THE WALL STREET JOURNAL

02-DIC-2016
da pag. 11
foglio 1

Dir. Resp.: Thorold Barker

A Potential Banking Crisis Awaits the Next Eurozone Exit

There's one kind of debt that governments won't be able to inflate away. And its value could be crushing.

By Marcello Minenna

Commentators have speculated for years about whether this country or that would be leaving the eurozone. The debate has focused on political arguments about European solidarity and macroeconomic arguments about competitiveness and currency valuation. Now, thanks to new data, another question is coming into focus: As a practical matter, can a country leave even if it wants to?

As with so much else in the eurozone, this is a question of debt. One of the most plausible arguments for leaving the common currency is that doing so would allow a country to devalue its way out of a solvency crisis. Were Italy to leave the euro, perhaps as an eventual consequence of this weekend's constitutional referendum, a re-created lira could in short order plausibly lose 40% of its value against the euro. The British pound lost 25% of its value after Brexit, and that was with a government committed to fiscal responsibility.

This scenario assumes that debt would have to be redenominated in the new currency. A sharp, sudden devaluation would make it difficult to repay old debts in euros. To avert widespread defaults of banks, enterprises and households, a government leaving the euro would soon find it impossible to avoid invoking *lex monetae*—an internationally recognized principle under which a government may set the currency to be used to settle debts contracted under that government's jurisdiction without automatically triggering a default. That would include money borrowed locally from a foreign entity. A mortgage borrowed by an Italian from the Florentine branch of a German bank would be subject to such redenomination.

Economists and politicians who support leaving the euro are correct that this would allow governments to inflate away debts, and that there's little anyone could do to stop them. The only check would be political, since this would also eat away at the $1.6 trillion in bank deposits Italians have stashed away in Italian banks.

But there's one huge pile of debt this euro-exit plan doesn't account for: debt contracted overseas. This includes debts such as bonds issued in Frankfurt by a Greek company, or derivatives contracts made by an Italian company in London or New York. Because these contracts wouldn't be under the jurisdiction of the government leaving the eurozone, they wouldn't be subject to forcible redenomination. And because the eurozone has encouraged the internationalization of European debt markets, the amounts of such debt are huge.

Just how huge is tricky to measure. The best data come from the Bank for International Settlements. These statistics don't single out so-called foreign-law bonds, lumping them instead into the broader category of "international debt." It's estimated that foreign-law bonds make up about 90% of international bonds, and is the most reliable data currently available on foreign-law debt outstanding. The numbers are eye-opening.

The Netherlands is the most internationally exposed economy in the eurozone, with more than $1.9 trillion in foreign-law bonds outstanding. France follows with more than $1.4 trillion. Italy has around $770 billion.

Most of this debt is owed not by governments but by financial institutions. Dutch banks account for most of that country's foreign-law debt, and French banks account for around $1 trillion of that country's liabilities. Italy's troubled banking system has issued more than 80% of that country's foreign-law bonds. The Italian government, in contrast, has issued around €97 billion ($103 billion) in international bonds, in addition to around €40 billion in derivatives that would be immediately due in hard currency were Rome to leave the euro.

One country that wouldn't have a problem with this, ironically, is Germany. While it owes €1.2 trillion in foreign debt, a new deutsche mark freed from the rest of the eurozone would probably strengthen relative to the euro, devaluing Germany's foreign-law debt in domestic terms.

These data suggest that, whatever the country, the likely outcome of a euro exit would be a full-blown banking crisis. An emergency plan should focus on a limitless supply of foreign currency to national banks, along the lines of that done by the Bank of England after Brexit.

Governments could face their own challenges with foreign debt. Under EU rules, since 2013 more than 50% of long-term eurozone bond issues have been provided with special collective-action clauses that expand the veto power of creditors against a unilateral action to restructure or redenominate the sovereign debtor. A country leaving the eurozone could try to override such a clause but it's uncertain whether it would prevail in front of an international court. Moreover, the ECB is the major creditor for more than €1.2 trillion of government bonds purchased via its quantitative-easing process; it could well constitute by itself a blocking minority to a redenomination.

Breaking ties with the eurozone is always possible. But don't believe anyone who argues it would be simple.

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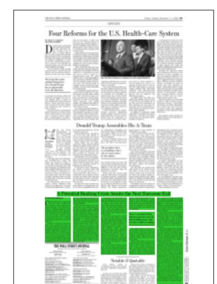

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