Greece Should Not Quit the Euro Area, Part I

Anders Åslund explains why Greece would invite far more troubles to its economy from quitting the euro area than from staying in it and reforming.


Steve Weisman: The debate over Greece's future in the euro zone continues. Anders Åslund of the Peterson Institute for International Economics has written an important Policy Brief clarifying what would happen if Greece were to leave. This is Steve Weisman. In the first part of this interview, Anders, I'd like to ask why leaving the euro zone is not a solution for Greece.

Anders Åslund: There will be lots of problems and what that [departing the euro zone] would amount to is only devaluation. But Greece needs to do substantial reforms. What will happen immediately [after a departure] is that the exchange rate will plummet. The bank run will be massive. There will be huge bankruptcies; there will be default in Greece and it will be a total disorganization of the economy.

Steve Weisman: Some respected economists say that this could be managed if it's well-planned.

Anders Åslund: What they forget is that there are massive imbalances in the euro zone today, unpaid imbalances. And if the euro zone breaks up, these imbalances would lead to the payments mechanism collapsing in the midst of huge bank runs and liquidity freeze, and there will be no functioning currency or any functioning payment system for months.

Steve Weisman: We'll get to the impact on the European banking system in the second part of this interview. But you argue that Greece can carry out a 'devaluation' without leaving the euro zone. How?

Anders Åslund: We've already seen how Latvia has undertaken a very effective internal devaluation. What Greece needs is a complete reform of its economy and wage counts. That can be done within the euro zone. The structural reforms will be much more effective if Greece stays in the euro zone, as Latvia has shown with maintaining its exchange rate to the euro.

Steve Weisman: The term “internal devaluation” is favored by economists describing harsh medicine and a lower standard of living for Greece. Explain what an ‘internal devaluation’ means for the Greeks.

Anders Åslund: Essentially, it means that you cut the cost. That is, you cut salaries with a specific percentage and if you take Latvia as an example, they cut on average, in one year, the public salaries by 26 percent and the private salaries by 10 percent. The latter was done on the market.

Steve Weisman: What about the cost of goods that people have to buy?

Anders Åslund: What really happens today is that prices are set internationally. So, even in Latvia, one only saw devaluation for one year, and it's very difficult to get devaluation in one single country by cutting the cost. Greece's common assumption is that it would be a devaluation
by 75 percent. But it means that the euro wage instantly would fall to one quarter or a bit worse. If we instead cut the salaries, perhaps 20 percent needs to be cut. And after this has been done, the prices will quickly rise towards the euro level, which means that we would expect a couple of hundreds of percent of inflation in Greece and then we will get into a devaluation inflation cycle.

Steve Weisman: It’s ‘pick your poison,’ I guess. For Greece an internal devaluation is a least worst poison.

Anders Åslund: Yes. We can also see that Greece has now had steady decline in GDP for five years, while Latvia took a hard cure of two years of declining GDP and after that, it started growing very solidly again.

Steve Weisman: Is it your view that Greece has done a little or a lot so far?

Anders Åslund: Greece has done very little in terms of reform. We can say that the first year, they did no reform at all. The most striking is that the number of public servants under the so-called “austerity” increased until July 2011 by a net of 5000, a gross of 15,000.

Steve Weisman: What are the prospects now?

Anders Åslund: I think that everybody realizes that there’s no other way out. Greece has to come down to a price level that is competitive and Greece has to deregulate and improve its government. It ranks 80 on the Transparency International Corruption Perception Index and it ranks 100 on the World Bank Ease of Doing Business Index. There is so much to be done in terms of deregulation and cleaning up at the top of society. What we now realize is that the [Prime Minister George] Papandreou government [2009-2011] was never serious about reform.

Steve Weisman: Let’s stop there and pick up in the second part of this interview on the potential impact of a Greek exit from the euro zone on the rest of Europe. Thank you.