FINANCIAL TIMES

May 22, 2012 7:13 pm

Some euros are more equal than others

5+

By John Kay

Are your European assets Greek euros, or Spanish euros, or Finnish euros, or German euros? The defining feature of a single currency is that no one asks that question. They do not distinguish Massachusetts dollars from Californian dollars and they do not – yet – ask whether the pounds they hold are Scottish or English.

But now they do ask that question of the euro. When countries joined the single currency, a relatively simple piece of domestic legislation converted contracts in drachmas, pesetas, markkas and Deutschmarks into contracts in euros at a prescribed exchange rate. But you cannot simply reverse that process when countries leave the single currency. You have to prescribe which contracts are now to be fulfilled in drachmas and which remain in euros or converted into Deutschmarks. That determination is politically fraught, technically complex and subject to long legal challenges.

About two years ago some large businesses and wealthy individuals began seriously to ask, "if the euros were to unwind, in which currency would my asset or contract be denominated?" The issue is not whether the euro coins in your pocket carry an Athenian owl or German imperial eagle. The issue is the status of bank deposits and loans, residential mortgages and commercial contracts, as well as wages and prices. The drain of funds from Greek banks is an indication that ordinary people are now thinking in these terms.

Europe's hapless politicians, having asserted that exit from the single currency was impossible, must now claim that exit would be relatively easy. Only then can they plausibly threaten the Greek electorate with expulsion if they vote the wrong way. But exit was never impossible, never easy and even when it was publicly unthinkable central banks would have been negligent not to have put in place contingency plans.

That is why even though Greece is a small part of the eurozone, a Greek exit is an existential threat to it. Once a path to exithas been defined, business and individuals will have a template for understanding the consequences of further unwinding.

Once people generally come to think they hold Spanish euros or Finnish euros, the single currency is effectively at an end. Gresham's Law – bad money drives out good – dates from an era of metallic currency: debased coins circulated, genuine ones were hoarded. Robert Mundell, the doyen of the theory of currency areas, has explained the correct modern generalisation "cheap money drives out dear, if they exchange for the same price". In the European context,

- Finnish and German money, which carries only upside risk, is cheap relative to Greek and Spanish money, where the only risk is loss.

Once there are national euros, there is simply a currency peg between different euros and pegs have rarely been stable in the face of global capital flows. Unless economies whose exchange rates are pegged converge – the condition the eurozone has failed to meet – then the survival of the peg depends on the willingness of the country with the potentially stronger currency to accumulate indefinitely the debt of the other parties. The peg of the Hong Kong dollar to the US currency has lasted because of the unlimited willingness of the Hong Kong Monetary Authority to accept claims on the US: the peg of the Argentine peso to the US currency did not survive because US banks were unwilling to do the same for Argentine debt.

The growth of indebtedness of the weak euro currencies to the strong has already happened and is continuing. When Europe's leaders claim the continent is now better placed to withstand a crisis they mean only that this accumulation has been largely transferred from the private to the public sector, mainly the European Central Bank. Since there is potentially no limit to the willingness of the private sector to exchange weak euros for strong, the only limit to the process is the patience of German and Finnish taxpayers. So check whether the euros you hold are eagles or owls before others do.