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Possible Costs of a Eurozone Collapse

Kálmán Dezséri

A growing concern in Europe and the world is that the euro could collapse due to the debt crisis in some Eurozone countries. The situation in Europe is more serious than it has ever been. Until recently, even thinking about the consequences of a break-up of the euro was unimaginable. Many people did not think or believe the euro could fail. But if things continue the way they are going, then it may happen. Thus Europeans should be aware of the potential political, economic and financial consequences of a failure of the euro. If the process of collapse begins, either the EU as a community or the individual Member countries will no longer be able to completely control such processes.

The key determinant features of a potential collapse are the unsuccessfulness of the Greek economic policy and Germany's willingness or lack of it to support both the Greek stabilisation policy and the sustainability of the whole Eurozone. Doubts over how much more austerity recession-hit Greece can endure are growing by the day. They are matched by doubts over how long political and public opinion in Germany, the Eurozone's paymaster, will stand for keeping Greece and others on the bloc's periphery afloat with emergency loans and bond purchases through the ECB. Some within the ECB are equally unhappy about several aspects of the current direction and applied means of the European monetary policy. Views on the necessary economic policies and actions at the EU-level are diverging rather than converging.

If the outcome of the mounting crisis is more than unpredictable, so are the consequences of a collapse of the euro. Some consequences can, however, be well predicted.

Declining market confidence

The economies of the Eurozone are so interconnected that the secession of one of the 17 members would open up a Pandora's box. Greece could not quit or be expelled from the bloc without adverse effects and consequences. Markets would then most probably line up Italy in their sights. Due to its public debt equal to 120 % of GDP, Italy could possibly the next element to fall in a domino-like effect. While bail-out arrangements can rescue Greece, Ireland and Portugal, Italy is considered too large for this.

The fear and panic that Greece's exit from the Eurozone would cause is rather incalculable. The issue is that whatever happens in Greece is perceived by the global financial markets as a potential template for what could happen elsewhere. Thus, it would be disastrous for Italy. If Italy were then forced out of the Eurozone, France's banks—already under pressure from short-term funding strains—could melt down because of their exposure to Italian debt. Drawing the line would be almost impossible. Under normal circumstances, the EU could devise a framework for an orderly exit. But the crisis has most likely already gone much too far for that.

A Greek exit would not prevent global consequences

Politicians, particularly in the more developed countries of the EU, often view a Greek exit as positive for the euro's exchange rate. But many financial experts fear it would be a financial and economic disaster not only for Greece, but also for the other 16 Eurozone member states. One of the most important consequences will be a further loss in the credibility of the EMU as it becomes evident that the system is not prepared to provide the required support mechanism when a participating country is suffering from severe imbalances. This negative assessment will be aggravated by the fact that the other Eurozone countries are not able to act together to avoid adverse events. The euro will probably remain weak vis--vis other leading world currencies and its exchange rate will be exposed to speculative attacks. This may weaken economic policy efforts to restore economic growth in the European economies. These events could also have severe economic and political implications for the EU as a whole, and for the wider global economy.

Reinforcing the dollar as reserve currency

According to many analysts, the possible rush to safe-haven assets and to square positions after a break-up of the European Monetary Union would be akin to the aftermath of the Lehman Brothers' default. They argue first that the dollar would be the currency to benefit most from the likely run on the financial markets. For one, heightened volatility would prompt investors to buy back funding currencies. Second, a euro break-up would undermine its challenge to the dollar as a reserve currency. The dollar is also the obvious candidate if importers and exporters, anticipating a collapse of the euro, were to seek to trade in an alternative currency.

Increasing role of the Chinese Yuan in international finance

For the time being, China watches and waits. Fragmentation of the euro would also open the door for China to accelerate international use of the Yuan. China started promoting the Yuan as an invoicing and settlement currency after the Lehman's bankruptcy led to a drying-up of dollars to finance trade. China's exports slumped, costing millions of jobs. About 7 % of Chinese trade is now conducted in Yuan (or Renminbi). And that share would be sure to jump if the euro collapsed. Strategically, this means that a fall of the euro would help drive the globalisation of the Yuan. Indeed the risk is that the pace of its internationalisation would be too fast for China’s comfort. Thus, on the one hand, this is an opportunity for China, but also, on the other hand, a challenge because China probably does not want to move so fast.

Emerging Asia in the global economy

Many analysts agree that China would likely not only want to speed up use of the Yuan beyond its borders, but to activate Yuan swap lines and to take other measures to help Asia's economies if the euro broke up. As the Eurozone's problems are likely to reduce Europe's long-term growth potential, Asian companies would have an extra incentive to invest more in their own region and in other emerging markets. This would boost the Asian economies and increase their shares in the global economy in the medium and long run. However, in the short term, Asia also would not be able to escape unscathed from a collapse of the euro. Nearly all countries in the region export more to Europe than they do to the United States. And the exposure of European banks to Asia, excluding Japan, at $1.4 trillion, is three times greater than that of U.S. banks. If a meltdown occurs, the home bias of U.S. and European investors would kick in, particularly European banks. The risk that they would cut their credit lines in Asia is expected to be quite big. That is what happened after Lehman went bust. Nearly $80 billion left Asia in the fourth quarter of 2008 and the first three quarters of 2009. But in the following 18 months, nearly $500 billion of capital flowed back. If the euro's malaise causes history to be repeated, the reflows of money to Asia are likely to be on an even larger scale as investors weigh up which region has the brightest prospects.

European politicians must realise what the political, economic and financial consequences a failure of the euro are. They would not be able to control such a process. Both Greece's exit from the Eurozone and a collapse of the euro would inflict untold damage on Europe's economy, further brighten the attractiveness of a rising Asia and hasten the emergence of China's Yuan as a global currency. The relative strengths of Asia and the West are becoming starker and starker in terms of fundamentals and the room for policy manoeuvre. Thus, this could be one of the lasting lessons of the battle for the euro.

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