THE DRACHMA LEGACY

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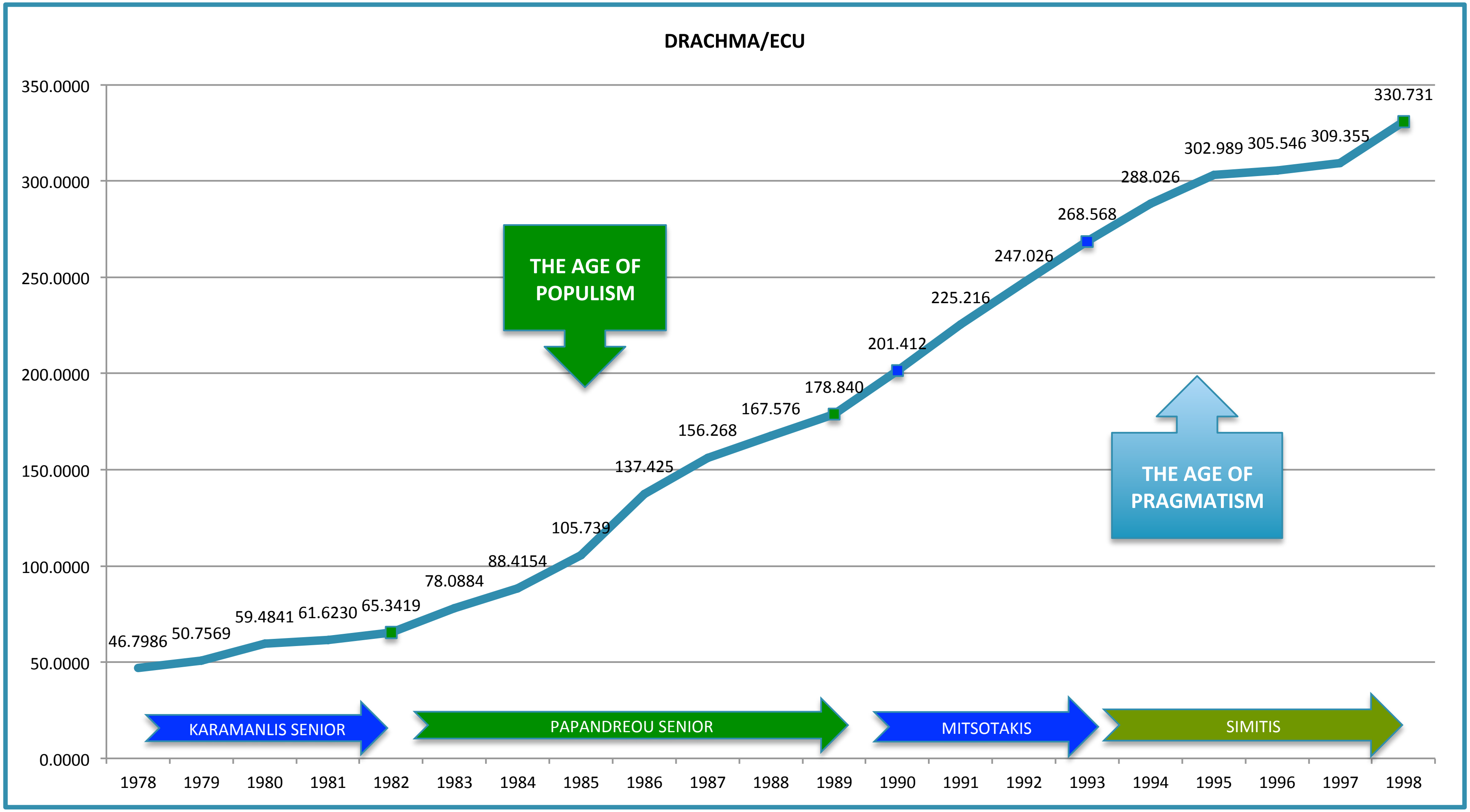
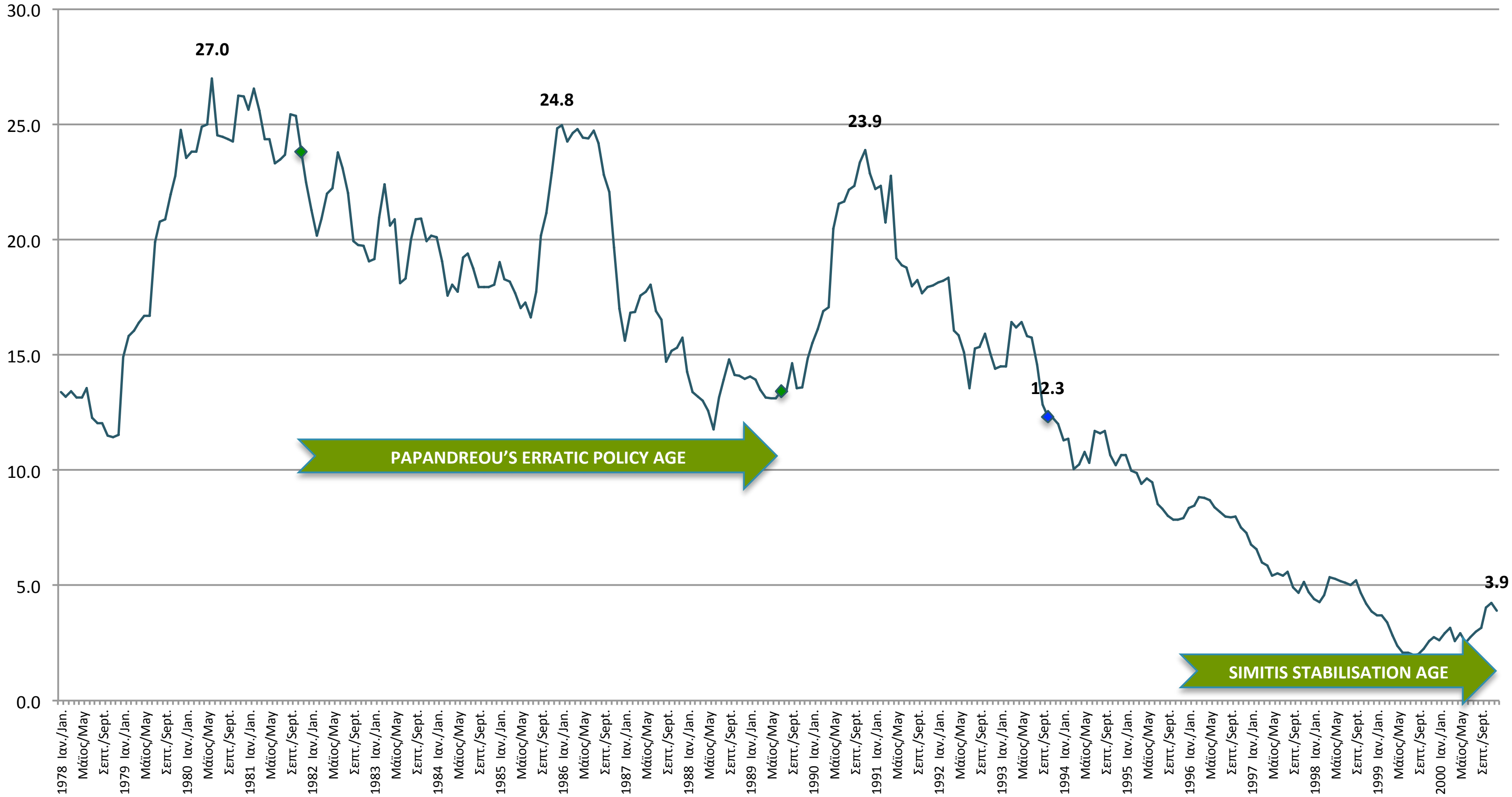
A RETURN TO OLD HABITS

- As Greeks are voting on the referendum tomorrow the return to a national currency cannot be ruled out whatever the result of the vote.
- The national currency is usually associated with the independence of economic policy. Even the IMF has indicated back in 2012 that as internal devaluation may not succeed in Greece an external devaluation may become inevitable.
- But the history of Drachma tell us a different story about policies independence and their impact. Independence will come at a high cost.

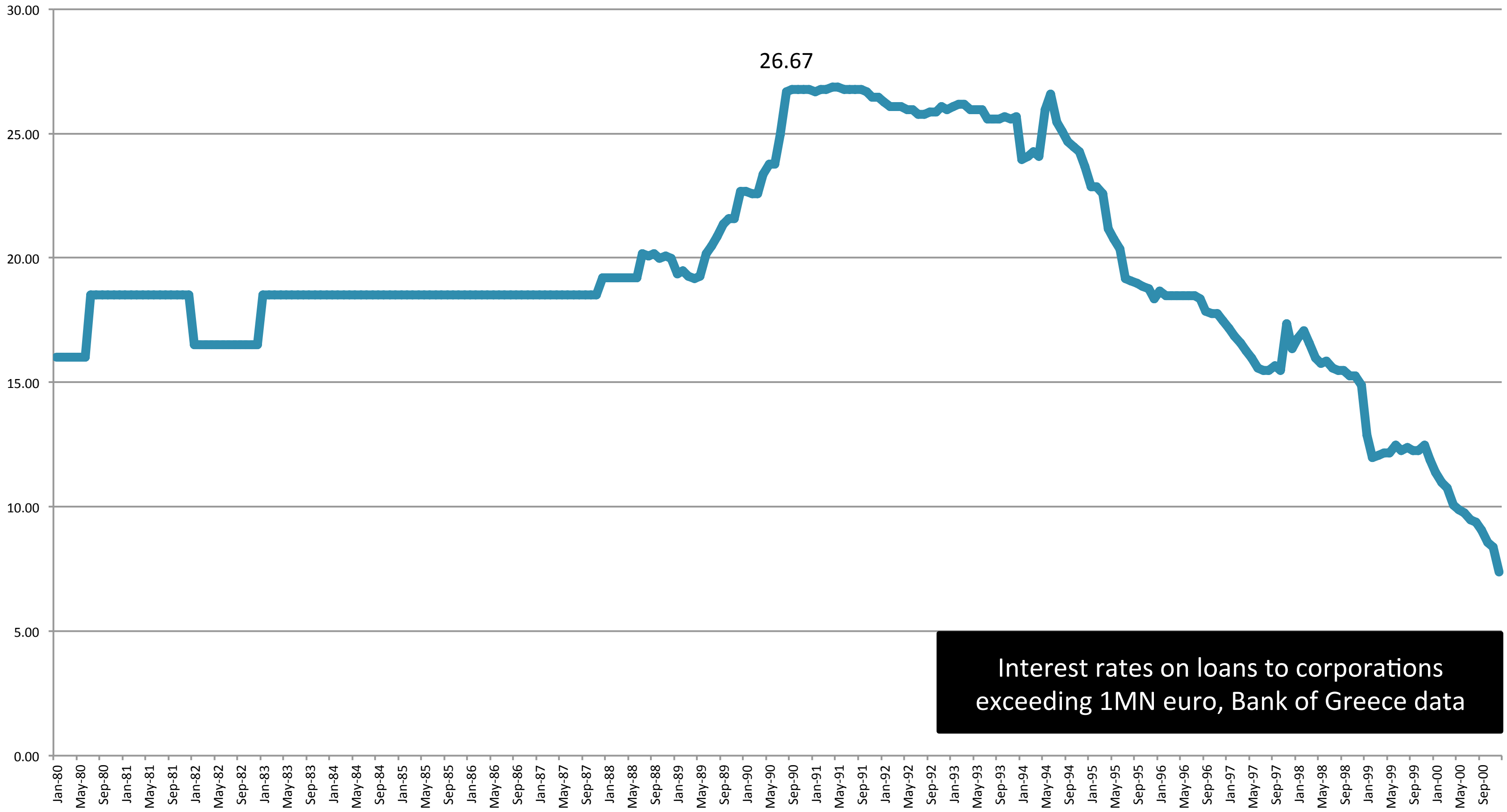
DRACHMAS INGLORIOUS HISTORY



RAMPANT INFLATION IN THE AGE OF POPULISM



INTEREST RATE HIKES DESTROYED THE REAL ECONOMY



THE YEARS OF POPULISM AND ITS LIMITATIONS

- The drachma slide by 174% in the 1982-89 period under PASOK was inevitable as a complex system of populism has been enacted leading to a vicious cycle of debts deficits high inflation and loss of competitiveness.
- Twice during that period (1982 and 1985) drachma was devalued outright to regain some competitiveness.
- In 1985 A. Papandreou engineered the first policy reversal appointing K. Simitis as Minister of National Economy when foreign exchange reserves fell to 100Mn dollars and an imminent collapse was looming. Greece was once again facing bankruptcy.
- The austerity program (not very different from the current creditors programs) involved:
  - *Devaluing the drachma by 15%, restrictions on the financing of imports, changing the system of automatic wage indexation so that the salary adjustment to be based on the estimated rather than the recorded inflation (net of the impact of imported inflation), reduced public sector borrowing requirement by 4 percentage points of GDP in both 1986 and 1987 and implement a stricter monetary policy aimed at slowing the growth of domestic credit and the gradual formation of positive real interest rates on all loan categories.*
- The stabilisation program was reversed towards the end of 1987 when A. Papandreou was planning to call early elections in 1988 as he was immersed in a major financial scandal. He fell ill and elections were lost in 1989 as he failed to contain the severe fall out from the scandal that he nearly cost his political career.
- Papandreou was an astute politician with some good intentions but his thirst of power failed him. He came on a wave of popular support and returned the favours to his clientele. Employment in the broader public sector soared wages exploded unfunded pension commitments skyrocketed.

THE TURN TOWARDS PRAGMATISM AND THE INCOMPLETE MODERNISATION

- The New Democracy party subsequently ruled Greece for 3 years and had attempted to implement a more liberal economic program with some structural reforms including privatisations and some liberalisation of markets. However, social resistance and internal divisions brought down the government in 1993.
- But the turn away from populism was now inevitable and the return of A. Papandreou was the beginning of a new era of pragmatism.
- Building on this change of attitudes Mr. K. Simitis was able to implement a genuine modernisation effort taking Greece to the Euro. But the reforms of that period were not deep enough.
- The subsequent governments of Mr. K. Karamanlis (junior) left the country largely unchanged and weaker to face the markets.
- Too many entrenched interests, rigidities, social attitudes, cultural peculiarities and lack of real leadership have prevented a more substantive transformation of Greece and real convergence with the EU. EU was just seen by the majority of the population as a source of easy funding for projects and social programs with little value added.
- Business elites were part of the problem as they were nurtured in an environment of favouritism with little drive for innovation and social responsibility.

IMF HAD WARNED GREECE ON THE LIMITATIONS OF INTERNAL DEVALUATION SINCE 2012

- The 2009/10 collapse has left Greece with few options and completely unprepared to face the adjustment required in order to return to stability. G. Papandreou had made things worse by promising that he will resolve the crisis without major sacrifices. His pre-election assertion that "LEFTA IPARHOYN" (we have money) will haunt him for ever.
- One of the central elements of the creditors program was ***internal devaluation*** engineered in an environment of fixed exchange rate. The assumption was that part of the adjustment in unit labour costs would come from the economic slowdown that would exert downward pressure on wages. The rest would follow from structural reforms that would free up Greece's rigid labor and product markets and raise productivity.
- But progress was slow and resistance grew by the day. The overprotection of the labour market insiders in the years of populism through mainly protective redundancy legislation had to be removed at a high political cost.
- The IMF has warned in 2012 that internal devaluation may not just work in time. Country Report No. 12/57 the Fund said:
  - *"Internal devaluations are almost inevitably associated with deep and drawn-out recessions, because fixed exchange rate regimes put the brunt of the adjustment burden on growth, income, and employment… Restoring competitiveness by way of internal devaluation has proved to be a difficult undertaking with very few successes. Countries with outright exchange rate devaluations usually recover faster…The experience of Argentina in 1998–2002 shows that an economy can get trapped in a downward spiral in which adjustment through internal devaluation eventually proves impossible, and the only way to an eventual recovery remains default and the abandoning of the exchange rate peg".*

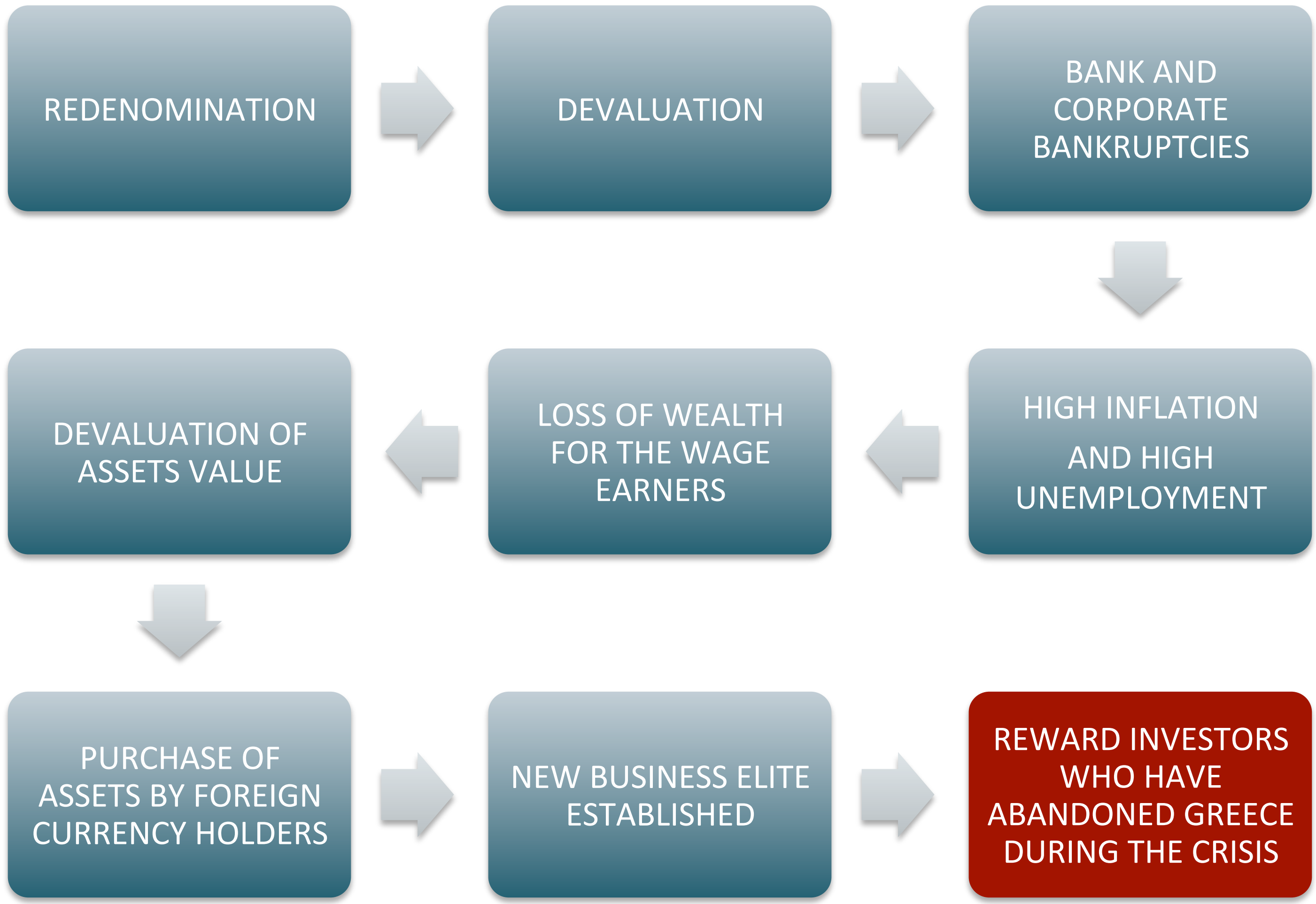
ARGENTINA's BAD EXPERIENCE OF TRANSITION BUT IN GREECE COULD BE WORSE

A SEA OF BANKRUPTCIES AND REDISTRIBUTION

- "In Argentina, where dollars were widely used as a unit of account, redenomination took the form of "pesification". It had vast redistributive consequences. If Greece abandons the euro the "drachmatisation" of loans and deposits—and the exchange-rate movements that would follow—would benefit bank debtors and harm depositors, leading to further social turmoil".
- "Argentina's experience also shows that exiting a long-term peg tends to sink large private corporations with access to international financial markets, because their foreign-currency liabilities cannot be redenominated. Indeed, Argentina's companies devoted years to negotiations with their foreign creditors and many had no choice but to default".
- "The position of Greek companies in this regard may be even worse. Many Argentinian contracts had continued to be denominated in pesos, since the currency board did not eliminate the local currency. These contracts, at least, could be honoured. But Greece would have to deal with the complete universe of covenants since every contract would need redenomination. <u>A sea of bankruptcies would follow</u>".

Mario Blejer and Guillermo Ortiz, former central-bank governors of Argentina and Mexico, LATIN LESSONS, Economist blog 2012.

THE TRANSITION TO A NEW CURRENCY WILL BE A NIGHTMARE – THE DRACHMA LOBBY HAS WON



THE ASSISTED DEATH OF GREECE

- Acrimonious negotiations and the sudden referendum decision have changed attitudes in EU circles.
- In the past week the discussions among creditors have taken a different perspective: From loans to humanitarian assistance.
- Under certain conditions Greece will be encouraged to leave the Eurozone with incentives, including:
  - Debt write off,
  - Currency reserve to back up the new currency,
  - Technical assistance to introduce the new currency.
- The real issue however remains whether and when the already dysfunctional real economy will benefit from such a development.