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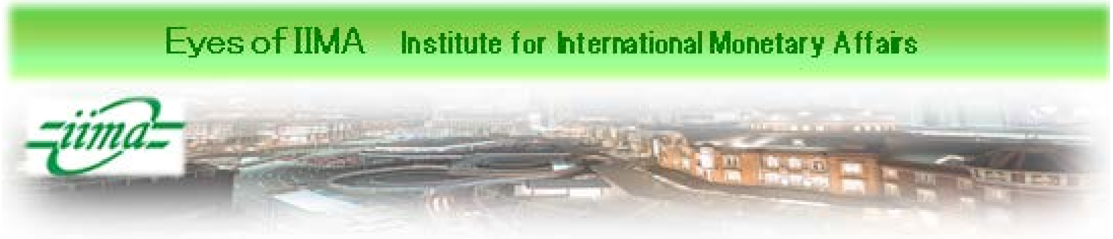

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Flaws of the Euro revealed by the chaos surrounding the Greek Crisis

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At the July 12th Emergency Euro Summit, after 17 hours of discussion, unanimous agreement was reached to start negotiation for a support package to Greece through the European Stability Mechanism (ESM). According to the statement after the leaders' meeting, it will be required for the Greek government to review its economic reform plan[1], majority portions of it will have to be legislated by the July 15th, a EUR 50 billion Greek assets will be transferred to an independent fund and the proceeds by monetization of the assets will be pooled and used to repay its debts[2]. It is estimated in the next three years, EUR 82 to 86 billion will be needed and if necessary a bridge financing will be considered.

After the Greek referendum on July 5th, in which well over 60% of the people voted against an EU economic reform plan which was one of the conditions for financial support from the EU, concerns over the possibility of a Grexit increased. The European financial markets responded negatively, and stock and bond prices fell which then affected markets of other areas. In terms of regulations, in the Economic and Monetary Union there are no withdrawal provisions but as for the EU, there is a provision in which member states can withdraw if they want to do so. It seems that the Tsipras government does not want to leave the Euro or the EU. After the referendum the only hope for him is to get an agreement with creditor countries by applying for financial support to the ESM with the support of the Greek public. On the other hand, for the creditor countries there may be opposition from their own people; any compromise may not be easy.

In the Greek banking sector, currently an outflow of deposits are continuing and it is relying on the Emergency Liquidity Assistance (ELA) from the Bank of Greece (Chart 1). As the European Central Bank (ECB) did not allow the Bank of Greece to increase its ELA, Greek banks have closed and limits were imposed on the withdrawal of cash from ATMs from the end of June.

[1] Presented by the Greek government on July 9th. Was a big compromise compared to the first Greek proposal and came very close to EU's plan.

[2] EUR 25 billion for recapitalization of banks, the remaining EUR 25 billion will be used half for repayment of debt and the other half for domestic investment

Implementation of such new regulations will further worsen the sluggish Greek economy. The EUR 3.5 billion of Greek government bonds held by the ECB will mature on July 30th, but without support from the EU they cannot avoid default. As a result, ECB will have to stop any ELA. Negotiations for financial support will be a race against time.

As negotiations become increasingly prolonged, liquidity will dry up, and scenarios will emerge in which the government will be forced to start issuing IOUs as payment. If IOUs circulate and become like a second currency, there is no denying that it will lead to an actual withdrawal from the Euro. In this case inflation will rise sharply and chaos in the economy cannot be avoided.

Authorities of the EU are aware of this situation, as EU President Tusk expressed his sense of danger by saying on July 7th, “If an agreement cannot be made it may possibly lead to the bankruptcy of Greece and insolvency of the Greek banking system; We are prepared to do what is necessary to maintain financial stability in the Eurozone”. For now the best scenario thinkable is if the Tsipras government can legislate reform plans by the due date, banks can reopen and funds for repayment of government bonds are secured.

The reduction of debt sought by the Greek government faced strong opposition and could not be accepted because of the “no bailout clause” of the EU treaty. But to support the Greek debt sustainability, the Eurogroup stands ready to consider, if necessary, additional measures (possible longer grace and payment periods) in the context of a possible future ESM program.

This crisis has as its background the flaws of the Euro, which is monetary union without fiscal and political union. EU itself, aware of these matters, is trying to deepen the consolidation. In the “Completing Europe’s Economic and Monetary Union” (known by the name of 5 Presidents’ report)[3] released in June included a roadmap targeting further consolidation by 2025. It mentions the direction of deepening and time frame of; 1) economic union (a new boost to convergence, jobs and growth), 2) financial union (complete the Banking Union and launch the Capital Market Union), 3) fiscal union (a new advisory European Fiscal Board), 4) Democratic accountability, legitimacy and institutional strengthening (strengthening the parliamentary control as part of the European Semester, Increase the level of co-operation between the European parliament and national parliaments). It is hoped that, while avoiding the current crisis, medium to long term system developments like these will progress steadily.

[3] Released in the name of President of the European Commission with the co-operation of the President of the EU, President of the Eurogroup, President of ECB and the President of the European Parliament.

(Chart 1) Greek Banking Sector B/S (Liabilities)