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On the Potential Threats from a
Greek Eurozone Exit

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Germany is strong and its resident investors are in search for yield. With German bund paying too low interest rates, with bonds from other euro area countries carrying too much risk and with highly volatile stock markets, many Germans have returned to residential investment. Almost everywhere house prices are falling (including China) except in Germany where house price increases range from 10% in Berlin to more than 50% in Munich. In Germany only 40% of households own a house (contrary to 67% in the United States and 80% in Italy), but the percentage is bound to increase.

Currently average earnings are much higher in Germany than in Italy, Spain and periphery countries (see Eurostat data on earnings for full time employees). With the forthcoming wage increase (unions are currently asking for a wage increase of 6%; public employees will receive wage increase of 6.3% over the next two years) wages will increase further and Germans might spend more domestically.

Those are all the signs of a strong economy, without yet over-heating. House prices as well as wage increases will certainly fuel inflation, but probably only moderately. A moderate wage and price inflation in Germany is actually even welcome by other euro area countries as the German revaluation can abate the devaluation required in other countries such as Italy and Spain. The increase in German labor costs implies indeed that periphery countries can reduce by less their wages in order to gain competitiveness.

However a potential danger exists and it lies in the massive flow of capital from periphery euro area countries (mostly from Greece) to Germany. Over the last month, depositors and savers from periphery countries have withdrawn their deposits and savings from their national banks and moved them to countries like Germany and Switzerland. With increasing fear of a Greek exit from the euro zone, depositors in Greece withdrew 700 million euros (\$890 million US) on Monday 17 of May 2012. For Greece this might potentially lead to barter economy if the entire liquidity flows out of the country: this is what happened in Argentina after the last default on sovereign bonds. The exit of Greece from the euro area might trigger a confidence crisis, which might increase the flow of capital also from other countries (Portugal, Italy and Spain).

The potential consequences of this massive capital flow for Germany are twofold. Both of them will not materialize immediately, but could be disruptive in case of Greece exit from the eurozone.

First, as noticed by other economists, since 2007 there have been large TARGET imbalances (TARGET balances or imbalances are the mechanism through which national central banks within the Euro-system lend to each other). One misplaced claim has been that target imbalances would drain liquidity from the German banking system. It is in fact the opposite: when depositors move liquidity out of Greek banks, the German banking system acquires liquidity. In this case the Greek National Bank is forced to refinance its banking system and it can do that by acquiring a debt vis-à-vis the Euro-system of central banks: putting differently the Greek National Bank becomes a net debtor versus the central banks of the Euro-system (including the Bundesbank). The dangers in this case are only potential and are connected only to the event of a Greek exit. If Greece exits the monetary union, indeed its National central bank would likely be unable to repay the debt acquired from the Euro-system, including the Bundesbank.

The second danger behind the large flow of capital lies in the fact that this is a potential fuel of accelerating inflation. With the German banking system flooded with liquidity, the banks will be eager to invest and the households will be eager to spend. In absence of profitable investment in safe assets such as government bonds (bund), whose rates are currently too low, those investors will turn to the housing market, possibly causing a bubble (signs of a bubble are already emerging in Munich). Housing investment and increases in domestic demand might induce over-heating in inflation. This phenomenon is not new: after the break of the Austro-Hungarian Empire, most residents of the periphery moved liquidity toward the countries which were perceived as strong (Austria and Hungary). This huge flood of liquidity was among the causes, alongside with other factors, of the Austrian hyperinflation.

The arguments above seem to suggest that any effort should be exerted to avoid Greek exit from the eurozone. Unfortunately at the current juncture there is no clear answer to this question. The current juncture represents a typical no win situation: avoiding Greek exit means committing to finance its expenditure until the country will be able to return to market finance; allowing Greek exit has unpredictable, but potentially disruptive consequences, even for strong countries.