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Are Markets Judging the Risk of Grexit Correctly?

Assessing the impact of a Grexit on financial markets and the Eurozone economy.

By Michael Heise, July 3, 2015

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On Sunday, Greek voters will decide whether they want to accept the creditors' terms for a bailout program or not.

That is not an easy choice to make, not least because many Greeks might be confused about precisely what they will be voting on.

The chances that they will vote "Yes" are somewhat greater than even in my view.

But what if they say "No"? It is hard to envisage a scenario under which a government with a mandate to reject another bailout could reach a deal with Greece's creditors.

In case of a "No" vote, **Grexit is the most likely consequence**.

What then? For Greece, an exit from the Eurozone would be an economic disaster. For its current Eurozone partners, the impact would be tangible, but manageable.

No crash, little contagion

So far, Europe's financial markets have remained fairly calm, despite the rollercoaster of the Greek crisis.

Germany's main stock indices, the DAX, for example, fell by less than 5% in the first two trading days after Alexis Tsipras walked out on the talks with Greece's creditors.

That is a correction in a jittery market, not a major slide.

There hasn't been much contagion in those Eurozone countries that investors used to worry about in 2011/12, at the height of the Eurozone debt crisis.

The risk premiums on Italian and Spanish long-term bonds widened by only 30 basis points.

The key question is: Are the markets judging the risk of Grexit correctly? If they are, then their reaction, in case Greece really does leave the Eurozone, should be muted.

If not, then the limited fall to date in equity and bond prices could be a sign that investors are only now waking up to the Grexit risk.

If that risk materializes, markets could spiral down in a panic.

So which one is it? I reckon that the answer lies somewhere in between. Grexit is not fully priced in. But neither is it likely to cause mayhem in the markets.

One reason for a more muted reaction is that Grexit would not be an event. It would be a process, probably an agonizingly slow one. To be sure, that process would be surrounded by great uncertainty.

Therefore, it would put a dampener on markets for some time and European equity prices would end the year below the levels at which they started 2015.

However, there would be no crash – and, crucially, very little contagion. The latter was the great worry in 2011/12, when Grexit looked likely for the first time.

Back then, it was not clear whether the exit of one Eurozone country could force others out of the single currency, too. Today, things are different.

Four reasons for a muted response

First, the Eurozone now has emergency lending facilities in place, most notably the European Stability Mechanism, and also the foundations of a banking union.

Second, in 2012, policymakers and investors feared that Grexit could be another “Lehman moment,” the shock of finding out just how interconnected our financial system has become.

Today, more than 80% of Greek debt is held by sovereign creditors. And those private creditors and foreign banks that hold the rest have had plenty of time to consider what a default would mean for them.

Third, the Eurozone members that were once considered “crisis countries” look much more solid, after years of budgetary consolidation and reforms.

Spain, Ireland and Portugal have closed their external deficits and are all on course to grow by 2% or more this year.

Fourth, in 2012 there were questions as to how far the ECB would go in defense of the Eurozone.

Since then, Mario Draghi has promised repeatedly to do whatever it takes to keep the euro together and has launched a large-scale asset-purchasing program, including government debt.

Today, few investors would want to bet against the ECB.

For all these reasons, Grexit would not result in a dramatic increase in risk premiums.

The yields on long-term Spanish and Italian bonds would probably not climb above 3%, a level that would not make debt service in these countries prohibitively expensive.

Beyond financial markets

What about the wider economic impact of Grexit? Greece accounts for less than 2% of the Eurozone economy. So for most other European countries, trade-related losses would be small.

However, there might be indirect effects to worry about. In Europe's fragile post-recession environment, business expectations are still extremely sensitive to external events.

Studies have shown (**Aspen Institute, April 2015**) that the level of uncertainty surrounding business decisions has increased. In turn, this has held back investment.

The prolonged uncertainty that would surround the process of Greece leaving the euro and introducing its own currency would give business leaders something to worry about.

For example, expectations in the German industrial sector have been subdued for two months already — which could be an indicator of things to come.

While uncertainty would weigh on economic activity, it would not push the Eurozone into recession.

The impact on growth would likely be in the vicinity of 0.25% of Eurozone GDP in both 2015 and 2016.

Notably, it would probably be less in the unlikely event that the euro falls sharply on Grexit fears. Such a turn of events would boost the exports that Eurozone countries sell to the rest of the world.