TD Economics

Details surrounding the referendum:

- In the late evening of Friday the 26th, Greek Prime Minister Tsipras announced a referendum to be held on Sunday July 5th. Although details remain murky, the referendum will be on whether to accept the latest proposal of reform demands made by Greece's creditors during the euro group meeting on Thursday June 25th, which would unlock €7.2bn in bailout funds.

- Several additional elements add to the uncertainty. One is that Greece's current bailout extension expires on June 30th and euro area finance ministers have so far rejected the idea of extending the bailout agreement until the referendum. In other words, the proposal from Greece's creditors on which Greeks will be voting is arguably no longer on the table.

- The government has framed the referendum on whether to accept the creditors' deal, and not as a vote on staying within the euro area. At this point, there has been little in the way of public statement or discussion from the Greek government related to what the government's plans would be in the case of a no vote. However, the reality is that it would significantly increase the likelihood of a Grexit.

- Finally, even assuming that Greeks votes to accept the creditors' proposal, a key wildcard that remains is political uncertainty following the referendum. Given that Tsipras has stated he would vote no – that is, for **rejecting** creditors' demands in the referendum – his political future following a hypothetical "yes" vote is uncertain. Furthermore, a potential schism within Syriza could lead to the need to form a new government, or to snap elections.

- Assuming a positive outcome of the referendum, European partners would likely move to quell the uncertainty. At the time the referendum was announced, European creditors were proposing a new €15.3bn bailout extension, which would provide enough funding to Greece until November.

Details surrounding bank holiday and capital controls

- In response to the announcement of a referendum and the decision by European creditors to not extend the bailout beyond Tuesday, the ECB decided to cap the amount of emergency liquidity assistance available to Greek banks at €89bn. Given the likelihood of further massive deposit withdrawals from the Greek banking system beginning today, Greece has imposed capital controls. The Athens stock exchange and banks will remain closed until July 6th, with withdrawals limited to €60 euros per day per account.

- Greece will almost certainly not pay the €1.5bn it owes the IMF on June 30th. In reality, this will have no immediate impact. Greece also owes fairly sizable salaries and pension payments on Tuesday. Greece is believed to have enough funds for these payments. In the case of non-payment, domestic unrest may increase.

Key Implications

- Our view is that a referendum is likely to result in Greeks accepting the proposal by European creditors. Polls before the referendum was announced indicated that roughly 57% of individuals supported accepting the proposals, a figure which has consistently held above the 55% mark. The additional uncertainty this week created by capital controls is likely to tip the scale further in the direction of accepting creditors' proposals. The Greek economy remains very cash-driven and the bank holidays will disrupt economic activity to a greater extent than they would otherwise in other countries.

- In terms of contagion risks, this is far from 2012. In the near-term, the euro area will likely survive any potential outcome from the current crisis in Greece. Exposures of European Banks to the Greek banking system have been significantly reduced. A large majority of Greek public debt is owned by official European creditors. The ECB has the ammo to quell rising volatility. Should peripheral bond spreads widen materially, the ECB's current QE program could be front-loaded into July and August. Furthermore, the ECB could also resort to the OMT if necessary. As stated in a press release yesterday, "The Governing Council is determined to use all the instruments available within its mandate".

- Markets are aware of this and moves have been limited so far considering the circumstances. Portuguese 10-year yields are up a relatively modest 28bp, and Spain and Italy's are up only 19bp, magnitudes lower than in 2012. The EURUSD, after falling as low as 1.09 in early trading, has since rebounded to 1.11. Euro softness relative the safe haven JPY and CHF has been more pronounced. The Swiss Central Bank has confirmed intervening in the market to limit CHF appreciation. All things considered, the euro is likely to remain range bound unless the likelihood of a Grexit materially rises, in which case, the EURUSD could easily retest its 2015 lows of 1.05 or less. If the exchange rate were to fall significantly below parity, we could see coordinated G7 central bank action to support the currency.

- Even under a yes vote, uncertainty is likely to persist for a good while longer, until the post-referendum political situation in Greece is resolved, and a potential deal is passed through Greek and European parliaments. For Greece, it will be difficult to fully remove capital controls over the near-term. In the case of the Cyprus experience, capital controls imposed in 2013 were only fully removed in April 2015. Still, a deal with creditors – one which unlocks bailout funds for Greece, while reopening support for Greek banks from the ECB's ELA – would reinstate a measure of confidence.

- In terms of implications for economic activity, the euro area was enjoying something of a resurgence of late, with a lot of undercurrent to its growth. If the uncertainty persists for a month or more, this would likely lead us to revise down our forecast for 1.6% real GDP growth in the euro area this year. Peripheral economies, where growth in particular was coming in quite strong, would be the most affected, as a result of heightened risk aversion and higher yields.

- Market attention will also turn to the Fed, and whether Greek-related uncertainty reduces the prospect of a September rate hike. Ultimately, this will depend on the persistence and extent of the uncertainty. NY Fed president Dudley stated on the weekend that a September rate hike (our base case scenario) is "very much in play". This is still the case today, and will remain so, unless the volatility in Greece spreads over several weeks and materially impacts European growth prospects.

Andrew Labelle, Economist
416-982-2556

Follow @TD_Economics