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Why a Common Eurozone Bond Isn't Such a Good Idea[©]

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As the crisis in financial markets has deepened, spreads between the government bonds of different countries in the European Monetary Union (EMU) have widened dramatically. In February, the spreads of secondary market yields of government bonds with maturities of close to ten years with respect to Germany were 141 basis points for Italy, 257 for Greece and 252 for Ireland, although back in 2000 these spreads had only amounted to 32, 84, and 25 basis points, respectively.

With the start of EMU, long-term interest rates in participating countries had more or less converged to the lowest level before the introduction of the euro in countries like France, Germany or the Netherlands. Italy and Greece, meanwhile, had enjoyed a decline in the cost of servicing their public debt in comparison to pre-EMU days which showed that they were drawing enormous benefit from their participation in the European Monetary Union. It was the judgement of market participants that the introduction of the euro as a common currency meant that not only the currency risk had disappeared i.e. the risk of devaluation; all eurozone members were seen as belonging to a zone of stability that clearly spanned not only monetary stability, but also through observance of the disciplines of the Stability and Growth Pact, fiscal stability too.

Spreads, meaning the difference in eurozone countries' long-term interest rates, normally moved around a low level of around 25 basis points, a difference that mainly reflected such technical factors as liquidity in the markets. And this was the situation that basically prevailed for many years, despite less favourable developments in fiscal policy in some eurozone countries.

Spreads over German government bond yields, 10 years maturity, in basis points.

	1992	2000	2009 (February)
Italy	542	32	141
Greece	1616	84	257
Ireland	122	25	252

Source: ECB (Secondary market yields of government bonds with maturity of close to ten years, monthly data) and Eurostat (Government bond yields, 10 years maturity, annual data).

But with the advent of the present crisis, all this changed rapidly. Countries with dramatically rising budget deficits like Ireland, along with high levels of public debt like Greece and Italy now have to pay substantially higher interest rates on

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government bonds. Investors who are becoming much more risk averse in these times of crisis demanded higher credit risk premia for buying bonds from those countries that were seen as weak debtors. By contrast, long-term interest rates in those countries that were seen as in a better fiscal position, like France, Germany or Finland, enjoyed very low rates as a consequence of investors' "flight to quality".

The increase in long-term interest rates hit those countries hardest that had already experienced a strong deterioration in their current or expected fiscal position. Concerns about the sustainability of public finances came to the fore, and the argument was even raised that a country might have to consider leaving the monetary union if this process were to continue - it's a threat, incidentally, that totally lacks substance because it would be the surest way to commit economic suicide. But it therefore came as no surprise that the idea of a common European bond should be proposed as a means of mitigating the impact of the crisis and of countering the problem of rising interest rate spreads in eurozone countries that are the most vulnerable to these developments. In fact, the notion of a common bond had been put forward some years before, although at that time the main argument was that a common bond would result in higher liquidity than that created by the issuing of different national bonds.

In the context of today, the liquidity argument is generally seen as being much less important. The main argument now is reducing the risk premia to be paid by creditors with lower fiscal credibility in the markets. Obviously, though, this could only be achieved by implicit or explicit guarantees from eurozone countries with sound public finances. A "true" multi-country European bond would have to comprise a full joint guarantee in which every participating country guarantees the full bond issued.

Supporters of the European bond idea argue that this would mean that the "strongest" guarantee for the "weakest", and ask whether this isn't exactly what Europeans mean when they talk of solidarity?

A common bond, by virtue of its construction, would delete the interest rate spread between bonds issued by different eurozone countries, so the question that has to be addressed is what effect the common issuance would have on the level of the interest rate, and more importantly on future fiscal policy and the euro itself.

A common eurozone bond would certainly imply that countries like France and Germany would have to pay higher interest rates, and that would in the end mean higher tax burdens for their citizens. It's also important to point out that once the markets expect substantial amounts of the common bond to be issued, interest rates on the huge stock of existing - purely national - bonds of solid countries would in the course of time be very likely to increase substantially. No one can possibly know in advance exactly how big this "bill" would be, and in any case arguing about billions of euros - important as that is - misses the crucial point;

issuing a common bond would be a first step on the slippery road to “bail-outs”, and thus the end of the euro area as a zone of stability.

The immediate trigger and the root cause of rising spreads were financial markets' growing concerns about the solidity of some eurozone countries. This loss of credibility has been a consequence of dramatic deteriorations in their current and expected fiscal positions. But, a common bond is no cure for a lack of fiscal discipline; on the contrary, it would tend to encourage countries to continue on their wrong fiscal course.

The global financial crisis was created not least by the excessive risk-taking of institutions that were being supported in their irresponsibility by the implicit “too big to fail” guarantees of their governments. Should the present crisis lead governments in Europe to create similar guarantees that “sovereign debtors are impossible-to-default”, the consequences would be probably even more damaging. So-called solidarity via common European bonds would perhaps in the short-term increase the re-election chances of those governments that created the fiscal mess – a situation that would be ironically similar to the large short-term bonuses paid to bankers who took excessive risks – as the costs of this “support” would have to be borne by the citizens of other countries. It would be hard to find a clearer case of a free riding. And the argument that some countries are in such a terrible situation that they will be unable to get out without substantial help from their neighbours is also unconvincing; in the end, that would turn against a common bond.

The only workable cure for the eurozone's ills is a credible commitment by all its members to reform and fiscal solidity. That's what would overcome investors' doubts and lead to the shrinking of the bond spreads.

A common bond would be no more than a placebo for a “weak” country, but it would also be harmful because it would foster the illusion that it is possible for a country to get out of difficulty without having undertaken fundamental reforms. And in fact the opposite holds true; times of crises give governments the best argument to take tough measures needed to get the country back on a sustainable path.

A common bond would be very costly for the more solid countries, but most dangerously of all, it would undermine the credibility of the eurozone as an area of stability and fiscal soundness. The major success achieved at the start of monetary union, when long-term interest rates in all countries converged to the level of the most stable members, would be spoiled. And the sanctions of negative financial markets reactions would mean that a high price had to be paid by all of the eurozone's countries.

In short, the “medicine” of a common eurozone bond would not cure the problems of its weakest members, but would instead prolong their reliance on budget deficits while encouraging them to hope for the de facto “bail-out” that is waiting just around the corner.

The biggest threat of all would come from the political repercussions of such a move. Any policy that involves a price to be paid by those countries that have opted for fiscal solidity in favour of those with high deficits and continuing high debt levels would strongly undermine the stability status of the eurozone, and thus the confidence of its citizens. "Solidarity" in the true sense means that all of the countries concerned should comply with the fundamental rules of EMU by observing the disciplines of the Stability and Growth Pact and the "no bail-outs" principle. Fulfilling commitments that have been so solemnly undertaken is a core part of this, and those countries that may be tempted to undermine these principles would be demonstrating their own lack of solidarity.