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MACROCOSM

Εκλογη

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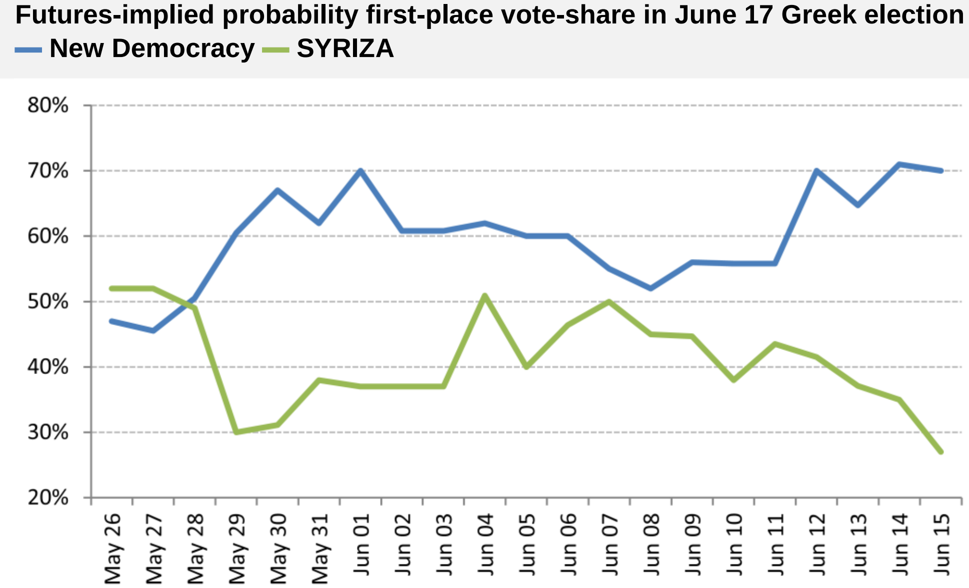
Short-term risks from the Greek election are much smaller than markets seem to think.

Greek (and French) elections, possible central bank interventions, and G20 and EU summits mean the coming weeks are going to be risky and noisy. First, front and center is the Greek election on Sunday, with results expected soon after polls close at 1:00 pm EDT. While it's easy to imagine worst-case outcomes and their worst-case consequences -- which a full-on media frenzy is helping markets to do -- we think the likeliest results will be relatively benign.

There are three possible outcomes of the election that would be relevant to markets.

- **First scenario:** New Democracy -- the party in government until 2009, which has signed the Memorandum of Understanding (MOU) with the EU/IMF/ECB "troika" to secure bailout funding -- will be the largest party after the vote, and able to form a coalition government with PASOK, who are the outgoing government party.
- **Second scenario:** Anti-MOU SYRIZA is the largest party, and is

Futures-implied probability first-place vote-share in June 17 Greek election



Source: Intrade, TrendMacro calculations

Update to strategic view

EUROPE MACRO, FX: Sunday's Greek election looks like a binary play. Either SYRIZA wins big, or it doesn't win at all. With odds now stacked against a SYRIZA victory sufficient to form a government, we should expect a rally on Monday to accompany reduced tail-risk of a hasty and destabilizing Greek exit from the euro. But, the market has also been promised a central bank response to a SYRIZA victory. So, even if the worst outcome happens, it can still lead to at least relief rally. But Europe remains on the risk radar, while we await details of whether Spain's bank bailout will subordinate sovereign debt.

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able to form a coalition with smaller communist parties, or is large enough to form a government on its own.
- **Third scenario:** The election again proves indecisive, and no party is able to form a government -- as happened on May 6 (see "On the French and Greek Elections" May 7, 2012).

At the moment, the first or third scenarios -- a New Democracy victory, or a hung parliament -- seem most likely. The second scenario -- a big win by SYRIZA -- seems virtually impossible.

- Coming first in the polls is very important in Greek elections, as it gives the first-place party 50 bonus seats in a 300-seat parliament.
- Polling has stopped now for two weeks under Greek law, but both Intrade political futures markets (see chart on the first page) and betting sites have it as a near-certainty that New Democracy, not SYRIZA, will come in first.
- Even if SYRIZA comes in first and earns the 50-seat bonus, it would have to have 37% of the popular vote to have a parliamentary majority (the actual threshold will be set after the election, as smaller parties with less than 3% of the vote are discounted). In the prior election SYRIZA got 16.8% of the popular vote. So to achieve a majority of seats in parliament, SYRIZA would have to more than double its prior vote-share -- which is extraordinarily unlikely.

But what if SYRIZA does win by a large enough margin to allow it to form a government?

- SYRIZA has stated that it will not respect the MOU with the troika. For their part, EU leaders have said that the bailout funding -- which is essential for Greece to continue to pay its bills -- would cease if a Greek government rejected the MOU.
- No cash and no funding for Greece would put pressure on Greece's membership in the euro currency union.
- But we are certain that the chance of a Greek exit from the euro currency in the near term are negligible. After all, while SYRIZA opposes the MOU, it is in favor or euro membership. But it is a non-zero risk, and if events unfold over the weekend in a way that heightens that risk, markets' reaction -- absent any external policy response -- will be very negative. There is always the chance that an intense market response, whether or not it is merely a groundless panic, could create a self-fulfilling prophecy. In the very worst case, it could so destabilize Europe as to lead to a chaotic 17-way breakup of the currency. That would be an immensely consequential global systemic event.
- But the first step to actualizing that risk is a SYRIZA victory -- and a big victory, at that. Without that improbably big victory, the first step in the sequence of dominoes is missing.
- So an early Greek exit from the euro -- even in the event of a SYRIZA victory -- is highly unlikely. But without the SYRIZA victory, chances become vanishingly small.

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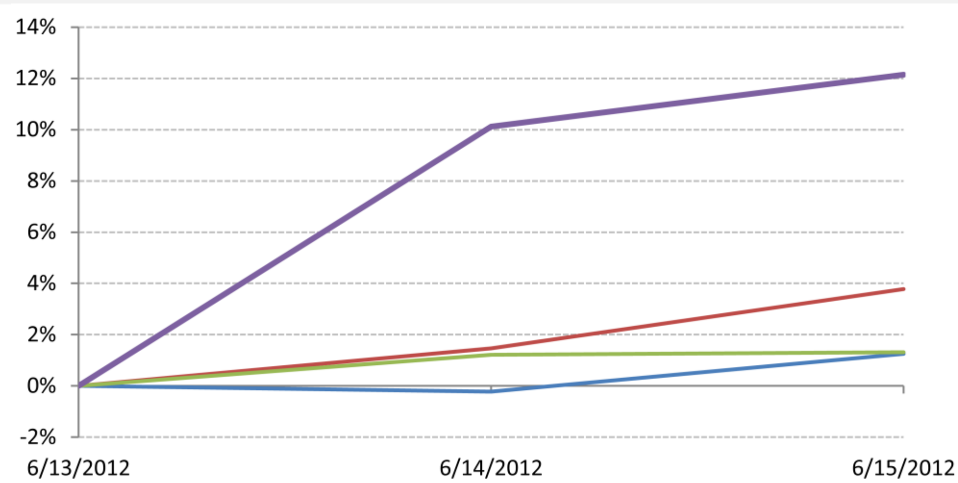
If no party is able to form a government -- our third scenario -- there could potentially be a third election, but the most likely scenario in this case would be an all-party agreement on a technocratic government.

- A technocratic government has the advantage for the parties that they would be able to avoid some of the blame for the continued reform measures that the Greek economy needs. And it would lead to a depoliticized environment in which Germany might be able to slightly soften its hardline stance on enforcement of the MOU.
- It would also probably be the most stable medium-term outcome to the election. Our base case -- New Democracy forming a government with PASOK after the election -- would be analogous to the Democrats and GOP forming a government in the US during a crisis. It might be possible, but it would not be stable.

Whatever the election outcome, the reaction by policy-makers outside Greece will have a lot to do with markets' reactions on Monday.

- No matter what happens, Greece will still be in the euro area next week. If it looks like there is a heightened chance that Greece may eventually leave the currency union, then central bank and other policy responses can reduce the negative feed-though from those worries.
- Already there is talk of a [coordinated central bank] response to any fallout from the election. This response would be needed if the Greek election increases the tail risk of an early exit from euro -- *i.e.* if SYRIZA wins big. Rumors of central bank action caused a market rally late yesterday -- and the authorities have not denied the rumors.
- If, on the other hand, there is no increase in expectations of an early Greek exit from the euro area -- due to either a New Democracy victory, or the likelihood of technocratic government --

Change in equity markets from close on Wednesday, June 13
— Greece — Germany — Spain — Italy



Source: Bloomberg, TrendMacro calculations the need for central bank or other policy action is reduced.

- So with the base case being that SYRIZA does not win, then the market may have already front-run much of a potential relief rally (please see the chart on the previous page). In a nutshell: without the bad thing -- SYRIZA victory -- there will not be the good thing -- central bank easing.

All that said, the Greek election is perceived by the market as a serious risk event. Getting past it -- especially when both a good election outcome or central bank intervention offer some upside -- will at the very least lead to a relief rally. Europe has promised to address many issues in the coming weeks, not least the critical details of whether the Spanish bank bailout will subordinate sovereign debt (see "I Love the Smell of Bailouts in the Morning" June 11, 2012). So the real sustainability of any rally in Europe will have more to do with factors very much outside of one little country with a gross domestic product the size of the city of Boston.

Bottom line

Sunday's Greek election looks like a binary play. Either SYRIZA wins big, or it doesn't win at all. With odds now stacked against a SYRIZA victory sufficient to form a government, we should expect a rally on Monday to accompany reduced tail-risk of a hasty and destabilizing Greek exit from the euro. But, the market has also been promised a central bank response to a SYRIZA victory. So, even if the worst outcome happens, it can still lead to at least relief rally. But Europe remains on the risk radar, while we await details of whether Spain's bank bailout will subordinate sovereign debt.