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The Risky Game of EMU Withdrawal

Karolina Borońska-Hryniewiecka

With the Greek parliamentary elections approaching, the possibility the country may leave the eurozone is gaining momentum. An analysis of the various legal, political and economic implications of EMU withdrawal indicates that the best option for the EU would be to solve the Greek debt crisis as it stands, with the second option being a two-tier euro arrangement for countries undergoing financial restructuring.

In light of the 25 January parliamentary elections in Greece, which might see the election of a new majority composed of radical left-wing party Syriza, one of the most pressing questions floating around the globe today is whether Greece might leave the European Monetary Union (EMU). While the European Commission (EC) officially states that EMU membership is "irrevocable," the leaders of creditor countries view a potential Grexit as both "manageable" and a "sovereign Greek decision."

Such a state of affairs creates confusion and leaves much room for speculation as to whether unilateral withdrawal from the eurozone is possible and, if so, whether it would necessarily entail also leaving the EU or treating them as separate questions. Also problematic are the legal conditions under which a departure would take place and ultimately its effects on the non-EMU Member States.

Although the EU treaties leave open the possibility legally for a country to quit the EMU, these are hypothetical scenarios. When taking into account the potential political and economic costs, however, none of them seems more advantageous than staying within the EMU under renewed financial and investment conditions.

Legal Context of a Potential EMU Withdrawal. The EC's statement about the legal "impossibility" of EMU withdrawal stems from the fact that no European treaty has included a provision for how a Member State could leave the single currency area. While Art. 50 of the Lisbon Treaty provides that any Member State may withdraw from the EU on the basis of a negotiated agreement with the EU institutions, it does not mention anything about the possibility of exiting EMU itself. At the same time, Art. 140 Treaty on the Functioning of the European Union (TFEU) provides that the rate at which the former national currencies are substituted by the "euro" for EMU members has been "irrevocably" fixed. What also follows from the EU treaties is that while membership is voluntary, participation in the EMU, apart from certain exceptions, is a legal, if eventual obligation of every EU Member State.

A country wishing to leave the EMU could, however, seek harbour in international law. The Vienna Convention on the Law of Treaties contains certain articles that allow a state to renounce an international treaty, or some of its clauses, even if the treaty does not provide for it. In order to do this, the clauses must be able to be separated from the rest of the treaty as far as their execution is concerned. Since some EU Member States are not presently required to take up the euro, this legal tack means the EU treaty clauses related to the EMU may *de facto* be separated from the rest of the treaty. Many analysts, including the European Central Bank (ECB), however, insist that the EU constitutes a distinct, supranational legal system, so international law should not apply in this case.

Amending the EU treaties to provide for a withdrawal from the EMU would entail a lengthy and unpredictable process of treaty renegotiation, and EU leaders would like to avoid it. Another option would be to use the existing body of EU law and exploit the avenue of a "flexibility clause," as offered by Art. 352 TFEU. It allows the EU to regulate issues not expressly mentioned in the treaties if they fulfil EU objectives. It could be argued that a country's withdrawal from the EMU due to the impossibility for it to comply with some of the treaty obligations can be one of these issues. Such a

solution, however, would require the unanimous consent of all the other Member States as well as the European Parliament.

Possible Scenarios. While a unilateral withdrawal from the EMU would be subject to painful fines for breaching EU treaties and therefore should be rationally discarded, one can think of three alternative options for a country to drop the single currency. The first entails leaving the EU using Art. 50 and negotiating a new membership plan that doesn't include the euro. This option would be very politically risky and fraught with legal difficulties, as it would require ratification by all the Member States, a vote which, for a now-former EU country with a troubled economy and unstable political situation, might be uncertain.

In the event of the effective application of Art. 352 TFEU, the second scenario is based on a more agreeable, negotiated withdrawal involving the EU institutions and, in particular, the ECB. In this case, the departing country would face a range of problems connected with its future relationship with the EU, such as capital controls, treatment of pending financial transactions, debt service or reimbursement of foreign reserve holdings by the ECB. In case of an indebted country, restoring its old currency would inevitably entail substantial legal complications with regard to the validity and enforceability of outstanding re-denominated contracts and obligations with its creditors. While, as a borrower, the state would prefer to convert its debts into the new currency, the lenders would likely demand to keep them in euro. Although the principle of *lex monetae* provides that a country is free to exercise its sovereign powers to establish a conversion rate for the exchange of the former obligations into the new national currency, such action may be in breach of EU legislation governing the EMU, exclusively governed by the EU. Consequently, if taken to court, the latter could refuse the right to convert any debts and contracts into the new national currency, thus raising the unpredictability of the risks. There would be no easy way out of this situation, as any solution favouring the debtor would inevitably penalise the creditors, and vice-versa. Leaving the eurozone, even if negotiated, would also lead to capital outflow and a bank run, and also the potential for bankruptcies in the financial sector. Finally, the devaluation of the currency as a result of an EMU exit (estimated for Greece at around 50%) would instantly hit consumer purchasing power and sharply reduce wages.

Euro Purgatory. The third option proposed by some economists would be to establish an additional "weaker currency system" to which the departing state could be temporarily moved in order to stabilise its finances and restore competitiveness. It would be open to countries that need to undergo financial restructuring. This purgatory zone would have an exchange rate for the euro fixed by EU authorities and would be managed by the ECB. In its bolder version, the latter could develop an additional bond-buying programme to inject liquidity into the banking system in order to stimulate economic activity.

Yet, such a solution would pose many problems such as the need to set up a new governance framework, establish new rules and hire additional staff. Second, it would create a problem of access to decision-making forums. Would these "in purgatory" countries be able to participate in Eurogroup meetings or would there be a parallel Eurogroup II? If they may participate, then where would that leave the non-EMU countries, such as the UK, Sweden or Poland? And third, there is the question about the credibility of the "weaker" currency, which, although backed by the ECB, might discourage investors. Setting up a "purgatory zone" would formally create a dual-level EU, stigmatising some countries, which might, though it does not have to have disintegrating political effects on the Union.

Between a Rock and a Hard Place. Unilateral withdrawal from the EMU without a simultaneous EU exit thus is practically legally impossible. It could happen only in close cooperation with all the Member States, followed by a political agreement among the EU institutions. While the possibility of leaving the EMU could make aspiring countries such as Poland more inclined to join the single currency, this would be only a psychological effect as probably no state would like to see itself in the burdensome situation of an exit. The political contagion of such a situation may spread and pose a dangerous precedent for anti-austerity parties such as Podemos in Spain to push for their country to leave the EMU as well. Finally, for a debt-impaired country, negotiating a favourable EMU-exit would be highly contentious and would definitely raise higher systemic risks than for the rest of the EU.

With the current economic scenario, it is therefore unlikely that Greece will unilaterally withdraw from the EMU. We should rather expect that Syriza's charade will end in some kind of negotiated compromise with the EU, the more so that Greece had a primary budget surplus of around 1.4% last year and it might be likely that its creditors will ease the debt burden by lengthening the maturity dates and reducing interest rates. There is more room to negotiate than is reported in media. In the eventual case of a Grexit, Greece has much more to lose than the EU, so it would not like to see its bluff called.

If staying in the EMU is ruled out, considering the likely transaction costs one of the most palatable options would be the creation of a two-tier eurozone. Yet, while the two-tier currency proposal would keep the EU together, it could have unpredictable external effects. Some claim that the weak-currency zone could give aspiring countries a realistic opportunity to join the EMU in the future, acting a bit like ERM II. Yet, Poland whose finances are in much better condition than Greece or Italy, is unlikely to share the house with the EU's laggards and aim straight for the core EMU club. The thing though is that Poland does not want to do that yet, due precisely to the lack of stability in the eurozone.