RESOLVING THE EURO DEBT CRISIS AND SAVING THE EURO: COULD A EURO-ZONE BOND BE THE ANSWER?

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If you think that Greece is the problem, think again. The problem is not so much with Greece, it is with the euro. It is a systemic problem, with financial, economic and political dimensions, which has manifested itself first in Greece, admittedly the country with the worst fiscal position in the eurozone.

True, countries in the periphery of the eurozone like Greece need to apply austerity measures in the short run to reduce budget deficits and they need to undertake structural reforms to make their economies more competitive in the long run. Slowly, but surely these countries are adopting austerity measures and undertaking structural reforms to fix their economies. The current crisis not withstanding, they needed to improve their fiscal position and increase their competitiveness anyway. They will be better for it in the long-run. But austerity and structural reforms alone in the periphery are not sufficient to resolve the present crisis in the eurozone. Europe also needs to undertake fundamental structural adjustments to its system of monetary, economic and financial governance. If the euro is to survive in the future, if it is to secure its place as a global reserve currency and if financial and economic stability is to return to the region, Europe needs to take bold and visionary steps toward further European integration.

Further European integration is not only important for Europe, it is equally important for the stability of the world economy and global security as well. Why? First, in a world of super-sized economic powers like the USA, China and soon India, Europe must stand as a single, cohesive economic and political power that speaks with one voice. If it does not move toward further integration so as to eventually become the *United States of Europe* (USE) by 2040 the individual collection of small European countries will be condemned to become the backwater of Asia and America, living standards will slip relative to the rest of the world, ethnic discord will rise and they will become vulnerable politically and militarily to outside forces. Force, especially the malignant sort, tends to gravitate toward weakness. A weak Europe will invite adverse challenges that it would rather avoid.

Second, the world economic and military balance today is resting on three pillars: the United States, Europe and China. While China seems well on its way toward becoming a more solid and secure pillar, the prospects for Europe have suddenly become cloudy. As the world evolves, and we have seen how far China has come over the past 30 years, Europe must evolve as well just to keep up, let alone to reach the point where it is able to assume and exert leadership in the world. If Europe fails in this drive toward further economic, political and military integration, it will destabilize the world order as we know it and will turn it to a much more dangerous place.

Let us start by putting things in perspective and stop looking at the world from a rear-view mirror. Yes, in the 19th century Europe ruled the world, but lost ground in the 20th century to the United States of America following two world wars it initiated. Since 1945, it has tried to salvage what was left of its global power status through the project for European integration: ECSC, EEC, EC, EU and since 1999 the EMU. It has managed to remain a prosperous and influential region in world affairs, but only subject to the hegemony of the United States, a friendly super power with a culture aligned to that of the old continent. But the world has not stood still. The rest of the world has continued to grow, develop and change. Now we see a new super power in the making, China, and there are more to come. For a view of what to expect in the next 40 years consider the GDP projections (nominal GDP in USD at market rates) made by Goldman Sachs in 2003. [1]

Table 1 clearly shows that unless the European countries proceed towards further economic and political integration they risk becoming third rate powers by 2050. Take Germany's position for example -the largest economy in the eurozone. It slips from being the 4rd biggest in 2010 to the 8th biggest by 2040. It has already slipped from 3rd place since 2000. The same applies to all the other major economies of the eurozone including the UK. What is worse is that in an updated projection done in 2007 by Goldman Sachs[2], Germany ends up in 10th position on the list, with France and Italy out of the list all together. See Chart 1.

TABLE 1

TOP TEN COUNTRIES BY GDP IN 2050

	2000	**2010**	**2020**	**2030**	**2040**	**2050**
China	1078	2998	7070	14312	26439	44453
EU	9395	12965	16861	21075	28323	35288
USA	9825	13271	16415	20833	27229	35165
INDIA	469	929	2104	4935	12367	27803
JAPAN	4176	4601	5221	5810	6039	6673
BRAZIL	762	668	1333	2189	3740	6074
RUSSIA	391	847	1741	2980	4467	5870
UK	1437	1876	2285	2649	3201	3782
GERMANY	1875	2212	2524	2697	3147	3603
FRANCE	1311	1622	1930	2267	2668	3148
ITALY	1078	1337	1553	1671	1788	2061
Germany's Rank	3	4	4	6	8	8

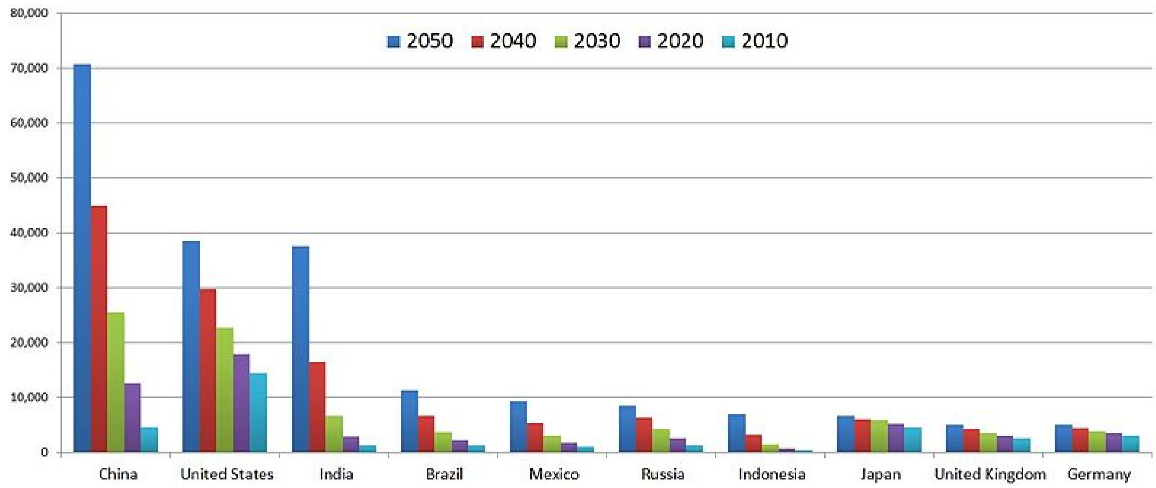
Source: Goldman Sachs, Global Economics Paper No. 99, October 2003

[1] Goldman Sachs, Dreaming With BRICs: The path to 2050, Global Economics Paper No. 99, October, 2003

[2] Goldman Sachs**,** BRICS and Beyond, 2007, See also "BRIC" on Wikipedia for the complete list.

What Europe needs is an urgent drive toward further economic and political integration. Doing so will maintain Europe's position in 2nd or 3rd place, on the list of the world's four most powerful economies. When you look forward to the new realities shaping our world one must ask, does Europe really have a choice? The answer is, No, it does not.

CHART 1
Top five largest economies in 2050



Wikipedia, Article on BRIC, taken from Goldman Sachs (2007)

The euro, the pride and joy of post-war European integration is now in grave danger, and along with it, global economic and military security as well. Urgent steps need to be taken and time is running short. Here is an outline of what is needed to fix the problem and position Europe on a path to economic prosperity and stability.

<u>What Must Europe Do?</u>

Eurozone member countries should resolve to merge their sovereign debts into one common euro-zone debt by exchanging maturing national debt obligations for ***euro-zone bonds*** (EZ bond). The euro-zone bond would be a new form of security similar to the existing national government bonds but with the difference that it would be backed by all eurozone member governments collectively. A euro-currency denominated borrowing instrument of euro member countries, issued by a new, to be created, Euro Treasury or European Finance Ministry and jointly and severally guaranteed by eurozone governments. It would be a new supranational debt obligation similar to those issued by the IMF and the World Bank. The ideal name for such a security should be 'Eurobond', but the name is already being used for foreign bonds issued and traded in countries other than the one in which the bond is denominated. Other names for the new bond can be '*pan-european bond*' or simply '*blue bond'*.

Based on IMF figures for 2010 in USD, the total stock of gross debt of the eurozone amounts to $10.3 trillion US dollars while the GDP of the eurozone amounts to $12.2 trillion, a collective debt/GDP ratio of 83.9%.Three countries alone (Germany, Italy and France) account for nearly 70% of the total stock. Greece, the country in the news accounts for 4% while the PIGs (Portugal, Ireland, Greece) account for 8%. See Table 2 below.

TABLE 2

DEBT STOCKS AND DEBT-GDP RATIOS, EUROZONE, 2010

	Debt/GDP Individual %	GDP in USD	Gross Debt in USD	Debt/GDP Collective %	Debt Shares by country
Austria	69.9	376.8	263.4		2.54%
Belgium	97.1	465.7	452.2		4.37%
Cyprus	61.6	23.2	14.3		0.14%
Estonia	6.6	19.8	1.3		0.01%
Finland	48.4	239.2	115.8		1.12%
France	84.2	2582.5	2174.5		21.00%
Germany	80	3315.6	2652.5		25.61%
Greece	142	305.4	433.7		4.19%
Ireland	96.1	204.3	196.3		1.90%
Italy	119	2055.1	2445.6		23.61%
Luxembourg	16.6	55	9.1		0.09%
Malta	67	8.3	5.6		0.05%
Netherlands	63.7	783.3	499.0		4.82%
Portugal	83.3	229.3	191.0		1.84%
Slovakia	42	87.5	36.8		0.35%
Slovenia	37.2	47.9	17.8		0.17%
Spain	60.1	1410	847.4		8.18%
EUROZONE	**69.1**	**12208.9**	**10356.1**	**84.8**	100.00
PIG (Portugal, Ireland & Greece)					7.9%

Source: IMF, 2010 Figures, WEO Data Base

Without going into the legal, political and financial technicalities of issuing euro-zone bonds (EZ bonds), let us look at the economic merits of the idea. Because the EZ bond will be backed by the entire region, it suddenly and immediately and in a one fell swoop resolves the current debt crisis in the peripheral nations, resolves the banking crisis in the core and sets the stage for sustainable economic growth and prosperity in the whole region. The current pressures are mostly psychological, i.e. there is a fear that these individual countries will be unable to redeem their bonds as they come due. As markets panic they are reluctant to lend more, interest rates are driven up increasing the cost of servicing public debt and force countries to take austerity measures or default on their obligations.

The EZ bond resolves the immediate pressure, postpones the problem and allows time for structural reforms and economic growth to do their magic in a timely fashion that does not jeopardize the economic recovery of these countries from the recent global downturn. In turn, economic growth helps reduce debt/GDP ratios and improves the fiscal outlook of all sovereign debtors in the region.

Second and equally important is that, the average interest on EZ bonds will be at least equal -if not lower- than those on German bunds, the top-rated sovereign bonds of the eurozone. Since they are backed by the entire group of countries spanning a wider, more diversified region, the EZ bond represents a much stronger obligation than the one that any single nation could offer. The reduction in the interest cost of carrying the public debts will result in huge annual savings for all countries, especially the ones that are more indebted and presently pay a hefty premium to refinance their obligations. This not only improves the long-term sustainability of their national debt but also reduces the annual budget deficits and allows them to achieve balance sooner and with less pain. It results in a virtual circle.

Third, the creation of this new euro-zone backed security will transform the European capital market for sovereign loans into one single but vast euro bond market that will rival the market for US Treasurys. A euro-zone bond market of $10.3 trillion compared to a US Treasury market of $13.5 trillion will create a vast market of such enormous depth, breadth and liquidity that it will make the euro-zone bond as good a security to hold, and to flee to safety in times of global financial instability, as the US Treasury market is today.

Fourth, it will go a long way toward complementing and solidifying the euro's status as a global reserve asset. Why? Presently, the euro has become the second most important currency on the planet for official *store of value* purposes, i.e. a reserve currency that central banks choose to hold their savings in. But it lags severely behind the US dollar as a *means of payment* instrument, because European debt markets are fragmented and not big enough. The debt traded in each of the three largest, namely Germany, Italy and France are well below $2 trillion each. Together, the EZ bonds can create a single unified debt market in excess of $10 trillion with such liquidity that any buyer or seller can trade in and out with minimal impact on price and yields.

Fifth, due to its increased depth, security and liquidity, holders of EZ bonds will be more than happy to hold them not only for *investment* purposes but for *payment* purposes as well which will increase the demand for them, raise their price and lower the yield on them. By enhancing the role of EZ bonds into a payment instrument as well, the way US Treasury bills, notes and bonds have served in the post-war period, they will result in a <u>significant reduction</u> in interest rates –what is known as *seigniorage*- that will lower the cost of capital significantly in the eurozone by at least 100 basis points. This will benefit not only the periphery but also the core countries such as France, Germany and the Netherlands.

The benefits accruing from *seigniorage* should not be underestimated. In a recent study Gourinchas and Rey (2005)[3] found that during the post Bretton Woods era (1973-2004) the real rate of return on US bonds held by US residents was 4.05% while the real rate of return on US bonds held by foreigners was only 0.32%, a whopping 373 basis point differential when inflation is factored into the equation. Each 100 basis point differential can save euro area governments over $100 billion US annually. This saving can go along way towards reducing budget deficits. Since all euro zone borrowers, both public and private stand to gain from the benefits of *seigniorage*, the total benefit to the euro economy can be much greater, resulting in lower rates on personal and mortgage loans as well as business credit. The important point being made here is that transforming the euro zone into a banker to the world by the introduction of euro-zone backed securities (EZ bonds), the European core countries will see interest rates <u>fall</u>, not rise, despite the inclusion of the euro periphery in the mix. Germans, instead of worrying that they will have to pay a higher interest rate to support the eurozone will actually get away with paying less, a net gain for the eurozone as a whole.

Sixth, the conversion of euro-area national debts into a common euro-zone debt will also benefit the banks in Europe and put a stop on the brewing banking crisis. Presently, European banks are severely undercapitalized with leverage ratios in excess of 30 times capital. The problem stems from the fact that they did not have to post capital against sovereign bonds. According to the Basel capital adequacy rules, they are treated as zero-risk obligations, therefore they didn't have to raise capital to mitigate against this kind of risk. Now that the prospect of sovereign defaults has arisen, these banks are hopelessly unprepared to meet any potential losses on their positions, this is why they have been bailing out Greece, resisting taking a haircut on their positions and stalling in order to build up provisions against these losses. Converting into euro-zone bonds, not only helps the high-debt countries, but also the leveraged banking sector, It not only helps the euro periphery, it helps the euro core as well.

The interest cost of servicing the EZ bonds should be proportional to the stock of gross debt contributed by each country so no one can complain that they are paying to service another country's debt. For example, Greece which would account for 4% of the EZ bond debt will contribute 4% of the interest payments on the new bonds even though it accounts for 2.5% of the euro economy.

Finally, why would a country like Germany with a debt/GDP ratio of 80% be willing to merge it's debt with a country like Greece with a 142% debt/GDP? First, because it is German banks that are owed much of this money to begin with so it is the German banks that would benefit as much, <u>while the German tax payer gets completely off the hook</u>! Secondly, it is because Germany has a more competitive manufacturing base so it is German companies and German workers who will benefit by selling more goods to Greece and the other countries in the periphery.

[3] Pierre-Olivier Gourinchas and Helene Rey (2005) "From World Banker to World Venture Capitalist: US External Adjustment and The Exorbitant Privilege", NBER Conference on G7 current account imbalances: Sustainability and Adjustment

Third, because costs of borrowing will fall below current German bund levels, the effect of the *seigniorage* benefit discussed above.

The euro-zone bond (EZ bond) is the one and only solution to the euzone debt crisis. It is the proverbial 'magic bullet' that can resolve the euro debt crisis and save the euro. Of course, it will have to be created with the appropriate institutional structures and mechanisms to support it such as a European Supranational Finance Ministry; a new Eurozone unified public accounts system (EUPAS) to record and report on a monthly basis the position of member governments; a euro-zone debt management agency and the creation of a European banking supervisory authority to monitor and regulate cross country lending.

It goes without saying that to win consent, countries will have to agree on a new stability and growth pact (SGP-II) with stringent conditions for entry accompanied with sanctions in the event of violations, to harmonize tax policies and major spending programs and agree on structural reforms in labour markets and social institutions such as public pensions and social programs. The mandate of the ECB would need to be expanded to include powers of lender of last resort and regulation of financial markets. What Europe needs is real institutional convergence as opposed to simply nominal convergence in economic aggregates.

TABLE 3

DEBT STOCKS AND DEBT-GDP RATIOS, NON-EUROZONE EU

	Debt/GDP Individual %	**GDP**	**Gross Debt**	**Debt/GDP Collective** %	**Debt Shares**
Bulgaria	18	47.7	8.6		0.30%
Croatia	40.0	60.6	24.2		0.86%
Czech Rep.	39.6	192.2	76.1		2.69%
Denmark	44.3	310.7	137.6		4.86%
Hungary	80.4	129.0	103.7		3.66%
Latvia	39.9	24.0	9.6		0.34%
Lithuania	38.7	36.4	14.1		0.50%
Norway	54.3	414.5	225.1		7.95%
Poland	55.7	468.5	261.0		9.21%
Romania	35.3	161.6	57.0		2.01%
Sweden	39.6	455.9	180.5		6.37%
UK	77.2	2247.5	1735.1		61.25%
Non-Euro	**46.9**	**4548.6**	**2832.6**	**62.3**	
Non-Euro x UK	**44.2**	**2301.1**	**1097.6**	**47.7**	

Source: IMF, 2010 Figures, WEO Data Base

Assuming that all this could be done tomorrow, what would the aggregate debt picture look like when the non-eurozone members are factored in the analysis. If the rest of the EU members were to join the eurozone (Table 3), the size of the euro debt market would increase to US $16.7 trillion ($15.0 if Britain chooses to stay out) and surpass the US market in terms of size, while the debt-GDP ratio would improve somewhat from 83.9% to 78.7%. Since the non-euro countries' debt is financed at higher rates than euro members, these countries would also benefit significantly in the form of reductions in their debt service costs, increased access to capital and improved macroeconomic environment.

Obviously, such a system cannot be put in place overnight while the issues surrounding its technical implementation are beyond the scope of this position paper. Whether they realize it or not, by creating the EFSF, European leaders have already created the embryo of what can become a common eurozone Treasury and the EZ bond, guaranteed collectively by all 17 members. What European leaders must do right now is revise the scope of the European Financial Stability Facility (EFSF) and expand its scale to at least $1.5 trillion along with making their plans known to markets that they are moving toward the direction of creating a pan European government debt market. As national bonds mature gradually they can be converted to EZ bonds which can also give governments time over a ten year horizon to harmonize their tax and entitlement programs. It must be noted that 'harmonization' need not imply uniformity but comparability. The goal is not to create a unitary state but a con-federal structure where there is room for countries to respond to individual needs yet operate within a more standardized framework.

As Table 4 shows, the creation of a euro-wide collective debt market catapults Europe to the same league as America and with a debt-GDP ratio of 83.9% (78.7% when non eurozone members are included) compared to 91.5% for America. But it also shows that both Europe and America and their allies, Japan and Canada are heavily indebted, whereas the emerging BRIC nations like China, Brazil, Russia and India enjoy lower debt ratios while undergoing more rapid rates of economic growth.

The Real Threats and Opportunities

What is the big picture here and what does it tell us about the real threats and opportunities facing the European region? The main threat to European prosperity is the high deb-GDP ratio coupled with fragmented national debt markets and insufficient economic and political integration. Europe cannot remain competitive compared to countries like China with only a 17.7% ratio. Nor should the current crisis be allowed to fester and create disunity and animosity between the core and the periphery. It risks reversing much of the progress that has been achieved to date. The real threats are external, not internal.

Rather, Europe should focus on the opportunities. By creating a unified government debt market with a common debt instrument along with the accompanying institutional framework to support it, Europe can create the only real alternative to the US Treasury market in the world. A pan-European debt market with depth, breadth and liquidity to match the US market is very much in demand today by sovereign and private pools of capital. It secures the euro's position as a global reserve currency and at the same time creates the conditions that allow the benefits of *seigniorage*, i.e. a significant reduction in real interest rates to levels well below those of German bunds. This is a win-win proposition, a positive-sum game for Europe. Europe must take advantage of the current crisis to complete the major final step remaining toward an economic union and cement its position as a real global economic super-power, not only in 2011, but in 2050 and beyond. It not only brings stability to Europe, it brings stability to the international monetary and financial system as well.

TABLE 4: Debt-GDP Ratios, International Comparisons

	Debt/GDP	GDP	Gross Debt	Debt/GDP
EU - Total		16757.5	13188.7	78.7
Eurozone		12075.6	10129.2	83.9
USA	91.5	14657.8	13411.9	91.5
CHINA	17.7	5878.3	1040.5	17.7
JAPAN	220.3	5458.9	12026.0	220.3
INDIA	69.2	1538	1064.3	69.2
BRAZIL	66.8	2023	1351.4	66.8
CANADA	84	1574	1322.2	84.0
RUSSIA	9.9	1465	145.0	9.9
AUSTRALIA	22.3	1235.5	275.5	22.3
MEXICO	42.7	1039.1	443.7	42.7
KOREA	30.9	1007	311.2	30.9
TURKEY	41.7	741.9	309.4	41.7
SWITZERLAND	55	523.8	288.1	55.0

It is time that Europeans start looking at the real threats and opportunities to their prosperity and start coming together to build a smart, viable and prosperous future! A stronger more secure Europe means a more stable and secure world.

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