Northern Trust

ECONOMIC UPDATE

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• The Greek Saga Escalates

The situation in Greece has taken some unexpected turns over the past several days, commanding the lion's share of the market's attention ever since. Following are answers to the questions we are being asked most frequently about the situation.

What happened over the weekend?

On Friday evening – apparently recognizing that the Greek parliament would never approve the pension reform its creditors demanded - the Greek government called for a national referendum on whether to keep accepting the terms of the European Union (EU)-International Monetary Fund (IMF) aid program.

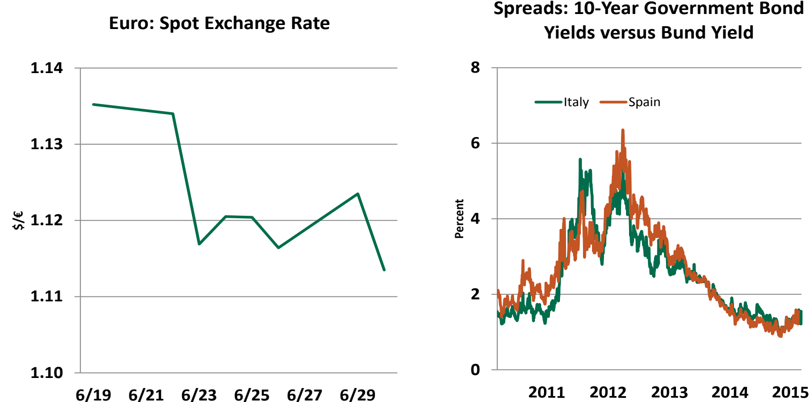
Once it became apparent that Greece would not return to the negotiating table until after the referendum on July 5, the European Central Bank (ECB) announced it would not increase the ceiling on the Emergency Liquidity Assistance (ELA) that the Greek central bank can provide to domestic banks. Without an increase in ELA, depositor flight would quickly drain those banks of liquidity. The government therefore decided on Sunday that an extended bank holiday and capital controls were necessary to prevent a run on the banks.

What do the capital controls mean?

For now, depositor withdrawals within Greece are limited to €60 a day, but all credit, debt and electronic transfers within the country can proceed normally. However, no payments outside the country are permitted (except for essentials such as medical supplies, which will be approved on a case-by-case basis). It is not clear how long these controls will remain in place, but they are unlikely to be lifted unless the banks are no longer in danger from capital flight.

How are the markets reacting?

Stock markets fell globally on Monday and Tuesday, but there were no signs of investor panic. The euro has held its value quite well.



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European stock markets remain higher than they were at the start of the year. European bond yields did rise, but they have started to ease back. It particular, spreads of 10-year government bonds in Spain and Italy are only running about 150 basis points (bps) over German bunds. This compares with spreads as high as 550 bps in 2011-12.

Is Greece now in default?

Greece will not be able to make a €1.55 billion debt service payment to the IMF today and could be declared in default on its IMF obligations within 24 hours – a first for an economically advanced democracy. However, an IMF default does not automatically mean that Greece will have to leave the eurozone. Both the creditors and the government have reiterated that they want to see Greece remain a member of the currency union.

A missed payment may not mean default, and default does not trigger exit from the euro.

The ECB has said that it will not increase the ELA ceiling, but it is unlikely to withdraw ELA while the referendum is still pending. If the ECB ultimately retreats from Greece, it would likely initiate a full-blown banking crisis there. Leading institutions are thought to be insolvent and will require careful monitoring even if financial support for the country is restored. .

What happens on Sunday?

Assuming the authorities can actually stage a national referendum with less than a week's notice, it is not clear just what the voters will really be approving or rejecting. The government has said the vote will be on a highly technical question related to the terms of the bailout program. But that program actually ceased to exist as of the end of today. Effectively, the voters will be asked whether or not they support the notion of reform in return for aid.

Various EU spokespeople have been quick to state that this will be a referendum on whether Greece wants to stay in the eurozone, but it is not at all clear that the voters will see it that way. To date, voter support for eurozone membership has been well over 70% even as barely 50% support the notion of further reforms.

Much may depend on how the government portrays the vote. If ministers stick to the line that Greece wants to stay in the eurozone but cannot afford any more austerity, then voters may think that a "no" vote will just buy them more time to negotiate. However, it is likely that the creditors will see a "no" vote as an outright rejection of eurozone membership and refuse to contemplate any more aid.

So what's the best-case scenario?

It is possible that Prime Minister Alexis Tsipras and his Syriza government assumed a market panic this week would put pressure on the creditors to offer Greece more generous terms for an aid program. That has not happened. All eyes are therefore on the Greek voters and how they react to these events.

The best outcome would be that the voters approve the notion of reform for cash, rejecting Tsipras' stance. This would likely trigger a change of government – either a new unity government of all the major parties that sidelines the most radical elements of Syriza; a technocratic government imposed by the president as an emergency measure; or a fresh

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general election. A new government could then open negotiations with the EU and IMF creditors on a third bailout package.

Ultimately, any long-term aid would have to include writing off a substantial portion of the debts Greece owes to fellow eurozone members. Under this scenario, capital controls would likely remain in place through the summer months but gradually be eased as a new program takes shape.

And the worst-case scenario?

The worst-case scenario is harder to predict but would likely start with the voters saying no to more reform on Sunday. This would keep an emboldened Syriza government in power and in turn would harden the resolve of the other eurozone governments not to give Greece any more aid. The ECB likely would cut off ELA. Investors and commentators alike would assume the inevitability of a Greek exit from the euro. . The Greek people would pay a terrible price.

Other countries have elevated debt and need reform, but none are in Greece's league.

But it is difficult to say just how this trajectory would play out. There is no precedent for a country withdrawing from – or being ejected from – the eurozone and nothing in the reams of legal paperwork on how this might occur. Everyone would be making things up as they go along. What is clear is that we would be in for a prolonged period of uncertainty, which could curb the nascent eurozone economic recovery.

What does this mean for global investors?

Greece is a small economy, but it could cast a bigger shadow.

The country's financial and trade linkages with others are modest; it is very unlikely that a Greek default would cripple financial institutions outside of Greece. Markets have been resilient so far; the impact on U.K. and U.S. equity indexes has been limited. The Federal Reserve is unlikely to alter its prospective course unless the situation evolves to diminish the economic outlook.

The potential for contagion centers on other European countries with large debt and structural challenges. It should be noted, though, that none have these afflictions in anywhere near the same measure as Greece does. If reason can keep psychology at bay, this understanding should limit any spillover effects.

There is still time to avoid the worst-case scenario, but the window is rapidly closing. We'll have more on the situation in our weekly commentary, and we'll provide another update early next week after the Greek referendum.

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