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MACROCOSM

What's Greek for "Groundhog Day"?

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Failure to form a Greek government means another election, more volatility, more tail-risk.

Last ditch efforts to form a Greek government failed this afternoon in Athens, with June elections now a certainty. The date for new elections has not been decided yet, but it is likely that they will be either June 10 or June 17. Those happen to be the dates of the first and second rounds of the French parliamentary elections, so there will be echoes of May 6, with important political activity taking place in both Greece and France (see "On the French and Greek Elections" May 7, 2012).

From a strategic standpoint, all that's important in the Greek political mess is whether it will lead to a Greek exit from the euro. Let's be clear about the tail-risk here: *Greek euro exit occurring chaotically in the near term and badly handled by Europe's institutions would be one of the most disruptive shocks to hit the global economy in a generation, eclipsing the collapse of Lehman brothers (see "On the Greek Referendum Surprise" November 1, 2011).*

That's the tail-risk (please see the chart below), and markets are correct to

Update to strategic view

EUROPE MACRO: Greece will now have to hold another election, in hopes that a government can be formed. The short term good news is that nothing important will happen until after that vote. Longer term, the tail-risk of Greece leaving the euro has increased. Already Europe's institutions are circling the wagons, and conditioning the market to expect that Greek exit won't be a systemic disaster.

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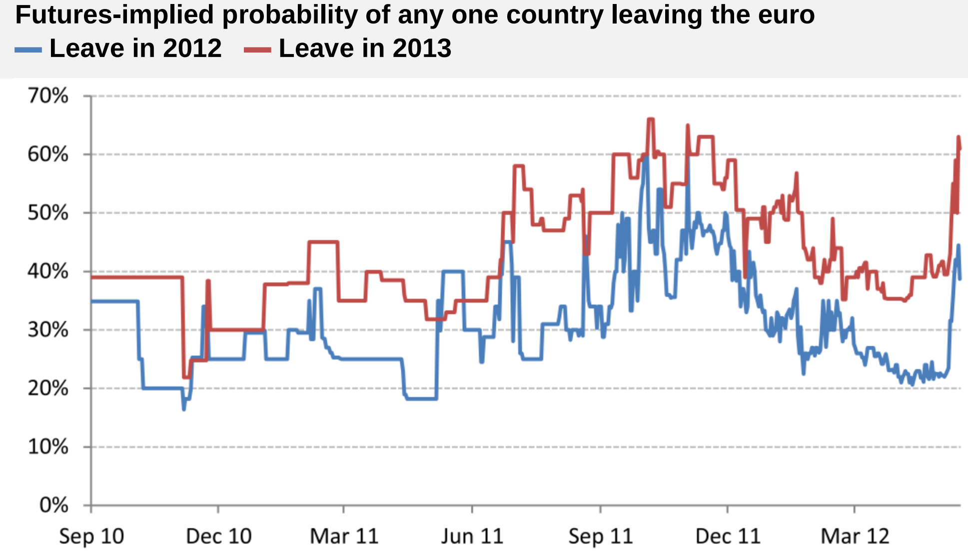
Futures-implied probability of any one country leaving the euro



Source: Intrade, TrendMacro calculations take account of it to some extent, in the form of widening risk premia. But it is our strong view that a Greek exit from the euro is not going to happen soon, or in a chaotic way, or without appropriate countermeasures by Europe's institutions. That is not to say that exit will never happen, but we are still a long way from the point where either Greece or the rest of the euro area need -- or want -- to take that risky step.

- Support for the euro within Greece remains strong, with polls consistently showing support over 65%.
- Even the anti-bailout party Syriza, which finished second in the May 6 election, is in favor of Greece remaining in the euro.
- The rest of the euro area is still -- officially at least -- in favor of Greece remaining a member. Jean Claude Juncker, outgoing president of the Eurogroup (the standing meeting of euro area finance ministers) said last night that "Talk of Greek euro exit is nonsense, propaganda."
- However, there has been an important change in the dynamic of the relationship between Greece and the rest of the euro area. As we pointed out last week (see "Sell in May and Go Away -- Volume 3?" Thursday, May 10, 2012), the main euro area power players, whether they are politicians or central bankers, have taken the extraordinary step of saying out loud the previously unspeakable idea that if Greece does not play by the rules of the euro club, it may have to leave.

So far, this feels to us like mere negotiating tactics from the euro area. The only leverage Greece has left in attempting to renegotiate the agreed bailout package is to threaten to leave the euro, plunging the whole euro area into crisis. By acting as though a Greek euro exit were a thinkable consequence, the euro area is seeking to reduce the power of Greece's threat.

- The euro area's tactic makes sense. It puts pressure on Greek politicians to step back from the edge of the abyss -- no Greek politician wants to be blamed by voters for leaving the popular euro.
- The range of euro area voices that were "on message" this week was impressive -- from central bankers Asmussen (Germany, ECB), Weidman (Germany, Bundesbank), Noyer (France, Banque de France) and Honohan (Ireland, Central Bank of Ireland) to government officials Schaeuble (Germany), Almunia (Spain), Fekter (Austria) and Monti (Italy) -- all saying that if Greece wants to remain part of the euro, it has to abide by the rules of remaining in the euro area.
- They all also reiterated that there is no alternative to the current bailout for Greece. That said, last night Juncker admitted that there could be some small movement on the schedules for Greece's reforms.
- But beyond putting pressure on Greece to stick with the bail-out, the comments by euro area leaders also prepare the market for the once unthinkable possibility of Greece eventually leaving.

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- So if negotiations eventually do come to the point where either Greece or the euro area calls the others bluff, then at least we will have been prepared for it.
- *The key to that preparation is the unanimity of the euro area's voice on the subject. This reassures the market that, just as with its debt default, a Greek euro exit would be one-off, it would be unique. It would not indicate that other countries -- weak ones like Portugal or strong ones like Germany -- would also exit.*

The only certainty at the moment is that nothing is going to happen in Greece until after the next election. This does not mean that there will be three to four weeks of calm for markets. Campaigning politicians make plenty of noise. And with opinion polling banned in Greece in the two weeks leading to an election, investors will be less well informed than usual before an important election.

- Even after the election there will be another messy period of squabbling parties trying to form a coalition government.
- Early polls indicate that Syriza may come out on top in the second election. If they do, they may be able to cobble together a government comprised of various radical parties on the left and the right -- and such a government would not be easy to negotiate with. But Syriza's leader Alexis Tsipras may get blamed for causing the second election, as his party was not seen as willing to negotiate in good faith for a grand coalition government.
- If New Democracy (ND) and PASOK -- the two pro-bailout parties -- can gain the majority they missed by one seat in the last election, Greece will be back on track. Or, at least, as close to back on track as they can be.
- But it's very possible the election will only lead to another fruitless round of negotiations to form a government. Knowing the difficult decisions that need to be taken, perhaps none of the political parties want to run Greece at the moment.

Potentially in an infinite loop of political muddle, we wish there were a Greek expression for "Groundhog Day." But ήδη δει is the ancient Greek equivalent of *déjà vu*. It's pronounced approximately "ee·thee thee." As long as markets are going to flail for another several weeks, once again the victims of this little country with an economy the size of Boston's, you might as well at least learn a fun fact.

Bottom line

Greece will now have to hold another election, in hopes that a government can be formed. The short term good news is that nothing important will happen until after that vote. Longer term, the tail-risk of Greece leaving the euro has increased. Already Europe's institutions are circling the wagons, and conditioning the market to expect that Greek exit won't be a systemic disaster.