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The implications of a Greek default for the euro

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The Greek government has now hit the panic button and activated the IMF/eurozone rescue plan. However, it is not clear that this bailout (whose implementation still requires approval by the German parliament) will work. Financial markets remain unconvinced as evidenced by the risk premia for Greek debt which remain extremely elevated. The experience of Argentina also shows that even repeated IMF programs cannot always stave off failure.

For European Union policy-makers, this raises the fundamental question of what would happen if the proposed €45 billion aid package can't bring this Greek tragedy to a happy ending. Would a default by Greece signify the end of the euro?

Behind this often-posed question is the assumption that the notion of 'default' has a precise meaning, which is not the case. Ratings agencies define default as a failure to make a contractual payment on time. In reality, however, markets have often been quite forgiving in situations in which a government only reschedules, i.e. does not pay on time, but makes a credible promise to repay the full amounts due at a later date. Such a 'soft default' would certainly not mean the end of the euro.

The real question is thus: Would a messy (and massive) default under which the country refuses to repay in full signify the end of the euro?

Yes and no.

A messy default would certainly end the ideal of the euro area as a club whose members are all equal and work toward a common goal, namely the stability of the common currency. Membership in such a club protects against financial problems because members are supposed to behave well and help each other in case of unjustified speculative attacks. Although the EU Treaty says that members are not liable for each other's public debt, there is an implicit political commitment, as we see right now, to provide emergency help.

The quid pro quo for this solidarity is of course the expectation that all members abide by certain standards, for example those embodied in the Stability and Growth Pact, that aim to limit budget deficits and debts. The continuing misreporting of fiscal data by Greece has already severely damaged the ideal of the euro area as a 'gentlemen's club'. But the club could still be saved if Greece undertook a determined national effort to service its debt and avoid a messy default.

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However, even a messy default by Greece alone would not necessarily mean the end of the euro area. The day after a formal default, Greek banks would no longer have access to the regular monetary policy operations of the European Central Bank because the ECB could no longer accept their collateral, Greek debt, which would immediately have junk status. The country would thus effectively cease to be part of the euro area. Its status would resemble that of Montenegro, which adopted the euro as legal tender without officially being a member of the single currency zone.

In Greece, following a messy default, euro notes and coins would still circulate in the economy, but one euro on a Greek bank account would no longer be automatically equivalent to one euro on a bank account elsewhere inside the euro area as Greek banks might immediately become insolvent and thus be shut out of the payment systems. Until Greek solvency has been reestablished, the eurozone would thus de facto have lost one of its members although the Greek Central Bank head would still sit on the Governing Council of the ECB and the Greek finance minister would still be a member of the Euro Group, with his country's normal voting powers intact.

The Greek economy would collapse, but the impact on the rest of the single currency zone should be minor given that the country represents only about 2% of the euro area's GDP and is not home to any systemically relevant financial institution.

In many ways, a messy Greek default would actually leave the eurozone in better shape. Its institutions would probably be strengthened because it would have become clear that the framework is strong enough to withstand the failure of one of its members. Tolerance toward deficit violations and inaccurate reporting would be much reduced. The club would have been transformed into a federation whose peripheral components can be told to "get lost", so to speak. As a result, majority voting would tend to replace consensus as the normal way of decision-making.

The spanner in the works would of course be contagion. The main reason why even Germany has agreed to the bailout package for Greece is the fear that a messy default would trigger speculative attacks on government debt and financial institutions in systemic countries like Spain and Italy.

But there is no fundamental rationale for contagion as the self-financing capacities of Spain and especially Italy are much stronger than those of Greece. However, markets can at times be irrational. The real test of the euro area is thus whether it can protect members that do follow at least the spirit of its rules from speculative attacks. Despite its large debt level, Italy, for example, has for most of the time kept its budget deficit below 3% of GDP.

The signals from financial markets are so far encouraging. After an initial bout of nervousness in February of this year, when it first became clear that the second leg of the financial crisis could imply sovereign default, markets have increasingly differentiated among the weaker members of the euro area. Risk premia have tended to move together in the same direction, but with completely different orders of magnitude. (The credit default swaps for Greek debt are now around 600%, compared to only 170% for Spain and even less for Italy.)

The default of any systemic country would indeed mean the end of the eurozone, but for the time being this remains fortunately only a tail risk.