To default or not to default? That is NOT the question!

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This blog opens at a time when Greece is (again) at a remarkable conjunction. On Wednesday 29/6 we will know whether the (too many times) revised Medium-Term Programme was approved by parliament, opening the road for the release of the 5th instalment of the May 2010 loan and for the substantive discussions to begin about the so-called 'second bailout' of 2012. We can discuss of course what were the problems of the Greek economy, society and polity, of international financial regulation and of the EMU institutional structure and political dynamics, that brought us here – indeed, this is largely what this blog aims to contribute to. But whereas this debate is open –and indeed should remain open for a long time, until the full dimensions of the "Greek tragedy" are deeply understood and convincingly communicated to the non-experts– the fact of the matter is that, whatever the causes, whatever the wrong-doings and the mis-firings, Greece is today deep into an insolvency crisis, experiencing a prolonged recession and one of the most severe austerity programmes seen in modern history.

Naturally, voices from across the political spectrum, from all strata of society and all corners of the academia (myself not excluded), question the rationale and effectiveness of the fiscal consolidation programme pursued in Greece and the austerity measures that are being implemented. The terrible D-word (default) is in everybody's lips, either in the form of a question (will Greece default? should it?) or in more assertive terms (Greece will/should default – note that present CDS rates imply an 80% probability of default!). I beg to differ. Although predicting the future is not an economist's strongest point (as the saying goes, economists are best for explaining tomorrow why the things they predicted yesterday did not materialise today), I think that a Greek default is neither inevitable nor forthcoming. And the reason for this –let's call it– optimism lies in a firm belief that a Greek default will be sub-optimal (the word economists use for catastrophic). Not so much because of its potential medium-term implications for the financial stability of the eurozone and world economy (for that too, though) or for its long-term effects on the 'European project', but predominantly for the future of Greece.

Let me start from the basics. Undoubtedly, a possible Greek default will be a big shock to the European banking system causing severe (but, I would think, manageable) losses for some European banks, especially in France and Germany. This will trigger the payment of insurance policies taken against Greek bonds (the infamous CDSs), thus spreading the crisis, via the CDS and bond markets, to the USA and Britain and, through them, to the rest of the western world. The subsequent 'Lehman Bros moment' will of course be managed at the end, but at a very high cost. In this process, the euro will experience a substantial depreciation and the spreads for sovereign bonds in other European countries will sky-rocket, creating new 'tragedies' in other parts of the eurozone (Portugal, Spain and beyond). In such a 'moment', Greece's position in the eurozone, and perhaps in the EU, will be severely compromised, if not fully unattainable: even without a forced exit (we shouldn't forget that there is no legal provision for this – although the same could be said for the bailout, which was explicitly forbidden), it is difficult to see how the Britains and Finlands of this world will continue to redistribute money to Greece (through the CAP and the Convergence Funds) and how they will continue to take lessons from Greece about who joins, and who doesn't, the European club (the so-called 'former Yugoslav Republic of' Macedonia comes to my suspicious mind).

More importantly, a Greek default will lead inevitably to a default of the Greek banking system (which has by far the greatest exposure to Greek bonds), as the ECB will naturally stop stretching its own regulations to provide short-term liquidity to the Greek banks (how can it continue to accept as collateral bonds issued by a country in default!?) and the markets will charge lending rates many times higher than what we have seen up to date. As a British-style nationalisation would not really be an option (how can a bankrupt state bailout a bankrupt sector?), the government would have to freeze private savings to avoid the inevitable bank-runs that would kill-off the banking system completely. But even irrespective of what happens to the banks and to individual savings, the Greek government, albeit relieved from the interest charges and capital repayments of its international loans, will have to implement further and deeper austerity measures in order to run a balanced primary budget (unless one is willing to entertain the though that the markets will keep lending to Greece after she defaults). With a bankrupt banking system and deeper cuts by the government, Greek GDP is going to slide down at a freefall and inflation will jump to levels not seen for generations. Even with zero political upheaval (just a simplifying assumption) and even if the Europeans still want Greece to stay-in (just being naïve now), Greece will have no option but to leave the eurozone in order to print new (super-devaluated) money and 'get the economy going' again.

Like Argentina, this will increase Greece's export-competitiveness and start a process of fast (in the good scenario) growth. Like Argentina, this growth will start from a much lower level of prosperity, with widespread absolute poverty and immense social tensions. But unlike Argentina, the recovery will take much longer as Greece is much more import-dependent for its energy and its raw and intermediate products. Because of that, the devaluation of its (new) currency will lead to hyper-inflation which will compromise its rates of growth, keeping the pace of the recovery slow and the rates of poverty to levels unseen in the country for decades. And unlike Argentina this will take place in a context of a eurozone (and EU) exit, a context of dis-empowerment in the international political arena, a context of 'slippage into irrelevance' in European and international politics.

Sure, international capital will be quick to capitalise on the new investment opportunities opening up in the country, as the depreciated public and private assets will make for a good investment even to the unsuspected westerner retiree who has just remortgaged their family home (with the market value of Greece's Public Power Corporation falling from what is now an estimated €2.5bn to what will certainly become in a post-default era a nine-digit number, it would only take a few thousand British retirees –the size of a Cornish town– liquidating their homes to buy 100% of the company!). But with this capital inflow there will come new pressures for market liberalisation, new measures of labour market deregulation and new forms of wage determination – of the cost-squeezing (not the productivity-enhancing) type. In this 'moment', Greece will have given away all that it prides itself for today – and that the proponents of a Greek default aspire to: its level of prosperity (somewhat surprisingly, Greece is still today the 27th largest economy in the world), its public ownership of strategic and less-strategic assets, its (ambiguous and 'dis-located') social protection system, and its membership to the 'European club'.

I may be wrong of course, but this seems to me to be the ultimate 'Lehman Bros' scenario for Greece. Irrespective of how Greece manages to sail through this crisis, the D-word ought to be out of question.

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