

Stress Test for the Euro

Countries tempted to abandon the European currency face formidable barriers

Barry Eichengreen

IF the ongoing credit crisis is the most serious economic shock to hit the world economy in 80 years, then it is certainly also the most serious problem to confront the euro area in its inaugural decade. It is precisely the kind of “asymmetric shock” warned of by early euro-skeptics and highlighted by the theory of optimum currency areas.

Although housing prices have fallen euro area wide, they have fallen more dramatically in some countries than others (see Chart 1). Although the crisis has meant large losses for banks throughout the euro area—often on those same housing-related investments—it has produced larger losses in some countries than others. It has led to rising unemployment throughout the euro area, but more in some countries than others. The result is more deflationary pressure, actual or potential, in some euro area countries than others. There are also more strains on the public finances of some euro area countries, as reflected in the widening of spreads on sovereign bonds and their associated credit default swaps (see Chart 2).

Under these circumstances, different euro area countries presumably would prefer a different monetary policy response. But the members of the euro area are necessarily subject to a one-size-fits-all policy, such being the intrinsic nature of monetary union. This tension has revived the pre-1999 debate over whether monetary union in Europe is a good idea. It has also given rise to chatter and speculation about the possibility that one or more euro area countries might now choose to abandon the euro. This article weighs the implications of such a move and, although finding it risky, costly, and complicated, concludes that it is not inconceivable.

Temptation is there

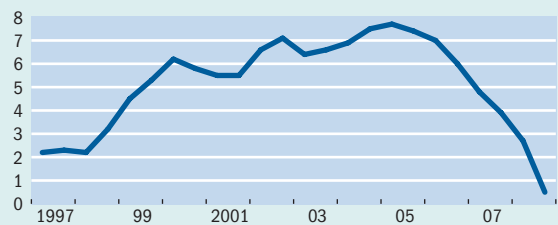
Since April 2008, the online prediction market Intrade has offered for trading a contract that pays off if any euro area

Chart 1

Wrong neighborhood

Although housing prices have fallen euro area wide, they have dropped more in some countries than others.

(euro area residential real estate prices, annual percent change)



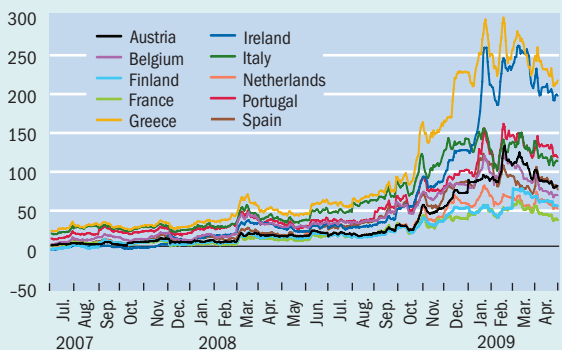
Source: European Central Bank calculations based on biannual national data.
Note: Euro area residential real estate price aggregate calculated from national series covering more than 90 percent of euro area GDP for whole period.

Chart 2

Pressure points

Wider spreads on the sovereign bonds of some euro area countries reflect increasing strain on their public finances.

(sovereign spreads, in basis points)



Sources: Datastream; and IMF staff calculations.
Note: Spreads calculated on 10-year bonds with Germany as benchmark.

country announces its intention of dropping the currency on or before December 31, 2010. As of mid-April, the pricing of that contract implied a 20 percent probability—in an admittedly thin market—of that event (see Chart 3).

No doubt the temptation is there. Policymakers in the countries where domestic demand is now weakest can imagine how, if they still possessed a national currency, they might allow it to depreciate or even actively push it down to encourage exports. Those with the most serious worries about failed government bond auctions can imagine how, if they still possessed an autonomous national central bank, they might enlist it as sovereign bond purchaser of last resort.

But for each of these arguments for contemplating the reintroduction of the national currency, there is a counterargument. Although the gain in competitiveness from currency depreciation will be transitory, many of the costs, both economic and political, will be permanent. Among other things, currency depreciation would escalate tensions within the European Union. The initiating country's EU partners would feel, not without justification, that it was exporting not just its merchandise but also its problems. If evidence of this danger is required, one need look no further than the reaction in other EU countries to the fall of sterling against the euro. More generally, the current downturn, like all the others, has intensified pressure for governments to support domestic producers in distress with concessional loans and other subsidies. In this way it threatens Europe's signal economic achievement, namely the creation of a true single market in which producers in different EU countries compete on an equal footing. More complaints of currency manipulation and competitive devaluation would place this achievement at risk.

Treaty obligations

Beyond that, a country that unilaterally abandoned the euro to “steal” a competitive advantage would jeopardize its status as a member in good standing of the EU. It would not be welcomed at the table where EU policies are discussed. The

Lisbon Treaty (admittedly yet to be ratified) contains a clause under which countries can conceivably exit the EU. But there is no clause concerning exit from the euro. The implication is that in order to quit the euro the country would also have to quit the EU, thereby abrogating the entire range of treaty obligations to its fellow member states. Nothing precludes this in principle, but given the high value that Europeans attach to their union, it is not something that a member state would contemplate lightly.

Nor is it clear that reintroducing the national currency would really make it easier for a euro area government to manage its finances. Hallerberg and Wolff (2006) show that sovereign bond spreads (interest rates on 10-year government bonds relative to the corresponding German rates) rise more quickly with the budget deficit and public debt-to-GDP ratio in European countries that are not members of the euro area. Eichengreen (2007) shows the same greater sensitivity outside the euro area for sovereign credit ratings.

“The main cases where participants have left preexisting monetary unions concern countries that were relatively closed to trade and financial flows.”

Evidently, both investors and the rating agencies informing their decisions take comfort in the fact that the conduct of fiscal policy in the euro area is overseen by the mutual surveillance and sanctions of the Stability and Growth Pact and by the fact that the European Central Bank (ECB)—unlike the typical national central bank—operates under a no-bail-out rule that prohibits it from buying bonds directly from governments.

Thus, even if debts and deficits rise in the short run, investors have reason to believe that the trend will not be allowed to persist. Spreads are therefore less likely to blow out. Even if reintroducing the national currency, and detaching the national central bank from the European System of Central Banks and the ECB, might make it easier for the government of a crisis country to fund its deficit in the short run, this will come at a cost in terms of more expensive funding on the market.

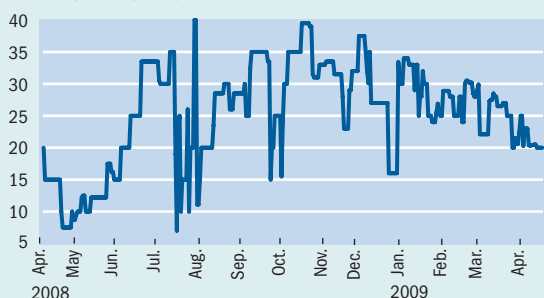
It is far from clear that the first consideration (more short-run flexibility) would dominate the second (higher longer-run costs) in the calculations of policymakers. Some recent commentary has suggested that if a heavily indebted euro area country found itself forced, as a result of the crisis, to default on its debt, it would at the same time leave the euro area so that the government could have recourse to money financing. But insofar as the government's objective was not just to finance its immediate expenditures but also to normalize its financial relations and reestablish its good credit, the conclusion does not follow. Abandoning the euro would only make its problem worse.

Chart 3

Keep the change

An online prediction market says there is a 20 percent chance that a euro area country will drop the common currency by end-2010.

(contract price, in points)



Source: www.intrade.com

And even if, despite all this, the temptation to exit the euro area remained, the technical barriers to exit would be almost impossible to surmount. It would be straightforward for a parliament or congress to pass a law mandating that the state and other employers would henceforth pay workers and pensioners in the new national currency. But with wages and other incomes redenominated into that national currency, it would become necessary to redenominate the mortgages and credit card debts of residents into the national currency as well. Currency depreciation would otherwise have adverse balance sheet effects for households, leading to financial distress and bankruptcies.

But with mortgages and other bank assets redenominated, bank deposits and other bank balance sheet items would have to be redenominated as well to avoid destabilizing the financial sector. With government revenues redenominated into the national currency, not just public sector wages and pensions but also other government liabilities, notably the public debt, would have to be redenominated to prevent balance-sheet effects from damaging the government's financial position.

Act of default

Technically, nothing prevents a national legislature from passing a law requiring domestic banks, firms, households, and governments to redenominate their contracts in this manner. Domestic investors are subject to domestic law, which the appropriate domestic authorities can change, but the claims of foreign investors are a separate issue. "Continuity of contract" provisions mean that foreigners could continue to demand to be paid in euros, and they would presumably sue to enforce their claims. Unilaterally redenominating the public debt would technically be an act of default, and thus leaving the euro area would not be a way of avoiding debt default. If the government did go ahead and redenominate their claims, its access to international financial markets might be curtailed indefinitely. If it chose not to, depreciation of the national currency against the euro would severely damage the public sector balance sheet because the domestic currency value of the external debt would rise.

Either way, in a democracy this decision would require discussion. There would be parliamentary deliberations. Market participants, meanwhile, would be aware that reintroduction of the national currency was being considered so that the national unit could be depreciated against the euro. They would have every incentive to act. Anticipating that domestic deposits would be redenominated into the local currency—which would then lose value against the euro—they would shift their deposits to other euro area banks.

A systemwide bank run would certainly follow. Investors anticipating that their claims on the government would be redenominated into the national currency would shift into claims on other governments, leading to a bond market crisis. If the precipitating factor were a debate among parliamentarians over whether to abandon the euro, it would be unlikely that the ECB would provide lender-of-last-resort assistance. And if the government were already in a weak fiscal position,

it would not be able to borrow to bail out the banks and buy back its debt.

As I have put it elsewhere, this would be the mother of all financial crises. And what sensible government, invested in its own survival, would willingly court this danger? What responsible government would even moot the possibility?

"A country that unilaterally abandoned the euro in order to 'steal' a competitive advantage would jeopardize its status as a member in good standing of the EU."

Revealingly, the main cases where participants have left preexisting monetary unions concern countries that were relatively closed to trade and financial flows and whose banking and financial systems were underdeveloped or very tightly regulated, so there was only limited scope for capital flight when deliberation and preparations were under way. The breakup of the Czech and Slovak monetary union and the dissolution of the ruble zone are cases in point. The fact that there was little in the way of financial wealth, that exchange controls were still in place, and that the economy was still in the early stages of being opened to the rest of the world made it possible to deliberate without precipitating a meltdown.

More generally, research by Nitsch (2004) for a large sample of cases suggests that more open economies are least likely to exit monetary unions. (Nitsch looks at trade openness rather than financial openness, but the two dimensions of openness are correlated. Among other things, trade over- and under-invoicing is an obvious conduit for disguised capital flows.) Clearly, the exceptional openness of EU member states with respect to trade and financial transactions of all kinds places them squarely in this camp.

Is it inconceivable, then, that a participating member state might leave the euro area? If the economic events of the past year have taught us anything, it is that many economic events we once thought to be inconceivable are not. But, if not inconceivable, we can safely say that exit from the euro area is exceedingly unlikely. ■

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