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The eurozone needs a government bond market

*di George Soros**

The euro suffers from certain structural deficiencies; it has a central bank but it does not have a central treasury and the supervision of the banking system is left to national authorities. These defects are increasingly making their influence felt, aggravating the financial crisis.

The process began in earnest after the failure of Lehman Brothers when, on October 12 , the European finance ministers found it necessary to reassure the public that no other systemically important financial institution would be allowed to fail. In the absence of a central treasury, the task fell to the national authorities. This arrangement created an immediate and severe financial crisis in new European Union member states that have not yet joined the euro and eventually it also heightened tensions within the eurozone.

Most of the credit in the new member states is provided by eurozone banks and most household debt is denominated in foreign currencies. As the eurozone banks sought the protection of their home countries by repatriating their capital, east European currencies and bond markets came under pressure, their economies sagged and the ability of households to service their debts diminished. Banks with large exposure to eastern Europe found their balance sheets impaired.

The capacity of individual member states to protect their banks came into question and the interest rate spread between different government bonds began to widen alarmingly. Moreover, national regulators, in their efforts to protect their banks, were unwittingly engaging in beggar-thy-neighbour policies. All this is contributing to internal tensions.

At the same time, the unfolding financial crisis has convincingly demonstrated the advantages of a common currency. Without it, some members of the eurozone might have found themselves in the same difficulties as the countries of eastern Europe. As it is, Greece is hurting less than Denmark, although its fundamentals are much worse. The euro may be under stress but it is here to stay. The weaker members will certainly cling to it; if there is any danger, it comes from its strongest member, Germany.

Germany is at odds with most of the world in its attitude to the current financial crisis but it is easy to understand why. It has been traumatised by its history during the 1930s when runaway inflation in the Weimar republic led to the rise of Hitler. While the rest of the world recognises that the way to counteract the collapse of credit is by expanding the monetary base, Germany remains opposed to any policy that might carry the seeds of eventual inflation. Moreover, while Germany has been a steadfast supporter of European integration, it is understandably reluctant to become the deep pocket that finances bail-outs in the eurozone.

Yet the situation cries out for institutional reform and Germany would benefit from it just as much as the others. Creating a eurozone government bond market would bring immediate benefits in addition to correcting a structural deficiency. For one thing, it would lend credence to the rescue of the banking system and allow additional support to the newer and more vulnerable members of the EU. For another, it would serve as a financing mechanism for co-ordinated counter-cyclical fiscal policies. Properly structured, it would relieve Germany’s anxiety about other countries picking its pocket.

The eurozone bond and bill markets would complement but not replace the existing government bond markets of individual states. They would be under the control of eurozone finance ministers. The regulation of the financial system would then be put in the hands of the European Central Bank while the task of guaranteeing and, when necessary, rescuing financial institutions would fall to the finance ministers. This would produce a unified and well supported financial system within the eurozone. Even the UK, which is struggling with an oversized and undercapitalised banking system, may be tempted to join.

Eurozone bonds could be used to assist the new EU member countries that do not yet belong to the eurozone. They could also serve to increase the lending capacity of the EU beyond the current mandates of the European Investment Bank and European Bank for Reconstruction and Development. The EU could then finance investment programmes that combine a counter-cyclical function with important European objectives such as an electricity grid, a network of gas and oil pipelines, alternative energy investments and employment-creating public works in Ukraine. All these investments would help break Russia's stranglehold over Europe. The objection that they would take too long to serve a counter-cyclical purpose can be rejected on the grounds that the recession is also liable to last a long time.

Two thorny issues would need to be resolved – one is the allocation of the debt burden among member states and the other is the relative voting power of the different eurozone finance ministers. The existing precedents, namely the EU's budget and the composition of the ECB, would be considered unfair and unacceptable by Germany. But many member states will balk at agreeing to a solution that changes the balance of power within the EU. Never-theless some concessions would have to be made to bring Germany on board. Usually it takes a crisis to bring about a compromise but the crisis is now brewing and the sooner it is resolved the better.

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