

A View from the Trenches Toronto, Thursday, January 7th, 2010

Good morning,

Yesterday, I attended the Economic Club of Canada's 2010 Economic Outlook event, presented by the chief economists of Canada's largest banks (W. Jestin, Bank of Nova Scotia; Craig Wright, Royal Bank of Canada; Don Drummond, TD Bank Financial Group; Sherry Cooper, BMO Capital Markets and Avery Shenfeld, CIBC World Markets). In one sentence, the collective outlook was of cautious optimism, favoring emerging markets, the Canadian dollar, equities (not bonds), subject to no escalation in sovereign risk. I was comforted to hear that some of the speakers shared my view that relevant volatility was still to be expected in 2010 (refer: www.sibileau.com/martin/2009/12/15 "Confusion wanes")

However, I see the picture for sovereign risk looking uglier by the day. Below, I have attached a chart (source: Bloomberg) with the credit default swap spreads (5-yr tenor) for the National Bank of Greece SA (NBG) and Greece (sovereign). As you can see, the spread of NBG has closely followed that of Greece. NBG is one of the banks (together with Alpha, Piraeus, EFG and Imi) that participated in Greece's EUR2BN private placement, on Dec 15th. Since then and given Greece's fiscal outlook, it has become more evident that the government can only access the private debt market. Furthermore, on January 5th, Mr. Spyros Papanicolaou, managing director of Greece's Public Debt Management Agency confirmed the intention of the government to find financial support in that market.

What does this mean? It means that the deposits of Greece's citizens are used to finance Greece's fiscal deficit. Greek depositors may believe their guaranteed investment certificates are liquid instruments, but in fact, they are being directed to buy sovereign debt nobody else wants to buy...

Should this be of concern? When this same situation unfolded in Argentina, in 1999-2000, it ended with the collapse of the financial system in December 2001. However, Argentina's banks could not be bailed out, because the Peso was convertible in US dollars. Argentina's Central Bank could not do "quantitative easing". Can Greece carry out quantitative easing? No, because the funds lent to the government are in Euros. Therefore, the final solvency of Greece's banks rests on the willingness of the European Central Bank to act as lender of last resort, if needed. This is exactly what is weakening the Euro lately.

The chart below also shows that since the statements made by Mr. Papanicolaou, the correlation between NBG and Greece's spreads has broken, with a wider NBG risk and tighter sovereign risk. This clearly shows the transfer of sovereign risk to Greece's financial system. Perhaps, rather than "transfer", "infection" is the better word here. In my view, if the European Central Bank validates this situation, both spreads should converge to a lower level. If it doesn't, they should converge to a higher level. The contagion is undoubtedly a fact, and under any scenario, this situation will continue to weigh heavily on the Euro. There is a lot of moral hazard at stake here as well, as other countries potentially embarked on the same path attentively watch things unfold. Nothing good can or will come of this. Trade accordingly.



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