A “Hard Money” Small Country Exit

• Triggers?
  – Dissatisfaction with ESM losses and further risk.
  – Unhappiness with monetary policy outcomes.
  – Rejection of a Treaty deemed necessary for EZ.

• How does exiting country deal handle process?
  – Maintain policy of one-to-one fixed exchange with euro for some period or a big once-off appreciation?
  – Capital controls to restrict inflows? (Tensions with EU membership /Article 65/Derogations).
  – Messy but “manageable”.
Impact of a “Hard Money” Exit?

• Arguments that it could be limited:
  – Euro remains the major currency bloc that countries would want to be attached to.
  – Greater coherence from removal of “awkward” characters.

• Stronger arguments for serious impact:
  – Shatters “fixed and irrevocable” myth (Who’s next?)
  – Provides a “roadmap” for how to exit.
  – A successful exit may lead to some countries choosing to copy (or being shoved out).
Filling in the Map

- Lord Melchett: Farewell, Blackadder [hands him a parchment]. The foremost cartographers of the land have prepared this for you; it's a map of the area that you'll be traversing. [Blackadder opens it up and sees it is blank] - They'll be very grateful if you could just fill it in as you go along. Bye-bye.
A Small High-Debt Country Exit

• Triggers? Pull and push:
  – Long slump with exports failing to offset weak domestic demand due to austerity.
  – Frustration. Nationalistic non-economic reasons.
  – Failure to pass a Treaty set down as a condition.
  – Failure to comply with programme conditionality.
  – Bailout fatigue in core countries.

• Response in other high-debt countries
  – Deposit flight (Are we next?)
  – Is a “ring-fencing” actually possible?
  – Capital controls (can these really be temporary?)
Spexit or Quitaly?

• Current thinking: Spain and Italy impose austerity and structural reforms (and sort out banks), return to growth, stabilise debt and OMT goes away.

• What if they don’t?
  – Open-ended OMTs and ongoing conditionality? Political resentment against euro builds.
  – Large-scale PSI deals? Strong vested interests against.

• Any exit of this type would clearly trigger deposit flight throughout the high-debt countries.

• Is this the end of the euro?
Can Deposit Flight Cause Breakup?

• So far, crisis limited to “deposit jogs” (some fairly brisk).
• But an actual exit could trigger mass withdrawals.
• Will ECB supply massive liquidity so all deposits are safe?
• Not so bad if banks are solvent but many are not, so this process Europeanises all losses in peripheral banks.
• In theory, Eurozone could choose to honour an exit-proofed deposit guarantee in euros. In practice, unlikely.
• Self-fulfilling equilibria: If ECB aren’t willing to fully back the banking system then this will be tested.
• And faced with exit versus deposit haircuts, which do governments pick?
The ECB’s Role: Whatever it Takes?

• OMT a success so far but is it a long-term tool to save the euro?
• ESM conditionality set by politicians but political atmosphere will sour if growth disappoints and public debt fails to stabilise.
• Given its legal and cultural inhibitions, is ECB capable of saving the euro if Plan A (austerity, reform) fails to work?
• “Whatever it takes” is Draghi’s personal commitment.
• OMT is a sign ECB can show the flexibility to save the euro but there’s a long way to go yet.
Interesting data-point yesterday: Irish promissory note deal sees huge €30 billion debt to recap dead bank Anglo kicked off for over 30 years.

Looks, walks and quacks like monetary financing but “noted” and not rejected by ECB.

But monetising Anglo’s debt didn’t represent a systemic risk to price stability.

Would ECB do a similar deal for Spanish or Italian banks?
Can A Break-Up Really Happen?

• Most Euro politicians more than willing to talk about exits which keeps the idea afloat.
  – Recommending “in or out” referenda (Merkel).
  – Saying Greek exit would be “manageable” (Juncker, all the time)
  – Saying ideally there should be an exit route (Lots of MoFs)
  – Cyprus “not systemic” (Schaeuble)

• Design flaws and political tensions of euro project will be hard to fix, particularly since new Treaties required.

• Break-up may be a negative sum game but so are wars. And yet wars happen, often from innocuous-looking beginnings.

• “Fixed and irrevocable”? Most thing aren’t. The End of History never happens.
WE ARE NEVER EVER GETTING BACK TOGETHER
After a Full Break-Up

• Currency mis-match everywhere. Initially a zero sum event but ...
  – Winners and losers (banks and corporates) but huge problems with transparency and resolution.
  – Lots of legal uncertainty and cases that could take years to sort out.
  – What happens to weighted average basket of post-euro currencies? Probably depreciate.
  – Leaves core-Euro, UK, Swiss banks heavily exposed.

• Easier or harder than assessing sub-prime exposures?

• More complex set of uncertainties than post-Lehman period.