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Will Greece exit from the Eurozone?

By Pradumna Bickram Rana

Synopsis

Political confrontation between Greece and its creditors has greatly heightened the possibility of the country exiting from the eurozone. But, at the end of the day, economics and common sense will prevail, and Greece will continue to be a member of the exclusive single-currency club.

Commentary

RELATIONSHIP BETWEEN Greece and its creditors which has been tense since the crisis began in 2010 ago has worsened significantly in the past few months and reached a breaking point. Last Wednesday the creditors gave the country a final chance to come up with a "credible" reform program in five days or else to exit from the eurozone (Grexit).

Five years after the crisis and two bailout packages later, the cost of austerity has been high. Greek GDP has contracted by 25 per cent while the unemployment rate has soared to 25 per cent – or 50 per cent among the youth. Nominal wages have fallen by 20 per cent on average and pensions by 20 to 60 per cent. Such adjustment costs have not been seen since the Great Depression of the 1930s. No wonder anti-austerity sentiments are rising in Greece.

Recent Political Developments

In January 2015, the Syriza party won the elections on a platform to end austerity and its left-wing leader Alexis Tsipras vowed that he would negotiate Greece's debt. Since then Tsipras has driven a series of hard bargains with his creditors.

Deepening ties between Greece's new government and Russia have also set off alarm bells across Europe. Is Tsipras committed to the European project? Many Europeans fear that Greece is inexorably moving away from Europe, towards Russia which could be a more benevolent ally, a potential investor and a creditor that might require less austerity. The first official to visit the newly-elected Prime Minister last January was the Russian ambassador, whereas it took two days for German Chancellor Angela Merkel to congratulate him with a rather frosty telegram.

On 27 June, Tsipras broke-off negotiations with creditors and called for a referendum for voters to decide whether to accept a bailout deal offered by the creditors. An unexpectedly high 60 per cent voted "no" and supported the government. The International Monetary Fund also came out with a report supporting the Greek position and calling on Europe to grant the country “comprehensive” debt relief, arguing for the doubling of the maturities from 20 to 40 years.

Armed with a fresh mandate, Tsipras went back to his creditors once again. But the creditors, upset with the “no” vote, were in no mood to negotiate. The new Finance Minister also did not have a written rescue proposal that many had expected. He instead gave a verbal outline of what the government was intending to submit to its creditors. In the strongest language used in recent months the creditors warned that any new bailout deal to Greece would include much tougher conditions than those that would have been gotten before the referendum.

Greece was asked to submit a new “credible” reform plan and reach a deal with its creditors on Sunday or face bankruptcy and exit from the eurozone. An emergency meeting of the leaders of all 28 EU members has been called to decide on Greece’s fate.

Will there be a Grexit?

The answer is, no. This is because the decision of a country to join a monetary union is effectively irreversible for three reasons which are mainly economic in nature:

• First, a country that leaves the euro because of problems with competitiveness would be expected to devalue it newly-reintroduced national currency. But workers would know this and demand higher wages which would neutralize any benefits in terms of external competitiveness.

• Second, leaving the euro and reintroducing the national currency would require that all contracts governing wages, bank deposits, bonds, mortgages and taxes to be re-denominated in the new domestic currency. Computers would have to be reprogrammed. Vending machines would have to be modified. This is a costly exercise. One needs to only recall the extensive planning that preceded the introduction of the physical euro in 1999.

• Third and most importantly, Grexit will introduce the possibility of destabilizing speculation, a permanent source of instability for a monetary union. It was this possibility that had led the founding fathers of the eurozone to not consider an exit option from the eurozone in the first place. Having a monetary union with an exit option would mean that Europe goes back its old exchange rate mechanism of the 1980s which ended because of speculative attacks with disastrous consequences.

Barry Eichengreen has, in fact, warned that a Grexit could have consequences for the European and global economy that would dwarf the panic following the bankruptcy of Lehman Brothers.

What will happen on Sunday?

Although in the past week an increasing number of European leaders have started to talk openly about the possibility of a Grexit, it is still possible that a political comprise can still be struck given the high economic costs of Grexit and the permanent instability that such a move would introduce to the currency union. If so, Grexit can be avoided.

Pradumna B. Rana is Associate Professor and Coordinator of the International Political Economy Programme in the Centre for Multilateralism Studies at the S. Rajaratnam School of International Studies (RSIS), Nanyang Technological University, Singapore.
