Economic Research

WEEKLY ANALYSIS

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Pyrrhic Victory for Tsipras: A Heavy Price to Pay

Europe accepts referendum results and awaits Greek proposals. ECB tightens requirements in terms of guarantees. Increased risk of a Grexit. Financial markets relatively calm.

Key Points

- 61% of Greeks vote "NO"
- Alexis Tsipras wins new mandate to negotiate with Greece's creditors
- Back to reality with a bump after scenes of jubilation
- The ECB keeps up the pressure, discounting the collateral used as guarantees. Greek national debt might only be worth 40-50% of its nominal value
- Merkel and Hollande leave the door open, respect the referendum results, but remind Greece that the conditions for an agreement are not in place
- The Eurogroup awaits Greek proposals
- Alexis Tsipras will propose debt restructuration
- Grexit would mean a Greek default and a huge dead loss of 320 billion for its creditors
- Agreement is rational and probable

Greece votes "no" to the July 5th 2015 referendum

Alexis Tsipras certainly caught European negotiators unawares by proposing to organize a referendum on the Greek bail-out and accompanying reforms in the space of just a few short days. This financial support is needed for the Greek economy to survive, as Greece becomes the first member of the European Union not to repay their debt, in this case €1.5 billion due to the IMF on June 30th.

The Greek leader had been elected to give the Greek people back a sense of dignity and hope, yet whilst he continued to state loud and clear that he wanted to keep negotiations open, he blocked negotiations and further isolated Greece whilst everyone waited for the referendum results.

Alexis Tsipras wanted to use the referendum to strengthen his mandate, but at the end of the day, it only raised levels of irritation and exasperation, both among the European political classes and the European public. Greek complaints are increasingly falling on deaf ears.

At the very least he won the bet, with a clear victory of more than 61% "no" votes.

But did the Greek people understand the question, and were they able to analyze the likely implications of the result?

On the evening of July 5th, scenes of jubilation on the streets of Athens and other European capitals seemed, in any case, to celebrate the Greek people's new found dignity. A simple "no" vote to a question as restrictive as the question the Greek government asked its people seemed enough to rekindle hope for a population left bruised and desperate by a perpetual economic crisis. Greece has been celebrating and proclaiming that Europe will no longer be calling the shots. They hope for democratic renewal and a new form of governance. Yet have the Greek people lost touch with reality?

Alexis Tsipras' initial reaction was more measured while he undoubtedly weighed up the relative importance of this vote of confidence in the eyes of the European negotiators, the ECB and the IMF.

At best, the referendum gives Tsipras a new mandate, but no new tools.

Perhaps, then, he was mainly hoping that a "no" vote would enable him to attend fresh negotiations having secured the full trust of the Greek people? This might allow him to pave the way for a future "yes" vote in the wake of the inevitable future compromise with Greece's creditors, allowing everyone to save face.

In any case, the European political class is in agreement that we should not fan the flames so soon after the vote. To start with, they have stated that we should accept and respect the results of the referendum as the democratic opinion of the Greek people, but quickly reiterated that everything still remains to be done and that any future agreement will depend on the content of Greek proposals. During the press conference on July 6th, Angela Merkel and François Hollande left the door open for discussions, whilst nevertheless highlighting that the conditions for an agreement were not in place and that the Greek Prime Minister should put forward concrete proposals at the July 7th Extraordinary Eurogroup Meeting. Even as we write this article, the Greek government has made no proposals. They are set to announce fresh proposals on Wednesday, July 8th, whilst the Eurogroup has set a final deadline for Sunday, July 12th.

Alexis Tsipras, on the other hand, has steered clear of the excessive publicity stunt which he could easily have given in to. Instead, he gave a somewhat humbler televised speech during which he confirmed that the referendum result did not mean that Greece was breaking away from Europe (which is undoubtedly not what the Greek people want), but that it consolidated the government's power to negotiate.

He believes that this result gives him the mandate to request that rescheduling of Greek debt be an integral part of the deal, and that it not be conditional on a preliminary agreement on the structural reforms to be carried out. However, this stance is far from gaining the acceptance of the European negotiators.

The almost immediate resignation of the Finance Minister Yanis Varoufakis clearly has a part to play in the Prime Minister's change of tack. He has been replaced by member of the negotiating delegation E.Tsakalotos, who is more open to compromise. Therefore, this should facilitate a new phase in the negotiations, which will now be much less conflict-oriented and much calmer. However, beyond the declarations of renewed support and solidarity by the parties, resentment still simmers, and the economic and political reality will bite back with a vengeance on Monday.

This is the 1st episode of "back to reality". The ECB reminded the Greek Prime Minister and the Greek banks of the urgency of the situation.

After having propped up Greek banks by providing them with the necessary liquidity to keep the banking sector ticking over, albeit at a slower pace, the ECB seems to want to react already by strengthening the collateral requirements needed for them to provide banking liquidity lines to Greek banks.
Emergency Liquidity Assistance (ELA) remained at €89 billion (frozen on June 28th), but the ECB has announced that they have adjusted the haircut to Greek bank collateral and refused to provide the €3 billion increase that banks had requested.

On the evening of July 6th, the ECB asked for greater guarantees from Greek banks, specifically different guarantees from those usually provided in the form of collateral against Greek national debt. The ECB's proposed haircut could be as much as 40-50% on Greek government bonds, which also provides a tantalizing glimpse of the ECB's real evaluation of Greece's risk of defaulting.

The ECB therefore believes that the "no" vote makes an agreement less likely.

Unless, that is, this is but an extra warning to Alex Tsipras pushing him to put forward a credible package of reforms before the risk of failure for Greek banks really takes shape.

For now, this harder line does not mean that Greek banks do not have the necessary liquidity to ensure minimum levels of activity; thanks to strict capital controls and ATM withdrawals limited to 60 euros a day they are still going. However, this process could lead to Greece leaving the Eurozone should future negotiations be blocked and collateral run out.

Alexis Tsipras is certainly well aware that it will be impossible to find a replacement creditor able to hook the Greek financial system back up to the Eurozone. As it currently stands, the financial system is ticking over, with imports and exports limited.

In this context it seems highly unlikely that Alexis Tsipras will be able to hold good on his assurance to the Greek people that this would be a 48-hour crisis. This week may be an even harder pill to swallow for the Greeks, as they could see cash withdrawal limits squeezed even further.

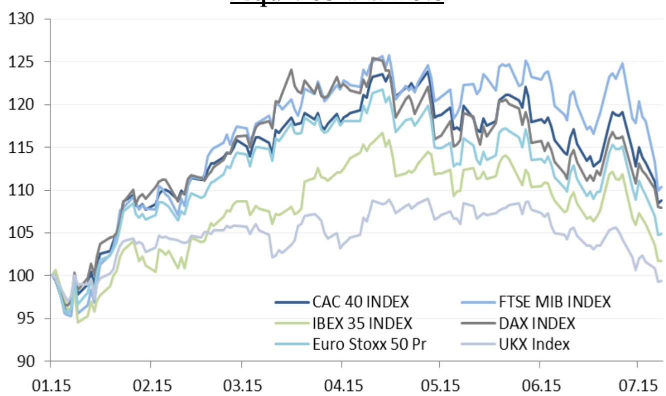
Does the ECB have any other choice? In theory, it cannot lend Emergency Liquidity Assistance (ELA) money to insolvent banks.

However, by increasing its collateral requirements, it risks indirectly eroding the solvency of Greek banks. The ECB clearly wants to push the Greek government into finding a political agreement with its creditors before Sunday, July 12th.

Reactions from Financial Markets

Financial market reactions following the Greek referendum results were rather restrained on Monday in the end. Whilst undoubtedly awaiting renewed negotiations on Tuesday, the European equities index recorded a -2.2% drop, whilst in the United States, the S&P500 index remained relatively stable, slipping -0.39%.

Equities Markets

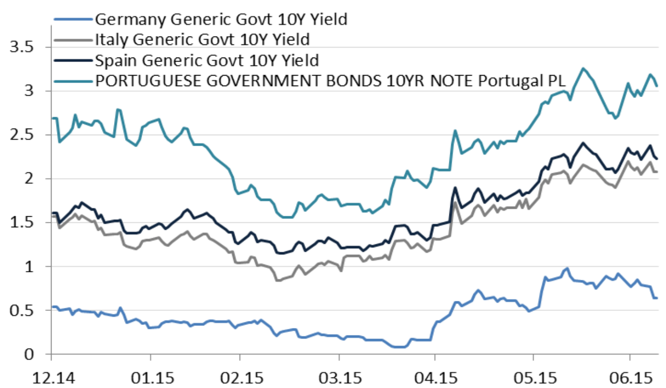


Sources: Bloomberg, BBGI Group SA

In terms of interest rates, there has been little reaction on peripheral debt markets. BTP, Bonos and PGB 10 year government yields have "only" increased by 14 points, 16 points and 24 points respectively.

German government debt enjoyed a very slight resurgence in investor interest for low risk investments, but this change remained very limited, with a drop of 3 points.

Bonds Markets

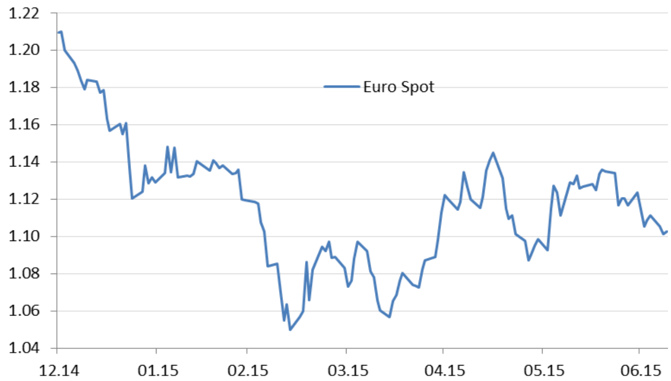


Sources: Bloomberg, BBGI Group SA

The euro has born up rather well throughout this new chapter of the Greek saga, dropping a minor -0.53%. In terms of currency, even the implied volatility of currency options indicates a certain serenity on the part of investors.

Gold prices signal no great concern either. Prices only increased from $1,168/ounce on Friday to $1,170/ounce on Monday.

Euro Dollar



Sources: Bloomberg, BBGI Group SA

For the time being, financial markets are almost indifferent to Greece's woes.

OECD Optimistic, IMF Ready for Action

The OECD is anticipating a twelfth hour agreement between Greece and its creditors.

The OECD Secretary-General Angel Gurria remains optimistic and believes that an agreement should be reached so that Greece can remain in the Eurozone. He thinks that too high a price would be paid should negotiations definitively fail. He also reminded us that we can estimate the cost of an agreement, whilst the price of not compromising simply cannot be estimated.

The IMF came to Greece's aid on Monday, saying that it was prepared to help if the country requests such assistance via the Director-General Christine Lagarde. The statement published by the IMF was relatively terse and brief, and did not specify the conditions of this request for assistance. However, it seems that the IMF informed Alexis Tsipras that any IMF support would be provided on the condition that they pay the €1.5 billion arrears.

Whilst European assistance for Greece expired last week, in theory Greece can access €16 billion euros of IMF loans, providing that the €1.5 billion is paid.

Before now, the IMF had suggested that Greece be granted European aid and that they should be offered 30% debt relief, to the surprise of European negotiators.

Today, the IMF will not be sat at the negotiating table and will therefore not be able to release the €16 billion in aid that is theoretically available, unless Europe decides to pay the IMF on Greece's behalf or grant Greece a specific loan so that it can settle its bills with the IMF. We should also remember that Greece requested a payment deadline which is yet to be examined by the IMF. Although the IMF did not seem very keen on this request, it seems entirely plausible that an agreement could be reached here. This would allow the IMF to exercise its influence in order to try and ensure Greece stays in the Eurozone.

Greek Debt Rescheduling?

Greek public debt stands at more than €320 billion euros, or 175% of the country's GDP.

Since 2010, the bulk of Greek debt has not been held by private investors, but by public and supranational institutions. The IMF holds €32 billion in loans, the European Financial Stability Facility (EFSF) holds €142 billion, and bilateral loans by Member States (Greek Loan Facility) account for around €53 billion. For its part, the private sector had already accepted a haircut in 2012 within the framework of Private Sector Involvement (PSI). Greece will certainly want to retain access to the financial market, so it is unlikely that they will want to restructure this portion of their debt. The country will therefore likely focus on negotiations with Member State creditors, the EFSF, and the IMF.

The current sticking point resides in part in the fact that the Tsipras government wants to incorporate debt readjustment into the negotiations on the structural reforms. This is currently unconceivable, especially from the German point of view.

Any possible solution to the crisis would involve incorporating this issue into the continuing negotiations over the coming days. The proposals that the Eurogroup are awaiting from the Greek government should reflect this. Re-profiling Greek financing, and restructuring its debt could also take many forms. It would of course not be necessary to fully write off Greek debt, and no agreement to this could ever be achieved in today's climate.

Aiming to reduce the debt to GDP ratio from 175% to 135% for example, would be sufficient if you compare it to the rest of Europe (Italian ratio); global European national debt stood at 97.5% of GDP in the first quarter of 2015.

Alexis Tsipras' government should come back to the table with credible, specific measures regarding pensions, the civil service and defense, offering rescheduling of IMF and EFSF debt, a partial write-off of Greek debt and/or deferral of repayment of Member State loans in return.

Negotiations are set to kick off again on Wednesday. As they await new proposals from Alexis Tsipras, financial markets have adopted a wait-and-see policy.

The threat of a Grexit intensifies as the arm-wrestle hots up. However, if all players were rational, the Grexit would not be a rational option. It is a one-way ticket to Greek default and the sure-fire loss of €320 billion in credit. Reason should win the day and authorize debt readjustment, which will be less painful for Greek creditors, whatever the outcome. We should not forget that a Grexit would open Pandora's Box and allow risks that the Eurozone does not need to rear their ugly heads. But politics is not always rational.

Conclusion

Following the Greek referendum, the reaction on the financial markets has been rather contained, and has not fore-shadowed another crisis. The likelihood of Greece leaving the Eurozone seems higher after the referendum on Sunday, but financial markets seem not to have spotted any systemic risk involved in a Grexit, and are undoubtedly more concerned by the tumbling Chinese equities market.

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