

A bank tax can help Greece avoid default

By: Jeffrey D. Sachs

The Greek government is on the knife-edge of solvency. Public debt is estimated to be around 160 per cent of the country's gross domestic product, of which around three quarters is owed to foreign creditors. We cannot be sure whether it can service its debts within the boundaries of political, social, and economic stability. But following from my [previous article](#), I believe a route to Greek solvency is possible.

To repay its debts, the Greek government must make two net resource transfers: from Greece to foreign creditors, and from the budget to all private creditors, domestic and foreign. Greece can probably sustain payments abroad of around two to three per cent of GDP per year, but larger transfers could trigger a political and social explosion. Internal payments are less explosive politically and a primary budget surplus can probably be sustained at around three to four per cent of GDP per year.

“Solvency” is therefore not a precise economic condition, but a reflection of long-term economic, social, and political conditions. Greece is close to the edge and, without a prospect of recovering economic growth and employment, even the limits just described will be unmanageable.

Greece's ability to “pay down” its debts and restore long-term confidence in its solvency will depend on the future real interest rates it will have to pay – balanced against the real growth rate of its economy. If it is pushed too soon to the private capital markets it will face sky-high rates, if it is able to borrow at all. Insolvency and default would then become inevitable.

Almost all of the proposals advanced in Europe until now, including many circulating before this Thursday's summit, have effective real interest rates of at least four per cent per year, against a prospective annual growth rate of perhaps three per cent, Greece's historic average. On this basis, debt would still be around 150 per cent of GDP in 2032. This has led many observers to conclude that Greece's default is inevitable. Yet that is an unjustified and hasty conclusion.

Interest rates are high because of the likelihood of default, and vice versa. Of course the risk of default reflects a very high debt burden and uncertain growth and fiscal trajectories. Yet suppose Greece could refinance its debts at a suitably low, “safe” market interest rate, and with a recovery of growth to historic averages. Greece could then work itself out of the debt debacle within a generation without unbearable net resource transfers or fiscal surpluses. It's a close call, but repayment in the long term is possible. There are three courses of action at this point. The first is to muddle through with measures such as the “rescue” packages of last March and the one announced earlier this month. This approach, providing temporary liquidity at high interest rates, will probably collapse within months: there is little prospect of the Greek parliament voting for another short-term austerity package to earn another short-term rollover.

The second approach is an early default. Greece would partly suspend debt payments, buy back its debts at below-market rates, coax some or all of its private creditors to exchange current bond instruments for new securities with lower par values (which might also carry official guarantees on the reduced par values, as in Brady bonds), or some combination of these actions.

The consequences here would depend on how the default is handled by regulators, market participants, foreign governments, the International Monetary Fund, and the European Central Bank. But advocates of default generally believe, wrongly, that Greece is already insolvent and default inevitable. They also generally believe a default can be predicted and smoothly managed.

Those are dangerous guesses. The most likely consequence of a Greek default will be a profound crisis of confidence that could swallow the Greek banks and possibly tear Greece from the euro.

If that were to happen, the costs to the entire eurozone would be devastating. The loss of credibility would lead to higher interest rates for a generation. Weaker countries would face repeated speculative attacks. Banking crises could become the norm.

Yet there is a further problem. German leaders in particular have been pushing this option in the belief that it is the only way to involve the private sector in refinancing Greece's debts. This is a tactical mistake. Rather than pushing for a bond exchange that will trigger a default, it would be better to tax the banks to build an insurance fund against a future Greek default.

The third approach, therefore, is to try to engineer a full Greek repayment of its debts in the long term. This requires a political agreement within Europe. Greece would consent to years of fiscal austerity and primary budget surpluses, but these would be moderate and predictable, as would net foreign resource transfers. The prospects for a recovery of economic growth, combined with an eventual pay down of the debts without default, would be widely understood and accepted by a majority of the Greek citizens as reflected in a sustainable parliamentary majority.

The key to this approach, as I argued in my previous article, is to lock in low long-term interest rates at the "safe" rate, close to the current German or French long-term borrowing rate. This could be achieved most directly through guarantees offered by the European Financial Stability Facility on Greece's future borrowing.

Here is one way the arrangement could work. The EFSF could borrow on the behalf of Greece as debts fall due. The EFSF borrowing rate, reflecting the backing of eurozone countries and hence an AAA rating, would be around 3.5 per cent per year on a 20-year maturity. All existing IMF, ECB, and EU debts (around €110bn) would be refinanced through the EFSF directly.

Greece would need around €250bn of EFSF borrowing to repay the outstanding bonds

held by the private sector: €100bn by the end of 2014, and most of the rest before 2020. This would be used to pay off debts and interest payments as they fall due. By 2016, Greece would owe some €250bn to the EFSF. All EFSF debts would be at 3.5 per cent interest rates fixed over a 20-year maturity (around two per cent real, given the eurozone trend inflation of around 1.5 per cent per year).

One further problem is that taxpayers would be put at risk by this arrangement, while banks would be advantaged. But there are several ways to compensate taxpayers by imposing a levy on the banks.

As Greek debt servicing is made to the private creditors, financial regulators in each country could require existing private creditors that are receiving debt payments to put some portion, perhaps 30 per cent of the repayments, into an interest-bearing escrow account that would serve as a “guarantee fund” in the event of a Greek default.

By the end of 2014, the combined sums in these accounts would total around €30bn, to be invested at around the safe market rate of 3.5 per cent. If Greece defaulted on principal or interest, the escrow account would be drawn down to repay the EFSF. If Greece ultimately repaid all its debts, the escrow accounts would revert to the financial institutions that are Greece’s current creditors.

Alternatively, the guarantee fund to back the EFSF could be raised through a tax on the banking sector as a whole, rather than on the holders of Greek bonds in particular. The levy could incorporate a variable tax rate based on the share of risky sovereign bonds in the bank’s balance sheet, or could be set independently of the specific asset composition of the bank. The details would depend on national laws and regulatory judgments.

There is a reasonable chance that this approach would avoid a default at any stage. Greece would service its debts at a real interest rate of two per cent and have the chance to restore economic growth of three per cent. The debt burden would come down gradually. In no year would Greece have to make net external resource transfers greater than 2.5 per cent of GDP, or primary budget surpluses greater than 3.5 per cent of GDP.

This would be no easy ride. The Greek government would be paying its creditors for more than a generation. The current fiscal austerity programme would continue, albeit with much better prospects of an early return to growth and an eventual restoration of creditworthiness. Structural reforms and encouragement of foreign investment inflows would help Greece restore sustained growth. The arduous national effort would be rewarded in time, and help to improve confidence even in the short term.

There is a chance – a rather good one, I believe – that in the end Greece would prove able to repay its debts over the course of 20 years at the low, safe interest rates established by the EFSF. It may be the last clear chance for Greece and Europe to avoid a potential calamity. It is an attempt well worth making.

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