Rabobank

Special: Make the euro stronger

March 2009

Develop the euro into a fully-fledged alternative to the U.S. dollar:

- by further strengthening the European Union institutionally
- without further eroding the autonomy of the member states
- by further tightening of budgetary discipline within the eurozone
- without undermining the ‘no bailout’ clause

Economic Research Department

Contents

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Completion date: March 25, 2009

Foreword

The euro is under pressure in many respects. Since early 2008 its exchange rate versus the dollar has on balance declined sharply in the financial markets. Within Europe, interest rate differentials are rising steeply. The European Union is facing the challenge of how the Union and its member states should deal with the problems arising from the financial crisis.
Various ideas have been put forward in the past few months to tackle the problems. One of them is to issue a 'eurobond' to fund support for member states that need help. Another is to fund government deficits of the eurozone member states centrally. These proposals have met with major political resistance.

But Europe cannot avoid taking effective measures if it is to come out of the current crisis with as little damage as possible and, better still, come out of it stronger. This study therefore presents a proposal aimed at helping to advance European integration. Specifically, it advocates central funding of government deficits in the eurozone on a basis that minimises interference with the budgetary autonomy of countries and avoids undermining the European 'no bailout' clause. At the same time a mechanism is put in place to tighten the budgetary discipline of participating countries.

The study briefly discusses the background of the euro and the advantages and drawbacks of joining the single currency in Part I. This is followed by a discussion of why it is important to strengthen the euro institutionally.

The actual proposal is set out in Part II of this study.

Utrecht, March 2009,

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* I wish to thank Tim Legierse and Allard Bruinshoofd for their useful comments on earlier versions of this Special.

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Make the euro stronger

Summary and conclusions

- The euro is under pressure. Following a strong surge, the European currency has lost terrain against the dollar again. Interest rate differentials between the various government loans are widening again within the eurozone, giving rise to speculation on the possible collapse of the euro. It is therefore time to strengthen the European currency institutionally.

  The euro is still an incomplete currency. In monetary terms the currency is complete, with a common monetary policy and one central bank. But the political integration of Europe is still incomplete.
- The euro continues to be disadvantaged against the dollar because the financial markets within the eurozone continue to be fragmented. The liquidity of the largest segment of the financial markets within the EMU (the German Bund market) is small compared to that for U.S. Treasuries.
- While widening interest rate differentials stem partly from differences in credit ratings between the various issuers of government loans, market liquidity is a factor as well. Compared to the market for German Bunds the liquidity of the other European bond markets is small.
- In theory, that difference can be resolved by creating a large federal budget within the European Union, analogous to the situation in the U.S. But as yet there is nowhere near enough political support for this step.
- Central funding of government deficits can eliminate this problem. If the member states of the EMU were to adopt this approach, a bond market would quickly emerge that could compete with that for Treasuries in terms of quality and liquidity.
- Central funding of public debt via a new fund to be created is easy to put in place. Countries would hardly have to surrender more autonomy than they already have, while the advantages for the financial stability of the eurozone are evident.
- It is a step that does not require far-reaching treaty amendments. If the countries with the highest credit ratings quickly form a core group to fund the government debt via a common agency in future, the process will swiftly acquire significant momentum and the euro will soon be ‘complete’.

Wim Boonstra
March 2009

Introduction

The euro was introduced in eleven member states of the European Union for cashless transactions in January 1999. Subsequently the eurozone was extended by four countries to fifteen member states. The euro has brought a large degree of financial stability for the participating countries, but is now under pressure as a consequence of the global financial crisis. This is reflected in widening long-term interest rate differentials between the participating countries.
This study argues that the euro is still an incomplete currency. This is the inescapable consequence of the fact that the monetary integration of Europe has leapt ahead of its political integration. Although the euro has already proved to be a strong currency, a further step in the integration process can further strengthen the currency institutionally. This is necessary because, as long as the financial markets are able to assail the euro from within, and as long as speculation can arise that some countries might want or have to abandon the euro, the currency remains potentially vulnerable.

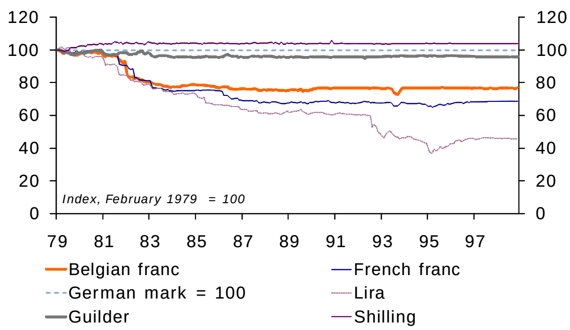
The required step is a move to central funding of all government deficits within the eurozone. That makes speculation from within impossible, eliminating the danger that widening interest rate differentials within the eurozone would force some countries to abandon the euro. Additionally, central funding of budget deficits would lead to a very large and liquid market in homogeneous eurobonds, which would further strengthen the position of the euro versus the dollar.
This step can be taken without affecting the present budgetary autonomy of the member states and without undermining the ‘no bailout’ clause of the Maastricht Treaty (MT). The instrument of central funding of government deficits could even be used to tighten budgetary discipline within the eurozone.
Central funding can be introduced quickly and easily with only a moderate expansion of the European institutional framework. In fact, this idea can be turned into a reality within a very short time by a group of core countries.

Part I: Background

I-1) The historical background

The advent of the euro can be viewed, in some respects, as the completion of the internal market. The internal market was introduced in 1993 and embodies the free movement of goods, services and people within the European Union.

Chart 1: Movement of main European currencies versus DM



Source: EcoWin

The importance of the euro for this project is evident on realising how disruptive currency fluctuations within such an internal market can be. In the past the exchange rates of the participating countries, which since February 1979 were virtually all interconnected through the exchange rate mechanism of the European Monetary System (EMS), were regularly adjusted. That was the consequence of divergent monetary and budgetary policies of the participating countries. The countries whose competitive position deteriorated excessively as a result of elevated inflation and wage increases regularly restored their competitive position, at least temporarily, by devaluing their currency in respect of the stronger countries (Chart 1).

This led to disruptions to the effectiveness of the internal market. Not just because the competitive playing field was often suddenly and steeply tilted, but also because there were often major and strongly fluctuating interest rate differentials within Europe. If parties in the financial markets doubted certain policy-makers, they began speculating against the supposed weak currencies, and in a world in which capital moves freely it was increasingly easy to forcibly bring about exchange rate adjustments.

The danger that major exchange rate instability would be responded to by measures impeding trade therefore always remained present. The only final answer to this is of course the introduction of a single currency. That currency was the euro.

I-2) Advantages of the euro

The advantages of the single currency for the participating countries are numerous. The currency contributes to greater economic efficiency, as it leads to a large and transparent market within which prices can be readily compared with each other and which provides an optimum basis for producers and consumers to make their decisions. This stimulates cross-border trade, at least within the single currency area. Moreover, interest rate differentials within the eurozone can be reduced, as no account needs to be taken any longer of exchange rate reshuffling within this area. The countries participating in the euro are no longer able to bolster their competitive position at the expense of their neighbouring countries by means of competitive devaluation. And a common monetary policy targeted at combating inflation is the best guarantee of structural low inflation and interest rates.

I-3) Drawbacks of the euro

Participation in a single currency also involves some drawbacks. It requires a country to surrender two instruments of economic policy, namely monetary policy and exchange rate policy. The first is centralised and is implemented by the European Central Bank (ECB) for the entire currency area. The ECB cannot differentiate its policy on the basis of the situation in the individual member states, just as little as the U.S. Federal Reserve is able to differentiate between states in its monetary policy within the U.S. Secondly, if the economic situation in a country starts getting out of step with that in the other member states, it is no longer able to eliminate the difference by adjusting the exchange rate.

Yet in practice this loss of national autonomy is less important than it may seem. Time after time in the past, countries that devalued their currency too often were punished in the form of structural higher inflation and interest rates, causing their economic performance generally to lag behind that of the countries with a stronger currency. Also, countries with relatively weak currencies were often characterised by relatively poor public finances, which led to policy-makers there to prefer slightly higher inflation levels.

By locking the backdoor of devaluation and placing monetary policy at several removes from day-to-day politics, countries are forced, as it were, to pursue a diligent policy. At least so the theory goes. As will become clear later on, various countries did not sufficiently understand that participation in the euro necessitated pursuing diligent macro-economic policies. They failed to put their public finances in order and to support the competitive position of the business community with stability policies. This failure is one of the reasons for the present tensions within the eurozone. Paradoxically, countries had to pursue healthy policies to take part in the euro but, once in, were able with impunity to maintain major domestic imbalances for a long time.

Surrendering national autonomy in respect of monetary and exchange rate policy constitutes, all in all, only a limited sacrifice for most countries, and one they had in practice already made. Most countries had, by linking their own currency to the Deutschmark, in practice already fully subcontracted their monetary policy to the Deutsche Bundesbank. But if it is to be maintained such a policy does require competitive strength to be maintained by means of systematic adjustments, as devaluation is no longer an option.

Part I: Background

I-4) Convergence criteria

To join the single currency, countries first had to satisfy the well-known joining criteria. These are laid down in the Maastricht Treaty (MT), which was negotiated in December 1991. In outline these criteria comprise the following:[1]

- Government deficit must be less than 3% of gross domestic product (GDP)
- Government debt must not exceed 60% of GDP, or be sufficiently diminishing
- For one year before joining, inflation must not be more than 1½% higher than in the countries with the lowest inflation
- At least two years' participation in the exchange rate mechanism of the EMS within the normal fluctuation margins without devaluation of own currency
- For one year before joining, long-term interest rates must not be more than 1½% higher than in the countries with the lowest inflation.

There are a number of additional conditions. For instance, the central bank must be placed outside the scope of influence of day-to-day politics (MT, article 107). There is also a ban on monetary financing (MT, article 104 (1)). In addition, and this is of major importance in the context of this paper, a 'no bailout' clause applies. This literally states that countries, if it comes to it, have to hold up their own financial pants. Because the Treaty says in so many words that both the Community and the member states shall *… not be liable for or assume the commitments of central governments, regional, local or other public authorities or public undertakings of another member state …* (MT, article 104B).

I-5) The Stability Pact

Initially it was thought that the EMU would start with a relatively small core group of countries, comprising the traditional countries with strong currencies. As the 1990s progressed it emerged that participation would be problematical for a number of the intended core group countries, particularly when strictly applying the debt criterion. The government debt of Belgium, traditionally much too high, was indeed diminishing, but the speed at which it did so could hardly be called sufficient. German government debt had by contrast risen continually in the wake of German unification. While the German debt ratio was much lower than the Belgian or Italian level, it was above the 60% limit and rising instead of decreasing.

In the countries with a weak currency, such as Italy, a process of sharp deficit reduction had gathered momentum. This reduction of the deficit was not only the result of policies targeting budgetary stability but also a consequence of the pronounced fall in interest rates that was starting to take hold in Europe. Markets began to believe in a broad EMU.

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[1] Maastricht Treaty, particularly Articles 104C and 109J plus associated protocol.

This translated into a certain degree of convergence of interest rates, which immediately benefited, for instance, the highly interest-sensitive Italian budget deficit. This movement in turn strengthened the positive market sentiment relating to Italy, creating a self-strengthening virtual spiral.

When it became clear that the EMU was very likely to be broad based, the policy-makers realised that while joining criteria had been defined for participation in the EMU, there were no rules and conditions for countries once they had joined. Fearing that countries with a traditionally weak budgetary discipline would revert to their bad habits after joining the EMU, the Netherlands and Germany in particular pressed for additional agreements. These were negotiated in 1997, at the Amsterdam summit, and laid down in the Stability and Growth Pact (SGP). In outline, this Pact endeavoured to ensure that countries would continue to adhere to the budgetary discipline after joining.

Much has already been written about this Pact. It is poorly drafted in terms of both contents and institutions, the agreed sanctions for countries failing to comply with it are weak and difficult to enforce, and it was clear from the outset that the Pact would de facto become inoperative as soon as one of the large member states were to prove unable to comply with it.[2] This was the case in 2003, which led to a revision of the Pact. It has not become stronger but more flexible.[3]

I-6) Why additional agreements?

Many opponents of the Stability Pact felt additional agreements were unnecessary. They counted on the disciplinary effect of financial markets to curb the public expenditure of the various member states. If countries were to let their budgetary policy slip they would be punished by the markets with a higher risk premium compared to the benchmark, Germany. With the ‘no bailout’ clause referred to earlier as an incentive, the markets would surely draw the distinction between good and not-so-good debtors.

This proved to be unjustified. Once the EMU was in place, a very rapid interest rate convergence occurred, with the difference in yield on government loans between the interest that the most solid government had to pay on the one hand and the rate on loans of the country with the weakest public finances on the other narrowing to a few dozen basis points at most and often less. Apparently the markets assumed the debtor risk of governments to be negligible in practice even in the case of government debt of more than 100% GDP.

Possibly, it was implicitly assumed that if it came to it the ‘no-bailout’ clause would prove ineffective.

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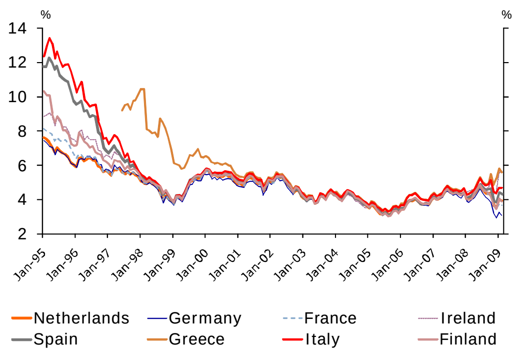
[2] See Boonstra (1999), Eijffinger & De Haan (2000).
[3] See Boonstra (2005), Buiter (2003).

Part I: Background

In that regard the proponents of additional budget agreements, with their lack of faith in the disciplinary effect of the financial markets, turned out to be right. Unfortunately the form of agreements made, i.e. the SGP, was not easy to apply in practice, particularly as a result of the poor drafting of this Pact.

Chart 2: Yield on government debt in the EMU

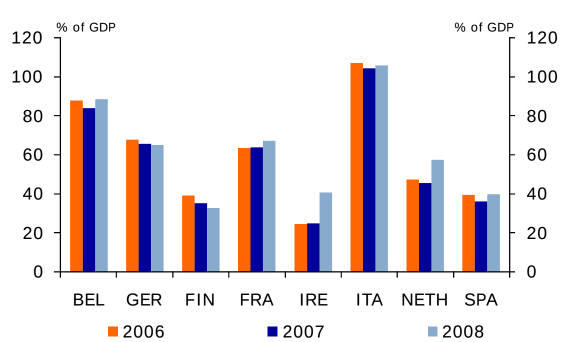


Source: EcoWin

I-7) Failing market effectiveness and the credit crisis

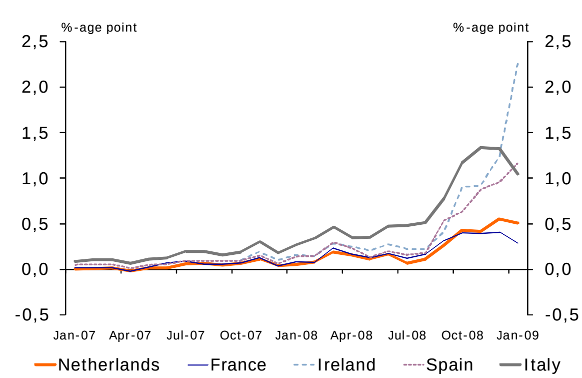
On balance, therefore, little disciplinary effects were produced by the financial markets within the eurozone. It is worth noting that this phenomenon occurred in the period preceding the credit crisis, a period in which it may be said that financial markets wholly inadequately reflected risks in pricing. The response once the crisis broke out was all the more pronounced. Risk has a price again, and one that is much higher than debtors were used to in the past few years or even decades. After October 2008, when the governments in the various European member states had to intervene on a large scale to save their own financial systems, public finances generally deteriorated sharply worldwide. The government debt in most countries in the eurozone rose steeply in the last quarter of 2008 due to the bailout operations. The Central and Eastern European member states that had joined in 2004 were confronted with financial problems; outside Europe, Iceland slid deeply into financial problems. For the coming years public finances are set to sharply deteriorate further as a result of the recession.

Chart 3: Government debt of EMU countries, 2007 and 2008



Source: European Commission

Chart 4: Five-year interest differential compared to Germany



Source: EcoWin

Part I: Background

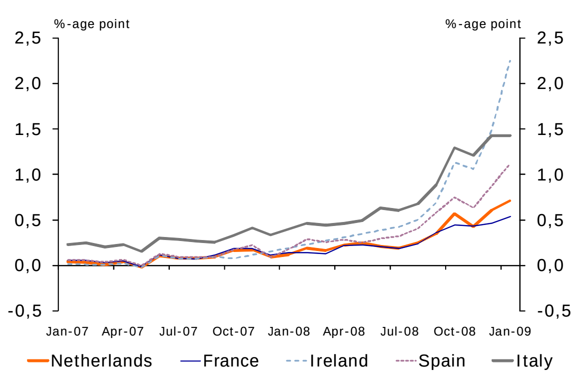
It suddenly became clear that governments of industrial countries could very well also run into financial problems. And the markets also started to differentiate acutely within the EMU between the various issuers of government debt.

I-8) Euro versus dollar

This development took place against the background of a recovery of the exchange rate of the U.S. dollar versus the euro. Although the U.S. dollar has on balance trended down versus the euro since 2002, this development does not proceed in a straight line. The underlying weakness of the dollar resides in the large savings shortage of the U.S. economy and the resulting net debt position. These parameters form the reflection at macro level of the cause of the credit crisis: Americans basically tend to consume more than they produce. The outlook for U.S. public finances for the coming years is dramatic. President Obama has now submitted a budget with an expected deficit of more than 12% of GDP for 2009 and only a very gradual levelling off after that. The savings balance of the private sector has improved rapidly as a consequence of the current plunge in demand, but this is for from sufficient to fund this kind of government deficit. Therefore, part of the deficit will be financed by printing money. There is no prospect of any equilibrium in the U.S. current account of the balance of payments in the next few years.

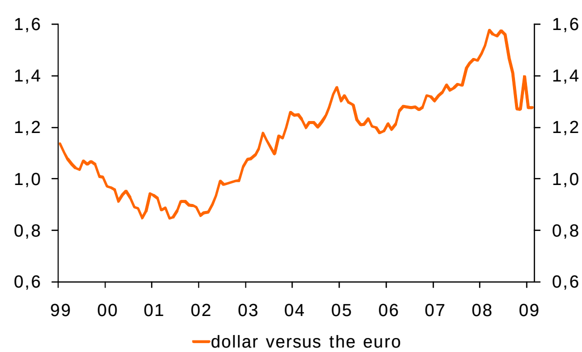
Nonetheless the dollar continues to act as a safe haven. Although the financial position of the eurozone is in general not as bad as that of the U.S., the dollar gains in strength in times of great uncertainty. In the first half of 2008 the U.S. currency was plummeting in value at record speed against the euro, but a remarkable recovery has occurred since then.

Chart 5: Ten-year interest differential compared to Germany



Source: EcoWin

Chart 6: Dollar versus the euro

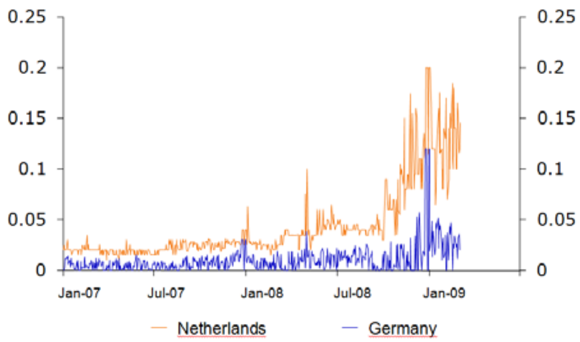


Source: EcoWin

Part I: Background

Several explanations underlie the fairly poor performance of the euro in the past few quarters. In part the movement of the exchange rate can be traced to the timing of the bad news. Early in 2008 the feeling predominated that the U.S. economy in particular would enter a recession, but that the European economies would remain relatively unscathed. The arrival of a new and inspiring U.S. President has no doubt also benefited the dollar.

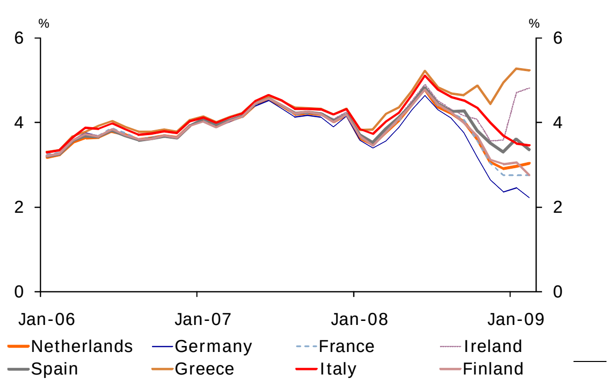
Chart 7: Liquidity: Bid ask spreads on various markets for government loans, Netherlands and Germany



Source: Bloomberg

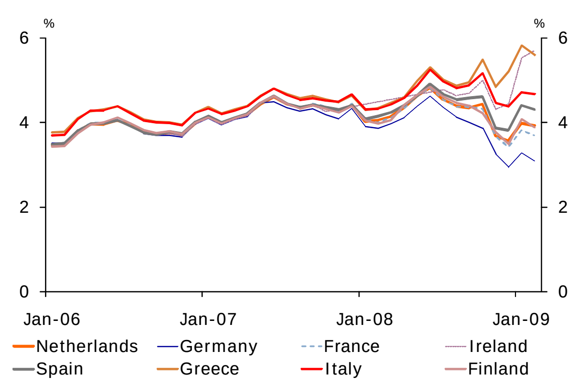
In addition, two important other explanations can be found. One is the size and liquidity of the U.S. market for treasuries. This is much larger than the most highly liquid market within the eurozone, i.e. the market for German Bunds. In times of uncertainty investors want to bring their funds into safety in a market in which not just gilt-edged paper is traded, but where the liquidity risk is also minimal. This inclination explains the relatively large demand for treasuries, which provides additional support for the dollar. In part it also explains why the interest rate differentials between various government bonds are widening once more within the eurozone. In this area, the relatively significant liquidity of the market for German Bunds also plays a part. A not insubstantial part of the widening interest rate differentials within the EMU is caused not so much by rising interest rates in the countries deemed relatively weak, but – by contrast – by the decline of the effective yield on German government bonds (Charts 8 and 9).[4]

Chart 8: Long-term interest rate (five years) within eurozone, 2006 – present



Source: EcoWin

Chart 9: Long-term interest rate (ten years) within eurozone, 2006 - present



Source: EcoWin

[4] Note that CDS spreads have recently also risen for Germany. But this market is relatively illiquid and young, and the question therefore is whether this market accurately assesses the various risks (Het Financieele Dagblad, 27 February 2009).

The second reason for the relatively weak euro can be found within the eurozone itself. Just as in 2005, when the euro lost value partly in response to the unsuccessful first referendum on the revision of the European Treaty, the currency is once again a victim of speculation on the inherent weakness of the European Union. In addition, European member states from outside the eurozone are in danger of running into financial problems as a consequence of the crisis, and are turning to the EU and the ECB for help.
The financial pressure on the eurozone is increasing substantially overall, from both within and outside. Even today some observers think it possible that the euro will in the end prove to be untenable owing to all the pressure. This could happen if, for instance, member states decided to revert to a national currency.

I-9) Can a country leave the eurozone again?

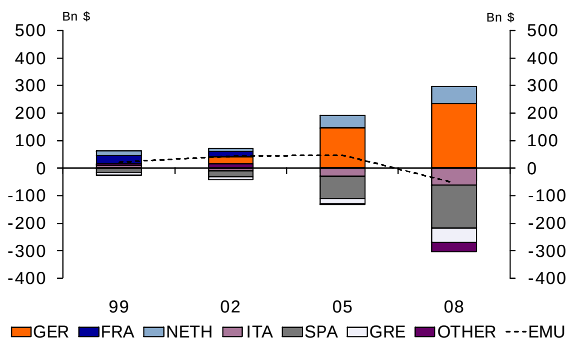
The MT and the later amendments to this treaty do contain a script for introducing the euro, but do not provide for an exit scenario. Once a country has been admitted to the eurozone there is no way back. Obviously, a country can always decide to abandon the euro unilaterally and to reintroduce a currency of its own, but this would be a flagrant breach of the European treaties. Whether a country can in that case revert to a national currency of its own without simultaneously surrendering all the other advantages of European integration, such as free trade within the internal market, is very much open to question.

The exit of a member state from the EMU would represent a major shock for all euro countries. Firstly, markets would assume that others are likely to follow and would start to speculate against other countries considered to be weak within the eurozone. This can generate very substantial pressure. Secondly, it can be expected that if a country voluntarily or forced by the markets proceeded to reintroduce the national currency, that currency would immediately plummet in value. This is very unfavourable for the exiting country, which would be confronted with high inflation and sharply rising foreign (government) debt in real terms. The remaining countries in the eurozone would rapidly see their competitive position deteriorating and the internal market contracting. If the country concerned is Greece or Malta, this problem may still be limited, but if Italy or Spain were to leave the immediate economic disruption would be much greater.
But it is illusory to assume that the strong euro countries would benefit if one of the weaker member states were to abandon the euro.

How realistic is the danger that a country would want to leave? Assuming rational behaviour and a sound understanding of all advantages and drawbacks of participation in the eurozone this danger can be said to be small. But that does not mean it could never happen. Firstly, the euro is accepted but not popular. Especially in times of crisis, in which the danger of populism is always present, it cannot be excluded that politicians may blame the euro for things that go wrong. This could get out of hand.

Secondly, it has to be said that a number of countries were willing to participate in the euro for the political prestige in particular. They subsequently cashed in on the windfall of lower interest charges for the public budget, but then failed to bring the competitive strength of their own economy up to par. This is reflected in major deficits in the current account of the balance of payments (national savings shortage), which need to be funded by other countries. The comparatively well-balanced external position of the euro-zone as a whole masks substantial imbalances between participating countries. These can be traced to large internal trade deficits and surpluses.

Chart 10: Current account balances within the EMU



Source: OECD

This would not necessarily be a major issue in economic terms within a single currency area, as can be illustrated by reference to an example that is, it should be noted, wholly fictional. Suppose that within the Netherlands (the monetary union of the former Dutch guilder) the province of Flevoland has a large trade deficit versus the rest of the country, which is funded by the inflow of capital from Utrecht, for instance. Investors in Utrecht purchase shares and debt instruments from Flevoland companies. This would not lead to major problems. The corporate 'sell-out' of Flevoland to Utrecht would remain unnoticed. Insofar as the weak competitive position of Flevoland businesses leads to a loss of jobs in Flevoland, more people from Flevoland will try to make a living in Utrecht or other provinces. And the taxpayer in Utrecht and the rest of the country will be paying towards unemployment benefits in Flevoland.

This example also clearly demonstrates why the euro is an incomplete currency. Because while the eurozone is a single currency area, the other mechanisms outlined in the above example are not yet in place. The mobility of labour within the eurozone is far from perfect. Most people feel much more French, Greek, German, Italian or Dutch than European, and it is therefore a sensitive issue for Italy indeed if shares on the Italian exchange increasingly fall into German or Dutch hands.[5] And there is no EMU-wide redistribution of wealth via a common budget or common social security system. In many respects, European integration has not yet progressed beyond the half-way mark.

[5] Even in the Netherlands the debate on the 'sell-out to other countries' rears its head again sometimes, although the country is itself a major international investor.

Part I: Background

History demonstrates that many attempts to realise monetary unions between countries fail. A good example is what is known as the Latin Monetary Union, which commenced in 1865. History also shows that many such attempts have in fact succeeded. The United States are one example of such success. And national currencies such as the former guilder and the mark were preceded by periods with fragmented currency areas. Almost every national currency of the present is itself a result of processes of monetary integration of the past.[6]
But as far as is known, it has not proved possible in the past to create a viable monetary union with a shared currency and equally shared monetary policy without political unification.

That does not mean it is not possible. The success of the brothers Wright in December 1903 to get a plane airborne for the first time was also preceded by centuries of failed attempts to fly. Virtually every successful innovation has followed a trail of failures. There is no objective reason why the euro could not be another successful innovation.

[6] See Kindleberger (1993) for a very detailed overview of the monetary history of Western Europe.

Part II: The EMU fund

II-1) How to strengthen the euro?

As stated earlier, the euro is still an incomplete currency. To some extent this is a problem that will resolve itself in due course. Future generations will increasingly see the euro as a given and no longer nostalgically pine for the pre-euro age. Naturally, the euro must be given enough time if that is to come about. In the meantime, everything must be done to further strengthen the euro. A major responsibility in this respect rests squarely on national policy-makers, who should use structural policy to achieve a strong economy and robust public finances. Unfortunately, the experience of the past ten years is not very promising in this regard, as we have seen.

A major intensification of European cooperation and strengthening of the euro would be achieved if a common public budget were indeed to be introduced in Europe, based on which those parts of the continent that are doing well start contributing to the funding of the problems in the weaker areas. This would be a major step, but one which at present is still completely unrealistic. The political basis for such a step has always been slender and is currently contracting further rather than growing. Subsequent generations may one day wish to take this step, but an EMU-wide common budget is at present still a long way beyond the horizon.

Another way of strengthening the euro can be sought in central funding of government deficits within the eurozone. But this must be done in a way that tightens rather than threatens countries' budgetary discipline, and encroaches as little as possible on their budgetary autonomy.

This idea is worked out in detail in the remainder of this paper.

II-2) Central funding in the EMU

It would be a good thing if the euro could be strengthened in a way that both gives the member states of the EMU greater freedom in their budgetary policy, that enhances the disciplinary effect of the financial markets and helps to parry the fragmentation of the European bond market.

The cardinal element of the proposal presented in what follows is that all member states of the EMU in principle remain as free or constrained in their budgetary policy as is the case at present, except for the way in which the deficit is funded. This means, specifically, that they must impose a number of restrictions on themselves with regard to the funding of the deficit. The arrangements to be agreed are as follows:

1. Government deficits must not be financed on a monetary basis. This rule was already laid down and hence endorsed by all member states in the Maastricht Treaty.
2. Government deficits must from now on only be funded by the intervention of a new central funding institution to be created. This institution is referred to here as the EMU fund. This means that government debtors may no longer directly turn to the capital market or private lenders. It is advisable to let this central institution handle the activities of other European bodies as well

in future, such as the European Investment Bank, the ECSC and the European Bank for Reconstruction and Development.

3. This EMU fund directly finances itself by means of the issue of bonds and other debt instruments in the financial markets. The funds raised in this way are passed on to the governments of the EMU member states, for which the EMU fund charges the various governments a fee comprising its own funding costs plus a margin.
4. This margin, which can be either positive or negative, is determined by reference to the relative performance of the member state concerned in the field of public finances. Criteria can include the government deficit, outstanding government debt and the share of the public sector in the economy, with the performance of the individual countries always being measured against the average within the EMU.
5. The sum of these margins equals zero; the EMU fund is deemed to break even. In addition the EMU fund is expected not to enter into an open interest position. It only acts as a channel for passing on funds.
6. Countries that break the rules must immediately be punished severely. This can include losing funds from the European budget such as the regional funds and losing political influence or the voting right in the bodies of the European Central Bank.

II-3) Advantages of the EMU fund

Establishing the EMU fund as outlined offers a number of evident advantages, for both the budget policy of the various member states of the EMU and for the effectiveness of the European financial markets. With regard to the first, it can be pointed out, for a start, that the fund can be introduced without significantly affecting the far-reaching autonomy in budgetary policy that the member states currently still possess.

Conceivably, this autonomy could even be increased by expanding the SGP. This could be desirable in view of the greater flexibility that can be required in the EMU of the national budget policy. As the EMU continues to increase in size in the future, at first with the current EU countries that are not yet participating, but over time perhaps also with new entrants, the importance of this factor will only grow. This is not necessary, however. The EMU fund could also be used in addition to the existing SGP. [7]

[7] See Boonstra (2005).

Part II: The EMU fund

An additional advantage is the fact that the costs of ‘bad policy’ (such as a government deficit rising too rapidly) are directly though gradually borne, in the form of a rising mark-up, by ‘the culprit’ itself, while the other countries are on the contrary confronted with a lower or even negative interest margin. The marginal costs of bad policy are therefore higher for the individual member states than they have been in the past few years; conversely, the advantages of ‘good policy’ are correspondingly great. Passing the buck is therefore not – or almost not – possible. At the same time, intelligent selection of parameters permits relatively differentiated approaches to be adopted for countries. This means, for instance, that a country with a government deficit that is rising too quickly but with relatively low government debt is punished less severely than a country that scores poorly on both parameters.

An enormous advantage is that mark-ups and mark-downs are determined on the basis of objective measures and are not sensitive to acute reversals of sentiment. The new fund on the one hand restores the disciplinary effect that the financial markets should - but in practice often do not - exert in normal times, while at the same time protecting countries against acute reversals in sentiment. The more systematic discipline of the EMU fund in this model replaces the more capricious discipline from the financial markets.
The EMU fund will soon by far be the most important issuer of eurobonds. Given the total volume of the funds to be raised annually by the EMU fund in the market this fund will be able to establish itself as benchmark across the entire maturity spectrum of the yield curve. Its depth and size will make the market for loans of the EMU fund highly attractive to large investors; in addition it will be much better able than the German Bund to support a large derivatives market, without the risk of illiquidity in times of strain.[8] The emission volume of the new fund will soon exceed that of the U.S. market for Treasuries and substantially strengthen the ‘competitive position’ of the euro versus the dollar. The dollar will no longer have a monopoly as the ultimate safe haven.

II-4) Drawbacks of the EMU fund

This approach also involves a number of drawbacks. The most important of these come down to the problems in objectively setting the mark-ups and mark-downs used by the EMU fund in its lending to the various national governments. A second drawback relates to the fact that this model at first sight, in a certain sense, appears to undermine the ‘no bailout’ clause of the Maastricht Treaty.

[8] This gives rise to a question relating to existing government debt. Should this also be taken on by the EMU fund or not? This is one of the points that need to be worked out in greater detail, but an initial thought is to let the existing government loans continue and replace them with EMU fund loans after repayment (possibly ahead of schedule). This will lead to a transition phase of a few years, in which on the one hand the EMU fund becomes the benchmark, while on the other the secondary market (the primary market no longer exists) for existing government loans will dry up.

Computing the margin

For the first issue, a simple straightforward formula such as the following will suffice:

$$R(i) = \alpha\ [O(i) - O(m)] + \beta\ [S(i) - S(m)]$$

Where:

- R(i) = the margin payable by country i over the funding costs of the EMU fund
- O(i) = the government deficit of country i, as a % of GDP
- S (i) = the government debt of country i, as a % of GDP
- The variables O(m) and S(m) represent the EMU average for government deficit and government debt
- The parameters α and β are coefficients, used to determine the weight of the relative performance on government deficit and government debt respectively in setting the mark-up.

Part II: The EMU fund

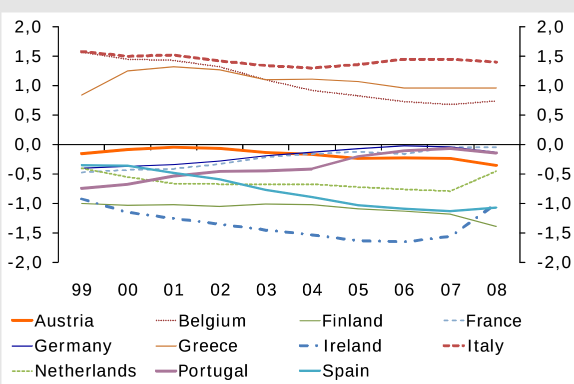
Box: Two sample calculations

Two scenarios are worked out in this box. As stated earlier, setting the parameters α and β is a comparatively arbitrary process. An important question in doing so is of course how sensitive one wants the spread to be calculated to be to developments in government debt or the budget deficit. Government debt is important as the best indicator of the financial status of the government of a country. The deficit performance obviously best reflects the current state of affairs. In addition, this parameter can be adjusted fairly quickly, offering rapid rewards for good policy. Driving down public debt that has risen too far is by its very nature a slower process that will take several years. Accordingly, setting the parameters involves considering both the relative ratio between the two parameters, and their level: how far does one want the maximum spread to rise.

The charts below illustrate two scenarios by way of examples. In the first scenario the α is set at 0.0075 and the β at 0.0375. In the second scenario both parameters are set at 0.05.

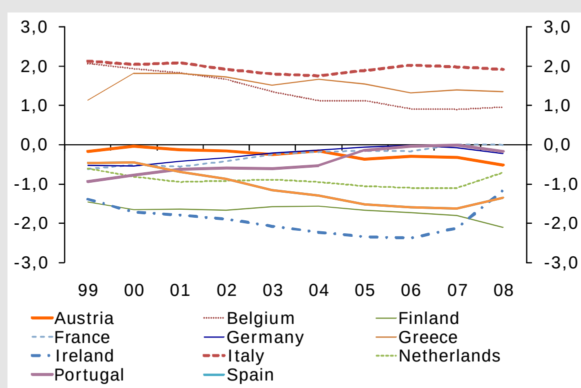
Setting the parameters α and β will therefore also to a large extent be a political process. This process has to be non-recurrent and take place at the inception of the fund. After initial setting, computing the spread is a straightforward process of calculation. Again, this is an improvement over the current situation in which every breach of the European budget agreements leads to new negotiations.

Chart 1 (Box): Scenario 1



Source: Own calculations

Chart 2 (Box): Scenario 2



Source: Own calculations

Obviously, variables can be added to this comparison, such as the level of public investment or the share of the public sector in the economy. The attraction of the variables selected here is, however, that the comparison as formulated does justice to both current developments (relative performance on government deficit) and the legacy of the past (existing government debt). It could be considered to include future developments in the deficit in the spread as well, for instance on the basis of the forecasts of the European Commission for government deficit and government debt.

The coefficients α and β will have to be set in advance, subject to the enabling condition that the sum of positive and negative margins must approximately equal zero. Setting these coefficients inevitably involves an element of arbitrary judgement, in which political considerations will also play a part. The key question is, naturally, how sensitive one wishes to make the system for relative performance.

But the seriousness of this element of judgement in setting the required parameters must not be exaggerated. For once they have been set, the parameters are not more or less arbitrary than the current ceilings deriving from the Maastricht Treaty and the Stability and Growth Pact. The good news is that once the parameters have been set the rest is a matter of straightforward calculation. The system is completely transparent.

The bankruptcy of a member state

Even if government deficits can in future only be funded by the EMU fund, a member state can in theory still go bankrupt. But the situation under the EMU-fund is fundamentally different than in the present scenario. If a country were to default today on servicing its government debt, it has to negotiate with numerous creditors and investors. Any default on the part of a government of an EMU member state in a situation of central funding of government deficits leads to a bilateral problem with the EMU fund. This EMU fund will experience an acute deterioration of the quality of part of its assets and will therefore have to enter into negotiation with the country concerned on how the latter will meet its obligations again.

The EMU fund will enter these negotiations from a position of strength, since a country that is in default in meeting its obligations in respect of the EMU fund will at that time have no alternative access to financial funds. It will no longer be able to turn to the capital market with a government loan: after all, a bankrupt country is the pariah of the international financial world. In such a situation the EMU fund will be able, analogous to the ability of the IMF to impose conditions on its members, to impose very strict and enforceable terms.

In practice things will not easily go that far. Firstly, the mark-up charged by the EMU fund to member states performing poorly will rise gradually. Governments will therefore already be confronted in an early stage with the consequences of their behaviour. A sudden deterioration of the market perception that would cause an acute liquidity shortage for a country within a very short timeframe is by definition not an issue in the proposed model. As soon as the deficit or debt ceilings laid down in the European treaties come into view, the EMU fund can attach conditions to its lending, comparable to the ability of the IMF to do so. This point can be readily further refined. However, the wholly ineffective sanctions from the SGP must be replaced with political, more effective sanctions.[9] Evidently, budget criteria imposed by the fund must be suitably far removed from the point at which a country is at risk of payment difficulties.

II-5) Simple introduction

In technical terms, setting up the EMU fund is easy. But the entire construction critically depends on the political willingness to accept the rules for the EMU fund. This means that national autonomy concerning the mode of deficit funding is ceded to the community level. It also means accepting the fact that relatively poor performance will be penalised in the form of an interest rate mark-up, whereas good performance will be rewarded with an interest rate reduction.

The beauty of the present proposal is, however, that it does not require waiting until the most reluctant country is on board as well. If only several large countries with the highest credit rating, including Germany, France and the Netherlands, decide to fund their government debt centrally via a common agency in the future, the new fund could be a reality very quickly. The advantages of the common funding would be quickly evident, after which the remaining countries would soon join. In the process, the strong countries can compel newcomers to accept the system of mark-ups and mark-downs. These are likely to agree swiftly because even for the weaker countries the advantages of the lower average funding (owing to the greater liquidity) and the greater stability will comfortably outweigh the mark-up they will be asked to pay.

[9] For a detailed proposal see Boonstra (2005).

Conclusion

The proposal presented here is not entirely new.[10] The first time this proposal was put forward, the transfer it required of budgetary sovereignty from a national to a community level proved to be a step too far.
Since then the euro has been introduced, the SGP has been in use for years and the single currency is a major success in many respects. Nonetheless, it is necessary to further strengthen the single currency. This can be achieved very quickly. As soon as a core group of important EMU member states with an AAA rating, such as Germany, France and the Netherlands, decide to fund their deficits via a common agency in future, possibly with mutual guarantees, the EMU will more or less already have crossed the Rubicon.
For if the most important countries in the eurozone adopt central funding of their government deficits they will not only make the euro a great deal stronger, but also send out an unambiguous signal that the introduction of the euro was an irreversible process.

The non-adopters will want to join soon in view of the evident advantages of common funding and are expected to be willing to accept additional conditions to that end. This is because if they remain outside the common funding system they will quickly be stigmatised as potential drop-outs.
Once they have joined the EMU fund the financial destiny of the participants will be irreversibly conjoined and the United States of Europe will be a reality in financial terms at least. No one would ever speculate again on the disintegration of the eurozone, just as the substantial economic differences within the U.S. never lead to speculation on the disintegration of the U.S. dollar.

By consolidating the euro for the future the European Union is also positioning itself as a financial superpower for the 21st century. By contrast, a disintegration of the eurozone would gradually condemn Europe to a marginal role in the global playing field. As a single block the EU is the world's largest economy and therefore a big player, whereas individually the member states, with the possible exception of Germany, would soon not have any part to play. However small the chances of a disintegration of the euro may be, the consequences would be so severe that it has to be avoided at any cost. The euro must accordingly be cherished, strengthened and made future-proof.

In sum, central funding of budget deficits within the EMU via a new EMU fund would be a logical next step on the path of European integration.

[10] See Boonstra (1991), (2005).

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