FINANCIAL TIMES

Last updated: May 14, 2012 7:25 pm

Greek fire could singe rest of euro

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Unanswerable question is how far contagion would spread

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Contagion. It is the word markets have feared throughout the eurozone debt crisis. And a Greek exit from the single currency would bring it to the fore in ways unimagined until now.

A "Grexit" would test the firewalls erected by policymakers, judged insufficient by many investors, and put the continent's banking sector under extreme stress. But the concern for many in the market is less the immediate impact and more the example Greece would set for other struggling eurozone countries.

"The main worry about this in our opinion is not necessarily the first order effect but what it says about the unbreakable nature of the euro," says Jim Reid, credit strategist at Deutsche Bank. "This would be especially relevant if in the future other countries continued to struggle. The full ramifications may not be felt immediately but a lot can happen over time and Greece leaving would remain a dangerous template if other economies continued to weaken."

The direct costs are not small given Greece is likely to default on all its debt but they are seen as bearable.

Nikolaos Panigirtzoglou at JPMorgan estimates the immediate costs to the eurozone at about €395bn – made up of €240bn through the international bailouts of the country, €130bn through "Target 2" lending from other eurozone central banks and €25bn from commercial bank lending.

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The big, unanswerable question is how far contagion would spread. Eurozone authorities have sought to create new institutions such as the European Stability Mechanism and European Financial Stability Facility, permanent and temporary rescue vehicles respectively, which together have about €750bn in

lending capacity. The European Central Bank has shown a readiness to support peripheral sovereign debt when needed.

Yet many in the markets worry that if the official creditors such as the European Union lose all their money on Greece, will they be ready to stand behind Rome and Madrid? The premium Spain pays to borrow over Germany reached a fresh euro-era record of 485 basis points on Monday.

Indeed, foreign investors appear to have drawn their own conclusions: selling by non-domestic bondholders in the past nine months has amounted to €200bn for Italian government bonds and €80bn for Spanish debt, says JPMorgan. Non-domestic investors hold about €800bn in government bonds in the two countries.

Two paths beckon. One is a disorderly default in Greece and the pandemonium that would ensue, including mass selling of Italian and Spanish sovereign debt. The other, less calamitous route would involve a huge, co-ordinated policy response. The ECB would resume buying government bonds directly as well as supporting the continent's banks. Some kind of fiscal union could even be declared, involving transfers from the strongest countries to the weakest.

Any contagion would be likely to be transmitted through the region's banks, whose funding costs could rise just as any remaining holdings of peripheral debt fell in value. The fact some Spanish and Italian banks have used cheap ECB loans to buy more domestic sovereign debt may only make them more vulnerable.

But the banking world is divided on how disruptive a Greek exit from the euro would be. Stuart Gulliver, HSBC's chief executive, last week played down the risks, stressing he the eurozone would survive intact.

Bankers say as much as been done as possible to plan for financial sector disruption. Many banks have cut their direct exposures to Greece and other peripheral countries. Contingency regimes are in place to cope within 24 hours with the phase-in of a new drachma.

"There are two major caveats," says Piers Le Marchant, European general counsel at Nomura. "You do not know what tools the EU would pull out of its toolbox. And you do not know what Greece or another country would do itself in terms of changing legislation to introduce currency controls or other measures to stop you getting paid."

"Basically, it's a huge chess game and it's very difficult to see more than one move ahead," he adds.

Even if a Greek exit is orderly, banks are braced for a period of disrupted supply of liquidity, higher funding costs and exchange controls.

"It's naïve in the extreme to think you can limit the knock-on effect," says one senior executive at a UK bank. "As soon as Greece leaves or defaults, contagion will pass like a cannon going off to Spain."

Banks say that regulators have recently broadened their demands for contingency planning, requiring them to model for a wholesale collapse of the eurozone rather than just a Greek exit. "Five or six weeks ago the requests became broader," says one banker. "But frankly, it has not been much use."

Bankers complain that regulators and governments have not done enough to give them answers about many of the remaining uncertainties – how existing contracts would be redenominated, for example, and to what extent material adverse change clauses would be triggered. Within the constraints that exist, though, bankers believe they have done as much as could be done to prepare themselves.

Mr Le Marchant says: "The big worry I have is the complete lack of preparation in the real world economy – the effect on goods and services."

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