

A Greek way out?

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After less than a week of frenetic activity, the outline of a compromise between the new left-wing government of Greece and its European partners is already emerging. The demand for a haircut of the official debt has been effectively shelved, and the Greek side is now proposing to link the timing of interest and/or principal payments to GDP growth. This makes sense in principle, and could probably be sold as a big victory in Greece. De facto it would be meaningless, however, given that the first substantial payments that Greece has to make on its loans from the euro-area partners would only start in 15 to 20 years. In the meantime, there will be several further elections in Greece, and nobody can predict how the economy will evolve. Nevertheless, it might be useful to agree on linking payments to GDP growth.

The second element on the table is the abolition of the Troika. This again is mostly form since the Greek authorities have to deal with these three institutions – the IMF, ECB and European Commission – anyway on an almost daily basis. The Troika had been an ad hoc arrangement, created when the euro area did not have any institutions capable of dealing with sovereigns in difficulty. This is different now. The European Stability Mechanism (ESM) could well take over much of the functions of the old Troika. Moreover, the IMF has been bruised by the case of Greece and would like to leave the Greek candle to the Europeans. The ECB should also recognise that it can only lose from being seen to impose detailed economic policy prescription on a member country. This destroys the credibility of its mantra that its policy goal is exclusively price stability.

The third element will be a new programme, which will have a high-sounding name, for example Greek Growth Compact. It will most likely contain lots of references to the need for more investment and protecting the most vulnerable members of society. Austerity will no longer be mentioned.

The new programme, aka the Greek Growth Compact, will be the key to deal with the real problem: namely liquidity.

Contrary to perceived wisdom, and the official stance of the new Greek Finance Minister, Greece is not insolvent. The debt-to-GDP ratio of 175% of GDP is a red herring. What matters is how much the Greek government has to pay for debt service. This is actually rather low, lower than for Italy or Ireland for that matter (for details, see Gros, 2015, and Alcidi & Giovannini, 2015).

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The effective debt 'service' ratio is thus already now close to that of a country with a formal debt ratio of 120% of GDP, but which has to finance itself on the market.

Moreover, the government should be able to run a modest primary surplus, if it does not increase expenditure too much (and tax collections can be maintained).

The real problem is thus liquidity, both for Greek banks, which are losing deposits daily, and the government which has to make some largish payments to the IMF rather soon.

However, the ECB effectively cut Greek banks from its ordinary monetary policy operations when it decided on February 4th that the existing programme was effectively dead, and that it could therefore no longer accept Greek government bonds as collateral.

This means that Greek banks can now get access to liquidity only via a mechanism called ELA (Emergency Liquidity Assistance) under which the Central Bank of Greece provides financing to them, but takes the risk as well.

ELA is supposed to be provided only to sound banks. But who decides whether a bank is sound? It is now the ECB itself, or rather is banking supervision arm called the Single Supervisory Mechanism (SSM).

This is the first time ELA is being granted under the common supervision and shows that the functioning of ELA needs to be reformed. Prior to 2014, one could assume that the national authorities knew best which banks were sound since supervision had been in national hands, usually with at least a heavy involvement of the national central bank. However, the ECB has created strong barriers (Chinese walls) between its monetary policy and its banking supervision arms. Although the two are not supposed to talk to each other, this does not make sense in a systemic crisis. The Governing Council of the ECB will have to take a decision on whether to allow the Greek central bank to issue ELA without being able to consult its own colleagues on the soundness of the Greek banks. Even worse, some members of the Governing Council are also involved in supervision. This could lead to the strange situation in which the Governing Council will have to take its decision based on information from the Greek central bank (which has an interest to recue its banks are sound), while some members have inside information from the SSM that this may not be the case. But they would not able to act on this information, although their vote might constitute a clear sign. In this particular situation, the management of the SSM will in any event have to agree that the Greek banks are solvent, given that the country's three largest bank banks just passed the Asset Quality Review, which the SSM had conducted in the course of 2014.

Thus, ELA is likely to be available in large quantities for some time.

Once the Greek Growth Compact has been agreed, the ECB can again allow the Greek banks to have access to its normal monetary policy operations.

References

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