*Economics Group*

WELLS FARGO SECURITIES

Special Commentary

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# Greece: Now What?

## Greek Voters Emphatically Say "No"!

Citizens in Greece went to the polls yesterday to vote on the referendum question on whether the country should agree to more austerity measures in return for another bailout package. More than 61 percent of the voters in Greece said "no", an emphatic rejection to more austerity measures. As a result of the outcome of the referendum, other European countries may now decide not to extend the Greek government more money. The yield on the 2-year Greek government bond has jumped from 36 percent on Friday to more than 53 percent today. Yields on sovereign bonds in Italy, Portugal and Spain are up 10 bps to 20 bps, and stock markets across Europe are down 1 percent to 3 percent as of this writing.

## Where Do We Go From Here?

German Chancellor Merkel and French President Hollande are scheduled to meet later today to discuss strategy, and the Governing Council of the European Central Bank (ECB) is also meeting. An emergency summit of European leaders has been called for tomorrow. Presumably, these leaders will come up with some sort of response to the Greek government. In the meantime, banks in Greece, which have been closed for the last week, will likely remain shuttered for the foreseeable future. Economic activity in the Hellenic Republic reportedly has slowed sharply due to the lack of bank financing.

***"Grexit" is not necessarily preordained.***

Although the probability of Greek exit from the Eurozone (a.k.a., "Grexit") is now certainly higher than it has ever been, it is not necessarily preordained. In a best-case scenario, Greece and its European partners could reach an agreement in coming days. As we wrote earlier this year, as Greek Prime Minister Tsipras has been claiming, and as the International Monetary Fund (IMF) has recently noted, it appears that the debt dynamics of the Greek government are unsustainable.[1] Therefore, the outline of any deal, the details of which are obviously impossible to know at this point, could involve some restructuring of Greek government debt in return for some reforms in Greece. If Greece and its creditors reach an agreement, then new money would start to flow again to the Hellenic Republic and the current crisis would quickly subside.

***The worst-case scenario could also occur.***

On the other hand, however, the worst-case scenario could clearly occur. The outcome of yesterday's referendum could embolden Tsipras to dig in his heels in upcoming negotiations regarding austerity and economic reforms. On the other side, some European countries are loath to offer more money and/or debt restructuring without some credible plan for economic reforms, and trust between both sides has eroded over the past few months. The resignation today of Greek Finance Minister Varoufakis, who has had a contentious relationship with his counterparts in some other European economies, may help facilitate upcoming negotiations, but it by no means guarantees their success. Negotiations between Greece and its creditors certainly could stall in coming days.

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**[1] See "'Long Road Ahead for Greece Has Become Longer" (February 26, 2015), which is available upon request. In a June 26, 2015 document, the IMF said that "at a minimum, the maturities of existing European loans will need to be extended significantly." See "Greece: Preliminary Draft Debt Sustainability Analysis", which is posted at www.imf.org.**

Together we'll go far

The Greek government needs to make a €3.5 billion bond payment to the ECB on July 20. If the Hellenic Republic fails to make payment, it would be in default to the ECB, which would then need to stop providing liquidity to Greek banks. Without liquidity support from the ECB, the Greek banking system would collapse and, with it, the Greek economy. At that point, Greece really would have few options other than to leave the Eurozone and re-introduce its own currency.

We want to stress that it is essentially impossible to accurately predict how the current crisis will play out. The dynamics will depend on political decisions that will be made in Greece and in other European countries in coming days and weeks. Until there is more clarity to the situation, financial markets, especially in Europe, will likely remain unsettled.

***More than just the fate of Greece is at stake.***

We also want to stress that more than just the fate of Greece is at stake in this crisis. The Eurozone clearly has more financial backstops in place today than it did during past episodes of the European sovereign debt crisis. The €500 billion European Stability Mechanism (ESM), the Eurozone's permanent bailout facility, is now capitalized and operational. The ECB has been buying sovereign bonds for the past few months under its quantitative easing program, and it arguably could ramp up its purchases further in an effort to stabilize financial markets. However, Grexit could call into question the immutability of the euro area, as we wrote in a recent report, and the rise in sovereign bond yields today in Italy, Portugal and Spain show that potential contagion is more than just an idle concern.[2]

## Effects on the U.S. Economy

We are often asked what the current crisis in Greece means for the United States. The direct effects of Greece on the U.S. economy are tiny. The United States exported less than $1 billion worth of goods to Greece last year, and the exposure of the U.S. financial system to the Hellenic Republic is miniscule. However, Grexit, should it occur, would likely lead to more financial volatility in Europe. In that case, the indirect effects on the U.S. economy could be more meaningful.[3] That is, a tightening in financial conditions, which would be expressed as a downdraft in stock markets and increases in corporate bond yields, could exert a slowing effect on U.S. economic growth in coming quarters.

As noted above, it is impossible to predict how the current crisis in Greece will play out, much less the effects it will exert on the U.S. economy. If the crisis is resolved quickly, then it will likely have few material effects on the United States. A more prolonged crisis or a cataclysmic Grexit that leads to financial contagion in other European countries could potentially have more profound effects on the U.S. economy. We are left to simply watch developments on the other side of the Atlantic and hope for the best.

**[2] See "Greece on the Brink" (June 29, 2015), which is posted on our website.**
**[3] See "Potential Financial Fallout from 'Grexit'" (February 12, 2015), which is available upon request.**

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