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The Greek Crisis – The Third Episode

We did not expect that as of July 16, Greece's creditors would still be attempting to keep the country in the euro with a plan that does not work with the economics of Greece. The list of painful reforms that the Greek Parliament accepted on July 16 was poorly designed and far harsher than that voted down by the Greek populace 10 days before.

A successful vote in the Greek Parliament was a precondition for the rest of the Eurozone governments to formally begin negotiation over a third Greek bailout package. Several countries also required authorization from their own parliaments before talks could begin. All these steps were necessary only to set the stage for negotiations and it will be weeks before Greece receives any funding from the new bailout program other than increased emergency funding from the ECB for Greek banks and a bridge loan from the EU to cover ECB payments from July 20 to August 20. The financial stabilization mechanism is also providing €7.0 billion until the bailout deal is completed. The short-term financing will enable banks to reopen on Monday, July 20, with a limit on withdrawals of €60 per day.

There is little doubt that the swelling of an excessive debt burden and continued depression in Greece will negate the possible effect of the reforms contained in the latest bailout package. At best, the short-term funding that the agreement in principle unleashed will delay Greece's slow motion departure from the euro, which started with capital controls. Greece has lost one third of its GDP since 2007 and the Greek economy could shrink another 4% this year, according to the European commission. As Keynes originally noted, policymakers cannot impose additional austerity in the middle of such a drastic downturn and expect things to get better. In the opinion of Stratfor Global Intelligence, "The bargaining over a third bailout will probably be as traumatic as the negotiation over the past five months and the European Union will continue to link the disbursement of money to a strict timetable of reforms and external reviews." [1]

[1] www.stratfor.com, July 16, 2015.

Greece should not have adopted the euro in 2001. It is clear that it would be better off today if it had remained on the Drachma. This is true if only because it would have borrowed far less externally due to having to pay much higher interest rates as a result of exchange rate risk and not having to abide by the Eurozone rule against sovereign default. In addition, it would have had an independent central bank which could have offset fiscal austerity measures with monetary expansion. Finally, a flexible exchange rate would have offset excessive wage gains and at least partially preserved Greece's international competitiveness.

The benefits of a flexible exchange rate, more realistic interest rates and an independent monetary policy should continue going forward. For this reason and because it enables radical debt restructuring, Grexit within one year remains our base case scenario. The threat of contagion that could result from Greece leaving the euro in the near future is far less than it was in 2011. Since then Portugal, Ireland, Italy and Spain, with similar fiscal policies as Greece, have progressed sufficiently that contagion is much less of a problem. Moreover, Greece has a cyclically-adjusted primary surplus and a normalized current account position which have improved to the point that Greece could be self-sufficient if it left the euro provided it could substantially reduce external debt service. However, Greece returning to its own currency, even in an orderly manner, is not a panacea. Greece would still be a small struggling country with limited growth prospects. Still, this seems better than a country perpetually caught up in crisis.

There is also evidence that Greece's creditors are more favorable to Grexit even with substantial debt write-downs. For example German's Finance Minister, Wolfgang Schaeuble, proposed in the week before the German parliamentary vote on July 16 that Greece might be better off taking "time out" from the euro zone. He suggested that such a temporary exit would allow Greek creditors to write down its debt, which has been politically difficult in the past. An IMF report has been leaked which states that the current Greek debt level is far from sustainable, even if one ignores the recent economic deterioration.

The Greek Parliament's vote on the Greek creditors' reform package, contrary to the majority will of the Greek people, has left the Greek government less stable than before, but not disastrously so. The Greek Prime Minister, Alexis Tsipras, relied on the support of the opposition party to get the Greek Parliament to vote for the even tougher set of reforms than those rejected by 62% of Greek voters ten days before. The Prime Minister had to explain to his Parliament that Greece's creditors have forced the Greeks into a Hobson's choice between waging "an unfair battle" and "handing in their weapons." Given his failure in negotiations with the creditors, it is astonishing, according to the Economist, that no more than 3 out of 10 Greeks are calling for Alexis Tsipras' resignation. [2] The Economist also notes that a majority of Greeks hope that Mr. Tsipras' party will not "rock the boat by calling for snap elections"[3] but will form a broader coalition by lining up with smaller parties.

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[2] The Economist, 'From Rage to Resignation', July 18-24, 2015
[3] Ibid.

The positive is that a more broad-based and hopefully more sensible Greek government may well be able to work out an orderly Grexit with Greece's creditors involving a radical restructuring of debt, independent Greek monetary policy as a well as a separate Greek currency. The head of the ECB and the German Finance Minister realize that the bailout package currently on the table is unrealistic and very difficult to implement, as well as being politically costly to maintain. At the same time, the Germans did not want to set a precedent that a country can receive a substantial debt haircut and still remain in the Eurozone. Since it is still based on a high probability of Greece departing from the euro within a year, our constructive and opportunistic stance toward European stocks remains intact.[4] The causes of the recent meltdown of class A share prices in China and the possibility of sanction removal in Iran will probably have a greater impact on world commodity and capital markets than the Greek situation.

If you have questions about the economic situation in Greece and Europe, please contact our team directly at lerskine@drexelmorgancapital.com or 610-971-1901.

[4] A radical rescheduling of Greek debt in lieu of Grexit cannot be ruled out, although it probably would not be acceptable to German taxpayers. It is not legally possible for a country to default and remain in the Eurozone, although interest rate reduction and terming out of principal payments is permitted. However, according to the IMF, even delaying payments for 30 years may not be sufficient.

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