Europe's Risky Moment

The ugly consequences of a Greek exit.

BY DESMOND LACHMAN

Judging by the strong Greek political backlash against budget austerity, European policymakers will soon be faced with a fundamental policy choice. Do they again make Herculean efforts to keep Greece within the euro? Or do they allow Greece to be cut loose and focus their efforts instead on ring-fencing the rest of the European economic periphery from any Greek contagion? How European policymakers answer this basic question will be critical not only for Greece's economic future but also for that of the eurozone as a whole.

After six years of economic recession, which has seen Greece's real GDP reduced by a quarter and its unemployment rate rise to over 25 percent, the Greek public appears to be at the end of its tether with economic policies imposed by the troika of the International Monetary Fund, the European Union, and the European Central Bank, which negotiate in concert the external assistance that they offer to Greece. This was to be seen not only in the recent electoral victory of the far-left Syriza Party, which has promised to tear up Greece's economic memorandum with the troika. It was also seen over the past six months in the reluctance of Antonis Samaras' New Democracy party to carry out the troika's dictates. That reluctance has prevented Greece from completing its long-delayed IMF review.

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Greece's anti-establishment Syriza party celebrates its landslide victory in the January 2015 elections.

The recent political turmoil that forced Greece to hold snap elections on January 25 is bound to exert a heavy toll on both domestic and international confidence in the Greek economy. It has resulted in the formation of a weak coalition government vehemently opposed to austerity and without a mandate for economic discipline and structural economic reform. This must be expected to extinguish any hope that the Greek economy might finally have turned the corner on its way to a meaningful economic recovery in 2015. As a consequence, it is also likely to have damaged Greece's already fragile public finances, which will require more budget adjustment measures from a country that has reached the limits of what it can socially bear.

Greece's already battered economy can ill afford a prolonged period of weak coalition government without the back-stop of a troika financial support program.

No longer will eurozone depositors feel secure that their deposits were fully backstopped by the ECB.

While Greece might now have a primary budget surplus, it has substantial official debt amortization payments to make in 2015 on its sovereign debt that now totals a staggering 175 percent of GDP.

Greece is also very vulnerable to a run on its bank deposits. This would especially appear to be the case in light of the Greek depositors' familiarity with Cyprus's 2013 experience, where that country's official international lenders insisted on a large write-down of bank deposits in return for their financial support. In the event of a bank run, and without a troika financial support program in place, Greek banks would not be in a position to access the ECB's rediscount window for want of good quality collateral. In this context, it has to be of concern that

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Greece has already experienced a large deposit outflow in the run-up to its elections.

European optimists argue that any spillover now from a Greek euro exit to the rest of the eurozone would be limited. They mainly base their view on the notion that the rest of the European economy is now staging an economic recovery and that Greece's situation today is very different from what it was some two years ago at the height of the euro crisis. Following a massive debt restructuring in which Greece's privately owned sovereign debt was written down by 75 percent in 2012, Greece no longer has a particularly high level of privately owned sovereign debt. As such, being a small economy without strong linkages to the European financial system, it is argued that European policymakers

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can now afford to let Greece be cut loose without fear of precipitating a European banking crisis.

It is also argued that facilitating a Greek exit from the euro now might be beneficial for the eurozone as a whole in that it might send a salutary message to the political class in the rest of the European periphery. On seeing Greece's economic and financial chaos, which will almost surely follow its euro exit as its citizens run on its banks, it is thought that the political class in France, Italy, Portugal, and Spain will see the folly of not playing by the eurozone's rules of budget austerity and structural economic reform.

Tempting as these arguments might be, one must hope that European policymakers weigh the very real risks to the eurozone that might result from a hasty Greek exit. Among the more important of those risks is that any run on the Greek banks and further collapse of the Greek economy might send a very graphic message to depositors in the rest of the eurozone's periphery as to what can happen to their deposits. No longer will eurozone depositors believe that euro membership is irrevocable. Nor will they feel secure that their deposits were fully backstopped by the ECB. This might produce real contagion from Greece to countries such as Italy, Portugal, and Spain as depositors in those countries rush to withdraw their bank deposits while the going is still good and before their already shaky economies weaken any further.

There also has to be the real risk that a Greek exit might fan the political forces in the eurozone's core countries opposed to bailing out countries in the European periphery. A financial and economic collapse in Greece will almost certainly cause Greece to default on its very large official debt from the ECB, the IMF, and the European Union. As a result, no longer will European policymakers be able to maintain the fiction with their taxpayers that there was little risk in lending money to the European periphery. This might make future European bailouts all the more difficult.

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The Greek public appears to be at the end of its tether.

A fundamental miscalculation that European policymakers might also be making in allowing Greece to be cut loose relates to the strength of the financial safety nets that they have put in place to protect the rest of the European periphery. To be sure, the eurozone now does have a well-funded European Stability Mechanism and an ECB that is committed to buying as many bonds as needed to keep member countries' interest rates at reasonable levels. However, these mechanisms can only be activated should the countries being supported commit themselves to IMF-style economic adjustment programs. Considering the anti-austerity political backlash now characterizing these countries, it is far from clear that they would agree to submit themselves to the tender mercies of the IMF.

Yet a further risk that European policymakers might want to consider is that a Greek exit could complicate the ECB's task of implementing full-bodied quantitative easing now to address Europe's deflation problem. If the ECB is forced to recognize large losses on its past Greek lending, one must expect that the resistance of those ECB board members already opposed to quantitative easing will grow. In particular, those members must be expected to strongly resist any notion that the ECB might buy the sovereign bonds of those countries with questionable debt sustainability that could result in the ECB incurring further loan losses on its balance sheet.

In September 2008, when U.S. policymakers were faced with the decision as to what to do about Lehman's acute financial difficulties, they grossly miscalculated the likely fallout from letting Lehman go bankrupt. That decision had devastating consequences for both the U.S. and global economies. One has to hope that European policymakers have learned the lessons from that sad episode and that they weigh very carefully the pros and cons of cutting Greece loose before they come to any hasty decision that they might later come to regret. ◆