The coming defaults of Greece

It seems that there will be no agreement between Greece and its Eurozone partners. Short of cash, the Greek government will have no choice but to suspend payment of its maturing debts. This column looks at what happens next. In brief, it will be very much up to the ECB to decide.

When thinking about Greece's dilemma, two facts from Reinhart and Rogoff (2009) research are highly relevant:

- Defaults on public debts are pretty mundane events; and
- Greece is historically the world's leading serious defaulter.

What makes the coming event interesting is that it will be the first time that a default occurs within a monetary union.

The crucial observation is that there is no automatic link between a default and monetary-union membership. As we know from previous experiments of government default within the dollar monetary union – the defaults of Orange County in California and Detroit in Michigan – a sub-central government can default and keep the currency. The unique characteristics of such events are that: 1) an exchange-rate depreciation cannot help shift expenditure to the defaulting region's production; and 2) there is no local central bank to provide liquidity to both the government and commercial banks during the hard phase of the default.

The Greek government might be tempted to recover its own currency but the short-run costs are likely to far exceed the short-run benefits, as explained by Eichengreen (2010). An idea of what would await Greece is provided by Levy Yeyati (2011) in his description of how Argentina gave up its currency board link to the US dollar, an easier case given that the national currency was already in place. The Argentinian example should warn the Greek authorities of the political turmoil that could follow a default.

In the longer run, however, a much-depreciated drachma could lift the Greek economy and, of course, the country might appreciate monetary independence following its wrenching experience inside the Eurozone.

Basically, the trade-off is a major shock and one more year of misery versus the removal of Eurozone membership shackles forever. The balance of benefits is difficult to evaluate since it depends very much on institutional issues that are not clear now. The key questions are:

- Will Greece be able to finally establish on its own fiscal discipline and will its central bank deliver high-quality monetary policy?
- Will the Eurozone draw all the lessons from a Grexit and amend its policies and governance?

In the short run, after a first default, even a partial one, the Greek government will have to balance its books because no one will lend anything any more. 'Balancing the books' can mean different things, however.

- One option is to run an overall balanced budget, thus continuing to service the debt after the initial wave of defaults.

The latest European Commission forecasts for 2015 are for a surplus of 1.1% of GDP, after a deficit of 2.5% last year. This might be optimistic as tax receipts seem to have slowed down.

- Another option is to balance the primary budget, which means no servicing of the debt.

The primary budget was just about balanced in 2014. With growth returning to the Eurozone in 2015 and with the end of the fiscal contraction of recent years, this is within reach if the government refrains from many of its electoral promises.

A balanced primary budget would shield the government from external pressure but the size of defaults will grow. It is argued that various debt restructurings have lengthened the average maturity to more than 15 years and provide a ten-year grace period on capital repayment, and even interest service to the European Financial Stability Facility (Darvas 2015). Yet, debt service remains non-negligible, especially for the rest of the year, with a debt service estimated at some $20 billion (8.5% of GDP). It will decline somewhat over the next few years, but not significantly.

Somehow, a debt restructuring, long overdue, will have to follow. There is nothing new here.[1] More novel is how a sovereign default can be handled within the Eurozone.

Sovereign default within the Eurozone?

Under normal conditions, a country whose government is in default but needs no financing, can remain within the monetary union. Current account deficits, if they exist, represent private borrowing. They are entirely financed, otherwise they would not occur. In the case of Greece, a number of things must happen for it to prosper in the longer run, but there is no immediate macroeconomic pressure that would jeopardise Eurozone membership.

Conditions are not normal, however, and a default would aggravate an already dicey situation.

Many people seem to equate default and Grexit. This is an instance of a self-fulfilling prophecy. If the Greek citizens believe that this is indeed the case, they will not want to keep their savings in Greek financial institutions. In fact, they are already moving them. Since December 2014, when the coming election outcome became obvious, according to various estimates, they have withdrawn about a fifth of their bank account balances. A default would likely trigger a full-blown run on already enfeebled Greek banks.

There is not much debate on how to deal with a bank run.

- First, short of declaring a crippling long-lasting bank holiday, bank withdrawals must be limited, which may, or may not, require controls on capital outflows.
- Second, the authorities must move to urgently stabilise the banking system.

This may involve urgent large-scale lending to solvent banks, and the takeover of insolvent banks.

In such a situation, determining bank solvency is more art than science, so value judgement is unavoidable. But who are the authorities? The defaulting government and the central bank. Either the government receives emergency funding, which is likely to be ruled out, or the central bank must foot the bill entirely on its own. That effectively means the ECB. As De Grauwe (2011) convincingly argued, the sovereign debt crisis only occurred because the euro was a foreign currency to Eurozone member countries.

- If, in the face of a bank run, the ECB does not act as lender of last resort, the Greek government will have no choice but to leave the euro under the most unfavourable of all circumstances.

Since the onset of the slow-motion bank run, the ECB has dithered. Its instrument, the Emergency Liquidity Assistance facility, leaves quite some discretion in the hands of the central bank. It has a ceiling, which it has raised repeatedly. It must list what is acceptable collateral, and the list has been repeatedly expanded. Since much of the collateral of Greek banks is soon-to-be-defaulted-upon Greek government debt, it is understandable that the ECB proceeds with caution.

- Once, following a default, a bank run is under way, in principle Greek bonds will not be acceptable to ECB; with no central bank able to act as lender of last resort, the Grexit prophecy will have become reality.

What this all means is that, if the aim is to avoid a Grexit, it is not possible to wait for a default to happen.

Avoiding Grexit means avoiding default or lining up a lender-of-last-resort

The vicious cycle that underpins the self-fulfilling prophecy must be broken now. That means ruling out either the first or the last step of the cycle.

- The way to avoid the first step, default, is to announce an agreement in principle to reduce the public debt of the Greek government.
- The way to avoid the last step, Grexit, is to announce that resources to thwart a bank run are available.

These announcements must be unconditional – independent of an agreement on the assistance programme – because it seems that such an agreement is beyond reach.

Concluding remarks

The problem is that European authorities are bound to find it politically impossible to give in, ditch the pre-existing agreement and abandon conditionality. Economically, they also face a conflict of interest. About 80% of the Greek debt is now owed to officials, the European authorities and the IMF. The official rhetoric is that “we have done enough for Greece”.

So far, however, the Europeans have not made any present to Greece,[2] only loans, initially on harsh financial conditions, then sweetened. A default would turn the loans into presents. Making it possible for Greece to comfortably default does not seem appealing at all.

National governments are elected by their citizens so they are most unlikely to act to prevent a Grexit. One more time, we have to turn to the ECB, whose essential mandate is to uphold the Eurozone.

It may be unfair, but the ECB’s duty is to announce very soon that it will do whatever it takes to keep the Eurozone whole.

References

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Footnotes

1 Wyplosz (2011).

2 The 2012 organized default, the Public Sector Involvement programme, was essentially at the expense of private creditors.