The Greek tragedy culminates: Comment on the latest developments

After the abortion of negotiations between the Greek government and its creditors, the European Central Bank feels impelled to end emergency liquidity assistance (ELA) for Greek banks. To prevent further capital outflows, the Greek government decides to introduce capital controls. The banks as well as the bourse remain closed until 6 July. Next Sunday, 5 July, the referendum shall decide about Greece's membership of the monetary union.

Why capital controls?

Capital controls, as introduced in Greece now, serve to limit the freedom of international capital. Cross-border financial transactions as well as cash withdrawals got restricted. The focus is on the prevention of large capital outflows. Especially problematic are the massive payouts from client deposits which have put the Greek banks under pressure for many weeks. On Saturday, the alarmed population stormed cash dispensers all over the country and withdrew around one billion Euros. On an average Saturday, withdrawals would reach 60 million Euros at most. Cash withdrawals for Greek citizens are now limited to 60 Euros per day. As the example of Cyprus has shown, capital controls do not automatically trigger exit from the currency union. The referendum will mark the decisive factor.

The role of the European Central Bank

For many weeks now, the European Central Bank (ECB) has been pumping liquidity into the Greek banking system to ensure its survival. During the last week, the central bank debated emergency credits (ELA) on a daily basis. It is the Greek central bank which awards these loans, but the ECB Council needs to consent and may stop the measure with a two-thirds majority. After negotiations between the Greek government and its creditors were aborted on Friday evening and the referendum was being announced, this case actually occurred. The ECB decided to not cover for the deposit withdrawals done on Saturday and to keep the ceiling for emergency loans at a level of 91 billion Euros, which was the level reached on Friday. This decision by the ECB made the introduction of capital controls unavoidable.

The stance of the creditors

A payment of 1.6 billion Euros for the International Monetary Fund (IMF) is due on 30 June. It is unlikely that Greece will make this payment. The four most important rating agencies had announced not to downgrade Greece to "default status" if the tranche is not repayed to the IMF. However, on 20 July Greek government bonds worth 3.5 billion Euros currently held by the ECB need to be repayed. Should this payment not occur, the ECB would need to declare the default of the Greek government und hence also of its banks. It is very uncertain how much cash remains in the hands of the Greek government.
Should the Greek reject the referendum, the ECB would most probably need to stop the emergency credits which would de facto lead to a Grexit. Moreover, the aid package of international creditors also ends on 30 June. In an emergency meeting, the finance ministers of the other Euro Area members denied the Greek request to extend it for another month. The creditors emphasized, however, that they still want to assist Greece.

Political options

There are still some possibilities left to avoid a payment default. A clear „yes" on 5 July could induce a turnaround. IMF chief Lagarde said that, in such a case, she would be willing to continue negotiations. Moreover, the heads of state or government of the EU could play an active role to encourage an approval of the Greek electorate. Current polls of Alco and Kapa Research indicate a clear approval of the reform package. However, during the next days opinions can change considerably. This year in particular, opinion polls were often misleading in predicting the actual outcome. If the Greek population votes in favour of the referendum about the austerity programme and staying in the Euro Area the current government of Alexis Tsipras will have a hard time to remain in office. Probably, a new government would take office and would engage in a new round of negotiations about another aid package. Further crisis summits and hence uncertainty would follow. We are however optimistic that a Grexit could be prevented in such a case. Yet a surprise coup with a loan from Russia is still possible. Although Russia currently has its own budget problems it could use a support for Greece as a "show of force" towards Europe.

Market reactions

Into the opening on Monday morning, markets reacted in a relatively contained manner. Major equity indices corrected by less than 4%. Sovereign credit spreads for peripheral debtors like Italy, Spain and Portugal widened somewhat. As was to be expected the Euro weakened markedly against other major currencies, in particular US Dollar, Yen and Swiss Franc. The EUR/CHF exchange rate recovered from 1.015 in the early morning to around 1.04 by noon. Apparently, the Swiss National Bank was active on FX markets to prevent the Swiss Franc from appreciating. Furthermore, market participants seem to understand that the ECB has sufficient and credible instruments at their disposal to protect sovereign debt issued by other member states than Greece from contagion. These defence lines hold. The current situation is not comparable with the collapse of Lehman Brothers in 2008. Since the start of the sovereign debt crisis back in 2010 investors had enough time to adjust their positions.

Portfolio implications

We are slightly overweight in equities in all our balanced mandates. Furthermore, the duration in our fixed income solutions is currently kept close to neutral. Recent developments did not make us change our constructive judgement as regards risky asset classes in general. As of today, the functioning of financial markets and the ongoing economic recovery in the developed markets are not being put at risk. Yet, we do anticipate more volatility on financial markets in the coming weeks, depending on the market reaction to changing political conditions. Equity mandates managed by Swiss Life Asset Managers are marginally exposed to Greece in those cases where passive world equity funds were added to the portfolios. Only in our High Yield Fund and related mandates managed in France do we hold a marginal exposure to no more than three Greek corporate issuers. As regards the Investment Grade segment and all of our mandates managed on behalf of Swiss customers, we currently have no direct exposure to Greek government paper or Greek firms.

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