THE TIMES

For Britain, collapse of the euro needn't be a disaster

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Last updated at 12:01AM, May 8 2012

The currency is now more likely to fail, but immediate action will protect us

If the new President of France lives up to his rhetoric and attempts to stimulate growth through further borrowing, then the death of the euro may be closer than even the most bearish of us feared.

The economics of issuing government debt to stimulate growth is a dangerous game for any country, and not just because the money is often wasted on hopelessly unproductive political projects. The risk is that markets lose faith in the state's ability to repay its debt. If this happens, then borrowing costs for the whole economy go up as investors seek a premium to cover the additional risk. At the same time, the exchange rate is likely to fall, as overseas investors sell risky assets in the overindebted state.

Now you might think that France, being in the euro, would be protected from the punishing judgment of the foreign exchange markets. Up to a point you would be right, but there's a catch.

The effect of France's borrowing would have implications for all eurozone countries, not least Germany. For in as much as German creditworthiness supports its more profligate European partners, their profligacy undermines the financial stability of Germany and indeed all other responsible members of the club.

That is why northern European leaders required Spain, Italy, Portugal and Greece to stabilise their national debt. And this leads to many in the southern European states feeling (not unfairly) that austerity has been forced upon them by an over-mighty Franco-German axis.

How will the unemployed of Spain (a staggering 25 per cent) feel about their financial straitjacket when the French Government decides its own population cannot bear a far smaller dose of austerity? The current rise of anti-austerity parties in Greece is testament to the risk. Some countries might simply decide to abandon austerity themselves and with that we would have an implosion, the end of the euro.

Of course President Hollande's victory does not guarantee the demise of the euro, but it nudges it closer to the precipice. We need to start thinking about what we should do.

Nobody knows exactly how the euro will be unwound, which is why I set up an economics prize to discover how this might best be done. However, the most likely scenario would appear to be the exit and concurrent devaluation of one or more of the weaker southern European countries.

Within those countries many commentators believe that any contracts made under the legal system of the departing nation — mortgages, wages, bills — will be re-denominated into the new local currency.

The problem is that the new Southern currencies (in pound terms at least) will be worth very much less than the old euro. To a foreign lender, the country will have unilaterally written down the value of its debts — default by another name.

Many times in the past such devaluations have been shortly followed by dramatic recovery. So, maybe not such bad news for the departing nation, but it leaves a legal and financial mess for overseas investors, most importantly the banks.

Imagine that Spain fell out of the euro. A UK citizen owning a Spanish villa is likely to see his property plummet with the new currency. But if he took out a euro mortgage with a Spanish bank, his mortgage repayments will also be in the new currency and will have similarly fallen. In pound terms he has a less valuable house but a smaller mortgage.

But what about his bank? It might have funded the mortgage with money deposits taken in Germany. These would have to be repaid in new (more expensive) German euros. The bank would suffer a serious loss, the difference between its expensive German deposits and its devalued Spanish mortgages.

So how can Britain ensure that, if the euro does collapse, our economy is as well protected as possible from the inevitable fallout? There are three areas we need to worry about. First, those who have euro deposits in southern European banks might be wise to transfer them, either to British banks or other northern European ones. And if you own a property in any southern eurozone country, it makes sense to ensure that any mortgage lent to you there is financed in euros.

Second, businesses with long-term contracts, denominated in euros, should make legal provision for the possibility for a euro collapse, with clear agreement as to what currency the contractual liabilities should be paid in if the eurozone breaks up. Nor should we limit our worries to contracts with southern European companies. The sounder economies are likely to possess a much stronger euro or their own new, stronger currency. For a British business, a long-term contract with a German supplier could suddenly get much more expensive if it is denominated in the German successor currency.

Third, and most importantly, British banks must ensure that the loans they have made in southern European countries are funded by deposits (or other funding) taken in that country and subject to the local law of that country. In simple terms, banks must make sure that the amount they lend, say, in Spain is no greater than the sum total of their Spanish deposits (or other funding). British banks with Spanish subsidiaries should be bridging any shortfall through borrowing from the central bank of Spain, not their depositors in London.

The demise of the euro and the turmoil in our largest export market will undoubtedly harm the UK economy. But the better prepared we are, the less likely it is to be a catastrophe. The more we plan, the safer we will be: a lesson that might well be useful in the eurozone itself.

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