Global Markets Daily: Why Greece Can't Just Print Drachmas

Published March 2, 2015

- The deal between Euro-area lenders and Greece reveals a rational policy reaction function…
- …and verifies our base-case for a mutually agreeable solution.
- However, amid a deteriorating macroeconomic situation in Greece, risks of an accident remain.
- In today's note, we expand on a recent piece on GRexit.
- More specifically, we discuss why it is nearly impossible for Greece to issue a viable new currency.
- A default would not lead to a debt write-down.
- In the presence of large-scale senior external debt, a new currency would merely work as means of (some) internal payments.
- And lead the domestic and external economy to a taxing liquidity drain.

1. Market Overview

As dollar strength extends at the start of the trading week, market focus has fallen on the CNY. The CNY has experienced significant trade weighted appreciation over the last few years, an appreciation which is hard to square up with the domestic picture of cyclical softness. The fact that the onshore USD/CNY rate has been trading at the upper level of the band has triggered market focus on potential outflows and the CNH has continued to trade in a volatile fashion along this theme. Over the weekend, Chinese authorities cut rates by 25bps to alleviate domestic liquidity tightening. This morning, onshore rates remain at the top of the band even though the fix edged slightly higher, indicating that the current FX band remains in place post easing.

India's budget announcements over the weekend came in line with market expectations, indicated steps of reform and signified a shift towards budget decentralization.

For the rest of the week, the focus will shift squarely towards US growth as we enter the data-heavy part of March. Today, we expect the ISM to edge down marginally from 53.5 to 52.5 (consensus is for a print roughly in line with last month's). On Friday, we expect Non Farm Payrolls to print at 220k, below consensus (of 240k).

2. Greece Reaction Function Points to Lower GRexit Risks

In our view, the costs of a collapse in the negotiations between Greece and its international lenders are high for both sides (but primarily and particularly high for Greece). The strong disincentive against such a collapse raises the probability that an agreement for the continuation of Greek funding may ultimately be reached.

More specifically, the agreement on the principles of a new Greek programme that was achieved early last week revealed the reaction function of Greek authorities ahead of a crucial dilemma. Practically, the Greek government would either need to agree on programme terms that would enable the sovereign to remain solvent or risk a default which would lead to a cap in ELA liquidity provision to Greek banks. The result of the latter option would be a shut-down of the banking system.

Rationally, the Greek government chose the solution that would be the least costly to the economy and the country overall – that of the acceptance of a mutually agreeable framework in order to continue negotiations for an updated Greek programme. And this rational choice is significant as it reveals the reaction function of Greek officials.

However, this does not mean all risks for Greece have declined. As we head into March, maturity payments towards the IMF primarily are expected to deplete cash reserves for the Greek government. At the same time, budget execution has deteriorated sharply and there are signs of an economic slowdown driven by uncertainty. The combination of the aforementioned factors implies that Greece will require funding quite urgently, perhaps even in March. And that the terms are likely to be harsher than they would have been, was the economy to remain on the late 2014 macro track.

The probability of an accident is still there. We continue to get questions on the likely shape and form of a GRexit. To these questions, we responded with a detailed piece on Friday. There we argue that GRexit is not the binary event it is often portrayed to be. Transitioning from the Euro to a new national currency is no straightforward task either for Greece or for Europe to pursue. In today's daily, we focus on why Greece can't just (re)introduce a national currency.

3. Debt Unpaid is Not Debt Forgiven

One of the first and most important issues to understand is that Greek debt structure does not resemble that of other Euro-area nations. The loans given to Greece as part of a) the first Greek Loan Facility, b) the EFSF/ESM-funded second Greek programme and c) the IMF sum up to more than EUR200bn, or 2/3 of the Greek debt stock. For all intents and purposes, they are foreign treaties with other governments and failure to pay them does not lead to an automatic write-off, particularly as maturities of those loans are primarily 15-30 years in the future (except for IMF loans that mature in the years ahead). They also cannot be redenominated.

Furthermore, about half of Greece's marketable debt of EUR66bn is in foreign law as a result of the PSI bond restructuring. There are also cross-default complications with the official sector as part of the co-financing agreement.

Overall, failure to meet obligations would not lead to a default and write-off of part of the debt stock. Instead, liabilities would most likely run in arrears that would need to be paid off before Greece could ever tap financial markets. And costly litigation would probably drastically reduce the flow of EUR funds in and out of the country.

There is of course the possibility of a mutual agreement on a write-off of a significant chunk of Greek debt following an exit. But that voluntary restructuring of official sector debt would require concessions on the Greek side. In the current Euro-area set up, this would probably involve a new MoU with fresh conditionality backing a "recovery" programme. And such an option is already on the table, at less punitive terms for the Greek economy. It may also take time to reach such a consensual agreement during which the Greek economy would come under severe strain.

4. Secluded from International Capital Markets, Greece would not be Able to Issue a Globally Traded Currency

With senior liabilities outstanding, Greece would be secluded from international capital markets. This would not just hold for the Greek government. It is likely that the implications touch the Greek private sector too, with Greek exporters and importers not being able to rely on letters of credit provided by Greek institutions. In such a case, Greek trade would collapse to the level that can be sustained by cash businesses in Euros.

Should a Greek currency be introduced following failure to pay, it would likely have very limited convertibility into Euros outside Greece. It would purely be a means of internal transactions, in all likelihood.

But is this an equilibrium solution for Greece? No. Because in such an event, it would be hard to convince even the Greeks to hold any drachmas. Put simply, while public sector employees, pensioners and government supply providers would be paid in drachmas (and be expected to pay part of their tax liabilities in the new currency), they would not be able to use that currency to buy imported goods. Exported goods would also become too valuable to be bought in drachmas, as they would correspond to hard currency receivables. Anticipating this, even providers of domestic services (taxi drivers, hairdressers etc) would avoid receiving payments in drachmas if possible.

If at all, the drachma would trade at a huge discount to the Euro. The economy would remain largely euro-ised but without a natural source of Euro-liquidity.

5. Drachma Would Prove An Unsustainable Means of Taxation

Ultimately as we discussed in our note on Friday, it would be very hard for Greece to introduce a viable new currency unilaterally. Baring the complications of actually printing a new note, such a move would likely lead to a collapse in Greece's international transactions and trade (both for the government and the private sector), would expose the country to litigation risks and trigger a significant destabilization of the banking system.

The only function of such a new currency would be to "tax" parts of the population that would not naturally receive hard currency as part of their payments structure. But that tax would not lead to a natural increase in government receivables as the economy (both the internal and the external economy) would shrink in a downward spiral.

The equilibrium outcome of such a situation would be a deep recession that would help build current account surpluses despite declining export activity. Once such recessionary surpluses were realized, a natural flow of hard currency would be established, which would help Greek authorities start meeting external financing requirements again.

As we conclude, we would like to point out that this is a highly theoretical exercise. We do not think that such an outcome is either desirable or feasible by the current Greek leadership. Instead, this exercise is meant to illustrate the strong disincentive for unilateral default and currency introduction from the Greek side.

6. Tactical Trading Views

The following trading ideas from the Global Markets Group reflect shorter-term views, which may differ from the longer-term 'structural' positions included in our 'Top Trades' list further below.

On Equity:

1. Stay long US Consumer Growth basket (BBG ticker: GSWBCOGA Index), opened at 104.8 on 8 Jan 2015, with a target of 110 and a stop on a close below 100 (revised from 102), currently at 107.8.

7. Recommended Top Trades for 2015

Longer-term structural views are expressed in our Top Trade recommendations. These are typically managed with a wide stop, and assessed on the basis of whether the fundamentals continue to support the medium-term investment theme.

1. Stay long EUR/$ downside via 1-year 1.15/1.10 put spread (originally at 1.20/1/.15 with a premium of 70bp EUR at initiation), expiring on 20 Nov 2015 for a maximum potential payout of 7.5 to 1 (originally 4.5 to 1), opened at a spot EUR/$ of 1.253 on 20 Nov 2014, currently at 1.119.
2. Buy a constant maturity 10-year US Treasury 3.00-3.50% 'cap-spread', funded by selling a corresponding 2.24-1.75% 'floor spread', both expiring on June 30, 2015, opened at zero cost on 20 Nov 2014.
3. Close long Dec-2015 Eurostoxx 50 3150/3450 'bull' call spread on 19 Feb 2015, opened at 101.5 on 20 Nov 2014, for a potential payout of c1.8-to-1.

4. Stay long risk on the 5-year CDX HY 23 junior mezzanine tranche (the 15-25% portion of the loss distribution), opened at 495bp on 20 Nov 2014 (on a running spread basis), with a target of 440bp and a stop on a close above 600bp, currently at 452bp.
5. Stay long on a basket of EM crude oil importers stock market indices, implemented via equal part of TWSE, XU030 and NIFTY indices, opened at 100 on 20 Nov 2014, with a target of 115 and a stop on a close below 93, currently at 104.9.
6. Close short CHF/SEK on 15 Jan 2015, opened at 7.70 on 20 Nov 2014, for a potential loss of 16.5% including carry.
7. Stay short Dec-15 LME Copper futures and close long Dec-15 LME Nickel futures on 11 Feb 2015, for a potential gain of 7% on the relative value trade. On the remaining short Copper leg, initiated at 6580 on 20 Nov 2014, target 5200 or lower, with a stop on a close above 6000, for a target of at least 12.8% (revised from 20%) and a stop on a close below 1% (revised from -10%) on the overall commodity trade, currently at 2.5%.
8. Close long USD against a basket of HUF and ZAR on 21 Jan 2015, opened at 100 on 20 Nov 2014, for a potential gain of 8% including carry.
9. Stay long USD against a basket of ZAR and KRW (on a spot basis), opened at 100 on 3 Feb 2015, with a target of 110 and a stop on a close below 95, currently at 101.3.

Equity basket disclosures

The Securities Division of the firm may have been consulted as to the various components of the baskets of securities discussed in this report prior to their launch; however, none of this research, the conclusions expressed herein, nor the timing of this report was shared with the Securities Division.

The ability to trade these baskets will depend upon market conditions, including liquidity and borrow constraints at the time of trade.

Themos Fiotakis and Olivia Kim*

*Olivia Kim is an intern with the Global EM team.