Macro Comment 10/07

Shahin Kamalodin

Should the Greeks go on a holiday?

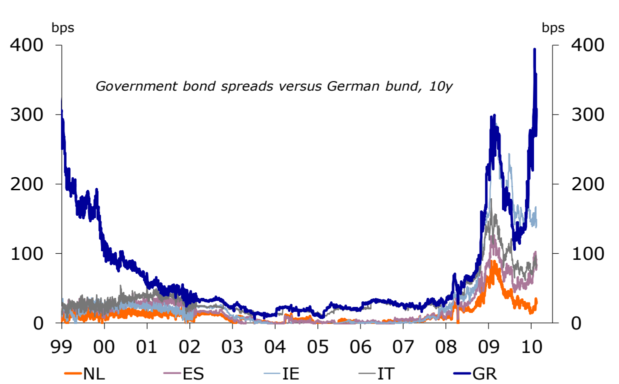
Some market participants and notable economists (most recently Prof. Feldstein of Harvard) are arguing that Greece needs to exit the eurozone, even temporarily, in order to regain its external competitiveness. As attractive as this option sounds, we are inclined to strongly disagree. In our view, the economical, political and procedural costs certainly outweigh the short-term benefits of devaluation. Against this backdrop, the only viable solution for the Greek government is to quickly adopt credible austerity measures as well as structural reforms before it's too late.

Being part of a monetary union can be a blessing in disguise. At least, that is what Greece's experience in the eurozone shows. Once the country introduced the euro, its government could fund its budget deficit against very favorable interest rates as exchange rate risk was eliminated and solvency risk was significantly reduced against the backdrop of an implicit bailout guarantee (i.e. markets' belief that no eurozone country would be allowed to default). Now, the country is stuck between a rock and a hard place. On one side, the financial markets and the EU are pushing it to announce credible austerity measures so that it will take control of its ballooning public debt-to-GDP ratio. On the other side, Greek citizens will protest against any measure that will result in lower pay and subsidies. The consequences are well known, roads will be blocked by tractors and airports will be shut-down around the country. The Greek government's awkward position at the moment is thanks to their reluctance in taking the necessary structural reforms during the "good" years to address the country's lack of competitiveness in the global market place. Thus, to regain its external competitiveness, Greece must lower its real effective exchange rate in one way or another. Some market participants and notable economists are arguing that Greece can do that by reintroducing the drachma. Most recently, Martin Feldstein, professor of economics at Harvard and president of the National Bureau of Economic Research (NBER), argued that Greece needs to exit the eurozone temporarily. More explicitly, he states:

"*The rest of the eurozone could allow Greece to take a temporary leave of absence with the right and the obligation to return at a more competitive exchange rate. More specifically, Greece would shift its currency from the euro to the drachma, with an initial exchange rate of one euro to one drachma. Bank balances and obligations would remain in euros. Wages and prices would be set in drachma. If the agreement called for Greece to return at an exchange rate of 1.3 drachmas per euro, the Greek currency would immediately fall by about 30 per cent relative to the euro and other non-euro currencies. If there is little or no induced inflation in Greece, Greek products would be substantially more competitive in both domestic and foreign markets.*" Feb. 16. Financial Times "**Let Greece take a eurozone holiday**".

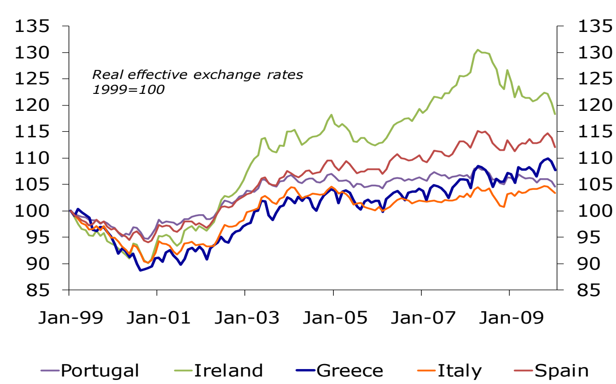
Under such policy measure Greece can regain its competitiveness overnight. This is, obviously, much less painful than an internal devaluation – lowering real wages and domestic prices. This begs the question, however, why has the Harvard-educated Prime minister of Greece not come up with this easy solution months ago? In our view, the reason he has not done so until now is because of three important costs that some market participants, including prof. Feldstein, tend to ignore. For the sake of the argument, let us

Figure 1: Markets mispriced default risk for years



Source: Reuters EcoWin

Figure 2: Lost competitiveness in the periphery



Source: BIS

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assume that the fixed exchange rate is actually *reversible* (i.e. the EU treaties contain no provisions for a country to leave the eurozone).

The first is the economic costs involved. Of course, in the short-term Greece can boost its external competitiveness by devaluing its currency, but we must not forget that such significant devaluation will put upward pressure on import prices (empirical evidence suggests that the *exchange-rate pass through effect* is substantial in small and open economies). This is bound to increase inflation and, thereby, push the country back to square one (i.e. inflation would neutralise any/most benefits in terms of external competitiveness). Something Prof. Feldstein does not entirely agree with. Another important economic cost is the explosion in the value of the euro-denominated debt, which has to be serviced while the country's assets are re-denominated in less valuable drachmas (see our Special Report "*Greece the main player in a European drama?*"). Mind you that this unwanted currency mismatch in the private sector's balance sheet was the very reason why the Baltics refrained from de-pegging their currencies from the euro. On top of that, Greece's already high public sector debt, which will remain denominated in euros, will sharply rise in the aftermath of the devaluation. The fiscal position will deteriorate even more when investors also start to ask a higher interest rate in order to be willing to hold on to the country's drachma-denominated debt. This is because the exchange rate risk reappears and the implicit bail out guarantee disappears.

The second cost relates to politics. It's not difficult to imagine that a country reneging on its euro commitments will be treated as a second class member of the EU (we do not believe the euro community will allow countries to merely take sabbaticals when faced with tough policy decisions). At the very least, they might not be invited to high-level EU meetings where important decisions are being made. In the extreme case, they might even be asked to leave the EU.

The third obstacle that has not been discussed by prof. Feldstein is the procedural costs of reintroducing the drachma. Re-denominating all contracts – including bonds, deposits, and wages – is a herculean task. Other costs include reprogramming all computers, modifying vending and payment machines and repositioning the notes and coins around the country. One need only recall the extensive planning that preceded the introduction of the euro.

But let us assume that (i) the government can control inflation in one way or another as prof. Feldstein assumes, (ii) the EU countries are totally okay with such a temporary absense and (iii) the procedural costs are affordable. Should Greece still opt for such a holiday? The answer is again, no. The reason why is because reintroducing the drachma is much more difficult in practice than in theory. If the Greek prime minister was to announce tomorrow that he wants to leave the eurozone so that the country can have a weaker currency, what would be the consequence of that decision? Once households and firms are sure about this fact, they would immediate shift their deposits to other euro-area banks (i.e. a system-wide bank run could follow the same day). The countries' bonds will experience a massive sell-off as investors' anticipate, quite rationally, that their claims on the Greek government would be redenominated into drachmas. And given that the Greek government is already in a weak fiscal position, it would not be able to borrow to bail out the banking sector nor will it be able to buy back its debt to prevent the long-term interest rate shooting upwards. If this ain't the mother of all financial crises, then what is?

So we hope that the Greek authorities as well as the proponents of Greece's exit from the eurozone are also aware that taking such shortcuts is bound to bring the country's economy to its knees. Thus, reintroducing the drachma has never been and will *definitely* never be an option. Even the Irish did not book their tickets for a holiday although their real effective exchange rose far beyond Greece's during the past decade. This shows that the only viable solution for the Greek government is to follow the Irish government's footsteps and quickly adopt serious austerity measures and structural reforms before its too late.

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