Papandreou’s gamble brings currency block to the brink

Reuters

Tim Shufelt Nov 1, 2011 – 6:47 PM ET | **Last Updated: Nov 1, 2011 6:48 PM ET**

The great European currency experiment has been put at risk of imminent collapse, analysts say. In defiance of eurozone leadership, Greek Prime Minister George Papandreou will test a hard-fought bailout plan by way of a general referendum, putting Greece’s fate in the hands of its embittered voters.

His gambit could take the eurozone one giant leap closer to those possible upheavals until now considered remote — a hard Greek default, an exit from the eurozone, and even the undoing of the currency bloc.

“Papandreou has taken his finger out of the dike,” said Alex Jurshevski, a Toronto-based expert in sovereign restructurings.

The ensuing deluge could engulf the tenuous European economic peace process and could nullify the hard-fought grand agreement to save Greece and smother contagion.

Global market enthusiasm sparked by last week's agreement, which was essentially two years in the making, vanished Tuesday.

Stock markets bled, the euro at one point lost more than 3¢ against the U.S. dollar, and Italian debt yields rose into the same territory that proved almost fatal for Ireland.

Much of the same can be expected over a two-month interim before a referendum can be held early next year. That's assuming, of course, Mr. Papandreou can hold on to power that long.

A confidence vote to be held by the end of the week in Athens will challenge the prime minister's mandate. He does hold a two-seat majority, and he did survive a recent confidence motion, but his stunning about-face is inciting confusion and dissent within Greek parliament.

"Mr. Papandreou is dangerous, he tosses Greece's EU membership like a coin in the air," said Yannis Michelakis, an opposition spokesman.

The prime minister even reportedly withheld his intention to announce a referendum from his own finance minister, Evangelos Venizelos, who is leading bailout and debt talks with the EU, the IMF and banks.

"It's crunch time," Mr. Venizelos said on Monday. "Citizens will have to answer the question: are we for Europe, the eurozone and the euro?"

If a referendum does come to pass, depending on how the question is phrased, it's hard to imagine sufficient support for the austerity on which bailouts have been made conditional.

"I don't think there's any way, given what we've seen in Greece in terms of the demonstrations and riots, that there's going to be any kind of consensus for accepting a deal they consider to be unfair," Mr. Jurshevski said. "They will reject it."

Perhaps that's Mr. Papandreou's big idea. Voter rejection would amount to a mandate to decline the bailout, paving the way for an exit from the eurozone.

"That means that Greeks will fire up the Bank of Greece again, and everything gets converted to drachmas," Mr. Jurshevski said.

The country could then follow the traditional path out of a sovereign debt crisis — a substantial currency devaluation. And Greece could forgo the imposed austerity that many, including Greeks themselves, view as punitive.

"Greece has little chance of fulfilling its austerity-program targets within the euro," Charles Dumas, chief economist at Lombard Street Research, said in a note. "The current approach amounts to 'pain for pain's sake.'"

If the referendum took root in the desire to be free from the currency bloc, the consequences of that tack for the eurozone and the global economy, however, could be dire.

"We expect the crisis to build, prompting a prolonged recession in the eurozone, further turmoil in the markets and, at some point, the end of the euro itself in its current form," said John Higgins, an economist at Capital Economics.

As usual, the greatest fears lie in the spread of contagion to regional powers, including Italy, Spain and France.

Part of last week's plan involves seeking support from international investors, including China, to top up the bailout fund to about €1-trillion in order to insulate major economies exposed to risky debt.

Mr. Papandreou's gamble undermines those fundraising efforts.

"As an investor, I would question the viability or the credit integrity of that fund right now," Mr. Jurshevski said. "The Chinese are looking to invest in assets and gain leverage, not to provide bailout funding."

And without a credible stabilization fund, Italy, for example, is as vulnerable as ever.

Greek default could also provide the catalyst for positive change, giving the eurozone the opportunity to "cauterize" the problem and patch up its institutional shortcomings, like the lack of a fiscal union, Mr. Jurshevski said.

"The quicker this gets sealed off, the better. But based on what they've done so far, I'm not optimistic we're going to get to that point."