Thumbs Down *on the* Common Bond

BY OTMAR ISSING

Countries like France and Germany would pay higher interest rates.

With the deepening of the global financial crisis, spreads between the government bonds of different European Monetary Union (EMU) countries for a while widened dramatically. Relative to German bonds, the spreads in February of secondary-market yields of government bonds with maturities of close to ten years were 141 basis points for Italy, 257 for Greece, and 252 for Ireland, compared to just 32, 84, and 25 basis points, respectively, in 2000.

In EMU's early years, long-term interest rates in eurozone countries more or less converged to the low levels seen in countries like France, Germany, and the Netherlands before the euro's introduction. Italy and Greece enjoyed huge declines in the cost of servicing their public debt in comparison to pre-EMU days. For many people, the introduction of the euro meant not only that currency risk—that is, the risk of devaluation—had disappeared, but also that all eurozone members now belonged to an economic area of monetary stability and, thanks to the discipline of the Stability and Growth Pact, of fiscal stability.

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Moreover, before the crisis, differences in long-term interest rates among EMU members were around 25 basis points, despite unfavorable fiscal developments in some EMU countries. But today, countries with rising budget deficits, like Ireland, along with countries with high levels of public debt, like Greece and Italy, are at risk to pay substantially higher rates on their government bonds. Risk-averse investors may now demand higher risk premia for buying bonds from countries seen as weak debtors. On the other hand long-term interest rates in countries with stronger fiscal positions—France, Germany, and Finland—have enjoyed low rates as a consequence of a "flight to quality."

This rise in long-term interest rates has hit the countries with sharply deteriorating fiscal positions hardest. It is even suggested that some countries might abandon EMU if this process continues—a threat that, if carried out, would amount to economic suicide.

It comes as no surprise, then, that the idea of a common European bond is becoming popular as a way to counter the risk of rising EMU interest-rate spreads. The main idea is to reduce the risk premia paid by debtors with lower fiscal credibility. But this can be achieved only by implicit or explicit guarantees from EMU countries with sound public finances. A "true" pan-European bond would have to entail a joint guarantee by all countries of the full bond issue, with the "strongest" guaranteeing the "weakest," which supporters of a bond idea suggest constitutes true European solidarity.

A common bond would eliminate the interest rate spread between bonds issued by different eurozone countries, so the question that must be addressed is what effect its 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 certainly implies that countries like France and Germany would have to pay higher interest rates, ultimately resulting in higher tax burdens for their citizens. Moreover, 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 be likely to increase substantially. No one can possibly know in advance exactly how big this "bill" might be, though that question—important as that is—misses the crucial point: a common bond would be the first step down a slippery slope to bail-outs, and thus to the end of the euro area as a zone of stability.

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To see why, recall that the immediate trigger for rising interest rate spreads was financial markets' growing concerns about the solidity of some eurozone countries, owing to dramatic deterioration in their current and expected fiscal positions. A common bond would be no cure for a lack of fiscal discipline; on the contrary, it 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 to get out of fiscal difficulty without undertaking fundamental reform.

Encouraging weak countries to prolong their reliance on budget deficits by holding out the hope of a *de facto* bail-out would be very costly for EMU's more solid countries, while undermining EMU's hard-won credibility as an area of stability and fiscal soundness. And this latter cost would have to be paid by all eurozone countries.

A pan-European bond would also have serious political repercussions. Any policy that forces countries that opted for fiscal solidity to pay for those with large deficits and high debt levels would strongly undermine public support for the eurozone. "Solidarity" in the true sense means that all eurozone countries should comply with EMU's fundamental rules by adhering to the Stability and Growth Pact and the "no bail-outs" principle. Countries tempted to undermine these principles by failing to fulfill their solemn commitments only demonstrate their own lack of solidarity. ◆