Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Michael Warren, Energy Strategist

MACROCOSM

From Grexit to Griddance

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Donald Luskin

If Friday's deal blows up and Greece leaves the euro, that could be the least risky outcome.

Late Friday the Eurogroup of euro area finance ministers announced what will probably stand as at least a temporary solution to Greece's latest debt crisis, extending aid for four months. But the crisis is not necessarily over, even in the short-term.

- Even Friday's temporary solution is contingent on Greece providing a proposal today for exactly how it wishes to meet its existing overall reform targets. Considering that Greece's ruling SYRIZA party was elected and was able to form a ruling coalition on the promise *not* to honor the targets at all, there is the possibility that its proposal will be inadequate, or won't be made at all.
- *On the surface of it, the Eurogroup seems to be pursuing a hyper-aggressive "'all or nothing" bargaining strategy, demanding unconditional surrender from Greece, and willing to walk away if it doesn't get it* (please see the game theory payoff matrix below).
- *Indeed, it almost seems as though the Eurogroup has intentionally set things up to achieve a negotiating breakdown that would lead to "Grexit" -- that is, Greece leaving the euro currency.* After Friday's session, German Finance Minister Wolfgang Schäuble told the press with an unseemly degree of *schadenfreude*, "The Greeks certainly will have a difficult time to explain the deal to their voters."

Greek bail-out extension negotiations: game theory payoff matrix
Europe's favored outcomes **Greece's favored outcome**

		Europe	
		Extend	**Don't extend**
Greece	**Comply**	SYRIZA rendered ineffective	Infeasible outome
	Don't comply	Europe caves to populism	Grexit, failed state

Source: TrendMacro calculations

Update to strategic view

EUROPE MACRO, EUROPE STOCKS, FX: It looks like Greece under SYRIZA has capitulated to the Eurogroup's demands in order to earn another four months of bail-out funding. But Friday's deal could still come off the rails if Greece doesn't provide details of how it will comply with its pre-existing reform commitments. Europe has been utterly uncompromising, willing to court the risk of "Grexit," because Greece leaving the euro currency is no longer the euro area's gravest risk. Now the biggest risk is that a SYRIZA negotiating victory will encourage radical parties throughout Europe to overturn reform. Forcing Greece to comply, or letting it fail outside the eurozone if it won't comply, is now the least risky and most markets-friendly course. The Eurogroup's strong play in this negotiating game convinces us that Europe's elites understand where the risks truly lie, and underscores our bullish view on euro area stocks. A "Grexit" panic, if it comes to that, would be a buying opportunity.

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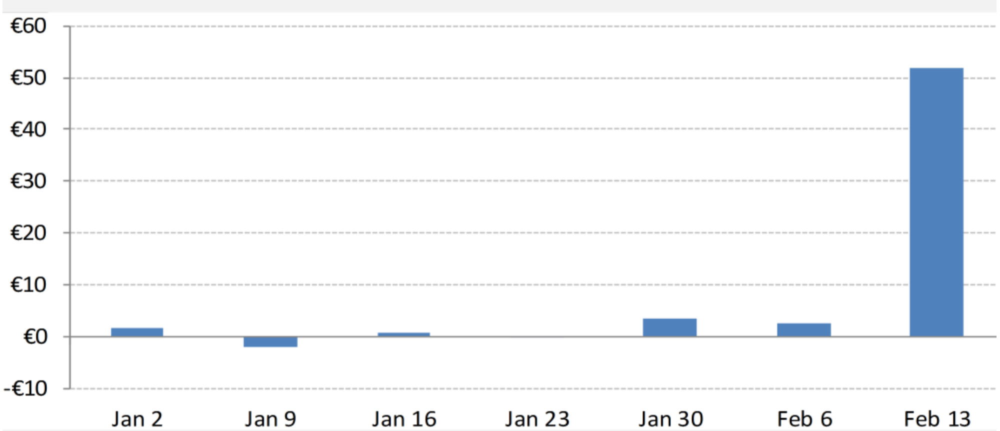
- Greece's explanation, over the weekend, has been to vainly try to paint it as a victory. This follows weeks of a Greek negotiating strategy to portray itself as willing for negotiations to break down, assuming that the Eurogroup would be afraid to let that happen. Its new finance minister Yanis Varoufakis, a game theory expert, has deliberately antagonized his Eurogroup colleagues with his casual and disrespectful manner, to demonstrate fearlessness and resolve. If he sticks with this course, when and if Greece presents its proposals later today, they may be calculated to lead to breakdown.
- *We don't think provoking a breakdown at this point is likely. Surely Greece sees now that it has been misreading the situation. Europe does not fear a negotiating breakdown, and markets shouldn't fear it either. Considering all the factors in play now, saying good riddance to Greece may be the euro area's least risky strategy.*
- Varoufakis is right to anticipate that Europe would, as always, adopt a "minimax" strategy in this game -- that is, it would seek to minimize the possibility of the maximum loss. *But he is wrong if he thinks that Europe's maximum loss is "Grexit."*
- To be sure, that was the maximum loss less than three years ago, just after the prior Greek election. But that was before ECB President Mario Draghi's "whatever it takes" declaration assured markets of the continuity of the euro (see "On Draghi in London" July 26, 2012). So "Grexit" isn't so much of a risk now.
- "Grexit" would mean that the ECB would pull the plug on the approximately €60 billion in Emergency Lending Assistance that is keeping the Greek banks funded (please see the chart below, and "Understanding ELA: Emergency Liquidity Assistance" July 15, 2011). Greece would have to impose strict capital controls, much as Cyprus did under similar circumstances in 2013 (see "On the ECB's Move Against Cyprus" March 21, 2013). Greece would not have to officially drop the euro just because the ECB no longer funded its banks. It would be like using Windows XP on your laptop -- it would work, even though Microsoft will no longer support you. Without officially introducing a new drachma, the government could pay its bills in small-denomination euro-denominated bearer bonds,

ECB Emergency Liquidity Assistance Weekly change, € billions



Source: ECB, TrendMacro calculations

Contact TrendMacro

On the web at
trendmacro.com

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Donald Luskin
Chicago IL
312 273 6766
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Michael Warren
Houston TX
862 812-7374
mike@trendmacro.com

[About us]

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Journal of Economic Perspectives
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Charles Blahous
e21
February 19, 2015

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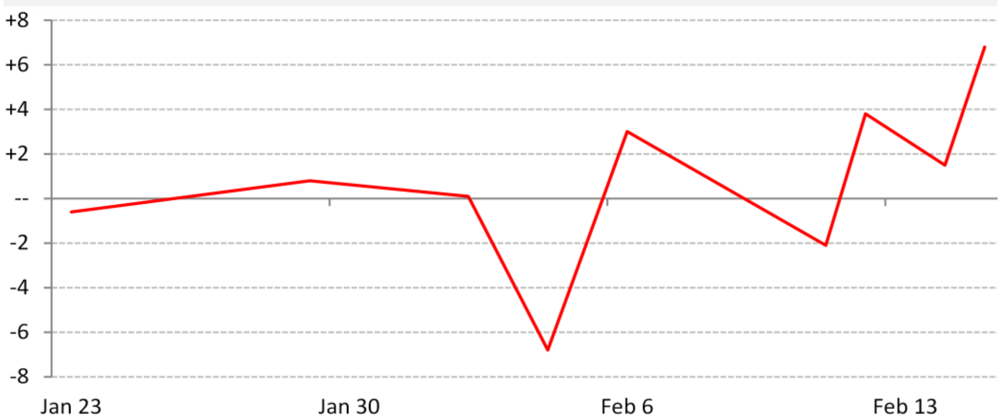
which would trade at a discount.

- *There is little in that for the rest of Europe to fear at this point.*
- Rather, in today's game the maximum loss that Europe wants to minimize (the bottom-left cell in the payoff matrix on the first page) is encouraging the contagious spread of SYRIZA-style radical politics to other nations, especially Spain (see "Greece: Failure Is an Option" February 10, 2015). So Europe's new "minimax" solution is to go for either of two other outcomes, both of which send the message to Europe's electorates that the core nations won't underwrite a return to borrow-and-spend policies: either (1) force SYRIZA to comply (the upper-left cell, and seemingly the outcome as of this writing), or (2) let Greece leave the euro and become a failed state (the bottom-right cell).
- *Either way, the message to radical parties throughout Europe is: don't think you can scare us into forgiving your debts, or letting you off the hook for promised reforms.*
- So far so good on that. Since SYRIZA's election in late January, and the Eurogroup's hard-line negotiating stance, Spain's reform-oriented ruling party, *Partido Popular*, has pulled ahead in the polls versus the radical-left *Podemos*, its SYRIZA-like opposition (please see the chart below).

Polling spread for 2015 Spanish election, *Partido Popular* over *Podemos*



Source: Wikipedia, TrendMacro calculations

- *It is encouraging to us that Europe's elites seem to understand where the risks truly lie now -- not in the currency union, but in the future of reform.*
- *If Friday's deal breaks down, and if that leads to "Grexit," we think that would present a useful buying opportunity in euro area stocks.*

Bottom line

It looks like Greece under SYRIZA has capitulated to the Eurogroup's demands in order to earn another four months of bail-out funding. But Friday's deal could still come off the rails if Greece doesn't provide details of how it will comply with its pre-existing reform commitments. Europe has been utterly uncompromising, willing to court the risk of "Grexit," because Greece leaving the euro currency is no longer the euro area's gravest risk.

Now the biggest risk is that a SYRIZA negotiating victory will encourage radical parties throughout Europe to overturn reform. Forcing Greece to comply, or letting it fail outside the eurozone if it won't comply, is now the least risky and most markets-friendly course. The Eurogroup's strong play in this negotiating game convinces us that Europe's elites understand where the risks truly lie, and underscores our bullish view on euro area stocks. A "Grexit" panic, if it comes to that, would be a buying opportunity.