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Thinking ahead for Europe

TRAC
A market-based tax on capital flight as an alternative to Grexit

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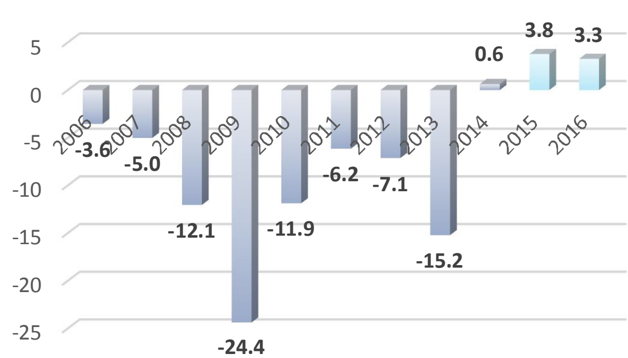
7 May 2015

As the negotiation marathon (or theatre?) continues, Greece seems once again to be moving towards the abyss of default, followed possibly by an exit from the euro area. This unsettled state of affairs has naturally made Greek depositors nervous, leading more and more Greeks to empty their bank accounts. This raises (again) the question of how to manage the banking system and the currency during uncertain times.

A number of proposals for a parallel currency have been made recently that would paper over the cash crunch for the government and allow the exit to take a more gradual form. In most cases, however, these proposals are based on flawed assumptions. Greece does not need to have a new currency in order to correct a large external deficit since the current account is in rough balance, heading, according to the IMF, towards a surplus of 1.5% of GDP this year. There is also no need to create a 'script' for the government to pay its bills since the primary balance is also in a rough balance. The negotiations with the creditor are not about funding of large further deficits, but only about the size of the primary surplus. The surplus of over 3% of GDP originally planned for this year is of course no longer attainable, but a rough balance should be achievable, even given the negative impact of the present uncertainty on the economy.

Greece's primary balance (€ billion)



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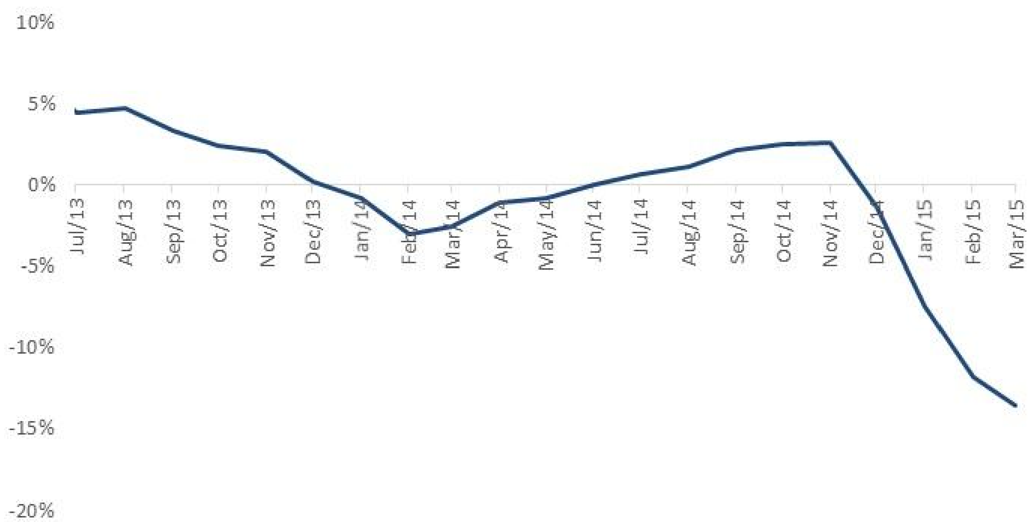
The problem at present is thus very different from 2012, when the country was still running large twin deficits. Today the 'only' problem is capital flight, as shown in the figure below. Due to a lack of confidence, i.e. depositors fear that the country might leave the euro area and are thus withdrawing cash from their bank accounts – thereby making this event more likely.

Year-on-year change (%) in Greek domestic bank deposits
(Households and non-financial corporations)



Note: Year-on-year percentage change in domestic deposits and repos from households and non-financial corporation held with MFIs.

Source: Bank of Greece (2015).

Under these conditions, the country does not need a new currency, but some limits on capital flight until the dust has settled. Capital controls constitute the standard answer to capital flight, but there exists a better alternative, which uses market signals.

Capital flight is taking place through two channels: cash withdrawals from bank accounts and via the euro area's payment system called Target. The Target balances have shot up from about €30 billion last year to over €90 billion by the end of March. Cash withdrawals also continue at a high rate. This increase cannot go on forever.

A crunch might soon come when the ECB stops providing additional funding for Greek banks under emergency liquidity assistance (ELA), but Greek depositors would like to withdraw funds from their bank account or transfer their funds abroad.

The problem (and the solution) is quite simple: Outgoing payments from Greek banks via the TARGET system should be limited to the amount of incoming payments (i.e. revenues of Greek exporters or payments by tourists).[1] The same would apply to cash withdrawals: deposits of cash should be of the same size as withdrawals. There is enough cash in the Greek economy with a total of €27 billion in circulation, or 15% of GDP, which is much higher than the euro-area average.

[1] Technically this would require the Target system to be put on 'manual'. This mode of operation is already foreseen in the current Target operations manual.

How could this be achieved?

At first the government could just announce a simple tax on cash withdrawals and bank transfers abroad. At the beginning the tax might have to be rather high given the uncertainty that accompanies any new measure. If the tax were to be 100%, anybody still wishing to withdraw cash from his or her bank account would see double the amount withdrawn debited from the account. ATMs would only have to be re-programmed so that for a withdrawal of €100 euro in cash, the account would be debited by €200, with €100 going to a government account. This would of course be valid only for Greek bank accounts. Tourists who withdraw cash from their foreign bank accounts would not be affected. There would be no need to make special rules for euro banknotes with the 'Y' identifier (the one used for Greece) and no need to impose border controls. The euro would remain legal tender as before.

The same principle would apply to transfers via the target system abroad. The tax would work in the same way: for every euro transferred abroad, another euro goes to the government.

The tax rate of 100% was chosen just for purposes of simplicity. The government should of course announce from the very beginning that the tax will decline over time (e.g. 1st week, 100%, 2nd week, 90% and every week 10 points less.) This will provide a further brake on the capital flight since people will have an incentive to delay their cash withdrawals if they know that they will become cheaper over time.

A tax only increases the cost of capital flight, but it does not provide a direct incentive to put money back into bank accounts. Over time, the tax should be transformed into a market-based system of 'Transfer Certificates' (TRACs). Each of these TRAC would give the holder the right to withdraw one euro from a (Greek) bank account or transfer one euro via TARGET abroad. Every deposit of cash into a bank account would be credited with one TRAC (and every transfer into Greece via TARGET would also be credited with one TRAC).

The Central Bank of Greece could then conduct regular (daily or weekly) auctions of these TRACs. The price of the TRAC would provide an immediate market signal of the scarcity of 'foreign exchange'. Exporters would receive more from depositing their export earning into a Greek bank account.

A direct consequence of the TRAC approach would be that exporters would suddenly be much better off because for each euro of revenue they would receive one TRAC, immediately increasing the profitability of exports. Tourists paying from their foreign credit card accounts would find that that they receive a bonus relative to each euro debited on their foreign account, making Greece a more attractive destination.

The current account might thus improve quickly even further.

Moreover, recorded exports are likely to be lower than actual exports since as long as the fear of Grexit exists exporters have an incentive to build up assets abroad (thus under-invoicing) and importers have an incentive to accept formal over-invoicing and pre-paying bills while they still can.

In the absence of capital flight, the expectations of Grexit should plummet, reducing Greek citizens' incentive to withdraw cash. With an increasing current account surplus, the demand for TRACs might thus fall quickly and with it their price. Moreover the government will have some additional revenues from the tax on capital flight – contributing further to stabilisation. Once further falls in the price of TRACs are expected, there might actually be flows back into bank accounts.

Patient depositors would be rewarded, but impatient ones (or those who do not believe in the future of their own country) would have to pay a price whose magnitude would be determined by the market. The TRAC would constitute a (variable) tax on capital flight in the form of a de facto, but not de jure, dual exchange rate. Such an approach seems preferable to the quantitative capital controls that have been used in the case of Cyprus because the TRAC approach would provide a price signal, which would help the adjustment.

Over time, the price of the TRAC should fall as the current account continues to improve and deposit flight abates. Once the price has fallen to zero, the emergency would be over and the country would once again become de facto, and not only de jure, a fully-fledged member of the euro with unlimited cash withdrawals and transactions via TARGET allowed again.

The approach outlined here has two key advantages:

Firstly, payments within Greece would remain unaffected, thus allowing the domestic financial system and economy to continue to function as before. This is a key aspect compared to the option of a parallel currency, which would need a parallel payments system and would disrupt the domestic economy much more.

Secondly, it would make cash transactions more expensive. Since the underground economy (and corruption) are based on cash, the TRAC approach would help in the fight against tax evasion and corruption. Legitimate transactions via the banking system would not be affected.

The strategic advantage of the TRAC approach is that it provides an immediate market signal and a variable tax on capital flight.

The TRAC could thus provide the time required to bridge the period needed for the Syriza government to come to some agreement with its creditors. Such a scenario seems preferable to the creation of a parallel currency (or 'standard' capital controls or a formal exit followed by the introduction of a new Drachma).

Any interference with the free movement of capital should be avoided as much as possible. In this specific situation, however, Greece can argue that it is threatened by serious balance-of-payments difficulties (and thus justified under the Treaty to undertake this step). Moreover, the euro-area countries and the ECB might at some point prefer Greece to undertake this step in order to limit their own exposure.

Experience shows that capital controls tend to remain in place much longer than the emergency situation that justified them in the first place. Iceland is a case in point, where the controls have not been lifted seven years after they were introduced. But in Cyprus, the controls are being dismantled. The problem with removing administrative controls is always that the authorities cannot know what would happen in the absence of controls. The advantage of the TRAC system proposed here is that it would provide a market signal: as the premium on TRACs goes towards zero, it is clear that the system can then be dismantled.