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ECONOMICS: EUROPEAN PERSPECTIVES

ROCKY ROAD AHEAD FOR GREECE'S NEW GOVERNMENT

+ Dennis Shen, Economic Associate—Global Economic Research, dennis.shen@abglobal.com
+ Darren Williams, Senior European Economist—Global Economic Research, darren.williams@abglobal.com

A confrontation is underway between Greece's new government and the EU establishment on the terms of the country's bailout. Although Syriza has struck a more compromising tone this week, the gulf is still wide. We expect a rocky negotiation with last minute compromises to stem default. Greek bond markets are likely to remain volatile amid uncertain negotiations and potential political instability.

After January's parliamentary election, the Coalition of the Radical Left (Syriza) became the first "anti-establishment" party to take office in Greece since the economic crisis. The victory is symbolic of wider changes in the political landscape across Europe—with high unemployment and the unpopularity of austerity policies resulting in the fragmentation of the political center. Syriza has stated that its triumph is not just about Greece, but about a debate on the general economic direction of the region.

Last week, Syriza announced segments of its economic agenda, including an increase in the minimum wage, the rehiring of some public sector servants and the cancellation of several privatization plans. These announcements caused fears of an outright confrontation with Greece's lenders. In response to the fallout in financial markets and concerns of a split with its European partners, the party struck a more moderate tone this week. Prime Minister Alexis Tsipras signaled that Greece would "soon" reach "a mutually beneficial agreement" with its creditors and added that Greece would repay debt due to the International Monetary Fund (IMF) and European Central Bank (ECB).

A More Conciliatory Tone

A more conciliatory tone was also signaled this week by Greece's new finance minister, Yanis Varoufakis. In an interview with the *Financial Times*, he backed away from Syriza's original calls for an outright haircut of Greece's debt. Because the euro area's creditor nations will not accept a write-down, he instead proposed a "menu of debt swaps," in which Greece's long-maturity European Union (EU) rescue loans (62% of Greece's debt) will be replaced with new debt linked to nominal growth, and its short-maturity bonds held at the ECB (8% of Greece's debt) will be replaced with "perpetual bonds." Privately-held bonds would go untouched. The objective is the same, however: to improve long-term debt sustainability and attain short-term breathing space.

While it's important that Varoufakis has sought compromise, his new proposal is unlikely to be accepted by the creditor nations: the swap for growth-linked debt would imply potential losses for the creditors, and the perpetual bonds would violate rules against monetary financing. However, new iterations on the form of debt relief will probably arise and be proposed while negotiations continue. To date, the EU has insisted that nothing except interest haircuts and maturity extensions on Greece's loans from the EU are on the table.

Hardline Stance

While Syriza has moderated its policy stance, there is still a clear difference between its vision for Europe and that of the EU establishment. This week, Germany signaled a hardline stance in negotiations, stating that there must be a "full implementation of key reform measures" in exchange for continued solidarity.

On Wednesday, after Greece's new government held to its position against completing the last Troika review, the ECB upped the ante with a decision to lift a waiver on below investment grade-rated Greek government and government-guaranteed bonds. As a result, these bonds can no longer be used after February 11 by local banks as collateral to draw ECB funds. While Greek banks will just transition to higher-cost funds from the Bank of Greece (through the emergency liquidity assistance (ELA) facility) for now, the decision was a clear warning shot to Athens that ECB support is not unconditional if Greece does not comply with the Troika's terms.

So, the dilemma that Tsipras faces is that the creditors hold the cards to the solvency of both his government and the nation's banks. If Greece intends to meet its repayments to the IMF over the next few months, it needs the lenders to approve an increase in the maximum limit of Treasury bills that it can issue. If Greece intends to fulfill its commitment to repay the ECB this July and August, it will need either a Troika deal for a €7 billion aid tranche, or access to the Hellenic Financial Stability Fund, both of which are controlled by the lenders. And, if the Greek banks are to stem a crisis, they will require uninterrupted access to the ELA—which the ECB can threaten to cut if negotiations stumble. These are powerful bargaining chips.

Bailout Extension

Syriza's stated intention to repay the IMF and ECB and to continue talks over the debt and its economic platform means that the party now faces the very difficult dilemma of how much ground to give up to the creditors. To date, the party has indicated that it won't extend the existing EU bailout (which terminates at the end of February), and that it will instead request a "new deal" with the lenders, under new terms. Greece will probably hold to this line for now, but the pressure will only increase on it to give in to creditor demands to comply and extend the existing framework. If Syriza in the end requests such an extension (which could lengthen talks for several months), it would represent a further departure from its original campaign platform to end the Troika memorandum.

What's Next?

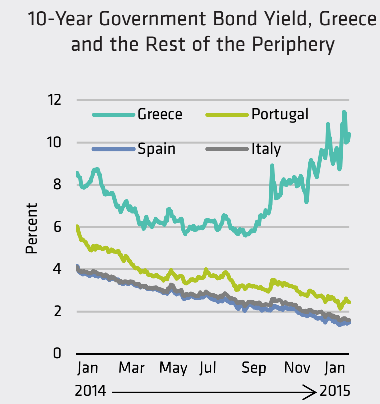
Against this backdrop, our base case is for a rocky negotiation between Greece and its creditors. With the Greek government facing an imminent cash crunch, things are likely to happen quickly in the coming weeks. Because both sides in the end have an incentive to stem a Greek default (on debt owed back to the official sector), we expect last-minute compromises to materialize during the negotiations. To reach a deal in the months ahead, Syriza would need to soften significantly and/or reverse segments of its policy platform and the creditors would have to accept some of Greece's policy demands (for example, on tax reform and public administration reform).

If instead the creditors maintain a hardline stance, a potential alternative scenario could see the new Greek government faced with an impossible decision within the next few months of whether to back down on many of its policy commitments or face imminent default. In this case, heightened political instability cannot be excluded if the Syriza government steps down (unable to make that decision) and/or fails after internal dissent. This could lead to some form of government reorganization (involving a provisional unity government) and/or commitment to hold a second early parliamentary election.

Volatile Greek Markets

Markets remain tense. Greece's 10-year yield now stands at about 10% **(Display 1)**. In the months to come, we expect Greek bonds to be volatile along with the twists and turns of the negotiations. Given high uncertainty for the path of negotiations

Display 1
Volatile Greek Markets



As of February 6, 2015
Source: Bloomberg and Thomson Reuters

and an ongoing cash crunch in Greece, further spillover from Greece to the rest of the periphery is probable (in both a positive and negative direction).

However, our base case assumes contagion can be mitigated by other factors. For example, the ECB's quantitative easing program will provide support for regional bond markets. The worst-case scenario of a disorderly Greek default and/or euro exit would pose much more significant spillover to other markets. We don't expect this scenario, but will monitor the risk as negotiations proceed. ■