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Parallel currency in Greece?

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Last Sunday, the Greek people decided with a clear majority to follow the proposal of their government. With 61.3%, the No camp rejected the conditions of the expired adjustment program. Thereby, Greece is one step closer to an exit from the Eurozone and the European Union.

What follows is unclear. The terms of the creditors – reforms in exchange for financial aid – will also be embedded in a still possible third program. Greece is not able to service its debt without financial aid. In the meantime, the primary balance, i.e. the budget balance exclusive of interest payments, is probably already negative. Furthermore, the European Central Bank will no longer accept Greek governments bonds as collateral for the emergency loans.

Therefore, a political decision whether to guarantee the Greek debt will have to be taken by the countries of the EU or the EMU. If this is the case, the ECB would able to continue to supply emergency loans. Either way, the Greek government will probably issue Vouchers (IOUs) soon, to pay for expenditures (pensions). This would represent a parallel currency which would rapidly lose value, if the IOUs are not 1:1 convertible into Euros.

Greek banks will remain closed and the capital controls implemented. No financial aid, a frozen financial system and a too strong, i.e., not devalued own currency will lead to a further severe recession. A working financial system is a necessary condition for the proper functioning of the economy. The absence of an economic recovery and the possible withdrawal of the ECB emergency loans argue for the conversion of deposits into bank equity capital. The only other possibility is a currency reform, i.e., the conversion of euro cash, deposits, and obligations into a new currency.

De jure, Greece will remain a member of theEurozone for the foreseeable future. Due to capital controls and the probable introduction of a parallel currency, Greece has de facto said goodbye to the EU.

Things can still be turned around. The Greek government never accepted the conditions of the expired adjustment program. Neither a debt haircut nor economic stimulus measures were included. Both would support the sentiment of the Greek people. But the moral issue – who wants to pay back debt and accept austerity – remains. If both the creditors and the Greek government are of good will a compromise between reform and aid can still be reached.

The European Central Bank is an important stakeholder not only for Greece. The council has affirmed that everything within its mandate will be done to safeguard the financial system. The instruments are rate cuts, the bond buying program (QE), and the conditional provision of unlimited amounts of liquidity to governments (OMT) and banks. In addition, new instruments can be invented, like crises-induced asset purchase programs.

On markets the already fallen risk appetite will remain subdued. Temporary price losses of government bonds with credit risk, higher corporate credit spreads and falling equity prices are conceivable. In case the ECB provides more stimulus measures, the Euro will weaken.

As long as the negative spillover effects on financial markets remain restricted, sentiment among consumers and corporations will be affected only to a limited extend. Bank's balance sheets are sounder, government's fiscal policies no longer restrictive, the European Central Bank's policy is extremely expansionary and has invented new tools and a bailout fund (ESM) has been installed. Thus, the moderate economic recovery in the EMU will not be derailed. From a strategic point of view, the big question remains: What will be stronger – the integration or the disintegration forces within the EU and the EMU?

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