



## Greece - The fire is out, but there are still problems

Markets initially rallied on the back of the latest stabilisation measures for Greece. In this Point of View, AXA's Chief Investment Officer Mark Dutton considers whether the package is big enough to contain the situation.

### In brief

- The magnitude of the €750 billion stabilisation package announced last week largely surprised financial markets.
- It buys time for Greece and other troubled countries in the Euro periphery to get their financial houses in order.
- The plan requires Greece to reduce its budget deficit to under 3 per cent of GDP by 2014 – it's currently around 13.6 per cent of GDP.
- Risks still remain – recent events indicate the difficulties that other countries will face in getting their debt levels under control.

### At some point the numbers have to add up

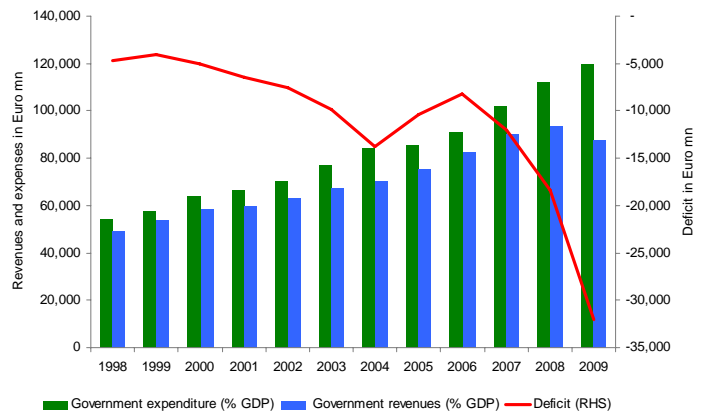
The problem in Greece is both simple and complex. The Greek government has spent years overspending and understating its budget deficit to the wider market. Recent events have shown this kind of situation can't continue forever – at some point the numbers have to add up.

This is where the situation becomes more complex. Figure 1 shows the degree to which Greece's expenditure has been out of control. The red line shows the escalating budget deficit.

The numbers are huge. Over the space of 10 years, Greece's budget deficit has increased from just over €5 billion to almost €33 billion. If we look at the situation in relation to Greece's economy, the budget deficit has almost quadrupled over the past 10 years to 13.6 per cent of GDP.

The problem is that Greece, on its own, can't keep financing this amount of debt until its budget position improves. In an effort to stabilise financial markets and prevent another global financial crisis (GFC) occurring, Europe's leaders surprised the markets by creating a €750 billion stabilisation package.

Figure 1: Greece expenditure out of control



Source: OECD; Bernstein analysis

### Is €750 billion enough?

The €750 billion stabilisation package is a bigger rescue measure than many investors anticipated. It has largely met the initial challenge of stabilising markets and preventing contagion to other markets.

Importantly, it not only supports the €125 billion funding requirements for Greece between now and the end of 2012, but also those of Portugal, Ireland and Spain which require a further €560 billion.

But whether €750 billion is enough largely depends on whether Greece and other Euro area countries use the 'time' this stabilisation package has bought to get their financial houses in order.

### Significant risks still remain

This is a key risk because of the pain it will inevitably entail. In agreeing to the rescue package, Greece needs to reduce its deficit to 3 per cent of GDP in the next four years.

It's always easier to spend more than less. It will be very difficult for Greece to reverse the

budget deficit in less than half the time it took to reach current levels of around 13.6 per cent.

Compounding this problem is that a large portion of Greece's economy operates as a black market and the mechanisms are not in place for the government to easily cut expenses and collect revenue.

There are also some risks with the stabilisation package itself. First of all, only €60 billion of the €750 billion of funds provided by the European Commission is available at short notice.

The bulk of the funds, provided by the new Special Purpose Vehicle (SPV), need to be approved by national parliaments. This creates a degree of uncertainty for the markets in terms of decisions being made in a timely manner.

#### ***The financial support package***

There are several elements to the €750 billion support package:

- The first is €60 billion of short-term financing provided by the European Commission. This facility can be activated quickly as it does not require approval in national parliaments.
- The second is a €440 billion SPV which will require parliamentary approval in most Euro-area countries.
- The IMF will also contribute a further €250 billion.

#### **What this means for investors**

The financial support package for the Euro-area periphery has been positive for the countries involved and the broader market. It has significantly reduced the risk of contagion to other markets in the short term.

Recent events have highlighted that heightened volatility is likely to be an ongoing feature of the recovery. Greece is by no means the only country that needs to get its financial house in order.

Other western countries outside the Euro-periphery area, such as the UK, will also face tough challenges in reducing budget deficits in years ahead.

The impact on fixed-income markets is already being felt. Yields relative to standard Euro bond rates had risen to historic levels and the stabilisation package has brought them back in.

Two years ago, governments around the world stepped up to the plate and implemented unprecedented measures to prevent a deep and sustained recession.

In doing so, they bought time and gave banks the opportunity to rebuild their balance sheets. The subsequent recovery has exceeded expectations.

Last week's stabilisation package shows that Europe's leaders are prepared to get ahead of the curve. Europe's peripheral countries now have a similar opportunity – and they need to make the most of it.

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