



## Is The Greek Dra(ch)ma Making a Comeback?

**If Greece leaves the Euro area, it could generate a crisis of unknown consequences. This should drive the negotiators to seek compromise over the issue of reforms.**

Greece and its European partners are in one more round of negotiations to seek a last-minute solution before the Greek government runs out of money. The talks could end up going in any direction. Greece is unlikely to score a massive win but it could buy itself some time if there is agreement around a reasonable set of reforms that are to be implemented over the coming months, reforms that could be sold in a different way domestically to the way they are presented in Brussels. What Greece really wants out of these negotiations is straightforward: a restructuring/reduction of its current debt that allows it to survive over the coming years with a primary balance in (small) surplus. This would mean that their pressure is gone and that they can implement any policies they want without worrying about new loans as long as they can keep a primary surplus, which might be feasible given the current state of the budget. In return, it will be easy to promise reforms that can have enough support at home (removing bureaucratic barriers, broadening the tax base, improving government efficiency). Of course, when it comes to the actual implementation of those reforms, the support could turn into strong opposition. Greece also does not want to leave the euro. Support among Greek voters is very high and the government understands the uncertainty and likely downside risk that it would face if Greece exits the Euro area. What the European partners

want is much less clear. They would love to be repaid all the current Greek government debt that they hold but that's unlikely to happen. Some would love to see Greece outside of the Euro area so that they do not have to deal with this again. There is a sense that whatever agreement is found now will not be the last one. The lack of trust has reached levels that has made it clear to some that Grexit is the best long-term outcome. But they are afraid of the consequences, both in the short run and in the long run in terms of credibility of the membership that would be left after Greece was gone. What no one wants is an agreement that does not offer a permanent solution to the problem. But is this possible? You need a credible commitment from Greece on implementing reforms in a way that can guarantee a large enough primary balance so that the possibility of future crisis goes down significantly. But credible commitment on reforms is not feasible. Reforms take time to be designed and implemented and there is enough uncertainty about growth and interest rates to ensure that a future crisis can be ruled out. The gulf between what the Greek government wants and what the European partners want is an empty one today (once we remove all the unfeasible solutions). And that's why a risk of collapse in the negotiations is real. The only thing that can stop the collapse is the willingness by Germany (and the others) to compromise out of the fear that a default by Greece and the possibility of

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an exit from the Euro area can generate a crisis of unknown consequences. No doubt this fear has decreased over the last few years as markets are happy with low rates on Spanish and Italian debt while these negotiations are going on. But maybe they are happy because they assume a last-minute compromise will be reached (a good prediction given what we have seen in the past) or maybe because they believe the ECB could protect the other periphery countries from contagion with yet another “whatever it takes” statement. But the power of the ECB to contain a potential exit from the euro is not infinite. It will depend on how the exit plays out. Maybe they can contain some of the economic risk but what about the political risk? With coming elections in key EU countries (U.K., Spain) with interesting political dynamics when it comes to EU membership or policies, the range of political outcomes remains too wide to feel too comfortable about an exit from the Euro area.

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