

How to Contain Risks Throughout the Process of the Eurozone Dismantlement and Rebuild Confidence in the Future of the European Union

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CONTINUATION OF THE PREVIOUS PAPER

In the previous paper* we argue that:

- ▶ The problems with a single currency in Europe are neither temporary nor curable.
- ▶ The Eurozone should be dismantled in an orderly manner in order to save the European Union and the Single European Market.

In this paper:

- ▶ We undertake a deeper analysis of the risks associated with the dismantlement.
- ▶ We consider the measures which would minimize those risks and contribute to building confidence throughout the process of dismantlement.

*/ S. Kawalec and E. Pytlarczyk 'Controlled Dismantlement of the Eurozone: A Strategy to Save the European Union and the Single European Market,, *German Economic Review*, Volume 14, Issue 1, February 2013, pp.31-49. <http://onlinelibrary.wiley.com/doi/10.1111/geer.12003/abstract>

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1. The European Union and the Single European Market – great achievements of post-war Europe, that should be defended and saved
 2. The Euro – introduced with the aim to underpin and strengthen the achievement of European integration
 3. The Euro - in fact - a serious threat to the project of European integration:
 - ▶ Greece, Portugal, Spain, and Italy are trapped in recession and cannot restore their competitiveness by devaluating their currencies.
 - ▶ On the other hand, the northern Eurozone countries have to participate in endless bail-outs and have been forced to disregard their values of prudent financial policies.
 - ▶ This situation has created a vicious circle of resentment and populism in the southern countries and a revival of nationalistic tendencies in the northern countries, which may ultimately tear Europe apart.

It is largely believed that the euro is a path of no return:

Backtracking on the euro project would be a lethal blow to trust in European integration

- ▶ *could be the beginning of the end of the EU and the Single Market.*
- ▶ *would lead to economic chaos.*

The possibility of a euro collapse generates fear among Europe's economic partners, including the US and China.

KEY ELEMENTS OF THE PROPOSED DISMANTLEMENT STRATEGY

1. The Eurozone dismantlement should not be a result of the unilateral decisions of some countries to leave but a consequence of a consensus to replace the euro with an alternative system of currency coordination.
2. The process should start with the exit of the most competitive countries.
 - ▶ The euro may remain, for some time, the common currency of less competitive countries.
 - ▶ Ultimately - a return to the national currencies or to different currencies serving groups of homogeneous countries.
3. Only domestic contracts should be converted into new currencies in exiting countries.
 - ▶ Contracts with foreign parties (including bank deposits by non-residents and loans to non-residents) should remain in euro.
4. The ECB should remain the central bank for all 17 current Eurozone countries.
5. Adjustable currency bands should be put in place to keep Current Account balances within sustainable limits.
6. Countries in crises (and their banks) should continue to receive support and sovereign debt and bank restructuring should be carried out as necessary.

LEGAL POSSIBILITY OF EXIT THE EUROZONE WHILE REMAINING IN THE EU

1. Unilateral decisions to leave Eurozone, and thus breach the EU treaties, could trigger demands for compensation from the EU Commission or retaliation by other member countries. Consequently, it could endanger the functioning of the Single Market.
2. However, If the exit is a result of a commonly agreed upon strategy aimed at overcoming the crisis and helping all EU member countries, there will be plenty of options to deal with legal obstacles.

In recent years, the European Union and the Eurozone had to undertake actions which were believed necessary during a time of crisis despite legal obstacles (for instance: bailing out of some countries by other Eurozone members, or the ECB policy of unlimited acquisitions of member countries' sovereign bonds on the secondary market).

3. Without entering into further details at this stage, we think that the controlled dismantlement of the Eurozone will be manageable from a legal point of view, provided that EU member countries' governments and the EU institutions such as the ECB, the European Commission, and the European Parliament accept this as a necessary economic solution.

RISK OF BANKING PANIC AND CAPITAL OUTFLOWS/INFLOWS (1)

1. If bank depositors in less competitive countries expected their euro deposits to be converted into the new national currencies and then subsequently be devalued, it would result in a bank panic.
2. However, in the proposed exit sequencing, bank deposits in less competitive countries remain in euro and should not be exposed to conversion to any presumably weaker currency. So, the mechanism of a potential bank panic, as described above, is nonexistent in the proposed dismantlement strategy.
3. In the most competitive countries, like Germany, domestic depositors would not be afraid of losses resulting from devaluation if the euro were replaced by, say, the German mark. Rather, they would expect their deposited wealth to move with the new currency, which would be likely to appreciate vis-à-vis the euro.
4. Since in exiting countries only deposits by residents would be converted into a new currency, there would be no point in transferring money there by nonresidents. So depositors in less competitive countries would not have a reason to withdraw their deposits in order to transfer them to more competitive countries.

RISK OF BANKING PANIC AND CAPITAL OUTFLOWS/INFLOWS (2)

1. Banks in the Eurozone's less competitive countries are heavily dependent on the support provided by the strongest countries and financing from the ECB.
2. In addition, the ECB credibility also relies on the strength of the more competitive European economies.
3. So, a Eurozone exit by Germany accompanied by the other most competitive economies could, in some circumstances, undermine confidence in the solvency of banks in less competitive countries remaining in a curtailed euro area.
4. However this would not be the case in the proposed strategy:
 - ▶ After leaving the euro, Germany and other more competitive economies will remain participants in the ECB which will continue to be the central bank for all 17 current Eurozone member countries.
 - ▶ Germany and other exiting countries will continue to participate in mechanisms supporting banks and governments in less competitive countries and will participate in necessary foreign debt restructuring.

LEGAL PROBLEMS WITH REDENOMINATION

1. The dissolution of the Eurozone, in some circumstances, could result in difficult legal disputes concerning the redenomination of existing contracts, especially contracts governed by foreign law: “

Just which Euros stay Euros and which will be redenominated? Or, even more puzzlingly, what happens if the Euro ceases to exist?”

2. In the proposed strategy, this issue would be simplified.
 - ▶ Following the exit of Germany and some other more competitive countries, the euro would continue to exist as a currency and the ECB would continue to exist as its issuing bank.
 - ▶ There would be no redenomination of international contracts.
 - ▶ There would be no redenomination of contracts in less competitive countries keeping the euro.
 - ▶ In exiting countries, only domestic contracts with residents would be redenominated into new currencies (or currency).

BALANCE SHEET EFFECTS

1. If a less competitive country left the Eurozone and its new currency depreciated, at first it would suffer from a negative balance sheet effect: the depreciation of the new domestic currency would result in a dramatic increase of the foreign debt to GDP ratio, as well as an increase of the value of corporate foreign debt in relation to current corporate sector cash flow.
2. In the proposed strategy, such effects would not appear. Although countries in crisis would benefit from a relative depreciation of their currency (the euro) vis-à-vis the currencies of the exiting countries, they would not be exposed to any balance sheet effects. This is because they would keep the euro and there would be no redenomination of their existing contracts.
3. There would be, however, balance sheet effects (both negative and positive) in the exiting countries:
 - ▶ Banks in these countries would suffer because of the appreciation of the value of domestic deposits converted into the new currency vis-à-vis their euro-denominated assets such as loans extended to foreign countries and the portfolio of international securities. This would result in losses in exiting countries' banking sectors which would require recapitalization from public money. This is the specific cost of the dismantlement that the exiting countries would have to bear.
 - ▶ On the other hand, the euro-denominated foreign debt of the exiting countries would diminish in real terms as a result of euro depreciation vis-à-vis new national currencies.

RISK OF AN EXCESSIVE APPRECIATION OF THE NEW GERMAN CURRENCY

1. Some appreciation of the new currencies of exiting countries is actually a desired and indispensable element of the proposed strategy.
2. The risk that should be avoided is the excessive appreciation of the new German currency (and currencies of other exiting countries) resulting in a shift from a trade surplus to a significant trade deficit and a painful recession in Germany and other exiting countries.

This aim should be achieved by the new currency coordination mechanism with adjustable currency bands managed by the ECB.

DEBT SUSTAINABILITY OF THE COUNTRIES IN CRISIS

1. As a result of the proposed strategy, the value of the foreign debt of the countries in crisis would not jump up, while the ability to service that debt, both private and public, would increase significantly.
2. However, that does not mean that all of the countries currently suffering from insolvency would quickly become solvent again. At least in some of these countries, debt reduction (a haircut) would be necessary.
3. The scale of reduction and the cost to creditors would be smaller, though, than in a situation in which these countries remained in the current Eurozone and their economies suffered below-potential growth and high unemployment.

RISK FOR MACROECONOMIC INSTABILITY IN LESS COMPETITIVE COUNTRIES AND CURRENCY WARS

1. Dismantling the Eurozone and allowing countries in crisis to use a means of currency depreciation to improve their competitiveness could potentially also create the following two risks:
 - ▶ The risk of high inflation in devaluation countries which could undermine any competitiveness improvements resulting from a currency depreciation.
 - ▶ The risk of currency wars as well as excessive currency fluctuations between European countries.
2. In the proposed strategy, these risks are controlled by the projected role of the ECB as the central bank of all countries concerned even after Eurozone segmentation and by the proposed new currency coordination mechanism.

FEARS OF EUROPE'S ECONOMIC PARTNERS (1)

Europe's economic partners, including the US and China, have reason to be concerned about a potential Eurozone segmentation. They may fear that a Euro collapse could trigger:

- ▶ a dramatic economic depression in Europe which would directly damage their exports,
- ▶ political conflicts in Europe that may endanger international cooperation and peace,
- ▶ an intensification of competitive devaluations which could lead to an increase in currency wars worldwide,
- ▶ and could put the value of Eurozone member countries' sovereign bonds and other euro denominated assets held in their monetary reserves at risk.

The proposed strategy addresses these fears.

FEARS OF EUROPE'S ECONOMIC PARTNERS (2)

The proposed strategy addresses these fears.

1. The controlled Eurozone dismantlement, as result of consensus agreement and managed by the ECB, would not undermine the functioning of the EU and the Single Market, and would result neither in economic collapse nor in political conflicts.
2. The proposed currency coordination system could be more advantageous to Europe's trading partners than policies likely to be pursued otherwise.
 - ▶ In the case the 'euro is defended at all costs', the Eurozone is likely to conduct a policy of 'weak euro' in an attempt to build a substantial trade surplus in the Eurozone as a whole, which may intensify global currency wars.
 - ▶ On the other hand, the proposed new currency coordination system would enable the liquidation of trade deficits in countries in crisis through balancing imbalances among post-Eurozone countries, without causing an overall negative trade effect in Europe's trading partners.
3. The proposed strategy would result in the relative depreciation of the euro to new national currencies. So, a depreciation of the euro vis-à-vis leading world currencies such as the US dollar, Japanese yen, or Chinese renminbi is very likely, however the magnitude of the depreciation constrained by currency bands would be rather moderate while compared to the biggest cyclical fluctuations that used to happen among major world currencies.
 - ▶ From the perspective of Europe's trading partners, there would be a negative balance sheet effect since the value of the euro-denominated assets would relatively diminish.
 - ▶ However there would be no overall negative trade effect (as the depreciation of the euro would be counterbalanced by the appreciation of the new German currency and the new currencies of other exiting countries).

ECB AS THE INSTITUTIONAL GUARANTOR OF THE PROCESS (1)

1. Preserving the role of the ECB as the central bank for all 17 post-Eurozone countries:
 - ▶ would facilitate the implementation of a robust currency coordination system among former Eurozone countries. It would lend credibility to the currency bands or other arrangements made to prevent currency wars and excessive currency fluctuations.
 - ▶ would diminish the risk that after segmentation, less competitive countries would run expansionary monetary policies and high inflation would undermine any competitiveness improvements resulting from a currency's relative depreciation.
2. The ECB would be able to:
 - ▶ calculate the necessary level of debt reduction (haircut) for current Eurozone members that need sovereign debt reduction.
 - ▶ estimate the potential bank losses, in particular in EU countries, resulting from expected exchange rate movements as well as the necessary sovereign debt reductions of some countries.
 - ▶ analyze and prepare solutions to all technical details (including reserves, seignorage gains *etc.*).
3. Preserving the role of the ECB would also buy more time to resolve the problem of existing claims and liabilities in Target 2.
4. It would be rational for the ECB to cooperate with the IMF and benefit from its expertise and institutional capacity.

ECB AS THE INSTITUTIONAL GUARANTOR OF THE PROCESS (2)

1. Preserving the ECB as the central bank for the whole post-Eurozone area and its commitment to continue support to the banking sectors and sovereign bonds markets would prevent a collapse of confidence in countries in crisis, following a Eurozone exit by the strongest economies.
2. The proposed role of the ECB would demonstrate that the segmentation of the Eurozone is part of the orderly transformation of the European currency system and that it would be carried out under the control of the most respected and credible European institution.
3. It would also dispel the worries of the main European economic partners about the situation getting out control and resulting in economic or political chaos.

EU-US FREE TRADE AREA AS A NEW FLAGSHIP PROJECT

1. While
 - ▶ the failure of the euro project has damaged European morale,
 - ▶ the EU-US free trade agreement could become a new flagship project, building momentum and restoring confidence in the future of Europe.
2. Together, the EU and the US account for about 46% the world GDP and about 30% of the world trade. Studies suggest that EU-US free trade agreement will bring substantial increases in welfare and unemployment reduction in the US and EU member states as well as in the third countries.
3. *“... two economic blocks are sufficiently similar in terms of their cost and productivity structures. This makes it very unlikely that an agreement involving comprehensive liberalization generates strong competitive effects based on different wage levels”.*
4. Decisive progress with the EU-US trade agreement could have an important contribution to rebuilding confidence and trust in the future of European Union, both in Europe and in the world.

WHO CAN INITIATE THE PROCESS

1. The idea that Germany and some other more competitive countries should leave the Eurozone to help to resolve the crisis in the south has been around for at least two years.
2. The signatories of the European Solidarity Manifesto (2013) state that the controlled segmentation of the Eurozone would be an expression of European solidarity. They underline that: *“... the exit from the Eurozone does not mean that the most competitive economies will not bear the cost of diminishing the debt burden of the countries in crisis. This will happen, however, in circumstances in which such assistance would help them to return to economic growth, as opposed to the current bailouts, which lead us nowhere”*.
3. As of today, neither the member states of the Eurozone, nor the European institutions such as the European Commission or the ECB have been able to come up with a game changing proposal such as the Eurozone dismantlement.
4. This perspective may change however as a result of adverse economic and political developments. One of the potential triggers could be the situation in France which is heading for an economic crisis with very high social costs. France was very much the key initiator of the European single currency. However, today the euro constitutes a lethal danger to France.
5. As Europe’s founding father, France has the standing to advocate a strategy of dismantling the euro system for the sake of the European Union. The alternative is economic failure, deeper divisions and bitter resentments among Europe’s nations, putting the most valuable achievements of European integration at risk.
6. One day Germany could realistically decide to leave the Euro prompted by an explicit request from its core French partner or as a result of the growing economic crisis in France.

References:

European Solidarity Manifesto (2013), Brussels, January 24, signed by a group of economists from 6 EU countries See: www.european-solidarity.eu

Kawalec, S. and E. Pytlarczyk (2013), 'Controlled Dismantlement of the Eurozone: A Strategy to Save the European Union and the Single European Market, *German Economic Review*, Volume 14, Issue 1, February, pp.31-49. <http://onlinelibrary.wiley.com/doi/10.1111/geer.12003/abstract>

Thank you for your attention

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