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The alternative to bailouts [1]

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Greece was bailed out, then Ireland was bailed out, and now Portugal has been bailed out. All of these countries were made to agree fairly stringent deficit and debt reduction packages. All three face years of fiscal tightness, reduced services and living standards, and low economic growth. It is by no means certain that the populations of these democracies will tolerate this for the length of time it will require to put their affairs to rights.

There is an alternative. It is to let these countries default, offering a percentage of the debts' face value as settlement. There would be turmoil. Some bondholders, including European banks, would lose substantial sums. But at the end of it confidence would return and economies start to grow again without that burden of debt.

The decision was made to protect small depositors, bondholders and to some extent bank shareholders, at the expense of taxpayers. It was an unwise decision, both morally and from the point of view of efficiency. One could argue that small depositors were not a party to the causes of the crisis, and should not be made to bear its burdens. Bondholders and shareholders, however, should have known better.

The main argument in favour of default is that it will be effective in putting a line under the crisis. Instead of limping along for years with lacklustre economies struggling to meet debt repayments, the over-indebted countries can get it over with and turn the page.

It looks very much as if the bailout option has been taken to protect the euro and European banks, but it would not be the end of the world if a few countries that should never have been in the single currency have to leave it. And if a few European banks had to restructure, recapitalize or be taken over, this, too, could be survived. Allowing the euro to lose momentum might be a setback to European political union, but this would be no bad thing.

The bailout strategy might keep things going for a while, with more patches to counter the recurring crises. Or we could take the hit now, accept the consequences of folly, and start to rebuild on firmer foundations. It looks increasingly like the better option, especially if there's a bigger storm on the way?

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