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Greece: Will this time be different?

- This weekend's negotiations were more difficult than any side anticipated – highlighting Europe's lack of trust in Greece. A set of highly detailed milestones has been agreed which Greece has to deliver to obtain financing. The overall size of the program has been set at EUR82bn to EUR86bn, IMF participation will stay. Greek PM Tsipras has had to accept extremely rigorous creditor monitoring, bringing arrangements back to the framework of the past few years.
- We suspect the ECB will stall an ELA decision until Greece begins to legislate the new deal later this week. Greece would still face a tight ELA cap, however. We expect the ELA cap will remain carefully calibrated and controlled at least until the new ESM loan is fully in place. Access to banks could be fully normalised only in the fall.
- Will Greece manage to implement reforms and finally return to sustainable growth? The fact that Grexit is no longer taboo has increased the stakes. If there is again a new impasse with the Greek government, creditors will be including Grexit among the options much earlier in the negotiations. Greece's politicians should now be more aware that failing to deliver the reforms could take the country out of the euro area. This may decrease the probability that the euro area will by default revert to its main strategy with Greece – kicking the can.
- Based on the agreement reached this morning, the role of structural reforms in the new Greek programme have increased. This is a positive. Relative to early commitments and demands, Greece will have to implement a broader set of product market reforms and a major overhaul of the civil justice system as well as benchmarking the status of Greece's labour market institutions against a broader benchmark.
- It is necessary but not sufficient to pass reforms in the parliament. Steady, multi-year implementation is what is required. A technocratic or weak national-unity government can promote pro-growth reforms under creditors' pressure but it cannot guarantee their implementation. Hence, this time is likely to be different only a strong political leadership backs the reforms over the medium term. Implementation risk and political uncertainty will remain high.
- We do not expect the latest development in the Greek saga to have a major bearing on the forthcoming elections in Spain (or Portugal or Ireland). The fact that euro-exit is now among the options is a double edged sword in the medium term for countries with a high proportion of populist parties.

Tougher-than-expected negotiations

This weekend's negotiations between Greece and its creditors were more difficult than any side anticipated. Following already protracted talks and missed deadlines, the default on the IMF and the resounding rejection of the austerity referendum, Europe's lack of trust in Greece was a significant impediment to a deal. The lack of trust was embodied in German FinMin Schaeuble's tough additional demands.

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In our view, enough of these demands made it into the final summit agreement for Schaeuble and German Chancellor Merkel to be more confident of carrying the necessary votes through the Bundestag, for example, a EUR50bn state asset fund to facilitate the repayment of debt. The terms were tougher than what Greece had rejected in a referendum a week earlier, but this was the price Greece had to pay to remain in the euro.

As Greece's third bailout programme gets negotiated, we ask whether things will be different this time. Both Grexit and excessive compromise entail risks to the medium-term stability of the euro area. We have repeatedly made the case that the only sustainable solution, for Greece and the euro area, is a balanced compromise.

In the second part of this note, we discuss whether this time there are reasons to believe that the reform implementation will be better than in past Greek programmes. We conclude with a short section on the periphery-wide consequences of the past two days.

What next

As explained by George Saravelos in his earlier note, a set of highly detailed milestones has been agreed which Greece has to deliver to obtain financing.[1] Greece has to first vote a package of measures through parliament by this Wednesday, inclusive of VAT and pension reform. This would then allow creditors' national parliamentary approval processes for an initiation of talks around an ESM program to take place, followed by a formal start to negotiations.[2]

In the meantime the Eurogroup later today will begin discussing bridge financing. This will most likely cover Greece's financing needs over July and August in the form of bilateral loans. Different sets of legislation will need to be delivered by Greece over the next few weeks, in turn allowing disbursements to be made under the bridge financing arrangements and ESM negotiations to proceed.

The overall size of the program has been set at EUR82bn to EUR86bn, IMF participation will stay (the IMF program expires next March but Greece will re-apply post expiry) and mission reviews will be taking place in Athens in contrast to the last few months.

Overall, it is clear that Greek PM Tsipras has had to accept extremely rigorous creditor monitoring for the new program, bringing arrangements back to the framework that has been in place over the last few years.

ECB: ELA cap will remain

As we wrote in *Focus Europe* on Friday, a deal ought to give the ECB sufficient "perspective" on the ongoing solvency of Greece to reduce the haircuts on ELA a little and thus create more liquidity for Greece. However, we suspect the ECB will await validation that a deal is being implemented. This means the ECB will stall an ELA decision until Greece begins to legislate the new deal later this week. Bloomberg News has reported that there was no easing in the ELA constraint today.

[1] For more details see http://pull.db-gmresearch.com/p/5230-F728/74906260/DB_SpecialReport_2015-07-13_0900b8c089ea68d1.pdf

[2] The first vote should be in Germany on 17 July.

Greece would still face a tight ELA cap, however. We expect the ELA cap will remain carefully calibrated and controlled at least until the new ESM loan is fully in place – probably not before September. Even then there could be an argument to maintain it for some time afterwards if its complete removal risks a massive draw-down of deposits due to a lack of trust in either the ECB not reintroducing a cap or the Greek government delivering on the deal with the EU.

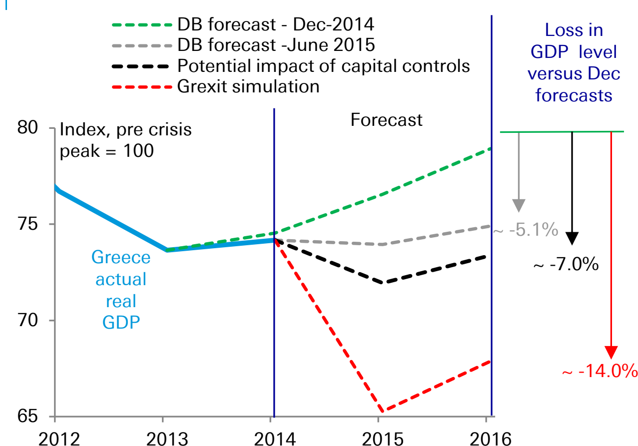
The deal allows for the ECB/Single Supervisory Mechanism to conduct a comprehensive assessment of the Greek banks recapitalization needs by late summer. The EA leaders' statement says the capital shortfalls would be assessed "after the legal framework is applied". Under the Bank Recovery and Resolution Directive (BRRD), which Greece is being asked to legislate immediately, there can be no injection of public money into the banks without bail-in, so we interpret this statement as signaling a potential deposit bail-in (it may be possible to waive their requirement if there are financial stability concerns – this cannot be judged yet). If deposit bail-in is to play a role in the recapitalization process, it is highly unlikely that access to banks will fully normalize until the fall.

Is this time different?

We are not overly optimistic, but is there are reasons to think that this time could be different? The answer is maybe, because the genie is out of the bottle.

First, what the above question really means is whether Greece will manage to implement reforms and finally return to sustainable growth. Understandably, clients tend to be very skeptical. However, recall that not too long ago several market commentators argued that Ireland and Spain could not remain within the euro area. These two countries are now among the fastest growing economies in the euro area. Before the general elections we were forecasting Greece to grow in line with Ireland and more than Spain in both 2015 and 2016.

Figure 1: The interruption of the economic recovery at the end of 2014 could mean a 7% loss in GDP



Source: EUROSTAT, Haver Analytics LP, Deutsche Bank

The problem is that Greece's challenges appear more economically, socially and politically entrenched than in the other peripherals. Syriza won the elections with a political programme that was calling for a reversal of reforms – for example in the labour market. There were pledges about reducing tax evasion and corruption – but it appears that tax receipts have fallen materially in past few months. Indeed, since December economic prospects for Greece have deteriorated sharply.

So are we destined to experience a new Greek crisis over the next year or two? While it is difficult to be optimistic, we think something has changed.

Grexit: the genie is out of the bottle

Grexit is no longer taboo. European officials have mentioned it explicitly as a concrete possibility. For example Germany's Finance Minister mentioned a temporary exit (in the box we argue that such a concept is even more damaging than an outright exit). We do not think that putting Grexit on the table as an option was just a bargaining tactic. Public opinion has been shifting.

This has at least two consequences. First, if there is again a new impasse with the Greek government, creditors will be including Grexit among the options much earlier in the negotiation process. Second, Greece's politicians should now be more aware that failing to deliver the reforms could take the country out of the euro. Given that Greek citizens appear to remain staunchly pro-euro, they may now face greater incentives to deliver.

So the stakes are much higher. This may decrease the probability that the euro area will by default revert to its main strategy with Greece – kicking the can. This does not mean that a positive solution will be always be found – divisions across euro area governments could increase.

Box 1: A revolving door-euro area would reintroduce exchange rate risk

The main consequence of Grexit is that it destroys the argument that membership to the euro area is permanent. The possibility of exiting and then re-entering the euro area would transform the monetary union into a fixed-exchange rate regime with the possibility of step adjustments to countries' conversion rates. Relative to the traditionally unstable fixed exchange regimes there would be the extra complication of re-printing the local currency. But apart from this technical difference, the inherent flaws typical of a fixed exchange regime would remain.

The first would be the credibility of the arrangement. The government of a country with weaker macro fundamentals than the euro average would have the choice to address an adverse shock with either a "temporary" exit and devaluation or structural reforms. The latter would be the best economic option, but it would likely be politically painful. The devaluation would be the easy option – above all if the country is led by a populist or euro-skeptic government (or a fragile government and a fragmented political spectrum).

The consequence would be that weaker countries would face the constraints of being in a monetary union without fully experiencing the benefits. In the eyes of the investors, the risk of redenomination in the presence of an adverse shock in a country with a populist government would likely call for a significant reduction of exposures to the country's debt. Government yields would increase, at least during recessions. Risk premia would be higher, the volatility of the business cycle would increase and potential GDP would fall.

Could structural reform regain the centre stage?

Higher stakes do not guarantee that all participants will behave rationally. In last Friday's *Focus Europe* we showed that the key to the medium-term success of the Greek programme is neither fiscal consolidation nor debt relief. Both elements are necessary, but not sufficient. Medium-term economic equilibrium will depend on the implementation of further structural reforms.

Based on the agreement reached this morning, the role of structural reforms in the new Greek programme have increased. This is a positive. Recall that negotiations over the past five months had centered disappointingly on fiscal targets and a future commitment on debt relief, leaving vague commitments on the structural reform side.

Relative to early commitments and demands, Greece will have to comply with a broader set of product market reforms. The OECD has an agreed set of standards – toolkits – for product market flexibility. Greece must now implement everything in the OECD Toolkit #1 and must add the all-important manufacturing sector to the sectors for which the Toolkit #2 reforms were being implemented.

Important too is the broader benchmark against which the status of Greece's labour market institutions will be judged. Greece had argued that its labour market practices are no worse than elsewhere in the euro area. Europe will examine whether this is true, but will now judge Greece against international as well as European best practice. This makes a reversion of earlier reforms less of a risk.

A major overhaul of the civil justice system has also being included in the demands. This can cut business operating costs.

Based on today's euro summit statement there is a chance of more focus on structural reforms. Overall we think that Grexit could be permanently avoided – but the latest agreement still leaves substantial implementation risk.

Implementation requires political will and stability

Grexit can be permanently avoided if the country finds its way to sustainable growth. Debt relief within the euro-area (in the form of maturity extension) and tolerable fiscal prudence will then follow.

Such sustainable growth requires reforms. It is necessary but not sufficient to pass reforms in the parliament. Steady, multi-year implementation is what is required. A technocratic or weak national-unity government can promote pro-growth reforms under creditor pressure but it cannot guarantee their implementation. Hence, this time is likely to be different only if strong political leadership backs the reforms over the medium term.

The past few months have been highly detrimental for the Greek economy (see figure above) – but the referendum strengthened PM Tsipras' domestic political grip. The opposition appeared in disarray. Maintaining domestic political support, however, will now become more complex for PM Tsipras.

Based on today's statement, Tsipras will fully support the agreement in the Parliament. However, over the weekend, at least 32 government MPs indicated they would be unwilling to support an agreement, effectively denying Tsipras his parliamentary majority. The support of Independent Greek junior coalition MPs remains highly uncertain. It follows that the potential loss of more than 40 MPs from a government that had a 11-seat majority.

Still this should not be too much of an issue in the short term. It is highly likely New Democracy, PASOK and River will vote in favour of the programme on Wednesday – they cumulatively count for 100 MPs. After the vote, Tsipras could try to opt for a minority government or a national unity government could be formed.

But the real question in terms of implementation is what happens then? Will a new early election take place? Will Tsipras assume full ownership of the programme and at the same time maintain control of the majority of Syriza and the support of public opinion in the medium term?

As we expected, in today's statement Tsipras pointed to a victory for Greece in terms of the creditor commitment on debt relief. Debt relief had been on the table since 2012. Based on today's euro summit statement the current debt relief pledge will follow in spirit that of 2012 (insuring debt public debt below 110% of GDP by 2022) but sensibly focus on gross financing needs rather than a debt-to-GDP ratio. This commitment may be more difficult to explain to the electorate. But even a vague commitment on debt relief along with avoiding Grexit may still play in favour of PM Tsipras.

Alternatively, Tsipras could lose the support of voters. The question then becomes whether more moderate centrist parties will benefit or whether the new agreement pushes those who voted NO at the referendum towards even more radical parties.

So it is still all about implementation risk and political uncertainty. But this time the debate could move from being about austerity to being pro- or anti-euro. The pro-euro camp can prevail if structural reforms are strictly implemented in exchange for fiscal flexibility within rules. An acceleration of infrastructure investment via the Juncker plan could also help.

Consequences for the euro area

We see short and medium terms ramifications of this week-end tough negotiations.

Short-term: focus on Spain

Within the next year there will be elections in Portugal, Spain and Ireland. The chance of seeing a parallel to the Syriza government emerge elsewhere is relatively low, in our view. Focus will likely be on Spain and the risk of Podemos being part of a government coalition.

Although the current economic picture in Spain is undeniably positive, the end-year general election is of crucial importance. The result of the regional elections and the local alliances post election re-focused investor attention on political risk. Support for Podemos peaked in late 2014. Nevertheless, a coalition between the Socialists (PSOE) and Podemos is a possibility. So is an unstable minority government without Podemos.

We think that a Grexit would have materially decreased support for Podemos. Conversely, a soft agreement for Greece after the referendum would have strengthened Podemos. We think that a tough agreement for Greece that avoid Grexit will be broadly neutral for Podemos.

Focus will go back to domestic politics. Recent opinion polls (Invymark and Celeste-Tel) show on the one hand a slight weakening of Podemos and a modest gain for the ruling PP. But on the other hand, the PP's most likely post-election ally, Citizens, has been losing support since the May elections.

Medium-term: growth is the only effective weapon against populist parties

The more optimistic observers will point to the fact that Grexit has been avoided, but euro-exit is no longer taboo.

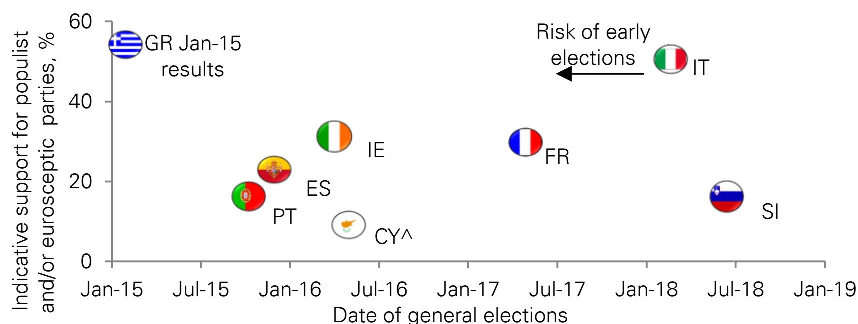
This could lead to opposing interpretations. First, the risk of euro-exit could re-focus attention of governments in economically weaker countries on boosting their potential GDP growth. On the other hand, euro skeptic parties could point to the fact that a (temporary) exit from the monetary union within the EU was contemplated during the weekend talks.

Countries with the largest proportion of populist or euro-skeptic parties could become a source of concern in the medium term during economic downturns. Below we reproduce a chart from our Special Report on potential contagion from Greece (29 June). We have aggregated the total support to either populist

or euro-skeptic parties. The numbers should be seen as indicative as parties have sometimes ambiguous positions[3].

Note that, after Greece, the highest proportion of support for euro-skeptic and/or populist parties is in Italy. The great majority of the Italian parties in opposition are euro-skeptic – for example Grillo's 5SM and the Northern League. Berlusconi's Forza Italia maintained an ambivalent position versus the euro, but its support has been falling dramatically and the priority for the ex-PM to form an alliance with the Northern League and other smaller euro-skeptic parties.

Figure 2: Support for populist and/or euro-skeptic parties and timing of elections



Source: Deutsche Bank, National election agencies, national opinion polls.
Indicative support numbers are based on recent opinion polls where available. Exceptions are Cyprus (support based on 2014 European elections), France (2015 departmental elections).
^Given the presidential political system in Cyprus the 2016 parliamentary elections are unlikely to result in a change of government with the 2018 presidential elections more important in this respect

In Italy there is no planned general election until Q1 2018, although we cannot fully exclude the possibility of an early election. The government has made some progress on reforms, but political support for populist parties is strengthening. The hope for the government is that the expected economic recovery inverts this trend. In any case, the opposition remains divided. This is important. The new electoral law will give the absolute majority in the Lower House (but not in the Senate) to the first party. Based on the current opinion polls, the centre-left ruling PD is leading but with a decreasing margin versus the 5SM. That said, for the first time since Renzi took over as PM, an opinion poll (Ipsos) showed that a centre right alliance under a single list name could defeat the PD in the second round.

[3] For example, in Ireland we assume the support of the openly anti-austerity/euro-skeptic Sinn Fein plus 50% of the support for 'independents/others' many of whom are anti-austerity.

Appendix 1

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