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CAPITAL MANAGEMENT

Dancing with PIIGS

"Is a euro held in an Irish bank in Dublin, or in a Portuguese bank in Lisbon, as sound and secure as a euro in a German bank in Berlin? That apparently simple question holds the key to understanding why the euro zone may splinter and bring a new financial crisis." Tyler Cowan, Professor of Economics at George Mason University in the New York Times, April 17, 2011.

A euro is a euro, right? Worth the same in Ireland, Portugal, Germany, France and Greece? Well, maybe not. There is a lot of political and economic dancing going on in Europe these days and the name of that tune appears to be "Love Can Keep Us Together." And it sounds just as vapid and schmaltzy as the original by the Carpenters. But I have become convinced that something else is going on – namely a monumental effort to restructure the EU by removing the weakest links in as orderly a fashion as possible. Greece is the first to be loaded into the cannon so let's use them as the guinea PIIG (sorry).

Reasons for Greece to remain in the EU

1. Greece reaped huge benefits by joining the EU; no one wants to appear ungrateful.
2. Exiting the euro would mean currency devaluation, austerity and inflation – very painful for the Greek people at least for a while (though look at what Iceland has done after driving into a ditch during the credit crisis - http://news.investors.com/article/602944/201203020802/iceland-fixes-bank-crisis-ireland-a-mess.htm .
3. Greece's debts are denominated in euros (or dollars or yen); paying it all back in devalued drachma would be a nightmare.
4. If Greece were to exit, wouldn't there be a domino effect igniting a regional if not global contagion?

Reasons for Greece to quit the EU

1. The odds of Greece recovering economically and repaying its debts (even after the current restructuring) as a member of the EU are somewhere between slim and none.
2. The Greek economy is not competitive and austerity measures being imposed will make things a lot worse before they get better; the current government doesn't want to be thrown out.
3. To regain growth and competitiveness, Greece needs to go back to the drachma and allow it to devalue to the point that Greek goods and services are once again attractive to foreign buyers.
4. By one account (http://blog.variantperceptions.com) there have been 69 currency breakups in the past 100 years; short-term pain results in long-term gain so long as the country implements real reforms (something that might or might not happen in Greece)

So let's say you're Greece and you want out. And let's say your core EU buddies (Germany and France) are down with that but worried about undesired consequences – say the complete collapse of the European banking system. What do you do?

Constructing a graceful exit

1. Negotiate a big reduction of your existing debts. Promise whatever it takes to get your creditors to take a huge haircut. The less you have to ultimately repay, the better your chances of minimizing the pain on exit. (This is happening as we speak.)
2. Get Germany and France to pressure the ECB to provide cheap loans to all the banks who have to take the big haircut on Greek debt, along with unrealized losses on Portugal, Spain, & Italy, so that they aren't rendered insolvent. (The ECB has undertaken two longer-term refinancing operations (LTRO) with more than a trillion euros loaned to more than 500 banks across Europe.)
3. Make lots of noise about remaining true to the euro. This is required to minimize the exodus of bank deposits from Greece to safer havens. To answer Tyler Cowan's question as a Greek, a euro on deposit in Berlin is worth a lot more than one in Athens that will be stamped and turned into devalued drachma. (Greek Prime Minister George Papandreou has consistently stated that his government will do whatever it takes to remain in the euro.)
4. After completing steps 1, 2 and 3, pick a weekend to announce that Greece is quitting the euro and reinstating the drachma. Close the banks the following Monday while you stamp all the money in circulation and restrict international transfers. All euros on deposit and circulating in Greece are then exchanged for lots and lots of drachma.
5. An optional step (for bonus points) would be to default on any remaining external debt denominated in euros – that would be whatever is left outstanding after the current restructuring. This will speed the recovery and, hey, did anybody really believe they would get their money back?

The aftermath

1. Nobody wants the drachma right away, so Greece keeps printing it until there's enough to make everyone happy.
2. Greeks have to put up with inflation in their local economy but have a shot at selling stuff to foreigners again; tourists slowly come back because it's so damn cheap.
3. Giving business a chance to recover puts the government in a position to reform a lot of bad habits and create a framework for longer-term stability, assuming that old habits don't refuse to die.
4. Hey, if it works for Greece, maybe we try it for Portugal. What the heck, maybe even Spain and Italy.

I'm no geo-political or macro-economic expert, but it seems pretty obvious that this is where we are headed. When a company can't pay its debts, a well-orchestrated bankruptcy can provide a fresh start after creditors and equity owners are beaten over the head and forced to take their losses. Getting through this process in Europe would take the inevitable and make it history. IMHO, the whole world would be better off.