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And now? A dark scenario

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Eurozone members, the IMF, and the ECB have announced significant commitments to assist debt-laden Greece. This column outlines a dark scenario in which the plan fails and contagion spreads, necessitating further assistance to other indebted Eurozone governments. That could risk high inflation or debt problems for the entire Eurozone.

The weekend announcement of a new plan for Greece, topped by the ECB decision to accept low-grade Greek debt instruments, is commonly seen as a European success. Quite to the contrary, we may have just planted the seeds of an unraveling of the monetary union. Here is a dark scenario.

Bailing out Greece

The plan will not work. Greece is supposed to reduce its deficit by 11% of GDP in three years. This would have been a tall order of requirement if the recovery was going to be strong. The drop in public spending, along with the psychological impact of the crisis, will provoke a profound recession that will deepen the deficit. This, along with the social and political impact of the crisis, will undoubtedly prevent the Greek government from delivering on its commitments. What will be done then? The IMF has the option of suspending its disbursements and forcing a default, as it did with Argentina. The EU governments, facing another loss of face (after letting the IMF into the den), may be tempted by forbearance. If they do, they will eventually to put in more money. If they don't, the Greek government will default, precisely what the whole plan aims at avoiding.

Once the markets realise this, they will further raise the interest that they request to roll over the maturing debt or simply refuse to refinance the debt. Greece will then depend entirely on the lifeline of the IMF and the European governments. At least, this will clarify the situation: the plan is about bailing out a Eurozone government, in direct violation of Art. 125 of the European Treaty, the so-called no-bail-out clause. The matter will be for judges to decide.

What about the others?

The next headache should be contagion. There was no fundamental reason for markets to run on the Greek debt. But we know that self-fulfilling crises may happen, and that they may be contagious (Obstfeld 1986, Eichengreen et al 1996). Even if it seems unfair, other countries stand to face the same situation. Already we see markets fretting about Portugal and Spain. What has been offered to Greece cannot be refused to other Eurozone governments. So, one more time, a (dwindling) group of deficit-stricken countries will have to provide money to increasingly large debtors. In fact, this process means that ultimately there is no national debt anymore, at least for the next few years. In effect, in the market eyes, there will then be just one Eurozone debt. Could markets run on all Eurozone public debts? Once again, no one would expect all Eurozone governments to be forced to default but markets can and do panic and self-fulfilling crises can occur wherever there is vulnerability. Just imagine that, one by one, each Eurozone country falls in the same trap as Greece. Eventually, Germany could be last one. Could it underwrite all the other public debts, on top of its already own respectable one? Current estimates set the overall Eurozone public debt level at 90% of GDP in 2012. This is reassuringly lower than Greece's 135%, but it is about the same as Portugal's and it represents 330% of the German GDP.

An alternative to spreading mutual underwriting is debt monetisation. The Greek debt is about one sixth of the ECB monetary base, already bloated after one year of credit easing. Absorbing part of this debt is doable. In fact, it is being done. The ECB has already on its book a lot of Greek debt as collateral for its lending operations. Having just accepted to continue accumulating more, even though its previous rule would have forbidden doing so after the latest rating downgrades, it would be surprising that much of the debt, now sub-investment grade, does not end up on the book of the ECB. Now assume that the Greek government defaults. The ECB does not buy assets outright, so the loss would be borne by the banks that used the Greek bonds as collateral for repo operations with the ECB. But banks are the ECB's counterparties; if they default, the loss is the ECB's. This can be called indirect monetisation of the debt. If the debt crisis stops here, this is manageable. Add Portugal, Spain and others, and you have the seeds of very, very high inflation.

This scenario may never happen, but then it may. Was there no other way? It would have been very easy to let Greece go straight to the IMF months ago and reschedule its debt with IMF's assistance. This would have been a partial default, and the haircut could have been quite small. Most banks that are exposed to the Greek debt should have been able to withstand such losses. With a grace period of, say, three years, Greece would have had the breathing space that the latest plan tries so hard to organise, but much simpler and much, much less dangerous. Well, it's not too late.

References

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