Athens upset could spark European QE risk

Time for Greek resolution running out

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Greece's dangerous drift towards default or a parallel currency could reignite 'convertibility risk'– the threat of a potential redenomination of euro member government bonds into a different currency caused by a country's exit from the single currency.

If this risk grows, financial operators will buy German government bonds as a hedge, calculating that, in extreme circumstances, Germany would return to a revalued D-mark and German government bonds would appreciate in value.

All this would take place against the background of the European Central Bank's quantitative easing policy, under which the ECB is stabilising the interest rate 'spreads' between German and other countries' bonds through monthly purchases of €60bn of bonds.

There is a widespread view that QE protects the euro area from 'contagion effects'. However, we doubt whether this shield would work properly in the case of a Greek upset.

Market participants are not focusing on the way the QE programme could be impaired by massive demand for German bonds for hedging purposes. This issue could be game-changing.

Up until about a month ago, yields on German government 'Bunds' yields were negative up to nine year durations, reflecting the ECB bond purchases, but yields have risen sharply in recent weeks reflecting anticipation that inflation in the euro area may have bottomed out.

There have been some doubts whether the Bundesbank may be able to find sufficient stocks of Bunds with yields above minus 0.2% (the cut-off set by the ECB) to fulfil its quota of total asset purchases of more than over €200bn over the life of the QE programme, as pointed out by rating agency Moody's in a recent study.

If an indiscriminate flight to quality occurs after a disruptive event in Greece, the Bundesbank may not have enough bonds to purchase and the ECB's QE could be impaired just at the exact moment when it should serve to prevent contagion from 'Grexit'.

These considerations are important because pessimism is growing about the likelihood of a deal between Greece and the Eurogroup of finance ministers. The Greek government made a due payment of €750m to the International Monetary Fund on 12 May by using emergency holdings of Special Drawing Rights in its IMF holding account, a signal of its increasingly desperate cash crunch. Salaries and pensions are being paid by plundering the treasuries of public utilities.

The European Central Bank's ban on Greek banks increasing holdings of government debt, continued deposit flight (with a reported €7bn flowing out in April) and a further struggle with debt service could soon force the government to pay salaries and pensions in IOUs. These instruments would ultimately circulate as a parallel currency, a step that the ECB considers as part of a possible exit from the euro.

If Athens was unable (or unwilling) to repay IMF loans, this would probably lead to a default vis-à-vis the European Financial Stability Facility, the EU's temporary resolution scheme set up in 2010, where the amounts (€143bn) are much greater. The EFSF is a special purpose vehicle that has no capital (unlike the European Stability Mechanism) but it is funded on the guarantees given by euro members. In case of a Greek default, the guarantees are likely to have a negative impact on euro area taxpayers of at least €70bn (assuming the EFSF would be able to recover 50% of the value of defaulted Greek bonds).

Central banks are backing the EFSF via QE, under which the ECB is purchasing €5bn a month of EFSF bonds. This means that, in the course of a year, national euro area central are accumulating on their balance sheets total EFSF exposure equivalent to potential EFSF losses on loans to Greece. This internalises within the Eurosystem the entire cost associated with a possible Greek default.

There is speculation that the Greek government is targeting a 'reprofiling' of public debt to spread out further its debt repayments. An agreement on this basis would be a good way of preventing disruptive market developments – but it would have an immediate effect on the roughly €30bn of Greek government debt that the ECB holds directly on its balance sheet in the form of bonds purchased after 2010. One point is clear: the time for a Greek resolution is running out perilously fast.

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