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Subject: FW: Greek Euro Exit

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Attachments: Should_Greece_leave_the_euro.docx

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This may interest you. I have the EU competition commissioner coming for dinner tonight.

From: Stephen Adams <[REDACTED]>

Date: Sun, 13 May 2012 14:55:36 +0100

To: Peter Mandelson <[REDACTED]>

Cc: Global Counsel Office <[REDACTED]>

Subject: Greek Euro Exit

Peter,

You asked for a note that took you through the scenarios for Greece leaving the euro, and the case against. This should fortify your dinner table conversation tonight.

Stephen

Should Greece leave the euro?

The case for or against a Greek euro exit hinges on some serious known-unknowns. It depends heavily on the degree to which it was managed and the second order effects in the Eurozone. Why does anyone advocate it? Because Greece has a competitiveness problem and the fastest way to deal with this in theory is to revalue the costs of its exports. It cannot really do this in the Eurozone except through an internal devaluation - a squeeze on wages. This is pretty much the current strategy. However for a heavily indebted country with little external demand to grow off the back of, wage deflation just increases the scale of debt, and thus reduces the scope to invest and grow.

What would happen if Greece left the euro?

The obvious trigger of an 'unplanned' euro would be the withholding of the next tranche of bailout funds which would render Greece insolvent and unable to service debt or pay pensions or salaries. ECB support for Greek banks (which is all that keeps them alive) would also be withdrawn. Greece and its banks would go bust.

- 1) There would be a run on the Greek banks. This has sort of happened already since 2009 - about a quarter of the deposits in the Greek banking system have been removed. But at the first hint of a serious prospect of redenomination, people would want to get euros out of the country, and the government would have to freeze bank accounts and impose capital controls to stop this happening.
- 2) The Greek government would launch new banks, capitalised from the redenominated deposits of existing depositors. This new currency would fall sharply in value - it is impossible to know how much, but estimates suggest 30-60%. So depositors would see a huge fall in their paper wealth. People who owed debts in the new currency would however see the value of their debt fall - so the process would transfer wealth from savers to debtors. All external debts

would dramatically increase, and there would be a huge wave of defaults. Every single legal contract in the country involving money would have to be renegotiated.

- 3) In principle, Greeks themselves would try to leave Greece as the labour market collapsed. It is not inconceivable that the Greek government, or neighbouring governments could actually try to stop this.
- 4) Anyone holding Greek debt outside of Greece would see that holding massively devalued, and probably defaulted on. The ECB would take a substantial hit. The Cypriot banking system is heavily exposed to Greek debt and would probably collapse. The French and German banking systems would also be hit. The cost of this would be substantial, and probably require substantial bank recaps across the Eurozone.
- 5) It is unlikely that the Greek government would have the resources to meet obligations and would probably try to cover them by printing money.
- 6) The second order effect on sentiment is hard to predict. It seems very likely that there would be a massive run on euro-denominated assets. The markets would assume that Portugal or Spain would be next. Their borrowing costs would spike. The likelihood is that this would trigger the existential crisis that saw the ECB have to basically guarantee the entire debt of the periphery...or not. The convulsions - economic, political, geo-political - if it did not would be global in scale.
- 7) After redenomination Greek exports would in principle be a lot cheaper - this would probably boost the tourist industry. But inputs for re-export would also become more expensive (and as far as I can work out, about 35% of the value of Greek manufacturing exports is represented by the value of a processed import). This assumes that the rest of the EU did not respond to the devaluation by imposing tariffs on Greek exports (why should other EU states tolerate rogue devaluers?) Greek corporates would probably not be able to borrow from banks outside of Greece, so reinvestment would depend on profitability.

But doesn't Argentina suggest that it can work?

Argentina devalued in 2002 and grew quickly over the following decade. So why can't Greece do the same? There are some key differences:

- 1) Argentina devalued in its own currency. It did not have to go through the process of changing into a new currency which is legally and technically incredibly complicated.
- 2) The devaluation destroyed a huge amount of wealth in Argentina. The subsequent growth rates reflect the fact that the devaluation basically trashed the economy and society.
- 3) Argentina devalued against the backdrop of a booming world economy. Strong demand for its commodity exports helped fuel growth. The second order effects from the devaluation were relatively limited: nobody went short Brazil because Argentina had devalued. This is not the case for the Eurozone.
- 4) However, as we have seen, the huge debts that it carried over in dollars have been a major strain on foreign reserves and one of the underlying causes of the current wave of nationalisations.
- 5) It is hard to measure, but there is a cost to devaluation in investor confidence. The default left a stain on Argentina's credibility. Argentina is hardly regarded as a model sovereign a decade on.

As bad as it is, surely it can't be worse than where we are currently headed?

Not if the above is correct. Unlike Argentina in 2002 Greece's devaluation is not simply Greece's business I would be ushering in a wider crisis. As strange as it sounds, there is a strong case that Greece should NOT BE PERMITTED TO LEAVE THE EURO (although no one can actually stop them obviously).

Saving Greece will be pretty expensive for the other Eurozone states, but through a combination of further debt write-downs, bank recaps (including the ECB) and transfers (including through above Eurozone wage inflation in Germany and internal devaluation in Greece) and IF the external environment improves, it is probably possible to pull Greece round. But the experience on the

ground in Greece is going to be horrific - a purge of an entire rent-seeking political class and a reconfiguring of the whole state after a period of terrible austerity.

The bottom line is that there is no easy option. There will have to be a Greek devaluation - internal or external - and it will hurt a lot either way. It is just that the external devaluation route would have massive systemic consequences and would leave a stain on Greece's investment environment that would be hard to erase.

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