

Greece's Soft Budgets in Hard Times

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The first de facto default of a country classified as 'developed' has now taken place, with private international creditors 'voluntarily' accepting a 'haircut' of over 50% on their claims on the Greek government. As a result, Greece now owes very little to private foreign creditors. The country also agreed to even more stringent budget targets and, in return, received funding of more than €100 billion (\$134 billion) to stabilise its banking system. The purpose of the entire package is to avert a full-scale default and allow the country to complete its financial adjustments without unsettling financial markets too much. But this approach (a haircut on private sector debt plus fiscal adjustment) is unlikely to work on its own.

The real problem of Greece is no longer the fiscal deficit, but a combination of deposit flight with continuing excess consumption in the private sector, which for more than a decade now has become accustomed to spending much more than it earns. In Greece, this over-consumption had been financed (at least until now) by the government and as a consequence, most of the foreign debt comprised public-sector liabilities. The official line is that the over-consumption will cease once the government reins in expenditure and increases taxes.

But this might not turn out to be the case. The Greek population has become accustomed to consuming above its means; and it can continue to do so because effectively it faces a soft budget constraint: when Greek households have to pay higher taxes they can simply withdraw funds from their savings accounts and go on spending much as before. This is why, despite the strong fiscal adjustment, Greece's current account deficit remains close to 10% of GDP.

Moreover, depositors have increasingly withdrawn their funds from Greek banks and transferred the money abroad. Estimates vary, but the best guess seems to be €50 billion, which is equivalent to a whopping 25% of GDP.

This cannot go on. Greece cannot regain access to financial markets until the current-account deficit is eliminated, and deposit flight stops. Unfortunately, the opportunity cost of keeping a bank deposit in Greece is rather low. Greek banks pay their depositors only about 2.8% interest. While this is better than zero at a German bank, the difference is too small to make a difference, given the real danger that Greece might have to leave the eurozone; which would render local deposits worthless. Interest rates must therefore be substantially increased to

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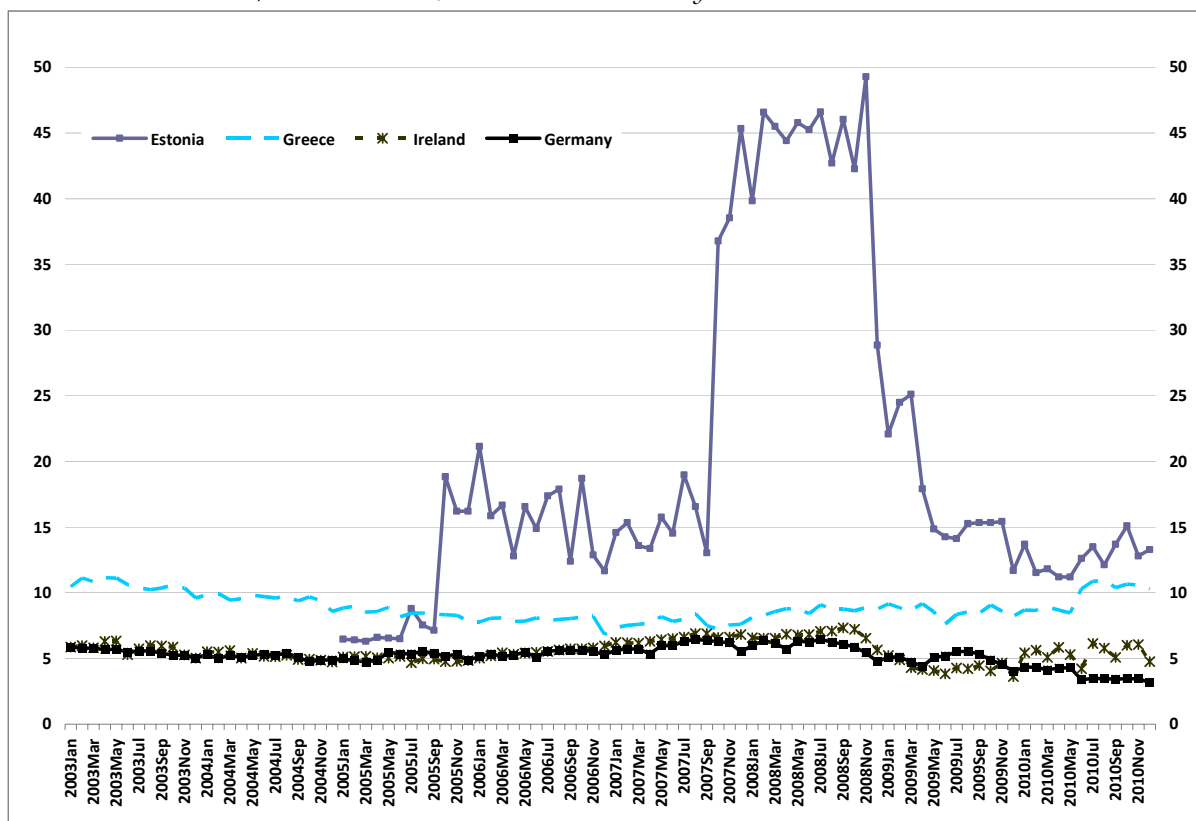
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induce Greek savers to keep their deposits and stop the haemorrhaging of the Greek banking system. At the same time, the cost of financing excessive expenditure must also be increased; otherwise, the current account deficit will continue.

At present, the average cost of new loans to enterprises and households is still only 6-7% in Greece. This might appear substantial, but in fact it is only a few percentage points higher than in Germany. The cost of credit for the Greek private sector remains surprisingly low for an economy that has been totally cut off from foreign capital markets, and whose government cannot obtain private funds under any terms. This must change. Estonia, which had an even larger current-account deficit before the crisis, offers an interesting counter-example. There, borrowing costs for new loans shot up over 40% when the financial crisis erupted (see figure below). This led to a very sharp adjustment in domestic consumption. But the benefit of this brutal adjustment was that the current account quickly turned into a surplus, and the country's creditworthiness was never questioned.

Figure 1. The difference eurozone membership makes in the cost of credit in a crisis: Estonia (non-euro at the time) versus Greece, Ireland and Germany



But why are interest rates in Greece still so low? The answer is simple: Greek banks still have access to financing from the European Central Bank at very low rates (1-3%). As long as this flow of cheap money continues, so will capital flight; no adjustment in consumption will take place as long as the country faces only a very soft budget constraint.

The ECB cannot stop the continuing flow of cheap funds to the country because it cannot discriminate between Greek and other banks. Under its current rules, Greek banks can obtain unlimited amounts of funding at ultra-low interest rates under the same conditions as other banks in the euro area. The ECB's first line of defence used to be that banks have to provide it with good quality collateral. But in the case of Greece (and Ireland), banks simply no

longer have enough good quality collateral. This is why an important change that has taken place in the financing of the Greek banking system in recent months has received little attention (and has been hidden as much as possible in the official statistics). Greek banks are no longer being refinanced via the normal channels of ECB lending against good quality collateral to so-called 'Emergency Liquidity Assistance' (ELA), for which the main security for the ECB is the national government guarantee – in this case a government that has just effectively defaulted on its private creditors. In effect, the Greek Central Bank has a license to print euros (as long as the government signs a pledge to make up for any losses).

The European Central Bank cannot tolerate this for too long, of course. But all it could do is to order the Central Bank of Greece to stop granting ELA to Greek banks. This means that at present the ECB cannot apply graduated pressure, which puts the ECB in something of a quandary. Either it leaves the tap on and allows the Greek Central Bank to continue supplying its banks with ELA, or it turns off the tap completely, which would mean the immediate collapse of the Greek banking system. The only way to get the ECB out of this lose-lose situation is to provide market incentives for savers to keep their deposits in Greece.

This is also the reason why the existing adjustment programme would not be sufficient, even if the Greek government were to implement everything as planned. If nothing is done to stop the capital flight and reduce private domestic expenditure, the Greek banking system will become ever more dependent on 'monetary' financing. The ECB has already provided about €120 billion to Greek banks (equivalent to 60% of GDP), and cannot tolerate any further increase in its exposure to a country that has just defaulted.

Massive increases in domestic interest rates might still be sufficient to induce savers to keep their deposits at home. If this is not done quickly, deposit flight is likely to escalate and the government will in the end have to impose a freeze on deposits or capital controls. But any move of this kind would lead to a breakdown of the Greek banking system, and potentially to massive contagion affecting Portugal, Spain and Italy.

If Europe's policy-makers do not recognise that deposit flight and continuing excess private expenditure constitute the real danger to the adjustment programme in Greece, they might soon have another crisis to deal with – of even greater proportions.