

The Five Stages of Greece

By: James Solloway, CFA, Managing Director, Senior Portfolio Manager

Psychiatrist Elisabeth Kübler-Ross is best known for her theoretical model of The Five Stages of Grief, which holds that, when faced with a catastrophic loss, most individuals pass through five distinct emotional stages—Denial, Anger, Bargaining, Depression and Acceptance. Interestingly, Greece’s experience as a member of the single-currency eurozone appears to be following a similar trajectory. There was profound denial of the problems surrounding Greece’s long-term fiscal health as far back as the signing of the European Union’s (EU) Maastricht Treaty in 1992. There has been widespread anger at the discovery that Greece’s finances were in a worse state than believed, and at the austerity measures being demanded of Greece by the EU. Greece has been forced to bargain intensively with the EU and other parties since its troubles came to light, and the conditions imposed by those deals are now ushering in a period of economic depression. We continue to believe that the EU and Greece will eventually be forced to accept the latter’s departure from the single currency union.

Greece’s experience as a member of the eurozone appears to be following a trajectory similar to the five stages of grief. The first stage took place in 1992.

Stage 1—Denial

In the Maastricht Treaty of 1992, EU member nations pledged to limit deficit spending and national debt levels. Fiscal conservatism has also been a key requirement for membership in the single-currency Economic and Monetary Union (EMU). On that basis, the admission of Greece to the EMU should have raised the eyebrows of anyone who had studied the history of sovereign debt defaults. As economists Carmen Reinhart and Kenneth Rogoff demonstrated in their book, *This Time is Different: Eight Centuries of Financial Folly*, the Greek government has been in default roughly 50% of the time since the nineteenth century, far more than any other EMU member.

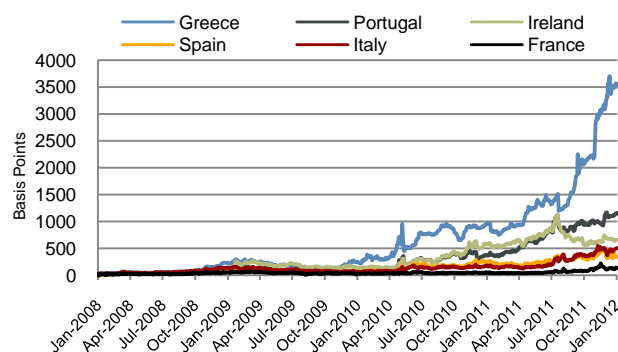
Greece’s admission into the EMU was not just a matter of denial—it may also have involved a certain degree of deception. A small cadre of investment banks helped create complex, structured agreements that allowed Greece and other EU countries to obscure a portion of their liabilities and thus avoid running afoul of their treaty obligations. These, measures, along with what Rogoff described as “decades of low investment in [Greece’s] statistical capacity,”¹ have created a climate of severe mistrust between Greece and its fellow EMU members,

¹ Kenneth Rogoff, “Can Greece Avoid the Lion?” *Project Syndicate*, 2/3/2010, <<http://www.project-syndicate.org/commentary/rogoff65/English>>, accessed 2/13/2012

which is reflected in the harsh austerity measures being demanded by the EU.

Once these shenanigans, and the significant damage done to Greece’s finances by the 2008 global financial crisis, became apparent, denial quickly evaporated. This was reflected in exploding yields on Greek government debt, as shown in Exhibit 1.

Exhibit 1: Ten-Year Government Bond Yields



Source: Reuter’s/Datastream, national sources
One basis point equals 0.01%; 100 basis points equals one percent.

Stage 2—Anger

Naturally, denial and deception gave rise to widespread anger. Other EU and EMU nations are angry at Greece for its failure to fulfill its treaty obligations. Greek citizens are angry at their politicians, and angry about having to endure substantial austerity measures imposed from

outside their political system. The most recent austerity package, passed by the Greek Parliament this weekend, has been met by renewed demonstrations and violence. Press reports indicate that unrest has spread to many parts of the country, and that as many as 80,000 protesters caused significant property damage in Athens, with hundreds of injuries to both protesters and security forces.

Stage 3—Bargaining

The Greek government has been actively bargaining with the EU and other external parties, as well as its own citizens, since it first formally asked for assistance in 2010. The measures agreed to in recent days took many months to hammer out, and are required to prevent an outright default by Greece in late March, when a significant principal payment on its debt comes due. Judging by the late-stage negotiations, mistrust and frustration continue to influence participants' actions. For example, after presenting a hard-won package of deficit reduction proposals to the European Commission (the executive body of the EU), three additional conditions were imposed upon Greece: (1) the promised budget cuts had to be specified in more detail; (2) the package would have to be approved by the Greek Parliament before being approved by the EU; and (3) Greece would have to provide a written guarantee that the measures will be enacted regardless of the outcome of national elections expected in Spring 2012. The hard line being taken by the *troika* comprised of the EU, European Central Bank (ECB) and International Monetary Fund (IMF) is likely to fuel further anger in Greece.

There has also been intensive bargaining among holders of Greek debt. As we have noted in previous commentaries, the decision to enforce a haircut upon private sector Greek debt holders (an IMF-imposed condition), while preventing it from being termed a default (presumably a condition of core EMU countries whose banks are heavily exposed to such an event), has had unintended but serious consequences. First, the ECB has remained adamant that it expects full payment on all of the Greek debt it has purchased—a somewhat peculiar demand, given that (1) the ECB is the sole institution that can create euro-denominated financial capital at will; (2) buying Greek assets at a discount and demanding full repayment constitutes a form of monetary tightening, all else equal; and (3) its demand for favorable treatment will tend to intensify anger and mistrust between official institutions and the rest of the eurozone economy. (*The Wall Street Journal* recently reported that the ECB had softened its stance somewhat, and would exchange its Greek debt holdings for bonds issued by the European Financial Stability Fund, or EFSF, though details are still forthcoming.) Second, if Greek debt is eventually discounted to a significant extent, then other troubled eurozone

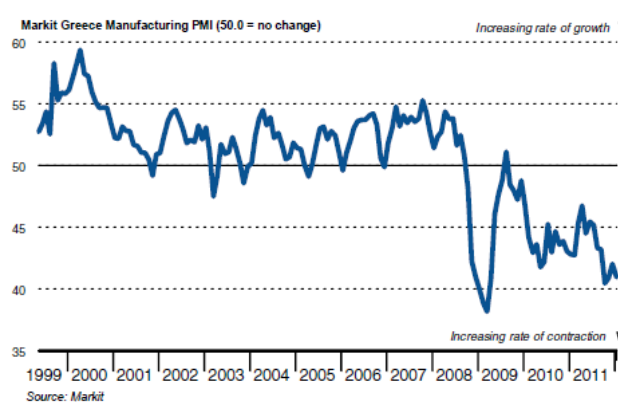
governments can be expected to demand similar concessions. In fact, Ireland has stated publicly that it is watching this aspect of the Greek negotiations closely. If other nations follow the path Greece is on, the result would constitute a much greater hollowing out of the eurozone's financial assets than a Greek default or haircut, and the risk of such an event could cause significant financial turmoil if suddenly and fully discounted in market prices.

Stage 4—Depression

As we observed in our most recent Economic Outlook, "SEI has steadfastly believed from the start that any attempt to resolve the crisis, short of full fiscal union, a massive transfer of aid, and socialization of national governments' debt through the issuance of eurobonds was likely to fail. The weakest members of the eurozone are simply too indebted and uncompetitive. Germany's insistence that the periphery debtors deflate their way to health is reminiscent of the eighteenth century practice of throwing a person into debtors' prison until he has worked off his obligations."

The demands from core EMU nations for Greece to deflate or 'internally devalue' its way to competitiveness have not abated in the most recent agreement, and the inevitable result—depression—continues to be reflected in Greek economic statistics, such as the January Purchasing Managers' Index, shown in Exhibit 2, which measures the performance of the country's manufacturing economy.

Exhibit 2: Greece Manufacturing PMI

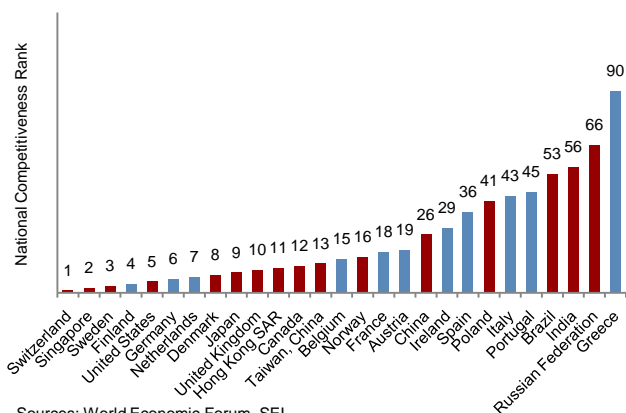


According to the Markit PMI® report, "Greece's manufacturing sector remained deep in recession during January, with output, new orders and employment all declining at severe rates...Remaining well below the 50.0 no-change mark, the headline index signaled another steep deterioration in operating conditions and extended the current period of contraction to 29 consecutive months."

Stage 5—Acceptance

Consistent with the Five Stages of Grief model, we believe that the ‘fifth stage of Greece’ will involve acceptance, by the troika and Greece, that the latter must depart from the single-currency union. Under the EMU’s current institutional framework, the adjustments necessary to close Greece’s competitive gap (shown in Exhibit 3) are simply too severe, and imposition of those measures too far outside of democratic processes, to endure long-term.

Exhibit 3: National Competitiveness Rankings



Sources: World Economic Forum, SEI
Rankings consist of 142 countries in total. Blue columns denote eurozone nations.

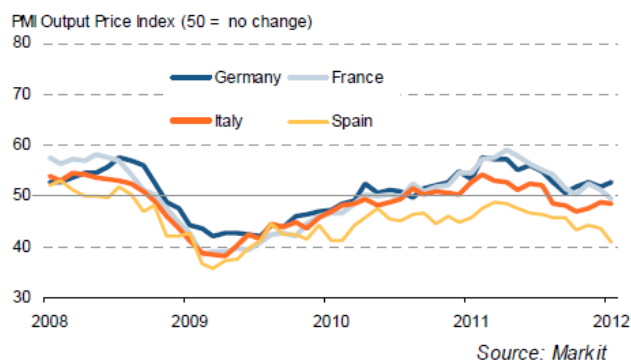
Our View

We do not believe that departures by Greece or other periphery nations will lead to the collapse of the eurozone, however. As we noted in a December 2011 Commentary (“The European Union’s ‘Fiscal Compact’—More of the Same”), “We continue to expect that Greece will eventually exit the eurozone...Such news could cause market dislocation, at least in the short-term, but we do not believe it would spell the end of the euro. Instead, we expect the eurozone to remain intact as long as a majority of the citizens in EMU nations (and aspiring EMU members) believe it is in their interest to do so and are willing to pay the price. We would become more concerned for the euro if Italy or Spain started to seriously entertain the possibility of exiting, but at this point, there’s no sign of that, and the latest agreement is clearly intended to prevent that from happening.”

In that same report, we also observed that the ECB was likely to play an increasingly active role: “The ECB is likely to become more active if a slowing eurozone economy is reflected in falling price levels. While a deep recession and ongoing policy errors pose clear risks to the euro’s future, they are also likely to stimulate additional summits and perhaps more forceful ECB interventions.” Under its new leadership, the ECB has

played a far more activist role since late 2011, with positive effects on eurozone markets. And as Exhibit 4 shows, the latest PMI price indices for the eurozone are quite dovish, providing the ECB with ample room to continue easing policy and to support the EMU’s ongoing attempts to ring fence the larger economies of Italy and Spain.

Exhibit 4: PMI Output Price Indices



Source: Markit

Our Funds

SEI’s fixed-income funds do not currently hold any Greek sovereign debt. That noted, the situation in Greece remains a concern due to the potential for contagion to other European countries.

This material is provided by SEI Investments Management Corporation (SIMC) for educational purposes only and is not meant to be investment advice. The reader should consult with his/her financial advisor for more information. This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. There are risks involved with investing, including possible loss of principal. SIMC is a wholly owned subsidiary of SEI Investments Company.