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Greek Fire

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With the potential for a Greek default on the horizon, what impact would 'Grexit' have on Europe and investors?

Greece has challenged every presumed pillar of European monetary union; starting with the 'no bail-out' commitment in 2010, followed by the notion that eurozone sovereign default was 'inconceivable' and, if agreement with its EU creditors is not reached soon, the 'irrevocable' nature of euro membership. We believe this is the fundamental question that investors, as well as the Greek nation and the EU, will have to address over the coming days and weeks.

Investors have been conditioned to believe that in the minute before midnight, policymakers always steer the eurozone away from the precipice. They may do so again. But for both sides the stand-off is about much more than differences over budget targets and debt. Greece's Syriza government has directly challenged the creditor-led policy and governance framework that evolved in response to the eurozone debt crisis. Investors and policymakers should heed ECB President Mario Draghi warning that the eurozone would enter 'uncharted waters' in the event of a Greek default to the IMF.

Failure by Greece to pay EUR1.6 billion to the IMF on 30 June, and secure an extension of the current IMF/EU agreement, would jeopardize the lifeline of ECB emergency liquidity assistance to Greek banks, even as the outflow of deposits accelerates. The Syriza government would be forced to choose between accepting the strictures of its creditors or the imposition of deposit and capital controls as a prelude to an exit from the eurozone. It is uncertain whether the Syriza government would survive the political as well as financial consequences of choosing the path to euro exit.

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The siren call of ECB quantitative easing (QE) has lulled markets into largely discounting the risks from a Greek sovereign debt default. It is also true that the negative feedback loop between stressed sovereigns and weak banks – a key channel of cross-border and market contagion at the height of the eurozone debt crisis – is much less pronounced today. Better capitalised European banks' exposure to Greece has fallen from EUR125 billion in 2009 to just EUR14 billion at the end of 2014.

Nonetheless, the still relatively limited contagion so far also reflects investor 'fatigue' with the Greek crisis and the assumption that the likelihood of Greek exit from the eurozone – 'Grexit' - is low. In the current iteration of the Greek crisis, it is an increase in the probability attached by market participants to Grexit, rather than the financial losses incurred by a Greek payment default, that could trigger a potentially violent re-pricing of euro assets. The euro area would be transformed from irreversible monetary union into a system of fixed exchange rates that can be broken. Euro-denominated assets would warrant a higher convertibly risk premium eroding the success of ECB President Mario Draghi's commitment to do 'whatever it takes' to preserve the euro.

In our view, a euro exit by Greece (and consequently from the European Union) and repudiation of its liabilities to other European taxpayers would be a profound shock to Europe's political and investment landscape. The euro support mechanisms now in place – the European Stability Mechanism (ESM) – as well as QE, means that the spread of flames across European financial markets from a Greek exit could be dampened by policymakers. Much less likely than financial market volatility but much more threatening if it were to arise would be a deposit run on banks across the eurozone. As the pain of the losses imposed on Greeks from the forcible conversion of their euro deposits into devalued 'new drachmas' is witnessed across Europe, it could prompt depositors to shift into cash and transfer deposits to the 'core' or even outside of the euro area. The failure of European policymakers to put in place a credible euro-wide deposit insurance backstop is a fundamental flaw in European monetary union.

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Many commentators and policymakers portray the Greek crisis as reflecting an isolated and unrepeatable set of circumstances. Yet inefficient product and labour markets, weak international competitiveness, persistent budget deficits and high public debt are most evident in, but not unique to, Greece. What is unique is the election of a government unwilling to even pretend to adhere to the euro membership rulebook. If another government in Europe were elected on a similar platform, the market response and contagion will likely be much faster and more brutal.

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The denouement of the Greek crisis is fast approaching. Our current assessment is that there is sufficient public support in Greece and political will in European capitals to keep Greece within the eurozone. But in the near term, an intensification of the crisis is at least as likely as resolution.

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