THE FUTURE OF THE EURO ZONE: JOHN REDWOOD

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He has lectured on the Euro scheme at Oxford and Cambridge Universities, at Middlesex Business School and Henley Management Centre. He has spoken and written widely on the Euro for 20 years in a range of locations and for national and international publications. Over the last four years he has published a daily blog with a topical commentary on the Credit Crunch and the Euro as a main theme, and has written for a range of investment titles.

He has written several books on economic and political topics. He wrote the Penguin putting the case against the UK's membership of the Euro, entitled "Our currency Our country". There was a companion volume in favour of UK entry.

In the 1980s and 1990s he wrote on wider ownership and privatisation, publishing "Popular Capitalism" in 1989 (Routledge). In 1993 he produced "The Global Marketplace" (Harper Collins), a study of the likely development of globalisation.

In the last decade he worked on public sector management and private sector financing of the public sector. His "Third Way Which way?" set out a new way of analysing public and private sector activities, and identified various hybrids between the two.

More recently he has concentrated on the Credit crisis and the Euro. He forecast banking and credit crunch problems in 2007-8. In 2009 he published "After the Credit Crunch " (Middlesex University Press) and "Surviving the Credit Crunch (Evercore Pan-asset).

He has extensive political and business experience. He has chaired a UK Stock Exchange listed industrial Group, and a small global engineering business. He has been a Director of Rothschilds bank and of various financial sector companies. He was a DTI, and Environment Minister, before entering the UK Cabinet in the 1990s. He was Chief Policy Adviser to the UK Prime Minister in the middle 1980s.

The political context

1-The history

The Euro was always primarily a political project. The member states of the European Union wish to pursue the goal of ever closer union set out in the founding Treaty of Rome. The architects of more European common government always saw a monetary union as an essential foundation for a larger coming together. They wished to banish the wars and divisions of the old Europe. They saw monetary union as an essential feature of their emerging state.

The architects were of course well aware of the economic complications a single currency posed. They began their odyssey by seeking to bring the competing currencies of the old Europe closer together. There were two attempts to move to a single currency through exchange rate convergence. The first was the Snake in the early 1970s. The second was the Exchange Rate Mechanism in the late 1980s.

The founding fathers argued that if they could bring the member states' currencies into ever closer alignment and keep them there in the otherwise volatile foreign exchange markets, it would be a simple step to locking the exchange rate between the various currencies. Once locked together, it would be possible to replace the locked currencies with a single currency.

This was a good approach to the problem. It was a market based approach. The markets would judge whether the differing economies of western Europe had converged enough. If they had, the markets would allow the participating currencies to trade ever more closely together, signifying that the economies had converged. If the currencies continued to fluctuate, with some being forced into devaluation against others, it was a sign the economies were still not correctly compatible with each other. The designers of this scheme recognised that it would require more common policies to bring the currencies into closer alignment. They welcomed and argued for such a move, appreciating this both helped their wider aim of more integration, and made successful stability of the currencies easier to achieve.

The early 1970s experiment ended relatively rapidly. The pound sterling joined the snake, but was an unruly partner for it. Several currencies struggled to stay in line. Not enough work had been done on common policies. Achieving convergence between economic policies of widely differing countries is a long and arduous task. The snake broke up, ushering in an extended period of adjustments to currency rates within the EU.

The successor scheme, the Exchange Rate Mechanism, lasted for longer in the later 1980s and early 1990s. More had been done to encourage countries to get their balance of payments into better equilibrium. More had been done to tell them that their budget deficits and borrowing levels were matters of common concern, which would have a bearing on their currency fluctuations. The original Treaty of Rome had seen balance of payments issues as crucial to the construction of a successful European Economic Community. Subsequent work went further and identified state finances as equally important issues of common interest.

The Exchange Rate Mechanism later floundered as markets wished to challenge and change the chosen rates between currencies. The stronger currency countries had to print too much of their currency for comfort and keep selling it overseas, to try to keep their rates down. This tended to be inflationary, unless the authorities found ways to offset the extra money being created. The weaker currency countries had to keep buying up their own currency, which was deflationary, weakening their economies further. As they bought up their currency, so the amount of money reduced. The scheme was abandoned when it became clear that neither the pound nor the lire could remain in at the chosen rate. The Exchange Rate Mechanism demonstrated the dangers of trying to lock currencies together when the states had been pursuing such divergent policies on debt and deficits, had differing inflation and cost levels and very variable levels of competitiveness one with another.

The United Kingdom has an unhappy time in the Exchange Rate Mechanism. In the first phase of its membership the pound wanted to go above the bands allowed for fluctuations. The authorities created pounds and sold them across the exchanges, unleashing an inflation in the UK domestic economy as the money supply was boosted. Subsequently, the markets took fright at the inflation rate, and the process reversed. The UK authorities then had to buy back pounds, real money supply was squeezed, and the economy fell into decline. The Exchange Rate Mechanism recession in the early 1990s led to the collapse of the Conservative government in 1997, when people were predictably complaining about the 15% interest rates and other difficulties which the economic policy had brought them.

Understandably because it was a political project with ambition well beyond currency values, the member states were not to be defeated. They decided to move straight to a single currency without going through a prolonged period of currency stability, living within the tighter bands. It is true that the founding thinkers of the Euro did wish the countries to follow tough rules of economic and monetary conduct for a probationary period. However, as few countries met the criteria laid down, they decided to go ahead regardless of the rules. If they had followed all the rules about debt, deficits, interest rates and inflation, the project would have worked much more smoothly. Simply bypassing the stage of bringing currencies into line with each other because it had proved so difficult increased the risks of the project.

The economic pressures which came out in the form of foreign exchange devaluations and revaluations now had to come out in some other way. They were destined to emerge in the bond markets, and in the form of much higher unemployment in the poorly performing parts of the union. In the early days of the scheme some countries saw property and credit bubbles inflated on the back of their access to large amounts of cheaper credit at low interest rates related to the common short term official rate. Countries like Ireland and Spain enjoyed the free rider effect, the ability to borrow more cheaply than if they had stayed with their own currencies. This caused big problems for later in their overextended banking and property markets.

The politics of the Union are complex. The wish is to create "ever closer union". Most of the participants recognise that more needs to be done in the centre, to provide consistency and Union level control over economic and monetary matters. The Union has set up a number of Union institutions to do this. The European Central Bank is the currency's own bank, with the power to issue money, and the duty to police the commercial banks throughout the zone. The Council of Ministers acts as a collective cabinet, providing political leadership. The EU Commission provides day to day administration, proposes and drafts new laws, and offers strategy and other advice to the Council. The Parliament is there to provide some democratic accountability over decision making, both concerning law making and over the administration of the Commission. The three largest states, Germany, France and Italy, now often have informal bilaterals and trilaterals before important meetings. The important German message that each Euro member state is responsible for keeping control of its own spending and borrowing is widely accepted. Both Italy and France have recently announced more measures to keep their own budgets under control.

The problems arise, however, from the mixture of a partial central government of the Union with intergovernmental negotiation between member states. Some matters can be decided in a timely way by the Bank or the Commission. Many need to go to meetings of Ministers or to the Heads of government meeting as the Council. This can slow down responses to a crisis and make reaching a conclusion very difficult. Increasingly the Euro matters have been decided by bilateral meetings between the Chancellor of Germany and the President of France, with or without the help of Italy. In their frequent meetings they make decisions on the future course of the project, and then communicate that to the other players at the appropriate time and place. Other members of the zone have usually accepted Franco German leadership, understanding its importance to the project.

Some disagreements between France and Germany over the scope of the role of the Bank, over whether the Bank can undertake money printing and bond buying, and over how central controls should be imposed on high deficit countries, has made finding a lasting solution more difficult.

The Political context
2-seeking a political solution
The best way for the economic process to be managed

This paper seeks to marry the legal constraints, the economic necessities and the political realities. We need to understand and combine answers to all three to find the best path to stability and success for the Euro area and for any states leaving it. I have been seeking a solution to the problem of some countries belonging to a currency zone when they are unable to maintain all the disciplines required to enjoy successful membership.

The solution has to avoid undue disruption to the countries that are happily in the zone and able to finance themselves. It needs to respect the wish of many countries to be in the currency, and the absence of any clear legal power to expel members that are struggling with their membership. It also needs to find a way of allowing members to make the necessary adjustments to their budgets, competitiveness and balance of payments without placing too large a burden on the other states to finance them or to make large transfer payments to help them out of difficulties.

There is no political ability in the stronger states to require increases in taxation to pay substantially more to the poorer states. The German people in particular feel they are paying enough for the Euro already. They remember the large bills they had to meet to complete the DM union of the 1990s. There is a danger if discipline is relaxed too much that the credit status of the stronger member states becomes compromised to some extent as well.

We also need to be sympathetic to the genuine difficulties of the weaker states. For whatever reason, the Euro faces the problem that some states are too heavily in debt. These same states now face persistent recessions, high unemployment, and difficulties in borrowing. They need a solution that allows them to cut their deficits and in due course reduce their debts, without creating a downwards spiral of cuts, more recession, more cuts. This will ultimately prove politically too difficult for them to sell to their electors.

A third group of countries in the middle wish reassurance that their membership of the Euro is not in doubt. They wish to know that all possible measures are being taken to reconcile differences and strengthen the currency. Italy in particular wishes to be reassured that now her government is taking all sensible measures to curb debt and deficits, there will be Euro area support for her position.

The summary of my proposed solution is that any country that needs to seek subsidised or special finance from the EU or IMF to carry on its normal public finance function should discuss with the rest of Euroland exit from the zone for a period, allowing it to make some of the necessary adjustments by devaluation through creating a new currency. No country will be forced out of the zone that is able to maintain its own financing.

If the rest of the Euro area decide it is best for a state in trouble to leave, that country will resume an Article 139 derogation from Euro membership under the Treaty and become a candidate member again. The troubled state will either consent willingly to leaving, or will have to leave owing to the inability to raise money from the EU and IMF unless they do. They will be eligible to join again as and when their economies have properly converged and all are satisfied that it could work in their mutual interests. This approach minimises political and legal risks, allows a proper IMF recovery programme to be put into the exit state, and relieves the pressures of very weak states on the rest of the zone. It helps build the necessary discipline within the zone.

To produce and understand such a working solution, we need to understand how the single currency came about, and to see the economic divergence and future difficulties built into the Euro by the choice of a wide membership at the outset.

The sensible requirements of the founders of the single currency

The founders of the currency had a shrewd understanding of the degree of convergence needed to ensure success for their new currency. They understood that member states joining the scheme had to achieve similar rates of inflation, to control their budget deficits to similar levels, maintain similar interest rates, and show their currencies could stay in line with the other currencies of applicant states. Had all this been observed the recent history of the Euro would have been much more successful.

The debt controls

The Treaty of Maastricht laid down that a member state had to limit its borrowing to 60% of GDP, and to avoid a deficit of more than 3% of GDP in any given year. Article 126 of the Consolidated Treaties states that "Member states shall avoid excessive government deficits". It goes on to require compliance with both deficit and stock of debt controls.

In 2000 when decisions were being made about entry into the Euro Belgium, Italy and Greece had total borrowings of 111%,111% and 102% of their GDP respectively. Austria and Spain were also above the 60% threshold.

Several countries struggled to get their budget deficits down to 3% for entry. Some used creative accounting methods to finance items off balance sheet and to be able to report a lower figure for the apparent deficit in order to comply. There have been subsequent arguments about the extent of this in the case of Greece. Other states, however, also used accounting methods to reduce the apparent values of their deficits by moving items off balance sheet and off revenue account to avoid scoring against the debt ceilings and deficit controls.

The importance of controlling total debt and the growth of debt was fully understood and strongly reflected in the Treaty language. The free rider problem was obvious to many. If a country decided to borrow more than the average, the country hoped to take advantage of the generally lower interest rates afforded the zone as a whole. Northern prudence was going to influence the way all the state borrowings were considered by the market, given the architecture of the Union and the pressures to conform with lower borrowing requirements. For a period this worked, and the high borrowing states were able to renew their high levels of existing debt at favourable rates, and to increase their stock of debt by exceeding the 3% limit. They did not pay the higher interest rate they were used to paying when using their own currencies.

The EU regularly met to review these matters, and to require poorly performing member states to take further action to control their debts and deficits. Sometimes they did, but low growth thwarted their plans, depressing the growth of revenues. Sometimes things were put off. When recession struck in 2008-9 all the countries were blown off course and ended up borrowing more. Markets then decided they had been too generous in making money available at low rates to countries with stretched balance sheets, and started charging them more. The worst feature of the current crisis is the difficulty some states experience in borrowing enough at low rates to pay their bills.

The inflation requirement

Member states entering the Euro were required to achieve “a high degree of price stability”. This was defined as keeping the inflation rate to not more than 1.5% above the average of the best three member states for low inflation in the year prior to joining.

By the time the Euro was established the best three low inflation countries enjoyed an average rate below 2%. Ireland, Portugal, Greece and Spain exceeded this level by more than the 1.5% permitted margin. As with the debt and deficit criteria, the EU decided to overlook its own carefully chosen requirements and allow all in who wished to join.

The point of seeking a low and relatively similar inflation rate to the core countries in the currency union was well judged. As they were about to enjoy the same short term interest rate and the same exchange rate as each other, it was important to start from similar levels of inflation. If one part of the zone was much more inflation prone than the average of the zone, interest rates would be too low for that part and its inflation performance could deteriorate further as cheaper Euro money was made available. If parts of the zone inflated too quickly, they would become less and less competitive against the rest, causing more and more internal strains on the balance of trade and the flow of payments.

This is of course what subsequently happened. Overriding the warnings was not a wise move. Competitiveness was eroded faster in countries like Greece and Portugal, with a history of higher inflation than the Euro core. This has led to strains in financing their internal trade deficits with the other members. It has also led to high levels of unemployment, which in turn has stretched public budgets further.

The interest rate requirements

The Treaty was equally sensible in requiring interest rate convergence before countries were allowed to join the Euro. A member state seeking to join was meant to demonstrate that its average nominal interest rates on long-term government bonds were not more than 2% above those of the three lowest inflation rate countries joining.

This requirement buttressed the inflation criterion for membership. If a country was more prone to inflation, its long term interest rates were likely to be substantially higher. It also buttressed the debt and deficit criteria. If a country had too much debt which needed to be renewed, or if it had too large a deficit that needed financing, its long-term interest rate was likely to be higher, reflecting these pressures in the government bond market.

The aim of the interest rate criterion was to stop free riding, where a country that was borrowing too much and/or experiencing too much inflation could join the Euro and get an immediate boost from a drop in the long term interest rate.
Spain, Ireland, Portugal, Greece and Italy all had a history of interest rates considerably higher than the core countries of the new Euro. Despite this, they were allowed in.

The currency requirements

The Treaty also persevered with its belief in the Exchange Rate Mechanism, despite the experience of 1992 owing to market pressures. The ERM was a scheme designed to keep the European currencies aligned with one another, permitting only small fluctuations in value. Countries were required to intervene in foreign exchange markets to keep their currencies within the narrow bands. If this was proving difficult they needed to take other actions, like cutting spending or raising taxes, to reassure markets and increase the value of their currency where it was under attack.

The Protocol to the Treaty made it clear that keeping a currency in line with the others was crucial to qualifying for membership of the Euro:

"The criterion…shall mean that a member state has respected the normal margins provided for by the Exchange Rate Mechanism of the European Monetary System without severe tensions for at least two years before examination. In particular, the member state shall not have devalued its currency's bilateral central rate against any other member's currency on its own initiative for the same period."

The countries with a poor inflation and interest rate record did have problems keeping their currencies in line with the DM, but again this did not prevent their entry into the Euro scheme with the others.

Market pressures

The creators of the Euro did learn something from the bitter experiences of the Snake and the ERM. They decided to embark on a much wider ranging set of requirements to ensure economic convergence prior to allowing countries to join the new currency. As we have seen, the Maastricht Treaty laid down four main demands.

If all countries had met these requirements we would not be facing the current crisis. The present problems stem from the way countries were allowed in who broke these rules from day one, and from allowing other countries to break the rules once inside the single currency. On entry Belgium, Greece and Italy had large past accumulated debts at more than 100% of GDP. Many others including Denmark, Ireland and Portugal were well above the 60% limit. The refinancing of these large overhangs is one of the problems they now face.

From the outset Greece, Spain, and Portugal did not meet the inflation requirement. Entering with a faster inflation rate, and sustaining that, hastened the day when these countries could no longer compete effectively within the zone . They inflated their way into more unemployment. No longer able to devalue to make their goods cheaper to other member states, they simply sold less beyond their borders. This adversely affected their trade with the rest of the world as well as with the rest of Euroland.

Greece, Portugal, and Spain had high government bond yields, reflecting their poor inflation performance. In some cases they were more than double the anchor yields of

German bunds. Divergence of borrowing rates subsequently proved to be one of the greatest weaknesses of the initial Euro scheme.

Greece and Spain were nowhere near keeping within the 3% budget deficit ceiling. Most countries broke this rule, but some by much more than others. Once again it was the southern states that had the biggest divergence.

The troubles of the Euro were agreed the day they decided that the southern countries could join from the outset. They had not been able to keep their currencies closely aligned with the best. Their inflation rates were too high for them to stay competitive. Their stock of debt was too high to be easily refinanced at fine rates. Their budget deficits were too high.

I urged them to consider more real economy variables when setting up their scheme. I was concerned by the prevalence of high unemployment in the southern states prior to entering the Euro. Inside the currency, with no scope to devalue, any country not able to compete easily would experience a big build up in unemployment. As the most vulnerable states started from higher levels of unemployment , it put them in an even worse position. The absence of strong regional policy with substantial transfers of money from rich to poor was bound to become a big issue. Today Spain faces 25% unemployment, with half of her young people out of work.

From the beginning the Euro scheme contained the seeds of future market pressures. Markets had warned that the currencies were not ready to stay together, reflecting the reality of a lack of proper economic convergence. The bond markets were flashing red lights, that these countries enjoyed very different fiscal positions and could not borrow at similar rates to each other. The data on prices and unemployment showed that competitiveness was a problem, and it would get worse once devaluation was taken away from the weaker economies.

Adjustment difficulties within the Euro area

There are four main problems which are serving to disrupt the Euro scheme. The first is trade and finance imbalances between the different member states, the problem of competitiveness. The second is the big imbalances in income and employment levels, the problem of regional divergences. The third is how to finance the large inherited debts and high deficits which some member states are still running. The fourth is the weakness of the banking system, faced with declines in sovereign bond prices and with asset deflation on the periphery in countries like Spain and Ireland.

The nature of the currency union requires countries to take responsibility for sorting out their own imbalances. . The member states decided on the German model. In this the Central Bank is not allowed to print more money to make things easier for countries within the union to borrow. There are no cross guarantees between the different countries seeking to borrow. If a country finds it difficult to borrow it has to cut its deficit, or seek external help from the IMF. If a country experiences more inflation or fails to raise productivity as much as other parts of the union it will become uncompetitive. The answer to this issue should be a reduction in wages or a surge in productivity until competitiveness is restored. If a country has persistent regional problems, it needs to tackle these from within its own domestic budget, although there are some EU wide programmes which are designed to help.

Most currency unions are part of a single country. In this people usually speak the same common language. This makes labour movement from the poorer to the richer areas easier. In the Euro area there are many different languages. Countries unable to compete well owing to higher inflation are also finding it difficult to adjust by letting their people move to the more competitive parts of the union, owing to the cultural and language barriers to movement.

In a normal single country currency union these problems are prevented or tackled in other ways. In the sterling or dollar unions, the Central Bank is allowed to print money in times of low demand and monetary weakness to stimulate activity. Individual states or regions within the union have access to substantial transfer payments and guaranteed loans at lower rates from the central government. There are large regional policies in place, through the payment of nationwide benefits to those in need, through local and state government assistance from the centre, and through other national programmes. Despite all of this, some parts of these single currency areas remain relatively depressed and relatively uncompetitive.

The dangers from early exit of some countries from the Euro have been overstated

The current mood claims that break-up of the Euro would be very damaging to economic output and to financial stability. It is difficult to see why the more extreme versions of this are taken seriously. Some have suggested half of EU output could be lost in the alleged chaos that break up of the currency would create. These forecasters concentrate entirely on the negatives, and give no credit to the opportunities for market based adjustments that would flow from the restoration of selected national currencies.

There is first the alleged large losses which banks would record, threatening a further major banking crash. These forecasts do not put in the gains banks would make from their holdings of German and other strong government bonds, if these countries restored their own strong currencies, or remained in a stronger Euro free of the weaker members.

It is true there could be further losses on the bonds of weaker countries. However, Greek bonds have already plunged to a fraction of their original issue value as the government is negotiating an arrangement where much less than half the borrowed money will be repaid. Portuguese bonds have fallen by less, but have moved onto a considerably higher yield basis than German bunds already. Their prices are currently depressed by fears of default spreading. If these bonds were backed by a single currency country that could print however many drachmas or escudos were needed to repay them, the spectre of default would be lifted. This could help raise their value.

I accept the need in any break up scheme to make provision for the losses banks will make or crystallise on their current bond holdings, but it is important not to exaggerate these. In the case of various EU banks they are likely to make more on the currency gains on the stronger country bonds than they will lose on their much reduced holdings of weaker country bonds.

The second is the alleged loss of output. This follows presumably from the forecast collapse of banks and the large losses some will make on their bonds. If the banking problems are less severe than these pundits imagine, so too will the loss of output be less. Private holders of country bonds, like the banks, will also include winners as well as losers, so the spending power of savers overall will not be reduced much if at all. The policy recommended below to limit banking damage is designed to avoid a severe credit and liquidity squeeze stemming from partial break up of the Euro zone.

These estimates do not put in the gains that would come to output in the weaker countries once they have devalued. We might see devaluations of more than 20% in the worst cases. Such a positive shock should cut imports substantially, and stimulate more domestic production and export. It is true Germany and the other strong countries would experience some loss of exports as they see the Euro go up in value against the new currencies. They have managed such a position before when they used the DM. As a big part of the problem is too large a German surplus within the zone, there will have to be some downwards adjustment in German exports, and an increase in German imports, to bring things back into better balance.

How individual countries could leave the zone, and how that could enhance their stability and the stability of the remaining Euro area

There is a positive case to be made for an orderly exit of the most divergent economies from the single currency. We will turn soon to consider how best this might be done, but it is important to stress at the outset that it could be good politics as well as good economics to organise an orderly and legal process.

The restoration of selected national currencies allows the large trade and payments imbalances to be adjusted mainly through currency exchange rate adjustments. If the Greek drachma devalues by say 30% against the Euro, Greeks will be able to buy less German product. In that sense they will be poorer. It is not, however, as politically difficult as demanding a 30% cut in Greek wages. Greeks have the chance to offset the loss of purchasing power by buying more from cheaper countries, including their own. More people and other resources may be used within Greece, which currently has a large unemployment problem. A lower exchange rate gives them more chance to export.

The restoration of full Central Bank powers to the Bank of Greece allows Greek governments more discretion over how tight or loose monetary policy should be. During the transition it would be wise to keep banks and markets liquid. The ECB has been unable to do this for Greece, as people and banks have doubted the Greek ability to stay in the Euro and have diverted funds from Greece to elsewhere. This has intensified the squeeze.

Greece could choose her own short term interest rates, and would have a bit more influence over the borrowing rates she had to pay for state debt. She would not need to default, as she could print money to repay or roll over the debts. She will still need a credible deficit and debt reduction strategy to reassure markets and to help get her interest rates down, but with her own money supply and a market determined currency level she has more chance of doing that.

Perhaps most important of all, the restoration of national currencies restores important powers to elected democratic governments. The current experiment in Greece with a technocrat government put in to implement the agreed programmes required by the IMF and the EU has survived their first few months. It is not, however, a lasting solution. The imposition of austerity measures requires political leadership enjoying the support of enough people. It is easier to win and hold that consent if the government wins elections and uses the election to explain the necessity for its chosen course of action.

If all exit countries established their old currencies on a given date, the banks would win and lose on the assets and liabilities they held as the various currency rates adjusted upwards or downwards. It would be a major shock to the system. It would require the newly empowered national Central Banks to make plenty of liquidity available to commercial banks in their territories. It would require rapid analysis and reassuring action and statements about banking solvency in each jurisdiction. Some banks would need recapitalisation.

Summary of the economics of monetary unions

A successful currency union needs to co-exist with harmonised economies that are freely competitive one with another, to the point where they become one large borderless economy. As the founders of the Euro knew, there need to be conditions for common interest rates, inflation rates, levels of competitiveness and reasonable employment levels at the common exchange rate throughout the union. A currency union needs to meet four main conditions to work.

Firstly, there needs to be proper central control over how much each part of the union borrows. They are borrowing in a common currency with a centrally chosen short term interest rate. To avoid free riders and to ensure stability the aim is to allow fair amounts of borrowing for each part of the union at similar rates for longer term money.

Secondly, there needs to be sufficient common policy to ensure the differing regions or states in the zone remain competitive one with another, and can settle their trade accounts with each other easily. The more the currency area can have a common approach to wages, to innovation and productivity, and to market regulation generally, the more likely it is to work smoothly. The Eurozone has to try to offset the linguistic barriers to the free movement of workers from the less successful to the more successful states and regions. The more perfect labour mobility is, the easier it is to smooth out imbalances between less and more competitive areas. Substantial migration from East Germany to West Germany was an important part of consolidating the DM currency union of the 1990s.

Thirdly, there needs to be state intervention to ensure transfer payments on a sufficient scale. Despite the common policies mentioned above divergences between states and regions will persist. Successful currency unions usually have regional policies for sending grants and employment stimulating measures to the weaker areas. There is often a common benefit system to augment the incomes of those in low income jobs or unemployed. There are usually substantial transfers to local governments with bigger amounts per head transferred to the poorer places. Fewer transfers occur within the Euro currency area than in the dollar or sterling unions, reflecting the differing political structure. To the extent that member states want fewer transfers, they need to promote greater economic convergence between areas to compensate.

Fourth, the Central Bank of a currency zone has to pursue policies which operate in the wider interest of the whole zone. They need to regulate all commercial banks well to keep credit growing at a sensible pace and to avoid banking shocks. They need to set interest rates and money growth at levels which make sense for the maximum number of states in the zone.

Measures needed to improve stability in the Euro area.

The EU authorities are taking further action to strengthen the all important controls over debt levels and deficits. The Germans are understandably keen to ensure better enforcement of the sensible rules limiting state debts in future. This is the single most important requirement to create greater stability. The largest market tensions are currently evident in the bond markets. Markets are unwilling to lend to Euro member states with large inherited debts and high running deficits. The Union needs to get all remaining Euro zone members into good discipline on future borrowing levels. Where states in the zone still have large inherited debts, there should be an agreed longer term programme to reduce these levels as conditions permit.

The EU authorities also recognise the need to promote policies to foster growth. The prime concerns on deficit control to tackle immediate stresses in bond markets has tended to overshadow the work to foster growth. It is , however, equally important. The indebted countries need rising tax revenues and falling cyclical spending on unemployment. The EU agenda to promote capital investment, small enterprise, innovation and competitiveness are all important responses to the Euro troubles.

The EU authorities have to reinforce the work they have done on the state of EU banks. The publication of realistic stress tests needs to be followed up by prompt action to recapitalise weak banks, and to show to markets intelligent management of historic loan and bond assets that could cause more trouble.

The need to buttress the Euro has to be seen by members remaining in the system as an opportunity to strengthen economic ties between members. More action is needed to create a common labour market. More work is needed on suitable reasons and mechanisms for the transfer of funds from stronger to weaker regions. This needs to be done with the agreement of both sides in the equation, and needs to be seen to be both necessary and fair. It will require high levels of statesmanship in the richer countries called upon to put more resource into a transfer system, and cannot be successful without their enthusiasm and belief that it is essential and just.

The Optimum monetary configuration

In forming a judgement about the optimum monetary union I am swayed more by the politics than by the economics. The economics points to an inner core of northern states being capable of forming a cohesive and balanced currency area. The politics points to a much wider area, reflecting the aspiration of many on the continent for the states to come together in a wider and closer union.

There is no power in the Treaty to expel members from the Euro. All current Euro member states wish to be in and stay in. It would be difficult legally and politically to negotiate a change of the Treaties in order to expel a member state which wishes to remain in. Such a Treaty would need unanimous support, and might not attract that from any member state that feared for their own exit.

It therefore seems best to say that the trigger point for the possible exit of a country from the single currency will be the inability of that member state to fund themselves in the markets in the normal way. When a country like Greece reaches the position where it can no longer borrow money to pay its bills at acceptable rates, it seeks EU and IMF assistance. It negotiates a package enabling it to carry on borrowing at subsidised rates of interest from the EU and IMF in return for policy promises.

Such an event naturally triggers a reconsideration of the country's whole economic policy. It could be used to encourage or even to require the exit of a country from the Euro as part of the package to restore its economic health and to ensure its future financing. The legal means could be to change the troubled member state from full member of the Euro to candidate member. This can be done under existing Treaty provisions. The state leaving the Euro would then be free to request re entry into the Euro, but would need to demonstrate full compliance with all the economic convergence criteria before being readmitted.

The aim of this policy would be to ask Greece to leave on this basis as part of their current package with the EU and IMF. Given their poor performance at trying to comply with loan agreements, they should be asked to leave come what may. Portugal and Ireland should also be asked to enter discussions on their possible exit. They may agree to do so if it can be shown they would speed their own recovery and help the stabilisation of the Euro area by so doing. They could be reassured to learn they can re-enter when they have converged properly.

Italy would be given every support to remain within the zone.

Any country in the zone would know that in future if it finds the unemployment consequences of its lack of competitiveness have become too severe, it could leave the Euro by this route. If it can no longer finance itself, and has to seek EU financial assistance, it could be asked to leave as part of the price of receiving special EU financial support.

It is recommended that Greece be asked to leave the Eurozone immediately. Ireland and Portugal should be invited to discuss in private whether leaving the zone would speed their recovery and help stabilise the rest of the zone. Their exit is recommended. Markets would be told that any country no longer able to fund itself in bond markets would be invited to discuss exit on at least a temporary basis from the zone. All countries remaining in the zone and capable **of financing themselves would receive full support from the Euro institutions.**

The legal position

The currency was set up by the provisions of the Treaty on European Union, agreed at Maastricht. This Treaty was subsequently added to by the Treaty of Amsterdam, to allow enlargement and to change the votes following more countries joining, and by the Treaty of Nice. All the Treaties were consolidated and amended further by the Lisbon Treaty, an amended version of the European Union constitution. Amsterdam removed twenty four vetoes and Nice 46 vetoes, making common majority voting the norm for most EU matters. This facilitates putting through regulations and Directives needed to help stabilise the Euro area further.

The Treaty makes clear that the ECB cannot lend directly to member states in trouble. It lays down the excessive deficit procedure, which states that a country refusing to implement an EU programme for deficit reduction can have to deposit money with the EU until the deficit is reduced, or face a fine. The Treaty confirms the functional independence of the Central Bank. All member states without special arrangements are either in the Euro or are preparing to join it, with their potential membership assessed regularly against convergence criteria. The simplest way of allowing a country to exit would be to allow it an Article 139 derogation, disapplying the Euro provisions from that member state. This would bring an exiting state into a similar position to the other non Euro members of the EU. In due course revision of the Treaties might be appropriate, but the legal mechanism exists to allow legal exit with a sensible new status within the union.

The Treaty is silent on how a country can leave the Euro. It would be wise when planning the exit of one or more countries for there to be a unanimous vote of the Euro member states to allow the exit, and their consent to a motion to say they will sign any reasonable legal document necessary thereafter to confirm the position. This agreement could be reached during a private meeting convened for the purpose of allowing exit from the Euro in an orderly way. This should not be advertised in advance as the purpose of the meeting.

The Central Bank of any member state withdrawing from the Euro would need to withdraw from the European system of Central Banks, and restore the full range of its powers to conduct monetary policy at home. This may require national legislation in each case. A withdrawing member should have an emergency Bill ready for its own Parliament to give its Central bank the enhanced powers it will need from the day of exit. It will need to restore the power to print and issue notes and coin, to supervise domestic banks and conduct a full range of monetary and currency operations in markets.

Articles 119 to 144 of the Consolidated texts of the EU Treaties deal with economic and monetary matters. Articles 123 and 124 rule out lending by the ECB to member states. Article 126 bans excessive deficits.

Article 128 gives the exclusive right to the ECB to issue bank notes. When a member state exist the currency it can gain the rights that the non Euro members enjoy to issue their own notes.

Article 133 gives to the Council and the European Parliament the right to “lay down the measures necessary for the use of the Euro as a single currency”. This is a useful Article which facilitates changes to the scheme through the normal legislative route, which could be expedited in an emergency exit or break up.

Article 139 sets out which parts of the Treaties applying to the Euro do not apply to countries with a derogation from current membership of the single currency. This measure disapplies:

Article 121 (2) adoption of broad economic policy guidelines
Article 126(9) and (11) coercion to control, excessive deficits
Article 127 (1), (2),(3),(5) the objectives and tasks of the ECSB
Article 128 Issue of the Euro
Article 132 acts of the ECB
Article 133 Measures governing the use of the Euro
Article 219 monetary and exchange rate measures

Article 283(2) appointment of Executive board members of ECB
Article 138 (1) creation of common position for international monetary conferences
Article 138 (2) unified representation at conferences

This is a useful list of the more privileged or onerous requirements of Euro membership which have been suspended for non Euro EU members. It provides a useful means of creating an early and simple exit from the Euro for individual countries, which could legally be transferred from Euro membership to countries holding a derogation. We know this status works legally, as 10 countries enjoy it under the current Treaties. It would give time to consider properly more fundamental changes to the Treaties to reflect the fact that the Euro might no longer be the single currency for more EU members.

Recommendations:

1. **The meeting to decide on the exit of several countries from the Euro area, or the exit of an individual country, should pass the following motion unanimously: "The Euro member states have agreed that (x should leave the Euro zone) . All member states leaving the existing Euro area will be granted an Article 139 derogation from their Treaty obligations. "**

2. **States leaving the Euro zone will table at the meeting draft national legislation for approval, which will grant sufficient powers to their Central Banks to perform the full duties of a currency issuing and bank regulating authority.**

3. **In the event of a decision to create a southern and northern euro there would need to be the following resolution passed unanimously:**
   "The Euro states agree to amend the Treaty to allow two separate Euro currencies, one for the northern group of states and one for the rest. This resolution shall provide an interim legal base for the changes, resolving as it does that each member state shall be held to fulfil its obligations under the Treaty by opting for membership of one or other of the new Euros and accepting the terms and conditions of that membership. The rest of the Treaty provisions will remain the same".

   Treaty changes

   This provisional legal position may invite further changes to the Treaties, once the new currencies have been established.
   A member leaving the Euro could return to the position of an applicant, and face the tests and periodic review of economic performance like the other candidate members. This would not necessarily require further Treaty change.
   Alternatively, an exit country on request could be granted the same status as the UK, with a permament opt out from the Euro. This too is provided for in the current structure of the Treaties, and would need simple amendment to include a further country as possessing a permanent opt out. There is no need to settle that on first exit, where the candidate status membership works for the immediate purposes.
   In the unlikely event that all countries leave the Euro, it would be wise after sorting out the reality of the new currencies to proceed to substantial Treaty amendment, repealing the sections of the Treaty that requires membership of the Euro. It would

also be necessary to wind up the European Central Bank in an orderly way, and make arrangements for its closure. (see below) The sections on the ECB can then also be repealed.
If the intention is to create a southern and a northern Euro, or a hard and soft euro, the Treaties will need amending to establish the criteria for membership and the countries concerned in the two blocs. This would be the most complicated of all the main proposals for change. It would necessitate the creation of two new Central banks from the ECB, founding statutes for the new banks, and suitable treaty language for their creation. Member states would have to decide which Euro applicant countries would be required to join as part of their membership obligations to the EU. For these reasons this is not recommended. There would doubtless be rows over which Euro each country could join, and prolonged negotiations over the new institutions needed for the second Euro being created.
On grounds of minimum disruption and maximum legal certainty it is recommended the EU proceeds by way of granting an Article 139 derogation to Euro membership for the minimum number of states necessary to stabilise the Euro area.

The law affecting the holders of Euros and Euro instruments.

The international nature of the Euro complicates the question of how holders of Euro assets and liabilities will be treated in the event of the exit of one or more countries from the zone. It does not, however, prevent such action. There are many previous models of countries leaving international currency unions where people and companies have accepted the changes that have occurred to their financial position.

It is important to remember that there will be gains as well as losses from these changes. It is not all negative. The lawmakers and decision takers have to come to a just judgement about how the gains and losses will be apportioned between the different categories.

Case One: A exit country with domestic bonds and mortgages

Let us take two simple cases, hypothesising that Greece leaves the union and recreates the drachma. Mr First Greek owns a euro denominated bond issued by the Greek state. He finds this has been compulsorily converted into a drachma bond at the initial rate. The foreign exchange markets quote the drachma 25% below the initial or swap rate, so he apparently loses 25% of the value of his bond. However, he might have some offsetting gain from the fact that bond buyers take comfort from the fact that the Greek state now has an easier task in repaying its debts, and can resort to printing more drachmas making further default less likely. The drachma bond may settle on a lower yield than the euro bond that it replaces.

Mrs First Greek has a euro denominated mortgage advanced to her by a Greek bank. If her mortgage is denominated in drachmas, she will benefit when she comes to repay from the lower value of the drachma against the initial rate used to switch it from Euros.

If, as seems likely, the Greek state decided to compulsorily swap all Greek citizens assets and liabilities denominated in euros into drachmas at an initial rate, holders of assets would tend to lose out and borrowers would tend to gain, assuming the drachma then depreciated. As Greeks would be paid in drachmas and receive benefits and other state payments in drachmas, it would make sense to switch all their assets and liabilities into drachmas. Greece would have the power to legislate to do this on conversion day where all these assets and liabilities are held onshore.

Case Two: An exit country with assets and mortgages held offshore by citizens of the exit country

The Greek state could also assert its jurisdiction over Greek citizens holding Euro assets or liabilities offshore. If it did so it would help borrowers and harm savers as above, by compulsorily converting euro instruments like bonds and mortgages into drachma ones.
It could alternatively leave the offshore Greek asset and liabilities in Euros, favouring the savers and penalising the borrowers. It would be easier to do nothing. Requiring conversion to drachmas would entail forcing conversion. This is easier to do if the person is living in Greece and paying Greek taxes, than if they are living abroad. If the Greek state wished to pursue offshore citizens, it will need the co-operation of the other jurisdictions where the Greeks are living. Ultimately it could cancel their citizenship and withdraw their passport if they refuse to comply. Other European jurisdictions might be willing to help with compulsory conversion if that is the preferred approach.

Case Three: Assets and liabilities held by foreigners within a country leaving the Euro.

The easiest approach to these would be to leave them in Euros. A foreigner with bank deposits in Greece could still have a Euro account, and would then be little troubled by the decision to recreate the drachma. A foreigner taking a loan from a Greek bank would still have to repay in Euros. The absence of any change would avoid legal difficulties.

It would be possible with international agreement to compulsory convert the holdings of foreigners in Greek banks into drachmas. Greece would be asserting her domestic right over people banking with her. This would be easier to do for other EU citizens, if the EU as whole wished to enforce such changes, and if the EU was willing to reflect that in EU law.

The Greek state might wish to compulsorily convert all state debt into drachmas, whoever held it. That would be a different decision, building on the decision to ask bank holders to accept a halving of the repayments due. It would probably become a technical default, but might be a sensible measure given the state of Greek public finances and debt market values.

Case Four: Assets and liabilities held by foreign banks operating in a country leaving the Euro

The same rules can apply to foreign banks operating in Greek jurisdiction as apply to domestic banks. They could be required by Greek law to compulsorily convert Greek resident holders of financial instruments, real estate and mortgages, loans and other liabilities into drachmas. They would be treated the same as domestic banks for these purposes. The banks would win on assets they held for clients, and lose on money owed to them by clients. As many will be running reasonably balanced books, the overall impact will be very limited.

Summary of recommendations on the implications for sovereign debt, private savings, domestic mortgages and other claims.

1. **On conversion day, all domestic holders of Euro assets and liabilities would have these converted compulsorily into the new local currency. This would apply to bank deposits and mortgages through foreign banks resident in the exit country as well as to those held through domestic institutions.**
2. **On conversion day citizens of the exit country who are holding assets and liabilities offshore are not subject to compulsory conversion for these, though of course their domestic assets and liabilities will be converted like everyone else's.**
3. **Foreigners owning assets and liabilities through foreign or domestic banks in the exit country would continue to hold euro assets and have to repay euro claims. If they held property or exit country bonds these effectively become new currency denominated assets.**
4. **The exit country converts all its existing debt into its new currency from Euros. EU and domestic law codes might be changed to say this does not constitute a default, but the markets and Rating Agencies will come to their own decisions whether or not this is done.**
5. **These changes should be the subject of early legislation to confirm them, both in the exit country and at EU level. The aim would be to place them beyond legal doubt or challenge by buttressing the decision of the EU and exit country government with a simple statement of the law that these changes were properly made.**

Banknotes

There have been various unconfirmed vague rumours circulating that countries as divergent as Greece and Germany are busily printing banknotes in their old currencies against the day when the Euro splits up. Advance printing of new currency would make switch over easier, but carries with it the risk that it is difficult to do without detection. Confirmation of what remain thin and unsubstantiated rumours to date would be bad for confidence in the Euro. If market participants had good reason to believe that either or both of the strongest and weakest countries in the Euro scheme were planning an exit by printing new money it would be that much more difficult to borrow and trade in Euros.

For this reason I am not recommending advance printing of new money banknotes in an exit country. It could become a self fulfilling prophesy, and could force the hands of the authorities to make the move more quickly than they would like.

Fortunately most money these days is electronic money. Most of us hold our cash reserves in the form of deposits with banks, or in the form of easily traded bills and notes in the case of larger companies. It is this money which can be converted from currency A to currency B at the touch of a mouse on banking computers when the instruction is given to do so. This reduces the worry of how people would have access to the new currency from the first minute of its creation.

When we buy items we might use a credit card. This too, like a bank account, can have its currency switched as soon as the change over is ordered. We might write a cheque. This can be drawn on a bank account which is automatically switched to the new currency. We might pay bills by direct debit after the service has been supplied. From changeover hour and day these bills can accrue in the new currency, and debits taken from the client's bank account which has also be compulsorily converted.

Although our use of notes and coin is limited and now represent a small proportion of total money, we do nonetheless need notes and coin to go to the local shops and to operate the various slot machines that supply goods, control car parks and request payment for other services like car wash or trolley use.

The Note issue.

Let us deal first with notes. One of the aims of the exit of a weaker country from the union is to engineer a devaluation. We have already argued that citizens of the country concerned will face compulsory conversion of their assets and liabilities to the new currency, which means they lose from the devaluation if they hold assets and gain if they owe money. The same principle would apply to holders of bank notes. They are assets in the hands of their owners, and they will be devalued. The converse of course applies if a country leaving the Euro is a strong economy likely to experience a revaluation.

The simplest way to solve the note problem is to continue to use the old Euro notes, making one euro the equivalent of one new unit of currency. All domestic holders of euros will have their money in bank accounts converted to the same number of units of their new currency on Day One. Once the new currency starts trading it is likely to devalue. Let us suppose it falls by one quarter, meaning the new currency unit is now only worth 75 Euro cents. A foreigner now coming in with 1000 Euros to spend has spending power of 1330 new currency units, following exchange of his Euros. The domestic holder has only 1000 to spend.

The domestic holder of Euros may hold Euro banknotes. In the transition period they can spend them in the normal way, at the original conversion rate of 1 Euro equals one new currency unit. If they take them to the bank for conversion they will only be given 1000 new currency units for 1000 Euros in notes. A foreigner, on production of passport or other means of establishing identity, can switch at the market rate, and will receive 1330 new currency units for the same 1000 Euros.

Over the period needed to print enough new notes, local people can either spend their Euro notes in local shops or take them to banks for conversion to new currency notes. Shops would be encouraged to bank as many Euro notes as possible, and to receive floats in new notes to speed the transition. There would be a cut off date for people to switch their bank notes to domestic currency.

For this to work fully to ensure local people experience the full devaluation there needs to be a control over citizens taking their Euro notes and going to another country to spend them. This could be done by the exit country making it an offence to take Euro notes and coin abroad to spend, unless these notes and coin had been recently purchased or earned with proof that they had been obtained legally at the new market rates applying. Citizens could be asked at the port of exit from the country to comply.

The EU as a whole could require an exit country's citizens to demonstrate proof of purchase of Euro notes at a post exit exchange rate for any significant transaction.

Random searching of some travellers departing could be quite a deterrent. Anyone from the country concerned at an air or sea port could be asked to confirm they have no Euros other than ones they have purchased at the new market rate. If they are found to have smuggled money it could be confiscated or other penalties enforced.

There will be some who break the rules or exploit the system. There always are. It is a question of how much effort the originators of the scheme think it is worth putting in to ensuring detailed compliance. Banks could be asked only to issue new notes once the scheme has been announced, to limit the ability of people to walk away with large numbers of Euro notes seeking the windfall element.

The coin issue

On the first day of the new currency it is important that slot machines continue to operate. The easiest way for them to do so is for them to continue to accept the Euro coins as if nothing had happened.

There will be a rough justice to this. The impact of the devaluation of a weak currency – or revaluation of a strong currency – will be delayed until the coin machine can be switched to new coins and values. Euro cents will circulate as new cents for the new currency whilst new coins are being created.

The state should have a programme for making enough new coin to replace the old issue as quickly as possible. As shops and coin machine operators collect in euro coins they should be required to take them to a bank to switch into new currency. The government would have to work with coin machine operators over the nature of the new coins. They could share most of the characteristics of the Euro coins to make transition easier, or they need to agree a deadline for changing over coin machines to coincide with sufficient new coin being in circulation.

To prevent abuse citizens and resident businesses should be told it is illegal to take Euro coin out of the country unless it has been purchased for the purpose at the new exchange rate. Foreigners coming in would be able to use their Euro coin in the early days. Once transition is completed they will have to acquire new coin for their local use like everyone else, by swapping their Euros or other foreign currency at a bank or Bureau de change.

Summary of recommendations

From Transition day all currency is converted officially for domestic holders at one Euro equals one new currency unit. Local holders of Euro bank notes and coin can either spend them in the shops at the one to one conversion value, or take them to a bank and get them changed into new local currency notes and coin.

Locals may not take the Euro notes and coin out of the country to spend. If they wish to do so they need to convert it to new currency at the one to one official rate, then buy Euros at a bank at the new market rate. People leaving the country

for abroad would be subject to random searches for euros, and will need a recent receipt for its purchase to confirm they have been through the correct exchange procedures.

Foreign buyers of goods and services in the exit country can exchange their Euros for new local currency at market rates. They would be free to use Euros at the one to one official rate in shops during the transition, but would be unlikely to do so if there has been a devaluation.

State debt instruments.

Once the country has switched its currency from the Euro to the new currency there is every reason to do the same switch for government debt instruments.

There would be no argument about future government debt issues. New borrowings by the state will be largely in the new currency. Those investing in this state debt will know what they are buying. They will be buying in after the initial devaluation or revaluation. The markets will have established a market value for the new currency.

Because the value of the new currency can and will fluctuate against other currencies including the Euro, there would be too much risk for the state to go borrowing in foreign money. Countries traditionally issue most of their debt in their own currency. Buyers can take some comfort from the ability of the state to print its own money, making repayment more likely. The state also primarily collects revenues in its own currency, as most taxation is paid by individuals and companies generating income in the local currency. Again this points in the direction of mainly issuing local currency debt.

I have also recommended that the state compulsorily converts its stock of debt into its new currency. This is more contentious. Holders may well argue that they intentionally bought Euro denominated debt because they had faith in the currency. They may need Euros when the bond expires or when they sell it on. If they receive a new currency instead they may experience a currency loss on their holding.

One of the most likely origins of the exit of a weaker country from the Euro is the inability to borrow enough and afford the interest payments on the debt. This problem does not automatically disappear once the country leaves the Euro scheme. Whilst the devaluation that follows does help the balance of payments, it makes government purchases of foreign goods and services dearer. It makes the country appear a less good risk to lend to. The debt problem remains.

Greece has already announced its plans to halve the amount it repays to private sector institutions and investors who have lent it money. Redenominating state debts in the new currency reduces the burden of repayment by the amount of the devaluation. This could help when it comes to refinancing and to trying to get the budgets closer to balance.

There are several arguments against doing this. In the case of a country where devaluation is likely to result from a new currency an enforced redenomination of debt is the equivalent of a default. This could trigger default swap insurance claims, and could leave some banks weakened from the losses. The European Central Bank will be a substantial loser, as the ECB has been busily buying up sovereign bonds issued by the weaker Euro area covenants. Some commercial banks outside the exit country may also have substantial positions, and would have to find additional capital to make good the losses following devaluation.

The truth is the policy of exit can only work if it achieves a combination of effects. It needs to lower the value of the new currency relative to the Euro to give the country back some of its lost competitiveness, to start to bring the current account into better balance. It needs to help reduce the debt interest burden, a contributory factor to the large deficits being run by countries at risk.

The paradox is the larger the devaluation the greater the restoration of competitiveness, but the larger the losses on government bonds issued by the exit country. If the country is not allowed to redenominate its bonds the debt burden gets even worse, as the state has to find the extra money to allow for the devaluation as well as the high interest burden.

The EU is likely to want a compromise along the Greek deal lines already identified for the debt issue. They may well want the bonds outstanding to the ECB, other EU institutions and member states to be repaid in full in Euros, whilst allowing forced change to the new currency for the rest.

Such a policy makes legal challenge to the process from the US and elsewhere outside the EU more likely. Non EU holders of EU state debt might take exception to the EU looking after its own public institutions but forcing losses on others. The EU can enforce its solution on all EU institutions and investors through its own law codes and the dependent jurisdictions in national authority within the EU. It will find it more difficult to uphold its verdict beyond the EU, unless it is manifestly fair.

I think it would be best to redenominate all state debt in the new currency. There is precedent for doing this from previous currency unions that have broken up. There is an equality of misery for all bondholders. EU commercial banks by now should have run down their holdings of the more dangerous sovereign debts within the zone. The public institutions will have losses, but they also have the power to tax and to print to pay the losses. Making an exit country repay all its old debts in full adjusted for the exchange rate will continue the budget cutting agony that helped force these countries to consider exit from the currency bloc. It delays the day of default, but cannot remove the ultimate need for at least partial default in the case of the most heavily indebted member states. Using the new currency as partial cover for the default is the best means of carrying out a difficult action. It also provides a market test on the extent of the default.

Recommendation: All state debts in an exit state should be compulsorily converted into the new currency, whoever owns the bonds. The EU could protect its own position in these bonds if it wished.

Commercial loans and debts

The same arguments do not necessarily apply to companies that have borrowed in Euros within a country that is about to exit that currency. Companies wish to maintain their credit rating. They have not usually got themselves into the same overextended financial position of the weaker Euro member states. They did not themselves seek the new currency and the consequent devalution. It is recommended that the default position for companies with Euro debt is that they should continue to honour it as a Euro debt, unless the whole zone breaks up or creates two differing Euro currencies.

A global group which happens to have some assets and liabilities in a Euro state that is planning to leave the Euro should be able to afford to honour its Euro debts, even if some fraction of its revenues are compulsorily switched into a new currency by the exit of a member state from the Euro. Global groups have often managed their treasuries in sophisticated ways, and should have been taking measures to manage the possible exit of a country from the Euro. It is rare for a large global group to have a significant asset and revenue stream in Greece, and for it to have large Euro borrowing just to support such a business. If we are faced with Greece leaving the Euro most large multinationals need not disturb their pattern of debts, and should be able to afford to repay Euro borrowings in due course.

Conversely, a Greek company with Greek borrowings supporting its current business in Euros would be well advised to switch its loans from Euros to the new currency on Transition day. Greek law could accommodate this by saying that it will be normal for a Greek business with Greek borrowings to switch them at the one to one rate on T Day. The future revenues of the business will be devalued, so it is important the debts are as well. Most of these loans will be from Greek banks, or from local capital sources.

There will be a few difficult cases. The most difficult are the smaller global business with a large Greek business financed by debts in Euros, and a larger Greek business with substantial EU interests with large Euro financing of its Greek business. Let us consider each of these in turn.

The smaller global business with a large Greek business will suffer from the change of its Greek revenues to the new devalued currency from the Euro. If it has to keep on paying interest and capital repayments in Euros for its debt, but is only earning drachmas, it will be worse off. There will be very few businesses in this position. It will be one of those unfortunate risks which should have been managed better. I suggest not making special provision for such businesses to switch their debts out of Euros. It would be complicated finding a governing law that allowed them to do so successfully. It would be a scheme open to abuse.

The larger Greek business with Euro financing of its Greek as well as its Euro business is easier legally to deal with. The business is within Greek and EU legal jurisdiction. It is a variant of the Greek domestic business described above. The EU and Greek authorities could define circumstances where it was legal for it to switch its Euro borrowings into drachma loans, against the wishes of the lenders. It is recommended that this be done in as few cases as possible, by defining the qualifying criteria in a way which rules out most cases. The Greek business would need to be a substantial part of the total EU business, and it would need to be heavily geared, to allow it the special privilege of devaluing its debts. By taking a tough stance on most cases of corporate debt, less damage is done to the EU wide banking system and to savers.

Recommendations

Large international corporates should not be allowed to switch Euro debt into new currency debt against the wishes of the lenders. They should be expected to manage the consequences of new currencies, just as they manage the consequences of daily currency fluctuations for non Euro currencies they deal in.
Local companies in the exit country should be able to switch all their debts into the new local currency at the same time as all their revenues and assets are compulsorily switched. This could include a small number of multinational EU companies predominantly trading in the exit country, who would be able to convert their Euro debt if they matched strenuous criteria on proportion of turnover and degree of historic gearing that made such conversion necessary for the future stability of the business.

Loans and mortgages

Similar considerations apply to loans and mortgages. The easiest cases are the most common. If Greece leaves the Euro a Greek person owning a property with a Greek mortgage will experience a loss on the Euro value of the property as the drachma devalues. There is justice in allowing the mortgage to reduce at the same pace as the house value by redenominating the mortgage in drachmas too. The individual is probably reliant on drachma income to pay the mortgage, so symmetry is preserved by allowing the conversion of the debt.

If a foreigner has bought a Greek property on a Euro mortgage from a non Greek bank there is no obvious reason why their mortgage should be converted to drachmas. Whilst it is true they will experience the devaluation of the Euro value of their property, they are likely to have earnings and other assets in non drachma areas. They took out a Euro mortgage knowing the risks. Why should the bank that lent them the money have to take the loss? That bank may not have matching drachma/Euro gains in the way a Greek bank will have. The Greek bank will be able to compulsorily convert all its debts to drachmas to offset losses on its assets.

The hybrid cases are as always more difficult. What should happen to a foreigner who owns a Greek property on a Greek mortgage from a Greek bank, and who has little income from his home territory? Isn't he more like the Greek citizen? He is the hard case, but it is probably legally sounder not to allow such people to convert their debts to drachmas. It would be easier to do for an EU citizen, assuming the rest of the EU agreed to such a law, but more difficult for non EU citizens in a similar situation.

Conversely it would seem reasonable to allow the Greek citizen facing devaluation of his house value and income, to devalue his mortgage with a foreign bank in Greece. If he has taken out a foreign mortgage outside Greece he should be expected to repay it in the currency of the original contract.

Recommendations

IT is recommended that Greeks with loans for property or other purposes from banks operating in Greece should be allowed to convert their loans to drachmas

from Euros on Transition day. This would be made legal by the passage of a suitable Greek law, buttressed by EU measures to endorse the Greek action.

Foreign owners of Greek property with Greek Euro mortgages would be expected to honour their Euro commitments. Foreign banks would be at risk of loss on Euro mortgages advanced to Greeks in Greece, but not on other Greek property loans.

The same approach should be adopted towards personal and other business lending.

Implications for international contracts

It is wise to meddle with private contracts as little as possible. All foreign contracts entered into by people and businesses in an exit country should continue to be enforced by usual means in the currency of the contract.

All internal contracts between people and companies within the exit country should be converted by compulsion on Transition day. These rules would apply to foreign owned subsidiaries operating as local companies from offices and other premises in the country concerned. It would not apply to export and import contracts with foreigners. It would apply to foreigners normally resident and paying taxes in the exit country, but not to foreigners temporarily resident or living there in second homes without being citizens or paying full local taxes.

Export and import contracts will need revisiting, but this should be a matter left to the contracting parties.

If we explore the case of hotel and restaurant contracts for overseas tour operators, we can see the forces at play. A UK tour operator may have a contract to rent a certain number of nights accommodation and to buy meals at Greek hotels for his tour operator business for the next season. This may well be a contract to pay a certain Euro price for the rooms and meals, without a break clause or drachma conversion clause in it.

If Greece leaves the Euro and the drachma devalues by say 25%, the tour operator will be required by contract to pay 33% more than someone coming in and buying the equivalent room or meal post devaluation . This assumes similar buying power, discounts and other matters.

The tour operator will complain and say they need to pay the new drachma price, and get benefits from the devaluation. It would be extremely difficult to draft a law which could enforce conversion for all companies from all countries that had entered such contracts.

It is likely, however, that the Greek hotels and restaurants will wish to make an adjustment to their prices to reflect the new realities and to retain customer good will. In practice there will be a renegotiation between the larger tour operators and the hospitality industry, leading to lower prices and drachma bills. This is best left to the market to sort out.

Recommendation

All contracts between citizens and companies trading as local companies should be compulsorily converted into the new currency on transition day. All contracts involving foreign people and companies should be left to private negotiation to sort out following devaluation.

What if the country leaving the Euro has a strong new currency?

Similar considerations apply to an exit country that creates a currency which revalues. In this case borrowers in the currency are hit and owners of assets in the currency gain. The thinking behind who should win and lose could be similar to that set out above. The main consideration should be to convert by compulsion the assets and liabilities of citizens and resident companies undertaking most or all of their activity in the domestic currency. The aim should be to leave foreign individuals and companies to sort out things for themselves, meeting their contractual obligations in Euros as planned.

If Germany left the Euro and recreated the DM , it would probably appreciate substantially against the Euro. German and foreign holders of German assets would benefit from the currency gain. German holders of debt would have their debt converted into DM debt, so they would lose on the conversion. They have the consolation that their assets and their income has gone up in Euro terms, allowing them to meet the higher debt payments.

Recommendation

The proposals on how to handle company and individual loans, debts, property and financial assets and contracts applies to exit countries with both weaker and stronger currencies than the Euro they are leaving. Borrowers fare better with a weak currency, and asset holders fare better with a stronger currency. In both cases the main rule is that citizens and local companies in the exit country face compulsion to adopt the new currency for all purposes. Foreigners largely remain with the Euro, and can negotiate their own new arrangements where necessary.

Minimising adverse consequences of Euro withdrawal by certain countries

The protagonists of the Euro scheme now argue that keeping the Euro together is important to avoid a worse disaster. They suggest that allowing break-up of the Euro could lead to a sharp contraction of output throughout the zone, with knock on consequences for the rest of the world. They fear a banking crisis or crash, which is presumably part of the reason why they fear a decline in output and incomes. They expect a withdrawal to be disorderly, expensive and damaging to trade. We need to look at each of these fears in turn, and see what action is needed to prevent or ameliorate possible bad consequences.

Would Euro break up lead to a sharp fall in output?

Break up of the Euro if it happens will mainly be fuelled by the poor growth of the Eurozone as a whole, and by the recession inducing characteristics of policy within the zone for the weaker countries.
The Euro and IMF/EU policy requirements can make it difficult for Greece, Portugal, Italy, Spain and Ireland to stimulate the growth they need to get out of high debts and

deficits. The need to borrow more money to pay for the large public sector and banking deficits, generates the forced requirement to raise taxes and cut spending in an effort to get the budget deficit down. The failure of the economy to grow places strains on revenue raising, reducing the natural buoyancy of tax income. It also induces higher public spending, as rising unemployment swells benefit bills. It is the inability of the weaker countries to break out of this vicious circle which is forcing bond interest rates up, and keeping deficits stubbornly high.

The added difficulty stems from the trade imbalances. The more Germany and the stronger countries sell to the rest of the zone, the more need there is for trade finance to flow from the strong to the weak. The refusal of the zone to accept higher transfer payments from rich to poor, and the absence of any regular method to allow the poorer parts to borrow at the common low interest rate, makes financing these trade deficits painful.

It is therefore ironic that some claim the danger in breaking up the zone will be felt in a sharp contraction in output. Output is or has fallen sharply in the more exposed peripheral economies as a result of current policies and Euro membership.

We need to ask why there could be a further fall in output if a country left the zone. It is true that when a country establishes a new currency its total output measured in Euros is likely to fall. The new currency may well devalue against the Euro. Indeed that is the main reason for advocating the creation of a new currency, so that more of the strain of adjustment can be taken by a flexible exchange rate. There will, therefore, be a one off decrease in the value of output measured in harder currencies. Conversely, if one of the strong countries left the Euro there will be an increase in their output when measured to reflect the upwards movement of their new currency.

The change in valuation of output is not, however,quite the same as a further fall in physical output. Instead the cut in spending power within the economy brought about by devaluation limits the economy’s ability to import, but also encourages more domestic output to substitute for dearer imports, and to export more to cover the trade gap. The impact on output in the country leaving the Euro and experiencing a devaluation is likely to prove positive after the initial devaluation impact, once the economy can start to adjust to the new relative exchange rate. If it does not, the main purpose of the exercise is lost. Critics of exit strategies suggest that the exchange rate effect could be overwhelmed by the crisis that exit might engender. They probably have in mind further losses in the banking sector, leading to a further reduction in credit available for the private sector. They fear that confidence could be badly damaged by exit, leading to cancelled orders and lower activity. They worry lest the currency uncertainties put off investors.

Impact of Euro withdrawal on the banking sector

The banks stand to lose and gain from a Euro exit by individual countries. Too much of the commentary just looks at the losses which would occur.

If Greece left the Euro the drachma would devalue against the Euro and other main currencies. Banks holding Greek assets would therefore have a currency loss on their holdings. If they have to mark this to market or make further provision for it, it entails recording a loss and reduces their available capital. They therefore have weaker balance sheets.

However, much of the bad news from Greece is already in the price. If the banks’ holdings of Greek state bonds were reduced in value by the devaluation, they might have

some offsetting gains on the underlying value of the bonds. The markets might think that the withdrawal of Greece from the Euro improved the prospects for the Greek economy and for tax revenues. They might be relieved at the thought that the Greek authorities could now repay the debts by printing drachmas, a freedom they did not enjoy when in the Euro. There could paradoxically be an improved sentiment towards Greek state bonds if there were a new Greek currency.
Similarly, the banks will record extra losses on Greek private sector loans from the currency devaluation. However, if the devaluation and the creation of a more independent Greek economic policy designed to promote growth begins to improve the prospects for the Greek economy, the general standing of Greek risks improves. If the Greek economy can perform better with its own currency, then the likelihood of bankruptcy and default by private sector companies is on average reduced. This helps banks with assets in Greece.
We also need to remember that banks have liabilities as well as assets in Greece. These liabilities could also be reduced by the devaluation as and when they are converted into drachmas. They need to be viewed as offsets to the losses on the assets.

Actions to be taken to reduce banking risks at a time of currency withdrawal.

It is most important that when a new currency is created the incoming new Central Bank to that currency makes clear its wish to support its banking system. The Central Bank needs to be available as lender of last resort to ensure proper liquidity. If Greece left the Euro, the Bank of Greece could do worse than follow the recent example of the ECB, making substantial lines of credit available to Greek banks both short term and medium term at the outset of the new monetary regime. The Bank of Greece also needs to work closely with the commercial banks in its system, to ensure they have strong enough balance sheets to be able to lend more to the ailing economy and to finance a recovery in due course, by encouraging them to recapitalise as soon as possible.

The creation of a new currency does not overnight either solve or worsen the banking crunch which is one of the worst problems facing the modern Eurozone. It does, however, enable an exit country to establish its own sensible monetary regime. Under the common or single currency there is a danger that money is especially tight in the weaker parts of the zone. Banking regulation and money growth is geared to the more successful core, and may not accommodate the needs of the endangered periphery. There tends to be a flight of deposits to the stronger countries.

The Central Bank of the exit country could allow lighter capital requirements for its commercial banks for a transitional period, to avoid undue monetary tightening. It can make sums available to ensure strong liquidity, both to reassure markets about the future of the commercial banks, and to give them money to lend.

Recommendation
On exit, the Central Bank acting for the new currency should ensure good liquidity to its commercial banking sector. It should make available both short term and medium term lines of credit. It should allow transitional lower capital ratios to ensure adequate new lending, as encouraging growth in the exit economy is fundamental to success of the policy.

The impact of Euro break up on confidence

It is difficult to see how confidence in the Euro area could be much worse than it has proved at times in recent months. The zone has moved from crisis meeting to crisis meeting, as the politicians have struggled to catch up with the markets. The current bond yields for Greece, Ireland and Portugal show little confidence in those countries within the zone. Yields for Italy and even Spain are also worrying, though strong recent monetary action by the ECB has calmed the markets somewhat. A recession is likely in most of the zone this year, as business confidence is low and austerity programmes are adversely affecting demand.

Critics of managed exit from the zone of some countries suppose that demand and investment would be worse after break up than before. This is unlikely. Countries leaving the Euro to devalue would have a need for more investment to cater for the extra demand from import substitutes and for export. They are more likely to benefit from inward investment as they will have their own currencies and balance of payments, in need of matching flows to finance the opening deficits whilst the economy adjusts with the help of the new exchange rate.

The exit from the Euro of a weak country should have beneficial effects on confidence both in that country and the remaining Euro zone. The zone itself would no longer be prey to so many rumours and doubts about its sustainability if weak countries leave. The zone members would no longer be under any pressure to lend more or make larger transfer payments to the weak countries. Even Germany is occasionally subject to market fears about her own credit status as markets wonder if she will be drawn into standing behind and financing the weak parts of the zone.

The exit countries would also benefit. They are currently pensioners of the IMF and EU. Their state finances depend on special terms lending from international organisations, as the ordinary markets are effectively barred to them. If they leave and devalue they will get their current accounts into better balance and will speed the day when they can return to market borrowing. They also have the opportunity to use the devaluation to reduce the real burden of their debts.

It is true that the exit of weaker countries will reduce their demand for German exports. Similarly, the exit of Germany followed by revaluation would serve to cut German export orders from southern Europe. This has to happen as the balance of payments imbalances are too large. As Germany understandably does not want to send the southern countries the money by way of grants and transfer payments to carry on buying German goods, there has to be an adjustment. German taxpayers do not wish to make the scale of transfer within the union from their own taxation that is common in other currency unions, so the alternative should be the exit of the countries most in need of subsidy and assistance. Germany in the past lived well with a rising DM. Her industry can direct more of its output to countries outside the EU with growing demand. She will prove able once again to raise productivity and control costs to combat a stronger currency.

The impact of exit on the capacity of member states to borrow money

Critics of exits from the Euro say that a country leaving the Euro would find it very difficult to carry on borrowing the cash it needs to finance its deficit and roll over its old debts.

Whilst it is true it will not be easy, the reason we are discussing the break-up at all is because states have found it impossible to borrow the money they need in the normal way on the markets whilst being part of the Euro.

Greece, Ireland and Portugal have been forced into borrowing from the IMF and EU on special terms. They have been required to follow a specified programme of tax rises and spending cuts, to bring their deficits down. Today within the Euro their market borrowing rates are still too high for them to be able to borrow from the markets in the normal way, despite instituting programmes to control their deficits which are meant to build market confidence.

Meanwhile, Italy, Spain and even Belgium are also experiencing higher borrowing rates than the core countries in the Euro. Italy in particular has recently faced rates of over 7% for 10 year money, a level which many think is unsustainable for anything more than a few months. At that rate of interest, as debt is refinanced by the Italian state, the interest charges come to absorb too much of the tax revenue available. That in turn intensifies the squeeze on more productive public spending, and takes more demand out of the economy. It is welcome news for the Euro that recent ECB action has brought these yields back down to around 6%, a more realistic level.

Allowing a devaluation and creation of a new currency does not make this position worse. If it is handled well the country should regain access to debt markets at more affordable interest rates more quickly, for two main reasons. Firstly, the real burden of the existing debt is reduced by the amount of the devaluation, as much of the existing state debt will be switched into the new local currency. It is a kind of back door default, easing the legacy position by the extent of the devaluation.

Secondly, the devaluation should help bring the balance of payments into better balance, permitting more exports. As the external balance of the economy strengthens, so there will be more activity and tax revenue, which in turn improves the public finances. Outside investors will have more confidence in the economy if it can adjust its cost base through currency changes.

In practice the most likely candidates to leave the Euro are the countries that are already following an IMF programme. The creation of the new currency and its devaluation makes the IMF package more traditional. The IMF usually advises in favour of a devaluation as well as urging tighter fiscal measures when helping countries with problems. Were the Euro problem countries to do this it would put them in the IMF mainstream, and make it more likely the IMF package worked.

The Governing law

Changing a currency entails dealings with several jurisdictions depending on the transaction or agreement. There are broadly four categories we need to consider. There are agreements and contracts within the country leaving the Euro. There are contracts and agreements between people and companies in the exit country and people and companies elsewhere in the Euro zone. There are agreements and contracts between people or companies in the exit country, and people and companies outside the Euro zone. There are contracts and agreements between people and companies outside the exit country using the Euro for their own purposes.

Contracts and agreements between people and companies within the exit country.

These contracts and agreements can be changed by domestic law in the exit country. If the recommendation is accepted that these should be changed automatically into new currency contracts and agreements, the exit state needs to pass the relevant law making it clear this has to happen.
It would be wise in the new law requiring this to deal with the issue of whether adversely affected parties could appeal to European jurisdiction against the change. The domestic law could include a clause pointing out that the exit country has now become an EU country with a derogation over belonging to the Euro. It could also explicitly suspend appeal on these matters to the ECJ. This could be buttressed by a decision of the EU to say that the EU approves of the decision to convert these contracts into the new currency, making an appeal futile or impossible.

Contracts and agreements between people and companies within the exit country and people and companies within the rest of the EU

This is a more difficult set of cases, if the decision is taken to convert these into the new currency as well. Lenders from other EU countries will lose from devaluation, though borrowers will of course benefit. Unless express legal action is taken there could be law suits by losers from outside the country complaining about the compulsory conversion of their contract.
If the decision is taken to proceed with compulsory conversion of these contracts it would be wise to change EU law expressly and accordingly. The EU could pass a regulation denying redress to individuals and corporations who had lost money as a result of the compulsory switching of their assets to a different currency.

Contracts and agreements between people and companies within the exit country and people and companies from outside the EU

Varying these contracts would be an assertion of extra territorial powers, which might be going too far in the circumstances. The easiest option is to leave these contracts and agreements in Euros, as the Euro survives as a trading currency if one or a few countries leave it.

The EU did of course assert such jurisdiction when it established the Euro. By destroying big trading currencies like the DM and the French franc it forced conversion of contracts and agreements. It got away with it, without a big legal challenge to its chosen course of action. Were the EU to decide to abandon the Euro and to return all countries to their own currencies, then it would have to take a similar legal risk to the risk it ran when establishing the currency. There would be limited point in people challenging the decision, as the Euro would cease to exist, making enforcement of the Euro contracts impossible.

The decision could be taken to convert all these contracts into new currency. Individual contracts might be exempted, depending on the governing law determining the contract. It would be a matter for individual negotiation and decision in the light of the general policy and the governing law in each case. It is recommended that the EU does mnot seek to assert jurisdiction if presiding over limited exists from the zone.

Contracts and agreements between people and companies outside the exit country in Euros.

In the circumstances where the Euro continues as a main currency, it would be best to leave all these contracts in Euros. Whilst some of them relate to assets and liabilities within the exit country, neither the EU nor the exit country government have clear powers over the contracting parties. It would seem to be a needless complication to try to assert power to convert against the wishes of one or more of the contracting parties. They might decide to do so for their own reasons, but that can be left to private negotiation.

Contracts between people and companies in countries remaining in the Euro area

There can be a genuine choice of options here. The EU as a whole would have the legal clout to enforce compulsory conversion of contracts into the new currency. There would, however, be no pressing need to do so, as the contracting parties would still be working on most of their other budget matters in Euros and may well have Euro streams of revenue.
There is a case for the compulsory conversion of Euro contracts relating wholly to exit country assets and liabilities into the new currency. There is also a case for leaving it to individual negotiation. For the sake of simplicity I recommend not seeking compulsory conversion.

Transition - The need for speed and accuracy

If the EU decision takers take too long about making the decision to let a country leave the Euro, or if they leak their decision making process in advance, they will make it all much more difficult. It is best done at a single meeting of Heads of government over a week-end, with everything in place for when the markets open on the Monday morning following the decision.

The EU does not have a good record with such matters. Its attempts to talk its way out of the banking difficulties have forced them to revisit banking cash and capital on several occasions. Still they have failed to get ahead of the markets, and have been forced in cases like Dexia to stitch together solutions at the last minute. The stress tests or solvency checks were not sufficiently rigorous and the weaknesses were not followed and cured in an energetic way, leaving certain banks vulnerable to market moves.

Similarly, the EU has watched as three countries have lost their ability to borrow in the markets in the usual way to finance state deficits. Three countries are now on life support from the EU and IMF. Part of the reason was the way embarrassing conversations about their financial condition were leaked or briefed as Euro area members argued over what to do to stave off the mini crises country by country. Loose tongues followed by too little action make the problems worse.

If the EU allows the exit of one or more country to become a common talking point whilst they debate action, it will make the situation worse. More people and companies will withdraw their Euros from the country concerned, to bank them more securely in a strong Euro country or outside the zone altogether. No-one wants to wait for a devaluation of their savings and deposits. It will remain impossible to borrow money for the state if a devaluation is feared, or in the case of a country not yet into the IMF it could be the tipping point which makes the rate too penal for them to carry on borrowing in the market. It will also start to disrupt normal commerce and contracts. Contracting parties from outside the country will want protection clauses against devaluation.

For all these reasons it is important to move swiftly, and to move stealthily. If the discussions are confined to Heads of Government, and the papers released to them at the week-end meeting the chances of embarrassing leaks within trading hours are reduced. The Heads of Government could take this business at one of their regular meetings, so no-one needs speculate on why they are meeting. If the crisis is more immediate and they have to summon a meeting rapidly to deal with Euro problems, the meeting can be described as a meeting like all those before it to resolve the crisis of the Euro without suggesting that it is the meeting to break the Euro area down to a more manageable size.

The meetings of the Heads of government needs to consider the following papers:

1. The general case for allowing or requiring the exit of a country from the Euro. This informs the discussion in principle, leading preferably to the conclusion that the exit of one or more country is needed for their sakes and for the stability of the wider zone.
2. The legal and administrative steps that need to be taken to allow the exit and the establishment of new currencies. The aim should be to switch all relevant deposits and electronic money before the markets open the following Monday, and to phase in new notes and coin as rapidly as practical.
3. The press statement, summarising the case for the action taken. This should also state clearly the resolutions carried at the Heads of Government meeting, and the necessary legal cover to allow the exit countries to move to the status of having derogations from belonging to the Euro under the Treaties.

The paper summarising the general case for selected exit of countries

This paper could draw on the arguments presented above. It would summarise why under the present Euro regime certain countries are unable to get their debts and deficits down to anything like the reference levels in good time and good order. It would explain the large trade and commercial imbalances within the zone that are proving difficult to finance. It would remind member states that the original criteria were there for a good reason, to improve the chances of currency success.

The meeting may have to deal with the problem that country like Greece may not wish to leave the Euro. Under the Treaty there is no way of enforcing her withdrawal. However, the Treaty permits the status of candidate member whilst a country is preparing to join and trying meet the requirements of the union. As Greece (and Portugal,Spain and others) did not meet the requirements by a long way on entry day, the other member states could jointly request that Greece withdraw to prepare again and to sort her economy out. If appeal to her own interests and reminders that she neither met the requirements nor presented honest figures on entry is insufficient to persuade her, then the Union can simply say they are no longer prepared to finance the Greek state through the special loans the EU and IMF are making available. This should be sufficient for the Greeks to accept they need to follow the EU's advice.

The Member states would then resolve that Greece had agreed to accept the status of a candidate country and currency under the Treaty, and to act under the derogation from Euro membership, all the time she was unable to meet the debt, deficit and other requirements of the Treaties. A unanimous resolution of all member states with the consent of the exit country should be sufficient.

The paper setting out the legal and administrative steps to be taken to allow exit

The member states need to resolve that they will take all necessary legal measures to ensure the smooth and legal transition of all contracts, assets and liabilities in Euros into the new currency of any exit country according to an approved procedure. This paper has gone into detail of the arguments over which contracts, assets and liabilities should be compulsorily converted and which may stay in Euros. The Heads of Government should be presented with a preferred version, but be able to debate the options. They should be reminded that if the compulsion applies just to people and companies within the jurisdiction of the exit country, the legal and administrative tasks are easier. The exit country needs to prepare and clear rapidly the necessary domestic legislation to regularise the position. If the EU wishes to convert contracts and assets held by other EU citizens outside the exit country, then it needs to resolve accordingly and to commission rapidly the necessary supporting legal texts preferably by directly acting regulations that can enforce these decisions.

The Heads of Government need to give general authority to officials, to the ECB and the other central institutions, to take all appropriate measures to ensure as favourable a reception as possible of the new policy. Heads of Government should understand that the ECB needs to keep the markets liquid whilst this is going on, and needs to offer assurance by word and probably by deed as well that it stands behind the main commercial banks in the exit country.

The press release covering the meeting

Heads of Government, being politicians, are likely to be most interested in what they can say about the new policy when their meeting breaks up and the world is told of their decisions. The draft document might include the following:

" At a meeting in Brussels over the week-end, the Heads of Government of the European Union have decided that they need to bring to an end unhelpful market speculation and pressures on individual member states within the Euro. They recognised that several member states are now encountering difficulties with raising the money they need to carry on their normal operations, and understand that there are serious trade and financial imbalances within the Euro zone that are proving difficult to sort out. There are limits to how much austerity countries can accept in trying to meet the requirements of the currency zone.

The Heads of Government have therefore decided that it is in the best interests of European harmony and co-operation, and of the Euro itself, if the member states most badly affected by the current configuration of the currency leave the Euro for the time being. XXX will set up their new currencies, the YYY, in time for the markets opening on Monday. The creation of these new national currencies will enable the exit countries to regain competitiveness, dealing with the large imbalances they have on trade and capital account with the rest of the Euro area, and will ease the burden of their debt by the amount of any devaluation the markets think necessary.

This will, in the view of the Heads of Government, leave a strong and united Euro zone with a group of countries whose economies have come closely together and who can live with the tough budgetary and inflation discipline which was always designed to be central characteristics of the Euro area. The exit countries become countries with a derogation from belonging to the Euro for all the time their debts, deficits, inflation and interest rates remain outside the Treaty values required for new members. They are free at any time to become members again, but will need to satisfy fully all the criteria. We realise it was a mistake to relax the requirements as much as our predecessors did in their enthusiasm to have so many member states in the original Euro.

The legal basis for these decisions will be this high resolution of the Heads of Government set out below:

“The 27 Heads of Government meeting as the European Council have resolved that xxx are allowed to leave the Euro zone, establishing their own currencies on ddd. These countries become member states with a derogation from belonging to the Euro under the Treaties, and are free to reapply for membership when they meet the criteria laid out.”

More detailed contractual matters affecting people and companies with assets, liabilities and contracts in the exit countries, will be governed by their domestic law. The exit member states will be setting this out at the earliest opportunity. The EU stands ready to pass any regulation or other instrument necessary to give good effect to these necessary decisions stated in the High resolution. “

The timetable

The timetable is of necessity rapid.

Day 1. Following a decision meeting between the Heads of Government of France, Germany, and the exit countries to approve the necessary work, officials prepare secretly for the next European Council the specified papers.

Day 5. France and Germany review these papers just before the Council, and contact the exit countries by phone conference to sound them out.

Day 6. European Council

Day 7. Announcement of results of Council

Day 7.5 All relevant bank accounts and electronic money in the exit countries is converted to the new currencies. Orders are placed for new notes and coin. Instructions are issued concerning continuing use of Euro notes and coin until new notes and coin are available in sufficient quantity.

Day 8 First trading day. Exit country Parliaments meet to debate and ratify the decisions of their governments . They cannot be given warning, so they will be in the same position as Parliaments were when faced with a devaluation of a domestic currency. Exit country governments publish draft laws to enforce the changes to bank accounts, and set a tight timetable to legislate.

Day 8 and beyond European Central Bank makes clear it is willing to assist Euro area banks with problems arising from bond and currency losses brought about by exits from the single currency. Domestic Central Banks in the exit countries make general statements of their proposed policies for their new currencies and their banking systems. They also make it clear they stand behind their leading banks and are willing to supply substantial liquidity in their new currency.

Day 14 Central banks in exit countries make fuller statements of their intended monetary and banking support policies.

Day 15 Legislation completed in exit country Parliaments and in European Union, to confirm legality of actions taken and to be taken.

Day 22 Most notes and coin replaced by new issue. Successful trading continues in new currencies and in reduced Euro area Euros. Devaluation and revaluation values settle down in markets.

Day 30 Devaluing countries start to present revised national budgets, including measures to promote growth.

Day 50 Signs of stability returning to capital flows. Some people who had successfully taken their money offshore from struggling Euro members start to repatriate money into the new currencies.

Day 100 Improved balance of payments figures start to appear from countries that have devalued.

Brief history of past currency unions..

I have found there are at least 87 examples of countries leaving currency unions and establishing their own money since 1945. In most cases establishing an independent currency allowed the country concerned to set more sensible interest rates and an exchange rate to help them grow. In every case it gave them more independence, strengthening their ability to make their own decisions free of external interference.

Within Western Europe the Latin currency union led by France and the Scandinavian currency union both broke up without great calamity at the time of the First

World War. It is instructive to compare the fortunes of the German, Latin and Scandinavian currency unions established in the later nineteenth century.

The German one survived the horrors of the First World War. It is true the currency went on to suffer bad times, with the German hyperinflation leading to a new version of the currency being established to control price rises. After the Second World War another new version, the DM, was established. This became a much loved and very successful currency for the German people. The German experience shows that where a single currency is an expression of a nation, one of many unifying forces for a people to come together for government, it survives. No-one can claim the German currency of the 1920s was an economic success. However, the German people persevered with a single currency of their own, despite the crises of the two wars and the inter war period. They proved a currency is resilient if it is backed by a people who wish to live together in a single state.

In contrast, the Latin and the Scandinavian currency unions fell apart as a result of the pressures of First World War finance. There were disagreements about the amount of borrowing it was reasonable and realistic for individual member countries of the union to undertake. There were problems in maintaining payments flows at the common exchange rate. The lack of political union between the participants led to an agreement to disagree, and to break up of the unions. The individual countries reverted to their own currencies, by breaking the link to the common valuation and allowing new currencies to emerge with differing values. This in turn allowed them to settle their own debt issues, and to create currency values that allowed flows of money to settle payments more easily. These currency unions were part of a global; gold backed system at the time.

Between 1945 and 2007 according to the Monetary Authority of Singapore 69 countries have left currency unions. This figure leaves out a number, including the break up of the rouble currency in the early 1990s. It also excludes the split of Czech and Slovak currencies in 1993.

The sterling area which offered a common currency for many countries with special links to the UK split up gradually. New Zealand left in 1967 to create its own dollar. Ireland left in 1979 to create the punt. It happened by agreement with a relatively smooth transition. In both cases there were no obvious crises. The authorities made sure they managed the liquidity of the banking systems, put in place surveillance of capital flows in the early days and supervised an orderly issue of new notes and coin.

The Indian union also lost some members. Countries like Bangladesh left it, partly as an expression of nationhood. They wanted to have control of their own money and banking arrangements. Others left former colonial unions: Mozambique for example left the Portuguese area in 1977 and Algeria left the French franc area in 1969. Again these changes caused so little disruption that most have forgotten they ever happened.

It was with more sense of turmoil and crisis that the rouble area broke up in the period 1992-5. 16 members of the rouble union broke away forming their own new currencies. This includes Russia that established a new differently valued rouble for herself. Latvia, for example, did it in two stages. First she created a Latvian rouble, which started at a one to one exchange with the old common rouble. Then she launched a new currency, the lat, to replace the Latvian rouble. It worked and allowed her economy to develop well for the ensuing few years.

The 87 examples I have looked at illustrates that it can be done. More importantly, none of them became disasters warning us not to do it again. In most cases the transition was smooth. Where there were frictions there was little protest, as the people affected by the changes were usually keen to have control over their own currencies. If people feel they are more in control of the decisions, they will be less critical of the situation, recognising that they are free to make mistakes as well as to succeed.

The history of currency unions shows they work best where they are part of a wider political movement to create a single country or political union. A currency is usually an expression of common purpose and a common culture. Notes and coin are decorated with symbols and national figures that mean something to the users of the money. Breaking them up is easiest where they are broken into country sized units, backed by people and political institutions that feel capable of self government. Countries like Greece and Portugal are in that position. Recreating the old currencies of Europe, or creating some new ones for countries that do not fit comfortably into the Euro scheme, is possible. This paper has shown how it can be done technically.

Bibliography

The best sources to understand the legal and financial structure of the Euro and its supporting constitution are the European Central Bank and the European Commission's websites. These contain the essential background Treaties and Regulations, much of the history of the project, and up to date texts of the latest changes. The Bank of International Settlements, along with the ECB provide numbers on the banking systems and money supply. I have also relied on a printed copy of the Consolidated Treaties of the European Union for my discussion of the legal challenges in splitting the currency.

All of the Quotations from the Treaties come from the latest Consolidated version. The references to the workings of the ECB are sourced from the ECB website and publications. The assertions about the attitudes of the German, French, and Italian governments are derived from recent public statements of their leaders. The Commission's position has been derived from their website.

There are many books of commentary. These include:

R Baldwin and C Wyplosz The Economics of European Integration
A Browne   The Euro Yes or No
Buti and others The Euro (Cambridge University Press)
J Lanchester   Whoops
J Levin A Guide to the Euro
D Marsh The Euro – The Politics of the new global currency
J Redwood Our currency, our country (Penguin London)
J Redwood Just Say No
J Redwood Superpower Struggles
J Redwood The Death of Britain?
H Scheller The European Central Bank