Euro Area Exit: Still a Remote Risk

Insight beyond the rating

Key Highlights:

- Developments in Italy earlier this year raised the specter of a country abruptly exiting the euro, but have also illustrated some of the hurdles that would make exiting the common currency so difficult.
- An attempt to exit the euro would in most circumstances generate an economic and financial crisis, exacerbating domestic challenges and potentially bringing down the government without necessarily guaranteeing a durable increase in competitiveness via currency depreciation.
- Voter opinion remains strongly in favor of the euro in most countries. Even where support is lower, advocacy for a new currency and an independent monetary policy remains rather muted. The euro is likely to prevail in the absence of an attractive alternative.

Earlier this year, market fears regarding the possibility of a country exiting the euro area resurfaced again. This renewed concern followed the formation in Italy of a government with eurosceptic elements in its agenda. Coalition discussions had reportedly included some consideration of introducing a parallel currency. Moreover, the government initially sought to appoint a finance minister who had previously voiced support for Italy to exit the monetary union. Subsequent developments, which compelled the incoming government to provide reassurances regarding Italy's remaining in the euro area, have illustrated the strong institutional constraints and political incentives that help to anchor countries inside the union.

In light of the persistence of Euroscepticism even as macroeconomic conditions have gradually improved, DBRS has recently expanded its analysis of the risks and implications of a single country or group of countries exiting the euro. The main analytical considerations have been incorporated in greater detail within DBRS's sovereign methodology.[1] DBRS continues to view the risk of a euro exit event as remote. No provision exists for exiting the euro without also exiting the EU, and this seems unlikely to change. Moreover, the necessary national conditions do not appear to be in place for any individual country to engineer an exit. DBRS considers the EU reform agenda to be incomplete, but also concludes that the reforms of the past decade have been enough to strengthen the currency area and leave it in a better position to weather future crises. Nonetheless, continued efforts to preserve and strengthen the integrity of the monetary union may be needed to reduce the likelihood of any exit in the long-term.

Euro Exit Risk Considerations Center on Political and Economic Factors

DBRS considers three main factors in determining the risk of a country abruptly exiting a monetary union. In approximate order of importance, these include: (1) political ability (i.e., national institutional and legal constraints); (2) macroeconomic imbalances and vulnerabilities; and (3) political willingness. Typically, countries are placed in one of three country risk categories: low, moderate or high risk of exit.

At this juncture, DBRS concludes that all euro system members except Greece remain in the low risk category. This assessment generally reflects the considerable hurdles to executing an exit from the monetary union. While Greece faces similar hurdles, it falls into DBRS's moderate risk category. The main factor setting Greece apart from other countries is the high stock of official external debt, which Greece will need to gradually repay via primary surpluses. Despite the favorable terms on Greece's official debt, DBRS considers that this debt burden could again become a source of tension between Greece and its main creditors. If Greece is unable to sustain its primary surplus commitments, its creditors may be less willing to contemplate additional debt relief. If simultaneously faced with persistently weak growth, a future government could conclude that Greece has exhausted other options and the cost of remaining inside the currency area is too high.

Institutional and Political Constraints are Aligned in Favor of Staying in the Euro

Institutional and political constraints are a primary factor weighing against a country attempting to abandon the euro. The present Treaty of Lisbon does not include any mechanism for exiting the currency area. The nineteen-euro member countries agreed to this treaty, making change difficult, although some political parties within various European countries have advocated reforms to the treaty. Moving to introduce a new currency would effectively imply an outright rejection of Article 128 of the treaty and would bring serious consequences, including the possibility of a forced exit from the EU. It would be

[1] See Appendix C of DBRS's Sovereign Methodology, *Rating Sovereign Governments*, available at www.dbrs.com

difficult for any country to engineer an exit without considerable disruptions to the flow of finance, goods, services and people to and from the relevant member state. Even the strongest euro area members would be likely to experience adverse consequences because of an exit, no matter how well-planned the process.

The logistics of introducing a new currency within a short period of time while avoiding a financial panic and preserving confidence in the country's economic future appear nearly impossible to navigate successfully, particularly for the less competitive member countries. If an exit is expected, residents would have a strong incentive to obtain physical euros or move bank deposits to another country, effectively generating a run on the new currency before it is introduced. Any government developing a plan to leave the euro risks a banking crisis, resulting in financial and economic turmoil that spurs calls for a reversal and stabilization program within Europe. Similarly, the introduction of a parallel currency, even if on a relatively small scale, would likely force the government to either impose deposit and capital controls or reverse course. Even if a government formulates a plan in strict secrecy, this could raise questions regarding the legitimacy of the government's actions and would not necessarily reduce the associated economic and financial turmoil.

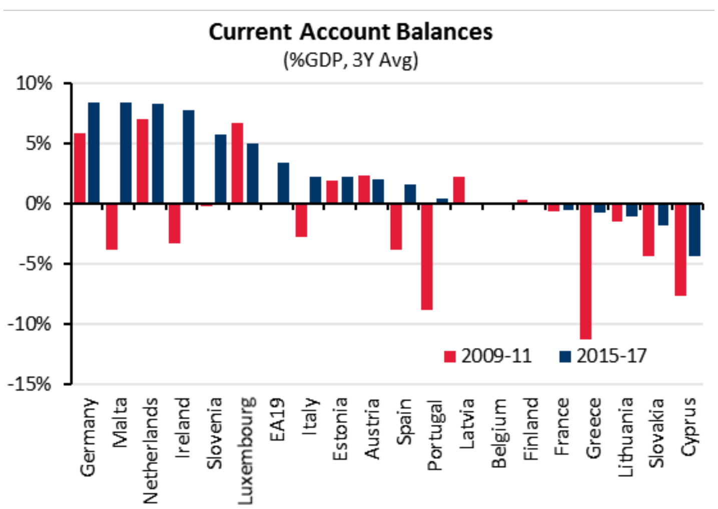
At least two national elections in euro area countries – Greece 2015 and Italy 2018 – have produced governments with some evident interest in easing the constraints imposed by the common currency and the associated fiscal rules. In both cases, the incoming governments appear to have recognized that any attempt to take steps toward an exit would (1) not solve the country's underlying fiscal or economic challenges, (2) likely involve an immediate and substantial loss of national wealth via devaluation and a loss of access to EU support mechanisms, and (3) potentially bring down the government itself as these adverse consequences pan out. It remains unlikely that any government will accept all these short-term consequences in exchange for the uncertain future gains associated with any increased external competitiveness, which might not be sustained.

Some Countries Will Continue to Struggle Within an Imperfect Union

Although the path to leaving the euro is likely to be extremely difficult for any country, the presence of macroeconomic and external imbalances within the union imply that the risk cannot be entirely ignored. An underdeveloped system of fiscal transfers, financial market segmentation, and real interest rate differentials may continue to hamper growth prospects in certain countries and regions. While exiting the euro will most likely be considered only a last resort, a failure to find other solutions to economic challenges could continue to push countries to explore more radical options.

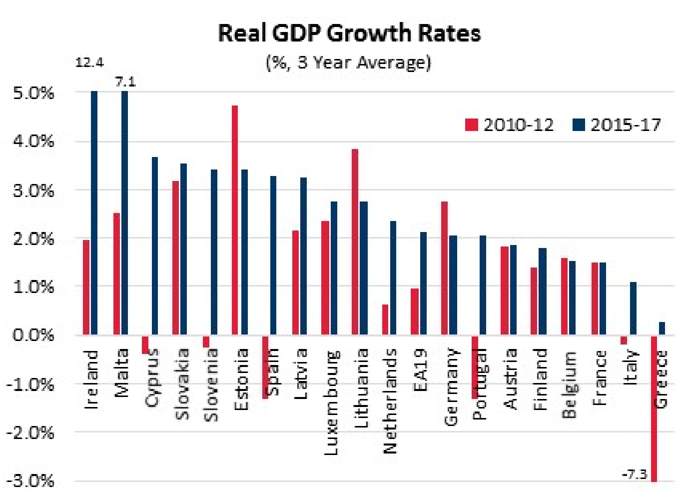
The euro system has already undergone a significant rebalancing in the wake of the global financial crisis, shifting toward a sizeable external surplus. However, certain countries and regions still suffer from a relatively weak external position. Germany and the Netherlands have seen their already large surpluses increase in recent years (see Exhibit 1). Most countries have undertaken measures to boost competitiveness, but relative performance may not durably improve.

Exhibit 1.



Source: IMF, Eurostat, DBRS.

Exhibit 2.



DBRS continues to monitor macroeconomic imbalances within the union as a key indicator of whether individual countries will remain under pressure to solve a competitiveness problem. These imbalances have materially declined in most countries since the height of the crisis. Moreover, most countries have demonstrated a strong commitment to the common currency, even while undertaking significant and politically costly structural reforms. Also noteworthy is the financial support available to member countries to facilitate internal adjustment. Nonetheless, competitiveness and relative progress on structural reforms could continue to impact relative macroeconomic performance within Europe (see Exhibit 2), particularly as quantitative easing by the ECB is gradually withdrawn over coming years. Countries that continue to face high external debt burdens, fail to maintain fiscal discipline, or otherwise fail to adequately implement growth-enhancing structural reforms may remain vulnerable to both sovereign debt crises, and to the political discontent that such crises tend to generate.

Euroscepticism Will Shape European Policy, But Is Unlikely to Put the Entire Project at Risk.

Since 1945, memories of war and the associated tragedies have driven Europe gradually, and democratically, toward an ever-closer union. The policy response to the financial crisis affirmed the collective commitment of European governments toward that union. Although nationalism has intensified in Europe and can be traced in part to concerns regarding the policy response to the crisis, DBRS views this revival partly as a cyclical phenomenon that is likely to recede as economic and financial conditions improve. Nonetheless, some factors – such as concerns over immigration and national or cultural identities – are likely to persist within some segments of the population even when incomes and employment are rising.

European nationalism has manifested itself in a variety of forms, including Euroscepticism and separatism, but also in efforts to reform the EU from inside. The balance of attitudes toward the EU have turned negative in several countries, such as the UK. The balance of opinion for the euro remains quite favorable in comparison to the EU, particularly among euro area countries (see Exhibits 3 and 4). Although support for the euro has declined marginally from high levels in a few countries, it has risen considerably in several others where it was previously low, including the countries that have struggled most through the crisis. When employment and incomes stagnate, discontent is likely to grow, but DBRS concludes that the widespread support for the euro is likely to encourage major political parties in euro area countries to move to the center on this issue. DBRS sees a greater risk of the EU losing its non-euro area members, one of which, the UK, is already preparing to leave, and many of which have had a lower opinion of the EU and euro to begin with.

Exhibit 3.

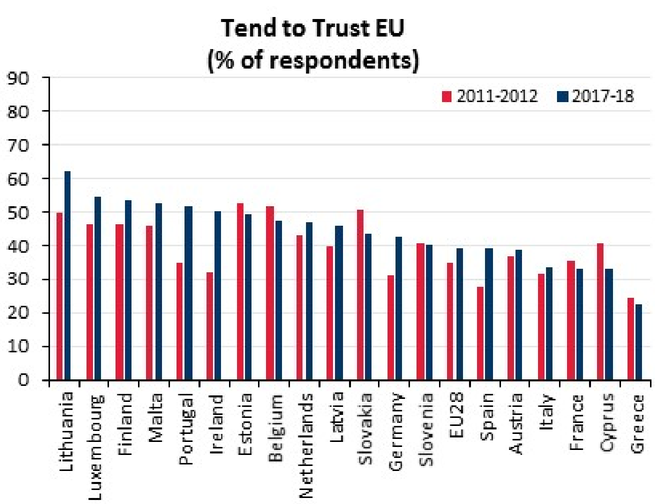
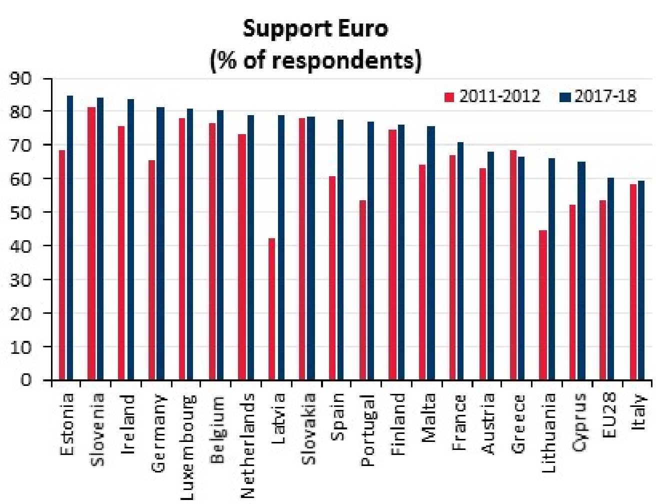


Exhibit 4.



Even if major political parties remain in support of the euro, could some countries exit via referendum? Nine countries allow for the possibility of a binding referendum, including Austria, Cyprus, Estonia, Greece, Latvia, Lithuania, Portugal, Slovakia, and Slovenia. At present, public support for the euro within these countries averages 75%. Of this group, support for the euro has historically been relatively low in Greece and Cyprus. Nonetheless, in Greece, support for the euro has not declined below 60% since before the crisis. This factor contributes to DBRS' s view that Greece is in the moderate rather than considering the high exit risk group, despite the possibility of future re-emerging tensions between Greece and its European institutional creditors related to the primary fiscal surpluses needed to fund debt service payments. In Cyprus, the depositor bail-in had an adverse impact on support for the euro that persisted for several years, but as of end-2017 Cypriot support for the euro is at record levels within the country. Support for the euro remains relatively low in Italy as well (slightly below 60%), but no provision for a binding referendum exists.

The lasting popularity of the euro is tied in part to the unifying institutional and political frameworks that define the EU. Membership of the EU and the euro area has provided considerable benefits to member states and their citizens. These include the basic freedoms to travel to, work in, and trade with people and businesses in other nations in a politically stable and wealthy continent, where individual freedoms and the rule of law are broadly respected. The euro has gradually become a symbol of those freedoms and as such remains popular.

Euroscepticism will certainly persist and continue to shape the debate around treaty reforms and the scope for deeper integration. A strong performance of the Eurosceptic block in next year's parliamentary elections could lead to increased pressure for reforms. However complex and contentious these debates over reform may be, they are unlikely to prove the undoing of the entire EU project. Immigration, for example, is most contentious as it relates to migrants from outside of Europe and is largely a question of security and burden sharing. While the issue seems unlikely to be easily resolved, it is similarly difficult to imagine this single issue becoming the wedge that breaks the euro area apart. Likewise, low growth is a key concern in many countries and new political willingness may emerge from the European elections in May next year that could pave the way for modifications to EU governance designed to support economic growth.

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