



Perspectives by Ruth Lea

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Another attempt to “save” the Eurozone, but history reminds us currency unions have collapsed before

Introduction: another rescue plan for the Euro

Last weekend’s IMF and G20 meetings were of the utmost significance. Amidst crashing equity markets and IMF downgrades, the Eurozone’s leaders came under intense pressure and criticism from other participants to resolve the Eurozone crisis. By Saturday night another rescue plan for the Eurozone had been revealed which, at the very minimum, should give the currency union some breathing space and, at last, seemed to acknowledge the near certainty of a Greek default.

The IMF’s communiqué’s suggested firm resolve¹:

- “Euro-area countries will do whatever is necessary to resolve the euro-area sovereign debt crisis and ensure the financial stability of the euro area as a whole and its member states. This includes implementing the euro-area Leaders’ decision of July 21 to increase the flexibility of the European Financial Stability Facility (EFSF), maximizing its impact, and improve euro-area crisis management and governance.”

It has been reported that the latest rescue plan involves²:

- A wide-scale recapitalisation of European banks, including French banks, to allow them to absorb sovereign debt losses,³ regain access to funding markets and reverse the contraction of credit.
- Measures to leverage up the size of the EFSF (the bailout fund), using liquidity provided by the ECB, significantly increasing its fire-power in order to protect Spain and Italy.
- This may be followed by “orderly” default, of perhaps 50%, on Greek sovereign debt. (Note that Greece is currently waiting for next tranche of the first bailout, €8bn, to be agreed by the “troika” of the IMF, the European Commission and the ECB.⁴ It is estimated that the state would otherwise run out of money by mid-October.)

In addition it was provisionally agreed that the parliaments of the Eurozone countries should ratify the agreement (21 July) on the increased powers of the EFSF and the second Greek bailout by mid-October, ahead of Cannes G20 meeting (3-4 November).⁵ The Bundestag is due to vote on the agreement on 29 September.

Though these decisions are to be welcomed, we are unconvinced they address the fundamental structural problems of the Eurozone. As we have written before, full fiscal union will surely be needed to hold the currency union together in its current configuration, or it will have to be restructured. Otherwise the currency union could break up altogether.⁶ It is instructive to note that currency unions have broken up before. But before pursuing this idea further, it is worth recording the pessimistic tone of the IMF's latest economic assessment, with the Eurozone at the "epicentre" of the economic crisis.

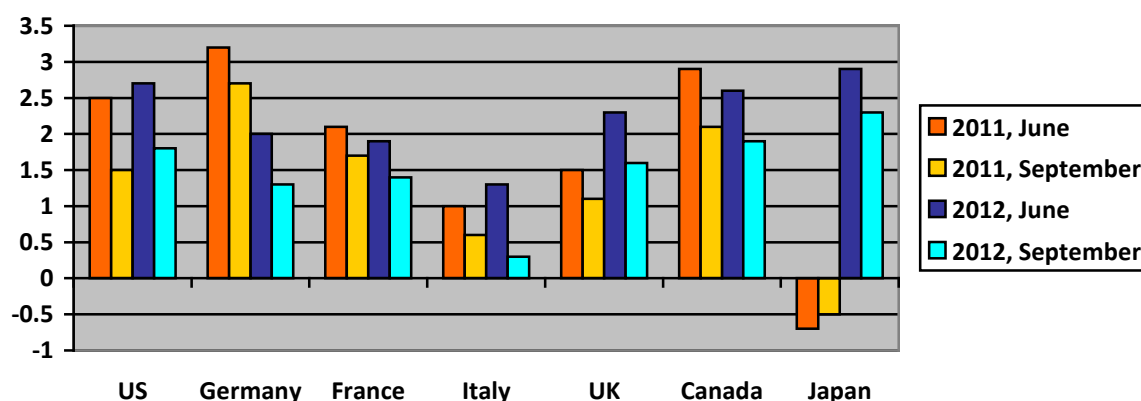
The IMF's latest forecasts

The IMF's latest downgrades to GDP forecasts, hinting at "double dip", were not unexpected. The IMF said "the global economy is in a dangerous new phase. Global activity has weakened and become more uneven, confidence has fallen sharply recently, and downside risks are growing."⁷

Hot on the heels of the IMF's comments, the Federal Open Market Committee (FOMC) added to the gloom by saying "...there are significant downside risks to the economic outlook, including strains in global financial markets". In order to stimulate the economy, the Fed announced that the Committee intended to purchase \$400bn of Treasury securities with remaining maturities of 6-30 years by the end of June 2012 and sell an equal amount of Treasury securities with remaining maturities of 3 years or less.⁸ This move, "Operation Twist", was an attempt to lower long-term interest rates - it was not a further round of Quantitative Easing. As if to add to the US's woes, last week the House of Representatives initially voted down the stop-gap spending bill for financing government operations for the first few weeks of the new fiscal year, starting 1 October.

The IMF's assessment of the economic prospects in the western economies was especially dire. Chart 1 shows how the projections have weakened since June for both 2011 and 2012. The US is expected to register just 1.5% growth this year, followed by 1.8% next year. Germany, the Eurozone's "powerhouse" may grow 2.7% this year, but will slow to 1.3% next year as fiscal retrenchment hits growth. The IMF put UK growth at 1.1% for 2011 and 1.6% for 2012.

Chart 1 IMF GDP forecasts for G7 countries, June and September forecasts



Source: IMF, *World Economic Outlook, weak and bumpy global recovery ahead*, 20 September 2011.

The IMF's latest financial stability, also released last week, reinforced the sense of crisis.⁹ It cautioned that the "...risks to global financial stability have increased substantially in recent months, during which heavy public debt burdens and weak growth prospects in many advanced economies combined with a series of shocks to the global financial system... Moreover...as the crisis has moved into its 5th year, it has entered a new phase in which political differences within and across economies are impeding progress to address the legacies of the crisis". The EU's perceived lack of political will to resolve the Eurozone crisis was seen as the greatest threat of all.

The costs of a Eurozone break-up

Even though the latest rescue plan will buy time, it is likely that speculation about the eventual restructuring of the Eurozone, or even break-up, will continue. Such speculation will continue to focus on a Greek exit despite the legal issues involved. Strictly speaking the treaties provide for no withdrawal from the Euro-area, unless the country leaves the EU.^{10,11} But political expediency tends to triumph over legal niceties, as in the case of the "no bailout clause", when Europe's politicians will it.

Studies have already attempted to calculate the costs of any break-up. One such study, with rather blood-curdling conclusions, was recently released by UBS.^{12,13} UBS claimed that if Germany left the euro its new currency could appreciate 40%, "slamming the country's exporters and forcing recapitalisation of the banking sector". (If this did occur, the new currency would however then depreciate and Germany would regain competitiveness.) Germany would moreover incur costs worth 20-25% of GDP in the first year and then roughly half that amount in each subsequent year. The potential damage of euro departure for a weak country such as Greece or Portugal, or even Italy and Spain, would be even higher. The new currency would slump, leading to mass sovereign and corporate default, a rocketing cost of capital, a crash in trade and the implosion of the banking system. If Greece were to quit, for example, the first year cost would be 40-50% of GDP, and subsequent annual costs would be around 15%.

But the UBS scenario probably exaggerates the costs. It was, for example, based on the extreme assumption that countries leaving the euro would have to leave the EU. Moreover, economic history is littered with examples of currency unions that became disunited and, more frequently, fixed exchange rate systems that became unfixed. Yet the countries in question have, more often than not, tended to fare as well if not better than if they had remained in the currency union or the fixed exchange rate system, though there was often an initial period of serious disruption. In other words, economies do not necessarily suffer if they leave a monetary union or a fixed exchange rate system – on the contrary they can thrive.

Monetary unions have broken up before

There are many studies on the break-up of monetary unions including that by Bordo and Jonung¹⁴, who made the distinction between:

- National monetary unions: in which there was both political and monetary sovereignty. A national monetary union had, as a rule, one single monetary authority, commonly a central bank. Examples of the break-up of these unions are discussed below.
- Multinational monetary unions: in which international monetary co-operation between independent countries was based on permanently fixed exchange rates between their currencies. Sometimes the same currency was

used though, as a rule, there was no common monetary authority. The authors discussed the now-defunct Latin and Scandinavian monetary unions of the late 19th and early 20th centuries. We will not discuss them further.

Writing in 1999 Bordo and Jonung commented “...the EMU-project is unique in the history of monetary unions. We have not found any clear...historical precedent to EMU, where a group of monetary and politically independent countries surrendered their national currencies to form a common monetary union based on a new unit of account under the leadership of a common monetary authority – while still retaining political independence. Monetary unification has heretofore followed political unification – not the other way round...EMU is unique in the sense that monetary coordination within Euroland will be stronger than political and fiscal coordination.” They concluded the Eurozone had more in common with a national monetary union than a multinational monetary union, though obviously lacking the common political sovereignty. And they added with great foresight “...monetary unification is an evolutionary process...this process will continue as long as the political will to maintain the union is present. Once it disappears the EMU may break apart.”

In the political turmoil of the 1990s three national monetary unions broke up: the USSR rouble zone, the Yugoslav monetary union and the Czechoslovak monetary union. They did so for overwhelmingly political, not economic, reasons. War and/or political disunity brought about the dissolution of these three nation states and, as a consequence of political separation, monetary divorce followed.

The rouble zone disintegrated in a lengthy process during the first half of the 1990s ending in a large number of new currency areas, with all the ex-Soviet states (plus Mongolia) adopting their own currencies. Economic disruption followed, not least of all in Russia and the Ukraine, but the individual countries subsequently recovered well. The Yugoslav monetary union collapsed into several new monetary unions, each associated with a new state and a new currency, in the context of a civil war.

Czechoslovakia split into the Czech Republic and Slovakia on 1 January 1993 (the “velvet divorce”) and the monetary union broke up on 8 February 1993. The Czech monetary break-up is comprehensively annotated. In order to deal with the chaos of the fragmenting monetary system, the border was effectively sealed and capital transfers were halted. Limits were imposed, for example, bank withdrawals. A clearing system was developed in order to regulate transactions between the two countries which lasted until 1995. The result of the break-up was the creation of two new currencies (the Czech crown & the Slovak crown) and the abolition of the Czechoslovak crown.^{15,16} The economies of the Czech Republic and Slovakia, it should be noted, have grown well since the monetary divorce.

Fixed exchange rate systems

Fixed exchange rate systems are also relevant to any discussion on the potential break-up of the Eurozone. Economies can struggle to thrive if they are locked in inappropriate fixed exchange rate systems and, once they are free, they can prosper. The UK’s membership of the EU’s Exchange Rate Mechanism (ERM) between 1990 and 1992 is one such example. The ERM was a semi-fixed system, with German interest rates the *de facto* floor. High German rates in the wake of unification were prolonging Britain’s recession and, on 16 September 1992, the markets forced the pound’s exit from the ERM, UK interest rates were cut and recovery followed. The

exit costs for Britain were, of course, relatively modest. The central bank was already fully functioning and there was no need to introduce a new currency with all its complexities and costs. There was no need, for example, to recalibrate everyday items from computers to parking meters into a new currency, which would have been the case if the UK had been leaving a currency union instead of an exchange rate system.¹⁷ The economic lessons are however relevant.

Concerning Greece there is probably an even more relevant precedent in Argentina's severing of the peso's link with the dollar during the debt and currency crisis of late 2001 and early 2002.¹⁸ Argentina had established something close to monetary union with the US in 1991, in order to eliminate hyperinflation, when it fixed its currency to the dollar, backing the link through the foreign-exchange reserves of a currency board.¹⁹ Argentina's experience in the ensuing decade was similar to Greece's after it joined the Euro in 2001. Both countries initially thrived but then experienced deteriorating competitiveness (requiring devaluation or savage deflation to correct it) and worsening public finances. Greece's current problems resemble those in Argentina before it defaulted on its debt (December 2001), abandoned the dollar peg (January 2002) and devalued. Argentina's crisis was highly disruptive, including limits on bank withdrawals (the "corralito") and big losses for depositors and banks as their assets were redenominated. But it proved to be an economic turning point.

Chart 2a shows the extent of the devaluation of the peso against the dollar after the abandonment of the dollar peg and chart 2b shows that, after a further slide in GDP in 2002, Argentina grew by 9% in 2003 and almost maintained this rate until checked by the financial crisis. The recovery in national prosperity has occurred despite the fact that rancorous disputes over the default have kept the country shut out of the international markets.²⁰

Chart 2a Argentina: US \$ - peso exchange rate, annual averages: 2000-2010

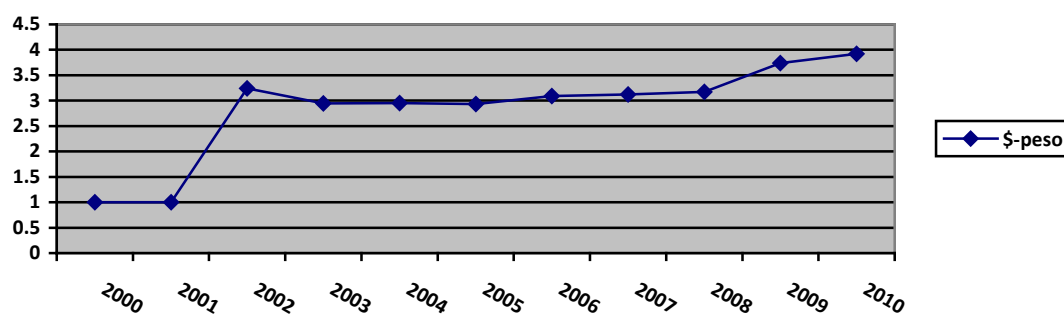
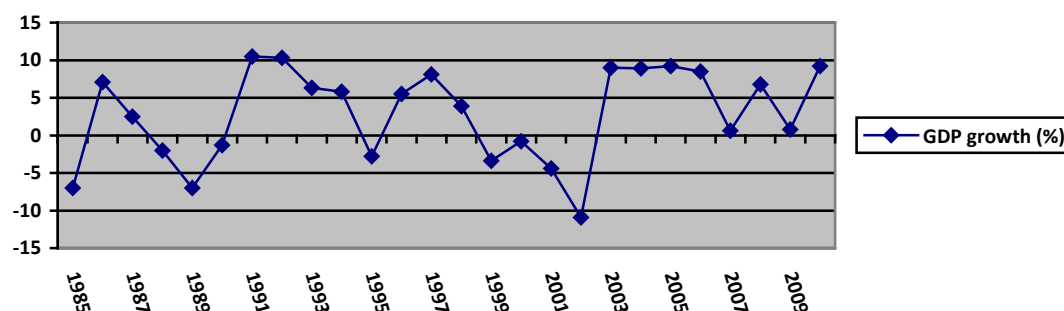


Chart 2b Argentina: GDP annual growth rates (%): 1985-2010



Sources include the IMF database, www.imf.org.

Concluding remarks

The Eurozone is, of course, a political project with huge economic implications. It is moreover an extraordinary and unprecedented hybrid – a monetary union without political union. And, whilst an imminent break-up (partial or otherwise) is unlikely, there has to be a strong possibility that at least one country (most likely Greece) will exit in the next 1-2 years. History tells us that countries survive such events, indeed they can thrive, but usually not without initial disruption and pain.

It would be unwise to dismiss the economic costs and political seriousness of any break-up. The real worry remains that a Greek exit, for example, could trigger panic elsewhere in the Eurozone. Given the depth of financial integration, the Eurozone offers scope for contagion on an epic scale – not least of all to Europe's banks. The latest rescue plan seems to have been designed to contain such contagion in the event of a probable Greek default. Perhaps Greek exit is not so far behind after all.

References

1. Communiqué of the Twenty-Fourth Meeting of the International Monetary & Financial Committee (IMFC): Collective Action for Global Recovery, IMF, 24 September 2011
2. Sunday Telegraph, "Fear stalks the corridors at IMF summit", 25 September 2011
3. See Ruth Lea, "A second Greek bailout: nearly there", Arbuthnot Banking Group, 27 June 2011 for exposures to Greece of the major banking systems.
4. *FT*, "'Good progress' made on Greek deal", 21 September 2011.
5. The agreement to enlarge the EFSF so that it can lend its full €440bn has also to be ratified. This was initially agreed in March 2011 and the details were agreed in June 2011. The EFSF has not been able to loan the full €440bn to date because of the need for certain guarantees required to maintain its triple-A credit rating. The guarantee amount has been raised to €780bn to enable the fund to realise its headline lending power of €440bn.
6. Ruth Lea, "Options for the Eurozone: fiscal union or reconfiguration", Arbuthnot Banking Group, 1 August 2011.
7. IMF, *World Economic Outlook, weak and bumpy global recovery ahead*", 20 September 2011.
8. Press release, 21 September 2011, website: www.federalreserve.gov.
9. IMF, *Global Financial Stability Report, grappling with crisis legacies*, 21 September 2011.
10. "Euro exit as legal quagmire", 12 May 2011, www.ft.com/blog, states that "European Community law makes withdrawal impossible and EMU exit means leaving the EU altogether".
11. Brendan Brown, "Exiting EMU", *International Economy*, Spring 2004, observed that "the Maastricht Treaty contains no exit procedures, but bailing out would not be that difficult". He also provided a comprehensive analysis of phased and sudden withdrawal scenarios for a country exiting the Eurozone. His example was the Netherlands.
12. *Economist*, "After the fall", 17 September 2011.
13. *Times*, "The devastating price of pulling out of the euro", 7 September 2011.
14. Michael Bordo & Lars Jonung, *The future of EMU: what does the history of monetary unions tell us?*, National Bureau of Economic Research (NBER), Working Paper 7365, September 1999. See annex for the unions analysed in this paper. EMU stands for Economic and Monetary Union.
15. UBS Investment Research, "How to break up a monetary union", February 2010.
16. Jan Fidrmuc & Julius Horvath, "Stability of monetary unions: lessons from the break-up of Czechoslovakia", noted that the break-up was characterised by low exit costs and lack of political commitment.
17. See the Treasury, *The National Changeover Plan (third outline)*, 2003, for the necessary procedures if the UK had joined the Euro. In the case of a country leaving the Euro, these procedures would of course have to be implemented in reverse.
18. *Economist*, "After the fall", 17 September 2011.
19. A currency board is a monetary authority which is required to maintain a fixed exchange rate with a foreign currency.
20. Robert Flood and Nancy Marion, "Getting shut out of international markets: it doesn't take that much", IMF Working Paper, WP/06/144, June 2006, reported that Argentina was shut out of the capital markets months before it defaulted formally in December 2001. It defaulted on bonds worth \$95 billion, the largest sovereign-debt default in history – to date.

Annex

Michael Bordo & Lars Jonung: analysis of monetary unions

Table 1a: The creation of some monetary unions in the 19th century

Monetary area	Time of creation
National monetary unions:	
The United States	1789-92
Italy	1861
Germany	1875
Multinational monetary unions:	
The Latin monetary union (initially France, Belgium, Italy & Switzerland)	1865
The Scandinavian monetary union (Sweden, Norway, Denmark)	1873-75

Table 1b: The dissolution of some monetary unions in the 20th century

Monetary union	Time of dissolution	Causes of dissolution
National monetary unions:		
Austria-Hungary	1919-27	Defeat at war, creation of several new nation states
Russian Empire	1918-20	Creation of several new nation states
USSR	1992-94	Political unrest, creation of several new nation states, replacement of Soviet rouble by 15 currencies including Russian rouble.
Yugoslavia	1991-94	Political unrest, civil war, rise of new states, replacement of Yugoslav dinar by individual currencies (Montenegro adopted the euro)
Czechoslovakia	1993	Political divergences, rise of new nation states, replacement of Czechoslovak crown by Czech crown & Slovak crown
Multinational monetary unions:		
Latin monetary union	1914-27	Divergent monetary policies
Scandinavian monetary union	1914-24	Divergent monetary policies

Michael Bordo & Lars Jonung, *The future of EMU: what does the history of monetary unions tell us?*, National Bureau of Economic Research (NBER), Working Paper 7365, September 1999, with additions by the author.

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