

Italy exits Euro before Greece in BofA game theory

Friday, 13 July 2012

Italy

and Ireland have more incentive to quit the euro than Greece, while Germany may have limited room to prevent departures from the currency union, according to Bank of America Merrill Lynch.

Using cost-benefit analysis and game theory, BofA Merrill Lynch foreign exchange strategists David Woo and Athanasios Vamvakidis concluded in a July 10 report that investors "may be underpricing the voluntary exit of one or more countries" from the bloc. "Our analysis produces a few surprising results that even readers who may disagree with our conclusion are likely to find interesting," the strategists wrote.

Italy, the euro area's third-largest economy, would enjoy a higher chance of achieving an orderly exit than others and would stand to benefit from improvements in competitiveness, economic growth and balance sheets, they said.

While Germany is the nation deemed able to leave the euro zone most easily, it has the least incentive of any country to quit because it would face weaker growth, possibly higher borrowing costs and a negative hit to its balance sheets, the strategists said. Austria, Finland and Belgium also have little reason to quit, they said, while Spain has the weakest case for leaving among economies most directly affected by the crisis.

The analysis is based on a framework which ranks eleven of the 17 euro-area nations on criteria such as how orderly their exit from the bloc would be and how it would affect economic growth, interest rates and balance sheets. Ireland and Italy received an average ranking of 3.5, while Greece was at 5.3 and Germany had the highest score at 8.5. The lower the number, the more there would be to gain from leaving.

Woo and Vamvakidis employ game theory to suggest that while Germany could "bribe" Italy to remain in the bloc and avoid the fallout from an exit, its ability to do so is limited. That's because Italy has more reasons than Greece to leave so any compensation could become too expensive for Germany and Italians may be even more reluctant than the Greeks to accept the conditions for staying.

"If our inference turns out to be correct, this could have negative implications for markets in the months ahead," they said.