

ECONOMICS: EUROPEAN PERSPECTIVES—JANUARY 9, 2015

Greek Risk Rises as Election Looms

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Greece will head to early parliamentary elections on January 25, with a victory for the leftist party, Syriza, the most likely outcome—a prospect that threatens fresh volatility in Greek government bond markets. But contagion to the rest of the periphery is likely to be mitigated by the expected launch of ECB QE.

With the Greek parliament unable to elect a president in December, early parliamentary elections will now take place on January 25. The most likely outcome is a victory for the anti-austerity party, the Coalition of the Radical Left (Syriza), which has recently polled in the 32.5%-37.5% range (adjusting for undecided voters). The outgoing Prime Minister's center-right party, New Democracy (ND), has reduced Syriza's lead in recent weeks to about 4% (**Display 1**)—this could close further before voting day. However, we currently don't expect New Democracy to gather enough momentum to change the result of the election.

If Syriza holds on to win, a 32.5%-37.5% vote share would translate into close to 50% of seats (if not just above) in parliament (because a 50-seat "winner's bonus" is automatically granted to the largest party), putting it in a strong position to form the new government. This would most likely be a coalition administration, though a majority Syriza government cannot be ruled out.

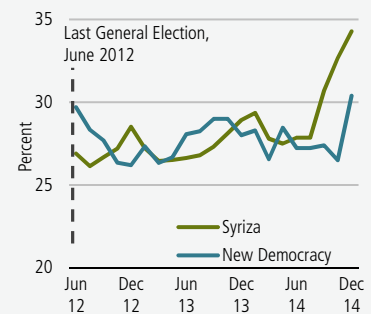
Talk of Euro Exit

What would a potential Syriza administration mean? ND's campaign strategy has been to portray a Syriza victory as meaning bankruptcy for Greece and its exit from the euro. The fear factor has been bolstered by warnings from German politicians about the implications of a Syriza victory. With 74% of Greeks in favor of staying in the euro, these warnings have been partly a campaign tactic and partly a warning to Syriza that it won't be able to implement its policy agenda without major ramifications. Ultimately, though, neither the European Union (EU) nor Syriza truly wants to go down an exit route.

From its own standpoint, Syriza has emphasized its commitment to the euro area. Party leader Alexis Tsipras said recently that his party is not a "threat to Europe" but instead a force for a change in its policy direction. To him, the debate in Greece is not just about Greece (and it's not about the nation's euro membership), but rather concerns a battle for the economic policy direction on the conti-

Display 1
The Ruling Party Has Cut Syriza's Poll Lead

Voting Intentions for the Next Greek Parliamentary Election, Poll of Polls



As of January 2015
 The result adjusts for undecided voters, by allocating their votes under the same distribution as the decided voters.
 Syriza is the far-left main opposition party.
 New Democracy is the center-right governing party.
 Source: Various Greek Polling Companies and AllianceBernstein

ment, pitting tight fiscal discipline and market liberalization against a more Keynesian approach. While this austerity and growth debate has already been taking place in Europe (and has gathered momentum), Syriza's intentions to push the debate much further and demand immediate changes to Greece's bailout terms (including reversals of wage and pension cuts, a cancellation of austerity and a haircut on Greece's loans) are unlikely to find much sympathy from the euro area's creditor nations.

Political Brinkmanship

Given the inherent conflict between Syriza's platform and troika conditionality, a confrontation seems inevitable if Syriza gains power. A game of political brinkmanship would follow between Tsipras and Greece's official creditors, with a further extension of the end-February deadline for the current and final bailout review probably on the cards. The true deadline for when Greece must have a deal on the last review to unlock a €7 billion tranche of troika funds (and avoid defaulting on bonds held by the European Central Bank (ECB) and loans from the International Monetary Fund (IMF)) is probably end-June. Around that time, negotiations for a precautionary credit line from the EU and IMF (to follow the bailout) must also be completed if Greece is to not be left without a financial assistance program. Without one, local banks' access to ECB liquidity would be in jeopardy.

In this scenario, our base case assumes that Syriza and the EU come to some form of last-minute compromise whereby the troika extends funds to prevent a Greek default. We don't think a Syriza government (particularly one in coalition with a more moderate party) would risk a disorderly default and euro exit. We also don't expect the troika to sit by while Greece defaults on debt owed back to it. However, there's obviously considerable uncertainty on how this plays out. If the troika gives too much ground to Syriza, it risks undermining the credibility of its financial assistance programs and governing institutions. But if Syriza accepts some of the troika's terms and backs down on many of its commitments, it risks internal divisions that threaten its stay in

power. A conceivable alternative scenario therefore involves one in which Syriza faces dissent from its radical fringes and/or from its potential coalition partner, with the result a second dissolution of parliament and early election.

Debt Renegotiation

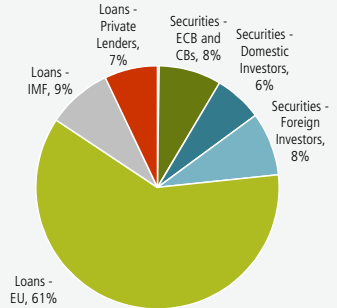
In order to seek mainstream votes, Syriza has recently softened its stance in many policy areas. One such area is its position on the government debt, with the party rejecting former plans to *unilaterally* "write off the majority" of the country's debt (both official loans and marketable bonds). Instead, Syriza has recently stated that it wants to *negotiate* a write-down of loans owed to the EU (61% of Greek debt, **Display 2**) and a maturity extension on bonds held at the ECB (a further 8% of its debt). But Tsipras noted that Greece's loans from the IMF (9% of the total) "must be paid off" and that it would not seek to renegotiate the private debt as it had "already been cut".

While Syriza's plans make sense given the unsustainable level of Greek debt, major restructuring of this type is unlikely in the near term. This is due to both political considerations (e.g., the opposition of creditor nations, particularly Germany, and potential implications for Portugal and Ireland's official debt, etc.) and legal constraints (it would violate the EU's "no bail out" clause). What's much more likely to be on offer from the rest of the EU—and which Syriza may be forced to accept, if it can remain compliant with the troika program—is a continuation of the region's approach on debt relief to date: further interest-rate reductions on EU loans and maturity extensions, but no cut in the

Display 2

Greece's Debt is Predominantly Owed to the Official Sector

General Government Debt by Holder, % of Total



As of the second quarter of 2014
Source: Eurostat, Bank of Greece, ECB and AllianceBernstein

face value. However, this approach is fast running out of meaningful value in Greece's case.

Market Sell-Off

The Greek 10-year yield now trades at 10.1%, up from lows of 5.6% last September. If Syriza wins on the 25th, more volatility in Greek government bonds is to be expected. With markets now focusing on the risk of a Greek exit, speculative selling and some further contagion from Greece to the rest of the periphery is probable. But we expect this to be mitigated by the anticipated launch of an ECB quantitative easing program. Much more significant spillover would certainly materialize in the event of worst-case scenarios involving Greek default and/or the country's exit from the euro area, but we currently regard these scenarios to be tail risk events.

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