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Free Lunch: How Europe invented too big to fail in Greece


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Athens was never a Lehman Brothers: its debt should have been written down in 2010

Paying the price for Lehman Syndrome

A deal, of sorts, was concluded by the euro countries' top leaders this morning. As I wrote in a quick take for the FT comment pages, Alexis Tsipras avoided having to send Greece's fairest one hundred maidens in tribute to Berlin. Apart from that, however, the agreement looks remarkably like the debt bondage of old, complete with a grab on assets thrown into the mix. Among the most curious elements is the fact that Europe's most elevated politicians find it appropriate to spend their time signing off on such specifics as the competitive conditions of the Greek bakeries sector. Read the final document in full, as it will take time for everyone to digest the content.

This is a good moment both for looking forward and back. Going forward, plenty of hurdles remain. The Greek parliament will have to pass a bundle of laws in days before the eurogroup will start formal negotiations for a new loan programme. Those negotiations could still stall, or fail. And some sort of bridge financing has yet to be arranged in the interim. So we could quite possibly be back to another stand-off soon. And that means the ECB's policy remains key.

On July 20, Greece is due to repay a bond worth €3.5bn which it cannot refinance except with official loans. The ECB, which bought the bond in the markets in 2010, has made clear it will let the Greek banking system atrophy if it finds Athens in default. It is the cap on liquidity to Greek banks that has forced Tsipras and his party to their knees. So in the next few weeks and months, everything depends on whether the threat to kill the banking system remains in place. Most likely, the formally independent ECB will follow the political signals from governments, and loosen its fist if politicians look like they'll reach an agreement.

More improbably - but potentially more importantly - Frankfurt may be challenged in court. A small Greek company has lodged a suit with the Court of Justice of the European Union. The full argument is available here. (Free Lunch has already examined similar arguments why the ECB is acting in breach of the Treaty.) This will be exciting to follow.

As for looking back, it is a good time to remember how we ended up in this situation. In honour of Yanis Varoufakis, the game theorist temporarily turned finance minister, we can do it by "backward induction", also known as reasoning backward from the end. Greece needs to do what its creditors say because its only alternative - unilateral default on eurozone partners - will make the ECB force it out of the euro by killing its banks. The reason why Athens ended up with eurozone partners as creditors in the first place is that they all agreed Greece's sovereign debt (to what were then all private creditors) could not be tolerated. The resistance was particularly fierce in the ECB, Paris and Washington, as a thriller-like historical account of the 2010 "rescue" by Paul Blustein makes clear.

This was always misguided. History proves that sovereign restructurings work well - two of the best academics on the topic recently concluded a study of 45 crisis episodes as follows: "The economic landscape after a final debt reduction is characterised by higher income levels and growth, lower debt servicing burdens and lower government debt."

So why didn't everyone just let Greece default in 2010, offering perhaps some loans to cover deficits (only one-tenth of the actual loans were used for this purpose), and let the chips fall where they may? Partly for selfish reasons - some of those chips concerned other eurozone country banks. But the main motivation was fear. The Greek sovereign debt crisis came to a head 18 months after the bankruptcy of Lehman Brothers. The ensuing seizure of global financial markets had scared the living daylights out of policymakers. Struck by Lehman Syndrome, they proceeded to act as if every debtor, no matter how small and non-systemic, was too big to fail. That included Greece in May 2010, and it included bust Irish banks six months later.

Lehman Syndrome was not policy wisdom but a decision making disorder. Just understanding a little of what Lehman actually did is enough to see why neither a peripheral European sovereign nor an Irish bank could topple the financial system the way Lehman could. Lehman was a big player in the tri-part repo market and therefore was indeed a key hub in global financial markets. (Whereas Athens was no hub at all but a final destination for loans financing excessive consumption; and Anglo Irish Bank was a final destination for loans thrown into overvalued Irish housebuilding.) Never heard of the tri-party repo market? Not to worry: the New York Fed's economics blog recently published posts on the origins of the market and how it turned into a cauldron of bubbling systemic risk. In brief: Lehman's bankruptcy at a stroke undermined the expectations of the most important market through which banks channel cash between one another.

This is technical stuff, but of huge political importance. Proper economic research finds that, unlike with Lehman, there was no reason to fear much contagion from a Greek default in 2010. The ill-fated choice to treat Athens as if it were Lehman is at the root of everything that has later gone wrong in the eurozone. The price is being paid for it now - but it would be fairer if those who shared in the mistake also share in the cost.

Numbers news

No surprise there: European bank shares jump on the news of a Greek deal.

Chinese stocks also rose at the Monday open.

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