PERSPECTIVE

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GREECE CANNOT BE ALLOWED TO LEAVE THE EURO

Political brinkmanship over the terms of Greece's financial bailout program is an increasing risk to the economic and financial outlook for Europe, with potential implications to the broader world economy and financial markets. We should not be surprised that this is happening.

From the perspective of Greece, current economic conditions are unacceptable. Although the economy is growing, the level of economic activity has fallen a shocking 26% in real terms since early 2008. The unemployment rate is 25.8%, with youth unemployment at 51%. Although private sector debt holders took a massive haircut on their holdings of Greek debt in 2012, the country's debt-to-GDP ratio has gone from 148% at the start of the fiscal crisis in 2010 to 175% today. It is clear that Greece cannot meet its financial obligations over the long term. The only reason that the financial commitments are not crushing the economy at the moment is that interest payments have been trimmed, while the maturity of principal payments have been extended into the future. It should be noted that Greece has made considerable fiscal progress, with the country running a large primary budget surplus (i.e. a surplus excluding interest payments), but the resulting fiscal austerity is deeply constraining economic growth.

The sustained dire economic and financial conditions led to the election in January of a new government dominated by the Syriza party on a platform of renegotiating the terms of the Greek financial bailout program funded by the Troika – the European Union, the European Central Bank, and the International Monetary Fund. Given the plight of Greek citizens, it should not be surprising that an anti-austerity party did well at the ballot box.

The incoming government is faced with a very tight deadline in negotiating with the Troika, as the financial support program expires on February 28. Since the government wants to renegotiate the terms of the financial aid – they have stated that they do not want to exit the euro currency – the new government launched talks with the major governments in the European Union and the ECB. The talks have not gone well. The request for a bridge loan to allow time to renegotiate the terms of the financial aid has so far been declined, and the appetite for significantly changing the terms appears close to non-existent.

There are two reasons for push back against the Greek demands. First, in order to be a member of the common currency regime, it is essential that Greece have a competitive economy. Greece fudged their fiscal numbers when they applied to join the euro area. Then, the financial dividend earned by joining the common currency, such as the financial savings created by the lowering of interest rates required on Greek government debt, was not invested profitably. The Greek economy became more uncompetitive over time, with unit labour costs higher than other countries in the common currency. Following the financial crisis, two things became clear. Greece could not meet its financial commitments, but it also needed deep structural reforms if it were to remain a euro nation. The problem is that structural reforms mean fundamentally changing the nature of an economy to make it more efficient, productive and competitive. To Greeks, this means accepting fundamental changes, which as one can imagine is deeply unpopular. It can also depress the economy during the implementation period. Over the long term, reforms can lift a country's trend rate of economic growth and raise the standard of living of citizens. But, the creative destruction to get to the goal can be incredibly painful.

The second resistance to the Greek demands is the precedent it sets for other countries in the euro zone that have undergone financial aid programs. The negative impact of fiscal austerity and the hardship of structural reforms are being felt in other countries as well, such as Spain. If Greece is allowed to materially renegotiate their financial support, others could demand a similar treatment. This could also bolster the political fortunes of anti-austerity parties across the euro zone, as voters will know that new governments can get better deals.

All of this leads to today's political standoff, and the clock is ticking. The immediate deadline is the February 28th expiration of the current bailout arrangement, but a case can be made that the real deadline could be as late as July-August when significant financial payments by Greece are called for. However, it is important to stress that what political brinkmanship does is take one to the brink. It is when politicians look over the precipice and see that a completely unacceptable outcome will occur if they do not change course that they relax their demands and return to the bargaining table. In this case, the other side of the brink is the possibility of a Greece exit from the euro zone.

Some have argued that the euro zone could cope with a Greece exit. Indeed, they argue that both Greece and the other euro countries would be better off under this scenario. It is partly true that Europe has taken many steps since 2010 to reduce the potential fallout of a Greece departure. The story goes that banks are better capitalized; there has been time to reduce risk exposure to Greece; and, private sector exposure to Greek debt was reduced by the prior default.

This view of complacency over a Greece exit is deeply misguided. If Greece leaves the euro area, there will be significant financial market volatility at a time when the euro zone, and the global economy in general, is very weak. This would materially increase the downside risks facing the economy, which could intensify the possibility of deflation. However, the bigger risk is the precedent it would set for the future of the euro zone. If Greece exits, every time another euro zone member experiences significant economic, fiscal or financial distress, financial markets will bet heavily on that country leaving the euro. The problem with financial markets is that if enough investors believe in the worst case scenario playing out, the financial strains can become so acute as to cause that outcome. At the moment, markets think there is a possibility that Greece could leave, but it is only speculation. If Greece does exit, they will know with certainty that it could happen to another country.

The central problem is that the euro zone is not what economists would deem to be an optimal currency area. The euro member countries have not put in place the political, economic and institutional linkages to achieve that goal. For example, there is a currency union without a complete banking union. This makes the common currency region vulnerable. Future financial strains in other member countries are likely. So, a case can be made that Greece should never have been allowed to adopt the euro; but, now that it has, it cannot be allowed to leave.

The Troika wants to maintain Greece in the euro zone. Similarly, Syriza wants to keep Greece in the monetary union as the near-term consequences of exiting the euro zone could be disastrous. The difficulty in reconciling the positions of both parties suggests that the political standoff with Greece will not be resolved easily. Greece will strive to get the best deal it can, while the Troika will resist changing the terms of financial aid as much as possible. Financial market anxiety could persist and there is a risk it could intensify. But, the odds still favour some sort of resolution that keeps Greece in the euro zone. All eyes will be on the upcoming meetings of the euro zone finance ministers and their heads of state for guidance on how this issue will ultimately be resolved.