DOWN TO THE WIRE IN GREECE

INVESTMENT INSIGHTS
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"We are a few days or hours away from a possible deal on Greece."[1]

François Hollande
French President

"I have no information that anything decisive has changed in terms of substance."[2]

Wolfgang Schaeuble
German Finance Minister

"We need unity, we must avoid division. I am confident that the political leadership of Europe will do what needs to be done. It will accede to realism."[3]

Alexis Tsipras
Greek Prime Minister

After months of negotiations, an agreement remains elusive for the release of the remaining funds from Greece's 2012 bailout by the European Commission, the European Central Bank and the International Monetary Fund. Indeed, the quotations at left from three key participants on just one day last week reflect how far apart Greece is from its creditors.

Until this month, the base case of many analysts and strategists was for an eventual agreement, even though no one had offered a clear road map on how to get there. In our view, such optimism suggested that these observers were overlooking the facts on the ground.

Virtually no progress toward an agreement has been made since the Syriza government took office in January. We would argue that by rejecting existing agreements, sending conflicting messages and failing to provide detailed alternative proposals, Syriza has damaged Greece's relationships with creditors. Now the country has little money left and has made no reforms or even commitments to reforms — and nearly all eurozone goodwill and solidarity has evaporated in the process.

Higher risk of default

June promised to be a milestone in the Greek debt saga, with the month's first debt service installment payable to the IMF on 5 June and the second bailout program expiring at the end of the month. On 4 June, however, Greece took advantage of a rarely used IMF procedure to bundle together its 5, 12, 16 and 19 June installments totaling 1.5 billion euros and delay payment until 30 June.

Running out of cash and credit, Greece may be facing a political crisis, as the Syriza government's adherence to its anti-austerity election platform could be putting the country's economic future at risk. We suspect that holding a referendum on extending austerity measures or launching a snap election now would be unlikely to solve much at this stage. Even if another party could win an overall majority, it would take weeks to organize a budget and put forward an actionable plan for further reforms that would be acceptable to the creditor countries. Regaining the confidence and goodwill of its creditors could take Greece years.

Before last week we thought Greece might miss a payment, though without that leading to a declaration of default by the IMF. After last Friday's delayed payment, we are raising the probability we assign to default. And with large debt repayments due to the ECB by 20 July, political uncertainty further increases the chances that the default process could become disorderly.

[1] "Seeking compromise deal, Greece warns it might skip IMF payment," reuters.com, 3 June 2015.

[2] "Germany's Schaeuble dashes hopes for quick Greek deal," reuters.com, 3 June 2015.

[3] "Prime Minister Alexis Tsipras' statement prior to his departure for Brussels in order to meet with the President of the European Commission Jean-Claude Juncker," primeminister.gov.gr, 3 June 2015.

Anticipated timeline

Last week's nonpayment may be a default in all but name, yet the distinction is important. Once a payment has been delayed, the ECB is more likely to increase the haircut on Greek treasury bills. Moreover, the ECB would be unlikely to increase the emergency liquidity assistance to a state that is neither able to meet its obligations nor in a debt restructuring program. This could happen even before a formal declaration of default.

Such a declaration would occur at the discretion of the IMF and the European Financial Stability Fund.[4] After a short grace period following a nonpayment, Christine Lagarde, the IMF's managing director, would formally notify the executive board that the payments are due and late. At that point, the EFSF has the discretion to consider Greece in default on the loans it provided to Greece as part of the second bailout.

In order to close its near-term financing gap and improve its long-term debt sustainability profile, Greece has reportedly proposed to take the profits earned by the ECB from buying Greek government bonds, write off half the loans it received from the EFSF and extend indefinitely all other bilateral loans made by its eurozone partners as part of the first bailout. To date, Greece has offered its creditors few tangible benefits or commitments to further reform in exchange for such debt restructuring.

Based on the details reported, the Greek proposal — if accepted by the creditors — would mean that eurozone countries would extend financial assistance to Greece by way of a subsidy rather than a loan. Any loans written off by the EFSF would have to be made good by the eurozone countries guaranteeing the EFSF. This decision would cause an increase in the national debt of each EFSF guarantor and potentially result in credit rating downgrades for some — not a very palatable prospect for any government.

Terms of agreement

From the perspective of creditors such as Germany, the main point is that a framework for the second bailout package had been agreed upon with the government of a sovereign country. By the terms of this 2012 bailout, tangible reforms were supposed to be implemented in exchange for funding. Then another government under Prime Minister Tsipras came into power by promising to renegotiate the terms of this bailout — especially its onerous conditions for reform.

Now creditors wonder whether this or any successor government will honor any existing agreements. That is why the creditors have been so inflexible. Politicians in the creditor countries need to see far more compromises on structural reforms before extending additional funding to Greece.

We have observed an increasing acceptance that Greece could default on its sovereign debt or other state obligations and still remain within the eurozone.[5] After all, a country cannot be expelled from the common currency zone; it has to choose to leave. If Greece chooses to leave the eurozone, it would also need to leave the European Union under current treaties, and the Greek population clearly does not want that to happen.

[4] The EFSF is an entity guaranteed by all eurozone countries except Greece, Cyprus, Ireland and Portugal. The guarantees are proportional to the size of each country's economy, similar to the capital base of the ECB.

[5] In this event, capital flight would be exacerbated and capital controls would need to be introduced, which in itself would require a great deal of planning and organization.

Nonetheless, we are facing a significant amount of market uncertainty and potential dislocation if we enter the uncharted territory of a default within the eurozone or a country leaving the European Union. Based on the relative stability of periphery bond spreads and equity markets, it seems that investors may be underestimating such risks.

Admittedly, the likely intervention of the ECB — as well as the implementation of the relatively new EFSF, Outright Monetary Transactions and banking union reforms — should help to provide financial stability and support asset prices in the near term. At the very least, however, we would likely see increased volatility — particularly on the currency side — and a migration toward "safer haven" assets. Given the uncertainty that surrounds such a default or "Grexit," we would warn against assigning too low a probability on a negative market event. ■

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