



Greece and Related Peripheral Issues

Summary

Since making the news last April for needing additional finance to meet its fiscal deficit funding needs, Greece has failed to stay out of the headlines. Funding arrangements have actually worsened. Markets continue to be uncomfortable with developments, to the point where outright default and Greece's exit from the euro is now being discussed openly. **Unless a credible solution to the problem is found, market volatility is unlikely to subside.**

How did we get here?

Immediately after coming to power in October 2009, Greek Prime Minister Papandreou's government was forced to reveal that the government's finances were in far worse shape than previously published. The budget deficit was confessed to be 12.7% of GDP, four times higher than the permissible limit under the Maastricht Treaty.

By May 2010, it had become clear that the fiscal position had become unsustainable and that Greece could possibly default on its debt if left unaided. Between the European Union and the International Monetary Fund (IMF) a total of EUR 110 billion was committed to Greece under the European Financial Stability Fund (EFSF).

It was never the view that this amount would be a permanent solution. The debt burden in aggregate was simply too large: a total of EUR 390 billion (EUR 290 billion principal and EUR 100 billion interest). Of this, roughly EUR 100 billion was due by the end of June 2013, which was also the date at which the (stop-gap) EFSF is to be replaced by the longer-term European Stability Mechanism (ESM).

What is the current state of play?

Unfortunately, the assumption that EUR 110 billion would be enough to get Greece through to June 2013 proved incorrect for two reasons. First, it was surmised last year that handing out some cash to Greece would stabilise markets and allow Greece to return to the government bond market to borrow at reasonable rates sooner than is currently likely. Instead of dropping to about 5%, the funding rate for Greece (as expressed by the yield on 10-year bonds) has continued to rise inexorably above 16% (at last count). Second, it transpired subsequent to the first bailout that the fiscal position was even worse than estimated: the budget deficit was still over 10% last year.

The combined effect of these factors has left Greece in a position where it requires an estimated EUR 57 billion in addition to the initial EUR 110 billion agreed last May. Compounding the issue, the Greek government bond maturity schedule is particularly heavy in the near term with large maturities falling due in 2012 and 2013.

In Summary

- Market volatility looks set to continue near term as Greece continues to seek EU/IMF funding
- Following a successful confidence vote, attention will turn to a passing of the fiscal plan
- Contagion risk still paramount as European banks' exposure to Greek debt significant

It is now obvious that short of an additional infusion of cash, Greece will run out of money sometime around Q2 2012, somewhat more than a year earlier than planned. In fact, the near-term risk of default has escalated to the point that Standard and Poor's has put Greece on the lowest possible rating above default.

Where we are now is that the EU has to agree soon (by the end of June 2011 or very soon thereafter) to approve the release of the next tranche of the EUR 110 billion funds to Greece. The IMF is likely to also release its next tranche of support, conditional on the Greek government agreeing to necessary austerity and structural adjustments. In aggregate, these funds will then buy time for a full-time solution to be found for Greece and also the other two countries currently receiving funds, Ireland and Portugal.

What happens from here?

The risk of default and contagion is large. Our view is that sanity will prevail and that a way will be found to avoid a near-term default. Longer term (beyond June 2013 for the purposes of this argument) many options are still open, even a restructuring, but that can only be achieved in an environment where some of the risks have been mitigated.

Some of the obvious risks in the event of default:

- There may be serious contagion across the region as the debt markets of Ireland, Portugal and possibly Spain and Italy react to a Greek default.
- Losses suffered by the outright holders of Greek debt, as well as the entire credit default swap counterparties, may cause a need for capital raising at banks across Europe.
- Complete loss of control of the overall situation.

Stand-off between the ECB and Germany: Standing in the way of the disbursement of funds to Greece is the insistence of Germany that private bond holders have to share in the burden. This basically means that it wishes to have bondholders take losses voluntarily,

and simultaneously avoid triggering credit default swap agreements. Germany's position seems untenable. In the short term, such a course of action is clearly risky and perhaps not even practicable. A more practical solution, if undeniably politically less palatable, is to find a way to plug the Greek funding gap in the near term. **Over the weekend, it appears that Germany had softened its stance to take account of this reality. It has admitted that allowing a hard default may cause damage that will be hard to quantify in advance.**

The issue of private sector participation is better addressed in the longer term under less distressed market circumstances; that is to say, we concur with the ECB's position that a default can possibly trigger a financial chain reaction that will be impossible to contain. With Germany softening its stance, it would be a first step in easing some of the immediate contagion fears in the market.

Greek domestic politics have become a major challenge for Mr. Papandreou. He successfully passed (by a slim margin) a vote of confidence on Tuesday night; however the political climate remains volatile. At the same time, there have been riots on the streets of Athens in protest at the severity of the austerity measures being introduced. Following the vote of confidence, it is unlikely the Medium Term Fiscal Plan (MTFP) detailing the austerity measures, structural reforms and privatisations will not be passed. Should it not be passed it could delay any agreement on the MTFP for Greece, reducing further the likelihood of disbursement of the next tranche of the EU-IMF loan, increasing the risk of near term default. Currently, we view this possibility as low.

This also highlights the fact that the situation around solvency is far from solved for Greece. That is to say, much work needs to be done to get the budget to the point where it is in fact sustainable. At present there is a cloud over the ability of Greece to deliver spending cuts, tax increases (or at least more reasonable methods of collection) and large-scale privatisations to reduce the debt burden. While the MTFP might be approved, the difficulty will likely be in the enforcing of it.

Avoiding contagion

Looking narrowly at the exposure to Greek sovereign debt is not a suitable way to gauge the loss range in the event of a debt restructuring: the interconnections among European economies are much wider, and that is why a default (even if orderly, although we doubt that is really possible) would be a systemic shock, the consequences of which will be difficult to quantify.

Much has been made of the relatively large weighting of

German and French banks to Greek debt: roughly EUR 40 billion in the case of Germany, and EUR 62 billion in the case of France. These numbers are for exposure to Greek public sector, banks and non-bank private debt in aggregate. Other euro-area countries have far smaller exposures. **However, if we extend the same analysis to include the wider peripheral euro-area, the numbers jump exponentially; a quick estimate of the aggregate exposure is somewhere in excess of EUR 700 billion.**

Important events from now onwards

- The Greek government passing a MTFP – expected to be passed by end-June following the successful vote of confidence.
- The EU and IMF to make the disbursement of the next tranche of the package. If all goes to plan, this is hoped to be confirmed by early July. The hard deadline is July 11.
- Agree on the terms for an additional package. The amount would have to be around EUR 60 billion. It is hoped these details will be provided by early July, especially given the IMF's urgency for the EU to have in place a plan to make up Greece's funding shortfall from mid-2012 to mid-2013.
- Gradual easing in market tensions; particularly peripheral bond markets but also the wider market.
- Progress required in the banking sector: a new set of stress tests will be undertaken, and in Spain there is the continuing recapitalisation of the regional banks. Credible stress tests and successful further banking reform/recapitalisation will likely alleviate market stress.

Conclusion: avoiding contagion is the key

Looking at the way the market is pricing risk at present, there is still some observable element of complacency. Implied volatility in fixed income and equity markets is still quite low, leading one to wonder whether the market is complacent about contagion. We think caution is still warranted. Equity markets are showing clear aversion to the current uncertainty; perhaps a more realistic reflection of the contagion risk embedded in the situation. The recent vote of confidence for Mr. Papandreou should ensure the MTFP is approved. However, the timeline for Greece over the coming weeks is full, with decisions on the EU/IMF disbursement of the fifth tranche and a second bailout package, including the possible role of the private sector within this, still needing to be finalised. Much like the streets of Greece, the markets are likely to remain volatile in the near term.

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