Members of the Shadow ECB Council evenly split over assessment of a possible Greek exit

At the meeting of the Shadow ECB Council on 27 May 2015 it became clear that the spectre of Grexit is polarizing not only policy makers but also economists. About half the members of the Shadow ECB Council would regard an exit of Greece from the currency union a very bad and dangerous outcome. Roughly the other half would consider it well manageable or even desirable.

Inflation forecasts far below ECB projections

Compared to three months ago, the average forecast of the members of the Shadow Council for inflation this year rose to 0.3 percent, after it had declined a record 0.9 percentage points to 0.0 percent in the preceding three-month period to February. This compares to a 0.0 percent forecast of the ECB-staff from March, which came down from 0,7 percent in December. The Shadow Council's mean forecast for 2016 went up slightly to 1.2 percent, still far below the medium-term target of the ECB of roughly 1.9 percent and also below the ECB's March-projections of 1.5 percent.

The Shadow Council's mean forecast for GDP-growth in 2015 increased slightly to 1.3 percent; for 2016 it stayed unchanged again at 1.5 percent. Thus, the decline of the euro exchange rate in the last half-year (and the decline of oil prices) did not materially alter medium-term growth expectations.

Shadow Council macroeconomic forecasts

(ECB's December projections in brackets)

	HICP-Inflation	GDP-Growth
2014	0.4	0.9
2015	0.3 (0.0)	1.3 (1.5)
2016	1.2 (1.5)	1.5 (1.9)

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A possible Grexit is polarizing opinions

Members were split about half and half on the assessment of a possible exit of Greece from the currency union. Views ranged from this being a “grossly naïve and dangerous policy mistake” to “an orderly and managed exit is the least damaging solution for all parties”.

The main argument of the first camp was that an exit of one member would change the nature of the currency union to something more akin to the former European Exchange Rate Mechanism (ERM).While most members agreed that the ECB and the ESM had the means to prevent contagion via the bond markets from reaching dangerous levels in the short term, the pessimistic camp (on Grexit) was very concerned about the medium to long term. It was argued that once the next recession would hit some of the weaker members of the currency union, the possibility of eventual exit would be entertained by the markets immediately, which could lead to a self-fulfilling prophecy or speculative attack.

The other camp raised a similar argument with regard to the possibility of letting Greece stay in the currency union despite its government’s refusal to accept conditions attached to earlier emergency loans. There was concern that this would entice voters and governments in other crisis countries to renege on bailout conditions and that this could endanger the fabric of the currency union in the long term.

A further argument of the pessimistic camp was that – even if no outright speculative attacks would take place – economic actors and the government in weaker countries would suffer from permanently higher financing costs due to a risk premium demanded for the exit risk. The other side held, however, that this outcome would be desirable, as in their view the absence of significant country risk premia had been a contributing factor to the crisis.

Some members warned that Grexit might turn out to be (or appear to be) successful for Greece, in the sense that there might be an economic rebound after a year or so, and that this real or apparent success of exit would undermine the commitment to the currency union of voters or governments in other countries. A few members argued that Greece was in a liquidity crisis, not a solvency crisis, and thus a Grexit was easily avoidable if the Euro Group showed more flexibility in helping the Greek government over their liquidity problem.

Those holding the view that Grexit would be manageable or even desirable stressed the fact, that relatively few Greek government bonds were still held by non-Greek banks, such that contagion risk via bank balance sheets was small. They also pointed to a “slow motion run on deposits” at Greek banks, which would make them insolvent at some point anyway, and argued for capital controls to stem the exodus of euros from Greece.

There was a strong consensus, including members of both camps, that preserving membership of Greece in the EU was very important for geopolitical reasons.

No need to act on interest rates

Members largely kept their rate recommendations unchanged from three months ago, with a very large majority in favour of unchanged rates.

Member	**Affiliation**	**Rate recommendation**
José Alzola	The Observatory Group	unchanged
Marco Annunziata	General Electric	unchanged
Elga Bartsch	Morgan Stanley	unchanged
Andrew Bosomworth	Pimco	unchanged
Sylvain Broyer	Natixis	unchanged
Willem Buiter	Citigroup	cut to -0.25
Jacques Cailloux	Nomura	unchanged
Julian Callow	Catalyst Economics	unchanged
Eric Chaney	Axa	unchanged
Janet Henry	HSBC	unchanged
Merijn Knibbe	Wageningen University	unchanged
Fabian Lindner	IMK	unchanged
Jörg Krämer	Commerzbank	hike to 0,30%
Erik Nielsen	Unicredit	unchanged
Richard Werner	University Southampton	hike to 0,55%

Frankfurt, 1 June, 2014

Norbert Häring (Non-voting Chairman)