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GREXIT? BEWARE OF SLIPPERY SLOPES

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EXECUTIVE SUMMARY

"IS AN EXIT LEGALLY, ECONOMICALLY AND POLITICALLY POSSIBLE?"

The discussion of a Greek exit from the euro area dominates the news once again. In those debates, it seems that many people take the theoretical option of an orderly exit of Greece from the euro area for granted. But is that the case? Is an exit legally, economically and politically possible? What exactly would paths to Grexit look like and where would they be likely to end? This Policy paper provides a brief overview of the relevant legal framework, and discusses whether exit scenarios can be considered a realistic option from political and economic perspectives.

The Policy paper confirms the legal difficulties for a member state to leave EMU and the legal impossibility for the EU to expel a member state. However, certain chains of events could lead to a situation in which Greece would introduce a parallel currency alongside the euro. This Policy paper analyses the circumstances and possible implications of such a move. It shows that a 'de facto Grexit' in an orderly fashion looks impossible. It would lead to tremendous financial, political and legal uncertainty. Three scenarios are assessed:

- Greece jumps: Under pressure to fulfil its election promises, the Greek government decides to introduce a new parallel currency.
- The Eurogroup and the ECB actively decide to push Greece out by restricting liquidity access, thus forcing the government to introduce a parallel currency.
- Grexit by accident: Brinkmanship on both sides leads to a bank run in Greece leaving no short-term alternative than introducing a parallel currency.

The analysis shows that such a 'de facto Grexit' would likely leave both sides severely handicapped. Greece would still be formally member of the euro area but run a parallel currency. The Policy paper also illustrates how quickly a negotiation scenario can turn into a confrontational one, underlining the acute risk of an 'accidental Grexit'.

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INTRODUCTION

Since the election of the Syriza government, the fear of a Greek exit from the euro area dominates the news once again. It is striking, how easily media and academics refer to the possibility that a country could leave the euro area. Tyler Cowen argues that "Germany will (…) simply pull the plug,"[1] Hans-Werner Sinn argues that now "only the Drachme can help"[2]. Kenneth Rogoff warns that "If Greece does not accept the conditions imposed on it to maintain its membership in the single currency, it risks being thrown out of the European Union altogether"[3].

These opinions suggest an exit from the euro area was simply a matter of political choice and could easily be implemented. But is that right? Building on recent contributions as well as on concepts developed during the first bout of Grexit fear in 2012, this Policy paper provides an overview of the relevant legal framework, analyses possible exit scenarios and discusses their political and economic consequences.

1. The legal framework

The starting point of any legal analysis needs to be the sentence in the EU Treaties that the decision to introduce the euro is "irrevocable" (Art. 140 TFEU). This then raises two questions:

- Can an EU member state leave the euro only if it leaves the EU altogether?
- Can the EU expulse a member state either from the Union or from EMU?

1.1. Leaving EMU

Article 50 TEU grants EU member states the right to withdraw from the European Union. The question whether such withdrawal would directly lead to withdrawal from EMU is not clarified, but it is implicit that the two go together. As EMU membership comes with certain rights in the Treaties (e.g. voting rights on certain issues, participation in the Eurogroup), it is inconceivable that a non-EU member could be formal member of EMU.

So one technical possibility to leave EMU could be to abandon EU membership. Looking at the procedure leading to EU secession, however, it becomes clear that for EMU members, the short-term implications from initiating such a step would be considerable. A unilateral withdrawal from the EU takes effect only two years after the country announces its intention. In cases of EMU members, it is obvious that such an announcement would immediately imply exit from the monetary union and thus instantly lead to devastating financial market implications. Without capital controls, such an announcement would precipitate massive capital flight from the country, most likely resulting in a breakdown of the Greek financial system (bank-run). Avoiding such implications would only be possible in absolute secrecy. This is hard to imagine, given that the Council, the European Parliament and the relevant Greek institutions would have to be consulted.

No legal provisions exist for withdrawing from the euro area while remaining a member of the EU. It has sometimes been argued that the Vienna Convention on the Law of Treaties could enable a country to unilaterally withdraw from the currency union citing a "fundamental change in circumstances", but this is highly

1. Cowen Tyler, "Why I think Greece will leave the eurozone this year or soon thereafter", 01 January 2015.
2. Sinn Hans-Werner, Interview with BILD. 16 February 2015, quoted by Reuters.
3. Rogoff Kenneth, "What Is Plan B for Greece?", *Project Syndicate*, 2 February 2015.

controversial[4]. The Vienna Convention states that a denunciation is only possible if "it is established that the parties intended to admit the possibility of denunciation or withdrawal" (Art. 56.1). This is clearly not the case given that the exchange rate of EMU members was fixed "irrevocably" (Art. 140 TFEU).

1.2. Expelling a member state from EMU

If withdrawing from the euro area is extremely difficult, removing a country against its will from EMU looks impossible. A large majority of scholars agrees that the Treaties neither allow for an expulsion from EMU, nor from the EU itself[5]. Arguments based on the idea of annulling earlier Council decisions seem far-fetched at best[6]. International law does not offer a viable alternative[7] and the last remaining option, an amendment of the Treaties, would require the consent of all member states, including the one to be expelled (Art. 48 TEU). The most stringent sanction available to EU member states is therefore a suspension of voting rights (Art. 7 TEU). However, such harsh punishment can only be applied to a member state that is found to be in breach of the fundamental values of the European Union, a set of principles amongst which fiscal responsibility does not feature[8].

Similarly, there are no legal provisions for excluding a national central bank from the European System of Central Banks. It may even be argued that its role confers the ECB a responsibility for maintaining the unity of euro area, although this is not explicitly mentioned in its statutes.

2. Three Grexit scenarios

> "AT A CERTAIN POINT THERE COULD BE A FORCED INTRODUCTION OF A PARALLEL CURRENCY"

If the legal situation seems clear and both sides have stated their intention to keep Greece in the euro, why is there still so much debate about Grexit? The answer to this question relates to the risks arising in the context of current negotiations between Greece and the rest of the euro area on conditionality, compliance, and a new programme. Many market participants fear that at a certain point there could be a forced introduction of a parallel currency, creating economic facts regardless of the legal context.

From a purely logical perspective, three main scenarios are thinkable:

- Greece jumps: Under pressure to fulfil its election promises, the Greek government decides to finance them by introducing a parallel currency.
- The Eurogroup pushes: Faced with an intransigent Greece, the Eurogroup decides to bully the country into introducing a parallel currency.
- Grexit by accident: Brinkmanship on both sides leads to a bank run in Greece leading into the introduction of a parallel currency.

In the following, I will discuss the implications of these scenarios.

2.1. Greece unilaterally decides to introduces a parallel currency

Would a Greek government consider introducing a parallel currency? As of now, a majority of Greeks support EMU membership, so the question is not on the political agenda. Syriza leaders have made it clear they don't

4. Dor Eric, "Leaving the euro zone: a user's guide", *IESEG Working Paper 2011-ECO-06*, 2011; Athanassiou Phoebus, "Withdrawal and expulsion from the EU and EMU: some reflections", *ECB Legal Working Paper Series*, No. 10, 2009.; Schuster Thomas, and Jürgen Matthes, "Wie soll die Europäische Währungsunion mit reformunwilligen Staaten umgehen?", *IW Policy Paper 3/2015*, 2015.
5. Athanassiou, *Withdrawal and Expulsion*, *op. cit.*; Eichengreen Barry, "The Break-Up of the Euro Area", in Alesina, Alberto and Francesco Giavazzi (ed.), *Europe and the Euro*, University of Chicago Press. 2010, pp. 11-51.
6. A summary of these contributions can be found in Schuster and Matthes, "Wie soll die europäische Währungsunion", *op. cit.*
7. Proctor Charles, "The future of the euro – What happens if a sember state leaves?", *Journal of Financial Transformation*, vol. 19, 2007, pp. 141-157.
8. The values include respect for human dignity, freedom, democracy, equality, the rule of law and respect for human rights.

want to even consider that option. However, there is the theoretical possibility this might change – for example if the Greek government felt that there was no other way to fulfil its campaign pledge to "end austerity".

How could a country unilaterally introduce a new currency? In 2012, the "Wolfson Economics Prize" contest was organized to shed light on that question. The winner contribution by Roger Bootle shows how difficult such a move would be[9]. Bootle argues that, in short, the preparations would have to take place in a small, secret group of high-ranking officials. The IMF and the EU would be informed only shortly before the conversion. One or several bank holidays would be introduced in order to avoid capital flight, cash withdrawals would be restricted for a time and the euro would continue to coexist with the new currency, at least until coupons or new banknotes were available in a sufficient quantity. If the plan was discovered prematurely, it would have to be accelerated, causing greater disruption but ultimately leading to the same outcome. The politics of such a plan look highly unrealistic and almost impossible to implement in a democratic context. Could the Greek government initiate such steps without involving the Greek parliament? Such a step would amount to an economic "coup d'État".

The consequences of a parallel currency

But even if it were possible to implement that step, the economic consequences for Greece would be ambiguous. Having regained control over its central bank, the Greek government could fund its spending promises (albeit at the price of higher inflation) and the competitiveness of the Greek economy might profit from a rapid depreciation of the new currency. However, the experience of Latin American countries that have tried to scale back dollarization suggests that Greece may be unable to prevent the continued use of euros as a unit of account. If, due to network externalities or the superior price stability, wage contracts and retail prices were still (explicitly or implicitly) calculated in euros after the exit, a depreciation of the new currency would not improve the price competitiveness of the Greek economy[10]. Concerns that high unit labour costs never were the decisive factor in the Greek export weakness raise further doubts about the optimistic tale of a Drachma-led recovery[11].

Similarly, a redenomination of Greek debt would not be as straightforward as it appears at first sight. While it would reduce the real debt burden, the government could gain only little fiscal space in the short run since debt service currently accounts for a mere 2.5% of GDP. At the same time, long legal battles would ensue as international creditors would fight for compensation.

"THE EU WOULD LIKELY BE VERY RELUCTANT TO OFFICIALLY LEGALISE THE NEW GREEK STATUS"

The enormous losses a redenomination would inflict on official creditors would poison the Greek political relationship with the EU and the IMF. It would also debilitate highly indebted countries such as Italy and Spain, calling into question their membership and Germany's willingness to lend great sums to another assistance programme. The reliability of the European Stability Mechanism (ESM), the centrepiece of the EU's new crisis response framework, might be called into question.

In spite of all the damage done, Greece would formally remain a member of EMU and the EU, but how cooperation could continue under these circumstances is entirely unforeseeable. Can a single currency be said to exist while a parallel currency circulates in one country? How would Greece and the EU trade? The EU would likely be very reluctant to officially legalise the new Greek status and the new currency, since this would pave the way for opportunistic euro exits whenever a government feels that the burden of its debt too heavy.

2.2. The Eurogroup forces a Grexit

The scenario most frequently evoked in press articles is the failure of negotiations between Greece and the Eurogroup. In such a situation, the Eurogroup might get into a situation in which it could feel forced to decide

9. Bootle Roger, *Leaving the Euro: A Practical Guide*, 2012.
10. Koning John Paul, "Grexit: An escape to more of the same", 24 January 2015.
11. Pelagidis Theodore. "Why internal devaluation is not leading to export-led growth in Greece", 2015; Gros Daniel. "What makes Greece special?", *CEPS Commentary*, 2014.

between lowering its demands and escalating the situation. Fearing to appear susceptible to blackmail, decision makers could in theory opt for escalation. As analysed above, the EU lacks the legal options to formally expel Greece from the euro area if the country refuses to leave under Article 50 TEU. Consequently, as one article puts it, "the European hoteliers would (...) [assert] that the Greek guest, after losing his chips at the casino, had decided to leave town."[12]

The leverage: ELA

"THE ECB (...) DE FACTO ENJOYS FAR-REACHING DISCRETION IN DETERMINING THE EXACT MEANING OF THE TERM 'ADEQUATE COLLATERAL'"

One way to do this would be for EU member states to threaten Greece with officially declaring that it is not complying with its obligations, upon which the ECB might cut off the provision of liquidity[13]. While such a step may raise questions about the independence of the central bank, it would to a certain extent be consistent with the ECB's prior interpretation of its mandate. The ECB's statutes require it to provide the financial system with liquidity by lending central bank money based on "adequate collateral" (Art. 18.1 of the Statutes). The past years have shown that it de facto enjoys far-reaching discretion in determining the exact meaning of this term[14]. Frankfurt has made it clear that in the case of troubled periphery countries, it considers the participation in an adjustment programme a key precondition for continued assistance.

With regards to Greece, the ECB has repeatedly allowed Greek government debt to be used as collateral, "irrespective of any external credit assessment"[15]. When the country seemed to lapse on the agreed reforms, it later revoked such exemptions – most recently on 4 February 2015[16]. Frankfurt also has the last say over an alternative channel of liquidity provision, the so-called "Emergency Liquidity Assistance" (ELA). While ELA is the responsibility of the national central bank, it can be vetoed by a two-thirds majority in the ECB Governing Council if it is found to "interfere with the objectives and tasks of the Eurosystem"[17]. Former ECB president Trichet's letters to the Irish finance minister provide a vivid example how one could justify an interruption of ELA on the grounds of monetary policy if Greece announced a reform stop[18]. But what would be the real implications of an end of ELA?

Option A: The ECB pulls the trigger

The Greek banking system is highly dependent on central bank liquidity. If Greece refused to leave the euro area and the ECB vetoed ELA, Greek banks would almost certainly be unable to refinance themselves on the financial markets. In such a situation, the Greek government would probably have to close the banks for an extended period of time and prepare the introduction of a parallel currency. This scenario has some absurd characteristics: Greece would formally and legally remain a member of the common currency, but introduce a parallel currency to keep its banking system afloat. The uncertainty arising in such a context would be huge. In other words, cutting off central bank liquidity constitutes a "nuclear option". Indeed, it is hard to imagine a decision to end ELA unless there was a clear view shared between the ECB and the Eurogroup that there was no other choice than getting a country to leave "de facto". Such a radical step, however, would not only deal great damage to the credibility of EMU, it would also lead to enormous uncertainty or chaos in Greece, financial markets in the European Union, and potentially worldwide. It is almost impossible to imagine an "out of the blue" decision by the ECB to cut-off ELA.

Option B: Agreement on a negotiated exit

12. Barber Tony, "Greece and Europe must compromise to avoid Grexit", *Financial Times*, 12 January 2015.
13. Schuster and Matthes, "Wie soll die europäische Währungsunion", *op. cit.*
14. Guideline of the European Central Bank, Chapter 2.
15. Decision of the European Central Bank ECB/2012/32.
16. E.g. Decisions ECB/2010/3, ECB/2012/2, ECB/2012/3, ECB/2012/14, ECB/2012/32; European Central Bank, "Eligibility of Greek bonds used as collateral in Eurosystem monetary policy operations", 04 February 2015.
17. Art. 14.4 of the ECB Statutes and European Central Bank, "ELA Procedures", February 2014.
18. *The Irish Times*, "Read: the four letters between Lenihan and Trichet in late 2010", 6 November 2014.

Given the difficulty to use the "nuclear option" of a sudden end to ELA support, one could theoretically imagine a negotiated solution under the threat of an end of liquidity support and the likely ensuing financial breakdown. Should there be a political decision by the Eurogroup to push for Grexit, then one could indeed imagine a context in which Greece and the rest of the Eurogroup might negotiated some kind of ad-hoc agreement on exit features, such as the treatment of outstanding debt and the transition into a new currency, with the objective of containing the likely financial market disruption. Even accounts that are optimistic about the feasibility of a Grexit stress the importance of maintaining some legal certainty and an EU membership[19]. However, the required time and goodwill necessary for such complex negotiations make it near inconceivable that this outcome could be achieved under pressure. At the same time, any leak could trigger a financial meltdown[20]. This would undermine the very rationale of an "orderly" exit.

2.3. Grexit by accident

„A STANDSTILL IN NEGOTIATIONS (...) COULD QUICKLY TRIGGER PANIC MOVES"

Even if both the EU and Greece were determined to avoid a Grexit, it is imaginable that the course of events could take a turn in which a sudden bank-run could technically force the Greek government into introducing a parallel currency. For example, a temporary standstill in negotiations between Greece and the rest of the Eurogroup could tempt the ECB to explicitly or implicitly threaten not to raise the ceiling for ELA any higher as long as there was no major concession from the side of the Greek government. Such a situation could quickly trigger panic moves. It would not necessarily lead to an uncontrollable vicious circle, but it is not excluded the situation could get out of control. Rumours about empty ATMs might spread, culminating in a full-blown bank run.

Option A: Common effort to contain damage

In such a scenario, it seems reasonably realistic that the EU and Greece would cooperate in order to contain the damage. Building on the experience with Cyprus in 2013, measures to stop capital flight could be introduced and the ECB might soften its stance concerning the ELA ceiling. Still, the damage would be done. Capital controls in Greece would constitute the second case after Cyprus, which was supposed to be unique. Since a euro in Greece would be de facto less worth than one in the rest of the euro area, this would blur the boundaries of a Grexit[21].

Concerning the unity of the single currency, this outcome could be almost as destructive as full exit. Markets might no longer expect the clean exit of a euro area member state, but they would expect capital controls and, perhaps, asset seizures when a country experiences serious economic problems. The euro area would be in risk of fragmenting again, with possibly dire consequences for crisis countries considered by financial markets participants "to be next".

Option B: Greece introduces a currency of its own

Although a coordinated response seems to be the intuitive reaction, it cannot be taken for granted. Before concerted action could be taken, the two sides would have to resolve their standoff. In the meantime, a bank run could well develop into a national financial crisis. Faced with this situation, the Greek government might opt for starting a currency conversion under financial market pressure to preserve the liquidity of the banking system. This process would be very similar to the one described above. Of course, the political consequences for Europe and EMU would be no less dire than if one of the two sides had really intended from a start to disrupt the unity of the single currency.

19. Bootle, *Leaving the Euro*, *op. cit.*
20. Eichengreen, "The break-up of the euro area", *op. cit.*
21. Wolff Guntram B., "Capital controls will put the euro at risk", 26 March 2013.

CONCLUSION

Even though Grexit is one of the buzz words in current analyses of the Greek case, it is totally unclear how an exit from the euro area could be managed. As this analysis has shown, here is no legal or political approach to Grexit. Any hopes some may harbour to see the current conflicts quickly and cleanly resolved by the introduction of a new currency for Greece seem unfounded. An orderly exit is virtually impossible in the current situation. It would imply comprehensive negotiations among several institutions under the cover of absolute secrecy, thus violating the very basic laws of democracy.

> "THE UNILATERAL INTRODUCTION OF A PARALLEL CURRENCY WOULD LEAVE BOTH SIDES SEVERELY HANDICAPPED"

The unilateral introduction of a parallel currency would leave both sides severely handicapped, but still bound together through rules that can only by dissolved by consensus – and such a consensus would be hard to achieve in precisely that kind of situation. The EU would find itself in an impossible position: Legalising a unilateral exit would convert EMU into a fixed exchange rate regime and reward countries for redenominating their debt.

What this analysis has also shown is that there is an important risk of slippery slopes. Hawks in both camps may underestimate how quickly a game of chicken might lead into an unstoppable path towards a "parallel currency".

Both Greece and the EU therefore carry a great responsibility when choosing their negotiation strategies. There are entirely rational considerations underlying their hard stance. The EU is in a delicate situation as some of its member states fear being blackmailed. The Greek government is under pressure to fulfil its election pledges. But these matters will seem trivial if they miscalculate the other side's true intentions and the situation spirals out of their control.

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