In 2008-2013 Greece suffered an extraordinary economic decline, from which it has not yet recovered. For a while, the idea of exit from the **Eurozone** gained ascendancy, then it receded without going away completely. Our recent **REScEU** working paper tries to work out what *Grexit* would actually entail.

First, there would be a transition period lasting a few months, during which the national currency (call it the new Drachma) would not be available in physical form and, consequently, both the euro and some **alternative means of payment** would be circulating in parallel, with strict capital controls in place.

[By leaving the Euro] Greece would have to default. Similarly, many firms with foreign obligations would default too.

No matter which form the parallel currency might take, there would be a unanimous expectation that the new currency would be devalued. In this context, the remaining euro banknotes held by the public would disappear, while the velocity of circulation of the alternative currency would soar. **Two sets of prices, in euros and in the parallel currency, would emerge, the exchange rate between them being inherently unstable**. In short, for the first few months, Greece would be without a functioning currency. As **James Galbraith**, an advisor to **Finance Minister Varoufakis in 2015**, and a proponent of the parallel currency, has admitted, widespread civil unrest might be inevitable.

The effects on the banking system would be crippling; credit would dry out. **Imports would freeze. Acute shortages would arise. Production would be disrupted** (most manufactured goods, including those exported, have a high import content). The resulting instability would hardly make Greece attractive as a tourist destination.

Eventually, the new Drachma would become the sole legal tender. Once that happened, it would be floated and devalued. Nobody knows how much. Most analysts think by 50% or more. This would sharply raise the cost of living (and of producing). A 25% inflation rate in year 1 would depress the value of real incomes by as much as the 2008-2013 recession, further depressing domestic demand.

The non-convertible part (roughly 90%) of public debt would be unserviceable. **Greece would have to default**. Similarly, many firms with foreign obligations would default too. The ensuing litigation would exacerbate uncertainty. Commercial banks would be bankrupt. They would have to be recapitalized or nationalized. The Bank of Greece would lose its independence.

An offsetting export-growth?

The key question is the extent to which the decline in domestic demand might be offset by export growth and import substitution. In the short run, import substitution would be limited: the economy is dominated by non-tradeables, while the production of tradeables is heavily dependent on imported inputs. That leaves exports. Again, in the short run no impressive gains can be expected: **the export base of Greece is the narrowest in the EU**, while recent export growth has been anaemic in spite of falling unit labour costs and export prices. The current account would turn a surplus, but this, at least initially, would be the result of a further decline in imports.

For a couple of years post-*Grexit*, the economy would go into a second depression. The resulting income and job losses would not be distributed equitably.

Would the pain be worth it in the medium term?

The eventual success of devaluation would depend on two conditions: a) that the initial inflationary burst is contained, preserving competitiveness gains, and b) that low-priced assets encourage significant investment.

On current form, **Greece would be unable credibly to implement the stringent policy required for containing inflation**. Interest groups in or around the public sector would obtain pay rises compensating them for higher prices. Despite the slump, these would eventually spill over to the rest of the economy, generating a wage-price spiral. Fiscal deficits would emerge, financed by printing money. The central bank, newly placed under government control, would not be allowed to contain inflationary pressures nor stabilize the Drachma.

Changing the nominal exchange rate would do nothing to address structural blockages on the offer-side

Investment would have to be mostly foreign, but low asset prices would not generate enough of it. Uncertainty, political instability and the peculiar traits that led to low foreign investment in the past (including bureaucracy and hostility to business) would deter it.

In short, medium-term success would require a miraculous transformation of Greek society and politics.

The roots that prevented a dynamic response

The immediate cause of the **2008-2013 depression** was collapsing domestic demand. However, **what prevented a dynamic response on the part of firms was** a series of structural blockages on the supply side.

a) *Low competitiveness*. Greek exports have low-income elasticity, unexceptional quality and low technological content. These features are structural. On the one hand, while tradeables are exposed to foreign competition, non-tradeables are often protected by a web of restrictions favourable to insiders, distorting incentives and the allocation of resources. On the other hand, the average firm size is the smallest in the EU. The preponderance of small firms is due to the formal and informal advantages they enjoy. Most of them have neither the resources nor the vision to sell in markets beyond their immediate locality.

b) *Low and falling private savings*. This is a persistent trend, not merely cyclical. The required investment effort cannot be financed by domestic resources alone. A large devaluation and a substantial decline in the real value of savings would hardly steer savers in the desired direction.

c) *Pensions and welfare*. The welfare state was built on a regressive pension system, whose deficits contributed to the fiscal derailment, and crowded out all other social benefits. When the crisis erupted, the social protection system failed to alleviate poverty. Despite recent cuts, pensions will remain a drag on public finances for many years to come.

d) Historically, the tax system featured extensive evasion and avoidance, very narrow base, and poor quality of administration. Improvements brought about by recent reforms would be unlikely to survive leaving the Eurozone.

e) *Public administration.* A bloated and inefficient public sector hinders economic growth. Employees there continue to enjoy better pay, easier working conditions, and greater job security, which distorts the structure of incentives and squeezes exposed sectors.

Changing the n**ominal exchange rate would do nothing to address these blockages**. Departure from the Eurozone would remove the external pressure for reform.

Setting the priorities

The adjustment programmes demanded simultaneous progress on many fronts. But although economic recovery is urgently needed, the country has a limited capacity for reform. Higher priority should be attached to a more limited set of objectives.

The necessary demand stimulus cannot come from a burst of consumption financed by public spending; it can only come from investment. **Thus, reforms specifically related to an investment-led strategy ought to be prioritised**. These include the speedy implementation of the privatization programme, the reduction of the backlog of non-performing loans, the removal of legal and bureaucratic obstacles to business activity, and the streamlining of the judicial process.

Restructuring public debt would help, but would not be enough on its own.

Grexit would be lot of pain for no gain. The first couple of years would be tortuous. Moreover, no Greek government could stick to the policies needed to stabilize prices and the currency in the aftermath of *Grexit*. (The country would not be where it is now if it could.) The economy would risk disintegrating.

The fundamental blockages to growth are structural, not nominal. History shows that reforms rarely happen without outside pressure. Leaving the Eurozone, even the EU, would simply condemn Greece to insularity and decline.

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