Why the Greek Government Rejects a Grexit

European leaders like Merkel and Hollande have argued that the referendum in Greece tomorrow on an expired offer from the creditors is a vote on whether or not to stay in the Eurozone. When the press picked up their pronouncements, Greek officials reacted quickly and furiously, accusing Greece's creditors of trying to push Greece out of the currency union and saying they would fight any such effort vigorously. In keeping, Yanis Varoufakis, stated in Why we recommend a NO in the referendum – in 6 short bullet points:

> *5. Greece will stay in the euro…Geece's place in the Eurozone and in the European Union is non-negotiable.*
> *6. The future demands a proud Greece within the Eurozone and at the heart of Europe. This future demands that Greeks say a big NO on Sunday, that we stay in the Euro Area.*

Varoufakis curiously maintains this position despite having his key assumptions back in February overturned:

> *The Greek state, let me remind you, is quite close to a primary surplus. With judicious top-down reductions of wages and pensions, plus the issue of tax-bonds, the Greek public sector could finance itself for the foreseeable future. All that is needed is that the ECB continues to provide liquidity to the Greek banks….As for those who argue that the ECB will take an aggressive stance, think again: the ECB will not knowingly take steps which will destroy the eurozone.*

In fact, the ECB has taken a stunningly aggressive move by refusing to increase the ELA and pushing the Greek banking system towards failure by limited the support it has provided to deeply insolvent institutions. The ECB looks to have been authorized by European leaders to naplam Greece to produce regime change. This would hardly be the first instance of German/creditor meddling in domestic politics. As the Economist observed in a 2013 story on Merkel, "…she helped get rid of clowns like Italy's Silvio Berlusconi."

The lenders could have engineered Syriza's demise less thuggishly by refusing to give ground in negotiations and letting the Greek government cross its red lines itself by being unable to pay pensions and salaries in cash, which would have been certain to start happening in July. A month or two of payments partly or fully in scrip would lead to a rapid decay of support for the ruling coalition.

But as brutal as this move is, the ECB is within its rights. As the Economist noted in February:

> *The growing reliance on ELA makes the banks, and thus the Greek government vulnerable. According to Karl Whelan, an economist at University College Dublin, the ECB has great discretion over how much ELA to permit and when to withdraw it. So Greek banks' growing dependence on ELA leaves the government at the ECB's mercy as it tries to renegotiate its bail-out.*

Accordingly, we've been saying for months that the ECB holds the whip hand. It has finally decided to use it. This is what a mere four days of a bank holiday and capital controls had produced. From Ambrose Evans-Pritchard of the Telegraph:

> *Greece is sliding into a full-blown national crisis as the final cash reserves of the banking system evaporate by the hour and swathes of industry start to shut down, precipitating the near*

> *disintegration of the ruling coalition…*
>
> *The daily allowance of cash from many ATMs has already dropped from €60 to €50, purportedly because €20 notes are running out. Large numbers are empty. The financial contagion is spreading fast as petrol stations and small businesses stop accepting credit cards…*
>
> *Constantine Michalos, head of the Hellenic Chambers of Commerce, said lenders are simply running out of money. "We are reliably informed that the cash reserves of the banks are down to €500m. Anybody who thinks they are going to open again on Tuesday is day-dreaming. The cash would not last an hour," he said.*
>
> *"We are in an extremely dangerous situation. Greek companies have been excluded from the electronic transfers of Europe's Target2 system. The entire Greek business community is unable to import anything, and without raw materials they can't produce anything," he said.*

Yves here. It isn't just "can't produce for export." In Greece, a large percentage of imports aren't inputs to production (major exception being unrefined petroleum) but final consumption goods

The next day, last Friday, Evans-Pritchard reported:

> *Food has been exempted from an import freeze since capital controls were introduced last weekend. Grains, meats, dairy products, and other foodstuffs should be able to enter the country freely, averting a potential disaster as the full tourist season kicks off.*

Translation: Food imports are so important that the government is taking the risking bank survival to keep that supply chain open.

The Guardian was also grim:

> *Greece's economy is on the brink of collapse after the capital controls imposed ahead of Sunday's referendum left the country with shortages of food and drugs, the tourist industry facing a wave of cancellations and banks with barely enough money to survive the weekend.*
>
> *Banks said they had a €1bn cash buffer to see them through the weekend – equal to just €90 (£64) a head for the 11 million-strong population – and would require immediate help from the European Central Bank on Monday whatever the result of the referendum, in which the two sides are running neck and neck…*
>
> *The survival of the Syriza coalition, formed just over five months ago to repudiate five years of austerity programmes, was in doubt as Greece started to suffer shortages of basic provisions, including the sale of vital drugs in pharmacies nationwide.*
>
> *Food staples, such as sugar and flour, were also fast running out on Friday as consumers started to feel the effect of the restrictions.*
>
> *"We have shortages," said Mary Papadopoulou, who runs a pharmacy in the picturesque district of Plaka beneath the ancient Acropolis. "We've run out of thyroxine [thyroid treatment] and unless things change dramatically we'll be having a lot more shortages next week."…*
>
> *"Imports, exports, factories, firms, transport – everything is frozen," said Vasilis Korkidis, who heads the national Confederation of Hellenic Commerce. "The only sectors in demand are food and fuel."*
>
> *Korkidis said the economy had suffered losses worth €1.2bn in the past week and that the cost*

> *would have to be added to any fresh bailout deal. "Even in the best-case scenario, it is going to take months to recover from the shock of closed banks and capital controls," Korkidis said. "Now that they are in place, capital controls may last for a year."*

We had warned readers that a 12 day bank holiday in Cyrpus, with capital controls that continued for two years, did major harm. Businesses were on the verge of failure. And Cyrpus was prosperous when the bank holiday started. In far more fragile Greece, which has already been suffering a slow-motion bank run for months, the shockwave hit harder and faster.

Yet quite a few pundits who claim they support self-determination for Greece advocate a Grexit despite the clear preference of Syriza leadership and the Greek public otherwise. A Bloomberg poll last week found that 81% wanted to Greece to remain in the Eurozone. That demonstrates that Greek citizens appreciate that as bad as things are under austerity, a Grexit could tip Greece into being a failed state. What is starting to happen now, the inability of companies to import, constrained access to international payment systems like debit and credit card networks, is a pale shadow of what Greece would experience with a Grexit.

We've tried to convey what it would mean for Greece to convert to drachma and have a dracma-based payment system interface with international payment systems. Payment systems run at mission critical standards; errors or unplanned outages can lead to huge losses, as well as serious to disastrous effects for end users. And as many readers know, IT projects in large organizations, even with stable systems and capable staff, take months to complete even when they go well. The failure rate for large IT projects is well over 50 percent. As as we hope to convey, a reintroduction of the drachma is an order or two a magnitude more daunting than a "normal" big IT project. Hence the Greek government's refusal to consider it is well justified (note that our sources who are in contact with Greek government officials say the government has not undertaken any preparatory IT work for a Grexit).

As we'll discuss, even introducing drachma notes, a comparatively simple part of this exercise, would be a well over six month project for Greece in and of itself. But if a payments system is like an electrical grid, being reduced to using cash only is analogous to Iraqis using portable generators after the US took the electrical system out in the 2003 war. It's still well short of what would be needed to get the power back in your outlets, or the streetlights and subways working again.

Reintroducing Drachma Notes

We turn the mike over to our expert Clive:

> *Way way a-back when dinosaurs roamed the Earth and I was a junior in my TBTF I worked in the ATM Operations unit. It was a big, big unit. The logistical effort is considerable in maintaining an ATM estate — and that is under BAU conditions. Cash is bulky. The security requirements are considerable. The ATM hoppers are designed for specifically sized notes (the specification is exacting — if the notes are not precisely the same height, width and, crucially, paper grade, the ATM will jam up quickly; this applies to note counters as well). You can't just max out high denomination notes either — a functioning cash currency needs sufficient quantities of various notes and coinage in the right proportions. Physically stocking, balancing and making an ATM ready for service once depleted takes a finite amount of time and that time isn't trivial. And most ATMs are "dual control" — you need two operators for fraud prevention. Like I say, for a single TBTF to maintain a network of ATMs takes several hundred head office staff and a lot more in-situ staff. Then you need armoured cars, guards, access to premises. That's many hundreds more needing to be planned, rostered and actually turning up each day. It is a major undertaking — and this is under normal, day-to-day operational conditions. Factor in secrecy (which would be inevitable, certainly in the run-up until the last few days anyway) and it is even more difficult.*
>
> *And then you have self-service tills in supermarkets, vending machines, ticket machines and so on. Again, the specification of the physical currency is critical. For stores, marking prices is a labour-*

> *intensive job.*

Bloomberg concurs:

> *Wintergerst says introducing a new currency typically takes at least six months, and sometimes as long as two years. Artists must draw the notes, security experts then add anti- counterfeiting measures such as watermarks and special inks, and bank officials need to plan how much of each denomination is needed and get the money to banks.*
>
> *"The most challenging thing was to establish efficient distribution and make sure the new currency was available everywhere," said Boris Raguz, head of the Treasury Directory at Croatia's central bank, who in 1993 oversaw the introduction of the country's currency, the kuna, after the breakup of Yugoslavia*

Some Examples of IT Issues

There's a reason converting to the Euro took ten years of planning and three years of execution to have it go smoothly The list of IT issues to address in the reintroduction of drachma is far too voluminous to cover in a post, or even a book. We'll give a couple of examples. If you haven't read it already, your first stop should be Clive's accompanying article today on **card system requirements**

Transition. Switching drachma to Euro at a fixed rate took years of planning and rehearsal. The fixed rate is a big simplifier, though: during the transition, counterparties don't really care if they receive Euro or Drachma in settlement.

With a switch to a new floating currency, outstanding transactions in Euro would have to be settled in Euro. New transactions would have to be booked and settled in Drachma. You need a new currency code. For imports and exports, you need a functioning market in a new currency, too: a 1:1 exchange rate wouldn't last for long. Overseas suppliers wouldn't be at all naive or trusting about that rate.

Thus, the system changes required for a new currency at a floating rate appear to be significantly more complex than the 2001 Drachma-to-Euro switch. As far as one can see, there would be no lead time at all, either. There is new exchange rate risk for everyone to manage, and on Day One of the new Drachma, there won't necessarily be a way to do that. This is not a recipe for success.

Lack of an ISO code. There is now no ISO code for the drachma. International payment systems like Swift won't accept drachma transactions until there is an ISO code for them in its system. The ISO is a very deliberate body, so don't expect that to happen quickly. Even though the odds are high that the ISO will re-adopt the old ISO code for drachma, GRD,GRD, but only if there are no concerns that the new 2015 drachma could possibly be confused with the old, pre-2001 drachma. Most banks won't bother to start their own coding to handle drachma till they have an ISO code and have an idea when Swift will be ready. That means drachma trading will probably be limited to buccaneers, um hedge funds, like Glencore (the successor to Marc Rich, which specialized in trading with countries subject to embargos), foreign banks with operations in Greece and banks that trade exotic currencies. For example, Barclays was strong in exotic currencies due to having a large branch network in Africa.

Those niche players may make some sort of joint effort to develop risky kludges for the time being. The result will be that the drachma market will be thinly traded and volatile, and dealing will be relatively expensive. For how long? Well, even if the ISO agrees quickly and produces a new code promptly, it would take a great deal of time, up to a year, to update all the various systems with the new ISO file.

The usual legacy systems issues within banks. New requirements and their consequences for bank systems are ***always*** more complex than anyone thinks. Part of the reason is this: a lot of very singular legal structures have resulted from bank mergers. The legal requirements spawn in turn a set of unintegrated and juryrigged IT systems, all different from bank to bank. The overall result is that bank systems are far more decentralized than most laypeople assume. This decentralization makes it hard to understand just which systems have to change in order to satisfy a new requirement. So the changes take even longer. Miss a key requirement, and, at best, expensive remedial work is involved. At worst, your newly modified system isn't fit for purpose at all. Related to all that, there is the usual development backlog at banks: where does the putative New Drachma fit into the schedules?

The implication is that Syriza is not simply following public sentiment. Varoufakis has been firmly opposed to a Grexit even before he became Finance Minister, and his stance hasn't changed even as the Eurozone has become a more obviously hostile environment that it seemed before he took office. As as much as it would be emotionally satisfying to see Greece take a hike out of the Eurozone and have its revenge by living better, or even not that much worse, that's just not in the cards. Greeks are overwhelmingly opposed to leaving the Eurozone and EU because they recognize that the costs of departure aren't just high but catastrophic.

.