



Economic Flash!

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Working Assumptions Regarding US Debt Ceiling and the Greek Situation

US Debt Ceiling

- Our working assumption is that an agreement will be reached by the deadline. There are some indications that the two sides will compromise on issues such as means-testing Medicare, a move to a chained consumer-price index, and tax loopholes. It is very clear that whatever the agreement is, it will not be comprehensive enough to provide a clear road-map towards reducing the deficit on a longer-term basis. Rather, we might get a short-term solution that will open the door for a debt ceiling increase of roughly \$2 trillion—enough to carry operations until the next presidential elections.
- A clear tail-risk of around 10%-20% probability (which is probably not priced in) is that an agreement will not be reached by the August 2nd deadline, but the government will be able to continue to service its debt for a period of time. During the month of August, the government will face maturing T-bills, notes and coupon payments of roughly \$200 billion. As indicated in our latest analysis of the situation (Economic Insights—June 29th) the government can use an array of maneuvering tools (mainly through prioritizing payments) to avoid technical default. But such a situation will force all rating agencies to put US debt on a negative watch. Under such a scenario the US dollar will lose ground, potentially a short-end to 1-year inversion of the yield curve, and equity sell-off—mainly in US markets.

The Greek Situation

- Filtering through all the noise, it appears that there are three possible responses to the crisis.
 1. Continued official lending for as long as needed—with a possible private sector involvement in a creative way that does not trigger a “credit event”.
 2. Pre-emptive restructuring with a significant face value reduction.
 3. A combination of options 1&2, accompanied with recapitalization of Greek banks.
- Our working assumption is that option 3 is the most likely outcome. Under this scenario, official lending will continue in order to buy time and prepare the market for an eventual restructuring.
- Given the potentially disastrous outcome of a rushed restructuring, the likelihood is that official lending will continue to be the main short-term solution while the framework for restructuring is being established. At this point, we see reduced probability of a private sector involvement (akin to the French proposals) given the fact that the rating agencies (and in many ways, the ECB) view it as de-facto default.

- So the next few months and quarters might see short-term relief as Greece continues to receive official money. Any positive market reaction during this period will probably be temporary and can be seen as a good exit point for investors.
- Hard restructuring of Greek debt means a roughly 40% face value reduction. This without a doubt will wipe out the capital base of the country's banking system—with major negative implications for the European financial system as a whole. This is not a probable option.
- Accordingly, any restructuring will have to be accompanied with recapitalization of Greek banks from official EU money, such as from the European Investment Bank, the EFSF (which will require a mandate change) or the Hellenic Financial Stability Fund (HFSF). Access to liquidity will be the main issue here. Note that Greek banks are presently funding €70 billion in mostly sovereign debt at the ECB. A probable solution here might be a Brady-type bond guaranteed by the EFSF and/or the establishment of an Exceptional Liquidity Assistance (ELA) facility by the Greek central bank.
- Bottom line: Greece will restructure, but this process will not start before the framework to recapitalize its banks is established. Meanwhile, expect official loans to continue to keep Greece afloat—with any improvement in market sentiment during that period to be seen as a potential exit point for investors.

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