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Controlled dismantlement of the Eurozone: A proposal for a New European Monetary System and a new role for the European Central Bank

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ABSTRACT

In Kawalec and Pytlarczyk (2013), we argue that the single European currency constitutes a serious threat to the European Union and the Single European Market, and we propose a controlled dismantlement of the Eurozone. In this paper, we undertake a deeper analysis of the measures which would minimize the risks throughout the process of the Eurozone dismantlement and contribute to rebuilding confidence in the future of Europe.

- The dismantlement should be the result of a consensual decision to replace the euro with an alternative system of currency coordination.
- The dismantlement should start with the exit of the most competitive countries. In the meantime, the euro should remain the common currency of less competitive countries.
- The European Central Bank (ECB) should be preserved as the central bank for all 17 Eurozone member countries, even after some of those countries have replaced the euro with new currencies. In this capacity, the ECB should be in charge of designing, preparing, and implementing the segmentation of the Eurozone as well as managing the new currency coordination system – European Monetary System 2.
- The forthcoming EU – USA free trade agreement would build new momentum for economic growth and contribute to restoring confidence in the future of Europe.

As of today, neither the member states of the Eurozone nor European institutions such as the European Commission or the ECB have been able to come up with a game-changing proposal such as the Eurozone dismantlement. However, this may change as a result of adverse economic and political developments. One of the potential triggers could be the situation in France.

JEL classification: E5, E58, F15, F31, G18

Keywords: Eurozone crisis; Euro breakup; European Central Bank; Dismantlement of the Eurozone; currency coordination; European Monetary System 2.

Introduction

The creation of the European Union and the Single European Market are remarkable political and economic successes of post-war Europe. The introduction of the single European currency was seen as the next logical step to strengthen those achievements. However, contrary to these good intentions, the euro has turned out to be a serious threat to the project of European integration. Greece, Portugal, Spain, and Italy are trapped in recession and cannot restore their competitiveness by devaluating their currencies. On the other hand, the northern Eurozone countries have to participate in endless bail-outs and have been forced to disregard their values of prudent financial policies. This situation has created a vicious circle of resentment and populism in the southern countries and a revival of nationalistic tendencies in the northern countries, which may ultimately tear Europe apart[1].

In Kawalec and Pytlarczyk (2013), we justify the notion that the problems with a single currency in Europe are neither temporary nor curable. We argue that, in order to salvage the most valuable achievement of European integration and allow the European Union to enter onto a path of economic growth, the Eurozone should be dismantled in an orderly manner.

The controlled dismantlement of the Eurozone is not only about economics, but also politics and social psychology. European leaders are afraid that backtracking on the euro project would be a lethal blow to trust in European integration and could be the beginning of the end of the EU and the Single Market. Many believe that the dissolution of the Eurozone would lead to economic chaos. The possibility of a euro collapse also generates fear among Europe's economic partners, including the US and China.

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[1] Sinn (2013) gave the following summary of the current Eurozone plight:
"Crunch time is fast approaching. Cyprus is almost out of the euro, its banks' collapse having been delayed by the European Central Bank's provision of Emergency Liquidity Assistance, while euroskeptic parties led by Beppe Grillo and Silvio Berlusconi garnered a combined total of 55% of the popular vote in the latest Italian general election. Moreover, the Greeks and Spaniards are unlikely to be able to bear the strain of economic austerity much longer, with youth unemployment inching toward 60%. The independence movement in Catalonia has gathered so much momentum that a leading Spanish general has vowed to send troops into Barcelona should the province hold a referendum on secession. France, too, has competitiveness problems, and is unable to meet its commitments under the European Union's Fiscal Compact. Portugal needs a new rescue program, and Slovenia could soon be asking for a rescue as well."
Beylin (2013) advises that in crisis-ridden Portugal, 87% people are dissatisfied with the democratic regime, and nearly half of the population positively assess the dictatorship which was overthrown in 1970s (according to an opinion poll in late 2012). *"Across Europe, nostalgia for a strong order and powerful leaders proliferates, while the memory of misfortunes caused by dictatorships pales,"* he writes.

A strategy for the controlled dismantlement of the Eurozone has to be credible enough to address these fears. To this end, it is important to address major concerns beforehand. EU leaders must demonstrate that the institutional and instrumental capacity is in place to manage the dismantlement process, resolve potential problems that may arise, and prevent the process from getting out of control. It is equally important to demonstrate that despite seemingly backtracking on the euro project, the EU would have new goals to pursue that will create the momentum needed to reinvigorate European cooperation and create a positive perspective for economic growth.

The aim of this paper is to contribute to the development of such strategy. We focus on the implementation of the controlled dismantlement of the Eurozone and consider the associated issues and risks as well as measures that could be instrumental in containing those risks.

We think that Europe is not defenseless in the face of a potential Eurozone dismantlement. There are two important weapons that the EU has at its disposal: the European Central Bank and the forthcoming EU-US free trade agreement. Utilizing these weapons properly would allow EU policymakers to dismantle the Eurozone in a controlled manner, while at the same time rebuilding confidence and trust in the future of European Union, both in Europe and in the world.

I. Economic and political rationale for a controlled dismantlement of the Eurozone (main theses)

This section presents some key conclusions from the analysis elaborated in Kawalec and Pytlarczyk (2013).

1. The key to the problems of the Eurozone countries in crisis (except for Ireland) is the loss of international competitiveness combined with their inability to correct their external exchange rates:
   - Exchange rate adjustment is not a miraculous solution that can substitute for a sound macroeconomic policy. It is an instrument that should not be abused in order not to harm the health of the economy and or that of its neighbours. There are emergencies, though, in which getting the economy back on track without a devaluation is very difficult or even impossible.
   - In the case of losing international competitiveness or in times of abrupt, adverse swings in market confidence, currency depreciation (complemented by proper monetary and fiscal policy) is effective in restoring the competitive advantage of a country and in improving the balance in external flows.
   - In addition, currency depreciation provides a progrowth stimulus which can serve to counterbalance the recessionary effects of fiscal and monetary tightening and enable a country to quickly embark on a growth path.
   - If accompanied by an adequately restrictive macroeconomic framework, currency depreciation may bring durable improvement in competitiveness.
   - Closing the competitiveness gap without altering the exchange rate and by relying only on fiscal austerity and monetary tightening generates high costs in terms of real GDP contraction and unemployment. Under a democracy, such policies tend to end in failure.
2. The expectations that progress towards fiscal union or creating a Federal State of Europe would provide alternative instruments that would help overcome differences in competitiveness among the Eurozone members are unfounded:
   - It is unjustified to expect that a large inflow of funds from the EU (or the Eurozone's) central budget would be able to solve problems of insufficient competitiveness in some countries. This can be demonstrated by the Italian and German experiences. Both countries spent huge amounts of taxpayer money to stimulate the uncompetitive regions of southern Italy and East Germany and achieved no substantial results. It is hard to imagine that non-competitive Eurozone countries could continually expect to receive annual transfers worth 25% of their

GDP (as in East Germany) or 16% of GDP (as in southern Italy). These examples show that structural policies aimed at improving the competitiveness of under-developed regions of a single currency area are so ineffective and expensive that they cannot contribute significantly to boosting competitiveness in problem Eurozone countries.

- Similarly, the belief that evolution towards a Federal European State could ultimately allow the euro area to function as well as the single currency area of the United States does, is baseless. Europe is fundamentally different from the USA because it consists of nations speaking different languages, drawing on different traditions, and is organised into national (sovereign) states. Nation states constitute the main axes of citizens' identity and are the sources of legitimacy of power. Nothing suggests that this situation will change during this century. The EU and its institutions are auxiliary entities, created in order to improve the security and economic prosperity of its member states. The success of European integration was based on the philosophy of respecting the needs of all members, accepting solutions that serve everyone and threaten no one. Yet implementing a common currency undermined this philosophy. A Eurozone member that loses competitiveness for whatever reason or is forced to liquidate its current account deficit may be practically doomed to economic, social, and civilizational demise, with no chance of changing this situation. These problems have totally different and far more serious dimensions when they concern whole countries rather than underdeveloped regions within particular countries. The lack of prospects for whole countries, and the situation in which its citizens are forced to spread out across Europe as "Gastarbaiters" can lead to serious tensions and conflicts, especially if it concerns countries as large as Spain and Italy.

3. It is unrealistic to assume that the new instruments of fiscal consolidation and fiscal discipline being implemented in the Eurozone will prevent the future reappearance of competitiveness problems in member countries:
   - Better fiscal discipline may limit the risk of irresponsible budget policy, but will not prevent problems with competitiveness from other sources. Competitiveness problems caused by, among others, overly expansive credit creation for the private sector, the inflow of foreign capital financing investment in non-export sectors, temporarily high proceeds from the exploration of natural resources, faster improvements in competitiveness in trading partners, and by technological or demographic changes, will certainly emerge in the future in some countries.
4. In the foreseeable future, the euro has no chance of becoming a pillar underpinning the EU and the Single Market, as it was intended to be. Instead, it will continue to be an instrument dividing the EU and threatening the whole edifice of the European integration:

- The fate of a country that loses competitiveness while remaining in the Eurozone will never be positive. A potential Eurozone exit may end with a bank panic, whereas staying in may be equivalent to a long-lasting recession. Awareness of such traps limits the chances for further Eurozone expansion, even in the optimistic case in which the current crisis is overcome. Currently, out of 27 EU countries with about 500 million inhabitants, 10 countries with 170 million inhabitants are outside the Eurozone and this group is unlikely to shrink significantly, as only some small countries that already have their currencies pegged to the euro may be interested in joining the Eurozone in the near future.
- As long as the Eurozone exists, EU members will remain divided into three groups: 1) Eurozone members in crisis and suffering economic stagnation, 2) Eurozone members regarded as reasonably competitive that are being asked to help those in crisis, and 3) countries outside the Eurozone and in no hurry to join. It will be a "three-speed Europe".

5. Defending the euro 'at all costs' may lead to political collapse in some countries and a disorderly Eurozone break-up, a scenario that has unpredictable political and economic consequences for all of Europe.
   - Preserving the existing Eurozone means long-lasting recession and high unemployment in countries using fiscal austerity to engage in "internal devaluation".
   - A relevant historical parallel is the defense of the gold standard during the interwar period. At that time, economic and political leaders were strongly convinced that the gold standard was the only system underpinning a sound currency. While defending the gold standard up to the last moment, they believed they were 'saving the world'. In fact, clinging to the gold standard was a key factor that aggravated and spread the Great Depression internationally and nearly resulted in a breakdown of democratic regimes around the world.
6. A controlled dismantling of the Eurozone should be carried out in order to forestall a chaotic breakdown and to allow the European Union to return to economic growth:
   - A new European monetary order should be established, based on national currencies or currencies of groups of countries that are alike in economic terms.
   - Eurozone segmentation conducted via the exit of less competitive countries could result in bank runs and the collapse of the banking sectors in these countries. That is why the Eurozone should be dismantled via the gradual exit of the most competitive countries.
   - A controlled Eurozone dismantling would improve the competitiveness of endangered countries via currency weakening. However, some of them may still need to restructure and cut back their public debt. The necessary reduction of debt and the underlying costs shouldered by creditors would be smaller, though, than in a situation in which these countries remain in the Eurozone and their economies suffer below-potential growth and high unemployment.

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II. Key elements of the proposed dismantlement strategy

This section highlights key elements of the proposed Eurozone dismantlement strategy.

1. *The decision to replace the euro with an alternative currency coordination system should be consensus-driven.*

The segmentation should not be a result of the unilateral decisions of some countries to leave but rather a consequence of a consensus to replace the euro with an alternative system of currency coordination.

2. *The process should start with the exit of the most competitive countries.*

The segmentation of the Eurozone should start with the jointly agreed-upon exit of the most competitive countries. The euro may then remain, for some time, the common currency of less competitive countries. This would ultimately mean a return to the national currencies or to different currencies serving groups of homogeneous countries.

3. *Only domestic contracts should be converted into new currencies in exiting countries.*

In exiting countries, only domestic contracts should be converted into a new currency, while all contracts with foreign parties (including bank deposits by non-residents and loans to non-residents) should remain in euro. At the very moment of Eurozone exit, non-residents in exiting countries would be legally prevented from making deposits in the new currency (or currencies). This restriction could be lifted after a very short period (possibly one or two weeks), once the new currency (or currencies) have already appreciated within the exchange rate band (or bands).

4. *The ECB should remain the central bank for all 17 current Eurozone countries.*

The European Central Bank should be preserved as the central bank responsible for monetary policy in all current 17 Eurozone member countries, even after some of those countries replace the euro with new currencies. In this capacity, the ECB will be in charge of designing, preparing and implementing the segmentation of the Eurozone as well as managing the new currency coordination system.

A combination of the return to national currencies and the proposed role of the ECB would mean that member countries (or homogeneous groups of countries) would regain important adjustment instruments i.e. their own currency and monetary policies. However, they would not regain full sovereignty in handling these instruments, as the exchange and monetary policy decisions for each monetary area would be taken by the relevant bodies in the ECB structure.

5. *A new currency coordination system (European Monetary System-2) should be established in order to keep Current Account balances within sustainable limits.*

A new system of currency coordination (e.g. based on flexible exchange rates within adjustable currency bands) should be agreed upon beforehand. We suggest that the new system could be based on the European Monetary System (EMS) that operated from 1979 to 1999[2]. (hereinafter we call the original EMS EMS-1 and the new proposed system EMS-2). The aim of the new EMS-2 currency coordination system should be to keep current account imbalances among European countries at sustainable levels, while preventing excessive currency fluctuations. The EMS-2 would be managed by the ECB in its capacity as the central bank of all countries concerned. To this end, the ECB could use typical monetary policy instruments, such as interest rates or open market operations, as well as currency interventions. The ECB could also adjust currency bands based on the monitoring of trade and capital flows, and would also be authorized to impose specific capital controls if necessary. With the proposed role of the ECB, the EMS-2 would be more robust than its predecessor, EMS-1. While member countries had independent and often unsynchronized monetary policies under EMS-1, under EMS-2, monetary policy coordination would be assured by the ECB as the central bank for all countries concerned. In addition, the mechanism of reserve transfers among currency partners that was considered but never implemented under EMS-1, under EMS-2, it could be de facto materialized easily as all currency reserves would be managed by the ECB.

6. *Countries in crises (and their banks) should continue to receive support and sovereign debt and bank restructuring should be carried out as necessary.*

The ECB should continue its commitment to support the sovereign bonds of the Eurozone countries on the secondary market as long as it is deemed necessary and until credible debt restructuring is concluded where needed. Also, the ECB's liquidity support for the banks should be continued until

[2] Sławiński (2012) argues that following the extension of the currency bands from +/-2.25 to +/- 15% (in 1993), the EMS should have been maintained for a longer period and its replacement by the single currency (in 1999) was premature.

the necessary restructuring is successfully concluded. All of the 17 current Eurozone countries will continue to participate in mechanisms supporting banks in less competitive countries as well as in mechanisms providing concessional financing to those countries' governments. Ultimately, they will also participate in necessary debt restructuring.

III. Containing the risks related to the Eurozone dismantlement

This section discusses the key risks related to the Eurozone dismantling and explains how the proposed strategy would contain those risks and contribute to building confidence throughout the process of Eurozone segmentation.

1. Legal possibility of exit the Eurozone while remaining in the EU

There is a legal issue: Can a country exit the Eurozone and remain a EU member without prior changes to the European treaties? In the case of a need to amend the treaties, there is the problem of the lengthy ratification process and the risk that some member countries will not be able to ratify the changes.

If some countries make unilateral decisions to leave Eurozone and thus breach the EU treaties, this could trigger demands for compensation from the EU Commission or retaliation by other member countries. Consequently, it could endanger the functioning of the Single Market, having a negative impact on trade and the GDP of particular countries as well as the whole EU[3].

Although none of the treaties of the European Union recognize the possibility of a controlled segmentation of the Eurozone, this does not mean that an implementation of this strategy would not have a legal basis. The Vienna Convention on the Law of Treaties (1969), which defines the rules of conduct in relation to the international law on treaties between states, creates a legal framework for such an operation in several of its articles.

More importantly, if the exit of some countries from the Eurozone is a result of a commonly agreed upon strategy aimed at overcoming the crisis and helping all EU member countries, there will be plenty of options to deal with legal obstacles. The formal rules of the treaties are not an end in themselves. As it may happen in many instances, in a number of institutions and organizations, a divergence from some formal rules can be tolerated if it is deemed to serve the common cause and is accepted by all interested parties[4]. In recent years, the European Union and the Eurozone had to

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[3] See: Deo *at al*. (2011).

[4] Under such circumstances, there are various theoretical options to resolve or to live with a supposed legal inconsistency including, but no restricting to, the following:

1) Agreement on an interpretation that there is no breach of the formal rules.
2) Formal waiver accepting a divergence from the rules.
3) De facto agreement that the supposed breach will be tolerated as no eligible party will protest against it and no legal consequences will be triggered.

undertake actions which were believed necessary during a time of crisis despite legal obstacles (for instance: the ECB policy of unlimited acquisitions of member countries' sovereign bonds on the secondary market).

Without entering into further details at this stage, we think that the controlled dismantlement of the Eurozone will be manageable from a legal point of view, provided that EU member countries' governments and the EU institutions such as the ECB, the European Commission, and the European Parliament accept this as a necessary economic solution.

2. Risk of banking panic and capital outflows/inflows

As a result of the segmentation of the Eurozone, less competitive and more competitive countries will have different currencies. The anticipation of this change could create a risk of bank runs in less competitive countries and capital outflows to more competitive ones. If bank depositors in less competitive countries expect their euro deposits to be converted into the new national currencies and then subsequently be devalued, they will rush to withdraw their deposits beforehand. However, in the proposed exit sequencing, less competitive countries would not exit the Eurozone, and bank deposits there remain in euro and should not be exposed to conversion to any presumably weaker currency. So, the mechanism of a potential bank panic, as described above, is nonexistent in the proposed dismantlement strategy.

On the other hand, in the most competitive countries, like Germany, domestic depositors would not be afraid of losses resulting from devaluation if the euro were replaced by, say, the German mark. Rather, they would expect their deposited wealth to move with the new currency, which would be likely to appreciate vis-à-vis the euro.

Since in exiting countries only deposits by residents would be converted into a new currency, there would be no point for nonresidents to transfer deposits there. So, even anticipating an exit from the Eurozone by more competitive countries, depositors in less competitive countries would not have a reason to withdraw their deposits in order to transfer them to banks in countries that are expected to exit. Nordvig (2013) indicates that although it would be difficult to entirely avoid some capital inflows into property and other non-deposit assets in strong countries, the capital fights issue would be much more manageable and less damaging to the banking stability (compared to the alternative scenario in which less competitive countries exit the Eurozone).

Banks in the Eurozone's less competitive countries are heavily dependent on the support provided by the strongest countries and financing from the ECB. In addition, the current ECB credibility also relies on the strength of the more competitive European economies. So, a Eurozone exit by Germany accompanied by the other most competitive economies could, in some circumstances, undermine confidence in the solvency of banks in less competitive countries remaining in a curtailed euro area. This would be certainly the case if the exit of the strongest economies were a method used by them to shirk responsibility for the countries in crisis. However this would not be the case in the proposed strategy, because the exiting countries will not abandon the less competitive ones. Germany and other exiting countries will continue to participate in mechanisms supporting banks and governments in less competitive countries and will participate in necessary foreign debt restructuring. Also, after leaving the euro, Germany and other more competitive economies will remain participants in the ECB which will continue to be the central bank for all 17 current Eurozone member countries.

3. *Legal problems with redenomination*

According to Nordvig and Firoozye (2012), the dissolution of the Eurozone, in some circumstances, could result in difficult legal disputes concerning the redenomination of existing contracts, especially contracts governed by foreign law: *"Just which Euros stay Euros and which will be redenominated? Or, even more puzzlingly, what happens if the Euro ceases to exist?"* (Nordvig and Firoozye 2012, p. 15).

However, in the proposed strategy, this issue would be simplified. Following the exit of Germany and some other more competitive countries, the euro would continue to exist as a currency and the ECB would continue to exist as its issuing bank. There would be no redenomination of international contracts. There would be no redenomination of contracts in less competitive countries keeping the euro. In exiting countries, only domestic contracts with residents would be redenominated into new currencies (or currency).

4. *Balance sheet effects*

If a less competitive country left the Eurozone and its new currency depreciated, at first it would suffer from a negative balance sheet effect: the depreciation of the new domestic currency would result in a dramatic increase of the foreign debt to GDP ratio, as well as an increase of the value of corporate foreign debt in relation to current corporate sector cash flow. However, in the proposed strategy, such effects would not appear. Although countries in crisis would benefit from a relative

depreciation of their currency (the euro) vis-à-vis the currencies of the exiting countries, they would not be exposed to any balance sheet effects. This is because they would keep the euro and there would be no redenomination of their existing contracts.

There would be, however, balance sheet effects (both negative and positive) in the exiting countries. Banks in these countries would suffer because of the appreciation of the value of domestic deposits converted into the new currency vis-à-vis their euro-denominated assets such as loans extended to foreign countries and the portfolio of international securities. This would result in losses in exiting countries' banking sectors which would require recapitalization from public money. This is the specific cost of the dismantlement that the exiting countries would have to bear. On the other hand, the euro-denominated foreign debt of the exiting countries would diminish in real terms as a result of euro depreciation vis-à-vis new national currencies. These negative and positive balance sheet effects should be estimated beforehand.

5. *Risk of an excessive appreciation of the new German currency*

Some appreciation of the new currencies of exiting countries is actually a desired and indispensable element of the proposed strategy. The risk that should be avoided is the excessive appreciation of the new German currency (and currencies of other exiting countries) resulting in a shift from a trade surplus to a significant trade deficit and a painful recession in Germany and other exiting countries. This aim should be achieved by the new currency coordination mechanism with adjustable currency bands managed by the ECB.

6. *Debt sustainability of the countries in crisis*

As a result of the proposed strategy, the value of the foreign debt of the countries in crisis would not jump up, while the ability to service that debt, both private and public, would increase significantly. However, that does not mean that all of the countries currently suffering from insolvency would quickly become solvent again. At least in some of these countries, debt reduction (a haircut) would be necessary. The scale of reduction and the cost to creditors would be smaller, though, than in a situation in which these countries remained in the current Eurozone and their economies suffered below-potential growth and high unemployment.

7. *Risk for macroeconomic instability in less competitive countries and currency wars*

Dismantling the Eurozone and allowing countries in crisis to use a means of currency depreciation to improve their competitiveness could potentially also create the following two risks:

- The risk of high inflation in devaluation countries which could undermine any competitiveness improvements resulting from a currency depreciation
- The risk of currency wars as well as excessive currency fluctuations between European countries

In the proposed strategy, these risks are controlled by the projected role of the ECB as the central bank of all countries concerned even after Eurozone segmentation and by the proposed new currency coordination mechanism.

8. *Recreating divisions between France and Germany*

Sinn (2013) warns that: *"Politically, it would be a big mistake for Germany to exit the euro, because that would reinstate the Rhine as the border between France and Germany. Franco-German reconciliation, the greatest success of the postwar period in Europe, would be in jeopardy".*

We share Sinn's opinion of the critical importance of the Franco-German reconciliation. However, we think that the economic consequences of the single European currency constitute the main danger to relations between the two biggest EU member countries. As Spiegel (2013) reports *'Berlin and Paris are at odds on almost every issue when it comes to tackling the current crisis'*, and '*they continue to block one another'*. Franco-German relations are likely to deteriorate even further, should the current policies in the Eurozone are continued.

The proposed Eurozone dismantlement would not only allow France to improve its competitiveness and regain its inhibited political position in Europe, but would also create conditions for genuine improvement in Franco-German relations (especially if France took a lead in proposing the dismantlement strategy as discussed in section VI).

9. *Fears of Europe's economic partners*

Europe's economic partners, including the US and China, have reason to be concerned about a potential Eurozone segmentation. They may fear that a Euro collapse could trigger:

(a) a dramatic economic depression in Europe which would directly damage their exports
(b) political conflicts in Europe that may endanger international cooperation and peace
(c) an intensification of competitive devaluations which could lead to an increase in currency wars worldwide
(d) and could put the value of Eurozone member countries' sovereign bonds and other euro denominated assets held in their monetary reserves at risk.

The proposed strategy addresses these fears:

Ad (a) The proposed controlled Eurozone dismantlement, as result of consensus agreement and managed by the ECB, would not undermine the functioning of the EU and the Single Market, and would be unlikely to cause any deep recession, but rather, would create the best conditions for a quick return to the growth path.

Ad (b) The proposed strategy does not aim to provoke political conflicts, but rather, to help avoid conflicts that are likely to break out otherwise.

Ad (c) The proposed currency coordination system could be more advantageous to Europe's trading partners than policies likely to be pursued in the case the 'euro is defended at all costs'. In the latter case, the Eurozone is likely to conduct a policy of 'weak euro' in an attempt to build a substantial trade surplus in the Eurozone as a whole[5], which may intensify global currency wars. The proposed new currency coordination system would enable the liquidation of trade deficits in countries in crisis through balancing imbalances among post-Eurozone countries, without causing an overall negative trade effect in Europe's trading partners.

Ad (d) The proposed strategy would result in the relative depreciation of the euro to new national currencies (or common currencies for groups of European countries). So, a depreciation of the euro vis-à-vis leading world currencies such as the US dollar, Japanese yen, or Chinese renminbi is very likely, however the magnitude of the depreciation constrained by currency bands would be rather moderate while compared to the biggest cyclical fluctuations that used to happen among major world currencies. Nevertheless , there could be some negative balance sheet effects in countries holding substantial amounts of the euro-denominated assets in their monetary reserves. However it is worth underlining that, from the perspective of Europe's trading partners, there would be no overall negative trade effect (as the depreciation of the euro would be counterbalanced by the appreciation of the new German currency and the new currencies of other exiting countries).

[5] If the Eurozone as a whole had a substantial trade surplus, the less competitive member countries might liquidate their overall trade deficits despite their deficits in intra Eurozone trade. See: Feldstein (2011), Kawalec and Pytlarczyk (2012).

IV. ECB as the institutional guarantor of the process

Preserving the European Central Bank as the central bank responsible for monetary policy in all 17 post-Eurozone member countries will play a key role in the dismantlement strategy. In the proposed capacity, the ECB would be in charge of designing, preparing, and implementing the segmentation of the Eurozone as well as managing the new currency coordination system:

- Preserving the role of the ECB would facilitate the implementation of a robust currency coordination system among former Eurozone countries (as explained in section II, point 5). It would lend credibility to the currency bands or other arrangements made to prevent currency wars and excessive currency fluctuations among post-Eurozone countries as well as the excessive appreciation of the new German currency.
- The proposed role of the ECB would diminish the risk that after segmentation, less competitive countries would run expansionary monetary policies and high inflation would undermine any competitiveness improvements resulting from a currency's relative depreciation.
- The ECB would be able to calculate the necessary level of debt reduction (haircut) for current Eurozone members that need sovereign debt reduction.
- The ECB would be able to estimate the potential bank losses, in particular in EU countries, resulting from expected exchange rate movements as well as the necessary sovereign debt reductions of some countries.
- The ECB would be able to analyze and prepare solutions to all technical details (including reserves, seignorage gains *etc.*).
- Preserving the role of the ECB would also buy more time to resolve the problem of existing claims and liabilities in Target 2 (the interbank gross settlement system operated by the Eurosystem) as analyzed by Sinn and Wollmershaeuser (2012). A controlled dismantlement of the Eurozone would prevent a further increase in Target 2 imbalances, however the existing balances would continue to be serviced under the auspices of the ECB. Once the economic prospects of the Eurozone countries now in crisis start to improve, capital will begin to return to these countries' banks and post-Target 2 imbalances will diminish. Once the situation in Europe stabilizes, the remaining post-Target 2 claims, if any, will have to be settled or restructured in an agreed upon manner.
- Taking into account the above mentioned extensive tasks and responsibilities, it would be rational for the ECB to cooperate with the International Monetary Fund and benefit from its expertise and institutional capacity.
- Preserving the ECB as the central bank for the whole post-Eurozone area and its commitment to continue support to the banking sectors and sovereign bonds markets would prevent a collapse

of confidence in countries in crisis, following a Eurozone exit by the strongest economies (as explained in section III, point 2).

- Most importantly, the proposed role of the ECB would demonstrate that the segmentation of the Eurozone is part of the orderly transformation of the European currency system and that it would be carried out under the control of the most respected and credible European institution. It would also dispel the worries of the main European economic partners about the situation getting out control and resulting in economic or political chaos.

V. EU-US free trade area as a new flagship project

While the failure of the euro project has damaged European morale, the EU-US free trade agreement, as declared by the leaders of the European Unions and the United States in February 2013, could become a new flagship project, building momentum and restoring confidence in the future of Europe.

Together, the EU and the US account for about 46% the word GDP and about 30% of the world trade. Studies suggest that EU-US free trade agreement will bring substantial increases in welfare and unemployment reduction in the US and EU member states as well as in the third countries (see: European Commission 2013, Felbermayr *at al*. 2013a and 2013b). In addition, as Felbermayr *at al*. (2013b, p.11). note:

"… two economic blocks are sufficiently similar in terms of their cost and productivity structures. This makes it very unlikely that an agreement involving comprehensive liberalization generates strong competitive effects based on different wage levels".

We believe that decisive progress with the EU-US trade agreement could have an important contribution to rebuilding confidence and trust in the future of European Union, both in Europe and in the world.

VI. Who can initiate the process

The idea that Germany and some other more competitive countries should leave the Eurozone to help to resolve the crisis in the south has been around for at least two years[6].

The signatories of the European Solidarity Manifesto (2013) state that the controlled segmentation of the Eurozone via the jointly agreed-upon exit of the most competitive countries would be an expression of European solidarity. They underline that: *"… the exit from the Eurozone does not mean that the most competitive economies will not bear the cost of diminishing the debt burden of the countries in crisis. This will happen, however, in circumstances in which such assistance would help them to return to economic growth, as opposed to the current bailouts, which lead us nowhere".*

Granville *at al.* (2013b) explain why, as of today, neither the member states of the Eurozone, nor the European institutions such as the European Commission or the ECB have been able to come up with a game changing proposal such as the Eurozone dismantlement. This perspective may change however as a result of adverse economic and political developments. One of the potential triggers could be the situation in France. Following a diagnosis by Granville (2013), Granville *at al.* (2013a and 2013b) state that France, the second largest European economy, is heading for an economic crisis with very high social costs. France was very much the key initiator of the European single currency. However, today the euro constitutes a lethal danger to France.

"The euro was seen as the ultimate underpinning for the edifice of European integration. The financial crisis and its aftermath have shown that the euro instead has the potential to destroy the whole project. It impedes the reforms necessary to restore France's fading international competitiveness. Retaining the present euro system whatever the cost will cripple the French economy, undo French social cohesion, and weaken France's position in Europe and the world.
As Europe's founding father, only France has the standing to advocate a strategy of dismantling the euro system for the sake of the European Union. The alternative is economic failure, deeper divisions and bitter resentments among Europe's nations, putting the most valuable achievements of European integration at risk." (Granville *at al.* 2013b).

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[6] Demetriades (2011), Henkel (2011), Kawalec and Pytlarczyk (2012 and 2013), Griffin and Kashyap (2012), European Solidarity Manifesto (2013) and Granville *at al.* (2013a and 2013b) present this option as the first best solution to the Eurozone crisis. Soros (2012 and 2013) presents this option as the second best solution. Soros (2012) states that Germany should leave unless it is ready to lead the Eurozone countries in "*the creation of a political union with full burden-sharing*". Soros (2013) argues that Germany should leave unless it is ready to accept the Eurobond solution.

As Granville *at al.* (2013b) believe, one day Germany could realistically decide to leave the Euro prompted by an explicit request from its core French partner or as a result of the growing economic crisis engulfing France.

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