Faultlines emerge in euro zone

THERE IS A SMALL BUT NEVERTHELESS REAL RISK THAT SOME EURO ZONE COUNTRIES COULD FIND THE POLITICAL STRESSES CAUSED BY THE FISCAL STRAIN OF SUPPORTING THE SINGLE CURRENCY TOO MUCH, AND BE FORCED TO ABANDON THE EURO. **TIM MCCULLOUGH** EXPLAINS WHAT THAT COULD MEAN FOR UK CORPORATES.

The euro came into being in January 1999 when the currencies of 11 (now 16 out of a current total of 27) EU member states were fixed to the euro and hence to each other at irrevocable rates. Three years later euro banknotes and coins were introduced in the 12 countries that then made up the euro zone.

There were fears that some countries might rely on others to bail them out of difficulties arising from their own economic mismanagement. But assurances were given that the "weaker" countries would be constrained by the EU's Stability and Growth Pact into finally reforming their economies once they had surrendered their traditional ploy of devaluing their way out of trouble. Various economic criteria were devised to satisfy membership of EMU (economic and monetary union: see Box 1), but none could be used to expel a member once it had joined the euro zone.

Those criteria (which in theory still apply to countries applying for EU membership) include:

- a 3% limit on the national budget deficit as a proportion of GDP;
- total public debt below 60% of GDP;
- inflation no higher than 1.5% above that of the three lowest members; and
- long-term interest rates within 2% of those of the three lowest members.

However, the sanctions for breaches of these four key rules have been weakened so often as to leave the enforcement regime with little more credibility than a handful of A-levels.

There is no legal provision for any member to leave EMU, nor would a country be asked to leave for continued failure of a criterion, which begs the question whether EMU is in fact PMU (political and monetary union). The political will among the national governments and within the European Commission to maintain EMU cannot be overstated. As the economic strains and differences have become more clear over the last year or so, it is the single currency that has provided the most binding political glue within the EU.

Figure 1: Spread of 10-year government yields, Ireland versus Germany

Executive summary

- Domestic popular refusal to accept economic constraints could eventually force national governments to leave the euro, despite strong political support for the single European currency. Translation, transactional and financing risk for UK corporates would accordingly increase dramatically.

But there has been talk about economic weakness directly prompting an existing member to abandon EMU. Only a few financial markets differentiate between member states: primarily sovereign credit default swaps (CDS) and the spread of the yields on 10-year national government bonds versus those of Germany (the traditional benchmark for fiscal probity). The lack of liquidity and history of CDS make them a weak measure of broad sentiment towards any government debt default.

The 10-year government yield spreads arguably tell a fuller picture of changing sentiment. The most extreme pricing has perhaps been in Irish government debt.

During the exchange rate mechanism (ERM) crisis of 1992-93, Irish gilts traded at up to 3% higher than equivalent German bunds. Once the political impetus for EMU made a single currency increasingly likely, this spread had narrowed to around 50bp by 1998. The phenomenon was repeated in other countries that had also been forced into ERM devaluations. It was accepted that these economies were moving towards long-term economic convergence, even if the dynamic was more an aspiration than a reality.

The narrow spread continued until mid-2007, before global conditions worsened. Since then, spreads in general versus Germany have widened, but the Irish spread almost hit its ERM-crisis level. While it has narrowed to 1.6% at the time of writing, the wider spread still suggests a reassessment of longer-term risk.

Previous market pricing of, among others, Irish, Greek and Spanish debt as proxies for German debt may have implied that a country might be bailed out by others or by the European Central Bank. Therefore the wider spreads since 2007 may reflect a new realisation that each country bears responsibility for its own performance, rather than an explicit risk on EMU membership.

These wider spreads are nevertheless significant as investors are passing up what in theory is a risk-free opportunity (to buy undervalued bonds of a country in long-term economic convergence with other members). By tolerating a sustained yield spread, investors may be acknowledging that these economies will take much longer to harmonise than previously envisaged, or that this is now irrelevant, since they have been really pricing the prospects of political rather than economic union.

The widening spreads do not in themselves quantify a direct threat to continued EMU membership. They do, however, reflect investors' reluctance to fund budget deficits of more than 10% (versus the 3% criterion) without adequate compensation. In turn, this highlights the pressure on countries to bring their deficits under control.

RISK Risk has become less economic and more political. To what extent and for how long can a national population tolerate sustained cuts in public services and rises in taxation to support a fixed currency regime when many cannot appreciate the consequences of abandoning that regime?

As politicians lose respect, voters may seek to abandon EMU simply because it is the core policy of those they wish to punish. So far the visible signs of political unrest are minimal, but cuts in domestic spending and levels of unemployment are increasing. Politicians will find it harder to justify domestic economic restrictions, as neighbouring non-EMU members devalue their currencies. This is particularly so if there is a perception that the pain is being borne disproportionately by ordinary voters. The cost of continued membership of the euro zone and ERM II (for example, in Estonia, Latvia and Lithuania) is being felt almost entirely by the domestic economies and populations. The real risk is that a country is forced to leave, not by the markets, nor other members, but by its own voters.

In theory ERM II members could adjust or even abandon their euro pegs without direct consequence for existing EMU members, but in reality international investors would probably again sell weaker euro zone bond markets, raising the costs of funding those countries' deficits. If any single EMU member were to secede, the euro would in theory break up, causing all members to reintroduce national currencies; in reality emergency provisions would probably allow some countries to break off, leaving a core in a smaller form of EMU.

It is almost impossible to measure this political risk. But so long as yield spreads remain above previous levels, investors are pricing in risk that was not recognised earlier.

EXPOSURE If only a core group of EU states retained the euro, with others reintroducing national currencies, then the latter would be devalued, with likely defaults on foreign currency debts (although some governments might seek to redenominate such existing debts into their new national currencies). The core euro would by contrast attract significant inflows as long-term investors sought the security of the bonds of its fiscally reputable countries.

The impact on translation risk for UK companies would be considerable. For assets and euro liabilities within the remaining EMU countries, there should be no change from any current exposure. If, however, assets were in countries leaving the euro, their value in sterling terms would be dramatically reduced by the currency weakness and potential subsequent economic weakness. Translation risk could become overhedged if euro-denominated debt were retained in euros, but would theoretically be less affected if the debt were redenominated into the new national currency by the relevant government. Future refinancing of assets in the new currency would certainly be more expensive.

Transactional currency risks would also rise substantially. New national currencies would be prone to high volatility, as would working capital costs because interest rates would rise to attract funding and contain inflationary pressures from the currency devaluation. Exporting from those countries might become cheaper in theory, but leaving EMU may make commerce harder rather than easier.

NEW NATIONAL CURRENCIES WOULD BE PRONE TO HIGH VOLATILITY, AS WOULD WORKING CAPITAL COSTS BECAUSE INTEREST RATES WOULD RISE TO ATTRACT FUNDING AND CONTAIN INFLATIONARY PRESSURES FROM THE CURRENCY DEVALUATION.

Box 1: Who's in the EMU?

There are three stages in the EU goal of economic and monetary union (EMU). All 16 member states that have adopted the euro have already reached EMU stage 3. The 16 are: Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain.

Four other countries (Denmark, Estonia, Latvia and Lithuania) are at EMU stage 2, often referred to as ERM II. Their national currencies still exist but must trade within specified bands of a central rate against the euro (in other words, their currencies are pegged to the euro within those bands). Stable maintenance of this peg for at least two years is one of the criteria for moving on to stage 3. However, under the Treaty of Maastricht, Denmark, like the UK, has an opt-out from having to move to stage 3.

All other EU countries including the UK are at EMU stage 1. All bar the UK, which has an opt-out, are committed under Maastricht to reaching stage 3 when possible. The six at stage 1 are: Bulgaria, the Czech Republic, Hungary, Poland, Romania and Sweden.

When talking about EMU membership, commentators are generally referring to the 16 euro zone countries.

RISK MANAGEMENT It is extremely difficult to hedge the currency risks of one or more countries leaving the euro zone or ERM II. The main problem is a lack of national currency to sell now in the case of euro zone members, while in some ERM II currencies the forward foreign exchange markets have already virtually disappeared. Complicated indirect hedges could be attempted via bond spreads, but these are prone to uncertainty of timing and the problem of quantifying currency devaluations in terms of widening bond spreads.

If UK companies accept that political risk to EMU membership exists and that this would have profound economic as well as financial consequences, they could consider altering underlying commercial arrangements in those countries. At the very least they should be aware that this risk is now recognised by international investors and can be observed loosely via bond spreads.

The risk scenarios outlined above are theoretical and do not represent a specific forecast. Although the risk is currently low, the consequences would be so serious as to justify planning for this contingency now, with time and space to seek independent advice. Waiting until a possibility becomes so obvious as to become a probability could be too late.

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