EUROPEAN SOVEREIGN DEFAULTS: A PREVIEW

THE OPPORTUNITIES FOR SOCIALLY IRRESPONSIBLE SPECULATION

THEY DON'T LIKE YOU

- UN BANQUIER EST SOLDAT AU SERVICE D'ETAT– JEAN BAPTISTE COLBERT.
- SOLDIERS WHO DISOBEY THEIR OFFICERS IN TIME OF WAR ARE SHOT.
- YOU ARE A BIT SAFER, DUE TO THE INEFFECTUALITY AND HESITANCE OF THE AUTHORITIES.
- YOU CAN EVEN MAKE A PROFIT OFF THE CRISIS.
- JUST REMEMBER THE AUTHORITIES' PREMISE: THEIR INCOMPETENCE IS YOUR FAULT. AGREE WITH THEM IN PUBLIC

THIS HAS ALL HAPPENED BEFORE.

- AS JIM GRANT HAS POINTED OUT, THERE IS NO REAL INNOVATION IN FINANCIAL MARKETS. JUST SHORT MEMORIES.
- HERE,THE RELEVANT FADED MEMORIES WOULD BE THE "LDC DEBT" DEFAULTS OF THE '70s, 80s, AND 90's. THE BRADY BOND DEALS.
- THE SHORT TERM SOLUTIONS WILL BE NEW LOANS, THE MEDIUM TERM SOLUTIONS WILL BE EXCHANGE OFFERS AND OFFICIAL ACCOUNTING FAKERIES, AND THE LONG TERM SOLUTIONS WILL BE RE-DEFAULTS, ALONG DEVALUATIONS OR EXCHANGE CONTROLS.

THE EURO' S PROGENITORS WERE ECONOMICAL WITH THE TRUTH

- ARTICLE 125 OF THE MAASTRICHT TREATY, 1992: "The Union shall not be liable for assume the commitments of central governments, regional, local or public authorities, other bodies governed by public law, or public undertakings of any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project."
- Jacques Delors, former President of the European Commission, 1995: "Monetary Union means that the Union acknowledges the debts of the Member States of the Monetary Union."

THE EURO-SOURCERER'S APPRENTICES HAVE A PLAN

- Within a month or so, Portugal will likely have a re-stabilization and refinancing plan with the European Financial Stability Fund.
- There could be also a Jesuitical re-interpretation of the EFSF guarantee agreements to increase its effective size to its nominal 400 billion euros.
- Plans for a Greek voluntary exchange offer, that is, a non-default default, will then proceed. The impending Spanish bank crisis will just be ignored.
- The eurocrats think they can target speculators, but will not eliminate speculative opportunities.

EUROCRATS ACCEPT SOVEREIGN DEFAULT, NOT DEVALUATION

- Eventually, of course, they' ll get both.
- To predict eurocratic actions, consider what is the best policy from the point of view of career strategies.
- That would be getting credit for re-inventing the wheel. So simply taking the old Brady Bond forms would be too obvious.
- Instead, there will be mistaken tweaks, and new labels on old bottles.

THE CURRENT PLAN FOR GREECE

- “Speculators” must not win. The eurocracy wants to avoid a formal Event of Default, the worst outcome for eurocratic careers, though not for Greece.
- Such a fix is possible, though really pointless.
- Instead of declaring default, and reducing Greece’s real debt burden by the half or more that is necessary, the declaration of insolvency will be deferred with a “voluntary exchange”
- The idea is to avoid nominal reductions in principal or interest, by stretching out maturities for at least five more years.

WHAT ARE THE MECHANICS OF THIS INEFFECTUAL "SOLUTION"?

- Over 90 percent of Greek government bonds are covered by Greek law. That law can be changed retroactively by the Greek parliament.
- The change will be an amendment to the law governing Greek government debt imposing an "aggregate collective action clause"
- This allows a supermajority, say 80 percent of holders of all bond issues (that's the "aggregate") to agree to a change in terms. "Voluntarily". Not.
- At mid last year the thinking was that collective action would allow for a reduction in the real burden of Greek official debt. Bondholders would get haircuts, and receive "par bonds" to support accounting fictions, or "discount bonds", if they wanted to trade the paper.
- Now, though, eurocratic strategists seem to be concluding that even that would be too close to reality, and too embarrassing.

WHAT WILL THIS ACCOMPLISH?

- Declaration of an Event of Default would be avoided. So the CDS, representing less than 2% of Greek bonds, would not be triggered. So what?
- The remaining cash in the EFSF can be used for covering the current Greek current account deficit, or recapitalizing the Greek banking system.
- The political opposition in northern European countries to further euro-area fiscal integration will, it is hoped, be lessened.
- Careers will be enhanced by an economically pointless, but creative, non-solution!

WHAT'S IN IT FOR SPECULATORS? AN EXAMPLE:

- If 90% of Greek sovereign bonds are covered by Greek law, 10% are not.
- Consider the Greece 650 mm 2.125% Swiss franc bond, governed by Swiss law, which matures on July 5 of 2013. It's quoted at a yield of 12.391%.
- Compare that to a YTM of 11.8% on the ten year GGB euro pay bond, governed by Greek law.
- The Swiss bond is difficult for Greece to restructure, the euro pay bonds can be changed with a weekend's parliamentary vote.
- Why is there an arb? The longer, less secure bond can be repo'd at the ECB. It's a carry trade trap.

ANOTHER, LESS COMPELLING ARBITRAGE: THE PHARMA BONDS

- Global pharma companies weren't paid by the Greek hospitals. Last year they stopped shipping, which got Greek attention.
- So in July the Greek government agreed to exchange the bad receivables for one, two, and three year zero coupon bonds.
- These have Euroclear International Securities Identification Number. That sounds like they're real.
- Except that the issue size is unclear, (5.7bn euros?) and no-one seems to have any documentation for the bonds.
- But they are ECB repo-able, so trade at only a small discount to the on-the-run Greek Government Bond.
- I have my doubts about these things.

DISTRESSED EUROPEAN BONDS ARE IN THE WRONG HANDS

- The euro sovereigns are still being traded and held by IG dealers and investors.
- The sovereign bond desk and buy side "union" has kept out the EM distress people.
- That partly explains why value differences are not yet reflected in prices.
- That sounds like there should be good trades, but for the most part the entire sector is over-valued. That will change.

THE FIRST RESTRUCTURINGS WILL CREATE NO SOLUTIONS OR VALUE

- The Irish bank "bailout" is probably unsustainable, politically and economically. Also true of the planned Greek exchange.
- Real, explicit, defaults will be necessary to create value. Defaults followed, in some cases, by devaluations.
- Iceland is the closest to a successful workout. Default, devaluation, liquidation, denunciation, and quicker recovery.

IS THERE AN ALTERNATIVE TO DEFAULTS AND DEVALUATION?

- Yes, a stupid, destructive one. Which doesn’t mean it won’t happen.
- European institutions and the ECB can be stuffed with bad paper marked at par.
- To avoid depositor and capital flight, exchange controls would be necessary.
- Anti-terrorism, anti-money laundering, and tax-related reporting requirements, with improved IT, make such controls possible.

WHICH TAKES US BACK TO GOLD

- Europe has been an exporter of gold to the Middle East and Asia.
- Capital controls, or the risk of capital controls, could change that. Gold is much harder to control than securities and bank deposits.
- There would be a shift from 400 oz. good delivery bars to kilo bars and coins. Become a refiner!
- The European public will likely join China and the Middle East in driving demand for bars and coins.
- Gold holders are among the most likely beneficiaries of European sovereigns' financial-political trap.