Greece will default, but not this year

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I am willing to risk two predictions. The first is that Greece will not default this year. The second is that Greece will default. The **Greek government** has demonstrated that it can still borrow at a rate of about 6 per cent but if you do the maths on the public debt dynamics, as I did recently, it would be hard to arrive at any other scenario than an eventual default.

The adjustment effort needed to prevent a debt explosion is extremely large. The Nordic countries achieved adjustment on a similar scale during the 1980s and 1990s, but they had two advantages over Greece. They did it in a different global environment; but more crucially they were, in part, able to devalue and improve their competitiveness. As a member of a large monetary union Greece can improve its competitiveness only through relative disinflation against the eurozone average, which in effect means through deflation. But as the French economist Jacques Delpla* has pointed out, this will invariably produce a **debt-deflation dynamic in the Greek private sector** of the kind described by the economist Irving Fisher during the 1930s.

So Greece will not only have to make an extremely large public sector deficit reduction effort but it will also have to do this under a condition of disinflation, and possibly deflation, which would push its nominal growth rate to negative levels during the adjustment period. That, in turn, would jeopardise the debt reduction programme of both the public and private sectors. Under those circumstances, there is no way that Greece could ever stabilise its debt-to-gross domestic product ratio, no matter how hard the government of **George Papandreou** tries.

To get out of this mess, one of five things will have to happen. The first, and most optimistic, solution would be a significant fall in the euro's exchange rate, say to parity with the US dollar, coupled with a strong recovery in the eurozone. This might just do the trick to sustain Greek growth as it adjusts. The second is that Greece gets access to low interest rate loans from the European Union and the International Monetary Fund. The third would be a private sector debt restructuring to prevent a Fisher-style debt-deflation dynamic. The fourth is that Greece leaves the eurozone. The fifth is default. If you go through the options one by one, you realise that the first is improbable. The EU has in effect ruled out the second. The third would require an unlikely additional bail-out of the European banks. While option four would be most convenient for the Germans, the Greeks are not so stupid as to leave the eurozone. That leaves them with option five: to default inside the eurozone. It is the only option that is consistent with what we know.

But it would throw the **eurozone** into a potentially terminal crisis. **Spain** and Portugal have problems of a different kind but of a similar dimension. Spain will have to go through a disinflation/deflation period that will produce a formidable private sector debt-deflation spiral. Without devaluation, or the possibility of a sustained fiscal boost, the Spanish depression could last forever, or at least for as long as the country stays in the monetary union. Portugal, like Greece, suffers from a combined public and private sector debt problem.

When a country such as Greece pays 300 basis points over the yield of a supposed risk-free bond, this means, mathematically, that investors see a probability of around 17 per cent that they will lose 17 per cent of their investment. So in other words, a spread of 300 basis points is a valuation in which default is still considered improbable. If those perceptions changed from improbable to, say, moderately probable, the yield spreads between southern European countries and Germany would explode.

For the time being, Greece can get by because of its excellent debt management, which is why I am confident that Greece is not going to need an immediate bail-out. But given the political economy of the EU, this might turn out to be a disadvantage. Europe's complacent leaders will only step in if a crisis is both imminent and visible. The really treacherous aspect about the Greek crisis is that the country's liquidity position is better than its solvency position. Insolvency is a gradual, invisible process. The negative effects of debt-deflation dynamics have not yet begun, but will become inevitable as the Greek public and private sectors go through a simultaneous debt reduction process. In such an environment my assumption of a 2 per cent rate of nominal growth might be far too optimistic. And even with such an unrealistically optimistic assumption, default would be hard to avoid.

There have only ever been two intellectually honest views about economic and monetary union. The first is that it could not work, as it would eventually produce a situation in which a country's national interest conflicts with the interest of the monetary union at large. The second is that it could work, but only for as long as member states are ready to co-ordinate economic policy in the short run, and move towards a minimally sufficient fiscal union in the long run. The message from the EU, and from **Germany** in particular, is that the latter has now been ruled out.

Il est urgent de lutter contre la déflation par la dette en Europe du Sud,* **www.lesechos.fr

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