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Greek asuterity after Syriza

By Dan McCrum **January 26, 2015**

A brief collection of reaction to Sunday's election in Greece follows. Before we hear from the professional financial crowd, however, a word from Eric LeCompte, executive director of Jubilee USA…

"This election was a referendum on austerity and debt policies. The people of Greece voted and said no to austerity and yes to renegotiating Greece's debt. Austerity programs can be likened to trying to help a patient on life support by punching them."

So, this could get interesting. Greece's pile of sovereign debt is almost twice the size of annual economic output, the International Monetary Fund, European Central Bank and European Union have helped to fund the country since 2010, imposing vicious/essential (delete as appropriate) cutbacks and reforms on the state to fix the problems/keep the euro intact. There are more young people out of work than in it, while Greece is supposed to dedicate almost 5 per cent of its economy to repaying debt in 2016.

First there are the assessments of Alexis Tsipras, leader of the radical Syriza party, which won Sunday's election in Greece. The FT's Tony Barber wonders whether the radical will in fact govern like a pragmatist, a Brazilian Lula rather than a Venezuelan Chávez.

David Mackie and co at JP Morgan set out some of the areas where the so-called Troika of multinational institutions and a new Greek coalition will have to work things out.

Assuming a coalition is formed, which seems very likely at this stage, the new government will need to decide relatively quickly how it will approach the Troika. A proposal from the new government will be needed to start discussions with the Troika on a further extension of the [European Financial Stability Facility] program—which is due to expire at the end of February. The Troika may only agree on a further extension of the EFSF program if the new government makes certain commitments. The new Greek government will also need to make proposals to the Troika in order to start discussions on how to successfully conclude the EFSF program (and receive the delayed €7bn of disbursements) and on how to structure further financing arrangements (most likely an ESM Enhanced Conditions Credit Line).

It is not clear how Syriza will develop a constructive proposal to approach the Troika, which respects what are likely the Troika's four lines in the sand (an ongoing structural reform effort, the maintenance of a primary surplus, no face value debt relief and net present value debt relief only in exchange for acceptable reforms). Syriza will be able to offer proposals which differ from those of New Democracy, but it will still have to work within the broad contours of the region's governance framework. Our judgment has been that the Troika will deal with a Syriza government as firmly as it dealt with the previous government, while recognizing that there is likely some scope for the composition of the adjustment and reform effort to be changed.

One key uncertainty is whether the Troika will change its view on the primary surplus objective, presumably in exchange for other structural reforms. In the current program there is an objective for the primary surplus of 4.5% of GDP in 2016, which would need more fiscal measures. We have long argued that this primary surplus objective is too high given the net present value debt relief that Greece has already received. But, the Troika has continued to focus on the headline debt-to-GDP ratio as a guide to what the fiscal objective should be. It is not clear whether the Troika's position on this will change.

The bank identifies four points of pressure. First is general economic and financial stress, with Greece worse off if there is a standoff. Second are refinancing needs this year, €8.5bn IMF loans, €6.7bn of debt owned by the ECB, spread throughout the year. Third are the Greek banks, who rely on the ECB for financing. Finally, Quantitative Easing: Greece needs Troika agreement to get in on that.

JPM remains bearish on the euro, with a target versus the dollar of $1.10. Also they continue to like long duration and swap-spread widening. Here's one idea:

On Friday we entered swap spread wideners on the German curve with the Buxl as our preferred point. The uncertainty around the Greek political landscape should put widening pressure across the German curve, especially if we see any flare up in concerns around Grexit leading to flight to quality dynamic. We keep wideners in 30Y as we believe the scarcity premium attached to German paper will impact mostly the ultra long end.

Elsewhere, here's Gary Jenkins of ING Capital, on the political calculations:

exactly what kind of change will be achievable is a moot point as Ms Merkel may prefer to see Greece leave the Eurozone than allow Mr Tsipras to dictate the entire economic policy of the euro area, although the most likely outcome remains a compromise which maintains the status quo because the alternatives are potentially so negative. Mr Tsipras could of course play hard ball and there have been suggestions that Greece could default on the basis that they are running a primary surplus. Technically possible I guess but any politician taking that decision might want exact clarity on how much of the economic activity is reliant upon being a member of the Eurozone before taking that option.

The unknowns of withdrawing from the Eurozone are such that Mr Tsipras might rather prefer to take his time through negotiation and continue to enjoy the benefit of the QE program. If that is the case then Greek bonds may well be the major beneficiaries of QE from a performance perspective over the next 6-12 months. After QE finishes (if…) might be the better time for Mr Tsipras to consider the nuclear option.

What happens now, though? Lets turn to Citi's Ebrahim Rahbari for some practicalities:

Next steps. Syriza leader Tsipras will likely be given a three-day mandate today to form a government. The Eurogroup on January 26 will discuss an extension to Greece's bailout (which expires at end-February), but a formal request for such an extension by the Greek government is required before it can be approved. Negotiations over a follow-up bailout may well take months, in our view, and be associated with some financial market volatility. In this context, it is worth noting that even though an eventual agreement on a bailout is likely needed to keep Greek banks and the Greek government funded, buffers exist to potentially address funding pressures in the interim, such as emergency liquidity assistance for Greek banks or increased bill issuance or arrears for the Greek sovereign.

BNY Mellon's chief market strategist Simon Derrick, meanwhile, caught some German reaction, which we'll bold.

the real ground zero for the crisis right now is probably Germany as officials, politicians and the public contemplate both unpopular monetary policy settings and Greece's calls for an end to "austerity" (while also considering what this might mean at the polls for Spain – the leaders of Podemos have been watching developments in Greece very closely as they consider their approach to the election later this year). Beyond the reaction in the German popular press to events over the past few days, the most telling response so far has come from the head of the Bundesbank, Jens Weidmann**.** Speaking to German public broadcaster ARD yesterday he stated: **"**I believe it's also in the interest of the Greek government to do what is necessary to tackle the structural problems there. I hope the new government won't call into question what is expected and what has already been achieved." When asked directly about the possibility of a third haircut for Greece, he said**:** "For me it's decisive that Greek public finances are stable in the long term and as long as that's not the case, a haircut would only grant a short pause for breath." This sounded an awful lot like a "no."

Still, there is at least a hint of optimism from Reinhard Cluse at UBS, or at least a hint of grounds for possible optimism in the future:

Key points: From possible to improbable

We identify three crucial areas of talks. Firstly, we think that there could be a compromise on debt relief, as long as it is in the form of extending maturities and lowering costs (a recent Bruegel paper calculated a possible reduction to the NPV of Greek debt by 17% of GDP using these tools1). In contrast, we believe that outright haircuts are unlikely to be acceptable for the creditor countries. Secondly, some easing of austerity and primary surplus targets (from the planned 4-4.5% of GDP until 2022) might also be agreed, although this is likely to come at the cost of slower future debt reduction. Thirdly, probably the most difficult area of the discussions might be around structural reforms, as the Troika sees structural reforms as the key precondition to lift economic growth in Greece, while SYRIZA is aiming to reverse many of these measures, based on its pre-election manifesto. We are uncertain whether the talks could be concluded by the end-February review deadline, and similarly, whether the Eurogroup would be willing to extend the deadline and for how long.

Finally, Giovanni Zanni of Credit Suisse note the key question of the junior party in the coalition.

There are three likely candidates: the centre-right, anti-memorandum, ANEL; the centrist, pro-European, To Potami; and Venizelos' center-left (ex-Pasok) party. Markets will probably be relatively reassured with the latter two, and worried if ANEL is chosen instead. Probably To Potami would make more sense, as it is a new party with little or no ties to the previous administration. An alliance with Pasok seems unlikely, at this stage. We should know pretty soon, anyway.

And he too sees the *possibility* of a happy ending: QE helps stabilise expectations on the euro area and provides a further incentive for Greece to seek an agreement with the European Commission (and the IMF), we believe. And contagion can also work in reverse: if Greece manages to strike a deal with the EU/IMF, the overall result of the Greek elections and of an "extremist" party gaining power will act as a reinforcement of the solidity of the Union, rather than the opposite. As such, all parties are interested in a positive solution. Europe is ready to be more flexible, we believe: see for example the recent relaxation of the Stability Pact rules last week. And Greece has a series of incentives (QE of its bonds, various support mechanisms coming from Europe) to agree on a common path of reforms, we believe.

But he also notes that it could come after a protracted bout of volatility in the coming weeks and months. A national democratic mandate versus international institutions, inside a currency union. Watch this space.