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VIEWPOINT

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The Greek tragedy unfolds

The Greek financial crisis deteriorated over the weekend of 13-14 June after talks between the Greek government and the 'institutions' providing financial aid to the Greek government – the EC, the IMF and the ECB – failed to come to come to any agreement, with discussions collapsing after just 45 minutes. The IMF's negotiators had left the talks earlier in the week, citing the lack of progress in narrowing the differences between Greece and the IMF. Markets are now focusing on the meeting of euro-area finance ministers, which takes place on 18 June. For some ECB and EU officials, this is a make-or-break meeting, which could determine whether Greece defaults on its debt and potentially leaves the currency union.

The concept of a 'Grexit' is nothing new and markets have until now largely shrugged off the worsening financial crisis, believing that some of sort of compromise or 'fudge' would be reached one way or another. Now it appears that Europe is preparing for the worst, with the ECB reported to be drawing up contingency measures in case Greece does leave the eurozone. This uncertainty has driven a 'risk off' trade in markets, with yields on peripheral debt rising while treasuries and gilts have benefited from safe haven buying.

What happens from here is hard to judge, with the situation changing on a daily and sometimes an hourly basis, but what is clear is that some form of Greek default cannot be ruled out. Our own research suggests that, absent any further support from the institutions, Greece will run out of cash on or before 30 June. At this stage, Greece would find it difficult to pay any benefits or indeed the salaries of state employees, throwing the country into chaos.

Although it has often been said that it is in no-one's interests for Greece to leave the eurozone (the consequences for the Greek people would be dire and it is clear that Chancellor Merkel is loath to let the euro project fail on her watch), the political trade-offs that are needed to engineer a deal are much more challenging now than they were in the past. Alexis Tsipras, the Greek prime minister, is clearly losing credibility with both the institutions and the hardliners in his own party, Syriza, but at the same time recognises that most Greeks would like to keep the euro. The institutions, meanwhile, have absolutely no incentive to cave in to Syriza's demands, as this would only encourage anti-austerity parties in Italy and Spain; indeed the best way to suppress these could be to let Greece default, in order to teach other countries a lesson.

Although a Greek default and exit would be uncharted territory, it is worth remembering that the ownership structure of Greek debt has shifted considerably, and this should limit contagion within the wider

eurozone: our analysis suggests that the European Financial Stability Facility is the chief holder (47%); followed by eurozone governments (19%); private investors hold a relatively modest 12% share. In other words, it is the 'institutions' rather than private investors or privately-owned banks that would take the biggest hit in the event of a default. This is a very different situation to a few years ago, when a number of the quoted European investment banks were known to be holders of Greek debt, and were not in a position to absorb large losses. While the direct costs may now be manageable, the impact on confidence is somewhat more difficult to gauge. We suspect the realisation that the eurozone is no longer irrevocable would not be merely shrugged off by markets, particularly in the periphery.

On balance, we believe the most sensible option would be for the institutions and Greece to reach some kind of agreement before the end of June. Whether or not this will happen is a very different question: the institutions need Greece to be stable, which requires further reforms that the Greeks have little or no appetite to implement. It is possible that the Greek government will have to agree some deal with the institutions (in order to allow the country to keep functioning) or at least propose a solution that is put to the electorate via a referendum: the former suggests heightened risk premia, and the latter points to a greater chance of Greece staying in and swallowing the bitter medicine, given that most Greeks want to keep the euro. In the interim, it appears likely that Greece will probably miss its June IMF repayment, but the ECB will probably wait for events to unfold further before going down the route of implementing capital controls.

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