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The Economist

The costs of break-up

After the fall

The aftermath of disaster is all the more frightening for being incalculable

Sep 17th 2011 | from the print edition

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THE costs of efforts to save the euro are justified by the claim that the alternative would be too dreadful to contemplate. But economic history is littered with examples of fixed exchange rates that came unfixed; the disuniting of currency unions, though rarer, happens from time to time. So how do the costs of sustaining the euro compare with the costs of its falling apart?

The question does not have a simple answer. For a start, there are lots of different ways to fall apart: a wholesale dissolution into the original currencies; a fissioning into northern hard-currency and southern soft-currency blocks; or the exit of a trickle of countries, or just one. Further complexities come from the panoply of choices the departing and remaining states would make after the fall. And all this turns as much or more on law and politics as on economics.

Take two specific scenarios. Germany could leave, either on its own or with a select group of small economies—Austria, Finland and the Netherlands—as recently suggested by Hans-Olaf Henkel, a former head of the Federation of German Industries. Second, and more likely, Greece might secede or be forced out.

In each instance, the economic consequences could be devastating, argue many analysts. If Germany were to leave, its Neue Deutschmark would soar as international funk money piled into a bigger, better Switzerland, and German manufacturing firms would suffer. German banks could cope with the switch of domestic deposits and loans into the new currency, but they would have to be recapitalised because their foreign assets in euros would now be worth less in domestic terms.

If Greece were to leave, its reborn drachma would plummet—which might be good for its exporters but which would trigger what Barry Eichengreen, a monetary historian at the University of California, Berkeley, has called "the mother of all financial crises". The devaluation of the drachma against the euro would turn any debts that remained in euros into a crippling burden. At the same time depositors, who are already edging towards the exit, would break into a headlong rush, bringing down Greece's banking system.

A recent study by economists at UBS, a Swiss bank, suggested that the costs in each of these

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eventualities would be forbiddingly high. If Germany were to leave, it would incur costs worth 20-25% of GDP in the first year and then roughly half that amount in each subsequent year. If Greece were to quit, the first-year cost would be 40-50% of GDP, and subsequent annual costs would be around 15%.

Such costs dwarf the one-off expense to Germany of bailing out Greece, Ireland and Portugal were they to default. But the report is based on the extreme assumption that countries leaving the euro would have to leave the EU. There is a legal argument for this position, but politics would almost surely trump it. It would not be in the broader interest of Europe to have an embittered neighbour in the eastern Mediterranean, or to cut Germany adrift. European policymakers would be hellbent to conserve the single market rather than immolate it in the bonfire of the euros. This suggests that the economic impact of a break-up would be less catastrophic than envisaged by the UBS economists.

Don’t cry for me, Athena

What of the lessons of history? Currency unions tend to collapse as part of a broader political break-up. The rouble area did not long outlive the Soviet Union; the monetary union of the Czech Republic and Slovakia lasted only a matter of weeks. Such situations do not offer obvious parallels. But there may be an instructive precedent for Greece in Argentina’s severing of the peso’s link with the dollar during the debt and currency crisis of late 2001 and early 2002. Argentina had established something close to a monetary union with the United States in 1991 when it fixed its currency to the dollar, backing the link through the foreign-exchange reserves of a currency board. Its experience in the ensuing decade was disconcertingly similar to Greece’s after it joined the euro in 2001. Both countries initially thrived but suffered a deterioration in competitiveness and in their public finances. The recent plunge in the Greek economy echoes the one in Argentina before it defaulted on its debt and devalued.

That crisis was bloody, including limits on bank withdrawals—the *corralito*—and big losses for depositors and banks as their assets and liabilities were redenominated, each at a different exchange rate, but it proved to be a turning-point (see chart). After a further slide in output Argentina grew by 9% in 2003, and carried on at around that rate until checked by the financial crisis of 2008 and global recession of 2009 (it is currently growing at close to 10%). The resurgence in national prosperity, helped by booming global demand for agricultural commodities, has occurred despite the fact that rancorous disputes over the default have kept the country shut out of international capital markets.

That may appear an encouraging portent for Greece, if it were forced to leave the euro. Rather than the protracted process of forcing down wages to regain competitiveness, the devaluation would be a prompt remedy. Moreover, the vast bulk of Greece’s bonds are written under local law, which gives it a more-or-less-free hand to impose a much bigger haircut than the trim being planned. That will no longer be the case if the currently proposed debt exchanges go through; the new contracts, written under English law, protect investors a lot more.

But the Argentine precedent shows just how savage the crisis can be; massive social unrest, a sequence of toppled presidencies, and so on. And Greece’s crisis would be worse. For one thing, the distortions, such as a burgeoning current-account deficit, that Greece allowed to build up in the good times far exceeded Argentina’s. And on top of blocking bank withdrawals

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and imposing capital controls Greece would also face the massive problems of introducing a new currency in the form of new coins and notes and procedures. Everything from computers to parking meters would need to be recalibrated; a thousand new hassles would make an already dire situation worse.

But the real worry, for investors and European leaders alike, is that a Greek departure could trigger panic elsewhere, with runs on banks in Portugal and Ireland and maybe Italy and Spain. Greece is far more fully integrated into the rest of Europe's finances than Argentina was into anyone's. Though the euro area may have proved a disappointment in economic integration, financial integration has gone apace—which now proves the opposite of a consolation. The euro zone offers scope for contagion, and confusion, on an epic scale. That is what makes its crisis so troubling—and so hard to treat.

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Briefing

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