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Greece's exit may become the euro's envy

8

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Default will be disastrous for Greece and the resulting contagion would be damaging for Europe. So goes the conventional wisdom. The only debate has been about the strength of contagion and the appropriate response of vulnerable countries and of the cheque-writing country. Might the debate be misguided because the premise is flawed? Expelled from the eurozone, Greece might prove more dangerous to the system than it ever was inside it – by providing a model of successful recovery.

There is an overlooked scenario in which default is not a disaster for Greece. If this is the case, the real, more existential threat to the eurozone might be a very different one, in which the Greeks have the last laugh. Consider that scenario.

The immediate consequences of Greece leaving or being forced out of the eurozone would certainly be devastating. Capital flight would intensify, fuelling depreciation and inflation. All existing contracts would need to be redenominated and renegotiated, creating financial chaos. Perhaps most politically devastating, fiscal austerity might actually need to intensify, since Greece still runs a primary deficit, which it would have to correct if EU and International Monetary Fund financing vanished.

But this process would also produce a substantially depreciated exchange rate (50 drachmas to the euro, anyone?) And that would set in motion a process of adjustment that would soon reorientate the economy and put it on a path of sustainable growth. In fact, Greek growth would probably surge, possibly for a prolonged period, if it adopted sensible policies to restore rapidly and sustain macroeconomic stability.

What is the evidence? Just look at what happened to the countries that defaulted and devalued during the financial crises of the 1990s. They all initially suffered severe contractions. But the recessions lasted only one or two years. Then came the rebound. South Korea posted nine years of growth averaging nearly 6 per cent. Indonesia, which experienced a wave of defaults that toppled nearly every bank in the entire system, registered growth above 5 per cent for a similar period; Argentina close to 8 per cent; and Russia above 7 per cent. The historical record shows clearly that there is life after financial crises.

This would also be true in Greece, even allowing for the particularities of its situation. Greece's low export-to-GDP ratio is often said to preclude the possibility of high export-led growth. But that argument is not ironclad because crises can lead to dramatic reorientations of the economy. India, for example, managed to double its similarly low export-to-GDP ratio within a decade after its crisis in 1991, and doubled it again in the following decade even without a big currency depreciation.

Greece, moreover, would experience a mega-depreciation, like the countries mentioned above, not a modest one. Such a change would necessarily create new opportunities for exports and convert marginally non-tradeable activities into tradeable ones. What these exports might be will, by definition, be unpredictable. But the strong incentives that will be created by a super-competitive exchange rate are undeniable.

Suppose that by mid-2013 Greece's economy is recovering, while the rest of the eurozone remains in recession. The effect on austerity-addled Spain, Portugal and even Italy would be powerful. Voters there would not fail to notice the improving condition of their hitherto scorned Greek neighbour. They would start to ask why their own governments should not follow the Greek path and voice a preference for leaving the eurozone. In other words, the Greek experience could fundamentally alter the incentives for these countries to remain in the eurozone, especially if economic conditions remained grim.

At this stage, politics in Germany would also be affected. Today, Germany grudgingly does the minimum needed to keep the eurozone intact. If exit to emulate Greece becomes an attractive proposition, Germany will be put on the spot – and the magnanimity it shows in place of its current miserliness will be the ultimate test of how much it values the eurozone. The answer might prove surprising. The German public might suddenly realise that the eurozone confers on Germany not one but two "exorbitant privileges": low interest rates as the haven for European capital and a competitive exchange rate by being hitched to weaker partners. In that case, Germany would have to offer its partners a much more attractive deal to keep them in the eurozone.

Such a scenario would be rich in irony. Greece is viewed as the pariah polluting the eurozone; its expulsion might make it a far bigger threat to the single currency's survival. If a eurozone exit creates the conditions for a rebound in Greece, it may prove an infectious model. The ongoing Greek tragedy could yet turn out not too badly for the Greeks. But tragedy it might well be for the eurozone and perhaps for the European project.

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