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Greece update: crisis escalates, thoughts on the week ahead

Recent developments escalate crisis

There have been three major developments on the Greek crisis over the last forty-eight hours.

First, the Eurogroup meeting yesterday confirmed that the EFSF Greek loan program will expire on June 30th, without an extension. This was close to our expectations, so that the undisbursed amounts available to Greece will cease to exist after Tuesday. The tone of the meeting was sombre, with the Greek finance minister abstaining from the written statement and an additional follow-up meeting taking place after his departure.

Second, the government's referendum proposal yesterday passed through parliament with the support of the governing coalition as well as extreme-right Golden Dawn. The vote will take place on Sunday July 5th, with the Greek people are being asked if they accept the creditor proposal as submitted to the Eurogroup last Thursday. Interestingly, the Greek PM outlined three reasons behind the break-up in talks: strong disagreement on the distribution of cuts (creditors wanted a package with greater focus on pensions), an insufficient European commitment on debt relief, and a tight disbursement schedule providing insufficient financing to the Greek state as well as monthly creditor monitoring.

Third, the ECB has today decided to cap ELA provision to Greek banks at Friday's level. Given the substantial amount of deposit withdrawals over the weekend (mostly via ATMs), this likely means that only a small buffer now exists (if at all) between the available liquidity to Greek banks and their needs. Depending on the size of this buffer, it is likely that capital controls (which would ration remaining liquidity) or an outright bank holiday will be announced. The Greek council of systemic stability under the Bank of Greece Governor and Finance Minister has been meeting today. The Greek cabinet meets this evening at 6pm London time to discuss the same issue. At the time of writing, Greek press reports suggest that a one-week bank holiday has been decided.

A critical week begins

As the week begins, developments will likely remain fast across multiple fronts. We would focus on the following:

First, the ECB reaction function. In a statement accompanying the decision to keep ELA usage unchanged, the ECB stressed it is "closely monitoring" market conditions and stands ready to use "all instruments" to defend its policy stance. How quickly and explicitly this support materializes over the next few days will be important for broader market stability. From a Greek perspective, more decisions from the ECB will likely need to be taken after program expiry on

Tuesday. The ELA collateral schedule has not been published so we don't know if this has been changed in today's decision. Either way, an increase in collateral haircuts or an outright suspension of ELA after Wednesday would provide added pressure to the Greek banking system. A suspension of ELA would be on grounds of Greek bank insolvency however and would be hard to reverse. We would consider an ongoing ELA cap (possibly with increased haircuts) as the most likely outcome over the course of the week.

The **second** factor to watch will be ongoing Greek domestic political developments. Opinion polls have yet to be published on the referendum question (the ones reported so far by the press are out-dated), but our assessment is that it is unlikely they provide a conclusive answer on the outcome. The question being posed relates to the creditor proposal rather than euro membership, with the government campaign emphasizing the negative aspects of the "austerity package", and the opposition stressing that it will be equivalent to a euro exit. It is therefore likely that the question is perceived differently by different segments of the electorate. More generally, the creditor proposal itself is complex with detailed references to legislative changes, making the political debate more likely to focus on the overall fiscal cuts rather than the specifics of the proposal. Beyond that, the immediate impact of potential capital controls on the economy will also play a role. It is important to note however that the government's stance towards the creditors is becoming increasingly critical, with the re-introduction of the term "Troika" in the political narrative being a notable example. The extent and direction to which the electorate apportions responsibility for recent developments therefore remains an open question.

Third, the IMF and European political reaction function over coming days will be important as well. It is likely that IMF managing director Lagarde notifies the board of a failure to pay event in the days after a non-payment on Tuesday. Whether the EFSF board subsequently decides to accelerate Greece's loans on the back of cross-default loan provisions will be a political, rather than a financial decision signaling a further escalation of pressure from the European side. We would consider more likely that the EFSF board refrains from exercising until after the referendum outcome is due.

More broadly, it is important to note that in contrast to the Papandreou 2012 referendum proposal, the European side has not yet identified the government's referendum as an in/out question on euro membership. It remains to be seen whether this stays the case over the course of the week, with Merkel holding a meeting on Greece with German political leaders tomorrow. For now, such a stance is indirectly indicative of greater willingness by the European side to stay on the negotiating table. This was also confirmed in yesterday's Eurogroup statement where the desire to assist Greece "as required" following the expiration of the EFSF program was noted.

A last-minute attempt to salvage negotiations tomorrow cannot be ruled out, also mentioned by finance minister Varoufakis on Saturday. The European Commission earlier today published its own version of the set of proposals that were discussed last week which seems to grant some additional moderate compromises versus the Greek mix of measures. We would consider the odds of a last-minute breakthrough as low given that the government's criticism of the agreement has become materially broader than the differences that were separating the two sides last week.

Uncertain outcome even after the referendum

Still, the most important medium-term question on what happens after Sunday's referendum remains. A negative vote will be perceived by the Greek government as a strong mandate to pursue changes to the current proposed framework, but in the face of a non-functional banking system. As has been evidenced over the last few months, the scope for creditor flexibility would likely be limited, leaving the possibilities of a potentially more targeted bank recapitalization program without state financing or Eurozone exit as the most likely alternatives. The outcome of a "yes" vote would be equally uncertain however. Finance ministers yesterday highlighted the important credibility issues that would arise from Greek government implementation of an agreement it campaigned against. A government change and a cabinet of national unity - possibly under the pressure of a continuously strained banking system - would be the most likely outcome. Any agreement would likely have to be fast given the accelerating impact of the crisis on the economy.

In sum, a new chapter of uncertainty has opened up with the Greek crisis. More clarity on the eventual outcome is unlikely until the following Sunday and likely beyond.

Footnote

*http://www.protothema.gr/economy/article/488565/sunedriazei-to-sumvoulio-sustimikis-eustatheias/

Appendix 1

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