

Strategy and economic research

Market Insights

KEY TOPICS

Greece: what are the real default risks?

The prospect of Greece defaulting seems exaggerated from the standpoint of economic fundamentals, although major structural reforms in the areas of statistics, accounting and tax are surely needed. Yet the country is currently beset by market and liquidity risks. The voicing of support by other eurozone member states is a timely way of venting pressures, but it creates longer-term problems.

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The eternal question of the Stability and Growth Pact

On Thursday, February 11, the European Union heads of state finally delivered the message that the financial markets were waiting for: if one country (Greece in this case) should have difficulty refinancing its debt in the markets, a certain form of internal euro area solidarity would be exercised. This statement, which says nothing about the mechanisms that would be implemented, should as a general rule alleviate the pressures seen in the sovereign bond markets of the euro area in the last several weeks. But it does not settle the question of consistency in euro area budgetary policy.

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China: where do we go from here?

A combination of country specific factors and global uncertainty has suddenly increased perception of Chinese risk. In this piece, we attempt to clarify the key issues and explain where our view differs from the extreme ends of the spectrum. Overall, we maintain our pragmatic stance: just as we had a hard time understanding the doomsayers in 2009, we find it difficult to understand the carefree bulls in 2010. Instead, we argue that a deeper understanding of China's macro dynamics will help avoid the symmetric bias that keeps shifting from worries about overheating, to indiscriminating fears of excessive tightening.

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Greece: what are the real default risks?

> Has Greece's productive base suffered a structural breakdown?

Greece's nominal GDP is nearly €250 billion. The European Commission estimates that in 2009 the real economy contracted by -1.1%, while inflation rose 1.4% on average. The recession was thus not very deep by comparison with the average performance in the eurozone (-4.0%), especially the "PIGS" (Portugal, Ireland, Greece and Spain, -4.7%). There are various explanations for this comparative resilience, rooted mainly in the country's economic structure. Greece did not experience significant internal imbalances in its property and credit markets during the 2001-2007 cycle. Consequently the recession caused neither a sharp fall in construction nor a steep drop in house prices, with the attendant consequences for employment and household wealth. This also helped to curb the momentum of private-sector lending, thus holding down the rise in domestic risky assets on banks' balance sheets. Unlike Spain and Ireland, where the property market occupied a dominant place in the pre-crisis economy and where deflation pressures have now taken hold, Greece is still focused on traditional activities. It therefore has the ability to rebound in the context of global recovery. The main sources of added value are in services (76%), as in most developed economies, with a special emphasis on tourism and transport (33%) because of the country's historic and geographic advantages. Thus, the prospect of a default cannot be explained fundamentally by a structural breakdown in Greece's productive base.

> Structural reforms are needed

Speculation on default is more directly attributable to management of public finances, where huge accounting and tax irregularities came to light in 2009. Last year Greece's government deficit was 12.7%, twice the official forecast. This naturally drew attention to transparency and credibility issues. Most of all, the current trajectory of government finances is unsustainable for a country where government debt reached 113% of GDP in 2009. In response, the European Commission initiated a sanction procedure against Greece, rating agencies lowered their ratings and some investors sold massive quantities of Greek government bonds.

These pressures prompted the authorities to take structural measures to organise their statistical system with greater independence. Simultaneously, a drastic fiscal austerity plan was ordered with a view to reducing the government deficit to 8.7% in 2010, then to 5.6% in 2011, and to bring it back under 3% in

2012. For the longer term, the economy's administrative costs must also be brought under control to improve structural competitiveness and reduce external imbalances. Naturally, it is too early to tell whether these measures will be effective. The 2010 government deficit target seems credible, at least. The government can rely on potential short-term levers to increase fiscal revenue. In 2009 a general election and social unrest spurred the former government, already vulnerable in the polls, to adopt a looser attitude toward the budget, and even to slacken its tax collection efforts.

> Market and liquidity risks

Although Greece has in fact approved substantial fiscal measures that will enable it to generate primary surpluses, this may not be enough to alter the trajectory of its government debt. Indeed, the positions taken by some investors in anticipation of a default could prove self-fulfilling. As the risk premia demanded by investors increase, interest costs automatically become more burdensome, and this could prove financially suffocating. To deal with this risk, on Thursday 11 February the eurozone countries expressed their solidarity, tantamount to an implied guarantee.

The aim of these measures is to curtail market risk, but investor confidence must be bolstered at the same time. The main risk to Greece's debt certainly stems from refinancing. The country is open, and most of its financing comes from non-residents, making the value of the debt very sensitive to international capital flows. This risk would naturally be heightened if the rating agencies were to downgrade Greece's bonds once again, and particularly if Moody's cuts its rating by two notches from the current level (A2). If so, Greece would lose its ECB eligibility. However, we believe that this scenario is unlikely. The ECB would certainly act pragmatically if necessary. Above all the support expressed by eurozone members has mitigated Greece's sovereign risk and should help to stabilise its rating.

On balance, although the prospect of Greece defaulting seems exaggerated from an economic standpoint, the eurozone's show of solidarity is still timely: it compresses market risk and wards off the threat of refinancing problems. However, that intervention may eventually have unintended consequences – for example, other member states may be tempted to relax fiscal discipline. It is therefore necessary to work out the terms and conditions of an insurance premium, and, more importantly, to rethink the structural aspects of the eurozone's institutions, especially as regards the Stability and Growth Pact.

Florian Roger

The eternal question of the Stability and Growth Pact

On Thursday, February 11, after the meeting of the European Union heads of state, Mr. Van Rompuy, President of the European Council, finally delivered the message that the financial markets were waiting to hear: "The euro-area member states will take determined and coordinated action if needed to safeguard financial stability in the euro area as a whole." In other words, if one country (Greece in this case) should have difficulty refinancing its debt in the markets, a certain form of internal euro area solidarity would be exercised. This statement, which says nothing about the mechanisms that would be implemented, should as a general rule alleviate the pressures seen in the sovereign bond markets of the euro area in the last several weeks. But it does not settle the question of consistency in euro area budgetary policy.

> When the spendthrift penalises the thrifty

After stating "that countries in difficulty had to find the appropriate budgetary resources alone" (German Chancellor Merkel), that "Greece had all his confidence to make the necessary decisions" (ECB President Trichet), the European authorities, traditionally reticent about any form of budgetary solidarity, finally understood that they could not leave one euro area country alone to its fate. The principal leaders in effect realised that a default in one euro area country could have as large an impact on the financial markets as the failure of Lehman Brothers. In particular, it would create the risk of a knock-on effect in other countries with weak financial positions, such as Italy and those referred to by the insulting acronym PIGS (Portugal, Ireland, Greece and Spain). It would also penalise the euro area as a whole, including the most financially solid countries: the credibility of the ECB would be seriously eroded, the euro would lose value (which for now would be positive, but detrimental in the medium term), the other member States would have to pay an additional risk premium and the European banking system as a whole would be weakened once again.

> A bridge loan is the most credible solution

The current crisis once again reveals that the European institutions are not suited to this type of situation. The Maastricht Treaty stipulates that the States of the European Union are not liable for the debts and commitments of other European States (art. 103). However, it sets out rescue measures in the case of exceptional circumstances "beyond its control" (art. 100). It appears difficult to evoke this particular case when a country has failed to sufficiently manage its public finances. The ECB also finds itself disadvantaged. The Maastricht Treaty prohibits the ECB from extending loans to States or buying State securities in the primary market. However, the ECB may purchase securities on the secondary market that it accepts as collateral, but it has never engaged in such transactions. This would truly be a last resort.

In order to avoid having a country experience a liquidity crisis, several financing methods have been mentioned, such as the issuance of a European Union bond, the mobilisation of structural funds, or the intervention of the European Investment Bank (EIB). These solutions are improbable, in particular because non-member countries of the euro area such as the United Kingdom or Sweden believe that this problem must be dealt with exclusively within the euro area. In addition, the most probable scenario is that a group of euro area countries (Germany, France, the Netherlands, etc.) would provide a bridge loan to help Greece weather the storm. In order for this type of loan to be accepted by their national parliaments, these countries will probably require a short maturity (6 or 12 months) and an attractive return, so as to state that their taxpayers will gain from showing solidarity.

> Strict terms and conditions to avoid moral hazard

The euro area authorities will nevertheless place very strict terms and conditions on such a rescue measure, in particular that Greece (or any other country) fully achieves its adjustment programme. This is to avoid rewarding moral hazard: without strict counterparties, a country could be tempted to let go of its public finances, thinking that other countries would come to its rescue anyway. We can certainly imagine that the country, drawing on lessons from the past, would succeed in regulating itself. But, this is not an easy thing and two trends are now taking shape. On one side, there are the supporters of intervention from the IMF, which has experience and credibility in matters of structural adjustment. Such intervention (which is preferred by the main representatives of the CDU/SCU and the FDP parties in Germany) would have the advantage of not giving the impression that it is Germany (or a group of countries) that is dictating budgetary austerity. In 1994, when Mexico was rescued, President Clinton had for a time considered only involving the United States before realising that it was preferable to have the IMF impose its terms and conditions. On the other side, German Chancellor Merkel, French President Sarkozy and ECB President Trichet inferred that IMF intervention would be an unacceptable admission of weakness for the euro area.

The crisis clearly reminds us that, even in a monetary union, a lack of budgetary discipline is not permitted, since the market brings the States back to discipline. Revised in 2005, the Stability and Growth Pact is once again showing its limits. Whether we want it or not, in order to be credible, a monetary area must also have an integrated budgetary policy capable of making transfers from the central level (the euro area) to the lower levels (the countries). The challenge is significant: the institutional framework of the euro area's economic policy needs to be reformed. In the meantime, caution is called for, the weak links will remain weak links, and the price volatility of euro area State borrowings will remain high.

Michel Martinez

China: where do we go from here?

Despite broad-based confidence in China's macro-story in the Q4.09, a combination of country specific factors and global uncertainty has suddenly increased perception of Chinese risk. Only two months ago, it was hard to find any short-term bear on China. Opinions are now spread across a broad range of forecasts. Economic collapse in 2010 is at one end of the spectrum, while another very rosy scenario is at the opposite end. In this piece, we attempt to clarify the key issues and explain where our view differs from the extreme ends. Overall, we maintain our pragmatic stance: just as we had a hard time understanding the doomsayers in 2009, we find it difficult to understand the carefree bulls in 2010. Instead, we argue that a deeper understanding of China's macro dynamics will help avoid the symmetric bias that keeps shifting from worries about overheating, to indiscriminating fears of excessive tightening.

> Neither Heaven nor Hell

Fears of an outright collapse in credit growth seem to be overdone. Credit growth should only moderate from a very high base. Credit growth was above 30%/y in 2009, which was clearly unsustainable despite all the quibbling. China's official target for loan growth in 2010 is 15%. Our view is that credit growth should reach about 15-20% in 2010, with lending remaining very strong in the first quarter followed by a gradual moderation starting in the second quarter. Some administrative, policy-driven cycles with monthly boom/bust patterns are likely to persist into the foreseeable future. It seems fairly unlikely at this stage that China will implement systematic quotas by sector or for each maturity bucket. Administrative guidance should be enough, with tough rhetoric from both the State Council and CBRC. In short, get ready for a significant slowdown, not an abrupt collapse.

Although we expect credit growth will remain comfortable at the macro level, pain will be felt in some sectors. Infrastructure investment will be the least at risk. Credit should continue to flow to existing projects – at the central and, more selectively, at the provincial level – as well as to strategic new projects. Risks surrounding public infrastructure projects are real, but sometimes they are misunderstood. The revival of global uncertainties may force the central government to maintain very accommodative policies, and avoid any abrupt withdrawal of fiscal stimulus. Compared to many other countries throughout the world, China is one of the few economies that can afford an extended period of stimulus, despite all the uncertainties surrounding the true level of public debt.

Specifically, the real estate sector is at risk, but the structure of the downturn should be different than in 2007. Credit availability is already becoming an issue for this sector, and also for some specific construction-related sectors – the steel sector being one of the usual suspects. Although officials claim that they will differentiate between the good stories (home ownership of the

middle class, social housing) and the bad stories (luxury segment, speculation in coastal cities) in the real estate market. There is a significant risk that property prices will drop across the board, irrespective of the segment or the location. From an equity market perspective, the fact that some cities might be more resilient than others is irrelevant and there could be very little discrimination on the way down. Given China's lack of efficient market tools, the property market remains a policy-driven sector despite the very positive long term drivers. Still, this down cycle should be shorter than 2007 and we wouldn't be surprised if real estate prices start climbing again in late 2010.

> 2010 is the Year of Differentiation

We think that at least three key fears are short-sighted and contribute to significant misunderstandings:

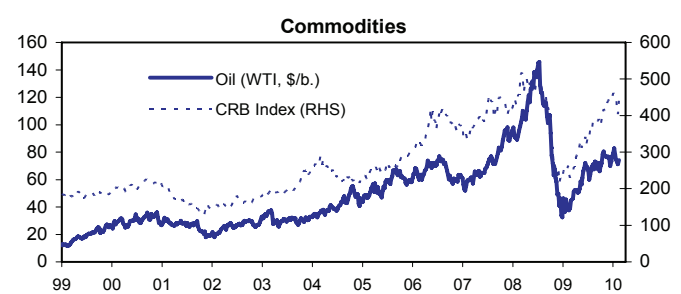
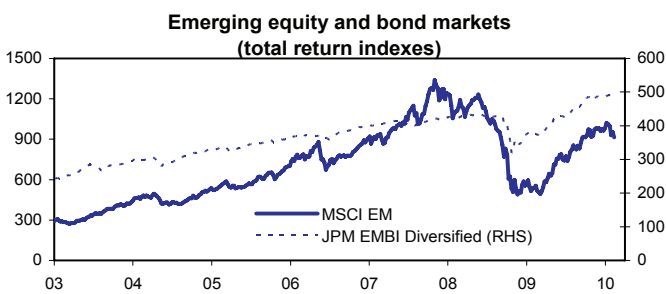
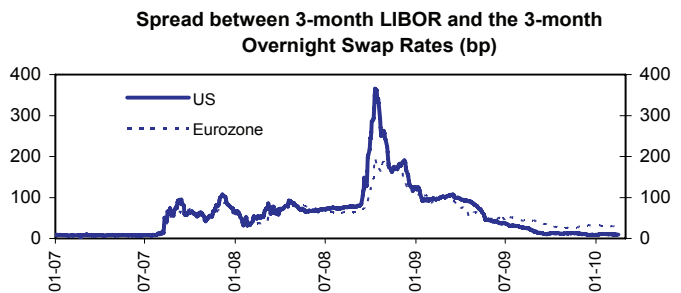
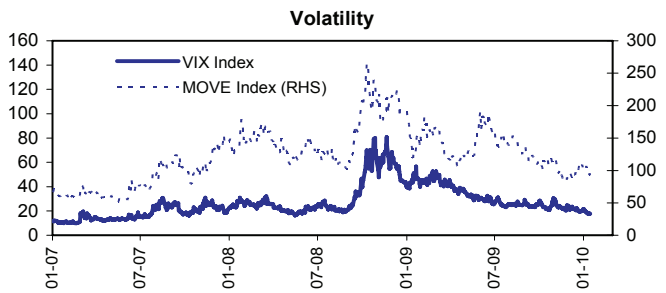
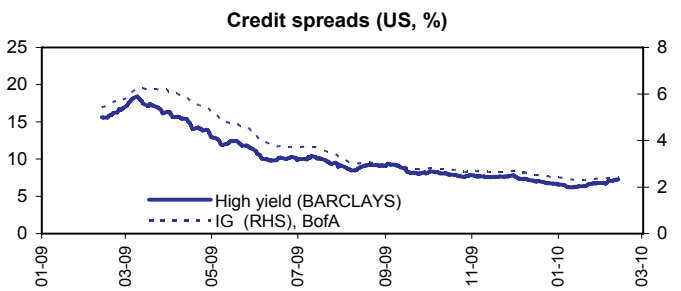
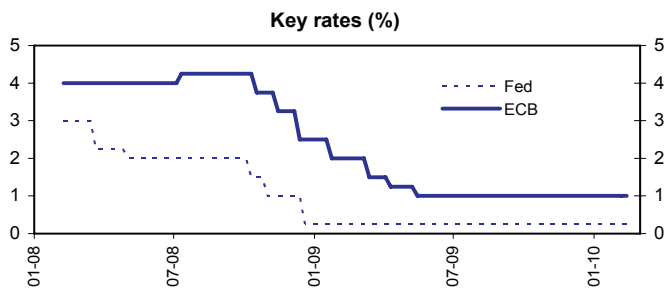
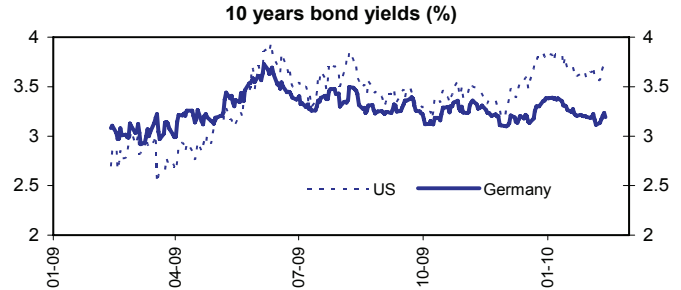
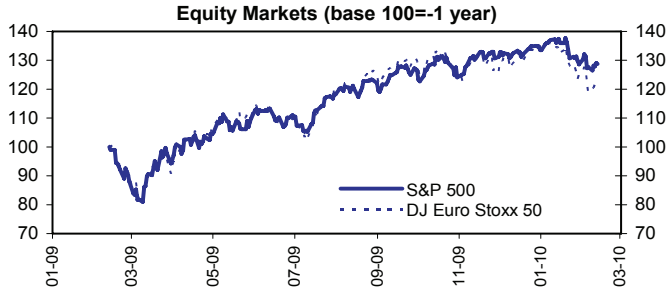
1) Fears of a sharp investment collapse are overdone – (at least for 2010) as non-performing loans and overinvestment remains a significant medium-term issue. Still, the investment pattern will change noticeably compared to 2009. Property related investment may decline, but private sector capital expenditure should pick up. Capex already shows some signs of recovery on the back of a cyclical recovery in exports. Machinery imports have already started to accelerate since December. Overall, fixed asset investment should continue to grow by at least 20% despite some ugly sector-specific issues.

2) Fears of an outright collapse of commodities imports do not appear fully justified. Exports have begun to rebound in the last two months, growing 17%/y in December and 21%/y in January. However, the key surprise will come from imports, which surged 85%/y in January. The positive base effect has created massive distortions, but imports were also driven by non-commodities (capital goods, machinery, etc.). Looking ahead, some commodities imports could fall sharply later this year (steel, iron ore, base metals), driven by a drop in property investment and less import-intensive infrastructure projects. Still, other commodities imports should remain resilient. We see no justification for collapsing oil and coal imports in 2010. While we do not believe that the trade balance will fall into deficit (an unlikely scenario for 2010) a scenario of rebounding exports and shrinking trading surplus is very likely.

3) Inflationary risks are lower than the consensus currently thinks. A base effect in January and February could even keep inflation quite low on a y/y basis. Inflation will pick up from Q2.09, but barring an unexpected spike in food prices, this is not the key issue on policy-makers agenda. While we do anticipate more significant tightening down the road (+100bp in reserve requirements, +54-81bp in deposit and lending rates starting in Q2.09), the tightening cycle could be less aggressive than anticipated as inflation worries give way to renewed concerns about economic growth. Given the recent rise in global uncertainties, policy-makers favoring pro-growth measures will likely be heard over the tightening advocates at the Central Bank.

Jean-Charles Sambor

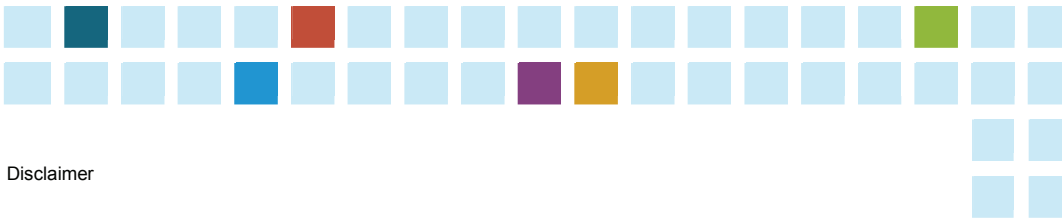
Market Data



Select Global Exchange Rates (February 12, 2010)

	F/X Rate	% Ch. WoW	% Ch. YTD	End year			
				2009	2008	2007	2006
USD/EUR	1.36	-0.9%	-5.8%	1.44	1.39	1.47	1.32
USD/GBP	1.56	-0.4%	-3.7%	1.62	1.46	2.01	1.96
GBP/EUR	0.87	0.5%	2.2%	0.89	0.95	0.73	0.67
JPY/USD	90.13	-0.7%	2.6%	92.43	90.64	112.04	119.16
JPY/EUR	122.3	0.1%	8.9%	133.2	126.1	164.9	156.9
CHF/USD	1.08	-0.7%	-4.6%	1.03	1.07	1.12	1.22
CHF/EUR	1.47	0.2%	1.3%	1.48	1.49	1.65	1.61

Sources: Strategy and Economic Research Amundi Group, Datastream and Bloomberg.



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