

Giving Greece a Chance: Grexit and the case for cooperation.

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A Grexit will happen, sooner or later. The sooner the better, provided the creditors of Greece accept to really help an obviously bankrupt government with a major upfront debt relief, while guaranteeing its continued access to international finance during a critical transitional period.

The "bailout" that the cartel of Greece's creditors (the « troika » of the European Commission, ECB and IMF) claims to be offering to that country amounts in reality to a cynical sinking of the Greek economy, a Greek disaster. The reason is simple: Extending loans to an insolvent debtor is a recipe for permanent depression.

A Ponzi Scheme.

Additional loans extended by the cartel, amounting in the present episode to € 86 billions over the next three years, are intended to help Athens repay interests on its previous debts, but they also add a new layer of debt to the old ones and will require additional payment of interests in the future. Increasing current debts in order to repay interest on previous ones is a well-known financial device: it is called a Ponzi scheme and leads invariably to bankruptcy because larger budget surpluses will be required to service the new "bailout" loans that in turn imply further cuts in government spending and increased taxation.

Those deflationary measures will shrink tax revenues, making the search for increased budget surplus even more elusive. At the same time the contraction of output will produce still more deflation than the current one (about minus 2% a year), thus aggravating the real burden of the old debt (the value of which stays constant in nominal terms) relative to a GDP that shrinks both in real terms (recession) and in nominal terms (as a consequence of the falling price level). Given the magnitude of previously accumulated excesses of Greek products prices over those of competitors within the Eurozone, it would take ten years of deflation at that rate, or more, to restore Greek competitiveness. Long enough to raze the economy to the ground.

The destructive consequences of additional borrowing-cum-budget-austerity lock up the Greek economy in a vicious circle. But they also trap the creditors, as far as they logically lead Greece to an increasing debt/GDP ratio and pursued deflation, thus to another crisis in the coming months that will require a new bailout.

Deep Exchange Rate Disequilibrium.

The current focus on the “debt crisis” however diverts attention from the main fact: it is a collateral damage stemming from exchange rate disequilibrium. Greece cannot escape from the debt/deflation vicious circle because its fundamental problem is not addressed nor resolved. It was not, initially, a problem of excess indebtedness, although it is currently an excessive debt level that makes the country insolvent. The deep source of the economy’s predicament is to be found in the destructive, disequilibrium current and prospective real exchange rate (competitiveness) within the Eurozone that the country cannot compensate anymore by a change of the nominal parity of its own currency. The overvaluation resulting from the substitution of the euro – a DM clone – to the Drachma ruined its export competitiveness as well as its import competitiveness in the confrontation with artificially cheapened imported products. It has even induced successive governments to borrow unsustainable amounts of debt, with the active complicity of French and German banks, in order to absorb the social and political consequences of the deflationary shocks caused by the exchange rate imbalance.

Indeed, since the Greek economy used traditionally to be more inflationary than the other members of the Eurozone, the suppression of any possibility of devaluation that the entry in the zone implied rapidly eroded the competitiveness of Greek products in foreign (Eurozone) markets, as well as in the domestic market. And this depressing effect increased as the national inflation rates divergence grew over time. It brought a progressive deterioration of national growth while the government was left with the sole budget policy to compensate for the falling incomes of firms and households.

Classical IMF solution plus Marshall Plan.

This was all the more tempting since, given the relatively high Greek inflation, the moderate nominal ECB interest rates were transformed into negative real rates for Greek borrowers. As a borrower, the government was then rewarded by a positive return to float larger amounts of debt ...

By the “virtue” of the euro entry, the vicious circle of production was thus complemented by a vicious circle of financial policy. Without an exit from the euro and its vicious circle of non-competitiveness no solution to the current depression is possible.

This is not a radically new situation, unknown of. The IMF has been confronted, in the past, to similar cases in several countries. The classical, standard, solution is well known: a **simultaneous use of the three instruments of massive debt relief, substantial devaluation of the currency, and financial help during the readjustment period** since the government’s access to international capital markets is jeopardized by default and devaluation. That’s what the Greek economy requires to return to competitiveness and solvency: massive debt relief plus exit from the euro.

The growing cost of non-exit.

Even though Greece is a small country within the European Union and the Eurozone, whose national product amounts to no more than 2% of the Union GDP, a unilateral exit from the euro could prove costly for Greece but also for the Eurozone.

Were Greece forced to a confrontational Grexit, without agreement or help from other Eurozone members, the necessary devaluation of a new Drachma would maximize the burden of foreign debt in euros, which proves already unbearable today. A devaluation of 30% vis-à-vis the euro for instance would instantly increase by 30% the amount in drachmas that the Greek government would have to raise to pay interest on that debt, and there would be no possibility whatsoever to borrow in international capital markets, making a unilateral debt default unavoidable. Bankruptcies would follow as well as a deepening of the current depression. And the default on debts would lead to costly litigation with European creditors undermining any return to confidence in the Greek economy.

That perspective could explain why the public opinion in Greece still favors staying in the euro in spite of the fact that the euro itself is the main cause of the problem and precludes any return to growth. On the other hand, Eurozone politicians' fear that a Grexit would lead to contagion and refusal of austerity in other southern countries currently trapped in austerity-cum-depression.

And given the close association between big banks and big governments, a shrinking Eurozone resulting from one or several exits would constitute a serious drawback for private and public interest groups that political leaders do not want to displease.

In spite of periodic announcements of an imminent return to prosperity in the south, austerity policies have clearly failed to restore growth there. The only perspective for the southern part of the Eurozone is one of a continuing stagnation. The Greek case is even worse since the Ponzi scheme of bailouts must lead to recurrent crises, and ultimately to bankruptcy and euro exit. It follows that a contagion effect is unavoidable in southern Europe. International investors are progressively learning that and the confidence in the euro must be eroding in the near future.

It follows that in spite of the opposition to a Grexit both in Greece and in the rest of the Eurozone, the shrinking of the Euro area will prove impossible to avoid. The choice for its leaders is thus not one of "shrinking versus not shrinking" of the euro, but of a managed shrinking intended to avoid major disruption of southern economies and to limit the costs to the northern Eurozone citizens, versus saving the current euro membership "whatever it takes", implying larger losses to both Greeks and other Eurozone citizens.

Big Bills Left Lying on the Sidewalk.

The earliest exit is the best solution, first and foremost for the Greek citizens themselves of course, because a return to growth under conditions of a deep disequilibrium in the

exchange rate is impossible. But also for the taxpayers of creditor countries because the Maastricht treaty forbids monetization of a governmental debts, so that bailout “aid” has to be financed by national taxes, difficult to increase for governments that are already struggling to reduce their own budget deficits. And these contributions will be lost when the final bankruptcy will occur.

The conclusion is that the costs of a Grexit to Eurozone institutions, in terms of contagion effects on other southern countries (including France) and reduced credibility of the euro in international financial markets, cannot be avoided and won't be avoided, while the losses to Eurozone taxpayers will increase with the passage of time and further delay in exiting. The losses to Greek citizens will also increase due to the continuing economic contraction. Thus the costs of exit will materialize in all cases, while the costs of non-exit will keep growing. The balance of costs and benefits will increasingly favor exit. It follows that of all the options at the table an assisted Grexit now, augmented by a Marshall Plan to help Greece modernize, would be the best one¹.

Shortsighted politicians that keep neglecting this best option do let the equivalent of “big bills lying on the sidewalk”. We should pick them up and reap the benefits.

¹ See my proposal, “Grexit: A European Solidarity Solution”, posted on my blog (April 15, 2015) at: <http://jjrosa.blogspot.fr/>.