

TRENDMACRO LIVE!

On the Euro Summit "Agreement"

Monday, July 13, 2015

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Prisoners dilemma solved. Greece punished. Varoufakis humiliated. Message sent to Spain.

After [marathon](#) meetings of the Eurogroup of finance ministers and a summit of European Union leaders, there is what [European Council President Donald Tusk calls](#) an "agreement." It is very much what we've been expecting all along as our baseline scenario (see, among others, ["Greece at the Cliff: Thermopylae Edition"](#) June 26, 2015) -- a beyond-the-last-minute solution to the "[prisoners dilemma](#)" between Greece and the euro zone that optimizes the aggregate outcome. *But it is also very much not a done deal.*

- [The agreement](#) only commits the euro area and the International Monetary Fund to negotiate on the exact terms of a €82 to €86 billion bailout.
- *But to get to that negotiation, Greek Prime Minister Alexis Tsipras must get his parliament to accept conditions of so-called "austerity" that are harsher than the ones rejected in last weekend's referendum. So it is possible that the Greek government could fall, adding at least another element of delay.*
- By Wednesday the Greek parliament must enact laws to reform the VAT system and pensions, put in place automatic spending cuts in case of excessive deficits, and assure the independence of the Greek economic statistical agency ELSTAT. By July 22, new laws must reform civil justice procedures and bank resolution policies.
- Longer term, Greece will have to carry out other reforms -- further pension restructuring, liberalization of labor and product markets and privatizations.
- We have no idea how Tsipras is going to approach this. Normally the loquacious prime minister would have had a flamboyant statement on his web site by now -- as of this writing, [nothing](#). [Update: [he's saying](#) it could have been worse, and blame Greek's "oligarchs."]

From the strategic point of view, we are pretty happy with this outcome.

- We have long argued that the euro area's chief aim here is to handle Greece in a way that does not encourage SYRIZA-like populist movements elsewhere in Europe, especially Spain (see, among others, ["Greece: Failure Is an Option"](#) February 10, 2015).
- The euro area's brinkmanship in the agonizing decision process over the weekend -- led by Germany, which went so far as to [float the idea](#) of a 5-year "time out" for Greece from the euro currency --

Update to strategic view

EUROPE MACRO:

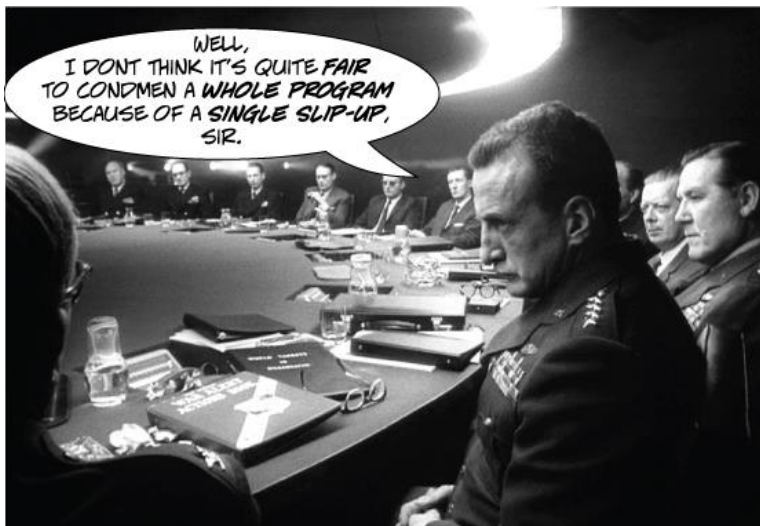
"Agreement" has been reached -- an agreement to negotiate on a huge Greek bailout, provided that the Greek parliament submit to various so-called austerity measures by Wednesday. The Greek government could fall in the process, which would introduce further risky delays. This is the compromise in the "prisoners dilemma" we've been expecting. It seems about optimal. It avoids the many risks of default and "Grexit." But the euro area's brinkmanship over the weekend demonstrated its resolve in the face of a blackmailing suicide threat, and the demands now upon Tsipras and Greece are punishments that should dissuade populists in Spain and elsewhere from imagining that they can vote away their debt obligations.

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seem to be [political theater designed to show](#) that Europe will not be blackmailed by suicide-threats to default and exit the common currency.

- All the wrangling over the weekend, and the political [labors of Hercules](#) now imposed on Tsipras, seem designed to punish Greece for attempting that blackmail, demonstrating to Spain and others that it's less painful to play along than to try to rebel.

Looking back it, it would seem we were correct in our intuition that Tsipras actually wanted a "yes" vote in the referendum (see ["On the Greferendum 'OXI' Surprise"](#) July 6, 2015). That would have gotten his government off the hook for caving in to Europe, without Tsipras himself having to take the blame for the failure of his blackmail gambit. But the "no" vote meant he had to soldier on in a war he knew he could not win -- and indeed made his eventual defeat all the more crushing.



- So we know now why former Finance Minister Yanis Varoufakis was sacked Sunday night after the "no" vote. He was the game theory master who had coached Tsipras through the whole negotiating process. He no

doubt concocted the referendum as a last-ditch gambit, assuming it would get a "yes" vote. When the "no" vote came in, we can imagine a replay of the scene in "Dr. Strangelove" in which, facing nuclear Armageddon, the US president shouts at an Air Force general, "you assured me there was no possibility of such a thing ever occurring!"

- What game theory expert Varoufakis apparently didn't consider all along is the trust element that accrues between players of "repeated games" -- that is, games in which there are multiple rounds between the same players who acquire knowledge of each other's strategies along the way.
- When the surprise referendum was called, what little trust the euro area had for Greece was wiped out -- no matter what the ultimate result of the vote. After that, the creditors of the euro area would have seemed -- indeed, would have been -- fools to lend more money to a nation that argues it can vote away its prior obligations. That would have been an engraved invitation to populist movements throughout the debtors of Europe.
- As late as Friday, exiled from power, Varoufakis was still churning out [incendiary challenges](#) to Europe's creditor nations.

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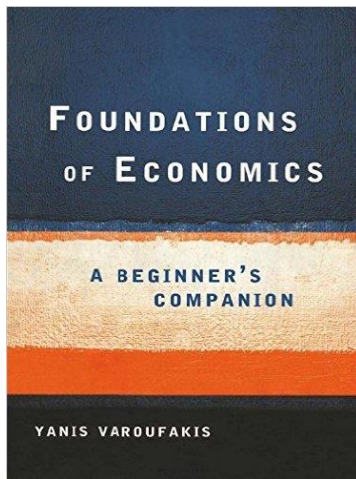
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Recommended Reading

[Greece's "No" is No Victory for Democracy](#)
Bernard-Henri Lévy
Project Syndicate
July 7, 2015

[Germany won't spare Greek pain – it has an interest in breaking us](#)
Yanis Varoufakis
The Guardian
July 10, 2015

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- In the absence of trust -- but still wishing to avoid the various risks of default and "Grexit" (again, see ["Greece at the Cliff: Thermopylae Edition"](#)), Europe had no choice but to impose a requirement of pre-compliance upon Greece as a precondition.
- There was a clue all along. The title of Varoufakis's Intro Economics textbook is *Foundations of Economics: A Beginner's Companion*. A beginner indeed -- and going up against some of the world's shrewdest and most sophisticated politicians, from German Chancellor Angela Merkel to ECB President Mario Draghi.

Bottom line

"Agreement" has been reached -- an agreement to negotiate on a huge Greek bailout, provided that the Greek parliament submit to various so-called austerity measures by Wednesday. The Greek government could fall in the process, which would introduce further risky delays. This is the compromise in the "prisoners dilemma" we've been expecting. It seems about optimal. It avoids the many risks of default and "Grexit." But the euro area's brinkmanship over the weekend demonstrated its resolve in the face of a blackmailing suicide threat, and the demands now upon Tsipras and Greece are punishments that should dissuade populists in Spain and elsewhere from imagining that they can vote away their debt obligations. ▶