Europe lurches into crisis again. Will eurobonds help stabilise euro zone economies? Or should debt-laden countries fix their fiscal policy first? And is Europe doomed to a decade of stagnation *a la* Japan?

The eurobonds' false promise

By Klaus F. Zimmermann
For The Straits Times

IT SEEMS like 1997 all over again. The big difference is that, this time, it's Europe, along with the United States, but definitely not Asia, that is teetering.

At a time when the entire financial world looks at developments in Europe with baited breath, it is pivotal that Europeans resist the temptation to put the cart before the horse yet again – and jump headlong into new economic realities largely based on either wishful or overly optimistic thinking.

That, after all, is precisely what Europeans did in the run-up to the euro, when all of official Europe put its collective hopes into the promising-sounding Growth and Stability Pact. At the time, the switch to a common European currency was sold, in part, with the argument to put an end to American dominance of foreign exchange markets in general – and to the dollar's status as the reserve currency in particular.

This time, the case for launching eurobonds is made along similarly tantalising lines in the global power game.

The creation of Eurobonds is intended to have European debt capital markets compete head on with the US Treasury market. By making European markets equally deep and liquid, the hope is for lower interest rates on that debt.

Such grand designs aside, in a debt-infested world, all that ultimately matters is fiscal stability. That is why, in my view, before we get too excited and see eurobonds as some kind of panacea, we would do well to acknowledge that Europe failed in the mission of obtaining fiscal stability once. We cannot afford to do so again.

That certainly is the unequivocal view of the financial markets. There are two other, equally powerful reasons speaking in favour for consolidating our finances: First, fiscal stability is needed in order to have any hope of bringing about sustainable economic growth; and second, to stop burdening future generations with ever more debt.

Eurobonds can be a useful instrument over the longer term, as the end point of a process of fiscal consolidation, once the hard labour required in that regard has been done. In other words, their introduction should be a reward for past performance, not an illusory incentive for better fiscal behaviour in the future. The latter approach is precisely what Europeans embraced at the launch of the euro, with known results (i.e. near failure).

Europe's credit hinges on the fiscal performance of countries such as Germany, the Netherlands, Denmark, Finland and Poland. Making these countries, in effect, fiscally liable for the debt of other nations, as the premature introduction of eurobonds would do, is a recipe for the euro's demise.

Moreover, notions such as a "fiscal union" are not to be taken lightly. Even those who argue that it is in the logic of the European integration project to move in that direction – and who say that the process of the formation of the United States of America historically shows the way forward for Europe – forget one crucial thing. Most US states have a balanced budget requirement to meet each and every year. In addition, in the US there is no federal bailout clause for the debts incurred by individual states.

What is needed then is not some heady optimism, but sober thinking and a disciplined sequencing of events and conditions before we can introduce eurobonds. Key among them is the so-called "debt brake", a constitutional requirement in Germany as of 2016 that will severely limit further increases in public debt absent narrowly defined emergency situations.

In a positive sign of rising budgetary seriousness throughout Europe, this self-disciplining instrument is now also being introduced, or contemplated, in Spain and Italy. In many ways, this tool is akin to the balanced budget requirements at the US state level.

This also points the way to what is needed in case eurobonds are being introduced. Profound changes in the institutional set-up will be required. In addition to the introduction of a European finance minister, there is, most notably, a requirement for a eurozone body with unassailable veto rights over national budgets (in cases of continued fiscal malfeasance). With all that entails rethinking the traditional prerogatives of national Parliaments in terms of their historic power of the purse.

But for Europe, the lesson of the past 15 years is clear. National governments cannot, on the one hand, merrily issue debt – and then, on the other hand, expect other European nations to stand in for that debt in the end. National sovereignty cuts two ways. It is there when you manage your affairs competently and with discipline – and it must be restricted when you are incapable, or unwilling, to raise sufficient revenues domestically. Obliging others with no restraint is a recipe for disaster.

Finally, it is important to realise that, for all those constantly chanting the "spend, baby, spend" refrain, the stability-oriented German position is, surprisingly perhaps, very Keynesian in nature. The eminent British economist was far from the one-armed economic policy operative he is made out to be today.

Yes, John Maynard Keynes explicitly advocated for high government spending in times of economic (near-)collapse, but only under the simultaneous and unbending condition that, in sunnier times, savings would be piled up to pay back past debts – and, ideally, to build up a rainy day fund.

In that sense, the German constitutional provision requiring strict limits on further debt increases is, in effect, giving the tough side of Keynes's policy prescriptions the rank of constitutional law. In a debt-addicted world, that is an important policy innovation.

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ST ILLUSTRATION: ADAM LEE

The crisi of fiscal imagina

By Dani Rodrik

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