Global Economics View

Greece: What's Next?

- The Greek government has called a referendum on the latest proposals from the creditor institutions to be held on Sunday, 5 July. The question to be put in the referendum is in essence: *Do you approve/agree with the latest proposal of the institution*s. The Greek government will campaign for a 'no' vote. We expect that the referendum will take place as scheduled, though as in the proposed 2012 referendum, there is a possibility it will not.

- The European members of the institutions have rejected the request from the Greek government for an extension (by a month) of the current programme. This means that, unless there is a major change of position by the Greek government or the European institutions, the Greek government will not gain access to the up to €16bn funding remaining under the European part of the current programme. As a result we expect the Greek government to miss the IMF debt repayment due on 30 June.

- We think the most likely sequence of events will be: **i)** on Monday, 29 June, there will be a deposit run on the Greek banks, leading to the likely imposition of Cyprus-style capital outflow controls, including deposit withdrawal limits, compulsory bank holidays and restrictions on external payments. **ii)** Greece does not make the €1.5bn payment owed to the IMF on 30 June and is consequently cut off from further IMF funding under the continuing IMF programme. **iii)** The ECB restricts access to the emergency liquidity assistance facility (ELA) for Greek banks at the Bank of Greece. **iv)** From Wednesday, 1 July to Friday, 3 July, tighter enforcement of capital controls, deposit withdrawal controls and other external payment controls will become very likely.

- We expect the referendum to result in a comfortable majority for the 'Yes' camp, and expect no Grexit this year and a lower risk of Grexit in subsequent years. Either a belated extension of the European programme (expiring on 30 June) or a new interim programme, to take us close to the end of the year, would be negotiated in our view. If the Greek authorities comply with the terms of this extension or interim programme, this could set the scene for a new one-year or even multi-year programme after the end of 2015. Given the track record of the Greek authorities on the structural reform front, however, it is likely that disagreements and tensions between the institutions and the Greek government could flare up again soon. A rerun of the scenario since the beginning of 2015 is therefore possible.

- With a 'No' vote or an unconvincing 'Yes' vote, it is hard to see how a government willing and able to implement anything like the latest proposals of the institutions could be in place for the rest of this year. Unless there is a change of government in Greece (or a major change of views among the institutions), the slide into Grexit would be very likely, even though it might take a long time.

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Greece: What's Next?

The Greek government has called a referendum on the latest proposals from the creditor institutions (the EU Commission/European Stability Mechanism (ESM), the ECB and the IMF), increasing the uncertainty in what has been an exceptionally tense period of negotiations. The referendum is scheduled to be held on Sunday, 5 July. The question to be put to the Greek population in the referendum, which was approved by the Greek parliament on 27 June with 178 votes in favour vs. 120 against, in the first referendum to take place in Greece since the 1974 vote that abolished the monarchy, is in essence: *Do you approve/agree with the latest proposal of the institutions*. The Greek government has indicated it will campaign for a 'No' vote, a stance which has further stoked tensions with Greece's creditors.

We expect that the referendum will take place as scheduled, though as in the proposed 2012 referendum, there is a possibility it will not. The Managing Director of the IMF, Christine Lagarde, has said publicly that, because the European part of the programme expires on 30 June, and because the proposals by the institutions related to the completion (and possible extension) of the European part of the programme, the referendum on 5 July, after the European part of the programme has expired, would be invalid. Whatever the legal merits of this view, we expect the referendum to go ahead as currently planned, given the statements from the Greek leadership having explicitly framed the referendum question as being about the creditors' proposals, and not about Eurozone membership. At this stage, polling evidence is scant; although a majority in favour seems the most likely outcome, much could change in the week ahead to influence public opinion. So far, although queues are reported at Greek banks, calm has prevailed on the streets. Whether social unrest would increase in the event of a deteriorating economic situation is a key variable.

The European members of the institutions have rejected the request from the Greek government for an extension (by a month) of the current programme – the European part of which expires at the end of Tuesday, 30 June. The IMF programme runs till March 2016. No extension of any kind has been agreed to – not even till (the day after) the referendum. This means that, unless there is a major change of position by the Greek government, the European institutions or both, the Greek government will not gain access to the up to €16bn funding remaining under the European part of the current programme that expires on 30 June, including profits made by the ECB/Eurosystem through the Securities Market Programme (SMP, adding to €1.9bn for 2014 and up to €1.5bn for 2015), the €10.9bn set up originally for Greek bank recapitalisation, and the rest of the programme (€1.8bn).

30 June, 6pm Washington time (midnight in Athens) is also when a €1.5bn payment from the Greek government to the IMF is due. Regardless of whether the Greek government has sufficient funds in its possession to make this payment, it is unlikely to make the payment unless Greece has been guaranteed the disbursement of the remaining €16bn funding under the current programme.

In our view the most likely sequence of events is the following:

- On Monday, 29 June, we expect there will be a large deposit run on the Greek banks (the Greek media reports there were already people queuing outside banks on Saturday to withdraw cash). This would be driven by the anticipation of the non-payment of the IMF on 30 June, and the fear of the imposition of Cyprus-style capital outflow controls, deposit withdrawal limits, compulsory bank holidays and restrictions on external payments. Behind this would be the perception of a material increase in the risk of Greece euro area exit (Grexit). It is unlikely that the desired deposit withdrawals can be managed by the Greek banking system.

We think there are therefore likely to be limits on deposit withdrawals, and possibly selective or even across-the board bank holidays.

- Greece does not make the €1.5bn payment owed to the IMF on 30 June and is consequently cut off from further IMF funding under the continuing IMF programme.
- The ECB may restrict access to the emergency liquidity assistance facility (ELA) for Greek banks at the Bank of Greece as early as Monday, 29 June. We believe an increase in the haircut on Greek sovereign debt or sovereign-guaranteed financial instruments (currently at around 30%) would be the mildest tightening of the conditions for access that can be anticipated. Access to ELA would likely be restricted, and possibly capped in absolute terms at something not much above the current €89bn level if the Greek government does not make the IMF payment on 30 June.
- From Wednesday, 1 July to Friday, 3 July, uncertainty about the outcome of the referendum on Sunday 5 July will likely increase the desire of the holders of the remaining €130bn of deposits (held by the private non-financial sector) in Greek banks to take their money out – abroad or 'under the mattress'. Tighter enforcement of capital controls, deposit withdrawal controls and other external payment controls will become likely.

We expect the referendum to result in a comfortable majority for the 'Yes' camp – the camp favouring acceptance of the latest offer of the institutions. However, because the Syriza-Anel government will campaign in favour of a 'No' vote, its position would likely become awkward and vulnerable, probably undermining the government's ability, in the eyes of creditors, to implement the deal.

The President of the Eurogroup of Eurozone Finance Ministers has said that even if there is a 'Yes' vote in the referendum, a Greek government that actively campaigned for a 'No' vote would not be a credible party for implementing the programme proposed by the creditors and approved in the referendum. This suggests that the European institutions may be looking for, or are expecting, a change of government following the referendum. However, public opinion polls are consistent in highlighting public support for Syriza's negotiating stance and for the party's increase in support, suggesting that fresh elections could see their share of the vote increased. The disconnect between the Greek government and the creditors is a key source of the current uncertainty: while we have long emphasised that the distance between the party's positions could be bridged in our view, the rapid deterioration in trust and goodwill between the parties has reduced the room for manoeuvre and increased the chance of accidents (e.g. Grexit).

Until this issue is settled and a government viewed as sufficiently credible by the institutions is in place, we believe there will have to be continued Cyprus-style capital outflow controls and access of the Greek banks to the ELA facilities will be severely restricted. This could carry us to the point where, on 20 July, the Greek government has to redeem SMP bonds worth €3.5bn held by the ECB/Eurosystem. A similar €3.2bn payment is scheduled for 20 August. A default by the Greek government on its ECB commitments would end the ability of Greek banks to offer Greek sovereign debt or sovereign-guaranteed debt as collateral at the ELA. Because the Greek banks would probably be deemed insolvent at that point (if not earlier), any access to the ELA would likely be terminated.

If a new government (with or without new parliamentary elections that could be called at any time following the referendum) were to emerge willing to implement the latest proposals of the institutions, the situation could normalise quickly. It is even possible that the existing government could be deemed a credible counterparty again by the institutions. A sufficiently convincing ‘Yes’ vote could, as stressed by Lagarde, create scope for further negotiations. The institutions were widely reported to be ready to offer further concessions to Greece when the negotiations were broken off because of the announcement of the referendum. And we continue to believe that for a range of reasons, not least Greece’s geo-strategic position and NATO membership, its continued membership in the euro and EU is the desired outcome.

So, given a convincing ‘Yes’ vote in the referendum, we expect no Grexit this year and a lower risk of Grexit in subsequent years, a gradual normalisation of Greek bank access to the ELA and a gradual end to capital outflow controls, deposit withdrawal controls and other controls on external payments. Either a belated extension of the European programme (expiring on 30 June) or a new interim programme, to take us close to the end of the year, would probably be negotiated. If the Greek authorities comply with the terms of this extension or interim programme, this could set the scene for a new one-year or even multi-year programme after the end of 2015. Given the track record of the Greek authorities on the structural reform front, however, it is likely that disagreements and tensions between the institutions and the Greek government could flare up again soon. A rerun of the scenario since the beginning of 2015 is therefore possible in our view. We term this the ‘kicking the can down the road and hoping-against-hope for a better outcome’ scenario.

With a ‘No’ vote or an unconvincing ‘Yes’ vote, it is hard to see how a government willing and able to implement anything like the latest proposals of the institutions could be in place for the rest of this year. With the Greek banks cut off from ELA support, their ability to intermediate and fund the real economy would be impaired severely and the Greek recession would deepen. If the Greek government defaults on the IMF (on 30 June) and on the ECB (on 20 July and 20 August), the value of the Greek government debt and sovereign-guaranteed debt held by the Greek banks (and other institutions that have to mark-to-market) would fall dramatically. The Greek banks would effectively be insolvent. Their equity would be wiped out, followed by the unsecured subordinated creditors, the holders of senior unsecured debt other than deposits and ultimately by large deposit holders. Scrip (deferred tax certificates) would likely have to be issued by the Greek government to pay its domestic bills. Unless there is a change of government in Greece (or a major change of views among the institutions), the slide into Grexit would be very likely, even though it might take a long time. We term this the ‘from Grimbo to Grexit’ scenario.

Formally, Grexit would only occur if and when the Greek government introduces a new monetary law (Lex Moneta), declaring its scrip (the New Drachma, say) to be legal tender in violation of the Treaty, and redenominating the existing contracts and outstanding financial instruments denominated in euro that are under Greek law into New Drachma. Although the Greek government would do all it could to remain current on the exchange bonds issued during the 2012 debt restructuring and on its Treasury bills, its ability to do so would depend on the degree of financial chaos that would result from Grexit.

We think both scenarios are likely, with the ‘kicking the can down the road scenario’ the more likely of the two. However, the ‘kicking the can down the road scenario’ could easily metamorphose into the ‘from Grimbo to Grexit scenario’.

If Grexit were to happen it would probably have sizeable negative consequences for Greece. We think that Grexit (if it happens) would probably only have modest and temporary negative effects on the overall euro area economic outlook, reflecting low economic and financial exposure to Greece and the likely scope for policy response from ECB and other EU bodies (for more see *Euro Economics Weekly - What If Grexit Were to Happen?*, 17 April 2015). But such an outcome would likely send a chill throughout Europe, and raise fears that political uncertainty in Greece could lead to a weak state in Europe's periphery during a period of global instability.

Market implications

The unilateral decision by Greece to call a referendum on 5 July on a bailout deal that is no longer is on the table marks an escalation of the Greek crisis that we think infers capital controls, default and rising Grexit risk. In our view, the main market expectations of the latest developments are likely to be:

- Risk aversion to rise significantly in the near term but limited banking systems/economic contagion means that investors would eventually buy the dip in periphery. The longer-term implications of Greece would be more negative.
- The market assumption had been that a deal would be worked out and the periphery had traded well in recent days on this basis.
- Expect Bunds and Treasuries to rally hard on this news. How hard? Bunds could rally 15-20bp in the near term, in our view.
- Periphery widening is likely until some clarity is achieved on (a) the absence of banking system, economic and political contagion or (b) some form of ECB reassurance that it will not tolerate a meaningful tightening in financial conditions.
- Investors we surveyed have consistently pointed to 50bp widening as being an opportunity to buy. It remains to be seen whether risk aversion will dominate.
- We believe the longer-term implications are however more negative because: the absence of long-lived stress (even on Grexit) would make it unlikely that moves to create a deeper fiscal, banking and political union will be fruitful. There is a perversity to limited near-term contagion and long-term EMU structures.
- Default, but with Greece remaining in the euro, would not be good news from here. Default inside the euro area may be economically painful but would still be seen as an option by radical parties across a number of countries.
- Grexit raises periphery risk premia and would bring focus to anti-austerity and anti-reform political movements. The risk premia are likely to become more elevated in recessions and in those countries that are unable to bring down unemployment rates.

Appendix A-1

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