

Beyond Greece

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Over the weekend, a colleague wrote at Schumpeter on a conference he'd recently chaired:

At an Economist Conferences event for CFOs and finance directors in London this week, I asked the audience whether Greece would end up leaving the euro zone. Every single hand went up. Asked whether more countries than Greece would leave, roughly two-thirds of the audience agreed they would...

It is already happening, after all: a 70%-plus fall in the net present value of private-sector bonds counts as a pretty severe pasting for investors. The worry is the unpredictable impact of a euro-zone exit, not just for Greece but for the rest of the euro zone. The Economist has argued for a Greek default for a year, but always on the presumption that default need not mean exit. But it is ever harder to envisage a situation in which official creditors take a loss on their Greek bond holdings, which is needed to put Greek debt on a sustainable footing, but also agree to keep funding the country until it starts running a primary surplus. Default and exit are becoming inseparable.

Which brings us to the third reason why exit is likely. The prospect of euro-zone departures (even multiple ones) doesn't scare people as much as it should. The overall mood of the delegates at the conference was relatively sanguine about the effects of an exit. Contingency plans were in place at their firms to deal with it; this wouldn't be another 2008.

Yet 2008 is what the current situation ominously resembles...

Default and exit are increasingly intertwined, because the political limits to support for the Greek economy are looming, if not already breached. With great difficulty, euro-zone leaders agreed a new bail-out plan for the struggling Greek economy, but it is far from clear that the obstacles to implementation—financial and political—will be managed. Even if they are, another bail-out will probably be needed; the fiscal and growth goals for the Greek economy built into the new bail-out are extremely optimistic by several analyses—including one prepared for euro-zone finance ministers. It's hard to imagine another billion-euro package being put together for the struggling Greeks.

Not least since euro-zone leaders seem to think they're prepared for exit. And maybe they are; they have had almost two years to cut exposure to Greece and prepare for the worst. My colleague is right, though; officials don't allow terrible things to happen if they can help it, and usually when terrible things happen it's because leaders didn't think they'd be so bad—like the Lehman bankruptcy.

This week, the European Central Bank will shower the euro-zone banking system with another burst of cheap liquidity via its second round of long-term refinancing operations. Since the first round of LTRO lending back in December, there has been a substantial recovery in most (though not all) of the prominent crisis indicators. Measures of financial stress reversed, equities rose, and Spanish and Italian sovereign-debt yields came back to manageable, though still elevated, levels. This dynamic, I think, is a big reason why there is such complacency about a Greek exit.

What the LTRO has not necessarily improved, however, is the state of the peripheral economy. A reduction in the threat of broad financial crisis has allowed the German economy to regain its footing. Across the periphery, however, the bad news continues to accumulate. Output will probably contract across southern Europe in 2012. Portugal's situation, especially, looks dire. A contraction of 3.3% is forecast for the year. Its government is on track to hit its short-term fiscal goals—thanks largely to one-off measures that can't be repeated in future.

Whatever happens to Greece, it is becoming increasingly difficult to pretend that the most unpleasant dealings with that economy—repeated bail-outs, private-sector involvement in debt restructuring, and missed deficit targets—will not be allowed to occur elsewhere. Europe is breathing easier about a Greek exit. If it wants to ensure that a departure isn't a swift route back to acute crisis, its leaders need to do far more to establish a firewall between the damned and the purgatorial. But that's what people have been saying since the beginning of this mess.

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