Global risk watch

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

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- 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.

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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-

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
Risk Scenario (Prob. >50%): Greece exits the Eurozone			-	---	-	--	--	+	-	-	-	++	--	--	-	--	-	--	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

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