How likely are capital controls in Greece?

Raoul Ruparel, *Open Europe*, 18 March 2015

Eurogroup sends Greece a warning message

In an interview with Dutch BNR Nieuwsradio yesterday, Eurogroup Chairman Jeroen Dijsselbloem said:

It's been explored what should happen if a country gets into deep trouble. That doesn't immediately have to be an exit scenario…[In Cyprus] we had to take radical measures, banks were closed for a while and capital flows within and out of the country were tied to all kinds of conditions, but you can think of all kinds of scenarios.

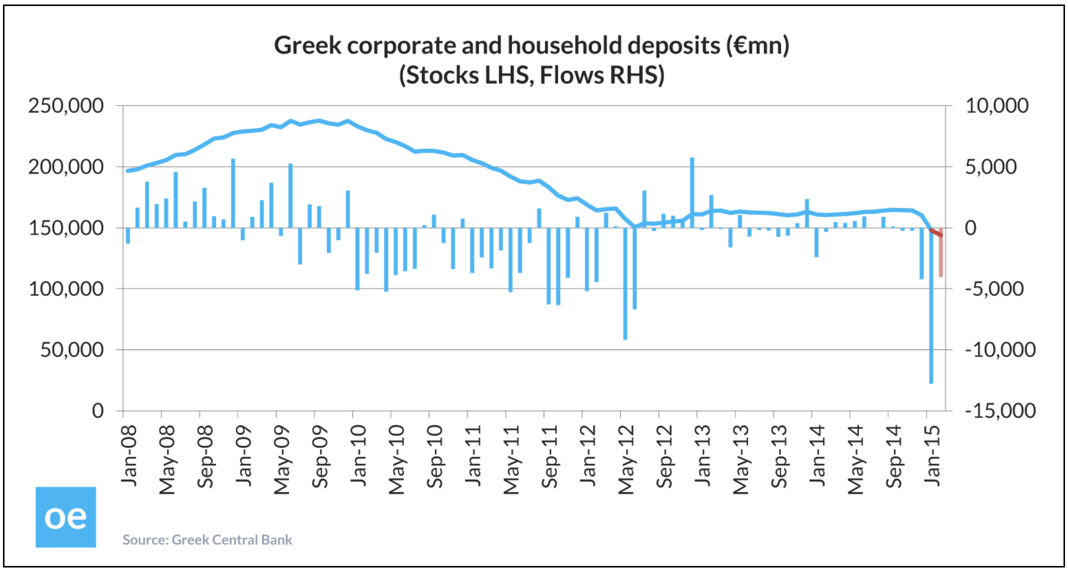
Despite some slips earlier in his tenure, notably around Cyprus, Dijsselbloem is a fairly shrewd operator and has become very deliberate in his language. Given the recent news flow around the lack of progress on the ground in Athens and the lack of cooperation with the 'institutions' (European Commission, IMF and ECB), it seems likely that he was using the opportunity to send Greece a veiled message. It is also a similar message to the one the ECB has been sending to Greece with regard to its limit on the Emergency Liquidity Assistance (ELA) – namely that it needs to get its act together and start enforcing the February extension agreement, or things could spiral out of control.

Dijsselbloem's comments did not go down well in Athens. Greek government spokesman Gabriel Sakellaridis told Bloomberg:

It would be useful for everyone for Mr Dijsselbloem to respect his institutional role in the Eurozone…We don't easily understand the reasons that drove him to make statements that don't fit the role he's been entrusted with. All the rest are fantasy scenarios. Needless to say, Greece won't be blackmailed.

What is the logic behind capital controls in Greece?

The logic is fairly simple. If the situation worsens again, as now looks possible, Greece could once again see an increased level of deposit flight, and potentially even a bank run. As the graph below shows, in January the uncertainty led to the largest outflows of deposits since the crisis started. In such a situation, capital controls could help stop the deposit outflow and stabilize the banking system. By stabilizing the banking system, the risk of a serious downturn in the economy is somewhat reduced.



Under what scenario might capital controls be needed or used?

Technically, capital controls should never really be needed in the Eurozone due to the nature of the Eurosystem. In theory, banks can continue to tap ELA emergency funding as long as they have some viable collateral (for which the standards are very low). Even if the money is flowing out of Greece to other countries in the Eurozone, the Target 2 system simply accrues liabilities to the Eurosystem. This liability rises on the Greek Central Bank's balance sheet to replace any deposits lost from the system. As such, deposit flight should not directly lead to a funding crunch for the banking system. This is what has been happening so far, as the chart below shows.

But as we have seen, things can shift in the Eurozone crisis for a number of reasons. So, in what scenario could capital controls emerge?

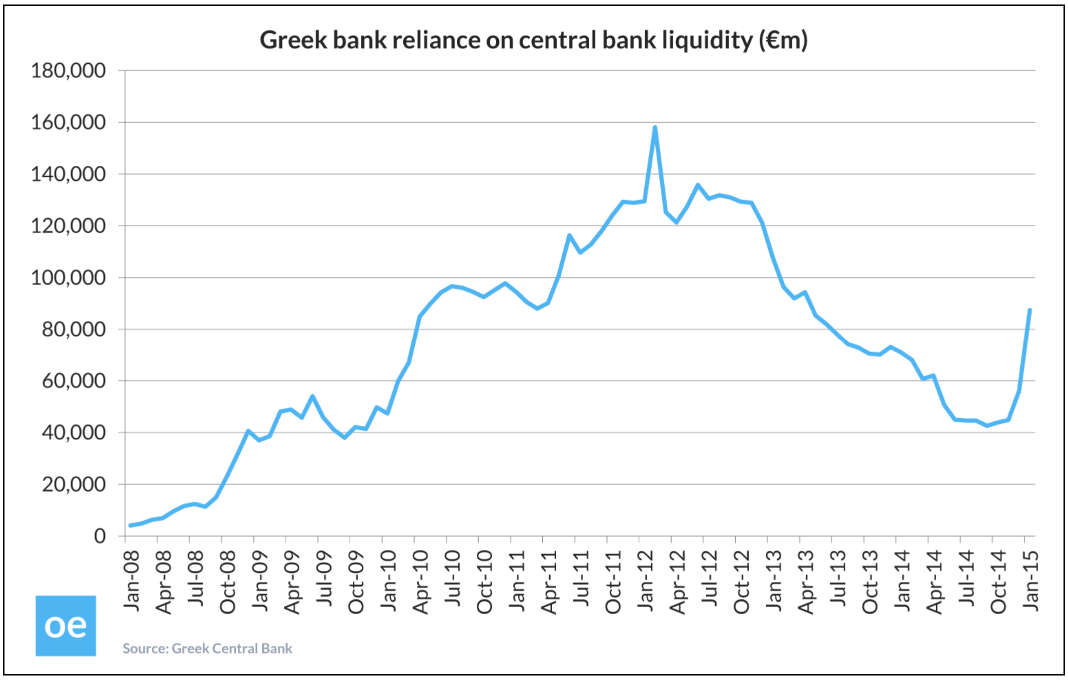
- **The ECB refuses to raise the limit on ELA** – There is currently a €69.4bn limit on the level of ELA borrowing allowed to Greek banks. If the deposit outflows restart at a significant pace and this limit is not raised, then Greek banks will not be able to replace the lost deposits with funding from the Greek Central Bank via the ELA. This would lead to a funding crunch and possible to them not being able to fulfil their obligations.

- This is not an impossible scenario. The ECB has only raised the ceiling incrementally, often by less than requested by Greece. The latest increase, on 12 March, was only by €600m. The ECB has also demonstrated throughout the crises in Greece and Cyprus a willingness to restrict ELA if needed.

- The ECB has taken on a broader role as the Eurozone's single banking supervisor – meaning that it pays more attention to concerns about the solvency of Greek banks. As I discussed in detail on my Forbes blog, it has some strong reasons for believing that Greek banks may not be as solvent as suggested, not least because they are so closely tied to the Greek state. Let's not forget the Greek Finance Minister Yanis Varoufakis has repeatedly declared the Greek state "bankrupt". If that is true, it is hard to see Greek banks as solvent.

- While the decision on capital controls would be down to Greece, there is a point where Eurozone partners may actually support their use. At some point, if they believe exit is looking likely, allowing the ELA and Target 2 effect explained above to continue would simply be increasingly their exposure to Greece and therefore their losses in the case of Grexit.

- Nevertheless, this is a worst-case scenario and capital controls would likely be a last resort. Even if capital controls were imposed, if the ELA ceiling were not increased, then the banking system would not be stable for long. Even domestic withdrawals/bank runs could bring it down. In actual fact, the capital controls would need to be combined with an extended bank holiday. But this can really only be done for a short time before the whole economy struggles to function. As such, capital controls would only buy Greece a few days or weeks max.



Greece and Cyprus are in different situations

One important point to note is that Greece is in quite a different situation to Cyprus when it imposed capital controls despite some superficial similarities.

- **Cyprus was focused on deposit write down** – The main motivation for the capital controls in Cyprus was to allow for the restructuring of the banking sector, which involved depositors taking losses. These controls, along with bank holidays, were needed to stop depositors withdrawing funds or avoiding the write down. The situation in Greece is somewhat different. The controls would be used to ensure the basic solvency of the economy.

- **Capital controls would not solve Greece's problems** – Linked to the above, in Cyprus the controls helped to maintain the funding of the banking sector and along with the bailout helped to finance the country. However, Greece is now running fatally short of cash and shows little sign of securing any new cash injections from the Eurozone. Therefore, even if capital controls were imposed, it seems that the Greek government would still seriously struggle to make its payments.

- **Political situation in Greece is more toxic** – As we have noted numerous times, if SYRIZA were to fail to deliver on its election promises – it seems imposing capital controls would fit into this category – then the political fallout is hard to judge. People rarely react well to such measures but given how long the crisis has been dragging in Greece and the expectations that SYRIZA would improve things, the move could have unexpected consequences.

Overall, I believe capital controls would be a last resort for Greece. They do not really tackle the fundamental problems facing the government and may only be useful to buy a few extra days in the case of a very tight negotiation. Even then, the situation would have needed to have reached the stage where the ECB has limited ELA. This alone, even with capital controls, may precipitate a Grexit. Cyprus and Iceland have shown they can be useful in specific situations to help stabilize a financial sector undergoing a deep restructuring – though they are hard to remove once imposed. In the end, Greece's current problems run far deeper than that.