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GREEK ELECTION: WHERE DOES GREECE GO FROM HERE?



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EXECUTIVE SUMMARY

One month after Greece's second election in nine months returned Prime Minister Alexis Tsipras' Syriza-led coalition to power, the Greek people find themselves in the familiar position of having to contend with the strict terms of a bailout program agreed with the country's creditors. However, while the prospect of Greece leaving the eurozone – and potentially prompting other countries to follow – has receded for the time being, questions remain over whether the latest agreement will hold over the longer term.

In this Price Point, Kenneth Orchard and Ivan Morozov analyze whether Syriza's second victory in nine months finally signals the beginning of sustained stability for Greece or merely brings temporary respite before bigger storms hit further down the line.

WHAT DOES THE ELECTION RESULT MEAN FOR GREECE?

The election result made life slightly easier for Tsipras, who called the country to the polls in late August following a series of revolts from Syriza MPs over the latest bailout agreement. To pass the new program through parliament, Tsipras had to rely on votes from opposition parties. Once parliamentary approval was obtained, Syriza's rebel MPs left to form a new party called Popular Unity, which won just below the minimum threshold of 3% of the vote and consequently has no parliamentary representation.[1]

Syriza will therefore continue with a slightly improved mandate, and it will be highly motivated to meet the terms of the program in the short term: A review of its progress is due soon, probably in November. If that goes well, it could open the way for debt relief, most likely in the form of longer debt maturities and interest payment holidays, toward the end of the year or early in 2016.

[1] Source: Greek election rules.

Market reaction to Syriza's second victory in nine months was muted as the result had been widely anticipated. This mirrored the reaction to January's election result, which was also priced in well before votes were cast. Between the two elections, however, volatility spiked as Syriza battled with its creditors and a Grexit began to look like a realistic prospect. Greek 10-year yields reached 13.5% in April and went above 13% again in June before falling back below 8% once parliament approved the new program in August.[2] Peripheral yields were also hit by tensions in Greece, rising to their highest levels since last November before they also settled back down after the crisis passed.

Doubts remain over the longer-term prospects for Greece. The full extent of the damage inflicted on the Greek economy by this year's tortuous (and ultimately futile) negotiations with the country's creditors has yet to be fully assessed. Capital controls, though relaxed, remain in place. Serious questions persist about Tsipras' ability to deliver what is required to keep Greece in the eurozone and ensure its long-term economic survival. If the economy performs worse than expected in 2016, this could undermine Greece's ability to meet agreed budget deficit targets – and it would be politically very difficult for Syriza to impose fresh austerity measures.

Equally important is the question mark over the depth of Syriza's commitment to the current terms of the bailout program. Ahead of the parliamentary vote on the program, Tsipras described the rescue package as a "necessary evil" for the nation to avoid a Grexit. He added: "The real dilemma posed in the 17 hours of negotiations was not a bailout or disorderly bankruptcy, but a bailout with the euro or a bailout with the drachma."

Tsipras made it clear that Syriza does not really believe the program is in Greece's long-term interests and only agreed to it because he felt there was no other choice. This is a cause for concern. Implementing tough new measures requires hard work and deep commitment; reluctant acquience is not usually a strong formula for success. Greece has agreed to the terms of various different rescue programs over the past five years, under both left-wing and right-wing governments, and made only limited progress. It remains to be seen whether the country is capable of implementing the changes it needs to make, irrespective of which party is in charge.

MAJOR CHALLENGES AHEAD

Perhaps the most challenging of Greece's commitments under the terms of the new program is its promise to restructure the pension system with the aim of saving 1% of GDP by the end of 2016. This will require cutting early retirements and – controversially – phasing out EKAS, the top-up solidarity grant for elderly Greeks who have very small pensions by 2019.

Other measures in the program include the successful recapitalization of Greek banks before the end of the year; the privatization of a number of sectors, including ports, airports, waterworks, and the country's national electricity grid operator; a commitment to tackling Greece's "clientelist" system in which rent-seeking interest groups are bought off with tax breaks, favorable regulation, and guaranteed jobs; and the phasing out value-added (VAT) discounts applied to Greek islands.

Reducing government debt is the ultimate goal. The Greek authorities are committed to reaching 0.5%, 1.75%, and 3.5% budget surpluses in 2016, 2017, and 2018, respectively. In addition, the Ministry of Finance needs to gain parliamentary approval for the 2016 budget and the fiscal plan for 2016—2019, which together identify €3.2bn of additional austerity measures.[3] Although not an immediate risk, problems may arise if the government does not reach its 2016 target and needs to identify further measures to compensate for that.

[2] Source: Bloomberg.

[3] Source: Terms of ESM Program for Greece agreed with the European Commission.

Meeting all of these requirements in the tight time scales imposed by the program would be a steep challenge for any government of any country. For a government that originally came to power on an anti-austerity ticket and only reluctantly signed up to the bailout terms after months of fierce resistance against its creditors, the task will be even more onerous. In addition to meeting the terms of the program, Syriza's other major priority will be attracting new investment. However, with a discount rate of more than 7% (Greek 10-year bonds are currently yielding just under 7.5%),[2] it will be difficult to attract any sophisticated long-term investment other than through the privatization programs outlined above and the tourism industry, which remains Greece's biggest asset.

IMPLICATIONS FOR EUROPE

The reelection of the Syriza-led coalition, together with its official commitment to the terms of the third bailout program, has significantly diminished the possibility of a Grexit in the near to medium term. It remains a possibility in the longer term, depending on Greece's ability and willingness to adhere to the terms of the bailout program, but the market isn't currently pricing this in because it is too distant a prospect. If Greece successfully negotiates some debt relief over the next three to four months, yields on Greek debt will likely tighten; if it becomes clear further down the line that Syriza is struggling to implement its planned reforms, a repeat of this summer's sell-off of Greek bonds is likely, which will also impact peripheral yields.

Outside Greece, the failure of Syriza to successfully challenge austerity seems to have dented the popularity of some anti-austerity parties in other countries. In Spain, Podemos – which has close connections to Syriza – has lost support over the past few months as people have realized that its brand of far-left radicalism is perhaps not as easy to implement as it sounds. In Portugal, the center-right ruling coalition of the Social Democrats and Christian Democrats, which has overseen the implementation of austerity and structural reforms, managed to win the general elections on October 4, despite lagging behind the center-left Socialist Party in opinion polls earlier this year.

Here again, however, longer-term risks remain. While the argument for remaining in the eurozone seems to have been won, for the time being at least, in countries like Spain, Italy, and Portugal, the reality of living under the terms of that deal has yet to be fully tested. If the situation in peripheral eurozone countries begins to deteriorate again, requiring more painful reforms, the people of those countries might once again begin to think that leaving the single currency is not such a bad idea after all. The exit of a number of countries in a short period would inflict significant volatility on markets, carrying a major threat to the eurozone and the global economy. We do not anticipate this situation arising in the near to medium term; beyond that, it cannot be ruled out.

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