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Article

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

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

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 stand-off 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 deci-

bles-griechenland-papier-im-wortlaut-anmerkungen-zu-den-juengsten-grie-
chischen-vorschlagen/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 an exit clause, debt relief, and a relaxation of fiscal rules in the Eurozone. Establishing the withdrawal framework today ensures it will be in place when it is truly needed.

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

5 Huysmans and Crombez (2016) highlight the fact that the Latin Currency Union between Belgium, France, Italy, and Switzerland, which existed from 1865 to 1937, 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).
The Eurozone is a currency union of sovereign states. In view of this fact, it is plausible that members states can withdraw from the Eurozone if they wish to; but there is no explicit legal procedure for leaving. Therefore, a 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 covers the withdrawal of a member state from 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 TFEU 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 subsidised for the currency of the Member State concerned”. The European Commission has adopted the view that the irrevocability of a 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.1

The ECB and the German government immediately threatened to take legal actions to avoid expulsion from the Eurozone.2  The Eurozone is of deemed irrevocable: “The irrevocability of a 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.”3

The Greek government immediately threatened to take legal actions to avoid expulsion from the Eurozone.4 It was stated that the euro is irrevocable.5 There is currently no legal rule in the treaties underlining the Eurozone 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.6

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.7 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.8 Dannemann (2016, p. 724-725) argues that this outcome cannot be excluded:

One fact, one can easily imagine scenarios where a member state’s conduct represents a vital threat, any functioning of the Eurozone. For example, a member state might openly declare that it would permanently disregard any rules pertaining to the Eurozone, and that there was a “real risk” of Greece the people voted against the European bailout proposal.9

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 add to the likelihood that a country would want 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 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. So the design of the exit clause that sets 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 risk premium (Huysmans and Crombez 2016). By doing so the clause would reduce the economic cost of exit for both the exiting country and the countries remaining in the currency union. It would also reduce the likelihood of the exit 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 contracts, which, if in turn, influence the economic costs and benefits of an 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 developed and 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 the number of countries in the union. If a country wants to secede, the additional cost of providing the good in the new country is given by f(N). The government is financed through a non-discriminatory tax denoted by t. The government finances the public good and distributes the difference between 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

\[
T(1-Y(N)/(Y(N)-C(S)/Y(N)+T(Y(N))/N) \quad \text{which implies that the tax rate compatible with preventing secession is given by}
\]

\[
t = 1-Y(S)/(N) + C(S)/(N)Y(N) + T(Y(N))/N
\]

The highest possible tax rate is increasing in i) the private income of those countries which leave the 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 redenomination as members of the currency union should be willing to accept higher hurdles for exit if exit is introduced with a lower risk premium than the debt limit of 60% of GDP stipulated in the Treaty of Maastricht. This implies that the eurozone 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 ECB currently plays this role. Through the Ongoing Monetary Transactions (OMT) programme the ECB has also positioned itself as a lender of last resort, which is a controversial part of its independence.

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 higher risk premia. The overall risk premium can in turn increase the pressure on a member state to leave. If the existence of an exit clause increases the likelihood of exit connected to a situation without such a clause, there may be a cost in terms of higher uncertainty or a lack of commitment (Borgonieu and Brunso 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 about the costs that they may lose out through redenomination or bailouts. This requires low hurdles for exit unless other institutions credibly guarantee limits on redistribution, for example the eurosystem. Secondly, the exit rule should not create uncertainty by undermining commitment to remaining in the currency union. This requires high hurdles or even financial (ex post) exit penalties, as suggested by Huysmans and Crombez (2016). 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 parishes unilaterally trade-off. 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 countries with weak national currency. 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 to avoid is the accumulation of high levels of debt, which can be written down after exit. This suggests that unless severe debt, and particularly very high TARGET balances, are a potential source of destabilisation for the currency union (Sinn 2014).
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.\textsuperscript{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.

REFERENCES


Duff, A. (2016), VerfBlog 2016/7/04: Everything you need to know about Article 50 (but were afraid to ask), https://verfassungsblog.de/brexit-article-50-duff/.


\textsuperscript{17} In the context of the current political uncertainty about the positions of Italy’s new government regarding the Eurozone this is understandable.