Greece's best option is an orderly default

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It is time to recognise that Greece is not just suffering from a liquidity crisis; it is facing an insolvency crisis too. Rating agencies have started to downgrade its public debt to junk level, while spreads on Greek sovereign bonds last week spiked to new highs. The €110bn bail-out agreed by the European Union and the International Monetary Fund in May only delays the inevitable default and risks making it disorderly when it comes. Instead, an orderly restructuring of Greece's public debt is needed now.

The austerity measures to which Greece signed up as a condition of its bail-out require a draconian fiscal adjustment of 10 per cent of gross domestic product. This would prolong the country's recession and still leave it with a public debt-to-GDP ratio of 148 per cent by 2016. At this level, even a small shock is likely to trigger a further debt crisis. Sharp austerity may be needed – as agreed by the Group of 20 over the weekend – to stabilise debt-to-GDP ratios by 2016 in advanced economies; but for Greece such "stabilisation" would be at levels that are unsustainable.

Compare Greece today with Argentina in 1998-2001, a crisis that culminated in a disorderly default. Argentina's fiscal deficit at the onset was 3 per cent of GDP; Greece's is 13.6 per cent. Argentina's public debt was 50 per cent of GDP; Greece's is 115 per cent and rising. Argentina had a current account deficit of 2 per cent of GDP; Greece's is now 10 per cent. If Argentina was insolvent, Greece is insolvent to the power of two or three.

Those arguing that Greece can escape debt restructuring point to previous sharp fiscal cutbacks made by countries such as Belgium, Ireland and Sweden in the 1990s. But such examples are irrelevant, having occurred over longer periods and in times of economic growth. They also took place against a backdrop of falling interest rates, with depreciating currencies helping to boost growth.

Others think a Greek restructuring would see massive losses for the European financial institutions that hold most of the country's public debt. Yet while a pre-emptive restructuring could limit this damage, postponing will only make it worse. As both Argentina and Russia's crisis in 1998 showed, support from the IMF does not prevent an eventual default. Indeed, it can actually cause greater damage to the country and its creditors when the former is insolvent.

When official money is used to keep a country afloat, those lucky investors whose debt claims are about to come to maturity often exit scot-free as IMF/EU support allows them to be paid in full. But when the eventual default comes, losses to the remaining creditors are more severe, because public creditors get the first slice of what remains. In short, orderly restructurings – as happened in Pakistan and Ukraine in 1999 and Uruguay in 2002 – are better for most private creditors, the debtor nation and multilateral institutions than an Argentine-style botched bail-out.

Pakistan, Ukraine and Uruguay all restructured their debt by swapping old obligations to creditors with new deals that extended for many years the time over which the countries had to pay back. These agreements also capped the interest rates on the new debt to sustainable and below-market levels. Importantly, the total face value of the debt was not reduced, as normally happens in abrupt defaults.

Of course, giving nations longer in which to pay and helping with generous rates mean creditors experience losses. But their loss is much less than under an outright default. Since the market value of their existing debt has already fallen sharply, there will be no additional mark-to-market losses either, which is part of the reason why these orderly restructurings saw the vast majority – more than 90 per cent – of creditors sign up.

Indeed, restructuring Greece's debt should be even easier. In those three emerging market economies, public debt was issued in foreign jurisdictions – namely London and New York – creating a risk that creditors would hold out and sue to regain their assets, as sovereign immunity is limited in foreign courts. But 95 per cent of Greek debt was issued in Greece itself, where domestic sovereign immunity laws greatly reduce the risk of hold-outs and litigation.

Another advantage is that most of the banks holding Greek debt are keeping it in their "to maturity" bucket rather than their "trading book" bucket. So long as the face value of the debt is not reduced they can still pretend – as they are doing now – that it is still worth 100 cents on the dollar when the actual market value is already lower.

The bitter pill of debt restructuring could be taken with appropriate sweeteners, such as credit enhancements supported by the IMF and EU. Certainly, it would be better to use a small amount of public money to tempt creditors into a pre-emptive deal now than waste €110bn of it trying to prevent an unavoidable restructuring later. Such public resources would be better used to help ring-fence other embattled eurozone economies – such as Spain – whose debt may come under renewed pressure.

In short, an orderly restructuring of Greece's public debt is achievable and desirable for the debtor and its creditors. If Europe wants to avoid a deepening crisis, it is unavoidable too.

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