

## The Fiscal Economics of a Greek Exit

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How much would Greece's creditors lose if the country were to exit the eurozone?

- It is widely assumed that an exit would be followed by a default because the new currency would depreciate so massively that debt service in euros would be impossible.

This assumption is wrong.

- Most of Greece's debt is foreign debt and must thus ultimately be serviced through higher exports or import compression.

An exit followed by a massive depreciation of the new drachma should accelerate export growth and provoke a further fall in imports, thus increasing the capacity of the country to service its foreign debt. After a decade of adjustment, Greece might be able to pay its debts.

### What is the basis for the assumption that exit = default?

At the present time, Greek GDP amounts to about €200 billion (per annum). If Greece were to (re-)introduce the drachma, the new currency would likely depreciate by about 50%, so that Greece's GDP would fall probably to below €100 billion. The revenues of the Greek government would also fall in a similar proportion, from about €80 billion today to about €40 billion after an exit from the euro. These meagre resources appear totally inadequate to service the over €330 billion that the Greek government owes to its foreign creditors.

Most of the country's remaining debt is owed to official European creditors (principally the EFSF and the ECB). At first sight, it appears thus that the official foreign creditors would have to write off most of their claims on the country. (We leave aside here the €22 billion of claims the IMF has on Greece, which are indisputably senior and likely to be serviced in full.)

However, after the initial overshooting, the exchange rate is likely to return to its longer-run equilibrium and growth is likely to resume, slowly closing the output gap. Experience with similar cases of emerging markets suggests that after ten years nominal GDP (measured in a hard currency) should return to at least its previous level, say about €200 billion.

Moreover, exports do not necessarily fall with a devaluation. On the contrary, they are likely to grow by more than GDP (Borensztein & Panizza, 2010). This would increase over time the capacity of the country to service foreign debt. Exports might well double over a decade, bringing them from about €42 billion (goods plus services) today to about €85 billion. At that

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point the country might well be able to service its external debt, provided the interest rate is low enough.

Table 1. Exposure to Greece, by country (€ billion)

	Official (shares in EFSF/ECB)	Private (BIS data)	Total	% of GDP
France	66.5	34.7	101	5.1
Germany	88.6	10.5	99	3.9
Italy	58.4	1.7	60	3.8
Spain	38.9	0.7	40	3.7
Netherlands	18.7	2.7	21	3.6
Belgium	11.3	0.6	12	3.2
Portugal	5.3	6.3	12	6.8
Austria	9	1.8	11	3.6
Finland	5.8	0.02	6	3.1
Ireland	3.4	0.15	4	2.1
<b>TOTAL</b>	306	59.42	366	

Source: Own calculations based on data from BIS, ECB and EFSF.

### Private versus official debt default

A Greek exit followed by the introduction of a drachma that depreciates by 50% might thus be followed by the following scenario: the Greek government officially defaults on its remaining obligations to private creditors and the Greek private sector will be largely unable to service its foreign debt. This implies that European banks will have to write off most of their remaining €70 billion of exposure to Greece (and given that the banks rely on the sovereign for their support, this implies essentially a corresponding loss for the governments as well).

However, the official eurozone creditors can afford to take the long view and could agree to a standstill under the usual combination of 'extend and pretend'. Let us assume that the official creditors grant a grace period of 10 years followed by a full repayment over the next 20 years (the terms of the latest EFSF deal) and an interest rate of 1.5% (the rate on Bunds today). Under this scenario the debt service of the country (aggregating the Greek government's obligations towards the EFSF and the debt of the banks towards the ECB) would be only about €6 billion per year, equivalent to 3% of GDP, hardly an unsustainable burden. This would apply in particular to the government, whose domestic obligations would have been wiped out in the meantime. Moreover, the necessary transfer of resources to foreigners would amount only to about 6% of total export revenues, again not a heavy burden. Furthermore, as Greece's GDP is likely to grow in nominal terms by much more than 1.5%, the debt service capacity should continue to improve after the country has adjusted to the new equilibrium.

Of course, at first sight, an interest rate of 1.5% represents an extraordinary subsidy for a country whose existing bonds trade at yields above 25%, which would imply in present value terms a haircut of over 80% through the rescheduling of the official debt. But these yields on private sector bonds are so high because all claims of the public sector have de facto become senior to private sector claims.

For the German government, however, an interest rate of 1.5% would just represent the cost it faces to refinance its claims on Greece and thus effectively entails no haircut at all. This implies immediately that if Greece were able to service its debt over 30 years at an interest rate of 1.5%, the German government might in the end not suffer any loss on its exposure. Table 2 below shows that any losses for Germany would come from the small, residual exposure of German banks.

However, most other eurozone governments would have to carry a substantial burden given that they face much higher refinancing costs. For example, Italy and Spain would have to participate in the rescheduling of Greek debt with an amount equivalent in terms of GDP similar to that of Germany (about 4% of GDP – see Table 1). But given that their refinancing costs are now over 6% per year, Spain and Italy would make a loss of about 60% (in present value terms) in the kind of operation described above (see Table 2 below).

Table 2. Total fiscal loss (in € billion and as % of GDP)

	Loss on private exposure (loss rate 75%) (€ billion)	Present value of rescheduled debt*	Loss on public debt (€ billion)	Total present value loss (€ billion)	Total loss (% of GDP)
France	26.1	0.757	16.2	42.2	2.1
Germany	7.8	1.007	-0.6	7.2	0.3
Italy	1.3	0.419	34.0	35.3	2.2
Spain	0.5	0.400	23.3	23.8	2.2
Netherlands	2.0	0.916	1.6	3.6	0.6
Belgium	0.5	0.670	3.8	4.2	1.1
Portugal	4.8	0.147	4.5	9.3	5.4
Austria	1.4	0.814	1.7	3.1	1.0
Finland	0.0	0.946	0.3	0.3	0.2
Ireland	0.1	0.321	2.3	2.4	1.5

\*Calculated at present interest rates.

Source: Own calculations based on data from BIS, ECB and EFSF.

Table 2 also shows that the one country least able to withstand a further burden, namely Portugal, is also the one that would stand to lose the most, over 5% of GDP.

The irony of the present situation is that the one country that has the largest absolute exposure and that dictates much of the policy on Greece is also the one that in the end is likely to lose the least (0.3% of GDP). The real burden of a Greek exit would fall disproportionately on the weaker members of the eurozone, which would be hit by a ‘double’ whammy of the contagion effects and the direct fiscal costs, which for them would be ten times as high at about 2.2% of GDP.

## References

Borenstein, Eduardo and Ugo Panizza (2010), “The costs of sovereign default: Theory and reality”, VoxEU.org, 6 May.