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Can Europe Be Spared Cascading Collapse?

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The failure of the European authorities to arrest the speculative run on Greek bonds and the sense of inevitable wider collapse reminds me of the diplomatic failures that led to World War I.

In the summer of 1914, myopic bluffing by Europe's key leaders produced a catastrophe that nobody wanted. It began in Serbia, a small nationalistic province of a decaying Austro-Hungarian empire, but the conflagration soon spread to all of Europe like a chain of firecrackers. No leader was farsighted enough to grasp the wider common stakes and head off disaster. Each pursued only narrow self-interest.

The impending economic collapse of Europe is looking like one of those avoidable calamities in slow motion.

Here are the elements of the Greek crisis, its wider ripple effects, the diplomatic paralysis, and the solution that seems beyond the grasp of European politics.

Greece, a small nation of just over 11 million people, has a government debt that it cannot service without external aid. Speculators expecting a default have been making bets that Greece will fail to pay, raising its interest costs and thus increasing the likelihood of the default they are betting on.

One can fairly debate how much the Greek fiscal woes are the result of earlier profligacy during the boom years, or failure to collect adequate taxes on

Greece's gray economy, or overly generous protections for civil servants -- or the result of the recession itself. But these are questions for another day. When a house is on fire and threatens the whole neighborhood, it's not smart to dither about whether there was adequate fire-prevention while the place burns down. You put the fire out.

As a technical matter, it would not be hard to put out the fire that is consuming Greece and threatening the rest of Europe. Short term Greek debt needs to be exchanged for longer term, lower interest bonds issued or guaranteed by the EU. The current bondholders, Greek and foreign banks, as well as issuers of credit default swaps, would need to eat some losses. In the case of banks, that capital would need to be made up by some combination of the European Central Bank, the International Monetary Fund, and the European Union.

Greece would then be allowed to resume economic growth, instead of being pushed further and further into a self-reinforcing austerity (which is obviously not working) to reassure bondholders (who are not reassured). Then, with Greece spared either default or prolonged austerity, and the immediate threat to the Euro and the European economy prevented as well, leaders could then take a deep breath and pursue longer term structural reforms.

A negotiated restructuring along these lines was exactly what Nicholas Brady, the Treasury Secretary under Bush I, achieved with his Brady Plan in 1989. Several Latin American and other debtor countries were being denied the capacity to grow because they were weighted down with crippling debts, high interest costs, and austerity demands by creditors.

Brady, not exactly a left-winger, negotiated a deal that required creditors to take their feet off the oxygen hoses of struggling countries. Some creditors lost money in the grand bargain, but wider damage was contained. Latin America could put its "Lost Decade" behind it, and resume growth.

Why isn't something similar being done for Greece, a far smaller economy than those that got Brady Plan relief?

First, helping Greece is very unpopular with several constituencies, including German taxpayers, the German finance ministry, and leaders of the European Central Bank. The most that European leaders have been able to negotiate is a slow drip of financial aid -- just barely sufficient to enable Greece to keep current on its payments to bondholders.

As the proverbial pound of flesh to demonstrate that Greece is not being rewarded for past sins, Greece is being made to sink deeper and deeper into austerity. Just about every knowledgeable European leader recognizes the perversity of this policy, but nobody seems able to alter it.

A second political obstacle is the fear that helping Greece will lead to similar demands from Portugal, Spain, Ireland, and even Italy, to Europeanize their national debts.

A third obstacle to a solution is the political power of the banks and other financial players. The bankers who hold Greek debt don't really care if Greece gets bled dry. They just want to be paid and not have the capital value of their Greek bonds decline further.

The big financial houses that have issued credit default swaps (CDS) on Greek bonds have also resisted any Brady-style restructuring plan, which would technically be considered a default since bondholders would not be paid back at 100 cents on the Euro -- thus triggering payments under CDS contracts.

Normally, a country that got into a debt crisis and needed relief would have the option to include devaluation as part of a restructuring deal. That would make its exports cheaper and its imports more expensive, reducing domestic consumption and stimulating the economy. But Greece, as a member of the Euro zone, is stuck using the same currency as richer countries like Germany and the Netherlands.

So in addition to a short term plan to give Greece deeper debt relief, Europe needs several kinds of structural reforms. It needs a fiscal authority to issue bonds on behalf of national governments.

The overly inflation-phobic European Central bank needs to purchase more bonds to take the pressure off national governments.

And the power of bankers and other financiers to turn the financing sovereign debt into a speculative circus needs to be broken. Side bets -- "naked credit default swaps" -- on sovereign debt should be prohibited outright.

The financial sector needs to be both simplified and more effectively regulated. Before this crisis is over, many of Europe's large banks may need to be partly recapitalized by the ECB and European governments. And this time, unlike the US bank bailout under the TARP program, drastic regulatory limits on speculation should be part of the bargain.

The issue of whether the Euro was always a fatally flawed idea is also a separate question. Some will say that it was never possible to have monetary union without budgetary union, that the Euro was an accident waiting to happen.

I disagree. Until speculative private finance crashed the larger economy, the EU was dealing with strains of its weaker and stronger economies more than adequately.

Will European leaders pursue any of these remedies, most of which sound utopian in the context of the current political blockage? I hope so. European leaders should compare these policies with the alternative -- a Greek default spreading to defaults of other European government bonds, the insolvency of several of the largest European banks, a deep recession of the real economy -- and some kind of more extreme emergency rescue in even more dire circumstances. Maybe they will act while there is still time to head off deeper disaster.

Robert Kuttner is co-editor of The American Prospect and a senior fellow at Demos. His latest book is A Presidency in Peril.

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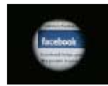

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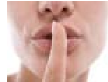

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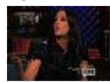
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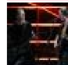
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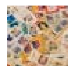
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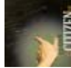

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