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The Greek referendum: Raising the stakes

- The announcement by Greek prime minister George Papandreou to call a referendum on the acceptability of the second aid package has added to disarray in sovereign spreads this morning, and the vote is likely to continue to be a source of instability over the coming weeks. Assuming that the government wins the confidence vote in parliament this week and the referendum takes place, we think it likely that the people of Greece will vote for the aid package, probably allowing Greece more breathing space going forward. However, a referendum raises the stakes considerably for Greece and the crisis as a whole: the impact of a no vote could be very significant, and the market will have to price that to some extent.

- At present, our best guess is that the Greek people will vote in favour of the terms of the second aid package because of the potentially severe consequences of not doing so, as much for Greece as for the euro area, and below we consider some of the consequences of the referendum result.

- However, if the parliamentary confidence vote later this week does not pass, general elections would likely be of a higher priority and the referendum proposal would probably become redundant. The confidence vote will likely be close anyway. Mr. Papandreou's PASOK party has a majority of 152 seats out of 300 in the Greek parliament, following another defection by a PASOK parliamentarian on Tuesday. In addition, 6 PASOK members have called for Mr. Papandreou's resignation on Tuesday, according to Greek news agency ANA.

- The Greek press reports state that the referendum will take place in December or January. Even if the final vote approves the second aid package, uncertainty over the result is likely to be a driver of more volatility in European sovereign debt markets until then. The potential of increased contagion comes at an unwelcome time, at the point that European policy makers are seeking investor participation in new facilities established to help contain the crisis in Italy and Spain.

- There is also a possibility that the referendum announcement might hinder the payment of the IMF's share of the 6th tranche of the first aid package, due to be paid in the next few weeks. The IMF has not yet formally approved the payment, and the promise of a second aid package has become a condition for further aid disbursement by the IMF. However, we believe the payment will still go ahead. The troika (of advisers from the European Commission, the ECB and the IMF) has already recommended that the payment be made and until and unless Greece votes against the second aid package, enough of a case can be made that it will take place.

- Despite public and policy maker reaction to the announcement, it is not a complete surprise that a referendum has been called as the Greek parliament voted on 4 October to allow a referendum in the near future. However, at the time, the government did not state that it would be held to approve the aid package, with interior minister Haris Kastandis leaving its purpose as more general: "*The question that will be posed will relate to the fundamental interests of the Greek people in the face of the fiscal and economic crisis… It will involve a question or questions that will relate to the* *crucial economic and fiscal situation."*

- The referendum would not have been possible at all until last month, when the Greek parliament voted to allow referendums for issues of great national importance. In Greece's modern history the only referendum carried out to date was in 1974, over the question whether to restore the monarchy after the end of military rule.

Consequences of a "yes"

- Greece needs a political consensus behind its efforts to reduce its deficit and return to a primary surplus. A referendum result in favour of the measures asked of the country by the EU and the IMF would clearly achieve that. With a large enough majority, a mandate of this kind might even last for some time, with the potential of enabling future payments of aid and – along with PSI/default – clearing a path to debt sustainability.

- Political support for deficit reduction could of course also be achieved through other means such as the forming of a national coalition government or via new elections. The opposition New Democracy party, while recognising the need for austerity, has argued that the government should have negotiated harder for a shallower gradient of deficit cuts. Perhaps in the light of this, Mr. Papandreou's response to calls for early elections has been that such a move would be "dodging the issue", according to the Greek press.

- One of the major concerns about Greece has been its ability to commit itself to the austerity demands of the EU and IMF. The parliamentary vote on the medium term austerity plan was passed at the end of June by only a handful of votes. The 2012 budget went through more comfortably, but the combination of an increasingly difficult political process for budget approvals and anger elsewhere in Europe over budget implementation in Greece has provided us with a bleak outlook for Greece until now. A yes vote should facilitate future commitments to deficit reduction and the implementation of it.

Consequences of a "no"

- The potential consequences of a "no" vote might be for deeper PSI or more EU/IMF funds in the best case scenario, or bank runs and/or euro exit in the worst case.

- The exact question being asked of the Greek people will have to be designed carefully. Assuming it is one between the requirements of the second aid package as it will stand and an alternative path of austerity, the government would in theory have to go to the EU and the IMF to re-negotiate the terms of the aid package, in the case of a rejection of the government's policies. But were Greece's deficit reduction to be less front-loaded than planned, more funds would have to be made available to the Greek state, either from the public sector in the form of increased aid payments or - more probably - from the private sector in the form of greater concessions in PSI.

- The EU and IMF would of course need to agree to take that course. In the unlikely event that they rejected it, at an extreme Greece might be forced to leave the euro in order to monetise government spending and keep its banking system afloat. Perhaps for this reason, some European politicians are already referring to the vote as a referendum on euro membership. Naturally, the possibility alone of that outcome might have the potential to trigger widespread deposit withdrawal from the banking system in Greece. But were an exit actually to take place the probability of bank runs elsewhere in the euro area (among other undesirable events) might also be high because of the newly-set precedent of euro exit.

- As a result, we think that a deeper financial loss for bondholders, possibly through coercive action, would seem the most likely scenario in a "no" vote. In either case new elections would also be needed in order to provide the Greek government with a mandate to govern. Much will depend on the wording of the question, but it would of course be necessary for the newly-elected to government to respect the referendum result.

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