GREEK DEBT: DEFAULT OR RESTRUCTURING

Luiz Carlos Bresser-Pereira
Valor, June 18, 2010

There is no reason for the world to plunge once again into crisis.

After Greece, what? Hungary? Or a low growth prospect for Europe? Or the frustration with American recovery? Or, still Greece? The international financial markets are always nervous and unstable - sometimes sad, sometimes euphoric, but always in a dialectics of rationality and irrationality. Despite of our more "scientific" look, we economists make the same mistakes. In view of this situation, perplexed politicians and entrepreneurs - the agents in the real economy - ignore what to do. To invest or not to invest? To continue with the expansive fiscal policy, or is it already time to take care of each State's high public debt and of each country's sometimes high foreign debt? And they ask: is this the beginning of a W-shaped crisis?

Greece's problem actually posed the threat of a strong recurrence of the crisis. Germany's delay contributed to worsen the problem. However, in the end, Germany and the European Central Bank (ECB) did what was expected from them: they guaranteed Greece's debt and, more broadly, the debt of the other countries of the euro and, although this did not solve everything, the crisis eased off. Everyone knows that, structurally, Greece's problem is not solved because, even if it carries out its program of fiscal adjustment to the letter and its GDP falls around 3% to 4% in the next two years, at the end of this period its public debt/GDP ratio would still be 150%.

Given such a setting, the question arises again as to whether would Greece withdraw from the euro system, but this is very unlikely. The advantage of having a currency that would begin its history already depreciated as compared to the euro does not counterbalance the risks of remaining outside the protection of the euro system. There is, however, the possibility of restructuring the public debt within the euro system. This would be the best course of action for Greece, given its insolvency, because even if the interest rate on its securities goes back to a reasonable level and stabilizes at that level, Greece will not be able to honour its financial engagements and to grow again.

But a reader might ask: are you then proposing "default"? No, my friend, I am suggesting that Greece should "restructure" at a discount. Which is the same as a default and something entirely different. It is the same thing, because the outcome is identical for the creditor: he receives only part of his credit. It is entirely different, because the word default has a derogatory tone to it that suggests an irresponsible debtor. Yet restructuring has a more lenient meaning, not only because it divides the guilt between the debtor and the creditors, but mostly because in the end all or the vast majority understand that it was the only rational solution for the problem, given the insolvency of the Greek State.

When a sovereign debt crisis is settled by a "default", it is usually an unsatisfactory solution because it means that there was no insolvency, or that the financial markets have not accepted the diagnosis of insolvency of the debtor country, and consider that it acted in bad faith. Yet restructuring, although it is basically unilateral or almost unilateral, is a better solution for the problem, because, in the end, it sanctions the creditors' loss that reasonably efficient financial markets must have already foreseen by pricing the credits at a discount.

The governments of countries whose State became insolvent are afraid of restructuring because they fear that this would be seen as a default. I understand this fear. The financial markets, the governments of rich countries, and the International Monetary Fund always do what is expected from the "establishment": they put pressure on the country to make the adjustment instead of restructuring the debt. And they always warn that the action will be considered as a default and that, ultimately, the country will be forced to yield, given the power of the creditors or the power of international law. If the situation is not of insolvency, but of liquidity - a mere imbalance between maturity dates and revenues - these threats may be enforced. However, in a situation of clear insolvency, as is the case of Greece today, these threats are rather rhetoric than real. The financial markets already know that restructuring is necessary. They know it because their economists and traders are aware of the figures, and know what they mean. They also know it because economists such as Martin Wolf, and economic publications they respect, such as, for instance, "The Economist", have already said that this will probably be the most appropriate solution for the Greek crisis. Those economists and publications represent a sort of financial "public opinion". Which, as any public opinion, may be wrong, but this is not important - the important thing is that actions performed according to it become promptly legitimate.

There is no reason for the world to plunge once again into crisis. The crisis still costs rich countries a lot of money, but their governments knew how to deal with it, and their economies are on the way to recovery. Meanwhile, crises such as the Greek one may occur, but if its government has the courage and the determination to do what must be done, the other governments and the financial market itself will understand, and this source of crisis will soon be neutralized, instead of festering for a long time.