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The Euro Exit

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This Sunday, June 17, Greeks once again will go to the polls to elect a new leader. Unlike the past when elections were all about the right versus the left side of the political spectrum, this one is about whether Greece should stay in the European Monetary Union (EMU) and implement the necessary austerity. The threat of an imminent Greek exit from the euro is self-evident.

Unfortunately, policymakers in the eurozone underestimate how difficult it will be to hold the remaining euro area together if Greece exits. Greece is playing a massive game of chicken with its EMU partners, and could still win.

The reason is that the euro area was designed to be irreversible. The foundation of EMU, the Maastricht Treaty, makes no provision for exit. This commitment constitutes the critical difference between EMU and other fixed exchange rate regimes from which countries can (and routinely do) exit.

Fixed exchange rate regimes are inherently unstable in a world of free capital flows. To make them work, policymakers must commit credibly to act in the future in ways that will on occasion prove wildly inconsistent with their future preferences. Economists call this the problem of time consistency: making such commitments credible is not always feasible.

It is not as if Europe hasn't gone through this before.

The 1992 crisis of the European Exchange Rate Mechanism (ERM) -- a fixed exchange rate regime -- illustrates the problem. At the time, much like today, Germany was experiencing an economic boom, while other ERM countries were suffering slumps of various intensity. To cap German inflation, the Bundesbank hiked interest rates above 9 percent. Central banks in Britain and Italy could not credibly commit to sustain the high interest rates needed to avoid a devaluation. The obvious time consistency problem invited self-fulfilling speculative attacks that quickly caused both countries to devalue. Britain never returned to the ERM.

First called Black Wednesday, named for the day (Sept. 16, 1992) on which Britain was forced to leave the ERM, the events later were cheekily renamed White Wednesday. Some of Britain's subsequent economic success has been attributed to its policy flexibility after exiting the ERM.

No such luck with the euro.

A Greek exit would be a logistical nightmare. The original Greek currency, the drachma, no longer exists. Any "electronic euros" in Greek banks will flee the country or be converted into euro notes that people can hoard. Banking chaos will lead to capital controls, but it won't stop there.

Today, if any country exits the euro area, the commitment of other EMU members not to exit the euro area will become vastly more difficult to make credible. The euro area will become much more like the ERM -- subject to doubts and speculative attack (including bank runs) whenever incentives affecting national policymakers become sufficiently misaligned.

What to do?

There is a short-run problem of how to put out the fire, and a long-run problem of making sure the fire does not start again.

Consider a lesson from history. In 1790, with its states burdened by debt from the Revolutionary War, the newly formed United States was on the verge of financial collapse. Alexander Hamilton, the first Treasury Secretary, argued that the only way to preserve the union was for the federal government to assume those state debts. "Assumption" involved a large fiscal transfer from the wealthier states like Virginia (who had paid off their debts) to others. Hamilton's promise to move the nation's capital to Washington, D.C., helped persuade Virginia's leaders, including Madison and Jefferson.

If EMU policymakers wish to preserve the euro, they will need a Hamiltonian solution, including both fiscal burden-sharing to halt the crisis and conditionality (or fiscal and financial rules) to prevent another crisis and avoid a persistent wealth transfer to peripheral EMU members. Only an extensive, credible fiscal commitment from the wealthy countries could end the uncertainty and the capital runs that plague the peripheral countries. Only a constitutionally anchored set of fiscal and policy rules could provide credible conditionality.

A Eurobond, which would constitute a large fiscal transfer from Germany and a few others to Greece, Ireland, Italy, Portugal, and Spain, might be unfair and will put pressure on German and French finances. It seems politically plausible only if EMU members dramatically reorganize their economic and financial systems to ensure the sustainability of EMU. Doing so requires sharply increased policy integration and burden sharing across an array of activities (such as banking oversight and public finances) that reduces the risk and magnitude of incentive misalignments for national policymakers.

EMU leaders are running out of time in their efforts to save the euro. Only decisive action can work -- and there still would be no guarantee of success. In the United States, it took a Civil War to settle that monetary union once and for all.

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