ECONOMIC RESEARCH

The NewsLine

July 1, 2015

} MACROECONOMICS | FINANCIAL MARKETS | ECONOMIC POLICY | SECTORS

Dr. Michael Heise
Phone +49.89.3800-16143
michael.heise@allianz.com
Allianz SE
https://www.allianz.com/economic-research/en

Allianz Research
https://twitter.com/AllianzResearch

GREECE

Grexit not yet averted

The Greek crisis has escalated. By walking away from negotiations and a further bailout, Greece has taken a large step towards Grexit. If a majority votes Yes in the referendum, as present surveys suggest, negotiations will be restarted soon, but even then there is no guarantee that Greece remains in the eurozone. In the case of a "No", a Grexit would be hard to avoid. On the financial markets, Grexit is probably not yet fully factored in, but would not trigger panic. Risk of massive contagion to other eurozone financial markets, as seen in 2011/2012, now unlikely. Rise in Italian and Spanish government bond spreads likely to be limited in event of Grexit. Uncertainties related to Grexit could dent growth temporarily but would not bring stabilization process to an end. We put potential knock to eurozone growth at a quarter of a percentage point in both 2015 and 2016.

Having walked away from talks on a further bailout program, Greece has moved one step closer to Grexit – its departure from the euro and introduction of a new currency. With the abrupt rejection by the Greek government of the conditions in the bailout on the table, weeks of talks to find a compromise between Greece and its international creditors ended in failure. Following Prime Minister Tsipras' announcement that the Greek people should decide per referendum whether to accept the creditors' final offer, talks have been put on ice for now, if not permanently, dashing hopes of at least a provisional accord before expiry of the second bailout. Without fresh financial aid, the country will soon face insolvency which in turn would call into question the continuation of the ECB's emergency liquidity assistance program that is currently shielding the Greek banking system from collapse. A Grexit could still be avoided, but this would require the willingness on the part of the Greek people as well as the government to reach an agreement.

In a first step, the Greek population must show its colors in the referendum scheduled for 05 July. In his own words, Tsipras hopes that a no vote will strengthen his hand in negotiations with the creditors. However, it is unlikely that the creditor countries will engage in new negotiations on sustaining Greece’s euro membership in case of a No vote. On the evening of the 30 June, the Greek government signaled the possibility that it may cancel the referendum, hoping for new negotiations on debt relief. A cancellation of the referendum or the Greek government actively campaigning for a Yes vote would possibly imply agreement to the terms of the expired bailout program. In that case, negotiations would be restarted as in the case of a Yes vote if the referendum takes place.

We consider a scenario in which the Greek population backs the tabled bailout program and hence for remaining in the eurozone as the somewhat more likely one (Probability: 60%). This is suggested by the fact that a clear majority of Greeks is opposed to Grexit. The imposed capital controls and the temporary closure of Greek banks have already provided a foretaste of the economic chaos Grexit would bring and are likely to supply further arguments for a Yes vote in the referendum. If the majority of Greeks vote Yes on Sunday, there is still hope for an agreement between the Greek government and the creditors. A Yes vote would make it likely that Greece could remain in the eurozone (Probability: 80%), but it wouldn’t guarantee such an outcome for the following reasons:

A Yes vote might well prompt the Greek government to resign and it is not clear who would assume control in this event. The options range from a new coalition under Syriza, an all-party government or fresh elections in which a renewed majority for Syriza cannot be ruled out. Given such political uncertainty, the best that could be hoped for would be a transitional arrangement between Greece and its creditors, which is unlikely to secure the country’s continued membership of the eurozone once and for all.

Nor would a Yes majority ensure that the ECB would continue to prop up the Greek banking sector with emergency loans. European policymakers would need to signal that they would be willing to enter into negotiations. The Greek banking sector has been under pressure for months in the face of growing Grexit concerns. The introduction of capital controls and the closure of banks following the ECB’s decision not to increase emergency loans illustrate how beleaguered the Greek banking system is. Although Greeks can currently withdraw a maximum EUR 60 a day from cash machines, it is unclear how long the banks can cope with the deposit outflows in the absence of a deal between the creditors and Greece. On 20 July at the latest, when Greece is unable to service a EUR 3.5bn repayment to the ECB, the European Central Bank could feel forced not only to cap the ELA loans but to demand them back altogether. Given Greece's insolvency, the solvency of the banks – the prerequisite for the granting of ELA loans – would no longer be guaranteed. After all, the banks hold huge amounts of Greek government bonds, the value of which would tumble in the event of sovereign default. In a default scenario, Greek banks would need to be recapitalized or nationalized.

In the event of a No vote (Probability: 40%) the resumption of talks between the Greek government and its creditors is hard to imagine. We think it unlikely that the international creditors would be prepared to make further concessions to Greece and rework the current final offer. The past few months have shown that the prospects of an agreement with the present Greek government are extremely low. The loss of trust caused by the abrupt and chaotic breakup of talks leaves no room for further concessions and the creditors would probably insist on using the last final offer as the basis for a resumption of talks. On a No vote, the ECB would also have to withdraw the ELA loans sooner or later as the prospect of an agreement with the creditors would be practically non-existent and default as good as certain. Greece would then be forced to introduce a parallel currency to supply liquidity to the banking sector and prevent collapse of the economy (Probability: 80%). The government could resort to IOUs to pay salaries and pensions for the time being. A parallel currency system along these lines would in principle provide the option of returning as a full member of the eurozone after a brief hiatus. However, should Greece again show little willingness to compromise, sooner or later a formal departure from the euro is inevitable. But this is unlikely to happen overnight. Rather it is likely to be a drawn-out process and months of grueling negotiations between Greece and its euro partners cannot be ruled out. After all, a euro exit is not envisaged in the treaties, so one can only speculate on how this might unfold. The prevailing opinion is that a country cannot be ejected from the currency union and that a corresponding treaty amendment would require the approval of all euro countries. On top of this come the logistical challenges – for instance, the reintroduction of the drachma could hardly be accomplished overnight. It also needs to be clarified what happens to Greece's liabilities towards its European partners. These include not only the bailout loans but also the Target2 claims.

Impact of Grexit on the economy and the financial markets

So far, Europe's financial markets have reacted relatively calmly to the ups and downs of the Greek crisis and the threat of the country leaving the euro. The uncertainty surrounding Greece's future is putting strain on the stock markets, with the DAX, for example, currently down by around 10% on its April high. Nevertheless, the 4.7% loss witnessed in the first two trading days after talks between Greece and its creditors collapsed is not a major slide. The risk premiums on Italian and Spanish bonds also reacted up to a point, widening by around 30 basis points for ten-year government bonds – but this was also against a backdrop of a decline in German government bond yields.

A key question is whether the financial markets are already anticipating a Greek exit from the euro, which would suggest that their reaction to an actual exit would be fairly muted, or whether stock market prices are just starting to crumble now that a real risk is on the horizon, the implication being that the materialization of this risk could end up pushing the panic button and sending the stock markets into a nosedive. As things stand at the moment, our view is that the markets are neither anticipating a Grexit in full nor are they likely to descend into panic. As we have already explained, Greece's exit from the euro and the launch of a new currency is likely to be a long and drawn-out process with a cloud of uncertainty hanging over it, which is likely to cast shadows over the markets for at least some time to come. In this scenario, the European stock markets would be extremely unlikely to close 2015 with considerable gains compared with the start of the year. On the other hand, there are virtually no contagion risks left for the financial markets of other eurozone countries – as seen on a huge scale in 2011/2012. Policymakers have already built solid protective walls to ward off these risks, while the ECB's bond-purchasing program is also likely to lend a helping hand. What is more, Greece's financial ties with private creditors and foreign banks are now very limited. All of these factors suggest that, were Greece to leave the euro, this would not prompt any dramatic increase in risk premiums for key eurozone countries like Italy and Spain. We consider 200 basis points for ten-year bonds to be the likely upper limit. This would mean that yields on long-term Spanish and Italian bonds would not overshoot the 3% mark by any margin to speak of, which would not pose any threat to debt sustainability in these countries. Presumably, this sort of yield level would only be clearly surpassed if the course of action adopted by the Greek government were to lead to "political contagion" in other countries.

The economic impact of a Grexit on the euro area depends on a whole number of factors. First, it is certainly true that curtailed trade with Greece would only have an extremely limited impact on the European economy given the relatively small volume. The only countries likely to feel any sort of real impact would be countries in the Balkans, and Bulgaria, in particular. Second, however, financial market reactions could have a negative knock-on effect on the real economy. Nevertheless, we do not expect to see either a massive contagion reaction in any of the eurozone's major economies or an interest rate shock that would put an end to the economic stabilization process. Third, however, we should be aware that economic expectations in the business sector have proved to be very sensitive to external factors since the economic crisis of 2008/2009. A number of empirical studies (Aspen Institute, April 2015) suggest that the level of uncertainty surrounding business decisions has increased, a trend which has had a negative impact on investment activity. A Greek exit from the euro and the launch of a new Greek currency, which would likely take some time, would leave business decision-makers, even those outside of Greece, with an additional dimension of uncertainty to consider. Last year's Ukraine crisis put a considerable damper on business expectations within Germany for a number of months. The downturn in expectations in the German industrial sector for two months now could be an initial indicator that the Greek crisis would have a similar effect. In our opinion, however, this uncertainty would only dent the economy and not trigger a sustained recession. We put the knock to the eurozone economy at one quarter of a percentage point in both 2015 and 2016. This dent in growth would be less pronounced if the euro were to slide sharply as a result of Grexit, but we do not expect this to be the case.

These assessments are, as always, subject to the disclaimer provided below.

ABOUT ALLIANZ

Together with its customers and sales partners, Allianz is one of the strongest financial communities. About 85 million private and corporate customers insured by Allianz rely on its knowledge, global reach, capital strength and solidity to help them make the most of financial opportunities and to avoid and safeguard themselves against risks. In 2014, around 147,000 employees in over 70 countries achieved total revenues of 122.3 billion euros and an operating profit of 10.4 billion euros. Benefits for our customers reached 104.6 billion euros.
This business success with insurance, asset management and assistance services is based increasingly on customer demand for crisis-proof financial solutions for an aging society and the challenges of climate change. Transparency and integrity are key components of sustainable corporate governance at Allianz SE.

CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

The statements contained herein may include prospects, statements of future expectations and other forward-looking statements that are based on management's current views and assumptions and involve known and unknown risks and uncertainties. Actual results, performance or events may differ materially from those expressed or implied in such forward-looking statements.
Such deviations may arise due to, without limitation, (i) changes of the general economic conditions and competitive situation, particularly in the Allianz Group's core business and core markets, (ii) performance of financial markets (particularly market volatility, liquidity and credit events), (iii) frequency and severity of insured loss events, including from natural catastrophes, and the development of loss expenses, (iv) mortality and morbidity levels and trends, (v) persistency levels, (vi) particularly in the banking business, the extent of credit defaults, (vii) interest rate levels, (viii) currency exchange rates including the euro/US-dollar exchange rate, (ix) changes in laws and regulations, including tax regulations, (x) the impact of acquisitions, including related integration issues, and reorganization measures, and (xi) general competitive factors, in each case on a local, regional, national and/or global basis. Many of these factors may be more likely to occur, or more pronounced, as a result of terrorist activities and their consequences.

NO DUTY TO UPDATE

The company assumes no obligation to update any information or forward-looking statement contained herein, save for any information required to be disclosed by law.