How the Euro can be Saved: A Common Euro Bond

By Kenneth Matziorinis*

When the Europeans decided to create a common currency, they were warned that the euro project was bound to fail. Since its launch in 1999, trade and payments imbalances within the Euro zone have led to a built-up of debt levels in the euro periphery which have driven bond spreads back to pre-union levels and are threatening to tear the currency union apart. With the euro experiment in disarray, Europeans are pointing fingers at each other and the cohesiveness of the euro zone is fast approaching a meltdown. Who is to blame? Is it the euro periphery that borrowed too much? the euro core banks that lent too much? the global financial crisis of 2008? the global downturn of 2009? the global deleveraging process that we are in? Sure, there is plenty of blame to go around. Countries outside the euro zone like the USA, the UK and Japan are in similar mess, yet are not facing an immediate crisis.

The real reason why the euro zone is experiencing a sovereign debt crisis, why Greece is on the brink of default, why euro banks are in trouble and why the euro currency is on the verge of collapse is a structural flaw in the design of the European Monetary Union (EMU) itself. Only by identifying the real cause can the problem be fixed.

A common currency pulls prices of products and resources, including capital and labour, to the same level across the currency area. Unless productivity levels in the countries sharing the same currency are the same, it results in rising unit labour costs in the less productive members and reduces their relative competitiveness which inevitably results in rising trade and payments imbalances. To sustain these imbalances the less competitive members need a source to finance them. Deficits can be financed either through fiscal transfers or through borrowing or both.

When the EMU was designed, Euro countries decided to unite their currencies and form a common central bank, the ECB, but chose not to unite their debts and form a common EU Treasury, common borrowing instrument and debt agency. This meant that although they shared a common cheque book, each country was responsible for its own debts. The currency risk was transformed into a credit risk. This is the root cause of the euro zone’s problem. Although rules were set in the Stability and Growth Pact (SGP) to mitigate against this risk the enforcement mechanism was not designed properly and then violated by France and Germany which opened the door for other countries to do the same. While interest rates remained low and the tide of financial leverage was rising, the defect remained hidden but when the tide reversed and the global financial and housing bubble burst then it came to the foreground. There is no reason why Greece which accounts for less than 3.0 % of GDP and less of than 4.0 % of the euro area gross debt threaten the entire union. Right now the euro is as strong as its weakest link. That shouldn't be the case.

What can be done now to fix it? Deal with the problem, not the symptoms. Administering hard doses of austerity on Greece and the entire euro area reduces income, raises deficits and increases the debt-GDP ratio. It is only making matters worse. The medicine is killing the patient. Markets are not buying the prescription as rising spreads on peripheral euro area bonds suggest. Nor have euro area governments been convinced of the wisdom of throwing so much good money on one band-aid solution after another. All they are doing is bailing out the banks from their lending profligacy, punishing the debtors to appease the markets and kicking the can down the road.

To have a common currency you need a common bank account, otherwise you are not a union and the currency is a sham. What Euro leaders need to understand and do so before the markets lose patience, is that the only way to fix the problem is to take the 'bull by the horns' to make the one final step left to close the hole in the integration process, which is a fiscal union. Euro countries must combine their fiscal debts and create a single European government bond (EGB) market, convert their national bonds into a common euro bond, create an EU Treasury and debt management authority and start coordinating fiscal policies. Only then will there be an economic union.

Let's imagine for a moment what effect this would have on the markets and what benefits it would bring to the euro zone. If Euro area leaders were to emerge from an emergency three day meeting in a chateau in Luxembourg to announce that the Euro Area will proceed in this direction, bond spreads would plunge and bond and equity prices would sore in one of their biggest gains in history. Although it would still require time for the details to be worked out and the euro parliaments to approve the decision, it would ease pressures, stop the financial panic and buy the time that is so needed right now for the zone to implement the plan. The time table for the application of fiscal consolidation measures and structural reforms can be extended to the medium term to provide immediate relief and boost confidence in the hard hit economies, ease the transition and prevent a double dip in the euro economy.

It is clear how this would benefit the euro periphery. How does it benefit Germany and the euro core? By pooling fiscal risks and issuing jointly-backed euro bonds, a unified European government bond market of $11 trillion will be created with a breadth, depth and liquidity to match the US Treasury market. A euro bond carrying a 'AAA' rating will enhance the role of the euro in the global economy by turning it into a global payment currency in addition to its present role as a global reserve currency. The 'big fish, small pond' problem presently hampering the development of small and fragmented national European bond markets will be eliminated. The demand for euro debt instruments will rise sending yields down across the maturity spectrum as central banks, wealth funds, hedge funds and multinational corporations start using the euro as a bank account and as a 'safe haven' currency the way they have used and still use the US dollar in the post war period. The 'seigniorage' gains that will accrue from this development, what has been called 'the exorbitant benefit' will reduce the cost of borrowing for Germany and the euro core as a whole below present levels. With euro bonds, German banks and tax payers have nothing to fear and everything to gain.

But, if a common borrowing instrument such as the euro bond is created, how does it stop member countries from running up the tab? Without the disciplining role of markets how do you keep profligate members in check and mitigate the moral hazard? Simple, internalize the disciplining role of the market by agreeing on a formula where the marginal cost of financing rises in lock step with the debt-GDP ratio of the member country. This way, countries with higher debt ratios are penalized by paying at a higher rate for their share of the interest on the common debt while they have an incentive to reduce debt and grow their economies.

The introduction of a euro bond along with a common treasury, resolve the euro zone's problem. It is the only missing ingredient to restore confidence in the euro zone and allow it to function normally. Sure, countries run periodically into debt and payment problems. Canada did so in the 1990s, but the key ingredient to fix the problem, i.e. a common treasury and a common borrowing instrument, was there. Europe right now lacks this ingredient. This treats the cause of the problem. It is the simplest and most effective solution. It is a lasting solution. It is also the lowest cost solution. Pooling national debts into a single collective debt is like an all stock merger of companies, it does not require any additional cash yet the synergies and cost savings resulting from creating a stronger whole benefit everyone.

The Euro debt crisis stems from a structural problem that requires a political solution. Euro area leaders must accept the obvious and do the right thing. Stop focusing on the wrong issues and pandering to misplaced public feelings and uninformed public opinion and take enlightened, bold and effective action to fix the problem now. This is not only about the stability of the European economy, it is also about the financial and monetary stability of the entire world.

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