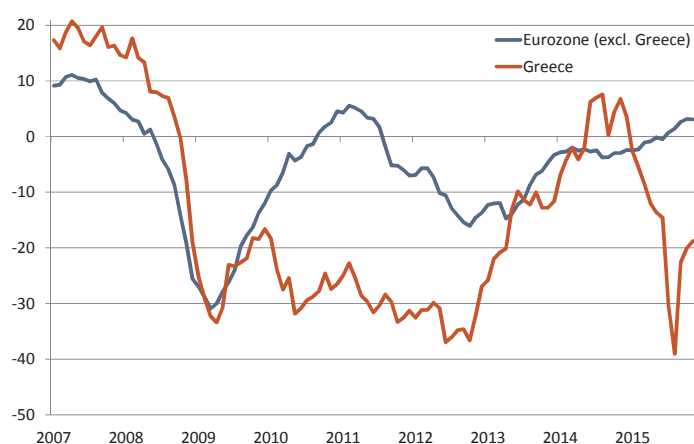


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31 December 2015

Mind the political risks: a salutary lesson from 2015

The Varoufakis effect: business confidence in Greece and the Eurozone



Weighted average of confidence in industry, services, construction and retail trade for Greece and the Eurozone excluding Greece. Source: European Commission; Berenberg calculations

- Apologies to our regular readers:** We have shown this chart before. But its key messages are potent enough to be repeated: (1) In Europe, we have to watch the political risks more than the plain economics; (2) reforms work but reform reversals can be very costly; and (3) shattering confidence is easy, rebuilding confidence is hard.
- The Varoufakis effect:** Rarely has a new government caused so much damage as Greece's first Tsipras administration with finance minister Yanis Varoufakis from January to July 2015. Business confidence plunged, capital fled the country and the banking system virtually collapsed. Confidence recovered only halfway after prime minister Alexis Tsipras finally ousted Varoufakis. As a result, Greek GDP at the end of 2016 will probably be 7% lower and Greece's ratio of public debt to GDP will be some 25 percentage points higher than it would have been without the Varoufakis accident, including the long-term costs of the required bank bailouts.
- Contagion control is working:** The chart also shows that the Eurozone economy as a whole was not affected at all by the Varoufakis accident. In mere economic terms, Greek reform reversals matter to the Eurozone only slightly more than the travails of debt-ridden Puerto Rico matter for the US.
- A lesson for Portugal, Spain, Poland and others:** No other country in Europe is in a similarly fragile position as Greece was a year ago. But the overall lessons still apply: Reform reversals and open confrontation with Europe and other creditors can be very costly indeed. Under their recent governments, Portugal and Spain have regained market confidence the hard way. Low borrowing costs and the gains in employment, underpinned by labour market reforms, now give these countries some leeway to soften their adjustment programmes at the edges. But if they go too far and impair market confidence, they could pay a high price for that.
- Politics matter more than economics.** Wrong political choices can derail an economy that is on the right track otherwise. And while the European Central Bank can control any financial contagion risk, the real threats to growth in Europe arise from the political sphere. In all decisions, including those on how to manage the refugee crisis, policymakers need to carefully consider what their decisions mean for the political cohesion of Europe.
- The top risks for 2016.** The populist backlash against the indignities of globalisation, migration and the inevitable fiscal repair poses a threat to the coherence of Europe, which underpins free exchange and prosperity across Europe. For example, the UK has one of the most solid economies in Europe. But its current account and fiscal deficit and its dependence on free access to the EU market make it vulnerable. If the UK were to damage investor confidence in its economic future by deciding to leave the biggest single market in the world, it could pay a steep price for a reversion to such isolationism. The 30% Brexit risk is among our top concerns for 2016.

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