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ERIC LASCELLES – AN UPDATE ON GREECE

Greek referendum

The big news over the weekend was the announced plan for a July 5th Greek referendum to approve or reject creditors' bailout offer. Given the date of the vote, it appears that Greece will not secure the next tranche of bailout funds in time to make its June 30th debt obligation to the International Monetary Fund (IMF). This is not necessarily a default per se, as one only occurs when Christine Lagarde, the IMF's Managing Director, officially informs her board, which can be delayed as long as four weeks. This means that if the IMF elects to play ball, the referendum and resultant delay of payment need not spell doom for Greece. Alternately, the IMF could choose to quickly define the non-payment as a default, though it is hard to imagine them doing so before the referendum.

The creditors are now quite displeased with Greece, and further scheduled negotiations have been called off in favour of contingency planning in the event of a Greek default/exit.

These are frustrating developments given that the negotiating gap had shrunk substantially last week.

A referendum was always thought to be a possibility for Greece as a way to reconcile Syriza's impossible election promises with the reality of what the creditors are willing to offer. However, Greece has certainly left the timing quite tight for this – it could just as easily have held a referendum on the subject months ago. As such, it seems likely that this is at least in part a tactic designed to put pressure on the country's creditors to back away from some of their reform demands. We are doubtful that the creditors will blink.

The referendum's specific subject and timing is quite odd for the following reasons:

- First, the question may be illegal, as Greece is not allowed to hold a referendum on fiscal matters. However, this doesn't appear to be a practical constraint.

- Second, a proper question would be whether Greece wishes to remain within the eurozone. Polls show that 70%+ of Greeks would answer "yes". Instead, the actual referendum asks whether Greece should accept the bailout conditions proposed by its creditors. Two polls on this question conducted before the announcement put the fraction in favour at 57% and 47%, respectively – in both cases significantly exceeding the "no"s – 29% and 33%, respectively. The actual referendum may be closer than this, given Syriza's support of the "no" position. It is still unclear whether the rest of Europe will interpret the question as essentially one of eurozone membership. We think there is still a possibility that Greece remains within the eurozone even in the context of a "no" vote, but it would be difficult.

- Third, the ideal time to hold the referendum would have been before June 30th. As the IMF's Lagarde has noted, the creditors' offer expires on June 30th. This isn't just a tough bargaining tactic: the debate since January has been about releasing the final tranche (7 billion euros) of Greece's second bailout package. However, the second bailout officially expires on June 30th. After that date, the 7 billion euros remaining to be disbursed theoretically disappear as the European Financial Stability Facility loan program closes to Greece.

So, are the Greeks misinformed/behaving irrationally? Ultimately, the answer could well prove yes. But for now, we suspect there are several motivations:

- This high-stakes situation could prompt creditors to make concessions and rescue a deal before June 30th, avoiding a default and rendering a referendum unnecessary. However, this now seems quite unlikely given the response of the creditor nations.

- A “no” vote – which Syriza is officially campaigning for – might force creditors to offer a significantly more generous package. However, again, the creditors do not seem inclined to comply at this point and, technically, the existing bailout cannot be extended without going to all of Europe’s many parliaments, though perhaps there are loopholes that will yet be discovered. Instead, a Greek exit (“Grexit”) would be the most likely outcome.

- A “yes” vote might force Syriza hardliners to comply with the bailout terms, permitting a deal to be struck. This is certainly possible, but there is also a high probability that Syriza would collapse, be forced to find new coalition partners or cede power to a national government, eventually resulting in elections.

Capital controls

As we had long predicted (our last estimate was 60–70% probability), Greece will now impose a bank holiday/capital controls starting June 29th and lasting past the referendum. Part of the reason for the closure are the rapid deposit outflows in recent weeks, which would presumably have surged this week in the aftermath of the referendum announcement and a likely non-payment of the June 30th debt obligation. Another reason for the capital controls is that the European Central Bank (ECB) is opting to halt its prior pattern of ever-increasing emergency liquidity assistance facility limits that were funding Greek banks. It is hard to imagine the capital controls ending even after a “yes” vote given how short of cash Greek banks are. They will probably now need a bailout targeted at them in addition to sovereign assistance.

Default risk

As of last week, we had taken to describing the odds of a Greek default as over 80%, but with two very different scenarios:

- One was that creditors would provide debt relief in the form of a reduction in the net present value of Greek debt via later maturities and lower coupons. This had precedent – Greece enjoyed a similar reduction in its debt load a few years ago, and with limited financial market consequence given that less than 20% of Greek debt is in private sector hands.

- The other scenario was the Greece could simply default on its debt in an uncoordinated way, potentially leading to its exit from the eurozone. The odds are probably now around 100%, split 50% between a constructive solution involving debt relief and a 50% chance of uncoordinated default.

Arguing for the former, the creditors could still blink, and the expectation is that any deal would likely include some form of debt relief. Alternately, the creditors could not blink and Greece fails to make its June 30th payment (which would eventually be deemed a default if not remedied shortly thereafter), or fails to make payment on an ECB loan that comes due on July 20th.

Grexit risk

We’ve said for some time that the odds of a Greek exit from the eurozone were around 30%. We would now put that up to 40%. It would be strange for Greece to exit given that the majority of Greeks prefer to stay, and given that European leaders would prefer the country to stay, even if their own citizens are no longer sure. The negotiating positions between the two parties are no longer very large. However, there simply isn’t much time left to sort things out, the referendum question and timing are unfortunate, and Greek capital controls paired with a default on the IMF debt could well spell the beginning of the end (though Cyprus demonstrates that capital controls alone are not enough to knock a country out). If Greece votes “no” in the referendum, it seems likely that it will exit the eurozone, initiated by a significant default, capital controls and likely some sort of IOU currency.

Alternately, if this gets patched up over the next nine or so days, then worries will substantially abate, but not vanish altogether:

- Greece's economy will be devastated by this development. Tax compliance will fall to almost zero in this context, a lack of access to money will constrain economic activity and an inability to withdraw money or use credit cards will hit the summer tourism season hard.
- Greece will unambiguously need a third major bailout package once it emerges from this mess and its banks will need help, all of which will have to be negotiated then formally approved by all eurozone parliaments. This is something of a moving target given the deterioration in Greece's fiscal position by the day.
- There is a significant chance of political change along the way, either in terms of Syriza's coalition partners or an actual election. Of course, an election could not happen quickly enough to resolve any of the most acute near-term issues.

Knee-jerk market response

In theory, the logical outcome is: lower euro, lower yields and lower equities (especially European). The ECB will likely be out there trying to calm sentiment, with the possibility that quantitative easing (QE) is ramped up if markets take a particularly negative interpretation.

In practice, the euro has been remarkably stable, and other markets have shown considerable resilience despite softening somewhat.

If the situation continues to deteriorate toward a major default or Grexit, there are several contagion channels to think about:

Economy: The Greek economy is just 2% of Europe, and so around 0.5% of the global economy. This is not a serious concern.

Banking: Few international banks have exposure to Greek banks (or Greece) any more. However, Greek banks have significant operations in a handful of smaller Eastern European countries, and so damage could cascade in that direction.

Private investors: Most private investors have long since fled Greece. As noted earlier, less than 20% of Greek public debt is held by private sector investors, and those are presumably mostly within Greece (the Greek banks, mostly). Investors that remain exposed to Greece surely understand the risks by now.

Official lenders: If Greece were to default in a major way on its debt, several official lenders (IMF, ECB, EFSF) would find themselves with big capital holes. This would not result in panic since these are not publicly traded entities, and there is no serious risk of their insolvency or failure. However, the cost of recapitalizing these entities would not be trivial, and would be borne primarily by European countries. The extra amount would be painful (conceivably 100 billion euros or more), but in the grand scheme is not crippling given that the eurozone is a 10 trillion euro economy – just 1% of GDP.

Confidence: The real X-factor is the confidence channel. If markets decide to panic, then financial markets globally could suffer significantly. It is more likely, we think, that financial markets will express displeasure, but not respond as forcefully as they did in the fall of 2011. In theory, markets should prove capable of reversing most of the initial losses in time. Naturally, European markets should be affected the most, and this injects considerable uncertainty into our bullish European economic and equity calls. European yields could retrace a significant fraction of their recent selloff.

Short-term contagion: There would perhaps be an elevated risk of contagion to other peripheral European players, such as Italy, Spain and Portugal. So far, the positive correlation has been fairly small, but nevertheless Italian and Spanish 10-year yields rose by 22 basis points on Monday, June 29, but remain lower than the U.S. equivalent. The fear, of course, is that if Spain or Italy were to wind up in a similar situation, Europe wouldn't be big enough to save them. Barring aggressive market pressures – and Europe seems to have enough additional protective instruments in place relative to 2011 that this should not be the default expectation – we actually think it is more likely that voters and politicians in those countries recoil at how badly Greece is damaged by these events, and do not seek to follow suit.

Long-term contagion: There are legitimate questions in the context of a Greek exit that would be raised about the long-term viability of the eurozone. We happen to think there are quite a number of reasons why the experiment is likely to persist.

"Black Swan" contagion: As the Lehman-induced global financial crisis demonstrated, there can be totally unexpected channels (money market funds in the case of Lehman) that prove surprisingly consequential.

Conclusion

We will know much more over the next seven to nine days. Greece is slightly more likely to remain in the eurozone than exit, but the risks are growing given the imposition of capital controls as well as a rising chance of a major uncoordinated default.

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