Europe's Economic Crisis is not a Euro Crisis

The funny thing about the 'euro crisis' is that it is not a euro crisis. The currency itself is meandering along serving as a unit of account and means of payment.

Instead, we have a crisis of insolvency, first among certain profligate governments and second among banks. This has nothing to do with the euro itself.

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What should be simple debt workout matter is in danger of spinning into a genuine catastrophe

Greece has about the same population as Los Angeles. If the government of Los Angeles defaulted on its debt, does that mean that Los Angeles must leave the 'dollar zone' and issue a new Los Angeles peso? The issues facing the Greek government are not really any different from those facing millions of US homeowners who borrowed more than they should have. Hard decisions must be made. But nobody suggests that those foreclosed homeowners need their own personal currency.

The other strange idea out there is that these various insolvency problems require some sort of aggressive federalization, the creation of European super state. The rationale behind this argument seems to be that the super-statists want some kind of central body of such immense stature that it can bail out the entire continent. The reasoning behind that, lenders should never take an honest loss when the losses can be foisted on the innocent taxpayer instead.

The other insolvents in our drama are the banks themselves. They are busy promoting the line that any bank losses need to be made up via a taxpayer-funded recapitalization, usually on terrible terms that amount to little more than theft.

A more sensible and fair approach would be a debt for equity swap. In the simplest terms, a typical bank will have 1000 Euros of assets in the form of loans, 900 Euros of liabilities in the form of borrowed money and 100 Euros of equity. After a series of losses the bank's assets are worth 800 Euros, but the 900 Euros of liabilities remain.

At this point, 300 Euros of bonds could be converted t equity. This would leave the baks with 800 Euros of assets, 600 Euros of borrowings and 200 Euros of equity, thus returning the bank to a state of health without the need for taxpayer funds. A huge equity cushion remains for any future losses.

Do banks know this? Of course.

They employ hundreds of sophisticated securities analysts. JPMorgan Chase's takeover of Washington Mutual in 2008 was done under similar conditions. The unsecured debt was eliminated, thus recapitalizing the bank. WaMu's bank operations continued, quickly rebranded as Chase. We can only wonder why this option is not being more fully discussed across the pond.

The basic problem with the euro project is that it is in the hands of incompetents who seem to have no idea what to do when a borrower can't make the payments. The rules of capitalism on that score are clear: If the borrower is no longer able to borrow, the lender takes a loss. Both can learn from their errors and avoid them in future.

Unfortunately, what should be a simple debt workout matter is in danger of spinning into a genuine catastrophe.

The idea, repeated so often, that the euro zone needs to either break up into multiple currencies or form some sort of super state has no basis in reality.

Europe's problems are eminently solvable. However, given the very poor quality of leadership on the continent today, lots of unpleasant things that doesn't have to happen might indeed anyway. Europe has no one to blame but itself.