CORE Comments
ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

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The End Game for Greece Approaches

The inability of Greece to form a government in the two weeks after its recent election has caused another to be scheduled. The parties winning the most votes two weeks ago opposed the painstakingly negotiated agreement that Greece had made with the so-called 'troika', the European Union, the International Monetary Fund and the European Central Bank. With each passing day, the odds of Greece's exit from the Eurozone seemed to increase. With this has come the realization that chaos across Europe and throughout the banking system would follow. Stock markets around the globe have fallen almost daily and selling has begun to arise even among assets that seem rather remote from these problems. What are the risks now?

In the last week, it appears that Greek banks are losing their deposits. Their depositors are reckoning by day the odds that their deposits in Greek banks, now denominated in euros, may be forcibly converted to new drachma, most assuredly worth far less than euros. The rational action for Greek individuals and businesses is to open new accounts in Germany, Switerland, London, or elsewhere, and transfer one's euros from one's Greek bank account to one's new account at, for example, Credit Suisse in Zurich. Thus begin bank runs.

Greece is well and truly insolvent; it cannot repay its debts. Spain is not insolvent; it faces a liquidity crisis, in that it cannot borrow from private markets at rates low enough to permit Spain to service its debt. The severe fiscal contraction in which Spain finds itself causes its economy to shrink, unemployment--already at an astonishing 24%--to rise. This terrible situation also causes Spanish banks to lose deposits, not yet at the Greek rate, but …. And, if a disorderly exit of Greece from the Eurozone will cause widespread losses--and it will--then a run on Spanish banks would cause extreme chaos. Unless the troika quickly finds a resolution to the Greek problem, bank runs will begin in Portugal, Spain, Italy, and perhaps in France with catastrophic consequences.

Germany, often cast as the villain of the piece, is, in very important ways, operating effectively and in the interests of preserving the grand European project. It has rejected solutions that could support government borrowing by the weaker countries without the imposition of strict conditions to improve those governments' financial condition. But, recall that in December, when a banking crisis loomed urgently, Germany did not prevent the European Central Bank from undertaking its massive one trillion euro loan program to recapitalize European banks. In my judgment, Germany will again take actions--or refraining from forestalling actions by the ECB--that will prevent the crisis in Greece from causing a European-wide or world-wide financial crisis.

By

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One solution that is often mooted--and most assuredly being considered by the major actors--would involve the use of the European Stability Mechanism (ESM) to lend directly to governments, using funds loaned to it by the ECB. This is complicated for various reasons, including that the ESM has not yet come into existence! It will succeed the European Financial Stability Facility (EFSF) shortly as a 'permanent' rescue funding mechanism for governments. If it were to obtain a banking license, the ECB could lend to it and the ESM could directly lend to Italy, Spain and others. The ECB and Germany have already rejected this idea out of hand, but when comes the moment that unlimited funds are required to prevent the collapse of everything European, this approach may be the one employed.

France's new president, Francois Hollande, last week said "either the European Central Bank should lend directly to states, which it refuses to do for the time being, or there is another option...rather than lending to banks, the ECB could lend directly to the ESM." Given that the ECB can create and lend onwards an unlimited amount of euros, this scheme could end in an instant the liquidity problems facing Italy, Spain, and others.

This is not the only scheme to halt the crisis. Eurozone-wide deposit insurance, akin the FDIC insurance in the US, would be fully effective to prevent bank runs. Other approaches are also possible. All have so far been opposed by Germany.

Over the weekend, heads of state and of governments of the G8 met at Camp David. No announcement was made of a new accord to settle the Eurozone crisis, and experience teaches us not to expect decisive action until the last possible moment before disaster is at hand. Experience also teaches us that, at that last possible moment, Germany, the ECB and the IMF will take action. As a result, we can hold investment positions that offer good value, even if their prices are temporarily depressed by anxieties arising from matters European. We intend to continue our use of the volatility index, discussed in our last letter, as a hedge during the bouts of market anxiety.

By 'decisive action', I do not suggest that European leaders will agree to a comprehensive plan to solve the inherent problems with a currency union that lacks a central government for taxation, bank guarantees and the like. Unless and until the Eurozone is bound more coherently in a political way, the crisis in Europe will continue this experience of bouts of crisis, followed by periods of relief and calm. For now, we are in another bout of crisis.

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