Bloomberg
Businessweek

The EU’s Secret Plan for a Catastrophic Grexit

A new book, *The Last Bluff*, reports on official preparations for the disaster that almost was.

By Viktoria Dendrinou and Eleni Varvitsioti

14 Ιουνίου 2019, 7:01 π.μ. EEST

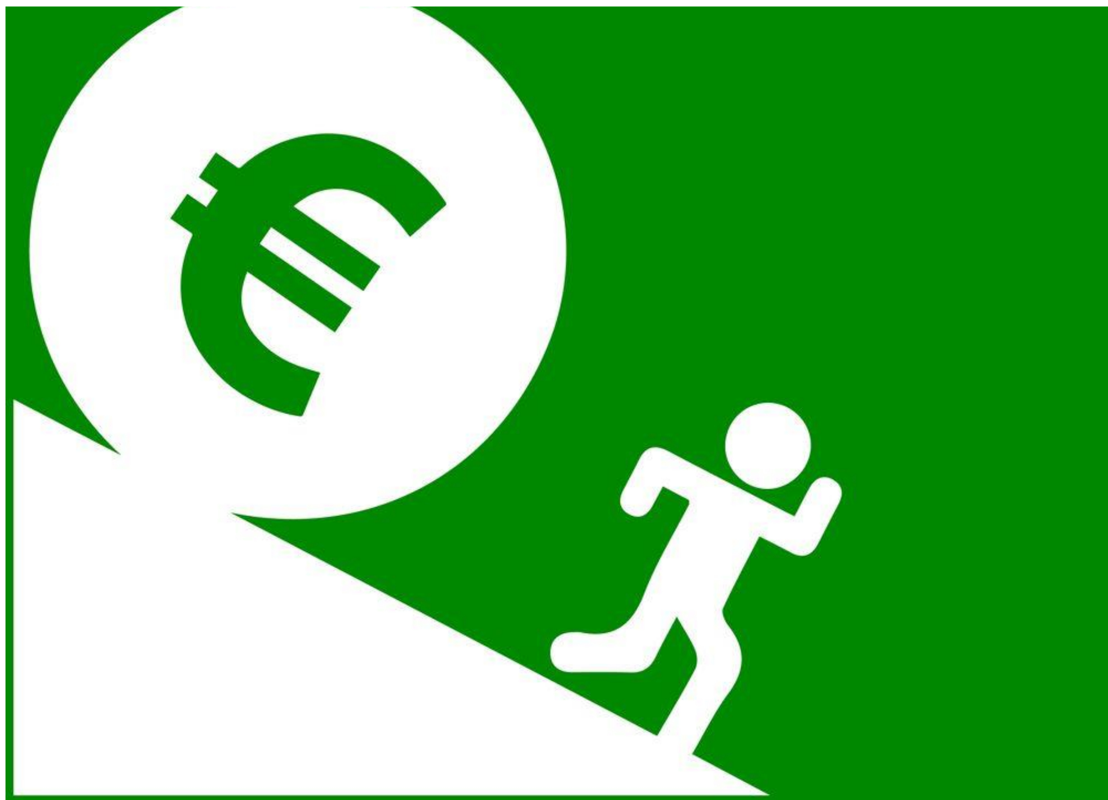

ILLUSTRATION: 731

The top-secret plan had been filed away in 2012, the previous time Greece had teetered on the edge of default. It was code-named "Croatia's Accession to the European Union" to disguise that it was a doomsday scenario for the country farther south. Any hint it even existed would have sent Greece deeper into crisis, spooked financial markets, and shaken confidence in the euro itself. Then in early June 2015 a fresh round of default negotiations seemed to be at an impasse. Not till negotiations ended on July 13, 2015, did the EU and Greece agree to a third bailout. In the meantime, the EU's preparations for catastrophe continued, as detailed in this excerpt adapted from Viktoria Dendrinou and Eleni Varvitsioti's book, The Last Bluff.

A small team of 10 EU economists and lawyers huddled on the 15th floor of the Charlemagne building, the European Commission's economic headquarters in Brussels, and dusted off the old Plan B in case negotiations failed and Greece defaulted. The reasons for secrecy remained the same as 2012. But the plan had to be renamed because Croatia had since joined the EU. Thus, the 157-page "Albania Contingency Analysis & Plan, Sovereign Default 2015" was all about what to do to minimize the economic and humanitarian catastrophe should Greece be forced out of the EU and the euro zone.

The second chapter, Managing Exit, looked at the stark costs of a Grexit. At that point, Greece owed €342 billion ($387 billion in current dollars) to the European Financial Stability Facility, the European Central Bank, the European Investment Bank, and other euro zone governments and banks. A table calculated in detail each euro zone country's exposure. In the case of Italy, that amounted to €63 billion, or 4.1% of its gross domestic product. For Germany, the sum was far greater. At €92.8 billion, or 3.4% of its GDP, the sum was the highest in absolute terms. But Slovenia had the biggest exposure as a percentage of its economy—at €1.7 billion, it amounted to 6.7% of its GDP.

Pivotal to the sequence from a government default to a Grexit was the complete reliance of Greek banks at that point to Emergency Liquidity Assistance (ELA)—approved by the ECB and extended to them by the Bank of Greece. To get these cash loans, banks had to put up collateral, mainly bonds guaranteed by the Greek state. Plan B assumed that once Greece defaulted to a creditor such as the ECB, it would be impossible for the

governing council of the ECB to continue to accept Greek government bonds as adequate collateral, and the ECB would need to call back the ELA it had given to the country's banks. This would quickly trigger a series of events whereby the illiquid banks would almost immediately become insolvent and collapse. The only way to avoid that would be to find liquidity elsewhere. But being in the euro zone meant Greek banks didn't have the same options as in an independent monetary system. They would be stuck without liquidity because that could come only from the euro system—which by that point would have shut them out. This meant that the country would be left with just one option to prevent its banks from collapsing. The Bank of Greece would have to provide liquidity in a new currency—essentially exiting the euro zone.

This wouldn't require printing new money right away. The practical part could be dealt with within hours, only requiring the central bank to change its information technology systems so it could convert the euros in bank accounts to its new currency. In a matter of hours, the Bank of Greece could convert everything. Contracts under Greek law would become redenominated, and civil servants and pensioners would have to be paid in the new currency, while taxes would have to be paid in it as well. The new drachma would depreciate against the euro instantaneously. For the currency change to become reality, "Greece will need to introduce new legislation," the document said, "swapping euros under Greek law to the new drachma." The currency would become the sole legal tender, and all euro deposits would have to be swapped to it, too.

But that wasn't the only implication of a currency switch. "If Greece left the euro zone, clearly the first thing that would happen would be that the new currency would have no credibility," an official involved in the discussions says. "No one would want to hold that currency, so you would soon enter into a spiral of devaluation." This meant the currency would keep losing its value against the euro, a fall that would feed inflation and in turn further currency weakness, making imports more expensive. This would have major implications for Greek debt, as it still would be denominated in euros. A likely immediate depreciation of 50% against the euro would instantly boost the debt-to-GDP ratio, which in June 2015 stood at 180%. The ratio would immediately double to 360% and very soon to 500%, given the impact on the economy. This meant a "very significant debt restructuring would be necessary," the plan said.

The paradox was that the only sure thing about a Grexit would be that the country would immediately need another bailout. It felt almost absurd, going through all this trouble to avoid a bailout, only to enter a situation where another one would be needed. “That’s the irony of the whole thing,” another one of the officials involved says. “No matter where you looked, there would have been a bailout. Maybe not instantly, because the government would say no, but very soon the reality would force them. It would be the only way to stabilize the currency and get a grip on inflation.”

Whereas the electronic switch to a new currency could happen within hours, converting to a new physical currency would be much more complicated. The change would pose major logistical challenges, especially given the severely limited capacity of the Greek administration.

A multicolored bar chart in the Plan B outlined the time needed for different types of currency to be made available after the currency switch. For the first two weeks after Grexit was triggered, no physical notes would be available, and economic and financial activity would halt completely. From Week 2 and up to four months, central bank emergency checks could be used for transactions, while for the next four to eight months provisional emergency banknotes could be used. The introduction of new paper notes would be possible only after at least eight to nine months had passed.

Plans for the provision of emergency banknotes were rife with technical issues. One option the members of the contingency team considered was to use existing euros and punch holes in them, branding them “new euros” for a while until a system that could print the new currency was set up. But ATMs most likely wouldn’t be able to accept these new euros because of their different texture. Another idea would be to use existing banknotes and stamp them, differentiating them from standard euros. But that would still not guarantee that ATMs would be able to tell the difference between a new euro note and an old one, since the security features would remain the same. Besides being impractical, any plans for punching holes or overprinting would imply a de facto devaluation of the euro, according to the plan. Also, this “would have a negative impact in the global reputation of euro and the trustworthiness of the currency,” the plan said. The physical production of the emergency notes probably wouldn’t be a major issue. Euro-printing operations were spread across member states; in 2015 Greece printed 10-

euro notes in its national mint in the Chalandri suburb in northeastern Athens. Ironically, Greece's capacity to print euros could facilitate its switch to a new currency, as the euro plates could be easily adjusted and the spare supplies of paper, paint, and security materials at the mint could be used to print emergency banknotes until the new setup was up and running.

Another factor complicating the switch to a national currency and the estimates of how long the transition would take was the high amount of cash circulating in the economy. Fearing imminent closures, many Greeks withdrew their money from the banks, stuffing it under their mattresses, in plant pots, or safety deposit boxes. So the first few weeks probably would be manageable, officials who worked on the plan thought. By late June, cash circulation had reached around €50 billion—equivalent to more than a third of total deposits and five times the average circulation in the euro area. This would mean it would take time for the new currency to fully circulate because Greeks would resist converting their euros to the less valuable new notes.

A final concern, especially for the ECB team, was what would happen if Greece unilaterally decided to use the remaining supplies in its mint and print more euros. Officials involved in the talks say this was extremely unlikely, because it would amount to counterfeiting and fall under criminal law. The political fallout of such a decision would be huge; it probably would sever Greece's ties with any institution that could help it during such a difficult time. Even if the Greek government took the risk, the implications it would have in terms of the euro's circulation would be insignificant, officials working on the plan concluded.

In any case, the ECB had already mapped out some key steps to guarantee that the government wouldn't use excess unfinished stocks of euros at the Bank of Greece. First, a special security inspection team would go to Greece to check the accuracy of the reported numbers by "conducting sampling at the 16 branches of the Bank of Greece where the excess is held." Then, the ECB security accreditation that's necessary for the Bank of Greece to produce banknotes would be suspended. The third step foresaw the ECB instructing manufacturers to stop supplying Greece with stock necessary to produce new notes, while Step 4 included sending a special ECB inspection team to identify and secure the materials on site as well as materials produced in house, such as

printing plates, for immediate destruction at the Bank of Greece printing works. Any excess stock would be repatriated to the rest of the euro zone.

As the Plan B team was mapping out the legal, financial, and technical details, a separate team at the European Commission's Secretariat-General worked on humanitarian aid. A default almost certainly would push many people below the poverty line and render them unable to cover their basic needs, including food and housing, causing a crisis not seen in Europe since the Second World War. Letting an EU member endure such suffering was inconceivable, especially as another crisis was brewing. Migration was further stressing Greece, with the government struggling to manage the influx of refugees from war-torn regions.

Officials began by crunching some basic numbers. Given the severity of the situation that Greece would face in the event of a euro zone exit, they calculated that about 20% of the population—about 2 million people—would immediately face acute needs. This meant that the commission needed to create a safety net that would cover food, medical provisions, and even clothing. There were discussions about how to ensure that hospitals would continue to operate without having shortages of drugs. Another consideration was the possibility of fuel shortages. Even if the EU could ensure that fuel would be provided, arrangements had to be made to make sure that Greeks could pay for it.

Since the EU had no provisions for humanitarian aid to one of its members, a way had to be found by which Greece could receive such funds, while nongovernmental organizations on the ground could help with basic needs. The officials soon realized that a minor change in EU legislation could enable Greece to use a pot of money from the bloc's structural and investment funds. The mechanism for such aid was found, and the issue resolved.

Dendrinou is a reporter with Bloomberg News. Varvitsioti writes for the Greek daily Kathimerini. The Last Bluff is published in Greek by Papadopoulos Publishing.

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