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The terrible consequences of a eurozone collapse

By Willem Buiter

What happens if the euro collapses? A euro area breakup, even a partial one involving the exit of one or more fiscally and competitively weak countries, would be chaotic. A full or comprehensive break-up, with the euro area splintering into a Greater Deutschmark zone and about 10 national currencies would create pandemonium. It would not be a planned, orderly, gradual unwinding of existing political, economic and legal commitments. Exit, partial or full, would likely be precipitated by disorderly sovereign defaults in the fiscally and competitively weak member states, whose currencies would weaken dramatically and whose banks would fail. If Spain and Italy were to exit, there would be a collapse of systemically important financial institutions throughout the European Union and North America and years of global depression.

Consider the exit of a fiscally and competitively weak country, such as Greece – an event to which I assign a probability of about 20-25 per cent. Most contracts, including bank deposits, sovereign debt, pensions and wages would be redenominated in new Drachma and a sharp devaluation, say 65 per cent, of the new currency would follow. As soon as an exit was anticipated, depositors would flee Greek banks and all new lending governed by Greek law would effectively cease. Even before the exit, the sovereign and the banking system would fail because of a lack of funding. Following the exit, contracts and financial instruments written under foreign law would likely remain euro-denominated. Balance sheets would become unbalanced and widespread default, insolvency and bankruptcy would result. Greek output would collapse.

Greece would temporarily gain a competitive advantage from the sharp decline in the new Drachma's value, but like Portugal, Spain and Italy, Greece does not have the persistent nominal rigidities to make it a lasting competitive advantage. Soaring wage and price inflation would restore the uncompetitive status quo. Without external funding, imports would collapse, disrupting domestic production. Aggregate demand and aggregate supply would chase each other downwards.

If Greece storms out of the eurozone there might be little fear other countries would follow suit.

However, if Greece is pushed out of the eurozone because other member states refuse to fund

the Greek sovereign and the European Central Bank refuses to fund Greek banks, the markets could beam in on the next most likely country to go. This could prompt a run on that country's banks and stop funding for its sovereign, financial institutions and companies. Fear might actually then force the departure of the afflicted country. Exit contagion might sweep right through the rest of the eurozone periphery – Portugal, Ireland, Spain and Italy – and then begin to infect the “soft core” of Belgium, Austria and France.

A disorderly sovereign default and eurozone exit by Greece alone would be manageable. Greece accounts for only 2.2 per cent of eurozone area GDP and 4 per cent of public debt. However, a disorderly sovereign default and eurozone exit by Italy would bring down much of the European banking sector. Disorderly sovereign defaults and eurozone exits by all five periphery states – an event to which I attach a probability of no more than 5 per cent – would drag down not just the European banking system but also the north Atlantic financial system and the internationally exposed parts of the rest of the global banking system. The resulting financial crisis would trigger a global depression that would last for years, with GDP likely falling by more than 10 per cent and unemployment in the West reaching 20 per cent or more. Emerging markets would be dragged down too.

Exits by Germany and other fiscally and competitively strong countries could be even more disruptive. This might occur amid attempts to introduce a one-sided fiscal union with open-ended and uncapped euro-bonds or other transfers from the strong to the weak without a corresponding surrender of fiscal sovereignty to prevent future crises or if the ECB were to “go Weimar”. I consider this highly unlikely, with a probability of less than 3 per cent. Following such an exit, Germany and the other core eurozone member states (perhaps excluding France) would introduce a new Deutschmark. The sovereigns in the periphery would default. The new Deutschmark would appreciate sharply. Financial institutions in the new area would have to be bailed out because of losses from exposure to the old periphery and the soft core. As nothing would be holding the remaining eurozone countries together, the rump would split into perhaps 11 national currencies. The legal meaning and validity of all euro-denominated contracts and instruments would be up for grabs. Everyone, except lawyers specialising in the Lex Monetae, would become much poorer.

Even if a break-up of the eurozone does not destroy the EU completely and precipitate the kind of conflicts that disfigured the continent in the past, the case for keeping the show on the road seems rather robust.

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