




Street View

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A large graphic on the left side of the page, shaped like a diamond. It features a complex network of orange and blue lines connecting various nodes, with a large white '2σ' overlaid on it.

EXECUTIVE SUMMARY More than half of a decade after the beginning of its economic crisis, Greece remains exposed to the possibility of a sovereign default and the reintroduction of the drachma. Yet despite the widely held belief, the former event need not lead to the latter. Three historical case studies refute the notion that a euro zone exit would prove inevitable following a sovereign default.

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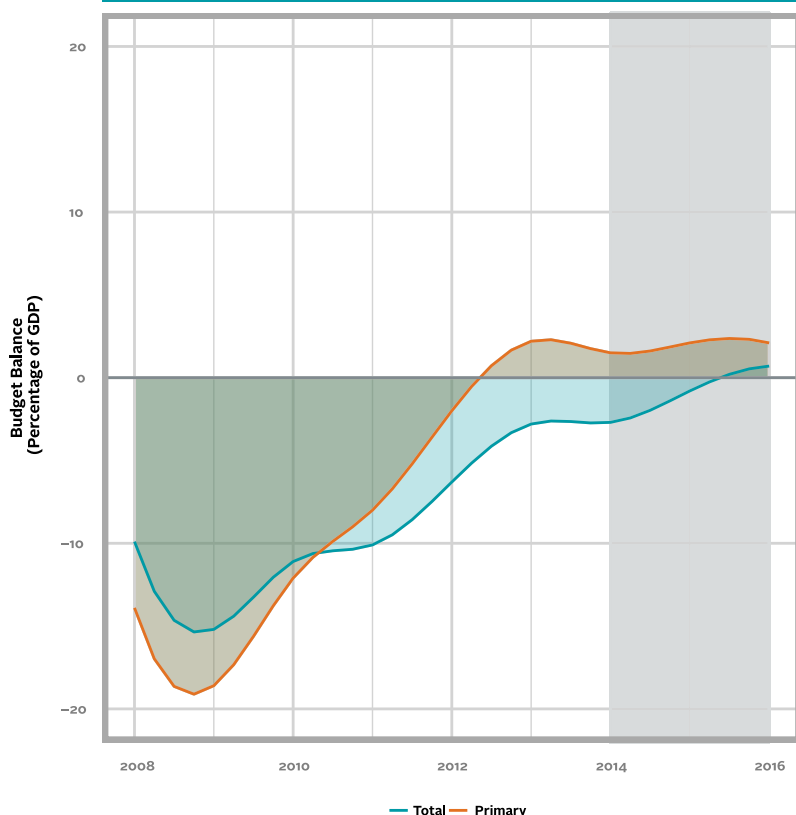
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Inside:
Greek Sovereign Default \neq Grexit

GREEK SOVEREIGN DEFAULT ≠ GREXIT

AS THE IMPASSE between the Syriza-led government and the country's largest creditors continues to show no sign of resolution, Greece's mostly on- but occasionally off-again debt crisis has once more reared its head. In some ways, little has changed since Greece's center-left PASOK party won power in October 2009 and revealed that Greece's government deficit would exceed twelve percent of GDP. Greece still suffers from low or even negative growth, inefficient tax collection, and debt in excess of 175 percent of GDP and counting (IMF, 2015). In other ways, much has changed. The euro zone as a whole enjoys modest economic growth, and the financial stresses born by "periphery" countries (other than Greece) seem to have abated. Perhaps more importantly, Greece itself has made important reforms. It still runs a deficit of 2.7 percent of GDP, but its primary budget (i.e., its fiscal budget excluding interest payments) turned to a surplus in 2013.¹ According to the IMF (Figure 1), that surplus continued through 2014 and will likely persist for the next few years. So, even if Greece were to default – it faces nearly €6 billion in debt payments through July alone – the government could in many ways continue with business as usual, with the exception of paying creditors.

FIGURE 1 Government Total and Primary Budgets



NOTES

Data from IMF (2015). Grey shaded region denotes IMF forecast.

Market observers seem not to have digested the full significance of Greece's structural changes. There is no way to directly measure the likelihood that a default will force Greece to exit the currency union, but recent polls show that the prospect of a "Grexit" remains unpopular among Greek voters.² Moreover, a variety of indirect gauges imply that observers may overestimate the probability of a Grexit. According to data from Google Trends, for example, more than 95 percent of articles on Greece's fiscal health suggest such an outcome. Meanwhile, prediction markets like Paddy Power and PredictIt put the odds of a 2015 Grexit at about 38 percent as of May 15, 2015 (higher, strangely, than the 36% probability Paddy Power assigns to a Greek default in 2015). In any case, what many seem to be missing is that while both default and Grexit remain possible, the former will not necessarily result in the latter.

Three brief historical case studies demonstrate the feasibility of Greece remaining a euro-based economy even if it defaults. The first reviews defaults by sovereign states in the U.S. The second describes Panama, a dollarized economy whose financial system does not have a central bank with

1 Data from IMF (2015). Alternative measures (e.g., Eurostat) of Greece's budget show a primary deficit in 2013 and 2014. The IMF data is the official data used to measure Greece's compliance with the "Economic Adjust Program." See http://ec.europa.eu/economy_finance/publications/occasional_paper/2010/pdf/ocp61_en.pdf

2 See, for example, http://kaparesearch.com/index.php?option=com_k2&view=item&task=download&id=53_b3ef7169857197b9d5fd5588fd9ef1e&Itemid=137&lang=en

currency-printing authority to backstop it. The third discusses Cyprus, a euro zone economy that successfully utilized capital controls to avoid the collapse of its banking sector. All three case studies support the notion that even if Greece defaults, its use of the euro is likely to continue.

CASE STUDY 1: SOVEREIGN DEFAULTS DO NOT FORCE MONETARY UNION EXITS

During the roaring 1820s and 1830s, the United States enjoyed rapid growth backed by structural economic changes like the spread of canals and the proliferation of banking institutions. Similar to Greece's inclusion in the European Union (1981), and later the euro zone (2001), these structural changes integrated relatively insular local (intrastate) markets into a much larger (interstate) economy. This transformed the individual sovereign states of America into a single economy or what economists call an optimal currency union (Rockoff, 2000).

The boom years also encouraged sovereign states to accumulate excessive debt. During the 1840s, this debt led to crisis. Nine states defaulted between 1841 and 1842: Florida (then a territory), Mississippi, Arkansas, Indiana, Illinois, Maryland, Michigan, Pennsylvania, and Louisiana. Five of those states ultimately repudiated their debt, while two states resumed partial payments within a decade and the other two eventually repaid creditors in full (Grinath, Wallis, and Sylla, 1997).

The U.S. federal government of the era offered minimal assistance. The period pre-dated automatic interstate transfer payments such as unemployment insurance. The eleventh amendment to the Constitution prevented the government from interceding on behalf of debtors suing sovereign states. No central bank existed to backstop the states, as the Second Bank of the United States (then the central bank) lost its charter in 1836, and the National Banking Act would not take effect until 1863.⁴

Of those states, all remained part of the currency union known as the United States of America.

CASE STUDY 2: PANAMA, A COUNTRY WITHOUT A CENTRAL BANK

The first case study offers examples of sovereign defaults within an official currency union. Some might quibble that the example covers states eventually served by a single central bank. Greece may not have that option. In the event of a Greek default, the European Central Bank might decide that it will no longer serve as a lender of last resorts to Greek banks. Yet that is not a reason by itself to assume that a Greek default will necessitate a Grexit.

Panama, like Greece a tourism and maritime-skewed economy, offers another example. Since 1908, Panama has used the U.S. dollar as legal tender. While the balboa also serves as a national currency, it is used primarily for small transactions and is exchangeable one-for-one with the U.S. dollar (Goldfajn and Olivares, 2001).

Fully evaluating the merits of a dollarization policy (i.e., a policy of adopting a foreign currency as official legal tender) remains beyond the scope of this Street View, but a few points warrant note. By adopting the U.S. dollar, Panama enjoys inflation rates on par with the United States and far below its Latin American peers. Panama also benefits from lower cross-country transaction costs. However, Panama's inability to print money on demand limits its fiscal flexibility, and the country has required frequent IMF intervention. Panama's financial system cannot call upon a lender of last resort, so it has relied instead upon foreign banks (Goldfajn and Olivares, 2001).

Greece owns the same option. Were Greece to default on its debt, and if the ECB declared that it would not underwrite Greek banks, Greece could still retain the euro as its official currency. Greek banking customers might prefer the security of a foreign-owned bank to a domestic competitor, but the European Union already grants Greece the ability to access non-Greek banks easily. In Panama, foreign-owned banks enjoy a disproportionate share of the market, but that does not seem to stop Panama's economic gears from turning.

In short, the ECB cannot force Greece out of the euro zone any more than the United States can force Panama to stop using the U.S. dollar.

CASE STUDY 3: CAPITAL CONTROLS CAN SHIELD FINANCIAL INSTITUTIONS WITHIN A MONETARY UNION

Some argue that Greece would need to introduce its own currency following a sovereign default in order to prevent a run on Greek banks. Yet as Cyprus shows, countries inside the euro zone have successfully imposed capital controls to protect their domestic banking sector.

The Cypriot financial sector appeared stretched as early as 2008, but the situation did not appear critical until 2011. Cyprus' economic growth slowed due to its exposure to Greece and the rest of the European Union (Orphanides, 2014). Worse, Cypriot banks held relatively large amounts of Greek sovereign debt. When Greece wrote down some of that debt in July 2012, ratings agencies downgraded Cypriot banks. Both Cyprus' citizens and foreigners holding assets in Cypriot banks began withdrawing funds, thereby sparking a slow-moving bank run. By March 2013, the Cypriot government needed to impose a bank holiday, seek a bailout from the ECB and IMF, and impose capital controls to limit the currency leaving the country (Panayi and Zenios, 2014).

Cyprus' experience was surely painful and not one that Greece would like to endure. However, the alternative of converting euros to a new currency might be worse for Greek savers. Were rumors of such a policy to arise, Greeks' euro deposits would almost surely begin flowing out of the country anyway, so Greece might not have a choice.

The lesson from Cyprus is that capital controls, while painful, have at times proven effective within the euro zone. In April 2015, two years after initiating its policy, Cyprus ended its capital controls. Its banks now appear to rest on sounder footing.

IMPLICATIONS FOR INVESTORS

As Reinhart and Rogoff note in *This Time Is Different*, one of the best-known scholarly books on financial crises, "From 1800 until well after World War II, Greece found itself virtually in continual default" (preface page xxx). The clock on that "continual default" seemed to restart over the past few years. But consistent with the intentionally ironic title of the book, "this time" in Greece is not very different than situations that other sovereign states have endured during modern history. The details and experiences may vary, but the challenges and option set Greece now faces appear similar in flavor to previous episodes of financial and currency crises. Whether Greece can (or should) avoid defaulting on its debt remains unknown. The answer likely lies partially outside of the Greek government's control. However, the answer to whether Greece will exit the euro zone does not. Changing currencies is a choice only the Greek government can make. A sovereign default may prove the impetus to such an action, but it will not force the government's hand.

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