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Common Euro Bonds: Necessary, Wise or to be Avoided?

The sharp widening of yield spreads among EMU sovereign bonds in the course of the economic crisis and concerns that some EMU member countries would encounter difficulties in rolling their existing debt and funding new budget deficits have revived proposals for a common bond issuance by EMU countries. Could these be put into practice without creating a moral hazard issue and conflicts with the no-bail-out clause of the Maastricht Treaty? Would the establishment of a European Monetary Fund offer better prospects of overcoming the present problems?

Paul De Grauwe and Wim Moesen*

Gains for All: A Proposal for a Common Euro Bond

Until the eruption of the credit crisis in August 2007 financial markets were gripped by a "flight to risk". The perception was that risks were very low. This perception was fed by the rating agencies which liberally distributed top ratings to dubious assets. Dulled by this low risk perception, investors and financial institutions accumulated vast amounts of risky assets in their balance sheets. Today the markets have moved to the other extreme and perceive risks everywhere. They are now gripped by a "flight to safety". This has profound implications for the workings of the government bond markets in the eurozone.

Dramatic Increase in Spreads

Spreads of sovereign debt within the eurozone have increased dramatically during the last few months. Figure 1 shows the evidence. The governments of Greece and Ireland now (in February 2009) pay an interest rate on their debt that exceeds the German government bond rate by more than 250 basis points, while the governments of Portugal, Italy, Spain, Austria and Belgium have to pay more than 100 basis points extra. Thus, sovereign bonds with the same maturity but issued by different national governments are now perceived as imperfect substitutes.

Since all these bonds are expressed in the same currency, the euro, these spreads reflect either a pure default risk (assuming that the German bonds are free of default risk) or a liquidity risk. There is empirical evidence that part of the spreads are due to the fact that (with the exception of the German government bond market) the government bond markets in the eurozone have become less liquid.[1] This liquidity problem itself is due to the "flight to safety" syndrome that has gripped the financial markets. This can be explained as follows. The panic that followed the banking crises has led investors into a stampede away from private debt into assets that are deemed safe. These are mainly government bonds of a few countries that are perceived to provide safety. The USA, Germany and possibly France are a few of these countries that have been singled out as harbours of safety. Other countries did not profit from the same "panic flight to safety". This is shown in Figure 2, which presents the levels of the government bond rates in the eurozone. We observe a significant decline of the German government bond rate by more than 100 bp since November 2007. Germany was singled out by the market as the country offering safety. France also benefitted from this, but less so. With the exception of Greece and Ireland (and to a lesser degree Portugal), the other countries kept their bond rates more or less unchanged (compared to a year ago) suggesting that these countries were bypassed by panicky investors. Only Greece and Ireland saw their bond rates increase significantly over the last year, suggesting that the increased spreads of these countries are not only due to panic, but have a country-specific cause. As a result of this flight to safety, the liquidity of most government bond markets

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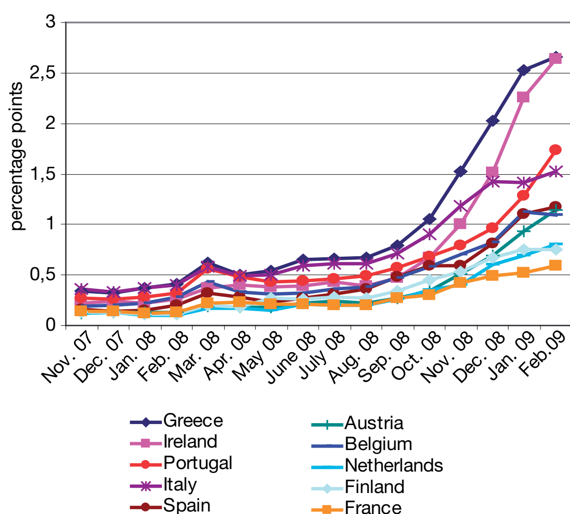
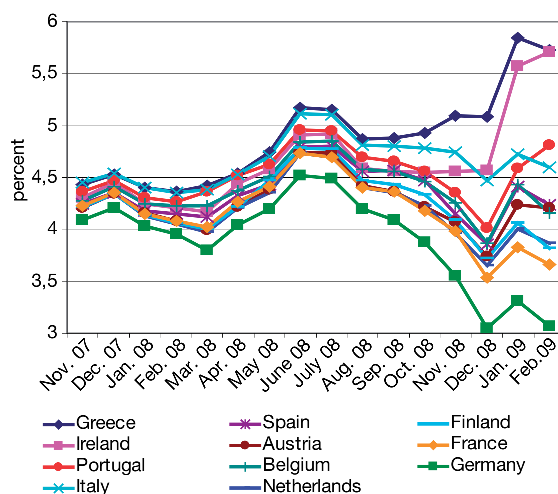
[1] Cf. K. Schwarz: Mind the Gap: Disentangling Credit and Liquidity in Risk Spreads, Colombia University Graduate School of Business, November 2008.

Figure 1
Interest Differential with Germany
(long-term government bond rates)



Source: ECB, https://stats.ecb.int/stats/download/irs/irs/irs.pdf and FT for January and February 2009.

Figure 2
Long-term Government Bond Rates in Eurozone



Source: ECB, https://stats.ecb.int/stats/download/irs/irs/irs.pdf and FT for January and February 2009.

in the eurozone has suffered, leading to an increased spread. (Note that we are not arguing that the whole of the spread is due to liquidity problems. Another part surely is also influenced by the perception that default risk has increased).

To the extent that these spreads reflect reduced liquidity they create distortions. More specifically, the interest rate spreads faced by Southern European countries and Ireland are giving the governments of these countries incentives to reduce their efforts to stabilise their economies. Extra spending which leads to higher deficits is punished by a higher interest cost discouraging these countries to stimulate their economies. No such penalties are imposed on Germany and France.

In addition, these spreads create a perception of future default crises and impending fiscal doom. This impacts on the effectiveness of budgetary policies. We know that fears of future default crises reinforce the "non-Keynesian" effects of fiscal policies, i.e. when agents fear such future crises they are more likely to react to budgetary stimulus by increasing their savings.[2] As a result, budgetary stimulus packages lose their effectiveness.

The penalties imposed by increasing spreads on Southern European countries and Ireland also create negative externalities. For example, the rescue of banks in these countries is more expensive than in the rest of the eurozone, making it more difficult to resolve the banking crisis in these countries. This is likely to lead to further weakening of economic activity in these countries with possible feedback again on the banking system, on the government budget deficits and on the ratings applied by the rating agencies.

Dealing with Distortions and Externalities

How should one deal with these distortions and externalities?

It will remain difficult to prevent cycles of euphoria and panic to affect perceptions of risk in the markets. Authorities can, however, attempt to offset the distorting effects these cycles produce. There are two possible approaches.

A first approach implies action by the European Central Bank. As the ECB will be forced very soon to engage in quantitative easing, it will be buying long-term assets, in particular government bonds. It should at that moment privilege the buying of Irish, Greek, Spanish and Italian government bonds. In doing so, it would increase the price of these bonds and reduce their yields. Thus such a quantitative easing would tend to reduce the spreads in government bonds in

[2] Cf. Francesco Giavazzi, Marco Pagano: Non-Keynesian effects of fiscal policy changes: international evidence and the Swedish experience, in: Swedish Economic Policy Review, May 2006.

the eurozone, and would reduce the distortions and the externalities that these spreads create. It would also make it possible to stimulate the economies of all eurozone member countries, benefitting the whole area.

The second way to deal with the problem is through the issue of euro denominated bonds that would be guaranteed collectively by the governments of the eurozone. These could be issued by a European institution such as the European Investment Bank (EIB), or directly by the member states' governments. In both cases the guarantee would be provided by these eurozone governments which have the taxing power to back up such a guarantee. The advantage of such a Eurobond issue is that countries which now face high spreads would have an easier and cheaper access to the financing of their budgetary stimulus programme. But this feature is also its drawback. Countries like Germany object. They fear that such a joint euro bond issue will create a free-riding problem. The governments of Ireland, Greece, Portugal, Italy etc. which today face high spreads will have fewer incentives to conduct sustainable fiscal policies. As a result, the countries with low spreads, and especially Germany, may have to bail out the governments of these countries in case of default.

Whatever one may think of the motives of Germany, the German resistance to a joint euro bond issue is a fact of life. The question then is whether this opposition can be reduced by going some way towards relieving the German fears that it will have to foot the bills. Here is our proposal.

Characteristics of a Euro Bond Issue

The euro bond issue would have the following characteristics. First, each euro government would participate in the issue on the basis of its equity shares in the EIB. Second, the interest rate (coupon) on the euro bond would be a weighed average of the yields observed in each government bond market at the moment of the issue. The weights would also be given by the equity shares in the EIB. Third, the proceeds of the bond issue would be channelled to each government using the same weights. Fourth, each government would pay the yearly interest rate on its part of the bond, using the same national interest rates used to compute the average interest rate on the euro bond. Thus, using the February 2009 data, Greece (we use Greece here as the prototype high risk country) would have to pay a yearly interest on its part of the outstanding bond of 5.7% while Germany would have to pay only 3.1%.

What are the advantages for the different countries? Let us concentrate on Germany first. Much of the fear that a common euro bond issue would lead to a free riding problem forcing Germany to foot the bill disappears in this scheme. Greece would pay the interest rate it faces in the market today. Thus the incentive to free ride on Germany would decline. In addition, in our proposed scheme Germany would pay the same interest rate it pays when issuing government bonds on its own. Thus contrary to other proposals for joint euro bond issues, Germany would not be penalised by a higher interest rate.

This leads to the question of what the benefits are for Greece. If Greece pays the same interest rate as it does when it issues bonds on its own, it may have little incentive to participate in a common euro bond issue. We believe that Greece also would reap benefits from the common euro bond proposed here. These benefits arise from the fact that Greece faces the problem that it may be shut out from the market, as long as the flight to safety syndrome exists. Thus the common euro bond issue is a gate for Greece to access funding, which it may not have as easily when it issues bonds on its own. And Greece would obtain this easier access without imposing burdens on the other participants of the scheme.

Practical Problems

There are some practical problems to think about concerning the common issue of euro bonds. We mention two here. The first one relates to how the collective responsibilities underlying the bond issue are shared. If the common euro bond issue is done by the EIB the national governments would be liable according to their equity shares in the EIB as is the case for normal EIB bond issues. A similar formula of collective liability could be spelled out if the common bond issue were done independently from the EIB.

A second issue relates to the possibility that the yield of the composite (common) bond differs from the (weighted) sum of the yields of the national bonds constituting the common bond. The issue is reminiscent of the divergences that happened in the past with ECU-bonds. If our analysis is correct, i.e. some of the high yielding national bond markets have high yields because of a lack of liquidity, their inclusion in a composite common bond would implicitly increase their liquidity. As a result, the composite common bond would have a lower yield than the weighted sum of the constituting national bonds. This assumes of course that the common euro bond market itself will have a

sufficient size so as to make these bonds liquid instruments.

We conclude that it is possible to create an attractive common euro market for sovereign bonds. The formula proposed here avoids the free-riding problem that has marred previous proposals. In addition, on the demand side it will meet the desire for safety of investors and financial institutions, and on the supply side it will make it easier for sovereign borrowers with different needs to have access to the capital market. In a nutshell, it is a proposal that is "Pareto optimal", i.e. it allows to improve the welfare of some without reducing the welfare of others.

Wim Kösters*

Common Euro Bonds – No Appropriate Instrument

At present there are growing demands for the issuing of common euro bonds and the setting up of a European Stability Fund to fight the economic problems some EMU countries are facing.[1] Interest-rate spreads of sovereign debt within EMU have increased significantly since September 2008. The interest differential for long-term government bond rates with respect to Germany in February and March 2009 at times was more than 250 basis points in the case of Greece and Ireland as well as more than 100 basis points in the case of Austria, Belgium, Italy, Portugal and Spain. Since government spending in those countries is thus much more expensive the proponents of common euro bonds fear that stabilisation efforts might be too low, leading to an aggravation of the present crisis. In the last instance, if a refinancing of outstanding debt becomes impossible, a troubled country even could go bankrupt. All this could do a lot of damage to the euro and could even let EMU fall apart, it is argued. Therefore, the EU should react and issue common euro bonds. This paper will critically assess this position.

The Rules of the European Treaties

In creating a common currency the Maastricht Treaty fixed the nominal exchange rates of the participating countries and centralised monetary policy ("one size fits all") committing it to the goal of price stability. Thus both instruments can no longer be used as adjustment tools at the national level. In contrast, the sovereignty of, and responsibility for, fiscal policy was principally left with the member states of EMU. They, however, were obliged to follow the rules of the treaty put in concrete terms in the Stability and Growth Pact (SGP) which set the well-known limits for public budget deficits and debts, equipped with sanctions. In addition, article 103 of the European Treaty clearly determines that neither the EU nor other member states are liable for the debt of a member state (no-bail-out clause). This clearly states that no government can hope for financial aid from outside if it lets its public budget drift into an unsustainable position. All member states accepted these rules when entering EMU. In the ratification process involving referenda and voting in parliament citizens and members of parliament were made to believe that everybody would keep them. Again and again politicians promised that the rules would be followed strictly in order to get an assent.

The economic rationale behind the rules is, first, the protection of the independence and stability orientation of the ECB since experience tells us that excessive public debt in the end mostly has led to inflation. Second, limiting the excessive use of fiscal policy should enforce urgently needed structural reforms making prices and wages more flexible and thus enhance the adaptability of the economies. This should serve as a substitute for the discretionary use of exchange-rate policy, monetary policy, and to a certain degree fiscal policy which is no longer possible in EMU. In sum, the Maastricht Treaty contains a policy assignment in which monetary policy is mainly directed towards the goal of price stability, fiscal policy is geared more to

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[1] Cf. e.g. P. de Grauwe, W. Moesen: Gains for all: A Proposal for a Common Euro Bond, in this issue; D. Gros, S. Micossi: A bond-issuing EU stability fund could rescue Europe, in: Europe's world, spring 2009 (http://www.europesworld.org/NewEnglish/Home/Article/tablid/191/ArticleType/articleview/ArticleID/21306/Default.aspx). Political support for those plans comes also e.g. from IMF Chief D. Strauss-Kahn and Italy´s economics minister G. Tremonti (Handelsblatt, 21 February 2009). The case of other troubled EU countries will not be discussed here. Our reflections are limited to EMU.

allocation than to stabilisation purposes, and finally incomes policy (wage setting) is in the first instance responsible for the goal of high employment. After all, with fixed nominal exchange rates continued increases in prices and wages in one member country above the EMU average mean a real revaluation, leading to a loss of international competitiveness showing up among other things in higher current account deficits.

This new European framework for economic policy was thought to meet the challenges of globalisation and aging societies faster and better than the attempts at the national level. At the time these were not very successful because they were too slow and too half-hearted. The inappropriate use of fiscal policy had led to excessive public deficits and debts. There was the fear that Europe might fall back economically behind the USA and other faster growing countries, endangering the consent to the process of European integration.

Basic European Economic Constitution

The rules of the Maastricht Treaty and of the single market in this respect can be looked at as a self-commitment by European countries to abstain from the excessive (and very often inappropriate) use of fiscal policy and to submit to systems competition. In this way, urgently needed structural reforms should be carried out, bringing about more wage and price flexibility and thus a greater adaptability of the economies. Systems competition was decisively increased, first of all by raising factor mobility via by the single market rules and the introduction of a single currency. Free migration of labour and free movement of capital allows an escape from national laws and regulations which are considered to be unfavourable and the choosing of a production site in a country with a jurisdiction found more suitable. Second, even without moving a choice between national regulations is possible because of the validity of the country of origin principle. This requires that in the single market national regulations have to be mutually recognised so that goods can be sold everywhere in the EU even if they do not fully conform to the respective national regulations. Third, in addition there is yardstick competition because a European public is developing through the improved information of voters with respect to the policies and their results in other EU member countries.

The three factors mentioned above were expected to bring about a higher degree of systems competition than can be observed anywhere else in the world. If it works voters (especially the mobile ones) would put pressure on the government ("voice and exit"[2]) to go ahead with the necessary reforms. In this way Europe could gain a lead over others in meeting the challenges of globalisation because the adjustment would be speeded up markedly.[3]

The basic rules of the Maastricht Treaty briefly described above can be seen as a kind of rudimentary political union and, together with the single European market, are certainly important elements of the European economic constitution.[4] Solidarity and of course the rule of law require that it is kept and not disposed of at will. Just as at the national level, constitutions can only be changed with qualified majorities in a due process. In the case of Europe this would mean changing the treaties.

Violations of the Rules in the Past

But already in the past the due respect for the rules agreed upon in the treaties very often was not shown. They were violated again and again without sanctions being enacted against those responsible. On the contrary, the "sinners" demanded that the rules be changed and were even successful. Well-known examples in this respect are the admission of Greece on the wrong terms because the figures of the convergency criteria reported by the Greece government at that time were forged, as it turned out years later. When Germany and France – two big EMU-members – exceeded the 3% deficit criterion for the first time they massively tried first to prevent an early warning and then the running of the excessive deficit procedure laid down in the SGP. With great political pressure they finally managed not to be fined but to have changed the rules of the SGP in their favour instead.

The toleration of violations of the treaties and the dilution of announced strict rules like the SGP slacken the self-commitment of political actors, damage their credibility, and change the European economic constitution step-by-step. This lowers the political pressure for carrying out the structural reforms needed in order to meet the challenges of globalisation better and faster. Therefore, changes should not be allowed to take place at will due to political intervention but only when

[2] A. Hirschman: Exit, Voice and Loyalty. Responses to decline in Firms, Organizations and States, Cambridge Mass. 1970.

[3] All this seems to have been forgotten after the start of EMU because in the Lisbon agenda different means are provided for serving the same goal.

[4] For this view cf. e.g. R. Caesar, W. Kösters: Europäische Wirtschafts- und Währungsunion: Europäische Verfassung versus Maastricher Vertrag, in: Integration, Zeitschrift des Instituts für Europäische Politik in Zusammenarbeit mit dem Arbeitskreis Europäische Integration, Vol. 27, No. 4, 2004.

they are well considered within the due process laid down in the treaties.

Common Euro Bonds as a Violation of No-bail-out

This is especially true for the proposed issuance of common euro bonds because this could be a very big further step in the history of violations and dilutions of the European economic constitution. It means disregard of the no-bail-out clause and thus the breaking of Art. 103. In this way serious moral hazard problems have been created since no-bail-out is a necessary condition for the working of the SGP.

A common euro bond issued in favour of e.g. Greece means that from now on every other EMU member state could also count on such a bail-out if it could threaten bankruptcy. No reasons could be given to turn down such a demand in the future. Pointing to the severity of the present financial and economic crisis will not really help. What happened once will happen again.

At present public budget deficits in EMU countries are increasing fast. Nearly all will exceed the 3% threshold by 2010, in some cases drastically. Bringing them down will be difficult anyway. If a bail-out can be expected the consolidation process of public budgets will certainly last longer and will perhaps not take place at all in some countries. Sustained big differences in the stance of fiscal policy will create severe problems for EMU since such imbalances arouse centrifugal forces which could even finally cause it to fall apart. In addition, a severe breaking of the treaty such as the disregarding of the no-bail-out rule could do great damage to the further European integration process. If regulations in existing treaties are not kept anyway why should we strive for new ones like the Lisbon treaty? It is often lamented that voters seem to be weary of Europe. Maybe they are just frustrated about promises broken too often.

The present crisis reveals in an incorruptible way what went wrong in the past. Countries with high public debts and formerly relatively high inflation rates like e.g. Italy and Greece profited from joining EMU by much lower interest rates. Financing public deficits and debt thus became cheaper. Because of this the promises made with respect to the consolidation of public budgets and to following the rules of the SGP before entering EMU were not kept. Clearly, those countries did not show solidarity with the other members of EMU in the past. They were neither sanctioned by the EU nor by the markets, because the latter drew the conclusion that the no-bail-out clause was not credible. As a result interest-rate spreads stayed low for a long time. State bankruptcy of an EMU member was not considered very probable since it would have negative effects not only on the country in question but also on the other members as well as on the euro.

Therefore it was expected that there would be a bail-out despite all the declarations in the treaties. Thus, de facto, a joint liability (Haftungsgemeinschaft[5]) has developed as a result of the policy in the past.

Bail-out and No-bail-out Strategies Compared

The present crisis, with the possibility of the bankruptcy of one or more EMU states, confronts politicians with a dilemma: they either have to give up the no-bail-out promise and break the treaties formally with the consequences described above or they have to stick to it and find ways to cope with the effects. In both cases costs will arise which have to be considered as the price of wrong political decisions in the past. They have to be compared with possible gains to find the net value.

If a political decision is made in favour of a bail-out the following problems, among others, arise in addition to the ones already mentioned. There is no guarantee that common euro bonds will mean (net) gains for all.[6] First of all, the interest rate could converge more to that of the country in trouble and not to that of the country considered economically sound, because common euro bonds are structured products presently mistrusted. In addition, the risk could be estimated to be higher if it is expected that sound countries have to take responsibility for a growing number of troubled or bankrupt states. In this instance the interest rate for own bonds would increase too. Secondly, how could e.g. the German government explain to its citizens that they have to pay for the mismanagement of the governments of other EMU countries contrary to the treaties?[7] How will the spending of that money be democratically controlled? Bilaterally or by a European institution? In the first case the danger of quarrels leading to political tensions is large. In the second case if a new European body is created it could develop into a *gouvernement économique* endangering the independence of the ECB and markedly changing the present character of the European economic constitution.

[5] Cf. J. Starbatty: Sieben Jahre Währungsunion: Erwartungen und Realität, in: Tübinger Diskussionsbeitrag, No. 308, Tübingen 2006.

[6] P. de Grauwe, W. Moesen, op. cit.; D. Gros, S. Micossi, op. cit.

[7] The German Federal Ministry of Finance estimates that a 1% interest-rate increase will cost the German taxpayer € 3 billion p.a.

Alternative bail-out strategies have their problems too.[8] This is true for the proposal that the ECB, when easing quantitatively, should buy more government bonds from countries in trouble. This would partly be a renationalisation of monetary policy, would endanger the independence of the ECB, and would cause tensions in EMU. Extended loans by the European Investmentbank (EIB) are unsuitable. The EIB is designed to finance projects but not public budgets, and member states are shareholders. Art. 119 EC treaty, which allows for mutual support in cases of heavy balance of payment problems, is not applicable to EMU states. Finally, bilateral loans could be used for bail-out. Since the market for German government bonds is the most liquid one and interest rates there are lowest, Germany would play a central role and would have to carry the main burden.

As already stated, bail-out in whatever way is against the law of the EU. Therefore, it can be expected that proceedings against a bail-out will be instituted before the European court or national constitutional courts. If they were successful this would cause a loss of reputation for those who had enacted the bail-out strategy under scrutiny of the court. The total costs of a bail-out, especially those in the medium and long term, will most probably exceed the possible gains in the short run.

Therefore, sticking to no-bail-out is the better option. The bankruptcy of a member state would stabilise EMU in the long run, argues von Hagen[9] and points to the example of the near bankruptcy of California in 2003. "Misunderstood solidarity" he calls an incentive for lack of discipline, destroying EMU in the long run. He pleads for keeping no-bail-out und letting bankruptcy just happen.

If, however, the resulting costs for all parties are considered to be too high, leaving EMU could be an alternative for a member state in trouble. Meyer[10] explores the possibility of a voluntary exit or the exclusion of bankrupt countries. Since state bankruptcy is a heavy violation of the European treaty, one-off payments should be made so that the insolvent country could voluntarily leave EMU in a well-ordered process. But he also considers exclusion to be possible in this case.

Since all EMU states are members of the IMF, there is, finally, the option to let the fund take care of the country in trouble. The procedures to be followed are well-established. European politicians seem to be hesitant even to think about this, because they fear being blamed for being unable to solve the problem within the EU. But this simply is the case and cannot be hidden from the world. The lack of solidarity and discipline of some of the EMU states and the inability to find binding sanction-proven rules for public budget deficits and debt is the reason for the present problems. They cannot be overcome by bail-out.

[8] For the following cf. D. Meyer: Die Zahlungsunfähigkeit eines Euro-Landes – No-no-bail-out und Austritt aus der Eurozone, in: ifo-Schnelldienst, Vol. 62, No. 7, Munich 2009.

[9] J. von Hagen: Gefährliche Solidarität, in: Handelsblatt, 14. April 2009.

[10] D. Meyer, op. cit.

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The Case for a European Monetary Fund

Periods of crises and tensions have generally been catalysts for advances in European political and economic integration. The European project itself was born out of the dreadful experience of the interwar period and the devastations of WWII. The European Monetary System emerged after the breakdown of the Bretton Woods exchange-rate system and the Great Inflation of the 1970s; the Single Market project was triggered by the pervasive growth pessimism of the early 1980s; and EMU owes its existence to a significant extent to the fall of the Soviet Empire and the re-unification of Germany.[1] Past experience suggests that the present financial and economic crisis – which has led to severe tensions in EMU sovereign bond markets – is much more likely to induce a further step towards greater integration than the disintegration of

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[1] This is obviously not an uncontroversial interpretation. But would Germany have given up its beloved D-Mark for any lesser price than the backing of re-unification by its EU partners? And would the latter have demanded anything less for accepting a large, re-united Germany in the centre of Europe than the abdication of the mighty Bundesbank?

EMU, as often feared by US or UK investors. In the following I shall argue that a decisive step towards a better coordination of national fiscal policies among EMU member countries, institutionalised in a new "European Monetary Fund", would be an appropriate response to the present challenges.

The Elusive Common Euro Area Bond

The sharp widening of yield spreads among EMU sovereign bonds in the course of the economic crisis and concerns that some EMU member countries would encounter difficulties in rolling their existing debt and funding new budget deficits have revived proposals for a common bond issuance by EMU countries. The idea of a common euro area bond dates back to the report of the Giovannini Group released in November 2000, which discussed public debt issuance in the euro area.[2] Although it did not specifically endorse such an instrument, the Giovannini Group recommended keeping the issue under review over the coming years. However, the subject was not pursued further until recently, and even now the official response to renewed proposals of a common euro area bond has been distinctly cool.

Notwithstanding the obvious advantage of creating a more liquid euro area bond market, scepticism towards issuance of a common euro area bond is based on two concerns. First, if bonds are issued jointly but under several liability of the participants, the credit quality of the bond would at best reflect the weighted average quality of the participants (and possibly even be subject to a further discount as market participants have become averse to complexity in financial products), making it rather unattractive for high quality issuers to participate. As the dispersion of ratings of EMU sovereigns has increased in the course of the crisis this concern has become more important lately. Second, if bonds were issued under joint liability, countries in good standing would subsidise weaker countries, potentially creating a moral hazard issue and conflicts with the no-bail-out clause of the Maastricht Treaty.[3]

A number of ideas have been put forward to address these concerns. The Securities Industries and Financial Markets Association (SIFMA), for instance, investigated the possibility of attaching a guarantee fund to a common euro area bond designed to cover any defaults on interest or principal payment by a joint issuer.[4] The authors of the report hoped to achieve a top rating and quality with this instrument, but pricing surveys showed that dealers priced the structured bond significantly cheaper than the five best single sovereign bonds. Another interesting proposal was recently made by Jacques Delpla, who suggested that countries divide their public debt into a senior and a junior tranche.[5] The latter would absorb any default, acting as a buffer for the former, similar to the equity tranche in a Collateralised Mortgage Obligation. However, the question remains as to whether investors would deem the political risk of a government reneging on its commitment to service the senior tranche of its debt under all circumstances as negligible. Moreover, from the issuers' point of view, the question is whether any reduction in the costs for servicing the senior debt would be compensated by an increase in the costs for servicing the junior debt.

How to Conduct Fiscal Policy in EMU

Against this background it would seem to me that a new initiative aimed at reducing present public sector funding problems of some EMU countries and putting future public debt issuance in the euro area on a sound basis would have to start with answering the question of how to conduct fiscal policy in a common currency area. When EMU was launched the view prevailed that fiscal policy ought to abstain from demand management and to focus on sound funding of public activities. In this view, there was no place for the coordination of pro-active fiscal policies among countries and between them and the ECB. Instead, the Stability and Growth Pact aimed at securing fiscal discipline by setting limits to budget deficits. "Bail-outs" of EMU countries by other countries or EU institutions was forbidden. Against this background, it should not have come as a surprise that the response of euro area economic policy to the present financial crisis, which has necessitated combined monetary and fiscal policy efforts to counter the risks of deflation and depression, has been half-hearted and confused.

[2] See "Coordinated Public Debt Issuance in the Euro Area", Report of the Giovannini Group, Brussels, 8 November 2000.

[3] According to Article 103 of Consolidated Treaty Establishing the European Community "The Community shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project. A Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project."

[4] SIFMA: A Common European Government Bond, Discussion Paper, September 2008.

[5] Cf."Should Euro Area Governments Issue Joint Eurobonds?", presentation given on 17 February 2009 at Bruegel in Brussels.

A particularly striking example has been the question of how to assist an EMU country in financing difficulties. After a considerable period of silence the official line has emerged that support would be given so as to prevent default, but that the arrangements envisaged for such a case would remain secret. This rather peculiar effort at restoring confidence in the EMU sovereign bond market can only be explained with the presumption that governments may have reached an agreement in principle but lack a detailed plan. Perhaps they are hoping that the financial storm will blow over without testing their resolve. A better approach would be to create the institutional arrangements in time so that support can be given without delay when it is needed.

A Platform for Emergency Assistance and Fiscal Policy Coordination

The establishment of a European Monetary Fund (EMF) as a platform to coordinate national fiscal policies with each other and with monetary policy, and to provide funding to countries in financial distress, would meet both the demands emanating from the present crisis and the need to improve the stability of EMU in the long term. I have dubbed this institution EMF because of the similarities it would share with the IMF. These would include: (1) professional surveillance of countries' economic policies; (2) financial assistance in times of stress under strict policy conditionality; and (3) peer review of policies and peer control of financial assistance. However, there would also be significant differences to the IMF: (1) the EMF would act as a lender of last resort to EU countries only; (2) EMU countries would commit themselves to accept EMF rulings on economic policy as binding (with fines for violations similar to those of the Stability and Growth Pact); and (3) the EMF would be a platform for fiscal policy coordination among EMU countries and between them and monetary policy.

It could of course not be ruled out that, despite the initial commitment to follow the policy advice, a country in financial difficulties defied EMF conditionality and threatened to default in order to blackmail its peers – who would fear systemic risks from a sovereign default – into setting more lenient terms for the assistance. In this case, the EU could cut off the country in question from all support programmes and the EMF could opt to cover only interest and principal repayments on outstanding debt so as to avoid a debt default with potentially systemic consequences. The country would then be on its own to meet other pressing payment obligations (e.g., salaries of civil servants or social payments). The heavy price put on an uncooperative attitude would most likely be an effective deterrent from such behaviour.

The capital structure of an EMF could resemble that of the European Investment Bank: equity capital provided by EMU member countries in relation to the size of their economies and the authority to borrow in capital markets with full and joint liability by the shareholders. However, to ensure that the EMF would have sufficient means to provide assistance in emergencies it would probably need to have about twice the size of the EIB. With equity capial of EUR 60 billion and a leverage ratio of ten the balance sheet of the EMF would be equivalent to about 10% of the euro area's outstanding government debt and about 6.5% (5%) of the euro area's (EU's) GDP. Its organisational structure and staffing could be similar to that of the IMF. Over time, the EMF could be developed further towards a common fiscal policy authority capable of providing ordinary public debt funding for EMU governments in good standing. Economic policy surveillance similar to IMF Article IV consultations could establish quality seals for national fiscal policies, allowing approved countries to participate in EMF bond issuance (backed by the joint liability of all EMU countries). This would help to create a large euro bond market, reduce premiums charged for a lack of liquidity in a number of smaller sovereign bond markets, and support the euro as an international reserve currency.

As always when institutional changes are considered in the EU the question arises whether the new proposals are consistent with the existing Treaty. The question of whether a European Monetary Fund would violate the no-bail-out clause in Article 13 is a tricky one (especially for an economist with little expertise in EU law). However, since an EMF would give financial assistance only subject to conditions with regard to economic policies to be followed by the country receiving the help the no-bail-out clause contained in Article 13 would not seem to apply. In any event, creation of a European Monetary Fund might qualify as "enhanced cooperation", which is backed by the Treaty.

Why Not Leave all Emergency Assistance to the IMF?

With the EMF looking a lot like the IMF the question arises whether my proposal is not tantamount to reinventing the wheel. I see at least two good reasons why this is not the case. First, EU countries in general and EMU member countries in particular have much

closer economic and political relations with each other than the average IMF member country. The principle of subsidiarity suggests that problems specific to these countries are better dealt with at the regional than at the global level. For instance, an adjustment programme for a European country launched at the European level may be better suited to address European issues and carry more political legitimacy than a programme designed at the global level and subject to approval by large non-European shareholders in the IMF (where it competes with programmes in other regions of the world).

Second, and more importantly, an EMF should over time develop into an institution allowing a better coordination of fiscal policy among EMU member countries and between fiscal and monetary policy in EMU. Moreover, it could manage the issuance of a common euro government bond in the future. Thus, creation of an EMF now would not only address problems created by the present economic and financial crisis but also use this crisis as a catalyst to deepen European integration in line with numerous important historical precedents.

What about “New Europe”?

Creation of an institution able to give financial assistance in emergencies and to provide a platform for better fiscal policy coordination will not be enough to fortify EMU if the problems presently affecting the new EU member states are not also addressed. These countries have relied heavily on foreign borrowing and direct investment to fund investment growth during the last decade. They have also allowed their companies and private households to borrow heavily in foreign currency. As risk aversion among international investors has soared during the present crisis several of these countries have encountered serious external financing problems. Like Asian countries in the wake of the 1998 emerging markets crisis, many of the new EU member countries will have to rely much less on foreign funding of their investment in the future. However, unlike the Asian countries, they have only limited room for exchange-rate depreciation to facilitate the adjustment as foreign exchange related losses would jeopardise the solvency of a great number of companies and private households. Given the strong presence of banks domiciled in EMU countries in the new EU member states, banking crises in these countries caused by mass defaults of borrowers in foreign currency would quickly spill over into the euro area.

Against this background, it is in the interest of EMU countries themselves to assist new EU member countries in their adjustment process.[6] One important step would seem to be the transfer of the exchange-rate risk from private borrowers to a body in a better position to carry this risk. With local governments severely cash-strapped an EU institution would have to step in to fund the conversion of foreign currency debt to local currency debt at exchange rates that allow the borrowers to remain solvent. General adjustment funding subject to policy conditions as presently provided by the IMF would remain important. But the European Monetary Fund would seem to be suitable to support IMF programmes by establishing currency conversion schemes for indebted private sector entities. By shouldering more of the burden presently carried by the IMF in Europe it would also allow the latter to re-adjust its focus in line with its prospective change in quotas that is likely to reduce Europe’s influence in the organisation.

Conclusion

The blueprints for EMU rest on the ruling economic paradigms of the 1980s and 1990s stipulating that economic agents always form their expectations rationally and financial markets are efficient most of the time. In this world, the central bank is given strict political independence and charged with pursuing a consumer price inflation target. Fiscal policy is to focus on a sound financing of public expenditures over the medium term. Discipline of monetary and fiscal policy is being maintained by financial markets imposing inflation or default risk premia on government bonds when policymakers stray from the path of virtue. The key mistake revealed by the events of the last few years has not been to accept these paradigms, but to assume that they hold universally and all the time. As a result, we have neglected what Keynes so aptly called “animal spirits” as drivers of business and credit cycles and failed to appropriately take account of them in the set-up of our policy and market institutions. The aim of my proposal for a European Monetary Fund is to remedy this shortfall in the area of monetary and fiscal policy in EMU and eventually the EU. Had the IMF not already existed we should have invented it to help us cope with the present global economic crisis. But what holds at the global level surely holds also at the European one.

[6] Cf. also D. Gros, S. Micossi: A call for a European Financial Stability Fund, CEPS Commentary, 27 October 2008.