**Project Syndicate**

Europe's High-Risk Gamble
September 2011

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CAMBRIDGE – The Greek government needs to escape from an otherwise impossible situation. It has an unmanageable level of government debt (150% of GDP, rising this year by ten percentage points), a collapsing economy (with GDP down by more than 7% this year, pushing the unemployment rate up to 16%), a chronic balance-of-payments deficit (now at 8% of GDP), and insolvent banks that are rapidly losing deposits.

The only way out is for Greece to default on its sovereign debt. When it does, it must write down the principal value of that debt by at least 50%. The current plan to reduce the present value of privately held bonds by 20% is just a first small step toward this outcome.

If Greece leaves the euro after it defaults, it can devalue its new currency, thereby stimulating demand and shifting eventually to a trade surplus. Such a strategy of "default and devalue" has been standard fare for countries in other parts of the world when they were faced with unmanageably large government debt and a chronic current-account deficit. It hasn't happened in Greece only because Greece is trapped in the single currency.

The markets are fully aware that Greece, being insolvent, will eventually default. That's why the interest rate on Greek three-year government debt recently soared past 100% and the yield on ten-year bonds is 22%, implying that a €100 principal payable in ten years is worth less than €14 today.

Why, then, are political leaders in France and Germany trying so hard to prevent – or, more accurately, to postpone – the inevitable? There are two reasons.

First, the banks and other financial institutions in Germany and France have large exposures to Greek government debt, both directly and through the credit that they have extended to Greek and other eurozone banks. Postponing a default gives the French and German financial institutions time to build up their capital, reduce their exposure to Greek banks by not renewing credit when loans come due, and sell Greek bonds to the European Central Bank.

The second, and more important, reason for the Franco-German struggle to postpone a Greek default is the risk that a Greek default would induce sovereign defaults in other countries and runs on other banking systems, particularly in Spain and Italy. This risk was highlighted by the recent downgrade of Italy's credit rating by Standard & Poor's.

A default by either of those large countries would have disastrous implications for the banks and other financial institutions in France and Germany. The European Financial Stability Fund is large enough to cover Greece's financing needs but not large enough to finance Italy and Spain if they lose access to private markets. So European politicians hope that by showing that even Greece can avoid default, private markets will gain enough confidence in the viability of Italy and Spain to continue lending to their governments at reasonable rates and financing their banks.

If Greece is allowed to default in the coming weeks, financial markets will indeed regard defaults by Spain and Italy as much more likely. That could cause their interest rates to spike upward and their

national debts to rise rapidly, thus making them effectively insolvent. By postponing a Greek default for two years, Europe’s politicians hope to give Spain and Italy time to prove that they are financially viable.

Two years could allow markets to see whether Spain’s banks can handle the decline of local real-estate prices, or whether mortgage defaults will lead to widespread bank failures, requiring the Spanish government to finance large deposit guarantees. The next two years would also disclose the financial conditions of Spain’s regional governments, which have incurred debts that are ultimately guaranteed by the central government.

Likewise, two years could provide time for Italy to demonstrate whether it can achieve a balanced budget. The Berlusconi government recently passed a budget bill designed to raise tax revenue and to bring the economy to a balanced budget by 2013. That will be hard to achieve, because fiscal tightening will reduce Italian GDP, which is now barely growing, in turn shrinking tax revenue. So, in two years, we can expect a debate about whether budget balance has then been achieved on a cyclically adjusted basis. Those two years would also indicate whether Italian banks are in better shape than many now fear.

If Spain and Italy do look sound enough at the end of two years, European political leaders can allow Greece to default without fear of dangerous contagion. Portugal might follow Greece in a sovereign default and in leaving the eurozone. But the larger countries would be able to fund themselves at reasonable interest rates, and the current eurozone system could continue.

If, however, Spain or Italy does not persuade markets over the next two years that they are financially sound, interest rates for their governments and banks will rise sharply, and it will be clear that they are insolvent. At that point, they will default. They would also be at least temporarily unable to borrow and would be strongly tempted to leave the single currency.

But there is a greater and more immediate danger: Even if Spain and Italy are fundamentally sound, there may not be two years to find out. The level of Greek interest rates shows that markets believe that Greece will default very soon. And even before that default occurs, interest rates on Spanish or Italian debt could rise sharply, putting these countries on a financially impossible path. The eurozone’s politicians may learn the hard way that trying to fool markets is a dangerous strategy.

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