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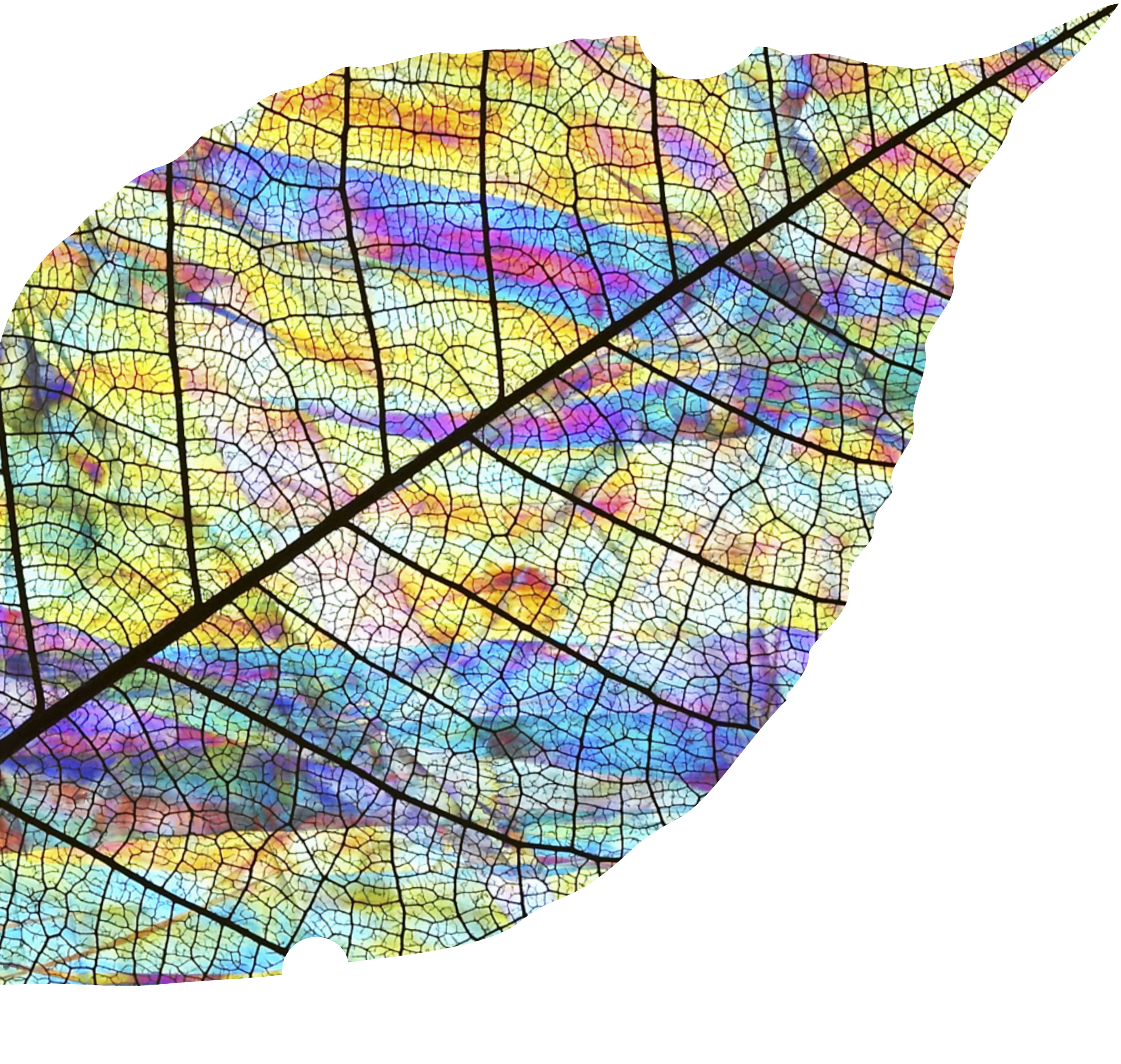
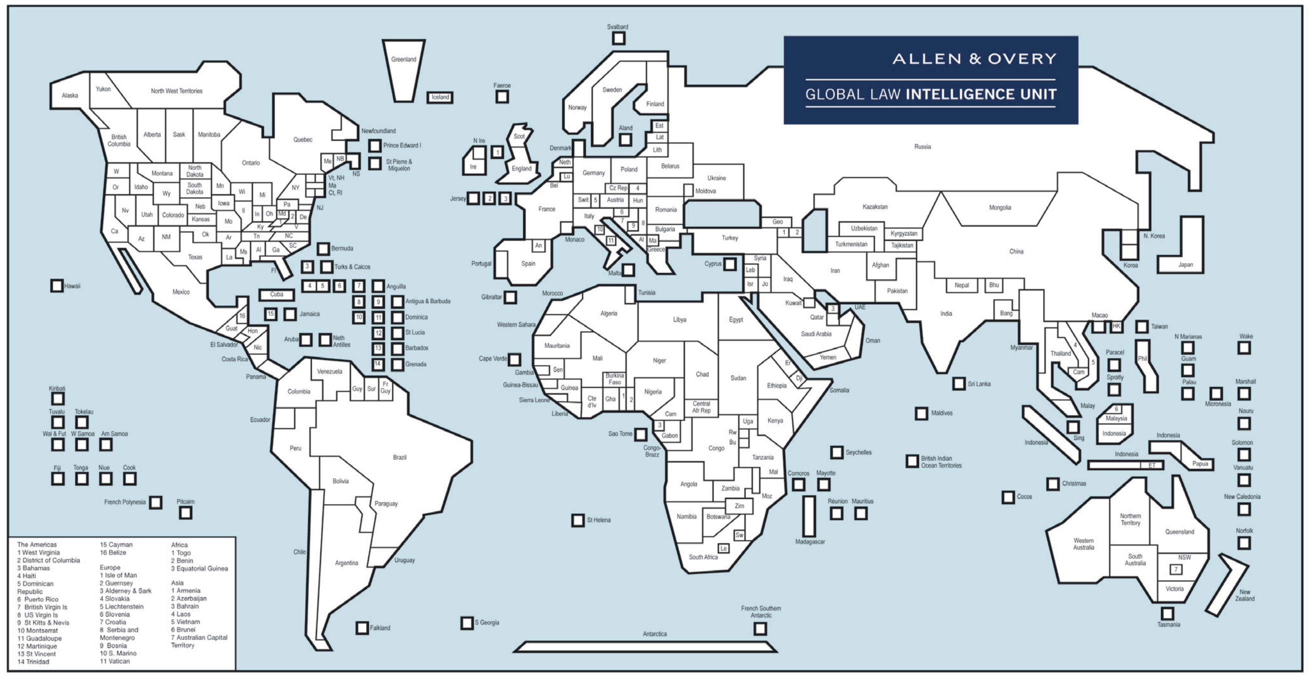


The euro and currency unions

October 2011

Key map of jurisdictions



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Introduction

This paper reviews the role of the euro in the context of the formation and break-up of currency unions.

We consider the impact not just in relation to sovereign states but also corporations and banks.

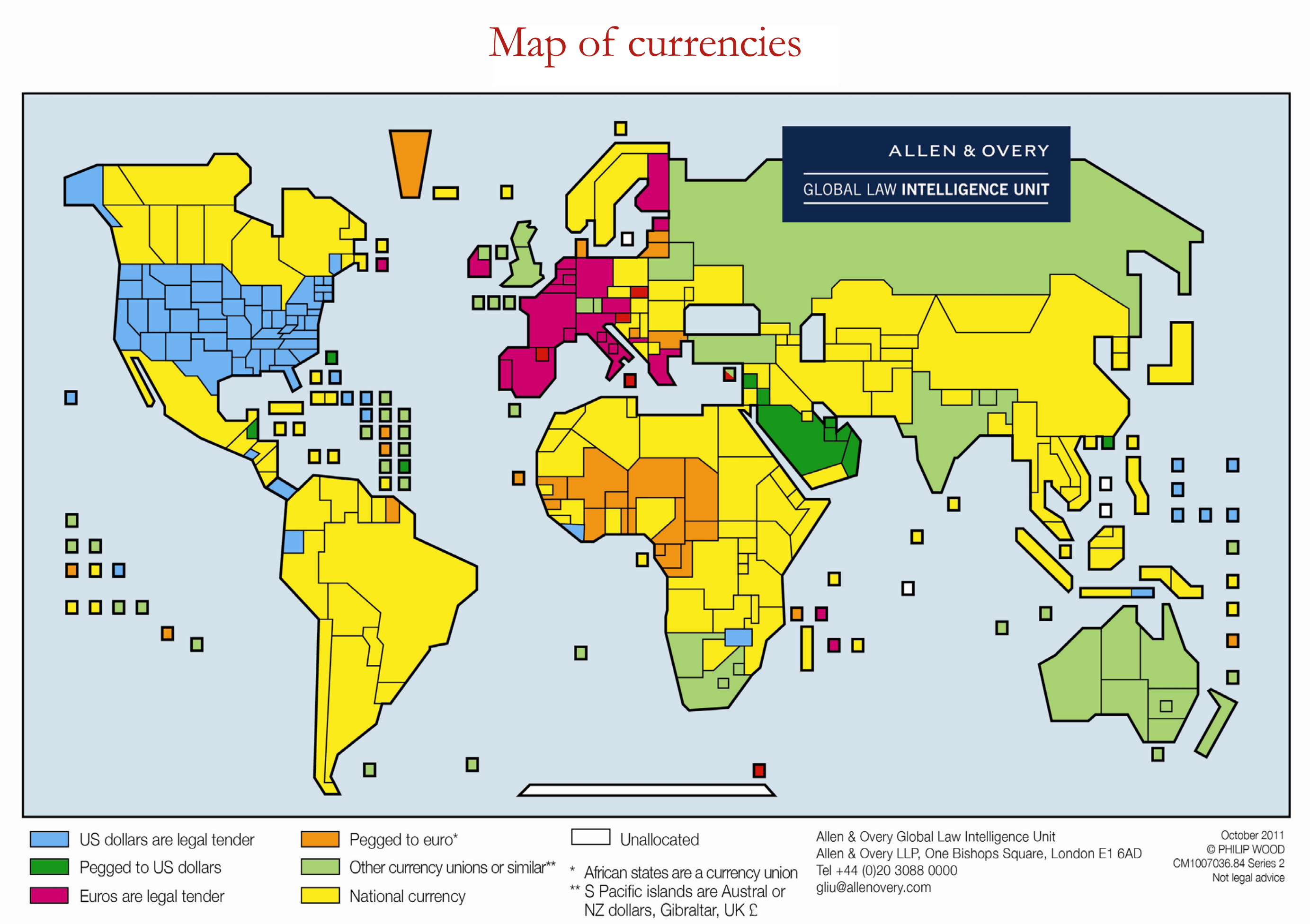
We deal with various questions raised by market participants about what would happen if the euro broke up and how this would work. We do not express a view as to whether the talk predicting a breakup of the euro is the profound foresight of great thinkers or just vapid gossip.

The views of the executive of the Intelligence Unit as to whether or not breakup of the eurozone currency union would be a bad idea will appear in the course of this paper.

Currencies are creatures of the law. They are also subject to the rule of law – or should be.

Map of world currencies

Set out below is a map showing the currencies of the world. On the back of the front cover page there is a map identifying the jurisdictions.



- Jurisdictions where U.S. dollars are legal tender.
- Jurisdictions where the currency is pegged to U.S. dollars.
- Jurisdictions where the euro is legal tender.
- Jurisdictions pegged to the euro. The African states coloured orange are a currency union.
- Other currency unions or similar currency federations. The South Pacific islands are based on Australian or New Zealand dollars. Gibraltar has the British pound.
- Jurisdictions which have their own national currency.
- Jurisdictions which are not allocated in the map to one of the other groups for various reasons.

Altogether there are between 130 and 140 currencies in the world. There are about 195 sovereign states at present so at least we are making some progress in reducing the number of currencies.

Money is the product of a large part of the value of the work of the people of the planet. The foreign exchange market, which involves the sale of one currency for another, is by far the largest market in the world. Annual volumes are about one quadrillion which is one plus 15 zeros as follows, expressed in U.S. dollars:

1,000,000,000,000,000

This number is about 20 times world gross domestic product. Average daily value is well over USD5 trillion which is somewhat less than half of the GDP of the United States. Peak day amounts had been well over USD10 trillion. This approaches the GDP of the eurozone.

It follows therefore that this massive market for currencies is much bigger than the market for bonds or shares or other securities, much much bigger than the market for commodities, such as oil or minerals, and much, much, much bigger than the market for land.

The volume of money which is traded vastly exceeds the quaint money of ancient times in the form of cowrie shells or gold.

We can assume therefore that currency plays some uniquely important role in our societies.

Currency unions

Presently there are several currency unions in the world where two or more sovereign states share a common currency. The eurozone is the most important. The biggest changeover in the history of money was completed in the first two months of 2002 when twelve nations and 300 million people switched to the euro.

In addition, there is the CFA Franc zone pegged to the euro. This zone is made up of the Central African Monetary Union and the West African Monetary Union. Then there is the East Caribbean Monetary Union, formed in 1965.

There has been discussion about a currency union in the existing Economic Community of West African states and a monetary union of some of the states which are members of the Gulf Cooperation Council.

There are numerous historical examples of currency unions, eg the 19th century Latin Monetary Union, the Scandinavian Monetary Union of 1873, the German Zollverein of 1834 and the Rhenish Monetary Union of 1385. Other cases of de facto unions where money circulated outside the issuing state include the Roman denarius, the Byzantine solidus (produced for 700 years), the penny introduced in the 8th century by Pepin (the father of Charlemagne), the Florentine florin, the Spanish real, and the Maria Theresa thaler.

Currency unions express common interest and interpendency. They are not there just for functional utility.

Break-up of currency unions

The break-up of currency unions is well precedented historically.

Relatively recent examples are the breakup of the USSR after 1989, and the breakup of Yugoslavia: Slovenia was the first to adopt another currency (the tolr – which, if you pronounce it correctly, sounds like "dollar") at a time when the Yugoslavian dinar still existed. In the early 1990s the Czech Republic and the Slovak Republic both adopted their own crown on a one-to-one ratio.

Around the 1960s, de-colonisation of western European empires led to the fragmentation of currencies which were formerly, for example, based on the British pound sterling or the French franc.

In June 1948, both parts of Germany discontinued the Reichsmark and introduced the Deutschmark. In the 1920s, the Republic of Ireland separated from the UK. Earlier in the century Australia introduced its own currency alongside the UK pound.

The split of the U.S. dollar following the breakaway of the U.S. Confederacy at the time of the American Civil War is another example. There are many more.

Break-up of federations

The break-up of currency unions have typically been associated with the break-up of federations or other political units.

If a federation breaks up, the resulting partition of assets and liabilities is generally settled by treaty, but, if not, by the law of state succession. State succession is the subject of the Vienna Convention on Succession of States in respect of State Property, Archives and Debts of 1983. The Convention never came into force – mainly because some of it reflected the argumentative views of recently decolonised states. Nevertheless it contains much useful guidance.

How could the eurozone break up?

The withdrawal of a member state from the euro or the collapse of the euro itself, if it ever happened, would be a major event which one would expect to be dealt with at the political rather than the legal level. Nevertheless, we summarise the technical legal position, however theoretical, because strict legal rights, even if never exercised, are an important factor in determining bargaining positions.

There are many ways in which the eurozone could break up, if it ever were to do so. A single country could leave or a group of countries could leave. The euro could disappear or it could be given some new name. The zone could break up into two blocs. It could break up into three blocs. There could be more blocs.

On the other hand, other countries could join in in order to protect their economies. Countries outside the current eurozone and even outside the current EU could decide to unilaterally adopt the euro: there are a huge number of examples of this process elsewhere, eg the dollarization of Panama.

Countries could have their own currencies but peg or link them to the euro or operate some kind of snake. All manner of splintering and fragmentation can be conceived by the imagination, although contrary to reality.

Rights of withdrawal from the eurozone

The better view is that a eurozone country could legally abandon the euro and adopt a new home currency in place of the euro only if (1) the withdrawing country ceased to be a member of the European Union itself or (2) obtained the agreement of all the other members of the European Union, including non-eurozone countries like the UK and Sweden.

This is because article 50 of the Treaty of Lisbon allows a member to withdraw from the European Union under an agreement approved by 72% of the members of the European Council. If no agreement is reached, the member state can exit the European Union unilaterally after two years. This would probably carry with it a departure from the euro, although legally this is perhaps not necessarily the case and commentators differ in their views.

The European treaties are vague on the subject of member states leaving the euro. When the treaties were negotiated, it was felt that explicit rights of withdrawal might damage confidence in the new currency. So there is a legal vacuum which has to be filled by implications and inferences, thereby leaving room for differences of opinion.

There are no explicit legal rights to expel a state from the EU or the eurozone.

Legal rights against a member withdrawing from the eurozone unilaterally

A treaty is just a contract and contracts do get broken. The question therefore is what the legal position might be if a eurozone member unilaterally decided to withdraw from the eurozone in violation of the treaty and to create some new currency at a specified rate of conversion. What legal rights would there be against the withdrawing state for having broken the treaty contract?

At present the strictly legal sanctions which would be attracted by unilateral withdrawal seem rather thin. Consider the following:

– Under article 260 of the consolidated version of the EU Treaty, the Court of Justice of the European Union could impose an unlimited penalty or fine. One imagines that this would be rather unlikely and pointless.

– There might be disputes as to whether the departing member would be entitled to get its own reserves back from the European Central Bank or to recover its capital contribution to the European Central Bank. The European Central Bank holds the foreign reserves of eurozone member states. At the time these reserves may be rather small.

– It seems unlikely that EU private sector individuals and firms, such as bondholders, would have direct rights of action for compensation against a non-complying member state under, for example, the Francovich principle. Under this principle of European law, EU individuals can sometimes, and subject to various conditions, bring action against national authorities for a breach of European Community law. There are probably no rights of direct action under the EU treaty in relation to this issue.

– A private investor might have rights against the departing member under bilateral investment treaties entered into by the departing member mainly with emerging countries. The eligible investors must generally reside in the emerging country concerned, eg be a company incorporated there. There are other obstacles to these claims.

– It is extremely unlikely that there would be a claim under the European Convention on Human Rights in view of the exits from the protections laid out in this Convention. One could expect national constitutional preventions protecting private property to have similar exemptions.

Even if there were a creditor right of action against a departing state, a creditor would have to show that the court has jurisdiction if it wished to sue the sovereign state in a foreign court. The sovereign state is in any event likely to be protected by sovereign immunity since a change of currency would normally be regarded as a sovereign act.

The reality is that one can forget about legal rights against a member state which unilaterally withdraws in breach of the EU treaty.

What would a currency law say?

Normally a currency law which changes the currency of the legislating state specifies a conversion rate between the old and the new currency. This conversion rate affects the degree of appreciation or depreciation of the new currency, amongst other things. The market rate may be very different from the official conversion rate.

It is conceivable that there could be two conversion rates according to the type of transaction. A dual conversion rate is typically a feature of exchange control laws where there might, for example, be one conversion rate for foreign trade sales and another for foreign direct investment.

In the past many currency laws have not stated precisely to what obligations they apply. Typically they state that legal tender "in" the relevant country for the payment of public and private debts is the new currency. You therefore have to work out what is meant by the requirement that the payment is "in" the country, ie within its territorial domain. Sometimes the currency law specifically states that the rules apply to debtors who are resident in the country (as opposed to nationals who may be resident anywhere) or if the place of payment is local, or that they apply if both these criteria are satisfied or that they apply only to domestic transactions.

Currency of debtors' obligations to creditors

The issue here is whether creditors can claim the old currency from debtors or are left with a claim for payment in the new currency.

Generally speaking, the impact of the currency law on creditor rights against debtors depends on which courts have jurisdiction.

If an action by a creditor is brought against the debtor in the courts of the sovereign state concerned, then these courts will typically apply their mandatory currency laws and hence recognise the change of currency if it is within the scope of the law. Countries invariably give effect to their legal tender laws.

If the action is brought in a foreign jurisdiction, eg because the creditor holds a bond which was issued by the sovereign state or a corporate entity within the sovereign state and which contains a foreign jurisdiction clause, the position may be summed up in the following propositions:

– **Local law obligation** If the bond or other obligation is governed by the local law of the converting sovereign state, then that sovereign state could by statute change the currency of the bonds. Foreign courts in many countries will recognise this change in the nature of the obligation. This is because, under the private international law rules of probably most countries, including countries in the EU, a choice of governing law is that system of law as it applies from time to time.

  There is a massive amount of case law in the leading jurisdictions showing that moratoriums or exchange controls or reductions in debt obligations are recognised abroad if the debt obligation is governed by local law and the local law is changed by the country concerned.

  The position in the United States is somewhat different in that the home state can change the bond only if the obligation in question is "located" within the domain of the legislating state, subject to exceptions. The U.S. approach is that a state can by statute prejudice property only if the property is within the territorial jurisdiction of the state – they cannot prejudice foreign property. But you often get to the same result in practice.

– **Foreign law obligation** If the obligation, such as a bond, is governed by a foreign law, then the converting country cannot by its domestic statute change a foreign law. In the classic statement in one of the leading English cases, the law of Tonga cannot change an English law bond. Hence the choice of an external governing law insulates or shields the bond against a unilateral change of currencies by a statute of the converting country.

– ***Lex monetae*** There is one legal exception to the principle that the foreign law insulates against a change of currency. This is that, if the obligation concerned clearly refers to the currency of the converting sovereign state, then a change in that currency is universally recognised at the conversion rate decided by the issuing state. You look to the law of the country creating the money, called the *lex monetae* – the law of the money, meaning the law of the state which issues the money. Accordingly, if Japan gets tired of the yen and switches to ducats, all the yen obligations within the scope of the law are redenominated in ducats, regardless of governing law. This is logically necessary because only the issuing state can change its currency and you have to follow the succession currency if the former currency ceases to exist. Otherwise you would have an obligation without a currency.

  The rule of the *lex monetae* came up for decision in Germany in the nineteenth century Austrian Coupons cases. In these decisions Austrian railway companies issued bonds which, at the option of the bondholder, were payable either in Austrian silver guilders or in thalers then circulating in Germany. When the thalers were replaced by a mark currency based on gold in Germany, the Austrian silver guilder depreciated. The borrowing railway companies denied that they were liable to pay the loan in the new currency based on gold. The German Supreme Court decided that, if the thaler option was exercised, the debt was payable in marks at the rate of conversion established by the German legal tender statute, although the bonds themselves were governed by Austrian law and even though no place of payment in Germany had been agreed upon.

Role of the *lex monetae* if the old currency (euro) is still in existence

If the old currency still exists, then you get a different situation to that proposed by the simple application of the *lex monetae* rule described above.

If one eurozone member state were to withdraw from the euro, but the other member states of the eurozone kept the euro, then one has to decide whether the obligation continues to be payable in euro or whether you have to adopt the *lex monetae* rule in which event the obligation is converted into the new currency of the state concerned.

In most cases it will be obvious that the bond or other obligation refers to the euro of the eurozone if it still exists, although truncated. Thus, if New York City were to secede from the United States and form the Duchy of Manhattan with the talent as its currency, then it would usually be obvious that parties referring to the U.S. dollar in their contracts meant the U.S. dollar as it remains, not the new Manhattan talent.

It is possible that the contract could be interpreted as referring only to the currency of the converting state as it is from time to time, but it is considered that there would have to be an extremely clear intention that the parties meant the currency of the converting state from time to time, as opposed to the euro.

It is thought that the mere fact that the debtor is a sovereign state or that place of payment is local or that the obligations are listed on a local stock exchange or cleared through a local security settlement system would not be enough to create an inference that the parties meant the local currency with the result that euro would be converted into whatever is the new currency of the sovereign state concerned.

If the eurozone broke up completely so that there was no such currency as a euro, you might have to split a euro obligation into its 17 new currencies at the conversion rate for each currency.

There might be borderline cases where it would be hard to tell whether there is still a euro or not. For example, if the euro broke into blocs, one might struggle to determine which currency was the successor to the euro. There might be a question as to how many member states are necessary to maintain the euro.

Creditors' rights of action against debtors for currency depreciation

The almost universal rule is that a creditor cannot require a debtor to top up a debt obligation if the currency is depreciated by inflation or otherwise. This is known as the principal of nominalism, ie creditors can claim only the nominal amount of the debt and cannot insist on a revaluation. The first case in England establishing this principle was in 1604. Some countries have an exception to this in the case of hyper-inflation, eg Germany.

If there was no principle of nominalism, then creditors and debtors would forever be arguing about rates of inflation or deflation and it would be virtually impossible to work out how much one was to pay or how much one was owed. The legal position therefore is that debtors and creditors must take the risk of the currency in the normal case.

Creditors can provide for revalorisation or maintenance of value or indexation to some asset deemed immutable and there is a huge history of loan and bond clauses pegging the debt to gold or some other standard. Nowadays, if creditors or debtors want protection against value swings, they buy a derivative – a sensible and efficient outcome.

The question of whether nominalism does or does not apply is decided by the governing law of the obligation. Most states acknowledge nominalism. But, as we shall see, nominalism has vengeful bite when it comes to insolvency, where foreign currency claims are compulsorily converted into local currency. Freedom of choice of law is irrelevant when it comes to bankruptcy.

Why would a eurozone member want to leave? - the advantages

National currencies are symbols of national potency. They also confer hard political power. Hard political power attracts the question of whether this power is subject to the rule of law.

This sovereign power over money is at the root of why a eurozone member might want to leave.

Inflation For example, if the eurozone member is over-burdened by debt and the debt is denominated in its own currency, then it can simply inflate the currency by increasing the money supply. In that way the country pays a bankruptcy dividend.

Almost all countries in the world have used this ability to take away creditor assets. Even now, almost all central banks think that moderate rates of inflation are not a bad thing at all and are inevitable.

The cumulative effect of low percentages of inflation over quite small timescales is huge. The public does not notice how ferocious the taking is, how quickly the value of your money is halved.

The largest recorded denomination banknote (resulting from the highest recorded inflation) was issued in Hungary in 1946. It was for 100 million trillion pengős (one followed by 20 zeros) and was worth less than GBP1 sterling.

The idea that inflation often springs from increasing the quantity of money goes back at least to Aristotle. One of the greatest writers on the subject was Nicole Oresme (1320-1382) of France, long before Milton Friedman. A central bank can nowadays very easily increase the supply of money by sending an e-mail to banks or bondholders advising them that the central bank owes them whatever amount it cares to name.

When is inflation permissible? It is considered that a deliberate inflation by increasing the money supply is permissible in at least two cases. The first is where the state is bankrupt and must therefore pay a dividend. Everybody knows that bankruptcy is bankruptcy. The second is where there is a general collapse of the banking system in which case it is legitimate for the central bank to provide unlimited liquidity.

But countries should not inflate the currency in other circumstances because this is a taking otherwise than through the taxation system.

Control of interest rates To return to the advantages of euro withdrawal. The central bank of the converting country can manipulate interest rates and reduce them so that in effect money is given away for nothing. Since the money concerned is not that of the central bank but rather other people's money, ie the money of savers and creditors, the central bank is giving away savers' money to debtors. It is playing Robin Hood with the property of savers.

Control of exchange rates A country in charge of its own currency can manipulate the exchange rate of the currency, eg by manipulating interest rates for the supply of money or by buying and selling the currency in the market. If company directors were to do the same with the shares of their company or commodity brokers in a commodity market, then they would likely find themselves in deep trouble with the law.

No eurozone fiscal control A departing eurozone member would have more freedom on fiscal policy, eg it could theoretically borrow more to avoid the EU treaty debt to GDP ratio and to avoid the budget deficit limit under the stability and growth pact of the relevant EU treaty. Provided lenders were still willing to lend, political popularity could be bought.

The country could introduce exchange or capital controls if it also withdrew from the EU. This is not normally possible for EU members by reason of a prohibition in the EU treaty which requires the free movement of capital, but they can do so if the capital control falls within the "public policy or public security" exemption in Article 65 of the Treaty, provided that this does "not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments as defined in Article 63."

The escaping country could evade the effects of a misalignment of the entry exchange rate.

Exporters would have a bonanza because exports would be cheaper for foreigners. It is true that imports would be more expensive. The country would not have to deflate wages and prices in order to compete but simply devalue its currency by permitting inflation.

The country could impose tariffs and import controls. These are not possible for EU members as regards domestic EU trade.

Conclusion on advantages In summary, by controlling its own money, the state could assert tribalism and nationalism. It could enlarge the quantity of money to the detriment of quality. It could favour debtors against creditors, favour the young against the old, and generally game the system. It can flout the rule of law.

If we were to stop there, these fruits of currency power must seem overwhelmingly attractive.

Why would a eurozone member want to leave? - the disadvantages

Against the above advantages, one must consider the disadvantages of withdrawing from the eurozone.

These disadvantages of withdrawal would depend upon whether the withdrawing state was economically strong or economically weak.

If the state were economically weak, there would be risk of a sovereign default with a consequent hard restructuring, coupled with a collapse of the banking system and the default of corporates.

There would likely be a huge depreciation of the currency.

Businesses would run bigger currency risks.

There could be shambolic initial disruptions in terms of contract mismatches, legal problems and confidence. Thus banks and corporates may still have to pay foreign loans in euro at a time when their revenues are converted into a new and depreciated local currency.

Over the medium term, though, exports could be boosted.

Internationally, those dealing with the country would lose the transparency emanating from a single currency which enables prices to be compared.

The country would lose the possibility of participating in the future in a reserve currency with lower overall borrowing costs. It would lose the EU umbrella of bail-outs and EU support. It would lose the possibility of lower EU interest rates and the future potential of a common eurobond market funding.

The people would lose the fiscal and monetary discipline of a currency union, where the central bank is less vulnerable to politicians.

Foreign direct investment might be hit because of greater uncertainty, higher transaction costs and political risks.

If the whole of the eurozone were to collapse, then the eurozone would suffer a loss of political soft power. The eurozone could become a slave to the U.S. dollar or the renminbi or the rupee.

The withdrawal of a single state might violate the break-up taboo and cause a general fragmentation.

Some say that the withdrawal from the European Union by an economically weak state would be a suicide note.

Even if one takes a cooler view about the above, the peoples of the eurozone would, despite all the problems of a currency union, still have to believe that 17 currencies are better than one.

History of expulsions

Historically, cases where a country has actually been expelled by other countries from a political or monetary union are extremely rare. Federal states just do not throw away part of their territory. In almost all cases, break-ups have occurred because countries themselves want to withdraw. People have fought terrible wars to keep their countries together. Consider the U.S., China, Rome, Athens.

What do you need for a currency union?

Many commentators on the euro insist that there is something wrong with the currency in the sense that it is a flimsy fiction without any base, unlike other real currencies.

Currency as fiction or reality The reality is that all currencies are now cut loose from any anchor in real things. The final break happened in 1971 when the United States declared that the U.S. dollar would no longer be payable in gold. At the time, many currencies were linked loosely or tightly, directly or indirectly, to the U.S. dollar so that there was a linkage with gold. From 1971 onwards, currencies everywhere became fictional creatures, whose quality and quantity were determined solely by central bank decision. In that sense, all currencies are a nothing.

Yet it is obvious that all currencies are something. If we were to follow the nothing argument, then even all companies would be a nothing since companies are merely a construct of the legal imagination. Companies are a mark in a registrar's book. Yet patently they exist. They are something. So is money. All these are creatures of the law, our servants, not our masters.

Central bank The euro has a central bank (the European Central Bank (ECB)) and therefore somebody with exclusive rights to issue legal tender within the territory, with exclusive control of the money supply and with intervention powers on interest rates. It has a central bank which is independent, one of the most independent in the world.

Euro has a tax base The eurozone does not have a single central tax policy in the sense that a central authority fixes the tax rates. But the eurozone has a tax base. Taxes are high and are collected vigorously in most states. It does not seem essential that taxes should be uniform. There is great variation, for example, in state taxes in the United States.

Is regional homogeneity necessary? Economists have often claimed that currency unions do not work in the absence of homogeneity between the regions. This means that the regions of the currency union need to have roughly equal economic performance or at least sufficiently flexible regions whereby, if one region is economically unsuccessful compared to the others, wages and prices are lower and the labour force can move to take up jobs in the richer regions.

This and other criteria are deemed useful for optimal currency areas. It is nevertheless obvious that in most major countries with a single currency, there is considerable disparity between the regions. There are very poor and very rich states in the United States, in India, in China, even in the United Kingdom, even in Italy.

In fact it is only in very small countries that there is homogeneity in the normal case.

Is a transfer union necessary? It is then said that, if there is disparity between regions, there must be a transfer union. This means that the central government must transfer funds from richer to poorer regions out of central tax revenues so as to finance the poor regions – their roads, their unemployment benefits, their medical care, their hospitals, their power stations. This would of course be nice for the poorer regions, but it is not necessary to sustain a currency. It is a bonus for rich eurozone states that they do not have to do this. Germany and France do not have to pay for the health service in Greece or Portugal.

Impact of bankruptcy of a member Finally, it is said that, if there are no common fiscal policies and no central control over regional borrowing, the bankruptcy of a region in the currency union is fatal to the currency.

This seems doubtful. If California or New York City are bankrupt, has this ever had any effect whatsoever on the U.S. dollar? The U.S. federation has been well populated by bankrupt states and municipalities. Countries such as Ecuador, Panama, Liberia and Zimbabwe have U.S. dollars as legal tender. If any of these countries were bankrupt (as some of them are), nobody suggests that this would have an effect on the U.S. dollar. Admittedly they are very small countries economically.

Historically, there have been numerous cases of the insolvency of state sub-divisions without the fragmentation of the currency, eg Australia, Canada, probably most developed countries.

However, if a significant proportion of regions in the currency union are bankrupt, then this could potentially have a serious and possibly catastrophic effect on the currency.

The risk of over-borrowing is true of the municipalities of England, the provinces of Canada, the states of India, Mexico or Brazil or the United States, the cantons of Switzerland, the prefectures of Japan, the members of the Russian Federation or the provinces of China.

Division into regions which can potentially become insolvent is not some special idiosyncrasy or weakness of the euro.

Therefore, assertions that there is some unique defect in the design of the euro currency union seem exaggerated. The Florentine florin and the Maria Theresa thaler did very well in their time, notwithstanding that those currencies had none of the attributes recommended by the theorists of optimal currency areas.

Bailing out bankrupt member states

If a significant proportion of eurozone member states become bankrupt, either because they over-borrow or because of contagion from a single member state bankruptcy, the eurozone would have a choice of either permitting the collapse of the euro or bailing out the member states concerned.

The member states which do provide bail-out cash insist on austerity measures by the bankrupt state as a condition of the bail-out.

The eurozone members have set up a Luxembourg company, known as the European Financial Stability Fund (EFSF), to provide bail-out funds to eurozone member states. This company will be replaced by an international organisation formed by treaty in or around 2013. In the meantime, it is to be able to provide last resort emergency money to member states and to buy their bonds. This company is said to be the beginnings of a European Monetary Fund.

Effectively the EFSF is a shadow of or substitute for the ECB because it can supply cash and therefore indirectly create money in circumstances where the ECB would be reluctant to do so in view of its mission to control inflation.

European fire-power

Since the central bank and its shadow have the potency between them to create as much money as they like and as the eurozone agrees, they have enormous fire-power. Buying all the bonds of Greece, Portugal, Ireland, Spain and Italy would be within spitting distance of what the U.S. Federal Reserve and the U.S. government took on in the TARP programme to rescue banks in 2008-2009 and in the effective U.S. nationalisation of the mortgage companies Fannie Mae and Freddie Mac in 2008. The ECB can pay the purchase price for bonds simply by sending the bondholder an email stating that the ECB owes the bondholder the price. The eurozone taxpayers do not have to empty their pockets. It is that easy. The cost would be the risk of inflation and other confidence issues.

Situations where states have inflated their own currency to pay their debts are virtually routine in the context of state insolvency and even by solvent states who prefer to pay creditors as little as possible.

So even the bankruptcy of the member states of a currency union can be beaten. If the member states agree.

A possible result of a bail-out is that the currency union moves towards greater fiscal union in order to restrain future errancy.

There is nothing wrong with the concept that the member states of the currency union might from time to time be put in the position that they have to bail out a bankrupt member, just as a central government (ie. the other regions of a country) may have to bail-out a bankrupt province or municipality. This is just one of the potential costs of a currency union. Bail-out is also one of the potential costs of having a banking system. Nobody suggests that it is better not to have a banking system at all than to have to bail it out from time to time.

Governments have to do things like that. They also have to do it for water systems, electricity systems, food supplies, defence. That is one of the reasons we have governments – as a last resort back-stop. We are always faced with the choice of whether we want something which carries some fatal defect so that we might have to rescue it, as against completely getting rid of the thing we want.

Are new clauses needed to deal with a change of currency?

This section deals with the question as to whether new clauses are needed in financial documents to deal with the possibility of a change of currency. The main documents concerned include syndicated bank loan agreements, capital markets bond issue documentation and derivatives contracts. The impact of a change in currency on sovereign credit default swaps is dealt with in another Intelligence Unit paper, "Sovereign state restructuring and credit default swaps", October 2011.

As a general rule, legal tender legislation provides that debts are payable in the legal tender of the country concerned but that payment in a foreign currency is permitted if the parties so stipulate. Hence there is freedom of contract. This is true of the civil codes, for example, in Germany, Japan, Switzerland and Italy.

If indeed the doomsters are right, it still seems fanciful that we would wake up one Monday morning to discover that the eurozone was abolished after supper the previous Sunday night. It seems realistic to assume that there would be legislation, probably developed over a protracted period. It also seems more sensible to work on the basis that the legislation would presumably deal with many of the questions which are considered below and lead to different conclusions. For example, all EU states could introduce legislation dealing with currency changes.

In addition, as discussed below, protections in documents may be overridden if enforcement is required in the enforcing state or if the creditor becomes involved in bankruptcy proceedings in the enforcing state because in those cases the creditor will normally be subject to the law of the withdrawing state.

Frustration of contract Generally speaking, it seems most unlikely that a contract for a loan, bond or derivatives will be frustrated and therefore brought to an end by reason of a change in currency or a mismatch. This is considered true even of forward currency exchange contracts where one of the currencies is changed.

There is a somewhat vague clause dealing with a change of currency in the standard form syndicated credit agreement of the Loan Markets Association. This reads as follows:

> "(a) Unless otherwise prohibited by law, if more than one currency or currency unit are at the same time recognised by the central bank of any country as the lawful currency of that country, then:
>
> (i) any reference in the Finance Documents to, and any obligations arising under the Finance Documents in, the currency of that country shall be translated into, or paid in, the currency or currency unit of that country designated by the Agent (after consultation with the Company); and
>
> (ii) any translation from one currency or currency unit to another shall be at the official rate of exchange recognised by the central bank for the conversion of the currency or currency unit into the other, rounded up or down by the Agent (acting reasonably).
>
> (b) If any change in any currency or country occurs, this Agreement will, to the extent the Agent (acting reasonably and after consultation with the Company) specifies to be necessary, be amended to comply with any generally accepted conventions and market practice in the Relevant Interbank Market and otherwise to reflect the change in currency."

This clause only contemplates the situation where there is more than one currency recognised by the central bank of a country as the lawful currency of that country, ie parallel currencies. It does not deal with a change of currency to a completely new currency and the disappearance of the old.

While it is sometimes the case that derivatives documents contain provisions ensuring that the adoption of the euro does not result in a frustration of the contract, there are no standard provisions governing a departure of a member state from the euro. Redenomination provisions appear in many bond issues but they deal only with redenomination into euro and typically there are no provisions dealing with redenomination out of the euro.

Currency mismatches Currency mismatches could often arise where, say, revenues are received in one currency but obligations are payable in another if one were to apply the above rules for currency determination. The result of the mismatch could be, for example, that one currency has depreciated in relation to the other or that there are exchange controls or currency blocks on one currency but not the other.

It does not seem realistic to endeavour to work through all the possible situations and the potential consequences but examples include the following:

– A bank funds its loans in one currency but the loan is denominated in another. Consider also bank deposits.

– A loan to a project is payable in one currency but the revenues from the project, eg from a sale or offtake agreement, are now payable in another currency or currencies.

– A loan sub-participation is converted to a different currency from the currency of the ultimate loan.

– A note issue financing a securitisation relies on mortgage loans now denominated in a new currency.

– A guarantee or export credit insurance or letter of credit covers a loan or other obligation now converted into a different currency.

– The currency of obligations on either side of a central counterparty for a settlement system are split into two currencies.

– A custodian has to pay a different currency from that receivable from sub-custodians.

– Collateral is denominated in a different currency from the obligation it secures. The value of the collateral may be protected by the clause requiring top-ups if the value of the collateral sinks. Consider also the impact on repos and stock lending agreements.

- A derivative transaction exchanges cashflows denominated in euros in exchange for the return on a portfolio of underlying assets which are redenominated into another currency.
- A derivative transaction denominated in euros hedges an income stream or liabilities that are redenominated.

In each case, there is effectively a chain in which the links in the chain cease to be the same.

One could in each case work out some formula for dealing with the contingency. It will often be found that a formula cannot deal with the potential range of contingencies or is unnecessary or is commercially not acceptable to one or other party. Or sometimes it may well be found that it does not matter much, eg if revenues are in a depreciated currency, then there is likely soon to be a default in any event so no new clause would be needed.

Events of default In the case of standard bank loan or bond or derivative contracts, a change of currency will not usually be an event of default unless, say, the currency of the contract is not changed by virtue of the above rules and the borrower fails to pay in the correct old currency.

If the event of default does not state that it is an event of default if the wrong currency is paid, in the normal case one would imagine that there would still be a default, assuming that the currency obligation has not been legally changed in accordance with the above rules. One cannot claim to have paid a debt by handing over something other than the required money.

Whether or not a borrower would have an advantage of a longer grace period because the failure to pay was caused by a disruption event would depend upon the language of the clause.

The circumstances surrounding the change of currency might crystallise a typical "material adverse change" in bank loan agreements if the currency change adversely affects the financial condition of the borrower within the clause.

Events of default or mandatory prepayment clauses could theoretically deal with the situation where the debtor's country withdraws from the euro or the currency of the loan is changed.

In the case of derivatives contracts, any exchange controls that are imposed by the exiting member state may, depending on the facts, result in a Termination Event such as illegality, impossibility or force majeure, or in a disruption event pursuant to the relevant ISDA definitions booklets. Whether such event has occurred will depend on the nature of any exchange controls and the effect, if any, that they have on the ability of the parties to perform their obligations or make the applicable calculations.

Governing law and jurisdiction An external governing law and external jurisdiction clause provide some protection against unilateral changes in the currency of a loan or bond by the converting state.

States converting in a hurry might introduce exchange controls to protect against capital flight. Exchange controls are currently prohibited by the EU Treaty, subject to a public policy or public security exception which in turn is qualified. Note that in certain countries, court interpretation of article VIII 2(b) of the IMF Agreement might require recognition of the exchange controls of an IMF member interfering with loan obligations and overriding an external governing law so as to destroy the insulation achieved by an external governing law. Case law indicates that this seems to be the case in France, Luxembourg and possibly Germany, but not the United Kingdom, the United States or Belgium.

Overriding insolvency laws An attempted immunisation or insulation achieved by foreign law can be overridden in practice if there is a local insolvency proceeding involving the debtor and if either the creditor is forced to claim locally for some other claim and local law exclusively applies, as in the case of the EU Insolvency Regulation of 2000. This applies where the debtor's centre of main interests is in the EU, except Denmark. There are similar rules for EU credit institutions and insurance companies.

Local enforcement If a creditor has to enforce a judgement or claim within the territory of the withdrawing state, then the creditor's enforcement will normally be subject to the laws of the withdrawing state, including its legal tender laws.

Conversion of foreign currency debt on insolvency In most countries a debt payable in foreign currency is converted into local currency if the debtor is insolvent. The conversion generally takes place at the time of the commencement of the insolvency proceedings. This is true in the United Kingdom, France, Germany, Spain, Switzerland, Norway, Italy, Austria, Denmark and the United States, although not common in the case of judicial reorganisations.

Hence, if the local currency is depreciating rapidly, so does the amount of the debt. Effectively, foreign currency creditors are expropriated if the proceedings are long drawn-out. It often happens that a local currency is depreciating by reason of the economic depression which brings on the bankruptcy or by reason of a sovereign insolvency. This would be an important result in the case of a eurozone member leaving the eurozone and could lead to significant losses.

Thus, in the case of Argentina's insolvency in 2002 onwards, foreign creditors were very anxious to forestall the bankruptcy of local companies which would have been catastrophic because of this rule.

It is generally not possible to contract out of this rule. Most syndicated credits and trust deeds for bond issues (but not usually bonds without a trustee) contain a top-up clause but this is unlikely to be effective on bankruptcy so as to override the compulsory conversion rule.

Definition of the currency Attention should be paid to the definition of the currency if in euro, ie that it is intended to be the lawful currency of the eurozone (if that is indeed what is intended), not the lawful currency of a particular state. The purpose of this is to avoid the possibility that the currency referred to is the currency from time to time of a particular eurozone member in which case the eurozone member could unilaterally change it under the lex monetae principle.

There is no definition of the euro or the eurozone in the standard documents of the Loan Market Association.

Often there is no definition of the euro in the terms and conditions in relation to a bond issue. But sometimes the eurozone is defined as the region comprised of the member states of the European Union that have adopted the single currency in accordance with the Treaty establishing the European Community as amended. Offering circulars sometimes have a similar definition of the euro.

It is hardly surprising that these documents do not find it necessary to go into great detail: one does not, for example, have a pedantic definition of the U.S. dollar in documents.

In the case of derivatives contracts, various ISDA definitions booklets define the euro as the lawful currency for the time being of member states that have adopted the single currency in accordance with the EC Treaty. There are subtle differences between some of the definitions, as some refer to the EC Treaty as amended from time to time, while others refer to the EC Treaty without reference to further amendment. This may, but will not necessarily, have an effect on the potential outcome if the departing member state leaves the euro by way of an amendment to the EC Treaty itself.

Place of payment In appropriate cases, consideration should be given to clauses to make payments in different centres in the eurozone where they do not already appear. This would help avoid the concentrated association with one jurisdiction when applying the *lex monetae* principle.

For example, the payment clause of the Loan Market Association standard syndicated credit document provides that payments in euro must be made in a principal financial centre in a participating member state (as defined) or London with such bank as the agent bank specifies.

Many bond issues give creditors the opportunity to specify the place of payment in the case of euro. The documents typically state that "payments in euro will be made by credit or transfer to a euro account (or any other account to which euro may be credited or transferred) specified by the payee or, at the option of the payee, by a euro cheque. Payments will be subject in all cases to any fiscal or other laws and regulations application thereto in the place of payment."

Related contractual terms

Other terms of contracts may also be affected upon redenomination of obligations owing under that contract into a new currency. These include:

– Day count fractions (the new currency may have a different day count fraction to the euro).

– Interest rates (EURIBOR is unlikely to be appropriate as an interest rate for the new currency).

– Price sources.

– Business Days (TARGET2 is unlikely to be appropriate for the new currency) and Business Day Conventions.

Neutering of protective clauses by currency law

A currency law might attempt to neuter avoidance clauses. The success or otherwise of this neutering is likely to depend upon whether or not the debt obligation is governed by a foreign law or local law.

Clauses which neuter events of default operating on bankruptcy are often found, for example, in existing corporate reorganisation statutes, such as the U.S. Chapter 11 and the various strong-arm bank resolution statutes now in vogue, such as the British Banking Act 2009. Legislators might have recourse to a similar technique if there were a change of currency.

Other impacts of a currency change

Other factors worth considering in the context of a currency change include the impact on:

– Payment systems

– Securities settlement systems

– Eligible collateral for central bank facilities

– Majority voting clauses in syndicated credits and collective action clauses in bonds

– Capital adequacy and stress tests

– Set-off and cash pooling agreements

– Equity and preferred shares and other provisions in corporate documents regarding shares.

Reaction of markets

At present there does not appear to be much pressure to introduce new special clauses into financial documents to deal with a break-up of the euro. This may be because market participants believe that a break-up is very unlikely or because they are too sensible to jump at every rustle in the bushes.

Markets are well organised when it comes to developing market solutions. A classic example is the ISDA protocol. This was recently used in relation to credit default swaps where virtually the entire derivatives market agreed to change their private documents in accordance with protocol amendments developed by ISDA. Similarly, when the euro was first adopted, ISDA published a protocol which allowed parties on a multilateral basis to amend their ISDA documents to change all currencies to the euro and to make all associated amendments such as price sources, interest rates, day count fractions and so on. It is perhaps likely that a similar initiative would occur in the case of a departure of one or more member states from the euro.

One could expect organisations such as the Loan Market Association to perform a similar role if we ever got to a situation necessitating action.

Conclusion

Money is a public utility. It is the commons.

As a means of exchange, money is essential to modern societies. One could otherwise not in practice buy even a loaf of bread.

As a store of value, it enables us to control the future by saving now for future income and diversifying.

Currency establishes a mutually beneficial interdependence between peoples because of the possibilities of specialisation and trade. This interdependence also arises from the sharing of surpluses and the provision of cross-border credit.

Currency is essentially liberalising and fundamental to prosperity. It was Dostoevsky who observed that "Money is coined liberty". Liberty is a product of the rule of law.

It must therefore follow that any steps which are in the direction of protecting currency from destruction should merit support. Currency and money are subject to the rule of law.

As these Europeans, in their peninsulas and islands on the end of Asia, plod to and fro from their jobs, eyes down, as they stand in their trains and sit in their cars, as they gaze at their televisions, they should ask themselves which continent in the world produced in aggregate the most noble manifestations of human aspiration, science, art, architecture, music, philosophy, the world's legal systems and all the rest, everything from Aristotle to Einstein, Beethoven to Shakespeare, Leonardo to Newton.

The Europeans fittingly expressed their astonishing common achievement in a common currency, or some of them did.

Is the currency worth fighting for? That is, from their point of view and the point of view of the rest of the planet?

We think it is.

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