The Economist

Search Economist.com

Welcome
My account
Log out
Manage my newsletters

Subscribe today and get 4 FREE trial issues

Tuesday December 29th 2009

Site feedback

Home
This week's print edition
Daily news analysis
Opinion
All opinion
Leaders
Letters to the Editor
Blogs
Columns
KAL's cartoons
Correspondent's diary
Economist debates
World politics
All world politics
Politics this week
United States
The Americas
Asia
Middle East and Africa
Europe
Britain
Special reports
Business and finance
All business and finance
Business this week
Economics focus
Management
Economics A-Z
Business education
All business education
Which MBA?
Markets and data
All markets and data
Daily chart
Weekly indicators
World markets
Currencies
Rankings
Big Mac index
Science and technology
All science and technology
Technology Quarterly
Technology Monitor
Books and arts
All books and arts
Style guide
People
People
Obituaries
Diversions
Audio and video
Audio and video library
Audio edition
The World In
The World in 2010
The World in 2009

Special report

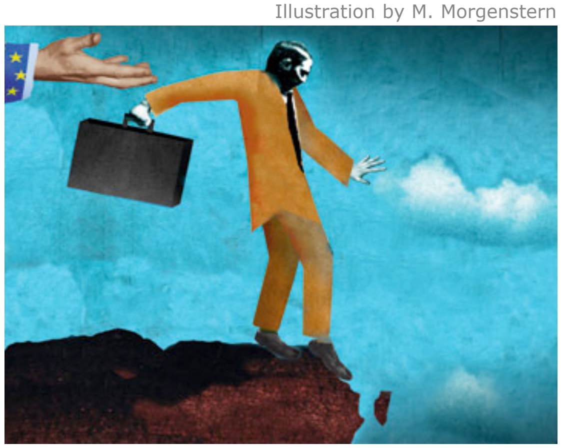
A special report on the euro area

No exit

Jun 11th 2009
From *The Economist* print edition

Staying in the euro will be tough for some members, but leaving would be too awful to contemplate

Illustration by M. Morgenstern



IN THE weeks following the collapse of Lehman Brothers last September the number of euro banknotes in circulation suddenly increased. Fears about the rickety state of banks had made many people mistrustful of keeping money on deposit. Far safer to keep cash stuffed under a mattress. The more discriminating hoarders, it was said, were careful to squirrel away banknotes with serial numbers prefixed by the letter "X", indicating currency issued in Germany. Notes with "U" (French) or "P" (Dutch) prefix were also fine, but those with a "Y" or an "S", issued by Greece and Italy, were shunned.

The logic was that if you were preparing for financial apocalypse, you had better not rely on the euro area surviving intact. In fact, banknotes are a shared obligation of all euro-zone members, no matter where they are printed. If the issuing country were to leave the single currency, a five-euro note would still be worth five euros, whatever the serial number. However, interest-bearing debt denominated in euros is a different matter, and bond markets quickly started to sort the Xs from the Ys.

By early 2009 the yield on a

Comment (3)
Recommend (38)
E-mail
Share
Print
Buy PDF
Reprints & permissions

Related Items

In this special report
Holding the euro area together
The euro's tortured history
The euro and its troubles
No euro exit
Euro reform
The euro and the crisis
The euro and the state
Euro positives
Sources and acknowledgments
Offer to readers

Audio
An interview with John O'Sullivan, author of this special report.

Video
Reports on Italy and the euro and Spain and the euro.

More articles about...
The European Union
The euro

Websites
The EU has economic statistics for member states. The ECB and the European Commission both give historical information on monetary union and the euro. See also the Centre for European Policy Studies.

Advertisement

The World in 2008
The World in 2007
The World in 2006
The World in 2005
The World in 2004

Research tools
All research tools
Articles by subject
Economics A-Z
Special reports
Style guide

Country briefings
All country briefings
China
India
Brazil
United States
Russia

My account home

Newsletters and alerts
Manage my newsletters
Manage my e-mail alerts
Manage my RSS feeds
Manage special-offer alerts
More »

Print subscriptions
Subscribe to *The Economist*
Renew my subscription
Change my print subscription delivery, billing or e-mail address
Pay my bill
Activate premium online access
Report a missing copy
Suspend my subscription
More »

Digital subscriptions
Subscribe to Economist.com
Manage my subscription
Mobile edition
Audio edition
Download screensaver
More »

Classifieds and jobs

The Economist Group
About the Economist Group
Economist Intelligence Unit
Economist Conferences
Intelligent Life
CFO
Roll Call
European Voice
EuroFinance
Reprints and permissions

EIU online store

Economist shop

Advertisement

ten-year Greek government bond was almost twice that on a comparable German Bund. The spread over Bunds for Italian, Spanish and Irish bonds also widened dramatically before narrowing again more recently. One explanation was that in skittish markets Bunds were prized for their extra liquidity. Another was that the bond-trading arms of bombed-out banks were less willing to make markets in the issues of small countries, such as Greece and Ireland, which left their prices unmoored.

But at least part of the rise in spreads reflected concern that countries might find it hard to pay back their borrowings. The government bonds of Greece, Ireland, Portugal and Spain were all downgraded a notch by credit-rating agencies. For some, bond spreads are a crude gauge of the risk that the euro will break up. If a euro-zone member were shut out of capital markets and had to default on its debt, it might be tempted to use the opportunity to recreate its own currency and devalue. In that event, creditors could be forced to convert their bonds into claims in a new currency at a discount linked to a new exchange rate against the euro. Default would be one way for countries to free themselves from the euro's shackles—or, to look at it from the opposite point of view, for the euro zone to rid itself of troublesome members.

A game of consequences

That kind of thinking, however, is found mostly among those who were doubtful that the euro would ever get off the ground in the first place. It is rare in countries seen as candidates for exit. As Eurocrats in Brussels are keen to stress, far from breaking up, the euro zone is growing. Since its launch it has taken on five new members, and more are queuing to join.

The costs of backing out of the euro are hard to calculate but would certainly be heavy. The mere whiff of devaluation would cause a bank run: people would scramble to deposit their euros with foreign banks to avoid forced conversion to the new, weaker currency. Bondholders would shun the debt of the departing country, and funding of budget deficits and maturing debt would be suspended.

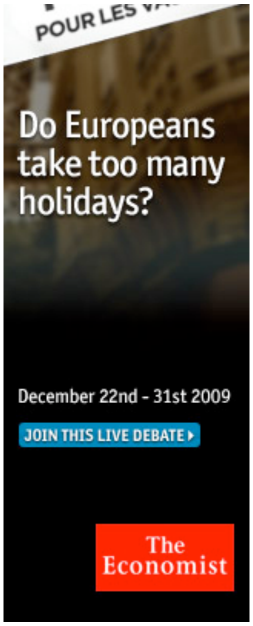
Changing all contracts in euros—bonds, mortgages, bank deposits, wage deals and so on—to the new currency would be a logistical nightmare. The changeover to the euro was planned in detail and the exchange rate was fixed in advance, in co-operation with all the euro members. The reverse operation would be nothing like as orderly, not least because the exchange rate would be a moving target.

If businesses converted their debts to a weaker currency, that might constitute default and trigger legal challenges. If they stuck to their covenants, they would have to service their euro debts from earnings in a weaker currency. That would hurt firms which rely mostly on profits from their domestic market. The convulsions would be felt by other euro-area members too. The writedown of the departing country's government bonds might threaten the solvency of banks in the rest of the euro zone. Around half of Italian government bonds, for instance, are held outside Italy. Other euro-area members could suffer contagion as markets bet on further defaults.

If the act of leaving would be hard, the aftermath might be even harder. A country that forced bondholders to take a loss would be punished. Continued access to bond markets would come at a high price. Investors would ask for a huge premium to cover the risk of further default. On that count alone, borrowing costs would be far higher than they were within the safer confines of the euro area.

Investors would have to protect themselves from two further risks: exchange-rate volatility and inflation. A former euro member would have to reinvent its own monetary policy and would struggle to convince investors that it could keep a lid on inflation. One of the euro's big attractions was that it offered many countries a shortcut to a credible monetary set-up. Devaluation could itself trigger a wage-price spiral. For high-debt countries, such as Greece and Italy, the interest rates demanded by markets to insure themselves against such risks would be ruinous.

And even though the costs are likely to be heavy, the immediate benefits might



prove only transitory. A devaluation is a proxy for a national pay cut: it helps exporters but makes consumers of imports poorer. Workforces would put up strong resistance to being paid in a weaker currency. In countries such as Greece and Ireland, whose exports contain a lot of imports, a devaluation would push up inflation. And where a large proportion of wage contracts is indexed to prices, as in Spain, higher inflation would rapidly work its way through to wages.

The wrong cure

An exit from the euro would not tackle weak productivity growth and inflexible wages, which are the root causes of low competitiveness. In time, further devaluations might be needed. Countries with high debts and a history of poor macroeconomic management would be most tempted to leave. But these are also the countries most likely to be hurt.

A more plausible, though still unlikely, scenario would involve a breakaway by a group of low-debt and cost-competitive countries, centred around Germany. Members of a new, "hard" European currency would leave behind a stock of depreciating euro debt and might be rewarded by lower borrowing costs on debt issues in the new currency. Yet a large part of the appeal to Germany of the single currency has been that it rules out revaluations and rewards its firms for being competitive. Germany, France and the rest have too much invested in the success of the EU and the euro to put it at risk. As Daniel Gros of the Centre for European Policy Studies, a Brussels think-tank, puts it: "The weak can't leave and the strong won't leave."

Readers' comments

Readers have commented on this article (the window for new comments is now closed).

View all comments (3)

Next article »

Advertisement

Classified ads

Office of Fair Trading
Non-Executive Directors
London

Who's Who 2010 out now
Information on 33,000+ people of influence, interest and distinction in society today. New names for 2010: Roger Federer, Paulo Coelho, Matthew Brittin and Martin Lewis.

Università Bocconi: Economics and Management Education since 1902.

- Bachelor
- Master of Sciences
- PhD

Download your Welcome Kit!

Standard Chartered PLC
Senior Manager, Thought Leadership

Explore Poland's investment opportunities

MBA-DBA-PhD FRANCE, US, JAPAN, CHINA
Boost your career with accredited Diplomas at ISM
Flexible schedules
Part-Time Study
Worldwide

Sponsor's feature

About sponsorship

Copyright © The Economist Newspaper Limited 2009. All rights reserved. Advertising info Legal disclaimer Accessibility Privacy policy Terms & Conditions Help