



Euro-crisis: Are the bitter pills working?

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- **Surveillance a mess, programs a mess, astonishing forecast revisions**
- **Broke own rules:** Lending into unsustainable debt burden
- **Treated Eurozone** as a partner to be accommodated, not patient to be cured.
- **Fundamental diagnostic errors**
 - Supervision blueprint for Europe too late by 15 years
 - Bank recap efforts too little, too late
 - Fiscal multiplier advice incoherent
 - Unequivocal praise for German supply side reforms

IMF's maximum forecast revisions of nominal GDP across all forecast vintages April 2012 to April 2013

	2013	2014	2015	2016
Cyprus	-18%	-24%	-26%	-27%
France	-6%	-6%	-7%	-7%
Germany	-6%	-7%	-7%	-6%
Greece	-25%	-27%	-27%	-24%
Ireland	-10%	-10%	-11%	-4%
Italy	-9%	-10%	-11%	-11%
Portugal	-9%	-10%	-10%	-9%
Spain	-10%	-11%	-12%	-13%

Note: Maximum revisions are defined as the % change from the strongest to weakest projection between WEO vintages.
Source: IMF WEO, [leaked](#) Troika documents for Cyprus, Exotix calcs.

- **Poor leadership:** DSK had enormous power to install his own people. European Director post turned over five times
- **Analytical conservatism:** Groupthink; Troika forecasting is an exercise in the search for the path of least resistance
- **Inadequate accountability**
 1. Decision to go ahead with Greek prog in 2010 and deny restructuring...and 28 months later to scalp bondholders with no OSI...
 2. ...by supporting change in local bond law to allow CACs
 3. Supporting Greek bond buyback, pretending buying debt back from banks made debt more sustainable.
- **Library of leaks instead of proper explanations:**
Inadequate official explanations, so Press offices to try to brief the tide of history in their favour (Cyprus)

Decisions at Fund a cocktail of analysis and politics:

1. Fund staff: over 50 review a Greek programme document, 100s by time it goes to Board, + parallel process in EC. What has that achieved?
 2. Form IMF Policy Committee, **seven voting members**, as follows: 2 of 5 MDs on rotating basis, with MD or first Deputy MD in the Chair
 - *Director of country's regional department (or alternate)*
 - *Director of SPR (or alternate)*
 - *Three other "Externals".*
 3. Revamp Independent Evaluation Office: set up "to conduct independent and objective evaluation of Fund policies and activities"...
- Current work program reads like an instruction to stay away from the elephant in the room (nothing on eurocrisis!!)
 - Silly that MD European (for 67 years), in case of eurocrisis also disastrous, attempts to reform Board important but of little impact on policy

Time for transparency revolution at IMF (4): Evolutionary alternatives

- There have been significant improvements in transparency in recent years. Post-event evaluation, Article IVs, MoU now generally published

Need to go further:

- Publish exceptional access cases before they go the Board. In eurocrisis economies these have in any case generally leaked out of Brussels
- Publish minutes of Management Review Meeting around the time of publication of key country reports. Make new appointees to this meeting from outside the IMF's Management structure
- MD to inform the Board about the views of the two members of staff signing off the document (area department and SPR)
- In turn, the Board's approach of taking all decisions by consensus or with a couple of abstentions at most needs to change

Current context: Europe's crisis in five Acts

Act I: 2007-8; global financial crisis

Act II: 2008-9; procrastinate/pretend instead of recapitalising banks

Act III: 2010-11; leaders of crisis countries walk tightrope, mixed implementation of austerity, all fall

Act IV: 2011-12; leaders of creditor countries walk tightrope, decide to bail out everything, but funding insufficient to ensure recovery

Act V: 2013-2015; race between institutional reform & political fragmentation

- OMT, common supervision, ESM injections into banks, more generous bailout terms

versus

- Syriza, Catalanian independence, Cypriot communists, unstable Italy
- Fed and BoJ

Greece (1): Economy-loss bond rallies

Greek government bond prices (source Bloomberg, Exotix)

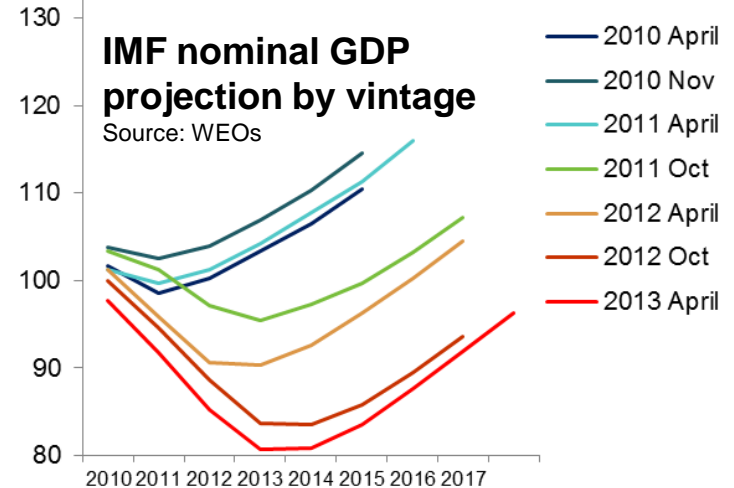


- Global conditions now affect Greece more than Greece affects global conditions
- QE (by Fed/BoJ) works very well for Greece, no risk of overheating!
- But when will lower yields mean investment in physical assets?

Greece

IMF nominal GDP projection by vintage

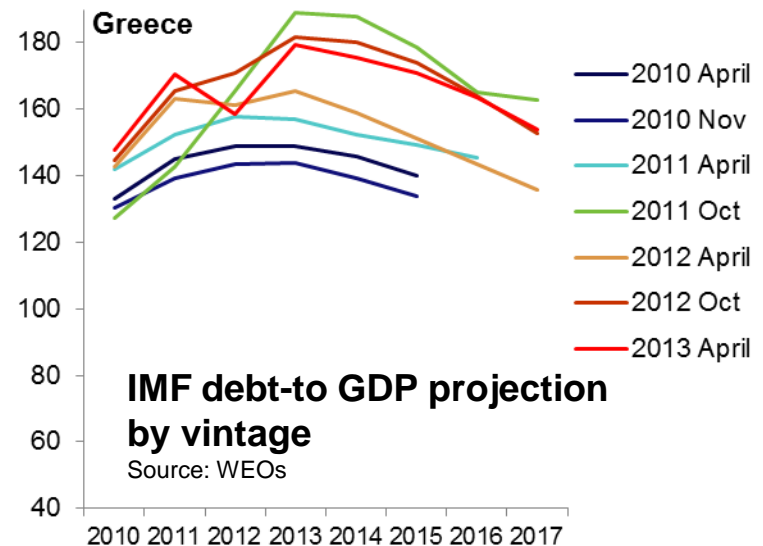
Source: WEOs



Greece

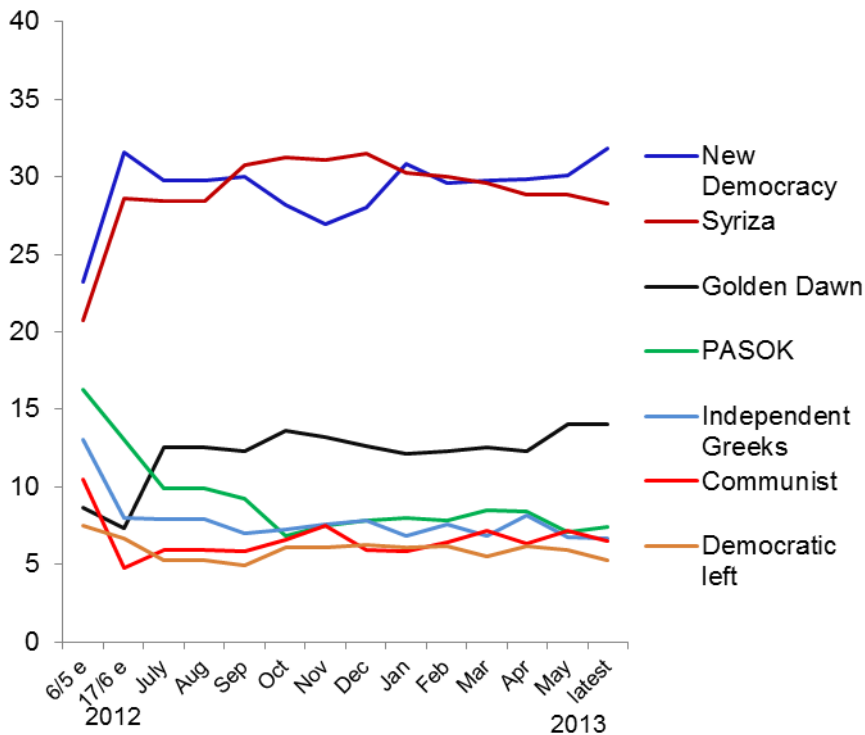
IMF debt-to GDP projection by vintage

Source: WEOs



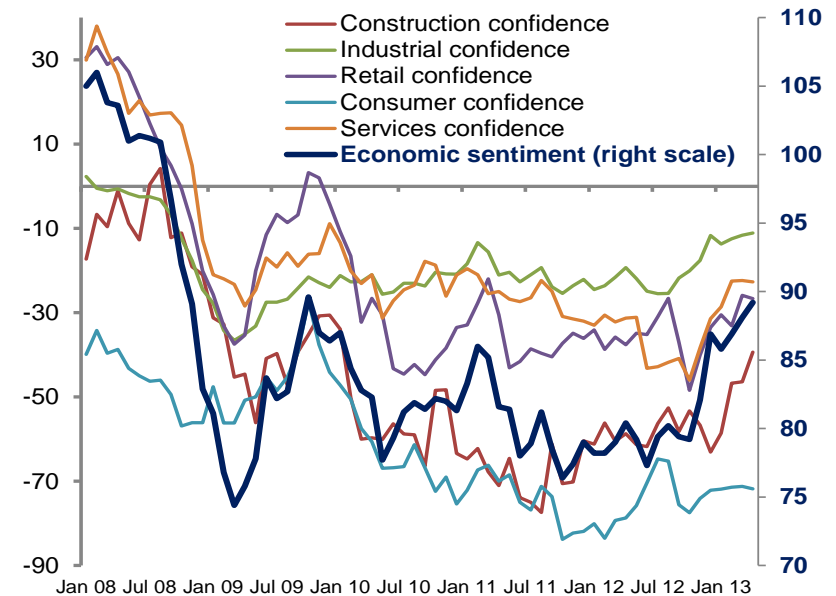
Greece (2): Green shoots/seeds given more time to germinate

Greek opinion polls (source: Elogika)



Greece surveys : not positive, less negative

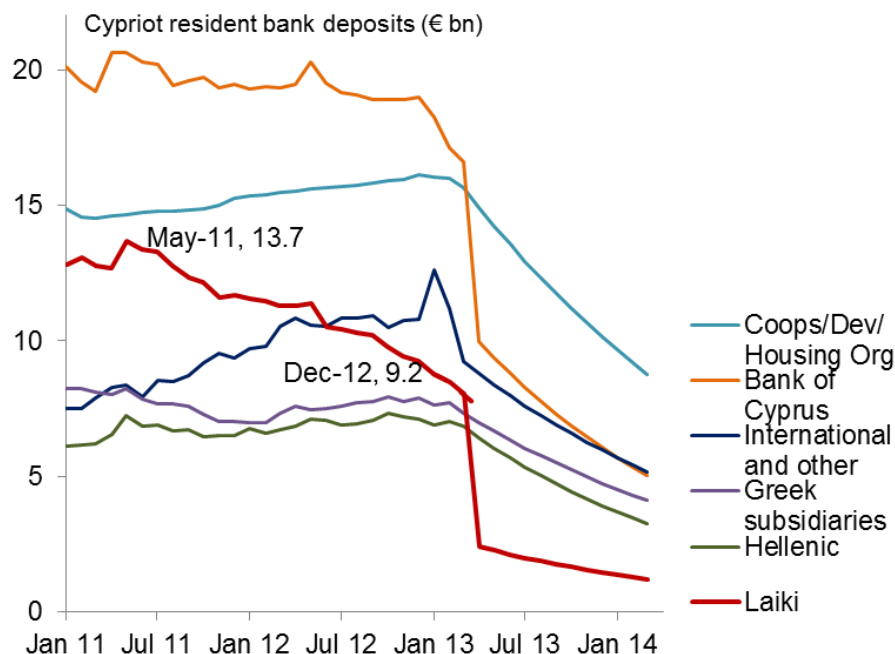
Source: European Commission



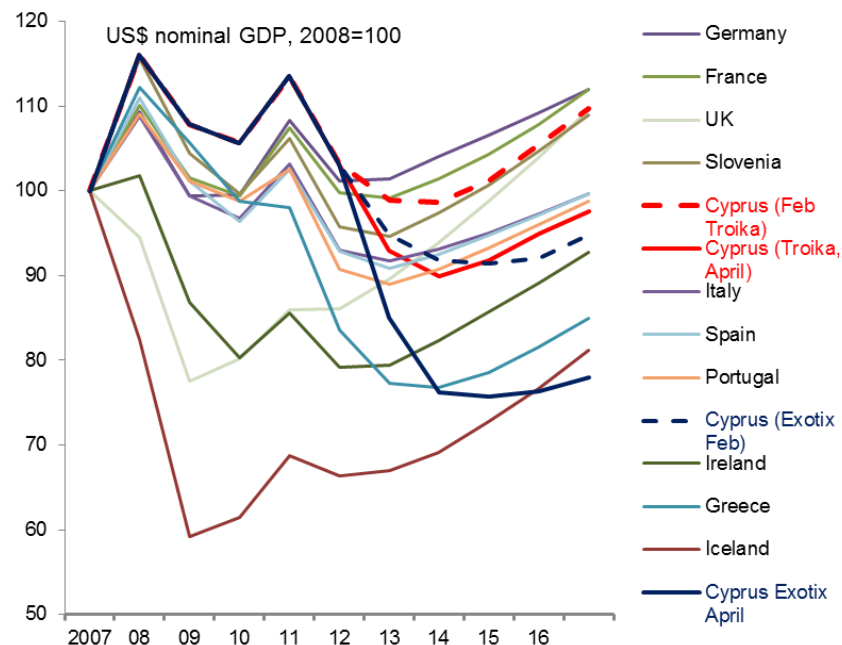
- Big surprise is the Greek population's tolerance of economic pain
- Support for centre-right party gathering momentum
- Confidence indicators
- Not many physical green shoots, but seeds of recovery given more time to germinate

Cyprus (1): Outlook for Cypriot banks and economy

Cypriot bank deposit projections if capital controls lifted (based on 6% deposit flight/month) source: BoC/Exotix calcs



GDP 2007-16 in various economies source: IMF WEO, Exotix

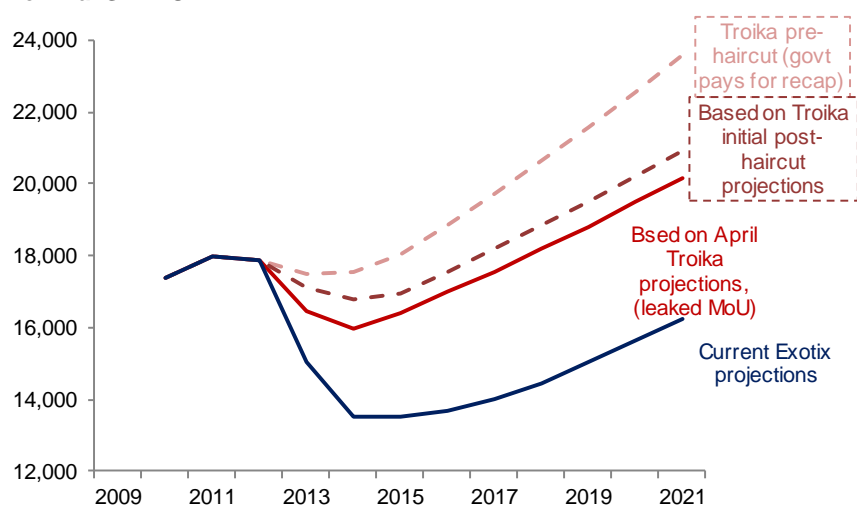


- If capital controls released, Eurosystem lending to Cypriot banking system could have to rise 4x, to around €40bn within a year
- From IMF <http://www.imf.org/external/np/sec/pr/2013/pr13175.htm> “Temporary payment restrictions should be relaxed at a pace consistent with maintaining financial stability, while minimizing distortions to economic activity”
- So capital controls could be in place for a long time
- Will Cypriot GDP be more like Iceland (our view) or Ireland (Troika view)?

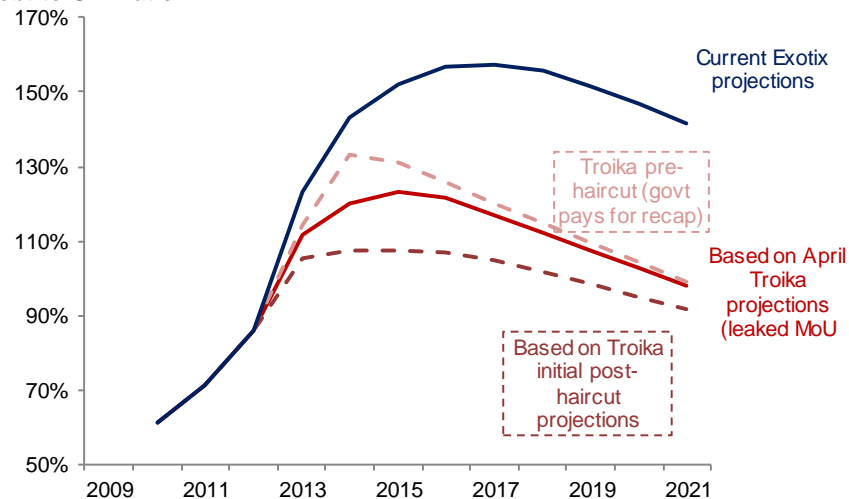
Cyprus (2): debt sustainability analysis through the crisis (Troika versus Exotix)

(source: IMF, EU, Cypriot Ministry of Finance, Exotix calculations)

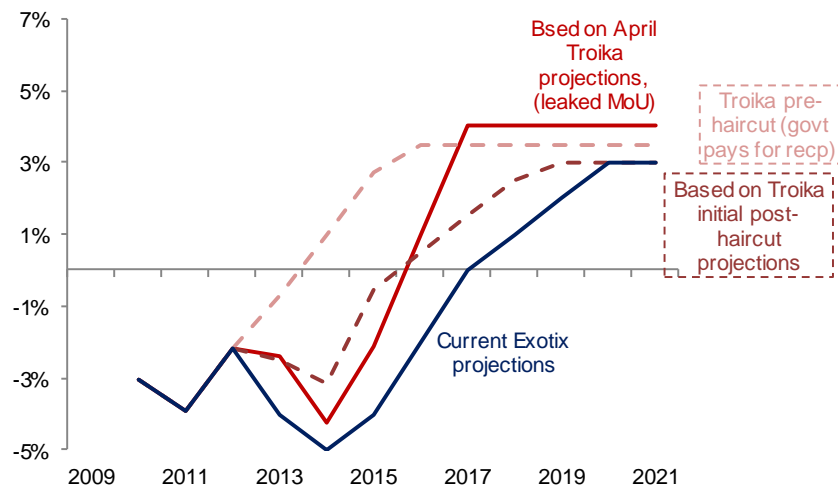
Nominal GDP EUR mn



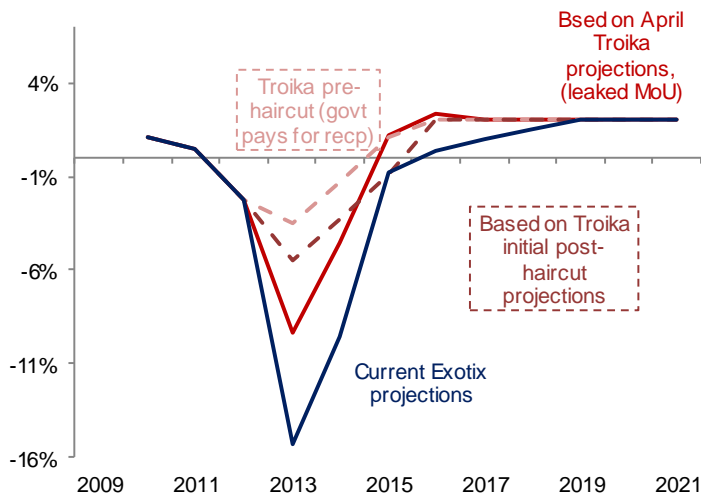
Debt-to-GDP ratio



Primary balance (% GDP)



Real GDP growth (%)



Cyprus (3): Unusual anger on IMF Board (leaked Cyprus Greys)

http://www.stockwatch.com.cy/media/announce_pdf/May15_2013_IMF.pdf

Preliminary statement

- “rumors in the press regarding deposit haircuts and the consequent fall in confidence led to accelerated and substantial deposit outflows.
- **[On money laundering report]** “The results serve further evidence that some perceptions abroad were highly exaggerated.”

Brazilian Board member

- “Every program needs a pinch of optimism but in this one [the] suspension of disbelief, if you will – goes way beyond the average.”
- “Either Board approves a program that has little ownership and even less chances of success, or runs risk of exacerbating crisis in Cyprus which could engulf bystanders such as Slovenia or Malta and Greece.

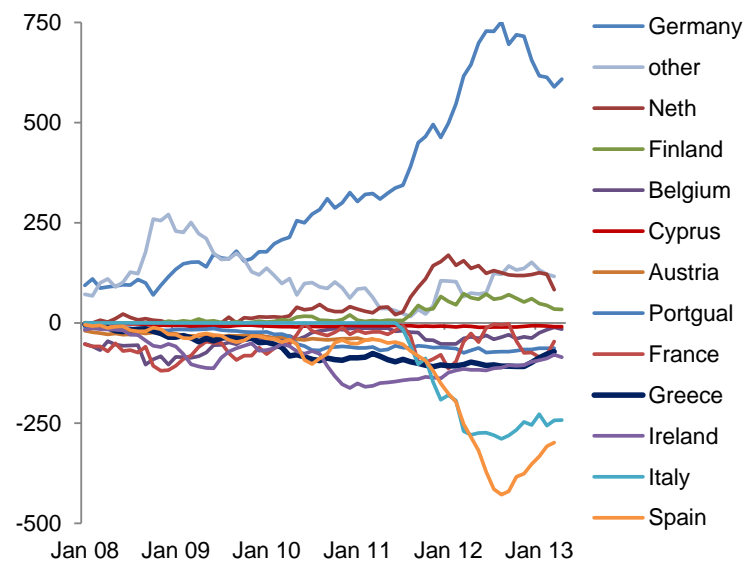
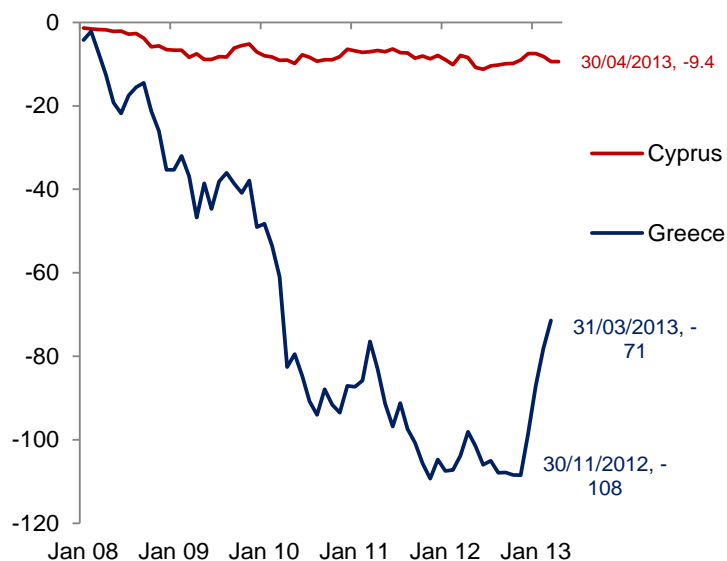
Russian Board member

- “we wonder to what extent the obvious complacency of the Cypriot bankers stemmed from the fact that in 2010-2011 the Fund had been actively supporting an illusion that Greek public debt was sustainable.”
- will most likely not hold even for 2013, not to mention a longer period.”
- “It is often said now that the whole business model of Cyprus relying on an over-extended financial sector was unsustainable and doomed to fail. We believe this conclusion is not fully supported by the facts, at least at this stage.”

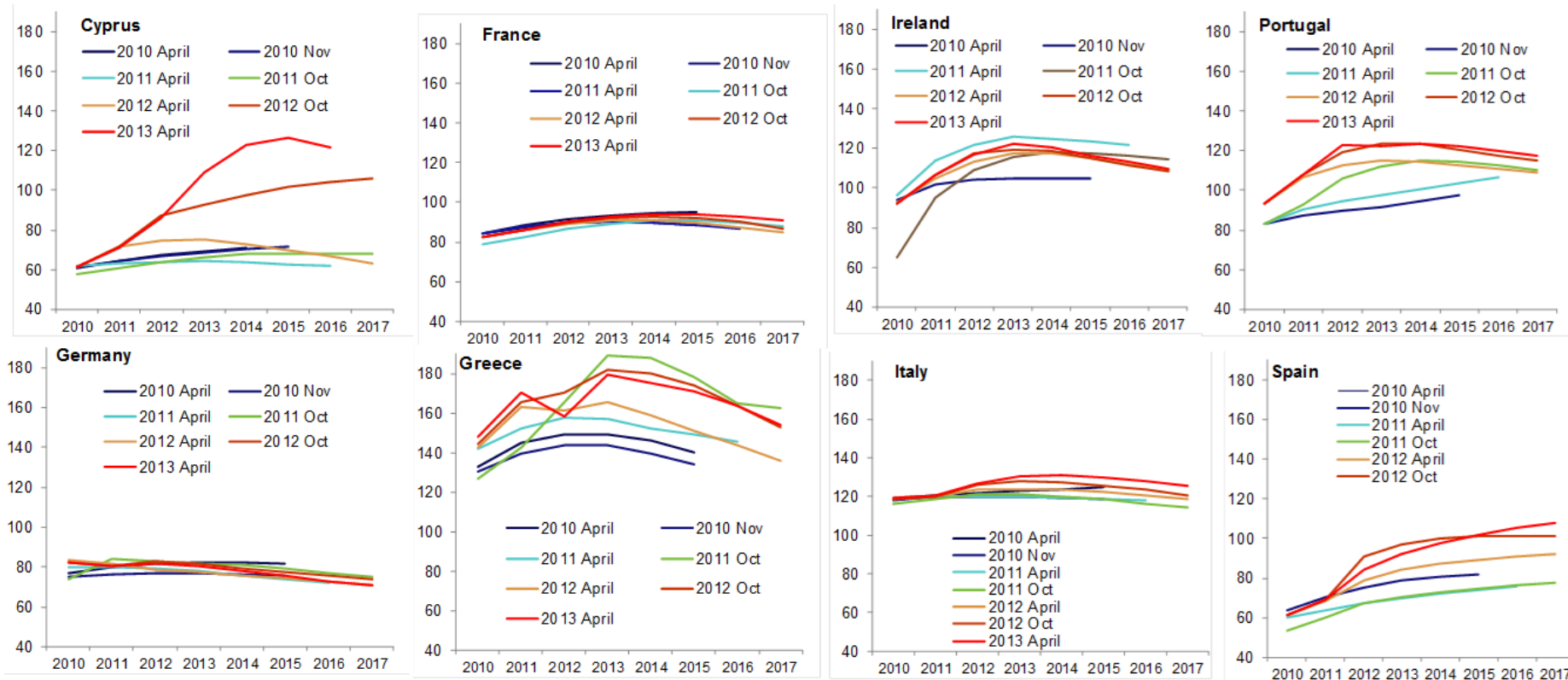
General lessons

- Uncertainty about Germany's preferred policy responses has increased (softer than expected in Greece, tougher in Cyprus, both for ESM injections)
- Germany showing signs of weariness with programmes that go off track
- Germany learned the weak are only willing to take brinksmanship so far
- Apparently healthy political allegiances may be discarded
- Vulnerable assets may be caught by contagion fears
- Germany more worried about direct liability (Greece than contagion)

Target2 imbalances between central banks in eurozone, in Greece, Cyprus (first chart), and rest of Eurozone (second chart)
(source: Bloomberg)



Not just Greece and Cyprus: (IMF debt-to-GDP projections in selected Euro Area countries, source IMF WEOs)



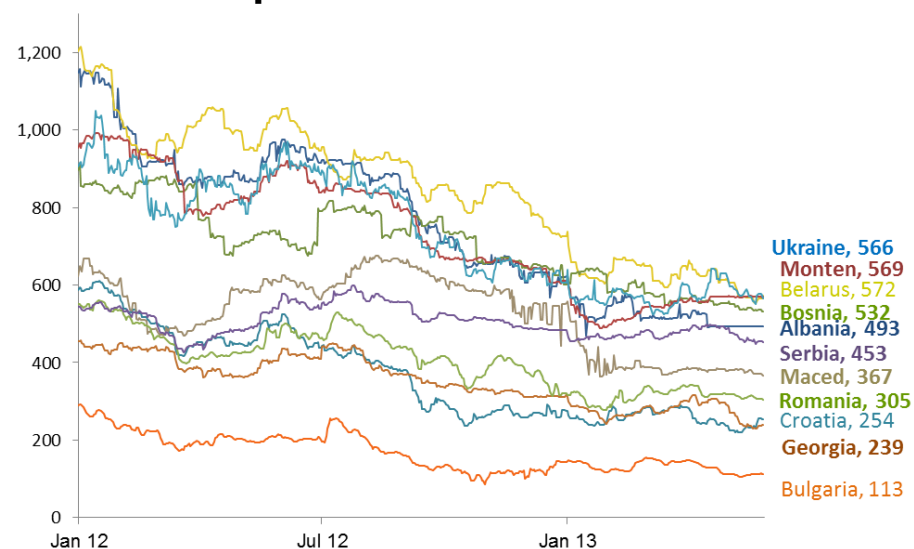
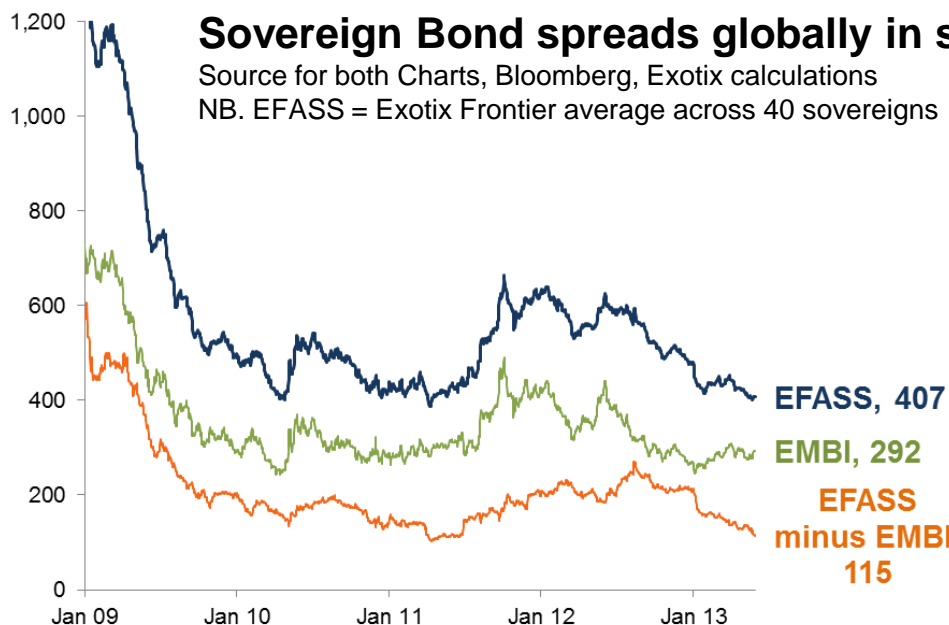
Questions, questions

- Will the eurozone economies recover before politics implode?
- When will economies turn around/deleveraging reverse?
- Will Germany become a minority of one?
- What are the potential triggers going forward?
- Does it matter given apparently limitless faith in the euro?

Sovereign Bond spreads globally in selected European EM

Source for both Charts, Bloomberg, Exotix calculations

NB. EFASS = Exotix Frontier average across 40 sovereigns



- Rally highly correlated across all EM and frontier markets
- Higher the risk, the bigger the rally
- Highly correlated rally with low volatility so far...
- EM a slave to global developments (in positive way so far, golden handcuffs)
- Hard to find negative triggers (outside the Fed)

- Euro-crisis built on hugely costs incentive mismatches between north and south of Europe...
- ...fuelled by IMF policy mistakes
- Rally built on Merkel's decision to not let Greece exit, then ECB's OMT, Fed and Bank of Japan
- But harder to generate recovery in real economy
- Lots of political risks
- But southern European societies have high pain tolerance...
- ...So plenty of time for seeds of recovery to germinate.



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