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When the Euro Falls Apart — A Sequel

By Hal S. Scott

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I. Introduction

When my article "When the Euro Falls Apart" was published in International Finance in 1998, it dealt with a different set of concerns than confront us today. No one foresaw that the creation of the euro would enable some Member States like Greece or Italy to issue excessive and unsustainable debt because the market did not differentiate the riskiness of their debt from that of more disciplined countries like Germany. Analysts assumed that there was a real anti-bailout policy and did not anticipate that the European Central Bank (ECB) would place an equal value on all countries' sovereign bonds when used by banks as collateral. I did discuss the possibility that a country might seek to leave the euro to get control over monetary policy or devalue its exchange rate, but did not anticipate that this might be motivated by the desire to reduce its debt burden, the situation faced today. I assumed that euro area Member States would resist withdrawals because they would see this as a step backward in European integration and would therefore not facilitate them.

The 1998 article did, however, look at obstacles to withdrawal that still remain today and which are further analyzed in this Sequel: (1) the absence of a legal framework for withdrawal (although the nature of this problem changed with new provisions in the 2009 Treaty of Lisbon); (2) the possibility of bank runs triggered by cross-border movement of funds out of a withdrawing country and whether capital controls could stop this; (3) the difficulty of establishing a new currency, such as a new drachma or lira, alongside a continuing euro; and (4) major legal difficulties in redenominating debt. Again, these problems were analyzed largely with the assumption that remaining euro members would not take action to facilitate withdrawal.

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The Sequel continues to be pessimistic about the viability of non-consensual withdrawals from the euro area. However, today the issue is whether a consensual withdrawal would work — that Greece, and perhaps other countries, would withdraw from the euro with the help of their peers. This is decidedly more realistic. What is required for a viable withdrawal is a collaborative approach, in some cases involving legal changes: (1) a rapid treaty amendment permitting withdrawal from the euro area without necessitating withdrawal from the European Union; (2) cooperation in the temporary imposition of capital controls to block cross-border euro flight; (3) establishment of a new currency; (4) entry of withdrawing members into the Exchange Rate Mechanism (ERM) at a pegged exchange rate with unlimited swap lines from the ECB to limit the impact of devaluation losses on European banks and to make credible the strength of the new currency by insuring future discipline in domestic monetary policy (entry into the euro for some like Greece was a way to achieve such discipline, which is still needed); and (5) a European Union, and indeed international, legal framework legitimizing redenomination which otherwise would be subject to broad and disruptive litigation. This framework would be similar to the one constructed when countries redenominated obligations as part of their adoption of the euro.

All of these measures would have to be properly sequenced. Any move toward withdrawal would risk severe capital flight, so at the outset of the announcement of a planned withdrawal capital controls would have to be imposed. Once the treaty amendment permitting withdrawal was secured, all of the other measures would be adopted. Capital controls would be lifted once the new exchange rate under the ERM was credibly established.

As this essay is being written, the possibility of euro withdrawal, unilateral or consensual, is not high. European policymakers generally see this option as off the table. Their opposition is perhaps for the reason I discussed in 1998: that it would be seen as a step backward in European integration. But this is a mistake if the continued insistence on all countries remaining in the euro, with the continued support this entails from the ECB and other Member States, will lead to an unsustainable spiral of debt and demands for support that may ultimately wreck the European Union itself. It may be far better to relieve the pressure by allowing withdrawals and put those withdrawing in the purgatory of the ERM from which they can return some day to euro membership.

In my view, euro withdrawal is preferable to the restructuring of continued euro denominated debt. Euro withdrawal allows for currency devaluation that can restore the competitiveness of economies (Mankiw 2004), an improvement that cannot be attained by debt restructuring. Both techniques can decrease debt burden. And the amount of devaluation can, like the debt haircut achieved through restructuring, be limited so as not to impose unacceptable levels of loss on European banks. However, redenomination of debt has distinct advantages over restructuring as a technique to reduce debt burden. Redenomination, within a proper legal framework, avoids the need to negotiate debt reduction levels with creditors and the disruption in payment and trade flows that may be necessitated to shield country assets from exposure to attachments by holdout creditors. Redenomination also places an equal burden on public and private holders of debt whereas public creditors have long insisted (perhaps wrongly) and continue today to insist on super priority in any debt restructuring. Euro withdrawal also relieves the burden of fiscal support from stronger countries and from the ECB necessitated by

countries remaining in the euro. Despite these advantages, Greece — the leading candidate for euro area withdrawal as of this writing — seems as if it is more likely to pursue restructuring than redenomination. Such a decision would be regrettable, because it would not address the problem of Greek competitiveness. If Greece does pursue restructuring, it cannot also pursue withdrawal, at least in the immediate future — the prospect of redenomination losses added to restructuring haircuts is more than European banks can bear. However, establishing a withdrawal framework now makes sense regardless of what path Greece pursues. After all, the true threat to the long-term viability of the euro area does not come from the current debt crisis in Greece, but from the looming crises in Italy and other large Member States. Establishing the withdrawal framework today ensures it will be in place when it is truly needed.

In the longer run, measures must be adopted to avoid continued debt crises. While euro withdrawal may be preferable to debt restructuring, neither is desirable. The fundamental flaw of the euro, monetary integration without fiscal integration, must be addressed. The Sequel proposes that all debt of euro area members be issued with cross-guarantees but also be subject to euro area approval if the debt exceeds sixty percent of GDP, or what is otherwise thought to be a clearly sustainable level. In a transition period, Member States would be able to issue ten percent more cross-guaranteed debt over their current debt levels, recognizing that in most cases current debt levels are significantly over sixty percent of GDP. This is a more binding approach to debt limitation than yet another toothless Stability and Growth Pact or national "debt brakes" that can be easily circumvented. Yet it stops short of full fiscal integration because it leaves debt issuance up to sixty percent of GDP, as well as spending and taxation

decisions, to national discretion (albeit spending and tax policies will be constrained by the debt limit).

II. An Orderly Withdrawal From the Euro Area

An orderly withdrawal from the euro area requires a series of legal changes by all involved — in some cases not just the nations of Europe, but also major economic powers around the world. In this Part, I first describe those changes in detail and then address the question of how they should be sequenced to minimize disruption to the financial system.

A. Create a legal basis for withdrawal

One of the first issues Greece, Italy, or any other Member State would confront in attempting to withdraw from the euro area is finding a legal basis for exiting a monetary union that the E.U.'s underlying "constitutional" treaties have repeatedly described as "irrevocable" (Articles 4(2), 118, and 123(4) of the Treaty Establishing the European Community, and Article 140(3) of the Treaty on the Functioning of the European Union). Neither the Treaty on European Union (TEU) nor the Treaty on the Functioning of the European Union (TFEU), the two treaties that today create the E.U.'s governing legal structure, provide any mechanism for unilateral withdrawal from the euro area. Accordingly, a negotiated withdrawal through treaty amendment is the only realistic possibility.

1. The E.U. treaties do not permit unilateral euro area withdrawal.

The only existing treaty mechanism speaking to unilateral withdrawal is Article 50 of the Treaty on European Union. Added by the Treaty of Lisbon in 2009, Article 50 is a blunt instrument: it permits a Member State to withdraw from the E.U. *completely*.

Article 50 anticipates a process for negotiated withdrawal, with the Council representing the E.U. in drafting an agreement that must be approved by the European Parliament. Despite the goal of negotiation, however, Article 50 clearly allows for unilateral action. Specifically, the right to withdraw is linked to a Member State's "own constitutional requirements" rather than any steps taken by the E.U. If the European Council fails to act on a Member State's notification of intent to withdraw, withdrawal becomes effective automatically after a two-year waiting period. Thus if Greece or Italy decided to leave the E.U., apparently abandoning the euro in the process, they would not need the consent of any other Member States.

However, there is no treaty authority for a unilateral decision to abandon just the euro. Some commentators have suggested that this silence in the treaties could mean that withdrawal from the euro area, regardless of a Member State's right to withdraw unilaterally from the E.U., must always be negotiated through treaty amendment (Athanassiou 2009). Other commentators have questioned whether the "greater power includes the lesser," such that Article 50's creation of a unilateral right to *complete E.U. withdrawal* necessarily creates a unilateral right to *euro area-only withdrawal* (Smits 2005; Athanassiou 2009). Despite such speculation, the consensus view is that to the extent Article 50 allows euro area withdrawal at all, such withdrawal is possible only in conjunction with complete E.U. withdrawal. The reason is that participation in the E.U.'s Economic and Monetary Union, including adoption of the euro, is a fundamental part of the E.U. *acquis communautaire*, or underlying legal order binding on all Member States. Other than the United Kingdom, which negotiated an opt-out as part of the Maastricht Treaty, and Denmark, which negotiated a special post-Maastricht opt-out through the

Edinburgh Agreement, all Member States are obligated to adopt the euro. Although Sweden has avoided joining the euro area by declining to satisfy the necessary prerequisites, all other non-euro area Member States are in the process of doing so. Accordingly, to read a distinct right to unilateral euro area-only withdrawal into Article 50 would fundamentally conflict with the premise of the E.U. treaties. This premise has been described since the 1950s as an "ever closer union among the peoples of Europe." As commentators almost universally recognize, the legal process of European integration is a one-way ratchet in which commitments, once made, cannot be undone.

Put simply, a Member State likely could unilaterally leave the euro area pursuant to Article 50 only if it also were willing to sacrifice its E.U. membership entirely. Even if it were willing to do so, the withdrawing Member State likely would still face a potentially protracted legal battle over claims that it was obligated to negotiate separately the terms of its withdrawal from the euro area.

2. Public international law does not support euro area withdrawal.

The apparent impossibility of unilateral euro area withdrawal under the E.U. treaties has prompted some commentators to turn to public international law as perhaps providing a distinct legal mechanism for unilateral withdrawal. Any reliance on public international law is unconvincing on two levels, however.

First, given the E.U.'s unique legal structure, the ability of a Member State such as Greece or Italy to invoke any sources of international law other than the treaties themselves is sharply limited when E.U. interests are at stake. As the European Court of Justice (ECJ) explained in the landmark case *Van Gend en Loos v. Administratie der Belastingen*, what are now known as the E.U. treaties created "a new legal order of

international law, for the benefit of which the States have limited their sovereign rights." The ECJ later made explicit in *Costa v. ENEL* that the "transfer by the States from their domestic legal system to the Community legal system of the rights and obligations arising under the Treaty carries with it a permanent limitation of their sovereign rights, against which a subsequent unilateral act incompatible with the concept of the Community cannot prevail." In short, a claim that international law can provide rights not contemplated by E.U. law is at best highly contestable and would be subject to a serious legal challenge. The result would be significant economic and political consequences across Europe for the withdrawing Member State.

Second, and just as problematic, even if Greece, Italy, or another Member State could invoke public international law to modify its E.U. obligations, that law would be unavailing in the case of euro area withdrawal. Contra some commentators (Dor 2011), the refusal of some Member States to ratify the Vienna Convention on the Law of Treaties has no effect on the possible invocation of the public international law rules that govern treaties, because the vast majority of the Convention's provisions simply codify customary international law that binds all states. Specifically, public international law, as codified in the Vienna Convention on the Law of Treaties, recognizes a right to treaty withdrawal in only a handful of circumstances. First, withdrawal may be permitted if the parties intended to allow withdrawal or if a treaty implies such a right (Article 56). Second, withdrawal may be permitted if performance is impossible (Article 61) or there has been a fundamental change in circumstances (Article 62). Withdrawal also may be permitted in a handful of circumstances not relevant to the current debate over the euro area, such as fraud or coercion.

The first set of these circumstances clearly does not apply to euro area treaty commitments, given the "irrevocable" nature of economic and monetary union and the understanding that assuming E.U. obligations is a one-way ratchet. Plainly none of the Member States intended to allow or imply a unilateral right to withdraw from the euro area. As for the second set of these circumstances, they are interpreted so narrowly that they can rarely, if ever, apply in practice. The impossibility of performance doctrine typically involves tangible objects that are "indispensable" to the fulfillment of treaty obligations. A nation's obligations under a riparian rights treaty may be impossible to meet if a river dries out, for example. Furthermore, the doctrine cannot be invoked by parties to a treaty that have themselves created the impossibility at issue. To the extent that Greece, Italy, or another Member State has difficulty fulfilling its monetary union obligations, that difficulty is almost certainly the result of its own fiscal policies. The change in circumstances doctrine is even more narrowly interpreted. It applies only if the circumstances that have since changed were an essential basis for a party's consent to the relevant treaty and only if the new circumstance radically transform the extent of treaty obligations. A state wishing to withdraw from the euro area could point to no "changed circumstances" — simply its own miscalculation about the benefits of monetary union.

In short, even if public international law could be invoked within the E.U. legal order — a highly doubtful prospect — it would not support a unilateral right to withdraw from the euro area.

3. A treaty amendment is the clearest path to euro area withdrawal.

In short, the clearest legal path to euro area exit is a negotiated amendment to the treaties. The recent "intergovernmental agreement" by which euro area Member States

agreed to impose new fiscal discipline rules without going through the E.U.'s treaty amendment process might raise the tempting prospect that a similar agreement would be sufficient to permit euro area withdrawal. However, the differences between that agreement, which is essentially a new fiscal treaty, and withdrawal are striking. Whereas the proposed treaty will add additional duties for a subset of Member States, euro area withdrawal would fundamentally alter the terms of a Member State's participation in the E.U. itself. Intergovernmental agreements can be employed only to govern matters outside an area of E.U. competence provided for in the E.U. treaties. For example, a subset of E.U. Member States recently adopted the so-called Prüm Convention, which governs border and law enforcement issues not addressed by the existing treaties. As the Convention itself makes clear, it applies only insofar as it is compatible with E.U. law, and in case of a conflict, E.U. law always takes primacy (Article 47). The draft text of the new fiscal treaty includes a similar provision (Article 2(2).) Because the operation of the euro area is a core E.U. competence, and because withdrawal clearly conflicts with the E.U. treaties, an intergovernmental agreement is impossible. Thus treaty amendment is unavoidable. While the Treaty of Lisbon introduced a "simplified revision procedure" to make amendment easier, given the broad treaty changes required, this procedure almost certainly would not apply (Zbíral 2010). Moreover, even the simplified approach does not avoid the main obstacle to any change — unanimity among the Member States, which must then approve the amendment "in accordance with their respective constitutional requirements" (Article 48(6) TEU). However, if Member States reached consensus on the need for an amendment, its adoption could occur rapidly; a plausible

timeline is two to four months. The new fiscal treaty, for example, is set to take effect by March 2012, despite having been proposed only in December 2011.

Commentators correctly note that any amendment is difficult, and the potential for an extended amendment period — during which capital controls, as described below, would remain in effect — is an admitted (although unavoidable) weakness of any withdrawal plan. Nonetheless, the difficulty of a euro withdrawal amendment should not be overstated. Such an amendment is a realistic possibility, particularly if it came as part of a broader "grand bargain" setting the terms by which such a withdrawal would take place (described in more detail below). An amendment substantially altering the terms of a country's membership in the E.U. would not even be unprecedented. In 1984, before Article 50's adoption required it to do so, the E.U.'s predecessor, the European Economic Community, negotiated the Greenland Treaty, which permitted Greenland to leave the EEC the following year and assume the status of an overseas territory.

B. Implement capital controls

As soon as treaty amendment became a realistic possibility, perhaps the most pressing problem a Member State withdrawing from the euro area would face is the prospect of capital flight. For example, following the breakup of the Austro-Hungarian monetary union in 1919, citizens feared converting their existing crowns to replacement local currencies, which might lose value quickly. Thus, residents of Austria and the future Yugoslavia moved their money to Hungary, where it could be redeemed for the stronger new Hungarian crown. The Czechoslovakian monetary union breakup in 1993 saw a similar dynamic. When it became clear following the 1992 election that the country would divide in two, residents of the future Slovakia began moving their money

to the future Czech Republic, which was seen as having better prospects for economic growth and a stronger currency. (The breakup of the Soviet monetary union in roughly the same time period is of limited instructive value; although the situation paralleled a possible euro breakup in that only some countries abandoned the ruble, that currency's hyperinflation meant that those abandoning it had little need for capital controls since the remaining ruble was a weaker currency than the newly established ones.)

1. Capital controls are necessary but the E.U. treaties present a possibly significant legal impediment.

The lesson is clear: if a Member State such as Greece were to announce that it was abandoning the euro, Greek businesses and citizens alike would begin moving money to euro-denominated accounts elsewhere in the E.U. or foreign-denominated accounts abroad lest the value of their Greek accounts be severely diminished when they were redenominated in new drachma. Only once Greeks were convinced that the new drachma was a stable currency, no longer subject to speculative attacks likely to cause further major devaluation (as described more fully below in the discussion of the Exchange Rate Mechanism), would they be confident about keeping their money in new drachma. Until that time, the country would have to adopt capital controls to ensure existing accounts were not rapidly drained. Such controls were of at least some value in limiting the effects of cross-border capital flight following the collapse of the Austro-Hungarian and Czechoslovakian monetary unions. Austria, for example, froze 50 percent of bank deposits. It also declared that existing currency was no longer legal tender within the territory and that only crowns that had been physically stamped with the national emblem were valid. Czechoslovakia was even more aggressive; as the Czech Republic

and Slovakia divided, they limited capital flight by restricting the withdrawal of hard currency, stopping account transfers, and closing their common border.

Problematically, however, virtually any attempt to stop money from moving elsewhere in the E.U. risks violating the principle of free movement of capital, which is considered one of the foundational "four freedoms" of the E.U. This principle is enshrined in the E.U. treaties as Article 63 TFEU, which sets out a sweeping prohibition against "restrictions on the movement of capital between Member States and between Member States and third countries" (that is, those not in the E.U.).

Various "safety valves" exist that allow a Member State to derogate from this provision. Article 65(1)(b) TFEU, for example, provides that the guarantee of free capital movement exists "without prejudice to the right" to "take measures which are justified on grounds of public policy or public security." Article 347 TFEU explicitly contemplates a Member State taking internal actions that may be incompatible with the E.U. "integrated market" in the case of "serious internal disturbances affecting the maintenance of law and order." Nonetheless, ECJ jurisprudence makes clear that the protections of Article 63 are to be read broadly and the exceptions are to be read narrowly. Accordingly, although a withdrawing Member State could attempt to invoke one of these safety valves, it would face an uncertain prospect for success. However, given that any successful withdrawal from the euro area likely will occur through treaty amendment, perhaps the most straightforward approach would simply be the inclusion of an Article 63 temporary derogation clause that could be invoked by a Member State availing itself of the newly adopted euro area withdrawal procedures. Such a clause might build on the existing Article 66 TFEU, which creates a process by which the E.U.

can adopt "safeguard measures" for six months if movements of capital to or from non-E.U. countries "cause, or threaten to cause, serious difficulties for the operation of economic and monetary union." If withdrawal were to occur before the necessary treaty framework was established — in which case capital controls would be imposed while the amendment process took place — the derogation clause would have to retroactively absolve violations of Article 63 specifically linked to a Member State's withdrawal from the euro area.

2. A withdrawing Member State must declare a brief bank holiday combined with a longer period of restrictions on transfers abroad.

Assuming a withdrawing Member State could resolve the legal impediments to capital controls, effective controls would entail multiple measures: most likely a brief bank holiday shutting down the domestic banking system, combined with a longer period of restrictions on financial transfers abroad.

The experience of other countries in using these techniques is worth examining. For example, during the Great Depression, dollars in some regions of the United States came to be seen as more valuable than dollars in other regions of the country. The problem began when the Federal Reserve districts of Chicago and Cleveland experienced a disproportionate share of the nation's bank failures — more than half, when weighted by deposits. These collapses began to spark bank runs in those districts, as depositors attempted to move their money to New York-based banks (or even their own homes), which were seen as more secure. The new administration of President Franklin Roosevelt responded with a two-week bank holiday, after which banks reopened with de facto full deposit insurance. The holiday effectively ended the banking crisis by preventing citizens from exacerbating problems while the government acted. Of course,

deposit insurance would not stop capital flight in the case of a Member State's withdrawal from the euro area (where the risk is devaluation not bank failure), so the instructive value of the U.S. is quite limited.

More relevant is the different approach Argentina adopted during the financial crisis that occurred in 1999-2002 when it took its peso off a fixed exchange rate with the dollar. Rather than adopt a full bank holiday, it imposed a US$1,000 monthly limit on withdrawals and converted all checking and savings accounts above a certain balance (US$10,000 and US$3,000, respectively) into certificates of deposit that were then frozen. In addition, the country imposed a host of restrictions on foreign exchange, investment, and stock purchases abroad. This plan, known as the "corralito" (little corral), effectively stymied most efforts to move currency out of the country and remained in effect for a year.

If a Member State such as Greece were to withdraw from the euro area, it might first declare a bank holiday (or a partial holiday sharply limiting cash withdrawals and prohibiting foreign transfers) for a short period while it dealt with creating a new physical currency within its territory. It then could lift the holiday while retaining a prohibition on foreign transfers for a more extended period.

The bank holiday would allow Greece to prepare a new currency to replace the existing physical euros within its territory. This would occur in several steps. First, the Greek government would declare that until it began circulation of new drachma coins and banknotes, only euros stamped with the new drachma emblem were legal tender within Greece and that transporting euros out of or into the country was prohibited. Simultaneously, the government would declare that all circulating currency must be

brought to government-run locations for stamping within a short fixed period of time, say two weeks, or it would lose its status as legal tender. The government also would simultaneously order banks to stamp their existing stores of currencies. By the time banks reopened, few unstamped euros would be circulating within Greece. Second, when sufficient new drachma had been produced, the government would mandate a transition period, perhaps a month, during which stamped euros would circulate alongside new drachma, for which they could be freely exchanged at any bank. At the end of the transition, stamped euros would cease to be legal tender, but citizens could continue to exchange them for new drachma over an extended period. (For example, although the original drachma ceased to be legal tender in Greece on February 28, 2002, the Bank of Greece and Greek tax authorities continued to exchange euros for drachma until March 1, 2004.)

In addition to the bank holiday, a withdrawing Member State such as Greece would have to take steps to limit transfers of money abroad. The capital controls not only would have to be comprehensive, but also would have to include exemptions for foreign direct investment, various portfolio investments, and current international transactions (Ariyoshi et al. 2000). These restrictions would go into effect simultaneously with the bank holiday but would remain in effect for some time afterwards until citizens could be confident that the new drachma would hold its value against the euro and other foreign currencies. In addition to prohibiting physical transport of euros out of Greece, the restrictions would require limits to electronic transfers. While mandating that the new drachma be used as legal tender would require Greeks to hold some amount of new

drachma, such local payments would be a small part of total assets of wealthy individuals and corporations. Thus, restrictions on cross-border transfers would be essential.

Greece would have to lead the way in establishing those measures unless an amendment to resolve the E.U. treaty impediments to capital controls also granted the E.U. new powers to enact such controls. Under current law, the E.U. does not have authority to freeze financial assets except in certain, very limited circumstances. Under Article 75 TFEU, the E.U. can adopt "a framework for administrative measures with regard to capital movements and payments, such as the freezing of funds," but only to combat "terrorism and related activities." Article 215 TFEU allows "interruption or reduction, in part or completely, of economic and financial relations," but only with non-E.U. countries or groups that are subject to E.U. sanctions. Clearly, neither provision of the treaties contemplates intra-E.U. capital controls. As for the ECB and European System of Central Banks (ESCB), although their operation of the TARGET2 payment system makes them a natural choice to assist in implementing capital controls, they also lack clear authority to act. The ECSB is charged with promoting "the smooth operation of payment systems" (Article 127(2) TFEU) and the ECB may issue regulations on a host of matters, including measures that "ensure efficient and sound clearing and payment systems" (Article 132(1) TFEU, Article 22 ECB Statute). A payment system freeze on transfers into or out of a Member State, however, presumably would be considered an internal market issue, and authority over such matters falls to the Member States, the Council, and the European Parliament. The ECB's TARGET2 guidelines do contain authority to suspend payment-system access following certain events, but withdrawal from the euro area is not among them.

Nonetheless, a withdrawing Member State such as Greece would be able to rely on its own domestic authority to act. For example, amid the financial crisis in Iceland, in late 2008 the United Kingdom issued the Landsbanki Freezing Order, which froze the U.K. accounts of Icelandic banks and public bodies, including the government of Iceland, to prevent money from being transferred to Iceland. (The U.K. was motivated by fears that the money would be directed to Icelandic depositors in Iceland's banks at the expense of British depositors.) The U.K. invoked provisions of its own Anti-terrorism, Crime and Security Act 2001 that allowed the Treasury to freeze funds in order to prevent "action to the detriment of UK's economy or part of it." Although the U.K.'s initiative was directed at several named entities rather than an entire nation of depositors seeking to transfer money from their own accounts, in principle the same steps could be taken on a broader basis. This action on the part of the withdrawing Member State could be supported by coordinated action in other Member States. Although the E.U. may lack the authority to impose capital controls itself, nothing would prevent its members from imposing such controls as part of a negotiated withdrawal process.

C. Reestablish an independent national central bank

Once a Member State successfully negotiated its withdrawal from the euro area, it would immediately face the task of establishing an independent national central bank (NCB). Because NCBs continue to exist within the Eurosystem and share a host of responsibilities with the ECB, this task is far less daunting than the establishment of an entirely new NCB would be. Nonetheless, a withdrawing Member State would face a host of practical considerations that would have to be confronted quickly.

1. A withdrawing Member State must issue its own currency.

If Italy or Greece were to exit the euro area, the most tangible change in the lives of most of its citizens would be the appearance of the "new lira" or "new drachma." New bills and coins would be more than a highly visible symbol of exit from the euro area, however — their production would be among the first responsibilities of a withdrawing Member State's NCB. Under the Eurosystem, each member of the euro area shares responsibility for currency production. Accordingly, euro area Member States have a substantial capability to produce currency, typically on a very large scale. The Banca d'Italia, for example, put nearly 10 billion euro coins into circulation in the five years following the currency's introduction, and it operates a massive banknote printing works in Via Tuscolana. Obviously some production downtime would occur as the withdrawing Member State prepared new coin dies and banknote plates, but this would be a comparatively minor delay.

Some commentators have suggested that production of a new currency would not be immediately necessary and that euro banknotes and coins could be used instead of a new currency for an extended transition period. This argument rests on the unique national identifying marks on banknotes and coins. Per a European Commission recommendation, all euro coins are supposed to bear the name of the minting Member State. While various Member States, including Greece, do not follow this recommendation, their coins are nonetheless identifiable by the designs of their obverse faces. The Greek €1 coin, for example, depicts the 4 drachma coin of ancient Athens. As for euro banknotes, they are distinguishable by their serial numbers. The serial number of a Greek banknote always begins with the letter "Y," for example. But euro coins and

banknotes circulate freely throughout the euro area. Thus as a practical matter it would be extraordinarily difficult to declare, for example, that all €1 coins depicting the Vitruvian Man on the obverse were worth 1,000 new lire and all €5 banknotes whose serial numbers began with "S" were worth 5,000 new lire. A vending machine in Hamburg or Marseille might return lira as change for a purchase made in euros, while an ATM in Milan might dispense banknotes with serial-number prefix "Z" (indicating Belgian euros) for an account supposedly denominated in the new lira. For any transition period, the euro coins and banknotes in a withdrawing member state would have to be physically stamped with an identifying mark, a process discussed more thoroughly above in the context of capital controls.

2. A withdrawing Member State must develop the necessary payment systems.

In addition to producing a new physical currency, a withdrawing Member State would have to ensure that the necessary payment systems for that currency was in place.

The greatest challenge in this respect would be the creation of a domestic payment system that could process large value payments in the new currency. Following the initial transition to the euro, participating Member States maintained their own local real-time gross settlement systems and linked them together through the ECB-operated TARGET system. As experts pointed out at the time, while this made adopting the euro easier since a whole new payment system did not need to be invented, it also made abandoning the euro relatively easier since national payment systems were preserved (Scott 1998). In November 2007, however, the ECB introduced a single, shared platform RTGS, TARGET2. TARGET2 has replaced the national RTGS systems. Accordingly, local payment systems such as HERMES, operated by the Bank of Greece, and New

BIREL, operated by Banca d'Italia, are no longer operational. Nonetheless, Member States have substantial recent experience operating their own payment systems, so the challenge of developing a new system would not be insurmountable.

Additionally, it is worth noting that the transition from TARGET to TARGET2 has actually solved one potential problem related to withdrawal. Under TARGET, there was no daily settlement. Thus following a transfer from the Bank of Greece to the Bundesbank, the Bundesbank simply recorded a due from asset of the Bank of Greece and the Bank of Greece recorded a due to liability to the Bundesbank. Under such a system, a significant risk existed that the NCB of a withdrawing Member State could simply walk away from massive liabilities owed to the NCBs of remaining Member States. Experts first noted this danger more than a decade ago (Scott 1998). Although some commentators remain focused on the problem today (Dor 2011), they have overlooked or ignored TARGET2, which provides for daily settlement of outstanding balances through national central bank accounts at the ECB.

Establishing the wholesale payment systems that would have to be in place following a Member State's withdrawal from the euro area would not require developing a new payment system. First, linking the NCB of a withdrawing Member State to a payment system that could process large value payments in euros is relatively easy. The NCB of a withdrawing Member State clearly would not be required to remain part of TARGET2, but it could connect to the system on a voluntary basis and use it to carry out euro payments. Non-euro area Member States such as Denmark and Latvia currently are linked to TARGET2 in just such a manner. Alternatively, a withdrawing Member State could rely on one of the other large value RTGS payment systems that handle euro

transactions, such as EURO1, operated by the European Banking Association, CLS, operated by CLS Bank International, or euroSIC, operated by SIX Interbank Clearing AG Zurich. Further, banks need not have a dedicated platform to make transfers in euros or any other currency — such systems are a relatively new development. Banks could just rely on correspondent accounts, accounts banks hold with each other, to affect payments.

Second, ensuring that appropriate retail payment systems were in place would not be problematic. Although euro area Member States are working toward a single shared system analogous to TARGET2 known as SEPA, the end date for migration is February 1, 2014. Accordingly, euro area Member States maintain their own retail payment systems to handle both electronic- and paper-based payment instruments. In Italy for example, Banca d'Italia maintains the BI-COMP system, which processes both checks and credit transfers. In Greece a private company founded by the Hellenic Bank Association maintains the DIAS system for credit transfers, while the Bank of Greece operates the Athens Clearing Office to process checks. At the moment, these systems are designed to handle payments denominated in euros, although most systems currently in use previously handled payments denominated in a former national currency. Although some technical changes would be necessary to begin processing payments in a new national currency, the changes would certainly entail less work than the creation of a new large-value payment system in the same currency.

3. A withdrawing Member State must unwind its connections to the ECB.

The final step the NCB of a withdrawing Member State would have to complete to reestablish its independence would be disconnecting itself from the ECB in various respects. Some of the necessary changes, though significant, are obvious and relatively

straightforward. The conduct of monetary policy and foreign exchange operations would fall naturally to the withdrawing NCB, as would supervision of its official foreign reserves. Some other ECB tasks, such as the collection of statistics, are already highly decentralized and carried out by NCBs using their own systems and processes. In these domains, virtually no operational changes would be necessary.

A more significant practical step required to unwind an NCB such as Banca d'Italia or the Bank of Greece from the Eurosystem is that the capital the withdrawing NCB previously provided to the ECB would have to be returned. The E.U. treaties and the ECB statute do not contain any provisions for such a return since they do not specifically address an exit from the euro area in any way. However, the size of each NCB's capital contribution is clearly defined and practical mechanisms for transferring funds from the ECB to NCBs are already in place. For example, Article 33.1 of the ECB statute provides that parts of the ECB's profits are paid out to the NCBs.

Depending on the Member State that withdraws, the amount of capital required to be repaid could range from insignificant to relatively substantial. For example, the Bank of Greece contributes just under two percent of the ECB's capital, less than €180 million, whereas Banca d'Italia contributes more than twelve percent of the ECB's capital, over €1.13 billion. As a practical matter, assuming that the withdrawing Member State remained part of the E.U. and thus a participant in the ECSB, not all of is capital would returned; non-euro area NCBs support the ECB's operational costs by contributing a small amount of their share in the ECB's subscribed capital. This amount is currently 3.75%, yielding insignificant contributions to the ECB. For example, Narodowy Bank

Polski (Poland), with a nearly five percent share in the ECB, has contributed less than €20 million.

Although the prospect of the ECB paying out potentially significant amounts of capital to a Member State that would then impose a significant haircut on the banks of the remaining euro area Member States through redenomination might be politically unseemly, it would not have a meaningful immediate impact on the ECB's operations. The ECB, like any central bank, can operate with negative capital (Hart 2011) since it can create money to fulfill its obligations, although the principle of financial independence — spelled out in the E.U. treaties as Article 282(3) TFEU — might require or impel the ECB on its own to raise additional capital. The ECB would deal with these losses under the procedure provided for in Article 33.2 of its governing statute, drawing first on the reserve fund and then on its yearly income. If it sought to raise still additional capital, however, the ECB would rely on Article 28.1 of its statute, which gives the ECB Governing Council authority to promulgate regulations governing the amount of capital increases. Council Regulation 1009/2000, issued in May 2000, authorized the ECB to raise up to €5 billion of additional capital. The ECB announced a full €5 billion capital increase in December 2010, which currently is being phased in over three years with NCBs contributing in proportion to their ownership shares in the ECB. Because the ECB thus has taken advantage of the full increase currently provided for by regulation, it would have to seek approval from the Governing Council, presumably in the form of new regulations, if it needed to raise additional capital.

D. Establish a domestic and international legal basis for redenomination

A key purpose of a withdrawal from the euro area is, of course, currency redenomination: providing that contracts and instruments (including sovereign bonds) in euros can be repaid in a new, devalued national currency. Such redenomination with devaluation would allow a withdrawing country to significantly reduce its debt burden, a major desideratum in the current crisis. This aspect of withdrawal is perhaps the most complicated; it would require not just legislation in the withdrawing Member State and the EU, but also coordinated action by countries around the world, most importantly major markets, principally the United States and Japan.

1. A withdrawing Member State must adopt enabling legislation and contend with challenges based on its own constitution and international human rights law.

The process of redenomination *within* a withdrawing Member State is relatively straightforward. For example, if Greece were to withdraw from the euro area, it simply would pass legislation providing that in Greece, all contracts specifying payment in euros — from government bonds to commercial loans to home mortgages — were to be satisfied in new drachma. Greece and the other Member States within the euro area are intimately familiar with this process, since they had to pass similar enabling legislation to adopt the euro when they first joined the monetary union.

The most significant impediment to redenomination within a Member State likely would be the country's own constitutional provisions protecting private property or contract rights. Obviously, many creditors would vigorously contest the legality of a redenomination whose primary effect was to subject them to substantial losses. This concern did not arise when Member States adopted the euro—although there was some

concern in the strongest currency country, Germany—because there was no widespread ex ante expectation that creditors would be worse off under the new currency.

Virtually every Member State in the euro area has a constitutional provision that could be invoked by creditors opposed to redenomination. For example, Article 17 of the Greek constitution provides that "[p]roperty is under the protection of the State" and Article 42 of the Italian constitution provides that "[p]rivate property is recognised and guaranteed by the law." Of course, the particular issues presented by a constitutional challenge would vary from state to state. In Greece, for example, Article 17's applicability to contract rights is a somewhat unsettled question (Spyropoulos and Fortsakis 2009). Nonetheless, given the common structure of property rights across Europe, the primary constitutional issues would be the same: first, whether redenomination was in the public interest and second, whether compensation was required. Article 17 of the Greek Constitution, for example, permits expropriation of property "for public benefit which must be duly proven" as long as "full compensation corresponding to the value of the expropriated property" is provided. Article 44 allows that in "cases provided for by the law and with provisions for compensation, private property may be expropriated for reasons of general interest." Since paying compensation for redenomination losses would nullify the very benefits of the process, avoiding the application of these constitutional protections would be required. Rather than pursue the lengthy and uncertain process of constitutional amendment, however, a Member State might be able to invoke various constitutional "safety valves." Under Article 106 of the Greek constitution, for example, the state is empowered to "plan and coordinate economic activity" when necessary to "to consolidate social peace and protect

the general interest." While scholars divide on how widely this provision might be interpreted and applied (Buchheit and Gulati 2011; Spyropoulos and Fortsakis 2009), in the case of a truly unprecedented crisis involving euro area withdrawal, Greece would have a colorable legal argument that Article 17 should not limit its ability to redenominate without compensation. Although the Italian constitution lacks a comparable emergency procedure, legislative practice, ratified on at least one occasion by the Italian Constitutional Court, recognizes that certain rights protections may be modified in times of emergency (Angiulli 2009). Similar safety valves exist in other Member States.

Even given the possibility of derogating from national constitutional protections, a withdrawing Member State still might confront challenges based on protections enshrined in binding international human rights law. First, all E.U. Member States are parties to the European Convention on Human Rights (ECHR), which allows aggrieved persons to directly challenge state action in the European Court of Human Rights. Accordingly, a creditor opposed to redenomination might assert a violation of Article 1 of ECHR Protocol 1, which specifies that no one "shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law." The Court has interpreted this provision broadly when states violate their own laws. *Solodyuk v. Russia*, for example, held that a delayed pension payment not authorized by law during a time of high inflation constituted a deprivation of property because the payments ultimately received were worth far less than they would have been had they been paid on time. However, the ECHR specifically permits deprivations of property provided for by law, as long as they are taken in the

public interest. In reviewing such deprivations, the Court assesses whether they are "necessary in a democratic society" — that is, proportionate to the ends pursued. Given that redenomination would occur pursuant to domestic law and would be intended to avoid national (and perhaps international) financial chaos, a creditor asserting a violation of the ECHR likely would face an unreceptive Court. A withdrawing Member State could further bolster the legality of its actions under the ECHR by formally invoking Article 15, which allows derogation from the protection for property (as well as most other rights) in cases of public emergency.

An aggrieved creditor might also assert a violation of the E.U.'s "fundamental rights." Such rights are those guaranteed in the ECHR as well as "the constitutional traditions common to the Member States" (Article 6 TEU), and their violation can be redressed by the European Court of Justice. However, E.U. fundamental rights traditionally apply only when a Member State is acting pursuant to its E.U. obligations, whereas a withdrawal would be the very renunciation of those obligations. A few recent cases have applied fundamental rights more broadly, but the status of such cases is highly contested following the Treaty of Lisbon. The Treaty adopted an E.U. Charter of Fundamental Rights (distinct from the "fundamental rights" enshrined in the ECHR and Member States' constitutions) that applies to Member States "only when they are implementing Union law" (Article 6 TEU; Article 51 Charter). Many interpret this constraint as having overruled the cases applying fundamental rights more broadly. In any event, given that a successful withdrawal from the euro area can occur only pursuant to a treaty amendment (as discussed above), the Member States could insert an additional

clause clarifying that fundamental rights do not limit a Member State's ability to enact legislation reestablishing its national currency.

In short, challenges to redenomination based on international human rights law are either not particularly strong or could easily be addressed as part of the withdrawal framework established by the E.U. Derogation from domestic constitutional protections might prove politically controversial but likely would permit a withdrawing Member State's courts to enforce national redenomination legislation.

2. Other jurisdictions also must adopt enabling legislation.

While redenomination within a Member State would be relatively simple, effecting redenomination outside of the country's jurisdiction would be an order of magnitude more difficult. Unlike the courts of the withdrawing Member State, which would be bound to apply its national redenomination law, foreign courts (both within and beyond the E.U.) would have a choice of which jurisdiction's law to apply. Depending on the law they selected, they might well find redenomination legally impermissible.

In the ordinary case of a single country moving from one currency to another, the choice-of-law question is straightforward and likely to result in a finding that redenomination is effective. Courts' generally apply the lex monetae, the law of the currency issuer (Mann 1960; Nussbaum 1950). For example, when the hyperinflation of the 1920s forced Weimar Germany to replace the Mark with the emergency Rentenmark and eventually the permanent Reichsmark, foreign courts enforced redenomination because it was legal under the lex monetae — German law.

In the case of withdrawal from a currency union, however, there may be no clear lex monetae (Scott 1998). For example, if Greece withdrew from the euro area and

mandated that euro contracts were to be redenominated in new drachma, Greece would be the issuer of the replacement currency, but the Member States of the euro area would remain the joint issuers of the replaced currency. While the definition of "euro area law" for lex monetae purposes might be contested, presumably such law is synonymous with E.U. law, which consists of both the E.U. treaties and various types of "secondary law," such as E.U. directives. None of these speak to redenomination with particular specificity, but the treaties plainly contemplate an "irrevocable" monetary union (Articles 4(2), 118, and 123(4) EC, and Article 140(3) TFEU). Thus one possible law of the currency — Greek law — would permit redenomination, while another possible law of the currency — E.U. law — likely would not. As Mann recognized, the very concept of lex monetae is unhelpful when the "question is which of two competing laws of the currency shall prevail" (Mann 1959, p. 261).

Mann's proposed solution to this dilemma of rival leges monetae was that courts should apply the law specified in the legal instrument at issue — the "law of the contract." For many obligations in a withdrawing Member State, the law of the contract would be its own national law. For example, nearly 90 percent of Greek government bonds have been issued under Greek law, while in Italy, a statute mandates that government bonds issued domestically are "titoli del debito publicco" (public debt securities governed by Italian law). As of December 31, 2011, only €26.1 billion of Italian debt was issued under foreign law — approximately 1.65% of the total. Accordingly, a foreign court employing a law-of-the-contract approach presumably would permit the redenomination of such bonds. However, other obligations, such as some of the Greek debt or more generally commercial loans, may specify that they are

governed by the law of another jurisdiction. Additionally, if a contract fails to specify any governing law at all, a court outside the withdrawing Member State would be forced to apply its jurisdiction's own conflict-of-law rules to decide what law properly governed.

Although the legality of redenomination would vary with the law applied, some jurisdictions plainly would be quite hostile to an assertion that a contract made in euros could be repaid in anything other than euros. In the United Kingdom, for example, English courts do not give effect to any foreign law that runs contrary to English public policy. Case law suggests that English courts would apply this principle to refuse recognition of foreign legislation that was inconsistent with a treaty to which both the United Kingdom and the enacting state were parties (Proctor 2006). Although the United Kingdom is not a member of the euro area, it is a member of the E.U. Accordingly, withdrawal from a monetary union that, under the E.U. treaties, is "irrevocable" once joined, likely would constitute just such an inconsistency and thus would not be recognized in English courts. Anticipating how courts might rule in other jurisdictions, such as the United States or Japan, is difficult; no judicial opinions have addressed the withdrawal of a country from a surviving monetary union. Regardless of the outcome in any particular court, however, if foreign law applied to a substantial number of outstanding contracts involving a withdrawing Member State, there would be protracted litigation and severe economic disruption.

The prospect of such crippling uncertainty would create a strong incentive for the E.U. and major economic powers to pass their own laws addressing a withdrawing Member State's adoption of a new currency (Scott 1998). Such laws would mirror those

passed fifteen years ago to address adoption of the euro itself. In 1997, for example, the E.U. itself enacted Council Regulation 1103/97 (commonly deemed the "235 Regulation" for the E.U. treaty provision that provided its underlying legal authority). The regulation specifies that the "introduction of the euro shall not have the effect of altering any term of a legal instrument or of discharging or excusing performance under any legal instrument, nor give a party the right unilaterally to alter or terminate such an instrument." Other jurisdictions followed the E.U.'s lead. The state of New York, for example, passed General Obligations Law 5-1602 the following month. The law specifies that if "a subject or medium of payment of a contract, security or instruments is a currency that has been substituted or replaced by the euro, the euro will be a commercially reasonable substitute and substantial equivalent."

As part of establishing a framework for a Member State's withdrawal from the euro area, the E.U. could adopt a "reverse-235 Regulation," providing that Member States were bound to honor redenomination, subject to the agreed-upon terms for withdrawal. (Of course the treaty amendment providing for withdrawal would have to permit adherence to such a regulation notwithstanding the E.U.'s "fundamental rights" guarantees or the E.U. Charter of Fundamental Rights.) Other jurisdictions, such as Japan and New York, could adopt similar laws. Although creditors in those jurisdictions would suffer substantial losses, the fixed exchange rate to be implemented after withdrawal would limit such losses, perhaps even leaving creditors better off than if euro debt were restructured. In any event, the U.S. and other major countries would facilitate the redenomination if they saw it as a reasonable solution to the euro area debt crisis that threatens all major markets and banks, not just those in the euro area.

E. Limit redenomination losses by pegging the value of the withdrawing Member State's new currency to the euro

As both an economic and political matter, withdrawal from the euro area is possible only if there is some upper limit to the losses that the withdrawing Member State imposes on its public and private creditors through redenomination and devaluation. Otherwise, redenomination and devaluation could impose severe losses on Europe's banks creating the possibility of contagion, panic and bank failure across the continent and beyond. For example, according to data from the Institute of International Finance, banks stress tested in 2011 in France and Germany have, respectively, exposures of 3.55% and 4.10% of their Tier 1 capital to Greek debt, and 19.75% and 19.38% of their Tier 1 capital to Italian debt. Individual systemically important banks also have very substantial exposures to Greece as a percentage of their Tier 1 capital. For example, Deutsche Bank's exposure is 1.84%, BNP Paribas's is 5.96%, Société Générale's is 4.80%, and Intesa Sanpaolo's is 2.27%. Banks' exposure to Italy as a percentage of Tier 1 capital is much more substantial. Deutsche Bank's exposure is 6.6%, BNP Paribas's is 32.3%, Société Générale's is 16.4%, and Intesa Sanpaolo's is a striking 152.5%. The levels of exposure, particularly to Italy, underscore the concern with creating a contagious bank run by exposing banks to losses through restructuring or devaluation. The impact on banks would have to be cushioned by some combination of ECB lending and, in the case of particular banks, capital injections.

In the case of euro withdrawal, the E.U. can generally limit losses from devaluation through fixing the exchange rate between the euro and the currencies of non-euro area Member States through use of the Exchange Rate Mechanism (ERM). By placing the withdrawing Member State into this system, with an agreed band width, the

E.U. could try to ensure that redenomination losses did not exceed an acceptable, predetermined upper limit.

While critics might contend that denying a withdrawing Member State exchange-rate flexibility (and monetary independence) eliminates one of the principal benefits of reestablishing a national currency, this argument is overstated if not incorrect. First, there would be some exchange rate flexibility and room for monetary adjustment within the bands. More generally, the discipline of a pegged rate within bands would provide the monetary discipline that withdrawing countries might need, and that their population appears to demand. Finally, some evidence suggests that a small country with high capital mobility may better off with a fixed rate (Buiter 2011). In any event, whatever benefits a completely floating exchange rate might offer a withdrawing Member State, they would be far outweighed by the costs to the international financial system, at least in the short run.

1. The Exchange Rate Mechanism already provides a way to fix exchange rates against the euro.

The E.U.'s current Exchange Rate Mechanism, established by a Resolution of the European Council (Resolution 97/C 236/03), is the second incarnation of a system designed to limit fluctuations in exchange rates among Member States' currencies. The first ERM linked the value of each participant's currency to a weighted basket of all participants' currencies. The system operated from 1979 until the introduction of the euro in 1999, when ERM II replaced it. Under ERM II, the currencies of participating non-euro area E.U. Member States float within a set band around a central rate of exchange with the euro.

As the Council explained in establishing ERM II, the system serves two primary functions. First, membership is a means by which non-euro area Member States can fulfill their E.U. treaty obligation to treat economic policy as a matter of common E.U. concern (Article 121 TFEU). Denmark, which negotiated a special treaty opt-out and thus does not have to adopt the euro, nonetheless participates in ERM II as a way of coordinating its economic policy with other E.U. Member States. Second, membership is one of the economic "convergence criteria" Member States must satisfy to adopt the euro. The E.U. Member States that joined the euro area after the introduction of the euro — Greece, Slovenia, Cyprus, Malta, Slovakia, and Estonia — all participated in ERM II. Latvia and Lithuania, which are waiting to join the euro area, are current participants.

No preconditions exist for participation in ERM II, and joining is relatively simple. A Member State sets both its central exchange rate and the size of the band around that rate by negotiating a multilateral agreement with other key parties. These include the euro area Member States, the ECB, and other ERM II participants. The E.U. Economic and Financial Committee and the European Commission are also involved. Non-euro area Member States not participating in ERM II are free to join the discussions, but their role is limited to consultation only. In principle, the parties to an ERM II agreement set the central rate equal to the equilibrium rate at the time the multilateral agreement is adopted. They do so in light of not just the then-current market rate, but a variety of broader economic indicators. The Council's ERM II Resolution sets a standard fluctuation band of fifteen percent, although the parties are free to negotiate a narrower band.

Once the parties have finalized an ERM II agreement, the national central bank of the participating Member State is expected to intervene automatically at the margins to ensure that the rate stays within the agreed-upon range. In practice, the national central bank can adjust interest rates, or, as the ERM II Resolution makes clear, obtain short-term financing from the ECB. The ECB makes swap lines available for this purpose. For example, Danmarks Nationalbank, the national bank of Denmark, has negotiated a €12 billion swap line with the ECB.

Despite such interventions, a central rate may eventually become unsustainable if the equilibrium rate evolves over time. Accordingly, all parties to an ERM II agreement, including the ECB, have a right to initiate confidential procedures to renegotiate the central rate.

2. A withdrawing Member State should immediately enter the Exchange Rate Mechanism.

Since ERM II already creates a framework for fixing the value of a non-euro area Member State's currency within a set range, the terms of any withdrawal from the euro area should include immediately establishing an ERM II agreement with the withdrawing Member State. But contrary to normal procedure, the central rate would not be set at an equilibrium or market rate since that rate could impose unacceptable levels of loss on creditors, most notably banks. In the case of Greece, for example, although standard economic models predict a new drachma would decline in value approximately forty percent against the euro, my conversations with those involved in the market indicate that much greater losses are more likely. Traders assume that if the value of a new drachma were left entirely to the market, it would decline more than seventy percent from the rate at which the original drachma was fixed to the euro: 340.750 to 1. Accordingly, the

central rate and width of bands would have to insure that redenomination and devaluation losses stayed within an acceptable limit.

For example, if Italy were to consider euro area withdrawal, the E.U., in consultation with major economic powers such as the United States and Japan, would first determine the losses that would be acceptable if Italy instead restructured its debt. Those losses would serve as the presumptive limit on how much the new lira should be allowed to depreciate against the euro — that is, if Italy were discussing a fifty percent haircut with its creditors, the new lira would be allowed to depreciate no more than fifty percent. If there were justification for allowing greater losses through redenomination than those being considered in restructuring, the redenomination losses would nonetheless have to be held within an economically sustainable upper limit. To establish this limit, the E.U. and the major powers would need to determine how much Italian debt systemically important financial institutions held, and what losses the most recent stress tests indicated those institutions could bear.

If, following such determinations, Italy proceeded with a withdrawal, the E.U. and Italy would establish an ERM II agreement whose rate and fluctuation band held losses upon contracts' redenomination in new lira to the agreed-upon limit — either the restructuring loss, the maximum sustainable loss, or something in between, by setting the band width. Without question, this rate would be under immense pressure from the very beginning. Unlike the typical ERM II agreement, which sets the central rate at the parties' best estimate of the equilibrium rate, the E.U. would be deliberately propping up the value of the new lira. Accordingly, the currency could be expected to drop

immediately to the bottom of the allowed range (a likelihood that should be taken into account in setting the central rate and the size of the bands).

Given this pressure, the reestablished Banca d'Italia would not easily be able to maintain the agreed-upon rate by using foreign exchange reserves, which are currently US$186 billion, the fifteenth or sixteenth (depending on the data set) largest in the world, or by intervening at the margins with interest rate adjustments; it would need additional massive external support. This could be provided by the Banca d'Italia obtaining a swap line with the ECB. The ECB currently has swap lines in place with a variety of ERM II and non-ERM II Member States — in addition to the €12 billion line with Danmarks Nationalbank mentioned above, it has established a €10 billion swap line with Sveriges Riksbank, the national bank of Sweden, and a £10 billion swap line with the Bank of England. These amounts are trivial compared to what would be required to maintain the value of the new lira against the euro, however.

Put simply, only an unlimited swap line would succeed. The fate of the old lira under the original ERM shows what can happen when speculators begin to question a central bank's commitment to a supposedly fixed exchange rate. On September 12, 1992, foreign exchange traders decided "the emperor had no clothes" (Hansell 1992, p. 47) — that is, that the central banks maintaining the ERM did not have the power to make it hold — and took substantial positions against the lira. Despite massive interventions by central banks across the continent, Italy was forced to devalue the lira by seven percent. A few days later, on September 16, speculators managed to force the United Kingdom out of the ERM entirely when thousands of them bet against the pound. The Bank of

England hiked interest rates by fifty percent and burned through US$15 billion of its reserves before conceding defeat.

The danger of an unlimited ECB swap line, of course, is that it may create inflationary pressure on the euro by putting more euros into circulation. At least in the short- to medium-term, however, this fear is overstated. If the ECB funded swap lines simply by creating additional euros (without an offsetting sterilization) which were then used by the swap recipient, it could drive up inflation. However, under very plausible assumptions, the ECB's non-inflationary loss-absorption capacity is as high as €3 trillion (Buiter 2011). Thus the ECB could clearly fund swap lines far above its current range of €10-15 billion without pushing inflation over its target rate of two percent annually. Furthermore, the ECB would not need to be the sole institution helping maintain the ERM II rate. The International Monetary Fund could support the ECB's efforts with loans, for example, and the United States Federal Reserve could further extend the dollar swap lines it established in May 2010, which are set to expire on August 1, 2012. Currently, the ECB has over US$80 billion outstanding under its dollar swap line. Of course, if the swap line "bazooka" is credible, there would be no need to use the lines and money supply should be unaffected.

Ultimately, maintaining the value of a withdrawing Member State's new national currency against the euro could present a substantial challenge; the tools exist, but the ECB and other international financial institutions would have to be completely committed to using them. Perhaps the alternative — massive losses that could threaten to bankrupt European banks and throw the world economic system into disarray — would assure the market that the tools would be used.

F. Sequence changes to minimize disruption

Each of the measures described above must be properly sequenced to minimize disruption to the financial system. An extended period in which a Member State's commitment to the euro is uncertain would cause severe capital flight, beginning the moment withdrawal from the currency union became a realistic possibility. Indeed, substantial deposits have already been withdrawn from the Greek banking system. Accordingly, a successful exit would have to unfold in four parts. First, the withdrawing Member State would simultaneously announce that it was beginning treaty negotiations to withdraw from the euro area and that that it was imposing capital controls. Second, while the treaty amendment was being negotiated, the withdrawing Member State would begin the work of reestablishing its independent national central bank, developing new payment systems, and taking other practical steps toward monetary independence. Also during the treaty negotiation period, the Member State and other jurisdictions would pass the necessary redenomination laws. Third, as soon as the treaty amendment was adopted, the previously prepared measures would immediately take effect. The Member State would withdraw from the euro area and immediately enter the ERM. Fourth and finally, after the use or threat of the swap line "bazooka" discouraged speculators and established the new currency's viability within the ERM arrangement, the Member State would end capital controls.

III. Euro Withdrawal Compared to Euro Debt Restructuring

In considering the range of possible responses to the E.U.'s sovereign debt crisis, many policymakers (as contrasted to most economists) have held fast to the notion that withdrawal from the euro area and redenomination in a new national currency is an

inferior option to debt restructuring. These policymakers are deeply devoted to the *political* project of European integration, and see withdrawal from the euro area as a step away from integration and perhaps toward the unraveling of the European Union itself. However, this opposition cannot be allowed to obscure the *economic* reality that redenomination is at least a marginally better solution than restructuring — and in certain circumstances, a markedly better solution. Indeed, the superiority of withdrawal as a solution in the case of potential future crises in Member States such as Italy means that the E.U. should adopt a framework for withdrawal as soon as possible, regardless of how the restructuring debate is resolved in the current Greek crisis.

A. Redenomination avoids the holdout problem

Perhaps the greatest difficulty with restructuring is the well-known holdout problem. Holdout creditors — sometimes referred to as "vulture funds" — buy up debt at a significant discount and then simply refuse to participate in a restructuring. Instead, after other creditors have agreed to the restructuring, the holdouts file suit in a foreign court, attempting to collect fully on the debt they purchased for a fraction of its face value. Sovereign immunity is of little help to debtor countries, since bond issuance is considered a commercial activity outside the scope of the doctrine (see, for example, the U.S. case *Republic of Argentina v. Weltover*).

Assuming they prevail in court, holdouts can pursue a variety of means to collect on the judgments they receive. Debtor countries may own substantial assets outside their own territory, where attachment by a foreign court is more likely. More importantly, they may send and receive payments or goods abroad, which can be subject to attachment. Attempts to insulate these assets from attachment may force debtor countries

to hold assets and enter into transactions that are suboptimal, just to avoid the risk of attachment. For example, since its 2002 default Argentina has had to rely on domestic bond rather than eurobond issuance and has had to hold most of its foreign reserves at the Bank of International Settlements. While holdout creditor litigation is not often successful, it can be, and this threat hangs over the defaulting sovereign. The holdout problem would be especially severe for a restructuring involving a euro area Member State. First, the free movement of goods, capital, and services within the E.U. means that most Member States have significant flows of payments or goods elsewhere in the E.U. that holdout creditors could seek to attach. Second, despite the rapid pace of privatization across Europe in the past several decades, many Member States still retain significant state-owned enterprises. Greece is a notable example. If a Member State refused to honor the bonds of holdout creditors, its equity holdings in such enterprises might be subject to seizure. Finally, the mass of often-interlocking and overlapping human rights guarantees that apply to E.U. Member States, described in more detail above, have prompted some states to adopt extremely powerful protections for creditors.

Greece, for example, instituted such protections in response to a 1995 ruling by the European Court of Human Rights that found the country had failed to honor private-property and fair-trial rights. In 2001, Greece adopted a constitutional amendment that mandated enforcement of court judgments (Article 94 ¶ 4). The Hellenic Parliament then passed implementing legislation allowing attachment of the government's "private assets," which the Areios Pagos, the Greek Supreme Court, has interpreted as allowing seizure of municipal fees and tax revenues not dedicated to a payment for a particular service. While Greece and other Member States may be able to invoke emergency

provisions in their constitutions to deprive creditors of these rights, doing so would open a fresh line of attack for creditors in the European Court of Human Rights.

In the particular case of Greece, at least some hedge funds have reportedly avoided buying up Greek bonds on the theory that because the vast majority of the debt has been issued subject to Greek law, the prospect for a successful suit abroad, let alone attachment of government assets, remains remote. Not all funds agree, however. Significantly, Greece's plan to avoid the holdout problem through retroactive insertion of collective action clauses in existing bonds seems particularly likely to meet strong legal opposition in the United Kingdom, given English courts' refusal to give effect to any foreign law that runs contrary to English public policy. Whereas the United Kingdom likely would pass a law authorizing redenomination, it might be reluctant to pass a law permitting just the modification of Greek bond contracts. Additionally, it is not clear whether funds would have the same concerns about their prospects for success in pursuing a holdout strategy in Member States other than Greece. In short, the risk of holdout creditors remains substantial for any restructuring involving a euro area Member State.

In comparison, redenomination provides the clear advantage of making holdouts simply impossible. All existing debt is automatically converted to the new national currency upon passage of the appropriate national legislation. Because the haircut in a redenomination is imposed through devaluation, the alteration of payment terms simply does not exist as a grounds for suit. Accordingly, as long as enabling redenomination legislation were adopted in other jurisdictions, as discussed above, creditors would have no way to seek the original full value of their bonds.

B. Redenomination affects all creditors equally

A major sticking point in the ongoing negotiations between Greece and its creditors has been the decision not to subject debt held by public bodies, such as the ECB and the IMF, to the haircut it is proposing that private creditors accept. These creditors are seeking to retain their customary super priority and impose the losses on the private sector. Such discrimination between public and private creditors does more than raise concerns about equitable treatment. By subjecting only private creditors to restructuring, discrimination quite obviously increases the magnitude of the losses those creditors must bear.

Redenomination, in contrast, makes the problem of discrimination much more difficult; all creditors necessarily receive the same devaluation haircut. Rather than renegotiate the terms of particular debt agreements, the debtor country simply redenominates all outstanding debt, imposing equal, across-the-board losses through devaluation. This straightforward approach might attract significant support among private creditors by lowering their losses through the means of more equitable distribution. It is conceivable that public authorities could insist that their euro holdings be paid in full but this would have little precedential justification.

C. Redenomination may not trigger credit default swaps, while coercive restructuring almost certainly would

In theory, either a restructuring or a redenomination of a Member State's debt could constitute a credit event that triggers credit default swaps (CDSs) on that debt. At least in the Greek case, however, proponents of restructuring seem to be proceeding on the theory that any restructuring agreement easily could be configured to avoid a credit event. Such confidence is misplaced. At the same time, it is also the case that a

redenomination involving any of the euro area's largest Member States almost certainly would not constitute a credit event.

As the International Swaps and Derivatives Association's (ISDA) Master Agreements establish, a transaction in which creditors "voluntarily" exchange their existing bonds for new bonds is not a credit event. This would be the case, according to ISDA (2012), if creditors could either tender their existing bonds for new bonds with a substantial haircut or retain their existing bonds and continue to receive payment in full. But the idea that any bondholders would choose to participate in such an exchange when they could be paid in full is absurd (Gulati and Zettelmeyer 2012). Furthermore, the passage of a law retroactively inserting collective action clauses in existing Greek bonds—to minimize the holdout problem—strains the definition of voluntary far enough to break it. Accordingly, such a coercive restructuring almost certainly would trigger a credit event.

For redenomination, in contrast, the voluntariness of the plan has no bearing on whether or not a credit event occurs. The key inquiry is whether the redenominating country is a G7 member or an OECD member with a AAA credit rating; under the ISDA Master Agreements, a redenomination constitutes a credit event if the country does not fall into either category. Accordingly, for the smallest and most economically distressed Member States, redenomination confers no advantage over restructuring with respect to CDS triggers. Greece, for example, is not a G7 member and, although a member of the OECD, is far below a AAA credit rating. Accordingly, a Greek redenomination would constitute a credit event just as would a Greek restructuring that is deemed involuntary (as any successful restructuring likely would be). However, data from the Depository

Trust & Clearing Corporation (DTCC) indicate that the total net exposure for sellers of CDSs on Greek sovereign debt was a comparatively minor US$3.2 billion as of early 2012. Furthermore, this exposure is partially offset by collateral and the recovery value of the underlying assets. ISDA (2012) hypothesizes CDS sellers could be liable for only fifty percent of the aggregate amount payable, or US$1.6 billion — a minor sum, given the magnitude of Europe's sovereign debt crisis.

Thus, for the smaller Member States, the difference between restructuring and redenomination is minimal and the impact of the triggering CDS payments is small. However, for the larger Member States that are in the G7, such as Italy, a coercive restructuring would trigger CDS payments while a redenomination would not. The potential payouts in the case of such a restructuring would be an order of magnitude larger than those in Greece. According to the DTCC, the total net exposure for sellers of CDSs on Italian sovereign debt was US$22.2 billion as of early 2012. Applying the same assumptions regarding collateral coverage and the value of the bonds that ISDA employed for Greek CDSs, the amount payable would be US$11.1 billion — seven times the amount payable for Greece.

IV. The Future Stability of the Euro Area

The final component of any agreement to allow withdrawal from the euro area must be a concrete mechanism that provides for the future stability of the monetary union. The euro will endure for the foreseeable future even if one or more Member States abandon it, but without serious reform, the remaining Member States will repeatedly face the burden of dealing with the debt of profligate members that remain in

the euro area. Exit at its best is a difficult process and should not be regarded as the solution to overspending members.

As many critics noted even before the euro's introduction (e.g., Feldstein 1997), the basic problem with the current arrangement is that it combines a single monetary policy, administered by the ECB, with an array of fiscal policies, determined by individual Member States. Thus any single Member State can make borrowing and spending decisions that create inflationary pressure and drive up interest rates for all other Member States — and, as recently demonstrated, create pressures on other euro area members for fiscal support or on the ECB for potentially inflationary liquidity. Unfortunately, the E.U.'s primary existing method for addressing this problem, the Stability and Growth Pact, has failed, and euro area Member States' latest efforts to strengthen this Pact do not promise meaningful improvement. Accordingly, a truly new approach is necessary. An effective and realistic option is transferring debt decisions, under defined conditions, from Member States to the E.U. by mandating that all future debt be issued in eurobonds approved and cross-guaranteed by all Member States.

A. Existing mechanisms for imposing fiscal discipline have failed

At the December 1996 Dublin Summit, the E.U. introduced the Stability and Growth Pact as its chief means of ensuring coordinated fiscal discipline. The Pact's key requirement was that Member States' budget deficits could not exceed three percent of GDP. A Member State that exceeded the limit for more than ten months was to be subject to various fines, eventually rising as high as 0.5 percent of GDP. The Pact also required that Member States' national debts could not exceed sixty percent of GDP, but this provision was seen as less significant than the deficit limit. Although economists

criticized the Pact as dangerously constraining Member States' ability to respond to major recessions, its flaw proved to be just the opposite: it was entirely toothless. This failing became apparent in 2003, when the Council was unwilling to apply sanctions to Germany and France despite their violation of the Pact's deficit ceiling.

In the years since, the E.U. has adopted various reforms, to little effect. In 2005, the Council announced its first set of changes, supposedly intended to make the Pact more flexible and therefore enforceable. While retaining the deficit and debt limits, the revised Pact offered Member States greater freedom to temporally run excessive deficits. On the enforcement side, the changes included new advice and warning powers for the Commission, to supplement the existing sanctions power (which the reform plan itself conspicuously avoided mentioning). The changes did little to control spending and debt — as the present crisis so forcefully demonstrates. In 2011, as part of a package of six economic governance reforms (the "six pack"), the Council revised the Pact again. The most significant change was a new provision for supposedly "automatic" sanctions when a Member State's debt exceeds the sixty percent ceiling. Tellingly, however, the fines still require the Commission to initiate an enforcement action, which can be blocked if a qualified majority of Member States in the Council vote against enforcement. Also in 2011, the euro area Member States (joined by a handful of other E.U. Member States) made an additional commitment to "translate" the Stability and Growth Pact's limits into their own national laws in the form of "debt brakes" that prohibit excessive spending. Of course, even an amendment to a Member State's constitution can be undone at any time. Unsurprisingly, the then-president of the ECB, Jean-Claude Trichet, criticized the package of reforms as insufficient.

Unfortunately, the E.U. has shown no indication that it will pursue more binding constraints. Most significantly, the intergovernmental agreement it agreed to pursue in December 2011 (following the United Kingdom's veto of an E.U. treaty amendment) appears unlikely to offer new fiscal controls. The Treaty of Stability, Coordination, and Governance, as the agreement apparently will be called, is still being drafted as of this writing. However, press reports indicate that it mainly repeats existing goals, such as establishing debt brakes to enforce Stability and Growth Pact limits through national law. A recent draft of the new Treaty indicates the Commission will be empowered to file suit in the European Court of Justice against Member States without an authorizing vote of such States, giving it greater powers than it has had until now. But even if the Commission were to use these powers over the express objections of Member States, an ECJ ruling that a Member State has breached its fiscal obligations would do nothing to actually limit spending. A Member State consciously violating the new Treaty is unlikely to be deterred by judicial declarations confirming what it already knows. If, as has been reported. Member States have empowered the ECJ to impose monetary sanctions, the prospects for compliance might be somewhat improved, but control up front would remain preferable. Litigation can only address problems that already have arisen — not prevent them outright. With no effective limits or automatic enforcement, the treaty is likely to represent a continuation of the E.U.'s failed fiscal-control policies.

B. Eurobonds offer a way to impose fiscal discipline by transferring debt decisions from Member States to the E.U.

The most direct solution to the euro area's problem of uncoordinated and undisciplined fiscal policies would be adopting a full fiscal union on the model of the United States, where a central federal authority controls most spending, debt, and taxes.

But such a union would face substantial popular opposition in virtually every Member State. A less comprehensive but more politically feasible solution would be mandating that, under certain circumstances, all future debt issuance be controlled at the E.U. level, thereby eliminating the problem of individual Member States making borrowing decisions without concern for the euro area as a whole. In exchange for giving up the right to issue their own debt as they saw fit, Member States would be able to issue eurobonds, for which all euro area Member States would be jointly and severally liable. Proportional liability is a less satisfactory option because of the likelihood that Member States in fiscal straits would not be able to fulfill their obligations.

Under this proposed eurobond system (I do not discuss other less practical or effective eurobond proposals), Member States would automatically be entitled to issue debt up to the current Stability and Growth Pact limit of say sixty percent of GDP. Once a Member State reached that ceiling, however, it would be permitted to issue additional debt only after receiving approval from an E.U.-wide body, such as the Council. To avoid the prospect of small coalitions of Member States banding together to approve debt increases for each other, the authorization vote would follow the E.U.'s qualified majority procedures. These procedures would ensure that debt increases were approved only by a "double majority" — that is, a majority of the participating Member States, which together represented a majority of the population of the participating Member States.

While the Council undoubtedly would authorize some debt issuances above the sixty percent ceiling if a Member State's particular circumstances demanded it, the approval requirement would serve as a real constraint on spending. In contrast to a true

fiscal union however, Member States would retain a significant degree of fiscal autonomy by continuing to make their own taxing and budgeting decisions (subject, of course, to the E.U. debt constraints). Of course some Member States might be willing to partially surrender this authority and implement policies mandated by other Member States in exchange for authorization to issue additional bonds above the sixty percent limit, but the choice to do so would remain in each Member State's hands. In this respect, this proposed eurobond system would confer virtually all the advantages of Chancellor Merkel's proposal in late January 2012 to take over authority for the Greek budget, but by remaining voluntary would be far less intrusive — and thus more realistic.

Admittedly, transitioning to this eurobond system would present several challenges. The first is legal. Contrary to some commentators' assertions, the issue is not that eurobonds providing for joint and several liability violate the E.U. treaties' no bail-out clause (Article 125 TFEU), which bars the E.U. from assuming the commitments of governments or other public bodies, "without prejudice to mutual financial guarantees for the joint execution of a specific project." The absence of a definition for "specific project" renders this provision meaningless (Buiter 2011). Virtually any clearly defined program, even a bailout program, meets the definition. Nor is there a legal issue that eurobonds might violate two other closely related treaty provisions, Articles 123 and 124 TFEU. Article 123 prohibits the ECB and Member States' NCBs from establishing "[o]verdraft facilities or any other type of credit facility" for the benefit of governments and public bodies, and bars the ECB from purchasing government or public debt in the primary market. Article 124 bars the E.U. and Member States from obtaining "privileged access" to financial institutions without heeding "prudential considerations." Like

Article 125, these provisions contain massive loopholes. Notwithstanding Article 123, the ECB can purchase public debt in the secondary market. And under Article 124, Member States are free to assess for themselves "prudential considerations." The size of these various loopholes already has clearly been established in practice. After all, the various entities the E.U. has established to respond to the continent's sovereign debt crisis, such as the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM), have already issued bonds backed by all the Member States, and ECB purchases in the secondary market have also bailed out profligate countries. In short, the legal issue does not involve current "prohibitions" in the treaties. Rather, the legal issue is that an effective eurobond system likely would require a treaty amendment to bar Member States from issuing national bonds. Without such a prohibition in place, Member States might be expected to pull out of the eurobond system and return to issuing their own national debt if they could not secure approval to issue eurobonds above the sixty percent ceiling.

The second challenge is political. At least in the short term, the Member States with the strongest economies could find it more expensive to issue eurobonds in place of their own national bonds, given their greatly expanded possible liabilities. Such Member States might resist any eurobond proposal. (Of course the Member States with the weakest economies could find it cheaper to issue debt, given a new continent-wide guaranty. Such Member States might strongly favor any eurobond proposal.) While the political dynamics are complex, ultimately all Member States share an interest in creating a more stable euro area. For example, while German debt costs would increase, the need for German fiscal support of other countries, or inflationary dangers of increased ECB

liquidity support, would decrease. Furthermore, Germany would significantly decrease the risk of the euro area completely collapsing, a development that would cost the country far more through the loss of its competitive exchange rate. Accordingly, even those Member States that might be forced to pay a higher rate on bonds in the immediate future could conclude that the increased stability ultimately saved them money.

The final challenge is practical. At the moment, debt as a percentage of GDP is far above sixty percent in most Member States: it is 142.8 percent in Greece and 119 percent in Italy, for example. Even in France and Germany, debt is more than eighty percent of GDP. Accordingly, a new eurobond system would have to provide for a transition period during which Member States could unilaterally issue some new E.U. guaranteed debt over the sixty percent limit, say 10 percent, without seeking E.U. approval. Unlike the existing bond issues by the EFSF and EFSM, which have required raising significant capital, there would be no cost to this guarantee; all Member States simply would be liable for the debt issued. The transition period would provide Member States with a degree of flexibility while they worked to bring their existing debt — which would not be converted to eurobonds — under the sixty percent limit. A reasonable period would give Member States three years or so to reduce their debt, although the optimal duration of the transition is open to discussion. After three years, any new debt issues above the sixty percent limit would follow the normal voting procedure. The voting procedure would also apply if a Member State wished to increase their debt by more than ten percent during the transition period.

In short, although introducing eurobonds would require overcoming a variety of obstacles, none are insurmountable. More importantly, by ensuring that debt issuance

would be controlled at the E.U. level, this eurobond approach offers a real solution to the problem of uncoordinated and undisciplined fiscal policies across the euro area, one that a revised SGP does not.

V. Conclusion

This essay has set forth a plan for euro withdrawal that would allow Member States to both restructure their debt and retain competitiveness through substantial changes in their exchange rates within the ERM framework. Restructuring, at best, only addresses debt restructuring. This plan would require many legal and operational changes, including a framework for redenomination and the imposition of short-term capital controls. I believe these measures are practical and achievable. If this approach is not adopted for Greece, the required framework should be put in place to deal with other countries, if future withdrawals are required. Some will see Euro area withdrawal as an undesirable step unraveling European integration but without measures to address the real issue of unsustainable debt limits and uncompetitive economies, the burdens put on Member States by their profligate peers will prove unsustainable and will ultimately wreck the entire Euro area. It is better to send Member States in trouble to an ERM purgatory from which they can return in the future.

Going forward, the euro area needs to find a way to limit excessive debt of its constituents. I propose to do this by having all debt in the future be issued by eurobonds cross-guaranteed by all Member States. Countries whose debt was below sixty percent of GDP could issue such debt themselves, while any issuance over sixty percent would require the approval of the Euro area countries. Such a plan avoids the toothless approach of the Stability and Growth Pact, on the one hand, and does not require

complete fiscal union. While countries will remain free to make their own taxing and spending decisions, they will be constrained by the eurobond requirements.

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