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Commentary

Let Greece Default

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The debt crisis in Europe gets worse with each passing day. Ratings agencies have recently downgraded Greek bonds to junk status, as well as lowered the ratings of Portugal and Spain. In response, the European Union and the International Monetary Fund are pondering whether to bail out Greece, perhaps to the tune of 120 billion euros.

This is the wrong medicine for Greece--and for Europe.

A bailout will not address the fundamental causes of Greece's fiscal problems. Greece has an expansive but highly inefficient civil service and an economy stifled by regulation, favoritism and rent-seeking. These policies have generated double-digit deficits and a debt-to-GDP ratio well over 100%. The situation is not even close to sustainable, so absent a bailout Greece will default on its debts.

A bailout, however, does nothing to fix the misguided policies that have generated Greece's existing debt and ongoing deficits. Bailout therefore merely postpones the day of reckoning. Worse, bailout both rewards Greece's bad past behavior and encourages such behavior in future. Greece will never change its misguided policies if the E.U. and IMF infuse it with new cash, just as no teenager who has overspent an allowance will reform if the parents merely expand that allowance.

Thus bailout merely transfers resources from other nations to Greece. This is presumably beneficial for Greece in the short term because it postpones painful adjustments like lower salaries for government employees. But a bailout harms the citizens of these other countries, who did not live beyond their means. And a bailout harms Greece in the longer term by delaying adjustment of the fundamental flaws in its economic policies.

The negatives do not end with the current bailout. Greece will be back for additional bailouts in short order, since under a bailout it will not fix its underlying problems. And once the EU and IMF have bailed out Greece, they will find it impossible to resist bailouts for Portugal or Spain. As the recent downgrading of these countries' bonds suggests, they (perhaps along with Italy and Ireland) are also at risk of default in the near future.

These other countries will claim their difficulties result from the contagion effects of Greece's imminent default, but that excuse is not persuasive. Events in Greece may have prompted both rating agencies and investors to take a closer look at the fiscal situations in other countries, but concern arose precisely because these other countries are pursuing their own excessive spending and counter-productive economic policies.

Thus bailing out Greece will not "save" Spain or Portugal; these countries will only escape Greece's fate if they reform their own economies. In Portugal, in fact, the leaders of the main parties have just announced plans to push through a substantial austerity program. That is a promising start, although the magnitude of any adjustment remains to be seen.

Rather than bail out Greece, therefore, the E.U. and IMF should allow it to default. This will hurt Greece's creditors, but those entities assumed the risk when they loaned to a country long known for its profligate ways. In contrast, a bailout forces unwitting taxpayers to foot the bill for Greece's sins. This can only breed resentment, not to mention reduced incentives for other countries to restrain their own spending.

If Greece does default, its economy may suffer in the short term. External credit will be scare to non-existent, so Greece will have to live within it means. This will require slashed pay-scales and benefits for civil servants and drastic cuts in the number of such jobs. It will also require the repeal of Byzantine regulation, burdensome taxes and policies that force a large fraction of the population to feed at the public trough.

But however painful this adjustment may be, it is unavoidable if Greece wants to join the first rank of nations; current policies are unsustainable from every perspective, so the sooner Greece abandons them the better.

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