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Is the Euro Irreversible?

Brexit happened. Given large accumulated imbalances, the restrictions of membership in the Economic and Monetary Union (EMU) create much larger problems for some troubled Member States. However, the accumulated imbalances must be resolved in any case, inside or outside the euro area. Fundamentally, the decision about an exit is a tradeoff between shock therapy and gradualism. In addition, exit might lead to forced default on a large scale. No such debt forgiveness seems possible within EMU. To avoid a bias towards exit, the euro area would need sovereign bankruptcy procedures with debt relief in line with a country's debt capacity, coupled with an economic restructuring plan.

When adopting the euro, countries must give up their own monetary policy, and exchange rates among Member States are irrevocably fixed. The heterogeneity of Member States in the euro area is huge. The EZB must make decisions conditional on the average state of the euro area economy but an average Member State does not exist. In consequence, common monetary policy is never right for each individual country. Interest rates are too low for Germany, but too high in some crisis countries who must accept deflation to regain competitiveness. The external euro exchange rate is too high for poorer countries with stagnant growth, and too low for Germany.

Key adjustment mechanisms are lost and are seemingly difficult to replace by corrections on other fronts. If adjustment does not happen, recessions tend to be much harsher and booms more exaggerated, and Member States tend to build up large imbalances over time. Member States need low sovereign debt to allow for more fiscal space and powerful fiscal stabilizers. They need a robust banking sector with larger equity capital to become a robust shock absorber, rather than a source of contagion for the real economy, the government or other countries. Member States need more flexible labor market institutions to keep wages at their level of productivity, to absorb more short-run fluctuations, and prevent accumulating external imbalances. Apart from high labor market

flexibility for internal adjustment, economic theory mentions additional preconditions for a successful 'optimum' currency area: substantial fiscal insurance; high labor mobility; and high capital market integration. However, there is little fiscal equalization and insurance in the euro area. Labor mobility is low and yet meets popular resistance. Capital markets have defragmented to some extent since the start of the crisis in 2008.

Is the euro irreversible? Brexit happened. For no compelling economic reasons. Membership in the euro area involves a much greater loss of autonomy than EU membership. The irony is that the EZB must conduct a common monetary policy, but cannot implement the structural reforms that are necessary for more internal flexibility. However, such flexibility is a precondition for common monetary policy to be successful. If national governments are not able to implement required reform and large imbalances accumulate, the euro becomes a straitjacket that creates much more compelling and tempting economic reasons for an exit than the UK ever had in leaving the EU. Given the large unresolved imbalances both in the weak and strong parts of the euro area, one might expect that the likelihood of a euro area exit in the next severe recession is larger than the probability of a Brexit before it actually happened.

While there is an established and lengthy mechanism to prepare entry to the euro area, there is no equivalent

procedure for an exit. How are imbalances resolved upon an exit? What are the rules and obligations? Must one expect massive default? How does it affect economic performance in the short- and long-run? In the absence of a systematic investigation of euro area exit, how could policy makers make an informed decision when sudden economic shocks and unforeseen events forces them to decide? How could the population form a popular opinion about the value of euro area membership if it knows little if anything about the alternatives? The lack of an exit procedure and the lack of investigation a priori is likely to lead to very chaotic events when the 'accident' happens. In all likelihood, an unprepared and chaotic exit would be much more costly and could impose unduly large economic costs.

What would actually happen if a country chooses to exit the euro area? Clearly, there are huge practical difficulties that are not at all symmetric to entry procedures for joining the euro. The biggest challenge would be to avoid that market participants start to anticipate an exit. The Greek experience showed that this could trigger massive capital flight, involving bank-runs as well, which would multiply the economic costs for a country that chooses to exit. A large devaluation of the new currency would mean a large reduction in financial wealth relative to other countries. Even unsubstantiated rumors might lead domestic and foreign investors and depositors to panic and quickly move money out of the country, to convert it into safe currencies. By way of contrast, a strong country such as Germany would probably experience huge capital inflows in anticipation of a large appreciation of the Deutsche Mark, allowing investors and depositors to reap large windfall gains.

If an exit were to take market participants by surprise, and if bank

holidays and capital controls could prevent large capital movements prior to an exit, the distribution of losses would be rather different. The consequences could nevertheless be very large. They would differ substantially across countries, depending on the nature of imbalances that have built up prior to the event. Three cases can illustrate the argument. Consider Italy: productivity is stagnant and wage costs are too high relative to the euro area average. The banking sector is fraught with a large amount of non-performing loans. Government debt is excessive. The country ran up large TARGET2 liabilities. Imbalances are huge. One must expect a sharp correction upon an exit. The new Lira would have to depreciate substantially to regain price competitiveness. With a depreciation, the real value of foreign debt of the private and public sector in EUR and US-Dollar would suddenly explode, causing massive default. Italy could probably not pay back its TARGET2 liabilities. The government would be unable to service foreign-owned sovereign debt. Given cross border integration of banks and capital markets, the losses would spread all over Europe. Many unprofitable firms would have to close down and unemployment would shoot up. Given the inability of the over-indebted government to intervene, the central bank would need to initiate a massive one-time expansion of money supply to recapitalize banks. An inflationary shock would further deflate the value of debt in national currency and reduce real incomes. After a very severe short-run financial crisis of one to two years with a large output loss and unemployment, the country would probably start to grow fast to catch up and bring back unemployment from excessive levels.

A German exit scenario would be entirely different. Consequences would be quite dramatic as well since Germany

also runs large imbalances towards the euro area, including unit labor costs substantially below average and huge trade and current account surpluses. Institutions and government finances are strong. The largest effects would be in the export sector. A large appreciation of the Deutsche Mark would strengthen Germany's purchasing power and allow the country to reap large gains from trade that the euro has prevented. One might expect the shock to be considerably larger than the Swiss Franken shock with a 20% appreciation that Switzerland had to digest. By substantially impairing export demand, unemployment would rise again and growth would come to a halt with negative consequences for public budgets. Another shock would be large windfall losses due to a substantial depreciation of German wealth invested abroad. Up to now, German foreign financial wealth is denominated mostly in EUR and US-Dollar. Even if foreigners could fully repay these liabilities in EUR or US-Dollar, the real value in Deutsche Mark would fall substantially resulting in a large onetime loss. It seems also inconceivable that Germany's large TARGET2 claims could be settled in full.

A third illustrative case is Austria. In isolation, one would expect only minor disruptions. For Austria, the euro is about right. Imbalances relative to the euro area are small. Its own institutions and public finances are reasonably robust. There are no obvious reasons that Austria or other European countries could not fulfill their financial obligations after an exit. Historically, there were examples of exiting a common currency without much friction, such as Czech Republic and Slovakia. Given the absence of large imbalances, such separations can happen relatively smoothly. An important difference is, however, that Austria is part of a big heterogeneous currency

area. While an Italian or German exit would remove the extreme poles and make the rest of the Eurozone more homogeneous, an Austrian exit would diminish the center and leave the extremes, making the remaining euro area even more conflict ridden.

Where does that leave the debate? One must again consider the trilemma that governed the euro area crisis: government finances paralyzed by too much fiscal debt; a weak and excessively leveraged banking sector; and competitiveness problems, trade imbalances and international indebtedness due to the inability to replicate real exchange rate movements by internal price flexibility (internal instead of external devaluation or appreciation). Another problem is that a country can no longer condition its monetary policy on the state of its own business cycle, which tends to magnify fluctuations and make booms and recessions more severe and costly. A first conclusion is that the economic problems that might lead to a euro area exit do not simply disappear after an exit. Government debt would have still to be reduced to allow fiscal stabilizers to work and to retain fiscal space in the event of a severe recession or crisis. Second, a weak and highly leveraged banking sector is a problem within and outside the euro area, leaving no alternative but regulatory and institutional reform. Third, competitiveness problems and sustained trade imbalances require a price correction in any case. Internal devaluation by real wage moderation or external exchange rate depreciation are just two alternative ways to achieve such a correction. In both cases, a country gets poorer relative to the rest of the world. Sustainable increases in long-run per capita income are only possible with sustained increases in productivity and wages growing in line with it.

In the end, euro area countries must reduce the large imbalances in all scenarios, within or outside the euro area. The ultimate trade-off is between shock therapy versus gradualism. Leaving the euro area is a shock therapy creating crisis in the short-run with the promise of faster recovery thereafter. Institutional reform within the euro area is a prolonged gradual process, avoiding severe short-run disruptions in exchange for stretching out the adjustment problems over a longer period. It then takes much more time to recover fully from the crisis. Following a gradual reform path within the euro area would be in cooperation with the other Member States, thereby improving the prospects of a cooperative Europe that is able to create and cultivate common goods to the benefit of all. Gradualism would also have the added advantage of more intergenerational fairness by stretching the costs more evenly across present and future generations instead of concentrating all pain on current generations to the benefit of future ones. On the negative side of gradualism weighs the risk of lacking reform commitment, where negative political developments in the future could undo much of the achievements until then.

For a country with large imbalances, exit from the euro area would be a very risky undertaking at the expense of current voters and do not in itself solve the economic problems that led to this decision. However, a country could substantially benefit if an exit, on a massive scale, leads to default on claims of other Member States whereas continued EMU participation does not allow for such debt forgiveness. Such a scenario would involve a huge one-time redistribution from creditor to debtor nations. Future recovery after an exit would then be much easier since the country would start with a much lower debt overhang.

Such an asymmetry in debt resolution within and outside EMU creates a bias towards exit.

To avoid such a bias in favor of exit by large debtor countries, it is important to apply the market principle with orderly sovereign default procedures within the euro area. When a private sector firm goes bankrupt, control goes from management to creditors who must agree on a debt cut and a restructuring plan so that the company can recover and pay back at least a substantial part of its debt. Largely the same applies in the banking union under the new guidelines for resolution and restructuring of troubled banks. The principle also applies to the mission of the European Stability Mechanism (ESM) or IMF and involves three steps when giving new credit to illiquid sovereigns. First, calculate the debt capacity of the country and work out a 'restructuring plan'. Second, impose a haircut on existing creditors so that repayment of the remaining debt becomes credible with regard to the calculated debt capacity. Third, give new credit only in tranches against achieving milestones of the agreed reform plan. The purpose of the restructuring program, associated with a substantial loss in autonomous policymaking, is to maximize the country's debt capacity and thereby to reduce the losses of the creditors. An important element of this mechanism is, however, to apply the right debt haircut to free the country of an excessive debt overhang. Failure to do so delays insolvency rather than fostering recovery and new growth, as illustrated many times in the private sector. Today, other Member States and the ECB hold a large part of sovereign debt of crisis countries. By not being willing to apply the market principle to insolvent countries, these institutions do not only risk delayed and even more costly sovereign bankruptcy but also create a bias towards euro area exit.

