Breaking The Euro

So far most commentary about a possible break up of the Euro has focused on an instantaneous exit by a single country. Their expectation that it would inevitably be very damaging leading to extended bank holidays, highly probable defaults, bank runs, and capital flight are not incorrect. However, what they may have missed is that the Euro was not created in a day, and a country need not exit the Euro in a day.

The members of the European Monetary Union had a decade since the Maastrict Treaty to get their finances in order and to stabilize their currencies against one another and the ECU, a notional accounting currency, before the introduction of the Euro on 1 Jan 1999. Three years later Euro notes and coins were issued.

The logical step at this time is to prepare for a potential break up of the Euro.

Reduce external debt. This can be done if there are backstop buyers of European sovereign bonds. Apart from the ECB the only natural candidates are the European banks. It seems counterintuitive but European banks need not just to deleverage their balance sheets, they need to avoid currency mismatches in the event of a disintegration of the Euro. This means that European banks have to buy their own nation’s debt.

Banks need to have sufficient capital to instill some level of confidence. At the moment it is hard to see any buyer in sight save for some rather broke sovereigns. Alternatively there are retained earnings but where could this come from? Perhaps from a levered carry trade on the respective sovereign bonds.

A phased exit beginning with, for example, a pegged Drachma and Lira. The peg, to the Euro, could be established for a year after which there would be a managed float to keep the currencies within defined bands of the Euro. This would in effect be a reversal of the ECU mechanism. It would provide time for legal, logistical and commercial contracts and issues to be novated from the Euro to the local currencies. No amount of time can sort out political issues.