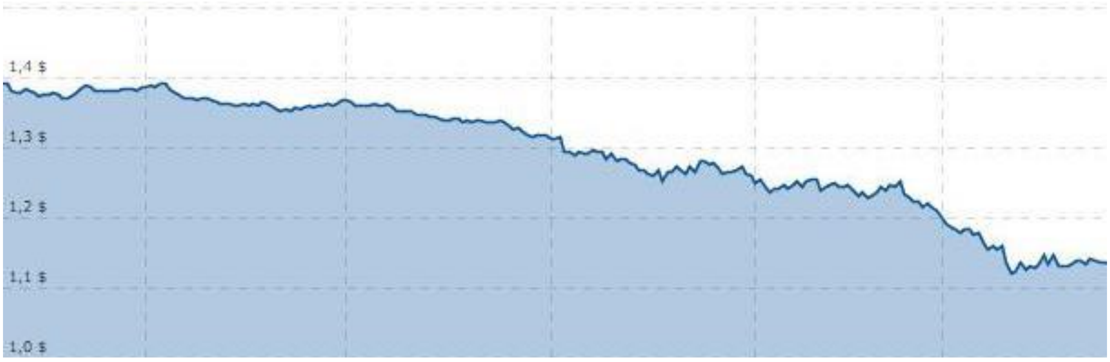
INSTITUT Thomas More

Paul GOLDCHMIDT
March 2015

News Note 29

THE EURO'S FALL | IS THE ECB CONSIDERING BREAKING UP THE EURO?



The apparently contradictory currents that crisscross financial markets confronted with multiple political, economic and financial uncertainties in the European Union, leave most observers disoriented. It behoves the Authorities responsible for stability, badly shaken by the financial crisis, to anticipate and manage the failure to complete the European Monetary Union (EMU) by minimising as far as possible the disastrous consequences of an implosion of the single currency. Taking note of a situation that seems hopeless, is the ECB considering breaking up the Euro?

The acceleration of the €'s fall to $ 1.05 against $ 1.40 last May (amounting to some 25%), gives pause for thought.

Several months ago, scores of politicians, economists and commentators were criticising the "strong" € considered to be responsible for the sluggish economy in particular of exports. Today those voices are silent as the fall in oil prices, the rebound in the US economy and quasi zero inflation add new factors that should support EU growth.

| Disillusionment below and disagreements at the top

Nevertheless, citizen's disillusionment over the European Union (EU) is reaching new heights as demonstrated by the electoral breakthroughs – confirmed or announced – of radical mostly Europhobic parties. Thus, in France the National Front is credited from 29 to 33% of vote intentions, according to the polls, in the forthcoming departmental elections. Such success, as in other EU Members, is further comforted by the weakness of governments who consistently blame the EU for their own shortcomings.

While Jean-Claude Juncker is advocating building an integrated European defence capability in order to address neighbouring geopolitical threats (Ukraine, Middle East, Africa), with the Commission following through on existing initiatives aimed at deepening EU and Economic and Monetary Union (EMU) integration, with the Transatlantic Trade and Investment Partnership (TTIP) and the Banking Union, and starts work on new groundbreaking policies (Capital Markets Union, Energy Union), never have the disagreements between Member States appeared so great, undermining the expected solidarity between them.

The fears surrounding "Brexit" or "Grexit" illustrate these disagreements. Each has the capacity of jeopardising the progress made over decades. The implosion of the EU/EMU would have catastrophic consequences, a fact that the majority of Greeks have well understood but leaves a most British indifferent. That is why "politically correct" appeals calling for all Member States to abide by the rules are being expressed: the Eurogroup to Greece, the Council/Commission relative to the European Semester and the ECB for structural reforms to underpin its monetary policy.

| The behaviour of financial markets leave most observers perplex

In this highly unstable environment, the behaviour of financial markets leave most observers perplex. The € had retreated – in relation to the $ – ever since the possibility followed by the announcement and finally the implementation of QE was mooted last summer. These developments were reinforced by American monetary policies which in turn suspended QE, announced a future tightening and are now waiting for the decision. The implementation of these diametrically opposed policies has lead to record low levels of interest rates as well as high stock market indices in Europe. This trend could continue insofar as movements associated with the low (negative) € interest rates (which are close to their floor) are relayed by an increase in $ rates, leading to further depreciation of the €. If such a fall may be justified in relation to the fundamentals of the weaker EMU Members (Greece, Italy, or even France?), it appears overdone concerning the stronger ones (Germany, Holland, Austria). Unless…

| Unless…

Unless the ECB considers a breakup of the euro… Indeed if, in parallel to its official pronouncements calling for structural reforms and further budgetary discipline, the ECB had doubts that its exhortations will be heeded, would it not be prudent for the Bank to consider a "Plan B"? The media have echoed the existence of contingency plans prepared by some EMU Member States (and some non Members) in case of an implosion of the single currency; would it not be normal that the ECB had its own?

If national currencies were reinstated, would it not be far easier to manage the process if the € was worth, say $0.83, its lowest historical value reached in 2001? In the event, the legal concept of the "continuity of contracts", that underpinned the introduction of the single currency could largely be upheld insofar as all contracts would remain denominated in € and would be executed at the counter value of the rate of exchange of the € (=$0.83) with the "new national currencies" at the time they fell due.

Instead of a series of "devaluations" relative to the €, inevitable in case of an uncontrolled implosion of the single currency, leading unavoidably to the default of Greece (and other Member States), the "new drachma" could hope to maintain a parity close to $ 0,83 while the other "new" national currencies could revalue in varying proportions. Sovereign debts, which would also remain denominated in €, would be devalued accordingly, allowing each country to decide on its own between a "strong" currency which would reduce its outstanding debts to a greater extent and a "weaker" one that would reinforce its competitivity. Several countries could agree to recreate a "currency snake" limiting fluctuations between them.

By avoiding the default of its Members, the ECB would protect its own balance sheet by ensuring that assets and liabilities remained balanced by avoiding the need of substantial write-offs. It would be necessary to reinstate as soon as possible a free foreign exchange market which would allow the new European national currencies to adjust between themselves and versus third party currencies. The European "single market" should also be preserved leaving to the market to adjust rather than having recourse to protectionist measures.

| After all…

This scenario, which is at this stage purely speculative, could explain the recent good performance of stock markets because the value of individual shares tend to adjust to their intrinsic characteristics and are therefore privileged by investors as a hedge against an "orderly" dismemberment of the €. As far as bondholders are concerned, the losses incurred in $ terms would have been endured progressively as the € "devaluation" ran its course in contrast with the more usual inflation lead process that reduces the value of bonds. Of course, if after the dismemberment of the € is completed, the former Eurozone were to go through a bout of inflation, bondholders would endure "double jeopardy"!

Maybe this hypothesis, which some might applaud and others deplore (including us), will turn out to be mistaken. It contains many risks among which the loss of control of operations resulting from financial market's reactions. It could, however, not be worse than doing nothing and letting a hopeless situation deteriorate even further. If managed correctly, this scenario might save the essential of the "European dream" before re-initiating its march forward on a sounder basis.

Paul GOLDSCHMIDT | Graduated from the Free University of Brussels with an MBA and a degree in Commercial and Financial sciences, Paul GOLDSCHMIDT joined Goldman Sachs in New York (1962-69) then Goldman Sachs International in London, where he was made a Director (1970- 1985). After spending 7 years as a financial consultant in London and Monaco (1985- 1993), he was appointed Director of the "Financial Operations" Service within the "Economic and Financial Affairs" Directorate General of the European Commission (1993- 2002), where he played a central role in the harmonization and reform of European financial markets before and during the advent of the euro. He also sat on the Board of Directors to the European Investment Fund (2001- 2002). Since 2002, Paul GOLDSCHMIDT has been writing about current political and financial affairs and participating in numerous international symposia. He is alpso member of the Advisory Board of the Thomas More Institute.