

Euro Endgame

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The European Central Bank (ECB) is facing a dilemma similar to that faced by major U.S. banks in the 1980's with defaulted loans to Latin America. The PIIGS (Portugal, Ireland, Italy, Greece and Spain) collectively require debt write-downs that exceed banks' capital and reserves, and the tantrums of Jean Claude Trichet, President of the ECB, won't change that fact.

The crazy but true strategy so far has been "Don't call bad debt, bad debt"—at least not openly. The continued attempt to "convert" bad loans to good loans by lending bad debtors more money so they can pay interest on bad loans, makes it temporarily unnecessary for Eurozone Banks and other debt holders to take write-downs.

Greece provides one example. The current last-ditch attempt by the IMF and Eurozone Banks is to impose on Greece exogenous wage deflation under the guise of "internal devaluation," higher retirement age and pension reforms, reduced spending protocols, and "privatization" of Greek assets by foreigners. Greece is coming under pressure to sell crown jewels like Thessaloniki Water and Sewage and Piraeus Port Authority. Greek citizens may view that as robbery, since it will only provide enough to make interest payments on debt for a short period to help the ECB cover-up its problems. This benefits the Eurozone banks that are in denial, but it doesn't help Greece.

The most egregious mistake is the attempt to impose exogenous reform of Greece's inefficient and often ineffective tax collection system. Similar to Iceland, Greek citizens may object to outside interference, demand a vote, and repudiate Greek debt, especially since there is a widespread perception that crony capitalism enriched irresponsible bankers and connected government officials while saddling disenfranchised Greek citizens with a multi-generation bill. Greeks invented democracy and they may be inspired by a slogan of the American Revolution: "No Taxation without Representation!"

Greece will have to impose fiscal restraint. The austerity measures forced on Greece from the Eurozone will be more onerous than those Greece will have to impose on itself, if it takes back control of its own currency and devalues it.

Euro: Super Deutsche Mark with a French Accent

The immediate crisis is in Greece, but it is not alone. It is futile to blame the citizens of deadbeat borrower countries, and given the flaws in the European Union, it isn't entirely their fault. The Euro is a super Deutsche Mark with a French accent. There was no Renaissance of manufacturing and productive jobs in the outer reaches of the Eurozone.

When you're overleveraged, your entire future depends on cash flow, and the cash flow isn't there for countries like Greece. The ECB is threatening to cut Greece off from bank liquidity— triggering Greek bank failures—if there is any restructuring of Greek debt. But the cash flow isn't there to service and repay existing debt, and even selling off assets won't change the long-term situation for Greece.

The ECB alone bought €75 billion in government bonds, and €45 billion or around 60% of them are Greek debt. Despite JPMorgan's estimate of around €81 billion in capital and reserves for other European banks to sustain a 50% haircut in various government bonds, it likely isn't enough given that government bonds aren't the only challenges the banks face.

The ECB's problem and the problem for many Eurozone banks is that they do not want to mark their bonds to market. They don't want to know what the debt is really worth, and it's not worth anything near what they're telling themselves it is worth. Threatening Greece so that they can cover-up the problem is only a temporary fix, and it isn't fooling anyone.

Deep Discounts: If PIIGS Owe You Money, You're in Trouble

Given that no one wants to face the magnitude of the problem, it is difficult to say how bad this can get, but history gives us an example of what needs to be done. In the late 1980's if U.S. banks had marked-to-market their Latin American debt, the losses would have wiped out the capital of Bank of America and Manufacturers Hanover (now part of JPMorgan Chase). Citibank was close to being wiped out. Other banks were also on the ropes: Irving Trust (now part of Bank of New York Mellon), First Chicago (now part of JPMorgan Chase), and Continental (later seized by the FDIC due to other bad loans).

By the end of 1987, Latin American debt ranged from around 15 cents on the dollar for Bolivian debt to around 35 cents on the dollar for Argentine debt. Market value estimates at the time recognized a valid appraisal method based on the fact that the U.S. had forgiven a large chunk of Mexico's debt and restructured it.

After Latin American countries defaulted on debts, the subsequent granular restructuring negotiations resulted in various dollar-denominated Brady Bonds, named for then U.S. Treasury Secretary Nicholas Brady. Each country negotiated its own terms. In the earlier Mexican debt restructuring for example, half of the \$20 billion debt was forgiven, and the principal of the other half of the debt was secured with a zero coupon UST bond then trading at around \$2 billion of the \$10 billion face value (the other half of the original debt). Mexico then had to meet the interest payments to service the \$10 billion bond.

Greece is a sovereign country. The ECB is acting as if it can dictate terms to Greece, but as U.S. banks found out, when someone owes you a lot of money and they cannot pay it back, you are in as much trouble—and sometimes in more trouble—than they are.

Endgame for the Euro

The crisis the Eurozone now faces is that citizens of countries with the most fiscally irresponsible governments and banks may be of a mind to vote out their current governments and repudiate their debt. If the ECB keeps storming out of meetings and isn't willing to engage in meaningful negotiations, then it will be in Greece's best interest to exit the Euro. The ECB can threaten all it likes, but it is dealing with sovereign states.

Greece can exit the Euro, implement its own austerity programs, force a renegotiation of its debt, and devalue its own currency. If politicians dig in their heels at the expense of Greek citizens, the Euro will likely end not with a whimper, but with a bang, and other distressed debtor countries may follow suit.

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