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How Greece Could Escape the Euro

High & Low Finance

By FLOYD NORRIS OCT. 6, 2011

Greece would be in much better shape now if it had never joined the euro zone, or if it had been kicked out in 2004 when it admitted that it had lied about its finances to join the club. So would the rest of Europe.

So why not get out now?

One answer is the same one that was given when Greece's cheating was revealed: Legally, there is no way out. The euro was designed to be the Roach Motel of currencies. Once you enter, you can never leave. There is no provision for departure.

But, of course, there is a way out. It would be messy, and perhaps disastrous. But no one is going to send an army to Athens to force it to keep the euro.

If Greece were to follow the example set by Argentina nearly a decade ago, it would simply convert its debts from euros into its old currency, the drachma, at the old exchange rate of 340.75 drachmas to one euro. It could also convert euro currency in the country at the same rate. So if you owned one million euros in Greek bonds, they would be converted to bonds with a face value of 340.75 million drachmas.

With a printing press available, Greece could meet those obligations. Of course the drachma would soon be worth a lot less — perhaps 1,000 to the euro. So bondholders would have lost two-thirds of face value. Greece might do O.K., but for reasons we will see, the move could be devastating to the rest of Europe.

In 2002, Argentina's currency, the peso, was officially tied to the dollar at a one-to-one parity. There was a "currency board" that was supposed to assure the tie could never be broken, and it had worked for a decade. But Argentine inflation had outpaced that of the United States, and the peso was seriously overvalued.

In early 2002, a new Argentine government ended the peg and did much more. It defaulted, and it required its citizens to do the same. If you had a dollar deposit in an Argentine bank, it became a peso deposit, soon to be worth about 30 United States cents to the peso. That was true regardless of who owned the bank. If you wanted to get dollars back from your Citibank deposit in Buenos Aires, you were out of luck.

Argentina was cut off from international credit. Imports plunged and the country entered a deep — but relatively brief — recession. The peso lost two-thirds of its value within a few months. Argentina was sued by everyone in sight.

But devaluation worked, as it often does. Argentine exports became competitive thanks to lower costs, and the economy rebounded. There are international judgments still outstanding against the country, but when it comes to sovereign states it can be easier to get judgments than to collect on them. Diplomatic assets are off limits — no one can grab the Argentine Embassy in Washington — and monetary assets can be kept with the Bank for

International Settlements in Switzerland, which will not allow them to be seized.

Argentina's decision to abrogate private contracts was a crucial part of the package, said John Hempton, an Australian hedge fund manager who has studied what happened. "The Argentine banks all had lots of U.S. dollar funding," he said. If they had to repay those dollars, while their assets were devalued, "then they would all have uncontrolled defaults, a true disaster, and the country would lose its institutions."

The Argentine experience was not pretty, but it may well be more attractive than the seemingly endless rounds of austerity, strikes and missed fiscal targets that seem to be leaving the Greek economy in a permanent recession. From the Greek perspective, the course could seem attractive.

There are some important differences, of course. Argentina had a currency that still existed, and there were peso notes. There are no drachma notes floating around Athens or anywhere else. If the drachma suddenly became the legal currency again, currency would be needed. Printing new notes in secret would be a challenge.

Would the bond switch be legal? For some bonds, clearly it would not be. British courts "would enter judgments saying Greece owes x billion euros," said Whitney Debevoise, a lawyer with Arnold & Porter, "but would then have to find assets."

But British courts would have jurisdiction only over the minority of bonds issued under British law. Most Greek bonds were issued under Greek law, and presumably Greece can change that law to legalize what it does. Greek bonds already trade for less than 40 percent of face value, so it is possible that their actual value might not decline all that much, assuming investors believed the drachmas would be repaid.

Greece would suddenly be forced to run a balanced budget, or to borrow from its own citizens, whose savings would have lost much, if not most, of their value.

For Greece to pull that off, it would probably have to do it over a weekend, without leaks of what it was planning. If people got wind of what might be coming, there would be an immediate run on Greek banks.

When Argentina did it, there was no immediate ripple effect. But in Europe the result would very likely be explosive. There would be a run on banks in peripheral countries. If Greece can do it, what about Portugal, or Spain, or Italy?

Mr. Hempton has a vision of what rational people in the peripheral countries would do as soon as they heard about the Greek move. “Max all your credit cards for cash, draw all your bank deposits” and drive to somewhere safe. Money would pour into banks in Germany.

Or maybe not. German banks would have a lot of assets that were suddenly worth less, particularly if other countries did follow Greece. Owing euros to depositors, and getting devalued drachmas, or lire, or escudos, or pesetas from borrowers is one way to make capital vanish.

None of this is made any easier by the fact that in the old days to have a run on a bank you needed to show up at an office during banking hours. When the Austro-Hungarian empire collapsed after World War I, countries stamped the old currency to convert it into their currencies and stopped people at borders to search for cash. Now we live in a world of wired money. Most money is not in bills or coins but in bank deposits that can be moved halfway around the world nearly instantly. Border guards might not be much help.

In other words, Greece would fare poorly if it tried the Argentine strategy, but would have hope for recovery. But it might be impossible to halt the crisis for the rest of Europe.

Which brings us back to what is going on now.

European leaders hold meetings — this week in Luxembourg, next month in Cannes — at which they say they are determined to deal with the problem but seem to be unable to do much. The July 21 agreement for a new bailout of Greece is nearing ratification by all the euro area governments but seems woefully out of date. Greece's fiscal situation is growing worse, so it cannot meet its deficit targets. Some politicians want banks to take bigger losses than the July deal envisaged, but bank regulators are afraid of what would happen as a result. Greece remains woefully uncompetitive in export markets, and there is no credible plan to get its economy growing. The rest of Europe uses the threat of cutting off funds to force more and more austerity on the Greek government.

Many Greek citizens are acting as if there really is no need for all that austerity. There was a one-day general strike on Wednesday, with 20,000 marchers reported on the streets of Athens. The tax collectors, of all people, have staged job actions because they fear being laid off. To say the least, there is no sign of a national spirit of sacrifice to save the country.

The message from Greece now may be summarized as, "I'm small. I've suffered. You can afford to rescue me. If you don't, I can create chaos for all of you."

They may be right.

Floyd Norris comments on finance and the economy at nytimes.com/economix.

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