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Greece's Road to a New Currency

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OVERVIEW

Bottom Line: If Greece exits the eurozone, introducing a new currency could occur quickly; getting the policies right is the more difficult challenge facing the country.

Greece is engaged in last-ditch negotiations with creditors over policies, financing, and debt relief. Without a deal, Greece is headed down a path that could lead to its exit from the eurozone. There is a widely held belief that introducing a new currency will be difficult, perhaps prohibitively so. Amid crisis and chaos, efforts by a discredited Greek government to reintroduce the drachma would lead to further economic chaos, rapid depreciation, and hyperinflation. Some economists have even argued that a currency reform would fail, leaving Greece like Montenegro—without an effective currency and operating on the euro but outside of the eurozone. In fact, the opposite is the case: introducing a new currency is the easy part. Much harder will be the task of building a social consensus in Greece—inside or outside of the euro—for sustainable and growth-promoting economic policies.

EURO OR DRACHMA: THE PRESSURE TO DECIDE

Much of the discussion about Greece remaining in the eurozone has focused on whether it is part of an optimal currency area with the rest of Europe. This is part of a broader debate over whether Greece can be competitive and grow within the eurozone. Even those who believe the answer is yes, including the International Monetary Fund (IMF), acknowledge that the path for success is narrow. There is likely one last chance to reach a comprehensive agreement that combines significant policy reform with upfront debt reduction and adequate financial support. But financial conditions in Greece leave little time for negotiations.

> *Much harder than introducing a new currency will be the task of building a social consensus for growth-promoting policies.*

As of this writing, Greek banks remain closed and ATMs have run out of euros, which means the formal payments system consists of electronic transfers into blocked accounts. The economy, to the extent that it is operating, relies almost exclusively on barter. In this environment, Greece shows three characteristics common to many countries that have chosen to reform or change their currencies: a government unable to finance essential services (i.e., in fiscal crisis), sufficient legal and political control to enforce the currency used in commerce within its borders, and politically unacceptable distributional consequences to remaining fully reliant on barter.

The government could begin to issue IOUs to address the fiscal issue, but not the distributional costs of the bank closure. There is a broad group of Greeks, including pensioners, who rely on cash from ATMs to survive. An IOU, unless it can be easily bartered for goods and services, will not address their concerns. In some cases, such as Argentina before its exit from its currency board in 2002, a market for these IOUs developed that allowed cash to circulate within the economy. The deep discount on those IOUs became a proxy for the value of the new currency that ultimately replaced them. Here, however, without a credible bank-based payments system, it is hard to see such a market surviving in Greece. In this environment, the pressure to change currency policy is substantial.

The introduction of a new currency rarely happens by the book.

The critical question from this perspective is not whether such a move meets the test of an optimal currency area. That question is usually answered with an assessment of whether the geographic and policy situation makes the currency an effective store of value, unit of account, and medium of exchange—the well-established purposes economists look to in assessing the efficiency of money. The real issue is whether the state has the authority to implement the move; that is, can it force citizens to accept the currency within its borders, to use it to pay taxes, or to accept it in return for services to the government. And from this perspective, even amid the chaos, the answer in Greece is yes.

This idea, that decisions on currency are ultimately driven by questions of state power, is what economist Charles Goodhart calls the "cartalist" theory of money. As Goodhart and others have pointed out, there is a strand running through cases as diverse as ancient Rome's use of a cow standard for its currency (the word pecuniary comes from *pecus*, the Latin word for cow), the U.S. confederacy's rapid introduction of a new currency after the Civil War began, and the breakup of the former Soviet Union: the evolution of money is linked to the state's need to increase its power and to command resources through monetization of its ability to spend and tax.

CURRENCY REFORM LESSONS

A successful currency reform requires meeting a number of conditions over months or even years, including implementing legislation, issuance of new notes and coins, and measures to recapitalize and reopen the banking system. But the rich diversity of experiences regarding the introduction of a new currency affirms that this rarely happens by the book, and almost never when the change is driven by an economic crisis. At its most basic, the introduction of a new currency can be as easy as stamping the existing notes with a mark as a transitional measure until the new currency is developed. Brazil's transition from the cruzeiro to the real began by establishing "units of real value" as market-based units of account, and gradually adding other functions as the currency moved to legal tender. The Real Plan showed that a gradual transition can soften concerns about weak monetary institutions.

It is the overall macroeconomic and structural policies that determine the success of a new currency.

Analysts often point to the breakup of the former Soviet Union for examples of countries that moved to introduce their own currency only after detailed planning and preparation. But that was not always the case. In June 1992, months before the collapse of the ruble zone was certain, Estonia became the first of fourteen countries to break from the currency union. Over a weekend, Estonia abandoned the ruble and relaunched the kroon as the sole legal tender. The Bank of Estonia, which a year earlier had only twenty-five employees, had neither the experience nor institutional capacity that the Bank of Greece has; and tensions with Russia and the former Soviet republics made it difficult to discuss settlement arrangements for a currency transition. As a result, the currency fluctuated wildly at first, though it eventually stabilized and provided support for the subsequent economic transition. Tight fiscal policy and structural reforms complemented the rigidity of the currency board, easing Estonia into a market economy.

There are costs to these types of transitions, notably in reduced credibility for the new currency. A rapid introduction of a new currency raises the risk of counterfeiting, fraud, or abuse. But, in the end, macroeconomic and structural policies determine the success of a new currency, rather than logistical or legal questions. I have argued elsewhere that there is one last chance to reach a deal that keeps Greece in the eurozone, and if that fails an exit makes most sense for Greece and for Europe. But exit, depreciation, and default will not provide the basis for long-term growth absent structural reforms that enhance the credibility of the new currency and support the transformation of the economy. Today, achieving these structural reforms appears a hard task for any Greek government.

Looking Ahead: Kahn's take on the news on the horizon

More than stopgap measures for Ukraine
While Ukraine continues to negotiate with creditors over a debt restructuring, attention shifts to longer-term financing needs and the proper role for Western governments.

Waiting for normalization
The Federal Reserve looks poised for an interest-rate liftoff later this year, but markets expect monetary policy to remain highly accommodative.

Trade advances
Now that the U.S. Congress has passed trade promotion authority, there is pressure to conclude the Trans-Pacific Partnership agreement by the fall.