

## Take it to the bank

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The euro is used by many European countries but each nation still has its own liabilities for the currency

A recent alteration to the Euro rules brokered by German chancellor Angela Merkel aims to regulate the default of a Eurozone sovereign and ensure that holders of sovereign debt bonds will experience a partial loss of principal in a bailout.

Tom Sartain, a fund manager at London-based Schroders, said: "Merkel wants to reassure voters Germany will not underwrite the obligations of the rest of Europe."

There were no rules to be altered, chancellor Merkel has clarified what exists. The existence of doubt - and that the EU and eurozone governments allowed doubt to linger - exposes the fault lines at the heart of the euro as a currency.

A euro-denominated sovereign obligation is as good as that nation's ability to produce euros from 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. 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 the pound and kroner.

Sovereign obligations in euro are several and not joint. The legal tender aspect, however, is jointly underwritten. Note and coin are issued under joint and several liability by the European System of Central Banks, each owned by its nation state. But this role does not extend to producing the currency of the state in sufficient quantities, on occasions, 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.

Today's situation contrasts with the policy measures aimed at bringing the euro economies so into convergence that the relative sovereign risks evened out.

These policies were first the exchange rate mechanism to squeeze out exchange rate fluctuations. Second the Maastricht criteria - the qualifying criteria for a country to join the euro - aimed at convergence of inflation, interest rates and public debt. Third the stability and growth pact to govern the economies in the euro after its establishment, to control budget deficits and government debt.

Euro members handed over control of foreign exchange and monetary policy to EU institutions, those being main policy levers of a sovereign central bank, along with monopoly control over the supply and production of the state's currency. A eurozone central bank could no longer produce currency by issuing bonds to fill a deficit.

As with note and coin, other practical aspects remain decentralised. This has led to a lack of clarity as to who is on the hook to pay as primary and secondary obligors, to the benefit of the euro and its weaker members.

The Venn diagram of respective powers and resources of the European Central Bank, as opposed to the European System of Central Banks, or Eurosystem, as opposed to the eurozone National Central Banks lies at the heart. The Eurosystem consists of the ECB and all the NCBs of the whole EU, the eurozone NCBs are a subset of the Eurosystem. 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 or the national legal tender. All the euro notes appear identical, while the coins have national characteristics, but the euro notes bear no words, just the abbreviation ECB in several languages, the word Euro and a signature.

Contrast that with the clarity around the pound – Bank of England, I promise to pay the bearer on demand the sum of x pounds, signed by Andrew Bailey, Chief Cashier.

The inference is that it is the ECB who has the liability to pay out on euro note and coin, but the ECB has no bullion or currency reserves and is not the note issuer. On this point all eurozone NCBs have equal and shared liability to pay out. If backing for the currency and liability were both shared, then you have the bones of a real currency. But they are not. The situation is asymmetrical, liability is shared but the bullion and currency reserves backing the obligation are owned by the eurozone NCBs individually, not by the ECB.

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 resources and overlooking policies aimed at smoothing out variations in credit worthiness.

ERM, Maastricht and the SGP have failed, not least by targeting a measure of inflation that excluded real estate prices. The ECB's interest rate policy has fostered a 5 per cent wide spectrum of real interest rates. Germany had real interest rates of +2 per cent, Spain of -3 per cent.

This divergence is now reflected in the Bund spread, the yield differential on the bonds of each eurozone sovereign compared to bonds of Germany. Bund spreads of 4 per cent or more reflect the economic divergence and the differences in sovereign creditworthiness.

This in turn illuminates the 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, and control of interest and exchange rates. 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 a dematerialised currency like the European currency unit, exchanged into the Euro at 1:1. The ECU was a basket currency composed of weightings of all the constituent currencies of the EU.

The answer is that it is a bit of both. 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. The new deal clarifies this, while not dispensing with the ambiguity that a eurozone nation's bullion and currency reserves asymmetrically back both the liability for sovereign debt, which is several but not joint, and also the liability under note and coin, which is several and joint. In parallel the EU nations carry joint and several liability for any deficit incurred by EU supranational institutions like the European Investment Bank, the key to its AAA rating.

It is not entirely surprising that the EU politicians preferred that the Venn diagram remained obscure. Eurozone countries have benefited from a magic dust that facilitated a low Bund spread for weaker borrowers. The dust has been blown away and the precise nature of each country's liabilities laid bare, as stronger ones seek to avoid being brought down by the weaker ones.

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 it has no monopoly of the euro notes and coins and because control of interest and exchange rates has been given up.

The mantra governments never default was long ago to be replaced with governments never default on obligations in their own currencies. Markets will not accept a version that governments never default in their own currencies as long as the currency in question is its own sovereign currency.

That is too complex. Markets will look through the currency of the debt to the tax-raising capacity of each country individually and its individual bullion and currency reserves. Markets view the harmonisation of legal tender as a smokescreen and synthetic because euro usage denotes participation in a patchwork of institutions, policies, resources, rights and responsibilities which do not add up to the same bundle in a currency where the risk on the currency and on the nation associated with it are one and the same.

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