

# Global risk watch

## Greek euro exit: near-term risk, medium-term likely

- We now see a 20–25% probability that Greece will leave the euro in 2012 and a greater than 50% probability that it will leave within the next 12 months.
- After the Greek elections we lowered our probability assessment to mid-single digits for six months and 20–25% over 12 months.
- However, we now see signs that we may have underestimated the near-term exit risk, due to factors such as the protracted bailout negotiations and the IMF and Germany's declining commitment to continue supporting Greece.

In our 18 June assessment of the Greek election results, we expected an agreement on a slightly modified Memorandum of Understanding to be reached within a few weeks. This did not happen, and current plans indicate that a new round of negotiations may be necessary by September, while the Greek demands and the concessions acceptable for the International Monetary Fund (IMF) and Eurozone representatives still appear a long way away from each other. Prolonged inactivity on reforms in Greece this year has greatly increased the amount of financing it needs, by up to EUR 50bn, just to have a chance to reach initial plan targets. Major contributors like the IMF and Germany look increasingly frustrated and hesitant to commit further support funds.

### Change of mood

We see the following qualitative observations as a further indication that we should now raise our exit risk assessment:

1. German Vice Chancellor Rösler openly said in a 22 July interview that a Greek exit from the euro is much less scary today, and other members of the German government have also insisted on the initial targets for Greece. While this may be seen as a means of putting pressure on Greece to sign the memorandum, we notice that there has been a clear shift from the past political mantra that an exit from the euro is not an option. Also, these comments remind us of the way policymakers prepared markets for the March 2012 Greek default by gradually moving from their long-held "there will be no default in the Eurozone" position towards the view that a default was inevitable.
2. Statements from IMF officials indicate that the fund is considering ending its involvement in Greece. If the IMF does in fact end its involvement, several core European countries, possibly including Germany, would most likely end their support for the country as well.

**Thomas Wacker**, CFA, analyst, UBS AG  
thomas.wacker@ubs.com

**Jürg de Spindler**, PhD, economist, UBS AG  
juerg.de-spindler@ubs.com

**Dirk Effenberger**, strategist, UBS AG  
dirk.effenberger@ubs.com

### Related research reports

- Eurobonds – wrong way out of the crisis, 10 July 2012
- Why investors should read the summit statement, 3 July 2012
- Exit risk reduced by Greek election results, 18 June 2012
- The risk of Greece exiting the euro, 18 May 2012
- Italy tries a U-turn on the road to nowhere, 8 May 2012
- Spanish and Italian yields likely to rise further, 18 April 2012
- Greece's orderly default, 12 March 2012
- Demystifying the TARGET2 issue, 13 February 2012
- Portugal's agony of austerity, 6 February 2012
- Breaking up the Eurozone: Unlikely but not unthinkable, 19 January 2012

Source: UBS

The above-mentioned statements could be interpreted as an attempt to provide tactical support to the Greek government, which is currently in a process of hard domestic negotiations with social partners about an austerity package of EUR 11.5bn. Nevertheless, we think that these quite explicit statements could also signal that government officials intend to prepare the public for this possible event.

### **Greece as a pawn sacrifice**

Italy and Spain have so far supported keeping Greece within the euro, since they feared the massive contagion risk an exit would present for their banking systems and government bond markets. However, both countries are currently under massive pressure already with banks unable to tap the market and government bond yields at record premiums over German Bunds. The vague statements following the EU and Eurozone summit on 28–29 June demonstrated that the core countries and the European Central Bank (ECB) are hesitant to provide massive support to Italy and Spain, for example in the form of large-scale bond purchases in the secondary market.

Allowing Greece to leave the euro could provide a new justification for core countries to commit to further support measures: preventing contagion, in particular to Spain and Italy. Possible extraordinary measures could include a European Stability Mechanism (ESM) banking license, and the ECB may be willing to engage in support measures like bridge financing the otherwise less powerful support entities European Financial Stability Facility (EFSF) and ESM (through its fiscal agent role), bond purchases, Long Term Refinancing Operations (LTRO) and more monetary easing. A Greek exit would pose a significant risk to financial stability and could allow the use of emergency law to take measures that would otherwise be impossible under national law, international treaties or central bank statutes.

### **The timing of a Greek exit**

Our current assessment of an exit risk of 20–25% within 2012 implies that we continue to believe the Greek government and its creditors will agree on a new memorandum over the coming months. However, the risk of this not materializing has increased significantly compared to our post-election assessment in June.

In our 18 May publication, "The risk of Greece exiting the euro," we indicated a greater than 50% exit probability within a three-year horizon. We have now shortened this time horizon to 12 months, maintaining our baseline view that Greece will ultimately leave the euro. However, we are now less convinced by our earlier assessment that most of the Eurozone countries would be committed to providing further support in order to prevent an exit for longer. In particular, the argument based on preventing contagion to other peripheral countries has weakened substantially, in our view, since Spain and Italy are under massive pressure anyway and could benefit from the support that may be forthcoming in the wake of a Greek exit.

### **How an exit may occur**

We have described the process and consequences of a country leaving the euro in our previous Risk Watch publications as well as our 19 January note, "Breaking up the Eurozone: Unlikely but not unthinkable." For the current risk case of a near-term Greek exit from the euro, we think that failed negotiations with the IMF, Eurogroup and ECB (the "Troika") may result in the IMF withdrawing support. Without the IMF on board, several euro member countries may be unwilling to provide further support. Greece could wind up unable to service its debt in the absence of external funding, and thus may need to introduce an internal form of payment to compensate state employees. This new internal currency could then gradually replace the euro. In a scenario where Greece starts to issue currency at its own dis-

# Global risk watch



cretion, the Eurosystem – consisting of the ECB and the Eurozone national central banks – is very unlikely to continue extending credit to the Bank of Greece through the European payment system (TARGET2). This step would de facto mean a cut-off from the Eurosystem. We refer to a more detailed explanation in our 13 February publication, "Demystifying the TARGET2 issue."






There is no legally defined process for an exit from the euro, but Greece would theoretically need to leave the European Union (EU). However, we believe that such hurdles can be overcome if there is the political will to ensure that Greece can remain part of the EU.

## Conclusions

- We think that Greece will ultimately need to leave the euro.
- The risk of this happening in 2012 is significant, but it is not our base-line scenario.
- Over 12 months, we see a greater than 50% probability that Greece will exit the euro.
- We will reassess these probabilities after more details are available, in particular the final Troika report.

**Fig. 1: Asset Class impact of main risk scenario (major risk in case of several risk scenarios)**

| Risk Factor   | Likelihood  |   | Impact      |              |                |             |             |                           |               |                |                |     |            |     |               |             |                 |        |                    |
|---|---|---|-------------|--------------|----------------|-------------|-------------|---------------------------|---------------|----------------|----------------|-----|------------|-----|---------------|-------------|-----------------|--------|--------------------|
|   | Current   | Previous  | Equities    |              |                |             |             | Fixed Income              |               |                |                |     | Currencies |     |               | Commodities |                 | RE     |                    |
|   |   |   | US equities | EMU Equities | Swiss Equities | UK equities | EM equities | Gov. (benchmark) Bonds DM | Gov. Bonds EM | Corp. Bonds IG | Corp. Bonds HY | USD | EUR        | CHF | EM currencies | Base metals | Precious metals | Energy | Listed Real Estate |
| <b>Risk Scenario (Prob. &gt;50%): Greece exits the Eurozone</b> |  |  | -           | ---          | -              | --          | --          | +                         | -             | -              | -              | ++  | --         | --  | -             | --          | -               | --     | n.a.               |

Probabilities:  <10%  10-20%  20-30%  30-40%  >50%

Source: UBS CIO WM Research. Impact ranges from +++ (very strong positive impact) over n (neutral) to --- (very strong negative impact).

## Appendix

### Global Disclaimer

UBS CIO WM Research is published by Wealth Management & Swiss Bank and Wealth Management Americas, Business Divisions of UBS AG (UBS) or an affiliate thereof. In certain countries UBS AG is referred to as UBS SA. This publication is for your information only and is not intended as an offer, or a solicitation of an offer, to buy or sell any investment or other specific product. The analysis contained herein is based on numerous assumptions. Different assumptions could result in materially different results. Certain services and products are subject to legal restrictions and cannot be offered worldwide on an unrestricted basis and/or may not be eligible for sale to all investors. All information and opinions expressed in this document were obtained from sources believed to be reliable and in good faith, but no representation or warranty, express or implied, is made as to its accuracy or completeness (other than disclosures relating to UBS and its affiliates). All information and opinions as well as any prices indicated are current as of the date of this report, and are subject to change without notice. Opinions expressed herein may differ or be contrary to those expressed by other business areas or divisions of UBS as a result of using different assumptions and/or criteria. At any time UBS AG and other companies in the UBS group (or employees thereof) may have a long or short position, or deal as principal or agent, in relevant securities or provide advisory or other services to the issuer of relevant securities or to a company connected with an issuer. Some investments may not be readily realizable since the market in the securities is illiquid and therefore valuing the investment and identifying the risk to which you are exposed may be difficult to quantify. UBS relies on information barriers to control the flow of information contained in one or more areas within UBS, into other areas, units, divisions or affiliates of UBS. Futures and options trading is considered risky. Past performance of an investment is no guarantee for its future performance. Some investments may be subject to sudden and large falls in value and on realization you may receive back less than you invested or may be required to pay more. Changes in FX rates may have an adverse effect on the price, value or income of an investment. We are of necessity unable to take into account the particular investment objectives, financial situation and needs of our individual clients and we would recommend that you take financial and/or tax advice as to the implications (including tax) of investing in any of the products mentioned herein. This document may not be reproduced or copies circulated without prior authority of UBS or a subsidiary of UBS. UBS expressly prohibits the distribution and transfer of this document to third parties for any reason. UBS will not be liable for any claims or lawsuits from any third parties arising from the use or distribution of this document. This report is for distribution only under such circumstances as may be permitted by applicable law. In developing the Chief Investment Office economic forecasts, CIO economists worked in collaboration with economists employed by UBS Investment Research. Forecasts and estimates are current only as of the date of this publication and may change without notice.

**External Asset Managers / External Financial Consultants:** In case this research or publication is provided to an External Asset Manager or an External Financial Consultant, UBS expressly prohibits that it is redistributed by the External Asset Manager or the External Financial Consultant and is made available to their clients and/or third parties. **Australia:** 1) **Clients of UBS Wealth Management Australia Ltd:** This notice is distributed to clients of UBS Wealth Management Australia Ltd ABN 50 005 311 937 (Holder of Australian Financial Services Licence No. 231127), Chifley Tower, 2 Chifley Square, Sydney, New South Wales, NSW 2000, by UBS Wealth Management Australia Ltd.: This Document contains general information and/or general advice only and does not constitute personal financial product advice. As such the content of the Document was prepared without taking into account the objectives, financial situation or needs of any specific recipient. Prior to making any investment decision, a recipient should obtain personal financial product advice from an independent adviser and consider any relevant offer documents (including any product disclosure statement) where the acquisition of financial products is being considered. 2) **Clients of UBS AG:** This notice is issued by UBS AG ABN 47 088 129 613 (Holder of Australian Financial Services Licence No 231087): This Document is issued and distributed by UBS AG. This is the case despite anything to the contrary in the Document. The Document is intended for use only by "Wholesale Clients" as defined in section 761G ("Wholesale Clients") of the Corporations Act 2001 (Cth) ("Corporations Act"). In no circumstances may the Document be made available by UBS AG to a "Retail Client" as defined in section 761G of the Corporations Act. UBS AG's research services are only available to Wholesale Clients. The Document is general information only and does not take into account any person's investment objectives, financial and taxation situation or particular needs. **Austria:** This publication is not intended to constitute a public offer or a comparable solicitation under Austrian law and will only be used under circumstances which will not be equivalent to a public offering of securities in Austria. The document may only be used by the direct recipient of this information and may under no circumstances be passed on to any other investor. **Bahamas:** This publication is distributed to private clients of UBS (Bahamas) Ltd and is not intended for distribution to persons designated as a Bahamian citizen or resident under the Bahamas Exchange Control Regulations. **Bahrain:** UBS AG is a Swiss bank not licensed, supervised or regulated in Bahrain by the Central Bank of Bahrain and does not undertake banking or investment business activities in Bahrain. Therefore, Clients have no protection under local banking and investment services laws and regulations. **Belgium:** This publication is not intended to constitute a public offering or a comparable solicitation under Belgian law, but might be made available for information purposes to clients of UBS Belgium NV/SA, a regulated bank under the "Commission Bancaire, Financière et des Assurances", to which this publication has not been submitted for approval. **Canada:** In Canada, this publication is distributed to clients of UBS Wealth Management Canada by UBS Investment Management Canada Inc.. **Dubai:** Research is issued by UBS AG Dubai Branch within the DIFC, is intended for professional clients only and is not for onward distribution within the United Arab Emirates. **France:** This publication is distributed by UBS (France) S.A., French "société anonyme" with share capital of € 125.726.944, 69, boulevard Haussmann F-75008 Paris, R.C.S. Paris B 421 255 670, to its clients and prospects. UBS (France) S.A. is a provider of investment services duly authorized according to the terms of the "Code Monétaire et Financier", regulated by French banking and financial authorities as the "Banque de France" and the "Autorité des Marchés Financiers". **Germany:** The issuer under German Law is UBS Deutschland AG, Bockenheimer Landstrasse 2-4, 60306 Frankfurt am Main. UBS Deutschland AG is authorized and regulated by the "Bundesanstalt für Finanzdienstleistungsaufsicht". **Hong Kong:** This publication is distributed to clients of UBS AG Hong Kong Branch by UBS AG Hong Kong Branch, a licensed bank under the Hong Kong Banking Ordinance and a registered institution under the Securities and Futures Ordinance. **Indonesia:** This research or publication is not intended and not prepared for purposes of public offering of securities under the Indonesian Capital Market Law and its implementing regulations. Securities mentioned in this material have not been, and will not be, registered under the Indonesian Capital Market Law and Regulations. **Italy:** This publication is distributed to the clients of UBS (Italia) S.p.A., via del vecchio politecnico 3, Milano, an Italian bank duly authorized by Bank of Italy to the provision of financial services and supervised by "Consob" and Bank of Italy. **Jersey:** UBS AG, Jersey Branch, is regulated and authorized by the Jersey Financial Services Commission for the conduct of banking, funds and investment business. **Luxembourg:** This publication is not intended to constitute a public offer under Luxembourg law, but might be made available for information purposes to clients of UBS (Luxembourg) S.A., a regulated bank under the supervision of the "Commission de Surveillance du Secteur Financier" (CSSF), to which this publication has not been submitted for approval. **Mexico:** This document has been distributed by UBS Asesores México, S.A. de C.V., a company which is not subject to supervision by the National Banking and Securities Commission of Mexico and is not part of UBS Grupo Financiero, S.A. de C.V. or of any other Mexican financial group and whose obligations are not guaranteed by any third party. UBS Asesores México, S.A. de C.V. does not guarantee any yield whatsoever. **Singapore:** Please contact UBS AG Singapore branch, an exempt financial adviser under the Singapore Financial Advisers Act (Cap. 110) and a wholesale bank licensed under the Singapore Banking Act (Cap. 19) regulated by the Monetary Authority of Singapore, in respect of any matters arising from, or in connection with, the analysis or report. **Spain:** This publication is distributed to clients of UBS Bank, S.A. by UBS Bank, S.A., a bank registered with the Bank of Spain. **UAE:** This research report is not intended to constitute an offer, sale or delivery of shares or other securities under the laws of the United Arab Emirates (UAE). The contents of this report have not been and will not be approved by any authority in the United Arab Emirates including the UAE Central Bank or Dubai Financial Authorities, the Emirates Securities and Commodities Authority, the Dubai Financial Market, the Abu Dhabi Securities market or any other UAE exchange. **UK:** Approved by UBS AG, authorized and regulated in the UK by the Financial Services Authority. A member of the London Stock Exchange. This publication is distributed to private clients of UBS London in the UK. Where products or services are provided from outside the UK, they will not be covered by the UK regulatory regime or the Financial Services Compensation Scheme. **USA:** This document is not intended for distribution into the US and / or to US persons. UBS Securities LLC is a subsidiary of UBS AG and an affiliate of UBS Financial Services Inc., UBS Financial Services Inc. is a subsidiary of UBS AG.

Version 05/2012.

© UBS 2012. The key symbol and UBS are among the registered and unregistered trademarks of UBS. All rights reserved.