THE EURO AND DEMOCRACY[1]

Introduction

The formation of the European Monetary Union (EMU) is emerging as the biggest mistake in economic policy in modern times. Parts of Europe, especially the crisis countries in the eurozone, have become victims of a humanitarian, economic and political disaster.

Much, but not everything, is the fault of the euro. The primary objective of this essay is to analyse why the destructive effects of the EMU make the dissolution of the union both desirable and likely.

There are different scenarios as concerns the splitting up of the eurozone, none of them too pleasant. The best scenario would be if Germany, and perhaps a few other countries, decided to exit by implementing a carefully prepared, but secret, plan. But it is more likely that some of crisis countries decide to, or are forced to, abandon the euro. This could lead to a dangerous chain of events, but would still be preferable to the disaster scenario: permanent crisis management led by an incompetent, unelected body – the infamous Troika composed of the European Commission, the European Central Bank (ECB) and the International Monetary Fund (IMF) – with little legitimacy among the EU population.

1. An economic, political and human disaster

After two years of recession, the GDP of the eurozone witnessed a slight recovery in the last quarters of 2013, which led some commentators to heave a sigh of relief. Interest rates on government bonds fell, and in November, Ireland became the first bailed-out eurozone country to exit its rescue programme and make a full return to financial markets.

There is, however, little hope for the real economy: output, employment and welfare. In the worst-affected countries - Greece, Ireland, Italy Spain and Portugal (hereafter GIIPS) - there is stagnation and decline. Greece's GDP is 25% lower than in 2007, and there is no improvement in sight. In Greece and Spain unemployment exceeds 25%.

In Portugal, according to Eurostat, there are 89 job seekers for every job; in Spain 71, and 31 in Ireland. In 2013, 121 000 well-educated, skilled people left Portugal, mostly for Germany, France, the UK and even Sweden and Norway. Portugal and Spain's qualified young people are also leaving for former colonies in Latin America and Africa.

The long-term effects of high youth unemployment are difficult to measure. Young people´s inability to enter the labour market or them accepting unskilled jobs that do not utilise their education represents a huge human and economic loss. Modern skills do not have a long shelf life if studies are not immediately put into practice. Valuable human capital is lost.

The GIIPS have become net exporters of manpower and the birth rate, already low with the exception of Ireland, has fallen further. In Italy, Spain, Portugal and Greece the birth rate is now below 1.5 children per woman.

1 Published in Jack Soifer (ed.), *Portugal pós-troika?* (in Portuguese) and in English "*Economic Democracy? In Europe???",* Lisboa 2014

Social problems will follow in the wake of the crisis. Depression and suicide have become more common and Greece, which before the crisis had the lowest suicide rate in Europe, is now experiencing double.[2]

The EMU has increased political divisions within and between countries and created permanent tensions. Greece and Spain have seen their democratic rights reduced. The Spanish Government has recently passed a bill, the *Ley de seguridad ciudadana*, going so far as to criminalise "illegal gatherings" and "insults to Spain."

2. Monetary unions' Achilles' Heels

No economist has yet said that the EMU, with its 18 members at present, represents an optimal currency area. Key requirements for a well functioning currency union include relatively well-synchronised business cycles and similar rates of inflation and productivity growth. A high mobility of labour between countries is also desirable, as well as coordinated fiscal policies which are able to support countries in crisis. To reduce the risk of bank runs, common deposit guarantees are a useful complement, if bank depositors become nervous.

Not all of these requirements must be met. A common fiscal policy may, for example, compensate for the lack of mobility of workers. However the EMU does not meet *any* of these requirements.

Also, the architects behind the EMU had no emergency plan is case things went wrong. In the Maastricht Treaty, there is even an outright veto on the bailing out of countries in crisis, and a ban on the ECB buying bonds directly from governments. Crisis management has consistently been negotiated at the very last moment, without involving any elected parliaments and with a complete lack of respect for the rules stipulated by the EMU. Emergency measures have so far saved the euro and solved the problems in the short term but have not tackled their root causes.

2.1 Pro-cyclical interest rates

The common rate of interest in the EMU boosted real estate bubbles in countries such as Ireland and Spain. In other countries, for example Greece and Portugal, the low interest rates and the early years of euro optimism brought an unsustainable increase in private and public consumption.

The common interest rate has a strong pro-cyclical bias: it stimulates the economies of the countries that are in the boom phase and tightens those in recession. The higher the inflation in a country and the more the economy needs to slow down, the lower the real interest rate. And vice versa, when the economy needs to be stimulated. This is an inherent perversity of a monetary union[3].

The differential in interest rates between the periphery of the eurozone and the core countries around Germany increased drastically after 2009. While the spread has fallen between German interest rates and the crisis countries after the ECB´s promise to buy “unlimited quantities” of bonds on the secondary market, the high interest rates that GIIPS countries have had to pay on their bonds have militated against efforts to curb their fiscal deficits.

Within countries, the interest rate differential has increased. The fragmentation of the eurozone´s banking sector has been rapid, and even though the ECB lends to commercial banks in all euro countries at the same low rate, this does not mean that businesses and

2 Stuckler, David & Basu, Sanjay, ”The body Economic. Why Austerity Kills (2013)

3 The common rate of interest refers to loans from the ECB to commercial banks in the eurozone. Naturally, the actual interest paid by households and businesses depends on many other factors in each country.

families pay equally low rates. In countries with a solid macroeconomic situation such as Germany, interests rates are actually far lower than before the crisis; liquidity in the banks of these countries has received a substantial boost due to capital flight from the riskiest countries.

2.2 Competitiveness

The major structural problem of the eurozone is the huge differences in international competitiveness between the member countries. These differences are due to developments since 1999, when the exchange rates were fixed between most of today´s EMU members.

At the turn of the millennium, the German overvalued exchange rate threatened its competitiveness. Thanks to increased productivity and very low inflation since the turn of the century, German exports increased considerably while the GIIPS, with high inflation and low productivity growth, lost competitiveness. Between 1999 and 2008, the unit cost of production in the GIIPS rose 20-35% compared to Germany, with a concomitant deterioration of their balance of current account. Germany, on the other hand, went from a small deficit to a huge surplus amounting to 5-8% of GDP. A small number of other countries, such as the Netherlands and Austria, have also registered large trade surpluses since the formation of the EMU.

It may be sustainable to run a current account deficit over a period of years. Capital for productive investment can be imported. However much of the capital, mainly private, flowed into GIIPS for construction and private and public consumption, with dubious effects on growth. In 2007, 4 of 5 GIIPS countries had a 2-digit external deficit, unsustainable in the long run.

Instead of the convergence of competitiveness within the EMU which had been expected, the eurozone witnessed divergence. The euro became increasingly overvalued for the GIIPS and undervalued for Germany, which in 2012 passed China as the country with the largest, in absolute terms, current account surplus in the world.

A depreciation of the euro would bring some relief to countries that have lost competitiveness. The main winner would however be Germany, with its highly differentiated and sophisticated export sector. As exports from the GIIPS mainly go to other members of the eurozone, their trade balance would not improve as much as that of countries with a higher share of exports going to trade partners outside the EMU.

All attempts to address these imbalances within the eurozone have, by and large, been unsuccessful. Pension cuts, higher health fees and mass firing of civil servants have exerted a substantial impact on imports but also on domestic demand and thus on employment, GDP and tax revenue, but have failed to restore international competitiveness. Some of the GIIPS, after several years of draconian austerity, are now approaching balance in their external account, but this is primarily thanks to falling imports. Meanwhile, many of the measures, e.g. reduced expenditure on research and development, health, education and infrastructure have impaired the crisis countries´ growth potential in the long term.

2.3 The Asymmetric Burden of Adjustment

In monetary unions, and in all agreements with fixed exchange rates, the burden of adjustment falls on the countries who are losing competitiveness. This occurred during the period of the gold standard, and has occurred again in the EMU.

The reintroduction of the gold standard in 1924 contributed to the deep depression of the 30s. Countries with a deficit, in order not to lose their gold reserves, were forced to adopt deflationary policies similar to those imposed in the crisis countries in the EMU: pay cuts, reduced public spending and cuts in social services. This strengthened the negative trends of the 1930s and prolonged the depression. The asymmetrical distribution of the burden of adjustment when countries move in different directions but share a common currency implies a deflationary bias; the deficit countries, and they alone, are forced to adjust by reducing aggregate demand. It is this danger that John M. Keynes emphasised in 1926, calling the reintroduction of the gold standard a "barbarous relic".

Before the Bretton-Woods agreement in 1944 Keynes warned, unsuccessfully, that a system of fixed exchange rates would require procedures for binding exchange controls as well as strong pressure on surplus countries to stimulate their economies. Keynes even suggested that countries whose currency reserves increased too rapidly should be forced to pay fines unless they stimulated their economies. The EMU has no such rules. Instead, the surplus countries keep telling the less fortunate members of the club: "Work harder and earn less in order to become as competitive as we are!" But external surpluses and deficits are two sides of the same coin: as long as countries trade between themselves and not with Jupiter or Mars, a current account surplus in one country necessarily means a deficit in another country.

2.4 More fiscal coordination?

Part of the debate on EMU has concerned the dangers of not having a banking union and a common fiscal union. But centralised fiscal policies would not solve the eurozone´s problems.

Those who defend a common fiscal policy – which, to repeat, would go against the very statutes of the club – argue that it was irresponsible fiscal policies that gave rise to the euro crisis. While it is true that the GIIPS ought to have maintained a tighter fiscal policy through the good years up to 2007 the main source of booms and bubbles and excessive consumption was the flow of private, speculative capital.

Before the global financial crisis of 2008, most of the euro countries showed fairly balanced state budgets. Among today´s crisis countries, Ireland and Spain even registered surpluses. In the five GIIPS, the average fiscal deficit in 2007 was 1,8 per cent of GDP. Not very alarming. In 2009, however, the average fiscal deficit reached 11,3 per cent – an increase of almost ten percentage points in two years. Similar, but slightly less dramatic, changes took place in the OECD area as a whole, where fiscal deficits increased from an average of 1,3 per cent of GDP to 8,2 per cent between 2007 and 2009.

It is therefore obvious that it was not fiscal deficits in OECD countries that caused the crisis - it was the financial crisis that gave rise to the deficits. The 2008 financial crisis was preceded by good public finances in most OECD countries including the eurozone. Those who believe that low budget deficits always reduce the risk of financial crises are obviously wrong. A balanced budget may simply mirror a rapid and destabilising growth of private debt. The housing bubbles in the U.S, UK, Spain and Ireland prior to 2008 were the result of irresponsible excesses from the private rather than public sector.

A crisis can be triggered or worsened by public as well as by private overspending and unsustainable debt levels. In some cases, e.g. USA, Greece and Portugal, both the public and the private sector spent more than they had.

In one prominent study (Reinhart and Rogoff 2009) of financial crises in modern times in 14 high and middle-income countries, the authors concluded that public debt in crisis countries increased by 86 percentage points. As shown by Reinhart and Rogoff, many countries entering crisis after good times had surpluses in their state budgets before the crisis broke out. The EMU´s *Stability and Growth Pact* was irrelevant for the GIIPS before the crisis, as almost none of them exceeded the 3% budget deficit in 2007 stipulated by the Pact.

The macroeconomic stability of the eurozone would gain from the transfer of capital from rich to poor countries, even if this would be in conflict with the Treaty of Maastricht. But transparent support under democratic control would hardly be accepted by political leaders and the electorate in countries such as Germany, Finland and the Netherlands. It is feared that large transfers to countries in crisis would risk becoming a permanent feature of the EMU. Also, in Germany and Finland, there is strong opposition to the introduction of common euro-bonds, something proposed by many politicians from southern Europe, and individuals such as George Soros[4].

There are many internal transfers in EU countries, for example in Italy and Spain. After 150 years of unification in Italy, the South is a net recipient of state subsidies and exporter of manpower to the North. Regions such as the Basque, Catalonia and Northern Italy have for decades subsidised their poorer cousins. Every year Western Germany transfers 3% of its GDP to the former East Germany, which helps to explain German resistance to paying the bill for the EMU to become a "transfer union".

A union with common fiscal rules does not guarantee a solution to the structural problems of EMU, where the difference in competitiveness is the key weakness. It is also likely that political tensions between the member countries would increase further if national parliaments were to lose control over their state budgets.

2.4 The problem of moral hazard

The constant violations of the EMU´s no-bailout clause have increased moral hazard. The short-term solutions "to save the euro" therefore often serve to increase long-term dangers to financial stability. Banks continue to take huge risks with the assurance that they will be rescued before bankruptcy. The same applies to states - the Troika supplies support if a crisis s regarded as a threat to the euro.

The fear of default, followed by exit from the EMU is great. Every time Angela Merkel uses her famous "If the euro falls, Europe falls", or M. Draghi, the ECB President says he will do everything to defend the euro, risk-taking banks and insolvent countries feel strengthened.

Insolvent countries will need large loans and face hard, non-negotiable conditions when a new crisis comes. Even if the loans granted or the purchases of GIIPS bonds by the ECB on the secondary market are said to save a particular country, most of the funds have actually gone straight to German and French banks and investment funds.

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4 Soros, George, "How to save the euro from the euro crisis", The Guardian 9 April 2013. The alternative to Eurobonds would, according to Soros, be that Germany leaves the EMU.

2.6 Insolvency

When the first Greek crisis exploded in early 2010, the EU Commission, ECB and IMF understood it as a liquidity crisis. This has been a common mistake. A liquidity crisis can be solved with new loans, but insolvency cannot. Every year since then, the solvency of most euro countries has deteriorated. In the 5 GIIPS, the average debt/GDP ratio increased from 75 per cent in 2008 to 129 per cent in 2013.

The forecasts for growth and debts of countries in crisis have consistently been too optimistic. Budget deficits have always been higher than expected, and GDP growth much worse. The ratio, i.e. the ratio of government debt to GDP, has worsened as GDP has fallen and public debt increased.

The problem with so-called internal devaluations is that if they succeed, i.e. if nominal wages and prices fall, the real value of all debt increases. The burden on families, businesses and the public sector increases as nominal incomes decline. If and when improved competitiveness results in economic growth employment starts to rise again, but a recovery is likely to take time. In the meantime, lower wages bring less aggregate demand and lower employment and tax revenue, while insolvency in government, companies and households is aggravated.

In order to curb unsustainable debts it is necessary to, in addition to cancelling part of the debt, reactivate consumption and private investment. But who wants to invest in countries where the explicit objective of economic policy is deflation? For many years, investment in physical and human capital has fallen in the GIIPS, while capital and people are exiting.

2.7 A banking union?

A banking union would probably make the EMU a more well- functioning monetary union. The link between a bank crisis and a sovereign debt crisis would be weakened if the recapitalisation of failing banks were a common responsibility for the EMU.

A banking union should have three pillars: a single financial supervision authority for all large banks – which is already under implementation by the ECB -, a common resolution mechanism to handle banks in crisis and a common deposit guarantee.

The proposed joint handling of banks in crisis aims to reduce the cost to taxpayers for the recapitalisation of distressed banks by forcing different groups - shareholders, owners of bank bonds, creditors and deposits exceeding €100,000 - to cover part of the losses. After the fiasco of the management of the Cyprus crisis, when the initial proposal by the Troika was that even small account holders would suffer a haircut, it was decided that deposits under 100,000 euro would be exempt. But who would cover the part of the recapitalisation of troubled banks that now burdens the taxpayer? There is still no decision to create a single resolution fund, supported by all EU members, that would shoulder the financial burden if a large bank were on the verge of collapse.

In order to reduce the risk of a bank run, when large numbers of small depositors take out their money out of a troubled bank or troubled country, a common deposit guarantee would be necessary. Strong opposition from Germany and some other countries has, however, ruled out this third, and vital, pillar of a genuine banking union.

3. Lessons from monetary unions

Since the EMU faces serious problems, what impact might a breakup of the EMU have? Can history help us?

In general, monetary unions end. Most fixed exchange regimes - like the gold standard, the Scandinavian Monetary Union, the Bretton Woods System and the European Exchange Rate Mechanism which preceded the euro - vanished. Other currency unions that have been dissolved include Ireland - UK in 1979,[5] former Yugoslavia, former Soviet Union and former Czechoslovakia. The trend has been to create new currencies rather than currency unions. Today there are a far greater number of currencies than 20-50 years ago.

In general, the introduction of a new currency may not be too dramatic, even during political turmoil. The rouble continued to be used in the new republics during a transition period after the dissolution of the USSR, although the Baltic republics were eager to abandon the rouble as soon as possible. When Russia, in 1993, forced the new states to leave the rouble, around half of them already had their own currency. In former Yugoslavia, with hyperinflation and the horror of the civil war, the German Mark and then the euro played the role of hard currency for a long period of time. After the split in 1993, the Czech Republic kept the *krona* and Slovakia adopted the euro.

In former colonies, a new currency has normally been introduced as a symbol of national independence. However some have maintained a close link with the old currency for a longer or shorter period.

Even messy breakups of currency unions have apparently had few adverse effects in a longer term perspective. Jonathan Tepper[6] studied 69 countries, mainly low and middle-income countries, which had left a currency area or a fixed exchange rate regime. While Tepper stresses that the EMU is exceptional in many ways, the objective of the study was to find parallels with the current euro crisis. In most countries that changed currency old notes were stamped until new notes were printed. Often the new currency coexisted with the old during a transitional period. All goods and services were then given two prices, and the relationship between them fixed at the new, and usually market-determined, exchange rate.

The introduction of a new currency has normally been accompanied by temporary exchange controls and restrictions on the purchase of foreign currencies, sometimes also by restrictions on the withdrawal of bank deposits.

When a country leaves a fixed exchange rate or a currency union in an economic crisis, almost always it reassesses its debt according to the new exchange rate. The burden of the foreign debt is thus reduced, which is often one of the objectives.

Tepper´s study clearly indicates that if a country is in the same situation that several members of the EMU are, i.e. a combination of insolvency and poor international competitiveness, they must "*leave the euro, default and devalue*". An orderly withdrawal is obviously preferable, but a chaotic, disordered flight but is still better than trying to remain within a currency union. In the 69 cases studied, GDP fell, often dramatically, up to a year after exit. Next came a more or less rapid economic recovery. Compare this with the pain in the GIIPS. In Greece, GDP has now been falling for six consecutive years.

It is difficult to find examples of countries that regret having left a currency union or a fixed exchange rate. The common criticism is that they waited too long.

5 The British and Irish pounds were linked to each other until 1979, but the two countries did not form a monetary union of the EMU kind.
6 Tepper, Jonathan (2012).

4 Exit the Euro: some scenarios

A monetary union with some rich countries and many less wealthy is a unique experience, and any predictions about the breakup of the EMU and its consequences are speculative.

Given the many crises that beleaguer the eurozone, sooner or later a severe crisis is likely to push one or more countries to leave, or be forced to leave the union. It is difficult to assess probabilities, but the following events are possible:

4.1 What might trigger a dissolution of the EMU?

- An acute **liquidity crisis** if theTroika rejects a new emergency loan, stating that a country has not fulfilled its commitments and thus cannot borrow more. The German Constitutional Court may also declare a future rescue package unconstitutional and create a crisis that the EMU, in its current form, would hardly survive.

- Bank **insolvency**. If people empty their savings accounts in a crisis country, as result of e.g. political instability or bank failures, this would result in a rapid outflow of capital to other countries and/or mattresses. It would be impossible to mobilise the capital necessary to rescue the Spanish, Italian or French banking system if there was a major bank run in these countries.

-A **political crisis** in a euro country resulting in the advent of a new government that refuses to accept the austerity policies dictated by the Troika. Massive popular indignation could also lead to social explosion, violent street demonstrations with many injured, widespread strikes and turbulent political developments that cannot be predicted.

- **The ECB** may decide at any time not to accept collateral in securities issued by countries in crisis which thus lose access to the liquidity offered by the eurozone system. If this were to occur, the country in question could hardly remain in the EMU.
There are many other events, difficult to predict today, which could lead to an uncontrollable chain reaction that would result in a total or partial dissolution of the EMU.

4.2 The rupture of the euro

A country abandoning the euro would, to begin with, have to issue new notes and coins. During a transition period, stamped notes could be used, as has been shown in past examples of a the break-up of a currency union.

Strict border controls may have to be introduced in a transitional period, to prevent the smuggling of notes without stamps. Temporary restrictions on bank withdrawals in order to reduce the risk of panic and capital flight would probably also be necessary. Recent examples are Argentina, Iceland and Cyprus.

The entire system of electronic payments must be reprogrammed and restarted as quickly as possible. There are already signs that banks, insurance companies, travel agencies and others are preparing themselves for a scenario in which one or several countries decide to leave the union. Hopefully, central banks and finance ministries across Europe also have some sort of Plan B.

The EMU countries enjoy one advantage compared to countries that have adopted a new currency after having gained national independence: they can recover the former functions of their own central banks.

One problem is how to establish the value of the new currency in order to settle the value of government bonds, and of claims and liabilities in general. As a general rule, all national contracts, including domestically issued government bonds, can be paid in the new,

devalued currency. Debts in USD or euro to foreign creditors such as the IMF or the EU´s rescue funds are a different matter. Such foreign debt ought to be repaid in hard currency, and disputes would be resolved in foreign courts.

The level of public external debt of the crisis countries has grown drastically, and the composition of the debt has deteriorated as both emergency loans and government bonds sold abroad have tended to replace securities issued domestically. This indicates that the return to a country´s former currency will not necessarily solve, only ease, the problem of insolvency.

4.3 An orderly withdrawal

The Lisbon Treaty states that an EU country is also member of the EMU and uses the euro as its currency if it fulfils the requirements and has not, like the UK and Denmark, been granted an exception. The new EMU members cannot leave the euro and stay in the EU. But the Treaty does provide an opportunity that did not exist before which is to leave the EU. If it does, it is of course possible that this country may be allowed to conclude an association agreement which would preserve the right to free access to the EU internal market.

Another option is to leave the EU and the euro and then submit a new application for membership of the EU. If there is political will, it could be approved. As the free circulation of goods, services, capital and people is a cornerstone of the EU, the imposition of exchange controls would be a violation of the Maastricht and Lisbon Treaties. The EU however allows a member to impose obstacles to the free movement of capital out of the EU, but never within the EU. Violating this principle, e.g. after a bank run, would be incompatible with continuing in the EU. But this rule was broken in the emergency phase of the crisis in Cyprus.

The euro was a high-risk project. Collapse in one country might bring high levels of inflation, angry protests and bank collapses with global effects. Hopefully the necessary fragmen tation or dissolution of the EMU will be carried out in an orderly manner.

4.4 The best way: strong economies leave the euro

The only reasonably orderly way would be for Germany and perhaps a couple of other strong economies to switch to some type of enlarged D- mark. The ideal would be to carry this out in secret. I myself hope someday to wake up on a Saturday morning, when most banks and stock exchanges are closed over the weekend, and hear on the radio that Germany and some other countries had left the euro. And that there were already new notes ready to be used, and reprogrammed cash machines. The major credit card companies and commercial banks had taken precautions in case of a euro split and had developed systems able handle the transition to the new currencies on short notice. The IMF, ECB and the national central banks of the EU, but nobody else, had been warned in advance, and tough exchange controls with immediate effect would be introduced in countries that left the EMU. The IMF and ECB would be ready to compensate for transitional problems in accessing foreign currency in the departing countries.

But there are obstacles. No German chancellor wants go down in history as the person who sank the monetary union. Much political prestige has been invested in the euro, and a German exit would be regarded as a defeat. The fact that the world would eventually thank him or her would not be enough a politician wanting to win next year´s election.

In a short-term perspective, the biggest losers might be found in Germany. German exports have benefited from the fact that the crisis countries have made the euro cheaper than a German currency would have been. A strong appreciation of the German currency would be

good for German workers, whose real wages would increase, and it would balance the international competitiveness within the eurozone. The German economy has also benefited from low interest rates and capital flight to German banks and bonds.

For the GIIPS it would be far better if Germany and a few other countries left the euro. If the crisis countries were to be expelled, the result would be a drastic appreciation of the euro, which would spell disaster for those who have liabilities in euro. The insolvency of weak countries, heavily indebted in euro and whose currencies would fall some 30-50% in relation to the euro, would be greatly increased. The real burden of their foreign debts would be much higher in relation to their GDP than the German war reparation after the First World War.

In a short-term perspective, the ECB, Germany and other creditor countries would stand to lose if their claims on the debtors were to be repaid in a devalued euro. But the question is not if they will back the full value of their rescue packages and other loans back. The question is when losses will arise, how the losses will be accounted for and who will foot the bill .

When I refer to “strong economies”, I do not include France. In a longer-term perspective, it is difficult to see how France, with its eroded international competitiveness and a host of structural problems, could remain in a eurozone dominated by Germany, or leave the euro and join Germany in a new, smaller monetary union.

4.5 Another solution

Another comparatively good scenario is the orderly exit of several countries in crisis. This is, however, not very likely; it would be difficult for them to prepare a simultaneous move without leaking their plans, and an exit would probably be connected with an economic or political crisis in one of the countries.

Best would be if Greece and Portugal left first; among the GIIPS they have the worst blend of illiquidity and eroded international competitiveness.

It is unlikely that Greece and Portugal alone would be able to plan and execute a successful exit. In such a case, countries like Spain, Italy, Cyprus and Slovenia might not be able to resist. Mediterranean countries compete with similar goods and services - tourism, transportation, agricultural products and various services. While the manufacturing sector in Spain and Italy is far more diversified and competitive than in Portugal and Greece, competition from countries with a devalued rate of exchange might become overwhelming within a brief period of time. In addition, capital flight from troubled countries would be huge when the first country abandons the euro.

The exit of a single country may, at worst, lead to disaster. But if economic recovery is fairly quick there, other countries will probably want to return to their national currencies. Much depends on the political will and economic capacity of the other EU members to support the first ones who leaves, fully aware of the fact that generous support to the quitters would increase the willingness of other countries to follow.

4.6 Worst-case scenario: the EMU survives

In 2013 politicians, journalists and heads of the European Commission and the ECB – but not the IMF - argued that the crisis was almost over. The stock market rose, and interest on bonds issued by the crisis countries reached their lowest level since 2010. Already in January of 2013 a triumphant Manuel Barroso said "The euro is saved, the crisis is history" (The Guardian, 7 Jan 2013). But it is enough to open a serious newspaper, such as the Financial

Times, to be healed of his optimism. Just read the headlines from one single day (28 June 2013):

”Athens fights to avoid implosion of second sell-off deal”

“Ireland hit by recession as exports fall”

“Improvisation still key to winding up banks”

“France risks missing deficit target”

“Unions strike in protest at austerity in Portugal”

“Deeper recession adds to challenge for Italy coalition”

The dissolution of the eurozone entails economic and political risks. But the real disaster would be if the EMU, with 18 or even more members, continues for a number of years. We will see similar headlines as those above, giving evidence of recession, protests, new austerity measures, political chaos, government crisis and political turmoil. The survival of a poorly designed monetary union with an inherently pro-cyclical bias renders long-term recovery from the crisis difficult or impossible. The longer it takes for a number of countries to leave the euro and have part of their debts cancelled, the more difficult the road to sustained recovery will be.

Political democracy is already exposed to severe stress. The Troika does not allow economic policies to be decided in a transparent, democratic manner The infamous claim by the president of the ECB, Mario Draghi, that there was an "autopilot" installed in Italy, no matter who won the general elections in 2013, confirms the widespread impression that economic policies in the GIIPS are decided independently of the popular will.

The EU crisis is not only economic and social. It is also political. In the wake of the crisis, we see increasing contempt for politicians and a rapid growth of nationalistic and xenophobic parties and movements. What was supposed to be a peace project has actually served to increase contradictions and conflicts within and between countries. The tensions created by the euro have resulted in dwindling popular support for the EU as a whole and for the grand ideas behind the creation of a common market.

"You cannot run a gold standard in a democracy", concludes Mark Blyth (2013, p 197), in his analysis of the restoration of the gold standard between the two World Wars. But the EMU is nothing more than a modern variation of the gold standard. Sooner or later, either the EMU or democracy must give way.