Citi GPS: Global Perspectives & Solutions

08 December 2011

What Happens if the Euro Collapses?

by **Willem Buiter**

A break-up of the Euro Area would be rather like the movie "War of the Roses" version of a divorce: disruptive, destructive and without any winners. A break-up of the 17-member state Euro Area, even a partial one involving the exit of one or more fiscally and competitively weak countries, would be chaotic. A full or comprehensive break-up, with the Euro Area splintering into a Greater DM zone and around 10 national currencies would create financial and economic pandemonium. It would not be a planned, orderly, gradual unwinding of existing political, economic and legal commitments and obligations.

It took seven years of careful preparation and planning to launch the then 11-nation Euro Area in 1999. Exchange rates of the 11 candidate national currencies converged smoothly to the irrevocable euro conversion rates agreed among the member states well in advance. Even the fiscally weak and uncompetitive Euro Area candidates had, under pressure to meet the Maastricht criteria for euro area membership, engaged in years of fiscal austerity, inflation convergence and domestic cost control prior to entry. Although we now know that there was extensive fiddling of the national data used to verify fiscal compliance with the Euro Area membership criteria, even the most egregious corner-cutters made serious efforts to comply. The creation of the euro was not accompanied by sharp and unexpected last-minute currency revaluations.

In contrast, exit, partial or full, would likely be precipitated by disorderly sovereign defaults in the fiscally weak and uncompetitive member states, whose currencies would weaken dramatically and whose banks would fail. If Spain and Italy were to exit, there would be a collapse of systemically important financial institutions throughout the European Union and North America and years of global depression. Even if the likelihood of an eventual exit or break-up were to be assessed accurately by the markets - something for which there is preciously little evidence - the timing of any exit or break-up is bound to come as an unexpected and deeply disruptive event.

Consequences of Exit or Break-up

Three kinds of consequences of exit or break-up can be distinguished: First, balance sheet or portfolio revaluation effects; second, international competitiveness effects, and third, procedural, redenomination or legal effects.

Consider the exit of a fiscally and competitively weak country, say Greece - an event to which I assign a probability of around 20 or 25 percent. Following exit, most contracts, including bank deposits, sovereign debt, pensions and wages would be redenominated in New Drachma and a sharp devaluation, say 65 percent if we take the collapse of Argentina's currency board in 2001 as a guide, of the new currency would follow. Consequently, as soon as an exit is anticipated, depositors will flee Greek banks and all new lending and funding governed by Greek law will cease. Even before the exit occurs, the sovereign, the banking system and indeed any enterprise in the real or financial sectors dependent on external finance will be at high risk of failure because of a lack of funding. Following the exit, contracts and financial instruments written under foreign law will likely remain euro-denominated. Balance sheets that were thought to be balanced in the absence of redenomination risk will become severely unbalanced and widespread default, insolvency and bankruptcy will result. Greek domestic demand and output will collapse.

Without continued support from the troika facilities and even from the ECB for the exiting member state(s), there could be cash points running out, depositors and savers besieging banks, riots and shortages of food and other essentials.

An exiting country, facing massive disruptions in its international capital account transactions would need to impose strict capital and foreign exchange controls following exit if some semblance of financial order is to be maintained. However, Article 63 of the Consolidated Version of the Treaty on the Functioning of the European Union does seem to rule out the imposition of capital controls and payments controls not only between 27 members of the EU (regardless of whether they are members of the Euro Area or not), but also between members of the EU and countries outside the EU, so-called third parties.

"1. Within the framework of the provisions set out in this Chapter, all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited.

2. Within the framework of the provisions set out in this Chapter, all restrictions on payments between Member States and between Member States and third countries shall be prohibited."

Fortunately, for every Article in the TEU and the TFEU asserting that something is either required or not allowed, there is another Article or Protocol asserting the opposite or creating a loophole. TFEU Articles 346, 347, 348 and 352 invoke the threat of war, serious internal disturbances and other unforeseen contingencies as grounds for overriding Treaty clauses and other legislation, and provide mechanisms for implementing such overrides. Articles 258-260 provide a blueprint for how the European Commission, other member states and the European Court of Justice should handle a member state whose actions are not in compliance with the Treaty. This seems tailor made for countries introducing capital controls following an exit from the EMU.

Good Will is Essential

In the EU, as in life, love normally finds a way around mere Treaty-based and legal obstacles to common sense. But good will is essential. If a country were to exit in a haze of confrontation and hostility, it is unlikely it would be shown the kind of forbearance that is in principle possible in a consensual exit. In the worst-case scenario, exit from the Euro Area would precipitate exit from the EU.

The sharp decline in the New Drachma's external value following exit would temporarily give Greece a competitive advantage. But Greece (like Portugal, Spain and Italy) does not have the persistent nominal rigidities found in more Keynesian economies like the US, the UK and perhaps even Ireland that would turn a depreciation of the nominal exchange rate into a lasting competitive advantage. Soaring wage and price inflation, driven by the collapse of the currency itself and by the monetisation of the likely remaining government budget deficit, would quickly restore the uncompetitive status quo. The official forecast that the Greek general government sector will run a primary (non-interest) surplus in 2012 looks optimistic. In addition, the Greek sovereign's debt under English and New York Law, including its borrowing from the IMF (with its preferred creditor status) and from other official creditors (including the Greek Loan Facility and any borrowing from the EFSF or the ESM that Greece may yet

engage in) are unlikely to be repudiated or written down following a Greek exit. A sizeable government deficit would remain to be funded. Monetisation of the remaining deficit through the issuance of a New Drachma, for which there would be very little demand as the Greek economy would remain informally eurosised to a significant degree, may well be the only funding option.

Greece's continuing current account and trade deficit, reflecting its private sector financial deficit as well as its government deficit, would be impossible to fund in the short term. Without external funding, imports would collapse, further disrupting domestic production already weakened by collapsing domestic demand. Aggregate demand and aggregate supply would chase each other downwards.

If Greece storms out of the EA, something that has become more likely following the growing political unrest and economic uncertainty and distress in the country, there might be little fear other countries would follow suit. However, if Greece is *de facto* pushed out of the EA, say because, following another attempt by Greece to renegotiate the terms of its financial support package and/or wilful non-compliance with the terms of the troika programme, other member states refuse to fund the Greek sovereign and the ECB refuses to fund Greek banks, the markets could beam in on the next most likely country to go. This would prompt a run on that country's banks and a sudden funding stop for its sovereign, its financial institutions and its corporations. This self-fulfilling fear might force the actual departure of the afflicted country. This exit contagion might sweep right through the rest of the EA periphery - Portugal, Ireland, Spain and Italy - and then begin to infect the EA 'soft core': Belgium, Austria and France.

A disorderly sovereign default and EA exit by Greece alone is manageable. Greece accounts for only 2.2 percent of EA GDP and 4 percent of EA public debt. However, a disorderly sovereign default and EA exit by Italy would bring down much of the European banking sector. Disorderly sovereign defaults and EA exits by all five periphery states - an event to which I attach a probability of no more than 5 percent, would drag down not just the European banking system, but the north Atlantic financial system and the internationally exposed parts of the rest of the global banking system as well. The resulting global financial crisis would trigger a global depression that would last for years, with GDP falling by more than 10 percent and unemployment in the West reaching 20 percent or more. Emerging markets would be dragged down too. Even the limited financial turmoil emanating from the Euro Area thus far has contributed to the marked slowdown of growth in the world's three most important emerging markets - China, Brazil and India.

Exit by Germany and the other fiscally and competitively strong countries would be possibly even more disruptive. This might occur if there were attempts to introduce a one-sided fiscal union with open-ended and uncapped euro-bonds or other transfers from the strong to the weak without a corresponding surrender of fiscal sovereignty to prevent future crises or if the ECB were to 'go Weimar'. I consider this highly unlikely, with a probability of less than 3 percent. Following the exit, Germany and the other core EA member states (perhaps excluding France) would introduce the new DM. The sovereigns in the periphery would default. The new DM would appreciate sharply. Financial institutions in the new DM area would have to be bailed out because of losses from exposure to the old periphery and the soft core. As nothing holds the remaining EA countries together, the rump-EA splits into perhaps 11 national currencies. The legal meaning and validity of all euro-denominated contracts and instruments is up for grabs. Everyone, except lawyers specialising in the Lex Monetae, becomes much poorer as business is put on hold while the mills of the courts grind slowly.

Even if the break-up of the EA does not destroy the EU completely and does not represent a prelude to a return to the intra-European national and regional hostilities, including civil wars and wars, that were the bread and butter of European history between the fall of the Roman empire and the gradual emergence of the European Union from the ashes of two made-in-Europe world wars, the case for keeping the Euro Area show on the road would seem to be a strong one: financially, economically, and politically, including geopolitically.

Citi is one of the world's largest financial institutions, operating in all major established and emerging markets. Across these world markets, our employees conduct an ongoing multi-disciplinary global conversation - accessing information, analyzing data, developing insights, and formulating advice for our clients.

As our premier thought-leadership product, **Citi Global Perspectives & Solutions (Citi GPS)** is designed to help our clients navigate the global economy's most demanding challenges, identify future themes and trends, and help our clients profit in a fast-changing and interconnected world. Citi GPS accesses the best elements of our global conversation and harvests the thought leadership of our research analysts and a wide range of senior professionals across our firm.

citigroup.com Terms of Use Privacy

Copyright © 2016 Citigroup Inc.