

The implications of a Greek default for the euro

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Greece has now received a package worth €110 billion (\$135 billion) from the IMF and euro area countries ensuring that the country will not need any fresh money from the markets for the next 2-3 years. In return the Greek government has signed up to a programme of expenditure cuts and tax hikes of extraordinary severity. The Greek parliament has approved this programme but financial markets remain unconvinced as evidenced by the risk premia for Greek debt which remain extremely elevated even for the short maturities falling within the time frame of the package. Markets remember the case of Argentina in which even three consecutive IMF programmes could not stave off failure.

For European Union policy-makers, this raises the fundamental question: What would happen if the austerity programme package does not work? Would a default by Greece signify the end of the euro?

Behind this often-posed question is the assumption that the notion of 'default' has a precise meaning. But this is not the case. Ratings agencies define default as a failure to make a contractual payment on time and the definition of a 'credit event' in Credit Default Swaps is similarly stringent. In reality, however, markets have often been quite forgiving in situations in which a government only reschedules its payment due, i.e. it does not pay on time, but makes a credible promise to repay the full amount due at a later date. Such a 'soft default' would certainly not mean the end of the euro.

The real question is thus: Would a messy (and massive) default under which the country simply refuses to repay signify the end of the euro?

Yes and no.

A messy default would certainly end the ideal of the euro area as a club whose members are all equal and work towards a common goal, namely the stability of the common currency. Membership in such a club protects against financial problems because members are supposed to behave well and help each other in case of unjustified speculative attacks. Although the EU Treaty says that members are not liable for one another's public debt, there is an implicit political commitment, as we see right now, to provide emergency help.

The quid pro quo for this solidarity is of course the expectation that all members abide by certain standards, for example those embodied in the Stability and Growth Pact, that aim to limit budget deficits and debts. The continuing misreporting of fiscal data by Greece has already severely damaged the ideal of the euro area as a 'gentlemen's club'. But the club could still be saved if Greece undertook a determined national effort to service its debt and avoid a messy default.

Even a messy default by Greece alone, however, would not necessarily mean the end of the euro area. At that point, the decisions of the European Central Bank would become crucial. As a consequence of the default,

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the Greek public debt would immediately be demoted to less than junk status and hence, if the current rules for the eligibility of collateral remain unchanged, Greek banks would no longer have access to the regular monetary policy operations of the ECB. The day after a formal default, the country would thus effectively cease to be part of the euro area. Its status would resemble that of Montenegro, which adopted the euro as legal tender without officially being a member of the single currency zone.

However, the ECB has recently suspended its normal collateral rules and decided to accept Greek government paper irrespective of its ratings. The (semi-)official justification was that the ECB had made its own assessment of the Greek economy and its public finances by approving the €110 billion IMF/euro area package and the Greek austerity programme. Hence, according to the official justification, the ECB does not need to rely on the judgment of the ratings agencies to assess the creditworthiness of Greece. The real motive of course was the need to continue to allow access by Greek banks to the regular monetary policy operations of the ECB. It is thus not clear what the ECB would do if the government of Greece defaulted on its debt. Would the ECB accept as collateral 'new' debt of the Greek government (or of the Greek Central Bank). In principle it should not do so because a default would mean that Greece was not implementing the austerity programme that provided the official justification for continuing to accept Greek collateral, despite the negative verdict of the ratings agencies.

If the ECB is to remain true to its mandate, it should thus apply its normal rules, which are that it can lend only against good-quality collateral. This implies that the ECB would not be able to effectively bail out Greek banks following a messy default by the Greek government (which would anyway be probably followed by a massive series of downward ratings and defaults in the private sector).

In Greece, following such a 'messy default' without a bail out by the ECB, euro notes and coins would still circulate in the economy, but one euro on a Greek bank account would no longer be automatically equivalent to one euro on a bank account elsewhere in the euro area as Greek banks might immediately become insolvent and thus be shut out of the payment systems. Until Greek solvency has been reestablished, the eurozone would thus de facto have lost one of its members. Under current institutional arrangements, however, the Greek Central Bank head would still sit on the Governing Council of the ECB and the Greek finance minister would still be a member of the Euro Group, with his country's normal voting powers intact.

The Greek economy would collapse, but the impact on the rest of the single currency zone should be minor given that the country represents only about 2% of the euro area's GDP and is not home to any systemically relevant financial institution.

In many ways, a messy Greek default would actually leave the eurozone in better shape. Its institutions would probably be strengthened because it would have become clear that the framework is strong enough to withstand the failure of one of its members. Tolerance towards deficit violations and inaccurate reporting would be much reduced. The ECB would have shown that it does not finance wayward members. The club would have been transformed into a federation whose peripheral components can be told to "get lost", so to speak. As a result, majority voting would tend to replace consensus as the normal way of decision-making.

This assumes of course that contagion can be limited. The main reason why even Germany agreed to accelerate the bailout package for Greece is that Spanish financial markets have clearly been affected by the Greek crisis with share prices falling and spreads on Spanish government bonds increasing. In contrast to Greece and Portugal, Spain and Italy are systemic, i.e. they are 'too big to fail'.

Will contagion prove fatal? The fundamentals of Spain and Italy, especially in their self-financing capacities, are much stronger than those of Greece and Portugal. Moreover, neither Spain nor Italy would gain much from a default since most of their public debt is held by their own citizens. A default would thus not lower the foreign debt of the country. For Greece, by contrast, 90% of all public debt is held by foreigners, who could be expropriated by a default (for Portugal this would be 60% of GDP).

However, markets can at times be irrational. The real test of the euro area is thus not whether it can save Greece, but whether it can protect members that do not have an insolvency problem from speculative attacks.

The signals from financial markets are so far mixed. Markets do differentiate among the weaker members of the euro area but risk premia have tended to move together in the same direction. The spreads on Spanish bonds thus have increased considerably, but they remain at less than one-third of those of Greece, with Italy even lower. It is too early to tell whether the 'testing' of Spain and Italy will continue. Much will depend on the resolve of the governments in these countries to take decisive (and preemptive) action to demonstrate to nervous markets that their public finances are under control.

The fate of the euro is not decided in Athens, but in Madrid and Rome.