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The new Greek situation: broken negotiations and the call for a referendum

What we know

On Friday 26 June, Greek PM Tsipras held a comprehensive offer from lenders to release €15.7bn in a 5-month extension of the second bailout, starting on 1 July. The offer also included ‘a Commission-led package for a new start for jobs and growth.' Saturday’s Eurogroup meeting was supposed to fine-tune the proposal and 'address future financing needs and the sustainability of the Greek debt.’ In plain English, start talking about a third bailout and debt restructuring.

But the decision to reject the offer, calling for a referendum of the Greek people to vote, on Sunday 5 July, on the lenders’ proposal, was taken after a cabinet meeting in Athens on Friday night, without warning euro area partners. All Greek cabinet members have announced that they would vote No.

The Eurogroup has unanimously (except Greece) decided that the proposal was no longer on the table, that the programme will end on Tuesday 30 June, and that EU institutions, including the European Stability Mechanism (ESM), would stand ready to guarantee the financial stability of the euro area, including Greece. The ECB has decided to maintain emergency liquidity assistance (ELA) at €89bn, but not to increase this amount.

In Greece

The Greek Parliament has voted a decree allowing the referendum, supported by the coalition (Syriza and rightist Independent Greeks) and a far right party (Golden Dawn). All other parties (left and right) were opposed. The decision to hold a referendum led to a nationwide run on ATMs during the whole weekend, with as much as €2bn withdrawn.

Capital and deposit controls have started today (Monday 29 June). Banks, ATMs and the Athens stock market will be closed on Monday. When ATMs re-open late today, daily withdrawals will be limited to €60. The bank and market holiday is likely to last until next Monday (6 July), i.e. until the day after the referendum.

It is hard to see how Greece could pay its due to the IMF (€1.6bn) on Tuesday. A technical default is therefore a quasi-certainty.

What we think is likely – what we guess

Tsipras’ strategy seems to be to raise once more the stake in order to force the hand of euro area lenders to get better conditions and a more explicit commitment for a debt relief.

Euro area partners may make a last effort during the week (vindicating Tsipras’ supposed strategy). Germany and France have the same position on keeping Greece in the euro that we would phrase this way: “It is crucial [to keep Greece in the euro] because there are too many unknowns in the case of Grexit – but it cannot be accepted at any cost”. The divergence is likely to start on the cost threshold. The US is insisting on keeping Greece inside the euro for stability and geopolitical reasons.

The ECB will have to acknowledge the IMF technical default in its policy vis-à-vis Greece. It looks very improbable that the ECB would cancel the ELA or declare that all assets backed by the Greek government (this includes banks’ assets, since they are owned by the government) ineligible for ELA operations. Instead, a larger haircut on Greek assets is likely, which would reduce the amount of liquidity available for the economy, until the referendum takes place.

What we do not know

Questions on the constitutionality of the referendum have been raised (by former Finance Minister Venizelos among others), because the proposal on which the Greeks would have to vote is almost entirely about fiscal matters, which aren't supposed to be put to a referendum. In addition, since the Eurogroup has withdrawn its proposal, the vote would be on a document that has historical but not actual value. Another political coup de theatre, the government dropping the referendum and calling for elections is therefore a (remote) possibility.

The case of a missed payment to IMF when a grace period has already being given (the bundling of June payments into one single at the end of the month) seems to be new. Hence we do not know to what extent the usual routine following a missed payment (ordinarily bilateral exchanges, then the Fund's Managing Director notifying the board, which would normally take up to six weeks) is valid or not. This is important because once a default is notified to the board of the IMF, the European Financial Stability Facility (EFSF)/ESM will have to consider whether activating or not the cross-default clause of the agreement with Greece. In that case, the EFSF would ask for immediate repayment of the loans already paid to Greece. Obviously a political decision.

How looks this week (main case scenario)

With banks and markets closed, ELA will keep the banking system liquid (electronic operations and the interbank market should work almost as usual), at least until the ECB takes its decision post-IMF default. Higher haircuts would not likely render the banking system suddenly insolvent.

We'll know on Wednesday, the next critical moment, if euro area countries are willing to sweeten their offer and give more details about what would come next if the proposal is accepted (EU investment in Greece and debt relief). The leeway looks limited, but a last chance gesture is a distinct possibility.

In the meantime the reaction of the financial markets could be very bumpy/severe:

- €/US$ down possibly 5%.
- Expect global stock markets to correct:
  - Euro area markets will most likely correct between 5% and 10%; should the referendum turn out to be a NO then an even harsher down-side is most likely – 15%, mainly via the Financial sector.
  - Other markets will decline, though to a lesser degree. We see global markets down by around 5%, depending on the stock market beta. As the US will be considered as a safe haven we think Wall Street will correct less; other markets will presumably print deeper red numbers (on uncertainty and fear).
- Fixed income markets will see diverging movements:
  - US-Treasury, Bund and other semi-core yields will decline. We would not rule out Bund yields reaching 50 or 60 bps as a knee-jerk reaction.
  - Italian and Spanish spreads could widen to possibly 200/220bps or the equivalent of roughly 2.5 to 3% in yield level terms.

What if the Yes vote wins?

The Syriza-Independent Greeks cabinet resigns and the Greek President starts consulting the various parties to form another coalition. A grand coalition, including Syriza, is a possibility. Otherwise, elections would be needed.

International lenders are likely to ease the financial conditions of Greece, so that payments due to the IMF and the ECB (on 20 July) would be possible and the banking system stabilised, with withdrawal limits progressively removed.

Once a new cabinet is in charge, the lenders' proposal passes the Greek Parliament and the promised €15.7bn is channelled to Greece. Negotiations on a third bailout and debt relief would start shortly after.

Financial markets are likely to recover strongly in the case of a Yes vote. The Fed policy would, again, be markets' main focus.

What if the No vote wins?

Euro area partners would probably consider that the Greek people have expressed a view not consistent with Greece remaining a member of the euro.

Greece would make it clear that the bonds due to the ECB won't be paid back (at face value at least).

The ECB would probably (although not immediately) consider Greece in default and Greek banks insolvent, laying the groundwork for the cancellation of ELA, which would make the banking system immediately bankrupt

Capital and deposit controls would be strengthened and Grexit logistics prepared.

In case of speculative attacks on peripheral debt (Portugal being the most vulnerable), the ECB could allow national central banks to increase their purchases of their government debt within the framework of the Public Sector Purchase Programme (PSPP).

Yet, financial markets would most likely react negatively, with the euro down another 5% to 10%, as well as equity markets. Peripheral spreads are unlikely to widen dramatically beyond what is mentioned above, given the threat of ECB's interventions

Financial market volatility might convince the US Federal Reserve to keep interest rates on hold at its September meeting

- EU countries, with the support of the US, would do their best to keep Greece in the EU, in order to avoid dangerous political instability in Eastern-Southern Europe. Yet, the decision will be in the hands of the Syriza-led coalition and the truly worst case scenario, a Grexit, would become a real possibility. Social and civil unrest in Greece could become a serious issue

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