BETTER OFF OUT?
The short-term options for Greece inside and outside of the euro

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By

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CONTENTS

Executive summary

- There are clear economic benefits to Greece leaving the euro, but the risks involved in an imminent exit could well outweigh these benefits in the short term. We estimate that if Greece left the euro now, it could still need between €67bn and €259bn in external short-term support, potentially split between the IMF, the eurozone and non-euro countries including the UK. These figures do not include longer-term support or contagion costs to the rest of the eurozone.

- A Greek exit and the withdrawal of ECB support would almost certainly lead to the undercapitalised Greek banking sector collapsing. To avoid a massive bank run and huge losses to pensions, we estimate that banks and pensions funds between them would instantly need a €55bn injection of fresh capital, which would be difficult for Greece to afford without external support.

- The new Greek Central Bank would also need to create at least €128bn worth of the new currency (63% of Greek GDP) in liquidity to help keep Greek banks afloat. This could trigger high levels of inflation, though these might only be temporary.

- At the same time, however, the new Greek currency could devalue by around 30%, which could significantly increase chances of growth, including a potential boost to exports equivalent to 10% of GDP. However, any potential export gain could be diminished if the 'stub euro' weakens or demand in Europe decreases further. Unlike previous devaluations in Argentina and Iceland, Greece has few natural resources or industries to fall back on, which may limit the benefits of devaluation.

- An exit and devaluation could also ease austerity and the pressure on the Greek people, particularly in the long term. However, Greece would still need to find immediate savings of at least €12bn to pay various bills, including hospital and social security expenditure.

- Therefore, two steps would significantly boost the prospects of a managed Greek exit from the euro: first, the banking sector should be recapitalised, shrunk, consolidated and restructured. Secondly, a primary surplus should be achieved to allow the state to fund its day-to-day running costs without external help. This would make an exit far more appealing and potentially beneficial for Greece in the long-term.

- Looking at five different options for Greece over the next year, and taking the factors above into consideration, we assign a 60% probability of a compromise being reached after the June Greek elections, involving a new Greek government (even if Syriza-led). This would see Greece remain in the eurozone. There is still a 25% probability of the country leaving the euro within the next year. We see a Greek default within the euro and the creation of a parallel currency as highly unlikely outcomes. The worst possible outcome would be if Greece left both the euro and the EU. However, even if a compromise is reached, unless Athens is put on permanent fiscal transfers, a Greek euro exit may now be matter of when, rather than if.

- Contrary to popular belief, Greece would be able to exit the euro and still remain a full EU member, possibly using the EU treaties' 'flexibility clause', followed shortly afterwards by a full treaty change. This would change Greece's status from a euro to a non-euro member while allowing for temporary measures such as capital controls to be implemented. This would be a messy and highly unpredictable process, and all member states, including the UK, would have a veto over such changes, which could therefore be subject to various domestic political demands.

Option	What it involves	Pros	Cons	Likelihood
Compromise on current path	- Compromise reached by the Greek government and eurozone leaders. - Will probably allow for a delay in deficit targets for Greece, some more focus on growth (mostly in rhetoric) possibly reduction of interest rate on loans and extension of IMF loans maturity. - Continued financing.	- Avoids Greek exit from euro and immediate Greek default (along with all political and economic costs). - Fits with democratic will in Greece. - May allow time for banking sector to be sorted and primary surplus to be achieved, making future exit easier.	- Temporary solution, current plan still flawed even with adjustments. - More taxpayer money put on the line to fund Greece in the interim with future default still likely. - Moral hazard, Greece continues to receive funding despite missing all targets.	- Remains most likely option. - Even with SYRIZA led coalition in Greece, some compromise likely but far from guaranteed. - **Probability: 60%**
Default inside euro and EU	- Greece defaults, remains in euro, either unilaterally or with acceptance of other EU members.	- Avoids Greek exit and provides the debt relief Greece needs.	- Huge losses for eurozone taxpayers on official loans, leads to significant moral hazard. - Sets precedent for other countries. - Greek incompatibility with euro not solved (still competitiveness issues)	- Almost impossible. - Defaulting on so much taxpayer backed eurozone debt and then asking for more funding seems incompatible and unclear if Greece can remain inside the euro without support - **Probability: 5%**
Default, leave euro and stay in the EU	- Greece leaves euro but with support from EU 27 and transitional funding. - Article 352 used to adjust treaty & keep Greece in the EU, followed by a 'full' EU treaty change.	- Greece gets benefits of exit (devaluation, potential growth, political and economic sovereignty) but costs are shared and managed (default, bank recapitalisation, transitional funding provided).	- Large transitional support needed, €67bn - €259bn. Cost to eurozone without same ability to enforce conditions. - Lower default in exchange for support. - Open to legal challenges. - Concerns over stability of new Greek currency.	- Exit looking more plausible, of all exit scenarios this seems the most likely. In everyone's interest to manage the move as much as possible. - Compromise likely in the short term. Long term without move to full integration or full support for Greece (incredibly unlikely) some exit scenario along these lines is probable. - **Probability: 25%**
Default, leave euro and EU	- Complete breakdown in negotiations, funding to Greece cut off and Greece forced to unilaterally exit the euro. Disorderly default and exit ensue.	- Eventually benefits of devaluation will be realised.	- Banking sector collapse in Greece, potential hyperinflation due to devaluation & money printing. - Huge amount of uncertainty for both sides. Possible political upheaval & social unrest in Greece.	- Very unlikely, but not completely impossible. Negotiations would have to get incredibly negative & hostile to reach this point. Low probability but still a tail risk. - **Probability: 5%**
Dual currencies	- Unofficial currency introduced to run in tandem with euro. Focused on domestic transactions. Devalues relative to euro. - External support for banks maintained in euros.	- In theory allows Greece to gain competitiveness & remain in euro. - Limited upheaval, no institutional change.	- Real proposal is how to deal with banking sector. eurozone guarantee is unlikely, without it plan cannot work. - More eurozone money at risk, significant moral hazard.	- Nice idea in theory but reliant on banking sector support which is unlikely. - **Probability: 5%**

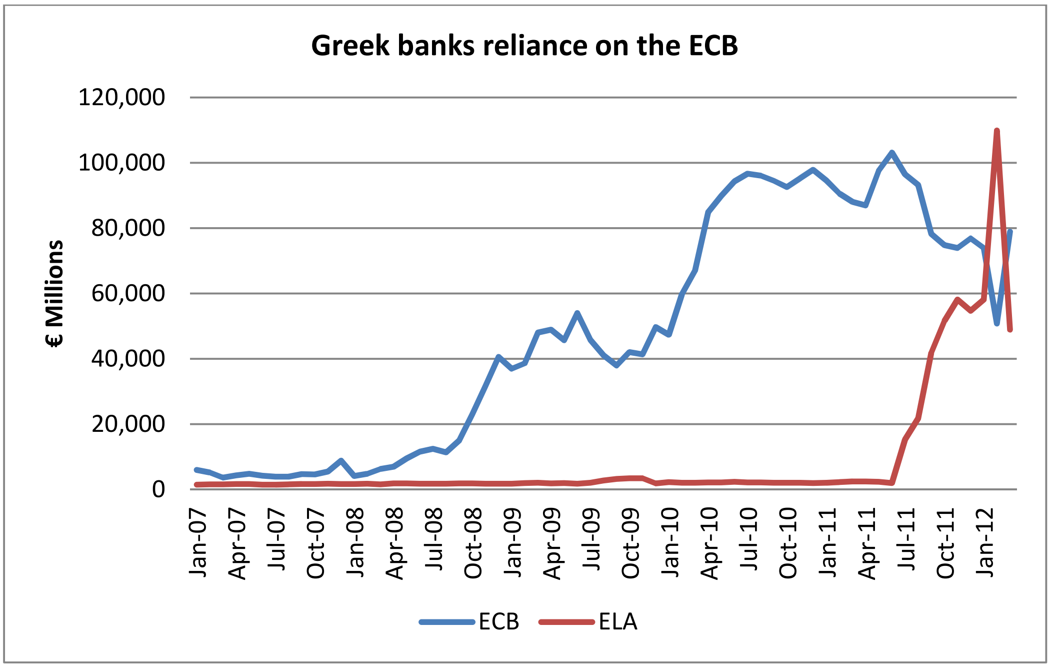
1. IS IT ECONOMICALLY BENEFICIAL FOR GREECE TO LEAVE THE EURO NOW?

With respect to the short-term prospects for Greece and whether it would be economically beneficial for the country to exit the eurozone this summer, four questions need to be answered:

1.1 Can the Greek banking sector withstand an exit?

Having a stable and efficient banking sector is, needless to say, vital for a healthy economy – currently Greece's is neither. Leaving the euro at this moment in time may worsen the state of Greek banks.

Reliance on ECB liquidity: As of March 2012 Greek banks were entirely reliant on the ECB for liquidity, borrowing close to €79bn, having been shut out of the interbank market for some time. Additionally, they were also borrowing a further €49bn from the Greek Central Bank (GCB) under the 'Emergency Liquidity Assistance'.[1] If Greece left the euro, both lines of funding would instantly be cut off, possibly leading to a collapse of the Greek banking sector.



Source: Greek Central Bank

Banks remain massively undercapitalised after the Greek restructuring: Furthermore, Greek banks are currently woefully short of capital after taking huge losses from their involvement in the Greek restructuring scheme, where their large holdings of Greek sovereign debt were written down by 53.5%. Greece has already received €25bn to aid in their recapitalisation and is expected to receive a further €23bn. However, there have been substantial delays in putting this to good use.[2] Leaving the euro would cut off this line of funding, leaving the banks massively short of a working capital level. The banks would have to find other sources of funding to make up for this shortfall (such as greater central bank funding).

[1] This is sanctioned by the ECB but is a liability of the Greek Central Bank and State. Ultimately it is therefore backstopped by the eurozone given the bailout programmes. For a full discussion of this programme see: http://worldcommercereview.com/publications/article_pdf/472

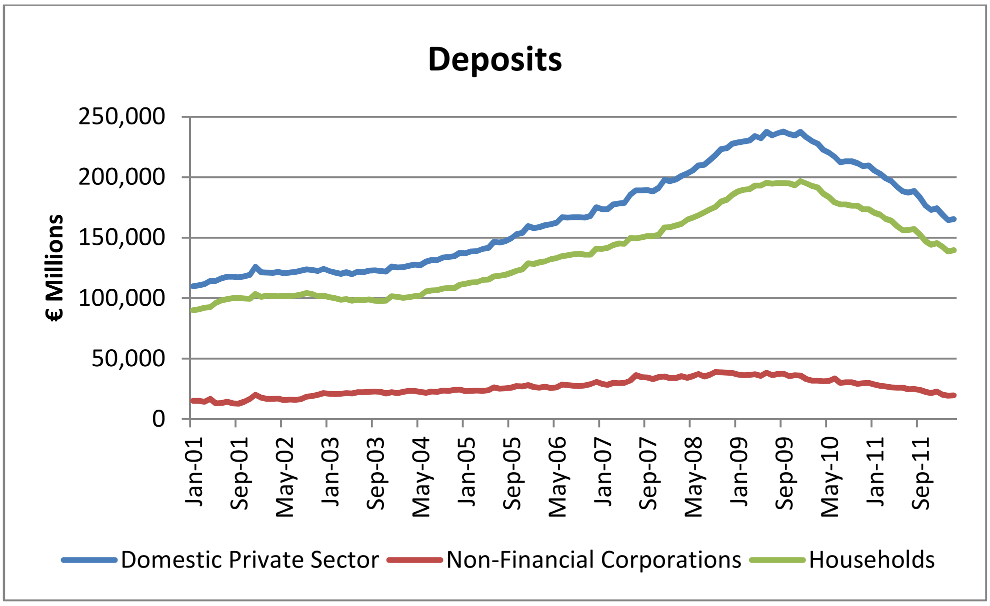
[2] Cited by *Reuters*, 'Greek banks get €18bn recapitalisation', 22 May 2012: http://www.reuters.com/article/2012/05/22/greece-banks-recapitalisation-idUSL5E8GM48W20120522

In addition, if Greece did leave it would likely default on all remaining privately held Greek debt (including to its banks). We estimate this would add another €22bn to the funding needs of banks, giving a total recapitalisation cost of around €45bn (in current euro terms) following a Greek exit and default.

In the same vein, Greek pension funds would also take large losses on the sovereign bonds which they hold, leaving an additional funding shortfall of €10bn. In total, there would be need for a €55bn capital injection, which would have to be provided virtually overnight.

As all other funding sources would be cut off, this cash would almost certainly need to come from the Greek state or the Greek central bank – the former reduces the level of debt reduction, while the later increases inflationary pressures.

Erosion of deposit base: The outflow of deposits from Greek banks over recent months is well documented, with reports suggesting that over €3bn has been withdrawn from Greek banks since the 6 May election, as discussion of a Greek exit from the euro took centre stage.[3] The majority of the decrease has come from households withdrawing their money, which could be down to wealthy individuals moving money abroad, into alternative assets or households running down savings due to unemployment or cuts to benefits, for example.



Source: Greek Central Bank

The erosion of the deposit base further weakens these banks and increases their need for large amounts of liquidity to maintain stability. The threat of bank runs if Greece were to exit the euro is well known, further enhancing fears of a series of bank failures, particularly if any advanced warning of the Greek exit were made public.

The only recourse would be money printing: Since the Greek state is unlikely to have the cash or quality assets needed to stabilise the banks, the most plausible option for Greece would simply be for its central bank to 'print' money to fill the void. At the very least the newly independent Greek Central Bank (GCB) would need to fully replace the liquidity demands for Greek banks, meaning it would need to flood the system with €128bn worth of its new

[3] Cited by *FT Alphaville*, 'Plug-pilling in Athens', 16 May 2012: http://ftalphaville.ft.com/blog/2012/05/16/998501/plug-pulling-in-athens/

currency, equal to 63% of Greek GDP. This will likely need to be increased to account for further outflows of deposits.[4]

Additionally, due to the poor quality of collateral taken on, and the fact that nearly all the collateral in Greek banks will take a sharp downturn in value during a Greek exit, the recovery value on ELA collateral is likely to be close to zero – implying a €49bn loss for Greece.[5] This may require additional transitional funding to cover the loss or a further €49bn in money printing.

The impact of all this could be very high levels of inflation, especially given the already large devaluation (discussed below). In turn, this could undermine the credibility of the Greek Central Bank which has little capital or institutional credibility to fall back on.

Bank nationalisation could be self-defeating for Greece: Full nationalisation of Greek banks – which has been mooted by the Syriza party for example – would likely be self-defeating. The current balance sheets of the six largest Greek banks are equal to 113% of Greek GDP. Fully nationalising these banks and taking on all their liabilities would send Greek debt to GDP skyrocketing once more, reducing any benefit from a default on the current huge Greek debt burden and exit from the euro. Nationalisation would again have to be combined with some money printing as the banks would still require liquidity to function.

Greek banks need to be recapitalised/restructured before Greece leaves: The difficulties for Greek banks in coping with an exit and the knock-on effects on the Greek state, central bank and economy leads to one conclusion: if possible, the Greek banking sector needs to be recapitalised, shrunk, consolidated and restructured following a full assessment of the risks it holds, *before* the country exits the euro. If a credible programme could be established to flush out the Greek banking sector, it would make it far more likely that a Greek euro exit could be managed and contagion contained.

1.2 By how much would a new devalued currency aid Greece?

The key benefit to leaving the euro has always been that Greece would be able to devalue its currency to better reflect the state of its economy. Such devaluation would help restore some of Greece's lost competitiveness and make its exports look far more attractive. If Greece was to leave the euro, we estimate that a devaluation of around 30% could easily be expected for the new Greek currency against the euro[6] – but this could even reach 60% or higher in some scenarios.[7]

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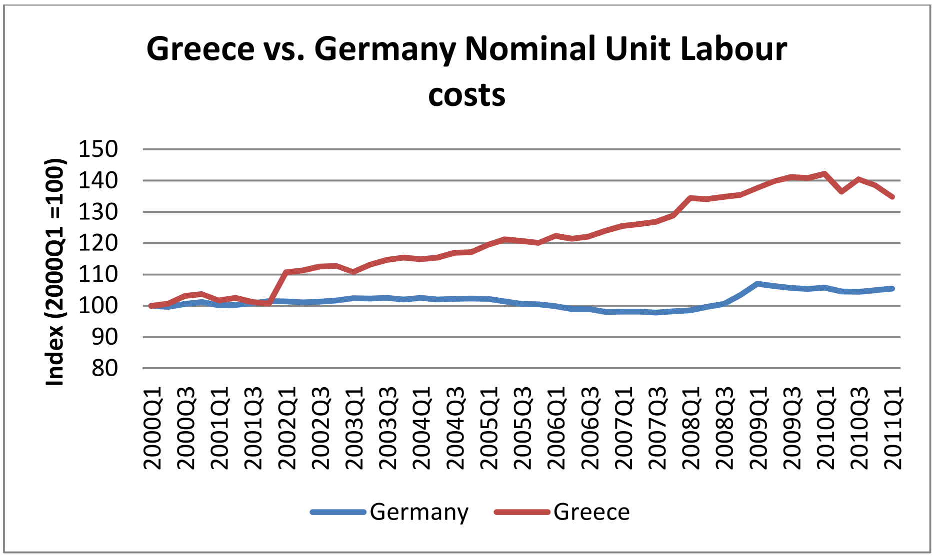
[4] It has been suggested that further liquidity provision or money creation could fill in for deposits if a full scale bank run materialised but this would at best be a short term sticking plaster. JP Morgan noted recently that there are limits to the level of collateral available for banks to borrow against, suggesting that liquidity provision could only rise by another €65bn. Beyond that the GCB could simply give money to banks and increase the monetary base rapidly but this could prove incredibly risky and would undermine trust in the new currency and the GCB.

[5] This impact could be delayed by simply switching the existing ELA loans onto the new liquidity provision by the GCB. However, this would only mask the problems since the loans would still be unlikely to be recovered. If the Greek banks had actually used or lost this money during the turmoil of the exit they would likely renew their demands for similar levels of liquidity.

[6] The competitiveness gap is much lower when compared to the eurozone as a whole or the other struggling economies. This is to be expected and would not represent a fair expectation of the devaluation needed since these other countries also need to substantially improve competitiveness while an un-weighted average which is often used obviously does not fully represent the adjustment needed when GDP levels are taken into account. Additionally their internal devaluation makes their competitiveness levels somewhat of a moving target making a comparison difficult. A similar point has been put forward by Paul Krugman recently: http://krugman.blogs.nytimes.com/2012/05/21/how-overvalued-is-southern-europe/

[7] Other estimates from Nomura and ING put the potential devaluation as high as 60% - 80% respectively, although this is under a wider break up scenario where the new German currency also appreciates. Though taking Germany as a point of comparison may overestimate the devaluation that will follow, the main exporters with whom Greece will compete with for are the Northern European economies (all of whom have similar

Historically devaluations of this size tend to ‘overshoot’ meaning the initial drop could be even larger (50% - 60%). This again highlights the uncertainty which such a move brings, although given the likelihood that Greece will impose capital controls and may have some support from global central banks (discussed later) in targeting an exchange rate means this is less of a concern.[8]



Source: Eurostat

Given the size of the devaluation it is likely to bring some benefits:

Increasing chances of returning to growth: Within the euro, one way or another, Greece is likely to be subject to strict fiscal constraints and a raft of (admittedly necessary) structural reforms. Although both of these may be important objectives for the long term health of the Greek economy, in the short term – if too deep and fast – they risk choking off growth and fuelling a downward spiral. This is particularly true when Greece lacks the flexibility to adjust the mix of these prescriptions or to offset them with monetary policy.

Upadhyaya, Mixon and Bhandari (2004) looked at the impact of currency depreciations in Greece and Cyprus over the period 1969 to 1998 finding that the impact is generally expansionary in the short run and neutral on the economy in the longer term.[9] Given the unique situation of exiting the euro an immediate drop in growth is unavoidable (as seen when Argentina removed its dollar peg). However, following this, a boost in growth can be expected (mostly thanks to a jump in exports boosting aggregate demand, discussed below).

Ultimately, the long term reforms will still be needed but can only be successful if a short term catastrophe can be avoided – at this point that is far from certain in Greece. An exit would afford Greece greater flexibility and allow a better mixture of growth and reform –

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competitiveness gaps over Greece to that of Germany). These are also some of the key import markets which Greece will need to gain access to if it is to grow sustainably once more.
8 The overshooting occurs partly due to market uncertainty and somewhat of a herd mentality but is also expected as the nominal exchange rate compensates for the time lag in the actual adjustment of wages and prices in the real economy. Over the past year we have seen the difficulties in adjusting wages and prices, particularly downwards, in Greece so some delay in this adjustment may be expected.
9 Upadhyaya, K.P., F.G. Mixon, R. Bhandari, (2004), Exchange rate adjustment and output in Greece and Cyprus: evidence from panel data, Applied Financial Economics, Vol.14, pp.1181- 1185. Overall the literature on devaluation presents a mixed picture but there seems to be a general indication that for developed countries over the short term it can have an expansionary effect.

although it is important to note that if the reforms do not continue the short term boost may be wasted.

Source: World Bank

Benefiting Greek exports: A devalued currency would make Greek products far more attractive.[10] Finding historical examples of the potential gains is tricky given the unique nature of the eurozone as a currency bloc. The graph above provides some context by showing the impact of the Argentinian devaluation following its default and removal of its dollar peg at the end of 2001 and the start of 2002. We also show the Icelandic example, where the country defaulted and devalued its currency by over 35% in the space of a few months when the financial crisis hit in 2008. Both countries benefitted substantially from their large devaluations. Argentina's exports rose by around 15% of GDP while Iceland's jumped by over 20% (although more gradually due to the more drawn out nature of the devaluation).[11]

The long term trend for the value of Greek exports before it entered the euro was around 20% of GDP (slightly higher since then), highlighting that, contrary to some reports, Greece does have a reasonable export base which could benefit from a large devaluation.[12]

However, there are also a number of caveats to potential export gains for Greece if it exited the euro. Devaluing an existing currency or even removing a peg is not the same as introducing a whole new currency, particularly since the institutions underpinning the currency will need to be established and build credibility. All the prices and contracts within the economy will need to be redenominated (or not as the case may be), introducing long legal negotiations and likely some high transaction and transformation costs on the economy.

[10] Data taken from the World Bank, see: http://data.worldbank.org/indicator/NE.EXP.GNFS.ZS
[11] The corresponding impact on inflation and economic growth was also fairly large, particularly in Argentina which saw net economic growth of +10% following the removal of the dollar peg. Argentina also saw its GDP deflator triple over the next decade showing a substantial spike in inflation from the move. Iceland's inflation also increased although fairly steadily and not completely out of trend with past GDP deflator growth, while its economic growth saw around an 8% jump from its trough during the financial crisis. Clearly these impacts cannot be solely put down to the devaluation given the huge range of economic factors at play here but are simply provided for context given the comparisons made here. Figures here are taken from the IMF World Economic Outlook database.
[12] Although, it is worth noting that this is far from the levels seen in some other European economies such as Germany 40%+ and Ireland over 100% of GDP.

In addition, both Iceland and Argentina benefitted from having more favourable business climates in general (though in the case of Argentina, IMF-mandated structural reforms were a key factor in the export boost). Argentina's recovery and export growth also came at a time of global prosperity – in stark contrast to Greece whose trading partners are going through tough economic times.

Furthermore, both countries had significant natural resources upon which to fall back on, particularly in commodities. Greece's resources are limited although shipping and tourism do present avenues for growth. It is worth noting that Greece imports a large amount of raw materials (in total imports account for 29% of GDP), including oil (which is equal to 8.3% of GDP) and others important in the production of exports – on net around 65% of Greek energy is produced using imports.[13] This could further hamper the benefits to devaluation as imports become more expensive and it takes time for the economy to adjust away from these, although in the long run this should happen.[14]

Would the euro rally following a Greek exit?

Given that the eurozone will remain Greece's largest trading partner the value of the euro post a Greek exit will be important for a number of reasons, including the impact on Greek exports. The stronger the euro, the more attractive Greek exports look. The strength of the euro ultimately depends on whether a Greek exit will spread to other economies as well, such as Spain and Portugal. The contagion effects are almost impossible to estimate and predict, but clearly more contagion would keep the euro weak for longer. It is possible that following an initial period of uncertainty (however long it may be) the euro will rally strongly. However, although it is true that markets will be relieved to be rid of the political and economic uncertainty which Greece brings to the eurozone, the crisis goes far beyond Greece. Even without Greece, the structural flaws of the euro will remain (one size fits all monetary, and now fiscal, policy as well as large competitiveness imbalances) as will pockets of extreme financial stress (such as the unresolved problems in the Spanish and Irish banking sectors). A weaker euro would erode some of the benefits from Greece's newly devalued currency.[15]

Can high inflation be managed? A large devaluation would be accompanied by a spike in inflation, though this would be manageable in the short term. However, if it became prolonged or was pushed further by other factors (such as money printing to solve a banking crisis) it could drastically hamper the stability of the Greek economy outside the eurozone. Again there are few valid comparisons, although the British exit from the Exchange Rate Mechanism may be one. Many expected a huge spike in inflation, which never materialised despite the devaluation. The same could happen in Greece, although it is worth noting that the British economy was backstopped by a credible central bank and state, something which Greece is unlikely to have under most exit scenarios. Citi estimates that inflation will top 20% for three years following an exit and then settle to around 7%.[16]

[13] Data taken from World Bank, see: http://data.worldbank.org/indicator/EG.IMP.CONS.ZS/countries/1W?display=default

[14] Oil data taken from IMF WEO database, based on estimated 2012 figures; figures on imports taken from Eurostat database for 2011Q1, some fall in the level of imports since then can be expected although data is not available.

[15] The overall level ultimately depends on the policy response to the Greek exit which introduces further unknowns. However, any response from the ECB in terms of extra liquidity or lower rates would usually be seen as negative for the value of the currency, despite being positive for the markets generally. For an excellent discussion of the issues see Citi's Stephen Englander, as cited by Zerohedge, 'And now back to Europe which is more unfixed than ever', 18 May 2012: http://www.zerohedge.com/news/and-now-back-europe-which-more-unfixed-ever

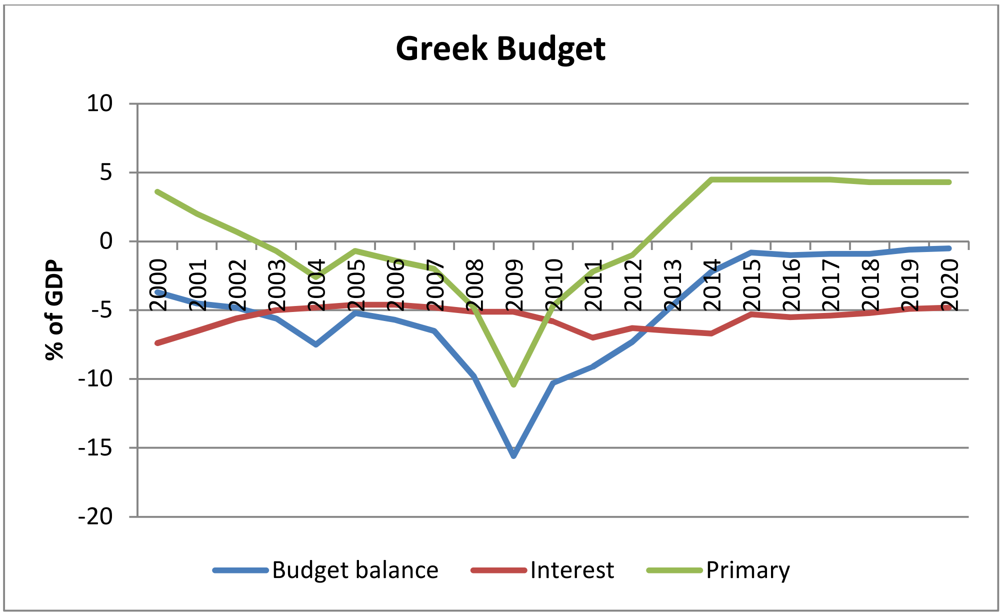
[16] Estimates taken from Citi, 'Global Economic Outlook and Strategy', May 2012 (p.6).

Take away pressure for reform: Devaluation could also take away pressure for pursuing much needed structural reforms in Greece and used to compensate for lack of competitiveness of the Greek economy. Indeed, one of the few benefits of the current crisis is that it does at least push the eurozone periphery into rethinking its labour market models. This needs to be balanced with the need for economic growth, but by no means should be abandoned and forms an important part of the future of the Greek economy whether inside or outside the eurozone.

Overall, then devaluation would come with some clear benefits for Greece but it does also have pitfalls. In any case, given the uncertainty, inflationary pressures and risk of a banking sector collapse, if Greece withdrew over the next six months, the benefits of devaluation may not outweigh the cost of an exit.

1.3. Would an exit be the end of fiscal consolidation for Greece?

It is a widely held belief that the burden on Greece's finances could substantially ease if Greece defaulted on its debt and left the euro, and although possibly true in the long run it may still not mean an immediate end to 'austerity' for Greece. We estimate that, even if it exited, Greece may need to find close to 6% of GDP in cuts (€12bn) quickly and more if some interest payments or debt repayments remain.



Source: IMF WEO

Greece would still need to find cash: The graph above highlights the current Greek budget forecasts by the EU/IMF. The key measure is the primary balance (the amount the government spends relative to its revenue without accounting for interest payments) which is currently -2.3% of GDP and is not expected to be in surplus until the end of this year.[17]

This is not overly concerning given the large adjustment which Greece has made over the past two years (around 9% of GDP decrease in the primary deficit) – finding another 2.3% of GDP even outside the euro should be within reach, but will remain a challenge.[18] The

[17] Although, this relies on Greece achieving the current programme of spending cuts and optimistic growth assumptions, which will likely not be achieved under an exit scenario.

[18] Greece will continue to be locked out of the markets meaning any gap between spending and revenue will have to be closed quickly as it will not be able to borrow to finance such gaps.[19] Defaulting on the new privately held Greek bonds will also be tricky since they are issued under UK law, creating potentially a long and drawn out

determining factor will really be the remaining interest payments which Greece faces, this depends on how much of its debt Greece defaults on. This may seem simple at first – Greece should be able to just walk away from all of its debts leaving almost no interest payments. In theory this may be possible; in reality it is much more difficult.

Defaulting on all debt may not be as easy as expected: Following the second bailout and the Greek restructuring, around 63% of Greek public debt is held by the official sector (EU, IMF, and ECB). Defaulting on this debt, which is essentially the most senior of debt, would make it hard for Greece to continue working with these institutions upon which it is clearly very reliant. If it completely wiped out its debts to these institutions it is hard to imagine Greece being allowed to stay in the EU (whether this is possible at all is discussed more below) or gain any transition funding or support from the IMF and eurozone. Maintaining some of this debt would mean that the interest and principal payments must be kept up, further increasing the austerity cuts which would need to be made to bring the budget into balance even if Greece left the euro.[19] Paying off this debt will probably require external support, this might be forthcoming as it would essentially be eurozone countries paying off themselves while delaying any potential losses.[20]

Large stock of unpaid bills: The Greek government also has a large stock of arrears estimated by the IMF to be over €7bn (3.5% of GDP) at the end of 2011. Under the current plan these are due to be cleared this year, however, if Greece exits the euro this is unlikely to happen. This would further increase the burden on the Greek state. A large amount of this money is owed to hospitals and social security funds meaning that if the state fails to pay out on these commitments there will be a real impact felt by the general population and potentially a large negative social and political fallout.

The shock of an exit is also likely to cause consumption to drop, while the constraints which would need to be imposed (capital controls, limits to cash payments and changeover of hard currency) would have additional hits to liquidity and spending in the economy (as was seen in Argentina after its default).[21]

The key point is that the 'austerity' and fiscal consolidation which Greece is undertaking is not guaranteed to stop if Greece exits at this point in time. Therefore, if possible, it would be beneficial for Greece to wait until it has achieved a primary surplus before exiting, which at least would allow it to run the country on a day to day basis without the need for external support. Given the long term competitiveness problems and the unrealistic expectations of the Greek adjustment programme an exit at some point may return the economic tools to Greece which it needs if the economy is to grow sustainably in the future.

Greater long term flexibility: At the same time, however, on its current path, Greece could well face continued 'austerity' for over a decade and at the very least will be confined to a fiscal straitjacket for some time. The extent and length of the Greek fiscal consolidation programme go above and beyond anything that has been achieved in history – in large part because Greece does not have the option of devaluation (unlike Ireland in the 1980s and 1990s for example) and therefore has to cut much deeper to compensate for a massively

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legal process over the settlement of the debt. Having this hanging over the new currency could be detrimental, although it is worth noting that this did little harm in the Argentinian case.

[19] Defaulting on the new privately held Greek bonds will also be tricky since they are issued under UK law, creating potentially a long and drawn out legal process over the settlement of the debt. Having this hanging over the new currency could be detrimental, although it is worth noting that this did little harm in the Argentinian case.

[20] It might also avoid some tricky legal problems for the ECB. Any losses on the SMP and Target 2 would create legal problems for the ECB and may set a worrying precedent. 21 BofAML cite the example of Czechoslovakia break-up, where the newly formed Czech Republic's consumption fell by 21.4% and overall GDP fell by 11.6%.

21 BofAML cite the example of Czechoslovakia break-up, where the newly formed Czech Republic's consumption fell by 21.4% and overall GDP fell by 11.6%.

overvalued currency. But so far internal devaluation has made little progress and it is highly unlikely that Greece would ever come close to closing the gap in competitiveness to Germany and other stronger economies – as illustrated in graph XX. Over the long term the greater flexibility afforded by an exit and running its own monetary policy would allow Greece to ease up its internal devaluation or at least manage it more carefully.

1.4 How much support would Greece need if it left the euro now?[22]

Given all the factors above, it is therefore clear that Greece will need substantial external support if it left the euro. We estimate that between €67bn and €258.5bn may be needed will the GCB will have to provide another €128bn. The support is broken down below:

i) Support it would definitely need:

Liquidity to banking sector: €128bn
This would likely be provided by the Greek Central Bank, would involve significant creation of new currency and may have inflationary tendencies.

Bank capital: €45bn
Primary Deficit and unpaid bills: €12bn
Refilling pension funds: €10bn

Currently Greek banks are due to receive a further €23bn in capital from the eurozone bailouts to compensate for their losses under the Greek restructuring. If Greece were to leave the euro, and default on their remaining privately held debt, Greek banks could need a further €22bn to help cover new losses.[23]

ii) Support it might need:

Money to pay off ECB and NCB holding of Greek debt (including interest): €57.5bn
Remaining IMF loans: €30bn
Target 2: €104bn

This depends on the exact exit scenario (discussed in detail in Section 3) but if it is still working with the EU and IMF and receives support, some compromise is likely to be reached on Greece paying out its debts to these institutions. We assume all debt owed to the EFSF and eurozone countries directly will be defaulted on (a main benefit of an exit). Since the IMF is always the most senior creditor and will need to play a large role in rebuilding Greece, a deal might be struck to allow Greece to continuing serving this debt.

The bonds held by the ECB and NCBs might also be paid off as this avoids these institutions taking losses which would create legal problems (such as renewed legal challenges to the SMP in Germany) and may require a recapitalisation.[24] We have already seen a similar process take place in May as the eurozone dispersed a tranche of bailout funds despite

[22] These are all calculated in current euro terms. One advantage is that these loans could be given in the new Greek currency so may be made cheaper by devaluation, however, this is only like to aid the repayment of pensions. This is because the deficit and bank recapitalisation costs will be in reference to overall GDP and bank balance sheets both of which would rise under a devaluation, meaning proportionately the amount needed will remain the same. Any euro denominated debts or holdings would also increase in value.

[23] This additional capital need would come from the further losses on the banks' holdings of Greek debt as the state defaulted on all remaining private obligations and also due to losses on other capital assets many of which will be closely linked to the Greek state.

[24] Given that the ECB would have already taken large losses on its €79bn in loans to Greek banks this may a strange course of action. There is however an important differentiation, in that credit risk in terms of liquidity provision is expected and acceptable in terms of the ECB statute, taking losses on questionable interventions into sovereign debt markets is not.

huge uncertainty, since the large majority of the money was used to pay off a bond held by the ECB.[25] The same goes for the Target 2 balance, some of this could be paid off by the GCB but it's unlikely it will have the funds to do this or the credibility to do so (Target 2 balance is currently equal to 60% of the GCB balance sheet, but it only has around €15bn in capital, provisions and gold). Likely need to be done in euros so could not be printed.

Total support between: €67bn - €258.5bn + €128bn (in liquidity support provided internally by the Greek central bank)

iii) How would this support be provided?

Lower bound: €67bn (50% from IMF, 50% from eurozone) (UK share €1.5bn through IMF)

Under this scenario we expect that the IMF would play a larger role than it has in the Greek bailouts to date, as this is the type of crisis for which it was created. In particular its expertise in managing currency devaluations and restructurings would be of vital importance. Support for the banking system and the pension system also provide broader societal benefits as well as benefits to the global economy suggesting a larger global approach might be acceptable.

Upper bound - €258.5bn (62.5% from eurozone, 37.5% from IMF) (UK share €4.36bn through IMF)

In this case much of the funding, €161.5bn, would be used to avoid the ECB (and therefore eurozone countries) taking losses meaning it would have to be paid in full by the eurozone. The remainder used to cover the IMF loans and aid the transition of the Greek economy would be provided by the IMF. In both cases any burden on the UK would come through its IMF commitments.

iv) Could the EU's 'Balance of Payments Assistance' facility be used?

It has been suggested that if Greece exited the euro, but stayed in the EU, the EU's Balance of Payments (BoP) assistance facility could be tapped. The BoP was set up to help countries outside the Eurozone, and in particular member states that joined the EU since 2004, which ran into difficulties following the financial crash in 2008. So far Latvia, Hungary and Romania (x2) have tapped the fund. The facility totals €50bn, with €35bn remaining.

It is very difficult to predict whether this fund would be used, though legally, there is nothing stopping it as the only legal constraint is that the fund should not be used for euro countries (which Greece would not be any longer). For the three countries that received assistance, the usual format of the programmes is heavily focused on the IMF with the BoP often providing only a limited amount (around 30%, although never more than €6.5bn) of funding. There is no direct limit on how much money a single country can receive – the fund was originally limited in size to €12bn but as noted above has now been increased to €50bn (there has been some confusion over this point).[26] Politically it would also be contentious, particularly in the UK which would underwrite roughly 13% of the fund (via the EU budget).

[25] This could be done relatively easily using the 'Escrow account', which stipulates that Greece must always have enough funding in a separate account to service its debts. If some version of this agreement is maintained the support money could be paid out in time and in proportion with maturing debt held by the ECB ensuring it goes straight into the account and not into any other uses.

[26] Council Regulation (EC) No 431/2009 of 18 May 2009 amending Regulation (EC) No 332/2002 establishing a facility providing medium-term financial assistance for Member States' balances of payments: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32009R0431:EN:NOT

However, the BoP has the great advantage of already being agreed and in place, which could bring vital speed to any Greek contingency funding. In addition, decisions to use the facility are taken under Qualified Majority Voting, meaning the UK could and other reluctant member states similar to what happened when the separate European Financial Stability Mechanism was created in 2010. Its use should therefore not be ruled out.

Potential funding scenarios include:

<u>*Lower bound: €67bn (33% from IMF, 33% from eurozone and 33% from BoP) (UK share €1bn through IMF and €2.9bn)*</u>

<u>*Upper bound: €258.5bn (62.5% from eurozone, 30% from IMF and 7.5% from BoP) (UK share €3.5bn through IMF and €2.5bn)*</u>

These are obviously hypothetical scenarios (although based broadly on previous use of the BoP) but indicate that there is potential for a UK liability to arise in terms of transitional support during a Greek exit from the euro. This could range between €3.9bn and €6bn, certainly not a huge amount given the potential implications of a Greek exit from the euro (although this only takes into account the initial support costs for Greece not the contagion effects or any losses on exposure to Greece).

2. IS IT POLITICALLY BENEFICIAL FOR GREECE TO LEAVE THE EURO NOW?

In so far as the politics can be separated from the economics, a euro exit involves a clear political trade-off for Greece: winning back economic sovereignty (e.g. ability to ease austerity measures) but risking years of uncertainty, which in turn can fuel political instability.

2.1 Do Greeks want to leave the euro?

Somewhat paradoxically (given the current situation), democracy and EU membership are still closely linked ideas in Greece, and Greek voters still associate 'Europe' with stability and prosperity – marking a break from its chequered past with 'The regime of the Colonels', for example. The country has spent 31 out of 38 years as a modern democracy inside the EU. This explains why the majority of the population still do not see the euro discussion as a choice between 'austerity' inside the eurozone or 'growth' outside, but as a choice between 'growth and austerity' inside the euro. A majority remains fully committed to both the euro and Europe.

That said there is a tipping point, where the euro and possibly the EU would become directly associated with the austerity and pain which the economy is being subjected to. Post-election opinion polls suggest that we are not there yet. A Kapa Research survey, conducted before the definitive collapse of coalition talks, showed that 78.1% of respondents wanted the new government to do "what is necessary" to keep Greece in the eurozone, as opposed to 12.9% who were in favour of a return to the drachma.[27]

A separate RASS poll indicates that 81.4% of Greeks are in favour of their country staying in the euro, while 16.3% are against.[28] However, the same poll also shows that 38% of Greeks think their country should reject the existing economic programme, even if the move meant "immediate bankruptcy".[29]

Ahead of the 6 May elections, a MRB Hellas poll showed that 67.1% of respondents thought that Greece should keep the euro but tear up the EU-IMF bailout conditions, as opposed to 12.8% saying that Greece should remain in the euro and stick to the memorandum. 13.1% of respondents said that Greece should leave the euro altogether.[30]

These poll results clearly show that Greeks do not see eurozone membership in itself as the problem, as much as the tough austerity measures Greece is being imposed by the EU and the IMF.

Are there any political benefits to leaving the euro? Given the clear democratic support for staying in the euro the benefits seem limited in the short term. The key one is the ability for Greece to retain its economic and political sovereignty. The renewed flexibility should ease tensions and hopefully reduce social unrest and reduce support for extreme parties. However, this depends on how the exit is managed and how toxic it is – a disorderly exit and default could well have the opposite effect.

Over the longer term a Greek euro exit may prove beneficial since first, not being forced to cut cost purely through internal devaluation which could significantly reduce the risk of a political backlash. Secondly, the Greek administration and political culture does not seem well suited to the supranational governance which is being touted as the future for the

[27] Telephone interviews conducted on 9-10 May 2012, on a sample of 1,007 people.
[28] Telephone interviews conducted on 10-11 May 2012, on a sample of 1,002 people, see http://www.rass.gr/surveys/survey_eltypos_140512.pdf, p9
[29] See http://www.rass.gr/surveys/survey_eltypos_140512.pdf, p8
[30] Telephone interviews conducted on 18-19 April 2012, on a sample of 1,007 people, see http://www.mrb.gr/Mrb/media/RN-18-19-04-2012.pdf, p50

eurozone, for example, debt pooling in return for strict, binding and enforceable eurozone budget rules. Forcing it into such a situation could lead to a massive popular backlash, which we are already seeing a taste of. Furthermore, we have already seen the increasing hostilities and political divisions between Greece and other European countries as a result of the imposition of stringent conditions. Removing this tension and this dividing force could actually prove beneficial to the European project in the long term.

Are there any political drawbacks? Leaving the eurozone would mark a large shift in Greek society and politics. If the exit is not managed, it could trigger a prolonged (as opposed to temporary) series of detrimental economic events – including hyperinflation. In such a scenario a Greek exit from the euro could actually be a source of political instability, not the cure for it.

The key question is whether Greece will be able to remain within the EU or not, which directly relates to whether Greece exits with support and cooperation of the other eurozone and EU members or unilaterally decides to withdraw. We address this below.

2.2 Can Greece leave the euro and remain an EU member?

There have been plenty of suggestions that Greece would be forced to leave the EU if it left the euro, though surprisingly little written on the issue. The entries to the "Wolfson Prize" on how to break up the euro largely glossed over the question, for example.

The EU treaties provide no mechanisms for a country leaving the euro, either unilaterally or in a negotiated manner. Nor does it provide for a member state being expelled. There is, however, a mechanism for an EU country to negotiate an exit from the EU as a whole under Article 50 TFEU. The process for this is:

- The country that wants to leave notifies to the European Council;
- Negotiations setting our arrangements for withdrawal and future relations with the EU;
- Agreement concluded by the Council of Ministers (QMV) plus consent of the EP
- EU Treaties cease to apply to the withdrawing country from date of entry into force of withdrawal agreement or after two years from initial notification (the two-year period can be extended)

There are on-going discussions with regards to international law about the right of a country to *unilaterally* withdraw from international treaties and principles for when this can take place – most notably the so-called Vienna Convention. However, in practice, just like any other nation, Greece can unilaterally choose to denounce both the euro as a currency and the EU treaties at any point in time, and create a new set of domestic laws independent of the EU treaties. Whether or not it chooses to is a matter of politics, not law. The relevant discussion is whether Greece can go back on its binding obligation under EU law to have the euro as a currency, and remain an EU member.

Since there is currently no legal arrangement or stage 'between' euro membership and full EU exit, some have concluded that this is not possible - even if subject to negotiations. Austrian Finance Minister Maria Fekter said recently that, "One can leave the EU, the treaty allows for that" but that "Greece can't (simply) leave the eurozone."[31] Similarly, a 2009 paper

[31] Cited by WSJ, 'Greece can't leave the euro and stay in the EU', 14 May 2012: http://online.wsj.com/article/BT-CO-20120514-711313.html

by Phoebus Athanassiou, published by the ECB, concluded that "a Member State's exit from EMU, without a parallel withdrawal from the EU, would be legally inconceivable."[32]

However, beyond attempts at putting pressure on Greece, our view is that there is a way for Greece to denounce the euro but still remain a member of the EU – though this would depend on the nature of the Greek euro exit. There are two main legal scenarios under which Greece can withdraw from the euro, one 'negotiated' and one 'unilateral'. Naturally, the first could allow it to remain in the EU, the other likely seeing it being forced out – either directly or indirectly.

i) Agreement at 27: Greece can stay in the EU

This scenario involves Greece leaving the euro, probably due to the Greek government refusing to adhere to the bailout conditions, leading to eurozone leaders refusing to pay out more bailout money and the ECB cutting of liquidity to Greek banks (which are no longer seen as solvent due to lack of recapitalisation funds). However, even though Greece would not be able to pay both sides would accept that it is still in their best interests to work together to manage the exit, limit contagion and keep Greece within the EU to aid its recovery and reduce political uncertainty.

Crucially, in leaving the eurozone, Greece would be in breach of the EU treaties which oblige it to have the euro as a currency. In theory, Greece could enter and exist in a stage in which it is in breach of the EU treaties on euro membership. Sweden, for example, has no opt-out from the euro and is legally obliged under the EU treaties to join once it fulfils the Maastricht criteria (which it did years ago save some technical issues around its central bank).

However, this is an unlikely outcome for Greece, not least because, as long as its currency is the euro under EU law, Greek debt held by foreign law would have recourse to the EU treaties. This would be a nightmare for Greece, in that redenominating public and private contracts into a new currency would be even more difficult, since legal challenges would ensue and have good cause in courts outside Greece given that legal text defining Greece's currency as the euro would still be in force.

Furthermore, just over 50% of Greek exports go to EU member states meaning Greece gains a large advantage from the favourable trading relationship which EU membership provides.[33] Losing this would likely impose a huge cost on the Greek economy at a tumultuous time, while there is no guarantee that new free trade agreements would be reached with EU members following the hostile negotiations surrounding a Greek exit from both the euro and the EU. A massive rise in the level of tariffs on Greek exports to the EU could substantially reduce the benefits of a devaluation following a euro exit. As noted above the EU is also associated with democracy and fairness in Greece and is widely seen to help promote political and social stability, two things which may already be at risk is Greece left the euro.

Therefore, if it left the euro, Greece has strong incentives to bring the EU treaties in line with Greek domestic law by negotiating a new settlement within the framework of EU law. This can happen in two ways:

- Changing the EU treaties to allow for a euro exit mechanism, perhaps modelled around Article 50 (possibly even simply extending the Article to refer to a euro exit) or the idea – floated by German politicians – to automatically trigger an exit if a state is

[32] Athanassiou, Phoebus, 'Withdrawal and expulsion from the EU and EMU some reflections', ECB Legal Working Paper Series, No 10 / December 2009, see: www.ecb.int/pub/pdf/scplps/ecblwp10.pdf
[33] Figures taken from Eurostat for the end of Q4 2011.

unwilling or unable to comply with the rules governing the single currency. This would require agreement amongst all 27 member states and would essentially be a treaty renegotiation (making it complex and long winded).[34]
- Using existing articles in the treaties which provide flexibility to address a number of issues, such as Article 352, to legally facilitate withdrawal from the euro but not the EU. This would also require agreement amongst all 27 member states and the European Parliament.

Per definition, a decision for Greece to leave the euro has to happen essentially overnight (some estimates have put the real time available at 46 hours). This is problematic as a treaty change could take months, even using the fastest track (the simplified revision procedure, which needs to go through at least some national parliaments).

Historically, political expediency has trumped EU law.[35] Although it would not be clear cut or easy – and involve a legal stretch – we believe that in order to take a swift decision and avoid a Treaty change EU leaders could (and most likely would) use existing provisions in the EU treaties to allow for a Greek euro exit. In particular Article 352 TFEU – sometimes referred to as "the flexibility clause" – allows member states to take measures to achieve EU "objectives" (subject to unanimity and consent of the European Parliament but not ratifications in parliaments), when those are not already provided for in the EU Treaties. Article 352 states,

> *"If action by the Union should prove necessary, within the framework of the policies defined in the Treaties, to attain one of the objectives set out in the Treaties, and the Treaties have not provided the necessary powers, the Council, acting unanimously on a proposal from the Commission and after obtaining the consent of the European Parliament, shall adopt the appropriate measures. Where the measures in question are adopted by the Council in accordance with a special legislative procedure, it shall also act unanimously on a proposal from the Commission and after obtaining the consent of the European Parliament."*[36]

This article could be used to provide a legal temporary avenue for Greece to leave the euro within the framework of the EU treaties. Article 352 has been used before in a variety of cases in particular with social and employment law, for example in the application of social security and its impact on migrant workers.[37]

This would be far from an easy process; there would likely be numerous legal challenges against the move, while the negotiations would be hazardous and subject to domestic political constraints. At the same time legal challenges against the losses on the EFSF loans and possible ECB lending would probably be taking place, while private bondholders would

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[34] Article 50 refers to the procedures for a country to exit the EU. Rewriting this article to allow for an exit from the euro could be possible. States could also look to incorporate an exception to the article which allows for countries exiting the euro to exit the EU as a whole and re-join essentially instantly, somewhat circumventing the issue.
[35] As happened for example when EU leaders agreed over a weekend to use Article 122 in the TFEU (support for member states in case of natural disasters) to create the European Financial Stability Mechanism (EFSM).
[36] Declaration 42 on Article 352 suggests that the article cannot be used to further the powers of the EU or to replace the usually processes for amending the treaty. However, in this instance, particularly if there was broad agreement to allow Greece to exit the euro but stay in the EU it is likely that the article could still be used, with fuller treaty amendments following quickly. It is worth noting that the use of the article would likely be justified to protect the EU under extraordinary circumstances and would not be furthering its power but maintain the status quo.
[37] See Open Europe, 'Repatriating EU social policy', November 2011: http://www.openeurope.org.uk/Content/Documents/Pdfs/2011EUsocialpolicy.pdf, the fallout from amending the treaty fully could be greater uncertainty surrounding the euro, since it would enshrine the possibility of leaving the euro in law. This is concerning but since Greece will already have left the precedent would be set and the knock-on effect of putting it in writing should be limited since in practice it would have already been demonstrated that an exit is possible.

be challenging the repudiation of their Greek bonds (now under UK law following the bond swap) in UK courts – although these are aspects which have to be handled in any exit scenario.

Precisely for this reason, a full treaty change would almost certainly be necessary very soon after the actual Greek exit (and use of Article 352), which would change Greece's status under the EU treaties from a euro member to a non-euro one and recognise, at least in retrospect, that there is a way for a country to leave the euro (under an expanded Article 50 for example). Such a Treaty change would, at least in theory, go some way to counter some of the political uncertainty and legal ambiguity around the status of Greece's EU membership and therefore reduce the risk of legal challenges.

However, a full treaty change would come with its own set of political and legal complications. As with Article 352, a treaty change could only happen if all member states agreed. In addition, the changes would most likely have to be ratified in national parliaments. This could be problematic in some countries, for example in the UK, where MPs may require substantial concessions – such as the repatriation of some powers or safeguards around UK interest as the euro goes though an unpredictable phase – as quid pro quo for agreeing to the change. There may be some serious hostility in other national parliaments as well, including potentially the Bundestag, as at that point, Greece could have defaulted on huge amounts of taxpayer-backed loans.

ii) No agreement at 27: Greece is forced to leave the EU

This scenario involves a complete break-down in negotiations between Greece and its EU partners. Greece could either unilaterally decide to withdraw from the euro, following increasing demands for reforms and budget cuts (in effect renouncing all support), or the negotiations could drag on and get so hostile that bailout funds are halted, meaning Greece runs out of cash and is forced to unilaterally withdraw and institute a new currency.

Without leeway and support from the EU and IMF, Greece would be forced to break numerous EU laws on the free movement of labour and capital to protect its economy (for much longer periods than in our scenario above) while it would need to completely renounce the EU treaties in order to ensure the legal primacy of its new currency. Without doing this holders of Greek debt would have strong support from the EU treaties to tie Greece up in litigation for some time and likely force repayment at some point. The economic impact of this is mixed (Greece could ultimately not pay) but the broader impact on investor sentiment would be huge and there would be little investment in Greece in the interim, pushing the economy and the new currency to the brink of destruction.

As such Greece could likely be forced to use Article 50 to ensure its EU exit and allow it to fully and freely reduce its debt burden and take the steps necessary to rebuild its economy. Being stuck in limbo outside the euro but within the EU, without the support of EU partners would be a very difficult place for Greece to be legally, economically and politically. Investors in particular would be unclear on the situation and managing the impact of this while trying to introduce a new currency would likely be too large a task for any Greek government to handle (especially given the recent political turmoil).

This is an unlikely outcome but not unfathomable. For example, if a Syriza-led government came to power and simply renounced all the EU bailout programmes it is likely that funding would be cut off forcing the situation outlined above. This would likely be the worst case scenario for all involved and would trigger massive political instability, while Greece's ability to adjust its economy and institutions to a life outside the EU (in terms of market access and trade relations), would be a major unknown.

3. WHAT ARE THE OPTIONS FOR GREECE?

There are five broad options or scenarios which Greece could now undertake; below we outline the pros and cons as well as the likelihood and viability of the options.

3.1 Current path with minor adjustments

What does it involve?

Some compromise is reached between creditor countries and the Greek government (assumes one is formed following 17 June elections) as has often been done over the past two years. The compromise would most likely allow for a delay in deficit targets for Greece, some more focus on growth (mostly in rhetoric), possibly a reduction of interest rate on loans – although the scope to do this is limited following previous reductions – and an extension of the maturity of IMF loans.

Pros:

- Avoids Greek exit from euro and immediate Greek default (along with all political and economic costs outlined in Sections 1 and 2).
- Delays complex questions over the future of the eurozone and Greece, something which eurozone leaders have shown a fondness for.
- Fits with democratic will in Greece currently – as we demonstrated in Section 2, a large majority of Greeks still back the country's euro membership.
- May allow time for banking sector to be sorted and primary surplus to be achieved – as Section 1 showed managing an exit may be easier once these problems are off the table.

Cons:

- Ultimately, any compromise will only be a very small sticking plaster. The current adjustment plan is flawed: Greek debt remains unsustainable, Greece has few growth prospects, while the on-going austerity and recession will become even bigger political problems.
- More taxpayer backed funds will likely be put on the line in the interim (transitional funding outlined in Section 1) while a larger Greek default on official loans is still likely in the future.
- Reaching a compromise will be tricky and stocked with potential potholes. Talks risk becoming drawn out and divisive leading to Option 4.
- May lead other countries (Ireland, Portugal and Spain) to expect similar easing of targets and greater compromise if their problems grow.
- Significant moral hazard involved, continued support despite Greece missing all of its targets. Double moral hazard as it once more protects banks from losses.

What is the likelihood of this option?

At the moment this looks to be the most likely option. We expect that even a Syriza-led government would probably compromise given the overwhelming public desire to stay in the euro. On the other side, Germany and the IMF look likely to soften their stance if the other side shows desire to stay in euro and meet some requirements (now more about effort than success). But there is still a risk that Syriza could go the other way, or more likely that the vote would be split leading to no new government being formed and another round of elections (both of which could result in Option 3.4).

Probability: 60%

3.2 Default within the euro and the EU

What does it involve?

Under this option Greece defaults on its debt but remains (or tries to remain) within the euro. In theory this could be undertaken in two ways: unilaterally, where Greece simply repudiates all debt; or multilaterally, where the eurozone allows Greece to default on much or all of its official sector debt.

Following the second bailout and the Greek restructuring, around 63% of Greek public debt is held by the official sector (EU, IMF, and ECB). Defaulting on this debt, which is essentially the most senior of debt, would naturally make it hard for Greece to continue working with these institutions and, in the wake of the default, Greece would probably be disqualified from any funding or support from the IMF and eurozone. In effect, this would involve the first outright fiscal transfer from one eurozone government to another, as the losses on EFSF and bilateral loans would mean that Germany and others have directly financed the Greek state (as the loans are not paid back).

Pros:

- In theory, avoids turmoil of Greek exit (in practice may bring it about), while also giving Greece the debt reduction it sorely needs.

Cons:

- Looks unviable in practice following the second bailout and the fact that a huge amount of Greek debt backed by eurozone taxpayers
- Once such relief is given to Greece, it cannot be turned down for other countries. Therefore, this option would imply an acceptance of an ultimate eurozone backstop for sovereign states and mark a move towards fiscal union, which would be political dynamite after Eurozone taxpayers have faced billions in losses from the Greek default.
- As with option 1 the Greek problems of trying to exist in the eurozone are not solved (monetary policy, value of currency, fiscal constraints, and competitiveness problems).

What is the likelihood of this option?

Almost impossible. Defaulting on so much taxpayer backed eurozone debt and then asking for more funding seems far-fetched. Trust between Greece and the rest of Europe would be eroded to the point of Greece being required – through one mechanism or another – to leave altogether. Before the botched second bailout and restructuring this may have been possible, even desirable, however it is simply not practical now.

Probability: 5%

3.3 Default and leave the euro but remain in the EU

What does it involve?

This is essentially the ‘Agreement at 27’ scenario outlined in section 2. This scenario involves Greece leaving the euro, probably due to the Greek government refusing to adhere to the bailout conditions, leading to Eurozone leaders refusing to pay out more bailout money and the ECB cutting of liquidity to Greek banks (which would no longer be seen as solvent due to lack of recapitalisation funds). Importantly, under this scenario, the decision is seen to be taken reasonably amicably and a managed transition is agreed to be in the best interest of all parties.

Pros:

- Greece gets the benefits of exit (devaluation, growth, political and economic freedom) while the costs are shared and managed (default, bank recapitalisation, refilling pension funds all covered as transitional funding provided).
- Greece holds onto the benefits of EU membership (access to the single market and key trading partners).
- This broadly aligns with democratic support for Europe, although disappoints the large majority in favour of euro membership.

Cons:

- Still uncertainty surrounding even a managed exit. Large transitional support needed: between €67bn and €258.5bn plus an additional €128bn (in liquidity support provided internally by the Greek central bank). This is still likely to come with strong conditions.
- Some debt may be maintained, as the eurozone and IMF lend money to Greece to protect their institutions from legally complex losses. The value of any remaining euro denominated debt would also spiral during the devaluation. This would reduce the level of reduction achieved from the default.
- As pointed out in Section 1 Greece will be locked out of markets for some time, meaning austerity will continue, while hyperinflation remains a threat. To build a credible new currency will also be a challenge.

What is the likelihood of this option?

With a Greek exit looking more plausible, of all the exit scenarios this seems the most likely. It remains in everyone's interest to manage the currency switch as much as possible. Even if a compromise can be reached this time, in the long term without a move to full integration or full support for Greece (incredibly unlikely) the country is likely to leave the euro sooner or later. Indeed, whether a Greek exit can be managed will be a major test for the viability of the entire European project.

Probability: 25%

3.4 Default and leave the euro and the EU

What does it involve?

This option would be similar to the 'No agreement at 27' scenario outlined in section 2. It involves a complete break-down in negotiations between Greece and its EU partners. In essence, talks become so hostile following a unilateral Greek withdrawal from the euro that continued cooperation under the EU treaties becomes impossible, and Greece leaves the EU.

Pros:

- Some benefits from devaluation and flexibility in fiscal and monetary policy. However, very difficult to predict given huge uncertainty about Greece's economic and political position in the global economy.

Cons:

- The costs of both an EU and eurozone exit will be combined at once.
- Given the preceding breakdown in negotiations, Greece will be stuck with poor economic and political relations with its main trading partners (protectionism may come into play).
- Large losses on all sides (see section 1 for impact on Greece).
- Significant risk of social unrests and political instability as EU membership no longer provides a check on Greek governance and politics

What is the likelihood of this option?

Very unlikely, but not completely impossible (as it once seemed). Eurozone-Greece negotiations would have to get incredibly negative and hostile to reach this point. If a short term compromise is reached as part of a Greek euro exit, this option becomes far less likely in future.

Probability: 5%

3.5 Introduce dual currencies, essentially remain in euro and EU

What does it involve?

Various proposals have been put forward, with the most recent and probably most prominent being Deutsche Bank's 'Geuro'. The idea essentially involves Greece officially staying within the euro, using the currency to support its banking system (probably with external support) and deal with foreign debts, but using a separate currency (possibly based on IOUs) for domestic debts and transactions. The domestic currency devalues delivering the reduction in costs and improved competitiveness needed. Importantly, under the 'Geuro' plan Greek banks are taken under European administration, basically offered a blanket guarantee from the eurozone.

Pros:

- In theory this would allow Greece to regain competitiveness but stay in the euro.
- Avoids much of the political and economic upheaval associated with an exit - a new currency can be introduced slowly and controlled by Greek governments' borrowing needs.
- No significant institutional or legal changes needed, although some 'menu' costs will fall on the economy as switch to new internal currency takes place.

Cons:

- The key idea with many of the proposals is not actually the dual currency but how to deal with the banking sector – once this is sorted the actual currency issues are much easier to deal with. The 'Geuro' assumes a blanket guarantee for Greek banks from the eurozone. This would be political dynamite in northern European countries, making it incredibly unlikely. It would also represent a large risk for these states to take on and may impact their credit ratings in some cases. Without this, the plan could probably never work. Ultimately, the issue of supporting the banking sector and dealing with their euro denominated debts is at the heart of this issue and remains almost impossible to solve.

- The exchange rate of the new currency may still be unstable, while higher inflation remains a threat in Greece if prices adjust to compensate for new devalued currency.[38]
- Creating a credible unofficial currency is difficult, particularly when solely backed by the Greek state which many people may not see as credible. People may simply decide to stick with euros as much as possible making it hard to get the currency off the ground.
- This again requires eurozone taxpayers to take on further burdens in the form of continuing to support Greek banks and the country's external debts. If the new currency fails this could prompt a full exit and even larger losses for the eurozone.

What is the likelihood of this option?

Again this option sounds plausible in theory but in practice the banking sector problems outlined in Section 1 make it very unlikely that a dual currency system would work in Greece. Unless Europe moves to a eurozone wide bank guarantee and resolution system (and is willing to incorporate Greece) this option will be impractical. Some version of bank guarantee schemes are being discussed but are some way off and may not include Greece or at least not to the extent needed.

Probability: 5%

[38] For an interesting assessment of the issue see Gavyn Davies blog for the *FT*, 'A parallel currency for Greece?', 24 May 2012: http://blogs.ft.com/gavyndavies/2012/05/24/a-parallel-currency-for-greece/#axzz1vh5d4DqR

4. CONCLUSIONS

There are potentially some benefits from Greece leaving the euro, but the risks in involved in an imminent exit – most importantly the potential bank collapse and the knock-on effects that would have on the entire Greek economy – could well outweigh these benefits. If possible, therefore, the Greek banking sector needs to be recapitalised, shrunk, consolidated and restructured *before* the country exits the euro.

In addition, due the on-going funding needs of Greece even in the case of a default and exit, it would be highly desirable for the country to achieve a primary surplus to allow it to more comfortably pay for the day-to-day running of the Greek state and economy. If these two were achieved, a Greek exit would be far more manageable for both Greece and the eurozone.

Despite the extremely complicated political situation in Greece itself as well as between Athens and the rest of the eurozone, there is still scope for negotiations over the second Greek bailout. The most likely outcome following the Greek elections on 17th June remains a new compromise, which would allow Greece to remain in the eurozone. However, even with such a compromise the country's future inside the Single Currency remains highly uncertain. Without permanent transfers or willingness to accept a decade or more of austerity, questions over whether Greece can remain a member will resurface before too long.

ANNEX: Methodology

Transitional support: The bank recapitalisation is estimated by adding the remaining needs (€23bn) to the potential losses if Greece defaulted on 75% the remaining bank debt held by Greek banks (around €29bn following the Greek restructuring) for the lower bound scenario. The default rate would in all likelihood actually be closer to 100%. The same calculation is made for pension funds (and other Greek non-banks) which hold around €13bn in Greek debt following the restructuring. The higher bounds are calculated using the remaining debt estimates shown in the main body of the paper, it is likely that each organisation would only allow funding to be used to pay off debts to itself, hence the structure of the higher bound bailout plans. The deficit needs are calculated by adding the current deficit to the level of arrears facing the Greek state currently.

Devaluation: The level of devaluation in the new Greek currency is based on the disparity in labour costs between the likes of Greece and Germany. The overshooting is based on historical examples of devaluations which tend to overshoot by 10%-15% in the short term, given the uniqueness of the Greek situation this could be even larger for Greece.

Funding scenarios: These are obviously hypothetical scenarios but based on previous experience. Generally the burden has fallen more heavily on the eurozone than the IMF, however, if Greece were to exit the euro it is likely that the IMF would take on a larger role especially given its experience in dealing with such situations. The balance of payments facility use is based on its use in other packages and its remaining funds, as well as the role of EU funds in other eurozone bailouts (it is worth noting here that it is possible for some funds to be provided by the EU underwritten European Financial Stability Mechanism, although it only has €11.5bn remaining).

Probabilities: These are our own estimates of how we believe the situation in Greece will play out. They are based on the information provided in this paper, in particular the threat of a banking collapse in Greece, potential hyperinflation and the remaining strong public support for Greece to stay in the euro and the EU. They are aimed at the short term, with a maximum time horizon of around a year (although main timeframe of six to nine months). As we demonstrate, although we assign them lower probabilities, at this point in time no extreme scenario should be ruled out.