Investment Note

Manulife Asset Management

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Greece: Implications of an upcoming liquidity crunch

As Greece approaches its May deadline for the repayment of International Monetary Fund (IMF) loans, Megan Greene, Manulife Asset Management's chief economist, explains why a "Grexit" – while still unlikely – has implications, not just for the eurozone but also for the wider global economy.

I spent most of this year's IMF and World Bank spring meetings pinching myself to make sure I hadn't somehow been transported back to 2012. While there were organised panels at the IMF meetings on issues with obvious far-reaching implications such as the impact of lower oil prices on the global economy, the potential consequences of US Federal Reserve liftoff and lower global productivity, the topic at the tip of everyone's tongues was Greece. It is likely that Greece will avoid a unilateral default and/or exit from the eurozone (Grexit), but the negotiations are expected to go down to the wire and there is a good chance Greece will have to impose capital controls.

Liquidity squeeze

Both the Greek government and Greek banks are facing a major liquidity crunch. The Greek state has to repay the IMF around 780 million euro in May, roll over around 5.5 billion euro T-bills in June, roll over around 2 billion euro T-bills in July, repay the European Central Bank (ECB) 3.5 billion euro in July and repay the ECB 3.2 billion euro in August[1]. To meet these obligations, the state has been raiding pension funds, state utilities and municipalities for cash. On 20 April, the government issued an urgent decree requiring state entities –including municipalities, schools, hospitals and orphanages – to transfer their assets to the Bank of Greece's common capital fund.

There are daily reports suggesting the Greek government is about to run out of cash. Prime minister Alexis Tsipras and finance minister Yanis Varoufakis' spokespeople have not dispelled this notion, most likely to keep pressure on their creditors. Still, government arrears in Greece are around half of the peak in 2012 and so have a long way to rise before Greece runs out of cash.

Greek banks are being kept alive solely by ECB life support in the form of Emergency Liquidity Assistance (ELA). As deposits have left the country in what has been a bank "jog", the ECB has plugged the gap with ELA. The risk is that the ECB can shut down Greece's ELA program whenever it wants, in which case the Greek financial system would collapse.

The Greek government and its creditors are currently negotiating a series of reforms that, once passed into Greek legislation, will allow international creditors to release part of the last tranche of funding from Greece's bailout program. Then Greece will have to agree to a third bailout program to take over when the current one expires on 20 June. Given how far apart the two sides are on mutually acceptable reforms, these two negotiations are likely to be wrapped up into one.

A question of politics

Ultimately, the prospects for Greece and its creditors finding agreement come down to politics. The big question is whether policymakers on both sides will be practical or ideological. On the side of creditors, the other peripheral countries are pushing back against giving Greece concessions, wary that doing so would

[1] Source: http://www.theguardian.com/business/2015/apr/24/greek-debts-what-does-it-owe-when-will-the-money-run-out

provide a boost to domestic anti-establishment parties by legitimising Syriza in Greece. In Germany, the finance ministry seems more than willing to consider a Greek exit from the eurozone (Grexit). As a protégé to Helmut Kohl – one of the main architects of the Maastricht Treaty – German Chancellor Merkel is believed to be doing everything she can to build a bridge for Greece in negotiations.

Even if Chancellor Merkel is able to build a bridge, however, Greek prime minister Alexis Tsipras and his government must be willing to cross it for a deal to be done. Greece's third bailout will most likely involve – among other things – a targeted primary surplus and debt path for Greece, debt relief in the form of official sector involvement (OSI) and privatisations. The Greek government may have difficulty compromising on these issues without Syriza splitting. About a third of Syriza is fervently against many of the reforms on the table. Still, their willingness to stay in power may trump their ideology and a deal could be found that leaves the government intact. This would be the best possible outcome for Greece, and is – just barely – the most likely one.

If prime minister Tsipras thinks his party might split over the reforms, he may call a referendum to force the detractors within his party to stay on side. A referendum would likely accelerate the bank jog into a bank run, and it seems probable that capital controls would need to be imposed to support the Greek financial system.

If Greece does not compromise and agree to reforms by 20 June, the ECB is likely to find it hard to continue its ELA program. ELA can technically only be extended if the ECB believes that country's banks to be solvent. If the Greek government is no longer in a bailout program and Greek government guarantees are being used as collateral by banks for ELA, then the ECB may turn off the taps of funding for Greek banks. Capital controls would be needed to avoid a collapse of the banking sector.

The Greek government might respond similarly to the Cypriot government in March 2013 when the ECB cut Cypriot banks off of ELA – Cyprus signed up to a bailout program within days. A U-turn by the Greek government would once again risk splitting the party. Alternatively, there is a small chance that both Greece and its creditors would agree that it would be better to facilitate a Greek exit from the eurozone.

Why a Grexit matters for the global economy

The chances of Grexit remain small, but the implications would be significant – contrary to what some European policymakers and investors suggest. That Grexit would be a disaster for the Greek economy at this stage is almost uncontested. Greece would likely face cascading defaults, hyperinflation and a significant drop in living standards in the immediate term.

The impact of Grexit on the rest of the world, however, is more disputed. The creation of banking union and acceptance of bail-ins means that some of the financial contagion from Grexit would likely be mitigated. Analysts sometimes argue that the ECB's quantitative easing program means that any losses resulting from Grexit could be printed away by the central bank. This is only partly right though. The ECB must buy bonds according to its capital key, which is roughly determined by the size of a eurozone economy. The central bank is therefore not free to plug holes in balance sheets wherever it wants.

EU Commissioner for Economic and Financial Affairs Pierre Moscovici highlighted at the IMF meetings in Washington DC in mid-April that a Grexit would turn the eurozone from a common currency area into a currency peg. The latter is far less stable than the former. Reputational and geopolitical risks would arise as a result. These risks are difficult to measure and so are often wrongly ignored.

Even without a Grexit, the eurozone suffers from a lack of aggregate demand, high unemployment and a significant debt overhang. The region arguably could be creeping towards a Japanese-style lost decade. Against this backdrop, there is also weak growth in Japan and China's economic growth is slowing. The US has emerged as the single engine leading the global economic recovery. In the first quarter of this year, lacklustre economic indicators in the US have suggested that growth there is faltering too. A Grexit could be a big enough trigger to derail this recovery, with implications expanding far beyond Europe.