Drachma Ante Portas. How it can be done.

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Any decision, Euro or Drachma has its winners and losers. The way either solution is implemented would define the proportion and the section of the Greek society from which they would come.

First ever Greek and European coin

Last Gold Greek Drachma

As much as the Greek government wants to exorcise the question of regaining monetary independence it keeps coming back with increasing force both in Greece and in European politics. The financial weather forecast is not good for Greece. Financial year 2015 must be considered as a lost year for Greece. Till June or until the new bail out is agreed not much is going to move in Greece. Then there is the three month recess of the glorious Greek summer and by the time something is done in September the year is over. Compound this with the fact that the current government is not a reformist government by any stretch of imagination and it would take time to become one, the writing on the wall is crystal clear. It spells Drachma.

Unemployment inched down the last few months but now is likely to start increasing again. Primary surplus already is discounted close to zero, if at all. The meagre growth printed in 2014 would in all probability be reversed. Pension fund gap runs into hundreds of billions, and there is an acute shortage of cash in the market both because Greek banks are in a difficult position but mainly because the state is starving everyone else. Greek banks have close to 40% of their assets or 100bln classified as Non-Performing-Exposure (NPL’s at 80bln). That is a staggering 60% of GDP. Government tax arrears are estimated at 70bln with a realistic chance of recouping only around 10%. And there is a growing culture of non-payment based both on history and pre-election promises. Sophocles could not think of a better tragedy plot.

An observer at the bank gates may well shout “Drachma ante portas”. Many economists of renowned reputation think that regaining monetary sovereignty is a viable alternative. Others think it is a matter of when and not if. Even if the ECB relaxes its rules and the overdue dose is released many think that the economic position is hard to reverse.

In any case, if the Drachma is the solution how is it going to be done? What are the steps that would be taken? In this letter we do not touch on the pros and cons of the drachma solution but rather attempt to sketch how it could be done. Of course there is a high degree of uncertainty as there are too many moving parts and stakeholders (ECB, IMF, Eurogroup, Commission, Europarl, Politicians, People, Geopolitical and geostrategic considerations etc) and events may develop in a totally different way from any plan.

Legal aspects of Exit.

It is widely acknowledged that the Treaties do not cater for a Eurozone exit, no matter how delinquent, miscreant or rogue a government or its representatives are. The only case is article 7 which basically allows suspending a member country if there is a serious breach of article 2. This article specifies "*respect for human dignity, freedom, democracy, equality, the rule of law and respect for human rights, including the rights of persons belonging to minorities. These values are common to the Member States in a society in which pluralism, non-discrimination, tolerance, justice, solidarity and equality between women and men prevail*". It is clear that this can only happen in case of a fascist or neo-nazi regime, something that presently has small albeit non-zero probability not just in Greece but in other European countries too.

On the other hand article 50 does allow for an EU exit in accordance with its constitutional rules. Thus, if Greece decides on its own accord or is pushed to leave there are three basic paths.

- **Article 50.** To exit the EU (article 50) and apply for re-entry only to the EU but not in the Eurozone. In this case it would adopt similar exemptions as Britain. The problem is that normally, re-entry would mean satisfying all the usual criteria and Greece most probably would not, unless there is a pre-negotiated exemption. It may also take a long time between announcement and implementation and thus Greece would need not only strong political leadership but also social and financial stability.
- **Breaching the Treaties**. This is certainly the least attractive method. In this case there is a unilateral breakaway without the consent of the other European partners. This is a hellish scenario for Greece, one that must be avoided at all costs. Exiting this way does not absolve Greece of its legal responsibilities; it just makes Greece a pariah state and possibly a failed one.
- **Article 352.** The third and possibly the most probable way, is to invoke article 352, which allows the Council with the approval of the Euro-parliament to make the necessary framework for exit. This is the best way and involves amendment of the treaties, almost on the fly.

However, before Greece reaches that point there are plenty of technical details that need to be worked out. A necessary condition as we shall see is to have capital controls. A scenario that is very much in fashion lately due to the deposit flight from the Greek banks.

<u>Technical issues</u>

- **Banknotes**. There are so many technical details that need to be taken care that securing confidentiality and secrecy for a long time is next to impossible. Banks may need at some stage for example to close for few days to reprogram the software and the payment systems which currently are linked to the Eurosystem (Target2). Printing new notes may take up to 5-6 months but the time can be shortened to few weeks if the order is given to more than one printers (probably china can do it more effectively and in less time). Greece could opt for no paper currency i.e. electronic money only, in order to fight tax evasion and ease the come back into the Euro at a later stage but this is logistically unlikely to happen at this stage.
- **Capital Controls.** Since the main reason for regaining monetary sovereignty is to increase the competitiveness of the Greek economy a basic initial step would be the imposition of capital controls and limits to deposit withdrawals. These would probably precede the introduction of the Drachma by a month or two. Naturally, trade and border controls would also be placed for some time as the Euro would still be a legal tender in the rest of Europe. This is what makes the change rather unique.
- **Parallel circulation.** The change to the new currency is not accompanied with the death of the old one. So Greece would have to accept the parallel circulation of Euros for some time. Otherwise they would create the

largest black market in the world. For example until the new Drachma notes are ready the state can pay in Drachmas but do an immediate conversion to Euro at the prevailing rate. This brings us to the financial repercussions

Financial Issues. 20% Deval, 30bln Golden Parachute plus ECB support.

- **Contract Redenomination**. Introducing a new currency means redenominating all contracts in the new currency (Principle of "Lex Monetae"). If a contract is under Greek law and is judged by Greek courts then redenomination is automatic. There is nothing one can do. If a contract is under foreign law and is judged by foreign courts (usually English) then there is high degree of confidence that they would not be affected. In every other case it is more difficult to say and law firms would be the real beneficiaries of such a Greek Euro exit.
- **Greek Debt**. The Greek debt is in its majority (>80%) under English law and it would not redenominate. The bonds that are with the ECB, through the Securities Market Program (SMP) are under Greek law and can be redenominated if Greece chooses to do so.
- **Restructuring of debt.** However, if the divorce is done by mutual consent then Greece's European creditors can restructure the debt along the lines that are already being discussed. In other words, extend the maturities and give a grace period on the bilateral loan (53bln) in the same way as with the EFSF loans (143bln).

100bln Drachma. German Occupation

- **Golden Parachute. Control Devaluation** This restructuring, together with giving around 30bln as a golden parachute to Greece not only would avoid a possible default but may also avert or at least limit a big Drachma devaluation. An initial devaluation of around 20% can be sustained or gradual devaluation of 1% per month for example can be introduced.
- **Currency Board. Euroization** The Drachma can be further supported by the ECB in a sort of currency board way provided Greece sticks to prudent fiscal policies, or policies that are negotiated with the EU. Effectively a Drachma euroization avoiding high inflation rates.
- **Avoid Default.** Thus if done properly Greece can exit the Euro and still avoid a default by servicing the post-PSI bonds (around 29bl with annual cost of 600mln) and the IMF. Greek corporate defaults may not be averted on the other hand and Greek banks would need to be recapitalised by the state.

The original exchange rate is nominal. What is important is the ability of the Bank of Greece to limit or regulate any sudden devaluation. If a dowry of 30bln is given, plus the tacit approval of the ECB it should not be too hard. It is in the interests of all EU governments for the transition to be smooth. If the offer is comprehensive then it may be hard to reject it on economic grounds. After all European countries want to be repaid not punish Greece by making it a failed state. The geopolitical risk is too high.

The 30bln or so needed are not very far from what is being discussed for the 3rd bailout agreement in any case. In other words, the EU may have to choose between paying the Greek government to stay in the Euro or paying to leave. Either way, EU pays. Now that the ECB is printing 1.1trillion, thus shielding the rest of Europe from any financial fallout, the decision may veer towards the exit.

Eurosystem Issues

- **ELA**. There are also some direct consequences to the Eurosystem. At the moment the Greek banks draw their liquidity from the ELA mechanism which is not really part of the Eurosystem even if it is reported weekly. Under the current regime any losses are being assumed by the central bank providing the ELA, i.e. the Bank of Greece. What would happen if Greece is to leave the Eurosystem? Most likely the losses would be taken by the Greek government which would redenominate them to Drachmas. Since both assets and liabilities would be converted there is limited damage. Thus ELA funding may facilitate a smooth exit.
- **Target2 Imbalances**. Another complication is the famous Target2 imbalance. Currently Greece is running at 91bln. This however, does not have a maturity and is being serviced in any case by paying interest on the balance equal to the ECB deposit rate. This raises an interesting side if not a rather funny situation. As the deposit rate is negative does Germany pay on the huge Target2 surplus? In any case, the Target2 imbalances can stay on the balance sheet without being paid for a long time.
- **Euro Notes**. Then there is the question of the Euro-notes. Greece's quota is around 26.7bln but since the Greeks don't trust their government they have withdrawn an extra 13.2bln notes that the Bank of Greece had to borrow from other NCB's. Thus at least a total of 40bln of physical notes need to be returned to the ECB. The idea of distinguishing the Greek notes from their initial letter is not practical at all as notes are circulating freely everywhere (Greek notes start with the letter "Y" and if you sum all the numbers you come up with 10).
- **ECB Capital and Reserves**. Lastly, as the BoG is a shareholder of the ECB the capital including any reserves would have to be returned (around 1.7bln). Gold is valued at around 4.5bln and half of it is in Greece and the rest is with the FED, BoE, and SNB. In any case, as the ECB may suffer from its Greek SMP holdings it is not clear how this would be resolved.

Conclusion

Exiting the Euro is easier said than done. Although not insurmountable, the technical, legal and financial details are considerable. A big challenge would come from the ability, knowledge and efficiency of the Greek political system to handle such a project. Even more important is the reaction of the Greek people once this alternative is given to them. Any decision must be taken after an extensive and informative consultation on the benefits and shortcomings. It cannot be taken based on some parochial ideology and cannot be taken by a single party or a leader. Nor can it happen based on a sentimental referendum were anger against certain European countries, extreme populism and nationalism is replacing economic facts and rationality. And for sure it needs to be done by mutual consent. If these preconditions are not observed then it would be better for Greece not to attempt it as the danger of a failed state is lurking.