Greece, Sovereign Debt Crisis and the Euro

For a collection of countries to share a common currency and thus monetary policy, it is not clear that a common fiscal policy is required or desired. This is just another claim made by experts that hasn't been questioned or challenged.

More important is that prices within each member country can adjust to demand and supply. Without their own currencies to make the adjustment, domestic prices must exhibit sufficient flexibility to achieve equilibrium. This should be evidenced by volatile inflation numbers, i.e. a lack of price stability. This is hardly a good thing. If, even with a common currency, price stability is achieved, then it is a good thing but this is wishful thinking. Even without a common currency, price stability is a fragile state of affairs.

The matter of Greece is a complex affair. Two related issues dog Greece. One is its ability or intention to remain within the euro, and the other is its ability to service and indeed repay its debts.

Greece is cash flow insolvent. It is unclear if any country is balance sheet insolvent since a country's largest asset is the capitalized value of its tax base, whose value is highly dependent on the population, employment, economic growth, corporate profitability and the capitalization rate. Cash flow solvency is very sensitive to market rates of interest and thus to panic and fear (as well as complacency.) A cash flow solvent country or borrower can quickly become cash flow insolvent if the market ratchets up its cost of refinancing.

The options before Greece and her creditors are difficult. A debt reorganization or a default is recommended. Anything else will only delay the inevitable.

The second consideration is whether or not Greece should remain within the euro. It should not. The cost of removing Greece would be high, with possible runs on banks, corporate bankruptcies etc. This is why a euro exit should be planned within the context of a general sovereign debt restructuring.

A restructured Greece within the euro will still face pressures on domestic prices. Greece needs to become competitive. Without a currency of its own to devalue, it must deflate. For example, the average income in Greece needs to fall in euros by 30-40%, or it can be fixed in drachmas which devalue by 30-40%. Clinging to the euro is only defensible if one believes that the Greek economy can deflate significantly, and that the Greeks can withstand such a deflation.

A drachma with a 1 year peg to the euro followed by a period of flexibility within a trading range is the way to go en route to a full float. The initial fixing should be such as to render the Greek economy competitive at a stroke. Such an exit plan would be a template for further exits should such become necessary for the likes of Italy.

Membership to the euro should be based on eligibility, not entitlement. Until that happens, the Germans will have too weak a currency, the Italians too strong a currency, the Spanish, Portuguese and Irish too high an interest rate and Germany too low an interest rate. It makes for very rich pickings for the astute investor but for the euro citizens, its all a horrible mess.