BANK OF ENGLAND

Currency in search of confidence

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The euro's travails provide riveting reading. Debate over austerity, imbalances and firewalls fills the printed page. Indeed, the eurozone challenge is daunting - but so too is the political will to defend it. To prevail however, authorities must go beyond containment; they must restore complete faith in the construct. Until this is achieved, uncertainty will feed fear and create a hidden drag on economic recovery. This has already begun.

For example, those Greek citizens concerned that their country might quit the common currency have shifted their euros from local banks for fear they may not be free to do so in the future. Quite a few must be concerned: Greek banks have lost nearly a third of their deposit base. Capital flight from a number of other euro-zone countries has commenced. Have you tried to buy a flat in London lately? You have competition. Property agents openly refer to the "Bank of Belgravia." Want to open an account in Lugano? Get in line.

Some lenders are also leery. Stories of international credit card companies altering prior arrangements due to potential currency changes have been widely reported; quiet cut-backs in credit facilities from banks in the north to borrowers in the south less so. Contingency planning in the lower bowels of the upper reaches of finance is in train. Senior bankers have begun to speak of "Greek Euros" or "Spanish Euros."

The specter of cross-border risk has returned. This is the risk that a borrower might not be able to repay his euro lender in full for reasons more related to the sovereign than to the corporate borrower itself. Currency re-denomination from euro to drachma could be one threat; exchange controls another. Take an example: a German bank in Munich has lent euros to the Athens subsidiary of BMW. Now suppose Greece exits the euro and reintroduces the drachma. Is the loan still a euro loan or a drachma obligation? If it is a euro loan, the BMW dealership will have to repay euros from depreciating drachma revenues – that is if exchange controls permit. Alternatively, if it is now deemed a drachma loan, then the lender has a depreciating drachma asset funded by a hard currency euro liability.

The concept of cross border risk is well understood by bankers who lend euros to borrowers outside the euro-zone or rubles funded from it. But lending in euros within the zone was supposed to be free of such risks. And indeed it is – *provided* the euro hangs together. The traumatic troubles in Greece have introduced a degree of doubt.

Banks can manage cross-border risk in two ways. In the long run, they can balance loans to local borrowers with deposits from local savers. Should a currency change cause the asset to fall in value then at least the liability declines as well. If one changes the other changes. The interest rate spread remains. Achieving asset / liability matching may require a sharp expansion of the lender's local deposit base. This can take time. In the short run – and until local assets and liabilities are in balance, the bank can limit the degree of mismatch. Unfortunately, this means limits *on* or cutbacks *to* lending into a region funded from deposits taken outside.

So here's the problem: capital is leaving the very countries who need it – and flowing to the countries who don't. Simultaneously, financiers are beginning to cut back on their lending to needy areas while they determine and manage their appetite for potential cross-border risk. For the moment, the ECB and other official entities help plug the gap.

When European leaders finalized the Greek restructuring "within the euro," they avoided an uncontrolled default and potential Greek exit with unknown knock-on effects to other peripheral countries. This was a major achievement. The challenge now is to restore complete confidence in the viability of the euro-zone so as to banish cross-border risk from financial planning. Until this is accomplished the free flow of capital within the euro-zone will be impaired and along with deleveraging more generally, add to the hidden headwinds to economic recovery.

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