Greek election outcome

New Democracy (ND) comes as the first party winning the 50 bonus seats in parliament.

ND negotiates with other parties to form a new coalition government as it is most likely to not have enough votes to form a government on its own.

ND fails to form a new government

ND is successful in forming a coalition government with PASOK and maybe + Independent Greeks or Democratic Left

A

- If this is the case even under an ND victory, the chances of any other party succeeding to form a government would be very slim.
- There is likely to be some attempt at forming a technocratic government or a referendum on Greece's euro area membership. Eventually, Greece may end up leaving the eurozone in an orderly or disorderly form.
- Market is likely to experience weeks of turbulence at least, which eventually could trigger bold actions from the ECB and politicians along the lines of QE, LTROs, capital controls, banking and fiscal union agreements (pan-european level bank recapitalisation, eurobonds/debt redemption fund), in exchange for a loss of sovereignty for countries.
- These bold actions would address Spanish banks recapitalisation issues as well.
- While it is difficult to say exactly how long the market chaos would last, ultimately the policy actions should be the seed for stronger European institutions in the long term, and markets are likely to respond positively at some stage.
- As such, the rally from the trough in risky assets and sell-off in bonds could be substantial in magnitude and last much longer ultimately.

B

- No immediate exit from the eurozone
- Risky assets will likely get a relief rally and bonds should sell off
- However, the magnitude and the length of this market reaction very much depend on how the Spanish banking recapitalisation issue is dealt with as outlined below (this is most likely to be decided in the aftermath of the Greek elections, when the IMF and external audits of Spanish banks are completed, but it can also come before).

Spanish banks are recapitalised via direct contributions to banks by either EFSF/ESM or through a set-up of pan-European level bank recapitalisation.

Spanish banks are recapitalised via contributions to the FROB (Spanish banks recapitalisation entity) in the context of a bank dedicated programme with limited conditionality.

Spanish banks are recapitalised via contributions to the Spanish government from EFSF/ESM under the current frameworks, within the context of a broader adjustment programme

BC1

- This solution is what is favoured by EC and Spain and the ECB (especially the banking union and pan-European level bank recapitalisation fund).
- It would require EFSF framework changes or ESM Treaty changes (or more legal work if done via a pan-European level bank recapitalisation fund), which could be time consuming.
- However, ECB financing could play a bridging role until funds are ready via these entities.
- This decision would largely break the sovereign/bank negative feedback loop.
- More importantly, it will, in essence, provide a step towards a banking union in Europe and can be seen as an important step towards fiscal union.
- This scenario is likely to trigger a big rally in risky assets, a sell-off in bonds, and a big outperformance of Spanish bonds. The length of this market reaction is likely to be measured in months rather than weeks.
- However, the lack of further bold actions, such as agreement on eurobonds/debt redemption fund, ECB QE might bring back concerns about Europe in the medium term.

BC2

- This solution would be a midway solution between BC1 and BC3.
- It would send a weaker signal than in BC1 regarding an intent to break the sovereign/bank negative feedback loop in Europe and a move towards banking and fiscal union in the medium to long term.
- Conditionality would apply to the banks rather than the sovereign, and no IMF financing would be involved. If EFSF is used, the loans would not involve subordination of existing Spanish bond holders because of the bank recap programme itself. But any stigma of a larger programme later on might keep subordination concern still alive.
- This scenario is likely to trigger a rally in risky assets and sell-off in bonds, especially if combined with supportive Greek election outcome (as outlined in this branch of the tree).
- However, the magnitude and the length of this market reaction is likely to be much shorter than with a branch BC1 outcome.
- A lack of further actions such as agreement to eurobonds/debt redemption fund, ECB actions is likely to bring back concerns about Europe relatively soon.

BC3

- In practice, there is little difference between BC2 and BC3 for the banks' recapitalisation itself: the EFSF/ESM as they stand can only channel funds to a sovereign. At the margin, chanelling funds to the FROB as in BC2 (similar to the funds provided to the HFSF in Greece) highlights that the funds are dedicated to banks' recapitalisation, rather than part of a broader programme (BC3).
- But, in practice, the loans would be taken by Spain in both cases (as the HFSF funds were part of the broader Greek package), with the risk of subordination of existing bondholders it raises.
- There would be more "stigma" for Spain if this scenario leads to a full programme (rather than a programme limited to banks), which could imply a notable subordination of existing private Spanish bond holders if it materialised and involved IMF financing (note though, that only about 20% of bonds are now held by foreigners, and any PSI would be self defeating).
- This subordination risk to private bondholders could lead to higher Spanish bond yields, which would also affect Italian yields negatively.
- As such, this scenario is likely to trigger only a brief rally in risky assets and sell-off in bonds (if at all), more due to a positive Greek election outcome than a market-friendly solution to Spanish bank recapitalisation.
- Therefore, there is a good risk that under this scenario, a lack of further actions such as agreement to eurobonds/debt redemption fund, ECB actions is likely to bring back concerns about Europe relatively soon.