

FINANCIAL NEWS

Merkel highlights fault lines in the euro

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German chancellor Angela Merkel has said she 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. Some took the claim as a new tough measure to reassure her country's voters that they would not underwrite the obligations of the rest of Europe.

But there were no rules to be altered. Chancellor Merkel has merely clarified the existing situation and highlighted the fault lines at the heart of the euro as a currency.

On the one hand, a euro-denominated sovereign obligation is as good as the underlying nation's ability to produce euros out of its own economy. There is no sharing of liability between the euro countries just because they share the currency in which the bonds are denominated.

On the other hand, there is a joint underwriting of the legal tender aspect. Euro notes and coins are issued under joint and several liability by the European System of Central Banks – each of whom is owned by its nation state. The true nature of the responsibility is obfuscated in the notes' appearance – the coins have national characteristics, euro notes are identical – they bear no clarifying words, just the abbreviation ECB and the word euro.

Compare this to the pound. On each denominated note Andrew Bailey, chief cashier, promises that the Bank of England will pay the bearer the face value of the note on demand.

For the eurozone, being responsible for notes and coins does not mean that a central bank may produce the currency of its nation state to cover the nation's spending deficit. That link is broken in the euro, so each nation state itself stands or falls on its own, notwithstanding the policy measures aimed at a convergence of the euro economies where relative sovereign risk would be eliminated.

Euro members progressively handed over control of foreign exchange and monetary policy to EU institutions, those being main levers of a sovereign central bank, along with monopoly control over the supply and production of the state's currency.

The partial centralisation of euro roles and powers has confused who is on the hook to pay as primary and secondary obligors, a situation that has benefited the euro and its weaker members.

In the UK, where the Bank of England is owned by the government, and the government's debts are backed by the UK's bullion and currency reserves and a look-through to the tax-paying capacity of all entities that use the pound as legal tender, the country and its currency represent the same political risk.

The euro, by contrast, is a Venn diagram of respective powers and resources of the European Central Bank and the European System of Central Banks, or [Eurosystem](#), which consists of the ECB and all the national central banks of the EU.

While the national central banks are presented as branches of the ECB, they have an autonomous and sovereign status in national law and are owned by their nation states.

A situation where all eurozone national central banks have equal and shared liability to pay out would indicate a real currency, if the backing for it was also shared. It isn't. The bullion and currency reserves backing the euro are owned by the eurozone national central banks, not by the ECB. Similarly these reserves back the debts of each eurozone sovereign severally, there is no pooling.

Against that background it cannot be a surprise that the capital markets are increasingly looking through the currency of a debt 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.

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