JVB Financial Group, LLC

CRONIN'S CORNER MONTHLY

A Perspective on the International Economy

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by Keith Cronin, JVB Senior Vice President of US Credits and International Sovereign Trading

It is agreed across the pantheons of scholarly thought that western civilization's origins can be definitively traced back to Ancient Greece. The Classical culture of ancient Greece has had an immense influence upon global culture and had even helped shape the foundations of mighty Rome. From Homer's literary magnificence to Hippocrates, the father of Medicine, to Pythagoras' and Archimedes' fulgurous scientific and mathematical doctrines the influence is immense. But magnificence can be ephemeral within the vastness of our planet's historical calendar. Fast forward two and a half thousand years and the shambled ruins of an ancient culture are symbolic of the shambled ruins of a contemporary one. Not culturally but at least, perhaps, economically.

The tail end of last year seemed destined to saunter into 2010 with a degree of optimism regarding the world's global health. Then news broke from the Middle East that Dubai World, a state owned corporation, had announced that they basically could not pay the interest bill on its outstanding debt. Although the nominal value of the outstanding debt wasn't astronomical, the specter of a possible default spooked the markets. Not long after the digestive period of this news, the Fitch rating agency cut Greece's long term debt rating to BBB+ from A- because of the country's ballooning budget deficit. This marked the first time in ten years that Greece's debt was rated below A and gives the Hellenic state the ignoble distinction of now being the only Euro area country with a Sovereign rating of less than A. The reaction of the markets was unambiguous. Equity markets sold off, Greek government yields and CDS soared and the Euro weakened across the board. The possibility of a Greek default would have staggering consequences for the Euro zone and thus that perception made the European unit's appeal evaporate. It is logical to assume perhaps that the European Union would not allow a member state to default on its debt. It would completely undermine the strength of the zone and further highlight the imbalances that exist there. However, one of the clauses of the Maastricht Treaty (the treaty that constitutes the birth of the Euro and the Euro zone) is that any member state cannot be bailed out by the community. So, whist constitutionally the Greeks cannot be bailed out, economically they cannot be allowed to default at all costs. However, we question the rigorous implementation of any constitutional law within the Euro-zone. Following the debacle of the Lisbon Treaty with the Irish voters, we think that if the Greek government needs a bailout, that they will get one. The laws will be re-written to appease. They've done it before. The only other alternative would be for Greece to leave the Euro-zone community. With its public deficit at close to thirteen percent of GDP – more than four times the EU's permitted level – one could argue that they should be forced to leave. This however, is not the image that Trichet, the ECB and the EU as a whole want to exude. The EU professes a United States of Europe. Dropping a member because of fiscal recalcitrance would completely undermine that doctrine and bring the whole existence of the Euro-zone and the Euro into question. We doubt it will come to this. The Greek's instead will be forced to under take some serious fiscal austerity measures. The Greeks have already proposed a three year budget plan that includes more than ten billion Euros in deficit reduction measures for this year alone. This is a start but probably not nearly enough and tougher measures will prove difficult to impose. The substantial degree of fiscal tightening that is required will have to be implemented against the backdrop of anemic economic activity. Thus, with the country facing soaring unemployment proposals to cut spending and raise taxes will obviously prove economically and politically distasteful to the Greek people. It is important that the Greek authorities remain resolute and convincing in their implementation of these measures. Any further downgrades (which at this stage we think may be inevitable) or further wobbles within the markets could exacerbate the problems facing the Greek government. As a result of the sell off in Greek debt, following the Fitch downgrade, the soaring yields has now made it more expensive for the government to borrow as long term rates are now higher. Another unfortunate resultant of the downgrade may be Greece's eligibility to use its Government bonds as collateral with the ECB as

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part of its funding operations. Since the inception of the financial crisis the ECB has poured liquidity into European institutions by accepting collateral against the loans that it was making. The minimum rating on any collateral that was accepted was initially A- but that was then reduced to BBB- as the crisis worsened. Whilst Greek debt is still three grades above this minimum requirement, the ECB could probably this year increase the requirement back up to A-. If this did happen and Greek banks were no longer able to use their country's sovereign debt as collateral we would continue to see yields soar. We doubt that the ECB would exclude Greek debt from its liquidity program but we think that countries like Germany will want to begin the process of reversing the availability of these emergency programs this year. The Greeks will have to act severely and swiftly.

The Greeks are not the only country in Europe facing a severe fiscal crisis. Countries like Ireland, Spain and even the UK will sooner rather than later have to impose severe austerity measures to puncture their swelling budget deficits. However, for now, most eyes will be upon Greece to see if the developing theatrics eventually result in a real Greek tragedy. •

Keith Cronin
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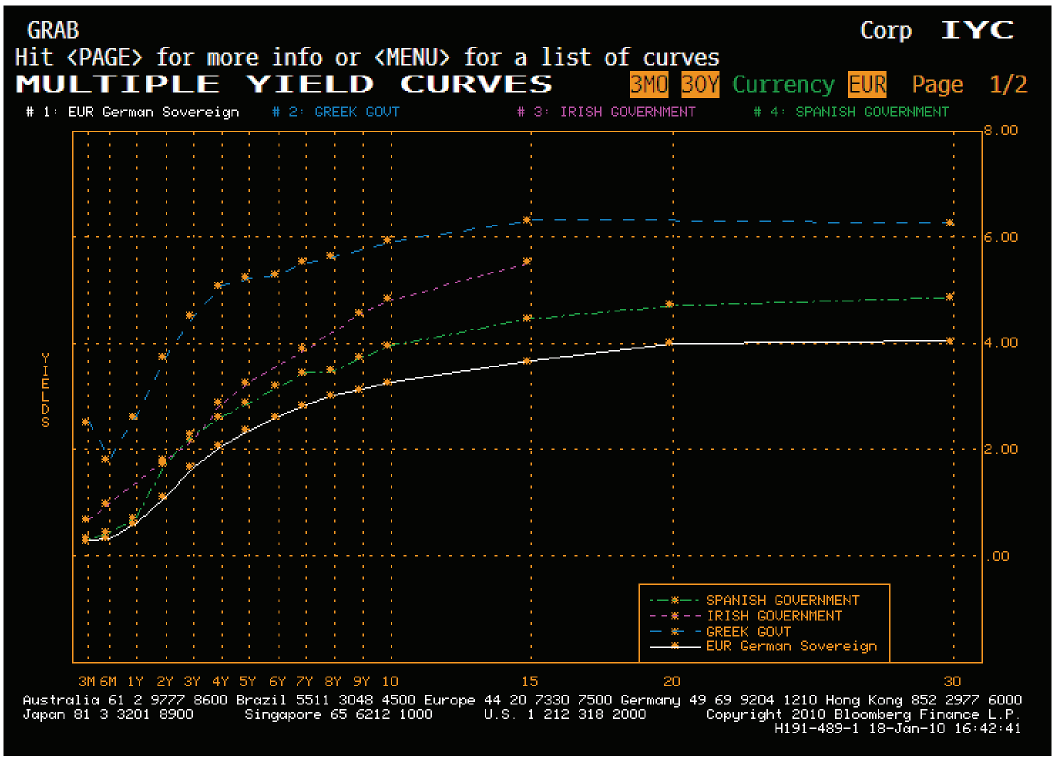

Source: Bloomberg 1/18/10

The downgrade of Greece's sovereign debt and the consequent rise in yields has now made it more expensive for the Greek Government to borrow.

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