Turmoil in Greece Raises Euro Risk

Though Financial Markets Are Relatively Calm, Concern Grows About Impact of Potential Exit From the Common Currency

By CHARLES FORELLE

Financial markets’ relatively calm reaction to the Greek turmoil masked rising risks Greece is on a road that leads to its exit from the euro zone, with hard-to-predict consequences.

The weekend’s inconclusive elections were seen by many as a possible beginning of the end, by choice or by necessity, for Greece’s membership in the common currency. If Greece is unable to form a government that can abide by the conditions of its bailout package, it faces another election in June and will be on a collision course with its rescuers: other euro countries and the International Monetary Fund.

Despite the political disorder, there are powerful forces still holding the euro zone together, and investors haven’t concluded the moment for a great schism is at hand. For now, markets are gauging that it’s still too painful for both sides, Greece and the rest of the euro zone, to sever ties.

Asian markets fell in early trading Wednesday and the euro slipped amid fresh concerns about Europe’s monetary union. Stocks in Europe slumped Tuesday, but after a day of gains Monday.

Some analysts said that this belies extraordinary tensions inside the euro zone—and that the declines are the first inkling of a wider reassessment of the impact of Greece’s woes.

"The market is really working out what the risks are," said Justin Knight of UBS. "It is a bit of a slow burner, but it is gathering pace."

Whether investors are right depends on a messy drama under way in Athens, in which the leading parties have been sidelined in favor of a collection of radicals bent on upsetting the painful measures that are Europe’s price for Greece’s bailout.

On Tuesday, the head of Greece's leading left-wing party, Alexis Tsipras of Syriza, took a turn at trying to form a government. His conservative counterpart, whose party won slightly more votes on Sunday, tried and failed Monday.

Mr. Tsipras demanded that Greece renounce the bailout’s required Greek budget cuts, saying they were nullified by the "people’s verdict" of the election. But Mr. Tsipras's party won just 52 of the 300 seats in parliament, and chances he could form a governing coalition appeared slim.

European authorities have demanded Greece's government—whatever it is—plan €11.5 billion (about $15 billion) in budget cuts for 2013 and 2014 by June.
If Greece leaves the euro, the impact could be grave. Much of the debt crisis's strain has come from whipsawing financial flows: deposits leaving weak countries, undermining their banking sectors, and investors pulling out of their government bonds for the safety of Germany. A sudden change in sentiment would rapidly upset the precarious status quo.

Many believe the combination of wrenching economic stress in Greece and the humbling of two parties that provided stability, for better or worse, for two generations has put the country on an unpredictable path.

"The markets are definitely underpricing the risk," said Lefteris Farmakis, a strategist at Nomura in London. "I don't see why the market is not pricing in protracted instability."

If the prospect of a Greek exit appears to grow, it might be difficult to stem a flight from Europe's periphery.

An exit from the currency would throw into doubt contracts denominated in euros, with consequences for the real economy, not just the financial sector.

Absent assurances that a euro payment will actually be made in euros, companies might be less willing to conduct business or trade in vulnerable states.

"The natural thing is for investors to start looking at other countries," said Mr. Knight of UBS. He added that there is a weakness of natural demand for Spanish and Italian government bonds, which foreign investors have been selling all year, that could "deepen very, very quickly." Bank deposits, too, are shaky in Spain and Portugal.

Even if both Greece and the euro zone are inclined to keep the country in, rather than risk the turmoil of letting it go, there are several places where the bonds could fray.

Marchel Alexandrovich, an economist at Jefferies & Co., said one early risk is that the IMF could stop making further loans to Greece. The fund has lent alongside the euro-zone nations, but it has been uncomfortable with Greece's performance.

It is possible, too, that Greece's messy politics could result in a new government that actively repudiates the bailout—leaving Greece without its rescue aid. If official funding from the IMF and the rest of Europe were cut off or diminished, the Greek government would have no sources for the fresh cash it needs to keep going.

It could try to stretch out payments to suppliers and government workers and live off its remaining funds, said Mr. Knight, "until you get to a point where you have to start thinking about something else. And if you are not going to do the spending cuts, that something else is printing your own currency to pay for government services."

For all the questions, there are reasons the system can continue to hold—with Greece included in it, at least for the near term.

For one, leaving is hard for Greece to do.

Even if it stopped repaying all of its debt, the government would still spend more than it takes in. The bailout money is now the only thing plugging that gap; without the bailout, Greece would have no choice but to suffer more of the painful cuts Greeks are rebelling against.

For another, the bailout has left the governments of Europe, the European Central Bank and the International Monetary Fund as Greece's chief creditors. Letting Greece go would surely mean losses for some of them.

In fact, the two-year-old bailout program and the massive debt restructuring earlier this year have helped insulate Europe's banking system and private sector from Greek troubles.

Many banks have written down their exposure to Greece or dumped their positions entirely. Much of the exposure has been moved to the public sector.

"For now, the core has more to lose than Greece does," says William Porter, head of credit strategy at Credit Suisse in London.

But like many, Mr. Porter is not so sanguine. The longer the process drags on, he says, "the more beneficial to
Greece exit becomes."

—Alkman Granitsas
contributed to this article.

Write to Charles Forelle at charles.forelle@wsj.com