

Focus Online

June 17, 2015

Expert Opinion

Should the ECB so wish, the lights would go out in Greece

by Michael Heise

What would happen if the European System of Central Banks stopped financing the Greek economy? Although there are no indications in this regard at present, in view of the lack of progress of the negotiations with Greece closure of the ECB floodgates cannot be ruled out. This would have severe consequences, particularly for the banking system in Greece.

Currently the focus is on negotiations among politicians; in actual fact, however, it is the European System of Central Banks (ESCB) that is currently playing the key role in financing the Greek economy. It enables the Greek Central Bank to accept securities as collateral, the credit rating of which does not correspond to normal standards and which are in danger of being downgraded (ELA=Emergency Liquidity Assistance). Here we are talking about bonds which are issued to a large extent, but not solely, by the Greek state. Greek banks are buying these securities and pledging them to the Central Bank. Many voices are calling for ELA credit lines to be frozen or restricted. After all, for Greece's euro partners, rising ELA credits constitute a significant financial risk. Fundamentally, all foreign transfers carried out by Greek banks on behalf of their customers are financed via a central bank credit for Greece. Put plainly this means that Greek companies or private households moving capital abroad are financed by a public credit. This creates a "Target2 balance", a net claim of the European Central Bank vis-à-vis the Greek Central Bank. It is true that these claims are upheld, without an expiry date, as long as Greece remains in the eurozone. If, however, the country were to leave the currency union, at least a significant proportion of these claims are likely to become void, since Greece hardly has the resources to pay off these credits. The German Bundesbank alone is set to lose EUR 27bn.

It would be possible to freeze or trim ELA credit lines, if a 2/3 majority resolution of the European Central Bank Council were to be passed. The consequences of such a resolution would be significant: without these emergency credits, which now total approx. EUR 83bn or about 45% of Greek GDP, two enormous problems would arise. The state would be unable to refinance government bonds that become due in the short-term, because the Greek banks - the main purchasers - would no longer be able to exercise any buying power. The likelihood of a government default would increase. And Greek banks would only have a limited ability to perform foreign transfers for their customers. This would put a stop to the build-up of Target2 balances. In addition it cannot be ruled out that Greek investors, anticipating restrictions on the deployment of their funds, would go to their banks in large numbers to withdraw their deposits. This would automatically lead to official restrictions on capital movements - e.g. limits on foreign transfers or cash withdrawals. Yet another possibility is that the Greek Central Bank would generate liquidity of its own, i.e. sort of create its own money. This would de facto be the first step away from the monetary union.

So the potential consequences of restricting ELA credit could be far-reaching. But ultimately the necessity of these emergency credits is the consequence of a policy which has destroyed the trust of private investors, cutting off both the Greek state and the Greek banks from the international market in the process. Over the longer term such a situation cannot be stabilized by new international credits. There comes a point when it is no longer possible to shield the population from the consequences of such policies. In Cyprus, emergency credits were restricted in the end to curb capital flight from the country and the risk for creditors.

As a last resort such a tool must not be declared off-limits. Imposing restrictions on ELA credits would significantly increase the pressure on the Greek government to arrive at an agreement with its creditors. Naturally it would be preferable if the Greek government were itself to recognize the threat of a default and a euro exit and engage in confidence-building policies. It is not yet too late to embark on such a course and to create the conditions under which capital stashed abroad would be able to flow back to Greece. This would hit several birds with one stone: the Greek banking system would regain liquidity, credit lines within the framework of the European System of Central Banks would be reduced and the economic development of the country would be boosted by investments. By contrast, the current political strategy pursued by the government is promoting capital flight. It fuels concerns about a sovereign default and the maintenance of the free movement of capital. The Greek people ought to realize that a sovereign default will also trigger a banking crisis. In that case, not only the creditor states, but also the Greek population itself will need to waive its claims.

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