

New deal for the euro exposes the currency as synthetic

Guest blogger, **Bob Lyddon**, managing director of the IBOS Banking Association, says alterations to the euro rules have merely served to clarify that individual countries within the eurozone are "on the hook" for their own financial difficulties. Germany will not underwrite the obligations of the rest of Europe.



The "alteration to the euro rules" brokered by German chancellor Angela Merkel, aims to ensure that holders of sovereign debt bonds will experience a partial loss of principal if there is bailout of a euro nation. "Merkel wants to reassure voters Germany won't underwrite the obligations of the rest of Europe," said Tom Sartain, a fund manager at London-based Schroders Plc.

There were no rules to be altered: chancellor Merkel has merely clarified the existing situation and 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 euro 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. A euro obligation of the UK or Denmark has no different status just because these countries have a different legal tender for daily use.

On the other hand there is a joint underwriting of the legal tender aspect: euro note and coins are issued under joint 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.

But being responsible for notes and coins does not mean that a eurozone 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 the 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.

These policy measures include the Exchange Rate Mechanism, which is designed to squeeze out exchange rate fluctuations; the Maastricht Criteria aimed at convergence

of inflation, interest rates and public debt, and the Stability and Growth Pact, to control budget deficits and government debt after euro adoption.

Euro members progressively handed over control of foreign exchange and monetary policy to EU institutions, 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.

Contrast the situation in the UK where the Bank of England issues notes and coins, and 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 (ECB)
- the European System of Central Banks, or Eurosystem - the ECB and all the national central banks (NCBs) of the EU
- the eurozone national central banks - a subset of the Eurosystem.

While the NCBs are presented as branches of the ECB, they have an autonomous and sovereign status in national law and are owned by their nation state. A situation where all eurozone NCBs have equal and shared liability to pay out would indicate a real currency, if the backing for it was also shared.

But in fact it isn't: the bullion and currency reserves backing the euro are owned by the eurozone NCBs, not by the ECB. Similarly these reserves back the debts of each eurozone sovereign: there is no pooling.

Against that backdrop it should come as no surprise that the capital markets are increasingly looking at 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.