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Guest post: Thinking the unfolding — the break-up of monetary union

Posted by **Guest writer** on Nov 28 14:00.

Many in the market are now thinking through the consequences of any one country (or all 17 member states) changing currencies on departing the euro. Gilles Thieffry, a Partner at GTLaw, Geneva, has perhaps been thinking it through earlier than most. He started in 1998. We are pleased to present his analysis of the "redenomination risk" confronting markets in 2011.

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In a series of three articles written since 1998, I studied the legal consequences of the break-up of European monetary union. The legal challenges related to the creation of a currency without a single sovereign, a 'sovereign-less' currency, were studied. Events are now unfolding and the redenomination risk of debt instruments has been identified by markets as a serious challenge (as identified in my last two articles on this topic).

Monetary union was intended to be an irrevocable process. No resignation or expulsion is provided under the Treaties. Falling short of diktats (which no one can benefit from – our common history shows what a diktat by one or two countries may lead to), any break-up will require consensus if no one wants to contemplate disaster. To understand the issue at hand, it is worth remembering that the Euro is the lawful currency of all and each of the EMU participating states.

However large and powerful a country may be, the Euro is as much the lawful currency of each of Greece, Spain, Portugal and Ireland as it is the lawful currency of Germany or Slovenia, as well as being a currency managed by the whole. As I did in my last article in late 2010 (Thinking the Probable), I shall take Greece as my example. Needless to say, what follows applies to all participating member states.

When Greece issues a bond denominated in euros under Greek law, legally speaking the bond is issued in the lawful currency of Greece for the time being, i.e. the euro means the lawful currency of Greece as far as Greek law is concerned (this is also known as the *lex monetae* principle). As mentioned in my previous articles, the situation is different for bonds governed by a foreign law (say English law) and/or its place of payment is outside Greece (the best legal analysis of the *lex monetae* and international ramifications can be found in Proctor in Mann on the Legal Aspects of Money, Oxford University Press).

Suffice it to say that 90 per cent of Greece's government bonds are governed by domestic Greek law and are payable in Athens (see Pricing Terms in Sovereign Debt Contracts: A Greek Case Study with Implications for the European Crisis Resolution Mechanism – John M. Olin Law & Economics Working Paper No. 541 (2d Series), February 1 2011).

If Greece were to reintroduce unilaterally its own currency (for convenience I called it in my previous article the New Drachma or ND, as there cannot be a 'reintroduction' of the legacy currencies that were subsumed into the euro), the Greek government will set by law the conversion rate between the euro (the then former lawful currency of Greece) and the ND (the new legal tender for Greece). This statutory rate will apply across the board (true for bonds, as well as the rent of an apartment or prices at the supermarket etc.). Greece could impose, if it so wished, a statutory rate of ND 1 = Euros 1,000. The conversion rate does not need to take into account the expected external value of the ND, but definitely needs to provide certainty for all aspects of domestic life (all wish to know what rent they will have to pay at the end of the month and what their salaries will be etc.).

This is why various countries could change their currencies in history without much trouble, for example France in 1960 after the creation of the new franc (NF 1= Old francs 100), Germany after WWII, or Austria after WWI. The goal is to allow life to continue. New currencies were introduced in history without major legal challenges. It is very likely that the same monetary law would provide that during the transition period bank notes denominated in euros in circulation in Greece would be representations of the ND at the official conversion rate. One can be certain that such a statute would be strictly enforced and that exchange controls would be imposed (usually this type of statute provides for criminal law sanctions). All can imagine the disastrous consequences such a redenomination would have on foreign investors.

If the international holders of Greek bonds governed by Greek law and payable in Athens tried to sue Greece for what they would perceive as an unfair conversion rate, Greek courts would have little option but to apply the law of the land (unless one tries to challenge the constitutional validity of the new monetary law, but this would inevitably take a lot of time and the outcome is doubtful). If the holders of bonds were to sue outside Greece (besides the legal challenges relating to jurisdiction etc…) they would face well-established case law that I mentioned in my last article (cases relating to Serbian loans and Brazilian loans decided after WWI by the Permanent Court of International Justice).

Sadly, little has been done over the last two years. The above and my previous articles should convince all involved that a country withdrawing unilaterally overnight will be detrimental to all (besides constituting a breach of the Treaty) and that such an action would lead to a long period of instability for the entire eurozone (if not beyond).

It was, and it is still, my contention that serious consideration should be given to an idea suggested when the Maastricht treaty was being negotiated by then UK Prime Minister John Major: a dual currency system. The concept would just have to be adjusted to the new prevailing circumstances. Instead of introducing a single currency, certain countries of the euro zone would introduce a local currency whilst their debt would remain denominated in euros. A dual currency system would give the departing country the choice over several years either to rejoin the 'strong euro', or to effect an orderly 'repatriation' of its monetary sovereignty based on the progressive re-accumulation of reserves to base its new currency.

However unpleasant the choice may be, there seem to be only two sensible solutions to the current predicaments. The first is economic, fiscal and budgetary union (what many describe as federalism). Each reader can make up his or her mind as to whether this will be politically acceptable to the nations involved, but it is doubtful that there is now sufficient time to implement it (even assuming each nation were democratically to approve of it). The other solution is an organised dismantlement of the euro as we know it and to introduce a dual currency system.

Roman wisdom teaches us that 'Errare humanum est, perseverare diabolicum'. Postponing has rarely improved matters, and time is running short. Indecisive action or unilateral decisions will lead to the unknown, recrimination and the rebirth of nationalism that the European construction was meant to make a thing of the past.

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By Gilles Thieffry

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Comments

Great article, thanks.

@Sparkie
And exporters can first benefit if they can import in other countries. If Greece would leave the EU it would effectively not exists for most Customs in the world and it is very difficult to import is such a situation(probably impossible).

@sparkie

Presuming their products are not using imported material.

Interesting post Gilles, thanks!

"a country withdrawing unilaterally overnight will be detrimental to all"
- not true. The country's exporters will benefit hugely from a switch to a local currency and the subsequent devaluation.

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pegnu most sorry did not edit properly i get paid monthly in YEN and its then converted into the GBP every month at moment

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But pengu i still get paid in YEN every at moment and that's converted into £ so if want to borrow say for house then i am doing the same thing.

@Oshi
That's right I agree!

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pegnu Iam sorry but what i have been reading in the press there are many who have done so in central and eastern Europe but also in western EU as well,Some in eastern EU in swiss currencie but also in the EURO as well.These are in the billions in assets but also did not banks who are based in Switzerland and western EU have banks in eastern and central Europe and they where very happy to sell these mortgages when the good times where around.I see the Austrian banks are one of the most exposed to these countries.So no wounder the EU is one big mess where was the Authorities when this was happening why where there central banks at time not over looking at these banks exposure.Do you no what the EU reminds of,Japan and what happened there,Every one was happy because it was one massive huge bubble and now EU has now burst.You cant seem to be able to fix it.

@Oshi
yes but you don't want consumers taking out mortgages for example in foreign currencies.

Also are there not companies who list there share in the UK who price there share in £ but pay Dividends in the $
HSBC,GLENCORE and BP being three i think who do so.

Most products and services sold on global markets are sold in the $USA so most companies already borrow and trade in two currency already and even pay salaries when employees are working abroad in the $.Because you maybe working in a country example the PRC where you can not exchange RMB that easily abroad when you leave so its better to be paid in $.

@Javelin
It looks to me against the legislation one would expect, it is basically counterfeiting.
Anyway you can make a law but enforcing it is something else, in practice you would probably see all sorts of schemes to avoid it. Putting pressure on the monopoly money in the same direction as without the law. Look at eg Brasil 1990's, or Cuba de facto only currency that is accepted is the USD.

@ppplusofonia

you think this is a good thing? Earning in one currency and borrowing in another is not a good idea and will eventually blow up in your face.

Many emerging markets are dollarized, with houses, cars, many contracts and even rental contracts being denominated in USD.

Certainly European citizens, who all insist they want to stay in the Euro, are likely to want to keep their contracts denominated in Euro.

As part of the second bailout, the IMF forced Greece to change the jurisdiction of bonds from Greek law to English law:

http://online.wsj....5990542256190.html

"The debt restructuring euro-zone leaders agreed to last week would cut its private debt in half—but changes the jurisdiction governing the bonds to English law, making redenomination impossible."

The estimated assets by jurisdiction are listed here by Nomura using BIS data:

http://www.scribd....k-up-Legal-Aspects

@Rik

2. Dual Currency is paid to civial servants. Government simply dont have any money to pay to them. Shops and banks are forced to accept it at parity. Euro would stil remain "main" currency.

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1. Structured exit is also for the country involved the only option for other reasons. Basically it means leaving the EU as a whole. Which is almost impossible to arrange half a countries legislation has EU links many essential institutions are EU linked (from CB to vetinary control) many Customs all over the world will not know how to handle Greece as a seperate country. Just a few examples. Almost impossible to organise and certainly impossible when under heavy time pressure.
All parties have more or less the same interest when this becomes unavoidable so likely a traety can be drafted to do so and leave Greece in the EU.
2. I donot think the double currency will work. The Euro would remain currency as well and will drive out the local monopoly money. People will prefer the Euro over say the new Drachma. Cannot create an artificial demand as it is not allowed to forbid payments in Euro for certain goods.
3. It might be that European law gives a possibility for holders and subsequently non-Greek European courts. That is why also in this respect treaties will have to be cancelled when doing it by itself. Another reason why a break up must be with some sort of mutual consent. Plus it makes the concept of leaving the EZ unilaterally but not the EU imho even more unlikely.
4. What imho should happen is people working on it. All sort of practical stuff has to be solved. Basically now you probably need approval of the 27 to stay in the EU but leave the EZ.
5. The solution that comes out at first is likely another kicking the can.

I've posted a few times on this site that a dual currency is the only option that everybody will agree on. Hobsons choice.

Could this not be workable in the mean time Gilles?

http://wealthoflab...t-begging-the-ecb/
