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Eurozone: If Greece goes ...

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With an exit looking possible, policymakers and investors are shifting focus to the consequences

The idea of a Greek exit from the eurozone is no longer fanciful. After 70 per cent of voters in elections on May 6 supported parties that rejected the terms under which €174bn of international bailout loans were offered to Athens, many investors now see a fissure in the 17-member eurozone as increasingly likely. European governments are furiously thinking through the various scenarios, while still urging Athens to stick to its agreements on austerity and reform. If those hopes are dashed and Greece goes, what happens next?

1. Is Greece serious about quitting the eurozone?

Who knows? Opinion polls showing 80 per cent of Greeks in favour of staying in the euro combine with the election result to offer a scene of confusion.

Greece's European partners say Athens cannot have it both ways. But the siren call from the radical left coalition Syriza, that Greece is safe in the eurozone with its creditors poised to ease the harsh bailout, is music to the ears of hard-pressed citizens.

Popular anger is running high at the prospect of three more years of austerity while Athens implements the rest of the reform programme agreed with the EU and International Monetary Fund. "We desperately need a break ... If my pension is cut again, I might as well commit suicide," says Angelos Syrigos, 85, whose modest income has been slashed by 30 per cent in the two years since the bailout began.

Alexis Tsipras, Syriza's charismatic 37-year-old leader, who emerged as a kingmaker following his party's surge to second place at last Sunday's inconclusive general election, is gaining in support. Opinion polls published at the weekend showed Syriza would win first place in a second election, with 20-25 per cent of the vote.

Mr Tsipras insists Brussels and Berlin will not force Greece out of the euro because of the contagion effect this would have on Portugal, Ireland and Spain. He has demanded a reversal of salary and pension cuts imposed by the bailout, as well as the hiring of 100,000 new public sector workers to reduce the impact of a 21 per cent unemployment rate.

Middle-aged Greeks are afraid of a eurozone exit, fearing a further collapse in property values, the crumbling of the banking system and high unemployment.

"The gravity of the situation isn't appreciated. Some people believe Syriza will change its tune, others that the Europeans make empty threats," says Takis Michas, a political commentator. "The only thing that will focus minds is when the money to pay pensions and salaries just doesn't arrive."

2. Is Europe ready to jettison one of its own?

Eurozone officials had prepared contingency plans for a Greek exit – or "Grexit" as some have called it – after George Papandreou, then prime minister, proposed a national referendum in October on euro membership. Indeed, Wolfgang Schäuble, German finance minister, actively urged the referendum to halt the endless questioning once and for all, according to one senior European official.

This week in the FT

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Even then, such officials were uncertain whether the rest of the currency union could survive the shockwaves unleashed by a return of the drachma – particularly in bailed-out countries such as Portugal and Ireland, where bank runs and market panic could follow on the assumption that others could follow Greece out of the eurozone door.

But now, with a new, permanent €500bn rescue fund backed by the strength of an international treaty with multiple tools to buy sovereign bonds on the open market and inject capital into eurozone banks, some officials believe the contagion could be contained – much as it was after Athens finally defaulted on private bondholders last month.

"Two years ago a Greek exit would have been catastrophic on the scale of Lehman Brothers," says a senior EU official involved in discussions about Greece's future. "Even a year ago, it would have been extremely risky in terms of contagion and chain reaction in the banking system. Two years on, we're better prepared."

The new eurozone firewall – now backed with additional resources for the IMF – is not the only reason some officials are becoming increasingly sanguine about losing Greece. Spain and Italy, they say, have taken huge steps to put their economic houses in order, enabling them to bounce back quickly if credit markets suddenly dry up and their banks wobble.

Still, uncertainty over how Europe's banks would be affected has continued to be the primary concern. Witnessing Greek bank customers suddenly having their euros turned into drachmas overnight, depositors in other peripheral banks might suddenly withdraw their cash and place it in seemingly safer euro accounts in Germany or elsewhere. Such a massive run could destroy much of the eurozone periphery's banking sector. "The ball is genuinely in their court," says the EU official. "Those who understand the situation realise their room for manoeuvre is extremely limited. We simply have to wait."

3. What would exit from the eurozone entail?

In a game of brinkmanship, neither Athens nor the rest of the eurozone would want to take responsibility for a Greek exit from the single currency. Recriminations would fly.

Against accusations that it is imposing, in the words of Mr Tsipras, "barbarous" demands, the core of the eurozone is already positioning itself to ensure any exit is seen as a sovereign decision. "The future of Greece in the eurozone lies in the hands of Greece," Guido Westerwelle, German foreign minister, said on Friday. "If Greece strays from the agreed reform path, then the payment of further aid tranches won't be possible. Solidarity is not a one-way street."

Slippage against the agreed EU and IMF agreements would probably be accepted for a period, so the trigger for exit would be a deliberate rejection by a new Greek government of the requirements for austerity and structural reform in the existing agreement that Athens signed with the "troika" of the European Commission, the European Central Bank and the IMF in February. "It would be more of a case of Greece walking than of Greece being pushed out," says Willem Buiter of Citigroup.

Exit would occur because, without disbursements of additional loans, the government would run out of money to pay social security and public sector wages. In addition, the ECB could withhold needed funds from Greek banks, bringing them down. At this point Athens would need to pass a new currency law, redenominate all domestic contracts in a new drachma, impose exchange controls, secure the borders to limit capital flight and take steps to introduce a paper currency.

Printing and distributing new notes would be no easy feat. In 2003 the US-led coalition managed to do it in Iraq in less than three months. But that required the efforts of De La Rue, a

British speciality printer, a squadron of 27 Boeing 747s and 500 armed Fijian guards to ease the process.

After exit, Greece would have to negotiate continued EU participation. The EU treaties have a provision for leaving the union, but not just the eurozone. That negotiation would be all the more difficult if new Greek authorities defaulted on debt to the European Financial Stability Facility, the ECB and the IMF.

If the country defaulted on its IMF debts, it would join a small ignominious club of nations – including only Zimbabwe, Somalia and Sudan – that have overdue financial obligations to the fund.

4. What economic effects will Greece suffer?

In any exit scenario, the new drachma would depreciate rapidly. How far cannot be predicted but the IMF estimates Greece needs at least a 15-20 per cent devaluation against the eurozone average – and considerably more against Germany – just to achieve a current-account balance. Currency moves tend to overshoot, and US investment bank Goldman Sachs has estimated that to stabilise Greece's international debts at a reasonably low level – needed to ensure the country can insulate itself against the risk of capital flight – a devaluation of 30 per cent is needed compared with the rest of the eurozone, and more than 50 per cent with Germany.

Such a devaluation would restore competitiveness, but it would be far from the end of the story. A new administration would probably repeal a law that prioritises debt interest over other forms of government spending, and a new default would occur on the remaining private sector debt and on official sector debt owed to European institutions and the IMF.

Even if all interest payments were stopped, additional austerity would still be needed for a period because Greece's tax revenues still fall short of its public spending – a primary deficit. The IMF estimates that even if there is no exit there will be a primary deficit of 1 per cent of national income in 2012, a figure that would almost certainly rise in a recession deepened by uncertainties surrounding exit and a bust banking system.

There are two plausible scenarios. In the brighter one, a responsible government is able to restart the banking system, run a balanced budget and persuade the public to accept sharp declines in living standards as import prices rise quickly. After a period of deep austerity, rapid growth might be possible. Under the alternative scenario, a government takes office that seeks to use its new powers of monetary autonomy to offset the effects of devaluation and spend its way to prosperity. The danger is that hyperinflation after short-term relief would be followed by further currency depreciation and money printing.

5. Is Greek business ready for an exit?

The blunt warning this month from Evangelos Mytilineos to shareholders offered a rare insight into the thinking in the boardrooms of Greek businesses with international operations. The chief executive of Athens-based industrial group Mytilineos said that the headquarters of Metka, a subsidiary that builds power plants in eastern Europe and the Middle East, may be moved abroad. "Our Greek background is not very helpful when it comes to competing internationally," Mr Mytilineos said.

While some large businesses have prepared contingency plans in case of a "Grexit", medium-sized companies are waiting to see what happens, say Athens-based consultants.

"I think it's too early to start thinking about drachma-isation," says a Crete-based hotelier, citing the wildly diverging exchange rate estimates for a new currency. Last year he rejected a contract amendment proposed by Tui, a German travel operator, relating to financial obligations in the event of the return of the drachma.

Even those not planning to move are making sure any money earned abroad stays there. "[One basic lesson of the crisis] has been to make sure that your receivables are not brought back to Greece," says one exporter. "I keep almost all my funds abroad."

Businesses serving the domestic market are downsizing after two years of trying to keep costs down amid a dramatic plunge in sales. "We're planning to close half of our outlets by the end of the year," says the general manager of one retail chain. "If we go back to the drachma we'll keep only a flagship store in Athens."

Solon Molho, an analyst, says the disastrous consequences of leaving the euro are not yet fully appreciated. "You would most likely decide to shut down operations, sell the business if you could find a buyer, and perhaps leave the country altogether."

6. Can the eurozone contain the contagion?

This is the biggest unknown. If the eurozone authorities could persuade investors and the public that Greece was a special case, the effects of an exit could be contained. If not, a Greek exit would soon become a disorderly break-up of the euro project.

The inevitable question after a departure is: "Who's next?" Eyes would turn rapidly to Portugal, which followed Greece into the bailout club. Investors would sell Portuguese bonds, seek to extract money from the country's banks and take euros across the border for fear of an exit and devaluation. Currency risk has been evident in the European banking system since late last year, but the incentives to move deposits into German banks from those in Portugal, Ireland, Spain and Italy would be clear.

If the political will to hold the single currency together exists, the eurozone has a big weapon in its arsenal to contain the contagion: unlimited action by the ECB. It could restart bond-buying at very high levels to limit rises in sovereign bond yields and offer unlimited liquidity to peripheral-nation banks to offset a run on deposits. This would worry Berlin, which feels the ECB has already gone too far in underwriting bank and sovereign debt in peripheral countries. But the alternative is worse, as the EU has no other sufficiently powerful defence against a systematic bank run in such nations.

The answer, therefore, is that the eurozone could limit contagion, but it is highly uncertain whether it would. If it did not, the end of the euro would be nigh.

In either case, the outlook for the European economy is highly risky. After the Lehman collapse in 2008, it was not a dearth of bank lending that plunged the region into its worst recession since the second world war, but a collapse in confidence and spending as households and companies decided simultaneously to tighten their belts in fear of what might happen next. Unless the European authorities are extremely skilful in ringfencing Greece, a similar scenario would be a severe danger.