The Road To Grexit

Frances Coppola, *Forbes*, July 3, 2015

Ever since the Greek government called a referendum on the June 25th proposal from the Eurogroup, the Troika and representatives of other EU governments have insisted that the referendum is a vote on whether or not Greece stays in the Euro. Despite Greek objections, the media has generally echoed their view. Here, for example, is the BBC's Robert Peston in a very good blogpost explaining why a No vote in the referendum could mean Grexit:

So whether the Greek government likes it or not, and apparently it doesn't, the President of the European Commission, Jean-Claude Juncker has said that Sunday's referendum is a vote on whether Greece will stay in the euro…..

A no vote would presumably see Greek banks subject to economy-crushingrestrictions on cash withdrawals and international transfers for the indefinite future.

Greece would be careering towards the euro door marked exit, even though such a door was never supposed to exist, let alone be opened.

Robert Peston goes on to explain why this would be terrible for the whole Eurozone, not just for Greece. I have covered similar ground previously.

But what does Grexit actually mean? Most commentary on this quickly gets bogged down in whether or not there is any legal means for Greece to leave the monetary union. The legal position is actually unclear, since leaving the Euro was never intended to be a possibility. But the consensus appears to be as follows:

1. Greece cannot be ejected from the Euro by a coalition of the other Eurozone member states

2. Greece cannot be ejected from the Euro by Eurozone institutions

3. Greece cannot choose to leave the Euro while remaining within the EU (though this is disputed)

4. Greece can choose to leave the EU, which would of course mean relinquishing Euro membership

5. If Greece were to leave the EU, it could still continue to use the Euro, just as Panama uses the US dollar. The EU cannot prevent this.

Furthermore, sovereign default does not imply Euro or EU exit. The two are quite separate. Greece can default while remaining legally a member of the Euro – though there would be economic and political consequences.

So on the face of it, all this talk of Grexit appears to be so much hot air. But as usual with anything involving the Eurozone, it is not so simple.

Point 5 is key. Any country can use the Euro as its currency, whether or not it is a member of the Euro. And some do: Montenegro, for example, and Kosovo are both Euro users though they are very far from being accepted into the EU, let alone becoming Euro members. So what distinguishes a Euro member from a Euro user?

Normally, the distinction between a sovereign currency issuer and the (foreign) user of a currency is that the sovereign currency issuer has complete control of the money supply, whereas the user must earn, borrow or buy its currency from external sources. But Greece cannot be considered a sovereign currency issuer. Its central bank can only issue the amount of Euros that the ECB allows it to. That amount has just been frozen by the ECB. Greece must now borrow, buy or earn additional Euros from external sources. That is what currency users have to do, not currency issuers. So Greece has no control of its money supply. It is as if it were using a foreign currency as its domestic currency.

Bloomberg reports that Bulgaria, which is not a Euro member but backs its currency with Euro reserves, has just been allowed to borrow from the ECB at the same rate as Euro members, thus enabling it to firewall its banks from Greek contagion. This is a privilege normally only accorded to Euro members – and it has been WITHDRAWN from Greece. If this is true, then Bulgaria (non-Euro member) can obtain Euros from the ECB while Greece (Euro member) cannot. It is hard to see what benefit Greece's Euro membership confers, apart from redistribution of seigniorage receipts.

Really, Greece is a "dollarized" (or "Euroized") economy whose fiscal and trade position is so dire that it is not able to borrow, buy or earn the currency that it needs. It has a foreign exchange crisis.

Greece has imposed draconian measures to preserve its Euro reserves. It has closed its banks indefinitely and limited cash withdrawals from ATMs by Greek residents. And it has introduced capital controls: money is only allowed into Greece, not out of it. This is partial suspension of Greece's use of the Target2 settlement system. Deposit flight has stopped, but so have payments for imports. The benefit of this is of course that there will now be a sharp correction to Greece's trade balance. But this is far outweighed by the disastrous consequences for the economy of such a drastic tightening of monetary policy.

Two things should by now be apparent. Firstly, that the Euro is not in any sense "Greece's" currency. And secondly, that this is true of all Euro members, not just Greece. None of the Euro members are sovereign currency issuers. All of them are using a foreign currency. But if none of them are sovereign currency issuers, who is the issuer of the Euro?

The issuer of the Euro is, of course, the ECB. It decides how much money each of the member states can have. This is not unique to Greece: money creation in all the member states is limited by the ECB. So we have supposedly sovereign states allowing their money supply to be determined by an unelected supranational body that is above the law and accountable to nobody. And that body can freeze or withdraw money from member states' banks at any time and for any reason.

For the central bank of a currency union to deliberately restrict the money supply in regions within the currency union is bizarre. No other currency union central bank on earth does this. It would, for example, be unthinkable for the Bank of England to deny liquidity to Scotland's banks. But the ECB has denied liquidity to Greece's banks, not because they are insolvent (which is a reasonable reason to deny liquidity to banks) but because the sovereign won't toe the fiscal line. It has taken on a political role that it should not have.

Of course, the ECB's shareholders are the member state governments. But those governments have bound themselves by laws and treaties that prevent them interfering with or in any way controlling the ECB. So the Eurozone is in reality a financial dictatorship run by bankers. I struggle to see why anyone would voluntarily join it, let alone want to stay in it. But that's democracy for you.

Grexit is a process, not an event. And it is a process that has already begun. Greece's membership of the Eurozone was partially suspended when the ECB capped ELA. Whether that suspension becomes permanent depends on the response of the ECB to forthcoming events.

If the ECB responds to a No vote in the referendum by increasing collateral haircuts for bank funding – in effect making cash margin calls on Greece's banks – Greece's money supply will dwindle still further and its banks may fail altogether, leaving it with little choice but to introduce a parallel currency. Greece may remain a Euro member in name, but using the Euro as its domestic currency may become impossible. Grexit, de facto if not de jure.

Greece's Euro reserves would then slowly dry up, making it impossible to purchase essential imports such as oil. Redenominating deposits and bonds in the parallel currency would help preserve reserves, though that would be yet another step down the Grexit road. So would outright default. Why pay out scarce Euros to the very creditors who have made them scarce?

As Greece's foreign exchange crisis intensified, mortgaging ports to China in return for US dollars, and hosting military bases for Russia, would suddenly make complete sense. Faced with a serious shortage of hard currency, it would be hard to blame Greece for looking east. No wonder the US is increasingly worried about the Eurozone's handling of the Greek crisis.