

Europe's Line in the Greek Sand

February 16, 2012

Who gets what?

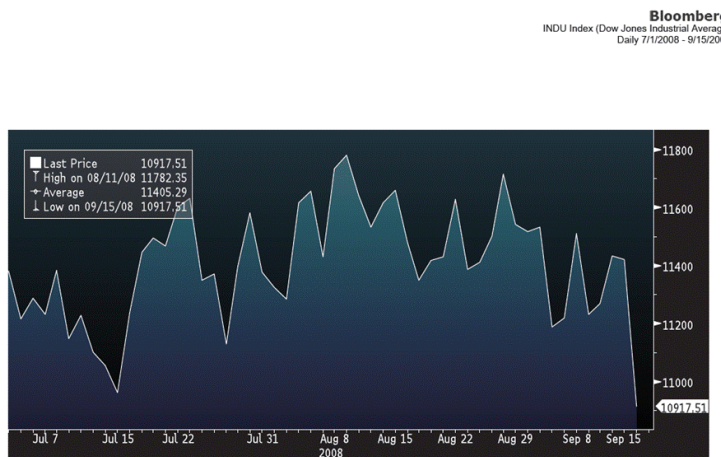
Greece has a lot of sand. Europe for weeks now has drawn a line in it. And yesterday the line was tested and held. Those-in-charge of Greece voted into law the austerity measures Europe wanted.

Those-in-charge of Greece will get to convert existing debt into less debt (the haircut). They will get their next chunk of bailout cash on March 20th most of which they'll never see because it will be used to pay back European banks.

Those-in-charge of Europe get to protect their banks from write-downs or credit-default-swap payments a Greek default would bring. They get to transfer newly-converted debt to English from Greek law, a much more favorable contractual environment. And, if Greece fails to comply in any way, they get to force Greece out of the euro without (at least in their eyes) being blamed for it.

The conventional wisdom is upbeat. And tired.

The conventional wisdom of investors and people-of-influence is roughly this. They think this deal defuses any crisis. They think that, even without a deal, Greece wouldn't have been much of a problem. It's too small. Banks have had ample time to write down a lot of their bad Greek debt. And Greece is a unique mess whose disease possibly only Portugal shares. Plus: the conventional wisdom is tired. They have crisis fatigue. Greece fatigue. Europe fatigue. As Cyndi Lauper's famous pop song says: "Girls Just Wanna Have Fun."¹ So do investors. So do people-of-influence. As far as they're concerned on Sunday, February 12, 2012 at 10 p.m. Greenwich Mean Time, the Greek crisis – as something to seriously worry about – ended.



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Hank Paulson and remembrance of lines past.

Lines in the sand remind me of the summer of 2008.

One Henry Paulson, US Secretary Treasury, was angry that shaky banks, investment banks, and mortgage institutions, were getting the dangerous idea that the Fed and US Government were just going to bail out anyone who cried "bankruptcy" in the financial theater.

Yes, they had saved Bear Stearns on March 16, 2008. Yes, they were thinking about Fannie Mae and Freddie Mac.² But, make no mistake, Hank Paulson and the government were drawing a line in the sand, specifically about Lehman Brothers whose troubles had been mounting and stock price falling since the

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winter of 2008.

Mr. Greenspan's magical piggy bank.

Others shared Mr. Paulson's deep aversion to the onset of more "moral hazard" – the temptation to do irresponsible financial things when you feel sure someone will make you whole. One was Alan Greenspan who worried on September 5 that people were looking at the Fed as "a magical piggy bank."

³ Another was the former President of the St. Louis Fed, William Poole, who wanted to see the cathartic effect of financial bankruptcies to cleanse the system. The Fed Chairman, Mr. Bernanke, shared this moral-hazard worry and, if he didn't want to draw any lines in the sand, never said so.

September 15, 2008 – the day the line held.

On the weekend of September 13 and 14 the line held firm. Merrill Lynch was sold to Bank of America. Lehman was given the go-ahead to go under. On Monday, September 15 it did.

That afternoon *Forbes Magazine* ran an article entitled "Paulson's Line In The Sand" in a column called "Moral Hazards." The article is remarkably blasé about the Lehman bankruptcy. That's because the conventional wisdom of many investors and people-of-influence was remarkably blasé. William Poole reflected a view I well remember (though even at the time did not agree with). When asked if the Lehman bankruptcy was worth it, he replied: "Absolutely."⁴ He believed AIG, Washington Mutual and maybe a few others might have to come out of the woodwork and we'd likely be home free.

Hank Paulson was more circumspect. While he said at a press conference on September 15 that "moral hazard is something I don't take lightly" he was smart enough not to completely rule out more magical piggy bank moves (obviously not calling them that). Good thing. On September 16, the magical piggy bank was hauled out, this time for good, to save AIG. It is still in action as I will show in a future BLOG.



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Two different collapses then and now.

What's the connection between two very different lines in the sand – Europe's with Greece and Paulson's with Lehman?

In the case of Greece, will the line in the sand cause some sudden downturn à la Lehman? Unlikely. Probably the contrary. Greece has been expected. A relief rally would be in order.

But as Mark Twain is said to have said "history does not repeat itself but it does rhyme." In this case there won't likely be a repeat of a stock-market collapse.

But there is another type of collapse going on right before our eyes – a social collapse of Greece. And that collapse is far more slow-motion, far harder to see the consequences of. Frankly, markets have always been uninterested in political and social risk. You can't quantify it. It evolves too slowly. Markets get interested when political and social risk is really serious – and then it's too late.

Greece is talking to Europe.

So how will this Greek social collapse look to the Portuguese? To the Irish? To the Spanish? To Europe as a whole? To see the euro being saved, European banks being saved, a future united Europe being saved while Greek society unravels?

After all, it is not lost on anyone, except the most obtuse, that all the debt Greece piled on was piled on by those who were then in charge of Greece and by willing European banks and European countries who liked the fact that Greeks were buying German cars, French wines, etc. And it is not lost on anyone that those who will most suffer the consequences of this debt binge will **not** be those in charge of Greece today.

The movie most people are watching is "Good Germany. Bad Greece." Next door is a much duller one – because it is being played in slow motion – cryptically entitled: "What Greece Is Saying to Europe."

– John Allison

¹ In the album "She's So Unusual", 1984.

² The government did take over Fannie Mae and Freddie Mac over on September 6, 2008.

³ As reported by the Associated Press on September 5, 2008. The phrase came from an epilogue to the paperback edition of Greenspan's memoir, *The Age of Turbulence: Adventures in a New World*, which was released on September 9.

⁴ Zumbrun, Joshua. "Paulson's Line in the Sand." In a column called "Moral Hazards." *Forbes*. September 15, 2008.

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