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Jean Pisani-Ferry August 22, 2012

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EUROPE

Europe should choose whether it wants Greece in or out

For the third time in three years the Europeans' stance on Greece is economically inconsistent.

The first time was in 2009-2010 after then prime minister George Papandreou indicated that he would need to file for assistance from the International Monetary Fund. The European response was to reject the principle of IMF intervention while not offering an alternative to it. It took several months until an agreement was found, in May 2010, to combine European and IMF conditional support.

The second time was in 2010-2011 when Greece's solvency became the urgent issue at hand. Two camps emerged. One advocated swift debt restructuring, emphasising that Greece was a unique case and that markets could be convinced that no other European country would follow suit. The other one stressed the adverse spill-over effects of a default and favoured keeping Athens afloat through cheap loans. The compromise was to lend at penalty rates while letting markets expect that restructuring would perhaps come, but at a later date. Each of the two positions was internally consistent but the compromise was not. It took more than a year, until the second half of 2011, to recognise this contradiction.

The third time is now. Again, Europe is divided. One camp, well represented in northern Europe, considers that Greece should leave the eurozone because it is not fit for purpose either economically or politically.

This view is actually held by both eurosceptics (who want to demonstrate that exit is possible) and europhiles (who hope to win over opposition to further integration). The latter camp, more vocal in France and southern Europe, is adamant that the integrity of the eurozone must be preserved, because Greece's departure would have adverse contagion effects on other southern countries.

Each of these positions is also internally consistent. But it is not consistent to urge an exhausted country to make all possible efforts to meet the targets of the IMF/euro area programme, while fuelling anticipations of a forced exit. For domestic agents, the risk of the financial disruptions an expulsion would cause acts as an incentive to export capital or hoard cash. For foreign investors, including overseas Greeks, it is an incentive to refrain from investing in the country in the hope of future bargain acquisitions. In such conditions one should not wonder why investment in the first quarter of 2012 was only 46 per cent of its level four years previously (in fact one may wonder why it was still so high). But without investment and a return of confidence, Greece is bound to remain caught in a vicious circle of recession and whatever its efforts, it is unlikely to meet its creditors' demands.

European leaders should choose. If they really think they would be better off with Greece out they should offer it an exit package. Evidently, an exit will cost them dearly because the sharp currency depreciation that is certain to take place will force the country to default on its euro liabilities. Also, Athens will remain in need for financial support, if only because it is still far from having returned to budgetary and external balance. The credibility of the euro will suffer and other countries will have to be protected from contagion. And finally the EU cannot forget Greece because whatever its fate in the EU, it will remain in Europe and will matter for the whole continent. So on closer examination the option looks less attractive and more dangerous than seems at first sight. But at least it has an internal logic.

If the Europeans accept that a Greek exit is not in their interest, they should recognise the efforts made and give it a real chance to adjust further and recover within the euro. Obviously they cannot remove the redenomination risk entirely but they can at least make speculation of exit a less-assured bet. Beyond a reasonable extension of the assistance programme, this means giving clear signals that Europe believes in a possible success. One possibility, which is certainly not without difficulty, would be a conditional relief on the debt to official creditors, what the jargon calls official sector involvement. Another one would be to foster

public and private equity investment, through debt-equity swaps, investment by international financial institutions (such as what the European Bank for Reconstruction and Development has done in eastern Europe), or a revival of the too quickly derided Eureca plan for the pre-privatisation once proposed by Roland Berger, the consulting firm. The key is that private agents can only believe in the revival of Greece if the Europeans themselves invest in it.

When Prime Minister Samaras meets with fellow European leaders later this week, he should offer them a small gift for late summer reading: a copy of Alfred de Musset's play, *A door must be either open or shut*. It is short and inspiring.

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