TD Economics

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CONFIDENCE VOTE REMOVES IMMEDIATE POLITICAL HURDLE BUT RISKS REMAIN

- Greek Prime Minister George Papandreou has won the parliamentary confidence vote, avoiding snap elections.
- According to Reuters at the time of writing, Papandreou told parliament before the vote that he would go to the Greek president on Saturday to discuss formation of a broader-based government.
- This is an indication that Papandreou could be stepping down and a coalition government would be formed.
- As long as there is stable government, even if it is a coalition government poised to call elections in the near future, there is now a high probability that Greece will receive the €8-billion September tranche from the IMF / EU bail-out. This removes the immediate risk of default.

Key Implications

- Today's passage of the confidence vote and approval of the new €130 billion bail-out program by the Greek Parliament renders a sigh of relief, but this week's political theatrics merely highlighted the fragility of the current environment across Europe. A series of risks and obstacles continue to loom around the implementation of the measures agreed upon by European leaders on October 26th. On Monday, markets will focus once again on these enormous impending tasks. Unfortunately, the Eurogroup / Ecofin meetings scheduled for November 7th and 8th will likely show little progress on that front.
- For instance, it will be very hard to remove from the collective minds of investors comments made by several European authorities regarding the potential exit of Greece from the euro zone. Although realistically there is no forcible way to prevent a member state from leaving if its citizens want to part with the euro zone, the prospect of it being raised by Chancellor Merkel gave it a much more palpable dimension. This could complicate efforts towards achieving a high participation rate on the 50%-haircut debt swap recently agreed. The new long-term Greek bonds into which old Greek debt is going to be swapped may now look less attractive after those break-up comments.
- Furthermore, the Cannes G-20 summit ended without any announcement on non-euro zone support for the European Financial Stability Facility (EFSF). This underlines the difficulties the EFSF will face in attracting large institutional investors to participate in its special purpose vehicles. There was some speculation ahead of the summit that countries with large pools of foreign reserves, namely China and Brazil, would pledge support for the EFSF. No mention of this was present in the final communiqué. This, in combination with the fact that the EFSF had to postpone a €3-billion bond auction this week due to lack of interest during the pre-pricing of the bonds reinforces a concern we have raised in the past with regards to the structure of the EFSF. Given that investors are intensively scrutinizing Italy's debt dynamics and showing more reluctance towards

Italian debt purchases, it will become increasingly difficult to elicit demand for EFSF debt. Italy accounts for roughly a fifth of EFSF guarantees. If the country were to be in need of financial assistance and have to “step out” of the EFSF as a guarantor, the entire EFSF scheme could be overwhelmed.

- With total Italian debt standing at €1.9 trillion and roll over requirements of roughly €560 billion over the next two years, Italy is too big not only for the EFSF, but potentially even for the IMF. Furthermore, Italy has a debt-to-GDP ratio of 120%, projected nominal growth of 3.4% and a primary fiscal balance barely in positive territory. The longer yields on Italian debt hover at 6%, the more Italian sovereign solvency will be called into question by market participants. It is for this reason that Italy must show a strong commitment to fiscal discipline (i.e. to raise its primary surplus) and for structural reform (i.e. to boost their economic growth). Until markets see solid evidence of progress in that direction, Italy will remain under pressure, and so will be the euro zone as a whole.

- Against this backdrop, the inability of G-20 leaders to announce concrete steps to increase IMF funding will weigh heavily on markets in the weeks to come. Their statement only went as far as to note that G-20 leaders “stand ready to ensure additional resources could be mobilised in a timely manner and ask our finance ministers by their next meeting to work on deploying a range of various options including bilateral contributions to the IMF, SDRs, and voluntary contributions to an IMF special structure such as an administered account.” But, as we have witnessed over the last two years, translating words into action is never an easy task.

- Since the onset of the crisis we have argued that Greece is insolvent and that fiscal tightening, through its negative impact on economic growth, would prove self-defeating. Today’s confidence vote does not change that conclusion. Thus, it is of outmost importance to manage an orderly Greek default – most likely through a series of debt swaps. Failure to do so could drag Italy into the fray and both the European and multinational financial infrastructure are ill equipped to deal with that event. If we were to get to that point, it would be up to the ECB to play “lender of last resort”. As much as Mr. Draghi and the rest of the ECB board might resist that idea, the alternative would be far more indigestible. But, make no mistake, in the end, the definitive cure will only come from sound fiscal policy and stronger economic growth, the other alternatives, however successful they might be, are bound to be temporary fixes.

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