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Europe Shouldn't Let Greece Default

The case for a stiff haircut is easy to make, but masks serious risks to the euro zone.

By HOLGER SCHMIEDING

Does Europe need a default? As euro-zone leaders work to defuse the dangerous debt crisis that is raging at their periphery, more and more observers seem to believe that part of the solution should be a major cut in the face-value of outstanding Greek and possibly Irish government bonds.

At first glance, the case for a stiff haircut is easy to make: The current strategy of buying time has not put an end to the debt crisis; contagion risks from a forced debt-restructuring have diminished as markets have gotten used to the idea that public debts may not be repaid in full; and some countries are said to be bust anyway. So the argument goes that the sooner the issue of public debt is resolved, the sooner markets and policy makers can move on to other issues. Advocates of a haircut also point out that debt restructuring has been part of the solution in many previous emerging-market debt crises, and it is thus a tried and tested procedure.

But any default constitutes a serious breach of contract and trust, and should always be a very last resort. For the time being, the case against a forced restructuring of peripheral European debt remains strong.

Primarily, this is because the current approach of buying time has not failed at all. It has successfully shielded the euro-zone economy from the turmoil at its periphery while providing a framework through which the periphery can adjust. The process has unleashed a wave of pension, labor-market and other structural reforms that almost certainly would not have happened otherwise. The current approach needs to be amended, but not ditched in favor of a "let's get it over with" default.

A default would also raise a serious moral-hazard issue. It would lessen the future burden on taxpayers in those countries that have run up excessive deficits in the past. It would also hurt the taxpayers in those prudent countries that have underwritten some of Greece's and Ireland's debts, and might have to pay higher taxes to stabilize their own financial systems in the wake of a Greek or Irish default.

Financial markets remain very nervous in the aftermath of the Lehman disaster. Any major adverse event, such as a default of one or more euro-zone sovereigns, carries a risk that events may again spiral out of control. In this respect, we need to distinguish between two kinds of contagion. The risk of a major banking crisis and credit crunch across Europe stemming from, say, a 50% haircut on Greek bonds, is probably receding, now that banks and their regulators have had time to prepare for such an eventuality. But the risk still looms large that a haircut on Greek debt could make it impossible, or at least prohibitively expensive, for other countries such as Spain or Italy to find external buyers for their debt.

So for peripheral countries to maintain their access to capital markets if the debt of one country is restructured, Europe and the International Monetary Fund would therefore have to guarantee the remaining and future public debt of the defaulting country in question. European countries at the periphery and the core might also have to recapitalize some of their domestic banks and provide a robust defense against the risk of contagion to other countries. It is not obvious why this would put less German taxpayer money at risk than the alternative of giving Greece a few more years to bring its debt under control.

Since developed countries typically have much higher public-debt levels than emerging markets, the guarantees needed to stabilize markets after a forced euro-debt restructuring may be much larger than were required in the Brady-bond type resolutions to Latin American debt crises in the 1980s.

The investor base for euro-zone public debt is also very different than it was for Latin American debt in decades past. In emerging markets, running a significant risk of default used to be part of the deal. But if the much more conservative investors in European public debt—often banks, insurance companies and foreign central banks—are subjected to a forced restructuring, their trust in euro public debt as an asset class may be shattered for a long time. The experience of emerging markets offers no reliable guide to what may happen if Europe's monetary union allowed the first default of a developed country since 1948.

Though we do not see a strong case for a forced restructuring of euro-periphery sovereign debt now, we can not rule it out at some point in the future. But regardless of what we consider to be necessary or not, the risk that politicians will just want to "get it over with" seems to be rising.

Greece is making Herculean efforts to adjust. The situation is dire, but Greece still has a chance. The country had no real-estate bubble and does not suffer from excessive private debt. Once the current adjustment recession is over, the Greek economy could snap back to significant growth, altering all calculations about potential debt-to-GDP ratios after 2012. Whether or not Athens will eventually have to restructure its debt is thus an open question, and should be answered only when the outlook for the Greek economy becomes clearer in 2012 or 2013. Of course, lengthening the maturity of official support loans to Greece could make sense if Athens continues to faithfully implement the EU-IMF program. But we would not count this as a default.

For other countries, we see no argument for even contemplating a default on public debt. Irish industrial output and exports are already booming, with growth rates well ahead of the euro-zone average. We expect Irish construction and consumer spending to hit bottom later this year, allowing strong industrial data to propel the economy back to significant growth thereafter. Within a year, an export-led rebound of the highly flexible Irish economy could convince markets that Ireland is safe. Such an Irish turnaround could set a positive precedent. It could also vastly reduce the risk of contagion if, say, Greek debt still had to be restructured later on.

The way in which Europe deals with the current crisis will set a precedent. If the euro zone gets through the crisis without an outright sovereign default—without a forced restructuring of public debt—its global reputation could still be salvaged. Europe, in turn, could become a more attractive place for global investors. That seems far more attractive than "just getting over with" a risky Greek haircut.

Mr. Schmieding is chief economist at Berenberg Bank.