On the Brink: An Update on Greece

First Western Investment Research
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Following five months of "11th hour" negotiations that generated a lot of posturing by officials but little substantive progress, the Greek debt situation took a dramatic turn over the past weekend. Late Friday night, Greek Prime Minister Alexis Tsipras surprised both European leaders and the citizens of Greece when he called for a referendum to be held on July 5th allowing the people of Greece to decide whether or not the government should accept the most recent proposal put forth by the country's creditors- the European Central Bank (ECB), the International Monetary Fund (IMF) and the European Commission.

In addition to announcing the referendum, Tsipras called on European leaders to provide Greece with a short -term extension of the bailout program while also making it clear that he would campaign for a "no" vote against the creditors' current demands. Not surprisingly, European leaders refused the request. That rejection forced the Greek government to announce that the country's banks would be closed until after the vote and that cash withdrawals from ATMs would be severely limited.

As it now stands, Greece is technically in arrears, not default, on its payments to the IMF having missed a €1.55B payment due on June 30. For all intents and purposes, however, Greece has defaulted on its debts as the country is unable to service them without further assistance from its creditors.

While Sunday's referendum vote is straightforward- should Greece accept or reject the most recent proposal put forth by the country's creditors- the results, no matter the outcome, will be complicated. A "no" vote will allow Tsipras to claim a mandate to demand more concessions from its lenders. However, there is no guarantee that European officials will be any more inclined to grant them. It would also do little to alleviate the current situation on the ground in Greece. Without additional funding, Greece will be forced to keep capital controls in place hastening the demise of its economy.

A "yes" vote would serve as a rebuke of Tsipras but increase the likelihood of the EU's willingness to work with Greece. However, the question is with whom would they be working? Many political analysts believe a "yes" vote would effectively spell the end of the current government, thereby necessitating the formation of a new one. If the current government were to survive, it is not at all clear that European leaders would be willing to work with them given the current level of distrust and animosity.

So what is the impact for markets? Certainly, the situation in Greece has resulted in extraordinary political theatre, but from a pure economic standpoint, Greece in a vacuum is of little consequence. According to the World Bank's most recent figures (2013), Greece accounted for just 1.4% and 0.3% of the European Union's and global GDP, respectively.

Where could Greece matter? Contagion. While Europe has come a long way from the dark days of 2010 and 2011 when the sustainability of the Euro was called into question, the current crisis has reignited some of those old fears. However, thanks to the creation of various financial instruments and programs since 2010, the ECB and other institutions are now much better equipped to handle such a crisis.

Still, European leaders must be concerned about other "peripheral" countries currently struggling with austerity, namely Portugal, Spain and Italy which according to the World Bank, collectively account for 20.5% of the European Union's economy. If those countries see Greece secure better bailout terms *and* stay in the Euro, they may very well be emboldened to push for a similar deal. Likewise, if Greece were to default, exit the Euro, and, freed from the burden of its debts, stage a faster economic recovery than if it stayed in the Euro Zone, those peripheral countries might question the need to be part of the Euro. That leaves European leaders walking a fine line. Certainly they want to keep Greece in the Euro if at all possible, as an exit would raise fundamental questions and fears about the long-term sustainability of the monetary union. In essence, European leaders are left trying to balance keeping Greece in the Euro while at the same time making enough of an example out of the country that others will not seek to violate the terms of their bailout agreements.

Thus far, the traditional measures of "contagion"- peripheral bond yields, the European stock market, and the Euro- do not seem to be overly affected by the current events. While peripheral bond yields have certainly risen and the stock market has fallen, overall, the moves have been relatively muted, especially compared to 2010 and 2011. As for the Euro, it too has been largely unaffected.

Trying to predict the outcome of the current situation is nearly impossible, given the complexities and politics involved. As the current situation remains very fluid, a deal could be struck at any time. For the time being, however, European officials appear willing to bide their time until the July 5th referendum, likely with the hope that the citizens of Greece vote "yes", the current government is replaced, and a new government, one more willing to work with the country's creditors, is elected.

So what does this all mean for investors? In the short-term, the potential for increased volatility. In the longer-term, probably not much. The market's reaction thus far suggests that investors view the current situation as a Greek problem, not a broader financial markets problem. This makes sense given that Greece is no longer a "surprise" like it was in 2010. Also, the ECB now has various financial instruments and programs at its disposal to prevent contagion that it lacked in 2010. Therefore, we believe that any fears of contagion will likely pass quickly and investors should not treat this as a panic situation and sell. Finally, improving Euro Zone economic data, the ECB's recently launched quantitative easing program, and the retreat of deflation fears, all give us further reason to believe that outside of Greece, the outlook for the rest of Europe is positive.

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