



What History Tells Us about a Potential Greek Exit

By David Schawel

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Greece's future is less certain given the recent elections, as is the outcome of its previous bailout. Is an exit now possible or probable? What would an exit from the euro look like, and how would it be accomplished? Some historical examples give us a clue to the repercussions.

A number of hours per week for me are spent reading through various pieces of sell-side and independent economic and macro research. The merits of such a practice can be debated, but without question it provides a "consensus" of current economic views. Over the last week or two the sell-side has increasingly raised the likelihood of a Greek exit from the euro.

Take for instance JP Morgan, which raised the odds of a Greek exit to 30-50%.

"The fear scenario is as follows...massive capital flight in anticipation of exit force capital controls in Greece, and new IOUs to pay public workers which starts the process to a new currency; capital flight from rest of periphery. If periphery countries then impose capital controls, the monetary union is effectively dead, as one country's euros are then not the same as another country's euros."

We have already seen capital flight within the EU. As Nomura economist Richard Koo stated just recently, "...Spain has a private sector that is deleveraging in spite of near-zero interest rates. But the resulting savings surplus has not remained within the country. Instead it has fled to Germany, causing Spanish yields to rise and forcing the government into austerity." The average observer can see this in action with bund yields plummeting to ~1.50% as of May 11.

Now back to Greece. John Hempton, a brilliant hedge fund manager with Bronte Capital, touched on this topic in an unnoticed [blog post](#) last September. Below is an excerpt, in which he compares Greece's situation to Argentina's default in 2001:

When Argentina defaulted not only did the government default but they forced a private default. If you had a debt in US dollars in Argentina prior to the default you were forced to pay it back in pesos. Indeed it was illegal to make payment in US dollars.



Likewise if you had a US dollar asset you got back pesos. A dollar deposit in Citigroup in Buenos Aires became a peso deposit. If you really wanted to keep your dollars you needed to make your Citigroup deposit in New York.

The forced private sector default was necessary for Argentina. The Argentine banks all had lots of US dollar funding. If you devalued without forcing their default then they would all have uncontrolled defaults (a true disaster) and the country would lose its institutions. Telefonica Argentina would have failed too – failing to replay USD debts.

The same applies in Greece. If the Greek Government were to devalue the new drachma (to perhaps a third the value of the euro) then the banks (which are loaded with Greek sovereign paper) would default. Even Hellenic Telecom would default because they would be forced to repay their billions of euro borrowings whilst collecting only drachma phone bills.

The Argentine economy was doing quite nicely after the devaluation. The lesson was that devaluation worked – provided you simultaneously forced private sector default.

If you were Greece you would take this option without hesitation. However this option has explosive implications for Europe. You see a bank deposit in Athens is going to turn your euros into drachma. Overnight it will lose 70 percent of its valuation.

So it has to be done quickly and with an element of surprise (as per Argentina when most people did not get their dollars over the border). Without surprise people will rush their money to Deutsche Bank in Munich.

One weekend we will just find that the Greeks have done it. But now suppose Greece does pull this trick. The day after we have a drachma – deposits are in drachma. We might print a single 10 drachma note and allow it to settle against the euro – then over time print more. This should work for Greece.

Now if you are Irish or Italian or Portuguese (or even Spanish) you know the rules. You get to get your euro out of the PIGS and into the core (Germany) as fast as possible. So max all your credit cards (for cash), draw all your bank deposits and load them in the boot of your car and make the drive to Switzerland or Germany. Somewhere safe. Otherwise you are going to lose half the value the day that the rest of the PIGS do a Greece.

And this bank run – a run including tens of thousands of Italians driving their Fiats – will surely blow apart every Italian bank. And their Euro-skeloritic compatriots will sign the death knell for all their banks too.



If you are going to go the devaluation route you are going to have to do it all at once. Like the big-bank weekend (maybe coinciding with a weeklong bank holiday) in which all core European countries get their own currency back.

There is a precedent. It is not a pretty one. When the Austro-Hungarian Empire collapsed there was a single currency over a huge area covering much of what is now Euroland. In this case the rather Germanic Austrians were in charge (or rather were in charge until their empire collapsed).

What they did was put troops on all the borders and made it illegal to take cash (or wire cash!) across borders. Then all Austro-marks in each country was stamped – converted to drachma for Greece, marks for Germany, peseta for Spain or whatever the currencies of the day were.

In this conception all Spanish debts become peseta debts. All German debts become mark debts. All Greek debts become drachma debts. Unstamped currency goes worthless.

If you are going to split the currency I see no alternative to a big bang – and if you do that I see no alternative to troops at the border stopping transfers (and wire transfers) because shifting cash north looks so profitable against a sudden devaluation. Suddenly – and against all historic hope – it's time again to guard the French-German (and every other European border) with troops for a week whilst the money is stamped.

Note however almost every country borrowed in hard currency (marks) and got to repay in soft currency (drachma). This is a scheme which shifts the loss home to Germany and with little compensating benefit except that they get their beloved mark back. It's a scheme that is way better for the periphery because they get to keep their institutions. In two years they should bounce back like Argentina bounced back after its default.

Unilateral Greek default and devaluation without planning for the periphery to do the same – well that is a true mess. Too ugly almost to think about – and it would be unilateral for less than a week. The rest of Europe falls into that abyss with maximum movement of deposits and cash in the meantime.

Wow. What a great piece by Hempton, and awesome food for thought. But this could be reality in a matter of weeks or months. Could you imagine troops at borders preventing the transfer of euros to places like France and Germany? It would need to be done quickly.

Capital flight has already started in earnest as brisk flows into Germany have depressed bund yields.



Can anything be done now to soften or avoid this outcome? The issue is greater than just Greece. Koo and others have recommended that eurozone governments prohibit selling bonds to people outside of their own borders. Private Spanish savings, for instance, could be invested in Spanish bonds instead of German bonds.

It's clear that the dynamics between heavily indebted peripheral countries and creditor nations such as Germany are inextricably linked. The capital flights into Germany are affording an already "healthy economy" (unemployment at a 20-year low, industrial production approaching record highs), to potentially overheat. Koo speculates that this could lead to a German housing bubble.

The actual implications of a Greek exit are being underestimated. Thanks again to John Hempton for a vivid description of what that might look like. Could that possibly be in the cards for additional peripheral countries if things continue to deteriorate?

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