likely, the risk being further depreciation later on if Greek authorities do not manage the devaluation well.

Losses through the international trade channel: small

We identify two channels through which a Greek default and devaluation would hit investors, namely international trade and financial transactions. *Exhibit 7* shows that Cyprus is the most exposed euro area member through trade. Neighbouring Bulgaria is the most exposed Central Eastern Europe economy to Greece through trade, but this exposure is limited. Hence, the repercussions for the euro area countries following a Greek default and the introduction of the NGRD would be limited for all countries but Cyprus.

Exhibit 7 Exports to Greece (September 2011)

	% of total exports
Austria	0.4
Belgium	0.7
Cyprus	26.9
Estonia	0.2
Finland	0.2
France	0.6
Germany	0.5
Ireland	0.3
Italy	1.5
Luxembourg	0.6
Malta	0.2
Netherlands	0.5
Portugal	0.2
Slovak Republic	0.4
Slovenia	0.2
Spain	0.8
Bulgaria	7.5
Poland	0.3
Romania	1.4
Serbia	1.5
Czech Republic	0.2
Hungary	0.4

Source: Datastream, AXA IM Research

Losses through the financial channel: very high (€92bn)

The redenomination of contracts will hit investors through the large international financial liabilities of the Greek economy. *Exhibit 8* shows that net foreign liabilities stood at €200bn (426bn minus 226bn) or 93% of Greek GDP at the end of 2011. Foreign exchange liabilities primarily consist of tradable debt and other external liabilities, including the bilateral loans already disbursed to Greece under the GLF. Panel (ii) of the same table shows that the government has issued the largest amount of foreign liabilities, followed by the BoG and other Monetary Financial Institutions (MFIs). Nevertheless, we believe that the foreign liabilities of the BoG mask the foreign liabilities of other MFIs, as the latter are largely dependent on European Central Bank funding. In the last column of *Exhibit 8*, we calculate losses following the launch of the NGRD, and

assume a stress scenario which includes a 20% recovery rate post the sovereign default and a 50% depreciation of the NGRD versus the EUR.¹ We apply the loss only to liquid external liabilities such as equities, tradable debt, derivatives and other. Also, we subtract €20bn from other external liabilities, which corresponds to the amount already disbursed to Greece by the IMF under the GLF, as the IMF has preferred creditor status.

Exhibit 8
International investment position, EUR bn (2011Q3)

(i) by type	External liabilities	External assets	Losses (under our stress scenario)
Foreign Direct Investment (FDI)	20	33	
Equities	7	18	6
Debt	109	55	98
Derivatives	0	2	0
Other	291	113	244
Reserves		5	
Total	426	226	348

(ii) by sector	External liabilities	External assets	Losses
BoG	101	17	91
General government	176	0	140
Other MFIs	109	121	98
Other sectors	21	50	19
Total	407	187	348

Memorandum item: Greek GDP in current prices = €215bn (2011)

Note: Total foreign liabilities in panel ii do not include the stock of liabilities due to FDI, while total foreign assets in panel ii do not include the stock of FDI assets and the reserves of the central bank.

Source: Bank of Greece (BoG), AXA IM Research

Under this scenario, foreign investors would incur a loss of €348bn. However, a portion of these potential losses will already be written off under the PSI agreement. Greek investors hold about 26% of tradable GGBs or €90bn, implying that about €116bn of the €206.6bn of PSI eligible GGBs are held by

¹ Assume that V_0 is the asset value in EUR before the introduction of NGRD; R , $R > 0$ is the recovery rate after the default, and d is the depreciation rate of the bilateral exchange rate S expressed in number of EUR per one unit of NGRD. We assume that the euro value of assets will decline by d after the launch of NGRD and $R\%$ will be recovered post default. Then, losses will equal $(1-d) \cdot V_0 \cdot R - V_0$.

foreign private investors. Assuming a 90% participation rate in the PSI debt exchange and applying a 53.5% notional haircut, private foreign investors participating in the PSI would shoulder a loss from the PSI of €56bn. Therefore, total losses to foreign investors subject to the stress scenario and assuming participation in the PSI would be €292bn (348 minus 56).

The official sector would take 90% of the total loss

We now attempt to identify which portion of the €292bn losses would burden euro area governments and which would fall on private investors, post PSI. We are particularly interested in the exposure of euro area taxpayers who have disbursed funds to Greece either through the ECB or the GLF.

Greek banks have absorbed liquidity from the ECB equal to €77bn via repo auctions and €60bn through Emergency Liquidity Assistance (ELA, December 2011). Also, euro area governments have contributed €53bn of the €73bn already disbursed to Greece under the GLF. Countries remaining in the euro area after Greece exits would have to share the losses that the ECB would incur after the writedown of BoG's €109bn in net intra-eurosystem liabilities (TARGET2). Applying modified capital keys to the repo and ELA funding of Greek banks, BoG's TARGET2 liabilities and the €53bn of bilateral loans disbursed to the sovereign, we show that countries contributing the most to ECB's capital are the most exposed to Greece (*Exhibit 9*).

Computing the loss for each country by type of exposure, we notice that the overall loss that euro area governments would have to take equals €264bn. Therefore, private investors would assume a loss of €28n (292 minus 264). In other words, the official sector would foot 90% of the Greek failure bill. This implies serious risks of political backlash against the euro in most euro area countries, starting with Germany, where the no bailout clause was an essential part of the *quid pro quo* for trading the mark for the euro.

Euro area investors would bear 67% of the private sector losses...

To infer the nationality of private investors incurring the €28bn loss, we use the Coordinated Portfolio Investment Survey (CPIS) compiled by the IMF, which collects information on the stock of cross-border holdings of equities and long- and short-term debt securities broken down by the economy of residence of the issuer. At the end of 2010, investors from euro area countries held €123bn of Greek tradable debt and €3bn of equities. France, Germany and Cyprus topped the list. The total loss incurred from Greek tradable debt and equities would have totalled €113bn had the default and exit occurred in 2010, vs. 292bn post PSI, on our estimates. IMF data also show that 67% of losses hitting the private sector would be for euro area resident institutions. Therefore, the loss euro area investors would incur today following a Greek default and exit from the euro area would be €19bn (28 x 0.67).

Exhibit 10 Holdings of Greek portfolio investment assets by investors' nationality (2010)

	Holdings	
	Equity securities €bn	Debt securities €bn
Austria	0.0	4.1
Belgium	0.2	7.3
Cyprus	0.1	14.3
Estonia		0.0
Finland	0.1	1.8
France	0.8	32.1
Germany	0.4	29.9
Ireland	0.4	2.3
Italy	0.2	4.1
Luxembourg	0.6	5.2
Malta		0.4
Netherlands	0.4	6.3
Portugal		5.3
Slovak Republic		0.9
Slovenia	0.0	0.5
Spain		8.0
Total	3.1	122.6

Source: International Monetary Fund (IMF), AXA IM Research

Exhibit 9 Exposure of euro area governments to Greece (December 2011)

	Outstanding values					Losses				
	Repos	ELA	EU	TARGET2	Total	Repos	ELA	EU	TARGET2	Total
Belgium	2.8	2.2	1.9	4.0	10.9	2.5	2.0	1.7	3.6	9.8
Germany	20.9	16.5	14.4	29.7	81.5	18.8	14.8	13.0	26.7	73.4
Estonia	0.3	0.3	0.2	0.5	1.3	0.3	0.2	0.2	0.4	1.2
Ireland	1.4	1.1	0.9	1.9	5.3	1.2	1.0	0.8	1.7	4.7
Spain	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
France	9.3	7.3	6.4	13.1	36.0	8.3	6.5	5.7	11.8	32.4
Italy	15.8	12.4	10.9	22.3	61.4	14.2	11.1	9.8	20.1	55.2
Cyprus	13.9	10.9	9.6	19.7	54.0	12.5	9.8	8.6	17.7	48.6
Luxembourg	0.3	0.2	0.2	0.4	1.1	0.3	0.2	0.2	0.4	1.0
Malta	0.3	0.3	0.2	0.5	1.3	0.3	0.2	0.2	0.4	1.1
Netherlands	0.2	0.2	0.1	0.3	0.8	0.2	0.1	0.1	0.3	0.7
Austria	4.5	3.5	3.1	6.4	17.6	4.1	3.2	2.8	5.8	15.8
Portugal	2.3	1.8	1.6	3.2	8.8	2.0	1.6	1.4	2.9	7.9
Slovenia	2.1	1.6	1.4	2.9	8.0	1.9	1.5	1.3	2.6	7.2
Slovakia	0.5	0.4	0.3	0.7	1.9	0.4	0.4	0.3	0.6	1.7
Finland	0.9	0.7	0.6	1.3	3.5	0.8	0.6	0.6	1.1	3.1
Total	75.4	59.2	52.0	106.9	293.4	67.8	53.3	46.8	96.2	264.1

Source: European Central Bank (ECB=), Bank of Greece (BoG), AXA IM Research

... and euro area banks would take €48bn of losses

Exhibit 11 shows that euro area banks reporting to the Bank for International Settlements (BIS) have a total exposure of €53bn to Greece. French banks are exposed through their majority stakes in two banks (Emporiki and Geniki, owned by Crédit Agricole and Société Générale, respectively), while German banks are primarily exposed to the public sector. On our estimate, European banks would incur a total loss of €70bn, of which €48bn (i.e., 57% of the losses borne by private investors) for euro area institutions.

Exhibit 11
Exposure to Greece of euro area and European banks reporting to the BIS by sector of exposure, €bn (2011Q3)

Country of bank's residence	Exposure				Total	Losses
	Banks	Public sector	Non-bank private sector	Unallocated by sector		
Belgium	0.0	1.0	0.0	0.0	1.0	0.9
Germany	0.7	8.4	4.7	0.0	13.8	12.4
Spain	0.0	0.3	0.5	0.0	0.8	0.7
France	0.4	5.4	29.7	na	35.5	31.9
Italy	0.1	1.1	1.2	na	2.3	2.1
Total	1.3	16.0	36.1		53.4	48.1
All EU reporting countries	3.0	22.6	51.8	0.1	77.6	69.8

Memorandum item: Greek GDP in current prices = €215bn (2011)

Source: Bank for International Settlement (BIS), AXA IM Research

The risk of contagion is substantial

A disorderly default by the Greek government followed by an exit from the euro area, as outlined above, would represent a new “quantum leap” in the euro crisis that would entail large global repercussions. The total losses incurred by foreigners would reach around €290bn (post PSI), of which 90% would be borne by euro area taxpayers and 10% by private investors. Beyond the sheer size of the losses, a qualitative psychological taboo would be breached, which could unleash massive selling pressure on other peripheral euro area countries. A precedent was the imposition of a “voluntary” PSI on Greece’s private bondholders during the summer of 2011, which, as the ECB had warned, contributed to widening the sovereign crisis to Italy and Spain (along with the ill-designed EBA stress tests).

Cyprus and Portugal are the most vulnerable to contagion...

Beyond Cyprus, which would be badly hit and most likely bailed out by its European partners, the next domino would be Portugal which, like Greece, suffers from structural twin deficits (external and fiscal deficits) due to excessive public spending, not excessive private investment in property (as in Ireland and Spain). Resolving these deficits has proved to be extremely difficult in a recession. Indeed, Portugal recorded a large 9% of GDP fiscal deficit in 2011; the fiscal deficit target of 5.9% of GDP was reached by a one-off transfer of bank pension fund assets to the government balance sheet as “fiscal revenue”. To meet its 2012 fiscal target of 3% deficit, Portugal is expected to achieve a 6% of GDP deficit reduction, in an economy shrinking by 3%, a feat which would seem to defy gravity. Fiscal slippage seems all the more warranted in that the government has ruled out some IMF-proposed radical adjustment measures, such as a ‘social VAT’.

Not only is the long-term fiscal sustainability of the Portuguese government dubious but, in addition, the private sector is the most highly indebted in Europe. Portugal thus appears vulnerable to a contagion sell-off in the wake of a Greek default. Vulnerability is increased by the fact that 55% of the Portuguese public debt is in foreign hands. Yet Portugal is less likely to follow the Greek path, as long as its population is ready to take the pain of the macro adjustment (lower wages and pensions) within the euro area, which seems to be the case so far.

... but both would benefit from the IMF/EU firewall

According to its IMF-EFSF bailout plan, Portugal only needs to access capital markets to roll over T-bills in 2012, which we think is unrealistic. The troika has proved so far complacent in its monitoring of the Portuguese bailout, and we believe this strong political support would continue if the government’s fiscal performance worsens due to a contagion shock (higher interest rates on T-bills, deeper recession, higher recapitalization needs). Indeed, the EFSF’s remaining lending capacity (around €250bn) should prove sufficient to prevent sovereign defaults in both Portugal and Cyprus.

The liquidity tensions resulting from deposit flight could also be adequately addressed in the current ECB emergency liquidity framework. At its February meeting, the ECB announced a further widening of its eligible collateral list for 7 national banking systems: France, Italy, Spain, Austria, Ireland, Portugal and Cyprus. The new eligibility criteria should qualify between 600 and €700bn new assets for the ECB's repo operations, resulting (post-haircut) in more than 200bn of new liquidity injections, notably through the next 3-year LTRO. There is no doubt that this measure aims to ensure that European banks do not run short of collateral in case of renewed liquidity tensions, such as a run on deposits further to a Greek default. This new layer of liquidity insurance by the ECB will also conveniently shield Spanish, Italian, French and Irish banks, which could also suffer from deposit withdrawals.

Spain and Italy should weather the shock of a Greek default...

Spain and Italy have benefited from the return of risk appetite following the huge take-up at the ECB's first LTRO. In recent weeks, Spanish and Italian bond yields have decoupled from the trajectory of Greek yields. Investors seem ready to give the benefit of the doubt to the strategies followed by the reform-minded governments of Mr. Monti and Mr. Rajoy. Spain has already completed roughly one-third of its refinancing program. Debt redemptions for the remainder of the year are a manageable €45bn. The recent successful auctions have accredited the return of investor appetite for Spanish risk, on the part of both domestic and foreign investors. Italy is facing a more challenging 176bn redemption wall for the remainder of the year. However, banks could be lured back into the BTP market by the two LTROs. In order to reduce the interest paid at auctions, sovereign issuers could further shorten the maturity of new securities offered, as the Italian Treasury has started to do.

...but the EFSF/IMF safety net is still undersized

Nevertheless, uncertainties run high regarding the level of contagion the Spanish and Italian debt markets could experience in the wake of a Greek default. Should 10y yields return to their summer 2011 levels, i.e., above 7%, the question of bailing out both countries would re-

emerge. Some progress has been made since then, as the ESM launch has been brought forward to July of this year (from July 2013), with a more benign dilutive effect for private bondholders, since PSI is no longer automatic for a country receiving its help. However, the option of leveraging up its theoretical €500bn lending capacity is still in its infancy, and its co-investment sister vehicle, financed by third parties (central banks, SWF, etc.), has attracted little interest thus far. Likewise, negotiations on an IMF recapitalization to enable it to shoulder a €300bn bailout of Spain and Italy are still ongoing at the G20. It seems likely that, in such stress scenario, the ECB might turn to outright quantitative easing (i.e., buying government bonds from all EMU countries) or reactivate its Securities Market Program while an IMF/ESM upsizing plan is negotiated.

Market reaction would be a typical risk-off positioning

Beyond sovereign markets, we expect a significant sell-off of risky assets in the wake of a Greek hard default. A 15-20% drop in European equity would be our guesstimate. Sector-wise, European bank equity would suffer the most, given that banks may have written off their sovereign holdings by 75%, but not their exposure to the Greek private sector, where German and French banks are the most involved.

The EUR/USD rate could drop down to 1.15, but the sell-off could be limited by the fact that speculative investors are already massively short the euro. Bund and Treasury yields would mark new lows to 1.5%. The British pound could fall against the US dollar half as much as the Euro given that the UK's growth prospects would plummet with continental Europe's. EUR/JPY could significantly underperform the EUR/USD, since Japanese investors would be tempted to repatriate a large part of their €400bn holdings of euro area bonds. Should EUR/USD decline below 1.10, or EUR/JPY below 80, concerted actions by G7 central banks should be expected. Emerging market assets (equity, currencies), which benefited from massive inflows in recent weeks, would underperform developed markets. Precious metals would see a return of safe haven flows, and outperform oil and base metals.

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