

# After Eurogeddon?

Frequently asked questions about the break-up of the euro zone





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**T**hirteen years since its launch, Europe's common currency is in crisis. A Greek debt restructuring is inevitable, and concern is now focusing on contagion among the larger euro area economies. The prospect of a cascade of disorderly sovereign defaults is chilling investors, and the departure of some members from the common currency is increasingly being discussed. The Economist Intelligence Unit's central forecast is that the currency area will survive, but the odds of failure are too high to ignore.

To help clients anticipate the implications for their operations of a collapse in the euro zone, we have compiled a list of frequently asked questions (FAQ), exploring the potential scope and impact of a euro-area break-up. We look at what "break-up" could mean, although in practice numerous possible permutations exist between the extremes of departure by a single country and the exit of all 17 members.

There are too many unknowns to make confident predictions about the trajectory of the crisis or the extent and speed of any break-up, should efforts to save the single currency fail. The following FAQ represents an exploration of alternative scenarios that diverge from our central forecast. We attach a 60% probability to this central "muddle through" scenario, not least because the catastrophic consequences of a break-up provide a strong incentive for policymakers to do whatever is necessary to save the euro. In contrast, we think there is a 35% chance of a break-up of the euro zone, in which the most likely scenario would be the exit from monetary union of the smaller so-called "periphery" economies, as well as both Italy and Spain. We assign a 5% probability to Greece leaving the euro zone on its own, without triggering other departures.



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# FREQUENTLY ASKED QUESTIONS

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2. What would be the likely trigger for a country leaving the euro?
3. Could a country default and stay within the euro?
4. Would an exit by one country (such as Greece) cause others to leave the euro?
5. Which countries would be most likely to stay in the euro, and which would be most likely to leave?
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### 1. Can a country leave the euro?

Technically, no. However, we assume that under extreme circumstances, procedural and legal obstacles would not prevent an exit. No formal mechanism exists for a country to be expelled from the euro area or to leave of its own volition, and a comprehensively negotiated exit—if even possible—could take years. Instead, a country might leave unilaterally, breaching many of its legal obligations to the EU, its creditors and others. In this messy scenario, uncertainty in the interim over a country's formal membership status would quickly become secondary to its *de facto* status as a pariah. Alternatively, a stricken country could in effect be expelled if policy institutions and fellow euro members decided to withhold financial support, thus pushing the country towards a position in which it felt unilateral exit was its best choice. The practical challenge of switching rapidly to a new currency—countries had years to prepare for the introduction of the euro—would also be formidable.

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### 2. What would be the likely trigger for a country leaving the euro?

It is conceivable but highly unlikely that Germany or another fiscally and economically strong country might decide to leave the euro. The more likely eventuality, which we examine here, is that of a weak economy such as Greece leaving. The most likely initial trigger would be a disorderly sovereign default. This could happen if the country refused to accept harsh terms for financial support; or if euro institutions, the IMF and other euro members declined to intervene further on the grounds that the country was failing to implement effective deficit-cutting measures. The former is most likely. Default would wreak havoc in the domestic banking system because of banks' sovereign debt exposure. In fear of bank failures, panic withdrawal of funds could follow. Unless countered by the provision of sufficient liquidity from the European Central Bank (ECB), this would in effect lead to the collapse of the banking system, making normal commercial life impossible. At this point, the only way to restart commercial activity could be to introduce a new national currency.

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### 3. Could a country default and stay within the euro?

A default would not automatically imply exit. A country could stay within the euro if sufficient institutional support and external financing for its banks were forthcoming. (Fears of systemic contagion, indeed, could make such support more likely.) The biggest factor would be whether the necessary political will existed inside the country, among its euro partners and from the "troika" of the ECB, European Commission and IMF. We believe that the costs of abandoning the single currency would far outweigh the benefits, such as currency depreciation that promoted export competitiveness. However, populist politics and/or opposition from an austerity-fatigued public to further painful cutbacks could create conditions in which the argument for leaving the euro appeared persuasive.

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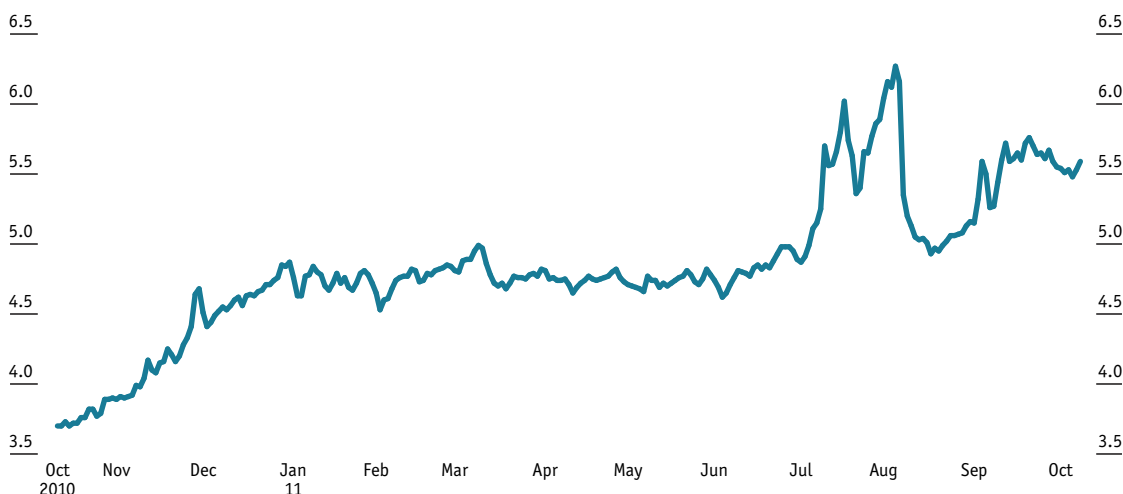
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### 4. Would an exit by one country (such as Greece) cause others to leave the euro?

There is a major risk that it would. For example, if Greece left the euro, the market pressures on the countries perceived as the next most vulnerable would rapidly become overwhelming. Bond yields would skyrocket, making funding from private markets unaffordable, even on the (generous) assumption that markets remained willing to lend at exorbitant rates. In one sense, such sovereign funding issues would not immediately matter for countries such as Portugal and Ireland, which are supported by a programme agreement with the European Financial Stability Facility (EFSF) and IMF. However, it is likely that these countries' banking sectors would also come under increasing pressure amid heightened liquidity and solvency fears, raising immediate funding concerns and possibly triggering runs on deposits. These pressures could ultimately exceed the willingness of official institutions to intervene. In the case of countries without fiscal support programmes, the ECB and EFSF could either choose or feel compelled to intervene, but they might not be able to do so on a sufficient scale to calm the markets. In both cases, the same process of collapse of the banking system leading to a political decision to exit the euro would then risk being repeated. The danger is that with each cycle, a bigger and harder-to-save economy would come under pressure, reducing the chances of policy success.

#### Italy 10-year govt bond yields

(%)



Sources: Reuters; Haver Analytics.

It is worth noting that the chronology of contagion would be untidy. During the exit process, severe market pressures would already be present in other countries as investors priced in the anticipated impact. As the chain reaction spread across Europe, we think contagion would be rapid, dramatic and uncontrollable at times, but there might also be periods in which events moved slowly. For example, in the case of Italy, it would take time for higher interest costs on newly issued debt to increase the total interest burden to an unaffordable level. Every escalation of the crisis could also inspire greater official commitment to saving the euro, which would calm markets temporarily.

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### 5. Which countries would be most likely to stay in the euro, and which would be most likely to leave?

Firm predictions are tricky, but broadly a fracture between a strong northern “core” and the weaker “periphery” looks most likely. The process would, in our view, probably entail periphery countries breaking off individually to leave a “rump” of northern countries still within a currency union. Once one peripheral country (say, Greece) left, all the other vulnerable countries would probably follow. This means that Portugal, Ireland, Italy and Spain would leave the euro, although not necessarily immediately. Malta would probably leave, and Cyprus would have little choice but to exit as its banking system would be nearly wiped out by a Greek collapse. Up to ten countries could remain members of the euro: Germany, France, Austria, Belgium, Finland, Luxembourg, the Netherlands, Slovakia, Slovenia and Estonia (the last three all being small, open economies like Malta and Cyprus, but with healthier fundamentals).

France’s status would be key. With memories of the speculative attacks and devaluations of the 1970s and 1980s still fresh in policymakers’ minds, no appetite whatsoever exists in the political mainstream for a return to a national currency. France would therefore make every effort to stay in the euro. However, a slimmed-down northern core would cause dramatic currency appreciation that would make it difficult for France, with its external deficit rising as a result, to remain viable in the euro. Nevertheless, we think that monetary union with Germany is so fundamental to France’s view of its political and economic interests that it would be determined to stay, and that Germany would be willing to provide extensive financial support to enable France to do so. For Germany, close co-operation with France is a more fundamental part of its political culture than that with the peripheral countries. If France stayed, the new bloc could still be considered a smaller euro zone; if it left, the result would in effect be an enlarged D-mark zone.

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### 6. What would be the immediate economic and financial consequences for countries leaving the euro?

The consequences would be numerous and unpleasant. In anticipation of the euro exit, an accelerating bank run would be likely, as institutions and individuals rushed to move their deposits out of the country. This would severely threaten the banking system and would have to be halted by a prolonged bank holiday and/or capital controls. While bank withdrawals were frozen, the government would legislate to create a new currency. It would redenominate existing bank assets and liabilities into the new currency, and new banknotes and coins would be created. The new currency would depreciate dramatically against existing global currencies.

Any debt that remained in euros would be much higher in local-currency terms. So too would debt in other currencies such as US dollars. The result would be massive balance-sheet problems, and many companies would become insolvent. External funding would also be cut off. Public-sector salaries and most private-sector salaries would have to be paid in the new currency. The country would suffer





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a sharp compression of imports, to the point where it could only import goods and services up to the value of hard currency it earned through exports. New trade contracts would have to be denominated in external currencies, as suppliers would want payments in strong currencies.

If the introduction of a new currency had been preceded by sovereign default, this would mitigate the debt-servicing burden. However, any government that had not previously achieved a primary fiscal surplus would either have to implement further austerity (which would be deeply unpopular) or monetise the deficit, which, added to massive currency depreciation, would be highly inflationary. Exiting from the euro would not in the short term prevent savage recession. At some point in the future, the country might be able to begin to return to sustainable growth on the basis of regained competitive advantage, although the difficulty of achieving the necessary internal adjustment could be formidable. In any event, successful economic reconstruction would only occur if wages could be reduced in real terms and efforts to compensate for inflation resisted. Recession in the rest of the euro zone would deplete demand for the departed country's exports even after currency depreciation.

Even under this grim general scenario, some economies would fare better than others. For example, Italy's well-established export-manufacturing base and reasonably sound economic fundamentals (domestic debt aside) would mitigate the damage. Greece, in contrast, lacks a strong industrial base and would have little in the way of a functioning economy to fall back on.

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## 7. And for the countries that stayed?

The stronger northern core would suffer in three main ways. The most immediate and dramatic impact of a fracturing of the euro zone would be massive losses on domestic bank lending to governments and companies in the countries that had left. This would require major public intervention, possibly on an even larger scale than in 2008. In turn, this would add considerably to sovereign debt levels in Germany, France and elsewhere. Second, sharp currency appreciation would erode export competitiveness. Third, export demand in neighbouring countries, particularly those whose currencies had depreciated, would collapse. This would have a serious impact, given the importance of trade between euro members. For example, Germany sent 41% of its exports to other euro area countries in 2010. For Austria, the corresponding figure was 54%. In both cases, the "weak" countries accounted for much lower shares of exports. However, a break-up of the euro would also cause recession in the stronger core and undermine global demand, so the overall downturn in exports would be substantial.

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## 8. What would be the impact on global financial markets?

Again, this would depend on the nature and scale of the break-up, but it would certainly be negative for equities and other risk assets, resulting in flight to safety on a potentially epic scale. Stockmarkets would fall dramatically in most countries. Although investors have already priced in substantial negative expectations, a euro break-up would have a much more dramatic impact on confidence.

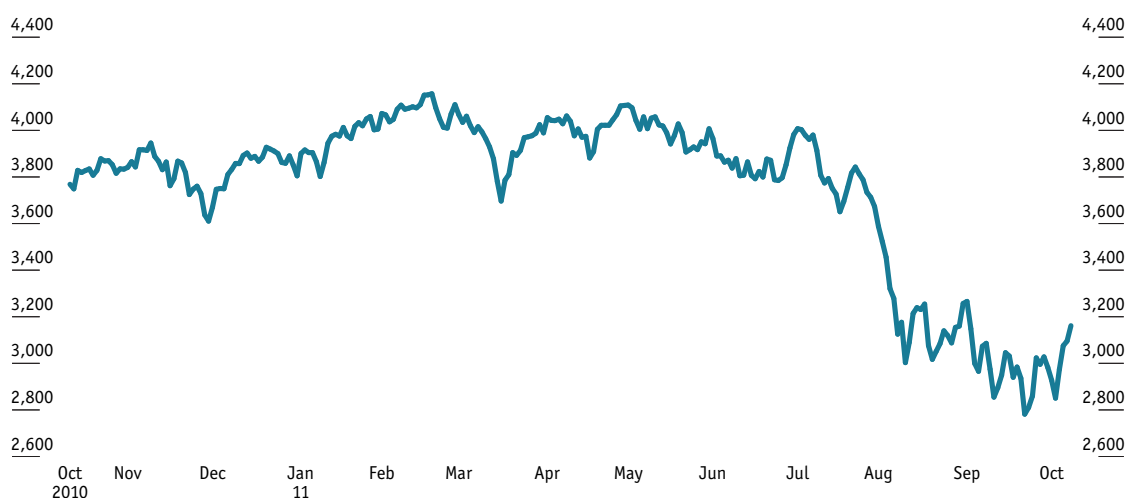


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Government bond markets would probably be split between those seen as relative safe havens and the rest. US bond yields could fall even further as investors piled into the “risk off” trade. German bunds could also benefit similarly, although this would depend on market perceptions of Germany’s success in isolating itself from weaker euro members. As in the aftermath of the collapse of Lehman Brothers in 2008, dislocations in the short-term markets that lubricate the global financial system would emerge. In Europe, the impact of break-up would probably surpass the turmoil seen in the wake of Lehman’s collapse.

### France CAC 40



Sources: Wall Street Journal; Haver Analytics.

The potential fallout elsewhere in the world is difficult to judge, but with each new country that left the monetary union, the impact would become more severe. For example, departure and default by Italy—the world’s third-largest government bond issuer, with bonds worth about US\$2.1trn in circulation—would immediately imperil the solvency of financial services companies across the world. Those that could not raise sufficient funds to compensate—a foreseeable problem given that liquidity would be tight—would have to turn to governments for support. The resultant market turmoil could be exacerbated by limited capacity for states to support the financial sector on a similar scale to that in 2008-09.

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## 9. What would be the impact on the euro in relation to global currencies?

Throughout the initial stages of break-up, the downward forces on the euro would be severe. If the ECB, for example, vastly expanded its bond-buying programme—in effect mimicking the US Federal Reserve’s quantitative easing—in an attempt to contain the crisis, the euro could drop sharply. The potentially lengthy limbo period during the break-up would also be highly negative for the single currency, owing to safe-haven factors. Money would flood into the dollar and potentially into other



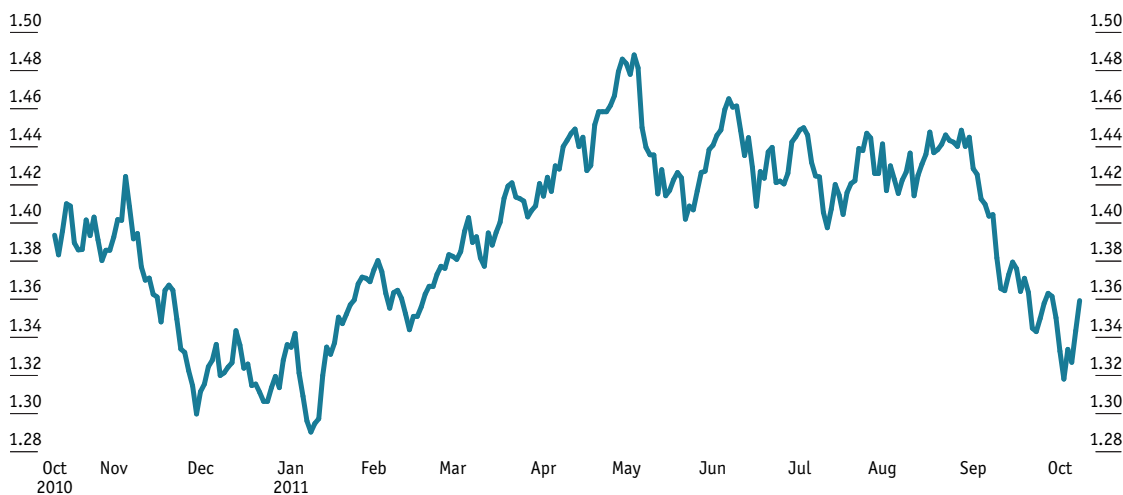


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currencies such as the Swiss franc. However, if the situation stabilised, the rump euro would be a strong currency since it would contain only healthier northern economies. The euro would also benefit from the poor fundamentals of the US dollar, which have been masked by other factors until now.

### US\$:€ exchange rate



Sources: European Central Bank; Haver Analytics.

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## 10. Would a global recession be inevitable if the euro collapsed?

A break-up would cause a deep recession throughout what is now the euro zone. Demand would weaken because of a combination of consumer retrenchment, higher unemployment, reduced spending power in countries that suffered sharp currency depreciation, and weaker exports. At the same time, the need for austerity would make substantial fiscal stimulus unaffordable in most west European countries.

We also think serious disruption in the euro area would tip the US into recession. Moreover, even if the euro area avoids outright break-up, the uncertainty over the future of the single currency and associated economic weakness could still have a significant impact on US and global growth. US exports to the current euro area, which account for about 14% of the total, would suffer badly. There would also be a negative wealth effect as a result of sharp falls in US equity prices, which would hit US consumer spending. A renewed credit crunch driven by severe strains on the financial system would further limit the economy's ability to expand.

Other economies, including fast-growing emerging markets like China, would also be seriously affected. The EU is a major market for many export-oriented developing countries. Moreover, China is not in a position to match the scale of the stimulus package that it deployed in response to the global crisis of 2008-09—although the government would still be able to launch a substantial stimulus, and the approach of a major leadership transition in 2012-13 would make the Chinese Communist Party



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particularly keen to ensure that the economy continues to grow rapidly. It is also worth stressing that China is not as reliant on exports to drive economic growth as it was in 2008-09. Nevertheless, Chinese growth would clearly be hit if the euro zone broke up or went into depression.

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### 11. What would happen to banks in countries that left the euro?

There would be widespread insolvencies. A run on banks in the countries considered close to leaving the euro would be one of the likeliest triggers to make an exit reality. As the possibility of a euro exit—and inevitable devaluation of a new national currency—became more credible, depositors would rightly transfer their euros to banks in other countries. To a certain extent, this is already happening across the euro area's periphery. An acceleration of this trend in Greece, Portugal or any other country believed to be on its way out of monetary union would devastate domestic banks, saddling sovereigns with the cost of recapitalisation, which would, in turn, hasten defaults on government debt. Given that banks hold large amounts of sovereign debt, this would further weaken lenders' balance sheets and, ultimately, lead to the effective bankruptcy of a country's financial system.

Once a country was outside of the euro zone, domestic loans and deposits would be redenominated in a new, weaker currency. Restrictions on withdrawals would be likely. Banks would probably default on most, if not all, external debt that remained denominated in euros, dollars or other hard currencies. They would be shunned by international capital markets, and reliant on funding from official sources. Larger banks might be able to find some support from income generated at subsidiaries abroad, although overseas revenue could also suffer indirectly as customers abroad shunned the beleaguered institutions. (Foreign units could also be sold to raise funds to cover losses at home.) A country's pariah status in global markets, and the likely imposition of capital controls, would mean that banks' fortunes would be tied almost entirely to activity in the domestic economy, which would take years to recover.

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### 12. Could private debt in euros be enforced?

This would depend on whether contracts were under the law of the countries leaving the euro zone, countries remaining in the euro zone or third countries. In the first case, the countries concerned would be likely to legislate to convert all euro contracts into national-currency contracts at the rate at which the new currency was introduced (despite likely subsequent depreciation). Contracts in other countries would legally be valid in those countries, but attempts to enforce such contracts could in many cases lead to companies declaring bankruptcy, although some multinational companies could probably survive.

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### 13. What would happen to sovereign debt?

It is likely that foreign sovereign debt would be renounced, or renegotiated under threat of being renounced. Domestic sovereign debt would be honoured, but only at the official exchange rate with the new currency.

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### 14. Could EU internal market rules be maintained?

Only partly. A key element of the EU internal market is free movement of capital, and this would almost certainly be abandoned for some years owing to the introduction of capital controls to prevent all the new money being exchanged for foreign currency. It is also quite possible that other member states would restrict free movement of labour, to avoid a huge exodus of workers to other countries in the EU. The abrogation of these rules would provide a dangerous precedent. However, the interests both of countries that had left the euro zone and of the rest would be served by maintaining rules to enable a reduced level of trade in goods and services to continue.

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### 15. Would countries that exited the euro remain in the EU?

We think so. If the assumption is that efforts would be made to maintain an internal market for the movement of goods and services, remaining in the EU would be the best way of enabling this to happen. Although it is possible to exist outside the EU and enjoy some of the benefits of membership—as in the non-EU states of Norway, Iceland and Switzerland, which are effectively integrated into most aspects of the EU internal market—it is still difficult to see why countries leaving the euro zone would leave the EU. Remaining in the EU would make it easier for internal market rules other than those on free movement of capital and labour to be observed.

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### 16. What levels of social and political upheaval would be expected?

Violent protests took place when deposits were frozen during the Argentinian crisis of 2001, and similar turbulence could occur in countries leaving the euro. Depositors would only be able to withdraw money eventually and in a new, depreciated currency. Falls in real incomes and possible shortages of imported goods would cause huge stresses. These could worsen, leading to further social and economic breakdown in subsequent years. However, it might also be possible to rebuild trust gradually as people worked together to overcome problems and the new currency stabilised.

Considerable social tensions could also be seen in countries that remained in the euro. In France, for example, further severe austerity would be needed to match German demands and reassure markets.

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### 17. What should businesses do now?

Businesses need to make contingency plans and review risk-management processes in much the same way that they would consider the impact of other major events, whether it be a natural disaster, political upheaval or the loss of a major customer. Contingency plans would depend on the nature of the company's business and its direct exposure to the euro zone, but in general terms the main issues to consider could include finance and cash management, business continuity, revenue assumptions and targets, and client and supply chains. Below is a list of more specific actions that might be necessary:

- Adjust internal budget assumptions and targets to take account of much weaker economic conditions both in the euro zone and globally.
- Examine supply chains (going back several levels, to suppliers' suppliers) and identify weak links. Which suppliers might go out of business?
- Prepare for supply-chain disruptions, for example by increasing precautionary inventories of business-critical components sourced from euro zone countries, in case supply is interrupted.
- Establish or expand alternative supplier arrangements in non-euro countries.
- Examine client relationships to determine which clients might experience financial difficulties that would prevent them from making payments or renewing contracts.
- As with supply chains, consider diversifying revenue risk by expanding client bases in non-euro countries.
- Limit the time cash balances are held in banks in at-risk countries.
- Examine invoicing and billing systems, in case these need to be reconfigured to reflect changes in currency regimes. Are internal systems robust and flexible enough to cope?
- Prepare for potential disruptions to agents conducting business on the company's behalf in at-risk countries, and to mission-critical partners such as payroll services providers. Consider contingencies such as sourcing alternative agents and partners.
- Evaluate financial-management policy. Consider the impact of (a) extreme movements in exchange rates, (b) extreme movements in asset prices or (c) the sudden loss of access to credit. Are counterparties financially secure?
- Ensure bank relationships are the right ones. If possible, assess whether the banks on which the company relies are healthy enough to withstand the collapse of the euro.
- Firm up funding arrangements in advance, putting in place guaranteed lines of credit if possible. Assess internal reserves of cash.
- Re-examine contracts written in euros or with entities exposed to the euro crisis. Determine the extent of possible losses should contracts not be honoured, along with threats to the company's own ability to honour contracts.



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- Look to lower costs and maximise operational efficiencies. Use crisis preparation to help drive organisational change, replacing obsolete or underperforming product lines.
- Make contingency plans for the possibility of political or social unrest in euro countries, and evaluate the security of physical assets and staff.

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