What's at Stake in the Greek Vote

If a Greek exit from the euro zone looks close to certain after Sunday's election, we will see a full-fledged bank run.

By NICHOLAS ECONOMIDES, YANNIS IOANNIDES, EMMANUEL PETRAKIS, CHRISTOPHER PISSARIDES
AND THANASIS STENGOS

This Sunday Greeks go to the polls confused, fearful and experiencing a frightening deterioration of their standard of living. The country's voters now face a crucial dilemma that will determine the future of Greece for generations: Stay in the euro or commit fiscal suicide with a return to the drachma.

At first glance, there is an easy answer to the dilemma: Stay in the euro—the preference of about 80% of Greeks, according to opinion polls. Of its own initiative and per the commitments in its EU-IMF debt agreement, Greece has undergone severe austerity for more than two years. It has been in recession for five years, while managing to dramatically reduce its primary deficit to 5% in 2010 from 10.4% in 2009.

Although Greece has lost competitiveness in terms of unit-labor costs since the first quarter of 1999—as have all euro-zone countries except for Germany and Austria—Greece has adopted significant wage and salary cuts. In the past two years the country has written off close to one-third of its debt and now has very low interest rates on its remaining debt. Its future success depends on the implementation of drastic reductions in public spending, more efficient tax-collection, and productivity improvements.

Enlarge Image

Getty Images

There are tremendous negatives to leaving the euro and printing new drachmas. If a Greek exit from the euro zone looks close to certain after Sunday's election, we will see a full-fledged bank run. Greek banks would collapse unless the European Central Bank takes extraordinary measures, possibly in violation of its charter. The market exchange-rate would likely be two or three drachmas to the euro, which would double or triple the Greek price of imported goods within a few days. Prices of assets, including real-estate assets, would crumble. Those who moved their deposits abroad would be able to buy these assets cheaply, leading to a significant, regressive redistribution of Greek wealth.

Besides the supply-side inflation, there would be additional inflation as Greece would be printing drachmas to finance its deficit. Finally, businesses would be unable to import without paying in advance with scarce euros. Necessities would run short and trade would be at a standstill. Greece would be forced into a crisis many times more severe than its present one, further fueling social unrest.

But three key forces work against Greece remaining in the euro. First, Greek voters have not been well-informed. While they feel their current suffering very acutely, they do not know or understand the full consequences to themselves of leaving the euro zone. Populist politicians minimize these terrible consequences.

Second, some Greek political parties argue that the consequences of Greece leaving the euro zone would be more severe for the EU than for Greece. They propose a game of "chicken" with German Chancellor Angela Merkel and are threatening to scrap the last government's agreement with its lenders. If these parties do well on Sunday and those threats become a reality, it is hard to see what would prevent Greece's almost immediate exit from the euro zone.

Greeks have also come to identify their European debt agreement with austerity, layoffs and salary and pension cuts, due to the fact that the EU, ECB and International Monetary Fund have put growth-promoting reforms in second place, behind fiscal consolidation, while setting the terms for their support for Greece.

Assuming that rationality prevails on Sunday, a new Greek government—most likely a coalition government—will recommit to the euro and to Greece's existing debt agreements by the end of the month. Greece will ask the EU to ease its austerity measures and commit to significant investments in infrastructure. The EU at that point should breathe a sigh of relief and agree to both requests, since it is clear that severe austerity alone will not bring Greece to stability.

The EU must also help Greece achieve immediate structural reforms to radically improve the ease with which business can be conducted, and to reduce tax evasion, eradicate corruption in procurement and liberalize the labor and product markets. It must do all this while also ensuring supervision over Greece by competition authorities, improving efficiency in its justice system and health sector, and opening access to its artificially closed markets in transportation, pharmaceuticals and engineering, among others.

As long as Greece leaves the door open to the disastrous consequences of exiting the euro, the rest of the currency zone will have to deal with the contagion in Spanish, Italian and other bond markets and banks, through direct intervention by the ECB. Like the Lehman collapse, there may be a number of markets severely affected by a Greek exit that are not immediately obvious. Delay in dealing with these problems, or denial that they exist at all, will only make the fallout more expensive.

Mr. Economides is at the New York University Stern School of Business; Mr. Ioannides at Tufts University; Mr. Petrakis at the University of Crete; Mr. Stengos at the University of Guelph; and Mr. Pissarides, a 2010 Nobel laureate, at the London School of Economics. All are professors of economics.

A version of this article appeared June 15, 2012, on page A11 in the U.S. edition of The Wall Street Journal, with the headline: What's at Stake in the Greek Vote.