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Leaving the euro: how would it work?

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Would Ireland be better off if it left the euro and revived the Punt? Would the Greek economy recover more quickly with a new Drachma?

Much has been written about the theoretical attractions for financially troubled countries in exiting the euro-zone.

But the question of how a country would go about it is less well explored.

And the more closely you examine the question of "how" - as opposed to "why" - a country might leave the euro, the clearer it becomes that the practical difficulties are huge.

Capital flight

To establish a new currency a country would have to convert all existing euro-denominated savings at a fixed rate on a given date.

But savers and businesses would not wait passively for that date to arrive.

The main reason for creating a new currency would be to increase the country's competitiveness by making its exports cheaper.

So savers and investors would assume that the new currency would depreciate against the euro - probably very rapidly - and want to keep their savings in euros, or transfer them to another well-established currency such as the US dollar.

The first practical problem, then, is that if it becomes clear that a country is seriously thinking of leaving the euro a huge amount of money will leave the country.

This is sometimes referred to as "capital flight".

The overall effect would be to trigger huge transfers of deposits out of the country and wreck the banking system.

The government in question would almost certainly try to impose controls to prevent this kind of capital flight, but senior policy-makers are very sceptical about whether such controls would be effective in 21st century Europe.

But if a prolonged national debate about leaving the euro creates a risk of capital flight, would the alternative be to prepare in secret and announce it suddenly?

Such a plan might work in a totalitarian state, but does not allow for parliamentary debate, legislation and all the other processes of a modern democracy.

And the idea that huge numbers of new bank notes could be prepared and distributed in secret - ready for the appointed currency conversion date - is absurd.

Risky approach

However, suppose for a moment that these practical problems could be overcome, where would the country leaving the euro stand financially?

It would have a large national debt denominated in euros.

Remaining committed to paying interest on that debt in euros while tax revenues are generated in the new currency would be a big risk.

The alternative would be to announce that national borrowings have been converted into the new currency.

For overseas bond investors, this would amount to a default.

When the country wanted to borrow more it would almost certainly have to pay punitive interest rates to persuade bond market investors to participate.

Unbreakable currency?

The counter-argument to all this is that currency conversions have been achieved successfully in the past.

The euro came into circulation without too many hitches, albeit with many years of preparation.

East Germany's Ostmarks were converted into Deutschmarks.

But the key difference is that in these cases the currency into which savings were being switched was perceived to be stable. The

incentive for capital flight did not exist.

This does suggest that if the fundamental problem is substituting a weak currency for a strong one, the most practical solution would be for the strongest members of the euro-zone to leave the currency union.

It means that - in purely practical terms - Germany could leave the euro while weaker countries could not.

But while some Germans clearly feel nostalgic about the Deutschmark, it seems massively unlikely that a German government would initiate the break-up of the euro.

The euro was not designed with any possibility of break-up in mind.

Governments can choose to shadow another currency and then change their minds - the UK did just that in 1992.

Governments can create a supposedly fixed link to another currency which - in extreme circumstances - can be unfixed.

But the point of a currency union is that it is supposed to be unbreakable.

And whatever the theoretical attractions of breaking up the euro might be, the practical difficulties of doing so should not be underestimated.

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