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Grexit: Lose-Lose

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- **Despite the agreement reached at the end of February, the idea of a Greek exit – or *Grexit* – from the euro zone has not been eliminated.**
- **The economic and political costs of a *Grexit* are potentially considerable, not only for Greece, but also for the euro zone.**
- **For Greece, this would mean a further significant deterioration of living standards, exposing the country to serious political and social unrest.**
- **For the rest of the euro zone, over and above the associated financial losses, a *Grexit* would kill the idea that membership of the monetary union is irrevocable.**
- **Even if it did not trigger an immediate domino effect, the integrity of the euro zone would come under fresh threat with each episode of political uncertainty. There would be a risk of self-fulfilling mechanisms being created, against which the firewall introduced during the crisis would have little effect.**

The agreement of 20 February reduced somewhat the uncertainty around Greece. The flight of deposits, which had hit EUR 20 billion since December, should slow or even stop. The idea of a *Grexit*, the ultimate risk in the event of a failure in negotiations, has eased, but not completely disappeared.

The February agreement did not come without costs for the Greek government. Although it is presented as a victory, it is a Pyrrhic one at best. Although public opinion still backs the executive, part of Syriza's left wing is already cutting loose, denouncing the government's weak hand. In particular, the left faction has highlighted the refusal to consider an exit from the euro zone as a credible Plan B that could have increased negotiating power. Syriza's left platform will push for a more confrontational approach in the future.

So the game is far from being over. The February agreement is only the beginning of a potentially long and troubled process. The list of measures accepted by the Eurogroup, which underpinned the agreement, is only a starting point. It will be subject to negotiation through to late April. These talks could be the source of tension between the Greek government and its lenders. The IMF, the ECB and some European Finance ministers have already criticised Greece's reform proposals. Furthermore, key topics such as Greece's fiscal stance over the long term, and the associated questions relating to the financing of the country and the restructuring of its public debt, were not covered in the agreement. They will probably give rise to subsequent tough discussions.

The threat of Grexit will continue to lurk until a long-term solution has been found between Greece and its European partners. In this article we will review the main consequences of such a scenario, both for Greece and the rest of the euro zone.

For Greece

If it left the euro zone, the Greek government would have to create a new currency whose international value would probably depreciate substantially. The financial sector would naturally be at the centre of monetary transition. After a period on capital controls, private agents' deposits would be converted into the new currency, resulting in a considerable reduction in their purchasing power and savings. The price of imports, a large part of which cannot be substituted for by local production (medicines and energy for instance), would increase sharply, resulting in high inflation. The worsening of the terms of trade would produce a significant deterioration in trade balances, with export growth failing, in the short term, to offset more expensive imports. The impossibility of financing an external deficit would require a substantial reduction in domestic demand and thus in economic activity.

The benefits of devaluation on exports could, at first, be limited. First, the gains in price- competitiveness resulting from the devaluation would be partly offset by an increase in the cost of inputs, and perhaps in salaries if wage rises were granted to limit the loss of purchasing power.

Secondly, devaluation would not boost real growth in sectors where there are constraints on supply. For example, devaluation would not allow Greece to welcome more than the 22 million tourists who visited in 2014. The positive effect would come solely from the increase in the real value of cash receipts from tourist businesses, as it is likely that prices in the new national currency would remain close to their euro equivalent. Lastly, the return to a national currency could produce a series of bankrupt, as companies would be deprived of credit from international suppliers and of bank lending. In the short term, it is possible to envisage a contraction in the export base.

The effects of a return to a national currency on the Greek banking sector would be closely tied to the political choices regarding the rules for the conversion of assets and liabilities of financial agents. The case of Argentina helps throw some light on the matter. In 2002, following the abandonment of a fixed exchange rate against the dollar, the Argentine peso saw a serious devaluation. Debt contracts, denominated in dollars, became impossible to repay with revenue now in pesos. The government declared default on its external debt. As far as private sector commitments were concerned, the Argentine authorities opted for an asymmetric "pesification" of balance sheets: deposits were converted at 1.4 pesos to the dollar, whilst debts were converted at parity. The government thus elected to settle financial conflicts in favour of debtors, to the detriment of the banking sector. In the event of a *Grexit*, the position of the financial sector would crucially depend on political choices. A conversion unfavourable to creditors would imply losses in the banking sector, and a need for recapitalisation which would probably be satisfied by printing money. The risk would therefore be that the value of the national currency plunge further. Even in the event of a “neutral” conversion, the banking sector would continue to face significant liquidity constraints. Capital controls would have to be maintained for some time after the country left the euro zone, while the credit crunch would exacerbate the recession.

Would the return to a national currency give Greece more room to manoeuvre on fiscal policy? Nothing could be less certain. Public debt would become impossible to repay, forcing the government into default. The interest charge would thus be eliminated, but the return to recession would wipe out the primary surplus. Without external financing, a new dose of austerity would be required. The government could be tempted to turn to the printing press to finance its budget deficit, but this would put greater pressure on the currency, forcing a new contraction in domestic demand. Eventually, fiscal policy would be limited to maintaining a balanced budget. In addition, the return to a national currency would do nothing to improve tax collection or the functioning of the State, which are fundamental problems of the Greek economy.

However, it would be excessive only to consider the negative aspects of a devaluation, even though, initially, these would significantly outweigh the positives. After some time, a return to a national currency could facilitate the rebalancing of the Greek economy. Within a monetary union, without the exchange rate instrument, an economy seeking to become more competitive must adjust through a slower increase in costs and prices than in competing economies. This “internal devaluation” is very difficult to achieve in an environment of near-zero inflation. It leads to a fall in prices, which increases the value of debt in real terms and hurts growth. Conversely, a fall in the nominal exchange rate gives a direct gain in price-competitiveness. Moreover, by increasing the relative price of tradable goods and services (relative to non-tradable goods and services) it helps the redeployment of the production factors towards exporting sectors. However, it is important to stress that whilst devaluation can help adjustments through the play of relative prices, it does not, in itself, improve the structure of the supply of goods and services. It does not obviate the need to introduce structural reforms in order to improve the functioning of the economy. Countries using devaluation as a means of avoiding the introduction of difficult measures often end up devaluing repeatedly, causing repeated cuts in the standard of living.

In short, Greece’s departure from the euro zone would bring another (severe) contraction in economic activity, an increase in unemployment and significant impoverishment. After six years of recession, and with the unemployment rate running at 26%, a further worsening of the situation would expose Greece to major political and social unrest. In Argentina, the end of the Currency Board led, in the first half of 2002, to a 15% fall in production, inflation of 30% and a rampant rise in poverty. The rapid recovery in the Argentine economy was driven by its large agricultural sector, which in the 2000s benefited from the combined effect of devaluation and commodities boom.

In Greece, the benefits of devaluation would probably only be felt after some time. Provided that the necessary structural reforms were introduced, devaluation could lead to the development of tradable sectors, a rebound in exports and a recovery in economic growth, albeit from a very low level.

For the rest of the euro zone

For the rest of the euro zone the costs of a *Grexit* would be potentially significant, even though they might appear to be contained in the short term.

In terms of known outcomes, the member states of the euro zone would lose all, or at least a large part, of the loans made to Greece since 2010, that is to say EUR 53.9 billion in bilateral loans and EUR 141.8 billion in loans made through the EFSF. As we discussed above, Greek public debt, denominated in euros, would become impossible to repay in full. A default, even if only partial, would be inevitable. As for the losses relating to the TARGET2 system, these are potentially substantial but the outcome is less clear cut (see also Box 1).

The unknown factor would be the markets’ reaction to a *Grexit*. Some have highlighted the fact that the monetary union is now better equipped to tackle financial contagion than it was in 2012. It is true that the rapid reduction in macroeconomic imbalances in the euro zone’s periphery (Spain, Ireland and Portugal), coupled with the decisive role played by the ECB have reduced short-term systemic risks. Since the announcement of the OMT in 2012 and even more since the launch of quantitative easing in early 2015, the risk of financial destabilisation appears reduced for the short term at least.

From this point of view the lack of reaction from the peripheral bond markets to the vicissitudes of the latest negotiations between Greece and its European partners, is striking, especially compared to the volatility that similar circumstances produced in 2012. Things could, however, take a very different turn in the event of *Grexit*.

Even if the consequences of an exit could be contained in the short term, the blows to the euro zone could be deep and lasting. A *Grexit* would destroy the idea that membership of the Eurozone is irrevocable. The perception of the risk that one or more member states would leave the euro *sooner or later* would increase. It is certainly possible that the economic crisis that Greece would experience leaving the euro could eat into the support for Eurosceptic parties. But in the absence of significant improvements in living standards elsewhere in the euro area, these could see a resurgence. Their recovery could be fuelled by a certain degree of myopia. After a sharp fall in revenue, Greece would see a potentially strong recovery. Although economic activity in Greece would remain significantly below its pre-exit level for a while, such a dynamic could mistakenly be perceived as more favourable than regular but slow growth, particularly in countries where the unemployment rate struggle to decrease.

The credibility of the European Central Bank, which has undertaken to do whatever it takes to maintain euro zone unity, could also take a hit. Calling into question the irreversible nature of the euro membership could thus revive the financial fragmentation within the monetary union. The perception of the value of the euro would vary across the member states as a function of the perception of the underlying exchange rate risk. Risk premium spreads between eurozone members could widen once again. This discrimination would not come without economic costs, substantially reducing the expected benefits of being part of the monetary union and thus further worsening the position of the weakest countries.

Thus, although it might not be immediate, the risk of a Greek precedent triggering a domino effect cannot be ruled out. In the event of political instability or uncertainty in one of the countries of the eurozone, self-fulfilling mechanisms could set-up. The firewall introduced during the crisis could be of little help. It should be remembered that access to the European Stability Mechanism is not automatic but conditional. Its necessary counterpart is that a country - allegedly under stress - asks for a financial assistance programme to its European partners. This is where the problem lies. After a *Grexit*, markets could begin to doubt about countries where anti-austerity/eurosceptic sentiment is on the rise, that is to say, precisely in countries most likely to oppose the conditions for being covered by the ESM-OMT umbrella.

■TARGET2 accounts

TARGET2 positions – often presented by creditor nations as a 'secret bailout' – are less clear. To recap, TARGET2 processes transactions by commercial banks and/or their clients within the framework of cross-border transactions or capital flows (portfolio investments, direct investment, deposits). For instance, when a Greek private agent transfers its bank account from a Greek commercial bank to a German commercial bank, this translates into an increase in the deposits of the German bank and a reduction in the deposits of its Greek counterpart. In the absence of access to the interbank market, the latter will borrow an equivalent amount from the Greek Central Bank, whilst the German bank will deposit the amount transferred in the current account it holds with the Bundesbank. The balance sheets of the commercial banks are thus balanced. This is not the case for the two national central banks. To achieve accounting balance without requiring the transfer of financial assets from the Greek Central Bank to the Bundesbank, the national central banks use the TARGET2 system. Thus the Greek Central Bank increases its TARGET2 liabilities with regard to the Eurosystem, whilst the Bundesbank's TARGET2 claims increase. TARGET2 liabilities imply interest rate payments at the rate of ECB's main refinancing operations, currently 0.05%. These interest payments are collected by the ECB and shared out proportionally between national central banks that have TARGET2 assets.

What would happen if Greece left the euro? The Greek Central Bank, which would now be unable to issue euros, would no longer be able to repay its TARGET2 "debt" to the Eurosystem. In January 2015, this stood at EUR 76bn. The ECB would record a loss that could eat into its capital. However, it is not certain whether this would entrain a cost for European taxpayers. It is not specified whether national governments would be obliged to recapitalise the ECB. In monetary systems based on fiat money, the central bank's capital is simply the confidence that agents place in the purchasing power of the currency. If this confidence is not damaged, then no recapitalisation is necessary. Even so, although the costs relating to TARGET2 would not be automatic, they would be subject to a political decision. The interpretation of the treaties could therefore lead to a recapitalisation of the ECB by member states proportionately to their share of its capital.

Another solution could be that the Bank of Greece would maintain its TARGET2 liabilities with the Eurosystem. One of the features of TARGET2 balances is that they do not have any specific maturity. In theory, they could thus be maintained so long as interest payments are met. Moreover, several countries that are not members of the monetary union use the TARGET2 system and Greece would probably continue to record transactions in euros after its exit.

Box1 Source: BNP Paribas

Conclusion

The economic costs of a *Grexit* would probably be substantial. For Greece, this would mean a further significant deterioration of living standards, exposing the country to serious political and social unrest. For the rest of the euro zone, the immediate losses would be in the hundreds of billions of euros. But this would only be the tip of the iceberg. A Greek precedent would reintroduce underlying convertibility risk, reviving financial fragmentation within the monetary union. It could also be like opening the Pandora's Box. Even if it did not trigger a short-term domino effect, the integrity of the euro zone would come under fresh threat with each episode of political uncertainty within member countries.

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