FINANCIAL TIMES

MARKETS INSIGHT

June 21, 2012 4:04 pm

89

Race to save euro will follow ‘Grexit’

By Willem Buiter

Following the re-run of the Greek parliamentary elections, we have a New Democracy-led coalition government. This removes the risk of an early “Grexit” as it is likely the minimum demands for relaxation of fiscal austerity by the new government will not exceed the maximum fiscal austerity concessions Germany and other core euro area member states are willing to make.

Some relaxation on the timing of austerity, some limited early disbursement of funds to pay for essential public goods and services, and some token pro-growth gestures courtesy of the European Investment Bank and EU structural and cohesion funds will most likely keep Greece in the euro for the time being.

However, we consider it highly unlikely that Greece will comply sufficiently with even “lite” fiscal austerity conditionality, let alone with structural reform conditionality, including privatisation targets, which are unlikely to be relaxed. Political opposition to both austerity and reform is now stronger in Greece than ever before. So is resistance to bailouts in the core. The troika – the European Commission, European Central Bank and the International Monetary Fund – may forgive a Greek failure in the September progress assessment, but is unlikely to tolerate another failure to comply on all fronts by the December assessment.

Grexit may well be triggered by a troika review declaring Greece wilfully non-compliant with the conditionality of its programme, stopping the disbursements to the Greek sovereign. Greece defaults and the eurosystem and the Greek ELA (emergency liquidity assistance provided by the Greek central bank) stop funding the Greek banks. At that point Greece exits the euro area, following the imposition of capital controls, foreign exchange controls, restrictions on deposit withdrawals and a temporary suspension of the Schengen agreement.

It is highly unlikely the core eurozone would be willing to take on significant exposures to Spain and Italy unless it can be established unambiguously that a wilfully and persistently non-compliant programme beneficiary will be denied further funding. Therefore Grexit would become even more probable should Spain and Italy require a broader troika programme and external help, respectively, which appears likely. The greatest fear of the core nations is not the collapse of the euro area but the creation of an open-ended, uncapped transfer union without a surrender of national sovereignty to the supranational European level.

Grexit is likely to create extreme deprivation in Greece, and lead to social and political instability . We are likely to see evidence of this even before it takes place. The damage can be limited by ensuring that Greece stays an EU member even after it exits the euro. This is the most likely outcome.

The direct impact of a Greek exit on the rest of the eurozone, the EU and the rest of the world through trade and financial links is minor. The only risk is through exit fear contagion. This will lead to a sudden funding stop for all sectors in any economy perceived as being at material risk of exit after Greece. The European Central Bank, supported by the troika, has the resources and may have the will to keep at-risk sovereigns and banking sectors funded until the markets are convinced no country that is adequately compliant with programme conditionality and which does not want to leave the euro will be allowed to be forced out by a sudden stop on market funding.

There is now a material risk, if procrastination and policy paralysis prevail, that the endgame for the euro could be an onion-like unpeeling and unravelling. Survival to fight another crisis will require at least the following: an enhanced sovereign liquidity facility, banking union and sovereign debt and bank debt restructuring, with only limited sovereign debt mutualisation.

The endgame for the euro area, if the political will to keep it alive is strong enough, is likely to be a 16-member area, with banking union and the minimal fiscal Europe necessary to operate a monetary union when there is no full fiscal union.

Minimal fiscal Europe will consist of a larger European Stability Mechanism, the permanent liquidity fund, and a sovereign debt restructuring mechanism (SDRM). The ESM will be given eligible counterparty status for repurchase agreements with the eurosystem, subject to joint and several guarantees by the euro area member states. There will be some ex-post mutualisation of sovereign debt. Sovereign debt restructuring through the SDRM will recur.

Banking union aims to sever the poisonous umbilical cord between sovereigns and the banks in their jurisdictions. A road map to banking union will likely be announced at the EU summit on June 28-29. It had better be a credible path. In any case, implementation is the hard part, and time is of the essence.

Willem Buiter is chief economist at Citigroup

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