GREEK UNCERTAINTY
(A whole lot of posturing going on)

On May 6th, the Syriza party, which means "Coalition of the Radical Left" surprisingly came in second in the Greek national election with 16% of the vote. Their leader, Alexis Tsipras, has vowed to cancel the European bailout deal, tax the rich, delay debt payments and cut the defense budget. He would also nationalize the banks, cancel labour reform and pension cuts and re-hire 100,000 public sector employees. The two historically dominant parties, New Democracy party and Panhellenic Socialist Movement (PASOK) collectively received only 33% of the popular vote but missed forming the government by only 2 seats.

Nonetheless, Tsipras claims that he wants to remain in the Euro as do 75-80% of the general public, yet almost 70% voted for parties that reject the terms of the bailout. Not surprisingly, their European partners are not on for that and have said that you can't have it both ways. Regardless, Tsipras contends that the Europeans will not force them out of the Euro because of the "contagion" effect.

With the inability of the parties to form a coalition government, new elections will be held on June 17th. In the meantime, there is no functioning government and we will not know for another three weeks how things will be resolved. That's a long period of uncertainty for the stock market and whether they stay with the Euro or leave is not really the issue. It is the contagion by other peripheral countries that is the real concern.

So, it might be helpful to understand the posturing and brinksmanship that is at play in what I think is a two step strategy.

The first phase is the pre-election period when the Greek parties again restate their position and the Europeans do their best to educate the Greeks on the consequences of withdrawal. From a contagion point of view, this would be the best time to contain the issue by establishing solidarity of the Eurozone.

Phase two comes if Greece allows the Syriza party to head the government. Should they leave the Euro, certainly the remaining Euro members will want to set an example for other countries that may consider the same thing.

Right now, the markets have rendered this issue down to this choice: you're in or you're out.

Well, unfortunately it isn't that simple. June 17th could come and go and Tsipras could be elected leader with no resolution to the Euro issue for months, if not longer.

So, let's examine each of these stages to get a better understanding of how they might be resolved.

The Election Phase

As I stated initially, Greece has not been able to put together a coalition government and the Syriza party has upset what seemed to be a deal to keep Greece within the monetary union.

Between now and June 17th, you can bet that the other European countries and the parties favouring the negotiated settlement will do their best to frighten Greek voters into a more rational choice. The European Central Bank (ECB) has already stopped lending to some Greek banks as a way to focus political minds on reform efforts. Unfortunately, they're going to scare the devil out of the rest of us at the same time.

Regardless, this is a united Europe's first line of defense, to prevent any kind of a breakup in order to avoid a precedent setting event.

If the traditional New Democracy and PASOK parties can recover control, there will be relief. Should they not, then we go to phase two.

New Democracy and PASOK Parties Recover

I wouldn't rule this out; in fact, I think it is probably the likely event.

When polled, 75-80% of Greeks say they want to stay in the Eurozone and the same number say they would stick with the terms of the bailout. Only 24% are in favour of abandoning the Euro.

More importantly, the majority say that the May 6th vote was to punish the pro-bailout parties of New Democracy and PASOK. After all, it was their collaboration that negotiated the austerity agreement and drove public debt to GDP from 20% to 170% during a 40 year period.

Although Syriza received 17% of the vote, that's only 1.0 million votes. Another 1.2 million Greeks voted for parties or candidates that fell short of the required 3% to constitute representation in Parliament. It was also a low turnout election with only 65% going to the polls.

So on June 17th, the Greeks may feel they've punished these parties sufficiently and when faced with the consequences of being cut off, decide to return these parties to a coalition government.

In a poll reported May 27th, this is exactly what seems to be playing out as the New Democracy party ranked first in six polls conducted on the election with a 5.7% lead on Syriza.

However, a lot can change in three weeks and this first line of defense against contagion could fail. The Syriza party could form the next government.

Syriza Wins the Election

In this scenario, the likely path is for the new government to reverse the agreed to austerity measures which would require Europe to withhold any further payments. Greece runs a structural budget deficit of about €4 billion, so it would probably run out of money by August and be forced to introduce the drachma. This would require Greece to pass a new currency law, redocument all domestic contracts, impose exchange controls and secure their borders to prevent the flight of capital, plus print and circulate the new currency.

This would be complicated by their default on the European Financial Stability Facility, the ECB and the IMF.

Furthermore, this would result in the Greek banks losing access to the ECB for funding in the face of a run on their deposits.

Most estimates suggest that the newly introduced drachma would devalue by 25 – 50% almost immediately. This would result in Greece defaulting on the balance of its debt and would do little to resolve the fact that tax revenues would still fall short of public spending.

Under this exit scenario, the government would have two options. First, it could take a responsible path to restart the banking system, run a balanced budget and persuade the public to accept a sharp decline in living standards while import prices rise dramatically. However, with a devalued drachma there would be more competition. Bottom line, this doesn't sound much better than staying in the Euro and the negotiated settlement.

The second option has the government using its new monetary tool to offset the effects of devaluation by spending its way to prosperity through printing drachmas. This would likely result in hyperinflation and further devaluation.

Faced with these two options, businesses are already considering moving their headquarters out of the country and currently leaving all receivables outside of Greece.

The consequences of such actions would likely result in the fall of the government and its replacement by a pro-IMF coalition which would attempt to negotiate a re-entry into the Eurozone.

At least this is the current consensus, but it might not necessarily work out that way. There is another alternative that isn't getting much press.

Let's assume Syriza wins and defaults on the country's agreements. The budget problems arise as expected, but what if they don't drop out of the Euro? One economist with the Peterson Institute for International Economics speculates that instead of Greece reintroducing the drachma, it instead stays in the Eurozone. Since there is no mechanism to kick them out, they could simply print Euro denominated IOU's, similar to what California did in 2009 when it ran out of money. There's no doubt these "Eurodrachs" would trade at a discount, but the country would avoid a lot of the problems of changing its currency and would not violate the public's preference to stay in the union. This would at least leave open the opportunity to rejoin the Eurozone at a later date.

Furthermore, all the focus is on Greece's budget deficit which is only the tip of the iceberg. The real problem is their trade deficit, which is true for most of the peripheral countries except for Italy.

So, suppose Greece does cut its spending and balances its budget. The fact that it imports more goods than it exports means that it has to borrow that difference in order to maintain its standard of living. When buying oil or European goods, it is unlikely anyone would accept either the drachma or Eurodrachs.

Faced with the need to purchase imported goods, it's likely that many businesses, especially those in tourism, will demand payment in Euros and operate in the black market. That's good for exporters but tough on civil servants.

Borrowing to pay social benefits is one thing, but getting your fuel oil shut off will get the Greeks' attention real quick and may turn things around in a lot of the peripheral countries that are in a similar position of running a trade deficit.

But Assume Greece Leaves

Remember the issue here is contagion, not Greece. If they leave the Eurozone, it is likely that the European Union countries would do their best to punish Greece in order to make an example of them for any other peripheral country thinking of leaving.

Otherwise contagion has many elements. First, everyone recognizes the potential of a Greek withdrawal having an impact on the banking system as deposits are withdrawn from banks in peripheral countries. The only positive here is that there is now a mechanism in place to control this, such as the long-term refinancing operations (LTRO) and European stability mechanism (ESM).

Bottom line, the ECB would have to offset transfers by either offering unlimited liquidity to the banks or by buying sovereign bonds.

Second, lenders are going to have to take some losses. Greece currently has €266 billion of debt outstanding with €194 billion or 73% being held by the ECB and the IMF.

When you include household and corporate debt, this number swells to €422 billion according to the IMF. Under their assumptions, losses could reach €66 billion for France and €89.9 billion for Germany assuming a 50% devaluation of the drachma. Of this loss, €19.8 billion would hit French banks while costing German institutions €4.5 billion.

Third, the trade deficit issue creates a problem for Germany and this expands dramatically if other countries consider default and withdrawal from the Euro. Trade deficits had been funded by sovereign borrowings, which are now being fulfilled by the ECB. These borrowings then work their way back to Germany for the goods that it sells. It essentially becomes an obligation of the Bundesbank. Effectively, Germany is lending to peripheral countries via the ECB, which isn't too far removed from floating Euro bonds which Germany is opposed to. It's basically a back door approach as each Euro member country is financially obligated to the ECB based on a combination of economic size and population. Under this formula, Germany inherits 27% of the ECB's obligations. Given that the ECB's paid in capital is only €6.4 billion, this is quite substantial and this is why Germany resists letting the ECB get further involved.

Lastly, there is an estimated €107 billion that is in the Target 2 interbank payment system that is used to process cross border transfers throughout Europe. When someone transfers his money out of the country, it flows from his local bank to the Greek Central Bank and then to the central bank of the receiving country through the Target system. Any default on the Greek side would be a liability for the receiving institution.

Conclusion

Greece is important and will have an effect if it leaves the Euro but it's far from conclusive what the result will be.

Although Europe can financially deal with a Greek default, they would rather not. Instead, they will attempt to convey the worst possible of consequences as a deterrent, not only to frighten the Greeks, but mostly to persuade other countries to stay within the Euro.

Nonetheless, these conditions can take on self-fulfilling and unintended consequences. Right now, we're caught in a game of brinksmanship with the ECB unlikely to offer any solutions to either the Greek or Spanish governments for fear of removing market pressure before the June 17th vote.

In the meantime, investors will probably respond to the worst possible conclusions that are being floated.

Once past the elections, policy makers will get back to work and regardless of the election outcome will have to contain worsening economic conditions in the peripheral nations and the financing of their banks and sovereign debt issues.

So far three ideas have been suggested: (1) a Pan-European bank deposit guarantee program, similar to the FDIC, (2) granting the ESM a bank license that would allow it to borrow from the ECB and expand its ability to lend to the banks, and (3) Euro bonds. Germans reject the last alternative yet they would be hurt the most by defections and its impact on their trade surplus combined with a likely strong Euro. Besides, as I have pointed out, Germany through its funding of the ECB has already conceded the joint responsibility for Euro debt. Unfortunately, it's politics that seems to be in the way.

Regardless, my view remains that the Europeans would rather paper over the problem than deal with defaults, wage deflation and a lower standard of living.

The market will take its hint from how creditable the European governments handle this latest flare-up in the solvency of the Euro community, but we may have to wait until after the Greek elections on June 17th.

In the meantime, Spain has taken over the headlines as there is more talk about its economic conditions and the health of its banking system. The result has been rising bond yields for the country.

Is it directly related to Greece? Only partly. Their problem is pretty straight forward. Earlier this year Spain declared that the underfunding of their banks would amount to about €15 billion. Unfortunately, one bank, Bankia, a conglomerate of seven regional banks, showed up asking for €19 billion.

Spain claims that it's a one off problem but investors are concerned that the predicament is much larger and will require more government funding. We will have higher bond yields until this situation can be resolved.

GRC/amh
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