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A Money Too Far

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So, is Greece the next Lehman? No. It isn't either big enough or interconnected enough to cause global financial markets to freeze up the way they did in 2008. Whatever caused that brief 1,000-point swoon in the Dow, it wasn't justified by actual events in Europe.

Nor should you take seriously analysts claiming that we're seeing the start of a run on all government debt. U.S. borrowing costs actually plunged on Thursday to their lowest level in months. And while worriers warned that Britain could be the next Greece, British rates also fell slightly.

That's the good news. The bad news is that Greece's problems are deeper than Europe's leaders are willing to acknowledge, even now — and they're shared, to a lesser degree, by other European countries. Many observers now expect the Greek tragedy to end in default; I'm increasingly convinced that they're too optimistic, that default will be accompanied or followed by departure from the euro.

In some ways, this is a chronicle of a crisis foretold. I remember quipping, back when the Maastricht Treaty setting Europe on the path to the euro was signed, that they chose the wrong Dutch city for the ceremony. It should have taken place in Arnhem, the site of World War II's infamous "bridge too far," where an overly ambitious Allied battle plan ended in disaster.

The problem, as obvious in prospect as it is now, is that Europe lacks some of the key attributes of a successful currency area. Above all, it lacks a central government.

Consider the often-made comparison between Greece and the state of California. Both are in deep fiscal trouble, both have a history of fiscal irresponsibility. And the political deadlock in California is, if anything, worse — after all, despite the demonstrations, Greece's Parliament has, in fact, approved harsh austerity measures.

But California's fiscal woes just don't matter as much, even to its own residents, as those of Greece. Why? Because much of the money spent in California comes from Washington, not Sacramento. State funding may be slashed, but Medicare reimbursements, Social Security checks, and payments to defense contractors will keep on coming.

What this means, among other things, is that California's budget woes won't keep the state from sharing in a broader U.S. economic recovery. Greece's budget cuts, on the other hand, will have a strong depressing effect on an already depressed economy.

So is a debt restructuring — a polite term for partial default — the answer? It wouldn't help nearly as much as many people imagine, because interest payments only account for part of Greece's budget deficit. Even if it completely stopped servicing its debt, the Greek government wouldn't free up enough money to avoid savage budget cuts.

The only thing that could seriously reduce Greek pain would be an economic recovery, which would both generate higher revenues, reducing the need for spending cuts, and create jobs. If Greece had its own currency, it could try to engineer such a recovery by devaluing that currency, increasing its export competitiveness. But Greece is on the euro.

So how does this end? Logically, I see three ways Greece could stay on the euro.

First, Greek workers could redeem themselves through suffering, accepting large wage cuts that make Greece competitive enough to add jobs again. Second, the European Central Bank could engage in much more expansionary policy, among other things buying lots of government debt, and accepting — indeed welcoming — the resulting inflation; this would make adjustment in Greece and other troubled euro-zone nations much easier. Or third, Berlin could become to Athens what Washington is to Sacramento — that is, fiscally stronger European governments could offer their weaker neighbors enough aid to make the crisis bearable.

The trouble, of course, is that none of these alternatives seem politically plausible.

What remains seems unthinkable: Greece leaving the euro. But when you've ruled out everything else, that's what's left.

If it happens, it will play something like Argentina in 2001, which had a supposedly permanent, unbreakable peg to the dollar. Ending that peg was considered unthinkable for the same reasons leaving the euro seems impossible: even suggesting the possibility would risk crippling bank runs. But the bank runs happened anyway, and the Argentine government imposed emergency restrictions on withdrawals. This left the door open for devaluation, and Argentina eventually walked through that door.

If something like that happens in Greece, it will send shock waves through Europe, possibly triggering crises in other countries. But unless European leaders are able and willing to act far more boldly than anything we've seen so far, that's where this is heading.