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## Brussels must start issuing sovereign debt

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Why has the euro been plunging against the dollar and the yen? Why are European banks coming under renewed pressure in spite of massive rescue programmes?

The euro has been falling because investors, in their scramble for safety and liquidity, are flocking to US – and to an extent also Japanese – government paper, driving their yields close to zero. US and Japanese paper is considered safer than other government-backed assets – including public debt instruments issued by European governments. In other words, the separate markets for sovereign debt paper of unequal quality issued by European governments cannot compete with the US market for financial flows in search of a safe harbour; and they will not be able to compete in times of turbulence until the European Union develops a unified market for bonds denominated in euros.

As a result, capital is not coming to Europe, where it is needed to shore up the banking system. Even the most virtuous EU member states now pay 2-3 percentage points more on short-term borrowing than the US government, although public sector finances are under more stress in the US. Moreover, the US will continue to dictate the agenda in international monetary affairs, even now, after the colossal damage inflicted on the world by its misguided macro and regulatory policies.

The overall message from financial markets is that investors everywhere have developed a strong preference for public debt. In the US and Japan public debt is riskless because, if needed, the government could always force the (national) central bank to print the money necessary to meet its obligations. But this is not the case in the eurozone, since no government can force the European Central Bank to print money. For international investors, there is no euro area government bond in which they could invest to diversify their risk away from the dollar.

We thus have both strong demand for “European” bonds and a need for massive government capital infusions to prevent the crisis from getting worse in the banking sector and on the European periphery, whose difficulties are aggravating the banking crisis given that EU banks have about \$1,500bn (€1,600bn) of claims on emerging Europe that are now at risk as well.

This is why the EU should set up a massive European financial stability fund. The fund will probably have to be at least on the scale of the US troubled asset relief programme – say, €500bn-€700bn. It would issue bonds on the international market with the explicit guarantee of member states. As the rationale for the EFSF is crisis management, its operations should be wound down after a predetermined period (five years, perhaps). For global investors EFSF bonds would be practically riskless. But this does not imply stronger member countries would have to pay for the mistakes of the others since, at the end of its operations, losses could be distributed across member countries according to where they arose. In all likelihood the fund would not lose, as it could finance itself at much lower cost than national governments.

This fund could be set up quickly at the European Investment Bank, which already exists with the necessary expertise. (Technically the EIB is an agency of member states under the control of their finance ministers.)

The resources would be used mainly for bank recapitalisation, especially for those banks that “gamble for resurrection” rather than accept the heavy-handed interference of national governments. The EFSF could also beef up the funding of existing EU instruments for balance-of-payments assistance to countries on the EU’s periphery. But, given the unpredictable nature of this crisis, a crucial consideration should be for the EU to prepare for the “unknown unknowns” that are certain to arrive sooner rather than later.

French president Nicolas Sarkozy has recently called for creation of an economic government for the euro area. Under normal circumstances one would have replied that the economic governance of the eurozone was assured by the independence of the ECB and the stability pact. This is clearly no longer sufficient when Europe faces the worst economic and financial crisis since the second world war. The speed and depth of

the crisis have overwhelmed the usual decision-making mechanisms. Europe needs action on a scale that can be decided only at the highest political level.