Comment | Not so unthinkable – the break-up of European monetary union

The euro is suddenly under pressure after the apparent demise of Europe's constitution. Gilles Thieffry assesses the legal risks of a member state pulling out of monetary union

In the wake of the results of the French and the Dutch referenda on the EU constitution, and the negative feelings expressed towards further European integration, many have started to wonder about the future of the euro – a currency without a sovereign. German newspaper Frankfurter Allgemeine Zeitung on June 1 revealed that the German finance minister and the governor of the Bundesbank attended a meeting where the end of the euro was discussed. It was also revealed that the German Bundestag had commissioned a report on the subject, though the Bundestag denied this. In Italy, a member of the government expressed the view that an Italian currency should be introduced and, in France, the president of the National Assembly overtly criticized the Economic and Monetary Union (EMU) stability pact.

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 Nabarro Nathanson). This was published in various legal and banking magazines and was met with some circumspection as to its political correctness. 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). It is too early to know whether the French and Dutch referenda represent a mortal blow to the creation of a more integrated Europe, but there is no doubt that at the very least the democratic expression of both the Dutch and French people will slow down the integration process, with no guarantee closer union will ever happen. This leaves the sovereign-less currency isolated from the benefits of closer integration for the foreseeable future.

The possibility of a break-up of EMU is not so unthinkable at this juncture, partly because the German Bundestag is ready to consider it, and partly because the stability pact has come under severe attacks from several participating member states. Recent events therefore raise the spectre of one or several member states quitting EMU.

A member state leaving the euro

First, it must be remembered that monetary union is intended to be an irrevocable process. It follows that (i) the EMU process involves an irrevocable delegation of national monetary sovereignty to EC institutions (including the European System of Central Banks) and (ii) any 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 EC Treaty. No mechanism exists in the Treaty to allow a participating member state to withdraw from EMU. Indeed, even non-participating member states are required to respect the momentum towards EMU, as confirmed by Article 123 of the EC Treaty and Protocol 24 on the Transition to a Third Stage of Monetary Union.

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The sheer enormity of the effect of a possible withdrawal from EMU by a member state should not be underestimated. It would not be a repeat of Black Wednesday, when the UK withdrew sterling from the Exchange Rate Mechanism (ERM). The ERM was simply a mechanism to peg the exchange rate levels of the currencies of member states to each other within certain bands. The exchange rates did vary within these bands and control of each member state's individual currency, monetary policy, reserves and potential liabilities remained with that member state's central bank under its own jurisdiction. But a member state could leave the ERM without any particular legal difficulty, because its own national currency remained intact and retained a legal existence separate from other currencies within the mechanism.

EMU is different because (i) a single currency was created and (ii) a new – and supranational – institutional infrastructure is in place to oversee the new currency and monetary policy. The following consequences should be noted:

- on January 1 1999, the individual currencies of participating member states ceased to exist and were converted into the euro at fixed rates;
- control of the euro was vested in a new body, the European System of Central Banks (ESCB), which consists of (i) the central banks of participating member states and (ii) the European Central Bank (ECB). The ESCB has the power to conduct the eurozone's monetary policy with a view to the maintenance of price stability (in consultation with the Council of Ministers), and is also responsible for the holding and management of the official reserves of the participating member states;
- on January 1 1999, the national central banks transferred a total of EUR50,000 million in foreign reserve assets to the ECB; further reserves have been transferred since that date. These foreign reserve assets were provided on a pro rata basis by reference to the amount of capital provided by each of the national central banks.

Negotiated withdrawal

The states party to a treaty are of course free to agree any amendment or variation to its terms at any time. Although concluded specifically within a Community context, the same principle applies to the provisions of the Treaty.

This straightforward principle would clearly translate into fairly tense negotiations between the withdrawing state and the continuing, EMU-participant states. At a financial level, the following issues would arise:

- the withdrawing state would need to create a new national currency, in substitution for the euro within its own national borders (and while not a legal issue, the logistics of it should not be underestimated);
- the withdrawing state would have contributed its initial portion of the capital of the ECB. Since the national central bank of the withdrawing state would cease to be a member of the ESCB, it would presumably seek a refund of these amounts in order to support its new currency;
- since monetary union involved a pooling of the foreign reserve assets of participating states – and profits and losses accrued to the pool over the period – the withdrawing state would presumably seek reimbursement of the foreign reserves contributed by it to the ECB, plus its share of any accrued profits but net of its share of losses;
- in practice, of course, matters would not be so straightforward. The Treaty does not allow for the withdrawal of contributed capital or reserves from the ECB, and financial terms would require a new negotiation. Such negotiations would be complicated by a number of factors; in particular, the withdrawal of a member state would shake market confidence in the euro and would be likely to lead to extreme volatility in its external value. This could only be mitigated by (i) retention of a portion of the contribution of the withdrawing state and (ii) an additional financial contribution to the ECB by participating member states in order to support the euro. It is probable that the available funding within the ECB itself would not be enough to (i) support the euro adequately and (ii) support the creation of a new national currency by the withdrawing state. This, in turn, might render it impossible to negotiate exit terms without placing the entire EMU process under impossible strain;
- withdrawal from EMU by a participating member state would have big implications both for the withdrawing state and the continuing participants. For the departing state, there would be the costs of establishing a new national currency and the uncertainty of its external value. This uncertainty would endure for a lengthy period given the need to renegotiate the monetary aspects of the Treaty and the inevitable complexity of transitional arrangements. The scale of the costs and liabilities involved – and the difficulty of quantifying them with any precision – must of themselves be significant deterrents to any attempt by a participating state to negotiate a withdrawal. For those States, which continue to form a part of the eurozone, the existence of such negotiations would clearly have an adverse impact on the value of the euro and on their financial markets generally.

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Practical implications

Assuming that all of the above barriers to withdrawal could be overcome and that a departing member state has negotiated satisfactory terms for its withdrawal from the eurozone, what would be the implications for financial or payment obligations?

It is necessary to examine the consequences for an obligation expressed in euros where (i) a member state pulls out of EMU and (ii) 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? 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. In general terms, it seems that the following would apply:

- if an obligation expressed in euros was created after January 1 1999 (obligations created prior to January 1 1999 in legacy currencies were subsumed into the euro), and if the debt is payable within the territory of the withdrawing member state, then the debtor can discharge the obligation either (i) by payment in euro, since the obligation is expressed in that currency or (ii) by payment in the new currency, because the law of the place of payment may be taken into account in determining the means or method of payment. In the latter case, the appropriate rate of exchange between the euro and the new currency would be governed by the law applicable to the instrument or obligation in question – the courts would not necessarily adopt the exchange rate prescribed by the withdrawing state's new monetary law;
- if the obligation was created after January 1 1999, but payable in euros outside the withdrawing state, then it seems that the alteration in the currency should be irrelevant. Performance of the obligation in euro in the stipulated place of performance is entirely possible, because the euro would remain the currency of the other, EMU-participant states. But complex issues could arise if the entity owing an obligation is incorporated in the withdrawing member state and the place of performance of such an obligation is outside the eurozone. This is significant given the number of such obligations outstanding in London, New York or Switzerland (for a detailed analysis see Proctor in Mann on the legal aspects of money, Oxford University Press. Sixth Edition, pp 776-782);
- the change in currency should not have the effect of terminating or frustrating the obligation (though the issue on continuity of contract could most certainly be raised, but with the same chances of success as when the euro was introduced);
- where a contract is converted from the euro to a new national currency, clauses stipulating for a floating rate of interest would be deemed to refer to an appropriate price source for the new currency.

Whatever the financial position and political implications, it is clear that an EMU withdrawal by a member state would create a number of difficult but not insurmountable legal issues that would create what markets hate most: uncertainty. Should a negotiated withdrawal be required, the negotiations should not only focus on the macroeconomic issues, but also on a concerted effort to ensure that courts – especially in big financial centres – apply a uniform resolution to these issues.

Unilateral withdrawal

If a negotiated withdrawal remains difficult to contemplate, it is almost impossible to envisage circumstances in which a participating member state could unilaterally withdraw from EMU.

The Treaty does not provide for unilateral withdrawal or termination by a participant state. The other member states could have claims for compensation against the departing state and could be entitled to take countermeasures, for example by withholding moneys or benefits due to the departing state under other treaties. The consequences of a unilateral withdrawal in the context of monetary instruments or obligations in this context would be:

- once again, the withdrawal from the eurozone necessarily involves the creation of a new national currency by the departing state, and the introduction of a new monetary law in that state;
- no doubt the courts of the withdrawing state would give effect to the new, national monetary law in accordance with its terms;
- but it is probable that courts in the other member states would refuse to give effect to the currency change in the withdrawing state on the grounds that (i) the monetary law would have been enacted in breach of a treaty to which the EU member state is itself a party and (ii) recognition of the monetary law would be manifestly incompatible with the public policy of the EU and (consequently) of the relevant EU member state.

Quite apart from the financial and political risks which a unilateral withdrawal would provoke, the departing state would have to accept that its new currency may not be recognized in other member states – at least until a settlement of the situation had been negotiated. The departing state – and entities carrying on business within it – would thus be exposed to new exchange risks. These risks would be very difficult to quantify at the point of departure, given the uncertain value of the new national currency and the impact of the departure upon the value of the euro.

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Alternative scenarios

For the purposes of this short article, two issues have not been addressed. The first issue relates to a decision of all participating member states to wind up EMU, with each creating its own new national currency. In the light of the issues raised above on a negotiated withdrawal of one member state, it is easy to imagine the daunting challenges to be overridden relating to euro-denominated obligations and the external values of the new currencies.

Another suggestion made by a member of the Italian government is the introduction of new Italian currency notes and coins that would exist alongside the euro. Either the new currency would fluctuate against the euro or, as was suggested by the Italian minister, the new currency notes and coins would be a representation of the euro at a fixed exchange rate. The first case would mean a withdrawal from EMU and the issues raised above on withdrawal would become valid (with the added complication that Italy would then have two currencies being legal tender). The second solution would be a return to the transition period (1999-2001) and would require approval from participating member states. Such a decision does not seem to address the issue of monetary sovereignty and it would create in essence a non-decimal monetary system in Italy. This would be a strange situation, but would present few challenging legal issues.

The impossible hedge

If one takes the view that the withdrawal of one or more member states is a possibility, then there are questions of currency risk in the EMU zone. But in practical terms, it is impossible for international businesses to guard against this risk. An EMU exit necessarily involves the creation of a new national currency; and it is not possible to hedge against the emergence of a new currency.

A member state that sought to withdraw would invite serious dislocation from its own economy and financial markets. What is new since I wrote, "Thinking the unthinkable" with Charles Proctor, is that there is a growing belief among some politicians and commentators that regaining currency sovereignty outweighs the difficulty of abandoning the euro.

For this reason, the break-up of the eurozone would inevitably require a political settlement. It could also trigger a serious period of turbulence in Europe, in particular for private obligations. If politicians choose such a hazardous path, enormous care will have to be dedicated to ensure a harmonized legal solution to the payment of obligations denominated in euros. ■

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