The eurozone crisis – rescuing Greece

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Greece's long-standing public debt problem became a crisis at the start of 2010 and has since escalated to a point where it threatens the survival of the euro. In the face of rising government borrowing costs, the country first requested international assistance on 23 April 2010. The €110bn eurozone-IMF loans agreement it received came with strict conditions on economic policy and reform. A worsening recession and rising public opposition to further austerity meant the Greek government struggled to meet the conditions of the agreement. Meanwhile, the prospects of it returning to borrow on the open market by 2012, as originally envisaged, became increasingly hopeless.

Drawn-out discussions on a second 'bail-out' for Greece began at an official level on 22 July 2011, and by 21 February 2012 the pieces of a more complicated arrangement had almost fallen into place. As well as the traditional 'loans and austerity', the second bail-out involves Greece's private sector creditors taking losses on their holdings of Greek sovereign debt: this follows from a belated recognition that no amount of austerity and loans on their own could put Greece's debt burden on a sustainable footing.

The second agreement avoided the imminent prospect of disorderly default only until parliamentary elections in Greece on 6 May. The indecisive result, and the polarisation of parties over Greece's continued acceptance of the terms of the bail-out, meant no government could be formed. Another election has been called for 17 June. If Greece rejects the terms of the loans agreement, its future in the eurozone will ultimately be a political decision on the part of the rest of the eurozone. The European Central Bank is the institution with the power to force the withdrawal of Greece from the euro, by denying its national central bank and financial institutions access to emergency funding.

The consequences of Greece's departure from the eurozone are highly uncertain. Within Greece, the extent of disruption will depend on whether it receives support from EU Member States and institutions, in the short-run by their agreeing to capital controls, providing technical assistance and possibly funding the recapitalisation of Greek banks, and in the long-run by their allowing Greece to remain within the EU.

The exit of one country from the eurozone, though it would undoubtedly be characterised as 'exceptional' by eurozone leaders and officials, would inevitably raise questions about the cohesion of the single currency. Even if Greece did eventually prove to be the exception, it is argued by some that the uncertainty this would create would lead to a costly period characterised by risk aversion, reduced confidence, depressed asset prices and economic contraction in the wider euro area. The UK, through its trade and financial linkages with the currency union, may see its faltering recovery stifled further, were the eurozone crisis to continue or worsen following Greek exit from the single currency.

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1 Background – the run-up to crisis

Greece has form when it comes to sovereign debt crises. It has spent 100 years of the past 200 in default,[1] and even when it joined the euro in 2001, its public debt exceeded 100% of GDP, and has remained among the highest in the eurozone ever since.[2] Joining the euro, as for other countries, allowed Greece to refinance its existing debt on more favourable terms, and borrow more. Other factors contributing to the build-up of public debt in Greece include:-

- high levels of tax evasion and weak tax administration associated with a large informal economy
- inefficient public administration
- poor management of public expenditure, especially with respect to public sector wage policy
- lack of transparency in public accounting, and a fragmented budgetary process
- unsustainable levels of pension spending, and weak incentives to work up to the retirement age of 65.

Greece's competitiveness has also been weak in relation to the eurozone 'core', with rising labour costs and low productivity growth placing constraints on economic growth.[3]

Despite its debt burden, and a record budget deficit in 2008, there was little evidence that market sentiment was turning against Greece until late 2009: borrowing costs remained within two percentage points of Germany's, and its credit rating was downgraded just one notch, a typical revision for the peripheral eurozone countries. The decisive moment came after general elections in October 2009, when the new government revised the estimate of the budget deficit for 2009 from 6.7% to 12.7% of GDP, shaking confidence in both Greek statistics and the sustainability of its public debt.

The major ratings agencies quickly downgraded Greece's credit rating to speculative grade, and 10-year bond yields, a measure of the cost of government borrowing, increased from 4.9% at the start of December 2009 to 7% by the start of April.[4] Amidst rising doubt about its ability to raise funds to pay debts falling due in May 2010, it formally requested assistance from the IMF and eurozone on 23 April 2010.

2 The May 2010 bail-out

2.1 Financing and conditions

Following a request made by the Greek authorities for financial assistance on 23 April 2010, an agreement was finalised on 2 May providing €110bn of loans over a three-year period.[5] Because no formal mechanisms[6] existed at this point to provide financial support, €80bn was financed using bilateral loans from euro area member states only. These were pooled and their disbursement managed centrally by the European Commission. The IMF provided the remaining €30bn under its stand-by arrangement.

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[1] Reinhart, C. M. and Rogoff, K. S. (2008) *This time is different: a panoramic view of eight centuries of financial crisis*

[2] IMF *World Economic Outlook* database

[3] See, for instance, OECD *Economic Survey of Greece, 2011*

[4] Bloomberg

[5] By the time of the second agreement, only €74bn had been disbursed; some of the outstanding balance is being rolled-in to the second loans package.

[6] I.e. the European Financial Stabilisation Mechanism (EFSM), and the European Financial Stabilisation Facility (EFSF)

The release of the each of the tranches of money to Greece, Ireland and Portugal was subject to the approval of the 'Troika' (the EU, ECB and IMF), following a review of their success in meeting the conditions attached to the loan. These conditions are set out in a Memorandum of Economic and Financial Policies, which provided an overarching strategy for the economy over the 3-year disbursement period, and a separate Memorandum of Understanding. The latter document detailed a highly specific programme of reform, timetabled on a quarter-by-quarter basis.[7]

The conditions attached to Greece's first loan agreement required further austerity measures beyond those already enacted by the government, including public sector wage and employment cuts, reform of the state pension system, and increases in the minimum retirement age). Beyond direct fiscal measures, more fundamental structural reforms were also required as part of the package. This followed from the recognition that the deficit targets required could not be achieved through tax increases and spending cuts alone. The structural measures aimed, among other things, to tackle 'inflexibilities' in the labour market to allow for greater management control over wages, working time and recruitment; to improve tax collection; and to 'modernise' public administration.

There were no specific requirements in the original loan agreement for Greece to privatise state assets. However, in return for the lower interest rates and longer repayment schedule agreed in March 2011, the government agreed a sell-off of €50bn of public-sector assets in April 2011, to be completed by 2015.[8]

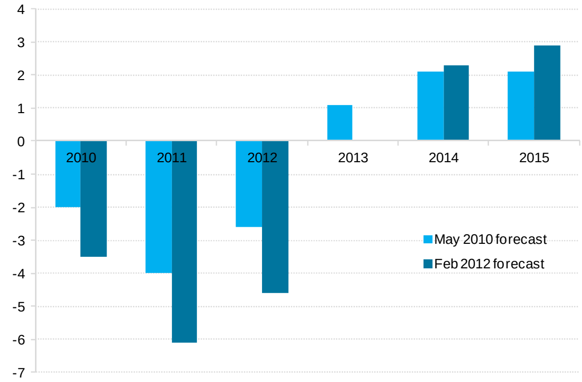
2.2 Performance and outcome

The central objective of the first loans agreement, to restore the sustainability of Greek debt and enable it to borrow on the open market, has clearly not been achieved. Greece's debt forecasts and borrowing costs are far higher than they were in May 2010, and by the start of 2012, a new agreement was urgently needed to prevent Greece from defaulting on debts falling due.

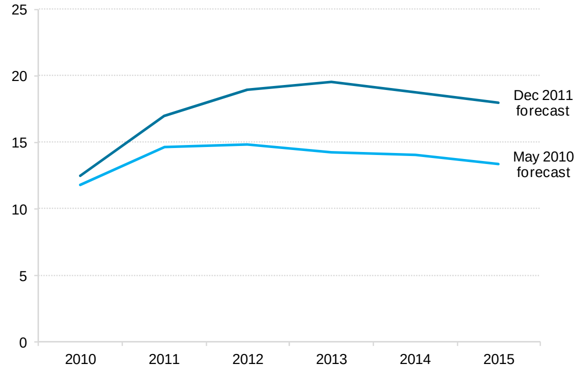
Greece's economic performance, too, has been far worse than was anticipated when it first requested assistance (see charts). Partly as a consequence, it has struggled to implement the reforms and meet the targets for public finances enshrined in its loans agreement. Greece's difficulty in implementing austerity measures has also been due to the problems in securing political agreement, and, according to the OECD, the organisation of the Greek state:-[9]

> The central administration lacks the management, oversight and co-ordination structures to support effective

Greece's economy has contracted faster than anticipated
GDP growth - May 2010 forecasts vs Feb 2012 outturn and forecasts



And unemployment has risen faster
Unemployment rate (%) - May 2010 forecasts vs Dec 2011 outturn and forecasts



[7] Greece *Memorandum of Economic and Financial Policies*, etc.
[8] The deadline for completion of the privatisation programme has since been extended to 2020.
[9] OECD, *Greece: Review of central administration* (Dec 2011)

implementation and long-term management of policy measures, including structural reforms to support sustained economic growth. This is a fundamental obstacle upon which many reforms have already stumbled.

As Greece has struggled to meet the conditions of the programme, payment of loans instalments by the eurozone and IMF, crucial to prevent a 'disorderly' sovereign default, have been delayed and conditioned on further revenue-raising and expenditure-cutting measures, including the privatisation of an additional €50bn of state assets. As the prospects of Greece returning to the market to borrow by 2012 became increasingly hopeless, discussions over loans instalments under the first package also became tied-up with the negotiations over a second loans agreement. This process culminated in the resignation of the Prime Minister George Papandreou on 9 November, following an announcement that a referendum would be held to secure a mandate for future reforms (the vote was never held).

3 The February 2012 bail-out

The drawn-out discussions over a second assistance package began at an official level at a summit of eurozone leaders on 21 July 2011.[10] These continued up to February 2012, when the prospect of Greece's imminent default served as a spur to action. The second agreement is more complicated than the first, and reflects the consensus that has developed since May 2010 that Greece's debt burden as it stands is fundamentally unsustainable, and that no amount of loans and austerity *on their own* will place its public finances on a sustainable footing. Taken together, the measures in the second agreement are expected under certain assumptions to bring Greece's debt-to-GDP ratio down to 120.5% by 2020, close to the level deemed sustainable by the IMF (120%).[11] The package can broken down into three parts, discussed in turn below:-

3.1 Loans and reform strategy

As under the first agreement, loans are to be provided to Greece. These are necessary to prevent a 'disorderly default', whereby Greece is unable to access the funds to pay off debts falling due, most notably a €14.5bn bond redemption on 20 March. They will also ensure the Greek government has access to finance until at least 2014. €130bn in loans is to be provided, although the balance between the European Financial Stabilisation Facility (EFSF) and the IMF has not yet been decided. The loans are likely to comprise €117bn in loans from eurozone member states through the European Financial Stabilisation Facility (EFSF), and €13bn from the IMF. €10bn in outstanding IMF contributions from the previous loans arrangement will be added to the new arrangement, and the repayment schedule for these extended from five to ten years. At 10%, the IMF contribution is expected to be proportionally far lower than in previous agreements (it contributed a third of the funds to the Irish, Portuguese and first Greek packages). The UK does not underwrite the EFSF (this is a eurozone-only facility), but it does contribute to the IMF's resources through its quota and certain standing arrangements: the UK' current share in the total (global) lending by the IMF is around 3.2%.

In return, Greece will have to adhere to conditions relating to public spending, fiscal policy and economic reform, and accept a high degree of oversight from ECB, European Commission and IMF monitors; indeed, the Commission is now to have a permanent presence in Greece specifically to monitor compliance with the programme. It will also have to amend its constitution to prioritise debt servicing payments over other government

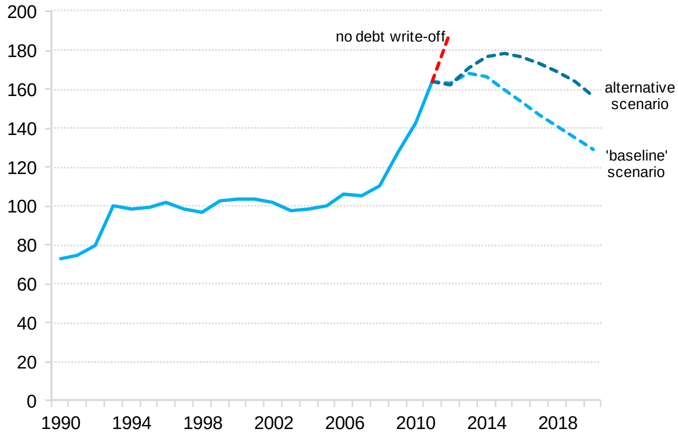
[10] Council of the European Union, *Statement by heads of state or government of the euro area and EU institutions*, 21 July 2011

[11] For access to the IMF's resources at the level Greece is requesting, the IMF requires that 'there is a high probability that... public debt is sustainable in the medium term'. This criterion may be relaxed if there is a 'high risk of systemic spillovers'. See *Selected Decisions and Selected Documents of the IMF* (2010), p.426

expenditure. Even in advance of the agreement on the package, Greece was obliged to pass into law a €3.3bn package of public spending cuts, and the main opposition leader, Antonis Samaras, has been required to commit to honouring the 'objectives, targets and policies' contained in the loans agreement Memorandum of Understanding, were he to be elected in April.

There is likely to be considerable resistance to the reforms and austerity envisaged in the package, and there are high levels of uncertainty both that the measures will be successfully implemented, and that Greece's debt burden will be returned to a sustainable level. This is partly because the two objectives of the package – reducing public debt as a proportion of GDP, and restoring competitiveness through internal devaluation – are in basic conflict: in simplified terms, because structural reforms and public spending restraint impact negatively on both debt and GDP, the debt-to-GDP ratio may still remain high even as the absolute level of debt declines. This 'fundamental tension' was acknowledged by a confidential debt sustainability analysis prepared by the troika (also see chart), which illustrated that under plausible assumptions, Greece's debt might not be reduced below 160% GDP before 2020, rather than 120% envisaged under the programme:-[12]

Under the Troika's alternative scenario, debt in 2020 will remain well above the 120% GDP deemed sustainable by the IMF
Greece, public debt, % GDP - long-term projections



> The debt trajectory is extremely sensitive to program delays, suggesting that the program could be accident prone, and calling into question sustainability

Other risks to the programme include low participation from the private sector in Greek debt restructuring (see following section), a weaker than expected global economic environment causing an even sharper contraction than envisaged, and difficulties in implementing the €50bn privatisation programme.[13]

3.2 Private sector involvement

The new agreement differs from all those that have gone before in that it 'bails-in' Greece's private sector creditors, albeit on a voluntary basis; that is, Greek bondholders are to be encouraged to exchange their existing bonds for new ones with a lower nominal value.[14] The precise terms of private sector involvement, which essentially amount to a restructuring of Greek debt, are being drawn up by the International Institute of Finance (IIF). The main components of the arrangement are to include:-

[12] *Greece: preliminary debt sustainability analysis*, Feb 15 2012

[13] The difficulties associated with the privatisation plan have been pointed out by a number of commentators; as the FT's Lex column put it: *"In the context of the crisis Greece finds itself in... the plan borders on the improbable. If investors are shunning Greek debt... it is hard to see why they would suddenly develop an appetite for Greek equities"*

[14] A voluntary agreement is required to avoid triggering credit default swaps, financial instruments that insure against the default and forced restructuring of debt, which could generate further financial instability.

- A 53.5% ‘haircut’ on the nominal value of existing debt (higher than initial estimates of up to 50%)
- Of the remaining 46.5%, two-thirds will be converted into bonds of typically longer maturity (between 11 and 30 years), and lower interest (2% to 2015, rising to 3% to 2020, and then 4.3% to 2042), partly backed by €30bn from the EFSF
- The remaining third will be converted into shorter-maturity (2-year) EFSF bonds

Together, this will combine to reduce the net present value of privately held Greek debt by around 75%[15] and, assuming full participation among Greece’s bondholders, a €100bn reduction in debt burden.

A key concern in the PSI deal is the level of participation among Greece’s private sector creditors. Although official sources have stated that this is likely to be ‘near universal’, other reports have suggested that it may be as low 70-75% of Greece’s outstanding privately-held debt, with a number of hedge funds amassing Greek debt with the intention of refusing to participate in any restructuring agreement. The troika’s debt sustainability analysis stated that for every 5% decline in participation, Greece’s debt-to-GDP ratio in 2020 would increase by 2%. In order to encourage participation, Greece will ‘retrofit’ any bonds not exchanged through the main PSI deal with collective action clauses, although this has been described as ‘not an attractive idea at all’ by the chairman of the IIF, Charles Dallara. Some commentators predict that retrospectively changing the terms of bonds in this way could activate credit default swaps (financial instruments that pay out in the event of a forced Greek default or restructuring), generating financial instability.

Another reason the PSI deal is being treated with trepidation is that it could reduce the likelihood of Greece issuing debt on the open market for the foreseeable future. This is because the bonds being exchanged under the PSI deal are partly backed by the EFSF, making them a far less risky prospect for investors than bonds backed by the Greek government alone. In effect, buyers of any new Greek debt in the future would, in the event of default, now be at the bottom of a large heap of creditors to be paid back in the event of default, including the IMF, individual eurozone governments, the EFSF, the ECB, and PSI participants.

By reducing the face value of their holdings, the PSI deal will affect all private sector holders of Greek bonds, although the drawn-out nature of the crisis has meant that many financial institutions have already made allowances for a significant write-down of Greek debt. Financial institutions in Greece, however, which hold large quantities of Greek sovereign debt, will face crisis without significant recapitalisation. It is reported that this will be funded through purchase of shares by the Greek government; these are to have restricted voting rights, thereby technically avoiding the nationalisation of major Greek financial institutions. The troika’s debt sustainability analysis projects that €50bn will be needed to recapitalise Greek banks to a level where they can absorb these losses.

3.3 Official sector involvement

The European Central Bank and the national central banks of the eurozone member states are not included in the PSI deal described above. The ECB is the largest single holder of

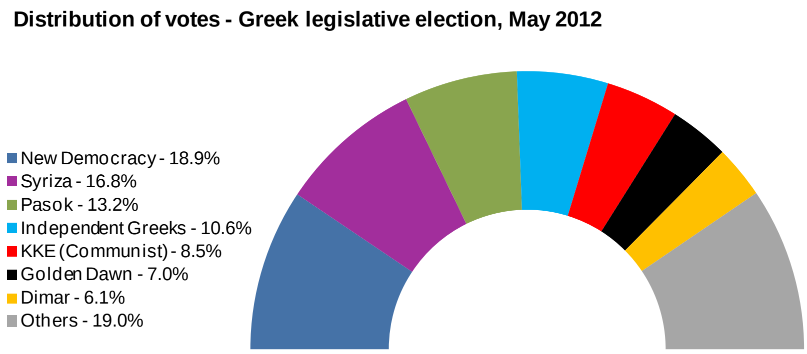
[15] The net present value is the value of the bond principal and the interest payments over time discounted back to their present value. The net present value cut is higher than the ‘haircut’ because both the face value of the bond and future interest payments have been reduced.

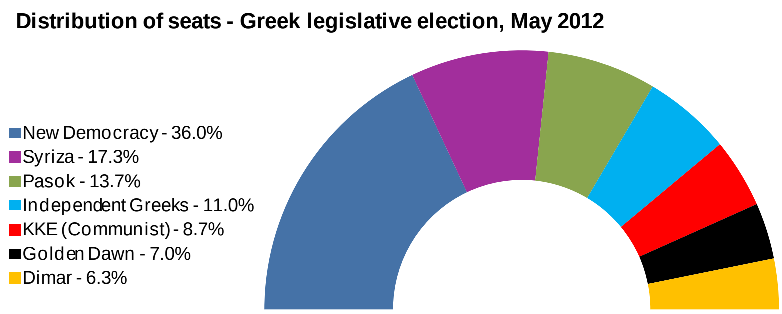
Greek debt (estimates put its holdings at €40bn), which it has acquired at depressed prices as part of its Securities Markets Programme over the past year. Until recently, it had been fiercely resistant to having its holding of Greek debt restructured, arguing the debt had been acquired for monetary policy purposes, and that allowing its face value to be reduced would violate the principle of ‘no monetary financing’ of eurozone governments.

The difficulty with this position, as pointed out by the head of the IMF, Christine Lagarde, lay in the fact that unless such official holdings of Greek debt were restructured, commensurately larger ‘haircuts’ would be required of the private creditors, which reduced the likelihood of achieving an agreement with widespread participation.[16] Other commentators also pointed out that there was no legal reason why ECB holdings of Greek bonds should have any special status imparted to them, and that it stood to profit from its Greek debt holdings, since they were acquired at below their face value.[17]

Under the programme, the ECB has agreed to distribute profits from its holdings of Greek government bonds to the eurozone's national central banks; these proceeds will then help to fund a lowering of the interest rates on all official loans to Greece (i.e. under the first and second programmes), so that the margin on these is 150 basis points (1.5%) above the market cost of financing the loans, as opposed to 200 basis points (2%) previously. In exchange, the ECB has been allowed to swap its existing Greek bonds for new contracts that will ensure it cannot be compelled to participate alongside private sector creditors in future restructurings. Profits from any holdings of Greek government debt held by national central banks are to be distributed directly to Greece.

4 The May 2012 election





The legislative elections in Greece on 6 May 2012 left its parliament divided evenly between groups of parties that support the loans agreement and those that oppose it. In particular, the *Syriza* party, (also known as the Coalition of the Radical Left), which placed second in the elections, are strongly opposed to the agreement, describing the attached conditions as ‘barbaric’. The party refused to engage in negotiations with the ‘pro-bailout’ Pasok and New Democracy parties, despite the Pasok leader and former Deputy Prime Minister Evagelos Venizelos proposing a ‘progressive disengagement’ from the loan conditions. Dimar (also known as the Democratic Left) was unwilling to enter into a coalition without the participation

[16] See, for instance *Lagarde presses ECB over debt deal*, 24 Jan 2012

[17] See, for instance, the FT Alphaville blog *Dealing with Greece's biggest holdout*, 13 Jan 2012

of *Syriza*, leaving the parties irreconcilably polarised and unable to form a majority government.[18] A new vote has been called for 17 June.

The indecisive result in Greece, and the strong vote for parties opposed to the terms of the bailout, have once again called into question the country's future in the euro, and the sustainability of externally-imposed measures that, at least in the short-term, are so economically damaging and lacking in public support. The results left senior eurozone leaders in a bind, since they firstly had to be seen to respect the election results; secondly to be seen to believe in the cohesiveness of the currency union; and thirdly to take a non-negotiable stance on the bailout conditions. The response has been to play on Greeks' desire, evident from opinion polls, to remain in the euro. Just as the aborted referendum on the terms of a second loans agreement in November 2011 was characterised as a vote on eurozone membership (see Section 2.2), so too has the June 2012 election been recast as a referendum on Greece's future in the single currency:-

> We have to respect that there will be new elections in Greece... we will make it clear that we want Greece to remain in the eurozone, and that is what the citizens are voting on. [Angela Merkel, following first meeting with Francois Hollande, 15 May 2012][19]

> We want Greece to remain part of our family, of the European Union, and of the euro... this being said, the ultimate resolve to stay in the euro area must come from Greece itself [European Commission president Jose-Manuel Barroso, 17 May 2012][20]

Although this approach has been described as an 'agreed position' of the EU institutions and eurozone leaders, there are some indications of discord. EU Trade Commissioner Karel De Gucht said on 18 May that the Commission and ECB were 'working on emergency scenarios if Greece does not make it'; but the Economic and Financial Affairs Commissioner Olli Rehn denied this. The President of the Eurogroup, Jean-Claude Juncker came out fighting in a press conference on 14 May, describing talk of Greek exit from the euro as 'nonsense [and] propoganda... we have to respect the Greek democracy', but was reported as warning the Greek finance minister at the meeting that same day that the 17 June elections were Greece's 'last chance' to stay in the eurozone, and that were a secret vote to be held among eurozone leaders on Greece's membership, 'an overwhelming majority [would be] against'.

5 Possible outcomes from the June 2012 election

5.1 Pro-bailout majority

If a majority coalition of 'pro-bailout' parties can be formed after the 17 June elections, a disorderly default and the possible exit of Greece from the euro area may be averted, at least in the short term. However, the country has already experienced an exceptionally severe recession and cuts in public sector spending (see table below), and if its economy does not quickly see a return to growth and a revival in employment under the new programme, the same pressures could re-emerge. If this happens, the question of Greece's exit from the single currency will be firmly back on the table.

[18] Of the remaining parties, KKE (Communist) is opposed to the bailout, along with Independent Greeks (moderate right) and Golden Dawn (extreme right).

[19] Quoted in *Merkel and Hollande spell out Greek fear*, 15 May 2012

[20] Quoted in *Greeks urged to run poll as vote on euro*, 17 May 2012

Greece's recession and austerity have been severe by eurozone and international standards
Selected indicators, peripheral eurozone and other economies experiencing financial and sovereign debt crises

	Greece	Ireland	Portugal	Spain	Italy	Latvia, 2007	Argentina, 2002	Mexico, 1994	Indonesia, 1998
GDP fall, peak to trough[a]	-16%	-12%	-5%	-4%	-5%	-24%	-20%	-8%	-13%
Peak unemployment	21%	15%	14%	23%	9%	17%	24%	8%	6%
Private consumption, peak to trough[a]	-15%	-14%	-6%	-6%	-2%	-27%	-25%	-9%	-4%
Real disposable income, peak to trough	-23%	-9%	-8%	-4%	-6%	-24%	-24%	-5%	-18%
Government expenditure, peak to trough[a]	-34%	-14%	-7%	-4%	-2%	-18%	-7%	-9%	-25%

[a] Fall from peak to Q4-2011 for eurozone countries

Sources: Reuters; IMF *World Economic Outlook* database

Indeed, even the IMF itself has suggested that the terms of the bail-out may be too harsh, and that the pace of fiscal consolidation could be slowed. The fifth review of Greece's performance under its loans agreement, in March 2012, stated:-[21]

> Staff argued that demand effects from the implementation of structural reforms, as well as weaker economic prospects in Europe, called for a longer adjustment period (thus also allowing a more accommodative fiscal policy in the near term). The authorities argued that prolonging the adjustment path beyond 2014 would pose risks to credibility, and given resistance from their European partners, worried that this would be seen as a lack of commitment to Stability and Growth Pact targets.

In this context, it seems that a renegotiation of the bailout may well occur even if Greece elects a government that supports the conditions as they stand.

5.2 Anti-bailout majority

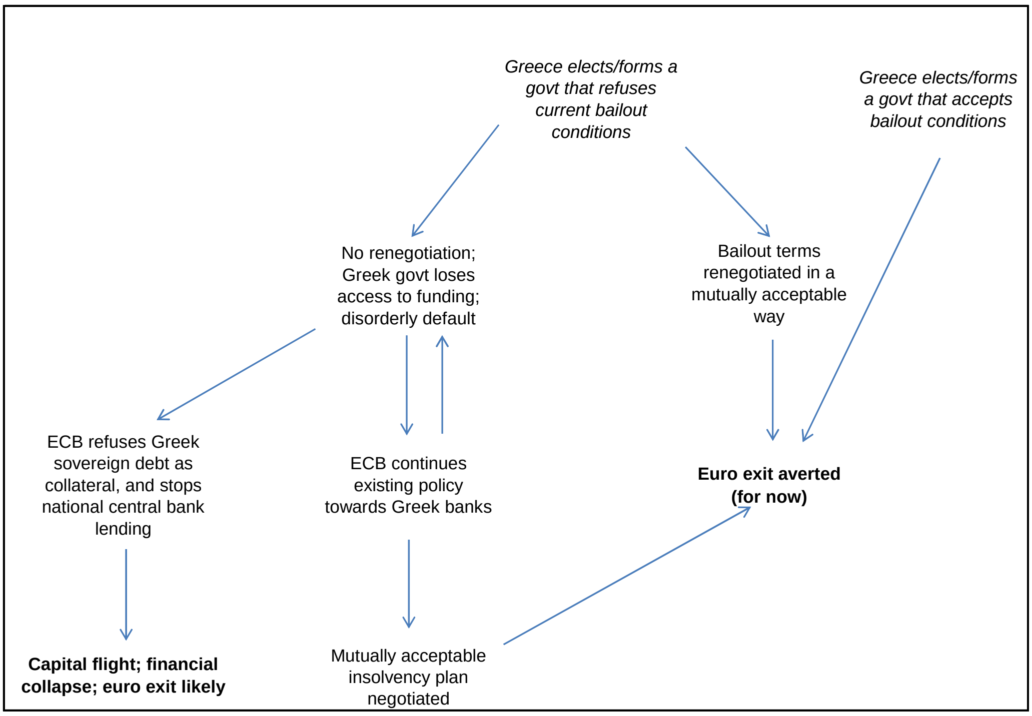
Conversely, if *Syriza* win the June 2012 elections, an a majority 'anti-bailout' coalition may be formed.[22] Ultimately, Greece's future in the euro if it rejects the terms of its current loans agreement will be a political and economic, rather than a legal one. On the one hand, EU Member States may 'blink' and agree to relax the terms of the agreement in a way that is acceptable to the *Syriza* party; on the other, they may refuse and stop disbursements of loans under the existing arrangement. With Greece unable to service its debts, it would default in a 'disorderly' way at some point before the end of June.[23]

Even if this political trigger were activated and Greece defaults, it does not necessarily follow that the country needs to leave the euro. The probable death-knell would be the refusal of the European Central Bank (ECB) to accept Greek sovereign debt as collateral against lending to Greek banks. Shut out of interbank lending markets, banks in Greece have become heavily reliant on emergency lending from both the ECB and Greece's national central bank. This lending is secured against their holdings of Greek sovereign debt and other collateral. The ECB has repeatedly lowered the standards of collateral it accepts in its emergency lending operations to accommodate Greek banks; the Greek national central bank, meanwhile, accepts even lower-quality collateral. Outright default on Greek sovereign debt would be a very good reason for the ECB to reject this collateral once and for all. With a two-thirds majority, the ECB can also stop any increase in the Greek national central bank's

[21] IMF *Greece: request for extended arrangement under the extended fund facility – staff report*, p.19 (March 2012)
[22] The winner of the largest number of votes gets a 50-seat 'bonus' in the Greek parliament, making the fact of victory as important as the margin.
[23] Reuters *Greece might run out of cash by end June if no government – sources*, 7 May 2012

lending to Greek banks. This would effectively 'pull the plug' on the Greek financial system. Were the ECB to call in the €140bn debts already extended to Greek banks, this could happen in dramatic fashion, since every domestic bank in Greece would be rendered immediately insolvent.[24]

Options for Greece



There are other options for the ECB, however. If it is willing to bend its collateral rules still further, or continue to allow the Greek national central bank to lend to the financial sector, then Greece can be kept in the euro area. Again, the ECB's decision will be a political one. As a recent Goldman Sachs report noted:-[25]

> In the end, the ECB is unlikely to accept final political responsibility for excluding Greece from the Euro area and/or precipitating a Greek financial collapse. It will therefore have to make decisions across these dimensions in conjunction with the governments of core Euro area countries, who would then decide Greece's fate in that regard.

Even if the ECB were to continue to support Greece following default, a plan to deal with sovereign insolvency would quickly have to be negotiated and agreed. Some commentators have suggested a 'Marshall Plan' for Greece, involving debt relief and fiscal transfers from the eurozone 'core', although there has been considerable resistance in countries such as Germany to provide the eurozone periphery with loans, let alone grants.[26]

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[24] See, for instance, Paul Mason for BBC *Watch deposit flight, not the eurocrats*, 16 May 2012
[25] Quoted on zerohedge blog *What happens if Greek payments stop: Goldman's thought experiment on 'the day after'.*
[26] See, for instance, JP Morgan *Greek contagion*, reproduced on zerohedge blog, 14 May 2012

6 Leaving the euro

Greece's exit from the euro would occur at the point where the ECB refuses to lend to Greek banks and stops Greece's national central bank from doing the same.[27] Without the support of the ECB, Greece's relationship with the euro would be similar to that of Montenegro's, which uses the currency without being part of the currency union and (hence) without access to ECB support. Such a situation might be induced by the interaction of market forces and politics: for instance, a deadlock between the Greek government and EU Member States and institutions could cause a run on Greek banks and the need for a sharp increase in emergency central bank funding. Were the ECB to refuse this, (i.e. deny the Greek central bank the ability to create euro-denominated loans), the pressure to prevent a collapse of the Greek financial system by imposing capital controls and redenominating to a new currency, would be overwhelming.

If it seems unlikely that other eurozone members would wish to Greece stay in the euro having again repudiated the terms of its loans agreements, it is worth bearing in mind the costs attached to Greek exit from the euro not just for Greece itself, but for the euro area and the wider EU. This is discussed in Section 6.4.

6.1 Practical issues and short-term consequences for Greece

For a peripheral country like Greece, there are two stages to leaving the euro. The first would be **redenomination**, a technical exercise whereby all prices, payments, bank deposits and those debts issued under Greek law are converted into the new currency (call it the *new drachma*) through an act of parliament. Taken with devaluation (see next paragraph), this would result in them losing their value (in euro terms). Those contracts issued under foreign law could also be redenominated, but creditors would have recourse to courts outside Greece to secure repayment in euro.

The second stage would be **devaluation** (a loss in the value of the new drachma, relative to the euro and other countries), which would be an inevitable economic consequence of leaving the euro for a country like Greece. This is partly because the country has weak competitiveness, and there would be an excess of supply over demand for its the drachma at the starting rate; and partly because the widespread expectation of devaluation would precipitate just that outcome (a self-fulfilling prophecy), as individuals exchanged drachmas for euros 'today' in anticipation that the rate at which they can do so 'tomorrow' will be lower. Based on the experiences of Latin American countries in the late 1990s and early 2000s, some commentators have suggested that a new Greek currency would lose 30-60% of its value.[28]

The effect of redenomination and devaluation would be to lower the purchasing power of Greek wages and savings, but also to reduce the value (in euro terms) of debts and other obligations. In advance of any departure from the euro, there would thus be a strong incentive for savings held within Greece to be moved abroad (a process known as capital flight), or simply held as cash, to spare them from redenomination. The effects of this could be severe, with runs on banks creating the possibility of financial collapse, especially if the Greek central bank was prohibited from providing lender of last resort protection to financial institutions. As Willem Buiter notes, 'the Greek banking system would collapse even before

[27] The 'formal' exit of Greece for the eurozone would be a far more drawn-out process, involving changes to the EU Treaties (see Section 6.2)

[28] See, for instance, Buiter and Rahbari *Rising risks of Greek euro area exit*, 6 Feb 2012

Greece had left the monetary union'.[29] To an extent, capital flight has already been occurring for two years, and accelerated following the election results on 6 May (the term 'bank jog' has been used by some commentators to describe the recent outflow of deposits).[30]

To mitigate these effects, careful planning would be necessary in the run-up to euro exit. An element of secrecy could be maintained in the early stages, but most commentators believe that the process of printing a new currency could not be done in secrecy. Capital controls that prevent cross-border movements of money, combined with bank holidays to prevent withdrawal of deposits, could buy time to allow the redenomination of debts and savings to take place; both of these measures would have to be imposed without warning if they were to be effective.

In terms of printing and distributing new notes and coins, Capital Economics estimates the lead time for this process at anything from a few weeks to six months. It is clearly not possible for banks to be shut for this long. The solution they propose in their Wolfson Prize submission is to accept that there will be a period without new notes and coins, and to rely on non-cash payment mechanisms (electronic, cheque and informal) for the majority of transactions. Euros could continue to be used (at least for a transition period), though euro withdrawals from banks would need to be treated as a foreign currency transaction, debited from drachma-denominated accounts at the prevailing exchange rate.

Clearly the extent of disruption to Greece caused by euro exit will depend to a great extent on the level of co-operation and support provided by EU Member States and institutions, in the short-run by agreeing to capital controls, [31] providing technical assistance and possibly funding the recapitalisation of Greek banks, and in the long-run by allowing Greece to remain within the EU.

6.2 Legal issues

There are no provisions in EU law that allow a country to withdraw from the euro. The Lisbon Treaty did, however, include an article that allowed for the withdrawal of a member state from the EU itself:-[32]

> Any Member State may decide to withdraw from the Union in accordance with its own constitutional requirements.

The exit clause further provides that a Member State wishing to withdraw from the EU must inform the European Council of its intention; the Council is to produce guidelines on the basis of which a withdrawal agreement is to be negotiated with that Member State; and the Council, acting by a qualified majority and after obtaining the consent of the European Parliament, will conclude the agreement on behalf of the EU. The withdrawing Member State would cease to be bound by the treaties *either* from the date provided for in the withdrawal agreement or, failing that, *two* years after notification of its intention to withdraw.[33] Having withdrawn from the EU, the former Member State would then be at liberty to choose their currency. Of course, a country wishing to leave without going through these formalities could

[29] Buiter and Rahbari, *Citi Global Economics View*, 13 Sep 2011

[30] See, for instance, FT Brussels Blog *The slow-motion run on Greece's banks*, 17 May 2012

[31] These contravene EU Treaties, but can be imposed for up to six months if approved by the Commission, the ECB and a qualified majority of Member States

[32] A more thorough analysis of the legal issues surrounding leaving the EU can be found in Library Standard Note SN/IA/6089 *In brief: leaving the European Union*

[33] ECB *Withdrawal and expulsion from the EU and EMU – some reflections*, Legal working paper series 10/2009

simply walk away from its treaty obligations, though it could be fined at the Court of Justice for doing so.[34]

There is, however, no mechanism by which a country could leave the euro while remaining a part of the EU, and the weight of legal opinion, including that of the ECB, is that withdrawal from the euro without simultaneous EU membership withdrawal would be illegal under the current Treaty provisions, and in defiance of the 'irreversibility' of monetary union. For a country to remain an EU member having withdrawn from the euro would thus require a negotiated agreement with other Member States. Such an agreement would necessarily involve a Treaty amendment and the unanimous consent of Member States.

Some commentators have suggested that a possible Treaty change that would allow Greece to remain in the EU having left the euro would be the insertion of a monetary union 'opt-out' along the same lines that enjoyed by the UK and Denmark. [35]

6.3 Longer-term consequences for Greece

Positive consequences – the case for euro exit

The question of whether exit from the euro would be 'desirable' for certain countries, especially Greece, is hotly debated. On the one hand, some commentators point out that currency devaluation is exactly what many struggling peripheral countries need to restore their export competitiveness (through the effect on relative prices of exports and imports), and reduce relative wages and unit labour costs. A new, relatively cheaper, currency would also make the country more attractive as a destination for both doing business and taking holidays. Leaving the euro and letting the currency fall, therefore, offers an alternative to the harsh process of fiscal austerity and 'internal devaluation' (the process of allowing price-adjusted wages to fall) currently being imposed on the eurozone periphery, a process which, it is asserted, is doomed to failure:-

> Cutting public deficits will reduce demand both at home and in other euro-zone members. As several, if not all, members of the euro-zone are attempting to improve their position through cutbacks, they will find that they are pedalling ever harder to remain in more or less the same place. Even if the consequent downward pressure on wages and prices results in an improvement in competitiveness, for most countries this will take many years, if not decades, to work.
>
> Moreover, price deflation would worsen the financial problem because it would increase the real value of debt, thereby intensifying both the downward pressure on aggregate demand and the fragility of the banking system. (This is the phenomenon of debt deflation, as explained by Irving Fisher.) So the objective of improving competitiveness is at odds with the objective of reducing the debt burden. [Capital Economics, Wolfson Prize submission, p.7-8]

Combined with devaluation, redenomination could also achieve a major reduction the effective public debt burden in euro terms, and it would be possible to reduce the real value of the debt in 'drachma' terms by engineering or tolerating a higher rate of inflation (something not currently possible with the ECB in control of monetary policy). Though there will be little scope for boosting demand through fiscal measures, the flexibility to undertake alternative monetary policy, such as quantitative easing, may enable governments to stimulate domestic consumption. Finally, regaining control over currency issuance would

[34] Ashurst London *Exiting the euro – legal consequences*, Jan 2012
[35] Capital Economics *Leaving the euro: a practical guide*, see in particular p.26-7

enable the exiting country to finance its debts (or at least credibly commit to doing so) through printing money; it may therefore enable the Greek government, over the longer term, to borrow money on the open market once again.

Negative consequences – the case against euro exit

On the other hand, it is asserted by some that the benefits of exchange rate devaluation in the eurozone periphery are exaggerated. In Greece, for instance, Willem Buiter points out that, with only two large labour unions, there are currently no significant co-ordination problems that might prevent downward adjustment of wages, and therefore the benefits of adjustment through the alternative mechanism of devaluation are minimal:-[36]

> It is our view that, without simultaneous deep structural changes in the legal... and regulatory determinants of the balance of bargaining power in labour and product markets, without the removal of barriers to entry in the private service sectors and without the privatisation of a vast array of inefficient state-owned enterprises, a sharp depreciation/devaluation of the New Drachma would go through the nominal wage and other nominal domestic cost structure like a dose of salts. Following a sharp bout of inflation, the same uncompetitive real equilibrium would be restored.

At least initially, even if the country did not default in a technical sense, the effective default on liabilities arising from redenomination would mean the government and private sector would be cut off from external funding (i.e. they would be unable to borrow on the open market). In assessing the benefits of euro exit with respect to debt and borrowing conditions, the crucial questions are then how soon they would regain access to external funding, and at what interest rate. Greece is heavily reliant on external funding to finance its current account deficit, and a prolonged period shut out of debt markets would, according to Buiter, 'force a savage compression of imports and a deep recession'.[37]

It is also pointed out that euro exit cannot simultaneously address the problem of poor competitiveness and excessive debt. As Capital Economics points out:-[38]

> A successful devaluation which left a lasting impact on competitiveness would depend upon any inflationary upsurge being kept in check. So even if inflation were a viable and successful way out of the debt problems (which is itself debatable) the need to improve competitiveness rules it out. This means that excessive debt will need to be addressed by other means, probably involving some measure of default.

A devaluation might also eliminate the economic imperative to enact the structural and fiscal changes many see as necessary to repair the Greek economy; namely, reforming labour markets, raising the retirement age, and reducing the generosity of pensions.

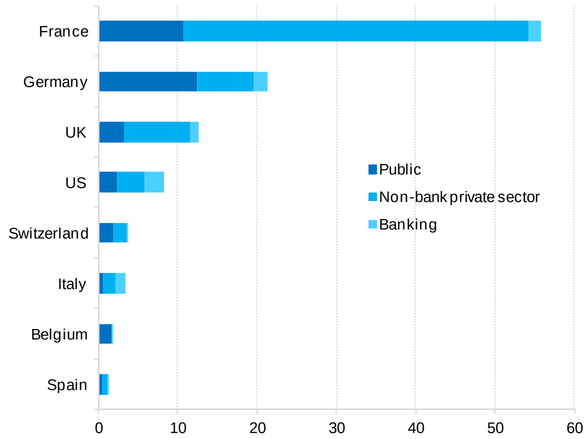
[36] Buiter and Rahbari, *Citi Global Economics View*, 13 Sep 2011
[37] Buiter and Rahbari *Rising risks of Greek euro area exit*, 6 Feb 2012
[38] Capital Economics *Leaving the euro: a practical guide*, p.12

6.4 Wider consequences

Private sector losses

To the extent that foreign banks are exposed to (i.e. held) the private, banking and public debt of Greece, they could experience losses on its exit from the eurozone, whether or not the currency in which the debt was payable was changed.[39] The chart on the right shows the exposure of Greece's public and private sector creditors by location: France and Germany hold the majority of Greek debt. UK financial institutions hold around $8.3bn of Greek non-bank private debt, $3.3bn of public debt, and $1.1bn of banking debt.[40] Foreign banks have reduced their exposure to Greek debt by over 60% since 2009.

Exposure to Greek debt, by location
Selected economies, by sector, Dec-2011, $bn



Quarterly Review, Appendix Table 9E

Official sector losses, including TARGET2

To varying and complex degrees, official institutions in the eurozone are exposed to Greek debt. Eurozone states are exposed through loans provided directly and via the EFSF under the Greek bail-out agreements (around €53bn in bilateral loans and a further €73bn through bank recapitalisation and guarantees for private bondholders agreed as part of the second bail-out). They are further exposed through the ECB and national central bank holdings of Greek debt: the ECB also holds around €40bn of Greek debt, although this has been exempted from any future restructurings, meaning it will get paid back ahead of ordinary creditors in the event of default. The IMF has disbursed around €23bn in loans to Greece, of which the eurozone is liable for around €4.4bn (and the UK €1bn), although in the event of default the IMF gets paid back before all other creditors.

One of the most significant liabilities to eurozone countries arises through the mechanism that processes cross-border bank transfers in the eurozone, known as TARGET2. Following the creation of the eurozone, financial institutions retained their accounts at their respective national central banks. Through these accounts, cross-border payments are credited and debited. As this occurs, the national central banks mediating the transaction accumulate credits and liabilities to the TARGET2 payment mechanism. For instance, a cross-border payment of €1,000 from Greece to Germany leads to a claim by German central bank on the TARGET2 mechanism of €1,000, and a liability by the Greek central bank for the same amount. Greece's liability to the TARGET2 system has accumulated rapidly in recent years, partly as a result of its weak competitiveness and trade deficit (more is paid for imports than is received in return for exports), partly because investors have scaled back their holdings of Greek debt, and more recently as savings in Greek banks are moved abroad. So long as the euro area is cohesive, there is no risk of loss through TARGET2; but where a country with liabilities to TARGET2 reverts to its own currency, it may repudiate the claims of other central

[39] If redenomination of debts into the new currency did not occur, the burden of repayment would increase as the new currency depreciated in value, making default more likely. If redenomination did occur, this would be tantamount to default since the value of payments in the new, depreciated currency would be lower than if they were in euro.

[40] Bank of International Settlements, Quarterly Review, Appendix Table 9E

banks. Formally, these losses would be shared out among the remaining eurozone countries in proportion to their capital share in the ECB (based on population and economic size); however, in the event of the collapse of the eurozone, this formula might not be relevant.[41]

Official sector exposure to Greece

	Bilateral loans	EFSF	ECB Target2	ECB/EIB holdings of Greek debt	IMF	**Total**	*% GDP*
Belgium	1.9	2.7	4.6	1.5	0.3	**11.0**	*2.9%*
Germany	15.2	21.2	36.2	12	1.1	**85.7**	*3.3%*
Ireland	0.3	0	2.1	0.7	0.1	**3.2**	*2.0%*
Spain	6.6	9.3	15.9	5.3	0.4	**37.5**	*3.4%*
France	11.4	15.9	27.2	9	0.8	**64.3**	*3.1%*
Italy	10	14	23.9	7.9	0.6	**56.4**	*3.5%*
Cyprus	0.1	0.2	0.3	0.1	0	**0.7**	*3.3%*
Luxembourg	0.1	0.2	0.3	0.1	0.1	**0.8**	*1.8%*
Malta	0.1	0.1	0.1	0	0	**0.3**	*4.3%*
Netherlands	3.2	4.5	7.6	2.5	0.4	**18.2**	*2.9%*
Austria	1.6	2.2	3.7	1.2	0.2	**8.9**	*2.9%*
Portugal	1.1	0	3.3	1.1	0.1	**5.6**	*3.3%*
Slovenia	0.2	0.4	0.6	0.2	0	**1.4**	*3.9%*
Slovakia	0	0.8	1.3	0.4	0	**2.5**	*3.7%*
Finland	1	1.4	2.4	0.8	0.1	**5.7**	*2.9%*
Estonia	0	0.2	0.3	0.1	0	**0.6**	*4.2%*
Euro area	***52.9***	***72.9***	***130***	***43***	***4.4***	***303.2***	***3.2%***
Memo: UK	*0*	*0*	*0*	*0.1* [a]	*1.0*	***1.1***	*0.06%*

[a] The UK is exposed via the EIB's holdings of Greek sovereign debt, which are said to be between €100m and €1bn. Based on a 16.2% shareholding, this gives the UK an exposure of between €16.2m and €162m.

Source: Nomura Economics; IMF finances data; Bloomberg; ONS National Accounts

Contagion and secondary effects

The idea of a country leaving the euro was until recently a political taboo. This is because investors' perceptions of the riskiness attached to the debt of particular eurozone countries is to an extent dependent on their belief in the commitment of leaders to do whatever is necessary to maintain the currency union in its present form. By admitting that they were willing to conscience euro exit for Greece (which they began to do from November 2011),[42] eurozone leaders were implicitly admitting they are willing to conscience it for others, too. Similarly, the exit of one country from the eurozone, though it would undoubtedly be characterised as 'exceptional' by eurozone leaders and officials, would inevitably raise questions about the cohesion of the single currency. Even if Greece did eventually prove to be the exception, it is argued that the uncertainty this would create would lead to a costly period characterised by risk aversion, reduced confidence and depressed asset prices. Higher risk premiums for the debt of other peripheral eurozone countries would increase the likelihood of sovereign debt crises, while capital flight and risk aversion among banks would raise the chances of financial crises. Economic activity would also be depressed by a drying-up of credit to businesses, and by the effects of weak consumer and business confidence on investment and consumption.

[41] See, for instance, Martin Wolf *What has the ECB done in the crisis? The role of TARGET balances*, FT 28 Dec 2011. For more on the TARGET2 system and the accumulation of claims on the eurozone periphery through this mechanism, see Sinn and Wollmershaeuser (2011) *Target loans, current account balances and capital flows: the ECB's rescue facility*

[42] Following the Greek Prime Minister's announcement of a referendum on the terms of a second loans agreement, Angela Merkel stated at a press conference on 3 November 2011, "the referendum will revolve around nothing less than the question 'does Greece want to stay in the euro: yes or no?'"

Eurozone survival

Greece's exit from the euro is unlikely to cause the break-up of the currency union on its own: its economy is small, and its interconnectedness with the rest of the eurozone, via the financial sector and trade, is comparatively limited. In isolation, the wider losses from Greek exit would, in the view of many, be sustainable. The real danger of Greek exit arises from the contagion to larger and more integrated economies discussed above. Whether this happens will depend on the extent to which investors see Greece as a special case, and hence on whether a convincing posture of solidarity and commitment to the currency union can be sustained following Greece's departure.

6.5 Focus on the UK

Despite the focus on the problems of the eurozone, the UK's economy has not outperformed the currency union as a whole over the past two years, and its output remains further below the pre-recession peak. The Government has distanced itself politically from the eurozone through its refusal to sign the 'fiscal compact' Treaty. However, the UK and the eurozone economies for the time being will remain closely intertwined: strong links through trade and the financial sector mean that, were the eurozone crisis to continue or worsen following Greek exit from the single currency, it could further stifle the UK's faltering recovery. As Mervyn King put it:-[43]

> The euro area is tearing itself apart without any obvious solution. The idea that we could reasonably hope to sail serenely through this with growth close to the long-run average and inflation at 2% strikes me as wholly unrealistic

As in the rest of Europe, the effects of Greek exit on the UK are highly dependent on the extent of contagion, described in Section 6.4 above. In isolation, even a severe economic crisis in Greece would not be disastrous because the UK's trade links with Greece are minimal, and its exposure to Greek debt is relatively low and declining. The secondary effects of Greek exit, however, in the form of a collapse in confidence and a more general downturn in the euro area, are potentially more severe and highly uncertain.

Trade

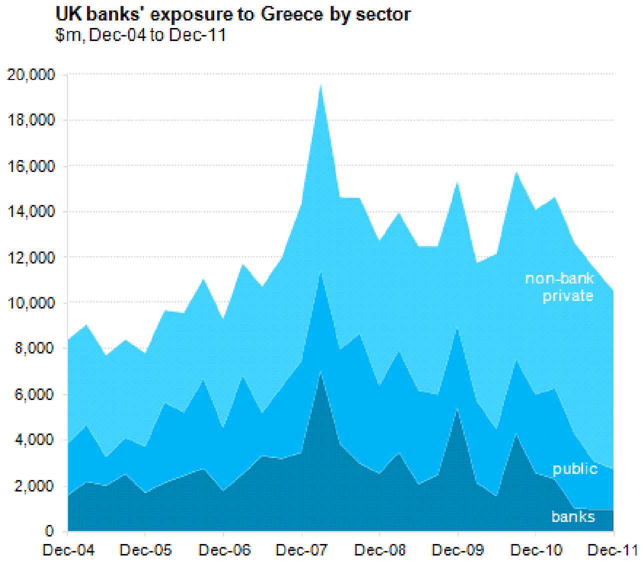
In 2010, Greece was the 32nd most important destination for UK goods (£1.4 billion or 0.5% of all UK goods exports) and the 29th most important destination for UK services (£1.1 billion or 0.7% of all UK services exports). It is thus not a significant export market. More details are available in the Library Standard Note *UK-Greece Trade Statistics*.

More generally, 47% of total UK exports went to the eurozone in 2011. Exports to the eurozone have held up despite the crisis (see chart), largely because most go not to the beleaguered periphery, but to Germany, France and the Netherlands, which have performed far more strongly. Most forecasters expect trade to be the strongest driver of GDP growth in the UK in 2012, and so adverse developments there have the potential to return the UK to recession, particularly if the effects are felt in the eurozone 'core' that comprise the UK's key export markets. Demand for UK exports might also be affected were the euro to fall significantly against sterling, as might happen were the economic situation to deteriorate.

[43] Press conference on Bank of England *Quarterly Inflation Report*, quoted in BBC *Bank governor warns of euro crisis 'storm'*, 16 May 2012

Financial sector

The UK financial sector was exposed to around $12bn of Greek debt at the end of 2011. In the event of euro exit, there is a high risk of heavy losses on this debt, both directly through default, and indirectly through the redenomination of contracts into a new currency (which would rapidly devalue). In isolation, the effects on the UK financial sector from Greek exit are widely considered to be manageable.[44] Linkages through third countries may, however, generate more substantial losses: UK financial institutions are more heavily exposed to French banks, which in turn have much greater exposure to Greece (around $56bn at the end of 2011).



Source: Bank of England statistical database, Series VPQB2S3GR; VPQB2S4GR; VPQB2S5GR

Note: due to differences in methodology, figures may not precisely match the chart showing international comparisons of exposure in Section 6.4

Significant writedowns on their holdings European debt would raise concerns about UK banks' profitability. This, combined with more general stress in financial markets that might follow from Greek exit, could raise UK banks' borrowing costs and limit their capacity to lend to the domestic economy, something which could hinder economic recovery. More seriously still, in the event of larger economies such as Spain and Italy being forced out of the euro, or full eurozone break-up, the financial linkages between the eurozone and the UK would, in the view of many, precipitate a banking crisis in the UK and the requirement for urgent recapitalisation, possibly using public funds.

[44] See, for instance, *UK fears sound of a Greek exit*, FT 18 May 2012