TD Economics

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What happened:

- The people have spoken. Greek citizens voted “no” in a referendum on whether to accept the last bailout plan proposed by creditors. Contrary to early polls, it wasn’t even a close call with 61.3% of the votes falling into the “no” camp. We have officially entered no-man’s land, with Greece pushing the boundaries on the monetary union.

Where to next:

- There will be meetings upon meetings over the next two days, starting with Merkel and Hollande today in Paris and the eurogroup of finance ministers tomorrow. But, the most important meeting will be the Euro Leaders summit at noon Eastern Time tomorrow. This is where the appetite for compromise between parties will become apparent. Greece has yet to table a new proposal, and the European leaders have yet to craft a cohesive response on next steps. The outlook is clouded at the moment, but there are key elements that will give us hints of the willingness to compromise in the days to come.

- The first pertains to Greek banks facing a major choke point of running out of cash, even with capital controls in place. Although Greek officials have stated the desire to reopen banks as of Tuesday, this is unlikely to occur without greater funding from the ECB. Sentiment is currently leaning to not providing additional funding beyond what was agreed to last week, but should we see the tap opened further, it would be a positive signal of compromise.

- The ECB will host a conference call today on whether to accept an increase in emergency loans for Greece. In the absence of additional liquidity for the Greek banking system, economic activity in Greece will be stymied even further. After already defaulting on €1.6 billion owed to the IMF, the next required loan payment is €3.5 billion to the ECB on July 20th. This has direr consequence, as failure to pay would likely mean that the ECB removes ELA funding - so far it has only been capped - without additional euro area involvement. In such a scenario, with Greek banks facing bankruptcy, it is difficult to see Greece remaining in the euro area.

- Initial comments from EU leaders indicate that they are waiting for Greece to take the initiative of tabling a proposal that is reasonable to creditors. But, ultimately the ball is in the EU's court and markets will be hanging on every word that comes out of Tuesday's summit meeting. It is unlikely leaders will accept a proposal that is more lax than the original, as it creates moral hazard on bending to a single country's demands. In particular, Greece can create a domino effect, with Spain's governing party facing general elections later this year and anti-austerity parties already agitating on the sidelines. Germany is the country that needs the most convincing in striking a deal. Even in the case of a grand bargain deal including debt relief, stringent reforms will be demanded of Greece.

Market reaction and implications

- So far, market reaction has been eerily tame. The general risk-off theme of last Monday has resurfaced, however market moves have been more tempered. European equities have sold off, but the euro is down less than 1% relative to the USD. In standard risk-off fashion, the Canadian dollar is down roughly 0.6% relative to the USD at last Friday's close. Ten-year bund yields are down 3bp, while Portuguese, Spanish and Italian counterparts are up roughly 19bp, 11bp and 9bp, respectively. Part of the tempered reaction is due to the fact that markets are in a wait-and-see mode, pending details on the next step in negotiations.

Therefore, trading could remain range-bound until we learn more about European intentions come Tuesday afternoon.

- There is also a view in the markets that contagion risks are far smaller than they were in 2012, and rightly so. Greek debt, at roughly €322bn, is manageable by European standards (~3% of GDP, going up to 4% if Target2 liabilities are added on top). Of those billions of public debt, private sector holdings are less than 20% following the debt restructuring during the 2012 Greek sovereign debt crisis. Among European banks, Germany's are the most exposed to Greece's economy, to the tune of $16bn, including derivative exposure (relative to $32bn in late 2010). Compared to three years ago, the ECB has additional tools, such as the on-going QE program and the OMT, to help quell market fragmentation across European countries.

- It is hard not to see uncertainty remaining elevated over the near future. There is as of yet still no formal mechanism for a country to exit the euro area, without also exiting the EU. Moreover, euro area countries may not accept an outright default of Greece while remaining in the euro area, as this would create a precedent where countries could default without having to undergo European oversight of structural reforms. Finally, the degree to which the Syriza party remains open to compromise remains in question. In other words, political change in Greece may still be required before a final compromise is accepted. We will continue providing updates as details filter through.

Andrew Labelle, Economist
416-982-2556