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A Grecian Formula for Courting Disaster

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Greece's position is now much worse. Voters seem not to have realized how much pain Europe's help averted.



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Yanis Varoufakis, trying to leave on his motorcycle after resigning as Greek finance minister, meets the press in Athens, July 6. PHOTO:PETROS KARADJIAS/ASSOCIATED PRESS
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Following their charismatic prime minister and a pied piper parade of left-leaning economic pundits, the Greek people have voted resoundingly to “reject creditor demands for more austerity.” That’s nice, but who exactly is going to pay for *less* austerity?

For most of the past several years, Greece has received considerably more cash than it has paid out. Although you would never know it from the world press, the so-called austerity that Greece has experienced since 2010 is almost entirely a result of having to rein in budget deficits that were wildly out of control.

At least in the near term, Greece would have been much better off saying “yes” to the creditors’ late-June offer. That deal would have provided the country with more than enough money to cover 2015 interest and principal due. There would have been enough left over for the Greek government to run a 3% deficit for the remainder of 2015, not to mention the usual 2%-plus subsidy Greece gets every year in aid transfers from the European Union.

In urging Greek voters to reject the eurozone’s “humiliating” deal, Prime Minister Alexis Tsipras persuaded his countrymen that they can do better than a “mere” 5% of income transfer from their European neighbors, in addition to outside support for their banking system. Yes, there would have been future payments expected, but those could have been renegotiated later, as Greece has been doing all along.

The untold story is that in calling the referendum, Athens has fired its most powerful weapon against Europe—and so far the contagion effect has been minimal. Let’s face it, the No. 1 reason Europe has been willing to bend over backward to help Greece is that the EU leadership feared the fallout from a Greek exit. Yet spreads on bonds for other nations of the eurozone periphery inched up only 10-20 basis points on Monday. This lack of contagion seriously undermines Greece’s bargaining power.

What the Greeks might not have understood is that when the Europeans said they were pulling last week’s offer from the table, they might have really meant it. If Greece’s intention was to try

to blackmail Europe with the referendum, it has backfired. Yanis Varoufakis, who was pushed out as finance minister on Monday, prided himself on using game theory in his negotiations. It is not too late, as he leaves the stage, for Mr. Varoufakis to tell his fellow members of the hard-left Syriza party that rolling the dice with the referendum has changed Greece's position radically for the worse.

If the Greek government really wanted to come clean, it would explain that even if all the country's debt were wiped out tomorrow, policy makers would still have to find a way for Greece to escape the current epic recession while living within the country's means. Those who claim that the "troika" (the European Commission, the European Central Bank and the International Monetary Fund) forced monstrous spending cuts on Greece don't seem to realize that spending cuts would have been even deeper without the over €80 billion (\$88 billion) in net new loans and aid that Greece received from 2010 to 2013, equal roughly to 10% of its GDP.

Unless massive increases in aid are forthcoming, the only way for Greece to have less austerity is to have more structural reform—which, by the way, should not be conflated with budget cuts. Yes, Greece should be allowed to design its own program. Structural reforms imposed from the outside seldom work.

It isn't just about balancing the budget; Greece needs to reform its chronically corrupt governance structure from the inside out. Fortunately, the Greeks can probably still get the troika to accept the blame for any adjustment pain. And that is a good thing, because there is still much pain to come. In addition to making the inevitable budget cuts, Athens may well end up imposing harsh haircuts on bank depositors.

People ask how Europe will respond to the "no" vote. The sad fact is there isn't much Europe can do for Greece other than continue to postpone official debt repayments and keep pouring in aid. Europe's leaders will try hard to stop the spread of contagion, if it develops, to countries that they believe are playing by the rules, but it isn't clear that Europe will ever figure out how to reduce growth-impeding debt burdens in other periphery countries.

The real question isn't how Europe responds, it is how Athens responds. Greece must somehow find a way to shape itself into a modern European state. That remains possible in the long run, but it is discouraging to hear elements of the Syriza brain trust still seemingly intent on turning their country's economy into Cuba's or Venezuela's. With luck, as long as Greece remains a democracy, Europe will have little to fear.

The people of Greece have voted decisively that they don't want further government spending reductions or additional cuts to the social-welfare state. That is all well and good. But now Greeks must also decide on a way to pay for what they do want. Greece cannot demand to be treated like a Egypt-type client state but also demand to be a card-carrying member of the euro. It was fine for Greece to vote "no," but it now urgently needs to propose a realistic solution for which the rest of Europe can vote "yes."

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