



Leaving the euro: An emergency exit for the currency union?

The euro does not provide its members with any option to leave. This protects the common currency against speculative attacks on the one hand. The euro crisis demonstrated on the other hand how difficult it is for Eurozone countries to constructively solve economic and fiscal policy conflicts among themselves. Why was the euro designed as a one-way street? What would be the consequences of an exit option? And what alternatives are there to an exit?

Why was the euro designed as a one-way street?

The European Treaties stipulate that the introduction of the euro is irreversible. There is no option to leave. That is in line with the core logic of the EU where peace is founded upon economic exchanges; such exchanges upon one common market; and the common market in turn upon the fact that the member states do not create any unfair advantages in trade by intentionally weakening their currency.

The departure of a country from the Eurozone would destabilise the entire currency union. Additional departures and thus related losses on euro-denominated financial assets would suddenly be possible. The currency union would hardly be more credible than a → **system of fixed exchange rates**. Capital market participants would find it enticing to flee from crisis countries and bet on further exits.

The euro crisis showed, however, that irreversibility also raises problems. It can be difficult for members of the currency union to escape an economic crisis. A Eurozone country cannot devalue its currency so as to sell its own products more cheaply on the global market. What's more, it cannot pursue a monetary policy

tailored to its needs in order to stimulate investment. Instead, a Eurozone country in a crisis often has no other option than to drastically reduce wages and make its exports more attractive that way. The population suffers from this “internal devaluation”.

The dilemma: National sovereignty is difficult to combine with European stability. What is to be done if a Eurozone country does not recover and the population grows tired of cutting back and implementing reforms under → **European Stability Mechanism (ESM)** programmes? On the one hand, a sovereign country would understandably like to freely choose its economic policy. On the other, a country cannot obligate other Eurozone countries to cover the costs of these decisions. This is why – despite all the risks – it has been repeatedly discussed whether the currency union needs an exit option.



System of fixed exchange rates

An agreement among states to keep the exchange rate between currencies at a pre-fixed level. If financial markets view this rate as too high or too low, the central bank has to stabilise it by buying or selling currency. However, persistent pressure may force the central bank to abandon the exchange rate.

European Stability Mechanism (ESM)

The ESM is a financial institution that is controlled by the Eurozone countries. It allows for individual countries to be supported through loans if they risk to become illiquid. The ESM can lend up to 500 billion euro, with 373 billion euro still available.



„L'euro è irrevocabile. The euro is irreversible. Questo è il trattato. This is the Treaty.“

Mario Draghi, President of the European Central Bank in a hearing at the European Parliament on 6 February 2017



“In case, debt sustainability and a credible implementation perspective cannot be ensured upfront, Greece should be offered swift negotiations on a time-out from the Eurozone, with possible debt restructuring, if necessary, [...] over at least the next five years.”

German Federal Ministry of Finance
in a position paper on 11 July 2015

How has the Eurozone handled possible exits?

At the start of the euro crisis, all Eurozone members were in agreement that there could be no exit option. Instead, the Eurozone set up bailout funds such as the ESM for countries in crisis, with these programmes providing bridging loans in return for budget consolidation and extensive economic reforms. During and after the crisis, however, debate has raged on what level of budget cuts is appropriate and on whether leaving the currency union might be the lesser evil in some cases.

The choice between implementing painful reforms and leaving the euro has been too much for national democracies. This was seen most clearly in the case of Greece where a clear majority of the people voted to reject the EU bailout in 2015. At the same time, however, two-thirds of Greeks wanted to remain in the euro. Other European governments rejected a haircut for Greek debt, pointing out that they had a democratic mandate of their own. Consequently, the will of

the people could not be implemented simultaneously everywhere. The Greek government ultimately decided to stay in the Eurozone by accepting the conditions of the ➔ **Troika**.

The absence of any official exit option has held the Eurozone together.

There is no obvious way to kick a country out of the common currency and the European Treaties foresee no euro exit without an EU exit. Since there was no clear political and legal framework, the European Central Bank took on a key role in the crisis: It could have cut off Greek banks from the supply of money, which would have forced the government to introduce a ➔ **parallel currency** and thus effectively leave the euro.



Troika

Name for the representatives of the European Commission, the IMF and the ECB who negotiate the joint bailout programmes with countries in crisis and check compliance with reform requirements. If the ESM is included, one may refer to a Quadriga.

Parallel currency

If a state introduces a parallel currency in an economic crisis, for example by issuing government-backed IOUs, it can settle its liabilities domestically and control the money supply. A new currency could freely devalue vis-à-vis the euro and would make exports more competitive, but this would also lead to a sharp rise in inflation.



“There is no such thing as temporary Grexit, there is only a Grexit or no Grexit. There is Greece in the euro zone or Greece not in the euro zone. But in that case it’s Europe that retreats and no longer progresses [...]”

François Hollande, President of the Republic of France according to the news agency Reuters on 12 July 2015



“I will demand from the EU that we gain control over our currency. That means converting the euro from a single currency to a common currency. A currency that does not affect daily purchases, but only the large companies that engage in international trade.”

Marine Le Pen, Chairwoman of the French party Front National in Le Parisien on 30 April 2017

EURO EXIT

EUROPA
briefing

A look ahead



SCENARIO 1

Disorderly exit

If there are insurmountable differences of opinion between a Eurozone country in a sovereign debt crisis and the rest of the currency union, a disorderly exit is conceivable. The ECB can in effect exclude a highly indebted country from the euro by refusing to accept its government bonds as collateral. In this case, the affected country's financial system would collapse. Either as a reaction to this situation or of its own accord, a state may introduce capital controls and a parallel currency.

There are doubts as to whether such an exit scenario is realistic: For example, a parallel currency would have to be printed secretly, the capital controls monitored perfectly, and the population forced to use the new currency. Even more difficult, however, is the question of who would be authorised to make such a decision without a democratic debate. This is because as soon as an exit is publicly considered, a massive flight of capital begins since companies and citizens fear the devaluation of their assets. This requires an immediate reaction: Either the state blocks the transfer of money overseas and thus takes the first step toward leaving the currency union or it puts an end to the exit discussions and seeks greater support from the ECB.

SCENARIO 2

Exit as threat

If the Eurozone sticks to the path of compromise between European stability and national sovereignty that it pursued during the crisis, the option of exclusion could continue to be used as a vaguely defined threat. If a country faces potential default, it negotiates with the Troika to set up a conditional lending programme.

A failure of the programme is a risk for all participants since the consequences are unclear and potentially far-reaching. The bailed-out country fears immediate economic collapse, while the other Eurozone countries worry about the crisis spreading to more member states. Therefore, controversial negotiations repeatedly lead to a compromise. At the same time, however, the population in the crisis country has no democratic choice on the content of any reform programmes.

It is in the short-term interest of many Eurozone countries to preserve the status quo. This allows them to avoid an official exit option and nonetheless prompt countries at risk to introduce reforms. There are two risks in the medium term, however: First, the current approach strengthens euro-sceptical movements. Second, no precautions are taken to handle the event that a country decides, against expectations, to refuse a bailout programme.

SCENARIO 3

Restructuring debt without exit

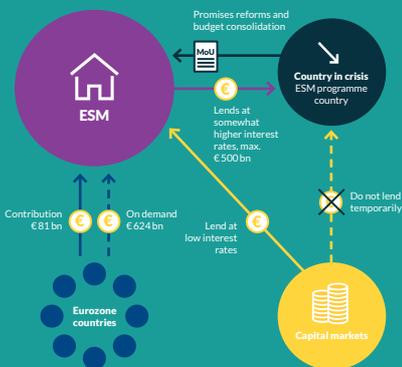
The conflict between sovereignty and stability can also be settled by offering Eurozone countries an orderly insolvency process for their debts without requiring an exit from the currency union. A country in crisis can decide between two options: Either it requires bailout loans and accepts the greater influence of the Eurozone over its economic and fiscal policy for the length of the bailout programme. Or it enters into a kind of insolvency process that entails very hard cut-backs over the short term, but the country maintains control over its economic policy.

In the past, a restructuring of debt was inconceivable. It was feared the European financial system was unequipped to handle the resulting losses, and financial markets would lose confidence in all euro-area sovereign debt. A new insolvency process would have to be accompanied by institutional reforms that strengthen the resilience of banks and credibly demonstrate that the Eurozone can protect each of its members if a country wants to.

This scenario requires a strong central decision-making body such as a European finance minister who would in turn have to come under strict democratic control. To date, not all Eurozone countries are ready to transfer such competences to the EU. At the same time, however, sharing sovereignty at the European level would restore member states to a position where they can again decide autonomously upon their economic policy.

FACT #1

Euro bailout fund: How does the ESM function?

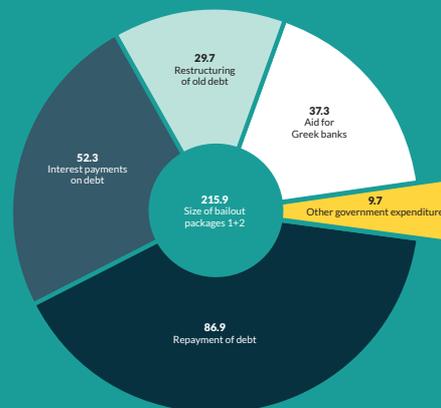


The solvency of the European Stability Mechanism (ESM) is guaranteed by all Eurozone countries. This allows it to borrow money under better conditions and lend it to countries that do not have access to the capital markets themselves on account of a crisis.

Source: Author's representation.

FACT #2

What is the money from the bailout packages used for? The example of Greece, in billion euro



A majority of the funds that Greece received in the first two European bailout packages went to private and public sector creditors. Only ten billion euro was used for classical government responsibilities such as investments, salaries or pension payments.

Source: Author's graph based on Jörg Rocholl, Axel Stahmer (2016): Where did the Greek bailout money go? ESMT Working Paper WP-16-02.

FACT #3

System of fixed exchange rates vs. currency union

	System of fixed exchange rates	Currency union
Characteristics	Is the exchange rate irreversibly fixed?	✗
	Is there only one central bank and monetary policy?	✗
	Do national currencies continue to exist?	✓
	Is an exit possible at any time?	✗
Effects	What is the most important economic effect?	Promotes trade
	How are economic imbalances resolved?	Through reforms or exit
	What is the greatest challenge?	Credibility
	What determines the stability of the system?	Central bank currency reserves

Although a system of fixed exchange rates and a currency union pursue similar goals, they differ in important regards. A system of fixed exchange rates limits its members less, but is more susceptible to speculative attacks.

Source: Author's representation.



"A euro exit does not permanently resolve either debt or economic problems. The governments of Eurozone countries only damage themselves when they regularly play off their national democratic mandates against each other. Instead, Europe needs to legitimise the governance of the common currency democratically on the European level, even if that is very difficult."

Jörg Haas
The author is a Research Fellow at the Jacques Delors Institut - Berlin.

EUROPA

briefing

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Project team

Prof. Dr. Henrik Enderlein

Director,
Jacques Delors Institut – Berlin,
Vice President and Professor
of Political Economy,
Hertie School of Governance

Joachim Fritz-Vannahme

Director,
“Europe’s Future” programme,
Bertelsmann Stiftung

Dr. Anna auf dem Brinke

Research Fellow,
Jacques Delors Institut – Berlin

Sabine Feige

Project Assistant,
“Europe’s Future” programme,
Bertelsmann Stiftung

Dr. Katharina Gnath

Senior Project Manager,
“Europe’s Future” programme,
Bertelsmann Stiftung

Jörg Haas, Author

Research Fellow,
Jacques Delors Institut – Berlin

Heidi Marleen Kuhlmann

Project Manager European Politics
and Communication,
Jacques Delors Institut – Berlin

Max Emanuel Mannweiler

Project Manager European Politics
and Communication
Jacques Delors Institut – Berlin

Katharina Späth

Project Manager,
“Europe’s Future” programme,
Bertelsmann Stiftung

Philipp Ständer

Research Fellow,
Jacques Delors Institut – Berlin

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Bertelsmann Stiftung
Carl-Bertelsmann-Straße 256
33311 Gütersloh, Germany
Tel. +49 5241 81-81183
www.bertelsmann-stiftung.de

Jacques Delors Institut – Berlin
Pariser Platz 6
10117 Berlin, Germany
Tel. +49 30 467 260-905
www.delorsinstitut.de

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ETC Europe scrl, Brussels

Edit
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ressourcenmangel
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Persons responsible according to
the German Press Law
Prof. Dr. Henrik Enderlein,
Joachim Fritz-Vannahme