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MACROCOSM

Papandemonium!

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Lorcan Roche Kelly

The Euro area calls Papandreou's referendum bluff. There are limits to debtor's leverage.

Euro area leaders have dared to call Greek prime minister George Papandreou's bluff. And now his dangerously destabilizing referendum gambit (see "On the Greek Referendum Surprise" November 1, 2011, and "On the Greek Referendum Surprise, Volume 2" November 2) seems likely to become his political epitaph.

- If this were a game of poker, then French president Nicholas Sarkozy -- enraged by Papandreou's betrayal just before the France-hosted G20 meeting -- and German Chancellor Angela Merkel went "all in" by demanding that the referendum be a vote of in-or-out of the euro currency for Greece.
- IMF chief Christine Lagarde further upped the pressure saying that the desperately needed €8 billion aid tranche for Greece would only be approved when "the referendum is completed, and all uncertainty removed." We note that she refers to "uncertainty" as though it were separate from and beyond the referendum -- surely she is hinting that the present brinksmanship must end, which would seem to be best achieved by Papandreou's removal.
- Opposition to the referendum from within Papandreou's own party has been building, with his finance minister Evangelos Venizelos issuing a statement early this morning calling for the "the sixth tranche to be disbursed, without any distractions or delay." Since the referendum could not possibly happen before December at this point, this was a thinly veiled call for the referendum to be withdrawn.
- Developments this morning -- which are still very fluid -- suggest that Papandreou's time as prime minister can be measured in hours. There are moves underway to try to form a national unity government under Lucas Papademos, formerly a vice president of both Greece's central bank and the ECB. It is unclear at this moment how viable this solution is, or even if Papademos wants the job -- he is not a politician, and has recently taken up a position as a visiting professor of public policy at Harvard.
- Overall, it feels to us that things are moving -- even if chaotically -- in the right direction. On Tuesday it seemed that Papandreou had presented the Euro area with on unsolvable existential threat. Now

Update to strategic view

EUROPE MACRO: In calling Papandreou's referendum bluff, Merkel, Sarkozy and the IMF have forced Greece to explore ways of standing down, if only to survive. Thus the Euro area authorities have now, for the first time, put a limit on debtor's leverage by countries facing debt crises -- and thus a limit to moral hazard. This will be the model going forward: the benevolent "axis" of France and Germany will allow countries in crisis to experience intense pressures in order to drive them into an increasingly unified core of Europe.

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it seems that institutions in Europe and within Greece itself are struggling to reorganize themselves to find a solution.

Chaos of the moment aside, there is an important strategic lesson to be taken from developments in the last 24 hours.

- Papandreou found that there are limits to the extent to which a small Euro area nation can apply debtor's leverage. That Merkel and Sarkozy were willing to risk a country voting to leave the euro currency area is a major change in Euro area politics -- previously, such a possibility was something that could barely even be spoken out loud.
- We see this as a logical next step in France and Germany's consolidation of strength and power as a benevolent "axis" within the core of an increasingly unified Europe (see "Two-Tier Europe is Born" August 17, 2011).
- As we have warned, this means that nations facing debt crises will be allowed to experience intense pressures, to drive them toward making the sacrifices of sovereignty required to join the new core (see "Six Days to What?" October 17, 2011). This will go on for years. At moments when those pressures have been allowed to build to near the breaking point, Europe will over and over again be a source of global risk.

Bottom line

In calling Papandreou's referendum bluff, Merkel, Sarkozy and the IMF have forced Greece to explore ways of standing down, if only to survive. Thus the Euro area authorities have now, for the first time, put a limit on debtor's leverage by countries facing debt crises -- and thus a limit to moral hazard. This will be the model going forward: the benevolent "axis" of France and Germany will allow countries in crisis to experience intense pressures in order to drive them into an increasingly unified core of Europe.

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