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An Exit Strategy From the Euro

The euro can be phased out the same way Europe’s individual currencies were. The bonds of troubled member states would benefit as a result.

By ROBERT J. BARRO

Until recently, the euro seemed destined to encompass all of Europe. No longer. None of the remaining outsider European countries seems likely to embrace the common currency. Seven Eastern European countries that recently joined the European Union (Bulgaria, Czech Republic, Hungary, Latvia, Lithuania, Poland and Romania) have announced their intention to revisit their obligations to adopt the euro.

Two non-euro members of the EU, the United Kingdom and Denmark, have explicit opt-out provisions from the common currency, and popular opinion has recently turned strongly against euro membership. In Sweden, which lacks a formal "opt-out" provision (but has cleverly refused to fulfill one of the requirements for membership), a November poll on whether to join the euro was overwhelmingly negative—80% no, 11% yes.

In light of the political response to the ongoing fiscal and currency crisis—which is leaning strongly toward a centralized political entity that will likely be even more unpopular than the common currency—I suggest that it would be better to reverse course and eliminate the euro.

When the United Kingdom debated whether to join the path to a single currency in the mid-1990s, my view was that the benefits of euro membership—enhancements for international trade in goods and services and financial transactions—were offset by required participation in its poor social, regulatory and fiscal policies. Still, I thought the U.K. should join if it could get just the common currency.

Now I think that the option of a monetary union without the rest of the baggage is an impossible dream. The single money is inevitably linked to a common central bank with lender-of-last-resort powers. This setup creates important features of fiscal union, showing up recently as bailouts in Greece, Portugal, Ireland, Italy and Spain.

The political reaction at each step of the ongoing crisis has been to strengthen this union—bailout money from the EU and the International Monetary Fund, fiscal involvement by the European Central Bank, and more EU influence on each government's fiscal policies. A common currency loaded on top of a free-trade zone is leading toward a centralized political entity.

Despite some scale benefits from having larger countries, the cost of forcing heterogeneous populations with disparate histories, languages and cultures into a single nation could be prohibitively high.

One legitimate counterexample is to point to the United States. It has prospered with fiscal union, despite the continuing potential for federal bailouts of state governments (such as through explicit rescue programs or the kinds of transfers contained in the stimulus package of 2009-10).

The main saving grace is that, except for Vermont, the states have long histories of balanced-budget requirements. However, with the growing unfunded programs for pensions and health care for state government workers, the balanced-budget requirements have become less meaningful. Structural fiscal problems in the U.S. federal system may eventually become as serious as those in Europe.

The EU specifies with great detail how candidate countries can qualify for euro membership, but it offers no recipe for exit or expulsion. A natural possibility would be to start by throwing out the least qualified members, based on lack of fiscal discipline or other economic criteria. Greece is an obvious candidate—it has been increasingly out of control fiscally since the 1970s. But instead of expulsion, the EU reaction has been to provide a sufficient bailout to deter the country from leaving.

A better plan is to start from the top. Germany could create a parallel currency—a new D-Mark, pegged at 1.0 to the euro. The German government would guarantee that holders of German government bonds could convert euro securities to new-D-mark instruments on a one-to-one basis up to some designated date, perhaps two years in the future. Private German contracts expressed in euros would switch to new-D-mark claims over the same period. The transition would likely feature a period in which the euro and new D-mark circulate as parallel currencies.

Other countries could follow a path toward reintroduction of their own currencies over a two-year period. For example, Italy could have a new lira at 1.0 to the euro. If all the euro-zone countries followed this course, the vanishing of the euro currency in 2014 would come to resemble the disappearance of the 11 separate European moneys in 2001.

A key issue for the transition is to avoid sharp reductions in values of government bonds for Italy and other weak members of the euro zone. After all, the issue that has prompted ever-growing official intervention in recent months has been actual and potential losses of value of government bonds of Greece, Italy and so on. Governments and financial markets worry that these depreciations would lead to bank failures and financial crises in France, Germany and elsewhere.

Worries about values of government bonds are rational because it is unclear whether—even with assistance from the center—Italy and other weak members will be able and willing to meet their long-term euro obligations. A new (or restored) system of national currencies would be more credible, because Italy should be able and willing to meet its obligations denominated in new liras. This credibility underlay the pre-1999 system in which the bonds of Italy and other euro-zone countries were denominated in their own currencies. The old system was imperfect—notably in allowing some countries to have occasionally high inflation—but it's become clear that it was better than the current setup.

My prediction is that an announcement of the new system would raise the value of German bonds, because Germany has strong individual credibility and would no longer have to care for its weak neighbors. Even Italian and other weak-country bonds are likely to rise in value because concerns about individual credibility would be offset by the improved functioning of the overall system.

The euro was a noble experiment, but it has failed. Instead of wasting more money on expanding the system's scope and developing ever larger rescue funds, it would be better for the EU and others to think about how best to revert to a system of individual currencies.

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