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TRENDMACRO LIVE!

## On the Greek Referendum Surprise, Volume 2

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**Markets will flail until Europe passes the biggest test yet of its muddle through crisis strategy.**

It remains the case that more is unknown than known in Europe, in the wake of Greek prime minister George Papandreou's surprise announcement that he intends to seek a referendum (see "[On the Greek Referendum Surprise](#)" November 1, 2011). Once again, let us review what is known:

- A meeting last night of Papandreou's cabinet agreed to proceed with pursuing a referendum. Previously it had been an entirely unilateral initiative by Papandreou.
- This is only a ministerial meeting though, and the parliament still has to have its say -- which they will in the form of Friday night's vote of confidence.
- If Papandreou wins the confidence vote, then he will (if his intentions remain unchanged) call a parliamentary vote on the referendum. If passed, its result would be a request of the Greek president to call the referendum.
- If the president agrees -- which is not certain -- then the referendum will go ahead. Originally the referendum was penciled in for January, but latest comments suggest it may be held in December.
- Even if the referendum is run, there is a chance that the required 40% of Greek voters needed for a quorum will not turn out. Referenda have a tarnished history in Greece, as they were used frequently by the military junta in the 1970s to give itself legitimacy, and have generally been avoided since.
- Papandreou said yesterday that the referendum would include an affirmation of Greece's staying in the euro. This is comforting in one sense, since 70% of Greeks favor the euro -- so this makes the referendum more likely to pass. At the same time it undermines the very premise of the euro currency -- that member nations are committed to it irrevocably.
- It remains unclear why Papandreou has called for a referendum at this time. He talked in June about an autumn referendum "[on the great changes of this land.](#)" But since then it seemed it was off the table, as EU aid to Greece was negotiated.
- It is a stark betrayal of undertakings with other Euro area leaders. German chancellor Angela Merkel and French president Nicolas Sarkozy are meeting with Papandreou this evening. Sarkozy is

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### Update to strategic view

#### EUROPE MACRO:

Papandreou's referendum initiative has plunged fragile Europe deep into "unknown unknowns," and markets will flail until there is more clarity. It's not that there aren't solutions -- diplomatic persuasion, elections for a new government, or even successfully passing the referendum. We remain optimistic that solutions will be found. But most of them require time, which is dangerously short in Europe. Greece is near the end of its runway on funding. And a speculative attack focused on Italy is underway. This is the biggest test yet of Europe's ability to "muddle through."

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reportedly livid, as Papandreou has ruined what would have been a moment of triumph for him at this week's G20 meeting in Cannes, at which he could have taken credit or solving Europe's crisis.

- Papandreou may be angling for improved terms for Greece as the aid package is finalized. Sarkozy has signaled no willingness to renegotiate, [stating today](#) that last week's announced bail-out is "the only way to solve Greece's debt problem." Even if Sarkozy and Merkel were to sweeten the deal for Greece, it's not obvious exactly how Papandreou could now stand down from his call for a referendum.
- Papandreou may simply perceive his grip on power to be lost. The referendum could be a form of legitimizing his legacy, or preparing a populist argument to use in elections he fears will be upcoming. His firing of military generals yesterday is symptomatic of last minute house-cleaning (not, as some have speculated, designed to forestall a coup -- if that were the purpose, he would have fired colonels).
- If the confidence vote fails, or if the president refuses to call the referendum and instead asks for an election, Papandreou's government could fall before Monday.
- Other than some rapidly negotiated deal between Merkel, Sarkozy and Papandreou tonight, an election may be the best-case scenario. An election could be held quickly, in the first week of December. It is unlikely that a referendum would be run after an election -- the election itself would likely be seen as a referendum on government policies.
- In an election, there is little risk of an anti-bail-out or anti-euro coalition coming to power. The electorate strongly favors euro membership, and all major parties recognize the necessity of some form of bail-out, with all the attendant costs.
- Meanwhile, the Greek funding issue is still not sorted in the immediate term. Greece is now saying it is adequately funded to mid-December, which contradicts earlier statements putting the deadline at [mid-November](#).
- The IMF has yet to approve the sixth €8 billion tranche due to Greece since September under the 2010 bail-out. The Euro area agreed to the tranche already, but IMF approval is needed to release it, and the present chaos makes approval problematic. IMF head Christine Lagarde's comments at this week's upcoming G20 meeting will be closely watched.
- If the referendum throws Euro membership in doubt, then an accelerated run on Greek banks becomes a real possibility.
- The chaos caused by the referendum surprise has destabilized the Euro area just days after it seemed the summit meeting had imposed some measure of order (see ["On the Europe Summit"](#) October 27, 2011). As we warned Monday, a speculative attack is underway (see ["Not Crazy, Still Cheap"](#) October 31, 2011).
  - Today the European Financial Stability Facility (EFSF) [delayed a planned €3 billion bond issuance](#) for Ireland funding, citing "market uncertainty and volatility." Even though a €4.4 billion Irish bond comes due in nine days, we think this presents no funding risk threat to Ireland's

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treasury in the near term. But it is worrying, as the EFSF is supposed to be a safe haven -- a "virtual Eurobond" backed by the credit of the entire Euro area, something that investors can fly to in a crisis. If it is being viewed as a risk asset, then it has already failed.

- Italian yields continue to rise, especially for short term debt, with 6-month paper now over 4.5%. Italian government ministers are currently holding rounds of crisis meetings to try to agree on a series of economic reforms demanded by EU and ECB, ahead of the G20 meeting. There were rumors this morning about Bank of Italy intervention in the market for Italian bonds, which have been denied.

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### **Bottom line**

Papandreou's referendum initiative has plunged fragile Europe deep into "unknown unknowns," and markets will flail until there is more clarity. It's not that there aren't solutions -- diplomatic persuasion, elections for a new government, or even successfully passing the referendum. We remain optimistic that solutions will be found. But most of them require time, which is dangerously short in Europe. Greece is near the end of its runway on funding. And a speculative attack focused on Italy is underway. This is the biggest test yet of Europe's ability to "muddle through." ▶