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Germany will have to yield in dangerous game of chicken with Greece

'You cannot keep on squeezing countries that are in the midst of depression,' says President Barack Obama, lining up with the Greeks

By **Ambrose Evans-Pritchard**

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George Osborne has warned that the escalating showdown between Greece and the eurozone has become the “greatest risk to the global economy”.

In this the Chancellor is right. North European politicians assert with remarkable insouciance that EMU is now strong enough to withstand the effects of contagion if Greece is forced out of the euro, and some say it may even emerge stronger. This is courting fate.

It is true that QE by the European Central Bank has anaesthetised the bond markets. Yet Grexit would convert the eurozone into a fixed exchange rate system overnight, a sort of 'ERM3' in the words of Morgan Stanley. Portugal would be a sitting duck. Whether Europe’s leaders could stop the EU itself from disintegrating after such a breach of political solidarity is an open question.

Mr Osborne pointedly refused to take sides, and came very close to rebuking the EMU authorities for carelessness after his meeting with the Greek finance minister Yanis Varoufakis.

“I urge the Greek finance minister to act responsibly but it’s also important that the eurozone has a better plan for jobs and growth. We have got to make sure that in Europe, as in Britain, we choose competence over chaos.”

In Washington, President Barack Obama tilted even further towards the Greeks. “You cannot keep on squeezing countries that are in the midst of depression. When you have an economy that is in freefall there has to be a growth strategy and not simply an effort to squeeze more and more out of a population that is hurting worse and worse."

This should be a cautionary warning to Brussels, Frankfurt and Berlin that they do not have a green light from the rest of the world to do as they like with Greece – however irritated they may feel by the provocations of Alexis Tsipras. There are larger diplomatic and strategic matters at stake.

The European Central Bank must move with particular care. Eyebrows were raised over the weekend when two ECB members threatened to cut off support for the Greek banking system if the new Syriza government walks away from its Troika bail-out obligations on February 28.

There is near universal agreement that such action would precipitate a systemic banking crash in Greece, lead to full-blown default and force the country's ejection from the eurozone with days. Greece would have to impose capital controls, nationalise the banks and reintroduce the drachma in short order.

Delayed data show that ECB support for the banks has reached €54bn. It is surely rising very fast since capital flight has accelerated to almost €1bn a day, leading to an offset from the ECB through the Target2 payments system. Finland's governor, Erkki Liikanen, was categorical. "Some kind of solution must be found, otherwise we can't continue lending."

So was the ECB's vice-president Vitor Constancio. Greece currently enjoys a "waiver", allowing its banks to swap Greek government bonds or guaranteed debt for ECB liquidity even though these are junk grade and would not normally qualify. This covers at least €30bn of Greek collateral at the ECB window. "If we find out that a country is below that rating - and there's no longer a (Troika) programme - that waiver disappears," he said.

These esteemed gentlemen are sailing close to the wind. The waiver rules are not a legal requirement. They are decided by the ECB's governing council on a discretionary basis. Frankfurt can ignore the rating agencies if it wishes. It has changed the rules before whenever it suited them.

The ECB may or may not have good reasons to cut off Greece – depending on your point of view – but let us all be clear that such a move would be political. A central bank that is supposed to be the lender of last resort and guardian of financial stability would be taking a deliberate and calculated decision to destroy the Greek banking system.

Even if this were to be contained to Greece – and how could it be given the links to Cyprus, Bulgaria, and Romania? – this would be a remarkable act of financial high-handedness. But it may not be contained quite so easily in any case, as Mr Osborne clearly fears.

I reported over the weekend that there is no precedent for such action by a modern central bank. “I have never heard of such outlandish threats before,” said Ashoka Mody, a former top IMF official in Europe and bail-out expert.

“The EU authorities have no idea what the consequences of Grexit might be, or what unknown tremors might hit the global payments system. They are playing with fire. The creation of the euro was a terrible mistake but breaking it up would be an even bigger mistake. We would be in a world where anything could happen.

“What they ignore at their peril is the huge political contagion. It would be slower-moving than a financial crisis but the effects on Europe would be devastating. I doubt whether the EU would be able to act in a meaningful way as a union after that.”

In reality, the ECB cannot easily act on this threat. They do not have the political authority or unanimous support to do so, and historians would tar and feather them if they did. The ground is shifting in Paris, Rome and indeed Brussels already.

Jean-Claude Juncker, the European Commission’s president, yielded on Sunday, accepting (perhaps with secret delight) that the Troika is dead. French finance minister Michel Sapin bent over backwards to be accommodating at a meeting with Mr Varoufakis. There is no unified front against Greece. It is variable geometry, as they say in EU parlance.
Greek bonds and equities rallied on Monday on reports that Greek leader Alexis Tsipras has agreed to uphold Greece’s debts after all. He did no such thing.

He very specifically said Greece would pay the IMF (never in doubt) and the ECB. What he left out was the bulk of the debt owed to the EMU bail-out machinery in its various forms.

How this will end is anybody's guess. With goodwill on both sides, you could imagine a deal along the following lines:

The Troika is renamed the Love Brigade. Greece's primary surplus for coming years is cut from 4.5pc to 2.5pc of GDP, moving closer to fiscal neutrality and creating some leeway for Syriza's social welfare programmes (not that expensive).

To pay for this, the debt could be stretched out until 2055 – a date already circulated before – with the average interest rate cut by around 1.5 percentage points.

Chancellor Angela Merkel could agree to this without having to admit to the Bundestag that German taxpayers have lost a lot of money (bailing out German banks in Greece) or having to submit the losses as a line-item in the annual budget.

Syriza would have little difficulty calling this debt relief. There would be no more extend-and-pretend loans shovelled onto Greece. All would have a face-saving way out. The cost would be trivial compared with the huge sums already wasted.

Yet such happy formulations overlook the furious passions ignited by six years of depression in Greece and the raging battle under way to wrest control over the economic levers in Europe and to overthrow the contractionary regime that has pushed the whole currency bloc into a deflationary vortex.

Joschka Fischer, the former German foreign minister and vice-chancellor, says the Syriza victory is really **a "Greek burial" for the broader German strategy of belt-tightening and austerity for Europe**. If I may quote him at length:

"Not long ago, German politicians and journalists confidently declared that the euro crisis was over; Germany and the European Union, they believed, had weathered the storm. Today, we know that this was just another mistake in an ongoing crisis that has been full of them," he wrote for Project Syndicate.

"Even before the leftist Syriza party's overwhelming victory, it was obvious that, far from being over, the crisis was threatening to worsen. Austerity – saving your way out of a demand shortfall – simply does not work. In a shrinking economy, a country's debt-to-GDP ratio rises rather than falls, and Europe's recession-ridden crisis countries have now saved themselves into a depression, resulting in mass unemployment, alarming levels of poverty and scant hope."

"Warnings of a severe political backlash went unheeded. Shadowed by Germany's deep-seated inflation taboo, Chancellor Angela Merkel's government stubbornly insisted that the pain of austerity was essential to economic recovery; the EU had little choice but to go along. Now the backlash has arrived.

"It does not take a prophet to predict that the latest chapter of the euro crisis will leave Germany's austerity policy in tatters – unless Merkel really wants to take the enormous risk of letting the euro fail.

"There is no indication that she does. So, regardless of which side – the troika or the new Greek government – moves first in the coming negotiations, Greece's election has already produced an unambiguous defeat for Merkel and her austerity-based strategy for sustaining the euro.

"Simultaneous debt reduction and structural reforms, we now know, will overextend any democratically elected government because they overtax its voters. And, without growth, there will be no structural reforms, either, however necessary they may be.

"That is Greece's lesson for Europe. The question now is not whether the German government will accept it, but when."

So who really holds the trump cards here?