Northern Trust

ECONOMIC UPDATE

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• Greece: Closer to the Brink

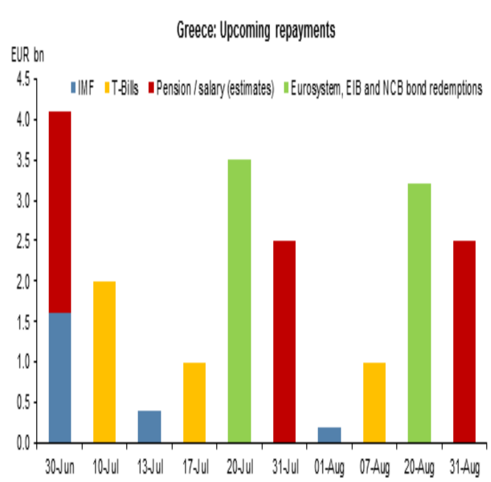
Greek voters declared an overwhelming “no” on Sunday – by a margin of 61% to 39%. Whether they were rejecting the notion of reform for aid or perceived German bullying is not clear, but the message to the rest of Europe was clear.

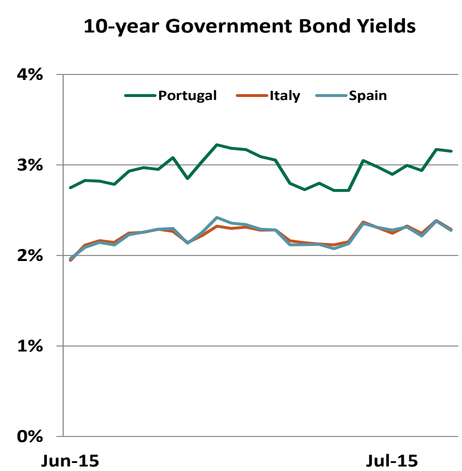
At the time of this writing, eurozone leaders are gathering to decide whether it will be possible to craft yet another aid program for Greece. But there are some hefty barriers to overcome, not the least the margin of the “no” vote.

The International Monetary Fund insists that it will not take part in any aid program unless it includes a write-down of some of the debt held by official creditors – reportedly by as much as 30%. Debt forgiveness would set a precedent for other heavily indebted members and would be politically difficult to swallow for some other eurozone leaders. German politicians are getting the most attention for stating that Greece must implement structural reforms in return for aid. But governments in other countries also must face their own electorates, many of whom have suffered through their own programs of austerity and reform.

And in Greece itself, the strength of the “no” vote will make it very difficult for Prime Minister Alex Tsipras to agree to the pension or tax reforms that creditors will likely demand in return for aid.

Greece faces some hefty repayment obligations in the coming weeks and currently does not have the resources to pay them. Meanwhile, the European stock and bond markets have reacted little to the crisis, convincing many in the region that a Greek exit from the eurozone would be no big deal.





Sources: RBS Credit Strategy, IMF, Bloomberg, Thomson Reuters

So where do we go from here? The nation's banks remain closed and will likely run through their liquidity buffers by the end of this week. The European Central Bank (ECB) has kept the ceiling on Emergency Liquidity Assistance (ELA) at €89 billion since late June and yesterday increased the amount of collateral that banks must offer as security for ELA access. If today's meetings do not raise the prospect of a new aid program, it will likely be only a matter of days before ELA is reduced or even stopped altogether. That would trigger the outright collapse of the Greek banking system.

Decisions must be reached with a two-thirds majority of the ECB Governing Council; reportedly the debates have been increasingly contentious in recent days. At some point, the Council will say "enough." Meanwhile, there are reports of one or more of the major Greek banks drawing up plans to "bail in" (i.e., raid and haircut) bank accounts over €8,000 if more ELA is not forthcoming.

For now, the best-case scenario is that today's meetings result in some form of short-term bridge program while both sides work on a third aid package. However, unless PM Tsipras does a complete U-turn on reform, there is scant evidence that the rest of the eurozone is willing to be flexible.

If both sides stick to their previous positions, then the Greek state will be effectively insolvent within days. The government would have to start issuing IOUs to pay some, or all, of next week's mid-month public sector wage bill. Capital controls would remain firmly in place. The rest of Europe would likely craft a humanitarian aid program to ensure basic food and medicines are available.

The next major date to watch is July 20, when Greece owes the ECB about €3.5 billion on a bond the bank holds. If some form of interim deal has not been reached by then, Greece will default on its ECB debt. The ECB will cease all ELA (if it has not done so in the interim). The European Financial Stability Fund, the main holder of Greek sovereign debt, would likely call in its own loans to Greece – which could not be paid. It is hard to see how a bankrupt country could continue to function inside the eurozone, making "Grexit" at that point all but inevitable.

Keeping Greece in the eurozone will require both forthright and unified leadership from the largest members of the eurozone and a clear articulation by the Greek government to its voters of what must be done. Neither has been in evidence in recent months. Much as it pains us, we can only conclude that a Greek exit from the eurozone is now the most likely outcome.