European Central Bank tightens its grip on Greece in response to Syriza “debt swap” proposal

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6 February 2015

The “debt swap” menu proposed by Greek Finance Minister Yanis Varoufakis during his tour of European capitals this week has two central objectives.

It is aimed at ensuring that there is a continuous flow of money out of Greece, stretching into the indefinite future, in repayment of its €315 billion foreign debt, while at the same time giving some breathing space for the new government and creating the illusion that it has won some genuine concessions from the European banks.

Vourafakis’s plan followed the repudiation of the central plank of the program on which it was elected to government just two weeks ago—the writing off of the greater part of the public debt. Recognising that such a “hair cut” would not be accepted, Vourafakis crafted his proposals accordingly.

He proposed that Greek bonds owned by the European Central Bank be converted into perpetual bonds. Normally a bond stipulates that the issuer will redeem its face value at the end of its term. If the existing bonds were made perpetual they would never be redeemed and the Greek government would continue to pay interest on them indefinitely. This would have the effect of writing down the value of the debt owed by the Greek government, though in practice it would make little difference because the existing bonds are long term, extending over more than 30 years.

The other proposal was that interest payments on bonds held by European governments would be indexed to nominal economic growth. That is, if Greek growth increased, the payments would increase, and they would decline as growth fell.

Vourafakis also proposed that the stipulation that Greece should run a budget surplus, after interest payments, should be reduced from 4 percent of gross domestic product to between 1 and 1.5 percent. He insisted this requirement would be met even if it meant the Syriza government would not meet many of the public spending promises on which it was elected.

The proposals won initial support, with the *Financial Times* commenting in an editorial that as Vourafakis sought support for the new deal he deserved “a full and even sympathetic hearing.”

The *Financial Times* also indicated that, as most of the Greek debt is owed to other European governments, Vourafakis’s insistence that he talk directly to those governments, rather than to the troika—compromising the European Commission, the European Central Bank and the International Monetary Fund—may have some merit. It seems the *Financial Times* is of the belief that a Syriza government may be the best instrument for breaking up the power of the Greek oligarchs and opening up lucrative sections of its economy to access by international financial institutions.

But after winning some initial expressions of support, Vourafakis’s mission suffered a significant setback on Wednesday when the European Central Bank intervened.

Having, at least nominally, repudiated the existing bailout terms, the Syriza-led government is seeking €10 billion in “bridging” finance while a new agreement is worked out over the next three months.

However, the ECB put a spoke in its wheel when it withdrew the waiver on the use of Greek government bonds held by Greek banks as collateral for loans it provides.

Under its rules, the ECB should not accept Greek bonds as collateral as they are of sub-investment grade, essentially junk-rated. But the ECB had agreed to waive that stipulation, provided the Greek government remained compliant with the terms put in place by the troika. With the decision of the government to withdraw from that agreement, the ECB announced that it was ending the waiver.

The issue would have come up anyway at the end of the month, when the present agreement was due to run out. This would have required agreement for an extension which the Greek government has said it will not seek. Wednesday's ECB decision has served to speed up the confrontation.

In its statement, the ECB said it had taken the decision "in line with existing Eurosystem rules since it is currently not possible to assume a successful conclusion of the program review." However, it said that Greek banks would still be able to obtain funds from the country's central bank "by means of emergency liquidity assistance (ELA) within the existing Eurosystem rules."

The decision, while not completely undermining the Greek banks, has, nevertheless, dealt them a major blow because it has reduced the collateral they have available when seeking loans from the ECB. Consequently, shares fell sharply after the decision was announced.

The Greek banks are facing growing liquidity problems because of significant cash withdrawals in the recent period. According to a report in the *Economist* magazine, some €4.4 billion was withdrawn in December and more than double that amount in January.

Much of this money consists of funds being taken offshore by financial oligarchs seeking a "safe haven" in case capital controls or other government restrictions are imposed. Some of them will also have made the calculation that if the crisis deepens and Greece withdraws from the euro zone, they will be able to use offshore funds to pick up lucrative assets. These would be at rock-bottom prices as a result of the severe devaluation of a reinstated drachma as the national currency.

While the Greek banks will still have access to liquidity through the country's central bank under the terms of the ELA, the ECB move is a significant tightening of its grip both on the Syriza-led government and the national banking system.

The ECB has the power both to determine the amount of ELA and can decide to withdraw it completely.

As the *Economist* noted, the "Greek banks' growing dependence on ELA leaves the government at the ECB's mercy as it tries to renegotiate the bailout."

It also pointed out that the ECB has taken action previously. In 2013, the ECB announced that it would stop the authorisation of ELA to Cypriot banks within days unless the government agreed to its bailout terms, forcing it to accept. A similar threat was used to get agreement from the Irish government in 2010.