

## Grexit 2015: A primer

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### This time is different

2015 is different from 2012 because markets behave differently and because the fundamentals are different. Contagion is almost absent because the other peripheral countries now run current account surpluses (and thus they do not need fresh capital), and they have shown their ability to adjust their economies. For several years, Greece has distinguished itself by foot-dragging on reforms and posting an abysmal export performance.

### Grexit is a 'red herring'

Officially nobody wants Grexit: Not Syriza, which wants Greece to stay in the euro. It is 'only' asking for a reduction in Greece's official debt and an end to austerity. The German government also does not favour Grexit because European unification remains the central project for German policy-makers across all mainstream parties. Only some protest parties and vocal economists think Greece (and Germany) would better off with a new Drachma.

The substantive issues are thus the demands for a reduction of the official debt of Greece and an end to austerity. Both are eminently fudgeable. In any event, change in policy will be minor if a Syriza government is as successful in fulfilling its promise to spend as the previous government was in promising not to spend.

However, the rhetoric on both sides about Grexit might lead to a bank run, thereby forcing the ECB to limit financing for Greek banks. But even then, an exit from the eurozone is not preordained as capital controls should be able to deal with this problem. In any event, the argument that a new currency is needed to regain competitiveness no longer applies since wages have already declined so much.

### Debt reduction or OSI (official sector involvement)

The justification is that Greece's public debt (most of which is external) is not sustainable. There are two points of view on this assertion:

The country's (gross) public debt/GDP ratio is close to 180%, which is way above the 120% of GDP threshold usually applied in debt sustainability exercises. But the Greek government also has large assets – it had to take large stakes in its banks and keep cash under the PSI (private sector involvement) provisions. The net debt ratio is thus about 120-130% of GDP, lower than that of Italy.

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Moreover, Greece has been accorded very low interest rates by its official creditors. It thus has to spend less (yes, less) on debt service than Italy or Ireland, which have both much lower debt-to-GDP ratios. For 2015, the payments on its official foreign debt would amount only to 1.5% of GDP. From this point of view, Greece should be able to service its debt.

The near-term payment obligations of the country are so small that there are no good targets for a default. The only large payments, which Greece has to make in 2015 are to the IMF and the ECB.

The ECB holds two bonds of €3.3 billion each, which mature in July and August. It would make sense for both parties to 'extend and pretend'. Syriza can hardly default on these bonds and expect that Greek banks will continue to obtain financing from the ECB. The ECB will also prefer to avoid the loss of face that would result from an outright loss on these bonds.

The IMF might be a tougher nut to crack as it is much less likely to agree to an 'extend and pretend' deal since its staff generally regards Greece as a basket case. But Greece does not have the money to pay back the IMF loans on time. Syriza might then have to choose between defaulting on the IMF (which puts Greece in the same league as Argentina) or asking its European partners for more money! Berlin and Brussels will have a lot of fun watching Athens battle it out with Washington.

Bottom line on the debt reduction demanded by Syriza: A rescheduling of some payments due in 2015 should be possible. An outright reduction in the nominal amounts owed to the ESM (and other credits from euro-area countries) seems very hard to achieve given that nothing is due to them anyway for a few years. The creditors, which have to be paid first (the ECB and the IMF), are de facto super senior, leaving only the ESM as the most likely victim of OSI. Moreover, Italy would have to shoulder 20% of the losses of the ESM, Spain another 10%. Does the Greek government want to default on its obligations towards other highly indebted countries and fellow sufferers from austerity?

### **End of austerity = return to growth?**

Greece is the only country whose problem was clearly excessive public, not private spending. Its fiscal adjustment has thus been larger than that of any other country (including Ireland or Portugal). But the real reason for the depth and length of the fall in GDP has been that exports have not increased to offset the reduction in the public-sector deficit. This failure of Greek exports to increase remains a mystery as wages and costs have declined by over 20% relative to Germany, and until recently Greece's main export markets in the Middle East were booming. Portugal managed to increase exports by more than 30% since 2008, although wages did not decline and its main export market (Spain) had collapsed. Greece will be able to grow on a sustained basis only when its exports start to grow.

At any rate, austerity is ending naturally since the Troika programme foresees no further large reductions in expenditure (both social security and investment expenditure is supposed to remain constant). The surpluses expected for this year and next are based only on revenue increases, not on further expenditure cuts.

In reality, 'austerity' is a fuzzy notion and even the detailed fiscal programmes under the Stability Pact have become very much subject to political compromises reached over the heads of the Commission's ECFIN Directorate General as the experience with France and Italy has shown a few months ago. Some creative accounting combined with more optimistic revenue projections might well allow a new government to spend a bit more and the EU to pretend that the fiscal targets can still be reached.

A first conclusion is that both OSI and the end of austerity can be fudged and have anyway no direct link with euro membership.

### Why is Grexit ‘in the air’?

The link is indirect, via the banking system, and this leads back to the central role of the ECB: 2015 poses the same conundrum as 2012 did for the ECB. The key issue is again ELA (emergency liquidity assistance). ELA is provided by the national central bank under its own responsibility and is thus backed up by the national authorities. How can the ECB allow the Greek National Bank to provide ‘emergency’ financing to Greek banks when the guarantee for that lending is provided by the Greek government which at the same time wants to renege on its own debt?

Greek banks still have almost €40 billion of ELA outstanding. More might be needed if the Greek public starts to take its money out. If Frankfurt then cuts access to ELA, Greek banks might run out of money – making Grexit inevitable, according to many.

However, the Cyprus example shows how this outcome could be effectively avoided: capital controls. Imposing capital controls is equivalent to an indirect Grexit, but also a more gradual one depending on the stringency of the capital controls. In the case of Cyprus, the controls are slowly being dismantled and they are now only a nuisance. In this sense Cyprus is coming gradually back to being a ‘full’ member of the euro area. In the case of Greece, the controls might have to be more draconian and long lasting if the government really wants to spend more and the banks remain cut off from ECB funding.

The most likely outcome appears to be a typical European fudge on several fronts:

- some rescheduling of official debt payments,
- some relaxation of the fiscal targets, and if Greek depositors get nervous,
- some capital controls to pretend that Greece is still part of the eurozone.

The next few months are thus likely to be full of drama, but in the end, the difference between a government that has never made good on its promises to pay and a government that promises not to pay might not be that large.

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