Euro(zone) in light of the ECB's quantitative easing and the Greek election

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Introduction

The topic that resonated the most in the first month of this year both in economic and EU circles was the current and future development of the euro exchange rate. During January, the euro sank to its lowest level in 11 years against the dollar and also prompted debate about to what extent the euro project could survive in the current makeup of the Eurozone, which gained its 19th member as of 1 January 2015.

What was the cause? There were clearly **two key factors**, which we will focus on below:

- The European Central Bank's notification of the **start of quantitative easing** on 22 January;
- The early parliamentary elections in Greece, which were held on 25 January and were won overwhelmingly by the SYRIZA radical left coalition.

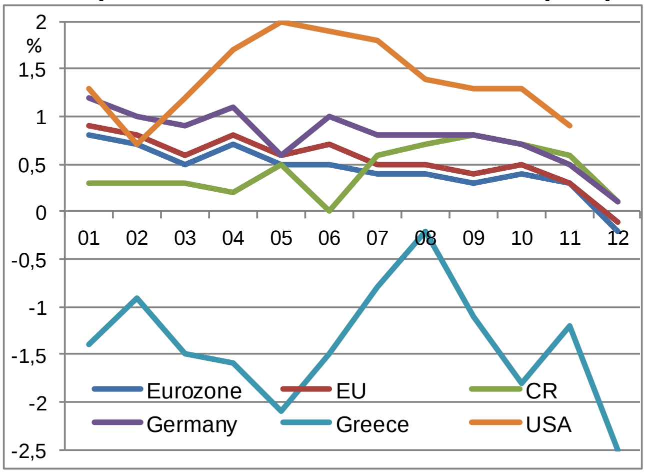
European Central Bank carries out QE

On 22 January 2015, the European Central Bank decided to expand its programme involving purchasing of assets and bonds issued by governments and agencies in the Eurozone and European institutions. The purchases of these assets are expected to reach EUR 60 billion per month. In view of the intention to carry out these purchases from March 2015 until the end of September 2016, 1.08 trillion euros is involved.

The aim is to correct the development of inflation, which is currently reaching deflation values in the Eurozone. The European Central Bank's long-term objective is to maintain the inflation level over the mid term at below 2%, but near that level.

In December 2014, according to available data from Eurostat, the year-to-year inflation level in the Eurozone, measured by the Harmonised Index of Consumer Prices, reached 0.2% (in the previous month of the same year it was 0.3%, which was 0.5 pp higher), and in the EU the inflation level reached -0.1%. Deflation occurred in more than half of the EU member states. The worst off state in the Eurozone is Greece, where the inflation level reached -2.5% in December. This decline is reflected mainly in the decrease in the pace of energy price growth and to a lesser extent in the decline of year-to-year changes in food prices.

Development of the inflation rate in 2014 (in %)



Source: Eurostat

In the months to come, a very low or even negative inflation level can continue to be expected (in part due to the recent oil price declines). However, thanks to the EBC's adopted monetary policy measures, the anticipated increase in demand and the anticipated gradual increase in the price of oil, the inflation level in 2015 and 2016 could begin rising gradually.

It is apparent from the ECB's declaration that in March 2015, the Eurosystem will begin purchasing investment securities on the secondary market in euros issued by governments and agencies in the Eurozone and European Institutions. The purchase of securities in the Eurozone will be based on the shares of national central banks in the key for subscription of ECB registered capital. For countries falling under the EU/IMF recovery programme, certain additional eligibility criteria will apply.

The expanded programme of purchases of assets by the ECB will be complemented by the already ongoing programme involving the purchase of bonds secured by assets (ABS) and covered bonds. The bought assets must fulfil these conditions:

- They must be issued by an entity established in the Eurozone and from the group: central governments, certain agencies or international or supranational institutions located in the Eurozone.
- Their issuer or guarantor must have a rating falling into the investment zone and corresponding at least to an ECB evaluation in the grade CQS3 (equivalent BBB-/Baa3).
- Under certain conditions, it will also be possible to purchase bonds that have a lower rating, but their eligibility will be suspended if an evaluation is carried out of the particular state during provision of a rescue programme to that state, and it will be cancelled if the result of the evaluation is not positive.

- Purchased bonds within the new programme that do not fall either in the ABS category or in the program for purchasing covered bonds will have maturity between two and thirty years.

More details regarding (among else) the technical annexe of the ECB can be found at www.investicniweb.cz.

In the case of purchases of assets themselves,t he Board of Governors of the ECB shall retain control over all parameters of the programme, and the ECB will coordinate those purchases.

This will ensure the single nature of the Eurosystem monetary policy. For the purpose of mobilising its resources, the Eurosystem will carry out this activity in a decentralised manner.

The Board of Governors has decided that in the event of division of hypothetical losses, purchases of securities of European institutions (which will represent 12% of additional purchases of assets and will be carried out by national central banks) will be subject to division of losses.

The remainder of the additional purchases of assets by national central banks will not be subject to division of losses. The ECB will retain 8% of the additionally purchased assets. This means that 20% of additionally purchased assets will be subject to division of risks.

The ECB shall ensure price stability by aiming to get inflation below 2% over the mid term. One of the ECB's tools for doing this will be its setting of interest rate amounts. If the Central Bank wants to act against excessively high inflation, it usually increases interest rates, which increases the cost of borrowing money and makes saving more interesting.

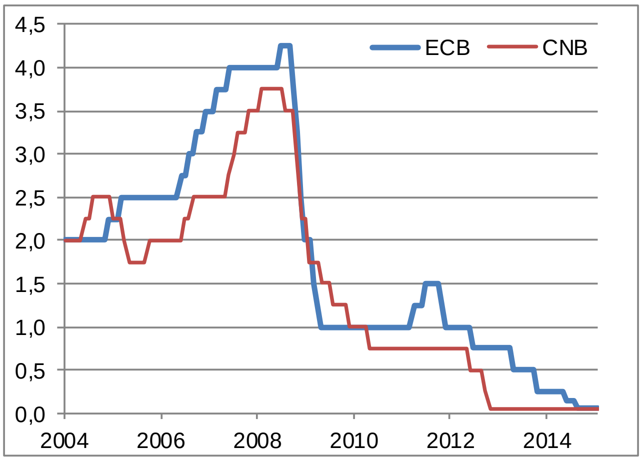
However, if it wants to combat too low inflation, it reduces interest rates. Since already last September the Bank reduced all three basic interest rates by 10 basic points to historic minimums:

- the basic interest rate for main refinancing operations was reduced to 0.05%;
- the interest rate for the marginal lending facility intended for one-day loans to banks to 0.30%;
- the interest rate for the deposit facility even to 0.20%.

It does not have many other ways of intervening against the pressure of deflation other than through quantitative easing.

Besides the notification of the expansion of the asset buying programme, at its meeting held on 22 January the ECB also decided to leave interest rates unchanged.

Development of the key interest rate of the ECB and the CNB



Source: ECB, CNB

From the point of view of further development of measures, the ECB shall in a decisive manner support anchoring of mid-term to long-term inflation expectations. The conditions for financing businesses and households in the Eurozone will continue to improve.

These factors should jointly increase demand, increase the use of capacities and support growth of monetary reserves and the volume of loans, which will contribute to the return of the inflation level to positive values.

This recovery should also have a positive influence on improving exports. However, a certain brake on the Eurozone will be the continued high unemployment level, which in some states even exceeds 25%.

However, the situation on the labour market is expected to improve gradually.

Greek legislative election

Genesis of the Greek political crisis

The political crisis in Greece, which eventually culminated in early elections, began already last December. At the beginning of last December, the then prime minister from New Democracy, Antonis Samaras, announced that the government's candidate for president would be a former deputy chairman of his party and a former Euro Commissioner (for environment), Stavros Dimas.

The opposition under the leadership of Syriza did not present any candidate. The cabinet also hurried with the announcement of new elections, which were held already on 17 December 2014, even though the current head of state, Karolos Papulias, has a mandate until this March.

Although the representatives of the Commission welcomed the nomination of the renowned and well known face, political commentators and investors already saw the signs of the approaching political crisis, which was apparent from the deep decline of the Greek stock market. (Following the announcement of the candidate's name, Greek stocks fell to their lowest level in nearly 30 years.)

The Greek Constitution stipulates that if the president is not successfully elected, the parliament must be dissolved, and early elections must take place. Since the governing coalition of conservatives from New Democracy and socialists from PASOK held only 155 of the 300 parliamentary seats, and a qualified majority of 200 and 180 votes respectively is needed to elect a president, there were legitimate concerns about the failure of the vote. That was eventually confirmed, and the president was not elected even in three rounds – see table.

Greek presidential elections – December 2014

Round	Date	Needed votes	Received votes
1.	17. 12. 2014	200	160
2.	23. 12. 2014	200	168
3.	29. 12. 2014	180	168

Source: ČTK

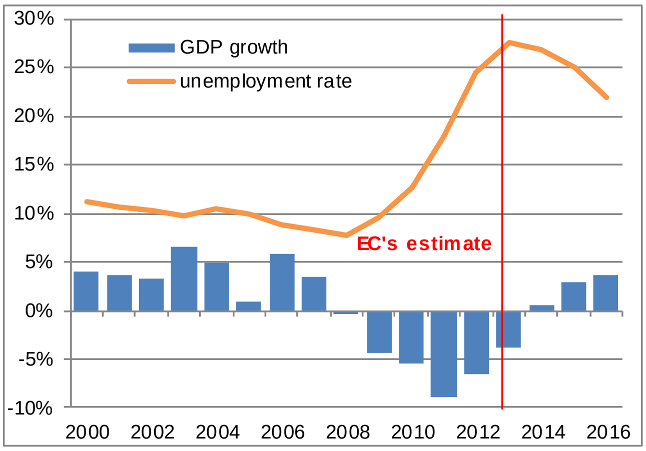
Former prime minister Antonis Samaras was not as lucky this time. The Greek parliament was dissolved as a result of the unsuccessful elections, and the government scheduled the early elections for 25 January 2015. Samaras' pro-reform government went into history one year and a half sooner than had been expected. (The regular parliamentary elections were not supposed to take place until mid 2016.)

Results of Greek parliamentary elections

Pre-election public opinion surveys already indicated that the era of Antonis Samaras at the top of the Greek political pyramid was ending. The radical left coalition Syriza emerged as the clear favourite, led by charismatic politician Alexis Tsipras, and it was only a matter of time until Syriza won enough support to be able to set up a government. When just before the holding of the elections Tsipras called on his voters to give him enough votes to be able to govern without a coalition partner, it seemed like a sci-fi scenario.

However, in the end it was not far from reality. The poisonous cocktail of the lengthy six-year recession, record unemployment and increasingly weak light at the end of the tunnel (from the point of view of independent analysts) led Greek voters to reject resoundingly the policies of austerity and painful reforms. Syriza won more than 36% of the votes, which led to 149 mandates in the 300-member Greek parliament. The Party of Independent Greeks, with 13 lawmakers (4.75%) rushed to form a majority government, and that party and Syriza have a common demand, which is that public debts be written off. The new coalition will have a majority of votes in parliament (162 votes).

Economic growth and the unemployment in Greece



Source: Eurostat, European Commission

For the first time since the demise of the military junta in 1974, a party other than New Democracy and PASOK, which have been taking turns ruling since then, has come to power. New Democracy took a devastating blow, finishing in second place with 27.8% and 76 mandates (compared to 129 legislators previously), which is a failure. Its former coalition partner PASOK did even worse, winning only 4.68% (13 lawmakers) and just barely exceeding the 3% minimum needed to enter parliament. The radical, even Fascist-leaning, Golden Dawn party came a distant third, followed closely by the new River (Potami) party and the Communists.

Results of the Greek elections from 25th January 2015

	Share of votes	Number of seats
SYRIZA	36.34	149
New Democracy	27.81	76
Golden Dawn	6.28	17
To Potami	6.05	17
Communist Party of Greece	5.47	15
Independent Greeks	4.75	13
Panhellenic Socialist Movement-Democratic Alignment	4.68	13

Source: Greek Interior Ministry

Reactions to election results

The direct reaction to the elections on the financial markets was very negative. The exchange rate of the euro declined further and Greek state bonds along with stocks weakened, led by banking stocks. However, during the day the situation improved, and the euro eliminated all of its initial losses against the dollar.

The concerns were mainly prompted by Syriza's economic programme – see box. In its first place is the agenda, which Syriza (one of few) has in common with its coalition partner, the Independent Greeks: revision of the rescue programme for the purpose of evaluating approved savings and reforms, an agreement with international creditors under the leadership of the Group of Three (the European Commission, the ECB and the IMF) to achieve further writing off of Greek public debt.

Main points of Syriza's economic programme

- Achieving writing off of a large share of public debt, so that it becomes sustainable, like when debt was written off in Germany in 1953; pay off remaining debt instalments through "growth";
- Creation of a European New Deal project, which would be financed by the EIB;
- Free electricity to 300,000 households living below the poverty line;
- Food subsidies for 300,000 families without include and subsidies for housing and rent;
- Reintroduction of the 13th pensions of 1.2 million retirees;
- Reduction of consumer debt for heating and diesel fuel;
- Cancellation of the flat real estate tax rate and introduction of taxes for larger real estate;
- Cancellation of income taxes on income up to EUR 12,000 annually and introduction of progressive tax policy;
- Debt relief for debtors through debt restructuring;
- Raising the minimum monthly salary to EUR 751;
- Implementing work measures to protect employees and make it more difficult to lay off employees;
- Increasing the transparency, economic autonomy and effective management of regional state institutions;
- Increasing civic participation and direct democracy;
- Regulation of the television and radio environment and reintroduction of state television and radio.

Source: Presentation of Syriza's government programme by Alexis Tsipras at a conference in Solun on 15th September 2014

EU leaders' reaction has been rather negative. This sentiment was expressed clearly by a member of the ECB's executive committee, Benoit Coeuré, who said that the ECB would not get involved in any writing off of Greek debt. Another warning was sent to Athens by German Bundesbank chief Jens Weidmann, who reminded the new leaders in Greece of their obligation to honour their agreements with international creditors. However, Europe also showed Greece a friendly face.

Jeroen Dijsselbloem, chairman of the group of Eurozone finance ministers, cited the need for Greece to fulfil existing agreements, but he also left room for a potential compromise with his statement about future discussions regarding the "sustainability of Greek debt". The most understanding for Alex Tsipras' plans has been expressed by left-wing (often) opposition parties in Europe, who have cited what they consider the ineffectiveness of austerity measures pushed through so far in Greece. Those measures have been pushed by European political heavyweight Germany, which thanks to its position as the largest European economy and the largest "sponsor" of EU rescue mechanisms will probably have the main say.

However, instead of official press releases, Berlin's position has been hinted at more by information leaked to the media. At the beginning of January, that information revealed that Germany would no longer defend Greece at any price if it had to leave the Eurozone. That reportedly would happen if after the elections Greece abandon austerity policies and stopped repaying its debt. German Chancellor Merkel and Finance Minister Schäuble reportedly believe that it would now be acceptable for Greece to leave the Eurozone, since in recent years the EU and the Eurozone have taken systematic measures that would minimise the impacts of a departure from the Eurozone by Greece. Greek officials themselves do not question the principle of debt repayment, but they want to link it to the country's ability to grow and to repay its debts thanks to a growing economy. Finance Minister Janis Varufakis has already presented a plan for exchanging current Greek state bonds for two new types:

- **Bonds linked to economic growth** would replace debt held by Eurozone states and the EFSF;
- **Material bonds** (perpetuity, with the issuer paying endless interest, but not principal), would be replaced by bonds owned by the ECB.

Now it will be key whether this – or a similar – scenario of restructuring of debt burden (without leading to writing off of the nominal value of debts) will receive support from key EMU states. The first sign is positive; French Finance Minister Michel Sapin, after meeting with his Greek counterpart, stated publicly that "repayment of current Greek debt must be bound to the country's ability to renew growth."

The Greeks also refuse to negotiate further with the group of three inspectors representing international creditors, the EU, the ECB and the IMF, and they are not interested in extending the existing rescue programme, which will expire at the end of February 2015. According to the Greek government, it should be followed by a four-month bridging loan lasting until June 2015, in which the ECB would be significantly involved. A concession would be a pledge to maintain a primary public budget surplus (after clearing away the effects of debt repayment instalments) of between 1 and 1.5% of GDP, even though that would mean that Syriza would not fully be able to implement its election programme.

Future developments in Greece and the Eurozone

It would not be right to agree with the claim that Europe is better prepared for the departure of the weakest link in the Eurozone. Since May 2010, when Greece accepted the first aid package, the EU has built up necessary mechanisms and instruments. The key ones include:

- **the European Stabilisation Mechanism (ESM)** – a permanent rescue fund with injection power of EUR 500 billion, from which aid for Eurozone member states is financed.
- **the Banking Union** – a project to unite the European banking sector, including a joint supervisory mechanism and a joint resolution mechanism, which would make it possible to finance the financial restructuring of problematic banks.
- **the programme for purchases of government bonds by the European Central Bank (Outright Monetary Transactions, OTM)** – the aim is to purchase state bonds from the Eurozone on secondary markets in order to reduce their yields to more acceptable levels.

Rescue packages for Greece

	1st package (First Economic Adjustment Programme for Greece)	**2nd package** (Second Economic Adjustment Programme for Greece)
Approval by the Euro group[1)]	2nd May 2010	14th March 2012
Provided for the period	V/2010 až VI/2013	III/2012 až XII/2014[2)]
Volume in billions of euros	73,0[3)]	164,5[4)]
of that the Eurozone	*52.9 (Greek Loan Facility – bilateral loans between EMU states and Greece)*	*144.7 (European Financial Stability Facility)*
of that the IMF	*20,1*	*19,8*

Source: European Commission (DG Ecfin), 1) comprised of finance ministers from Eurozone member states, 2) rescue programme extended until II/2015, 3) the original volume was set at EUR 110 billion (EUR 80 billion in bilateral loans of Eurozone states + EUR 30 billion from the IMF), but only EUR 73 billion was drawn, and the remainder was transferred to the 2nd rescue package, 4) consists of undrawn amounts in the first rescue package (reduced by EUR 2.7 billion for the non-participation of Slovakia, Portugal and Greece) and an additional EUR 130 billion.

Nonetheless, a potential exit from the Eurozone by Greece would cause major turbulence on financial markets, negative effects on the real economy and concerns about the potential departure of other Eurozone members. Whether this scenario will eventually play out or will remain the subject of speculation will depend on whether the new Greek government headed by Syriza leader Alexis Tsipras and key politicians from the EU led by Angela Merkel manage to reach a deal. Syriza's programme so far and the terms of the agreements connected with the financial rescue of Greece and its remaining in the Eurozone are mutually incompatible, after all. Therefore, it cannot be ruled out at all that Greece may exit the Eurozone, even though Syriza and most Greeks want to keep the euro as their currency.

Potential scenarios in Greece and the Eurozone

Under the condition that Greece does not soon experience a new political crisis and new early elections:

a) Real politics and pragmatism will win (30%)

This scenario anticipates that Tsipras and his coalition partner Panos Kammenos from the Independent Greeks party will recognise that the fulfilment of all of their pre-election promises is not a realistic expectation and that the rest of Europe will not be willing to forgive more Greek debt. Most of Samaras' government's reform steps will continue to be followed. Some steps increasing fiscal spending will be made up for by increased tax collection thanks to more intensive combatting of tax evasion and corruption.

The nominal value of the debt will not change, but the EU will accept further restructuring of Greek debt (linking repayment to growth, extending the periods until debt maturity, reducing interest, etc.). Greece will continue to report primary state budget surpluses, and public debt will gradually begin to be reduced to more sustainable levels. Investors' confidence, disrupted by the commotion surrounding the early elections, will return, the economy will embark on a path of cautious economic growth, and unemployment will begin to decrease. **Best** possible scenario for Europe.

b) The EU will make concessions, due to concerns about a "European Lehman Brothers" (25%)

Syriza, under the influence of more radical legislators, over whom Prime Minister Tsipras will not have influence, will eventually give in and will insist on not conditioning the election programme on the completion of the austerity measures, which Tsipras has described as "fiscal waterboarding". European politicians, headed by Merkel, will offer Greece another rescue package with order number 3.

It will include additional writing off of public debt held by banks (Private Sector Involvement, PSI) and will shatter taboos and lead to a "haircut" of debts held by public institutions as well (Official Sector Involvement, OSI), especially Eurozone states through bilateral loans and the European Financial Stability Facility (EFSF).

Besides writing off of debt, the Greek government will also negotiate concessions in the approved austerity programme. Prime Minister Tsipras will win, but at the price of a dangerous precedent. Similar concessions and writing off of debt will also be demanded by other states (such as Portugal, Spain and Cyprus) and by their politicians. This will be true of both the current political leaders and the new ones who win in future parliamentary elections. The first of them will be the Spanish Podemos movement, which will take power after the elections held last December. **Worst** possible scenario for Europe.

c) Prepare the rotators for the new Greek drachma (45%)

Following the initial rounds of bilateral negotiations between Greece's new leaders and EU and Eurozone officials, no agreement is reached, due to opposing points of view. Such situation will either emerge by the end of February, when the extended period for revision of the rescue programme expires, or several months later.

Although primary law does not define the legal mechanisms for a country's exit from the Eurozone, in view of the critical circumstances a quick solution will be found, which will be that the founding agreements will not be revised. In view of the above, an agreement between both sides must be reached. Unilateral steps can be ruled out. A potential compromise could take the form of radical forgiveness of debt in exchange for the country's exit from the Eurozone.

The euro is proving to be too strong of a currency for the Greek economy, and the reintroduced drachma will weaken against the euro initially by nearly half and enable the country's inhabitants, who are against further austerity, to get a breath of fresh air. The failing Greek banks will be propped up by the Bank of Greece in cooperation with the ECB, and for a few years the free movement of capital and money across borders will be limited for Greece. In order to prevent a chain reaction resulting in the departure of additional countries from the Eurozone, the ECB will begin intervening on bond markets and issue a clear pledge to rescue the other vulnerable economies of the Eurozone and their banks.

For Europe from a short-term point of view, this would be the **most painful** scenario, but from a long-term point of view it could be beneficial for all sides.