June 21, 2015 7:16 pm

There is a way past the insanity over Greece

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Default need not trigger a sudden exit from the currency union, writes Willem Buiter


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The obvious solution has been tried, and it has failed miserably. Drastic structural reforms, "owned" by the Greek population and government in return for a mix of debt relief and new funding, have proved beyond reach. The two sides need a different way out — one that grants the Greeks their wish to be (or appear to be) masters of their own destiny; and that limits the exposure of the country's creditors. Here is such a solution. It comes in five parts.

First, as regards fiscal austerity and structural reforms, the Greek government should be told it is free to do as it pleases. The awkward ritual of oversight by international institutions (formerly known as the troika) should end.

Second, the debts owed by the Greek state to the European institutions and the International Monetary Fund have to be dealt with. The European Central Bank feels itself unable to extend these debts, arguing

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that doing so would amount to the monetary financing of a eurozone government, which is proscribed by treaty. Instead, they should be bought by the European Stability Mechanism, the emergency fund established by eurozone states in 2012. This could be done via a loan to Athens that involves no debt service for the next few years. Since most of Greece's other sovereign liabilities have long maturities and deferred interest payments, payments to creditors would fall sharply.

Third, international institutions would not lend the Greek state any more money. The remaining €7.2bn committed to the existing bailout programme would not be disbursed. The Greek government would be on its own.

Fourth, to prevent money from international monetary institutions finding its way into Greek government coffers by the back door, the ECB would strictly enforce its risk-management framework, no longer accepting exposure to the country's sovereign debt. Such debt would be excluded from its programme of asset purchases, launched earlier this year to provide a monetary stimulus to the eurozone economy. It would no longer be accepted as collateral for lending to eurozone banks, either in the course of routine funding operations or emergency assistance to banks facing liquidity problems.

These actions by the ECB would result in many Greek banks being unable to fund themselves. So the fifth element of the plan would entail recapitalising and restructuring these banks, to enable them to function without relying on government collateral. This work should be carried out by the European authorities. Greek banks would continue to have access to routine ECB funding, and to emergency liquidity assistance if necessary, provided they are deemed solvent and can offer adequate collateral, unrelated to the government.

The ECB would bar Greek banks from making new loans to the state; existing bank holdings of Treasury bills and other Greek sovereign debt would run off as they mature. Any attempt by the state to expropriate money from the banks via a capital levy would be treated as a hostile act.

This proposal returns ownership of Greek policies to the Greek population. It establishes a drastic form of banking union for Greece, making it possible to rescue the banks without rescuing the government. It reinforces the principle that monetary union is no obstacle to an orderly restructuring of the sovereign debt of one of its members.

It ends the soft bailouts of the Greek banks and government that have been conducted under the guise of liquidity assistance, thereby capping the damage done to the ECB's credibility. It also spares the IMF from throwing its principles overboard by going along with lending to a patently insolvent sovereign. The disgraceful situation where countries that are much

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Eurozone taxpayers would end up holding, via the ESM, a large number of Greek bonds that may never be repaid. But they already hold most of these bonds anyway, via eurozone monetary authorities. The only additional outlay of any real significance that this plan requires is the recapitalisation of the Greek banks. This seems a small price to pay for eliminating many of the distressing features of the Greek saga. And part of the cash can come from the Hellenic Financial Stability Fund, where money has been earmarked for that purpose.

If it works, reforms are implemented in Greece, growth is restored and the government regains market access — good for the institutions and for Greece. Replication elsewhere is not likely, but not necessarily undesirable.

If it does not work, the suffering of the Greek population continues, Cyprus-style capital controls are imposed and scrip is issued by the state to pay its domestic bills. A failing Greek government may still eventually resort to leaving the eurozone. But there is no automatic link. Government default does not trigger bank runs and a sudden exit from the currency union.

It is said that insanity is doing the same thing and expecting different results. It is high time to stop the insanity in the eurozone and Greece.

The writer is chief economist at Citi. Ebrahim Rahbari, a director at Citi, co-authored this article

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