CEPS COMMENTARY

Thinking ahead for Europe

The Euro as a Foreign Currency for Greece

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Key Point

In an earlier note, I discussed how a Greek parallel currency to the euro could allow the Greek government to gain some room for manoeuver in fiscal policy while at the same time continuing the adjustment programme demanded by the country's creditors. In this Commentary, I explore the question of how the Greek population could still keep the euro after a default of its government.

Contrary to general belief, Grexit and the reintroduction of the euro as a foreign currency would probably be positive for the Greek economy. Creditors, however, would be hard hit. It is therefore primarily in their interest that default and Grexit are avoided.

A default against official creditors only

A key assumption in my proposal for a Greek parallel currency to the euro, published in a CEPS paper last month,[1] was that the Greek government would reach an agreement with its creditors in order to avoid a default. In the meantime, however, the options have narrowed: Either the creditors further water down their conditions for financial assistance to an extent that allows the Greek government to sign on to additional help without changing its position, or both sides stick to their positions and Greece will run out of money to make upcoming debt repayments. In this note, I assume the latter will happen.

In the intermediate future, sizeable debt repayments are due only to the International Monetary Fund and the European Central Bank. Debt servicing of the rescheduled private debt is moderate in the near-term, and repayments to the European Stability Mechanism do not begin before the end of this decade. Representatives of rating agencies have pointed out that it is not clear whether a default against the IMF and the ECB would lead to a default rating on Greek market debt. As long as Greece avoids default against the debt held by the private sector, it may escape a default rating and hence keep market access open for the future. This possibility lowers the costs of defaulting against the official creditors and makes default therefore more likely. However, escaping a default rating is not of material importance for the consequences of a default against the 'institutions' (the new label for the European Commission, the ECB and the IMF), which is discussed below.

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[1] See T. Mayer, "A Parallel Currency for Greece", CEPS High-Level Brief, CEPS, Brussels, 20 May 2015 (www.ceps.eu/publications/parallel-currency-greece).

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Separating the Greek banking sector into a 'good' and a 'bad' bank

At the end of April, the size of the balance sheet of the Greek banking sector (monetary financial institutions) amounted to €315 billion. On the liability side, Greek banks owed €113 billion to the Bank of Greece. This sum included ordinary credit as well as Emergency Lending Assistance (recently raised to €84 billion). Deposits and liabilities under repurchase agreements amounted to €175 billion. Capital and reserves totalled up to €70 billion, with €52 billion being share capital (presumably including deferred tax credits against the government). On the asset side, Greek banks held loans to the Greek government in the amount of €9.5 billion and Greek government bonds of €13.6 billion (hence total claims on government of some €23 billion). Loans to the private sector amounted to €211 billion. The remaining assets included among other things debt securities and shares issued by borrowers in other countries. Table A1 in the Appendix gives a stylised balance sheet of the Greek banking sector.

Should the Greek government decide to default against its official creditors, banks' balance sheets would in a first step have to be temporarily frozen by introducing capital controls and restrictions to cash withdrawals from sight deposits. In a second step, however, it could restructure the banking sector into a 'good bank', which would retain the euro, and a 'bad bank', which would wind down non-performing assets against haircuts of liabilities of the bad bank to the Bank of Greece. Based on unofficial estimates, we assume non-performing domestic loans to amount to 40% of the total loan volume, i.e. €84 billion. As we assumed that the government would not default on its obligations to the private sector, we keep the €23 billion claims on government in full.[2] But to be on the safe side, we apply the same 40% write-off to other credit and assets. The adjusted assets are now transferred into the good bank.

Assuming an equity-to-capital ratio of 13% (as in April 2015), we establish the good bank with equity capital in the amount of €32 billion. We are able to transfer the entire €175 billion amount of deposits and repo liabilities to the good bank and are still left with €39 billion in reserves and other liabilities. Thanks to the elimination of the liabilities to the Bank of Greece, we end up with a quite solid good bank (Table A2 in the Appendix).

The bad bank contains the non-performing domestic loans and other credits and assets of lower quality. Against these assets stand the €113 billion liabilities to the Bank of Greece, leaving a nominal equity cushion of €36 billion (with a nominal equity-to-capital ratio of 24%) (Table A3 in the Appendix).

A raw deal for creditors

The exercise looks fairly attractive on paper. In effect, it represents the 'dollarisation' of the Greek economy without the economic resource costs usually associated with such a move.[3] However, it entails a seriously hostile act against the official creditors, in the case of the construction of the bad bank especially against the ECB. Depending on the recovery rate of the non-performing loans, claims by the Bank of Greece on the bad bank will have to be written off. Assuming a recovery rate of, say, 10%, assets of the bad bank could be reduced to

[2] As we shall see later, honouring the debt to the private sector is not crucial to our argument. We assume this to be the case only as the benefits of default on this part of the debt are smaller than the costs.

[3] 'Dollarisation' means the replacement of domestic currency by a foreign currency. For a general discussion of this issue and the experience of Montenegro, see Nikola Fabris et al., "Economic policy in dollarized economies with a special review of Montenegro", Central Bank of Montenegro, Working Paper No. 1, 2004.

just €15 billion. As a result, after having wiped out its equity position, the bad bank would default on some €62 billion or about half of its liabilities to the Bank of Greece. With the latter having equity of just €5.5 billion, the European System of Central Banks would have to bear losses in the amount of some €58 billion. These come of course on top of the losses on bonds held by the ECB and of euro-area governments that have loaned or guaranteed official loans to Greece.

How to deter Greece from Grexit

Contrary to general belief, default, Grexit and the reintroduction of the euro as a foreign currency would probably be positive for the Greek economy. Confidence could come back as private and public excess debt would have been reduced at the expense of foreign creditors. The good bank would have a solid balance sheet with which to make new loans. In order to avoid the introduction of a new currency for the purpose of funding primary deficits, the government would have to achieve primary budget balance. But this has been the objective of the new government from the beginning. The good bank would lack a lender of last resort in the form of a central bank, but this would not need to be a serious disadvantage. Reserve requirements of 100% for sight deposits and a healthy equity cushion to protect longer-dated deposits from impairment through credit losses would make a central bank and government-backed deposits insurance scheme unnecessary.

On the other hand, creditors would be hard hit. Not only would they lose their €216 billion in financial assistance but they would also have to cover the losses of the ECB caused by the default on the Greek bonds in its portfolio (€17 billion) and the claims from the interbank payments system Target 2 (€99 billion as of end-April).[4] The total loss (before recovery) of €332 billion could be a major political liability for many leading policy-makers in the creditor countries. It would therefore be rational for them to attach a high cost on a Greek default in order to deter, first, the Greeks from walking away from their debt, and second, other countries from imitating the Greek strategy.

One way of raising the costs of default would be to appeal to honesty and fairness. Would Greece really want to "bite the hand that fed it" for so long? But moral appeals usually don't go very far in international relations. Another way would be to threaten a cut-off from structural funds. However, Greece is set to get only a little more than €3 billion per year until the end of this decade. Debt relief is therefore worth 100 years of structural funds (even ignoring discounts for future receipts). Finally, the creditors could link the exit from EMU to a forced exit from the EU. The costs of leaving the EU and foregoing all privileges of a member of the club could be quite high and hence an effective deterrent. Yet, this is not very likely as the EU leaders will want to keep Greece in the EU for geopolitical reasons. In the event, the only viable strategy for the creditors would seem to be to give Greece the debt relief it can easily secure at moderate cost through unilateral default on the official creditors, 'Grexit' and the reintroduction of the euro as a foreign currency. But policy-makers in the creditor countries would have to disguise the debt relief from their electorates so as to avoid political punishment.

[4] See Hans-Werner Sinn, "Die griechische Tragödie", *Ifo-Schnelldienst*, 29 May 2015 (Table 1, p. 6) for a summary of Greece's liabilities. Since Greece's Target liabilities have been caused in part by the extension of ELA, losses of the ECB from the default on ELA are included in the losses on Target claims.

Appendix Tables

Table A1. Simplified balance sheet of the Greek banking sector (excluding the Bank of Greece, April 2015, € bn)

ASSETS		LIABILITIES	
Claims on government	23	Bank of Greece (inc. ELA)	113
Domestic private loans	211	Deposits and repos	175
Other credit and assets	161	Reserves and other liab.	55
		Equity	52
Total	395	Total	395

Source: Bank of Greece.

Table A2. The 'good bank' after eliminating non-performing loans and liabilities to the Bank of Greece (€ bn)

ASSETS		LIABILITIES	
Claims on government	23		
Domestic private loans	127	Deposits and repos	175
Other credit & assets	97	Reserves and other liab.	39
		Equity	32
Total	246		246

Table A3. The 'bad bank' taking over non-performing loans and liabilities to the Bank of Greece (€ bn)

ASSETS		LIABILITIES	
		Bank of Greece (inc. ELA)	113
Domestic private loans	84		
Other credit & assets	64		
		Equity	36
Total	149		149