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The Macro Costs and Benefits of a Sovereign Greek Default

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European politicians will make decisions in the next few weeks that are likely to determine the future prosperity of Europe. The leaders have two choices. Feed the crisis by ignorance, political disagreement, forbearance, muddling through and inaction the ostrich scenario. Or they can recognize the reality on the ground, face the upfront cost of restructuring, remove the information uncertainty and create conditions for future prosperity the reality scenario. Government officials have not put a price tag on either approach, but we believe the discussion would be served by having estimates of the costs and benefits of the choices.

There are two approaches for gauging the cost implications of the sovereign debt crisis. The bottom up micro based approach tries to estimate the write downs of a default by considering all exposures within the financial sector. The BIS provides detailed information on this,[1] but still there are significant information gaps rendering the micro approach challenging. Alternatively, the macro approach considers the difference in growth rates between the current program and the default scenario. By our analysis the relative benefit of opting for the reality scenario is a gain of 22% of the European GDP over the coming two decades.

The Ostrich's Choice

Ever since the sovereign debt crisis exploded on the horizon, the EU authorities have been hoping it would go away. As recently as last Friday they in effect reshuffled the lounge chairs on the deck of the Titanic by postponing the decision over the next tranche for Greece, once the Greek finance ministry revealed it still had some money.

In order to estimate the cost of the ostrich attitude it is useful to look at what has happened in other large economies facing similar choices. There is no better example but Japan, as the EU approach to crisis management does have a strong parallel with how Japan handled its crisis in the early 1990s. There are differences of course, but the slow crisis management approach of the Japanese state to its crisis is eerily similar to what we see now from the EU authorities: Hoping for the best, doling out partial bailouts, ever greening loans, and trying to maintain the status quo ex ante. This created zombie banks, triggering years of debt deflation and economic stagnation. The analysis by Koo in his 2008 Holy Grail of Macro Economics demonstrates in detail the vicious effects of such balance sheet recession mechanics. The cost to Japan has been an economic growth of 0.67% a year for the past two decades. Consequently, in order to

[1] http://www.bis.org/statistics/bankstats.htm

put a number on the cost of the ostrich approach in Europe, the Japanese number of 0.67% growth per year is a reasonable estimate.

In the case of the Euro, the main reason for slow growth under the ostrich scenario would be the continuing uncertainty about the political will to tackle the crisis as well as ongoing uncertainty regarding the strength and exposures of commercial banks. Ultimately this leads to unwillingness of the private sector to invest. There is even a real fear we have started to see the emergence of zombie banks Japanese style, as the ECB is becoming the lender of first resort for many banks, entire banking systems and even national governments. This leads to a vicious feedback loop between a drop in liquidity, reduced lending and diminished economic growth.

The Choice for Growth

The alternative for the EU authorities is to recognize reality. Allow restructuring of Greek and possibly Portuguese debt, giving these economies the option to start growing again if they make the right adjustments, like labor market liberalization involving wage cuts to regain competitiveness.

We suspect the benefits of a default would be substantial for the entire European economy, including those defaulting. Consider the plot below showing that recessions go hand in hand with significantly heightened uncertainty as measured by daily stock market volatility. The political risk created by EU leaders vacillating, the general uncertainty about the amount of exposures and how these will be resolved has created an expectation of a worst-case scenario. A vicious cycle between a lack of confidence, banking crisis, increasing borrowing costs and fall in liquidity has been created. Muddling through will maintain this vicious cycle. Defaulting will break the cycle.

In order to put a number on the relative cost of the reality scenario, a lower bound would be the average growth in the euro zone over the past 20 years, 1.67%. This is to be contrasted to the 0.67% from the ostrich scenario. The 1% difference is a lower bound and if accompanied by other structural reforms is likely to be higher. With a growth rate of close to 2%, the euro area GDP would be 22% higher after 20 years, adding €3.5 trillion to current GDP, while the muddling through would in 20 years only add €1.3 trillion.

Implementing the Default

It would be preferable if the default was orderly instead of being the chaotic endgame it would likely be in the ostrich approach. The authorities would need to be proactive in ring fencing assets and be prepared for possible liquidity and balance of payments problems for certain countries like Italy and Spain. The IMF, the institution set up for that purpose, should stand ready to provide the necessary support. It is important that the ECB would not continue being abused to provide liquidity or balance of payments bailouts. Its credibility already dented, a sound currency is a necessary condition for the growth scenario.

This does leave the cost of the default. Greek debts approaching €350billion, amounting to a debt to GDP ratio of 150%**.** Suppose Greece were to default, it is hard to see its debt tolerance becoming much higher than, say Argentina, at around 50%. More optimistically, assume the government would manage a primary surplus and keep the limit imposed by the stability pact, 60%, with its GDP remaining unchanged. Then the write down would amount to €210 billion. A Portuguese default might follow. Portugal has a debt ratio of 83% and restructuring towards the 60% level would cost about €40 billion.

These would not be the only costs. A default would have a domino effect, perhaps requiring a number of financial institutions to be recapitalized. Some member governments might need to bail out their banks, requiring further funds in the short run, even if those might be recovered in the future. For example, the IMF in the September Global Financial Stability Report assesses the needs of the European banks in the order of €300 billion. This number is probably an

overestimate in case of the reality scenario since there would be immediate positive benefits from a default.

Some commentators brand around much larger costs, often mentioning a Lehman's type scenario, with a major liquidity and banking crisis following its default. In the case of Lehman, however, there was high uncertainty over who owned whom and this froze the interbank market. But the Greek default would by contrast reduce the asymmetric information by revealing the market values of banks' exposures to Greece and financial institutions in difficulty.

The immediate costs of defaulting are significant, but so is the cost of muddling through. A default realizes the cost immediately but maintaining the status quo simply parcels out the costs over time. After all, in the absence of default the EU governments have in effect taken over responsibility for the bulk of Greek debt and the secondary cost impacts on the banking system. In net present value terms it is hard to see how the expected costs from the two scenarios could be much different. Regardless, the direct costs from a Greek and Portuguese default are relatively small considering the overall euro zone GDP of over €9 trillion. These direct costs have in effect already been incurred, what matters now is the indirect costs due to uncertainty, that is the 1% GDP difference between the ostrich approach and status quo. With the euro zone GDP exceeding €9 trillion a year, the status quo approach costs Europe €95 billion a year, and is likely to do so for the foreseeable future.

Conclusion

The European Union has wasted much time wishing the crisis away, and now has little time left. It can either directly tackle the underlying problem and put Europe onto a sensible growth path or let the problem fester, likely to result in long run slow growth and political instability. Our calculations indicate that the difference in those approaches could be a 22% difference in EU GDP over the next 20 years, or over €95 billion a year.