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Morgan Stanley fears German exit from EMU

Morgan Stanley has warned that the Greek debt crisis is setting off a chain of events that may prompt German withdrawal from the eurozone, with grim implications for investors caught off-guard.

Greeks are rush to test their luck in the Joker lottery with its €19m jackpot as the country's borrowing rate shot up again above 7pc. Photo: AFP

By Ambrose Evans-Pritchard

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"The backstop package for **Greece** and the ECB's climb-down on its collateral rules set a bad precedent for other euro area states and make it more likely that the euro area degenerates into a zone of fiscal profligacy, currency weakness, and higher inflationary pressures over time," said Joachim Fels, head of research, in a note to clients.

The US bank said a bail-out for Greece may be necessary to avoid a crisis for Europe's financial system, but warned that it also "sows the seeds for potentially even bigger problems further down the road".

Mr Fels said weak states cannot easily leave EMU because they would pay a stiff penalty in higher rates, would be stuck with euro debt contracts, and might need controls to stem capital flight. It is a different calculus for Germany, which would see lower rates and might view EMU exit as the only way to ensure monetary stability.

"Obviously, we have not reached the end game yet. However, with the latest developments, such a break-up scenario has clearly become more likely. The risk is far from negligible and the consequences for financial markets would be very severe. Investors ignore the break-up risk at their peril," he said.

Jürgen Stark, the European Central Bank's chief economist, vowed on Thursday to resist pressure to help spendthrift governments out of their troubles by resorting to easy money. "Let me stress that any call to reduce the real value of public debt through higher inflation will be firmly opposed by the ECB," he said.

Dr Stark said the global credit crisis is starting to metamorphose into a deeper solvency threat to highly-indebted states. "We may already have entered into the next phase of the crisis: a sovereign debt crisis following on the financial and economic crisis. Most governments in the advanced countries will exit from recession with the highest deficit and debt-to-GDP ratios recorded in times of peace. It is essential to prevent public finances from running out of control," he said.

Dr Stark said public debt will reach 88pc of GDP next year in the eurozone and the UK, 100pc in the US and 200pc in Japan. "There is no doubt that fiscal policies have been put on a path that is not sustainable," he said.

He did not name the eurozone's main sinners, but his warnings are clearly directed at Greece, Spain, Portugal, Italy, and Ireland. The refusal to let EMU-wide inflation creep up means that these countries will have to carry out "internal devaluations" - or deep wage cuts - to bring their economies back into line with North Europe. Debt costs must be serviced from a shrinking economic base. Critics - including some in IMF circles - retort that such a policy risks pushing these states into debt-deflation spiral and may not work.

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