OPINION

A Better Grecian Bailout

By John B. Taylor

With Tuesday's vote, the finance ministers of the European Union have agreed to a second giant Greek bailout, just two years after the May 2010 bailout that was supposed to be all that was needed. While the day-to-day machinations of this long saga seem monotonous from afar, a closer look reveals several changes that bode well for the future of economic policy in Europe.

> The fears of contagion from Athens were always exaggerated. Now the issues are whether Greece will reform and whether Europe will cut it off if it doesn't.

First, the new bailout involves a substantial write-down of Greek bonds—close to 75% of their economic value. At the time of the first bailout and until very recently, all parties to the funding agreements denied the possibility of a write-down, claiming that the problem was illiquidity not insolvency. Many of us with experience from emerging market crises of a decade or more ago recommended admitting the insolvency problem at the start, restructuring the debt, and moving on with economic reforms. Alas, we also knew it is not unusual for international officials to be slow to realize and admit the obvious.

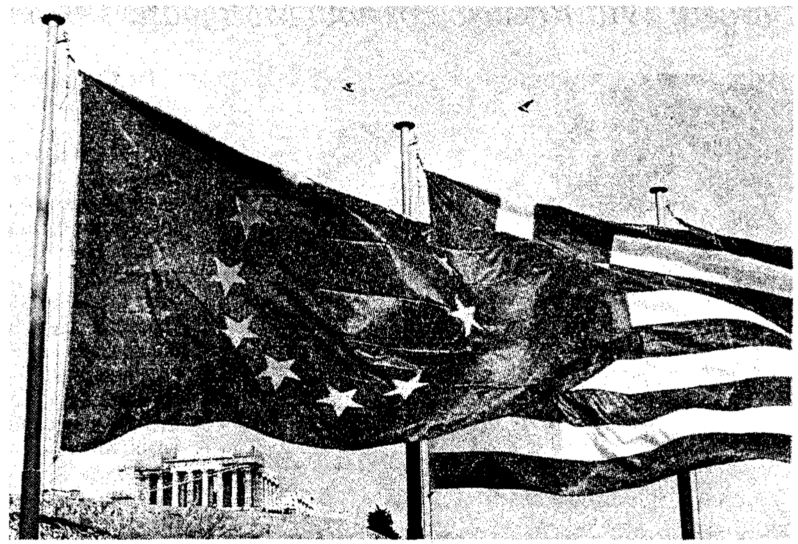
Second, the fears of contagion—that a write-down on Greek debt would cause a run on the debt of other European countries—are far less than they were two years ago. Investors have adjusted their portfolios, foreign bank exposure to Greece is way down, and the correlation between spreads on risk-sensitive Greek credit default swaps and spreads on default swaps on sovereign debt elsewhere in Europe has declined.

Moreover, the anticipated orderly write-down will be far less damaging than a sudden default. Even if it triggers default-swap payments, those should be manageable, since the outstanding credit default swaps on Greek debt total only about $3 billion.

In my view, fears of contagion were exaggerated in the first place—as they always are by people who stand to benefit from bailouts or lose from write-downs. These fears led top officials in Europe to try to avoid the inevitable restructuring. But contagion is unlikely if policy is predictable. International contagion was negligible following the anticipated Argentine default in 2001, in comparison with the surprise Russian default in 1998.

Third, there's a growing recognition that Greece's problems arise mainly from failure to adhere to basic principles of good economic policy. Greece ranks 119th on the Heritage Foundation-Wall Street Journal Index of Economic Freedom—lower than many sub-Saharan countries.

More responsible fiscal policy will move Greece up in the ranking, but many of the reforms Greece needs are less about austerity and more about what the International Monetary Fund (IMF) appropriately calls "growth enhancing structural reforms"—more reliance on private



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The European Union flag, left, and Greek flag fly near the Parthenon temple in Athens.

markets, incentives and the rule of law. The Greeks should welcome such pro-growth reforms.

Will the debt write-down, the diminished contagion, and the recognition of the policy problems be enough to make the second bailout work as agreed to, with Greece fulfilling the required conditions? Unfortunately, the answer is probably no.

The IMF forecasts for Greek economic growth are too optimistic, and some Greek politicians, including Antonis Samaras, leader of the major conservative party, have already said they will try to change the conditions of the agreement after the upcoming election. The bailout is front-end loaded, with about €90 billion of the €130 billion paid at the start to recapitalize Greek banks, sweeten the debt deal, and finance the budget.

If Greece violates the agreement, Germany and the rest of Europe will have to decide whether to continue future disbursements. If the European governments are at all concerned with maintaining credibility internationally or accountability with voters at home, they won't.

That would mean Greece has to achieve a budget balance sooner than otherwise. This will be tough but doable because interest payments will be quite low after the debt write-down, and the Greek banks will be recapitalized with funds from the bailout. Greece's politicians will see that they can gain voter approval by casting aside the conditions imposed from the North and establishing Greek ownership for policy that is best for Greece.

Saying yes to more disbursements while Greece deviates from the program the current government agreed to would send a terrible message to other countries. Portugal, which has recently been adhering to the terms of its bailout agreement, would have little incentive to do so in the future if Greece continued to get funding while ignoring its side of the agreement. Cutting Greece off if they renege on the deal would begin the long cure of the bailout disease which has plagued Europe over the past few years.

There are risks to this forecast. If Greek leftist parties win a majority, they may renege on all the remaining debt and leave the euro zone. Another risk is that even with the reforms, the lack of Greek competitiveness will be an insurmountable barrier to growth. By some estimates, higher Greek wage inflation has brought labor costs to more than 40% above Germany's.

Yet another risk is that some negative political or economic news will cause European leaders to abandon any such new "say no" strategy. This would be the worst possible outcome. Instead of taking the opportunity to begin to end the bailout mentality—as occurred with tremendous payoffs for emerging market countries a decade ago—Europe would perpetuate incentives to follow poor economic policies for years in the future.

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