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After the Greek Default
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CAMBRIDGE – The Greek government, the European Commission, and the International Monetary Fund are all denying what markets perceive clearly: Greece will eventually default on its debts to its private and public creditors. The politicians prefer to postpone the inevitable by putting public money where private money will no longer go, because doing so allows creditors to maintain the fiction that the accounting value of the Greek bonds that they hold need not be reduced. That, in turn, avoids triggering requirements of more bank capital.

But, even though the additional loans that Greece will soon receive from the European Union and the IMF carry low interest rates, the level of Greek debt will rise rapidly to unsustainable levels. That's why market interest rates on privately held Greek bonds and prices for credit-default swaps indicate that a massive default is coming.

And a massive default, together with a very large sustained cut in the annual budget deficit, is, in fact, needed to restore Greek fiscal sustainability. More specifically, even if a default brings the country's debt down to 60% of GDP, Greece would still have to reduce its annual budget deficit from the current 10% of GDP to about 3% if it is to prevent the debt ratio from rising again. In that case, Greece should be able to finance its future annual government deficits from domestic sources alone.

But fiscal sustainability is no cure for Greece's chronically large trade deficit. Greece's imports now exceed its exports by more than 4% of its GDP, the largest trade deficit among eurozone member countries. If that trade gap persists, Greece will have to borrow the full amount from foreign lenders every year in the future, even if the post-default budget deficits could be financed by borrowing at home.

Eliminating or reducing this trade gap without depressing economic activity and employment in Greece requires that the country export more and import less. That, in turn, requires making Greek goods and services more competitive relative to those of the country's trading partners. A country with a flexible currency can achieve that by allowing the exchange rate to depreciate. But Greece's membership in the eurozone makes that impossible.

So Greece faces the difficult task of lowering the prices of its goods and services relative to those in other countries by other means, namely a large cut in the wages and salaries of Greek private-sector employees.

But, even if that could be achieved, it would close the trade gap only for as long as Greek prices remained competitive. To maintain price competitiveness, the gap between Greek wage growth and the rise in Greek productivity – i.e., output per employee hour – must not be greater than the gap in other eurozone countries.

That will not be easy. Greece's trade deficit developed over the past decade because Greek prices have been rising faster than those of its trading partners. And that has happened precisely because wages have been rising faster in Greece, relative to productivity growth, than in other eurozone countries.

To see why it will be difficult for Greece to remain competitive, assume that the rest of the eurozone experiences annual productivity gains of 2%, while monetary policy limits annual price inflation to 2%. In that case, wages in the rest of the eurozone can rise by 4% a year. But if productivity in Greece rises at just 1%, Greek wages can increase at only 3%. Any higher rate would cause Greek prices to rise more rapidly than those of its eurozone trading partners.

So Greece faces a triple challenge: the fiscal challenge of cutting its government debt and future deficits; the price-level

challenge of reducing its prices enough to wipe out the current trade gap; and the wage-productivity challenge of keeping future wage growth below the eurozone average or raising its productivity growth rate.

Ever since the Greek crisis began, the country has shown that it cannot solve its problems as the IMF and the European Commission had hoped. The countries that faced similar problems in other parts of the world always combined fiscal contractions with currency devaluations, which membership in a monetary union rules out.

A temporary leave of absence from the eurozone would allow Greece to achieve a price-level decline relative to other eurozone countries, and would make it easier to adjust the relative price level if Greek wages cannot be limited. The Maastricht treaty explicitly prohibits a eurozone country from leaving the euro, but says nothing about a temporary leave of absence (and therefore doesn't prohibit one). It is time for Greece, other eurozone members, and the European Commission to start thinking seriously about that option.

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