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TRENDMACRO LIVE!

On the French and Greek Elections

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Lorcan Roche Kelly

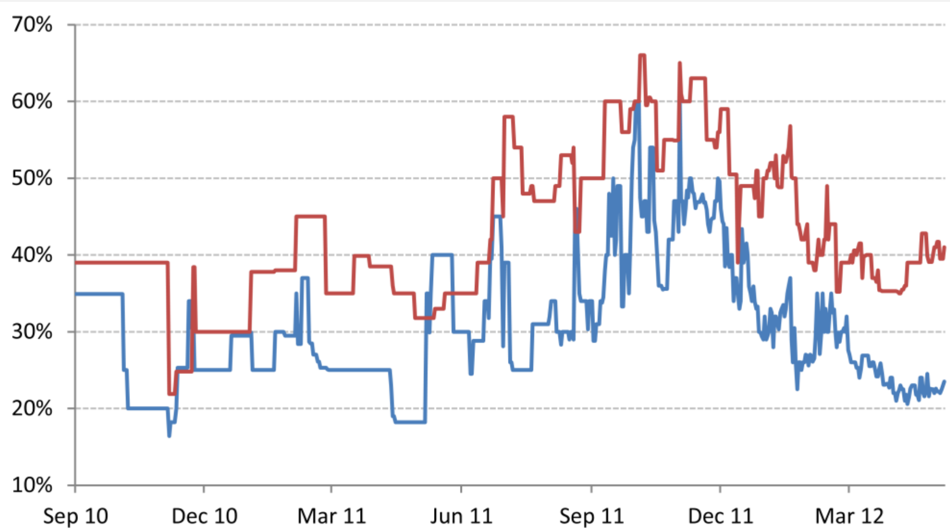
The Greek dog is barking again -- but the euro area caravan will move on.

The only surprise in yesterday's French and Greek elections was that in Greece, it seems that nobody won. PASOK and New Democracy -- the two pro-bailout parties, and traditional duopoly of Greek government -- failed to gain a majority between them. In France, about as expected François Hollande won with 51.7% of the vote.

For all the chatter about Hollande representing rebellion against Europe's so-called "austerity," Hollande's election as French president should not come as a shock to markets -- it is not a surprise, but most fundamentally it does not represent a policy sea-change for the euro area.

- Hollande is a committed europhile (see "The French Election Connection" February 7, 2012), so he will do nothing to derail the process of euro area fiscal and political integration that is the long-term key to solving Europe's debt problems.

Futures-implied probability of any one country leaving the euro
Leave in 2012 **Leave in 2013**



Source: Intrade

Update to strategic view

EUROPE MACRO, EUROPE STOCKS, US STOCKS: Hollande won the French election as expected -- the surprise is that, nobody won the Greek election, ushering in another period of political instability there. Hollande may change the tone a bit in the euro area, but he certainly won't change its direction. Ever closer integration -- the only permanent solution to the euro area crisis -- will proceed. The risk that Greece will leave the euro is heightened, but that remains unlikely. While a potentially existential risk, continuing political and fiscal integration by the rest of Europe can deflect it. The initial panic in markets was an over-reaction. We continue to think the correction in developed economy equity markets is merely that -- a correction.

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- The election means the end of the Merkel-Sarkozy partnership -- the world dubbed it "Merkozy" -- which had been the *de facto* leadership of the euro area response to the crisis (see "Two-Tier Europe is Born" August 17, 2011). Hollande now has to establish the relationship with German Chancellor Angela Merkel that will allow France to continue in its leadership role. His first trip after his inauguration on May 15 will be to Berlin.
- Merkel and Hollande's inevitable partnership doesn't lend itself to a euphonious mash-up like "Merkozy." But "Merklande" might make a good name for the federal Europe they may create together.
- Hollande is being pushed into Germany's arms by competition from Italian Prime Minister Mario Monti. Last week Monti made overtures to Merkel to forge the kind of bilateral ties between Germany and Italy that Sarkozy and Merkel worked out for Germany and France last year (again, "Two-Tier Europe is Born"). Hollande was elected on a pro-growth, anti-austerity platform. It was an easy message to sell in an election with France in recession -- in practice this probably won't amount to much within France, and even less across the euro area.
- His growth message has gained traction, with a growth compact now being discussed at the European Union level to match the fiscal compact agreed -- but not yet ratified -- earlier this year. The growth compact as presently discussed mostly concerns mechanisms for funding euro area investment. It does not concern, either favorably or unfavorably, the labor and product market reforms that we believe are, in fact, the keys to Europe's future growth (see "Europe's Supply-Side Revolution" February 17, 2012). Nor does it concern giving the ECB a growth mandate -- that idea was floated by both Hollande and defeated Nicolas Sarkozy in the election, just as it has been -- to no avail -- in previous elections.
- For the euro area as a whole, the election of Hollande may lead to a change of tone, but it will not lead to a change of direction.

While thankfully the French election does not point to any important strategic instability for the euro area, sadly the Greece election thrusts it back onto the world's risk dashboard. The surprisingly strong results by the anti-bailout Syriza party -- and the generally mixed results of the election that leave Greece in real danger of not being able to form a government -- raise urgent intermediate-term questions about its solvency as a nation and its membership in the euro currency.

- In our view, at this point, it is only the currency issue that matters.
- Under the debt restructuring completed early this year, Greek sovereign bonds in the hands of the world banking system are down to truly *de minimis* levels.
- With a gross domestic product the size of the city of Boston, the Greek economy is not intrinsically important.
- But with the rise of anti-bailout political power -- and with Greece likely without an elected government for months -- it may fail to do what is necessary to keep obtaining needed funding from the bail-out.

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- The risk is that under the resulting stress Greece might leave the euro currency. That would be an existential event for the euro area.

Let's take a close look at the election results, and the internal political process that will immediately follow.

- It was expected that the outgoing PASOK party and the main opposition party -- New Democracy -- would gain enough seats between them to gain an overall majority and be able to cobble together a government. But they have fallen 2 seats short of the 151 required for a majority.
- The biggest winner was the left wing Syriza party -- which finished second ahead of PASOK. Syriza is actually a coalition of leftist parties, led by the fiery young Alexis Tsipras, the president of Synaspismos, the largest party in the coalition.
- The leading parties now have a maximum of nine days to try to form a government. If -- more likely, *when* -- negotiations fail to lead to a stable government, another election will be called. The earliest possible date for that election is June 10.
- The only parties in Greece that have shown commitment to the agreement for Greece's bailout out by the euro area's so-called "troika" are PASOK and New Democracy. If they cannot form a government, then Greece's willingness and ability to abide by the difficult terms of the bailout are very much at risk.

For the euro area, political turmoil from Greece is an unwelcome recurrence of the crises of the last two years. But, this time, things are very likely to be substantially different.

- Greece has already used up its most effective debtor's leverage in negotiations with the rest of the euro area -- its sovereign debt held in the global banking system has now been substantially written off.
- More generally, Europe's banking system has been systemically protected from a funding crisis by the ECB's massive LTRO operations (see "On the Second 3-year LTRO" February 29, 2012).
- The only card it has left to play is to threaten to leave the euro.
- Throughout the crisis, we've always believed that a member state leaving the euro was a nuclear event (see "Papandemonium!" November 3, 2011). The logic being that if any country *does* leave the euro, then any country -- including Germany -- *can* leave the euro.
- To avoid this scenario, the rest of the euro area may have to keep cutting checks for Greece, even as it repudiates its obligations under the bail-out.
- But there is another outcome that is possible. The rest of the euro area could continue on with the political and fiscal integration process without Greece. This would make the euro area -- without Greece -- an increasingly coherent and indissoluble whole, in which it would be procedurally impossible for a member to leave.

- As Greece finds itself more and more isolated under such a scenario, the probability of its leaving the euro would increase, but the damage of it would be trivial -- except to Greece.
- All that said, a Greek euro exit is not a strong possibility. The majority of the Greek people still favors membership even as it opposes the difficult terms of the bailout -- and that is the exact position of the Syriza party. For what it's worth, the political futures markets on any single country leaving the euro have barely budged since the election results (please see the chart on the first page of this report).

The euro area has a good track record for sweating out crises, for running out the clock and adjusting expectations, and thus strengthening the euro area as a whole from small but potentially systemic threats (see "Greece: Suicide, Not Murder" June 7, 2011). Remember, two years ago the market was certain that a Greek debt default would be the end of the world. Well, default happened -- and the world did not spin off its axis. Now, the doomsday scenario is Greece leaving the euro. If the euro area -- ex-Greece -- can continue to integrate and thus externalize small threats like Greece, then it may well be that a Greek exit will turn out to be the non-event that the Greek default was.

The global sell-off in the wake of the election results that began when Asian markets opened this morning has already abated, as of this writing. In our view the initial panic was an over-reaction, and we are not changing our call that the correction in equity markets in the developed world is merely that. Political risk in Europe will continue to be a source of market agitation for years -- we are witnessing, after all, a great geopolitical transformation that will take a long time to play out, and presents many uncertainties along the way. But the French and Greek elections represent nothing novel to perturb that strategic view.

Bottom line

Hollande won the French election as expected -- the surprise is that, nobody won the Greek election, ushering in another period of political instability there. Hollande may change the tone a bit in the euro area, but he certainly won't change its direction. Ever closer integration -- the only permanent solution to the euro area crisis -- will proceed. The risk that Greece will leave the euro is heightened, but that remains unlikely. While a potentially existential risk, continuing political and fiscal integration by the rest of Europe can deflect it. The initial panic in markets was an over-reaction. We continue to think the correction in developed economy equity markets is merely that -- a correction.