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The need for contingency planning: potential scenarios of Eurozone disintegration

by Marek Dabrowski

Since the beginning of 2010, the common currency area in Europe found itself under serious strain as a consequence of the sovereign debt crisis in several member states. While a substantial political and financial effort has been made to avoid a collapse of the Euro project, its ultimate outcome remains uncertain due to continuous financial market pressures and political challenges faced by individual member states. Therefore, one cannot entirely rule out the possibility of either a partial or total breakup of the Eurozone, even if such a demise would bring about disastrous economic and political consequences for the entire EU and its external partners.

Hypothetical scenarios

To address and minimize the potential risks, and, in the worst-case scenario, to minimize the scale of the Eurozone breakup and its negative spillovers, advance contingency planning is critically needed. It should start with identifying the most likely scenarios of monetary disintegration in Europe. In our opinion, there are three such scenarios: (1) the voluntary exit of a peripheral country; (2) the involuntary exit of a peripheral country; (3) the voluntary exit of a core country or group of core countries. [1]

By core countries we mean those perceived by financial markets as having solid macroeconomic and fiscal fundamentals and therefore being in a position to provide assistance to their weaker partners. Peripheral countries, on the other hand, already face the risk of sovereign insolvency and are seen by financial markets as potential candidates for leaving the Eurozone (voluntarily or involuntarily).

Scenario1: Voluntary exit of a peripheral country

Since Since the beginning of the sovereign debt crisis in Europe (early 2010), many commentators suggested that the country in trouble should leave the Eurozone and reintroduce its national currency, which would depreciate against the Euro, allowing the country to regain its external competitiveness. However, leaving the Eurozone will not help to resolve fiscal problems, it will make them even more dramatic. Such a policy recommendation also overlooks the negative effects which a Eurozone exit may produce for the country in trouble, its common currency partners, and the rest of the EU.

Exiting the highly integrated monetary union with a single legal tender in which all the contracts are denominated in a common currency is a much more complex and hazardous operation than a simple devaluation of the national currency (like the case of the devaluation of the British pound in 1992). Even such an "ordinary" devaluation is usually contractionary in the short-term because it negatively affects domestic demand. In countries in which a substantial part of public and private debt is denominated in foreign currency, the consequences of a devaluation are much more severe as the size of external liabilities increases in the local currency and in relation to GDP.

A departure from the Eurozone would mean an immediate default on all public and most private liabilities as old contracts would remain denominated in Euro. Any attempt to redenominate them involuntarily into the new weaker currency (as well as the discrimination of residents against non-residents or vice versa) would involve serious legal objections that are not easily overcome in an EU country with a democratic rule-of-law.

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Despite its formal status as legal tender, a new currency might not be accepted by economic agents who would prefer to continue using the Euro or another foreign currency. If not supported by tough monetary and fiscal policies (a rather unlikely scenario when government is unable/ unwilling to increase tax revenue and cut budget expenditure), a new currency would rapidly depreciate which could lead to high inflation or hyperinflation. This was the experience of many successor states of the former Austro-Hungarian Empire (after 1918), as well as the former Soviet Union and former Yugoslavia (both after 1991).

Finally, reintroducing a national currency (unlike currency devaluation) is quite a complex technical operation which requires time and the administrative capacity to be prepared in secrecy. The operation itself would most likely have to include a temporary bank holiday and the reintroduction of customs controls on a country's borders to stop the outflow of Euro cash. However, it would not require stopping (the highly unlikely) inflow of Euros from other countries or stamping Euro banknotes, as was practiced, for example, after the breakup of the former Austro-Hungarian Empire in 1919-1922 or former Czechoslovakia in 1993.

For other Eurozone members and European/ global financial markets at large, the exit of any country from the Eurozone may have a far-reaching contagion effect. In particular, financial markets may increase their pressures for the Eurozone exit of other peripheral countries. Furthermore, the holders of claims against the exiting country's government, banks and enterprises would have to accept huge loses as a result of the country's default (see above). Nevertheless, if the remaining part of the Eurozone is able to absorb these loses and stop contagion pressures, the common currency project will have the chance to survive without the exiting country.

All of these potential complexities and unpleasant consequences have become better understood over the last two years and, as a result, the appetite for a voluntary exit from the Eurozone has seriously declined. Even the main anti-austerity political party in Greece (Syriza) claims that it does not want the country to leave the Eurozone. Nevertheless, one cannot completely rule out such a scenario.

Scenario 2: Involuntary exit of a peripheral country

Even Even if unwelcomed and disastrous for all parties involved, a peripheral Eurozone member may be forced to leave a common currency area involuntarily as a result of its failure to fulfill the rescue plan agreed upon with the IMF, the European Commission and the ECB. Such a failure may be caused by a poorly designed program, insufficient rescue resources or, most likely, the lack of political consensus and/or capacity in the country in trouble to carry out the agreed austerity and reform measures. The two potential triggers of such an involuntary exit are related to sovereign default and a banking crisis.

Sovereign default can take various forms but here we mean a situation in which the government does not have enough Euro cash to pay wages and salaries, pensions and other social transfers, bills for goods and services supplied to the government, etc., and is unable to reduce its expenditure commitments or raise additional revenues or receive additional financing (because of its failure to implement the adjustment package agreed upon with official creditors).

In the short term, such a government may postpone its payments and start to build up arrears as was done by several governments in the former USSR in the 1990s. However, this solution works for weeks, perhaps months, not longer. And the consequences for payment discipline in the entire economy are obviously negative. Sooner or later, the government must do something and issuing promissory notes or other kinds of monetary substitutes is one of several possible solutions. Even if denominated in Euro (still the official legal tender), these substitutes would be traded on the private market at a discount. And the government would have to accept them as the means of payment, for example, of taxes or fees for government services. If it remains unable to redeem them at nominal value in some reasonable period of time, a parallel currency, a kind of "local" Euro will be de facto installed.

While issuing money substitutes by a cash-strapped government gradually opens the door to having a parallel currency (a process which can be reversed for quite a long time if the government manages to increase its cash revenue or receive external financial assistance), the consequences of a banking crisis would be even more immediate and dramatic.

In fact, commercial banks in peripheral countries have already experienced net deposit withdrawal. In periods of higher political and market uncertainty, deposit flight has intensified, threatening to become a full-scale banking panic. To avoid a run on those banks, the ECB has provided them with massive liquidity support by lowering collateral requirements, launching new long-

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term refinancing programs (like the LTRO), and opening a special lending window, the Emergency Liquidity Assistance (ELA), against the guarantees of national governments (which are already insolvent). Indirectly, all of these channels of liquidity support have helped troubled governments stay afloat as local banks continued financing a substantial part of government debt.

One can imagine the situation in which the ECB stops increasing liquidity support to banks in the troubled country, either as a result of the latter's failure to implement the agreed adjustment program or the ECB's unwillingness to further build up its risk exposure, or both (in the case of the voluntary or involuntary exit of the troubled country from the Eurozone, all ECB claims to its banking sector will be lost). It is also possible that in the case of particularly strong political or market shocks, an ECB intervention would be unable to stop a banking panic. The banks would have to be closed for extended bank holidays and their liabilities frozen due to insufficient liquid assets.

Although living with closed banks and frozen deposits is technically possible (as demonstrated, for example, by the US banking crisis in the early 1930s), this would be a painful scenario, both economically and socially. More likely, bank defaults would push the government to offer the owners of blocked Euro deposits to voluntarily convert them into the new national currency, which would raise less legal objections than a mandatory conversion. However, this would require reverting to a national monetary policy (to provide banks with liquidity in the new currency) and then printing new banknotes and coins to allow free deposit withdrawals.

Another hypothetical sub-scenario involves the "rebelling" of a national central bank (NCB) against the ECB instructions and, as a result, providing commercial banks with liquidity support beyond the ECB limits and lending conditions (related to eligible collateral and its quality). This could happen if the ECB decided to limit its exposure to a peripheral country. This kind of rebellion was observed both in the former USSR and former Yugoslavia during their political disintegration, i.e. between 1990 and 1992. The republican central banks (formally the branches of the State Bank of the USSR or the National Bank of Yugoslavia) started to issue credit money on their own, without authorization from their headquarters.

The most likely ECB reaction would be cutting a rebel country and its banks off from the Target-2 payment system. As a result, the Euro non-cash turnover in a rebel country would become separated from the remaining part of the Eurozone. Once owners of Euro deposits in the rebel country learn about this separation, they would likely start testing the ability of local banks to cash their deposits, leading to either bank closures or the necessity to print local cash currency.

Most probably, an involuntary exit would be even more disastrous, economically and politically, than a voluntary one because of its spontaneous and highly unpredictable character.

Scenario 3: Voluntary exit of core country/countries

One can imagine the hypothetical scenario in which improper crisis management would damage the reputation of the ECB to the extent that inflation in the Eurozone would increase and the Euro's exchange rate vis a vis the US dollar and other currencies would substantially depreciate. In such a situation, countries with a stronger fiscal position and macroeconomic credibility and a lower inflation tolerance may want to leave the damaged currency and either reinstate their national currencies or introduce a new common currency which would be limited to a smaller number of member states.

Although less chaotic for the exiting countries than scenarios 1 and 2, scenario 3 is not free from serious economic and political costs. The new currency would be stronger than the Euro, bringing a negative shock to exporters and domestic competitors of imported products. Although exiting countries may diminish their external debt (denominated in Euro) as a result of new currency appreciation and there is no danger of mass domestic defaults (like in scenarios 1 and 2), some banks and corporations which are net creditors to other Eurozone countries may suffer potential loses coming from the reemerging currency mismatches.

Exiting would not require controlling capital outflow. However, there might be a need to prevent speculative capital inflows (Euro denominated financial assets) at the time of monetary separation. Stamping Euro banknotes and rationing the amount of Euro cash to be converted into a new currency may become one such preventive measure.

On the other hand, the remaining part of the Eurozone would have to absorb the negative financial and macroeconomic shock originating from the exit of its core members. Most likely, such an impaired common currency area would not survive for long, even if its members enjoyed some competitiveness gains vis a vis exiting countries.

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This scenario does not seem to be very likely today. The Euro continues to enjoy the reputation of a strong and stable currency, in spite of the fiscal troubles experienced by several Eurozone member countries and growth stagnation/ recession in Western and Southern Europe. However, the increasing scale of ECB engagement in the rescue operations of troubled countries against its conventional operational rules and, as a result, the rapid accumulation of bad assets in its balance sheet brings us closer to the point at which ECB credibility may start to be questioned by financial markets and the broader public. In addition, some core countries may become concerned about both the inflationary and redistributive consequences of the ECB's quasi-fiscal operations. The debate on imbalances in the Target-2 system and their origins is evidence of such rising concerns.

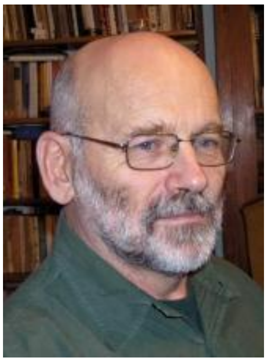
Benefits of analyzing worst-case scenarios

Hopefully, none of the above scenarios will ever happen. However, analyzing them may help us understand the consequences of imprudent policy responses and how to avoid them. For example, blackmailing any peripheral country by threatening that it may be pushed out of the Eurozone can become a self-fulfilling prophecy: it can trigger a banking panic which would lead to Scenario 2.

The same concerns excessive ECB involvement in sovereign debt crisis resolution. Although such interventions usually calm financial markets for a while, they can also undermine political consensus around a common currency and lead to Scenario 3.

The above scenarios can also help us identify actual policy choices and room for policy maneuver. For example, the countries that are in trouble must be aware that leaving the Eurozone will not ease their fiscal constraints and will not free them from austerity policies. On the contrary, it can make things much worse.

Marek Dabrowski is a CASE Fellow. Since the late 1980s, he has been involved in policy advising and policy research in Central and Eastern Europe, Central Asia, Africa, and the Middle East, as well as numerous international research projects on monetary and fiscal policies, currency crises, international financial architecture, European integration, European Neighborhood Policy and the political economy of transition.



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