6 SAVING MONETARY UNION? A MARKET SOLUTION FOR THE ORDERLY SUSPENSION OF GREECE

Pedro Schwartz with Francisco Cabrillo and Juan E. Castañeda

The Greek misadventure has given birth to mistaken remedies that have neither healed Greece nor stopped contagion. The original design of the euro, as the only legal tender currency in the euro zone, has turned out to be socially and politically costly. It implies transforming nominal convergence of deeply diverse economies into real convergence. Simply bailing out an errant member, while imposing ill-planned expenditure cuts and inordinate tax increases, is turning out to be counterproductive. More generally, the attempt to keep ailing members within the euro against all the odds is endangering European Economic and Monetary Union (EMU) and even the EU itself. The interested parties are at loggerheads as to what to do to save the single currency. The debtors want mutualisation of sovereign debts; the creditors resist any mitigation of the rules governing the European Central Bank (ECB). Despair is setting in. Even if one thinks that monetary union was a good idea to start with, a collapse of the euro now would result in painful monetary chaos.

The mismanagement of the Greek crisis could turn out to be a blessing. Expelling Greece from the euro system is legally difficult if not impossible. For the Greeks to leave the euro zone voluntarily is also complicated: they would have to exit the EU and then return as an aspiring member of EMU on the same terms as recent new entrants. There is another way. The euro could be made a competing currency alongside national currencies. The solution may sound outlandish to many but it is similar to John Major's 'hard ecu' proposal. In 1990, the then Chancellor of the Exchequer, John Major, proposed a common European currency

instead of a single currency. It would have been electronic money to be used by business and tourists. Its value would initially have been equal to a basket of EU currencies but it could not subsequently have been devalued relative to any member currency. This would have made it as hard as the hardest member currency. Major's idea was rejected, but we now see that it could have saved us from the present troubles.

Why not consider a temporary suspension of EMU membership and allow Greece to reissue drachmas while keeping the euro in circulation? Greece could be rescued from its plight by running drachmas and euros in parallel, fully convertible at floating rates. This would allow it to heal its economy while not forsaking the euro project. Such a move would have to be carefully designed but is feasible. Bank deposits in euros would have to be guaranteed to avoid a bank run – the main cost of the scheme though a dwindling one. True, foreign debts expressed in euros would become an extra burden on banks and on mortgagees, but those debts could be alleviated along the well-tried lines of the Club de Paris for sovereign debt and the London Club for private debts. The main advantage for Greece would be that pricing wages, taxes, social benefits and domestic assets in drachmas would help make the Greek economy competitive in foreign markets and achieve the necessary price adjustments. By not forsaking the euro totally, balance of payments deficits would continue to be financed for the time being as at present by Target 2. Greek banks could have recourse in moments of need to both the ECB and the Greek central bank. The drachma need not disappear if the Greek central bank applied a conservative monetary policy – indeed, the central bank would have an incentive not to misbehave if it wished to maintain its seigniorage income. A full return to the euro could be contemplated at a later stage, if Greece wanted this.

Why is the euro failing?

A stable currency is an important factor in the prosperity of a country. In the long run the denomination of the money matters little since, given

time, individuals and firms will adjust prices and wages to changes in currency values. In the short term, however, life can be made very difficult by changes in the value of money. The euro had been designed as a stable currency, independent of the real and credit circumstances of different member countries. In its first ten years both price stability and low transactions costs were beneficial. The fact that there was some degree of free-riding by countries unwilling to play by the rules was not thought to be of great importance.

The present crisis has shown otherwise. In the boom years euro interest rates had been managed by the ECB following the example of the Federal Reserve. They were too low even for Germany, where their effect was to exaggerate the export capacity of its economy. They were certainly low for the rest of the euro zone. Since asset prices tend to vary inversely with interest rates, cheap money led to steep rises in asset values and there was an incentive to invest imprudently. Low rates also induced people to run excessive debts, as ever-rising asset prices made all investments appear riskless for lenders and for borrowers. With interest rates of the whole area converging on the German rate, governments, firms and households in deficit countries felt able to borrow abroad without limit. All this led to long periods during which debtor countries had little incentive to reduce costs and improve productivity.

Thus it is that the pro-cyclical policies of the central bank in a monetary zone can cause what is known as a 'bubble': the CPI price level may be stable for a while when money supply is expanding, but asset values keep rising for as long as the real yield of the 'overpriced' assets does not disappoint investors' expectations. Once those expectations turn, the financial crisis sets in. The natural consequence should have been sovereign defaults and private bankruptcies. Failures need not become systemic as long as the money supply is maintained by the central bank.[1] Furthermore, the rule of the Maastricht Treaty was that

1 Ever since Friedman and Schwartz (1963) we have known that it is crucial that in a crisis central banks act as lenders of last resort and abide by the Bagehot rule (1999 [1873]) of lending money to solvent banks at punitive rates. Congdon (2011) applies the Friedman

there should be no bailouts. When this rule was not obeyed, contagion of the whole euro zone was unavoidable.

The euro zone was not an optimal currency area

For five or six years the euro seemed to be functioning well despite the fact that the euro zone was not an optimal currency area, as Mundell (1961) defined the term. This was not thought to matter, since Mundell taught that monetary zones with a single currency could exist even if they differed in economic structure, under two conditions: firstly, easily transferable or movable factor services; and, secondly, flexible prices and wages. If factors of production could move easily from one occupation to another and from one location to another, then a fall in demand for a product in one place or industry could be compensated directly by factors moving to another place or activity. There would be no need to use the exchange rate to return to full employment. Equally, immobile factors could stay in their original employment if wages and prices were so flexible that the local market always cleared. In any case, he added, direct adaptation through wages and prices was not so different from adaptation to economic shocks through the exchange rate. The only difference, he thought, was one of perception or money illusion.

The experience of EMU, however, has shown that it is not money illusion which makes some countries prefer devaluations to cost-cutting. If European governments often hanker after the possibility of devaluing it is because differences in language, nationality, unionisation, welfare entitlements, taxation, property rights and so on hinder the easy movement and the realistic pricing of factor services.

Suboptimal currency areas are not static. Areas can come closer to optimality through structural changes leading to greater factor mobility, real exchange rate convergence and openness to foreign markets.[2] Unfor-

and Schwartz warning against falls in the quantity of bank money to the present situation.

2 Vaubel (1978: 64–71) proposed that we take the divergence of real exchange rates in the various regions as an index of how low the optimality of the currency area is.

tunately, the creation of the euro zone by itself has not visibly fostered factor mobility and structural convergence. Despite all efforts to create a single market in the EU, barriers remain and have even grown through the very regulations intended to bring them down.

When exchange rates are fixed (as they are in a monetary union) and capital movements are free, a government has only one remaining policy instrument left if any at all – fiscal policy.[3] In the last resort, activist governments will want to stimulate their economy despite the evidence that increased public expenditure financed with sovereign debt is ineffective in the long run. To guard against the temptation for governments to spend for electoral purposes the founder members of the euro signed the 'Stability and Growth Pact' in 1997. Unfortunately it was watered down in 2005. Seeing its ineffectiveness, a new 'euro-plus pact' was drawn up in 2011. Reactions to the present crisis make one doubt that such agreements can stop governments from trying to escape the discipline of the single currency.

The euro as politics

Ultimately, the euro is a political project for state-building and not a way of opening the EU to the world. The enormous efforts to save Greece and others show how far euro zone leaders are ready to go it together. They think all would be well with a more executive, functioning, integrated, protected and powerful European Union. To the disappointment of all concerned, the Greek quagmire is slowly sucking in the single currency ... and its passengers.

3 This is what has come to be known as the Mundell trilemma, which states that only two of fixed exchange rates, open capital markets and monetary sovereignty can be attained. A government, when exchange rates have been fixed, can exercise monetary sovereignty only if it places strict controls on capital movements. Since, in EMU, internal capital controls are forbidden, the only remaining policy instrument is fiscal. However, the inertia of tax and expenditure policies blunts this instrument.

Two lessons from the past

The real and the pseudo gold standard

To have adopted the euro is often likened to functioning under a classical gold standard. In both cases a country gives up two important macroeconomic tools, the management of the rate of exchange and the possibility of running a chronic budget deficit. In gold standard years the Bank of England used interest rates simply to speed up the adjustment of the economy when there was a loss or accrual of gold. When domestic banking crises occurred, the Bank of England acted as a lender of last resort. There was no need for a political authority to govern this automatic system. Under the euro the ECB enjoys a margin of safety even the Bank of England did not have in the second half of the nineteenth century. The ECB is not bound by its reserves of metal but by a much more flexible rule that consumer price inflation has to be kept below but close to 2 per cent per year. The (nominal) bank rate can be used to decrease or increase the money supply. Euro zone member states still have fiscal policy as a macroeconomic instrument, but recourse to budget deficits was in theory limited under the Stability and Growth Pact. At one point it was intended that the ECB should be as independent as the Bank of England: by design the original euro system was not supposed to need a central political authority.

When fragile peace was restored to Europe in the 1920s the larger countries returned to gold, but the standard was made to work differently to how it did before World War I: the only currency directly linked to gold was the US dollar; the others were simply kept at a fixed exchange rate to the dollar. As the Great Depression struck, one by one countries gave up even this 'exchange gold standard'. The fundamental reason for giving up gold was that the pre-World War I parity of the national currency to gold implied deflations that proved unfeasible, given the habits and institutions of twentieth-century societies. As Keynes said in August 1931 when the devaluation of sterling with respect to gold was being discussed: 'our choice lies between devaluation, a tariff

... and a drastic reduction of all salaries and incomes in terms of money'.[4] Keynes's phrase accurately portrays the plight of Greece and other euro zone nations today, barred from devaluing, from controlling capital movements and also finding internal devaluation well-nigh impossible. Only the three Baltic republics have shown the mettle to make the euro work in a crisis. Making the euro a solid and stable currency for the other European nations is proving just as difficult as the use of gold in the 1930s.

What is it that makes the classical gold standard impractical in our unionised welfare societies? The classic gold standard has an element of imposition or central regulation that prevents it from being a completely free market currency. The rate of exchange of the pound, the dollar and the franc was fixed to gold effectively by decree. The result was that note circulation was governed by gold reserves. To compete in world markets nations had to have to resort to deep cost-cutting. The same can be said of the euro.

Milton Friedman in 1961 proposed another form of gold standard, one from which we can draw inspiration in the euro zone: a 'real' gold standard contrasted with the 'pseudo' gold standard of classical times, as he called it. Gold certificates would circulate as currency if people freely preferred to use them in their contracts. The certificates would be issued by institutions holding gold deposits, institutions that would be separate from the central bank issuing the local currency.

> Side by side with such a standard, there could, of course, exist strictly national currencies. For example, in the United States from 1862 to 1879, greenbacks were such a national currency which circulated side by side with gold. Since there was a free market in gold, the price of gold in terms of greenbacks varied from day to day. (Friedman, 1987 [1961]: 456)

The only conditions needed for such a flexible gold standard to function would be that the rate of exchange between paper and gold

4 Keynes (1982), p. 605.

would be flexible, not fixed; exchange and capital movements must be totally free; and legal tender should be abolished so that contracts and tax payments could be made in gold or paper or any other money that people freely chose.

This analysis can be applied to the parallel currency system that we propose for Greece. The euro, well anchored by the issue rule of a truly independent central bank, could circulate side by side with national money. Crucially, the ECB would issue euros based on a credible monetary standard (a 'hard euro') and would not act like a conventional national central bank, but merely be the issuer of a parallel hard currency. In this scenario, the 'new ECB' would not implement monetary policy decisions to achieve any macro goal or to 'drive' the growth of the economy. Public administrations, firms and private individuals would freely choose in what currency to denominate their taxes, obligations and contracts. The competition with the euro would discipline the local central bank. This system could be used not only in Greece but in any member country that had to go back to its national currency.

The shambles of the currency board in Argentina

The disorderly exit of Argentina from a decade-long currency board arrangement is a strong warning of what could happen to Greece if it were suddenly forced to exit the euro by a wave of speculation.

A history of repeated inflation had led the Argentinian government to set up a currency board in 1991 permanently linking the peso with the US dollar at a one-to-one exchange rate. It lasted for a little over ten years. During those ten years the conditions for a well-functioning currency board were flouted with catastrophic consequences. Those conditions are that the local currency must be fully convertible; the central bank may not finance spending by domestic governments; and the central bank must have reserves at hand that cover 100–115 per cent of the domestic monetary base. Convertibility was held for as long as possible but disregard for the second condition fatally undermined

the system: the public deficits of the state and provinces led to monetisation of the debt. Dollar reserves melted as confidence dwindled and the board was nearing collapse.

In 2001, a recently elected President De la Rúa, having inherited a fiscal deficit of $7,350 million, tried to save convertibility by further deflating an economy already stagnant for two years. He called back Domingo Cavallo, the founder of the currency board, who tried to stem growing capital flight. After $18 billion had left the country during the first eleven months of 2001, Cavallo tried to rebuild confidence by having the government pass a 'zero deficit law' and an 'intangibility of deposits law'. Still fearing a run on the currency, he also called on the IMF for what we would today call 'big bazooka' help, but this simply increased the alarm of investors.

Cavallo then imposed what many specialists think will be necessary if Greece or another EMU member is forced to leave the euro overnight: he ring-fenced the money market, with what Argentinians immediately called the 'cattle pen' or '*corralito*'. To stop the bank run individuals were not allowed to withdraw more than $200 in cash per week or transfer more than that amount abroad without central bank permission. Even so, in the first quarter of 2002, bank current accounts shrank by 25 per cent and GDP fell by a further 45 per cent. De la Rúa and Cavallo resigned. The new interim president, Duhalde, first devalued the peso by 50 per cent. He then decreed that deposit holders could withdraw their frozen dollar assets in pesos at the rate of 1.40 peso per $1 and that dollar loans owed to banks could be repaid in devalued pesos at the favourable rate of 1 peso per dollar. To save banks from collapse the government gave them bonds equal to the value of their loss due to devaluation. Finally a new president of the country defaulted on $132 billion of foreign debt. Growth ensued but inflation soon returned.

What happened in Argentina is clearly a warning to European authorities facing a possible Greek default. If nothing is done, a moment will come when commercial banks in a besieged country will suffer a sudden liquidity crunch. An overnight *corralito* would have to be

imposed. This would very quickly reflect on the real economy, especially if the Target interbank, inter-country transfer system were to shut down overnight. The economy would then become moneyless and would grind to a halt.

The chaotic euro zone non-exit strategy

Direct and indirect costs of keeping Greece afloat

Keeping Greece within the fold of the euro by piecemeal measures instead of radical and immediate remedies has entailed direct and indirect costs which are increasing by the month. These costs are centred not only on Greece but also on those other countries in the euro zone suffering from the repercussions of the Greek bankruptcy.

The direct costs include the loans to bail out Greece (€240 billion committed of which €150 billion has been paid out), Ireland (€67.5 billion), Portugal (€78 billion) and now Spanish banks (a €100 billion facility out of which €35 billion is to be paid out immediately). A total of €485 billion has been promised and €330.5 billion spent. There are also costs implicit in the debt guarantees proffered by the EU at a level of more than €600 billion.[5] In addition, the ECB has greatly expanded and will go on expanding its balance sheet by purchasing bonds of doubtful quality. It has also promised to buy sovereign debt on the secondary market, with the pretext that the ensuing interest rate reduction would increase the efficiency of the monetary policy transmission mechanism.

Many of the bailout loans come with frills attached. In the case of Greece, for example, when in November of last year it was granted the third instalment of its €240 billion facility amounting to €34.4 billion, a number of further concessions were made: the period of past loans was extended by two years, their rate of interest reduced to 0.5 per cent above the three-month Euribor rate, and a further €9.6 billion was promised for a debt buy-back operation.[6] All these concessions have

5 Public debt data from Eurostat (as available up to November 2012).

6 Greek debt is trading at 35 cents on the euro, a sizeable discount. It is probable that

been calculated to amount to a further cost of at least €32.6 billion (Stravis, 2012).

The indirect costs include the insurance premiums or spreads paid by the less credible countries: this has meant an increase in sovereign bond interest payments for Greece, Portugal, Ireland, Spain and Italy to the sum of €28 billion. Also, there are costs that are difficult to measure, such as the loss of confidence in EU institutions, mainly the ECB, owing to the amount of bad paper in the ECB portfolio.

Prevarication to avoid a write-down

As at December 2012, Greek debt amounts to €301 billion. A write-down of 53.5 per cent was imposed on the holdings of private banks in the first bailout agreement in October 2011. With the proposed debt buy-back, holders wishing to sell will suffer another haircut since the current discount of Greek bonds on the market is 35 cents on the euro. In the agreement of November 2012, granting the third tranche of the €240 billion facility, official institutions have been exempted from taking a cut on their Greek debt holdings, which means that taxpayer-backed institutions, though holding 70.5 per cent of Greek debt, have been exempt from haircuts. The ECB holds €36 billion of Greek debt and marking it to market would draw a question mark over the whole of its portfolio and perhaps force a recapitalisation – a politically embarrassing move, especially for Germany.

Parallel currencies and transition problems

The parallel currencies system we propose will be different from Major's hard ecu proposal or a classical currency board. The drachma and the euro would be on a clean float and neither would need to be legal tender.

holders of bonds issued under English law will keep them to maturity (Open Europe blog, 28 November 2012). Also, the German finance minister, Wolfgang Schäuble, is on record as saying that there would be no new loans for the buy-back (Stravis, 2012).

This means that Greece or any other European country deciding to follow this route will not have to exit the euro zone. How this parallel currencies system will function is more fully described below, but the problems that could arise in the transition must first be analysed.

Avoiding a run on deposits after suspension

The whole scheme that we propose could founder if a bank run developed. Money, as is well known, performs three functions: it is a standard by which to compare the relative value of goods and services; it reduces the cost of exchanging goods and services; and it can be a store of value for future use. So the stable value of money is a condition for a well-functioning economy.

Today, around 85 per cent of a country's money supply is bank deposits in financial institutions. The 15 per cent cash reserve backing banknotes is thus 'fractional'. When depositors lose confidence in the bank that keeps their money, the bank will find itself without enough cash to satisfy their calls. It may not be able to realise its other assets and panic may ensue. Such a flight to cash will leave the economy without ready means for transactions and cause a steep fall in production. If Greek holders of euro accounts fear their deposits will suddenly be redenominated in devalued drachmas they will try to convert them into euro notes immediately or send them abroad. Panic will ensue. This is the reason why experts say that any plan to expel a member from EMU has to take deposit holders by surprise and be preceded by capital controls (see the chapter by Neil Record). Gros (2012) has suggested a simple way to suspend the free movement of capital without resorting to border controls or the prohibition of money transfers. It would be enough to suspend the automatic functioning of the European interbank clearing system Target 2, so that Greek resident banks would be unable to charge money transfers to other European banks. All these measures take away one of the essential freedoms of the European Common Market and should be avoided.

One way of preventing a run would be fully to guarantee deposits in euros. The cost of a 100 per cent deposit guarantee in Greece would have been less than the transfers squandered by the non-exit strategy (the narrowly defined €130 billion or the total commitment of €240 billion seen above). In January 2012 the total amount of bank deposits in Greece was €225.25 billion. It will have fallen further by now. The total guarantee of those deposits would not have cost that much since only the difference between the value of the deposits before and after devaluation would have to be met. In fact, the €240 billion committed so far to the Greek non-exit strategy would have covered the greater part of the cost of guaranteeing Greek bank deposits in euros.

Keeping commercial banks solvent

Of course this would create problems for the solvency of Greek banks. However, the only help that is needed is to keep the euro denomination of deposits. In our proposal, loans to the private sector and those pension fund assets invested in bank deposits would be redenominated in drachmas. Since public debt would, in any case, have to be restructured by way of a substantial 'haircut' for creditors, it is not important for banks whether or not it is redenominated in drachmas. As such, for the sovereign bonds owned by banks a menu of two options could be offered: an issue of new bonds in euros with, let us say, a 50 per cent reduction in their nominal value; or a redenomination of public debt in drachmas maintaining their nominal value. The effects would be the same for the banks' balance sheets.

With regard to the non-financial private sector, their bank deposits would not be re-denominated in drachmas, but mortgages and other loans from banks to the private sector would have to be re-denominated to maintain the solvency of the majority of households and firms as wages would be paid in drachmas. Since the general public holds about €225 billion of bank deposits which would remain in euro, but banks'

assets would be redenominated, the banks would need substantial financial assistance from foreign governments and international financial institutions.

In sum the total cost of the suspension of Greece to set up a system of parallel currencies would be the cost of keeping their *deposits* denominated in euros and of being content to recover the value of their euro *credits* in drachmas. The exact amount of the aid commercial banks needed would depend on how much the drachma devalued.

The gainers from this process would be Greek citizens, who (in aggregate) maintain the euro value of deposits but have their borrowing transformed into drachmas. Given this, we would also suggest the introduction of a new windfall tax on the withdrawal of funds from euro-denominated deposits. This should not be a general tax on financial transactions, but a temporary tax for the specific purpose of helping to keep Greek banks solvent to be paid by people withdrawing money from their deposits in euros. This will serve several purposes. Firstly, it would reduce windfall profits obtained by Greek residents with bank deposits in euros; secondly, it would create incentives to delay withdrawals from deposits in euros and thus reduce the possibility of bank runs; finally it would help finance subsidies that banks would receive from the government for having to redenominate their credits in drachmas.

How much devaluation?

How large a devaluation of its new currency would Greece suffer before finding its appropriate level? Several calculations have been made. Nouriel Roubini estimates that the euro is overvalued in Greece by at least 30 per cent.[7] Michael Hart, using unit labour cost levels, suggests that, to eliminate its current account deficit, Greece should devalue by 50 per cent and even more to enter a sustainable growth path.[8] Nomura

7 *Financial Times*, 22 November 2011.

8 RGE Share, 26 September 2011.

Bank calculated in 2011 that the value of European currencies in a euro break-up scenario needed to fall in the region of 60 per cent for Greece, around 50 per cent for Portugal and 25–35 per cent for several countries, including Ireland, Italy, Belgium and Spain.[9]

In any case it is very difficult to determine the equilibrium exchange rate for a currency *ex ante*. Also, in an exit scenario, there may be some overshooting. But we can assume that 50 per cent is a reasonable extent of the necessary devaluation of the new Greek drachma. Therefore, capital losses on assets newly denominated in drachmas can be estimated at 50 per cent. Also, Greek residents will find it very difficult to pay back private euro debts after devaluation, so that some means of settling defaults would have to be found.

The Shylock syndrome

The exit of a nation from a currency board arrangement or from a monetary union is usually accompanied or even preceded by a large default, be it direct or by devaluation (see Reinhart and Rogoff, 2009, 2011). Up to the 1970s the settlement of foreign defaults was left to the markets. In the last third of the twentieth century defaults of sovereign debt were settled in Brady Bonds, which at present are touted for Greek-like situations.

In 1988, Treasury Secretary Nicholas Brady proposed his eponymous plan whereby banks that had lent too much to Latin American states 'voluntarily' accepted to receive a smaller amount in bonds on condition that debtor countries would open and free up their over-regulated markets. The plan worked with the help of loans from international organisations and a US Treasury guarantee for those new bonds, so

9 Nomura, in what it calls a 'redenomination scenario', takes into consideration both real exchange rate current misalignments and future inflation risk, measured by four parameters: sovereign default risk, inflation pass-through, capital flow vulnerability and past inflation track record. See Niki Kitsantonis, 22 January 2012, http://topics.nytimes.com/top/news/international/countriesandterritories/greece/index.html, accessed 23 January 2012.

that disappointed creditors were at least able to trade their paper on the international market.[10]

There are, however, private ways of dealing with default that are more conducive to the ultimate recovery of defaulting countries, which ensure that costs do not fall on the shoulders of creditor countries' taxpayers. Some intermediaries are for-profit companies, such as the World Debt Corporation. Others are informal organisations that have emerged in the second half of the last century where creditors meet failing debtors: the Paris Club for sovereign creditors and the London Club for private creditors. From the mid-1950s the Paris Club has assisted in the sovereign debt restructuring of more than eighty countries. More than four hundred agreements have been reached; and total debt covered in the framework of Paris Club agreements amounts to more than $550 billion. The London Club has also reached a large number of debt reconciliations. This includes, among others, the private debts of Serbia and of Soviet Russia.

People have often argued against private settlement of defaulting sovereign debt as giving debtors too much bargaining power. Experience shows, however, that creditors can strengthen their negotiating positions by (a) keeping their loans current for as long as possible; (b) closing the door to further credit; (c) restructuring their loans with debt-for-equity swaps, debt buy-backs, debt exchanges, debt-for-bond swaps, and settlement of debts; and (d) buying their claims at a discount in local currency and using them to purchase equity in the debtor countries. Debtors too, if they hold foreign currency reserves, can repurchase their own debt at depressed market value and thus indirectly obtain a reduction in their indebtedness.

Lenders have a strong incentive to find the amount of debt reduction that will maximise the recovery of a failing nation. A creditor may very often benefit from forgiving some debt, so that payments of interest and principal do not strangle the debtor. Shylock had much reason to

10 See Ian Vásquez's (1996) summary of the scheme applied to Mexico in 1989.

hate Antonio and Christians in general. His contract with Antonio was valid. But by claiming his pound of flesh he lost all – the ducats, a fair daughter and the desired revenge. Sometimes it is better to pardon than to receive.

The proposed monetary regime

Parallel currencies with no legal tender

With a parallel currency regime, residents, banks and governments would still be able to use the euro. Commercial banks especially would keep their connection with the ECB as well as with the new drachma central bank: i.e. both central banks would act as lenders of last resort along Bagehot lines. Neither currency needs be legal tender. European politicians and officials will want to reject this solution of floating parallel currencies for its apparent untidiness, however, for fear of competitive devaluations and because 'it has never been tried'.

Free competition always looks untidy to the planner. We are highly sceptical of the supposed benefits of competitive devaluations without capital controls as there would simply be either open or repressed inflation. It is notable that in the years after the Civil War, when greenbacks and gold certificates circulated in parallel, as explained by Friedman and Schwartz (1963) and Friedman (1987 [1961]), American dealers engaging in large foreign transactions maintained both gold balances and greenback balances in New York banks. The 'greenback dollar' and the 'gold dollar' constituted 'a dual monetary standard'. Their relative value was determined in a free market. That is why they could coexist side by side without either driving the other one out.[11]

If people are free to choose the money they prefer, monetary

11 If residents are forced to use currencies that are exchangeable only at a fixed rate, bad money will displace good by the effect of Gresham's law. 'Gresham's law that cheap money drives out dear money applies only when there is a fixed rate of exchange between the two. It therefore explains how greenbacks drove out subsidiary silver. [... S]ilver could still have stayed in circulation, as gold could and did, by being accepted at its market value rather than its nominal value' (Friedman and Schwartz, 1963: ch. 2, n. 16).

competition will make convergence towards better currencies easier. As Vaubel (1978: 68–9) said in his path-breaking study, choice on the *demand side* of financial services makes for stable money. Over time, people tend to grow out of the illusion that inflation leads to growth. Also, choice in currency will bring the monetary area nearer to optimum size. And there will be a demand for a conservative monetary policy in relation to the new drachma because of the availability of the euro as an alternative – especially for savers. Supply side oligopolists may try to exploit money illusion.

It is clear that drachmas would be used in parallel with euros so long as they float freely and neither is legal tender. The euro will not push conservatively managed drachmas out of circulation or reduce them to the role of small change.[12]

A temporary reserve for the new drachma

As the new drachma floated freely against the euro and residents freely chose which of the currencies to use, the drachma would in the end find its level. In the first flush of distrust, however, there could be a great deal of volatility and possibly even rejection of the new currency. The example of Estonia could be followed. It decided to have a currency board arrangement with the euro, guaranteeing the solidity of its kroon fixed exchange rate by using its forests as a reserve asset. Along these lines, the Greek government could pledge state properties as a temporary guarantee for its new drachma. Alternatively the Bank of Greece could earmark its tourist income as a guarantee in the same way that the Spanish Habsburgs made over the income of their '*alcabalas*' or sales taxes to their German and Genoese bankers.[13]

12 Sargent and Velde (2002: ch. 14, especially fig. 14.1).

13 The Bank of Greece recorded its high-powered money as €21,687 million in September 2012. If we assume a devaluation of 50 to 60 per cent when starting to issue new drachmas, the circulation of the new currency will be in the range of ND8,575 million to ND13,012 million. The tourist income of the Bank of Greece was €10,505 million in 2011. This amount translated into new drachmas at the assumed devaluation would more than

One can reasonably assume that, once the initial uncertainty was over, a conservative monetary policy on the part of the Greek authorities would stabilise the purchasing power of the new drachma.

Two clubs in competition

Two banking clubs in competition[14] would provide the central banks at their head with the right incentives to offer the best services to their members. In this new scenario, the commercial banks of the suspended country would have the choice to be members of – and obey the rules of – either or both clubs. In essence, they will move their deposits according to the quality of the services provided by each currency, measured in terms of the ability to preserve purchasing power in the medium to long term. In the absence of obstacles posed by legal tender and capital controls, and in a world dominated by instant communication, competition in the money issue market is a real possibility.[15] Additionally, with increased competition, there would be no incentive for explicit or implicit collusion between the two issuers of money, as there is today in the central bankers' oligopoly.

The Greek national bank would perform the following functions.

- Issue its own currency.
- Act as one of the two suppliers of liquidity to the monetary system.
- Provide different clearing facilities to the bank members of its club.
- Purvey regular and extraordinary credit as needed.

Self-interest would drive the new Greek monetary authority to

cover the new drachma's MO.

14 See Goodhart (1988), where he defines the role of central banks as heads of clubs of commercial banks with powers to inspect and duty to lend in the last resort.

15 The benefits of monetary competition are receiving increasing attention among economists. Starting with Hayek (1976), there is quite an extensive literature on this question (among others, White, 1984, and Selgin, 1988). See King (1999) as well, when he was the deputy governor of the Bank of England.

control money growth and inflation. The commercial banks of the suspended country would presumably be members of both clubs: they still should have access to Target 2, the euro-wide clearing facility, as well as to the national clearing facilities in drachmas. Greek banks would also have the choice of receiving regular credit from the ECB in euros, as they would have deposits and investments in both currencies. The ECB would accept as collateral sovereign debt denominated in either euros or drachmas valued at market prices with appropriate haircuts. This would make both bonds in euros and in drachmas tradable in financial markets. The initial exchange rate of the national currency would be subject to high volatility just after launch but then would settle down, when the market started to perceive that sound fiscal and monetary rules were being followed.

A central bank's target will be to maximise its seigniorage in the long term. Since the seigniorage associated with money issue ultimately depends on the demand for the currency, the national monetary authority would soon feel that an inflationary fiscal and monetary policy mix was hurting it as individuals and commercial companies moved to the more stable currency, the euro.

A new fiscal policy in the suspended country

Fiscal discipline will be reinforced by the need to have the drachma compete with the euro. In order to defend the drachma, there must be a truly binding fiscal rule that must include:

- A specific fiscal target.
- A time horizon to evaluate the achievement of the target.
- Exposure of the government in office in case of a deviation from the target.
- Timely and transparent accountability measures to make sanctions effective.

- Greece should leave the euro temporarily.
- A new drachma would be issued allowing the circulation of the euro at a freely floating exchange rate.
- Exchange and capital controls would not be necessary to avoid a run on Greek banks as deposits in euros would be guaranteed.
- Liabilities of the Greek state and all Greek residents would be redenominated in drachmas.
- Arrangements such as the Club of Paris and the Club of London could be reached on euro-denominated private and public debt.
- Parallel circulation of euros and drachmas would encourage the Bank of Greece not to over-issue and the Greek Treasury not to overspend, under pain of shrinking seigniorage.
- Parallel circulation might slowly lead the Greeks back into full membership of the euro zone if they so wanted, by the free choice of Greek residents and businesses.

All this could include regular hearings in parliament, open letters between the prime minister and the governor of the central bank in the case of discrepancy, and a required adjustment plan with specific measures and a timetable to achieve the pre-announced goal.

A summary of the whole process is provided in the box above.

Conclusion and wider implications for remaining members of the euro zone

A parallel currency approach to the Greek situation would not involve amendment of the treaties, since temporary suspension is not equivalent to a country voluntarily or forcibly leaving the euro. The approach would be market-driven and create currency competition and a new dynamic

towards decentralisation. It could also be achieved at much lower cost than the costs of deferring exit that are currently being incurred.

The temporary suspension of a member of the euro zone, however, would increase the speculation already taking place against other vulnerable members. Hence, such a move would pose a dilemma for EU and national authorities. They could either allow parallel currency circulation in other failing countries or they could impose an immediate and drastic programme of fiscal consolidation of the kind applied by the three Baltic countries. As noted, the Greek experience shows how tardy and expensive the second solution can be. The other fringe members of the euro zone are also finding the fiscal consolidation way politically difficult – and this includes Spain and Italy. The lesson may be that forcibly keeping a country in the euro will end in failure.

It is a fact that attitudes towards the euro differ sharply in the core and the fringe members of the euro zone. The group headed by Germany would like to have the zone abide by the original EU treaties, including the no-bailout clause, and see the ECB committed again to long-term price stability. The ECB is performing de facto as a conventional central bank, however, and thus is also committed to rescuing states in crisis and supporting its own currency. Also, the fringe members are asking for full bailouts when needed and an accommodating monetary policy. Such a divergence is endangering European unity and the consequent indecision will cost the taxpayer a great deal of money.

The best way out of this quandary is to allow parallel currency exit for all members of the euro zone that wish to use it. Those members who want a solid euro should demand monetary management along classical lines from the ECB, with the ECB becoming, once again, fully independent. The stronger countries should also allow the weaker members to issue their old currencies anew in free competition with a well-managed euro. The availability of a credible and well-defined exit strategy for failing countries would help alleviate pressures on the whole euro zone. This solution requires that EU politicians put the welfare of Europeans ahead of the objective of making the EU a single-currency world power.

References

Bagehot, W. (1999 [1873]), *Lombard Street. A Description of the Money Market*, London: John Wiley & Sons, Inc.

Congdon, T. (2001), *Money in a Free Society: Keynes, Friedman, and the New Crisis in Capitalism*, San Francisco: Encounter Books.

Einaudi, L. (2001), *Money and Politics. European Monetary Unification and the International Gold Standard (1865–1873)*, Oxford: Oxford University Press.

European Central Bank (2008), 'Ten Years of TARGET and the launch of TARGET 2', *ECB Monthly Bulletin*, November.

Friedman, M. (1987 [1953]), 'The case for flexible exchange rates', in *Essays in Positive Economics*, Chicago, IL: University of Chicago Press. Reprinted in Kurt R. Leube, *The Essence of Friedman*, Stanford, CA: Hoover Institution.

Friedman, M. (1987 [1961]), 'Real and pseudo gold standards', *Journal of Law and Economics*, 4, October, pp. 66–79. Reprinted in Kurt R. Leube, *The Essence of Friedman*, Stanford, CA: Hoover Institution.

Friedman, M. and A. Schwartz (1963), *A Monetary History of the United States, 1857–1960*, NBER and Princeton University Press.

Goodhart, C. A. E. (1988), *The Evolution of Central Banks*, MIT Press.

Gros, D. (2012), *How to Avoid a Greek Exit and Still Establish Price Signals*, CEPS Commentary, Summer.

Hart, M. (2011), 'Valuing the new Greek drachma', RGE Share.

Hayek, F. A. (2008 [1976]), *Denationalisation of Money*, London: Institute of Economic Affairs.

Keynes, J. M. (1982), 'The 1931 financial crisis', *Activities 1929–1931*, ed. D. Moggridge, in *The Collected Works of John Maynard Keynes*, vol. XX, Macmillan and Cambridge University Press.

King, M. (1999), 'Challenges for monetary policy: new and old', Presented at the Jackson Hole Conference 'New challenges for monetary policy', Federal Reserve Bank of Kansas City, August.

Mundell, R. (1961), 'A theory of optimum currency areas', *American Economic Review*, 51(4): 657–65.

Reinhart, C. M. and K. S. Rogoff (2009), *This Time Is Different. Eight Centuries of Financial Folly*, Princeton, NJ: Princeton University Press.

Reinhart, C. M. and K. S. Rogoff (2011), 'From financial crash to debt crisis', *American Economic Review*, vol. 101(5): 1676–1706.

Roubini, N. (2011), 'Greece should default and abandon the Euro', *Financial Times*, 19 September and 22 November.

Sargent, T. J. and F. R. Velde (2002), *The Big Problem of Small Change*, Princeton, NJ: Princeton University Press.

Selgin, G. A. (1988), *The Theory of Free Banking: Money Supply under Competitive Note Issue*, Totowa, NJ: Rowman and Littlefield (also at the Online Library of Liberty).

Stravis, M. (2012), 'Greek debt deal explained', 'Brussels Beat', *Wall Street Journal*, 27 November.

Vásquez, I. (1996), 'The Brady Plan and market based solutions to debt crises', *Cato Journal*, XVI(2): 233–43.

Vaubel, R. (1978), *Strategies for Currency Unification: The Economics of Currency Competition and the Case for a European Parallel Currency*, Tübingen: J. C. B. Mohr.

White, L. H. (1984), *Free Banking in Britain: Theory, Experience and Debate, 1800–1845*, Cambridge: Cambridge University Press.

White, L. H. (1999), *The Theory of Monetary Institutions*, Oxford: Blackwell.

Wikipedia, 'Greek sovereign crisis', downloaded throughout November 2012.