Union Bonds, Eurobonds and a New Deal for Europe

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Introduction

Union Bonds or Eurobonds have hit headlines since the case for them in an article in The Financial Times in December by Jean-Claude Juncker and Giulio Tremonti.[1] But there is resistance to debt buy-outs, national guarantees and fiscal transfers between member states.

This paper argues that none of these are necessary either to convert a share of national bonds to the Union, or for net issues of Eurobonds. In doing so it recalls the rationale for the proposal of Union Bonds to Jacques Delors in 1993.[2]

1. In funding the New Deal the Roosevelt administration did not buy out the debt of member states of the American Union, nor require them to guarantee US Treasury bonds nor demand fiscal transfers from them.

2. The US funds its Treasury bonds from federal taxes whereas Europe does not have a common fiscal policy. But member states can finance the share of their national bonds converted to Union bonds without fiscal transfers between them.

3. The EIB has issued its own bonds for fifty years without national guarantees or fiscal transfers and already is twice as large as the World Bank. The ECB is the guardian of stability, but the EIB Group can safeguard growth.

4. Conversion of a share of national debt to the Union could be on an enhanced cooperation basis whereby some member states could retain their own bonds.[3]

5. Jean-Claude Juncker and Giulio Tremonti are right in that sovereign Union bonds should be globally traded, would attract global surpluses and could enable the euro to become a global reserve currency.

6. But a conversion of a share of national into Union Bonds could be held by the Union on its own account, rather than traded. This would ring fence the converted bonds from rating agencies and enable governments to govern rather than the agencies rule.

A higher political profile also should be gained for the case that while some member states are deeply indebted, the Union itself has next to none. Until May last year and the beginning of national debt buy-outs it had none at all.

Even with such buy-outs and salvage operations for banks, Union debt still is less than one per cent of Union GDP.

This is less than a tenth of the debt to GDP ratio of the US in the 1930s when the Roosevelt administration began to shift savings into investment through the expansion of US Treasury bonds.[4] Unlike the US the Union has a late starter advantage.

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[1] Jean-Claude Juncker and Giulio Tremonti (2010). E-bonds would end the crisis. The Financial Times, December 5th.

[2] Stuart Holland (1993). *The European Imperative: Economic and Social Cohesion in the 1990s.* Nottingham: Spokesman Press, Foreword Jacques Delors.

[3] According to the Lisbon Treaty enhanced cooperation is by a minority of member states. Yet the introduction of the euro itself was a *de facto* case of majority enhanced cooperation.

1. The Bruegel Proposal

The Bruegel Institute proposal of a conversion of national debt of up to 60% of GDP to Union Blue Bonds has been useful in.[5] But the proposal:

1. assumes that the debt would be traded;

2. would need a new institution;

3. proposes joint and several liability for the Blue Bonds held by the Union;

4. calls for a standardised collective action clause;

5. needs a guarantee by all member states and their taxpayers and therefore requires approval by all national parliaments;

6. allows for a an 'orderly default' on the remaining debt.

This paper agrees with the principle of conversion of a share of national debt to European bonds, but submits that by implying national guarantees and therefore fiscal transfers the Bruegel proposal does not meet the political and electoral concerns of Germany and some other member states or the risk that its recommendations could be challenged by the German Constitutional Court.

It suggests that that none of the above six conditions for the Bruegel proposal are necessary for the following reasons.

1. Converted debt need not be traded. If held and managed on its own account by the Union, it would be ring fenced and a long-term and sustainable interest rate determined by the Eurogroup rather than rating agencies.

2. Member states' share of the converted debt would be serviced by them from their national tax revenues, without national guarantees and without fiscal transfers.

3. Joint and several liability for the bonds and a standardised collective action clause therefore would not be needed.

4. A clearer distinction would be made between conversion of a share of national debt in ring fenced Union bonds and net issues of Eurobonds to finance growth.

5. Neither the transferred debt nor net bond issues necessarily would need a new institution.

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[4] The US did not opt for deficit financing until Roosevelt's second term. But the main driver for recovery from the Depression in both his first and second administration was by bond financed social and environmental investments which Europe could parallel now to achieve recovery.

[5] Delpla, Jacques and von Weizsacker, Jakob. (2010). The Blue Bond Proposal. Bruegel Policy Brief 2010/03, May

6. An ‘orderly default’ on remaining national debt would be less probable in that a ring fenced bond conversion of up to 60% of GDP also would mean that most member states thereby would be Maastricht compliant on what remained as national debt.

2. A Ring Fenced Bond Conversion

The optimal basis for the conversion of a share of national debt to Union sovereign bonds would be unanimous. But if it were by enhanced cooperation, and if France, Italy, Spain and Poland supported a bond conversion this would include four of the five major Eurozone economies. With others doing so this could include 12 or more of the 17 euro member states.

1. The conversion would be for a share of national debt of up to 60% of GDP, as in the Bruegel Proposal

2. The debt converted to Union Bonds would not be a write-off nor need fiscal transfers between member states. It would require that the member states agreeing to it service their share of it from national revenues.

3. A conversion of debt of up to 60% of GDP from member states to the Union also would mean that the remaining national debt of most member states would be Maastricht compliant.

4. This would not need a revision of the Stability and Growth Pact but could gain it the credibility it currently lacks with markets.

3. Sustainable and Unsustainable Debt

For a member state as Greece whose remaining national debt still would not be Maastricht compliant a debt conversion should be conditional on an agreed schedule for its reduction.

But this need not necessarily be so for others since their national debt would be within the 60% SGP limit.

The central issue is not reduction per se but sustinability.

- *Sustainable Debt*

Whether a debt is sustainable depends not on its level but whether it can be serviced. Until the end of 2009 this was not a problem for most member states. Few of them initially had a debt servicing problem even when they salvaged banks.

Whether a given level of debt can be serviced relates also to whether it is externally or internally sourced. Some member states such as Italy have a high debt to GDP ratio which, like the much higher Japanese 200% ratio, has been sustainable since mainly self-financed.

A major share of Italy's debt is precautionary rather than profligate. There are fewer pension funds in Italy than in many northern European member states. Individuals hold Italian Treasury bonds on a precautionary basis to finance their retirement, or the education or endowment of family members.

Italy therefore is not as exposed as several other member states to speculation against national debt by rating agencies, even if not immune.

- The Greek Case

Near to all evidence of successful debt reduction, as under the Clinton administration in the US in the 1990s, shows that growth aids debt reduction. It increases national fiscal receipts whereas recession reduces them.

It is forecast that the Greek debt in 2012 will be 159% of GDP. But with a conversion of 60% to the Union its excess over what then would be the Maastricht compliant national level would be 39% rather than 99%.

This still is a serious excess. But a reduction (1) would be financially feasible with a lowering of the cost of Greek debt of 60% of GDP by conversion to the Union; (2) more politically acceptable if the deflationary effects of reducing national deficits are offset by Eurobond finance to make a reality of the European Economic Recovery Programme (below).

4. Who Should Hold Union Bonds

The Bruegel Institute proposed a new institution to hold the conversion of national sovereign debt to the Union. There are two main alternatives for which existing institution might do so without needing this.

- ***The European Financial Stability Facility***

The European Financial Stability Facility could hold the ring fenced converted debt. This would be consistent with its stabilisation remit. It could do so even though it is due to be replaced in 2013 by the European Stability Mechanism. The converted debt then might be held by the ESM.

The terms of reference for the ESM have not yet been defined. Those of the EFSF have proved contentious. Yet the principle that converted debt should not be traded would safeguard the EFSF from downgrading by rating agencies and bond markets.

- The European Central Bank

An alternative for holding the converted debt could be the ECB.[6]

[6] This has been submitted in a series of papers by Yanis Varoufakis and myself under the title of The Modest Proposal. The modesty, if such, lies in that it would not need new institutions. Otherwise it parallels this paper in proposing bonds without debt buy-outs or national guarantees or fiscal transfers. See further The Modest Proposal for Overcoming the Euro Crisis

For Germany such a proposal might initially be dismissed out of hand. The ECB is the guardian of price stability and must remain so.

If the ECB were to hold the converted debt it would need to do so without prejudice to its primary responsibility for price stability.[7] But this need not be prejudiced.

1. The conversion would be inflation neutral since it would not increase liquidity. It would not be more money but the same debt held differently and more securely.

2. The lower and sustainable long-term interest rate on the converted and ring fenced bonds could reduce inflationary pressures.

3. Since the converted debt would not be traded, the ECB held debit account for a share of converted national bonds would not be exposed to evaluation by rating agencies.

4. A Treaty revision would not be needed. The ECB already is Treaty obliged, without prejudice to its primary responsibility to ensure price stability, 'to support the general economic policies of the Union' as defined by the European Council.

5. This provision is not new nor a reaction to the current Eurozone crisis. Its wording that the ECB should support derived directly from the terms of reference of the Bundesbank.[8]

6. Debt stabilisation of the Eurozone is a general economic policy of the Union.

The ECB's holding the converted debt therefore need not compromise its primary commitment to ensure currency stability since a debt conversion would not increase liquidity and therefore would be inflation netural.

It also thereby could secure the now vital issue of the stability of the Eurozone.

- Internal and External Inflation

Inflationary pressures are increasing. But the causes are external in terms of high demand for commodities in the emerging economies, and also speculation.

The pressures are global. Their cause is not internal to the Union even though they affect it. With reason, President Sarkozy has submitted that such commodity speculation needs to be addressed by the G20.

Deflation of EU demand will not in itself reduce global inflationary pressures while it compromises the Treaty commitments of the Union since 1957 to a high level of employment and the commitment of the 1986 Single European Act to both economic and social cohesion.

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[7] Central banks do not normally hold or issue bonds rather than finance ministries and treasuries. But Europe does not have one. While innovative, there are multiple precedents for bond issues in public sector credit institutions. Besides which, as argued in this paper, the ECB could hold and manage the conversion of a ring fenced share of national debt, but not be involved in net bond issues.

[8] These terms were based on those of the Bundesbank, i.e. *die allgemeine Wirtschaftspolitik der Bundesregierung zu unterstützen.*

5. Issuing Eurobonds for Recovery

The ECB need not be involved in net bond issues. The initial design for the Union to issue its own bonds was that this should be by the European Investment Fund, which was set up in 1994 and since 2000 has been part of the EIB Group.[9]

The proposal both of EU Bonds and of the EIF was in response to a request from Jacques Delors to design financial instruments to realise the commitment to cohesion in the Single European Act.

The primary design role for the EIF was for common bonds to counterpart a common currency. Its secondary design was financial support for small and medium firms and new high tech start-ups, which has been its sole role since 1994.

- *The EIF Design and Eurobonds*

The initial EIF design recognised that a single currency would deprive member states of devaluation as a means of balance of payments adjustment, and that there was no political support for fiscal transfers on the scale recommended by the MacDougall Report.[10]

But, drawing on the precedent of the New Deal, it recognised also that European bonds could finance structural, social and regional policies which had been the intent of the 1956 Spaak Report for a Common Market.[11]

This also was consistent with the aims of the MacDougall Report for ‘structural, cyclical, employment and regional policies to reduce inter-regional disparities in capital endowment and productivity’.

- *The EIF Design for Venture Capital*

The 1993 recommendation that the EIF should support small and medium firms also was not only for equity guarantees but for a European venture capital fund with a budget of up to 60 billion ecu and a special remit to finance high tech start-ups.

Financed by EU Bonds, this would be invested over several years but as more than one per cent of the then EU GDP would have macro potential. Sound management of the fund, in cooperation with national credit agencies and regional development agencies with knowledge of local SMEs, should ensure that the bonds could be financed by returns on the equity capital.

The aim was that this would offset the lack of private venture capital in Europe relative to the US, reduce the dependence of SMEs on fixed interest borrowing which penalised new start-ups before they could secure a market, and thereby reinforce micro innovation and competitiveness with macro economic and social gains.

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[9] Holland (1993) Op cit.

[10] Of from 5% to 7% of GDP European Commission. (1977) Report of the Study Group on the Role of Public Finance in European Integration [The MacDougall Report] Brussels.

[11] Intergovernmental Committee on European Integration (1956). *Report on the General Common Market* [The Spaak Report] Brussels. MacDougall Report, 14-15).

A venture capital rather than loan guarantee role for the EIF was neglected when it was set up in 1994, with the outcome that until it was brought into the EIB Group in 2000 it had guaranteed only 1 becu for SMEs.

Its original design for a micro instrument with macro effect was only recovered by the September 2008 Nice Ecofin which scheduled €30 bn for support for SMEs yet still only through loans rather than equity.

● A venture capital fund role for the EIF rather than only loans should be reconsidered as part of the net issues of Eurobonds to complement the conversion of a share of national debt to the Union.

- ***The EIB***

● While the European Central Bank is the guardian of stability the EIB Group can safeguard growth.

After the 2008 financial crisis, the EIB was approached and asked whether it would hold and issue bonds for debt stabilisation. It declined which, at the time, was understandable.

First it issued its own bonds and could prefer to retain their distinct identity.

Second, issuing bonds for debt stabilisation would be monetary policy whereas the EIB's institutional expertise and culture was project finance.

Third, there was the presumption that servicing Eurobonds would need fiscal transfers, whereas the EIB serviced its own from revenues on project finance.

Fourth, that the fiscal transfers could need an increase in Commission Own Resources which would be improbable.

- Distinguishing Stabilisation from Growth

● Price stability and monetary policy is the prime responsibility of the ECB. As already indicated, the ECB could hold an untraded transfer of national debt to the Union. It need not be involved in net Eurobond issues to finance growth.

In 2009 there also was a general view among national credit institutions that while Union Bonds or Eurobonds should be reconsidered, the European Investment Fund was not the right institution.

But this was before the serial destabilisation of the bonds of the more debt exposed member states from the end of 2009.

It could be reconsidered in terms of a distinction between a conversion of a share of national debt to the EU as Union Bonds and net issues of Eurobonds for project finance.

Conversion would cut the Gordian knot which governments have been trying to unravel by buy-outs and fiscal transfers. It would be a proactive strategy rather than reaction to rating agencies

● The view of national credit institutions in 2009 that the EIF was not appropriate to manage a conversion of national debt into EU sovereign debt was as justified as the reluctance then of the EIB to do so.

With its reduced role of equity guarantees for SMEs the EIF was not equipped to manage a national bond conversion.

Nor was this part of its design in 1993 rather than for net issues of bonds to ensure that the recently agreed principles for an SGP could mean that the Union could fulfil both stability and growth.

- Complementary EIB and EIF Roles

● But the EIF's initial design role to issue bonds for project finance could well be achieved now, especially with a distinction between Union Bonds for debt stabilisation and Eurobonds for growth, for several reasons.

1. Unlike a once-off conversion of a share of national bonds to the Union, the net issue of Eurobonds would be incremental.

2. As part of the EIB Group - already twice the size of the World Bank - such issues of the bonds by the EIF would carry more conviction long-term with non-EU central banks and sovereign wealth funds than their issue by a temporary institution such as the EFSF.

3. The EIB has issued bonds successfully for fifty years without national guarantees, or fiscal transfers or national debt buy-outs. Its bonds are not counted against national debt by any of the major Eurozone member states. Nor need EIF net issues of Eurobonds be so.[12]

4. The EIB and the EIF already are partners within the EIB Group, yet different institutions. As such, EIF Eurobonds would be distinct both from EIB bonds and the Union Bonds held by the EFSF or the ECB.

5. EIF issues of Eurobonds could match EIB bonds in project financing. The servicing of the bonds could be from revenues gained on jointly funded EIB-EIF investment projects rather than from fiscal transfers. The EIB would retain control, with the projects dependent on its approval, and managed by it, thereby safeguarding its integrity in project management.

[12] This has near to no public profile. But on the proposal of Union Bonds to Delors, and the case that they need no more count on member states' debt than did US Treasury bonds, a senior director of the EIB rang me to say that, of course the President of the Commission could have any bonds he liked so long as they gained the support of the European Council, but that perhaps he was not aware that only two of the then 15 member states counted EIB borrowings against national debt – the UK and the NL.

6. Where it needed commitment from local partners, which is important to it, the EIB could gain this by cooperation in project management with national credit institutions such as the *Caisse des Depôts et Consignations,* the *Cassa Depositi e Prestiti* and the *Kreditanstalt für Wiederaufbau.*

- ***EIF bond management***

The EIF would need a new executive division to manage the open market issues of the bonds which was central to its initial design.

This would need a team with high professional competence, but it could draw it from the ECB and national debt agencies. Since its issuance of Eurobonds would be incremental, it also could build the team over time.

Ecofin is the governing body of the EIB Group. A decision by it that the EIF should issue Union Bonds would not need a Treaty revision any more than the establishment of the EIF in 1994 did.

6. Both Stability and Growth

One of the forceful points made by Jean-Claude Juncker and Giulio Tremonti in their Financial Times article of December, echoing the Bruegel proposal and the earlier proposal in 1993 of Union Bonds to Delors, was that net issues of Eurobonds would attract surpluses from the central banks of emerging economies and sovereign wealth funds.

These financial inflows to Eurobonds could make a reality of the commitment of member states and the European Parliament since 2008 to a European Economic Recovery programme.

Although initial flotation of the bonds would be incremental, the cumulative inflows from a share of the near $3 trillions of the surpluses of the central banks of the emerging economies and sovereign wealth funds would be substantial.

● The inflows could well come to match or exceed the Commission's own resources and do so without the fiscal transfers which Germany and some other member states oppose.

Incremental issues of Eurobonds also could be over-subscribed which would merit a low interest rate on them.[13]

- Legitimation and a European New Deal

With a strategy of austerity in response to rating agencies, the European Economic Recovery Programme has been displaced. Most electorates are not even aware of the Union's commitment to it yet are well aware that they are being asked to accept sacrifices for the salvage of banks and hedge funds.

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[13] The interest rate is of less concern for central banks of emerging economies and sovereign wealth funds than to diversify their holdings from dependence on the dollar. The bonds therefore would primarily have a store of value function rather than only revenue generation.

The title of A European Economic Recovery Programme or EERP also has no resonance for a wider public.

● What could resonate is that Europe, by drawing both on new financial instruments and existing institutions could achieve a parallel of the US 1930s New Deal.

- Criteria for the Recovery Programme

The criteria for a European Economic Recovery Programme do not need to be decided by Ecofin or need a proposal from the Commission.

The EIB has been given both cohesion and convergence remits by the European Council since the Amsterdam Special Action Programme and the Luxembourg 1997 and Lisbon 2000 European Councils to invest in:

> health, education, urban renewal, the urban environment, green technology, financial support for small and medium firms and new high-tech start ups as well as the trans-European transport and communications networks.

Since 1997 the EIB has successfully quadrupled its annual investment finance to the equivalent of two thirds of the Commission's Own Resources.

By quadrupling these again by or before 2020, aided by co-finance from investment in Eurobonds by the central banks and sovereign wealth funds of surplus economies it could make a reality of the EERP.

This is especially the case in terms of evidence that investment multipliers are as high as three and therefore double to treble fiscal multipliers.[14]

● Such bond financed and investment led growth within the EIB Group's convergence and cohesion remit could approach the macroeconomic level for fiscal transfers recommended by MacDougall without the need for them.

7. Global Implications

As Jürgen Stark recently has stressed, if some member states of the Eurozone default, and the single currency serially disintegrates, there would be catastrophic consequences not only for Europe but also for the US and the global trading system.

Yet debt stabilisation by cuts alone in Europe, without a recovery programme, would be profoundly damaging for the US and risk a double dip recession in both.

- Offsetting Default Risk

By contrast, net issues of Eurobonds would:

[14] Creel J., P. Monperrus-Veroni & F. Saraceno (2007). Has the Golden Rule of public finance made a difference in the United Kingdom? Observatoire Français des Conjonctures Économiques, *Working Papers* 2007-13.

1. Secure the euro as a reserve currency and contribute to the more plural global reserve system which is one of the main aims of the Brazil, Russia, India, China and South Africa.

2. Contribute to balanced global growth which is a central aim of the G20 by recycling global surpluses.

- Implications for the US and Europe

The implications for the US of the Euro as a global reserve currency are two sided:

1. The dollar would no longer have the advantage of being the sole reserve currency

2. Inversely, it would not be subject to the risks of not being able to sustain this.

The depreciation of the dollar due to its twin trade and fiscal deficits has been long standing since the Nixon devaluation. But the downgrading of US Treasury Bonds by Standard & Poor this April is the first since S&P started ratings seventy years ago.

The rating change from 'stable' to 'negative' means that there is a one third chance of a further downgrade in the next two years.

China is asking guarantees for its two thirds of a trillion holdings of US Treasuries.

● Unlike the US, Europe is broadly in balance in its trade with the rest of the world and has no fiscal deficit as a Union, nor would have one on the basis of Union Bonds without debt buy-outs and without national guarantees or fiscal transfers.

Net gains for the US would depend on net issues of Eurobonds to finance the European Economic Recovery Programme.

With such a recovery, and with Europe a third of the global economy, US exports would increase.

In its own interest, yet also to mutual advantage, China could agree to an orderly reduction of its holdings of dollars, or to maintain them while its net surplus flows are into euros.

8. An Agenda for the G20

The Eurozone crisis compromises the current French Presidency of the G20.

By contrast, with a decision to issue Eurobonds, the EU could offer the more plural global reserve currency system for which Brazil, Russia, India and China have called since Yekaterinburg and in which they were joined by South Africa last month.

The emerging economies also want a global institutional framework which reflects new realities rather than only the Bretton Woods institutions.

● An initiative which could address this is that the G20 should constitute the governing body of a World Development Organization.[15]

Consent for it could be enhanced by a decision-making mechanism which neither would be supranational, but nor would depend on unanimity and therefore be ineffective.

This could be the EU principle of enhanced cooperation thereby enabling joint actions on a range of policies without binding those governments either not disposed or not ready as yet to adopt them.

Dominique Strauss-Kahn also has proposed that the IMF should report to the G20. This could be extended.

● A G20 governed World Development Organization could encompass the Bretton Woods institutions. It also could include the main UN agencies on its working groups and committees, as well as regional development banks and sovereign wealth funds.

This proposal gained the interest, without dissension, in a meeting in New York in 2009 from the Permanent Representatives to the UN of China, Japan, India, South Africa, Brazil, Mexico, the UK, Germany and the Deputy Permanent Representative of the US.

The paper provoked no dissent. The German representative opened discussion by welcoming it and commenting that although there might be no immediate decision on it by the G20, it could prove to be a blueprint for future agreement.

There was no representative from France, yet such a proposal could gain more than interest during the current French presidency of the G20.

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[15] The proposed name is not crucial, although a World Development Organization would have more resonance among developing countries than an Economic Security Council.