The best way forward for Greece is a major debt restructuring and a 'hard' budget constraint

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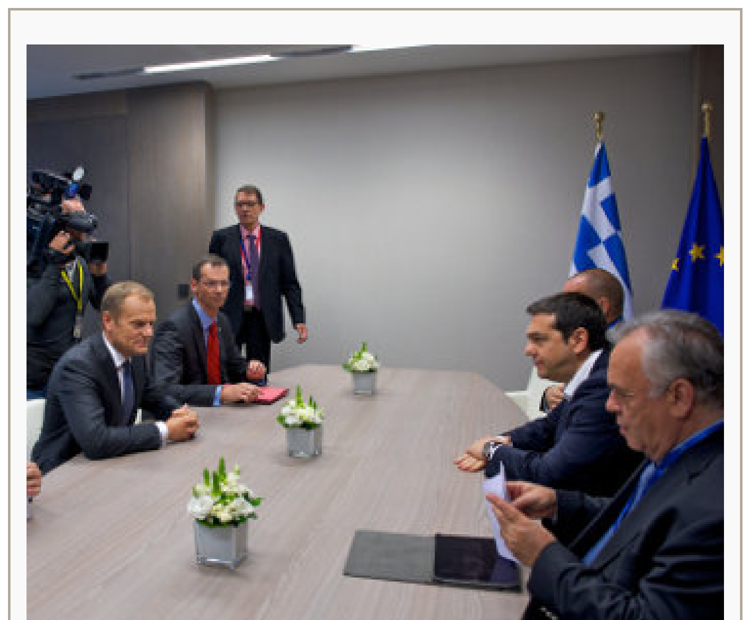
Talks are continuing between Greece and its creditors in advance of a scheduled Greek debt repayment to the IMF on 30 June. **Charles Goodhart** *and* **Dimitrios P. Tsomocos** *argue that the best way forward for Greece would be to undertake a major restructuring of Greek debt and to enforce a 'hard' budget constraint on all future public expenditure.*

During the extended discussions over the Greek debt crisis, the Greek Prime Minster continues to describe Greece as a sovereign country. While this is true politically, it is not economically sovereign. The control of the money stock, and the related seignorage, has historically been closely related to economic sovereignty. In economic terms, Greece is much closer in analogy to Detroit than to the United States.

In order to discern how this sorry story might best be taken forward, it is better to think of Greece as an equivalent to a defaulting city or US state, rather than to a fully sovereign country. The question then is how would one handle a city or state which had run up debts, which it had no real likelihood of ever repaying, as a result of borderline corrupt, sweetheart deals with cronies, unions and oligarchs?

The obvious immediate response is two-fold, first to have a major restructuring of the city or state's debt – a normal and in this case appropriate response – while enforcing a hard budget constraint on the city/state in future, whereby pensioners, unions, and other groups can only get paid out of incoming tax receipts: i.e. a genuinely hard budget constraint on all public sector expenditures from now on.



Talks between Donald Tusk and Alexis Tsipras on 22 June 2015, Credit: European Council President (CC-BY-SA-ND-NC-3.0)

The ensuing recession in such a federal state as the United States would, of course, be lower. The state's pensioners, unemployed and food stamp recipients would be funded from the federal budget rather than from the state. Thus, the recession would not be as severe as in Greece where a total reduction of 25.5 per cent of GDP has occurred in just six years (2008-14). Major restructuring is all the more appropriate since the structure of the bailouts so far have had the effect of saving German and French banks rather than the badly-hit Greek public.

The main additional difficulty in Greece is not only what ought to happen with the public sector, where major restructuring plus a truly hard budget constraint is the obvious answer, but also what should be done with the banks. To go back to our original analogy, Greece is like a city/state in the US, without built-in stabilisers, but with four systemic banks' headquarters domiciled there – and these are the only banks in town. So, if they go down, the whole economy collapses. The critical issue is, therefore, not what to do with the Greek public sector, but what to do with the Greek banks.

The first best solution would be for the ECB to keep these afloat, but, following the earlier major restructuring, it would and could only do so if it took control over the banks by injecting additional capital, in addition to such emergency liquidity assistance as continues to be required. This would, of course, reinforce the hard budget constraint on the Greek Government, because the ECB would only lend additional money to them against cast-iron expectations of a future budget surplus, i.e. temporary liquidity smoothing.

This would reinforce the hard budget constraint on the Greek public sector, leave Greece in the Eurozone and the EU, and probably be the best possible outcome from a difficult situation. Indeed, were this to be done, and the Greek banking sector come under the effective control of the ECB, the prior deposit flight would probably reverse quickly, and with future monetary certainty and a strict hard budget constraint, one would hope that the recovery would ensue rapidly.

The alternative, should the Greek Government regard losing their banks from Greek national control as too strong a pill to swallow, is clearly for capital controls in the short run and eventually a return to a national currency, as proposed by numerous Syriza MPs. Although this outcome might restore economic and monetary sovereignty to Greece and allow them to adjust relative wages and prices and enhance exports, the basic problem is that it would relax the essential hard budget control on the present government.

The ability to print money enables any populist government to finance expenditure in the short run without the prior need to raise taxes to fund it. The overriding concern is that Syriza would take that route to increase public spending rather than through public investment, and would not impose the necessary hard budget constraint, so the return to economic and monetary sovereignty would presage an accelerating collapse into ever-higher inflation. If a country is going to make devaluation work, and especially so if there are difficulties in switching resources into the tradeable goods sector – the only alternative growth path for the Greek economy – then the imposition of a hard budget constraint is all the more necessary. But the fear is that the present government would see the ability to print money as a way of avoiding such a constraint.

While major restructuring accompanied by national currency introduction might seem a step in the right direction, the probable outcome would be ever-worsening inflation, followed by economic chaos and, ultimately, a disaster for Greek society.

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Note: This article gives the views of the authors, and not the position of EUROPP – European Politics and Policy, nor of the London School of Economics.

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