

# Greece and the Eurozone: Why Grexit is the Most Likely Outcome

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*Ahead of Greece's referendum on a bailout plan in early July, EU decision makers, including Eurogroup Chairman Jeroen Dijsselbloem, warned a "no" vote might lead to Greece's exit from the Euro. After Greece's overwhelming "no", and Eurozone leaders' latest ultimatums, there are a number of factors that indicate that "Grexit" may indeed be the most likely outcome.*

## 1. Greece is already in default to the IMF

Last week, Greece defaulted on its obligations to the IMF, even if we technically would need to say it was put in "[arrears](#)". Greece is the first developed country to do so. Currently, the Greek banking system is dependent on the ECB allowing the Greek Central Bank to issue loans to Greek banks through a scheme called [Emergency Liquidity Assistance \(ELA\)](#). As the name suggests, this funding can only be provided to deal with liquidity problems, so it cannot prop up insolvent banks. Greek banks are intimately [linked](#) with the insolvent Greek state, meaning they are insolvent themselves, meaning in turn that the ECB would need to cut off funding.

The necessary two thirds majority [needed](#) within the ECB Governing Council to block the Greek Central Bank from creating euros to lend to Greek banks under ELA hasn't been reached so far. As a result, the ECB has had to come up with all kinds of excuses, the latest being that it will only cut off ELA funding for Greek banks in case there is "[no prospect of a deal](#)". The ECB's excuses are likely to run out soon, especially if the Greek government defaults on payments to the ECB on 20 July. This week, the [ECB restrained ELA](#) a little more, but it's expected to provide ELA funding at least [until Sunday](#). Political cover would be needed for any further actions though.

Greek pensioners are meanwhile standing at the gates. A logical outcome would be for the Greek government to pay them in "IOUs" or in a parallel currency, which could be used to pay for government services, for example health care, something which the outgoing Greek Finance Minister already [suggested](#).

Another problem is that Greek banks will be running out of actual physical bank notes, possibly by the end of this week. Closing banks is bad enough, but closing ATMs is a recipe for chaos. It would force the Greek government to print Drachmas, while uncertainty would reign during the transition period.

## 2. Greece and the rest of the Eurozone are further apart than ever

Given that Greece's finance gap will only have grown bigger as a result of the economic damage inflicted by capital controls, Greek politicians likely will need to accept even more "austerity" than was on offer before the talks with creditors broke down. German Chancellor Merkel [stressed](#) earlier this week that Greek measures will have to "go beyond" what was demanded by the creditors before the referendum. How likely is this to happen in the face of the massive "no" vote? Costas Lapavistas, the leader of the radical wing of Syriza, already [warned](#) that "the referendum has its own dynamic. People will revolt if [Tsipras] comes back from Brussels with a shoddy compromise." Some Greek analysts [think](#) Tsipras doesn't actually want a deal.

It must be said that the so-called "austerity" was always more a synonym for monstrous [tax hikes](#) than for actual spending cuts. One of the recent [Greek government's proposals](#), for example, was to unleash 2.69 billion euro in tax hikes on the Greek private sector this year - perhaps hoping the money wouldn't be raised anyway - while only cutting spending on "pensions" (which more than often seems to mean the pension administration, not actual pension payouts)- by 60 million euro.

There is still a chance that Greece will back down completely in the next few days, giving up its demand for debt restructuring, which Merkel has called "out of the question". The result of this would be that Greece would enter a new European Stability Mechanism (ESM) programme. So far however, it looks like the Greek government hasn't come up with detailed proposals, apart from a general request for ESM support.

It's therefore more likely that the EU Summit this Sunday decides to exclude the country from the Eurozone and provide funds to make the transition to Drachma through the so-called "Balance of Payments" facility for non-euro states which has been used for Romania, Hungary and Latvia. The invitation of all EU member states to this Summit is already a sign that Grexit is likely, given that they would be needed to sign off on this scenario. In any case, whatever happens next, the fact that EU Commission President Juncker [declared](#) that "We have a Grexit scenario, prepared in detail" proves for the first time that the euro adoption is not irreversible.

### **3. Capital controls are notoriously hard to unwind**

According to official Greek data , there was still almost 130 million euro deposited in Greek banks before capital controls were announced. If Greek banks were to reopen, few might trust they wouldn't close again soon, potentially causing a run. As the ECB is unlikely to provide enough ELA funding for banks to open without a deal, and a deal itself still seemingly unlikely, the government in Athens will have to seriously consider printing its own currency should it ever want to open its banks again.

### **4. The "no" vote protects the Eurozone's politicians from looking like they pushed Greece out**

In the event of a Grexit, prepare for more blame games between Greece and the rest of the Eurozone. Now that the Greek people have sent a powerful signal that they desire a full-blown "transfer-union", which is not on offer, it will be much harder to blame Eurozone politicians for refusing more transfers than the ones already conducted, through the ECB and bailout loans with low interest rates.

### **How might Grexit playout?**

Eurozone countries could fly in periodical shipments of euro bank notes until the end of summer, in order to avoid a risk of social breakdown. This special “transition bailout” – possibly financed by future cuts to EU subsidies for Greece – could be decided, as a means of raising hopes for an orderly transition to the Drachma. There is also an [alternative scenario](#) in which Greece – after having defaulted and restructured its banks – uses the euro but doesn’t enjoy the cheap money from the ECB, like Montenegro.

This would give Greece an incentive to stay in the EU – and NATO – and to play along when it is legally relegated to the “[euro derogation](#)” (the status of Bulgaria, Sweden and Poland) i.e. obliged to join the eurozone in the future. The fact that German Finance Minister Schäuble mentioned ahead of the referendum that a Greek “no” may lead to a “[temporary](#)” Grexit may refer to this potential scenario. The IMF and European Parliament President Schulz have been making noises about “[IMF assistance](#)” and “[humanitarian aid](#)”.

It looks like this is finally it.

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