

Greece can be saved – here's how to do it

By: Jeffrey D. Sachs

Greece avoided an imminent default by taking a brave vote for more fiscal austerity on Wednesday. Europe and the International Monetary Fund will now release short-term financing to enable Greece to service its debts at least through the summer. Yet there can be no doubt that this second bail-out, which follows a similar short-term package in March 2010, must be the last of its kind. Either Greece with its eurozone partners will agree on a long-term solution, or the rioters in the streets of Athens will prevail the next time that the Greek political system is pushed to the financial brink.

The stalwart Greek people deserve our gratitude for this week's vote. A default could have led to a dramatic unravelling of the European economy, and even beyond. Many of my colleagues in academia have blithely called upon Greece to default, and thereby force an involuntary restructuring of its debts. I find such advice to be naive. Nobody can guarantee a managed default in today's global financial system. Bank runs, a contagion to other countries, the triggering of credit default swaps, legal actions by vulture funds that buy up cheap Greek bonds and then sue for full repayments, and heated political recriminations within Europe, are but some of the consequences that could quickly follow a default. An unravelling of the monetary union could not be excluded.

A default may indeed eventually occur, but should never be a first or early resort. I say this not because of the sanctity of sovereign debt contracts, but out of pragmatism. I myself have helped to negotiate a number of sovereign debt restructurings, from Bolivia to Poland to Nigeria and beyond. But Greece is different. It is a developed economy. It has not collapsed into hyperinflation. It has not emerged from externally imposed communism, as in Poland two decades ago. Greece over-borrowed and overspent, then got caught in accounting shenanigans as well as the global financial meltdown in 2008. Now Greece needs to adjust, if that adjustment is within reason and decency rather than the kind that would kill the economy.

Many of those who argue for the inevitability of default claim that Greece can never repay its mountain of debt. They may eventually prove to be correct, but it is still far too early to say, or to act on that hunch. The claim of inevitability is that with public debt owed to foreign creditors around 120 per cent of national income, Greece's debt servicing will break the economy and prove, sooner rather than later, to be politically unsustainable as well. With average interest rates on Greek bonds expected to stay above 6 per cent per year on the business-as-usual scenario put forward by the IMF and EU, interest servicing to foreign creditors would also remain higher than 6 per cent of gross domestic product in the coming years. That indeed would be an impossible load to bear, both economically and politically.

Fortunately, that dire forecast is not necessarily right. Greece need not pay anything near to that level if the financial crisis is better handled from this point forward. Here is how. The IMF-EU estimates are based on the idea that Greece will have to pay high market-based interest rates that include a significant premium for the risk of default. The

obvious problem facing Greece is a potentially self-fulfilling prophecy of default. High interest rates will lead to an intolerable debt-service burden and the inevitability of default. The prospect of default, in turn, will lead inexorably to high interest rates. The better policy is to get Greece's interest rates sharply lower, consistent with an alternative scenario in which Greece is in fact able to manage its debts because debt servicing is moderate, gradual and backed by renewed economic growth.

Suppose that instead of sky-high interest rates, Greece is enabled to service its debts on Germany's borrowing terms, roughly ten-year fixed interest rates of around 3.5 per cent per annum. With annual eurozone inflation of 1.5 per cent or higher, real interest rates would be 2 per cent or lower. If Greece can resume an annual economic growth rate of around 3 per cent, then Greece will be able to service its debts and reduce the ratio of its foreign public debt to GDP from around 120 per cent to around 70 per cent over a twenty-year period, while also keeping net resource transfers to foreign creditors to around 2 per cent of GDP per annum.

This is the main point: Greece can probably service its debts in the long term, without a default, if a low interest rate (at the level of today's AAA sovereign borrowers) is locked into place and repayments are stretched out over 20 years. Simply stretching out repayments – as is now being discussed by the banks and the French Government – without permanent and significantly lower rates would not do. Nor would a “trigger” clause that raises Greece's repayment rates when economic growth resumes. Greece can succeed only if low rates are locked into place.

Such favourable terms could conceivably arise through a spontaneous and self-confirming bout of optimism – the condition in which Greece's greatest fear would no longer be “fear itself”, in the famous words of America's greatest salesman of financial optimism, President Franklin Roosevelt. More realistically, we are past the point of self-confirming optimism.

Low interest rates should instead be put in place through Europe-wide guarantees on Greece's debt service. In effect, Greece would be enabled to finance its debts on German and French borrowing terms, as those countries and the rest of the eurozone stand behind Greek debt servicing. German Chancellor Angela Merkel has so far resisted this kind of solution, while Axel Weber, former Bundesbank President, recently hinted at such an approach.

Ms Merkel is afraid to be tarred with a taxpayer-financed bail-out of Greece and the banks. This concern is grossly exaggerated, at least relative to the far-greater concerns regarding a disorderly default. After all, taxpayers would surely pay much more in that event. They would pay nothing at all on the guarantees if Greece indeed succeeds in servicing the debt over twenty years at the locked-in rates.

There is also an effective way to address the heavy political burden of a European guarantee on Greek debt. The EU has been moving towards new taxes on the financial sector, perhaps on bank balance sheets or on financial transactions. Such taxes could in

effect back the guarantees on Greek debt servicing. Building up a guarantee fund at the European Central Bank that can be drawn in the event of a Greek default would be one option. In this way a triple bargain would be struck: Greece would repay at low interest rates, the eurozone would survive and the banking sector (ie wealthy shareholders and major investors, in effect) would stand behind the bargain.

In the best case, there would be winners all around. Greece would disprove today's pessimists by repaying the debt over twenty years. Let's face it. The pessimists are just guessing. A gradual repayment at low interest rates is worth a try. In the worst case, Greece defaults to its European guarantors, without triggering a banking panic or a breakdown of the single currency.

Of course the concept of a no-default workout is based on a critical assumption, that Greece can resume economic growth while remaining tethered to the Euro. There are many reasons to believe this to be the case. Greece in fact enjoys many interesting growth prospects.

Greece has vast solar and wind power to export to energy-hungry northern Europe. Greece offers a superb transport hub for Europe-Asia trade. Young Greek software engineers are making their mark in information technologies. And of course Greece remains one of the world's glorious destinations for tourism, exploration, and ruminations on the human condition. With some luck, Greece will be ruminating in the future about how it stuck to a narrow path in the early twenty-first century, and found honour and vindication for its labours.

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