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A eurozone bond need not be a freeloaders' charter

Peter Bofinger

After four months of very low inflation, the spectre of deflation is haunting the eurozone. It appears especially frightening because interest rates are already close to zero and cannot go much lower.

A negative interest rate is not an impossibility. This would result in a small amount being lopped off depositors' bank balances every year, instead of added on. But savers can avoid negative bank rates by locking cash in a safe-deposit box instead of paying it into an account. This costs money but not much. It is futile to set interest rates so low that savers deem them confiscatory.

The Keynesian medicine of deficit spending, which would boost demand and lift prices, is unavailable in the heavily indebted member states where the threat of deflation looms largest. The only obvious remaining option is for monetary authorities to buy assets using newly minted cash. Such quantitative easing is intended to lift prices by increasing the supply of money. In contrast with other leading central banks, however, the European Central Bank has so far shunned this course.

One reason may be that it is not obvious what assets the ECB would buy. This question did not arise when, for example, the US Federal Reserve began buying government debt. But the ECB presides over the economy of 18 sovereign states. It cannot simply decide to start buying government bonds: it must also decide which ones.

One option would be to buy bonds from all eurozone members in amounts proportional to their gross domestic product. Even Germany's constitutional court would be unlikely to object that this crossed the line between monetary and fiscal policy. Still, there are difficulties.

For example, the effect on bond markets in Finland (where the stock of outstanding government debt is small relative to the size of the economy) would probably be much greater than in Italy (where the government owes far more).

Matters would be made easier if the member states issued a common bond. But the jointly guaranteed bonds that have been mooted in the past proved deeply divisive because of the possibility that taxpayers in one nation might end up assuming the liabilities of another that went into default. There was little prospect of such proposals being implemented, even before the incoming German coalition government definitively ruled it out.

But a joint debt instrument can be designed without joint liability. The member countries could issue joint bonds in the form of "euro bundles". Such a security would package together the bonds of national governments in proportion to the size of their economies, so that a €100 bundle would contain a German bond of €28, a French bond of €22 and so on. Each country would be liable only for its part of the bundle.

If the ECB decided to embark on a bond-buying programme, euro bundles would be the assets of choice. But the benefits do not stop there. Eventually, the market could grow larger than the individual national bond markets in the eurozone. This could reduce interest rates, especially for countries whose government bond markets are small and illiquid. Germany could help the new securities gain acceptance by issuing all its new bonds in this form. Based on Germany's current debt levels and the relative size of the bloc's other economies, euro bundles could then cover about 90 per cent of the financing needs of eurozone governments. This would make it much harder for investors to move their money out of one state's bonds and into another's. Such flows

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have been a significant source of instability in the past few years.

Countries with additional funding needs could still issue their own bonds.

In addition, euro bundles could create incentives for the member countries to reduce their public debt. Germany will countenance such an arrangement only if each government pays a different interest rate, reflecting the health of its public finances. For example, governments with small debts could receive a discount to the euro bundle interest rate, paid for by a surcharge on more indebted countries. Such an incentive mechanism for fiscal discipline would be much more reliable than the erratic risk premiums that are enforced by financial markets.

Euro bundles are not a great leap forward to a fiscal union but they could provide an important step towards a more integrated and more resilient European monetary union.

The writer is professor of economics at Würzburg university and a member of the German council of economic experts

Germany could help the new securities gain acceptance by bundling all its new debt with other countries' debt