Marginal REVOLUTION

Is there a new and good plan to exit the euro?

by **Tyler Cowen** on July 9, 2013 at 6:43 am

Ross Macleod, from ANU, has an idea:

> Greece or any other country in the euro zone could easily reintroduce a national currency without generating the kind of financial and economic calamity envisioned so far—provided it got the mechanics right.
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> The key is to fix the initial amount of new currency to be issued while allowing the market to set the price at which the exchange takes place. In this scenario, the central bank would announce that it is willing to purchase euros from domestic banks, the Greek public and anyone else, using newly issued drachmas as payment. All such transactions would take place during a specified transition period and be entirely voluntary. This would not be an exercise in confiscation.
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> After the transition period, the Greek government would deal only in drachmas in its day-to-day financial transactions. Nobody would be forced to hold drachmas, but those wishing to transact with the government would need drachmas to do so.
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> At the start of the transaction period, the central bank would announce the initial rate at which it offered to exchange drachmas for euros, but it would explicitly make no promise about what the rate will be in the future. The initial rate would be entirely arbitrary, as indeed would the name of the new currency.
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> …The price offered for euros would be adjusted on a daily basis to generate sales of euro to the central bank of the required magnitude. Sales on the first day may well be zero. But as the offered buying price increased, gradually some people would be willing to have a gamble. Eventually a price would be found at which there were significant demand for the new drachmas. People would be taking the risk that the price of euros will increase in the future—that is, that the new drachma will depreciate.

One problem is that of credibility. Even seeing a new currency, no matter what the plan, could cause people to think their bank accounts will be redenominated, leading to bank runs.

But more fundamentally, this plan does not do two things which any euro replacement plan must, if it is to have a positive (but also disruptive) impact:

1. Redenominate wages and prices in terms of the new medium of account, to achieve wage and price flexibility, and

2. Ease the government's budget constraint, by redenominating and indeed lowering the real value of the government's guarantee to the domestic banking system.

You might ask what pins down the value of the new currency and the answer has to be that the government accepts it for tax payments. But to that extent the fiscal position of the government

becomes worse because they are relieving liabilities and receiving in return an asset on which at best they break even.

Imagine the following plan: the Portuguese government creates a parallel currency by announcing that it will conduct some or all of its transactions in terms of the New Zealand dollar. Let's say they find some takers and indeed some Kiwi dollars flow into Portugal. The country will then have two currencies, but neither problem #1 nor problem #2, as stated above, will be solved.