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Credit FAQ:

Sovereign Rating Implications Of A Possible Greek Withdrawal From The Eurozone

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Table Of Contents

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In 13 days Greece returns to the polls in another attempt to elect a viable government. The fate of Greece's position within the European Economic and Monetary Union (eurozone) could hang on the outcome. But if Greece were to exit, what would be the impact on the country, its creditors, including the European Central Bank (ECB, AAA/Stable/A-1+), and the eurozone as a whole?

Here, Standard & Poor's Ratings Services provides its views on questions investors and others have asked on the potential implications should Greece indeed abandon the euro.

FREQUENTLY ASKED QUESTIONS

In your opinion, has the likelihood of a Greek exit from the eurozone increased following the previous inconclusive parliamentary election?

Yes, we now believe there is at least a one-in-three chance that Greece (Hellenic Republic; CCC/Stable/C) will exit the eurozone. The May 6 parliamentary elections failed to generate a viable majority, so citizens will return to the polls on June 17. The outcome of that election remains highly uncertain. Greece's political landscape is in flux, and the center has diminished. Many Greeks hold the center-left PASOK (Panhellenic Socialist Movement) and center-right New Democracy responsible for the deep economic and social crisis. As a result, other political groups have benefited from popular support--particularly Syriza, which is a loose coalition of 13 parties of the left that broadly reject the conditions of the EU International Monetary Fund (IMF) program.

While opinion polls suggest that a large majority of Greeks favor staying in the eurozone, the fiscal and structural reforms that had been agreed with the troika--the European Commission (EC), IMF, and ECB--have become increasingly unpopular as the economic and employment crisis deepens, wages decline, and a return to growth appears more remote. Because Greece's public sector employs more than one-quarter of all working Greeks, we expect a large segment of the voting population will be inclined to oppose any party that supports the current EU/IMF program, as it includes a commitment to eliminate 150,000 state jobs or 15% of the total, as well as further planned reductions in public spending.

We see a possibility that the elections could lead to the formation of a government fundamentally opposed to the implementation of the program's current conditions. At the same time, we believe that the willingness of Greece's European partners to tolerate sustained and significant deviations from the program's conditions is diminishing. Greece's noncompliance with program conditions could therefore lead to a cessation of disbursements from the IMF and Greece's European partners.

What do you think could happen were disbursements to stop?

In our view, cessation of disbursements would lead to another default (as defined by Standard & Poor's criteria) on Greek sovereign obligations. On Aug. 20, 2012, the government is due to make a €3.1 billion payment to the Eurosystem (comprising the ECB and eurozone national central banks) on its holdings of Greek government debt. In the absence of a disbursement of EU/IMF lending to Greece before that payment date, we would expect that official creditors, potentially including the ECB, would incur losses, after having been exempted in the restructuring earlier this year.

Any discontinuation of official disbursements to Greece could also--if Greece remained in the eurozone--force the Greek government to immediately balance its cash budget, as no meaningful new official or private financing would be forthcoming, with the possible exception of limited bill auctions. Greece still has a sizable fiscal deficit even after deducting interest payments (the so-called primary deficit). Due to the demonstrated administrative and political difficulty of raising additional revenue, we believe the government may have no alternative but to progressively delay payments to suppliers, state employees, and pensioners. This would likely further fuel social discontent, with a possible radicalization of the political landscape.

We believe that in such an environment Greece's economic decline is likely to gain speed, with additional private sector job losses in its wake. Before any new government even reaches a definitive position on whether or not to implement the EU/IMF program, liquidity conditions for Greek commercial banks could worsen further. In our opinion, such a confluence of events could make the electorate more susceptible to populist and unconventional policy measures, and may embolden Greek leaders to prepare to leave the eurozone. After such a departure, the government would have at least one other funding option--to monetize the deficit. However, we generally expect that this option, should it be chosen, would lead to a rapid increase in inflation and an additional decline in real incomes.

We believe that any exit would likely be a domestic political decision. We understand that there is no legal instrument to expel a country from the eurozone, even if all the remaining eurozone countries felt inclined to expel Greece, which we consider very unlikely in the short term. Nevertheless, the ECB has the power to force the issue by refusing to accept Greek collateral, should the Greek government reject the program. This could, in turn, prevent the completion of a necessary ongoing recapitalization of the Greek banking system. However, given the ECB's mandate and its large holdings of Greek government bonds, combined with the Eurosystem's sizable TARGET2 (gross payments clearing system) exposures to the Bank of Greece (close to €100 billion as of April 2012), we believe the decision to definitively refuse Greek collateral would most likely only be taken after all other alternatives were explored.

What could be the economic consequences for Greece following an exit?

In our opinion, adopting a national currency is likely to be very costly for the Greek population. While temporarily reducing the cost of Greek exports relative to trading partners, an exit would not in itself sustainably cure any of the Greek economy's fundamental problems--as manifested in its lack of competitiveness and large imbalances. A moratorium on foreign debt servicing would initially improve Greece's current account deficit via a reduction of the deficit in the income balance. However, the remaining underlying current account deficit might prove extremely difficult to finance at an acceptable cost, hurting an economy so dependent on imported food (40% of total food consumption) and virtually all oil and gas consumed in the country. We believe that a rapid devaluation of the real effective exchange rate would, moreover, almost certainly diminish efforts to continue growth-enhancing supply-side reforms and correct the structural rigidities that have held back the Greek economy for decades. Unlike Argentina's (B/Negative/B) at the time of its devaluation, Greece's export sector is not visibly working below potential capacity. If it were, this potential could be tapped to drive growth at a more competitive exchange rate. Only Greece's tourism sector--now generating 11% less in current account receipts than at its 2008 high--might initially benefit. However, this sector is also relatively import-intensive and might suffer a reputational setback from the economic crisis and dissolving social cohesion. In Argentina it took several years and a buoyant global economy to significantly boost export performance. Greek inflation is also likely to surge as imports become more expensive, further reducing citizens' living standards.

While this might signal a return to the pre-eurozone stop-go pattern of Greek economic cycles, a eurozone exit could, in our view, have additional negative ramifications. Any indication of a Greek government seriously considering a eurozone exit is almost certain to lead to a run on deposits at Greek banks as savers try to avoid "drachmafication". This will bring down the remnants of an already debilitated Greek financial system--despite its late-May-receipt of €18 billion in recapitalization funds in the form of European Financial Stability Facility (EFSF; AA+/Negative/A-1+) securities--with state finances in no condition to prop up the banks. We expect that the introduction of a new currency would also lead to a likely wave of personal and corporate bankruptcies as debtors fail in their struggle to service euro-denominated obligations on devalued drachma incomes. While Greek lawmakers could legislate a currency conversion of private loans made under Greek law, this may be contested in overwhelmed courts and lead to problems at the creditor level. In any case, the Greek private sector has accumulated a large stock of debt contracted abroad, which remains payable in euros irrespective of decisions taken in Athens. The same holds true for the cash-strapped government, which we believe would be very likely to discontinue debt service. Shut out of access to trade financing and import insurance markets, Greece could find it challenging even to finance the import of basic necessities, such as energy and medicine.

How could this scenario affect Greece's fiscal performance?

With the financial sector insolvent, widespread private sector bankruptcies and disrupting litigation, the Greek economy would face increasing risks of prolonged economic depression. Government revenues would likely erode further, forcing the government to cut back on its own outlays. In other words, a euro exit scenario is likely to foster the downward spiral of economic contraction and fiscal austerity that the critics of the troika-inspired adjustment program hope to avoid. The current account deficit, which we presently expect to narrow to a still-high 6% of GDP for 2012, would be forced to close overnight once limited foreign exchange reserves ran out. Investment might remain depressed for a long time as the business environment deteriorates further and trust in the sanctity of contracts is eroded. With no foreign official or private creditor likely to grant credit to a Greek government in such an environment, the government may be tempted to fund its spending via advances from the Greek central bank. This could lead to inflationary pressures, further undermining the credibility of the new currency and hitting the living standards of the Greek population.

Do you believe any other eurozone members would follow a Greek exit?

While this potential exit scenario is, in our view, a clear negative for the creditworthiness of Greek issuers, including the sovereign, the impact on other so-called "peripheral" sovereigns is more uncertain.

Currently, we do not foresee any political party attaining power in the eurozone periphery that would support a eurozone exit. We believe that the hardships the Greek population would suffer were Greece to exit would dissuade any other member state from following suit. Other members' resolve to pursue adjustment programs could even strengthen when what we expect to be the negative consequences of leaving the eurozone become more tangible and observable. By the time the (highly uncertain) benefits of a Greek currency devaluation were felt, most program countries receiving troika financial support are likely to be closer to program conclusion and most of the unpopular policies would have been implemented. For these countries, social and political costs would have already been incurred, reducing political incentive to fundamentally change course.

In our view, should Greece actually withdraw, its European partners would provide additional support and flexibility, as appropriate, to dissuade additional eurozone departures. We believe that policymakers would be keen to demonstrate that Greece is a special case and would expect growing financial support and leniency in the face of slipping targets for other sovereigns embroiled in the debt crisis.

Accordingly, we currently do not consider that a Greek withdrawal would automatically have any permanently negative consequences for other peripheral sovereigns' prospects of continuing eurozone membership. For the same reasons, it is our base-case assumption that a Greek exit by itself would not automatically trigger further downward sovereign rating actions elsewhere. Much will depend, however, on the European policy reaction following a Greek exit.

What are the potential downside risks for weaker sovereigns in the eurozone?

We expect that a Greek exit would likely strengthen the resolve of other program countries to pursue reforms and avoid the economic consequences of an exit. We also consider it likely that the European partners and the IMF would take a very supportive stance in order to prevent concern regarding additional departures. Nevertheless, it remains uncertain whether these efforts would be perceived as sufficient in scope and scale. Moreover, while the signalling of a Greek exit would probably reinforce peripheral governments' commitment to structural reforms, it could also be highly negative, creating new and untimely pressures for the peripheral member states. It would, we believe most damagingly, establish that eurozone membership is reversible, implicitly reintroducing currency risk. Without a robust policy response from eurozone political and monetary authorities, a Greek exit may hasten further capital outflows from the periphery. This would likely lead to additional increases in real borrowing costs for governments and banks, further depressing economic growth prospects.

In such a fluid environment, we would argue that the ECB would likely respond vigorously. The timeliness and strength of the response by member state governments is less predictable. Without the existence of appropriately sized and flexible financial mechanisms, the likelihood of lastingly restoring confidence in major eurozone financial institutions over the near term is, especially at the periphery, doubtful.

We believe that a tentative policy response could result in the ratings on the affected sovereigns coming under downward pressure. If the national and European policy response were to prove inadequate to restore depositor and investor confidence, economic and financial problems could, in our view, escalate, including the possibility of sovereign debt restructurings in countries other than Greece.

At present, this turn of events is not our base-case scenario, as reflected in our current ratings. Nevertheless, we are also mindful that a policy response to a potential Greek exit that is insufficient to credibly arrest contagion could create significant additional downside pressure on sovereign ratings. This applies especially, but not necessarily exclusively, at the eurozone periphery.

In our view, Cyprus (BB+/Negative/B), due to the very large direct exposure of its banking system to the Greek economy (see "Exposure To Greece Poses Significant Risks For Cyprus, As Standard & Poor's Stress-Test Scenarios Show," published on April 14, 2011 on RatingsDirect) could be particularly affected by a Greek withdrawal. However, Portugal (BB/Negative/B), Ireland (BBB+/Negative/A-2), and Spain (BBB+/Negative/A-2) are also characterized by weak banking sectors. Moreover, a number of sovereigns on the periphery, including Italy (BBB+/Negative/A-2), remain vulnerable to market sentiment and rising debt funding costs.

How could the ECB be affected?

The Eurosystem is primarily exposed to Greece through three channels:

- Greek sovereign bonds purchased through the ECB's Securities Market Program (SMP, face value estimated at €50 billion);
- Greek collateral held in return for ECB loans (a total of €50 billion on Feb. 29, 2012); and
- The Bank of Greece liabilities for transactions over the TARGET2 payments system (€98 billion on April 30).

The Eurosystem's total exposure to Greece is about €200 billion. This is equivalent to just over 2% of 2011 eurozone GDP or more than one-quarter of estimated gross borrowing by eurozone sovereigns in 2012 (see "European Sovereign Borrowing To Stabilize In 2012 At Close To All-Time High Levels," published on April 30, 2012, on RatingsDirect). Any losses incurred by the ECB would be shared by all member national central banks. An entire loss of this exposure could wipe out the Eurosystem's equity of €86 billion (as of May 25, 2012). While additional financial buffers exist (namely the €399 billion in the Eurosystem's revaluation account), large losses on the Greek exposure may be likely, triggering a significant write-off.

A central bank does not need to comply with minimum regulatory capital requirements. Indeed, some central banks can successfully operate over extended periods of time with negative equity. Nevertheless, a significant erosion of its capital could weaken the ECB's perceived credibility, making a challenging task even harder. Capital replenishment through member states could be seen by investors as weakening the ECB's political independence. Replenishing the capital over a longer period by retaining profits would negatively, if only gradually, impact the budgetary outcomes of eurozone sovereigns, which previously received dividends.

The ECB avoided taking losses on its SMP holdings in the Greek debt exchange earlier this year (see "ECB Greek Bond Swap Results In Effective Subordination Of Private Investors," published on Feb. 24, 2012). In a Greek exit scenario, however, preferential treatment of the ECB is much more uncertain. The TARGET2 balance of the Greek central bank with the ECB would in our view also be at acute risk of non-service. In effect, these are liabilities of Greek banks with banks elsewhere in the eurozone, intermediated through the national central banks and the ECB. In an exit scenario, we believe many, if not all, Greek banks would almost certainly be insolvent and most of those balances unlikely to be recoverable. It is important to note, however, that these losses would also be borne by all national central banks in relation to their ECB capital contribution, independent of their individual TARGET2 balances.

The outlook on the ECB's unsolicited credit rating is stable (see "European Central Bank," published on May 31, 2012). We do not presently expect that the rating on the ECB would change in the wake of losses incurred by a Greek default, should it occur, as we generally do not believe that it would undermine the credibility of the ECB's institutional framework, its monetary flexibility, and the reserve currency status of the euro. We would also expect that the average subscription-weighted ratings of eurozone sovereigns would remain very strong (see "Standard & Poor's Ratings Definitions," published on May 23, 2012). Indeed, in the longer term the credibility of the euro may be enhanced following a departure of its weakest member.

What could be the outcome for Greece's official creditors should the country exit?

If Greece were to leave the eurozone, debt-service risks to its obligations to official creditors would rise appreciably, in our view. The share of official creditors in the sovereign's debt stock stood at just under 10% at the end of 2010, but will likely surpass 60% this year.

The IMF has so far disbursed just over €20 billion from its three-year standby agreement totalling €30 billion. We expect the IMF will be able to enforce its preferred creditor status and is likely to be paid back in full. Other official creditors may have to contemplate losses on their Greek exposure.

Cofinancing the IMF, eurozone member states have disbursed about €53 billion (out of a total €80 billion committed) in the context of the three-year program (2010-2013). We believe that these bilateral loans are in a weaker position than the IMF loan. The bilateral lenders are, in our view, unlikely to invoke preferred creditor treatment. Also, a Greek euro exit might occur under politically heated and acrimonious circumstances, reducing Greek incentives to honor that debt as agreed. Furthermore, given the dire economic circumstances that might surround an exit, the Greek government may not be able to service the obligations. The projected direct cost to the eurozone governments of a total write-off would be moderate at just above 0.5% of their respective GDPs. But the indirect cost of economic dislocation and potentially the need to support domestic banking institutions is likely to be greater. In the context of our sovereign rating analysis, the liabilities raised by eurozone member states' in order to finance bilateral loans to Greece are already incorporated into net government debt. On the other hand, we have not included the loans to Greece as general government assets due to their low liquidity and credit quality. Therefore, our view of net general government debt of the sovereign bilateral lenders is unlikely to be affected by a failure of the Greek government to service these obligations.

The European EFSF has long-dated exposure of €108 billion, of which about €70 billion was incurred in support of Greece's sovereign restructuring. Given that the EFSF is not designed to be a preferred creditor, it could also face significant loan losses, which the EFSF's eurozone sovereign guarantors are committed to bearing pro rata with their ECB shareholdings. The rating on EFSF would not be directly affected by a Greek default. Rather, our view of its creditworthiness depends solely on the credit quality of its sovereign guarantors. Greece has not been a guarantor on securities issued by the EFSF. Eventual losses on EFSF loans to Greece would trigger a call on the guarantee to the EFSF, extended by eurozone member states. Contrary to the accounting approach taken by Eurostat, the official European statistics office, Standard & Poor's decided not to include the EFSF liabilities pro rata on the central government debt stocks of the guarantors, but to treat them as contingent liabilities of the same (see "S&P Clarifies

Its Approach To Accounting For EFSF Liabilities When Rating The Sovereign Guarantors," published on Nov. 2, 2011). In the context of our sovereign rating analysis, this would imply a crystallization of the contingent liabilities related to the EFSF guarantees, as these would migrate to the governments' balance sheets, potentially pushing the respective sovereigns' net government debt higher. To the extent that such an increase implies deterioration in sovereign fiscal risk, as defined by our criteria (see "Sovereign Government Rating Methodology and Assumptions," June 30, 2011), this may lead to negative rating actions.

Among the rated multilateral lending institutions, the European Investment Bank (EIB, AAA/Negative/A-1+) has the largest absolute exposure to Greece, with €14.9 billion of disbursed loans by year-end 2011. Until now, the EIB, as well as other supranational lenders, has been able to enjoy preferred creditor treatment and has not been affected by the Greek debt restructuring earlier this year. Even a partial loan loss on this exposure might reduce the EIB's balance-sheet capital (€42.5 billion at year-end 2011) and could reach more than one-third of total capital in an extreme scenario of complete a write-off. The EIB's capital ratios, as measured according to our methodology for rating supranational entities, are lower than those of most other 'AAA' rated multilateral lending institutions. A hypothetical Greek default would weaken the EIB's relative capital position further and could exert pressure on the 'AAA' rating.

To what extent official creditors (with the exception of the IMF) might recover some of their claims would largely depend on the political environment, Greece's future relations with the EU, and the ultimate recovery of the Greek economy.

When would Standard & Poor's change the 'AAA' transfer and convertibility (T&C) assessment on Greece?

A T&C assessment reflects our opinion of the likelihood of a sovereign restricting nonsovereign access to foreign exchange needed for debt service. If a sovereign, through membership of a monetary or currency union, has ceded monetary and exchange rate policy responsibility to a monetary authority that the sovereign does not solely control, the T&C assessment reflects the policies of the controlling monetary authority vis-à-vis the exchange of its currency for other currencies in the context of debt service. A T&C assessment may change sharply if a sovereign introduces a new local currency by entering or exiting a monetary union, or through some other means. This is because the new local currency, and in some cases the new monetary authority, may operate under very different monetary and exchange regimes. The T&C assessment does not normally reflect the likelihood of a country leaving a monetary union and adopting a currency other than the common currency.

So, for eurozone members, including Greece, the T&C assessments reflect our view of the likelihood of the ECB restricting nonsovereign access to foreign exchange needed for debt service. As long as Greece remains a member of the eurozone, its T&C assessment remains at 'AAA'. Should Greece exit and introduce a new local currency, the T&C assessment would be reset to reflect our view of the likelihood of the Greek sovereign and its central bank restricting nonsovereign access to foreign exchange needed for debt service. Contrary to the current case, the euro would in this scenario be a foreign currency, and the T&C assessment would address the likelihood of restrictions on the ability to exchange new drachmas for euros, dollars, and other currencies needed for debt service. The Bank of Greece (the central bank) would no longer be part of the Eurosystem. Our T&C criteria allow the T&C assessment to be, at most, three notches above the sovereign foreign currency rating in countries where the sovereign controls its own currency.