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Let Greece take a holiday from the eurozone

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Loan guarantees or temporary credits from Germany and France may allow Greece to avoid a refunding crisis later this spring. But temporary financial patches will not deal with the real problem: Greece's budget deficit of 13 per cent of gross domestic product. To prevent an exploding ratio of government debt to GDP, Greece needs to cut future annual spending and increase its future taxes in a com-bination equivalent to at least 10 per cent of GDP.

Unfortunately, such a fiscal contraction would sharply increase unemployment, already at a painful 10 per cent; and political opposition makes such action impossible.

If Greece still had its own currency, it could, in parallel, devalue the drachma to reduce imports and raise exports, cutting the 15 per cent of GDP trade deficit. The level of Greek GDP and employment might then actually increase if the rise in exports and decline in imports added more to domestic employment and output than was lost through raising taxes and cutting government spending. But since Greece no longer has its own currency, it is not free to follow this strategy.

So what can Greece do? It can simply raise taxes and cut spending, asking its population to suffer many years of high unemployment. Or it can seek a real bail-out from its euro partners, in which they give the Greek government enough money year after year to pay its bills without raising taxes. Even if the small size of the Greek economy made that feasible, it would be rejected because Germany and France would correctly fear that doing so would lead to pressure for similar bail-outs from larger eurozone countries. Another option is for Greece to secede from the eurozone, perhaps starting a process in which other eurozone countries with large fiscal and trade deficits also drop out.

None of the above choices appeals to Greece or its eurozone partners. But there is a better idea that could preserve the single currency while helping the beleaguered country to adjust its twin deficits.

The rest of the eurozone could allow Greece to take a temporary leave of absence with the right and the obligation to return at a more competitive exchange rate.

More specifically, Greece would shift its currency from the euro to the drachma, with an initial exchange rate of one euro to one drachma. Bank balances and obligations would remain in euros. Wages and prices would be set in drachma.

If the agreement called for Greece to return at an exchange rate of 1.3 drachmas per euro, the Greek currency would immediately fall by about 30 per cent relative to the euro and other non-euro currencies. If there is little or no induced inflation in Greece, Greek products would be substantially more competitive in both domestic and foreign markets.

In exchange for permission to reset its exchange rate, Greece would have to agree to tough fiscal measures to bring its budget deficit down quickly and keep it down. Although the higher cost of imports would cut local real incomes, damage would be limited by the fact that imports are less than 20 per cent of total Greek GDP.

Other eurozone members might object to giving Greece this improved competitiveness. They might worry that other countries with large trade deficits would press for a similar deal. But allowing Greece to reset its exchange rate might still be better than having the country permanently leave the eurozone. It would certainly be better than

condemning the Greek people to a decade of suffering. It would also be better than Germany and other countries providing continual financial assistance to Greece, since such a process might make Germany itself want to quit the eurozone.

The European economic and monetary union is doubly flawed. First, it forces diverse countries to live with a single interest rate and exchange rate that cannot be appropriate for all members. Second, combining a single currency with independent national budget policies encourages fiscal profligacy. The Greek situation is a manifestation of these flaws. If European political leaders nevertheless want to preserve the current system, allowing a temporary exchange rate reset for Greece may be the best option.

The writer is professor of economics at Harvard and president emeritus of the National Bureau of Economic Research. He chaired the Council of Economic Advisers under President Reagan and is a member of President Obama's Economic Recovery Advisory Board.