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Greece's Choices: Deep Cuts or Default

By AP / CHRISTINA REXRODE and PAUL WISEMAN

Why would Greece accept more pain when unemployment is at 21 percent, the economy is enduring its fifth year of recession and rioters are hurling gasoline bombs in the streets of Athens?

Because the alternative might be worse.

Greek leaders are gritting their teeth as they move forward with a plan to further slash spending in return for a bailout of about $172 billion (€130 billion) from other countries in Europe and around the world. The Greek Parliament is scheduled to vote on the plan Sunday.

Greece is trapped in a lose-lose predicament: It must deepen an austerity plan begun in 2010 that will throw many more people out of work. Or it must default on its debts, abandon Europe's single currency and see its banking system implode. "The choice we face is one of sacrifice or even greater sacrifice — on a scale that cannot be compared," Greek Finance Minister Evangelos Venizelos said.

Here is a closer look at Greece's two bleak options:

—Impose deep spending cuts in exchange for the bailout.

The pros:

Greece needs the bailout to make a $19.1 billion (€14.5 billion) bond payment due March 20. Prime Minister Lucas Papademos warned that "a disorderly default would cast our country into a catastrophic adventure." Papademos said the plan would help lift Greece out of recession next year.

In addition to the $172 billion bailout, Greece is negotiating a deal that would reduce the roughly $264 billion in debt it owes private creditors. Under that arrangement, about $132 billion would be shaved off the national debt and Greece would get more favorable repayment terms. Selling government-owned companies, exposing professionals like architects and pharmacists to more competition and imposing other reforms is designed to make the economy more efficient in the long run.

Even with the austerity plan in place, the International Monetary Fund estimates it will be 2020 by the time Greece can shrink its debt load to a sustainable level.

The cons:

Such austerity can be counterproductive because it can slow the economy and reduce tax revenue.

The government acknowledges that the austerity plan would cause Greece's economy to shrink 4 percent to 5 percent this year. Without it, the government would expect the economy to contract just 2.8 percent. The plan includes lowering the minimum wage by 22 percent and laying off 15,000 government workers this year.

So far, austerity has done nothing to reduce Greece's debt burden. Government debt as a percentage of the economy actually grew after it began imposing austerity — to nearly 160 percent in the July-September quarter of 2011 from 139 percent a year earlier. "The whole plan was a losing proposition," says Dimitri Papadimitriou, president of the Levy Economics Institute and professor at Bard College.

Austerity is causing widespread hardship and inflaming social tensions. Papdimitriou worries that Greek society is "disintegrating" under the strain: "Poverty has been increasing, homeless rates have been increasing."

So have crime and suicides.

—Default and drop the euro.

The pros:

Defaulting on its debt would ease the immediate strain on Greece's finances and probably cause it to abandon the euro, the currency used by 17 countries. Dropping the euro would leave Greece with a much cheaper currency, its own drachma. That would juice Greece's economy by making Greek products less expensive around the world. This would give Greek exporters a competitive edge.

In the 1990s, Canada used a weak currency to expand exports and grow its way out of high government debts, says Simon Tilford, chief economist at the Centre for European Reform in London. As long as it's shackled to the euro, Greece lacks that option.

Bernard Baumohl, chief global economist at the Economic Outlook Group, thinks economic and financial pressure will eventually drive Greece to drop the euro. And he thinks that would be for the best. "What is worse for Europe — to have this matter linger on and on, with European citizens having to continue to bail out Greece and Portugal? Or to face the reality that these countries should not have joined the euro in the first place?" **Baumohl** asks.

The cons:

Exiting the euro would throw Greece's banking system into chaos. Lenders would panic over the prospect of being repaid not in euros but in drachmas of dubious value. Adopting a suddenly much weaker currency could also ignite Greek inflation because prices of imported goods would soar.

International investors would be reluctant to lend to Greece's government, its companies or its banks. The freeze-up in credit could cause a depression, worse than what Greece is suffering now. Economists at UBS estimate that Greece's economy would shrink by up to 50 percent if it left the eurozone. The pain would also likely spread as European banks absorbed losses on their loans to Greece. The worst-case scenario: A disaster akin to what followed Lehman Brothers' collapse in September 2008. Banks grew too fearful to lend to each other. Credit froze worldwide.

Some economists would like to see European governments produce a rescue package that pairs government cuts and reforms with economic aid designed to spur growth in Greece. "When you have over 20 percent unemployment, you need to do something," Papadimitriou says.

He wants European countries to propose something like the U.S. aid plan that rescued an impoverished Europe after World War II. "You need something similar to the Marshall Plan," Papadimitriou says.