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This is How Greece Might Leave the Euro

Germany and the ECB may not come to the rescue this time.

An interesting month lies ahead for the Euro area. On January 22nd the ECB will meet and they will either announce a QE-style monetary policy action, as most expect by now, or they will disappoint markets with yet another statement suggesting the need to wait for more data and the effects of what has been done so far. On January 25th, three days later, elections in Greece will decide whether the first political party with strong views against austerity and with an explicit proposal for a serious haircut on its government debt reaches power in the Euro area.

No doubt that the outcome of these two developments will determine the fate of the Euro economy over the coming years but it is also possible that it determines the fate of the Euro area -- at least the current membership.

Rumours have started **reaching the press** that the Germans will not negotiate with Syriza and that they are ready to let Greece leave the Euro. We have seen this before and we know the outcome. Back in 2011 and 2012 when the fear of Greece leaving the Euro was at its peak (and the threat of Syriza winning the elections was also real), the contagion to other countries, in particular Italy and Spain, forced the Germans (and the ECB) to come to the rescue. A haircut on Greek debt plus the "whatever it takes" statement from Draghi saved the day and ensured that no country left the Euro area.

It's different this time

But the situation is very different now for many reasons. So far, contagion has not spread to other Euro countries, possibly because the other countries are seen as having stronger fundamentals. But what really matters might not be economics but politics. In some of the other Euro countries we have political parties with platforms that are very similar to the Syriza party in Greece (for example, *Podemos* in Spain). They (and the citizens of these countries) will be looking very carefully at what is happening in Greece. If Syriza wins and their negotiating strategy is successful, it is likely that we will see similar political changes in other Euro countries and a revolt against the current Euro economic policy. This is the last thing that Germany wants.

How does Germany avoid this outcome? Let me be cynical and argue that they only have one potential strategy, a very risky one. Let the ECB be nice on January 22nd and let them go ahead with a full-blown QE policy involving government bonds. Let the Greeks decide on January 25th if they want to be part of the Euro. If the Greeks vote for Syriza then the Germans will not negotiate and will only leave Greece with one alternative, to leave the Euro. If that happens, the financial system in Greece is likely to be under enormous pressure with a high chance of bank runs. While the risk might spread to other countries, the ECB could be very aggressive to avoid contagion. If a bank run happens in Greece and the ECB refuses to provide liquidity, Greece will default and be out of the Euro. This will lead, at least in the short run, to a deeper crisis in Greece with strong disturbances to the banking sector and businesses. This is exactly what the Germans need to scare the other countries in the Euro area not to follow the same path and stay in the Euro. The costs are the potential losses on Greek debt but at this point very few people believe that Greece will be able to pay its debt.

This is a serious gamble. It requires that German voters accept the new ECB aggressive policies. That the potential losses associated with a Greek default and exit from the Euro are contained and that the other Euro countries play along with this strategy. Very risky.

But maybe I am wrong and the Europeans will find once again a way to kick the can further down the road without either a proper solution or a final crisis but I feel that this time it is different and the possibility of a serious political challenge to the status quo is too high to ignore the possibility of a very volatile period ahead.

Antonio Fatas *is a Professor of Economics at INSEAD. You can follow him on Twitter at* **@AntonioFatas**, *and read his* **blog**.

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