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Greece: Reverberations and Ongoing Risks

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Highlights:

- *Austerity resistance increasingly points to Greek euro exit. The Greek electorate clearly rejected politicians supporting austerity in May 6 elections. Now the parliament is without a working majority and fresh elections may be needed.*
- *The downside risks of a Greek exit have fallen but may still be hard to control. The Eurozone banks have lowered exposure to Greece; however Greece still owes about € 157 bln to the rest of the Eurozone. Any losses due to a Greek default would be split proportionately by the remaining Eurozone members—which would be particularly stressful to the remaining peripheral countries. Greece faces risks as well, especially to the banking sector.*
- *ECB role likely to be key: further bond purchases may be needed in the event of a Greek exit as such an event would likely exacerbate the current recession. However, the ECB would have to overcome Bundesbank resistance first.*

Greece's continued membership in the Eurozone is looking increasingly at risk. The general election in Greece on May 6 failed to deliver a stable government, ie at least one that had a working parliamentary majority, with the clear impression that the Greek electorate gave a resounding rejection to the austerity measures being demanded of the country as part of its bail-out conditions.

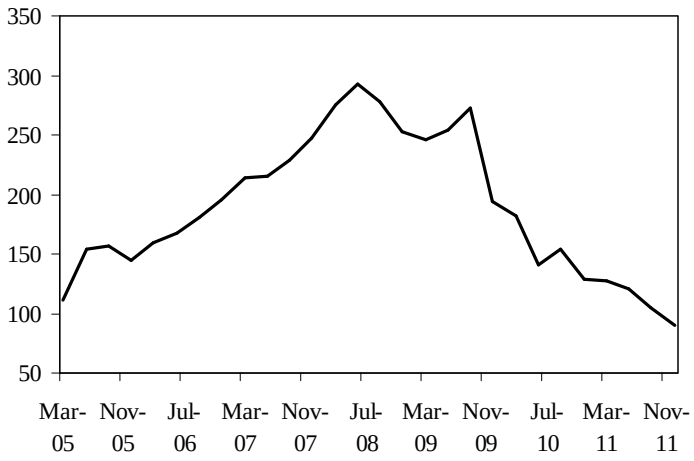
Fresh Elections: A Referendum on the Euro. However, the EU and IMF have made it clear that unless the bail-out conditions are adhered to, further bail-out funds will not be forthcoming, raising the stakes that Greece may be forced into a default in the next few months alongside a likely exit from the euro. Admittedly there are other possibilities. At this juncture, *Greece is unlikely to cobble together any stable coalition*, implying that fresh elections may be needed, with a date of June 17 already circulating. A different result is possible. Notably, while mustering only some 32% of the vote, the two pro-austerity parties (New Democracy and PASOK) actually came close to winning a parliamentary majority: their thinking may very well be that they could win more seats next time around, especially if they were to turn the election into an effective referendum on Greece staying in the euro, aware that opinion polls suggest that the Greek electorate still largely backs membership.

EU Patience Running Out? Such an election swing could very well win Greece more time. However, the risk is still that any such a victory for these two parties would not quell the demands within the country for a bail-out renegotiation and an easing in austerity. Regardless, *the rest of the Eurozone (and especially the IMF) may be losing whatever patience they have left with Greece* and may say that enough is enough, deciding that Greece has shown itself unwilling to reform rather than merely being unable to do so. In addition, Greece may decide it too may fare better outside the Eurozone.

The Risks to Greece. While the implied default and curtailment of bail-out funds would rob Greece of any external financing, the fact that the country is close to running a primary budget balance would mean that the ensuing domestic fiscal jerk may not be too severe on the economy. Admittedly, *the clear risk for Greece would be the damage to the banking system from a default/euro-exit*. There is another risk in the extent to which any boost to competitiveness stemming from the re-introduction of a (markedly devalued) drachma would be frittered away into higher prices.

The Risks to the Eurozone. At first glance, it would seem that the Eurozone could withstand a Greek exit, undoubtedly much better to that perhaps two years ago (when Greece won its first bail-out). As Chart 1 shows, exposure by European banks to Greece has fallen back markedly of late, with these figures (ending in Q4 last year) failing to take account of the debt swap achieved in February when banks will have reduced their exposure further. However, and unfortunately, **other risks have arisen in the last few years**, most notably the money that Greece owes the rest of the Eurozone mainly in the

Chart 1
Eurozone Bank Exposure to Greece Down Sharply, € bln



Source: BIS

form of the € 107 bln liabilities (as of February) the country has in its TARGET2 account (ie the intra-Eurozone clearing system run by the ECB), a result partly a repercussion of the fact that the country is still running a current account shortfall of close to 9% of GDP. In addition the ECB holds some € 50 bln in Greek bonds. Should Greece leave the euro, the taxpayers of each of the Eurozone countries would have to make good any losses incurred by the Euro-system in proportion to their relative size – thereby meaning further liabilities for already stretched peripheral countries.

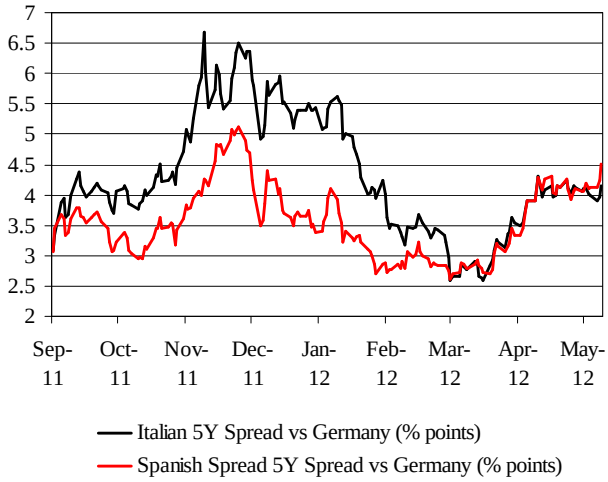
Admittedly, the circa-€ 120 bln that emerges from unused Greek bail-out funds could be used to plug this hole. However, it would mean that *there is no effective top-up to the bail-out funds* that may (increasingly) be needed elsewhere in the Eurozone given the clear risks of some domino effect on other peripheral countries from a Greek euro exit (see Chart 2). At this juncture, some effective € 500 bln is available but only half that may be accessible in the next few months as the much heralded ESM is not due to come into existence until July – at the earliest.

ECB Back in the Spotlight? As a result, should the financial market repercussions from a potential Greek exit prove hard to control, then the economic damage may be equally insidious. If so, then *the threat is that the so-far mild, but continuing, Eurozone recession could turn far more severe*, potentially mimicking the near-5% collapse in GDP seen in 2009. Surely, the ECB would then respond, albeit more on the unconventional side, by providing more liquidity and/or resuming government bond purchases. Most likely this will be the case, but the ECB Council may have to overcome Bundesbank resistance first.

Overcoming Bundesbank Resistance. The German central bank is clearly uncomfortable with the stance of ECB policy, even this week noting that Germany is subject to a very expansionary monetary policy which needs to be offset elsewhere. This seems hard to square with signs that the German labor market may be taking a turn for the worse and where German Q1 GDP data (due Tue) may fail to show any recovery from the drop of the previous quarter. Even so, the Bundesbank is clearly uncomfortable with the inflows coming into Germany and which are evident in the huge rise in the German TARGET2 balance (see lower chart), these actually being a mirror-image of the TARGET2 shortfalls in peripheral countries and are being driven by capital flight. The clear Bundesbank worry is that these inflows (at over € 500 bln, they are worth over 20% of German GDP) may ferment financial instability problems for Germany in due course, maybe not in terms of formal consumer price inflation but in asset bubbles.

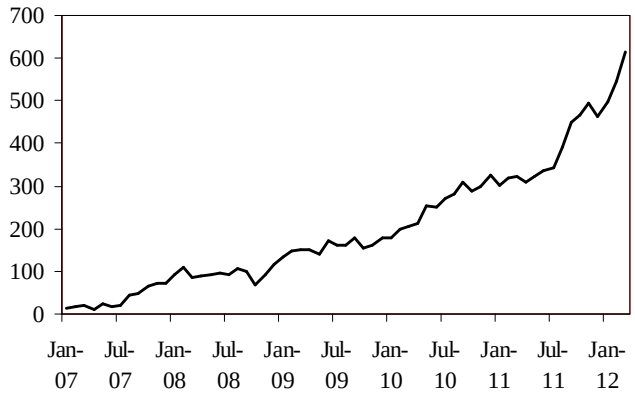
More likely than not, should it need to in coming months, the ECB will overcome these German reservations regarding more unconventional easing. Indeed, while only a month ago, the ECB was contemplating an exit strategy from its current monetary stance, it may have to come up with an entirely different 'exit' strategy if the worse comes to worst as far as Greece is concerned.

Chart 2
Eurozone: Periphery Strains Returning



Source: Bloomberg

Chart 3
Germany: Soaring Bundesbank TARGET2
Net Position, € bln



Source: Bundesbank