

Update

The Colour of Money: Currency Considerations of a Eurozone Withdrawal

Policymakers, the European Central Bank (“ECB”) and the International Monetary Fund (“IMF”) continue to search for a way to alleviate the Eurozone’s debt crisis. Meanwhile there is a growing threat that one or more of the Eurozone Member States (“EMSs”) will be forced to leave the single currency. As countries such as Greece, Italy, Portugal and Spain remain locked in debt restructuring negotiations, the words of British economist John Maynard Keynes hold greater resonance than ever: “if I owe you a pound, I have a problem; but if I owe you a million, the problem is yours”.

If an EMS does exercise the “nuclear option” of leaving the Euro the potential financial consequences for the global economy are colossal, and companies worldwide are now carefully considering the problems that they may face. Following on from our first paper on the implications of the withdrawal of an EMS from the Eurozone, this paper examines the historical impact of currency redenomination and the key issues for businesses to consider.

Lessons from history

Although over 60 countries have left currency unions since World War II – many such as Pakistan and the Republic of Ireland after obtaining political sovereignty, others such as Germany and France to join the Euro – should an EMS leave the Eurozone there is uncertainty as to the impact on its new currency. Whilst it was

not a member of a monetary union equivalent to the Eurozone, valuable lessons can be learnt, and potential implications for the exit from the Eurozone identified, from Argentina’s decision to re-float the Argentine Peso (“Peso”) in 2002.

When the current version of the Peso replaced the Austral in 1992, after a period of hyperinflation, Argentina’s Central Bank (“ACB”) pegged it to the US Dollar at a 1:1 exchange rate and in addition the country’s financial reserves held one US Dollar for every Peso in circulation. As with the countries in the Eurozone – who have their interest rate set by the ECB – in effect, Argentina had relinquished its sovereignty over monetary policy as its interest rates were ultimately set by the U.S. Federal Reserve. Pegging the Peso to the US Dollar initially helped to stabilise inflation and attract investors, but imports rose

(harming domestic producers), GDP fell and unemployment rose. As the country struggled to service its very high international debts the IMF pressed the government to adopt an austerity budget, and civil unrest spread. At the very end of 2001 the country defaulted on US Dollar 132bn of its public debt, and the following month the government allowed the ACB to set a new “official” exchange rate of 1.4 Pesos to one US Dollar. It also redenominated US Dollar bank accounts into Pesos at this new rate. Soon afterwards the Peso was allowed to float freely, and by June 2002 it had depreciated to a rate of 3:1 against the US Dollar.

Many contracts with foreign investors were denominated in US Dollars, as one would expect. With the flotation of the currency, this meant the cost of contractual payments rose significantly. However, the political risk element for such foreign investors arose in the actions of the Argentine Government at the time passing legislation to “pesify” contractual payment terms denominated in US Dollars. The Government also stepped in to emasculate provisions (often called stabilisation clauses) by which tariffs in the gas and electricity markets were linked to the US price index. Devaluation led to a surge in inflation and the insolvency of a number of companies, though over the succeeding years GDP rose at an impressive rate.

In the absence of any European legislation that provides a mechanism for withdrawal from the Eurozone, there is wide-spread uncertainty as to how an exiting EMS would reinstate its pre-Euro currency. Notwithstanding the practical considerations associated with any reversion, such as the time and finances required for the secure printing of a new currency (an issue that Argentina was not forced to deal with), learning from the Argentine experience it is widely anticipated that in the short term the exiting EMS would experience significant economic problems. If investment were to immediately flow out of the economy, the exiting EMS would be faced with a dilemma: either to impose exchange control restrictions which could inhibit its competitiveness or to free-float the new currency and risk a strong surge in inflation. In any event it is clear that alongside widespread unrest, a redenomination and the probable depreciation of the new currency would expose those companies around the globe with business interests in the exiting EMS to financial risks.

Future of the Eurozone: Considerations for companies

In light of the potential ramifications, companies would be wise to consider the potential impact to their business in the event that an EMS withdraws from the Eurozone. Although policymakers are confident that the Eurozone’s seventeen members will remain in the single currency, it remains far from certain as to whether the necessary antidote to Europe’s debt crisis will be agreed upon before exercising the “nuclear option” is considered the only solution.

In the event that an EMS does withdraw from the Eurozone, there are a number of issues which may arise such as:

Question:

I have a contract with a company incorporated in an exiting EMS which provides that payments are to be made in Euros. Will redenomination of the exiting EMS’s currency have any impact?

Answer:

Potentially, as redenomination of contractual payments would be subject to the internationally recognised “lex monetae” principle. This principle provides that where a monetary obligation is stipulated in a particular currency, an implied choice of law of that currency’s country determines the currency to be applied. As the Euro is not the currency of one particular country, it is not certain how the courts would apply this principle, for example, when having to decide on a contract denominated in Euros between a buyer and seller incorporated in different EMSs. When identifying which country’s law applies a court will take into account a number of issues, including the contract’s expressly agreed governing law, the parties’ intention when entering into the contract, the place of performance and the place of payment. The court will also take into consideration the Rome Convention which provides that when the place of performance is in doubt it is not necessarily the place of payment. Mandatory rules (i.e. those which apply regardless of the parties’ choice of law) will also be key. Should the court decide that the law of the contract is that of the exiting EMS, or that the law of the exiting EMS applies regardless of the parties’ choice or intention, then the contractual payment is likely to be redenominated into the new currency of the exiting EMS.

In this event there are a number of potential consequences that a business should consider. As redenomination is anticipated to result in a subsequent depreciation of the exiting EMS’s new currency, it is likely that the real value of the contractual payments would be significantly reduced. Alternatively, if contractual payments were to remain in Euros the value of the contracts could increase for contracting parties in an exiting EMS whose bank deposits would have been redenominated. Accordingly, there is a real risk that such companies, in particular those that rely heavily on domestic revenues, would be unable to satisfy their contractual obligations. Furthermore, even where a company is able to pay there is the possibility that such payments could be delayed or blocked as a result of exchange control mechanisms in the exiting EMS. Irrespective of the potential fluctuations in the value of contracts, where a new currency renders performance more expensive under English law it will not provide grounds for the contract to be frustrated. Additionally, companies should also consider the mandatory rules that an exiting member state may implement which could, for example, impact on the governing law of contracts.

Question:

I've got a Letter of Credit ("LC") from a bank incorporated in an exiting EMS. Will I still be able to rely on this LC and will the monies be redenominated from Euros into the exiting EMS's new currency?

Answer:

Ultimately this will depend on the specific terms of the LC and any legislation passed by the exiting EMS. In the absence of any terms/law which provide that the issuing bank may revoke the LC in the event that (for example) the EMS where the bank is incorporated withdraws from the Eurozone, it is likely that the bank will not be able to do so. In any event, it is rare to find an LC that is revocable. However, as bank deposits and guarantees are likely to be redenominated in the new currency, the value of the LC may depreciate in line with the likely devaluation to the new currency. This would mean that a company that holds a LC with a bank in an exiting EMS may find that its value is now significantly less than when it was first issued.

Additionally, as history shows us redenomination is likely to result in significant financial disturbances and a withdrawal of capital from banks incorporated in the exiting EMS, there is a risk that banks would be unable to meet payment obligations and be forced to write off loans to their insolvent borrowers. In the event that banks struggle to obtain external financing, either through government or capital markets, their credit ratings would be impacted or in the worst case they may face insolvency themselves. Already we are witnessing banks in vulnerable EMSs facing insolvency proceedings and companies should be aware that the global economic debt crisis has meant that banks can no longer be considered "bullet-proof". By way of protecting their interests, companies should carefully examine the terms of their LCs and look to obtain confirmation of the issuing bank's obligations from a confirming bank in their jurisdiction. Further, companies should also consider alternative measures to obtain security, for example with banks in less vulnerable EMSs or in non-Euro member states and/or by guarantees from a company in the corporate group based outside of the exiting EMS (although, as everyone is coming to appreciate in this crisis, banks and even countries presently thought to be "safe" can quickly become a credit risk).

Question:

I have obtained a judgment from an English Court. Can I enforce it against the assets of a company incorporated in an exiting EMS?

Answer:

Under the Brussels Regulation (EC Regulation 44/2001) (the "Regulation") there is a reciprocal enforcement of judgments amongst European Union ("EU") member states. However, as there is no enshrined mechanism for withdrawal from the Eurozone it is not certain whether the Regulation would apply to an exiting EMS. As new legislation to restrict the flow of monies out of its economy would be implemented, it is possible that judgments denominated in Euros would not be enforced in Euros by a court in the exiting EMS. It is possible that the new legislation may provide that the courts in the exiting EMS can only enforce payments in their new currency and accordingly there is a risk that the judgment's value would be significantly diminished.

Question:

I am currently negotiating a deal in Euros. Should I insert any particular wording into the contract or would you advise an alternative currency for payment obligations?

Answer:

Whether or not to amend a contract, or face the possibility of a change of currency, will be a risk and reward balancing exercise for each counterparty. There will be many contracts under which one of the parties would be very happy if their obligations were redenominated into a depreciating currency. However, where a party wished to ensure the currency always remained the Euro, clear wording should be inserted to the effect that "Euro" means the currency of the Eurozone from time to time and not the domestic currency of the EMS where the company is incorporated.

Alternatively, to avoid any potential disputes regarding the currency of contractual payments, companies may consider denominating the contract in a currency other than Euro, such as US Dollar or UK Sterling. Although, again, this would be a risk assessment for each contract counterparty, as no guarantees can be given in this crisis about the strength of any currency.

Question:

I am looking to enter into business with a company incorporated in a peripheral Eurozone economy. What steps should I take to protect my interests?

Answer:

When looking to enter into a new business venture or renewing contracts in an existing relationship with any company based in the Eurozone or elsewhere they will no doubt take heed of the current political and economic climate. Should an EMS withdraw from the Eurozone, or in the worst case the Eurozone disbands, there are likely to be significant ramifications for businesses worldwide. Companies should carefully review the terms of any agreements and consult with their lawyers to contingency plan. Some issues which they may wish to consider are:

1. Whether the governing law is the law of a vulnerable economy
2. Whether it is appropriate to insert terms to the effect that each party waives any right under their applicable domestic law to satisfy payment in any currency not stipulated under the contract
3. Whether the parties should agree to consult and re-negotiate the currency provisions in the contract should an EMS withdraw from the Eurozone As part of their contingency planning, when obtaining security companies should also consider checking the geographical location of the account of the issuer and consider whether potential

As part of their contingency planning, companies when obtaining security should also consider checking the geographical location of the account of the issuer and consider whether potential redenomination legislation and exchange control mechanisms could impact on any future payment obligations.

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