Greece’s Dilemma and Europe’s Anxiety, Part II

Jacob Funk Kirkegaard and Arvind Subramanian debate whether a Greek exit from the euro area will be an incentive for Spain, Portugal, or other countries to stay—or to follow the Greeks.


Steve Weisman: This is Steve Weisman at the Peterson Institute for International Economics with Jacob Kirkegaard and Arvind Subramanian talking about the possibility, and the consequences, of an exit from the euro area by Greece. In Part I, we talked about the impact on Greece. Let’s talk now about the impact on the rest of Europe.

Arvind, in the last interview, you said that Greece, after an initial costly and difficult period, could recuperate. But what do you say about the argument that a breakup of the euro zone would spread contagion, spike interest rates and cause bank failures throughout the region?

Arvind Subramanian: I think my view is that if in the scenario that Greece starts doing reasonably well, and posts growth rates that have eluded, not just Greece, but Spain and Portugal and Italy for many years, the interesting question is what will that do in terms of the incentives for Spain and Portugal to remain in the euro zone. Because they will continue to face austerity -- as I call it, they would be “austerity addled and hope deprived” for a long time. My view is that if Greece does well (and Jacob and I disagree on whether Greece will do well or not), and posts, say, a five percent growth for seven quarters or six quarters, then voters in Portugal and Spain will say “Wow! Should we emulate the Greek example and actually choose to leave the euro zone?” So the politics of the euro zone and the impact on the other countries could change if Greece recovers from the wrenching short-term costs that it is bound to experience.

Steve Weisman: Jacob, suppose that happens. Would it be good to see a breakup of the euro zone in the way Arvind has described?

Jacob Kirkegaard: I think that even if it did happen the way Arvind projects, and Greece began to rebound after a cataclysmic transition out of the euro area, I strongly doubt that that rebound which would come after a catastrophic decline in living standards in Greece. I don't think that this would be very endearing to electorates in Portugal and Spain or Italy, or anywhere else in the euro area for that matter. It's not clear than an export-led growth boom that Arvind is predicting is actually going to have particularly widespread social benefits. It is, for instance, in my opinion not clear that such an export boom, which might be sizeable in GDP terms, is going to do very much to keep down costs of inflation and other things, which we know have very sizeable social costs. Therefore fundamentally, even a rebounding Greece, when it is basically picking itself up from the depth of an economic disaster, is not going to be a very good example to follow for the rest of the euro area.

Steve Weisman: There is a lot of political and cultural attachment to a unified Europe, unified through its currency and increasingly through other rules: fiscal banking, etc. Does that go down the tubes, Arvind, in your scenario?
Arvind Subramanian: I think the dilemma in my scenario for voters in Spain and Portugal is exactly going to be that, that there are all these benefits from being part of Europe. But, if they don't see any hope on the horizon in terms of their economic prospects improving, that's the dilemma they'll confront. And, generally, let me invoke behavioral psychology. I think behavioral psychology says that, it's kind of a hedonic treadmill thing. Yes Greece will suffer, but people forget all that and then they look forward and say, “What is the rate of change? Is it positive? Is it happening fast enough?” Remember, people say, “Well, austerity will be combined with structural reform and that will get the growth going.” As Martin Wolf rightly pointed out, the notion that structural reform could improve growth in the short run is nonsense. Structural reform in the short run will lead to more job losses, more dislocation, and the benefits will take a considerable time coming. So it's in that scenario that these countries will confront the dilemma.

Steve Weisman: Jacob, you on the other hand have said in many of your postings that structural reform is the key to returning the peripheral countries in Europe to growth. Do you think that it can happen inside or outside the euro zone?

Jacob Kirkegaard: I think one of the challenges that even a Greece that decided to leave the euro area is facing is that it would still need to do a tremendous amount of structural reform. Because we have to remember that the IMF program Greece is currently under and that part of the political system in Greece now wants to repudiate, is not only about austerity. It's actually about fundamentally reforming this economy and turning it away from what some Greek politicians have described as the “last Soviet economy in Europe.” So this is a problem that Greece faces inside or outside the euro area.

But I agree with Arvind that the economic benefits of structural reforms are not going to happen in the short run. I will just say that the kind of boost that Greece is going to have after recovering from the cataclysm of departing from the euro is also not going to be happening three to six months after that event. I would see that at best as a medium-term positive event, which means that it would, probably, in my opinion, happen about the same time as the positive benefits of structural reform in other parts of the euro area begin to take effect. So again, I am not predicting that it's going to be easy for Portugal, Spain, Italy and others in the euro area in the years ahead. But I will still believe very firmly that the message that they will get from a Greek exit is that “We are going to stay the course and not emulate the Greek economy.”

Steve Weisman: Arvind, last words.

Arvind Subramanian: The last word, I think, is simply that all the things we say now about Greece, about it being sclerotic, the last Soviet economy, etc., were actually similar to things said about Indonesia and Korea at the time of their financial crises. Indonesia was thought to be the world's most corrupt kleptocratic economy in the world; Suharto had run the place to the ground. In Korea, the chaebols were messy, oligopolistic havens of inefficiency. And they rebounded. So I think to me a lot of the evidence suggests that one way out of financial crises is to get exports via super competitive exchange rate. And remember, the big difference in terms of structural reform is that Greece will be doing it not under conditions of austerity, but under conditions where it is has super competitive exchange rates. And that alters the plausibility, the effects, and the timing and so on.

Steve Weisman: Thank you both very much.