



“Grexit” to Eden?

It is difficult to speculate on what happens next in the brinkmanship going on in the eurozone regarding the continuation of Greece’s membership in the club. Each day, there are conflicting reports indicating the parties are nearing agreement or, conversely, preparing for an eventual, and complicated, exit. While it seems that brinkmanship is to no one’s advantage, the cat-and-mouse game between the various leaders makes for entertaining headlines and helps to foster volatility in world markets. But should it? This issue of *Investment Brief* considers the near-term impacts of a potential Greek exit — or “Grexit” — from the eurozone and whether that outcome would ultimately leave Greece and the rest of Europe better or worse off in the long run.

How Did We Get Here?

There are a few noteworthy items that provide a basic backdrop for how we got to where we are and what it might mean. First, a perfect storm created this particular crisis. Greece, for many years, had been less than disciplined in its fiscal affairs and was allowed entry into the eurozone when its financial characteristics were somewhat suspect from the start. Then, a global financial crisis struck with variable effects across countries in terms of gross domestic product (GDP) (very negatively affecting Greece’s tourism industry). The final blow was the implied borrowing power of the total eurozone-enabling “have-not” countries that borrowed at extremely low interest rates. The result was a massive buildup of debt without any classic economic method for devaluing a currency to pay it back.

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We do need to think about Greece in proper perspective, however. According to the International Monetary Fund (IMF), the Greek economy has a GDP of about €250 billion. This is 1.5 percent of the eurozone overall (€17 trillion) and compares as being a little bit larger than the economy of Connecticut and smaller than Louisiana. Greece’s population of 11 million is also quite small compared to

the eurozone’s 335 million, but the percentage of GDP is larger, at 3.3 percent. The Greek stock market’s total capitalization is \$36 billion USD (and declining), which is about the same amount a single U.S. bank’s cap increased during one year (Wells Fargo, calendar year 2014). Even if Greece eventually exits the euro, the long-term economic impact to the rest of Europe should be limited.

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What Could Happen Next?

Ah, but there is that debt. Some €315 billion of which over three quarters is held by the IMF, the European Central Bank (ECB) or some form of Eurosystem financing. And this, to many, is the rub. The impact of a Greek default upon the already strained eurozone banking system could be substantial. We do note, however, that the amount of capital provided for the Greek rescue efforts amounts to only 3.3 percent of the eurozone’s GDP. Even with the establishment of the European Stability Mechanism and the European Banking Union, there is also the concern of possible contagion effects:

- Might similar strains come from Italy, Portugal, Spain or Ireland?
- Are the circumstances with Greece simply the latest in what could be a string of problems that occur due to fundamental flaws with the nature of the design of the eurozone and the ECB, combined with the effect of home rule and nationalism?
- How will a Greek default and potential exit impact depositors in other countries?
- Will the same cash-withdrawal pattern occur, thus increasing regional financial system illiquidity?
- And what about Germany? Perhaps it is willing to throw good money after bad, because the Greek drama helps keep the euro low, which benefits Germany’s economy through cheaper exports. We also note that the sentiment in Germany appears to be moving toward less patience with Greece’s pushback on calls for austerity.

Segal Rogerscasey Canada's View

For all the uncertainty, it seems clear that continuing to kick the can down the road will simply replace potential solutions with hope. It is unlikely that circumstances will be different three months from now or that the players will somehow have found another answer. So, in the short term, there will likely be more volatility in Europe, as we have recently seen, as long as it is unclear what the outcome of the Greek crisis will be. Continued unresolved turmoil may likely express itself, near term, in a sell-off of risk assets and peripheral Europe sovereign bonds with an accompanying flow of funds to safe-haven assets.

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Europe has begun to grow in general, and while growth is certainly uneven, it appears sustainable. A “Grexit” may deflect that momentum, but also may put an end to speculation and doubt. We note that in recent weeks (and even with the recent announcement of Greek bank closures pending a referendum), the euro’s fluctuation relative to the U.S. dollar and other currencies has become relatively benign. (Is it because no one takes the matter seriously anymore, or are the consequences, good or bad, already priced in — or can they be priced?) Sure, equity markets are experiencing a drop on recent news, but that would just mean that the ECB would be engaged in its monetary easing program for a bit longer, which can work to recoup equity losses.

Greece is better off in the eurozone than out, even though that feels painful for its citizens today. The eurozone, however, stands to gain potentially as much as it loses by resolution one way or the other. Greece should blink. ■

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Questions? Contact Us.

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