Print Close

Could Greece End Up as Europe's Lehman Brothers?

By Matt Egan

Published May 23, 2012 | FOXBusiness

As jitters about Greece leaving the eurozone reach a boiling point, one of the key lessons of the Lehman Brothers collapse should loom large over the heads of policymakers: the interconnectedness of the financial system can create unforeseen consequences that quickly ripple around the world.

The chances of a Greek exit appear to have hit a new high this week as leaders in Europe are reportedly planning contingencies ahead of a key vote in Greece next month and as financial markets set off alarm bells once again.

While there are clear differences between this scenario and the one experienced in 2008 with Lehman, there are also eerie similarities that bear watching.

“With Lehman, I don’t think people appreciated the interconnections. I see the same argument with Greece,” said Marc Chandler, global head of currency strategy at Brown Brothers Harriman.

During the Lehman crisis, U.S. policymakers displayed “hubris” about the fallout of a failure, essentially saying, “Sorry, we can’t save Lehman, but we’ll fix the mess. Little did they know how big of a mess it would be,” said Chandler.

Exit Could Backfire Through Contagion

Some market participants believe the eurozone should cut Greece loose, making an example out of the debt-ridden country in an effort to shock others like Spain, Portugal and Italy into getting their own houses in order.

“There must be a credible threat. A Greek exit would show some backbone” and “provide a strong incentive to other countries to adhere to the rules -- or else,” Cam Harvey, a finance professor at Duke University, wrote in an e-mail.

This thinking is reminiscent of the apparent desire by Henry Paulson and other U.S. officials to draw a line in the sand regarding moral hazard during the Lehman episode.

However, some forecasters believe the overall cost of a Greek exit could range between 500 billion and 1 trillion euros ($639 billion to $1.28 trillion), including cross-border contagion impact.

“Consequences would be severe and that contagion to the other weak eurozone economies would be difficult to stop,” Mike Ryan, chief investment strategist at UBS (UBS), wrote in a note on Monday.

Impact on Banking System

Due to the domino nature of both crises, contagion spreads to the parties perceived by the markets to be the next weakest. In 2008, this meant the markets set their sights on Merrill Lynch and eventually Morgan Stanley (MS) and Goldman Sachs (GS), forcing the government to step in.

In Europe, analysts believe the bond markets would likely punish Spain and Italy with higher yields, threatening to shut them out entirely.

“If you told me Greece is squeezed out, then why shouldn’t Portugal be next? It’s a slippery slope,” said Chandler. “Once the toothpaste is out of the tube, it’s hard to squeeze it back in.”

The Greek cancer could easily spread through the banking system as the Lehman one threatened to. If Greek banks are forced to issue residents a severely devalued drachma instead of the euro, depositors in other weak eurozone countries could yank their cash, sparking a bank run that threatens the European banking system.

“I share the view that if Greece defaults and exits the euro, the consequences for the eurozone -- its financial system and real economy -- will be profound,” Greece’s former prime minister, Lucas Papademos, told *The Wall Street Journal* this week.

Overblown Fears of Exit?

Of course, these dire forecasts that are being repeated by some in Greece could turn out to be too severe.

After all, policymakers in Europe have had an enormous amount of time to brace for a potential exit by Greece or another member. That stands in stark contrast to 2008, when the rapid demise of Lehman seemed to take U.S. officials by surprise.

“Greece is no surprise. It has been in our face for years and there have been many supports that have been offered by the eurozone,” said Harvey.

Jan Randolph, director of sovereign risk at IHS Global Insight, noted that the European Central Bank and other authorities have had time to construct bad banks and force the private sector to write down the value of Greek debt.

“The Europeans do have contingency plans they could use to absorb the shock of an actual default,” said Randolph.

Harvey said these preparations should prevent the disorderly nature of the Lehman unwinding that caused panic and spread the crisis.

While the Greeks have “been using this contagion card” as leverage in their negotiations, “it’s a game of poker that Greece cannot win,” said Randolph, who is based in London.

“There is no way the IMF and Germany will blink. This is the way European politics works -- it’s brinksmanship,” said Randolph. “At least we’re not using armies this time.”

Risk Worth Taking?

Another key difference between Greece and Lehman is that while Lehman mostly ceased to exist after collapsing, wiping out shareholders, Greece and its struggling residents will still be here even if it leaves the euro.

There is “a lot of the talk is about the downside of leaving the euro -- what about the upside?” said Harvey.

Specifically, he pointed to the ensuing devaluation of the drachma that will make Greece’s debt load more manageable, boost exports, lower labor costs and encourage growth.

This balancing act between two difficult outcomes for Greece is playing out in the financial markets each day.

As the euro on Wednesday tumbled to levels unseen since August 2010, the Dow is on track for its 14th decline in the last 16 sessions, something that hasn’t happened since August 1982.

Keeping in mind the miscalculations of 2008 in the wake of Lehman, investors’ preference may be for the apparent safer route.

“It is reasonable to expect the eurozone authorities, including the ECB, to take action to try to prevent contagion in the event that Greece leaves. However, given the experience over the last two or three years, it is hard to have confidence that they will have a great deal of success,” Ryan wrote.

URL

http://w w w .foxbusiness.comhttp://w w w .foxbusiness.com/economy/2012/05/23/could-greece-end-up-as-europe-lehman-brothers/