One-way euro

Barry Eichengreen argues it’s impossible to unwind the mechanism behind Europe’s single currency— or is it?

One of the oldest democracies faced a crisis it had never imagined. With its parliamentary debate becoming unwatchable, the country began to discuss this option. How might that happen? If the government was discussing the possibility, investors would thus respond by transferring their Greek bank deposits to Germany. All of them. On the first minute that would not get out that the government was discussing the possibility, investors would sell their Greek stocks and bonds, for the same reason. This would be a fully fledged financial panic. It would be a full-out bank run. It would be the mother of all financial crises.

Greece would have to close down its banking system until order was restored. It would have to suspend trading on its financial markets. It would probably have to seal its borders to prevent residents from ferrying cash out of the country. Being forced to take these steps would not exactly enhance the reputation of the politicians forced to take these emergency actions as a result of their own prior discussions. All this could be avoided, you might say, if the decision was taken in secret and announced as a fait accompli. Residents would wake up one morning and be told that their euro stocks, bonds, cash and bank deposits would all be converted into drachmas. End of story.

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

Moreover, once Greek banks and financial markets were shut down, they would have to remain shut for an extended period. Reintroducing the drachma entails more than just issuing drachma banknotes or over-stamping the euro banknotes circulating in the country with a big “G”. The banks’ computers will from being locked into subterranean garages. In all, reintroducing the national currency will be a logistical nightmare.

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

So I concluded in my article four years ago that abandoning the euro was out of the question because a country even considering whether to do so would inflict upon itself a massive banking crisis and have to close down its banking system. What I failed to imagine was that a modern European country could have that kind of banking crisis for entirely separate reasons, such as a self-inflicted debt crisis and that it might force to close down its banking system anyway. If Greece almost certainly receive support for its banks from its European Union partners and the European Central Bank.

Such support would be in the partners’ self-interest. Greece’s departure would add to the credibility of its own reforms, while making preparations for abandoning the euro would immediately raise expectations that other Southern European countries might follow. These countries would experience banks’ panics of their own, requiring the ECB or the EU’s newly created Financial Fire brigade, the European Financial Stability Facility, to support their financial markets and guarantee their bank deposits. It would be better, or at least cheaper, the Europeans are certain to conclude, to instead provide Greece with additional support and it could continue down the path of austerity and adjustment and avoid fiscal fire.

This, of course is just what the EU decided last week.

Germany is the only country that could contemplate exiting the euro area without precipitating a run on its banks. Since the “deutschmark” would be expected to strengthen against the rump euro, money would flow into the German banking system. But German exports would be smashed when the deutschmark went through the roof, driving down the currency of the country’s European neighbours. This is why Germany business remains firmly in favour of the euro, in contrast to the reservations of the typical denizen of a Munich garage.

But a Greek exit would be. It is widely expected that German economic miracle of the last 10 years can be summed up in one word: exports. Since Germany’s export competitiveness has been greatly enhanced by a euro exchange rate that has been kept down at reasonable levels by the fact that Germany shares the currency with other weaker economies. Germany business understands that a move to reintroduce the euro would create massive fiscal cost to other European countries, as individuals there shifted their bank deposits en masse to Frankfurt. And any significant financial crises in other European countries are of course the last thing that Germany wants. This is why Germany will, in the end, swallow hard and agree to the higher taxes and transfers to other weaker countries needed to make the monetary union work. It will not do so happily. It will not do so at all. But it will do so eventually because there is no more attractive alternative.

World War I was a policy mistake. It resulted from a series of strategic miscalculations by the European powers that resulted in a catastrophic coalition from which no one stood to gain and that no one truly wished to fight. It led to the dismantling of the Austro-Hungarian Empire and all the borders of nationalized borders to be redrawn, sometimes in countertrendive ways. Even if the decision leading up to the war were regrettable, these consequences were irreversible. The same is true of the decision that Greece made when it joined the euro.

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