# Greece Should Default and Abandon the Euro

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- Greece is insolvent, uncompetitive and stuck in an ever-deepening depression, exacerbated by harsh and excessive fiscal consolidation. It is time for the country to default in an orderly manner on its public debt, exit the eurozone (EZ) and return to the drachma to rapidly restore solvency, competitiveness and growth.

- Exit will require a conversion of euro liabilities into the new currency to limit the balance sheet effects that the depreciation of the new national currency will entail.

- Greece can exit the monetary union in an orderly and negotiated manner (i.e. limit the collateral damage to its own economy and financial markets that this exit would imply) if orderly mechanisms are used and appropriate official finance is provided. Such official finance to Greece and other EZ members under stress will limit the contagion and the losses for other periphery and core creditor countries, and will ensure that the domestic Greek financial system and economy does not suffer a chaotic implosion.

- Default and exit will be painful and costly, but the alternative of a decade-long deflation and depression would be much worse, economically, financially and socially.

- Moreover, there are historical precedents for countries successfully taking the route of an orderly default on unsustainable foreign liabilities and exit from unsustainable currency pegs and/or currency boards.

**Why a Default/Debt Reduction and an Exit from the EZ Are Necessary and Desirable**

Greece is now in a vicious circle of insolvency, lack of competitiveness and ever-deepening depression, exacerbated by draconian fiscal austerity that is making the recession much worse. Greece's public debt is heading toward a level of 200% of GDP in two years' time. And while fiscal austerity and structural reforms are necessary to restore medium-term debt sustainability and growth, in the short run they will lead to an even deeper recession, thus making the deficit and debt even more unsustainable. Indeed, the latest economic data suggest that the Greek recession is becoming a near depression, with GDP expected to fall by over 7% this year and with forward-looking indicators of economic activity (such as the PMI, which is at a level of 43) suggesting a deepening recession. Argentina in 1999-2001 fell into the same trap of deficit, austerity, deeper recession, depression, higher deficit, greater insolvency.

Thus, it is time for Greece to orderly restructure/default on its public debt, exit the EZ and return to the drachma to restore solvency, competitiveness and growth.

***Default/Debt Reduction***

First, the recent debt exchange deal negotiated to bail-in Greece's private creditors was an outright rip-off for the country: The net present value (NPV) debt reduction was formally only 21% when the country needs at least 50% debt relief, based on RGE's analysis of debt sustainability. And even that 21% headline is not a true measure of debt relief as a massive sweetener for creditors in the form of a Brady-style principal collateral guarantee will increase Greece's gross public debt by another €30 billion. So, doing the math right and considering a likely rather than optimistic exit yield, the true debt relief for Greece out of this deal is at best close to zero or, at worst, possibly an NPV increase in its debt burden.

Greece should put a halt to this unfair debt-exchange offer and, under threat of outright default, negotiate a better deal (with no credit sweeteners) that offers at least a 50% debt relief to the country. Going for the current deal now and hoping to negotiate something better in a second round is a much more difficult task: Given the full guarantee of the €100 billion principal via the collateral private sector creditors, the credit risk for private creditors would now be limited to the coupon payments, a paltry €5 billion per year. Then, further insolvency and the need for more debt relief for Greece would imply that the official sector (IMF, European Financial Stabilization Mechanism, European Financial Stability Facility and ECB), which is already bailed in via an effectively coercive maturity extension of its claims, would have to suffer a major and draconian haircut on its claims, thus becoming junior to private creditors. Thus, Greece should renegotiate a better deal—and one that keeps its debt under the domestic governing law, unlike the current debt exchange that transfers such governing law abroad—rather than accepting a lousy fake debt relief now. It would be better if the current debt exchange fails—with less than 90% of creditors accepting the offer—so that the country can target a fresh approach with greater debt relief, rather than going into a debt exchange where additional debt relief would have to come mostly from allegedly more senior official creditors, rather than formally more junior private creditors that end up being more senior. A formal default will not be necessary to achieve meaningful 50% debt relief; a credible threat of default if creditors don't accept an exchange offer at more favorable terms would be sufficient. Currently, many creditors of Greece are holding out even on the current most generous exchange offer because they hope they will be paid in full as the EU/ECB/IMF want to avoid, at any cost, a technical default. Only a credible threat not to be paid will bring recalcitrant creditors into line.

***Exit from the Eurozone***

Second, even if Greece were to be given significant relief on its public debt via an orderly but deep debt reduction under threat of default on its debt (i.e. a better debt exchange than the current one under a credible threat of default), the economy would not return to growth unless its competitiveness is rapidly restored. And, without a rapid return to growth, public and private debts would remain unsustainable while the social and political backlash against austerity and continued depression would come to a boil. There are only four options to restore competitiveness and growth, all requiring a real depreciation of the currency for Greece:

- First, a sharp nominal depreciation of the euro toward parity with the U.S. would lead to real depreciation; this outcome is unlikely to occur as the U.S. economy is weak, thus exerting downward pressure on the U.S. dollar, while within the EZ Germany is still uber-competitive;

- Second, a rapid reduction in unit labor costs via the acceleration of structural reforms and corporate restructuring, leading to a rapid increase in productivity growth above wage growth (the German solution); this option is also quite unlikely as it took almost 15 years for Germany to reduce its unit labor costs and restore its competitiveness via that process;

- Third, a rapid five-year cumulative 30% deflation in prices and wages—about 5% per year for five years—(also referred to as the "internal devaluation" solution) would imply an equivalent real depreciation; this path to a real depreciation is unlikely to be feasible as it would be associated with another (socially unacceptable) five years of ever-deepening recession/depression; also, even if feasible, such deflation would make the country undertaking it more insolvent, given a 30% increase in the real value of its debts. Argentina tried the deflation route to a real depreciation and, after three years of an ever-deepening recession/depression, it gave up and decided to default and move off the currency board peg with the U.S. dollar;

- Thus, if the first three options cannot restore competitiveness, the only other option left is the exit of Greece from the monetary union. Only a return to a national currency and a sharp depreciation of that currency would quickly restore competitiveness and growth, as it did in Argentina, which rapidly moved from a current account deficit to a surplus and from depression to high growth. The trade losses for the EZ core that a return to a national currency in Greece would entail would be extremely modest as the total GDP of Greece is barely 2% of the EZ total, while its trade with Germany and the rest of the EZ represents an even smaller share of GDP. Conversely, in short order, Greece could restore its competitiveness, turn its current account deficit into a surplus and start growing rapidly again.

Take the example of Argentina: Until December 2001, GDP was free falling, dropping by an annualized rate of 20%; three months later, in March 2002, after a default and move from a currency board to floating rate, the economy started to grow at an annual rate of 8%, and has grown at very rapid rates for a decade since. The usual argument that Greece doesn't have much of a competitive advantage is as inane for Greece as it was for Argentina; then, it was argued that Argentina, with exports representing barely 10% of GDP, could never compete, even if it had a weaker currency; but that argument was proven to be utterly wrong when Argentine exports boomed following the depreciation. Greece, with a much larger share of trade in GDP than Argentina, could see its trade balance turn around dramatically following a sharp depreciation—and thus support strong GDP growth via net exports—even if domestic demand remains weak in the context of the collateral damage of default and exit from the monetary union.

**Real GDP and Wealth in Greece Will Fall Sharply, Regardless of Whether Greece Exits the EZ or Not; But Higher Over Time in the Exit Scenario Compared With the Alternative of Depressive Deflation**

***The Effect of an Exit on GDP***

Some argue that exit from the EZ would be a disaster for Greece as the ensuing nominal and real depreciation of its currency would sharply reduce the real value—in euros—of its output and wealth. These arguments are flawed in a number of ways. First, if Greece has to be stuck with falling GDP for another five or 10 years in an ever-deepening recession and depression, it is better that it is able to grow rapidly, even from a lower level of GDP, than being stuck in a depressive trap of ever-deepening recession and rising unemployment.

Second, Greece's real GDP in euro terms will fall over time by about 30%, regardless of whether it exits the EZ or not. Since the currency is overvalued in real terms by at least 30% (the increase in Greek unit labor costs that has occurred over the past decade while wages were growing more than productivity), even the supporters of pain and austerity for Greece fully agree that such real depreciation is necessary to restore competitiveness, although they argue that such real depreciation should occur via "internal devaluation"—i.e. a cumulative fall of 30% in Greek wages and prices over a period of a few years—rather than through exit and the nominal depreciation of a new currency. But if such internal devaluation were to occur over time, Greece's real GDP—or its purchasing power over the goods and services of other EZ members—would fall over time by 30%. So, even if Greece sticks with the euro, its true (terms-of-trade-corrected) real GDP will be lower over time by 30%; that is the sense of the argument (which all agree on) that Greece needs real depreciation to restore competitiveness and growth.

Thus, the only issue here is not whether Greece's real GDP (in terms of purchasing power over foreign goods) will be lower by 30%, as that outcome is sealed either way; rather, the issue is whether that result should be achieved over five or 10 years via an ever-deepening recession and depression triggered by massive deflation; or whether it should be achieved overnight via exit from the euro. The latter option—exit—has the benefit that economic growth and employment growth will resume right away; the former option—depressive deflation—will lead to another five-to-10 years of socially and politically destabilizing recession, depression and a sharp rise in joblessness. So, since the eventual outcome—lower PPP-based GDP—is the same, a path that restores growth, jobs and incomes in the short run is vastly preferable to another decade of depression that will eventually lead to massive social and political instability.

Resuming growth right away is far preferable to many more years of misery, austerity, rising poverty, falling output and jobs and much higher unemployment rate. And while the exit will lead to an immediate fall in the real PPP value of Greek GDP, the substitution from foreign to domestically produced goods will dampen the impact on true real income and purchasing power that such a devaluation would entail.

Also, although in the short run of the exit scenario, the nominal exchange rate may fall by more than 30% (it will certainly overshoot) and thus reduce (in the short run) Greece's GDP in euros by more than 30%, over time inflation will return that above 30% nominal depreciation into a 30% real depreciation; so the bigger fall in euro GDP will only be temporary and the final outcome for real GDP will be the same. Also, note that a short-term overshooting of the

exchange rate will lead to a stronger recovery of net exports and growth; thus, overshooting can work both ways, with additional costs as well as benefits.

***The Effect of an Exit on Wealth***

The same logic applies to the argument that the exit of Greece from the EZ will suddenly reduce the real value of the euro-denominated wealth of Greece's residents. That is as flawed as the previous argument about the effect of an exit on the value of Greece's real GDP in euros. If Greece does not exit the EZ, the slow and depressive deflation that is needed to achieve a restoration of competitiveness will reduce the real euro value of the purchasing power of Greek euro-denominated assets over foreign goods and assets. Assets in the non-tradable sectors of Greece—such as real estate, whose claims can be traded internationally, but that provides non-traded housing services—would be 30% lower in euro value after the deflation has occurred; and the real value of Greek traded assets—firms in the import-competing and export sectors—would also be 30% lower if a 30% fall in the prices of their goods is necessary to restore their competitiveness. So, Greece will be—wealth-wise—30% poorer regardless of whether the necessary real depreciation occurs via deflation or via exit and nominal depreciation. Again, the end-game result for wealth is exactly the same.

So, it is wrong to argue—as many do—that an EZ exit and the conversion of euro assets into drachma ones will sharply depreciate the real euro value of such assets and wealth. That reduction in their real euro value of wealth will occur even if exit doesn't take place and a painful deflation does the dirty job. At least in the case of exit Greece can reduce the negative impact on its foreign net worth (assets minus liabilities) via a conversion of euro liabilities into drachma liabilities. Such a capital levy on Greece's foreign creditors—given the unsustainability of Greek public and private debts—makes Greece better off (wealth-wise) in the exit scenario than in the no exit and deflation scenario. So, Greece is, at worst, as well off (or as worse off) in the exit scenario compared with the deflation scenario; or, more likely after debt reduction, it would be better off under the exit scenario.

In summary, the arguments that Greece's real GDP and wealth will be much worse in the exit scenario than the deflation scenario are utterly flawed. Quite the reverse is true: By restoring growth right away, rather than being stuck in a decade-long depression, Greece's real income and wealth is eventually higher in the exit scenario.

**Why Conversion of Euro Debts Into the New National Currency ("Drachmatization") Is Necessary, Post-Exit**

The most significant losses that a Greek exit from the EZ would entail are the capital losses for core EZ financial institutions resulting from the balance sheet effects of a return to a national currency: Overnight, the foreign liabilities in euros of Greece's government, banks, corporate firms and households would surge by a percentage amount equal to the rate, first, of the nominal and, over time, the real depreciation of the new national currency. For example, following a 50% depreciation of the new drachma relative to the euro, Greek public debt would go from the current 160% of GDP to 240% of GDP; ditto for the private sector's foreign liabilities. Then, there would be only two options available to deal with such unsustainable balance sheet effects: Either a coercive conversion of such liabilities from euros into the new

national currency at an exchange rate different from the new floating rate of the national currency; or, a default on and then a negotiated reduction of such euro-denominated debts.

The first option would be legal for liabilities issued in the domestic jurisdiction (where the Greek law governs claims)—that is, most of the assets and liabilities in the economy. For example, both assets and liabilities of the banks would be converted from euros into drachmas. The second option would be available for liabilities incurred cross-border and where the governing law is foreign. This is what Argentina did in 2001 when it moved off its currency board—a "pesification" of its dollar debts—and this is what the U.S. did in 1993 when it depreciated the dollar by 69% and repealed the gold clause. A similar unilateral "drachmatization" of euro debts would become necessary and unavoidable; and even conceptually, once Greece goes back to the drachma, a conversion of all assets and liabilities into the new national currency would be logical: The drachma would become the new unit of account, means of payment and store of value for assets.

Then, losses that core EZ banks and investors would suffer from such a capital levy on their euro claims on the Greek government, banks and corporate firms could be large, but manageable if core EZ financial institutions are properly and aggressively recapitalized and proper forbearance is used to spread their losses over time. Also, an orderly case-by-case negotiated reduction of euro debts issued in a foreign legislation (say Frankfurt or Paris) by Greek agents would be manageable as the number of banks and corporates with such liabilities is modest.

Avoiding a banking system implosion after an EZ exit would entail, unfortunately, the imposition of Argentine-style measures—such as bank holidays (deposit freeze) and capital controls—to prevent disorderly fallout; realistically, lots of collateral damage would occur, but this could be managed and limited. Banks could be recapitalized by the government through the issuance of recapitalization bonds; while this recapitalization would initially increase public debt, the reduction in public debt from a significant default would give some fiscal margin to achieve such recapitalization.

**How to Minimize Contagion to the Rest of the EZ (Both Periphery and Core)**

The other type of collateral damage from a Greek default and EZ exit would be potential contagion to the rest of the EZ periphery: Portugal, Ireland, Italy and Spain. Investors will ask: Who is next in line for default and exit? This is a serious risk, but there are ways to manage it:

- First, it is not obvious that all EZ periphery members are illiquid but solvent given fiscal austerity and reforms: For some—Portugal and Ireland, in particular—a restructuring of their public debt will be necessary at some point, regardless of whether Greece defaults and/or exits the EZ;

- Second, some EZ periphery members have the same competitiveness problem as that of Greece; so, for example, Portugal may also eventually have to follow the path of Greece and exit the EZ;

- Third, illiquid but solvent (given austerity and reforms) economies such as Italy and Spain (assuming, and this is a big assumption, that they are solvent conditional on

adjustment) should receive lender-of-last-resort support—LOLR—(either from the ECB or a tripled EFSF or E-bonds) regardless of whether Greece defaults/exits; indeed, a self-fulfilling run on Italy and Spain's public debt at this point is almost certain in the absence of such LOLR. Thus, Italy and Spain will be either rescued and swim via a large enough LOLR, or they will sink regardless of what Greece does;

- Fourth, as the collateral damage to Greece of default and exit will be significant, other EZ economies in crisis will have a chance to see and decide for themselves whether they want to follow Greece with all the benefits as well as the substantial costs that this entails; or whether they want to differentiate themselves and remain in the monetary union via appropriate policy changes and reforms. For example, unlike what many opponents of debt restructuring feared, Greece's decision to have an orderly debt exchange of its public debt did not lead to other EZ members—such as Ireland—asking for debt relief in a "me too, me too" contagion effect. If anything, so far, Ireland has been trying to implement policies that would differentiate itself—in terms of sovereign risk—from Greece;

- Fifth, the substantial official resources currently wasted to bailout Greece's private creditors could be used to ring-fence the illiquid but solvent countries elsewhere in the periphery: More money would be available to support sovereigns and to recapitalize undercapitalized EZ banks;

- Sixth, regardless of whether Greece defaults/exits, EZ banks should be rapidly recapitalized via an EU-wide TARP-style program as markets and investors don't believe the EU's fudged estimates—through two rounds of phony stress tests—of the capital needs of EZ banks. So, a Greek default/exit should be the catalyst for a much-needed TARP program.

***Collateral Damage and Contagion Can Also Be Reduced if Default/Exit Is Orderly/Negotiated***

The collateral damage to Greece and to the rest of the EZ could also be reduced if, instead of a disorderly default and exit from the EZ, the whole process is negotiated and becomes orderly. So long as the process is negotiated and orderly, the official sector may still want to provide some financing to Greece to reduce the collateral damage both for Greece and the rest of the EZ.

For example, Greece should <u>not</u> formally default on its public debt; rather, it should stop the current unfair exchange offer and renegotiate a new one—under threat of default—that gives the country true debt relief (of the order of 50% of GDP) without any sweeteners for creditors, such as the Brady-style collateral guarantee of principal. Avoiding a technical default and achieving meaningful debt relief via a more generous exchange offer is the way to contain the cost of a disorderly formal default. Similarly, the exit should be negotiated in an orderly manner with the rest of the EZ: Agreement should be reached about the exchange rate—in new drachmas—at which cross-border euro debts of Greece's government, banks and corporate should be converted into drachmas. Even the exchange rate at which local law assets and liabilities in euros are converted into new drachmas could be discussed and managed to avoid the overshooting of the exchange rate.

***Collateral Damage to Greece Can Also Be Reduced if Default/Exit Is Managed With Some Official Resources to Prevent Overshooting and Financial Meltdown***

One of the big mistakes of the official sector approach to Argentina must be avoided in the case of Greece. The IMF was very generous with Argentina for years to prevent an unavoidable default and devaluation; but once that default and devaluation eventually occurred, it fully pulled the plug and provided none of the financial support that was necessary to manage the collateral damage of those unavoidable decisions. As a consequence, Argentina suffered a massive overshooting of its exchange rate, a huge temporary increase in its inflation rate and major financial sector disruption and near meltdown. There is a risk the same mistakes will be made now, first wasting hundreds of billions of euros to bailout private creditors and trying to prevent Greece's unavoidable default and exit; and then providing no support afterwards, ensuring a disorderly outcome and massive contagion to the rest of the EZ periphery.

The right approach would instead be to immediately stop the current bailout program, which only benefits the exit of Greece's private creditors, and negotiate an orderly debt reduction and orderly EZ exit, while providing some modest but generous official support to Greece to prevent a disorderly financial meltdown once the orderly debt reduction/EZ exit occurs. For example, in Argentina, the nominal exchange went from parity with the U.S. dollar to 3:1, once the move to floating rates occurred, in an obvious overshooting of the nominal exchange rates, as the Argentine peso was overvalued only by 30% or so, not by 200%. Then, the ensuing high inflation eventually returned the real exchange rate to its appropriate equilibrium value. In Greece, the degree of overvaluation of the real exchange rate is probably in the 30% range; so, official resources should be used to minimize the degree of nominal exchange rate overshooting that will obviously occur once the exit takes place. Also, official resources could be used to finance the primary deficit that Greece will still have once the default does occur.

Without such official resources (to be provided in exchange for a credible plan to achieve, over time, a primary balance and then surplus), Greece would be forced to monetize its deficit once it has lost domestic and foreign market access, leading to high inflation. That inflationary burst could be contained if official loans are available to finance a shrinking primary deficit. Official resources could also be used to recapitalize Greek banks; creditors in the core EZ would then benefit from having an equity position in Greek banks as the result of such support. So, the basic qualitative parameters of the current EU-IMF program for Greece—support of the sovereign and resources to recap the banks—could be maintained, but the overall size of the program would be much smaller as the expensive free exit of Greece's foreign creditors would be completely stopped. The key to reduce the collateral damage to Greece and the EZ is to make the default/exit process orderly and negotiated. Breaking up is hard to do, but the damage from the break-up can be minimized.

**Further Risks of Exit/Default to Greece, Both Real and Imagined**

***Risks of High Inflation or Hyperinflation in Greece Post-Default/Exit Are Vastly Exaggerated and Can Be Contained With Sound Fiscal Policies and Official Support***

The risk that a Greek default and EZ exit will lead to high inflation or even hyperinflation in Greece is also vastly exaggerated. The same claims were made about Argentina when it defaulted and moved to a floating rate. But, even in a country like Argentina, with a long history of inflation and hyperinflation, the move to a float did not lead to hyperinflation as some scaremongers had wrongly predicted; inflation spiked for a year after the exchange rate overshot its fundamental value, but then it rapidly returned to low double digits. The way to prevent Greece from experiencing high inflation after an exit from the euro is for that exit to be orderly, to put in place official resources to prevent the overshooting of the nominal exchange rate and to provide some non-monetary financing of the remaining primary deficit. As the experience of Argentina shows, even in the absence of such official resources, inflation—after a first-year burst—can be contained at modest levels as the default and exit leads to growth and to greater fiscal discipline, given the binding constraints of limited domestic and external bond financing. And experience suggests that floating exchange rates provide greater fiscal market discipline than fixed rates or monetary unions as, under flexible exchange rates, policy slippages automatically lead to upward pressure on interest rates and downward pressure on the currency value. Joining the monetary union had disastrous effects on the incentives for fiscal discipline in Greece.

It should also be clearly stressed that default and exit are not a substitute for painful fiscal austerity and needed structural reforms. The problems of Greece were self-inflicted with over a decade of fiscal laxity and structural rigidities. Over time, only austerity and reforms will lead to sustainable productivity growth and success. But as such policies are depressionary in the short run, and as even draconian fiscal austerity cannot reverse an unsustainable debt burden, an orderly significant debt reduction and exit from the EZ are necessary to jump start competitiveness and growth and restore solvency.

***Tail Risks of a Default and Exit***

We don't want to minimize the risks of default/exit for Greece. In Argentina, the economy turned from a free-fall depression—with GDP falling at an annual rate of almost 20% at the end of 2001—to positive 8% GDP growth by early 2002 after default and exit from the currency board. But the transition was very ugly and costly: Riots and blood in the streets and dozens of deaths; massive social and political instability and five different presidents in one year; a deposit freeze in the banking system; capital controls; asymmetric pesification and the need to recapitalize insolvent banks; the loss of external market access; a sharp short-term rise in poverty and unemployment (before high growth rapidly cut both); inward-looking economic policies and political economy; the retardation of economic reforms; a sharp fall in inward FDI; and an overall change in economic policies toward long-term populism and policy mismanagement. So, breaking up is hard and costly to do and every country considering it should be fully aware of the risks of such collateral damage. And if a society finds such costs unbearable it should stick to the policy sacrifices necessary to avoid that painful break-up.

But we should also be aware of the important caveats to the costs and risks of breaking up. First, the resumption of rapid growth was better than a decade of depression. And, second, a decade-long depression was not a real alternative, as the same social and political instability and financial collateral damage would have occurred if the path of depressionary deflation had been pursued. So, the relevant comparison to make is to ask the question: Which social, political, economic and financial disaster would Argentina have faced if it had followed a

policy of deflation and depression? Most likely, the result would have been a 1930s-style depression that would have resulted in the same social and political instability and unrest—or most likely, worse—than that which resulted from the default and exit from the currency board.

Third, things became disorderly in Argentina because the default and exit was disorderly and, after the crash, the official sector—ever too generous to bailout private creditors before the crash—decided to fully pull the plug on Argentina and provide no further official financing. To limit the collateral damage to Greece and the EZ contagion of a Greek default and exit, such a transition should be orderly and negotiated, and official resources should be generously provided to Greece; not to finance—like now—the exit of private creditors, but rather to contain the fallout and collateral damage of a difficult orderly debt reduction and EZ exit.

As the recent example of Iceland (which is now starting to grow robustly after its severe crisis) suggests, defaulting in an orderly manner on unsustainable foreign liabilities (in Iceland's case, those of the private financial sector) and experiencing a sharp nominal and real depreciation is the path to resuming growth and jobs, even after a very painful financial crisis.

Similarly, in all the successful resolutions of dozens of emerging market (EM) crises in the past 15 years, the return to competitiveness and growth was rapid—V-shaped recoveries from crises to high growth in a matter of 12 months. This is because, in addition to fiscal austerity and structural reforms, these countries received generous official financing from the IMF and World Bank, performed orderly restructurings of their private and public external debts when they were unsustainable and moved from unsustainable overvalued fixed exchange rates (or currency boards) to floating exchange rates that rapidly restored competitiveness and growth. The lesson of the past is that debt reductions and exits from unsustainable exchange rate regimes do not have to be as disorderly and painful as the extreme case of Argentina. Iceland and a dozen episodes in EMs point to a more orderly and less costly path to growth and competitiveness, which Greece should follow.

**Conclusion: A Break-Up Is Painful and Costly, but a Rotten Marriage Is Worse: A Plea for an Orderly Divorce**

Some private sector analysts have recently estimated that the cost of exit from the EZ could be as high as 40-50% of GDP for the exiting countries (such as Greece). Such estimates appear to be vastly exaggerated and based on utterly flawed assumptions; losses could be much smaller if the process is orderly, if official support is maintained, if debts are converted in an orderly manner into the new local currency and if sharp currency depreciation rapidly restores economic growth. The alternative—a decade of depressive deflation— would be much worse for Greece. In conclusion, first Greece and then other EZ periphery members may need to exit monetary union and can do so in an orderly and negotiated fashion—i.e. limiting the collateral damage that this would imply—if mechanisms are implemented and appropriate official finance is provided to limit the contagion and the losses for the other periphery and core creditor countries, and to ensure that the Greek domestic financial system and economy does not implode in a disorderly fashion.

Like a broken marriage that requires a break-up, it is better to have rules—divorce laws—that make separation orderly and less costly to both sides. Breaking up and divorcing is painful and costly even when such rules exist. But being stuck in a marriage of convenience that is not working any longer is more costly and painful for the couple and their offspring (children/future generations) than an orderly and civilized break-up. Once the pain and costs of the break-up are managed, both sides can look forward to a more friendly relationship and a brighter future.