Eric PICHET
Professor at BEM- Bordeaux School of Management
3rd January 2012
Published in L'AGEFI HEBDO n° 307 12-18 January 2012, page 6.

THE NECESSITY OF CREATING EURO-BONDS

THE EUROPEAN CENTRAL BANK MUST PRESERVE ITS CREDIBILITY WITH MEMBER STATES FINALLY ASSUMING THEIR RESPONSIBILITIES

The bond market's sudden shutdown in May 2010 following the problems experienced by Greece has forced the European Central Bank (ECB) to inaugurate as a last ditch measure an unprecedented policy of purchasing treasury bonds issued by states that find it difficult to fund their deficits. Trading solely in the secondary market and officially intended to lower public borrowing costs to levels considered sustainable (somewhere around 6%), this new and unconventional policy - presented as something limited and temporary - runs counter to the Lisbon Treaty, which prohibits any direct funding of member states by the ECB. Now in early 2012, with the cumulative volume of purchases so far having reached €211 billion or 3% of the total public debt denominated in this currency, many economists are pleading for the ECB to act much more audaciously and follow the example of the US Federal Reserve and the Bank of England, each of which hold around 17% of their respective state's public debt.

This comparison is invidious due to the fact that the budgetary imbalances characterising the United States, the world's leading economic power, stem first and foremost from a political deadlock mainly caused by Republican politicians' (ideologically-driven) refusal to revisit the big tax reductions from which wealthier taxpayers benefited during the Bush Administration. Moreover, the solvency of the United Kingdom has never been in doubt. Lastly, whereas Germany (the Eurozone's safest borrower) is comparable to the US and the UK, the other 16 countries have credit ratings that are as heterogeneous as the states comprising the United States of America, which unlike the federal government do have a history of defaulting on long-term debt, the most recent case being Arkansas in 1933 during the Great Depression.

Under these conditions, the ECB's bond purchases – even at relatively lower prices – exposes it to capital losses, especially given that the implied yield on 10-year Greek debt rose from 10% in May 2010 to 37% by late 2011. It has becoming increasingly likely that in case Greece does default, the ECB's losses would be much higher than €4.9 billion, the previous record that French bank Société Générale suffered due to the malfeasance of a rogue trader, Jérôme Kerveil – a magnitude that should be analysed in light of the fact that the ECB's own equity position, despite recent capital injections, is only €10 billion. The ECB's treasury bond repurchasing policy may have helped to delay a Greek default but it also exposes the naivety of the Bank's 23 Board members, all of whom generally benefit from a long and useful career in managing monetary policy yet lack any bond trading experience whatsoever.

At the same time, it remains quite obvious that central banks lack the ability to impose their will on the offshore money markets. Neither the ECB's direct bond purchases since May 2010 nor its direct loans to banks (limited only by the amount of collateral they can provide and charging a mere 1% for 3 years) kept Italian rates from hitting the 7% mark at the last government bond auction on 29 December 2011, with only €2 billion being lodged in bids. This is why the solution to the Eurozone's sovereign debt crisis is now solely in the hands of the continent's heads of state or government. In principle, they will have to implement the €500 billion European Stability Mechanism by March 2012 and activate it by the month of June.

This being the case, the politicians in question might draw inspiration from the example of Alexander Hamilton, America's first Secretary of the Treasury in 1790, who created US treasury bonds by replacing the states' existing debt with new securities. It is through the creation of euros-bonds, whose technical modalities can always be adjusted to fit circumstances, that it becomes possible to achieve a positive exit from the Eurozone debt crisis and relaunch the European integration process. By returning to its core mission; ensuring the internal stability of its currency; refusing an overall monetisation of public debt that is both counter to the spirit of the Lisbon Treaty and dangerous and illusory given signatories' variable credit quality; and forcing politicians to show fiscal discipline, the ECB can work to preserve its main asset – the credibility that it has patiently built up over the past 12 years through an otherwise relatively successful monetary policy.