Grexit remains unlikely, but time is against the Greek government

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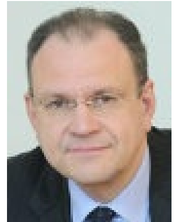
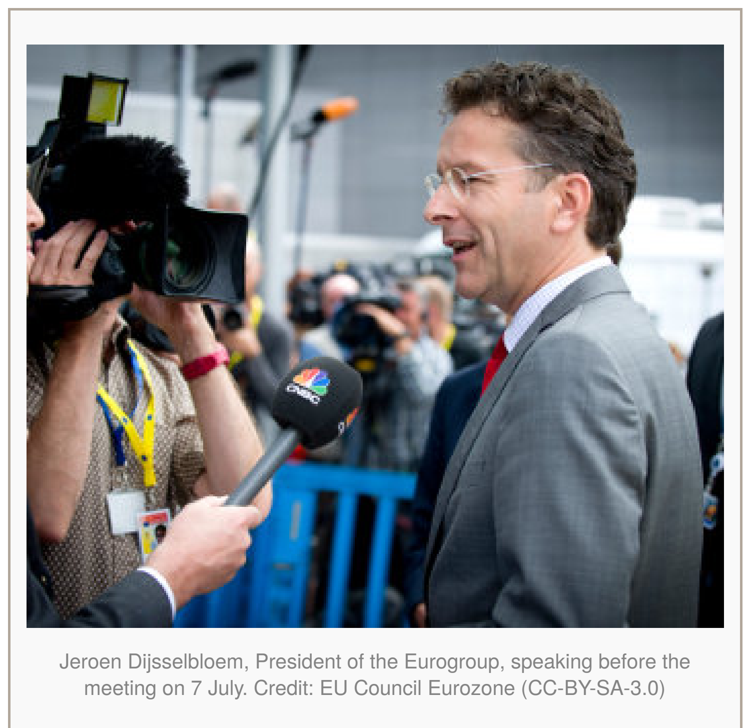
Eurozone finance ministers met on Tuesday to discuss the Greek debt crisis following the country's 'No' vote in its bailout referendum on 5 July. **Lorenzo Codogno** *writes that while a Grexit remains unlikely, the risks have clearly increased since the referendum and the financial and economic situation in Greece may further deteriorate before a solution is in sight.*



Following the 'No' vote in the Greek referendum, there is deep uncertainty over what the possible scenarios are now for Greece. This article addresses some of the key questions prompted by the result. Firstly, what was the referendum all about? The question was certainly not easy to interpret for the average Greek voter, but the overall message was clear. On paper, it was a vote on the creditors' financing package. More broadly, it was a confidence vote on the Greek government and its attitude in the negotiations with creditors and towards the conditionality required on Greece to get financial support. At face value, however, it was not a referendum on the euro.

From this perspective, the referendum was useless and probably counterproductive, but it raised fundamental issues. In fact, while the vote has immediate practical implications, it is also a soul-searching exercise for Europe, what it stands for, what kind of governance is the most appropriate for the future.



Jeroen Dijsselbloem, President of the Eurogroup, speaking before the meeting on 7 July. Credit: EU Council Eurozone (CC-BY-SA-3.0)

Countries must give up sovereignty as they enter monetary union, and it will become even truer as the Eurozone moves toward 'ever closer integration'. Moreover, the current governance implies an incremental withdrawal of sovereignty as a country proceeds into a formal infringement procedure, implements a Memorandum of Understanding and gets financing. A country cannot impose its own rules at the expense of the others, especially if it has a very high debt versus the rest of the Eurozone.

The current debate goes far beyond the Greek situation. It goes straight to the heart of what European integration is all about, and thus it will have long-lasting implications for the future of the Eurozone. This reasoning would lead me to a long discussion, while the purpose of this commentary is to pinpoint possible near-term developments.

What next?

At face value, a 'no' vote does automatically translate into plain rejection of the last-ditch bailout offer by Greece's creditors. However, things may be more complex than that for a number of reasons. First, the text submitted to the referendum was already obsolete as negotiations had advanced in the meantime. Tsipras said he would head straight to Brussels if he gets a 'no' vote and he is expected to present proposals later today. Even more important than the vote, however, is the political reaction in Eurozone capitals, and especially in Berlin. If the attitude remains

constructive, proper negotiations will now resume, but time is of the essence here as the financial/economic situation in Greece is deteriorating fast.

Second, the fact that just over 61 per cent of Greek voters voted ‘no’ cannot be totally dismissed in Brussels and in the other European countries, but the starting point of fresh negotiations is likely to be the end-point of the previous ones. My guess is that creditors will initially be unwilling to change much with respect to the latest offer. They have made it perfectly clear that further debt relief will be on offer only once Greece implements the programme. This is unlikely to have changed with the referendum. It is a sensible attempt to reward good behaviour and, if anything, this stance may have hardened.

Third, it is not clear whether there will be any room for further concessions by Eurozone governments with their taxpayers’ money (they have democratic mandates to honour as well) simply because Greek voters want them to do so. Tsipras has already completely lost trust among the creditors, and thus now he has a much more difficult task.

Fourth, there will likely be a need for some bridge financing to avoid an immediate collapse of the Greek financial system and this may prove particularly difficult. The Greek government will have to confirm the closure of Greek banks and maybe even introduce IOUs or promissory notes for a while. Negotiations will likely take more than a few days.

Is the current programme suitable?

My guess is that the programme tabled by the Eurogroup on 25 June (voted at the referendum) will become substantially different over the next few days. It is apparent by now that the programme is inadequate to address the fundamental issues facing Greece. In particular, it has a short-term approach (understandably so, given the lack of trust with regards to the ability of the Greek government to deliver); it does not address the long-term financing issue of the economy (these needs would call for a 10-20 year “Marshall Plan” for Greece); it is heavily skewed towards higher revenues (given the Greek government’s stance on spending cuts), which would not help Greece’s economic recovery; it does not properly acknowledge the issue of aggregate demand (even the IMF is now fully on board with this); and there is no attempt to provide any form of debt relief (creditors are unlikely to give Greece the benefit of the doubt, especially after the outcome of the vote), but the commitment should be clearly spelled out.

Can a butterfly in Brazil cause a tornado in Texas?

The knee-jerk reaction by financial markets is likely to continue to be negative. Government bond spreads could easily widen sharply. This also depend on the signals coming from Athens: when the noise is conciliatory, with a constructive attitude in finding an agreed solution, the widening of spreads may well prove temporary. However, if the perceived probability of Grexit increases, the widening of spreads and market turbulence may become more pronounced.

In financial markets, a butterfly in Brazil can cause a tornado in Texas. This event is more than just a butterfly and the tornado can easily spread to a substantially larger area. Danes rejected the Maastricht Treaty in the 2 June 1992 referendum with a tiny 50.7 per cent majority. It was widely perceived as a blow to the process of European integration (and, for a short while, indeed it was). It was sufficient to trigger the currency turmoil in 1992-1993. Since then, issues relating to European integration have been subject to greater scrutiny.

The current situation is more delicate for Europe than the one back in 1992 and the sense of uneasiness for the European integration process more pronounced. Moreover, the social and political backlash of the financial and economic crisis in Europe has brought to the fore explicit opposition to European integration both in core Europe and in the periphery. For instance, I was shocked to see that, according to a poll, 49 per cent of Italians would vote ‘no’ to the Greek referendum. Far-left and far-right populism is on the rise almost everywhere in Europe. The whole confrontation with Greece may have far-reaching political consequences. There could be political contagion in the rest of Europe.

Aside from this, however, it is difficult to see any mechanical channel through which contagion could spread in financial markets. The referendum was widely debated and financial markets were prepared for the possibility of a 'no' vote. In other words, the surprise outcome of the vote was not totally unexpected (while the Greek decision to call for a referendum was a genuine surprise). The Greek exposure is almost entirely towards other European countries and international institutions, which could more easily absorb losses. As a result, there is limited risk of setting in motion a spiral of financial problems that leads to widespread changes in economic agents' behaviour. This is particularly true for the European banking sector and institutional investors.

In case of default also of the private side and/or exit from monetary union, the banking sector in Greece would de-facto be insolvent and it would have to be recapitalised. Still, the international exposure to the Greek banking sector looks limited and unlikely to trigger widespread contagion (Greek banks are present in some other countries, notably in Bulgaria, Serbia, Romania and Turkey). To some extent, a default in Puerto Rico would produce much larger contagion as most of its debt is in the market.

What can the ECB do?

In the short term, the heavy lifting will have to come from the ECB. The ECB is expected to front-load asset purchases undertaken as part of its quantitative easing programme should financial markets drive up government bond spreads across Europe. It could easily double or triple, or even buy a multiple of its usual daily amounts of bonds bought under the programme. The recent move to broaden the set of assets the ECB can buy is to be considered as part of the attempt to increase its ammunitions.

Specifically on Greece, I doubt there will be any possibility for ELA extension before any political decision. The ECB could provide technical assistance to the Bank of Greece for managing the liquidity situation, but I find it difficult to believe that it can provide any financing before a political green light. Moreover, if a solution is not found by 20 July and Greece defaults on the ECB, even the current stock of ELA extended to the Greek banks will have to be reconsidered. In case turbulence continues, the ECB has a clear mandate to preserve financial stability and singleness of monetary union, and thus other tools may be introduced.

Can the situation generate much-needed clarification within Europe?

Some people argue that this Greek saga may lead to significant steps toward integration in the Eurozone, a speed-up in the ever closer integration. I doubt it. Since the European political elections in May 2014, there has been a clear shift in sentiment toward Europe and the appetite for "more Europe" is probably at historical lows.

In my view, the only significant step that in the near future could prevent the spreading of tensions to other Eurozone countries would be an unlimited insurance on the denomination of bank deposits across the Eurozone. In other words, European institutions would not guarantee the banks but the denomination of deposits to avoid future potential bank runs. Never say never, especially if the situation worsens significantly. Yet, politically the situation does not look mature for any sizeable step toward more Europe, not even in the technical domain of economic governance or deposit insurance.

Nevertheless, such an extreme event would justify a deep soul-searching exercise over the coming months. I think this exercise is badly needed and it may eventually turn into a renewed commitment and a fresh relaunch of the integration process. But it will take time.

Bottom line: down but not out

Financial markets are braced for significant tensions. The ECB has the tools to prevent contagion in the near term, but any step to provide liquidity support to Greece can only happen with political blessing. Grexit remains unlikely, but the risks have clearly increased. It would represent permanent damage to monetary union. European leaders will work on a solution over the coming days to prevent Grexit by seeking a reasonable compromise with the Greek

government.

Time plays against the Greek government. It may take at least a few days and the financial/economic situation in Greece may further deteriorate before a solution is in sight. The immediate negative reaction by financial markets may prove short-lived if an agreement is eventually reached.

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Note: This article gives the views of the author, and not the position of EUROPP – European Politics and Policy, nor of the London School of Economics.

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