

Why Greece declined a euro holiday

Daniel Gros

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For the entire first half of this year, since the far-left, anti-austerity Syriza party came to power in January, the Greek saga virtually monopolised the attention of European policy-makers. Even as their country's economy crashed, Greece's new government remained adamant in demanding debt relief without austerity – that is, until mid-July, when they suddenly agreed to the creditors' terms. Indeed, as of July 13th, Greece's staunchly anti-austerity government has been obliged to impose even tougher austerity and pursue painful structural reforms, under its creditors' close supervision.

Why did the Greek government concede to terms that not only controverted its own promises, but also closely resembled those that voters had overwhelmingly rejected in a popular referendum barely a week earlier?

Many believe that Greek Prime Minister Alexis Tsipras was responding to an ultimatum from his European partners: Accept our demands or leave the euro. The question is why a Greek exit from the euro ('Grexit') amounted to such a potent threat.

In fact, from an economic perspective, Grexit no longer represents the potential catastrophe that it once did. After all, the main short-term cost – financial-system disruption – has already materialised in Greece: banks and the stock market have been shut down, and capital controls have been imposed. While those actions were needed to stem large-scale capital flight and prevent the banking system's collapse, they also caused the Greek economy to contract sharply.

In this context, Greek negotiators might have considered another proposal, circulated informally by the German finance ministry, recommending that Greece receive immediate debt forgiveness, in exchange for leaving the euro temporarily. If Greece remained in the euro, no relief would be granted – a proviso consistent with the German position that debt restructuring for eurozone countries would be illegal. While the legal argument is probably spurious, an outright debt reduction for a eurozone country remains politically impossible.

The German proposal, spearheaded by Finance Minister Wolfgang Schäuble, highlights the fundamental change that has occurred in Greece's relationship with its

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European partners since its last bailout package three years ago. In 2012, Greece was offered hundreds of billions of euros in financial support, and its creditors, including Greek commercial banks, were pushed to accept substantial 'voluntary' haircuts.

Tellingly, when George Papandreou, Greece's prime minister at the time, proposed a referendum on the existing adjustment programme and his country's continued eurozone membership in 2011, he was warned off in no uncertain terms by France's then-President Nicolas Sarkozy and German Chancellor Angela Merkel. Though Papandreou would have campaigned for the adjustment programme and the euro, a referendum was a risk that his European partners were unwilling to take.

Tsipras's government, by contrast, was able to hold its referendum, and even campaign against the creditors' proposed adjustment programme (which, it should be noted, was no longer on the table). Even the resounding "no" delivered by Greek voters could not strengthen the government's negotiating position, for a simple reason: Grexit is no longer considered a threat to the euro's stability. That is why German officials – especially Schäuble – have been encouraging Greece to leave.

One can only speculate about Schäuble's motivation in pushing for Grexit. He seems to believe that a more integrated eurozone, although certainly desirable, is not feasible with a country that cannot be trusted to abide by the terms to which its government has agreed.

Whatever Schäuble's reasons, his proposal could have represented a way out for Greece, whose economy had been squeezed dry by austerity and whose banking system was already closed. Immediate debt reduction and the recovery of economic sovereignty – even at the expense of exiting the euro, at least temporarily – would seem to have offered significant long-term benefits. In a sense, it amounted to a golden opportunity, with Germany offering to pay for something that many believe Greece should be doing anyway.

Nonetheless, the Greek government rejected an exit, and instead accepted the creditors' tough terms. This suggests that, during the negotiations, Greece's leaders were driven by more than economics. Perhaps, contrary to popular belief, countries' political attachment to Europe via the euro remains very strong, even where, as in Greece, people have endured unprecedented hardship since joining the monetary union.

The monetary union's rationale, as many have noted, was always more political than economic. For precisely that reason, it may well be too early to write off the single currency.