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CAPITAL ECONOMICS

Grexit might be unavoidable, but it need not be a crisis

- In 2012, Capital Economics won the *Wolfson Prize* for our submission on how the exit from the eurozone of a small country like Greece might best be managed. **Given the still significant risk that negotiations this week fail to reach a deal to keep Greece in, this *Update* discusses the changes in the situation since then and updates the recommendations of the Wolfson Report accordingly**.

- **Planning/secrecy**. We recommended in the original Wolfson plan that the preparation for a euro exit be done in secret where possible. This would help to avoid the huge outflow of bank deposits and capital that we were sure would accompany speculation of exit, damaging the financial sector and economy.

- That ship has clearly sailed in light of the drawn-out speculation over a "Grexit" and corresponding drop in bank deposits over recent months. It would still be preferable if measures such as currency printing could at least be commenced in secret (it is even possible that this is underway). But it now seems more likely that a Grexit would be a fairly abrupt result of failed negotiations and financial pressures, rather than a negotiated and organised process conducted in planned stages over time.

- **Banking conditions**. Until recently, the Greek banking sector was showing some signs of improvement compared to 2012 and stress tests published by the ECB last year revealed that most capital shortfalls were already being addressed. But more recently, deposit outflows have surged again, leaving banks to rely on central bank funding of €128bn, €89bn of which is in Emergency Liquidity Assistance from the Greek central bank. They are reportedly running out of eligible collateral to access these funds and ELA will no longer be permitted by the ECB in the quite likely event of Government default anyway.

- **Capital controls**. Given all of the above, we were clearly right to state in 2012 that a euro exit would need to be accompanied, and ideally preceded, by the imposition of substantial capital controls and the temporary closure of Greek banks. We argued then that such controls need not breach EU laws if imposed in an emergency. Since 2012, the imposition of controls in Cyprus has proved us right on the legal point and arguably provided a blueprint for Greece to follow. Controls have been key to Cyprus' recovery and the authorities were able to remove them after a relatively short period of two years. Greek controls would almost certainly be needed for longer, but they seem necessary nonetheless.

- Note, though, that while such controls should limit outflows of deposits, they cannot make money flow back to the country, as also evidenced by the Cypriot experience. Upon exit, then, we maintain our 2012 view that the reconstituted Greek central bank should provide liquidity to the banking system. Indeed, this is more straightforward than it would have been then since it is already doing it through ELA (it will simply no longer need ECB permission). As we said in 2012, the Government should consider recapitalising the banks permanently as soon as it could issue new debt.

Source – Capital Economics

- **Currency depreciation**. In the Wolfson Report, we estimated that the drachma would need to drop by as much as 40% to restore Greece's competitiveness against the rest of the euro-zone. Since then, sharp falls in Greece's relative wage costs and the depreciation of the euro exchange rate suggests that the required depreciation has lessened. But given the weakness of domestic demand, Greece probably needs to become super-competitive if net trade is to pick up by enough to ensure a broader recovery. A drop of over 20% is probably still required and some overshoot seems likely due to initial uncertainty.

- **Default/debt ownership**. A key proposal in the Wolfson Report was that the Greek Government needed to default on at least half of its debt and that, where legally possible, it should do so by redenominating its international debts into drachma. Since then, private sector debt has been restructured and largely replaced by loans from other euro-zone governments, the European Financial Stability Fund (EFSF) and the IMF, as well as bond purchases by the ECB. But a massive default is still needed.

- Euro-zone creditors are unlikely to let Greece redenominate its debt into drachmas, so a straightforward default will be required. This is more likely to end in effective expulsion from the euro-zone than the previous possibility of a default on private sector debts, particularly those held within Greece. But the fact that the Greek private sector if now less exposed should mean less damage to the Greek economy.

- Of course, Greece's international political relations could be hit hard and this might have economic effects. So it would still make sense to negotiate the default with euro-zone authorities. Greece's recent proposal for half of the EFSF debt to be written off while interest rates on the other half were increased might soften the blow to creditors. Remaining repayments could be linked to Greek GDP growth.

- **Financial support**. One prospect to have emerged in recent weeks is the possibility that Greece might continue to receive some form of financial support even after exiting the euro-zone. This could involve bailout or aid payments in the event that an exit leads to economic weakness or a humanitarian crisis.

- **Fiscal conditions**. One apparently significant change since 2012 has been the further improvement in Greece's fiscal position under continued severe austerity and, in particular, the movement of the primary budget balance from a deficit of about 2% of GDP into surplus of 1%. On the face of it, this suggests that Greece might be largely self-sufficient upon leaving the euro-zone and defaulting.

- In reality, a deeper downturn in the Greek economy immediately after exit would probably move the primary surplus back into deficit, for a while at least. But the stronger starting point means that less post-exit fiscal tightening would be needed than was previously the case. Note that a set of fiscal rules would need to be drawn up to replace the Stability and Growth Pact and re-assure markets.

- We still think that the Greek central bank would launch quantitative easing to try to keep government borrowing costs down and raise funds. The ECB's launch of QE since then has given it an example to follow and legitimised such action to an extent. But a clear inflation targeting regime would have to be announced as well, especially given the current Government's inexperience and lack of credibility.

- **Economic conditions**. In contrast to its budget position, Greece's economic health has deteriorated further since 2012, with real GDP falling by another 2% despite a short period of growth in 2014 and consumer prices dropping by another 4%. This sounds bad for Greece. But one upside of the extra slack in the economy is that a devaluation following exit might cause less inflationary pressure than otherwise. The decline in the real exchange rate might therefore be sharper and the positive economic effects bigger. What's more, reforms that Greece has already implemented could start to bear fruit.

- **Contagion**. In the Wolfson Report, we argued that the rest of the euro-zone would need to employ various policy measures to limit contagion effects in the event of a departure from the currency union. Since then, some measures have been established in the form of the bailout funds and the ECB's bondbuying programmes. But the authorities would need to make their commitment to implement such programmes very clear. Even then, if Greece does well, there is a risk that others may ultimately follow.

- The upshot is that some elements of our 2012 plan are no longer viable. Speculation of exit has been allowed to grow, causing significant damage to Greek banks. And the fact that Greece's debts have been taken on by euro-zone institutions means that a default will be more damaging to international relations. **But careful management of an exit that we still see as inevitable could yet mean that it ends up as a favourable economic development for both Greece and the rest of the euro-zone.**

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Indicative timetable for Greek exit from euro-zone

Step 1 (a few days before exit) Close banks (including ATMs) and announce intention to exit

Step 2 (immediately after decision) Start printing new currency

Step 3 (during the week before exit) Enforce and assist in redenomination of all domestic bank accounts, wages and prices

Step 4 (during the week before exit) Announce intention to default on at least half of public debt and start negotiations with the Troika

Step 5 (during the week before exit) Redenominate private international debts into drachmas where possible

Step 6 (during the week before exit) Announce inflation targeting and strict fiscal rules for the future

Step 7 (exit day) Announce reinstatement of drachma at parity with euro, reopen banks and impose capital controls

Step 8 (in few days after exit) Recapitalise banks and large firms with euro-denominated debts, using QE if necessary

Step 9 (for up to six months after exit) Electronic transactions in drachmas, small amount of euros available for necessary cash transactions

Step 10 (about six months after exit) All euros replaced with new drachmas, conversion complete

Source – Capital Economics