ECB risks crippling political damage if Greece forced to default

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Anybody who thinks the loan package forced on Greece in 2010 was fair treatment should read the protests by every member of the IMF Board from the emerging market nations Photo: Reuters

By Ambrose Evans-Pritchard

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The political detonating pin for Greek contagion in Europe is an obscure mechanism used by the eurozone's nexus of central banks to settle accounts.

If Greece is forced out of the euro in acrimonious circumstances - a 50/50 risk given the continued refusal of the creditor core to acknowledge their own guilt and strategic errors - the country will not only default on its EMU rescue packages, but also on its "Target2" liabilities to the European Central Bank.

In normal times, Target2 adjustments are routine and self-correcting. They occur automatically as money is shifted around the currency bloc. The US Federal Reserve has a similar internal system to square books across regions. They turn nuclear if monetary union breaks up.

The Target2 "debts" owed by Greece's central bank to the ECB jumped to €49bn in December as capital flight accelerated on fears of a Syriza victory. They may have reached €65bn or €70bn by now.

A Greek default - unavoidable in a Grexit scenario - would crystallize these losses. The German people would discover instantly that a large sum of money committed without their knowledge and without a vote in the Bundestag had vanished.

Events would confirm what citizens already suspect, that they have been lied to by their political class about the true implications of ECB support for southern Europe, and they would strongly suspect that Greece is not the end of it. This would happen at a time when the anti-euro party, Alternative fur Deutschland (AfD), is bursting on to the political scene, breaking into four regional assemblies, a sort of German UKIP nipping at the heels of Angela Merkel.

Hans-Werner Sinn, from Munich's IFO Institute, has become a cult figure in the German press with Gothic warnings that Target2 is a "secret bailout" for the debtor countries, leaving the Bundesbank and German taxpayers on the hook for staggering sums. Great efforts have made to discredit him. His vindication would be doubly powerful.

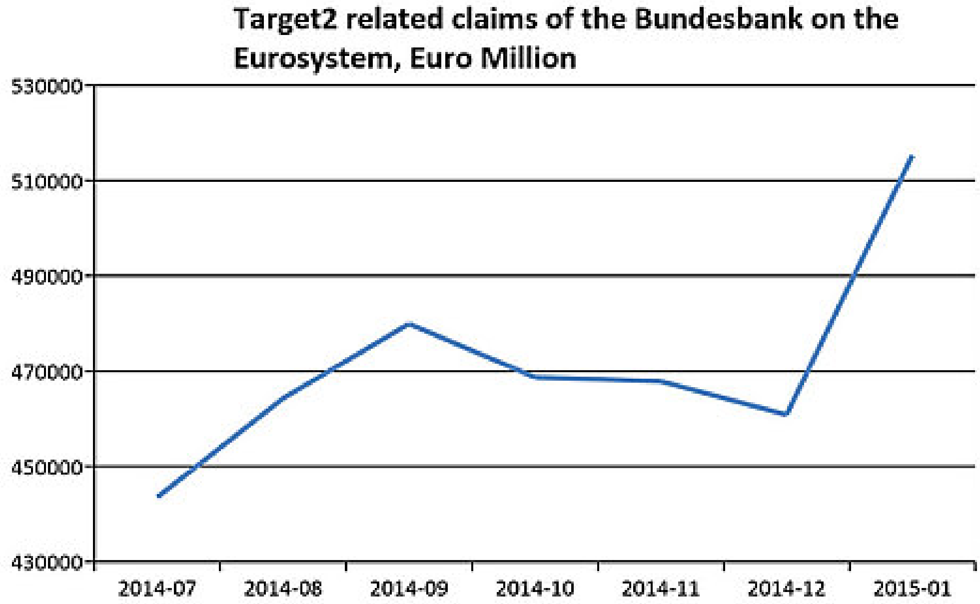
An identical debate is raging in Holland and Finland. Yet the figures for Germany dwarf the rest. The Target2 claims of the Bundesbank on the ECB system have jumped from €443bn in July to €515bn as of January 31. Most of this is due to capital outflows from Greek banks into German banks, either through direct transfers or indirectly through Switzerland, Cyprus and Britain.

Grexit would detonate the system. "The risks would suddenly become a reality and create a political storm in Germany," said Eric Dor, from the IESEG business school in Lille. "That is the moment when the Bundestag would start to question the whole project of the euro. The risks are huge," he said.

Mr Dor says a Greek default would reach €287bn if all forms of debt are included: Target2, ECB's holdings of Greek bonds, bilateral loans and loans from the bail-out fund (EFSF).

Markets remain relaxed. Yields on Portuguese, Italian and Spanish debt have been eerily calm. Investors are betting that the ECB could and would contain any fallout as its launches €60bn a month of quantitative easing, simply blanketing the bond markets of EMU crisis states.

This ignores the great unknown. Would the Bundestag or Holland's Tweede Kamer, or any creditor parliament, continue to let their national central banks supply unlimited Target2 credits to Latin bloc states via the ECB nexus once the system had blown up in Greece.



As a practical matter, the ECB itself would be in trouble. Any Target2 losses must be shared, according to the ECB's "capital key". The Bundesbank would take 27pc, the French 20pc, the Italians 18pc and so on, but these are uncharted waters.

"I do not believe that the Germans would allow the Bundesbank or the ECB to carry on with negative capital. They would demand recapitalisation and consider it a direct loss to the German state," said Mr Dor.

If so, Chancellor Merkel would face an ugly moment - avoided until now - of having to go to the Bundestag to request actual money to cover the damage. Other forms of spending would have to be cut to meet budget targets.

Syriza's leader, Alexis Tsipras, holds a stronger hand than supposed, and he is not shy in playing it. His speech to the Greek parliament on Tuesday night was flaming defiance. "We are not taking even one step back from our promises to the Greek people. We will not compromise, and we won't accept an ultimatum," he said.

"There is a custom that newly-elected governments abandon their election promises. We intend to implement ours, for a change," he said, basking in approval from 82pc of Greek voters.

The new Greek plan to be submitted to Brussels is scarcely different from the proposals already rejected by the EMU finance ministers on Monday. The elemental demand is that there must be no further austerity. This has not changed.

The Eurogroup insists that the primary budget surplus be raised from 1.5pc of GDP in 2014, to 3pc this year and 4.5pc next year. As Nobel economist Paul Krugman says, they want to force a country that is already reeling from six years of depression - with the jobless rate still near 50pc - to triple its surplus for no other purpose than paying off foreign creditors for decades to come. They are doing to Greece what the Western allies did to a defeated Germany at Versailles in 1919: imposing unpayable and mutually-destructive reparations on a prostrate nation.

The fear of the Northern bloc is that austerity discipline will collapse across southern Europe if Greece wins concessions, but collapse is exactly what is needed for Europe to escape from a debt-deflation trap and prevent a second Lost Decade.

"It has become an ideological battle over austerity. Conservative governments want to ram though their retrenchment policies whatever the cost," says Sven Giegold, a German Green MEP.

Many of the attacks on Syriza are caricature. Athens is not taking on more public workers. It is rehiring 3,500 people "unjustly fired", offset by reductions elsewhere. "On privatisation, the government is utterly undogmatic," said finance minister Yanis Varoufakis.

"We are ready and willing to evaluate each project on its merits alone. Media reports that the Piraeus port privatisation was reversed could not be further from the truth," he told his Eurogroup peers. What Syriza will not do is carry out a "firesale" of assets at giveaway prices in a crushed market.

Talk of a debt write-off is a red herring. The Greeks are not asking for it. Mr Varoufakis wants a bond switch to "GDP-linkers" tied to future economic growth rates. He would probably settle for lower interest payments by stretching maturities.

The issue that matters is the primary surplus. Do the creditors wish to risk an EMU break-up and all that could follow in order to extract their last pound of flesh regardless of history's verdict?

Anybody who thinks the loan package forced on Greece in 2010 (with the collusion of the Greek elites) was fair treatment should read the protests by every member of the IMF Board from the emerging market nations. With slight variations, all said Greece needed debt relief from the outset, not fresh loans that stored greater problems. All said the bail-out was intended to save foreign banks and the euro itself at a time when there were no EMU defences against contagion, not to save Greece.

"The scale of the fiscal reduction without any monetary policy offset is unprecedented," said Arvind Virmani, India's former representative to the International Monetary Fund, according to leaked minutes. "It is a mammoth burden that the economy could hardly bear. Even if, arguably, the programme is successfully implemented, it could trigger a deflationary spiral of falling prices, falling employment and falling fiscal revenues that could eventually undermine the programme itself." This is exactly what happened.

Jean-Claude Juncker, the European Commission chief, implicitly recognises that Greece has a legitimate moral claim on Europe. He is quietly helping Syriza, just as France is quietly helping to shift the balance in the Eurogroup. The united front against Greece is a negotiating posture. It will fray under pressure.

Whether the EMU powers can resolve their own deep differences before Greece runs out cash - within a week, reports Ekathimerini - is an open question. Francesco Garzarelli, from Goldman Sachs, said he is "more worried" now than at any time since the start of the EMU crisis.

"The risk of a miscalculation in the negotiations remains high and will peak between now and month-end. Should Greece drop out of the single currency, the risk would become systemic. We doubt that even the major markets would be unaffected," he said.

On balance, and with little conviction, my view is that Chancellor Merkel will ultimately overrule the debt collectors and will yield in order to save Germany's 60-year investment in the diplomatic order of post-war Europe. It is a view shared by German eurosceptics such as Gunnar Beck, a legal theorist at London University.

"Germany's leaders can't let Greece leave the euro, and the Greeks know it. They will die in a ditch to defend the euro. This is our Eastern Front, our Battle of Kursk, and I'm afraid to say that it will end in unconditional surrender by Germany," he said.