SPECIAL REPORT

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Wolfson Economics Prize 2012

Summary of the winning entry

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- **A team from Capital Economics, led by Roger Bootle, has won the Wolfson Economics Prize 2012**. The Prize, which is the second-biggest award to an economist after the Nobel Prize, sought to find the best answer to the question: "If member states leave the Economic and Monetary Union, what is the best way for the economic process to be managed to provide the soundest foundation for the future growth and prosperity of the current membership?".
- **The most realistic scenario for euro break-up is that one or more of the weaker peripheral countries will leave the euro-zone, introduce a new currency which then falls sharply, and default on a large part of their government debt.**
- Other forms of break-up are possible but the analysis of these will involve the same issues, albeit, in the case of strong countries leaving, often with the signs reversed. Accordingly, our analysis centres on the departure of a single weak member, and we then note any instance where the issues and conclusions need to be modified for other forms of break-up.
- It will not be possible to be open about preparations to leave for more than a very short period of time without precipitating damaging outflows of money which could cause a banking collapse. Accordingly, **preparations must be made in secret by a small group of officials and then acted on more or less straightaway**.
- Given the short time from announcement to implementation, it will not be possible to have new notes and coins available immediately when a country exits the euro. This is unfortunate, but it is not as serious as is often imagined. **The authorities should allow euro notes and coins to continue to be used for small transactions**. But straight after the decision to leave the euro has been announced, they should commission new notes and coins to be produced as soon as possible.
- In order to facilitate the convenient use of euro notes and coins, to help to maintain price transparency and to boost confidence in the new regime, **we recommend that the new currency, say the drachma, is introduced at parity with the euro**. Accordingly, where a price used to be 1.35 euros, it would now be 1.35 drachmas. Of course, the drachma would be free to fall on the foreign exchange markets and indeed it is vital that it should do so.
- **We reckon that if any or all of the weaker members of the euro-zone left, their currencies would depreciate by something like 30-50%**. This would probably add about 10% to consumer prices, which, spread over two years, would cause the annual rate of inflation to rise by roughly half this figure. But international experience suggests that such a spike can be short-lived and inflation can then return to something like its previous level.
- Just before departure, **some form of capital controls will be essential**, including at least closure of the banks. But after departure, capital controls should be avoided and, if used, should be withdrawn as soon as possible. (Continued overleaf.)

- **The government should redenominate its debt in the new national currency and make clear its intention to renegotiate the terms of this debt**. This is likely to involve a substantial default – perhaps sufficient to reduce the ratio of debt to GDP to 60%. But the government should also make clear its intention to resume servicing its remaining debt as soon as practically possible.
- In order to restore confidence further, we recommend that the exiting country immediately announces a regime of inflation targeting, monitored by a body of independent experts, adopts a set of tough fiscal rules, outlaws wage indexation, but announces the issue of index-linked government bonds. The government should also continue with structural reforms designed to increase the flexibility of product and labour markets.
- The national central bank of the exiting country should stand ready to inject liquidity into its own banking system, if necessary by quantitative easing. The monetary authorities should also announce their willingness to recapitalise the banks if necessary.
- **The authorities should provide as much clarity as possible on the legal issues, including the status of the exiting country's membership of the European Union and the impact on international contracts currently denominated in euros**. EU approval would also be needed for any capital controls, but this would have to be sought retrospectively. All of this would require close cooperation with other EU member states and institutions, including countries in the Northern core.
- At the same time, to minimise the risk of contagion to other countries that might otherwise wish to remain within the euro (and whose interests are best served in the long-term by doing so), **the Northern core may need to accept faster progress towards full fiscal and political union**.
- **Domestic economic policy may also have to adapt**. Indeed, policymakers in the Northern core should have more freedom once they are no longer constrained by the need to set an example for weaker countries that have left. Since the value of the euro would rise, the Northern core would initially suffer from a loss of domestic demand, although it would enjoy a lower inflation rate. This combination would give it the incentive to undertake measures to boost domestic demand, especially through monetary policy and structural reforms.
- Such a rebalancing of the economy away from reliance on net exports would be in the interests of the whole of the current membership of the euro-zone, as well as countries outside it.
- Overall, **our analysis has revealed a series of very tricky issues which any exiting country would need to face. But all of these difficulties can be overcome**.