OXFORD ECONOMICS

Global Outlook

Must Grexit be a disaster? Some lessons from history

- **Conventional wisdom suggests euro exit would be an economic and financial catastrophe for Greece. But looking at the historical evidence, it is not clear that this must necessarily be the case. Some currency union exits have been relatively painless and even in the event of severe financial crises, real output can be surprisingly resilient and financial markets can sometimes rebound rapidly.**
- More than 70 countries and territories have exited currency unions since 1945. In only a small minority of cases has this been followed by steep losses in output and at least some of those cases can be explained by other factors such as civil wars or transition from planned to market economies. Based on history, and the likelihood that a euro exit is unlikely to be very smooth, Grexit might see Greek GDP drop around 10% initially, but the output loss could be somewhat smaller if the exit is well-handled.
- Historical examples also suggest a good chance that stock markets can recover quite sharply after financial crises, and there may also be value in some segments of Greek debt in the event of Grexit if it is accompanied by a write-off of much of Greece's debt to the EU.

Many exits from currency unions…

The probability of a Greek exit from the Eurozone has risen significantly this year, and in our view is now around 40%. Many observers have taken the view that 'Grexit' would be likely to be catastrophic for Greece, featuring a massive drop in GDP and a severe financial crisis. But is this view supported by the historical evidence?

Exits from currency unions are more common than might be imagined: since 1945, there are around 70 examples of countries and territories leaving currency unions, or an average of roughly one per year.

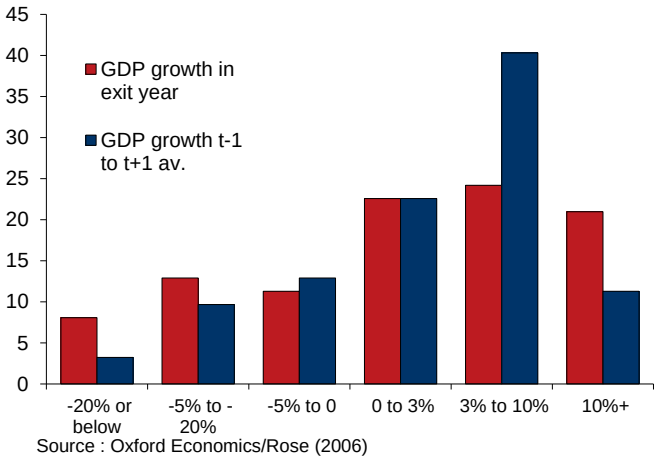
Many of these exits involved African and Asian countries setting up new currencies after independence in the 1950s-1970s. But there have also been more recent examples. Several newly-independent countries exited the rouble zone (of the former USSR) in the early 1990s, the Yugoslavian monetary union broke up at around the same time and the Czechoslovak monetary union was dissolved in 1993. Another often-overlooked example is the end of the Anglo-Irish monetary union in 1979.

What does the evidence from these many cases tell us about the risks surrounding a Greek euro exit (Grexit)?

We consider a large sample of currency union exits based on Rose (2006)[1] and supplemented with the examples already mentioned from the 1990s in central and eastern Europe.

Currency union exits

% of episodes



Source : Oxford Economics/Rose (2006)

[1] A.Rose 'Checking Out: Exits from Currency Unions' Haas School of Business 2006

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…with growth outcomes mostly benign…

If we look at GDP growth in these countries in the year of exit, we find that most countries, far from experiencing steep recessions, saw growth. GDP growth was positive in around two-thirds of the cases, negative in only one-third. Very negative outcomes, with GDP declining 20% or more, were rare, at only 8% of cases.

Looking at just the year of exit could be misleading if significant stresses were seen in the run-up to or just after exits, but if we look at average GDP growth from one year before exit to one year after, the results are similar. Indeed, the share of exiting countries recording positive average growth over this three year window is around 75%.

The median outcome for growth in the year of currency union exit, for this sample, is a 2.7% increase. For the three year window (t-1 to t+1), the median is a little higher, at 3.2%.

There is, however, a very wide spread of results around this central tendency. There are several cases where GDP in the year of exit dropped by over 20%, and several more where declines were in the 5-10% range. At the other end of the scale, there are also a number of cases of double-digit GDP growth in the year of exit from a currency union.

The wide range of results strongly implies that the circumstances under which a currency union exit takes place matter a great deal for the economic consequences of such a move.

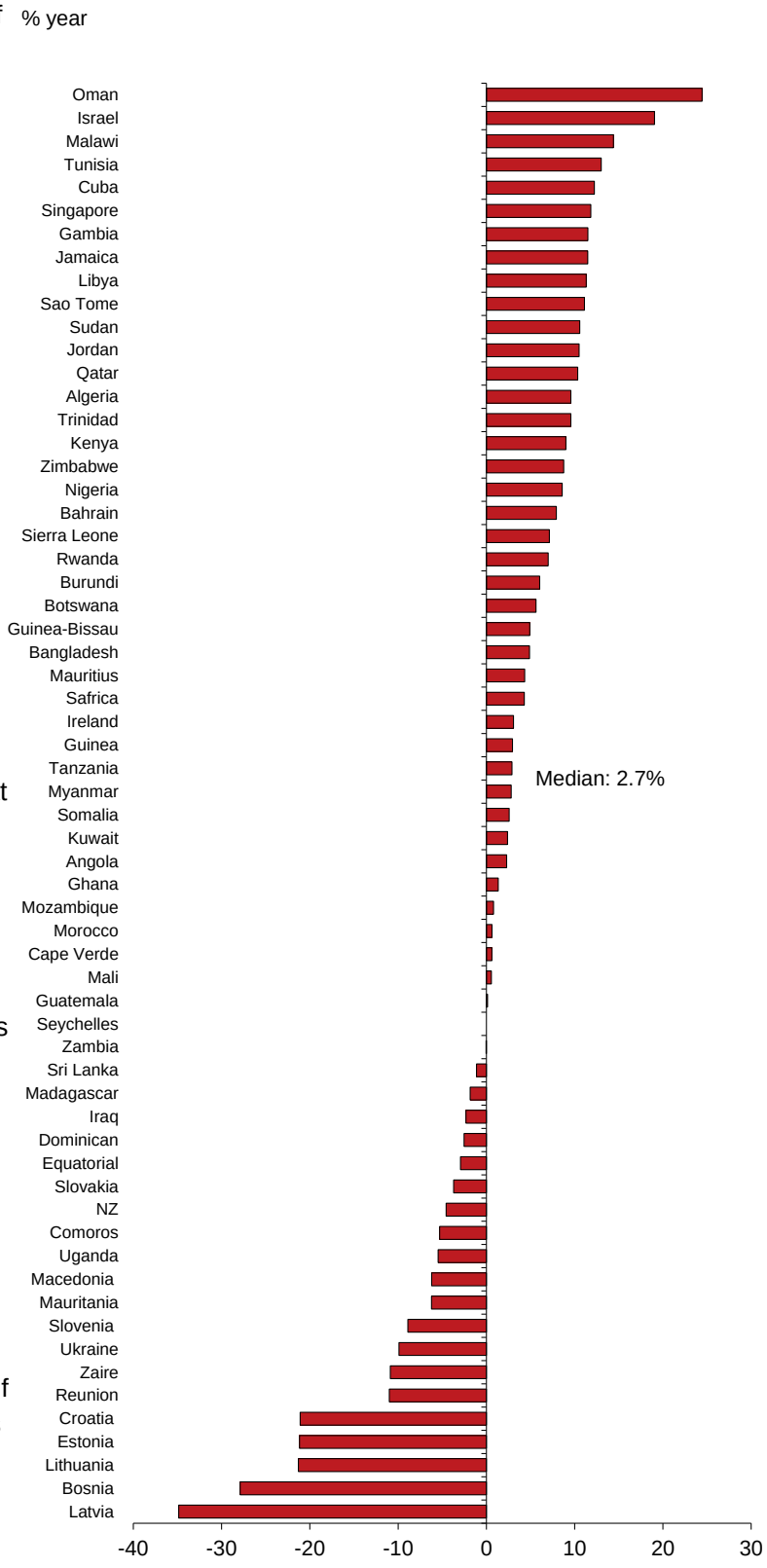
This encompasses two sets of factors. First, the actual process of exit itself – how well it is handled, and the direct knock-on effect it has on economic and financial conditions in a country.

Second, other contemporaneous economic and political developments: it may be that a currency union exit took place against an extremely unfavourable (or favourable) general background and that what we observe in terms of the GDP outcome around the currency union exit reflects these factors as much as the effect of the exit itself.

…but extremely varied

If we look at the worst outcomes in terms of GDP growth the importance of 'circumstances' is very clear. Most of the worst performances are in the central and eastern European countries in the early 1990s – the Baltic States,

GDP growth in year of currency union exit



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Ukraine and the ex-Yugoslavian states where GDP declined 20-30% in many cases in the year of currency union exit.

In our view these examples are not very good analogies for the situation in Greece today. In all these countries, the early 1990s was a period featuring a switchover from centrally-planned economies to market economies, a shift that created major adjustment costs (including massive rises in many basic prices e.g. for energy as these were decontrolled).

Currency union exits and other financial crises

Episode	GDP change, exit year	GDP decline, peak to trough	GDP change, t-1 to t+2	US$ GDP chge. t-1 to t+5 ***
ex-USSR Economies				
Latvia 1991	-32.1	na	-47.0	-24.3
Lithuania 1991	-21.3	na	-37.8	-18.1
Estonia 1991	-14.1	na	-31.6	-6.0
Ukraine 1992	-9.9	na	-40.4	-35.2
Other CEE economies				
Bosnia 1992	-27.9	na	-49.0	na
Croatia 1991	-21.1	na	-35.9	-4.4
Slovenia 1991	-8.9	na	-11.4	23.0
Slovakia 1993	-3.7	na	10.4	93.3
Other economies				
Argentina 2002	-10.9	-14.5	3.1	1.3
Russia 1998	-5.1	-9.7	10.7	6.3
Cyprus 2013	-5.4	-8.0**	na	na
Ireland 1979	3.3	na*	8.5	37.3
Nordic crisis economies				
Finland 1989-93	na	-12.3	na	na
Iceland 2008	na	-11.7	-7.0	-28.5
Sweden 1990-93	na	-6.2	na	na
Norway 1987-89	na	-0.5	na	na

* no sustained decline ** decline still continuing *** current prices & exchange rates
t= year of currency system exit or main crisis year

This was more serious for the ex-USSR countries than those of former Yugoslavia where the economic system had long been much more liberal. But in the latter group of countries there was an additional complicating factor in the shape of civil war – which had a profound economic impact on Croatia and Bosnia in particular. Notably, the ex-Yugoslav republic least affected by the early 1990s conflict, Slovenia, suffered the smallest decline in GDP in the year it introduced its new currency, of around 9%.

It also probably fair to say that many of the currency union exit episodes in the 1950s-1970s involving low-income developing countries are also not very good indicators of what might occur in the case of a 'Grexit': structurally, these economies were very different from Greece today.

Examples of exits involving relatively high income countries over recent decades do however provide some useful lessons in our view:

Ireland 1979: Ireland operated what amounted to a currency board system with sterling as the base currency from independence in the 1920s to 1979. At that point Ireland joined the European Monetary System and ended the link with sterling. There were no obvious indications of economic stress around this time, despite the close relationship between the UK and Irish economies: GDP rose 3.3% in 1979[2]. One reason for this may have been that Ireland was essentially shifting from one pegged system to another (semi-fixed) one, an institutional change that may have been less of a 'leap in the dark' than other types of currency union exit.

Czechoslovakia 1993: the dissolution of the Czechoslovak monetary union in 1993 suggests that economic costs of currency union exit need not be severe. The whole process was managed over the span of just five weeks, and while it did involve temporary exchange controls and movement restrictions, the economic damage was limited – the GDP of Slovakia, the junior and weaker partner, fell less than 4% in 1993 and was 10% higher in 1995 than it had been in 1992.

In the two examples above, currency union exit did not cause severe financial crises (though there were some brief dislocations in the Slovak case) and output losses were modest or negligible. The risk of a financial crisis in Greece after Grexit is generally considered to be quite high, but even if this proves correct, output may prove more resilient than many expect, as some other recent cases illustrate:

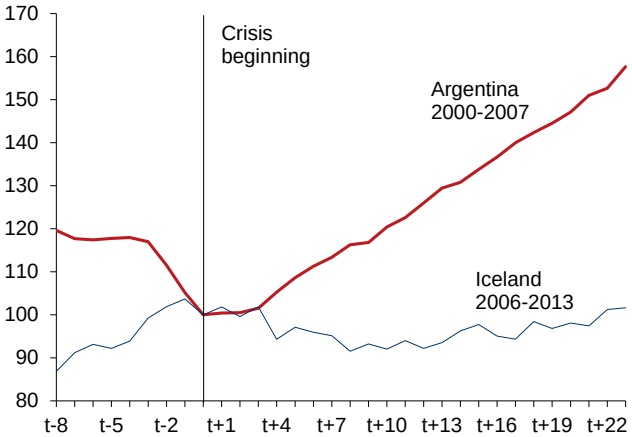
Argentina 2002: at the start of 2002 Argentina abandoned its currency board system, triggering a massive devaluation of the currency. While the currency board system did not represent a currency union with the dollar, it had some features of one and there is no doubt that the ending of the system caused serious financial distress. The changeover was badly handled, with deposit freezes, numerous bank holidays and forced conversions of dollar assets to pesos – the whole process dragged on for a around a year. Argentina also defaulted on most of its foreign debt, cutting it off from international capital markets. In many respects, it is hard to imagine a messier exit from a currency system.

[2] Exchange controls were however extended by Ireland at the time to cover transactions with the UK (which accounted for around half Ireland's trade at that time).

Nevertheless the growth outcome could have been a lot worse. The initial peak to trough decline in GDP was quite severe, at around 15%, but GDP was back above its 2001 level by 2004. Even current US$ GDP sneaked above 2001 levels by 2007.

Argentina and Iceland: GDP

Real GDP, start of crisis=100



Source : Oxford Economics/Haver Analytics

Iceland 2008: Iceland suffered a severe economic crisis from mid-2008 onwards, with a slump in the currency, a default on many foreign obligations and the collapse of the country's banking sector. Exchange controls were also introduced as an emergency measure (and remain in place).

The path of GDP has been rather different to that in Argentina, despite superficial similarities between the two cases. Icelandic GDP fell by around 12% from peak to trough, but then flatlined before starting a gentle upward trend. The level of real output climbed above its 2008 peak level last year, but nominal dollar GDP remained well below 2008 levels. This is an example of a financial collapse having a long-lasting negative impact, though arguably not a catastrophic one.

Russia 1998: Russia in 1998 suffered an all-encompassing financial crisis including massive debt default and a huge devaluation. The process was messy and chaotic, (again) featuring significant exchange controls and other restrictions and also (initially) very inflationary monetary policy. The initial fall in GDP was sharp, at around 10% peak-to-trough. But as in Argentina, the rebound was surprisingly strong. Real GDP was 11% above its 1997 level by 2000 (though this was helped by a sharp rebound in oil prices in 1999-2000) and nominal dollar was GDP above 1997 levels by 2003.

Cyprus 2013: Cyprus entered a serious financial crisis in 2013 resulting in the imposition of exchange controls, closure of a large bank and levies on some bank deposits. GDP fell by over 5% in 2013 and has fallen by around 8% since H2 2012 when the crisis started to become acute. However, this decline has been less severe than was widely expected – many forecasts (including the IMF's) expected around a double digit fall in GDP for 2013.

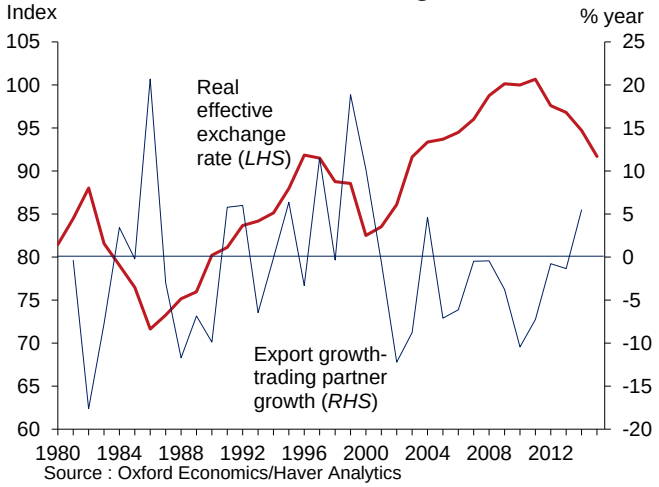
Nordics 1990s: Norway, Sweden and Finland suffered very serious banking crises in the late 1980s/early 1990s which spilled over in the latter two cases into serious currency crises as well. Arguably, these economies were more sophisticated – and therefore vulnerable to financial distress – than Greece is today.

But again, real output arguably proved surprisingly resilient. Output losses in Norway were limited, and while Sweden saw GDP decline 6% from peak to trough in 1992-93 output rebounded strongly in 1994-95 with few signs of permanent damage. In Finland, the peak to trough drop in GDP was larger, at 12%, but this was exacerbated by the (unrelated) collapse of the import Russian export market at the time. GDP recovered its pre-crisis level by 1996 though.

Recovery from Grexit could be rapid…

The preceding examples suggest that output can be surprisingly resilient in the face of currency union exits and the severe financial crises that sometimes accompany them. Initial declines in GDP are often less severe than expected, and even when they are large, the subsequent rebound is often rapid as well.

Greece: Real effective exchange rate



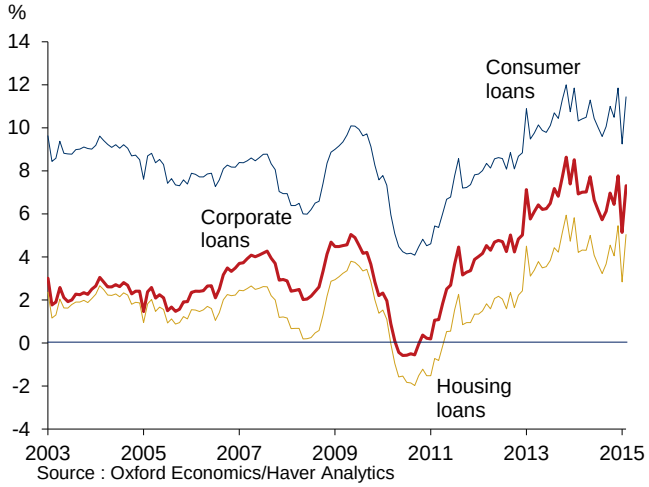
Source : Oxford Economics/Haver Analytics

In the case of Greece, it is sometimes argued that the country would not gain much from Grexit. Apart from Grexit triggering a financial crisis, it is also argued that Greek exports would not benefit much from the depreciation of the currency that Grexit would lead to.

This export pessimism is not easy to understand. Greece saw large real depreciations in the mid-1980s and from 1996-2000 and in both cases this led to Greek exports growing faster than demand in Greece's main trading partners, i.e. Greece gained market share. Since 2011, there has also been a real effective depreciation of around 9% resulting from cost cuts and (more recently) the weaker euro. And again, there are signs this is feeding through to exports, which rose 8% last year.

In addition, focusing only on exports is incorrect. Greece can also benefit in the event of Grexit from much looser monetary conditions which should boost the domestic economy. Currently, monetary conditions look very tight on all measures. Real borrowing rates for households (at 5-11%) are high, as they are for corporates (around 7%) – and have risen substantially since 2011.

Greece: Real interest rates



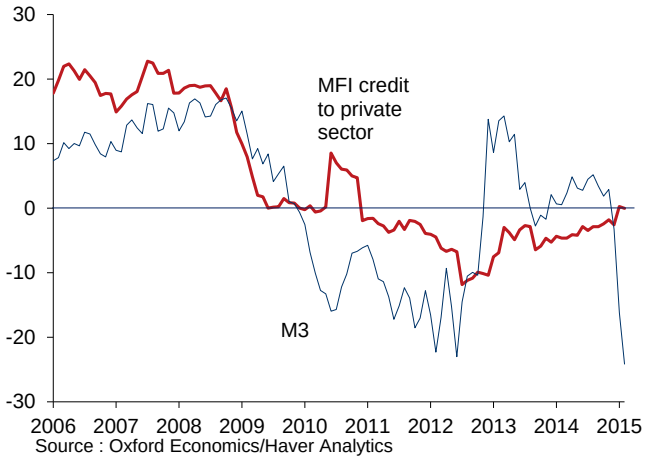
Note: Real rates calculated as nominal rates- year-on-year CPI

Meanwhile, broad money is collapsing thanks to the recent drain of deposits from the banking system. Six-month annualised M3 growth was -24% in February – worse even than in 2010-12, the previous acute phase of the Greek crisis.

The combination of depreciation and monetary loosening under a newly-independent monetary policy could help output rebound quite quickly after Grexit, even if there was an initial negative shock.

Greece: Money and credit

%, 6m annualised



The scale of the financial shock and its impact on confidence is an area of great uncertainty. A particular concern is the possibility of negative balance sheet effects, for example firms facing a massive rise in in their debt burden due to devaluation (where debts are in euros) or firms, banks or households suffering big losses due to currency mismatches (e.g. having assets in depreciated new drachmas but liabilities still in euros).

There is little doubt that such issues will cause significant dislocations in the short-term, although there are reasons for believing balance sheet risks in aggregate may be less severe in Greece than often assumed[3]. Also, while depreciation might well push firms and banks to default on some foreign obligations, the scale of these is not very large: BIS data suggest foreign claims of about US$27bn on Greek banks and US$17 billion on Greek firms.

There are also serious risks to the banking sector in a Grexit scenario. But if the banking sector needed to be recapitalised, the fiscal space to do this could exist if Greece also defaulted on its debts to the EU, which account for 108% of GDP (bank capital meanwhile being around 20% of GDP).

Finally, the impact of the likely slump in the stock market (banks are 20% of the market so a likely slump in their share prices alone would generate a big impact) could also prove quite modest, given that Greek households hold just 2% of their financial assets in listed stocks and only 7% in investment fund shares and pension and insurance products.

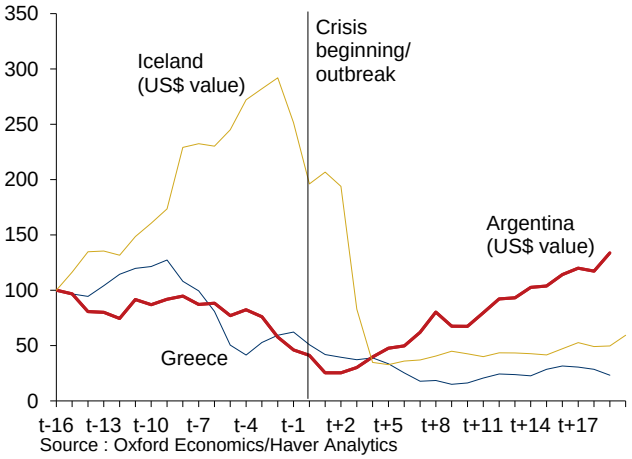
[3] This issue is explored in detail in a forthcoming research briefing.

…and some financial upsides too?

What about financial market recovery? The evidence from historical episodes suggests much depends on the starting point. In Iceland, the pre-crisis period featured a massive stock market bubble that then burst, dropping equity prices by around 90% in dollar terms. Today's prices remain over 70% below their peaks.

Stock markets and financial crises

Index, t-16 quarters=100



Source : Oxford Economics/Haver Analytics

By contrast, Argentine stocks crashed 70% in dollar terms from Q2 2001 to Q2 2002 but were rising again in dollar terms by end-2002, regained their mid-2001 levels by Q1 2004 and continued to grow rapidly in the succeeding years.

Which of these cases does Greece most resemble? It's certainly hard to argue Greek stocks are in a bubble – even with a rally in 2013-14 Greek stock prices remain dramatically below their pre-crisis levels. This still looks like a bombed-out market, resembling Argentina more than Iceland at the point of crisis. Once the shock of Grexit is over, Greek stocks could rally quite strongly.

What about bonds? Greek bonds have sold off sharply over recent months as Grexit fears have grown, reflecting concerns that Grexit will also mean default. Default certainly seems likely to accompany Grexit, but what sort of default?

A key point here is that most of Greece's debt is now owed to official creditors, largely the EU institutions. ECB bond holdings and EFSF and GLF loans account for around €230 billion of Greece's €316 billion public debt. Tradable securities held by the private sector are only around €55 billion.

Given this, it would be probably be possible for Greece to remain current on the tradable portion of its debt (and its €24 billion of IMF debt) over the medium term if it repudiated the debt owed to the EU institutions. There are legal complications to this, and other factors that might make such a move unwise but there are also precedents: most notably, Russia in 1998 continued to service its Eurobonds despite defaulting on most of its external obligations. Russian Eurobond prices collapsed to as low as 10 cents on the dollar but nevertheless these bonds were repaid, so those with strong stomachs reaped rewards.

Conclusion

Historical episodes suggest that output losses in the event of currency union exits need not be very steep. Many of the cases of currency union exit where GDP has fallen 10% or more have involved other serious complicating factors such as wars or economic transition. Other examples involving advanced economies also suggest real output can be relatively resilient in the case of serious financial crises.

It is still likely that Greek GDP would fall significantly in the event of Grexit. In our view, Grexit is unlikely to be a smooth process: it is likely to lead to great economic uncertainty initially; agreeing/implementing debt write-downs with the EU could take some time; exchange controls and restrictions on banks are likely to be severe at least initially; the risk of policy errors is high. As a result, an initial fall in GDP of around 10% is quite possible, broadly in line with other messy financial crises such as in Russia, Argentina and Iceland.

But there is an upside risk - if reasonably well organised, historical experiences suggest Grexit might see a much smaller initial drop in GDP. In addition, historical episodes also suggest there could be a rapid rebound in activity after an initial drop, and the fact that monetary conditions in Greece are so tight currently supports this – as does the fact that Greek GDP has already slumped by 25% since 2010: the economy is operating way below potential.

There could also be some upside for financial markets: Greek equity prices are still at depressed levels and could rally strongly once growth restarts. Even some parts of the bond market could offer value if Greece opts for a policy of 'selective default'.

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