OPINIONS

Thinking the Probable: The Break-Up of Monetary Union

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In March 1998, I co-authored an article, "Thinking the unthinkable—the break-up of monetary union" with my then partner Charles Proctor (now a partner at English firm Bird & Bird). This was published in various magazines and was felt to be doubtful as to its political correctness. This article analysed the legal consequences of a break–up of EMU (however unlikely this may have seemed then). The creation of a currency without a sovereign—a fairly unique situation in History—was to be followed rapidly by a more integrated Europe (this was clear from the Maastricht Treaty where EMU was one of the steps on the road to an "ever closer Union" between EU Member States). In 2005, I published an article entitled "Not so unthinkable—the break-up of European monetary union" as, at that stage the Dutch and French referenda clearly indicated that the "ever closer Union" was not to be. Unfortunately, it is now time to publish "Thinking the probable: the break-up of monetary union" as the 2008 crisis has left exposed to the clear weakness of History a sovereign-less currency system.

Whilst economists and financiers are already forecasting the re-introduction of several national currencies in lieu of the euro, it is important to look at the legal ramifications of the reintroduction of national currencies that were subsumed into the euro in the light of the substantial increase of governments' debts denominated in euros. It is also time to make a few suggestions to allow an orderly resolution of the challenges which a break-up of monetary union would present rather than wait for an implosion of the system that will translate in acrimony amongst EU members. As always, pragmatism has to control dogma.

It must be remembered that monetary union was intended to be an irrevocable process. The EMU process involves a permanent delegation of national monetary sovereignty to the European Union and any unilateral attempt by an EMU participating state to re-establish a separate national currency would (in the absence of consent from other participant states) represent a breach of the Treaties. No mechanism exists in the Treaties to allow a participating Member State to withdraw from EMU. It is also worth remembering that the euro is the lawful currency of all *and each* of the EMU participating states. However large and powerful a country may be, the euro is as much the lawful currency of each of Greece, Spain, Portugal and Ireland as it is the lawful currency of Germany.

It follows that a withdrawal by a Member State participating in EMU would have to be a negotiated. In my previous articles I indicated that this process would not be trouble free, as the setting of the external value of a new currency and the transfer of reserves from the ECB to the central bank of the departing country would undoubtedly be difficult. In a working paper published by the ECB entitled "Withdrawal and Expulsion from the EU and EMU",[1] the author shares the views I put forward since 1998, although it should be noted that such papers do not represent the official views of the ECB.

In my previous articles I dealt with the challenge posed by financial obligations expressed in euros where a Member State pulls out of EMU; and the obligation falls due for payment after the effective date of a Member State withdrawal.

The essential question would be: is the obligation to be paid in euros, or would the obligation be satisfied by a payment in the new national currency at the rate prescribed by the withdrawing Member State's new currency law (conversion rate)? The difficulties in answering this question are compounded by the fact that the euro would continue to exist as the lawful currency of the remaining participant States and would thus be available as a medium for payment, despite the exit of the Member State. Overall I indicated that such issue would not be insurmountable, especially for obligations expressed to be payable outside the withdrawing country or governed by a law other than the law of the withdrawing country. This is significant given the number of such obligations outstanding in London, New York or Switzerland).[2]

However, the recent dramatic increase in national debts and government bonds to finance budget deficits sheds another light on the legal implications for euro-denominated debt obligations issued by governments under their domestic law (which is the case for most government bonds). If, for example, Greece were to

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[1] Phebus Atanasiou, *Withdrawal and Expulsion from the EU and EMU* (ECB, December 2009).
[2] For a detailed analysis see Charles Proctor, *Mann on the Legal Aspects of Money*, 6th edn (Oxford University Press, 2005), pp.776–782.

reintroduce a new currency (for ease of reference call it the New Drachma or ND), the monetary law of Greece will set a conversion rate of the ND, the new lawful currency of Greece, against the euro the then former currency of Greece. Assuming the ND is freely convertible, any subsequent fluctuation of the exchange rate ND/euro, will only find its translation in the price of the bonds themselves (i.e. differential between the conversion rate and the free exchange rate from day to day). It follows that certain bondholders that have purchased euro denominated bonds issued by the Greek Government and Greek entities with a place of payment outside Greece (and probably governed by a foreign law), will probably be in a position to claim payment in euros (but with the risk that the Greek issuers be tempted to argue that the payment should be in ND at the conversion rate—however unlikely courts outside Greece would accept such a reasoning), whilst the holders of domestic bonds will have to live with the conversion rate set on the date the ND is introduced whatever its subsequent fluctuations. In such a case we could see court cases that may not be dissimilar in nature to the Case Concerning the Payment of Various Serbian Loans Issued in France decided by the Permanent Court of International Justice in 1929.[3] The size of the domestic bond market in each participating Member State, and the euro debt market outside such withdrawing country/countries is such that we could face a serious legal dislocation of the government bond markets and a long period of uncertainty.

The above and my previous articles should convince all involved that a country withdrawing overnight from the eurozone will confront significant challenges and that such action would lead to a long period of instability for the entire eurozone. It is my contention that if a country were to consider withdrawal—because the social and political cost of abrupt budget adjustments is too high risking severe political upheavals that may lead to the unknown—serious consideration should be given to an idea (somewhat adjusted to the new reality) that was suggested when the Maastricht Treaty was being negotiated by then Prime Minister John Major: a dual currency system.

Michael G. Arghyrou and John Tsoukalas advocate temporary implementation of a two-currency EMU, with both currencies run by the Frankfurt-based ECB. They propose that the core countries continue to use the strong euro while the periphery regions could adopt the weak euro (in our example the ND). The weak euro could be restricted to the relevant country (through a temporary exchange control system). Despite the adoption of a weaker ND, the Greek bonds (irrespective of the place of payment or governing law) would stay in strong-euro terms, thus avoiding a debt market crisis. Upon its introduction, the ECB would devalue the ND by a percentage sufficient to restore the competitiveness losses Greece has suffered over the last decade against their main trading partners, the core-EMU countries. The ND would be a representation of the euro, but at a new conversion rate (a system not dissimilar to the transition period from 1999 to 2001 when legacy currencies were representations of the euro). The ND would only be convertible on a restricted basis by the ECB. This will give the periphery a competitiveness boost while also giving breathing space to the European Union to introduce extensive structural reforms (in essence either to further integrate and create a genuine economic and budgetary union ("create a sovereign above the euro") or to dismantle the euro in an orderly manner if, as seems likely, the nations of Europe are not willing to create a supra national power). The ECB would implement monetary policy for the whole of the EMU with its primary objective being price stability for all its members, strong- and weak-euro countries. It will do so in much the same way it does now, the only difference being that the ECB will be setting two rather than one reference rates.

In due course such a dual currency system would either give the departing country (in my example Greece) the choice over several years either to rejoin the "strong euro", or effect an orderly "repatriation" of its monetary sovereignty based on the progressive re-accumulation of reserves to base the new introduced currency.

It seems to me that it is not for economists or lawyers to make political proclamations for or against the euro, but to provide time and tools for governments to consider and design carefully the next steps rather than be forced by markets to take abrupt budgetary decisions each time a bond market is under pressure. The EMU participating Member States, having lost the monetary tool to adjust to economic difficulties, have no option but to implement severe fiscal and budgetary policies. Stark austerity measures will inevitably trigger radical reactions on the part of the people who bear the consequences of such severe policies. Better to find the legal and economic tools to create the breathing space necessary for the current Member States' governments to strengthen or dismantle EMU in an orderly fashion, rather than to await a populist and reactionary tidal wave.

[3] One of the issues dealt by the Permanent Court of International Justice in the Case Concerning the Payment of Various Serbian Loans Issued in France dealt with the reference to "Gold French francs" in loans issued prior to the First World War and whether lenders were entitled to receive gold at the pre–war content of the French franc, or merely post–war French francs that were not anymore exchangeable for a fixed content of gold after the end of the Gold Standard. Similar issues were raised in cases relating to Brazilian loans. The cases can be accessed on *http://www.worldcourts.com/pcij/eng/decisions/1929.07.12_payment1.htm*. See also A.F.M. Maniruzzaman, "State Contracts in Contemporary International Law: Monist versus Dualist Controversies" (2001) 12 E.I.J.L. N.2 309.