Greece's Dilemma and Europe's Anxiety, Part I

Jacob Funk Kirkegaard says an exit by Greece from the euro area will be disastrous, but Arvind Subramanian argues that in the medium term Greece will be better off.

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Steve Weisman: Europe is aflame over the debate on whether Greece should stay in the euro zone and undertake major austerity steps or leave the euro zone, which some say might be worse, some say might be better. This is Steve Weisman at the Peterson Institute with Jacob Kirkegaard and Arvind Subramanian, who have differing views. Jacob, for this first part of the interview, let me start with you. If Greece leaves the euro zone, what would be so bad?

Jacob Kirkegaard: I think we need to keep in mind that Greece exiting the common currency would be quite different from many of the parallels that a lot of people are drawing. They draw inferences from Argentina in 2001 or the Asian financial crisis in the late 1990s. In most of these developing countries, it's either currency pegs or current account types of crises. The reality is that Greece, in my opinion, is very, very different. First of all, it's a developed economy, it's an aging population, and it's more importantly, going to leave a currency. It is going to redenominate the unit of account for its entire economy. I do not believe that this is something that they can get away with without having an economic disaster. And, more importantly, I also don't think that we can gain a lot of insights from history about the effects of this.

Steve Weisman: They would suddenly have to pay all their debts with more—in effect, all their debts would become more expensive.

Jacob Kirkegaard: Presumably, as they leave the euro, one of the first things they would do is repudiate unilaterally all their debt. But the problem that Greece faces is that, even today, it still has a relatively small primary deficit of about two percent or so GDP. They would, of course, need to finance that. More importantly, this means that they would immediately have to do even more austerity than the IMF program entails. They also have a sizeable current account deficit which they would need to finance in something. I think most foreign suppliers to Greece would not accept being paid in Greek IOUs or new drachmas. When we look at the kind of things that Greece actually imports -- several food items, fuel, medicines, etc. -- I think there is a real risk that you would have shortages of a lot of really critical supplies in Greek society as a result of this.

The other major thing is that the redenomination away from the euro into the new drachma would essentially mean the destruction of the entire savings base in the Greek economy, which would devastate, in my opinion, Greek's middle class. Finally, Greece is a country that really doesn't make very much that the world wants to buy. It has the lowest export ratio in the euro area, and I don't believe that even a very large competitive devaluation—which would be the effect of leaving the euro and returning to the drachma—I don't believe that that is going to lead to a great boom in Greek exports.

Steve Weisman: Arvind Subramanian, you have written in the Financial Times op-ed page this week that, in the long run, Greece might benefit [from a euro exit]. How so?

Arvind Subramanian: First, I don't think that there is any doubt that, in the short run, there will be severe costs, including the ones that Jacob alluded to. But the key point is that once you get over the admittedly difficult hump or trough, Greece would have a very, very competitive economy. And I think the exchanges would depreciate a lot. It would gain a huge amount of competitiveness and all the experience shows that. Because, remember, the analogy with the Asian countries, Russia, is inexact because of the point of having to redenominate contracts, and so on. But, once that's done, the real economy is exactly like those other countries, and all the experience shows that once you have this competitive exchange rate, growth bounces back

Steve Weisman: What do you make of Jacob's argument that Greece is not an exporting economy and is not going to benefit from a depreciated currency?

Arvind Subramanian: I think there are two things here. If we look at the export of goods, just manufactured goods to GDP, Greece is low. But if you look at the ratio of export of goods and services, which includes tourism, actually Greece is just above, or close to, what Argentina was in 2001. So that's the first point.

The second point, I think, is that India for example, had a very low export-to-GDP ratio, comparable to Greece, when its financial crisis happened. India had managed to double, and then double again, its exports-to-GDP ratio. But the key point is this: I think that when you get such a large depreciation, things that we didn't know could be exported would become exportable. Some non-tradable goods would become exportable. In a sense, the fact of the low export-to-GDP ratio would be reversed by this enormous boost to competitiveness What Greece will export, as a consequence, is something that's fundamentally unpredictable today.

Steve Weisman: Jacob, respond.

Jacob Kirkegaard: I guess one thing that I would certainly pick an argument with is that it's true that Greece has a sizeable services export sector, but the problem is that when we look at this services sector, it largely comprises two things: logistical services, i.e. shipping, and tourism. The problem is that, from the perspective from getting a competitive benefit from adevaluation in these two sectors, most of the cost of shipping is actually done in dollars around the world. So the fact that the Greek homeland or domestic economy would devalue by going from the euro to the new drachma actually wouldn't have much of an effect on Greek competitiveness in shipping, because it fundamentally is largely a sector denominated in dollars.

With respect to tourism, it's generally the case that tourism is very sensitive to fluctuations in exchange rates—the elasticity, if you like, of demand. We know that if a country becomes cheaper because of devaluation of its currency, it tends to attract a lot of new arrivals. So you might think that that will be great for Greece if it went back to the drachma. But the problem is that we also know that tourism arrivals (and this is something that we have recently seen playing out across the Middle East), are even more sensitive to social unrests. Basically, people do not want to visit a country that is plagued by serious social unrest. And, unfortunately, the kind of cardio arrest that I think will happen in the Greek economy as a result of the shift from the euro to the drachma is going to create precisely the kind of social unrest that is going to keep tourists away.

Steve Weisman: Jacob and Arvind, I am going to stop there for this part of the interview and we will pick up on the second part later. Thank you both.