How to exit the eurozone

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June 26, 2018

Global Policy Lab

Italy is right to consider leaving the EU's common currency area.

What's the best way to leave the euro? That question is now back on the table after a Euroskeptic government took charge in Italy. Yes, key ministers have pledged to keep the country in the EU's common currency area. But those commitments should not be seen as immutable. They must be considered in the context of Italy's broader bargaining position: The new government wants to make it clear that it is not just a spoiler. It would prefer to stay within the eurozone, but it wants change.

Italy's new leaders are right that the eurozone is badly in need of reform. The euro has been flawed since its conception. For countries like Italy, it took away two key adjustment mechanisms: control over interest rates and exchange rates. And instead of putting anything in their place, it introduced tight strictures on debts and deficits — further impediments to economic recovery.

The result for the eurozone has been slower growth, and especially for the weaker countries within it. The euro was supposed to usher in greater prosperity, which in turn would lead to renewed commitment to European integration. It has done just the opposite — increasing divisions within the EU, especially between creditor and debtor countries.

The resulting schisms have also made it harder to solve other problems, most notably the migration crisis, where European rules impose an unfair burden on the frontline countries receiving migrants, such as Greece and Italy. These also just so happen to be the debtor countries, already plagued with economic difficulties. No wonder there is a rebellion.

German resistance

What needs to be done is well known. The problem is Germany's reluctance to do it.

The eurozone has long recognized the need for abanking union. But Berlin has insisted on postponing the key reform — a common deposit insurance — that would reduce capital flight from weak countries: Capital flight was a key factor in explaining the depth of the downturn in the crisis countries.

> Greece gave into being strangled by the European Central Bank. But it didn't have to.

Germany's domestic economic policies aggravate the eurozone's problems. The key economic challenge faced by countries in a currency union is the inability to adjust misaligned exchange rates. In the eurozone, the burden of adjustment is currently imposed on the debtor countries, already suffering from low growth and incomes. If Germany had a more expansionary fiscal and wage policy, some of the pressure would be shifted off of these countries.

If Germany is unwilling to take the basic steps needed to improve the currency union, it should do the next best thing: Leave the eurozone. As George Soros famously put it, Germany should either lead or leave. With Germany (and possibly other Northern European countries) out of the currency union, the value of the euro would decline, and exports of Italy and other Southern European countries would increase. The major source of misalignment would be gone. At the same time, the increase in Germany's exchange rate would go a long way to curing one of the most destabilizing aspects of the global economy: Germany's trade imbalance.

Why leave

The trouble, of course, is that Germany obstinately refuses to take either of the two paths forward. That leaves citizens in countries like Greece and Italy with a choice they shouldn't have to make: between membership in the eurozone and economic prosperity.

A timid and inexperienced Greek government chose to stay in the currency union. The result was stagnation. By 2015 the country's GDP had plunged 25 percent from its pre-crisis level. Since then, it has barely budged.

> The challenge, of course, will be to find a way to leave the eurozone that minimizes the economic and political costs.

Italy has the opportunity to make a different choice. In the absence of meaningful reforms, the benefits for Italy of leaving the euro are clear, straightforward and considerable.

A lower exchange rate will allow Italy to export more. Consumers will substitute Italian-made goods for imports. Tourists will find the country an even more attractive destination. All of this will stimulate demand and increase government revenues. Growth will increase, and Italy's high level of unemployment (11.2 percent, with 33.1 percent youth unemployment) will decrease.

There are, of course, many other reasons for Italy's malaise, and these will be at most only partially addressed by leaving the euro. Governments like those of U.S. President Donald Trump or former Italian Prime Minister Silvio Berlusconi — dominated by corrupt rent-seekers with no understanding of the true bases of sustainable long-term growth — do not provide the political leadership necessary for strong and sustainable growth.

At the same time, however, the slow and unequal growth that Italy has experienced as a result of the euro almost surely provides fertile ground for such populists.

There would be further political benefits too. A more prosperous Italy would be more likely to cooperate in other key areas in which Europe needs to work together: migration, a European defense force, sanctions against Russia, trade policy.

Trade or migration policies produce benefits for the entire country, but there are also losers — and the fiscal constraints imposed by the eurozone have made it all but impossible to provide those losers with adequate protections. An Italy outside the eurozone would be better positioned to share the benefits of its international polices, while mitigating the pain associated with them.

How to do it

The challenge, of course, will be to find a way to leave the eurozone that minimizes the economic and political costs. A massive debt restructuring, carefully done, with special attention to the consequences for domestic financial institutions, will be essential. Without such a restructuring, the burden of euro denominated debt would soar, offsetting possibly a large part of the potential gains.

Such restructurings are a normal part of large devaluations. Sometimes it's done quietly and obscurely — as when the U.S. went off the gold standard. Sometimes it's done more openly, as in Iceland and Argentina, with debtors crying foul. But such debt restructurings should be viewed as an inherent risk of cross-border investing, one of the reasons that "foreign" bonds often yield a risk premium.

It may be in Italy’s interest to leave the eurozone, but doing so is a steep challenge | Facundo Arrizabalaga/EPA

From an economic perspective, the easiest thing to do would be for Italian entities (governments, corporations and individuals) to simply redenominate debts from euros into new lira. But because of legal complexities within the EU, and because of Italy’s international obligations, it may be preferable to enact a super-Chapter 11 bankruptcy law, providing expeditious recourse to debt restructuring to any entity for whom the new currency presents severe economic problems. Bankruptcy laws remain an area within the purview of each of the nation states of the EU.

Italy could even choose not to announce that it’s leaving the euro. It could simply issue script (say government bonds) that would have to be accepted as payment for any euro debt obligation. A decrease in the value of these bonds would be tantamount to a devaluation. This would at the same time restore the efficacy of Italy’s monetary policy: Changes in central bank policy would affect the value of the bonds.

Hue and cry

Of course, there would be a hue and cry from other members of the eurozone. Introducing a parallel currency, even informally, would almost certainly violate the eurozone’s rules and certainly be against its spirit. But this way, Italy would leave it to the other members of the eurozone to decide to expel it.

Rome could take the chance that the fractious members of the currency union would never take such strong action, since that would confirm the fraying of the eurozone. Then Italy would have its cake and eat it too. It would remain part of the eurozone but would have accomplished a devaluation.

And if Italy lost the wager, the political onus of its leaving the eurozone would be more clearly on its “partners.” They would be the ones who took the final step.

Greece gave into being strangled by the European Central Bank. But it didn't have to. Athens was already well into creating the infrastructure (an electronics payment mechanism under the new drachma) that would have eased a transition out of the eurozone.

Greece was eventually suffocated by pressure from the European Central bank | Christopher Furlong/Getty Images

Advances in technology over the past three years make creating electronic currency systems all the easier and more effective. Should Italy choose to use one, it wouldn't even have to face the difficulties of printing new currency.

Italy could also blunt some of the pain of its departure if it were to coordinate its exit with other countries in a similar position.

The motley group of countries that now forms the eurozone is far from what economists call an optimal currency area. There is just too much diversity, too many differences, to make it work without better institutional arrangements of the kind that Germany has vetoed.

A southern eurozone would be far closer to an optimal currency area. And while it would be difficult to arrange a coordinated departure in a short period of time, if Italy successfully manages its way out of the euro, others will almost surely follow.

Costs and benefits

To be sure, one shouldn't underestimate the costs of a large devaluation. Any large change in a key price in an economy is a significant perturbation.

The price of foreign exchange is, of course, pivotal in any open economy. It has knock-on effects on the prices of all goods and services. Some — perhaps many — firms will go bankrupt. Some — perhaps many — individuals will see their real incomes decline.

But it's equally important not to underestimate the costs of Italy's current malaise. If Italy's economy had spent the 20 years since the euro's creation growing at the rate of the eurozone as a whole, its GDP would be 18 percent higher.

> If the new Italian government were to successfully navigate such an exit, Italy would be better off. And so would the rest the Europe.

The cost of persistent unemployment, especially among its youth, is enormous. Young people in their 20s and early 30s should be honing their skills in on-the-job training. Instead, they are sitting home idle, many of them developing a resentment toward the elites and the institutions they blame for their predicament. The resulting lack of formation of human capital will also dampen productivity for years to come.

In an ideal world, Italy wouldn't have to leave the eurozone. Europe could instead reform the currency union and provide better protection for those adversely affected by trade and migration.

But in the absence of a change of direction by the EU as a whole, Italy needs to remember that it has an alternative to economic stagnation and that there are ways of leaving the eurozone in which the benefits would likely exceed the costs.

If the new Italian government were to successfully navigate such an exit, Italy would be better off. And so would the rest the Europe.

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