

Chancellor Merkel's 'new deal for the euro' confirms where euro sovereign risk lies

A recent 'alteration to the Euro rules' was announced around how a default by a euro sovereign would be handled. The 'new deal', brokered by Chancellor Merkel, envisages an orderly liquidation of the bonds of defaulting euro sovereign governments. The 'new deal' aims to ensure that holders of sovereign debt bonds will experience a partial loss of principal if there is a bailout of a euro nation, thereby reassuring voters that Germany does not underwrite the obligations of the rest of the eurozone.

The key point here is that there were no rules to be altered. All that Chancellor Merkel has done is to make clear the existing situation. The fact that there was any doubt about this – and the fact that the EU and eurozone governments have allowed ambiguity to hang around this issue - exposes the ambiguities around the euro as a currency.

The central ambiguity is that the euro lacks a risk-free investment which normally acts as the anchor point for the financial market in the currency. The risk-free investment is normally the bonds issued by the government in its own currency: by the US government in US dollars, by the UK government in pounds. It is risk-free, according to the theology of sovereign debt, because the investor will always get the right amount in the currency, even if the respective government has to debase the currency by simply printing more of it to meet its obligations.

No government in the eurozone has the right to print euro, so instead each sovereign obligation represents a genuine credit risk. The markets have installed German sovereign risk as a surrogate for 'risk-free', hence the emergence of the 'Bund spread' as the expression of the credit risk premium payable by other eurozone sovereigns to reflect their divergence from the German model.

A euro-denominated sovereign obligation is as good as the underlying nation's ability to produce euro out of its own economy. There is no sharing of debt liability between the euro countries just because they share the currency in which the bonds are denominated. In that sense a euro obligation of the UK or Denmark has no different status just because these countries have a different legal tender for daily use, namely pound and kroner.

However, there is a joint underwriting of the legal tender aspect, and this is the crux of the problem: there is an effective sharing of the liability under euro note and coin that can be tracked back, through the note and coin issuers (the central banks) to their owners (the sovereign states). The physical form of the currency is then effectively a joint and several liability of the eurozone members, exercised through the European System of Central Banks, but the non-physical form is not.

The objective of the anomaly is to deny the central banks of the eurozone nation states (the Eurosystem members in the eurozone) the right to print the currency to cover the nation's spending deficit, a right that the non-eurozone members of the Eurosystem retain regarding their national currency. In the euro that link is broken, so the nation state itself stands (or falls) on its own.

Sovereign obligations in euro are several and not joint, notwithstanding the policy measures and agreements taken to foster convergence and to bring about a situation where the euro economies were so intertwined and successful that the relative sovereign risks evened out.

These policies were firstly the Exchange Rate Mechanism aimed at squeezing out exchange rate fluctuations. Secondly the Maastricht Criteria, the qualifying criteria for a country to join the euro, aimed at convergence of inflation, interest rates and public debt. Thirdly the Stability and Growth Pact, to govern the economies in the euro after its establishment, to control budget deficits and government debt.

In this process eurozone members handed over control of foreign exchange and monetary policy to EU institutions, those being main policy levers of a sovereign central bank (or Finance Ministry), along with monopoly control over the supply and production of the state's currency.

Notwithstanding the handover of powers, certain practical aspects remain decentralised such as note and coin issuance. This has led to a lack of clarity as to who is on the hook to pay as primary and secondary obligors, a situation that has benefited the euro and its weaker members.

The grey area at the centre of this is the respective powers and resources of the European Central Bank (ECB), as opposed to the European System of Central Banks, or Eurosystem, as opposed to the eurozone National Central Banks. The Eurosystem consists of the ECB and all the National Central Banks (NCBs) of the whole EU: the eurozone NCBs are one subset of the Eurosystem, the non-eurozone ones are the balance. While the NCBs are presented as branches of the ECB, in fact they still have an autonomous and sovereign status in national law and are owned by their nation state.

The NCBs are the issuers of notes and coins – euro ones if the country is in the eurozone, or national legal tender if it is not. All the euro notes appear identical, whilst the coins have national characteristics, but the curiosity is that the euro notes bear no words, just the abbreviation ECB in several languages, the word Euro and a signature with no name against it. There is a degree of obfuscation.

Contrast that with:

- Pounds – “Bank of England I promise to pay the bearer on demand the sum of n pounds, signed by Andrew Bailey, Chief Cashier”
- US Dollar: “Federal Reserve Note The United States of America This Note is Legal Tender for all debts Public and Private, signed by Treasurer of the United States and by the Secretary of the Treasury”
- Danish kroner: “Danmarks Nationalbank Issued in accordance with the law governing Denmark's central bank”

Who has the liability to pay out on euro note and coin? Euro note and coin are fully fungible, and can be converted into central bank money, without the respective central bank distinguishing between note and coin it issued itself from those issued by a sister eurozone NCB. So far so good. If all eurozone NCBs have equal and shared liability to pay out, then you have a real currency, as long as the backing for the currency is shared.

But the backing isn't shared, because the bullion and currency reserves backing the euro are owned by the eurozone NCBs, not by the ECB. The non-eurozone NCBs have control their own foreign exchange and monetary policy, and their own reserves, and there is no sharing whatsoever.

Against that background it cannot be a surprise that the capital markets are increasingly looking through the currency simply to each sovereign's ability to pay, and looking past any policy measures that were aimed at economic convergence superseding the issue of variations in creditworthiness.

The policy measures (ERM, Maastricht, Stability & Growth Pact) have not worked. In fact they have had in some ways the opposite effect. Not least by targeting a measure of inflation that excluded real estate prices (a mistake shared by Gordon Brown with disastrous consequences in the UK as well), the ECB's interest rate policy has brought about a broad spectrum of real interest rates over a 10 year period across the eurozone: the bid-offer is as much as 5%. Germany had real interest rates of +2%, Spain of -3%.

This divergence is now reflected in the "Bund spread": the difference between the yield on the bonds of each eurozone sovereign compared to the sovereign bonds of Germany. "Bund spreads" of 4% or more reflect the economic divergence and illuminate the differences in sovereign creditworthiness. "Bund" or "Bundesanleihe" has been installed by the capital markets as the surrogate risk-free investment in euro.

This in turn illuminates what kind of currency the euro really is. It is not a sovereign currency of a single nation state with its own central bank, monopoly of note and coin production, risk-free investment and control of interest and exchange rates. That sovereign also offers a crystal-clear look-through into the coffers of all tax-paying entities in its country. A UK government debt in pounds carries a look-through to the entire tax production capacity of the area in which the pound is legal tender.

Nor is it a completely dematerialized currency as was the EUA (European Unit of Account) and its successor the ECU (European Currency Unit) whose irrevocable exchange rate into the Euro was 1:1. The ECU was a basket currency composed of weightings of the constituent currencies of the EU (including pound and kroner), the weightings being determined by the size of the national economies. When the ECU was converted to the euro, the weightings of the euro-out currencies were backed out.

The answer is that it is a bit of both. The note and coin are underwritten jointly and severally by the eurozone members of the Eurosystem, but a eurozone government debt in euro does not carry a look-through to the entire tax production capacity of the area in which the note and coin are legal tender. That is the point that Chancellor Merkel's intervention has brought into the foreground: the ambiguities around the Eurosystem kept the issue in the background.

A curiosity in this is that a eurozone nation's bullion and currency reserves back both the liability for sovereign debt, which is several and not joint, and also the liability under note and coin, which is joint and several.

A complicating curiosity is that the debts of certain EU institutions do indeed carry a look-through to the entire tax production capacity of the EU, for example the debts of the European Community (and the European Coal & Steel Community which was subsumed into it in 2002), and of the European Investment Bank (EIB).

All EU member states are shareholders in the EIB, which is a not-for-profit bank. The EIB's self-description is that it gains its AAA rating from the identity of its shareholders, but this is only half true. The other half is the nature of the shares and the shareholders' agreement, which together oblige the EU member states, on a joint and several basis, to replenish any deficit that the EIB may incur.

The EIB is therefore not a limited liability company but an open partnership, or a Lloyds syndicate, where any member can be asked to pay in the entire deficit.

It is not entirely surprising that the EU politicians prefer this fact to be obscured. The arrangements around the euro and the financing of European institutions are a complex Venn diagramme of ownerships and

sharing of liabilities. The EU and the eurozone countries have benefited up to now from the magic dust around institutions like the EIB, which facilitated a low “Bund spread” onto other borrowers that their individual capabilities did not support. That era now appears to be ending and the precise nature of each country’s liabilities laid bare, as stronger ones seek to avoid being brought low by the weaker.

In a sense, then, the euro is both a national currency and a foreign currency for all eurozone countries: national because it is legal tender and because the national bank issues notes and coins, foreign because the national bank has no monopoly of currency issuance (and cannot print currency to meet the nation’s debts) and because control of interest and exchange rates has been given up. In addition, it is more foreign for the eurozone members who see a “Bund spread” on their own sovereign bonds (i.e. all eurozone sovereigns except Germany) because they own no risk-free investment benchmark in their own currency.

So what are the financial markets supposed to think, markets that like clarity?

Up until 1983 banks did not really appreciate the distinction between a country’s ability to meet its obligations in its domestic currency and foreign currencies. That is why Lloyds Bank International, for example, was willing to lend such large amounts into Brazil, Argentina, Mexico, Nigeria and others for capital projects with partial guarantees and credit insurance from Western governments and government agencies: the mantra was that “governments never default”.

Then, in 1983, Mexico defaulted on its foreign debt (in USD, GBP, DEM etc) but not on its peso debt, and others quickly followed suit. Lloyds Bank International was closed up by Sir Brian Pitman who moved all resources to the UK real estate market (Cheltenham & Gloucester, Gascoigne Pees, Black Horse Life).

The new mantra was then that “governments never default on obligations in their own currencies” – precisely because of the “print it” option; now we are having to refine that again to say “governments never default in their own currencies as long as the currency in question is its own sovereign currency, over which it has control of foreign exchange and monetary policy, and where it owns the bullion and currency reserves that back it directly or through its central bank”.

That is too complex for the markets to deal with so they look through the currency of the debt to the tax raising capacity of each country individually and its individual bullion and currency reserves, regarding the currency issue as a smokescreen, the currency in the case of the euro being synthetic because its usage denotes participation in a Venn diagram of institutions, policies, resources, rights and responsibilities which do not add up to the same bundle existing in a currency where the risk on the currency and on the nation associated with it are one and the same.