How to keep Greece in the Euro and why Europeans should do it

Despite the referendum’s resounding NO, despite Greece’s sovereign default, Greek banks should be made safe and viable, via a quick restructuring and recapitalization of the country’s four large banks, funded by the Eurozone large banks and/or by the European Stability Mechanism. Restoring confidence in the Greek banking system is critical. To this effect, we propose (1) to sever the link between banks and the sovereign; (2) to offer a Eurozone public guarantee (via the ESM) on Greek households deposits in the new four good Greek banks. In return, the Greek government would, first, agree not to meddle into the new good banks business. Second, not to levy exceptional taxes on these banks. Any infringement to these requirements would waive the deposit insurance. The Greek government would remain on its own, officially bankrupt, unable to borrow, free to choose its own economic policy, but forced to run at least a balanced primary budget.

1 No more “conditionality versus fresh money”

The Greek people have voted NO without any ambiguity in the July 5, 2015 referendum. Beyond the lack of specifics about the question on the ballot, Greek citizens have politically voted resolutely against the conditionality attached to the bailout programs sponsored by the EU, the IMF and the European Central Bank. They have rejected the whole idea of reforms against cheap money. It follows that a new bailout is now politically impossible. This NO vote comes after Greece has officially defaulted on its sovereign debt held by the IMF, and been forced to close its banks, threatening the whole Greek banking system.

2 NO vote does not imply Grexit

Many EU leaders and commentators have claimed, before the referendum, that a NO vote would entail a Greek exit from the euro (Grexit). At this point, common sense needs to prevail: Grexit is neither necessary, nor desirable. First, from a legal standpoint, there are no provisions in the EU Treaties for a country exiting the Euro. Second, there is nothing in the EU Treaties mandating that a sovereign default shall imply an exit from the euro, nor that a sovereign default would forbid the ECB to provide liquidity as needed, within its mandate. Third we firmly believe a Grexit could be a lethal blow for the euro. If Greece leaves, no matter
how hard the European Central Bank tries, redenomination risks will be forever with us. It will not be a question of “if” but “when” another country will face pressure to exit. Once the genie is out of the bottle... Fourth, there are geopolitical arguments for keeping Greece within the euro. Just look at a map of Greece...

It would be incredibly foolish to toss the Greek banking system overboard, the Greek economy with it, and possibly the rest of the Eurozone along. Forcing Greece out of the euro would be a terrible jump into the unknown. Anyone who claims to know the consequences of Grexit or claims to know how to ring-fence the rest of the Eurozone is likely deluding oneself.

The Greek people have not voted for leaving the euro, they have voted against what they perceived as excessively harsh conditionality. So let us take them at their words: let the government be free to choose its economic policy, without any conditionality or external money, but let’s keep Greece in the Euro. This requires that we do what is necessary save Greek banks.

3 Solving the Greek banking crisis is of utmost urgency

Greek banks, with a significant exposure to the Greek sovereign default, are de facto bankrupt, and are just days away from a complete asphyxiation and utter collapse. If unsolved, the situation will force a Grexit. Hence we need a short-term solution to keep Greece within the euro, without any third bailout program. To remain in the Eurozone, Greece needs safe banks.

Our proposal builds on Willem Buiter’s very insightful recent proposal (There is a way past the insanity over Greece, Financial Times, 21 June 2015). Unlike Buiter, we do not propose that the ESM purchases Greek debt held by the ECB and the IMF, this is beyond our scope here. But we share many of the remaining ingredients: 1) The end of program conditionality and funding for Greece; 2) Excluding Greek public debt from the ECB’s collateral list or ECB asset purchases; 3) A restructuring and recapitalisation of Greek banks by the EU authorities, with these banks being forbidden to lend to the Greek government.
4 How to save Greek banks

- The Greek banking holiday would be extended by a few days while preparations are made for Greek banks restructuring.

- In the meantime, the ECB would keep its Emergency Liquidity Assistance (ELA) unchanged.\(^1\) If Greek banks run out of cash at ATMs, so be it as long as the bank holiday runs.

- All Greek banks would be declared officially bankrupt, because of their exposure to defaulted Greek sovereign debt.

- The four Greek large banks (Alpha Bank, Eurobank, National Bank of Greece, PIRAEUS Bank), directly supervised by the ECB-SSM\(^2\), would be restructured along the lines of the new EU Banking Union, by the Bank of Greece (the legal supervisor and resolution authority until end 2015), with the help of the ECB-SSM and of the Single Resolution Mechanism (SRM).

- All four banks would be divided into a good bank and a bad bank.

- The four bad banks would be merged into a single entity, as was done in Ireland.

- The joint bad bank would have, on its asset side, Greek government debt, and non-performing loans from Greek corporates and households. On the liability side: any old bank’s equity (probably worthless), all types debts (even if small in Greece) owed by the banks, diverse assets (Greek banks' subsidiary abroad) and, mostly, ELA loans from the ECB (but guaranteed by the Bank of Greece).

- In the joint bad bank, ELA loans, on the liability side, would be senior to other liabilities. In case of losses imposed on ELA loans, these would be absorbed by the Bank of Greece (BoG). If these losses are larger than the BoG’s equity base, the BoG’ equity will turn negative. For a central bank, this need not be lethal. It just implies that future seigniorage revenues transferred from the ECB to the BoG will be used to replenish the holes in BoG’s capital. In other words, as long as Greece remains in the euro, the losses imposed by Greece’s sovereign default onto Greek banks will eventually be assumed by the Bank of Greece (and by the Greek Treasury, through lower BoG’s dividends), and not by the ECB or any Eurozone institution.

- The four good banks would retain, on their asset side, performing households and corporate loans. Greek deposits would form almost all the liability side. Those banks would take over all the payment system and infrastructures of

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\(^1\) Increasing the ELA amount is impossible as the collateral of Greek banks (defaulted sovereign Greek debt) cannot be refinanced by the ECB. Demanding a repayment of ELA loans is obviously impossible for Greek banks.

\(^2\) SSM: Single Supervisory Mechanism.
Greek banks. The payment system would resume; life and ATMs would go on normally for Greek citizens.

- The four good banks, being safe and viable, will be eligible for regular ECB liquidity operations or ELA, if needed.

- These good banks would be forbidden from lending to the Greek government, its agencies or local governments, as long as the sovereign remains in default.

- The good banks would be forbidden from holding Greek debt as safe assets, as long as the sovereign is in default. Instead, they would be required to hold European safe assets (EIB or ESM bonds, other EU governments bonds...).

- Smaller Greek banks, non-directly supervised by the ECB-SSM, would not be saved and would be wound down. What remains of their deposits, after small banks resolution, would be returned to households.

5 Recapitalisation of the four systemic Greek banks

The four good banks, after their restructuring, will require injections of fresh capital to compensate for the losses resulting from their exposure to the defaulted Greek government debt, in their capital base. As a conservative estimate, we consider that they will need about €15 billions, corresponding to the amount of their holding of government treasury bills. Where would the funds come from? Obviously not from the Greek government! Two sources of funding are available, and could be combined.

- Public sources. Since the four large Greek banks are already under the supervision of the ECB-SSM, the natural path to recapitalisation would be for the European Stability Mechanism to inject directly €15 billion in the new banks’ core capital. This will require all Eurozone Parliaments to vote on this issue. They might balk at the idea of providing fresh funding to the banks of a country that just defaulted on its debts. But it is important to separate the issue of financial stability and that of the sovereign default. Once again, the Greek banks’ recapitalisation is required within the next few days, if a total collapse of the Greek economy (already started) is to be avoided.

- Private sources. The largest Eurozone commercial banks and development banks (EIB, KfW, CDC, CdP...) could be ‘strongly invited’ to participate in the recapitalisation of the four Greek banks. National Treasuries could ‘coordinate’ these private recapitalisations within their country, using as national key the share of each country in the ESM. Why would European banks accept to participate in the recapitalization? They will begrudge the cost but should realize that 15 billion euros are less than 1.3% of their combined equity value. By point of comparison, the market value of European banks shrunk by 4% on Monday June 29, wiping out 45 billion euros, after markets realised Grexit was on the table. These recapitalisation funds would not be lost: they would be invested in the four Greek

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3 As in the 2012 Private Sector Involvement.
good banks and would benefit from the return to normalcy of the banking sector, without being saddled by non-performing loans or defaulted Greek government bonds.

Regardless of the source, 15 billion euros is a small price to invest for Eurozone governments or banks to avoid the fateful consequences of a first exit from the Eurozone.

6 Eurozone Guarantee of Greek deposits

While the Greek banks are likely to be insolvent following the Greek default, they also suffer from a liquidity run. As long as Grexit remains a possibility, and regardless of the soundness of their balance sheet, Greek banks will remain vulnerable to a liquidity run. This fragility is exacerbated by the inability of the Greek government which, in default, is unable to insure deposits.

It follows that the stabilization of the Greek banking sector requires that the Eurozone authorities grant a public guarantee to households’ deposits in the four good banks, up to a limit of, say, 100 000€, as stipulated by European laws. This guarantee would be backed by the ESM and would be completely independent from the Greek government.

This guarantee would play a dual role. On the one hand, it would provide a strong and credible signal that the Eurozone stands behind the continued membership of Greece in the euro. It would therefore help revert capital flight as Greek households would return their savings from the mattresses or from abroad to the banks. This would re-liquify the financial system and could spur a significant re-launch of the economy. On the other hand, it would be used as a significant lever against any temptation by the Greek government to meddle with the banks or attempt to get its hands on the EU liquidity provided to the banks. Any such attempt would be met with a suspension of the deposit insurance, all but insuring that these banks would experience an immediate liquidity run.

It is important to note that, once the banks are restructured, deposit insurance helps restores confidence but does not cost anything to the Eurozone taxpayers.

7 What would be required from the Greek government

Under our plan, the Greek government would be required to:

- Allow the recapitalisation of the four Banks -which would not be owned by Greeks but by Europeans.
- Agree not to meddle in these banks and to respect their independence.
- Agree not to impose exceptional taxes on these banks.
8 Conclusion

Our plan:

• Is modest and relatively cheap (€15bn), given the stakes. This is by far the least costly option on the table.
• Respects fully the results of the July 5 referendum. The Greek government would be free to choose its own economic policy.
• Avoids Grexit, keeping the integrity of the euro.
• Imposes a hard budget constraint for the Greek government.
• Saves Greek banks, reverting capital flight and helping to reflate the economy.
• Contains no moral hazard: any attempt by the Greek government to meddle with its banks in order to extract fiscal resources would suspend the deposit insurance provided by the Eurozone.
• Is transitory. Eventually, Greece will need to negotiate how to restructure its debts to official and private creditors. This will likely be a lengthy process.

To sum up: there is no need for Greece to leave the euro, there is no need to toss the Greek financial sector overboard, and there is no need to inflict more pain on Greece under the pretence of avoiding future moral hazard.