ECONOMICS: EUROPEAN PERSPECTIVES—OCTOBER 17, 2014

Early Exit and Elections in Greece?

- **Dennis Shen**
  Economic Associate—Global Economic Research, + 44 (020) 7173 9270
- **Darren Williams**
  Senior European Economist—Global Economic Research, + 44 (020) 7959 4543

Recent concerns over Greece's bailout exit and possible early elections have led to a sell-off in Greek sovereign bonds. In our view, Greece will most likely be forced to stay under at least a precautionary program from the EU. Moreover, the prospect of an early election raises spillover risk to other peripheral markets.

The Greek government and the "troika" of the European Commission, European Central Bank and International Monetary Fund (IMF) are currently negotiating how Greece will exit (or transition from) its financial assistance program when it concludes at year-end. How this transition is designed will have huge implications for the medium-term policy environment. In addition, these negotiations come at a difficult time, with a growing chance that the inability to elect a new president could trigger an early parliamentary election next year.

The bailout exit and early elections are intricately linked. A clean exit from the financial assistance program and an end to the associated conditionality would give a big boost to the government and reduce the risks of an early election. If Greece can't exit its bailout, early elections are almost inevitable.

Meanwhile, Greece and the markets are locked in a vicious circle. The harder that Greece pushes for an exit from the bailout, the more markets show skepticism and close the very market access Greece needs for this plan to succeed.

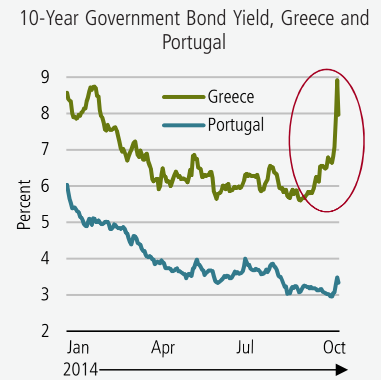
Greek Bond Yields Spike

Rising uncertainty around Greece's financing and political outlook, alongside the recent escalation of concerns about global growth, has contributed to a major sell-off of Greek government bonds. The yield on the 10-year bond has risen sharply to 8.0%, from lows of 5.6% in early September **(Display 1)**. In our view, higher Greek yields and increased volatility are likely to be the norm for the near term. Moreover, current yields mean the potential for spillover from Greece to other peripheral markets has increased—particularly if an early Greek election becomes more likely alongside any intensification of global risk aversion.

Focus on an Early Exit

When the troika review resumes in early November, the market's attention will center on negotiations around Greece's bailout, including a request for an early exit from IMF assistance.

Display 1
A Sell-Off in Greece



As of October 17, 2014
Source: Reuters

Under the current bailout, Greece's European Union (EU) loans (and the formal troika program) conclude at the end of 2014, but its IMF program continues through early 2016. To resolve the gap between the two programs—and to exit the memorandum in full—Greece has proposed an early termination of its IMF program (and withdrawal from the last €12.4 billion in IMF loans set for 2015 and 2016). This would let Greece exit both lending facilities at the end of this year, which could be presented as a political victory back home and a clear step towards Greece shaping its own future.

Can Greece Exit?

But is this really possible? This will depend on Greece's ability to meet its financing needs through private means. We estimate that, if Greece opts out of the remaining IMF loans, it would have a financing gap of about €13.5 billion for 2015 to early 2016 **(Display 2)**.

Although Greece is "fully comfortable" that it can meet this financing need without assistance, the EU and IMF are much less confident. And, based on the recent sell-off in Greek bonds, there are still significant doubts in financial markets about supporting Greece without troika involvement and against a backdrop of a deteriorating Greek political environment.

In our view, with market access now in question, Greece will most likely be forced to sign up to a new support line from the EU. What form it takes won't be decided until late this year. Owing to its preference for European support over the IMF, Greece has recently indicated that it is willing to negotiate a precautionary credit line from the EU (and maintain plans to forgo the IMF loans). This is probably the minimum that's needed now, to provide a safety net in case Greece runs into funding difficulties next year. The risk is that a third formal bailout facility from the EU may be required (to remove Greece's need to access markets altogether), but policymakers in Greece will resist this option for now owing to the heavy political costs that it would entail.

A Presidential Obstacle

The current bailout negotiations have taken place in the context of a very uncertain political environment, created by the risk of an early parliamentary election. The early election risk is the result of a way in which Greece's president is elected.

Every five years, the Greek president is elected by members of parliament (MPs), rather than through a direct popular vote. If parliament cannot muster a three-fifths majority to support a presidential candidate, it must be dissolved and new elections called. Opposition parties can use this as an opportunity to block the presidential candidate, and force early parliamentary elections. That's precisely what's happening now.

Several opposition groups, led by the Coalition of the Radical Left (Syriza), have committed to blocking the government's presidential nominee—on the expectation that an early parliamentary election would strengthen their own positions. Syriza currently leads in the opinion polls, with about 30%–35% of voting intentions (roughly 10 points more than the ruling party, New Democracy). With this share of votes, an early election would give Syriza nearly half the seats, and almost certainly bring in a government under its leadership.

Financial markets and European political leaders are very uneasy about this prospect. Syriza, with its traditional anti-establishment approach, is likely to escalate the confrontation with Greece's official lenders to new levels. In the past, the party has taken a hardline stance against austerity measures and supported a much more material renegotiation of the government's troika loans, including debt write-offs. While Syriza is committed to staying in the euro area, and has moved to a more centrist position in recent years, the risk of a split with the troika and abrupt changes in policy are still material concerns if the party comes to power.

Chance for an Early Election

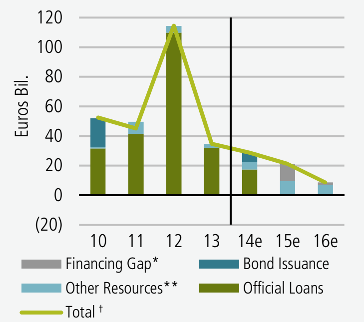
The question then is: Can early elections be avoided?

At present, the Greek government has 155 seats in the 300 seat parliament. For a three-fifths majority, the government needs 180 votes* for its candidate in next February's presidential election in order to prevent early parliamentary elections. That means it needs to find 25 votes from opposition groups.

Display 2

A Financing Gap of €13.5 Billion

Financing Requirements by Source of Financing



*Financing gap is the residual need after assuming €10 billion is drawn from cash (out of a bank recapitalization facility) in 2015, and assuming the withdrawal from the remaining IMF loans.

**Includes the drawdown of cash.

†The 2012 funding requirements are elevated owing to the PSI sweetener and bank recapitalizations.

Source: IMF, European Commission and AllianceBernstein

Currently, this looks like a big challenge. The government has had little success in rallying others to its cause. Several opposition parties have already pledged to vote against any presidential candidate the government nominates. And a failure to fully exit the bailout will further undermine potential support.

Of course, these positions may change as the threat of early elections loom. Some groups that are against the government may be even more against a Syriza alternative. Moreover, recent polls have suggested that the majority of Greeks don't want an early national vote.

Still, in our base case, we now anticipate an early parliamentary election to be held next year. If so, this will maintain selling pressure on Greek bonds for the near term. At the current levels, we are monitoring closely the potential for spillover from Greek risks to other peripheral markets. While in recent years there has been greater differentiation by investors between Greece and the rest of the periphery, the threat of an early election could reintroduce a degree of contagion. ■

*This threshold may be modestly lower at 175 votes for a 3/5th majority next February—if nine MPs from the party, Golden Dawn, remain in detention on charges.