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Why the Greeks will back down soon

by Michael Heise

The situation in Greece is coming to a head. Financial markets have given a clear answer to the new government's plans to slow reforms and fiscal consolidation. Once again, Greece is cut off from the markets, share prices are tumbling and anxious citizens are withdrawing their money from Greek banks, which are entirely dependent on the European Central Bank. Tax payments and investment decisions are being postponed, and the slight improvement in consumer and business sentiment that started in 2014 is at risk of reversing. If Athens and its creditors do not find a solution soon, the painful adjustments that the Greek population has been through in recent years will have been in vain.

Germany and Greece's other European partners want the country to stay in the eurozone, as do the vast majority of Greeks themselves. Europe's political will to accommodate the new Greek government, however, also depends on the economic and financial costs that a Greek euro exit would entail. These are easier to calculate today than during the turmoil of 2012.

The eurozone would not collapse like a house of cards if the "Greek card" was pulled out, as the new Greek finance minister would have us believe. After all, the main reason for the instability of recent years was a looming insolvency in Greece and the resulting risks of contagion to other eurozone countries. Monetary union could actually become more stable if it was made crystal clear that its rules have to be adhered to. The risk that other euro countries would follow a Greek exit looks small. For Greece, exit would mean a further collapse in incomes and wealth and it would amount to political capitulation – not something that other euro countries will hasten to emulate.

A Greek exit would also come at considerable cost to taxpayers in the partner countries. The emergency loans from other European countries and the ECB would have to be written off, at least in part. And it is unclear to what extent the Target2 obligations of the Greek central bank vis-à-vis the Eurosystem – €49 billion at the end of 2014 – would be settled. The recapitalization of Greek banks that would be inevitable after a euro exit would also cost money. The other European countries would presumably offer help here too, if only out of self-interest.

Unlike the economic costs, the political consequences of a Greek eurozone exit are impossible to calculate. Even without the single currency, Greece would most likely remain in the European Union. It would have to establish partnerships with the other member-states on a new basis. Meanwhile, the international standing of both the European Union and the euro would take a serious hit -- at a time when geopolitical challenges demand a strong and united Union.

A solution that is in the interests of both Greece and the rest of the eurozone looks eminently possible. We should hold the Greek government to its promises of collecting all due taxes, fighting corruption and improving the legal system. Such reforms could improve the Greek economy profoundly. In return, a limited raise in social benefits and minimum wages is acceptable. Greece's partners have to draw the line, however, at the principle that the Greek budget has to be more or less balanced. A return to budget deficits would be the end of efforts to manage and reduce Greece's debt mountain. Such a move would be impossible to sell politically, given how much debt relief Greece has been granted in recent years.

Greece's European partners could agree to a further extension of debt maturities – which in any case stretch into the second half of this century – and further interest relief as a sign of solidarity. For this to happen, Greece has to prove that it is serious about living within its means, which implies that some election promises cannot be kept and that state expenditure can rise only as tax revenue increases. The EU, meanwhile, should support investment in Greece, in particular through vigorously implementing the "Juncker Plan" there.

Given the horrendous costs that a euro exit would entail for Greece, it should be possible to persuade the Athens government to pursue a more pragmatic course. If Greece's European partners cannot persuade it, the financial markets certainly will.