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MACROCOSM

Greece: Failure Is an Option

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Donald Luskin

Europe can take a hard line, to discipline radical parties imperiling integration and reform.

Tomorrow Greece's new SYRIZA-dominated government goes into emergency negotiations with euro area finance ministers, on the same day that the European Central Bank has announced it will cease accepting Greek sovereign debt as collateral for almost €60 billion in outstanding refinancing operations (please see the chart below).

That funding will be replaced by Emergency Liquidity Assistance (ELA) provided by the Central Bank of Greece with the ECB's blessing, as it was in 2012 (again, see the chart below, and "Understanding ELA: Emergency Liquidity Assistance" July 15, 2011). That blessing won't last forever if negotiations don't move forward constructively. ECB Governing Council member Peter Praet said today that ELA has to be "a bridge to somewhere." If that bridge were withdrawn, as it was during Cyprus' banking crisis in 2013 (see "On the ECB's Move Against Cyprus" March 21, 2013), then even if Greece did not effectively exit the euro, it would have to impose capital controls and bail-in bank depositors, as Cyprus did.

- That would be a real mess, and it gives Greece some debtor's leverage. But we think Europe will take a hard line. So a complete solution is unlikely to emerge tomorrow.

ECB refinancing operations for Greek banks EUR billions

Source: ECB, TrendMacro calculations

Update to strategic view

EUROPE MACRO, EUROPE STOCKS, ECB: ECB funding of Greek banks with Greek sovereign debt ends tomorrow, replaced by temporary ELA, as Greece and Europe enter emergency negotiations. Europe can afford to take a very hard line, because seeing Greece fail spectacularly would be an ideal *realpolitik* outcome in the face of radical politics in other nations. We think the global economy could absorb such a blow. But Varoufakis, a game theory expert, is unlikely to let it come to that, and the euro area probably doesn't want to risk it. A "muddle through" solution will emerge, not necessarily tomorrow. As the risk lifts and as QE kicks in, European equities should continue to perform well. Depending on the message a Greek solution sends to radical parties in other nations, we'll be on watch to revise that expectation.

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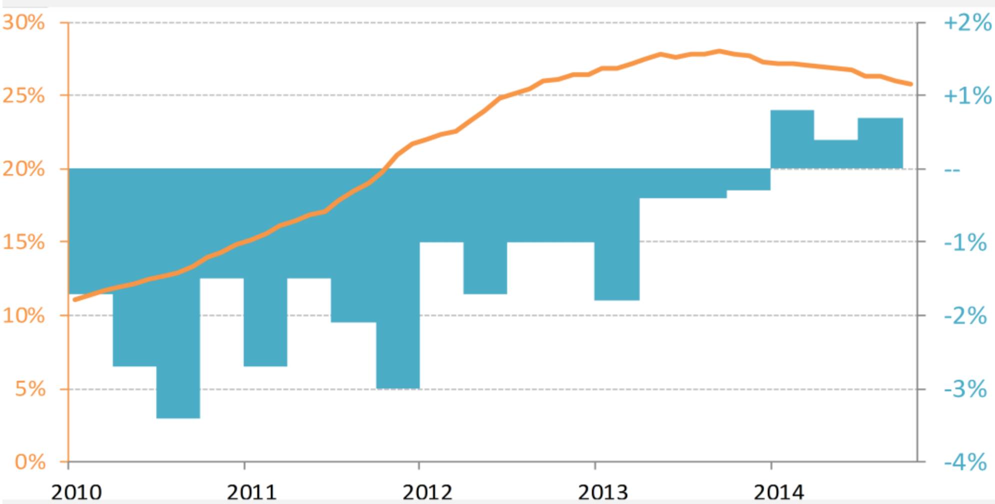
- *We think Europe can take a hard line because, as we think through the game theory of this situation, we become increasingly convinced that the objectively best strategy for Europe is to let Greece fail spectacularly.*
- *The euro area urgently needs to contain radical political movements on the left (such as [Podemos] in Spain) and the right (such as [Front National] in France) that threaten ongoing European integration and structural reform.*
- *The last thing Europe wants is for SYRIZA to demonstrate that it can bully its way back into pre-crisis borrow-and-spend policies, or to pull out of the euro and successfully go it alone.*
- We might go so far as to conjecture that radical politics in Europe is a luxury that can be indulged only now that the worst of the crisis has passed. We note that SYRIZA was unable to take power in 2012 at the worst of the Greek crisis (see "Εκλογη" June 15, 2012). Over and over during the crisis years, radical parties were defeated by pro-euro pro-reform conservative and center-right parties.
- But now that Greek unemployment has been moving lower for more than a year, and Greece has experienced three consecutive quarters of real growth -- that is, now that the pressure is off -- SYRIZA is able to take power (please see the chart below).

Greece — Unemployment rate ■ Real GDP growth, sequential quarter SAAR



Source: Eurostat, TrendMacro calculations

- So if Europe dares to play this at the extreme of *realpolitik*, it would want Greece to fail, to discredit SYRIZA as an example to be emulated in other nations, and to scare their electorates into the staying the course on integration and reform.
- *Obviously that course is fraught with risk for the euro area and the global economy. We think the world is strong enough to take the shock without the kind of crisis the mere risk of such a thing induced a mere three years ago. But nobody really wants to find out if they don't have to. So adjusted for risk, this "best" solution for the euro area is probably not optimal. But, as soon as costs imposed by Greece exceed the risks, it would become the optimal play for Europe. Either way, it enables a strong negotiating stance.*

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- Greece's new finance minister, the flamboyant and charismatic Yanis Varoufakis, is a former University of Texas economics professor, specializing in game theory. We think he and SYRIZA prime minister Alexis Tsipras understand exactly what they are up against, which is why despite bursts of populist rhetoric for consumption at home, with each passing day SYRIZA offers increasingly attractive compromise deals to Europe.
- They understand that they are dealing with an opponent who in the end is willing to go nuclear, indeed for whom that is in some sense the best play -- but who, nevertheless, has always displayed a strong preference for risk-reducing "muddle through" solutions.

A "muddle through" solution is our base case, and we think that even if such a thing doesn't emerge tomorrow, there's a decent chance that at least the path toward it will be clarified. In combination with the onset of the ECB's quantitative easing program next month -- which we think was put in place, in part, precisely to deal with risks arising from Greek politics (see "Here Come Greek Elections -- and QE from the ECB" December 30, 2014) -- European equity markets should continue to perform well, as they have so far in 2015, even in US dollar terms, despite the weak euro. Longer-term, depending on the exact nature of the Greek "muddle through" and its likely impact on upcoming elections in Spain and Ireland, we may want to revisit that expectation.

Bottom line

ECB funding of Greek banks with Greek sovereign debt ends tomorrow, replaced by temporary ELA, as Greece and Europe enter emergency negotiations. Europe can afford to take a very hard line, because seeing Greece fail spectacularly would be an ideal realpolitik outcome in the face of radical politics in other nations. We think the global economy could absorb such a blow. But Varoufakis, a game theory expert, is unlikely to let it come to that, and the euro area probably doesn't want to risk it. A "muddle through" solution will emerge, not necessarily tomorrow. As the risk lifts and as QE kicks in, European equities should continue to perform well. Depending on the message a Greek solution sends to radical parties in other nations, we'll be on watch to revise that expectation.