

Burning bridges

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If a general is worried about his army fleeing from battle, he can order the bridges across rivers that they have crossed to be burned. Retreat becomes impossible, leaving the army with only three choices – win, fight to the death, or surrender. This is where Greece now finds itself after the population voted 'no' in Sunday's referendum. There is no way to give ground on the negotiations and compromise, the only route is complete victory or utter failure.

The Greek Prime Minister, Alexis Tsipras, may feel he has won a tactical victory. He can honestly say that he is unable to compromise, and now he can say it is up to Greece's creditors to compromise if they want to save the Eurozone. This may be a tactical victory, but it may be a strategic failure simply because it comes too late.

Greece's second bailout programme expired at the end of June, which may sound like an administrative point but is crucial. The establishment of a third bailout programme would require the approval of many national parliaments, including the Bundestag in Germany. The decisions may thus be taken away from the heads of state – and here, the domestic politics in other Eurozone countries are likely to rule. Mr Tsipras may be about to learn that democracy cuts both ways.

Approval to even consider a third bailout programme could take weeks or even months (especially since parliaments may have to be recalled from summer recess). Greek banks are unlikely to last that long. Even with cash withdrawals limited to EUR60 per day, the banks are likely to run out of cash in a matter of days. Reducing that limit even further is likely to just send the economy into a steeper death spiral. Greek banks will only be able to survive with further Emergency Liquidity Assistance (ELA) from the European Central Bank (ECB).

The ECB can hardly justify increasing the ELA for Greece, since the banks are meant to pledge collateral – but much of that collateral is Greek government debt. But the ECB will not want to unilaterally decide to reduce ELA, since this would be tantamount to triggering a bank failure and kicking Greece out of the Eurozone. That is a political decision which the ECB will want to avoid. Masterful inactivity is the likely response – at least until 20 July, when Greek bonds held by the ECB mature. If Greece defaults on those bonds (which is virtually certain without outside support), then the ELA will have to be cut. However, the crisis point is likely to be reached before then. Without ELA, Greek banks would only be able to survive if the central bank prints a new currency.

The creditors are likely to find it very difficult to compromise. To do so would not only be politically unpalatable domestically, but would also send a strong signal to everyone else

that the Eurozone will capitulate when pushed. Greece may be a problem, but it pales into comparison against the problems that would arise if Spain or Italy elected anti-austerity governments. And in any case, capitulate today and you can be certain that Greece will come back for more concessions in the future. Many politicians will simply want to draw the line here and now. That makes a Greek exit from the Eurozone look highly likely.

Why then did Mr Tsipras think this strategy could work? Or did he never intend for it to work? One cannot help but wonder if the entire purpose of his strategy was to ensure that Greece does exit from the Eurozone, but in a way that could be blamed on the creditors rather than on Mr Tsipras. This may not be all that far-fetched – after all, the stated goals of Syriza are largely incompatible with a European Treaty that enshrines a single market and free trade. With their own currency, default and monetisation become possibilities.

If this is the case, and if everyone else knows it, then all we are seeing here is an elaborate political dance. Every offer or statement is designed to make it look like the other side is the one that is being uncompromising. Looking at the initial reactions to the referendum result, both in Greece and in the rest of the Eurozone, it is hard to reject the hypothesis that it is all about positioning the blame.

THE GROWTH ILLUSION

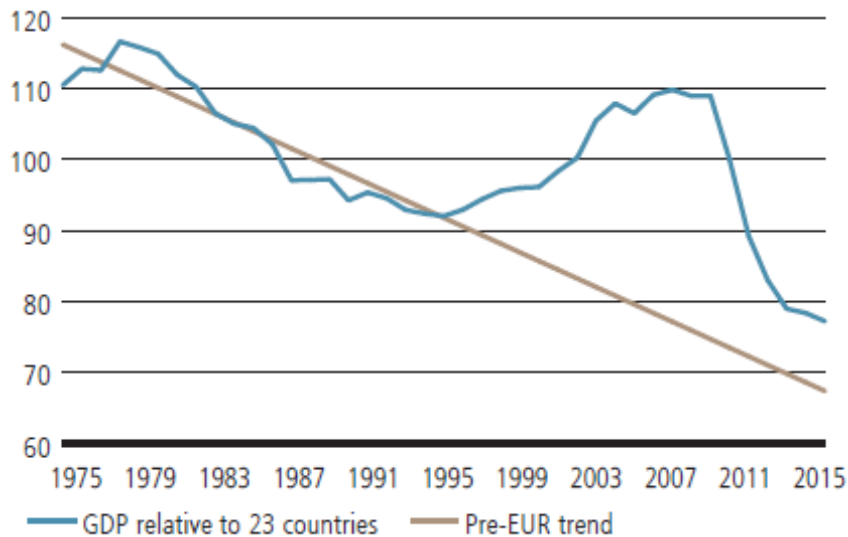
It is pretty clear that the Eurozone would have been better off without Greece, but would Greece have been better off without the euro? It is likely that Mr Tsipras, and many others, believe so. But what does the data suggest?

Rather than look at the level of GDP, which may be capturing many trends that affected everyone, it is better to look at the relative performance of Greece. On this basis, Greece was in terminal relative decline from the mid-1970s until the mid-1990s (Figure 1). Then, as it moved to meet the accession criteria to the Eurozone, the situation turned and after joining the single currency, Greece's relative standing bounced back up.

But since the sovereign crisis hit, Greece's relative performance has collapsed to a new low, although at least it is above the pre-crisis trend. It looks like Greece would have been better off without the euro – but the 'what ifs' of history are notoriously difficult to pin down. If Greece had been outside the Eurozone, it would have found it a lot harder to borrow so much money and become so indebted. The market believed there was an implicit guarantee from the core of the Eurozone (which turned out to be a mostly correct assumption). On the other hand, without that fiscal boost and the lower interest rates it got from the Eurozone, would Greece have been able to escape its relative decline even temporarily?

Figure 1: To have loved and lost

GDP relative to 23 developed countries, actual vs pre-euro trend (2010 = 100)



Sources: European Commission, UBS Global Asset Management

Some would point to the experience of Argentina, which suffered badly both before and just after it abandoned its peg to the USD. But after the initial harsh shock to the economy, growth actually accelerated. The weaker exchange rate may have helped, but more important was that Argentina regained control over monetary policy. With looser monetary policy, it boomed again (though Argentina's current predicament suggests that it may have loosened too much).

But how useful would independent monetary policy be for Greece? The ECB is already engaged in QE and has negative interest rates, which sounds pretty loose. And loose monetary policy can help a cyclical recovery, but not create a permanent improvement. If it could, then there would be no poverty in Africa and Zimbabwe would today be one of the richest countries in the world.

If Greece does end up moving towards exit from the Eurozone, it is unlikely to be a sudden binary move. The first clear step would likely be the issuance of IOUs by the government to pay wages and salaries. If these IOUs are tradable, then they have created a new currency. Or, it could be that the Bank of Greece breaks the rules by providing extra cash to the Greek banks without the approval of the ECB. The risk of civil unrest is then high. If the government falls in the interim, it may not be too late to pull Greece back from the brink, but it may be very difficult.

If Greece is going to remain in the Eurozone, it will need some bridge financing to see it through until a new bailout programme is agreed. But can you provide bridge finance to someone who has just burnt their bridges?

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