Greek lessons

Paul Krugman

The debt crisis in Greece is approaching the point of no return. As prospects for a rescue plan seem to be fading, largely thanks to German obduracy, nervous investors have driven interest rates on Greek government bonds sky-high, sharply raising the country's borrowing costs. This will push Greece even deeper into debt, further undermining confidence. At this point it's hard to see how the nation can escape from this death spiral into default.

It's a terrible story, and clearly an object lesson for the rest of us. But an object lesson in what, exactly?

Yes, Greece is paying the price for past fiscal irresponsibility. Yet that's by no means the whole story. The Greek tragedy also illustrates the extreme danger posed by a deflationary monetary policy. And that's a lesson one hopes American policy makers will take to heart.

The key thing to understand about Greece's predicament is that it's not just a matter of excessive debt. Greece's public debt, at 113 percent of G.D.P., is indeed high, but other countries have dealt with similar levels of debt without crisis. For example, in 1946, the United States, having just emerged from World War II, had federal debt equal to 122 percent of G.D.P. Yet investors were relaxed, and rightly so: Over the next decade the ratio of U.S. debt to G.D.P. was cut nearly in half, easing any concerns people might have had about our ability to pay what we owed. And debt as a percentage of G.D.P. continued to fall in the decades that followed, hitting a low of 33 percent in 1981.

So how did the U.S. government manage to pay off its wartime debt? Actually, it didn't. At the end of 1946, the federal government owed $271 billion; by the end of 1956 that figure had risen slightly, to $274 billion. The ratio of debt to G.D.P. fell not because debt went down, but because G.D.P. went up, roughly doubling in dollar terms over the course of a decade. The rise in G.D.P. in dollar terms was almost equally the result of economic growth and inflation, with both real G.D.P. and the overall level of prices rising about 40 percent from 1946 to 1956.

Unfortunately, Greece can't expect a similar performance. Why? Because of the euro.

Until recently, being a member of the euro zone seemed like a good thing for Greece, bringing with it cheap loans and large inflows of capital. But those capital inflows also led to inflation — and when the music stopped, Greece found itself with costs and prices way out of line with Europe's big economies. Over time, Greek prices will have to come back down. And that means that unlike postwar America, which inflated away part of its debt, Greece will see its debt burden worsened by deflation.

That's not all. Deflation is a painful process, which invariably takes a toll on growth and employment. So Greece won't grow its way out of debt. On the contrary, it will have to deal with its debt in the face of an economy that's stagnant at best.

So the only way Greece could tame its debt problem would be with savage spending cuts and tax increases, measures that would themselves worsen the unemployment rate. No wonder, then, that bond markets are losing confidence, and pushing the situation to the brink.

What can be done? The hope was that other European countries would strike a deal, guaranteeing Greek debt in return for a commitment to harsh fiscal austerity. That might have worked. But without German support, such a deal won't happen.

Greece could alleviate some of its problems by leaving the euro, and devaluing. But it's hard to see how Greece could do that without triggering a catastrophic run on its banking system. Indeed, worried depositors have already begun pulling cash out of Greek banks. There are no good answers here — actually, no non-terrible answers.

> **The Greek debt crisis is a terrible, tragic story. It's an object lesson for the rest of us, but what does it say?**

But what are the lessons for America? Of course, we should be fiscally responsible. What that means, however, is taking on the big long-term issues, above all health costs — not grandstanding and penny-pinching over short-term spending to help a distressed economy.

Equally important, however, we need to steer clear of deflation, or even excessively low inflation. Unlike Greece, we're not stuck with someone else's currency. But as Japan has demonstrated, even countries with their own currencies can get stuck in a deflationary trap.

What worries me most about the U.S. situation right now is the rising clamor from inflation hawks, who want the Fed to raise rates (and the federal government to pull back from stimulus) even though employment has barely started to recover. If they get their way, they'll perpetuate mass unemployment. But that's not all. America's public debt will be manageable if we eventually return to vigorous growth and moderate inflation. But if the tight-money people prevail, that won't happen — and all bets will be off.

E.U. officials outline terms for lending to Greece

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Greek debt, adding to the enormous pressure on the country.

Greece needs to raise €30 billion, or about $40 billion, by the end of May, according to estimates by economists at UBS, the Swiss bank. The country could run out of cash in as little as two weeks, the economists said in an April 8 report.

"We are ready to take action at any moment to come to the aid of Greece," Mr. Sarkozy said during a news conference, according to Reuters.

Reuters, quoting an unidentified person, reported that the agreement would require Greece to pay a relatively high rate of 6 percent interest on aid from other E.U. member states. The rate would be even higher for loans longer than three years, Reuters reported.

Reuters said members of the 16 countries could announce the terms next Friday, and earlier if needed.

An I.M.F. loan would normally carry an interest rate closer to 4 percent.

Comforting words also came from Silvio Berlusconi, prime minister of Italy, and Herman Van Rompuy, president of the European Union.

But officials in Brussels cautioned that any understanding on Greek aid would require agreement first by the finance ministers of the euro zone, then by national leaders. When the euro-zone finance ministers made their first agreement on a support mechanism for Greece last month, Chancellor Angela Merkel of Germany later insisted on attaching much tougher terms.

Any refinancing package would require first a formal request from Athens, then the agreement of the 16 euro-zone countries.

Still, progress appears to have been made when deputy finance ministers or state secretaries of the European governments met in Brussels on Thursday and Friday, with a gathering of representatives from the euro-zone countries taking place on the sidelines.

The talks seem to have gotten around German opposition to any financing that could be considered a subsidy or bailout.

Cristina Gallach, spokeswoman for the Spanish presidency of the European Union, confirmed that the meeting had taken place and added that there was "no more public information about the details of discussions relating to Greece."

Another official said, however, that the interest rate would be based on the framework offered by the International Monetary Fund, which would typically, for a three-year loan, add 300 basis points plus a surcharge of 50 basis points on top of its Special Drawing Rights rate.

But in the case of Greece, the S.D.R. rate would be replaced by the Euribor rate — that at which euro interbank term deposits are being offered by one prime bank to another within the euro zone.

Over all, the arrangement typically allows countries to borrow at rates several percentage points below the market level, while attaching tough conditions on spending and requiring government overhauls.

Greece's problems ultimately stem from a long history of government inefficiency and corruption, as well as an economy that can no longer compete globally, analysts say.

Under one possibility, the I.M.F. would allocate up to $10 billion, with additional funds from the European Union. But the I.M.F., based in Washington, would attach tough conditions, including pension overhauls, improved tax collection, increasing the retirement age, reducing the cost of firing workers and changing its practices for collective bargaining.

A third European official said that by sticking closely to the terms offered by the I.M.F., the European Union might have helped smooth German opposition to any subsidized loans because the fund is the lender of last resort.

Sticking to its terms could provide Berlin with political cover, he argued.

The yield on 10-year Greek bonds, which touched a record of 7.5 percent on Thursday, eased Friday. Global stock markets also rose.

Mr. Offer, of the German Finance Ministry, said that Greece continued to have access to financial markets, though he acknowledged the market turmoil. "The Greeks haven't asked for help," he said.

Spokesmen for Mrs. Merkel and the German Bundesbank, which would be a conduit for Germany's share of any aid, endorsed Mr. Offer's comments.

Fearful of alarming financial markets, Greek government officials on Friday avoided commenting on reports of an agreement in Brussels.

Stephen Castle reported from Brussels. Niki Kitsantonis contributed reporting from Athens and Landon Thomas Jr. contributed reporting from London.

E.U. officials agree on details of lower-interest loan to Greece

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FRANKFURT

BY JACK EWING AND STEPHEN CASTLE

European Union leaders firmed up plans to keep Greece from going off a financial cliff Friday, as deputy finance ministers outlined terms to help the country borrow more affordably. Heads of government including President Nicolas Sarkozy of France also offered words of support.

An E.U. official confirmed reports that leaders in Brussels had struck an accord on the technicalities of a possible loan for Greece. The terms would be based closely on those typically offered by the International Monetary Fund, allowing Greece to pay sharply lower interest than the 7.5 percent that markets were demanding early this week.

The E.U. official spoke on condition of anonymity because of the sensitivity of the issue.

The discussions in Brussels appear to have resolved one of the most complex impediments to a refinancing of Greek debt: constructing terms that get around German opposition to any financing that could be considered a subsidy or bailout.

But German officials, illustrating a continuing split among E.U. countries, insisted that Greece did not yet need help and described the work by the deputy finance ministers as merely contingency planning.

"There is no recognizable emergency," said Michael Offer, spokesman for the German Finance Ministry.

Elsewhere in Europe, leaders tried to reassure investors Friday after Fitch, a credit rating agency, downgraded

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