FINANCIAL TIMES – 26 GENNAIO 2009

The benefits of a single European bond

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The rise in European bond spreads has triggered a discussion among finance ministers about the wisdom of a joint issuance of a single European bond. It is a bad pretext for a good idea. It is difficult to see how a common bond issuance would solve the acute problem of a hypothetical payment default of a member state of the eurozone. But it is a good idea nevertheless. A common eurozone market for government debt would be a powerful rival to the US Treasury and it could bring substantial financial and economic benefits.

The idea was predictably knocked down by the German finance minister, who quickly calculated that a joint European bond would cost Germany extra annual funding costs of €3bn ($3.9bn, £2.8bn) a year. I do not know how he arrived at the figure because the actual cost depends greatly on how such a common bond would be constructed. In any case, if Germany was a loser, there would be a simple solution to the problem: let every loser be compensated by the winners. The financial and potentially economic benefits would be larger than the compensation.

When the Europeans created monetary union in the 1990s, the resulting short-term interest rate was not an arithmetic average. Instead, it converged towards the lowest interest rates among its members. So what would happen if you merged Germany's triple A bonds with the lower rated bonds of Greece, Italy, Portugal and Spain? Would you get an average? Would it converge to Germany's triple A rating, or towards Greece's A-minus? To answer that, the European Primary Dealers Association (EPDA) has conducted a survey among dealers and produced a discussion paper* to evaluate a number of competing options. Indeed, it turns out that simply merging everybody's old and new debt into a single eurozone bond without any further supporting arrangements might not be the best answer.

But there are several alternatives. You could create a fund that guaranteed the coupon payments. Member states would pay into this fund according to some agreed criteria. The success of such an arrangement would obviously depend on its credibility among investors.

Mark Austen, managing director of the EPDA, says a simpler alternative would be a system that provided automatic caps on participation. Those caps could be determined on the basis of credit ratings, or on the ratio of debt to gross domestic product.

Yet another option is to keep the traditional bond market national, while creating a joint European market for treasury bills only. A bond is a long-term finance instrument with a fixed coupon, paid in regular intervals. A bill, by contrast, has a much shorter duration, normally a year, or less, and it is a discounted security. This means you buy a bill at a discounted price and it is repaid at par value on expiry.

The treasury bill market is huge in the US, much larger than in the eurozone, which is more reliant on traditional bonds. But the creation of a common bills market could be a good start. It is not nearly as controversial politically and European governments may even start to shift from bonds into bills over time. Once this experiment is deemed to have worked, you could merge the bond markets in a second step.

Any substantial move towards joint issuance would produce a government bond market that is large and more liquid and thus more likely to attract foreign investors. It would also provide better hedging opportunities. At present, the Bund future is considered an efficient contract as the gap between buying and selling prices is very low. But the Bund future is no great hedging instrument if you hold, say, Greek debt. With common issuance, you would have large, liquid markets for European bonds and also efficient European bond futures.

Richard Portes, professor of economics at the London Business School, makes the point that the eurozone already has a single and highly efficient corporate bond market, which benefited greatly from increased liquidity. His research has shown that comparable corporate bond yields fell to levels below prevailing rates in the US.

There is no reason why that performance could not be matched in the market for sovereign debt. Largely because of the role of the dollar as a global reserve currency and the quasi-monopoly of the US treasury market, the US enjoys what economists pompously call the exorbitant privilege, essentially the ability to get something for nothing. In the case of the US, there is some research evidence that large demand for US treasuries from foreign investors has driven down bond yields. If the eurozone created an equally efficient bond market, there is no reason to think it would not share some of this exorbitant privilege.

What about the Maastricht Treaty's no bail-out clause? Would joint issuance not constitute an infringement of that rule? The answer is no. You can still have joint issuance, but divided liabilities. There are already plenty of examples, such as joint issuance of local government bonds in Japan and Scandinavia or joint issuance of the German regions.

We should remember, however, that common issuance cannot be a quick fix for rising spreads. This is why the timing of this debate is unfortunate. No scheme, however clever, will change the necessity for Greece, Portugal and Spain to undertake economic reforms.