Eurozone Crisis - Solutions in Prospect or Global Meltdown?

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Outline of the Presentation

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3. Recovery and Growth from Eurobonds

Introduction

The EU is nominally committed to a European Economic Recovery Programme.

But this will be savaged if the current round of cuts and austerity is not countered by a broad wave of EU financed investments.

Not least because negative fiscal multipliers could double the direct cuts in deficits and negative investment multipliers could treble them .[1]

The global implications in terms of beggar-my-neighbour deflation would be devastating

[1] Observatoire Français des Conjoncture Economiques 2010.

A *Gestalt* Shift

What is needed to ‘cut the Gordian knot’ on debt is a *Gestalt* shift and a recognition that while EU member states are deep in debt the EU itself has next to none.

It had none at all until May last year when the European Central Bank began to buy up tranches of some member states’ national debt

If the EU were to issue its own bonds to finance a New Deal style economic recovery it would be starting from less than a tenth of the borrowing base of the Roosevelt administration in the 1930s.

1. Parallel Twin Strategies for Europe

1. **Stabilisation by Union Bonds**

   The EU could cut the Gordian knot of the debt crisis if it converted a tranche of the sovereign debt of member states to Union Bonds which are not traded but held in its own 'debit account'

2. **Recovery through Eurobonds**

   A social investment led recovery programme funded, like the US New Deal, by 'borrowing to invest' through net issues of Eurobonds which are traded and would attract inflows from sovereign wealth central banks and central banks of the emerging economies.

Background on Union Bonds

In 1989 Jacques Delors requested my assistance to devise instruments and policies to make a reality of the commitment of the Single European Act to economic and social cohesion.

In interim and final reports I proposed EU or Union Bonds [1] and he included them in his 'full employment' White Paper of December 1993.

The key parallel was US Treasury bonds which do not count against the debt of American states such as California or Delaware.

Therefore Union Bonds need not count on the debt of EU member states.

[1] Stuart Holland (1993) The European Imperative: Economic and Social Cohesion in the 1990s, Spokesman Books

The ‘Lost’ New Deal Parallel

But the New Deal parallel was not made in the White Paper which meant a the major legitimation of the case for the bonds was lost.

The proposal therefore lacked resonance with a wider public.

For too many people ‘Union Bonds’ just seemed another arcane European financial instrument.

It then transpired that Helmut Kohl thought that a bond was something paid for by German taxpayers, which is among the reasons why he initially opposed them.

The EIF and the Essen European Council

The bonds were to have been issued by a European Investment Fund - EIF.

The EIF now is part of the EIB Group, but with a remit to assist SMEs.

At the 1994 Essen European Council only the NL and Luxembourg explicitly supported the case for Union Bonds. Both Germany and France were opposed. Others were uncommitted.

The case went by default which is why peripheral EU member states now are threatened by a default on their national bonds.

2. Eurozone Stabilisation by Union Bonds

The way to cut the Gordian knot on national debt is to convert the major share of it to the EU in a European Bond – a Union Bond .

I have recommended this since 2008 to several of the actors involved including several heads of government and members of Ecofin.

Jean-Claude Juncker has supported the bonds since they were first proposed by me to Jacques Delors in 1993.

A parallel proposal was made in May 2010 by the Brussels based Bruegel Institute.

1] **e.g. Bruegel Policy Brief 2010/3. The Blue Bond Proposal. Brussels www.bruegel.org**

The Bruegel Proposals

Eurozone national debt of up to 60% of GDP - the SGP national limit - should be converted to the EU.

The Bruegel Institute proposals are those being considered currently by finance ministers.

Their Blue Bonds would be held by the EU and therefore in principle more secure than national bonds, as illustrated in the following figure.

But they have key limits, which is why neither Ecofin nor the European Council have been able to agree on them.

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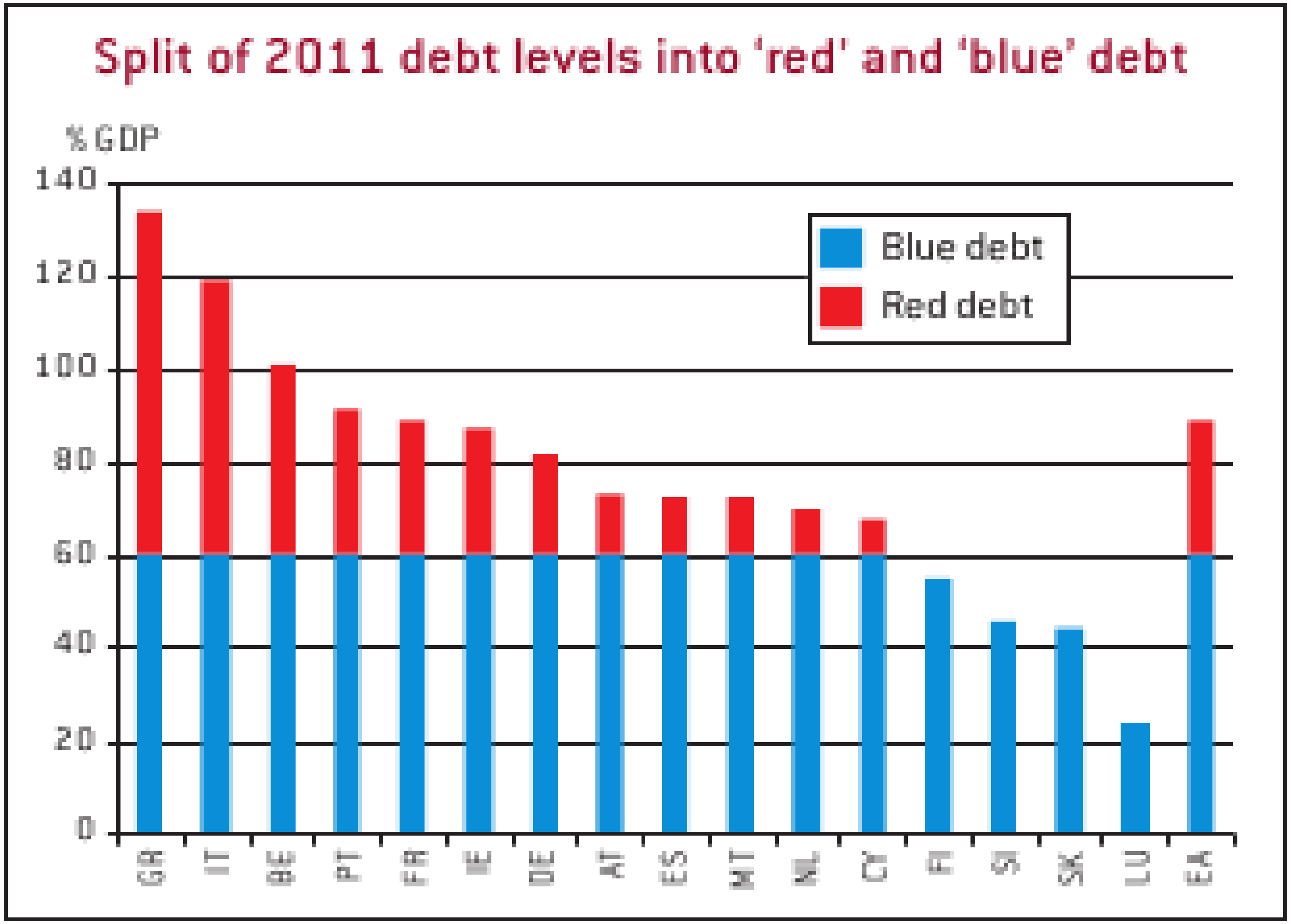
The Bruegel Proposal



Source: DG ECFIN, authors. EA = euro area.

Limits of the Breughel Proposals

The Breughel proposal:

1. assumes that the debt would be traded;

2. would need a new institution;

3. proposes joint and several liability for Blue Bonds held by the Union;

4. calls for a standardised collective action clause;

5. needs a guarantee by all member states and their taxpayers and therefore requires approval by all national parliaments;

6. allows for a an ‘orderly default’ on the remaining debt.

Not the Breughel Proposals

But none of the above six conditions for the Breugel proposal are necessary.

1. Converted debt need not be traded. It could simply be converted and held in its own debit account by the Union.

2. Member states' share of the converted debt would be serviced by them from their national tax revenues, without the need for national guarantees or fiscal transfers.

3. Joint and several liability for the bonds and a standardised collective action clause therefore would not be needed.

Debt Conversion Without Buyouts, Guarantees or Fiscal Transfers

A debt conversion therefore does not need buying up national debt as the ECB has been doing since May last year.

So far, this has not worked. It is not placating markets and there are several estimates that it could cost up to € 3 trillions to do so

Debt conversion would be a simple transfer held by the Union into a untraded debit account.

Nor does it need joint guarantees or fiscal transfers.

The European Investment Bank has issued its own bonds for fifty years without national guarantees or fiscal transfers or buying up national debt and already is twice as large as the World Bank.

Criteria for Conversion

The criteria for such a debt conversion without debt buyouts or mutual sovereign guarantees would be a ratio of remaining national debt to GDP at the time of the transfer.

Thus, if an investor holds a billion euros in Italian government bonds and Italian debt is 120% of GDP, half a billion for each bond of whatever maturity is transferred to the EU.

This then would be in an EU debit account, which would not be traded and therefore would be ring fenced against speculation by rating agencies.

As the maturities occurred on the converted debt, their interest rates would be determined by the Eurogroup of finance ministers rather than by rating agencies.

Enhanced Cooperation

Conversion of a share of national debt to the Union could be on an enhanced cooperation basis.

According to the Lisbon Treaty enhanced cooperation is by a minority of member states.

Yet the introduction of the euro itself was a *de facto* case of majority enhanced cooperation.

On this strong precedent not all member states need agree to the debt conversion to an EU debit account

Germany, Austria, the NL and Finland could keep their own bonds.

Key Implications of Debt Conversion 1

A key implications of debt conversion is that it would signal to financial markets that the EU has a strategic response to the crisis.

Holding the converted debt in an untraded debit account would mean that

- **It was ring fenced since not traded and show that governments can govern rather than rating agencies rule**

- **Since in a debit account rather than a credit account it could demonstrate to Germany and other member states that it could not be used for 'fiscal laxity'**

Key Implications of Debt Conversion 2

A further key implication of debt conversion into a Union debit account is that

- **This would mean that all member states other than Greece were Maastricht compliant on their remaining national debt.**

- **Greece would remain a special problem, but no more than that, and not of macro financial significance.**

- **It could be the sole or one of a few smaller member states which might need a buy out of a share of its remaining national debt by the EFSF**

3. Recovery and Growth Through Eurobonds

A clearer distinction than in the current debate should be made between

conversion of a share of national debt to ring fenced Union bonds and net issues of Eurobonds to finance recovery.

Eurobonds - or € bonds as markets could quickly dub them - would be purchased by central banks of the emerging economies and sovereign wealth funds.

The BRICs have made plain that they want to diversify out of the dollar.

These surpluses need to be recycled if there is to be a balanced recovery of the world economy, which is one of the central aims of the G20.

The Euro as a Reserve Currency

With net issues of Eurobonds bonds, the euro thereby would become a global reserve currency, taking the strain off the dollar

Both the US and the trade surplus economies would gain if this is part of a European recovery programme

- whereas contraction of the European economy as an outcome of debt stabilisation without a recovery programme would reduce both US exports and those of the emerging economies

Risking thereby a meltdown of the global economy

- risking also a double-dip global recession.