



CENTER FOR FINANCIAL STABILITY

Dialog • Insight • Solutions

The Euro, the Snake and the Drachma

Lawrence Goodman

May 14, 2012

As time progresses and the wall of official support for Europe seems to be hitting a ceiling, other solutions must be found. It is hardly a wonder that calls for a shift in exchange rate policy are now heard more frequently and loudly.

Similarly, questions surface surrounding the sustainability of the euro as a single currency, due in part to the history of the euro. The infamous "Snake in the Tunnel" in the 1970s, the European Monetary System (EMS) in the 1980s, and the European Exchange Rate Mechanism (ERM) in the 1990s all preceded the birth of the euro. These systems each provided varying degrees of currency flexibility, while simultaneously tying the nations' exchange rate policies together.¹

Present Challenges: Looking Forward while Peering Back

Recent CFS research replicated the experience of earlier European exchange rate regimes by synthetically creating individual member nations' currencies.² The research tracked how the individual exchange rates performed over time, whether they meaningfully lost competitiveness due to the constraint of being part of the euro, as well as contemplated implications for macro policy.³

The conclusions were clear:

- The euro can and should survive in close to its present form.
- Greece and probably Portugal would benefit from exiting the euro.

As our conclusions from December are more closely becoming reality with each passing day, evaluation of previous episodes of significant currency depreciation is warranted.

Is Depreciation always Detrimental?

With the possibility of a country exiting the euro, market participants and officials now need to assess the potential impact on financial markets and macro performance.

History provides some guidance. Since 1990, there have been 25 episodes of meaningful currency depreciation - as defined by a decline in CFS real trade weighted currency indexes for 38 nations.

¹ Goodman, Lawrence and Peter Pauly, "Equilibrium Properties of the European Monetary System" – University of Pennsylvania, Economic Department Working Paper, December 1986.

² Austrian schilling-ATS, Belgian franc-BEF, Finnish markka-FIM, French franc-FRF, Deutsche mark-DEM, Greek drachma-GRD, Irish pound-IEP, Italian lira-ITL, Dutch guilder-NLG, Portuguese escudo-PTE, and Spanish peseta-ESP.

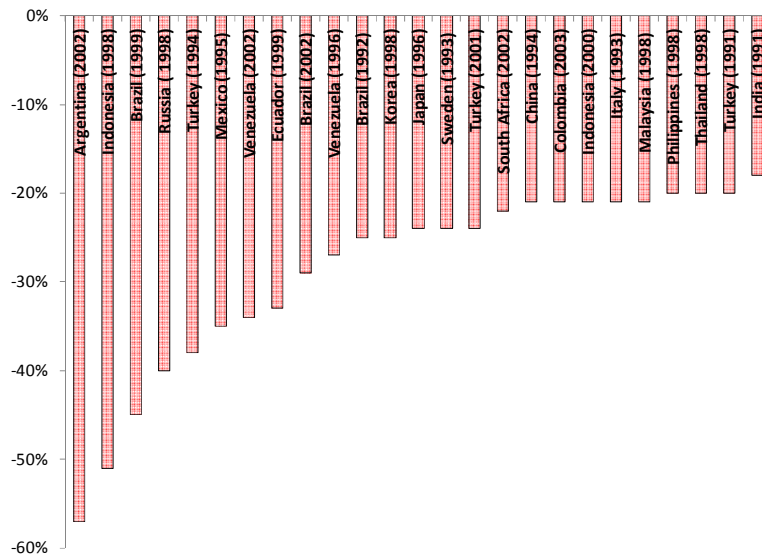
³ Goodman, Lawrence, "Does Math Support Euro Survival?" – Center for Financial Stability, December 5, 2011.



CENTER FOR FINANCIAL STABILITY

Dialog • Insight • Solutions

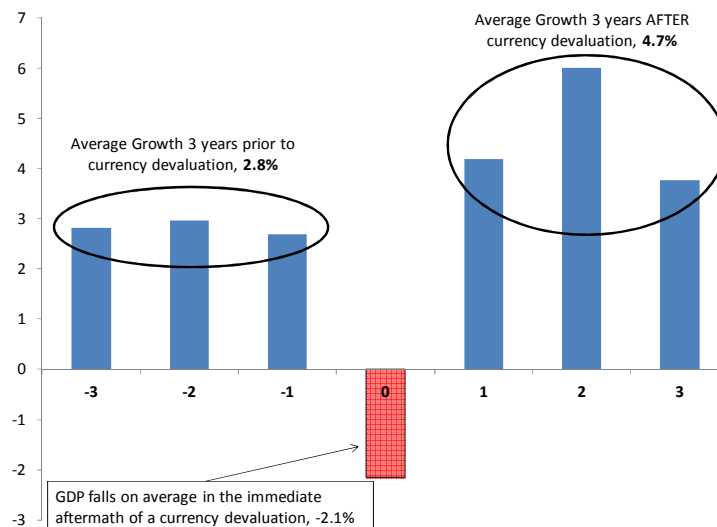
Figure 1. Episodes of Real Currency Depreciation since 1990 of >20%



Source: International Financial Statistics, Direction of Trade Statistics, and Center for Financial Stability.

Interestingly, most nations (14) actually demonstrated better economic growth in the three years after the currency depreciation relative to the three years before the exchange rate shift. In these cases of extreme foreign exchange rate depreciation, growth averaged 4.7% per annum in the three years following the weakening of the currency. In the three years prior to the depreciation, GDP growth averaged 2.8%. The longer-term improvement came at a cost. GDP typically fell by 2.1% in the year coincident with the currency depreciation.

**Figure 2. GDP Growth:
Impact of Real Currency Depreciations of >20%**



Source: International Financial Statistics, Direction of Trade Statistics, and Center for Financial Stability.



CENTER FOR FINANCIAL STABILITY

Dialog • Insight • Solutions

Conclusions

Ongoing stress in European financial markets is not surprising and will likely continue.

Fortunately, exchange rate regime shifts often unleash favorable macroeconomic outcomes under the right circumstances.

Thus, any exit from the euro must be accompanied by a well sculpted alternative exchange rate regime and macro policy mix.

With thanks to Jeff van den Noort for extensive use of technology and computer programming in developing CFS models and to Bruce Tuckman and Robin Lumsdaine for comments.

**CFS real effective exchange rate data
for synthetic euro component currencies
are available at:**

www.CenterforFinancialStability.org/euro.php

The Center for Financial Stability (CFS) is a private, nonprofit institution focusing on global finance and markets. Its research is nonpartisan. This publication reflects the judgments and recommendations of the author(s). They do not necessarily represent the views of Members of the Advisory Board or Trustees, whose involvement in no way should be interpreted as an endorsement of the report by either themselves or the organizations with which they are affiliated.