Can the Euro Area Hit the Rewind Button?

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July 23, 2011

With benefit of hindsight, it is easy to conclude that Europe's leap to monetary union was a mistake. Creating a single currency without also creating a single bank regulator, an emergency lender, and a credible set of fiscal rules gave Europe a common monetary house without a foundation. Europe acquired shiny coins and elegant banknotes but not the other elements of a workable monetary union. The need for these other elements may have been understood, but the national governments participating in the monetary union refused to cede sovereignty over their banking, financial and fiscal policies. Now they are paying the price.

Their error was compounded by opting for a large monetary union not limited to Northern Europe but including also the "Club Med countries": Italy, Spain, Portugal and Greece. How anyone could have expected these highly indebted, deficit prone countries to cohabit monetarily with their fiscally rigorous Northern European neighbors was never clear. Some policy makers presumably imagined that the Southern European countries would magically acquire Northern European habits. Or that, blessed with hard money, they would grow so fast that their heavy debt loads would disappear. As recent events remind us, such hopes were less than realistic.

So if Europe committed a grave mistake, shouldn't it acknowledge the fact and move now to unwind the project? Harvard's Martin Feldstein suggests that Greece should take a "temporary sabbatical" from the euro. Otmar Issing, former chief economist of the ECB, suggests that the country should leave the euro area permanently. Others suggest splitting the area in two, creating separate Northern and Southern European euros so that the two regions can have different monetary policies. Still others suggest that, given the continued reluctance of euro area countries to pool their sovereignty, it is time to acknowledge defeat and go back to national currencies.

What the advocates of abandoning the euro don't understand is that there are circumstances where history can't be run in reverse. There are cases where it is not possible to simply hit the rewind button. In practice some policy changes are irreversible. And, more likely than not, the creation of the euro is one of these.

This is what I concluded back in 2007 when I was commissioned by the U.S.-based National Bureau of Economic Research to study scenarios for the possible breakup of the euro area. While acknowledging that a breakup was not impossible, I concluded that it was exceedingly unlikely, given the technical, political and above all economic obstacles.

Consider what would happen if word got out that Greece was considering reintroducing the drachma. Everyone would understand that the new drachma was set to depreciate against the euro. The very point of reintroducing it would be so that Greece, mired in a deep recession, could have a looser monetary policy.

Depreciating the drachma would also be a way of making Greek exports more competitive. In the past, foreign banks and investors were willing to lend Greece money hand over fist. Now that they have awoken to the fact that the country has problems, that foreign finance has dried up. Where it once could run a large current account deficit, Greece now has to balance its external accounts. It can do so by compressing domestic spending, including on imports, which means continued recession. Or it can do so by exporting more, which will require lower costs. This is why some people advocate reintroduction of the drachma – so that it can be depreciated against the euro in order to help jump-start Greece's recovery.

Imagine that Greek policy makers began to discuss this option. How would investors respond? It would not require a Ph.D. in economics to understand that the savings of Greek residents were about to be converted into drachmas that would soon lose value against the euro. Investors would thus respond by transferring their Greek bank deposits to Germany. All of them. On the first minute that word got out that the government was discussing the possibility. Investors would sell their Greek stocks and bonds, for the same reason. This would be a full-fledged financial panic. It would be a full-out bank run. It would be the mother of all financial crises.

Greece would have to close down its banking system until order was restored. It would have to suspend trading on its financial markets. It would probably have to seal its borders to prevent residents from ferrying cash out of the country. Being forced to take these steps would not exactly enhance the reputation of the politicians forced to take these emergency actions as a result of their own prior discussions.

All this could be avoided, you might say, if the decision was taken in secret and announced as a fait accompli. Residents would wake up one morning and be told that their euro stocks, bonds, cash and bank deposits had all been converted into drachma. End of story.

But it is not a plausible story. This scenario might be possible in a dictatorship but not in the world's oldest democracy. The decision to abandon the euro would require a parliamentary debate. That debate would take time to conclude. But as soon as the existence of that parliamentary debate became known, all hell would break loose in financial markets. And that prospect, in and of itself, is a formidable disincentive to having the debate in the first place.

Moreover, once Greek banks and financial markets were shut down, they would have to remain shut for an extended period. Reintroducing the drachma entails more than just issuing drachma banknotes or over-stamping the euro banknotes circulating in the country with a big blue "G." The banks' computers will have to be reprogrammed. This will not be a straightforward process. While bank deposits will have to be converted, some of the banks other balance sheet items, like their borrowings from foreign banks, will remain in euros. Other financial firms doing business in the country will similarly have to update their electronic systems.

The changeover will also require completing other more mundane but equally important tasks in order to keep the economy going. Not least, the machines at which motorists pay for their parking will have to be reprogrammed to prevent their cars from being locked into subterranean garages. In all, reintroducing the national currency will be a logistical nightmare.

Recall that it took two years, from 1999 to 2001, to prepare euro for the introduction of physical euro notes and coins. The switch back could probably be done more quickly. But banks and financial markets would have to stay closed for the duration. Again, this is not a state of affairs that a government would be rewarded for provoking.

So I concluded in that article four years ago that abandoning the euro was out of the question because a country even considering whether to do so would inflict upon itself a massive banking crisis and have to close down its banking system. What I failed to imagine was that a modern European country could have that kind of banking crisis for entirely separate reasons, like a self-inflicted debt crisis, and that it might forced to close down its banking system anyway. If Greece experienced a bank run for other reasons and was forced to declare a bank holiday, in other words, why not use the occasion to reintroduce the drachma?

This is a logically correct argument. It is why where once I regarded the probability of a country abandoning the euro as essentially zero, I now attach a positive probability to the event.

But I still think the probability is very low. If there were signs of a bank run breaking out in Greece, creating the possibility that the country might have to declare a bank holiday, the Greek government would almost certainly receive support for its banks from its European Union partners and the European Central Bank.

Such support would be in the partners' self interest. Greece declaring a bank holiday and making preparations for abandoning the euro would immediately create expectations that other Southern European countries might follow. These countries would experience bank runs and financial panics of their own, requiring the ECB or the EU's newly created financial fire brigade, the European Financial Stability Facility, to support their financial markets and guarantee their bank deposits. It would be better, or at least cheaper, the Europeans are certain to conclude, to instead provide Greece with additional support so that it can continue down the path of austerity and adjustment and avoid fanning fears about other countries. This, of course is just what the EU decided last week.

Germany is the one country that could contemplate exiting the euro area without precipitating a run on its banks. Since the "new deutschemark" would be expected to strengthen against the rump euro, money would flow into the German banking system, not out.

But German exports would be smashed when the deutschemark went through the roof against the currency of the country's European neighbors. This is why German business remains firmly in favor of the euro, in contrast to the reservations of the typical denizen of a Munich beer garden. The German economic miracle of the last ten years can be summed up in one word: exports. And the country's export competitiveness has been greatly enhanced by a euro exchange rate that has been kept down at reasonable levels by the fact that Germany shares the currency with other weaker economies.

German business also understands that a move to reintroduce the euro would create massive financial crises in other European countries, as individuals there shifted their bank deposits en masse to Frankfurt. More financial crises in other European countries are of course the last thing that German business wants. This is why Germany will, in the end, swallow hard and agree to the higher taxes and transfers to other weaker countries needed to make the monetary union work. It will not do so happily. It will not do so all at once. But it will do so eventually because there is no more attractive alternative.

World War I was a policy mistake. It resulted from a series of strategic miscalculations by the European powers that resulted in a conflict from which no one stood to gain and that no one truly wished to fight. It led to the dismantling of the Austro-Hungarian Empire. It caused national borders to be redrawn, sometimes in counterproductive ways. Even if the decisions leading up to the war were regrettable, these consequences were irreversible. The same is true of the euro. Europe has its monetary union. It now has no choice but to make it work.

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