The eurozone deserves a common bond

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EU president Jean-Claude Juncker and Giulio Tremonti, Italy's Minister of Economy and Finance, have identified common euro bond issuance as a systemic solution to the European sovereign debt crisis. They argue that it will send global markets a clear message on the irreversibility of the euro and the political commitment to economic and monetary union.

Indeed the current crisis has led many to overlook the fundamental strength of the overall eurozone economy. According to International Monetary Fund forecasts, in 2010 the eurozone will have a current account surplus of 0.2 per cent of GDP in comparison with a 3.2 per cent deficit in the US and a trade surplus of 2.1 per cent against a US deficit of 3.5 per cent. Debt to GDP is forecast to be at 83.7 per cent versus the US at 92.7 per cent and similarly positive comparisons can be made in terms of structural deficits and savings rates.

It is therefore ironic that the eurozone is currently seen as such a great source of risk rather than a safe haven in the world economy. This is where the architecture of the European sovereign bond markets does the eurozone a huge disservice. Instead, investors are confronted with eurozone sovereign ratings ranging from junk to AAA and spreads from 0 to nearly 1000 basis points. As a consequence, there is an effective breakdown in the ability to price public and private sector risk across the eurozone, at huge risk to the euro system and great expense to the EU economy as a whole.

The debate about euro bond (E-bond) issuance is naturally political. But it needs to be rationalised. E-bonds will reflect the fundamental strength of the eurozone and the solidarity of its members. Through improvements in market efficiency and stability, euro bonds will lead to a reduction in the cost of capital across the eurozone.

The eurozone must enable its members to benefit from common issuance not only in times of crisis such as now through EU/eurozone-backed instruments such as the European Financial Stabilisation Mechanism and European financial stability facility, but also in normal times through issuance of benchmark E-bonds. This should mean the eurozone need not fall back on specific crisis related instruments.

As Mr Juncker and Mr Tremonti write, E-bonds should be issued in parallel with those issued by individual eurozone members and capped at, say, 50 per cent of an individual member's outstanding debt (greater for smaller eurozone members) and subject to agreed debt to GDP limits. If all eurozone members participate, E-bonds will become the clear benchmark issuer on behalf of the eurozone to rival US Treasuries for liquidity.

But first, consensus will have to be found on three key issues:

1: Does the "carrot and stick" approach provide eurozone governance with sufficient authority? The value of E-bonds will be clear to most eurozone members enabling them to raise attractive short- and long-term funds at interest rates that reflect the overall strength of the eurozone. Similarly, the ability to potentially deny access to this funding from E-bonds will be an effective stick to ensure eurozone members adhere to sustainable macro economic policies.

2: What will be the change in the funding levels for those members that believe that their bonds would trade at a lower yield than E-bonds? First of all it is questionable what their relative pricing would be. No US state would trade below US Treasuries. The combined credit quality of the eurozone, accompanied with clear macro economic governance, strong EU bank supervision, the credibility of the ECB and supported by liquid futures and repo markets, will ensure that E-bonds are recognised by investors as the benchmark representing the overall eurozone. Even if theoretically E-bond yields were to be higher, the incremental cost would be marginal and inconsequential compared to the cost of continued instability.

3: Bondholders will have to share the burden of any future sovereign debt restructuring. On the flip side, should eurozone members that guarantee E-bonds also share the cost of a restructuring? This is the most complex issue. Burden sharing means what it says and its fairness needs to be well understood by the market and politicians alike. The eurozone members that guarantee E-bonds will need to share in the burden of any restructuring through additional support to a European debt agency. In return they must obtain the governance that will ensure sustainable debt levels across the eurozone.

E-bonds will result in a better governed eurozone with better representation in global capital markets. E-bills should be a politically acceptable first step to prepare the ground for an effective permanent macro economic governance and optimal funding model. It is not too late to learn from mistakes. The euro is only a teenager, after all.