

October 2011

WORKING PAPER SERIES

2011-ECO-06

Leaving the euro zone: a user's guide

Eric Dor

IESEG School of Management (Lille Catholic University, LEM-CNRS)

Leaving the euro zone: a user's guide

Eric Dor

IESEG School of Management (Lille Catholic University, LEM-CNRS)

October 2011

Summary

It is well known that the exit of any country out of EMU would have an extremely destabilizing effect on all the euro zone countries as well as an extremely negative impact on their economy. However this hypothesis is often talked about without thinking of the real legal and practical consequences it could have. So it is important to enlighten the debate in an analytical way so that this kind of supposition is discussed taking the right implications into account.

For a country wanting to abandon the euro the only legal way possible following the European treaty regulations would be to leave the whole of EU using article 50 of the treaty and then try to rejoin but asking for special dispensation with regards to the monetary union. Another legal way would be to negotiate an amendment to the treaty with other member countries. All these options require long negotiations and ratification by all member states. Some people therefore think that, because of urgency, only a unanimous agreement by the European Council leading to the issue of a European regulation, could be sufficient despite the legal uncertainty that this could entail. Some articles from the Vienna Convention on the Law of Treaties could also be used when a country wants to leave the euro zone without leaving the UE, as long as it is accepted that international public law applies to the European treaty, which is however a much debated issue.

The difficulties related to the abandon of the euro by only one country (or a subset of countries) in the EMU arise because the other countries would keep the euro. The new currency of the country leaving the EMU will have to coexist with its old currency, the euro, that would be kept by the other countries. It must therefore not be taken for granted that any debt that the country had in Euros would be converted automatically to their new currency. This situation would be even more critical if the new currency was expected to depreciate and become worth less than its initial conversion rate with the euro.

A description of the procedures to be undertaken by a country when wanting to leave the euro zone allows you to measure the difficulties that you may come across in the process. A crucial question is how to undo the euro denominated debts and claims of the country's national central bank to or on the other national central banks in the Euro System, including the European Central Bank. To avoid a panic and too strong devaluation in the new national currency value, the saving accounts could be temporarily blocked. Moreover, contrary to the free circulation of capital in the EU, temporary measures of capital movements control may be taken even though this may be illegal under the European treaty.

In the hypothesis of a state wanting to leave the euro zone, it would only be under certain conditions that certain debts that would have been issued in euros by either a public or private institution of the country before the date of exit, or certain payments deriving from contracts in euro's settled before this date, could be automatically converted into the new currency at the initial conversion rate. In general such a conversion could only apply to debts and contracts for which the involved contractors intended to refer to the "lex monetae" of the leaving country.

However if the withdrawal is unilateral, thus illegal according to the European treaty, courts located in other countries than the country leaving the euro, would probably refuse the right to convert any debts and contracts into the new national currency if they were to be taken to court.

1 Introduction

It is well known that the exit of any member country out of the European Monetary Union could have an extremely destabilizing effect on the whole euro zone as well as having a strong negative impact on the economy in all the euro zone countries. Nevertheless this hypothesis is often discussed without considering what it would imply in practice. Therefore it is very important to discuss this subject scientifically so that this kind of supposition is discussed taking the right implications into account. The purpose of this paper is to describe how an exit from the euro could be organized in practice, and what could be the legal foundations of such a withdrawal. For an assessment of the economic consequences of a breakup of the euro area, see Eichengreen (2007).

This article thus begins with an examination of what could be the legal foundations of a decision to leave the euro by a country of the EMU. It will then describe the problems that would be encountered because the new national currency of the country leaving EMU would coexist with its old monetary unit, the euro, which would indeed be kept as the currency of the other member states remaining in EMU. The description of the potential procedures if wanting to leave the euro zone allows us to understand the complexity and incertitude of such a project. In the hypothesis of a country leaving the euro zone, one can also determine in which cases debts or other financial obligations taken out in euros before leaving the zone may be converted to the new currency.

2 Legal foundations of a decision to leave the euro zone

The Lisbon treaty contains a clause that allows a member of the European Union to leave it as a whole. It is article 50 of the consolidated version of the European Union Treaty, mentioning that any member state may decide to leave the European Union and that they must negotiate and come up with an agreement fixing the procedures of their withdrawal.

However the treaty does not have a clause that allows a country to leave the euro zone but at the same time remain a member of the European Union. For a country wanting to abandon the euro, the only legal way at the moment, if the Treaty has to be fully respected, would be to leave the UE using article 50. The country could then negotiate re-entering the UE without taking on the Euro currency (For example the UK benefits of such a dispensation at the moment). This process would be political risky as a new adhesion to the UE demands ratification by all the member states.

International law however allows other legal routes to be used, even if uncertain. The Vienna Convention on the Law of Treaties contains certain articles that define reasons authorizing a state to denounce an international treaty, suspend or even withdraw their application even if the treaty does not state the latter. Once again these articles are based on denouncing the

whole international treaty concerned. Article 44 of the Vienna convention however defines certain conditions that a state can use to denounce some of the clauses of an international treaty whilst still keeping some part.

In order to do this, the clauses must be able to be separated from the rest of the international treaty as far as their execution is concerned, and it must be established that acceptance of the clauses in question by the state did not constitute for the other nations an essential reason why they accepted to be tied to the whole treaty. As some member states of the EU are already dispensed (like the UK) from having the Euro currency a member state could suggest that the clauses of the European treaty linked to the EMU may be separated from the rest of the treaty.

We must now examine what the causes of withdrawal described in the Vienna Convention are that could be used to justify the right for a State to withdraw from clauses of the treaty of the UE that concern the EMU. Article 62 of the Vienna convention allows you to justify withdrawal by fundamental changes in circumstances compared to those that prevailed at the time the treaty was written, whilst these circumstances constituted an essential base in order to adhere to the treaty and that the change radically transforms any obligations that come from it. Greece could say that the loss of competitiveness in their economy due to the strong euro currency and the recession it is going through, has totally changed their balance between the advantages and disadvantages in their being part of the euro zone. The change in circumstances must not be due to the violation by the concerned State of certain clauses in the treaty. Greece's European partners could say that the austerity it is going through is partially due to lack of respect of their pact of stability in the past. Article 61 of the Vienna convention allows you to justify a unilateral withdrawal by the impossibility of keeping certain obligations of the treaty. Greece could state that the evolution of the macroeconomic conditions no longer allows the country to respect all the obligations that it must adhere to by being a member of the EMU. It is obvious that the acceptance of these different arguments from their European counterparts is uncertain.

Another uncertainty comes from the fact that certain Member States, such as France, Malta and Romania have not ratified the Vienna convention on the Law of Treaties.

Moreover some specialists do not agree with the applicability of the Vienna Convention to the UE treaty. Some lawyers even suggest that the very nature of community law is very different to international public law. The ECB of course privileges this point of view, see Atanasiou (2009). However these others seem to be contradicted by the facts. Indeed several rulings of the European courts like the Court of first Instance admit themselves that the Vienna Convention is to be applied in a Community context. Examples are provided by Proctor and Thieffry (1998) and by Wouters and Van Eeckhoutte (2002).

The most secure and legal method for a country to leave the euro zone without leaving the EU is to negotiate an amendment on the EU treaty. It is a theoretical but unrealistic hypothesis as the process would be lengthy and during the process other member countries would be fierce

and bitter towards those wanting to quit the euro zone. The countries willing to leave the Monetary Union would certainly experience a bank run and huge flight of capital.

As a consequence, certain analysts say that in a situation of urgency, European leaders could be happy with a political agreement at the Council, followed by the issue of a simple European regulation, but this infringement in the treaty would open a period of legal uncertainty and could be the target of lots of complaints in front of courts.

Whilst one can envisage a well thought out negotiated withdrawal of a member State with the agreement of the other members, the hypothesis of a unilateral withdraw would be an infringement to the treaty and could be legally dangerous for the State concerned. In particular the State concerned would be exposing itself to legal recourses in trying to convert its debts denominated in Euros into the new national currency.

3 The main source of problems related to the abandonment of the Euro by a member State.

The very particular difficulties related to an abandonment of the euro by a member State are due to the fact that other countries of the Euro zone would keep the euro as their currency even if a member State wishes to leave. The new currency of the country leaving the EMU must then coexist alongside its old currency, the euro, which would remain the currency of the other countries.

During the monetary separation of Slovakia and the Czech Republic, Czechoslovakia's currency lost all its legal value and paved the way for new currencies. So Slovaks and the Czech had to convert their currency to the new monetary units using the official conversion rate as the old currency was losing its value everywhere. As the currency of Czechoslovakia was going to disappear, we could not contest the automatic conversion of all contracts and debt into either of the new currencies.

If Greece or another country were to introduce a new currency, a new Drachmae for example, and abandon the euro, this would continue to have value as a currency of other countries in the EMU. There is one main question: can the old contracts and debts in euros be automatically converted to the new currency (new drachmae) in this case or will the receivers take payments only in euros seeing as it still exists. Matters become extremely difficult when it is forecasted that the new national currency, the new Drachmae for example, will lose value quickly compared to the euro. Indeed the borrowers would prefer to redenominate the debts in the new currency, while the lenders would demand to keep them in euro.

4 A practical guide for a withdrawal from the euro zone

In the hypothesis of a state deciding to unilaterally withdraw from the EMU, despite the legal risks entailed, the procedure could be as here below. This description focuses on essential points and therefore neglects lots of technical details, each of which would deserve a separate paper and require very long explications.

In what follows the country that leaves the euro zone, Greece for example is called secessionist and the banks of this departing country, Greek banks in the same example are called the domestic banks.

- The government of the secessionist country would freeze the euro reserve accounts of the domestic banks at the national central bank of the country with the exception of the part of their balance that represents reserves corresponding to bank deposits of non-residents.
- These frozen euro reserve accounts balances of the domestic commercial banks at the national central bank of the secessionist country, would be converted into a new currency at a rate of 1:1 (1 EURO = 1 UNIT of the new currency).
- Outstanding loans in euro's formerly granted by the secessionist national central bank to the domestic banks, in application of the monetary operations framework of the Eurosystem or under other mechanisms like Emergency Liquidity Assistance, will also be converted into the new national currency at the prescribed conversion rate.
- A law will set up a new operational framework for the national monetary policy, enabling the national central bank to provide liquidity in the new currency to the domestic banks. This framework can differ from the ECB rules, and for example authorize the national central bank to directly lend money to the government or purchase sovereign bonds on the primary market. The monetary policy rates would also be set independently of the ECB.
- The euro accounts of the residents in the domestic banks would immediately be converted into the new national currency on the same ratio of 1 EURO = 1 unit of the new national currency.
- The euro accounts of non-residents in the domestic banks would remain in euro's which would now be considered as a foreign currency in the departing country.
- Banks of the departing country would be temporarily prohibited from transferring balances from the residents' accounts denominated in the new national currency into new euro denominated bank accounts that they would open, or to euro denominated bank accounts of non-residents.
- All debts resulting from contracts between residents of the departing country, such as loans, salaries, rent or even bills that are due to be paid would be converted to the new national currency at the initial rate of 1:1.
- A foreign exchange market would open, where the new national currency could be traded against the euro and other currencies. One could think that the new currency would depreciate rapidly, the value of the new currency falling much below one euro.

- In order to avoid a panic with a bank run and a too strong devaluation of the new currency, domestic bank saving accounts converted in the new currency could be temporarily frozen.
- Moreover contrary to the law of free circulation of capital within the EU, temporary measures controlling capital circulation could be taken but the legality of doing this would remain uncertain.
- The government of the departing country would oblige all domestic shops to take all payments in cash in the new currency. This would also be applied to debit and credit card payments or any other electronic transactions.
- Whilst waiting for the printing of new banknotes denominated in the new national currency, banknotes denominated in euro's may still be used temporarily in the departing country, but will be stamped in order to indicate that their facial values represent values in the new currency.
- During this transition period euro notes given over the counter by domestic banks or taken from ATM machines will have been stamped beforehand indicating that their facial value is now expressed in the new currency and no more in euro's. These stamped banknotes would only be a lawful mean of payment in the departing country. Only stamped notes will be accepted as lawful banknotes in the new national currency until the new banknotes have been printed.
- Currency offices will be opened all over the country for a few days so that residents may go and ask for their outstanding euro banknotes to be stamped whilst waiting for the new notes. For most people the outstanding stock of banknotes is very limited. One could say that this is not necessary as you can identify on the euro notes those that have been issued by the national central bank of the departing country, but in reality this is not true. The identity of the national central bank who had the responsibility for producing a euro note is marked by a letter that precedes the serial number. However this does not mean that the national central bank is the «issuer» of the notes. As these notes circulate indifferently in all the Monetary Union it is anyway not imaginable that it is this identification that determines which notes will be converted to the new national currency. This would greatly penalize the non-residents who would hold banknotes “issued” by the departing country. The best solution would therefore be to stamp the euro notes held by the residents of the departing country concerned regardless of the national central bank that they were issued in. Of course, when considering the perspectives of devaluation of the new local currency, many residents of the country asking to quit the euro zone would prefer their stock of euro banknotes not to be stamped so that they can sell them later and get a better exchange rate.
- Once the new banknotes are printed, the residents of the departing country would have a few days to exchange their stamped banknotes in euro (but representing values in the new currency) against new notes denominated in the new currency. All the stamped euro denominated banknotes would thus be withdrawn.
- A new agreement between the country wanting to flee the euro zone and others from the EMU would explain the way that debt in euros would be dealt with considering in

this process the other national banks of the Euro System and Central Bank of Europe. This problematic represents great difficulties and uncertainties that would discourage those wanting to quit the euro zone.

- What would the monetary status of the enormous debts of the national central bank be towards other national banks in the Euro System? Leaving them the Euro could result in the bankruptcy of the national central bank wanting to quit, especially in the case of a strong devaluation of the new currency compared to the euro. But to convert them to the new devalued currency could result in tremendous losses for the other national central banks and their States.
- A typical national central bank of EMU holds several intra-Eurosystem claims among the assets of its balance sheet. The departing country should negotiate with the remaining members of EMU what these claims would become.
 - a) The participating interest of the national central bank in the capital of the ECB could be bought back by this institution, the capital of which would thus decrease. Another solution would be that this participation be bought by the remaining members of the zone. The national central banks of these remaining countries would thus increase their holding of shares of the capital of the ECB in proportion of their existing weight in the capital subscribed by the remaining NCB's of the Eurosystem. Such solutions would simply require a decision of the Council. The national central bank of the departing country could also keep its shares in the capital of the ECB. Indeed all the countries of the EU are currently shareholders of the ECB, even those who are out of the Eurosystem, because they all participate to the European System of Central Banks.
 - b) Normally the ECB should give back to the departing national central bank the reserves that had been transferred by this bank to the European monetary authorities when the country joined the euro zone. These reserves were transferred in the form of assets denominated in foreign currencies like USD and JPY and in the form of gold, against claims on the ECB, which are denominated in euro. The claims equivalent to the transfer of foreign reserves to the ECB, would thus be replaced by foreign reserves on the assets part of the balance sheet of the departing national central bank. The total foreign reserves of the ECB would thus decrease as a result. The ECB could also keep the initially transferred reserves among its assets, and the corresponding claim of the departing national central bank would now be considered as foreign reserves of the leaving country. It may indeed be expected that the departing national central bank would primarily need to hold reserves denominated in euro. Another advantage would be that the overall reserves of the ECB would not decrease.
- On the liabilities part of the balance sheet of a national central bank of the Eurosystem, the item «banknotes in circulation» is different from the actual value of banknotes that have been put in circulation by this central bank. Indeed this item is a

notional share of total euro banknotes in circulation, calculated on the basis of the banknote allocation key. The difference between the value of euro banknotes allocated to the NCB in accordance with the banknote allocation key and the value of the euro banknotes that it actually puts into circulation gives rise to a corrective item «Liabilities related to the allocation and of euro banknotes within the Eurosystem (net) » if the actual banknotes put in circulation by the NCB exceed its notional allocation. On the contrary the difference gives rise to a corrective balance sheet item « Claims related to the allocation of euro banknotes within the Eurosystem (net)» if the notional banknotes allocated to the ECB exceed the value of banknotes that this bank has put in circulation. Normally a big part of the euro banknotes formerly put in circulation by the national central bank of the departing country will be stamped and thereafter withdrawn as explained above. The other part of these banknotes will remain in circulation in the euro area. On the balance sheet of the national central bank of the departing country, it is thus likely that the former euro denominated items «banknotes in circulation» and «Claims or liabilities related to the allocation of euro banknotes within the Eurosystem (net)» will be replaced by a liability «New banknotes in circulation» in the new domestic currency and an additional liability to the ECB, expressed in euro and corresponding to the part of the formerly issued euro banknotes that will not have been withdrawn. This liability in euro will thus reduce the amount of euro reserves held by the national central bank of the departing country.

- The balance sheets of the national central banks of the distressed countries of the euro zone include a huge liability to the Eurosystem, which reflects the disequilibrium in the TARGET2 balances. This balance sheet item is generally identified as « Net liabilities related to transactions with the ESCB (TARGET2) ». These large TARGET2 balances result from capital and deposit flight out of the distressed countries towards core countries. The main counterpart of these liabilities is an extremely large claim of the German central bank on the Eurosystem, related to TARGET2 balances. These liabilities and claims on the ECB are of course expressed in euro. If it is a distressed country which leaves the euro, the departing national central bank will thus be left with a very large euro denominated liability to the ECB, that it would not be able to reimburse. The problem would be aggravated by the likely appreciation of the euro. A default of the departing national central bank on this debt would cause huge losses to the ECB. These losses would be shared between all the remaining NCB's of the EMU, in proportion of their participating shares in the capital of the ECB. In turn each of these NCB's would have to be recapitalized by its own government. To avoid such losses for the taxpayers of the member countries, the ECB could be compelled to formally grant a loan of the same amount in euro to the departing central bank, despite its location out of the euro zone, and to renew it indefinitely, or to spread the reimbursement over a very long time period. If a country like Germany is leaving the EMU, its central bank will be left with a huge claim in euro on the ECB. The German central bank will incur losses on this claim with the

likely appreciation of the new national currency relative to the euro. These losses will require an extremely large recapitalization by the German government.

The practical difficulties of setting up the procedure of a country wanting to quit the euro zone are often minimized by those suggesting such a move. From the above description of a likely exit scenario it is difficult to expect a sudden overnight withdrawal of a country. Several issues have to be negotiated in advance to avoid a dislocation of the financial markets.

5 The continuity of contracts in euros and the status of debts in euros of the departing country.

In the hypothesis of a state quitting the euro zone either unilaterally or after an agreement with other member states of the EMU, you have to decide in what currency must the contractual obligations established in euros before leaving be put, involving public or private institutions of the departing country concerned. Must the repayments and interest to be paid for a debt taken out in euros by a public or private institution before quitting be paid in euros or in the new currency? In general terms is it in euro's or in the new national currency that payments are due when they result from a contract established before the breakup, and for which at least one of the parties belongs to the departing country? In order to answer this question you need to determine what "lex monetae" did the parties want to refer to at the time the contract was issued.

The right of a Sovereign country to regulate the status of its currency is managed by the "lex monetae" in international law.

The principle of "lex monetae" stipulates that everything that concerns the currency of a country is legally managed by the state that issued it. An exhaustive coverage of this concept can be found in Proctor (2005). This rule is universal and has been confirmed by the International Law Court. That is how Germany for example decided that its currency "the mark" would be replaced by a new currency named the euro from 1999. English courts could not contest that any contract governed by English law, established before 1999 and stipulating payment in marks, implied payments in euro's after the launch of the EMU. The law of the contract, that is the English law, could not govern the issue of the replacement of the mark by the euro. When a state substitutes a new currency to its previous one, the replacement must be recognized by the other states and their courts. A contract governed by the law of a State but expressed in the currency of another State is governed by the "lex monetae" of this other State for anything that concerns the properties of the contract that are related to the currency.

6 The right to convert debt taken out in Euros before quitting the euro zone to the new currency.

In the hypothesis of a country wanting to leave the EMU to reintroduce their own currency, the citizens or institutions of this country having previously taken out loans in euros may try to be given permission to reimburse their debt and pay the interest in their new currency. The creditors may contest this option in the courts of the country concerned or foreign courts. The courts, whether they are those of the secessionist country or of other countries, will determine whether the payments may be paid in the new currency or euros as a function of whether the different parties contracted by reference to the “lex monetae” of the departing country or that of another member state of the euro zone.

As contracts do not normally mention the “lex monetae” that the parties refer to, the national or foreign courts try to determine which “lex monetae” the parties wanted to refer to at the moment the contract was taken out. Generally the law courts of the country quitting the EMU and those of other countries will assume that they referred to the “lex monetae” of the country departing in the following situations:

- A sovereign bond that had been issued in euro's by the departing country, directed towards local investors, not to be traded on a foreign market and payable in the country;
- A loan in euros that was agreed on to a debtor of the departing country by a bank of another country in the euro zone or out of the zone, and which stipulated that the repayments and interest were to be paid to a subsidiary of the lender in the debtor's country.
- A loan in euro's that was agreed on by a bank of the departing country, to a debtor of this country;
- A private or sovereign bond that had been issued in euro's and that was traded from the start on the secondary market of the country wanting to quit;
- A debt based on a contract that was taken out in euros and governed by the law of the country wanting to quit or that stipulates that the payments were to be made in that country.

The courts would then recognize and acknowledge the right of the borrowers to pay their debts and interest in the new currency of the departing State even though they were initially stated in euros. For a country quitting after an amendment of the treaty or any other agreement with other member states, the rights would be recognized not only by the courts of the secessionist country but also by those of the foreign countries.

In the case of a unilateral withdrawal, going against the European treaty, one could believe that only the courts of the country quitting would recognize the right to convert debts and repayments in the new national currency in the cases mentioned above.

Such a legal analysis shows that there are many cases where debt reimbursement and interest payments would have to remain in euro's for example:

- A sovereign bond that had been issued in euro's by the departing country and that was directed to international investors, that is traded on foreign markets or is payable abroad
- A loan granted in euro's by a bank from another country in the euro zone or even out of the euro zone, to a debtor of the departing country, and providing for the borrower to pay to a euro account in the country of the lender.

An interesting treatment of such issues is proposed by Proctor (2011), Proctor (2006), Thieffry and Proctor (1998), Thieffry (2011) and Proctor (2005, chapter 32).

7 Conclusion

There may be ways that a State may legally and above board quit the euro zone, but all of these would require lengthy negotiations and discussions, whose very existence would cause speculation making the application difficult. As far as a unilateral withdrawal is concerned it would expose the State concerned, to many recourses in front of national and foreign courts. If we assume that a state may withdraw from the euro zone, the procedures of a possible withdraw would cause many difficulties and uncertainties. In the same way a withdrawal from the euro zone does not automatically mean that all the contracts and loans etc.... may be converted to the new national currency. We have not discussed here other reforms of EMU that are sometimes suggested, like the proposal of Arghyrou and Tsoukalas (2010) to implement a two-currency EMU, with a strong euro for the core countries and a weak euro for the periphery countries, both managed by the ECB, with the bonds and external debt of the periphery countries staying in strong euro terms. However it must be pointed out that their practical implementation would entail even huger difficulties than the euro exit of some member countries.

8 References

- Arghyrou, M., and Tsoukalas, G., 2010, *The Option Of Last Resort: A Two-Currency Emu*, Business School of the Cardiff University working paper 14.
- Atanasiou, P., 2009, *Withdrawal and Expulsion from the EU and EMU*, European Central Bank legal working paper 10.
- Eichengreen, B., 2007, *The Breakup of the Euro Area*, NBER Working Paper 13393.
- Proctor, C., 2011, *The euro - fragmentation and the financial markets*, *Capital markets Law Journal*, 6 (1): 5-28.

Proctor, C., 2006, The future of the euro — what happens if a Member State leaves?, *European Business Law Review*, Vol. 17, Issue 4.

Proctor, C., 2005, *Mann on the Legal Aspect of Money*, Oxford University Press, 904 p.

Proctor, C. and G. Thieffry, 1998, "Thinking the unthinkable - the break-up of monetary union", Norton Rose.

Thieffry, G., 2011, Thinking the Probable: The Break-Up of Monetary Union, *Journal of International Banking Law and Regulation*, Issue 3, 103-104.

Thieffry, G., 2005, Not so unthinkable - the break-up of European monetary union, *International Financial Law Review*, July, 15-17.

Wouters, J. and D. Van Eeckhoutte, 2002, Giving Effect to Customary International law Through European Community Law, working paper 25, Catholic University of Leuven, Institute for International Law.