

WOLFSON ECONOMICS PRIZE 2012

If member states leave the Economic and Monetary Union, what is the best way for the economic process to be managed to provide the soundest foundation for the future growth and prosperity of the current membership?

[Author's Name withheld¹]

¹ Policy Exchange staff can access the author's name by referring to entry e-mail ref: 326065.

Table of Contents

Introduction.....	4
Background	4
Run up to departure.....	5
Secrecy.....	6
Exit types	7
Key considerations in planning an Exit	7
Planning is essential – the Task Force must be formed (and its existence denied).....	8
The Task Force’s key considerations.....	9
Exit – the run-up	9
First priority – preventing a European, and therefore global, banking collapse	9
Winners and losers.....	10
Euro banknotes – identifiable by country-issuer	11
Minimising windfall gains and losses.....	13
Redenomination uncertainty	14
Why should the Task Force recommend the abandonment of the Euro ?	15
Exit without Euro abandonment	16
The ECB – a major systemic risk	17
Why does the ECB/ESCB have such a large balance sheet ?.....	19
ECB on Exit.....	20
European Financial Stability Facility (EFSF).....	21
National Central Banks	22
Conduct of monetary policy	22
Lender of last resort.....	23
Exit/transition timetable.....	23
Task Force activation.....	23
Immediate aftermath – the first week	26
Notes and coins	27
Bank and savings accounts	28
Mortgages.....	28
Credit card debt and personal loans.....	28
Pensions and insurance contracts.....	29
The individual’s perspective	29
The business perspective.....	30

Multinational companies	30
Exporting & importing businesses	31
Local businesses	31
Constitutional and legal questions	31
A German-only back-up plan.....	32
Short-term disaster planning and avoidance	33
Future political, economic and financial health.....	35
What does success look like for announcement phase ?.....	35
Stability, growth and future prospects	36
Argentina	36
Argentinean and Greek parallels	38
Fiscal discipline	39
Trade and the EU	40
Post-Exit exchange rates	40
New Europe	41
Summary and Conclusion	41

Introduction

This essay will consider the wide-ranging implications of the putative exit from the Euro of one or more current member states. It proposes a plan to minimise the inevitable disruption and maximise the chances of future growth and prosperity.

It will not consider the likelihood of this event (since the essay title has made this the pre-existing condition). It will look in detail at the timelines that an exit might exhibit; critically, and in detail, at the implications on the financial infrastructure of such an event; at the legal questions and the ambiguities that will inevitably arise, and at the economic and financial implications in the immediate aftermath. It will not present a detailed longer-horizon analysis of the post-exit economies, except where it appears relevant to the central question.

Background

Almost every contemporary reader will be familiar with the background to this essay's central question. However, for future readers, or those small number who are unfamiliar with the background, I will summarise a very brief history of Europe's Economic and Monetary Union (EMU) up to the end of 2011.

EMU was first formally countenanced in the Single European Act of 1986, and set out in more detail in the Delors Report of 1989. The path to EMU was formally agreed at the Maastricht Summit in 1991 (signed, after some delay, in 1993), at which three stages (I, II & III) were planned, stages I & II heralding convergence to ultimate monetary union (stage III). Maastricht was signed by all the twelve member states at the time, although the UK and Denmark negotiated separate EMU opt-outs. Three further new member states joined in 1995, and they signed up to EMU by default – since the EU's constitution is the sum of its pre-existing Treaties. Maastricht imposed four criteria for member states entering stage III (full ERM membership – i.e. adopting a currency initially called the ECU but later (1995) called the Euro). These were:

1. **Inflation** – no higher than 1.5% p.a. above the average of the lowest three countries
2. **Fiscal Prudence** – Annual Government deficits not to exceed 3% of GDP; outstanding Government debt not to exceed 60% of GDP
3. **Exchange Rate** – Member states to have had two years' membership of the Exchange Rate Mechanism (and no devaluations in the period)
4. **Long-term Interest Rate** – Member states to have long-term interest rates no higher than 2% above the average of the three lowest inflation countries (i.e. those in (1) above).

Writing in early 2012, these criteria look rather quaint now. Interestingly, the first, second and fourth criteria have been largely forgotten; but the fiscal prudence criteria, formally referred to in the Maastricht Treaty as the *Excessive Deficit Procedure*, have lived on rather notoriously.

The various negotiations that took place between December 1995, when the new currency's name was changed from the 'ECU' (in the Maastricht Treaty) to the 'Euro', and May 1998,

when the initial membership and exchange rates to the Euro were decided and announced, are important because they sowed the seeds of the Euro's current travails.

The decision made on 3 May 1998, to admit eleven states to membership (the missing four being UK & Denmark with an opt-out; Sweden who "didn't qualify"² and Greece, who didn't qualify by reason of its excessive government deficit and debt). The market was genuinely unsure before the 3 May meeting whether Italy, who missed the outstanding debt criterion of 60% by a mile (with over 100% debt to GDP ratio), would be allowed to join. The decision to admit Italy, and blatantly flout the rules, turned out to be an accurate pointer to subsequent decisions on admission, and indeed to the policing of existing members. The fig leaf was instructive – Italy was admitted because its ratio of outstanding government debt to GDP was "sufficiently diminishing and approaching the reference value at a satisfactory pace"³. On any objective measure, there was no evidence in 1998 of "sufficient diminution and approaching the reference value" of Italy's outstanding debt⁴.

On 1 January 2001, just two years after the foundation of the Euro, Greece was admitted. There was little fanfare, and the official report which lifted the excessive deficit procedure for Greece⁵ allowed a great deal of optimism. At the report's own admission, Greece's outstanding Government debt was 104.5% of GDP in 1999 (following 106.3% in 1998). It later turned out that Greece has falsified both these figures, and also the Government deficit figures⁶. But even so, had these figures been correct, it would have taken Greece 25 years to reach the 60% debt reference level if the reduction had continued at the same pace !

There have been five more new Euro members since 2001 – Slovenia (2007), Cyprus & Malta (2008), Slovakia (2009) and Estonia (2011), making a total of 17. All are very small from an economic perspective.

Run up to departure

There are two types of departure possible – planned and unplanned. In some ways this is a continuum rather than a straight dichotomy, and indeed at one level any Eurozone exit is, by definition, unplanned. EMU's architects designed a system in which exit was neither possible nor conceivable. Hence the subject of this essay is dealing with the unpicking of a system which was not designed to be unpicked.

But for practical purposes, it does matter whether there is some time for planning or not, and indeed in the very short term, the difference between a planned and an unplanned exit is fundamental to the path of the crisis and probably the ultimate outcome.

² Failing on the exchange rate criteria. In reality, the Swedes chose not to qualify.

³ Maastricht Treaty; Article 104c; extract from 2(b)

⁴ Italian debt as % of GDP: 1995: 120.9%; 1996: 120.2%; 1997: 117.4%; 1998: 114.2%; Source: Eurostat, General Government Gross Debt as % of GDP (Maastricht definition).

⁵ 2000/33/EC: Council Decision of 17 December 1999 abrogating the Decision on the existence of an excessive deficit in Greece.

⁶ Although the word 'falsification' was never used in Eurostat's 2004 report (Report by Eurostat on the revision of the Greek government deficit and debt figures, 22 November 2004), the evidence on revisions, and the selective and inconsistent use of accounting conventions makes a damning case. As an example, this report shows that by 2004, Greece (at the behest of the EU) had revised its outstanding debt for 1998 and 1999 to 112.4% and 112.3% of GDP respectively.

Unplanned exit is likely to be the result of a major and unstoppable financial or political crisis⁷ which erupts despite the continued protestations of the main players that increasing fiscal integration remains the direction of policy.

I do not propose to dwell on the unplanned exit – by definition, many or most of the recommendations in this essay would not have been heeded or planned for in an unplanned exit.

So I will take as a pre-condition for this discussion that there will be some time, and some remaining discretion, available to the key policy-makers at the heart of the Eurozone. In practice this means Germany, and to a lesser extent France. But like a divorce, one of the most difficult issues to deal with is the consultation necessary between the parties in an environment where one party is making highly unpalatable suggestions (and possibly exercising disputed control) to one or more other parties. The constitution of the EU is not well suited to decision-making in this environment, and indeed one of the key challenges in a crisis period is to maintain the legitimacy (as well as effectiveness) of decision-making. I will address this issue in some detail later.

Secrecy

The exit of one or more Eurozone members is an event which will create classes of instant financial winners and losers. Although one of the principal criteria that I will recommend policy-makers to adopt is to minimise the scale, extent and uncertainty of windfall gains and losses, nevertheless the financial scale of remaining winners and losers will be very large indeed, possibly unprecedented.

As we have already seen in 2010 and 2011, markets are constantly probing and re-evaluating the probabilities and scale of alternative outcomes, and managing their investment and derivative positions accordingly. Planning for an exit which remains as orderly as possible will inevitably require secrecy of a military order. This will be extremely difficult to manage, particularly since there is little appropriate secure infrastructure available. EU Commission staff are neither going to be secure enough, nor be sufficiently well-equipped to design the demise of their own ‘great project’. The ECB suffers the same problem. It seems inevitable to me, therefore, that one (or at most two) countries will have to take the lead in designing the new post-exit order. I will deal with the EU constitutional issues associated with this later.

That country is Germany, and if two are involved, the other is clearly France⁸. I choose Germany because in both reality, and in the eyes of the financial world, it has unwittingly taken on the role of ‘guarantor’ of the Euro project. If it chooses to withdraw from the Eurozone, or fundamentally change the rules, then the other 16 members have little choice but to follow. No other country has such a grip on power within the Eurozone.

The complexities of genuinely secret large-scale planning are such that a two-country project is a major logistical headache, but of course will add to the ultimate legitimacy of the

⁷ For example, the surprise election of an avowedly ‘Exitist’ party to power in one member State; the failure of a sovereign to be able to borrow in the markets or, a military coup in, say, Greece.

⁸ It is of course possible for the planning to involve more countries (say like Netherlands), but since secrecy and speed are paramount, unless significant additional political credibility is to be garnered by extending the involvement beyond Germany and France, then the risks are probably too high.

proposals that emerge. I will not opine further on this issue – I will simply assume that a secret task force will be formed by (at the minimum) Germany, whose job is to plan exit, and ultimately to present a coherent and fully worked-out plan to the EU Council of Ministers. Indeed, it may already have been formed by the date of writing (Jan 2012).

Exit types

There are a surprisingly large number of alternative types of exit possible, and although the purpose of this essay is not to guess which one will emerge, it certainly is to examine which ones are most likely to lead to long-term financial and economic stability. I set out below what I perceive as the full likely set of possible exit types (note that there are in theory many more permutations possible, but I ignore them as materially similar to those listed):

1. Group leaves out of the top (“super Euro”); Euro intact below
2. Group leaves out of the top (“super Euro”); fragmentation below (Euro abandoned)
3. Fragmentation out of the top; Euro intact below
4. Fragmentation out of the top; new group (“Mediterranean Euro”) below (Euro abandoned)
5. Group leaves out of the bottom (“Mediterranean Euro”); Euro intact above
6. Fragmentation out of the bottom; Euro intact above
7. Fragmentation out of both top and bottom; Euro intact in the middle
8. Full fragmentation (Euro abandoned)

Note that ‘fragmentation’ in this context means that one or more countries resume the use of their own National Currency. In the essay, from this point onwards I will use “Exit” to mean any of the above unless otherwise specified.

Interestingly, most Press and other comment has hitherto focused on 6) above. I will discuss this in much more detail later as I discuss the financial and other implications of Exit.

Key considerations in planning an Exit

When the Exit Task Force that I recommend gets to work, it needs to have been given a policy framework (“Task Force Charter”) to guide its practical proposals. Sadly, this Charter will not be available for prior discussion, and the EU will have to depend on the sagacity of the Charter designers for the post-Euro order. On this will turn the success or otherwise of the future path of the EU, and, as in war, one key individual (or very small group) may emerge to show inspirational leadership in this context. But at the Charter design stage, it will all be secret.

I set out below the key goals that I believe the Charter could seek to achieve:

1. Maintenance of liberal democracies in all Eurozone member States

2. The continued existence of the EU⁹ as a voice in the world, and as a force for binding the nations of Europe by trade and mutual interest.
3. The continuation of a European free trade area, without capital controls, within the whole of the current EU (not just Eurozone) membership and EFTA.
4. Future economic & financial health of all Eurozone¹⁰ (and indeed EU) member States as far as is possible. This will require:
 - a. An Exit transition period which succeeds in preserving the integrity of the financial system in each Eurozone Member State. Which will in turn require:
 - i. as much certainty as possible in determining the currency of denomination of all financial instruments and contracts post-Exit, and
 - ii. the minimisation of windfall gains and losses, particularly in the banking system
 - b. An economic framework which provides aligned economic incentives for the future for both member state Governments and their people
 - c. A new European economic and financial order which is widely perceived to be sustainable and resilient in the long-term. It is essential particularly that the markets do not continue to bet on further crises.

Headings 1) to 3) above are political principles which I believe would resonate with the founding fathers of the European Economic Community in the 1957 Treaty of Rome. I will not discuss them further in this essay – I will take them to be in some sense self-evident and capable of commanding wide support. However heading 4) is the practical matter where all the energy of the Task Force in planning and policy will need to be concentrated. The remainder of this essay will concentrate on this heading.

Planning is essential – the Task Force must be formed (and its existence denied)

It takes little thought to reach the following conclusions:

1. Eurozone Exit in some form is possible.
2. If such a risk exists, whatever the desire on the part of the core Eurozone members for further integration within the Eurozone, then some contingency planning must be made.
3. The consequences of a completely unplanned Exit are likely to be catastrophic, and even a full understanding of how catastrophic can only be made in the context of a Task Force.

Hence, this essay's first concrete recommendation is that:

⁹ I suggest later that a name change (to 'New Europe', say) might be appropriate to signal the fundamental change that Euro Exit would bring. This would be the fourth name – the others (in order) were European Economic Community; European Community; European Union.

¹⁰ I.e. the current 17-member Eurozone membership – as per the essay title.

Recommendation 1: Germany (possibly together with France) establishes a secret Task Force, with a Charter to design proposals for planning and managing possible Eurozone Exit. Ideally France would join to give legitimacy – but secrecy and speed is essential, so only a token joint operation may be possible.

The Task Force’s key considerations

Exit – the run-up

The first and overriding requirement of the Task Force is secrecy. Failure to maintain secrecy would almost certainly lead to a complete freeze in the markets, making it impossible to finance Eurozone member States’ deficits or refinance Eurozone member States’ debt. This could create a vicious circle of acceleration before a credible plan was available, which would plunge the Eurozone into an existential crisis, and possibly also overwhelm the ECB in the process. This is the stuff of nightmares.

The risk of secrecy breaking rises with time, hence the next requirement for the Task Force is speed. Speed is in any case essential since many current Eurozone member States (and their banks) require large amounts of financing or refinancing on a continuous basis. This brings me to my next recommendation:

Recommendation 2: Whatever the results of the Task Force’s deliberations, firm plans and proposals should be in place by 30 April 2012, or as soon thereafter as is practicable using all means at the Task Force’s disposal.

It may be that the Task Force’s plans (and indeed the existence of the Task Force) never see the light of day. It may be that the plans only need to be brought to the Council of Ministers in 2015. It may be that they are needed immediately. Whatever the outcome, unless really rapid planning is completed immediately, then the EU (and the World) is at risk of a major financial collapse.

First priority – preventing a European, and therefore global, banking collapse

The Eurozone has created a series of unique problems for the management of an Exit. At the forefront of these is the Eurozone banking system, and their balance sheets which are currently denominated in Euros. No risk-weighting has been made (nor indeed permitted to be made) for currency risk within Euro-denominated assets. The problem is much compounded by the design of the Euro, which in effect denies that assets, liabilities or associated derivative instruments have country domicile. A founding principle of the single currency was that the country of domicile was irrelevant, and indeed often undefined. It is this single act of policy (the “welding shut of the emergency exits”) that has put the whole banking system at such risk. Let’s look at a stylised example: a Bank in a potentially ‘strong’ country, like Germany.

The balance sheet is expressed in National Currency (i.e. Euro pre-Exit, and DEM post-Exit). For convenience let’s assume that the EUR/DEM conversion exchange rate at redenomination is 1:1; and that following Exit, the DEM rises 30% against what’s left of the Euro; and that the Euro survives without Germany. We will revisit all these assumptions later.

Table 1

Example of German Bank Balance Sheet

National Legal Tender Currency, bn

ABC Bank, AG

	Pre-Exit (EUR)	Post-Exit (DEM)
Assets		
<i>Loans to German residents</i>	50	50 [§]
<i>Loans to non-German residents</i>	50	35*
Liabilities		
<i>Deposits</i>	70	70 [¤]
<i>Term debt</i>	25	25 [~]
Equity Capital	5	(10)

[§] Assume that all German residents' debt is converted to DEM

* Assume that the continuation of the Euro means that Euro-denominated debt owed by non-Germans remains in Euros. These loans include non-German sovereign debt and non-German mortgages.

[¤] Assume that all deposits in German branches are redenominated into DEM, irrespective of the domicile of the depositor (which would be difficult to ascertain). I assume this is a largely domestic bank, hence there are no depositors in non-German branches or outside the Eurozone.

[~] Assume that German law requires that Euro-denominated debt issued by German resident companies and banks is fully redenominated in DEM

The upshot of this is that ABC Bank is insolvent, and the extent of its solvency or otherwise is crucially dependent on the redenomination treatment of the various components of its balance sheet.

To the extent that this treatment is under Germany's control, the uncertainty can be contained or eliminated. Indeed, it is likely that all entities operating within Germany, or under German Law, will suffer forced redenomination of all their debt, and also their assets as far as they are under German control. And herein lies the problem. A German bank owning, say, French Government bonds, will not be able to have them redenominated into DEM. They will remain in Euros, or indeed themselves be redenominated into FRF if further fragmentation takes place. So as a general rule, it seems likely that the much or most of liability side of banks' balance sheets will be redenominated at Exit, but that only the domestic element of the asset side will be.

Winners and losers

If underlying Euro-denominated asset values are not changing, and the example German Bank above becomes insolvent, then who, if anyone, gains ?

There are two classes of winner. The first is bank customers.

At the time of writing, it is possible for a Greek resident person to travel to Germany, open an account there at the German branch of a German bank, and deposit any amount of money he can lay his hands on. He might even have increased his mortgage in Greece on his Greek home if he can to give himself some extra liquidity. If the bank chooses not to accept his deposit (unlikely if it is legally obtained), our Greek can simply decide to hoard German-issued Euro notes, ideally (just to avoid any possible exchange controls and subsequent illegality in moving cash across borders) stored in a safe deposit box in Frankfurt.

Euro banknotes – identifiable by country-issuer

It is worth noting, to the surprise of many commentators, that Euro notes are not formally issued by the ECB, but by each member State National Central Bank¹¹. Each Euro note is accordingly marked with a prefix letter according to its issuer as follows:

Table 2

**Serial Number Prefixes for Euro banknotes’
Country of Issue**

Country of Issue	Serial Number Prefix
Estonia	D
Slovakia	E
Malta	F
Cyprus	G
Slovenia	H
Finland	L
Portugal	M
Austria	N
Netherlands	P
Italy	S
Ireland	T
France	U
Spain	V
Germany	X
Greece	Y
Belgium	Z

So a Greek (or indeed any non-German resident) could sort through his or her notes as they acquire them, and pass all non-X prefix notes on to shops or back to the bank, and retain all X

¹¹ Right from the start of the Euro, it was understood that Euro coins would be nationally issued and marked accordingly on one side. However, it was thought at the start of the Euro that Euro notes would be nationally unidentifiable. This turns out to be a great help in an Exit.

prefix notes, perhaps in the safe deposit box in Germany. This is as close to a free financial option that any individual will ever be faced with, since the chance of loss is nil (the cost of holding ‘X’ prefix notes is the same as holding any other prefix banknote), and even compared to a bank account, the lost interest is negligible. The opportunity of gain (even if the probability is small) is very substantial indeed. Similarly with moving wholesale amounts of money via the banking system.

The other winners are likely to be the banking systems of weaker currency countries.

Let’s take the same size Bank as in Table 1, but analyse it as if it were domiciled in Greece. Let’s assume that the Euro survives, and that in Greece there is a new currency, the GRD, for which the official conversion rate is 1:1 (just for convenience). Assume the GRD falls by 60% against the Euro in the market on the first day of trading.

Table 3

Example of Greek Domestic Bank Balance Sheet

National Legal Tender Currency, bn

ABΓ Bank, AE

	Pre-Exit (EUR)	Post-Exit (GRD)
Assets		
<i>Loans to Greek residents</i>	50	50 [§]
<i>Loans to non-Greek residents</i>	50	125*
Liabilities		
<i>Deposits</i>	70	70 ^α
<i>Term debt</i>	25	25 [~]
Equity Capital		
	5	80

[§] Assume that all Greek residents’ debt is converted to GRD

* Assume that the continuation of the Euro means that Euro-denominated debt owed by non-Greeks remains in Euros. These loans include non-Greek sovereign debt and non-Greek mortgages.

^α Assume that all deposits in Greek branches are redenominated into GRD, irrespective of the domicile of the depositor (which would be difficult to ascertain). I assume this is a largely domestic bank, hence no depositors in non-Greek branches or outside the Eurozone.

[~] Assume that Greek law requires that Euro-denominated debt issued by Greek resident companies and banks is fully redenominated in GRD

So we can identify at least two potential ‘winner’ categories –

- All non-German individuals and companies in the Eurozone (and indeed any non-Eurozone resident who has the capacity and ability to exploit the free ‘redenomination option’)
- Weaker-country resident Banks

Minimising windfall gains and losses

It seems evident that one of the Task Force's principal tasks is to minimise windfall gains and losses, since many of the losses will be in geared financial institutions, and these threaten financial stability. There is the additional moral imperative that ordinary people's financial position is not impaired beyond repair or outside their control to an unreasonable extent. Clearly, it will not be possible to fully protect every group, just as Governments cannot, for example, fully protect classes such as savers from the effects of inflation.

Let us take the two principal classes of windfall winners identified above.

- **Non-German depositors (and German debtors in non-German domiciles)**
 - There is so far limited evidence of round-tripping domiciles in the mainstream Eurozone. There is some anecdotal evidence that, e.g., Greek residents have been hoarding cash in German banks, but almost no evidence of bank note hoarding¹².
 - It therefore seems possible to limit the windfall gains by avoiding any publicity or 'how tos' for non-German residents, and at the moment of Exit announcement to adopt the recommendations that I set out below.
- **Weaker-country resident Banks**
 - Reducing weaker-country resident bank windfall gains is the reciprocal of trying to minimise stronger-country resident bank losses.
 - There is little that can practically be done to alter the core transfer of value, and this is because the currency denomination of the debtor or debt issuer is under the control of the Government of the departing State. A departing State cannot influence the denomination of an asset issued outside its borders and not under its legal control.

In practice, therefore, the Task Force needs to make informed estimates of the likely scale of windfall gains and losses of all systemically important Banks in the Eurozone (in practice, in the EU).

The Task Force should then prepare each Government for the possible support needed for each bank (strong country banks), and perhaps encourage Governments to tax the windfall gains of the weak country banks. In the perfect world (unlikely in the fraught nature of these events), Governments from weaker countries might agree to transfer some of these windfall gains to stronger country Governments to help the latter support their own banking systems. Given that stronger countries have (almost by definition) stronger Governmental balance sheets, it is almost inconceivable in the real world that such transfers should be agreed and take place.

In practice, many large, stronger-country banks (based mainly in Germany, Netherlands, France and Austria) will become insolvent without Governmental assistance. It should be made abundantly clear in the Exit announcement that the Governments and National Central

¹² The ECB publishes Euro note circulation statistics, which show little movement (up to Jan 2012) in overall note issuance. <http://www.ecb.int/stats/euro/circulation/html/index.en.html>

Banks of their respective countries are standing fully behind each of these Banks. This should fall short of a full guarantee (i.e. not go the 2008 Irish route), but give normal depositors, bond and interbank markets, confidence that the entities will continue to fulfil their obligations. Support like this was administered to many of the world's largest banks in 2008 by (mainly) the US, UK and Switzerland.

Redenomination uncertainty

I turn now to one of the most intractable transition problems – namely the question of the redenomination or otherwise of commercial and financial contracts of all kinds which appear to be 'stateless', or where the legal system under which they are agreed to be judged is not a Eurozone member.

Examples of instruments exhibiting this uncertainty are:

- Forward foreign exchange contracts with the Euro as one leg, undertaken under non-Eurozone law
 - Even forward foreign exchange contracts with the Euro as one leg, undertaken under Eurozone law might be problematic if the 'location' of the Euro leg is uncertain.
- Euro-denominated interest rate and currency swaps undertaken under non-Eurozone law
- Euro-denominated debt issued by Eurozone corporations outside the Eurozone, and not under Eurozone law
- Euro deposits in banks domiciled outside the Eurozone, irrespective of the residency of the depositor (another point of contention)
- Euro denominated commercial contracts (e.g. long-term supply contracts, etc.), particularly where at least one party is located outside the Eurozone, and not under Eurozone law.

I could go on, but it is clear that just the foregoing runs into potential transfers of value of at least hundreds of billions of Euros. The Task Force needs to ensure that denomination disputes do not become a catalyst to damage fatally both the relevant financial systems, but also the ability of commercial companies to operate in a stable framework.

After much thought, I have come to the conclusion that the only way to prevent ruinous litigation (particularly relevant in the UK and US, under whose legal systems a large proportion of the world's financial instruments operate), is to **announce the complete abandonment of the Euro** on the first Exit. I believe that the Task Force may well come to a similar conclusion.

This may sound like the tail wagging the dog – the Task Force having to preside over the termination of the Euro project simply to find a mechanism to unblock litigation over denomination uncertainty.

To that criticism, I would say that if there is an Exit from the Euro, then the Euro project is over. The concept of the single currency was predicated on the impossibility of Exit – that it was irrevocable, and immune to the vagaries of market sentiment. For the Task Force to be

called to put its proposals to the Council of Ministers is a final recognition that this premise was flawed. There is no half-way house on this, and indeed I will discuss below alternatives to Euro abandonment. The conclusions of that discussion will emphasise the necessity of this radical route.

I should also say that the demise of the Euro is not necessarily the end of a single currency project. It is perfectly possible that a sub-group of current members may choose to create a new single currency. However, I personally think this highly unlikely, and indeed I would suggest that a Task Force would have its hands full managing the demise of this one.

This leads me to my next recommendation:

Recommendation 3: If circumstances require, the Task Force would propose to the Council of Ministers that the Euro should cease to exist on the day of the Exit announcement, to be replaced by new National Currencies.

Why should the Task Force recommend the abandonment of the Euro ?

If the Euro continues in existence, then there will be billions of Euros of contracts, of debt and of other instruments operating under non-Eurozone law, which will continue, in the legal sense, to be fulfillable and therefore required to be fulfilled.

Most of these will have been undertaken ultimately by entities within the Eurozone or its trading or investing partners for the purposes of normal commercial, financial and investment activity. If these contracts continue to exist, then they are most likely to become divorced from their original purpose, for example, a Eurozone pension fund hedging a foreign currency asset with a US Dollar sale and a Euro purchase forward contract or swap. If that pension fund finds that its obligations are redenominated into National Currency, then its hedge or swap becomes economically disconnected with the underlying risk, and therefore potentially very damaging. However, if the Euro continues, then it would be impossible for the pension fund to renege on its obligations towards these contracts without default. This scenario would be played out in countless different ways, many of them within highly geared financial institutions (banks, etc), whose inability to perform the contracts satisfactorily would again be highly damaging.

It is not only derivative contracts that would continue to run if the Euro continued to exist – it would be all debt obligations operating under non-Eurozone law. It is very difficult to quantify what proportion of Eurozone debt (commercial, bank and sovereign) has non-Eurozone jurisdiction, but we already know that Greek Sovereign debt issued under non-Greek law trades at a higher price than Greek Sovereign debt issued under Greek law¹³. This implies that the market is already pricing-in the probability of redenomination separately from the probability of default.

I recommend that the Task Force proposes the abandonment of the Euro because this would force the legal frustration of all outstanding Euro contracts, and this would allow all Euro contracts to be treated in a common way as far as is possible, rather than legal jurisdiction and disputes thereof dominating the redenomination question.

¹³ Nomura estimated in Dec 2011 that, for example, foreign-law Greek sovereign debt accounts for about €6 billion out of a total of €300 billion of total Greek sovereign debt.

I envisage that immediately following the Exit announcement, frustrated Euro contracts, with no natural domicile, could with the agreement of the parties be valued and terminated using the ECU calculation which formed the basis for entry into the Euro¹⁴. So since the Euro would be no longer deliverable, it seems possible that (at the behest of the EU) both the US and the UK (and other relevant, supportive jurisdictions) could enact legislation that allowed their courts to value outstanding contracts using the ECU basket representing the value of the defunct Euro, and if delivery was the only option, to deliver the basket. I suggest that actual delivery of national currencies would mostly be inappropriate, and that contracts would typically be valued and terminated with a payment one way or the other.

The great advantage of this route is that all Euro contracts would automatically come to an end. They would require legal resolution, and the process could be conducted as quickly as feasible, especially with the support of the Governments of the US, UK and others. Other relevant Governments likely to assist in a common resolution framework are Switzerland; Singapore; Australia; Hong Kong; Canada; Sweden, etc.

Exit without Euro abandonment

Many, probably most, commentators today (Jan 2012) would argue that while a Eurozone Exit is a possibility, if it is contained to, say, just Greece, then the Euro would be perfectly capable of surviving.

At one level, this is true. Outstanding Greek Sovereign debt is €30bn¹⁵, which while a very large amount for a small country, is not a large amount in the context of a Eurozone with annual GDP of €9.4trn¹⁶. A substantial amount of Greek sovereign debt is held domestically in Greece, and so redenomination would not directly affect these holders. Additionally, some €50bn or so of private Greek debt is held in the German and French banking systems. Since most Eurozone banks have already taken or recognised around a 50% write-down in Greek sovereign debt, redenomination should not punch a too-large-to-mend hole in European bank balance sheets.

So why such a drastic recommendation (Euro abandonment) for such a small Exit ?

The recommendation is because, as I stated above, any Exit demonstrates to the market that Exit is possible. Currently (Jan 2012) there remains a strong strand of belief (particularly in Eurozone countries) that Exit is impossible. This belief would be shattered, and once that happened, almost all of the advantages that a single currency had over an exchange rate mechanism evaporate.

The history of the European Exchange Rate mechanism (ERM) within the European Monetary System (EMS) is instructive in this regard. The ERM (a 1979 successor to the moribund European 'snake') survived a series of mini-crises (usually resulting in a

¹⁴ It sounds unlikely that banks could agree termination valuations on frustrated contracts in such a simple and quick way, but this is exactly what happened when, in Sep 1998, Malaysia imposed exchange controls with immediate effect, making the delivery of all forward contracts and other currency contracts impossible. Agreement on early termination and settlement was reached in three days or so between all offshore affected parties, and all outstanding contracts were settled at the same exchange rate, on the same day. This was informally called the 'Kuala Lumpur Accord'.

¹⁵ Source: Eurostat – debt at end-2010. End-2011 value may be 20-30bn higher (based on the Government deficit).

¹⁶ Source: Eurostat – 2011 Estimated 17-Eurozone member GDP at current prices

reevaluation of the DEM, and devaluations of the FRF and the ITL) for over a decade. However, when the Pound Sterling joined the ERM in October 1990, the scale of Sterling in the FX markets, and its relative independence from European economic cycles, created instability which encouraged a speculative attack, culminating in the exit of the Pound, the Italian Lire and the Swedish Krona in September 1992. But by now the market had recognised that it had the power to break even quite well established and sustainable links. In the summer of 1993 there was an unprecedented speculative attack on the DEM/FRF parity, which resulted in a crisis which effectively ended the ERM experiment. In August 1993, new bilateral bands of $\pm 15\%$ replaced the former bands of $\pm 2.25\%$. These bands were so wide that they allowed a free-float of the currencies that remained within the system. From that point onwards, the ERM effectively ceased to exist as a currency stabilisation mechanism.

The lesson of this period (and indeed going back further to the 1971-73 collapse of the Bretton Woods fixed parity system), is that if markets believe, with corroborating evidence, that they have the power to break systems of controlled exchange rates, then they have an incentive to do so. This applied in 1971-73; it applied in 1992-93, and it would apply to the Euro the moment the corroborating evidence (i.e. a Greek Exit) appeared.

After that, history tells us that a full Euro break-up, with all the series of crises that that would imply, would ultimately be inevitable. A good analogy for an Exit without planned Euro abandonment would be the conduct of the last year of the Second World War in Europe. Once the Allied Forces had obtained a serious foothold in Europe (say by August 1944), the grim reality for the Nazi regime in Germany was that defeat was inevitable. Had Hitler capitulated at that point, there would have been untold saving in life, suffering and property. Indeed the whole future of Europe would likely have been very different, possibly with Russia gaining much less influence in the East. If the supporters of the Euro project do pass the point of no return – which in my opinion is the first Exit – and they do not give up the project, then the economic and financial, not to mention political, losses may be many times greater (and certainly unknowable) than would be the case with an early capitulation.

There is only one sustainable counter-argument to this line of reasoning. That would be an enduring political union formed around whatever shape the single currency took at the time, and which was much more than simple fiscal discipline or even fiscal integration. It would have to be the creation of a new country, with a single democratic (or other) system of power and governance, and with a common and widespread desire, culture and will to be one country. The US is a good model for this case – although it only achieved ‘country’ status as we understand it after a vicious and destructive civil war nearly a hundred years after its formation as an independent state.

Hence it is the contention of this essay, and I believe an accurate representation of the evidence available, that the Exit of a small country from the single currency would sound the ultimate death knell for the Euro. In view of this, and to prevent disorderly break-up, I make the recommendation that the Euro must be abandoned on the first Exit.

The ECB – a major systemic risk

The ECB is a very unusual central bank, in that it does not have a single Government sponsor. For all major developed countries with their own currencies, the National Central Banks

(NCBs) are, in effect, an arm of Government, and are treated by the markets as if they were the Government of the relevant country.

There is good precedent for this. To my knowledge, no developed-country NCB has in modern times defaulted on its obligations without the sponsoring Government simultaneously also defaulting on its obligations.

Under normal circumstances, the ECB would not pose a particular threat to the European financial system. Its main remit is to control European inflation by exercising monetary policy – in effect setting Euro interest rates¹⁷.

However, beginning in 2008, the ECB began to provide ‘liquidity’ in large amounts to banks in the Eurozone. I put ‘liquidity’ in quotation marks because liquidity operations are normally just that – unlocking the value of less liquid assets so that banks under liquidity constraints can always provide the funds that their customers and counterparties require at all times. This ‘lender of last resort’ function is a well-established and very valuable part of the system of management of the integrity of national banking systems. It does not imply any kind of guarantee to any bank, nor does it prevent insolvent banks failing. It is designed to smooth liquidity shocks and short-circuit runs on banks. The ECB’s behaviour, however, has led it towards ‘solvency provision’ as well as liquidity provision.

Since the start ‘proper’ of the Euro crisis in 2010, the ECB has been providing core funding to a large number of Eurozone banks who cannot fund themselves except at ruinously high interest rates, or indeed at all. In effect, southern banks have been shunned by investors; these banks have turned to the ECB for funding, with ECB in turn funding itself with deposits from northern banks flush with cash and with no secure assets to invest in. The scale of the problem was illustrated just recently when the ECB opened a 3-year funding window to Eurozone banks at very advantageous interest rates¹⁸, and in one day €489bn was snapped up!

The unusual constitution of the ECB, and this large-scale credit provision, has led it into a very vulnerable position. It has a very small capital base – currently €6.4bn. This will rise by the end of 2012 to €10.7bn, and so this last €4.3bn can currently be seen as a 17-nation sovereign guarantee for this amount. But these amounts are tiny when compared to the ECB’s current balance sheet. Its last reported Accounts (Dec 2010) showed liabilities of €163bn. At the time the ECB’s capital was €5bn – this is a 3% ‘equity capital’ ratio, well below the requirements of the commercial banking system, and with very concentrated risk indeed.

But the ECB’s reported balance sheet is only half (indeed much less than half) of the story. The ECB is the heart of a larger grouping called the ‘European System of Central Banks’ (ESCB – also colloquially known at the ECB as the ‘Eurosystem’). The ESCB is the aggregate of the activities of all the 17 NCBs and the ECB, obviously netting off intra-system transactions and assets/liabilities.

¹⁷ “The primary objective of the ECB’s monetary policy is to maintain price stability. The ECB aims at inflation rates of below, but close to, 2% over the medium term”. Source: ECB.

¹⁸ Three year Long Term Refinancing Operation (LTRO) at 1% p.a. interest rate. Offered on 21 Dec 2011, 560 banks took up this facility to the tune of €489bn.

The liabilities on the ESCB balance sheet at end-Dec 2011 (which includes at the time of writing to an unknown extent the ECB proper) stood at €2.7trn¹⁹. The liability side of the balance sheet includes some €50bn of ‘cash balances’ held by the private Eurozone banking sector (in effect an ECB overdraft with the commercial banking sector – sometimes called ‘high-powered money’), as well as €90bn of banknotes in circulation. On the asset side sits €60bn of lending to the banking sector, much/most of it collateralised with Eurozone sovereign debt. I suspect that at least some of the other assets are non-Euro sovereign debt (the old ‘FX Reserves’ of the NCBs), although the classifications are so anodyne in the reporting (“Securities of Euro area residents in Euro = €20bn”; “Other Assets = €50bn”) that we really do not know.

If the ECB had a large Government (like the US) standing behind it, one would not worry about its solvency, beyond worrying about the solvency of the State itself. But with lending (even collateralised lending) to the European banking sector on this scale, and unknown quantities of less-than-perfect-credit sovereign debt, the ECB’s capital is evidently totally inadequate to be a stand-alone entity. We cannot know what the quality mix of the collateral at the ECB is like, as the ECB has been handed a mandate which enforces its acceptance of Eurozone sovereign debt as collateral. As we have seen in the past two years, much of this has been continuously marked down by the market to such an extent that the market is pricing in a high probability of default for several fringe Eurozone members countries – and almost inevitable default for Greece.

Why does the ECB/ESCB have such a large balance sheet ?

The ECB’s balance sheet is being inflated for a uniquely Eurozone reason partially described above. But the need for the ECB to bail out the European banking system has arisen through a horribly self-inflicted wound. What wound ?

The ‘wound’ is the scale of southern (and Irish) sovereign bonds which have been bought by the European banking system. Under normal circumstances, commercial banks would not buy sovereign bonds at all. They offer neither the yield needed to be commercially attractive, nor the interest rate structure to match banks’ typical liabilities, which are generally variable (i.e. short-term). Indeed, the orthodoxy for many years was that banking system purchases of sovereign debt was to be actively discouraged by the authorities, since this was seen as ‘monetising’ Government deficits. The orthodoxy would have Governments sell their debt to long-term savers – Pension Funds and Insurance companies - where these securities’ impeccable credit rating and long duration matched the institutions’ liabilities.

But as part of the Eurozone project, Eurozone banks were told, by their national regulators and by the ECB, that if they chose to hold sovereign bonds, these would be nil-risk-weighted in the calculation of their capital requirements. Under normal circumstances, this would not be odd – indeed bank regulators worldwide also assign nil risk weighting to their own sovereign bonds in their banking system balance sheets²⁰. But of course the Eurozone is different. It does not have one sovereign Government sponsor which can ‘print’ its own

¹⁹ Source: ECB Monthly Bulletin; Monetary Policy Statistics; Table 1.1 Consolidated financial statement of the Eurosystem; 30 Dec 2011.

²⁰ Under the (now rather discredited) Basle international bank capital rules, sovereign OECD debt has generally been accorded a zero risk weighting. This still applies under Basle III – the 2010 version of the rules.

money, or tax its own citizens at will. So when banks saw that southern sovereign bonds were trading at a modest interest rate premium to banks' costs of funding (particularly funding from the ECB), a 'riskless' arbitrage appeared: Buy Sovereign bonds for, say, Euribor + 2%; fund at Euribor, take the 2% as pure profit, and have no additional 'risk' visible on the balance sheet, and no additional capital required. This could be done almost *ad infinitum*, since the ECB would fund Eurozone banks who offered sovereign bonds as collateral with almost no 'haircut'. It looked like a 'money machine', and to the banks, still does. Except now they can make 5%-15% p.a. on the interest rate differential, depending on the quality of the Eurozone sovereign.

The problem, of course, is that the 'marked-to-market' value of the bonds has fallen almost continually over the past two years. The 'income' story remains compelling; the 'capital' story is a slow-motion disaster.

So the ECB is the creditor to a large number of fragile banks in the Eurozone to the tune of about €50bn. These banks are now poor credits because of their uncontrolled exposure to risky sovereign bonds, and indeed to new risk – the currency redenomination risk of some or all of these bonds. And all this because EU regulators made the rule that Eurozone sovereign bonds had nil risk attached to them. This was undoubtedly a consequence of the commitment to the 'Eurozone project'.

In practice, therefore, quite aside from the question of Eurozone Exit, the ECB may already be insolvent without additional support from its national Government sponsors.

Which brings us to the position of the ECB on Exit.

ECB on Exit

Let us start with a small country Exit, but the continuation of the Euro. Then we will move on to the position where if an Exit becomes inevitable, the Task Force recommendation that there is complete abandonment of the Euro is accepted.

Unless it is Germany that exits first, the ECB will be a 'strong country' bank (see Table 1 on page 10). This will mean that it will suffer redenomination losses on its collateral, and its debtors (Eurozone commercial banks) will suffer redenomination losses on their 'Exit country' assets. Assume that these combined losses are large enough for the ECB to be in evident need for more capital, then *who is going to pay* ? National Governments and their NCB's will have their hands full with fragile or insolvent commercial banks. It is quite easy to see from that position that, let's say Germany, who will be picking up a lot of commercial banking tabs, will begin to question the process by which the ECB became so exposed; to question the transparency of the information provided by the ECB; indeed to question whether the losses are really 'their' losses. I could quite easily see a subsequent row which would quickly crack investor confidence in the ECB – with disastrous results for the European banking system, and ultimately the Euro.

Suppose now that the first Exit brings about the abandonment of the Euro. An inevitable concomitant of this would be the demise of the ECB.

In view of the risks that the ECB is now posing to the continued stability of the Eurozone, it is my opinion that the Task Force should come to the Council of Ministers for a complete

resolution package for the ECB at the same time as the Exit plan. It might look something like this:

- The ECB to be dismantled with immediate effect, with only a small resolution staff remaining to tie up practicalities
- The balance sheet of the ECB to be carved out *pro rata* in the current national shareholding proportions to the NCBs (but see below on banknotes)
- All operations of the ECB to cease and critical operations to be transferred immediately to the relevant NCBs. Eurozone NCBs have remained well-staffed over the life of the Eurozone, so the skills and infrastructure are already in place
- Euro obligations within former Eurozone States' legal jurisdiction will be redenominated into the new national currency at official conversion rates agreed by each State (original Euro entry rates ?). Euro banknotes in circulation to be allocated to each NCB by serial number prefix, with the equivalent proportion of ECB assets allocated to that NCB.
- Euro banknotes could continue to function as a fractional denominations of the new national currency until new currency notes could be printed. This would mean that the international value of 'Y' denomination banknotes could be worth, say, less than half the international value of 'X' denominated notes.
- 'Orphan' Euro obligations, i.e. those with undetermined domicile, or operating under a non-Eurozone legal jurisdiction, will be likely to be the subject of dispute. The provisions I suggest in the 'Redenomination Uncertainty' section above, however, may mitigate much of the uncertainty, and the abandonment of the Euro will precipitate and force a resolution.
- The majority of the ECB staff to be redeployed in NCBs if possible, otherwise made redundant.

Failure to announce agreed terms on the closure of the ECB, and the repatriation of its central banking responsibilities back to the NCBs would leave the markets with a huge amount of uncertainty, which would be quite likely to compromise the support needed for the national banking systems. Leaving the ECB alive runs the risks that either States themselves, or the markets, question the basis on which the ECB will be resolved. In my opinion, the ECB must be closed and its responsibilities apportioned to NCBs immediately on an agreed basis.

Which brings me to my next recommendation:

Recommendation 4: The ECB would be closed and its functions terminated with immediate effect. All its functions to be transferred to the relevant National Central Banks (NCBs). Its balance sheet to be shared out *pro-rata* to NCBs by reference to the ECB shareholding proportions and (for banknotes), NCB banknote issue.

European Financial Stability Facility (EFSF)

I have not mentioned the EFSF so far, and there is a reason for that. The EFSF is an institutional arrangement for 'Europeanising' the sovereign debt of the weaker Eurozone

member states – i.e. a limited mechanism for allow Greece, Portugal, Ireland, Spain and Italy to borrow on the same or similar terms as Germany and France with their funds and/or their guarantee.

It reinforces, yet again, more of the misalignments of interests of the various Governmental parties in the Eurozone that has led the Eurozone into the deep and dangerous waters that it is now in.

Fortunately, the EFSF is superfluous in the post-Eurozone world, and I would recommend that the abolition of the EFSF [and its longer-term successor, the European Stability Mechanism (ESM)] is announced at the time of Exit.

National Central Banks

Eurozone National Central Banks (NCBs) will be required to resume all the functions that were removed from them with the arrival of the Euro. Most are in my opinion fully equipped to do this with little need for additional staff, expertise or infrastructure. For example, Germany's central bank, the Bundesbank, currently employs 9,750 staff²¹, whereas the Bank of England, which has retained all the central bank functions since the UK did not adopt the Euro, employs 1,760²².

The core functions which will revert to the NCBs are (a) the conduct of monetary policy and (b) the lender of last resort. Many NCB's still partially provide the second function – none currently provide the first. Taking each in turn.

Conduct of monetary policy

Most developed economy NCBs outside the Eurozone have adopted both a similar intellectual framework and similar inflation targeting techniques. The common intellectual framework is that inflation is (at least partially) amenable to monetary policy, which includes both interest rate policy and quantitative money supply targeting (or at least monitoring). One might call this 'soft monetarism'²³. Most economists, including those at many NCBs, think that inflation is not purely a monetary phenomenon, and that the transmission mechanisms for inflation are complex. They believe, as do I, that there are several different feedback loops, including (importantly) inflation expectations, general levels of aggregate demand and external (international) effects. Despite this acknowledged complexity, most NCBs have been content to accept responsibility for inflation targeting, and content also that the main lever available for them in this regard is the control of short-term interest rates. Hence it should not be too difficult for the newly enfranchised NCBs of Eurozone member states (and their Governments) to craft monetary policy remits that are effective and non-controversial.

²¹ Source: Bundesbank; Dec 2010 data.

²² Source: Bank of England Annual Report 2011; Number of staff (full and part-time) with permanent contracts. Feb 2011 data.

²³ By contrast, I would characterise 'hard monetarists' as those who believe that inflation is entirely a 'monetary' phenomenon, and that as a result, they believe in the causal direction running only from money stock to inflation, and not (via feedback loops) the other way round.

Lender of last resort

NCBs role as active lender of last resort is by definition only called into play occasionally. The importance of the role is similar to that of the nuclear deterrent – its very presence changes behaviour. It is therefore less easy to characterise the ‘normal’ way to conduct this role, and indeed an important part of this role is to provide confidence to fragile banking systems when needed, but not to provide an implicit guarantee, nor to underwrite excessive risk-taking by systemically important banks. So the details of the lender of last resort role are almost by necessity implied rather than contractual, unspoken rather than transparent.

This whole topic is one which has been extensively covered over the past four years, and I do not intend to replay that debate here. Suffice it to say, that subject to the political will, and the solvency of the national Government to fund itself, NCBs will quite naturally take on the lender of last resort role.

Exit/transition timetable

Once one member has concluded that they (or other members of the Eurozone) wish for them to Exit the Eurozone, either through ‘force’ or through choice, and this decision has become irreversible, then following the recommendations of the essay, Germany (and France if involved) would need to activate the Task Force plan. (I do allow for some variations on the plan below, but as we shall see, these may be limited or constrained by necessity). Exactly how that process comes about is unknowable, but to give some flesh it may be one or more of the following:

- A simple decision by the Government of a member state that they wish to leave the Euro
- A Council of Ministers decision that a member state’s continuing membership is untenable (say after a sovereign default)
- The election of a ‘Exitist’ party to power in a member state
- The complete inability of a member state to fund itself, either through private or public channels
- A military coup in a member state, and their abrogating the Euro
- A complete breakdown of law and order in a member state – i.e. a revolution

This list is not exhaustive, but gives some idea of the possible catalysts.

Task Force activation

The moment it becomes that an Exit is inevitable, Germany would call a Council of Ministers meeting (ideally on a Friday evening – but that may not be possible) which would take place that night between EU Heads of Government. It need not be a fully physical meeting.

Germany will reveal to the Member States’ leaders the existence of the Task Force, its Charter, and the outline of its Exit plan. In my opinion, there is only one question that Germany needs to ask, namely “is the Council of Ministers prepared to endorse the Task Force’s Plan?”. I suspect that current Treaty provisions get nowhere near being able to accommodate this question (and I briefly discuss this later), but the political reality is that if

the Council of Ministers agree, then they can decide in due course to amend the existing Treaties and associated domestic legislation to give their decisions legal force later. Of course, there will be serious domestic legal ramifications (for example, several countries have a constitutional requirement for a referendum on EU Treaty changes). However, Germany and its supporters can point to the catastrophic consequences of failing to adopt the Task Force's plan, and each EU Member States' political leaders can make up their own minds as to the balance of risks and rewards in giving or withholding their consent.

I suspect that if we have got this far, then Germany's backstop is to say that in the event of no agreement from the Council of Ministers, they will unilaterally withdraw from the Euro, and unilaterally announce the activation of a German-only Task Force Exit plan. I briefly cover this later.

Let us assume for the moment Germany does achieve the agreement it needs. From that moment, the Exit announcement should be made (perhaps early on a Saturday morning).

The initial announcement need only be quite short:

- From the moment of the announcement, the Euro no longer exists
- All Euro banknotes are no longer Euros. They are fractional denominations of their respective national currencies; the currency being determined by the prefix on the banknotes. Similarly for coins, which are more easily identifiable. Only nationally issued Euro notes and coins are legal tender in each respective country. Foreign-issued Euro notes and coins will have to be exchanged at a bank for domestically issued notes and coins at market exchange rates.
- All bank accounts held in each Eurozone country are now fractional denominations of new national currencies of the country in which the account is maintained. The domicile of the *ownership* of any bank account is irrelevant to its denomination. Bank accounts held either at home or abroad in foreign currencies are unaffected; bank accounts held outside the Eurozone, but denominated in Euros, will be subject to the treatment accorded by the relevant national legal system.
- All other commercial and financial contracts, including labour contracts, pensions and insurance and savings contracts, mortgages and debt contracts, will be redenominated according to the legal jurisdiction of the contract – i.e. *lex monetae* shall apply. Absent clear determination, the default position will be determined by the country of domicile of the issuer of the obligation.
- Each state will now revert to its previous national currency, converted from Euros at the entry rate into the Euro²⁴
- Each National Central Bank will provide unlimited liquidity to its own banks – all customer money in Eurozone banks is therefore secure
- New notes and coins will be printed and issued as soon as possible, but Euro notes and coins will be legal tender for at least one year²⁵.

²⁴ This is just for convenience – any state could choose different currency names and exchange rates, but for the market to be able to react quickly and with confidence, this seems a good default

- There will be a two-day bank holiday in the EU on Monday and Tuesday. Shops and commercial premises are welcome to open, but they must be aware of the new value of notes, coins and bank accounts.
- From Wednesday, banks will re-open, and there will be no exchange controls, and no limitation on cash or deposit withdrawal. Notes, coins and bank accounts can move freely across the exchanges, but all parties must be aware that exchanging different prefix notes is a foreign exchange transaction, and that moving a bank account to another former Eurozone country is also a foreign exchange transaction.
- From the moment of the announcement, the ECB ceases to function as a central bank, and all its functions are transferred to the respective National Central Banks. The EFSF and the ESM are abolished, and what little commitments they have are repatriated back to their respective National Governments.
- [If possible....]The respective Governments of all non-Eurozone EU member states, and the US, Japan, Canada, Australia, Hong Kong, Singapore...etc have agreed to facilitate as far as possible the same treatment for legacy Euro contracts as specified above. Genuinely 'orphan' contracts will be closed and settled if possible using a basket with currency weights of the ECU on 31 Dec 1998, and at market exchange rates and interest rates on the first Friday²⁶ after Exit.

The Task Force would have a detailed, hour-by-hour plan of the practical steps to make all of this a reality. I have chosen several parameters here which are not set in tablets of stone – they are just examples of the clarity that would be required.

One or two small but heavily indebted states may not be able to make the liquidity commitment to their banks with any conviction, and the IMF may agree to provide short-term liquidity to these. It has to be accepted in such a major crisis that there may be casualties – undoubtedly there will be businesses and or individuals who will fail financially as a result of the actions taken. The Task Force's remit is to minimise these – it cannot eliminate them totally.

Many in the 'strong currency' Governments may wish to go further, and say that during the transition phase they will provide whatever additional capital that each bank needs to remain solvent. We have sizeable precedents for this in the 2008 recapitalisation of US and UK banks by the US and UK states respectively, so the mechanics of the process are now quite well rehearsed.

There will undoubtedly be major teething problems with such a massive financial convulsion in such a short space of time. There will be unintended consequences that create unforeseen problems, but once the first step of the transition is completed, the next several steps are in much more familiar territory.

²⁵ The period should be as short as possible commensurate with secure printing and distribution of new National Currency notes and coins. One year is arbitrary.

²⁶ Friday (i.e. after three days of post-Exit trading) is arbitrary, and might have to be longer.

Immediate aftermath – the first week

It is idle to speculate, but useful for policy makers to brace themselves, as to what will happen in the week following the announcement.

The level of uncertainty, and the surprise effect of the announcement, would be so high that global equity markets would be most likely to fall sharply. The quantum of the fall is inherently unknowable, but major shocks often engender an initial strong downward movement followed by some retracement as the market reassesses (and usually moderates) the long-term implications. Since in my opinion, the longer-term implications are strongly positive (versus where the Eurozone is today), it may be the market also perceives this, and initiates a rally. Bond markets would not react in a common way – it would depend on the country, and currency, in which they were domiciled. One might expect German bond markets to be broadly flat or possibly rise, while most others might fall somewhat (expressed in their own, new currencies). Highly indebted countries, and those with a history of inflation, might see a much stronger fall in their bond markets. However, the likelihood of sovereign default for several sovereign bond issuers might recede (since it would be perceived that the newly independent National Central Banks could ‘print money’), so currency and inflation risk could partially replace default risk in the eyes of the market. For countries with the most fragile sovereign debt position, like Greece, bond markets expressed in the new national currency might even rise – only to be more than fully offset by a sharp fall in the new national currency.

There is no doubt that the first week would be extremely fraught. However, EU national Governments and their NCBs, possibly with the exception of Greece, are generally credible as providers of financial and liquidity support, and so once the first week was passed, the scene could be surveyed, and adjustments made to help particular casualties. The absolute key is to give members of the general public, and all businesses, a framework which they believe will be stable and sustainable. They will then be able to adjust, and most will find that possible. Some, particularly exporting businesses in the weak countries, will find life quickly becomes busy as their newly-competitive products find renewed world-wide demand.

In planning the announcement, I suggest that the Task Force give a high weight to avoiding panic ‘protective’ action or reaction from the general population or business. In my next specific recommendation, I have sought to find a mechanism to avoid panic reaction to the announcement:

Recommendation 5: Assign where legally possible (i.e. within Eurozone jurisdiction) currency redenomination to depend only on immoveable reference points. This will prevent as far as is practicable Eurozone individuals’ panic moving of assets or liabilities to achieve more favourable redenomination treatment.

I choose to emphasise ‘immoveable reference points’ because there is a tremendous risk at announcement (and possibly if there is any leakage prior to announcement) that people will panic, and try to move either themselves, or their assets, cash or debt, to different domiciles. This is a recipe for chaos, and a possibly disastrous breakdown in public order. We need to make it purposeless – and seen to be so – to take any precipitous action.

What do I mean by ‘immoveable reference points’ ? I mean that when each asset or liability is redenominated, this is done by reference to geographical characteristics which cannot be disputed (say like the location of a property on which a mortgage is secured), and which cannot change quickly, or indeed at all. It must not be based on the domicile (or claimed domicile) of individuals, nor on the physical location of bearer instruments, like cash.

So to avoid armed guards being forced to use their weapons at Eurozone borders, I recommend that borders remain open (both physically, electronically and legally), with no imposition of exchange controls at any stage during the Exit aftermath, and that this intention is announced at the time. This will mean that no-one will have an incentive to try to cheat or manoeuvre their asset & debt location.

This equally applies to corporations and institutional investors – who may not be climbing over barbed-wire border fences, but will certainly wish to move their assets and debt as fast as they can, if such a move assists their solvency. Making the redenomination reference points immoveable short-circuits this behaviour. If you know you can’t move your assets or debt to change their currency of denomination, and nobody else can too, then you won’t even try.

In the following sub-headings, I set out some detailed recommendations for both banknotes and other asset and debt types.

Notes and coins

My recommendation for the determination of the post-Exit value of Euro banknotes has already been set out in the ECB section above, and depends, for the avoidance of doubt, solely on the prefix letter on the banknotes. Nothing else will matter, and in particular the location of the notes will be irrelevant.

On 1 Jan 1999, national currency banknotes became ‘fractional denominations’ of the Euro. Exactly the same needs be done in reverse whenever the Task Force Plan comes into force. So Euro banknotes will become ‘fractional denominations’ of new national currencies.

This will mean that apparently similar notes (except for the prefix) will become worth different amounts, and the exchange rates between them will be highly variable. No long transition period is therefore desirable²⁷, since the public will find coping with notes that look ostensibly the same, but are very different in value both a practical and a psychological challenge. National Governments will quickly want to give their population their own banknotes, with all that this implies.

In view of this, and to help the general public to accept the *fait accompli* that has been presented to them, I would recommend that the Task Force facilitates the design, printing and distribution of new national currency banknotes as fast as is possible. This cannot practicably be commenced prior to the Exit announcement, and indeed it will clearly be the responsibility of each national Government to take responsibility for the design and production of their own banknotes. But serious thought should be given to providing the printing and distribution capacity needed for this to be completed at the highest possible speed. Germany alone, as the Task Force’s sponsor, may be able to short-circuit some of the lead time, but maintaining

²⁷ In contrast to the introduction of the Euro, when there was a three-year ‘national-currency-only’ banknote period, and a two month ‘both in circulation’ period.

absolute secrecy over the printing of new Deutsche Mark bank notes would be nigh-on impossible in the open democracies that we enjoy today in Europe.

Bank and savings accounts

I recommend that the Task Force plan directs that all personal bank accounts, and all savings institutions' customer accounts, be redenominated into the currency of the domicile of the branch from which the account is conducted. If the domicile of the two parties (bank and customer) is different (but both Eurozone) then redenomination should go with the bank or savings institution, not the individual. If nothing else, this avoids individuals trying to manipulate their domicile – and certainty (even if bad news) is much better than uncertainty in this context.

So as an example, if an investor in Germany chose to open a savings account in Spain, corresponding with or visiting a Spanish-based institution, then this account would be redenominated into the new Spanish national currency. If he opened an account in Germany, even if it is the branch or subsidiary of a Spanish institution, it would be redenominated into the new German national currency.

In the example on page 10 (the German bank balance sheet), I do only deal with a domestic bank with a domestic deposit (i.e. liability) base. Each foreign operation (branch or subsidiary) of each bank could be analysed this way to discover each entity's mismatch – and then these aggregated within a group for the group to understand the impact on their whole balance sheet. Multi-national retail banks obviously complicate the regulatory and lender of last resort issues as well, but this is a pre-existing problem, unrelated to the Euro, which we are not going to be able to resolve here.

Mortgages

My suggestion for the task force is that there is considerable economic and political mileage, and little financial disadvantage, to making a slightly different rule about redenomination for mortgages. Instead of the domicile of the mortgage lender being the determining factor for redenomination, I suggest that the domicile of the property on which the mortgage is secured is substituted as the only factor in determining the domicile, and therefore the currency of redenomination of the mortgage. This will sterilise consumers (in both directions) from windfall gains and losses (net of their property value), although it may expose banks to somewhat more currency risk than they might have expected. However, even if denomination was determined by the domicile of the lender, if the security (i.e. property) was redenominated (as it would inevitably be), then the banks might have to write the mortgage asset down on currency grounds anyway²⁸. The treatment proposed therefore gives a manageable outcome for the banks, a neutral outcome for most householders, and certainty for both banks and their customers.

Credit card debt and personal loans

These should be treated similarly to Bank and savings accounts – the denomination of the account will depend on the domicile of the branch or subsidiary who lent the money, not on the domicile of the debtor. For more international individuals, this could create some windfall

²⁸ I will make this point again with reference to Argentina.

gains or losses, but for most people, credit card and personal loans should not be too large, nor will a large proportion be international, and therefore redenomination should not be an overwhelming problem.

Pensions and insurance contracts

These should be based on the domicile of the pension provider or the insurance company. The same branch or subsidiary provisions should apply as with bank and savings accounts.

The individual's perspective

In really serious crises, all of us turn to our personal and family positions as our first instinctive response.

“Are we safe ?”; “What is the effect on my family finances ?”; “Are we bankrupt ?”; “Will I lose my job ?”; “Can I afford to live in my house ?”, “Can I keep the things that I care about (healthcare; education; holidays) ?” are the kinds of questions that every individual and family in the Eurozone will first think about at the moment of the announcement. The answer to most of the questions is that, at least in the short-term, most families will thankfully not be ruined, nor indeed either materially financially damaged.

Let us quickly look at four stylised household types.

Conventional family; children living at home; one parent in work, homeowners with Euro mortgage, no major other assets or debt.

- The critical element for this group is that their home is redenominated to the same currency as their mortgage
- Most property will be secured on mortgages originated in the same country, and under that country's legal jurisdiction, hence mortgage and property will have the same currency post-Exit.
- A minority may have the legal jurisdiction of the mortgage, and/or its country of origination different from the country of the property. I have already recommended that in enacting emergency Eurozone Member State legislation, Governments could ensure that Euro mortgages secured on residential property within the Eurozone are *all* redenominated to the currency of the country in which the property is situated. This would eliminate all uncertainty, and minimise windfall gains and losses to individuals. Foreign currency mortgages (e.g. US Dollar; Swiss Franc) would remain unchanged, and may continue to give their owners a currency mismatch.
- A few families may live in Eurozone countries which are different from their country of employment. This will create a mismatch between their income and their expenditure, and these households will have to make future decisions (employment; domicile) bearing this in mind.

Single person (or sharing in a household) in work; no children; renting accommodation; no major other assets or debt

- There are few critical elements for this group. In the longer-term their prosperity will depend on the wider national economy

Retired couple or individual; children left home and independent; own or renting accommodation; some savings; no debt; dependent on pension for living

- This group is potentially high risk because of their dependence on savings and pensions.
- Under my plan for the proposed Task Force, all national pensions will be redenominated to the country where the pension provider is domiciled (not where the pensioner is domiciled). Where the pensioner and pension provider are domiciled in the same country (the large majority, I suspect), there will be no immediate impact either way.

Individuals who are drawing a pension in one country's pension system, but living in another country, will see a material and immediate change to their living standards, but this could be better or worse depending on the domicile of the pension provider and the domicile of the pensioner. I suspect this might turn out to be quite a significant political and social issue.

Virtually all pension systems are still national, rather than international, so there should be little uncertainty here about their domicile (except perhaps for the employees of EU institutions!).

Unemployed individual or family, rented accommodation, some debt, no material assets

- This group is potentially high risk because of their dependence on the State and social insurance
- However, for the vast majority of this group, domicile is clear, and will be the same as the State social insurance system which supports them. They should therefore not suffer any material immediate windfall gains or losses.

The business perspective

No analysis would be complete without examining in some detail the immediate impact of Exit on businesses both within and outside the Eurozone. We have already looked in some detail at the impact on bank balance sheets, and so I will now briefly look at the balance sheets of different categories of commercial businesses. I will look at their profit & loss prospects in a later section.

Multinational companies

These are typically large and sophisticated economic entities, already with well-developed mechanisms in place to analyse and hedge currency and other financial risk. The difficulty that Exit presents for these entities is the sub-division of a currency bloc about which they had repeatedly been told (especially by any regulators involved) that it was a permanent feature, and for which no intra-zone hedging was either necessary or desirable.

Outside the banking system, my perception is that few large multinationals have large intra-Eurozone financial exposures to individual countries which are not backed by physical presence or established business revenues. Unlike banks, commercial companies are able to directly control the domiciles where they locate their assets and liabilities, and in view of the nearly two years to the date of writing when there have been increasingly loud warning bells

over Eurozone stresses, any commercial entity made insolvent purely by the fact of Euro Exit has been badly managed, and deserves to be so treated.

There is one caveat to this, though. Where there is genuine uncertainty as to the domicile (and therefore currency of denomination) of a company's Eurozone assets, debt, derivatives and other financial contracts by reason of being 'Stateless', and/or having been concluded under non-Eurozone legal jurisdictions, then the company may be left in a dangerously uncertain position with suppliers, creditors, debtors and shareholders unable to establish the position clearly. This is the mirror image of the uncertainty problem for Banks, and it is especially important in this context that the major non-Eurozone jurisdictions' Governments agree to co-operate (ideally on a Statutory basis, not just 'encouraging' civil courts) to help short-circuit this uncertainty.

Despite all the foregoing, there will clearly be winners and losers in the short-term, and this simply cannot be avoided. There will be much greater gains and losses, however, in the medium-term as the new economic realities kick in. We will come to these shortly.

Exporting & importing businesses

Many businesses are not multi-national, but have a significant amount of international business as their cornerstone. Unless a business in this category has an unusually exposed and complicated balance sheet, I don't expect a significant proportion of these businesses to be seriously embarrassed by Euro Exit in the short term.

In the medium-term, international changes in competitiveness are likely to have a profound effect on these businesses, but this will be on future profit & loss account, not the immediate balance sheet.

Local businesses

The vast majority of businesses by number (although not by employees and turnover) are privately-owned, and operate in one locality and/or one speciality. These are all the self-employed, or small employers up and down every country which lubricate all the minutiae of everyday economic life.

Mostly these businesses have very simple balance sheets, and are more likely to be affected in the same way as families and households are by Exit, rather than like multinationals. As a result, very few (just the reckless or the very unlucky) will be badly hit, at least on their balance sheet.

Constitutional and legal questions

All of the above pre-supposes that even with unanimous agreement from the Eurozone (and indeed the EU) members, that the requisite actions can be taken in a timely way without serious legal or constitutional challenge.

This is an area where I boast no expertise, nor, I suspect, do many individuals, since the questions being asked have so little precedent.

There has been some public comment by law firms and others, mainly very recently, when discussing the demise of the Euro had finally been ‘allowed’²⁹. However, my instinct is that if sufficient political capital is invested by a sufficiently large and powerful group within the Eurozone, then in practice, leaders will do whatever needs to be done under whatever EU Treaty or national legislative or constitutional provision they choose to act under (and they will undoubtedly find one). Then, when things have calmed down, there will be a slower national legislative programme to catch up, and an even slower EU Treaty to formalise and legalise the ‘de facto’, and set out a vision for the ‘New Europe’. I will make some suggestions for that ‘New Europe’ towards the end of this essay.

A German-only back-up plan

Germany needs to ask the proposed Task Force to prepare a secondary plan, which deals with its possible failure to secure Eurozone agreement to the principal plan from the Task Force.

This plan must be credible enough that Eurozone members’ leaders believe that Germany would follow it through if there is no agreement; it must be evidently less palatable to the non-German Eurozone members; and it must be deemed to be acceptable to the German public (although they would only have the opportunity to review it after the fact).

In my opinion, Germany must propose that it unilaterally breaks away from the Euro; re-establishes its own national currency, severs its links with the ECB [accepting liabilities and assets pro-rata to its (19%) shareholding], and takes no further part in the resolution of the Euro crisis (i.e. adopts a position like the UK). This is a less complex scenario (at least initially) for the Task Force planners, since it would not require the closure of the ECB and the total abandonment of the Euro. Many of the issues of redenomination uncertainty would still arise, but on a smaller scale simply because only Germany would be involved.

It is already clear from the earlier analysis that German banks would be badly hit by this route, but on balance no worse, I suggest, than with a total Euro abandonment. The German government would offer the same unlimited liquidity to German banks as in the main Plan, and would undoubtedly have to shore up the capital position of the largest German banks with new equity (or quasi-equity) capital injections.

It is not hard to envisage the reaction of the markets and the other Eurozone members to this turn of events – shock possibly followed by panic. My guess is that the threat of withdrawal of German support for the weaker members of the Euro, and from the ECB, would be enough to ensure that this plan never saw the light of day. If by mischance it did, my next guess is that complete and disorderly fragmentation of the Euro would quickly, possibly instantly, ensue.

The EU Treaties do not provide for the plan above; but then, as discussed above, neither do they provide for the main Task Force Plan. In extremis, as history teaches us, treaties are

²⁹ See, for example: Herbert Smith, Eurozone crisis: economic challenges and legal risks, Dec 2011; Slaughter and May, Eurozone Crisis – What do clients need to know?, Oct 2011; Nomura Fixed Income Research, Currency risk in a Eurozone break-up - Legal Aspects, Nov 2011; Clifford Chance, The Eurozone Crisis and Eurobond Documentation, Nov 2011. Blackrock, Euro Crisis Fallout and a call to Policymakers, Nov 2011, Linklaters, Eurozone Bulletin: Do I need a contingency plan?, Dec 2011, J.P. Morgan, Answers to 10 common questions on EMU breakup, Dec 2011.

often torn up for political and other (including military) necessities. This would be one of those occasions.

I very much doubt that the EU would be able to survive in anything like its present form if Germany had to go it alone in a Eurozone departure, and it runs the risk of engendering internecine warfare between former Eurozone members. This could herald a new and very dangerous period for Europe and the world, and is therefore to be avoided at all costs.

Short-term disaster planning and avoidance

To avoid the failure of planning that characterised, for example, the aftermath of the US-UK Iraq invasion, the Task Force needs to draw up as detailed a plan as is feasible to anticipate and deal with the enormous number of unique problems that the abandonment of the Euro will engender. Again, it will be impossible to anticipate every major problem and every possible outcome. But the driving criteria should be that no really serious issue emerges which was not already considered and an action plan formulated.

In this short essay, I cannot possibly hope to cover all of the issues, but here are a few of the more obvious ones (together with the briefest of suggestions for Task Force responses):

- Redenomination uncertainty creates an unstoppable run on Eurozone banks – plunging the global banking system into a crisis similar to Oct 2008 (or worse)
 - *Eurozone Governments to stand ready to provide major bank recapitalisation in the event of a systemic banking system collapse*
- One or more member states refuses (or claims to be unable) to agree to the Task Force plan, and makes this refusal public.
 - *The Task Force presses on with its plan, and leaves the door open for the recalcitrant member to soften. Ask the IMF to help this country in the very short-term.*
 - *A ‘refusnik’ country could in theory state that they will keep the Euro, but their own ‘Euro’ would in-effect turn into their own currency (i.e. a Spanish ‘Euro’), which would, de facto, be the same as a ‘new Peseta’.*
- In the immediate fall-out of the Exit announcement, one or more of the Governments of the Member States falls, freezing decision-making.
 - *Press ahead with the plan, and allow the political process in the affected country(s) to take its course. Under the plan as set out, the abandonment of the Euro will mean that each member has no choice but to accept redenomination. The comment in the paragraph above applies – namely that with no action, the national use of the Euro would most likely become, de facto, a new national currency, even if no domestic legislation is passed to put its new status into legal effect.*
- One or more Member States are so incensed at not being consulted prior to the Exit announcement that they unilaterally withdraw from the Eurozone (and possibly the EU).

- *This is an outcome much to be regretted, but it would not derail in any respect the Task Force plan.*
- The US (and others (China?)) are so incensed at not being consulted prior to the Exit announcement that they withdraw all co-operation with the EU, including co-operation to reduce redenomination uncertainty
 - *Again, this is an outcome much to be regretted, but such a move would not be irrevocable. Hence the larger and more influential countries could lead a charm offensive towards these nations to placate them, and involve them in the detail at the next stage of European developments.*
- An incensed China (Russia; Saudi, etc) declares that it will divest itself of all Eurozone members' assets in their Foreign Exchange Reserve fund, and announces that it will not re-invest in any of the new currencies of Europe
 - *Again, this is an outcome much to be regretted, but such a move would damage China more than the former Eurozone members. Europe as a bloc runs at approximately in trade balance with the rest of the world, with Germany in large surplus, and most of the remainder in various sizes of deficit. China's divesting of reserves would force the new exchange rates down vis-à-vis the rest of the world, an outcome which, on balance, would help struggling European economies, and damage China's exports to Europe.*
- A group of Eurozone members break away from Germany and attempt to form a new single currency immediately
 - *This is outcome 2) or 4) on page 7. It seems unlikely that markets will look very kindly on a new single currency formed immediately; without planning, and (particularly) without Germany. It would not affect the demise of the Euro directly, but it would require almost superhuman levels of confidence and optimism amongst the relevant Member States' leaders to embark on a new single currency at exactly the moment of destruction of an old one.*
- Germany fails to convince a critical mass of other Member States that the Task Force plan is the only viable route.
 - *This is covered on page 32 in the 'Germany Only' plan*
- Germany itself suffers unsustainable political turmoil; the Government falls, freezing the abandonment process
 - *This is a potentially serious development, since a high level of active political commitment from Germany will be required, firstly to abandon its current commitment to the Eurozone, and secondly to support its banking system. The hope is that the German leadership will in practice not be prepared to leave the country rudderless and vulnerable, even if there is also a political process going on in parallel potentially to replace them.*
- There is a serious breakdown of law and order in one or more Eurozone members

- *This is clearly highly regrettable, but European nations will be required to conduct themselves as they respectively see fit, and in the post-Eurozone world, there would be no role beyond encouragement, support and advice for other European nations. There is no reason to suppose that such a development would change the course of the abandonment of the Euro; the key for the Task Force is to ensure there are sufficient firebreaks in the banking system support network.*
- In extremis, one or more Eurozone members suffer military coups to restore ‘order’
 - *A similar comment as the previous paragraph applies.*

This list is somewhat daunting. A similarly daunting list could have been drawn up (and probably was), at the critical junctures of major international decision-making. The Cuban missile crisis; the collapse of the Soviet Union; the liberation of Kuwait; the invasion of Iraq and the rescue of the global banking system in Oct 2008 probably all had alternative, unpalatable scenarios which have remained unseen and unused. I sincerely hope that none of the above materialise. I suspect that mostly they won’t. But to the extent that they represent risks of major scale, they do need to be recognised, analysed and each have action plans.

To those readers who see so much potential downside that they back away from Euro abandonment, I would say that if the Euro cannot survive, then it will not survive. Hence, if an orderly rather than a disorderly Exit is to be achieved, some plans must be made, and however unpalatable, these are an example of such plans. Failure to plan at all would run even greater risks of disorder and chaos.

Future political, economic and financial health

I will turn now to look at the period post the immediate aftermath of the Exit, and make the optimistic, but probably realistic, assumption that the EU emerges intact, and that the former Eurozone members come through without major social and political disorder. Let’s start with looking back at the end of the first week.

What does success look like for announcement phase ?

In my opinion, a successful first week would be:

- First and foremost, a widespread belief among the general population, the markets and the political classes that all the shock and pain has been taken in one hit, and that the future looks viable and stable, with no further major ‘bad news’ anticipated
- A belief that EU can mend itself and survive as a free trade and economic co-operation area. No Eurozone nation-to-nation vendettas, and no EU departures.
- Active political and legal support from the US, China and the UK and the other major non-Eurozone nations. But note – no new bail-out money.
- An absence of any of the risks listed in the previous section materialising on any scale
- Major markets (equity; bond; currencies) in equilibrium, with two-way trading prices, by Friday of the first week

Stability, growth and future prospects

After the shock effect of the Exit announcement has worn off, the Task Force's aims will be to provide a framework where (former) Eurozone members can successfully plough their own independent furrows. What sort of conditions are needed for each member state for this to be the case ?

Each country should, I believe, attempt to minimise the domestic economic and financial impact of the Exit. Each must encourage normal economic, political and social life to continue. Business must be encouraged to continue as if nothing has happened, and for many, particularly in the short-term, this may broadly be true. However, all businesses, from multinationals to sole traders, will be profoundly affected by Exit in the long term.

Exit will return Eurozone countries to self-reliance, and to the disciplines of financing themselves in a world where financing deficits is voluntary, not a political imperative. It will expose Eurozone countries to feedback loops which had been cut – so fiscal indiscipline will engender higher national borrowing costs, a lower exchange rate and a higher risk of inflation.

It is to be hoped that a successful Exit will form a firebreak with the past, and that bank financing unfreezes as it becomes clear that banks will be supported by their respective Governments, and that the worst has come and gone. Commercial businesses will have to adjust to a more volatile economic relationship with other former Eurozone members, and businesses in weak currency countries will reap new cost advantages where they cannot now, and businesses in strong currency countries will find their competitiveness is tested by a new, higher, relative cost base.

For many weaker country businesses, there could be a bonanza. Any sceptic should look at the aftermath of emerging markets' currency collapses of 1997 and 1998, and of Argentina's in 2002. In all of these cases, apparent financial calamity preceded a low-cost-producer-driven export boom, which in the case of many of the emerging markets and, indeed, Argentina (as we shall see below) continued for more than a decade.

Argentina's economic history 1990-2010 shows particularly strong parallels with the weaker countries within the Eurozone, particularly Greece. I have therefore chosen to examine below, in somewhat more detail than at first might seem relevant, Argentina's experience over this period.

Argentina

In the 1980s Argentina suffered from a series of bouts of serious hyper-inflation. To keep the denomination of the currency manageable, in 1983, 10,000 Pesos Ley were redenominated into one Peso Argentino; after further hyperinflation, in 1985, 1,000 Pesos Argentino were redenominated into 1 Austral. The Austral lasted until 1991, when after yet another bout of hyperinflation, the 10,000 Australs were redenominated into 1 Peso (ARS), and this remains the currency of Argentina today. Greece has not suffered serious hyperinflation in its recent past, so the parallel is not strong here.

In 1991, in an effort to cut the vicious cycle on inflation, and impose price and wage discipline on the country, the then Government announced that the new Peso would be permanently pegged to the US Dollar 1:1. They enforced this by a mechanism called a 'Currency Board', in which all Peso notes and coins issued were backed by an equivalent

amount of US Dollars held at the Currency Board³⁰. Any increase in note-issuance meant an increase in the US Dollars in reserve at the Currency Board, preventing the free ‘printing’ of money. The Currency Board mechanism co-existed with free convertibility of the Peso on both current and capital account at 1:1 exchange rate, enshrined in law.

The Peso was pegged to the US Dollar, but Argentina’s economy was and remains very different from the US economy, and this meant, among other effects, that Argentina’s export markets dried up as the Dollar appreciated (along with the pegged-Peso) in the 1996-2001 period.

As a result of Argentina’s increasing international lack of competitiveness, it began to run larger and larger external (i.e. trade) deficits. The country financed these deficits not by private sector investment in the Peso (i.e. voluntary inward capital flows), but by Government borrowing in US Dollars, with which Pesos were bought in the market to maintain parity. This covered up the downward pressure on the Peso, by countering the current account external deficit, and also allowed (in fact, obliged) the Government to run increasingly large fiscal deficits to both cover the external deficit from a currency point of view, and to re-supply domestic aggregate demand which had been sucked out by the excess of imports over exports. The parallels with Greece here are striking – twin deficits (one – the external – largely hidden); a fixed exchange rate in an ‘immutable’ system, and a relative export disadvantage.

In 2001, downwards pressure on the Peso in the currency market was becoming intolerable, and the Government was struggling to support it. Eventually, Argentina ran out of borrowing power; the Government fell, the currency peg could no longer be maintained, and fell in the space of about six months to about one quarter its par-value (3.75 pesos per US Dollar), before recovering to about 3 per US Dollar, where it roughly remained for nearly decade (it is now about 4.3 Pesos per US Dollar). Most of Argentina’s sovereign debt was denominated in US Dollars (a result of the Currency Board and parity peg), and the devaluation made the debt unsustainable – so Argentina defaulted in the largest single sovereign default in history (about \$100bn).

Domestically, the financial impact of the crisis was very severe indeed – there was a freeze on bank account withdrawal; many Argentinean households and businesses had borrowed in US Dollars, and so there were a large number of people with houses worth less than half their mortgages! The banking system nearly came to a complete halt in early 2002, with real and tangible effects on jobs and poverty in the population. There was serious rioting, and loss of property and life.

As one response to this, most domestic US Dollar debts, bank accounts, mortgages and contracts were (in February 2002) unilaterally and forcibly converted to Pesos at non-market exchange rates. The Peso was falling rapidly against the US Dollar as the time (and was about 2 Pesos/USD by end-Feb 2002); Pesification (as it became known) required domestic Argentinean USD-denominated Bank loans to private sector debtors (i.e. mortgages; business bank loans) to be converted at 1:1. This was, in effect, a haircut to Banking sector assets of 50% (since the market exchange rate at the time was 2:1), and a one-off gain to the private

³⁰ In practice, a proportion of its US Dollar assets were Argentinean Dollar-denominated Government Bonds, which, although Dollar assets, created an element of circularity.

sector of the same amount³¹. By contrast, the Pesification conversion rate for private sector bank deposits (i.e. bank liabilities), and loans to the (Argentinean) Public Sector, was 1 US Dollar : 1.4 Pesos. This was, by contrast, a (somewhat lesser) transfer from the private sector to the banking sector on the one hand, but also a significant haircut for owners of domestically-issued public sector debt, even if the haircut was a little less than that forced on the banks with respect to private debtors.

The asymmetric Pesification was a deliberate choice to drain the banks of capital (to the apparent benefit of the general public), and, as could be predicted, it sent the banking system into insolvency (to be rescued by the Government).

Pesification is as close as any country has come in modern history to the kind of wholesale redenomination that a Euro Exit would require. Pesification was a recognition that the country could not operate with legacy US Dollar asset and debt denomination, and despite the arbitrariness of the exchange rates, it did allow a reasonably swift return to liquidity of the banking system.

As for the very large subsidy to the private sector debtors (the 1:1 exchange rate), since many US Dollar debtors were never going to be able to pay their debts anyway, it was less of a unilateral transfer than might be assumed.

Government spending was severely curtailed (principally by the Government's inability to borrow), and 2002 saw a very painful contraction in the economy, as public spending, lending and domestic expenditure collapsed. But, in an illustration of the power of economic signalling in markets, 2003 saw a return to very strong growth, led by an export boom stimulated by the much lower exchange rate. Real growth in Argentina remained very strong for the remainder of the 2000s, averaging over 6.5%³² p.a., despite Argentina's sovereign default and 'pariah' status in international finance continuing for much of the period.

Argentinean and Greek parallels

Argentina in the 1990s and Greece in the 2010s share poor political governance, a severe fiscal deficit; a large external deficit; an unsustainable Government debt burden and a fixed exchange rate, pegged to a large economy with fundamentally different characteristics. These are the parallels.

The difference is that were Greece to leave the Euro, the whole Greek economy would be redenominated, including most of the Government debt, into a new currency. So much of the pain suffered by ordinary Argentineans through the currency mismatch between assets and borrowings would be avoided.

International markets have proved surprisingly forgiving to sovereign defaulters, and although Argentina is still fighting isolated rearguard actions against recalcitrant bond-holders, nevertheless it has now broadly been rehabilitated. It is possible to imagine, although probably unlikely now, that Greece could redenominate its sovereign debt on Exit into

³¹ Note that the private sector was in dire straits (and this helped, somewhat), since the property on which, e.g., mortgages were secured would have fallen in Dollar terms by half in a couple of months.

³² 2003-10 average Argentina per capita annual real growth rate at constant 2005 Dollars & exchange rates. Source Economic Research Service, USDA.

Drachma, and choose not to default. If it could manage this feat, it would I suspect find the markets even more forgiving than they were to Argentina.

But default or not, the closest historical parallel we can find shows that economic life after a currency collapse can recover very quickly indeed.

Fiscal discipline

One of the most intractable problems faced by the architects of the Euro, and subsequently by its more disciplined members, was the seeming endemic lack of fiscal discipline of many of the weaker members. The founding fathers of the Euro clearly recognised this problem right at the start, but did not, it turned out, find any effective mechanism to create real disincentives for fiscal laxity. On the contrary, the system seems to have provided incentives at the member state level for a casual approach to budgeting – the strong members providing ‘cover’ (low interest rates; the protection of the ECB) for incontinent sovereign borrowers.

In the post-Exit world, it is my strong recommendation that (former) Eurozone members are not given any material inter-regional transfers, guarantees or protection. They should be told that they are standing on their own two feet, and that all their decisions will be ones they will have to take the longer-term consequences for. The abolition of both the ECB and the EFSF should reinforce this message.

The markets will have to conduct some very rapid calculations on some of the new post-Exit members. It seems likely that the more indebted nations will see their new national currencies fall sharply against the conversion rate, and borrowing costs, both short and long-term, rise. But, as mentioned earlier, the markets may find themselves pricing inflation risk rather than default risk in many of the weaker members.

Some countries – the most obvious being Italy – will find the new regime very challenging indeed. Italy has a very high debt to GDP ratio (118.4%³³); it generally has quite short maturity sovereign debt; and the average interest rate it is paying on that debt has been modest at 4% p.a.³⁴. If Italy returns to a monetary environment similar to the 1980s and 1990s, then it can expect to pay interest rates in double figures, or certainly high single figures. If we suppose that average debt service interest rate turns out to be 10% p.a., this would mean that Italy would be paying some 12% of GDP, or some 26%³⁵ of total Government revenues just on debt service.

Weaker, and more indebted, nations will find this a common problem. Market discipline will be a great deal tougher than Eurozone fiscal rules, and it implies that public expenditure will have to be severely cut to balance, or more than balance, these Governments’ books in the early months and years post-Exit, thereby satisfying the markets that the borrowing is sustainable. Since Government revenues are already running in the high 30s to high 40s percent for most Eurozone countries, imposing much higher tax rates is likely to be counterproductive on tax revenue for most.

³³ Source: Eurostat, Dec 2010.

³⁴ Source: Eurostat, Data for Italian Government borrowing; apparent average interest rate paid, 2010. For comparison, Germany is 3% p.a. for 2010.

³⁵ 26%=12%/45.8%, where 45.8% is Italian general Government revenue as % GDP 2010. Source: Eurostat.

For the weaker countries, inflation is likely to become the major challenge after fiscal discipline and debt service. Of course in one way it is the solution – it reduces the real value of an overleveraged household, public and banking sector. But inflation has proven in history to be destructive of business confidence; to be undermining of ‘economic morality’, and to be unpopular with the public in general, and with savers in particular. It is, after all, the enforced transfer of very large amounts of money from the careful, prudent and generally elderly (savers), to the young and generally economically active (borrowers). In practice, it may be that in the early years post-Exit, inflation is seen as moderately benign for the reasons first stated, and then in time, the perception will slowly change, as it did in the UK in the 1970s, so that inflation becomes political public enemy number one.

Germany is the only former member unlikely to face higher post-Exit interest costs on its debt. Its challenge will be an immediate loss of competitiveness vis-à-vis its European neighbours. Although it has an export mix which is reasonably price inelastic (dominated by high-quality engineering), nevertheless it will see its European trade surplus begin to fall. So it might also be facing a demand shortage, which will have its own economic and political knock-on effects.

Trade and the EU

It is vital, in my opinion, that the single market remains intact in the EU as a whole. Although the single market has not succeeded in spreading to all business sectors (housing; pensions; insurance and financial services generally are examples), in many areas the single market is working well, and already copes with ten countries within the single market, but outside the Eurozone. I see no reason why this cannot continue with all 27 countries having individual currencies.

I do not underestimate, however, the fundamental blow which an Exit will have inflicted on the EU project. At the core of the EU there will be deep despondency at the failure of the most important single flagship policy. There is a danger in this environment, I think, that the EU could begin a retreat across many fronts, and that the Eurosceptics, their tails in the air, will vigorously pursue a more nationalistic agenda egged on by national politics which will have been shaped by the painful recent experience. This is a recipe for renewed protection, for domestic preference, and for all the little ‘Spanish practices’ that prevented fully effective trade in many periods of history.

If we are to avoid a full-blown depression like the 1930s, then it is vital that the energising force of international trade, and its positive effect on the welfare and wealth of nations, is allowed to flourish.

Post-Exit exchange rates

In my opinion, there will be little appetite for renewed exchange rate systems post-Exit. Although it is currently popular to talk about the ‘Mediterranean Euro’ or the ‘Super Euro’, as successors to the Euro, once the Euro has shown itself to be mortal, then new currency groupings will look mortal themselves, and the markets, flush with their recent triumph, will take no time in attempting to demolish any new system, whether or not there is any fundamental rationale for demolition or not.

The foreign exchange market is remarkably resilient, and it has shown itself capable of adapting to almost any new conditions that present themselves. In my opinion, the foreign exchange market will very quickly find equilibrium exchange rates for all the new currencies, and even though I am sure these rates will be volatile in the early post-Exit period (just like in the 1970s post-Bretton Woods), the existence of deep, liquid markets will ensure that trade and investment can be conducted quickly and with certainty at very low transaction costs.

This brings me to my last recommendation:

Recommendation 6: Continued membership of the EU to require that each member state does not impose tariffs or restrictions to trade on any other member state, including requiring open and free-market currency markets in both current and capital account in unlimited amounts for all EU citizens.

If citizens of the EU are genuinely confident that their Governments will not impose restrictions on their ability to move their money to wherever they choose, then both EU and non-EU investors will remain confident about leaving their money domiciled within the EU.

New Europe

In my opinion, the Treaty of Rome set out a vision of a Europe of independent states united in friendly and co-operative trade, understanding and mutual respect. I can see a new beginning for Europe under a new banner (“New Europe ?”), replacing the discredited EU post-Exit.

The Treaty of Rome was a response to the horrors of the WWII, and in the minds of their grandsons and granddaughters now running the EU, the European project is still a project to prevent Europe ever again falling into military confrontation and conflagration. I think that the same spirit could inform ‘New Europe’, and I can envisage a new generation of politicians committing themselves to a New European ideal of co-operation, but respecting the differing cultures and customs, and celebrating the sovereign democracies of each individual state. I could see the rolling back of EU-level legislative institutions, to be replaced only by Treaties that seek to make the playing field reasonably level. In this framework, I can see Europe prosper again.

Summary and Conclusion

In this essay, I have sought to design a route out of the Euro for one or more countries, which will minimise economic, financial and political damage, and allow growth and prosperity to replace crisis and austerity.

The route that I recommend requires the formation of a secret Task Force by either Germany alone, or (possibly) by Germany as the lead, and France as a junior partner. I deem absolute secrecy and deniability to be essential, because if the markets get wind of any plans for the dismantling of the Eurozone in its current form, then events will accelerate and spiral out of these Governments’ control, rendering the Task Force’s plans irrelevant.

The constitution of the Task Force is difficult, because the requirement for absolute secrecy needs to be combined with a requirement for legitimacy. I conclude that the latter can only be realised by having Germany as the Task Force sponsor, and with France as the only possible

partner. A larger sponsor group would increase the risk to secrecy without adding sufficiently materially to the legitimacy of the plan.

This Task Force should, in my opinion, develop a plan which envisages the first Exit being the only Exit - namely the complete abandonment of the Euro when it becomes inevitable that one member is to leave. This radical approach has only been adopted with some reluctance. The complete abandonment of the Euro would be a momentous step for Eurozone members, and would mark the end of the integrationist project for the EU.

This essay recognises the magnitude of complete Euro abandonment, but I have considered very carefully the alternative (piecemeal departures), and concluded that the moment one country leaves the Euro, then the view that the Euro is 'unbreakable' or 'permanent' becomes untenable. This would give markets the evidence and the ammunition to continue to turn their fire on Euro structural weaknesses elsewhere. This is a recipe for a continuing crisis, resolved only when the last target that the market can find is demolished. In practice, this would be the enforced slow-motion dismemberment of the Euro.

It may be that no country does leave the Euro in the near future. However, if the plan I set out is adopted, Germany would henceforth be equipped with a blueprint which it may find serves it very well in the crisis conditions under which it would be obliged to make it public, and put it into action.

The essay looks in some considerable detail at the practical and immediate implications of Exit. It considers the major problem of redenomination uncertainty, the solvency of the ECB, and the conduct of National Governments and their National Central Banks in the first few days and weeks following Exit. It spends some considerable time discussing the difficulties likely to be encountered by the Eurozone banking system, and concludes that it is likely that all banks will need liquidity provision by the National Central Banks in the immediate aftermath of the crisis, and that some banks will need major recapitalisation. The only entities capable of doing that at the speed, and in the scale required, are the respective National Governments of the countries' banks. In this plan, National Governments announce their commitment to this recapitalisation at the outset.

I consider several unpalatable possibilities, but conclude, by drawing some parallels with the Argentinean experience, that open economies can recover surprisingly fast from currency collapses (and even sovereign defaults), and establish a path of sustained strong growth.

I make six practical recommendations in the essay:

Recommendation 1: Germany (possibly together with France) establishes a secret Task Force, with a Charter to design proposals for planning and managing possible Eurozone Exit. Ideally France would join to give legitimacy – but secrecy and speed is essential, so only a token joint operation may be possible.

Recommendation 2: Whatever the results of the Task Force's deliberations, firm plans and proposals should be in place by 30 April 2012, or as soon thereafter as is practicable using all means at the Task Force's disposal.

- Recommendation 3:** The Task Force would propose to the Council of Ministers that the Euro should cease to exist on the day of the Exit announcement, to be replaced by new National Currencies.
- Recommendation 4:** The ECB would be closed and its functions terminated with immediate effect. All its functions to be transferred to the relevant National Central Banks (NCBs). Its balance sheet to be shared out *pro-rata* to NCBs by reference to the ECB shareholding proportions and (for banknotes), NCB banknote issue.
- Recommendation 5:** Assign where legally possible (i.e. within Eurozone jurisdiction) currency redenomination to depend only on immovable reference points. This will prevent as far as is practicable Eurozone individuals' panic moving of assets or liabilities to achieve more favourable redenomination treatment. Notes and coins to be fractional denominations of their issuer's new National Currency, and their value dependent only on the identity of the National issuer, not on the owner or the location.
- Recommendation 6:** Continued membership of the EU to require that each member state does not impose tariffs or restrictions to trade on any other member state, including requiring open and free-market currency markets in both current and capital account in unlimited amounts for all EU citizens.

With these recommendations (and the others in the main body of the essay) enacted, and with a credible and fully thought-out plan as recommended, I believe it is possible for the Exit of one member (which in this plan implies the complete abandonment of the Euro) to be a turning point in the cycle of crises which have characterised the Euro in the past few years. Indeed I do think it is possible, despite the momentous scale of the event itself, that Exit could mark the start of a new and vibrant period in Europe's history.

Word Count: 19,140