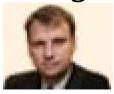
Greece has nothing to lose by saying no to creditors

Wolfgang Münchau, *Financial Times*, June 14, 2015



If it were to default on its official-sector debt, France and Germany stand to forfeit €160bn.

So here we are. Alexis Tsipras has been told to take it or leave it. What should he do? The Greek prime minister does not face elections until January 2019. Any course of action he decides on now would have to bear fruit in three years or less.

First, contrast the two extreme scenarios: accept the creditors' final offer or leave the eurozone. By accepting the offer, he would have to agree to a fiscal adjustment of 1.7 per cent of gross domestic product within six months.

My colleague Martin Sandbu calculated how an adjustment of such scale would affect the Greek growth rate. I have now extended that calculation to incorporate the entire four-year fiscal adjustment programme, as demanded by the creditors. Based on the same assumptions he makes about how fiscal policy and GDP interact, a two-way process, I come to a figure of a cumulative hit on the level of GDP of 12.6 per cent over four years. The Greek debt-to-GDP ratio would start approaching 200 per cent. My conclusion is that the acceptance of the troika's programme would constitute a dual suicide — for the Greek economy, and for the political career of the Greek prime minister.

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Would the opposite extreme, Grexit, achieve a better outcome? You bet it would, for three reasons. The most important effect is for Greece to be able to get rid of lunatic fiscal adjustments. Greece would still need to run a small primary surplus, which may require a one-off adjustment, but this is it.

Greece would default on all official creditors — the International Monetary Fund, the European Central Bank and the European Stability Mechanism, and on the bilateral loans from its European creditors. But it would service all private loans with the strategic objective to regain market access a few years later.

The second reason is a reduction of risk. After Grexit, nobody would need to fear a currency redenomination risk. And the chance of an outright default would be much reduced, as Greece would already have defaulted on its official creditors and would be very keen to regain trust among private investors.

The third reason is the impact on the economy's external position. Unlike the small economies of northern Europe, Greece is a relatively closed economy. About three quarters of its GDP is domestic. Of the quarter that is not, most comes from tourism, which would benefit from devaluation. The total effect of devaluation would not be nearly as strong as it would be for an open economy such as Ireland, but it would be beneficial nonetheless. Of the three effects, the first is the most important in the short term, while the second and third will dominate in the long run.

Grexit, of course, has pitfalls, mostly in the very short term. A sudden introduction of a new currency would be chaotic. The government might have to impose capital controls and close the borders. Those year-one losses would be substantial, but after the chaos subsides the economy would quickly recover.
Comparing those two scenarios reminds me of Sir Winston Churchill's remark that drunkenness, unlike ugliness, is a quality that wears off. The first scenario is simply ugly, and will always remain so. The second gives you a hangover followed by certain sobriety.

So if this were the choice, the Greeks would have a rational reason to prefer Grexit. This will, however, not be the choice to be taken this week. The choice is between accepting or rejecting the creditors' offer. Grexit is a potential, but not certain, consequence of the latter.

If Mr Tsipras were to reject the offer and miss the latest deadline — the June 18 meeting of eurozone finance ministers — he would end up defaulting on debt repayments due in July and August. At that point Greece would still be in the eurozone and would only be forced to leave if the ECB were to reduce the flow of liquidity to Greek banks below a tolerable limit. That may happen, but it is not a foregone conclusion.

The eurozone creditors may well decide that it is in their own interest to talk about debt relief for Greece at that point. Just consider their position. If Greece were to default on all of its official-sector debt, France and Germany alone would stand to lose some €160bn. Angela Merkel and François Hollande would go down as the biggest financial losers in history. The creditors are rejecting any talks about debt relief now, but that may be different once Greece starts to default. If they negotiate, everybody would benefit. Greece would stay in the eurozone, since the fiscal adjustment to service a lower burden of debt would be more tolerable. The creditors would be able to recoup some of their otherwise certain losses.

The bottom line is that Greece cannot really lose by rejecting this week's offer.