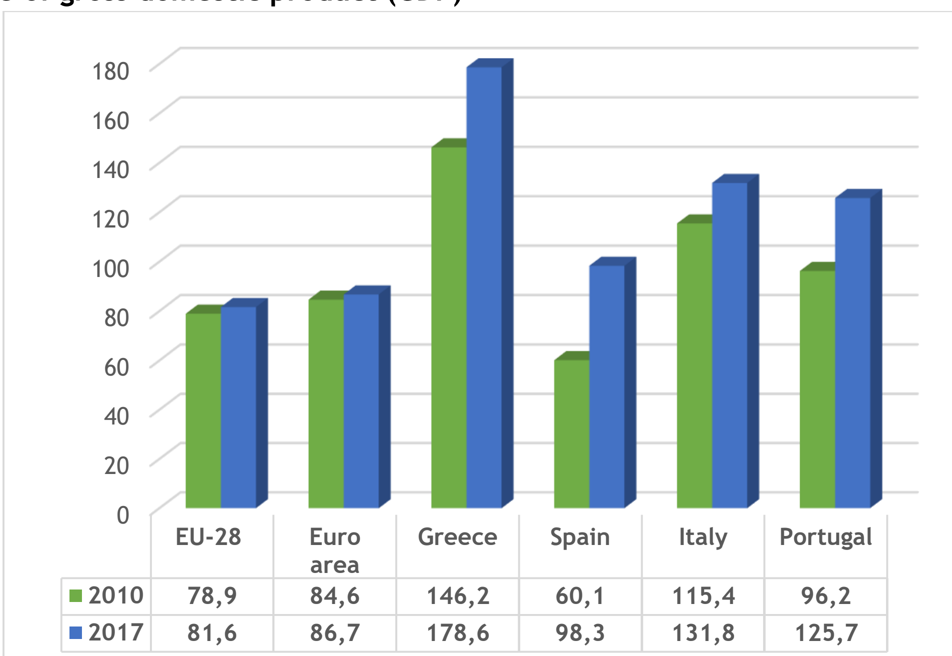
A Grexit won't Solve Greece's Problems

By Dimitrios APOSTOLOPOULOS

Two years ago, on the 20th of June in 2016, a remarkable exhibition opened its doors at the Acropolis Museum in Athens. The exhibition's title was "[Dodona. The oracle of sounds]" and its aim was to provide wider knowledge about the oldest (ancient) Greek oracle. From this exhibition comes the photo above, one of the thousands of questions carved into metal sheets of lead that were found in excavations in Dodona. In the sheet, which dates back to the late 5th – 4th century BCE, someone's asking if it would be better for him to pay off his debts immediately or leave them for latter. Unfortunately, we don't know the Oracle's response. What we do know however, is that debt -and the woes accompanying it- is a tale as old as time. Let us now take a leap of about 2500 years and arrive at today's Greece.

FIGURE 1

General government gross debt – annual data
Percentage of gross domestic product (GDP)



Source: Eurostat [sdg_17_40]

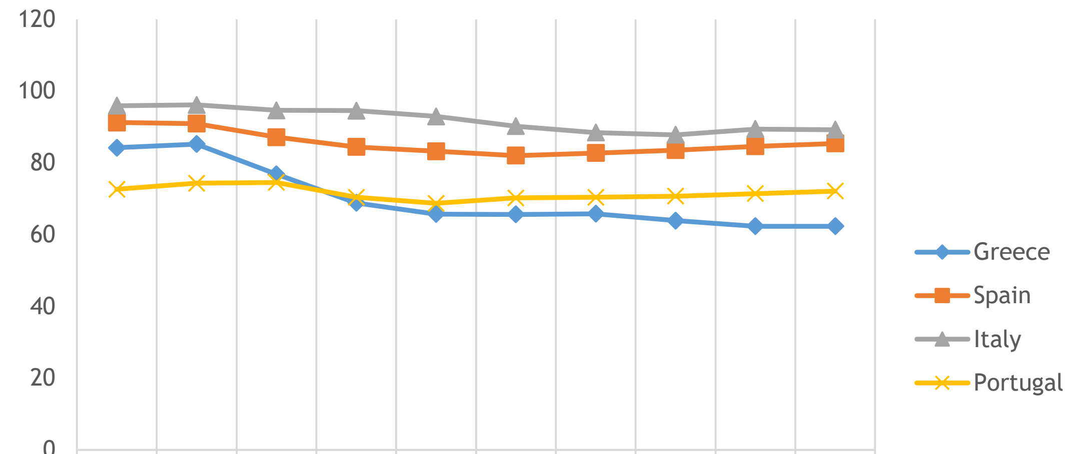
The 2010s have not been a great decade for nearly anyone –far less for Greece. Between 2008 and 2013 GDP declined by 26% and then stagnated for the following years (+0.1% in 2013-2016)[1]. Relative living standards (GDP per head compared to the west European average, Figure 2), having risen from 74% in 2000 to 85% in 2009, fell to 62% in 2016 (below their 1961 levels).

[1] Spain (-8.9%), Italy (-7.6%) and Portugal (-7.8%) have all experienced a less deep recession over the same years and, since then, experienced a recovery of +7.9%, +1.8% and 3.9% respectively. Source: Eurostat [nama_10_gdp].

Employment levels and disposable incomes fell while poverty rates skyrocketed. The magnitude of the Greek crisis has been staggering.

FIGURE 2

GDP at current market prices per head of population in purchasing power standards, relative to the EU-15 average



	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Greece	84,2	85,2	76,8	68,8	65,7	65,6	65,8	63,9	62,3	62,3
Spain	91,2	90,9	87,1	84,4	83,2	82	82,7	83,5	84,6	85,4
Italy	95,9	96,1	94,6	94,5	92,9	90,2	88,4	87,8	89,4	89,2
Portugal	72,6	74,3	74,5	70,4	68,7	70,2	70,4	70,7	71,4	72,1

Source: AMECO Eurostat

The magnitude and the impact of the crisis on everyday life in Greece caused such a political upheaval that discredited the parties that ruled the country since the restoration of democracy (1974)[2] and led (in January 2015) to the election of an anti-austerity coalition that ended signing up a third (and largely unnecessary[3]) austerity program (in July 2015) –just a week after the

[2] The most prominent example here is that of the Greek social-democratic party (PASOK) that dominated Greece's political life in the period known to Greeks as "*Metapolitefsi*" (1974-2010?), forming consecutive governments and ruling the country in 1981-1989, 1993-2004, and 2009-2011. PASOK saw a declining share of the vote in national elections from 43.92% in 2009 to 4.68% in 2015 and provided inspiration to journalists and academics for coining a term that describes the decline of social-democratic political parties in Europe (Pasokification). PASOK was the main but not the only Greek party that saw the decline of its popularity (and votes). New Democracy (the center-right party that was the main responsible for the restoration of democracy in 1974, and is the other major party in Greece's two-party system) saw a declining share of the vote in national elections from 41.84% in 2007 to 27.81% in 2015. It is telling that while in the election of 2007 these two parties gathered 79.94% of the votes, in 2015 their combined percentage was just 34.49% (slightly improving in the second round with 34.38%).

[3] According to Klaus Regling (19.08.2018), Chief Executive Officer of the European Financial Stability Facility (EFSF) and Managing Director of the European Stability Mechanism (ESM), the first half of 2015 (when the so called "negotiation" of Greece with its creditors took place) cost Greece €86-200 billions. See also a speech by Yannis Stournaras, Governor of the Bank of Greece, at the Conference organized by the Hellenic Observatory of the London School of Economics on "Getting Policy Knowledge into Government", London, 19 May 2016. "(…) [Nikos Theocarakis] *failed though to admit that the "brave" negotiations that he and Yanis Varoufakfis led, which led to the change of the name of the Troika to institutions and removed the Troika from the ministries to the Hilton, had also a cost. If we assume that what he described were benefits, the cost of course was €86 billion: That was the third memorandum and the capital controls that have been imposed after €45 billion of deposit outflows. And these capital*

voters had rejected a version of it in the referendum of the same month. The view that Greece might be better off outside EMU (that had already been circulated by Wolfgang Schäuble)[4] had already gained some popularity. Prominent economists (that, alas -and with the deepest respect for their intellectual stature, had little –at best– experience or knowledge of the workings of the Greek economy and of the Greek political system and society –and to use Nassim Taleb's words, had no "skin in the game") urged Greeks to reject the bailout program at the July 2015 referendum either because the uncertainty and the deterioration of the living standards that would follow a Grexit would still be better than "*the policy regime of the past five years*" (Krugman) or than "*the unconscionable torture of the present*" (Stiglitz). In the European political world, the supporters of a "No" were of a rather different flair. Marine Le Pen, UKIP's Nigel Farage and Matteo Salvini of Italy's "*Lega Nord*" had all been very vocal in their public encouragement to Greeks that would vote for a "No". Within Greece, however, opposition to the Euro was never popular, with 27% of the population being against the Euro and 69% being in favor[5].

It is not the aim of this note to offer an overview of the content, implementation and success (or lack of it) of the Economic Adjustment Programs for Greece. I will also not argue weather Greece has exited the crisis for good or not[6] (though the answer seems quite obvious if we look at Figure 1). Greece has (narrowly) averted Grexit in 2015. If it is going to be back on the negotiating table is something I don't know though I doubt it (for the foreseeable future). After Le Pen's failure to be elected President of France in 2017 and with Salvini's referendum on exiting the Euro appearing to be a "no go", the relevance of a scenario of exiting EMU seems reduced but, nonetheless, the argument that a Grexit will not solve Greece's problems might be relevant to public debates in Europe[7]. In any case, in order to solve Greece's (and Eurozone's) problems, one must first identify the crisis' true causes and setting the record straight is a move towards that direction.

The Treaties

First things first. Is it possible for an EMU Member-State to exit the Euro? Under the Lisbon Treaty it is now possible for a Member-State (MS) to withdraw from EU after negotiating the post-exit situation with the Union (Article 50). This is the path that the UK took after the decision to exit the EU (Brexit). It goes without saying that if the abovementioned MS is also member of the EMU, it withdraws from EMU as well. It should be noted that a country that exited the EU but wants to rejoin the Union is allowed to do so after negotiations with the

controls have been imposed in order to safeguard financial stability following the "brave" negotiations of Mr. Theocarakis and Mr. Varoufakis. I am sorry to say that, but I had the obligation to put the record straight."

[4] See also Spiegel's more dramatic *exposé* of the negotiation period between Greece and Germany.

[5] With the opposition to a "European economic and monetary union with a single currency, the Euro" in Italy, Spain and Portugal being 29%, 19% and 15% respectively. Source: Standard Eurobarometer 89, March 2018.

[6] For some (early) accounts on the ambiguous success of the bailout programs see here, here, and here. Some of the most insightful accounts have been written (perhaps not surprisingly) in Greek (Pagoulatos and Ioakeimidis).

[7] See also Iordanoglou and Matsaganis (2017) on the same topic.

Union. However, the consensus view[8] is that the decision to join EMU is irrevocable[9] and, thus, a MS of the EMU cannot exit the Euro and remain an EU MS. For the rest of the article, I will thus assume that an exit from EMU equals an exit from the EU as well (even temporary). I will also assume that aid of some short from the EU will be available –without it, the Grexit effects would be worse.

Scenarios and consequences

The cost and benefits of an exit from the Euro for Greece will depend on *how* Greece exits EMU. If we assume that Greece ever becomes adamant in its decision to abandon the single currency, we can outline three possible scenarios[10]:

1. Withdraw (even temporarily) from the EU following the procedures of the Article 50. This will be the legal process of exiting EMU and adopting the new Drachma.
2. Request a renegotiation of the Treaties that would allow an exit from the EMU without an exit from the EU.
3. Unilaterally withdraw from the agreements and declare bankruptcy.

The first two are time-consuming and would require some coordination with the country's creditors and the rest of the MS. The third would signify the expulsion of Greece from the capital markets for the foreseeable future.

At the same time, I identify two "types" of problems that Greece would face in its path towards regaining monetary policy autonomy: (i) political and (ii) organizational/technical (like printing the new currency and keeping the whole operation in secrecy).

I will argue that Greece will not only find it hard to deal with the challenges that the transition to Drachma will entail but that the (assumed) benefits of exiting the single currency will not be worth the cost due to both the scale and the nature of the needed reforms. My interest lies again with political economy. Following Polanyi I believe that the market (although having its internal logic) is embedded in the society and is deeply connected with the political and societal processes. A devaluation will not necessarily change the configuration of power relations within a society and the distribution of interests that will interact with the new situation and affect

[8] See the discussion in M. Herdegen, *Monetary Union as a Permanent Community Based on the Rule of Law*, Deutsche Bank Research, EMU Watch Nr.52, Frankfurt 1998. See also Ph. Athanasiou, *Withdrawal and Expulsion from the EU and EMU: Some Reflections*, ECB Legal Working Paper Nr. 10, Frankfurt/Main 2009. On the grounds of academic honesty, I must also mention that this view has come recently under attack, especially after the discussion of a multispeed Europe, on the lines that the EMU is just another EU policy with its opt outs and, thus, an exit from the EMU would not mean an automatic exit from the Union like an exit from, say, Schengen would not mean the exit from the EU. The Treaty on European Union from its part, states (Article 3 paragraph 4) that "*The Union shall establish an economic and monetary union whose currency is the euro*", under the provisions for the Union's aim to promote peace (paragraph 1), the free movement of people (paragraph 2) and the creation of the common market (paragraph 3).

[9] The Treaty on the Functioning of the European Union clearly states (Article 140 paragraph 3) that "*If it is decided, in accordance with the procedure set out in paragraph 2, to abrogate a derogation, the Council shall, acting with the unanimity of the Member States whose currency is the euro and the Member State concerned, on a proposal from the Commission and after consulting the European Central Bank,* ***irrevocably fix*** *the rate at which the euro shall be substituted for the currency of the Member State concerned, and take the other measures necessary for the introduction of the euro as the single currency in the Member State concerned.*" (Emphasis added).

[10] I take as a given that only one MS (Greece) would exit EMU. A "domino effect" or a collective exit (and breakup) of the EMU will not be examined.

the success of the adopted policy. A devaluation is not independent of policy (government, vested interests, institutions, etc.) and of the society (norms, behaviors, expectations, ideas).

As Iordanoglou and Matsaganis (2017:5-7) note, the effects of the transition to Drachma on the banking system "*would be crippling*". The currency change "*would terminally disrupt the* (…) *flows*" from the ECB and ELA[11] while, given the magnitude of the exposure of Greek banks to government debt (€17.4 billion as of February 2017), the banks' capital would be depleted. Finally, the weight of non-performing loans[12] would become even bigger and "*credit would dry-up completely*". On the front of the real economy, imports would plummet (foreign exporters would demand payment in hard currency) and exports would suffer since "*most Greek exports of goods have a high import content*"[13] and thus, shortages of imported goods would affect economic activity and pull down domestic demand and incomes. Of course, the longer the transition period, the bigger the cost[14].

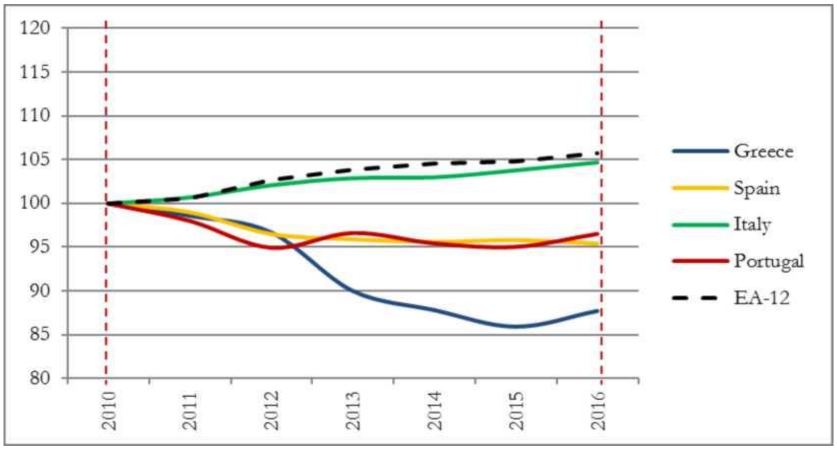
When Drachma is finally introduced as the only legal tender, a floating currency –that would be depreciated since the Central Bank lacks the reserves to back it[15], will be the outcome. The exact magnitude of that devaluation remains unknown, with estimates varying from a modest 20% to a staggering 85%[16]. A 50% devaluation (around which most analyses converge) would result in the doubling of the cost of imports –with the effects that this will have on the production of goods, employment and tax revenues[17]. The business sector, week as it is from the years of crisis, will most likely pass the higher costs to the consumers (stagflation). The estimates of the inflationary effect also vary[18] but Iordanoglou and Matsaganis (2017:8) estimate that an "*inflationary burst of 25% to 30%*" in the first year of Greece's adoption of Drachma "*would erode the real purchasing power of earnings by an amount comparable to their relative loss over the last 7 years*". Finally, one should not forget the weight of the (denominated in Euros) debt. More than 80% of the debt is in the hands of the official sector (EFSF, ESM, ECB, IMF, Eurozone governments) –while part of the rest has been issued to foreign private institutions under British law and cannot be re-denominated either. The only path for Greece would be to default (and be expelled from the capital markets until –at least- arrives at a settlement with the creditors).

The only hope for Greece under the circumstances described would be a boost of exports significant enough to pull the entire economy. But how realistic is such a scenario?

[11] According to the Bank of Greece, Greek commercial banks depended in 2016 on Eurozone funding for 28% of their liabilities.
[12] In September 2016 the non-performing exposures of Greek banks accounted for 45.2% of total exposures. Source: *op.cit*. p.193. Also note that a significant depreciation of the local currency may lead to a considerable increase of non-performing loans through the balance sheet channel (Espinoza and Prasad, 2010).
[13] According to a 2017 Bulletin of the Federation of Greek Industries (cited in Iordanoglou and Matsaganis, 2017:6), "*70% of Greek imports of goods represent inputs to production processes, while 25% of Greek imports are re-exported*".
[14] Capital Economics (2012) estimates that a period of six months will be probably needed. Introducing the Euro in physical form took around two years.
[15] As of July 2018, the Bank of Greece reserves (excluding its contribution to ECB capital) amounts to about €6.3 billion. Source: Bank of Greece data.
[16] Capital Economics (2012:52) estimates a 40%-50% fall in the new currency's nominal exchange rate, Buiter and Rahbari (2012) expect a 50%-70% devaluation, Christodoulakis (2014) anticipated an up to 50% devaluation, National Bank of Greece (2012) expects a 65% fall in the nominal exchange rate and a 40% fall in the real exchange rate, IMF (2012) expected that the fall of the real exchange rate would be around 50% and Lapavitsas and Flassbeck (2015:35) estimated a stabilization of the new currency at about 20% below its initial conversion rate. See also Iordanoglou and Matsaganis (2017:7).
[17] The compression of real incomes and the rise of unemployment will narrow the tax base and call for increased social spending. Thus, the fiscal position of the country would deteriorate from the current primary surplus into a deficit.
[18] National Bank of Greece (2012:6) expects the inflationary effect of the devaluation to be 30%-32% and cites BNP's and Citigroup's estimations (over 40% and 16% respectively). For IMF (2012:46) 35%.

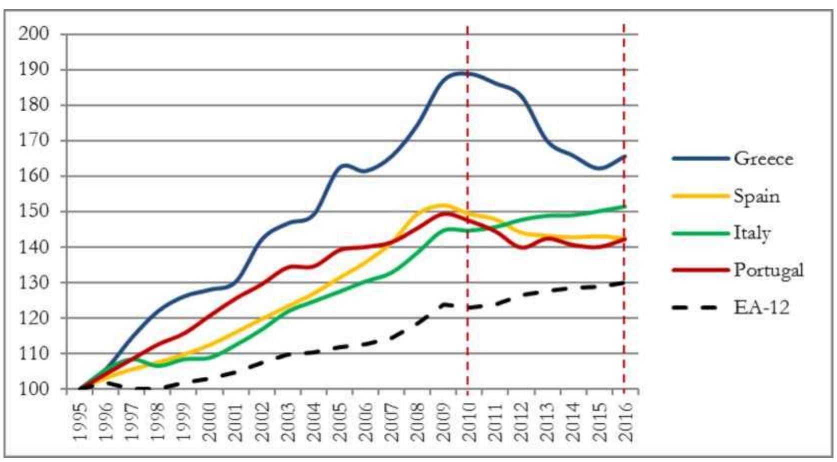
FIGURE 3

a. Nominal unit labor costs (2010-2016)



Note: Unit labor cost defined as the ratio of labor costs to labor productivity. Compensation of employees: all industries. Total employment: all industries, in persons (domestic concept). Index 2010=100

b. Nominal unit labor costs (1995-2016)

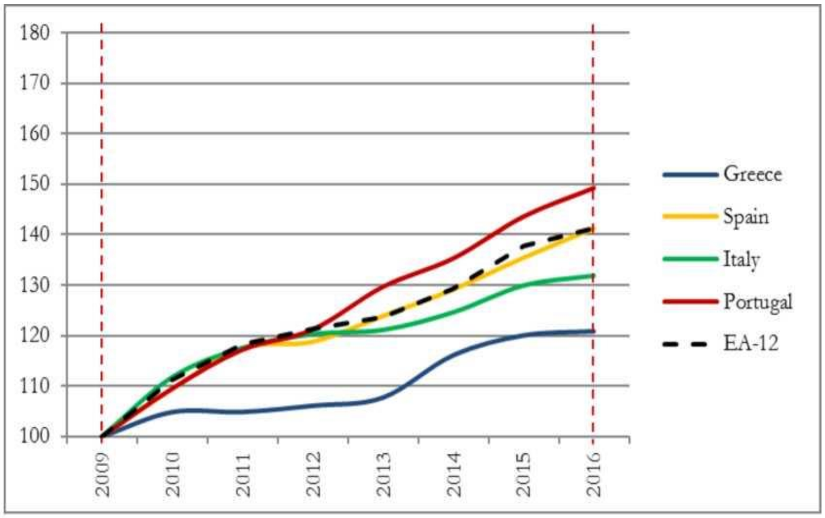


Note: Unit labor cost defined as the ratio of labor costs to labor productivity. Compensation of employees: all industries. Total employment: all industries, in persons (domestic concept). Index 1995=100. Source: Iordanoglou and Matsaganis (2017:11).

Before the crisis, Greece's export base was among the narrowest in the EU. During the crisis and due to the violent internal devaluation, export prices did fell but export growth was feeble.

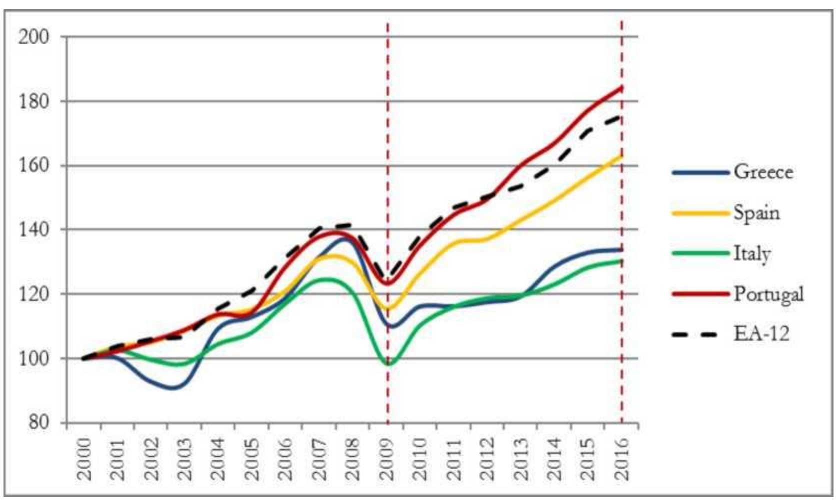
FIGURE 4

a. Exports of goods and services (2009-2016)



Note: Exports of goods and services, in billion euros, in constant prices. Index 2009=100. Source: Ameco data (National accounts).

b. Exports of goods and services (2000-2016)



Note: Exports of goods and Services, in billion euros, in constant prices. Index 2000=100. Source: Iordanoglou and Matsaganis (2017:12).

The performance of the Greek export sector indicates that deeper, structural factors are to blame.

The structural nature of reforms[19]

In a previous installment, I argued that the existence of a strong coalition of societal interests politically capable of protecting a Central Bank when it faces inflationary pressures is of critical importance for maintaining a low-inflation economy. The same can be said for a country's growth model since it can be greatly influenced by those "socio-economic coalitions" that dominate the political arena.

Trade deficits in Greece were the "normal" thing. Greece adopted the West's consumption patterns without adopting the respective production patterns. It is telling that the wages were not determined by what the tradable sectors' could sustain (in order to remain productive). The Greek State decided to protect the non-tradable sectors (an almost universal practice) but by reallocating resources to the detriment of the tradable (and this was Greece's "original contribution"). For producers', the only possible "defense" against these actions was tax-evasion and lowering their products' quality standards. This might explain why Greek exports involve "*low income-elasticity products, mostly of indifferent quality, and of rather low technological content*"[20]. One should also note the marginal representation of the tradable sector in both the Greek Parliament and Media. In Greece, the nexus of laws that regulate the business' operation were written without considering the needs of the tradables. Therefore, this sector is suffering disproportionately since it must be internationally competitive. This peculiar "Greek corporatism"[21] is mainly to blame for Greece's weak structural competitiveness and is highly unlikely to be corrected by devaluing the exchange rate. The "tradables coalition" is not big enough to oppose the "rent-seeking block". The Greek supporters of an EMU-exit are mainly to be found in this latter block that opposed the internal market in the first place and want to evade external control. By proposing a Grexit (and thus loosening the external constraint), this block hopes to a return to the *status quo ante* and arguing that a devaluation will make them shift strategies (and interests) in favor of an export-led growth and deep structural reforms borders with naivety.

To these rigidities and structural problems, one can add the fragmentation of the public administration, the lack of professionalism in bureaucracy and increased inefficiency as well as the narrow tax base, the persistent small size of the firms that lack the resources to innovate and the ability to gain from economies of scale[22], the low (public and private) savings (inefficient for securing an adequate level of domestically-funded investment) and the dysfunctional welfare state[23].

[19] Space constraints prohibit as from making a detailing analysis of the structural challenges that Greece face. These are analyzed in larger pieces of work. See, *inter alia*, Featherstone (2005); Kalyvas, Pagoulatos and Tsoukas (2010); Iordanoglou and Matsaganis (2017:13-27); Kazakos (2004).

[20] Iordanoglou and Matsaganis (2017:17).

[21] Doxiadis (2014:87-94).

[22] In manufacture, where labor productivity is the highest, in 2014 firms with less than 10 workers represented 95% of Greek firms and accounted for 42% of sectoral employment and 24% of value added with firms with over 250 people (0.2% of all Greek manufacturing firms) accounted for 21% of the sectoral employment and 37% of the value added. Source: Structural Business Statistics, Eurostat.

[23] A typical example (along with Italy, Portugal and Spain) of Ferrrera's (1996) Southern welfare state, characterized by services of poor quality but of great cost.

Conclusions

The arguments presented give the image of an economy with a limited production base, that is heavily dependent on services and, most importantly, on low-technology, non-tradable services. This is exactly why leaving the Eurozone would be of no avail for Greece. The argument most widely used by those (within and outside Greece) advising an exit from the Euro, is that Greece would be able to regain its monetary policy autonomy and use competitive devaluations to increase its exports. Let aside the fact that the monetary policy tool *per se* is not "good" or "bad" (useful or not) and that having an independent monetary policy does not guarantee the emergence of an internationally competitive export-led productive sector. Unless Greece undertakes a set of structural policies, aimed at increasing its competitiveness and expanding its productive base, policies aiming at altering the industrial relations, re-linking salary raises with productivity increases, improving the function of the labor market, introducing and supporting innovation, entrepreneurship, etc., Greece will not benefit from exiting the Euro and regaining its monetary policy autonomy. The irony is that if Greece undertakes all these structural changes and improves its productive base (and its competitiveness) there will be no reason for the country to leave the Eurozone in the first place.

According to my interpretation, it was mainly the domestic political economy conditions that led to the rigidities of Greece's growth model and the current crisis. Greece's problems, however, originate also from exogenous factors. The EMU is fundamentally flawed (it does not fulfill the Optimum Currency Area criteria, there are not automatic stabilizers financed through a central budget worth of its name, labor mobility is not high enough to correct imbalances within EMU, there are no bankruptcy rules for EMU's MS[24]). Moreover, the design of the Adjustment Programs themselves (especially the first one) was less than optimal by not including, *inter alia*, early debt restructuring. The political priorities of the creditors to rescue their banking sectors that had been overexposed to the Greek government debt and to avoid the contagion of the crisis prevailed. In addition, the quadripartite of institutions (EC, ECB, ESM, IMF) that led the negotiations with Greece, underestimated the impact of the fiscal measures on domestic production -something that has been recognized by the IMF[25]. According to analyses, the fiscal adjustment that was initially enforced in Greece, precisely because a debt restructuring was not included, explains almost 50% (!) of the magnitude of the crisis that followed. A more realistic approach to reforms from the quadripartite might have produced better results.

The argument that the design of the EMU was flawed should act as a reminder of the fact that we should take into account the framework under which the country is operating. The argument that the Adjustment Programs were not well designed should not let us overlook the domestic factors that made adjustment difficult. In any case, a change in exchange rates will not addres structural problems. The impact of a Grexit on GDP and employment would be severe while almost all the benefits depend on an almost miraculous transformation of the Greek economy and politics. Estimations vary[26] (again) from 13% to 22% -on top of the 26% decline since 2008- but the conclusion is clear-cut. A Grexit won't solve Greece's problems.

[24] Ironically, the current state of EMU on that area is much better after the Greek crisis, *because* of the Greek crisis.
[25] IMF (2012:41); IMF (2014).
[26] IMF (2012) estimates that the real GDP contraction following Grexit would be 13%, National Bank of Greece (2012) estimates a contraction of 22% and cites the estimations of BNP (20%) and Citygroup (17%).