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How can Greece leave the Euro?

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There are fifty ways to leave your lover, according to the song, but only two ways for Greece to leave the Euro. Nothing less than the survival of the Eurosystem and the fundamental freedoms of trade, capital and labour in the EU depend on the outcome, which also has trenchant implications for the global economy.

Expectations of a Greek exit from the Euro have been growing since the inconclusive elections held earlier this month. With an overwhelming anti-austerity vote, Greece now seems to be fast-tracking towards a formal debt default, following a probable impasse with the Troika over the terms of the second bail-out agreement. Even though continued membership resonates strongly in opinion polls and the major political parties in Greece, default is one of the major flashpoints that could trigger an exit. And that is why the circumstances are of the utmost significance.

Greece could leave in what is euphemistically called an 'orderly' way. In other words, it would leave with the reluctant blessing of its Eurozone partners, which would have to agree two major sets of initiatives. With regard to Greece specifically, the ECB would have to lend freely to stave off a collapse of the Greek banking system and stand ready to support the sovereign bond markets of other vulnerable countries, notably Spain and Italy, if necessary. And finance ministers should be prepared to restructure Greece's official debt, granting relief and/or forgiveness. These measures would keep the looming prospect of capital controls, which are 'verboten' with regard to other members, at arm's length, and keep Greece in the EU.

But leaders would have to seize the moment also to speed up and deepen integration. The fiscal compact as a downpayment towards fiscal union is already a fact. But it lacks immediate relevance. So, incidentally does the important debate about the balance between growth and austerity. Rather, new forms of banking and financial sector integration and authority need to be established as a matter of urgency.

True, we already have a European Banking Authority, European Securities and Markets Authority, European Insurance and Occupational Pensions Authority, and European Systemic Risk Board, but these institutions have limited authority, scope or legitimacy in the face of powerful national institutions. The Eurozone crisis should have made us all realise by now that without a strong central banking authority, and debt mutualisation, no fiscal compact and or existing institution can keep the Eurosystem together. European leaders need to agree new federalist structures for pan-European deposit insurance, bank recapitalisation and funding, and resolution authority on the one hand, and a routemap leading towards so-called E-bonds, on the other. These might then establish the integration momentum needed to command financial stability and the time needed to progress in other economic and governance areas.

These things are easy to assert on paper. In practice, we know that there are strong vested national interests between politics and banking in individual countries, which may balk at handing powers over to Europe. We know that there are strong legal and moral interests in Germany that cannot reconcile easily debt mutualisation with the German Constitution or the European Treaties. And we know that pervasive economic weaknesses and high unemployment in the Eurozone undermine the desire for the very integration which the system now needs.

But if all of this seems like a very tall order, just think about the alternative way for Greece to exit the Euro. It could leave the Euro in a disorderly way. The Greek banking system would shut down, be nationalised and require urgent recapitalisation. Capital controls, which would not be legal if applied to other European countries, would have to be implemented immediately. The depression in the economy would deepen, and social and political chaos would be rife. Bank runs would extend to other countries, including Spain, Portugal, Italy, possibly France. Self-fulfilling sovereign default risks would rise in many countries. There would be a catastrophic decline in output throughout Europe. And because Europe remains such a large part of global trade and commerce, the consequences for the global system would be enormous, not least for China and other emerging markets, upon which Europe and the US depend for growth in these fractious times. One is reminded of the results of the failed London Economic Conference, convened in 1933, to restore real and permanent financial stability to a global system in economic disarray. It is no exaggeration to assert that, amid the resulting political chaos and acrimony following a disorderly exit, the Eurosystem would not survive. It bears thinking about only because the economic, political and legal consequences for Europe's model are so dire.

Needless to say, if a Greek exit is unstoppable, then the orderly option is the only 'satisfactory' way. But time is running short and all the while, a financial fire is already smouldering, and threatening to dictate events. As the prospect of a Greek default looms, deposit flight from Greek banks has resumed. Depositors in Spain, moreover, have had their own reasons to take fright in view of local banking sector developments. The scale of deposit withdrawals remains relatively contained, but bank runs aren't known for their predictability. Hence the urgency of at least a European deposit insurance scheme, backed up by credible resources to recapitalise European banks.

If the contagion of deposit flight to other Eurozone banks cannot be stemmed quickly, the Bundesbank's financing of capital flight by lending to other Eurozone central banks under the Target2 system, will soar. It already has over 600 billion Euros in loans outstanding, with the Bank of Spain being the largest borrower recently. The ECB will be challenged to provide unlimited financial support to banks, exposing itself to ever greater credit and recapitalisation risk in the process. It had just over 6 billion Euros of capital at the end of 2011, scheduled to rise to over 10 billion buy the end of this year. But these numbers are rounding errors. Is it safe to assume that these central bank behemoths will behave as required? And what, if not?

A Greek exit, strictly speaking, should be seen as the plague under all circumstances. But if it cannot be averted for whatever reason, then Eurozone leaders have much work to do, and preferably before Greek voters have their say.