

Economics

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Global Economics Flash

'Grexit' Back In The Spotlight

- In light of the election results in Greece, we have raised our subjective likelihood of Greek euro area exit ('Grexit') to 50-75% over the next 18 months, from 50% before (see [Hollande Takes Over](#); ["Grexit" More Likely](#) and [Rising Risks of Greek Euro Area Exit](#)).
- Many of our related views remain unchanged. In particular, we continue to believe that the costs to Greece of euro area exit would be large and much outweigh the (likely temporary) boost to export competitiveness that would result from a sharp depreciation of a new Greek currency, the New Drachma, say, relative to the euro. The costs include the financial turmoil that would result in Greece from euro area exit, the inefficiencies and hardship that result from a drastic terms of trade shock (should a sharp depreciation of the New Drachma have a persistent negative effect on the relative price of Greek exports and imports), the procedural (legal and administrative) costs of contract redenomination, and the adverse repercussions of euro area exit for policy stability and predictability. Downside risks for governance are high, including the risk that the Greek economy and Greek society descend into an environment of persistent economic depression, political instability and social unrest with potential hyperinflation.
- In the near-term, political uncertainty in Greece is high. After New Democracy leader Samaras and Syriza leader Tsipras, Evangelos Venizelos, the leader of PASOK, has three days from today (10 May 2012) to try to form a coalition. If he fails, as seems likely, new elections will potentially be held on 17 June. We would not rule out that after the next election, a coalition can still be formed that notionally commits to the targets of the troika programme, or that these programme targets may be amended mildly to allow a near-term agreement between a new Greek government and the troika.
- But in our view, it is unlikely that even then Greece will build enough reform momentum to consistently meet fiscal and structural reform targets over the years to come.
- The rest of the euro area would then face **three** options: the **first** option is to continue to fund the Greek sovereign despite continued slippage in the fiscal and structural reform targets. The **second** option is to refuse to offer Greece significant concessions relative to already-agreed programme targets and for the Greek sovereign to exit the euro area, but for sufficiently decisive policy measures to be taken to 'ring-fence' other euro area countries potentially under attack by markets. The **third** would be for Greece to exit the euro area, but for exit fear contagion to be uncontained and therefore to result in euro area break-up through the exit of, at least, the other periphery countries.
- In our view, the second option is the most likely, with Greece ultimately exiting the euro area, but for full euro area break-up to be prevented by policy intervention by the ECB and the remaining euro area governments.

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- Given the complexities of euro area decision making and the myriad of political, legal and sometimes cultural constraints, we cannot assume with certainty that the choice between these three options will be wholly rational. But it is likely that the choice will ultimately be guided by the costs and benefits of Greek exit or of euro area break-up to the parties taking the decision.
- Direct costs to the rest of the euro area or the world at large of Grexit are low. Trade exposure to Greece is relatively low apart from its immediate neighbours and foreign private financial exposures to Greece have been much reduced, while the exposure of the official sector (other euro area governments, the ECB and the IMF) has risen.
- The indirect costs of Grexit for the rest of the world could be much larger and depend on the policy response, in particular by the ECB, but also by other euro area governments and the IMF. Absent an appropriate policy response, exit fear contagion following Grexit leading to investor flight from other fiscally, financially and/or competitively weak EA countries, including Portugal, Ireland, Spain and Italy, could lead to a major systemic financial crisis in the euro area and beyond, the default of a number of systemically important financial institutions and sovereigns, and even euro area break-up.
- There are also costs of keeping Greece in the euro area. The direct financial cost should not be underestimated in an environment of tight budgets everywhere, and to these financial costs, political costs have to be added, owing to rising euro-scepticism, growing nationalism and xenophobia, and bail-out sfatigue. But there are also the implications for the incentives of other EA debtor countries, or more broadly for the current crisis mitigation regime that puts austerity and structural reform conditionality as the central quid pro quo for funding support. Letting Greece off lightly would not set a good example for the others to continue to reform.
- The balance of the costs and benefits of the first two options suggests to us that Greek exit is more likely than continued troika funding despite reform slippage. In our view, the wide majority of the political leadership of the euro area would rather have a merely notionally compliant Greece in than out, so it would be more of a case of Greece walking than of Greece being pushed out. In our view it is unlikely that Greece could reject the troika Memorandum of Understanding (not just the current MoU, but any modification of it which would be acceptable to the troika) and still remain in the euro area. In that case, Greece would forgo funding not only by the EFSF and IMF, but also funding of Greek banks by the Eurosystem (including emergency liquidity assistance granted by the Greek Central Bank, but subject to ECB approval), precipitating exit.
- Between the second and third option, we consider a wider break-up of the euro area to remain unlikely. This is because we expect the policy response to Grexit by the ECB and the remaining euro area governments to be sufficiently decisive to contain exit fear contagion. This is primarily because the costs of a wider euro area break-up would be very large (see [What Happens if the Euro Collapses?](#), 8 December 2011). The immediate costs would be the result of a very high degree of trade and financial integration among the euro area periphery nations and between them and the core euro area nations, which would likely partly be unwound in the event of break-up. But longer-term strategic implications also play a large role for the euro area countries. A break-up of the Euro area would likely diminish the potential for further integration of the European Union. The constituent countries of the euro area have little hope, as both populations and living standards in the emerging world rise while Europe stagnates, to have a say as nation states on the world stage.

- But two other factors also play a role in favouring the second over the third option. First, the other programme countries, Ireland and Portugal, continue to show both willingness to reform and some progress, while Italy and, in particular Spain, have also embarked on a reform course. The willingness to reform in countries needing external support will make it much easier for creditor countries to offer that support. The second is the *ability* of policymakers to intervene to contain exit fear contagion. We again note that the overwhelming majority of euro area financial liabilities is euro-denominated and that the ECB therefore has potentially infinite capacity to address non-fundamental contagion, if it so chooses. In practice, substantial SMP intervention plus another round of extraordinary funding operations may well be enough in response to Grexit to buy some time for other measures to be taken, possibly including European deposit guarantees, a Euro-TARP, giving the ESM a banking licence or charting a way to a more closely integrated fiscal union.
- After New Democracy leader Samaras and Syriza leader Tsipras, Evangelos Venizelos, the leader of PASOK has three days from today (10 May 2012) to try to form a coalition. If he fails, as seems likely, new elections will potentially be held on 17 June and recent polls indicate that the extremist parties continue to gain in popularity at the expense of PASOK and New Democracy.¹ Given the sharp decline in public support for the mainstream Greek political parties and rise in support for anti-austerity parties evident in the recent elections, a pro-MoU government, if one could eventually be formed, would likely suffer from a lack of political legitimacy and could be subject to early collapse under the continuing weight of approving unpopular austerity measures. Although a short-term political compromise may yet emerge that would provide Greece with a functioning government, we have doubts about a new coalition's ability to govern for any length of time, as the political centre in Greece has substantially eroded over the past year and anti-establishment sentiment appears to be continuing to grow in the aftermath of the elections. Should an anti-austerity party (most likely the leftist Syriza party) or a coalition built around opposition to the bailout conditions be formed quickly, Grexit could happen as early as late June or early July.
- The process of exiting would likely be messy for Greece. At a minimum, a currency law would need to be implemented, redenominating domestic-law contracts from euros into New Drachma, and capital controls would need to be imposed. Given the dysfunctionality of part of the Greek bureaucracy and the domestic upheaval that is likely to be part of an exit scenario, it would be a surprise if implementing these two measures would go smoothly. In time, payment and other IT systems would need to be reconfigured and currency reintroduced (though presumably in countries with a large shadow economy and poor tax compliance, the case for abolishing currency and relying on electronic payments only is strong). Exit would very much be a sovereign decision by Greece, even if it would likely be precipitated by being refused further access to troika (EFSF, IMF and ECB) funding. Exit could be announced suddenly, but many elements of the exit process, including continued Greek EU participation post-Grexit would need to be negotiated, many of them after Grexit had taken place. It is likely, in our view, that Greece would continue to receive some funding from European governments, even though the political calculus might dictate that these funds be provided once hardship becomes evident post-exit, rather than to smooth the transition.

¹ See e.g. <http://online.wsj.com/article/BT-CO-20120509-717172.html>

- In the meantime, one mildly redeeming factor is that the immediate liquidity pressures are likely to be less pressing than might be presumed. The IMF forecast Greece's primary deficit in Q2 to be a tiny €0.5bn, but even if that turns out to be an underestimate (which we expect), the deficit is unlikely to be large. A further build-up of arrears is also likely. And while the troika is likely to hold back at least part of the €31.3bn that was due to be paid out in Q2, it is unlikely stop disbursements to Greece at this stage. Indeed the Financial Times reported today that the 'eurozone's stability fund' (presumably the EFSF) has agreed to disburse €4.2bn of a planned payment of €5.2bn on Thursday under Greece's bailout programme.² The overall deficit is much larger, with the remainder accounted for by the interest payments on the outstanding Greek government debt. There remains the issue that Greece has recently passed a law that prioritises debt service over other government expenditures, but we suspect that passing this law would be a mere footnote in a Grexit scenario.
- Irrespective of whether Greece leaves the euro area or not, we expect further restructuring of Greek sovereign debt including sharp NPV haircuts that apply this time not only to private creditors, but also the official ones (EA creditor countries, the ECB and the EFSF, but likely excepting the IMF).

² <http://www.ft.com/cms/s/0/8c11e28c-99d5-11e1-8fce-00144feabdc0.html#axzz1uRs4VkJ>

Appendix A-1

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