

Greece, Negotiations and the ECB

The "no" has won at the Greek referendum on July the 5th.

The Prime Minister, Alexis Tsipras, who went to a clash with the troika, is now the strong man in Greece. He made a call for a "no" vote and he has been followed by the Greeks with a large margin as the "no" had more 60% of the ballots. The "no" mustn't be understood as a rejection of the Eurozone but as a deep disagreement with the economic options that were proposed by the troika. On this issue, the main point is that the troika's proposals extend austerity policies until at least 2018 (time to converge to the primary budget balance target). The risk associated with this strategy is to create conditions that could extend the recession that has started in 2009 and that has reduced the GDP level by 25%.

The question now will be to restart negotiations.

Clearly the balance of strength between negotiators has changed. The "no" at the referendum has given legitimacy to Alexis Tsipras to negotiate and to create pressures on the troika. He has a clearer mandate taken from the results of the referendum. The agreement that has been made with other Greek's parties on his capacity to negotiate for Greece clearly shows that he is, without doubt, the strongest representative for Greece. He can push the troika as he thinks that European countries fear a Grexit as it could create troubles on the European construction and weaken institutions.

On the troika's side, the lead has been taken by Angela Merkel and Francois Hollande. They expect new proposals from the Greek government. Angela Merkel wants to restart where negotiations stopped 10 days ago and François Hollande is vaguer on this point. The situation will be tough as little countries in the Euro Area are not ready to accept a new plan for Greece.

But the Eurozone and more broadly the European Union are at a watershed as a Grexit could create reversibility in the European construction. Since the beginning, in the 1950's, European institutions have been built by adding countries. For the first time, a country could exit, creating uncertainty on the solidity of these institutions. If there is reversibility then other countries could exit raising questions on the future of Europe.

That's why there is a need for Angela Merkel and François Hollande to create conditions for a new step forward to improve the effectiveness and the efficiency of the Eurozone governance. There is a need to reaffirm European objectives.

Europe is, before everything else, a political construction, a way for people to live together. In this framework, Mario Draghi said on July the 26, 2012 in London that the Euro was just an instrument that can improve this political construction. He said that the ECB will take in charge this instrument, that's the famous "whatever it takes". Now there is a need to complete this construction with a political side.

For the Eurozone specifically, the need for a more cooperative and more coordinated fiscal policy is essential. In an Optimal Currency Area, there is a need for instruments to deal with asymmetric shocks. It's not easy to do that with monetary policy but it's easier for fiscal policies through in the best case a federal budget like in the US.

The crisis has shown that the Euro Area was not really efficient to deal with asymmetric shocks because of the absence of a fiscal arrangement that could redistribute from countries to another one as it is the case in a federal framework.

As the Eurozone is in a crisis now due to the uncertainty in Greece, it could be the moment to go further with a proposal that could go deeper in the European construction.

It's important to make this proposal now as with the risk of a Grexit we have the risk of reversibility. This would create a precedent. Some other countries could have the incentive to follow Greece; not now but it could be later if growth remains sluggish.

Reversibility could limit the possibility of the political institution that is necessary for the Euro Area. If a country can leave this political construction then incentives to create this institution will be low. In fact, can we imagine going into a political institution for which perimeter can change? This means that reversibility will imply a Eurozone construction that will stop at the current level.

Critics from American economists on the Euro Area come from this lack of political construction. There are no possibilities for adjustments as it can be done in a federal country. European economists know that but expect that in the future this political institution will exist. If there is a risk of reversibility, this institution will not be created and the Eurozone will just be a fixed exchange rate area. Who will dream with that?

If we want to sum up this part we have three points

- Greece has to make credible proposals to reopen negotiations. That's what Angela Merkel and François Hollande have asked on Monday evening in Paris.
- Grexit will create a precedent, making the European institutions reversible
- There is a need to complete the Eurozone architecture in order to be able to manage asymmetric shocks. But the political institution that is needed is not compatible with a system that accepts reversibility.

A last word of conclusion, the message on Europe and on the Eurozone is important as in some countries there are centrifugal strength that could derail the system. It's important again to fix the direction in which Europe is expected to go. That's the important message expected from Merkel and Hollande as leaders of the Eurozone.

There is another issue associated with the ECB.

Last week the European Central Bank has maintained the level of liquidity it provides to the Greek banking system. But with the panic it was not sufficient leading to capital control. This has implied a reduction of the amount each Greek could take with him at his bank. This is a real constraint for the whole economy and it was seen last week with empty stores shelves.

The ECB has an important role in the survival of Greeks' banks. As there is a risk of bank run, if the ECB provide ample liquidities, banks can still work. If it doesn't, banks will collapse increasing rapidly the risk of Grexit.

On Monday, the ECB has decided that the amount of liquidity that will be provided remains at the same level but the European Central Bank has increased haircut on collaterals. As these collaterals are government debt, the ECB has decided to increase the haircut, meaning that there is a need of more assets for the same amount of liquidity.

One goal for the ECB was to reduce the interdependence, the vicious circle, between the government and the banking system in a country. **By increasing haircut in this way, the ECB reinforce the link between the two and a weaker situation for the government would have a terrible negative impact on banks, creating conditions for an exit.**

The ECB is creating pressure on banks and their possibility to survive in the very short run. This situation is ambiguous. On the one hand, if, as the ECB said, the banking system is solvent then the ECB has to provide liquidities to maintain it and to help the economic activity. In that case, the liquidity that have to be provided are ample than the current level. On the other hand, if the system is not solvent, the ECB must stop its contribution in liquidity and applies the single resolution mechanism that would lead to restructuration of the banking system.

The ECB has currently a "not so clear" behavior that could push Greece out of the Euro Area.

Conclusion

A new step is starting in the negotiations between Greece and the troika. Greece will have to make credible proposals to restart the process. One important point to look at will be what will be said on debt relief. This is a part of the story that the troika didn't want to mention before the referendum. But since then, the IMF has published a report on Greek's debt sustainability, saying that the current situation is not sustainable. Germany doesn't want to talk about debt relief.

Negotiations could resume but debt relief is a constraint and the repayment of EUR 3.5bn to the ECB is something that could hasten an agreement or an exit.

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