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Surviving Greece's Liquidity Crisis

Banks won't be able to afford lifting capital controls unless the country's debt is restructured.

By Marcello Minenna

Markets celebrated the agreement earlier this month between Greece's Prime Minister Alexis Tsipras and his country's eurozone creditors because it reduces for now the risk of a Greek exit from the euro. But immense damage has been done to the economy in the past six months, and especially the past four weeks, and only now is it becoming clear what a long road it will be back to normal.

The immediate liquidity crisis that prompted the imposition of capital controls on June 29 has not abated. The European Central Bank is offering €90 billion in liquidity assistance to Greek banks, but it remains cautious as it awaits further political signals that a deal will hold. After months of rapid deposit flight—reaching more than €1 billion per day just before controls were imposed—banks could still run out of cash once they reopen on Monday, despite the new €420 weekly withdrawal limit on Greek depositors.

Observers assumed that once Greece's Parliament passed the necessary reforms Wednesday evening, increasing ECB support would be easy. The procedure isn't that simple. In order to borrow from the ECB under the Emergency Liquidity Assistance program, banks must put up eligible collateral. Currently they only hold between €15 billion and €18 billion in suitable government bonds that haven't already been pledged. Due to Athens's precarious fiscal situation, however, the ECB will only accept those bonds at half their face value. Which means in practice banks will only have around €7.5 billion to €9 billion in additional support available. Were capital controls to be lifted immediately and capital outflows to resume, new cash reserves would hold out for only a few days.

The obvious solution would be for the ECB to adjust the haircut it applies to Greek collateral. But here Mr. Tsipras will get in the way with the unsolved dilemma between reforms and economic recession. Although the ECB retains some discretion, it can't entirely ignore the credit ratings placed on Greece's debt. Those ratings are now well into junk territory, after six months of economic contraction and the unfruitful negotiations between Mr. Tsipras and Germany's Chancellor Angela Merkel. The ECB will have limited room to maneuver unless the reform measures accepted by Athens persuades at least one ratings firm to boost its assessment.

And that's just the immediate liquidity problem. Lifting capital controls will be difficult so long as a large portion of Greece's financial system remains so close to insolvency. Already some 30% of the funds in the bailout request under discussion are earmarked for recapitalizing banks. They may need more.

The four largest, partially nationalized Greek banks rely on deferred tax credits for 40% of their capital base. These are credits the banks have accumulated in recent years against their losses, which only become "real" capital if they allow banks to retain a higher portion of future earnings. In terms of saleable assets available now to cushion a crisis, Greek banks are severely undercapitalized.

The eurozone has attempted to address this shortfall by forcing Athens to create a holding fund for €52 billion worth of state assets that can be privatized to meet liquidity needs. Don't expect it to work. The International Monetary Fund exerted immense pressure for privatization under previous bailouts and expected €16 billion in revenues by this year under the first two deals. The real income was €3 billion.

The IMF now estimates, contrary to the eurozone's plans, that privatization will bring in around €500 million between 2015 and 2018. The Greek economy needs to privatize a range of assets to boost investment, competitiveness and growth over the medium term, but these deals will not provide enough cash to support the banks or do much of anything else.

That leaves restructuring Greece's debt as a crucial short-term step toward lifting capital controls. The eurozone prefers to defer this debate, assuming it's not relevant right now. But reducing the debt load is the only way the IMF and the European Stability Mechanism will be able to join the ECB in offering the banks liquidity support. They're precluded from doing so now since they're not allowed to lend to governments facing unsustainable debt loads.

Eurozone members have resisted debt restructuring on the theory that it would reward Mr. Tsipras's opposition to the euro. But the bigger threat to the common currency now is a member whose economy is on hold while the banks lack sufficient liquidity. If leaders can't fix this problem soon, the danger is that their entire €86 billion bailout package will go to waste.

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Sopravvivere alla crisi di liquidità della Grecia