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THE GREEK CRISIS: POSSIBLE COSTS AND LIKELY OUTCOMES OF A GREXIT

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Introduction

The European Union's (EU) handling of the Greek crisis has been an unmitigated disaster. In fact, EU political leadership has been an absolute failure of historic proportions, as its myopic, neoliberal bent and fear-driven policies have brought the eurozone to the brink of collapse. After more than two years of a "kicking the can down the road" policy response, it's a do-or-die situation for Euroland. Greece has reached the point where an exit looks rather imminent (it's really a matter of time, regardless of the June 17 election outcome), Portugal is bleeding heavily, Spain is about to go under, and Italy is in a state of despair. In the pages that follow, we briefly examine why the bailout policies failed to rescue Greece and boost the eurozone, and what effects a "Grexit" might possibly have on the country and the rest of the eurozone.

A political leadership that lacks the nerve and vision to implement a comprehensive strategy at the start of a crisis ends up with a live grenade in its pants.

Officially speaking, the Greek crisis began in December 2009, when Fitch downgraded Greece's credit rating after revelations weeks earlier that its deficit was close to 13 percent of GDP, and the newly elected Papandreou government announced a round of austerity measures in response. The Dubai crisis had already preceded it, which gave sovereign bond markets an extra incentive to look

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harder for nations in financial trouble and with weak support systems. Having surrendered their sovereign right to issue their own money, and functioning in a monetary union where, in the absence of political unification, there is no single institution responsible for economic policy, peripheral nations in the eurozone were precisely what the bond vigilantes were looking for in the aftermath of the global financial crisis. And Greece, the weakest link in the eurozone, having built up a huge stock of government debt and posting sky-high deficits, became the opening act.

Since then, Greece has preoccupied EU officials, markets, and bond investors. Twice the country has had to be "rescued" with massive bailout packages in order to avoid defaulting and thereby causing financial shocks throughout the eurozone and beyond. Continental European banks, mostly French and German, as well as British and American banks had large and highly concentrated exposures to Greek debt, even though the figures provided can vary from one source to the next. According to the Bank for International Settlements, French and German banks had between them more than $90 billion in lending exposure to Greece at the close of 2010; in terms of Greek government debt specifically, German banks held $22.6 billion and French banks $15 billion (Alloway 2011). According to data from Standard Life Investments, at the end of the fourth quarter in 2010 French banks still had the largest exposure to Greece but the figure was estimated to be $93 billion in liabilities, while German banks held $57 billion in Greek bonds (Fontevecchia 2011). Swiss banks also had large exposures to Greek debt (possibly larger than Germany's own), as, of course, did Greek banks (an estimated $84 billion for the fourth quarter of 2010).

Figuring out banks' exact exposure to debt is not a precise science, given the scores of interconnected trades that can be hidden from view, let alone the lying that is frequently involved or the accounting loopholes that can take place to avoid "haircut" losses. Also, an assessment of banks' exposure to debt may include credit exposure (as the figures cited above for German and French banks do), which is not direct exposure to sovereign debt. A related controversy was created over US bank exposure to Greece, which was estimated at $32.7 billion in June 2011 (BIS 2011). Likewise, there was an ongoing controversy about the reduction in German banks' direct exposure to Greek debt following the May 2010 bailout. The figures varied wildly, ranging between $10 and 20 billion in late 2011 (Kuehhen 2011).

Nevertheless, there was an overwhelming consensus back in early 2010 that a Greek default had to be avoided by all means necessary, in the belief that it could bring down the entire financial system. Comparisons between Greece and Lehman Brothers (specifically, the decision on the part of the US Treasury to let the firm collapse, and the consequences that followed) were frequently made in order to support the case against allowing Greece to default. Thus, the first Greek bailout, agreed to in May 2010,was unmistakably a bailout of the EU's banks, and the conditions that came attached to it—harsh austerity measures—were meant as a form of punishment for Greece having overspent, and also as a message to the other nations in the eurozone periphery about the fate awaiting them if they followed Greece's path. It was an imperial policy imposed on a colony, under the false assumption that it would appease markets and stop the contagion from spreading.

The decision not to allow Greece to proceed with an orderly default two years ago was a huge mistake. The bailout did not appease markets, nor did it stop the rest of the periphery from coming under the watchful eye of the bond vigilantes. Why? Because the terms that were imposed on Greece as part of the loan agreement consisted of seriously flawed economic policies that made an already bad situation much worse. The so-called "memorandum," a hurriedly prepared list of neoliberal dictats (of the kind blindly enforced by the International Monetary Fund on countries throughout the world over the last 30 years or so), had the predictable effect of sliding an ailing patient into a coma. Greek GDP took a nosedive immediately thereafter, and the economy experienced the most severe depression in its postwar history (Polychroniou 2012). Naturally, Greece's debt situation deteriorated and markets even began betting on a disorderly sovereign default, while at the same time eyeing other countries in the eurozone periphery.

Based only on the hard numbers involved, an orderly European default would have been rather manageable (*The Economist* 2011). What was missing was the political will and a strategy for what might follow an official sovereign default inside the eurozone. But, in general, this has been the problem all along with the EU: avoiding dealing directly with the crisis that has plagued the eurozone since the eruption of the global financial crisis in 2008. While Greece is indeed a special case, one that could have been dealt with quickly and efficiently when the problem first surfaced, the eurozone crisis is both a banking crisis—like their US counterparts, European banks loaded up on toxic mortgage-based assets—and the outcome of a system that operates mainly as an updated version of the old imperialist production and trading networks between north and south. As of late spring 2012, the EU chiefs have done virtually nothing on either front.

A lack of political nerve, vision, and imagination also drove the decision for a second Greek bailout agreement a few months ago, only two years after the first one became a reality and an inevitable failure. And if there were reasonable lingering doubts about the impact of a Greek default back in early 2010, there were virtually none in February 2012. The economic cost of an orderly Greek default could have been easily absorbed. And as the restructuring of the Greek debt proved, fears that this was going to be a cataclysmic event that could cause huge eruptions in global markets and potentially bring the eurozone crashing down were based on unfounded assumptions about market behavior and the relation between markets and states. Markets are concerned about stability and order above all else; in the final analysis, even cost containment is of secondary importance in the presence of a highly stable and orderly investment environment. Indeed, in contrast to fears about market panic over an orderly default or exaggerated concerns about moral hazard—a potential problem that, theoretically speaking, can never be completely eliminated—markets might have welcomed a process of catharsis inside the eurozone. In other words, market confidence in the eurozone would have been boosted if the EU had taken immediate and aggressive steps to resolve the Greek crisis two years ago through the establishment of permanent mechanisms for managing an orderly sovereign default—including, of course, mechanisms for sustaining growth.

Compounding one mistake with another (which is typical of the antidemocratic processes in EU policymaking), the second bailout agreement is even more ruthless than the first one, with even more demanding tasks for the restructuring of the Greek economy and an even more unreasonable time frame. The troika—the European Commission (EC), the International Monetary Fund (IMF), and the European Central Bank (ECB)—apparently feels that running a country is like running a firm. If it may take a firm, say, two to three months to unload inventory, cut down costs, and introduce new output equipment, why should it take longer for a national government to slash deficits, lay off thousands of public employees, privatize publicly run companies, correct longstanding administrative inefficiencies, and insert greater flexibility in the labor market? After all, haven't we seen how quick and efficient the EU bureaucrats have been at managing the eurozone crisis over the last two years? As fast, deft, and creative as a turtle with its neck cut off!

When the terms and conditions of the second bailout were accepted by Greece, the troika officials already knew that the scheme would fail, as a leaked report, prepared by troika analysts and marked "strictly confidential," clearly revealed (Spiegel 2012). But the intention, again, was not to "rescue" the Greek economy and help it get back on its feet, but to avoid a contagion effect and keep the banking system breathing until a more permanent solution could be found—a policy response EU leaders have clung to with amazing tenacity from day one of the eurozone crisis. All of the money that was approved for the second bailout goes back to the troika (Alderman and Ewing 2012). Indeed, it took the *New York Times* to confirm what average Greeks have felt all along, in spite of constant protestations by government officials and relentless propaganda by the nation's mainstream media: that the loans received from the bailouts do not go toward covering the cost of domestic public services but are siphoned off to repay Greece's creditors. Indeed, even at this moment, when the eurozone endgame has begun, Germany and EU officials continue to display a posture of confusion and paralysis wrapped around hypocrisy and falsehood. With Spain facing the prospect of ending up in a situation similar to that of Ireland, Greece, and Portugal (i.e., under the command of the troika) because of the likely collapse of its banking system, the European Commission engaged in its typical ritualistic postures by urging the government of Spain "to take market-calming measures" (Thomas 2012). And on the same day, the Commission's inimitable president, José Manuel Barroso, told eurozone national governments "to commit to tighter cooperation now, in order to restore investor confidence" (Kanter and Geitner 2012).

Greece's economic situation is as clear as a star-filled sky: unsustainable debt, severe lack of competitiveness, no growth prospects, low productivity rates, and huge unemployment. Throw into the mix a highly inefficient and resource-consuming public administration system that is unresponsive to calls for reform, and you have an economy that will take many, many years to reform. By then, of course, the gap between Greece and the eurozone core will have grown to immense proportions.

In this context, the odds of Greece remaining in the eurozone for much longer must be rather slim. For a "Grexit" *not* to happen, another, much larger debt restructuring will be required, along with a switch from austerity to pro-growth strategies (not the nonsense formula of both austerity *and* growth EU officials have been preaching about lately) and a huge injection of capital for investment purposes. Indeed, even without a debt to worry about, the Greek economy, in the absence of a boost in growth, will still need outside funding to cover viable public services—unless they all collapse to 1950s levels, or become privatized (which they're well on their way to being), so that only the rich can afford them.

Couldn't Germany turn around and show a willingness to renegotiate the bailout terms and introduce some kind of a Marshall Plan to spur the Greek economy toward recovery? The renegotiation of the bailout is very likely to happen no matter who forms a government following the June 17 Greek elections. But it will take nothing less than a large-scale recovery plan for the Greek economy to stabilize and then come out of its five-year-long depression. In the meantime, the EU is facing the challenge of rescuing Spain and building a firewall around Italy. Realistically, it will probably engage in macro-management over Spain and Italy within the next few months, taking a full-fledged European-wide approach, and confine itself to a micro-management process for a Greek exit.

Thus, a Grexit is a very likely scenario at this stage simply because of the nature of the economic realities involved.

A Greek exit is not necessarily a gloom-and-doom scenario.

Whether Greece remains in the eurozone or returns to the drachma, pain is unavoidable. There should be no debate about that. The only question is whether accepting a slow death by remaining in the eurozone in its current configuration is a better option for Greece than a return to a national currency. In the latter scenario, after a painful period of adjustment the prospects for recovery will become very real, as they always do after an economy has hit rock bottom and currency devaluation can be used to set up the economic conditions needed to produce long-term societal benefits—even though some will experience losses in the short run. Individuals whose incomes cannot keep up with inflation are the ones that suffer most as a result of devaluation, and those with savings will see the value of their money decline. But with increased competitiveness, long-terms benefits are derived; not only for the export sector but also for the overall economy, as underutilized resources (in the case of Greek labor) are more widely used(since imports will be much more costly).

Lately, there have been a lot of attempts at figuring out the impact of a Greek exit from the eurozone. While this is an impossible task, given that uncertainty can never be quantified and a Greek exit from the eurozone is unchartered territory, the overwhelming majority of those making these assessments apparently feel compelled to offer a gloom-and-doom scenario. There are studies indicating that the cost of a Greek exit could add up to anywhere from 300 billion euros (Alcidi, Giovannini, and Gros 2012) to more than one trillion euros (IIF 2012),[1] and that the overall impact would be felt throughout the global economy, even affecting producers and exporters in China and Russia (Varoufakis 2012).

Undoubtedly, some reports about the effects of a Grexit have clear political aims, seeking to influence Greek public opinion with an eye on the June 17 elections. A report released recently to the Greek press by the National Bank of Greece about the consequences of Greece's return to the drachma falls, unfortunately, under that category (Mylonas 2012). More scare tactic than objectively balanced assessment, it portrays a society sliding into chaos as a result of abandoning the euro but keeps silent about the economy's continuing collapse under the current EU arrangements.

The gloom-and-doom scenario involves a disorderly default on Greek government debt and assumes that Greece will be completely cut loose. This scenario essentially removes all political considerations from the picture and is highly unlikely to happen. It is a scenario much closer to a Hobbesian "state of nature," when a Machiavellian outcome is far more probable. Indeed, a more likely scenario is that the Grexit will be orderly (the German Ministry of Finance and virtually all major banks, including the ECB, have already made contingency plans), and that both the EU and the IMF will become involved in damage control. A huge debt write-down should be expected, as the Greek debt-to-GDP ratio will increase substantially because of the new drachma's inevitable devaluation.

Having said this, we should note that there are indeed market analysts who take a much more moderate view regarding Greece's exit from the eurozone. For instance, Guy Lebas, chief fixed-income strategist at Janney Capital Markets, observes that assets in the Greek banking system are just 1.4 percent of the assets across all euro-area banks, and that Greece's GDP is modest; on the basis of either economic or banking system impact, says Lebas, "it's hard to imagine a Greece euro exit causing irrevocable harm" (quoted in Slavin 2012).

In discussions on the effects of a Greek exit, the possibility of contagion spreading to the rest of the European periphery figures prominently. Here, too, fear and panic trump calm analysis. At this stage, any talk of contagion as a result of a Grexit suffers from a profound lack of understanding of what is happening in the eurozone. Portugal, Spain, and Italy are already infected, and what may happen in Greece couldn't possibly have much of an effect on them. Furthermore, any Greek contagion could easily be managed if the EU built a big enough firewall (more than two trillion euros) around Spain and Italy and the ECB began a new round of quantitative easing (which it has to do regardless). The alleged threats that a Greek exit poses to the rest of the eurozone are as exaggerated as the fears of debt restructuring were a year ago. If the rest of the European periphery falls, it certainly won't be because of Greece.

Much more uncertain is the extent to which Greek political forces will be able to manage the transition from the euro back to the drachma and balance potential gains with actual losses. Unfortunately, Greece is completely unprepared for such a transition, thanks to the infuriatingly opportunistic and incompetent character of its political parties. It is absolutely certain that no political party in Greece has prepared a Plan B. Still, one can expect the EU and the IMF to continue extending some loans to Greece while it makes a stable transition back to the drachma, and some EU structural funds might still be available.

Devaluation of the new drachma and a major write-down of both public and private debt would allow the economy to recover some of its lost competitiveness, even though some companies would undoubtedly go bankrupt—particularly with the redenomination of assets, liabilities, and contracts of all kinds. In this context, it is important to stress that the key to recovery does not lie with exports, as most analysts are keen on suggesting, but rather with a substantial increase in domestic demand. Even in the case of Argentina, with its fairly large export sector, it is the increase in domestic demand that has spurred the general growth of the last 10 years.

Regarding banks, which will certainly face the prospect of a collapse, it is important that they be brought under state control in order to ensure their survival, but not in a "too big to fail" model. Having a number of midsize banks is far more preferable than having a few huge nationalized banks. (Everyone recognizes that banks are important, but no one can explain why they should necessarily be privatized.)

The new currency and the changed economic setting should be seen as an opportunity to spur investment, public as well as private, and a competent government should make this its top domestic priority (Papadimitriou 2012). Supporting a vital welfare state without strong growth patterns is an illusion that some segments of the Greek left appear to have difficulty dispelling (e.g., they continue to promise a return to all the benefits that were lost during the implementation of the EU/IMF fiscal adjustment program).

Changing the tax system and making the rich pay will be another big task for Greece in the new era. How the inefficient and corrupt public administrative system will be able to deal with these new challenges is the $64 million question. Clearly, major changes would need to be institutionalized, including breaking the power that political parties have over the state bureaucracy and doing away with the practices of the past, where permanent, unproductive employment and the looting of public wealth drove people to join the public sector in the first place. Resurrecting the "common good" as a central value in the functioning of a democratic society is also absolutely key, as is a return to a culture of civic virtues. These elements are desperately missing from contemporary Greek political culture and civil society, and any hope for a sustainable recovery requires that they become part of the national fabric.

EU political leadership failed dismally in its handling of the Greek crisis. The least it should be able to do now is give a helping hand should a Grexit become inevitable, easing the country's exit from the euro and supporting Greece while it tries to make a new economic start under a new-old currency.

Note

1. Institute of International Finance (IIF) Managing Director Charles Dallara stated to Bloomberg three months later that a Greek exit would be unmanageable, and that the cost would ultimately exceed the original IFF estimate.

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