Redenomination Risk Following a Euro Breakup

1. The Euro Could Destroy the EU

When in the 1990s the decision was made about a common currency among qualifying member states of the European Union, no particular attention was paid to the need for longer-term fiscal discipline. The Stability and Growth Pact was, from the start, a “nice chaps” document, weighting about 1 percent when compared to the 100 percent of rules necessary for fiscal union and common currency stability requirements. In the 1990s, Euroland’s member states rejected a biting fiscal discipline because they were afraid that it would:

- Take discretion away from them,
- Precommit them to austerity measures during tough times, and
- Expose the malfunctions in their fiscal, economic, and financial systems.

The first years of the euro tended to prove that the doubters of the need for a fiscal union based on hard rules were right. Fiscal discipline was wanting, but 2001–2007 were the years of the fat cows. Things radically changed with the deep economic and banking crisis that started in mid-2007 in America, with the subprimes. Western economies went through the first deep trough in September 2008 with the eleventh-hour salvage (with taxpayers’ money) of AIG, Fannie Mae, Freddie Mac, and the bankruptcy of Lehman Brothers:

- The economic and financial landscape darkened, and
- The absence of a true fiscal discipline became Euroland’s Achilles heel.
Not only did the lack of coordination and convergence on fiscal issues make itself felt, but also the rather chaotic administrative arrangements in Euroland and the EU hamstrung attempts to react to the crisis early enough. Each member state took a defensive position, though the means by which Euroland’s member countries got themselves into trouble varied from one jurisdiction to the next.

Ireland was not profligate, but the Irish government foolishly offered blanket coverage of the liabilities amassed by the country’s banks when the latter got into trouble. In the aftermath, Ireland suffered a collapse in sovereign creditworthiness because its mismanaged banks had engaged in high stakes and their losses affected their obligations to both their domestic clients and those abroad.

The case of Greece, Italy, Spain, Portugal, and eventually France has been different. Some, like Italy and Greece, were not ready to join the common currency and to qualify for it they cooked their books (particularly their economic statistics). Others, like Spain, had superleveraged themselves through a real estate boom and their economy depended on it as if it would last forever. What all these member states, the Club Med, have in common is that they capitalized on easy credit to finance unaffordable government spending. In parallel to this there was:

- Endemic tax fraud,
- Unaffordable entitlements,
- Highly expensive and abused health care, and
- A fair amount of nepotism and corruption.

The problem of the so-called peripheral countries was not only that they used their membership to the common currency to borrow at low German-like rates, but also that their economies were sclerotic, inflexible, and old-fashioned. To make matters worse, there has been no political will to restructure labor laws and get the economy moving again.

This highly defensive policy did away with common currency benefits, exposing each country’s weak points. After the crisis broke out, investors demanded higher interest rates by several percentage points to hold Club Med’s bonds compared to German ones. Whether or not the ECB and different chiefs of state like it, there has been a de facto bifurcation in the value of the euro.

George Soros was right when he said that the euro could destroy the EU.\(^1\) If the currency union were just a fixed exchange rate arrangement, it would have had already collapsed; the fact that it is a monetary union will delay that outcome, but the euro is far from being out of the tunnel. Economists do not doubt that: