Flossbach von Storch
RESEARCH INSTITUTE

Economic policy note 4/2015

A Parallel Currency for Greece

Thomas Mayer

- Greece and her creditors seem to be engaged in a game of chicken: Either side expects the other to yield at the last moment before the default of the Greek government. The game will almost certainly end with each side deviating somewhat from its preferred course.
- In this note, we discuss how a parallel currency could contribute to a resolution of the conflict. In our view, it could be the least bad option for both sides.

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

EMU combined elements of the pure commodity money system (super-independent central bank, no bail-outs) with the fiat money system. The former were supposed to substitute for the state that EMU did not have. The construction turned out to be flawed. States and banks behaved as if they operated in a complete fiat money system and overborrowed. To prevent the failure of EMU, the 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 at which terms.

The ECB's role as buyer of last resort of government debt raises three problems: (1) The ECB lacks democratic legitimacy for this role. (2) The ECB creates moral hazard as the benefits of debt purchases accrue to individual governments and the costs in form of higher consumer or asset price inflation are (eventually) borne by all EMU members. (3) 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 progress to a state with monetary and most fiscal sovereignty vested in a central government, 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 had still control over the buyer of last resort of their debt. Since this is no longer the case in EMU, Greece has lost 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: (1) Accept the loss of sovereignty (and follow the programs demanded by the creditors). (2) Regain full sovereignty by exiting EMU and introducing its own currency. (3) Regain partial sovereignty by introducing a parallel currency to the euro for domestic use. Clearly, option (3) requires concessions by Greece so as to get approval for the action by its partners.

The road towards a parallel currency

The following sketches a few steps for the implementation of option (3).

1. Arrange for sufficient euro government revenue to service debt to the IMF and the ECB (or find at least an arrangement for the rescheduling of debt to the ECB, e.g. a standstill agreement for some time for the repayment of the debt).

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.

3. Denomination of the special debt would be in "Greek Euros" (in 2012 we called these "Geuros")[1], and the exchange rate at issue would be 1:1. However, the government would not intervene in the market to stabilize the exchange rate. The Greek Euro would float against the euro.

4. Create demand for special government debt by requiring employers to pay the increase in the minimum wage in this denomination. Thus, the new minimum wage would consist of a part paid in euros and another part paid in special government debt. Allow taxpayers to pay taxes in the currency (or mix of currencies) of their taxable income.

5. To protect banks' balance sheets, introduce capital controls and allow withdrawal of deposits only in Greek Euros at the official exchange rate of 1:1.

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. As labor costs would accrue in part in euro and in another part in the parallel currency, labor costs composed of both euro and parallel currency would decline against labor costs in euro only. This would raise competitiveness and help especially labor-intensive exports (e.g. tourism).

7. Aggregate money supply of both euro and Greek Euro would increase. The resulting monetary impulse would stimulate domestic demand. Price inflation measured in euro would remain unaffected, price inflation measured in Greek Euro would rise.

8. The monetary program cannot substitute for a further modernization of the Greek economy, but it could ease the straightjacket imposed by the single European currency on aggregate demand while supply-side reforms continue. As Greek output and with it the demand for Greek Euros rise the government could gradu-

[1] Thomas Mayer, „The Geuro: A parallel currency for Greece", DB Research, May 2012.

ally tighten the supply of Greek Euros so that the exchange rate between the euro and the Greek Euro moves back to parity. Eventually the government could lock the exchange rate, repurchase Greek Euros against euros, and return to the single currency regime.

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 the return to EMU as full member. Ideally, full EMU membership would be resumed when EMU has been put on a stable footing.

Site information

Publisher: Flossbach von Storch AG, Research Institute, Ottoplatz 1, 50679 Cologne, Germany; Phone +49 221 33 88-291, research@fvsag.com, *Directors:* Dr. Bert Flossbach, Kurt von Storch, Dirk von Velsen; *Registration*: No. 30 768 in the Commercial and Companies Register held at Cologne District Court; *VAT-No*. DE200075205; *Supervisory authority*: German Federal Financial Services Supervisory Authority, Marie-Curie-Straße 24 – 28, 60439 Frankfurt / Graurheindorfer Straße 108, 53117 Bonn, www.bafin.de; *Authors*: Dr. Thomas Mayer; *Editorial deadline*: 20/4/2015