

# Grexit or Grejection

Can you bail out a country by extending it more credit? Can a distressed entity borrow itself into solvency? The answer to both questions is, yes, but its hard. Greece seems to be expected to do so. In 2014 Greece has managed a primary surplus and is expected to repeat this performance in 2015.

1. <sup>1</sup>. Greece stays in the currency union but defaults on its debt.

This Greece has done before in March 2012 when creditors exchanged existing bonds for longer dated ones with a 53.5% write-down of face value. Absent a better business model or an internal adjustment to domestic factor prices, expect more defaults.

2. <sup>2</sup>. Greece stays in the currency union but has its debt restructured subject to austerity conditions.

This is what was the situation in 1 above was sold to creditors and the market. The restructuring above involved an exchange and a write-down. Absent a better business model or an internal adjustment to domestic factor prices, expect more debt restructurings.

3. <sup>3</sup>. Greece leaves the currency union.

It would be irrational for Greece to leave the union without also defaulting on its Euro denominated debt. This would be the main perk for leaving the union. A new Drachma would re-price rapidly to adjust domestic factor prices so as to reflect productivity. It is likely that inflation would surge as the Drachma fell and Greece would be pushed into stagflation. Then it would recover. Without the crutch or shackles of the Euro, a flexible Drachma would adjust where domestic prices were sticky and factor and goods markets would clear. Absent a better business model... well, you get the idea.

A country that defaults in Euros will default in Drachmas.

4. 4. Greece is ejected from the currency union.

The only reason Greece might be ejected from the currency union, apart from economic enlightenment, would be debt default. Actually, there is another reason but it is highly unlikely. The ejection of Greece would certainly encourage the rest of the union to take fiscal viability seriously. It is in Germany's interest therefore to eject Greece before any default or bailout is negotiated. Such brinksmanship is highly improbable.

What does Greece want? Scenario 1 is most preferable for Greece. A debt write-down would be ideal for the debtor nation but this would leave Greece locked out of debt markets for some time. If the ECB had intended to buy sovereign debt in its recent plans for QE, a Greek default would certainly delay if not destroy such plans as questions would be raised as to the treatment of Greek bonds already on the ECB's balance sheet. These bonds were not impaired in the first Greek debt exchange in 2012 and it is improbable that they would escape a write-down this time. Hold them at par and the recovery on the rest of the claims will be reduced. It would debase the entire "whatever it takes" pledge of the ECB.

What does Germany want? Fiscal rectitude and austerity on the part of Greece. Already it has leaked to the media its preparations for a Greek exit from the union, a leak which it subsequently quickly denied.