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An Election Too Far ?

Four scenarios for Greece after the elections

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The results of the Greek elections on 17 June are of crucial importance for both the country itself and the eurozone. This Policy Brief outlines the possible post-election scenarios. It argues that an intelligent modification of the current adjustment programme is the best course of action. Other policy choices would likely have a worse outcome, as they would either underestimate the resentment of the current programme among Greeks or risk leading to the country's exit from the eurozone.

Introduction

The Greek elections that took place on 6 May 2012 resulted in a severe political stalemate. As no parliamentary majority could be found, the country is heading

towards new elections on 17 June. The stakes are particularly high. Elections will be crucial for the economic adjustment programme that Greece and its international lenders agreed upon, as well as, in the end, Greece's membership of the eurozone.

Based on the current situation, four post-election scenarios for Greece seem possible:

- 1) The adjustment programme is maintained;
- 2) The adjustment programme is modified;
- 3) The adjustment programme is abandoned, but Greece stays in the eurozone;
- 4) The adjustment programme is abandoned and Greece leaves the eurozone.

This policy brief discusses each of these scenarios. As will become clear, not all of them are viable beyond the short-term.

Scenario 1: The adjustment programme is maintained

Scenario

The Greek government, backed by a majority in the Greek parliament, supports the adjustment programme as it has been agreed

upon by Greece and the Troika (the European Commission, the European Central Bank and the IMF).

Likelihood

International lenders favour this outcome. However, based on the election results of 6 May, this is an unlikely scenario. Only a third of Greek voters voted for parties favouring the adjustment programme as it currently stands. In addition, even the mainstream parties now seek to revise the programme to a certain extent, in spite of previous pledges.

Nonetheless, a large majority of Greek voters want to remain in the eurozone, and traditional parties might still gain a parliamentary majority in the new elections. This gives clout to the international lenders in demanding the execution of the current programme, making the scenario somewhat more likely.

Consequences

As the current programme focuses to a large extent on budget cuts, there is a risk that maintaining it will deepen Greece's economic recession. This will render the programme even less popular in Greece, making its future implementation politically most difficult. Therefore, even if the scenario would materialise, its longevity is improbable. Furthermore, maintaining the current programme will not end difficulties in Greece. It seems illusory to believe that efforts beyond the current bailout will not be necessary.

Scenario 2: The adjustment programme is modified

Scenario

The current adjustment programme is revised or “complemented” by new measures. These new measures could, *inter alia*, include:

- Spreading the reforms, notably the fiscal consolidation, over a longer period. The IMF indicated even before the elections that this should be considered¹. The adjustment programme indeed allows for such a revision²;
- Putting a strong emphasis on Greece and other weakened Member States in a future Growth Pact. Such measures should notably include investment projects, financed by the EU and private partners;
- Meaningful progress on European solidarity instruments. This includes Eurobonds (the partial pooling of sovereign debt issuances among eurozone countries) and a European deposit guarantee scheme (a guarantee of bank deposits at the European level);
- A new debt restructuring, including public debt held by the EU and the IMF.

Likelihood

It would prove most difficult to agree on changes or complements to the adjustment programme. On the one hand, EU leaders indicated that they are not willing to renegotiate the adjustment programme. On the other hand, most Greek political parties call for at least a radical overhaul of the programme. A Greek government that

¹ IMF, [Request for Extended Arrangement Under the Extended Fund Facility](#), 9 March 2012, p.17.

² European Commission, [The Second Economic Adjustment Programme for Greece](#), Annex 3: Memorandum of Understanding on Specific Economic Policy Conditionality, March 2012, pp. 113-114.

indicates its willingness to reform might be able to obtain some concessions. Yet, far-reaching demands would be rejected by the Troika.

Despite these difficulties, a modification of the programme is probable, as the other scenarios seem even less desirable for either Greece or the eurozone. The key to a successful modification of Greece's adjustment programme lies in finding a proper mix that is acceptable for both Greece and the Troika.

Consequences

The consequences of this scenario depend on the modifications to the adjustment programme. A growth programme and increased solidarity could have clear positive effects, both on market sentiments and on Greek ownership of the programme.

However, a revision of the programme would also set a hazardous precedent. It would reduce the eurozone's means to steer the future reform process in Greece. Other countries under financial assistance would see the revision as an indication that their programme can be softened as well. This is notably the case for Portugal, for which a second bailout may prove necessary. Concessions with regard to the programme would also intensify the drive towards slowing down fiscal consolidation in other eurozone countries.

This scenario would provide a short-term remedy for the current deadlock. Yet, it is questionable whether a compromise agreement would lead to a convincing and successful long-term strategy for Greece.

Scenario 3: The adjustment programme is abandoned, but Greece stays in the eurozone

Scenario

The adjustment programme is completely abandoned, but the Greek government wishes to stay in the eurozone nonetheless.

Likelihood

This scenario could occur either because the Troika agrees to support Greece despite lack of agreement on a revision of the current bailout, or because Greece is confident it can function without external financing. Neither scenario is likely or sustainable.

Consequences

The abandonment of the programme would lead to the non-disbursement of the planned financial assistance by the EU and the IMF. In order to keep Greece in the eurozone and prevent a default, Greece's lenders might nonetheless agree to temporarily continue financial support.

Otherwise, Greece could try to avoid running out of financial means by (temporarily) stopping repayment of its creditors and giving out debt certificates for part of its payments, similar to the IOUs (I owe you) that were used by California³. In the short-term, Greece's financial sector would also crucially depend on the ongoing support from the ECB which would have to cease at some point⁴, triggering a banking collapse and a Greek eurozone exit.

³ Greece's deficit excluding interest repayments (the primary deficit) is forecast by the Commission to reach 1% of GDP in 2012. This makes such an exercise conceivable in theory.

⁴ Although Emergency Liquidity Assistance is provided at its own risk by the Greek Central Bank, the ECB would not tolerate such a deviation from its own monetary policy given the political context.

In sum, the situation would not be viable beyond a few months. A more stable medium-term solution would then become necessary. This would either be a modification of the adjustment programme (scenario 2) or an exit from the eurozone (scenario 4).

Scenario 4: The adjustment programme is abandoned and Greece leaves the eurozone

Scenario

The adjustment programme is abandoned as no compromise between parties can be found on its modification. Greece leaves the eurozone as its lenders stop providing assistance⁵.

Likelihood

This scenario is unlikely in the short-term in so far that EU leaders and a majority of Greeks do not favour a Greek exit. Yet, it could result from a political deadlock over the adjustment programme, as well as a massive silent bank-run reaching unsustainable proportions.

Consequences

A Greek exit would present substantial legal and practical challenges. It would furthermore have considerable economic consequences extending well beyond the eurozone. Rough estimates put the additional economic loss for Greece at 7.5% of GDP. For the eurozone, a Greek exit would cut GDP by 1.6% on average⁶. The financial

sector and public finances would be particularly impacted, both directly and indirectly.

The direct impact of a Greek exit followed by debt restructuring and currency depreciation is that Greek financial assets held by banks throughout the eurozone would lose most of their value⁷. A Greek default would impact public finances of other eurozone members because of the previous loans to Greece⁸. The European Investment Bank and ECB Greek debt holdings would also be exposed to important losses⁹.

The indirect impact of the Greek exit - the contagion effect - is likely to be severe in sovereign debt markets as government bond yield spreads against Germany would increase, in particular in the most vulnerable countries such as Ireland, Portugal, Spain and Italy. Risk aversion could force several countries out of the markets as they would face interest rates above sustainable levels. Investors and depositors, fearing for their money, would pull-out of weak countries, potentially pushing fragile European banks into bankruptcy, further damaging public finances and perhaps forcing these countries to leave the eurozone. This self-reinforcing dynamic would be particularly strong in weak countries as a considerable amount of

⁷ Eurozone banks have 52bn EUR in remaining exposures, mainly to Greek corporations. Rest of the world exposure is 11.4bn EUR (the UK representing nearly 65%). See: NORDVIG, J., Preparing for a Greek Eurozone exit: Part 2. G10 FX insights, Nomura, May 2012

⁸ Total direct loan exposure reaches 130bn EUR, representing 1.4% of the eurozone GDP. See: DRAKOPOULOS, D., NORDVIG, J., Preparing for a Greek Eurozone exit: Part 3. G10 FX insights, Nomura, May 2012

⁹ Together with the EIB, the ECB holds 43bn EUR of Greek assets (and 130bn EUR in Target 2 and notes), see *supra*.

⁵ In theory, the other eurozone countries could decide to expel Greece from the monetary union. However, this is politically and legally next to impossible. Therefore, this scenario is not discussed.

⁶ CLIFFE, M., EMU Break-up. Pay Now, Pay Later. ING, December 2011, p.29

sovereign debt is held by domestic banks. In the worst-case scenario, a Greek exit, having demonstrated the end of the claimed irrevocability of the euro, could be the first domino leading to a break-up of the eurozone.

The extent to which such a contagion could be mitigated would depend on the belief that Greece is different from other weak countries. The deterrence effect of the firewall (EFSF/ESM) would hence be evaluated by market forces. If it proves insufficient, required intervention of the EFSF/ESM might necessitate remaining eurozone members providing it with extra capacity and, possibly, additional fresh capital.

Meanwhile, the ECB could be forced to act beyond its formal mandate in order to back-stop the contagion by engaging in massive bond-buying to support the affected countries. The ECB would also need to support the financial sector by easing refinancing conditions and providing emergency liquidity assistance to distressed banks.

Additional bolder actions to limit the risk of contagion could be (re)considered. These could involve the introduction of Eurobonds for countries not yet involved in a bail-out programme or a more effective ESM backed by the ECB. A comprehensive financial sector crisis management scheme at the EU level could also be adopted, allowing for direct support for bank recapitalization and better protection of depositors and tax payers.

Conclusion

The Greek elections will constitute a game changer for the country's bailout. After the elections in June, the continuation of the adjustment programme as it currently stands will likely prove to be politically unviable in Greece. At the same time, international lenders are forcefully excluding any programme revision. By insisting that the elections should be considered as a referendum on eurozone membership, they hope to influence their outcome. While Europe should indeed remain firm on the need for reforms in Greece, such a radical strategy could prove a mistake for two reasons.

Firstly, the strategy could backfire. Brinkmanship by Greece and the international lenders could close the door on a compromise. International pressure could therefore drive Greece towards renouncing the assistance programme altogether.

Secondly, the current strategy deteriorates the outlook for Greece. It adds further uncertainty to Greece's future in the eurozone, thereby increasing its economic and fiscal predicament and fuelling further bank withdrawal by depositors. As a result, Greece's financial assistance programme is becoming increasingly inadequate. Ultimately, escalating panic could lead to a point where a negotiated solution comes too late.

Given the problems attached to both maintaining and abandoning the programme, the only viable scenario seems a "smart" revision of the current programme (i.e. scenario 2 of this Policy Brief). Such a revision should signal that the vital policy reforms have to be implemented. At the same time, specific modifications can be

made, as they are likely to be beneficial for both Greece and the eurozone.

The timeframe of reforms that particularly undercut growth should be reconsidered, taking into account the worsened outlook (deeper recession, capital flight...). This would make the programme more credible and might result in a certain degree of Greek ownership.

Moreover, the eurozone should take steps towards more European solidarity. Several elements could be considered, such as a roadmap towards Eurobonds, a European deposit guarantee and a comprehensive Growth Pact with a particular focus on troubled Member States.

Such European solidarity would crucially demonstrate to Greece that European partners are willing to take a fair share of the burden if the country is willing to pursue its reform programme. Other eurozone countries, for their part, should accept such burden sharing as a necessary step-up towards a stable monetary union. Stronger eurozone solidarity instruments might be difficult to accept for some countries. However, without such measures the sovereign debt crisis risks deteriorating even further, rendering more solidarity unavoidable.

A compromise will not be easy to forge. Nonetheless, decisive action should be taken to alleviate the risk that the current stalemate and growing panic degenerate into a chaotic outcome that no one actually wants.

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