What's in a Euro? 12th June 2012

The ongoing Eurozone crisis introduces a high degree of uncertainty surrounding what the Euro Currency will become as the crisis reaches a crescendo. There are many questions yet to be answered as the situation unfolds, not least of which is a question mark over the EUR's possible composition, as opposed to the traditional currency questions regarding price movement and drivers.

When a currency hedger or speculator participates in currency markets, they are aware of what they are holding: i.e. a "long" position in one currency and a "short" in another. This implies a spot and forward exposure to two currencies simultaneously, and all the economic volatility that represents. In the past, (and that past is really pre-EUR crisis) when the EUR currency was traded, one knew what would be delivered or received upon a long-dated settlement. In other words, there wasn't any optionality with regards to the underlying currency's identity.

This is what makes the Euro crisis and the Euro unique. After all, currencies aren't meant to have optionality with regards to what they will become on a future date, if that were a possibility or probability, there should be an implied optionality embedded in that currency. An option by its nature has the ability to expose the investor to an asymmetric payoff for the speculator or hedger when they are purchased, and unlimited losses if they are sold uncovered.

Consider the appreciation of the EUR for the period July 2001 to July 2008. Over that period the currency moved from low 80's to 1.60 USD's per EUR. Investors owning EUR rode the positive benefits of a single currency union at the expense of the eternally debt-ridden funding 'piñata' – the USD. However, the shortage of USD during the credit crisis saw the EUR fall, and so the one-way dollar bet effectively died, due in no small part the death of unlimited (USD) credit. Throughout this episode, there was never any doubt about either currency's actual future; only their value and respective role in global finance.
So now, the EUR has embedded optionality creeping in. If one owns it, do you in fact own a partial Deutsche Mark "call" and the balance in some distressed currency basket? Are financial contracts valid in a EUR breakup scenario; will the ISDAs be enforceable? If it fragments, what will be the ratio of "solvent" currency to "insolvent"?

On the other hand, the short sellers (of which there are many) aren't just trying to participate in the sharp shift downward in the credit and economic performance of one country or zone versus another. Perhaps the market will sell EUR until it finds the eventual strike price of this "put." In a breakup scenario, who will divest and how far will the EUR fall versus currencies like the AUD or USD? But could a seller of EUR be an unwitting participant in a reconstruction that also involves assigning the short EUR position into several open positions in a new currency via some sort of conversion factor?

The EU summit will result in a few more steps to keeping the markets from melting down and assuaging the bondholders. However, beyond the snakes and ladders game of policy initiatives versus market reaction, another longer-term evaluation is taking place. That is, once the EUR is reborn, what will it comprise of and who will have borne the cost of the experiment thus far?

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