Comments on Greece: Entering an Extended Period of Uncertainty

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The situation in Greece took a sharp turn in recent days. Though we and the markets were optimistic the Greek government would negotiate a last-minute settlement with its international creditors, Prime Minister Alexis Tsipras' surprising decision to halt bailout negotiations and call for a referendum on July 5 has yielded disarray. While Greece is charging ahead with these referendum plans, there are substantial logistical, financial and legal hurdles.

We are now in an extended period of uncertainty that will not be resolved even after the July 5 vote. This situation is fluid, and anything can happen. We outline our current views below and will continue to monitor this saga as it unfolds.

The Referendum

The referendum question will ask Greeks to decide whether they accept the proposal put forth on June 25 by the European Commission, the European Central Bank (ECB) and the International Monetary Fund (IMF). A "Yes" vote is by no means assured, and with Tsipras actively campaigning for a "No" vote, the domestic political landscape is now considerably more volatile. A collapse in the government, a temporary unity government and fresh elections are all plausible.

- A “Yes” vote does not immediately produce a clear path for resolving the current impasse, as the second bailout will expire after June 30 and creditors have repeatedly refused to grant a further extension to this deadline. We see some signs that creditors are keeping the door ajar to negotiations, but after June 30, Greece may have to start again in negotiating a third bailout agreement.
- A “No” vote also doesn’t provide much additional clarity, and it would not immediately result in Greece’s exit from the euro zone.

The ECB’s Reaction Function is Crucial

For the Greek banks, the ECB opted not to increase the emergency liquidity assistance (ELA) provision beyond the €89 billion already allotted. Accelerating capital flight thus pushed the government to implement capital controls and close the banks.
This situation is likely to continue through at least this week.

The ECB will be keen to stem contagion risks, committing to using “all the instruments available within its mandate” should they be required. There are two key tools.
The first is quantitative easing (QE), which is probably already helping to keep the market reaction somewhat more muted than previous Greek flare-ups (and QE could be expanded or front-loaded if need dictates). The second is the as yet untested Outright Monetary Transactions (OMT) program, which also allows for debt purchases. Implementation of the OMT, however, would likely take some weeks, as it is conditional on a European Stability Mechanism (ESM)/IMF program being active in the recipient country.

The situation in Greece weighed on markets during June 29 trading, but investor faith in the ECB likely restrained that move.

On the Horizon

Key to where we head from here is whether markets believe that Greece is unique, or symptomatic of a broader failure of the euro area “experiment.” To date, the markets have acted along the lines of the former, but we will be watching closely for the latter (and remain concerned over that possibility for the longer term).

The Greek government looks set to miss its June 30 repayment deadline, placing it in arrears to the IMF. IMF Director Christine Lagarde has pledged to notify the IMF Board of this shortly afterward, although she has up to 30 days. The European Financial Stability Facility (EFSF) will then make the (political) decision whether to accelerate Greece’s loans, an event that would likely trigger cross-default provisions for private creditors. Greece’s failure to repay the IMF would not automatically constitute a credit event. The International Swaps and Derivatives Association (ISDA), the global trade association for over-the-counter derivatives, could be asked to rule on this question at any time. If ISDA declares a credit event, banks and other parties would be on the line for credit default swap (CDS) contracts they’ve written. Even if a “Yes” vote happens on July 5 and these defaults are avoided, Greece will have until July 20 to negotiate an agreement that allows it to meet a €3.5 billion repayment due to the ECB.

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