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THE SATURDAY ESSAY

The Greek Tragedy That Changed Europe

Greece's dysfunctional economy is now at the heart of a rescue effort that could be disastrous for the entire continent—and the rest of the world.

Greek firefighters protest government spending cuts on Jan. 29. *ASSOCIATED PRESS*

By SIMON JOHNSON and PETER BOONE
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Plutus, the Greek god of wealth, did not have an easy life. As the myth goes, Plutus wanted to grant riches only to the "the just, the wise, the men of ordered life." Zeus blinded him out of jealousy of mankind (and envy of the good), leaving Plutus to indiscriminately distribute his favors.

Modern-day Greece may be just and wise, but it certainly has not had an ordered life. As a result, the great opportunity and wealth bestowed by European integration has been largely squandered. And lower interest rates over the past decade—brought down to German levels through Greece being allowed, rather generously, into the euro zone—led to little more than further deficits and a dangerous buildup of government debt.

Now Plutus wants his money back. Europe is entering unprepared into a serious economic crisis—and the nascent global recovery could easily collapse due to the unsustainable and Ponzi-like buildup of government debt in weaker countries.

At the end of the G7 meeting in Canada last weekend, Treasury Secretary Tim Geithner told reporters, "I just want to underscore they made it clear to us—they, the European authorities—that they will manage this [Greek debt crisis] with great care."

But the Europeans have not been careful so far. The issues for troubled euro zone countries are straightforward: Portugal, Ireland, Italy, Greece and Spain (known to the financial markets, and not in a polite way, as the PIIGS) had varying degrees of foreign- and bank credit-financed rapid expansions over the past decade. In fall 2008, these bubbles collapsed.

As custodian of their shared currency, the European Central Bank responded by quietly opening lifelines to all these countries, effectively buying government bonds through special credit windows. Europe's periphery was fragile but surviving on this intravenous line of credit from the ECB until a few weeks ago, when it suddenly became apparent that Jean-Claude Trichet, president of the ECB, and his German backers were finally lining up to cut Greece off from that implicit subsidy. The Germans have become tired of supporting countries that do not, to their minds, try hard enough. Investors naturally flew from Greek debt—Greece's debt yields rose, and its banking system verged near collapse as investors and savers ran from the country.

But it's not just about Greece any more. Thursday's European Union summit ended with vague assurances of mutual support but did not fundamentally change the financial markets' assessment. Other countries can also be cut off from easy ECB funding, so worries have spread through the euro zone to Spain and Portugal. Ireland and Italy are also up for hostile reconsideration by the markets, and Austria and Belgium may not be far behind. If these problems are not addressed quickly and effectively, Europe's economy will be derailed—with serious, if hard to quantify, implications for the rest of the world.

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Demonstrators try to burn an EU flag in Athens on Wednesday. *ASSOCIATED PRESS*

Germany and France are cooking up a belated support package for Greece, but they have made it abundantly clear that Greece must slash public sector wages and other spending; the Greek trade unions get this and are in the streets. If Greece (and the other troubled countries) still had their own currencies, it would all be a lot easier. Just as in the U.K. since 2008, their exchange rates would depreciate sharply. This would lower the cost of labor, making them competitive again (remember Asia after 1997-'98) while also inflating asset prices and helping to refloat borrowers who are underwater on their mortgages and other debts. It would undoubtedly hurt the Germans and the French, who would suffer from less competitiveness—but when you are in deep trouble, who cares?

Since these struggling countries share the euro, run by the European Central Bank in Frankfurt, their currencies cannot fall in this fashion. So they are left with the need to massively curtail demand, lower wages and reduce the public sector workforce. The last time we saw this kind of precipitate fiscal austerity—when nations were tied to the gold standard—it contributed directly to the onset of the Great Depression in the 1930s.

The International Monetary Fund is supposed to lend to countries in trouble, to cushion the blow of crisis and to offer a form of international circuit breaker when everything looks fragile. The idea is not to prevent necessary adjustments—for example, in the form of budget deficit reduction—but to spread those out over time, to restore confidence, and to serve as an external seal of approval on a government's credibility.

Despite the fact that the IMF was created after World War II essentially as a U.S.-Western European partnership, and despite the fact that Europe has strong representation at the fund and has always chosen its top leader, in this instance the fund has been reduced to not-entirely-helpful kibitzing from the sidelines.

Dominique Strauss-Kahn, the fund's managing director, said recently on French radio that the fund stands ready to help Greece. But he knows this is wishful thinking.

"Going to the IMF" brings with it a great deal of stigma; just ask the Asian countries that had to borrow from the fund during their crises of the 1990s. And many in Europe view the fund as an American-influenced institution—located three blocks from the White House for a reason—that would be invading Europe's territory.

In addition, French President Nicolas Sarkozy has serious personal reasons to push the IMF away. Mr. Strauss-Kahn is a serious potential challenger in France's upcoming elections; Mr. Sarkozy would hate to see the IMF play a statesman-like role on his home turf.

Chancellor Angela Merkel, currently maneuvering to ensure a German is the next head at the ECB, is also concerned. The IMF might take the position that ECB policies have been overly contractionary—resulting in a strong euro and very low inflation—and not appropriate for member countries in the midst of a financial collapse. If the IMF were to support Europe's weaker economies, this would challenge the prevailing ideology among Frankfurt-dominated policy makers.

Nations outside Europe, such as the U.S., are naturally reluctant to get involved. Sending Greece to the IMF would result in some international "burden sharing," as it would be IMF resources, from its member countries around the world, on the line, rather than just European Union funds. Is the U.S. really willing to share the burden through the IMF?

And how would the Chinese, for example, react if such a proposition came to the IMF? No industrialized democracy is in a particular hurry to find out.

What is the solution? One possibility is to recognize that the current euro zone might not make sense. This is not a decision that anyone will take this week, but it may well be the fast-approaching reality.

If Europe really does want to save this version of the euro zone from collapse, what would constitute substantive steps?

First, the EU leadership should recognize that, despite all its warts, the IMF has unique expertise in designing programs that pull countries back from the brink of financial collapse. The latest indications are that the IMF could be brought in as "technical assistance plus" to comb through the books of troubled countries, work with the governments to determine what macroeconomic programs are needed, and then monitor the conditionality of such programs while reporting back to the EU (and, more informally, to the IMF executive board).

These programs would involve some upfront fiscal austerity to bring nations on a solvent path, but perhaps not as much as in the Franco-German bilateral-bailout scenario.

Second, Europe must soon create a multilateral funding system that ensured adequate finance was available to each nation that adhered to these conditional programs. This could be pooled resources of EU nations, and could be supplemented with IMF financing.

Relying on money directly from France or Germany is unwise. Finding a robust deal directly between hard-pressed French and German taxpayers and Greek public sector trade unions will be difficult. German voters, in particular, are fed up with subsidizing other Europeans—who they feel, with some justification, have not made the adjustments they promised when the euro was founded. Greek civil servants, on the other hand, are already pushing back hard against what they are framing as unwarranted German intervention and harshness.

The Europeans will experience firsthand what the IMF has long known. When you ride to the rescue of a financially embattled nation, your arrival is appreciated for about 20 minutes. Then people become embarrassed, resentful and even angry.

ILLUSTRATION BY ADAM MCCAULEY

Third, the European Central Bank needs to adjust its policies, lowering interest rates further and allowing higher inflation throughout the currency union. If such looser money policies are not palatable to the Germanic core, then Berlin/Frankfurt should get on with the task of admitting that the euro zone itself is a failure.

Finally, if the troubled countries cannot adhere to the conditionality attached to their lifelines, the European Union needs a graceful way out. They need "living wills"—plans for countries to exit from the euro zone. The mere existence of such living wills could lead to serious complications—perhaps inviting further speculative attacks—but failing to prepare would be completely irresponsible.

Frankly, it would be a disaster for weaker euro zone countries to leave the bloc. Exiting countries would need to rewrite all their contracts in terms of new currencies, converting as many liabilities and assets as possible into those, and then manage a new monetary policy. There would be legal challenges in international courts to rewritten contracts—some of which would certainly constitute default. Building trust in any new currency is always difficult. But a German exit from the euro zone, in a huff, cannot be ruled out—although its consequences could be equally chaotic.

Even following Thursday's EU summit, an orderly resolution of these problems seems unlikely. The Germans will push for draconian cuts to Greece's government spending and public sector wages but they won't budge on relatively tight monetary policy and the overly strong euro—and they definitely won't agree to loosen their own (German) fiscal policy.

Ireland is already cutting hard. Such fiscal austerity leads to double-digit declines in GDP, and risks massive political revolts. Ireland's banks are today probably insolvent. Who can afford to repay their mortgages when wages are falling and unemployment rising? Irish house prices continue to speed downward. This is not an example of a "careful" solution—it is a nation in a financial death spiral.

Other EU countries will lobby for a continuation of the status quo. They would prefer the ECB keep lending to the periphery, and the problems be pushed off for another day. This too is no solution.

For now Europe will try to muddle through. Greece will promise a pound of flesh, hoping not to pay, and other nations will be spared with promises of continued financing—but just for now.

Financial markets know that this makes no sense, hence the "largest ever" short euro positions, betting on a further decline of the currency. If one country must make a substantial and painful fiscal adjustment, eventually the rest will follow. The implication for bondholders is obvious: Edge towards the door. Bond yields will stay high or creep up, until the next wave of financial crisis and contagion. The problems could easily jump beyond Europe; any sovereign with shaky finances can be hauled before the harsh court of international creditor opinion.

The Obama administration should not recuse itself from these problems. The U.S. must press Europe to act in a way that supports the broader global economy. We should encourage an orderly resolution to problems in Europe, and press the Europeans to bring in the IMF in an appropriate fashion. The U.S. must stop relying on Europe to be "careful," and instead cooperate assertively to help reduce the risk of further collapse in Europe.

American leaders must also address problems at home. Unless and until the U.S. puts in place a plausible process to take its own government debt off an explosive path—for example, through an independent but Congress-backed fiscal commission of some kind, with everything on the table—we are vulnerable to the same kind of debt dynamics that now plague parts of Europe.

This is not a call for immediate fiscal austerity; that is the path back to the 1930s. But no country can go on issuing your debt without consequence when the buyers declare, "Enough!" In the case of the U.K. and the U.S., the macro situation remains stable only as long as foreigners buy and hold our government debt. This is a major economic and national security risk.

Financial markets are telling us the euro zone is under threat, but the real message is much broader: Unsustainable debt dynamics can undermine us all.

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