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Daily Note

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Gambler's fallacy alive in Europe

Greece has finally secured a second bailout, which should support market sentiment in the short term. But it's unlikely this marks the end of the crisis. Even on unrealistically rosy Troika projections, Greek public debt levels remain unsustainable.

Reading through the EU's announcement on Greece, I'm reminded of a conversation I once had with an equity strategist at an investment bank. He assured me that he had a 'fool-proof' way of making money from playing Roulette in a casino (you can see where this is going...). The strategy goes like this. Choose a colour (black or red) and keep betting on it until you win. When you win, stop playing. Sounds simple but to make it work you have to double your stake every time you lose. This means that potential losses increase rapidly and there is a good chance you lose everything before you win back a single penny.

The EU is apparently in a similar position with respect to Greece. Every new bailout is needed just to protect the funds that have already been 'invested'. Even though some politicians are urging the EU to just walk away from the casino, this is not yet the consensus. And so, in the early hours of this morning, the authorities announced they had finally reached an agreement with Greece after weeks in which we were told an agreement was 'just hours away' – technically true though somewhat misleading. In the short term, this should support market sentiment for the simple reason that it buys time and global investors are desperate to think about something – anything – other than Greece and the EMU. But it's unlikely this marks the end of the euro crisis.

The headlines/details of the package were broadly as expected. Private creditors accepted a haircut of 53.5% on the nominal value of their Greek bonds, plus a smaller coupon for the new bonds, starting at 2% and rising to just over 4% in 2020. This is equivalent to a write-down of around 75% in net present value terms. EMU member states have also agreed to reduce the interest rate they charge Greece by 50bps (applied retrospectively). The ECB will apparently pay for this by redistributing the profits it has made on its Greek bonds to national central banks (which, apparently, is far too convoluted to constitute 'monetary financing'). Governments will also return any profits they make on their Greek bond holdings back to the Greeks to further support their fiscal position.

Overall, the Troika estimates that this package will reduce the Greek government debt ratio to around 120% of GDP in 2020. That is clearly a significant improvement on the current level of 160%, but I don't recall anyone believing it was sustainable last time it was around that level in 2009. It is also similar to level currently seen it Italy – again, hardly a wonderful benchmark for debt sustainability. (And Italy is better placed, given its higher GDP per capita and better medium-term growth outlook.)

This is worrying, but the most significant problem is that even these forecasts are optimistic. The Troika assumes that the new austerity policies will improve the Greek public finances but have only a modest impact on economic growth. In their 'baseline scenario', GDP is expected to contract by just over 4% in 2012 and then stabilize in 2013 before growing robustly (at over 2% pa) thereafter. This, of course, is ludicrous and runs counter to all the evidence accumulated over the past couple of years. The Greek economy contracted by around 7% in 2011, a year in which the Greeks were roundly accused of not pursuing austerity aggressively enough! Greece's economic outlook is still deteriorating.

The troika's leaked 'sustainability report' describes these projections as 'accident prone'. That's an understatement. As we've explained before, the EU's policies (all stick, no carrot) almost guarantee failure. Understandably, this has encouraged some EU countries to push for greater protection for their funds. So the latest agreement forces Greece to deposit three months worth of debt servicing payments into an escrow account, which a permanent team of Troika officials will monitor. In addition, the Greeks must also pass legislation making debt repayment the top priority of government spending (something that might never happen – as my colleague Brian Reading explained in his note this morning). Presumably these conditions were seen as important in order to encourage national parliaments in other EU countries to sign up to the agreement, something that could still undermine the bailout in the short term.

The gamblers want insurance, but all they realistically have is an external authority that will drag them out of the casino more quickly when it becomes clear their losses are still accumulating. That buys Greece a bit more time, but it doesn't change our forecast for eventual Greek exit. This is probably the last Greek bailout we will see, but not for the reasons the authorities are claiming. Neither the Greeks nor the EU will have the patience for another round of negotiations once this latest package unravels.

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