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As Europe Debates Greek Debt Writedown, Economic Crisis Looms, Economists Say

By Bonnie Kavoussi

While significantly bolder than expected, the newest plan proposed by euro zone leaders may still not be enough to quell the crisis in Europe.

European leaders neared a decision on Wednesday to ask banks to write down more than 50 percent of Greece's debt, or about 100 billion euros. But two problems remain: Some banks may not comply with such an ultimatum, and even a writedown of more than 50 percent may not be enough to prevent a Greek default, according to some economists.

"The risks of a disastrous blowup in Europe are increasing by the day," said **Bernard Baumohl, chief global economist at the Economic Outlook Group**. "I don't see a solution until private investors finally have some confidence in the plan that's produced."

Euro zone political leaders promised to announce a final decision on the Greek debt on Wednesday, but talks have dragged on into the night. The European Union's talks with banks are deadlocked and have been suspended, according to Bloomberg News, since banks have said they are unwilling to take losses of more than 40 percent on Greek debt.

Some economists say that the lack of cooperation raises the possibility that some banks may not voluntarily write down their Greek debt as much as necessary, which could lead to a Greek default, followed by European bank failures and other European government defaults that could spur a deep recession in Europe and a global economic downturn.

European leaders are in a dilemma, according to some economists. If leaders demand that banks write down a clearly sufficient amount of Greek debt, such as 70 percent, then some banks may not comply, which could lead to a disorderly Greek default. But if political leaders ask banks to write down a smaller amount, such as 40 percent, then all banks would be likely to comply, perhaps calming the markets momentarily -- but it would be highly unlikely for Greece to pay the remainder of its debt, prolonging the sovereign debt crisis, economists said.

As European leaders have debated the issue, the economic crisis has grown without them. Borrowing costs for large countries such as Spain and Italy have spiked as investors have become increasingly uneasy about holding troubled European sovereign debt.

The situation in Italy, the largest European country in danger of default, has grown worse. As Italy's economy grows just 1 percent per year, it will become increasingly difficult for the country to pay its higher interest payments, since it will not collect much more in taxpayer revenue. But the government of Prime Minister Silvio Berlusconi has not been able to build political unity for budget cuts that may be necessary for Italy to contain its debt.

European leaders' tentative proposal to write down more than 50 percent of Greek debt may also not be enough to settle the crisis, some economists said. The Greek economy would need to grow in order to support paying the remainder of the Greek debt, and it is currently shrinking "sharply," making it unlikely for a 50 percent haircut to succeed, said Howard Archer, chief euro zone economist at IHS Global Insight.

Greece needs a 70 percent haircut on its sovereign debt, or else a contagion of bank runs and government defaults could spread through Europe, said California State University economist Sung Won Sohn. He said that even though the markets "will temporarily probably like" a 50 percent haircut, it is not enough, and no other solution -- including increasing the size of the bailout fund -- can substitute for a sufficient writedown of Greek debt.

"The smell of the rotten fish will get worse," Sohn said. "Look at the sorry state the Greek economy is in. The economy's in depression."

The Greek economy has been shrinking as the Greek debt grows, since tax revenues have fallen. European leaders have forced Greece to slash its budget in exchange for loans allowing the country to continue making interest payments. But budget cuts actually have caused the Greek deficit to rise, and the unemployment rate in Greece has spiked to 16.5 percent.

Meanwhile, European leaders need to announce a substantive solution soon, or else the stock market would likely plummet and borrowing costs would rise, some economists said. European leaders have disappointed investors repeatedly in the past, so investors are not likely to be forgiving again, Archer said.

Archer added that whatever European leaders announce in the next few days would only amount to "a bigger bandage over the euro zone, but there's an underlying injury still there": anemic economic growth in the euro zone coupled with burgeoning sovereign debt burdens.

"Even if they're able to douse the fires now," Archer said, "they will resurface further down the line."