Planning for the worst is the best way to save the eurozone

There was no plan for a eurozone break-up when the European Monetary Union was created. In fact, policymakers made an effort not to spell out any procedures for an exit from the eurozone as euro adoption was supposed to be "irrevocable". But the genie is now out of the bottle.

Those who pretend a eurozone break-up is not a possibility are ignoring reality. Various forms of eurozone disintegration are possible, ranging from a very limited break-up (involving one or a few small countries), to a full-blown break-up (which would see the euro cease to exist). Most would agree that a Greek exit is a very real possibility. But break-up risk is not only a Greece-specific issue. The fact that Italian five-year credit default swap contracts imply a roughly 30 per cent probability of an Italian default, highlights the possibility of a full-blown break-up scenario.

The increasing risk of a break-up is already having an impact on investor behaviour. Since the Italian bond market came under pressure in mid-2011, foreign investors have been looking to reduce their eurozone exposure across the board: in the second half of 2011, we estimate that foreign investors sold €130bn worth of eurozone fixed-income instruments. This compares to foreign purchases of €320bn in the first half of 2011. This huge swing highlights the size of the shift in foreign investor sentiment.

In the past two months, we have also seen a shift in euro trading dynamics. Euro weakness is now seen in the relative strength of currencies from both emerging markets and other European countries. This is a departure from patterns observed up to November, when euro weakness was concentrated versus the US dollar and the Japanese yen. The recent broadening of the euro weakness points to nascent capital flight out of the eurozone. This would be a disturbing development.

At this point, Europe needs to spell out a contingency plan for a eurozone break-up. Since fears about a break-up are already present and affecting investors' flows, the cost-benefit analysis of announcing such contingency plans is very different to what it would have been in 1999. At this juncture, contingency plans would help to reduce uncertainty, rather than add to it.

The plan must offer guidance on orderly redenomination of euro-denominated assets and obligations in a break-up scenario. Such guidance is crucial in connection with a full-blown break-up scenario, in which the euro would no longer exist as a currency. This scenario involves a host of very complex redenomination issues. In particular, a very large number of assets and obligations are subject to English law (not the laws of the eurozone countries), and it is highly uncertain how the redenomination process would work for such instruments.

The logical and fair way to redenominate would be to introduce a new European Currency Unit (ECU-2). This would be a basket currency linked to the new national currencies created after a break-up – akin to the original ECU basket. Current European Central Bankcapital weights could be used to define the currency weights in the basket.

The value of the new ECU would be mechanically linked to the performance of the new currencies of previous eurozone countries, and the redenomination process would mirror how ECU-denominated instruments were redenominated into euro in 1999. Introducing a new ECU would help to facilitate an orderly redenomination of a host of instruments such as debt issued in euros under English law, euro-denominated loans extended by global banks, and euro-denominated swaps and foreign exchange forward contracts. It would hardly make the break-up an easy process, but it would help the redenomination process by making it less inefficient and arbitrary.

Foreign investors are leaving eurozone fixed-income markets, in part due to the uncertainty about break-up and redenomination risk. A contingency plan for orderly asset redenomination in a break-up scenario could help alleviate investor worries about eurozone assets and improve the capital flow situation and funding costs. Ironically, spelling out guidelines for a eurozone break-up may – at this stage in the crisis – even help to reduce the risk of the break-up itself.

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