Both Greece and its creditors must compromise to prevent the risk of a Grexit

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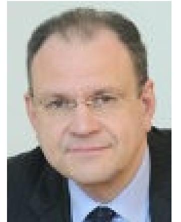

Greece and its creditors have been engaged in a two-month standoff over the release of further financial assistance to the country. **Lorenzo Codogno** *and* **Paul De Grauwe** *write that with no agreement yet reached, the possibility of Greece leaving the euro has now become real. They argue that the only solution to the crisis is for both sides to compromise, with the Greek government accepting deep supply-side reforms, and Eurozone policymakers offering Greece a fair deal on the demand-side.*

The Greek crisis has reached a new climax. The probability of a Greek exit from the Eurozone has now become real. Yet, after the Greek elections it appeared that people with common sense could come to an agreement. There was a new Greek government that wanted to get rid of corruption. In particular, in contrast with the previous Greek governments, it was eager to reform the tax system so that the rich Greeks would pay taxes. There was also a growing recognition within international institutions, such as the IMF and the European Commission, that the intensity of the austerity programmes imposed on Greece had gone too far and had pushed the Greek economy into a deep economic depression with unacceptable levels of unemployment rates.

A deal between the new Greek government with the creditor countries seemed possible. Such a deal could have been based on two pillars. Measures taken by the new Greek government to reform the tax system and a relaxation of the intense austerity programme. But such a deal proved particularly difficult because both sides around the negotiating table showed a disturbing lack of common sense and an unwillingness to arrive at a compromise.

Yet a compromise is necessary and possible. It should be based on the long-term benefits for the overall Eurozone and not just short-term fixings or kicking-the-can-down-the-road. Moreover, benefits should be weighted carefully against potential risks. In particular, the risks implied by the Grexit option appear significantly underestimated these days. Outright Monetary Transactions and Quantitative Easing by the European Central Bank provide a much welcome backstop, but may also introduce complacency and a false sense of security over any possible contagion.

First of all, Grexit would be a political defeat for the idea of a peaceful Europe that aims at furthering integration and prosperity for all. It would also be an admission of defeat: after eight years into the crisis European policymakers would exhibit their inability to deal with the problems of a country that accounts for well below 2 per cent of Eurozone GDP.

Secondly, Grexit would represent a permanent blow to financial and economic integration. If investors not only perceive the risk but also have the proof that leaving monetary union is possible, then they would start pricing it on a permanent basis. Historical experience of countries de-pegging or leaving a currency area suggests that a 50 per cent devaluation is not inconceivable. Even if you place a small probability on such an event, it would justify sizeable spreads on member-countries' debt.

Third the redenomination risk that would become a permanent feature of the new Eurozone would lead to widespread financial retrenchment and would make a mockery of the Capital Markets Union launched recently by the European Commission. It would also undermine the banking union. The reason is that banks and corporations would view across border exposures as risky despite the fact that they are denominated in the same euros.

Would the CFO of a French, Italian or Spanish company dare to issue a bond in euros when a redenomination could

cause the company to go under? Would a company invest outside its own country when there is a high uncertainty about the future denomination of its investment? There would certainly be a fundamental rethink of taking these borrowing and investment decisions within the Eurozone. If that happens financial and monetary integration would be set back, and could even lead to the end of the single currency. Crises would become a chronic feature of the Eurozone, very much as was the case in fixed exchange rate regimes.

How to get out of this problem? It all comes down to supply and demand. The Greek government should explain to the Greek population that structural reforms, even the most difficult ones, are in the best interests of citizens. While it is probably true that Greece's legislated reform effort is the strongest among OECD countries, it is also equally fair to say that the starting position was relatively weak and that implementation is still lagging. The Greek government must accept deep supply-side reforms and show commitment. Recent openings by the Greek government on a major pension reform would go in the right direction.

On the demand side, Eurozone policymakers should offer Greece a fair deal. If there is a credible commitment to structural reforms, they should offer an aggregate demand environment in which reform can more easily be introduced and their expected effects can take hold. This should come in the form of a more gradual fiscal consolidation, i.e. a reduced primary budget surplus, inclusion in the ELA and QE programmes by the European Central Bank and finally some near-term help in restoring credit flows in the domestic economy (while respecting EU rules on state aid). Some flexibility is again of essence for an economy that has shrunk by 26 per cent and is in the process of creating a lost generation.

Such a two-handed approach based on a willingness to make compromises would be for the greatest long-term benefit of Greece and the Eurozone as a whole.

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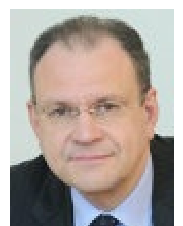

Lorenzo Codogno is Visiting Professor in Practice at the LSE's European Institute. Prior to joining LSE, Lorenzo Codogno was chief economist and director general at the Treasury Department of the Italian Ministry of Economy and Finance (May 2006-February 2015). In this capacity he served as chairman of the Economic Policy Committee, junior committee of Ecofin, in 2010 and 2011. He joined the Ministry from Bank of America where he had worked over the previous 11 years. He was managing director, senior economist and co-head of European Economics based in London. Before that we worked at the research department of Unicredit in Milan.

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