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What European dynamic can be expected after the announcement of the greferendum?

The framework of the euro zone has changed spectacularly this weekend. This is because on the night between Friday and Saturday, Alexis Tsipras, the Greek prime minister, announced that a referendum would be held in Greece on the measures desired by the troika (European Union, ECB and the IMF) as part of the negotiations on the Greek bailout.
This option was not expected, since Greek negotiators learned about it via Twitter. The break implies the end of negotiations, at least temporarily. These, before the announcement of the referendum, had become pointless, as the points of view were no longer compatible.

Faced with this sudden change, the Eurogroup had an emergency meeting on Saturday. It considered that the deadline of Tuesday for the end of the protocol on the commitments between the troika and Greece was maintained. There is no deadline extension, as requested by Greece, if there is no major change. The head of the Eurogroup, Jeroen Dijsselbloem, left the door partly open to discussions, in case of a Greek change of mind. (Jean Claude Juncker and Angela Merkel have said the same thing on Monday)

This implies that on Tuesday evening, beyond the negotiation, it is the entire process that is weakened and compromised.
On this point, there are three factors to be considered:

- The first is that the entire process of negotiation has failed. The second Greek bailout plan did not finish, thus not opening the way to a third one, which might possibly have examined the question of restructuring Greek debt. The lack of discussions on the restructuring and reduction of the debt was a key factor because Greece remained with this now-unmanageable stock of debt while an additional recession threatens the economy. This factor was bound to have been an influence in the option chosen by Tsipras.
- The second point to be remembered is that Greece will probably not be capable of reimbursing the 1.6 billion due to the IMF.
- The first aspect deprives Greece of the resources for keeping itself afloat, while the second creates a precedent concerning the ability of Greece to cope with its commitments. At this level, the next stage is the reimbursement, on 20 July, of 3.5 billion to the ECB, and very probably, Greece will not have the resources to honour this commitment.

What can happen now?
Greece will hold a referendum on 5 July and the question will ask whether Greeks wish to accept the reforms and measures presented last Thursday by the troika. The question will not relate to membership of the euro zone.
Before this, the Bank of Greece, with the aid of the ECB (the Bank of Greece still forms part of the European System of Central Banks) will implement a system of capital controls. The aim is to reduce outflows of cash from banks so as not to weaken the banking system even more. The outflow, which has accelerated over the last few days, is not sustainable for the Greek banking system. It must be stabilised. This is why the Greek banks will be closed until July the 7th, while these controls are put in place, to avoid an excessive flow of withdrawals.

The ECB announced on Sunday that it would maintain the amount of cash allocated to Greek banks under the ELA procedure. The amount is about 90 billion. This is a constraint for the banks because they will not have any margin. The ECB is not taking any position or making any commitments for the future, simply stating that the situation may evolve. In any case, the negotiation framework is open until Tuesday and therefore the ECB must, for the moment, remain within this framework.

What are the next stages?
Clearly, the decisive stage will be 5 July.
A "no" will suddenly and strongly increase the risk of Greece exiting the euro zone. The process of negotiation cannot resume and the half-open door will close. The ECB would then have no further reason to refinance the Greek banking system because the framework that defined this operation would have expired.
Henceforth, the banking system would no longer function and Greece would have to find the means of issuing a new currency. This would be devalued by 60 to 80% compared to the euro. This is generally the order of magnitude of devaluation in the case of a default. The more this risk approaches, the more the Greeks will be tempted to withdraw their cash from the banking system, worsening the overall dysfunction. The immediate risk is a recession of greater magnitude and over the long term.
A massive "yes" in the referendum has every chance of resulting in negotiations reopening and the signature of an agreement, because the result of the referendum would suggest the approval of Greeks to the effort required by the troika, even if this resulted in an additional recession. That said, the question remains

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concerning with whom the troika could sign. A massive "yes" would be a major rejection of the current government, which is calling for a "no" vote. It would have to resign and the agreement could only be signed by the successor of Alexis Tsipras as prime minister. In spite of this return "to normal" the economy is already weakened by the long period of uncertainty and its ability to recover is reduced. The economic situation would remain very fragile for quite some time.
The situation would be highly ambiguous in the case of an evenly-divided vote.

If the "no" wins, the situation would quickly become problematic in Greece because the change of currency and its depreciation and the negative impact, at least initially, on economic activity, coupled with the political uncertainty, would create conditions of significant political instability. Furthermore, the drop in economic activity and the impossibility, for the government, to fund itself externally, would result in a significant fall in remuneration and retirement pensions, particularly in the public sector, worsening instability. If the "yes" wins significantly, the measures proposed by the troika during Friday's negotiations (before the notice of the referendum on Twitter) could allow the risks to be reduced and minimise the impact of any contagion.

For the euro zone, the situation is not necessarily simple either if there is a "no", at several levels.

The first is that a Greek exit would create a precedent. European integration would, de facto, become reversible. This would imply that other members of the zone could, via a referendum, decide that it was appropriate to leave.
With regard to the political tensions that we see in Europe on the question of belonging to the euro zone, it is clear that strong internal tensions could appear. At the same time, this could reveal who supports which position.
The other aspect is that non-European investors will see this situation as special. The question of reversibility, which is already at the back of the minds of these investors, would be even more present. This would lead to increased caution concerning European integration. This could be directly detrimental to the dynamics of financial markets.

The second point is the risk of contagion, with the possibility of seeing risk premiums for countries considered as risky. Of course, the ECB has considerable resources for coping with this, if only the 60 billion that it has each month through quantitative easing. Benoit Coeuré mentioned the option to adjust expenditure during the year depending on the constraints of the moment (buy more when there are many issues of sovereign debt, otherwise a little less); we can imagine adjustment by country with the constraint of respecting equilibrium over the year (the weight of purchases of debt for each country corresponds to its weight in the capital of the ECB).

The third point is the uncertainty that any Greek exit would cause for the economic backdrop. The framework of the euro zone will change with Greece leaving the Euro Area. (See below). If certain countries have risk premiums, will companies invest in them as easily? Furthermore, if the framework changes, the new rules will have to establish themselves and, as long as this is not the case, we can imagine a more wait-and-see attitude.

The major change, in the case of a Greek exit, is a breakdown in European integration. Beside the reversibility being likely to cause greater uncertainty, it is clear that the order of priorities has changed. When, on 26 July 2012, Mario Draghi mentioned the ability for the ECB to do everything necessary to safeguard the euro zone, he first made reference to political integration. The will to live together was specified as crucial, while the euro was only an instrument. What therefore appeared essential was this political integration, and the ECB was in charge of the functioning of the instrument.

Now and since the beginning, the financial stability of the euro zone has been prioritised and the possible exit of Greece shows that this political framework, this desire to live and build together, has been relegated behind financial stability. The hierarchy has changed through acceptance of the possibility that a country might leave. This reversibility therefore suggests that a unified political framework has little chance of coming into being. If a country can leave, then the unified framework no longer has any meaning.
The hope of a deepening of the euro zone, through the establishment of a political structure capable of coordinating economic policy and making it cooperative, and ultimately creating common debt (Eurobonds), becomes a chimera.
It would require the rapid manifestation of a strong political will to reverse this perception.
This means that the adjustment mechanisms, few or none of which exist within the euro zone, for enabling convergence towards an optimal monetary zone, would not come into being. Henceforth, the system is turning into a system of fixed exchange rates, admittedly with a central bank but no longer with any expectation of a common and coherent dynamic. In a system of fixed exchange rates, everyone must move at the same speed, as shown by the European Monetary System, with several devaluations and ultimately, the broadening of fluctuation bands.

Europeans have long been aware of the criticisms, primarily from American economists, concerning the euro zone. The lack of any adjustment mechanisms (population movements, federal budgetary policy) was perceived

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as disadvantageous and rightly so. The Europeans nevertheless thought that collective will would enable the establishment of coordination and coherence mechanisms. Everyone knew that the euro zone was not an optimal monetary zone, but everyone hoped and expected change and convergence towards this situation.
This flame is now guttering in the wind and only a strong and sustainable political impetus will be able to protect it and resume movement towards the political construction of the euro zone. This is the challenge of the forthcoming months for Jean Claude Juncker, Mario Draghi, Angela Merkel and the other governments of the zone.

In the short term, on the financial markets, the increase in uncertainty will increase volatility and strengthen the weight of the countries considered as havens. Germany, which has finally imposed its way of seeing the Greek problem, by not wanting to negotiate debt reduction, appears as the winner and will benefit from its value as a safe haven. The weekend's developments should result in questions concerning the profiles of the peripheral countries, because now the European process will become reversible in the case of a "no" in the referendum.

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