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# On the Greferendum Surprise

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**Donald Luskin**

**Unknown unknowns. But most likely outcome: pro-euro "Yes" vote and back to negotiations.**

As we predicted on Friday, Greece has taken negotiations with Europe over the cliff (see "Greece at the Cliff: Thermopylae Edition" June 26, 2015). And, as we predicted, this has driven a risk-off move in global markets which, arguably, the consensus had assumed away. *It very much remains to be seen whether, as we predicted, Greece will ultimately capitulate. But we sure never predicted that Greece's endgame gambit would take the form it has -- a referendum on the bail-out to be held next Sunday, July 5 -- which, delays further negotiations many days past the June 30 re-financing deadline. Europe will not grant an extension while this plays out, so apparently Greece is headed for at least selective default.*

- The referendum is not on whether Greece should stay in the euro currency area, or the European Union. It is a narrow up-or-down vote on the most recent reform proposal put forth Friday by the IMF, the ECB and the European Commission as a precondition for further credit.
- In light of the referendum gambit, the ECB announced on Saturday that it will not increase its Emergency Liquidity Assistance (ELA) to the Bank of Greece, Greece's national central bank (see "Understanding ELA: Emergency Liquidity Assistance" July 15, 2011), to keep Greek banks afloat in the face of further deposit flight and cash hoarding.
- In counter-response, Greek Prime Minister Alexis Tsipras announced a bank holiday and capital controls, under the terms of which banks will be closed all week, ATM withdrawals limited, and other transactions restricted in unspecified ways subject to approval of an *ad hoc* bureaucracy.
- *Thus the ECB has maneuvered Tsipras into giving the Greek electorate a vivid preview of what it will be like to go it alone*.
- Terminating ELA, by contrast, would have been a death-blow, not a learning opportunity. Thanks to the ECB, Greece still has a chance to pull back from the brink of suicide.
- In a masterpiece of diplomatic nuance, the ECB said that the "Governing Council stands ready to reconsider its decision." Surely this is to be interpreted both ways -- that on the one hand ELA could be terminated at any moment, and on the other, if Greece behaves well, the ECB stands ready to welcome it back to the fold.
- At the same time, the ECB is braced for the worst, saying it "is closely monitoring the situation" and "is determined to use all the

**Update to strategic view**

**EUROPE MACRO, EUROPE STOCKS, EUROPE BONDS, ECB, FX:** We expected Greece to carry negotiations over the June 30 cliff, but we didn't anticipate a referendum -- which draws out the process by many days, and in the meantime has forced the imposition of bank closures and capital controls. The bank closures will give the Greek electorate a taste of what it would be like to default and leave the euro, and probably help get a pro-Europe "Yes" vote on the referendum. If that happens, the SYRIZA government will likely fall -- if it hasn't already in a panicky week -- bringing Greece back to the negotiating table, hat in hand. An anti-Europe "No" vote would mean a sequence of ever-larger Greek defaults, and the likely issuance of a parallel currency to recapitalize banks and pay daily bills. Either way, it's not a catastrophe for Europe unless some "unknown unknown" triggers a crisis of confidence. After a risk-off period, we think global markets will likely come back stronger than ever.

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instruments available within its mandate." Indeed, as we have emphasized all along, quantitative easing was introduced in the euro area -- just days before the Greek election that brought SYRIZA to power -- primarily as an instrument of prudential intervention (see "On the January ECB Policy Meeting" January 22, 2015).

- While we are the first to admit that we can't think of contingencies that we can't think of (again, see "Greece at the Cliff: Thermopylae Edition"), our baseline strategic expectation is that the global markets and banking system are robust to a Greek default or exit from the euro currency, and that the ECB is fully empowered to meet any short-term emergencies that arise.
- We continue to expect that, once the dust settles, it will turn out to be a good thing for Europe to be free of Greece as a source of uncertainty. Having Greece turn itself into a failed state will be a mind-clarifying event for electorates in other European nations -- especially Spain -- who might have otherwise been led from the path of reform by populist insurgents (see "From Grexit to Griddance" February 23, 2015).

So what happens next? We've already passed the "golden hour" in which the Greek parliament could have repudiated Tsipras' referendum gambit. Recall that's what happened in November 2011, in the heat of another bailout negotiation between Greece and Europe -- then-Prime Minister George Papandreou proposed a similar referendum (see "Papandemonium!" November 3, 2011) and, in a matter of days, he was ejected from office.

- Instead, this time around, Tsipras' referendum proposal -- made in a speech in the wee hours of the night on Friday, was approved by the Greek parliament on a narrow party-line vote in a fractious session on Saturday, with the ruling SYRIZA party, its coalition partner ANEL and the far-right Golden Dawn voting in favor. SYRIZA's primary opponent New Democracy voted against.
- If Greece falls into sufficiently panicky chaos this week, there's still some chance the government will fall as did Papandreou's.
- Or Europe could pitch a compromise deal. EU Commissioner for Economic and Financial Affairs Pierre Moscovici said on Sunday that there is still "room for negotiation" and that a new proposal would come from Brussels at noon today. But the European Commission has officially denied that.
- Failing these possibilities, the SYRIZA-led government will be campaigning this week for an anti-Europe "No" vote on the referendum, and New Democracy will be campaigning for a pro-Europe "Yes" vote.
- There's no polling yet on the referendum itself, but two polls taken on Friday -- before the referendum was announced, and asking Greek voters essentially the same question -- both have the pro-Europe "Yes" side far ahead.
- For what it's worth, as of this writing, betting at the Irish bookie website Paddy Power translates into a 63% probability for a pro-euro "Yes" vote.
- *If pro-Europe "Yes" prevails, we are assuming that the SYRIZA government will fall, and would be replaced by a "unity government"*

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*that would re-open negotiations with Europe. We doubt that, however angry Europe's leaders must be at the moment, they would turn away from a chance to rescue the situation, prevent default, and head off the first-ever defection from the euro currency. Overtures calling Greece back to the table have already been made.*

- *If anti-Europe "No" prevails, then we have to assume that Greece will continue in default of its loans from the IMF -- a default that will have become official at midnight on Tuesday, Then, one by one, as each obligation comes due, the defaults will mount.*
- On July 10, €2 billion in T-bills come due. They are held mostly by Greek banks who, presumably, could be ordered to roll them over whether they want to or not.
- On July 13, another €452 million comes due to the IMF, on top of the €1.55 billion due Tuesday.
- On July 17, another €1 billion in bills. The banks again.
- On July 20, €3.5 billion in bonds held by the ECB mature.
- Another €18.2 billion in outstanding debts comes due, to the same three creditors, by year-end.
- If the ECB yanks ELA from the Bank of Greece, then the Greek banks will need to be recapitalized.
- And all along, the Greek government will need cash to meet its ongoing operating budget -- cash barely covered by tax revenues even under the rosiest assumptions, and certainly not covered as the economy falls back into depression.
- *Under these pressures, Greece would have no choice but to start printing some form of money on its own authority -- even if it did not officially exit the euro.*
- *One option would be to print perpetual zero-coupon bearer-notes denominated in euros. They would be, for all practical purposes, drachma by another name. They would circulate in the Greek economy alongside actual euros, and trade at a discount.*

On paper, none of that is calamitous for Europe. In terms of sheer numbers, the worst case is that Germany, France, Italy and Spain have to pony up, together, something on the close order of €200 billion to top-up the European Financial Stability Mechanism bonds they have guaranteed and recapitalize the ECB if it ends up taking large losses on ELA.

- *But the calamity would not be in these sheer numbers. It would be in the potential blow to confidence in the face of unthinkable events that were supposed to never happen -- a default without remorse by a nation in the heart of modern Europe, substantial losses in the asset portfolio of a major modern central bank, and the first-ever departure from a supposedly irreversible currency union.*
- Our central tactical scenario here is that the referendum gets a pro-Europe "Yes" vote, the SYRIZA government falls, and Greece returns as a supplicant to the negotiating table. In that case the risk-off spasm in global markets will be a brief "buy the dip" episode -- when it's over, confidence will have been restored stronger than before for having survived the test.

- We're by no means ruling out an anti-Europe "No" vote, default, "Grexit," and all the rest. That's when we truly enter the world of unknown unknowns requiring a longer and deeper risk-off period, to end only when markets are assured that no systemic contagion will have issued through interconnections not currently anticipated, and when the relevant first-responder institutions -- primarily the ECB -- will have shown the capability and the resolve to have effectively intervened.
- A deeper crisis will help suppress populist insurgencies throughout Spain, and keep Europe on the path of pro-growth reform begun in the depths of the crises in 2011 and 2012.
- And it will drive Europe closer together. Already the euro area finance ministers announced, and the ECB affirmed, that "We stand ready to take decisive steps to strengthen the Economic and Monetary Union."
- Either way, we're relegating the possibility of truly catastrophic outcomes here to the realm of the highly improbable.

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**Bottom line**

We expected Greece to carry negotiations over the June 30 cliff, but we didn’t anticipate a referendum -- which draws out the process by many days, and in the meantime has forced the imposition of bank closures and capital controls. The bank closures will give the Greek electorate a taste of what it would be like to default and leave the euro, and probably help get a pro-Europe "Yes" vote on the referendum. If that happens, the SYRIZA government will likely fall -- if it hasn't already in a panicky week -- bringing Greece back to the negotiating table, hat in hand. An anti-Europe "No" vote would mean a sequence of ever-larger Greek defaults, and the likely issuance of a parallel currency to recapitalize banks and pay daily bills. Either way, it's not a catastrophe for Europe unless some "unknown unknown" triggers a crisis of confidence. After a risk-off period, we think global markets will likely come back stronger than ever.