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What Would Happen if Greece Leaves the Euro Zone?

The Grexit Dilemma

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Banks across Europe, including the European Central Bank, are preparing for the possibility of Greece leaving the euro zone. With Athens and Brussels still at odds, such an eventuality seems more realistic than ever. But how disruptive would a Grexit really be?

On Wednesday of this week, 30 top managers at a large German bank all received a text message and an email at the exact same time. A short time later, their mobile phones rang with an automated voice giving them all passwords and a number to call at exactly 8:30 a.m. to join a teleconference with the board of directors.

The communication blast was the initial step of the bank's emergency "Grexit" plan, a strategy laid out in a document dozens of pages long detailing exactly how managers should react in the event that Greece leaves the euro zone.

Each of the 30 bank managers were required to work through the emergency measures pertaining to his or her division. Information was to be transferred to the supervisory board and public officials were likewise to be kept informed as was the German Finance Ministry. The plan also called for large investors to be put at ease. Questions pertaining to potential bank losses from

Greek bond holdings were to be addressed as were changes in monetary transactions with Greece once it was no longer part of the common currency zone.

The response also extended to internal bank communication, with instructions to employees for dealing with the new situation posted in the financial institution's intranet. Customers and stake holders were also to be kept informed.

At exactly 6 p.m., the crisis came to an end, as did the work day. Plan "Grexit" was just a dry run, nothing more. At least not yet.

Such scenarios are being acted out across Europe these days as companies, banks and governments all prepare for the kind of worst case scenario that isn't even addressed in euro-zone statutes: the exit of one of the common currency area's member states.

On Thursday, Greece's new government under Prime Minister Alexis Tsipras finally applied for an extension to its bailout program. But, from the perspective of German Finance Minister Wolfgang Schäuble, he failed to fulfill the conditions laid down by the Euro Group. Chancellor Angela Merkel spoke on the phone with Tsipras and negotiations have continued, with the next major round scheduled for Friday night. But even if a compromise is found in the end, the game of high-stakes poker will not be over. Both sides would have to agree to a new plan for nursing the country back to financial health.

Far from Simple

Greece's creditors, now known as "institutions" rather than the "troika," will not just have to reach agreement with Athens on interest rates and payback periods, but also on issues such as the minimum wage and increases to retirement benefits. A possible "Grexit," as Greece's potential euro-zone exit has come to be known, would loom over the talks the entire time.

Such negotiations would be far from simple. On the one side are supporters of Tsipras' left-wing populist Syriza party, many of whom still live in the 1970s-era world of communist splinter parties. On the other side, the 18 euro-zone finance ministers have joined together to torpedo Tsipras' campaign promises. Syriza wants to increase public spending while the Euro Group wants to reduce it. Athens plans to increase the number of civil servants while the Euro Group believes public spending should be cut further. The Euro Group believes the privatization of publicly held assets should be a priority, but the Tsipras government has put the program on hold for the time being.

The climate is a poisonous one. For weeks, Prime Minister Tsipras and Finance Minister Giannis Varoufakis have presented their euro-zone partners with billions in demands without providing a single realistic proposal for how the plans should be paid for. Finally, Schäuble gave the Greeks an ultimatum in the notoriously wobbly English he often uses when things get serious. "On February 28, 12 p.m.," he said "is over."

Indeed, Schäuble seems at times to be playing the role of a strict father trying to keep his rebellious teenager in line. Many Greeks, though, have felt humiliated by the tone of the debate

and it is hardly one that is appropriate for the task at hand: that of finding a compromise between two semingly irreconcilable positions.

Success depends largely on Tsipras making concessions. To be sure, he may well be granted interest rate relief or be allowed to improve social conditions in Greece. But he would also have to agree to continued austerity and to implement the reforms demanded by his country's creditors. And that would be the exact opposite of what he promised Greek voters during the campaign.

The only other option would appear to be Greece's departure from the common currency union, the possible effects of which both sides are busily calculating. What would abandoning the euro do to the Greek economy? How high would the costs be for the euro zone? What would be the political consequences were Athens to turn away from Europe?

The European Central Bank (ECB) is also preparing for a possible Grexit. Officials are busily performing internal simulations to determine how the rest of the euro zone could be kept together if Greece goes. ECB officials believe that chances of a Greek exit have increased in recent days and, despite their strenuous denials, are urging Athens to finally implement capital controls in order to stem ongoing capital flight. Every day, Greeks are sending in excess of a billion euros abroad, the ECB believes.

Everyone involved insists that they don't want Greece to leave the common currency union. But it could ultimately become unavoidable if the political chasm between Athens and Brussels proves unbridgeable.

Headquarters

The party's heart beats on Koumoundourou Square, though the fact that it is still beating is rather astounding given the thick cloud of cigarette smoke that permeates the seven floors housing Syriza's headquarters. The high-rise is located in the heart of Athens' Chinatown.

The party leadership is in parliament to elect a new president during our visit. But the party's base camp, the cafeteria on the first floor, is full. The prevalence of experienced functionaries, men with gray stubble and corduroy sport coats, all of them communists who insist they "are not dogmatic," is notable. One of them is 61-year-old Alekos Kalivis, a member of Syriza's politburo, a labor union leader and a retired bank employee. "The Germans and the European elite want to suffocate us," he says, taking a long drag on his cigarette. "Why? Because they don't want Greece to become a precedent."

And what if the Euro Group remains unconvinced by such arguments? "They have to be convinced, otherwise it would be as if the election hadn't taken place. We can't, in any case, accept any solution that requires us to abandon our principles."

"Even if we fall in battle," Georgia Filiou, who works in the café, yells over from the sink, "then we'll fall with our heads held high." She dries her hands, goes over to her laptop and begins talking about the "180 billion that you Germans still owe us from the war."

The Syriza headquarters is its own world. Internationalist, but somehow screened off from the outside world and unexpectedly homey. It is a political refuge where the old certitudes still exist. But it is a refuge that has given birth to the new government of a European country in the 21st century. And it is a refuge that gives Tsipras the support he depends on. How many disappointments can his followers absorb?

"I have waited my entire life for anger against the system to reach the middle classes," says Vassilios Primikiris. "Now it has." The 63-year-old anesthetist spent the Greek military dictatorship in Italian exile. Now, he is in Syriza's central committee.

He says that Syriza is doomed to succeed and insists that the Tsipras government still has leverage in Europe. "A Grexit would be the most expensive solution for all involved," he says. And afterwards, he continues, the sharks would begin searching for fresh prey such as Italy or Spain. "Ms. Merkel," Primikiris says, "is Europe's gravedigger but it only appears as though Tsipras is as isolated as Iphigenia. He's not. And it is Agamemnon, the ruler, who will die."

The Commissar

Valdis Dombrovskis is a shy man. The new vice president of the European Commission is a trained physicist and has acquired the reputation in Brussels for being one of those politicians who only speaks when he has something to say.

Furthermore, the 43-year-old from Latvia knows how to navigate a country through financial difficulties. When the Baltic state became engulfed by the financial crisis in 2009, Dombrovskis was prime minister and he immediately reduced the number of civil servants on the government payroll by 30 percent and cut the salaries of those remaining by 40 percent. Two years later, his country's economy was growing once again. "You convince the financial markets that you are serious about the adjustment and you restore financial stability," he told the BBC in 2011, explaining Latvia's success story.

Now, Dombrovskis is Commissioner for the Euro and Social Dialogue and has opted for a strict approach to the debt dispute with Greece, a position he justifies with his own political past. "According to the program, Greece only receives funding under certain conditions," he says, "and that will remain so after March 1 as well."

Dombrovskis doesn't understand the Greeks. Prior to elections in January, the situation had been improving in the country. The government in Athens was bringing in more money than it was spending -- at least once interest payments were factored out -- and the economy was growing. The Organization for Economic Cooperation and Development (OECD) recently noted the country had made "impressive headway."

At the time, Athens would have had good chances of receiving new aid from Brussels, which would have created greater maneuvering room for the government to make its own decisions about its budget. But Tsipras' election radically altered the situation. Many Greeks either stopped paying taxes or paid less in anticipation of the tax cuts he promised during the campaign.

Meanwhile, companies slashed investments out of fear of the leftist government. The result is that now the holes in the national budget are as big as they were before.

Sources in Brussels say that the first steps taken by the new Greek government have destroyed any hopes for greater leeway. "Now there is no other option left for the Greeks but to apply for a comprehensive third bailout program," one Brussels insider says. And Dombrovskis, the man who had for years preached austerity and sacrifice to Latvians, is showing little inclination to bend over backward for the Greeks. It's a position shared by many finance ministers. The coming negotiations, a source in the Euro Group says, "will be tougher than anything we have experienced up until now."

The Bill for a Grexit

As the chairman of the Greco-German Chamber of Commerce, Athanassios Kelemis' job is to attract as many companies to Greece as possible -- at least during normal times. At the moment, though, even Kelemis is finding it difficult to promote his country. Without a clear outlook, he says, he can only advise companies against investing their money in the country. "Everyone is waiting to see what happens," he says. "2015 will be a lost year for the Greek economy."

Although the subject of Greece's exit is supposedly not a topic of discussion in talks between Athens and Greece, in reality all are considering the possibility -- either by accident or by dint of a realization that it may be the lesser of two evils.

If Greece were to stumble out of the euro, the government would have to circulate a new currency overnight that would immediate depreciate in value against the euro. At least initially, it would result in chaos. Banks would totter dangerously, interest rates would quickly climb and companies would go bankrupt. The number of insolvencies would rise by 50 percent in 2015 and again by an additional 30 percent the following year, predicts Ludovic Subran, the chief economist for credit insurer Euler Hermes. Even the country's largest electricity utility company, state-owned PPC, would likely go bankrupt, predicts rating agency Standard & Poor's.

In order to prevent people from making a run on the banks, the country would have to temporarily introduce controls on money flows. Transfers abroad would be banned, limits would be placed on withdrawals from automated teller machines and supplier contracts would be suspended. It's possible that medicines and foreign food products would only be available on the black market and that they could be purchased exclusively with hard currencies.

One potential consequence of the devaluation would be that Greek government debt would rise from the current level of 175 percent of gross domestic product to 230 percent, analysts at Germany's Commerzbank believe. Athens would no longer be able to service the debt on a large portion of its loans and the country would be at least partially insolvent.

It's difficult to predict how people would respond to such a situation. Argentina's declaration of bankruptcy in 2001 was followed by violent riots and looting. The Argentina example also shows how long it can take for an economy to recover from a crisis like that. Tens of thousands of Argentinians, many of them well educated, left their country, and many Greeks would do the

same. The faith of international investors would also be shaken. It is likely that the Greek government would have trouble raising money for years to come.

Opportunities?

At the same time, a new, cheaper currency could also create some opportunities. It would suddenly make Greek exports a lot cheaper. Hans-Werner Sinn, president of the Munich economic think tank Ifo, believes, for example, that the country could resurrect a textiles industry that disappeared a few years ago.

The country could also make gains with cheap vacation deals. Currently, many holiday destinations in Greece suffer because prices are cheaper in neighboring Turkey, where the skies and seas are just as blue. "The Greek tourism industry, in particular, would strongly profit from a Grexit," says Thomas Mayer, who formerly served as Deutsche Bank's chief economist.

The question here is the degree of stimulus this would provide to the exports and tourism sectors. More important yet is the question of when the boom would begin.

The Kiel Institute for the World Economy (IfW) doubts whether Greece would benefit from the drachma's reintroduction in the long run. "A clumsy devaluation would do absolutely nothing to change Greece's structural problems," says Stefan Kooths, head of IfW's forecasting center. The International Monetary Fund has a similar view of the situation. Sources at the IMF in Washington say they believe the cost of exiting the euro would be greater for Greece than continuing with reform measures.

But changing currencies could provide one key advantage for the Greek government: It could print as much money as it needed to finance the promises it made during the election campaign.

Europe's Dilemma

The risks of a Grexit for the entire euro zone are manageable and the ECB would use all measures at its disposal to defend the currency union. On the political side, the European Stability Mechanism, the euro backstop fund that has already proven to be an effective instrument in providing countries emergency funds, can be used should there be a spillover effect. The majority of the half-trillion euros in the fund has not been touched. The IMF has praised the Euro Group for building a "fire wall" to prevent Grexit-related turbulence from spreading to other countries.

Most important, however, is the fact that the countries on the periphery of the euro zone are no longer as susceptible to risk as they were during the outbreak of the euro turbulence in 2010. Yields on Spanish and Italian government bonds might increase slightly following a Grexit, experts at Commerzbank predict, "but there is no danger of a crash."

It would, however, lead to financial losses for the countries that lent Greece money. Partner countries, the European bailout fund and the IMF have provided €240 billion to Greece.

Germany either directly or indirectly guarantees almost €65 billion of these loans. If Greece were to leave the currency union, a large part of this money would never be seen again.

Still, such losses would hardly be noticeable in the coming years. With interest payments and amortization of the bailout loans having been suspended until 2020, Greece is doing very little to service those debts right now. Germany wouldn't have to book any of the losses until much later.

But the Greeks could produce costs elsewhere. As an EU member, Greece is eligible to apply for so-called "balance-of-payments assistance" from Brussels. Such assistance is available to EU countries outside of the euro zone that run into trouble. Hungary and Latvia are examples of countries who have taken advantage of such assistance.

Incalculable Economic Risk

The political damage, of course, would be much greater. A Grexit would represent a significant political defeat for European leaders. For the last five years, they have tried to keep Greece in the euro zone at almost any price. Were the country to leave the euro, there is a danger that it could begin to orient itself more toward Russia or China.

In the final analysis, leaving the euro zone would be an almost incalculable economic risk for Greece, but one which could pay political dividends. The reverse is true for the euro zone. As such, it is hardly surprising that cracks have become apparent in the Greek facade in recent weeks. Greek Finance Minister Varoufakis, for example, has made several concessions to his European counterparts only to see his prime minister withdraw them again.

Europe, too, has been anything but unified. Whereas European Commission President Jean-Claude Juncker has sought to find a compromise on his own, German Finance Minister Schäuble has often acted as though his preference would be for Greece to leave the euro zone. Even Sigmar Gabriel, head of Merkel's coalition partner, the Social Democratic Party, has expressed his opposition.

The best option for all involved remains that of finding a compromise. After the difficult structural reforms it has introduced in recent years, it would be extremely difficult for Greece to confront the additional pains of a currency reform. The euro zone, in contrast, has no interest in allowing Athens special rights that no other country could claim. A deal remains possible, but the longer the negotiations last, the more doubtful it becomes if both sides are willing to make the sacrifices necessary.

Those leading the negotiations on both sides have made clear that they don't have much room to maneuver. "Greece can no longer fulfill the demands of the program," Tsipras says. "That is why it must be modified." Chancellor Angela Merkel, for her part, said: "Solidarity and exertion are two sides of the same coin."