Markets Yet to Discount the Discounts

By Editor Test *Mon, Feb 13, 2012*

The author of "The Seven Deadly Innocent Frauds" and blogger at moslereconomics.com brainstorms about how the showdown over Greek debt might play out.

The issues I've been discussing over the last year or two, while now crystallizing, remain highly problematic.

The idea of Greek default transformed from being a Greek punishment to a gift, with the pending question, 'If Greece doesn't have to pay, why do I?' threatening a far more disruptive outcome that is yet to be fully discounted.

That is, should Greek bonds be formally discounted, the consequences of merely the political discussion of that question will be all it takes to trigger a financial crisis rivaling anything yet seen.

And note, also as previously discussed, that there has yet to be an actual Greek default, and that all Greek bonds have continued to mature at par, as there has yet to be an acceptable alternative.

So what are the alternatives?

1. Continue to fund Greece with terms and conditions.
2. Don't fund Greece, which forces:
   a. Greece to limit spending to actual tax revenues, or
   b. Greece to move back to the drachma.

And what are the 'terms and conditions'?

Austerity is always the lead demand, which slows both the Greek economy and to some extent the euro zone in general.

Additional demands currently include discounting Greek bonds to bring down their debt to GDP ratio to 'sustainable' levels. However, after eight months of negotiations, this has proven highly problematic, probably for reasons yet to be fully disclosed.

And, as just discussed, there may be a growing awareness that discounting opens Pandora's box with the politically attractive question 'if Greece doesn't have to pay, why do *we*?'

So what actually happens?

My best guess, and not with a lot of conviction, is that nothing is concluded before the coming maturity dates, and the ECB winds up writing the check to support short term Greek funding to buy more time for more inconclusive discussion. So, again as previously discussed, seems like this **is** the solution- death by

1,000 cuts and reluctant ECB bond buying when push comes to shove to keep it all going.

And, currently, the catastrophic risk I'd highly recommend immediately hedging is the risk that Greek bonds are formally discounted, rapidly followed by a global discussion of 'So why should we have to pay?'

Possible immediate consequences of that discussion include a sharp spike in gold, silver, and other commodities in a flight from currency, falling equity and debt valuations, a banking crisis, and a tightening of 'financial conditions' in general from portfolio shifting, even as it's fundamentally highly deflationary. And while it probably won't last all that long, it will be long enough to seriously shake things up.