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[Art 50] Ways to Leave the Euro – Does the Eurozone Need an Exit Clause?

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INTRODUCTION

Over the course of the Euro crisis the possibility that one or various member states may leave the currency union has been discussed intensively. During the standoff between Greece and the rest of the Eurozone the German finance minister Wolfgang Schäuble suggested that Greece should leave the Eurozone.[1] The current economic recovery has eased the pressure of the crisis and Grexit is no longer on the agenda. But the fundamental question of whether a euro exit clause is needed and how it should be designed needs to be clarified. Recently the Dutch government argued that a procedure for euro exit is missing.[2] In the academic literature on this topic, the issue of euro exit has been discussed for a long time (Sinn 2014 and Scott 2012)[3] and it should certainly be included in the current discussion over Eurozone reform.

This paper aims to discuss some of the key institutional and economic aspects of a euro exit clause. What are the pros and cons of introducing an exit clause for the Eurozone and how should it be designed? Clearly, an open and rational discussion about exit clauses among governments would be difficult because even putting this issue on the agenda of the next European summit could be seen as a signal that a member state may be about to exit. A balanced and constructive debate about introducing an exit clause in a monetary union is only possible in a situation where no country is close to exit.[4] This is the only scenario whereby decisions over the content of such a clause take place under sufficient uncertainty about whom it may potentially concern. Of course, this "veil of ignorance" is never perfect because it is clear, for instance, that countries whose currency would probably devalue after exit would have different interests to those of countries with strong currencies.

Section 2 of this paper discusses why existing federations usually do not have exit clauses while the EU does. Section 3 discusses whether exit from the Eurozone is possible under the existing institutional rules. Section 4 discusses the economic benefits and costs of introducing a euro exit clause, as well as aspects of its optimal design and section 5 draws some conclusions.

WHY DO SOME UNIONS HAVE EXIT CLAUSES WHILE OTHERS DO NOT?

Most federations do not have exit clauses, but the EU does.[5] Why is this the case? Rational thinking about constitutional design will usually lead to the conclusion that some provisions for ending membership of a union are desirable because the absence of any such exit arrangement can easily lead to destructive uncertainty and conflict. So why are exit clauses absent from many constitutions?

Firstly, discussing exit clauses in unions or other types of clubs is delicate because it may be perceived as undermining the spirit of cooperation or solidarity. Secondly, exit clauses could be avoided because there is a concern that countries could invest too little in political debate and negotiation ("voice" in the terminology of Hirschman (1970)) if exit is easily available. One should note, however, that "voice" may also be more effective if exit is available and not too difficult. Thirdly, constitutions are not always the result of a process whereby members of a union maximize progress towards a common long-term goal. Constitutions may be imposed from the outside. The rules may be written by powerful members who do not want to give weaker members the opportunity to leave while hoping that they will be powerful enough to achieve a good result through ad hoc negotiation if they want to exit themselves. The politicians involved in setting up unions may also want to tie the hands of their successors. None of these reasons implies that not having an exit clause is efficient or rational.[6]

It is interesting to ask why the EU introduced the exit clause of Article 50 TEU.[7] Andrew Duff (2016) offers the following explanation:

"The need to include a secession clause in the Constitutional Treaty (2003) and then the Treaty of Lisbon (2007) was upheld both by the federalists and by their

[1] "Anmerkungen zu den jüngsten griechischen Vorschlägen", *Handelsblatt*, 12 July 2015, http://www.handelsblatt.com/politik/international/schaeubles-griechenland-papier-im-wortlaut-anmerkungen-zu-den-juengsten-griechischen-vorschlaegen/12044368.html.

[2] "Following the request by member Schouten to the Finance Minister and the Prime Minister (issue number 2013Z01025) for a letter about the exit from the eurozone, we report as following. The cabinet introduced in its coalition agreement that it should be possible under mutual consideration to exit from the community arrangements (Schengen, eurozone, European Union). This requires in the case of the eurozone and Schengen a treaty change as the current EU treaty does not foresee this possibility." (Rijksoverheid 2013, translation by the author).

[3] For instance, Scott (2012, p.4) puts this as follows: "establishing a withdrawal framework now makes sense (…) After all, the true threat to the long-term viability of the euro area does not come from the current debt crisis in Greece, but from the looming crises in Italy and other large Member States. Establishing the withdrawal framework today ensures it will be in place when it is truly needed."

[4] Unfortunately, on May 15, 2018, a preliminary version of a coalition contract between the Italian 5 Stars Movement and the Lega Nord was leaked according to which the coalition will demand the introduction of a euro exit clause, debt relief, and a relaxation of fiscal rules in the Eurozone, see https://www.huffingtonpost.it/2018/05/15/un-comitato-di-conciliazione-parallelo-al-consiglio-dei-ministri_a_23435353/?utm_hp_ref=it-homepage. This has given rise to a renewed debate about Italy's membership in the Eurozone.

[5] Huysmans and Crombez (2016) highlight the fact that the Latin Currency Union between Belgium, France, Italy, and Switzerland, which existed from 1865 to 1927, introduced an exit clause in 1885.

[6] See also the discussion in Huysmans and Crombez (2016), p.29.

[7] Note that the Draft Treaty establishing a Constitution for Europe proposed by the European Convention (2003) also contained an exit clause for voluntary withdrawal of member states (Article 59).

opponents. Federalists saw the need to have a safety clause in the new treaty that would allow a let-out for any current member state which fought shy of accepting the leap forward in European integration that was at that time postulated. The UK government, aware of the risky nature of its ever-increasing exceptionalism, wanted a clause that would prevent the abrupt expulsion of an awkward member state by the mainstream majority. That said, none of us in the Convention ever expected the provision actually to be used – which might explain its relatively sketchy character. So it is vital to analyse very carefully what the clause says, why it says it, and how it is now to be deployed."

This explanation is interesting because its logic can be applied to the Eurozone too. Those who think that the sustainability of the Eurozone requires deeper integration may support an exit clause because it would allow member states that are unwilling to support these reforms to exit. Those who oppose deeper integration may want to minimize the cost of leaving. However, this logic implies that an exit clause is important for the process of transition towards the optimal club size, not necessarily as a permanent feature of the union. This paper focuses on the role of exit clauses as a permanent part of the institutional setup.

Huysmans (2017) provides a different explanation for the introduction of the exit clause. He argues that Eastern enlargement of the EU increased heterogeneity among member states. Combined with decision making by qualified majority rather than unanimity, heterogeneity implies that some countries may end up in a minority position and be forced into adopting policies they dislike. This may explain increasing support for an exit clause. The role of exit clauses for minority protection will be discussed further in section 4.

IS IT POSSIBLE TO LEAVE THE EURO UNDER THE CURRENT INSTITUTIONAL ARRANGEMENTS?

The Eurozone is a currency union of sovereign states. In view of this fact, it is plausible that member states can withdraw from the Eurozone if they want to; but there is no explicit legal procedure for leaving. Therefore, any country attempting to leave the Eurozone would face difficulties finding a legal basis for exit. Currently the only exit clause the Eurozone has is Article 50 TFEU, which specifies a procedure for countries wishing to exit the EU. If a member state of the Eurozone leaves the EU, this step would imply that the country also leaves the Euro. But Article 50 TFEU was not designed as an exit clause for the currency union. In the debate over a possible exit by Greece, a widely-debated issue was how Greece could leave the euro without leaving the EU.

The EU's treaties include a number of references characterising certain aspects of entry to the Eurozone as "irrevocable". For instance, Article 140(3) TFEU states that, in the process of integrating new members into the Eurozone, the European Council will "irrevocably fix the rate at which the euro shall be substituted for the currency of the Member State concerned". The European Commission has adopted the view that the Eurozone is indeed irrevocable: "The irrevocability of membership in the euro area is an integral part of the Treaty framework and the Commission, as a guardian of the EU Treaties, intends to fully respect it."[8]

Along similar lines, the European Central Bank (ECB) has argued that the euro is irrevocable. In correspondence with Claudio Morganti, a member of the European Parliament, ECB President Mario Draghi puts this as follows:

"The irrevocability of the euro has been part of the EU framework since the Treaty of Maastricht, which included a Protocol on the Transition to EMU whereby the Member States declared "the irreversible character of the Community's movement to the third stage of EMU", inter alia stating that all preparatory work should be concluded by 1998 "in order to enable the Community to enter into the third stage irrevocably on 1 January 1999"."[9]

The references to "irrevocability" in the treaties primarily occur in the context of how the process of entering the Eurozone is organised. However, whether these rules also imply that entry is irrevocable forever is questionable.

It is clear that euro membership is intended to be permanent; but it is also clear that an exit scenario cannot be ruled out. A key question is the type of exit scenario under consideration. Three scenarios are possible: firstly, expulsion of a country; secondly, a unilateral decision to withdraw; and thirdly, a consensual decision that a country leaves the euro.

Expulsion from the Eurozone

When the euro was created expulsion of a member state seemed irrelevant, but the Greek debt crisis changed that perception. In 2010 Manuel Barroso found it necessary to clarify that: "No country can be expelled from the Eurozone".[10] But when the crisis escalated and the Greek government organised a referendum about the bailout programme in 2015, the prevailing view among many policymakers in Europe was that a no vote would imply Greece has to leave the Eurozone. For instance, before the referendum Manuel Valls, who was French Prime Minister at the time, said that there was a "real risk" of Grexit if the Greek people voted against the European bailout proposal.[11] The Greek government immediately threatened to take legal actions to avoid expulsion from the Eurozone.[12]

The case of Greece in 2015 demonstrates that a currency union may need to deal with individual member states that refuse to comply with commonly agreed rules and procedures. Of course, the Greek standoff was not just about the Greek bailout programme. The Greek government had openly challenged the rules and principles of the Eurozone, and particularly the no-bail-out clause and the principle that member states in financial difficulties can only have access to credit from the European Stability Mechanism (ESM) if they accept conditionality, including painful measures to bring down the budget deficit.

There is currently no legal rule in the treaties underlying the Eurozone stating that a country that rejects the common rules about economic and fiscal policy can be expelled from the common currency. It has been suggested that the *Vienna Convention on the Law of Treaties* (1969) might provide a legal basis for expulsion. Article 62 of the Convention states that a fundamental change in the circumstances underlying a treaty "which was not foreseen by the parties" may justify the suspension or termination of the treaty under certain circumstances. But whether this may really serve as a basis for expulsion from the Eurozone, either generally or in the specific case of Greece, is controversial.[13]

Another potential basis for expulsion is Article 7 TFEU. Under this provision the European Council, "acting by a qualified majority, may decide to suspend certain of the rights deriving from the application of the Treaties to the Member State in question" if that state has committed a persistent and serious breach of the values listed in Article 2 TFEU.[14] Again, whether this provision is applicable to Eurozone membership is controversial. More specifically, the question arises of whether violations of the rules on fiscal and economic policy suffice to trigger Article 7 TFEU. Dammann (2016, p. 724-725) argues that this outcome cannot be excluded:

"In fact, one can easily imagine scenarios where a member state's conduct represents a vital threat to the functioning of the Eurozone. For example, a member state might openly declare that it would permanently disregard any rules pertaining to the Eurozone, as well as any fines levied against it and any judgments by the Court of Justice. Depending on the circumstances, such open defiance, if left unpunished, might well threaten the survival of the Eurozone."

Next to the legal question of whether expulsion is possible, there is a way of forcing a country to leave under certain circumstances. In the case of Greece, the ECB could have stopped its emergency liquidity assistance (ELA) for Greek banks. In this case the country would have been forced to introduce its own currency and exit from the common currency to avoid a collapse of its banking system. The ECB did not choose to pursue this course of action, but at some point, refused to further increase the level ELA, forcing the Greek government to introduce capital controls. This could have been a first step towards expulsion.

Unilateral Decision to Withdraw

As mentioned in the introduction, a country may unilaterally decide to leave the EU. Article 50 TFEU requires a country to make the exit decision "in accordance with its own constitutional requirements" and to "notify the European Council of its intention". This triggers exit negotiations, but irrespective of the outcome of these negotiations, membership ends two years after the notification. This clause allows individual countries to leave the euro on the basis of a unilateral decision.

For practical purposes, however, Article 50 TFEU does not constitute an appropriate euro exit clause. This is not just because Article 50 TFEU links exit from the euro to exit from the EU. An important issue is that leaving a currency union cannot be announced two years before membership actually ends because this would cause capital flight, increase uncertainty and create other disruptions. Various steps would need to be undertaken quickly after the announcement to implement the exit decision and measures would be required to limit the cost of exit.

An alternative and widely discussed way of leaving the euro on the basis of a unilateral decision would be to simply introduce a parallel currency.[15] Again, if a member state were to take such a step, the rest of the Eurozone would need to decide how to react, which raises the expulsion issue.

Consensual Exit Decision

Another scenario for exit of a country from the Eurozone would be a consensual withdrawal. If there is a consensus among all member states that one member state should leave the euro, the European treaties can always be amended to allow for this exit. In general, treaty changes are difficult to achieve and time consuming, particularly because they need to be ratified in the member states. There are different ways of implementing consensual withdrawal. One option would be to extend the special rules exempting the United Kingdom and Denmark from the obligation to join the Eurozone to more countries. This could be done on a case by case basis when the need arises and would imply that exit is permanent. Another approach would be to introduce a general exit procedure for the

[8] See response by Olli Rehn, European Commissioner for Economic and Monetary Affairs and the Euro, on behalf of the European Commission, to question submitted by Claudio Morganti, Member of the European Parliament, 22 June 2012, http://www.europarl.europa.eu/sides/getAllAnswers.do?reference=E-2012-004398&language=EN.

[9] See message by Mario Draghi, ECB, to Claudio Morganti, Member of the European Parliament, 6 November 2012, https://www.ecb.europa.eu/pub/pdf/other/20121107_morganti.en.pdf.

[10] See "Barroso: 'No country can be expelled from euro zone'", *Euractiv*, 19 March 2010, https://www.euractiv.com/section/eu-priorities-2020/news/barroso-no-country-can-be-expelled-from-euro-zone/.

[11] See David Revault d'Allonnes, "Face à la Grèce, Hollande joue les équilibristes", *Le Monde*, 23 June 2015, http://www.lemonde.fr/politique/article/2015/06/23/face-a-la-grece-hollande-joue-les-equilibristes_4659873_823448.html#fpI6DWElZm0D1Yyo.99.

[12] See Ambrose Evans-Pritchard, "Greece threatens top court action to block Grexit", *The Telegraph*, 29 June 2015, https://www.telegraph.co.uk/finance/economics/11707092/Greece-threatens-top-court-action-to-block-Grexit.html.

[13] See the discussion in Dammann (2016, p. 717).

[14] The values mentioned in Article 2 TFEU include "respect for human dignity, freedom, democracy, equality, the rule of law and respect for human rights, including the rights of persons belonging to minorities."

[15] For a discussion of this option, see Sinn (2014).

Eurozone similar to Article 50 TFEU, but with the objective of allowing countries that leave the euro to stay in the EU.

ECONOMIC BENEFITS AND COSTS OF EXIT CLAUSES

What difference would it make if a new exit clause for the Eurozone was introduced? One issue is whether it would affect the likelihood that a country wants to leave. The other issue is whether it would matter, given that a country has decided to leave. Let us assume that a country has made this decision. Without a euro exit clause, exit would happen on the basis of ad hoc negotiations or through Article 50 TFEU. As mentioned above, the latter would imply that the country leaving the euro also leaves the EU. This is very unlikely to be what either the exiting country or the other EU member states want. There would be ad hoc negotiations aimed at ensuring that the country can stay in the EU. What would the existence of a euro exit clause change? Theoretically such a clause could always be renegotiated. In this case it would not matter much how the clause is designed ex ante. In practice, however, it would matter since renegotiation is very complicated and takes a long time. In the case of Brexit, for instance, the framework given by Article 50 TFEU is very important and highly relevant. A euro exit clause that set out a clearly defined procedure, as well as rights and obligations of the involved parties, would have the effect of reducing uncertainty and the likelihood of conflict (Huysmans and Crombez 2016). By doing so the clause would reduce the economic cost of exit for both the exiting country[16] and the countries remaining in the currency union. It would also reduce the likelihood of the exiting country leaving the EU too, which would further increase the economic damage done.

In addition to reducing the overall economic cost of exit, the clause could regulate the distribution of exit costs. For instance, one key issue would be the redenomination of border crossing credit contracts, which would, in turn, influence the distribution of the economic costs and benefits of exit. An exit clause could even stipulate side payments: Huysmans and Crombez (2016), for example, propose an "exit penalty".

The Buchanan-Faith Model of "Internal Exit"

What does economic theory have to say about exit or secession clauses? A useful starting point for thinking about exit or secession is the "internal exit" model by Buchanan and Faith (1987). This model was not designed for analysing an exit from currency unions, but it includes some basic features that are useful for our discussion.

Let us consider a group of N countries initially forming a union. There is a publicly-provided good of a given quality, the cost of providing the good everywhere in the union is C(N). C(N) is a concave function of N, which means that there are increasing returns to scale. It follows that the larger the union, the lower the cost of providing the good per country.

Private income per country also depends on the size of the union and is given by Y(N). The government is financed through a non-discriminatory tax denoted by t. The government finances the public good and distributes the difference between tax revenue and the cost of public goods provision to a group of countries called the sharing coalition. Assume that a group of L countries forms the sharing coalition while the other S=N-L countries consider secession. Let us also assume that there is no separation into a sharing coalition and the rest in the newly-formed union. Suppose that there is also a clause specifying that countries which leave the union pay a transfer T, per country leaving, to the remaining countries (or receive a transfer from the remaining countries if T is negative). Under these assumptions, the seceding countries should be indifferent to staying in the union and leaving if

$$(1-t)Y(N)=Y(S)-C(S)/S-T$$

which implies that the maximum tax rate compatible with preventing secession is given by

$$t=1-Y(S)/Y(N)+C(S)/[SY(N)]+T/[Y(N)].$$

The highest possible tax rate is increasing in i) the private income gain associated with being member of the larger union, ii) the increase in costs associated with providing the public good in a smaller group of countries and iii) the secession fine paid by the seceding countries.

Implications of the Model for a Euro Exit Clause

What are the implications of the Buchanan-Faith model for the issue of a euro exit clause? According to the model, the role of an exit clause is primarily to prevent the exploitation of individual member states. The model also implies that countries that expect disadvantages from redistribution as members of the currency union should be willing to accept higher hurdles for exit if internal institutions support hard budget constraints and the no-bailout rule.

The Buchanan-Faith model also implies that neither exit nor redistribution is ever socially desirable. In a currency union neither of these two assumptions is entirely appropriate. Firstly, there may be situations where exit from the currency union is socially desirable. In the recent Eurozone crisis one of the key arguments of those supporting Grexit was that Greece needed to devaluate to regain competitiveness and that internal devaluation would not work, or would be too costly. Along the same lines one could argue that the exit by a highly competitive country could be desirable if that would lead to an external devaluation for the remaining countries. Those who reject these arguments claim that differences in competitiveness can and should be addressed by the internal revaluation of the more competitive countries. There may, however, be scenarios whereby this internal revaluation is simply too costly.

Similarly, it may not be redistribution but insurance, namely ex post redistribution, that has a role to play in a currency union. There is an inherent instability in currency unions related to the fact that member state governments do not have access to a central bank as lender of last resort. This makes highly-indebted countries and banks vulnerable to run situations.

One solution to this issue is that both countries and banks maintain sufficient buffers so that runs do not occur, not even in economic crises. Unfortunately, many of the Eurozone member states have accumulated high levels of public debt, which are far higher than the debt limit of 60% of GDP stipulated in the Treaty of Maastricht. This implies that these countries will be vulnerable to runs, at least for the foreseeable future. This means that the Eurozone needs something like a lender of last resort. The ESM currently plays this role. Through the Outright Monetary Transactions (OMT) programme the ECB has also positioned itself as a lender of last resort, which is a controversial part of its crisis management.

The issue of vulnerability to runs is directly related to the exit issue. If a member state is seen as a candidate for exit, this gives rise to uncertainty and increases risk premia. In extreme cases launching a debate over an exit may even trigger a run, which could in turn increase the pressure on a member state to leave. If the existence of an exit clause increases the likelihood of exit compared to a situation without such a clause, there may be a cost in terms of higher economic uncertainty or a lack of commitment (Bordignon and Brusco 2001), which will be reflected in higher risk premia.

Taken together these considerations suggest that an exit clause should achieve two objectives. Firstly, it should be acceptable for countries that are worried they may lose out through redistribution or bailout pressures. This requires low hurdles for exit unless other institutions credibly guarantee limits on redistribution, hard budget constraints and no-bailout. Secondly, the exit rule should not create uncertainty by undermining commitment to remaining in the currency union. This requires high hurdles or even (financial) exit penalties, as suggested by Huysmans and Crombez (2016). Incentives to leave should be avoided. This trade-off highlights the role of internal institutions, which guarantee a hard budget constraint and no bailout. If these institutions are credible, it should be possible to reach a consensus on exit clauses with high hurdles, where the cost of exit is primarily borne by the country leaving the union, or at least financial incentives to leave are avoided.

Content of an Optimal Euro Exit Clause

How should an exit clause be designed beyond the general principles described in the preceding section? The first question is who should be allowed to trigger an exit. As explained in the preceding section, a currency union requires a high degree of commitment from its members to avoid unnecessary uncertainty and financial fragility. This suggests that there should be high hurdles to Eurozone exit. However, since the Eurozone consists of ultimately sovereign states, a country will always be able to withdraw from the euro and introduce its own currency. Therefore, a euro exit clause should follow Article 50 TFEU in stating that member states can decide to withdraw according to their own constitutional requirements. Things are different when it comes to the expulsion of a member state. Here high procedural hurdles like those of Article 7 TFEU would be appropriate.

Clearly a euro exit clause should allow member states to remain in the EU. Since the EU treaties require all member states (with the exception of the UK and Denmark) to join the euro when they are ready to do so, euro exit would by definition mean a temporary exit. Of course, if a country really leaves the euro, re-introducing it will be practically off the agenda for at least a couple of years.

One important difference compared to Article 50 TFEU is that there can hardly be a two-year delay between the decision or the announcement to leave and the actual leaving date. Capital controls would have to be introduced immediately after the announcement in order to prevent capital flight either into or out of the country leaving the currency union. An exit clause should also include provisions regarding the financial arrangements. As explained above, financial incentives to leave should be avoided. Firstly, the national central bank needs to be disentangled from the European System of Central Banks. Secondly, redenomination of private contracts is necessary. These are hugely complex tasks and avoiding financial incentives to exit raises the prospect of some particularly unpleasant trade-offs. For instance, if a European system of deposit insurance is introduced in the future, will deposits in a country that leaves the euro still be covered in euros? If so, a financial incentive to leave is created for countries with weak national currencies. If not, bank runs may occur if the redenomination risk grows. The whole point of introducing a common system of deposit insurance in the Eurozone is to prevent such runs. Another financial incentive that should be avoided is the accumulation of high levels of debt, which can be written down after exit. This suggests that unsecured debts, and particularly today's very high TARGET balances, are a potential source of destabilisation for the currency union (Sinn 2014).

[16] In principle explicit exit clauses may also make exit more costly. Article 50 TFEU implies that membership of the exiting country ends automatically two years after notification. This probably increases the cost of exit relative to a situation where longer negotiations are possible.

CONCLUSIONS

The current debate over Eurozone reform offers an opportunity to consider the introduction of a euro exit clause. The current setup, whereby the only available exit clause would force a country that wants to leave the euro to leave the EU (Article 50 TFEU), is problematic. One reason why the member state governments and European institutions are sidestepping this debate is the concern that starting it could be perceived as signal that the Eurozone wants to expel a given member state, or that a member state wants to leave.[17] It is correct that introducing an exit clause for the Eurozone would be costly if it increased the likelihood that exit occurs. But whether it would have that effect depends on the design of the clause. At the same time, the risks of avoiding the debate about a euro exit clause are considerable. Firstly, if a country should want to leave, the cost to all member states, including the cost of potential conflict, will probably be much higher than necessary. Secondly, current developments, and particularly the accumulation of large imbalances including the TARGET balances, can create undesirable financial incentives for individual countries to leave the euro. Thirdly, countries considering entry to the Eurozone, and especially high-income countries like Sweden, may be more likely to join if an exit clause is available as a safeguard against undesirable redistribution within the currency union.

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[17] In the context of the current political uncertainty about the positions of Italy's new government regarding the Eurozone this is understandable.