

# High-Level Brief



Thinking ahead for Europe

## A Parallel Currency for Greece

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### Key Point

*Greece and its creditors seem to be engaged in a game of chicken: both sides expect the other to yield at the last moment. The game will almost certainly end with each side deviating somewhat from its preferred course.*

*In this Brief, we discuss how a parallel currency could contribute to a resolution of the conflict. In our view, it would be the least-bad option for both sides among three possible options on the table.*

### The dilemma of EMU

In our existing 'fiat' money system, book money is created by private banks through credit extension. The central bank accommodates banks' demand for reserve money and the public's demand for cash in the form of bank notes. By setting lending rates for reserve money, the central bank indirectly influences banks' credit rates and through this the growth of credit and money. A fiat money system needs a state that sets the rules for banks and the central bank, and gives democratic legitimacy to the operation of the central bank.

By contrast, in a pure commodity money system, e.g. the gold standard and 100% reserve coverage of bank deposits, the money supply is set exogenously through a fixed exchange rate between money and the underlying commodity (e.g. 1 ounce of gold = x USD). Since there is no fractional reserve banking, banks cannot augment the

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money supply, and there is no need for a central bank or a state to protect and legitimise money.

EMU combined elements of the pure commodity money system (super-independent central bank, no bail-outs) with the fiat money system. And the former were supposed to substitute for the state that EMU did not have. But the construction turned out to be flawed. States and banks behaved as if they operated in a complete fiat money system and over-borrowed. To prevent the failure of EMU, the European Central Bank (ECB) assumed state functions during the crisis. Most importantly, it assumed the role of the buyer of last resort of government debt. The Governing Council of the ECB decided which governments benefited from ECB purchases of their debt and on which terms.

The ECB's role as buyer of last resort of government debt raises three problems:

- i) The ECB lacks democratic legitimacy for this role.
- ii) The ECB creates moral hazard as the benefits of debt purchases accrue to individual governments and the costs in the form of higher inflation are (eventually) borne by all EMU members.
- iii) The influence of governments on the ECB is strongly skewed towards larger countries.

This set-up is unstable and EMU cannot survive in the long-term, unless the set-up is changed. To survive, EMU has either to evolve to become a state with monetary and most fiscal sovereignty vested in a central government (which can delegate part of its monetary sovereignty to an independent central bank), or it has to regress to a pure commodity money system.

### **The options for Greece**

The main reason for Greece's debt crisis is that the public and private sectors behaved as if the government still had control over the buyer of last resort of their debt. Since this is no longer the case in EMU, Greece has surrendered its sovereignty to those who can act as buyers of last resort of Greek debt. Assuming that the creditors will not completely yield to Greek demands for unconditional help, Greece now has three choices:

- i) Accept the loss of sovereignty (and follow the programmes demanded by the creditors),
- ii) Regain full sovereignty by exiting EMU and introducing its own currency or
- iii) Regain partial sovereignty by introducing a parallel currency to the euro for domestic use.

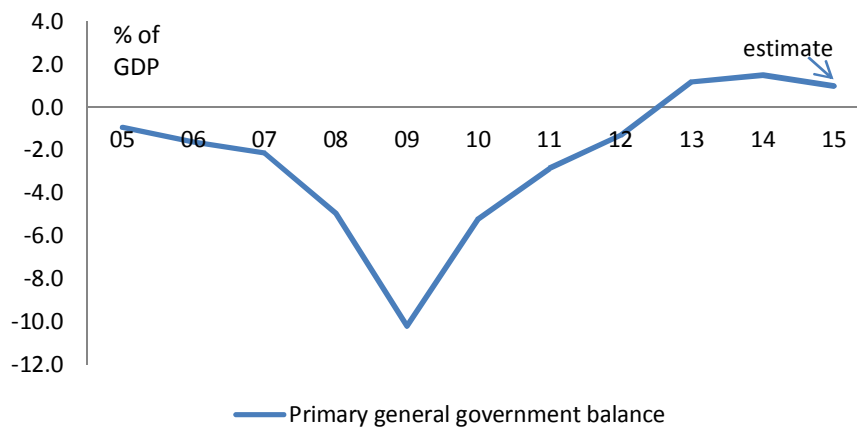
Clearly, the third option requires Greece to make concessions so as to secure the approval for the action by its partners.

### **The road towards a parallel currency**

We sketch below a few steps for the implementation of this preferred option.

1. Arrange for sufficient euro government revenue to service the debt to the IMF and the ECB (or find an arrangement for the rescheduling of the debt to the ECB, e.g. a stand-still agreement for a designated period of time for the repayment of the debt, or complete the present programme under the conditions outlined below for receipt of the last tranche) so as to avoid technical default.
2. Fund other government expenses by issuing special government debt as means of payment. Thus, instead of issuing government bonds to raise euros as payment for government spending, payment is made directly with special government debt. The two means of payment can be mixed (depending on the availability of euros). For example, existing pensions are paid in euros, pension increases are paid in special government debt. Ordinary (euro) government finances would remain unaffected by the issuance of special government debt. In this way, the Greek government could fund additional expenses without affecting the primary budget surplus in euros, or it could replace euro spending and increase the primary budget surplus (see Figure 1).<sup>1</sup>

Figure 1. Greece's primary budget balance



Source: Haver Analytics.

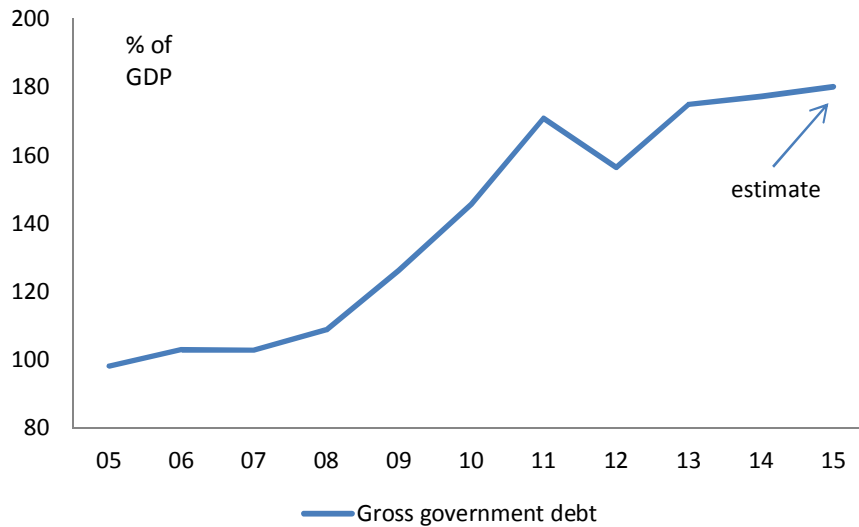
3. Denomination of the special debt would be in 'Greek euros' (in 2012 we called these 'Geuros'), and the exchange rate at issue would be 1:1.<sup>2</sup> However, the government would not intervene in the market to stabilise the exchange rate. The Geuro would float against the euro. The Geuro could be backed by government assets, which could be moved into a separate trust for this purpose. This would limit issuance and hence raise confidence in the new instrument.

<sup>1</sup> The savings of euros would be given by the euro spending replaced by special government debt minus any taxes lost on previous euro incomes generated by euro spending. Thus,  $y = x - t x$ , where  $y$  denotes euro savings,  $x$  euro spending replaced by special government debt, and  $t$  the tax rate applying to incomes generated by the previous euro spending. Assuming that  $t = 20\%$ , the replacement of one euro by special government debt with the face value of one euro would lead to effective budgetary savings of 0.8 euros.

<sup>2</sup> Thomas Mayer, "The Geuro: A parallel currency for Greece", DB Research, May 2012.

4. *Create demand for special government debt by requiring employers to pay any increase in the minimum wage in this denomination.* Thus, the minimum wage would consist of a part paid in euros and another part paid in special government debt. Taxpayers would be allowed to pay taxes in the currency (or mix of currencies) of their taxable income.
5. *To protect banks' balance sheets, tax withdrawal of deposits and money transfers abroad at the rate of the discount of the Geuro to the euro in the market (e.g. if €1 = 1.25 Geuro, then a withdrawal or transfer abroad of €100 would lead to an account debit of €125).*
6. *As the use of special government debt as means of payment increases, it becomes a parallel currency to the euro.* With the supply of parallel currency initially exceeding demand, it would depreciate against the euro (although the value of the collateral in the Trust Fund would limit the depreciation). As labour costs would accrue in part in euro and in another part in the parallel currency, labour costs composed of both euro and parallel currency would decline against labour costs in euro only. This would raise competitiveness and especially help labour-intensive exports (e.g. tourism).
7. *Aggregate money supply of both euro and Geuro would increase.* The resulting monetary impulse would stimulate domestic demand. Price inflation measured in euro would remain unaffected; price inflation measured in Geuro would rise.
8. *If the Trust Fund is established as a fully government-owned but separate corporation, any debt issuance by this institution (through Geuros) would not count towards public debt (see Figure 2).* Hence, debt sustainability would not be directly affected by operations of the Trust Fund. Debt sustainability could be indirectly affected as public assets moved to the Trust Fund would serve as collateral for Geuros and hence not be immediately available as a source for the repayment of debt. However, to the extent that the Trust Fund model improves the outlook for economic growth, debt sustainability could even increase. As a public corporation, the Trust Fund would not constitute a shadow budget of the government. Public corporations exist in all European countries and are seen everywhere as distinct from the government budget. Last but not least, Geuros would not be in conflict with the status of the euro as legal tender. There are many supplementary means of payments in the form of regional currencies in euro-area countries, which are tolerated by the monetary authorities. With Geuros designed to be a regional supplementary means of payment, there is no reason why they should not be treated equally.

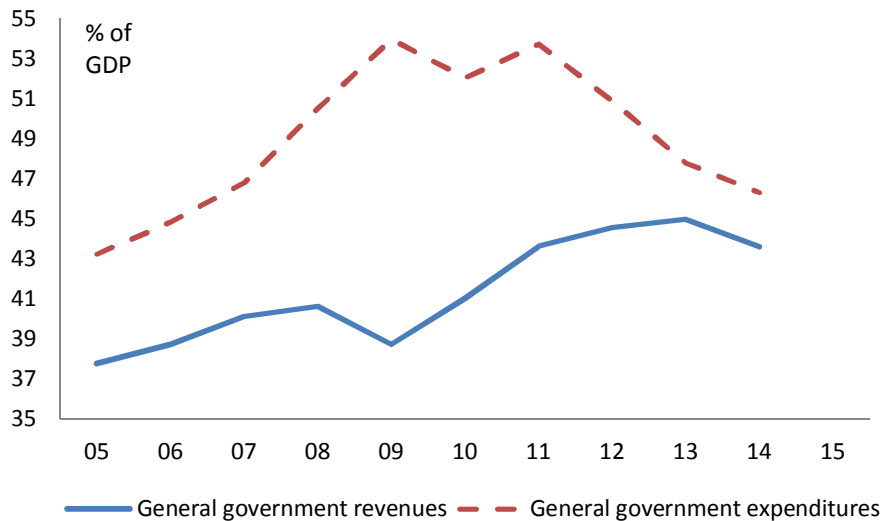
Figure 2. Greece's gross general government debt



Source: Haver Analytics.

9. *The monetary programme cannot substitute for a further modernisation of the Greek economy, but it could ease the straightjacket imposed by the single European currency on aggregate demand while supply-side reforms continue (see Figure 3 for recent developments of government expenditures and revenues). As Greek output and with it the demand for Greek euros rise, the government could gradually tighten the supply of Greek euros so that the exchange rate between the euro and the Geuro moves back to parity. Eventually the government could lock the exchange rate, repurchase Geuros against euros, and return to the single currency regime.*

Figure 3. Greek general government expenditures and revenues



Source: Haver Analytics.

## Better than 'Grexit'

Clearly, option (3) would impose considerable hardship on the Greek population, but it would probably be less destructive than full Grexit. If implemented in agreement with EMU partners, it would leave the door open to Greece's return to EMU as a full member. Ideally, full EMU membership would be resumed when Greek debt sustainability has been reached (and also when EMU has been put on a stable footing). There are historical examples of a parallel currency introduced during periods of financial stress, only to disappear again later. For instance, California in 2009 paid debt in IOUs that circulated temporarily as a parallel currency to the US dollar. The state repurchased these instruments against dollars after the financial tensions had eased. Also, during the US Civil War, the Union states in the north introduced United States Notes to fund war costs. These notes, dubbed 'Green Backs', circulated as currency in parallel to the Gold dollar and were later repurchased by the US government. Against this experience, Argentinian provinces issued IOUs during the debt crisis of 2001. But this was only a prelude to the abandoning of the peso-dollar exchange rate link and the introduction of a floating exchange rate regime for the Argentinian currency.



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