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### Economic Research Note

# Euro area: breaking up is hard to do

- **Financial integration makes exiting the euro very disruptive**
- **Benefits to fiscally challenged from exit unclear**

Let's be clear at the outset: we regard a decision by any of the current members of the Euro area to leave as very unlikely. Politicians in the region continue to declare their willingness to do "whatever it takes" to defend the euro, with the single currency one of the touchstones of the broader integration process. Nevertheless, as the region's crisis has persisted and broadened, the possibility that one or more of the fiscally challenged nations would leave, or that a group of core countries headed by Germany would break away, has been raised. From a narrow economic point of view, a look at the mechanics involved in leaving the Euro area helps shed light on why such scenarios, although not impossible, are very far from likely. It is not "just" the case that introducing new currency arrangements would be massively disruptive in the short run. Even if those costs are thought worth bearing, it is not clear that greater monetary autonomy for the fiscally challenged would put them on a path to sustained improvement in economic performance. Here we look at the issues involved in more detail.

## Past currency (dis)unions: what lessons?

Many seek to exploit the history of the formation and break up of currency areas in the past, for lesson as to EMU's viability. The results are controversial. Some argue that both history, and economic theory suggest a high degree of political integration and tolerance for fiscal transfers is a precondition for successful currency union. Others point out that optimal currency area theory performs poorly in predicting the observed shape of currency arrangements. On the historical record, Barry Eichengreen, among the most reputed of monetary historians, argues: "there is no historical precedent for Europe's monetary union...Some observers argue that monetary union without political union is not viable in the long run...My own view is that history does not demonstrate any such incompatibility because the combination has never been tried." (see Sui Generis EMU, NBER, 2008). It is also unclear that prior examples of breakup carry meaningful lessons: the extent of financial integration in the Euro area is larger than in recent instances of currency break up (such as the Czech-Slovak break up in 1993), while the political will to retain the currency arrangement is stronger.

## A rocky road to the exit

What steps would exit from the Euro area entail? At minimum, the exiting country (or countries) would have to pass a law redenominating existing contracts in terms of the new currency, and setting an official rate at which the conversion from euros would occur. It would need to make arrangements for new physical medium of exchange (notes and coins) to be introduced, and establish a new framework for domestic monetary policy. That may sound easy, but in practice would create a lot of difficulties:

- Anticipation of a potential change in currency arrangements would generate huge shifts of deposits between banking systems, capital flight, hoarding of physical cash, and delays in payments between agents. To some extent this could be prevented if the currency change was announced as a surprise move and implemented quickly. But given that use of the euro is more than just a technical arrangement, proposals for change would need to be debated in Parliaments before being implemented. It would probably be necessary to impose capital controls and limits on withdrawals from bank deposits over any period when such a change was being contemplated, but the incentives for individuals to attempt to circumvent them would be strong.

- The passage of a law redenominating existing contracts would create a host of legal actions as creditors and debtors sought to establish its jurisdiction. Clearing up the legal backlog would likely take years, leaving uncertainty over the distribution of consequent gains and losses in the meantime. Amid broader concerns about the stability of the European financial system, and given the scale of financial linkages in the region, this uncertainty would be destabilizing. Moreover, an exit by one country would cause a repricing of debt contracts throughout the region as the irrevocability of euro use was questioned.

- While electronic payments systems could be altered to facilitate transactions in the new currency relatively quickly, getting physical notes and coins into circulation would be a logistical challenge. One possible transitional step would be to employ existing euro notes and coins issued by the local specific central bank as the fledgling new currency. All Euro area coinage has the emblem of the issuing central bank on one side, while the first letter of the serial number on notes identifies the issuing central bank. Let's take a Greek exit from the Euro area and implementation of a "New Drachma" as an example. The Greek authorities could announce that euro notes and

coins issued by the Greek central bank (the notes have the letter Y at the beginning of the serial number) would now be honored as New Drachma rather than euros, and declare such as legal tender for goods and services in the country. Even this arrangement, however, would likely generate a sharp fall in the real value of notes and coins available: not all of the euro currency in circulation in Greece is issued by the local central bank, and it is likely that prices in the new currency would rise sharply, reducing the real value of the stock.

- As they stand, the Treaties that create the legal structure for Europe make provision for a country to take a unilateral decision to leave the EU, but do not make provision for a country to leave the Euro area. If a country (or group of countries) takes a unilateral decision to implement a new currency, it would be in breach of its European Treaty obligations as they stand, and the remainder of the region could withhold from it the benefits of being in the EU (such as free trade, free movement of individuals, or payments from EU funds). A decision to change currency arrangements could be negotiated multilaterally in advance, implying changes to the existing Treaty structure. But under a unilateral decision, those exiting the Euro area would be on a weak legal footing for renegotiating the remainder of their relationship with Europe.

## The problem is more than transitional

Beyond the very disruptive impact of euro exit in the short run, it is not clear that the reintroduction of a local currency would deliver the macroeconomic benefits to the fiscally challenged nations that are often claimed. Euro exit and depreciation of the newly introduced currency are often recommended as a means to improve competitiveness more rapidly than can be achieved within the Euro area. But gains in competitiveness will only occur if exchange rate depreciation is not accompanied or followed by an equivalent acceleration in wage and price inflation. The exchange rate depreciation is a means to lower real wages by pushing import prices upward relative to nominal wages. But amid the disruption caused by euro exit, it is not clear that workers would accept such a rapid reduction in their real incomes, or that firms would restrain their price increases as import and wage costs rose. Even amid high unemployment, many workers would try and protect their living standards. And new arrangements for domestic monetary policy would take time to establish anti-inflation credibility.

An alternative case for euro exit is sometimes made on the basis that, competitiveness aside, the return of monetary autonomy and a higher inflation rate would make fiscal positions easier to finance. A big shift upward in the price level after euro exit would erode the real value of extant debts, and the option of debt monetization could remove the possibility of default via non-payment of bonds. Some see reduction of debt burdens via a higher inflation rate as preferable to the alternatives. But unless a higher inflation rate will be allowed to persist indefinitely, the costs of re-establishing nominal credibility would remain to be faced at some point. Those costs would be larger given a history including Euro exit. The broader issue is that the Euro area embodies many aspects of institutional design that the economics textbook would advise: an independent central bank with a low inflation target, and a commitment to sustainable public finances over time. The region’s institutions have not delivered on the fiscal side of the bargain. But it is not clear that the fiscally challenged reject the need for an “orthodox” policy framework, and see that they would better off developing institutions of their own.

As for Germany and its neighbors choosing to exit, a very disruptive financial transition would still need to be faced, as would the prospect of a step change in the exchange rate and a tendency to appreciate in the future. And having run current account surpluses through much of the last decade, Germany has built up large exposures to the rest of the region which euro exit would see marked down. We suspect Germany will see its interest best served by seeking to exert influence on the architecture of the region from within.

## Did Greece threaten to leave?

Although the Greek debt crisis was ongoing, there was no specific reason to anticipate a policy response as we moved toward the weekend of May 7-8. On Friday May 6, Der Spiegel online reported that Greece had raised the prospect of reintroducing its own currency, and that an emergency meeting of finance ministers would take place that evening. The report of such a meeting was denied by spokesmen for Eurogroup Chair Juncker, monetary affairs commissioner Rehn, and by the German finance ministry. Despite those denials, a previously unscheduled meeting was subsequently confirmed to have taken place that evening in Luxemburg, with Finance Ministers from Germany, France, Italy, Spain, and Greece, ECB President Trichet, and EU officials in attendance. Officials have denied that a Greek exit from the euro was discussed at that meeting, and the Greek government has rejected the claims vociferously. Juncker stated that at the meeting a consensus was reached that a new adjustment package would be needed for Greece, a process which ultimately led to the second package of measures announced on July 21. The possibility that a Greek threat of euro exit played a role in moving the region toward further bilateral support, alongside restructuring of private sector debt, remains.