Contagion Scenarios for Euro Exits

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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?

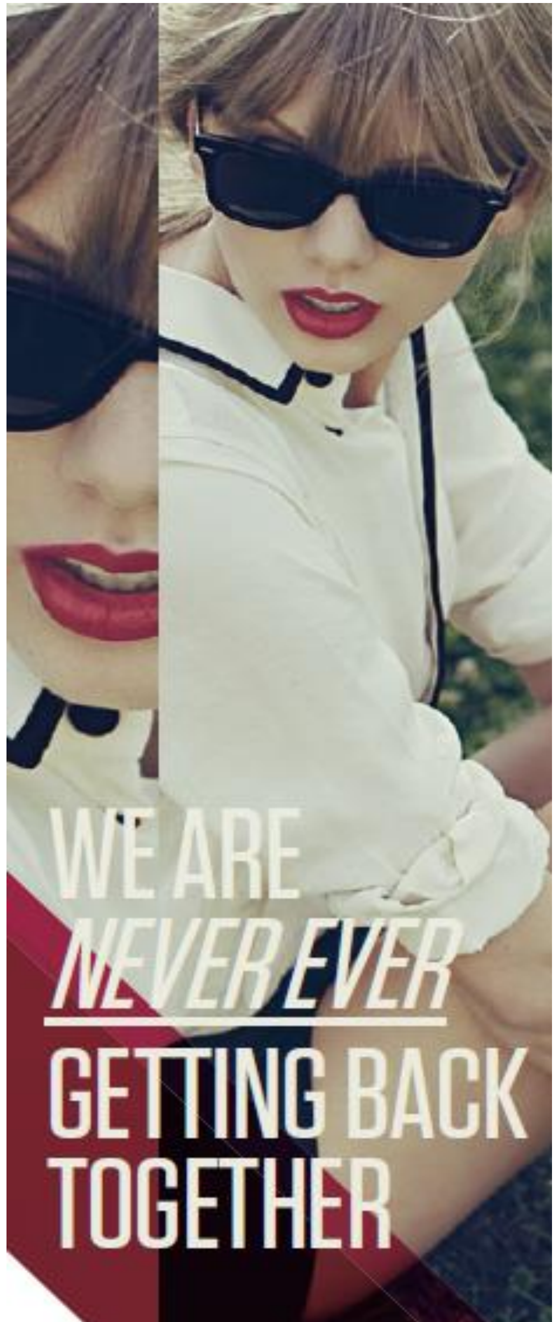
- OMT a success so far but is it a long-term tool to save the euro?
- ESM conditionality set by politicians but political atmosphere will sour if growth disappoints and public debt fails to stabilise.
- Given its legal and cultural inhibitions, is ECB capable of saving the euro if Plan A (austerity, 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.

An Interesting Data-Point

- 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.