# Germany and the Eurozone: Clutching disaster from the jaws of victory?

# [John Muellbauer](http://www.voxeu.org/index.php?q=node/415) 25 November 2011, VOX.EU

*For months economists have been arguing that Germany holds the key to ending the Eurozone crisis. Should it relax its anti-inflation stance and allow the ECB to inflate away sovereign debt? Or should it write a cheque of its own to the EFSF? Neither, says this column. There is a simple solution, if only Eurozone leaders can see it. Eurobonds are the answer – but with conditions.*

Aided by market panic and confusion, it could be said that German toughness has transformed the reform prospects for Europe. Italy, Spain, and Greece now have credible, reform-committed governments. Ireland, bailed out under tough conditions, has cut its unit labour cost by 17% over 2 years and is showing growth. Portugal is strenuously reforming its public sector and labour markets. However, market panic has been costly for the European banking system and for short-run economic prospects.

All this would be a price worth paying, however, if Angela Merkel now completes the final stage of what would be seen as a remarkable moral, political, and economic triumph. A few years ago, a sleazy and ineffective Italian government could borrow on the markets at a cost scarcely higher than that of Germany. Last week, it cost the new Italian government over 6 percentage points more to borrow for two years than it cost the Germans. (see for example [Manasse and Trigilia 2011](http://www.voxeu.org/index.php?q=node/7310)). There is a way to put an instant stop to this absurdity without the European Central Bank and the European Stability Fund.

The German Ministry of Finance could offer a two-year loan to the Italian government at 3% above what it pays, and promise that next year, if the Italian reform programme is showing visible signs of success, the spread could fall to 2.5% and then to 2% if progress continues. With backsliding, the cost would rise. This solidarity gesture would be highly profitable for the German taxpayer. The conditionality of the offer would keep the new Italian government committed to reform, aiding Italy’s credibility as a Eurozone member. Conventional Eurobonds, meanwhile, with the same funding costs for every country but with risk collectively underwritten, would likely be a recipe for disaster. They would encourage lax fiscal policy, backsliding on reform, and moral hazard. But *conditional* lending as illustrated above could be institutionalised in *conditional* Eurobonds as explained in my CEPR Policy Insight 59 ([Muellbauer 2011](http://voxeu.org/index.php?q=node/7081)).

For the investor, *conditional* Eurobonds trade at the same price for all issuing countries, but the riskier countries pay a premium, or ‘spread’, to the safer countries for underwriting their common debt issuance. Conditional Eurobonds, with spreads linked to the ratios to GDP of government debt and deficits, were first proposed by Wim Boonstra, chief economist of Rabobank, even before monetary union (Boonstra 1991). Had they been part of Eurozone architecture, the current crisis could largely have been avoided, and even without fiscal centralisation.

# Introducing conditional Eurobonds

*Conditional* Eurobonds would institutionalise, for all Eurozone countries, the simple example above of Germany lending to Italy. The *conditional* Eurobonds, issued on new borrowing, would be collectively underwritten by member governments of the Eurozone. Two design features would have to be settled: the formula that defines the spreads that each country has to pay into a central fund and the distribution of the payments resulting from the spreads to the guarantor governments. I argue that spreads should be determined by relative unit labour costs, and by relative government debt- and current account–to-GDP ratios. Including unit labour costs introduces incentives for improved competitiveness, promoting long-run economic growth.

The proceeds of the payments could be distributed in several ways. In the simple example of a bilateral loan from Germany to Italy, Germany would retain the entire spread. With multilateral underwriting, all Eurozone countries would receive shares of the payments into the central fund. The shares would be determined by the size of their own borrowings and their spreads relative to Germany. Per unit of borrowing, less risky countries such as France would receive more than riskier countries such as Belgium, but less than Germany itself. Boonstra recently suggested that part or all of the premium payments be retained in a central insurance fund against the possibility of a future debt write-down.

# Clear as day

The new European Commission draft Green Paper on the feasibility of introducing ‘Stability Bonds’ does consider conditional Eurobonds with spreads. But by presenting this as just another option, the document fails to point out clearly enough that the difference between these and conventional Eurobonds is like the difference between day and night. A hugely important point about conditional Eurobonds with spreads is that they address the German fear about the Eurozone becoming ‘a transfer union’. The point is also not made clearly enough that this kind of bond, by creating the right fiscal incentives, allows a kind of fiscal decentralisation or subsidiarity, which addresses one of the key worries about democratic governance in the Eurozone.

The Green Paper’s discussion of previous literature does not give the credit to the Boonstra proposal that it deserves, particularly as his predates EMU. Though competitiveness is mentioned a few times, the document does not explain how incentives for improved competitiveness could be linked to Eurobonds, an important part of my own proposal.

The new 2011–12 report from the German Council of Economic Experts contains a chapter on the Euro crisis which proposes a kind of Stability Bond in the form of a ‘redemption fund’ subject to strict fiscal discipline. The idea is that sovereign debts exceeding the Stability and Growth Pact’s target of 60% of GDP would be pooled in a jointly guaranteed fund to be paid down over 20 to 25 years. Strict supervision, surveillance, country legislation to give priority for each country’s payments to service its debt, and penalties for noncompliance, it is hoped, would counter the moral hazard of cheap borrowing with joint liability. It would very likely require a renegotiation of EU treaties.

The German experts’ report expresses confidence that the German Constitutional Court would approve such a Eurobond. The following comment in the European Commission Green Paper raises a question on this score in footnote 14: “…the German Constitutional Court ruling of 7 September 2011 prohibits the German legislative body to establish a permanent mechanism, ‘*which would result in an assumption of liability for other Member States' voluntary decisions, especially if they have consequences whose impact is difficult to calculate*’”. It also requires that in a system of intergovernmental governance, the parliament must remain in control of fundamental budget policy decisions. If the German experts’ confidence is well founded, it should presumably extend even more powerfully to conditional Eurobonds with spreads that reward the safer countries for assuming joint liability for new borrowing for all Eurozone countries, and which incentivise fiscal responsibility.

The ruling clearly would not prevent the temporary loan from Germany to Italy illustrated above. Such a loan could be quickly followed by setting up a Euro-treasury bill underwritten by all Eurozone countries but with a risk premium paid by the riskier countries to the safer ones.[1](http://www.voxeu.org/index.php?q=node/7332#fn1) A simple rule of thumb for setting the initial spreads on conditional Euro-treasury-bills would be 'split the difference'. In other words, if the market currently prices Italy's borrowing cost at 6% above the German ones and Spain's at 5.5%, have Italy borrow at 3% more and Spain at 2.75% more than Germany. This stop-gap measure would buy time while the design of a more permanent conditional Eurobond is negotiated and passed through domestic political processes and through the German Constitutional Court.

Feedback on my own proposal has suggested possibly severe political obstacles[2](http://www.voxeu.org/index.php?q=node/7332#fn1) to obtaining multilateral agreement on the spread-setting and distribution formulae needed to define conditional Eurobonds. These worries are exaggerated. Participation could be voluntary. As Boonstra (2011) points out, the AAA-rated countries could get together, agree the formulae, and issue Eurobonds. The other countries can then decide whether to accept the rules and be insured or try to borrow on their own.

# Europe at a crossroads

Europe’s economic outlook could be rapidly transformed. A German bilateral loan offer to Italy, followed by the announcement that *conditional* Euro-treasury bills would follow shortly, and that consultations were beginning on *conditional* Eurobonds, could be made within days. The yields on Italian government bonds would drop, followed by those of Portugal and Spain. Share prices of European banks holding Italian bonds would rise, restoring their ability to lend. The ECB’s recent interventions in the Italian and Spanish bond markets would make a large profit. Speculators who have shorted sovereign debts of Italy and others could find themselves skating on thin ice.

There is, however, an alternative. Germany could prove itself not to be a good European and instead clutch disaster from the jaws of victory over fiscal irresponsibility, unreformed labour markets, and corruption in the southern fringe of Europe. German inaction could trigger the most severe crisis since the collapse of Lehman Brothers.

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1 The German experts suggest that governments could pledge part of their gold and foreign-exchange reserves as collateral for borrowing which is jointly guaranteed. This idea could potentially be adopted to reduce the risk spreads Italy and the others would be asked to pay for such short-term borrowing.

# 2 See readers comments in the Economist.

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