Greece, responsible for 0.4 percent of the world economy, now poses a threat to international prosperity as investors raise bets its days using the euro are numbered.

A Greek departure from the currency would inflict “collateral damage,” says Pacific Investment Management Co.’s Richard Clarida, a view echoed by economists from Bank of America Merrill Lynch and JPMorgan Chase & Co. At worst, it could spur sovereign defaults in Europe as well as bank runs, credit crunches and recessions that may spark more euro exits.

Global trade and financial ties mean the pain wouldn’t be confined to the euro area. JPMorgan Chase estimates a 1 percentage point slump in the euro countries’ economy drags down growth elsewhere by 0.7 percentage point. Exporting nations from the U.K. to China would suffer and commodity producer Russia would face falling oil prices. While the U.S. may fare better, even it would feel echoes similar to the financial infection following the bankruptcy of Lehman Brothers Holdings Inc.

“An awful lot depends on what is done to limit the contagion within Europe,” said Barry Eichengreen, a professor at the University of California, Berkeley, and author of a 2006 history of the European economy, in a telephone interview. “If too little is done then, to use a financial term, all hell breaks loose. I can imagine things playing out that way.”

Base Case?

Citigroup Inc. economists, who earlier forecast departure chances at as much as 75 percent, now are assuming as a “base case” that Greece will leave on Jan. 1, 2013. BofA Merrill Lynch strategists estimate the euro-region’s gross domestic product would contract at least 4 percent in the recession that follows, similar to the decline suffered after Lehman’s 2008 collapse.

The euro would slide through $1.20 and Europe’s Stoxx 600 Banks Index would tumble below 110 points, from 123 yesterday, according to BofA Merrill Lynch’s May 17 report. The euro was little changed at $1.2534 as of 1:01 p.m. in Tokyo. Asian stocks rose, with the MSCI Asia Pacific Index up 0.7 percent.

Other crisis-torn countries, such as Portugal and Spain, would incur higher borrowing costs. In Germany, perceived by investors as a safe haven because of its stronger economy and lower debt, 10-year bund yields could fall to 1 percent, the report said.

’Disaster’ for Some

“If you let Greece go you would be sending the message that being a member of the euro zone is not necessarily permanent, which could be a disaster for some countries,” said Laurence Boone, chief European economist at BofA Merrill Lynch in London. Her primary scenario is that Greece remains within the euro because of the high cost of the alternative.

The creditworthiness of governments and banks in Italy and Spain, the euro area’s third- and fourth-largest
economies, would be thrown into fresh doubt as traders shun their sovereign bonds and pore over their financial institutions’ balance sheets, said Yiannis Koutelidakis, an economist at Fathom Financial Consulting in London.

Investors are signaling increased concern. The euro has dropped 5 percent in the past month against the dollar, while the cost of insuring Spanish government and financial debt reached a record this month. Germany, by contrast, last week sold 5 billion euros ($6.3 billion) of two-year notes with a zero-percent coupon for the first time.

**Trade Impact**

Beyond the euro area, major trading partners such as the U.K., Switzerland and nearby emerging economies including Romania’s could be hurt as demand slows. Their currencies would rise against the euro, making exports less competitive. China’s biggest investment bank says the nation could see its weakest growth in more than two decades.

Even if the dollar surges, the U.S. may be more insulated given signs of a rebound in its domestic economy -- at 8.1 percent in April, the jobless rate is down from a peak of 10 percent in October 2009 -- and the fact that just 13 percent of its exports head to the euro area. Capital flooding into a perceived safe haven may also hold down interest rates.

Still, BoA Merrill Lynch estimates U.S. bond and stock markets each account for a third of global capitalization, leaving them prone to a European shock. Greek elections helped wipe almost $3 trillion from worldwide equities this month.

**Obama’s Call**

If the U.S. economy is pulled down it may complicate President Barack Obama’s re-election bid, said Eichengreen. Obama said May 21 that what happens in Greece has an impact in the U.S. and called for “greater urgency” from European leaders.

“The election will turn on the economy and the economy is significantly affected by Europe,” Eichengreen said. “The longer it remains unresolved and the more volatility it creates the worse it is for Obama.”

A splintering of the 13-year-old currency bloc might not come to pass even if Greece next month elects parties campaigning to reject the terms of the bailouts needed to pay its bills, said Jacob Kirkegaard, a fellow at the Peterson Institute for International Economics in Washington.

Such an event would probably cut the nation off from outside aid, tipping Greece’s economy and financial system into such chaos that the new government would fall within weeks, he predicted. Credit Suisse Group AG analysts say a majority of Greeks back staying in the euro, the costs of leaving for the country and the rest of the euro region would be considerable and the single currency is a political project.

**Risk Estimate**

“I will attach less than a 5 percent probability for an actual Greek exit,” said Kirkegaard.

Continued membership may still cause headaches for the world economy as Greece suffers political paralysis, a fifth year of recession, the need to repay what it owes and the burden of austerity goals. “Our best guess is they’re not leaving yet and that this will be a story that will be discussed repeatedly for more than another year,” said Jim O’Neill, chairman of Goldman Sachs Asset Management in London.
Still, some companies are bracing themselves. Jan du Plessis, chairman of London-based Rio Tinto Group (RIO), the world’s third-biggest mining company, said May 10 that any exit by Greece “would destabilize the European economy to a significant extent.” With sales to Europe accounting for 12 percent of revenue last year, the region is “one of the many reasons why our posture has to be cautious,” he said.

**Recapitalize Banks**

If Greece does depart, the pressure would be on central bankers and governments to quarantine it, said Lucrezia Reichlin, the European Central Bank’s former chief economist, now a professor at London Business School. Governments would quickly need to recapitalize weak banks and guarantee deposits as the ECB provided emergency aid, she said in an interview.

Global central banks may also help out by pumping dollars around the world and pursuing easier policies where they can, said Nariman Behravesh, chief economist at Englewood, Colorado-based forecasters IHS Inc. The International Monetary Fund has already won pledges of new resources to help fight crises.

The cost of Greece exiting the euro would probably exceed the 1 trillion euros previously estimated by the Institute of International Finance, Managing Director Charles Dallara said in a May 25 interview. That bill includes direct projected losses from Greece’s debt and the need to protect Portugal, Ireland, Spain and Italy, as well as money for reinforcing banks.

** Fallout Spread**

The channels of trade, confidence and finance would spread the fallout beyond Europe, according to Joseph Lupton, an economist at JPMorgan Chase in New York.

Euro-area imports account for 5 percent of global GDP, Lupton estimates, so a 15 percent decline would drag down the world economy by 0.5 percentage point.

Euro-area nation economies would be first to feel the reverberations if Greece quits, given that about half their exports go to each other. Already, data last week showed declines in German business confidence as well as European manufacturing and services output.

Mark Cliffe, the London-based global head of financial markets research at ING Bank NV, calculates a Greek departure would leave output in the rest of the euro region about 2 percentage points lower than otherwise, with Spain and Italy suffering the most. A complete breakup of the euro would provoke a cumulative GDP loss of more than 12 percentage points over two years, he estimates.

**Credit Crunch**

Financial contagion is another damaging route, said Fathom’s Koutelidakis. Investors could dump the bonds of cash-strapped economies and pull money out of banks, tightening credit.

Greece defaulting would raise the odds of Portugal following, in turn setting off a domino chain that could leave a total euro breakup “very much on the cards,” he said: “It is foolhardy to assume a Greek exodus would be manageable.”

Greece’s exit could also spur bank runs and capital flight in Europe’s peripheral countries as investors flee corporate bankruptcies or try to escape redenomination of their accounts. European banks alone hold $1.2 trillion of debt issued by Spain, Portugal, Italy and Ireland, according to the bank for international settlements.
Another financial threat, says Lupton at JPMorgan Chase, is European banks pulling back some of the 5 trillion euros they have overseas.

‘Firing Line’

Beyond the euro area, Bulgaria and Romania are “first in the firing line,” according to Neil Shearing, chief emerging markets economist at Capital Economics Ltd. in London. Romanian exports worth 3.5 percent of GDP head to Greece and Greek banks have a large presence in both nations. Hungary, Slovakia and the Czech Republic each send shipments equivalent to more than 40 percent of their GDP to the wider euro area.

Eastern European banks are also dependent on euro-country parents for funding. Short-term credit lines are equivalent to over 10 percent of GDP in Hungary, Croatia and Bulgaria.

Oil-producer Russia could suffer: Capital Economics estimates Brent crude would fall to $95 a barrel as global growth declined. OAO Sberbank, the country’s biggest lender, estimates Russia’s economy would contract 2.1 percent and banks could lose $95 billion in capital in a worst-case scenario, while the Center for Strategic Studies in Moscow says President Vladimir Putin would risk increased political instability.

Greece quitting the euro could reduce China’s expansion to 6.4 percent this year, from 9.2 percent last year, if international growth is dragged down by half as much as during the 2008-2009 financial crisis and policy makers don’t offset the pain, economists at China International Capital Corp. said in a report last week.

Hit to China

Chinese exports, 19 percent of which go to the European Union, slowed unexpectedly in April. They may fall 3.9 percent this year if Greece leaves, compared with a 10 percent gain without an exit, CICC projected.

Weaker European demand may also be particularly troubling for Asian countries including Singapore, Thailand and South Korea, which are key to the global supply chain and for which overseas sales make up the equivalent of half or more of GDP.

As for the U.S., the hit to its economy from turmoil in Europe may be 0.5 percentage point at the very most, said Behravesh at IHS. In a sign the economy is on firmer footing, data last week suggested the housing market is stabilizing.

Financial ties may still pose a risk although these have diminished as the Greek travails have lasted. Fitch Ratings estimates U.S. money market funds have about 15 percent of their assets there.

For Clarida, a former U.S. Treasury official and now a global strategic adviser at Pimco, Greece leaving the euro may be too much of a risk for Europe to take. In an interview on Bloomberg Television’s “In the Loop” with Betty Liu, he recalled a prevalent view in the summer of 2008 that a Lehman failure would be manageable.

“We saw how that turned out,” Clarida said. “The one thing markets hate is making it up as you go along, and that’s what we’d have with a Greek exit.”