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Freeze the Grexit: Germany and the Latest Escalation of Eurozone Crisis

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A Greek exit from the eurozone is an unfavourable scenario for Germany. It would threaten not only German debt and economic interests but also its political leadership in the European Union, which Berlin has developed in recent years. The safest option is a continuation of support for Greece: strong enough to not bankrupt it, and modest enough not to strengthen the Syriza government.

Germany is generally perceived as "hawkish" among the euro area countries, categorically refusing debt restructuring and threatening Greece it may have to "exit" the eurozone in case it does not accept further cuts in government spending.

This view, however, is only partially true. It is to some extent the result of spectacular conflict between the Greek and German finance ministers, Yanis Varoufakis and Wolfgang Schäuble, respectively, and has included propaganda against Germans, such as comparisons of Chancellor Angela Merkel to Hitler, and a request for payment of reparations from the Second World War. Also, it has resulted in the emergence in Germany of the boisterous, though relatively small party AFD (Alternative for Germany) which promotes a Eurosceptic view of the eurozone crisis. The idea of Greece returning to the drachma is strongly supported by some renowned economists, such as Hans-Werner Sinn, the president of the Ifo Institute for Economic Research. Even if the German public increasingly favours such a move, the main actors in German politics, including primarily Merkel and Foreign Minister Frank-Walter Steinmeier, remain extremely cautious. A solution involving a Greek exit from the eurozone is, for them, too risky an option.

The Costs of a Grexit. Berlin's primary source of concern is Greece's public debt, which currently stands at €320 billion, of which the amount owed to Germany is about €70 billion. The possible departure of Greece from the eurozone would most likely result in a moratorium on debt repayment and loss of that money. It is hard to imagine Merkel formulating a political explanation for such a calamity: not only would Europe not be "saved" but German public finances would suffer a huge loss. Moreover, a Grexit does not necessarily mean that spending on Greece would end. It is almost certain that the country would face a deep depression and media from Helsinki to Lisbon would be full of dramatic reports of the chaos in public services, including closed schools and hospitals, and suspended wages. Under this scenario, the European Union would have to prepare a programme of humanitarian aid that would certainly be very expensive.

The German government is also concerned that predictions by economists about a "safe" Grexit are too optimistic. The lesson of the Lehmnan Brothers failure should be remembered: a relatively marginal event led to a downward spiral. A Grexit could trigger a wave of speculation that would result in an increase in prices for bonds issued by the weakest members of the monetary union and could threaten the stability of the whole group. These concerns are deepened by the fact that the economic situation in the eurozone is still considered fragile. While Germans are doing relatively well, the French and Italians are still stuck with stagnation. A Grexit would not help them.

Post-Grexit, the possibility of further disintegration of the eurozone would directly threaten German economic interests, especially exports. Before the rise of EMU, Germany struggled with constant appreciation of its currency, which badly damaged the competitiveness of German companies selling their products abroad. The euro has solved this problem: productivity growth has not translated into an increase in the exchange rate. In fact, this real undervaluation is a strong explanation for the booming surpluses in the German current account. If the eurozone begins to shrink in some of its highly productive economies, rapid appreciation of the currency would be inevitable.

The Defeat of the German Economic Model. Since the beginning of the crisis, Berlin has marketed its approach, advocating fiscal discipline and reducing labour costs as the best way to revive growth. At the same time, it has been reluctant to consider ideas to stimulate the eurozone economy through higher budget expenditures or monetary expansion.

"Austerity" policy is largely due to Berlin's perspective. A Grexit would be accepted as proof of that perspective's defeat—long predicted by many economists, including Nobel Prize winners Paul Krugman and Joseph Stiglitz. The ensuing wave of criticism of the German economic policy would probably also bring arguments that the German model only works in Germany and that its key elements cannot be applied in other countries. This would lead, furthermore, to increasing demands to more clearly address the issue of the German surplus in the balance of payments. The Germans themselves see this surplus as proof of the vitality of their Rhineland industry. Others, in particular France and southern EU countries, consider it an expression of the German obsession to curb spending, and one that causes morbid macroeconomic imbalances in Europe.

The European Project in Danger. If Greece leaves the eurozone, integration will have taken a step backwards and there would be a risk that the disintegration process would continue. It's hard to believe that German leaders are not aware that they could go down in history as those who started dismantling Europe. As well, in the near term looms the threat of Britain's exit from the EU. A Grexit would surely make that more probable.

In fact, failure of the negotiations with Athens would necessitate sending a strong signal of eurozone vitality. That would probably entail the announcement of a project to deepen eurozone integration with the introduction of a budget financed by a common tax, joint unemployment insurance and the creation of political representation for its 18 members in the European Parliament. Such demands have already appeared in a joint document released by the German and French ministers of economy, Sigmar Gabriel and Emmanuel Macron, respectively, and the project published by the "five presidents" of the European Union on the eve of the "last chance" negotiations with Greece.

According to these initiatives, Germany would still speak as the leader, but from a weakened position, nonetheless. A Grexit would suggest that Berlin is unable to foster the necessary universality and inclusiveness required for the integration project, preventing it from accommodating all the countries on the continent. As a result, France would probably have more to say than it does today and may advocate greater economic interventionism—something Berlin has effectively resisted so far. The chances of introducing mechanisms to a transfer union would also increase, supporters of which can hardly be found within Germany's ruling elite.

A Frozen Grexit. The notion that Greece would leave the monetary union carries too many risks for Germany for it to be seriously considered as a political option. Geopolitical factors should also be added to the list of problems: a humiliated Athens may seek to deepen cooperation with Russia and China, complicating the situation not only for the EU but also for NATO.

It is also difficult to identify unambiguously the positive effects of a Grexit for Germany. Paradoxically, even the strongest argument that proponents of this solution have—a return to growth thanks to a weaker national currency—is not devoid of controversy in Berlin. If the other peripheral countries see that the recipe for overcoming stagnation and high unemployment is returning to the escudo, peseta or lira, the days of EMU in its present shape will be numbered. Disintegration of the eurozone would only mark the return of the problem of a struggle with currency appreciation.

However, it is quite clear that a Grexit does not mean Germany would return to its notorious "checkbook" policy, characteristic of the Helmut Kohl era, and humbly agree to reduce Athens' huge debt, make subsequent transfers to it, and keep Greece in the EMU, for at least two reasons. First, in the global economy, Germany is a "structural creditor" that invests the surplus from its current accounts balance abroad. At the end of 2013, its net investment position exceeded €1.2 trillion, or about 43% of GDP. From this perspective, the obvious threats to Germany are initiatives to reduce the external debt of indebted countries. Greek debt is not recoverable anyway, but an official agreement on its reduction could encourage other "structural debtors" to demand similar treatment. Second, Berlin cannot afford to allow Greek Prime Minister Alexis Tsipras to emerge from this crisis as the winner. The Syriza government proposes economic policy experiments reminiscent of French socialists of the early 1980s and which the Germans consider extremely dangerous for the economic health of Europe. These ideas consist of generous social benefits, dense labour market regulation, the primacy of state property, protectionism and stimulating growth by increasing state spending. In the crisis-ridden EU, however, this approach may easily find imitators, such as in Spain, where there is a chance of the left-wing Podemos assuming power. Therefore, it is in Germany's interest to limit the Greek government's financial space to manoeuvre so that it fails to effectively turn its ideas into practice.

Since neither a Greek exit from the eurozone, nor far-reaching concessions to it are favourable options for Germany, an intermediate solution is more likely—a "frozen Grexit." The negotiations might be prolonged and creditors, among them Germany, can dispense financial support to Athens, enough at least so Greece can meet its financial obligations, but nothing more until it accepts expected reforms. By that time, Syriza may still refuse them and present itself as a defender of Greek interests, but its political capital will most likely vanish in the ever-deepening economic crisis. At the end of this scenario is a change of power and a new Greek government that could be an easier partner for the "institutions" (creditors) than the pairing of Tsipras and Varoufakis.