Eurozone Crisis: End game in the Eurozone?

“Over the past four years, the EU has responded decisively to the economic and financial crisis.”

(EU Commission Communication on Banking Union, 12 September 2012)

THE FOUR EUROZONE CRISES

WHERE ARE WE NOW?

• ECB’s 6 September 2012 announcement of “unlimited” Outright Monetary Transactions – secondary market purchases of shorter-dated eurozone sovereign bonds:
  – purchases to be “sterilised”
  – for countries complying with “strict and effective conditionality” attached to an EFSF/ESM programme, ideally with IMF involvement
  – pari passu ranking for ECB
• German Constitutional Court decision, 12 September 2012:
  – allows establishment of ESM and fiscal pact to proceed
  – requires Germany’s obligations to be interpreted as subject to a cap of EUR 190 billion
  – excludes the possibility of ESM borrowing from the ECB

POSSIBLE SCENARIOS

• Euro survives intact
• One or more Member States exit from the eurozone
• Euro breaks up
Eurozone outlook: lost decade or breakup?
Ernst & Young Eurozone Forecast
Marie Diron, Oxford Economics

DELEVERAGING TO TAKE YEARS

Eurozone: government debt

France: Sectoral indebtedness

SOCIAL COSTS OF INTERNAL DEVALUATION IS HIGH

Unemployment rate

Source: Oxford Economics/Haver Analytics

Source: Oxford Economics
WHAT IS NEEDED TO HOLD EUROZONE TOGETHER?

The Eurozone has ammunition to deal with crisis but needs to act swiftly:

- ECB even more interventionist
  - September meeting outcome was very positive

- More bailouts
  - ‘mini’ bailouts for Spain? Italy?
  - New bailout for Portugal?
  - Renegotiation for Greece

- Move towards fiscal & banking union

- Change in macro policy

PIECEMEAL POLICY ACTION LEADING TO EUROZONE’S LOST DECADE?

![Eurozone GDP growth graph](chart.png)

Source: Oxford Economics
IMMEDIATE CONSEQUENCES OF A BREAKUP – EXITING COUNTRIES

- Large devaluations of new currencies: +/- 50%?
- Inflation to rise sharply
- Interest rates to soar
- Bank runs and capital controls
- Risk aversion to lead to slump in share prices, foreign direct investment etc.

IMMEDIATE CONSEQUENCES OF A BREAKUP – RESIDUAL EUROZONE

- Movement of the euro vis-à-vis the US dollar, sterling etc?
- Risk aversion to lead to slump in share prices, foreign direct investment etc.
- Strains on banking sector
- Steep weakening of export markets

Bank exposures to government debt

Source: BIS
WITH BREAKUP RISK RISING, THE LONGER WEAK GROWTH PREVAILS

**Eurozone**: GDP

- **% year**
- **Baseline**
- **Eurozone break-up**
- **Forecast**

*Remaining 12 countries

Source: Oxford Economics/Haver Analytics

‘best case’ breakup scenario

BREAKUP WOULD SEND UNEMPLOYMENT TO YET NEW HIGHS

**Eurozone** unemployment

- **% of labour force**
- **Baseline**

Eurozone break-up

*Remaining 12 countries

Source: Oxford Economics/Haver Analytics

**Spain unemployment**

- **% of labour force**
- **Baseline**

Eurozone break-up

Source: Oxford Economics/Haver Analytics
CASE STUDY: GREEK EXIT FROM THE EUROZONE

- May 2010 Bail-out by IMF and Eurozone
- Austerity results in prolonged recession with 20% fall in GDP while unemployment increases to 24.4% (55% for under 25s) (June 2012) with further increases expected
- Political/social opposition blocks implementation of many structural reforms
- July 2011 announcement of second Greek package including PSI
- Protracted negotiations accompanied by increasing tensions between eurozone member states lead to agreement on 21 February 2012 on a second bail-out
- Orderly restructuring of privately held Greek bonds representing 74% reduction in NPV (but ECB stands aside)

NEW GOVERNMENT FORMED TO RENEGOTIATE BAIL-OUT

- New Democracy forms a government in coalition with PASOK and Democratic left after 17 June election
- Mandate to re-negotiate Greece’s second EU/IMF bail-out
  - tax cuts
  - suspension of cuts in public sector employment
  - extension of timeframe for compliance
- EU refuses to agree substantial concessions

THINGS FALL APART

- Attempts to implement agreed programme fail
- Spain seeks enhanced conditions credit line from ESM to activate ECB bond purchases under Outright Monetary Transactions programme
- EU/IMF freeze further funding of Greece
- Government unable to pay public sector workers
Violent disorder on streets/army deployed in city centres

Government falls as PASOK/Democratic Left withdraw

New elections called leading to SYRIZA victory

FROM DEFAULT TO EUROZONE EXIT

Tsipras seeks fundamental renegotiation of Greek programme involving cancellation of austerity measures and debt forgiveness

Refusal by EU leads government to declare moratorium on non-IMF loans

Mass capital flight leads Greece to impose capital and exchange controls; suspends Schengen membership

Greek exit agreed privately by Merkel and Hollande and announced at an emergency EU summit

EU adopts a regulation under Article 352 TFEU to give immediate effect to Greek exit

Buttressed by treaty amendment under simplified revision procedure to provide retrospective authority for regulation in case of legal challenge

THE RETURN OF THE DRACHMA

Banks close for one week after exit announced (with limited ability to make cash withdrawals)

Drachma introduced electronically. Euros may continue to circulate as cash at market rate of exchange. Alternatively, Greece may overprint Euros as new drachma

Drachma initially loses 50%-60% of value against Euro

Greece seeks new IMF package to cover balance of payments deficit

Paris Club negotiations on sovereign debt forgiveness possible (no payments of principal due on private bonds until 2023)
REDENOMINATING EXISTING TRANSACTIONS

- Greek legislation provides for redenomination of Greek law governed Euro debts, contracts and bank accounts at 1:1 exchange rate
- Foreign law governed contracts redenominated if contract closely connected with Greece
- Non-Euro contracts not affected but subject to exchange controls
- EU refuses to enforce Greek legislation owing to differences of view between member states … but does not prohibit recognition either

REDENOMINATION RISK FOR EXISTING CONTRACTS

- Greek courts will apply Greek law
- UK and other EU member states likely to recognise redenomination of contracts governed by Greek law
- Possible exception if redenomination is in breach of EU Treaties (e.g. if discriminatory) or if violates ECHR
- Foreign law contracts will be redenominated if lex monetae is the monetary system of Greece
- How do you identify the lex monetae where a contract requires payment in euros?
- Will a “hard Euro” definition help? What other practical steps can I take?
- If contract is governed by foreign law and lex monetae is not Greek contract will not be redenominated
- Exchange controls will complicate picture
- Possible claims under BITs

EXCHANGE CONTROL RISK

- IMF/GATS provide international framework
- Article 65(1)(b) TFEU allows exchange controls if “justified on grounds of public policy or public security”
- Greek courts will enforce controls
An English court will recognise Greek exchange controls if:

(A) required to do so by EU law (e.g. regulation implementing Greek exit);

(B) transaction is subject to Greek law; or

(C) the contract is an "exchange contract" and Greek exchange controls are consistent with Article VIII 2(b) IMF Agreement

UK/US courts take a narrow view on what constitutes an "exchange contract". Other EU jurisdictions including France and Germany take a broad approach.

WIDER IMPACT OF GREEK EXIT

- Risk of exit by other periphery states
- Deposit flight and renewed banking crisis
- Second credit crunch: increased funding costs and contraction in availability of credit across EU
- Eurozone recession will be longer and deeper – how will ECB respond?
- Further recapitalisation of EU banks – who pays?
- Will this lead to greater integration or a slow unravelling of the Eurozone?

EXIT – DAY 1 ACTION POINTS

- Exit is announced…
- How robust is your contingency plan?
- Consider whether to test contingency plan with a “dry-run” and give thought to “Day 1” action points, e.g.:

  1. Preliminary
     - communications (internal and external)
     - identify material exposures/arrangements which are likely to be affected (including intra-group arrangements)
– obtain legal documentation
– consider whether input from advisers is required (legal and/or financial)

• Analyse key legal issues and risks

• impact of new legislation, including local and EU legislation
• scope of new monetary law and capital and exchange controls
• guidance issued to markets (e.g. by ISDA)
• Remedies

• contractual termination rights and remedies
• impact of redenomination and capital and exchange controls on remedies
• notices and performance obligations
• litigation strategy

2. Analyse key legal issues and risks

– impact of new legislation, including local and EU legislation
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3. Remedies

– contractual termination rights and remedies
– impact of redenomination and capital and exchange controls on remedies
– notices and performance obligations
– litigation strategy
4. Insolvency
   - establish which legal framework/insolvency regime applies based on type of counterparty
   - proprietary or unsecured claim
   - consider notifying insolvency official to reserve rights/remedies
   - consider impact on termination, set-off, netting and collateral
   - consider impact of any moratorium (if applicable)
   - monitor insolvency process and take note of any deadlines/bar dates

5. Strategy
   - consider group strategy and next steps
   - consider applicable decision making-process
   - call board/committee meetings as required
   - consider paper trail

6. Other considerations
   - impact on operations, infrastructure and systems
   - regulatory overlay

RISK MITIGATION
- Continue to monitor, update and stress-test contingency plan
- Reduce exposure
- Consider whether to amend existing contracts and update internal guidelines/policies for new contracts
- Additional disclosures
• Consider additional protections for new M&A deals
  – more targeted due diligence
  – more bespoke provisions to address completion/valuation risk

POTENTIAL AREAS OF DISPUTE

• Contractual
• Jurisdictional
• Regulatory
• “International”:
  – Bilateral Investment Treaties
  – Challenges to EU/national legislative measures…?
  – Insolvency

REMEDIES/DR ISSUES

• Jurisdictional considerations:
  – Commencement
  – Enforcement
• Interim relief
• Substantive relief:
  – Breach
  – Frustration
WHAT’S NEXT?

• Longer-term market reaction as the OMT programme is implemented?
• Terms of Spanish and Cypriot bailouts to be confirmed
• Ireland and Portugal to work towards regaining market access
• Greek austerity package to be renegotiated/official sector debt forgiveness if exit is to be avoided
• Further steps towards fiscal union (fiscal transfer, eurobills, eurobonds)?
• Further steps towards banking union (bank resolution framework, single regulator and rule book)
• More elections (Italy, Germany)

… and years of continuing uncertainty